Inflation Report

February 2024

Year XX, No. 75

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NOTES

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

The source of statistical data used in charts and tables was mentioned only when they were provided by other institutions.

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Foreword

The primary objective of the National Bank of Romania is to ensure and maintain price stability, with monetary policy being implemented under inflation targeting starting August 2005. In this context, active communication of the monetary authority to the public at large plays a key role, and the major tool that the central bank uses to this end is the *Inflation Report*.

Apart from analysing the most recent economic, monetary and financial developments and explaining the rationale and the manner of implementing monetary policy in the previous period, the *Report* provides the National Bank of Romania's quarterly projection on inflation over an eight-quarter horizon, including the associated uncertainties and risks, and an assessment of the recent and future macroeconomic context from the perspective of the monetary policy decision.

By drafting and publishing the *Inflation Report* on a quarterly basis, in accordance with the frequency of the forecasting cycle, the National Bank of Romania aims to provide all those interested with the opportunity of best comprehending its analytical framework and hence the reasons underlying the monetary policy decisions. Securing a transparent and predictable monetary policy is meant to strengthen monetary policy credibility and thus help achieve an effective anchoring of inflation expectations and lower the costs associated with ensuring and maintaining price stability.

The analysis in the *Inflation Report* is based upon the most recent statistical data available at the date of drafting the *Report*, so that the reference periods of indicators herein may vary.

The *Inflation Report* was approved by the NBR Board in its meeting of 13 February 2024 and the cut-off date for the data underlying the macroeconomic projection was 6 February 2024.

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

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Summary

Developments in inflation and its determinants

The annual CPI inflation rate posted a faster downward path in 2023 Q4, reaching 6.61 percent in December (-2.22 percentage points versus the end of the previous quarter and -9.76 percentage points versus December 2022). At the same time, the indicator stood significantly (by 0.9 percentage points) below the projection in the previous *Inflation Report*, with favourable influences being associated particularly with motor fuel prices and food prices. In fact, the decisive contribution to disinflation in Q4 was made by the latter, owing to the joint impact of the following factors: the persistent downward trend of agri-food commodity prices, the large crops domestically and internationally, the broadening of the list of basic food products subject to the mark-up cap and the extension of the application period of this measure. In turn, energy prices continued to post a year-on-year decline in Q4, especially following some favourable base effects on electricity price dynamics. Conversely, the annual growth rate of fuel prices saw a slight acceleration, also ascribable to statistical effects.

The average annual inflation rate, a measure with inherently higher persistence, remained on a downward path, with the indicator calculated based on the national methodology falling to 10.4 percent in December (from the 15.3 percent peak seen in March). The indicator calculated in accordance with the harmonised structure (HICP) saw a qualitatively similar evolution, posting a correction to 9.7 percent after having peaked at 13.2 percent in March as well. The differential versus the EU-wide average inflation remained close to that recorded in the previous quarter, Romania further occupying a relatively favourable position across the region in terms of average HICP inflation.

After the peak reached in February 2023 (15.06 percent), the annual adjusted CORE2 inflation rate followed a steady downward path, at an even slightly faster pace of adjustment, i.e. 2.9 percentage points, October through December than in Q3. In December, the indicator came in at 8.4 percent, 0.8 percentage points below the projection in the previous *Inflation Report*. Behind the drop in core inflation stood primarily processed food prices, whose annual dynamics shed 5.1 percentage points during Q4. Moreover, both the annual growth rate of non-food prices and that of services prices reversed their previous upward trajectories, after more than two years of almost continuous increases. Among the drivers leading to these developments in the two segments were the downward corrections in import prices, on the one hand, and the gradual weakening of consumer demand in the first three quarters of the year, on the other hand. 2023 Q4 saw a further adjustment of the output gap, although still in positive territory, as well as of imported goods inflation, whereas financial analysts' inflation expectations showed only a mild moderation over the short-term horizon. Wage cost pressures remain pivotal for the consolidation of

the disinflationary trend in the period ahead in the case of both non-food items and especially services, as the average gross wage in the market services sector continues to post double-digit annual growth rates.

Although the annual dynamics of unit labour costs recorded a slowdown in 2023 Q3, the indicator remained relatively high (16.1 percent, -1.1 percentage points versus the previous quarter). This slight moderation was attributed to most of the sectors, except for market services where the growth rate of unit labour costs remained on an upward path. While compensation per employee posted a less brisk pace of increase (17.9 percent, -2.8 percentage points versus 2023 Q2), labour productivity growth rate also slowed down (1.6 percent, -1.4 percentage points versus the previous quarter), hence inflationary pressures can further arise from labour costs. In industry as well, the annual growth rate of unit wage costs decelerated both in Q3 and October through November 2023, to 20 percent, i.e. 4 percentage points below the local peak reached in 2023 Q2. Industrial activity continued to decline (yet at a slightly slower pace compared to 2023 Q2), while the adjustment in labour force was little noticed.

Monetary policy since the release of the previous *Inflation Report*

In its meeting of 8 November 2023, the NBR Board decided to keep the monetary policy rate at 7.00 percent per annum. The interest rates on standing facilities were also left unchanged at 6.00 percent per annum (the deposit facility rate) and at 8.00 percent per annum (the lending facility rate). In 2023 Q3, the 12-month inflation rate continued to drop, albeit at a slower pace than in the previous two quarters, given that the further sharp decreases in the dynamics of food prices and energy prices during this period were partly counterbalanced, in terms of impact, by the hike in fuel and medicine prices. In its turn, the annual adjusted CORE2 inflation rate saw a faster decrease in Q3, falling visibly below the forecast. The developments were mainly ascribable to declining prices of commodities, primarily agri-food items, and to the measure to temporarily cap the mark-ups on basic food products. However, they also reflected a weaker pass-through of higher corporate costs, especially wage costs, into consumer prices – amid the slowdown in consumer demand –, as well as a lower inflationary impact of imports.

Notable uncertainties and risks to the inflation outlook stemmed from the implemented increases in taxes and charges, aimed at speeding up budget consolidation, but also from the future fiscal and income policy stance, given the actions taken to contain budget expenditures in 2023 and the possible broadening over the next years of the package of corrective fiscal and budgetary measures, but also the potential implications of the legislation on pensions and wages in the public sector, as well as possible further pay rises in the budgetary sector. In addition, significant uncertainties and risks to the outlook for economic activity, implicitly the medium-term inflation path, continued to arise from the war in Ukraine and the Middle East conflict, as well as from the below-expectations economic performance in Europe, especially in Germany. Furthermore, the absorption of EU funds, especially those under the Next Generation EU programme, is conditional on fulfilling strict milestones and

targets. However, this is essential for carrying out the necessary structural reforms, energy transition included, as well as for counterbalancing, at least in part, the contractionary impact of supply-side shocks, compounded by the tightening of economic and financial conditions worldwide.

Subsequently, the annual inflation rate posted a faster-than-expected decrease in the first two months of 2023 Q4, falling to 6.72 percent in November amid the continued slowdown in the growth rates of food and energy prices, as well as following the decline in fuel prices, under the impact of lower crude oil prices. At the same time, the annual adjusted CORE2 inflation rate saw its downward trend steepen more than anticipated, shrinking to 9.1 percent in November, against the background of more widespread disinflationary base effects, ebbing agri-food commodity prices and the measure to cap the mark-ups on basic food products, but also in the context of the slower dynamics of import prices. In turn, economic growth slowed down significantly in 2023 Q3, to 0.9 percent from 1.6 percent in the previous three months (quarterly change), yet to a lower extent than anticipated, which pointed to a more moderate narrowing of excess aggregate demand over this period compared to expectations. At the same time, in comparison to the same year-ago period, GDP growth rose marginally in Q3, to 1.1 percent from 1.0 percent in Q2, thus remaining modest from a historical perspective, as the change in inventories increased its already very strong contractionary impact, and the contribution of general government consumption became slightly negative. However, gross fixed capital formation saw a re-acceleration in its annual growth to double-digit readings in 2023 Q3, while final consumption expenditure of households posted a slowdown. Furthermore, net exports continued to exert a larger expansionary impact, given the widening of the positive differential between the dynamics of exports of goods and services, in terms of volume, and those of imports, amid the latter falling more visibly into negative territory. Consequently, the trade deficit saw a renewed slightly faster annual decline, whereas the current account deficit posted further a significant year-on-year narrowing, albeit somewhat more modest than in 2023 Q2, given the slower pace of improvement in the primary income balance in 2023 Q3, on account of reinvested earnings.

At the time of the NBR Board meeting of 12 January 2024, the latest assessments indicated that the annual inflation rate would go up in January 2024 and then resume its gradual decline, on a lower path than that shown in the November 2023 medium-term forecast. The step-up was driven by the increase and introduction in January of some indirect taxes and charges aimed at furthering budget consolidation. Behind the subsequent fall in the inflation rate would further stand primarily supply-side factors – especially disinflationary base effects and downward corrections of agri-food commodity prices and crude oil prices –, as well as the decreasing dynamics of import prices.

