INFLATION REPORT

1/2003

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N O T E

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

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

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ABBREVIATIONS

AMIGO	Households Labour Force Survey
ANRE	Romanian Electricity and Heating Regulatory Authority
ANRGN	National Authority for Regulation in Natural Gas Sector
BARA	Bank Assets Resolution Agency
BIS	Bank for International Settlements
CEFTA	Central European Free Trade Agreement
CPI	Consumer Price Index
ECB	European Central Bank
EIA	Energy Information Administration
EU	European Union
EUR	Euro
FOB	Free on board
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IFS	International Financial Statistics
ILO	International Labour Organisation
IMF	International Monetary Fund
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	Overnight
OPEC	Organisation of Petroleum Export Countries
PSAL	Private Sector Adjustment Loan
SDR	Special Drawing Rights

Overview

- **Inflation rate stayed on a downward course**. The significant slowdown in consumer price increases in 2003 H1 was driven by the developments in all three main groups of goods and services. The strengthening of favourable macroeconomic developments, the steadier implementation of structural adjustment policies and the lower uncertainty of economic agents about the business environment helped curb CPI inflation.

- **Economic growth was further robust**. Unlike 2002, when external demand and investment were the main drivers of economic growth, in 2003 H1, the step-up in investment demand and household consumption boosted GDP, while the contribution of net exports to GDP growth turned negative. The increase in investment demand occurred amid the expansion of industrial output and lending. Household consumption surged as a result of the rise in purchasing power of net wages, but the ensuing inflationary potential was confined by: (i) the fact that additional demand was mainly directed towards durables and real estate, (ii) the slow increase or even the cut in prices for imported goods, as well as (iii) keener competition among retailers.

- **External demand was low**. Despite geopolitical tensions, world economy rose slightly, led mainly by the economic growth in the US and some Asian countries (including Japan). However, in 2003 Q2, the recession that hurt the economies of Romania’s major trading partners, i.e. the EU member states, dampened the pick-up of Romanian exports, which lagged behind that of imports.

- **Non-government credit increased significantly**. The upsurge in lending was spurred by macroeconomic stabilisation, lower interest rates and banks’ keener interest in strengthening retail market shares. The main sources of lending were foreign financing, particularly credit lines with maturity longer than two years, and the adjustment of banks’ asset portfolios to the detriment of foreign investments. Demand for credit in ROL posted a significant increase, mostly due to households.

- **Prudent stance in implementing monetary and fiscal policy upheld disinflation**. At the end of 2003 H1, the monetary parameters stood at levels appropriate for meeting the inflation target and ensuring the gradual re-monetisation of economy. The deficit of the consolidated general government budget was lower from the same year-ago period as a result of improved revenue collection and curtailment in expenditures under some headings.

- **Prospects for inflation developments are favourable**. Given the macroeconomic environment at the end of 2003 and the assumptions underlying the inflation forecast for 2004 H1 (the administered prices adjustment programme, the changes to be made to the fiscal regime, and the seasonal influences), the inflation trajectory is estimated to uphold the disinflation trend.

- **Domestic macroeconomic conditions and foreign environment require further prudent monetary policy stance**. The boom in lending is a major concern of monetary policy that must mitigate the impact this development has on inflation and the balance-of-payments current account. Apart from further rigorous monetary control by sterilising excess liquidity, the interest rate policy should be conducted firmly in order to encourage saving. Moreover, the slow recovery of the external environment and the uncertainty surrounding the world's currency markets urge the prudent stance of monetary policy that must be capable of warding off the possible inflationary pressures exerted by exchange rate movements.

1. Inflation developments in the first half of 2003

Consumer prices rose by only 5.7 percent (June 2003/December 2002) amid the strengthening of favourable macroeconomic developments, the steadier implementation of structural adjustment policies, and the lower uncertainty of economic agents about the business environment. This performance has substantiated the expectations of meeting the 14 percent annual inflation target.

In the period under review, the growth rate of consumer prices slowed down by 3.6 percentage points year on year (2.1 percentage points compared with 2002 H2). The developments in all three main groups of goods and services helped bolster disinflation, with services, the price increases of which slowed by 6.8 percentage points, making a significant contribution.

In 2003 H1, prices of foodstuffs grew 7.5 percent, 2.6 percentage points less than in the similar year-ago period, due mainly to the developments in prices for seasonal products (fresh and tinned fruit and vegetables). Despite the sizeable hikes of 23.1 percent on average, the size of change in prices for seasonal products went down to less than a half versus the same year-earlier period.

Tensions on the agrifood market were attributed to the decrease in grain stocks and the grim outlook for vegetal output in 2003. Adverse weather conditions (icy winter, protracted drought, storms and heavy rainfalls), combined with poor investment in technological upgrading were the main causes for the modest performance in agriculture over the past two years.

In the reviewed period, scant domestic supply led to steeper prices for milling and bakery products, sugar, milk and dairy produce[1] (in a range from 7.8 percent to 17.7 percent versus end-2002) and to larger imports of vegetal produce (46.4 percent against 2002 H1).

The prices for meat and products thereof, as well as tinned meat[2] were rather stable, as stockbreeders had to deal with the lack of necessary fodder, which entailed the increase in the number of slaughtered animals, as well as with lower prices for meat imports.

CPI by Category of Products

percentage change

	Dec.01/ Jun.01	Jun.02/ Dec.01	Dec.02/ Jun.02	Jun.03/ Dec.02
Bread and bakery products	0.9	4.6	5.4	13.0
Vegetables and fruit	-9.9	50.8	-1.5	23.1
Meat and fish	12.8	2.8	2.0	0.4
Milk and dairy produce	13.2	6.2	10.4	7.8
Alcoholic beverages and tobacco	8.5	3.0	11.8	10.7
Clothing and footwear	8.7	5.7	7.3	4.8
Household appliances, furniture	10.4	7.1	6.0	4.4
Fuels	14.1	10.2	16.4	5.5
Utility expenses*	41.6	12.6	12.0	4.1
Healthcare	9.0	8.3	8.8	5.3
Transport	24.6	10.5	5.6	8.9
Post and telecoms	16.6	6.2	7.4	-6.1
Leisure and culture	10.9	7.6	6.6	5.7
Other goods and services	17.2	5.8	13.6	1.4

*rent, water, sewerage, refuse collection, electricity, heating, gas

Source: NIS, NBR calculations

[1] Whose cumulative share in the CPI basket was 16.9 percent

[2] Accounting for 10.9 percent of the CPI basket

Administered Prices

			percentage change
	Jun.02/ Dec.01	Dec.02/ Jun.02	Jun.03/ Dec.02
1. Inflation rate	9.3	7.8	5.7
2. Administered prices geared to inflation, of which:	16.3	13.6	10.3
- railway transport	0.0	0.0	9.2
- water, sewerage, waste disposal	19.0	18.1	10.9
3. Share in CPI basket (%)	4.7	4.7	4.5
4. ROL/USD exchange rate (+ depreciation, - appreciation)	5.5	0.8	–3.2
5. Administered prices geared to ROL/USD exchange rate, of which:	10.7	12.5	1.1
- electricity	15.0	1.1	0.6
- heating	4.6	39.1	0.0
6. Share in CPI basket (%)	9.5	9.5	10.1
7. Administered prices geared to inflation and ROL/USD exchange rate, of which:	7.9	6.6	1.7
- telephony	7.5	10.1	–1.1
- postal services	19.7	17.7	21.0
- natural gas	8.4	0.0	7.5
8. Share in CPI basket (%)	5.3	5.3	7.1
9. Administered prices (total)	11.3	11.1	3.2
10. Share in CPI basket (%)	19.5	19.5	21.7
11. Contribution to inflation rate (percentage points)	2.2	2.2	0.7

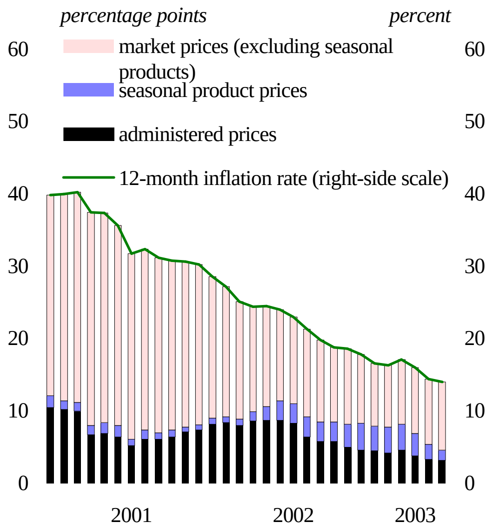
Source: NIS, NBR calculations

Non-food prices picked up 4.8 percent in 2003 H1 compared with 8 percent in 2002 H1. Within this commodity group, disinflation was upheld mainly by the slowdown ranging from about 4.4 percentage points to 14.4 percentage points in the growth rate of prices for electricity and heating[3], fuels, medicines and chemicals, whose cumulative share in the CPI basket stood at roughly 19 percent.

The other non-food items posted the same trend, albeit less steep (down 3 percentage points at the most), except prices for tobacco and cigarettes that stepped up 12 percent in 2003 H1 against 0.5 percent in 2002 H1. These prices, along with prices for other products that are subject to excise duties, were further affected by the depreciation of the ROL against the EUR (10 percent in June 2003 versus December 2002), with excise duties expressed in euro remaining unchanged in the period under review.

Even though in 2003 H1 prices of most services were higher than the inflation rate (5.7 percent), the increase posted by the whole group was only 3.4 percent[4] owing to lower prices for telephony and TV and radio subscriptions (1.1 percent and 20.7 percent respectively). In year-on-year comparison, the favourable developments exhibited by prices of the above-mentioned services, along with the significant slowdown in the growth rate of prices for water, sewerage, refuse collection and city transport, further spurred disinflation.

Inflation Rate



Source: NIS, NBR calculations

On the whole, products with administered prices[5] were only 3.2 percent more expensive over the period, compared with 11.3 percent in 2002 H1, thus making a noticeable contribution to curbing the headline inflation. The 3.2 percent[6] nominal appreciation of the ROL against the USD limited the increase in regulated prices anchored to the exchange rate, as well as to inflation and exchange rate by means of specific methodologies, to 1.1 percent and 1.7 percent respectively. However, the 10.3 percent hike in administered prices geared to inflation was further above the adjustment parameter (by 4.6 percentage points).

The decline in CPI inflation was also due to implementation of prudent monetary and fiscal policies. Thus, at the end of 2003 H1, the rigorous control of liquidity by the NBR brought

[3] Over the period under review, the price for electricity inched up 0.6 percent, while the price for heating remained unchanged, unlike 2002 H1 when prices for electricity and heating rose by 15 percent and 4.6 percent respectively.
[4] Against 10.2 percent in June 2002 compared with December 2001
[5] Accounting for 21.7 percent of the CPI basket in 2003 compared with 19.5 percent in 2002
[6] June 2003/December 2002, average monthly exchange rate

monetary parameters to levels compatible with meeting the inflation target and ensuring gradual re-monetisation of the economy. Furthermore, the deficit of the consolidated general government budget was 0.9 percent of GDP projected for 2003, 0.3 percentage points lower than in the same year-ago period, as a result of improved revenue collection and lower outlays under some headings.

The rise in the gross minimum wage from ROL 1,750,000 to ROL 2,500,000 at the beginning of 2003 fostered the step-up in gross wage (7.3 percent in real terms in 2003 H1 compared with the same year-ago period). Services recorded the highest real growth rates (9.7 percent), a significant contribution in this respect making the wages of public-sector employees[7] (up 11.4 percent). In the sectors facing external competition, the spillover effect of the rise in the minimum wage was confined by the need to preserve competitiveness. Therefore, the real increase in the gross average wage across manufacturing stood at 4.9 percent, in line with the significant labour productivity gains in this sector (11.6 percent on average in January-June 2003 compared with the same year-ago period).

The inflationary impact of the pick-up in wage costs was contained by the fact that significant pay increases were recorded in sectors providing goods and services with a relatively low share in the CPI basket (for instance, in publishing, education, tourism, and services rendered mainly to enterprises), while moderate pay rises were seen in the sectors providing goods and services with a larger share in total household expenses (food industry, energy, postal services and telecommunications). Even though inflationary pressures fed through into producer prices in some sectors that experienced large wage increases (wearing apparel, footwear and electrical appliances), they were only partly reflected by consumer prices; a reason for this was the slower rise or even the cut in prices of imported products that prevail on the aforementioned market segments.

The real 9 percent increase in net wages in January-June 2003 compared with the same year-ago period, along with the expansion of consumer credit, spurred domestic demand and hence imports, without however jeopardising disinflation. Apart from the favourable developments in import prices, the inflationary impact of consumer demand on the general level of prices was also alleviated by the following factors:

– the step-up in goods and services supply (output of non-durables and durables rose by 5.3 percent and 16.6 percent

[7] Accounting for 19.5 percent of total employees

respectively, and the turnover of services rendered to households went up 5.9 percent);

– consumers' greater interest in purchasing durables[8] and real estate[9] with a low share in the CPI basket;

– the increase in the ratio of fixed expenses[10]/disposable income, which may have confined other expenses. This ratio advanced from 14.1 percent in 1998 to 24 percent in 2002, and further adjustment of administered prices and the real expansion in loans to households (79.5 percent in June 2003 compared with December 2002) are illustrative of this trend remaining unchanged in 2003;

– the sharpening of competition between retailers as a result of the expansion of supermarkets and hypermarkets[11].

[8] The retail trade turnover of foodstuffs, beverages and tobacco, as well as of skin-care and medical products went up 2.5 percent and 3 percent respectively in January-June 2003 as compared with the same year-ago period, while retail trade turnover of household appliances and furniture stepped up 29 percent, and that of motorcars rose 19.4 percent.

[9] January through June 2003, long-term loans to households, considered as mortgage credit, expanded by 68 percent in real terms.

[10] Utility expenses (electricity, heating, natural gas, telephone, radio and TV), city transport bills, instalments paid for real estate, durables and motorcars.

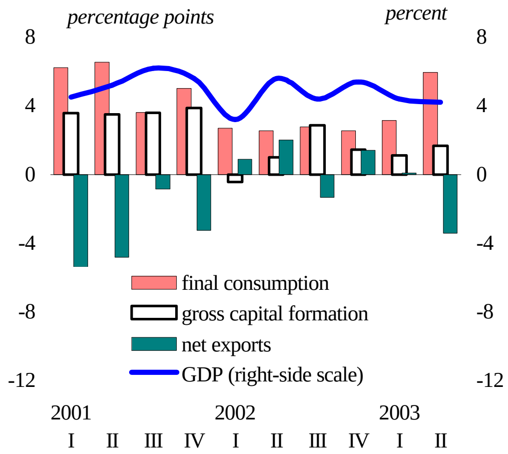
[11] The study released by PriceWaterhouseCoopers in October 2003 – "*Winning Strategies for Retail & Consumer in Russia and Central & Eastern Europe*" – highlights the increasing sensitiveness of Romanian consumers to prices and notes that competitive prices are key to the success of such companies.

