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N O T E

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The Research and Publications Department carried out the drafting,
English version and technical co-ordination.

Phone: 402 1/312 43 75; fax: 402 1/314 97 52
25, Lipscani St., 70421 Bucharest – Romania

www.bnro.ro

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1. INFLATION DEVELOPMENTS IN THE FIRST HALF OF 2002

Disinflation strengthened as a result of better co-ordination among ...

Disinflation, which had started in 2000, continued in the first six months of 2002 at a faster pace than initially expected. Thus, consumer prices rose by 9.3 percent, 5.5 percentage points below the level recorded in the first half of 2001 and 4 percentage points lower than the projected figure for the period under review. Slowdown in price growth rate has been manifest ever since the first few months of 2002 – March saw the lowest monthly inflation rate since the beginning of the transition period (0.4 percent) – due to better co-ordination of the key macroeconomic policies:

... monetary policy, ...

- Monetary policy ensured tight control over liquidity; extension of the central bank's market operations, lower fiscal dominance and increasing resilience of financial and banking sectors underpinned the improvement of the monetary policy transmission mechanism.

  Against the backdrop of appreciation of the EUR versus the USD, the NBR used, to a larger extent, the exchange rate policy for antiinflationary purposes, so that despite the interventions in the forex market to preclude overappreciation of the domestic currency, the real appreciation of the ROL against the USD during January-June 2002 (by 3.3 percent from end-December 2001) was 1.8 percentage points higher than in the first half of 2001. Productivity gains in the manufacturing sector and steady real depreciation of the ROL against the EUR, the main settlement currency in external transactions, were the two factors which contributed to preserving competitiveness of the Romanian exports and provided the exchange rate policy with room for manoeuvre to support disinflation.

... fiscal policy, ...

- Fiscal policy took a prudent stance during the period under review, leading to lower-than-projected budget deficits in the first and second quarters of 2002 (by 31 percent and 14 percent respectively). This was mainly the result of the tight control over expenditures. In an attempt to improve revenue collection, the fiscal authority also resorted to several measures that influenced prices in the first half of 2002 (such as the raise in excise duties on gasoline, ethyl alcohol and distilled alcoholic beverages and in tax on beer, starting with May 2002).

... wage policy

- Wage policy was more restrictive than in the first half of 2001, with wage hikes in the budgetary sector being significantly lower than in the same year-ago period. However, further weak wage discipline in the state-run enterprises *(régies autonomes,* national companies and commercial companies) was associated with wage increases surpassing average wage growth economy-wide.

Persistence of soft budgetary constraints

- The economy was still grappling with soft budget constraints as reflected by the persistence of inter-enterprise arrears and arrears to the government budget[1]. As arrears affected mostly the public utilities, additional increases in prices were needed to reduce losses incurred by these companies. Consequently, in the first six months of 2002 administered prices rose by 11.3 percent due mostly to higher prices for electricity, natural gas and water, sewerage and waste disposal services. As goods and services with administered prices accounted for 19.5 percent of the consumption basket (up 2.4 percentage points compared with 2001), the impact of these increases was reflected by weaker demand for other goods and services with market-driven prices.

Developments in prices of goods and services provided by monopolies

-percent-

	H1 2001	H1 2002
1. Inflation measured by consumer price index	**14.8**	**9.3**
2. Change in administered prices geared to inflation,	**15.0**	**16.3**
of which: - railway transport	11.3	0.0
- water, sewerage, waste disposal	12.4	19.0
3. Share of products with prices geared to inflation in CPI basket	**4.7**	**4.7**
4. ROL/USD exchange rate nominal depreciation	**11.6**	**5.5**
5. Change in administered prices geared to exchange rate,	**9.1**	**10.7**
of which: - electricity	6.0	15.0
- heating	0.0	4.6
6. Share of products with prices geared to exchange rate in CPI basket	**7.9**	**9.5**
7. Change in administered prices geared to inflation and exchange rate via specific methodologies,	**14.3**	**7.9**
- telephony	21.4	7.5
- postal services	12.1	19.7
- natural gas	0.0	8.4
8. Share of products with prices geared to inflation and exchange rate in CPI basket	**4.6**	**5.3**
9. Change in administered prices	**12.1**	**11.3**
10. Total share of goods and services with administered prices in CPI basket	**17.1**	**19.5**
11. Contribution of administered prices to general price level (percentage points)	**2.1**	**2.2**

A significant factor behind disinflation gains in the first six months of 2002 was alleviation of inflation expectations induced by both slower nominal depreciation of the ROL/USD rate and the downward trend in interest rates.

Development of consumer prices by commodity groups

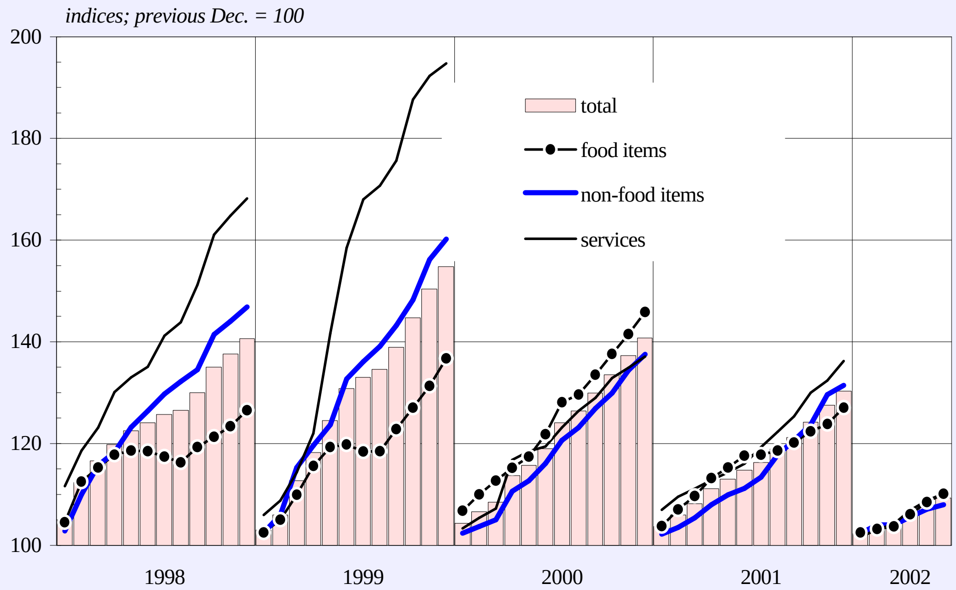
Against this background, in the first half of 2002, prices for food items rose by 10.1 percent under the impact of the seasonally-induced imbalance of the demand/ supply ratio and the spillover effects of increase in prices for goods that have a strong inflationary impact (such as electricity, heating and fuels). Prices for non-

[1] Total arrears economy-wide amounted to 35.8 percent of GDP at end-2001.

food items recorded the lowest growth rate (8 percent)[2]; one possible explanation for this development was the decline in demand for such goods suggested by both lower retail turnover (e.g. down 6 percent in the case of wearing apparel and footwear) and lower relative weight of this category of goods in the consumption basket (e.g. weighting coefficients for wearing apparel, footwear, cultural and leisure activities dropped in the range from 11 percent to 23 percent year on year).

Services grew more expensive (10.2 percent) under the impact of adjustments to controlled prices in services such as telephony, postal services, water, sewerage and waste disposal and increase in prices for city transport.

Consumer Prices



Source: National Institute of Statistics

Development of producer prices

Industrial producer prices on the domestic market increased by 11.6 percent in the first six months of 2002; the rise in prices for electricity, heating, gas and water (by 20.5 percent) fed through to the other industrial sectors. Producer prices in the manufacturing sector rose by 10.4 percent due to moderate price increases across food, metallurgy, and chemical sectors. Stronger inflationary pressures in tobacco processing, wearing apparel and footwear sectors fed through only partially to consumer prices.

[2] Excluding the impact of price adjustment for energy, heating, gas and fuels, the change in prices for non-food items ran at 3.7 percent.

2. DETERMINANTS OF INFLATION

Narrowing of the domestic demand/supply gap

The gap between the domestic demand and supply narrowed in the first six months of 2002 compared with the same year-earlier period amid the 4.4 percent real growth in domestic supply, about twice as high as that of domestic demand[3] (2.5 percent).

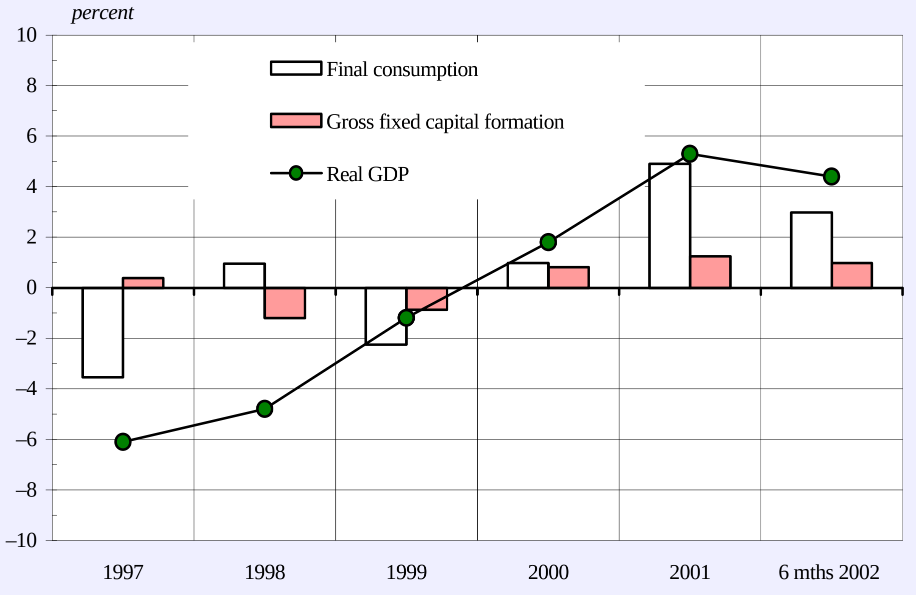
These developments were the mainstays of accelerated disinflation, with the average monthly growth rate of consumer prices (1.5 percent) down 0.8 percentage points year on year.

2.1. Domestic demand

Stronger domestic demand due to investment and consumption

Domestic demand continued to strengthen in the first half of 2002, but its components, i.e. final consumption and accumulation posted divergent trends; thus, consumption and gross fixed capital formation rose by 3.3 percent and 5.8 percent respectively while the change in inventories slowed down.

Contribution of the main demand components to real GDP growth



Source: National Institute of Statistics, NBR calculations

Against the backdrop of favourable developments in the external sector the domestic demand was met through net imports 17.5 percent lower from 2001 (accounting for 6.7 percent of GDP, compared with 9.4 percent of GDP in the first half of 2001).

[3] Computed as a sum of total final consumption and gross fixed capital formation.

2.1.1. Consumption

Smaller share of final consumption in GDP

The six-month **total final consumption,** estimated at more than ROL 521,495 billion in H1 2002, was higher in real terms than the figure recorded in H1 2001 but lower as a share of GDP, declining from 90.1 percent to 88.3 percent. Final consumption development reflected the upward trend of the two components, with household consumption prevailing.

Moderate growth of household consumption ...

Actual final household consumption increased by 3.6 percent in real terms, year on year, accounting for 93 percent of total final consumption. The growth in household consumption in the first half of 2002 was boosted by the faster pace of disinflation and higher incomes of population (during the period under review, the monthly growth rate in purchasing power of wages ranged from 3 percent to 5.4 percent against the similar months of the previous year; pensions were raised following indexation and re-correlation; at the beginning of 2002, Law No. 416/2001 on guaranteed minimum income to support the poorest groups of population came into force).

