INFLATION REPORT

1/2004

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N O T E

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The National Institute for Statistics, Ministry of Public Finance, Ministry of Labour, Social Solidarity and Family, National Employment Agency and National Bank of Romania.

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
ANRGN	National Authority for Regulation in Natural Gas Sector
BDGF	Bank Deposit Guarantee Fund
BIS	Bank for International Settlements
CEFTA	Central European Free Trade Agreement
CIB	Credit Information Bureau
CIS	Community of Independent States
CPI	Consumer Price Index
ECB	European Central Bank
EIA	Energy Information Administration
EU	European Union
EUR	euro
FOB	free on board
GCF	Gross Capital Formation
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IFS	International Financial Statistics
ILO	International Labour Office
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 Exporting Countries
PSAL	Private Sector Adjustment Loan
SDR	Special Drawing Rights
USD	United States Dollar

Overview

- **Disinflation strengthened**. Despite supply-side shocks, the growth rate of consumer prices slowed markedly in 2004 H1, owing mainly to the tight monetary and fiscal stance.

- **Economic growth exceeded expectations**. GDP growth was driven by the stronger domestic demand, with investment posting the fastest increase. The rise in domestic absorption had no significant impact on the progress of disinflation, being however the primary driver of trade deficit widening.

- **External demand stepped up**. The upward trend of world economy as a whole was bolstered chiefly by the economic growth of the USA, China and Japan. The economic performance of EU Member States, which are Romania's main trading partners, was moderate, but the rise in their demand for imports boosted the market share of Romanian products.

- **Prudent monetary policy supported disinflation**. In order to maintain the inflation rate in line with the annual 9 percent target (December/December), the NBR increased the positive real level of the policy rate gradually, kept a tight rein on liquidity and accepted a sustainable real appreciation of the ROL against the implicit currency basket.

- **Fiscal policy featured budget restraints**. The tight fiscal policy, which limited the budget deficit to 0.6 percent of GDP at end-2004 H1, alongside the measures to reduce arrears helped strengthen disinflation.

- **Growth rate of non-government credit slowed down**. The austere monetary policy together with the entry into force of the prudential norms issued by the NBR contained the pace of increase of non-government credit. The composition by currency of non-government credit underwent a notable change, with foreign exchange-denominated loans gaining ground, particularly as a result of their lower cost.

- **In 2005 Q1, the disinflationary trend might be cut off**. Taking into account the developments recorded in January-August 2004 and the assumptions underlying the inflation forecast for September 2004 – March 2005, the annual inflation rate is seen declining in 2004 Q4. Nevertheless, in 2005 Q1, inflation is expected to temporarily stop falling in the wake of the adjustments in the energy prices to be implemented in January, as well as the tensions caused by the surging oil price. Against this background, the mix of economic policies must be highly coherent, focusing on the implementation of prudent monetary and fiscal policies, as well as on the avoidance of slippages in income policy.

1. Inflation developments in 2004 H1

In 2004 H1, disinflation accelerated, with the rate of increase in consumer prices (3.7 percent, June 2004/December 2003) slowing markedly versus both 2003 H2 (by 4.2 percentage points) and the same year-ago period (by 2 percentage points). The main constituents of the economic policy mix which caused inflation to stay on a path consistent with meeting the 9 percent annual target (December/December) were the following: the contractionary monetary policy (featuring a high interest rate and a sustainable strengthening of the domestic currency), the tight fiscal policy (which kept the budget deficit at 0.6 percent of GDP at end-June) and the measures to reduce arrears in the economy[1] and prevent the build-up of new ones.

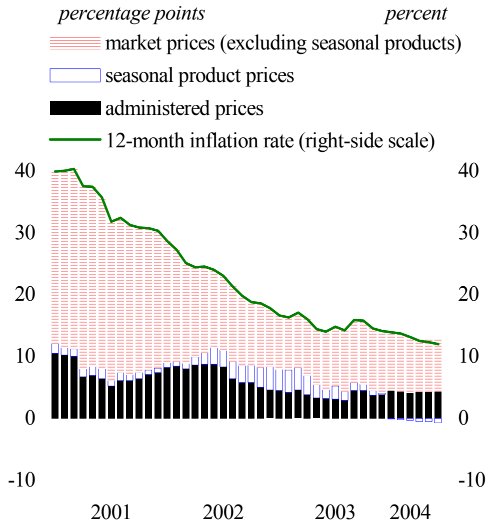
Inflationary pressures stemmed particularly from the supply side: the worsening of unit labour cost in industry (see Subsection 2.4.2. *Incomes*), the adjustment of administered prices, and one-off factors such as the high prices of wheat and oil on the international market (see Subsection 2.5.3. *Imported inflation*).

As far as demand is concerned, the inflationary pressures generated by the rapid growth of consumption following the rise in all categories of household incomes and the readily available bank loans were contained by keener consumer interest in imported goods amid lower import prices (see Subsection 2.5.3. *Imported inflation*) and a fairly stable exchange rate (given a 0.4 percent nominal depreciation[2] of the ROL against the EUR).

Moreover, the strong competition among retailers, spurred by the expansion of large trading companies, helped prevent supply-side tensions from feeding through into consumer prices.

In the reference period, disinflation was detected mainly in the case of market prices, which rose only 3.5 percent, i.e. 2.9 percentage points less than in the previous two six-month periods. The adjustments in administered prices further put significant pressure on consumer prices, their 4.4 percent increase exceeding by 1.2 percentage points the 2003 H1 reading (although the comparison with 2003 H2 underscores a sharp disinflation, this is irrelevant, as the developments in

Inflation Rate



Source: NIS, NBR calculations

Administered Prices

percentage change

	Jun.03/ Dec.02	Dec.03/ Jun.03	Jun.04/ Dec.03
1. Inflation rate	5.7	7.9	3.7
2. Administered prices geared to inflation, of which:	10.3	11.2	7.8
- railway transport	9.2	5.2	6.4
- water, sewerage, waste disposal	10.9	12.3	9.2
3. Share in CPI basket (%)	4.5	4.5	4.5
4. Exchange rate (+ appreciation, - depreciation)			
- ROL/USD	3.2	–1.2	–1.7
- ROL/EUR	–10.1	–6.2	–0.4
5. Administered prices geared to exchange rate, of which:	1.1	10.6	2.5
- electricity *	0.6	17.5	9.2
- heating *	0.0	0.0	0.0
- telephony **	x	13.2	2.3
6. Share in CPI basket (%)	10.1	15.0	15.7
7. Administered prices geared to inflation and exchange rate, of which:	1.7	38.4	9.3
- telephony *	-1.1	x	x
- postal services ***	21.0	31.3	0.7
- natural gas *	7.5	38.5	9.4
8. Share in CPI basket (%)	7.1	2.3	2.8
9. Administered prices (total)	3.2	13.6	4.4
10. Share in CPI basket (%)	21.7	21.7	23.0
11. Contribution to inflation rate (percentage points)	0.7	3.0	1.0

*) ROL/USD
**) ROL/EUR
***) ROL/SDR
Source: NIS, NBR calculations

[1] In relative terms (as a percentage of GDP), the total amount of arrears dropped 2.6 percentage points in 2004 H1.
[2] June 2004/December 2003

energy prices in the said period were strongly affected by incidental influences[3]). In addition, even though the growth rates recorded by the administered prices of some services (city and railway transport, water, sewerage and waste disposal) slowed slightly, they were considerably higher than inflation rate. A dampening impact on the growth rate of administered prices had only “Medicines” (shedding 7.1 percent, thanks to the cut in VAT from 19 percent to 9 percent) and “Telecommunications and postal services”, both groups displaying below-average dynamics against the background of a stable exchange rate.

The hike in the prices of electricity and natural gas (9.2 percent and 9.4 percent respectively), weighing heavily on the development of administered prices in 2004 H1, was the result of: (i) the need to cover losses incurred by the main electricity producers following the poor collections and the 2003 drought and (ii) the unfolding of a new stage of the programme for the gradual adjustment of the selling price of domestically produced natural gas to the import price.

CPI by Category of Products

percentage change

	Dec.02/ Jun.02	Jun.03/ Dec.02	Dec.03/ Jun.03	Jun.04/ Dec.03
Milling and bakery products	5.4	13.0	19.0	5.3
Fruit and vegetables	-1.5	23.1	-14.5	4.6
Meat and fish	2.0	0.4	3.1	4.3
Milk and dairy produce	10.4	7.8	8.2	2.6
Alcoholic beverages and tobacco products	11.8	10.7	11.4	5.3
Wearing apparel and footwear	7.3	4.8	4.6	2.7
Household appliances, furniture	6.0	4.4	3.8	3.1
Fuels	16.4	5.5	6.4	7.4
Utility expenses*	12.0	4.1	15.8	7.4
Healthcare	8.8	5.3	3.4	-1.3
Transport	5.6	8.9	8.5	5.1
Post and telecoms	7.4	-6.1	14.2	2.5
Leisure and culture	6.6	5.7	7.4	3.3
Other goods and services	13.6	1.4	15.0	-0.3

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

Source: NIS, NBR calculations

The growth rates of food prices recorded the steepest declines[4], owing to the diminishing pressures on the wheat market[5], the bumper production of spring vegetables and fruit, as well as to the lower depreciation of the ROL against the EUR (particularly during winter months, a significant share in the domestic consumption of vegetables and fruit is covered by imports). The group “Meat and products thereof” was the only one to show price increases higher than those recorded in the previous two six-month periods; the rise in demand for some meat varieties along with the restructuring of the activity of some producers and the drastic fall in pig numbers called for higher meat imports in order to supplement the domestic output, amid the increasing price on the international market. Despite being subject to considerably lower adjustments than in the preceding two six-month periods, prices of milling and bakery products put further pressure on the general level of consumer prices, rising above both the group’s average and the inflation rate (by 2.7 percentage points and 1.6 percentage points respectively).

Albeit slower, disinflation was also manifest in the case of non-food items (save “Energy” and “Medicines”, products with administered prices)[6]. Such developments were mainly

[3] Higher prices for producing electricity, because of the severe drought and the rise in the import price of natural gas

[4] 2.6 percent in the considered period as compared to 7.5 percent in 2003 H1 and 5.8 percent in 2003 H2

[5] Caused by the resort to some amounts of wheat from the state reserves and by the favourable expectations of the 2004 grain production.

[6] 4.6 percent in 2004 H1 compared to above 6 percent readings in the previous two six-month periods

supported by "Wearing apparel and footwear" and "Household appliances and furniture", as the slowing growth rate of demand and the competition among retailers on the two market segments[7], as well as the lower import prices and the stable exchange rate, helped contain the effects of producer price hikes from feeding through into consumer prices. Conversely, the groups "Fuels" and "Tobacco products" experienced higher prices (7.4 percent and 5.7 percent respectively), due to the rise in prices of raw materials on the international market.

Disinflation was not manifest in the case of services[8], which displayed the highest price changes among the items in the CPI basket. Market-priced services saw a 5.1 percent price rise[9] (the same as services with administered prices), owing to both the notable step-up in utility prices and wage increases.

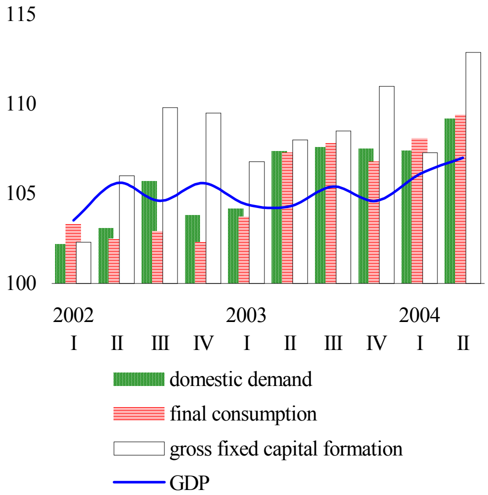
[7] Western style marketing policies were increasingly used on both segments. Illustrative for the former case is the larger recourse to clearance sales following the expansion of some well-known companies specialised in selling wearing apparel and footwear. In the latter case, the main retailers of electronic goods and household appliances facing stockpiles (as a result of last year's strong business expansion and sluggish demand in early 2004) resorted to aggressive promotional campaigns in order to boost consumer interest.

[8] The comparison with the preceding six-month period is irrelevant because of the incidental development of energy prices.

[9] 2.1 percent and 9.4 percent in 2003 H1 and H2 respectively

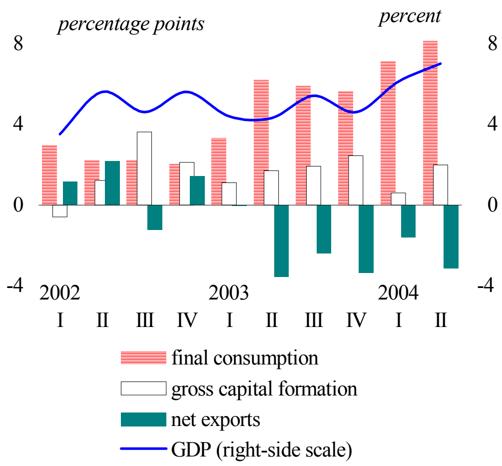
Domestic Demand

index compared to the same year-earlier period (%)



Source: NIS

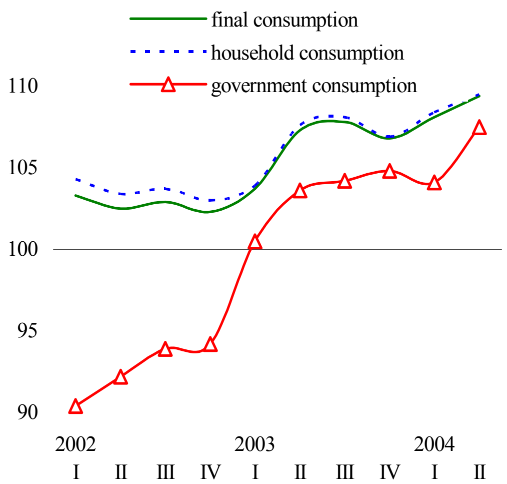
Contribution of the Main Components of Demand to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption

index compared to the same year-earlier period (%)



Source: NIS

2. Determinants of inflation

2.1. Demand

In 2004 H1, GDP growth[10] picked up 6.6 percent, being driven, as in 2003, by domestic demand, with investment and final consumption rising 10.4 percent and 8.8 percent respectively. In 2004 Q1, the growth rate of gross fixed capital formation lagged 1.1 percentage points behind that of household actual final consumption. April through June, demand for investment was yet again the main driver of economic growth.

