National Bank of Romania

INFLATION REPORT

August 2011

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New Series

N O T E

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

The source of statistical data used in charts and tables was mentioned only when they were provided by other institutions.

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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 August 2011 and includes data available until 29 July 2011.*

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

ABBREVIATIONS

AER	annual effective rate
AMIGO	Household Labour Force Survey
CCR	Central Credit Register
CD	certificate of deposit
COICOP	Classification of Individual Consumption According to Purpose
CPI	Consumer Price Index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
EIA	Energy Information Administration (within the U.S. Department of Energy)
EU	European Union
Eurostat	Statistical Office of the European Communities
GDP	Gross Domestic Product
GFCF	Gross Fixed Capital Formation
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
IFI	international financial institution
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MFI	monetary financial institution
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	Overnight
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
ULC	unit labour cost
UVI	unit value index
VFE	vegetables, fruit, eggs
1W	one week
1M	one month
3M	3 months
6M	6 months
12M	12 months

Contents

I. SUMMARY

Developments in inflation and its determinants

At the end of 2011 Q2, the annual CPI inflation rate stood at 7.93 percent, 0.08 percentage points below the level seen at the end of 2011 Q1 and 0.8 percentage points lower than that forecasted in the May 2011 *Inflation Report*. Better-than-expected inflation performance was primarily the result of the recent developments that eased the pressure on volatile food prices (of vegetables, fruit and eggs), sending them sharply down in June.

The explanation for these movements in vegetable and fruit prices lies with the signals of an incipient rebound in the domestic supply of these goods. Tensions also eased on the global markets for major agri-food commodities, but this was only partly reflected by the prices of processed food items included in the adjusted CORE2 index[1], as their year-on-year growth rate continued to post a short-term advance, reflecting the movements in volatile food prices with a certain lag, as well as a base effect.

Among other supply-side factors, a favourable influence on disinflation came in 2011 Q2 from fuel price dynamics, while accelerating growth in administered and tobacco prices had the opposite effect. Over the period, the annual CPI inflation rate continued to incorporate the first-round effect of the standard VAT rate hike on 1 July 2010.

At the end of 2011 Q2, the annual adjusted CORE2 inflation rate was marginally lower than in March 2011 (4.7 percent against 4.8 percent). In addition to the first-round effects of the VAT rate hike and the evolution of processed food prices, adverse effects to the dynamics of this index were also exerted by the lingering uncertainties related to the domestic and global macroeconomic environment on inflation expectations. Such effects were offset by opposite influences stemming from the persistence of the negative output gap and the somewhat lower tensions on global markets of some non-food commodities.

In the period April-May 2011, gross wages in industry rose faster than labour productivity, which caused the annual growth of unit labour costs to enter positive territory after seven quarters of negative readings. Even though this development is partly ascribable to incidental factors, it is necessary to counter the emergence of possible wage cost-induced inflationary pressures by maintaining the wage-productivity correlation.

Monetary policy since the release of the previous Inflation Report

In the NBR Board meeting of 3 May 2011, the monetary policy rate was left unchanged at 6.25 percent per annum. The decision sought to keep the real broad monetary conditions on track to fulfil the medium-term inflation target in a context characterised by adverse shocks arising from international commodity prices, the persistence of risks related to further movements in commodity and administered prices, as well as by the emerging risk of a pick-up in volatile capital flows.

[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.

Subsequent to the monetary policy decision of 3 May 2011, statistical data revealed a short-term softening of the upward trend in the annual rate of inflation. On the other hand, the analyses made by the NBR staff pointed towards the persistence of previously identified risks, with those coming from the sovereign debt crisis in the euro zone and the United States being attached stronger relevance. The co-existence of multiple risk sources and their bearing on inflation expectations were further indicative of a high inflationary potential, despite the persistence of a substantial negative output gap.

Given the major risks arising from supply-side factors, the NBR Board underscored in its meeting of 29 June 2011 the need to further pursue a prudent monetary policy stance with a view to countering possible second-round effects from adverse shocks through solid anchoring of inflation expectations. Hence, the Board decided to leave unchanged the monetary policy rate at 6.25 percent per annum and the minimum reserve requirement ratio on both leu- and foreign currency-denominated liabilities of credit institutions.

Inflation outlook

The updated projection envisages the annual inflation rate returning inside the variation band around the 3 percent target in early 2012, following the gradual fading-out of the effects of adverse foreign and domestic supply-side shocks that occurred in 2010 and earlier this year.

In 2011 Q1, the year-on-year real GDP growth reverted to positive territory for the first time following eight quarters of negative readings. According to the central bank's forecast, economic expansion appears set to continue at a moderate pace this year, largely driven by external demand. For 2012, GDP growth is projected to gather momentum amid the rebound in domestic investment and consumer demand. The resumption 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 via the leu exchange rate. Disinflationary pressures coming from the negative output gap will decrease gradually, albeit not entirely, throughout the projection horizon.

For end-2011, the baseline scenario of the current projection places the annual CPI inflation rate at 4.6 percent, 0.5 percentage points lower than the level in the May 2011 *Inflation Report* and 0.6 percentage points above the upper limit of the variation band around the 3 percent target. For end-2012, the inflation rate is forecast to stay within the variation band at 3.5 percent, 0.1 percentage points below the previously projected level.

The updated baseline scenario sees the inflation rate on a sharp downward trend between 2011 Q3 and mid-2012. A similar trend is expected for the adjusted CORE2 inflation rate. For both inflation measures, the fast-paced disinflation envisaged for the first part of the projection horizon is largely due to the fading out, during 2011 Q3, of the first-round effects of the standard VAT rate hike in July 2010. The base effect will contribute significantly to the anticipated fall in CPI inflation rate from 7.9 percent at the end of 2011 Q2 to 4.8 percent at the end of 2011 Q3. For 2012, CPI inflation rate is foreseen to return to and subsequently to stay inside the variation band around the central target, while the adjusted CORE2 inflation rate is expected to stay below 3 percent.

The significant downward revision of the projected levels of the annual inflation rate in 2011 is mainly due to a smaller contribution of volatile food prices, as a result of the improved outlook for the domestic supply and the relative easing of tensions on the relevant external markets. The projected dynamics of the oil price will have a somewhat more favourable bearing on domestic fuel prices in 2011. On the other hand, in 2011 Q3, the trajectory of tobacco prices and their contribution to inflation were revised marginally upwards compared to the previous *Inflation Report*.

The path in the adjusted CORE2 inflation and its projected contribution to CPI dynamics were revised marginally upwards in 2011. On the one hand, the expected growth rate of import prices is, compared to the previous forecast, less favourable to disinflation at the beginning of the reference period. On the other hand, relatively higher inflation expectations and a slightly wider negative output gap than in the previous projection round for the entire forecast horizon cause divergent effects on the dynamics of the adjusted CORE2 index. During 2012 though, once inflation expectations adjust downwards, the bearing of the negative output gap is projected to prevail, leading to a slight downward revision in the path of adjusted CORE2 inflation and in its contribution to CPI dynamics compared to the previous projection.

Against the current macroeconomic background characterised by the impact of repeated supply-side shocks and associated risks relevant over the projection period, in parallel with the persistence of the negative output gap, the central bank's primary concern is to prevent the second-round effects of these shocks from becoming manifest. Hence, the monetary policy rate will remain on a path in line with maintaining adequate real broad monetary conditions so as to ensure a solid anchoring of inflation expectations and enhance the prospects for inflation to converge towards the medium-term targets. Furthermore, the external and domestic equilibria of the national economy are strictly conditional on the monetary policy enjoying the support of the other policy mix components by consistently implementing the economic programme on fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank.

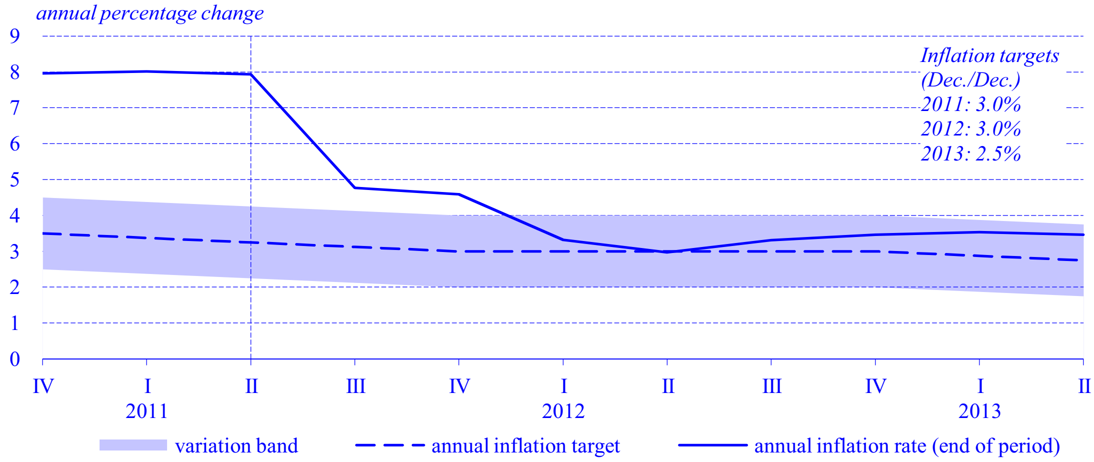
The sources of risks related to the baseline scenario of the inflation forecast are generally similar to those identified in the previous projection rounds and are attributed to both domestic and external factors. Over the short term, the balance of risks appears to have eased in relative terms, owing to lower tensions on global commodity markets for the time being and to favourable conditions for good crops domestically. However, over the medium term, the overall balance of risks appears to remain significantly tilted towards less favourable developments than envisaged in the baseline scenario.

Over the medium term, the major domestic sources of risks are associated with administered price increases and the time consistency of the macroeconomic policy package. The likelihood that measures weighing heavily on the dynamics of administered prices are taken in the reference period is relatively high, whereas the absence of an official timetable and quantitative benchmarks publicly assumed by the relevant authorities affects the adequate formulation and quantification of assumptions in the baseline scenario. As for the programme on fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank, the forthcoming 2012 elections pose the risk of social or political pressures that might deter its consistent implementation.

Should the risks coming from the above-mentioned sources materialise, inflation could deviate significantly from its projected path, including via spill-over effects on the leu exchange rate, markedly higher interest rates as a result of heightened risk perception and limited access of both private and public sectors to financing, as well as via pressures to raise wages in excess of labour productivity dynamics.

In the medium term, external risk sources that are a matter of concern relate to the possible worsening of investors' risk perception towards emerging markets and its ensuing effects on the Romanian economy given the aggravating sovereign debt crisis in the European Union and/or the United States. Although some of these tensions have softened somewhat over the past few weeks, their possible resurgence in the period ahead would entail wide-ranging uncertainties in terms of volatile capital flows related to Romania. At the same time, the reshaping of the scenario on euro zone economic growth, most likely at lower levels, and the change in the EUR-USD exchange rate as against the projected figures could translate into significant deviations of key macroeconomic variables from their trajectories in the baseline scenario. In addition, medium-term risks linked to movements in international commodity prices are persisting as a result of demand-side pressures from the fast-expanding emerging economies against the background of recovering growth of the global economy.

Inflation Forecast



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

Source: NIS, NBR projections

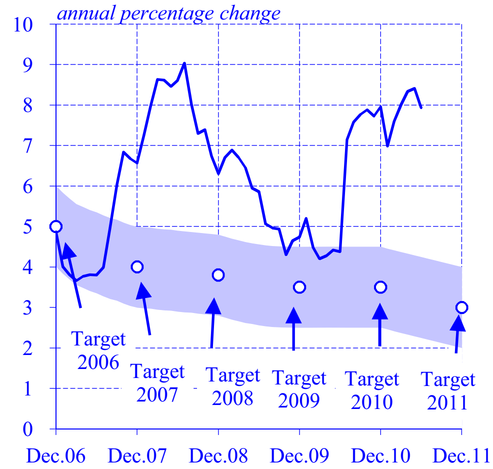
Monetary policy decision

In view of the heightened uncertainties about the ongoing sovereign debt crisis and its impact on the global financial markets, as well as, in the context of the balance of risks still tilted to the upside, the risk to medium-term inflation expectations coming from the likely administered price adjustments, the NBR Board has decided in its meeting of 3 August 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. Against this background, the NBR Board has reiterated that the consistent implementation of the commitments assumed by the Romanian authorities under the financing agreements signed with international institutions, especially those regarding fiscal consolidation and the wage-productivity correlation, is essential to ensure the consolidation of disinflation at the projected pace and a sound recovery of the economy in the context of the nominal and real convergence processes.

II. INFLATION DEVELOPMENTS

At end-2011 Q2, the annual CPI inflation rate stood at 7.93 percent, decreasing slightly from the level reported at the end of the previous quarter. The deviation of the inflation rate from the upper bound of the ±1 percentage point variation band around the 3 percent central target remained large, further capturing the statistical effect generated by the increase in value added tax rate in July 2010, as well as the impact of adverse supply-side shocks (oil and non-energy commodities) that became manifest recently. Nonetheless, the abatement of such shocks in the latter part of the quarter under review and the upbeat outlook for the domestic agricultural production were reflected by consumer price developments (particularly volatile prices), with June recording the highest monthly deflation since the early 1990s. Even though such effects were less visible in the case of the adjusted CORE2 inflation rate, the persistent demand deficit and the year-on-year appreciation of the domestic currency contributed to the halt in the upward trend that this indicator followed during the past year.

Inflation Developments



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

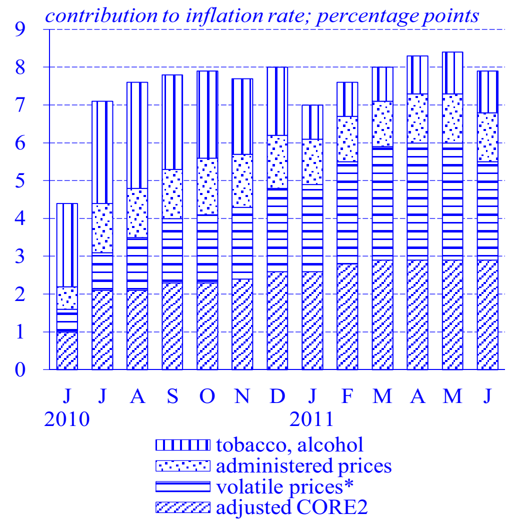
Source: NIS, NBR calculations

Volatile food prices made the largest contribution to the slowdown in annual inflation rate, as their growth rate decelerated by about 5 percentage points to 23.0 percent. The further increase in such prices in the first two months of Q2 was offset by the significant adjustment in June (-6.6 percent month on month), against the background of a normal agricultural year at both national and international levels. Fuel prices, the other component of volatile prices, showed higher downward rigidity, their development revealing only partially the prevailing downward trend in world oil prices[2], along with the domestic currency appreciation versus the US dollar (up 2.1 percent in June versus March 2011).