2. Determinants of inflation

2.1. Demand

The Romanian economy expanded 4.3 percent in 2003 H1 compared with the same year-ago period, displaying similar growth rates in Q1 and Q2, i.e. 4.4 percent and 4.2 percent respectively. Unlike 2002, when net external demand and investment were the drivers of economic growth, GDP growth in the first half of 2003 was propelled by the pick-up in investment demand and household consumption while the contribution of net exports was negative.

Contribution of the Main Components of Demand to GDP Growth



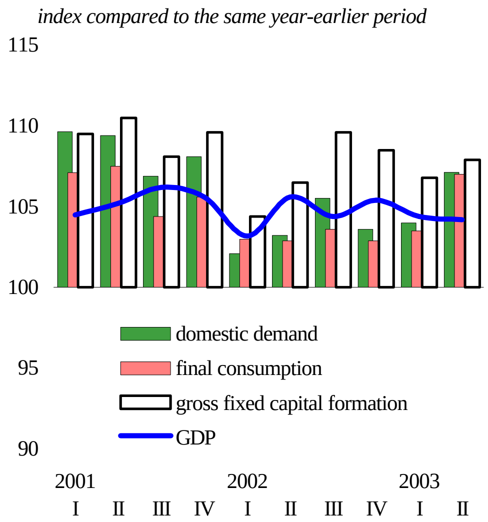
Source: NIS, NBR calculations

2.1.1. Consumer demand

In the first half of 2003, household final actual consumption leapt by a real 5.4 percent against the backdrop of (i) the increase in household incomes[12] in real terms (under the favourable impact of accelerated disinflation) and (ii) greater availability of consumer credit[13].

Nevertheless, household consumption posted different developments in the two 3-month periods under review. In 2003 Q1, the 3.8 percent growth rate in household consumption was only 0.6 percentage points higher than that recorded in the same year-ago period, with the upward trend in household demand for non-durables and services at market-determined prices being mitigated by: (i) larger outlays for utility expenses during the cold season, due also to the removal, in February, of the two-month lag in paying the heating bill so that households had to pay two bills in one month[14] and (ii) the propensity for saving, albeit lower than in the corresponding period of 2002[15].

Domestic Demand



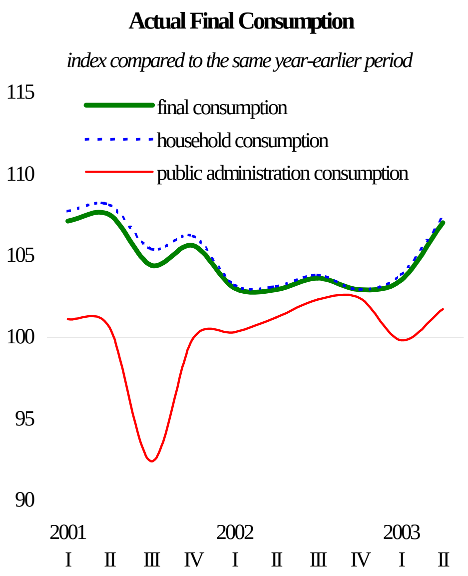
Source: NIS

[12] See Section *2.4. Labour market*

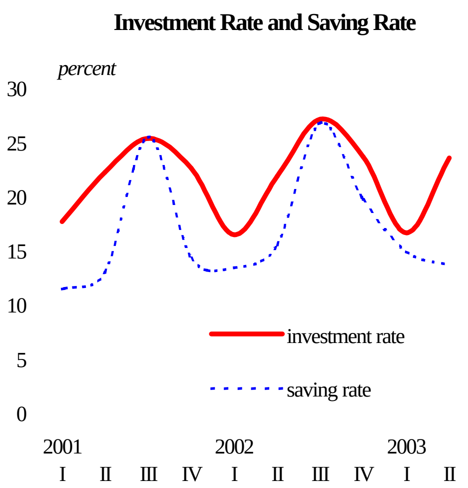
[13] In terms of the decrease in interest rates coupled with other incentives such as lower down payments and the fact that either endorser or collateral was no longer required. As a result, the real rate of increase in short- and medium-term loans to households jumped year on year from 128.9 percent in 2003 Q1 to 182.1 percent in 2003 Q2.

[14] Calculations based on data supplied by the NIS-led Household Budget Survey show that the proportion of utility expenses in household consumption expenses (monthly average per household) rose from less than 17 percent in the previous years to 21.2 percent in 2003 Q1.

[15] The real rate of increase in household time deposits equalled barely 2 percent in 2003 Q1 compared with 4.3 percent in 2002 Q1, yet above the 0 growth rate seen in 2003 Q2.



Source: NIS



Note: investment rate is the ratio between gross capital formation and GDP; saving rate is the sum between gross capital formation and current account deficit as a share of

Source: NIS, NBR calculations

Investment

change compared to the same period of previous year

	Years	Q1	Q2	Q3	Q4
Total	2002	2.8	6.2	8.7	8.7
	2003	6.7	7.0		
- new construction works	2002	0.1	6.1	7.0	5.6
	2003	0.1	6.3		
- equipment	2002	5.5	7.4	12.2	11.9
	2003	13.1	14.3		

Source: NIS

In 2003 Q2, however, household consumption surged by a sizeable 7.4 percent versus the similar period in 2002. In the first half of 2003 consumers exhibited sharp propensity for buying durables, as mirrored by further high growth rates in retail sales of furniture, lighting and electrical appliances (29 percent) as well as of motor vehicles and motorcycles (19.4 percent) compared to much lower rises (ranging from 2.5 percent to 9.4 percent) in non-durables (foodstuffs, wearing apparel, footwear, pharmaceutical and skin-care products) and services to households[16].

In 2003 H1, public administration final actual consumption inched up 0.3 percent, a tempo in line with the authorities' prudent fiscal stance.

2.1.2. Investment demand

Gross fixed capital formation, the fastest-growing constituent of domestic demand, exhibited a swifter rate of increase, from 6.8 percent in 2003 Q1 to 7.9 percent in 2003 Q2 compared to the same periods a year ago. Hence, investment rate in the first half of 2003 climbed to 20.6 percent, up one percentage point against the same period in 2002.

Investment demand rose 3.5 percentage points faster than first-half GDP amid a higher industrial production and sizeable upsurge in lending. Thus, in 2003 H1, loans for equipment and real-estate purchase advanced in real terms by 26.3 percent and 79.4 percent respectively year on year[17].

The improvement of the balance of foreign direct investment of non-residents in Romania (up 19 percent year on year[18]), largely as a result of the increase in equity capital of non-banks, points to favourable prospects for gross fixed capital formation.

The step-up in investment in 2003 H1 was reflected not only by the developments in gross fixed capital formation, but also by the 6.9 percent rise in whole-economy investment[19] (exceeding by 2.1 percentage points the rise in the corresponding year-ago period[20]). The increase in investment in 2003 H1 was chiefly driven by equipment (including transport means), the growth rate of which (13.8 percent) outran by almost 10 percentage points that of new construction works. Therefore, the share of equipment purchase in total investment widened to 47.7 percent in the first half of 2003.

[16] Changes versus 2002 H1
[17] Data supplied by Credit Risk Bureau
[18] Based on balance of payments expressed in euro
[19] Quarterly data disclosed by monthly statistical bulletins of the NIS
[20] Growth rates are compiled as against the same year-earlier 6-month period.

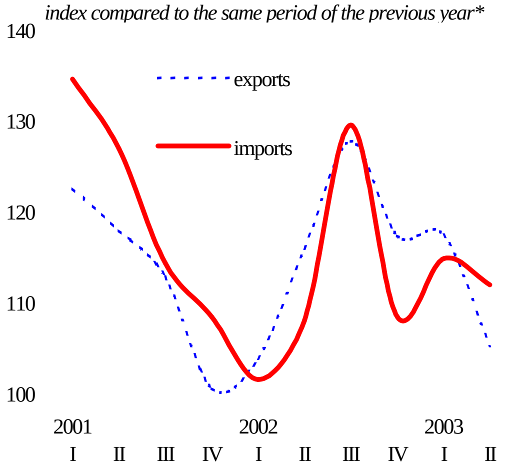
The same as in the first six months of 2002, behind the rising investment stood solely the developments in the private sector (up 13.1 percent year on year), with the bulk of outlays going chiefly for purchases of equipment and transport means. At mid-year 2003, the private sector accounted for 65.1 percent of total investment across the economy compared with 62.5 percent in the same year-ago period. The good performance in whole-economy investment was clouded, the same as in 2002, by the public sector where investment dropped by 3.5 percent in 2003 Q1 and 2003 Q2. However, mention should be made that the rate of decline slowed by 8.3 percentage points and 13.8 percentage points respectively, compared with the similar quarters of 2002.

2.1.3. Net external demand

In 2003 Q1, the rate of increase in imports further lagged behind that of exports (15 percent and 17.6 percent respectively) so that the contribution of net exports to GDP growth was positive, reaching 0.1 percentage points. However, in 2003 Q2, imports advanced at a fast clip (12.1 percent against the same year-ago period), owing to buoyant domestic demand, whereas the rise of exports slowed down markedly (up as little as 5.4 percent) because of the recession gripping the eurozone[21] – as a result, the contribution of net exports to GDP growth turned negative, reaching 1.6 percentage points in 2003 H1.

Exports and Imports of Goods and Services

*index compared to the same period of the previous year**



**) Based on data denominated in ROL, used for GDP calculation.*

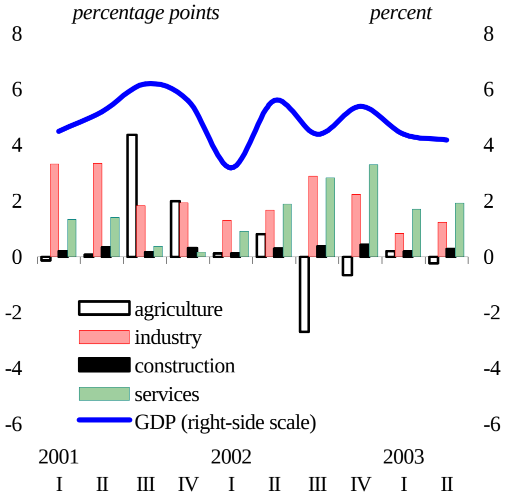
Source: NIS

2.2. Supply

Economic growth in 2003 H1 was bolstered mainly by the tertiary sector and industry, which contributed 1.9 percentage points and 1.2 percentage points respectively; despite the high growth rate, construction added only 0.3 percentage points, and the 0.6 percent drop in gross value added in agriculture resulted in a null contribution to GDP growth.

Agriculture posted the highest growth rate in the 2003 Q1 (up 7.1 percent year over year), but April through June it saw gross value added decline by 2.8 percent versus 2002 Q2. This development was accounted for by the poor weather conditions which had a direct impact on the vegetable production – mid-July statistical data on harvesting illustrate lower yields for all types of grains, with rates of decrease between 11.5 percent and 72.6 percent as compared to the results of the same year-ago period.

Contribution of the Main Components of Supply to GDP Growth



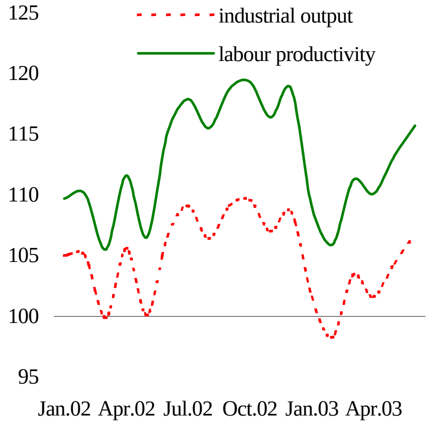
Source: NIS, NBR calculations

[21] See section *2.5. External environment*

January through June 2003, the other economic sectors – industry, services and construction – displayed growth of gross value added, at a faster year-on-year pace in Q2 than in Q1. This development was boosted by the rise in aggregate demand and supported by the availability and more efficient use of the workforce. In 2003 H1, industry recorded productivity gains of 11 percent, up 1.2 percentage points from 2002 H1. Thus, the favourable gaps between the growth rate of labour productivity and that of gross real average wage in mining, manufacturing and energy sectors (7.5 percentage points across industry[22]) was maintained.

Industrial Output and Labour Productivity in Industry

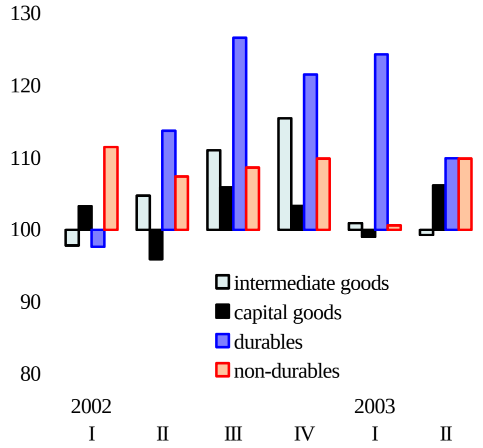
index compared to the same year-earlier period



Source: NIS

Industrial Output by Main Group of Commodities

index compared to the same year-earlier period



Source: NIS, NBR calculations

Although activity in **industry** stepped up in 2003 Q2 (its growth rate was 3.9 percent, 1.3 percentage points higher than that of Q1, versus the corresponding quarters of 2002), the dynamics of gross value added for the first six months was lower than that recorded in the prior year (3.6 percent as compared to 4.7 percent). Statistical data on output of the main industrial groups suggest that the slowdown was driven by the developments in the output of non-durables and intermediate goods[23]. The rate of increase of non-durables fell to 5.3 percent from 9.4 percent in 2002 H1, amid the change in households' consumption behaviour and the deceleration of exports (mainly wearing apparel and footwear, which account for about one third of the total value of Romanian exports and which posted a 4.2 percent rise in export receipts in 2003 H1, down 6.3 percentage points from 2002 H1). As for the intermediate goods industry, the slight contraction of activity (-0.2 percent versus +1.5 percent in 2002 H1) was due mostly to domestic causes related to the slowdown in the growth rate of non-durables output and the fall in metallurgy output.

The unfavourable impact of the output dynamics of these two categories on the growth rate of the whole industrial sector was alleviated by the faster rate of increase in the output of capital goods and durables, while energy output shrank in 2003 H1 at a pace similar to that in 2002 H1 (by 0.9 percent). The boost in investment induced the rise in capital goods output (up 2.9 percent in 2003 H1 as compared to the 0.7 percent drop in 2002 H1). Durables output, which posted a threefold rate of increase, (up 16.6 percent) from 2002 H1, was used to meet domestic demand (individuals became more interested in this type of goods) as well as to increase the export supply (by 29 percent, which represented almost a twofold increase of the growth rate from the same period of 2002).

