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N O T E

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

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Foreword

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

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

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

Inflation Report *was approved by the NBR Board in its meeting of 3 May 2011 and includes data available until 26 April 2011.*

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

ABBREVIATIONS

ACSI	Authority for Coordination of Structural Instruments
AER	annual effective rate
AMIGO	Household Labour Force Survey
APIA	The Agriculture Payments and Intervention Agency
BSE	Bucharest Stock Exchange
CCR	Central Credit Register
CD	certificate of deposit
COICOP	Classification of Individual Consumption According to Purpose
CPI	Consumer Price Index
ECB	European Central Bank
EFSF	*European Financial Stability Facility*
EIA	Energy Information Administration (within the U.S. Department of Energy)
Eurostat	Statistical Office of the European Communities
FED	Federal Reserve System
FOMC	Federal Open Market Committee
GFCF	Gross Fixed Capital Formation
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IFI	international financial institution
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MFI	monetary financial institution
MPF	Ministry of Public Finance
NAFA	National Agency for Fiscal Administration
NBR	National Bank of Romania
NCP	National Commission for Prognosis
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	Overnight
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
1W	one week
12M	12 months

Contents

I. SUMMARY

Developments in inflation and its determinants

In March 2011, the annual CPI inflation rate stood at 8.01 percent, 0.05 percentage points above the level seen in December 2010 and 1.2 percentage points above that forecasted in the February 2011 Inflation Report. The major factor which prevented inflation from declining in 2011 Q1, as envisaged in the baseline scenario presented in the previous Inflation Report, was that some of the significant risks mentioned in that Report materialised. Specifically, substantial increases in international food and fuel prices were recorded, which fed through to domestic consumer prices.

The pass-through of adverse shocks on global agri-food markets added to the increase in local producer prices of certain food items that was caused by weak domestic supply following unfavourable weather conditions during 2010, as well as by structural dysfunctions in the internal market. All these led to a notable rise in both volatile food prices and the prices of processed food items included in the adjusted CORE2 index[1].

The rise in the global oil price, against the background of escalating tensions in North Africa and the Middle East, along with that in the international prices of other non-food commodities, triggered additional effects on consumer goods prices.

The cluster of adverse shocks led to higher inflation expectations during 2011 Q1, with a detrimental impact on disinflation. Moreover, the first-round effect of the VAT rate hike starting in July 2010 has yet remained significant for the annual CPI and adjusted CORE2 inflation levels.

The persistence of a negative output gap and the moderate nominal appreciation of the leu against both the euro and, to a larger extent, the US dollar, together with the base effect on the annual dynamics of tobacco prices, helped mitigate the unfavourable influences on the annual inflation rate in Q1. In addition, there were no inflationary pressures stemming from wage costs in the period January-February 2011. The rise of gross wages industry-wide lagged behind that of labour productivity, which led to a faster annual decline in unit labour costs in the above-mentioned period.

Monetary policy since the release of the previous Inflation Report

On 3 February 2011, the Board of the National Bank of Romania decided to leave unchanged the monetary policy rate at 6.25 percent per annum. Behind this decision stood the need to preserve the prudent monetary policy stance with a view to mitigating the risks induced by the factors outside the central bank's influence that could prevent inflation rate from returning to a trajectory converging towards its medium-term targets.

Some of the risks identified in the updated macroeconomic forecast underlying the monetary policy rate decision of 3 February 2011 have subsequently materialised, as the sharp increases in global food and fuel prices fed through to domestic consumer prices. Moreover, the analyses made by the NBR staff highlighted a broad range of risks that were still relevant and even

[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: administered prices, volatile prices (of vegetables, fruit, eggs and fuels), tobacco and alcohol prices.

intensifying. At the same time, developments in economic activity revealed prospects for resuming economic growth in 2011 and for a gradual reduction of disinflationary pressures coming from the negative output gap.

Against this background, in its meeting of 31 March 2011, the Board of the National Bank of Romania restated the need to maintain a prudent monetary policy stance in a bid to firmly anchor inflation expectations. Therefore, the decision was taken to keep the monetary policy rate unchanged at 6.25 percent per annum and the minimum reserve requirement ratio on credit institutions' leu-denominated liabilities at 15 percent. Concurrently, the Board decided to lower the minimum reserve requirement ratio on foreign currency-denominated liabilities to 20 percent from 25 percent starting with 24 April in order to continue the gradual alignment to the European Central Bank standards in the field. At the same time, the Board initiated analyses regarding the possible adoption of prudential measures aimed at containing the growth in foreign currency loans to unhedged borrowers.

Inflation outlook

The updated projection envisages the annual inflation rate remaining at levels above the upper limit of the variation band around the 3 percent target until 2012 Q1, owing to the significant adverse foreign and domestic supply-side shocks that occurred in 2010 and early 2011.

In 2010 Q4, the year-on-year contraction in real GDP was far lower than that seen in the previous quarter, also as a result of a slight recovery on a quarterly basis. For 2011 Q1, the signals conveyed by certain sectoral indicators on economic activity suggest a possible consolidation of quarterly real GDP growth. Under the circumstances, economic growth is envisaged to return to positive territory in 2011 and gain momentum in 2012 amid the rebound in investment and the further rise in exports, which will have over time a favourable impact on private consumption. The moderate pace of economic growth will imply a mild widening of the balance-of-payments current account deficit by the end of the reference period, which is not however expected to generate significant inflationary pressures from the leu exchange rate. Against this background, disinflationary pressures are expected to be persistent throughout the projection horizon, but declining in magnitude following the gradual decrease in the negative output gap.

For end-2011, the baseline scenario of the current projection places the annual CPI inflation rate at 5.1 percent, 1.5 percentage points higher than the level in the February 2011 Inflation Report and 1.1 percentage points above the upper limit of the variation band around the 3 percent target. For end-2012, the inflation rate is forecasted to stand at 3.6 percent, 0.4 percentage points higher than the previously projected level, but still within the variation band.

After temporarily accelerating in 2011 Q2 under the impact of supply-side shocks affecting most emerging economies, the projected dynamics of annual CPI inflation and CORE2 inflation are expected to follow a sharply downward trend until early 2012. The fading out of the first-round effect of the VAT rate hike will play a major role in curbing the CPI inflation rate from an expected 8.7 percent in 2011 Q2 to 5.6 percent in 2011 Q3. In the second part of the forecasting horizon, the CPI inflation rate is projected to return and remain within the variation band around the central target, while the CORE2 inflation rate is envisaged to remain below 3 percent.

The significant upward revision of the projected path of the annual inflation rate in 2011 is largely the result of sizeable increases in international prices of food and non-food commodities, oil included. Given the magnitude of these shocks, the projected contributions to the CPI inflation rate are larger than in the previous forecast for both exogenous components (volatile and administered prices) and the CORE2 index.

The CORE2 inflation forecast is adversely affected not only by commodity price increases, but also by the ensuing upward revision of inflation expectations as well as the projection of an additional effect from the price dynamics of tobacco products in 2011 Q2. Moreover, having revised the negative output gap to relatively lower levels for the first part of the projection horizon also implies lower disinflationary pressures than those considered in the previous forecast. The projected dynamics of import prices imply a smaller contribution to CORE2 inflation in 2011, due to a stronger leu against both the euro and the US dollar over the first half of the year, and a slightly larger contribution in 2012.

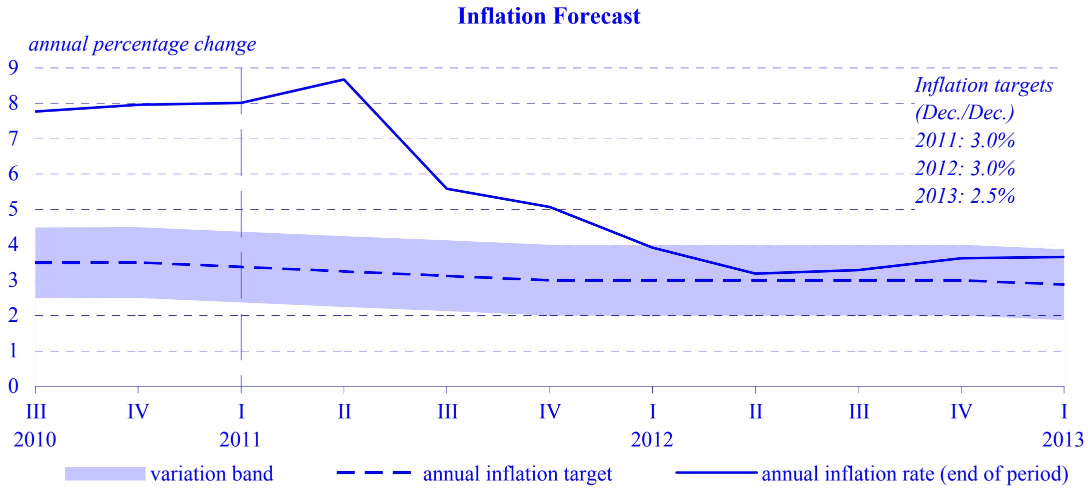
With the aim of enhancing the prospects of resuming disinflation in the medium term, the monetary policy rate will follow a trajectory in line with maintaining the broad real monetary conditions adequate to prevent second-round effects of such shocks from becoming manifest. Furthermore, ensuring the external and internal equilibria of the economy is strictly conditional on the other macroeconomic policy mix components cooperating with the monetary policy, through consistent implementation of the economic programme for fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank.

Similarly to previous forecasting rounds, the uncertainty associated with the current projection is high. Although some of the risks detected in the February 2011 Inflation Report have already materialised, sources generating additional risks remain highly relevant. Hence, the overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to remain significantly tilted to the upside.

This is due to both domestic and external risks. Among the former, a considerable risk arises from the possible adjustments in administered price structure and dynamics. In the absence of a calendar and of quantitative coordinates publicly committed to by the relevant authorities, the baseline scenario of the projection builds on conservative assumptions regarding administered price dynamics. However, the recurrent delays in some of these adjustments, along with the commitments implied by Romania's EU membership and those agreed under the arrangements with the European Union, the International Monetary Fund and the World Bank make it more likely that certain measures may be taken during the reference period that will impact considerably on the dynamics of administered prices.

Looking to the forthcoming election year, major risks stem from the fiscal policy stance and the structural reform programme. Any significant slippages from the coordinates agreed under the arrangements with the EU, the IMF and the World Bank, amid political or social pressures, would prove detrimental to the internal and external equilibria of the economy, entailing adverse effects on both inflation and economic growth.

Among the risks related to the external environment, the most relevant are those related to the ongoing tensions on global commodity markets, the vulnerability of the fiscal consolidation process and of external debt sustainability in several euro area countries, the imbalances that might be triggered by Romania's experiencing an increase in inflows of volatile capital over the reference period – which may also impose constraints on the dosage of monetary policy tools – as well as possibly major fluctuations in the EUR/USD exchange rate.



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

Source: NIS, NBR projections

Monetary policy decision

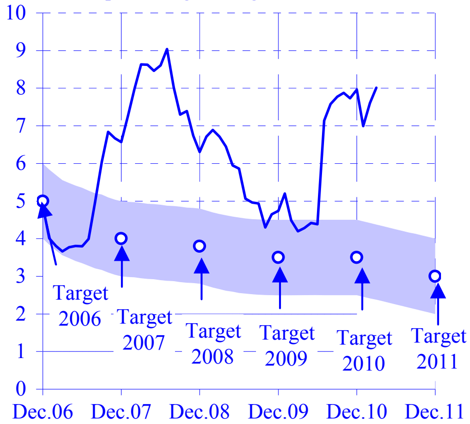
In view of the need to ensure a solid anchoring of inflation expectations given the relative worsening of the inflation outlook under the prevalent impact of adverse supply-side shocks and the additional risks to a sustainable resumption of disinflation following the possible increase in volatile capital inflows, the Board of the National Bank of Romania has decided in its meeting of 3 May 2011 to keep unchanged the monetary policy rate at 6.25 percent per annum. At the same time, the Board has decided to pursue 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. These decisions, along with the consistent implementation of commitments agreed by the Romanian authorities under the new financing agreements with international institutions, would ensure the preservation of prospects of a sustainable resumption of disinflation and a robust recovery of the Romanian economy during the nominal and real convergence process.

II. INFLATION DEVELOPMENTS

At end-2011 Q1, the annual CPI inflation rate stood at 8.01 percent, exceeding marginally the level reported at the end of the previous quarter. After narrowing somewhat in the first two months of 2011, the deviation of the inflation rate from the upper bound of the ±1 percentage point variation band around the 3 percent central target reverted to readings comparable to those seen in the previous period. Apart from the statistical effect induced by the hike in the value added tax rate in July 2010, the gap was also due to the sizeable increases in food prices, whose average monthly change (1.36 percent) stood above the Q1-related readings in the last eight years. The hikes were triggered by the wider imbalance between demand and supply on local and international agri-food markets, under the joint impact of incidental and structural factors. These factors had a bearing particularly on the dynamics of volatile food prices and, to a lower extent, on the annual adjusted CORE2 inflation rate[2] whose upward trend became more pronounced in the quarter under review.

Inflation Developments

annual percentage change



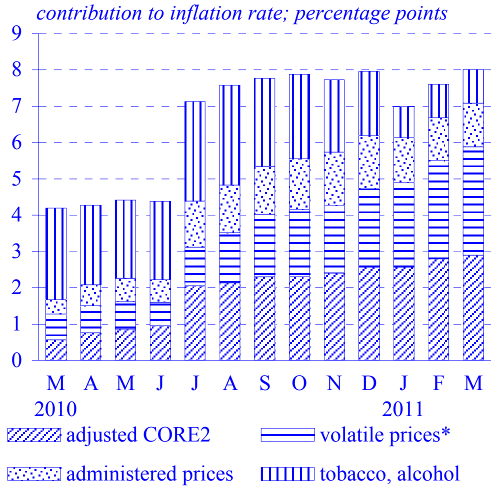
Note: Variation band is ±1 percentage point around the central target

Source: NIS, NBR calculations

Among the CPI main components, volatile food prices[3] saw the fastest annual growth rate, i.e. 28.2 percent in March (a seven-year peak for this group). The main explanation lies with the contraction of domestic and regional supply, caused by adverse weather conditions in the summer of 2010, which enhanced the effects stemming from the agri-food market structural dysfunctions (the drop in the number of cultivated lands, the closure of a significant number of warehousing areas, the delay in paying subsidies from the government budget, etc). Another driver of this development may have been the shift in consumers' preference for inferior goods, amid the lower disposable income (for instance, the price of potatoes increased by approximately 80 percent in annual terms). Above-average inflationary pressures were further visible in the case of fuels – the other component included in the group of products with volatile prices – given: (i) the change in two stages in the excise duties on fuels[4] and (ii) the hike in the international oil price[5] , which was only partly offset by the appreciation of the leu against the US dollar (+9.1 percent in March 2011 versus December 2010). Under the circumstances, at the end of Q1,

Annual Inflation Rate

contribution to inflation rate; percentage points



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

Source: NIS, NBR calculations

[2] Calculated by the NIS.

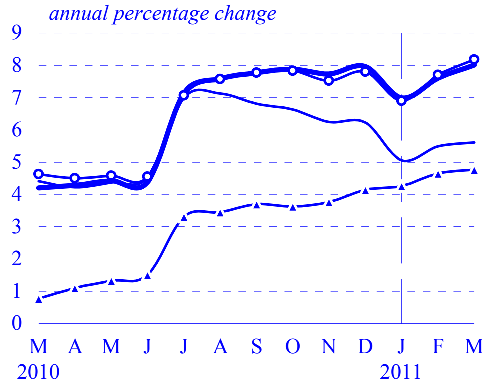
[3] The special aggregates calculated by the NBR (adjusted CORE2 components, administered price index, volatile price and volatile food price indices) were recalculated based on an aggregation methodology consistent with that used by the NIS.

[4] The excise duty was raised by about 3.3 percent in January 2011 and the cut in the excise duty on energy products with at least 4 percent fuel content was removed starting with 1 March 2011.

[5] The WTI crude oil price went up to USD 102.9/barrel in March 2011 from USD 89.1/barrel in December 2010, mainly as a result of escalating conflicts in the Middle East in the second part of the period under review.

Headline Inflation and CORE Inflation

annual percentage change



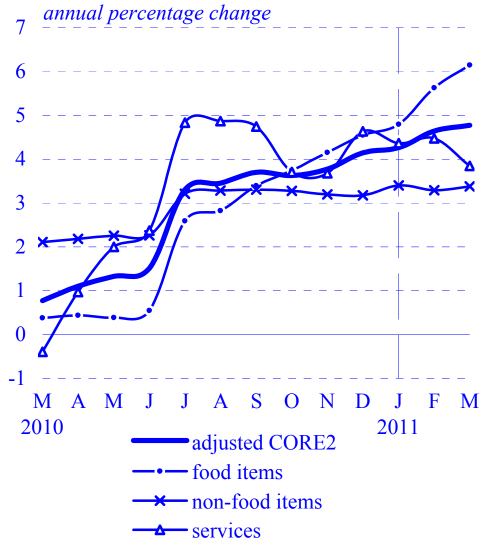
*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

Source: NIS, NBR calculations

Adjusted CORE2 Components

annual percentage change



Source: NIS, NBR calculations

volatile prices posted a 20.6 percent annual growth rate, making a 3 percentage point contribution to the inflation rate.

The annual dynamics of administered prices slowed down by almost 1.6 percentage points (in March 2011 versus December 2010) to reach 7.2 percent, given that, during the period under analysis, notable adjustments were made only to the prices of heating as well as water, sewerage and waste disposal services, whereas electricity and natural gas prices were kept unchanged.

The annual growth rate of tobacco prices witnessed a marked deceleration (-13.4 percentage points). However, the driver behind this evolution was the favourable statistical effect caused by the removal of January 2010[6] from the calculation period, rather than current developments. As a matter of fact, during the period under review, the prices of these products moved up by 2.4 percent from the end of the previous quarter, producers citing pressures from manufacturing costs and the decline in sale receipts.

