National Bank of Romania

INFLATION REPORT

November 2011

Year VII, No. 26

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 2 November 2011 and includes data available until 26 October 2011.*

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

ABBREVIATIONS

ACSI	Authority for the Coordination of Structural Instruments
AER	annual effective rate
AMIGO	Household Labour Force Survey
CCR	Central Credit Register
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)
ESI	Economic Sentiment Indicator
EU	European Union
Eurostat	Statistical Office of the European Union
GDP	Gross Domestic Product
GVA	Gross Value Added
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Office
IMF	International Monetary Fund
IPPI	Industrial Producer Price Index
MARD	Ministry of Agriculture and Rural Development
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NCP	National Commission for Prognosis
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	overnight
ROBID	Romanian Interbank Bid Rate
ROBOR	Romanian Interbank Offer Rate
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 Q3, the annual CPI inflation rate returned inside the variation band around the central target, standing at 3.45 percent, down 4.5 percentage points from the end of 2011 Q2 and 1.3 percentage points lower than the level forecasted in the August 2011 Inflation Report. The steep fall in the annual inflation rate in 2011 Q3 was mainly driven by two determinants, underpinned by the maintenance of adequate broad monetary conditions in real terms. The first one, i.e. the near fading-out of the first-round effect of the VAT rate hike on 1 July 2010, had been anticipated by the NBR and incorporated in the baseline scenarios of the previous projections. The second factor, whose strength and duration were more pronounced than previously anticipated, was the deflation that volatile food prices (of vegetables, fruit and eggs) recorded from June to September.

The large supply of unprocessed food produce as a result of the good harvest, along with the persistence of the negative output gap, created very favourable conditions for consumer price disinflation during 2011 Q3, thus offsetting the food price increases that had a detrimental impact on the inflation outlook during the first half of the year. The faster-than-expected decline in the prices of vegetables, fruit and eggs was the main reason for the deviation of the inflation rate from the values forecasted in the previous quarter. The plentiful agricultural supply also started producing effects on the prices of processed food items included in the adjusted CORE2 index[1], whose adjustment – expected to continue – was however contained by higher production costs incurred by industrial producers (natural gas).

As for administered prices, fuel and tobacco prices, the disinflation they recorded in annual terms was mainly attributed to the base effect stemming from the VAT rate hike, even though quarterly changes were also indicative of slightly lower inflationary pressures.

At the end of 2011 Q3, the annual adjusted CORE2 inflation rate was 2 percentage points lower than in June (2.7 percent against 4.7 percent), but remained above the level it posted prior to the VAT rate increase. Behind this development stood the near fading-out of the first-round effects of the VAT rate hike, the favourable supply-side shock on the agri-food market and the persistence of the negative output gap. Adding to these was the downward adjustment of inflation expectations, which was however limited by their primarily backward-looking nature, implying that the information on the recent favourable supply-side shocks has still been incompletely taken in.

According to data for the period July-August 2011, industry-wide gross wages in Q3 rose faster than labour productivity in annual terms, sending unit labour costs higher during this period. Nevertheless, the high volatility of production over the past few months makes it difficult to assess to what extent these developments affected the wage-productivity correlation, which is essential in order to avoid cost-push inflationary pressures from building up.

[1] This core inflation measure excludes from the overall 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.

Monetary policy since the release of the previous Inflation Report

The NBR Board decided in its meeting on 3 August 2011 to leave the monetary policy rate unchanged at 6.25 percent per annum. The decision sought to maintain adequate broad monetary conditions in real terms so as to enhance the convergence of the inflation rate towards the medium-term targets. The NBR Board underscored the need for a firm anchoring of inflation expectations in view of the significant risks to inflation associated with uncertainties surrounding the outlook for the sovereign debt crisis as well as global commodity prices and administered prices.

Subsequent to the monetary policy rate decision of 3 August, statistical data certifying the fading of the first-round effect of the VAT rate hike as well as the strengthening prospects of bumper crops came to confirm the improving short-run outlook for the inflation rate returning inside the variation band around the central target. On the other hand, beyond the near run, the risks related to potential adverse supply-side shocks from either domestic or external sources persisted and the repeated delays in the shaping of a consensual solution to the sovereign debt crisis meant that a grim scenario was still possible.

After assessing the balance of risks to the medium-term inflation outlook as being significantly tilted to the upside, the NBR Board decided to keep the monetary policy rate unchanged at 6.25 percent per annum in its 29 September 2011 meeting.

Inflation outlook

The updated projection envisages the annual inflation rate remaining inside the variation band around the central target (set at 3 percent in both 2011 and 2012 and 2.5 percent from 2013 onwards) for almost the entire reference period.

In 2011 Q2, the year-on-year real GDP growth continued at a slightly slower pace. Economic growth is projected to pick up in Q3 in both quarterly and annual terms following the substantial contribution from the agricultural sector, but thereafter to revert to moderate rates. In 2012, the slight acceleration of growth versus 2011 is expected to be driven by domestic consumer and investment demand, while external demand is projected to have a smaller contribution than in the current year. These developments in the factors driving GDP growth imply a mild widening of the balance-of-payments current account deficit by the end of the reference period that is not seen generating significant inflationary pressures via the leu exchange rate. Disinflationary pressures coming from the persistence of 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 3.3 percent, 1.3 percentage points lower than in the August 2011 Inflation Report. For end-2012, the inflation rate is forecast to hit the 3 percent central target, standing 0.5 percentage points below the previously projected level.

According to the forecast, following the marked decline in 2011 Q3, annual CPI inflation will remain on a downward trend and reach a low in 2012 Q1. After the fading-out of an unfavourable statistical base effect expected for 2012 Q3, annual CPI inflation will hover around 3 percent by the end of the projection horizon. The adjusted CORE2 inflation rate is anticipated to stabilise at levels close to 2 percent starting with 2012 Q1.

The significant downward revision of the projected annual CPI inflation for end-2011 is largely due to the contribution of the dynamics of volatile food prices (of fruit and vegetables), much more favourable than previously forecasted, due to the positive shock caused by this year's good crops. A similar but smaller influence comes from the adjusted CORE2 inflation projection, whereas the upwards revised scenario for administered prices has an adverse effect on the CPI inflation forecast. The revision of the projected level of CPI inflation at end-2012 was mainly determined by the faster decline in the adjusted CORE2 inflation than that envisaged in the August 2011 Inflation Report.

The current projection places the path of the adjusted CORE2 inflation entirely below the previous forecast. This is attributed to lower inflation expectations and a more negative output gap in relative terms throughout the reference period, primarily related to the adverse external developments. The anticipated dynamics of import prices is less favourable to disinflation than in the previous forecasting round over the first part of the projection horizon and more favourable over the remaining part.

The central bank will seek to calibrate the path of the monetary policy rate so as to adjust real broad monetary conditions, aiming at consolidating the prospects of keeping the inflation rate inside the target band and achieving a sustainable recovery of lending to the economy.

The balance of risks to the inflation rate projected in the baseline scenario appears to be broadly balanced in the short term. Over the medium term however, the overall balance of risks is still significantly tilted to the upside, albeit to a lower extent than in the previous round. Potential sources of risk relate to external developments, the fiscal policy stance, and administered price adjustments.

Major external risks are associated with a possible heightening of tensions on global financial markets following the delay in resolving the sovereign debt crisis. Such a scenario cannot be entirely ruled out, despite the recent scaling-up of the rescue fund[2] for the countries facing such difficulties. Thus, the stronger risk aversion of increasingly jittery investors could lead to higher financing costs and scarcer funding sources also for non-euro zone economies, Romania included. Such effects becoming manifest would tighten financing of both the fiscal deficit and the private sector, translating into higher interest rates, as well as depreciation pressures on the leu.

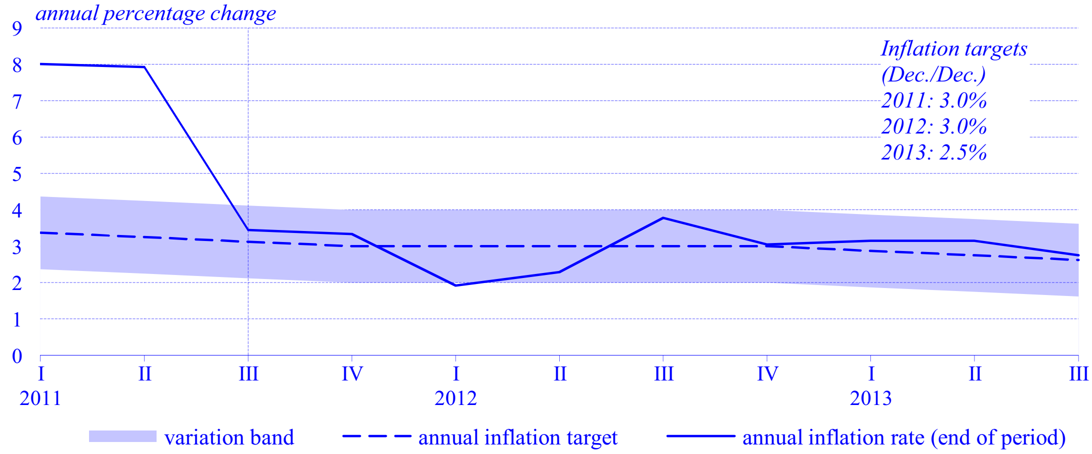
Considering the busy electoral schedule for next year, a significant domestic risk factor relates to potential slippages from the fiscal consolidation programme assumed by the authorities, especially in the event of a possible worsening of the wage-productivity correlation. The risk of the fiscal deficit overshooting the target implies substantial financing difficulties with consequences similar to those already mentioned. Adding to these financing difficulties is the risk of larger-than-projected increases in administered prices.

Should the aforementioned risks materialise, macroeconomic scenarios with a high likelihood of generating significant upward deviations of the inflation rate from the baseline scenario trajectory would develop.

2 Agreed upon at the euro zone summit held on 26 October 2011 under the aegis of the European Council.

Given the current macroeconomic picture marked by the persistence of considerable risks, safeguarding the domestic and external equilibria of the national economy is strictly conditional on the monetary policy enjoying the support of the other macroeconomic policy mix components through the consistent implementation of the economic programme on fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank.

Inflation Forecast



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

Source: NIS, NBR projection.

Monetary policy decision

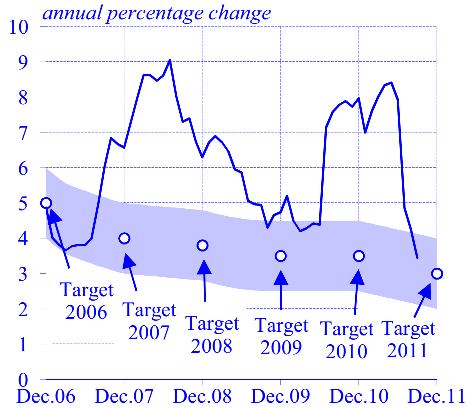
Given the significantly improved inflation outlook, which implies the projected annual inflation rate staying inside the variation band around the 3 percent midpoint of inflation targets in both 2011 and 2012, and considering the persistence of an asymmetric balance of medium-term risks to inflation, the NBR Board has decided in its meeting of 2 November 2011 to lower the monetary policy rate by 0.25 percentage points to 6.00 percent per annum. The NBR Board has also decided to pursue an adequate management of liquidity in the banking system and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

The judicious adjustment of the central bank's stance is aimed at steadily ensuring adequate real broad monetary conditions for effectively anchoring economic agents' inflation expectations and for securing a lasting maintenance of inflation inside the variation band around the targets, along with preserving financial stability. These elements, alongside the implementation of commitments on strengthening fiscal consolidation and structural reforms undertaken by the Romanian authorities under the multilateral external financing arrangements signed with international institutions, are essential for a sustainable recovery of the Romanian economy.

II. INFLATION DEVELOPMENTS

In 2011 Q3, the annual inflation rate followed a strong downward course, returning inside the variation band of ±1 percentage point around the central target (3 percent), similar to the period prior to the VAT rate hike in July 2010. The level recorded at the end of the third quarter (3.45 percent) is the lowest since the early '90s, the steep fall by 4.5 percentage points versus end-Q2 being driven by the fading-out of the first-round effect of the VAT rate hike and the impact on consumer prices of the above-average vegetal crops. Adjusted CORE2 inflation also saw a downward, albeit lower adjustment, amid the persistent negative output gap and alleviating adverse supply-side shocks (non-energy commodities).

Inflation Developments

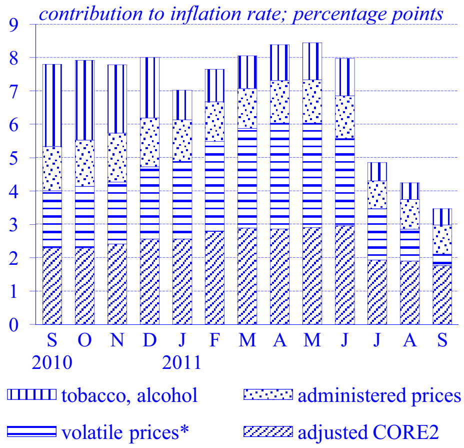


Note: Variation band is ±1 percentage point around the central target.

Source: NIS, NBR calculations.

Volatile food prices further made the largest contribution to the alleviation of inflationary pressures, as their annual dynamics entered negative territory (-10.7 percent), owing to the ample supply on the domestic market. Major adjustments in the period under consideration fully offset the hikes reported since the beginning of the latest inflationary episode, volatile food prices reaching levels lower than those seen in the summer of 2010. In contrast, fuel prices, the other component of volatile prices, stayed on an uptrend, reflecting the depreciation of the domestic currency versus the US dollar (6.3 percent in September compared to June 2011), which offset the impact of the prevailing downtrend in world oil prices[3]. Hence, fuel prices further saw brisk annual dynamics (12.5 percent), adding 1 percentage point to the inflation rate.

Annual Inflation Rate



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

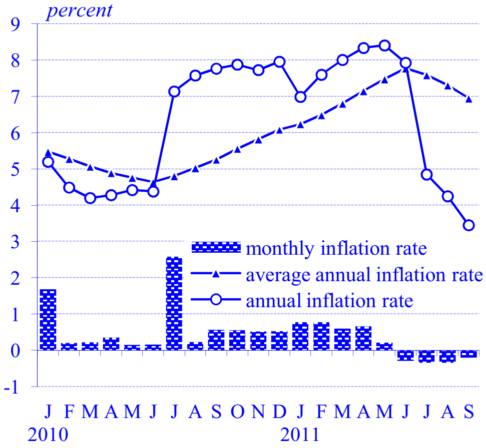
Source: NIS, NBR calculations.

One fourth of the annual inflation rate recorded at end-2011 Q3 is attributable to the annual change in administered prices (5.2 percent), stemming particularly from the previous adjustments of electricity and heating prices[4] as well as from the rise in prices for communal services in the reviewed period (up 9 percent in September compared to June 2011). Even though, in August, prices for passenger railway and underground transport saw a significant rise (18 percent and 16 percent on average) intended to balance the financial standing of specialised companies, this measure had a marginal impact on the annual inflation rate.

[3] Brent crude oil price dropped to USD 110.9/barrel in September 2011 from USD 113.9/barrel in June, mainly as a result of the worsening outlook for global economic growth.

