INFLATION REPORT

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N O T E

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The National Institute of 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 provided the English version of ***Inflation Report.***

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ABBREVIATIONS

AMIGO	Household Labour Force Survey
ANRGN	National Authority for Regulation in Natural Gas Sector
BDGF	Bank Deposit Guarantee Fund
BIS	Bank for International Settlements
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
ULC	unit labour cost
USD	United States Dollar

Overview

Inflation rate further headed downwards. July and August saw a disruption of the downtrend in inflation due to the adjustment of some administered prices and the unfavourable impact of some volatile prices (for fruit and vegetables, fuels), yet disinflation resumed in September. The 12-month rate of increase of consumer prices dropped at end-year to 9.3 percent (from 12.4 percent in August), a mere 0.3 percentage points above the 2004 inflation target.

The Romanian economy expanded at a robust clip. The larger-than-expected domestic demand provided an underpinning to the nearly 3 percentage point increase in GDP annual growth rate for 2004 Q3 and Q4. Consequently, GDP for the year as a whole advanced by 8.3 percent, surpassing both the initial target of 5.5 percent and the revised target of 7.3 percent. The main driver of growth was further the higher household actual final consumption as a result of fast rise in household incomes (including net remittances from abroad) and increased self-consumption.

Investment boosted economic growth only in the first part of the period under review, as the third-quarter expansion (as illustrated by the 17.3 percent annual rise in gross fixed capital formation) was followed by a sharp slowdown in 2004 Q4 (2.7 percent). Net external demand still made a negative contribution to GDP growth, yet a slight turnaround was manifest in the final quarter of the year.

Labour market conditions remained tight. The official unemployment rate continued to fall, touching 6.2 percent at year-end amid unusually weak seasonal effects in November and December. Whole-economy net average wage growth gathered momentum against the background of wage developments in the budgetary and industrial sectors.

Monetary policy retained its tight stance. In order to keep inflation on a path that should eventually lead to achievement of the inflation target and ensure sustainable disinflation in the longer run, the National Bank of Romania kept tight monetary conditions in place. Even though the central bank made gradual, frequent cuts in the policy rate, monetary conditions became relatively tighter given the more austere exchange rate policy.

For most of the reported period, fiscal policy featured belt-tightening, which was supportive of disinflation. With expenditures falling more steeply than revenues, the consolidated general government deficit for the latter half of 2004 stood at 0.5 percent of GDP (from 1.4 percent in the same year-earlier period). Despite the change in policy conduct in December, when spending shot up, the annual fiscal deficit was below the projected figure.

Non-government credit growth slowed further. The latter half of 2004 saw noticeable slowdown in non-government credit growth on the back of slackening ROL-denominated lending; both households and companies showed keener interest in foreign-exchange-denominated loans, due largely to their lower costs. Unlike in the same year-earlier period, lending was no longer a major driver of private consumption, as the high real deposit rates fostered saving.

Outlook for inflation is positive. The adjustment of energy prices and the change in excise duties that have occurred in April are seen causing in 2005 Q2 a short-lived deviation of annual inflation rate from the downward course; however, in 2005 Q3, inflation rate is expected to resume the path compatible with the attainment of the year-end inflation target.

1. Inflation developments in 2004 H2

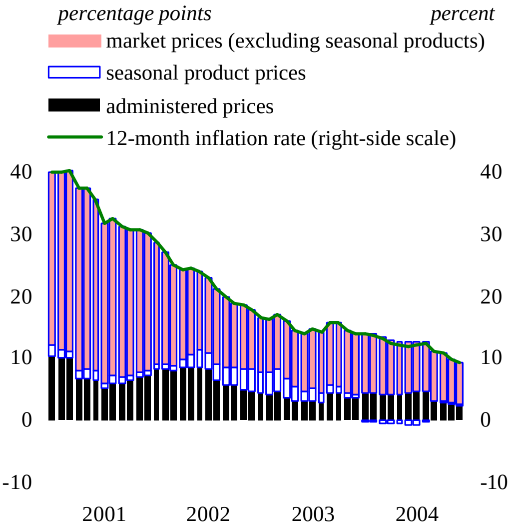
Disinflation continued in the latter half of 2004, even though month-to-month developments were mixed. July and August saw a disruption of the downtrend in inflation prevailing in 2004 H1[1] amid the adjustment of some administered prices (electricity, natural gas, water, sewerage, refuse collection) and the unfavourable impact of some volatile prices (fruit and vegetables, fuels), yet disinflation resumed in September. Thus, the 12-month rate of increase of consumer prices dropped in December 2004 to 9.3 percent, 2.7 percentage points below the mid-year level and merely 0.3 percentage points above the 2004 inflation target.

Unlike the previous 6-month period, when disinflation was more pronounced particularly in the case of food prices, in the latter half of 2004, prices of services witnessed the sharpest slowdown in their annual growth rate, shedding 8.1 percentage points to 8.5 percent. Special mention deserves the reduction in prices for telephony services in the final two months of 2004 following the nominal strengthening of the domestic currency versus the euro.

Food prices further posted the lowest annual growth rate (7.4 percent in December 2004), 1.2 percentage points below the mid-year reading. The favourable effect of bumper grain crops was overshadowed by (i) weaker fruit and vegetables supply because of adverse weather conditions (floods, hailstorms, thunderstorms) and (ii) heightening of tensions on the meat products market, owing to both external factors (higher world prices) and domestic factors (decline in domestic production).

The year-on-year growth rate of prices for non-food items fell to 11.4 percent in December, but remained above average, as the second-half magnitude of energy price adjustments was 2.7 percentage points higher than that of the first half of the year and the record high world oil prices[2] entailed significant domestic fuel price hikes. Therefore, the slowdown by 6.7 percentage points in the annual growth rate of regulated prices for non-food items (electricity and heating, natural gas, medicines), the major determinant of disinflation relative to this group[3], was not the result of the developments in the reported

Inflation rate



Source: NIS, NBR calculations

Administered Prices

annual percentage change

	2003		2004	
	III	**IV**	**III**	**IV**
Inflation rate	**15.0**	**14.8**	**11.9**	**10.0**
Administered prices	**15.9**	**19.3**	**17.9**	**11.2**
1. Non-food items:	**17.2**	**18.6**	**17.2**	**12.1**
electricity	6.1	18.1	30.7	17.7
heating	39.1	6.7	0.0	10.4
natural gas	25.6	47.0	36.1	22.2
medicines	11.8	6.4	–6.6	–6.9
2. Services, of which:	**14.1**	**17.4**	**18.2**	**9.8**
water, sewerage, refuse collection	21.6	22.2	23.2	23.4
telephony	9.7	14.0	15.4	–0.1
passenger railway transport	9.2	14.9	17.5	19.2
(passenger) city transport	17.1	19.4	16.4	17.0

Source: NIS, NBR calculations

[1] After having declined steadily from 13.9 percent in January to 12 percent in June, annual inflation rates rose to 12.1 percent and 12.4 percent in July and August 2004.
[2] See Subsection *2.5.3. Imported inflation.*
[3] In the case of which the annual growth rate of prices slowed by 2.4 percentage points compared with June.

period, but of the base effect from supply-side shocks triggered by the severe drought and the considerable increase in import gas price in 2003 H2.

CPI by Category of Products

annual percentage change

	2003		2004	
	III	IV	III	IV
Food items, beverages, tobacco	18.3	18.1	11.4	9.8
Wearing apparel and footwear	11.8	10.2	7.2	6.0
Household appliances, furniture	9.7	8.5	7.0	6.7
Fuels	18.7	13.1	15.6	20.1
Utility expenses*	19.1	21.2	23.2	18.4
Healthcare	13.0	10.0	1.7	0.9
Transport	15.0	17.6	15.2	15.8
Post and telecoms	3.5	8.4	14.2	1.0
Leisure and culture	11.9	13.7	10.9	8.7
Other goods and services	10.9	10.2	6.3	6.6

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

Source: NIS, NBR calculations

The same holds true in respect of administered prices in the latter half of 2004 (their growth rate slowed by 8.8 percentage points to 9.9 percent in December). Cheaper telephony services had a positive effect on disinflation as well.

Under the circumstances, the main inflationary pressures in 2004 H2 could be detected on the supply side, due largely to the administered price adjustments and the effects of substantial hikes in external prices of some commodities such as oil and meat. Moreover, although the average annual growth of nominal ULC in industry declined against 2004 H1 (by 2.1 percentage points), in some industries holding a significant share in the CPI basket it remained above average (food-processing) and even picked up steam (wearing apparel, leather products and footwear, and energy). However, the pressures on production costs were offset by favourable developments in prices of some commodities (wheat, cotton, wool), which caused annual growth rates in industrial producer prices for the domestic market to slow further (across manufacturing, reaching 16.7 percent at year-end, from 19.1 percent at mid-year). Moreover, a significant contribution to lowering inflationary pressures had the stiffer competition in the productive sector triggered by complementary imports and in the retail market following the expansion of hyper- and supermarkets.

On the demand side, the potential inflationary pressure arising from household consumption was higher than in the first half of 2004 on account of a looser income policy in the fourth quarter of the year (see Subsection *2.4.2. Incomes*). Nevertheless, the rise in imports (amid the limited flexibility of domestic supply) bolstered disinflation given the favourable trend in prices of imported consumer goods[4] and in the ROL/EUR exchange rate (in nominal terms, it appreciated 0.4 percent on average versus the first half of 2004, mainly on the back of the movements recorded in the final two months of the year).

[4] See Subsection *2.5.3. Imported inflation.*

2. Determinants of inflation

2.1. Demand

In the second half of 2004, annual GDP growth added 3 percentage points against the previous six months (10 percent[5] in 2004 Q3 and 9.7 percent in 2004 Q4). This development was further propelled by domestic demand, which featured steadily rising consumer demand and wide swings of investment demand growth (from 17.3 percent in Q3 to barely 2.7 percent in Q4).

2.1.1. Consumer demand

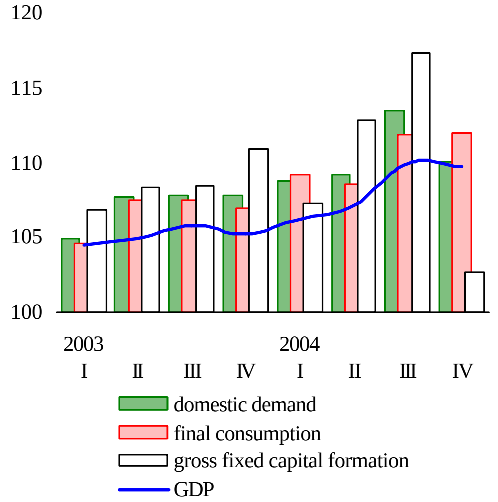
Household actual final consumption saw fast-paced rise in the latter half of 2004, with growth rates of 12.9 percent and 12.8 percent in Q3 and Q4 respectively, compared with the first-half average of 9 percent. This development was driven largely by the increase in real disposable income, following higher net wages and the slowing inflation[6]. The drivers of the accelerated growth rate were the three demand components: (i) purchases of goods and services, (ii) self-consumption and purchases on the agri-food market, and (iii) provision of services by public administration and non-profit-making organisations. Self-consumption was the fastest-growing component thanks to bumper grain harvest and the base effect, reported growth rates of 19.6 percent and 12.9 percent in Q3 and Q4 respectively, compared with below 2 percent levels in Q1 and Q2.

The acceleration of growth rate of households' purchases of goods and services was less rapid (between 1 and 1.5 percentage points), yet the associated inflationary pressures were higher. The growth rate of purchases of services stepped up by as much as 9 percentage points, while the increase in purchases of goods was more balanced. Demand for goods featured the following:

(i) robust demand for non-durables, i.e. foodstuffs, wearing apparel, footwear, pharmaceutical and cosmetic products;

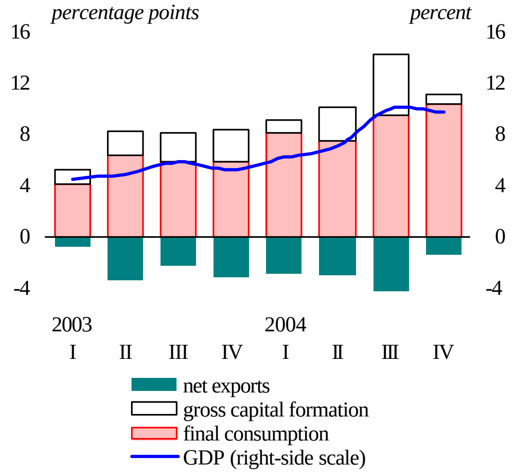
Domestic Demand

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



Source: NIS

Contribution of Demand Components to GDP Growth

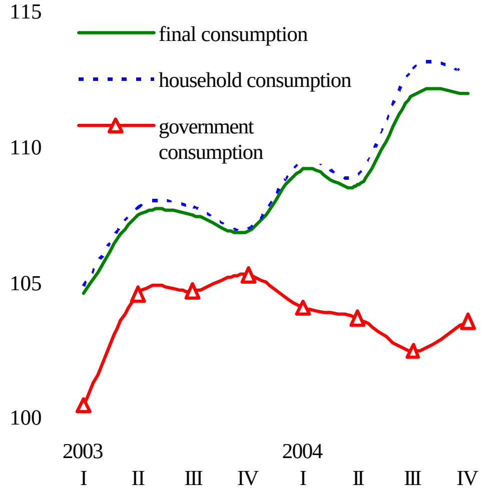


Source: NIS, NBR calculations

[5] Unless otherwise indicated, the growth rates given in Subsections *2.1. Demand* and *2.2. Supply* are annual percentage changes.
[6] In 2004 H2, real annual growth of whole-economy net average wage added 1.1 percentage points to 10.1 percent against H1.