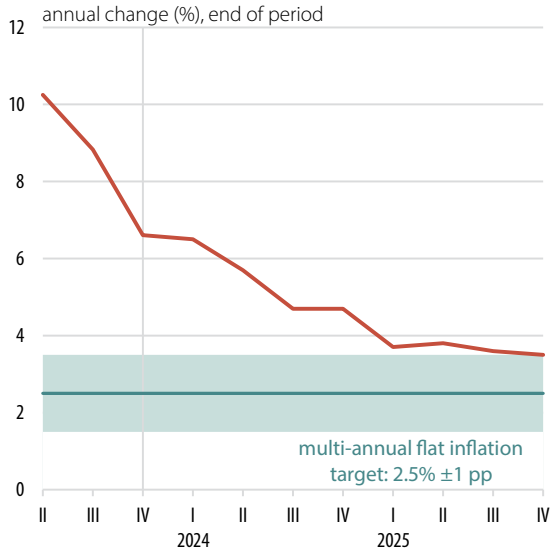
Based on the available data and assessments at that moment, as well as in light of the very elevated uncertainty, the NBR Board decided to keep the monetary policy rate at 7.00 percent per annum. The interest rates on standing facilities were also left unchanged at 6.00 percent per annum (the deposit facility rate) and at 8.00 percent

per annum (the lending facility rate). Furthermore, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

Inflation outlook

The global economy continues its recovery from the pandemic shock and the multiple adverse effects of Russia's invasion of Ukraine. Nonetheless, in both the European Union and Romania, the pace of recovery has recently slackened, as 2023 saw an economic slowdown. The overall trend in commodity markets has further been a correction of past increases, yet at the same time, the risks of potential new adverse supply-side shocks have also risen of late, as suggested in particular by the persistence and even recent heightening of tensions in the Middle East. Even though the world's major central banks halted the policy rate hiking cycle, financial conditions have remained tight, accompanied by new increases in uncertainty of economic agents, be they consumers or investors. Hence, as regards both economic activity and inflation, the overall picture is still beset with fragility and many uncertainties. Looking ahead, headline inflation in the euro area is foreseen to decline further, benefiting from the easing of pressures on commodity costs and the gradual pass-through of monetary policy decisions, yet the pace of this correction appears to be utterly gradual and possibly even marked by fluctuations. Similarly, the economies of Romania's trading partners will see a gradual strengthening of economic growth, but also in this case the materialisation of some risks which are expected to be predominantly adverse could prevent, over the medium term, the full recovery of EU economies, including that of Romania. Against this backdrop, the implementation of the fiscal consolidation package recently adopted by the authorities, whose effects on domestic economic activity are also mostly countercyclical, calls for caution in assessing all possible consequences.

Inflation forecast



Source: NIS, NBR projection

In Romania, subsequent to the increased resilience of economic activity at end-2022, with annual GDP growth rates above 4 percent, the latest official statistical data show a slowdown of the indicator to 1.1 percent in Q3. This rate, which is very close to that recorded in Q2 (1 percent year on year), points to a low of the recovery phase in the post-pandemic period. By contrast, sectoral economic developments between October and December 2023 hint at new positive annual GDP dynamics in Q4 as well. This reflects the slowdown and recently even the stagnation in EU economies for several quarters, under the persistent impact of previous supply-side shocks and the effects of monetary policy normalisation. For 2023 as a whole, GDP growth is estimated to stand in the vicinity of 2 percent, implying a deceleration compared

to 2022. Correlated with these developments, after an estimated peak in 2022 Q4, the positive output gap followed a downward path throughout the past year, for the end of 2023 and the beginning of 2024 being assessed to near the levels estimated in the previous *Inflation Report*. By contrast, considering current information known with certainty, over several years, excessive budget deficits will adjust only gradually, causing the output gap to remain in positive territory longer than assumed in the previous *Inflation Report*.

In 2023, gross fixed capital formation (GFCF) continued its remarkable performance, recording an annual growth rate close to 12 percent in Q3, well above GDP dynamics. In particular, EU funds contributed to this evolution, given that the 2014-2020 financial framework, drawing to a close, accounted for a total absorption of about 90 percent of total allocations at the end of last year. Adding to these were the funds under the 2021-2027 financial framework and the allocations under the Next Generation EU programme; against this background, GFCF is estimated to post higher dynamics and contribution to economic growth in 2023 than those of household consumption. Aside from EU funds, foreign direct investment remained another financing source of GFCF, but over the medium term its performance will increasingly reflect both the slowdown in domestic and external economic activity and the high uncertainty perceived by investors. Therefore, as households recover and subsequently strengthen their purchasing power, private consumption will become again the main driver of economic growth. In this process, the robust evolution of households' real disposable income will be decisive, being underpinned by ongoing disinflation, pay rises in both private and public sectors (also amid new minimum wage increases), as well as high rises in social transfers, especially those already announced for pensions.

On the external front, the developments in the current account deficit January through November 2023 confirm that, in this business cycle, the variable peaked at 9.2 percent of GDP at end-2022, with the 2023 correction being estimated at approximately 2 percentage points. The statistical data released since the previous *Report* reconfirm the prominent role of trade balance adjustments, together with a growing surplus of services, a component that has been improving steadily in recent years, even during the pandemic. Looking ahead, further corrections to the trade deficit will be fostered once trading partners' economies in Europe regain momentum. On the other hand, the only gradual correction of the excessive budget deficit expected over the years ahead is likely to prevent a larger adjustment of the external deficit, to induce, *caeteris paribus*, a relative worsening of its financing structure to the detriment of non-debt-creating sources and to deplete the available fiscal buffer in the event of adverse shocks to the economy. In addition, delays in making adjustments to bring the general government deficit back to the targets set with the European Commission could also depress the allocations of Next Generation EU funds, thereby increasing the financing requirements of the current account deficit.

According to the updated baseline scenario, after coming in at 6.6 percent at end-2023, the annual CPI inflation rate will stay on a downward path almost throughout the projection interval, yet the pace of disinflation is projected to ease markedly as from 2025 Q2. Specifically, the return of CPI inflation to the upper bound

of the variation band of the target is expected no earlier than at the projection horizon, i.e. 2025 Q4. The forecasted values for end-2024 and end-2025 are 4.7 percent and 3.5 percent respectively. The beginning of this year has seen several increases in VAT rates and excise duties, which cumulatively contribute 0.7 percentage points to the annual headline inflation rate, according to estimates. Considering also the hike in the excise duty on fuels planned for July, the total contribution of changes in indirect taxes to the annual CPI inflation is assessed at 0.9 percentage points at end-2024, before shrinking to 0.2 percentage points at end-2025. Hence, the annual inflation rate at constant tax rates would re-enter the variation band of the target as early as 2025 Q1, when it is foreseen to reach 3.3 percent.

Both for the end of this year and beyond, the adjusted CORE2 index will further be the main determinant of the developments in annual headline inflation rate. At the same time, the contribution of exogenous components to total inflation will diminish gradually in the course of this year, before stabilising at around 1.3 percentage points. The annual adjusted CORE 2 inflation will follow a continuously downward track, given the progressive closing of the output gap, lower inflation expectations and abating pressures from import prices. However, core inflation will exceed headline inflation over the entire projection interval, given the ongoing strong unit labour cost pressures (with expected double-digit annual growth rates in 2024), fuelled by both recently implemented and anticipated pay rises. In the private sector, high wage dynamics will be driven by the persistent skilled labour shortage, the wage increases granted by employers to restore their employees' purchasing power, the announced minimum wage increases, but also as a result of a demonstration effect induced by the expected public sector wage hikes. For the end of this year, the forecast of the annual core inflation rate was revised downwards to 5 percent (-0.2 percentage points compared with the previous *Report*), yet solely due to a more favourable performance posted by the indicator in the recent period, especially in the food segment. Subsequently, starting 2025 Q1, the new path of the indicator is foreseen slightly above the levels projected in the November 2023 *Inflation Report*, amid a further positive output gap and, to a lower extent, an upward revision of inflation expectations. Specifically, the annual dynamics of the adjusted CORE2 index would fall to 3.7 percent in September 2025 (an upward revision of 0.4 percentage points) and 3.6 percent at the projection horizon, 0.1 percentage points above the upper bound of the variation band of the target.

The NBR's recent monetary policy stance aimed to bring the annual inflation rate back in line with the 2.5 percent ±1 percentage point flat target on a lasting basis, *inter alia* via the anchoring of inflation expectations over the medium term, in a manner conducive to achieving sustainable economic growth.

Since the previous *Inflation Report*, a number of risk factors from those identified have materialised, in particular the fiscal ones (e.g. the enactment of the measure to recalculate pensions as from September 2024) and only partly those associated with heightened geopolitical tensions in the Middle East. Even in these circumstances, the assessed balance of risks suggests possible deviations, also on the upside, of inflation from its path in the baseline scenario.

The authorities have recently announced a package of measures aimed at achieving medium-term fiscal sustainability, subsequently followed by the publication of a new path of correction of budget deficits. This entails the extension of the timeframe needed for bringing the indicator back below the 3 percent-of-GDP threshold under the Excessive Deficit Procedure from 2024 to 2027. However, despite the envisaged downward path of budget deficits, the current assessments appear to point to the insufficiency of measures already enacted to achieve the proposed targets by 2027. An even presumptive assessment of the effects of the future fiscal policy stance on the baseline scenario coordinates, and in particular the future path of inflation, would also have implied knowledge of the dosage and nature of the fiscal measures that could be adopted: changes in direct or indirect taxes, measures for rationalising public spending and so on. In addition, relative to the fiscal adjustment path put forward by the authorities and to some ambiguities in the budget plan, at least over the short term, given the busy electoral calendar, a wider-than-expected fiscal deficit may occur already this year. For example, considerable uncertainty surrounds the wage dynamics in the public sector, as a result of both possible additional claims from certain socio-professional categories and the future enactment of the unitary wage law, one of the milestones of the fourth payment request under the National Recovery and Resilience Plan. From a budget arithmetic perspective, any wage increases beyond those assumed in the baseline scenario would cause larger budget deficits both this year and over the medium term, given the persistent nature of these expenditure categories. Such developments, with a potential for spillover on private sector wage dynamics, would entail upward deviations from the inflation path in the baseline scenario.

Externally, the risks of escalating geopolitical tensions in the Middle East have augmented noticeably of late. From an economic standpoint, it is the energy markets (oil, natural gas) that would most rapidly be affected by possible bottlenecks in important commodity passageways such as the Strait of Hormuz or the Bab el-Mandeb Strait, which are critical also for the smoothness of global transport networks for other goods. Such developments could fuel the uncertainty felt by consumers and investors and, at the same time, could prompt more market jitters. The disruption of supply of energy, other commodities and finished goods could dampen economic activity in energy-importing countries, but, generally, it would also hit the smooth functioning of the global economy. Furthermore, rising energy prices would further complicate central banks' disinflationary effort worldwide. In addition, by extending the period when inflation stays above the targets, the credibility of these institutions could be directly dented, and this perception would be difficult to reverse within a reasonable timeframe. Ultimately, such a context could trigger new bouts of inflation at global level, which would jeopardise the swift and full recovery of the affected economies, including that of Romania.