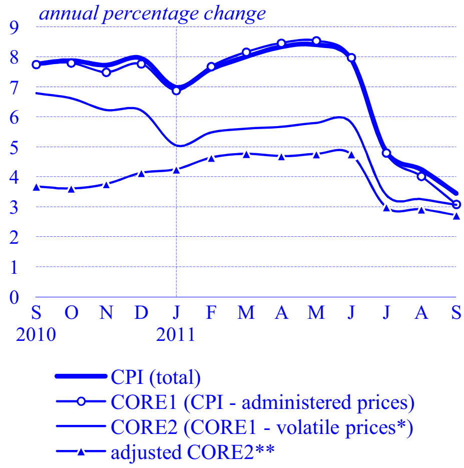
[4] The annual growth rate of heating prices still incorporates the first-round effect of the VAT rate hike, as heating started to be delivered in October 2010.

Inflation Rate



Source: NIS.

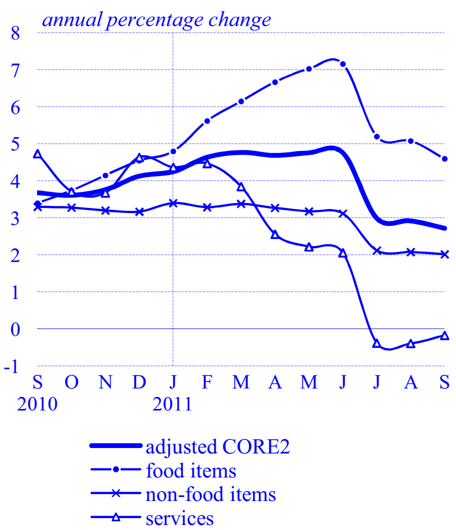
Headline Inflation and CORE Inflation



*) products with volatile prices: vegetables, fruit, eggs, fuels
**) excluding tobacco and alcohol

Source: NIS.

Adjusted CORE2 Components



Source: NIS, NBR calculations.

The annual growth rate of tobacco prices slowed down to 6.4 percent in September versus 15.2 percent in June, owing solely to a base effect associated with the VAT rate hike, enhanced by the implicit rise in excise duties[5]. In 2011 Q3, the adverse impact on cigarette prices that the change in excise duties producers claimed to have was subsequently offset in part by price cuts implemented with a view to preserving specialised companies' market share.

The analysis of price developments in terms of monetary policy scope focuses further on adjusted CORE2 inflation, which declined to 2.7 percent year on year, a figure which is however higher than that recorded prior to the VAT rate hike. The explanation lies with the dynamics of food prices, which in contrast to those of non-food items and of services, remained higher than in the summer of 2010. This was due to the adverse supply-side shocks manifest in August 2010 – May 2011 that were generated by unfavourable weather conditions and costlier agri-food commodities on international markets.

In the period under review, inflationary pressures alleviated in the case of all components of the adjusted CORE2 index, owing particularly to the flagging consumer demand[6] (as reflected by the persistent negative output gap). As for food commodities, the mounting supply of agri-food items on both domestic and international markets had a similar impact. For the time being, the effect of the two factors largely offset the impact that the rise in gas prices for industrial producers as of 1 July 2011 had on the producer prices of some processed food items.

Similarly, supply-side factors also had a divergent impact on the prices of non-food items included in adjusted CORE2 inflation. On the one hand, in July-August, the annual growth rates of domestic producer prices for consumer goods and of external prices for intermediate goods[7] decelerated, in the context of lower tensions on the external markets of major commodities. On the other hand, the year-on-year exchange rate movements of the domestic currency versus the euro (0.4 percent depreciation in September, compared with the 1.1 percent appreciation in June 2011), had a slightly negative impact on import prices. Although the recent depreciation of the leu fed through into prices for market services in monthly terms, particularly in telephony prices and rents, this group saw year-on-year deflation during Q3, as a result of the flagging demand on this segment as well.

[5] *Ad valorem* excise duty is applied to the maximum retail price.

[6] Despite a marginal increase in the volume of receipts from retail trade, except for motorcars and motorcycles, in July-August 2011 versus the previous quarter (seasonally adjusted data), the annual change of this indicator stayed in negative territory (at -3.9 percent in August 2011).

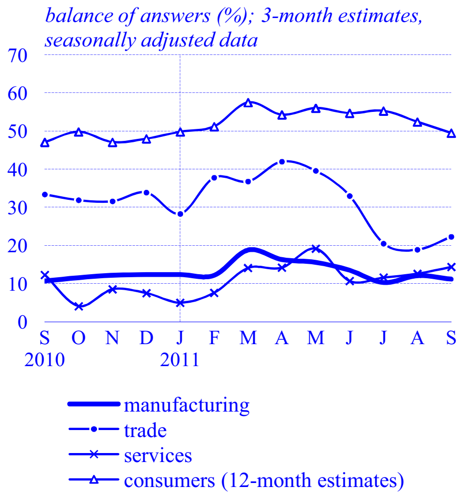
[7] Approximated by EU-15 industrial producer prices for the external market.

As the annual inflation rate followed a sharp downtrend, inflation expectations of consumers and managers in manufacturing, trade and services[8] dropped below the previous quarter's level. However, aggregate inflation expectations were further higher than those formulated prior to the VAT rate hike, the rigidity they showed reflecting their primarily backward-looking nature, as well as the uncertainty surrounding the global economic context.

As regards the inflation rate criterion laid down in the Maastricht Treaty, the average annual HICP inflation rate (6.9 percent) further posts a substantial positive gap, due to adverse supply-side shocks (changes in indirect taxes, developments in commodity prices and administered prices). Compared with June, this gap was 1.1 percentage points smaller, owing solely to domestic developments which contributed equally to the gap narrowing versus the EU-wide average inflation (to 4 percentage points).

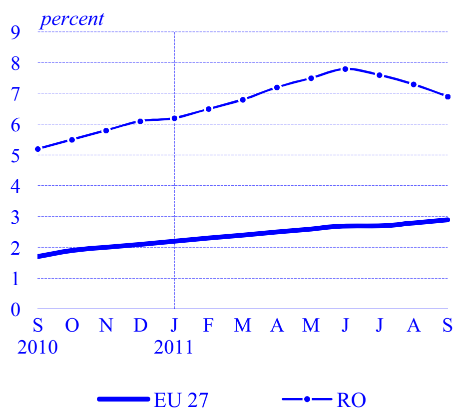
In September 2011, the actual annual inflation rate stood 1.3 percentage points lower than the projection included in the August 2011 Inflation Report. The deviation was mainly attributed to the ample adjustments of prices for fruit and vegetables, amid the mounting supply of food items in the context of a better-than-expected agricultural year.

Inflation Expectations of Economic Agents



Source: EC-DG ECFIN.

Average Annual HICP Inflation Rate



Source: Eurostat.

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

Box

The impact of base effects on the annual inflation rate

The annual inflation rate is one of the most frequently resorted to statistical measures for the analysis of price developments, also used by the National Bank of Romania to set the inflation target. According to the calculation method, this indicator cumulates the monthly inflation rates over the past 12 months, implying that its path is determined based on both current and previous year developments. The impact of atypical price changes in the previous year on the annual inflation rate is called base effect.

The annual inflation rate at a certain point in time t (π_t) ris the percentage change in the fixed-base price index at the moment t (P_t) versus $t-12$, which can be approximated by:

$$\pi_t = \left(\frac{P_t - P_{t-12}}{P_{t-12}}\right) \cdot 100 \simeq \left[ln(P_t) - ln(P_{t-12})\right] \cdot 100$$

The change in the annual inflation rate in the current month versus the preceding month is nearly equal to the difference between the monthly inflation rate in the current month and the monthly inflation rate recorded in the same year-ago period, so that:

$$\pi_t - \pi_{t-1} \simeq \left[ln(P_t) - ln(P_{t-1})\right] \cdot 100 - \left[ln(P_{t-12}) - ln(P_{t-13})\right] \cdot 100$$

Although base effects refer to the contribution of price movements in the same year-ago period ($[ln(P_{t-12}) - ln(P_{t-13})]$), to the change in the annual inflation rate, they are relatively difficult to identify in practice as only the atypical price changes in the previous year must be taken into account. Usually, price changes are deemed atypical when they deviate significantly from the pattern seen during a certain period and reflected by the historical average, to which add the impact of seasonal factors and the upward/downward trend, as the case may be.

An example of favourable base effect is associated with the 13.9 percent hike in tobacco prices in January 2010, as a result of the rise in excise duties, which pushed down the annual inflation rate on this segment, from 26.3 percent in December 2010 to 11.9 percent in January 2011, despite the price increases in January 2011 versus the prior month.

CPI for tobacco products

monthly change, percent

Jan.10	Feb.10	Mar.10	Apr.10	May 10	Jun.10	Jul.10	Aug.10	Sep.10	Oct.10	Nov.10	Dec.10	Jan.11
13.87	0.60	0.01	0.04	0.02	0.02	9.47	0.52	0.02	0.02	0.01	0.10	0.85

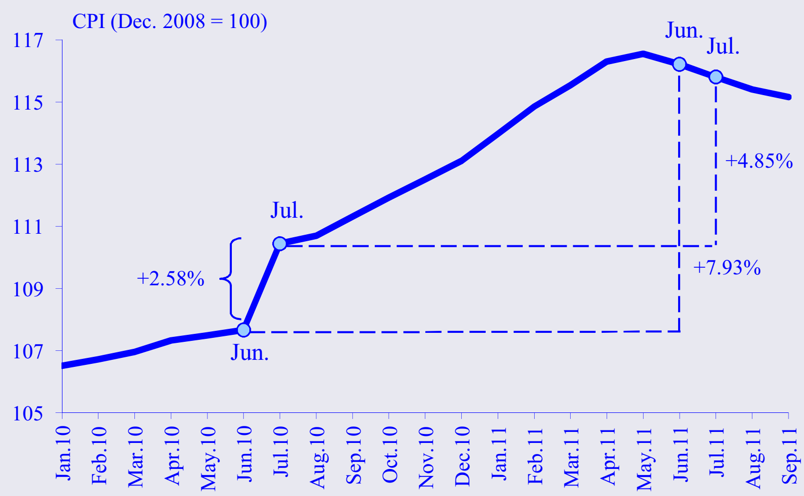
Annual rate in December 2010: 26.3 percent

Annual rate in January 2011: 11.9 percent

An example of unfavourable base effect is anticipated in the latter part of 2012 in the case of vegetables, as the months from June to September 2011, when deflation stood significantly above the historical average, are eliminated from the calculation period of the annual inflation.

A strong favourable base effect on the CPI annual inflation rate was manifest in July 2011, after July 2010, when prices rose considerably due to the VAT rate hike was eliminated from the calculation period. Hence, about 77 percent of the drop in the annual inflation rate from 7.93 percent in June 2011 to 4.85 percent in July 2011 is estimated to stem from the base effect associated with the VAT rate hike.

VAT Rate Hike-driven Base Effect on the CPI



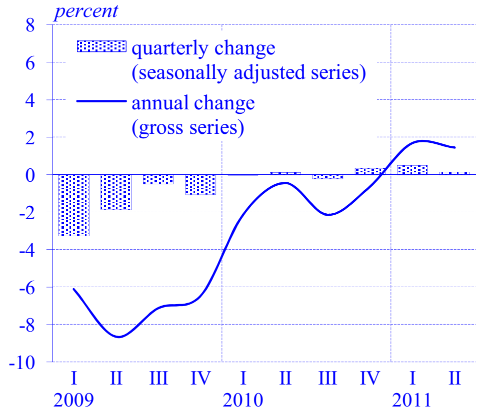
Source: NIS, NBR calculations.

III. ECONOMIC DEVELOPMENTS

1. Demand and supply

In 2011 Q2, real GDP rose by 1.4 percent[9], a level 0.3 percentage points lower compared with the previous period, mainly as a result of the slowdown in the current period (to 0.2 percent, quarterly change[10]).

Real Gross Domestic Product

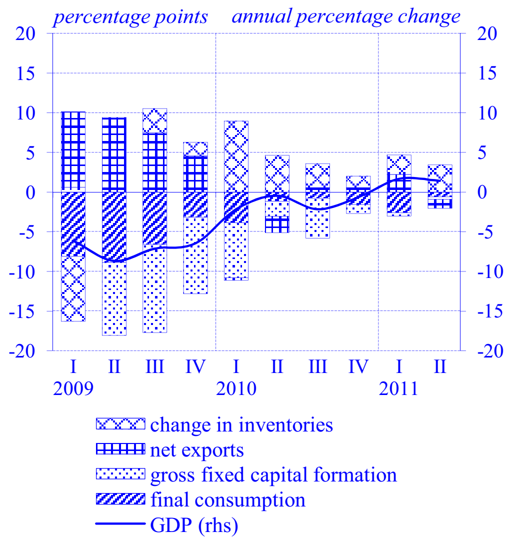


Source: NIS.

The gap between the actual outcome and the benchmark projection of June 2011 was significant (0.9 percentage points) in terms of the annual dynamics, the explanation lying almost exclusively with the characteristics of the seasonally adjusted series released by the NIS. Although fully revised, this series continues to generate annual rates markedly different from those relative to the gross series (-0.9 percentage points in 2011 Q1 and -0.6 percentage points in Q2). As for the quarterly change, the "actual level-projected level" difference equalled -0.2 percentage points and was attributed to the weaker-than-expected performance in industry and retail trade.

Similarly to Q1, the economic analysis in terms of demand shows that the segments with a major impact on the real GDP dynamics – in both annual and quarterly terms – were those with a minimum economic content, i.e. "change in inventories" and "statistical discrepancies". Therefore, according to the preliminary national account data, the GDP annual growth in Q2 was supported neither by the key segments of domestic absorption – final consumption and gross fixed capital formation continued to shrink, albeit at a slower pace –, nor by net external demand, given the deceleration of the growth rate of exports of goods and services to a level lower than that posted by imports, which entailed a negative contribution of net exports. In fact, the year-on-year increase in GDP in Q2 was generated by the twofold rise in "change in inventories". As for the quarterly real GDP series, the favourable influence from the slight rebound in final consumption and investment, compared with the previous period, was more than offset by the worsening in the external sector position, while "statistical discrepancies" made the largest contribution to the quarterly dynamics.

Contribution of Demand Components to GDP Growth



Source: NIS, NBR calculations.

On the supply side, the slowdown in the annual dynamics of real GDP in Q2 was due to industry, amid sluggish demand on both domestic and export markets. Current developments point to agriculture as the sector whose performance (return to an upward trend) generated the quarterly economic growth, whereas the developments in the other sectors offset each other (increase in gross value added in the services sector, but decline in industry and construction).

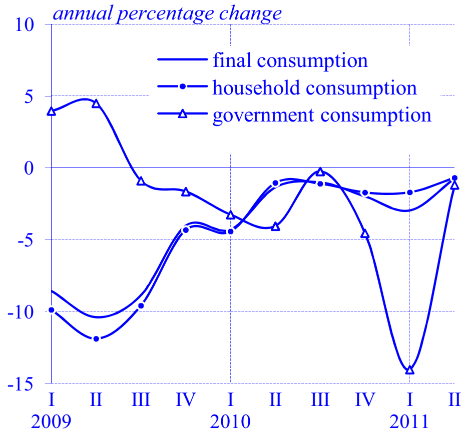
9 Unless otherwise indicated, the growth rates in this section are annual percentage changes, calculated based on unadjusted data series.