Actual Final Consumption

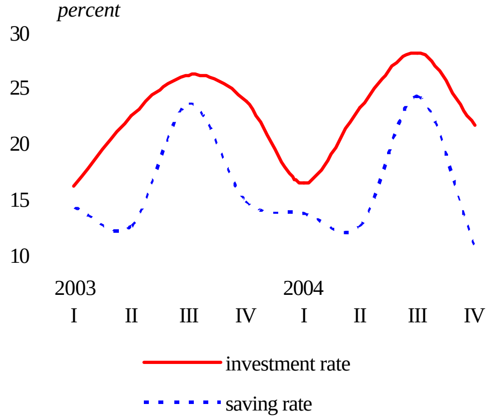
index compared to the same year-earlier period (%)



Source: NIS

Investment Rate and Saving Rate

percent



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

annual percentage change

	Years	I	II	III	IV
Total	2003	6.7	7.0	7.5	10.3
	2004	7.2	12.0	18.1	1.7
- new construction works	2003	0.1	6.3	7.2	6.3
	2004	7.6	9.6	13.3	6.9
- equipment	2003	13.1	14.3	3.9	15.9
	2004	14.9	26.4	38.4	5.5

Source: NIS

(ii) salient slowdown in the growth rate of demand for durables[7] caused by the lowering of the debt ceiling for individuals following the coming into force of the new prudential regulations on consumer credit[8]; however, a trend reversal occurred in the final two months of 2004, as a result of several supply-side factors such as sales promotion, refinement of instalment buying, including through the setting up, by major distribution networks, of affiliated companies granting consumer credit;

(iii) mounting interest in purchases of motorcars[9], particularly in the final quarter of 2004, that could be associated with the 196.7 percent growth of foreign-exchange-denominated medium-term loans.

Although public spending loosened up in the final three-month period of 2004 against the backdrop of general election, causing public administration actual final consumption to rise faster (by 1.1 percentage points than in Q3), the expansion of government consumption in the latter half of 2004 (2.5 percent and 3.6 percent in Q3 and Q4 respectively) lagged behind the first-half figure.

2.1.2. Investment demand

The second half of 2004 saw a marked change in investment behaviour. Consequently, after having stayed on a sharply upward path January through September, the growth rate of gross fixed capital formation decelerated to 2.7 percent in Q4.

As in 2004 H1, investment continued to surge in the third quarter of 2004, hitting a 6-year high of 17.3 percent[10]. This development was the result of the joint action of several factors: (i) good financial results of the corporate sector during the prior period; (ii) further readily available domestic and external funds; (iii) availability of non-redeemable external funds such as SAPARD, ISPA; and (iv) stronger foreign direct investment.

The final quarter of 2004 witnessed rather surprising developments, which can only partly be attributed to some investment projects being started earlier than scheduled over election uncertainties (as suggested by the sharp decline in government-backed foreign borrowings).

[7] Year-on-year growth of durables turnover slowed, from more than 25 percent in Q1 to about one percent in Q3, plunging into negative territory in October (-4.7 percent).

[8] Real growth of ROL-denominated short- and medium-term loans to households slowed during 2004, from 233.1 percent in January to 11.7 percent in December.

[9] Year-on-year growth rate of car sales doubled to almost 16 percent in 2004 H2.

[10] Quarterly national accounts data in compliance with ESA 95 methodology are available since 1999.

2.1.3. Net external demand

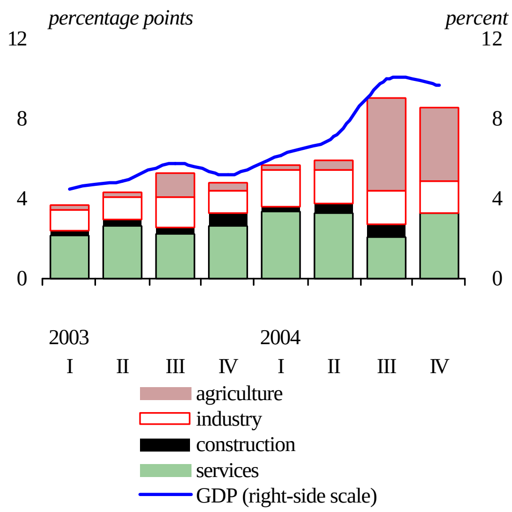
Over the latter half of 2004, net external demand continued to depress economic growth. Nonetheless, its negative contribution to GDP growth narrowed to 1.4 percentage points in Q4, compared with an average of nearly 3 percentage points in the first three quarters of 2004, as imports recorded faster slowdown than exports.

2.2. Supply

Against the background of faster economic expansion in the latter half of 2004, supply was better tailored to meet customer requirements in terms of price and quality.

Services rose by 5.4 percent and 7.1 percent in Q3 and Q4 respectively, contributing 2.1 percentage points and 3.3 percentage points to GDP growth. All major services reported good performance as efforts were made to meet the requirements of domestic consumers. In retail trade, for instance, economic agents' concern for quantitative improvements was accompanied by more flexible marketing policies. Thus, retail trade witnessed (i) expansion of hyper- and supermarkets which set up shops particularly around the main cities; (ii) larger number of relatively new types of stores such as retailers of consumer electronics and home appliances or the auto centres[11]; (iii) refinement of instalment buying, including through the setting up of affiliated companies extending consumer credit.

Contribution of the Main Supply Components to GDP Growth



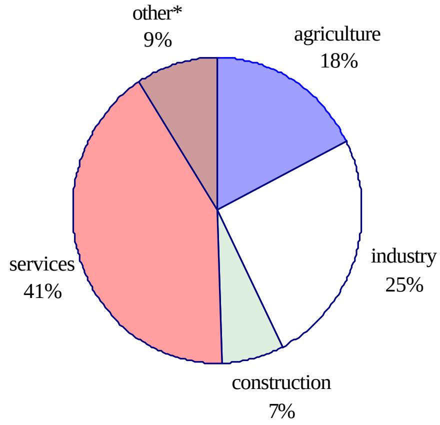
Source: NIS, NBR calculations

In Q3 and Q4, gross value added in **industry** increased faster than in the previous 6-month period (up 6.3 percent and 6.8 percent respectively). Good performance was recorded by most sub-sectors, bar the non-durable goods sub-sector whose output declined 3.8 percent in 2004 H2.

During the latter half of 2004, supply improvement further recorded a slow pace amid delayed restructuring (which had a direct impact on technological endowment and the level of professional skills) and the mismatch between increases in productivity and ULC in some sub-sectors; under these conditions, both domestic and external market shares held by Romanian manufacturers were affected. The need for a more flexible supply became the more so acute in the final quarter of 2004 as the stronger domestic currency led to higher competitive pressures from complementary imports.

[11] The former has on sale, aside from electronics and household appliances, IT products and home systems while the latter is a combination of the showroom and the after-sales service area.

GDP Formation in 2004 H2



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

Source: NIS, NBR calculations

As regards non-durables, light industry sub-sectors bore the brunt of the disturbances mentioned above. The technological and professional benefits of the extensive OPT arrangements were seriously threatened as a result. Food industry still grappled with difficulties, yet the expansion of takeovers and acquisitions (most notably in the meat and milling and bakery sub-sectors) is a sign of a possible improvement in supply for the period ahead.

Despite the large production capacities in metallurgy, the main industry of the intermediate goods group, the domestic producer's monopolistic position and focus on exports (to enter new markets and take advantage of favourable price movements) caused the mounting domestic demand to be met by sizeable complementary imports. Imported commodities hold a large share in the textiles industry as well, but for different reasons – inadequate supply as a result of undercapitalisation of companies in this line of business hampers the integration of domestic output of wearing apparel and footwear.

The Romanian industry however comprises parts that enjoy more flexible supply. The move recorded in the road transport means industry[12], which holds the largest weight in capital goods output, is a case in point. In 2004 Q3, the key car manufacturer decided to withdraw from the production line two models that were highly obsolete and subsequently launch a new model with an improved quality/price ratio. Hence, the pace of domestic and export sales[13] gathered momentum in the next quarter.

Gross value added in **agriculture** saw some of the highest growth rates for the past 15 years thanks to the bumper vegetal crops, reaching 25.6 percent and 27.6 percent in Q3 and Q4 respectively. As a result, in the latter half of 2004, this sector's contribution to GDP growth went upwards of 40 percent.

The **construction** sector also painted a brighter picture. In Q3, the 10.8 percent year-on-year advance was propelled by non-residential buildings and engineering constructions while the 9.1 percent year-on-year growth in Q4 was attributed chiefly to the performance of residential buildings – which only in the final 3-month period of 2004 saw a positive growth rate.

[12] Although car purchases are considered as consumption (according to national accounts methodology), the NIS classification by main industrial category includes cars under "capital goods".

[13] Compared with Q3, the annual growth rate of road transport means industry turnover in Q4 rose from 8.3 percent to 21.3 percent in the case of domestic sales and from 55.9 percent to 71.1 percent in the case of export sales.

2.3. Fiscal and budgetary developments

In an attempt to ensure a sustainable disinflation path and keep the current-account deficit under control, the Ministry of Public Finance retained a relatively prudent stance of fiscal policy in 2004 H2. In August, the deficit target set at the beginning of 2004 was revised downwards (for the second time in 2004) to 1.6 percent of GDP, whereas the main macroeconomic parameters underlying the new budget figures were left broadly unchanged, except the economic growth forecast which was altered, from 5.5 percent to 6.5 percent. The reduction of the budget deficit was due to larger-than-expected budget revenues in H1 and to the expansion of domestic demand, which threatened disinflation sustainability.

Even though some taxes and duties[14] were raised and the economy expanded, consolidated general government budget revenues decreased 0.3 percentage points as a share of GDP in 2004 H2 compared to the same year-earlier period. The explanation for the setback lies with the compression of collections of some indirect taxes, VAT in particular, which offset the larger receipts of income and profit tax, social security contributions and customs duties.

In 2004 H2, the decrease of consolidated general budget expenditures as a share to GDP was sharper than that of revenues (down by 1.2 percentage points compared to the same year-earlier period). Expenditures on goods and services, public debt-related interest payments as well as subsidies saw their shares in GDP falling in a range between 0.3 percentage points and 0.5 percentage points, whereas transfers (almost entirely for social purposes) and staff costs (fuelled by higher wages of budgetary personnel) saw an increase in their shares in GDP. Capital outlays, which occurred in a proportion of 46 percent in December, further accounted for 2.1 percent of GDP.

The faster decrease in expenditures than in receipts caused the deficit of the consolidated general budget[15] to narrow to 0.5 percent of GDP from 1.4 percent in the same period of the previous year.

The deficit of the consolidated general budget built up in December, taking more than 85 percent of the full-year deficit, compared to almost 67 percent at end-2003. In December 2004, spending soared 58 percent, while receipts picked up 20 percent

Consolidated Budget Revenues*)

percent

	2003 H2	2004 H1	2004 H2
Revenues	100.0	100.0	100.0
Tax revenues, of which:	93.3	94.3	94.2
Profit tax	7.8	9.0	9.3
Income tax	9.5	10.3	9.9
Social security contributions	32.1	31.5	31.9
VAT	24.1	23.7	23.1
Customs duties	2.3	2.2	2.4
Excise duties	10.7	10.8	11.7
Non-tax revenues	6.4	5.1	4.9
Capital revenues	0.3	0.6	0.5
Non-redeemable funds	0.2	0.0	0.3

*) transfers between budgets were removed

Source: NBR calculations based on MPF data

Consolidated Budget Expenditures*)

percent

	2003 H2	2004 H1	2004 H2
Expenditures, of which:	100.0	100.0	100.0
Public authorities	5.2	5.1	5.6
National security and defence, and public order	9.8	10.8	10.4
Education	9.5	10.7	8.9
Health	11.9	11.8	10.1
Social activities and culture	38.9	39.4	41.0
Economic activities	18.7	17.1	19.9
Interest related to public debt	5.5	3.8	2.5

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

Source: NBR calculations based on MPF data

[14] Excise duties on alcohol, tobacco products and mineral oils (following the implementation of the latest stage of bringing domestic excises into line with those in the EU), profit tax (on export-derived profit).

