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N O T E

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

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

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Foreword

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

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

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

This issue of the *Inflation Report* was completed on 3 August 2010 and approved by the NBR Board in its meeting of 4 August 2010.

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

ABBREVIATIONS

AMIGO	Household Labour Force Survey
BSE	Bucharest Stock Exchange
CCR	Central Credit Register
CD	certificate of deposit
COICOP	Classification of Individual Consumption According to Purpose
CPI	Consumer Price Index
EAR	Effective Annual Rate
ECB	European Central Bank
EIA	Energy Information Administration (within the U.S. Department of Energy)
ESA	European System of Accounts
Eurostat	Statistical Office of the European Communities
FED	Federal Reserve System
FOMC	Federal Open Market Committee
GFCF	Gross Fixed Capital Formation
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IFI	international financial institution
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MFI	monetary financial institution
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
1W	one week
12M	12 months

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I. SUMMARY

Developments in inflation and its determinants

In June 2010, the 12-month CPI inflation rate was 4.38 percent, i.e. 0.18 percentage points above the March reading. Inflation thus remained within the variation band around the central target, standing 0.12 percentage points below its upper limit. In 2010 Q2, the slight pick-up in the annual growth rate of consumer prices was mainly attributed to administered price dynamics and the domestic currency depreciation episode.

At the end of 2010 Q2, the annual adjusted CORE2 inflation rate[1] was 0.7 percentage points higher than the March reading, staying close to 2 percent. The disinflationary pressures from the persistence of the negative output gap were more than offset by some unfavourable influences over the reported period. They included the second-quarter leu exchange rate movements, supply-side constraints on the food market[2] (excluding items with volatile prices), and the worsening of inflation expectations in the context of uncertainties surrounding the implementation of the austerity measures necessary for fiscal consolidation.

During April-May 2010, the persistence of excess supply on the labour market contributed, along with some base effects, to the resumption of the downward trend in the annual pace of increase in average nominal gross wages. Over the same period, in the industrial sector, a further strong rise in labour productivity caused unit labour costs to drop at a faster pace than in Q1. In addition to fostering disinflation, developments in unit labour costs also helped improve the external competitiveness of Romanian products.

Among the exogenous factors, the swifter annual increase in administered prices in 2010 Q2 had a substantial adverse impact on the annual inflation rate. Significantly above-average annual dynamics, albeit slower than at the end of 2010 Q1, were still recorded by both fuel and tobacco prices (the latter's contribution to the annual CPI rate was in excess of 40 percent).

In 2010 Q1, real GDP continued to shrink, but its annual rate of decline slowed to -2.6 percent from -6.5 percent in 2009 Q4. This outcome was due not only to a slower quarterly pace of GDP decline than in the previous period, but also to a large base effect. Final consumption and gross fixed capital formation decreased further, posting annual rates similar to those seen in prior quarters, with a slight improvement in the latter case. Export growth picked up markedly in Q1, which caused imports to post a substantially positive rate of increase (after having fallen for five successive quarters), mostly as a result of the high import content of exports. These developments led to a significant decrease in the positive contribution of net exports to GDP dynamics, so that, compared to the previous quarters, the deceleration in the year-on-year contraction of economic activity was attributed in Q1 to the relative reduction in the negative contribution of domestic absorption. The latter evolution was driven by the significant favourable contribution of the change in inventories and, only to a smaller extent, by a moderation in the negative contribution of gross fixed capital formation.

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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 vegetables, fruit, eggs and fuels), tobacco and alcohol prices.

2 Such as the reduction in domestic commodity supply and the worsening of producers' financial standing.

The explanation for the protracted decline in domestic demand for consumption and investment lies with the ongoing reduction in own financing resources of households and corporations, as well as with the still pronounced prudent behaviour of both borrowers and lenders. This behaviour has been fuelled by the lingering uncertainties arising from the delayed emergence of clear signs of economic recovery in Romania. Additional uncertainties have arisen from the difficulties recently faced by the authorities in adopting and implementing a set of measures needed to fulfil the fiscal and income policy commitments.

Monetary policy since the release of the previous Inflation Report

On 4 May 2010, the Board of the National Bank of Romania decided to lower the monetary policy rate to 6.25 percent per annum from 6.50 percent. This decision was motivated by the prospects – as indicated by the baseline scenario of the updated macroeconomic projection – of inflation rate convergence towards the targets set over the forecast horizon, in the context of the anticipated fading of effects from adverse shocks seen in the previous periods and of the persistence of the negative output gap. On the other hand, the prudence reflected by the slower rate cutting pace than before was substantiated by the increasing upside risks to the projected disinflation trajectory. These risks were generated by both the domestic economic environment (relative to the prospects of fulfilling the fiscal and public sector income policy commitments) and the uncertainties surrounding the external economic developments amid the tensions caused by the public finance crisis in Greece.

The relevance of such risks was confirmed by events occurring after the monetary policy decision taken in May. On the one hand, they materialised in extending the episode of national currency depreciation that had started in April, which largely accounted for the halt, in April and May, of the disinflation trend manifest during the previous quarter.

On the other hand, the authorities' difficulties in enacting the measures needed to fulfil the fiscal and public sector income policy commitments, as agreed under the multilateral external financing arrangement signed with the EU, the IMF and other international financial institutions, prompted the government to decide on 26 June 2010 to raise the VAT rate to 24 percent (from 19 percent) as from 1 July 2010. Compared with the central bank's macroeconomic forecast coordinates in May, this measure entails both a substantial change in the short-term prospects for the annual inflation rate and higher unfavourable risks associated with its medium-term outlook. Specifically, the increase in value added tax immediately triggers a significant rise in consumer prices and consequently a temporary pick-up in the CPI inflation rate, while additional risks are generated by potential second-round effects of this measure via worsening inflation expectations.

Against this background, the Board of the National Bank of Romania identified, in its meeting of 30 June 2010, the need for maintaining a prudent monetary policy stance in order to counter second-round effects of the VAT rate hike and to anchor inflation expectations at levels in line with the medium-term inflation targets, as well as to mitigate the risks posed by the persistent uncertainties surrounding the results of fiscal consolidation efforts and external economic developments. Therefore, the Board of the National Bank of Romania decided to keep unchanged the monetary policy rate at 6.25 percent per annum and to ensure a firm management of liquidity in the banking system.

Inflation outlook

The updated projection envisages a significant but temporary increase in inflation under the impact of the VAT rate hike. Due to the transient nature of the first-round effect of this measure on price dynamics, the annual inflation rate will return within the variation band around the central target after mid-2011. After these effects have faded, the resumption of disinflation will be supported by GDP remaining below its potential level over the entire forecast horizon. The negative output gap is seen narrowing insofar as the economy gradually recovers, with a positive annual growth rate being foreseen in 2011. The upturn in economic activity will imply a moderate widening of the balance-of-payments current account deficit that is set to remain however at sustainable levels, which are not expected to generate inflationary pressures arising from the leu exchange rate. Given the high uncertainties associated, particularly over the short term, with domestic and global macroeconomic developments, the balance of risks surrounding the inflation forecast appears to be tilted to the upside.

For end-2010, the baseline scenario of the current projection places the annual CPI inflation rate at 7.8 percent, i.e. 4.1 percentage points higher than the level published in the May 2010 Inflation Report. The increase in inflation rate is however forecasted to be temporary, so that for end-2011 the inflation rate is expected to fall close to the central target of 3.0 percent and reach 3.1 percent, 0.3 percentage points above the previously projected figure.

The upward revision of the CPI inflation forecast is mostly attributed to the incorporation in the projection of the anticipated effects of the VAT rate increase to 24 percent (from 19 percent) as from 1 July 2010. The direct (first-round) impact of this measure is expected to be significant and to become manifest relatively shortly after the measure was implemented. This explains the wide deviation of the updated projection of the annual inflation rate compared with the previous end-2010 forecast.

While the first-round effect is permanent on the level of aggregate prices, it has only a temporary impact on price dynamics and, consequently, on the inflation rate, due to the one-off nature of the VAT rate increase. Therefore, the forecast envisages the annual inflation rate to return within the variation band around the central target starting with 2011 Q3. The moderate upward revision of the end-2011 projection is primarily the result of modest residual second-round effects of the shock caused by the VAT rate hike that are passed through via inflation expectations.

Under the impact of the VAT rate increase, the projected CORE2 inflation rate is also seen following a sharply upward trajectory over the first part of the forecast horizon and reverting after mid-2011 to levels close to 2 percent, similar to those in the previous projection. The significant negative output gap persisting throughout the forecast horizon is a major factor alleviating both first- and second-round effects of the VAT rate hike, especially as regards prices of products with relatively elastic demand. The projection anticipates a gradual reduction in the negative output gap as the economy recovers, returning to positive growth in 2011. Nevertheless, the negative output gap is foreseen to be higher in relative terms than that revealed by the previous projection, reflecting the expected influences of the recently-implemented austerity measures, including the higher VAT rate, and of marginally lower external demand than assumed in the May projection.

Although significant, the foreseeable deviation of the annual inflation from the December 2010 target does not entail an upward revision of the latter, given the temporary and, at the same time, corrective nature of the deviation of inflation from the target, as well as the need of a firm anchoring of inflation expectations in order to counter potential second-round effects of the VAT rate hike. Thus, throughout the projection horizon, the central bank will permanently focus on enhancing the prospects for inflation rate to return onto a downward trajectory. In view of the prudent monetary policy stance assumed by the Board of the National Bank of Romania for this purpose, the projection foresees adequate real broad monetary conditions being ensured in order to keep the annual headline inflation rate, recalculated by excluding the first-round effect of the VAT rate increase, on a path in line with medium-term inflation targets.

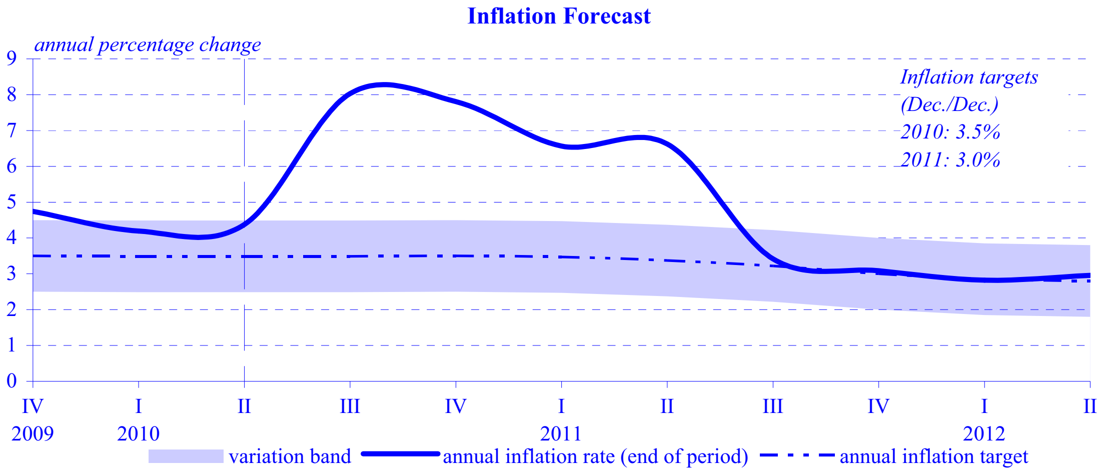
The convergence of inflation towards the medium-term targets and the sustainable recovery of both lending in the Romanian economy and GDP growth are strictly conditional upon all the elements of the macroeconomic policy mix complying with the updated coordinates of the economic programme under the external financing arrangement concluded with the EU, the IMF and other international financial institutions, as well as upon the absence of unforeseen adverse shocks over the forecast horizon.

Compared to the previous projection, the uncertainty associated with the current forecasting round is considerably higher, while the overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to be markedly tilted to the upside especially in the near run. Despite lingering risks related to future developments worldwide, the relevance of risks associated with the domestic environment clearly prevails over the reference period.

A major domestic risk is posed by the difficulties the authorities might face in efficiently implementing fiscal consolidation and income policy-related measures. Failure to meet the commitments under the financing arrangement with the EU, IMF and other international financial institutions could entail the worsening of international financial market sentiment regarding the outlook for the Romanian economy. This would bring about tighter external financing constraints on both the public and private sectors, with a detrimental impact on the leu exchange rate, inflation and economic growth.

A significant risk deriving largely from the potential solutions that may be resorted to in case of tighter fiscal constraints is associated with larger-than-projected hikes in administered prices. Given the limited information set available while preparing the projection and the uncertainties regarding the employed estimation, an additional risk stems from the impact on food prices of the floods that have recently hit several agricultural areas of the country. In the event of any of the aforementioned risks materialising, the shocks might induce additional deviations of inflation rate from the projected path via worsening inflation expectations and stronger second-round effects of the VAT rate hike.

Risks related to external developments are further associated with the so far fragile economic recovery in the euro area. The risk of contagion triggered by fiscal sustainability issues facing several European countries seems to have subsided to a certain extent, but some uncertainties are still manifest across the region. Favourable or unfavourable developments stemming from these sources would send ripple effects to the domestic economy via the foreign trade, financial and exchange rate channels. Other sources of risks from external developments are related to different trajectories than those assumed in the baseline scenario for the international oil price and the EUR/USD exchange rate, impacting domestic fuel price dynamics. Overall risks associated with the external economic environment appear to be relatively balanced.



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

Source: NIS, NBR calculations

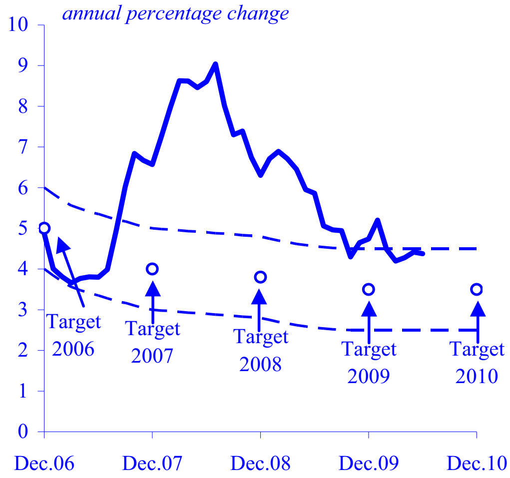
Monetary policy decision

Considering that, against this background, the priority of monetary policy is the solid anchoring of inflation expectations and, hence, the countering of potential second-round effects of the VAT rate increase, the Board of the National Bank of Romania has decided in its meeting of 4 August 2010 to keep unchanged the monetary policy rate at 6.25 percent per annum. Moreover, the Board has 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. The central bank Board aims, via the adopted measures, to ensure appropriate real broad monetary conditions in order to firmly anchor inflation expectations and to maintain the annual headline inflation rate, recalculated by excluding the first-round effect of the VAT rate hike, on a path in line with medium-term inflation targets. In this context, the Board of the National Bank of Romania has reiterated that the resumption of disinflation and restarting sustainable economic growth critically hinge on a firm implementation of fiscal consolidation measures, structural reforms and on improved absorption of EU funds, in line with the commitments set under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions.

II. INFLATION DEVELOPMENTS

Inflation Developments

annual percentage change



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

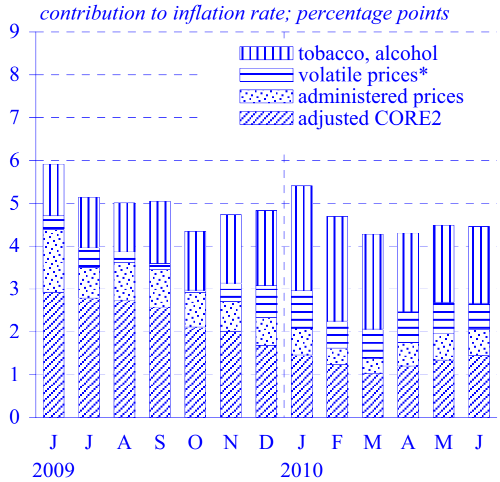
Source: NIS, NBR calculations

In 2010 Q2, the 12-month inflation rate remained within the variation band of ±1 percentage point around the 3.5 percent annual target, its downward trend coming to a halt. At end-June, the annual inflation rate came in at 4.38 percent (0.18 percentage points above the March reading), due mainly to the faster growth rate of administered prices and to the influence exerted by the domestic currency depreciation trend. In addition, adjusted CORE2 measure[3] posted an almost 0.7 percentage point increase, given that the upward trend followed by those components which are sensitive to exchange rate movements was only partly offset by the persistent disinflationary impact of the negative output gap. Furthermore, the increasing strains on commodity prices on the agri-food market were accompanied by a decline in the financial capacity of both producers and distributors to support promotional product sales.

After a marked alleviation July 2009 through March 2010, the annual growth rate of administered prices picked up 1.4 percentage points to 3.6 percent in the period under review. Behind the trend reversal stood both the hike in medicine prices in April[4] (entailed by the use of the new exchange rate in their calculation, i.e. RON 4.25/1 EUR in 2010 instead of RON 4/1 EUR in 2009) and the unfavourable base effects (brought about by the decreases in the prices of natural gas and fixed telephony services in 2009 Q2). In the reviewed period, no more unfavourable base effects were generated by the prices of natural gas and fixed telephony services, as the price of the former category was kept unchanged and fixed telephony services are no longer included in the category of products with administered prices.

Annual Inflation Rate

contribution to inflation rate; percentage points



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

Source: NIS, NBR calculations

The annual growth rate of volatile prices continued to decelerate to 4.3 percent, i.e. down 0.4 percentage points, this time on account of the developments recorded by fuel prices whose cumulative monthly increase was 1.1 percentage points lower in the period under review than in 2009 Q2. In the first part of the reported period, the pressures on fuel prices stemmed from the strains on the international crude oil market – the Brent crude oil price saw a gradual increase in April to reach a peak[5] of USD 88.1/barrel on 3 May 2010. Subsequently, such pressures were also generated by the weakening of the national currency against the US dollar

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

[4] Medicine prices were subject to adjustment in February 2009 so that the respective measure has no bearing on the current analysis.

[5] For the period spanning 6 October 2008-30 June 2010.

(-13.2 percent in June versus March 2010, with almost half of the depreciation being reported in May). The annual dynamics posted by the prices of foodstuffs in this category remained in negative territory, at a relatively steady level (-2.7 percent), despite the unfavourable signals on the fruit and vegetable segment (+1.6 percentage points over the quarter) as a result of the adverse weather conditions (low temperatures, heavy downfalls).

After the successive hikes during 2009 and in early 2010, the prices of tobacco products reported marginal monthly changes (of up to 0.04 percent), a development reflected by their 9.6 percentage point slower annual dynamics. Nevertheless, their annual pace of increase was further fast (38.9 percent), making therefore a considerable contribution to the 12-month inflation rate (1.8 percentage points at the end of 2010 Q2).

While, according to the provisions of the Tax Code, the calendar for increasing excise duties on tobacco products was completed in January 2010, the base effect associated with the price adjustments made in the previous year has caused the signal distortions generated by this group of products to be persistent. That explains why the analysis of core inflation must further take into account the relevant adjusted CORE2 measure.

After decelerating for seven quarters in a row, the annual adjusted CORE2 inflation saw an increase by almost 0.7 percentage points in the period under review, mainly owing to the faster dynamics of services at market-determined prices (+2 percentage points). The magnitude of this acceleration is entirely accounted for by the depreciation of the domestic currency against the euro passing entirely and simultaneously through into the prices of telephony services (linked to the euro); as for the other groups of services, the response of their prices to the exchange rate evolution was insignificant or even hardly noticeable against the background of a persistently weak consumer demand.

As concerns non-food items included in the adjusted CORE2 measure, the annual growth rate of their prices was further relatively steady during 2010 Q2, with disinflation on this segment being mainly slowed down by the domestic currency depreciation trend. This was particularly visible in the prices of cultural and sports products, which are generally more sensitive to exchange rate movements than the rest of the products in this group[6]. As for the other components, the annual growth rates of their prices

Administered Prices versus Market Prices

annual percentage change; end of period

	2009			2010	
	II	III	IV	I	II
Inflation rate	**5.86**	**4.94**	**4.74**	**4.20**	**4.38**
Administered prices*	**7.7**	**4.7**	**3.4**	**2.2**	**3.6**
1. Non-food items*:	**7.0**	**0.9**	**0.6**	**0.4**	**2.4**
electricity	4.8	0.2	0.2	4.2	4.2
heating	11.8	11.8	4.2	2.8	3.2
natural gas	8.6	–8.4	–8.4	–8.4	–5.1
medicines	5.6	5.7	8.2	2.5	6.4
2. Services*, *of which:*	**9.1**	**13.5**	**9.9**	**6.0**	**6.1**
water, sewerage, waste disposal	14.7	16.3	15.0	11.3	10.0
fixed telephony	5.9	16.6	7.9	x	x
passenger railway transport	0.0	0.0	0.0	0.0	0.0
(passenger) city transport	8.8	7.6	7.4	5.3	4.7
Market prices (CORE1)	**5.3**	**5.0**	**5.0**	**4.6**	**4.5**
CORE2**	**6.1**	**5.9**	**4.9**	**4.4**	**4.5**
CORE2 less tobacco, alcohol	4.8	4.2	2.8	1.6	2.3
tobacco, alcohol	20.1	24.2	29.3	36.7	29.7

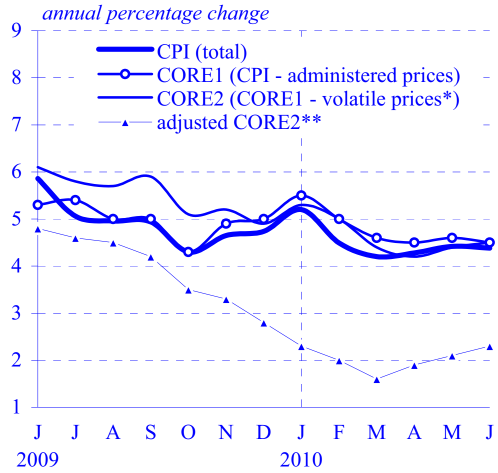
*) NBR calculations

**) CORE1 - volatile prices

Source: NIS, NBR calculations

Headline Inflation and CORE Inflation

annual percentage change



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

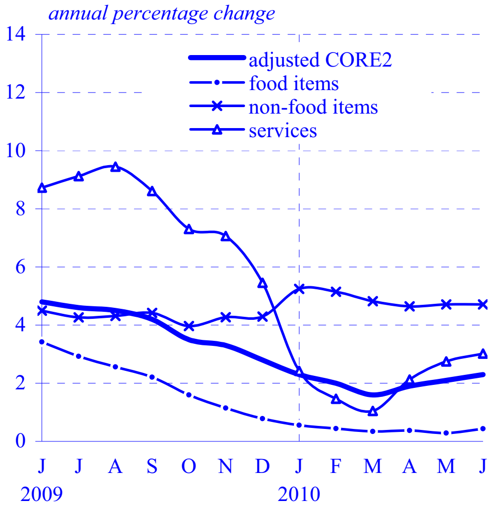
**) excluding tobacco and alcohol

Source: NIS, NBR calculations

[6] As a result of both expressing motorcar prices in euro and importing significant volumes of commodities and finished goods in the case of printing, electric and electronic products.