Monetary policy decision

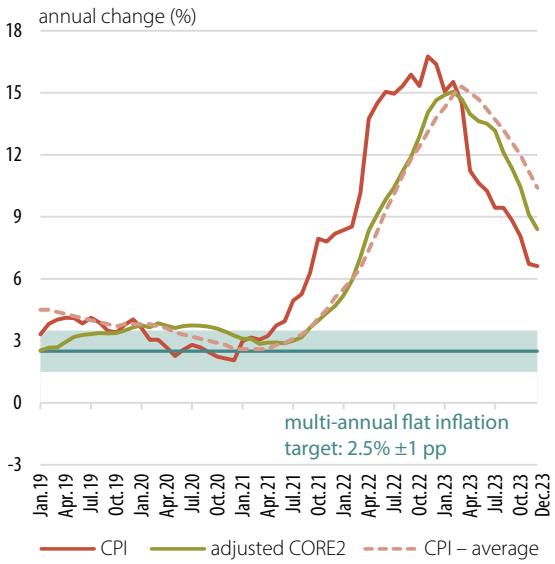
Given the outlook for a further decline in the annual inflation rate at a slower pace over the coming quarters, implying its fall to the upper bound of the variation band of the target no earlier than the end of 2025, and considering the associated risks

and uncertainties, the NBR Board decided in its meeting of 13 February 2024 to keep the monetary policy rate at 7.00 percent. Moreover, it decided to leave unchanged the lending (Lombard) facility rate at 8.00 percent and the deposit facility rate at 6.00 percent. Furthermore, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

1. Inflation developments

The annual CPI inflation rate remained on a downward trend in 2023 Q4, reaching 6.61 percent in December (-2.22 percentage points versus the end of the previous quarter), amid almost across-the-board disinflationary developments, with food items having the largest influence; behind this stood lower commodity prices, the adoption of certain administrative measures, as well as weaker consumer demand. The annual adjusted CORE2 inflation rate declined to 8.4 percent in December (from 11.3 percent at end-2023 Q3), the main contribution coming from food prices in this case as well (Chart 1.1).

Chart 1.1. Inflation developments

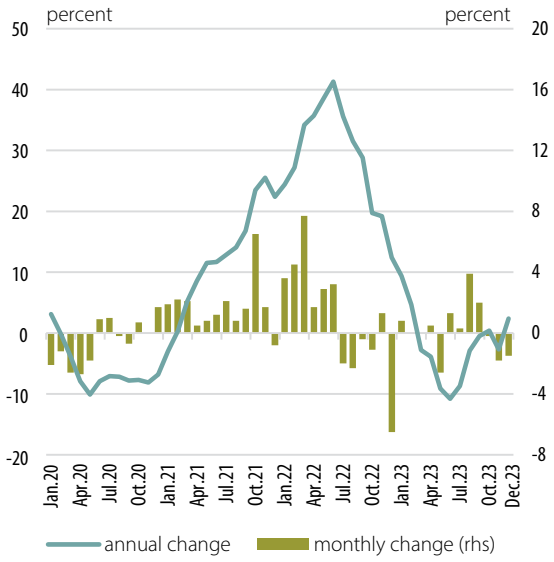


Source: NIS, NBR

Similarly to the previous quarter, the CPI inflation slowdown in the last three months of 2023 was ascribable to developments in food prices (for both processed and unprocessed items), which drove approximately two thirds of the decrease in CPI dynamics during the period under review. On the one hand, the persistent downward trend of agri-food commodity prices favoured the alleviation of producer price pressures in the food industry and companies further tended to pass through these developments into final prices (Box 1). On the other hand, the measure to cap the mark-ups on basic food products, established initially for three months, was extended for a similar period, and the list of products was broadened; at the same time, a maximum limit was introduced for the mark-ups on some imports that are not additionally processed in Romania.

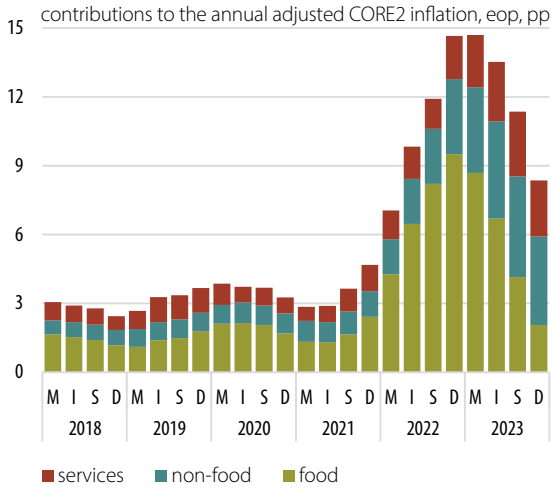
Energy prices continued to decrease in annual terms, their dynamics falling deeper into negative territory during 2023 Q4; behind this stood some base effects in the case of electricity (looking at current developments, the migration of households between consumption brackets generates minor monthly changes). The above-mentioned disinflationary influence was partly eroded by that coming from fuel prices, which was also driven by a base effect associated with the sharp drop in prices in December 2022 (resulting from the correction of the oil price, amid market uncertainty about the recovery pace of Chinese economy, after moving away from the "zero-COVID" approach). In the period under review, the Brent oil price declined to USD 77-79/barrel at end-2023; the spike associated with the outbreak of the conflict in the Middle East was short-lived, which favoured the decline in fuel prices in every month of 2023 Q4 (Chart 1.2).

Chart 1.2. Fuel prices



Source: NIS, NBR calculations

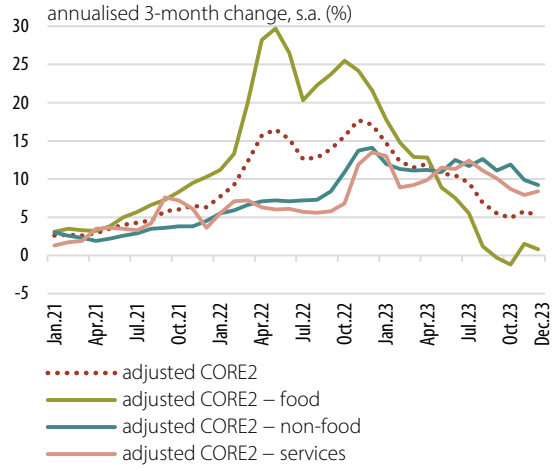
Chart 1.3. Adjusted CORE2 inflation components



Note: Contributions include VAT rate changes.

Source: NIS, NBR calculations

Chart 1.4. Developments in adjusted CORE2 inflation

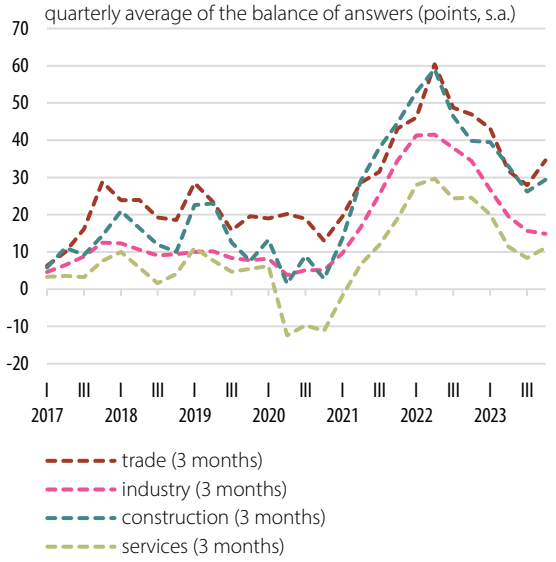


Note: The annualised rates were calculated using series that exclude the direct effects of VAT rate changes.

Source: NIS, NBR calculations

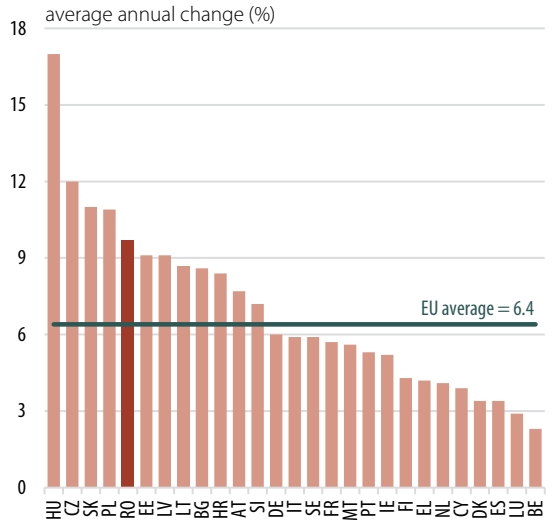
In turn, the annual adjusted CORE2 inflation rate decreased to 8.4 percent in December 2023 from 11.3 percent at end-Q3. Although following a downtrend almost the whole year, core inflation adjusted at a slower pace, its annual dynamics remaining above CPI inflation; however, the gap between the two rates contracted in the period under review. Behind this narrowing stood primarily processed food prices (Chart 1.3), whose annual pace of increase shed 5.1 percentage points during Q4, to 5.3 percent in December. Moreover, non-food prices corrected their inflationary trend, as this category of products, characterised by a significant direct reliance on imports, benefited, in terms of monthly price dynamics, from the steep downward trend in the UVIs of the main categories of imported goods (such as textiles, wearing apparel and footwear, hygiene and cosmetic products or toys). The annual growth rate of market services prices also decelerated, in correlation with weaker demand in the first three quarters of 2023 – turnover in market services gained momentum in the first month of the year, before its monthly changes showed an almost uninterrupted contraction until July, reflected gradually in consumer prices. After more than two years of practically continuous increases, recent developments reveal a turning point also in the path of annual dynamics of prices of non-food items and market services. However, for both segments, monthly price changes are still high by historical standards, which translates into a downward rigidity in inflation (Chart 1.4).

Chart 1.5. Expectations on price developments



Source: EC-DG ECFIN

Chart 1.6. Average annual HICP in the EU – Dec. 2023



Source: Eurostat

In addition, these components remain exposed to potential shocks: in the case of non-food items, one example would be the attacks on cargo ships in the Red Sea, which have already impacted international trade flows, while in the case of market services, labour costs continue to exert pressure. In both cases, the decrease in consumer demand seems to have come to a halt towards end-2023, amid the strengthening of households' purchasing power[1] and their renewed interest in consumer loans[2], possibly associated with the slight decline in interest rates, as well as with the price discounts in the final part of the year.

Under the influence of the new fiscal framework, but also, to a certain extent, amid the slight rebound in demand, in 2023 Q4, companies in most business activities – with the exception of industry – adjusted upwards their expectations on price developments (Chart 1.5). Financial analysts' expectations on the inflation rate over the one-year horizon slightly eased, yet the two-year ahead indicator was revised marginally upwards.