Administered prices had a contribution of over 1 percentage point to the 12-month inflation rate, their growth rate standing at 7.7 percent at the end of the quarter under review, as compared with 7.2 percent in March. The faster pace of increase was due to the 5 percent rise in electricity prices, following the implementation, as of 1 April, of a tax aimed at supporting electricity production in highly efficient cogeneration plants.

Tobacco prices also stymied disinflation, as their annual growth rate added 2.2 percentage points to 15.1 percent in June, with producers aiming to restore the profit margins that were affected by the previous increases in excise duties, higher commodity prices and lower volume of sales.

Annual Inflation Rate

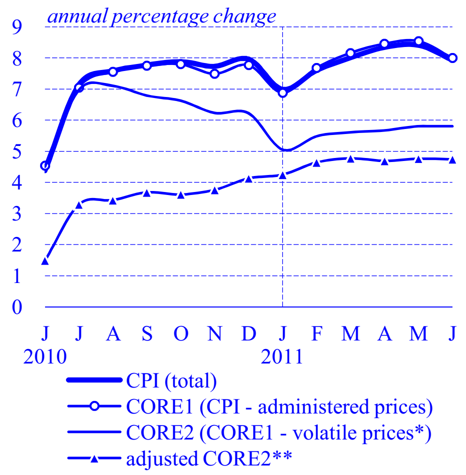


*) products with volatile prices: vegetables, fruit, eggs, fuels

Source: NIS, NBR calculations

[2] Brent crude oil price fell from the high level of USD 125.5/barrel recorded on 2 May to USD 110.8/barrel at end-June.

Headline Inflation and CORE Inflation

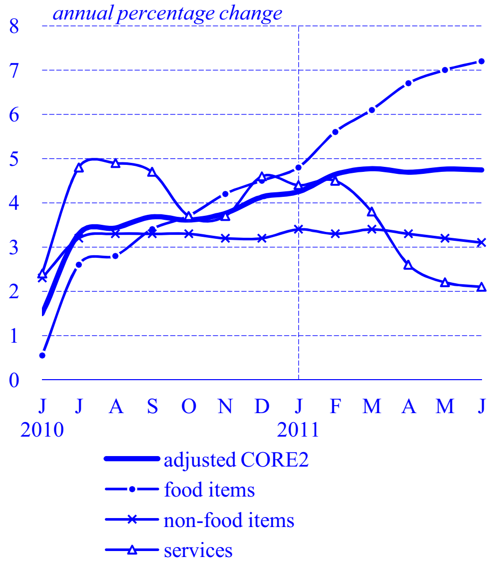


*) products with volatile prices: vegetables, fruit, eggs, fuels

**) excluding tobacco and alcohol

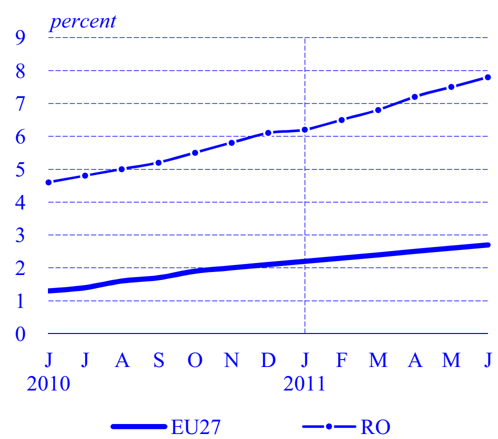
Source: NIS

Adjusted CORE2 Components



Source: NIS, NBR calculations

Average Annual HICP Inflation Rate



Source: Eurostat

The analysis of price developments from the perspective of monetary policy influence further focuses on the adjusted CORE2 inflation, which excludes excisable products. This measure flattened out at 4.7 percent year on year amid the larger discrepancy between its components. Thus, while disinflation was seen in the case of non-food items and services, the dynamics of food prices continued to accelerate, yet at a slower pace.

The flagging consumer demand[3] (as reflected by the persistent negative output gap) and the year-on-year developments in the domestic currency against the euro (1.1 percent appreciation in June as compared with 1.8 percent depreciation in March 2011) were decisive for alleviating inflationary pressures in the case of all adjusted CORE2 components. The latter determinant had a dampening impact on the dynamics of both prices sensitive to exchange rate changes[4] and import prices.

An additional positive impact on food prices also had the upbeat outlook for the 2011 vegetal production both domestically and internationally, which also influenced the inflation expectations of specialised producers. Nevertheless, the lag of the pass-through of previous increases in international commodity prices into consumer prices and the remaining of the former at high levels as compared with the same year-ago period (despite several downward adjustments in the latter part of the quarter) together with an adverse base effect, caused the protraction of the upward trend in inflation on this segment.

In contrast, supply-side factors had a prevailing favourable impact on the prices of non-food items included in adjusted CORE2 inflation. The abating tensions on certain international commodity markets contributed to the slowdown in the annual growth rate of domestic producer prices for consumer goods, as well as in that of external prices for intermediate goods and processed consumer goods, excluding food items[5]. However, this impact was reflected only partially by consumer prices in the quarter under review. Furthermore, despite the deterioration of unit labour costs in industry in April-May 2011[6], this development is deemed to have been the result of short-lived factors (temporary production chain disruptions and the calendar effect associated with the payment of bonuses in different months in 2010-2011) and to have a low inflationary potential, given the slower dynamics of domestic producer prices.

[3] Trade turnover volume declined marginally in April-May 2011 versus the preceding quarter (seasonally adjusted data), its annual growth rate remaining negative at about -6 percent.

[4] For instance, prices for telephony, as well as for cultural and sports products.

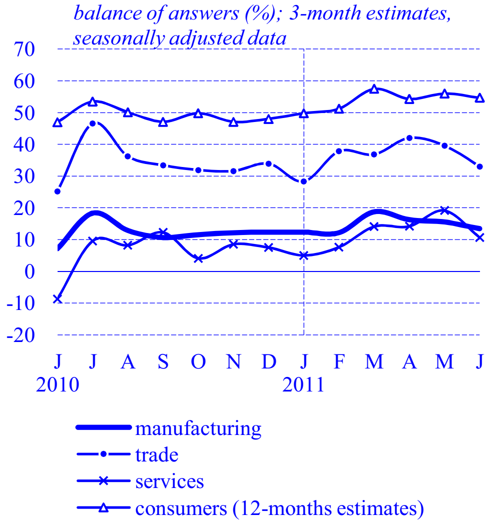
[5] For which EU15 industrial producer prices for non-domestic market were used as a proxy.

[6] They reverted to positive annual growth rates.

In general, inflation expectations formulated by consumers and managers in manufacturing, trade and services[7] were, on average, higher than in the preceding quarter due to previous rises in inflation rates, persistently high commodity prices and the uncertainty associated with the international economic and political environment. Hence, despite the alleviation seen in June, inflation expectations generally exerted a dampening impact on disinflation.

In June 2011, the actual annual inflation rate stood 0.8 percentage points lower than the projection included in the May 2011 *Inflation Report.* The deviation was mainly attributed to the significantly faster-than-expected moderation of pressures manifest in the case of volatile food prices, to which added a similar impact, though of a lower magnitude, exerted by the other exogenous variables (administered prices, fuels, tobacco).

Inflation Expectations of Economic Agents



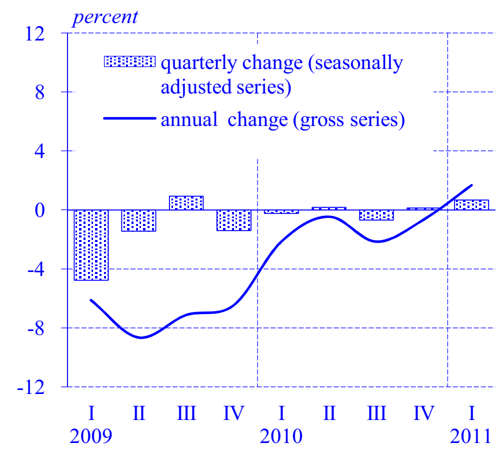
Source: EC-DG ECFIN

7 According to the NIS/EC-DG ECFIN Survey.

III. ECONOMIC DEVELOPMENTS

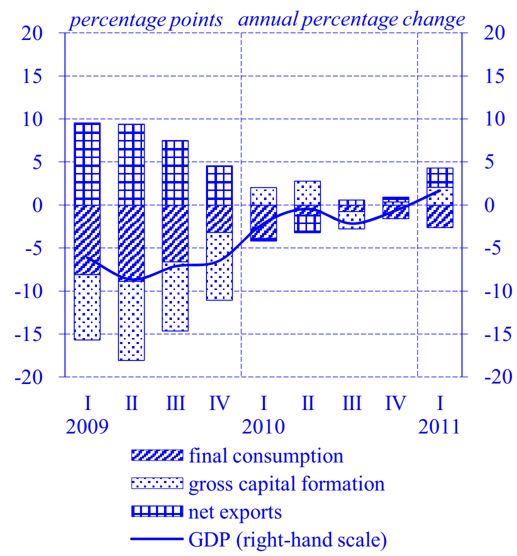
1. Demand and supply

Real Gross Domestic Product



Source: NIS

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations

According to the provisional data released by the NIS, 2011 Q1 witnessed a 1.7 percent increase in real GDP compared to 2010 Q1[8] *– after eight consecutive quarters of negative annual growth rates – owing mainly to current developments (+0.7 percent, quarterly change)*[9]*.*

The gap between the outcome and the March 2011 benchmark projection was significant (1.3 percentage points) in terms of the annual dynamics, the explanation lying almost exclusively with the difference between the annual index deriving from the gross series (released by the NIS) and the one calculated based on the seasonally adjusted series, used in the NBR projection. The comparison with the latter series results in a mere -0.1 percentage point gap. As for the quarterly change, there were no differences between the actual and projected GDP dynamics.

Turning to demand, the year-on-year rebound in real GDP was bolstered by the foreign segment, whereas final consumption and gross fixed capital formation made a lower joint contribution than in the previous quarter. Nevertheless, the significant role played by the "change in inventories" in explaining the GDP change should be emphasised, even though, according to the national accounts methodology, it is rather a balancing item for the two GDP approaches (by source and by expenditure) to match. In 2011 Q1, this component made a substantial contribution to both the annual change and the quarterly change in real GDP. As far as the latter is concerned, the faster economic growth compared to 2010 Q4 (from +0.1 percent to +0.7 percent) was not actually supported by any of the components with economic content – final consumption further decreased (by 0.8 percent), gross fixed capital formation witnessed a trend reversal (-2 percent) and net external demand made a lower contribution (from +1 percentage point to -0.3 percentage points).

On the supply side, the increase in real GDP in both annual and quarterly terms was basically due to industry, mainly as a result of the demand from the major foreign trade partners remaining on an uptrend.

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

[9] The quarter-on-quarter changes are calculated based on the seasonally adjusted data series.

1.1. Demand

Consumer demand posted a renewed decline in annual terms (-3 percent, against -2 percent in 2010 Q4), which was attributable to both households and the public sector. In the case of the former, the volume adjustment was similar in size to that registered in 2010 Q4 (-1.7 percent) and occurred against the backdrop of: (i) a further decrease in household disposable income[10]; (ii) persistent pressures from high indebtedness; (iii) lower recourse to bank lending – the consumer loan balance decreased by approximately 34 percent for the leu-denominated loans (real change) and by 6.6 percent for the euro-denominated loans –, comparable dynamics being also reported by overdraft loans[11].

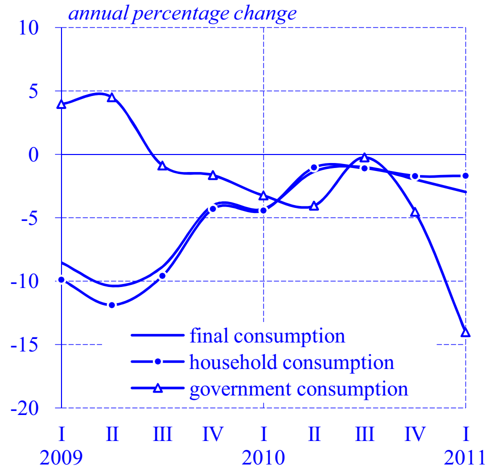
As concerns the influence of demand on consumer prices, the current developments in the volume of retail sales of goods holding a large share in the CPI basket do not suggest any pressure build-up in 2011 Q1 – purchases of food items and fuels (accounting for about 45 percent of the household budget) continued to decline (by approximately 3 percent quarter-on-quarter).

The fall in consumer demand affected in particular the market of domestically-produced[12] non-durables and durables. An exception was the motor vehicle sector, where the annual sales dynamics of locally-manufactured vehicles posted a 2.5 times increase (up to 45.9 percent, which was significantly above the growth rate in the volume of imports for this category of goods[13]).

In 2011 Q1, government final consumption stayed on a downward trend, which steepened from -4.5 percent to -14 percent year on year, in line with the dynamics in the number of employees in the public administration sector.

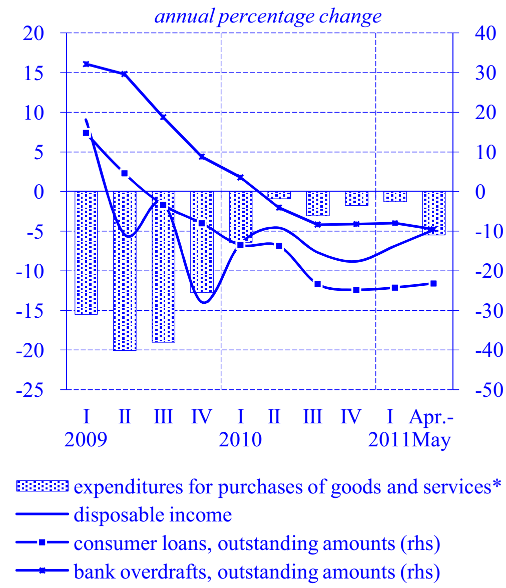
In 2011 Q1, the negative balance of the general government budget stood at lei 5,190 million[14] (1.0 percent of GDP[15]) and was

Actual Final Consumption



Source: NIS

Household Consumption and Main Financing Sources



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

Source: NIS, MPF, NBR calculations

[10] Approximated by the sum of incomes from wages, social transfers (state social security, unemployment benefit and health insurance) and inflows from abroad, i.e. workers' remittances and current private transfers by non-residents.

[11] An approach to loans from the standpoint of new business is of limited relevance to the analysis of the resources for covering consumer demand, given that refinancing prevailed in 2011 Q1 as well.

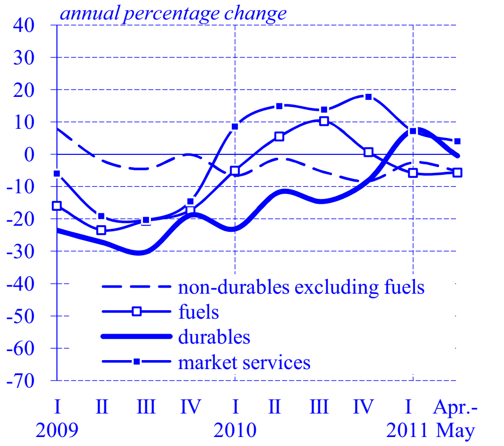
[12] The conclusions on domestic supply are suggested by the developments in the turnover volume of the industrial output on the domestic market.