Nevertheless, demand remained somewhat weak for the main consumer goods and services; thus, retail trade remained virtually unchanged compared with the first half of 2001 while turnover in the sector of market services delivered to households and sales of motor vehicles and motor fuels slowed down (turnover in the services sector dropped by more than 13 percent).

Under these circumstances, the structure of household consumption[4] showed the surge of public administration spending for individual consumption and of expenditures of non-profit institutions serving households; consumption of goods and services increased moderately mainly on the back of household self-consumption. Behind these developments stood (i) recurrent increases in housing expenses, which contributed to the gradual decline in demand for most consumer goods and services and (ii) the increase in saving (at end-June 2002, household time deposits were 17.6 percent higher, in real terms, than at end-June 2001).

...and public administration consumption

Actual final consumption[5] of public administration, the second component of total final consumption, inched up 0.3 percent year on year, accounting for 6.2 percent of GDP. This development reflects the steps taken to enhance effectiveness of the general public services and of legislative and regulatory activities (the effect of which was the decline in staff costs) as well as the efforts made by the authorities to bring defence and public order sectors in line with the standards required for Romania’s integration into the Euro-Atlantic structures (which translated mainly into additional capital expenditures driven by improvement of technical endowment of the aforementioned sectors).

[4] Includes expenditures on purchasing goods and services, public administration’s expenditures on individual consumption (education, health, social security, culture, sport, leisure activities, and refuse collection) and expenditures on individual consumption of non-profit institutions serving households, such as religious organisations, trade unions, political parties, unions, foundations, cultural and sports associations.

[5] Includes public administration’s expenditures on collective consumption (general public services, national defence and territorial security, public order, legislative and regulatory activities, research and development activities, etc.).

2.1.2. Accumulation

Accumulation accounted for 99 percent of the figure recorded in the same period of 2001 amid divergent developments of its constituents; gross fixed capital formation continued to increase at a rate similar to that registered in the first six months of 2001, while the growth rate of inventories slowed down markedly.

Higher investment rate

Gross fixed capital formation amounted to more than ROL 103,179 billion, accounting for 17.5 percent of GDP (up 0.5 percentage points from H1 2001). Gross fixed capital formation picked up 5.8 percent in real terms from the same year-ago period while investment rate[6] increased from 19 percent to 19.7 percent.

Investment in the economy totalled ROL 66,357 billion, up 4.8 percent in real terms from the first half of 2001; about 47 percent of investment funds went to the purchasing of equipment and transport means while almost 40 percent of the amounts were earmarked for new construction projects.

Private sector investment – on the upside

Investment posted divergent developments by ownership, with private sector showing a real growth of 21.5 percent, accounting for 62.5 percent of total investment while public sector investment scaled down after one year of expansion; although the economic growth continued and the government was actively involved in accomplishing some major investment objectives (such as the completion of the second reactor of the Cernavoda nuclear power plant, rehabilitation of some railway sections and of some irrigation systems), the public sector investment accounted for about 85 percent of the figure for H1 2001.

Slower growth in inventories

Expansion of inventories in January-June 2002 accounted for only 0.9 percent of GDP versus 2.2 percent in the similar year-earlier period. The major factors behind this development were the fall in output of grains (as a result of unfavourable climate conditions) and the decline in industrial producers’ inventories of finished goods (at mid-2002 stocks of finished goods accounted for 9.5 percent of the 2002 six-month resources, i.e. output and initial stocks, compared with 10.5 percent in the same year-earlier period).

[6] Calculated as a percentage ratio of gross fixed capital formation to gross value added.

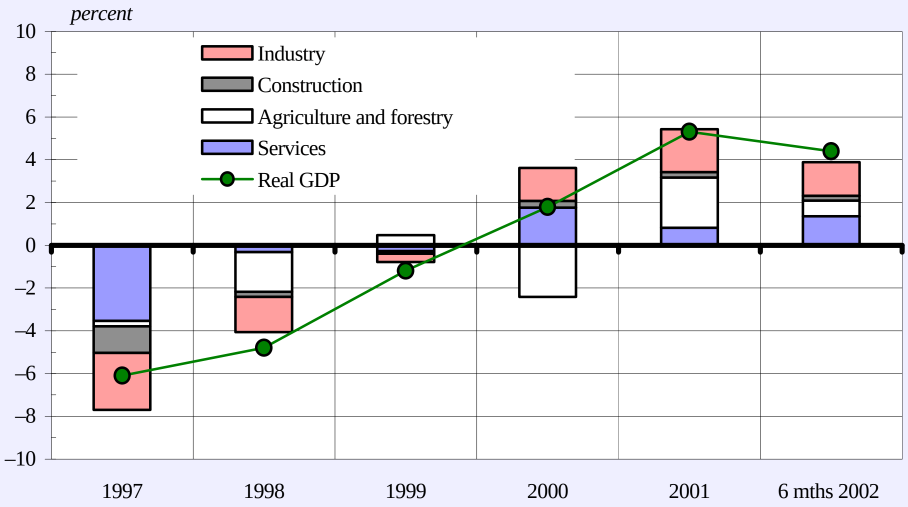
2.2. Supply

Increase in domestic supply driven by better performance of ...

Domestic market (output + imports – exports) expanded by 3.5 percent versus January -June 2001, with output increasing by 4.4 percent and exports rising faster than imports (8.8 percent versus 3.8 percent).

The growth of output was attributable to better performance of most sectors, particularly agriculture and forestry (underpinned by favourable results recorded in the animal breeding sector), and to the growth rates in construction and industry, exceeding GDP growth rate.

Contribution of the main supply components to GDP growth



Source: National Institute of Statistics, NBR calculations

2.2.1. Output by sector

...agriculture, ...

Agriculture displayed the most dynamic performance; despite the unfavourable weather conditions, which affected, to some extent, output of the vegetable sector, gross value added in the first half of 2002 was 11.4 percent higher than in the similar period of 2001. It is noteworthy the animal breeding sector, which witnessed overall increases in livestock, following sharp declines in the last ten years. Recovery of the agricultural sector was due to good performance of private farms.

... industry, ...

Except for one month, **industry** continued to display positive growth rates during the considered period, thus output being higher than in the similar year-earlier period. During the period under review industrial output was up 3.6 percent in real terms, due to the output gains of the manufacturing sector (4.9 percent), which not only offset the declines in output of the mining and energy sectors, but also spurred the upward trend of the industrial sector.

The most significant output gains were recorded in the consumer goods sectors (9.4 percent for non-durables and 5.2 percent for durables); given the slower growth in domestic demand, the oversupply was destined to external markets (exports of food items, beverages and other consumer goods accounted for about 44 percent of total exports in the first half of 2002, up 12 percent year on year). The 1.5 percent increase in the supply of intermediate goods occurred amid further economic growth while the supply of capital goods remained virtually unchanged from the previous year.

As a result of these developments gross value added in industry was 4.7 percent higher than in the same period of 2001.

... construction, ...

Activity in **construction** continued to strengthen; gross value added of the sector increased by 5.4 percent compared with the first half of 2001. The value of construction works exceeded ROL 46,386 billion, up 4.9 percent in real terms from the same year-earlier period, almost 58 percent of this value consisting of new construction works, mostly infrastructure projects.

The increase in construction activity was attributable to the private sector, which posted a 6.4 percent rise versus January - June 2001; by contrast, construction in the state-run sector continued to decline, the volume of construction works accounting for about 94 percent of that of the H1 2001.

... and services

Services remained the largest sector in the economy, its contribution to GDP resources exceeding 48 percent, slightly up from H1 2001. The modest performance in retail trade and the downward trend in market services rendered to population (13.3 percent) were offset by advances in most areas of the tertiary sector (special mention deserving real estate transactions, postal and telecom services, and transport); all in all, gross value added in the service sector was 2.9 percent higher than the level recorded in the similar period of 2001.

The balance between interest collected and interest paid by credit institutions dropped by 1.1 percent from the first half of 2001. Against the backdrop of economic growth and downward trend in bank interest rates which had started in 2001, financial intermediation services indirectly measured accounted for 1.5 percent of GDP.

A major resource of GDP was further provided by **net taxes on product** (VAT, excise duties, customs duties, and, to a lower extent, subsidies per product paid from the government budget), which picked up by more than 5 percent, accounting for 11.3 percent of GDP (compared with 10.7 percent in the same year-earlier period), a level similar to the record high recorded in the first six months of 2000.

2.3. Budgetary and fiscal developments

Against the backdrop of the prudent fiscal policy stance in the first half of 2002, budget deficits in the first and second quarters were considerably lower than the indicative targets of the IMF’s Technical Memorandum of Understanding.

Fiscal policy goals in 2002

The 2002 budget was aimed to provide fiscal policy with instruments whereby it could contribute to achieving the major goals of the economic programme: economic growth underpinned by domestic demand, especially by investment, further disinflation and slight reduction in unemployment. In order to cushion the conflict between these targets and implicitly to pave the way for their simultaneous accomplishment, fiscal policy focused on further restructuring of budgetary expenditures and containment of budget deficit at 3 percent of GDP.

One of the fiscal policy objectives was the slight reduction of taxation. Thus, the envisaged increase in excise duties and in tax on agricultural land as well as removal of some VAT[7] exemptions are to be offset by the relative lowering of income tax and customs duties. Consequently, budgetary expenditures were tailored consistent with the tight fiscal policy stance. Moreover, staff costs, material and services expenditures and public debt-related interest expenditures were cut back while according priority to expenditures meant to improve social protection (such as indexation of pensions and welfare allowances).

Fiscal policy measures taken in the first half of 2002

The six-month budget outturn was broadly in line with the budget approved for 2002. In pursuit of the objectives set, several measures were taken during this period, special mention deserving (i) granting of a monthly welfare allowance, according to Law No. 416/2001 on the minimum guaranteed income (which entered into force on 1 January 2002); (ii) re-correlation and indexation of pensions; (iii) increase in excise duties on alcohol, tobacco and petroleum products; (iv) reinstatement of tax on agricultural land stretching over 10 ha; (v) exemptions from customs duties according to Law No. 332/2001 on supporting strategic direct investment (Order No. 39/247/11.02.2002) supplementing Order No. 228/1437/2001 by the Minister of Development and Prognosis and the Minister of Public Finance on approving the list containing imports of technological equipment, installations, measurement and control apparatus, and software, which are exempt from customs duties).

Balanced government budget development – underpinned by severe control over expenditures

For the first time after 1989, the six-month government budget performance was based on the 2002 Budget Act. Thus, although monthly budget expenditures were no longer limited to the average level of the previous year, the outlays growth rate in the first five months of 2002 was modest. As a result, despite a relative relaxation of public expenditures in the first two months of the year, the cumulative government budget deficit for the first five months of 2002 ran at only 1 percent of GDP (25 percent of the projected annual figure)[8]. However, government budget deficit widened to 2 percent of GDP in June 2002 as a result of expenditures related to interest payments on public debt and exchange rate losses associated with

[7] According to Law No. 345/2002 (in force from 1 June 2002) the following exemptions were removed: (i) tax exemption on imports of raw materials and materials used exclusively for finished goods which are exported in 90 days, on lawyerly and notarial services, on activities performed in free area by authorised taxpayers; (ii) zero tax rate for building up dwellings, extension, consolidation and rehabilitation of existing dwellings; (iii) zero tax rate for tourist services delivered to foreigners, for which payment is made in foreign exchange.

[8] During the same period of 2001, government budget deficit accounted for 1.2 percent of GDP and 31.7 percent of the projected annual deficit.

redemption of some foreign bonds. Nevertheless, the government budget deficit in January - June 2002 was lower versus the same 2001 period (49.4 percent compared with 51.4 percent of the projected annual figure). This performance was attributable to the tight control over expenditures[9] rather than to a better collection of taxes and duties. Revenue collection rate fell to 42.2 percent of the projected annual figure, compared with 50.8 percent in the first half of 2001; revenue collection from excise duties, customs duties and income tax declined markedly; better performance was recorded only for VAT collection, which ran at 59.7 percent of the full-year target.