2.1.1. Consumer demand

Household actual final consumption rose rapidly, reaching 9 percent for the six months to June 2004, against the background of larger household incomes[11], the individuals' favourable expectations on both their future financial position and the overall state of the economy[12], the frequent resort to bank loans, and the psychological state induced in January by the approaching enactment of regulations[13] setting severer prudential standards in respect of consumer loans. Nevertheless, starting March, the annual rate of retail sales slowed down. Thus, the growth rate of non-food sales shed 2.1 percentage points[14], following the sizeable slowdown in ROL-denominated loans granted to households[15]. By contrast, the annual growth rate of motorcar and fuel sales rose 5.2 percentage points, due to still attractive foreign exchange-denominated loans.

In 2004 H1, the actual final consumption of public administration edged up 6 percent. In the April-June period, its growth rate accelerated mainly due to the budget outlays on organising local elections.

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[10] In the absence of an express mention, in Section 2. *Determinants of inflation* growth rates are determined by referring to the same year-ago period.
[11] See Subsection 2.4.2. *Incomes*
[12] According to the Consumer Confidence Barometer compiled by GfK Romania
[13] NBR Norms No. 15/2003 setting measures to mitigate credit risk attached to consumer loans, in force since 1 February 2004 and the Insurance Supervisory Commission Norms on limiting the risks attached to consumer and mortgage loans, in force since 30 March 2004.
[14] Difference calculated by comparing the average levels for the January-February and March-June 2004 periods
[15] In 2004 Q2, ROL-denominated short- and medium-term loans granted to households – considered as consumer loans – surged 106.4 percent in real terms compared with an increase of 2.8 times in the three months to March 2004.

2.1.2. Investment demand

In 2004 H1, gross fixed capital formation grew at a faster pace owing to the joint action of the following: (i) good financial results of the corporate sector in the previous six-month period; (ii) real rise in household incomes; (iii) further readily available domestic and external loans; (iv) non-redeemable external loans taken under programmes such as SAPARD and ISPA; (v) higher volume of foreign direct investment[16], particularly in the non-bank sector; (vi) the pick-up in private money inflows in the form of foreign current transfers[17].

Private and public investment projects expanded, as mirrored by the higher growth rates recorded by equipment purchases and the new construction works. Thus, purchases of equipment, including transport means, moved ahead 21.3 percent year on year. In order to meet demand, equipment and transport means were bought from both domestic and external markets; in the former case, purchases stepped up 7.4 percent in the January-June period, whereas in the latter case, they went up 17.9 percent for capital goods and 75.9 percent for transport means. The advance in new construction works stood at 8.9 percent in the six months to June and it was manifest in the case of residential, non-residential and infrastructure objectives. Behind this development stood: the sharper tendency, particularly outside large cities, to build plants, warehouses and outlets, and the individuals' greater interest in inner and outer residential suburbs.

2.1.3. Net external demand

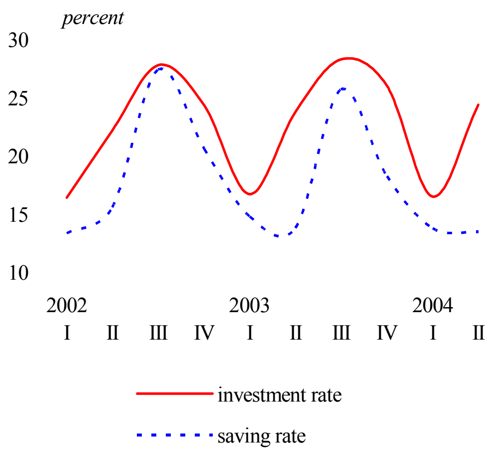
In 2004 H1, the improved external demand from EU Member States along with the higher domestic absorption brought about a year-on-year increase in foreign trade of goods and services. Thus, exports expanded 17.1 percent, while imports went up 19.1 percent. The persistent negative disparity between the growth rate of exports and that of imports took 2.7 percentage points off the GDP growth rate.

2.2. Supply

In year-on-year comparison, the economy grew 2.3 percentage points faster in 2004 H1 on the back of all its four sectors.

Services had the main contribution to GDP formation, i.e. 3.1 percentage points, due largely to the trading activity. In the considered period, trade underwent changes in terms of both

Investment Rate and Saving Rate



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 GDP

Source: NIS, NBR calculations

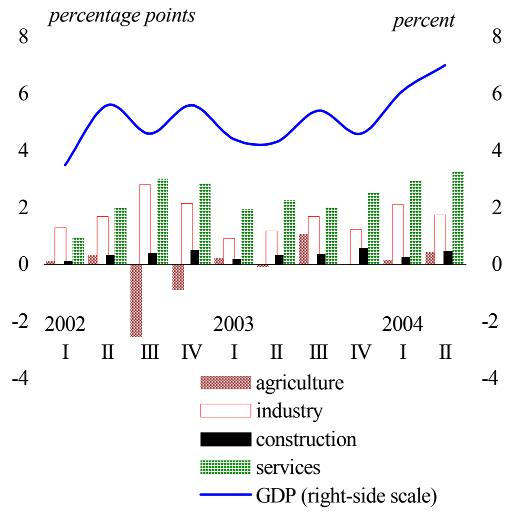
Investment

change against the same year-earlier period, %

	Years	Q1	Q2	Q3	Q4
Total	2003	6.7	7.0	7.5	10.3
	2004	7.2	12.0		
- new construction works	2003	0.1	6.3	7.2	6.3
	2004	7.6	9.6		
- equipment	2003	13.1	14.3	3.9	15.9
	2004	14.9	26.4		

Source: NIS

Contribution of the Main Components of Supply to GDP Growth



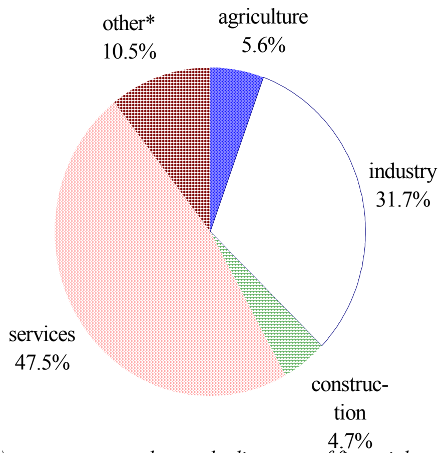
Source: NIS, NBR calculations

[16] In the first six months of 2004, the growth rate of foreign direct investment inflows more than doubled against 2003 H1, reaching 44.2 percent.
[17] In 2004 H1, the growth rate accelerated almost eight times year on year.

quantity (higher turnover and larger network of hyper- and supermarkets) and quality (improved pricing and promotion policies). Thus, retail sales of food and non-food items (save motorcars) climbed 14.1 percent; the 21.5 percent peak in January was attributed mainly to sales of electronic goods and household appliances. In 2004 H1, the motorcar market (where retail and wholesale trade picked up 11.7 percent), saw further expansion on its main segments: cars (owing to the considerable rise in the number of orders), commercial vehicles (as a result of enhanced transport of commodities both domestically and internationally) and vehicles used in mining and construction. Such developments entailed the expansion of a whole system of connected activities carried out by national networks of dealers[18], insurance companies, auto repair workshops, car washes, petrol stations, spare part shops, advertising agencies, etc.

The notable 17.5 percent growth rate of market services to households was actually attributed to the incidental 61.8 percent rise under "Gambling and other recreational activities"[19], amid the meagre 6.1 percent increase under "Hotels and restaurants", which holds the largest share of market services, and the 0.4 percent drop in the turnover of "Travel agencies and tour operators". In 2004 Q1, both "Hotels and restaurants" and "Travel agencies and tour operators" posted significant rises, averaging out at 9 percent and 15 percent per month respectively, mainly against the background of protracted cold season and a spate of foreign tourists. Nevertheless, April through June, the average monthly growth rate of the former subsector went down markedly to 4.1 percent, while that of the latter group showed a decline of 9.4 percent. Difficulties arising from the quality of services delivered and the unfavourable weather conditions during the summer were only partly offset by: (i) the slowdown in the growth rate of prices; (ii) the implementation of socially-oriented government programmes in May and June; (iii) the upturn in business tourism.

GDP Formation in 2004 H1



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

Source: NIS, NBR calculations

Positive growth rates were also recorded by other services – real-estate transactions (fostered by heavy demand for real-estate property); financial and insurance services (associated with the pick-up in lending); transport services (amid the expansion in domestic and foreign trade flows, and in passenger transport); telecommunications (given the larger number of users of fixed and mobile telephony, Internet and cable television); public services (whose gross value added was illustrative of wage hikes in the public sector).

[18] The delivery on a competitive basis of various automotive services, including financing, lending or leasing offers, maintenance services, guarantee and post-guarantee services, supplies of parts and accessories.
[19] Lottery funds carried forward for several weeks

Gross value added in **industry** moved ahead 5.9 percent, thereby strengthening the positive contribution of this sector to GDP growth (from 1.1 percentage points to 1.9 percentage points).

The main industrial groups displayed divergent developments in terms of output volume. Thus, "Durables" and "Capital goods" posted growth rates of 6.3 percent and 4.7 percent respectively, which are attributable to robust consumer demand and stronger investment in the considered period, on the one side, and to the rise in exports, on the other. In this context, the improved performance under "Road transport means" (30.4 percent in terms of output and 51.7 percent in terms of exports) is worth mentioning.

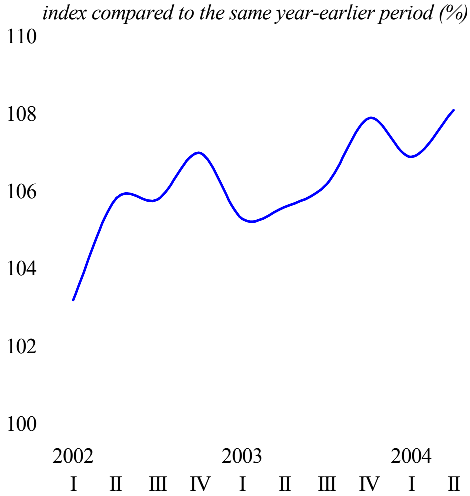
In 2004 H1, intermediate goods posted the sharpest rise, i.e. 12.3 percent, bolstered by the increasing demand of domestic producers, on the one side, and the expansion of exports[20], on the other. For example, the output of metal products surged 16 percent in order to meet both the additional domestic demand (related, for instance, to transport means and household appliances) and export orders (up 39.5 percent). This is also valid for building materials where the 16.9 percent output increase was driven by the expansion of the related economic sector.

Unlike the previous six-month periods, output of non-durables (down 1.9 percent) failed to underpin the pick-up in industrial output, due mainly to higher labour costs in light and food industries, costlier raw materials (in milling and bakery, and in the meat producing industry), and to the measures taken by some of the significant producers of meat and products thereof (against the backdrop of financial difficulties, aggravated by the paucity of fodder) to decrease capacity utilisation rate.

In the first half of 2004, gross value added in **construction** recorded the highest increase, i.e. 8.6 percent. Construction showed a sustained growth rate of 7.2 percent as early as the January-March period, owing largely to weather conditions. Quantitative changes were accompanied by structural changes – the ever increasing bias towards investment in non-residential industrial, social and cultural construction and civil engineering projects; as for residential buildings, the projects of residential compounds were on the rise. The domestic construction market gained in depth, which translated into increased output and distribution of building materials, and the development of services and real-estate market (mainly the sales of land).

Construction Works

index compared to the same year-earlier period (%)



Source: NIS

[20] First-half exports of intermediate goods climbed 30.4 percent, accounting for more than half of total exports.

The gross value added in **agriculture** rose 5.3 percent, owing widely to heftier vegetal output.

2.3. Budgetary and fiscal developments

The major objectives of fiscal policy established by the 2004 budget were the further restructuring of the tax and duty system and the allocation of budgetary resources destined to secure social protection, infrastructure development, support to small- and medium-sized companies and the fulfilment of commitments taken under accession negotiations. The public authority designed its policy so as to boost economic growth and cut unemployment rate, as well as to back deceleration of inflation and keep current account deficit under control. The priority initially attached to the first category of macroeconomic objectives was reflected by setting[21] the annual deficit of the consolidated general government budget at 3 percent of GDP as compared to 2.3 percent in the preceding fiscal year.