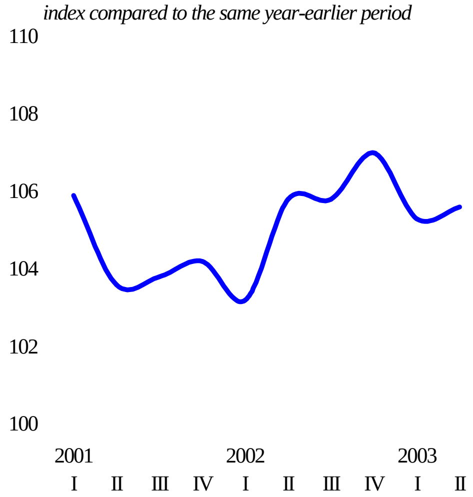
[22] The change in gross real average wage across industry was determined by using the consumer price index.
[23] These two groups account for about 60 percent of total deliveries of industrial goods.

Construction saw the sharpest growth in 2003 H1, with gross value added jumping 6.4 percent, up one percentage point year over year[24]. This development was bolstered, in the period under review as well, by the rise in real estate credit in the economy and by the progress of some foreign financing projects for road modernisation and school construction and rehabilitation.

Construction works in the private sector rose by more than 6 percent in 2003 H1, thereby securing the leading position of this sector (90.4 percent of the value of construction works at end-June 2003). Expansion of this activity was also supported, yet to a lesser extent, by the slower decline in the value of construction works in the public sector.

Construction Works

index compared to the same year-earlier period

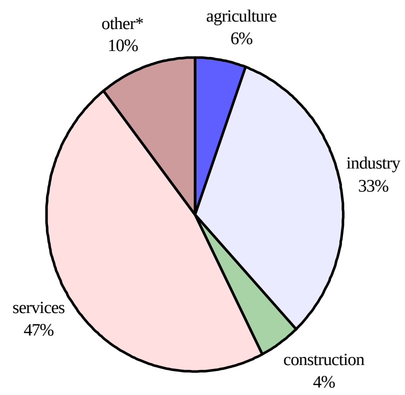


Source: NIS

Services sector made the largest contribution to GDP formation, with gross value added moving ahead 4 percent in 2003 H1, up 1.1 percentage points year over year[25]. Faster growth was detected for all the main components.

Statistical figures show that retail trade turnover (except motor vehicles and motorcycles) rose sharply (from 0.2 percent in 2002 H1 to 4.3 percent in 2003 H1). It is noteworthy, on the one side, the higher turnover of specialised stores as compared to non-specialised ones, for both types of products (food and non-food)[26] and, on the other side, the fall to less than half of the rate of increase in receipts from non-food sales that are not made by stores. In this context, the expansion of supermarkets and hypermarkets and the competition they generate in retail trade exerted a considerable impact on the receipts growth rate. Moreover, after recording a 10.4 percent drop in 2002 H1, sales of motor vehicles, motorcycles and fuels stepped up 13.4 percent in 2003 H1.

GDP Formation in 2003 H1



**) net taxes on product and adjustment of financial intermediation services indirectly measured*

Source: NIS, NBR calculations

The rate of increase of turnover related to services delivered to population reverted from -13.3 percent in 2002 H1 to +5.9 percent in the period under review, with most components posting increases in the range from 2.5 percent to 17 percent.

The faster growth in the services sector was also buttressed by the transport sector, as suggested by the larger turnover of fuel retail sales (up 8.5 percent in 2003 H1 from the almost 20 percent fall in the same period of 2002), as well as by the larger

[24] Growth rates calculated against the same year-ago period
[25] Growth rates calculated against the same year-ago period
[26] In 2002 H1, turnover of food sales through both types of commercial networks declined, while in 2003 H1, it rose by 4.8 percent in the case of specialised stores, 2.9 percentage points faster than the turnover of non-specialised stores. As for non-food, the turnover of specialised stores grew 8.6 percent while that of non-specialised stores contracted by another 3.9 percent.

receipts of hotels and restaurants (+2.5 percent versus -7.7 percent) and travel agencies (+7.3 percent versus +4.7 percent).

Public administration and defence, public social security, education, health and social assistance also posted notable rates of increase, mainly as a result of wage hikes during this period.

In 2003 H1, gross value added of **credit institutions** diminished by 2.6 percent year over year, yet displaying mixed developments during this period. Amid stepped-up competition in the retail services, in 2003 Q1, the banking sector adjusted the net interest margin, which entailed a 10.5 percent decrease in *financial intermediation services indirectly measured* year on year. During the first half of 2003, this development was partly offset by the 2.3 percent rise detected in 2003 Q2 due to the joint effect of two factors – further cut in deposit rates and expansion of non-government credit.

2.3. Budgetary and fiscal developments

In 2003, the Ministry of Public Finance aimed at turning the focus on containing the deficit of the consolidated general government budget at 2.7 percent of GDP. This level was seen as optimum in terms of further economic growth, ensuring fiscal sustainability in the medium-term, disinflation, and keeping the current account deficit below 4.5 percent of GDP. In preparing the 2003 Government Budget Law the newly-enforced Law on Public Finance[27] was taken into account, and the budgeting was based on the following prerequisites: (i) improvement in fiscal transparency by including the special fund for energy system development and the special fund for national roads into the government budget, (ii) lowering of the tax burden on workforce, (iii) increase in the share of outlays for social security, education, healthcare, agriculture and environment, (iv) matching public expenditures with anticipated revenues, and (v) ensuring funding for the steps underpinning integration with the European Union.

During the first half of 2003, several measures were taken in order to pave the way for accomplishing the objectives of the government programme. Several contribution quotas paid by employees and employers to the government were lowered or cancelled – thus, the social security contribution for healthcare and that for unemployment were cut by 0.5 percentage points, and 3 percentage points respectively, whereas the 2 percent quota to the special fund for the disabled was removed. Moreover, the development fee incorporated in the electricity

Consolidated Budget Revenues*)

%

	2002 H1	2002 H2	2003 H1
Revenues	100.0	100.0	100.0
Tax revenues, of which:	92.9	93.2	92.8
Profit tax	6.6	6.8	7.2
Income tax	9.4	9.2	9.5
Social security contributions	37.1	35.1	33.1
VAT	21.9	24.5	23.6
Customs duties	2.0	2.2	2.2
Excise duties	6.5	7.9	9.3
Non-tax revenues	6.9	6.3	6.9
Capital revenues	0.2	0.1	0.3
Non-redeemable funds	0.0	0.3	0.0

*) transfers between budgets were removed
Source: NBR calculations based on MPF data

Consolidated Budget Expenditures*)

%

	2002 H1	2002 H2	2003 H1
Expenditures, of which:	100.0	100.0	100.0
Public authorities	4.5	4.8	5.0
National security and defence, and public order	9.9	9.9	9.7
Education	10.8	9.0	10.8
Health	12.7	10.9	12.0
Social activities and culture	38.4	37.6	38.6
Economic activities	12.5	18.4	14.9
Interest related to public debt	9.5	7.2	7.2

*) including adjustments according to IMF methodology; transfers between budgets were removed
Source: NBR calculations based on MPF data

[27] Law No. 500/2002 in force since 1 January 2003

price was cut by one percentage point while the profit tax on exports was raised by 6.5 percentage points. In addition, the gross minimum wage increased from ROL 1.75 million to ROL 2.5 million, the child benefit was revised upwards by 17 percent, and pensions were subject to renewed realignment and indexation (January saw the implementation of the third stage of pension realignment while in March and June pensions were further indexed).

Implementation of these steps in 2003 H1 caused the consolidated general government budget to show a deficit of approximately ROL 16,835 billion, or 0.9 percent of GDP[28], compared with 1.2 percent in 2002 H1. The slower build-up in the deficit – in 2003 H1, it accounted for 34.5 percent of the full-year target figure as against 46 percent in 2002 H1 – was the joint effect of the uplift in revenue collection and the curtailment in spending. Specifically, the collection rate stood at 46.3 percent of the programmed figure compared with 45.8 percent in the same year-ago period, while the weight of expenditures fell from 45.7 percent of the expected full-year figure to 45.3 percent in 2003 H1 – behind the latter's decline stood mainly the lower amount of interest payments on public debt, which accounted for 43 percent of the targeted full-year figure versus 52 percent at mid-year 2002.

Balance of Consolidated Government Budget

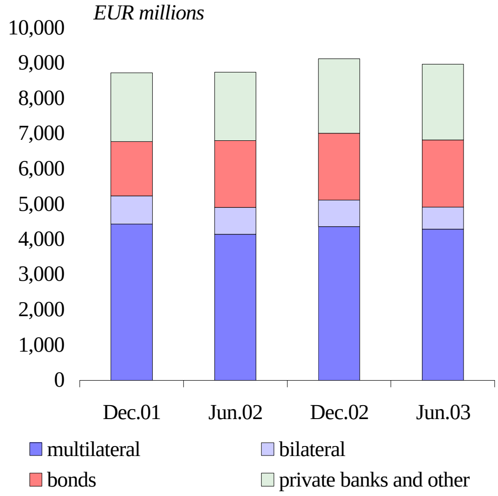
percent of GDP

	2002 H1	2002 H2	2003 H1
Conventional deficit	-1.18	-1.45	-0.92
Primary surplus (+)/ deficit (-)	0.40	-0.01	0.34

Source: NBR calculations based on data supplied by MPF and NIS

Even though the percentage of some contribution and tax rates was lowered, taxation – the ratio of tax revenues to GDP – rose by 0.5 percentage points year on year, from 12.6 percent to 13.1 percent. This owed to the hike in indirect taxes, excise duties and VAT in particular. Direct taxes went down somewhat, led by the drop from 5 percent to 4.7 percent of GDP in social security contributions after the respective rates were lowered.

External Public Debt
- financing sources -



Source: NBR calculations based on MPF data

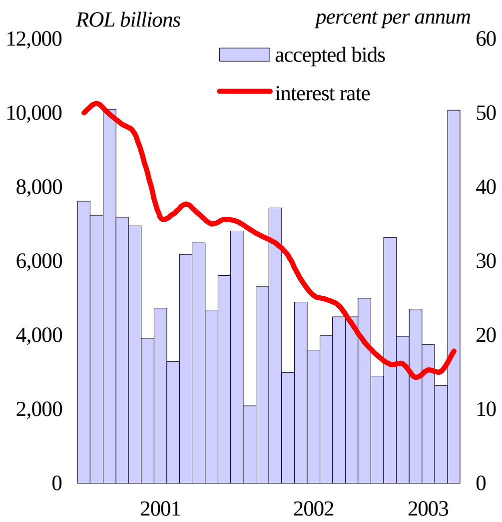
The primary surplus of the consolidated general government budget lagged behind its year-ago level, i.e. 0.3 percent versus 0.4 percent of GDP. The gains arising from the decrease in interest payments on public debt were virtually offset by the easing of outlays for subsidies and transfers and the increase in capital expenditures. The slim increase notwithstanding, the latter accounted for only 39 percent of the targeted full-year figure and the share of capital expenditures in total spending was no higher than 9.6 percent.

In 2003 H1, the government budget posted the highest wantage, i.e. ROL 16,524 billion, nearing the level of the deficit of the consolidated general government budget. The shortages of the social security budget and the special fund for healthcare were

[28] In 2003, these indicators were computed as a percentage of projected full-year GDP.

virtually bridged by the surpluses of other constituents, with local budgets reporting the largest one.

Government Securities Issues (Treasury Bills)

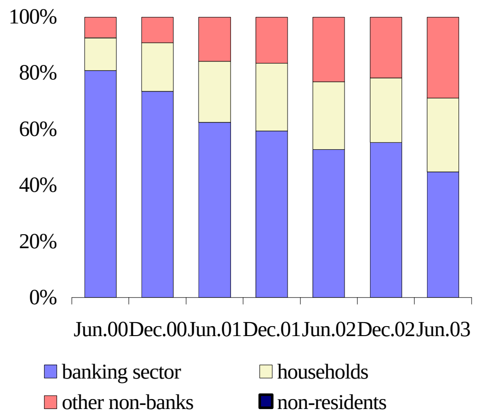


Both domestic and foreign sources helped cover the gap between public revenues and expenditures, as well as the public debt servicing. Since foreign resources fully ensured deficit financing, the amounts raised from domestic investors served to honour the obligations falling due. International financial institutions involved in the co-financing of several projects in Romania provided the funds necessary to bridge the government deficit. A small part of the proceeds from the Eurobond issued in 2002, which were not used by the end of the year, added to the above-mentioned funding.

Over the period under review, both ROL- and foreign-exchange-denominated funds were raised from the domestic market. The same as in 2002 H1, non-banks held the overwhelming weight in fresh funds channelled into the State's coffers. In the first half of 2003, the Ministry of Public Finance raised some ROL 3,300 billion from non-bank legal persons, whilst banks, albeit still the main creditor to the State, provided fresh funds amounting to merely ROL 188 billion.

The usual maturities of issues of government securities to be acquired by banks and their clients ranged from 3 months to 2 years, but starting March 2003, 3-year Treasury notes were also issued. First-half issues of government paper, most of which had one-year maturity, topped ROL 41,000 billion.

Composition of Government Securities Outstanding by Holder



Note: - forex-denominated securities converted in ROL at end-of-period exchange rate
- composition reflects secondary market movements

The issues of Treasury certificates destined to individuals were left open almost throughout the period under review, save April, when a temporary discontinuation was decided. Nonetheless, the gradual decrease in yields on T-bills (from 17 percent to 14 percent on 3-month paper and from 18 percent to 14.5 percent on 6-month paper) dampened individuals' appetite for such investments. As a result, the net amount individuals provided to the Ministry of Public Finance in the six months to June 2003 ran at ROL 69 billion only.

The same as in the first half of 2002, the Ministry of Public Finance raised from individuals, apart from ROL-denominated funds, foreign-exchange-denominated funds too. Thus, the public authority organised three auctions to sell foreign-exchange-denominated issues whereby it raised some USD 337 million; bonds had 3-year maturity at an average interest rate of 4.9 percent. The funds served to redeem part of the forex-denominated Treasury notes that came to maturity, i.e. USD 426 million.

Unlike the corresponding period of 2002, the Ministry of Public Finance resorted, particularly in January 2003, to deposits taken from the money market in order to close the temporary resource gap. Such deposits totalled more than ROL 9,400 billion in 2003 H1, with average maturity of 1.7 days and an average yield of 18.9 percent.

The large part of maturing government securities launched under the bank restructuring and recapitalisation process caused government credit composition to change. Thus, the Ministry of Public Finance redeemed government paper tantamount to ROL 4,954 billion and USD 21 million whereas the bad assets taken over by public debt were worth only ROL 11 billion and USD 7 million. At mid-year, the outstanding Treasury notes issued under the bank restructuring programme shrank to ROL 135 billion and USD 60 million.

As of end-June 2003, domestic public debt[29] approached ROL 128,686 billion, including collateral for domestic credit in ROL and foreign exchange, which accounted for about 7 percent of total domestic public debt (ROL 9,081 billion). Direct domestic public debt[30] as a proportion of GDP fell from 7.2 percent in 2002 H2 to 6.5 percent in 2003 H1.