Higher surplus of local budgets ...

Similar to the previous year, in the first half of 2002 significant amounts out of VAT and income tax revenues were transferred from the government budget to local authorities with a view to providing financial support for decentralisation of some expenditures (such as primary and secondary education, nurseries and local centres for agricultural consulting, subsidies for heating). Social allowances in accordance with the minimum guaranteed income scheme added to the aforementioned expenditures. Delay in appropriation of these expenditures allowed local government budgets to record a surplus of ROL 3,731.3 billion (0.25 percent of GDP, compared with 0.18 percent in the first half of 2001).

... and widening of the social security budget deficit

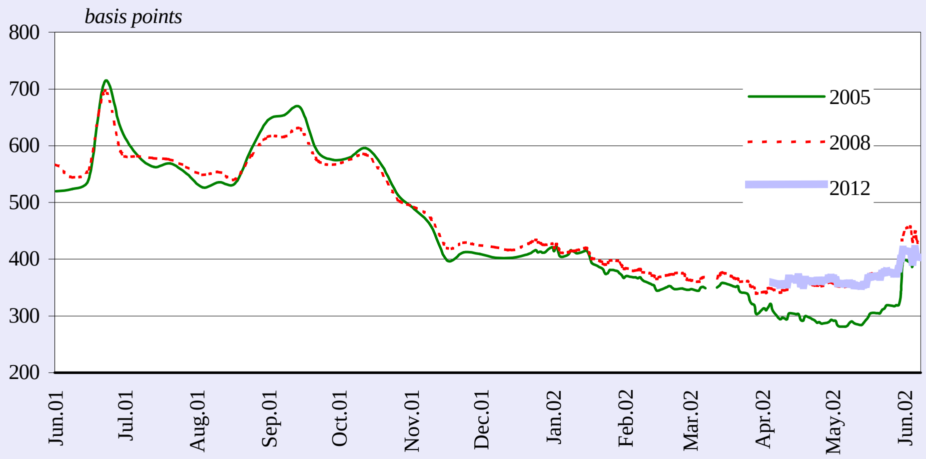
Although social security budget was expected to run a full-year surplus, at the end of June 2002 this budget exhibited a deficit of ROL 5,583.2 billion (0.38 percent of GDP), exceeding that recorded in the same year-earlier period. As a matter of fact, social security budget posted deficits in every month of the period under review, with a record high established in May (ROL 1,451.25 billion). This development was due to higher expenditures needed for the re-correlation and indexation of pensions (in March and June) and of other social allowances, on the one hand, and to the weak performance in collection of social contributions (39.7 percent of the figure projected), on the other.

Narrower deficit of consolidated general government budget

During the first six months of 2002, the deficit of the consolidated general government budget amounted to ROL 17,862 billion[10], accounting for 1.2 percent of GDP and 40.1 percent of the projected 2002 fiscal deficit; these figures show an improved budget performance compared with the same period of 2001 when the deficit accounted for 1.5 percent of GDP (given a target of 3.7 percent of GDP for 2001). Thus, the deficits of the government budget and social security budget as well as the negative balance (due to repayments) of loans to some ministries and of the agriculture development fund were partly offset by surpluses recorded by local budgets and by the six extrabudgetary funds, including the budget of the Authority for Privatisation and Management of State Ownership. Excluding the interest payments on public debt from the deficit registered in the first six months of 2002, the public sector displayed a primary surplus of 0.4 percent of GDP (0.3 percent in the same period of 2001), while the target for the year as a whole was 0.6 percent of GDP.

[9] As a result of expenditure cutbacks in education, social assistance and economic activities, public spending in the first half of 2002 accounted for only 44 percent of the projected annual figure, compared with 50.9 percent in the same 2001 period.
[10] The deficit was adjusted by deduction of the value of borrowings and repayments by each item of budgetary expenditures.

Spread between Romania's Eurobonds vs. Bunds



Note: Romania '05 was 660 bps over Bunds at launch and 402 bps on 28 June '02
Romania '08 was 592 bps over Bunds at launch and 427 bps on 28 June '02
Romania '12 was 365 bps over Bunds at launch and 402 bps on 28 June '02

Source: Reuters, Bloomberg

The tax burden (the ratio of tax revenues to GDP) was 12.9 percent at mid-2002, remaining unchanged from 2001 H1.

The consolidated budget deficit was covered from both external and domestic resources. Compared with the first half of 2001, when budget deficit was financed mostly from domestic sources (about 58 percent), in the same period of 2002, external sources accounted for about two thirds of total funds; external funds came from international institutions involved in projects co-financing and from funds raised following the Eurobond issues launched on the international capital markets. The improved investor sentiment paved the way for a ten-year Eurobond issue, with an 8.5 percent coupon (down more than 2 percentage points from the previous Eurobond issue). Part of funds raised (in amount of EUR 700 million) was used to repay external debt, while significant amounts were channelled into the Ministry of Public Finance foreign exchange account.

Increase in the share of non-bank sector in deficit financing from domestic sources

Resources supplied by domestic investors financed more than 32 percent of the consolidated general government deficit. The non-bank sector provided the bulk of fresh resources; both natural and legal entities increased their financial support to the public sector by purchasing new government securities in local currency in excess of ROL 10,000 billion. On the other hand, in the first half of the year, banks reduced their exposure to the public authority by almost ROL 500 billion.

The Ministry of Public Finance kept issuing 6-month Treasury certificates for households; 3-month issues were discontinued in June. The interest rate on Treasury certificates entered a downward path, falling from 35.1 percent to 27.4 percent for 3-month issues and from 35 percent to 26 percent for 6-month issues.

The Treasury certificate issues for banks and their clients contracted both in number and volume. During the reviewed period, 3-, 6- and 12- month Treasury certificates in local currency exceeding ROL 30,000 billion were issued; for the first time, the Ministry of Public Finance issued 24-month government securities in an attempt to consolidate the domestic public debt.

In order to round off its resources in domestic currency, the Ministry of Public Finance floated two issues of forex-denominated government securities in H1 2002, one for households and the other for banks and their clients, legal entities. The funds raised equalled USD 305.9 million, down about USD 14 million as compared to the volume of forex-denominated government securities maturing during this period. The volume of government securities issued in the first half of 2002 for restructuring of the banking system following the measures taken in 1999[11] dropped markedly, with impaired assets worth USD 8.6 million being taken over by the public debt (versus USD 20.6 million in H1 2001).

Domestic public debt...

At end-June, domestic public debt[12] added up to ROL 112,506 billion while actual public debt (which excludes bridging from the State Treasury) amounted to ROL 87,636 billion.

... and its composition

As compared to end-2001, domestic public debt composition experienced some changes. Government borrowings destined to financing and refinancing of public debt, whose share rose by more than 20 percentage points (from 65 percent to 86 percent) held the largest share in the government's financial obligations; during the reviewed period, bridge loans from government accounts, which had made up 18 percent in the similar period of the prior year, were no longer resorted to, and the share of government loans granted pursuant to special pieces of legislation fell from 17 percent to 14 percent.

2.4. Labour force

2.4.1. Employment and unemployment

Constraints in analysing labour market conditions in H1 2002

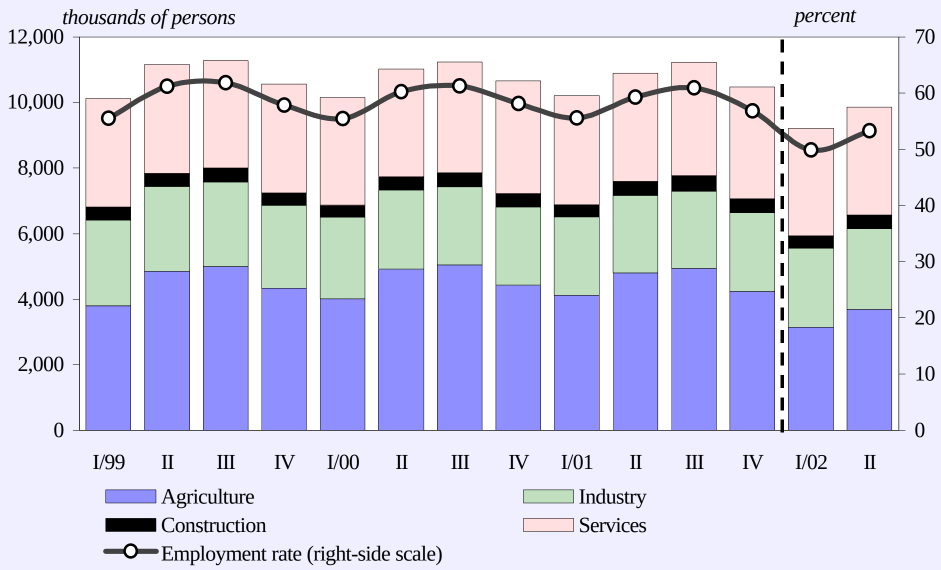
Labour market analysis focuses on the employment rate and unemployment developments in order to assess the inflationary pressures exerted by both wage costs and final consumption. Labour market developments are best illustrated by data provided by the AMIGO survey, but the changes following the revision, starting 2002, of definitions and scope of main indicators do not allow the assessment of labour market conditions in H1 2002 versus H1 2001. These constraints only enable a static analysis of labour market indicators in H1 2002[13]:

– activity rate of population aged 15 years and over (percentage ratio between labour force and population aged 15 years and over) was 56.7 percent, up 1.1 percentage points above the average in CEFTA countries;

[11] Bancorex merger through absorption with BCR.
[12] Defined based on Art. 1, para. 3 of Law No. 81/1999 – Public Debt Act.
[13] Based on the AMIGO survey, Q1 and Q2 2002 (NIS) and CESTAT No. 2/2002 (NIS).

– the employed were estimated at 9,536 thousand persons, of which 34.4 percent in the services sector, 35.8 percent in agriculture, 25.6 percent in industry and 4.2 percent in construction;

Employment by Sector and Employment Rate *)



) Employed / Working age population x100

Source: National Institute of Statistics

– ILO employees accounted for 62.3 percent of total employed and were 35.9 percent more than the number of employees reported by employers over the same period (according to monthly reports forwarded by companies to the NIS);

– ILO unemployment rate[14] reached 9 percent;

– long-term unemployment was still prevalent: average unemployment was 20.5 months, and 51.9 percent of the jobless people were looking for a job for at least 12 months;

– only 35.2 percent of ILO unemployed were registered with the Employment and Vocational Training Agency (EVTA);

– out of the persons declaring to be registered with EVTA, 17.8 percent were gainfully employed.

In the absence of comparable employment data, the only information available to use in analysing the labour market dynamics is that on recorded employment, recorded unemployment and vacancies. Against this background, the different definitions of the scope of the respective indicators, which lead to contradictory interpretations of their development, render difficult reaching a conclusion regarding labour market conditions in H1 2002 – relaxation or tightening. More specifically:

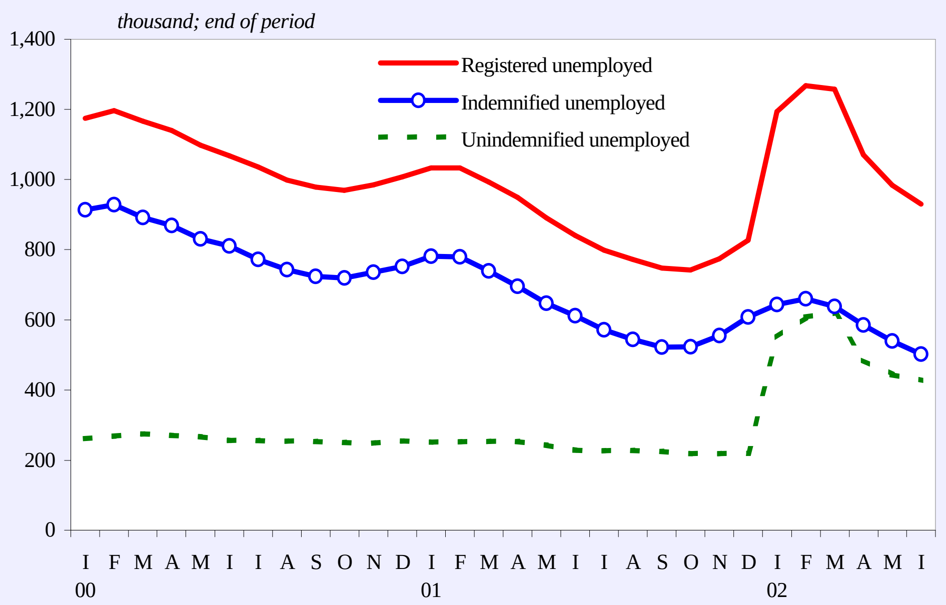
[14] Based on criteria applied by the International Labour Office (ILO).