10 The quarter-on-quarter changes are calculated based on the seasonally adjusted data series.

1.1. Demand

In Q2, the annual rate of decline in consumer demand slowed down four times, compared with the previous period, to -0.7 percent, with household and government sectors contributing to this development. Household final consumption fell by 0.7 percent (compared with -1.7 percent in Q1). The further decrease in household disposable income[11], the still high indebtedness and the lower resort to bank loans[12] led to a renewed drop in the purchases of goods and services; however, the rebound in the self-consumption of households and the purchases from the farmers' market, due to the good performance in agriculture, acted in the opposite direction.

Actual Final Consumption

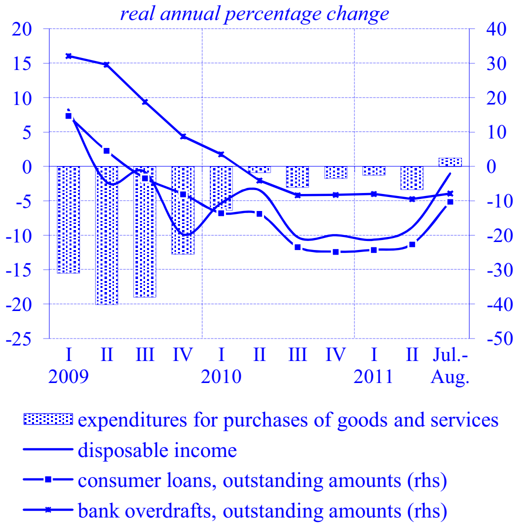


Source: NIS.

As regards the impact on inflation, the current developments in the volume of retail sales of goods holding a large share in the CPI basket further illustrate the lack of any demand-pull pressures, with the volume of non-durables purchases, except fuels[13], posting a slightly lower level compared with the period from January to March.

In terms of origin of consumer goods, Q2 saw an increase in the market share of foreign goods, as indicated by the larger physical volume of consumer goods imports[14] (even a faster growth in the case of non-durables), while the sales of domestically-produced goods, estimated based on the industrial production-related turnover for the domestic market, saw either further declines (-0.7 percent for non-durables; -13.3 percent for durables less motor vehicles) or an increase at a much slower pace than that of imports (almost three times slower in the case of motor vehicles).

Household Consumption and Main Financing Sources



Source: NIS, MPF, NBR calculations.

Government final consumption witnessed a notably more sluggish pace of decrease (from -14 percent to -1.2 percent, annual changes), which caused the negative influence of this component on GDP dynamics to fade (to -0.1 percentage points).

In 2011 Q2, the negative balance of the general government budget stood at lei 6,069 million[15] (1.1 percent of GDP[16]) and was

[11] 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.

[12] The consumer loan balance declined by around 30 percent for leu-denominated loans (real change) and roughly 7 percent for euro-denominated loans. Overdraft loans also followed a downward path.

[13] In Q2, these expenses exceeded 56 percent of household total consumption.

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

[15] Preliminary data published by the MPF in respect of the consolidated general government deficit for the period from January to June 2011 (lei 11,260 million) show compliance with the ceiling agreed under the IMF arrangement for 2011 H1 (lei 12,600 million).

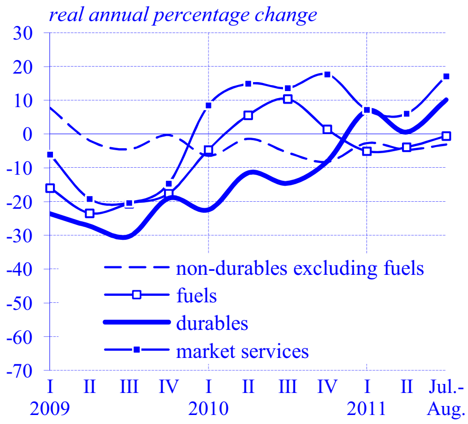
[16] The analysis relied on the operational data released by the MPF relative to June 2011 budget execution.

considerably below that posted in the same year-earlier period (lei 9,593 million[17], or 1.9 percent of GDP). The lower deficit was due to both the revenue growth[18], albeit at a slower pace than in the previous quarter (0.7 percent, compared with 2.5 percent) and, in particular, to the accelerated decrease in budget expenditure (-7.5 percent compared with -5.8 percent in the previous three months), especially in primary expenditure. The latter development resulted mainly from the dynamics of compensation of employees (-23.5 percent), social payments (-9.5 percent) and amounts allotted to "other transfers" (-19.3 percent) staying on a downward trend; by contrast, capital expenditure posted an accelerated growth (29.1 percent compared with 4.1 percent in the previous quarter).

The annual rate of decline in gross fixed capital formation also saw a deceleration (from -2.2 percent to -1.4 percent in Q2), but the developments in the main financing sources of investment and the analysis of the key types of investment show divergent pictures. Thus, on the one hand, the slower decline in investment demand appears to be backed by corporate loans, foreign direct investment and budgetary funds: (i) slight rebound in the volume of corporate loans for equipment purchase and real estate investment[19]; (ii) the threefold acceleration in the rate of increase in net capital inflows in the form of foreign direct investment by non-residents during the past four quarters, to around 29 percent, as well as (iii) the faster dynamics of capital expenditure from the government budget (to 38 percent, real change), with road infrastructure construction works as the main contributor. As regards household investment, the further downward trend in household disposable income and the quasi-unchanged stock of housing loans in real terms show that the blockage on this market segment still remains.

On the other hand, however, statistics on the main types of investment do not illustrate a slower rate of decline in gross fixed capital formation – new construction works and equipment purchase (including transport means purchased by companies and institutions) saw a faster decline (to -9.2 percent and -7.1 percent respectively), capital repairs failed to repeat the performance in Q1 (-1 percent from 23.2 percent), and the volume of "other investment" (consisting primarily in capital expenditure in agriculture and services expenditure associated with the transfer of ownership) dropped by 24.5 percent versus 2010 Q2. In this context, the upturn in the informal segment, i.e. underground activity in construction, is the only element that could justify the less sharp downward path of investment demand.

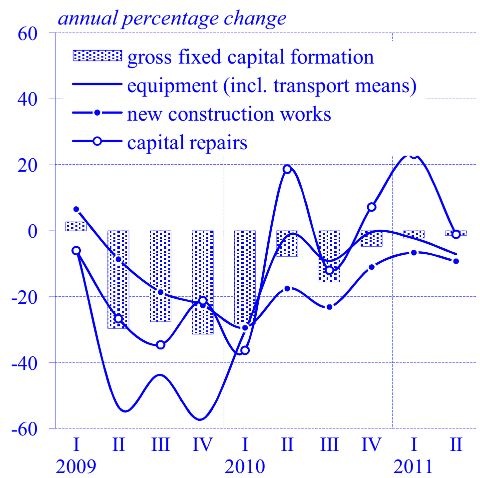
Purchases of Goods and Services*



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

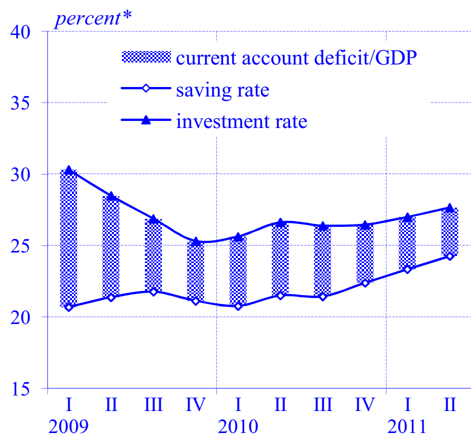
Source: NIS, NBR calculations.

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.

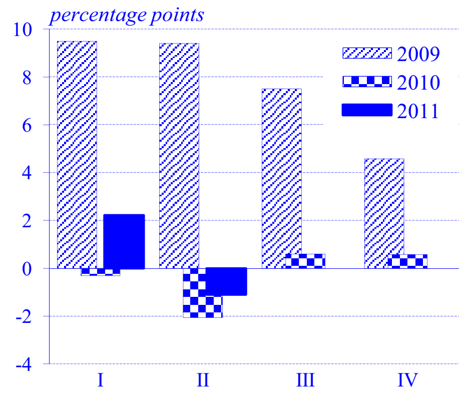
[17] Data relative to 2010 budget execution were recalculated by the MPF so as to ensure comparability with data for 2011.

[18] Unless otherwise indicated, percentage changes refer to the annual growth rates expressed in real terms.

[19] Based on CCR data.

Turning to demand components, in Q2, exports alone posted an increase in real terms, yet the growth rate was almost four times slower compared with the previous period (6.3 percent), mainly as a result of the sluggish economic activity in the case of Romania's key trade partners[20]. The high import content of exports generated a similar development in purchases from abroad, yet of a smaller scale (a 7.7 percent growth rate, i.e. half of the annual pace seen in Q1). Therefore, the gap between the growth rates of the two components of foreign trade in goods and services turned negative, entailing the worsening of net exports contribution to economic growth (-1.1 percentage points).

Net External Demand Contribution to GDP Growth



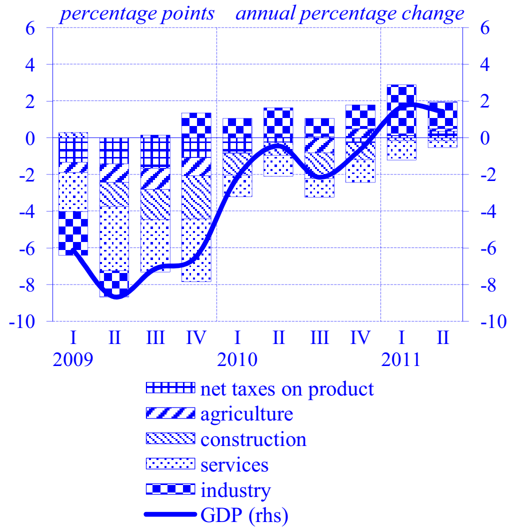
Source: NIS, NBR calculations.

The slower annual dynamics of exports was mainly due to three groups of goods[14], i.e. "machinery and equipment", "base metals" and "transport means" – the first two groups posted 3-4 times slower growth rates of the physical volume, while the third group saw a decline of around 6 percent for the first time in the past nine quarters.

1.2. Supply

In 2011 Q2, the slower annual dynamics of real GDP was attributed to the industrial sector, whose gross value added posted a growth rate of less than half of that reported in 2011 Q1 (to 4.9 percent). Behind this stood the slower growth in both domestic demand and exports. Gross value added in the other economic sectors witnessed either a slower pace of decline versus Q1 (services and construction) or a trend reversal – in the case of agriculture (from -0.4 percent to 3.4 percent), as a result of the good performance of the vegetal sector. Moreover, the rise in gross value added economy-wide for the second quarter in a row, as well as the tighter customs inspections led to the faster dynamics of net taxes by product (to 3.1 percent), which contributed 0.4 percentage points to the GDP growth.

Contribution of Supply Components to GDP Growth



Source: NIS, NBR calculations.

The structural analysis of industrial production illustrates the flattening of the upward path mainly in chemicals and pharmaceuticals, machinery and equipment, road transport means and electrical equipment, as well as a downturn in metallurgy. Although the base effect associated with these sectors' rebound in 2010 Q2 made a significant contribution, the current volume contractions cannot be overlooked, especially in metallurgy and transport means.

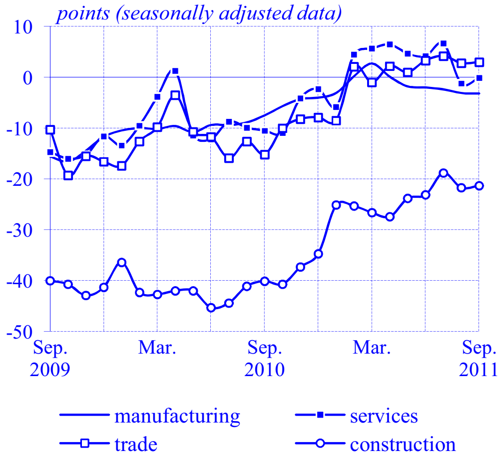
In the services sector, the slowdown in the annual rate of decline in gross value added (from -2 percent to -0.8 percent) was due to the slight increase in "financial activities, real estate transactions,

[20] At EU-25 level, real GDP stepped up 1.7 percent year on year, compared with 2.4 percent in 2011 Q1, which led to a 3.3 percentage points deceleration in the dynamics of imports of goods and services (to 5.3 percent).

rentals and services rendered to companies" (0.3 percent). An annual positive dynamics was also reported in the sub-sector "wholesale and retail trade; repairs of motor vehicles and household goods; hotels and restaurants; transport and telecommunications", but the growth rate decelerated (to 0.9 percent), thereby reflecting the fast drop in retail trade turnover and a discontinuation of the growth in wholesale trade.

Gross value added in construction posted again a slower rate of decline (to -1.9 percent). This was mainly due to the faster growth in the nonresidential buildings segment (7.9 percent) and, to a smaller extent, to a halt in the downward path in the engineering works segment. Conversely, the rate of decline in housing construction works doubled (to -32.4 percent).

Corporate Sector: Confidence Indicators for the Next 3 Months



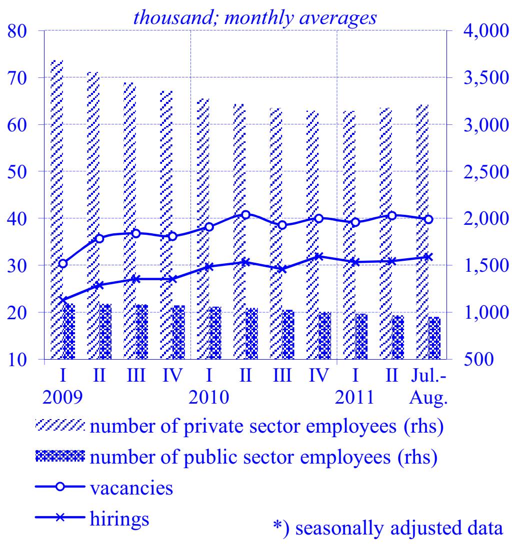
Source: EC-DG ECFIN.

2. Labour market

In July-August 2011, the labour market witnessed a relative stabilisation, which was expected to continue in the period ahead. The annual growth rate of net nominal wages remained relatively constant in the private sector; while in the budgetary sector it accelerated solely due to base effects. Unit labour costs in the industrial sector stayed above the readings in the year-ago corresponding period, especially in the consumer goods sub-sectors, but these developments' persistence and potential effects upon prices are uncertain, given the high volatility of production. Consequently, overall upside risks to inflation generated by labour market imbalances have remained low.