Adjusted CORE2 Components

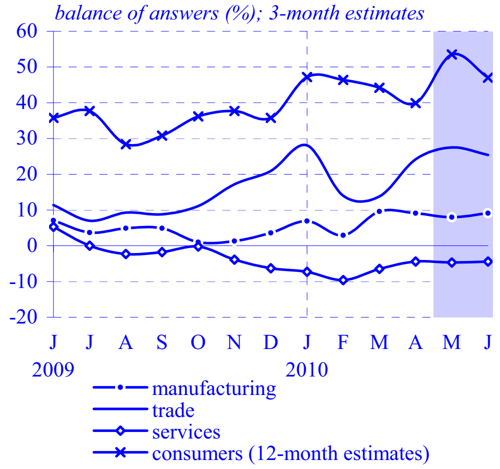
annual percentage change



Source: NIS, NBR calculations

Inflation Expectations of Economic Agents

balance of answers (%); 3-month estimates



Note: Starting May 2010, the indicators are calculated acording to CANE Rev.2

Source: EC - DG ECFIN

posted a downward adjustment speed comparable to or even faster than that reported in the previous quarter, given the still low volume of sales[7] which led both trading companies and producers to cut unit labour costs and/or profit margins. Furthermore, external prices had a relatively favourable bearing, as the annual dynamics of prices of consumer goods exports for EU15 external market posted minor changes compared to 2010 Q1.

The downward trend followed over the previous quarters by the annual pace of increase of prices of food items (excluding volatile food prices) came to a halt, owing to a few components only, i.e. milk and dairy produce, edible oil. Behind this evolution stood probably the decline in the domestic supply of raw material, the delay in paying farm subsidies, mounting tensions on the export market of unrefined oil, the decline in producers' capacity to carry on the promotional product sales organised in the previous quarters and, last but not least, the unfavourable base effects associated with price decreases in the same year-ago period.

The climate for disinflation was not favourable as illustrated by higher inflation expectations of consumers and managers in manufacturing, trade and services[8] than in the previous quarter, amid mounting uncertainties about the manner of implementing the belt-tightening policies necessary for correcting the budgetary imbalance.

The same as in the previous quarters, the analysis of the influence exerted by competitive pressures on tradables/non-tradables prices was distorted by extra-market factors, with the alleviation of the unfavourable base effect associated with cigarette prices (as a result of excise hikes in the previous quarters) making the largest contribution to the deceleration in the annual dynamics of tradables prices. The main driver of the faster annual dynamics of non-tradables prices was the evolution of some administered prices, although the upward trend in the exchange rate put prices of other components in this category (telephony services, books, newspapers, magazines) on an upward course as well.

The average 12-month HICP inflation remained on a downward trend, falling by another 0.4 percentage points to 4.6 percent. In spite of its contraction, the gap between the average 12-month HICP inflation in Romania and the average 12-month HICP inflation in the European Union continued to be significant

[7] April through May 2010 the volume of retail sales of non-food items (excluding fuels) continued to contract against the same year-ago period, with the 4.1 percent drop being however less sizeable than the 9.1 percent decrease seen in 2010 Q1.

[8] According to the NIS/EC-DG ECFIN survey.

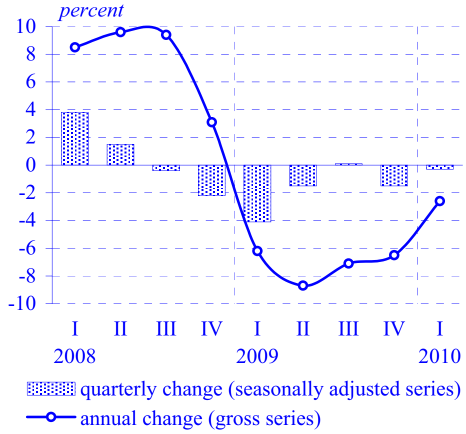
(3.3 percentage points), Romania ranking second after Hungary in this respect. The high inflation in Romania may be accounted for by a number of rigidities on the product and labour markets, as well as by the sizeable impact generated by the hike in excise duties April 2009 through January 2010.

At the end of 2010 Q2, the actual annual inflation rate was 0.1 percentage points higher than the projection presented in the May Inflation Report, against the background of a more pronounced depreciation of the domestic currency against the major currencies than that envisaged for the forecast.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

Real Gross Domestic Product



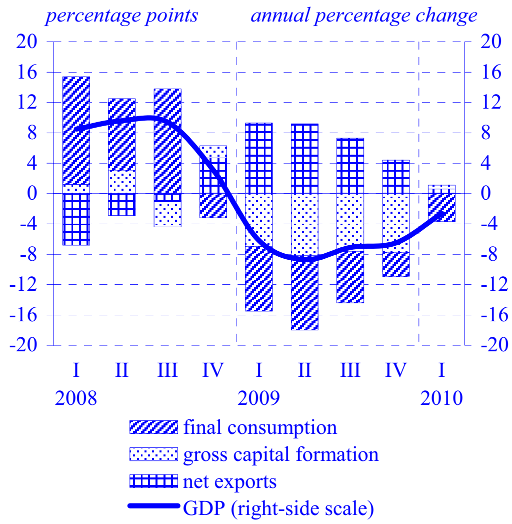
Source: NIS

In 2010 Q1, real GDP posted a slower rate of decline than in 2009 Q4 (by 3.9 percentage points to -2.6 percent)[9]*. Behind this performance stood both the five times slower quarterly pace of decrease reported in the considered period and the base effect associated with the contraction by more than 4 percent seen in 2009 Q1 (the largest in seven quarters).*

Seemingly, the year-on-year contraction was 0.5 percentage points lower than the March benchmark projection. However, the deviation is entirely attributable to the difference between the annual rates calculated on the basis of the unadjusted series and those calculated based on the seasonally adjusted series – envisaged by the forecast.

On the demand side, the economic decline moderated due to domestic absorption (-3 percent year on year compared to -9.9 percent in 2009 Q4), whereas the positive contribution of net external demand dissipated significantly. On the supply side, the slower economic decrease was supported by services and industry.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

The quarter-on-quarter analysis[10] *shows that the slower contraction in real GDP than in 2009 Q4 (to -0.3 percent) was mainly accounted for by the cumulative performance of "changes in inventories" and "the statistical discrepancy", to which added the influence, albeit of a visibly lower magnitude, of the revival in investment. By contrast, the contributions made by final consumption and net exports of goods and services saw a deterioration given that in Q1 both segments of consumer demand reported trend reversals and the strong acceleration in the dynamics of exports (to +12 percent) was accompanied by the upturn in imports; the joint contribution of these two components entered negative territory, after reporting positive readings for 7 quarters (-0.7 percentage points). On the supply side, except for services, whose quarterly growth rate reported a trend reversal, agriculture and construction continued to follow sharply downward trajectories (-4.3 percent and -5.9 percent respectively), while in industry the gross value added saw a visibly lower decline (to -0.2 percent).*

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

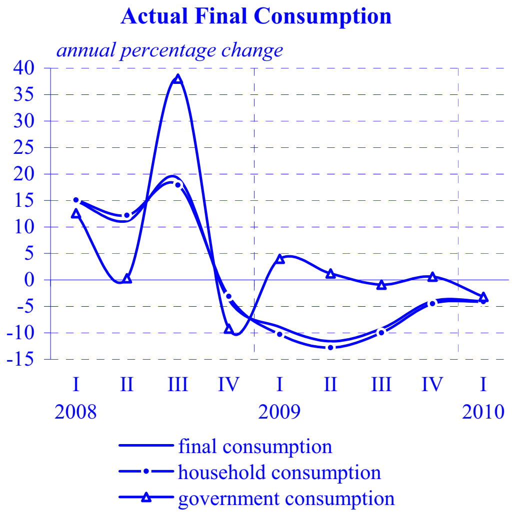
[10] Quarter-on-quarter changes in GDP and its components are calculated based on the seasonally adjusted fixed-base series.

1.1. Demand

The slower year-on-year decline in domestic demand than in the previous quarter may be attributed only to a small extent to the main segments, as the cumulative volume of final consumption and gross fixed capital formation remained on a downward path (-9.2 percent), albeit 2.5 percentage points slower than in 2009 Q4.

By contrast, "changes in inventories" made the largest positive contribution to GDP dynamics (7.3 percentage points) due among other economic factors (the base effect associated with the severe contraction in inventories available with both producers and traders, as a measure to protect liquidities in view of the demand adjustment) to a significant methodology-related residual factor[11].

The positive net contribution of exports fell almost seven times (to +0.6 percentage points), given that the favourable developments in exports of goods and services entailed a high import content.



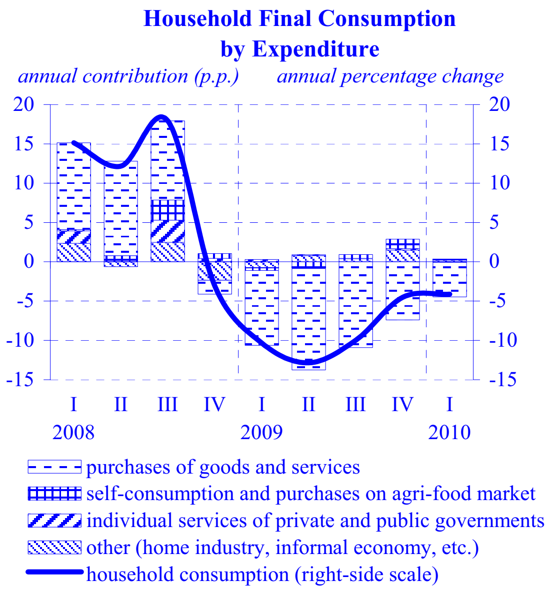
Source: NIS

1.1.1. Consumer demand

Consumer demand continued to decrease at a speed similar to that in the previous quarter (-4 percent year on year), with both components reporting negative annual dynamics.

Household consumer demand

The 4.1 percent drop in the private final consumption in Q1 was mainly attributed to retail purchases of goods and services, albeit their negative real dynamics decelerated to approximately half the reading in 2009 Q4 to reach -6.5 percent (annual change). The structural analysis shows that the consumer demand for durables saw further the most pronounced adjustment – the volume of sales on this segment plunged by more than 20 percent, whereas purchases of non-durables contracted by almost 5 percent compared to the same year-ago period. According to the consumer confidence indicator released by DG ECFIN, the prospects for an improvement in consumer demand in the coming 12 months are further unlikely.



Source: NIS, NBR calculations

At the same time, 2010 Q1 witnessed a contraction in the positive contributions made by "self-consumption and purchases on the agri-food market" and "other consumption" (with home industry making a significant contribution to this performance), as a result of their annual growth rates decelerating markedly to 3.9 percent and 1.7 percent respectively, in line with the unfavourable developments in agriculture.

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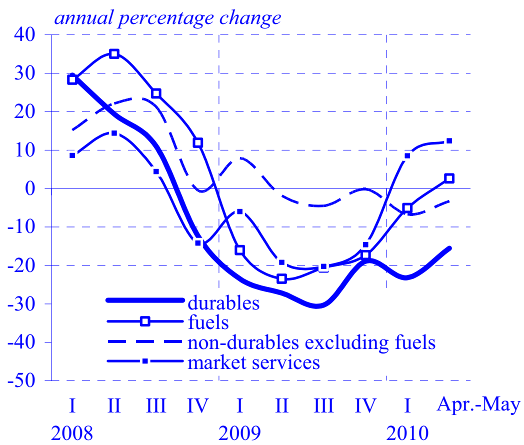
[11] In 2010 Q1, the statistical discrepancy reported a positive reading, accounting for roughly 6 percent of GDP (calculations based on the unadjusted series of national accounts in constant prices 2000=100).

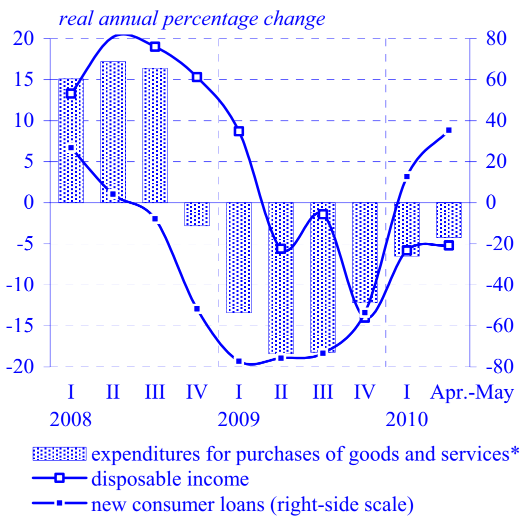
Purchases of Goods and Services*



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

Source: NIS, NBR calculations

Household Consumption and Main Financing Sources



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

Source: NIS, MPF, NBR calculations

As concerns the influence on consumer prices, the developments in 2010 Q1 in the volume of retail sales of products holding a large share in the CPI basket suggest further the absence of demand-side pressures, as illustrated by purchases of non-durables (-0.2 percent, quarter-on-quarter change) remaining on a downward trend (albeit les pronounced than in 2009 Q4). Moreover, if fuels are left apart, this trajectory is even steeper, with the dynamics of sales falling to -2.2 percent.

The analysis of financing sources of the private consumption reveals slower annual rates of decrease reported by the main banking channels; however, current developments are further broadly unfavourable.

(i) The downward path of household disposable income[12] slowed down from -14 percent in 2009 Q4 to -5.8 percent) owing to a base effect (severe trend reversals in the quarterly dynamics of all components in 2009 Q1) and to the revival of social transfers in the current period; by contrast, ongoing layoffs were conducive to a new real contraction in incomes from wages (quarter-on-quarter change).

(ii) The volume of new consumer loans (both leu- and euro-denominated loans) posted positive annual growth rates, after contracting for five straight quarters. Nevertheless, the outcome was due entirely to the fading negative influence of strong quarterly declines October through December 2008 and January through March 2009, while in the current period lending continues to reflect the prudent behaviour of both households and commercial banks.

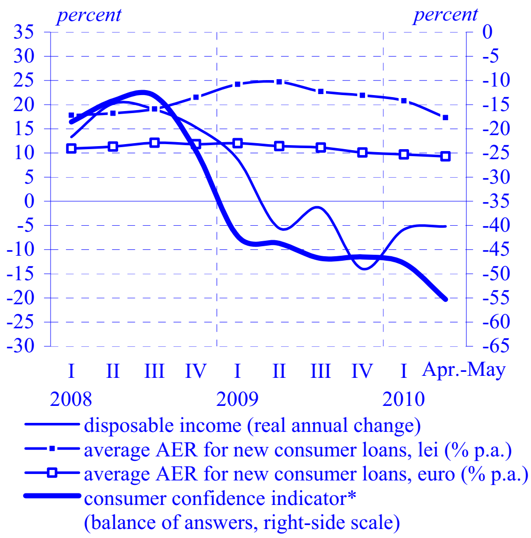
The contractionary impact of the drop in disposable incomes on household consumption was mitigated, to a certain extent, by the lower propensity for saving – the annual growth rate of new time deposits in 2010 Q1 saw a sign reversal owing not only to the base effect (the overly fast quarterly advance January through March 2009), but also to current developments (visible particularly in the case of euro-denominated deposits) entailed by the ever decreasing interest rates paid by commercial banks on such deposits.

As concerns the markets of origin of consumer goods, in year-on-year comparison, developments in 2010 Q1 hint at a potential strengthening of the market share held by the imports of non-durables (whose decline came to a halt) and motor vehicles

[12] 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.

(the physical volume of which expanded by 19.3 percent)[13]. By contrast, sales of domestically-produced goods remained on a downward trend, in spite of annual rates of decrease decelerating from the previous quarter (-7.4 percent and -0.6 percent respectively)[14]. The downward path reported by sales of domestic durables was less steep as well (-14.7 percent in Q1), while imports of durables posted mixed developments (with "electrical machinery and apparatus" recording a fast-paced increase and other categories of goods posting a decrease).

Main Determinants of Consumer Demand



*) seasonally adjusted data; the latest data refer to 2010 Q2.

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

Government consumption

Final government consumption dropped 3.2 percent against 2009 Q1, following developments in the number of employees in the budgetary sector.

Budgetary developments

In 2010 Q1, the consolidated general budget deficit stood at lei 8,219 million[15] (1.5 percent of GDP), relatively similar to that recorded in the same year-ago period (lei 7,925 million, i.e. 1.6 percent of GDP). Nevertheless, the primary deficit improved from the same year-ago period (-1.2 percent of GDP against -1.4 percent in 2009 Q1).

Total revenue dynamics[16] remained broadly unchanged from the previous quarter (-5.7 percent versus -5.9 percent in 2009 Q4), given that the sharper decline of fiscal revenues (-9.1 percent from -6.3 percent in the previous quarter) was further partially offset by the faster dynamics of non-tax revenues (15.4 percent against 13.1 percent in 2009 Q4). The contraction in fiscal revenues was due mainly to the steeper decrease in VAT collection (-15.4 percent compared with -10.1 percent in the preceding quarter), along with the relatively steady negative dynamics of social security contributions (-9.4 percent) and wage and income tax (-13.5 percent). The negative impact of these factors was mitigated by the positive influence of the loans extended by the EU, profit tax collection (4.1 percent) and excise duty receipts, albeit at a slower quarter-on-quarter pace (1.2 percent), as well as

[13] 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.

[14] 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.

[15] The analysis draws on operational data regarding the end-March budget execution released by the MPF.

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

the increase in the volume of property tax (5.9 percent from -10.2 percent in the previous quarter).

In turn, total budget expenditures further shrank (-4.9 percent and -5.9 percent in the case of primary expenditures), although at a slower pace versus the prior quarter (-16.2 percent from -17.7 percent). The adjustment was made chiefly by cutting capital outlays (-39.3 percent against -28.1 percent in 2009 Q4), while current expenses dynamics saw a significant slowdown (to -1.9 percent from -9.6 percent). Staff costs recorded the largest decline (-12.7 percent), but the downtrend manifest since 2009 Q3 slowed against the preceding quarter. Goods and services spending witnessed a much more significant moderation (-4.8 percent from -34.5 percent in the previous quarter). By contrast, expenditures under "other transfers"[17] posted a substantial reduction (-17.5 percent versus 43.3 percent in 2009 Q4). At the same time, social pressure intensified against the background of social spending dynamics gathering momentum compared with the previous quarter (10.5 percent from 0.7 percent) and holding a larger share in total primary expenditures (40 percent from an average of 34 percent in 2009).

The updating of the macroeconomic outlook and parameters of this year's budget execution, carried out in April-May 2010 on the occasion of the joint EU-IMF mission, pointed to the fact that the failure to take corrective measures would translate in an end-2010 budget deficit accounting for 9.1 percent of GDP (against 5.9 percent according to the initial budget planning). In this context, the Romanian authorities announced their intention to implement additional fiscal consolidation measures aimed at fulfilling the newly negotiated target for the consolidated budget deficit: 6.8 percent of GDP.

For this purpose, in June, the government assumed responsibility for two draft laws. The first stipulated the reduction by 25 percent in public sector employees' wages and by 15 percent in the pension point and other social transfers including unemployment benefits. The estimated impact of these two measures on the consolidated budget was 1 percent of GDP each. The second draft law[18] concerned the recalculation of pensions established under special

[17] The item includes domestic transfers (state aid schemes for development, investments by state-owned companies, proceeds from foreclosure on collateral extended by the National Credit Guarantee Fund for Small- and Medium-Sized Enterprises, transfers from local budgets to inter-community associations for development, financing research in economics, a.s.o.), current transfers abroad (quotas and subscriptions to international institutions, economic cooperation institutions, a.s.o.), as well as Romania's contribution to the EU budget.

[18] At present, published in the amended form in compliance with the decisions of the Constitutional Court by Law No. 119 of 30 June 2010 on some measures concerning pensions.

laws with a view to narrowing the gap between the aforementioned pensions and those regulated by Law No. 19/2000 on public pension system and other social security benefits. The initially approved set of austerity measures was amended on 26 June 2010, following the Constitutional Court's decision considering unconstitutional the reduction of the pension point. In this context, the authorities abandoned this provision and opted for raising the VAT from 19 percent to 24 percent as of 1 July 2010[19].

Some amendments to the Tax Code[20] were made with the same purpose of increasing other categories of budget revenues. The main changes envisaged the enlargement of the tax base[21] (all types of gains in the nature of interest, luncheon and gift vouchers, the reduction in the rate of deductible expenditures when establishing net incomes from intellectual property rights, a.s.o.) and the increase in taxes on buildings and means of transport[22]. In addition, new measures have been adopted aiming at reducing current expenditures[23], chiefly by (i) a 20 percent cut in goods and services expenses of public authorities and institutions, national companies, national corporations, companies with majority or fully state-owned capital and *régies autonomes*[24] and (ii) the decrease in staff costs at local government level[25].

1.1.2. Investment demand

In 2010 Q1, gross fixed capital formation stayed on a sharp downtrend (-28.9 percent, posting an annual contraction similar to the preceding quarter), amid a decline in own financing sources, the ongoing uncertainties surrounding the economic and financial recovery and commercial banks' reluctance to real economy financing.

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[19] In 2010 H2, the increase in consolidated budget revenues following the implementation of this measure is estimated by the MPF at about 0.7 percent of GDP.