The average annual inflation rate saw a steeper downward path in 2023 Q4, the indicator calculated based on the national methodology (CPI) falling to 10.4 percent in December and that calculated in accordance with the harmonised structure (HICP) going down to 9.7 percent (-2.2 percentage points and -1.7 percentage points respectively compared to end-2023 Q3). Although the differential versus the EU-wide average inflation remained close to that recorded in the previous quarter, Romania ranks among the Member States with a high average HICP inflation, while occupying a relatively favourable position across the region (Chart 1.6).

At end-2023 Q4, the annual CPI inflation rate stood 0.9 percentage points below the forecast shown in the November 2023 *Inflation Report*. Larger-than-expected disinflationary contributions mainly came from the food component of core inflation and from motor fuel prices.

1 Following the hike in wages for some categories of public sector employees and in the minimum wage, as well as the more visible slowdown in the annual pace of CPI inflation.

2 According to the NBR's November 2023 *Bank Lending Survey*.

Box 1. Profit developments over a period of high inflation

In recent years, a series of shocks of unusual magnitude caused significant fluctuations in the production costs of goods and services in the economy, which were further reflected in the inflation rate. Thus, due to large movements in energy and other commodity prices, first upwards and then downwards (accompanied by slightly less volatile labour costs), CPI inflation embarked on a steep upward path as of mid-2021, reached a peak towards end-2022, and subsequently followed a downtrend, on a relatively similar slope.

These changes in production costs and final prices fuelled debate about the evolution of corporate profits. Specifically, the question was raised whether the fast growth rate of consumer prices aligned with the trends in costs, or also left room for upward adjustments in profits. Under the circumstances, this box seeks to provide a few coordinates regarding the profits of economic activities in Romania, with a focus on the recent period of high inflation.

Theoretical benchmarks

An indicator frequently used in the literature to assess corporate profitability is the profit share. This is determined as the ratio of profit to gross value added, essentially measuring how the firm's gains are divided between employees and shareholders. The profit share is typically accessible and relatively easy to calculate, both at macro level, based on national accounts data, and at micro level, based on companies' balance sheets. It can be written as:

$$P_\pi = \frac{\pi}{GVA} = \frac{\pi}{\pi + w \cdot L} \tag{1}$$

where π is the profit, GVA is the gross value added, w is the gross average wage, and L is the number of employees. Dividing each term by total costs (TC) results in a relationship between the profit share and a measure of the profit rate (R_π):

$$P_\pi = \frac{\frac{\pi}{TC}}{\frac{\pi}{TC} + \frac{w \cdot L}{TC}} = \frac{R_\pi}{R_\pi + \frac{w \cdot L}{TC}} \tag{2}$$

The profit rate can be seen as determining the efficiency of economic processes at company level, indicating how many units of profit result from one unit of costs.

An additional step in the analysis of corporate profitability developments refers to mark-ups – defined as the ratio of price to marginal costs (see the equation below) and placed by economic theory at the heart of the production decision. This ratio measures the actual earnings of the firm from selling the product, above its production costs, revealing information on the company's competitive position and power in its relationship with consumers and suppliers, and on the demand conditions in the market for that product.

$$\mu = \frac{p}{MC} \tag{3}$$

The mark-ups can be highlighted as determinants for the profit rate:

$$R_\pi = \frac{\pi}{TC} = \frac{p \cdot Q - TC}{TC} = \frac{\mu \cdot MC \cdot Q}{ATC \cdot Q} - 1 = \mu \cdot \frac{MC}{ATC} - 1 \quad (4)$$

and for the profit share:

$$P_\pi = \frac{\mu \cdot \frac{MC}{ATC} - 1}{\mu \cdot \frac{MC}{ATC} - 1 + \frac{w \cdot L}{TC}} \quad (5)$$

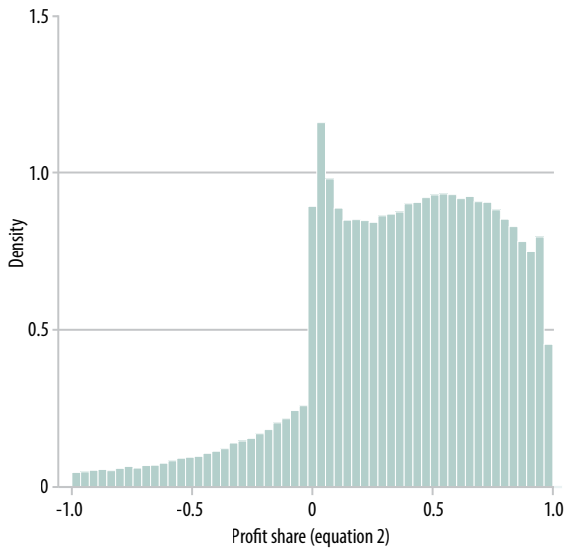
Above, *MC* is the marginal cost, *ATC* is the average total cost, while *p* and *Q* are the price and quantity sold.

The result is thus an explicit relationship between profit shares and mark-ups, showing that the dependence is not always direct and easily discernible. Profit shares essentially depend on three metrics: the mark-up μ, the ratio of marginal costs to average costs, and the share of labour costs in total costs. It is true that, *caeteris paribus*, a company's decision to increase the mark-up will translate into a rise in its profit share, yet the opposite is not always true. An increase in profit share can be due not only to higher mark-ups, but also to a faster growth of marginal costs compared to the average cost, or to a relative price increase in intermediate goods compared to wage costs[3].

Empirical exercise

The empirical analysis starts by looking at the profit share in 2022, determined based on the first equality in equation (1), the sample being built according to the specifications mentioned below (Chart A). With regard to the range of positive values, which make up most of the mass of the distribution, the calculations show a relatively uniform profile of the indicator, yet firms with a very small profit share prevail slightly in terms of number. At the same time, the mass of the distribution for negative values, representing companies with positive value added, but negative profit, is not negligible, even though it is smaller.

Chart A. Profit share economy-wide, 2022



Source: MF, NBR calculations

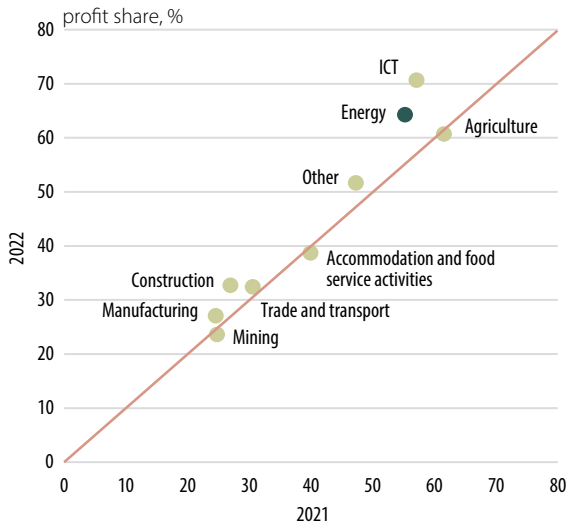
Further on, the evolution of profit shares of economic agents in 2022, as well as in the previous three years, is investigated. For each year, the sample retained between 300 thousand and 400 thousand firms, namely those that reported, in two consecutive annual financial statements, strictly positive turnover, number of employees and expenses, so that the relevant indicators could be calculated. In terms of representativeness, their turnover amounted to approximately EUR 340 billion in 2021 (the latest year for which

3 The same reasoning can be applied to the relationship between profit rate and mark-ups.

data on Romanian companies are available in the Eurostat database), compared to a total turnover of EUR 400 billion according to Eurostat, resulting in a coverage of about 85 percent.

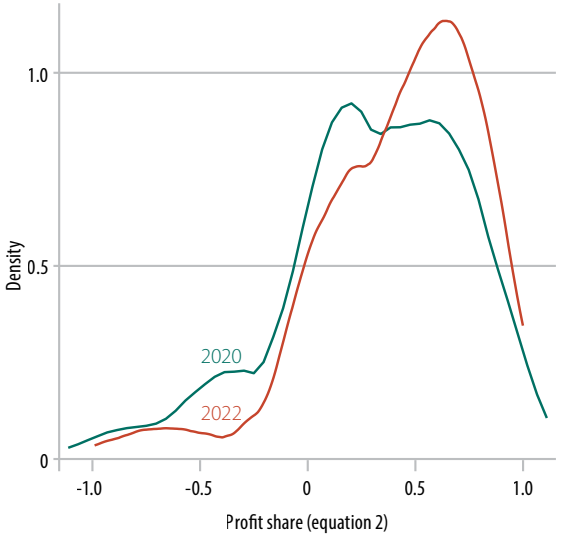
The results indicate a nearly perfect equilibrium in terms of the dynamics of the profit share for 2022, when the inflation rate reached a 20-year high. Specifically, this indicator decreased for approximately 51 percent of firms and increased for almost 49 percent of them. In fact, a relatively large discrepancy from this standpoint is visible only in 2021, when the profit share rose for little over 53 percent of firms and declined for less than 47 percent of them. A large proportion of firms that increased their profit shares at that time were from agriculture and energy, in the context of surging commodity prices, as well as from the accommodation and food service activities, a business sector that was recovering from a severe contraction recorded in the year before.

Chart B. Profit shares in 2021 and 2022 by business sector



Source: MF, NBR calculations

Chart C. Profit shares in energy in 2020 and 2022



Source: MF, NBR calculations

In 2022, there was generally strong symmetry within economic sectors as well; in all activities, the percentages ranged broadly from 45 to 55 percent. In trade and agriculture, firms with declining profit shares were marginally prevalent, while the opposite was true for construction firms. In manufacturing, the balance is almost perfect at an aggregate level. Looking at the breakdown, a larger proportion of firms with increasing profit shares were from the manufacture of paper and paper products, the manufacture of coke and refined petroleum products, and the manufacture of electrical equipment. By contrast, firms whose profit shares decreased in 2022 were predominantly from sub-sectors such as metallurgy, computers and electronics, and the automotive industry, which were affected that year by costlier and scarcer production inputs. Aggregating the data at sectoral level shows that, in most cases, the profit share remained similar in the period from 2021 to 2022, with some notable exceptions, i.e. ICT and energy, the latter

witnessing a profitability jump in 2021 too, once energy prices started to go up (Charts B and C).