Over the period under review, the signs of recovery in labour demand, reflected by the number of private sector registered employees remaining on an upward trend[21], were not echoed in the NEA vacancies and hiring statistics, which were comparable to those in the previous quarters. However, behind the step-up in labour absorption, which has been supported by the provisions of the new Labour Code, may have stood private recruitment agencies or companies' direct actions. On the other hand, although the registered unemployment rate declined further (5.1 percent against 5.3 percent in 2011 Q2), the estimated ILO unemployment rate points to a relative stability (at approximately 7.3 percent), which involves a high number of persons in search for a job either through private recruitment agencies or by their own means. This number probably includes not only former employees of both private and budgetary sectors as well as of state-owned companies (the number of employees in the budgetary sector stayed on a downward trend and public transport companies proceeded to redundancies), but also

Labour Force Demand Measures*



*) seasonally adjusted data

Source: NEA, NIS, NBR calculations.

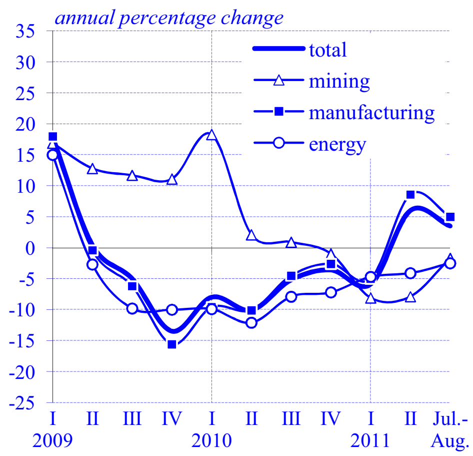
[21] Seasonally adjusted data series were used for the labour market indicators.

Unemployment Rate*

*) seasonally adjusted data

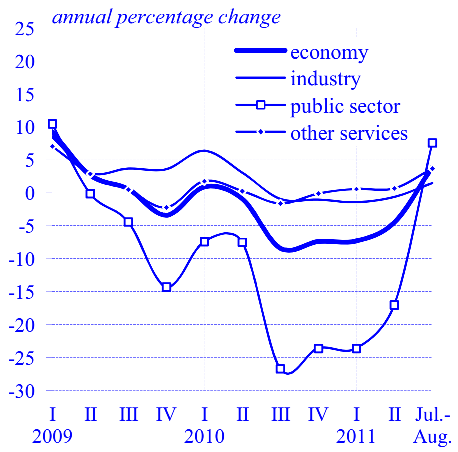
Source: NIS, NBR calculations.

Unit Labour Cost in Industry



Source: NIS, NBR calculations.

Net Real Wage*



*) deflated by CPI

Source: NIS, NBR calculations.

individuals previously inactive on the labour market[22]. Companies' employment expectations[23] for September-November 2011 slightly deteriorated in the manufacturing and services sectors, but remained roughly in line with the previous months' levels for construction and trade companies.

In the industrial sector, certain one-off factors and, later on, the slowdown in external demand entailed a deceleration in the annual rate of labour productivity growth by over 10 percentage points, on average, in April-August 2011, compared with the previous quarters and, thus, higher unit labour costs (annual rate of 6 percent in Q2 and 3.5 percent in July-August 2011, respectively, after almost two years of negative values). In August, the output recovery brought unit labour costs in the industrial sector back to a level below readings in the same year-ago period, but the movement was mainly due to the capital goods industries, while in the consumer goods industries the annual dynamics remained in positive territory. The highly volatile output witnessed in recent months renders however difficult the task of clearly identifying the trend from one-off drivers and, consequently, assessing the inflationary pressure potential of such developments (a fortiori, the recent experience of recession may reduce the time of response to imbalances through staff and/or wage adjustment measures).

The average net wage economy-wide increased at an annual rate of 8.6 percent in July-August 2011 from 3.3 percent in 2011 Q2, under the impact of a rebound in the annual dynamics of budgetary-sector wages (to 12.4 percent from -10.2 percent); this development was solely triggered by the base effect associated to a cut starting July 2010, while in monthly terms, a downward trend was manifest ever since April. In the private sector, the annual rate of net wages rose to 7.9 percent in 2011 Q2 mainly due to the different timing of Easter bonuses in 2010 and 2011, and then slowed to 7.3 percent. The annual change in wages in private services sector stayed above that in the industrial sector (8.4 percent versus 6.2 percent).

Over the period under review, the year-on-year negative dynamics of real disposable income moderated significantly (-1 percent versus -8.8 percent in 2011 Q2), mainly due to statistical effects associated to the austerity package adopted in mid-2010. Consequently, looking at the real disposable income's potential to boost consumer demand, its developments have further favoured disinflation.

[22] Improved consumer perception of unemployment starting April (according to the NIS/EC-DG ECFIN Survey) suggests a lower number of persons discouraged from seeking work.

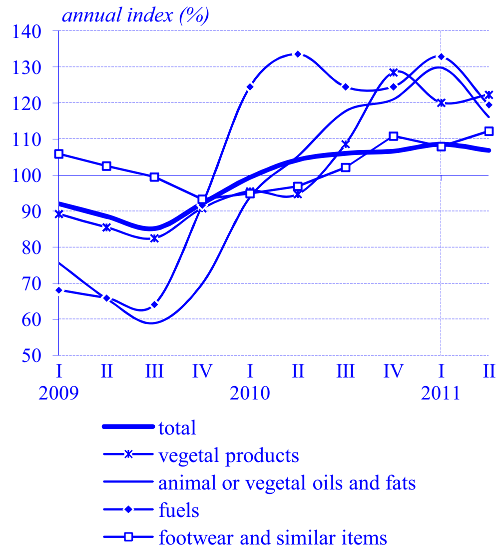
[23] The NIS/EC-DG ECFIN Survey on the expected development in staff numbers for the following three months.

3. Import prices and producer prices

In 2011 Q2, import prices and industrial producer prices exerted lower inflationary pressures, owing mainly to commodity price developments on the external markets. Agricultural producer prices posted marginal changes, the slower growth pace of vegetal product prices being offset by the higher dynamics of animal product prices. For 2011 Q3, import prices, industrial and agricultural producer prices are expected to see a slowdown in their annual growth rates, amid the alleviation of tensions on major commodity markets (agricultural commodities in particular).

In the second quarter of the year, import prices had a lower negative impact on domestic prices, given that the unit value index of imports dropped to 106.8 percent (down 1.7 percentage points versus the preceding quarter) and the domestic currency appreciated versus the euro and particularly versus the US dollar, the settlement currency of most imported commodities.

Major Inflationary Pressures on the Unit Value Index of Imports



Source: NIS, NBR calculations.

Amid the relative alleviation of tensions on the external commodity markets, external prices of energy and metals reported the sharpest falls in the annual dynamics, the unit value indices of imports decreasing by 13.4 percentage points and 5.5 percentage points respectively. Reflecting the positive impact of these developments on producer costs, the external prices of capital goods also posted decelerating growth rates, the unit value indices of imports of road transport means standing below par.

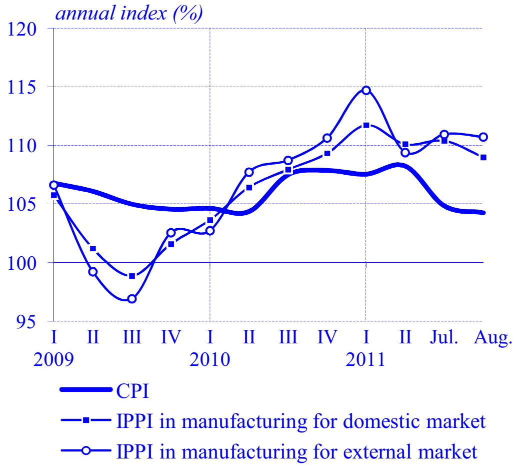
The growth rate of external prices of non-durables slowed down as well, yet this development is less relevant in terms of its impact on consumer price dynamics, being mainly triggered by the discontinuation of the uptrend in the unit value index of imports of pharmaceuticals. The other components of this group – food items, clothing, footwear – posted faster price dynamics. In the first case, the explanation lies with the ongoing upward trend in the annual changes of prices for agricultural commodities (base effect, but also the emergence of the first signs of price decreases no sooner than in the latter part of the quarter).

In contrast, external prices of several durables followed an upward course[24], the unit value indices standing above par, in line with developments in EU export prices.

The current external price developments are likely to continue in 2011 Q3, favourable movements being also expected in the case of prices for agricultural commodities and food items.

[24] Optical instruments and apparatus, photography, cinematography, medical and surgical instruments and the like.

Consumer Prices and Industrial Producer Prices

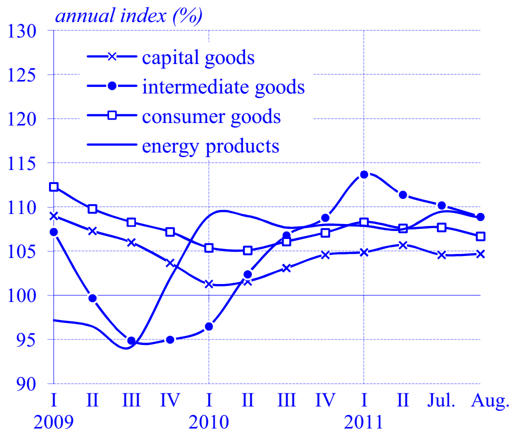


Source: NIS.

In 2011 Q2, the annual growth rate of industrial producer prices for the domestic market saw a reversal of the upward trend it had followed starting with 2009 Q4 (down 0.8 percentage points versus 2011 Q1 to 8.3 percent), under the main impact of alleviating tensions on the external commodity markets. This was largely mirrored by developments in prices for intermediate goods (down 2.4 percentage points to 11.4 percent, the fastest deceleration among all groups of industrial goods) and energy (down 0.3 percentage points to 7.5 percent). In the latter case, the relatively marginal adjustment of the growth rate was probably due to the adverse impact of higher costs incurred by electricity producers on the back of investments made to enhance the capacity for supplying renewable energy.

Similarly, non-durables prices saw their annual growth rate decelerating by 0.6 percentage points to 8.1 percent, solely on the back of the dynamics of producer prices for non-food items included in this group. In contrast, the annual price change in food industry (holding the largest share of non-durables) accelerated further, owing exclusively to a statistical effect, with current developments already illustrating the visibly alleviating tensions on the major agricultural commodity markets starting with May (in April-June 2011, the average monthly change was of 0.1 percent as compared with 2.8 percent in Q1; seasonally adjusted data series).

Industrial Producer Prices for Domestic Market by Industrial Products Group



Source: NIS.

In the quarter under review, the favourable impact of commodity prices on domestic producer costs was accompanied by the flagging domestic demand for most groups of products[25]. Hence, under the joint effect of these two factors, the annual dynamics of industrial producer prices for durables decelerated by 1.8 percentage points to 2.3 percent. A similar development was expected for producer prices of capital goods, yet their annual growth rate accelerated slightly (up 0.8 percentage points to 5.7 percent), mainly as a result of the persistent upward dynamics of prices for road transport means (partly due to the additional costs generated by the short-lived halt in activity at end-April, amid some supply chain disruptions).

Even though the annual growth rate of producer prices was faster in July than in 2011 Q2 (owing largely to the hike in prices in oil processing sub-sector and to a smaller extent to the 10 percent rise in the prices of gas delivered to industrial producers), in August it returned to a downward path, mainly on the back of food industry developments. Under the circumstances, current producer price developments are likely to continue in 2011 Q3 as well.

[25] The turnover for the domestic market dropped 1.9 percentage points and 12.4 percentage points respectively in the case of durables and intermediate goods. As for non-durables, the annual dynamics of turnover stayed in negative territory, even though it decelerated slightly versus the preceding quarter.

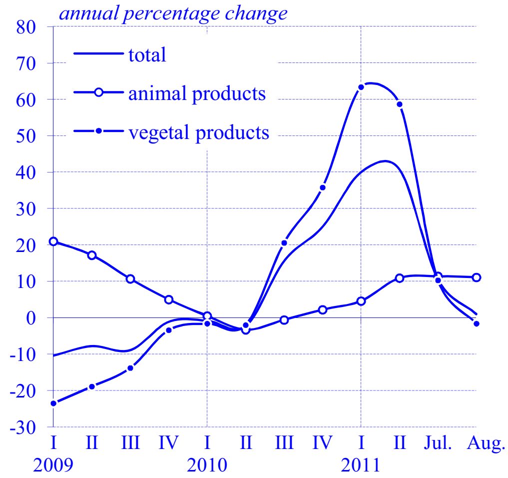
In April-June 2011, agricultural producer prices posted further high annual growth rates (40.8 percent), although their magnitude lowered starting with May.

The annual dynamics of prices for vegetal products, albeit on a downtrend versus the previous quarter (down 4.7 percentage points), remained high (58.7 percent), as a result of the twofold increase in prices of wheat and potatoes as compared with the same year-ago quarter. However, in both cases, prices saw significantly downward adjustments in July-August.

As for animal products, the annual growth rate of prices added 6.3 percentage points versus Q1 to 10.9 percent, given that fodder price developments (annual dynamics of 72.4 percent) pushed the prices of some meat types (beef, pork) and milk higher.

For 2011 Q3, the good crops in the current year are expected to induce a faster slowdown in the annual growth of prices for vegetal products and a possible trend reversal in prices for animal products.

Agricultural Producer Prices



Source: NIS.

IV. MONETARY POLICY AND FINANCIAL DEVELOPMENTS

1. Monetary policy

In both its meetings held during 2011 Q3, the National Bank of Romania Board kept the monetary policy rate unchanged at 6.25 percent per annum. Moreover, the levels of minimum reserve requirement ratios on leu- and foreign currency-denominated liabilities of credit institutions[26] *were maintained at 15 percent and 20 percent respectively. Following these decisions, amid the resumption and continuation of disinflation in line with the central bank's projections and the moderate leu exchange rate volatility, real broad monetary conditions remained adequate for ensuring convergence of the annual inflation rate towards the medium-term targets.*

In its meeting of 3 August 2011, the National Bank of Romania Board decided to extend the status quo of the monetary policy rate, given that, on the one hand, the updated forecast of macroeconomic developments in the medium term, which incorporated the influence of the gradual fading of the first-round effect of the VAT rate hike in July 2010, highlighted a relative improvement in the inflation outlook[27], over the short term in particular. The major determinants of the decision were the recent correction of some agri-food prices, a downward revision of the expected impact from the shocks related to the developments in prices for agricultural commodities and energy (crude oil included) and a higher-than-previously-forecasted negative output gap, implicitly its ensuing disinflationary pressures arising from prospects for a gradual economic recovery.

On the other hand, the risks to medium-term inflation expectations remained significant due to multiple adverse supply-side shocks over the previous quarters, as well as to the mainly backward-looking nature of inflation expectations of some economic agents. In addition, high uncertainty surrounding the sovereign debt crisis persisted and its possible aggravation, entailing higher volatility of capital flows towards the emerging economies, could have fuelled short-term inflationary effects stemming from the leu exchange rate. Over the medium term, another relevant risk to the inflation outlook was a possibly

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[26] Liabilities with a residual maturity of up to two years or with a maturity of over two years to which contractual provisions on withdrawals, transfers and early buybacks are attached.

[27] According to the baseline scenario of the updated projection, the annual inflation rate was seen reaching 4.6 percent in December 2011, down 0.5 percentage points from the previously forecasted level (May 2011 Inflation Report); the annual inflation rate for December 2012 (3.5 percent) was, in turn, 0.1 percentage points lower than previously anticipated.

higher-than-expected increase in some administered prices, in line with the measures aimed at liberalising the electricity and gas market set forth under the arrangements signed with the EU, the IMF and the World Bank.