The analysis of inflation from the viewpoint of the monetary policy influence further focuses on the adjusted CORE2 measure, which also excludes the change in the prices of excisable products. Adjusted CORE2 remained considerably below CPI inflation (approximately 5 percent in annual terms in March 2011), but it gained further speed amid new tensions on agri-food markets.

Recent developments in international commodity prices yielded significant effects on the food component included in the adjusted CORE2 measure, which made the largest contribution to the annual core inflation rate (further details see the Box in Chapter V. Inflation Outlook). The strong hike in external prices was determined by: (i) structural causes, such as the expansion of demand from emerging economies, amid the rise in incomes, the changes in the eating habits and the demographic trends (the rising number of population and increasing urbanisation), or the reallocation of a significant part of the agricultural output to biofuels production; (ii) cyclical causes, following the advanced economies' moving to an upward phase of the business cycle; (iii) incidental causes, having a bearing particularly in the short run, such as adverse weather conditions and the enforcement of protectionist commercial policies. The pass-through of these factors' joint influence into domestic prices, which was underpinned by the expansion of arbitrage practices given price mismatches between domestic and external markets, was accompanied by a drag on domestic supply from structural dysfunctions of the domestic agricultural market (high fragmentation of arable plots, the drop in the number of irrigated areas, the depreciation and obsolescence of the equipment in use,

[6] The hike in excise duties in January 2010 led to the largest monthly increase in tobacco prices over the last 11 years.

intermediation dysfunctions in the production and sales chain, etc.). Thus, the annual dynamics of prices gained momentum in all sub-groups of food items included in the adjusted CORE2 index, except for meat products, which are less responsive to external developments.

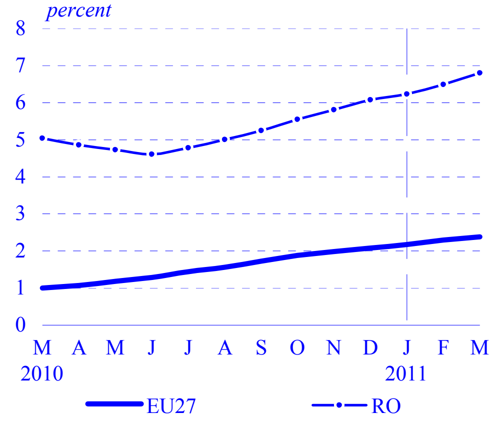
By contrast, the prices of non-food items included in the adjusted CORE2 measure continued to report the slowest annual change among CPI components, the 0.2 percentage point acceleration in March 2011 versus December 2010 notwithstanding. Behind this evolution stood the previously implemented staff adjustment measures – reflected by the decline in ULC –, the favourable evolution of the leu exchange rate against the euro[7], the moderate change in external prices of consumer goods[8], as well as weak support from domestic demand to producers[9]. These influences contained the impact from the rise in international prices of non-food commodities (cotton, wool, wood, metal, rubber).

Market services reported deflation in monthly terms throughout the period under review and disinflation in annual terms. The main determinants of this development were the sluggish demand and the appreciation of the national currency (reflected especially by the telephone rates and rents).

Inflation expectations formulated by managers in manufacturing, trade and services as well as by consumers[10] revealed a deterioration of perceptions on the future evolution of prices (particularly of those identified in the March survey). This trend may be explained by higher inflationary risks worldwide as well as by the recent inflation readings incorporated via inertial inflation expectations.

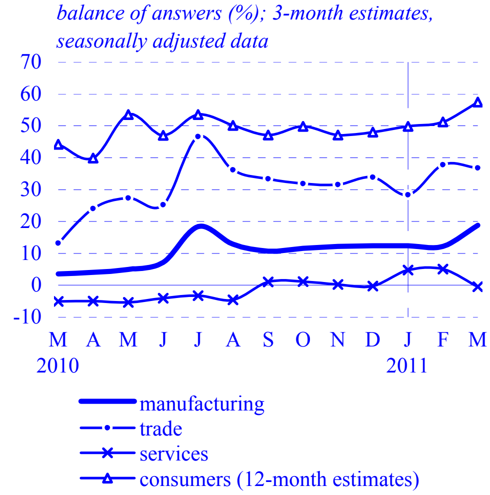
In March 2011, the actual annual inflation rate was 1.2 percentage points higher than the projection in the February 2011 *Inflation Report*. The deviation was attributed to the faster-than-expected rise in the prices of some exogenous components, especially volatile food prices, and fuel prices, whereas the error in forecasting the adjusted CORE2 inflation rate was marginal.

Average Annual HICP Inflation Rate



Source: Eurostat

Inflation Expectations of Economic Agents



Source: EC-DG ECFIN

[7] A 3.1 percent appreciation in March 2011 versus December 2010.

[8] Estimated based on EU15 industrial producer prices for non-domestic market.

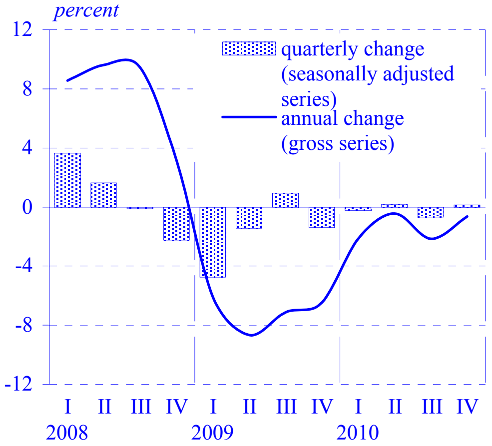
[9] The volume of receipts from retail trade in non-food items except for motor vehicles and motorcycles continued to decrease in annual terms, despite a slight upturn in January-February 2011 compared to the previous quarter (seasonally adjusted data).

[10] According to the NIS/EC-DG ECFIN Survey.

III. ECONOMIC DEVELOPMENTS

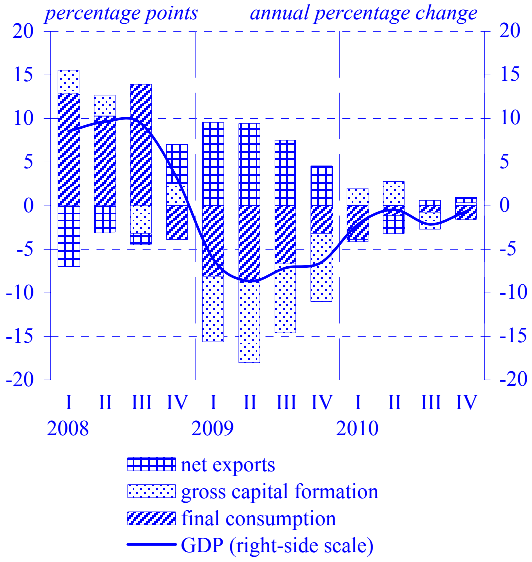
1. Demand and supply

Real Gross Domestic Product



Source: NIS

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

The fourth quarter of 2010 witnessed a slowdown in the annual rate of decline of real GDP to -0.6 percent from -2.2 percent in the previous quarter[11]. This outcome was ascribable to the slight recovery seen in the period under review (+0.1 percent compared to the previous quarter) and also to the base effect associated with the pronounced economic contraction in 2009 Q4 (-1.4 percent)[12].

The gap between the outcome and the December 2010 benchmark projection was marginal (0.1 percentage points) for both annual and quarterly dynamics.

The deceleration in the annual decline of real GDP was triggered by both domestic absorption and external demand. On the supply side, the slowdown in the annual pace of decrease of real GDP was brought about by industry, agriculture and construction.

Turning to the quarterly series of real GDP, gross fixed capital formation (+0.5 percent) was the only component with economic content that bolstered the frail recovery of the economic activity in Q4 (from -0.7 percent to +0.1 percent), while final consumption posted a faster decline (-1 percent) and net external demand made a lower positive contribution to GDP dynamics than in Q3 (1 percentage point compared to 2.4 percentage points). Similarly to the previous quarters of 2010, the change in inventories and the statistical discrepancy (segments with low economic content) reported the widest fluctuations. However, in Q4, they saw opposite movements which had contributions to real GDP dynamics (-7.3 percentage points and +7.4 percentage points, respectively). On the supply side, the most notable positive influence came from the gross value added in agriculture, following the step-up in its growth rate from +0.1 percent to +6 percent. Industrial and construction sectors had favourable contributions as well. The volume of services continued to contract, although at a slower pace than in Q3 (-0.2 percent).

1.1. Demand

In 2010 Q4, the slower annual pace of decrease of domestic demand (to -1.2 percent) was due to investment (-4.7 percent compared to -15.5 percent in the previous quarter), whereas final consumption followed an even steeper downward path (-2 percent compared to -1 percent).

[11] Unless otherwise indicated, the growth rates in this section are annual percentage changes, calculated based on unadjusted data series.

[12] The quarter-on-quarter changes in the mentioned indicators are calculated based on the seasonally adjusted data series.

Turning to external demand, the positive gap between the dynamics of exports of goods and services and that of imports thereof widened to 4.8 percentage points, with net exports making a renewed favourable contribution to GDP dynamics, similar in terms of size to that reported in the previous quarter (0.6 percentage points).

1.1.1. Consumer demand

The step-up in the annual pace of decrease of final consumption was attributable to both households and the government sector.

Household consumer demand

In 2010 Q4, the negative annual dynamics of private final consumption accelerated by another 0.6 percentage points to -1.7 percent.

(i) Retail purchases (down 5.6 percent) made the largest contribution to this evolution. The calculations based on the turnover volume of retail trade show a drop in the demand for both non-durables (by approximately 5 percent) and certain durables (home electronics and household appliances, IT&C, furniture).

(ii) Household final consumption was also affected by the decrease in expenditures on individual consumption incurred by public and private governments (to -5.3 percent), possibly owing to personnel cuts in relevant sub-sectors such as education, health, culture, administrative services, etc.

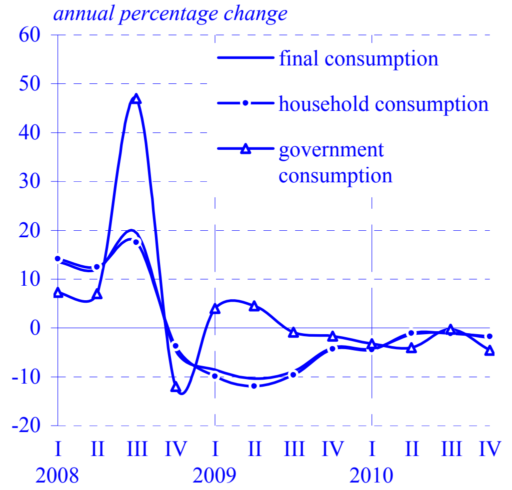
The negative influence from the above-mentioned components was partly offset by the upturn in the demand for motor vehicles[13] (amid the completion of the car fleet renewal programme for 2010 and ahead of the introduction of the pollution tax as of 1 January 2011) and by the faster growth rate of the volume of market services rendered, the available statistical data illustrating the favourable contribution from market services (tourism, hotels and restaurants).

As concerns the influence on consumer prices, the current developments in the volume of retail sales of products holding a large share in the CPI basket suggest relatively lower demand-pull inflationary pressures in Q4. Specifically, retail sales of non-durables followed an even steeper downward trend (the quarterly contraction in the reviewed period exceeded 6 percent), owing to most products in this group (including food items and fuels).

The persistently negative dynamics of consumer demand was due mainly to the faster annual contraction of household disposable

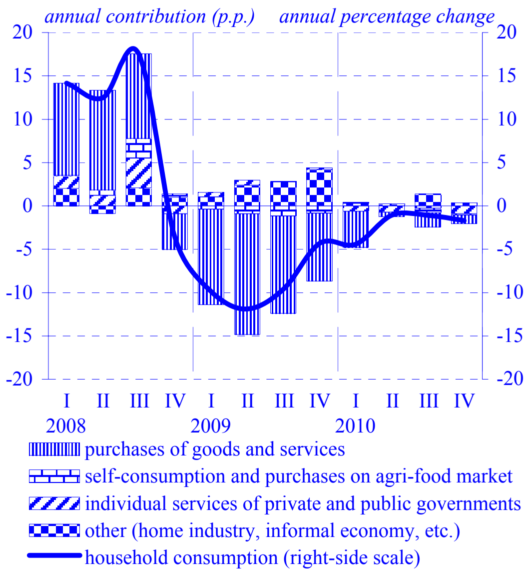
[13] According to the national accounts methodology, auto purchases by households are included in the actual final consumption.

Actual Final Consumption



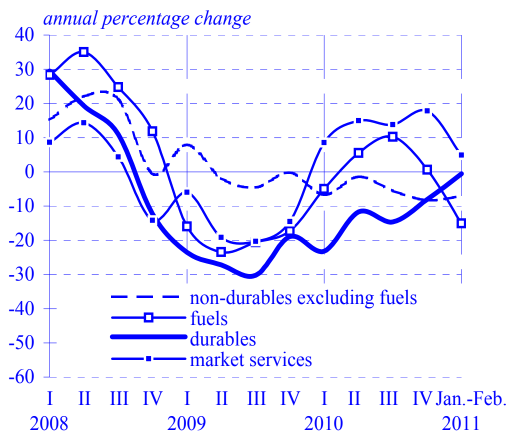
Source: NIS

Household Final Consumption by Expenditure



Source: NIS, NBR calculations

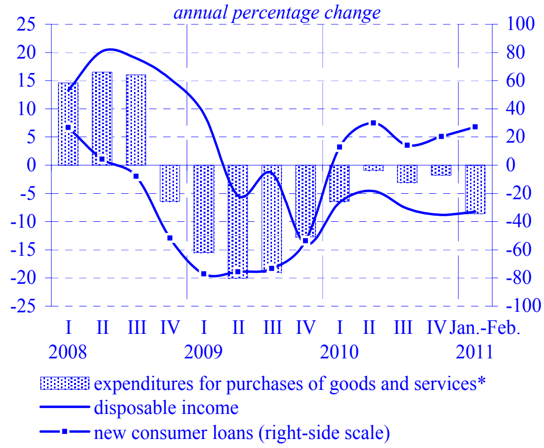
Purchases of Goods and Services*



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

Source: NIS, NBR calculations

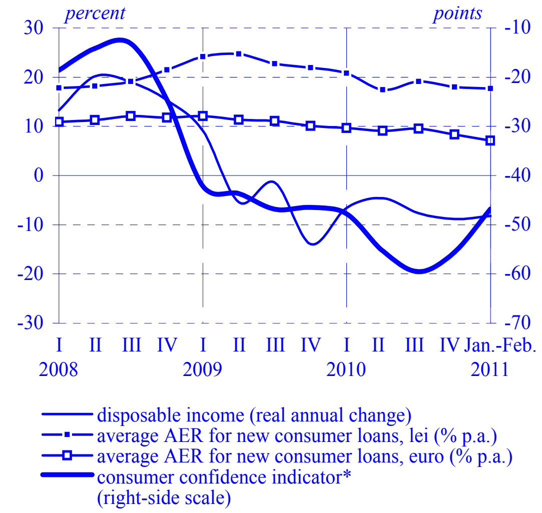
Household Consumption and Main Financing Sources



*) for Jan.-Feb. 2011, the turnover volume in trade and market services was used

Source: NIS, MPF, NBR calculations

Main Determinants of Consumer Demand



*) seasonally adjusted data; the latest data refer to 2011 Q1.

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

income in Q4, with all major segments reporting real declines – wage income, social transfers (state social security, unemployment benefit, health insurance) as well as transfers from abroad (workers' remittances and current private transfers by non-residents).

The fall in households' own financial resources was only partly offset by the almost 20 percent rise in the volume of new consumer loans amid the drop in related costs as well as attractive conditions offered by commercial banks in the last part of the year with a view to boosting retail purchases via credit card payments.

The analysis of consumer good purchases by market of origin shows, on the one hand, the slower advance in imports[14] for most categories; on the other hand, the preference for domestically-produced non-durables continued to decrease in 2010 Q4 (-9.8 percent), while that for durables (except of motor vehicles) saw a slight recovery (+1.2 percent compared to -8.6 percent in the previous quarter)[15]. The auto market posted faster annual growth rates in the case of both domestically-produced and imported goods.

Government consumption

In 2010 Q4, government final consumption shrank by 4.5 percent in annual terms, in line with larger staff adjustments in the public sector.

Budgetary developments

At the end of 2010, the consolidated general budget recorded a negative balance of lei 33,305 million[16] (the equivalent of 6.5 percent of GDP[17]), which was marginally below the nominal reference value agreed upon in the arrangement signed with the EU, IMF and the World Bank. The general government deficit was at the same time below that reported in the previous year (lei 36,435 million[18], accounting for 7.3 percent of GDP), with revenues reverting to positive growth (1.1 percent[19]) and expenditure posting a further compression (-1.7 percent).

[14] 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 and the breakdown by broad economic categories.

[15] The conclusions on the domestic supply are inferred based on the developments in the volume of retail sales of domestic industrial companies on the domestic market.

[16] According to the data on monthly budgetary executions, as published by the MPF.

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

[18] 2009 budget execution data were recalculated by the MPF to ensure consistency with the 2010 readings.

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

In 2010 Q4, the general government budget ended with a lei 9,981 million deficit (the equivalent of 1.9 percent of GDP), lower than that seen during the same year-ago period (lei 11,070 million, i.e. 2.2 percent of GDP). However, the deficit narrowed slowly on account of higher revenue growth (9 percent compared to 3.1 percent in the previous quarter), while the annual change in public expenditure reverted to positive territory (3.6 percent compared to -9.8 percent in 2010 Q3).

The performance of budget revenues was mainly due to higher VAT receipts (up 24.3 percent) and to funds from the EU which saw a threefold increase year on year; a favourable impact was also exerted by larger excise duty collections (up 13.3 percent versus 9.2 percent in the previous quarter), as well as by a further rise in non-tax revenues (7.2 percent).