Another stage of the empirical analysis refers to equation (2), seeking to establish the extent to which the profit rate and the share of labour costs in total costs contributed to developments in the profit share. In 2022, the median contribution of the profit rate to the dynamics of the profit share was marginally negative for firms in the economy as a whole. In other words, the profit rate of most firms in the economy eroded the share of profit in GVA. As for the share of wage costs (in total costs), its median contribution is nil, meaning that, for the median firm, the robust wage dynamics were accompanied by a similar rise in production input costs. In 2021, the median contribution of labour costs was positive, albeit visibly lower than that of the profit rate. In the previous two years, wage costs made a negative contribution, meaning that their share in corporate expenses widened (with labour costs growing more strongly than other costs), while the profit rate contributed positively to the change in profit share.

The latest available data help formulate some ideas on corporate profitability in the first part of 2023. Some firms submit semi-annual financial statements, which are used to determine the profit rate. However, this indicator should be interpreted with caution, as its value at mid-year can change by the end of the year, depending, *inter alia*, on the nature of activity. For instance, a firm making profit mainly during the winter holidays will have a small profit share at mid-year, which is not however relevant for its activity. Nevertheless, as compared with the previous mid-year, high frequencies of companies that recorded a decline in this indicator were seen in agriculture, accommodation and food service activities, the financial sector, trade or energy. In the manufacturing sector as a whole, the profit share shrank for approximately 56 percent of companies, which are predominantly from industries such as the manufacture of wood, metallurgy, building materials and furniture. Construction and the food industry are among the few economic sectors where firms with rising profit shares were prevalent in 2023 H1.

Conclusions

The analysis of the profit share in the recent period has revealed mixed developments, yet relatively balanced at aggregate level, making plausible the assumption that local companies did not show a systematic behaviour of an excessive passing through of positive cost shocks into final prices and/or delaying the transmission of cost reductions, when they occurred. Subsequent research in this field aims to estimate the evolution of corporate mark-ups, given the importance of this variable from the perspective of the production decision.

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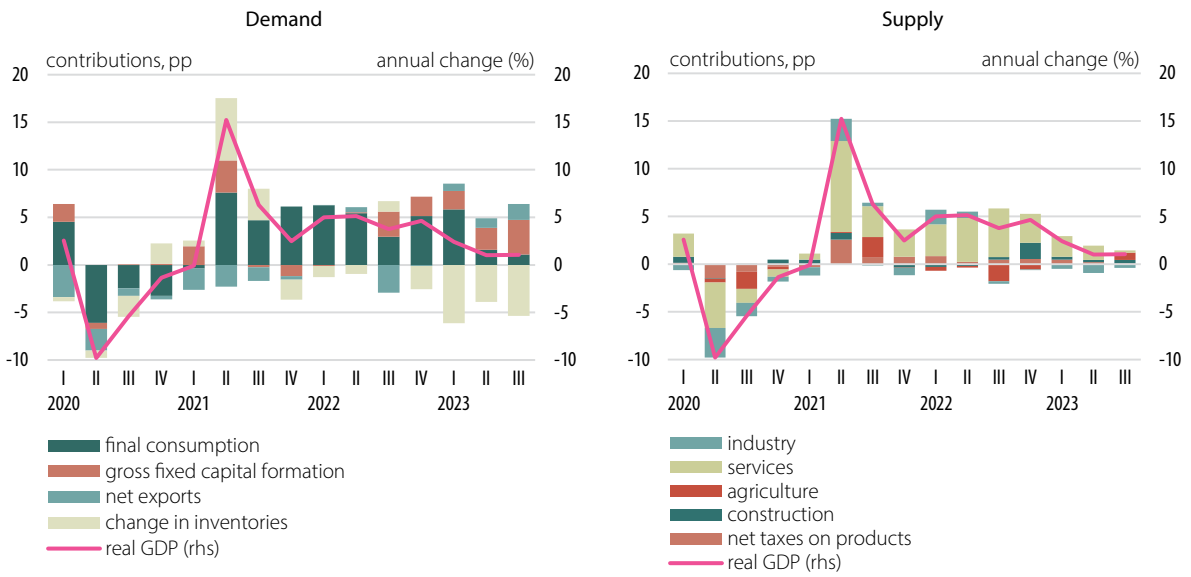
2. Economic developments

1. Demand and supply

In annual terms, real GDP dynamics[4] remained moderate (1.1 percent) in 2023 Q3. Investment strengthened its role as a driver of economic growth, but the other two components with significant economic content (household consumption and net exports of goods and services) also made larger contributions than in the previous quarter. Nevertheless, the favourable evolution of these three components was yet again undermined by the reduction of inventories (contribution of -5.4 percentage points).

On the supply side, the activity of non-agricultural sectors followed trends similar to those seen in the first two quarters of 2023 (decline in industry, deceleration in services, relatively swift rise in construction), the aggregate GVA dynamics in these sectors going down to 0.3 percent in annual terms (from 1.1 percent in Q2). Conversely, the bountiful fall harvest (wheat, rapeseed)[5] led to a 6.9 percent hike in GVA in agriculture, making a 0.8 percentage point contribution to real GDP growth in Q3 (Chart 2.1).

Chart 2.1. Contributions to economic growth



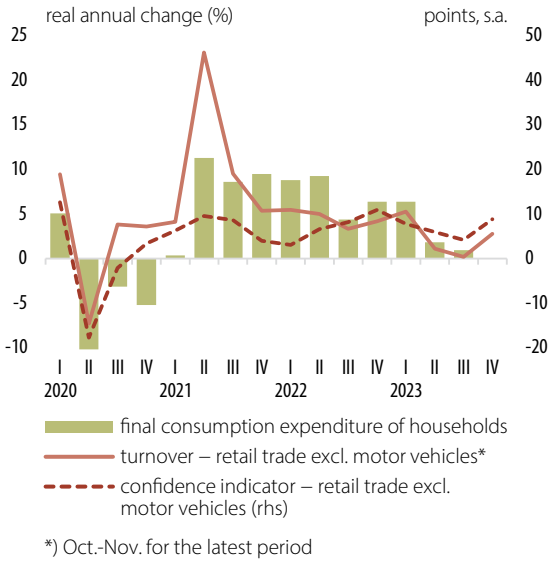
Source: NIS

4 GDP analysis refers to the annual changes calculated based on volume series expressed in the prices recorded in the corresponding quarter of the previous year. Data source: NIS.

5 The Ministry of Agriculture and Rural Development's 2023 provisional data for these crops indicate larger harvest than the multiannual high reached in 2021.

Household consumption resumed growth in annual terms (2.6 percent), after stagnating in the previous period. However, the trend was not supported by the final consumption expenditure of households[6], whose annual pace of increase slowed down, as reflected by the receipts from retail trade and market services to households (decelerations in real terms to 0.2 percent and 1.2 percent respectively). In the former case, the downward trend was almost across the board, with the notable exception of online sales, which reversed their trajectory, after five consecutive quarters of decline. Apart from playing a relevant role in the cost-cutting process, online trade also benefits from the rise in the number of dwellings with internet access (especially in the rural areas, where their share added approximately 5 percentage points in 2023 to 88.1 percent, according to the NIS data). The growth potential of the sector raises the interest of retailers, most of them showing their intention to increase the allocated resources for expanding the logistical capacities or developing new commercial strategies for this segment.

Chart 2.2. Household consumption



*) Oct.-Nov. for the latest period

Source: NIS, EC-DG ECFIN

In 2023 Q4, household consumption expenditure is likely to step up, amid the pay rises for certain categories of public sector employees and the hike in the minimum wage. The latter significantly spurs consumer demand, ensuring additional resources to the employees at the bottom end of the wage pyramid, which show a stronger propensity for consumption than the higher-income earners. At the same time, consumer credit demand remained high[7], due possibly to the slight decline in interest rates and the sales period in the last months of every year. The income growth will continue to boost consumer demand in the first part of 2024 too, as the raise in the pension point and new public sector pay rises become effective as of 1 January 2024 (Chart 2.2).

According to the monthly indicators capturing trade developments in the period from October to November, consumer demand will most likely gain momentum in 2023 Q4. Specifically, the volume of goods sales saw its annual dynamics accelerate to 2.8 percent, while that of receipts from market services to households also followed an uptrend, albeit less pronounced (1.6 percent). Moreover, the short-term expectations of retail companies (excluding the automotive segment) hint at a protracted upward trend in sales in the first months of 2024 (the related balance of answers rose by 9.2 percentage points in Q4 as compared to the Q3 average). In the automotive industry, the annual growth of the volume of sales slowed down to 4.5 percent in October-November, and it will possibly continue to do so in the following months too, amid the changes in the 2024 "Rabla Plus" programme, namely the considerably lower

6 According to national accounts data, the key driver of the rebound in households' actual final consumption in Q3 was the individual final consumption expenditure of general government (education, healthcare, social security and social activities, culture and sport).

7 According to the NBR's November 2023 *Bank Lending Survey*.

value of a voucher for purchasing electric or hybrid cars with CO2 emissions of less than 80 g per kilometre.

In 2023 Q3, the general government execution deteriorated year on year at a slower pace, resulting in a deficit of lei 19.2 billion (1.2 percent of GDP), slightly exceeding that posted in 2022 Q3 (lei 18.2 billion, i.e. 1.3 percent of GDP)[8], whereas against the previous three months, the negative balance increased significantly, the same as in 2022. This time around, the deepening of the deficit compared to the previous quarter resulted primarily from the reduction in total budget revenues[9], mainly on the back of the fall in receipts from corporate income tax[10] and in non-tax revenues, as well as in EU disbursements[11], whose joint impact was counterbalanced only partly by higher receipts from VAT[12] and from other taxes and fees on goods and services[13].

At the same time, total budget spending went up in 2023 Q3, albeit to a small extent[14], given that the increase in certain current expenditure items (subsidy expenses[15], compensation of employees[16], and interest expenses)[17], as well as the rise in capital expenditure, was largely offset by the decline in spending for projects financed from non-repayable external funds[18] and spending on goods and services[19].