The National Bank of Romania Board decided to leave the monetary policy rate unchanged at 6.25 percent per annum in its 29 September 2011 meeting as well. The context at that time was mixed: the current performance and outlook of inflation had improved markedly, whereas the uncertainties surrounding the sovereign debt crisis and its impact on the global financial market, including on capital flows targeting the Romanian economy, which were likely to generate inflationary risks, had heightened. The recent pick-up in disinflation illustrated by the annual inflation rate dropping to 4.25 percent in August (against 7.93 percent in June[28]) was attributed to the sharp decline in volatile food prices, the fading of the effect of the VAT rate hike, as well as to the still wide negative output gap.

In turn, the prospects for further disinflation in the period ahead relied on the most likely stronger volatile price deflation and the disinflationary pressures stemming from the negative output gap. Hence, the annual inflation rate was expected to near the year-end target. Moreover, the recent developments in key macroeconomic indicators pointed to a slowdown in Romania's economic recovery – amid the slackening global economy – that was, however, expected to be offset by the good performance of the agricultural sector in the latter half of this year. The relatively slower revival in consumer demand was suggested mostly by the slow-in-coming improvement in the consumer confidence indicator in the period from July to August 2011 and by the July decline in public spending on goods and services against the same year-ago period. In addition, the annual growth[29] of household deposits posted a relative rebound and the year-on-year dynamics of loans to households remained in negative territory.

Nevertheless, the average annual growth rate of loans to households saw its downward trend coming to a halt in the period from July to August 2011 (-4.2 percent compared to -8.9 percent), reflecting, in addition to the statistical effect from the leu exchange rate movements, the impact of a lower year-on-year contraction in leu-denominated loans to households. The move was more or less in line with the year-on-year dynamics of new leu-denominated business, which lost momentum but remained in positive territory, being likely underpinned by the slight advance in households'

[28] June figures incorporate the effects of the standard VAT rate hike (from 19 percent to 24 percent) in July 2010.

[29] Unless otherwise indicated, annual changes are given in real terms; the base effect owing to the VAT rate hike in July 2010 incorporated in the annual inflation rate causes some distortion to the indicators reviewed herein.

demand for loans against the backdrop of some improvement in their financial standing expectations and banks' easing of some credit standards[30]. An opposite impact came from the slight increase in rates on new leu-denominated consumer loans (after credit institutions adjusted upwards their margins against relevant ROBOR rates) and higher costs attached to such loans, reflected by the upsurge in the effective annual rate[31]. The reinvigoration in loans to households was more apparent in July, when the balance of credit saw a renewed positive monthly change (in nominal terms); in August, the indicator posted a decline following the contraction in foreign currency-denominated loans (expressed in euro). In the period from July to August, the pace of decline in households' consumer credit and loans for other purposes[32] decelerated year on year (-8.0 percent compared to -12.8 percent in 2011 Q2); in turn, housing loans saw their average annual growth rate picking up (to 5.8 percent from 2.1 percent in 2011 Q2) and their share in the household loan stock widened to 29.9 percent (up 0.6 and 1.5 percentage points respectively from their mid-2011 and end-2010 levels).

Over the period from July to August, the average annual dynamics of household deposits re-entered positive territory (1.8 percent compared with -4.2 percent in 2011 Q2), largely on the back of the faster increase in leu-denominated deposits. The development was fuelled by a relative improvement in wage dynamics and further high rates on bank deposits in local currency. Both overnight and time deposits saw average growth rates higher than those registered in 2011 Q2, but the former recovered at a somewhat faster pace. Demand for money for precautionary/investment purposes remained however robust, given that the share of leu-denominated deposits at the longer-end of the maturity spectrum (over six months) in new household deposits in local currency widened and the fast uptrend in households' holdings of government securities and money market fund shares carried on.

Similarly to the previous months, the central bank pursued a management of liquidity adequate to the specific functioning conditions of different segments of the local financial market. The banks' net liquidity surplus augmented slightly in July, but turned again into a deficit over the following months. However, during the quarter under review the developments in the banks' net liquidity position were uneven, with shorts and overs alternating

30 According to the NBR's August 2011 Survey on lending to non-financial companies and households, credit standards for households were eased in 2011 Q2 and this move was expected to continue in the period ahead. At the same time, costs other than interest on mortgage loans were lowered and the ceiling on the loan-to-value ratio was raised.

31 Both developments could have stemmed from the expiry of promotional offers.

32 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.

more or less frequently. In the period from August to September, the National Bank of Romania's monetary policy operations were again aimed at providing liquidity. For this purpose, the monetary authority conducted one-week repo operations through fixed-rate auctions with full allotment.

2. Financial markets and monetary developments

In 2011 Q3, the average interbank money market rate posted an increase, with a sharper adjustment at the shorter end of the maturity spectrum. During June-August 2011, lending and deposit rates on leu-denominated new business witnessed both-way movements, remaining however on an overall downward trend. Following a period of relative stability, the RON/EUR exchange rate re-embarked on a steeper upward path starting with the second 10-day period of September. Broad money dynamics posted less negative readings, as a result of the slacker negative growth rates of loans to the private sector and of net foreign assets of the banking system.

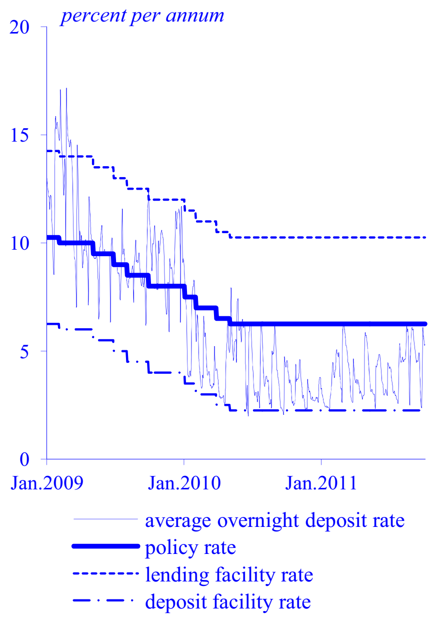
2.1. Interest rates

In 2011 Q3, the downtrend in interbank money market rates came to a halt, as liquidity conditions became slightly restrictive in the period under review. Thus, their average increased by 0.6 percentage points to 4.5 percent.

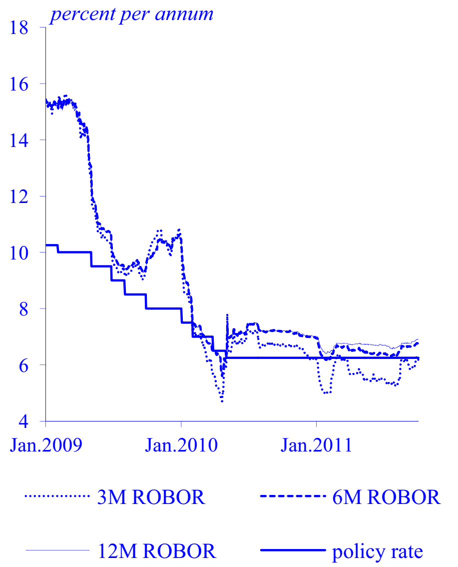
Starting with end-July, overnight rates reverted to higher levels, coming gradually closer to the monetary policy rate. This adjustment reflected the emergence and subsequent persistence of a reserve deficit in the banking system, as a result of both the movements in autonomous factors – the wider balance of the lei account of the State Treasury due to the seasonal rise in budget payments, followed by its gradual narrowing, and the increase in currency outside the NBR respectively – and the higher minimum reserve requirements. Overnight rates posted slightly lower readings towards the end of the reviewed period, fluctuating around 5 percent.

In turn, 1M-12M ROBOR rates followed an upward path, under the impact of changes in liquidity conditions and the adjustment in expectations on their outlook. Under the circumstances, shorter-term rates saw relatively sharper rises. The average 3M ROBOR rates stood 0.52 percentage points higher than in the closing month of the previous quarter to reach 6.02 percent, while average 6M and 12M ROBOR rates edged up 0.30 percentage points to 6.70 percent and 0.12 percentage points to 6.83 percent respectively.

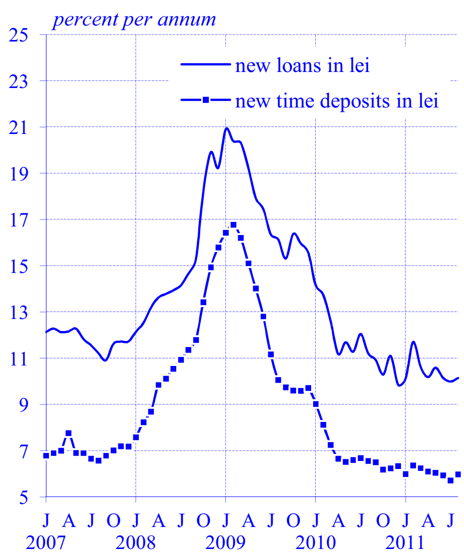
Interbank Money Market Rates



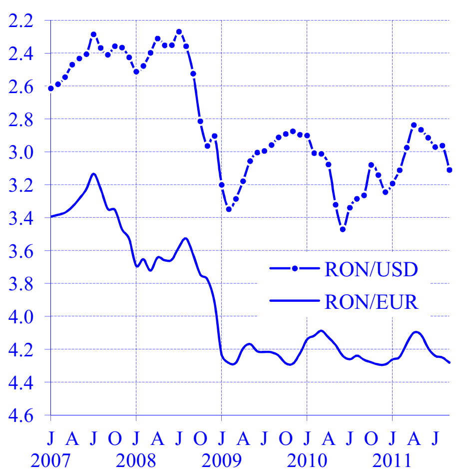
Policy Rate and ROBOR Rates



Bank Rates



Nominal Exchange Rate



The average yield on the primary market for government securities fluctuated throughout 2011 Q3, coming in at 6.82 percent in September, marginally lower than in June. The fluctuations reflected the slight increase in the maximum accepted yield, on the one hand, and the MPF decision to reissue T-bills[33], on the other. In July, the MPF also issued 4-year EUR-denominated bonds on the domestic market, at an average yield of 4.85 percent. In the final two months of Q3, the average yield on outright transactions on the secondary market for government securities followed an upward path as well, rising to 6.6 percent.

Average rates on banks' new time deposits and new loans broadly followed developments in interbank rates, decreasing further during June-July 2011, but increasing in August to 5.98 percent and 10.14 percent respectively. However, these levels were lower than in May 2011. A breakdown by customer reveals slightly divergent developments. Thus, over the period as a whole, the average interest rate on new time deposits shed 0.18 percentage points to 6.62 percent in case of households and inched down a mere 0.03 percentage points (to 5.52 percent in August) for non-financial corporations. At the same time, the average interest rate on new loans to households rose slightly (up 0.09 percentage points, to 12.16 percent), whereas that on new business to non-financial corporations dropped further, hitting a historical low of 9.06 percent in July.

2.2. Exchange rate and capital flows

The RON/EUR exchange rate rose at a slower pace in July and subsequently became quasi-stable, before re-embarking on an upward path starting with the second 10-day period of September, amid the abrupt increase in global risk aversion triggered by the worsening of the sovereign debt crisis.

Thus, in the period from July to September, the domestic currency depreciated against the euro by 2.2 percent in nominal terms (3.4 percent in real terms) and versus the US dollar by 7 percent in nominal terms and 8.2 percent in real terms, given the latter's significant appreciation on global financial markets. Looking at the average quarterly change of the exchange rate, the leu saw its strengthening trend manifest in the previous quarter come to a halt and posted a depreciation in relation to the euro and the US dollar in both nominal and real terms.

The RON/EUR exchange rate rose at a more sluggish pace in July (1.1 percent), yet witnessed considerably higher volatility[34], given that heightened tensions on global financial markets made

[33] In September, the MPF held two auctions for 6- and 9-month T-bills respectively.

[34] Posting the highest reading since April 2009.

investors increasingly wary in relation to the news/events and the statistical data released during the period under review. Hence, the favourable impact of Fitch upgrading Romania's sovereign rating to investment grade was only short-lived, since the domestic currency subsequently re-embarked – along with its peers in the region – on a depreciation trend versus the euro, amid a renewed spike-up in global risk aversion. This was triggered by Moody's decision to downgrade the sovereign rating of both Portugal and Ireland to below investment grade, and especially by heightened fears regarding the potential spreading of the sovereign debt crisis to other EU economies.

In August 2011, the adverse impact of external developments on the exchange rate trajectory was partly offset by the favourable effect of domestic economic developments, which were in line with the coordinates agreed under the arrangement signed with international organisations/institutions and also broadly matched market expectations. Against this background, despite the continued worsening of the global economic outlook and the ongoing tensions on international financial markets, the RON/EUR exchange rate volatility diminished, as its average reading stood only 0.2 percent higher month on month (the Polish zloty and the Hungarian forint weakened 3 percent and 1.7 percent respectively versus the single currency in the reported period).

However, the rise in the RON/EUR exchange rate regained momentum starting in the second 10-day period of September, amid a spike in global risk aversion triggered by: (i) the delay in adopting the technical details required for implementing the measures agreed upon by EU leaders on 21 July 2011; (ii) the discontinuation/postponement of talks between Greek officials and IMF, EU and ECB representatives ahead of disbursing a new tranche of the external financial support package; and (iii) the worsening global economic outlook[35]. Amid these developments, the forex market turnover peaked at a 32-month high, also as a result of the hike in speculative transactions, while the RON/EUR exchange rate posted the highest reading since July 2010, i.e. 4.3533, on 30 September 2011. However, over the month as a whole, the domestic currency weakened versus the euro at a slower pace (0.7 percent) than its regional peers, as the Polish zloty, the Hungarian forint and the Czech koruna depreciated against the single currency by 5.1 percent, 4.5 percent and 1.1 percent respectively.

[35] Data released during the reported period and the updated projections of the IMF, OECD and EC pointed to a slowdown in global economic growth during 2011-2012. Moreover, the ECB President, the Fed Chairman and the Secretary of the US Treasury warned about higher risks and uncertainties associated with the EU and US economies over the period ahead.

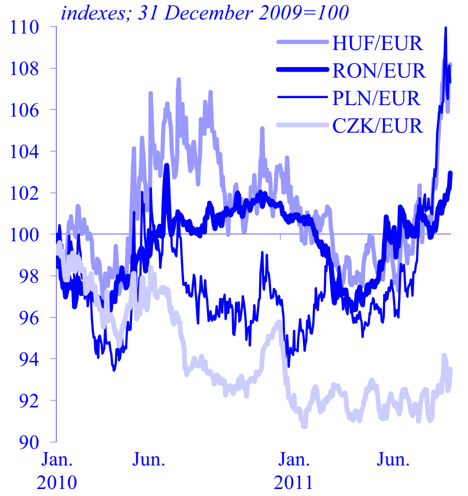
Key Financial Account Items (balances)

EUR million

	2010 8 mos.	2011 8 mos.
Financial account	**4,508**	**3,603**
Direct investment	**2,238**	**1,136**
- residents abroad	-108	10
- non-residents in Romania	2,346	1,126
Portofolio investments and financial derivatives	**652**	**2,626**
- residents abroad	-265	62
- non-residents in Romania	917	2,563
Other capital investments	**3,679**	**760**
- credits and loans from the IMF	3,365	908
- medium- and long-term investments	-575	-6
- short-term investments	-562	280
- currency and short-term deposits	1,378	-731
- other	73	308
NBR's reserve assets, net ("-" increase/"+"decrease)	**-2,061**	**-919**

Exchange Rate Developments on Emerging Markets in the Region

indexes; 31 December 2009=100



Source: NBR, ECB.