In its turn, the renewed growth of public spending was attributed to the rise in the primary component (3.4 percent), which was bolstered mainly by a further upturn in expenses with projects financed from non-redeemable external loans (165 percent), higher capital expenditures (14.8 percent), and renewed increases in goods and services expenditures (7.2 percent). The joint impact of such developments was stronger than that exerted by a more pronounced – compared with the previous quarter – deceleration of the annual dynamics in the public wage bill (-21.9 percent), subsidies (-31.4 percent), as well as social payments (-6 percent).

The 2011 budget[20] provides for a reduction in the general government deficit to 4.4 percent of GDP[21]. With the revenue-to-GDP ratio being envisaged as almost unchanged (32.9 percent of GDP), the deficit adjustment will be carried out through primary expenditure cuts amounting to the equivalent of 2.3 percentage points of GDP (down to 35.6 percent of GDP), mainly as regards compensations of employees, social payment and outlays on goods and services.

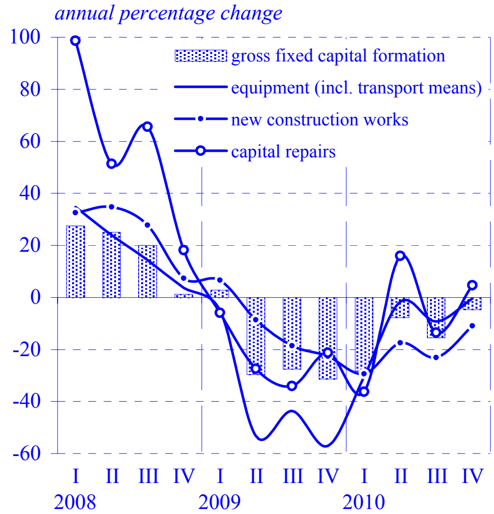
1.1.2. Investment demand

The marked slowdown in the fall of gross fixed capital formation was due, on the one hand, to the current upturn (+0.5 percent, quarterly change) after four consecutive quarters of decline and, on the other hand, to the base effect associated with the contraction in 2009 Q4 (-2.4 percent).

The year-on-year performance reported by investment demand was attributed to all its main components. The volume of equipment purchases (including transport means purchased by

Investment

annual percentage change

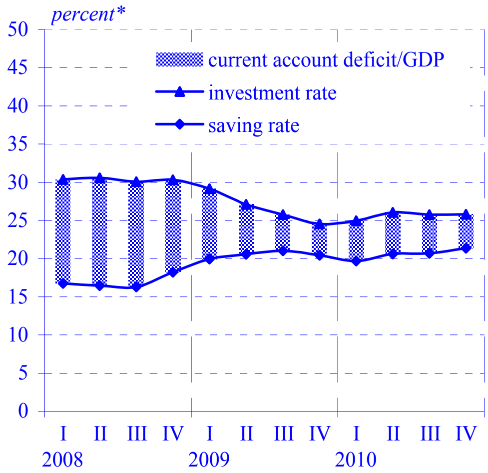


Source: NIS, NBR calculations

[20] As approved by Laws Nos. 286 and 287 of 28/12/2010 regarding the government budget, respectively the social security system for 2011.

[21] Nominal GDP taken into account for 2011 equals lei 544,425.5 million, according to the budgetary execution published by the MPF in February.

Investment Rate and Saving Rate

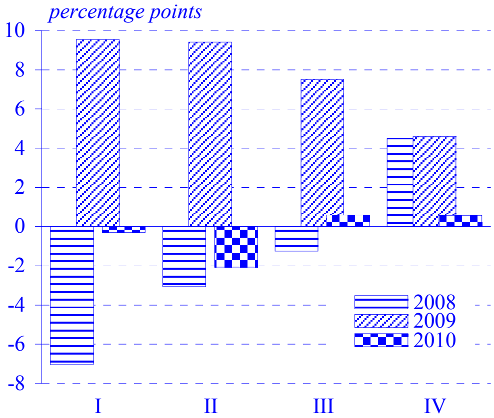


*) last 4 quarters average

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

Source: NIS, NBR calculations

Net External Demand Contribution to GDP Growth



Source: NIS, NBR calculations

companies and institutions) was only 0.4 percent lower than that reported in 2009 Q4 (compared to an annual decline of more than 9 percent in July-September 2010), the pace of decline of new construction works halved (to reach -11 percent), while capital repair works witnessed a trend reversal (+4.6 percent in 2010 Q4).

The deceleration in the negative annual dynamics of gross fixed capital formation was primarily ascribable to the corporate sector and the public sector.

(i) In the former case, the evolution is suggested by both the slight upturn in companies' financial result (given the 0.5 percent pick-up in the gross value added related to non-public sectors, after the 2.8 percent drop seen in the previous quarter) and the signals indicating a decline in the reluctance that has recently been visible in terms of lending and borrowing – the volume of new loans granted to economic agents posted a slower annual pace of decline, while the euro-denominated value of leasing contracts (a financing system dominated over 90 percent by the corporate sector) recorded positive annual growth for the first time in 2010.

(ii) The decline in the volume of capital investment from the public budget decelerated almost 10 times compared to 2010 Q3 (to -2.7 percent, annual change) with the data on the budget execution pinpointing the favourable contribution from the step-up in road infrastructure works.

Household investment demand further failed to see an improvement in the last three months of 2010, given that the disposable income posted an even steeper downward trend and new housing loans recorded a trend reversal, contracting for the first time in 2010 (annual change).

By market of origin of capital goods, Q4 saw a potential increase in investors' preference for domestically-produced goods – the available statistical data point to trend reversals in the annual dynamics of both sales of domestically-produced and imported goods, albeit in opposite directions: the former went up (from -6.4 percent in 2010 Q3 to +4 percent in the period under review[15]), while the latter moved down (from +2.5 percent to -3.5 percent)[14].

1.1.3. Net external demand

Similarly to the previous quarters of 2010, the advance recorded by the main trade partners[22] led to the rise in Romania's exports of goods and services, the national accounts data for Q4 indicating an even faster real growth rate (by 5.7 percentage points, to 17.1 percent). Imports also witnessed a step-up in growth,

[22] In EU25, real GDP rose by 2 percent in annual terms, along with a new increase in the volume of imports of goods and services.

although of a lower magnitude (reaching 12.2 percent), possibly amid a slight recovery in the domestic supply of both intermediate goods and some finished products, i.e. capital goods and durables.

According to the developments in the physical volume of trade[14], the main contributors to the boosting of exports were "machinery and equipment" (by roughly 7 percentage points) as well as "base metals" and "vegetal produce"; in the latter two cases domestic producers' stronger preference for the external market was stimulated by further attractive international prices (the average unit value of exports expanded by about 18 percent and 37 percent, respectively, in annual terms).

1.2. Supply

The slower rate of decline of real GDP in 2010 Q4 was attributable to the activity in the primary and secondary sectors.

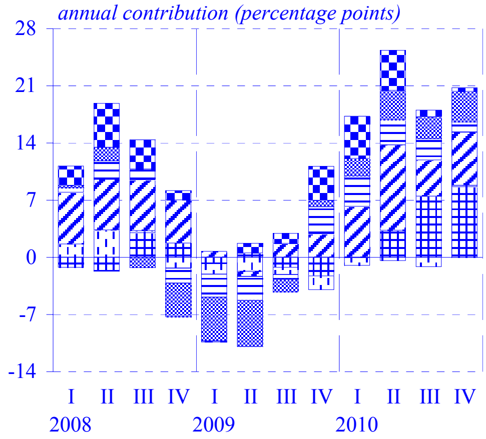
Gross value added in industry witnessed once again the best performance, the 5.8 percent annual dynamics incorporating three consecutive periods of positive quarterly changes. The highest annual growth rates were recorded by the production of road transport means, electrical equipment and that in the light industry.

Agriculture also had a favourable impact on real GDP dynamics. However, the strong trend reversal in gross value added (from -7.6 percent to +7.4 percent) was due mainly to the postponement, until the final quarter, of the harvesting of certain crops as a result of the unfavourable weather conditions. In fact, in 2010 H2, gross value added in agriculture fell by 1 percent in annual terms.

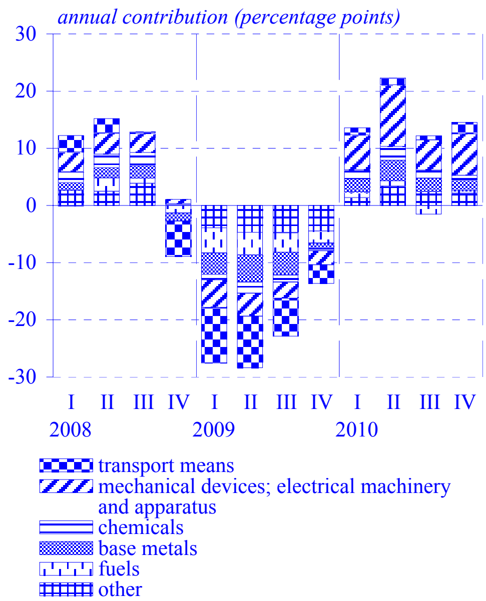
In the construction sector, the annual rate of decline of gross value added slowed down markedly (to -7 percent compared with -14.8 percent) on account of a base effect and the current rebound (+0.6 percent; quarterly change) supported chiefly by non-residential and engineering works.

Compared to 2010 Q3, the annual rate of decline of gross value added in the services sector accelerated by 0.4 percentage points (to -2.5 percent), its trajectory being influenced particularly by public services (-4.8 percent in Q4 versus -0.3 percent) and by the slower growth reported by financial activities, real estate transactions, rentals and services rendered to companies.

Export Physical Volume

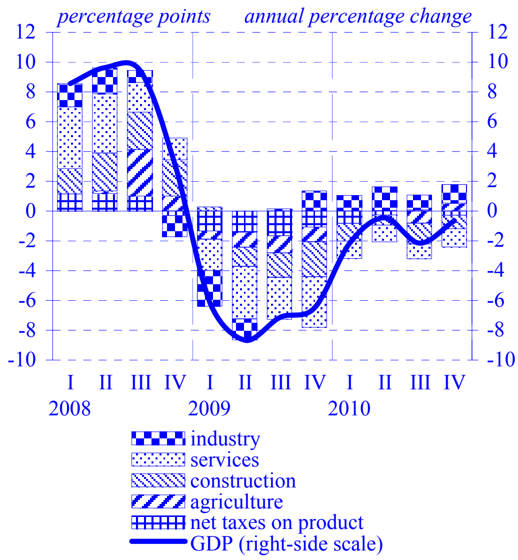


Import Physical Volume



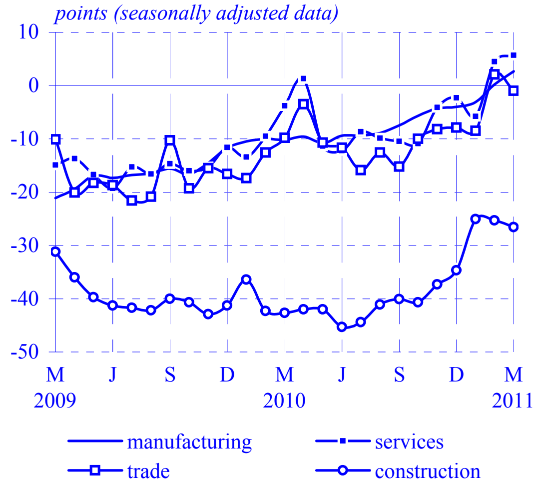
Source: NIS, NBR calculations

Contribution of Supply Components to GDP Growth



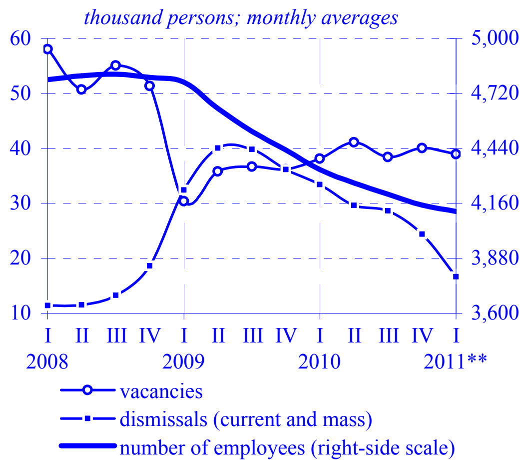
Source: NIS, NBR calculations

Corporate Sector: Confidence Indicators for the Next 3 Months



Source: EC-DG ECFIN

Labour Force Demand Measures*



*) seasonally adjusted **) Jan.-Feb.

Source: NEA, NIS, NBR calculations

Unemployment Rate*

*) seasonally adjusted **) Jan.-Feb.

Source: NIS, NBR calculations

2. Labour market

In January-February 2011, labour demand stabilised while the signs of a rebound in hiring were late in coming during a period when pressures from commodity prices have required increased caution in the management of the other categories of corporate expenses. In industry, the annual negative dynamics of unit labour costs accelerated on the back of productivity gains, thereby consolidating its disinflationary potential. Net nominal wage economy-wide remained virtually unchanged in annual terms.

2.1. Labour force[23]

The improvement in labour demand seen in November-December 2010 saw a reversal in January-February 2011, with the number of vacancies identified by the NEA contracting by 2.7 percent compared with the average for 2010 Q4. A possible reason behind companies' prudent stance in terms of hiring is the strict control of production costs, given the increasingly higher commodity prices. The number of layoffs further declined, which indicates that companies' staff needs have required less mass dismissals.

The prospects for labour demand in 2011 Q2, as illustrated by business surveys[24], further suggest its relative stability, with signs of a recovery in the demand for goods and services being still too feeble to boost hiring. Moreover, even in the case of certain industrial activities that witnessed significantly larger production volumes, companies focused particularly on making use to the fullest of the efficiency of the existing human resources (by increasing the number of hours worked, reorganising the working time by shifts).

Turning to labour supply, real time statistics are increasingly less relevant, with the trends of registered unemployment rate and staff numbers declared by employers growing more disconnected since the beginning of 2010 H2. Thus, the headcount kept declining in 2010 Q4 and in January-February 2011, along with the drop in registered unemployment rate to 6.3 percent. On the other hand, according to the Household Labour Force Survey (AMIGO), the contraction of excess labour supply in 2010 Q4 was not that visible – ILO unemployment rate saw only a marginal decline, and ILO employment stayed relatively unchanged.

The economic relevance of registered unemployment rate might have faded also due to the legislative changes concerning unemployment benefit, in force since the start of 2011:

[23] Data in this section are seasonally adjusted.

[24] The Manpower Employment Outlook Survey on hiring intentions and the NIS/EC-DG ECFIN Survey on the expected development in the staff numbers in manufacturing, construction, retail trade and services.

(i) unemployment benefit was reduced by modifying the calculation base, no longer relating to the minimum wage economy-wide and (ii) the persons refusing a job for which they are qualified shall no longer receive unemployment benefit (previously, the unemployed were entitled to turn down an offer for a job farther than 50 km from their domicile).

2.2. Incomes

In January-February 2011, the net nominal average wage economy-wide remained virtually unchanged from the same year-earlier period amid opposite developments in the budgetary and the private sectors. On the one hand, the annual rate of decline in budgetary sector wages accelerated slightly to -18.7 percent, given that the wage hike in January (15 percent compared to the October 2010 wage level) was offset by the elimination of the “13-month” wage relative to the prior year. On the other hand, the annual growth in private sector wages gained momentum (to 7.2 percent), with private services reporting the fastest rate of increase (roughly 1.3 percentage points); the rise in the minimum gross wage economy-wide is likely to have contributed to this development.

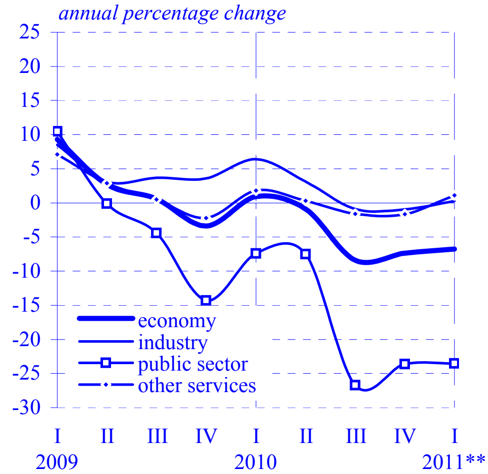
In industry, the annual dynamics of gross wage accelerated (to 8.7 percent in January-February 2011 and to 10 percent in manufacturing), being offset by robust productivity gains, which enabled the disinflationary potential of ULC to be preserved; the annual change in ULC widened from -3.6 percent in 2010 Q4 to -5.5 percent in January-February 2011 (from -2.6 percent to -5.6 percent in manufacturing). Improvements were registered in the food industry, chemicals, metallic construction, while metallurgy, machinery and equipment, as well as electrical equipment further performed well in this respect.

On the demand side, statistical data on the annual dynamics of real disposable income indicate a somewhat slower decline (from -8.8 percent in 2010 Q4 to -8.2 percent in January-February 2011), solely on account of the lower contraction in wage earnings (from -13.3 percent to -11.7 percent). Transfers from abroad witnessed a slightly steeper annual drop (to -13.6 percent) accompanied by a similar development in the case of social transfers (-3.2).

3. Import prices and producer prices

In 2010 Q4, import prices as well as industrial and agricultural producer prices exerted stronger inflationary pressures (to a lower extent in the case of import prices), with developments on the external markets acting as the main determinant. For 2011 Q1, no marks of trend reversals can be detected, in the context of unchanged influencing factors.