Consolidated Budget Revenues*)

%

	2003 H1	2003 H2	2004 H1
Revenues	100.0	100.0	100.0
Tax revenues, of which:	92.8	93.3	94.3
Profit tax	7.2	7.8	9.0
Income tax	9.5	9.5	10.3
Social security contributions	33.1	32.1	31.5
VAT	23.6	24.1	23.7
Customs duties	2.2	2.3	2.2
Excise duties	9.3	10.7	10.8
Non-tax revenues	6.9	6.4	5.1
Capital revenues	0.3	0.3	0.6
Non-redeemable funds	0.0	0.2	0.0

*) transfers between budgets were removed

Source: NBR calculations based on MPF data

The higher-than-expected budget revenues as early as the first months of 2004 and the risky expansion – from the disinflation standpoint – of domestic demand determined the monetary authority to revise the deficit target downwards to 2.1 percent of GDP. The budget rectification[22] that enabled this correction maintained the basic assumptions regarding the general macroeconomic framework of the original budgetary programme (economic growth of 5.5 percent, annual inflation rate of 9 percent, unemployment rate of 7.8 percent and a current account deficit of 5.2 percent of GDP). The budget rectification consisted in raising projected revenues and changing the expenditure composition by reallocating the savings under certain categories (mainly savings on public-debt-related interest payments) to other sectors, the level of total expenditure remaining almost unchanged.

The implementation of some financial measures envisaged for the current year had an impact on the budgetary execution in the first half of 2004. Revenues from profit tax rose to 1.3 percent of the 2004 projected GDP (as compared to one percent of GDP a year earlier) as a result of: (i) flat profit tax rate that shall also apply to profit from exports; (ii) removal of companies' obligation to pay the exploitation tax on oil fields, and (iii) the 3 percentage point cut in the social security contribution rate paid by employers. The latter development did not have an adverse impact on the volume of revenues from social security contributions, their share in GDP running at 4.6 percent in the

[21] In November 2003

[22] Approved in early July 2004

current half-year (as compared to 4.5 percent of GDP a year earlier) due to the measures taken to improve the legal framework for the recovery of past-due debts.

The cut in the VAT rate from 19 percent to 9 percent for some goods and services (medicines, books, museum fees, hotel accommodation, etc.) was offset by the larger volume of retail sales, so that the first half-year share of VAT revenues in GDP rose by 0.3 percentage points to 3.5 of GDP year on year.

The further harmonisation of excise duties to the European standards led to a larger volume of collections, which accounted for 1.6 percent of projected GDP as compared to 1.3 percent in the similar period of the prior year.

However, the improvement in tax collections was accompanied by higher subsidies and transfers, whose share in GDP widened year on year by 0.7 percentage points to 7.2 percent of GDP. The share of subsidies in GDP expanded by 0.3 percentage points (the decline in the annual forecast notwithstanding) and that of transfers by 0.4 percentage points; the former outlays went chiefly to transports, mining and energy sectors, whereas the latter expenditures were intended for financing social security services.

Staff costs and material expenditures also saw their shares in GDP rising by 0.2 percentage points and 0.3 percentage points respectively compared with 2003 H1. By contrast, the share of capital expenditures slid from 1.4 percent of GDP in 2003 H1 to 1.2 percent of GDP in 2004 H1; their full-year figure is projected to stay put at 3.5 percent of GDP.

The share of interest payments on public debt in GDP was on the wane too, down from 1.2 percent of GDP in 2003 H1 to 0.8 percent of GDP in 2004 H1, owing to lower interest payments on government borrowings.

Under the circumstances, at mid-2004 the consolidated general government budget deficit stood at ROL 14,303 billion (excluding the budget of the National Road and Motorway Company in Romania), with its share in projected GDP (0.6 percent) dropping 0.3 percentage points below the 2003 H1 figure. Both revenues and expenditures of this budget saw their share in GDP rising as against their year-ago levels, yet revenues grew at a faster pace, i.e. by 0.8 percentage points.

Consolidated Budget Expenditures*)

%

	2003 H1	2003 H2	2004 H1
Expenditures, of which:	100.0	100.0	100.0
Public authorities	5.0	5.2	5.1
National security and defence, and public order	9.7	9.8	10.8
Education	10.8	9.5	10.7
Health	12.0	11.9	11.8
Social activities and culture	38.6	38.9	39.4
Economic activities	14.9	18.7	17.1
Interest related to public debt	7.2	5.5	3.8

*) including adjustments according to IMF methodology; transfers between budgets were removed

Source: NBR calculations based on MPF data

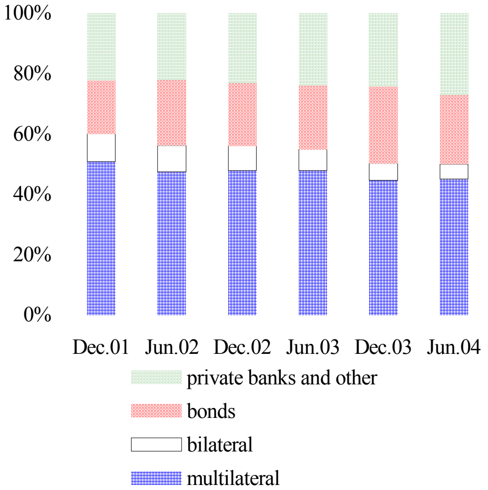
Balance of Consolidated Government Budget

percent of GDP

	2003 H1	2003 H2	2004 H1
Conventional deficit	-0.89	-1.42	-0.63
Primary surplus (+)/ deficit (-)	0.33	-0.53	0.14

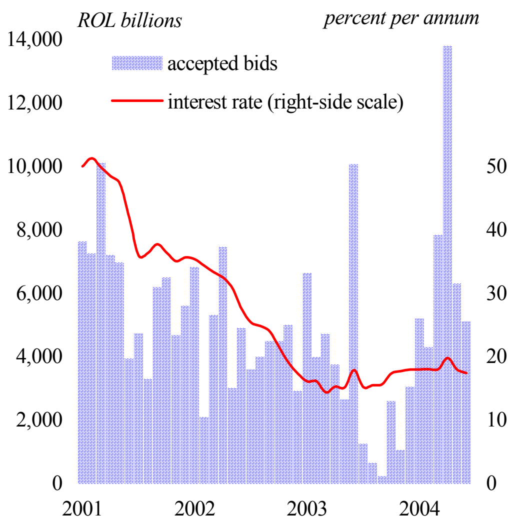
Source: NBR calculations based on data supplied by MPF and NIS

External Public Debt
- by financing sources -

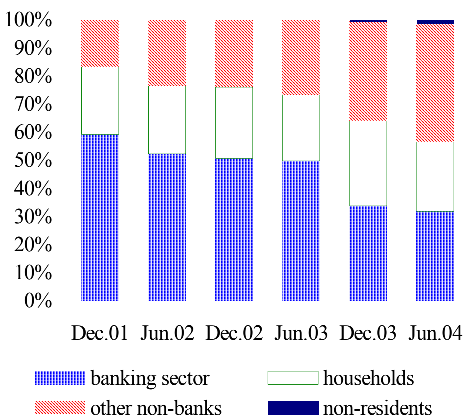


Source: NBR calculations based on MPF data

Government Securities Issues
(Treasury Bills)



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

First-half consolidated general government budget ran a primary surplus, which contracted sizeably versus the same year-ago period, from 0.3 percent to 0.1 percent of GDP. Behind the decrease in this balance stood the faster pace of growth in expenditures, save interest payments, compared with that of revenues.

In order to ensure deficit financing and public debt refinancing, in 2004 H1 the Ministry of Public Finance raised capital from domestic investors as well, a completely different picture from that in the first half of 2003 when only external sources were used for this purpose.

Nevertheless, foreign funds were still prevalent, covering nearly two thirds of the shortfall between revenues and expenditures of the consolidated general government budget. The funds were fully drawn from loans granted directly to ministries by various international financial institutions.

Domestic funding consisted of ROL- and foreign exchange-denominated government securities sold to banks, their clients, and individuals. There were also instances when the public authority resorted to deposit-taking in the money market.

Non-banks were the major provider of domestic capital with fresh funds coming close to ROL 16,500 billion in 2004 H1. This volume exceeded considerably that raised from banks, i.e. less than ROL 1,600 billion. The funds raised from the two sectors were destined both to cover the resource shortfall and to repay the maturing public debt. The share of government securities held by banks kept shrinking to 29 percent of ROL- and foreign exchange-denominated bills and bonds outstanding at mid-2004, down 6 percentage points from the end of 2003.

The term structure of issues of government paper in ROL sold at auction over the reference period included bills with maturities of up to one year and, until April, 5-year bonds as well. Issuance of government bonds with 2- and 3-year maturities was virtually discontinued, as all bids submitted for such notes were rejected. First-half issues of government paper topped ROL 43,000 billion, of which one-year bills accounted for close to 64 percent.

The period of subscription for Treasury certificates sold to individuals remained open over the entire period under review. In 2004 H1, individuals acquired government securities in amount of ROL 24,800 billion, showing the same keen interest in 3-month bills which made up slightly above two thirds of total bills issued.

As for foreign exchange-denominated government securities, banks bought 90 percent of the only issue in amount of USD 50 million launched in the first half of 2004.

In an attempt to secure smooth payments from the public budget, the Ministry of Public Finance resorted, the same as in 2003 H1, to taking overnight deposits from the money market. The value of such deposits neared ROL 3,950 billion in 2004 H1.

Municipal bonds were further on offer in the reference period, their value reaching some ROL 219 billion. The maturity of such bonds ranged between one and six years; the yields relating to such stocks comprised the mean of 6-month BUBID/BUBOR rates and an interest margin ranging between one and three percentage points. At end-June 2004, the value of municipal bonds outstanding with the public worked out at ROL 800 billion.

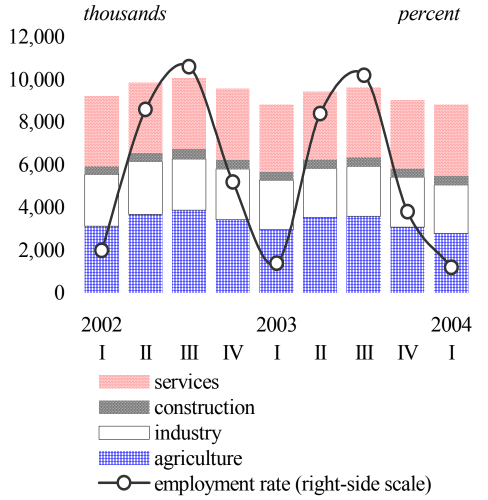
At mid-2004, domestic public debt ran at ROL 125,869 billion, nearly ROL 2,817 billion below the mid-2003 figure, accounting for some 5.6 percent of projected full-year GDP. Romania's domestic public debt rose by roughly ROL 10,928 billion against December 2003, with its share in GDP falling by half of a percentage point due to the 0.4 percentage point compression in direct public debt[23] and the 0.1 percentage point retreat in publicly-guaranteed debt[24].

2.4. Labour market

2.4.1. Labour force

According to data on labour market indicators released by AMIGO available for 2004 Q1 alone, employment resumed the upward trend, growing by 10.3 thousand people year over year. Against the backdrop of step-up in activity in construction and services, the demand for labour force rose by 10.1 percent and 6.2 percent respectively, to a total of 234.5 thousand people.

Employment by Sector and Employment Rate



Source: NIS - AMIGO

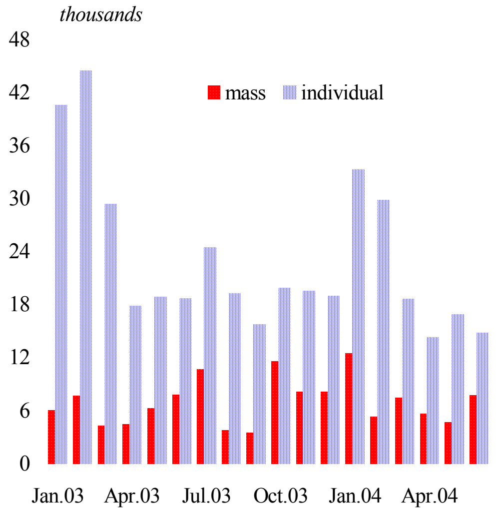
Compared to January-March 2003, the following major shifts in employment composition deserve mention:

(i) the number of self-employed dropped 12 percent, or 216.7 thousand, mainly as a result of the redeployment of workers formerly engaged in farming to other sectors, as the bad weather conditions that depressed the vegetal output in the past few years pushed down earnings. By

[23] Resulting from consolidated budget deficit and impaired assets taken over by the public debt

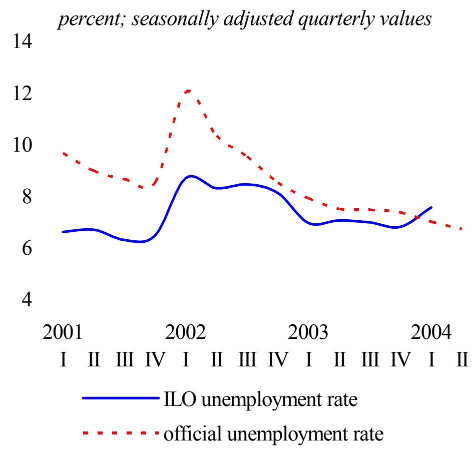
[24] Including collateral for domestic loans in both ROL and foreign exchange

Mass and Individual Dismissals



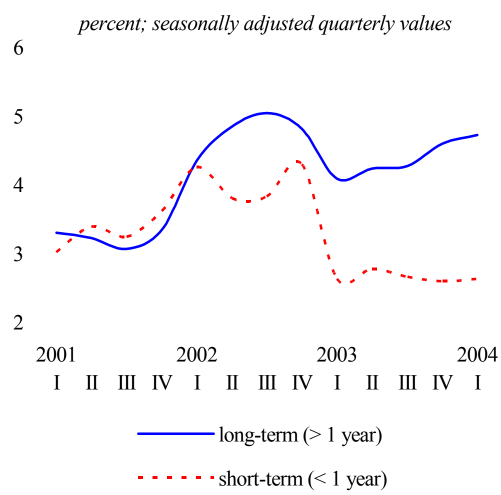
Sursa: ANOFM

Official Unemployment Rate and ILO Unemployment Rate



Source: NIS - AMIGO

Unemployment Rate by Duration



Source: NIS - AMIGO

contrast, some of the self-employed were better off, as they became entrepreneurs[25];

(ii) the number of employees increased by some 2 percent (111.7 thousand), with the tertiary sector and construction succeeding in absorbing the workforce coming from industry and agriculture amid restructuring and workers' migration;

(iii) part of inactive population joined the ranks of active population, probably to compensate for the reduction in the number of self-employed in farming and causing the number of unpaid family workers to rise by 4.8 percent (56.9 thousand).