2.3. Money and credit

Money

Annual Growth Rates of M3 and Its Components

real percentage change

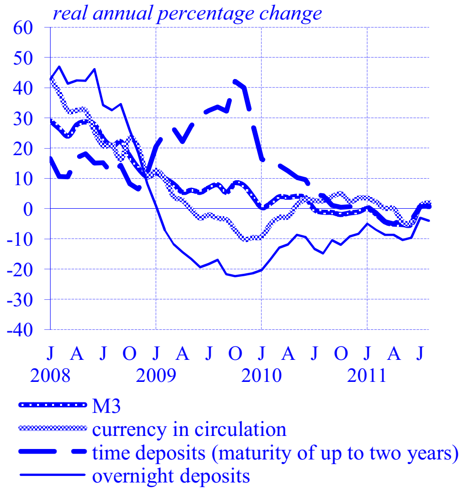
	2010		2011			
	III	IV	I	II	Jul.	Aug.
	quarterly average growth					
M3	-0.9	-1.4	-2.0	-5.1	0.6	0.7
M1	-8.1	-5.8	-4.1	-7.4	-1.7	-1.9
Currency in circulation	3.2	3.7	2.0	-2.9	0.9	2.2
Overnight deposits	-12.9	-9.8	-6.8	-9.5	-3.0	-3.9
Time deposits (maturity of up to two years)	3.4	0.6	-1.7	-4.1	0.7	1.0

Source: NIS, NBR.

June through August 2011, the dynamics of broad money[36] (M3) posted less negative readings (-1.2 percent, compared with -4.8 percent in the previous period), reflecting primarily the base effects associated with (i) the temporary hike in the annual inflation rate in July 2010 following the increase in the VAT rate, and (ii) the decline in households' disposable income as a result of the other fiscal consolidation measures taken in July 2010. Nevertheless, the annual pace of increase of broad money did not exceed the values recorded prior to 2010 H2, amid the still weak lending activity and, to a lesser extent, the keener appetite for deposits with a maturity of over two years and the unchanged interest in holding government securities.

All major components of M3 contributed to the slower decline of this monetary aggregate. Thus, time deposits with a maturity of up to two years had the most significant contribution, as their annual dynamics re-entered positive territory in the last two months of the period under review. The growth rate of narrow money (M1) also witnessed a rebound, albeit remaining in negative territory, mirroring developments in the dynamics of both currency in circulation and overnight deposits. The M3 breakdown by holder reveals a softer contraction of deposits of both households and companies, on the back of higher revenues from wages, other sources[37], and external loans[38]. The share of forex deposits in M3 shrank further, reflecting economic agents' appetite for deposits in domestic currency.

Main Broad Money Components



Source: NIS, NBR.

From the perspective of M3 counterparts, the rebound in broad money dynamics was brought about by the slacker negative growth rate of both credit to the private sector and net foreign assets. This impact more than offset the contractionary influence of the faster increase in long-term financial liabilities (capital accounts included) and of the more sluggish dynamics of central government net credit.

[36] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2011.

[37] Larger payments from structural funds (according to press releases of the Ministry of Agriculture and Rural Development and of the Authority for the Coordination of Structural Instruments), as well as dividend payments.

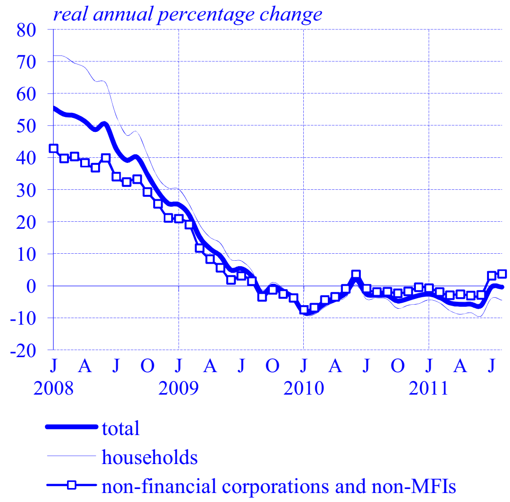
[38] According to balance of payments data, the period from June to July 2011 marked a significant net flow of short-term external financial loans to the non-banking sector.

Credit

June through August 2011, the negative dynamics[39] of credit to the private sector contracted to -2.3 percent from -5.6 percent previously, reflecting – aside from the statistical effect of the decline in the 12-month inflation rate – the rebound in the growth rate of the foreign currency component, expressed in EUR, as well as the dynamics of the domestic currency component staying on an upward path, although remaining in negative territory. The share of foreign currency-denominated loans in total credit to the private sector peaked again at an 8½-year high, also on account of the statistical effect of the RON/EUR exchange rate. Corporate and household demand for loans failed to show signs of considerable improvement in 2011 Q2[40], although lending rates on new business in domestic currency fell close to the minimum readings recorded over the past 20 years. However, the loan supply continued to improve, as the NBR survey on lending to non-financial corporations and households showed that banks resorted to less restrictive terms and conditions in most cases during the reported period. Moreover, the survey revealed that the trend was expected to persist into the following quarter as well.

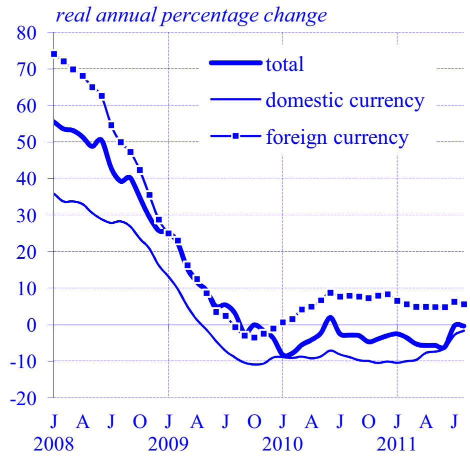
Against this background, corporate lending showed signs of recovery. Thus, the growth rate of loans to companies re-entered positive territory for the first time in the past two years, amid the higher volume of new credit lines and banks' net credit purchases[41]. The dynamics of household loans posted less negative readings, but remained low by comparison to the past two years' levels. The drivers behind these developments were: (i) the slightly lower volume of new business compared with the previous period, possibly on account of the expiry of promotional offers on refinancing loans (as also hinted by the rise in the overall borrowing cost – the annual effective rate), and (ii) the externalisation of a higher volume of household loans than that of purchased credits.

Credit to Private Sector by Institutional Sector



Source: NIS, NBR.

Credit to Private Sector by Currency



Source: NIS, NBR.

[39] Unless otherwise indicated, percentage changes refer to the average annual growth rates in real terms for June-August 2011.

[40] According to the NBR Survey on lending to non-financial corporations and households released in August 2011.

[41] Data on new business and transfers of both corporate and household loans off/into banks' balance sheets are based on CCR data and monetary statistics data respectively.

V. INFLATION OUTLOOK

For end-2011, the baseline scenario of the current projection places the annual CPI inflation rate at 3.3 percent, 1.3 percentage points lower than in the August 2011 Inflation Report. For end-2012, the inflation rate is forecast to hit the 3 percent central target, standing 0.5 percentage points below the previously projected level.

According to the forecast, following the marked decline in 2011 Q3, annual CPI inflation will remain on a downward trend and reach a low in 2012 Q1. After the fading-out of an unfavourable statistical base effect expected for 2012 Q3, annual CPI inflation will hover around 3 percent by the end of the projection horizon. The adjusted CORE2 inflation rate is anticipated to stabilise at levels close to 2 percent starting with 2012 Q1.

The significant downward revision of the projected annual CPI inflation for end-2011 is largely due to the contribution of the dynamics of volatile food prices (of fruit and vegetables), much more favourable than previously forecasted, due to the positive shock caused by this year's good crops. A similar but smaller influence comes from the adjusted CORE2 inflation projection, whereas the upwards revised scenario for administered prices has an adverse effect on the CPI inflation forecast. The revision of the projected level of CPI inflation at end-2012 was mainly determined by the faster decline in the adjusted CORE2 inflation than that envisaged in the August 2011 Inflation Report.

The current projection places the path of the adjusted CORE2 inflation entirely below the previous forecast. This is attributed to lower inflation expectations and a more negative output gap in relative terms throughout the reference period, primarily related to the adverse external developments. The anticipated dynamics of import prices is less favourable to disinflation than in the previous forecasting round over the first part of the projection horizon and more favourable over the remaining part.

The central bank will seek to calibrate the path of the monetary policy rate so as to adjust real broad monetary conditions, aiming at consolidating the prospects of keeping the inflation rate inside the target band and achieving a sustainable recovery of lending to the economy.

The balance of risks to the inflation rate projected in the baseline scenario appears to be broadly balanced in the short term. Over the medium term however, the overall balance of risks is still significantly tilted to the upside, albeit to a lower extent than in the previous round. Potential sources of risk relate to external developments, the fiscal policy stance, and administered price adjustments.

Major external risks are associated with a possible heightening of tensions on global financial markets following the delay in resolving the sovereign debt crisis. Such a scenario cannot be entirely ruled out, despite the recent scaling-up of the rescue fund[42] *for the countries facing such difficulties. Thus, the stronger risk aversion of increasingly jittery investors could lead to higher financing costs and scarcer funding sources also for non-euro zone economies, Romania included. Such effects becoming manifest would tighten financing of both the fiscal deficit and the private sector, translating into higher interest rates, as well as depreciation pressures on the leu.*

Considering the busy electoral schedule for next year, a significant domestic risk factor relates to potential slippages from the fiscal consolidation programme assumed by the authorities, especially in the event of a possible worsening of the wage-productivity correlation. The risk of the fiscal deficit overshooting the target implies substantial financing difficulties with consequences similar to those already mentioned. Adding to these financing difficulties is the risk of larger-than-projected increases in administered prices.

Should the aforementioned risks materialise, macroeconomic scenarios with a high likelihood of generating significant upward deviations of the inflation rate from the baseline scenario trajectory would develop.

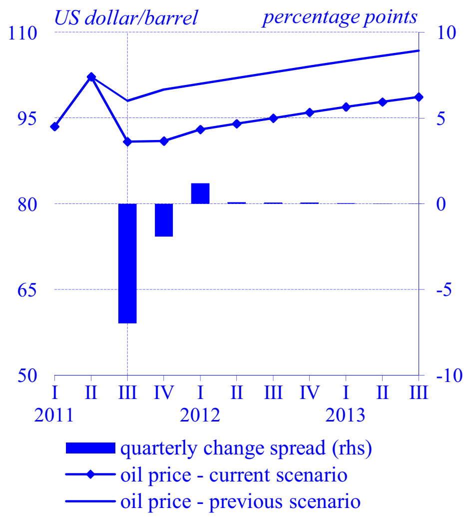
Given the current macroeconomic picture marked by the persistence of considerable risks, safeguarding the domestic and external equilibria of the national economy is strictly conditional on the monetary policy enjoying the support of the other macroeconomic policy mix components through the consistent implementation of the economic programme on fiscal consolidation and structural reforms agreed under the arrangements signed with the EU, the IMF and the World Bank.

1. The baseline scenario of the forecast

1.1. External assumptions

The scenario on the euro zone economy developments envisages average annual increases in real GDP of 1.6 percent for 2011 and 0.5 percent for 2012 – both figures were subject to downward revision against the previous forecasting round[43]. Behind the revision stand the recent slowdown of global aggregate demand dynamics, the erosion of financial markets' confidence in the sovereign debt crisis being properly addressed and, against this

Baseline Scenario for the International Oil Price



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

[42] Agreed upon at the euro zone summit held on 26 October 2011 under the aegis of the European Council.

[43] Values revised downwards by 0.4 percentage points and, respectively, by 1.2 percentage points versus the August 2011 Inflation Report.

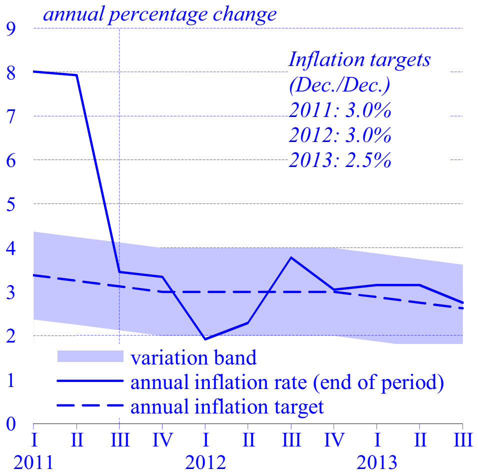
Expectations on the Developments in External Variables

annual averages

	2011	2012
Oil price (USD/barrel)	94.4	94.5
USD/EUR exchange rate	1.40	1.40
3M EURIBOR interest rate (% p. a.)	1.35	1.06
Economic growth in the euro zone (%)	1.6	0.5
Annual inflation rate in the euro zone (%)	2.5	1.7

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

Inflation Forecast



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

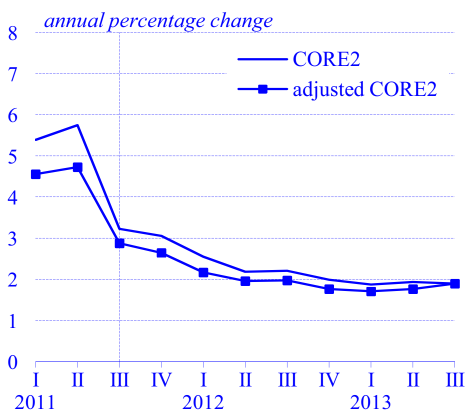
Source: NIS, NBR projection.

The Annual Inflation Rate in the Baseline Scenario

annual percentage change (end of period)

	2011	2012				2013		
	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Target	3.0				3.0			
Forecast	3.3	1.9	2.3	3.8	3.0	3.2	3.2	2.8

Annual CORE2 Inflation*



*) quarterly average

Source: NIS, NBR projection.

backdrop, the obstacles to some European banking groups' business, as well as the tighter fiscal policies applied by a number of Member States. The fragile economic growth in the euro zone is expected to be supported by the positive, albeit declining, contribution of net external demand and by the slight increase in domestic demand. Considering the anticipated deceleration in economic growth and the projected gradual fading of the impact produced by the recent supply-side shocks, the scenarios for the 3M EURIBOR interest rate and the HICP annual inflation rate were, in their turn, revised downwards throughout the projection horizon. The 3M EURIBOR foreign interest rate is expected to post a decrease over the first half of the projection horizon, followed by an uptrend in the second half, with values remaining nevertheless substantially below the previously-envisaged ones.

The scenario for the USD/EUR exchange rate anticipates a slight depreciation of the euro for 2011 Q4, followed by a stabilisation close to 1.4 USD/EUR for most of the projection horizon.