[20] In 2010 H2, the increase in consolidated budget revenues following the implementation of this measure is estimated by the MPF at about 0.14 percent of GDP.

[21] Government Emergency Ordinance No. 58 of 26 June 2010 amending and supplementing Law No. 571/2003 - the Tax Code as well as other financial and fiscal measures.

[22] Government Emergency Ordinance No. 59 of 30 June 2010 amending and supplementing Law No. 571/2003 - the Tax Code.

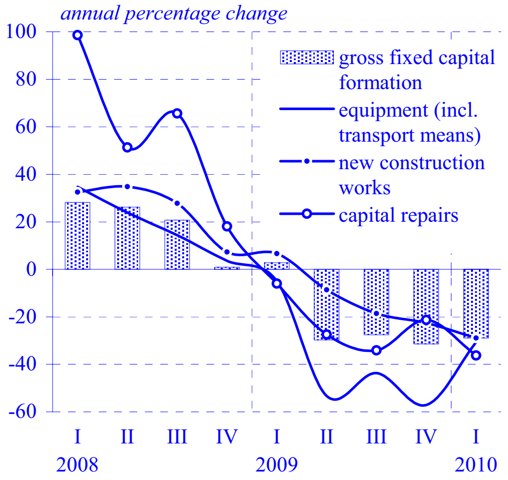
[23] In 2010 H2, the reduction in consolidated budget expenditures following the implementation of these measures is estimated by the MPF at about 0.3 percent of GDP.

[24] This measure (included in Government Emergency Ordinance No. 55 of 23 June 2010 on some measures aimed at reducing public expenditures) refers to the difference between the budget-related amounts approved for 2010 and those spent in 2010 H1.

[25] Government Emergency Ordinance No. 63 of 30 June 2010 amending and supplementing Law No. 273/2006 on local public finances and some financial measures.

Investment

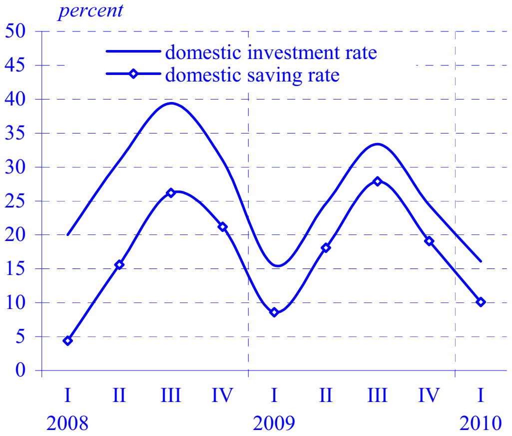
annual percentage change



Source: NIS, NBR calculations

Investment Rate and Saving Rate

percent



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

Some construction projects (new construction works or capital repair works) and purchases of equipment (including transport means bought by companies and institutions) posted significantly negative annual dynamics. In the latter case however, the pace of decline slowed markedly compared with 2009 Q4.

The ongoing adjustment in investment demand affected all major investors (corporate sector, public sector and households) and was reflected by the developments in all financing channels.

(i) The delay in the recovery of economic sectors and the ongoing downward drift in households' disposable income hint at the contraction in own sources.

(ii) Bank lending[26] destined to capital increases saw mixed developments:

– the volume of loans granted to the corporate sector for equipment purchase and real estate investment slightly increased in annual terms. Nevertheless, only the performance of the latter owed to a recovery in the reported period, supported by the launch of some investment projects in the logistics sector;

– also in the case of housing loans to individuals, the annual growth rate of new business volume in the period under review was attributable solely to the base effect associated with the severe contraction in lending both in lei and euro during 2009 Q1 (by about 59 percent and 71 percent respectively, quarterly change).

The decline in households' propensity to invest is reflected by the downward path in residential building permits recorded for the fifth successive quarter, with the usable area shrinking by more than 30 percent in annual terms. An improvement in households' propensity to invest is rather unlikely in the near future, given the gloomy outlook for the labour market and households' ability to repay loans, the fiscal adjustment measures to be implemented starting 2010 H2 and the expected further decline in prices on the real-estate market.

(iii) Lease financing, resorted to by over 90 percent of the corporate sector, witnessed a broadly unchanged trajectory, the EUR-expressed value of the contracts concluded in 2010 Q1 falling 32 percent from the same year-earlier period.

(iv) Non-residents' direct investment further decreased, with the dynamics of net flows during the last four quarters reaching about -59 percent[27].

[26] NBR calculations based on own data and those provided by the CCR.

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

(v) Capital expenditures made from budget sources contracted by 25 percent in real terms, mainly on the back of the decline in road infrastructure works to about two-thirds of the volume recorded in 2009 Q1.

– In 2010 Q1, investors' preference for domestically produced versus imported products, similar to consumer goods, saw a stronger preference for purchases from external markets. Thus, the annual dynamics of the physical volume of imported capital goods re-entered positive territory[13], while the turnover of capital goods production for the domestic market dropped further.

1.1.3. Net external demand

In 2010 Q1, the improvement in demand from the major foreign partners[28] had a favourable impact on Romania's international trade, as reflected also by the preliminary data on the national accounts.

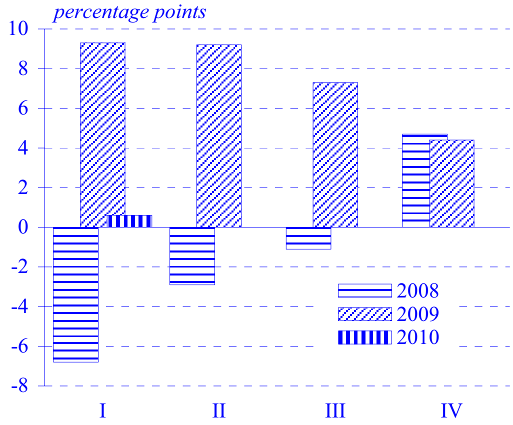
(i) For the third time in a row, the volume of exports of goods and services recorded a positive quarterly dynamics, entailing an increase of more than six times of the annual growth rate against that seen in the previous quarter (to 19.5 percent).

(ii) Nevertheless, the insufficient support from domestic supply to the export-oriented production led to a rise in the volume of imports of goods and services, the quarterly change of +8.9 percent in January-March 2010 causing the annual dynamics revert to positive territory (14.9 percent). The strengthening of the domestic currency starting December 2009 fostered the increase in imports as well.

Export composition reveals that products with high added value such as "machinery and apparatus" and "transport means" (up 5 percentage points each) had the largest contributions to the increase in the physical volume of exports[13]. "Chemicals" and "base metals" also had favourable contributions, albeit to a lower extent, a small part of the positive performance being offset by the decline in "fuels" and "vegetal products".

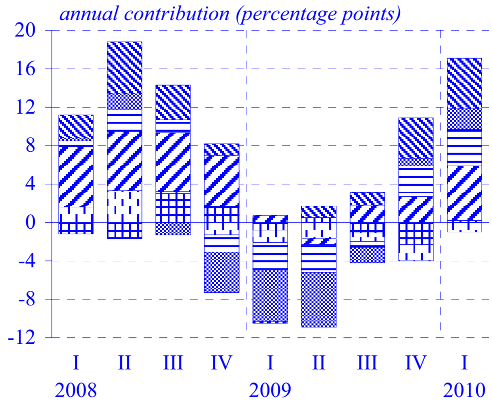
As for imports, about one third of the year-on-year rise in physical volume recorded in 2010 Q1 was due to the rebound in purchases of "electrical machinery and apparatus". Nonetheless, imports of "transport means", "base metals" "chemicals" and "fuels" witnessed a significant pick-up in their growth rates as well.

Net External Demand Contribution to GDP Growth

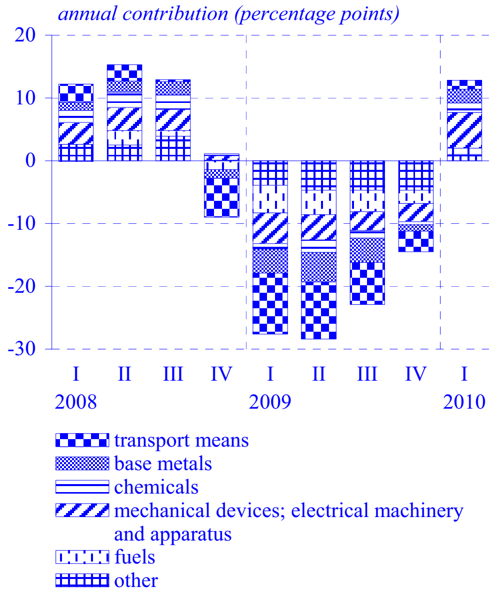


Source: NIS, NBR calculations

Export Physical Volume



Import Physical Volume



Source: NIS, NBR calculations

28 At EU27 level, the annual dynamics of real GDP saw a sign reversal (+0.6 percent from -1.9 percent in 2009 Q4) and was accompanied by a rebound in goods and services imports (+4.7 percent against -6.2 percent).

1.2. Supply

In 2010 Q1, the slowdown in the annual decline of GDP was chiefly due to the rebound in the services sector and industry.

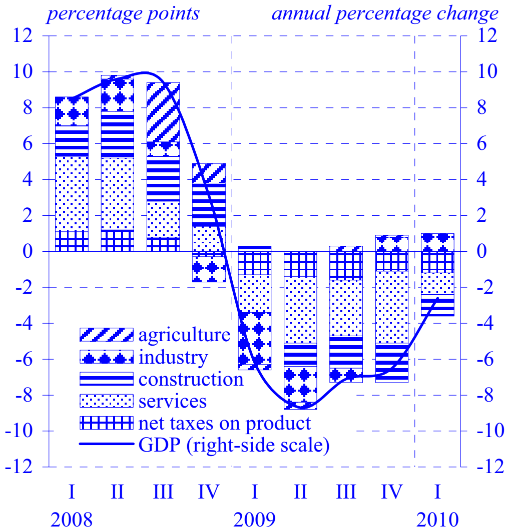
The decline of gross value added in the services sector slowed down almost 4 times (-2.1 percent annual dynamics). This development was attributable to “trade, hotels and restaurants, transports and telecommunications” and “financial activities, real estate transactions and rentals” and led to a -1.2 percentage point contraction in the negative contribution of this sector to GDP dynamics.

In industry, in 2010 Q1, gross value added further saw a positive annual growth rate (4.2 percent), largely as a result of: (i) the stronger demand for metallurgical products (as illustrated by the almost six-fold rise in the annual dynamics of output compared to 2009 Q4), the substantial base effect being associated, in the current period, with the faster quarterly growth of exports; (ii) the halving of the annual pace of decline in the oil processing sub-sector (to -6.3 percent), as a result of a base effect, as well as the currently stronger domestic demand; (iii) the maintenance of fast dynamic of output in the sub-sector producing road transport means and, by association, in the sub-sector producing electrical equipment (production growth in 2010 Q1 exceeded, on average, 60 percent and 40 percent, respectively), largely on account of export orders.

The annual dynamics of gross value added in agriculture posted a sign reversal, as the 0.9 percent drop was associated with the poor performance of the stock-breeding segment (particularly in the first quarter of each year, as vegetal production hinges on the weather conditions).

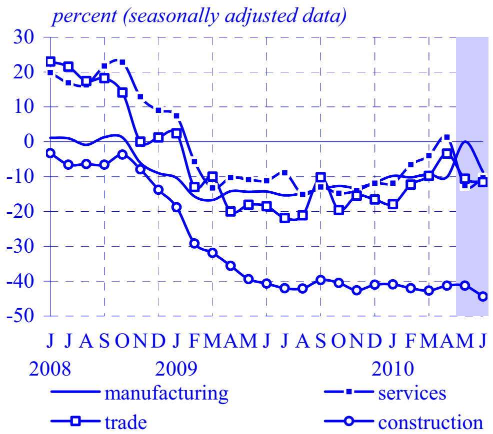
Construction activity further faced major difficulties, with gross value added posting an even steeper downward path (to -17.3 percent in annual terms). The prolonged stalemate in the real estate market forced most construction companies to reconsider their short-term budgetary strategies, revise their investment plans, implement flexible working arrangements and widen their range of activities. Structural analysis shows that the volume of residential and non-residential works posted even sharper declines compared to 2009 Q4 (44.1 percent and 31.3 percent respectively), while the volume of engineering works remained unchanged – it is to be noted that halt of the decline in the latter segment is due to a base effect, all the three above-mentioned categories of construction works posting significant quarterly changes in the current period.

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations

Corporate Sector: Confidence Indicators for the Next 3 Months



Note: Starting with May 2010, confidence indicators released by DG ECFIN for each economic sector are calculated based on NACE Rev. 2

Source: EC-DG ECFIN

2. Labour market

After the peak recorded in 2009 Q4, the gap between workforce demand and excess workforce supply narrowed slightly following a relative pick-up in the number of vacancies March through May 2010 and the flattening out of the upward path of registered unemployment. However, the gap was still wide, being indicative of the persistently moderate annual dynamics of wages in the private sector, tendency also bolstered by the expected and actual wage cuts in the public sector. Wage earnings helped ease inflationary pressures in terms of both demand and the impact on ULC in industry, the annual pace of decline being faster than in April-May 2010.

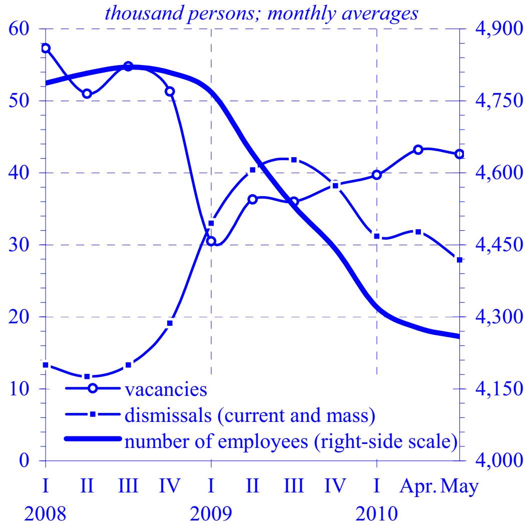
2.1. Labour force[29]

The latest statistical data corroborated the market signals (from private recruiting agencies and companies) regarding a slight rebound in labour demand starting with March 2010; apart from the positive influence of seasonal factors, this development was due to the restructuring and the diversification of private companies' activity with a view to their repositioning on viable segments. Accordingly, on the one hand, the number of vacancies as well as that of temporary and permanent employment contracts[30] increased and, on the other hand, total lay-offs continued to decline even though mass dismissals displayed a peak in March-April (especially as a result of staff cuts in certain state-owned railway transport companies, as well as in mining and energy sectors).

Nevertheless, the level of workforce absorption was well below the level prior to the crisis, while excess workforce kept rising, on a quarterly basis, by around 0.2 percentage points – registered unemployment rate went up to 7.9 percent[31] in the period under review, despite the slight drop in the number of first-time jobless claims and the gradual rise in the number of persons who did not renew their applications to be registered with the NEA after the end of the unemployment benefit period.

Under these conditions, staff numbers reported by employers kept declining April through May 2010, albeit at a slower pace than in 2010 Q1 (on the back of a similar development in the mainly

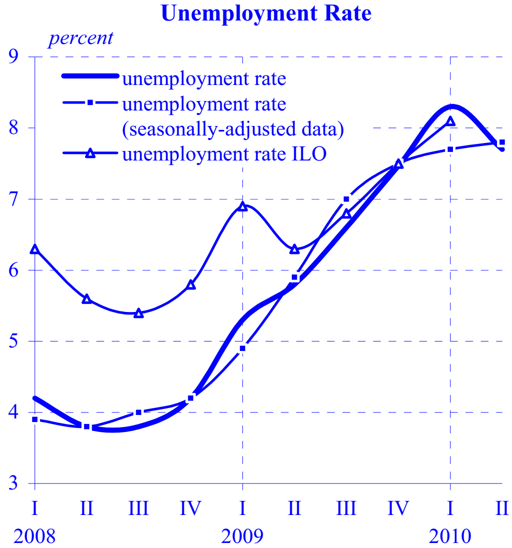
Labour Force Demand Measures*



*) seasonally-adjusted data

Source: NEA, NIS, NBR calculations

Unemployment Rate



Source: NIS, NBR calculations

29 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 2010 Q1, amid a severe drop in workforce demand at the beginning of 2009).

30 Starting with 2009 Q2, the share of temporary employment contracts stabilised at around one third of total hirings, well above the prior levels.

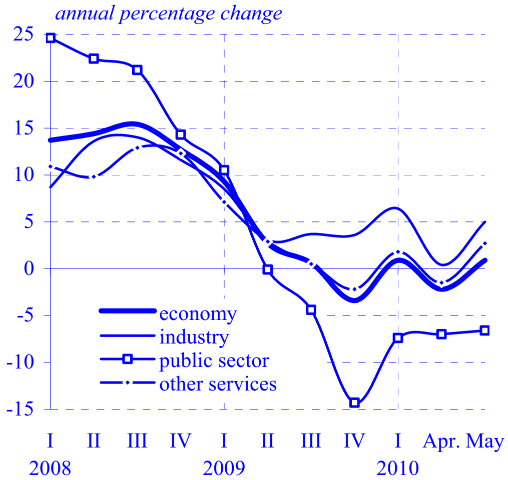
31 The decline in the non-seasonally adjusted unemployment rate (to 7.7 percent in May 2010 from a peak of 8.4 percent in March) was due solely to seasonal factors.

private sector[32]). The possible explanations behind this constantly downward trend are: (i) the additional staff adjustments, including those that are not entered into the NEA records due to cumbersome, time-consuming formalities or the increasing number of workers becoming discouraged about employment prospects. (ii) the shift of certain employees to another form of employment (free lancer, entrepreneur); (iii) retirements; (iv) expansion of informal economy.

2.2. Incomes

Net Real Wage*

annual percentage change



*) deflated by CPI

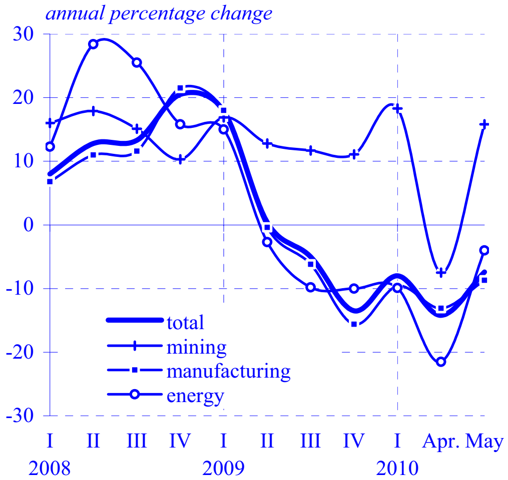
Source: NIS, NBR calculations

In the period under review, the annual dynamics of net nominal average wage economy-wide was impacted by the change in the pattern of granting Easter bonuses (in March instead of April in the prior year), the step-up to 5.6 percent reported in 2010 Q1 being followed by a 2 percentage point slowdown in April-May. This development was attributable to the private sector (deceleration of annual dynamics from 8.7 percent to 5.8 percent), while the annual pace of decline of net wage in the public sector stayed put (around -3 percent).

In industry, the downward trend of the annual dynamics of gross wages was reflected accordingly in the trend of ULC (a 10.9 percent drop in annual terms in April-May versus -8 percent in 2010 Q1), with labour productivity increasing at a similarly fast pace. Similar to the prior periods, manufacturing sub-sectors posted uneven developments: annual declines in metallurgy, chemicals, electrical equipment, light industry, flat performance of activity in oil processing and food industry. Overall, ULC further bolstered disinflation. Moreover, developments were favourable in terms of external competitiveness, albeit to a lesser extent than in the latter part of the previous year.

Unit Labour Cost in Industry

annual percentage change



Source: NIS, NBR calculations

The dynamics of real disposable income further acted as a deterrent on household consumption and, implicitly, on CPI inflation rate. Real disposable income fell by 5.8 percent in 2010 Q1 compared to a year earlier, on account of a severe contraction in transfers from abroad and wage cuts, while social transfers stepped up by roughly 10 percent, especially following the rise in unemployment benefit expenses. The sign reversal in the annual dynamics of social transfers represented the main explanation behind the annual decline in real disposable income from -14 percent in 2009 Q4. The rate of decline of real disposable income was similar to that in April-May, with a marked slowdown in external transfers due to the fading of the base effect being counteracted by the deceleration of the growth rate of social transfers.

[32] The classification includes state-owned companies and régies autonomes in the private sector, since the above-mentioned staff cuts (in railway transport, mining and energy sector) cannot be identified separately and reported as restructuring of public sector activity.

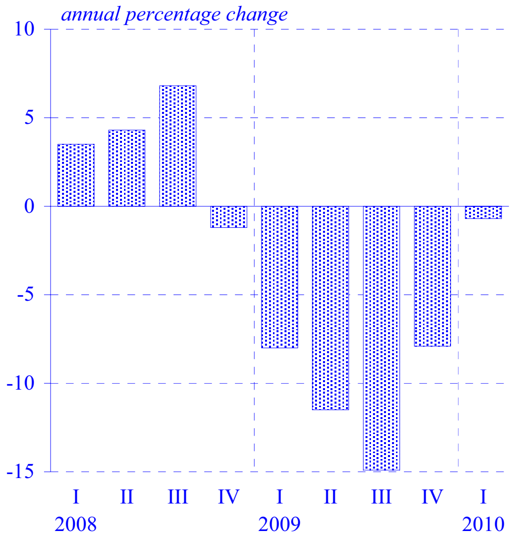
3. Import prices and producer prices

In 2010 Q1, both import prices and agricultural producer prices continued to have a favourable impact on domestic prices, yet to a lower extent than in the preceding quarters. Moreover, producer prices of consumer goods and capital goods also saw positive dynamics, their impact being however countered at aggregate level by the emerging pressures in the energy sector and, to a lower extent, in the intermediate goods sub-sector. In the second quarter of the year, producer prices of industrial goods and agricultural products are expected to follow a similar trend, yet pressures exerted by import prices are likely to increase.

3.1. Import prices

In January-March 2010, import prices continued to make a favourable contribution to domestic price developments, against the background of changes in external prices and the movements in the exchange rate of the leu versus the major currencies (appreciation versus the euro and the US dollar, which was stronger in the latter case). The annual unit value index of imports stayed below par (99.31 percent), despite the significant increase from the minimum level of 85.13 percent recorded in the past two quarters. The upward trend was due to external prices of fuels, which rose by nearly 25 percent as compared with the same year-ago period versus the decrease of over 35 percent reported in the past two quarters.