AMIGO data on the developments in the number of employees highlight the trend mirrored by the figures employers reported for 2004 H1 – accordingly, payrolls edged up year on year by 0.5 percent, or 23.4 thousand. According to the National Employment Agency, the new jobs in trade and most services helped absorb the excess workforce from industry, transport, postal services and telecommunications in the wake of restructuring these sub-sectors, which led to the 18.3 percent rise in the number of people subject to mass dismissals compared with 2003 H1. The number of people made redundant on an individual basis shrank by 24.8 percent year on year, hinting at the revival of economic activity and the decrease in managers' uncertainties on the business environment.

The number of the unemployed defined consistent with ILO standards grew by 71 thousand in 2004 Q1, with unemployment rate running at 8.8 percent, up 0.7 percentage points from the corresponding period in 2003. Behind this stood primarily the weaker picture in farm employment, down 6 percent (167.3 thousand), amid lower earnings in this sector and workers' redeployment to other sectors.

The degree of labour market mobility remained low, as illustrated by the 3.7 percentage point increase in the share of long-term unemployment (more than 12 months) in total unemployment to as much as 61.4 percent. Compared to the 10 new EU Member States, Romania reported the highest incidence of long-term unemployment (roughly 18 percentage points above the EU15 average), followed closely by Slovakia (61.1 percent).

The data released by NEA on the developments in unemployment January through June 2004 show a different picture than that painted by AMIGO. Accordingly, the number

[25] The number of employers in agriculture rose 13.8 percent versus 2003 Q1.

of the unemployed fell on average by 80.6 thousand (to 660.5 thousand) and the jobless rate touched 6.5 percent, sliding 0.8 percentage points below the year-ago level. The disparity between the data coming from the two sources may be attributed to: (i) the significant number of people who were no longer in NEA records due to subjective reasons, which can only be ascribed to them[26]; (ii) the notable percentage of self-employed formerly engaged in farming in total ILO unemployment – such workers did not ask for NEA support owing to their lack of skills and information.

The number of vacancies identified by NEA picked up 29.3 percent January through June 2004, causing the number of unemployed per vacancy to decline to 1.7 from 2.4 in 2003 H1. However, in the reference period, the number of newly-hired stood at 289.8 thousand, nearly one percent below the year-ago figure, owing possibly to the mismatch between the skills of job seekers and those required in the expanding sectors.

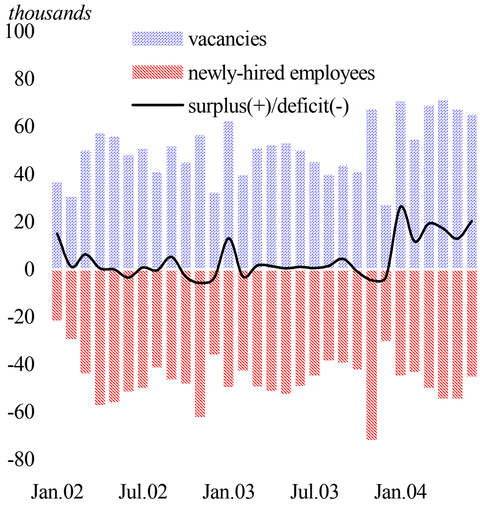
2.4.2. Incomes

In the first half of 2004, the wage policy was intended to be less loose than a year earlier – the hike in the economy-wide gross minimum wage[27] was correlated with the projected inflation rate, and the social security contribution rates to be paid by employees remained unchanged.

In the case of the 72 companies monitored based on Government Decision No. 536/2004, the average nominal year-on-year increase in gross wage was envisaged at a rate of 15.2 percent for 2004 and 13.3 percent in the first half of 2004. At the same time, the number of people employed in these companies was seen to diminish by 23,328, of which around 85 percent following mass dismissals in the first six months of the year.

Nevertheless, economy-wide gross average wage increased by a real 9.3 percent in January-June 2004[28], exceeding the growth rates displayed over the past couple of years. Although the 3 percentage point cut in the social security contribution rates to be paid by employers eased the pressure on production costs, developments in the first quarter[29] revealed the discrepancy

Number of Vacancies Reported by Employers and Number of Filled Vacancies



Source: NEA

[26] Unjustified refusal to accept a job, failure to request a visa or to renew the application for a job in the case of the unemployed not claiming benefits, or when the indemnification period expired.
[27] Economy-wide gross minimum wage grew to ROL 2,800,000 per month starting 1 January 2004.
[28] As compared to 2003 H1
[29] Employment data are available only for 2004 Q1.

Real Net and Gross Wages

change against the same year-earlier period, %

	Gross		Net	
	2003 H1	2004 H1	2003 H1	2004 H1
Whole economy	7.3	9.3	9.0	8.9
Agriculture, hunting and related services	4.7	4.8	7.4	4.4
Industry*	-0.1	4.5	5.6	9.7
of which:				
Mining	0.4	7.0	3.7	3.7
Manufacturing	0.3	6.3	7.0	11.7
Energy	-3.0	-4.3	3.4	4.0
Construction	7.7	3.8	9.5	4.2
Services**	9.7	9.9	11.0	9.1
of which:				
Public administration	15.6	8.2	14.9	7.6
Education	13.9	10.6	16.0	8.7
Healthcare	4.1	11.9	6.9	10.8

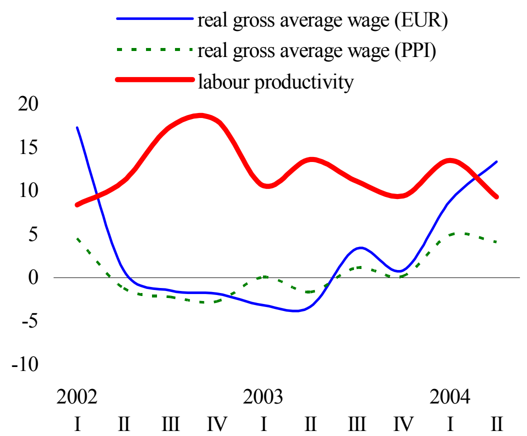
*) Gross wages in industry were deflated by PPI on the domestic market

**) 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: NBR calculations based on data supplied by NIS

Gross Wage and Labour Productivity in Industry

change against the same year-earlier period, %



Source: NIS, NBR calculations

between the wage dynamics and that of labour productivity[30] in the economy (6 percent in 2004 Q1 from the same year-earlier period), which is illustrative of some inflationary pressures. They could stem mainly from the developments in services and construction, which faced productivity losses (2.7 percent and 0.5 percent in 2004 Q1 from a year earlier[31]) but saw large wage hikes (9.9 percent and 3.8 percent respectively, in real terms). Mention should be made that the discrepancy between the wage dynamics and the productivity indicators in services and construction may be oversized, as some of the employed in these sectors belong to the informal economy and are probably paid lower wages than those reported by employers.

Pressures were also detected in industry, most sectors witnessing positive growth rates of the nominal unit labour cost[32] (11.1 percent across industry, 11.7 percent in manufacturing). In most cases, the pressures of wage hikes on costs were absorbed by current prices, the real unit labour cost[33] dropping in the reference period by 6 percent across industry and by 5.8 percent in manufacturing. There were however industrial sectors (most of them having an impact on the goods and services included in the CPI basket – textiles, wearing apparel, oil processing, water collection, treatment and distribution) which saw positive growth rates of the real unit labour cost (in the range from 1.7 percent to 9.2 percent), thereby suggesting the accumulation of an inflationary potential that might impede on the future development of producer prices.

In 2004 H1, economy-wide net average wage displayed an annual growth rate similar to that recorded in the same year-ago period (8.9 percent)[34], which boosted consumer demand.

The rise in other household incomes exceeded inflation rate, helping increase consumer demand as well; the purchasing power of the average monthly pension grew by 11.6 percent

[30] Productivity growth rate was calculated using the following formula: $\frac{I^{GDP}_{t/t-1}}{I^{EMPL}_{t/t-1}}(\%)$ where, $I^{GDP}_{t/t-1}$ = GDP volume index during period *t* versus period *t-l*; $I^{EMPL}_{t/t-1}$ = employment index during period *t* versus period *t-l*.

[31] Gross value added and the number of people working in the respective sectors were taken into account.

[32] Excepting metallurgy, chemicals, tobacco products, road transport means, publishing and printing, other non-metalliferous ores, where the nominal unit labour cost posted decreases in the range from 8.6 percent to 22.6 percent.

[33] Producer price index (domestic and external markets) was used as deflator.

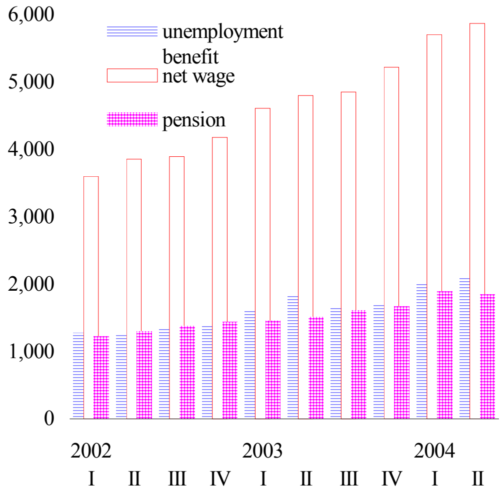
[34] Development illustrated by both wage hikes and the expansion of the luncheon voucher system (according to data provided by the Ministry of Labour, Social Solidarity and Family, the value of luncheon vouchers purchased by employers rose by a real 25 percent due to the larger number of recipients as well as to the nominal value of a luncheon voucher).

year on year following the new pension realignment stage[35], indexations granted in March and June[36] (2 percent each), and the twofold increase in farmers' pensions[37]; the average monthly unemployment benefit moved up 5.2 percent in real terms as compared to the same year-earlier period.

The welfare benefits granted by the Ministry of Labour, Social Solidarity and Family exhibited substantial real increases as follows: (i) the total amounts granted as child-raising allowance (during 24 months) grew by 92.6 percent in real terms due mainly to the alteration of the payment system – a fixed amount of ROL 6,500,000 per person is granted; (ii) the average number of people that benefited from heating allowances granted on a monthly basis for the 2003-2004 cold season was nearly twice as large as that recorded in the similar year-ago period.

Household Incomes

ROL thousands, monthly average



Source: NIS, NEA

The monthly minimum guaranteed income granted in compliance with Law No. 46/2001 moved up starting 1 January 2004 in line with the average inflation forecast (11.5 percent in nominal terms), and the average number of recipients climbed by 20.5 percent in 2004 H1 versus the same period a year earlier.

The same as in prior years, household incomes in 2004 H1 rose considerably as a result of inflows from private transfers between residents and non-residents (mainly remittances from abroad), up 37.5 percent from the year-earlier period.

[35] Government Decision No. 1433/2003
[36] Government Decisions Nos. 263 and 808/2004
[37] This measure applied only to the people retired before 1 April 2001 who did not benefit from other categories of pensions established under the state social security system.

2.5. External environment

2.5.1. External demand

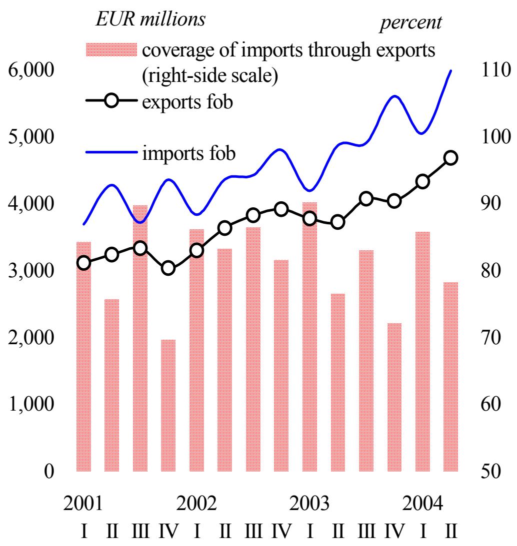
Following stronger-than-expected figures in 2003 H2, world economy further grew at a swift pace in the reference period. This owed much to the developments in the US economy (year-on-year growth rates of 5 percent and 4.7 percent in 2004 Q1 and 2004 Q2 respectively, upheld by consumer demand and private investment) and Asian countries (Japan and particularly China, the GDP of which posted a half-yearly increase of 9.7 percent[38]).