– previous analyses showed that the indicator "number of employees in the economy" underestimates the volume of wage earners (the number of employees provided by the AMIGO survey is about one third higher than the staff numbers reported by employers). The reasons behind this development are the existence of the informal economy and the large number of persons that are gainfully employed but are recorded as jobless with EVTA;

– the number of registered unemployed was subject, during the period under review, to some incidental factors pertaining to enforcement of Law No. 416/2001 on the guaranteed minimum income. As social security benefit applications need to be backed by papers certifying a monthly income lower than the minimum guaranteed one, quite a number of people requested to be registered with EVTAs as unindemnified unemployed, without actually meeting the primary condition, i.e. looking for a job. In these conditions, unemployment rate was raised artificially from 8.6 percent in December 2001 to 13.2 percent in February 2002. Subsequently, this influence alleviated as the persons in question no longer submitted social security benefit applications and, therefore, were removed from EVTA records. As a result, unemployment rate diminished gradually to 9.6 percent at end-June 2002;

– the number of indemnified unemployed – a more appropriate indicator to measure the labour supply across the economy than the total number of unemployed – was affected by the enforcement, in March 2002, of Law No. 76 on the unemployment insurance system and the boosting of employment. Pursuant to the new provisions, the duration of unemployment benefit is reduced to at most 12 months, according to the period the recipient paid contributions to the social security budget, which entailed the contraction in the number of indemnified unemployed as the period to grant unemployment benefit stipulated by the prior law (Law No. 1/1991, as republished and amended) expired.

Unemployment



Source: National Institute of Statistics

The ratio between indemnified unemployed and the number of vacancies (up from 26:1 in H1 2001 to 30:1 in the reviewed period), used as a yardstick for determining the gap between supply of and demand for labour force, reveals the easing of labour market conditions[15]. Apparently, this approach is also backed by the cut in the number of employees in the economy by 108.4 thousand on average, but the lay-offs following restructuring of energy, metallurgy, machinery and chemical products sectors account for this change only in part. Other influencing factors were: (i) the rise in the number of pensioners (by 80 thousand); (ii) stepped-up export of labour[16], and (iii) proliferation of underground economy (which might explain the contraction of the number of wage earners in trade and construction, although the latter saw production gains). As a result of divergent developments in the registered number of employees and that of retirees, dependency ratio[17] moved up from 1,568 persons in H1 2001 to 1,579 persons in H1 2002.

Measures to fight unemployment

A completely different picture, namely the tightening of labour market, indicates the 17.9 percent drop in the number of indemnified unemployed (June 2002 versus June 2001). However, for the abovementioned reasons, the respective change cannot be fully ascribed to an improved absorption capacity of the economy. Even though data do not allow separation of the two influences, the favourable impact of measures to fight unemployment stipulated in Law No. 76/2002 – organisation of training/retraining courses; providing counselling and support for free lancers and for starting up a business; providing incentives for employers, by granting direct subsidies or tax incentives, for creating jobs and hiring unemployed; soft loans for small- and medium-sized enterprises to create openings – cannot be overlooked.

Under the National Programme for Increasing Employment, the most effective measures where those concerning intermediation activities (direct contacts of the representatives of territorial employment agencies with companies, by regular on-site visits to identify openings and reduce the period of time between their identification and the hiring, organisation of employment exchanges, etc.), achievements exceeding several times the number of openings to be filled in via these activities.

Persistent rigidity of the labour market

Nevertheless, EVTA detects some rigidities still plaguing the labour market: (i) the conservative approach of unemployed older than 45 as regards retraining and changing jobs; (ii) companies' demand that youths should already have experience in the respective fields of activity; (iii) the wage policy pursued by many employers who pay low wages (due to high taxation), thereby encouraging the informal labour market; (iv) the differences between the capacity of geographical areas to absorb labour force, depending on the social and economic development of the region (the highest unemployment rates prevail in the north-eastern and south-eastern regions of Romania).

[15] Assessment of labour market conditions is made from the standpoint of employers (Jeffrey D. Sachs and Felipe Larrian B., "Macroeconomics in the Global Economy", Prentice Hall, 1993, p. 448).

[16] The Labour Migration Office (LMO), established at end-2001, carries out the recruitment and distribution of labour force based on bilateral agreements concluded between Romania and Germany, Spain, Switzerland, Hungary, and Luxembourg as well as on the protocol signed by the LMO and Contractors and Builders Association in Israel, which enable more than 18,000 persons per year to work abroad.

[17] The number of pensioners and unemployed claimants per 1,000 taxpaying employees.

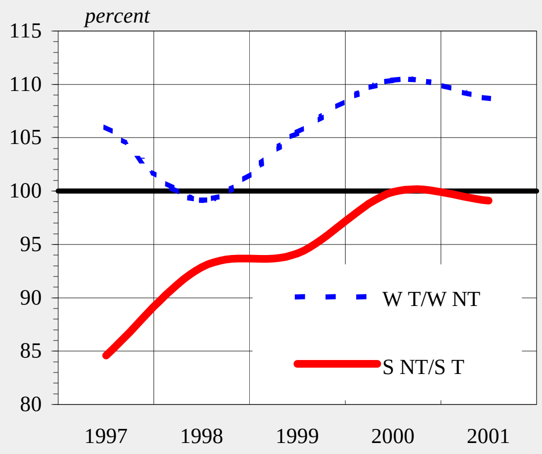
THE BALASSA-SAMUELSON EFFECT IN ROMANIA

In the process of convergence towards industrialised countries and integration in the international trade flows, emerging economies have experienced, in the tradables sector (T), a productivity growth rate higher than that recorded in the non-tradables sector (NT)*. This development is spurred by international competition and the inflows of capital and modern technologies generated by foreign investment in capital-intensive industries. As a stepped-up productivity generally entails wage hikes, wages in T sector will tend to move up faster than wages in NT sector. The Balassa-Samuelson (BS) effect hinges on the hypothesis that labour market will face pressures towards leveling wage earnings in the two economic sectors (or towards maintaining the relative difference between them).

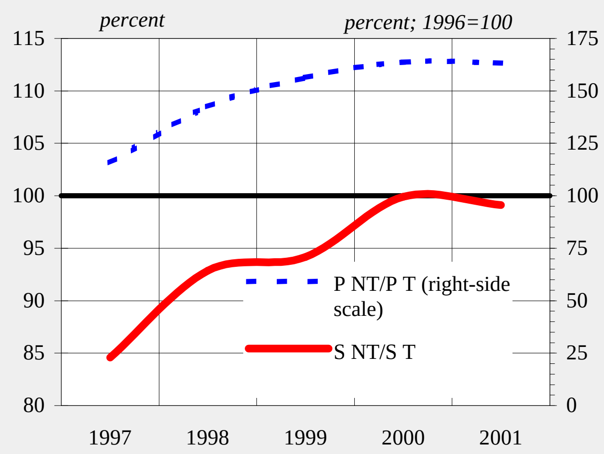
Amid lower productivity gains, NT sector can withstand these pressures only by including additional wage costs in prices, so that prices of non-tradables rise faster than prices of tradables. The general level of prices economy-wide will grow at a faster pace in transition countries than in developed ones, inducing a real appreciation of the exchange rate.

Many studies focusing on the empirical assessment of the BS effect use data on industry and services to approximate developments in T and NT sectors. Pursuant to this approach, in Romania, statistical data covering the 1997-2001 period substantiate the two hypotheses underlying the BS effect: (i) existence of a productivity differential benefiting T sector and (ii) the inter-sectoral trend of wages to become equal.

Relative Productivity (W) and Gross Nominal Wages (S)



Relative Gross Nominal Wages (S) and Prices (P)



Source: National Institute of Statistics, NBR calculations

Developments of prices for industrial goods and services, calculated based on gross value added deflators highlight the persistence of stronger inflationary pressures in NT sector as compared to T sector. This phenomenon gained in strength during 1997-1999, when gross wages in NT sector recuperated more than two thirds of the gap that separated them from wages in T sector (which had exceeded 22 percent in 1996). In the 2000-2001 period, the inter-sectoral wage ratio stabilised at 1:1, which caused the NT/T inflation differential to narrow.

Mention should be made that assessment of the BS effect is difficult to make both in the case of Romania and the other CEE countries as the inflationary pressures in the NT sector are partly caused by incomplete structural reforms and the liberalisation of public utility prices.

In the coming years, productivity gains in T sector are expected to consolidate; this is vital for the achievement of real convergence with EU countries, which will allow the BS effect to be manifest. Thus, concurrently with the cut in structural inflation, the larger price increases in NT sector compared to those in T sector will maintain an inflation differential versus the EU, translating into the real appreciation of the exchange rate.

* Tradables are subject to external competition, unlike non-tradables that can only be traded in the country of origin (Jeffrey D. Sachs and Felipe Larrain B., "Macroeconomics in the Global Economy", Prentice Hall, 1993, p. 657).

2.4.2. Incomes

2.4.2.1. Wages

Wage growth rate slowed down

The rise in net real wage in H1 2002 was 4.3 percent against H1 2001, down 1.6 percentage points versus H1 2001. Apart from the slowdown in wage growth rate in line with labour productivity development, it is also noteworthy that the former indicator stood below the GDP growth rate.

The wage increase was attributable to the good performance in the key economic sectors in 2001 and to the favourable prospects for 2002, as well as to the measures taken by the authorities to preserve the purchasing power.

Net Real Wage Earnings

percentage change from same year-earlier period

	H1 2001	H1 2002
Whole economy	**5.9**	**4.3**
Agriculture	8.5	2.0
Industry	6.0	1.7
of which:		
Mining	11.0	5.4
Manufacturing	6.2	1.1
Energy	3.6	5.8
Construction	0.9	7.9
Services*	6.9	6.0
of which:		
Public administration	15.7	6.9
Education	8.9	3.4
Healthcare	13.4	1.0

*By weighting to the number of employees in: transport and warehousing, postal services and telecommunications, trade, hotels and restaurants, financial and banking activity, real estate, public administration, education and healthcare.

Wage policy measures

The wage policy pursued by the Government focused on containing wage increases in the public sector at 22 percent in 2002, based on the anticipated annual inflation rate; wages were to be increased in two stages (by 8 percent as of 1 January 2002 and 12 percent as of 1 October 2002) concurrently with monitoring the development of wages of employees in 86 state-owned enterprises and the setting of quarterly wage ceilings[18]. Moreover, as of 1 March 2002, gross minimum wage economy-wide went up from ROL 1,400,000 to ROL 1,750,000 per month.

Wage earnings by economic sector:

services sector, ...

Against this background, net real wage moved up in every economic sector except trade and tourism. In H1 2001, the steepest wage increases were detected in the budgetary sector, mining and trade but in the reviewed period the development of telecommunications and financial intermediation services entailed sharp wage hikes of as much as 19.6 percent in real terms.