The composition of direct domestic public debt was broadly unchanged from year-end 2002. Government loans for budget deficit financing and refinancing held the largest share in the total figure, i.e. 72 percent, ahead of bridge loans, the share of which jumped from 21 percent to 28 percent, and loans based on special laws on banking system restructuring, the share of which narrowed from 7 percent to 2 percent.

[29] Defined pursuant to Art. 1, para. 3 of Law No. 81/1999 on public debt, i.e. the total of the government's domestic and foreign liabilities, at a given moment, contracted by the Ministry of Public Finance acting as the government's borrowing agent.
[30] The difference between domestic public debt and the collateral for domestic credit

2.4. Labour market

2.4.1. Labour force

In the first half of 2003, the labour market was influenced by further economic growth and structural adjustment of the economy, as well as by incidental and seasonal factors. Therefore, employment was determined mainly by the following:

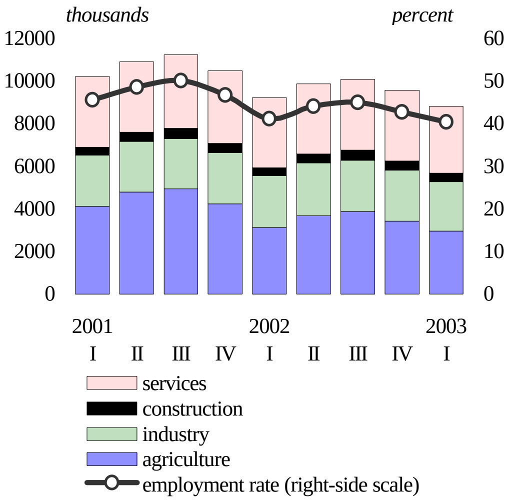
i) expansion of activity in some sub-sectors (construction, trade, real estate transactions and services delivered to companies) which created openings, thereby offsetting the cut in staff numbers in the sectors undergoing restructuring (petrochemicals, metallurgy, machinery and equipment, energy, post and telecommunications);

ii) productivity gains following investment in technology which suppressed demand for labour force;

iii) enforcement of new pieces of legislation in the field, of which the most relevant were Government Decision No. 1105 of 10 October 2002 that set the gross minimum wage at ROL 2,500,000 starting 1 January 2003 and Law No. 53 of 24 January 2003 – Labour Code, coming into force on 1 March 2003;

iv) further export of labour force.

Employment by Sector and Employment Rate



Source: NIS - AMIGO

The evolution of employment and unemployment determined based on the methodology of the International Labour Office (ILO) cannot be quantified for the time being, as the latest data provided by the AMIGO survey, relative to 2003 Q1, hinge on the outcome of the population and housing census conducted in March 2002, but previous data, for the 1996-2002 period, have not yet been recalculated in terms of total population estimated based on the census outcome.

Assuming that after recalculation the trends revealed by the existing series persist, it is to be noted the year-on-year drop in total population, employment and unemployment. The contraction of labour force appears to have been induced by the migration of labour force abroad rather than by its becoming inactive, as this category of population saw only a marginal increase. Therefore, the fall in the number of jobless may have been, to some extent, brought about by their being hired instead of people who went to work abroad, so that the employment rate[31] stayed relatively flat.

Under these conditions, in 2003 Q1, the activity rate of population aged 15 years or more[32] stood at 53 percent, 1.4 percentage points lower than the average for CEFTA countries. Unemployment rate fell to 8.1 percent on the back of short-term unemployment; long-term unemployment (more than one year) accounted for 57.7 percent of total, representing one of the reasons behind the rise in discouraged workers whose share in working age population (15-64 years) reached 3.5 percent in 2003 Q1.

The only statistical data for January-June 2003 available for an analysis of labour market dynamics are those supplied by the National Employment Agency (NEA). As already pointed out in the prior editions of Inflation Report, the scope of these data is incomplete compared with that of indicators used in the AMIGO survey and, therefore, a conclusion on the labour market development based solely on these data may prove inaccurate. However, given that both ILO and registered unemployment rates posted the same trend, the fall in unemployment rate coupled with the larger number of vacancies reported by companies to the NEA and of wage earners in 2003 H1 as compared to the same year-earlier period suggests that demand for labour was better accommodated by supply. Thus, the rate of filled available vacancies moved up 2.3 percentage points from 2002 H1 to 95.2 percent in 2003 H1.

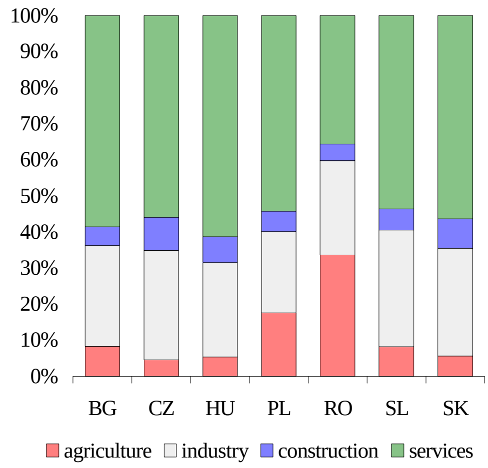
Consequently, although restructuring of loss-making companies sped up (the number of persons made redundant following mass dismissals picked up 77.3 percent in 2003 H1 year on year), at end-June 2003, unemployment rate fell to its lowest level since September 1997[33], i.e. 7.1 percent.

The stepped-up endeavours of the unemployed to find jobs were boosted by the following:

i) unemployment benefit can be claimed for 12 months at most, according to Law No. 76/2002, as compared to 27 months prior to 1 March 2002;

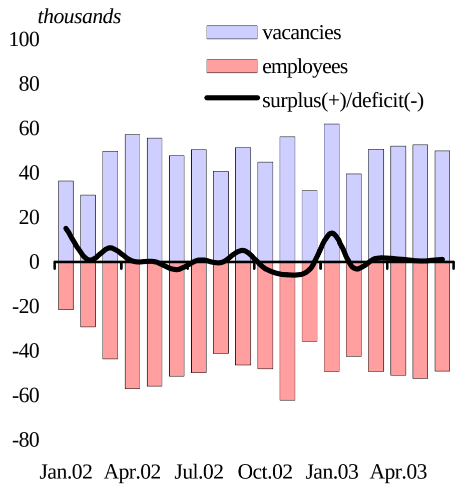
ii) gross minimum wage was raised by a nominal 43 percent;

Composition of Employment in CEFTA Countries, 2003 Q1



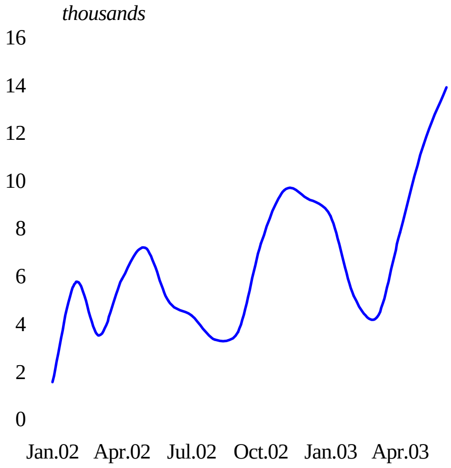
Source: NIS

Number of Vacancies Reported by Employers and Number of Filled Vacancies



Source: NEA

Mass Dismissals

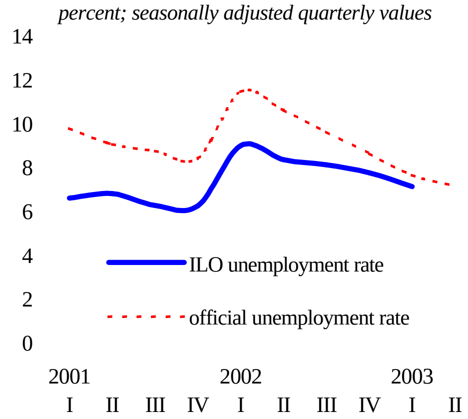


Source: NEA

[31] Ratio of number of people employed to total population
[32] Ratio of labour force to population aged 15 years or more
[33] The Directorate General for Employment and Social Affairs of the European Commission holds that official data underestimate the number of unemployed and warns about the need to fight black market, which is presumed to involve 25 percent of total active population.

Official Unemployment Rate and ILO Unemployment Rate

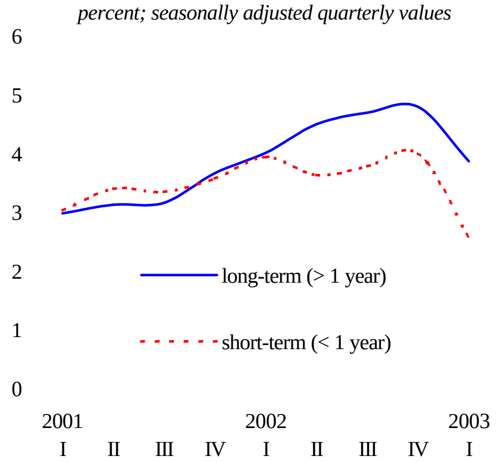
percent; seasonally adjusted quarterly values



Source: NIS - AMIGO

Unemployment Rate by Duration

percent; seasonally adjusted quarterly values



Source: NIS - AMIGO

Real Net and Gross Wages

change against the same year-earlier period, %

	Net		Gross	
	2002 H1	**2003 H1**	**2002 H1**	**2003 H1**
Whole economy	4.3	9.0	5.8	7.3
Agriculture, hunting and related services	2.0	7.4	3.8	4.7
Industry	1.8	5.6	2.7	3.5
of which:				
Mining	5.4	3.7	5.8	1.8
Manufacturing	1.1	7.0	2.3	4.9
Energy	5.8	3.4	6.4	1.7
Construction	7.9	9.5	10.5	7.7
Services*	6.0	11.0	7.5	9.7
of which:				
Public administration	6.9	14.9	7.4	15.6
Education	3.4	16.0	6.4	13.9
Healthcare	1.0	6.9	2.4	4.1

*) By weighting to the number of employees in: transports and warehousing, postal services and telecommunications, trade, hotels, and restaurants, financial intermediation, real estate transactions, public administration, education and healthcare.
Source: NIS, NBR calculations

iii) the measures implemented by the NEA, especially through the mediation services it provided, helped 97.6 percent of the 300 thousand[34] projected number of openings be filled as of 30 June 2003;

iv) the Office for Labour Force Migration made it possible for more than 21 thousand people to work abroad in 2003 H1.

According to the new Labour Code, the so-called "civil contracts" which allowed employers to hire people without recording them as employees have been abolished since 1 March 2003. The limp growth in payrolls[35] in the following months indicates that employers converted only a small number of "civil contracts" into individual labour contracts[36]. This development, which however did not induce the rise in the number of jobless, can be attributed either to employers' relinquishing co-operation with persons holding "civil contracts" (the latter already had a job, were retired or were not registered with unemployment agencies) or to further co-operation between the two parties without concluding formal contracts (as the payment of social security contributions would have pushed labour costs sharply higher).

2.4.2. Incomes

2.4.2.1. Wages

The first half of 2003 witnessed looser wage policy following the rise in the whole-economy gross minimum wage to ROL 2,500,000, the cut in labour-related taxes, and the substantial increase in public-sector wages. The effects of the above-mentioned measures did not delay to make themselves felt in the private sector, mainly in the expanding sub-sectors such as: trade, construction, real-estate transactions and other services to enterprises, but where wages have been running, by and large, below the average wage economy-wide.

Whole-economy gross wage edged up a real 7.3 percent from January-June 2002, 1.7 percentage points lower than the rise in net wages as a result of changes in the legislation governing wage taxation. As far as the employees were concerned, social security contribution decreased by 2.2 percentage points to 9.5 percent, health contribution moved down 0.5 percentage points

[34] Via the National Employment Programme
[35] By 71.9 thousand at end-June as compared to end-February 2003
[36] In accordance with the Ministry of Labour and Social Solidarity, by end-September, only 10 percent of about 1.6 million "civil contracts" outstanding in February 2003 were turned into individual labour contracts.

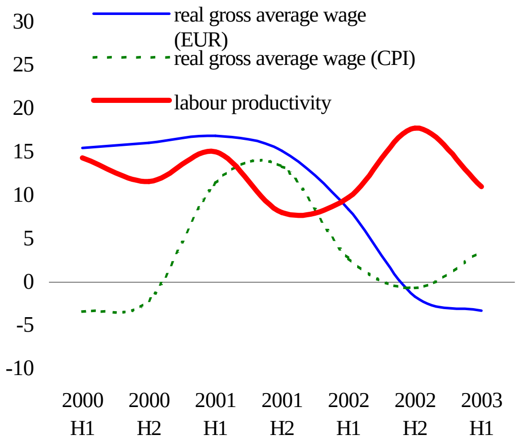
to 6.5 percent, and a new tax scale was implemented along with the increase in the basic personal deduction (by ROL 200,000).

Even though employers also benefited from the reduction of taxes levied on the wage bill, employment-related taxation remained high compared to other European countries, and that is why the authorities envisage its gradual lowering in the years to come.

By main economic sector, in year-on-year comparison, the highest growth rates of real gross average wages were recorded in construction and services (by 7.7 percent and 9.7 percent respectively), accounting for more than one half of the total number of employees. Underlying this development were wages in the budgetary sector (up 11.4 percent), transports (where state-run enterprises hold a large share), as well as in majority privately owned sub-sectors.

Gross Wage and Labour Productivity in Industry

change compared to the same period of previous year



Source: NIS, NBR calculations

In industry, the real gross average wage rose by a meagre 3.5 percent, considerably below the 11 percent pick-up in labour productivity. The concern for maintaining competitiveness prevented the increase in the gross minimum wage from spilling over to higher wages. In sub-sectors such as: wearing apparel, leatherwear and footwear[37], building materials and metal products – wage increases were not accompanied by the appropriate upswing in labour productivity, so that unit labour cost rose up to 14.6 percent[38]. Given the unfavourable external environment, which dampened import demand of Romania's main trade partners, the growth rate of the wearing apparel and footwear exports[39] slowed down significantly, while exports of the other two sub-sectors contracted against the same year-ago period.

In the period under review, the effects of the rise in wage costs on the general level of consumer prices were kept in check given that:

– wages increased moderately in sectors providing products that hold a large share of the consumption basket. Thus, real gross wages in food industry, energy sector[40], post and telecommunications were raised by as much as 4.8 percent,

[37] Low wages prevail in these sub-sectors, their 2002 average accounting for 64.4 percent and 66 percent respectively of the gross average wage across manufacturing.
[38] The development of the unit labour cost was established based on the ratio between the index of the gross average wage expressed in euro and that of labour productivity in the respective sub-sector.
[39] Accounting for roughly 30 percent of total exports
[40] Output, transport and distribution of electricity, heating, natural gas and hot water

while in fuel processing they shrank 5.9 percent year on year;

– although inducing higher producer prices, the increase in wage costs across sub-sectors producing wearing apparel, footwear, domestic appliances, chemical and skin-care products had a small bearing on consumer prices. Behind this development may have stood the large share of imports on these market segments and the positive effects disinflation in the main supplier countries had on the purchase prices of such goods.