Although the economies of EU15 saw far slower growth rates (1.6 percent and 2.2 percent in 2004 Q1 and 2004 Q2 respectively), the trend towards strengthening the signs of economic recovery that emerged as early as the latter half of 2003 was manifest for this trade bloc as well. With private consumption being one of the drivers of economic revival, import demand of EU15 rose by 5 percent in 2004 H1, causing the share of Romanian products in total EU imports to advance to 1.35 percent[39], slightly above the year-ago level.

CEFTA countries also reported much improved economic performances in 2004 H1 compared with the same year-ago period. The top performer was Poland, whose economy grew at a 6.9 percent rate in 2004 Q1.

2.5.2. Foreign trade[40]

Trade Balance



The first half of 2004 witnessed further worsening of Romania's external balance which became manifest ever since the second quarter of 2003, fuelled by the brisk increase in domestic absorption. After having sharpened in January, worsening of external accounts lost steam gradually, due to the economic rebound in Romania's trade partners, which caused Romanian exports to grow faster. However, the trade gap widened again in June when imports posted an abrupt expansion. In 2004 H1, the sustained growth rate in exports (20.2 percent, up 12 percentage points year on year) still lagged behind the increase in imports (22 percent). As a result, the trade gap widened by 30.9 percent versus 2003 H1.

Several factors brought about the rise in imports in 2004 H1, as follows:

[38] Growth rates are calculated versus the same year-ago period.
[39] The ratio of Romanian exports to the EU and EU imports originating in non-Member States.
[40] Figures showed in this subsection are calculated based on balance-of-payments data given in euro.

(i) step-up in investment[41], which boosted import demand for capital goods, save transport means (up 17.9 percent year over year);

(ii) stronger demand for durables, which caused imports of such goods to surge by 75.2 percent from the corresponding year-ago period, owing largely to imports of motorcars as a result of readily-available loans and the expansion of financial leasing (the group "motorcars, bicycles and motorcycles" posted a 147.8 percent increase);

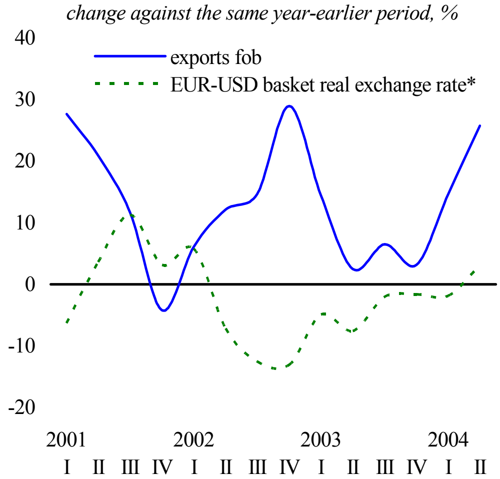
(iii) insufficient domestic grain harvest in 2003, entailing the 63.2 percent advance in imports of products of vegetal origin;

(iv) climb in electricity imports (5.4 times on the same year-ago period), induced most likely by favourable developments in external prices[42] and the ongoing liberalisation of the power market (the openness of which rose from 33 percent in 2002 to 40 percent in 2004). Moreover, crude oil imports augmented by 31.7 percent[43] and mineral fuel imports by 74.7 percent. In contrast to 2003 H2, natural gas imports did not put pressure on the energy bill, as their volume slid 18.4 percent[44] and the purchase price was relatively stable.

As for exports, "textiles, wearing apparel and footwear" further held the largest share in total exports, i.e. 29.3 percent, down 4 percent points, as the growth rate[45] lagged behind those of "base metals" (38.6 percent[46]) and "machinery and apparatus, and transport means" (35.2 percent).

Exports and Real Exchange Rate

change against the same year-earlier period, %

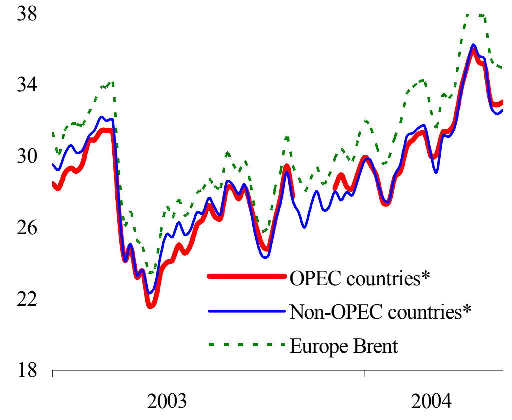


**) deflated by the unit labour cost index*
Source: NIS, NBR calculations

[41] See Subsection *2.1.2. Investment demand.*
[42] Retrenchment in domestic production of hydroelectricity and nuclear energy amid last year's drought required the increase in output of electricity produced by coal-fired power plants, at significantly higher output costs.
[43] Due largely to higher consumption and, possibly, following the trend towards replenishing stocks amid the upturn in prices on world markets.
[44] Because of the flagging demand in the context of mild winter conditions and the 5 percent rise in domestic production compared with 2003 H1.
[45] Owing not only to sluggish demand on European markets but also to worsening unit labour costs.
[46] Upheld by the expansion in world demand for steel (basically from China) and the restructuring of the domestic iron-and-steel industry.

World Crude Oil Prices

USD per barrel; average weekly spot price fob

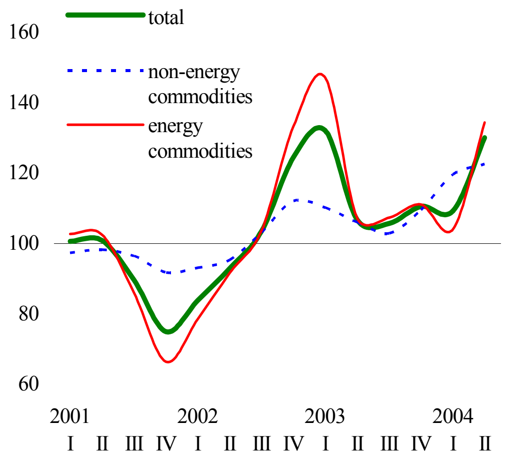


**) Averages weighted by estimated export volume.*

Source: EIA

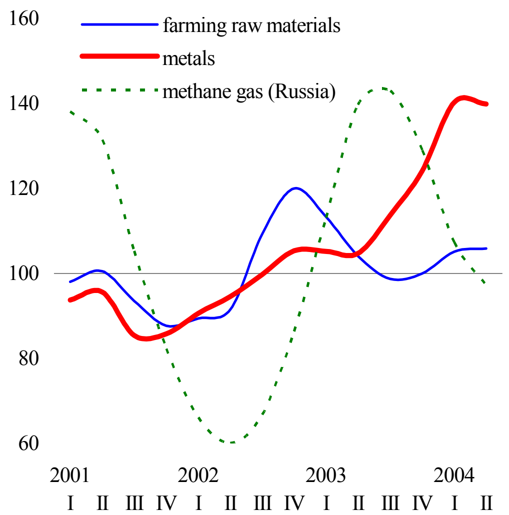
Prices of Raw Materials (a)

index compared to the same year-earlier period (%)



Prices of Raw Materials (b)

index compared to the same year-earlier period (%)



Source: IMF

2.5.3. Imported inflation

The first half of 2004 saw further inflationary pressures induced by external prices of major commodities. Against the backdrop of mounting demand for oil from the USA and China[47] and terrorist attacks in the Middle East, which sparked fears surrounding the supply, oil prices surged to two-decade highs[48]. However, these developments fed through into domestic fuel prices only in part, as SNP Petrom, the oil company having a stranglehold on the market, derives more than two-thirds of the oil intended for processing from domestic sources.

The tensions that built up on the international grain markets in the latter half of 2003 continued into 2004, with the wheat price at the Chicago Board of Trade peaking at USD 159.7 per tonne in March. Even though favourable estimates on the 2004 grain production worldwide helped ease prices in the last two months of the reported period, first-half average remained high (USD 143.7 per tonne), up 18 percent year on year. In addition, the shift in import origin countries from Europe and the Russian Federation to North and South America (USA, Canada, Brazil, and Argentina) sent transport costs sharply higher. Hence, in the first half of 2004, the average price of imported wheat reached USD 208 per tonne, nearly 80 percent above the year-ago reading.

Inflationary pressures from grain price hikes on foreign markets were mitigated in late February when the authorities decided to release 150,000 tonnes of wheat from the state reserves as a loan in order to ensure supply for mills and/or bakeries.

In contrast to the previous year, the price of natural gas imported from the Russian Federation did not engender significant inflationary pressures. After having posted annual growth rates of 25.9 percent and 35.6 percent in 2003 H1 and H2 respectively, the natural gas price was up by a paltry 2 percent in 2004 H1 over the same year-ago period.

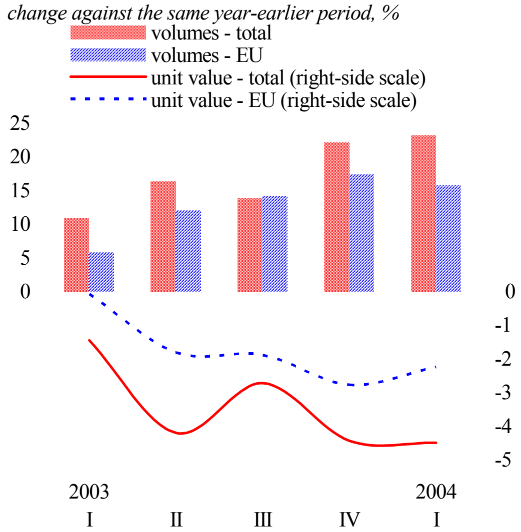
[47] The second-biggest oil consumer after the USA

[48] USD 39.07 a barrel on the London Stock Exchange in May 2004; the average price for 2004 H1 stood at USD 33.8 a barrel, 16.4 percent above the year-ago figure; the increase for June 2004/December 2003 stood at 20 percent.

Imported inflation via industrial goods originating mainly from the European Union provided an underpinning to disinflation in the first quarter of 2004 but this process fell short of expectations in the quarter that followed. Thus, unit value of imports from EU15 dropped in 2004 Q1 by 2.2 percent year on year on the back of declines in prices for every category of industrial goods, namely intermediate goods, capital goods, and consumer goods. Nonetheless, in 2004 Q2, despite lacking data on import unit value indices, the state of affairs appears to have become less favourable than that seen in the previous three-month period, as the annual rate of increase in EU15 industrial producer prices rose to 2.2 percent (from 0.4 percent in 2004 Q1). Even though the rise was manifest in the case of all categories of goods, prices of intermediate goods posted the heftiest rises, their annual rate reaching 2.9 percent against 1.3 percent in the first quarter of 2004. As for capital goods and consumer goods, both price increases and quarter-to-quarter changes in growth rates were far lower (from 0.3 percent to 0.6 percent and from 0.4 percent to 0.5 percent respectively), their impact on domestic prices being marginal.

Unit Value and Volumes of Imports

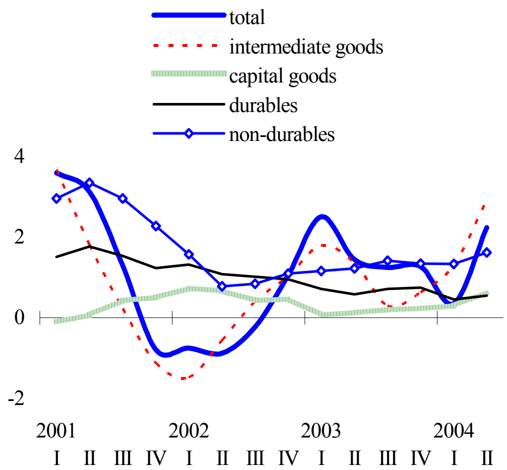
change against the same year-earlier period, %



** expressed in euro*

EU-15 PPI and its components

change against the same year-earlier period, %



Source: Eurostat

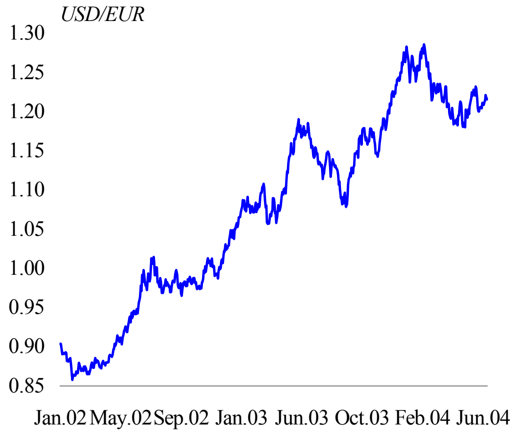
2.5.4. Exchange rate

First-half movements in the exchange rate bore the hallmark of the sharper foreign exchange surplus on the domestic market. This can be attributed to a stunning growth of capital flows[49] (97 percent against the corresponding period in 2003) and to inflows from private current transfers between residents and non-residents (37.5 percent).

In order to keep ROL appreciation within sustainable limits, the central bank moved to increase its currency market intervention in terms of both frequency and magnitude. As a result, net purchases by the National Bank of Romania over the reference period amounted to EUR 1,278.7 million, significantly higher than those recorded in the previous two six-month periods. The domestic currency strengthened by a real 1.5 percent against the euro[50] and exchange rate volatility was largely contained, the larger swings in the USD/EUR rate notwithstanding.

Against the US dollar, the Romanian currency posted an impressive 12.8 percent real appreciation against the same year-ago period because of lingering geopolitical tensions and the yawning US trade deficit.