[18] Government Emergency Ordinance No. 187/20 December 2002 and Government Decision No. 344/11 April 2002.

... budgetary sector, ...

The authorities' concern to pursue a tight wage policy resulted in the considerable slowdown in the growth rate of budgetary sector wages, particularly education and health care. The real 6.9 percent increase in wage earnings of public administration employees was generated mainly by the "13th-month" salary paid in January 2002 instead of December 2001 (unlike 2001, when such influences[19] did not occur); leaving aside these influences, only a minor positive change can be detected in public administration.

... régies autonomes and other state-owned enterprises …

Strengthening of financial discipline in the case of state-owned enterprises, *régies autonomes* and national companies by correlating wage increases with the fulfilment of performance criteria and the productivity growth rate (in compliance with Government Emergency Ordinance No. 79/2001) further proved to be hard to achieve. The sectors in which these enterprises and companies held the largest share (mining, energy, transport and warehousing) posted net wage increases in the range of 1.1 percentage points and 3.8 percentage points above the economy-wide average.

... industry.

However, in terms of cost-push inflation, it is to be noted the progress made in energy sector restructuring in the period under consideration as compared to H1 2001, as reflected by the 4 percent rise in labour productivity[20] and by the sharp decline in the unit labour cost[21] (by 16.2 percent), due to staff retrenchment, in contrast with mining, where the wage hike accompanied the decrease in labour force efficiency indicators.

In industry, which accounts for almost 42 percent of total employees, the net wage purchasing power inched up only 1.7 percent, 1.9 percentage points below the productivity growth rate, following the external competition-induced pressures on manufacturing. Although a balance was struck between the development in wage costs and productivity (unit labour cost was down 1.3 percent), a cautious wage policy is further required given that productivity gains were by far lower than in the prior year.

2.4.2.2. Pensions

Governmental authorities decided to implement a realignment scheme for pensions of public sector employees as of 1 January 2002, in six stages, on a half-yearly basis during 2002-2004 and to subject pensions to indexation by 85 percent of the anticipated growth of consumer price index for 2002[22].

Slight real increase of average pension

The additional realignment and quarterly indexation of pensions induced a real 2.5 percent rise in the average monthly pension during H1 2002 versus H1 2001. Although the retired-to-employees ratio remains high (1.46:1) the hike of average pension had a small inflationary impact as it represents about one third of the net average wage.

[19] The 13th-month salary was paid in December 2000.
[20] Calculated as a ratio between industrial output index and the index of employees in industry.
[21] Calculated as a ratio between gross real wage index and labour productivity index.
[22] Government Decision No. 1315/27 December 2001 and Government Decision No. 1299/ 20 December 2001.

2.4.2.3. Unemployment benefit and other welfare allowances

Higher incomes of the unemployed…

In the first half of 2002, purchasing power of incomes of the unemployed[23] expanded by 18.5 percent year on year, due to the change in the composition of indemnified unemployed (the share of unemployment benefit recipients moved up 5.6 percentage points to the detriment of the other two categories of indemnified unemployed) and to the expansion of all categories of unemployment benefits. As a result, unemployment benefit, welfare allowance and resettlement allowance grew in real terms by 13.3 percent, 10.9 percent and 9.4 percent respectively.

Starting March 2002, the calculation method of unemployment benefit was modified by Law No. 76/2002, which sets the unemployment benefit as a monthly fixed amount that is not subject to taxation, representing 75 percent of the gross minimum wage. Prior to March 2002, unemployment benefit was calculated by category of unemployed and years of service, taking into account the claimant's previous indexed gross minimum wage, net of tax.

... and of other vulnerable social groups

Other measures addressing social groups focused on fighting poverty by granting welfare allowances to secure the minimum guaranteed income (as from 1 January 2002), heating allowances during the cold season and increasing the child benefit.

2.4.2.4. Other incomes

External private transfers gained ground

Over the past few years, with the numbers of nationals working abroad on the rise, transfers of non-residents to residents became a significant income source for individuals. In H1 2002, these transfers totalled USD 629 million, up 26.3 percent from the same year earlier period.

2.5. External environment

2.5.1. External demand

The upturn witnessed by the main world economies – the USA and the euro zone – at end-2001 and in early 2002 generated optimistic prospects as regards the international economic environment in 2002, which were not, however, substantiated by subsequent developments.

Slow economic recovery in the euro zone...

The economic growth rates recorded in the euro-zone in the first two quarters of 2002 were almost similar (0.4 percent and 0.3 percent from the preceding quarter), but the main components of demand that bolstered this development made different contributions. Thus, in the first quarter, net exports (due chiefly to the decline in imports) and government consumption were the key factors of growth, but in the second quarter, private consumption took hold, stimulated by the more favourable price developments. As for H2 2002, the ECB analysts anticipate external environment worsening and adverse developments on the financial markets and deem economic upturn in the euro zone unlikely, resumption of growth rates consistent with output potential being expected no sooner than 2003.

[23] Average weighted to the number of indemnified unemployed.

... mainly as a result of economic performance of Germany and Italy

The delay in economic upswing in the euro zone is caused chiefly by the poor economic performance of Germany and Italy. In both countries, forecasts of GDP growth in 2002 were revised downwards – to 0.75 percent in Germany (from 1.4 percent) and to 0.6 percent in Italy (from 1.3 percent). Economic growth forecasts for 2003 were also adjusted: 1.5 percent for Germany and 2.3 percent for Italy from the original 2.5 percent and 2.9 percent respectively.

Albeit the EU is Romania's key trade partner, the slow recovery of Western European economies – particularly Italy and Germany, which account for about 60 percent of Romanian exports to this trade bloc – does not appear to affect exports to these countries (+10.8 percent in the reviewed period versus H1 2001), also due to the depreciation of the ROL against the EUR.

Downward revision of 2002 economic growth forecasts in the USA

After a better-than-expected outcome in the first quarter (5 percent in annualised terms versus Q4 2001), the growth rate in the USA declined to only 1.3 percent in the second quarter, which entailed the downward revision of forecast for 2002. The respondents participating in the August 2002 survey conducted by the Federal Reserve Bank of Philadelphia foresaw a GDP growth rate of 2.4 percent and 2.6 percent in the subsequently two quarters (0.8 of a percentage point below the forecast at the outset of 2002) and of 2.3 percent in 2002 (0.4 of a percentage point below initial expectations). The reasons behind the slowdown in economic expansion in the USA were the curtailment of investment, generated by the worsening investment environment and the drop in both private and government consumption. Moreover, although the USD depreciated against the main currencies, imports advanced at a faster pace than exports, which fuelled fears surrounding the size of current account deficit. For the second half of 2002, non-durables consumption is expected to decline further and durables consumption is seen to improve slightly amid low interest rates.

Steady GDP growth in accession countries

The economies of accession countries were more dynamic, with growth rates ranging from 2.5 percent and 6.9 percent in the first two quarters of 2002. Poland makes an exception, the GDP growth rate in the first half of the year (0.2 percent in Q1 and 0.5 percent in Q2[24]) illustrating the slowdown in economic activity.

2.5.2. Foreign trade

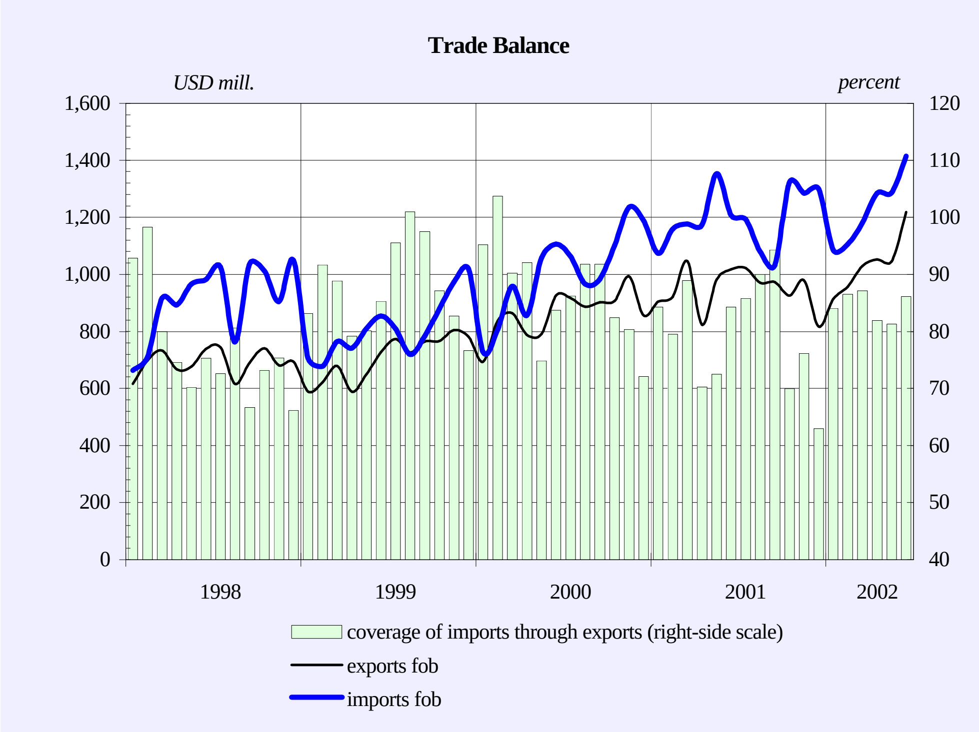
Narrowing trade deficit

In the first half of 2002, as compared to the same year-earlier period, the external sector experienced an adjustment process, backed by the restoration of a favourable differential between the rate of increase of exports and that of imports (9.1 percent and 3.1 percent respectively), that translated into the 20.9 percent drop in trade deficit and the 4.7 percentage point growth in the coverage of imports through exports.

Increase in exports boosted by...

Receipts from exports (USD 6,217 million) derived from definitive sales (in a proportion of 42.5 percent versus 40.1 percent in H1 2001), and domestic processing of some temporarily imported goods (57.3 percent versus 59.6 percent in H1 2001).

[24] Compared to the corresponding period of 2001.



Expansion of exports was boosted mainly by domestic factors during H1 2002. As far as exports are concerned, the shift towards less energy-intensive activities – bolstered by export credits with partially subsidised interest rate and granting of guarantees for complex products with long manufacturing cycle – caused the rise in the share of processed goods with higher value added. Increased specialisation in sectors in which Romania has a considerable comparative advantage (ready-made clothes, footwear, and furniture) and the stepped-up manufacturing output augmented the supply for export in the reviewed period.

... domestic factors and...

External factors generated the increase in demand on the major export markets and the downtrend in prices. In terms of quantity, exports of electricity and petroleum products moved up 77.3 percent and 27.9 percent on account of higher demand for mineral products of some European countries amid the downtrend in world prices. Strengthening of the EUR as against the USD in May and June prompted producers to supplement exports to the euro-zone.

...external factors

Imports (fob) totalled USD 7,362 million in H1 2002, with definitive imports still accounting for the largest share (65.5 percent) and imports destined to processing and subsequently exported holding a share of 33.2 percent.

Imports and their determinants

The growth of imports in H1 2002 was induced by the removal of customs duties for imports of industrial products from the EU, lower external prices and the larger share of imports of highly processed goods.

Competitiveness indicators followed a downward path in H1 2002 versus the similar period of 2001. The export effort diminished in the period under review, based on estimates, to 18.2 percent from 19.2 percent in H1 2001. As compared to 2000, this indicator gained 1.3 percentage points. The decline from H1 2001 is

Lower export effort and import penetration rate partly attributable to Romania's economic growth and domestic producers switching to the home market, which displayed steeper demand, especially for investment. Against this background, import penetration rate was 2.2 percentage points lower from H1 2001.