[15] Including the budget of the National Company of Highways and National Roads

versus the average for January-November period. Expenditures were spurred mainly by capital outlays and expenditures on goods and services, their monthly amount rising more than five times and almost two times compared with the average of the preceding months.

Balance of Consolidated Government Budget

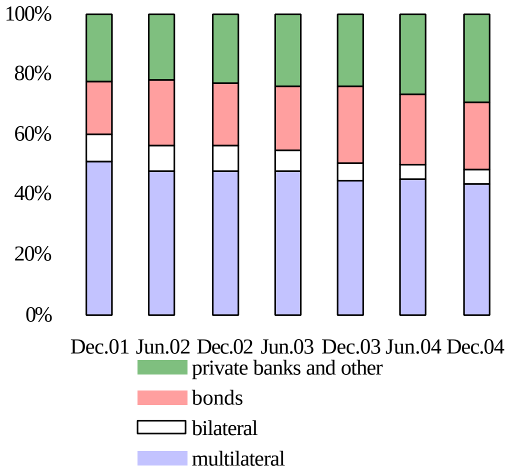
percent of GDP

	2003 H2	2004 H1	2004 H2
Conventional deficit	-1.42	-0.62	-0.53
Primary surplus (+)/ deficit (-)	-0.53	0.12	0.03

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

Unlike 2003 H2, in the six months under review, the primary balance went into positive territory, owing to lower primary spending (excluding public debt-related interest payments), whose share in GDP dropped one percentage point. July through December 2004, the primary balance recorded a surplus of 0.03 percent share-to-GDP, compared with a deficit of 0.5 percent share-to-GDP in the same six months of the previous year.

External Public Debt
- by financing sources -

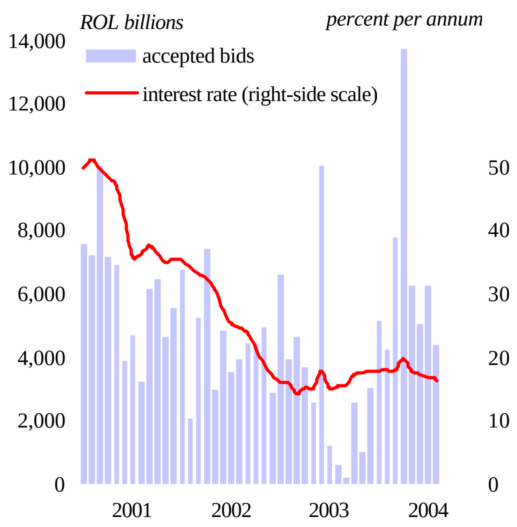


Source: NBR calculations based on MPF data

In 2004 H2, the budget deficit and the public debt refinancing were further covered from foreign and domestic sources. External funds stemmed exclusively from loans granted directly to ministries by international financial institutions while domestic funds came from both natural and legal entities through ROL-denominated government securities issues.

Public debt still posted limp growth as in 2003 H2, being financed entirely by non-banks. The funds provided by banks were used only to roll over part of the maturing public debt.

Government Securities Issues
(Treasury Bills)



In 2004 H2, the public authority put into circulation one fourth of total government securities issued throughout 2004, compared to 19 percent in the same six-month period of 2003. More than 60 percent of total funds raised by auction stemmed from bank clients compared to 35 percent in the same six months of the previous year. The newly issued government securities worth roughly ROL 14,394 billion covered 94 percent of the maturing paper. Starting September, the volume of paper reaching maturity exceeded steadily that of government securities put into circulation, net redemptions coming to approximately ROL 847 billion in the six months to December (versus ROL 17,480 billion in the same six months of 2003).

The term structure of government paper was subject to sweeping changes. Starting October, government securities with maturities shorter than and equalling one year were no longer issued. Only 2-year, 3-year and 5-year bonds continued to be launched. As a result, the average maturity of government securities issued in 2004 H2 expanded to 480 days, from 390 days in the second half of 2003.

In the six months under review, the Ministry of Public Finance raised funds from individuals on a regular basis, by extending or initiating new subscription periods for Treasury certificates destined to individuals. Thus, the public authority raised fresh funds every month (save November) to the tune of ROL 1,027 billion for the whole period under review. Yields on 3-month and 6-month securities were lowered twice, in September by half of a percentage point and in November by one percentage point. At end-2004, Treasury certificates outstanding amounted to ROL 21,966 billion, up only 14 percent from end-2003.

In an attempt to cover some temporary funding gaps, the Ministry of Public Finance resorted further to taking deposits from the money market, raising ROL 1,000 billion in overnight (ON) deposits.

Local authorities continued to issue municipal bonds, launching ROL 139 billion worth of paper, which accounted for only 39 percent of the volume put into circulation July through December 2003. The newly-issued bonds had maturities of 2 and 4 years and their compound interest was made of the 3-month and 6-month average BUBID and BUBOR rates and an interest margin ranging between one percentage point and two percentage points. At end-2004, municipal bonds outstanding totalled some ROL 838 billion.

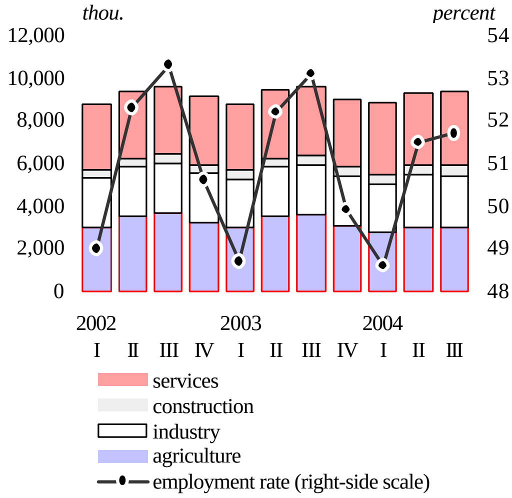
At end-2004, domestic public debt stood at almost ROL 145,716 billion, up approximately ROL 19,847 billion from mid-2004. July through December, the share of the domestic public debt in GDP picked up 0.8 percentage points owing to the rise in both its direct debt[16] and guaranteed[17] debt, by 0.3 percentage points and 0.5 percentage points respectively. In 2004 Q3, guarantees on domestic loans almost tripled from end-June, whereas in Q4 they stopped rising.

2.4. Labour market[18]

2.4.1. Labour force

The latest data disclosed by the Household Labour Force Survey (for 2004 Q2 and Q3) point to the ongoing restructuring of the economy, with a bearing on the composition of employment and unemployment. The sharper downtrend in the number of people working in agriculture[19] (569 thousand) occurred amid the

Employment by Sector and Employment Rate



Source: NIS - AMIGO

[16] Caused by the consolidated budget deficit and impaired assets taken over by public debt.
[17] Including guarantees on ROL-denominated and foreign exchange-denominated domestic loans.
[18] Unless otherwise indicated, the analysis in terms of growth of data in the present section was based on the comparison with the same year-earlier period.
[19] The workers who had been laid off following industrial restructuring were employed in agriculture, a widespread development of the transition to a market economy.

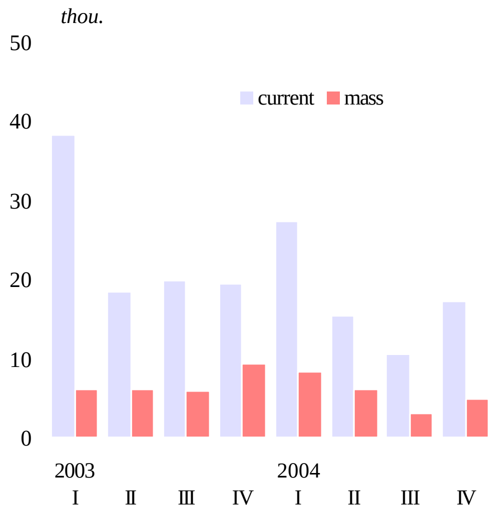
increasing number of openings in the secondary and tertiary sectors (where employment rate rose by 7 percent) which is indicative of producers' favourable prospects on economic activity. The rise in labour demand in those sectors prompted the previously inactive persons and the ones formerly employed in the agricultural sector to look for a/another job, as illustrated by:

(i) the 27 percent rise in the number of short-term unemployed;

(ii) the 15.8 percent fall in the number of discouraged workers (although available for work, such inactive people are not seeking work because they believe that none is available);

(iii) the sharp increase in the number of people hired in urban areas, which partly offset the drop in the number of self-employed and of the unwaged family workers (particularly in agriculture).

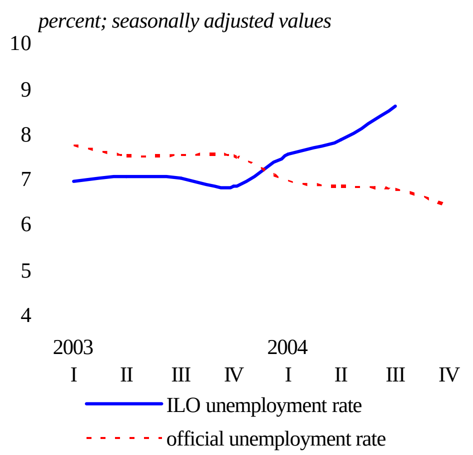
Mass and Current Dismissals



Source: NEA

On the other hand, structural unemployment lingered on – the number of long-term unemployed kept rising and the average duration of unemployment further was almost 2 years (22.8 months); although the lack of professional skills required on the labour market is a major reason for this development, only a small number of people attended training and retraining courses organised by employment agencies[20]. Moreover, the analysis of working population by ownership suggests another reason behind long-term unemployment, namely the fact that the number of jobs created in the private sector is still smaller than that of jobs lost in state-owned companies and in those with mixed ownership (partly public, partly private).

Official Unemployment Rate and ILO Unemployment Rate



Source: NIS - AMIGO

Another phenomenon which has a negative bearing on both prospective labour force and the equilibrium between revenues and expenditures related to state social security is the ageing of population as illustrated by: (i) the decrease in the number of people aged up to 34 years (included) and (ii) the change in the composition of population aged over 54 years, with inactive population growing to the detriment of active population.

The above-mentioned developments led to a drop in both the activity and employment rates of people aged 15 or more[21] by 0.5 percentage points and 1.1 percentage points respectively on average, as well as to a 1.1 percentage point rise in the

[20] According to NEA, at end-2004, the number of the unemployed attending these courses stood at 36,440.

[21] Calculated as a ratio between active/working population aged 15 years or more and total population aged 15 years or more.

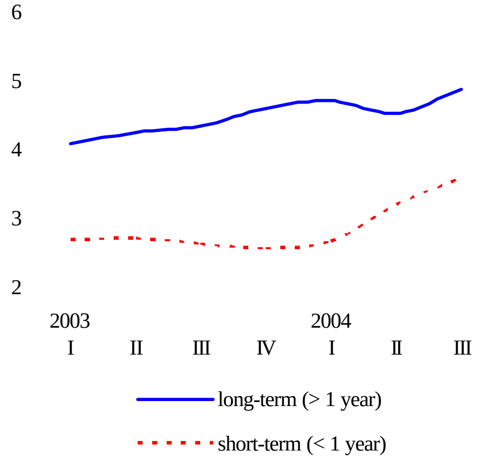
unemployment rate as calculated in compliance with ILO methodology.

In the considered period, the correlation between data supplied by the NIS in the AMIGO survey and those in the Statistical Monthly Bulletin grew weaker:

- unlike the ILO unemployment rate, registered unemployment rate shrank by 0.7 percentage points April through September 2004;
- the number of people in work who were registered as unemployed with employment agencies increased 2.5 times versus the quarterly average for January 2003 – March 2004[22];
- the ratio between ILO employees and the number of wage earners reported to the NIS by employers moved up from 1.31 in the six months to September 2003 to 1.39, the AMIGO survey illustrating more accurately the pick-up in the number of employees.

Unemployment Rate by Duration

percent; seasonally adjusted quarterly values



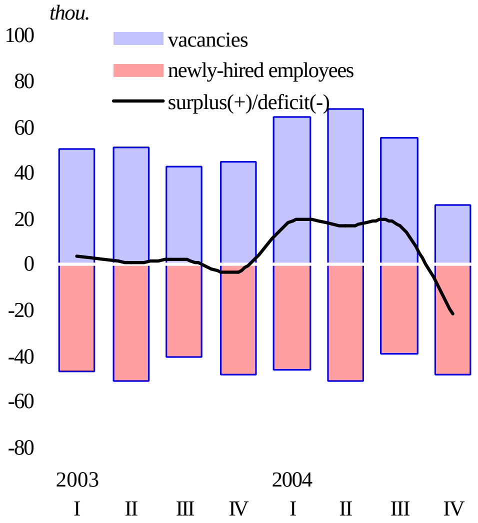
Source: NIS - AMIGO

The data show (i) the expansion of the informal sector, despite the authorities' efforts to contain its development by loosening fiscal policy relative to labour force – a possible explanation may lie with keener competition that entailed stronger pressures to cut costs and (ii) the shrinking of labour market, as the rise in ILO unemployment rate, caused largely by unskilled or low-skilled people, cannot be seen as reflecting the easing of labour market conditions.