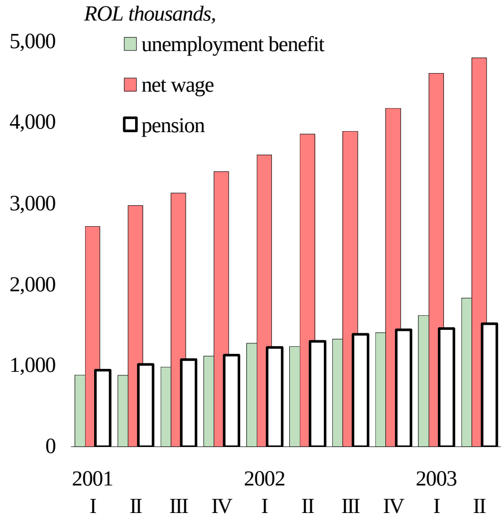
A stronger interlink between the rise in wage costs and that in consumer prices appears to have been detected across services, which are more labour intensive sectors than the industrial ones. Thus, most of the market-determined price and administered-price services posted above-average price increases. Nonetheless, given the low share of the aforesaid services in the consumer basket (below 10 percent), the impact on CPI inflation was mitigated.

Yet, it is likely that the price increases in goods and services at market-determined prices have also been spurred by the stepped-up demand following the climb in available household incomes.

2.4.2.2. Other incomes

The reported period witnessed a step-up in the purchasing power of pensions and social security benefits versus the same year-ago period. However, their low level and the decreasing number of beneficiaries confined the potential pressures on the consumer demand and, implicitly, on prices.

Household Incomes



Source: NIS, NEA

The incomes of pensioners moved ahead due to the implementation of the third stage of public pensions realignment in January 2003 and their indexation in March and June (by 3.5 percent and 2.7 percent respectively)[41]. In spite of the slight real advance year on year (by 1.9 percent[42]), the share of average pension dropped 2.2 percentage points to 31.6 percent of the net average wage.

In 2003 H1, the unemployment benefit[43] – the main social security benefit granted to the unemployed – expanded by 18.8 percent in real terms against the same year-ago period as a

[41] Government Decisions Nos. 1474 of 12 December 2002, 218 of 27 February 2003 and 614 of 29 May 2003

[42] Showing an undersized change as, starting January 2003, the contribution to healthcare social security is no longer included in the pension.

[43] Including the unemployment benefit granted pursuant to Law No. 1/1991, as subsequently amended and supplemented.

result of the increase in the economy-wide gross minimum wage, based on which it is calculated. Under the circumstances, the share of unemployment benefit went up 3 percentage points to 36.7 percent of the net average wage. The purchasing power of incomes of the individuals benefiting from vocational integration and welfare allowances[44] increased as well. Nonetheless, once the allowance collection period elapsed, their number contracted by 70 percent.

The amounts transferred by nationals working abroad were still an important source of incomes for many households. According to balance-of-payments data, these transfers went up 3.4 percent year on year, underpinning both domestic consumption and household saving.

2.5. External environment

2.5.1. External demand

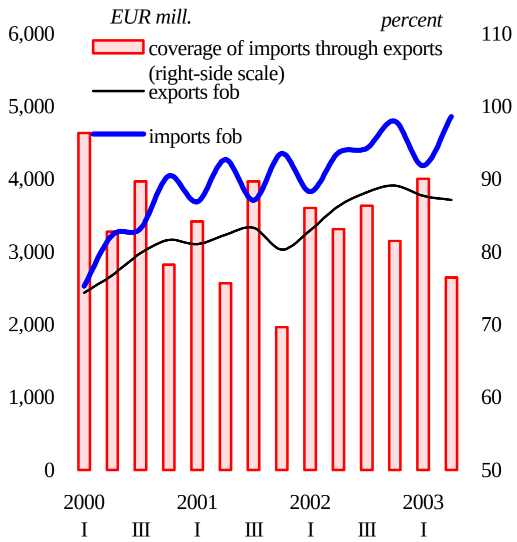
In 2003 H1, the world economy fared better, in spite of the negative effects of the geopolitical tensions and the severe acute respiratory syndrome. Behind this development stood mainly the American economy undergoing a sped-up GDP growth of 2 percent and 2.5 percent year on year in 2003 Q1 and 2003 Q2 respectively. The Asian economies (including Japan) and, to a lesser extent, CEE countries also contributed favourably to the brighter picture of the world economy.

As for the euro-zone, the economic activity posted low growth rates. In 2003 Q1 and Q2, year on year GDP growth rates of 0.7 percent and 0.2 percent respectively dropped below the already low levels recorded in 2002 Q1 and Q2. This development was attributed to: the scanty domestic demand (mainly the investment component) and the significantly stronger euro, which brought about a fall in the trade surplus to nearly one half of the level reached in 2002 H1, due to competitiveness losses of the European exports (down by 3 percent).

Amid the unfavourable external environment, CEFTA countries posted however further positive growth rates on the back of both exports and private consumption, the latter being boosted by higher real wage and looser monetary conditions. However, except for the Polish economy, which grew faster in the first half of 2003, all CEFTA countries recorded economic slowdown versus 2002 H1.

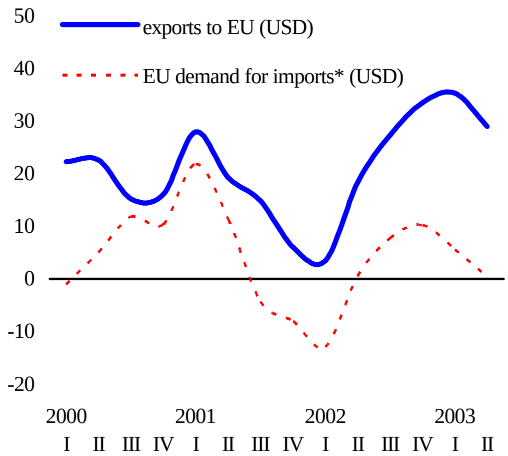
[44] Persons requesting these social security benefits prior to 1 March 2002 – the date on which Law No. 76/2002 came into force

Trade Balance



Exports to EU and EU Demand for Imports

change against the same year-earlier period, %

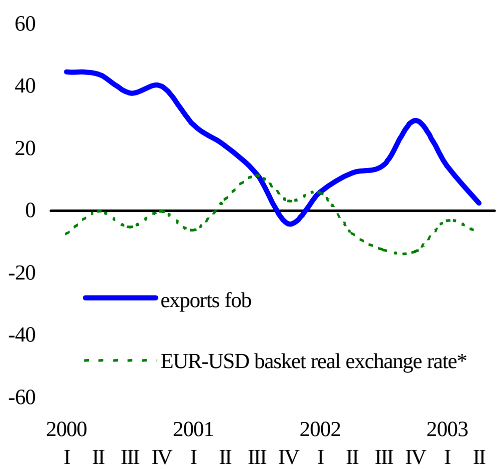


**) excluding trade between member states*

Source: IMF, NBR

Exports and Real Exchange Rate

change against the same year-earlier period, %



**) deflated by the unit labour cost index*

Source: NIS, NBR

2.5.2. Foreign trade[45]

After the thorough adjustment the trade balance underwent in 2002, the reviewed period saw the worsening of the foreign trade flows, which led to a 22.9 percent wider trade deficit against the same year-ago period. In this context, the coverage of imports through exports declined by 1.8 percentage points to 82.8 percent year on year.

Even though exports increased (8.1 percent in 2003 H1 against the same year-earlier period), the recession-plagued economies of Romania's main trading partners in the euro-zone made the growth rate of Romanian exports decline from 14.4 percent in 2003 Q1 to 2.5 percent in 2003 Q2. Nevertheless, the depreciation of the ROL against the euro, the significant productivity gains in manufacturing, and the expansion in import demand of transition economies, mainly CEFTA countries[46], offset the less favourable international economic climate and the restraint of the exporters' tax incentives (the profit tax rate rose from 6 percent to 12.5 percent).

As for the composition of exports two issues deserve mention: (i) the expansion of the share of definitive exports in total value (from 42.4 percent January through June 2002 to 45.3 percent in the period under review) on the back of the contraction of sales of products manufactured under OPT arrangements and (ii) the rise to 21.5 percent (up 0.8 percentage points) in the share of higher value-added products (machinery and transport equipment). However, the low value-added products continued to prevail, with the light industry – the main source of Romanian exports – further covering a third of total value of exports.

The sped-up growth in imports in the first half of 2003 (10.4 percent as compared to 2002 H1) may be ascribed to the joint action of the following factors:

i) **the step-up in the investment process** (particularly in industry and infrastructure), shown by the 13.6 percent advance in capital goods imports. This development, boosted by relevant policies such as the granting of government guarantees for the above-mentioned imports, could allow, once the investment projects were accomplished, the expansion of exports and the change of their current composition by enhancing the exports of specialised parts. According to the Government's Foreign

[45] Based on balance-of-payments data expressed in euro

[46] Transactions with CEFTA countries edged up 25.3 percent as compared to 2002 H1.

Trade Department, nearly 12 percent of imports are duty-free or exempted temporarily from customs duties;

ii) **the expansion of consumer demand** – amid the improved purchasing power of wages and less strict lending requirements –, which brought about the 9.6 percent increase in imports of consumer goods;

iii) **the rise in energy consumption** of companies and households, amid protracted cold season and enhanced purchases of electrical appliances;

iv) **the high level of the international oil price;**

v) **the protracted drought**, which pushed up imported agrifoodstuffs by 8.5 percent, among which vegetal produce went up 46.4 percent versus 2002 H1.

Although the hike in the economy-wide gross minimum wage on the 1st January 2003 put pressure on the wage costs in the first six months, the impact on the competitiveness of the domestic products across most of the sectors facing external competition was limited[47]. On the one hand, the increase of the lower wage bracket influenced marginally the higher wage brackets, and on the other hand, the productivity gains exceeded by far the implemented wage increases (the unit labour cost in manufacturing dropped 12 percent from 2002 H1).

2.5.3. Imported inflation

After hitting a record high of USD 34.18 per barrel[48] prior to the outbreak of war in Iraq, the oil price plunged after the end of the war[49] to reach USD 23 per barrel in early May. Amid the scanty world oil stocks, the difficulties encountered in resuming the Iraqi exports and the lower oil output in Venezuela and Nigeria brought the oil price back on an upward trend, so that the average price for the first semester neared USD 29 per barrel.

The rise by 28.4 percent (up to USD 140 per 1,000 cubic metres) in the price of natural gas imported from Russia induced by both the need to retool the gas industry and the pressures coming from the external environment, added to the inflationary pressures.

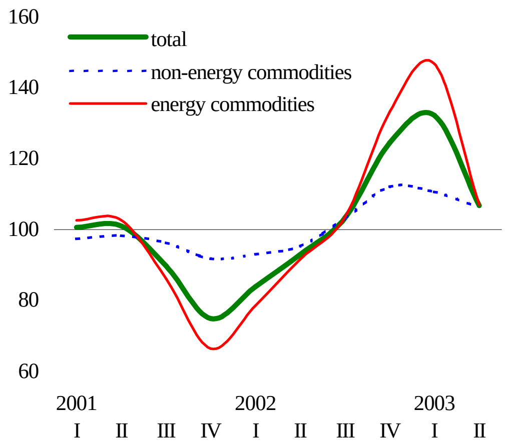
Foreign Trade by Group of Commodities

change against the same year-earlier period, %

	Exports 2002 H1	Exports 2003 H1	Imports 2002 H1	Imports 2003 H1
Total	9.1	8.1	3.1	10.4
1. Foodstuffs	23.1	-14.1	-11.9	8.5
2. Mineral products	12.3	10.3	-22.4	15.8
3. Chemicals and plastic products	-0.9	18.6	18.5	10.8
4. Wood products, paper	3.2	10.7	17.3	12.4
5. Textiles, wearing apparel, footwear	11.2	4.7	10.3	1.9
6. Base metals	3.6	7.0	3.2	13.8
7. Machinery and equipment	10.0	12.9	8.3	15.2
8. Other	12.9	8.0	8.1	4.8

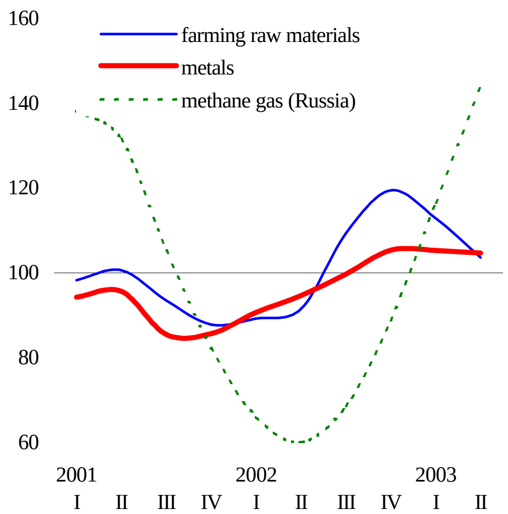
Prices of Raw Materials (a)

index compared to the same year-earlier period



Prices of Raw Materials (b)

index compared to the same year-earlier period

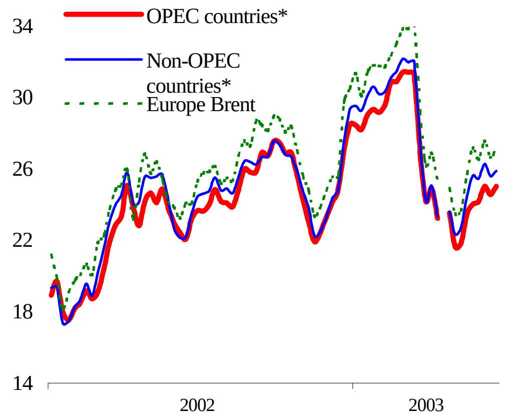


Source: IMF

[47] See subsection *2.4.2.1. Wages*
[48] London Brent
[49] In the second half of April

World Crude Oil Prices

USD per barrel; average weekly spot price FOB

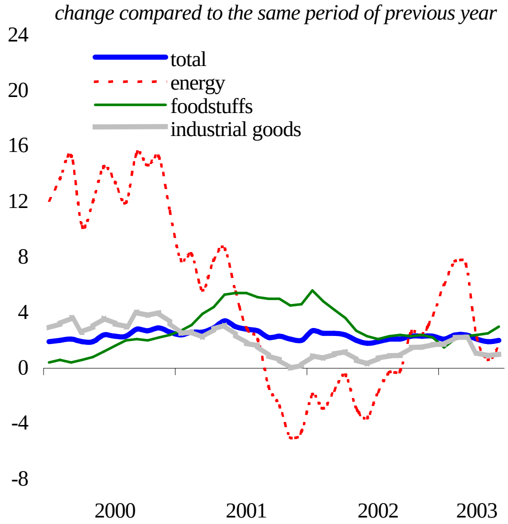


**) Averages weighted by estimated export volume.*

Source: EIA

HICP and its components

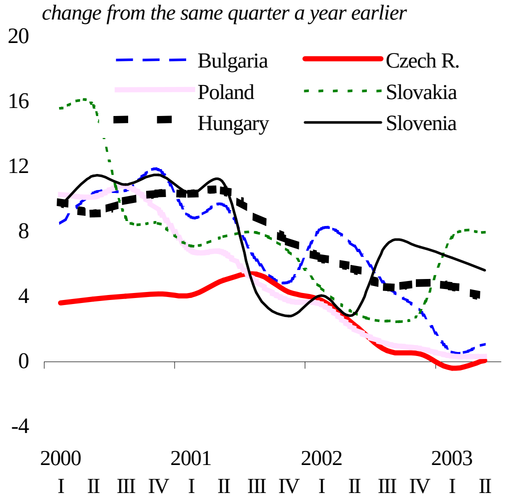
change compared to the same period of previous year



Source: Eurostat

Inflation Rate in CEFTA Countries

change from the same quarter a year earlier



Source: central banks

Prices of imported agrifoodstuffs posted favourable developments. Firstly, the bright picture relating to the grains output and, implicitly, the export capacity of the United States of America, Canada and Argentina offset the bad forecasts on the crops in the European and Asian countries, leading to a lower world price of agricultural raw materials by 2.7 percent in 2003 Q1 and 2.1 percent in 2003 Q2 (as compared to the previous quarter). Secondly, the European Union, providing 32.1 percent of Romanian agrifoodstuffs imports, witnessed considerable cuts in the agricultural producer prices (mainly for vegetables, fruit, animal products) in 2003 Q2. Thirdly, 26.7 percent of these imports came from CEFTA countries, at competitive prices, buttressed by both the disinflation and exchange rate depreciation exhibited by most of the member countries in the reported period and subsidisation policies of agricultural exports promoted by some of these countries (such as Hungary and Poland which accounted for the largest share of Romania's imports among CEFTA countries).