COMPETITIVENESS INDICATORS*

	1997	1998	1999	2000	H1 2001	H1 2002
Export effort (%)	13.7	11.8	15.4	16.9	19.2	18.2
Import penetration rate (%)	16.5	15.2	17.2	19.2	22.9	20.7
Difference between export effort and import penetration rate (p.p.)	-2.8	-3.4	-1.8	-2.3	-3.7	-2.5
Coverage of imports by exports (%)	80.5	73.8	85.3	85.4	81.3	84.9

*) NBR calculations based on data released by NIS

Memo items:
export effort=exports/output x100
penetration rate=imports/domestic market x100
domestic market=output+imports-exports
coverage of imports by exports=exports/imports fob x100

2.5.3. Imported inflation

The favourable developments in the oil price on world markets[25] and the inflation rate in the countries counting among Romania's main trading partners had a bearing on domestic prices both directly, by lowering the energy bill and prices of consumer goods imports, and indirectly, by influencing production costs which include the prices of imports of intermediate goods. Depreciation of the ROL versus the EUR had a detrimental impact, rendering imports invoiced in this currency dearer.

Inflation in Romania's key trading partners: the euro-zone...

Inflation rate in the euro-zone was 2.6 percent in Q1 2002 and 2.1 percent in Q2 year on year. The downward trend displayed by this indicator was induced mainly by the drop in the price of energy products and the appreciation of the EUR versus the USD. The respondents in the Survey of Professional Forecasters conducted by the European Central Bank are of the opinion that the rate of increase in prices in the euro-zone will further follow a downward course, and the annual forecasts for 2002 and 2003 are 2.1 percent and 1.8 percent respectively.

According to Eurostat analyses, introduction of the EUR contributed 0.2 of a percentage point at most to the 1.4 percent growth in the general level of prices in H1 2002 versus H2 2001.

...CEFTA countries...

Disinflation trends were also manifest in the other countries seeking EU membership and concerned with nominal convergence. The best-performing countries were the Czech Republic and Poland, which posted inflation rates close

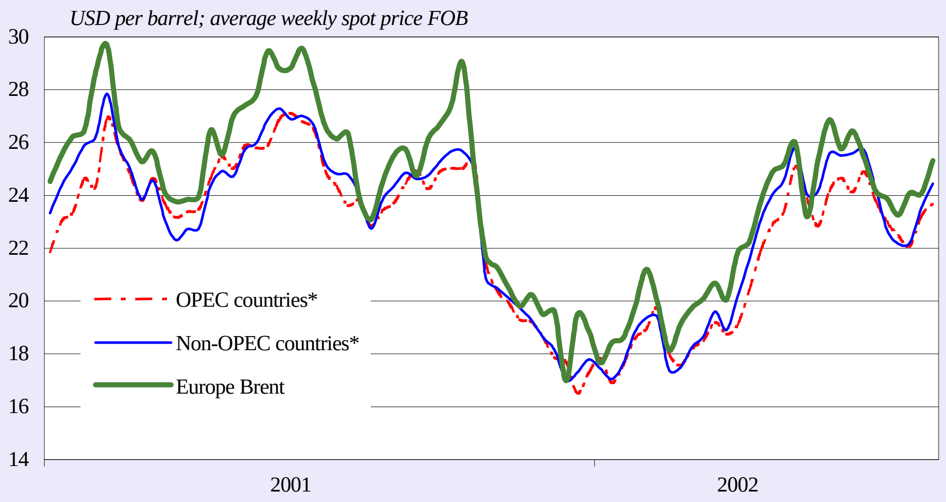
[25] Although the oil price set by OPEC countries rose from USD 19 per barrel to USD 24 per barrel in January-June 2002, the average for H1 2002 was about 13 percent below the level recorded in H1 2001.

to those in the euro-zone, i.e. 2.3 percent and 2.2 percent, in Q2 2002 versus Q2 2001. The highest inflation rate was recorded in Slovenia, with a 7.5 percent inflation rate in Q2 2002.

... and the USA

In the USA, the general level of prices picked up 2.2 percent in Q2 2002 year on year, after rising only 1.2 percent in Q1. The faster increase in prices was entailed mainly by the prices of energy products and services, which moved up 2.5 percent. Forecasts put annual inflation rates for 2002 and 2003 at 2.2 percent and 2.5 percent respectively.

World Crude Oil Prices



**) Averages weighted by estimated export volume*

Source: website of the US Energy Department (www.eia.doe.gov)

Development of the oil price…

Although the oil price followed an uptrend in the first half of 2002, it remained within the USD 22-USD 28 per barrel target range set by OPEC, thereby limiting the extent of external shocks induced by means of imported energy products. Expectations of stronger demand for oil in the latter half of the year (as a result of the Iraq crisis and further growth of world's leading economies) will put upward pressure on prices for energy products. Moreover, potentially resurgent inflation prompted by steeper oil prices would entail not only cost-push effects but also a cost-price inflationary spiral sending domestic prices higher in the medium run.

… and the USD/EUR exchange rate

In Q1 2002, the upbeat expectations on a rebound in the US economy outpacing that of the euro-zone delayed the strengthening of the euro against the US dollar, leaving the exchange rate broadly unchanged. Against the backdrop of heightening uncertainties about corporate governance and rising operators' concern over the staggering current account deficit in the USA, the next months saw the US dollar weakening on international financial markets. The exchange rate of the euro rose from an average of USD 0.886 in April to 0.955 in June 2002.

2.5.4. Exchange rate

Exchange rate policy in the first half of 2002 aimed to strike a balance between using this parameter as a stabiliser of inflation expectations and preserving external competitiveness. In view of substantial productivity gains in the manufacturing sector (Balassa-Samuelson effect), real appreciation of the domestic currency versus the main currencies did not affect export dynamics in the first half of 2002.

Real appreciation of ROL versus USD

Against the US dollar, the Romanian currency strengthened in real terms[26] by 1.4 percent in June 2002 against December 2001 and by 4.2 percent in H1 2002 compared to H1 2001. By contrast, against the euro, it eased by a real 3.4 percent in June 2002 versus December 2001, but posted an average appreciation of 5.5 percent in H1 2002 compared to H1 2001[27]. The developments in the ROL exchange rate over the last few months of the period under review can be traced to the US dollar's weakening against other main currencies (the euro, the yen, the pound sterling) as a result of several factors acting jointly. Among these factors were the widening current account deficit in the USA; expectations of a federal budget deficit; an anticipated full-year economic growth lagging behind original estimates; and the uncertainties surrounding the quality of corporate governance and the profits of US businesses.

Real appreciation of the ROL to the USD should have given USD-denominated imports a boost. In year-on-year comparison, the weight of USD-settled imports actually decreased from 35.1 percent in H1 2001 to 31.1 percent in H1 2002, due mainly to lower world prices for energy products, the settlement of which is made overwhelmingly in US dollars.

Over the reported period, although the direction in foreign trade grew more flexible towards the developments in external purchasing power of the domestic currency, elasticity was further weak, and the incomes yielded and costs incurred by traders were affected by their poor capacity of gaining fast access to more profitable markets.

Inflation expectations on the slide

Given that the ROL/USD exchange rate is a yardstick for prices economy-wide (in fact, most of the administered prices are subject to regular adjustment geared to this parameter[28]), real appreciation of the domestic currency helped cushion inflation expectations in the first half of 2002, thereby underpinning reinforcement of disinflation.

[26] Including the inflation differential against the USA.

[27] Versus the implicit currency basket comprising the EUR (60 percent) and the USD (40 percent), the domestic currency eased by a real 2.1 percent in June 2002 compared to December 2001 (including the inflation differential against the USA and the euro-zone).

[28] Prices for electricity, heating and medicines are geared to the ROL/USD exchange rate while prices for natural gas, telephone and postal services are subject to adjustment contingent upon both the inflation rate and the exchange rate.

3. MONETARY POLICY

3.1. General features

The 2002 economic programme of the Romanian government envisaged that monetary policy should enjoy the considerable support of other macroeconomic policies. Specifically, inflationary pressures of non-monetary origin would have to be curbed and the potential conflict between macroeconomic objectives would have to be dampened.

Contribution of macroeconomic policies to disinflation

From this perspective, the first half of 2002 saw improved consistency in the implementation of the authorities' economic programme, with the rather tight fiscal stance and firmer control over wages pushing inflation down. By contrast, further adjustment in some controlled prices, scant progress in restructuring at company level as well as the external shock of consistent fast appreciation of the euro against the US dollar put renewed pressure on some prices. Nonetheless, the furtherance of disinflationary policies materialised in higher-than-expected deceleration of inflation rate, below that corresponding to the full-year 22 percent target.

Reduction in central bank rates

Starting in March 2002, the National Bank of Romania proceeded to cautiously cut interest rates on sterilisation operations in order to confirm the downward course in inflation and to bolster public confidence in the sustainability of such a trend. In addition, the lowering of interest rates was aimed at boosting lending, which had been resumed in 2001, and thus at fostering economic growth. As a result of lower resort by the Ministry of Public Finance to domestic resources amid substantial foreign financing in H1 2002, the need to correlate the rapidly decreasing yields on Treasury certificates with the central bank's rates was another factor underlying the monetary authority's move.

The central bank's gradualist approach to rate cutting was warranted by the need to ward off a potential resurgence in inflationary pressures and inflation expectations. Such a situation would have required monetary policy to revert to a tight stance, ending up in renewed stop-and-go pattern. Thus, even though nominal interest rates on deposits with the NBR neared the all-time low[29], their real level stayed in positive territory; however, the average real interest rate on NBR operations – calculated *ex-post* – fell somewhat compared to H1 2001.

NBR stepped up its interventions in the foreign exchange market

During the last months of H1 2002, the National Bank of Romania stepped up its interventions in the currency market. Thus, the central bank sought to prevent the potential unfavourable effects on the competitiveness of exports settled in US dollars should the domestic currency continue to post a nominal appreciation against the US dollar.

In H1 2002, the monetary policy consolidated its disinflationary stance, due to the fact that the objective of price stability took precedence over that of upholding

[29] 28.04 percent in April 2000 (average monthly interest rate on deposits taken by the NBR).

external sector performance and to the lower fiscal dominance of the Ministry of Public Finance on the domestic financial market.

3.2. Conditions surrounding monetary policy implementation

Oversupply on foreign exchange market

The factors that regularly weigh on monetary policy conduct continued to make their presence felt in H1 2002 too, the conditions surrounding the foreign exchange market having the strongest impact. The market featured foreign currency oversupply, accounted for by both banks and their clients, except for two months, namely January and May. The central bank reduced the frequency of its interventions in the currency market, but increased their consistency, in an effort to stem too sharp a real – and at times even nominal – appreciation of the ROL against the USD, on the one hand, and to induce some unpredictability to the very short-term developments in the exchange rate (meant to deter speculative capital inflows), on the other. During the first half of 2002, the National Bank of Romania strengthened its buyer position, as net purchases ran at USD 840.1 million (compared to USD 524.7 million in the over-year-ago period).