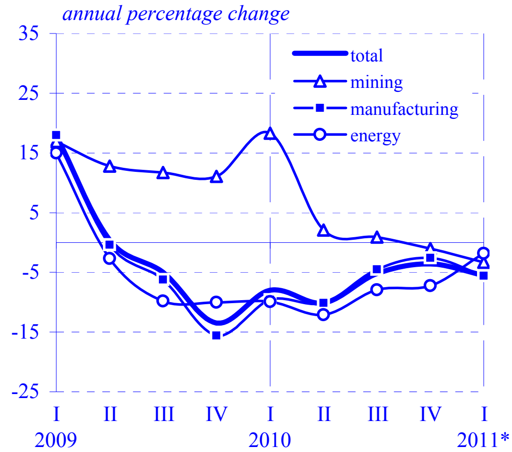
Net Real Wage*



*) deflated by CPI **) Jan.-Feb.

Source: NIS, NBR calculations

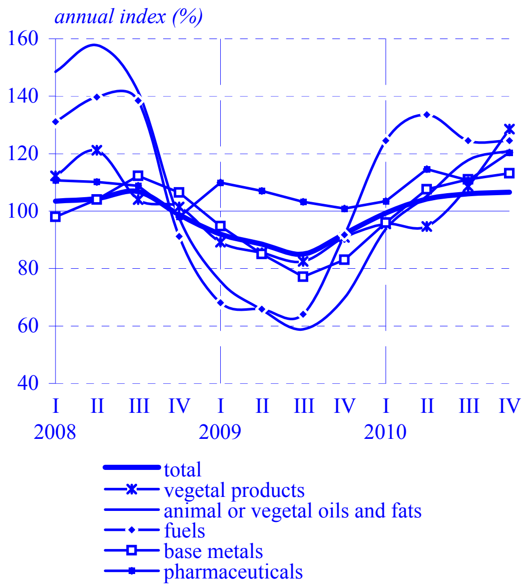
Unit Labour Cost in Industry



**) Jan.-Feb.

Source: NIS, NBR calculations

Major Inflationary Pressures on the Unit Value Index of Imports



Source: NIS, NBR calculations

3.1. Import prices

In 2010 Q4, the pressure from external prices remained high, yet unchanged compared with the previous period, given that the unit value index of imports increased marginally (to 106.6 percent from 106.1 percent), and the position of the domestic currency versus major currencies witnessed no considerable changes (the depreciation of the leu against the euro further showed comparable values, while that of the leu against the US dollar sharpened).

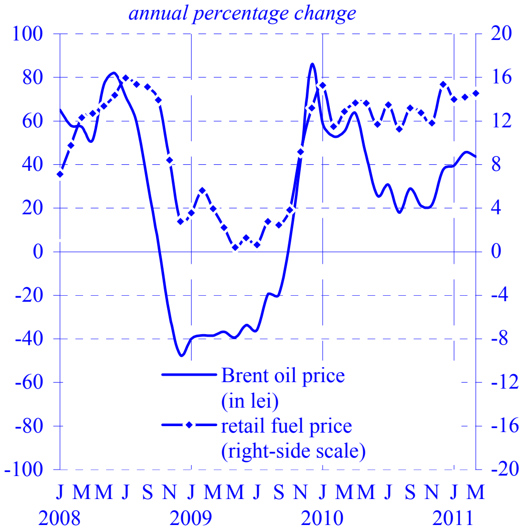
Similarly to the previous period, pressures were considerably stronger in the case of food and energy prices.

As concerns industrial goods, significant higher growth was reported for base metals. Moreover, external prices of capital goods, as well as those of transport means saw faster growth rates in 2010 Q4 (of up to 3.5 percentage points as compared with Q3), although the unit value indices stayed below par or grew above par only marginally.

Import price tendencies manifest in the last five quarters also continued in the first part of 2011, further rises in commodity prices being only partially offset by the slower depreciation of the leu against the US dollar, while that against the euro accelerated.

Oil Price and Retail Fuel Price

annual percentage change



Source: NIS, EIA, NBR calculations

3.2. Producer prices

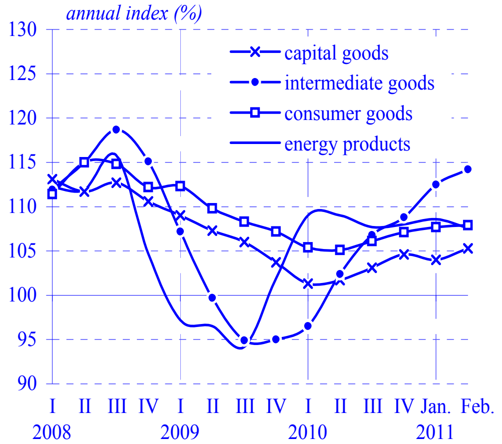
3.2.1. Industrial producer prices

The upward trend witnessed by the annual dynamics of industrial producer prices on the domestic market during the last four quarters continued into 2010 Q4, up to 7.6 percent, the highest level seen in the past two years. Current developments also illustrate upward pressures, as the quarterly change went up to 2.3 percent, against an average rate of 1.7 percent during the first three quarters of 2010 (seasonally adjusted data series). In manufacturing, the annual rate of increase of industrial producer prices on the domestic market ran at 9.3 percent in 2010 Q4, while the quarterly dynamics exceeded 2 percent for the third consecutive quarter.

The trajectory was again shaped by the prices of low value-added industrial products (energy and intermediate goods), that are strongly driven by the dynamics of external commodity prices.

Industrial Producer Prices for Domestic Market by Industrial Products Group

annual index (%)



Source: NIS

From the CPI perspective, the annual growth rate of producer prices for consumer goods also exerted a negative impact (increasing to 7.1 percent), due solely to foodstuffs (+9.3 percent), while the annual producer price dynamics for consumer goods, excluding food items, beverages and tobacco[25] remained

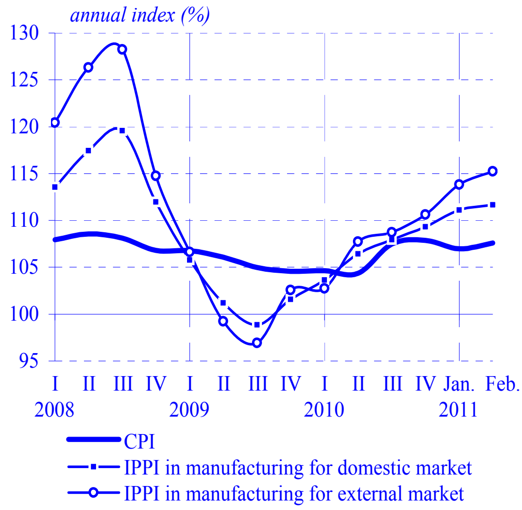
[25] Eurostat estimates.

unchanged at the previous quarter's rate. As concerns food items, the build-up of pressures became increasingly manifest (+3.2 percent quarterly rate; seasonally adjusted data series) with possible influences from: (i) reduction/depletion of stocks of agricultural commodities and increased resort to imports; (ii) renegotiation of delivery contracts at the beginning of the year. A further explanation may lie with the existence of previously built-up pressures, their pass-through into prices being delayed by unfavourable demand developments.

Faster growth rates were also seen by the capital goods and durables sub-sectors, the rise in costs of materials of input prices exerting a major impact in both cases. However, for both sub-sectors, the annual dynamics of producer prices remained considerably below the aggregate level, possibly on account of the dampening effect of domestic demand.

In 2011 Q1, the annual growth rate of producer prices for the domestic market will continue its upward trend, with further significant pressures from commodities. Local producers in certain sub-sectors (non-durables mainly) may further pass-through such pressures only slowly into prices, given the relatively modest volume of new orders placed by local consumers.

Consumer Prices and Industrial Producer Prices



Source: NIS

3.2.2. Agricultural producer prices

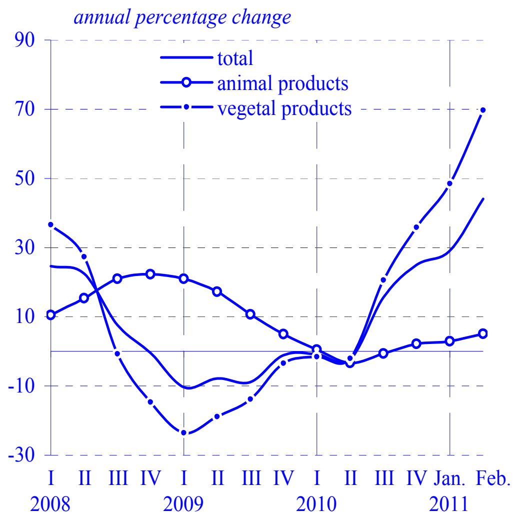
In 2010 Q4, agricultural producer prices witnessed a faster-pace annual growth rate by approximately 10 percentage points (up to 25 percent), against a background of generally higher vegetal product prices and, to a lesser extent, of animal product prices reverting to positive annual growth rates.

As seen in the previous quarter, the vegetal product price movements (+15.2 percentage points, up to 35.8 percent) were further due to external market developments, which continued to be marked by mounting tensions in 2010 Q4, as well as in 2011 Q1.

Animal product prices saw a trend reversal as compared with the previous quarter (the annual dynamics shifted from -0.6 percent to 2.2 percent in 2010 Q4), probably due to costlier fodder (+43.3 percent year on year). This development had an uneven influence on the main groups of products, only part of the meat types and the remaining animal products (milk, eggs) being affected.

In 2011 Q1 vegetal product price rises may be even steeper, while the current trends for animal product prices might persist, but at a slower pace.

Agricultural Producer Prices



Source: NIS

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

During February-March 2011, the NBR left unchanged the monetary policy rate at 6.25 percent per annum. Moreover, in the two months under review the NBR kept in place the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities at 15 percent and 25 percent respectively. At the same time, interbank money market rates came closer to the monetary policy rate – a process also underpinned by the NBR's liquidity management – and the domestic currency exhibited a sharp nominal appreciation, suggesting a relative tightening of broad monetary conditions.

The decisions to extend the status-quo regarding the monetary policy rate and the minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities taken by the NBR Board in its 3 February 2011 meeting were aimed at preventing the risk of second-round effects related to the recent and anticipated adverse supply-side shocks from materialising. The central bank's response was substantiated by the relative increase in the magnitude of such shocks arising mainly from a faster rise in commodity prices on world's food and energy markets and the upward revision in the expected administered price adjustments. Against this background, the inflation outlook on the longer-term horizon of the updated forecast saw a relative worsening[26], unrelated to the persistence of the forecasted negative output gap at elevated levels (slightly lower however than those projected previously), entailing the risk of stronger inflation expectations over the medium term

Another reason for the central bank's decisions was the persistence of risks regarding the upward deviation of inflation from the forecasted trajectory. The most relevant risks were the possible protraction/pick-up of the increase in external prices of farming and energy products and the potentially larger-than-expected regulated price adjustments.

The need to further anchor firmly medium-term inflation expectations and to prevent second-round effects related to the recent and anticipated supply-side shocks from materialising also substantiated the decision to keep the monetary policy rate unchanged at 6.25 percent per annum taken by the NBR Board in its meeting of 31 March 2011. This need was reconfirmed by the

[26] Compared with the previous projection in the November 2010 *Inflation Report.*

sharp growth in fuel and food prices during the first two months of 2011, which pushed the annual inflation rate up to 7.6 percent in February 2011, and by stronger risks to inflation in the short term. Such short-term risks were related to the behaviour of international agri-food and fuel prices (similarly to other emerging economies), as well as to the persistence of uncertainties surrounding the schedule and size of domestic administered price adjustments given the large share of the above-mentioned prices in Romania's CPI basket. The performance of some economic and financial indicators in the early months of 2011 revealed the high likelihood of a relatively slow recovery in key domestic demand components amid the projected persistence, albeit falling, of the negative output gap. As for consumer demand, the major signs were the following: (i) the persistent decline in the annual growth rate of turnover volume of retail trade of foodstuffs (in January); (ii) the mild acceleration of the negative annual dynamics of the average real net wage in the same month, and (iii) the January deepening, compared to the previous quarter's average, of the decrease in social transfers (year on year). Adding to these signs were the still negative growth rate[27] of loans to the private sector, i.e. households and companies, and the halt in the downtrend of the annual real dynamics of household deposits with banks.

In the period January-February 2011, the slight pick-up in the annual growth rate of loans to households (-4.9 percent versus -6.3 percent on average in 2010 Q4) reflected almost entirely the statistical effect of movements in the RON/EUR exchange rate[28], given that activity in this field was still dominated by debt restructuring. Thus, the slight improvement in the consumer confidence indicator in the early months of 2011 was not accompanied by a stronger demand for new loans. By contrast, the credit supply might have improved somewhat in 2011 Q1 insofar as the intention already announced by banks to ease lending standards became a fact. As a reflection of all these influences, the average year-on-year change in leu-denominated consumer loans and other types of loans to households[29] remained flat at -14 percent in the two-month period under review, whereas the same indicator for foreign currency-denominated loans (in EUR equivalent) declined marginally to -2.3 percent against -2.2 percent in 2010 Q4. In turn, during the period January-February 2011 the average annual dynamics of leu- and foreign currency-denominated housing loans (in EUR equivalent) kept declining, albeit at a slower pace than in 2010 Q4.

[27] Unless otherwise indicated, annual changes are in real terms.

[28] Based on annual change in the end-of-period exchange rate of the leu.

[29] The two indicators were cumulated in order to remove the altered-methodology effects arising from the entry into force of Norms No. 10/2009 issued by the NBR to implement Regulation (EC) No. 25/2009 of the ECB.

In contrast to the past evidence, the negative annual dynamics of household deposits with banks alleviated, on average, in the period January-February 2011 to -0.6 percent against -1.7 percent in 2010 Q4. The evolution was related to a relative slowdown in the annual decline of wage earnings and was due mostly to the recovery seen in the growth rate of leu-denominated deposits that returned to positive territory after three successive quarters of negative readings. Hence, the share of such deposits in total household deposits widened in the review period to reach levels similar to those recorded in the spring of 2010. The breakdown by maturity reveals a further expanding share of time deposits in total household deposits, which suggests a still strong money demand for precautionary purposes, i.e. saving/investment. To this contributed the widening spread between interest rates on households' time deposits and demand deposits. The average annual rate of increase of households' time deposits (over and up to two years) continued however to slow down in the period January-February 2011, reaching 5.8 percent versus 6.6 percent in 2010 Q4, partly due to the keener interest in government securities holdings.

Another reason behind the NBR Board decisions taken in March was the impact that the return of the RON/EUR exchange rate to a downward trend and its possible protraction in the foreseeable future could have had not only on broad monetary conditions, but also on inflation expectations. The explanation for the appreciation trend of the domestic currency, which gathered momentum in the run-up to the end of the quarter, lies mainly with the improving sentiment of foreign investors, financial entities included, towards the Romanian economy. This was also reflected in the significant narrowing of the sovereign risk premium and was supported, *inter alia*, by the encouraging signs relative to the envisaged signing of a new 24-month precautionary stand-by arrangement with the EU, the IMF, and the World Bank (see Subsection *2.2. Exchange rate and capital flows*).

The deepening of the adjustment of overly-high interest rates on non-banks' leu-denominated loans and deposits paved the way for the central bank to pursue first-quarter liquidity management so as to underpin convergence of interbank money market rates towards the policy rate. The central bank's net debtor position vis-à-vis the banking system declined considerably in the final two months of the reviewed period amid the contractionary joint impact of the autonomous factors of liquidity. Against this background, short-lived reserve deficits occurred in a period characterised by liquidity surpluses. In this context, throughout January, in early February and in late March the National Bank of Romania's monetary policy operations were aimed at draining excess liquidity. This was done via the deposit facility and a fixed-rate deposit-taking operation with one-week maturity whereby banks' bids totalling lei 7.8 billion were accepted up to the pre-announced volume of lei 0.5 billion. Conversely, on 28 February and in early March the central bank provided liquidity to credit institutions via two repo operations with one-week maturity[30] conducted in the form of fixed-rate auctions with full allotment where banks' bids amounted to lei 2.2 billion and lei 0.4 billion respectively. Under the impact of relatively tighter liquidity conditions and altered expectations on how the central bank would perform its liquidity management (induced also by the messages the NBR conveyed in its press conference held on 7 February), the average interbank money market rates at the short end of the maturity range and average longer-term rates seen as benchmarks in setting lending/deposit rates on new business stood higher in the latter part of 2011 Q1, thus nearing again the policy rate.

Also in its 31 March meeting, the National Bank of Romania Board decided to lower the minimum reserve requirements ratio on foreign currency-denominated liabilities with residual maturities of up to two years[31] to 20 percent from 25 percent starting with the 24 April – 23 May 2011 maintenance period. The measure was aimed at enhancing the flexibility of banks' foreign currency liquidity management and bringing the required reserve mechanism more into line with the ECB standards in the field.

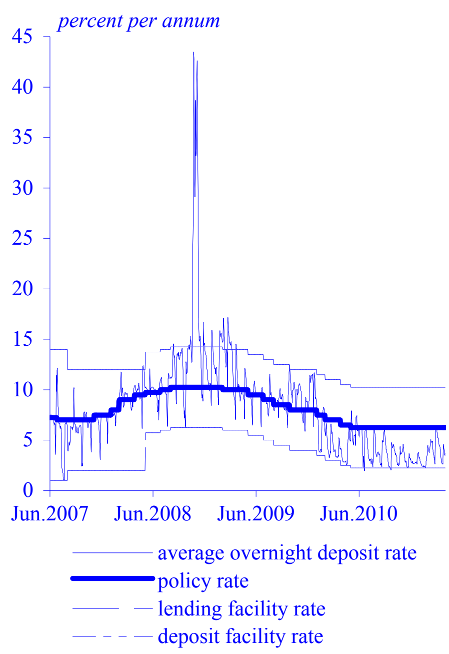
2. Financial markets and monetary developments

Average interbank money market rates saw their decline come to a halt and returned in the vicinity of the policy rate in the latter part of 2011 Q1. Lending and deposit rates on new business of non-bank clients further witnessed a downtrend December 2010 through January 2011, yet posted an upward adjustment in February, thus exceeding the readings seen three months earlier. The RON/EUR exchange rate followed a steeper downward path in the latter part of 2011 Q1 amid improved investor sentiment towards domestic economic prospects. Broad money dynamics posted less negative readings, given the relatively softer contraction in credit to the private sector.