USD/EUR Exchange Rate

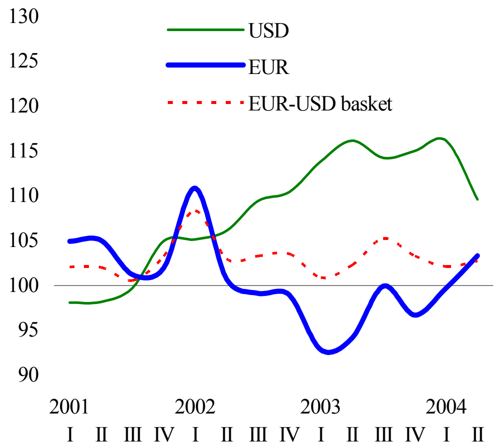


Source: ECB

[49] Direct investment of non-residents in Romania, short-term loans and credits, deposits of non-residents in Romania.
[50] Average value against 2003 H1.

Developments of ROL Exchange Rate*)

index compared to the same year-earlier period (%)



*) appreciation (+), depreciation (-) in real terms based on CPI

Source: NIS, NBR

In a move reflecting the prevalent share of EUR-denominated operations in total foreign trade-related transactions, along with accession requirements, the central bank decided to change the composition of the implicit currency basket by raising the weight of the European currency from 60 percent to 75 percent[51]. As a result, in 2004 H1, the domestic currency strengthened year on year by a real 3.9 percent versus the new currency basket, thereby preventing domestic prices from being severely affected by the pressure from large costs of energy, grain and intermediate goods imports, as well as from excise duties and administered prices geared to the two currencies.

[51] As from 1 January 2004.

3. Monetary policy

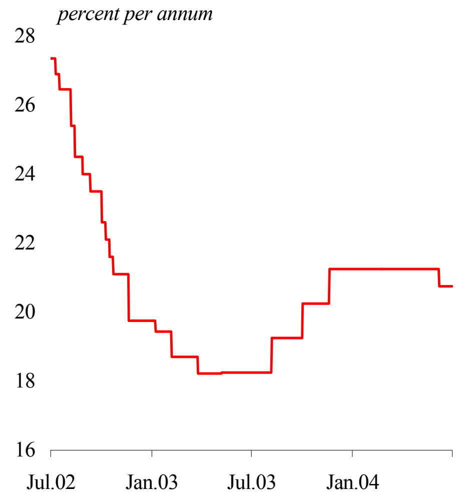
3.1. General features

The economic programme for 2004 was mapped out allowing for the need to accelerate the nominal and real convergence of the Romanian economy. The key points of the annual programme, i.e. to lower inflation to single digits, accelerate GDP growth, and keep the current account deficit within a safe range – were also subservient to the aim of achieving robust medium- and long-term economic growth.

In 2004 H1, implementation of the economic programme yielded higher-than-expected results relative to the progress in disinflation and, particularly, to economic growth, both being stronger than projected. During the first six months of 2004, the annual inflation rate dropped more than 2 percentage points (to 12 percent) while the upturn in domestic demand contributed to the 6.6 percent increase in GDP year on year, so that such developments paved the way for the overperformance of at least one of the annual objectives. The steady upward trend of domestic absorption had, however, negative effects as well, i.e. the widening of the trade deficit by 30.9 percent year on year and the ensuing increase in the risk of inflationary pressure.

Therefore, the 2004 H1 macroeconomic environment called for a more contractionary monetary policy, whose stance had already been tightened in the latter half of 2003. Despite the gradual decline in the twelve-month inflation rate, the NBR policy rate was kept unchanged for most of the period under review; the decision to prudently cut the policy rate was made only in early June. Consequently, the real positive policy rate was raised gradually, thus entailing tightening of monetary conditions; the trajectory of the ROL exchange rate had a similar effect, the local currency strengthening by a real 4.6 percent against the euro and 8.8 percent against the US dollar[52] in the last twelve months. Moreover, the central bank held the reins of monetary expansion, mopping up a large part of liquidity surplus despite its significant expansion.

Policy Rate*



**) maximum interest rate on one-month sterilisation operations*

The central bank's prudent approach in 2004 H1 was justified by the increased risk of demand-pull inflationary pressure and also by the attempt at averting implementation of a stop-and-go interest rate policy. Taking into consideration this state of

[52] Compared with an annual real depreciation of 3.7 percent versus the euro and a real appreciation of 16.3 percent against the US dollar at end-December 2003.

affairs, the central bank adopted a wait-and-see policy concerning the effects of interest rate hikes that had taken place in the latter half of 2003 (for the first time in the past three years) and of cautious policy measures adopted in February 2004.

Behind the prudent stance of monetary policy in 2004 H1 stood also the following factors:

(i) the need to contain the knock-on effect of administered price adjustments, which started in January 2004;

(ii) the uncertainties about fiscal policy stance, specific to the election year;

(iii) the prospects of a lax income policy; and

(iv) the difficulty to assess the inflationary impact of higher external prices for oil and some raw materials given the erratic development of producer price index on the domestic market.

3.2. Conditions surrounding monetary policy implementation

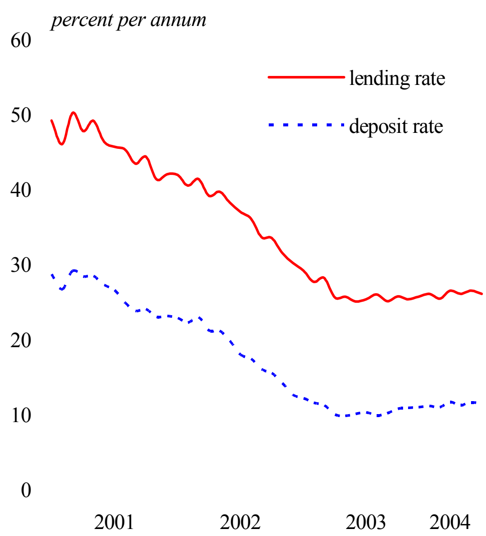
The main features of the conditions surrounding monetary policy implementation in 2004 H1 were the acceleration of economic growth and the increase in its likely adverse effect on achieving sustainable disinflation. Real GDP growth was unexpectedly strong, the expansion in domestic demand, in terms of both its components (household consumption and public and private investment), reaching the highest level so far (see Subsection 2.1. *Demand*). In the short run, the fast increase in domestic absorption was mirrored mainly by widening of the trade deficit (see Subsection 2.5.2. *Foreign trade*). On the supply side, a potential risk factor to disinflation was the uptrend of unit labour cost in industry given that labour productivity remained relatively steady or even declined across several sub-sectors (see Subsection 2.4.2. *Incomes*).

Despite the spike in inflation risk associated with demand and supply factors, disinflation accelerated markedly in 2004 Q2, the policy mix based on the gradual tightening of monetary policy, which started in the latter half of 2003 and the relatively austere fiscal policy pursued in 2004 H1 having as a result a slower growth pace in both market prices and prices for tradables as well as considerable alleviation of knock-on effects of increase in administered prices.

Moreover, there were signs that the growth of consumer demand might slow down, due probably to changes in household behaviour. During March-May, retail sales increased at a slower pace[53] reflecting the gradual fall in annual growth rate of ROL-denominated loans to households (down from 206.3 percent, in real terms, in December 2003 to 81.6 percent in June 2004). By contrast, turnover in retail trade of fuels as well as sale, maintenance and repair of motor vehicles and motorcycles posted a robust increase[53] bolstered also by larger foreign exchange loans deemed more attractive in terms of costs; as a result, in 2004 H1 the gap between the growth in ROL-denominated loans (4.4 percent in real terms against December 2003) and that in foreign exchange-denominated loans (23.8 percent) widened steadily. Household gross financial saving[54] rebounded (up 9.4 percent in real terms in 2004 H1 compared with 1.3 percent in 2003 H2) owing mainly to the uptrend in ROL-denominated deposits. High interest rates on deposits in ROL turned time deposits with banks into an attractive investment for companies as well. In an attempt to preserve their savings in ROL, it appeared that some of the companies opted for taking very short-term loans in foreign exchange (at low interest rates) to meet working capital requirements.

On the basis of such evidence, the central bank decided to lower the policy rate by 0.5 percentage points to 20.75 percent on 7 June 2004. Behind the cautiousness of this move stood the attempt at dampening too optimistic expectations of the general public and banks and at warding off a strong increase in lending.

Interest Rate Applied to Non-Bank Non-Gov't Clients

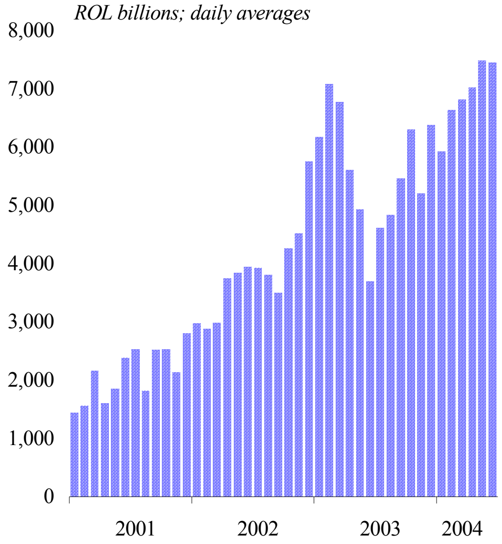


When making the decision to cut the interest rate on sterilisation operations, the central bank took account of the risks engendered by the increase in speculative capital inflows given the wide differential of interest rates on domestic and world financial markets; thus, behind the excess supply of foreign exchange in the currency market stood, among other factors, the threefold increase[55] in the cumulated balance of short-term loans granted by non-residents to residents and of non-residents' deposits (including banks). In order to mop up this liquidity influx, the central bank had to intervene more heavily in the forex market, with net purchases increasing more than 2.4 times compared with those recorded in 2003. Moreover, the NBR accepted a more significant real appreciation of the ROL, which

[53] See Subsection *2.1.1. Consumer demand*
[54] Consisting of bank deposits and government securities outstanding with individuals
[55] Compared with 2003 H1

Transactions on Interbank Money Market

ROL billions; daily averages



strengthened 3.9 percent[56] on average against the EUR-USD currency basket (compared with 1.6 percent in 2003 H1).

Acting counter to the expansionary impact that the increase in the central bank's foreign assets exerted on liquidity, the NBR made increasing use of liquidity-absorbing operations; these operations were boosted by the *de facto* diversification of the array of instruments provided to banks – the NBR started to issue certificates of deposit – and by credit institutions' keener interest in such investments amid the expected decline in policy rate.

Against this background, interbank trading (including the NBR) rose markedly, contributing to expansion in money market depth (calculated as a share of GDP), which reached the highest level in the past ten half-years.

The average daily volume of interbank transactions (the NBR excluded) rose by about 40 percent compared with 2003 H2, amounting to ROL 3,415 billion. The rise in demand was due to the banks which resort steadily to interbank resources in order to meet short-term funding requirements and to some banks which increased their deposits with the central bank, covering temporary liquidity bottlenecks by absorbing very short-term resources. The supply of interbank funds increased owing mainly to the relatively high interest rates on NBR deposits.

The average daily flow of deposits taken by the NBR went up 15 percent while the share of the central bank's operations in total turnover dropped. During the first five months of 2004, the NBR used only one-month deposit-taking operations, whose interest rate was maintained at 21.25 percent, thereby inducing market stability. In addition, banks managed their resources more properly due also to expected downtrend in the NBR interest rate.

Against this backdrop, volatility of interest rates lowered compared with the previous six-month periods. During the period under review, the corridor within which average daily interest rates fluctuated was as large as 8.8 percentage points, compared with 14.2 percentage points in 2003 H2, due to the 5 percentage point increase in the threshold of the interest rate corridor. In the case of the average interest rate on overnight and one-week deposits, whose cumulative share was 89.2 percent of total turnover, the fluctuation band was halved to 9.1 percentage points and 4.1 percentage points respectively. The spread between the NBR interest rate and average interbank rate

[56] Compared with 2003 H1

remained unchanged at 1.4 percentage points, as it was in 2003 H2.

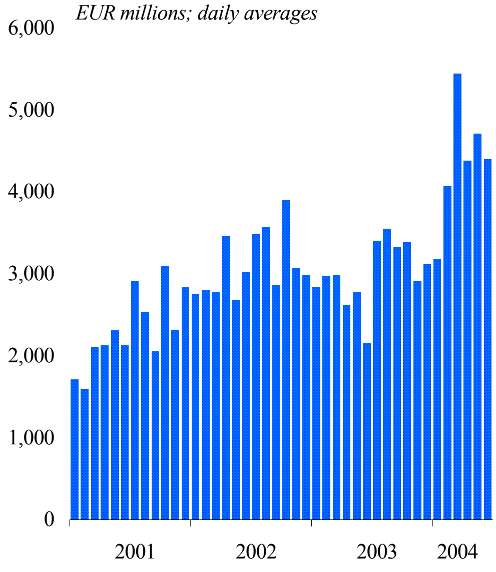
The interest rates on government securities were kept broadly unchanged, dropping in June in line with the fall in the NBR interest rate.

The interest rates paid to non-bank clients posted opposite developments, reflecting fiercer competition among banks and re-orientation, at least partial, of their development strategies. Interest rates on new short-term loans (of which 97.1 percent were extended to legal entities) edged down about one percentage point in 2004 H1; conversely, interest rates on new medium- and long-term loans (of which 71.2 percent were granted to individuals) went up 3.5 percentage points in the first five months of 2004, declining thereafter by roughly one percentage point. Average interest rate on new time deposits evolved divergently across the main maturities. Average interest rates on deposits with maturities of up to one year remained on hold or even decreased while those on deposits with longer maturities increased more than 0.7 percentage points, mirroring the rise in banks' demand[57] for longer-term domestic resources, given that individuals showed tepid interest in longer-term deposits (the share of new one-month deposits in total time deposits climbed almost steadily, from 65.4 percent in December 2003 to 73.1 percent in June 2004); yet another indication in this respect was the issuance of bonds by credit institutions for the first time ever. Another reason was the stronger competition between banks and the Ministry of Public Finance in raising savings of the private sector (the volume of government securities outside the banking system increased by 29.8 percent in real terms in June 2004 compared with June 2003, while quasi-money moved up 14.7 percent in real terms).