Treasury operations supported monetary control

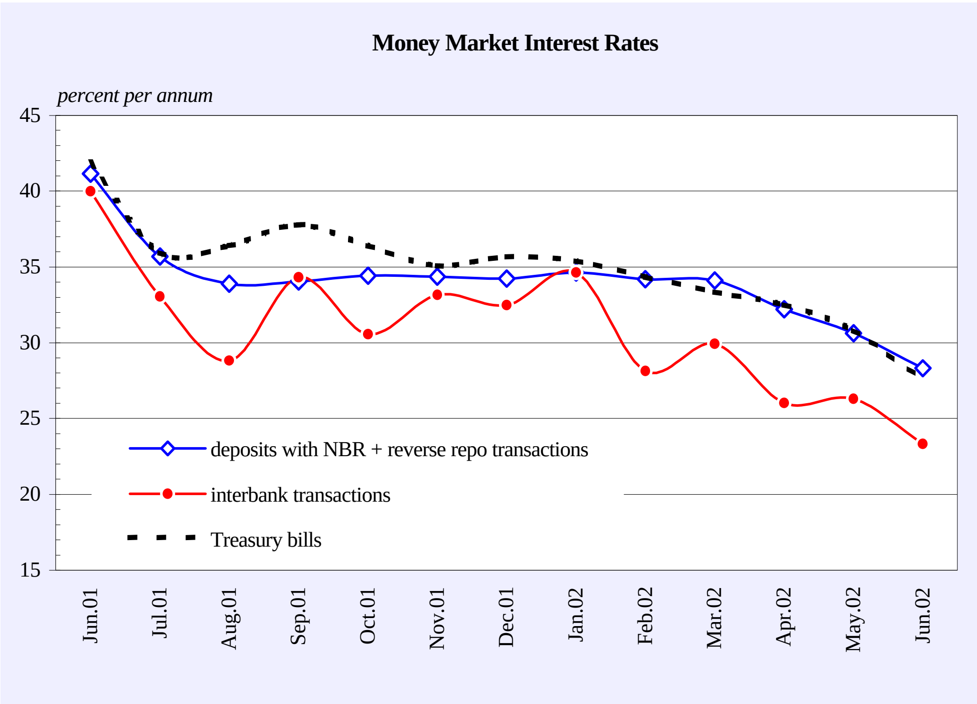
The deficit financing and public debt refinancing strategy was another factor with a bearing on monetary policy conduct. Its impact on the monetary control was favourable overall, due mainly to the ROL absorptions occasioned by external and forex-denominated domestic public debt repayments (for which the Ministry of Public Finance resorted to part of its foreign exchange deposits) to the tune of 0.7 percent of full-year projected GDP. In addition, the National Bank of Romania was made quarterly coupon payments on the securities held in its portfolio (thereby soaking up ROL 1,384 billion). Conversely, the Treasury made cash injections (usually at the beginning of the latter fortnight) by converting its foreign-exchange holdings into ROL to partly accommodate running expenditures; moreover, the Treasury opted for the partial redemption of the T-bills maturing in February by completely rejecting the bids at four successive auctions.

Lower yields on government securities

The start of a declining trend in interest rates on 3-month Treasury bills (boosted by strong increase in investor demand for government paper amid redemption made by the Treasury and expectations of lower yields on such investments) was followed by the drop in interest rates on NBR’s deposits, with a one-month lag. The ensuing lowering of the average interest rate on newly-issued certificates derived from the alteration in the term structure of the Treasury instruments, which caused their yield curve to undergo a radical change. Higher average maturity of government paper overlapped the already declining trend in interest rates, thereby boosting demand for securities with maturities ranging from 6 months to 24 months. Originally, banks exhibited a great interest in 24-month bonds that were launched starting May 2002 but subsequently their participation in auction sessions was rather insignificant. During the last four months of H1 2002, the average interest rate on 3-month Treasury bills went down, being almost equal to that on 3-month deposits taken by the National Bank of Romania.

Trading on interbank money market built up steam

On the interbank money market, interest rates on interbank transactions hit fresh record lows in response to the signals conveyed by central bank's rate-cutting actions. Moreover, the steeply upward path in quantitative parameters hints at halting the loss in depth that plagued the market in the past few years (the share of market turnover in GDP is estimated to have risen by more than 10 percentage points). The average daily turnover on the bank-to-bank market segment (leaving the National Bank of Romania out of account) saw a steady pick-up, except for the month of February, when a pull-down on demand for reserves was manifest. Behind this stood the joint action of falling central bank rates and the increased resort to longer-term sterilisation operations. In anticipation of further rate-cutting, a process the National Bank of Romania had initiated in March, more and more banks – in their attempt at maximising earnings – took on the liquidity risk of making 3-month deposits with the National Bank of Romania and accommodated their temporary demand for resources in the very short run.



Seasonal and incidental factors affecting liquidity

Efficacy of monetary control was also influenced by the developments in banks' demand for reserves and those in currency outside the NBR. These two factors had both a seasonal nature (volatile demand for reserves in January and February owing to seasonal fluctuations of reserve base; banks' increased bias towards holding excess reserves during the periods of profit tax payment; lower demand for cash in January and higher in April) and an incidental one (the let-up in demand for reserves in February, arising from stepped-up resort to reverse agreements between banks and their customers, and in April as a result of lowering of the required reserve ratio on ROL deposits; fluctuations in cash following indexation of pensions and other welfare payments).

3.3. The mix of monetary policy tools

Contraction in reserve money in real terms

Reserve money[30] dropped by a real 1.7 percent in the first half of 2002 compared with end-2001 following alteration of the required reserve ratio. The effects of adjustment in the level of required reserves left aside, reserve money dynamics in real terms was positive, i.e. a 4.3 percent advance. The increase in central bank's net foreign assets continued to be the driver of money issue, and it was only partly offset by the widening negative balance of net domestic assets of the National Bank of Romania.

With autonomous liquidity factors having, for most of the period under review, a less favourable impact on monetary control, at times the National Bank of Romania could not keep a tight rein on the developments in monetary aggregates. Thus, in the first half of February and the latter half of April, the average balance of banks' holdings in current accounts with the National Bank of Romania departed substantially from the required level of reserves.

The main types of operations the central bank performed in order to have an influence on liquidity were the following:

Net purchases of foreign currency by the NBR

Interventions in the foreign exchange market aimed at precluding the ROL exchange rate from veering off the course viewed as capable of both achieving disinflation and preserving external competitiveness. In the wake of central bank's making net purchases of foreign currency, more than ROL 26,600 billion were injected into the banking system.

Reserve ratios on deposits in both domestic and foreign currency brought at even levels

The change in the required reserve ratio. The development that hallmarked the monetary policy stance in the first half of 2002 was the flat rate applied to required reserves as from 1 April. The required reserve ratio on deposits in ROL was lowered by three percentage points while that on forex deposits was raised by two percentage points. Thus, a 22 percent rate was introduced for both ROL- and foreign-exchange-denominated deposits. The cut in the reserve ratio on deposits in ROL released some ROL 4,000 billion into the system, thus boosting the liquidity surplus, which had to be soaked up through open-market operations.

First, the decision taken by the National Bank of Romania to gradually lower the reserve ratio on deposits in ROL was justified by the need to enhance transparency of monetary policy and get it into line with ECB practices by shifting the focus from administrative tools to market-driven ones. More frequent resort to open-market operations not only clears the way for smoother transmission of monetary policy stimuli but also helps to increase the depth of money market, including the deposit market and the market for government securities. Furthermore, it urges banks to manage their liquidity more efficiently and raises their accountability.

Second, the reduction of the reserve ratio helps banks to cut costs and therefore causes the spread between lending and deposit rates for non-banks to narrow.

[30] Calculated as monthly average. Reserve money was adjusted for failure to comply with required reserves.

Required Reserve Ratio

-percent-

Period	on deposits	
	ROL	foreign exchange
1August 1998- 15 July 1999	15.0	15.0
16 July 1999 – 31 October 1999	20.0	20.0
1 November 1999 – 30 November 1999	25.0	20.0
1 December 1999 – 30 June 2001	30.0	20.0
1 July 2001 – 30 September 2001	27.0	20.0
1 October 2001 – 31 March 2002	25.0	20.0
1 April 2002 – 30 June 2002	22.0	22.0

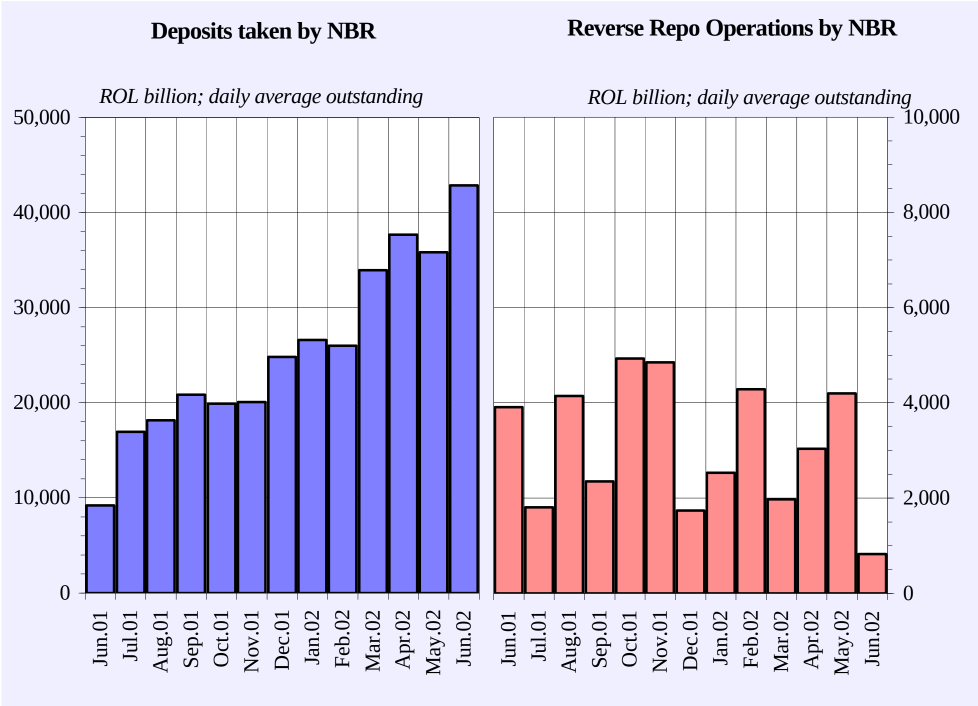
Sterilisation operations on the rise

Open-market operations meant to mop up excess liquidity comprised deposit-taking operations and reverse repo agreements. The increase in NBR's interventions was illustrated by the higher average daily volume of transactions, ranging from ROL 711.8 billion to ROL 1,686.5 billion while the average daily balance of such transactions picked up gradually, from ROL 29,151 billion to ROL 43,671.8 billion. The National Bank of Romania took chiefly 3-month deposits whose share in the average balance of sterilisation operations was running high all through the first six months of 2002 (between 81.5 percent to 94 percent).

Starting in March 2002, yields on sterilisation operations entered a downward path; the highest interest rate accepted on 3-month deposits declined every month in a range from 1.5 percentage points to 2.5 percentage points (individual adjustments ranged from one-half to one percentage point and were performed weekly or fortnightly). Interest rates accepted on sterilisation operations with other maturities were lowered accordingly, and the correlation between interest rates for different maturities stayed put. In H1 2002, the average interest rate on 3-month deposits shed 6.4 percentage points to 28.6 percent, and the average interest rate on sterilisation operations contracted by 5.9 percentage points to 28.3 percent.

Accommodation of temporary liquidity shortfalls

Operations for bridging temporary liquidity requirements. In January 2002, the central bank accommodated on two occasions the temporary liquidity gap engendered by higher-than-expected demand for reserves; as a result, the pressure on interest rates on bank-to-bank transactions was cushioned (at least partly) after having reached a 7-month high. First, the National Bank of Romania provided liquidity to a bank by injecting ROL 1,062 billion through two repo operations with maturity of 6 days and 12 days respectively, and the interest rate averaging 40 percent. Second, in late January, the monetary authority performed a repo agreement at auction; the ROL 1,799 billion deal had a one-week maturity and an average interest rate of 40.3 percent.



Rather frequent resort to deposit facility

Standing facilities. Commercial banks resorted quite frequently (48 times) to the deposit facility of the central bank. Seventeen banks made deposits with the National Bank of Romania in the range of ROL 1 billion and ROL 550 billion, taking the first-half figure to ROL 3,739.6 billion. The deposit facility was most resorted to in May (15 times) and only twice in February and March. The marginal lending facility was resorted to in the first two months of 2002 only, with roughly ROL 440 billion being drawn in January.