[13] The changes in the physical volume of exports and imports of goods were calculated based on balance-of-payments data, deflated by international trade-related unit value indices. The structural analysis was based on the Combined Nomenclature.

[14] Preliminary data published by the MPF in respect of the general government deficit at end-March 2011 thus show compliance with the ceiling agreed under the IMF arrangement for 2011 Q1 (lei 6,300 million).

[15] The analysis relied on the operational data relating to the end-March 2011 budget execution, as published by the MPF.

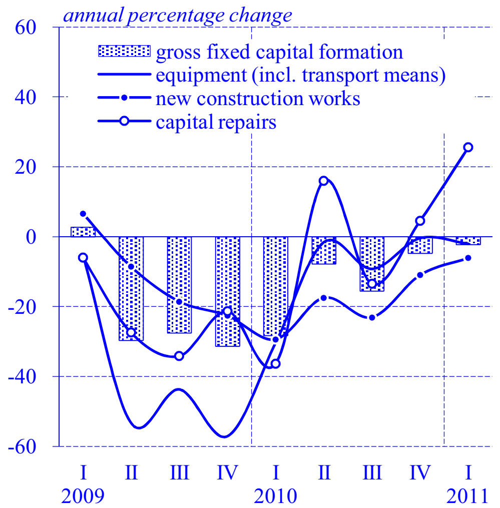
Purchases of Goods and Services*



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

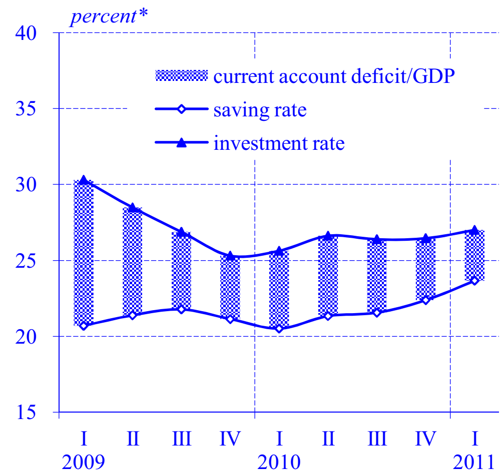
Source: NIS, NBR calculations

Investment



Source: NIS, NBR calculations

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

considerably below that posted in the same year-earlier period (lei 8,422 million[16], or 1.6 percent of GDP). The lower deficit was due to renewed revenue growth[17], albeit at a slower pace than in the previous quarter (2.5 percent compared to 9 percent), and in particular to the year-on-year decrease in public expenditure (-5.8 percent compared to a 3.6 percent increase in 2010 Q4). The latter development resulted mainly from a return to negative territory of the dynamics of the primary component of such spending (-7 percent, against +3.4 percent in 2010 Q4), driven by the further drop in compensation of employees (-26.2 percent) and social payments (-9.6 percent), as well as by a relative decrease in the amounts allotted to "other transfers" (-4.8 percent); the growth rate of capital expenditures also slowed down markedly in 2011 Q1, but remained in positive territory (4.1 percent).

Gross fixed capital formation saw its annual rate of decline moderating to less than half the reading posted in the final quarter of 2010, i.e. -2.2 percent. To this development mainly contributed the construction sector, as new investment works in terms of volume contracted at a slower tempo (-6.1 percent compared to -11 percent in 2010 Q4, solely due however to a base effect) and the rate of increase of capital repair more than quintupled (to 25.6 percent). By contrast, equipment purchase (including transport means bought by companies and institutions) fell at a faster rate in real terms: -2 percent from -0.4 percent in 2010 Q4.

With the contraction of own and borrowed sources still affecting households' appetite for investment, the alleviation of the decline in investment economy-wide seems to have stemmed, on the one hand, from the corporate sector, as indicated in particular by the pick-up in the annual growth rate of gross value added related to non-public sectors (up to 3 percent versus 0.5 percent in 2010 Q4), having a favourable impact on own financing sources, as well as from the rise in net foreign direct investment of non-residents[18] by approximately 9 percent in the last four quarters. On the other hand, capital investment was also reported in the public sector (+8.5 percent in real terms – according to the budget execution).

The ongoing economic expansion of Romania's main trade partners[19] translated into a faster annual growth in exports of goods and services: 23.6 percent, up 6.5 percentage points from 2010 Q4. Such a performance brought about a pick-up in goods and services

[16] The 2010 budget execution figures have been recalculated by the MPF to ensure comparability with those for 2011.

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

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

[19] For the euro zone (in its initial membership structure), real GDP saw a 2.8 percent increase in annual terms (versus 2.1 percent in 2010 Q4), along with a further rise in goods and services imports (by 9.8 percent).

imports, at a slower pace however than that of exports, possibly as a result of rebounding domestic supply of intermediate goods and certain types of finished goods, capital goods in particular.

More than half of the increase in the volume of exports[6] was due to three groups of goods – "machinery and equipment" (7.4 percentage points), "transport means" and "chemicals, including rubber products and plastics", with the latter two groups posting significantly faster paces of annual growth (up to 20 percent and 33 percent, respectively).

1.2. Supply

In 2011 Q1, the recovery of real GDP in annual terms was largely ascribed to the industrial sector, but the lower negative contribution of construction should not be overlooked. The contributions of the services and agricultural sectors to GDP growth were little changed versus the previous quarter.

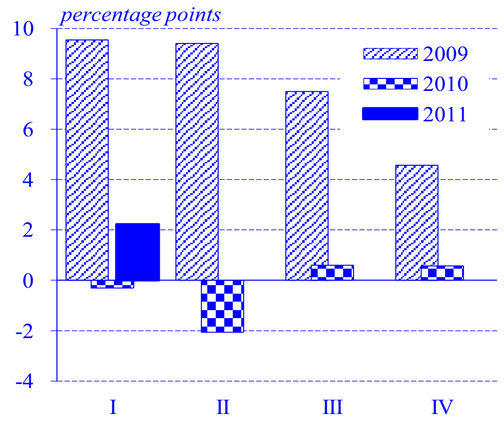
The annual rate of increase of gross value added in industry remained on an upward course, reaching 10.1 percent. In terms of industrial production, the fastest growing sub-sectors (nevertheless partially due to a base effect) were chemicals and pharmaceuticals, metallurgy, road transport means and, via the supply chain, electrical equipment, as well as machinery and equipment. It is worth noting that, aside from the beneficial impact of external demand on Romania's industrial output, first-quarter domestic sales went up for all the above-mentioned types of goods.

Gross value added in construction posted again a slower rate of decline to reach -2.4 percent from -7 percent in the final quarter of 2010. However, this was mainly due to a base effect, with current developments remaining subdued (housing construction works were close to a standstill and engineering works saw their volume shrinking).

A slight moderation was also detected in the annual rate of decline of the services sector, which stood at -2 percent, annual change. This owed solely to the recovery in "wholesale and retail trade; repair of motorcars and household goods; hotels and restaurants; transport and telecommunications", which reported a 1.1 percent increase in gross value added, against -2.9 percent in 2010 Q4.

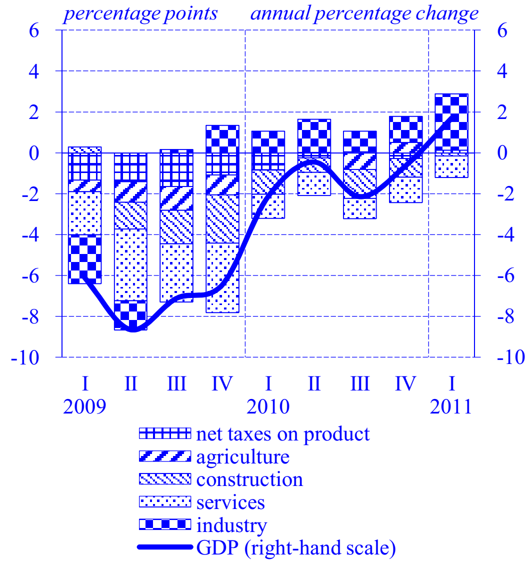
The year-on-year growth rate of the agricultural sector fell slightly into negative territory, touching -0.4 percent. Behind this stood the marked sign reversal in the quarterly dynamics of gross value added, from 6 percent in 2010 Q4 to -4.1 percent in 2011 Q1, chiefly on the back of certain crops being harvested with some delay.

Net External Demand Contribution to GDP Growth



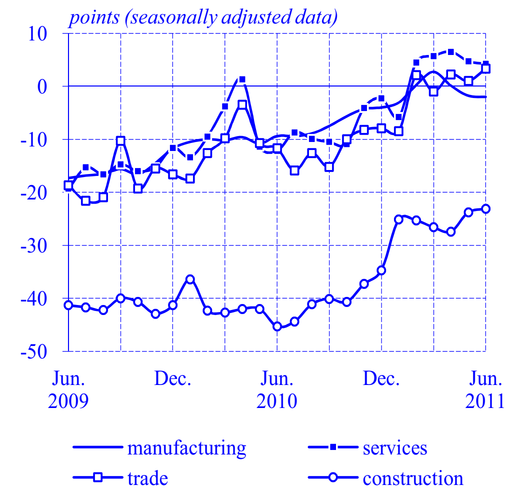
Source: NIS, NBR calculations

Contribution of Supply Components to GDP Growth



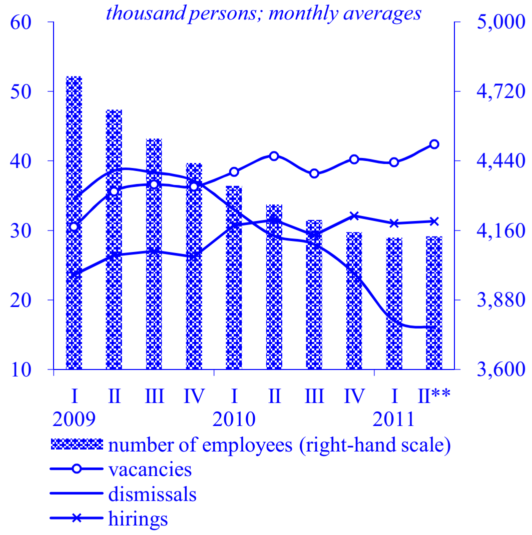
Source: NIS, NBR calculations

Corporate Sector: Confidence Indicators for the Next 3 Months



Source: EC-DG ECFIN

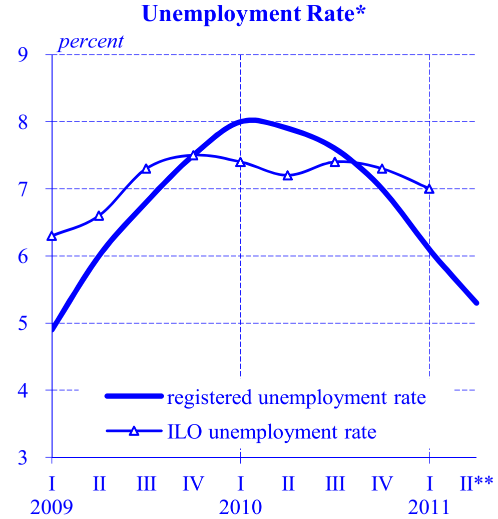
Labour Force Demand Measures*



*) seasonally adjusted data **) Apr.-May

Source: NEA, NIS, NBR calculations

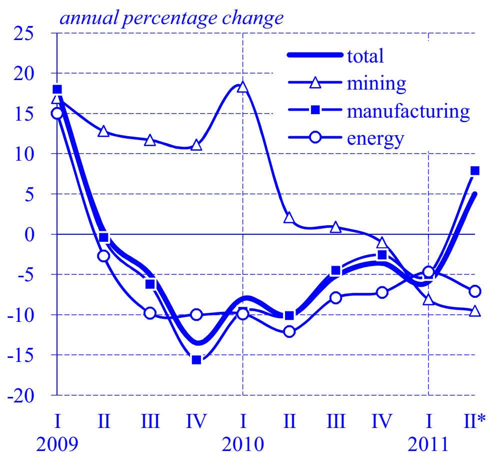
Unemployment Rate*



*) seasonally adjusted data **) Apr.-May

Source: NIS, NBR calculations

Unit Labour Cost in Industry



*) Apr.-May

Source: NIS, NBR calculations

2. Labour market

In March-May 2011, labour market witnessed mixed developments under the heavy impact of the incidental factors that temporarily affected economic activity and labour demand. Nominal wage reverted to annual positive growth rates but the prospects for labour market conditions to improve markedly remain uncertain, so that inflationary risks have remained moderate.

Based on the available statistics[20], the mismatch between labour demand and excess labour supply appears to have narrowed, mainly on account of the behaviour of the unemployed who forwent the NEA's support when the unemployment benefit period expired. Assuming that only part of these persons continue to look for a job on their own (while others decide to look for a job abroad or to join the ranks of inactive population), the sharply downward trend in registered unemployment (from 6.1 percent in February 2011 to 5.2 percent in May) illustrates the narrowing of eligible workforce supply. On the other hand, labour absorption played a minor role in narrowing the mismatch, the number of hirings April through May 2011 standing at a level similar to that recorded in 2010 Q1-2011 Q1. Nevertheless, amid the decline in lay-offs, the payrolls reported by employers rose after having been on the wane for ten quarters. The reversal of the downward trend was attributable to the private sector, where the turning point was detected as early as February, while staff cuts in the budgetary sector carried on.

Labour demand was somewhat influenced by the companies' expectations on the enforcement of the new Labour Code (in May 2011), as well as by the incidental factors that caused the slowdown in industry[21]. The companies' decisions ahead of the legislative changes materialised, on the one hand, in the surfacing of an existing demand segment from the informal economy, due to the tighter sanctions for the employers failing to hire staff based on legal labour contracts and, on the other hand, in the postponement of some hirings until the implementation of the new Labour Code. For June-August 2011, the results of the NIS/EC-DG ECFIN Survey[22] indicate a relative upturn in labour demand only in the trade sector, the prospects for a noticeable improvement of labour market conditions remaining thus uncertain.