AMIGO data are not available for 2004 Q4. Nevertheless, with the registered unemployment rate staying in that period at almost 6.2 percent (one percentage point lower than in the same year-earlier period), thereby showing no seasonal increase, as seen in previous years, labour market conditions remained tight. Statistical data supplied by the NEA point however to a possible stabilisation of labour market conditions given that (i) the number of the newly employed remained unchanged from the same period of 2003 (the development is nevertheless attributable to the requests of employers in the preceding period, considering the cut by more than 40 percent in the number of vacancies shown by NEA in the reviewed period); (ii) inflows into unemployment fell by 30.7 percent and (iii) although on the wane, the number of people exiting unemployment following non-renewal of registration with the NEA stayed at almost 120 thousand, a fact which might be

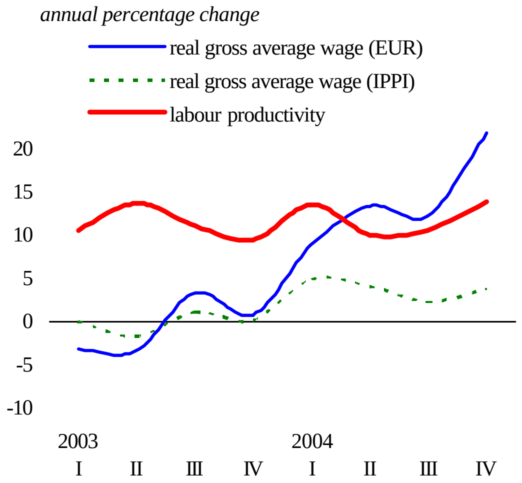
[22] Period for which data are comparable

Number of Vacancies and Number of Newly-hired Employees



Source: NEA

Gross Wage and Labour Productivity in Industry



Source: NIS, NBR calculations

attributed to their low professional skills and to their getting a job abroad or in the informal sector.

2.4.2. Incomes

In July-December 2004, wages and pensions were raised following new measures, other than those adopted in early 2004, ahead of the elections, which is illustrative of a looser income policy. Thus, in addition to the 6 percent indexation of budgetary-sector wages in October, the wages of civil servants and teaching staff rose significantly[23]. Furthermore, after the last stage of re-correlation in July, in September, pensions were subject to quarterly indexation, and public pensions set before 1 April 2001[24] were additionally raised. The drivers of the faster rise in the annual growth rate of real gross average wage (9.8 percent) than in the previous six-month periods were (i) further tight labour market conditions and (ii) granting of larger monthly bonuses than in 2003 in both the private sector, following its good performance, and the state-owned sector, including some industries facing financial straits such as energy industry.

Under the circumstances, wage developments in 2004 H2 exerted inflationary pressures driven by both supply, given the mismatch of wage dynamics and labour productivity in some economic sectors, and demand, via the increase in private consumption.

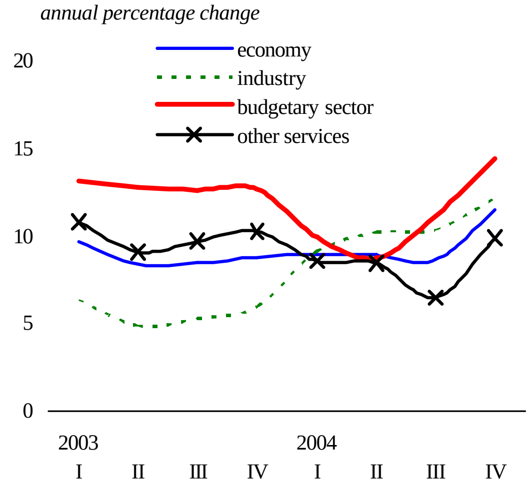
On the supply side, available statistical data point to a further positive real growth rate of ULC in construction and services. In those sectors, the rise in the number of people working seems to have led, at least temporarily, to an efficiency loss (possibly as a result of inadequate skills of the newly employed who would require on-the-job training), which was not accompanied by a symmetrical adjustment of real gross wage[25]. However, some of these workers may not be registered as employees[26] and their pays might be lower than the reported earnings. As a result, statistical data might overestimate the negative disparity between labour productivity growth[27] and the rate of increase of total real wages (registered and non-registered).

In 2004 H2, the growth rate of labour productivity in industry sped up to 12.1 percent from 11 percent in H1, whereas the

[23] Government Emergency Ordinance No. 68 of 16 September 2004 and Government Emergency Ordinance No. 82 of 14 October 2004
[24] Government Decision No. 1346 of 26 August 2004
[25] The growth rate of the real gross wage slowed down in construction and mainly private services, yet not enough so as to stop the increase in ULC.
[26] See Subsection *2.4.1. Labour force*
[27] Calculated as the ratio of the annual growth of GVA in an economic sector to the annual index of employees in the respective sector

annual growth rate of real gross wage (deflated by producer price index on the domestic market) slackened. Against this background, the positive spread between the growth rates of the two variables widened to 9.1 percentage points. Although the annual growth rate of nominal ULC slowed down by 2.1 percentage points in industry, it either trended strongly upwards across some sub-sectors producing goods with a large share in the CPI basket (wearing apparel[28], footwear, energy industries) or steadied at a considerable level (31.2 percent in food industry). Nevertheless, such pressures did not stem the downtrend of production prices entailed by the favourable development of costs of some raw materials, following the slowdown or even the decrease of prices on the external market and the appreciation of the domestic currency against the major currencies.

Net Real Wage (CPI)

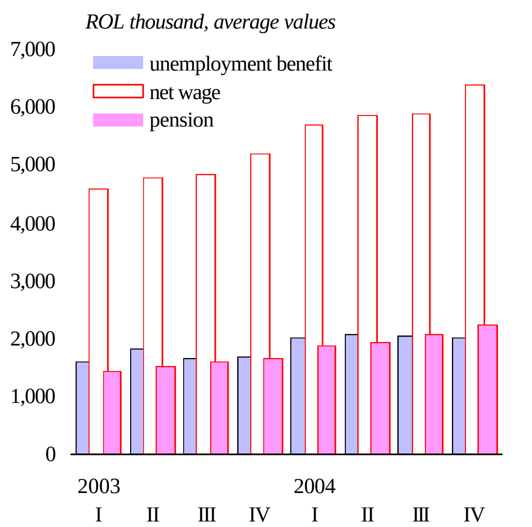


Source: NIS, NBR calculations

On the demand side, the main household incomes (wages and pensions) exerted higher inflationary pressures than in the previous period, as their purchasing power went up as a result of both their nominal increase and the 2 percentage point slowdown in the average annual growth rate of consumer prices.

Thus, net average wages rose by 10.1 percent in real terms, with the 1.1 percentage point acceleration in their growth rate compared to H1 stemming from developments in the budgetary sector (except for wages in the healthcare sub-sector which rose at a more moderate pace) and industry. Mention should be made that, considering the number of employees reported by employers, the annual hike in total wage earnings[29] reached 11.3 percent.

Household Incomes



Source: NIS, NEA

Although the decisions to raise pensions caused their average level to pick up 19.2 percent in real terms compared with the same year-earlier period, the average pension still accounted for almost 35 percent of the average wage.

The average unemployment benefit increased 9.9 percent in real terms compared with 2003 H2, yet the impact of this rise on consumer demand was offset by the 18 percent drop in the number of recipients.

Likewise, the inflows from private transfers from non-residents to residents, added to the compensation of employees[30] had a relatively lower bearing on household consumption, on the backdrop of an annual growth rate (27.5 percent) slower than

[28] +40.5 percent, the highest annual rise of all industrial sub-sectors
[29] Product of net average wage and the number of employees economy-wide
[30] Balance-of-payments data, expressed in euro

that seen in the previous six months and the nominal strengthening of the domestic currency against the major currencies in the past two months of 2004.

2.5. External environment

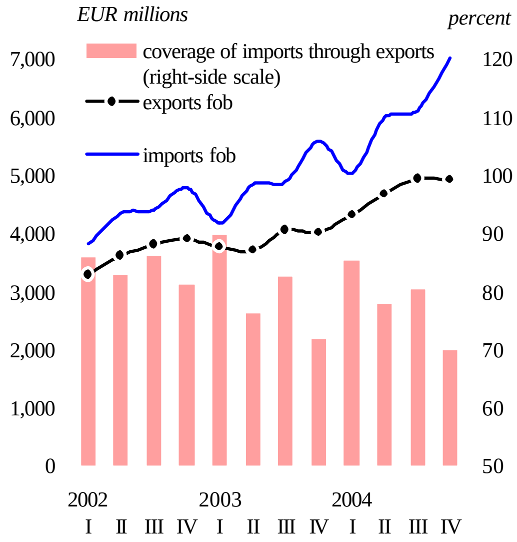
2.5.1. External demand

In the latter half of 2004, the growth rate of world economy slowed, chiefly as a result of the dampening impact of the oil price. However, the oil price development had different effects in the USA and the EU. Thus, in the USA, the annual growth rates of GDP remained high in the past two quarters (4 percent and 3.9 percent[31] respectively) driven by domestic absorption, whilst the worsening of net exports to the EU led to a slowdown.

Private consumption was further the engine of economic growth in EU-25. Nonetheless, the appetite for imports was conducive to deterioration in the external balance and the decline in annual GDP growth to 2.2 percent and 1.9 percent in Q3 and Q4 respectively, from 2.5 percent in Q2[32]. The demand for imports of EU-25[33] went up 13.1 percent in 2004 H2 compared to the same year-earlier period, yet, the market share of Romanian products remained virtually unchanged at 1.35 percent.

2.5.2. Foreign trade

Trade Balance



According to balance-of-payments data, in 2004 H2, Romania's external balance worsened, with the trade deficit expanding by 37 percent year on year. The annual volume indices of export decreased steadily throughout 2004 to 114.1 percent and 108.9 percent in Q3 and Q4 respectively[34]. The impact on trade deficit was partly offset by the favourable development in external prices; in the last two quarters of 2004, unit value indices were much higher than those recorded in the first half of 2004.

In terms of value, top performing groups were intermediate goods and capital goods, with exports rising 38.9 percent and 30.1 percent respectively. Exports of consumer goods, accounting for 36.7 percent of total exports, expanded by only 4.9 percent compared to the same year-earlier period. The lacklustre performance of exports of consumer goods may be attributed to competitiveness losses[35] entailed by higher ULC in

[31] Seasonally adjusted data
[32] Seasonally adjusted data
[33] Imports from non-Member states
[34] Compared to annual growth rates of 20.8 percent and 19.3 percent in 2004 Q1 and Q2
[35] External competitiveness is analysed based on the developments in ULC determined contingent upon wages expressed in euro

light industry[36] (the impact of which was magnified by the increasing competition from Asian countries) and furniture industry.

Compared to the first six months of 2004, some industries producing capital goods, such as electrical machinery and apparatus, road transport means and other transport means, experienced worsening of ULC as well. Nevertheless, the sustained growth rates of exports of the said industries and the stepped-up growth rate of producer prices for the foreign market[37] hint at favourable circumstances.

In the reviewed period, the growth rate of import volume slowed down by 2.3 percentage points to 21.8 percent. The rate of increase of import prices sped up, albeit to a lesser extent than that of exports. As a result, the value of imports rose by 25.5 percent year on year, 3.3 percentage points above the annual growth rate in the first half of 2004.

By composition, imports of capital goods and consumer goods posted growth rates of 44.4 percent and 20.5 percent respectively. Given that the development of production prices for the external market applied by the EU-25 to capital and consumer goods does not show significant pressures in this direction, the upward trend may be attributed to a higher volume of imports. The expansion of industrial activity led to higher imports of intermediate goods (20.9 percent) and raw materials (21.8 percent). However, in 2004 Q4, the growth rate of imports of raw materials slowed down steeply from 43.4 percent in the previous three months to 7.7 percent, possibly due to the decline in imports of agricultural raw materials.