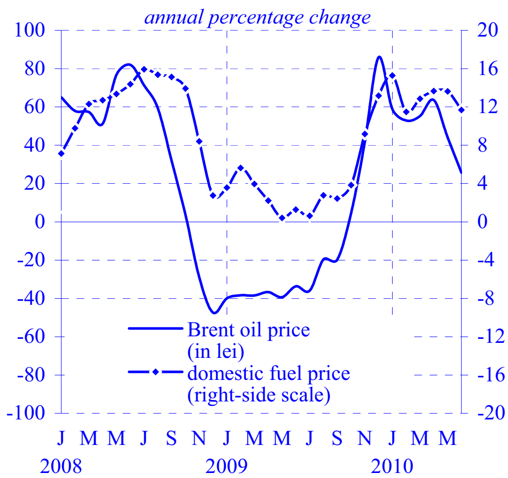
Unit Value of Imports



Source: NIS, NBR calculations

The unit value indices of imports of electrical machinery and apparatus[33] were also significantly above par (106.8 percent versus 94.6 percent in 2009 Q4), the analysis by origin market also showing that a contribution to these movements was made by developments across the EU (annual growth rates of nearly 10 percent). This trend is shown by industrial producer prices for the external market of euro area industries supplying such products, which consolidated their upward course, yet the magnitude of annual changes in the latter case is significantly lower (below 1 percent).

Oil Price and Domestic Fuel Price



Source: NIS, EIA, NBR calculations

The external prices for other groups of imported goods generally saw negative annual dynamics, albeit slower than in prior quarters, with a more pronounced difference of up to 24 percentage points in the case of food items (meat, vegetable products, oils and fats).

Given that the annual growth rate of external prices of commodities stayed on an upward course in 2010 Q2, while that of producer prices for the external market of the euro area manufacturing sector exceeded 4 percent year on year, the unit value index of imports is expected to revert to above par values in

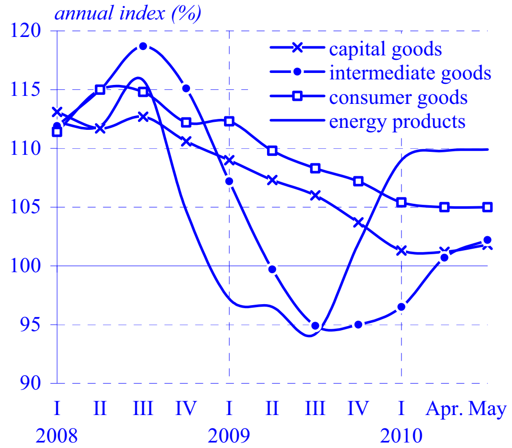
[33] "Electrical machinery and apparatus; reproduction and recorded media", according to the Combined Nomenclature.

the second quarter of the year. In addition, the marked depreciation of the domestic currency versus the US dollar and the slower appreciation against the euro could heighten pressures exerted by import prices on domestic prices.

3.2. Producer prices

3.2.1. Industrial producer prices

Industrial Producer Prices for Domestic Market by Industrial Products Group

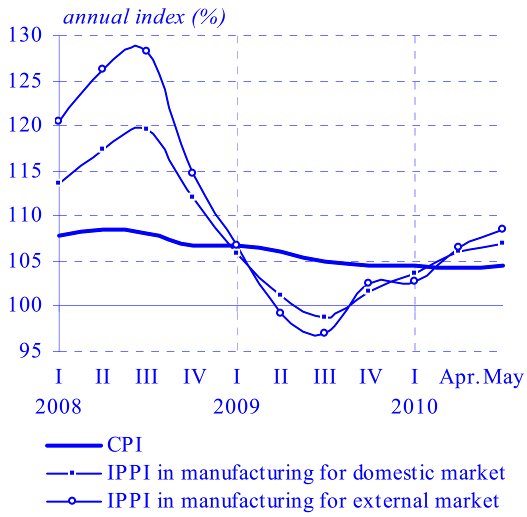


Source: NIS

In 2010 Q1, the annual growth rate of producer prices for the domestic market continued to accelerate as against the previous quarter (up 2 percentage points to 3.8 percent), the major contribution coming from energy products. Furthermore, prices for intermediate goods also had a favourable contribution, as revealed by the slowdown in their annual pace of decline. In both cases, the developments were the result of the combined effect of the pressures manifest in the period under review and the unfavourable base effects associated with low prices of energy and metals in the same year-ago period.

The annual dynamics of the other groups of industrial goods decelerated further, their downtrend being even sharper. In the first quarter of the year, the annual rates of increase of producer prices of capital goods slowed down by another 2.4 percentage points to 1.3 percent, a record low in the available data series (started in 2000). However, mention should be made that the trough of the curve described by the annual growth rates of producer prices was reached in March (0.3 percent), whereas a trend reversal was seen in the following months (up to 1.8 percent in May). In contrast, the monthly dynamics stayed relatively put (0.2 percent on average in April-May, similar to that recorded in 2010 Q1; seasonally adjusted data series), despite the hike in external prices for metals in the period under consideration, which indicates that the ongoing unfavourable developments in sales on the domestic market in the first months of 2010[34] has limited the producer tendency to feed through into prices the possibly emerging pressures in costs.

Industrial Producer Prices and Consumer Prices



Source: NIS

Similarly, changes in prices of durables, also influenced by the external prices for metals, were further favourable: (i) the annual growth rate decelerated to half of the previous figure in 2010 Q1 (up to 3.4 percent), whereas the downtrend tended to flatten out in April-May; (ii) modest monthly rates of increase (0.5 percent; seasonally adjusted data series).

In January-March 2010, the annual growth rate of prices for non-durables decelerated by 1.5 percentage points, yet remained significantly above the average for industry (5.6 percent), mainly

[34] January through May 2010, the volume of sales of capital goods on the domestic market stood nearly 12 percent lower year on year, significantly below the average for manufacturing (-7 percent).

on the back of developments in tobacco and pharmaceuticals industries (21.4 percent and 25.6 percent respectively). The other industries producing non-durables further saw favourable developments, as the annual growth rates of prices slowed down to 0.5 percent in food industry.

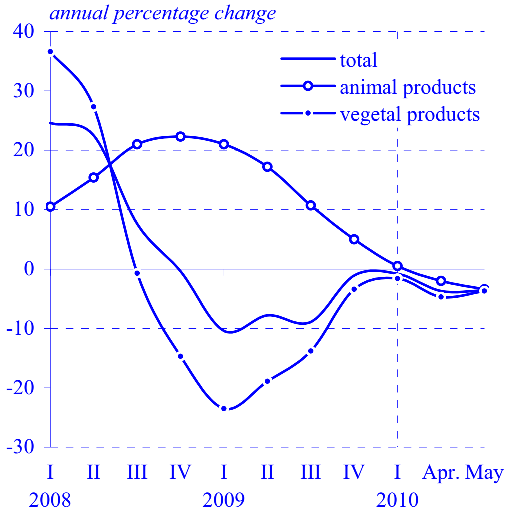
In 2010 Q2, the uptrend in the annual dynamics of producer prices is likely to sharpen, with prices for energy products further posting the highest levels; additional pressures are expected to be exerted in the case of intermediate goods. By contrast, no trend changes are expected to be recorded in the case of consumer goods, the annual dynamics of producer prices further hovering around 5 percent.

3.2.2. Agricultural producer prices

In 2010 Q1, agricultural producer prices further recorded negative, yet less pronounced, annual growth rates (-0.8 percent), given that prices for vegetal products saw a slower pace of decline (up to -1.6 percent). The annual growth rate of prices for animal products slowed down, nearing zero (0.5 percent).

Agricultural Producer Prices

annual percentage change



Source: NIS

The same as in the prior quarters, prices for vegetal products displayed mixed developments – prices for grains (except wheat) saw negative annual growth rates, albeit slower than in previous quarters, while prices of vegetables posted a faster pace of increase. The price of wheat, which reverted to positive annual growth rates (3.4 percent), owing possibly to the 2009 smaller, low-quality crops, is a particular case.

The slowdown in the annual dynamics of prices for animal products (to 0.5 percent from 5 percent in 2009 Q4) was underpinned by prices for all types of meat and was associated with both favourable base effects and higher domestic production than in the same year-ago period, in a period marked by the seasonal drop in the consumption of such goods. Prices for beef are an exception, as their monthly changes followed a significantly upward trend (average monthly growth rate of over 1 percent in 2010 Q1), in line with world market developments.

In the context of the persistence of actual trends, the annual growth rates of prices for animal products are expected to decelerate and enter negative territory (particularly due to some favourable base effects), which could lead to a sharper year-on-year decline in the overall agricultural output in 2010 Q2. Prices for vegetal products are not expected to undergo significant changes in the reported period.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary Policy

The National Bank of Romania decided to slow the downward trend in the monetary policy rate in May and to interrupt it in June, by keeping the key rate at 6.25 percent per annum. Moreover, starting May, the monetary authority increased gradually the tightness of liquidity conditions in the banking system. The central bank's actions were aimed to ensure ongoing disinflation in line with the medium-term targets, a sustainable revival of lending in the Romanian economy, especially to the private sector, and avoiding excess volatility of the leu exchange rate.

The decision to lower again the monetary policy rate (from 6.50 percent to 6.25 percent per annum) taken in the NBR Board meeting of 4 May 2010 was motivated by the prospects of ongoing disinflation being reconfirmed by the updated forecast of medium-term macroeconomic developments against the background of the expected pick-up in disinflationary pressures on the demand side. Behind this stood the high likelihood of a protracted downward trend in the negative output gap in 2010 Q1 and especially the outlook for the aggregate demand shortage remaining at its highest over most of 2010, given the expected delay in the annual GDP dynamics reverting to positive territory; implicitly, the recovery of economic activity appeared to be slower than previously anticipated over the entire projection horizon. The major indications and pre-requisites for the annual GDP dynamics remaining in negative territory during the first part of 2010 were the following: (i) the discontinuation of the further economic reinvigoration in the euro area in 2009 Q4 and the prospects of a fragile resumption in 2010 Q1; (ii) the adverse effect of the marked quarter-on-quarter decline in GDP in 2009 Q4 on this year's GDP evolution; (iii) the faster/protracted negative annual dynamics of a number of relevant indicators on consumer and investment demand over the first months of 2010 Q1; (iv) the ongoing financial deleveraging, along with the improvement in households' net savings with banks; and (v) a further worsening of labour market conditions in the first months of 2010. The shaping of a relative slowdown in the forecasted pace of disinflation consolidation[35], particularly the heightening of inflationary risks associated with the current projection – most notably the risk of fiscal policy to deviate from the agreed upon coordinates under the arrangement concluded with the EU, the IMF and IFIs, which would translate into the postponement of fiscal consolidation –, led the NBR Board to cut by half the pace of lowering the monetary policy rate. The prudent

[35] Compared with that projected previously.

approach also considered the higher uncertainties surrounding the external economic environment amid the resurfacing of global financial market turmoil caused by Greece's sovereign debt crisis.

In the meeting of 30 June 2010, the NBR Board decided to keep the monetary policy rate at 6.25 percent per annum, thereby interrupting this year's rate cutting cycle[36]. The monetary authority's response was motivated by the anticipated temporary pick-up in inflation as a result of the increase in VAT rate from 19 percent to 24 percent as from 1 July 2010[37] and, implicitly, the need for anchoring inflation expectations and preventing the second-round effects of this shock from materialising. The relevance of the risk of such effects materialising appeared, however, to be moderated by the prospects of the negative output gap deepening further and then remaining wide given that economic recovery is expected to be slower than envisaged in the most recent medium-term projection, also as a result of the implementation of budget austerity measures by the authorities starting July 2010. Thus, the monthly developments in key indicators over the first part of 2010 Q2 hinted at the annual dynamics of the major components of domestic demand (including the annual GDP change) remaining in negative territory, but there were significant uncertainties surrounding the scale of their contraction. As for households' consumption demand, the main signs of a delay in the improvement trend were the following: (i) the halt in the downward trend in the negative annual dynamics of turnover volume of retail trade and motor vehicles and motorcycles trade in April, (ii) the return to negative territory of the annual growth rate of the average net real wage in April, (iii) the sharp worsening of the consumer confidence indicator in May (its negative reading touching an all-time low); and (iv) the very likely materialisation towards the end of 2010 Q2 and especially in the following quarters of – direct and indirect – contractionary effects from the public-sector wage cuts and the increase in VAT rate, as well as in other types of taxes. Adding to these signs was the persistence of a relatively robust bank saving for precautionary motives and of a negative annual change in loans to households[38].

[36] In January-May 2010, the monetary policy rate was lowered four times (three times by 0.5 percentage points and once by 0.25 percentage points).

[37] The decision – following the Constitutional Court's rejecting the proposal of a 15 percent cut in pensions (one of the major components of the package of austerity measures assumed by the government before the Parliament, along with the 25 percent reduction in public-sector wages) – was taken on 26 June (one day after the Court's decision was announced), as the authorities sought to avoid major disruptions in the implementation of the EU-IMF-IFI external financing arrangement.

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

The dynamics of loans to households rebounded somewhat in April-May 2010 (-4.3 percent against an average of -8.2 percent in 2010 Q1). This was attributable largely to the ongoing, albeit uneven, implementation of the "First Home" programme and the substantial moderation of the deterioration trend in the loan supply. Nevertheless, demand for loans remained feeble, as the available data[39] reveal a slight recovery only in terms of (low-value) uncovered consumer credit, possibly owing to aggressive promotion campaigns launched by some credit institutions. The main dampening factors were the further worsening prospects on households' income and jobs, as well as the declining value of their real-estate assets. Such influences were only partly countered by the effects of a sharper downtrend in interest rates on new lei-denominated loans, consumer credit[40] in particular. In turn, the loan supply reflected the impact of the protracted worsening trend in the quality of some loans granted previously to households[41] and the continued real-estate market adjustment, on the one hand, and the incipient signs of growing competition, on certain market segments at least, on the other hand. Banks further slowed down in early 2010 the pace of tightening lending standards and terms[42], some of them even being left unchanged. Against this background, the average volume of new loans to households[43] during April-May was higher than in 2010 Q1; at the same time, it remained above the levels seen in 2009, but no clear signs of a pick-up in the annual dynamics were manifest. In turn, the average annual growth rate of household consumer credit rebounded slightly in the reported period (to -7.9 percent, 2.4 percentage points above the first-quarter average), primarily as a result of the foreign currency component, which further held the largest share in total new loans. Housing loans grew at a faster pace, their average annual dynamics (12.0 percent) doubling versus 2010 Q1 solely on the back of the

[39] See the NBR's May 2010 survey on lending to non-financial companies and households and CCR data.

[40] This appears to be widely associated with debt rescheduling (as suggested by the analysis of data on the volume and breakdown of flows and balances of lei-denominated loans to households revealing that, *inter alia*, new variable-rate loans and loans with an initial rate fixation of up to one year accounted, for the first time since records began, for less than half of the total new business in lei during the April-May period).

[41] According to Credit Bureau figures.

[42] According to the above-mentioned survey, in 2010 Q1 lending conditions for households were left broadly unchanged in the case of mortgage loans (although banks had previously expected a slight easing), due primarily to bank competition; however, standards tightened for consumer loans under the impact of collateral risks, expectations on households' financial standing and the risk associated with customers' creditworthiness. Lending terms continued to be tightened as far as consumer credit was concerned, as the spread between lending rates and 1M ROBOR rate widened and the indebtedness ceiling was lowered.

[43] 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.

foreign currency-denominated component (19.3 percent compared with 15.4 percent in 2010 Q1).

The annual growth rate of household savings with banks remained virtually unchanged, on average, April through May as against 2010 Q1, at a 9-year low of 6.0 percent, reflecting, *inter alia*, a stronger constraint from bank debt service amid the downward trend in household income. Time deposits (up to and over two years) saw their share in total household deposits widening to 76.1 percent, as money demand for precautionary motives was further underpinned by households' higher uncertainties on their financial standing; an opposite effect had the narrower spread between interest rates on households' new time deposits in lei and those on overnight deposits, as well as the emerging fears over a possibly stronger depreciation of the domestic currency that appeared to have fuelled, at least temporarily, the propensity for very short term deposits in foreign currencies. Nonetheless, the annual growth rate of time deposits of households kept slowing down (18.7 percent, down 5 percentage points from the first-quarter average), touching a level similar to that seen in late 2007 and early 2008. By contrast, the annual change in overnight deposits improved to -20.9 percent, from -25.6 percent in 2010 Q1, due mostly to the annual dynamics of very short term deposits in foreign currency entering positive territory.

Seen also from this perspective, another reason for the decision to contain the step of policy rate cutting and subsequently to resort to a status-quo was the risk of an overly-volatile leu exchange rate given the noticeable reduction in global risk appetite following the heightening fears over the intensification and broadening of the sovereign debt crisis in the euro area. The risk perception associated with local market investments was additionally magnified by worsening expectations on the short-term outlook for the Romanian economy and especially by the short-lived increase in uncertainties surrounding the adoption and implementation of the necessary fiscal consolidation measures by the specified deadline, a conditionality that had to be met in order for the IMF to release a new tranche under the EU-IMF-IFI arrangement.

In this context, another decision taken by the Board of the National Bank of Romania in June was to implement a firmer management of liquidity across the banking system. The central bank started to gradually tighten liquidity conditions ever since end-April after pursuing, in early April, an adequate management of liquidity aimed at supporting the adjustment in interest rates on lei-denominated loans and deposits: the central bank's net debtor position expanded temporarily in April, reflecting the expansionary impact of the autonomous factors of liquidity, and excess reserves were mopped up to a large extent by resorting to the deposit facility (whose average daily volume surged markedly). In the last

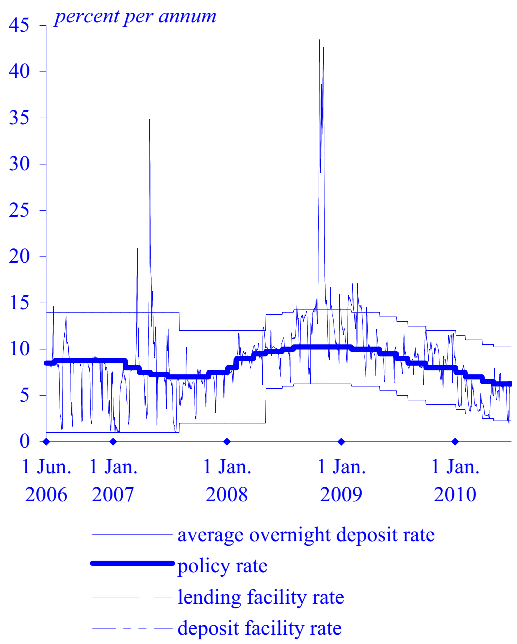
10-day period of April and throughout the following months, the NBR organised four auctions for deposits with one-week maturity, of which three had pre-announced volumes. Against this background, credit institutions' resort to the deposit facility declined and the spread between short-term rates and the monetary policy rate narrowed. Foreign market tensions, along with heightened fears regarding the scale of the budget deficit and the possibility of raising the necessary funds to ensure its financing, and the shift in expectations on future liquidity conditions weighed on longer-term interbank market rates. These rates went up markedly in early May and thereafter saw a relative stabilisation at levels above the monetary policy rate.

2. Financial markets and monetary developments

In 2010 Q2, money market interest rates reverted to higher levels, whereas lending and deposit rates on new business of non-bank clients saw a protracted decline. The RON/EUR exchange rate followed an upward course, amid the increased global risk aversion and, subsequently, the deterioration of investor sentiment on regional and local markets. Broad money resumed the upward trend, given the slower year-on-year contraction in credit to the private sector.

2.1. Interest rates

Interbank Money Market Rates



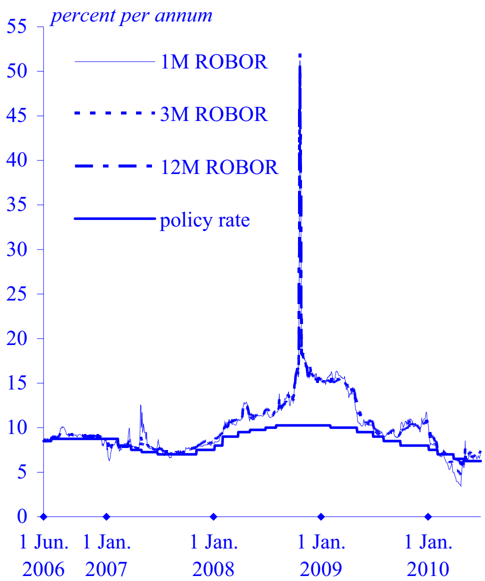
Interbank market rates witnessed an upward adjustment in late April, reverting to levels close to the monetary policy rate. However, average interbank market rates in 2010 Q2 (5.3 percent) stood half of a percentage point lower than in Q1, indicating the low levels recorded at the beginning of the period under review.

Hence, throughout most of April, overnight rates remained in the lower part of the corridor defined by interest rates on the central bank's lending and deposit facilities, against the background of the protracted easing of liquidity conditions, as a result of reserve injections generated by autonomous factors, as well as by the Treasury's operations. The liquidity surplus was largely drained via the deposit facility, the average daily stock of deposits increasing markedly as compared with the previous months.

At the beginning of the 24 April – 23 May reserve maintenance period, overnight rates reverted to levels close to the monetary policy rate, subsequently posting gradually lower fluctuations, including as a result of the rise in the share of one-week deposit operations conducted by the central bank in total liquidity-absorbing operations. However, the volatility of these rates saw a renewed temporary increase in the latter half of June, as the pronounced decline in very short-term interest rates, which was manifest on the back of a cumulated reserve surplus and the increased resort of credit institutions to the deposit facility, was followed by their reverting to levels close to the monetary policy rate.