In 2023 Q4, the general government deficit widened substantially, albeit less than in the same year-earlier period, reaching lei 33.4 billion (2.1 percent of GDP), compared to lei 39.1 billion (2.8 percent of GDP) in 2022 Q4. In 2023 as a whole, the budget execution posted, however, a deficit visibly above the one recorded in the prior year, i.e. lei 89.9 billion (lei 80.8 billion in 2022), yet accounting for 5.7 percent of GDP compared to 5.8 percent of GDP in 2022.

Gross fixed capital formation saw its annual dynamics step up to 11.9 percent, remaining the key driver of economic growth (with a 3.6 percentage point contribution), further supported mostly by civil engineering works; a positive contribution also came from equipment purchases, but their annual pace of increase decelerated sharply, on the back of the slowdown in companies and public institutions' purchases of transport equipment. Fixed capital investment will probably

8 The budget deficit in 2023 Q2 outweighed considerably the deficit from the same year-ago period (lei 14.5 billion, i.e. 0.9 percent of GDP, versus lei 7.8 billion, i.e. 0.6 percent of GDP in 2022).

9 Their real annual dynamics marginally entered negative territory (-0.1 percent from 3.1 percent in the previous quarter).

10 *Inter alia* on account of the base effect associated with the hike in receipts from corporate income tax in Q2, amid the extension until June of the payment deadline for the tax for the prior year (similarly to 2022). However, receipts declined in real terms compared to 2022 Q3 as well.

11 Nevertheless, this occurred after a significant increase in disbursements in 2023 Q2.

12 Their real annual rate of change returned to positive territory, yet this was also due to the slower dynamics of tax refunds.

13 Most likely also reflecting the evolution of state budget receipts from the taxation of economic agents in the energy sector.

14 It slightly contracted in real annual terms (by 0.5 percent compared to the 7.3 percent increase in Q2).

15 Especially due to payments made to compensate electricity and natural gas prices for non-household consumers.

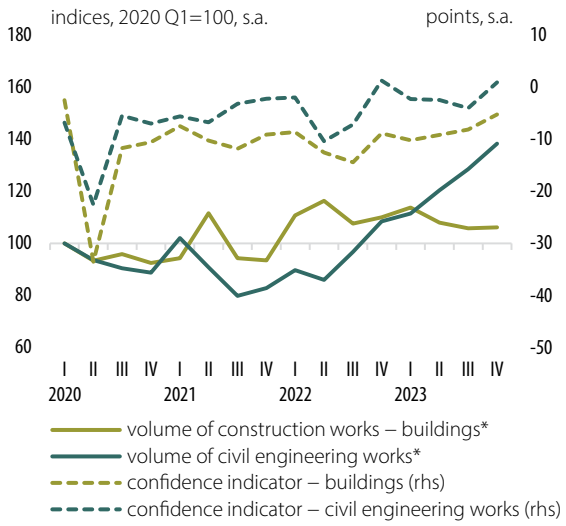
16 *Inter alia* as a result of pay rises in education, public administration, and health (in accordance with GEO No. 57/2023, No. 45/2023 and No. 63/2023); in that context, the real annual dynamics of staff costs saw a significant renewed increase, returning to positive territory, for the first time since 2021 Q1.

17 Spending on subsidies and interest expenses decreased, however, in real annual terms.

18 Which had, however, a low effect on the change in budget balance, following the similar developments in disbursements from the EU.

19 Both categories declining in real annual terms as well.

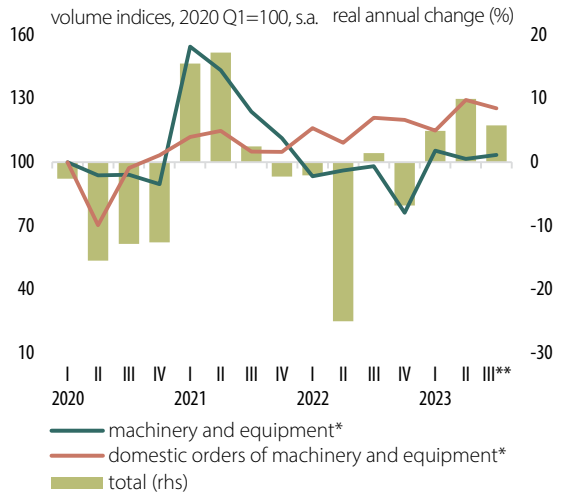
Chart 2.3. Construction



*) Oct.-Nov. for the latest period

Source: NIS, EC-DG ECFIN

Chart 2.4. Investment, excluding construction



*) excl. transport equipment

**) Jul.-Nov. for domestic orders

Source: Eurostat, NIS, NBR calculations

maintain its positive dynamics over the projection horizon, as shown by the relatively high net FDI inflows in the form of equity, including reinvestment of earnings (estimated value of EUR 6 billion January through November 2023), and by the stronger inflows of EU funds under the 2014-2020 MFF[20]. As for the financing through the National Recovery and Resilience Plan (NRRP), Romania received approval of the second payment request (EUR 2.76 billion in September). At end-2023, a third payment request (in amount of EUR 2.7 billion) was submitted to the European Commission.

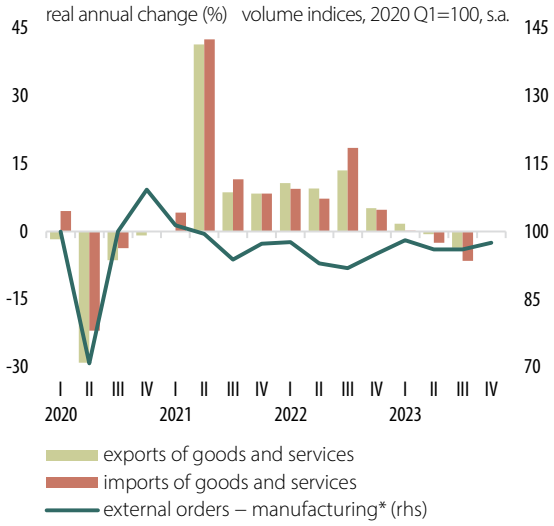
Investment in construction rose by more than 15 percent (annual change)[21], while continuing to post diverging developments in the main segments, which are expected to persist in the near future. Specifically, civil engineering works expanded their volume by approximately 30 percent in Q3 as well, while the end of 2023 was marked by the inauguration or the start of large-scale transport infrastructure projects. Conversely, the construction of buildings contracted further (by 2.6 percent) and the negative trend in the construction area stipulated in building permits over the past 12 months (until November 2023) suggests that a recovery is little likely to be seen in the short term (Chart 2.3).

Equipment purchases saw their annual growth rate nearly halving to 6.3 percent as compared to Q2, on the back of the slowdown in companies and public institutions' purchases of transport equipment. On the other hand, purchases of machinery and ICT equipment continued at a moderate pace (3.2 percent). Strong interest is further directed towards investment in expanding the production capacity for renewable energy, via large-scale projects (solar parks, in particular) and green energy projects for the own consumption of companies and households. Furthermore, the Green Home programme is expected to be resumed in the first part of 2024. In addition to the component managed by the Environment Fund Administration, the financing scheme will include a NRRP source, granted exclusively for the purpose of household consumption. Investments in electromobility projects are also under way, envisaging,

20 At mid-January 2024, the rate of absorption of EU funds earmarked exclusively for investment projects was 100 percent for the Cohesion Fund and 91 percent for the European Regional Development Fund.

21 According to national accounts data on gross fixed capital formation.

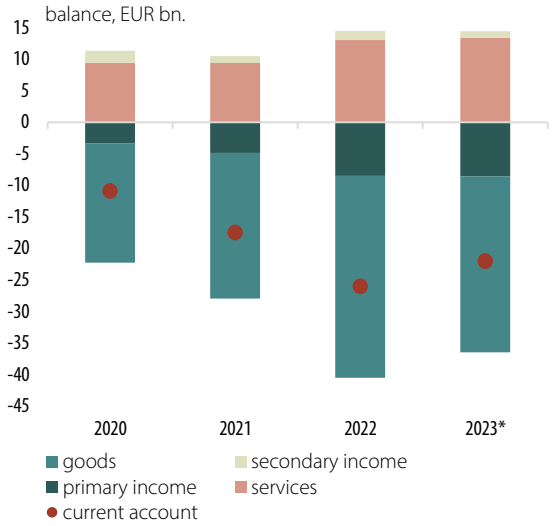
Chart 2.5. Foreign trade



*) Oct.-Nov. for the latest period

Source: NIS, NBR calculations

Chart 2.6. Current account



*) annualised data, based on 11-month actual data

Source: NBR

for instance, the opening of a production line for electric buses starting in 2024 H1, as well as the roll out of fully electric versions of some car models manufactured domestically (Chart 2.4).

Net exports of goods and services made a stronger positive contribution to GDP dynamics, i.e. up to 1.7 percentage points in Q3, as imports of goods recorded a sharper decline than exports (down 6.5 percent versus 3.6 percent, real annual changes) (Chart 2.5).

Behind the reduction in the deficit of trade in goods (in terms of volume) stood mainly the higher surplus of trade in agri-food commodities, the outstanding wheat and rapeseed crops having a favourable influence on both trade flows – 50 percent hike in exports, as well as the halving of imported quantities, due *inter alia* to a base effect[22]. Energy also made a contribution to the narrowing of trade imbalance in Q3, especially on account of natural gas transactions turning to surplus, given the decline in domestic industrial consumption and the mild rise in local production[23]. Unfavourable influences (of relatively low magnitude) on trade balance came from the industrial intermediate goods (particularly amid the difficult recovery of domestic energy-intensive industries) and some groups of capital goods (machinery and equipment, road transport equipment) and durables (furniture, household appliances), affected by weak external demand.

In the first three quarters of 2023, the favourable evolution of the volume component of trade balance also reflected in the balance of payments. January through November 2023, the deficit on trade in goods narrowed to EUR 25.6 billion (-12.1 percent in annual terms). The surplus on trade in services increased further (by 4.7 percent), so that the current account deficit stood at EUR 20.2 billion, 17 percent lower than in the same period of 2022 (Chart 2.6).