2.1. Interest rates

In 2011 Q1, interbank money market rates saw their decline come to a halt and returned in the vicinity of the policy rate, on the back of the relatively tighter liquidity conditions in the banking system. Over the period as a whole, average interbank rates edged up 0.5 percentage points versus the previous quarter to stand at 4.0 percent.

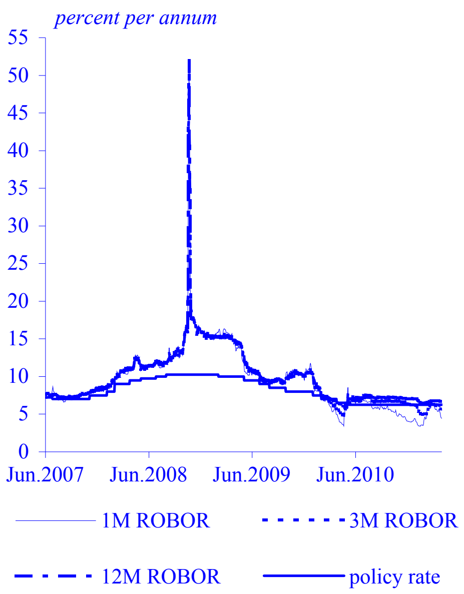
Interbank Money Market Rates



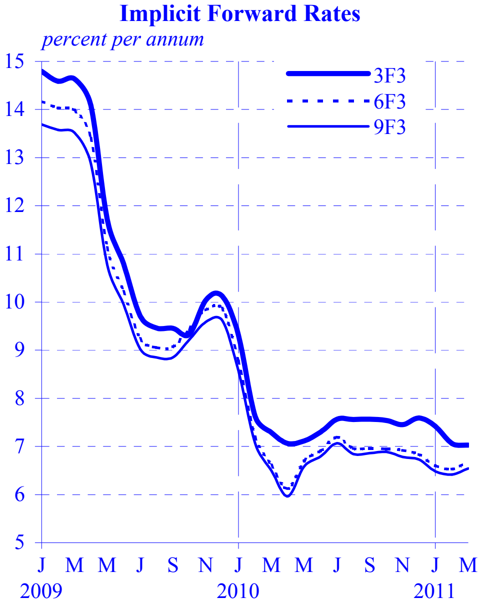
[30] For the first time in 12 months.

[31] The lower rate also applies to foreign currency-denominated liabilities with maturity of over two years to which contractual provisions on repayment, transfer and early buyback are attached.

Policy Rate and ROBOR Rates



Implicit Forward Rates



Following a protracted decline at the onset of the quarter under review, the overnight rates on the interbank money market witnessed an upward adjustment during the 24 January – 23 February maintenance period, under the contractionary impact of the autonomous liquidity factors[32]. The spread between overnight rates and the policy rate narrowed even further at end-February, with the renewed spike-up in the former being driven by a short-lived reserve deficit that was covered via the central bank's repo transactions. However, autonomous liquidity injections generated by Treasury operations at the end of the period under review led to another drop in overnight rates.

In turn, (1M-12M) ROBOR rates fell considerably at the beginning of the reported quarter owing to risk premium adjustment, also amid the significant alleviation of uncertainties previously surrounding the fiscal consolidation process until end-2010. Against this backdrop, 3M ROBOR rates stood at about 5 percent in the latter half of January, while longer-term rates came into line with the policy rate. However, in early February, these rates went up as well over the entire maturity spectrum, under the joint impact of: (i) relatively tighter liquidity conditions over the short term and (ii) reshaped expectations on interest rate developments, due also to the messages that the central bank conveyed as regards the future convergence of interbank money market rates towards the policy rate. Thus, monthly average 3M ROBOR rates came back into line with the NBR's key rate during the closing month of the quarter, whereas the positive spread between interest rates on longer maturities and the policy rate narrowed to 0.4-0.5 percentage points (around 0.3 percentage points below the December reading). Implicit forward rates (calculated based on March average quotations) saw the following developments: 3M rates shed 0.6 percentage points (to 7.0 percent) against the level recorded in December, while 6M and 9M rates posted lower declines to stand at 6.7 percent and 6.5 percent respectively.

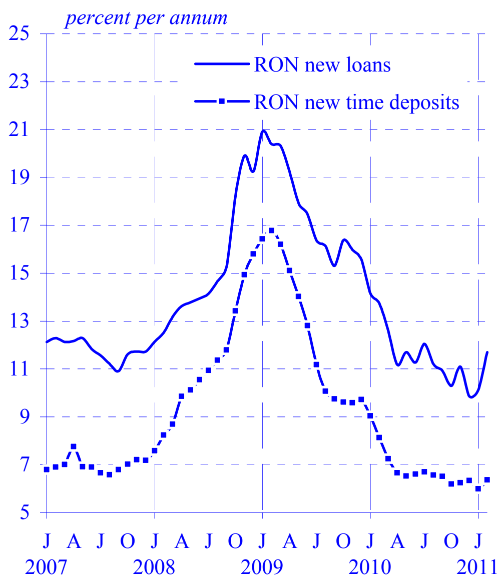
The average yield on the primary market for government securities saw its decline that had started in December 2010 come to a halt and witnessed a trend reversal, gradually rising in the final two months of the quarter under review to stand at 7.0 percent, also on account of the relatively longer maturity of securities issued. The average yield on outright operations performed on the secondary market for government securities followed a similar pattern, going up to 6.8 percent in March. The turnover of the secondary market for government securities rose, with outright transactions accounting for the largest part, i.e. 85 percent. Securities with residual maturity of up to one year were the most heavily traded (46 percent), their average interest rates remaining unchanged at 6.3 percent compared to the previous quarter. Non-residents' holdings of leu-denominated

[32] Primarily Treasury absorptions, triggered both by the seasonal increase in payments to the budget and the larger volume of government securities issued.

government securities went up markedly in early 2011 Q1, at a similar pace to that recorded October through December 2010.

Broadly in line with developments in interbank rates, average time deposit and lending rates on new business followed a downward path in December 2010 and in January 2011, but increased considerably in February to stand at 6.37 percent and 11.7 percent respectively, thus exceeding the November 2010 readings. The upward movement was more visible for interest rates on new loans, also mirroring higher interest margins. Moreover, developments were uneven for the two customer categories. Thus, average interest rates on new loans to non-financial corporations edged up 0.41 percentage points versus November 2010, to 11.16 percent in February 2011. At the same time, the corresponding rate on new time deposits of non-financial corporations picked up 0.43 percentage points to 5.74 percent in February 2011. By contrast, the average interest rate on new time deposits of households contracted 0.36 percentage points against November 2010 to 7.12 percent, while the corresponding rate on new loans to households rose 1.18 percentage points to 13.49 percent, despite an overall lower borrowing cost during the period under review, as reflected by the average effective annual rate on new consumer loans and housing loans respectively. This might have also been the result of the entry into force, at the beginning of 2011, of Law No. 288 of 28 December 2010 approving Government Emergency Ordinance No. 50/2010 on consumer credit contracts.

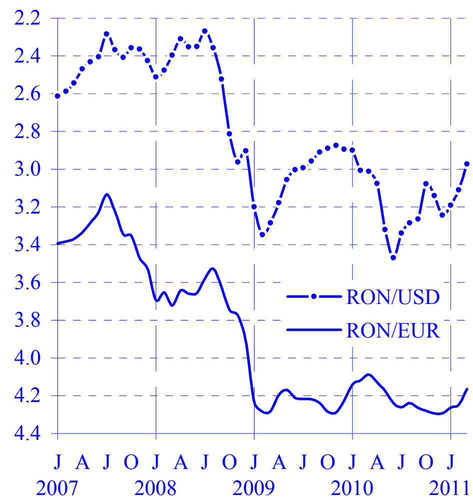
Bank Rates



2.2. Exchange rate and capital flows

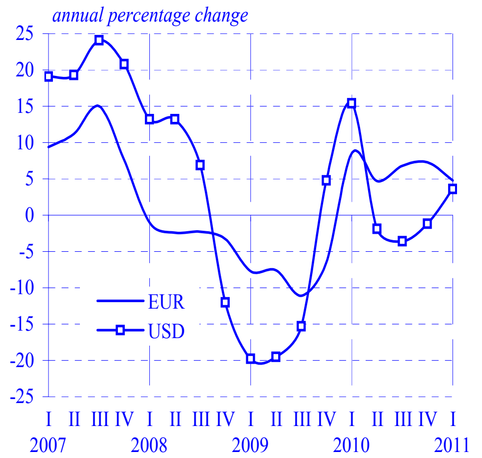
The slightly downward trend the RON/EUR exchange rate had embarked upon in the first part of January steepened beginning with the last 10-day period of February. This development reflected mainly the improvement in foreign investor sentiment towards the Romanian economy, amid lower risks associated with the prospects of fiscal consolidation and the implementation of structural reforms, also against the background of a new stand-by arrangement with the EU, IMF and the World Bank. To this added improved expectations on economic activity and external balance. Under such circumstances, the exchange rate escaped, to a certain extent, the influence of an international environment characterised by alternating events triggering frequent/ample shifts in global risk appetite. Nevertheless, the exchange rate volatility increased, peaking at an 8-month high in March, but remained lower than the volatility exhibited by the exchange rates of most currencies in the region.

Nominal Exchange Rate



Consequently, in January-March, the domestic currency appreciated against the euro by 3.1 percent in nominal terms and by 5.3 percent in real terms (as compared with a depreciation of

Developments of RON Exchange Rate*



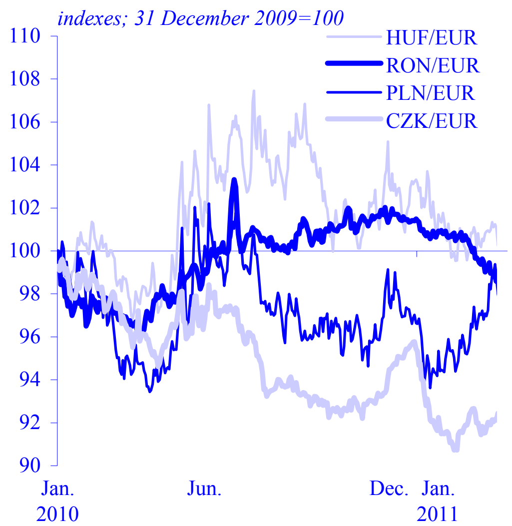
*) appreciation (+), depreciation (-) in real terms; deflated by CPI

Source: NIS, NBR

0.7 percent in nominal terms and an appreciation of 1.0 percent in real terms in 2010 Q4). The leu witnessed a visibly stronger appreciation versus the US dollar, i.e. 9.1 percent in nominal terms and 11.4 percent in real terms, given that the US currency depreciated considerably against the euro on global markets. Looking at the average annual change of the exchange rate in the first quarter, the domestic currency further weakened versus the euro in nominal terms (2.6 percent), but witnessed a softer nominal depreciation vis-à-vis the US dollar (3.9 percent).

The slightly downward path the RON/EUR exchange rate had embarked on towards end-2010 persisted into January 2011, under the favourable impact of improved global financial market sentiment, which also influenced the exchange rates of the other currencies in the region. However, investors' perception towards the Romanian economy was still marred to a certain extent by the protracted uncertainties about the pace of further fiscal consolidation and structural reforms, depending largely on the outcome of the ongoing talks on concluding a new arrangement with the EU, the IMF and the World Bank. Therefore, the monthly appreciation rate of the leu was slower than that of its regional peers. Nonetheless, non-residents' interest in the domestic financial market increased in the first month of the year, mainly due to more attractive remuneration of government securities investments and the start of trades in shares of *Fondul Proprietatea* on the Bucharest Stock Exchange. Consequently, interbank forex market turnover reached the highest level over the past two years, while its deficit more than halved from the prior month.

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

The RON/EUR exchange rate remained within a narrow variation band in the first two 10-day periods of February, as the impact of a renewed worsening of global market sentiment in that period[33] was countered by that arising from the announcement on the fulfilment of major objectives of the ongoing EU-IMF-World Bank arrangement and the staff level agreement on a new 24-month precautionary stand-by arrangement between Romania and the above-mentioned institutions[34]. A more discernable influence on financial investors' perception – reflected implicitly by the RON/EUR exchange rate resuming its downward trend in the closing 10-day period of the month – had the slightly higher-than-expected flash estimate on fourth-quarter GDP dynamics. However, over the period as a whole, the appreciation pace of the leu versus the euro remained slower than that of the Hungarian forint and the Czech koruna; the Polish zloty moved in the opposite direction vis-à-vis the single European currency, depreciating on

[33] Following the longer-than-expected EFSF restructuring and, implicitly, the resurging fears on the performance of euro area peripheral economies, as well as the heightening tensions in the Middle East and North Africa, which led to a sharp increase in the oil price.

[34] Approved by the IMF Board on 25 March.

average by 0.9 percent in the review period, hinting at exchange rates and specific investor expectations becoming increasingly responsive to domestic factors.

This change became more visible in March, when the leu strengthened further against the euro, unlike most currencies in the region. To this contributed the continued improvement in investor sentiment[35], amid the consistent pursuit of structural reforms and especially the improved/further favourable performance of several macroeconomic indicators, including some that are key to exchange rate developments, such as industrial output, budget deficit, trade balance and current account balance[36]. At the same time, the leu was influenced to a lower extent by the adverse factors that generated ample fluctuations of the global market sentiment, i.e. the disasters in Japan and the resurging uncertainties surrounding developments in euro area peripheral economies. Consequently, the RON/EUR exchange rate embarked on a steep downward trend, with the domestic currency strengthening 2.0 percent in nominal terms versus the euro over the entire month, while the Hungarian forint appreciated against the single currency by 0.1 percent and the Czech koruna and the Polish zloty depreciated by 0.5 percent and 2.2 percent respectively.

Key Financial Account Items (balances)

EUR million

	2010 2 mos.	2011 2 mos.
Financial account	**519**	**232**
Direct investment	**116**	**291**
- residents abroad	-22	-3
- non-residents in Romania	138	294
Portfolio investments and financial derivatives	**-1**	**387**
- residents abroad	-62	-350
- non-residents in Romania	61	737
Other capital investments	**1,328**	**-391**
- credits and loans from the IMF	2,453	908
- medium- and long-term investments	-983	-304
- short-term investments	-614	-454
- currency and short-term deposits	420	-608
- other	53	68
NBR's reserve assets, net ("–" increase/"+" decrease)	**-925**	**-55**

2.3. Money and credit

Money

December 2010 through February 2011, the dynamics[37] of broad money (M3) posted a less negative reading, i.e. -0.9 percent versus -1.5 percent in the previous 3-month period, reflecting the impact of the slight rebound in some economic sectors as well as the statistical effect of the weaker domestic currency against the euro[38] in annual terms.

M3 developments were triggered by the slacker negative dynamics of narrow money (M1), on account of the faster expansion of overnight deposits – particularly the leu-denominated component – manifest both for companies (peaking at a 2½-year high) and for households. By contrast, the dynamics of time deposits with a maturity of up to two years continued to contract until entering negative territory. Unlike the previous period, the decline was mainly ascribable to the protracted fall in the growth rate of

Annual Growth Rates of M3 and Its Components

real percentage change

	2010				2011	
	I	**II**	**III**	**IV**	**Jan.**	**Feb.**
	quarterly average growth					
M3	2.1	3.9	-0.9	-1.4	0.1	-1.8
M1	-14	-6.8	-8.1	-5.7	-2.3	-4.0
Currency in circulation	-5.7	0.6	3.2	3.7	3.6	2.2
Overnight deposits	-17	-9.9	-13	-9.8	-5	-6.9
Time deposits (maturity of up to two years)	15.1	10.8	3.4	0.6	0.7	-1.4

Source: NIS, NBR

35 Mirrored also by the narrower CDS and Romanian Eurobond spreads.

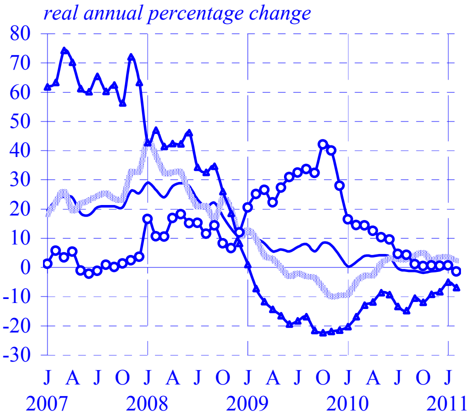
36 In January, the current account deficit (EUR 15 million) declined by 86.5 percent versus the same year-ago period, while the trade balance posted the first surplus since March 2003. At the same time, direct and portfolio investment amounted to EUR 789 million from EUR 62 million in January 2010.

37 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2010 – February 2011.

38 Based on end-of-period readings.

Main Broad Money Components

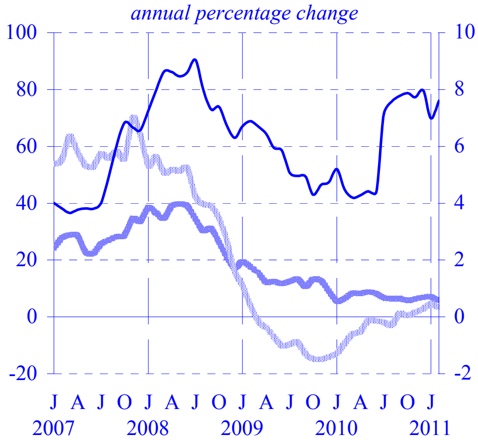
real annual percentage change



Source: NIS, NBR

Broad Money and Inflation Rate

annual percentage change



Source: NIS, NBR

household deposits, manifest for forex-denominated ones. However, the average share of time deposits in total household deposits peaked at a 5-year high of 79.1 percent, hinting at the possible persistence of keen money demand for precautionary purposes. The negative dynamics of corporate time deposits with a maturity of up to two years slowed down slightly, given the faster expansion of the leu-denominated component. Marketable securities further boasted the fastest growth rate of all M3 components, despite a certain deceleration generated primarily by a base effect.