Activity in the foreign exchange market was buoyant, with interbank trading experiencing the heftiest increase compared with the corresponding periods of the past four years. At the root of this performance was the swift pace of growth in financial transactions with foreigners[58], while the contribution of foreign trade to the expansion of domestic forex market was considerably lower[59]. The factors fostering the increase in short-term capital inflows were high interest rates on the domestic

Transactions on FX Market

EUR millions; daily averages



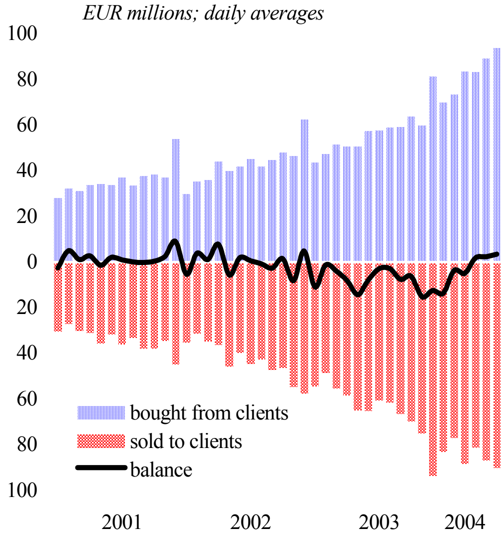
[57] Amid expectations of relatively more expensive external financing sources.
[58] Foreign direct investment, portfolio investments and short-term financial flows.
[59] Compared with 2003 H2, the average daily volume of interbank forex transactions rose by 34 percent, outstripping by far the increase in the volume of foreign trade (7.6 percent). Compared with 2003 H1, the average daily volume of interbank forex transactions went up 55 percent, while the volume of foreign trade grew by 20.9 percent.

market and maintenance of the nominal exchange rate of the ROL on a relatively stable trajectory[60].

Behind the upsurge in interbank forex transactions stood mainly credit institutions whose foreign exchange operations were spurred by temporary arbitrage opportunities provided by the interest rate fluctuations and movements of EUR/USD rate and, especially, by the central bank's sizeable intervention.

Clients' Demand and Supply on FX Market

EUR millions; daily averages



Forex transactions performed by bank clients followed an upward trend (demand for and supply of foreign exchange increased by 11.4 percent and 21.5 percent respectively), with the operations carried out by individuals making a noticeable contribution to the rise in liquidity of the interbank forex market; the share of such operations in total turnover reached a historical high in 2004 H1.

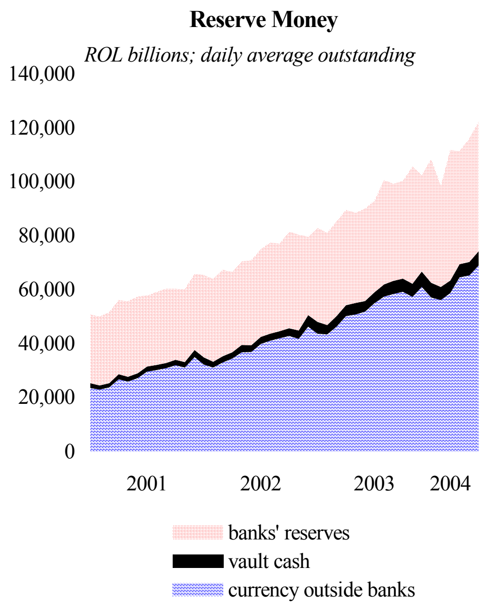
During the period under review, the ratio between demand for and supply of foreign exchange in the interbank market underwent a significant change, the large deficits recorded in 2004 Q1 reverting to mounting foreign exchange surpluses in 2004 Q2. The pressure from these surpluses on the ROL exchange rate was magnified by the net foreign exchange purchases of banks' exchange bureaux, which hit a record high of EUR 1,153 million; in order to cushion this pressure, the NBR had to mop up a large part of excess supply of foreign exchange, its net purchases reaching a 6-month high of EUR 1,279 million.

Lower volatility of the EUR/USD rate[61], the move to the new EUR-USD basket and the relatively more frequent and sizable intervention by the central bank contributed to the almost steady reduction in swings of the ROL against the EUR[62] during the period under review. The relative spread between banks' average bid/ask rates followed a downward trend, reaching its lowest reading since January 2003.

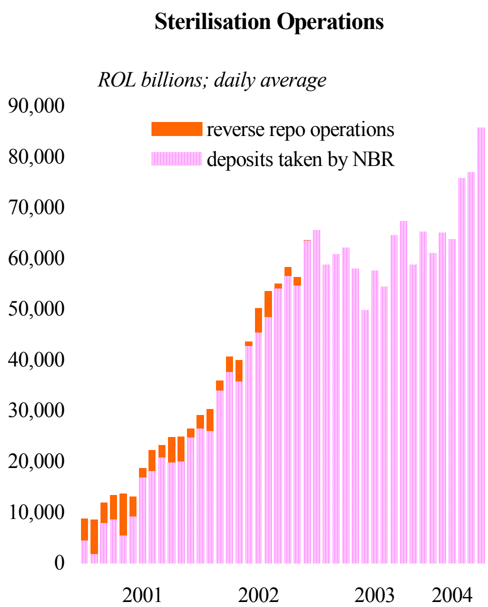
[60] Such capital inflows increased starting April 2004.
[61] Excepting May, the EUR/USD rate volatility dropped every month, in June reaching its lowest level since October 2002.
[62] Movements stepped up slightly in February only.

3.3. The mix of monetary policy tools

The central bank supported further remonetisation of the economy. As a result, reserve money[63] rose faster in real terms (15.1 percent), due mainly to the increase in banks' demand for reserves. The rise in reserve money was driven solely by the upsurge in the central bank's net foreign assets while net domestic assets continued to decline.



By resorting to sizable operations aimed at mopping-up capital flows, the NBR succeeded in keeping excess liquidity at a significantly low level. The efforts made by the central bank were heightened by both the rise in the volume of foreign exchange inflows and the relatively lower efficacy of required reserve mechanism, attributable to the expansion in the share of foreign liabilities with a residual maturity of at least two years (from 11 percent to 14.7 percent) included in the reserve base. Operations performed by the Treasury had a beneficial contribution to the sterilisation of excess liquidity, the new funds raised through government securities issues on the domestic market during the period under review being a source for partial repayment of external public debt and publicly-guaranteed debt.



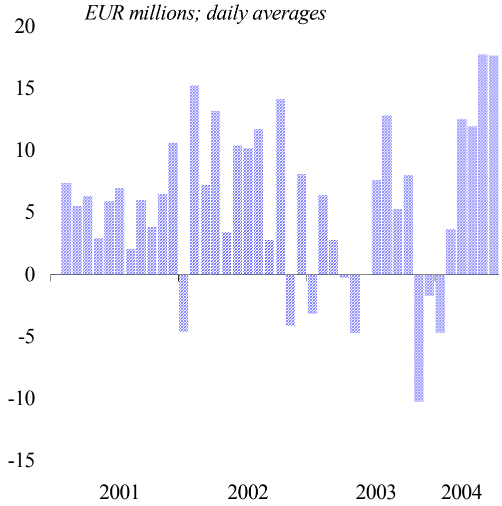
Given that annihilation of the impact of autonomous factors of liquidity called for significant increase in liquidity-absorbing operations, the NBR decided to diversify the array of tools used in implementing monetary policy by resorting to issuance of certificates of deposit in June 2004; certificates of deposit have a maturity higher than that of deposits, i.e. 3 months, they can be traded by banks and allow extension of sterilisation horizon amid a relatively lower liquidity premium. When defining the features of this new instrument, the criteria also included the fostering of a more proper management of resources available to credit institutions; to this end, the NBR operations in certificates of deposits have a standardisation degree higher than that of deposit-taking operations (organisation of only one auction session on a monthly basis, the date is announced in advance, the amount accepted by the NBR fluctuates within ±25 percent of the pre-announced volume). In addition, unlike deposit rates, the yield on certificates of deposit does not convey a signal, the central bank acting as a price-taker on the primary market for government securities.

In 2004 H1, the National Bank of Romania conducted operations with a considerable impact on monetary variables, of which the following deserve mention:

[63] Monthly average; June 2004 against December 2003.

Net Interventions* by the NBR in the FX Market

EUR millions; daily averages



**) purchases (+), sales (-)*

1. Interventions in the foreign exchange market. During the reference period (except January), the central bank intervened heavily to raise the demand for foreign currency. As a result, after having sold EUR 93.2 million in January, in the five months that followed, the central bank made net purchases tantamount to EUR 1,371.9 million, a fresh record high on a half-yearly basis.

2. Liquidity-absorbing open market operations. In order to stem the effects of massive foreign currency purchases on liquidity, the NBR increased markedly its sterilisation operations by collecting one-month deposits and issuing certificates of deposit. The average daily volume of open-market operations stood 16.4 percent higher than in 2003 H2, whereas the average daily balance on such deposits advanced by 24.1 percent. Deposits further held the largest share in the average balance of open market operations while certificates of deposit accounted for only 3.3 percent. Banks' expectations of a cut in the policy rate helped enhance the efficacy of the central bank's intervention, causing the ratio of the amount settled at term deposit auctions and the pre-announced amount to grow steadily in 2004 Q2, and even to rise above par in June.

3. Repayment of some special credit lines. Sterilisation operations were fostered by partial repayment of some loans granted to the Bank Deposit Guarantee Fund and Credit Bank to the tune of ROL 348 billion.

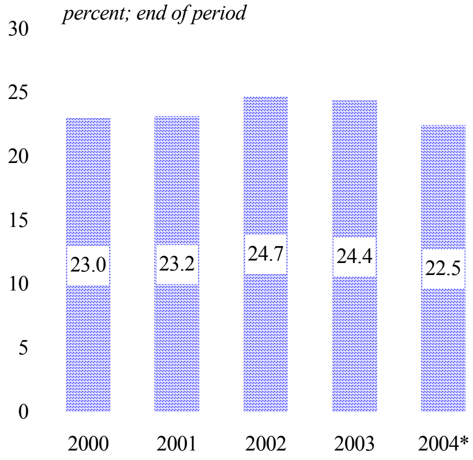
4. The NBR's standing facilities. Credit institutions showed far less interest in making use of the deposit facility, whereas the lending facility was not at all resorted to. Thus, 7 credit institutions made recourse to the deposit facility only 12 times, compared with 21 and 57 respectively in 2003 H2. Overnight deposits with the NBR ranged from ROL 17 billion to ROL 600 billion and the average value of a deposit placed with the central bank came to ROL 118 billion compared with ROL 251 billion in the latter half of 2003.

3.4. Main monetary developments

In the first half of 2004, demand for money was on the rise, despite its significant fluctuations caused by both seasonal and incidental factors, which affected particularly the economic agents' behaviour, with corporate deposits posting relatively large monthly swings. Conversely, household demand for money further grew at a steadier pace.

Under the circumstances, the growth rate of broad money (**M2**) touched a 9-year[64] record high (6 percent) in 2004 H1, which may point to the strengthening of the Romanian economy monetisation. Time deposits in ROL[65] accounted for 58.5 percent of the real increase in broad money, while currency in circulation and deposits in foreign exchange[66] contributed 30.5 percent and 12.1 percent respectively.

Broad Money (M2)
(Share of GDP)



**) M2 at end-June; GDP forecast*

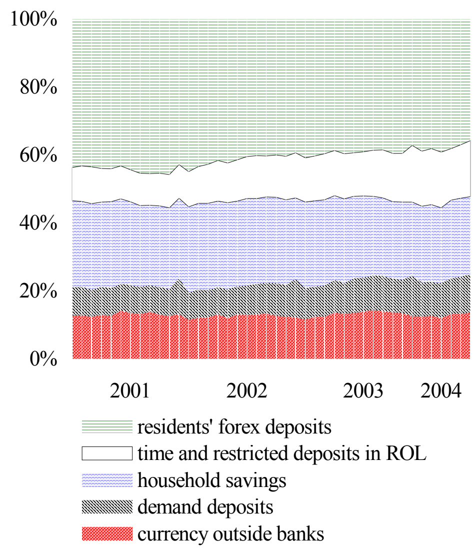
Source: NIS, NBR

January through June 2004, government securities outstanding with non-banks rose markedly, i.e. 30.6 percent in real terms from 2.8 percent in the same year-ago period. Thus, the monetary pseudo-aggregate **M2T**[67], which internalises the substitution between bank deposits and government securities, posted an all-time high in the first half of 2004 (8.3 percent in real terms).

Quasi-money reached an 8-year high, outpacing by a real 5.6 percent the end-2003 reading. These developments may be associated mainly with the increased bias of both households and companies towards savings in ROL, due to the more attractive interest rates on deposits in ROL than those on forex deposits.