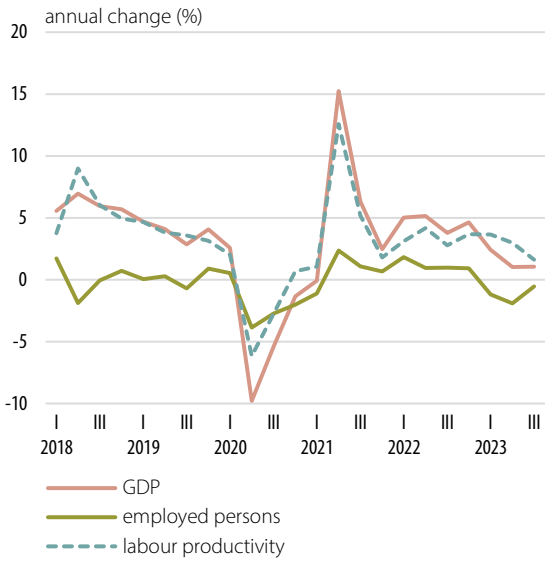
22 According to Eurostat (Comext) data, in 2015-2021, Ukraine was an immaterial supplier for Romania (the shares in total imports being smaller than 2 percent for wheat, maize, sunflower and 6 percent for rapeseed). In 2022, Ukraine became the supplier of more than half of imports for the first three aforementioned groups and 80 percent of imports of rapeseed, which ensured its prevailing contribution to the increase by approximately 30 percent in Romania's total imports of agri-food commodities.

23 In 2023 as a whole, Romania's net importer position improved as against the year before, from 1.9 billion cbm to 0.4 billion cbm.

Labour productivity

Labour productivity economy-wide increased at a slower pace in 2023 Q3, i.e. by 1.6 percent (down 1.4 percentage points from the previous quarter), on the back of weaker demand for services, the sectors that have supported the robust performance of the indicator so far (trade, accommodation and food service activities, transportation and ICT) witnessing losses of momentum as well (Chart 2.7).

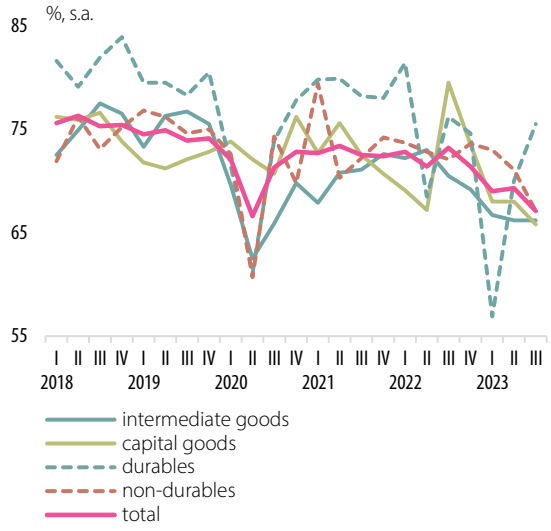
Chart 2.7. Labour productivity economy-wide



Source: NIS, NBR calculations

The situation in industry remained challenging, an improvement being likely to occur only over the medium term. Specifically, labour productivity fell by 5.9 percent[24], amid a 5.6 percent decrease in production versus 2022 Q3 and the still slightly positive dynamics of the number of employees. The subdued demand at EU level has not yet provided the necessary traction to the rebound in domestic industry, the volume of new external orders in this sector remaining only marginally higher in the first 10 months of 2023 against the same year-ago period. Manufacturing confidence indicators in the euro area have posted very low levels from a historical perspective, these companies citing as main obstacles the decline in the purchasing power, high financing costs and barriers to global trade.

Chart 2.8. Capacity utilisation rate in manufacturing



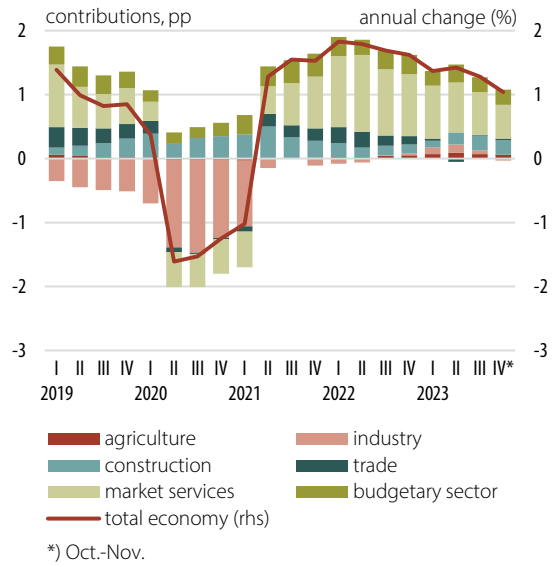
Source: EC-DG ECFIN

While the latter months of 2023 have not shown signs of a recovery either, a number of recent announcements referring to the closure of some plants that were facing problems, on the one hand, and to investments in new production facilities, on the other hand, suggest a potential shift in manufacturing over the medium term towards a more productive pattern. Thus, the former case refers to some chemical and car parts plants that manufactured goods for which the demand disappears gradually as markets undergo structural changes; in addition, according to market signals, the chemical industry faces the issue of persistently elevated production costs – the manufacture of fertilisers has been partially suspended again, with manufacturers complaining about the higher prices that industrial gas consumers in Romania are charged as compared to other European countries, which harms the price competitiveness of domestic goods. By contrast, several new, large investments are to become operational in the course of 2024

24 In October-November, the annual pace of decline of labour productivity slowed down to -3.2 percent, a favourable calendar effect making however a significant contribution thereto.

in sub-sectors such as the manufacture of tyres, household appliances and other electrical equipment, medicines or building materials. The automotive industry also benefits from some favourable prospects, related particularly to the launch of new models, hybrid and electric vehicles included, with higher value added. Nonetheless, car manufacturers consider that the legislative changes lowering the financial support granted through the car fleet renewal programme may exert opposite influences on this sub-sector's activity.

Chart 2.9. Number of employees economy-wide

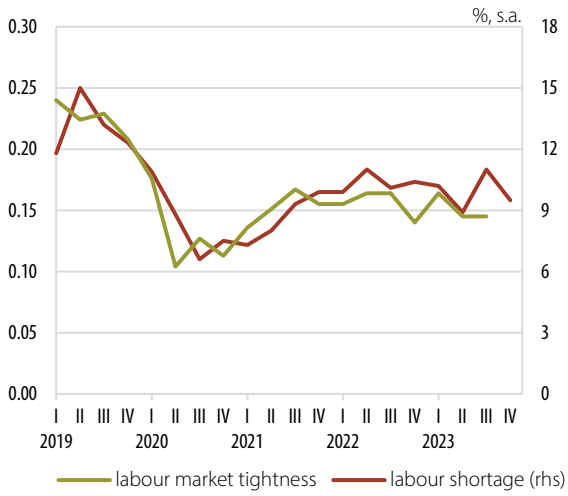


*) Oct.-Nov.

Source: NIS, NBR calculations

At the current juncture, the adverse cyclical position in terms of both domestic and particularly external demand, the gradual disappearance of markets for some domestically-manufactured goods and the competitiveness losses triggered by the structural changes in global value chains[25] have reflected in a further reduction in the capacity utilisation rate – to 67.1 percent in 2023 Q3 –, which now stands close to the level recorded in 2020 Q2 (a quarter marked by the outbreak of the first pandemic wave and the temporary shutdown of many production facilities), Chart 2.8.

Chart 2.10. Labour market tightness



Note: The labour market tightness indicator is calculated as the ratio of the job vacancy rate to the ILO unemployment rate (monthly data).

Labour shortage refers to the share of answers of companies citing the difficulty of finding workforce as a factor that constrains their economic activity; the indicator refers to manufacturing, construction and services and was aggregated depending on the number of employees in each sector.

Source: NIS, Eurostat, EC-DG ECFIN, NBR calculations

Labour market developments

The slowdown in economic growth has begun to gradually echo in the labour market too, which is however characterised by rather high inertia. This comes, *inter alia*, from structural problems such as the low labour force participation rate, the shortage of skilled labour or the inefficient education system, whose adaptation to market needs leaves to be desired.

The annual growth rate of the number of employees in the economy decelerated to 1 percent in October-November 2023 (from 1.4 percent in Q2 and 1.3 percent in Q3), market services being the main contributor hereto, under the impact of weaker demand. Industry, which faces difficulties at global and particularly European level, also made a contribution to the aforementioned slowdown. Nevertheless, the decline in the number of employees was only marginal (-0.1 percent). Thus, most industrial sub-sectors witnessed either a modest pace of hiring or job cuts (with larger reductions in the light industry and the manufacture

25 They particularly refer to the large reconfiguration of international trade in energy inputs in a very short time.

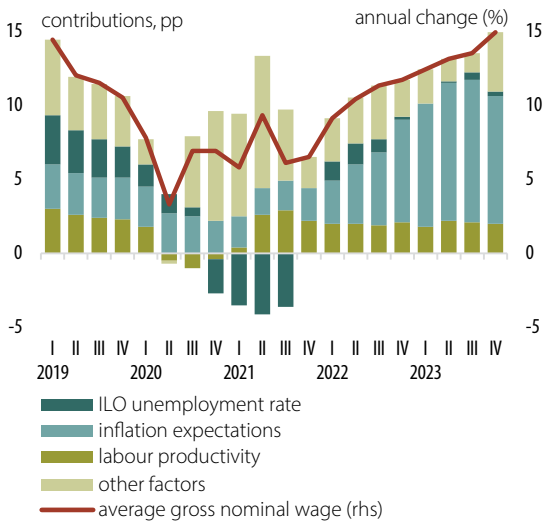
of furniture), yet the magnitude of layoffs was further limited as compared with the contraction in activity. Only few sub-sectors reported more solid dynamics of payrolls, namely the automotive industry, the manufacture of electronic products, of food products and of pharmaceutical products, as well as crude oil processing, yet a downtrend is visible in these cases too. The number of employees in trade remained virtually unchanged at the level recorded in the same year-earlier period, whereas the annual change in the number of employees in construction continued to be relatively robust (2.6 percent, similar to that in Q3), amid the numerous infrastructure projects underway. In the budgetary sector, the pace of increase of the number of employees decelerated, on the back of developments in public administration (Chart 2.9).

Companies' employment expectations suggest a continuation of the slowing trend in the pace of hiring over the near-term horizon, the DG ECFIN indicator declining in October-December 2023 to 104.8 points (from 106.6 points in Q3).