The international oil price is assumed to increase progressively over the entire projection horizon, but it will remain below the trajectory anticipated in the previous forecasting round.

1.2. Inflation outlook

According to the baseline scenario, the annual CPI inflation rate will stay inside the variation band around the central target[44] for almost the entire reference period. In line with the updated macroeconomic projection, the 12-month inflation rate will reach 3.3 percent at end-2011 and 3.0 percent at end-2012.

For 2011, the 1.3 percentage point downward revision of the annual CPI inflation rate compared to the previous projection stemmed from the significant adjustment of vegetable and fruit prices, as well as from the slowdown in CORE2 inflation, whereas the administered price inflation was revised upwards. The 0.5 percentage point downward revision envisaged for 2012 is largely due to the slower anticipated dynamics of CORE2 index.

The annual adjusted CORE2 inflation rate is expected to further decline until 2012 Q1 and then to stabilise at levels close to 2 percent. Amid the gradual fading of adverse supply-side shocks from the previous periods, the disinflation projected for the adjusted CORE2 index will be stronger than in the preceding forecasting round as a result of the demand deficit expected to narrow at a slower pace and of the downward revision of economic agents' inflation expectations.

[44] Set at 3.0 percent for both 2011 and 2012.

Import prices will rise more rapidly in the first part of the projection horizon, considering the recent depreciation of the domestic currency versus the euro and the US dollar. In the latter part of the projection period, given the fading unfavourable impact of the exchange rate and the slowdown in external inflation[45], import price dynamics is expected to decelerate.

The growth rate of tobacco prices is anticipated to have an inflationary impact similar to that forecasted in the previous round in 2011, yet higher[46] in 2012.

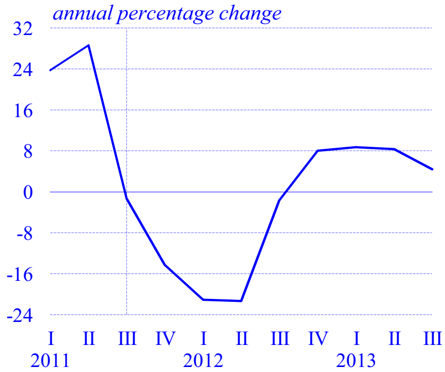
Owing to higher-than-expected agricultural output in 2011, the annual VFE inflation rate is expected to decline further and stay in negative territory for the following four quarters, particularly on the back of developments reported by fruit and vegetables. The assumption that 2012 will be a normal agricultural year adds to an unfavourable statistical base effect[47] and leads to the reversal of VFE inflation trajectory starting with the latter half of 2012. The projected annual contribution of VFE inflation to CPI inflation is higher in 2012 than that forecasted previously.

The annual growth rate of administered prices is expected to accelerate to 7.7 percent in 2011 Q4, under the impact of the announced elimination of central government heating subsidies[48]. In 2012 Q4, the annual rate of increase of administered prices will drop to 5.3 percent, slightly higher than the figure anticipated in the previous forecasting round.

The annual dynamics of fuel prices will slow down over the next six quarters on the back of the fading oil price shocks from 2011 Q1 and Q2. Still, assuming that oil price will increase over the projection horizon[49], the annual rate of increase of fuel prices will exceed the 12-month CPI inflation rate.

Overall, the cumulative contribution to the annual CPI inflation rate that the exogenous components in terms of monetary policy action – administered prices, VFE and fuels – are expected to make stands at 1.2 percentage points at end-2011 and 1.7 percentage points at end-2012.

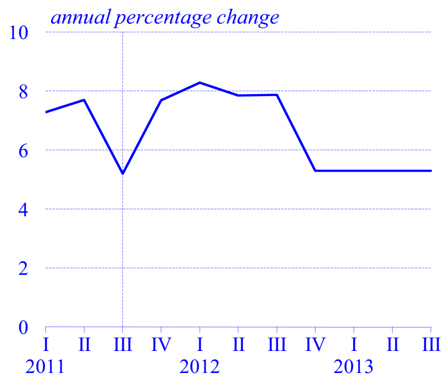
Vegetables, Fruit and Eggs Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR projection.

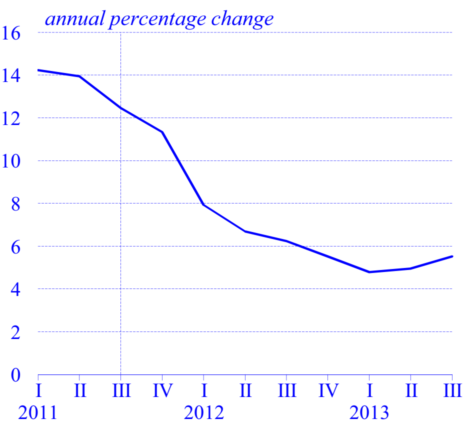
Administered Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR projection.

Fuel Prices Annual Inflation*



*) quarterly average

Source: NIS, NBR projection.

45 See Subsection 1.1. External assumptions.

46 The revision for 2012 relies mainly on an exchange rate for excise calculation in 2012 higher than that used in 2011 (RON/EUR 4.3 versus RON/EUR 4.265).

47 Which will reach its highest magnitude in 2012 Q3.

48 According to the latest assessments, the elimination of heating and hot water subsidies from the central government budget will have a 0.5 percentage point contribution to CPI inflation at end-2011.

49 See Subsection 1.1. External assumptions.

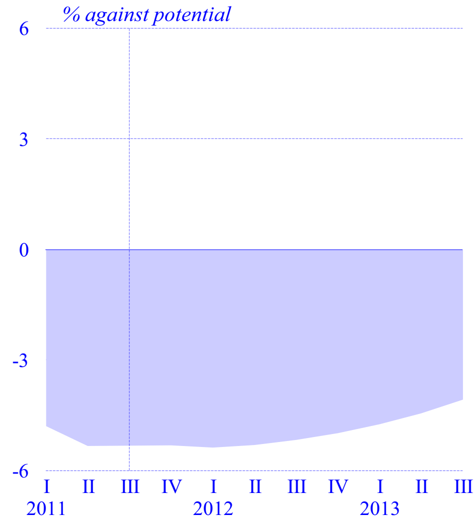
Components' Contribution to Annual Inflation Rate*

percentage points

	2011	2012
Administered prices	1.5	0.8
Fuels	0.7	0.4
VFE prices	-1.0	0.5
CORE2, of which:	2.1	1.3
– tobacco	0.4	0.2

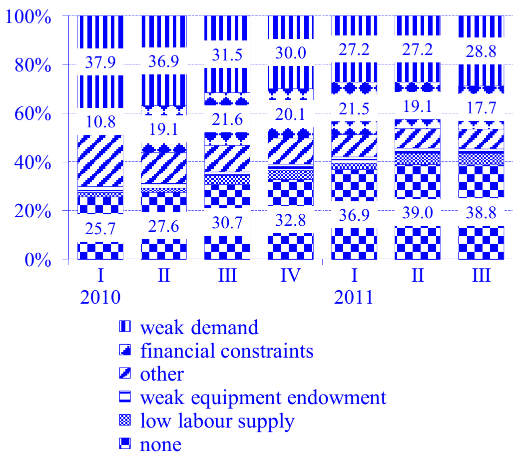
** end of period*

GDP Deviation



Source: NIS, NBR calculations.

Factors Depressing Industrial Output



Source: EC-DG ECFIN.

1.3. Demand pressures in the current period and over the projection horizon[50]

Output gap

Economic growth is anticipated to pick up moderately in 2011 Q3, following the modest quarterly rise in GDP (0.2 percent) in 2011 Q2. The annual growth rate of real GDP is expected to stay positive in 2011 Q3 as well.

The current forecasting round sees the potential GDP rebounding slightly[51], although its dynamics remains considerably slower than prior to the financial crisis, as suggested by the production function-based analysis. According to this, the marked deceleration of potential GDP dynamics against the background of the economic crisis is mainly attributable to the unfavourable performance of total factor productivity and to the lower contribution of the capital stock following the drop in investment flows.

The negative output gap in 2011 Q3 is assessed as posting a similar reading to that corresponding to the previous quarter, which means that, *ceteris paribus*, aggregate demand disinflationary pressures remain unchanged.

Developments in the aggregate indicator of economic activity[52] also underpin the output gap estimate. However, the decomposition of the indicator reveals that monthly indicators convey divergent signals on the evolution of the negative output gap. Thus, compared to the average for the previous quarter, industrial output edged up 1.8 percent during July-August[53], while the capacity utilisation rate in industry declined slightly. Furthermore, the share of respondents in the EC-DG ECFIN Survey citing "insufficient demand" as one of the factors depressing manufacturing production widened marginally in 2011 Q3. During the period under review, the economic sentiment indicator stood below the

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

[51] For the current forecasting round, it has been assumed that the supply-side shock induced by the better-than-expected harvest has no impact on the output gap, yet it has a positive (albeit short-lived) influence on potential GDP dynamics.

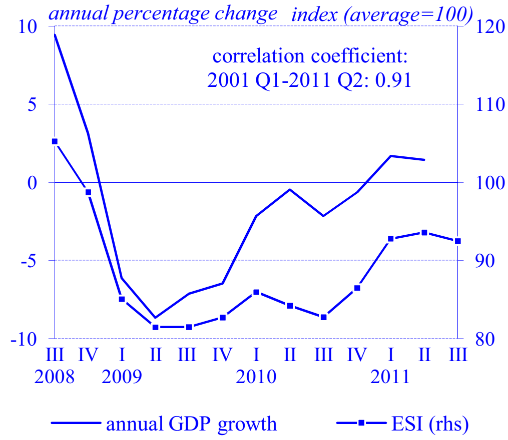
[52] The aggregate indicator combines developments in several macroeconomic variables into a single synthetic variable whose dynamics is significantly correlated to that of economic activity. The aggregate indicator is based on the normalised cyclical components of the following 11 variables (whose cyclical components have relatively high correlation coefficients with the cyclical component of real GDP): number of employees economy-wide, industrial output, unemployment rate, real consumer credit, capacity utilisation rate, real net wage economy-wide, real M1, EA16 GDP, economic sentiment indicator (ESI), energy consumption economy-wide, and the volume of new orders in manufacturing.

[53] Industrial output declined 0.6 percent in 2011 Q2 in quarterly terms.

previous quarter's average[54], while the ILO unemployment rate posted similar readings to those in 2011 Q2.

The forecasted values of the demand deficit are more negative than in the previous Inflation Report throughout the projection horizon, which implies stronger disinflationary pressures. The reassessment of the output gap[55] came from both the downward revision of its current values and the anticipated dynamics of economic fundamentals. Real broad monetary conditions will remain in line with the progress in disinflation and with the consolidation of economic recovery. Given the anticipated ongoing narrowing of the budget deficit over the period ahead[56], the fiscal impulse contributes to a wider demand deficit, exerting ampler contractionary effects in the first part of the forecast horizon. The projected decline in external demand[57] has also led to the downward revision of the previous forecast on economic activity.

Economic Sentiment Indicator and Economic Growth*



*) seasonally adjusted data

Source: NIS, EC-DG ECFIN.

Aggregate demand components

In 2011 Q3, the positive quarterly dynamics of actual final consumption of households is anticipated to carry on at a faster pace than in the previous quarter. The further uptrend of consumption is suggested by developments of both market services to population that moved up 5.7 percent during July-August compared to the 2011 Q2 average and net real wage economy-wide that rose by 3 percent during July-August compared to the average for the previous quarter. In contrast to the marked rise reported in Q2, public consumption for 2011 Q3 is foreseen to stay at the previous quarter's level, a development in line with the authorities' commitment to fulfil the deficit target agreed with the EU, the IMF and the World Bank for end-2011, i.e. 4.4 percent of GDP. According to the preliminary data released by the Ministry of Public Finance, the consolidated general budget deficit at end-September (cumulated) accounted for 2.52 percent of annual GDP, a level significantly lower than a year earlier.

Actual final consumption of households is anticipated to increase moderately until the end of the year, illustrating mainly the still slow dynamics of disposable income. For the following year, given the expected consolidation of economic growth in positive territory and the entailing gradual easing of financial constraints faced by economic agents, the dynamics of this component will accelerate slightly. The projected development of public consumption is marked by the fiscal consolidation measures necessary for further

54 The ESI averaged out at 92.5 in 2011 Q3, down from 93.6 a quarter earlier.

55 The reassessment, including for 2011 Q2, was mainly due to the NIS revising the real GDP level below the previously-released figures for several quarters of recent historical (seasonally-adjusted) data.

56 The arrangement with the European Commission on the excessive deficit procedure has set a 3 percent target for end-2012.

57 See Subsection 1.1. External assumptions.

adjustments of the budget deficit in the periods ahead; thus, public consumption is expected to fall in the current year and to rebound in the course of the following year.

Gross fixed capital formation is forecasted to keep dropping in annual terms in 2011 Q3 as well. Yet, its annual pace of decline is expected to decelerate further, as quarterly growth rates continue to be positive. More specifically, the quarterly growth anticipated for Q3 is supported by construction sector indicators which posted more favourable developments than in 2011 Q2[58]. In addition, the dynamics of investment in equipment is seen to enter positive territory, the rise in the turnover of capital goods for the domestic market (1.9 percent in real terms, in July and August versus 2011 Q2) being relevant in this respect.

For 2012, gross fixed capital formation is expected to witness a moderate upturn, particularly in the context of the rebound in the production for domestic consumption and also following the programmed increase in the capacity of absorbing European funds[59] compared with 2011.

Exports quarterly dynamics is seen to re-enter positive territory in Q3. This growth is suggested mainly by the good performance of manufacturing in July and August (a 1.8 percent rise from 2011 Q2). On the other hand, the quarterly change in imports is forecasted to post a negative reading in Q3 too, the July and August aggregate data on the imports of goods and services in the balance of payments showing a fall from the previous quarter's average.

According to the data available so far for the current year, exports will most likely post a faster pace of increase than that of imports. Conversely, imports growth is projected to accelerate slightly in 2012 amid the rebound in domestic demand, while exports growth is seen to be influenced by the slower dynamics of external demand. In this context, the current account deficit will widen moderately until the end of the reference period, without any noticeable inflationary pressures coming from domestic currency exchange rate dynamics.

Broad monetary conditions

Broad monetary conditions capture the impact on the future developments of aggregate demand of the dynamics of leu-denominated interest rates applied by credit institutions to their non-bank clients, the exchange rate and the costs of foreign currency-denominated loans.

[58] The new construction works index went up 1.7 percent during July-August from the average for the previous quarter, while the confidence indicator in construction rose from -24.8 in 2011 Q2 to -20.6 in 2011 Q3, and construction orders indicator grew from -42.3 in 2011 Q2 to -35.2 in 2011 Q3.

[59] They are expected to bolster mainly public investment.

In 2011 Q3, the interest rates applied by credit institutions to their non-bank clients decreased in nominal terms versus the previous quarter, but increased slightly in real terms due to a decline in inflation expectations. Nevertheless, the positioning in Q3 of overall real interest rates compared to the equilibrium levels over the medium term points to their ongoing stimulative effect on future economic activity.