3.4. Main monetary developments

Further resumption of financial intermediation

First-half monetary developments underscore the steady trend in the resumption of bank intermediation. Both broad money and the credit to non-government posted faster year-on-year real growth rates, i.e. 1.8 percent and 13.9 percent respectively. Furthermore, non-bank financial instruments, government paper in particular, were increasingly resorted to – as a result, the pseudo-monetary aggregate M2T[31] climbed by a real 3.9 percent. Nonetheless, financial depth of the Romanian economy – M2T or credit to non-government as a proportion of GDP – is still running low.

Broad money posted real growth amid…

M2 advanced by 1.8 percent in real terms compared to year-end 2001, pinpointing the first half-yearly growth over the last six years. The stronger demand for money translated into increases in net foreign assets and credit to non-government. M2 dynamics, which stuck to the upward course ever since early 2001 and was boosted by the increasingly robust saving in ROL, highlights the remonetisation of the economy.

[31] Comprising M2 and the government securities outstanding with non-banks.

… decrease in M1 and …

Demand for money for current transactions was modest January through June 2002, as M1 aggregate dropped by a real 8.4 percent compared with year-end 2001; this development however can be ascribed to the seasonally-induced, extremely high level of demand deposits at the end of 2001. The 1.7 percent real increase in currency outside banks in H1 2002 was offset by the hefty 21 percent curtailment in companies' demand deposits. Demand deposits of individuals stood 28.4 percent higher in real terms, driven partly by the expansion in card operations (up 64.2 percent in nominal terms as against year-end 2001).

… uplift in quasi-money

Quasi-money, the less liquid constituent of broad money, picked up 5 percent in real terms January through June 2002, due in particular to acceleration of saving in ROL.

Saving further on the rise

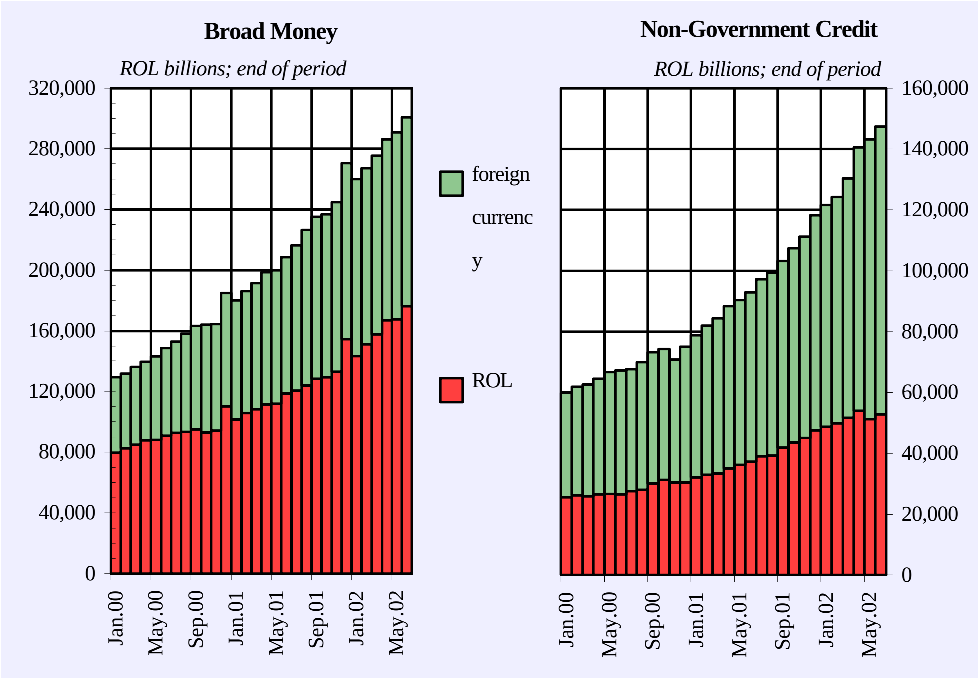
Household savings grew by a real 8.4 percent in H1 2002. It is worth mentioning that the growth was the result of increases in incomes of population (wages, pensions, welfare benefits, subsidies granted to farmers) and higher yields on deposits in domestic currency compared to those in foreign currency. Household ROL-denominated claims on the government, in the form of **government securities**, jumped by a real 13.2 percent in the first half of 2002.

Marked rise in time deposits in ROL…

Companies' time deposits in ROL leapt a remarkable 25.2 percent in real terms. The main drivers of the expansion in time deposits in ROL were the following: faster economic growth and the high level of lending, slower depreciation of the ROL to the USD, combined with fairly high real interest rates in most of the months under consideration. Government securities in ROL outstanding with companies customers raced ahead 43.9 percent in real terms.

… amid yields higher than those on forex deposits

Banks' interest rates applicable to non-bank customers stayed on the downward drift that had begun in early 2001. It was the average interest rates on time deposits that exhibited the steepest decline, standing 4.3 percentage points lower versus year-end 2001. The setback appears to have been spurred by a rather rapid shrinkage of yields on Treasury certificates for individuals, down 5.5 percentage points. Individuals proved sensitive to the gain differentials between the two types of saving tools, choosing mainly to place their money in deposits with banks (households' term deposits in ROL stood 16 percent higher year over year in real terms while the volume of Treasury certificates held by individuals went up 5.5 percent). Over the period, the real interest rate on time deposits (calculated *ex-post* on the basis of 3-month moving average rate of inflation) remained, bar January, in positive territory; starting April however, this rate tumbled to almost zero. In the first half of 2002, higher yields on savings in domestic currency induced a more rapid growth of household deposits in ROL with banks (9 percent in real terms) compared to forex deposits (0.5 percent, when expressed in foreign exchange).



Forex deposits posted limp growth

Residents' forex deposits, when expressed in US dollars, were up 1.5 percent from year-end 2001, featuring fluctuating monthly rates of growth, most of them standing at low levels. Household forex deposits inched up 0.5 percent, at a monthly growth pace of barely 0.1 percent. Corporate deposits exhibited a first-half decrease of 1.9 percent due to the 7.7 percent fall in time deposits. This development may be ascribed to the keener interest in foreign-exchange government securities as legal entities reported an upsurge of 72.2 percent in the value of such instruments in H1 2002. Under the circumstances, dollarisation of bank liabilities started losing ground – the share of forex deposits in total broad money dropped to 41.4 percent at mid-2002 compared to 43.1 percent at mid-2001.

In H1 2002, the domestic counterpart of broad money, i.e. **net domestic assets**, dwindled by 7.6 percent in real terms, as the 5 percent rise in **net domestic credit** made up only partly for the widening negative balance under "other net assets".

Non-government credit advanced swiftly

Among bank loans, the loans destined to the non-government sector were rife in the reported period as well. **Non-government credit** in H1 2002 posted a real increase of 14 percent, the largest rise in the last seven years for this time of year.

Stronger interest in forex loans

Interest rates on current loans dropped at a rather slower pace: average rates on short-term loans fell by almost 3.9 percentage points compared to the end of 2001 while average rates on medium- and long-term loans came off merely 2.6 percentage points. Given the circumstances, both businesses and individuals further displayed a great interest in foreign exchange loans – the growth of these loans (26.1 percent when expressed in foreign currency versus end-2001) outran by far that of loans granted in domestic currency (up 1.6 percent in real terms compared to end-2001).

Government credit, net, was sharply down

Government credit, net, contracted by a real 37.2 percent compared to the end of 2001, due to the climb in forex deposits of the Ministry of Public Finance. On the other hand, the State Treasury lowered its ROL deposits with the National Bank of Romania, thus prompting an increase in government credit, net.

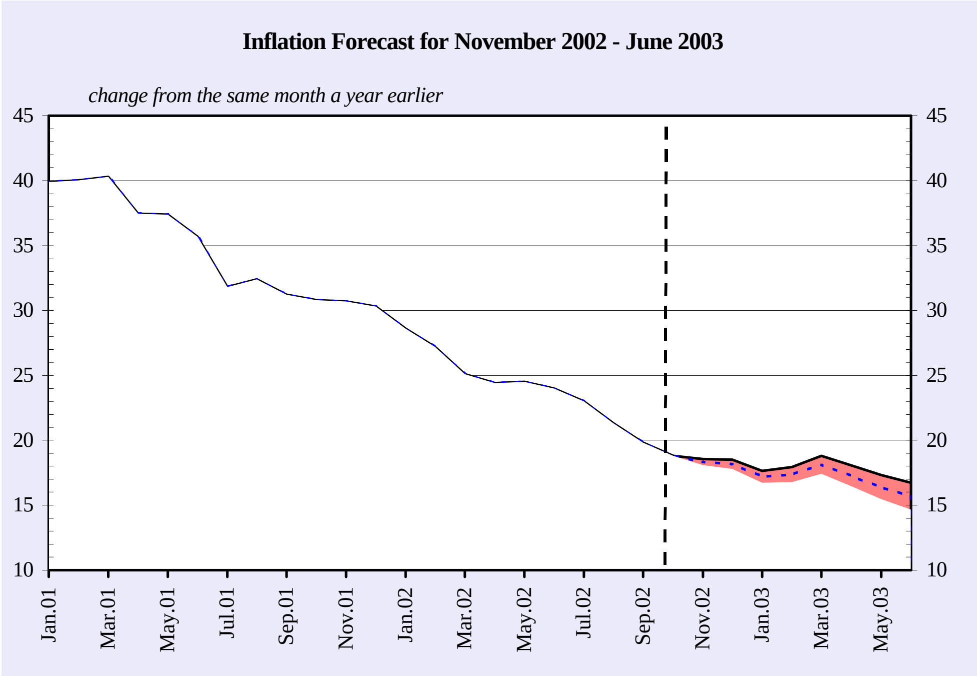
Greater reserve assets of NBR – the driver of money issue

The monetary expansion was solely due to the real 7.5 percent increase in **net foreign assets**. The central bank was solely accountable for this development, reflecting the rises in the first five months of the year (driven, to a large extent, by the proceeds from Eurobond issues) and the June decline (as a result of the peak in repayments of external public debt service in 2002).

4. INFLATION OUTLOOK

Overperformance on inflation target

Reinforcement of disinflation is set to carry on in the latter half of 2002; therefore, full-year performance (around 18 percent) will be below the 22 percent inflation target set forth in the economic programme of the Government.



Assumptions considered in inflation forecasting for November 2002 - June 2003

Monthly forecasts for November 2002 – June 2003 were based on the following assumptions:

– ever-lower increases in food prices, a trend that was manifest throughout 2002. Calculations also considered the removal, starting 1 January 2003, of incentives granted to depressed areas for the meat production and imports (tax incentives and exemption from customs duties);

– moderate appreciation (approximately 3 percent) against the implicit EUR/USD basket;

– adjustment in energy prices consistent with the programme agreed with the International Monetary Fund:

- for heating, the prices set on 1 July 2002 in USD terms are to be maintained. Since an increase in heating prices affects consumer prices no sooner than the beginning of delivering such a utility to consumers, the impact of the hikes announced in July 2002 will feed through in October and November (the influence spreads over two months because the delivery of heating to consumers was resumed on 15 October 2002);

- for natural gas, the price set on 1 April 2002 will remain in force in the latter half of 2002. For 2003, two adjustments are scheduled, as follows: on 1 January, the USD-denominated price is to be raised from USD 82.5 to USD 90 per 1,000 m^3 whereas the ROL-denominated price will additionally reflect the depreciation recorded in July-December 2002; on 1 April, the ROL-denominated price will be subject to renewed correction, in step with the developments in ROL/USD exchange rate in Q1 2003; and

- the adjustment of other administered prices in keeping with legal provisions (on a quarterly or monthly basis, as the case may be, dependent on exchange rate or inflation developments).

The inflation forecast for H1 2003, which took account of the above-mentioned assumptions, confirms the ongoing disinflation and is consistent with the 14 percent inflation target (December/December) underlying the preparation of the 2003 government budget.