In industry, after seven quarters of negative values, the annual dynamics of ULC re-entered positive territory in April-May 2011 (+5 percent), partly as a result of incidental factors manifest in manufacturing (+7.9 percent). Thus, only a few sectors further

20 NEA seasonally adjusted data.

21 Bottlenecks in the supply chain, extensive overhaul of metallurgical plants.

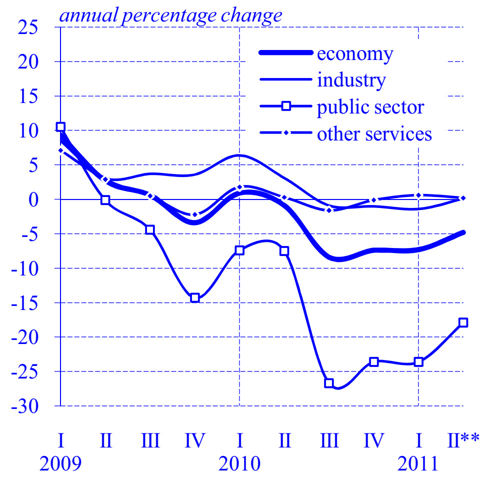
22 The survey on the expected development in staff numbers in manufacturing, construction, retail trade and services over the following three months.

witnessed favourable developments (food industry, oil processing, chemicals and pharmaceuticals), while light industry, metallurgy, machinery and equipment, electrical apparatus, electronics and motorcars saw ULC increases ranging between 8 percent and 27 percent in annual terms, amid significant output declines and, therefore, productivity losses.

In year-on-year comparison, net nominal average wage economy-wide was relatively constant in 2011 Q1 and 3.2 percent higher April through May 2011, partly due to the Easter bonuses granted in different months in 2010 and 2011. In the private sector, the annual rate of increase in the net wage accelerated from 6.5 percent in Q1 to 8.1 percent; in the absence of the said calendar effect, it would have been relatively stable throughout the first five months of 2011, which indicates that the pressures associated with wage bargaining did not intensify[23]. Budgetary sector wages continued to post significantly lower levels from a year earlier (-11 percent), but the gap narrowed somewhat.

Despite the rise in the net nominal wage, the real dynamics of wages stayed negative. This development, along with the persistent decline in remittances from abroad and the stagnation of social transfers, caused real disposable income to remain at levels lower than those recorded in the same year-earlier period (-4.8 percent in April-May 2011 versus -6.9 percent in 2011 Q1), which points towards the flagging consumer demand in 2011 Q2 as well.

Net Real Wage*



*) deflated by CPI **) Apr.-May

Source: NIS, NBR calculations

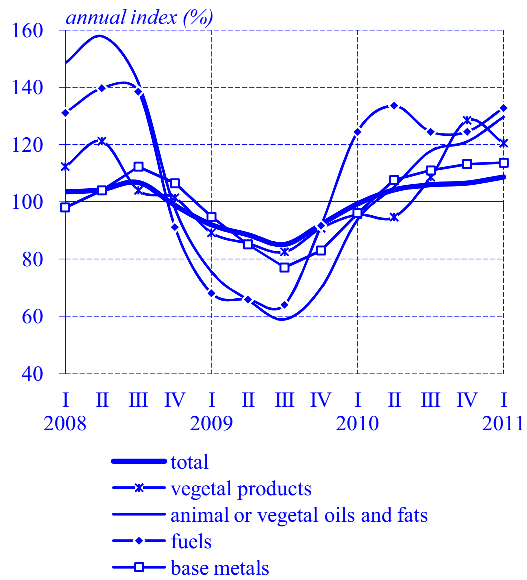
3. Import prices and producer prices

In 2011 Q1, the lingering tensions on the external commodity markets fuelled inflationary pressures exerted by import prices, as well as by domestic (industrial and agricultural) producer prices. For 2011 Q2, there are signs showing a trend reversal that is mainly attributable to international developments.

In 2011 Q1, imported inflation exerted a stronger negative impact on domestic price dynamics, given that the unit value index of imports increased by 2.1 percentage points from the previous quarter to 108.7 percent and the domestic currency depreciated versus major currencies.

The same as in previous quarters, external prices of food and energy further saw the sharpest annual changes (up to 32.8 percent). In the first case, more groups of goods recorded unit value indices significantly above par and generally on the rise as compared with the prior quarter (meat and sugar added to vegetal products, coffee, fats and oils).

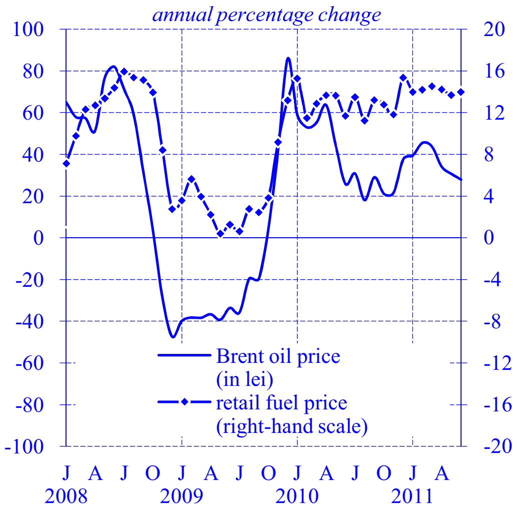
Major Inflationary Pressures on the Unit Value Index of Imports



Source: NIS, NBR calculations

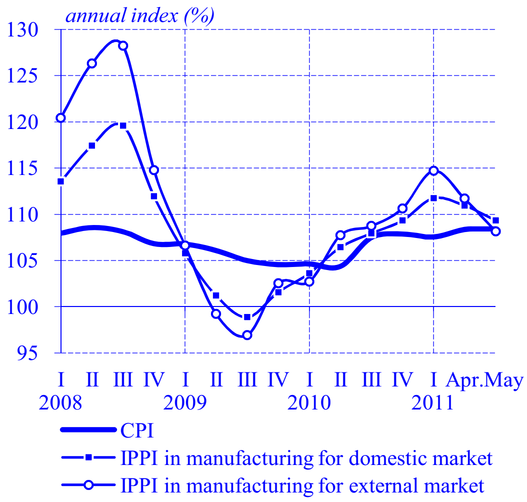
[23] Traditionally, the outcome of wage bargaining is reflected in the wage paid in March.

Oil Price and Retail Fuel Price



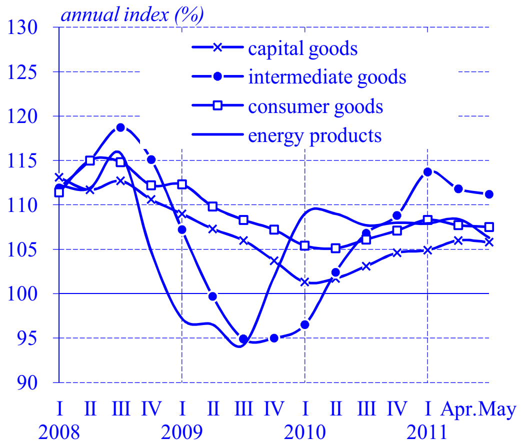
Source: NIS, EIA, NBR calculations

Consumer Prices and Industrial Producer Prices



Source: NIS

Industrial Producer Prices for Domestic Market by Industrial Products Group



Source: NIS

The unit value indices of some non-food items (pharmaceuticals, clothing, footwear) remained high (up to 109.1 percent), although somewhat lower than in the previous quarters. The unit value index of durables[24] saw even a trend reversal (from 97.7 percent in 2010 Q4 to 104.7 percent in January-March 2011).

In 2011 Q2, import prices could exert a lower negative impact on domestic price developments, given the signs of abating pressures manifest on external commodity markets and the favourable exchange rate effect.

The upward trend followed by industrial producer prices for the domestic market in the past five quarters continued in January-March 2011 (up 1.5 percentage points versus 2010 Q4 to 9.1 percent), high pressures being further exerted by external commodity prices. Intermediate goods and energy remained largely exposed to such influences, reporting the highest annual growth rates of producer prices (up to 13.7 percent).

Producer prices for consumer goods also posted a faster rate of increase (up 1.2 percentage points to 8.3 percent), yet, unlike the preceding quarters, the pick-up seems to be attributed to a larger extent to durables prices (up 2.7 percentage points to 4.2 percent), whose current developments indicate the highest quarterly change seen in the past six quarters (up 2 percent, seasonally adjusted series), even in the absence of clear signs of demand recovery. The acceleration to 8.7 percent in the growth rate of non-durables prices was again induced by food industry (up 15.7 percent), under the impact of unfavourable movements on the commodity markets.

Capital goods were the only group of products whose annual dynamics of producer prices remained unchanged as compared with prior quarters (4.9 percent).

The developments in April-May reveal the alleviating tensions on the external commodity markets (agricultural, in particular, as well as metals and energy), which entailed the deceleration in the annual growth rates of domestic producer prices to 7.8 percent in May. New pressures may build up starting with July, as a result of the rise in natural gas prices for industrial consumers, with an impact on producer costs in large gas-consuming industries (chemicals, metallurgy, food industry).

In 2011 Q1, the annual growth rate of agricultural producer prices accelerated by 15 percentage points (to 40 percent), with both components contributing to this increase.

However, vegetal product prices further exerted the prevailing influence, as their annual growth rate accelerated by

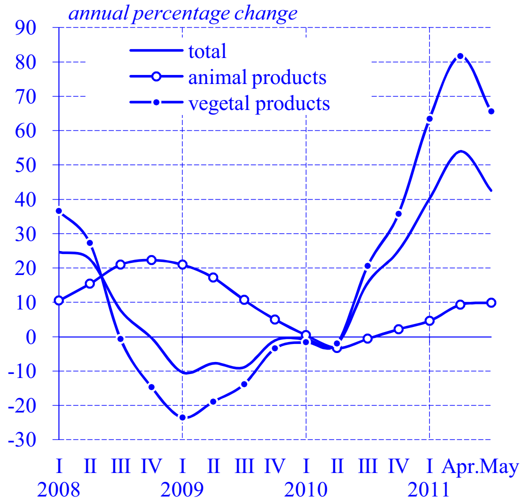
[24] Electrical machinery, apparatus and equipment in the Combined Nomenclature.

27.6 percentage points to 63.4 percent. The factors associated with the supply shortage generated by poor crops (particularly at international level) in 2010 remained the main determinants of this increase.

As for animal products, higher prices of fodder (annual growth rate of 56.9 percent) caused hikes in the prices for all types of meat. Stronger tensions were manifest on the mutton market (up 67.4 percent), due possibly to lower domestic supply in the context of higher related exports.

In 2011 Q2, abating pressures are likely to be visible on the vegetal product segment, as external markets reacted promptly to the announcement made by Russia and Ukraine on lifting restrictions on grain exports and some major international suppliers released favourable estimates on the agricultural production. No significant changes in this respect are expected on the animal product segment in the quarter under review.

Agricultural Producer Prices



Source: NIS

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

During 2011 Q2, the National Bank of Romania Board took two decisions: to leave unchanged the monetary policy rate at 6.25 percent per annum and maintain the existing levels of minimum reserve requirement ratios on credit institutions' leu- and foreign currency-denominated liabilities. Against this background, the implementation of the decision to lower the minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions[25] starting with 24 April, on the one hand, and the stronger quarterly appreciation of the leu versus the major currencies, on the other hand, reshaped the real broad monetary conditions, which remained adequate for attaining the medium-term inflation target.

The decision to leave the monetary policy rate unchanged at 6.25 percent per annum, taken by the National Bank of Romania Board in its meeting of 3 May 2011, was further warranted by the need to ensure a solid anchoring of inflation expectations with a view to preventing second-round effects of supply-side shocks from materialising, given that such shocks augmented over the recent months as a result of tensions on international commodity markets. Under their direct and indirect influences, the inflation performance worsened conspicuously[26] and the parameters of the latest medium-term projection[27] were revised accordingly. Thus, the updated path of the projected annual inflation rate climbed to higher-than-previously-forecasted levels, especially in the first part of the projection horizon. An additional reason for this adjustment was the relative increase in the scale of administered price hikes expected for 2011. At the same time, the baseline scenario of the updated projection foresaw the resumption of disinflation in 2011 H2, once the first-round effect of the VAT rate hike faded, followed by the return and maintenance of the annual inflation rate within the variation band around the central target in the course of 2012. Such an evolution was underpinned by the prospects of a slow economic recovery, which implied the persistence of a negative output gap together with the ensuing disinflationary pressures throughout the projection horizon.

[25] In its meeting of 31 March 2011, the National Bank of Romania Board decided to lower the minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions to 20 percent, from 25 percent, starting with the 24 April – 23 May 2011 maintenance period.

[26] Annual inflation rate reached 8.01 percent in March 2011.

[27] Included in the May 2011 *Inflation Report*.

Another reason for the National Bank of Romania Board decisions was the persistence of upside risks to inflation in the wake of developments in international prices of agricultural commodities and oil, along with the lingering uncertainties surrounding future adjustments in administered prices, which include those stemming from the commitments assumed under the arrangements signed with the EU, the IMF and the World Bank. From the perspective of ensuring a sustainable path for disinflation, yet another risk in the given context was an increase in volatile capital inflows, which may arise from a possible improvement in foreign investor perception towards the Romanian economy and the still high interest-rate differential.

The monetary policy rate was left unchanged at 6.25 percent per annum in the National Bank of Romania Board meeting of 29 June as well. This occurred against the background of a marginal advance in the annual inflation rate in May[28], in line with the latest medium-term projection prepared by the central bank, on the one hand, and still significant risks to the inflation outlook, on the other hand. The risks stemmed from the developments in international commodity prices, the uncertainties related to the timing and magnitude of administered price adjustments, possible large/sudden movements on global financial markets in the context of the evolution of the sovereign debt crisis, as well as potential second-round effects from the supply-side shocks seen in the recent quarters. The latter risk however was supposed to be further mitigated by the strong likelihood of a persistently-high negative output gap amid the expected slower economic recovery in 2011 Q2 given that the revival of the key domestic demand components has been long in coming. The major signs of such an evolution of consumer demand were the following developments registered in April: (i) the persistently negative annual dynamics of turnover volume of retail trade and the return to negative territory of the year-on-year change in the motorcar and motorcycle trade turnover volume; (ii) the further decline in the growth rate of the average real net wage, reflected also by the still sharp decrease in budgetary sector staff costs in real annual terms, and (iii) the larger annual reduction in social transfers compared to the previous quarter's average, as well as the compression in public spending on goods and services from the same year-ago period (both in real terms). Adding to these was the steeper negative growth[29] of corporate and household loans.

In the period April-May, the annual dynamics of the latter factor dropped, on average, to -8.7 percent, i.e. 2.8 percentage points below the first-quarter average. This was the result of joint effects from: (i) the persistence of sharply negative year-on-year dynamics of leu-denominated loans to households (-14.1 percent), (ii) slower

[28] 8.41 percent against 8.34 percent in April.

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

growth of foreign currency-denominated loans (in EUR terms), and (iii) the statistical effect of movements in the leu exchange rate. Nevertheless, both leu- and foreign currency-denominated loans (in EUR terms) to households rose slightly in each of the two months, suggesting that, apart from loan restructuring, banks also extended new business. This performance was to some extent associated with the lower interest rates on new leu-denominated loans and an easing trend in other lending conditions for consumer credit that became manifest in early 2011[30] as well as with the protracted trend of a slight improvement in consumer confidence indicator. Nevertheless, over the reported two-month period, the average annual dynamics of consumer loans and other types of loans to households[31] fell deeper into negative territory, standing at -12.8 percent against -10.7 percent in 2011 Q1. As for housing loans, their year-on-year growth rate decelerated even faster to 3.4 percent from 9.1 percent in 2011 Q1.