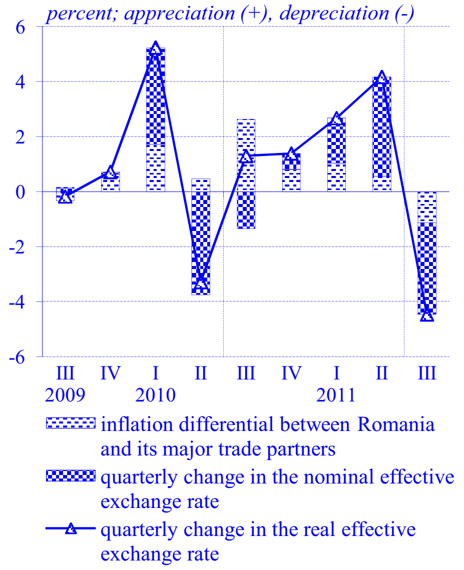
In 2011 Q3, the real effective exchange rate[60] depreciated, implying, *ceteris paribus*, an improvement in external price competitiveness and favourable effects on future net exports. To this contributed mainly the nominal depreciation versus the euro and the US dollar[61], which occurred amid the deterioration in investors' perception towards the prospects of the economies in the region following the uncertainties surrounding the financing of the sovereign debts of Greece and other euro area countries. Investors' heightened risk aversion was also echoed by the upward quarterly dynamics of the spreads of credit default swaps (CDS) for a number of states in the region, including Romania. Unlike the impulse sent via the net export channel, the developments in the exchange rate and the sovereign risk premium in Q3 trigger a restrictive impact on future economic activity by higher costs of foreign currency-denominated loans.

According to the NBR assessment, the adverse impulse generated by the movements in the costs of foreign currency-denominated loans in 2011 Q3 is offset almost completely by the stimulative impulse exerted by the real exchange rate via the net export channel and the real interest rates. Hence, the net effect of the configuration of real broad monetary conditions in Q3 on future aggregate demand is assessed to be neutral.

During the projection horizon, the slightly stimulative nature of overall real broad monetary conditions relative to economic activity is the joint result of the distinct developments in its components. In the first part of the forecast horizon, the real effective exchange rate fosters net exports, capturing the impact of the recent depreciation of the domestic currency against the major currencies.

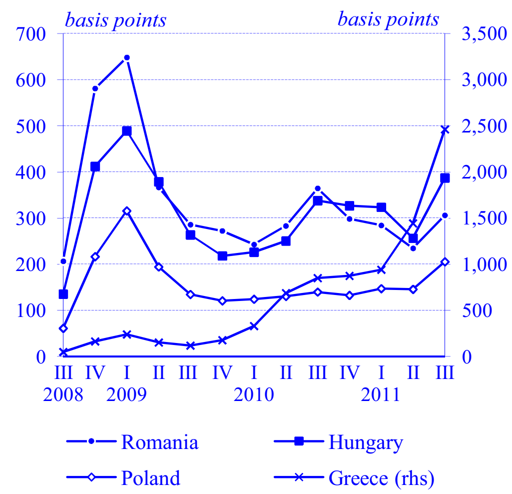
The wealth and balance sheet effects will have a restrictive bearing in the first quarters of the forecast due to the spillover effects from the sovereign debt crisis on investors' risk perception.

Quarterly Change in the Effective Exchange Rate



Source: Eurostat, U.S. Bureau of Labor Statistics, NBR, NBR calculations.

5-year CDS Spreads for Romania and Other Countries in the Region



Source: Bloomberg.

[60] 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.

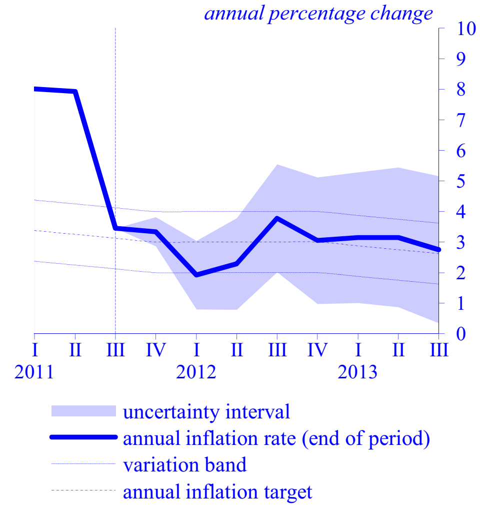
[61] Despite the negative inflation differential between Romania and its major trade partners also contributing to the real depreciation of the domestic currency in 2011 Q3, its relevance as an impacting factor on overall external competitiveness is low in this particular case, in which the differential is attributable mainly to the deflation of VFE that hold a small share in total exports and have a strong volatile nature.

The trajectory of the monetary policy rate in the baseline scenario is calibrated so as to ensure – along with stronger prospects on the inflation rate remaining within the variation band – the necessary conditions for the gradual resumption of lending to the economy. Under these circumstances, the deviations from the trends of real interest rates on leu-denominated loans and deposits are foreseen to exert, *ceteris paribus*, a stimulative impact on aggregate demand for most of the forecast horizon. The developments in the interest rates set by banks are based on the hypothesis that the functioning of the monetary policy transmission mechanism will normalize during the projection horizon. This assumption is justified amid the expected furthering of balance sheet adjustments by financial institutions[62] and the sustainable return of lending standards to levels that allow the removal of normal financing constraints of economic agents.

1.4. Risks associated with the projection

Although the current assessment points to a balancing of risks to inflation over the short term, a more favourable influence exerted by some food prices over this time horizon cannot be ruled out[63]. Over the medium term, the balance of risks is further tilted to the upside, although to a lower extent than in the previous forecasting round. The main sources of risk in the medium run are associated with external developments, the fiscal policy stance, and expected administered price adjustments.

Uncertainty Interval Associated with Inflation Projection in the Baseline Scenario



Source: NIS, NBR projections and calculations.

The global economy is currently facing several sources of risk[64] which affect confidence and delay the recovery. The outlook for the sovereign debt crisis in the euro area is still plagued by uncertainties over the quarters ahead. In the absence of a coherent response from the European authorities, the global financial market jitters manifest in recent months could persist and even intensify. Given the particular nature of the ongoing crisis, its effects would translate into significantly higher financing costs for both the banking sector and several sovereign entities in the euro area. Against the background of broad-based risk aversion, investors might treat indiscriminately the new EU Member States

62 Financial institutions reported a certain worsening of the loan portfolio quality as the effects from the financial crisis were spilling over on the domestic economic environment.

63 A more favourable contribution of volatile food prices to the 12-month CPI inflation rate than assumed in the baseline scenario would be manifest only up to and including 2012 Q2. Starting with the latter half of 2012, the balance of risks might tilt to the upside in the event of poorer crops than assumed in the baseline scenario, compounded by the expected adverse base effect associated with the annual inflation rate of volatile food prices, thus triggering a temporary spike in inflationary pressures.

64 Aside from the euro area sovereign debt crisis, mention should be made of the uncertainties surrounding the medium-term outlook of the US fiscal policy, the slower GDP growth in China – the main driver of economic expansion in Asia – and, last but not least, the G20 lack of coordination in the field of economic governance.

outside the euro area, Romania included, which would add to the depreciation of the respective currencies. In turn, this would have a detrimental impact on consumer price dynamics and households' purchasing power over the medium term, being a major factor that tilts to the upside the balance of risks associated with the inflation forecast.

Aside from the decline in foreign investment and capital inflows, higher risk aversion and financing costs would have negative wealth and balance sheet effects, forcing banks (Romanian ones included) to tighten lending standards[65] and/or reduce the volume of new loans, with a direct impact on investment and private consumption. Fiscal policy would be faced with an increase in interest rates on the public debt service and a scarcity of adequate financing sources, on the back of a downward revision in the pace of economic growth. In the event of such a scenario materialising, the economy's growth potential would diminish, with unfavourable effects on price stability over the medium and long term.

Domestic risk factors may stem from adverse developments in the budget deficit amid the busy electoral schedule for next year. The possible fiscal policy slippages could worsen the wage-productivity correlation, which would depress external competitiveness[66] over the medium term, thereby adding to the economy's vulnerability to external shocks. Further risks stem from the so far low absorption rate of EU structural funds, which hinders viable investment projects and contains the economic growth potential, depriving the state budget of additional sources of revenues over the medium term. Thus, there is still a considerable degree of uncertainty surrounding the future adjustments of administered prices[67] under pressure from public sector funding constraints.

2. Policy assessment

In line with expectations, disinflation – which had resumed in June – gathered momentum in 2011 Q3. The curbing of inflation was even stronger than anticipated, as the annual inflation rate plunged from 7.93 percent at the end of Q2 to 3.45 percent in September, thus reaching a 20-year low and returning inside the variation band around the year-end target. This development was largely attributed to the near fading-out of the immediate adverse impact stemming from the VAT rate hike, as well as to the heftier

[65] However, the tightening of lending terms might have a different impact across economic agents, as credit institutions would calculate a higher risk premium on "high risk" loans, thereby generating a rise in financing costs.

[66] The extent to which any pay rises in the public sector would feed though to the private sector (via the demonstration effect) is equally important.

[67] For natural gas, electricity, railway transport, etc.

adjustment of volatile food prices, amid the protracted interaction between the positive shock from this year's supply of agricultural produce and the persistence of weak aggregate demand.

Against this background, the updated medium-term inflation forecast was again revised downwards for the entire projection horizon, especially over its first part. According to the new coordinates, the projected 12-month inflation rate tends to drop during 2012 H1 to levels marginally below the lower limit of the variation band around the 3 percent target, but subsequently it is expected to return and remain close to the midpoint of the medium-term target.

Along with the recent sizeable adjustment of volatile food prices and the foreseeable acceleration of their annual decline, amid a still favourable base effect, a key determinant of the improved inflation outlook is the slower-than-previously-forecasted pace of economic recovery, only temporarily countered by this year's bumper crops. This implies, over the entire policy-relevant horizon, a relative increase in disinflationary pressures of the negative output gap, whose projected levels are on the rise, due also to the temporary shock from this year's supply of agricultural produce being incorporated into the potential GDP estimated for 2011 H2.

From the standpoint of monetary policy conduct, it is quite relevant that the current improvement in the inflation outlook stems also from the recently-shaped downward adjustment trend in inflation expectations that was confirmed by the dedicated surveys. In addition, the trend is very likely to become steeper in the period ahead, including over the longer horizons, given the mainly backward-looking expectations of some economic agents. As a reflection of these influences, the updated trajectory of the projected annual core inflation rate was also revised downwards, dropping to levels much lower than those in the previous forecasting round. The adjustment becomes more pronounced starting with 2012 Q2, given that in the near run it will still be slightly hampered by several factors such as (i) the gradual fading-out of the VAT rate hike effect, (ii) the lag related to the volatile price reductions feeding through to processed food prices and (iii) a possible downward rigidity of some of these prices. A similar influence will most likely have the recent softening of the leu versus the major currencies.

Tailoring the monetary policy reaction to the current medium-term inflation forecast is however complicated by the related heightened uncertainties and the intricacy of the balance of risks. These risks arise mainly from the considerably higher uncertainties surrounding the sovereign debt crisis and its impact on euro zone economies/banking systems and the world economy and financial market, the Romanian economy included. Thus, a possible aggravation/protraction of the crisis, entailing a further decrease in financial investors' risk appetite, would immediately bring about stronger-than-expected depreciation pressures on the leu versus the major currencies. The inherent inflationary impact of the leu exchange rate could be heightened/lengthened by a possibly severe tightening of external financing for local banks, assuming an additional worsening of some parent banks' financial standing and of confidence on global financial markets.

At the same time though, the escalation of the sovereign debt crisis might fuel disinflationary pressures from aggregate demand, given the anticipated slowdown in the pace of recovery of the Romanian economy, amid the unavoidable weakening of the world economy, the euro zone economy in particular. The adverse impact on the Romanian economy, and implicitly the demand-pull disinflationary effects, could be stronger and more persistent assuming that some advanced economies could fall again into recession or their rebound might be delayed, also as a result of furthering the necessary fiscal consolidation in some countries and of possibly greater difficulties their financial systems are facing.

In light of the recent years' experience, the potentially adverse effects of external developments are expected to hit particularly the major components of domestic demand, i.e. private consumption and investment, especially via a significant erosion of confidence and dwindling financing sources/tighter domestic and external financing conditions for companies and households alike. A negative impact will also be exerted on the financing of the public sector, as well as the budget execution, whose positive results have been preserved until recently. Thus, the risk of fiscal policy slippage that was somewhat less relevant during 2011 could again be looming, particularly over the longer term, also due to the busy electoral schedule in the coming years. Accordingly, a further resolute implementation of fiscal consolidation and structural reforms, pursuant to the commitments under the arrangements signed with the EU and the IMF, would be even more necessary, as this would be essential to prevent the risk premium related to local market investments from widening further, implicitly to strengthen disinflation and ensure a sustainable recovery of the Romanian economy.

At the current juncture, the risk that future movements in global agricultural commodity prices and energy prices, including the oil price, cause a deviation of the annual inflation rate from its projected path remains relatively balanced, at least in the near run. The assessment takes into account, on the one hand, the marked slowdown in global economic growth and the outlook for this trend to continue, as well as the recent sharp downturn in volatile food prices on the local market and its possibly longer-than-anticipated persistence, amid the ongoing/stronger favourable effects of the positive supply shock caused by this year's crops. On the other hand, unforeseen rises in global commodity prices should not be entirely ruled out if arbitraging operations on certain markets gather pace following the ample liquidity provided by leading central banks and/or given the assumption, which appears increasingly less likely though, that global demand for such goods rebounds earlier than expected.

By contrast, the risk of previous or anticipated adverse supply-side shocks translating into second-round effects is substantially lower, since the swift disinflation seen in the past few months and the significantly improved inflation outlook may give a boost to the downward adjustment of inflation expectations. An additional inhibiting impact on wage and ULC dynamics could have the expectations of a slower recovery of the Romanian economy amid the weakening world economy. The steady assessment of the potential inflationary risk stemming from the wage-setting behaviour – entailing the ongoing monitoring of developments in wages and of the wage-productivity correlation – is nonetheless necessary, also in terms of the possibly unfavourable impact on medium-term inflation expectations that would come from the measures to adjust/remove some administered prices due for the longer projection horizon. These steps are, to a large extent, conditionalities in the arrangements signed with the EU, the IMF and the World Bank.

Given the significantly improved inflation outlook, which implies the projected annual inflation rate staying inside the variation band around the 3 percent midpoint of inflation targets in both 2011 and 2012, and considering the persistence of an asymmetric balance of medium-term risks to inflation, the NBR Board has decided in its meeting of 2 November 2011 to lower the monetary policy rate by 0.25 percentage points to 6.00 percent per annum. The NBR Board has also decided to pursue an adequate management of liquidity in the banking system and to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

The judicious adjustment of the central bank's stance is aimed at steadily ensuring adequate real broad monetary conditions for effectively anchoring economic agents' inflation expectations and for securing a lasting maintenance of inflation inside the variation band around the targets, along with preserving financial stability. These elements, alongside the implementation of commitments on strengthening fiscal consolidation and structural reforms undertaken by the Romanian authorities under the multilateral external financing arrangements signed with international institutions, are essential for a sustainable recovery of the Romanian economy.