The sectoral breakdown of M3 reveals slower negative dynamics recorded by deposits of both households and companies in the period under review, with both sectors showing a keener appetite for placements in domestic currency. Hence, the share of foreign currency-denominated deposits in M3 narrowed further and reached a 2-year low of 30.8 percent (period average). The more sluggish pace of decline of household M3 deposits was driven by the slacker negative dynamics of the net average wage economy-wide (in real terms) as well as by higher disbursements from European funds[39] to certain categories of individuals. Some of these amounts could also be traced back to corporate deposits, along with additional revenues derived by economic agents from higher public spending on goods and services[40]. An opposite effect, albeit of a lower magnitude, on corporate deposits came from: (i) the potentially larger external debt service payments[41] and (ii) the larger volume of corporate holdings of government securities.

From the perspective of major M3 counterparts, the rebound in broad money dynamics reflected the slacker negative growth rate of credit to the private sector and the more sluggish expansion of long-term financial liabilities (including capital accounts). Their impact more than offset the influence of the slower dynamics of central government net credit and that of net foreign assets.

Credit

December 2010 through February 2011, the negative dynamics[42] of credit to the private sector slowed down slightly (-3.0 percent versus -3.9 percent in the previous period), reflecting mainly the statistical effect of the year-on-year increase in the

[39] According to press releases by APIA and ACSI, additional payments were made to farmers and in relation to projects financed from European funds, but a breakdown by recipient (households and companies) is quite difficult to perform.

[40] According to budget executions released by the MPF.

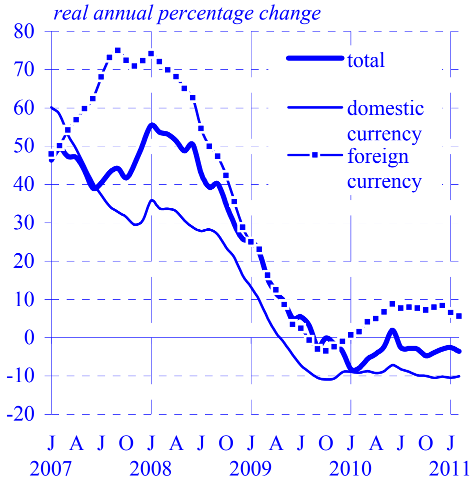
[41] According to balance of payments data, the value of financial loans-related net payments of the non-bank sector December 2010 through January 2011 exceeded that recorded in the previous period.

[42] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for December 2010 – February 2011.

RON/EUR exchange rate[43]. The growth rate of the foreign currency component, expressed in EUR, stuck to a downward path, while the negative dynamics of leu-denominated credit remained somewhat stable. However, the share of foreign currency-denominated loans in total credit to the private sector peaked at an 8½-year high of 62.9 percent, on average, over the period. The still weak lending activity to the private sector was due both to the persistently subdued demand for loans and to banks' still cautious stance, the latter being warranted by the protracted worsening of their credit portfolio quality. Nevertheless, the loan supply seems to have exhibited feeble signs of recovery, amid banks' estimates on the easing of some lending terms and conditions[44] and the more numerous promotional offers for refinancing products targeting mainly household loans[45]. Against this background, the slight pick-up in the volume of new business[46] as against the previous three months' reading may be ascribed primarily to the loan restructuring process. As far as companies are concerned, credit transfers performed by banks acted as another driver of this development, the outcome being a larger volume of loans purchased during the reported period compared to the volume of outsourced loans[47]. Developments in corporate loans reflected the favourable contribution of the leu-denominated component, especially the long-term one, whose growth rate re-entered positive territory for the first time in the past 18 months. Conversely, the pace of increase of the foreign currency component (expressed in EUR) contracted slightly. The weaker negative dynamics of household loans was largely attributable to the more sluggish decline of forex-denominated consumer loans and other loans[48]. The growth rate of housing loans (irrespective of denomination) declined further, mainly as a result of a temporary halt in the "First Home" programme. The dynamics of net credit to central government contracted on the back of the slacker growth of banks' government security holdings.

Credit to Private Sector by Currency

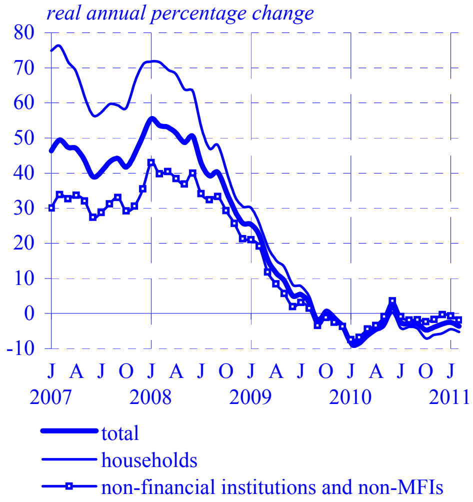
real annual percentage change



Source: NIS, NBR

Credit to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

43 Based on end-of-period readings.

44 According to the NBR's survey on lending to non-financial corporations and households released in February 2011, credit institutions expected, for 2011 Q1, an easing of lending standards related to short-term loans to non-financial corporations and consumer and housing loans to individuals.

45 Also underpinned by the entry into force of Law No. 288/2010 approving GEO No. 50/2010 on consumer credit contracts, which provides for lower or even zero early repayment fees.

46 Based on data reported by banks pursuant to NBR Norms No. 14/2006.

47 Transfers between local banks and other sectors impacting the loan stock.

48 The two loan categories have been reviewed as a single indicator so as to eliminate the effects induced by the changes operated in the statistical methodology as of June 2010, in line with ECB Regulation No. 25/2009 concerning the balance sheet of the monetary financial institutions sector.

V. INFLATION OUTLOOK

For end-2011, the baseline scenario of the current projection places the annual CPI inflation rate at 5.1 percent, 1.5 percentage points higher than the level in the February 2011 Inflation Report and 1.1 percentage points above the upper limit of the variation band around the 3 percent target. For end-2012, the inflation rate is forecasted to stand at 3.6 percent, 0.4 percentage points higher than the previously projected level, but still within the variation band.

After temporarily accelerating in 2011 Q2 under the impact of supply-side shocks affecting most emerging economies, the projected dynamics of annual CPI inflation and CORE2 inflation are expected to follow a sharply downward trend until early 2012. The fading out of the first-round effect of the VAT rate hike will play a major role in curbing the CPI inflation rate from an expected 8.7 percent in 2011 Q2 to 5.6 percent in 2011 Q3. In the second part of the forecasting horizon, the CPI inflation rate is projected to return and remain within the variation band around the central target, while the CORE2 inflation rate is envisaged to remain below 3 percent.

The significant upward revision of the projected path of the annual inflation rate in 2011 is largely the result of sizeable increases in international prices of food and non-food commodities, oil included. Given the magnitude of these shocks, the projected contributions to the CPI inflation rate are larger than in the previous forecast for both exogenous components (volatile and administered prices) and the CORE2 index.

The CORE2 inflation forecast is adversely affected not only by commodity price increases, but also by the ensuing upward revision of inflation expectations as well as the projection of an additional effect from the price dynamics of tobacco products in 2011 Q2. Moreover, having revised the negative output gap to relatively lower levels for the first part of the projection horizon also implies lower disinflationary pressures than those considered in the previous forecast. The projected dynamics of import prices imply a smaller contribution to CORE2 inflation in 2011, due to a stronger leu against both the euro and the US dollar over the first half of the year, and a slightly larger contribution in 2012.

With the aim of enhancing the prospects of resuming disinflation in the medium term, the monetary policy rate will follow a trajectory in line with maintaining the broad real monetary conditions adequate to prevent second-round effects of such shocks from becoming manifest. Furthermore, ensuring the external and internal equilibria of the economy is strictly conditional on the *other macroeconomic policy mix components cooperating with the monetary policy, through consistent implementation of the economic programme for fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank.*

Similarly to previous forecasting rounds, the uncertainty associated with the current projection is high. Although some of the risks highlighted in the February 2011 Inflation Report *have already materialised, sources generating additional risks remain highly relevant. Hence, the overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to remain significantly tilted to the upside.*

This is due to both domestic and external risks. Among the former, a considerable risk arises from the possible adjustments in administered price structure and dynamics. In the absence of a calendar and of quantitative coordinates publicly committed to by the relevant authorities, the baseline scenario of the projection builds on conservative assumptions regarding administered price dynamics. However, the recurrent delays in some of these adjustments, along with the commitments implied by Romania's EU membership and those agreed under the arrangements with the EU, the IMF and the World Bank make it more likely that certain measures may be taken in the reference period that will impact considerably on the dynamics of administered prices.

Looking to the forthcoming election year, major risks stem from the fiscal policy stance and the structural reform programme. Any significant slippages from the coordinates agreed under the arrangements with the EU, the IMF and the World Bank, amid political or social pressures, would prove detrimental to the internal and external equilibria of the economy, entailing adverse effects on both inflation and economic growth.

Among the risks related to the external environment, the most relevant are those related to the ongoing tensions on global commodity markets, the vulnerability of the fiscal consolidation process and of external debt sustainability in several euro area countries, the imbalances that might be triggered by Romania's experiencing an increase in inflows of volatile capital over the reference period – which may also impose constraints on the dosage of monetary policy tools – as well as possibly major fluctuations in the EUR/USD exchange rate.

1. The baseline scenario of the forecast

1.1. External assumptions

Expectations on the Developments in External Variables

annual averages

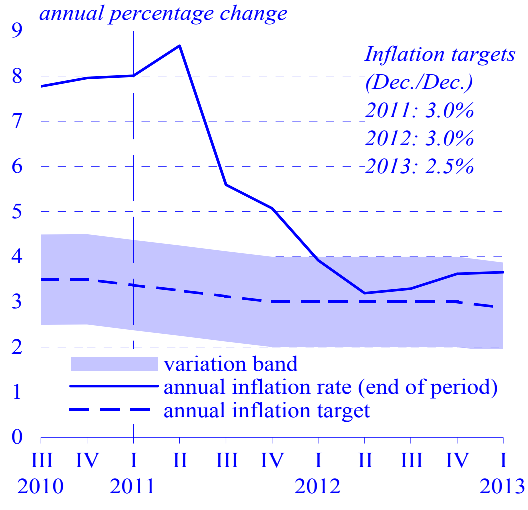
	2011	2012
WTI oil price (USD/barrel)	106.4	113.5
EUR/USD exchange rate	1.38	1.36
3M EURIBOR interest rate (% per annum)	1.55	2.58
Economic growth in the euro area (%)	1.7	1.7
Annual inflation rate in the euro area (%)	2.3	1.8

Source: NBR assumptions based on the data provided by U.S. Energy Information Administration, Eurosystem staff macroeconomic projections for the euro area, Consensus Economics

The scenario regarding the development of the euro area economy foresees the average annual real GDP growth to stand at 1.7 percent in both 2011 and 2012. This figure was revised upwards by 0.2 percentage points for this year and by 0.3 percentage points for next year compared to the February 2011 *Inflation Report*. Euro area growth is expected to be further supported by the favourable contribution of exports driven by the fast-growing emerging economies. Against the background of the pass-through of past monetary policy measures and of those aimed at restoring the smooth functioning of financial markets, domestic demand is anticipated to have a positive and rising contribution. However, the GDP performance is expected to be uneven across the euro area and economic recovery to be slow, owing to the implementation of fiscal consolidation measures, combined with persistently high unemployment rates in some Member States, and to the need for balance sheet adjustment in various sectors.

Under the current baseline scenario, the euro area annual HICP inflation is projected to average out at 2.3 percent in 2011 (revised upwards by 0.7 percentage points compared with the previous forecasting round) and 1.8 percent in 2012 (revised downwards by 0.3 percentage points). For this year, the upward revision is attributed to stronger-than-previously-expected increases in energy and food prices. Against the backdrop of substantially higher inflationary pressures, especially in 2011, the 3M EURIBOR path was revised upwards throughout the projection horizon. Consistent with the new path in the interest rate, the exchange rate of the euro follows a slightly higher trajectory than that previously anticipated.

Inflation Forecast



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

Source: NIS, NBR projections

The oil price[49] is projected to increase throughout the forecast horizon. Compared to the previous round, its quarterly change was substantially revised upwards for 2011 Q2, but differences are small over the remaining part of the projection horizon.

1.2. Inflation outlook

According to the current projection, the annual CPI inflation rate will stand at 5.1 percent at end-2011 (1.5 percentage point upward revision compared to the previous projection) and 3.6 percent at end-2012 (0.4 percentage point upward revision). The annual price dynamics is foreseen to temporarily accelerate in 2011 Q2 under the impact of some significant supply-side shocks. The fading out of such shocks – including the first-round impact from the VAT rate

[49] In the current round, the scenario regarding the developments in the oil price over the period 2011 Q2 – 2012 Q4 is taken from EIA.

hike – is expected to bring the inflation rate onto a disinflationary trajectory starting with 2011 Q3, while in 2012 Q1 the inflation rate is anticipated to re-enter the variation band around the central target.

At a disaggregated level, the components of CPI inflation which are exogenous in terms of the monetary policy scope, are seen having a substantial impact throughout 2011, with the annual dynamics of administered prices, volatile food prices (VFE) and fuel prices making a cumulated 2.8 percentage point contribution at end-2011. By contrast, the CORE2 index[50] will have a lower contribution to CPI inflation at end-2011, i.e. 2.3 percentage points, of which 0.3 percentage points owing to tobacco prices. For end-2012, CORE2 inflation is expected to make a larger contribution to headline inflation than the cumulated contribution of all the other components.

The significant revisions in the current projection were driven to a large extent by the materialisation of a few risks mentioned in the February 2011 *Inflation Report*: the first-quarter increase in international commodity (mainly oil) and food prices and, to a smaller extent, higher-than-previously-projected administered prices.

The tensions on the international agri-food market, which are anticipated to persist into 2011 Q2 amid the weak domestic supply, caused an upward revision in the projected trajectory of the annual inflation of volatile food prices (VFE) and of the CORE2 index (through the effect on the food items included in this index). The contribution of VFE inflation to CPI inflation at the end of 2011 was subject to an upward revision of 0.7 percentage points compared to the previous projection. Assuming normal crops in 2011 and 2012, the contribution of VFE inflation is forecasted to decline by the end of next year.

After reporting a larger-than-previously-projected increase in 2011 Q1, the world oil price is expected to surge more sharply in Q2. Consequently, the projected trajectory of the annual rate of fuel price inflation was subject to an upward revision for the whole of 2011, the marked hike in the oil price being only partly offset by a more favourable evolution of the domestic currency against the euro and the US dollar. The projected annual rate of fuel price inflation for 2012 is similar to that presented in the February 2011 *Inflation Report*.

The previous scenario on administered price developments during 2011 was updated based on first-quarter data and the price increases announced for April. Therefore, the trajectory of the annual change in administered prices for 2011 was revised upwards, the contribution of this category of prices to CPI inflation

[50] CORE2 is currently holding the largest share in the CPI basket, i.e. 68.61 percent.

The Annual Inflation Rate in the Baseline Scenario

annual percentage change (end of period)

	2011			2012				2013
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Target			3.0				3.0	
Forecast	8.7	5.6	5.1	3.9	3.2	3.3	3.6	3.7

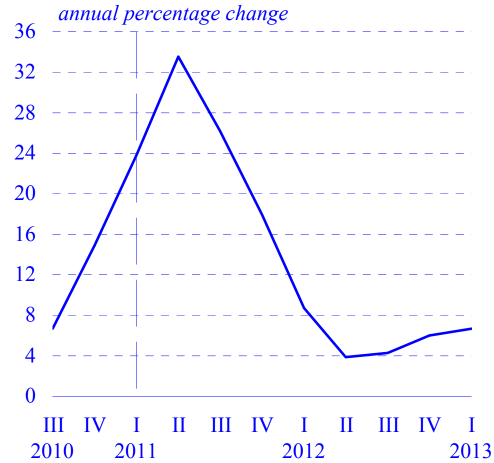
Components' Contribution to Annual Inflation Rate*

percentage points

	2011	2012
administered prices	0.8	0.8
fuels	0.9	0.5
VFE prices	1.1	0.4
CORE2, of which:	2.3	1.9
tobacco	0.3	0.0

** end of period*

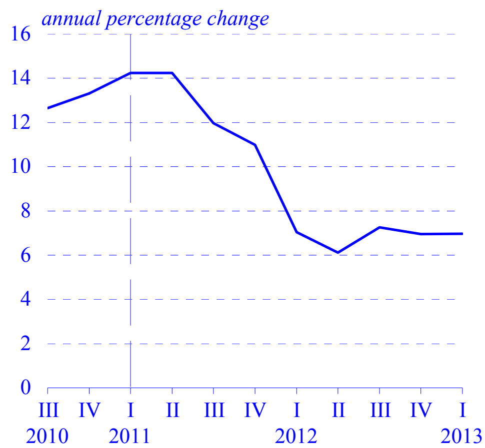
Vegetables, Fruit and Eggs Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR projections

Fuel Prices Annual Inflation*



*) quarterly average

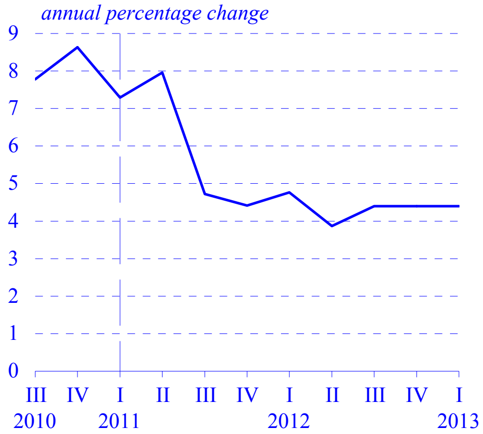
Source: NIS, NBR projections

edging up 0.1 percentage points. The February assumption of a 4.4 percent rise in administered prices was maintained for the end of 2012, their contribution to CPI inflation remaining therefore unchanged.