In contrast to the previous months, in the period April-May the negative annual dynamics of household deposits with banks grew sharper, on average, touching -4.3 percent versus -1.4 percent in 2011 Q1 against the background of the protracted compression in wage incomes, along with the need to repay the previously-contracted debt. The evolution was to some extent attributed to the advance in government securities holdings with households. The breakdown by maturity reveals that most types of household deposits exhibited slower annual growth rates than in 2011 Q1; nevertheless, the persistence of significant differences between these rates contributed to the widening share of time deposits in total household deposits: 79.8 percent.

In 2011 Q2, the central bank further pursued a management of liquidity adequate to the specific functioning conditions of various segments of the domestic financial market. The central bank's net debtor position vis-à-vis the banking system augmented somewhat, with short-lived reserve deficits occurring in a period characterised by liquidity surpluses. As a result, the National Bank of Romania's monetary policy operations were aimed particularly at draining excess liquidity, which was done solely via the deposit facility. Occasionally, the monetary authority provided liquidity to credit institutions via repo operations with a maturity ranging between three and five days conducted in the form of fixed-rate auctions with full allotment.

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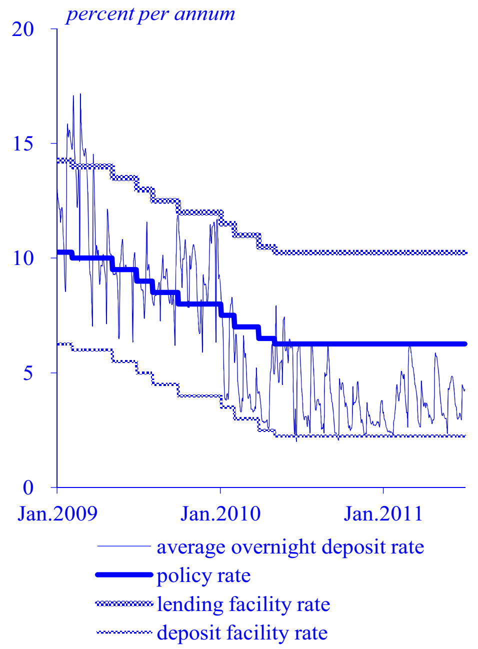
30 See the NBR's May 2011 survey on lending to non-financial companies and households.

31 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.

2. Financial markets and monetary developments

In 2011 Q2, average interbank money market rates declined slightly as compared to Q1, whereas lending and deposit rates on leu-denominated new business posted a sharper fall in the period March-May 2011. The exchange rate also recorded a further decrease in April, but witnessed a trend reversal subsequently, embarking on a steeper upward path towards the end of Q2. Broad money dynamics moved deeper into negative territory on the back of larger negative changes of loans to the private sector and of net foreign assets of the banking system.

Interbank Money Market Rates

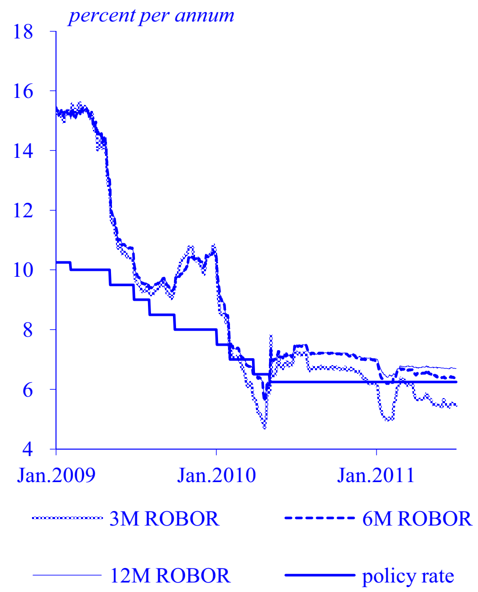


2.1. Interest rates

In 2011 Q2, average interbank money market rates declined slightly (by 0.1 percentage points to 3.9 percent), amid relatively looser liquidity conditions.

Overnight rates generally fluctuated within the lower part of the corridor set by interest rates on lending and deposit facilities, posting temporary increases in the early days of the reserve maintenance periods. These rates witnessed a more significant upward adjustment and implicitly a narrower spread vis-à-vis the monetary policy rate at end-April, given the emergence of a short-lived reserve deficit due to the seasonal drainage of liquidity generated by autonomous factors.

Policy Rate and ROBOR Rates

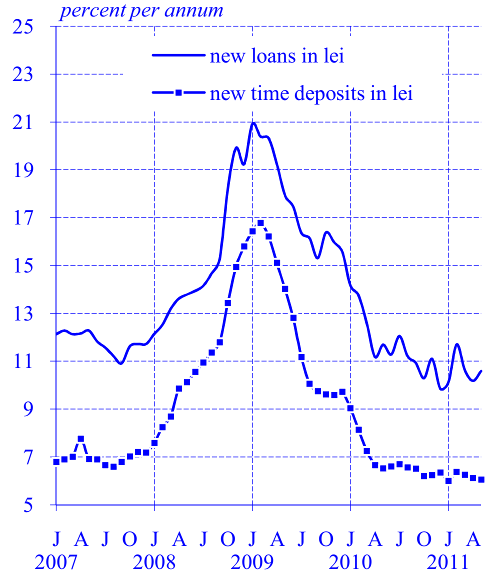


In turn, 1M-12M ROBOR rates followed a downward path, their average shedding 0.36 percentage points in June versus March. Shorter-term rates saw relatively sharper declines, as they were influenced to a larger extent by the current/anticipated liquidity situation. Average 3M ROBOR rates dropped 0.60 percentage points to reach 5.50 percent, while average 6M ROBOR rates edged down 0.23 percentage points, standing at 6.39 percent. By contrast, 12M ROBOR rates remained somewhat stable.

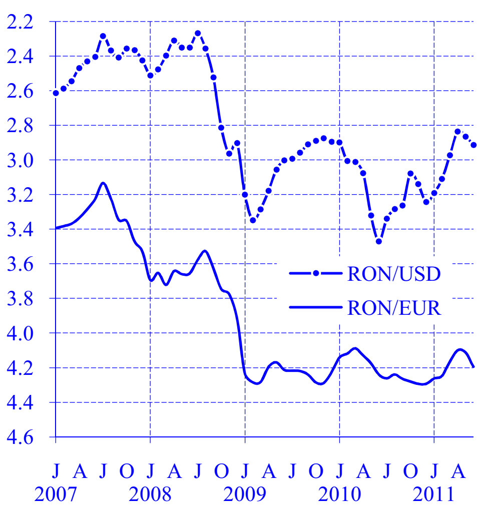
The average yield on the primary market for government securities declined from the level seen at the end of Q1, reaching 6.84 percent in June 2011, mainly due to the cut in the interest rate on securities with one-year maturity. Moreover, in the period under review, the MPF further extended the average maturity of securities, ceasing to issue 6-month T-bills as of June. In 2011 Q2, the MPF issued EUR-denominated government bonds as well. The two issues were launched on the domestic and the external markets, respectively, under the Medium Term Note (MTN) Programme. The 3-year bonds and 5-year Eurobonds were sold at an average yield of 4.89 percent and 5.3 percent, respectively.

The average yield on outright operations performed on the secondary market for government securities also decreased, from

Bank Rates



Nominal Exchange Rate



6.8 percent in March to 6.4 percent in June. Non-residents' leu-denominated government securities holdings increased further, recording however a slower growth rate in June.

Reflecting the downward movement of interbank rates, average time deposit and lending rates on new business declined during March-May 2011 by 0.32 percentage points to 6.05 percent and by 1.11 percentage points to 10.59 percent. The average interest rate on households' new time deposits dropped 0.32 percentage points to reach 6.80 percent, whereas the corresponding rate vis-à-vis non-financial corporations shed 0.19 percentage points, standing at 5.55 percent in May. On the assets side, the adjustment was sharper, as the average interest rate on new loans to households declined by 1.42 percentage points to 12.07 percent, while that on new loans to non-financial corporations decreased by 1.57 percentage points to 9.59 percent.

2.2. Exchange rate and capital flows

The relatively sharp appreciation trajectory that the domestic currency had pursued since the early months of 2011 was brought to a halt in mid-Q2 by a renewed flare-up of the sovereign debt crisis. Under the impact of the implicit rise in global risk aversion, the exchange rate of the leu embarked again on an upward path, which steepened considerably towards the end of the quarter under review, most likely due to the relatively higher contagion risk associated by investors with the local banking system and hence with the domestic economy.

Against this background, in the period April-June, the domestic currency depreciated against the euro by 0.7 percent in nominal terms (0.4 percent in real terms), yet strengthened versus the US dollar (2.2 percent in nominal terms and 3.5 percent in real terms), given the latter's relative weakening on global markets. Looking at the average quarterly change of the exchange rate however, the leu consolidated its appreciation in relation to both currencies, even in nominal terms.

The average RON/EUR exchange rate stuck to the downward path in April as well (1.6 percent in nominal terms), reflecting mainly the ongoing improvement in investor sentiment towards the Romanian economy, underpinned by the further favourable performance of relevant economic indicators such as budget deficit, current account, and the dynamics of exports and industrial output. The stronger leu in April also benefited from the relatively stronger investor interest in placements on the region's financial markets, which were perceived as having a more favourable return to risk ratio than that attached to securities issued by euro zone peripheral economies[32]. Under the circumstances, non-residents increased their holdings of leu-denominated government securities, while the interbank forex market net turnover re-entered positive territory for the first time in 13 months.

The subsequent rekindling of fears of a possible restructuring of Greece's sovereign debt, to which added the pessimism induced by the weaker-than-expected performance of world economy indicators, reversed the trend of the RON/EUR exchange rate in May. Against this backdrop, the relative worsening of forex market operators' expectations on the very short-term movements in the exchange rate was only marginally countered by favourable domestic developments, such as the higher-than-anticipated rise in GDP in 2011 Q1 and the successful completion of the first review under the new arrangement with the EU, the IMF and the World Bank. As a result, the domestic currency shed 0.3 percent to the euro.

The upward movement of the RON/EUR exchange rate gained momentum starting in the second week of June, amid the renewed spike-up in global risk aversion triggered by escalating political and social tensions in Greece, which jeopardised the adoption of additional measures to curb the budget deficit and public debt. To this added the risk of Greece defaulting on its debt, which the markets saw as generating major adverse effects on the European financial system. Under the circumstances, the success of Romania's first Eurobond issue under the MTN Programme did not appear to have a major favourable impact on investor sentiment towards the domestic economy, since the leu witnessed in June the sharpest depreciation (1.9 percent) compared to its regional peers[33]. This was most likely due to the higher contagion risk associated with the local banking system and the Romanian economy in several analysis reports. Hence, the volatility of the RON/EUR exchange rate also increased, peaking at a 12-month high.

2.3. Money and credit

Money

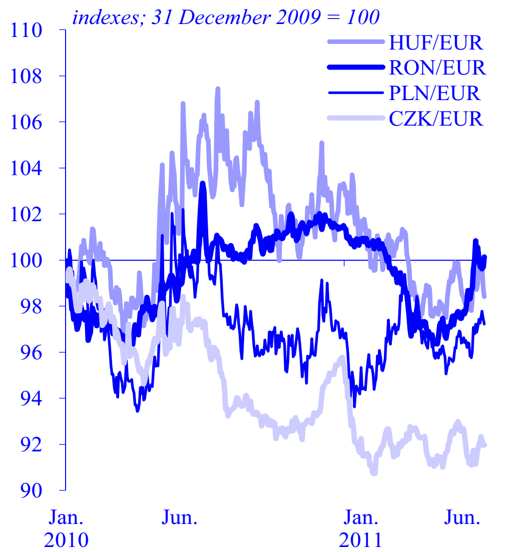
March through May 2011, the dynamics[34] of broad money (M3) fell deeper into negative territory and thus hit an 11-year low of -4.8 percent, reflecting the still weak lending activity and the

Key Financial Account Items (balances)

EUR million

	2010 5 mos.	2011 5 mos.
Financial account	**3,022**	**2,148**
Direct investment	**969**	**867**
- residents abroad	-72	68
- non-residents in Romania	1,042	799
Portfolio investments and financial derivatives	**1,364**	**1,549**
- residents abroad	-140	-251
- non-residents in Romania	1,504	1,801
Other capital investments	**2,930**	**909**
- credits and loans from the IMF	2,453	909
- medium- and long-term investments	-168	431
- short-term investments	-146	87
- currency and short-term deposits	890	-724
- other	-99	208
NBR's reserve assets, net ("–" increase/"+" decrease)	**-2,242**	**-1,177**

Exchange Rate Developments on Emerging Markets in the Region



Source: NBR, ECB

32 The rating agencies' decision to further downgrade Portugal and Ireland as well as speculations of a possible restructuring of Greece's external debt caused these countries' bond yields to soar to new record highs.

33 In June 2011, the Polish zloty weakened 0.8 percent versus the euro, while the Czech koruna and the Hungarian forint strengthened slightly against the single currency.

34 Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for March-May 2011.

Annual Growth Rates of M3 and Its Components

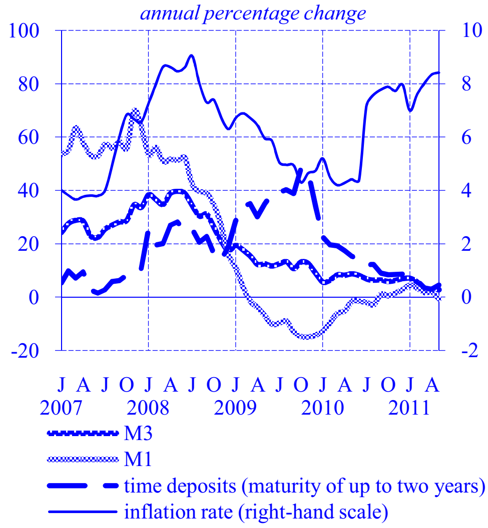
real percentage change

	2010			2011		
	II	III	IV	I	Apr.	May
	quarterly average growth					
M3	3.9	-0.9	-1.4	-2.0	-5.0	-5.2
M1	-6.8	-8.1	-5.8	-4.1	-5.9	-8.4
Currency in circulation	0.6	3.2	3.7	2.0	0.0	-4.3
Overnight deposits	-9.9	-12.9	-9.8	-6.8	-8.7	-10.3
Time deposits (maturity of up to two years)	10.8	3.4	0.6	-1.7	-5.1	-3.6

Source: NIS, NBR

Broad Money and Inflation Rate

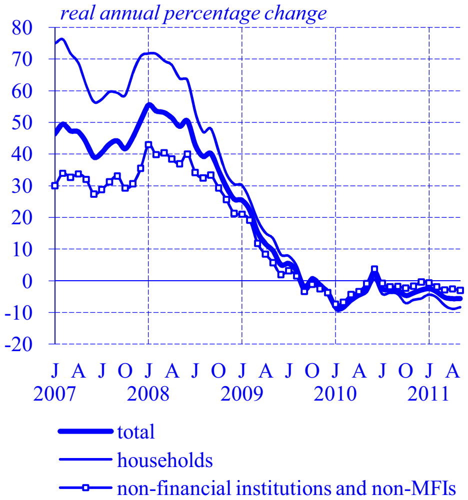
annual percentage change



Source: NIS, NBR

Loans to Private Sector by Institutional Sector

real annual percentage change



Source: NIS, NBR

statistical effect of the trend reversal in the exchange rate[35]. Unlike the previous 3-month period, all major components of M3 contributed to the slacker dynamics of this aggregate. The main culprit was narrow money (M1) contraction re-embarking on a steeper path, amid the growth rate of currency in circulation entering negative territory for the first time in 2011 and the sharper negative dynamics of overnight deposits (primarily on account of the slower pace of increase of corporate funds). In turn, the annual growth rate of time deposits with a maturity of up to two years continued to post more negative readings, as both households and companies registered worsening trends. At the same time, the pace of increase of marketable securities decelerated, but remained at elevated levels.