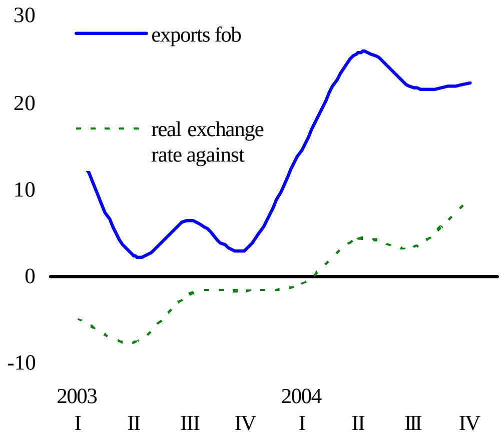
2.5.3. Imported inflation

The latter half of 2004 further saw inflationary pressures induced by external prices, even though the channels of influence were partly different from those in the first half-year.

The soaring oil price[38] on the international markets[39] added to the inflationary pressures, against the background of strong demand spurred by global economic upturn and inelastic

Exports and Real Exchange Rate

change against the same year-earlier period (%)

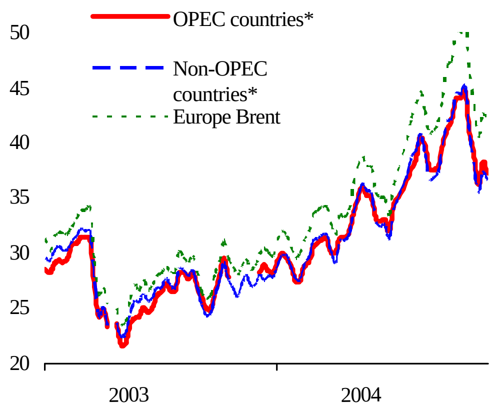


**) deflated by the unit labour cost index*

Source: NIS, NBR calculations

World Crude Oil Prices

USD per barrel; average weekly spot price fob



**) averages weighted by estimated export volume*

Source: EIA

[36] In 2004 H2, the annual growth rate of ULC in the wearing apparel and leather products industries rose by 23.1 percentage points and 19 percentage points respectively, while the growth rate of ULC in textiles industry fell by 16.9 percentage points.

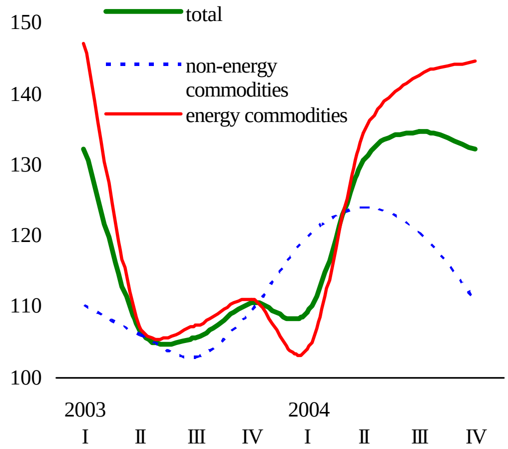
[37] Assuming that domestic producers act as price takers

[38] In 2004 H2, the annual growth rate of Brent oil price, i.e. 48.6 percent, was nearly three times higher than the previous six months' reading. October saw the highest prices of Brent oil, which averaged out at USD 49.67 per barrel.

[39] As the oil intended for processing by Petrom and Rompetrol, the two leading Romanian oil companies, derives from imports (up to 30 percent and 100 percent respectively).

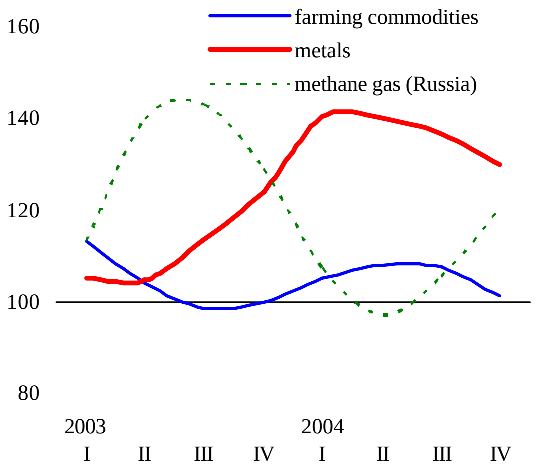
Prices of Raw Materials (a)

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



Commodity Prices (b)

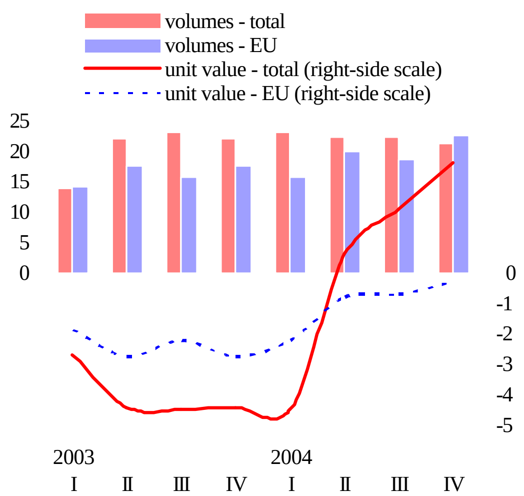
index compared to the same year-earlier period (%)



Source: IMF

Unit Value and Volumes of Imports*

annual percentage change



* *expressed in euro*

supply, as the production capacities of oil-producing countries are being used almost to the fullest extent. The movements in external prices fed through into domestic prices[40] relatively fast, even though its magnitude was diminished by the narrow share of raw material costs in the final fuel price (less than 40 percent, given that excise duties, value added tax, contributions to the special fund for petroleum products prevailed) and the nominal appreciation, mainly in the final quarter of the year, of the domestic currency against the US dollar (the main settlement currency for energy imports).

Another unfavourable development was the annual growth rate of the price for natural gas imported from Russia, which added 7.4 percentage points to 13.7 percent as compared with 2004 H1. However, the feeding through of the natural gas price hike into domestic prices for residential consumers was dampened by the administrative mechanism used in setting such prices, the quarterly adjustment of which was kept at 5 percent, roughly the same as in the preceding six-month period.

The external prices of grains (of wheat in particular) stayed on a downtrend, no longer putting inflationary pressures on domestic prices. Larger-than-expected crops both domestically and internationally caused the decline in complementary imports of grains and the sharp drop in purchase prices on world markets; the annual growth rate of import prices of milling wheat slowed from 59.2 percent in 2004 H1 to -24.3 percent in the considered period.

As for imports of agricultural products, significant tensions have been manifest on the meat market since May 2004, which pushed domestic prices higher. The average import prices for pork and beef jumped year on year by 48.4 percent and 36 percent respectively, with the pick-up in imports[41] following the decline in domestic output enhancing the impact of price hikes. This negative development was alleviated by the measures taken by the authorities to change the customs regime, namely (i) the exemption of import duties on frozen pork was extended until 31 December 2004; as of 1 July, subject to exemption were imports of frozen beef as well; (ii) the cut from 20 percent to 10 percent in import duties on pig carcass and half-carcass as of 13 September 2004.

Prices of the main raw materials for textiles (cotton and wool) on the international markets dropped as much as 22.2 percent against 2003 H2. The annual growth rate of metal prices on the

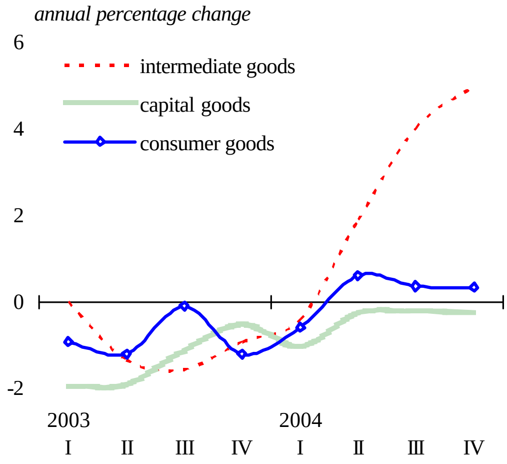
[40] The annual growth rate of fuel prices stepped up from 14.2 percent in June 2004 to 20.7 percent at end-2004.

[41] In the latter half of 2004, the quantities of imported pork and beef climbed 44 percent versus the same period a year earlier, 24.6 percentage points above the 12-month growth rate seen in 2004 H1.

international markets further decreased from 40.3 percent in the first quarter to 29.9 percent in the final quarter of 2004, amid the alleviation of pressures on metal prices due to heavy demand from China.

Import prices of industrial goods originating in the European Union (such imports hold a prevalent share) further underpinned disinflation in 2004 H2, albeit to a lower extent than in H1. Thus, the annual unit value index of such imports stood below par (i.e. 99.3 percent and 99.7 percent in Q3 and Q4 respectively). Starting with 2004 Q2, it followed the upward trend induced by the step-up in the growth rate of industrial producer prices for the non-domestic market in the EU-25 (mainly in intermediate goods sub-sector[42], while prices of capital goods and consumer goods saw no and respectively low pressures[43]).

EU-25 PPI and Its Components



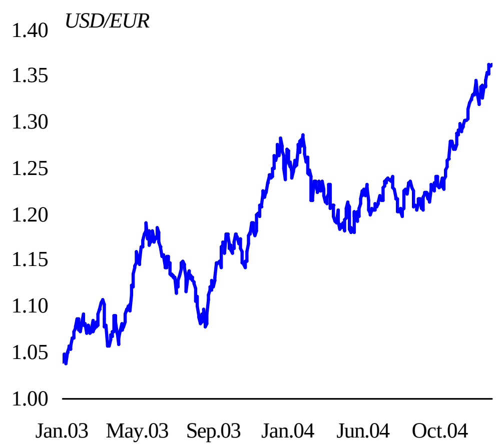
Source: Eurostat

2.5.4. Exchange rate

The exchange rate of the domestic currency bore the hallmark of the sharper foreign currency surplus on the domestic market, as a result of the swift increase in net capital inflows[44] and inflows of private transfers between residents and non-residents (68.3 percent and 25 percent respectively versus 2003 H2).

Against this backdrop, the National Bank of Romania acted in the forex market only as a buyer to contain the appreciation of the domestic currency, particularly during July-October, by increasing its currency market intervention in terms of both frequency and volume. As a result, net purchases by the central bank equalled EUR 1,940 million, the highest half-yearly reading so far. In order to fend off potentially reversible capital inflows, in November the NBR changed its exchange rate policy by intervening less frequently in the foreign exchange market, which led to higher flexibility and unpredictability of the exchange rate.

USD/EUR Exchange Rate



Source: ECB

Under these circumstances, the domestic currency strengthened by a real 5.8 percent[45] against the euro, which entailed lower pressures on domestic prices exerted by imports settled in euro, as well as by excise duties and administered prices geared to the euro. Against the background of the sharp weakening of the US dollar against the euro, induced by world markets' response to the unfavourable development of the US twin deficits, the

[42] Which posted a faster annual rate of increase (from 0.7 percent in H1 to 4.4 percent in H2)
[43] Annual growth rates of -0.2 percent and 0.3 percent respectively
[44] Direct investment, portfolio investments and other capital investments
[45] Average against 2003 H2

considerably stronger domestic currency against the US dollar (14.9 percent in real terms year on year) alleviated the impact on the costs of energy and raw materials imports. The domestic currency strengthened in terms of the EUR-USD basket (75 percent and 25 percent respectively) by 7.7 percent in real terms.

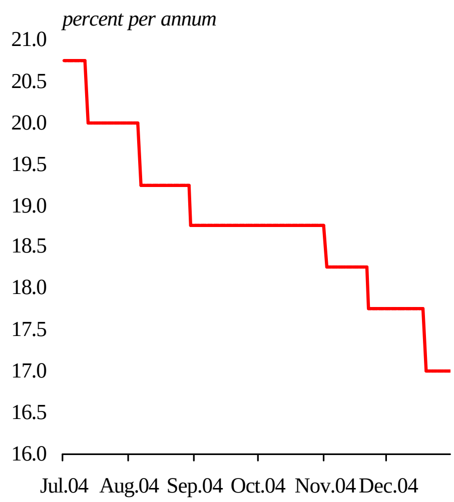
3. Monetary policy

3.1. General features of monetary policy

In 2004 H2, monetary policy stance remained tight, the central bank resorting, however, to recalibration of the interest rate policy and exchange rate policy. The mix of monetary policy levers underwent changes given the macroeconomic environment, which featured further consolidation of disinflation and fast economic growth as well as widening of external imbalance.

In 2004 H2, the faster increase in domestic absorption (as a result of the rise in budget outlays and the relative easing of income policy) and the bumper grain crop entailed higher-than-projected economic growth, with annual GDP picking up 8.3 percent for 2004. Despite higher demand-pull inflationary pressures and multiple shocks on the supply side – the latter making disinflation come to a standstill during two months of 2004 H2 –, the 12-month inflation rate continued to decelerate, the upward deviation from the December 2004 inflation target being brought down to only 0.3 percentage points. Against this background, the current account deficit widened to 7.5 percent of GDP. In addition, oversupply of foreign exchange in the market surged as a result of increase in foreign capital inflows, a large part of which was speculative capital.