The annual rate of CORE2 inflation is expected to follow a higher trajectory than in the February 2011 *Inflation Report* throughout the projection horizon, the upward revision being significant in the first part of the forecast horizon due to multiple supply-side shocks. Apart from the pick-up in the price of processed food items included in this index, an unfavourable effect on core inflation is also expected in Q2 from tobacco prices. The fading out of supply-side shocks, including the first-round effect stemming from the VAT rate hike, and the offsetting of second-round effects via monetary policy tools will help reduce the annual rate of CORE2 inflation starting with 2011 Q3 and will maintain it below 3 percent in 2012.

Administered Prices Annual Inflation*

annual percentage change



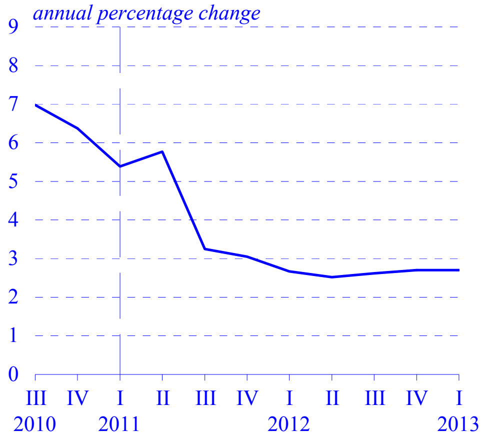
*) quarterly average

Source: NIS, NBR projections

As for the determinants of core inflation, similarly to the latest projections, aggregate demand is seen having a favourable impact on CORE2 inflation throughout the projection horizon, although its magnitude is expected to be lower than that envisaged in the previous *Inflation Report*[51]. Import prices are anticipated to have a lower contribution to CORE2 inflation in the first part of the forecast horizon, the upward revision of euro area inflation being countered by a comparatively more favourable evolution of the national currency. In the second half of the projection horizon, amid a more substantial contraction in the projected interest rate differential between leu-denominated deposits and foreign currency-denominated deposits[52], import prices are foreseen to have a somewhat greater contribution than in the previous forecasting round. The economic agents' inflation expectations are projected to follow a higher trajectory than in the previous forecast under the impact of multiple supply-side shocks in Q1, reflecting the uncertainties surrounding their future persistence and magnitude.

Annual CORE2 Inflation*

annual percentage change



*) quarterly average

Source: NIS, NBR projections

Although the Tax Code published in 2011 sets forth a higher excise duty on tobacco for 2011-2018, the increases are gradual and of a low magnitude in each period. The end-2011 projection was revised upwards, owing entirely to cigarette price rises in January and April that are not related to the higher excise duty on tobacco. For end-2012, the annual growth rate of tobacco prices is forecasted to be below one percent.

[51] For details on the developments in the negative output gap, see Subsection *1.3.3. Demand pressures within the projection horizon*.

[52] The decline is attributed to the renewed upward revision of the 3M EURIBOR path.

Box

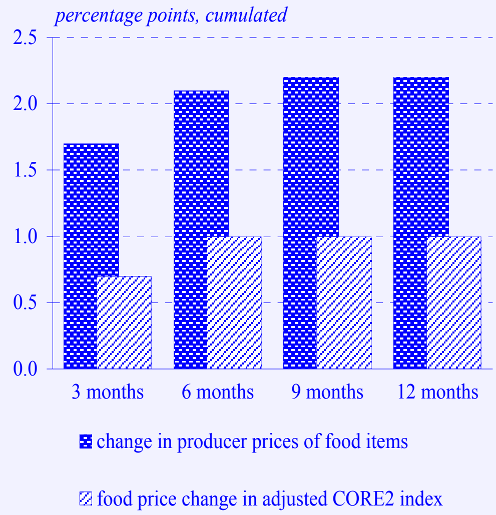
The assessment of the impact of a shock in global food prices on domestic macroeconomic variables

This box describes the results of a quantitative analysis focusing on the assessment of the impact of higher global food prices[53] on domestic macroeconomic indicators. The analysis includes both econometric estimations and simulations conducted using the macroeconomic model used by the NBR.

First, the pass-through of global food price dynamics to the domestic inflation rate was assessed on the basis of econometric models that take into account the supply chain approach: two separate equations were estimated, linking the dynamics of international food prices and those of the domestic producer prices, on the one hand, and the dynamics of producer prices and those of domestic prices of food items included in the adjusted CORE2 index, on the other hand (the methodology is similar to that employed by Bukeviciute et al., 2009[54]).

According to the results, about 10 percent of a shock in international food commodity prices feed through to the core inflation of domestic food prices in the course of one year, with the strongest impact occurring in the first quarter (see the adjoining chart). Given the share in the CPI basket of the food items included in the adjusted CORE2 index (nearly 30 percent), a shock of the aforementioned magnitude would add at least 0.3 percentage points to headline inflation should potential second-round effects be left out of account. Moreover, the analysis highlighted an asymmetry in the transmission of international prices to domestic food prices in that only price increases (unlike price decreases) have a statistically significant impact on domestic producer and consumer prices.

Pass-through of a 10 percent increase in global food prices



Source: NBR estimates

Impact of higher external prices is stronger on producer prices than on consumer prices. The explanation may lie with the producers' changes to the production cost structure or with the competition in the retail trade sector, which puts downward pressure on profit margins.

The methodology described above has also been applied to the sub-components of the CORE2 index for food prices. The results show that the pass-through of the external price movements to domestic prices varies considerably across food item groups. Thus, prices of bakery and milling products, edible oils and fats, and sugar and confectionery prove sensitive to the change in international commodity prices, while the prices of other food items such as meat and dairy products react more strongly to the fluctuations in local agricultural commodity prices.

[53] The assessment is based on the international food price indices computed by the ECB and the IMF respectively.

[54] See Bukeviciute L., Dierx A. and Ilzkovitz F. (2009), "The functioning of the food supply chain and its effect on food prices in the EU", *European Commission*, *Occasional Paper* No. 47.

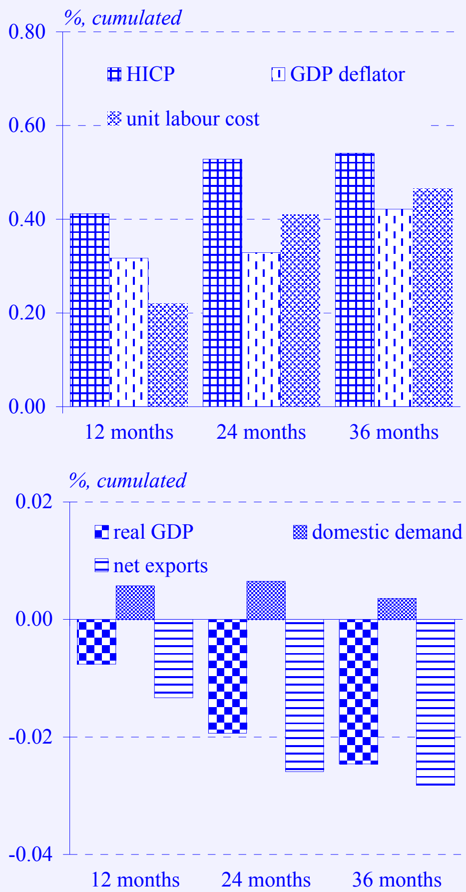
These preliminary econometric estimates have been incorporated in the NBR's macroeconomic model used for analysis and forecasting, which allows for quantifying the impact of a shock in global food prices on a larger range of indicators. The simulations were conducted under the following constraints: (i) an unchanged path of the monetary policy rate, (ii) an unchanged path of the nominal effective exchange rate (weighted basket made up of the euro and the US dollar), and (iii) no discretionary reaction[55] from fiscal policy. It should be stressed that the assumptions have a technical nature, aiming not to distort the size of the inflationary impact induced by the considered shock, by having the macroeconomic policies counteract the impact of the shocks. Hence, they should not be interpreted as expectations of fiscal and monetary policy stances.

The adjoining charts set out the responses of other relevant macroeconomic indicators following an adverse shock equivalent to a 10 percent increase in global food commodity prices. The figures are deviations from the initial equilibrium after 12 months, 24 months and 36 months respectively.

A 10 percent increase in global food commodity prices feeds swiftly through to import prices[56], entailing an almost 0.4 percent rise in consumer prices after 12 months. The hike in the general price level brings about, especially during periods of labour productivity increases, higher wage claims that push up wage costs, thereby depressing external competitiveness and, ultimately, the net exports. Private consumption does not undergo significant adjustments[57], but investment picks up under the impact of real monetary conditions turning slightly stimulative if no offsetting reaction from monetary policy (which is one of the assumptions the analysis hinges upon) occurs. Thus, real GDP growth slows down due primarily to net exports, contracting by a cumulated 0.02 percent after three years.

Note: It should be pointed out that the considered shock is a global one and the levels given herein exclude the impact that the higher food prices could have on Romania's trade partners, effects which could enhance the initial shock on domestic macroeconomic variables (net exports, real GDP, CPI inflation, etc.).

Effects of a 10 percent increase in global food prices



Source: NBR estimates

55 Some changes will definitely affect the consolidated general government budget, following the action of automatic stabilisers.

56 Food items account for 6 percent of total imports.

57 A main feature of food items is price inelasticity, i.e. a given change in prices translates into a smaller change in consumption.

1.3. Aggregate demand pressures

1.3.1. Current aggregate demand pressures

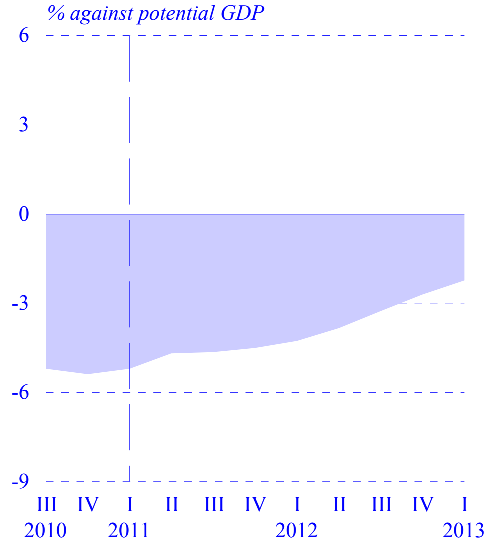
Real GDP for 2011 Q1 is anticipated to show a moderate quarterly growth rate[58], yet faster than that reported in the previous quarter. In this environment, for the first time since 2008 Q4, conditions are set for a positive annual growth rate of real GDP.

For the current forecasting round, the potential GDP growth rate remains at lower levels than those registered before the onset of the recession, as also suggested by the production function based analysis. According to this, potential GDP dynamics is attributable mainly to the unfavourable performance of total factor productivity and to the slower increase of the capital stock following the marked drop in investment flows. The contribution of the fall in employment to potential GDP dynamics continues to be small.

Given the positive GDP dynamics and a moderate rate of increase of potential GDP for 2011 Q1, the negative output gap is expected to narrow slightly versus 2010 Q4. This implies, *ceteris paribus*, the easing of aggregate demand disinflationary pressures. Mention should be made that, subsequent to the latest GDP revision by the NIS, the trajectory of the demand deficit in the periods prior to 2011 Q1 was revised downwards[59].

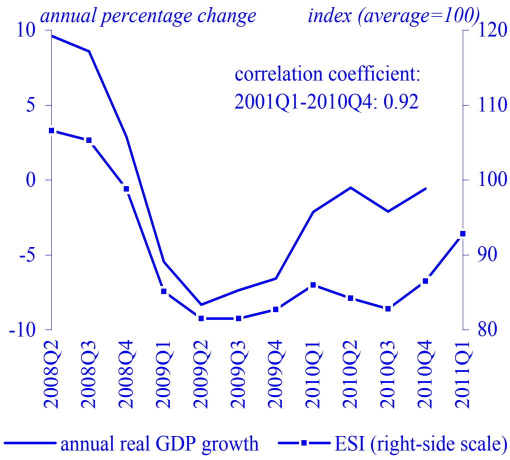
The narrowing of the negative output gap is also suggested by the performance, coincidental with GDP dynamics, of certain monthly indicators (particularly those associated with industrial activity). Thus, compared with the average for the previous quarter, industrial output rose by 2.7 percent in the period January-February, whereas capacity utilisation rate moved up 3.7 percentage points for the entire 2011 Q1. Moreover, energy consumption economy-wide increased[60] and the change in the economic sentiment indicator (ESI)[61] points to a significant improvement in overall expectations of both consumers and companies, although its value stays below the long-term average. Furthermore, insufficient demand in industry is cited to a lesser extent by respondents as one of the factors depressing manufacturing production.

GDP Deviation



Source: NIS, NBR calculations

Economic Sentiment Indicator and Economic Growth*



*) seasonally adjusted

Source: NIS, EC-DG ECFIN

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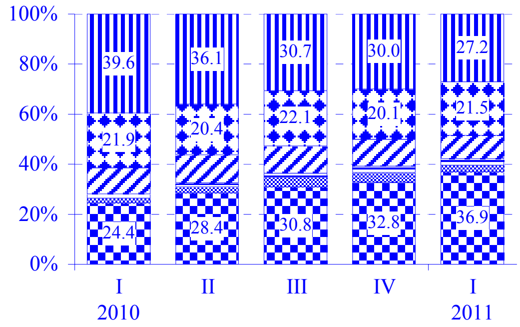
58 The quarterly growth rates of GDP and its components are consistent with the seasonally adjusted data series, whereas the annual growth rates are in line with the non-seasonally adjusted data series – both released by the NIS.

59 This was the result of a real GDP revised level (seasonally adjusted data) which, starting with 2009 Q3, was higher than the level referred to previously.

60 The 2.7 percent growth in the period January-February compared to the average for 2010 Q4 (NBR seasonally adjusted data).

61 ESI and the other above-mentioned confidence indicators are part of the EC-DG ECFIN surveys.

Factors Depressing Industrial Output



Source: EC-DG ECFIN

As regards aggregate demand components, the narrowing of the demand deficit for 2011 Q1 is indicative mainly of the less negative cyclical position of private consumption and gross fixed capital formation, while the positive cyclical position of net exports is seen to diminish slightly. These assessments are based on the expectation of moderately positive quarterly growth rates in 2011 Q1 for each GDP component by type of expenditure.

The quarterly growth rate of actual final consumption of households is expected to re-enter positive territory in 2011 Q1. Household disposable income went up moderately in the period January-February compared with the average for Q4, given the rise in the expenditures of the social security budget, with wage earnings and current private transfers, as well as new consumer loans posting slightly negative growth[62]. The performance of new consumer loans[63] does not mirror the expectations of commercial banks that, in 2010 Q4, foresaw both the easing of lending standards and higher demand for 2011 Q1.

A potential increase in consumption in 2011 Q1 is also suggested by the good performance of certain supply-side indicators. In the period January-February, retail sales turnover index (except of motor vehicles and motorcycles) advanced by 0.4 percent and the turnover volume index of market services to households rose by 3.7 percent compared with the average for Q4. At the same time, in 2011 Q1, consumer expectations concerning their financial standing and economic performance in the following 12 months improved versus 2010 Q4[64].

Public consumption is expected to see positive quarterly dynamics in 2011 Q1. According to preliminary data released by the Ministry of Public Finance, the consolidated general budget deficit at end-March 2011 accounted for 1.0 percent of GDP, a value lower than that recorded a year earlier.

Gross fixed capital formation is forecasted to post, in 2011 Q1 as well, a positive quarterly dynamics, on the rise from 2010 Q4. The uncertainty surrounding the anticipated performance is, however, elevated given that the relevant indicators witnessed divergent developments. Thus, in the period January-February 2011, capital repair works in construction advanced markedly (by 10.1 percent) and the turnover of the domestic market for capital goods increased by 3.6 percent, compared with the previous quarter average. On the other hand, during the same period, new construction works contracted by 7.7 percent.

[62] For a description of the dynamics of disposable income in 2010 Q4, see Chaper III, Subsection *1.1.1. Consumer demand*.

[63] -0.4 percent in real terms in the period January-February 2011 versus the previous quarter average.

[64] See footnote 61.

The quarterly dynamics of exports is foreseen to stay in positive territory and further exceed that of imports. The favourable development of exports will be fuelled by the expected further positive GDP dynamics in the euro area[65], against the background of the private sector's improved expectations on the economic activity[66] and the pick-up in industrial output[67]. Furthermore, the 2.7 percent increase in Romania's industrial output in the period January-February 2011 compared with 2010 Q4, as well as the expected positive developments in final consumption, gross fixed capital formation and exports lay the groundwork for further import growth in 2011 Q1.

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

In the first quarter of 2011, the domestic currency appreciated in nominal terms both against the euro and the US dollar as compared with the previous quarter. The joint effect of the two quotations on the nominal effective exchange rate[68] resulted in a quarterly appreciation that contributed, *ceteris paribus*, to the slower increase in consumer prices via the favourable influence it exerted on import prices. The nominal appreciation coupled with the positive inflation differential relative to trade partners led to an appreciation of the leu in real terms in Q1 2011 compared with the preceding quarter.

The first quarter of 2011 witnessed an improvement in investors' perception regarding the prospects of national economy, amid the successful completion of the arrangement with the EU, the IMF and the World Bank and the initiation of a new precautionary stand-by arrangement, as well as due to some encouraging signals on real economy developments. This was also reflected by the spreads of credit default swaps (CDS[69]) for Romania, which declined slightly against the background of a relatively stable climate in the region.

According to the NBR assessment, the real effective exchange rate will exert a neutral impact on aggregate demand via the net export channel in the short run. On the other hand, the real effective exchange rate will have a stimulative impact on aggregate demand via the wealth and balance sheet effects over the coming periods

[65] The quarterly real GDP growth in the euro area in 2010 Q4 stood at 0.3 percent.