The dynamics of total M3 deposits advanced into negative territory, hitting a historical low in case of households and an 11-year low for companies. Developments were ascribable, on the one hand, to the ongoing contraction of wages and the still high/rising debt service payments in case of corporate customers[36] and, on the other hand, to the partial shift of both customer categories towards lei-denominated deposits with a maturity of over two years and towards purchasing government securities. The economic agents' keener appetite for forex deposits notwithstanding, the share of these deposits in M3 shrank further during the period under review, under the impact of the trend reversal in the leu exchange rate.

From the perspective of M3 counterparts, broad money developments were shaped by the steeper negative dynamics of loans to the private sector and of net foreign assets. This impact more than offset the expansionary influence of the more sluggish growth rate of long-term financial liabilities and especially of the faster increase in central government net credit (reflecting the faster pace of decline of this sector's bank deposits).

Credit

The growth rate[34] of loans to the private sector advanced into negative territory during March-May 2011, standing at -5.6 percent versus -3.0 percent in the previous period. The development was manifest in case of both customer categories and was attributable to the dynamics of the foreign currency component (expressed in EUR) staying on a downward path as well as to the statistical effect of the movements in the RON/EUR exchange rate. However, early signs of a rebound in lending emerged in the period

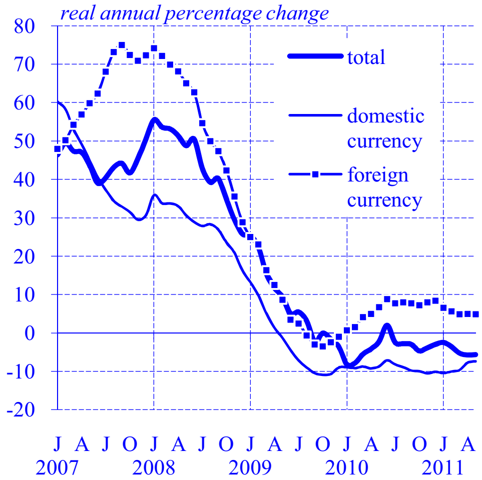
[35] Based on end-of-period readings.

[36] The real annual average dynamics of the net average wage economy-wide stayed in negative territory (despite a slight improvement), while the non-banking sector's external debt service payments rose 1.6 times during March-April 2011 versus the December 2010 – February 2011 reading.

April-May, when the monthly pace of increase of loans to the private sector entered positive territory. To this added a rise in the volume of new business[37] and the findings of the relevant survey conducted by the NBR[38], which pointed to a relative improvement in corporate and household demand for loans, accompanied by an easing of certain lending terms and conditions. The possible determinants of these developments were: (i) the overall downward trend in interest rates on new lei-denominated loans; (ii) keener competition among credit institutions; (iii) banks' somewhat more favourable expectations on the economic activity, as well as the improved outlook on the risk associated with certain debtor categories/sectors of the economy.

These changes fed through only partly into the annual dynamics of loans to the private sector. In case of companies, this may be due to the incomplete use of credit lines extended during the reported period, but also to a relative decline in the volume of banks' net credit purchases[39]. In case of households, the most likely explanations lie with the temporary halt in the "First Home" programme, a base effect associated with the previous stages of the programme, as well as with a potential rise in refinancing operations.

Loans to Private Sector by Currency



Source: NIS, NBR

[37] Data on new loans to companies and households are based on CCR data referring to loans in excess of lei 20,000 approved in the period under review.

[38] According to the NBR's survey on lending to non-financial corporations and households released in May 2011, lending standards were eased slightly in the first quarter of the year, except for those on real estate loans to households. For 2011 Q2, banks anticipated a broad-based easing of lending standards, but less so in case of long-term corporate loans.

[39] Based on monetary statistics data.

V. INFLATION OUTLOOK

For end-2011, the baseline scenario of the current projection places the annual CPI inflation rate at 4.6 percent, 0.5 percentage points lower than the level in the May 2011 Inflation Report and 0.6 percentage points above the upper limit of the variation band around the 3 percent target. For end-2012, the inflation rate is forecast to stay within the variation band at 3.5 percent, 0.1 percentage points below the previously projected level.

The updated baseline scenario sees the inflation rate on a sharp downward trend between 2011 Q3 and mid-2012. A similar trend is expected for the adjusted CORE2 inflation rate. For both inflation measures, the fast-paced disinflation envisaged for the first part of the projection horizon is largely due to the fading out, during 2011 Q3, of the first-round effects of the standard VAT rate hike in July 2010. The base effect will contribute significantly to the anticipated fall in CPI inflation rate from 7.9 percent at the end of 2011 Q2 to 4.8 percent at the end of 2011 Q3. For 2012, CPI inflation rate is foreseen to return to and subsequently to stay inside the variation band around the central target, while the adjusted CORE2 inflation rate is expected to stay below 3 percent.

The significant downward revision of the projected levels of the annual inflation rate in 2011 is mainly due to a smaller contribution of volatile food prices, as a result of the improved outlook for the domestic supply and the relative easing of tensions on the relevant external markets. The projected dynamics of the oil price will have a somewhat more favourable bearing on domestic fuel prices in 2011. On the other hand, in 2011 Q3, the trajectory of tobacco prices and their contribution to inflation were revised marginally upwards compared to the previous Inflation Report.

The path in the adjusted CORE2 inflation and its projected contribution to CPI dynamics were revised marginally upwards in 2011. On the one hand, the expected growth rate of import prices is, compared to the previous forecast, less favourable to disinflation at the beginning of the reference period. On the other hand, relatively higher inflation expectations and a slightly wider negative output gap than in the previous projection round for the entire forecast horizon cause divergent effects on the dynamics of the adjusted CORE2 index. During 2012 though, once inflation expectations adjust downwards, the bearing of the negative output gap is projected to prevail, leading to a slight downward revision in the path of adjusted CORE2 inflation and in its contribution to CPI dynamics compared to the previous projection.

Against the current macroeconomic background characterised by the impact of repeated supply-side shocks and associated risks *relevant over the projection period, in parallel with the persistence of the negative output gap, the central bank's primary concern is to prevent the second-round effects of these shocks from becoming manifest. Hence, the monetary policy rate will remain on a path in line with maintaining adequate real broad monetary conditions so as to ensure a solid anchoring of inflation expectations and enhance the prospects for inflation to converge towards the medium-term targets. Furthermore, the external and domestic equilibria of the national economy are strictly conditional on the monetary policy enjoying the support of the other policy mix components by consistently implementing the economic programme on fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank.*

The sources of risks related to the baseline scenario of the inflation forecast are generally similar to those identified in the previous projection rounds and are attributed to both domestic and external factors. Over the short term, the balance of risks appears to have eased in relative terms, owing to lower tensions on global commodity markets for the time being and to favourable conditions for good crops domestically. However, over the medium term, the overall balance of risks appears to remain significantly tilted towards less favourable developments than envisaged in the baseline scenario.

Over the medium term, the major domestic sources of risks are associated with administered price increases and the time consistency of the macroeconomic policy package. The likelihood that measures weighing heavily on the dynamics of administered prices are taken in the reference period is relatively high, whereas the absence of an official timetable and quantitative benchmarks publicly assumed by the relevant authorities affects the adequate formulation and quantification of assumptions in the baseline scenario. As for the programme on fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank, the forthcoming 2012 elections pose the risk of social or political pressures that might deter its consistent implementation.

Should the risks coming from the above-mentioned sources materialise, inflation could deviate significantly from its projected path, including via spill-over effects on the leu exchange rate, markedly higher interest rates as a result of heightened risk perception and limited access of both private and public sectors to financing, as well as via pressures to raise wages in excess of labour productivity dynamics.

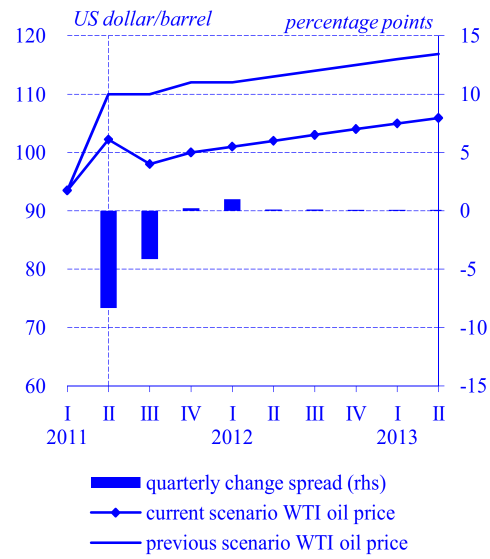
In the medium term, external risk sources that are a matter of concern relate to the possible worsening of investors' risk *perception towards emerging markets and its ensuing effects on the Romanian economy given the aggravating sovereign debt crisis in the European Union and/or the United States. Although some of these tensions have softened somewhat over the past few weeks, their possible resurgence in the period ahead would entail wide-ranging uncertainties in terms of volatile capital flows related to Romania. At the same time, the reshaping of the scenario on euro zone economic growth, most likely at lower levels, and the change in the EUR-USD exchange rate as against the projected figures could translate into significant deviations of key macroeconomic variables from their trajectories in the baseline scenario. In addition, medium-term risks linked to movements in international commodity prices are persisting as a result of demand-side pressures from the fast-expanding emerging economies against the background of recovering growth of the global economy.*

1. The baseline scenario of the forecast

1.1. External assumptions

The annual growth rate of euro zone GDP is expected to post positive levels in both 2011 and 2012, due to the developments in global demand for euro zone exports and the envisaged pick-up in investment. For 2011, the anticipated level of economic growth was revised upwards by 0.3 percentage points to 2 percent, while the outlook for 2012 points towards a rate of 1.7 percent, similar to that in the May 2011 *Inflation Report*. In terms of structure, the positive contribution of domestic demand will be increasingly strong over the entire forecast horizon, while the contribution of net exports will gradually diminish, but will remain in positive territory. The highest uncertainties relating to economic activity in the euro zone are associated with the sovereign debt sustainability problems experienced by certain member countries and with the developments in prices of oil and other commodities on world markets.

Baseline Scenario for the International Oil Price



Source: NBR assumptions based on the data provided by U.S. Energy Information Administration

Due to the recent step-up in the dynamics of energy and commodity prices, the euro zone annual inflation rate is likely to further exceed, for the remaining part of 2011, the levels close to, but below 2 percent aimed at by the Governing Council of the ECB over the medium term. The average annual rise in the Harmonised Index of Consumer Prices (HICP) is foreseen to reach 2.6 percent in 2011 and to decrease to 1.9 percent in 2012; the projected values are 0.3 and, respectively, 0.1 percentage points higher than those in the May 2011 *Inflation Report*.

The 3M EURIBOR interest rate is expected to follow an uptrend, nevertheless with lower-than-previously-envisaged values, especially during 2012. The euro is anticipated to post a slight gradual depreciation versus the US dollar, thereby reversing its recent appreciation trend. In this context, the average USD/EUR exchange rates for 2011 and 2012 remain marginally higher than in the previous forecasting round.

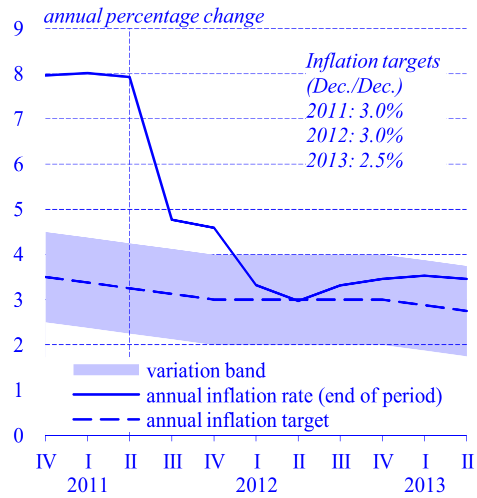
The exogenous trajectory of the international oil price in the updated projection[40] is lower than in the May 2011 *Inflation Report*, but the related quarterly changes are close to the previous assumptions, so that the revision does not have a relevant impact on the forecasted domestic fuel price inflation rates. As for the uncertainties surrounding the oil price scenario, U.S. Energy Information Administration has mentioned possible turbulences in certain oil-producing regions, disagreements between the Organization of the Petroleum Exporting Countries (OPEC) members with regard to the adjustment of production quotas and the evolution of the global economic activity.

1.2. Inflation outlook

According to the current projection, the annual CPI inflation rate will stand at 4.6 percent at end-2011 (0.5 percentage point downward revision compared to the previous projection), will re-enter the variation band around the central target in the first part of 2012 and will reach 3.5 percent at end-2012 (0.1 percentage point downward revision). The alleviation of supply-side shocks[41] that had a strong impact over the preceding forecasting rounds is expected to put the inflation rate onto a sharp downward path, from 7.9 percent at the end of 2011 Q2 to a low of 3 percent at the end of 2012 Q2. For the remainder of the projection period, annual inflation is foreseen to stabilise somewhat within the variation band.

The cumulated contribution of the annual dynamics of administered prices, volatile food prices (VFE) and fuel prices, i.e. the components of CPI inflation[42] which are exogenous in terms of the monetary policy scope, is projected to run at 2 percentage points at end-2011, down 0.8 percentage points compared to the previous forecasting round. By contrast, at end-2011, CORE2 index will have a contribution to CPI inflation estimated at 2.6 percentage points, 0.3 percentage points higher than in the May 2011 *Inflation Report*. For end-2012, the contribution of CORE2 inflation to headline inflation was revised downwards by 0.1 percentage points while the contribution of the exogenous components was left unchanged.