As regards imported inflation through industrial goods, the impact may be deemed limited; January through June 2003, industrial producer prices[50] in the European Union – providing most of the aforesaid goods – experienced a mere 0.5 percent rise, a lower figure than in the same year-ago period.

2.5.4. Exchange rate

In the first half of 2003, the exchange rate of the ROL against the EUR and USD was influenced by both: (i) domestic factors (the forex shortfall on the interbank market due to the widening of the current account deficit and the contraction of capital inflows[51], the switching to the EUR as the reference currency for the ROL), and (ii) external factors (among which the most important were the development of the USD/EUR rate on the international market, and the Iraq warfare). Thus, compared to the same year-earlier period, in 2003 H1, the local currency appreciated by a real 15 percent against the USD and depreciated by a real 6.5 percent against the EUR. The ROL appreciated by a real 1.6 percent year on year against the currency basket made up of 60 percent EUR and 40 percent USD.

Although the depreciation of the national currency against the EUR had a beneficial influence on the external balance, it affected the development of the general level of prices by means of both excise duties and imported goods, dampening the

[50] Construction and energy sector fell out of calculation.
[51] Owing to the unfavourable external environment, the Eurobond issue envisaged by the Ministry of Public Finance was postponed until the end of 2003 H1.

positive effect of disinflation and even that of price cutting in the main supplying regions.

However, the considerably stronger ROL against the USD had a favourable bearing on the development of inflation. Thus, on the one hand, it dampened the negative impact of the high price of oil and natural gas and, on the other hand, it did not put pressure on other administered prices anchored to the USD.

Euro Exchange Rate against US dollar

Source: ECB

3. Monetary policy

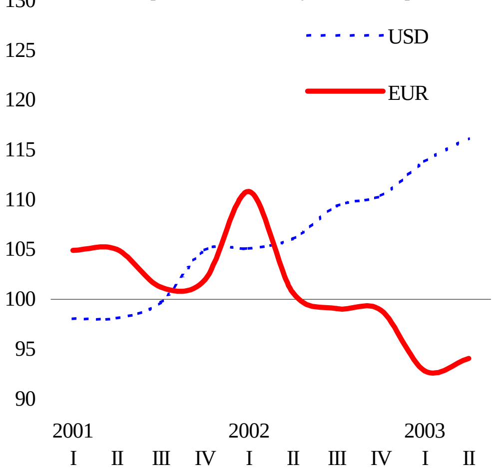
3.1. General features

The economic programme for 2003 focused on the consolidation of favourable macroeconomic performance achieved in the previous year, with primary objectives consisting of keeping up GDP growth and bringing down inflation rate gradually.

Macroeconomic developments in the first half of 2003 have been in line with the possibility to achieve most of the objectives of 2003 programme. Thus, despite the slowdown in industrial output growth, economic growth remained robust while disinflation proceeded at a faster-than-expected pace, the annual inflation rate falling to 14 percent at end-June 2003.

Developments of ROL Exchange Rate *)

index compared to the same year-earlier period



**) appreciation (+), depreciation (-) in real terms*

Source: NIS, NBR

Apart from the favourable developments, the period under review witnessed, however, re-emergence of some macroeconomic imbalances. On the one hand, the unfavourable external environment and pressures of domestic demand on imports affected the trade balance; on the other hand, the mounting instability and unpredictability of the developments in international financial markets induced weaknesses to the balance of payments financial account.

These developments had as direct effect the emergence and, subsequently, widening of the negative gap between supply of and demand for foreign exchange in the currency market. Against this background, the NBR undertook a number of measures aimed at alleviating the conflict between its primary objective and that of ensuring a comfortable level of official foreign exchange reserves. Thus, the central bank sold large amounts of foreign exchange in order to cover the deficit in the foreign exchange market. However, during the period under review, the central bank, which embarked on an important change of the exchange rate regime, shifting the national reference currency from the USD to the EUR as of 3 March 2003, admitted fast depreciation of the ROL against the EUR.

In an attempt to mitigate the effect of depreciation and to put a damper on the depreciation of the ROL, the central bank resorted to the interest rate and liquidity policies. The adoption of a prudent, tight stance in implementing the aforementioned policies became increasingly necessary towards the end of the first half-year when credit expansion proved to have negative effects on the trade balance and the trend of dissaving sped up.

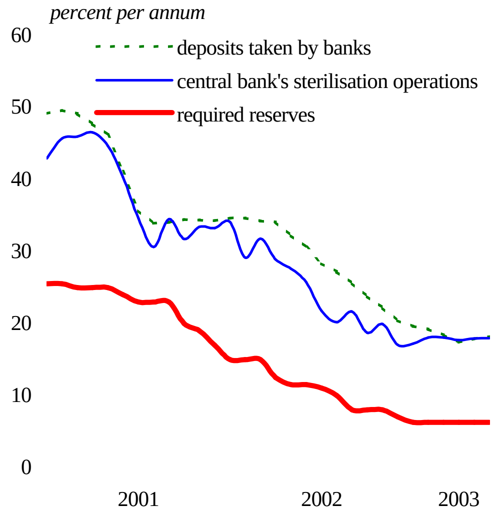
The fall in the ceiling of interest rates on sterilisation operations – in January, the NBR resumed rate cutting in response to decelerating inflation and lower inflation expectations – was slower than in the previous months. After cutting by 1.5 percentage points the maximum accepted interest rate on deposit-taking operations[52] in the first quarter of 2003, the central bank kept this interest rate on hold in the second quarter in order to restore the monetary conditions necessary for upholding disinflation and preserving external equilibrium. Moreover, at the end of the first quarter of 2003, the central bank narrowed the band within which the interest rates on the standing facilities fluctuated, lowering the upper limit, i.e. the interest rate on the lending facility, from 45 percent to 30 percent.

Except the end of the first quarter of 2003, when the ratio between the average level of surplus reserves and the average level of required reserves reached its highest reading in the last few years, in the period under review the monetary control was tight though it depended, to a larger extent than in the previous years, on banks' demand for liquidity driven by the manner in which banks managed their resources.

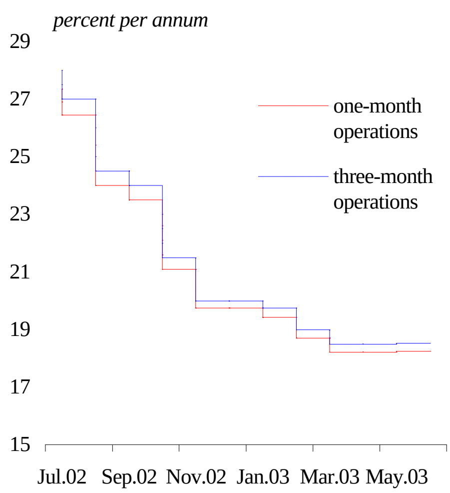
Against this backdrop, the interbank rates showed less sensitivity to daily fluctuations in liquidity. The level of interbank rates was increasingly established in step with the NBR interest rate on sterilisation operations, which strengthened its position as the benchmark for the interbank money market rates. As a result, in the latter half of H1, the spread[53] between the interbank rates and the interest rate on liquidity-absorbing operations narrowed as regards both the average monthly level and the average daily level; moreover, volatility of short-term interest rates diminished, attaining very low levels in May and June 2003, while BUBID-BUBOR (O/N) spread narrowed markedly.

During the first six months of 2003, the central bank continued to gear its tools and monetary tactics to the conditions typical of the period. In an attempt to enhance the effectiveness of the monetary policy tools, the NBR aimed to make a trade-off between the need for achieving flexible intervention in the money market (as the central bank could not engage in reverse repo operations[54], the scope of intervention was restricted) and that for performing long-term sterilisation operations. The central bank opted for shortening the maximum maturity of interventions in the money market, with the one-month deposit-taking operations moving into the forefront of the monetary

Interest Rates on the Interbank Money Market and on Required Reserves



Indicative Rate Set by the Monetary Policy Committee for 1- and 3-month Sterilisation Operations



[52] One-month deposits
[53] Under comparable terms as concerns the maturity
[54] As a result of the significant drop in the NBR's portfolio of government securities

policy tools. Another initiative undertaken by the NBR with a view to increasing the efficiency of the operational framework of the monetary policy was the temporary change[55] to the tactics adopted by the central bank in performing open market operations; i.e., the central bank absorbed no more than the volume of liquidity which was announced for the auctions and which had been set on the basis of surplus reserves resulted from the NBR daily forecasts.

At the end of 2003 H1, the performance of the main monetary indicators showed that monetary policy was steered so as to create a favourable framework for achieving disinflation, economic growth, and sound remonetisation of the economy.

3.2. Conditions surrounding monetary policy implementation

The reasons for the prudent stance of monetary policy during the period under review were both the international economic developments and the domestic macroeconomic conditions.

The external environment became increasingly less favourable, as the mounting uncertainties and the build-up in political and military risks dampened the rise in demand for imports by the main trading partners of Romania while contributing to the pick-up in world oil price, fast depreciation of the USD against the EUR, and higher volatility of the USD-EUR rate.

Adding to the relatively slowdown in export growth (which however occurred concurrently with the change for the better in the commodity composition of exports) was the stepped-up domestic demand. The main factors behind the rise in final household consumption and investment were the loose incomes policy (the economy-wide minimum wage growth was the key element underlying the 9 percent real increase in net average wage), affordability of bank loans and the build-up in arrears[56]. As a result of these factors and of the unfavourable weather conditions, imports increased faster than in the similar year-ago period.

Consequently, the balance of payments current account deficit was higher than projected – especially in the latter half of the period under review – following the widening of the trade and

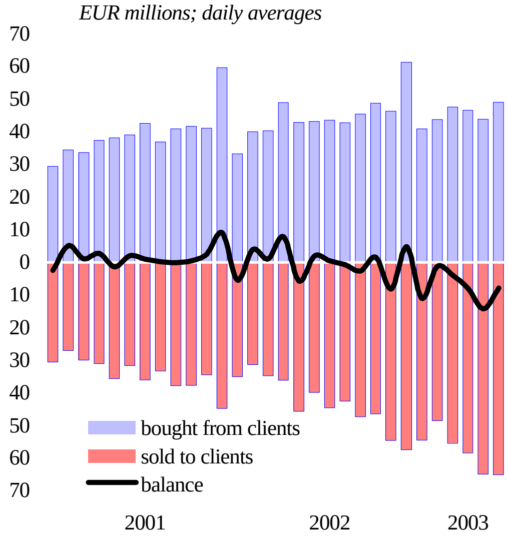
[55] During 15 February - 31 March 2003
[56] At end-June 2003, the stock of arrears of the 74 monitored state-owned enterprises was by 56.3 percent higher than the level projected.

income deficits[57]. An additional source of concern was underperformance of the financial account as a result of lower capital inflows associated primarily with the reorientation of financial investment flows worldwide.

This state of affairs led to the emergence and, subsequently, widening of imbalance of the supply/demand ratio in the foreign exchange market as well as to faster depreciation of the ROL. In order to avert a sharp depreciation of the national currency, which could have entailed inflationary pressures, the NBR supplied additional amounts of foreign exchange, being in the position of a net seller in the forex market for three months (January, April, and May). However, taking also into account the upward trend of the EUR/USD rate on the international markets, the monetary authority accepted a steeper depreciation of the ROL against the EUR. However, the ROL appreciated against the USD in nominal terms so that the ROL remained relatively stable, in real terms, against the currency basket (after having strengthened about 3.1 percent in the latter half of 2002[58]).

Customer Demand and Supply on FX Market

EUR millions; daily averages

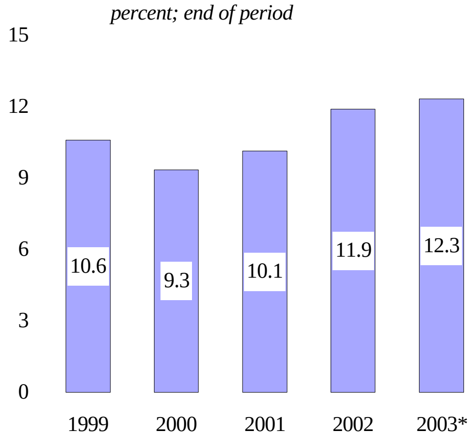


Credit expansion in the period under consideration was driven by changes in both the supply of and demand for loans. Although the increase in credit bolstered the necessary remonetisation of the economy, the fast growth rate of the credit volume has become a concern for the monetary policy, given the worsening of the current account.

Credit supply diversified in terms of both maturity and type of loans as a result of macroeconomic stabilisation, lowering of interest rates (including world-wide interest rates), and higher competition among banks (reflected by the narrowing of the profit margins). The central bank still had a relatively limited room for influencing credit supply given that its increase was fostered mainly by external financing, especially with maturities of more than two years[59] and adjustment of credit institutions' asset portfolio (to the detriment of external investments).