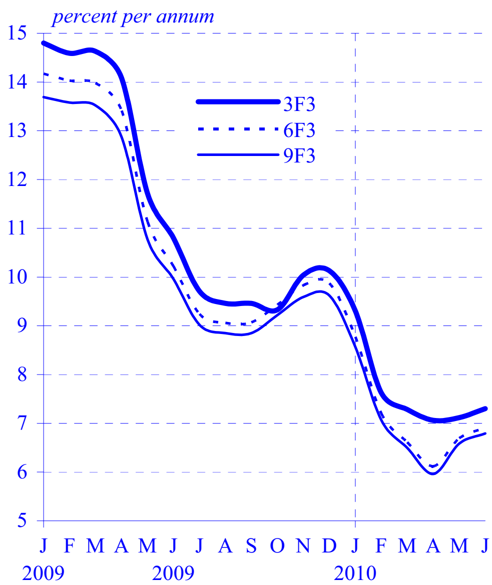
At the beginning of the quarter, (1M-12M) ROBOR rates reported a sharper decline, whereas they increased significantly in the last week of April and particularly in early May, their levels across the maturity spectrum standing higher than the monetary policy rate. This development reflected the rise in the risk premium – in the context of severely tight conditions on global financial markets (generated by investor concerns on a possible crisis that could have an impact on the sovereign debt of several euro area countries) and the heightened domestic risks associated with the achievement of the objectives pursued by fiscal and income policies in the public sector –, as well as the change in credit institutions' perception of the current state of affairs and the liquidity in the banking system in the period ahead. Subsequently, such interest rates neared the central bank's policy rate, after posting slightly volatile developments. Nevertheless, interest rates across the maturity spectrum resumed an uptrend in late June, as market participants reviewed their expectations on the future trend of the monetary policy rate, namely they did not anticipate the policy rate to decrease at end-June. As a result, average (1M-12M) ROBOR rates rose by half of a percentage point in June as compared with March.

Policy Rate and ROBOR Rates



Implicit forward rates also followed an upward course. In June, the expected 3M ROBOR rates covering 6 and 9 months (calculated based on June average quotations) stood at 6.9 percent and 6.8 percent respectively, 0.9 percentage points higher than those recorded in March 2010. The projected 3M ROBOR rate covering 3 months remained unchanged at 7.3 percent.

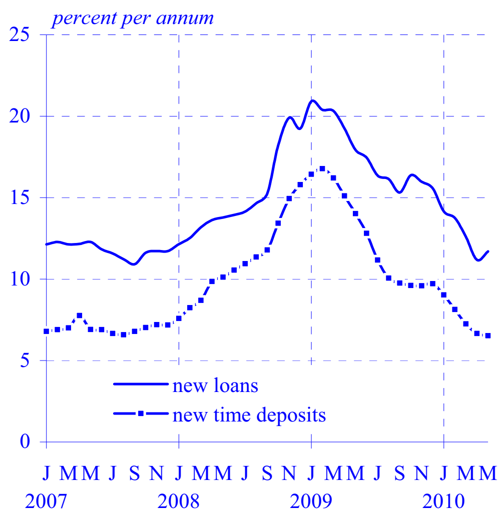
Implicit Forward Rates



In turn, interest rates on the primary market for government securities went down in April, yet they subsequently followed a gradual upward trend, rising to 7 percent (the maximum interest rate accepted by the MPF). The cumulated value of securities issued (lei 8.1 billion) accounted for only 60 percent of the total announced figure – the share of accepted volume in total announced volume narrowing to 21 percent in June – given that the MPF attempted to counter a higher interest rate increase, by rejecting in whole or in part the bids submitted at the auctions organised in May-June. Under the circumstances, the average interest rate on securities issued in 2010 Q2 stood at 6.5 percent, 1.25 percentage points below the first quarter's figure.

The yield on outright operations performed on the secondary market for government securities showed a similar development, adding 0.9 percentage points in May and June to 7.1 percent. However, the average yield on such operations was of 6.8 percent, standing 0.9 percentage points lower quarter on quarter. The quarterly turnover of the secondary market for government securities (NBR excluded) declined as against the first quarter to lei 23 billion (a figure similar to that reported in 2009 Q4), with the largest part (about 92 percent[44]) being accounted for by outright transactions. Securities with residual maturities of one and two years were the most heavily traded, their interest rates adding 0.98 percentage points and 0.66 percentage points respectively in the past two months. Amid the increased risk aversion and the heightened uncertainties surrounding the developments in the Romanian economy in the near run, non-residents' holdings of lei-denominated securities decreased starting with May – after increasing for 5 consecutive months – recording a level slightly higher quarter on quarter.

Bank Rates



In March-May 2010, average time deposit and lending rates on new business stayed on an overall downward trend, down 1.60 percentage points to 6.52 percent and 2.05 percentage points to 11.69 percent respectively, in line with the policy rate and interbank rates. However, developments were uneven as regards the categories of customers. Hence, average interest rates on households' new time deposits and loans decreased at a faster pace quarter on quarter (down 1.69 percentage points to 7.25 percent and 4.19 percentage points[45] to 11.80 percent respectively). By contrast, in the case of non-financial corporations, average interest rates on new time deposits and loans, after following a downward course in March and April, were on a rise, given the higher interbank rates and the heightened uncertainties surrounding the growth prospects for the Romanian economy. As a result, over the reported period, average interest rate on new time deposits of companies decreased by merely 1.47 percentage points to 5.98 percent, whilst average interest costs of new loans to such entities went down 1.57 percentage points to 11.66 percent in May.

[44] The volume of transactions in government securities performed via BSE was slightly lower than in 2010 Q1, totalling lei 1.16 billion. Securities with residual maturity of 4 years were the most heavily traded (64 percent of total turnover), their average quarterly interest rate dropping 0.61 percentage points to 6.83 percent.

[45] The sharp decline was mostly due to the lower average interest rate on new consumer loans with initial maturity and fixed initial period ranging from 1 to 5 years, with this category holding the largest share of total new loans to households. This movement can be accounted for by both banks' promotional campaigns and the restructuring measures of consumer loans.

Box

Interest rate transmission mechanism

Understanding the transmission of changes in interbank rates to lending and deposit rates (applicable to both households and companies) is essential for grasping the manner in which monetary policy conduct has an impact on the economy. It is particularly important in the context of the global financial crisis that generated the relatively weaker[46] interest rate pass-through which could add to the challenges to the stance and implementation of the monetary policy of the NBR and other central banks.

The analysis of the interest rate transmission characteristics was based on an error-correction model:

$$\Delta r_t = \sum_{i=1}^{k} \lambda_i \Delta r_{t-i} + \sum_{j=0}^{l} \gamma_j \Delta m_{t-j} + \alpha (r_{t-1} - \mu - \beta m_{t-1}) + \varepsilon_t ,$$

where r is the interest rate on the loans/deposits of non-bank clients, m is the money market rate, the γ_0 coefficient measures the immediate pass-through, the λ coefficients determine the interest rate response to loans/deposits in terms of changes in previous periods, α is the adjustment velocity to the long-term equilibrium relation, β is the long-term pass-through, while μ is the margin between interest rates on loans/deposits and money market rate. The analysis was based on monthly interest rates on new time loans/deposits of households and non-financial corporations recorded during May 2003 – December 2009; the 3M ROBOR rate was the key interest rate on the interbank money market, as it showed, in general, the closest correlation with interest rates applicable to non-bank clients.

The long-term transmission of changes in interbank rates to lending rates on new business stood above par for both categories of customers (Table 1). The empirical evidence – which seems to indicate a pronounced pro-cyclical behaviour of credit institutions – reflects the interaction between macroeconomic conditions and financial conditions specific to the reviewed period. In the latter case, an important part was played by the developments in the perception of risk associated by credit institutions with non-bank clients (including under the impact of several structural factors) and implicitly the related premium. By contrast, the long-term pass-through to deposit rates on new business was incomplete, as these rates captured only part of changes in interbank rates (about 80 percent for households and roughly 90 percent for non-financial corporations – Table 2)[47]. This can be attributed to the persistent liquidity surplus in the banking system throughout most of the period under consideration, as well as to credit institutions' readily available access to external financing.

The short-term transmission showed different features in terms of the two categories of bank clients/products. Interest rates on new time loans and deposits of non-financial corporations captured instantly nearly half of the change in interbank rates. Their response was stronger than that of interest rates on new business of households, in which case the transmission stood at nearly 20 percent. The explanation may lie with the different structure of loan/deposit agreements for the two categories: (i) most new loans to non-financial corporations have variable rates or fixed rates for up to one year, whereas new loans to households take a smaller share; (ii) as for new deposits, households may opt for fixed-rate time deposits rather than for variable rate deposits. At the same time, the different short-term transmission may be attributed to the frequent resort to direct indexation of interest rates on loans/deposits of companies in terms of interbank rates, as well as to the persistently stiffer competition on this segment, owing also to the stronger bargaining capacity of non-financial corporations than that of households (arising inter alia from the more readily available access to alternative financing/investment products).

Furthermore, deposit rates tended to adjust before lending rates. This behaviour – underpinned by the persistent liquidity surplus in the banking system – could reflect credit institutions' concern for preserving intermediation margins, given that interbank rates followed a downtrend during most of the period under review.

The deepening of the global financial crisis in the autumn of 2008 and its fallout on local financial market seem to have had a temporary impact on the interest rate pass-through. The temporary increase in interbank rate volatility was reflected by the weaker short-term response of interest rates applicable to customers, households in particular. A substantial disruption was reported by deposit rates on new business, subject to significant rises that exceeded the levels anticipated by credit institutions based on their track record. This development reflected both banks' fears of

[46] The reasons were discussed in the previous Inflation Reports.

[47] A long-term stable (co-integration) relation between deposit rates and interbank rates could not be specified. As a result, a model that does not include the error correction term was used.

the contraction in external financing sources and their concerns for adjusting the loan/deposit ratio, whose unsustainable level had turned into a serious vulnerability in the context of the financial crisis.

Looking ahead, the transmission of interest rates on new household loans can capture the impact of the recent amendment of the legal framework for consumer credit agreements[48]. In the short run, the adjustment by credit institutions of the cost structure of loans to households could lead to a temporary increase in the rigidity of lending rates. Taking a longer perspective, the elimination/containment of early repayment commissions could fuel competition, with favourable effects on both long- and short-term transmission. Moreover, the explicit linking of variable rates to benchmark money market indices is likely to improve, *ceteris paribus*, the short-term transmission. The behaviour of interest rates on time deposits could in turn be temporarily affected by the introduction of a 16 percent tax rate on gains from such placements as of 1 July 2010.

Table 1. Interbank rate transmission to lending rates on new business

	Immediate pass-through		Long-term pass-through		Adjustment velocity		Co-integration test (Boswijk)
Interest rates on loans to households							
5M 2003: 9M 2008	0.36	(0.17) **	1.63	(0.12) ***	-0.16	(0.04) ***	24.47***
5M 2003: 12M 2009	0.20	(0.09) **	1.57	(0.10) ***	-0.17	(0.02) ***	66.78***
Interest rates on loans to non-financial corporations							
5M 2003: 9M 2008	0.51	(0.14) ***	1.26	(0.07) ***	-0.22	(0.04) ***	31.95***
5M 2003: 12M 2009	0.45	(0.05) ***	1.20	(0.06) ***	-0.21	(0.04) ***	41.93***

Table 2. Interbank rate transmission to deposit rates on new business

	Immediate pass-through		Long-term pass-through	
Interest rates on deposits of households				
5M 2003: 9M 2008	0.27	(0.16) *	0.78	(0.11)
5M 2003: 12M 2009	0.21	(0.07) ***	0.80	(0.11)
Interest rates on deposits of non-financial corporations				
5M 2003: 9M 2008	0.62	(0.16) ***	0.87	(0.11)
5M 2003: 12M 2009	0.60	(0.13) ***	0.90	(0.10)

Standard deviations are showed in brackets. In the case of deposit rates, the standard deviation of the long-term pass-through is calculated by using the "delta" method.

***, **, * show the reading at 1%, 5% and 10% levels

As regards the entire sample, the model includes a dummy variable in order to control the strong global financial crisis fallout on the local financial market starting October 2008.

[48] Set forth by Government Emergency Ordinance No. 50/2010.

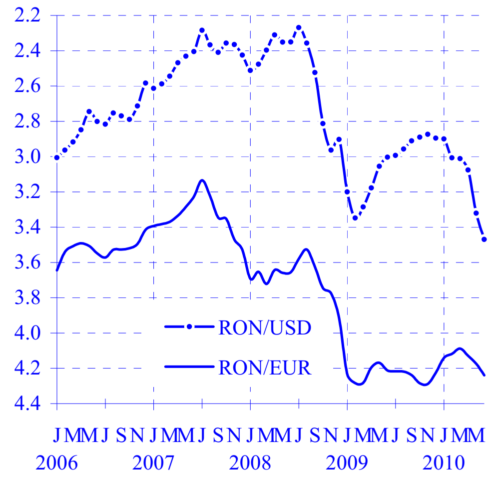
2.2. Exchange rate and capital flows

The RON/EUR exchange rate witnessed a trend reversal in April, as the upward movement seen throughout 2010 Q2 reflected mainly rising concerns generated by the Greek sovereign debt crisis and the risks of ripple effects being sent over to other euro area economies. The exchange rate embarked on a steeper upward path towards the end of the period under review, while daily volatility increased markedly, amid heightened tensions on the political stage and on the domestic financial market triggered by the worsening outlook on budget execution and the additional fiscal consolidation measures taken by the authorities.

Consequently, April through June, the domestic currency weakened against the euro by 3.6 percent in nominal terms and 3.1 percent in real terms, compared to an appreciation of 3.3 percent in nominal terms and 5.5 percent in real terms in 2010 Q1. In relation to the US dollar, the leu shed 12.7 percent in nominal terms and 12.4 percent in real terms (compared to a depreciation of 3.9 percent in nominal terms and 1.8 percent in real terms in 2010 Q1), given that the US currency strengthened abruptly against the euro[49]. Calculated as an average annual change for 2010 Q2, the domestic currency saw a significantly slower appreciation versus the euro in nominal terms (0.3 percent) and posted the first nominal depreciation in the past three quarters against the US dollar (6.4 percent).

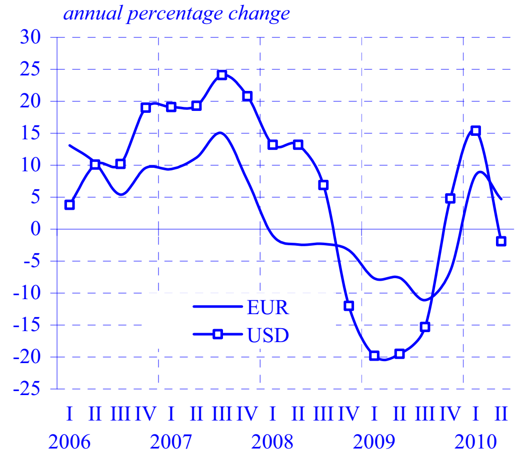
The trend reversal witnessed by the RON/EUR exchange rate in April was ascribed mainly to heightened investor concerns regarding Greece's debt crisis[50] amid rising uncertainties surrounding the manner in which the EU-IMF financial assistance package adopted on 10-11 April[51] would be implemented and the capability of the Greek government to apply the EU-required austerity measures. Subsequently, concerns triggered by the Greek crisis and its potential spill-over effects gained momentum and expanded on the global financial market, as a result of Standard&Poor's decision to downgrade Greece to below investment grade, while also downgrading the sovereign ratings of Portugal and Spain, with a negative outlook for all three countries. The takeover by the Spanish government of the CajaSur bank had a similar impact. Global market sentiment worsened further in May, as also indicated by the sharp drop in the EUR/USD exchange rate, an additional source of concern being the possibly adverse impact

Nominal Exchange Rate



Developments of RON Exchange Rate*

annual percentage change

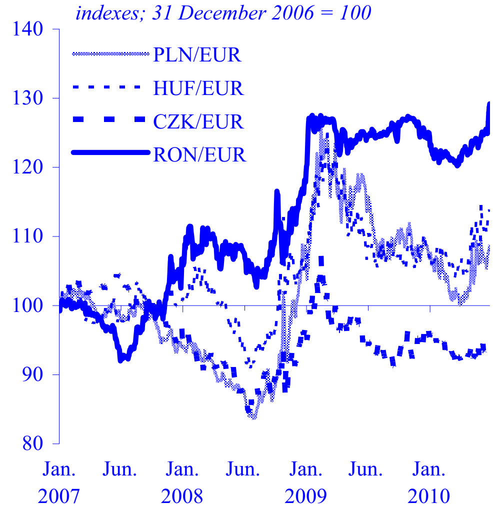


*) appreciation (+), depreciation (-) in real terms; deflated by CPI

Source: NIS, NBR

Exchange Rate Developments on Emerging Markets in the Region

indexes; 31 December 2006 = 100



Source: NBR, ECB

[49] The EUR/USD exchange rate posted on 8 June 2010 the lowest reading since 10 March 2006, i.e. 1.1942.

[50] Also reflected by the unprecedented rise, never before seen in EMU history, of the cost of financing of Greece on foreign financial markets.

[51] In addition, the EU-IMF financing package was perceived as assigning priority to short-term assistance, meaning that concerns lingered with regard to Greece's long-term fiscal standing.

of the fiscal consolidation measures[52] announced by the authorities on the pace of economic recovery in EU Member States. Against this background, the downward pressures on the euro and on the currencies in the region were only temporarily offset by the decisions taken by the European authorities during April-May to counter the adverse effect of the Greek crisis, namely activating the EU-IMF financial assistance mechanism at the request of the Greek government and setting up a European Stabilisation Mechanism worth EUR 500 million (supplemented to EUR 750 million via IMF's contribution).

Key Financial Account Items (balances)

EUR million

	2009 5 mos.	2010 5 mos.
Financial account	**1,146**	**2,809**
Direct investment	**2,134**	**1,365**
- residents abroad	40	-68
- non-residents in Romania	2,094	1,433
Portfolio investments and financial derivatives	**-219**	**1,362**
- residents abroad	-206	7
- non-residents in Romania	-13	**1,355**
Other capital investments	**-330**	**2,323**
- credits and loans from the IMF	4,925	2,453
- medium- and long-term investments	1,215	-475
- short-term investments	-2,800	-344
- currency and short-term deposits	-3,771	788
- other	102	-100
NBR's reserve assets, net ("–" increase/"+" decrease)	**-440**	**-2,242**

The upward movement of the RON/EUR exchange rate was also boosted by the deterioration of investor sentiment on the near-term outlook of the Romanian economy, in the context of: (i) the downward revision of GDP and budget deficit forecasts in 2010[53] and chiefly (ii) heightened uncertainties surrounding the government's ability to implement the measures aimed at cutting budget expenditures that had been announced on 7 May and hence to comply with the established coordinates of the agreement concluded with the EU, IMF and IFIs. These pressures were alleviated to a certain extent by the NBR's tighter management of money market liquidity and the ensuing increase in money market rates. The turnover of the local interbank forex market rose gradually, also as a result of more frequent speculative transactions, and peaked at a 16-month high in May, while the negative balance of foreign currency transactions widened to the highest reading year so far[54]. Against this background, on 20 May the RON/EUR exchange rate peaked at an 11-month high of 4.1998. Hence, the domestic currency weakened 2.1 percent versus the euro April through May, but fared better than the Hungarian forint and the Polish złoty, which depreciated against the euro 4.1 percent and 4.0 percent respectively.

In line with regional trends, the domestic currency weakened at a faster pace versus the euro in June, amid the worsening sentiment on the risk associated with developments across the region, Romania included. On the one hand, this came as a response to uncertainties surrounding the structure of the future ruling coalition in the Czech Republic, but especially to the unexpected statement of the Fidesz party vice-president claiming that Hungary was in a much more difficult situation than previously assumed[55], with only a slim chance of preventing a crisis similar to the Greek one.

[52] The Spanish, Portuguese and Italian authorities took additional deficit-cutting measures in May.

[53] According to a statement by the IMF Mission Chief for Romania on 10 May, the consolidated general budget deficit could shoot up to 9.1 percent of GDP in 2010 if no corrective action is taken.

[54] Also on account of keener net demand for foreign currency of resident clients, legal entities.

[55] Followed by a statement of the spokesperson for the Hungarian government claiming that reports of a possible default are not exaggerated.

However, the Hungarian government later backtracked on these statements, while also announcing a set of measures allowing the country to meet the initial deficit target. On the other hand, the worsening market sentiment was triggered by the hurdles faced by the Romanian authorities in adopting the additional fiscal consolidation measures, such as the no-confidence vote initiated by Parliament in relation to these measures and the Constitutional Court ruling the 15 percent pension-cutting decision as unconstitutional, which meant that it had to be replaced by a decision to raise the VAT rate. Otherwise, the IMF's Executive Board might have postponed its periodic review of the fulfilment of conditionalities laid down in the stand-by arrangement and hence the disbursement of a further tranche from the related loan might have been put off. Amid mounting uncertainties regarding the implementation of the austerity package proposed by the government, tensions built up progressively on the interbank forex market, as the turnover of transactions peaked at a 17-month high in June. The RON/EUR exchange rate witnessed an abrupt increase[56], posting successive historical highs[57] during the closing days of the quarter under review. At the same time, despite the rise in volatility, daily values remained below similar parameters reported by the main currencies in the region.

2.3. Money and credit

Money

March through May 2010, the pace of increase[58] of broad money (M3) picked up 1.9 percentage points to 4.0 percent, yet remained subdued compared to the readings seen over the past four years and a half. These developments reflected the opposing influences exerted, on the one hand, by the slower decline in the activity of several sectors of the economy (probably also underpinned by the rise in certain categories of public spending[59], on account of the partial use of external financing resources) and, on the other hand, by the partial shifts of currency holdings towards financial instruments with a maturity of over two years and by the accounting effect of the RON exchange rate[60].

Annual Growth Rates of M3 and Its Components

real percentage change

	2009			2010		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	5.7	6.8	6.7	2.1	3.8	4.2
M1	-12.4	-14.8	-18.3	-13.5	-9.0	-5.7
Currency in circulation	-0.1	-2.9	-8.9	-5.7	-2.6	1.3
Overnight deposits	-16.7	-19.0	-21.9	-16.7	-11.8	-8.7
Time deposits (maturity of up to two years)	26.8	49.9	36.7	15.1	12.5	10.3

Source: NIS, NBR

56 The domestic currency shed 3.2 percent against the euro during 24 - 30 June.

57 The IMF Executive Board's decision of 2 July to release the fifth tranche to Romania appeased tensions on the interbank forex market, while the leu regained some of the ground lost to the euro.