Inflation Forecast



Note: Variation band is ±1 percentage point around the central target
Source: NIS, NBR projections

Expectations on the Developments in External Variables

annual averages

	2011	2012
WTI oil price (USD/barrel)	98.4	102.5
USD/EUR exchange rate	1.42	1.40
3M EURIBOR interest rate (% per annum)	1.48	2.05
Economic growth in the euro zone (%)	2.0	1.7
Annual inflation rate in the euro zone (%)	2.6	1.9

Source: NBR assumptions based on the data provided by U.S. Energy Information Administration, Consensus Economics and futures prices

The Annual Inflation Rate in the Baseline Scenario

annual percentage change (end of period)

	2011		2012				2013	
	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Target		3.0				3.0		
Forecast	4.8	4.6	3.3	3.0	3.3	3.5	3.5	3.5

Components' Contribution to Annual Inflation Rate*

percentage points

	2011	2012
Administered prices	0.7	0.8
Fuels	0.8	0.5
VFE prices	0.5	0.4
CORE2, of which:	2.6	1.8
tobacco	0.4	0.0

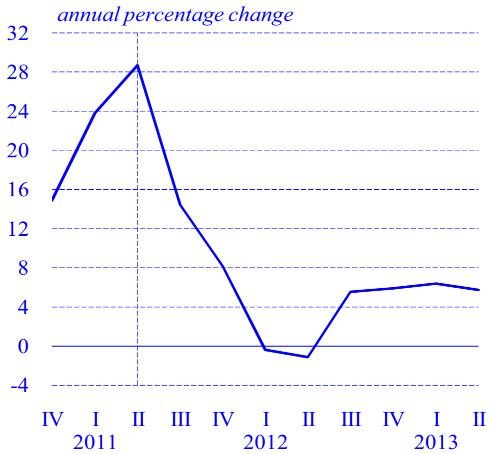
** end of period*

[40] Until the end of 2012, the scenario was assumed from U.S. Energy Information Administration.

[41] Consisting largely in the effects of indirect tax increases (VAT, excise duties), oil price spikes on world markets and tensions on international agri-food commodity markets in 2010 H2 and 2011 H1. Out of these factors, the fading to a large extent during Q3 of the first-round effect of the VAT rate hike implemented on 1 July 2010 appears to have the strongest disinflationary impact, estimated, *ceteris paribus,* at approximately 2.4 percentage points.

[42] Currently accounting for 31.39 percent of the CPI basket.

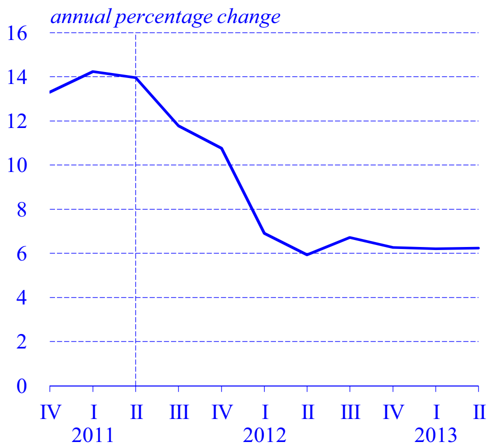
Vegetables, Fruit and Eggs Prices Annual Inflation*



**) quarterly average*

Source: NIS, NBR projections

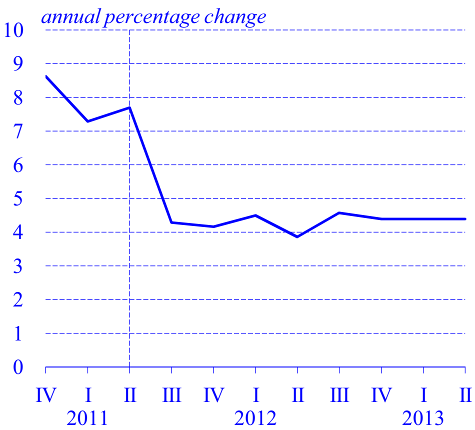
Fuel Prices Annual Inflation*



**) quarterly average*

Source: NIS, NBR projections

Administered Prices Annual Inflation*



**) quarterly average*

Source: NIS, NBR projections

For 2011, the substantial revisions in the current projection are largely due to the fading of supply-side shocks at a faster pace than previously expected. Given that tensions on international agri-food markets abated and the domestic food supply is expected to meet demand, and as the current trends are seen persisting into 2011 Q3, the projected path of the annual inflation of volatile food prices (VFE) was revised downwards. Thus, compared to the previous forecasting round, the contribution of VFE inflation to CPI inflation at the end of 2011 was subject to a downward revision by 0.6 percentage points. For 2012, the assumption of normal crops considered in the May 2011 *Inflation Report* was maintained, with the contribution of VFE inflation to headline inflation being forecasted to decline to 0.4 percentage points by the end of next year.

Against the backdrop of a projected persistence of the recent favourable developments in the growth rate of the world oil price and in the RON-USD exchange rate, the forecasted path of the annual rate of fuel price inflation was marginally revised downwards for the entire forecast horizon. As a result, the contribution of this category of prices to CPI inflation is estimated to be 0.1 percentage points lower at the end of 2011 and to remain broadly unchanged at the end of 2012.

The scenario on administered price[43] developments foresees an annual growth rate equal to 4.2 percent in 2011 Q4, down 0.2 percentage points from the previous round, chiefly under the impact of a more favourable performance than previously envisaged during Q2. For the end of 2012, the assumption of a 4.4 percent increase in administered prices used in the previous projections was maintained.

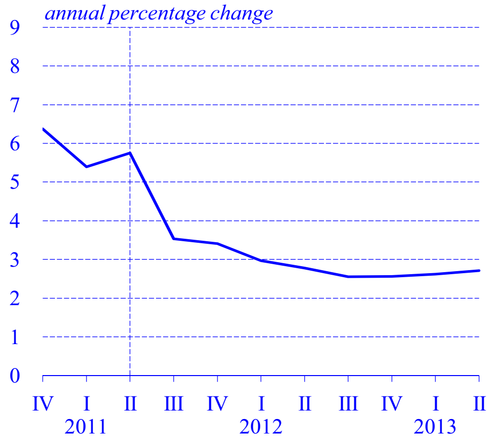
The annual rate of CORE2 inflation is expected to trend downwards until the end of 2012, but it will follow a higher trajectory than in the May 2011 *Inflation Report* in the first half of the forecast horizon. Its pick-up in the first part of the forecast period is also fuelled by the unfavourable effect stemming from tobacco prices, which is expected to become manifest during 2011 Q3 in particular. Additional pressures on the annual rate of CORE2 inflation are foreseen to come from inflation expectations throughout the forecasting horizon and from import prices in the first three quarters of the projection. Once those influences have diminished, disinflationary pressures from the negative output gap are projected to prevail again, contributing to a lower-than-previously-envisaged path of the adjusted CORE2 inflation rate.

As for the determinants of core inflation, inflation expectations of economic agents exhibited a stronger-than-previously-estimated

[43] Based on reliable information regarding administered price adjustments available on 29 July 2011.

reaction to the multiple supply-side shocks manifest in the preceding quarters. Nevertheless, throughout the projection horizon, the path of these determinants will enter a sharply downward trend, also due to the impact of the recalibrated real broad monetary conditions and of the resumed disinflation, once the effects of the standard VAT rate hike have fully fed through to the economy, in line with the NBR projections. The path of import prices is shaped by the faster-than-previously-projected dynamics of external prices[44] and a somewhat more favourable impact of the leu exchange rate. The annual growth rate of tobacco prices was revised upwards for end-2011, solely due to the cigarettes price hikes expected for Q3[45]. For 2012, in view of the minor amendments to the Tax Code regarding the excise duty on tobacco, the assumption of a below 1 percent annual growth rate of this category of prices was maintained.

Annual CORE2 Inflation*



**) quarterly average*

Source: NIS, NBR projections

1.3. Demand pressures in the current period and on the projection horizon[46]

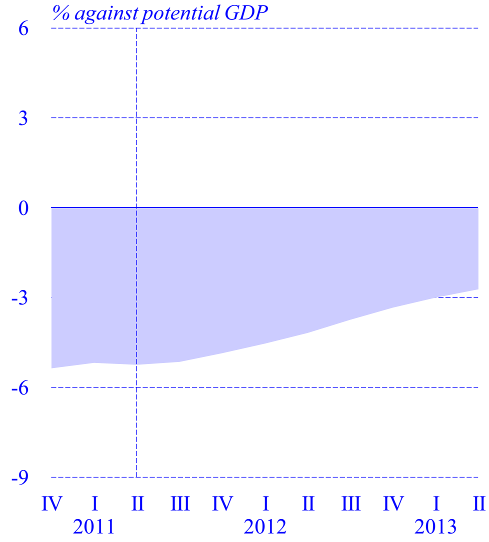
Output gap

Real GDP dynamics is anticipated to remain in positive territory in 2011 Q2 in quarterly terms, despite the slightly slower advance than in the previous quarter (0.7 percent). The annual growth rate of real GDP is expected to post positive readings in 2011 Q2 as well.

For the current forecasting round, the potential GDP growth rate remains at considerably lower levels than those registered prior to the outbreak of the financial crisis, as suggested by the production function based analysis. According to this, the deceleration of potential GDP dynamics is mainly attributable to the unfavourable performance of total factor productivity, under the impact of the crisis, and to the significantly lower contribution of the capital stock following the drop in investment flows.

The negative output gap in 2011 Q2 is expected to post a similar reading to that in the previous quarter, which means that, *ceteris paribus*, aggregate demand disinflationary pressures remain unchanged.

GDP Deviation



Source: NIS, NBR calculations

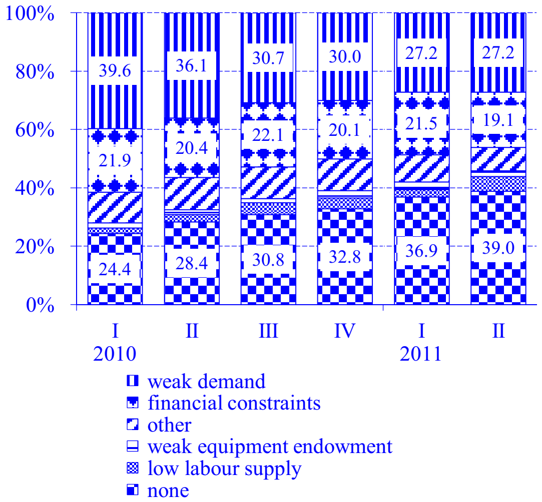
The slightly divergent developments in certain coincident indicators capturing GDP dynamics underpin the real output gap estimates. Thus, compared to the average for the previous quarter, industrial

[44] See Subsection *1.1. External assumptions*.

[45] There is no connection between these increases and the changes in the structure of the excise duty on tobacco prices implemented on 1 July 2011.

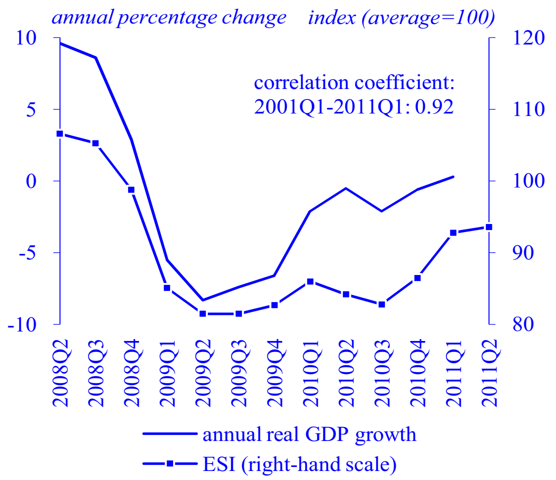
[46] Unless otherwise indicated, percentage changes are calculated based on seasonally-adjusted data series. Sources: NBR, MPF, NIS, Eurostat, EC-DG ECFIN and Bloomberg.

Factors Depressing Industrial Output



Source: EC-DG ECFIN

Economic Sentiment Indicator and Economic Growth*



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN

output rose at a slower pace[47] during April-May, while the capacity utilisation rate declined slightly. Furthermore, the share of respondents in the EC-DG ECFIN survey citing "insufficient demand" as one of the factors depressing manufacturing production remained unchanged. Energy consumption and the economic sentiment indicator (ESI) stayed on an upward path[48], although the latter's value is still below the long-term average.

The negative output gap is anticipated to persist throughout the projection horizon[49]. The forecasted values of GDP deviation are more negative than in the previous *Inflation Report*. The reassessment indicating a wider demand deficit was determined by a slightly slower anticipated economic growth in 2011 Q2 compared to the previous round. Also, the fiscal impulse exerts ampler contractionary effects over the first part of the forecast horizon. Assuming the budget deficit targets agreed under the multilateral external financial arrangement with the EU, the IMF and other IFIs, the more pronounced restrictive effect is primarily due to the forecasted sharper adjustment of the structural budget deficit in 2011, following the projection of a wider demand deficit and hence a larger cyclical component of the budget deficit. The fiscal impulse is expected to act pro-cyclically across almost the entire projection horizon, given the need to reduce the budget deficit and bring it as close as possible to the quantitative objective set for 2012, i.e. 3 percent of GDP. Real broad monetary conditions are projected to exert a relatively less restrictive impact on aggregate demand than previously anticipated. External demand is expected to have a favourable contribution to the dynamics of domestic economic activity.

Aggregate demand components

In 2011 Q2, the negative quarterly dynamics of actual final consumption of households is anticipated to carry on in the absence of any signs of a marked increase in households' disposable income[50], although consumers' expectations on their

[47] 0.4 percent versus a quarterly average of 2.4 percent during 2010 Q2 – 2011 Q1.

[48] Energy consumption economy-wide increased 5.1 percent during April-May compared to the average for 2011 Q1 (NBR seasonally-adjusted data). The ESI edged up 0.8 percentage points in 2011 Q2 against the previous quarter, the main drivers being the industry confidence indicator (40 percent) and the services confidence indicator (30 percent). The balance of answers inched down from -0.1 percent to -1.2 percent for the former indicator and rose from 1.5 percent to 5.1 percent for the latter.

[49] 2011 Q3 – 2013 Q2.

[50] Compared to the average for 2011 Q1, the expenditures of the social security budget and the current private transfers in April and May contracted (non-seasonally adjusted data), while wage income moved up. The increasing flow of new consumer loans to households is irrelevant insofar as refinancing loans are included. This latter aspect is also illustrated by the evolution of the loan stock that, against the backdrop of the faster increase in the new business flow, saw a real 1.6 percent decline in Q2 versus the average for the previous quarter (non-seasonally adjusted data).

financial standing and economic developments in the following 12 months improved versus Q1. The drop in the retail trade except of motor vehicles turnover index and in the market services to population turnover index[51] is also indicative of the delayed rebound in household consumption in 2011 Q2. The adjustment of government consumption in line with the authorities' commitment to fulfil the deficit target agreed with the international financial institutions for end-2011, i.e. 4.4 percent of GDP, is seen to continue in 2011 Q2 as well. According to the preliminary data released by the Ministry of Public Finance, the consolidated general budget deficit at end-June (cumulated) accounted for 2.07 percent of GDP, a level significantly lower from a year earlier.