Non-government Credit (Share of GDP)

percent; end of period



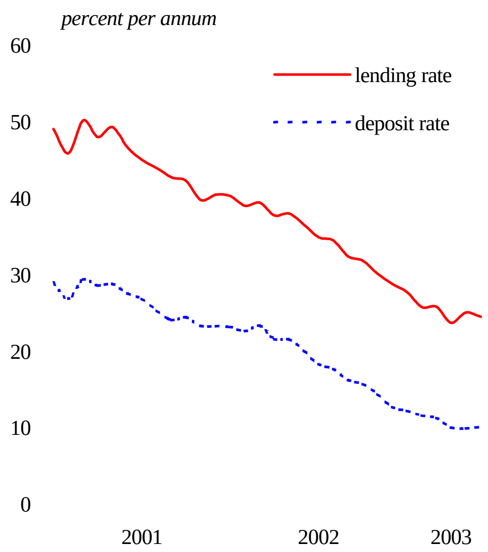
**) non-government credit at end-June; GDP forecast*

Source: NIS, NBR

Demand for ROL-denominated credit witnessed a strong increase, special mention deserving loans to households, which gained momentum. Thus, the rise in incomes of households was only to a small extent reflected by the expansion of household deposits, the propensity for saving being affected by the level of

[57] The income deficit widened due to the rise in income from direct investment repatriated by non-residents and the interest payments on Eurobond issues as well as to the decline in labour income.
[58] Leaving inflation rate in the Eurozone and the USA out of account.
[59] Banks' foreign liabilities expanded by about EUR 251 million in the first half of 2003; moreover, the average value of foreign liabilities with residual maturity of more than two years rose by EUR 160 million, their share in the reserve base increasing from 6.9 percent to 9.6 percent.

Interest Rate Applied to Non-Banks



deposit rates, which was deemed low. However, current loans to households picked up considerably, accounting for 17.8 percent of the total current loans (compared with 11.7 percent in December 2002); at end-June 2003, 30.7 percent of ROL-denominated current loans went to individuals. As a result of fast expansion in mortgage and consumer credit, the medium- and long-term current loans to households went up 104.6 percent, in real terms, accounting for 34.9 percent of such loans, compared with 24.1 percent in December 2002.

The same as in previous periods, the budget deficit financing and public debt refinancing strategy had an important bearing on the monetary policy stance, although fiscal dominance components had divergent effects.

Seen from the perspective of the direct impact on the volume of liquidity in the banking system, the actions undertaken by the Ministry of Public Finance provided an underpinning to the central bank sterilisation policy. The partial settlement of payments related to the forex-denominated external and domestic public debt service and the maturing government securities held in the NBR's portfolio contributed mostly to the outright absorption of more than ROL 16,000 billion (about 60 percent higher, in real terms, year on year).

However, the public authority's interest rate policy, which aimed at lowering the interest expenditures, was not always consistent with the central bank's interest rate policy. In the period under review, especially in the first quarter, the Treasury pushed for lower interest rates on government securities, accepting selectively the banks' bids submitted to auctions; the funds raised by the Ministry of Public Finance on a monthly basis dropped gradually to reach, in June, only 17 percent of the pre-announced volume of government securities issues. Consequently, the spread[60] between the average interest rate on 91-day government securities and the interest rate ceiling on sterilisation operations widened gradually, staying around 3.6 percentage points starting April 2003. Against the backdrop of worsening international market conditions[61], the rise in the spread halted as the Treasury had to change its tactics by resorting to a larger extent to the domestic sources to cover the public sector expenditures. Given that the curtailment of costs was the primary objective, the public authority made recourse to government securities with shorter maturities and diversification of instruments. Under the circumstances, after launching the first issue[62] of 3-year government securities in

[60] Under comparable terms

[61] Which made the Ministry of Public Finance postpone the launch of Eurobond issues.

[62] Leaving the issuance of government securities under the bank restructuring programme out of account.

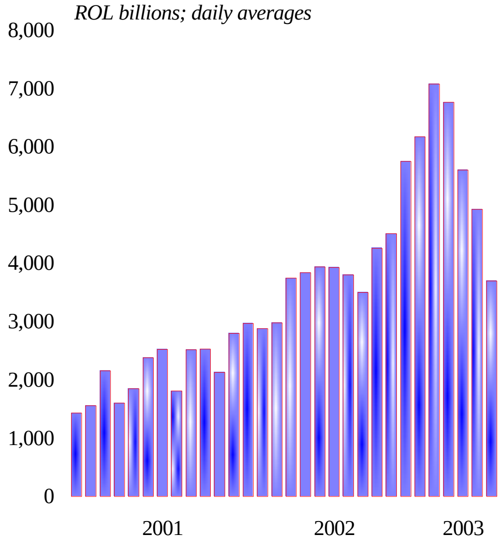
March 2003, the Ministry of Public Finance restrained gradually the share of bonds, resorting to collection of deposits in the money market (with maturities of up to one week) and issuance of short-term government securities (with maturities of one week and one month). The interest rates on very short-term government paper were however fairly close to the central bank's interest rate, usually matching the interbank rate.

A major role in influencing the liquidity conditions was played by banks' behaviour, which featured unsteadiness in the period under review. Thus, several credit institutions adopted an extremely prudent approach to reserve management, keeping holdings on current accounts with the central bank close to the level of reserve requirements. However, some banks engaged increasingly in speculative actions, bringing about temporary steep movements of overnight rates. Against this backdrop, in March the liquidity was unevenly distributed in the banking system as reflected by few banks running large reserve surpluses and, at the same time, most banks running liquidity deficits.

The interbank money market deepened further, albeit at a slower pace; the trading volume increased due almost solely to the NBR sterilisation operations. The central bank strengthened its position in the interbank market owing mostly to the decline in maturities of deposit-taking operations and the suspension of reverse repo operations as a result of government securities held by the NBR reaching maturity. The interbank trading gained momentum in the first three months of 2003 but in the second quarter the banks' increasingly prudent approach to reserve management contributed to the decline in interbank trading by about one third from the first quarter. The volume of transactions in the secondary market for government securities fell January through June, with the ratio of trading in this market to that in the primary market for government securities going down to 4.9 (compared with 7.4 in the previous six months).

Transactions on Interbank Money Market

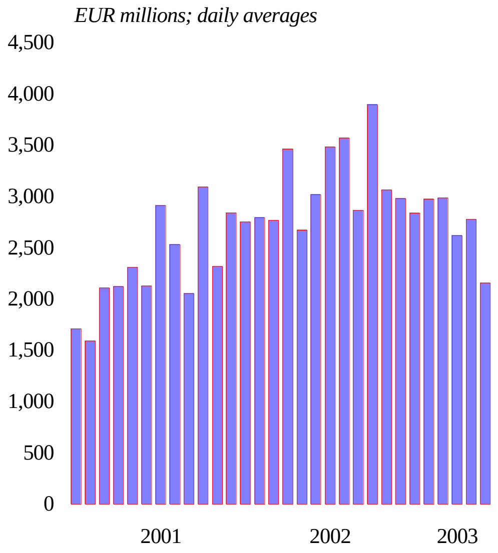
ROL billions; daily averages



Under the circumstances, the improvement in the pattern of interbank rates in the latter part of the period under review was a significant step forward of the money market. After having recorded high volatility in the first three months of 2003, the average daily interbank rates stabilised somewhat in Q2, the daily fluctuation band narrowing to less than 3 percentage points.

The interbank foreign exchange market continued to be the most liquid segment of the financial market although trading fell dramatically. The severe drop in trading was more salient in the second quarter of 2003 due to the contraction of the volume of transactions performed by banks on their behalf, amid higher volatility of the EUR/USD rate on the international markets. By contrast, transactions carried out by clients in the interbank forex market plummeted only on the supply side while purchases of foreign exchange picked up in H1. Against this background, the foreign exchange shortfall in the period under consideration reached a record high of EUR 864 million.

Transactions on FX Market



The impact of this state of affairs on the ROL exchange rate was partly offset by the foreign exchange surplus run by banks' foreign exchange bureaux[63] and by the central bank's foreign exchange sales. Thus, the NBR's net purchases of foreign exchange reached an 8-semester low of EUR 18.1 million, the central bank resorting to more sizeable, albeit less frequent, interventions.

Over the period under consideration, development of the ROL exchange rate against the key currencies was also affected by the shifting to the euro as the reference currency; this step induced the decline in volatility of the ROL against the EUR, and the increase in movements of the ROL against the USD. Due also to this step, banks rapidly changed the structure of foreign exchange transactions, the EUR-denominated transactions gaining ground (about 90 percent of total transactions performed in March, compared with 6 percent in February 2003). Bank clients' foreign exchange operations in euro stepped up as well albeit at a slower pace, accounting for 60 percent of total in June, compared with 48 percent in February 2003.

[63] The level of foreign exchange surplus was almost similar to that recorded for June-December 2002.

3.3. The mix of monetary policy tools

Reserve money[64] surged in the first half of 2003 by 7 percent in real terms; currency outside the NBR and banks' holdings on current accounts with the NBR increased by 4.3 percent and 11.7 percent respectively, both components contributing almost equally to reserve money growth. Unlike the previous half-yearly periods, the driver of reserve money expansion was the good performance of net domestic assets, which offset the slight shrinkage in central bank's net foreign assets.

Monetary control was firm, except for March, when banks' excess reserves outran by about 4.6 percent the required level. Unlike in the previous period, this development was buttressed by the contractionary impact of autonomous liquidity factors.

The main operations performed by the central bank, with significant impact on liquidity in 2003 H1, were the following:

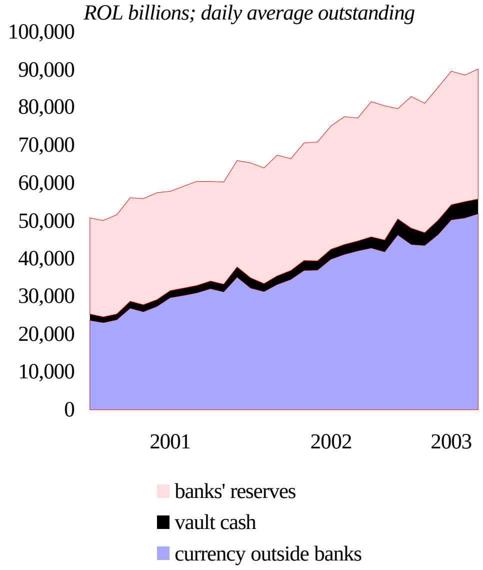
1. Liquidity-absorbing operations. The pick-up in credit institutions' demand for reserves associated with the favourable impact of autonomous liquidity factors caused the central bank's sterilisation operations to decline gradually. In June, the average daily volume of NBR's operations was 18.4 percent lower than in December 2002; likewise, the average balance on deposits taken by the NBR shrank 21.8 percent. Furthermore, the rate of increase in the half-yearly volume of NBR's mopping-up operations plunged from 53.4 percent in 2002 H2 to 5.3 percent in 2003 H1.

The sharp decline in the central bank's portfolio of government paper made mopping-up operations further consist of deposit-taking operations. In an attempt to enhance efficiency of the monetary control, the National Bank of Romania shortened the maximum maturity of deposits taken from the money market from three to one month. As a result, the average maturity of sterilisation operations contracted from 50 days to 29 days.

Unlike the preceding periods, the average interest rate on soaking-up operations turned off occasionally from the maximum interest rate accepted by the central bank. This spread was the result of the temporary change in central bank's tactics at end-February, when, in the wake of NBR's capping the volume of deposits taken, the competition among banks to place deposits increased and the interest rates asked by banks were sent farther and farther below the maximum interest rate accepted by the NBR. After the central bank gave up imposing a ceiling on the volume of deposit-taking operations, the interest

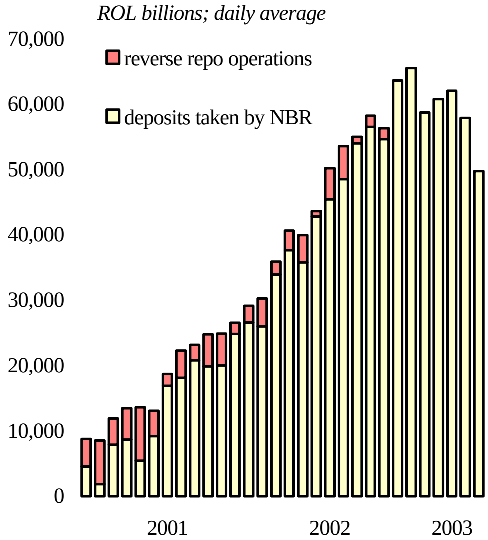
Monetary Base

ROL billions; daily average outstanding



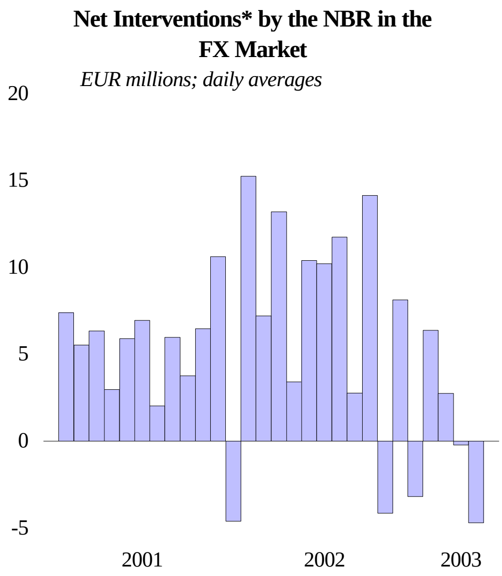
Sterilisation Operations

ROL billions; daily average



[64] Daily average (June 2003/December 2002)

rates charged by banks reached only gradually the maximum interest rate accepted by the NBR. The average interest rate on the central bank's mopping-up operations swung, dropping to 17.4 percent in March, then rising to as much as 18.2 percent in June, thereby reflecting the NBR's interest rate moves and the influence of the aforementioned factors.



*) purchases (+), sales (-)

2. Interventions in the foreign exchange market were smaller than in 2002 H2, with the central bank performing both sales and purchases. The National Bank of Romania sold EUR 167 million in January, April and May while in February and March it purchased a net amount of nearly EUR 185 million. Thus, in the first half of 2003, net purchases of foreign currency by the central bank came in at only EUR 18.1 million, tantamount to ROL 419 billion.

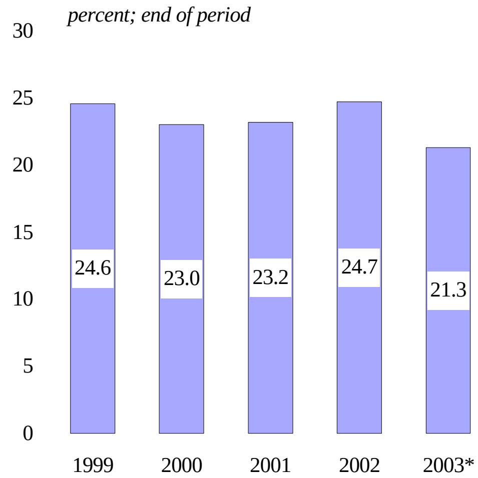
3. Repayment of some special credit lines. Mopping-up operations continued to be supported by the partial repayment of some credit lines opened by the National Bank of Romania for the Bank Deposit Guarantee Fund. In 2003 H1, the monetary authority soaked up liquidity to the tune of ROL 333 billion.