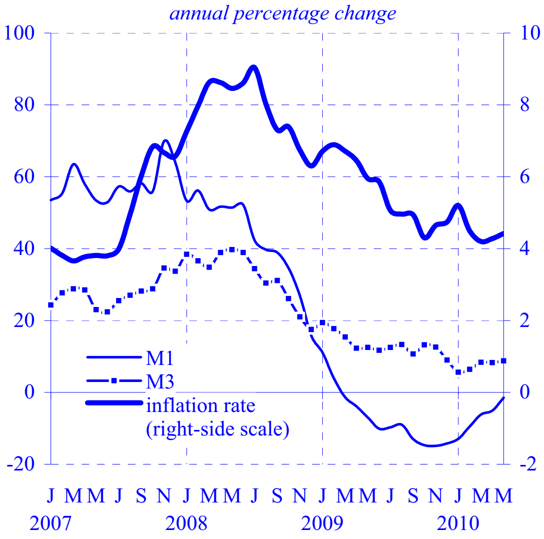
58 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2010.

59 March through May 2010, the real annual growth rate of public spending (less the contribution to the EU budget) went up for the first time since 2009 Q3.

60 In March and April 2010, the RON/EUR exchange rate (end of period) stood below the level seen during the same year-earlier period, while in May 2010 it equalled the May 2009 performance.

Broad Money and Inflation Rate

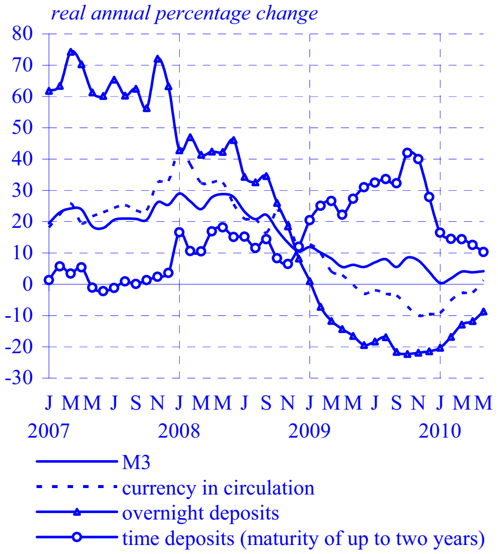
annual percentage change



Source: NIS, NBR

Main Broad Money Components

real annual percentage change



Source: NIS, NBR

The dynamics of the main components of M3 remained on the same paths they had embarked on during the previous quarter, i.e. the annual growth rate of narrow money (M1) recorded less negative readings and the pace of increase of time deposits with a maturity of up to two years decelerated. All the major components of M1 contributed to the slower decline of this monetary aggregate: (i) the downtrend in the annual growth rate of currency, which had been manifest over the past two years, came to a halt reflecting, inter alia, the impact of the slight upturn – albeit temporary – in wage dynamics[61]; (ii) the pace of increase of households' overnight deposits remained on an upward trend (driven especially by the rise in the foreign currency component expressed in euro), but still posted negative readings, while the growth rate of corporate overnight deposits re-entered positive territory for the first time in the past 18 months.

The relatively slacker dynamics of time deposits with a maturity of up to two years was ascribable to the decelerating trend in the growth rate of leu- and foreign currency-denominated household placements and of forex deposits of companies. The latter witnessed a partial shift towards leu-denominated time deposits with a maturity of up to two years and towards other types of foreign currency deposits, i.e. overnight and time deposits with a maturity of more than two years. Over the period under review, the average share of time deposits with a maturity of up to two years in M3 continued to grow in case of households, peaking at a 4-year high of 75.1 percent, and remained high, albeit slightly declining, in case of companies (58.0 percent). These developments, to which added the steady interest in money market fund shares/units, confirm the still keen demand for money for precautionary reasons, i.e. for saving/investment purposes.

The breakdown of monetary developments by institutional sector reveals that the faster M3 dynamics was due primarily to developments in corporate deposits, whose growth rate re-entered positive territory. Key determinants included several budget payments[62] and the car scrapping scheme, whose impact offset the opposite effect exerted by the swifter import dynamics[63] and by companies' keener interest in deposits with a maturity of more than two years (irrespective of denomination) and in leu-denominated government securities. Against this backdrop, the pace of increase of leu-denominated corporate deposits included in M3 peaked at an 18 month-high, whereas that of the corresponding forex deposits

[61] March through May 2010, the average annual growth rate of the net average wage economy-wide inched up in real terms (0.6 percent), after two quarters of negative readings.

[62] Including payments for agriculture, according to press releases of the MPF and of the Agency for Payment and Intervention for Agriculture.

[63] Medicine imports included, as specialised importers were the recipients of outstanding payments from the state budget in February 2010.

slowed to an 18-month low. At the same time, the growth rate of M3 household deposits slackened further and hit the lowest reading in the available data series. This was due both to the dynamics of household disposable income remaining in negative territory – to which added the impact of bank debt repayment – and to portfolio shifts primarily towards money market fund shares/units and foreign currency deposits with a maturity of more than two years. However, the more sluggish dynamics was only visible for deposits in domestic currency, while the forex-denominated component saw a relatively steady pace of increase, at the highest level in the past 18 months. Under the joint impact of the aforementioned factors, the average share of overall foreign currency-denominated deposits in broad money contracted slightly versus the previous quarters to stand at 31.9 percent.

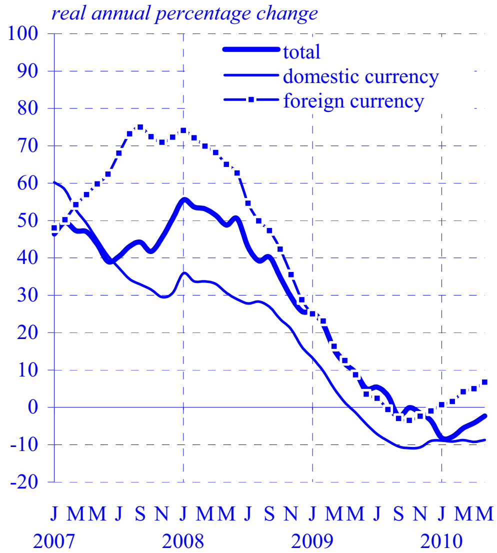
From the perspective of M3 counterparts, the faster dynamics of broad money was driven by the swifter expansion of net foreign assets in the banking system and the slacker negative pace of increase of credit to the private sector. An opposite influence came from the pick-up in the growth rate of long-term financial liabilities (capital accounts included) and from the slower increase in central government net credit.

Credit

March through May 2010, the downtrend that the growth rate[64] of credit to the private sector had embarked on two years earlier came to a halt, standing at -4.0 percent versus -6.6 percent in the previous quarter. The dynamics remaining in negative territory was due to the fact that neither the economic environment, nor the related outlook – and hence the current and expected developments in both companies' and households' financial standing – showed clear signs of recovery. Against this background, demand for loans remained subdued, while lending terms tightened further, albeit at a slower pace than in the previous quarters and only on certain segments[65]. Under the circumstances, the negative growth rate of leu-denominated credit remained somewhat stable at one of the lowest readings over the past nine years, whereas the pace of increase of the forex component further followed an upward path to a 12-month high. Hence, the average share of foreign currency credit in total credit to the private sector continued to expand and peaked at a 5-year high of 61 percent, despite the contractionary accounting effect of the RON exchange rate[66].

Credit to Private Sector by Currency

real annual percentage change



Source: NIS, NBR

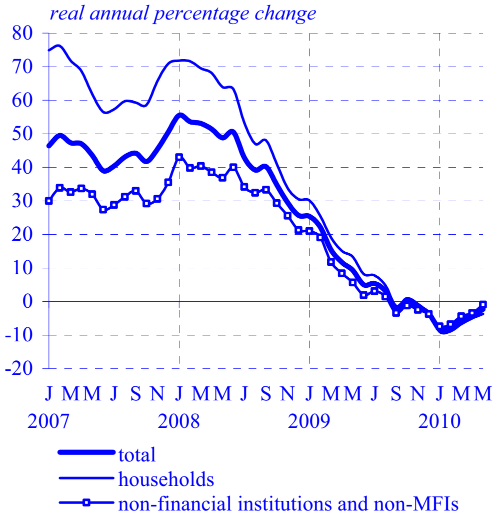
[64] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2010.

[65] According to the NBR survey on lending to non-financial corporations and households published in May 2010, the tightening of lending standards lost momentum, particularly in the case of short-term corporate loans and housing loans.

[66] End-of-month annual changes in the RON/EUR exchange rate.

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

The structural breakdown by institutional sector reveals that the softer contraction was more visible in case of corporate borrowings, whose average share in total credit thus remained somewhat constant at 50.5 percent. Long-term foreign currency borrowings continued to be the most dynamic component, posting the fastest growth rate in the past 18 months. Unlike the previous quarters, the other categories of forex-denominated corporate loans witnessed positive annual dynamics as well. Conversely, the negative pace of increase of corporate loans in domestic currency remained almost unchanged. Given that the volume of new business[67] to companies stood slightly below the previous quarter's reading, developments in the balance of corporate borrowings seem to have reflected primarily: (i) the ongoing loan restructuring operations amid the protracted uptrend in the share of overdue loans of non-financial corporations, hinted at by the relatively faster rise in long-term corporate borrowings in an environment riddled with uncertainties; (ii) the resort to credit lines granted by domestic banks during the previous quarters. The growth rate of household loans also saw a slacker decline, mainly on account of the renewed impetus in the dynamics of housing loans in foreign currency, whose annual pace of increase hit a 12-month high, spurred by the resumption in the "First Home" government programme. In turn, the negative dynamics of consumer loans shrank marginally, primarily on the back of its forex component. Behind this development seems to have stood the slight upturn in the demand for low-value loans (the share of the uncollateralised component in overall new consumer loans rose to 65 percent from 55 percent in the previous period[68]), amid the step-up in promotional offers and the lower lending rates on new business in domestic currency and in euro. By contrast to the modest developments in the balance of consumer loans, new consumer loans soared in terms of volume, which peaked at an 18-month high, but the evolution was most likely ascribable to restructuring operations.

Net credit to central government saw a slower expansion and thus stymied M3 dynamics. Developments reflected both the decelerating growth rate of the volume of government securities held by banks, irrespective of denomination, and the pick-up in the pace of increase of central government deposits.

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

[68] Also hinted at by the results of the NBR survey on lending to non-financial corporations and households published in May 2010.

V. INFLATION OUTLOOK

The baseline scenario of the current projection places the annual CPI inflation rate at 7.8 percent for end-2010, i.e. 4.1 percentage points higher than the level published in the May 2010 Inflation Report. The increase is however forecasted to be temporary, so that for end-2011 the inflation rate is expected to fall close to the central target of 3.0 percent and reach 3.1 percent, 0.3 percentage points above the previously projected figure.

The upward revision of the CPI inflation forecast is mostly attributed to the incorporation in the projection of the anticipated effects of the VAT rate increase to 24 percent (from 19 percent) as from 1 July 2010. The direct (first-round) impact of this measure is expected to be significant and to become manifest relatively shortly after the measure was implemented. This explains the wide deviation of the updated projection of the annual inflation rate compared with the previous end-2010 forecast.

While the first-round effect is permanent on the level of aggregate prices, it has only a temporary impact on price dynamics and, consequently, on the inflation rate, due to the one-off nature of the VAT rate increase. Therefore, the forecast envisages the annual inflation rate to return within the variation band around the central target starting with 2011 Q3. The moderate upward revision of the end-2011 projection is primarily the result of modest residual second-round effects of the shock caused by the VAT rate hike that are passed through via inflation expectations.

Under the impact of the VAT rate increase, the projected CORE2 inflation rate is also seen following a sharply upward trajectory over the first part of the forecast horizon and reverting after mid-2011 to levels close to 2 percent, similar to those in the previous projection. The significant negative output gap persisting throughout the forecast horizon is a major factor alleviating both first- and second-round effects of the VAT rate hike, especially as regards prices of products with relatively elastic demand. The projection anticipates a gradual reduction in the negative output gap as the economy recovers, returning to positive growth in 2011. Nevertheless, the negative output gap is foreseen to be larger relatively to that revealed by the previous projection, reflecting the expected influences of the recently-implemented austerity measures, including the higher VAT rate, and of marginally lower external demand than assumed in the May projection.

Although significant, the foreseeable deviation of the annual inflation from the December 2010 target does not entail an upward revision of the latter, given the temporary and, at the same time, corrective nature of the deviation of inflation from the target, as well as the need of a firm anchoring of inflation expectations in order to counter *potential second-round effects of the VAT rate hike. Thus, throughout the projection horizon, the central bank will permanently focus on enhancing the prospects for inflation rate to return onto a downward trajectory. In view of the prudent monetary policy stance assumed by the Board of the National Bank of Romania for this purpose, the projection foresees adequate real broad monetary conditions being ensured in order to keep the annual headline inflation rate, recalculated by excluding the first-round effect of the VAT rate increase, on a path in line with medium-term inflation targets.*

The convergence of inflation towards the medium-term targets and the sustainable recovery of both lending in the Romanian economy and GDP growth are strictly conditional upon all the elements of the macroeconomic policy mix complying with the updated coordinates of the economic programme under the external financing arrangement concluded with the EU, the IMF and other IFIs, as well as upon the absence of unforeseen adverse shocks over the forecast horizon.

Compared to the previous projection, the uncertainty associated with the current forecasting round is considerably higher, while the overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to be markedly tilted to the upside especially in the near run. Despite lingering risks related to future developments worldwide, the relevance of risks associated with the domestic environment clearly prevails over the reference period.

A major domestic risk is posed by the difficulties the authorities might face in efficiently implementing fiscal consolidation and income policy-related measures. Failure to meet the commitments under the financing arrangement with the EU, IMF and other IFIs could entail the worsening of international financial market sentiment regarding the outlook for the Romanian economy. This would bring about tighter external financing constraints on both the public and private sectors, with a detrimental impact on the leu exchange rate, inflation and economic growth.

A significant risk deriving largely from the potential solutions that may be resorted to in case of tighter fiscal constraints is associated with larger-than-projected hikes in administered prices. Given the limited information set available while preparing the projection and the uncertainties regarding the employed estimation, an additional risk stems from the impact on food prices of the floods that have recently hit several agricultural areas of the country. In the event of any of the aforementioned risks materialising, the shocks might induce additional deviations of inflation rate from the projected path via worsening inflation expectations and stronger second-round effects of the VAT rate hike.

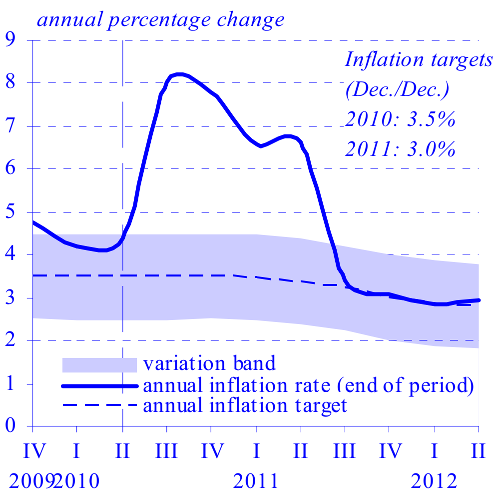
Risks related to external developments are further associated with the so far fragile economic recovery in the euro area. The risk of *contagion triggered by fiscal sustainability issues facing several European countries seems to have subsided to a certain extent, but some uncertainties are still manifest across the region. Favourable or unfavourable developments stemming from these sources would send ripple effects to the domestic economy via the foreign trade, financial and exchange rate channels. Other sources of risks from external developments are related to different trajectories than those assumed in the baseline scenario for the international oil price and the EUR/USD exchange rate, impacting domestic fuel price dynamics. Overall risks associated with the external economic environment 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 7.8 percent at the end of 2010 and at 3.1 percent at the end of 2011. Compared with the levels published in the May 2010 Inflation Report, the annual CPI inflation forecast is 4.1 percentage points and 0.3 percentage points higher in 2010 and 2011 respectively. The VAT rate increase[69] *will have a decisive contribution to the rise, in 2010 Q3, and maintenance, during the following four quarters, of the annual inflation rate above the upper limit of the variation band around the central targets set at 3.5 percent in 2010 and 3.0 percent in 2011. After the first-round effect of the VAT rate increase has faded in 2011 Q2, the annual inflation rate will fall, starting Q3, back within the ±1 percentage point variation band around the central target and will hover around 3 percent, in line with the inflation target set for 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

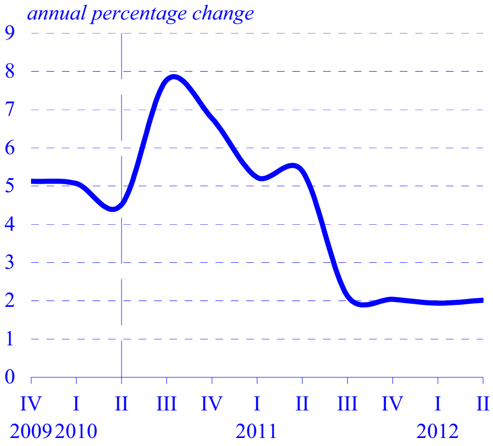
Period	2010 Q3	2010 Q4	2011 Q1	2011 Q2	2011 Q3	2011 Q4	2012 Q1	2012 Q2
Target		3.5				3.0		
Forecast	8,0	7.8	6.6	6.6	3.4	3.1	2.8	3.0

In the current projection, the VAT rate increase is expected to have a significant impact on the projected annual CPI inflation rate via the following effects:

(i) the first-round effect – the direct impact of the change in VAT rate on consumer prices and hence on the CPI inflation

[69] This change was implemented on 1 July 2010, taking the standard VAT rate to 24 percent (from 19 percent). The lower rate and zero rate were kept in place.

Annual CORE2 Inflation*



*) quarterly average

Source: NIS, NBR calculations

rate[70]. While the effect on the price level is permanent, the impact on inflation rate is temporary; the quarterly inflation rate will be affected only during the quarter when the new VAT rate is incorporated into prices, whereas the annual inflation rate will be influenced over a four-quarter time span. The maximum accounting effect on consumer prices of the VAT rate hike to 24 percent (from 19 percent) was estimated at about 3.9 percent in case of CPI inflation and 4 percent in case of CORE2 inflation rate[71]. As proved by recent VAT rate change episodes in other countries[72], the accounting effect may not feed entirely through to selling prices set by producers, who would rather bear part of the unfavourable shock and accept a squeeze on their profit margins, particularly in a macroeconomic context gripped by a significant demand shortfall. Other countries' experience and the NBR own assessment on a substantial domestic demand deficit[73] were taken into account when determining a realistic assumption on the extent to which the maximum accounting effect of the VAT rate increase feeds through to consumer prices in Romania.

(ii) the second-round effects – a measure of the indirect impact of the VAT rate increase on the CPI inflation rate; such effects do not necessarily fade away after four quarters, as their persistence depends on their correlation with other inflationary sources. Second-round effects may be caused by: higher wage claims given the drop in purchasing power as a result of the VAT rate hike, the increase in consumer prices by the companies selling products at lower or zero VAT rate in order to make up for the higher production costs, regaining – as demand recovers – the profit margins originally lost due to an incomplete incorporation of the VAT rate change in prices, etc.

Given that the first-round effect drops out of the annual inflation rate after four quarters from occurrence, the medium-term outlook of annual inflation rate will be influenced by the magnitude and persistence of second-round effects.

70 The VAT rate change track record in other countries revealed that most of the impact on consumer prices was manifest in the first month after this measure was implemented. In the case of Romania, the first-round effect will become manifest in July 2010. Considering that the inflation forecast is built by drawing on quarterly rates, the current projection incorporates the first-round effect in 2010 Q3.

71 The VAT rate increase to 24 percent (from 19 percent) would imply a maximum impact on consumer prices equalling 4.2 percent if all goods and services were to be subject to the standard rate. Considering however that the consumer basket includes items with lower or zero VAT rate (for which this rate was left unchanged), the maximum accounting effect is softer.

72 For example, Germany in January 2007, Hungary in July 2009 and Mexico in January 2010.

73 For further details, see Subsection *1.3. Aggregate demand pressures*.

The annual CORE2 inflation rate is expected to rise markedly in 2010 Q3, from 4.53 percent in June 2010 to 7.8 percent. In 2011 Q3, once the first-round effect of the VAT rate hike has dropped out of the annual CORE2 inflation, the latter will decline substantially and then hover around 2 percent over the remaining projection horizon. The contribution of the annual core inflation to CPI inflation is stronger in both 2010 and 2011. Except for the first-round effect of the VAT rate increase, as against the May Inflation Report, the current CORE2 inflation forecast is the result of several factors acting jointly, as follows:

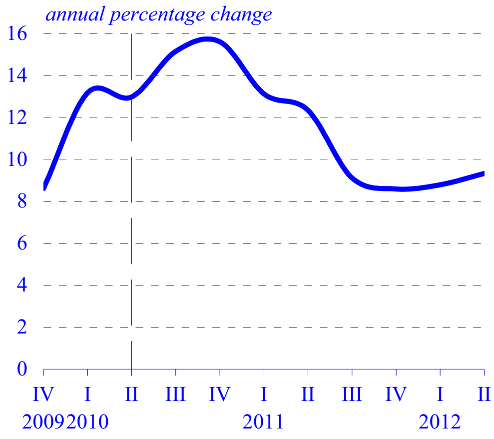
(i) the negative output gap projected at more favourable levels to disinflation over the entire projection horizon. The recent measures the authorities have committed to in terms of layoffs and wage cuts across the public sector will harm final consumption in particular. In addition, the increasingly unpredictable fiscal policy contributes to worsening household and corporate confidence in the economic outlook, thus compressing investment demand. Against the backdrop of excess production capacities, the persistence of domestic demand at such a low level bodes favourably for a continued disinflation, manifest especially starting 2011 H2, after the fading of effects induced by the VAT rate increase;

(ii) following the VAT rate hike, inflation expectations are anticipated to be revised upwards and may trigger second-round effects. Inflation expectations are projected to drop to levels similar to those in the previous forecasting round, as the higher VAT rate effects fade away towards the end of the projection horizon;

(iii) the announced increase in tobacco prices, which appears to be higher than that induced by the higher VAT rate[74];

(iv) stronger inflationary pressures from import prices. Amid the tensions in Greece, the deterioration of investor sentiment on the risk attached to investments in Europe's emerging economies entailed, during 2010 Q2, an episode of domestic currency depreciation that caused import price dynamics to veer off from the previous forecast trajectory. Moreover, the marginal upward revision of euro area inflation forecast over the first part of the projection horizon played a role in projecting a larger contribution from import prices to CORE2 inflation.