[66] The economic sentiment indicator (ESI) in the euro area averaged at 107.3 in 2011 Q1 compared with 105.6 in the previous quarter.

[67] Industrial production in the euro area rose by 1 percent in January and February 2011 compared with the average for 2010 Q4.

[68] The exchange rate based on which the assessment is made implies the RON/EUR and RON/USD exchange rates, according to the weights of the two currencies in Romania's foreign trade.

[69] Source: Bloomberg.

due to lower domestic currency-denominated costs of foreign-denominated loans.

In the first quarter of 2011, interest rates applied by credit institutions to their non-bank clients decreased both in nominal and real terms, amid stronger inflation expectations than those seen in the previous quarter. This development implies a slightly stimulative and growing joint influence of real interest rates on real economic activity.

As a result of the developments in the first quarter of 2011, the joint effect of the exchange rate and interest rates on aggregate demand in the future period is assessed as slightly stimulative.

1.3.3. Demand pressures within the projection horizon

Compared with the February 2011 *Inflation Report*, the negative output gap is projected to be less pronounced over the first part of the forecast horizon. The reassessment, also encompassing 2010 Q4, was due primarily to the NIS revising the real GDP level above the previously-released figures, for several quarters of recent historical data. Hence, the higher starting point and the projected dynamics of the fundamental drivers of the output gap, as detailed below, materialise in lower disinflationary pressures in the first part of the projection horizon.

Unlike the previous round, real broad monetary conditions are projected to exert overall a relatively more restrictive impact on inflationary pressures. The reassessment owes largely to the projected dynamics – less supportive in terms of net exports – of the real effective exchange rate, amid the steeper upward revision of the domestic inflation trajectory compared to the external one. This is partly offset by the more favourable effect of external demand for Romanian exports. The wealth and balance sheet effect is expected to have a more stimulative influence over the first three quarters, given the favourable impact of the projected developments in the real exchange rate. The joint effect of the deviations of real interest rates on leu-denominated deposits and loans from their trends is rather stimulative during the first quarter of the projection, amid rising inflation expectations, and less stimulative[70] over the remainder of the interval.

The fiscal impulse is expected to be pro-cyclical with respect to the economic activity throughout the projection horizon given the considerable fiscal effort implied by the government's attempt to gradually narrow the budget deficit in line with the quantitative

[70] Under the impact of a monetary policy rate trajectory calibrated so as to offset potential second-round inflationary pressures triggered by supply-side shocks forecasted for the reference period of the projection (see Subsection *1.2. Inflation outlook*) and create the conditions for a gradual resumption of lending to the real economy.

objective agreed with the EU for 2012, i.e. 3 percent of GDP. Building on a narrower budget deficit for 2010 than that projected in the February 2011 *Inflation Report*, the anticipated adjustment scheduled for 2011 has a lower magnitude and entails, *ceteris paribus*, a less restrictive impact on aggregate demand compared to the previous forecast. For 2012, however, the current projection envisages a less favourable contribution of the fiscal impulse to economic growth, mainly as a result of the lower structural component of the budget deficit for 2011.

The current round foresees a modest rebound in the annual dynamics of final consumption over the first part of the projection horizon. During the latter part of the horizon, this domestic demand component is expected to grow at a faster pace, amid stronger economic growth and the revival of consumer confidence. The advance in gross fixed capital formation is expected to outpace that of final consumption as domestic output is significantly supported by the external demand for Romanian products. The positive dynamics of real exports is anticipated to persist, fostered by the increase in euro area GDP, contributing – along with the forecasted recovery in domestic demand – to the rise in real imports throughout the projection horizon. Against this background, the current account deficit expressed as a share to GDP is expected to widen slightly by the end of 2012.

1.4. Risks associated with the projection

Developments in recent months indicate that some of the risks highlighted in the February 2011 *Inflation Report* have materialised. Since the influence of these supply-side factors is expected to persist, the overall balance of risks of inflation rate deviating from the baseline scenario trajectory appears to remain significantly tilted to the upside.

Among the risks related to the external environment, the most relevant are associated to the developments in global oil prices and international prices of food and non-food commodities[71] and their pass-through to certain domestic components of CPI inflation. The rationale behind these developments can be traced back to the dynamics of several emerging economies[72], although – when looking at the broader picture – the monetary policy pursued by some major central banks further acts as the key driver[73]. On the other hand, the lingering uncertainties surrounding the global

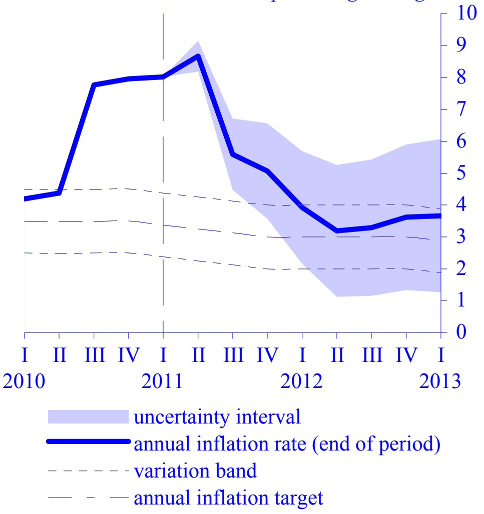
[71] See the Box titled "The assessment of the impact of a shock in global food prices on domestic macroeconomic variables".

[72] Such as those in Asia or South America.

[73] The effect of various monetary policy options may also be assessed in terms of the exchange rates between the currencies of the world's leading economies.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario

annual percentage change



Source: NIS, NBR projections and calculations

economy and the euro area economy in particular[74] act as further constraints upon the domestic economic activity.

One of the domestic risk factors relates to the fiscal policy stance. Any slippages from the targets agreed under the new precautionary agreement with the EU, the IMF and the World Bank could have a detrimental impact on the financing of the public and real sectors as well as on investor perception of Romania's sovereign risk, which fundamentally hinges on the coherence of economic policies pursued by the authorities. On the other hand, the volatility on global financial markets and that of capital inflows further act as a major source of uncertainties regarding inflation and domestic economic activity.

Neither the magnitude, nor the exact timing of possible adjustments may be accurately assessed in the absence of a firm implementation calendar and/or clear official signals regarding administered price changes expected over the period ahead. However, there are several elements hinting at the nature and direction of potential changes, such as cuts in subsidies[75], larger investment expenditure facing the *régies autonomes* under pressure to align to certain standards (in terms of environment, retooling, etc.) and rises in production costs under the impact of more expensive commodities on world markets. Another risk is related to the uncertainties surrounding the decision to liberalise the natural gas and electricity market, which is caught in between political and/or social motivations, on the one hand, and the need to comply with EU-wide requirements[76], on the other hand.

All these elements stand out as major risk factors related to the current scenario, given the emerging threat of disanchoring medium- and long-term inflation expectations.

2. Policy assessment

After having fallen in January[77], the annual inflation rate returned to a sharp uptrend in February to reach 8.01 percent at the end of 2011 Q1. Hence, its deviation from the upper limit of the variation band around the central target saw a renewed widening.

[74] Especially for the countries facing heightened vulnerability as regards the sustainability of their external debt and/or fiscal policy.

[75] For instance, depending on the actual timing and manner of eliminating heating subsidies (either from the government budget or from the local budgets), products with administered prices could add between 0.3 and 0.9 percentage points to the annual CPI inflation rate for end-2011.

[76] Directive 2009/72/EC and Directive 2009/73/EC.

[77] Due largely to the base effect following the hike in cigarettes prices at the beginning of 2010.

Against this background, the new medium-term inflation forecast coordinates were adjusted considerably, with the updated trajectory of the projected annual inflation rate rising far higher than the path presented in the previous forecasting round, especially in the first part of the projection horizon. The turning point of the trajectory expected for 2011 Q3 amid the fading out of the first-round effect of the VAT rate hike in particular appears however to be more pronounced than that previously forecasted. The combined effect of both prospects is the delay by only one quarter (2012 Q1) in the anticipated annual inflation rate falling back inside the variation band around the 3 percent target. Similarly to the previous forecast, the projected annual inflation rate will subsequently decline and remain close to the midpoint of the target over the following quarters, but will then see a relatively higher rise at the longer end of the projection horizon.

The significant worsening of the inflation outlook in Romania in the short term is almost entirely the result of the action of cost/supply-side factors arising chiefly from adverse developments on global commodity markets, which were boosted also by the recent environmental and geopolitical tensions in certain areas around the world. Thus, at the root of this worsening lies the sharp upsurge in food and fuel prices in the early months of 2011 as well as the high likelihood of a protraction in the upward trend in such prices, given the persistence of tensions on both global and domestic commodity markets, mostly farm produce markets, at least until the new crops. In the Romanian economy, the steep rise in food prices could also reflect the results of the recent measures to clamp down on tax evasion, especially as far as fruit and vegetables are concerned. Another major driver is the faster annual rate of increase of administered price adjustments expected for 2011, owing also to the unexpected electricity price hike, effective April, as well as the latest and future fuel price increases. Adding to these factors are the slight worsening of the projected evolution of core inflation, which reflects in turn the indirect effects of the already mentioned factors – primarily on processed foodstuff prices – and, to a far lower extent, the relative decrease in the disinflationary impact of the projected negative output gap following the downward adjustment of the latter; both influences are mitigated by the anticipated strengthening of the leu throughout 2011.

The risks and uncertainties surrounding the forecast of medium-term macroeconomic developments, and implicitly that of inflation, are deemed to remain significant. Particularly worrying are the uncertainties related to the magnitude and especially the timing of inflationary effects induced by the possible future adjustment/removal of some administered prices, which constitute, in part at least, conditionalities of the EU-IMF-World Bank agreement subordinated to the objective of reforming state-owned enterprises and, implicitly, furthering fiscal consolidation. A possibly fast implementation of most of these measures[78] could translate in the near run into a wider departure of the annual inflation rate from the upper limit of the variation band around the 3 percent target. By contrast, should the authorities choose to approach structural reforms gradually, disinflation over the longer term of the projection horizon and, implicitly, the convergence of the annual inflation rate towards the medium-term target would considerably be stymied.

From the perspective of keeping the annual inflation rate on the projected path, another major risk is the longer-than-projected growth/persistence of elevated levels of oil and agricultural commodity prices on world markets if the gap between supply of and demand for such goods carries on, also as a result of a quicker recovery of the latter. Under the circumstances, this risk is increasingly relevant given the possible lingering of geopolitical tensions in North Africa and the Middle East and of an overheating trend in some emerging economies, along with the potential rise in the rate of occurrence and magnitude of severe weather conditions around the world. Adding to this risk is that of an increase in the magnitude of some indirect tax and regulated price adjustments in EU/euro zone countries given the need for furthering fiscal consolidation in those countries.

In an economy where the resource utilisation would be at or come close relatively fast to the normal level, such a context would increase substantially the concern for the risk of second-round effects of past and foreseen adverse supply-side shocks materialising and thus call for the central bank to react accordingly[79] in order to ensure that inflation expectations are anchored over the medium term. In this context, a rate increase, as the one recently decided by the ECB and other central banks, would be all the more so motivated had the previous monetary policy stance been very accommodative.

However, the Romanian economy is undergoing a fairly different stage of the business cycle. According to estimates, it has only very recently reached the trough of the negative output gap and the likelihood of the risk of second-round effects of supply-side shocks materialising is substantially lower. Therefore, the most suitable response of the central bank would be to stick to the status-quo in the policy rate all the more so as its level over the past quarters, which is considerably higher than those prevailing in the EU, combined with the expected movements in the leu exchange rate, appears to be consistent with the outlook for

[78] They include chiefly the following: to reduce/remove subsidies for heating, to liberalise natural gas and electricity markets, and to raise public transportation fares.

[79] Which would also consider the monetary policy impulses transmission lag.

disinflation to resume in 2011 H2 and subsequently to strengthen, concurrently with the budding gradual recovery of the Romanian economy.

One of the prerequisites and a major condition of such a reaction by the central bank is the further consistent implementation, as the authorities have committed to, of fiscal consolidation and already initiated structural reforms that will mitigate the risk of an economic policy slippage. By way of its envisaged objectives – to ensure macroeconomic stability and enhance the efficient allocation and use of all types of resources, as well as to increase productivity and competitiveness of the Romanian economy –, the implementation of such policies could minimise the risk of second-round effects of the supply-side shocks, on the one hand, and could help improve investor perception on the economic outlook and reduce the local market risk premium, on the other hand.

It is an absolute must that the monetary authority should remain highly vigilant in order to prevent second-round supply-side shocks in the period ahead given the magnitude of the inflationary impact stemming from food price increases in particular. Across the Romanian economy, this is augmented by the very large share of these goods in the CPI basket and the poor elasticity of demand for some food items, due *inter alia* to rigidities in some household consumer preferences, arising also from their old-established behaviour. Against this backdrop, it is of utmost importance that the central bank monitors closely the results of wage bargaining/setting in various sectors and the degree to which they match productivity gains.

The assessment of possible risks of the wage setting behaviour to the future inflation developments is rendered difficult in this context by the uncertainties surrounding the turning point in economic activity expected this year, but especially the size and timing of effects of the labour market[80] reform that the authorities have recently embarked upon. Also from the latter perspective, pay rises should be moderate at least in the near run and the developments in ULC should further foster the resumption of disinflation amid the fading out of the first-round effect of supply-side shocks and the maintenance of the current account deficit at sustainable levels.

Such expectations are driven mainly by the protracted worsening of labour market conditions – reflected also by the decline in the number of employees economy-wide until recently – and the outlook for a delayed improvement of these conditions amid the slow economic recovery. Adding to this is the demonstration effect expected to come from a still tight public sector income policy, in

[80] Implying primarily the implementation of provisions under the new Labour Code and other pieces of legislation envisaging, *inter alia*, the jobs done occasionally by day labourers and social dialogue.

accordance with the current legal framework[81]. In certain sectors, especially export-oriented industries, the brisk wage growth manifest in early 2011 could however carry on provided it remains in line with productivity gains. A possible moderation of wage growth should not be ruled out in these sectors either assuming a further strengthening of the domestic currency in the period ahead against the backdrop of possibly heftier – especially volatile – capital inflows, which would depress the producers' profitability and induce risks to the competitiveness of Romania's exports.

The prospects of a slow recovery of economic activity, particularly during 2011, are yet again confirmed by the updated forecast of medium-term macroeconomic developments. The previously-assessed persistence of a negative output gap throughout the projection horizon, albeit slightly lower and slowly declining, is also reconfirmed to a large extent. This is expected to generate strong disinflationary pressures, even beyond the monetary policy-relevant horizon. In addition, the major risks and uncertainties relative to such projections are the following: (i) the magnitude and duration of increases in prices of energy, most notably oil, and agricultural commodities as well as the size of the ensuing contractionary effect on European economies, and directly on the Romanian economy; (ii) the possibly global consequences of the disaster in Japan; (iii) the potential impact on the pace of recovery in European economies, implicitly in the Romanian economy, coming from both the implementation of fiscal consolidation measures by EU Member States and a possible resurgence of global financial market tensions; and (iv) dampening effects from the ECB resuming the tightening cycle.

In this context, the pace of recovery of the Romanian economy, most notably of key domestic demand components, could be slower than projected. Constraining effects could affect most adversely private consumption, presumably depressed by certain fiscal consolidation measures remaining in force; detrimental effects would feed through largely via the abrupt decline in households' real disposable income as a result of the upsurge in food and fuel prices, and some administered prices, as well as via households' bank debt burden in domestic and foreign currencies. At the same time though, a relatively stronger reinvigoration of consumption cannot be overlooked, assuming a faster improvement of consumer confidence, along with the potential budding recovery of labour market conditions and a possibly swifter improvement in the parameters of banks' consumer credit supply.

As for investment, expectations are relatively more favourable, but its revival will continue to be hampered to some extent by the lingering fall in profits and the larger spare capacity in the sectors hit by the long-in-coming restoration in demand, construction included.

[81] Law No. 275/2010.

Contractionary effects could come also from the delays in improving medium- and long-term lending conditions for companies amid the persistence of credit institutions' heightened reluctance given the further worsening quality of loan portfolios and the expected tightening of external financing conditions. Against this backdrop, expectations of a relatively stronger restoration of demand for investment have relied widely on: (i) the expected increase in public-sector capital expenditures, in line with the budgetary programme on attracting European funds and resources earmarked by other international financial institutions and bodies, (ii) the almost exhausted spare capacity in some export-oriented manufacturing sub-sectors, along with the possibly ongoing strong rebound in external demand, and (iii) the gradual improvement in the business confidence, including that of foreign investors, given the very likely consolidation of economic reforms in the context of the new arrangement signed with the EU, the IMF and the World Bank.

Also from this perspective, a firm implementation of the economic programme embedded in the arrangement signed with the EU, the IMF and the World Bank, along with preserving the credibility of the programme, remains essential for a solid anchoring of inflation expectations in the medium term and for resuming and strengthening disinflation, concurrently with restoring confidence and ensuring a sustainable rebound in economic activity. In this context, it is crucial to keep up the pace of fiscal consolidation in order to minimise the risk of fiscal policy slippages from the programme coordinates stemming from a potential relatively slower economic recovery. Considering also the recent positive experience, the ongoing improvement in tax revenue collection and renewed impetus to the measures to clamp down on tax evasion will decisively contribute to all these efforts.

In view of the need to ensure a solid anchoring of inflation expectations given the relative worsening of the inflation outlook under the prevalent impact of adverse supply-side shocks and the additional risks to a sustainable resumption of disinflation following the possible increase in volatile capital inflows, the Board of the National Bank of Romania has decided in its meeting of 3 May 2011 to keep unchanged the monetary policy rate at 6.25 percent per annum. At the same time, the Board has decided to pursue 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. These decisions, along with the consistent implementation of commitments agreed by the Romanian authorities under the new financing agreements with international institutions, would ensure the preservation of prospects of a sustainable resumption of disinflation and a robust recovery of the Romanian economy during the nominal and real convergence process.