Policy Rate*



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

The central bank reacted prudently to the developments of macroeconomic and financial market indicators during this period by assessing both the inflation risks associated with faster increase in domestic absorption and enhanced cost-push inflationary pressures – mostly driven by the rise in administered prices and gradual adjustment of domestic prices for fuels – and the threat attending large capital inflows. In this vein, the central bank's decisions were aimed at tightening the monetary conditions in order to support disinflation over the short term and ensure longer-term sustainable disinflation, on the one hand, and at creating conditions for dealing with the challenges the monetary policy would have to face in 2005 (adoption of inflation targeting and liberalisation of non-residents' access to time deposits in ROL), on the other.

Against this backdrop, the central bank took a proactive stance and decided to cut the policy rate frequently but gradually; after lowering the policy rate six times[46], the ceiling of interest rates accepted on one-month deposit-taking operations reached 17 percent at end-December 2004, down 3.75 percentage points compared with end-June 2004. However, the central bank's real interest rate[47] fell much more slowly, with monetary conditions growing even tighter during this period under the impact of austere exchange rate policy. Behind the strengthening of the local currency stood mainly the capital inflows fostered by the relatively high interest rate differential between interest rates on the domestic market and those on the international markets and the decrease in the risk premium[48] as well as the expectations of a favourable development of the exchange rate of the ROL.

Starting November, real appreciation of the ROL gained steam under the influence of the change to the exchange rate policy. With a view to fending off volatile capital inflows, the central bank switched from a hard managed floating to a soft managed floating in order to enhance flexibility and unpredictability of the ROL exchange rate, which implied the NBR's less frequent intervention in the foreign exchange market[49]. Even under these circumstances, the NBR's foreign exchange purchases equalled a record high of EUR 1,940.5 million in 2004 H2 (about four times as high as in the same year-earlier period). However, compared with 2003 H2, the ROL appreciated in real terms by 5.8 percent against the EUR and by 14.9 percent versus the US dollar.

One of the adverse effects of the ROL strengthening was the growth of foreign exchange-denominated loans; apart from pushing up domestic demand, the rise in foreign exchange-denominated loans also enhanced the impact of increase in capital flows on prices of some assets, fostering the risk of a bubble on the real estate market. In order to dampen the robust pace of increase in foreign exchange-denominated loans and to reduce the risks to banks that persistent growth of the share of forex loans in total loans could trigger, the central bank raised the reserve ratio on forex deposits from 25 percent to 30 percent (as from 24 August – 23 September reserve maintenance period).

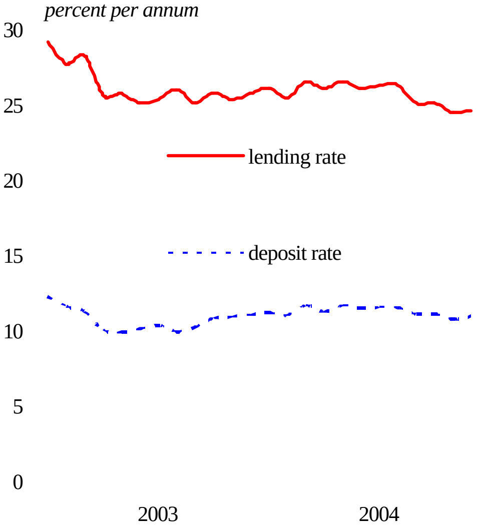
[46] The policy rate was cut on 12 July, 6 August and 19 December each time by 0.75 percentage points and on 30 August, 2 November and 22 November 2004 each time by 0.5 percentage points.
[47] *ex-post*, based on average annual inflation rate in 2004 H2
[48] Following the improvement of Romania's sovereign credit rating and completion of the first review of the IMF arrangement
[49] In November, the NBR refrained from intervening in the market while December witnessed only one intervention.

3.2. The background of monetary policy implementation

The decisions to cut the policy rate in 2004 H2 were made against the background of the relative conflict between decelerating inflation rate and gradual alleviation of inflation expectations, on the one hand, and the persistency of uncertainties and risks associated with faster increase in aggregate demand and the ensuing inflationary pressures, on the other.

The downtrend in annual inflation rate and its sustainability were the main factors behind the consecutive policy rate cuts. Although the inflationary effects of increase in administered prices in the first few months of H2 were higher than expected, the monetary authority considered that this state of affairs was temporary and could not jeopardise irrevocably the achievement of inflation target. Moreover, the impact of administered price increases on CPI was partly offset by faster seasonal drop in prices for some agrifoodstuffs and higher real and even nominal appreciation of the ROL against the EUR and, especially, versus the USD.

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



The policy rate cuts were also underpinned by strengthening of positive developments in some monetary variables. Thus, as a result of the rise in real interest rates applied by banks to non-bank clients, the growth of demand for ROL-denominated loans was contained while saving in local currency was spurred. Consequently, the annual real growth of ROL-denominated loans slowed markedly[50] (to 11.5 percent in December from 37.2 percent in June) while saving in local currency continued to reinvigorate; July through December, the average monthly real growth rate of household savings ran at 1.7 percent (a seasonal slowdown of 0.3 percentage points against H1), compared with a negative growth rate of 0.3 percent in the same year-earlier period.

The decisions to lower the policy rate in the period under review also reflected the central bank's concern to depress potentially volatile capital inflows and to reduce the risk associated with them given the announcement and ongoing preparations for liberalisation of non-residents' access to open time deposits in ROL with Romanian banks at the beginning of 2005 Q2.

Behind the prudent stance of interest rate policy, as illustrated by the low-profile strategy of rate cuts, stood basically the

[50] Due also to the new prudential rules enforced by the NBR starting February 2004, which tightened eligibility criteria for consumers.

increased inflationary pressure from aggregate demand whose growth outpaced even the most optimistic projections. This growth was underpinned mainly by faster increase in household consumption[51], which was fuelled by the more rapid hike in net real average wage than in the previous six-month periods and by the pick-up in non-residents' cash transfers[52].

Investment demand featured a high growth rate; however, compared with H1, the growth slowed slightly given investment demand lacklustre performance in Q4 (see Subsection *2.1.2. Investment demand*). Investment financing was ensured by the expansion of medium- and long-term corporate loans (up 24.4 percent in real terms compared with 11.3 percent in 2004 H1) and by the twofold increase in medium- and long-term external loans of non-bank sector (compared with 16.3 percent in 2004 H1), due mainly to the advance in non-government-backed loans[53].

The NBR's cautious stance was also aimed at alleviating the impact on prices and inflation expectations of administered price increases and of other supply-side shocks (the rise in world oil prices and in prices for some raw materials); the central bank's viewpoint in this respect was that a tighter stance prevents the short-lived increase in prices from feeding through into expectations, puts a brake on subsequent increase in wages, thereby reducing the magnitude of consecutive stages of price increases and, implicitly, the persistency of inflation.

Behind the prudent monetary policy decisions stood the difficulty in assessing durability and size of the impact of some factors which dampened the rise in retail prices; among these, the following factors deserve mention: (i) the good performance of cereal crop; (ii) the positive differential between labour productivity and real wages in industry; (iii) companies' inability to pass the producer price increase on to consumers (restricted so far by the expansion of chain stores and the rise in substitution of domestic goods for imported goods).

Another matter of concern which also stood behind the gradual but frequent cuts in policy rate was the uncertainty surrounding timeliness and size of banks' and financial markets' reaction to the decisions of the central bank.

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[51] From 9 percent in H1 (against 2003 H1) to a record high of 10.8 percent for the year as a whole.

[52] As shown partially under "errors and omissions" of balance of payments.

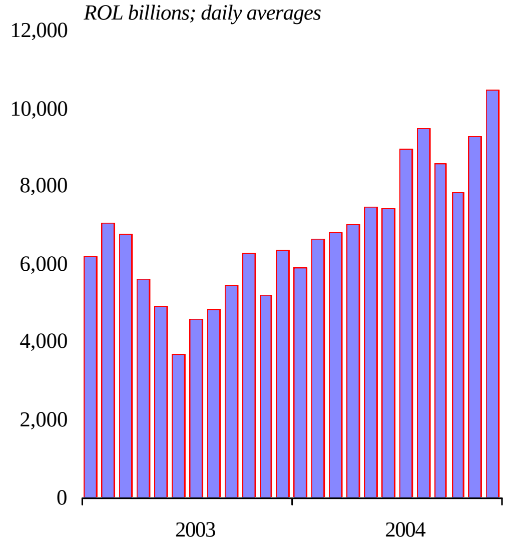
[53] Although the volume of publicly-guaranteed medium- and long-term loans rose about 2.2 times through 2004, they posted an uneven development. After increasing 4.4 times in the first 9 months of 2004, in Q4 the flow of the above-mentioned loans dropped by 33.1 percent compared with 2003 Q4, thereby contributing, possibly, to slower growth of investment (which affected equipment purchase in particular).

Against this background, banks' expectations of declining policy rate in the near term fostered significant increase in interbank money market transactions and helped reduce interest rate volatility in 2004 H2.

Under the circumstances, the interbank transactions reached a 6-year high, being about 50 percent higher than in 2004 H1 and two times higher than in 2003 H2. Strong increase in liquidity surplus and its uneven distribution amid downtrend of interest rates and expectations of further stepped-up decline in interest rates spurred the rise in interbank market transactions; consequently, demand for short-term interbank resources increased, liquidity being mainly intended for investment in instruments issued by the central bank (deposits and certificates of deposits) which provide a fixed income for relatively longer maturities.

Transactions on Interbank Money Market

ROL billions; daily averages



Expansion in interbank money market, although seemingly beneficial, occurred against the backdrop of a relatively higher concentration of the market, with the increase in demand for funds resting with only four banks. Moreover, the volume of deposits witnessed an expansion mainly on account of overnight deposits whose share rose to 87 percent of total deposits, compared with 79.5 percent in 2004 H1.

The interbank money market gained in depth, being accompanied by the increase of its efficiency; volatility of interest rates continued to lower in H2, although banks showed higher appetite for conducting short-term transactions, the interest rates of which were more sensitive to swings in liquidity. Assuming that interest rates had not declined at the end of reserve maintenance periods, the average daily interbank rates would have ranged within a spread of only 1.7 percentage points.

However, the average monthly interest rates entered a relatively downward trend keeping the pace with the interest rate on deposit-taking operations performed by the central bank, so that the spread between the two variables narrowed to almost one percentage point, compared with 1.4 percentage points in H1.

Conversely, activity on the primary market for government securities declined, following a path similar to that recorded in 2003 H2. The positive balance of the General Account of Treasury made the public authority discontinue issuance of Treasury certificates with maturities shorter than and equalling one year starting September (while issuing, instead, government bonds) and restrain markedly the volume of issues (which accounted for only 33 percent of the volume of government securities issued in H1). The interest rates on government securities had entered a downward trend in April and in H2 their fall steepened; thus, the interest rate on 1-year government paper fell by 1.2 percentage points during July-August while that on 2-year securities dropped by 2.5 percentage points September through December.

The volume of transactions on the secondary market for government securities rose by 44 percent compared with H1, reflecting a relatively keener interest of market operators in maximising returns, given the expectations of declining interest rates. Transactions performed between banks and clients, reached a historical high of ROL 55,012 billion in November.

Unlike the interbank rates, the interest rates applied by banks to non-bank non-government clients were less sensitive to the consecutive reductions in the policy rate, their decrease being less pronounced but encompassed most of the maturity spectrum.

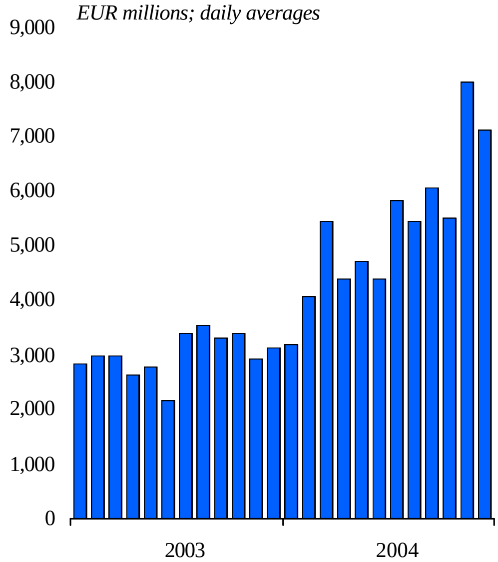
In H2, the average interest rate on new loans edged down 2.4 percentage points amid the 2.6 percentage point drop in average interest rate on short-term loans and the 2.3 percentage point fall in interest rates on medium- and long-term loans; as for the latter, the interest rate on household loans went down by 3.1 percentage points.