Fuel Prices Annual Inflation*



*) quarterly average

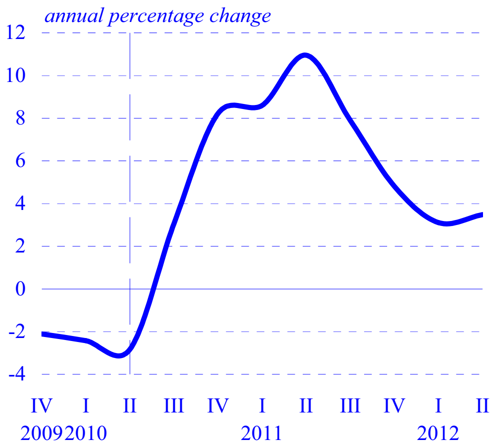
Source: NIS, NBR calculations

[74] The VAT rate increase has a direct impact not only on the retail price of tobacco products, but also on the calculation base of the *ad valorem* excise duty (that already incorporates VAT). The producers of tobacco products stated that part of the price increase implemented on 1 July 2010 is also motivated by the higher level of collateral associated with tax warehouses.

The contribution from the projected annual fuel price inflation rate is 0.5 percentage points higher in 2010 and virtually unchanged in 2011. Apart from the substantial impact of the VAT rate hike, the additional inflationary pressure from fuel prices in 2010 is attributed to an EUR/USD exchange rate scenario envisaging more favourable developments in the US dollar compared with those incorporated in the previous projections. The joint contribution of administered prices and volatile prices of vegetables, fruit and eggs to the annual CPI inflation rate will be higher than in the previous forecast in both 2010 and 2011, by 1.1 percentage points and 0.1 percentage points respectively[75].

1.2. Exogenous pressures on inflation

Vegetables, Fruit and Eggs Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR calculations

Compared to the previous projection, the cumulative effect of exogenous components[76] is seen making a higher contribution to CPI inflation, by 1.7 percentage points in 2010 and by 0.1 percentage points in 2011. For 2010 additional inflationary pressures stem from all exogenous components, owing largely to the impact of the VAT rate hike, while the revision for 2011 is due to the adjustment in the forecast on volatile food prices.

The scenario for the administered prices growth rates in 2010 was subject to an upward revision, mainly as a result of the increase in the VAT rate (a significant first-round effect[77] is expected for this category of prices), whereas that for the administered prices growth rates in 2011 remains unchanged from the previous projection[78]. Nevertheless, even leaving apart the first-round effect following the rise in the VAT rate, the scenario for the administered prices growth rates in 2010 is more unfavourable than in the previous forecasting round, given the projection of possibly larger changes in such prices in the context of the required budget deficit adjustment.

75 For further details, see Subsection *1.2. Exogenous pressures on inflation*.

76 The exogenous components of consumer price inflation include administered prices, volatile prices of fruit, vegetables and eggs (VFE) and prices of tobacco products.

77 The assumption of producers partially withstanding the shock by reducing profit margins is not plausible in the case of goods and services with administered prices. For details on the first-round effect of the VAT rate hike, see Subsection *1.1 Inflation outlook*.

78 In view of the high uncertainty associated with the projection of administered prices in the absence of an official calendar for their adjustment, an expert judgement was adopted for 2011. For further details, see Subsection 1.2 in Chapter V of the May 2010 Inflation Report.

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 (%)	9.9	3.,8	8.2	4.8
	Contribution to annual CPI inflation (pp)	*1.7*	*0.6*	*0.6*	*0.3*
Previous 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*

* Calculations for 2010 Q4/2009 Q4

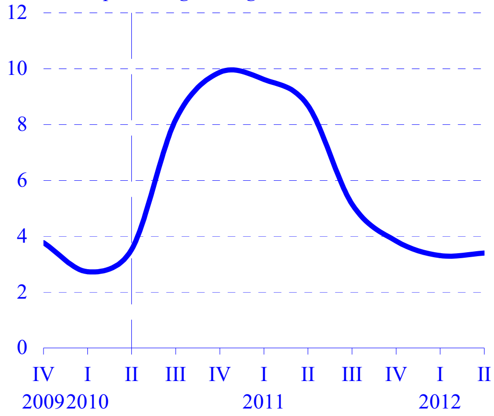
The forecast on the developments in tobacco product prices for 2010 was subject to an upward revision, the contribution of such prices to the consumer price inflation exceeding by 0.5 percentage points that in the previous projection. The baseline scenario of the current projection incorporates the price hikes applied by producers starting 1 July, including the effects of the increase in the VAT rate[79].

The forecast for volatile food prices was subject to revaluation for both 2010 and 2011, following the incorporation of the higher VAT rate and also the anticipation of a less favourable evolution in the agricultural sector following the recent adverse weather conditions.

The scenario on the developments in the euro area economy foresees a modest recovery, in view of the flagging demand. Compared to the previous projection, the economic growth forecast for 2010 was kept unchanged, while that for 2011 was subject to a downward revision (0.1 percentage points). In this context, the trajectory of the 3-month EURIBOR interest rate was also revised downwards throughout the projection horizon, whereas the annual CPI inflation is expected to post readings higher than those previously projected, primarily under the impact of the depreciation of the euro against the US dollar. The current projection assumes that the EUR/USD exchange rate will stabilise at a level close to that seen at present, i.e. 1.27 for the remaining of 2010 and 1.26 for 2011, in line with international expert forecasts. The scenario on the developments in the international oil price illustrates the anticipation of a gradual increase in the demand for commodities, albeit the expected readings are lower than previously projected.

Administered Prices Annual Inflation*

annual percentage change



*) quarterly average

Source: NIS, NBR calculations

[79] The VAT rate increase affected also the *ad valorem* duty, as the latter is calculated by adding the percentage set forth by law to the maximum retail price, which includes the VAT.

Table 5.3. Expectations on the developments in external variables

annual averages

	2010	2011
WTI oil price (USD/barrel)	78.7	83.9
EUR/USD exchange rate	1.30	1.26
3-month EURIBOR interest rate (%)	0.79	1.16
Economic growth in the euro area (%)	1.1	1.4
Annual inflation rate in the euro area (%)*	1.6	1.5

* in Q4

Source: Consensus Economics, EIA, Eurosystem staff macroeconomic projections for the euro area

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

According to the data released by the National Institute of Statistics, in 2010 Q1, the quarter-on-quarter decrease in real GDP was lower (0.3 percent, seasonally adjusted data) than in 2009 Q4[80]. In year-on-year comparison, GDP declined by 2.6 percent in 2010 Q1 (non-seasonally adjusted data).

The inertia of the effects of the global economic crisis passing through into domestic economic activity enhances the uncertainties surrounding the assessment of the economy's cyclical position. For a relatively long period of time, GDP stands considerably below its pre-crisis level; in the short run, the decline in GDP is brought about by total factor productivity, while in the medium run it is the result of the persistently subdued level of both capital stock (owing to the significant decreases in investment flows) and employment. The ongoing fall in GDP in the aftermath of financial crises implies both markedly lower GDP levels and significantly slower growth rates of potential GDP than those reported in no-crisis times.

The assessment made on the basis of the data provided by the NIS and the analysis of a wide set of economic indicators shows a relatively wider negative output gap in 2010 Q2 compared to the previous period. This entails, ceteris paribus, further disinflationary pressures from aggregate demand.

[80] 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.

According to the seasonally adjusted data, GDP posted the following quarterly growth rates in 2009: -4.1 percent in Q1, -1.5 percent in Q2, 0.1 percent in Q3 and -1.5 percent in Q4. Based on the non-seasonally adjusted data, real GDP posted the following annual dynamics: -6.2 percent in Q1, -8.7 percent in Q2, -7.1 percent in Q3 and -6.5 percent in Q4.

The slower pace of GDP decline in 2010 Q1 versus the prior quarter[81] was due to the slightly positive dynamics of investment and the swifter increase in exports than in imports, such developments being offset by the resuming of the decrease in actual final consumption[82].

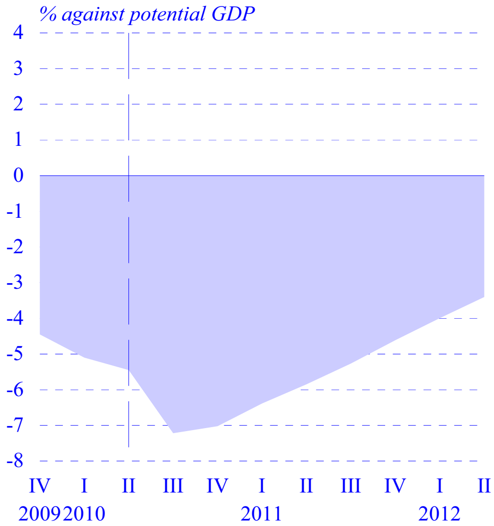
The quarter-on-quarter contraction of actual final consumption in 2010 Q1 against 2009 Q4 is the result of the decline in both household actual final consumption (down 1.7 percent) and general government actual final consumption (down 0.9 percent in 2010 Q1).

Household actual final consumption is expected to stay below the medium-term trend in 2010 Q2. For April-June 2010, the analysis of household disposable income reveals diverging developments in some components, as follows:

– wage developments reflected the adjustment in the number of employees in the economy as a whole (which decreased quarter on quarter for the seventh quarter in a row, namely by 1.1 percent in April and May as compared with Q1, seasonally adjusted data), as well as in the economy-wide net real wage (down 1.6 percent in the same period, seasonally adjusted data);

– the tightening of lending standards[83] for households was slower than in 2010 Q1, except for mortgage lending standards that remained unchanged. Credit institutions expect lending standards for both loan categories to ease in the period ahead. Hence, subsequent to the quarter-on-quarter decline posted in the prior three-month period, the volume of new loans to households increased by 32.5 percent[84] in real terms in April and May as compared with the average for the prior quarter;

GDP Deviation



Source: NIS, NBR calculations

[81] In 2010 Q1, gross fixed capital formation rose by 1.2 percent quarter on quarter, after dropping 2.7 percent in the previous quarter. Over the reported period, exports advanced by 12 percent quarter on quarter, as compared with the 0.7 percent marginal increase seen in the preceding quarter, at a faster pace than imports (8.9 percent versus the 1.4 percent decline in the prior quarter).

[82] Actual final consumption posted a dynamics reversal, returning to negative territory (-1.6 percent) in 2010 Q1 after reporting a slight increase in the past two quarters (quarterly growth rates of 0.1 percent and 1.1 percent in 2009 Q3 and Q4 respectively).

[83] According to the National Bank of Romania's quarterly survey on lending to non-financial corporations and households, released in May 2010.

[84] The annual change stood at 57.4 percent in April and May as compared with the average for 2009 Q2. Consumer loan stock declined by 0.2 percent in real terms in April and May as against the Q1 average, the annual growth rate standing at -7.8 percent.

– the sharp quarter-on-quarter declines reported in the previous periods by leu-denominated current transfers balance and compensation of employees[85] in the external balance of payments of Romania were offset by April and May rises (26.5 percent as compared with the average for the prior quarter);

– budget transfers (the expenditures of the social security budget, unemployment fund and health insurance fund) were close[86] to the 2010 Q1 figure.

Compared with the preceding quarter, in 2010 Q2, household saving with banks was relatively lower, as illustrated by the developments in household deposits (stocks and flows)[87]. A heterogeneous picture on consumer demand developments is rounded off by the dynamics of turnover related to market services to households which picked up 2.3 percent in April and May as against the prior quarter's average (seasonally adjusted data)[88] as well as by the retail trade turnover (except motor vehicles and motorcycles), which saw a slightly positive quarterly dynamics[89] in April and May after decreasing for seven quarters in a row.

After a quarterly positive change of 4.4 percent in 2009 Q4, general government final consumption resumed a downward path in 2010 Q1, dropping 0.9 percent quarter-on-quarter. At end-2009, the public deficit-to-GDP ratio was kept in the vicinity of the parameters agreed upon with the IFIs, i.e. 7.4 percent, whereas the cumulated deficit in 2010 H1 accounted for 3.35 percent of GDP[90].

According to the data released by the NIS, the quarter-on-quarter dynamics of gross fixed capital formation was slightly positive

[85] The quarterly growth rates were -28.0 percent in 2009 Q4 and -43.9 percent in 2010 Q1, non-seasonally adjusted data, expressed in lei, in real terms.

[86] Budget transfers inched up 0.5 percent in April and May versus the 2010 Q1 average. In year-on-year comparison, budget transfers increased by 2.3 percent in the first two months of 2010 Q2 as against the 2009 Q2 average (non-seasonally adjusted data expressed in real terms).

[87] In April and May, new household deposits fell by 6.2 percent in real terms as compared with the 2010 Q1 average. Nevertheless, over the reported period, cumulated household deposits (stock) in both lei and foreign currency stood 5.3 percent higher than in the preceding quarter, indicating the rise in both lei- and foreign currency-denominated deposits (2.3 percent and 10.7 percent respectively), NBR seasonally adjusted data expressed in real terms.

[88] This indicator posted a 12.4 percent increase in April and May 2010 in annual terms as compared with the average for 2010 Q2.

[89] In April and May, retail trade turnover (except motor vehicles and motorcycles) was 0.9 percent higher than the average for 2010 Q1, while the annual growth rate was further negative, standing at -3.7 percent in May 2010 as against the 2009 Q2 average (seasonally adjusted data, NIS).

[90] In 2009 H1, the general government deficit-to-GDP ratio was of 2.9 percent.

(1.2 percent) in 2010 Q1, with a 2.7 percent decline[91] in the final quarter of 2009. This GDP component is expected to remain below the medium-term trend in April-June 2010.

In 2010 Q1, investment in equipment further recorded strongly negative annual growth rates, i.e. -30.6 percent, as companies adopted a prudent stance with regard to continuing retooling due to uncertainties associated with future economic developments (with a negative impact on the growth rate of potential GDP as well). The sharp decline in investment in equipment is only partially reflected by imports of capital goods, whose annual rate of increase was negative[92] in 2009 Q4, yet showing signs of a slight revival in the first quarter of 2010 as illustrated by the annual growth rate of 4.8 percent. The other component of investment in the domestic economy, namely new construction works, stayed on a downward path[93], posting an annual growth rate of -28.9 percent in 2010 Q1, which reveals the substantial adjustment in the construction sector. The assumption of slower dynamics of the two above-mentioned components in the second quarter of the year may be substantiated by the less tight real lending rates, which remained on the downtrend manifest in the previous quarter. In this context, medium- and long-term loans to legal entities and long-term loans to households post positive quarter-on-quarter growth rates[94].

The positive and increasing quarterly growth rates of exports (12 percent[95]) were under the impact of the rebound in external demand in 2010 Q1[96]. High demand for intermediate goods and commodities used in export production[97] was one of the factors that generated the 8.9 percent quarterly rise in imports in 2010 Q1,

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91 The slightly positive dynamics was visible given that gross fixed capital formation was the GDP component undergoing the highest change in 2009 versus 2008, dropping 31.4 percent, the largest decline in quarterly growth rates (-32.3 percent) being recorded in 2009 Q2.

92 The annual change stood at -29.9 percent in 2009 Q4.

93 In 2009, the annual growth rate of investment in new construction works were indicative of a sharper decline, the figures reported in Q2, Q3 and Q4 being of -8.6 percent, -17.9 percent and -22.6 percent respectively.

94 The stock of these loans increased by 0.7 percent in real terms in April and May 2010 as against the average for 2010 Q1, while the annual growth rate remained in negative territory (-2.0 percent in 2010 Q2 as compared with the 2009 Q2 average).

95 In 2009 Q4, the quarterly growth rate of exports of goods and services stood at 0.7 percent.

96 Euro area GDP continued to rise (0.2 percent quarter on quarter), after posting a 0.1 percent rate of increase in the preceding quarter (seasonally adjusted data), while euro area imports, an alternative measure of external demand, advanced by 4 percent quarter on quarter versus 1.2 percent in 2009 Q4.

97 Imports of commodities and intermediate goods rose by 14.6 percent and 12.3 percent respectively in 2010 Q1 versus the prior quarter (seasonally adjusted data expressed in euro).

after seven consecutive quarters of decline[98]. Import dynamics was also fuelled by the real appreciation of the leu in the preceding quarters. In 2010 Q2, the effects of the aforementioned factors are expected to be further manifest, indicating that exports slightly exceeded the medium-term trend, while imports stayed close to the medium-term trend.

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

In 2010 Q2, the domestic currency weakened against the euro, thus partially reversing the appreciation tendency seen in the previous quarter. The depreciation of the leu against the US dollar was more significant, reflecting the appreciation of the US dollar against the euro. In this context, during the reported quarter, the leu depreciated markedly, in terms of nominal effective exchange rate[99]. Given the faster increase of domestic prices than that of external prices, the depreciation of the leu in real effective terms was slightly lower than that in nominal terms.

Over 2010 Q2, investor sentiment towards countries facing vulnerabilities associated with future public finances developments[100] worsened sharply and, via expectations regarding the contagion effect, had a negative impact on the movements in exchange rates of regional currencies. Pessimistic expectations concerning the pace of economic recovery in EU Member States contributed to the deterioration in international financial market sentiment as well.

As far as Romania was concerned, the worsening of investor sentiment was related to the uncertainties surrounding the authorities' capability to manage the budget deficit along the coordinates of the loan agreement concluded with the EU, the IMF and other international financial institutions. Moreover, GDP data for 2010 Q1 indicated a deepening of the recession and led to the shaping of negative expectations regarding the developments for the year as a whole. The aforementioned factors contributed to a gradual depreciation of the leu in nominal terms, which became more pronounced at end-June, when the quotations published by the NBR exceeded the historical high recorded in January 2009, amid the uncertainties surrounding the measures to be implemented with a view to ensuring public finance sustainability over the medium term.

[98] In 2009, the quarterly growth rates of imports were negative and stayed on a downtrend (in absolute terms): Q1 (-6.3 percent), Q2 (-4.5 percent), Q3 (-1.9 percent) and Q4 (-1.4 percent).

[99] 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.

[100] Risks are notable especially in Greece, but also in Spain and Portugal.

The impact of developments in the real effective exchange rate on economic activity is estimated via the net export channel and the wealth and balance sheet effects. As for the net export channel, the leu depreciation in real terms recorded in 2010 Q2 is assessed to exert a stimulative influence on net exports and, implicitly, on future aggregate demand. By contrast, via the wealth and balance sheet effects, the softer leu will have a restrictive impact on aggregate demand, with higher repayment costs expressed in leu for the loans in foreign currency. In 2010 Q2, the cumulative effect of the exchange rate of the leu on future economic activity via these channels is estimated to be stimulative. At the same time, higher quarter-on-quarter readings of the nominal exchange rate contribute, *ceteris paribus*, to pushing up consumer prices via an increase in import prices.

Over 2010 Q2, interest rates applied by credit institutions to their non-bank clients declined significantly. This adjustment was influenced by the successive cuts in the policy rate in the preceding quarters and the lower interbank market rates.

Inflation expectations for 2010 Q2 are assessed to remain broadly unchanged from the previous quarter[101]. Consequently, the reductions in nominal lending and deposit rates were transmitted almost entirely to real interest rate dynamics. These developments reveal a relative mitigation of the restrictive effect of interest rates applied by credit institutions to their non-bank clients on future economic activity.

The cumulative effect of the leu exchange rate and interest rates applicable to non-bank clients in 2010 Q2 on future aggregate demand is estimated to be slightly stimulative compared with the previous quarter, when it was assessed to be neutral.

1.3.3. Demand pressures within the projection horizon

According to the baseline scenario, the negative output gap is expected to widen even further throughout the projection horizon, compared to the level published in the May 2010 Inflation Report. The widening of the negative output gap is the result of both the reassessment at the starting point[102] of the projection and the substantial change, in some cases, of the foreseen evolution of fundamentals. The anticipated adjustment of the structural budget deficit[103] projected for the following eight quarters and the negative

[101] The VAT rate increase as from 1 July 2010 is estimated to have no impact on inflation expectations for 2010 Q2, as this measure was announced in the last week of June.

[102] 2010 Q3.

[103] Details on the relation between the change in the structural balance and the economic cycle are presented in Box 1 in the November 2008 Inflation Report.

deviation from the trend of external demand for Romanian products (in the first part of the projection horizon) will foster the persistence of demand shortfall, while the real broad monetary conditions are anticipated to have a less restrictive impact than in the previous Inflation Report.

The projection envisages persistently low levels of total final consumption in the first part of the projection horizon due to the restrictive effects of the measures[104] implemented by the government with a view to restoring budget balance, whereas, in the latter part of the projection horizon, total final consumption is seen to pick up as a result of the gradual restoration of confidence in the economy[105], in line with the stronger signals of coming out of the recession and the relative easing of financial constraints.

The current baseline scenario envisages a gradual recovery of gross fixed capital formation. However, especially in the first part of the projection horizon, it will be slowed down by the tight lending conditions and standards applicable to corporate loans and by the low capacity utilisation rate in comparison with the pre-recession period[106], as well as by the persistent consumer demand shortfall and the sluggish recovery of external demand. In the latter part of the projection horizon, the capacity utilisation rate is anticipated to improve to levels sufficiently high so as to mitigate the risks associated with new corporate investment, whereas consumer demand is expected to show signs of a sustainable upturn. Accordingly, starting with the second part of 2011, gross fixed capital formation is expected to make a positive contribution to real GDP growth.