4. Standing facilities. The deposit facility was less resorted to compared to the previous 6-month periods, reflecting the improvement in banks' reserve management. Except February, when banks displayed heavy recourse to the deposit facility, hinting at difficulties in accommodating to the central bank's new stance, the deposits placed with the NBR were far lower, ranging from ROL 10 billion to ROL 100 billion. Moreover, in 2003 H1 banks resorted to the deposit facility only 14 times compared with 65 times in 2002 H2, and only 10 credit institutions resorted to the deposit facility compared with 19 in the previous half-yearly period.

3.4. Main monetary developments

In 2003 H1, broad money (**M2**) built up at a slower pace compared with the previous year, following the seasonal fall in January. Thus, broad money dropped by a real 1.6 percent against end-2002, pointing to a slowdown in the re-monetisation of the Romanian economy. Moreover, the pseudo-monetary aggregate **M2T** (M2 + non-banks' government securities) slid 1.5 percent in real terms, the government securities outstanding with non-banks dipping by 0.4 percent.

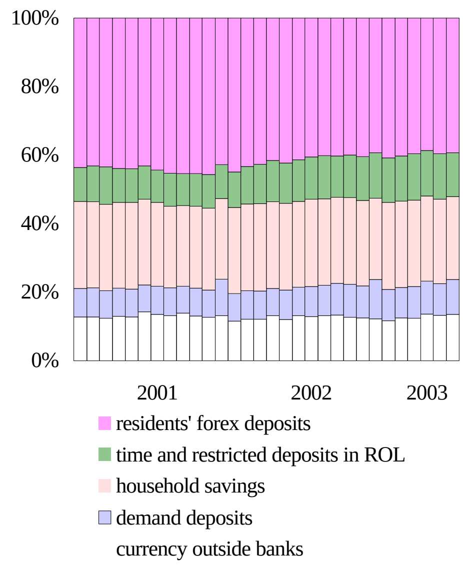
Broad Money (M2)
(Share of GDP)



*) M2 at end-June; GDP forecast
Source: NIS, NBR

Narrow money (**M1**) slipped 1.3 percent in real terms as a result of the mixed developments in its constituents. **Currency in circulation** picked up a real 9 percent due to significant seasonal increases in February and April 2003, as well as to the incidental impact of compensations granted to laid-off staff and the contraction in the number of the NBR branches. Currency in circulation posted the highest average monthly real growth rate ever recorded in the first six months of a year, i.e. 1.4 percent. By contrast, **demand deposits** edged down 12.3 percent in real terms. Personal current accounts were the only deposits in ROL that leapt (41.3 percent) in real terms versus end-2002, thus highlighting partly the expansion of ROL-denominated card-based transactions[65] whose value surged 23.3 percent in real terms in the reported period.

Broad Money

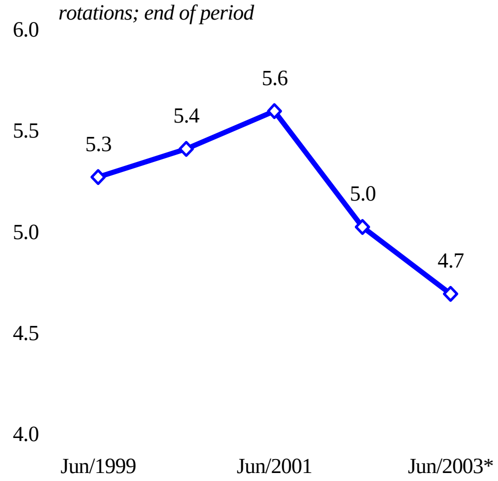


Quasi-money, the less liquid constituent of broad money, dropped 1.8 percent in real terms, showing a modest performance compared with similar periods of the past two years.

Household savings in ROL saw their previous-year upsurge coming to a halt, being flat in real terms compared with end-2002, despite the significant increase in household incomes. One of the factors that led to dissaving in ROL was the downtrend in average deposit rates (despite its alleviation in the latter half of the reported period) that induced the shift in household deposits in ROL to forex deposits and real-estate investments (or other non-bank assets). Over the period, the decline[66] in banks' average interest rates on time deposits[67] outran the fall in the NBR's interest rates. The decrease in real interest rates on time deposits[68] was so sharp that they reverted to positive territory no sooner than the latter part of 2003 H1.

[65] In 2003, NBR Regulation No. 4/2002 on transactions performed by means of electronic payment instruments and the relations among participants in these transactions came into force.
[66] Discontinued in May and resumed in June
[67] Starting May 2003, interest rates have been reported and calculated pursuant to NBR Norm No. 2 of 21 February 2003 and included, for the first time ever, the information provided by Creditcoop.
[68] Based on three-month moving average of inflation

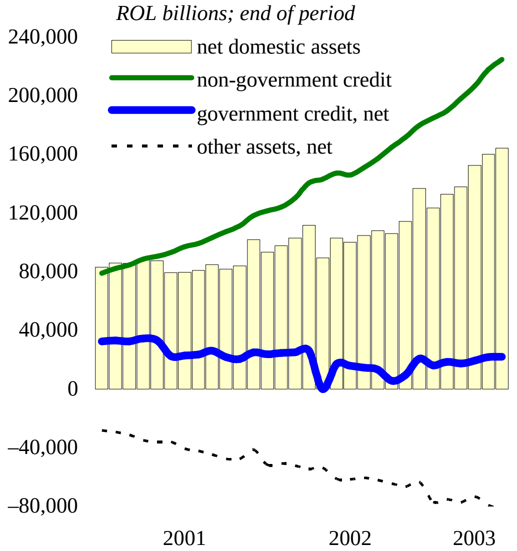
Money velocity



**) GDP forecast*

Source: NIS, NBR

Net Domestic Assets



Moreover, ROL-denominated government securities held by individuals shrank 5 percent in real terms.

Corporate time deposits in ROL edged down 5.3 percent in real terms against end-2002. Part of corporate disposable resources was channelled into the acquisition of ROL-denominated government securities (up 11.2 percent in real terms) and net purchases of foreign exchange.

Residents' forex deposits, when expressed in euro, went down 3.6 percent. Over the same period, the stock of foreign-exchange-denominated government securities outstanding with non-banks came off 21.3 percent (when expressed in US dollars). The share of forex deposits in broad money (M2) stayed on a downward trend over 2003 H1, recording a monthly average of 39.7 percent. The development in foreign exchange deposits reflected the bank clients' divergent behaviour. Thus, corporate foreign exchange deposits fell by 18.4 percent (when expressed in euro), while household foreign exchange deposits moved up 6.2 percent (when expressed in euro).

In the first half of 2003, the jump in net domestic assets touched an eight-year record high of 13.5 percent in real terms. This development may be attributed entirely to the 16.4 percent rise in **net domestic credit**, while the higher credit balance of "**other net domestic assets**" (up 22.7 percent) had a contractionary effect on net domestic assets.

In 2003 H1, **non-government credit** stayed on an upward trend, posting a real 18.2 percent increase. Non-government credit by client experienced a significant change that consisted in the increase in the share of loans granted to individuals in total non-government credit (17.6 percent in June 2003 versus 11.6 in December 2002 and 8.1 percent in June 2002). The boom in household lending was partly due to the inclusion of the first credit co-operative central body in the monetary survey as of May 2003.

Non-government credit **in ROL** displayed a sharp pick-up of 34.9 percent in real terms versus end-2002. **Foreign-exchange-denominated** non-government credit moved up 6.2 percent (when expressed in euro) as a result of the following factors: (i) the step-up in importers' demand for loans, as well as (ii) the growth of credit supply by banks that obtained higher returns from these investments compared with returns on foreign investments. Despite its prevalence, the share of forex non-government credit in total non-government credit followed a downward path, from 62.9 percent in December 2002 to 57.6 percent in June 2003.

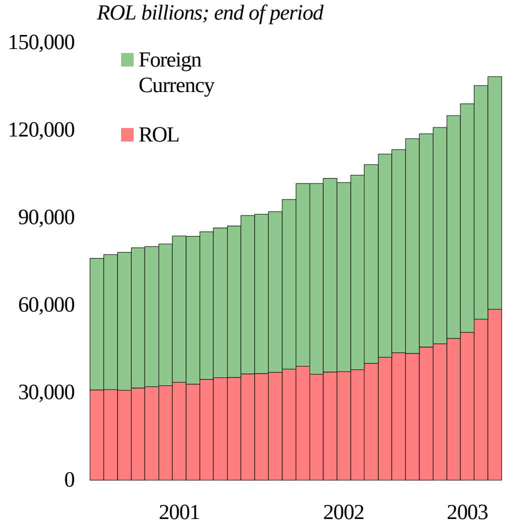
Current loans increased by a real 17.8 percent thanks to the lower interest rates set by banks. The coming into force, in January 2003, of the new regulation on classification of loans did not hamper the surge in current loans. Banks adjusted their current loan portfolios in favour of medium- and long-term loans, whose stock rose by a real 41.3 percent. Moreover, short-term current loans exhibited a real 5.5 percent uplift. Reflecting the increasing demand for such loans, the interest rates on medium- and long-term current loans proved to be the most rigid. Average interest rates on short-term current loans, whose decline was almost twice as large as that of interest rates on long-term loans, were more flexible and resulted in contraction of the spread[69] against the average interest rate on the interbank market to its lowest 2-year reading.

Government credit, net inched up 0.7 percent in real terms over 2003 H1. The increase in banks' net claims on the government sector occurred as a result of the lower balance of the State Treasury, whose influence was partly offset by the decline in the portfolio of government securities with banks and the rise in the forex deposits of the Ministry of Public Finance.

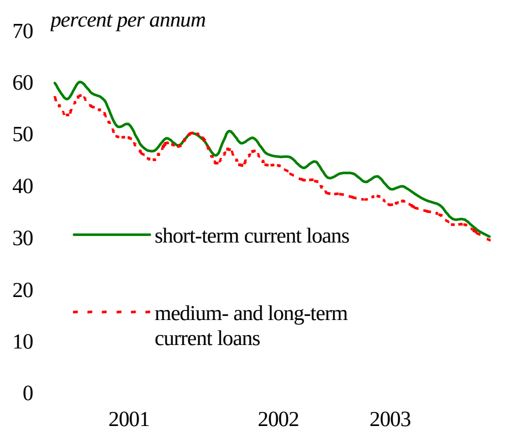
Net foreign assets of banks had a contractionary effect on broad money, dropping 12.6 percent during December 2002 - June 2003 (when expressed in euro). This reduction was detected for both the central bank (8.4 percent) and commercial banks (163.9 percent). The fall in NBR's forex reserves was partly counteracted in April 2003 by the disbursement of the fourth tranche (EUR 69 million) under the stand-by arrangement with the IMF, without influencing however the value of the central bank's net foreign assets. Starting March 2003, net foreign assets of commercial banks displayed a credit balance as a result of lower investments abroad and larger foreign debts.

Real Non-Government Credit

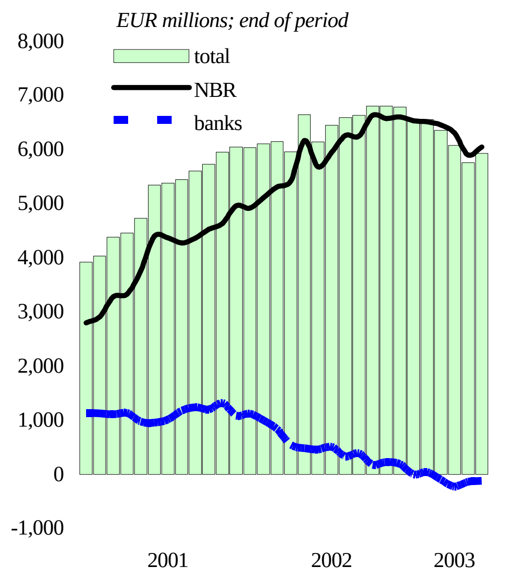
(deflated by CPI; Dec. 2000=100)



Lending Rates to Non-bank Clients

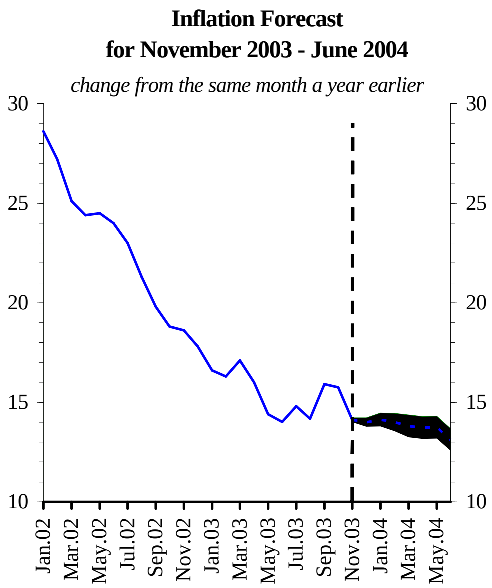


Net Foreign Assets



[69] Comparable terms

4. Outlook for inflation developments



When drawing up the forecast on inflation rate for November 2003 - June 2004, the following aspects have been taken into consideration:

– announcement of price increases for some products with administered prices (natural gas, basic postal services, passenger air transport) in the last few months of 2003;

– some pressure on milling and bakery products in the first few months of 2004, as a result of severe drought, which affected the cereals crop in 2003;

– further adjustment of prices for energy in accordance with the commitments assumed by the Romanian government under the fourth review of the IMF - SBA in October 2003, as follows:

  - gradual adjustment, on a quarterly basis, of the price for natural gas so as to make it reach the import price for natural gas by 2007.

Therefore, it was estimated that the price for natural gas might be raised at the beginning of 2004, given that Russia intends to increase gas export duty, from 5 percent to 30 percent. The price for natural gas is projected to be raised again in early Q2 2004, with a view to reaching import parity;

  - adjustment of prices for electricity and heating on a quarterly basis in order to keep them at a level that ensures cost recovery.

Since the price for heating is not usually subject to changes in the first part of the year, adjustments on a quarterly basis are expected only for electricity;

– adjustment of prices for some food items (alcohol and spirits) and non-food items (fuels, such as leaded petrol, diesel fuel), consistent with the schedule envisaging the rise in excise duties by the date of Romania's joining the EU.

Thus, in 2004 excise duties on alcohol and spirits will be raised by EUR 41.6/hl to EUR 150/hl, while excise duties on leaded petrol and diesel fuel will increase by EUR 6/tonne and EUR 34/tonne respectively.

Moreover, as regards fuels, the possible adjustment of their prices was taken into consideration in order to bring them in line with EU prices;

- adjustment of the other administered prices and tariffs in accordance with the legal provisions (on a quarterly or monthly basis, as the case may be, and contingent on the developments in the exchange rate or inflation);
- seasonal (Christmas and Easter holidays) and historical developments;
- moderate real appreciation of the ROL against the implicit currency basket, aimed at maintaining the equilibrium between domestic and external purchasing power of the ROL.

Taking into consideration the macroeconomic developments recorded in 2003 and the assumptions underlying inflation forecast for the first half of 2004, it is our opinion that the path of inflation will confirm the disinflation trend.