The average interest rate on new time deposits trended downwards more slowly (by 0.4 percentage points); the interest rates by maturity and depositor posted mixed developments; thus, the average interest rate on individuals' deposits decreased by 0.3 percentage points given that the average interest rate on 6- to 12-month deposits increased while that on deposits with maturity of up to one month dropped by 0.6 percentage points. Reversal of the spread between the yield on Treasury certificates targeting individuals and that on time deposits made the latter instrument more attractive than the former, which was reflected by the 15 percent increase in time deposits. The average interest rate on corporate time deposits dropped by 0.5 percentage points driven mainly by the development of interest rates on deposits with maturity of up to one month.

The average interest rate on demand deposits declined by 1.1 percentage points during the period under review, the interest rates on deposits of natural and legal persons posting opposing trends, i.e. an increase of 3.1 percentage points and a drop of 1.3 percentage points respectively.

Transactions on FX Market

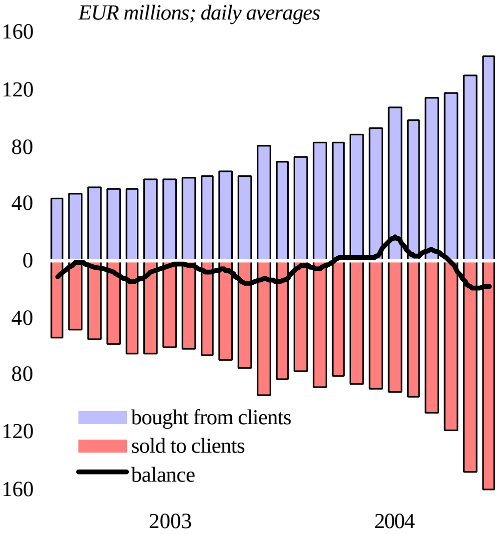
EUR millions; daily averages



The change in exchange rate policy in November and fast increase in foreign exchange market trading[54] reconfirmed the importance of the exchange rate channel of the monetary policy transmission mechanism and of the effective functioning of this financial segment. Stepped-up deepening of the foreign exchange market in the latter half of 2004 encompassed both segments, with interbank foreign exchange transactions resulting from financial operations and remittances of Romanians working abroad increasing markedly. An additional factor spurring the rise in the volume of interbank foreign exchange transactions[55] was the central bank's less frequent intervention in the interbank foreign exchange market starting November in favour of larger flexibility of the exchange rate and higher unpredictability of the exchange rate movements; this stance proved to provide a strong underpinning to the speculative appetite of credit institutions performing foreign exchange operations. The rise in the volume of foreign exchange operations carried out by banks was also attributed to the arbitrage opportunities provided by high interest rates of money market instruments, high unpredictability of the EUR/USD rate[56] and sizable intervention by the central bank in the interbank foreign exchange market (July-October).

Clients' Demand and Supply on FX Market

EUR millions; daily averages



Foreign exchange operations performed by bank clients went up 43.3 percent compared with H1, the individuals' operations in the interbank market gaining ground. The volume of transactions performed by the exchange bureaux posted an unprecedented upsurge.

The high volume of foreign exchange inflows during July-October[57] enhanced oversupply in the market[58], putting almost permanent pressure on the ROL exchange rate; in order to fend off the pressure, the central bank increased markedly foreign exchange purchases during July-October (EUR 1,763 million).

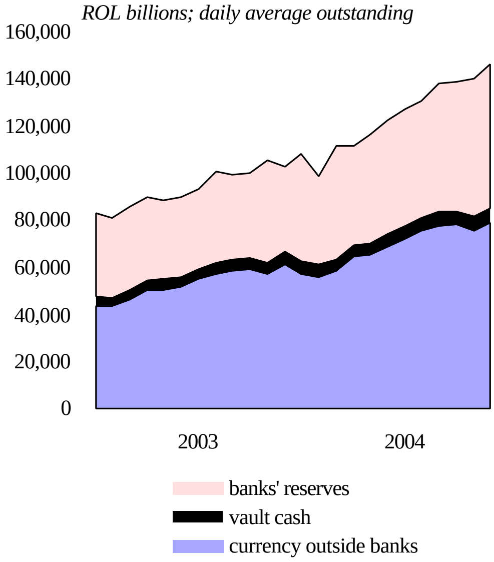
July through October, the ROL/EUR rate fluctuated within a range similar to that recorded in H1 while during November-December the ROL-EUR rate[59] volatility increased sharply and the relative spread between banks' average bid/ask rates widened as a result of less sizable intervention by the central bank in the market.

[54] The average daily growth rate of foreign exchange transactions rose by 45.3 percent compared with 33.2 percent in H1, hitting a 4-year high.
[55] Foreign exchange transactions in the interbank market reached record highs in November and December.
[56] In November and December, in particular
[57] Short-term and medium- and long-term loans and credits, private current transfers and potentially volatile capital inflows.
[58] Foreign exchange surplus (including interbank foreign exchange market and banks' exchange bureaux) reached a record high of EUR 1,578 million during July-October.
[59] 0.0037 in November and 0.0043 in December

3.3. The mix of monetary policy tools

Reserve Money

ROL billions; daily average outstanding



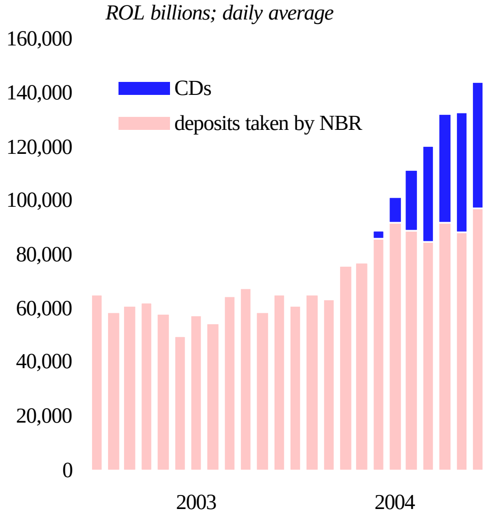
Demand for money, particularly for domestic currency, stuck to the upward trend, fostered by swift economic growth and further disinflation; as a result, reserve money picked up 13.2 percent[60] in real terms. The same as in the previous six-month period, the rise in NBR's net foreign assets, the average level of which surged by more than EUR 2 billion (30.7 percent), was the driver of reserve money expansion.

In an attempt to keep money supply at a level appropriate to prevent rekindling of inflation, the National Bank of Romania continued to sterilise massively capital inflows. The central bank chose to change the reserve ratio on forex deposits and raise the volume of its mopping-up operations in order to cushion the impact of the rise in banks' foreign liabilities on credit supply and that of the structural adjustment in banks' foreign liabilities (by faster increase in those with maturities longer than 2 years).

The main operations performed by the central bank, with a significant impact on monetary variables in 2004 H2, were the following:

Sterilisation Operations

ROL billions; daily average



Intervention in the foreign exchange market. Unlike the preceding six-month period, in the period under review, the NBR acted in the interbank forex market only as a buyer. In order to soak up the foreign exchange oversupply, the central bank purchased EUR 1,940.5 million, the highest half-yearly volume to date, the settlement of which caused an infusion of more than ROL 79,000 billion.

Liquidity-absorbing operations. In order to annihilate the impact of autonomous and discretionary factors of liquidity, the central bank increased its sterilisation operations by collecting one-month deposits (the main monetary policy tool) and issuing 3-month certificates of deposit. The average daily volume of sterilisation operations picked up 40.7 percent, while their average balance rose 62.8 percent as compared with 2004 H1. Deposit-taking operations further accounted for the largest share of NBR's operations, yet the share of CDs in the average balance of liquidity-absorbing operations expanded to 26.9 percent from 0.6 percent. The ratio of the average balance of NBR's mopping-up operations to the average level of bank's holdings on current accounts with the central bank increased to 2.3 from 1.6, thereby illustrating the steady rise in the volume of sterilisation operations. The policy rate remained on the downtrend, thus making deposits more attractive. The ratio of

[60] Changes in indicators are calculated as averages of December against June.

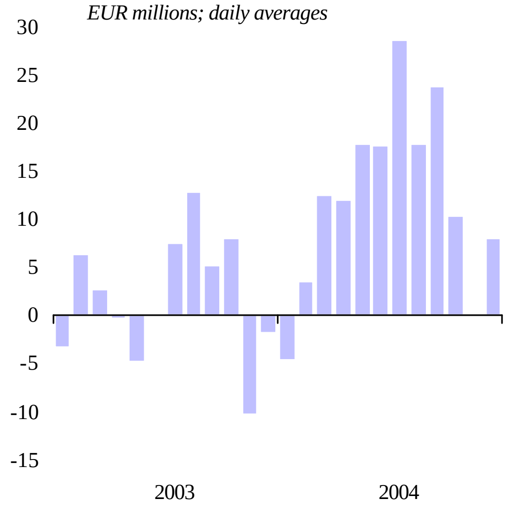
the amounts purchased on a monthly basis to the pre-announced amounts (ranging from 0.9 to 1.6) usually recorded values above par.

Repayment of some special credit lines. Mopping-up operations were fostered by new repayments of loans extended to the Bank Deposit Guarantee Fund and Credit Bank tantamount to ROL 638 billion.

Standing facilities. Credit institutions displayed more frequent recourse to the deposit facility, whereas the lending facility was not at all resorted to in 2004 H2; 9 credit institutions resorted to the deposit facility 18 times as compared with 7 and 12 respectively in the previous half-yearly period. Overnight deposits placed with the NBR ranged from ROL 20 billion to ROL 1,600 billion while the average value of a deposit placed with the central bank equalled ROL 315 billion against ROL 118 billion in the preceding six-month period.

Net Interventions* by the NBR in the FX Market

EUR millions; daily averages



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

3.4. Main monetary developments

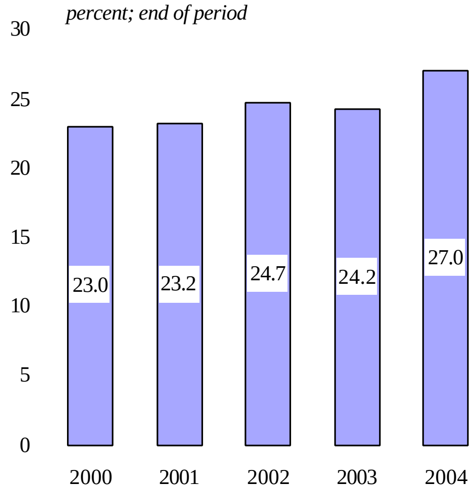
Broad money as a share of GDP rose to an 8-year high (27 percent), illustrating the strengthening of remonetisation in the latter half of 2004. Moreover, although the growth of non-government credit slowed, its share in GDP rose further, touching an 8-year high of 17.5 percent at end-2004.

In 2004 H2, the expansion in broad money (M2) hit a 9-year high for the second half of the year of 21.1 percent in real terms; the increase in capital of SNP Petrom[61] at end-2004 contributed nearly one third to the advance in broad money.

Narrow money (M1), the most liquid constituent of broad money, built up at a slower pace than quasi-money, its share in M2 reverting to a downward trend compared to 2004 H1. Demand deposits rose faster than currency in circulation, the growth rate of the latter slowing down, despite the numerous payments from budget intended for individuals. Behind this development stood some seasonal features[62], the removal of the petty cash ceiling for companies[63] and the step-up in ROL-denominated card-based transactions, the volume of which rose by a real 19.5 percent against end-June 2004.

Broad Money (M2)
(Share of GDP)

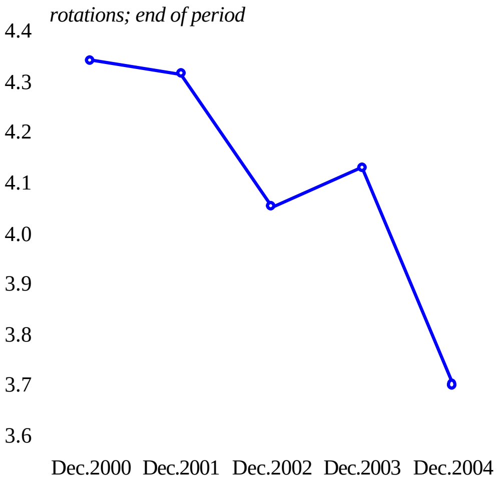
percent; end of period



Source: NIS, NBR

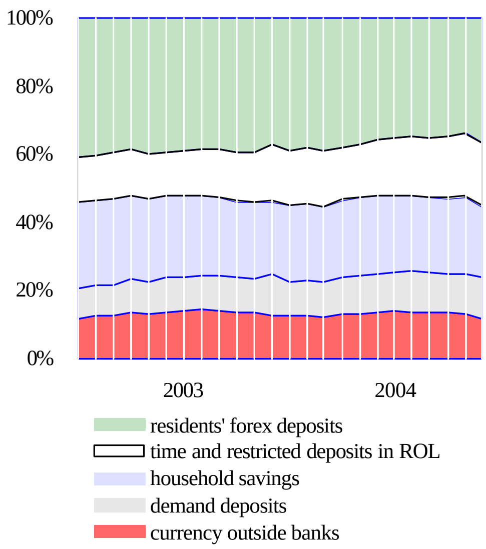
[61] Even excluding the increase in SNP Petrom capital, the expansion in M2 and its average monthly growth rate in 2004 H2 touched a 2-year high (14.9 percent and 2.3 percent respectively in real terms).
[62] Particularly in September, November and December 2004
[63] Law No. 507/2004, the provisions of which have been applied since December 2004.