The current projection anticipates a positive contribution of real exports to domestic economic activity, larger this year and smaller in 2011, compared to the previous round. In the first part of the projection horizon, the dynamics of Romanian exports will be boosted by the foreseen stimulative effect of the real exchange rate[107], while in the latter part of the projection horizon the external

[104] For example, substantial wage cuts in the public sector, higher VAT rate and broader tax base.

[105] The consumer confidence indicator is expected to pick up in step with the economic recovery under the impact of the macroeconomic policy mix aimed at restoring macroeconomic equilibrium. This will result in households' shift to consumption rather than saving, as well as slower recovery in central government consumption than in household consumption.

[106] According to the survey conducted by the European Commission, the capacity utilisation rate in the economy dropped following the fallout from the economic crisis from 81 percent in 2008 Q2 to 69 percent in 2009 Q4, to stabilise around 70 percent in 2010 Q1 and Q2.

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

demand for Romanian products is seen to be lower[108] than in the previous projection due to the modest economic growth envisaged for the euro area. In 2010, the current account deficit as a share to GDP is expected to widen at a moderate pace, largely on account of the unfavourable revision of the assumption regarding the dynamics of current transfers balance. Over the projection horizon, an anticipated higher domestic demand would be sustained by a rise in imports of consumer goods, commodities, intermediate and capital goods, which will largely make up for the foreseen growth of exports; therefore the current account deficit is projected to widen gradually but still remaining close to a sustainable level.

The deviations in real interest rates on lei-denominated loans and deposits[109] from the trend will have a stimulative impact on aggregate demand throughout the projection horizon, the impact being expected to be larger in the first part of the interval, due to a higher inflation rate fuelled by VAT rate hike and, therefore, to a repositioning of expectations regarding higher inflation rates. Both the positive deviation of the real effective exchange rate from the trend via net exports (for the first part of the projection horizon) and the negative deviation of the real interest rates on foreign currency-denominated loans and deposits are expected to contribute to the stimulative impact on aggregate demand. In this context, the set of real monetary conditions would be shaped by an adequate calibration of the NBR policy rate set to counter potential second-round effects of the VAT rate hike. This would create favourable conditions for the core inflation annual rate, recalculated by excluding from the CORE2 index the first-round effects of the VAT rate hike and the dynamics of tobacco prices, to stay around 2 percent during most of the projection horizon. The baseline scenario sees such a growth in the annual rate of CORE2 inflation as compatible with the monetary policy commitment of the annual CPI inflation rate reverting close to the medium-term targets, starting with 2011 Q3, when the first-round effect of the VAT rate hike has dissipated.

The recently adopted fiscal policy measures aimed at achieving fiscal consolidation have a decisive impact on the coordinates of the current macroeconomic projection. One of the key assumptions of the baseline scenario consists in maintaining fiscal policy indicators within the limits of the obligations assumed under the IMF-EU-IFI-led arrangement signed by

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

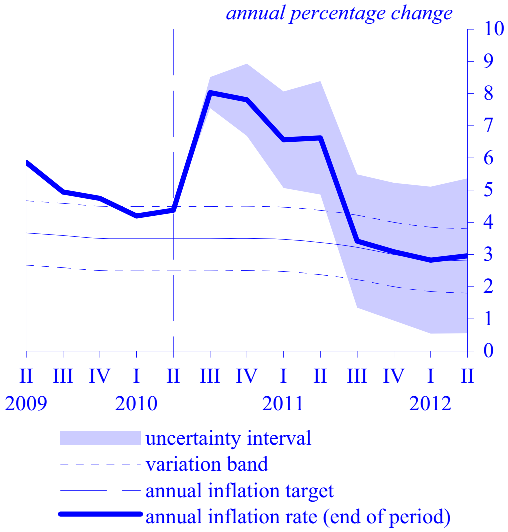
[109] The stimulative impact of lower interest rates on aggregate demand is only a price effect which is expected to be alleviated considerably, at least during the current year, by the more pronounced quantitative effect of the foreseen tighter conditions in the case of loan interest rates or by increased saving in the case of deposit interest rates.

Romania in April 2009 and updated in June 2010[110], during the carrying through of the arrangement[111]. As compared to the previous year, the sharper widening of the negative output gap[112], along with the anticipated adjustment of the cyclical and structural deficit, requires a significant correction of the structural deficit in 2010 and 2011. In this environment, the fiscal impulse in the current scenario is projected to have a more restrictive impact on aggregate demand compared to the May 2010 Inflation Report in both years.

1.4. Risks associated with the projection

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario

annual percentage change



Source: NIS, NBR calculations

The chart illustrates a quantifiable measure of the uncertainty associated with the inflation projection in the baseline scenario. Since the assessment takes into account past CPI inflation forecast errors, its prospective value in terms of monetary policy analysis is therefore limited. For a better understanding of risks and uncertainties surrounding the current projection round, due consideration should be given to several risk factors deemed relevant over the upcoming period, including in terms of the forecasted monetary policy stance.

As a general assessment, the distribution of risks to inflation developments is deemed asymmetrical, with the likelihood of the annual inflation rate running above the baseline scenario trajectory prevailing. A relatively higher likelihood is associated with a downward deviation of economic growth from the baseline scenario readings. Although the uncertainties afflicting the external economic environment remain high, those surrounding domestic developments prevail in the current projection round.

Romania's compliance with the commitments set under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions remains a necessary anchor at the current juncture. The June revision of the financing arrangement called for the reconfiguration of fiscal policy coordinates compared to the previous round. In terms of the fiscal consolidation envisaged for the upcoming years, there are significant uncertainties associated both with the authorities' ability to actually implement the measures required for sustainably narrowing the budget deficit in

[110] The coordinates of the current projection did not incorporate other changes in the parameters of the arrangement that are likely to emerge at a later date.

[111] The fulfilment of this commitment is expected to have a downside impact on foreign investors' risk perception towards Romania, as well as on the exchange rate volatility, which will boost domestic economic activity via the wealth and balance sheet channel and the restoration of confidence in the economy.

[112] Affecting the cyclical component of budget deficit.

line with the Accession Treaty and the impact of such measures on domestic economic activity.

The unpredictable nature of fiscal policy is generally a permanent source of risks and is highly relevant over the reference period of the current projection. Higher transparency and predictability in the fiscal area would help strengthen the confidence of the business community and consumers alike, which would find it easier to prepare business plans and take consumption decisions respectively. At the same time, the private sector might benefit by the potential cut in financing costs, as commercial banks adjust their lending standards in line with the lower overall risk associated with economic developments. Thus, assuming that the measures to restore the budget balance – which mainly affect the income of public sector staff and public sector employment – are kept in place over longer time spans, faster economic recovery driven by the private sector would help strike a balance on the labour market, also by reinserting some of the people made redundant into the labour force.

In close connection with the aforementioned risks surrounding fiscal developments, the balanced financing of the budget deficit – with a major role played by the domestic market – is all the more important judging by public sector financing constraints on the external market at reasonable volumes and costs in terms of external debt sustainability. Against this background, the risk of a partial crowding-out of the private sector from the bank credit market by the public sector cannot be ruled out, given the external financing constraints facing commercial banks, on the one hand, and the subdued domestic saving, on the other. Within a macroeconomic environment plagued by relatively scant and/or costly financial resources, any slippage in budget parameters from the coordinates agreed with international institutions might translate into the deterioration of investor sentiment on public finance sustainability. This would put considerable pressure on the domestic currency, which would have a detrimental impact on disinflation performance compared to the baseline scenario of the projection.

Similarly to the previous forecasting round, the calendar and magnitude of adjusting some key categories of administered prices (water, sewerage, waste disposal, heating, etc.) are still fraught with major uncertainties, although there is a higher probability for upward adjustments. Along with their direct contribution to inflation, these price hikes could entail indirect adverse effects on the other price categories, by raising economic agents' production costs and kindling inflation expectations. Given the current budget constraints, there is a high likelihood that some of these adjustments will be made over a relatively short horizon. Thus, in the absence of a formal stand clarifying the issue, the uncertainties associated with the baseline scenario remain high.

Given the adverse weather conditions (floods) that have recently hit several agricultural areas of the country, their impact on food price dynamics over the upcoming quarters is difficult to quantify accurately. The assumptions incorporated in the baseline scenario took into account a significantly larger inflationary contribution from this CPI inflation component, particularly for the current year. However, at the current juncture, the absence of data on the magnitude of damages or the effect on food prices calls for relative cautiousness in terms of estimates, as the associated risks to inflation can be easily underestimated from this point of view.

According to the baseline scenario of the current projection, the annual CPI inflation rate will return within the ±1 percentage point variation band around the central target at the end of 2011. As mentioned in the previous sections as well, this hypothesis is strictly conditional on the absence of any significant deviation of the trajectory of exogenous variables from the baseline scenario coordinates as well as on the efficient anchoring of inflation expectations, which are envisaged to revert in 2011 close to the inflation targets for next year. Given the projected macroeconomic environment, amid the second-round effects of the VAT rate hike, any of the aforementioned risks materialising could validate and even fuel inflation expectations that might exceed the baseline scenario level for a longer time period.

External developments have stabilised somewhat since the previous Inflation Report thanks to crisis management efforts at international level and to the relative alleviation of the risk of contagion triggered by fiscal sustainability issues facing several European countries. However, the future dynamics of euro area economy is still subject to uncertainty, with either favourable or unfavourable developments ahead, which might send ripple effects to the domestic economy via specific channels. For instance, the faster-than-expected recovery of world economy and international trade flows could support a swifter revival of euro area economic activity, also entailing a favourable impact on domestic economic growth via the external demand channel. On the other hand, the resurgence of heightened tensions on financial markets would have a detrimental impact on the financing conditions for the economy and on economic agents' confidence, with a possible pass-through to the Romanian economy via the financial and exchange rate channels. In the latter case, adverse pressure on the domestic currency would most likely bring about an upward deviation of the inflation rate from the baseline scenario trajectory.

Volatility on global financial markets seems to have subsided lately, as the exchange rates of the major currencies have stabilised around their current levels, although their future trajectories are still uncertain. There are differences as regards the positioning of the leading world economies within the business cycle, specific vulnerabilities and different prospects of economic growth that might entail distinct developments in the exchange rates of major currencies, which in turn may affect the current projection. For instance, the EUR/USD exchange rate deviating from the assumption incorporated in the baseline scenario would induce significant differences in terms of the annual CPI inflation rate projection, particularly in the case of fuel prices. Another considerable risk to fuel price dynamics stems from future developments in oil prices on the international commodity market.

2. Policy assessment

In 2010 Q2, the consolidation of disinflation was stymied by the renewed pick-up in the annual growth rate of administered prices and the slight rise in the annual adjusted CORE2 inflation rate, whose trend remained however around 2 percent. Apart from certain unfavourable base effects, the above-mentioned developments reflected mainly the impact of the year-on-year increase in the exchange rate of the leu against the euro and especially the US dollar. Their influence on the consumer price index was only partly countered by the relatively sharper deflation of volatile food prices as well as the relative step-up in demand-pull disinflationary pressures. Against this background, in June 2010, the annual inflation rate exceeded only slightly the March reading (4.38 percent from 4.20 percent). However, it remained within the variation band around the central target throughout the second quarter of 2010; in addition, the average quarterly inflation rate continued to go down, confirming the coordinates of the central bank's most recent quarterly forecast (May 2010 Inflation Report).

The updated medium-term forecast reveals however an abrupt deterioration of the short-term inflation outlook, including against the previous expectations, given the VAT rate increase to 24 percent (from 19 percent) as from 1 July 2010. The Romanian authorities took this decision in June, given the imperative of the fast implementation of a substantial set of additional fiscal consolidation measures needed to further keep the multilateral external financing arrangement signed with the EU, the IMF and other IFIs on track. Against this background, the projected annual inflation rate in 2010 Q3 rises sharply before falling gradually over the next three quarters; therefore, its trajectory is significantly above the upper limit of the variation band around the central target until the end of the first part of the projection horizon. After the fading out of the first-round effect of the VAT rate hike, expected for 2011 Q3, the projected annual inflation rate will see a strong downward correction and, implicitly, will resume its convergence towards the central target (3 percent).

Although significant, the foreseeable deviation of the annual inflation rate from the December 2010 target does not entail an upward revision of the latter. This approach, upheld in fact both by theory and central banks' practice over the past decades relies chiefly on the temporary and, at the same time, corrective nature of the deviation of inflation rate from the target, as a result of adverse supply-side shocks, triggered mostly by the VAT rate hike, which are factors beyond the scope of monetary policy. Another reason behind this approach is the need for preventing longer-term inflation expectations from becoming unanchored by maintaining the NBR's commitment to inflation targets and reaffirming central banks' focus on the medium-term target, which is the one within the control of monetary policy instruments given the time lag for an effective transmission of policy impulses to price dynamics.

The approach seeks also to counteract the second-round effects of the VAT rate increase. The risk of these effects materialising – via the significant worsening of inflation expectations in the near run, which may affect the price and wage setting behaviour over the longer term – is the major concern of the central bank at the current juncture. This concern is magnified by the unprecedented scale of the inflation flare-up the VAT rate hike might induce given the very large share of goods and services subject to the standard VAT rate in the CPI basket[113], on the one hand, and the potentially strong impact of this indirect tax hike on certain prices, on the other hand. However, the magnitude of the pass-through of the VAT rate increase is expected to be contained by a number of factors such as: (i) price elasticity of demand for certain goods and services, combined with expected developments in households' disposable income, (ii) the particularities of the market where the suppliers of those goods and services operate, and (iii) the producers' and retailers' profit margin and its potential change in terms of minimising the decline in turnover amid the persistence of weak aggregate demand.

Against this background, the uncertainty associated with the current inflation forecast is very high, especially over the first part of the projection horizon. To anticipate the magnitude of the direct impact of the VAT rate increase on the consumer price index is all the more so difficult as the relevance for this endeavour of recent, similar experiences of other countries is doubtful given the relatively low comparability of the specific conditions and behaviours. Nevertheless, the protracted contraction of the Romanian economy and, implicitly, the persistence of the

[113] Accounting for about 90 percent of the CPI basket.

aggregate demand shortfall are important prerequisites for an incomplete VAT rate hike pass-through to the consumer price index.

Great uncertainties are also related to the manifestation of the second-round effects of the VAT rate increase, as well as to their possible magnitude. The likelihood of this risk to materialise or of the scale of such effects to augment might be considerable assuming the occurrence of multiple supply-side inflationary shocks in the foreseeable future, which might thus confirm the higher inflation expectations. So far, the shocks induced by the ongoing adjustment of some administered prices and the rise in the fuel price, with the latter chiefly due to a possible appreciation of the US dollar versus the euro, are relatively certain. These effects might overlap however with the impact of higher prices of certain commodities on foreign markets and with the increase in some (particularly volatile) food prices given the expected farming losses caused by the recent floods and unfavourable weather conditions. Moreover, the likelihood of additional adjustments of administered prices by the authorities in the following quarters might also have a significant adverse impact.

Under these circumstances, the major concern of the monetary authority is to ensure a firm anchoring of inflation expectations, which is essential in preventing the occurrence of/increase in second-round effects of the VAT rate hike and of other supply-side shocks, and implicitly in reducing the magnitude and duration of the annual inflation rate deviation from the path consistent with the achievement of the medium-term inflation target. In order to be effective, the central bank’s firm action in this direction – reflected especially by the adoption of a prudent stance of monetary policy – should be backed by the economic policy mix being kept in compliance with the coordinates agreed upon with the IMF and the EU, which requires a pick-up in both the pace of structural reforms and fiscal consolidation efforts.

At the same time, the persistence of a significant aggregate demand shortfall is expected to have a considerable stifling impact on inflation expectations, the second-round effects of the VAT rate hike included. Thus, according to the updated forecast of medium-term macroeconomic developments, which is still marked by high uncertainties, the annual GDP dynamics’ return to positive territory is delayed yet again; therefore, the pace of economic recovery is anticipated to be slower than in previous projections, including as a result of implementation of additional fiscal consolidation measures by the authorities starting July.

In line with such prospects, the negative output gap appears set to extend its deepening trend until 2010 Q3 and stay high on a slight downtrend throughout the projection horizon. The relative pick-up in demand-side disinflationary pressures as a result of the aforementioned evolution is however hardly detectable over the first half of the updated trajectory of the annual adjusted CORE2 inflation forecast which incorporates expected first- and second-round effects (the latter at residual level) of the VAT rate increase. Demand-side disinflationary pressures become obvious after the impact from this indirect tax hike fades, with the updated trajectory of the annual adjusted CORE2 inflation forecast sliding to substantially lower levels over the second half of the projection horizon. The trajectory is nevertheless slightly above the readings resulting from the previous forecasting round, also due to expectations of a relatively higher RON/EUR exchange rate.

The annual GDP dynamics is seen remaining in negative territory in 2010 H2 as well, which is indicative of a relative widening of the demand shortfall. The major prerequisites and signs for such a performance are the following: (i) modest and uneven recovery of euro zone economy in 2010 H1 considering the highly uncertainty-ridden environment; (ii) a slightly larger-than-expected decline in quarterly GDP in 2010 Q1; (iii) the maintenance/relatively slow drop of the negative annual dynamics of a number of relevant indicators on consumer and investment demand over the first months of 2010 Q2; and (iv) further feeble lending to the private sector, along with still robust household demand for money for precautionary reasons.

Economic contraction will persist over the following two quarters and will most likely retain its pattern seen in the first part of this year, given that such an evolution is estimated to be the result of a sluggish revival in domestic absorption. The outlook for private consumption demand and investment demand, the major components of domestic absorption, is however surrounded by uncertainties. Thus, the pace of recovery of private consumption demand will largely hinge on how strong the effect of the budget austerity measures recently implemented by the authorities[114] and of the higher VAT rate on household real disposable income will be, on the one hand, and the future developments in labour market conditions, remittances from abroad, as well as consumer credit supply parameters, on the other hand. A key, difficult-to-quantify determinant of the future consumer demand behaviour is consumer confidence, whose specific indicator has deteriorated abruptly of late. Assuming a quick recovery of consumer confidence, the tempo of private consumption revival could exceed expectations, possibly on the back of dissaving. An opposite effect might derive from the persistence, or even increase, of household concerns regarding job security prospects, especially in the budgetary sector, and their capability to honour the bank debt service.

[114] The major austerity measures are the following: the 25 percent cut in budgetary-sector wages, taxation of other salary-related incomes and financial investment incomes, start of layoffs in the public sector.

The pace of the annual investment dynamics' return to positive territory is highly uncertain, including due to the unpredictable nature of the impact of fiscal consolidation measures on investment, particularly via the response and behaviour of consumer demand. The features of the recovery of investment demand will also hinge on the current and future developments in corporate profits, the spare capacity in some industrial sectors, as well as the real-estate market evolution. Nonetheless, for investment to bounce back, the business confidence, which has worsened markedly recently, the same as consumer confidence, is crucial. If business confidence improves considerably, also as a result of receding risks to macroeconomic and financial stability following the stepped-up efforts aimed at fiscal consolidation, the reinvigoration of investment, at least in terms of inventories, could proceed at a relatively faster pace.

Such an evolution is however largely conditional upon the improvement in corporate financing conditions. So far, this improvement is hardly detectable across local credit institutions, whose reluctance to lending is still fuelled by fears associated with the persistent worsening of their loan portfolios as well as by the concern for a sustainable reduction in the loan-deposit ratio. Looking ahead, banks' prudence may well increase assuming a further deterioration of their risk perception on economic sectors and types of debtors, including as a result of implementing budget austerity measures. In this context, the weakness in demand for loans might also linger on.

The prospects of external financing for companies are also uncertain, as they depend, *inter alia*, on the external environment perception regarding domestic political, social and economic developments, especially the outcome of fiscal consolidation measures that are essential to restore confidence in the Romanian economy. Nevertheless, investment dynamics could be spurred by a potential increase in public investment, namely in outlays for rebuilding the infrastructure damaged by the recent floods, over the short term, and in expenses financed via EU funds and resources provided by international financial institutions and bodies, over the medium term. Such an outlook however is contingent upon the relative reduction in current budgetary expenditures so as to meet fiscal commitments.

The restoration of demand for investment might also be supported by a possibly stronger rebound in external demand, chiefly in export-oriented sectors. Such a prospect is suggested by the robust increase in Romania's exports over the past few months and the ensuing incentive provided to industrial production. Still, the future recovery of advanced economies, especially those in the euro area, is surrounded by great uncertainties stemming largely from the possible effects of implementing and expanding the authorities' budget restraints in response to the unprecedented increase in budget deficits and sovereign debts. Adding to these uncertainties is the risk of a potential resurgence in tensions on international financial markets, which may have adverse effects on financing conditions and confidence.

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 IFIs is essential for a solid anchoring of inflation expectations and hence for resuming and subsequently consolidating disinflation, along with restoring confidence and ensuring a sustainable revival of economic activity. From this perspective, the major risk looming at the current juncture is a possible deviation of fiscal policy from the programme coordinates, arising from the prospects of a relatively slower economic recovery as well as from the uncertainties surrounding the efficacy of additional budget austerity measures taken by the authorities. This could entail the delay or the postponement of fiscal consolidation. In the event of this risk materialising, not only the short-term performance of the leu exchange rate and, in turn, the inflation rate could be adversely affected – given the likely worsening of the external financial environment perception regarding the future economic developments –, but also the tempo of a sustainable recovery of the economy and its growth potential in the medium term could be hurt as well.

Considering that, against this background, the priority of monetary policy is the solid anchoring of inflation expectations and, hence, the countering of potential second-round effects of the VAT rate increase, the Board of the National Bank of Romania has decided in its meeting of 4 August 2010 to keep unchanged the monetary policy rate at 6.25 percent per annum. Moreover, the Board has 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. The Board of the National Bank of Romania aims, via the adopted measures, to ensure appropriate real broad monetary conditions in order to firmly anchor inflation expectations and to maintain the annual headline inflation rate, recalculated by excluding the first-round effect of the VAT rate hike, on a path in line with medium-term inflation targets. In this context, the Board of the National Bank of Romania has reiterated that the resumption of disinflation and restarting sustainable economic growth critically hinge on a firm implementation of fiscal consolidation measures, structural reforms and on improved absorption of EU funds, in line with the commitments set under the multilateral external financing arrangement with the European Union, the International Monetary Fund and other international financial institutions.