Household savings in ROL were on the rise and hit an 8-year high in terms of corresponding 6-month periods (12.5 percent in real terms). The recovery of demand for such deposits owed much to both the step-up in household incomes[68], including their higher net sales of foreign exchange, and to the rise in the average interest rates on new time deposits (2.2 percentage points in real terms[69]). Moreover, ROL-denominated government securities outstanding with individuals climbed by a real 4.6 percent. Against the backdrop of massive foreign exchange inflows from abroad, households further held sufficient forex resources that helped them increase both

Broad Money

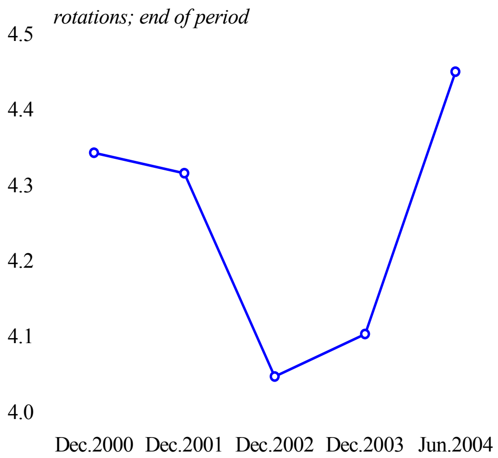


[64] The 6-month periods of the respective years
[65] Demand deposits in ROL had a negative contribution of one percent.
[66] Also include the influence of the ROL/EUR exchange rate
[67] M2 + government securities outstanding with non-banks
[68] January through June 2004, real net wage picked up 8.9 percent from the same year-ago period and 8.7 percent compared to 2003 as a whole.
[69] Based on CPI as compared with 2003 H1

deposits and government securities in foreign exchange (10 percent and 14.7 percent respectively, both expressed in euro).

Corporate **time deposits** moved ahead by a real 5 percent, the significant seasonally-induced declines recorded in January and April notwithstanding. Part of the ROL-denominated corporate funds was invested in government paper, whose volume rose markedly compared with end-2003 (58.7 percent in real terms). Conversely, **corporate deposits in foreign exchange** were on the slide, thereby illustrating the wider trade deficit and the increase in the balance of legal entities' holdings of forex government securities (23.3 percent when expressed in euro). Nevertheless, corporate deposits in foreign exchange picked up 4 percent (when expressed in euro) since the beginning of 2004, as a result of their mostly incidental step-up in March[70].

Money Velocity



**) M2 at end-June; GDP forecast*

Source: NIS, NBR

Despite the considerable increase in **residents' forex deposits** (7 percent, when expressed in euro), their share in broad money followed a downward drift (37.8 percent, the lowest average monthly reading of the corresponding 6-month periods from 2000 to date).

Narrow money (**M1**) climbed by a real 10.8 percent compared with end-2003. Moreover, its share in M2 rose to a 6-year high (23.4 percent, as a monthly average). The real monthly growth rates of M1 posted the smallest fluctuations in the past 8 years, possibly as a result of the increase in the substitution between the two components of this monetary aggregate.

Currency in circulation displayed the steepest rise for the corresponding period over the past 15 years (14.6 percent in real terms). In 2004 H1, demand for cash was spurred by seasonal factors, on the one side, and public spending, as well as the pick-up in individuals' sales of foreign exchange to exchange bureaux on the other side. Higher demand for cash had a negative impact on the value of card-based operations in ROL, which rose at a slower pace than in 2003 H1 (22.6 percent in real terms calculated based on the balance).

Given the improved financial standings of companies[71], **demand deposits** edged down merely 0.5 percent in real terms, thus offsetting to a large extent the seasonally-driven decreases they reported in early 2004.

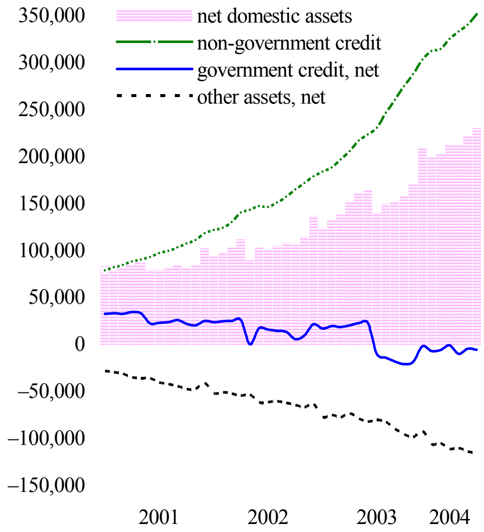
[70] This increase was driven by the redemption of "Termoelectrica" bonds in amount of EUR 150 million. Concurrently, the balance of the Treasury General Account fell on the back of the loan in ROL granted to purchase foreign exchange.
[71] In January-May 2004, turnover in industry (for domestic and foreign markets) expanded by 10.3 percent against the same period a year ago, whereas turnover of retail trade (except for sales of motor vehicles and motorcycles) rose 14.1 percent year over year.

In the first half of 2004, the main sources behind money creation were the expansion in both non-government credit and net foreign assets of the central bank.

In 2004 H1, **net domestic assets** of the banking system went up 6.2 percent in real terms, thus reflecting the discrepancy between the developments in net domestic credit (up 10.8 percent in real terms) and those under "other net domestic assets". The latter saw its credit balance increasing by a real 21.2 percent versus end-2003.

Net Domestic Assets

ROL billions; end of period



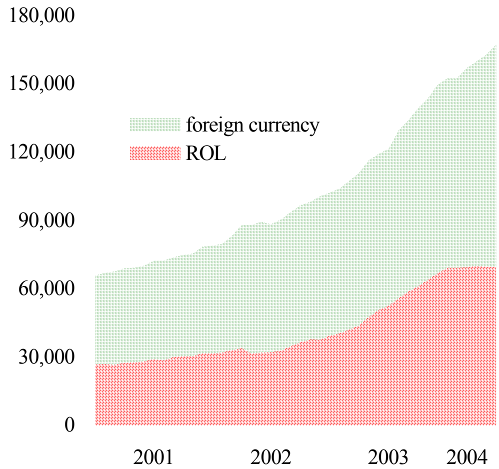
Non-government credit grew at a slower pace than in the same period a year ago (11.9 percent in real terms). The zero rate of increase (in real terms) recorded by non-government credit in ROL in February, when the prudential norms[72] issued by the NBR on granting loans to individuals came into force, had a strong impact on the development of non-government credit. Under the circumstances, the step-up in non-government credit in ROL outpaced by merely 4.4 percent the first-half inflation rate (versus 34.9 percent in 2003 H1), whilst the composition of non-government credit by currency underwent significant changes in favour of the foreign exchange component (holding an average monthly share of 56.1 percent of total).

Government credit, net had a contractionary effect on broad money, its credit balance widening by 179 percent in real terms, owing broadly to the seasonal improvement in the balance of the Treasury General Account[73] and the proceeds from the privatisation of Banca Comercială Română[74]. In the reviewed period, the government sector's financing by banks increased, in the form of both ROL-denominated government securities and bonds issued by the local governments. By contrast, forex-denominated government paper outstanding with banks decreased, being influenced by a considerable repo operation between a bank and a non-resident client in February.

Non-Government Credit in Real Terms

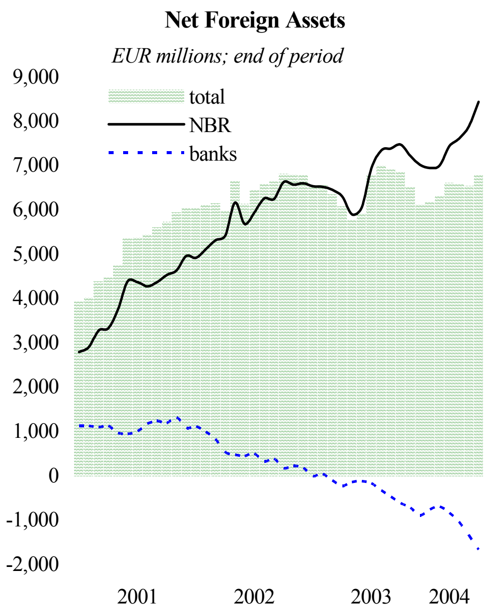
(deflated by CPI, 2000=100)

ROL billions; end of period



Foreign counterpart of broad money underpinned the expansion of M2 (10.6 percent, when expressed in euro), owing to the increase in net foreign assets of the NBR (20.2 percent, when expressed in euro). While foreign investments of the central bank went up 18 percent, when expressed in euro, due widely to large net purchases of foreign exchange and proceeds from the privatisation of Banca Comercială Română, net foreign liabilities of the monetary authority dropped 14.4

[72] Norms No. 15/2003 on the mitigation of credit risk for consumer credit and Norms Nos. 16/2003 and 1/2004 on mortgage credit (amendments to Norms No. 3/2000)
[73] In April 2004, the balance of the Treasury General Account hit an all-time high for data series available until the end of 2004 H1.
[74] To the tune of EUR 179.6 million (in June 2004)



percent, when expressed in euro, as a result of principal repayments and interest payments on borrowings from the IMF. Net foreign assets of credit institutions further increased their credit balance (almost twice as high as the end-2003 reading, when expressed in euro). This owed much to the faster growth rate of foreign liabilities of credit institutions than to their foreign assets: 45.6 percent and 2.8 percent respectively.

4. Outlook for inflation

The inflation forecast for September 2004-March 2005 was based on the following:

(i) Monetary policy will further focus on disinflation by keeping a tight rein on liquidity and pursuing a cautious interest-rate policy. The policy rate is expected to decrease gradually, in line with the strengthening of the disinflation trend.

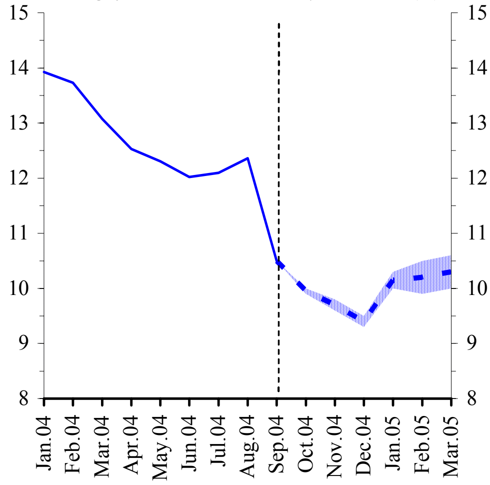
(ii) The exchange-rate policy will be aimed at achieving sustainable disinflation by maintaining the annual real appreciation trend of the ROL versus the main currencies. Moreover, a greater unpredictability of the daily movements in the exchange rate will be accepted as a hedge against the risk of volatile capital flows.

(iii) Fiscal policy will remain prudent, despite the relative loosening expected in 2004 H2 as compared with 2004 H1, illustrated by the difference between the revised target of the 2004 general consolidated budget deficit (1.64 percent of GDP) and the first-half achievements (0.6 percent of GDP), on the one side, and by the outlays related to the organisation of general elections, on the other. Provided that, in 2005, the budget deficit is kept low (1.5-1.6 percent of GDP), the improvement in revenue collection, amid sustained economic growth and tighter financial discipline, is expected to offset the measures aimed at reducing the tax burden as of 1 January 2005[75].

(iv) Income policy will ensure a real increase in wages; the gross average wage in the public sector is subject to 6 percent indexation in October 2004 and to another 6 percent in January 2005[76], when the gross minimum wage economy-wide is to be raised to ROL 3.1 million; pay rises in the state-run companies monitored pursuant to Government Decision No. 393/2004 must not exceed the projected average inflation rate. As public sector and farmers' pensions rose 9.5 percent and 8.3 percent

Inflation Forecast for September 2004 - March 2005

change from the same month a year earlier (%)



[75] By lowering the profit tax rate from 25 percent to 19 percent, the number of income tax brackets from 5 to 3 and tax rates from 18-40 percent at present to 14-38 percent, as well as by cutting the social security contribution rates by 1.25 percentage points.

[76] In 2005 as a whole, the nominal average wage will rise 12 percent, the indexation being scheduled for January and October, the same as in the previous years.

respectively as of 1 September 2004, their adjustment will be no higher than 3 percent in 2005. Moreover, the value of other social transfers will be raised (for instance, the heating allowance during the cold season was subject to 12 percent indexation in order to cover the increase in prices for heating, while the number of recipients is officially estimated to climb by more than 10 percent).

(v) Tensions in the oil market will persist, which may push domestic fuel prices higher. In the same direction may also act the gradual alignment of fuel prices to those in the EU and the nominal depreciation of the ROL versus the EUR (the excise duty on fuels is expressed in euro).

(vi) Administered prices will further exert inflationary pressures. In 2004, the 12 percent increase in the price for heating in August is to feed through into consumer prices in October and November[77]; natural gas prices are to be raised by 5 percent in October. Yet, electricity prices will remain unchanged after the 7.8 percent adjustment in July. According to the precautionary agreement concluded with the IMF in July 2004, prices for heating and electricity will be raised to cost-recovery levels on a half-yearly basis (on 1 January and 1 July) starting 2005; end-user regulated prices for natural gas will be adjusted once a year (in January), based on a new methodology, so that producer prices for natural gas[78] should reach import parity by January 2007. The other administered prices will further be adjusted periodically contingent on the movements in exchange rate and headline inflation.

(vii) Excise duties will remain unchanged by 1 July 2005.

Under the circumstances, further disinflation is forecasted for 2004 Q4; however, a short-lived disruption of this trend is likely to occur in 2005 Q1, due mainly to the impact of energy price adjustments in January and the pressures exerted by the soaring oil price.

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[77] Assuming that delivery of heating to households begins at mid-October.

[78] To rise from USD 60 per 1,000 m^3 to nearly USD 85 per 1,000 m^3 on 1 January 2005