Money Velocity



Source: NIS, NBR

Broad Money



In 2004 H2, deposits in ROL posted the fastest rate of increase in the past 10 years, i.e. 24.1 percent in real terms. This swift increase was underpinned by the stepped-up economic activity, the high interest rates on time deposits, the appreciation trend of the domestic currency against the main currencies and the launch of new bonds issued by commercial banks[64] on the domestic market. By contrast, ROL-denominated government securities outstanding with non-bank clients – the alternative investment instrument – contained the rise in demand deposits. However, the increased bias of both companies and households towards ROL-denominated assets caused the share of ROL-denominated deposits in M2 to rise gradually to 51.9 percent, the highest monthly average for H2 in the past six years. Unlike the previous year, the ratio of ROL-denominated loans to deposits in domestic currency narrowed at a steady pace, thereby proving that the surge in ROL-denominated deposits in the reference period stemmed also from large capital inflows to the Romanian banking system. Residents' forex deposits posted a significant rise as well (when expressed in euro, an all-time high of 32.8 percent and a 5-year high of 14.1 percent, excluding the effects of Petrom privatisation), pointing to the pick-up in foreign exchange inflows and forex-denominated loans, and the decline in the balance of forex-denominated government paper outstanding with non-bank clients.

Deposits of both companies and households increased compared with the same six-month periods of the previous years. In 2004 H2, corporate deposits showed the highest rise to date (41.4 percent in real terms), whereas household accounts hit a 3-year high (6 percent in real terms). Behind the pick-up in corporate deposits stood the expansion in economic activity and large payments from the budget intended for some state-owned companies[65]. The upsurge in household deposits stemmed mainly from the rise in household[66] incomes and remittances from Romanians working abroad.

However, the corporate sector's demand for money slackened in December 2004 as compared with the same period in the past three years, while the real rate of increase of household deposits followed a downward path in July through October.

In 2004 H2, the share of net domestic credit in broad money counterparts was on a downward trend. The growth rate of non-

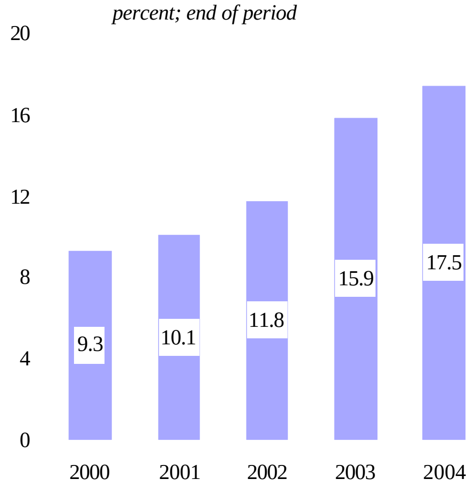
[64] In November 2004, FinansBank issued bonds on the domestic market to the tune of ROL 400 billion.

[65] In July, the Ministry of Public Finance earmarked ROL 4,065 billion to Distrigaz and Electrica for privatisation, whilst in September, the State Treasury granted a loan of ROL 2,000 billion to the National Company of Highways and National Roads.

[66] The real net wage went up 10.1 percent in July-December 2004 as compared with the same period a year earlier.

government credit dropped to a half in the last six months of 2004 as compared with the same period a year earlier (13 percent in real terms in H2 and a real average monthly growth rate of 2.1 percent. This development illustrated the slow-paced increase in non-government credit in ROL, which displayed the lowest growth rate for H2 in the past five years, and an average monthly rate of increase more than four times lower than in 2003 H2 (6.7 percent and 1.1 percent respectively in real terms). Foreign exchange-denominated credit increased at a faster pace, posting a monthly average of 4 percent, the highest reading of the corresponding six-month period in the past ten years, when expressed in euro. However, foreign exchange-denominated credit followed a downward path in July-November 2004, under the impact of higher reserve ratio[67]. Over the latter half of 2004, forex loans rose to an all-time high for H2 (26.7 percent), when expressed in euro. Both households and companies opted largely for forex-denominated loans, as these loans were deemed cheaper than ROL-denominated loans; thus, the share of forex loans in total lending steadied around an average of 60.4 percent. In order to ensure forex liquidity, banks resorted further to external borrowings, which made up 24 percent on average of the balance of forex loans (18.3 percent in 2004 H1).

Non-Government Credit
(Share of GDP)
percent; end of period

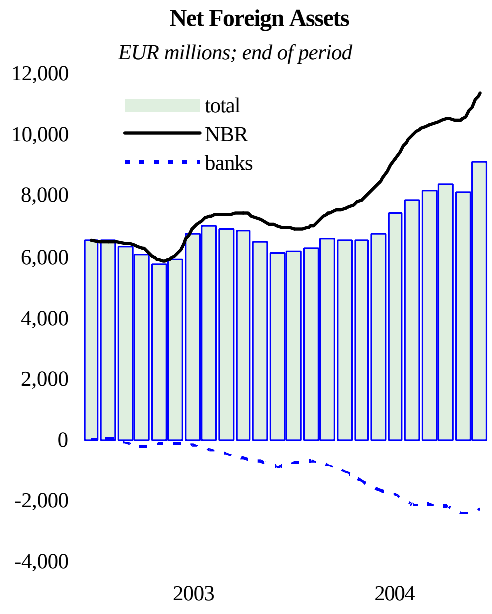


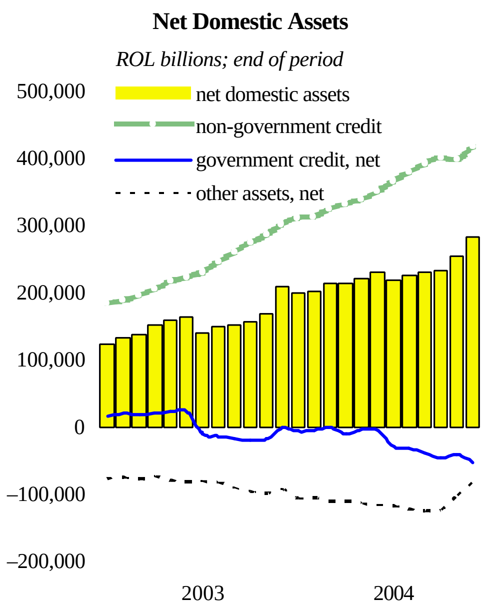
Source: NIS, NBR

Structural analysis of credit by borrower highlights the year-on-year decline in the growth rate of both corporate loans and household loans. Thus, the half-yearly growth rate in corporate loans dropped by one third (9.8 percent in real terms) as compared to the reading of the latter half of 2003, whilst the growth rate of household loans (22 percent in real terms) fell by 53.5 percentage points against the same period a year earlier. However, in 2004 H2, the average monthly rise in loans to households outpaced that of corporate loans. Among corporate loans, medium-term forex loans and long-term ROL-denominated loans posted the fastest increases. As for household loans, medium-term ROL-denominated loans and short-term forex loans posted the swiftest real increases in H2.

The balance of overdue loans remained low, displaying a monthly average of 1.3 percent of total loans.

[67] Reserve ratio for foreign exchange-denominated holdings was raised to 30 percent starting 24 August 2004.





The credit balance of government credit, net, widened almost 10 times as compared with the end of the preceding six-month period, as a result of improved balances of the Ministry of Public Finance's[68] accounts in ROL and foreign exchange. Moreover, bank loans to the government sector dwindled by 39.1 percent in real terms.

Net foreign assets of the banking system moved ahead 34.5 percent (when expressed in euro), due solely to the rise in net foreign assets of the central bank (35.1 percent, when expressed in euro). Net foreign assets of credit institutions continued to record a credit balance, the 40.5 percent increase (when expressed in euro) in their investments abroad in December 2004 (the second all-time high) notwithstanding. Commercial banks' foreign exposure decreased slightly in 2004 H2 as compared with the same period a year earlier, yet remained very high (42.1 percent, when expressed in euro).

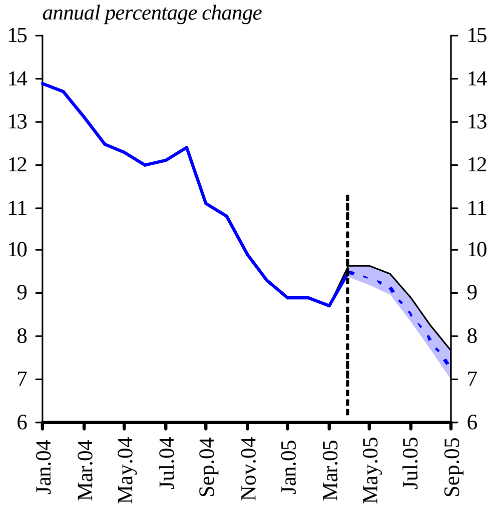
The items under "Other net domestic assets" recorded a 33.1 percent decline in their credit balance, in real terms, thus making a direct contribution to monetary expansion.

[68] The funds received under the PSAL II agreement (EUR 169.9 million) and PHARE programme (nearly EUR 149 million) in July, as well as the price for Petrom's equity stake in December

4. Outlook for inflation

In 2005 Q1, the 12-month inflation rate stuck to the downward trend, despite the temporary halt in disinflation envisaged in the previous near-term forecast, as the data available at that time[69] pointed to considerable price adjustment of energy products in January 2005. The estimated magnitude of such price adjustment included a 20 percent increase in the price of natural gas following the decision to compress the quarterly adjustment calendar to one stage in early 2005, and the implementation of the first stage of raising the heating price, out of the two stages under the programme (in January and July). Subsequently, the authorities opted for keeping in place the quarterly adjustment calendar for natural gas and delayed the rise in heating price.

Inflation Forecast for April - September 2005



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

(i) Tax cuts in early 2005 coming from the introduction of the 16 percent flat rate tax will further spur household consumer demand; however, in April, changes in the fiscal regime (implementation three months earlier of higher excises on fuels, alcoholic beverages, tobacco and cigarettes, and other products subject to excise duties, and the introduction of excises on electricity and gas used as car fuel) will dampen the rise in household consumer demand. Furthermore, the authorities are expected to cut public administration spending through the budget revision envisaged for Q2 in order to keep the budget deficit within the annual target of 0.7 percent share to GDP, 0.4 percentage points below the previous year's reading.

(ii) Income policy will be little changed in Q2 and Q3 following the measures taken in early 2005 (the increase to ROL 3.1 million in the gross minimum wage, pay rises in the budgetary sector, realignment of public pensions set in compliance with the laws in force prior to 1 April 2001). Consequently, despite the persistent effects of the income policy loosening during October 2004 - January 2005 against the same period a year earlier, no additional pressures will be exerted on consumer prices as compared with the first quarter of 2005.

(iii) The world oil market is expected to record no other negative shocks, with the forecasted increase in fuel

[69] From the precautionary agreement signed with the IMF

prices stemming mainly from the April rise in excise duties and the gradual alignment of prices with those in the EU.

(iv) Administered prices[70] will further be adjusted periodically, thus ranking among the main factors stymieing disinflation. Energy price adjustment, established in the precautionary agreement signed with the IMF in July 2004, will bring about the largest inflationary pressures. Prices of electricity and heating for residential users will be raised in July by 6.8 percent and 20 percent respectively in order to cover production costs. However, the higher heating price will put inflationary pressures on consumer prices no sooner than October and November, after the start of supplying heating to households. Prices of natural gas are expected to see the most sizeable hikes (nearly 30 percent) in April and July, following the enforcement of new measures provided for in the adjustment calendar for bringing domestic producer prices into line with import prices by early 2007.

(v) The rise in excise duties in April will feed through rapidly into fuel prices and gradually into prices of alcoholic beverages and cigarettes.

(vi) The sustained strengthening of the domestic currency against the main currencies will further contribute to curbing of inflation. The central bank will continue to favour a less interventionist stance in the forex market, underpinning the larger flexibility of the exchange rate in order to contain risks arising from volatile capital inflows.

Considering the changes in the adjustment calendar for administered prices and excise duties, a temporary halt in disinflation is expected to occur in 2005 Q2. Starting with Q3, the growth rate of consumer prices is seen slowing down in line with meeting the annual inflation target of 7 percent (December versus December).

[70] The share of administered-price goods and services in the CPI basket was little changed in year-on-year comparison (22 percent versus 23 percent in 2004).