Given the unfavourable performance of final consumption in 2011 Q1 and the values anticipated for Q2, the projection precludes the re-entering of final consumption into positive territory in the current year. However, for 2012, this component is expected to post a significant average annual rate of increase, in accordance with the consolidation of economic growth and the ensuing gradual easing of financial constraints faced by economic agents.

The forecast of a slightly negative quarterly dynamics of gross fixed capital formation in 2011 Q2 is surrounded by elevated uncertainty as a result of the divergent developments of the key indicators. Compared to the previous quarter's average, in April and May the balance of answers regarding construction orders and new construction works indicated slightly positive growth, while new construction permits, the capital goods industry turnover index related to the domestic market and the industrial production of capital goods posted declines[52].

Given the unfavourable performance registered in 2011 Q1 and anticipated for Q2, the growth rate of gross fixed capital formation is foreseen to be slightly negative in the current year, while domestic production is expected to be supported mainly by the foreign demand for Romanian products. For 2012, the expected revival of production for domestic consumption is seen to bolster a projected major rebound in gross fixed capital formation.

Exports are anticipated to further show positive quarterly dynamics in 2011 Q2, albeit lower compared to that in Q1[53]. The good

[51] In April and May 2011, compared to the average for the previous quarter, the rates of increase for the said indicators stood at -0.8 percent and -1.7 percent respectively.

[52] The quarterly growth rates for the considered variables were: -14.8 percent for new construction permits, -1.4 percent for the capital goods industry turnover index related to the domestic market, -4.6 percent for the industrial production of capital goods. The balance of answers regarding construction orders and new construction works rose by 2.9 percentage points and 0.9 percentage points respectively.

[53] In quarter-on-quarter comparison, the 10.6 percent increase seen in 2011 Q1 was the largest one reported over the past two years.

performance of exports will be supported by a relatively robust external demand, the increase in real GDP and in the euro zone industrial production being expected to carry on in 2011 Q2, amid the anticipations of economic activity posting levels above the historical average[54]. In 2011 Q2, imports are expected to follow a trajectory similar to that of exports, the assessment being backed by the said developments of the other GDP components.

Over the forecast horizon, real exports are foreseen to further post positive dynamics, under the favourable impact of the anticipated rise in external demand. Real imports are also expected to grow, spurred by the good performance of exports and the revival of domestic demand anticipated for the coming year. Exports are forecasted to increase at a faster pace than imports, while in 2012, amid the revival in domestic demand, the growth of imports will outpace that of exports. In this context, the balance of payments current account deficit will widen moderately by the end of the forecasting horizon, yet no significant inflationary pressures from the exchange rate of the domestic currency are anticipated.

Broad monetary conditions

In 2011 Q2, the domestic currency appreciated in nominal terms against both the euro and the US dollar compared to the previous quarter. The above-mentioned movements resulted in a quarter-on-quarter strengthening of the nominal effective exchange rate[55] 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 caused the leu to appreciate in real terms in 2011 Q2 compared to the preceding quarter.

The second quarter of 2011 witnessed an improvement in investors' risk perception regarding Romania and its regional peers compared to Q1. This was also reflected by the downward quarterly movement of the spreads of credit default swaps (CDS) for Romania, with the other countries in the region posting similar trends. Nevertheless, starting June, monthly data have shown a relative worsening of investors' risk perception amid renewed uncertainties surrounding growth prospects in major world economies and public finance sustainability in some euro zone Member States, as well as in the United States. Therefore, the EUR/RON exchange rate followed a slight uptrend. In view of the domestic currency's recent movements versus the euro, for

[54] Euro area industrial production expanded by 0.4 percent in April and May compared to the average for Q1. Economic sentiment indicator (ESI) for the euro area showed an average value of 105.6 in 2011 Q2.

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

2011 Q3 the EUR/RON exchange rate is forecasted to stand marginally higher than previously projected.

In 2011 Q2, interest rates applied by credit institutions to their non-bank clients decreased in nominal terms, but increased in real terms compared to the prior quarter, mainly on account of lower inflation expectations.

As a result of the developments in the second quarter of 2011, the effect of real broad monetary conditions on aggregate demand in Q3 will become slightly restrictive. According to the NBR assessment, the real effective exchange rate will exert a contractionary impact on aggregate demand via the net export channel. Its impact on aggregate demand via the wealth and balance sheet effects is expected to be stimulative due to lower leu-denominated costs of foreign-denominated loans. Relative to the estimated levels of medium-term trends, real interest rates further have a stimulative influence on real economic activity, albeit weaker than that seen in the previous quarter.

During the projection horizon, real broad monetary conditions are expected to have a restrictive influence on aggregate demand, owing to the major impact of the real effective exchange rate via the net export channel. On the other hand, the deviations from the trend of real interest rates on leu-denominated loans and deposits and the wealth and balance sheet effects of the exchange rate are anticipated to foster economic activity. The trajectory of the monetary policy rate is calibrated so as to offset potential second-round inflationary pressures resulting from the recent supply-side shocks[56] and to favour the conditions for a gradual recovery of lending to the real economy.

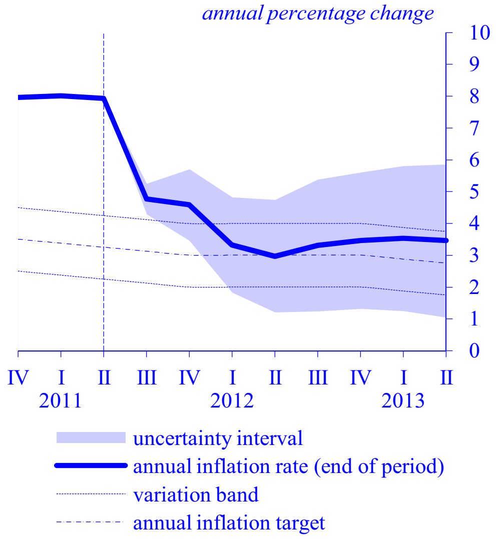
Real broad monetary conditions exert a less restrictive influence than that envisaged in the baseline scenario in the May 2011 *Inflation Report*. The projected dynamics of the real effective exchange rate is more supportive of net exports over the first part of the forecast horizon as a result of the downward revision of the domestic inflation rate and the upward revision of the foreign one, as well as of an anticipated higher level of the EUR/RON exchange rate in the first quarter of the projection horizon. The wealth and balance sheet effects will have a more stimulative impact for most of the forecast horizon following the downward revision of foreign interest rates (3M EURIBOR). The joint influence of the deviations from the trends of real interest rates on leu-denominated deposits and loans is foreseen to be more stimulative amid the upward revision of inflation expectations.

[56] See Subsection *1.2. Inflation outlook*.

1.4. Risks associated with the projection

Although the effects of some of the supply-side shocks over the recent months have been weaker than anticipated in the May 2011 *Inflation Report*, the relevant sources of risks for the current forecasting round do not differ considerably from those mentioned in the previous *Inflation Report*. The current assessment points towards a balance of risks in a relative equilibrium over the first part of the projection horizon, with higher risks of inflation rate deviating upwards from the baseline scenario trajectory over the medium term, primarily on account of expected administered price adjustments and developments in the external economic environment.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR projections and calculations

As regards the external environment, the relative stabilisation of international food prices over the recent months, as well as their medium-term outlook underpin the alleviation, compared to the previous round, of inflationary risks stemming from this source. Such improvement notwithstanding, this risk remains relevant to future developments in domestic inflation[57] amid the future sharpening of structural[58] and/or cyclical trends on those markets, to which adds the anticipated high volatility of food prices[59].

A possible deepening of tensions on global financial markets, triggered by sovereign debt sustainability issues facing certain EU Member States[60] or the United States, is still a matter of concern given its potential to send ripple effects to emerging markets in general and in the Romanian economy in particular. In the event of this scenario materialising, assuming the deterioration of investors' risk perception relative to regional and global developments, the exchange rate of the leu and interest rates on loans to sovereign and private entities in Romania could be impacted, thus entailing, especially via the former channel, the worsening of domestic disinflationary performance. In addition, the revision – most likely downwards – of the projected economic activity of Romania's major trade partners, the change in the EUR-USD exchange rate as against the projected figures and Romania tapping costlier sources of financing on international financial markets might have a detrimental impact on a broader set of indicators in the baseline scenario.

[57] For details on the effects of higher external prices of food items on domestic inflation rates, see the box in the May 2011 *Inflation Report*.

[58] Such as higher food consumption in emerging economies.

[59] Given the reliance of food prices on weather conditions and the depletion of global food stocks over the recent months.

[60] Such a scenario cannot be entirely ruled out, despite the recent decision of the European Council (21 July 2011) to supplement the rescue package for Greece, since the contagion effect on economies with similar vulnerabilities (Spain, Italy, Portugal and Ireland) may call the sustainability of these financial assistance schemes into question.

The most significant domestic risk factors are further associated with the future dynamics of administered prices, given the lack of accurate information on the calendar and magnitude of price hikes related to the projected elimination of heating subsidies[61] and on liberalising the natural gas and electricity markets[62]. In addition to the direct inflationary impact, the rise in these price categories could generate a wage-price inflationary spiral, especially if the situation is made worse by a potentially faster increase in wages following the sizeable cuts implemented during the crisis. Under the circumstances, the inflation targets set for the upcoming years would be seriously jeopardised.

Last but not least, significant risks stem from possible slippages of the fiscal policy and of the public sector income policy from the previously-agreed coordinates, especially when looking at the frequent election rounds scheduled for the forthcoming years. This would throw the macroeconomic policy mix off balance and would overburden monetary policy, which might translate into a weaker disinflationary performance than assumed in the baseline scenario.

2. Policy assessment

After having risen steadily for four months, the annual inflation rate fell in June to 7.93 percent from 8.42 percent in May. Behind this stood the significant decline in volatile food prices, against the background of the interaction between the sizeable increase in the domestic supply of seasonal agricultural products and the persistence of the negative output gap. Consequently, the deviation of the annual inflation rate from the upper limit of the variation band around the central target diminished slightly.

In this context, the medium-term inflation forecast coordinates were revised for the entire projection horizon. The largest downward revision saw the annual inflation figures expected for Q3, once the first-round effect of the VAT rate hike begins to fade out, and for the end of this year. At the same time, compared to the previous forecast, the return of the projected annual inflation rate within the variation band around the 3 percent target in 2012 Q1 is more visible and its subsequent path is closer to the central target.

The improvement in the inflation outlook is only partly the result of the recent correction in some agri-food prices. An additional reason for this consists in the relatively more favourable forecasts regarding the impact of supply-side/cost-related shocks deriving from the developments in international markets for food commodities and energy, including crude oil. A contribution to the

[61] Subsidies from government budget or local budgets. See footnote 75 in the May 2011 *Inflation Report* for a quantitative assessment of the implications of removing these subsidies.

[62] In line with Directive 2009/72/EC and Directive 2009/73/EC.

improved outlook also comes from the relative increase in the anticipated negative output gap compared to the previous forecast and, implicitly, in its expected disinflationary pressures; underlying such prospects are primarily the gradual restoration of domestic demand and the slowdown in the pace of global economic growth in Q2. The ensuing improvement in the expected performance of core inflation becomes however apparent only at the longer end of the projection horizon, given the adverse short-term effect coming from the temporary relative worsening of the leu exchange rate behaviour and the time lag with which the current declines in volatile VFE prices feed through to the dynamics of prices of processed food items holding a significant share in the adjusted CORE2 inflation basket.

Significant risks and uncertainties continue to weigh on the forecast of medium-term macroeconomic developments. From the viewpoint of monetary policy conduct, still worrying are the uncertainties related to the magnitude of the impact and to the timing of the measures to adjust/remove some administered prices[63], representing to a large extent conditionalities in the arrangements signed with the EU, the IMF and the World Bank, the implementation of which poses risks primarily to the medium-term inflation developments. In the short term, an inflationary risk induced by administered prices could be the potential magnitude of the indirect effect on the consumer price index of the July 2011 hike in the price of natural gas delivered to non-residential consumers as well as of its possible upward readjustment in the months ahead.

By contrast, the risk of a departure of the annual inflation rate from the projected path owing to future movements in oil and agricultural commodity prices on global markets has relatively diminished, in the near run at least. This assessment hinges, on the one hand, on high uncertainties over the outlook for the global economy stemming from both its recent recovery slowdown – only partly justified by the disruption in supply chains in the aftermath of the Japan catastrophe – and increasingly jittery international financial markets amid the deepening sovereign debt crisis. A possibly stronger-than-expected rise in this year’s domestic agricultural crops would entail a relatively higher and more sustained downtrend in volatile food prices that may bring about a downward deviation of the annual inflation rate from the projected path.

A matter of concern for the central bank remains however the risk of potential second-round effects of adverse supply-side shocks occurring simultaneously or successively over the recent quarters. In this context, the concern derives mainly from the annual inflation rate staying for a long period significantly above the upper limit of the variation band around the central target – due to

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

multiple severe supply-side shocks that hit the Romanian economy over the past 12 months – and the largely adaptive nature of some economic agents' inflation expectations. Another source is the outlook for the annual adjusted CORE2 inflation rate to remain at relatively elevated levels, reflecting only partly the pattern and the magnitude of the projected negative output gap.

The concern is also substantiated, despite the action of incidental factors, by the relative worsening of industry-wide ULC in April, after a long period of generating disinflationary pressures that also helped keep the current account deficit at sustainable levels. Seen from this perspective, to accurately identify and assess the possible risks that wage dynamics pose to the inflation forecast call for permanently adhering to the wage-productivity correlation.

The prospects for the sovereign debt crisis in the euro zone and the United States remain uncertain and may even deteriorate further. Should this risk materialise, capital flows in emerging economies could grow more volatile amid international investors' heightened risk aversion. This would translate, on the one hand, into the short-term increase in inflationary effects generated by the leu exchange rate and, on the other hand, into stronger and more persistent disinflationary pressures from the negative output gap amid slower economic recovery in Romania, along with weakening expansion of the global economy. Under the circumstances, it is imperative to further ensure firm implementation of fiscal consolidation and structural reform measures, in compliance with the commitments assumed under the arrangements signed with the EU and the IMF, including in terms of the requirement to minimise the risks triggered by the tension-ridden international environment. This is also a crucial condition for consolidating disinflation and putting the Romanian economy onto a sustainable growth path.

In view of the heightened uncertainties about the ongoing sovereign debt crisis and its impact on the global financial markets, as well as, in the context of the balance of risks still tilted to the upside, the risk to medium-term inflation expectations coming from the likely administered price adjustments, the Board of the National Bank of Romania has decided in its meeting of 3 August 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. Against this background, the NBR Board has reiterated that the consistent implementation of the commitments assumed by the Romanian authorities under the financing agreements signed with international institutions, especially those regarding fiscal consolidation and the wage-productivity correlation, is essential to ensure the consolidation of disinflation at the projected pace and a sound recovery of the economy in the context of the nominal and real convergence processes.