The job vacancy rate further stood at 0.8 percent in Q3 (the same as in the previous quarter), while the ILO unemployment rate fell slightly in October-November 2023 to 5.4 percent (5.5 percent January through September 2023). At the same time, according to the latest DG ECFIN survey, the share of companies citing labour shortage as a factor that constrains their activity shrank in 2023 Q4 against the previous quarter, returning to the levels recorded in the first part of the year. All these developments are suggestive of the relatively high inertia of labour market conditions, which show modest signs of easing for now (Chart 2.10).

The annual growth rate of the average gross wage economy-wide surged in October-November 2023 to 16.2 percent (versus 14 percent in 2023 Q2-Q3), on the back of the government's decision to raise the minimum gross wage in the economy (by 10 percent), as well as separately in construction, agriculture and the food industry (by almost 15 percent)[26]. By contrast, from the perspective of fundamentals, inflation expectations made a lower contribution to wage dynamics, while labour productivity exerted a smaller impact as well, in the context of slower economic activity (Chart 2.11). The rate of change of budgetary sector wages remained high, at 15.7 percent.

Chart 2.11. Developments in the average gross wage economy-wide



Note: In this specification of the wage Phillips curve, wage dynamics are determined by labour productivity, labour market conditions and labour market participants' inflation expectations (assumed to be adaptive) as follows:

$$\Delta average\ gross\ wage_t = \beta_1 \Delta average\ gross\ wage_{t-1} + \beta_2 \Delta labour\ productivity_t + \beta_3 \Delta CPI_{t-2} + \beta_4 \Delta ILO\ unemployment\ rate_{t-2} + other\ factors$$

Changes are approximated by logarithmic differences.

Source: NIS, Eurostat, NBR estimates and forecasts

26 The hike in the minimum gross wage in the economy (from lei 3,000 to lei 3,300) and in construction (from lei 4,000 to lei 4,582) in October-November is the second in 2023 (after the January wage increase by nearly 18 percent economy-wide and approximately 33 percent in construction). In agriculture and the food industry, the minimum gross wage was raised to lei 3,436 (from lei 3,000).

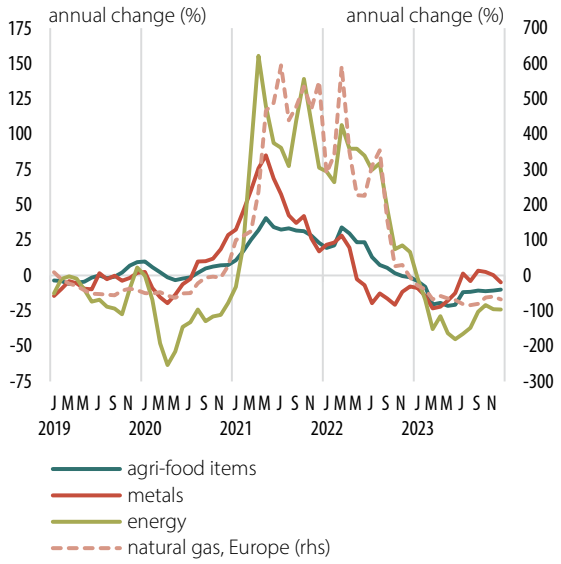
2. Import prices and producer prices on the domestic market

In the latter part of 2023, the still subdued outlook for global activity was reflected in international prices of main commodities running below those recorded a year earlier, resulting in an annual contraction in import prices and producer prices on the domestic market. For the period ahead, there are no indications of a trend reversal, as the driving factors are expected to act in the same direction.

2.1. Import prices

Given the persistence of muted prospects for global economic activity, in the last two quarters of 2023 most commodity prices stood at levels significantly below those recorded in the same year-earlier period, according to World Bank data (Chart 2.12).

Chart 2.12. International commodity prices



Source: World Bank, FAO, NBR calculations

The slower annual rate of decline towards year-end (to -17.4 percent from -27.4 percent in Q3) was ascribable to the trajectory of energy prices. A contribution thereto made natural gas prices on the European market, as October through November they reflected the impact of geopolitical turmoil and the coming cold season. However, this pick-up proved temporary, with prices returning in December to readings similar to those seen at end-Q3, due to the comfortable storage levels of natural gas and the low demand associated with temperatures above the seasonal average.

The Brent oil price declined during 2023 Q4, hovering between USD 75-80/barrel in December (after the previous quarter's rise to more than USD 95/barrel in September), given the containment of the regional spillover of the war in the Middle East and the plentiful global supply.

Industrial metal prices followed a relatively stable path, with annual growth rates of 0.2 percent and -0.9 percent in 2023 Q3 and Q4, respectively; these modest figures are in line with the profile of the global industrial sector, which is further hindered by difficulties. The price of iron ore rose towards end-2023, in correlation with the modest recovery in economic activity in China, amid incentives applied by the authorities.

Agri-food commodity prices stuck to a moderately downward trend, the negative annual rate of change of the FAO index coming in at about -10 percent. Grain prices mirrored the large crops internationally (in countries such as the US, Argentina, Australia and Russia), while meat prices, especially pigmeat, were affected by the weak demand. The annual growth rate of sugar prices exceeded 40 percent between September and November, before decelerating to around 15 percent in

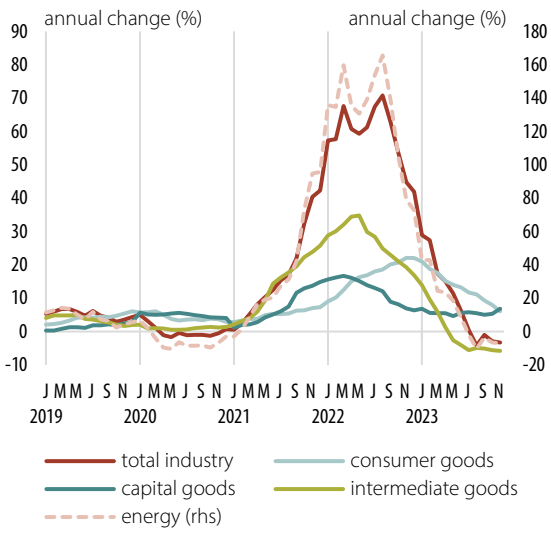
December 2023, against the backdrop of more favourable weather conditions in Brazil and India's decision to limit the use of cane sugar for ethanol production.

The still low levels of the main commodity prices were reflected in the persistence of the negative annual dynamics of import prices in 2023 Q3. Specifically, the unit value index (UVI) of imports remained below one (96 percent), dropping by 3.5 percentage points from the previous quarter. The downtrend was noticeable in the case of most groups of goods, being more pronounced for chemical products, wood products and building materials. As for consumer goods, the fading-out of inflationary pressures was visible for both food items (meat, vegetal products, oils and fats) and non-food items (clothing, footwear). The UVI of fuels increased, but the indicator remained below one.

2.2. Producer prices on the domestic market

In October-November 2023, the annual rate of change of industrial producer prices on the domestic market declined at a faster pace, reaching -3.1 percent, down by 1.5 percentage points from Q3. This was due to the dominant contribution of statistical effects in certain segments (energy and consumer goods), which overshadowed, at an aggregate level, the influence of price increases versus Q3 (Chart 2.13). The latter development came from energy goods, mainly as a result of higher spot prices in wholesale electricity and natural gas markets, the prices of non-energy commodities recording small fluctuations. The results of the DG ECFIN survey for December 2023 point to subdued pressures on price dynamics, which was a prevailing trend in 2023 H2.

Chart 2.13. Industrial producer prices on the domestic market



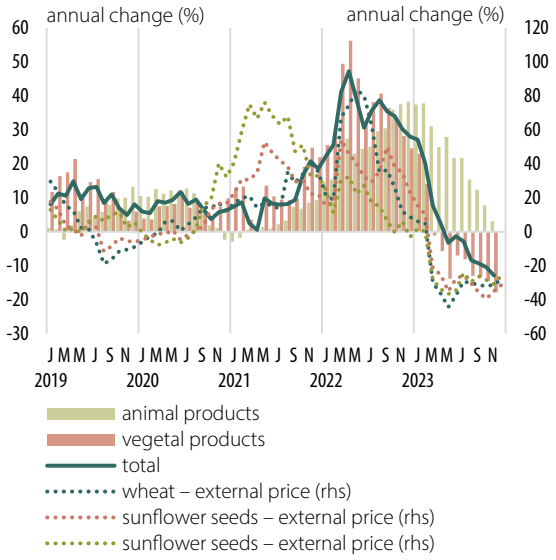
Source: NIS, Eurostat

Consumer goods prices reported the fastest deceleration in their annual growth rate (-3.7 percentage points, to 7 percent), owing considerably to the food industry, where the annual price dynamics fell to 1.2 percent (from 5.4 percent in Q3). Alongside a base effect, this further reflected the influence of low agri-food commodity costs, i.e. grains, oleaginous plants, pigmeat, the producer price dynamics in this last segment being limited by the competitive pressure from cheap imports.

The markedly negative annual growth rate of energy producer prices (-6.8 percent, down by 1.5 percentage points compared to Q3) was due solely to a base effect in the electricity, gas, steam and air conditioning supply, this segment witnessing price hikes against 2023 Q3, correlated with those seen in wholesale markets. Specifically, in line with developments at European level, amid geopolitical tensions, as well as seasonal influences, natural gas prices on the domestic market went up, but the rise was much softer than in the year before, given the high natural gas stocks. The movement may

have been underpinned also by the overhauls carried out by one of the local refineries in October. Domestic electricity prices in the free wholesale market increased in October, the greater electricity output from other renewable sources (wind, solar) only partially offsetting the weaker supply of hydropower (the Danube flow rates came in well below their multiannual average). Nevertheless, November saw a trend reversal amid the recovery of supply, bolstered by the production from renewable sources (including hydroelectric power plants). Crude oil processing prices continued to decline as well year on year, in correlation with the trajectory of international oil prices, albeit at a somewhat slower pace.

Chart 2.14. Agricultural producer prices



Source: NIS, Bloomberg, NBR calculations

The annual growth rate of producer prices for intermediate goods also decelerated, yet less sharply (-0.4 percentage points), the slowdown for building materials being cushioned by the smaller annual contraction in the chemical industry. Conversely, the annual dynamics of producer prices for capital goods picked up slightly (by 0.6 percentage points), in line with developments in the automotive industry, possibly due to the change in the main manufacturers' model range.

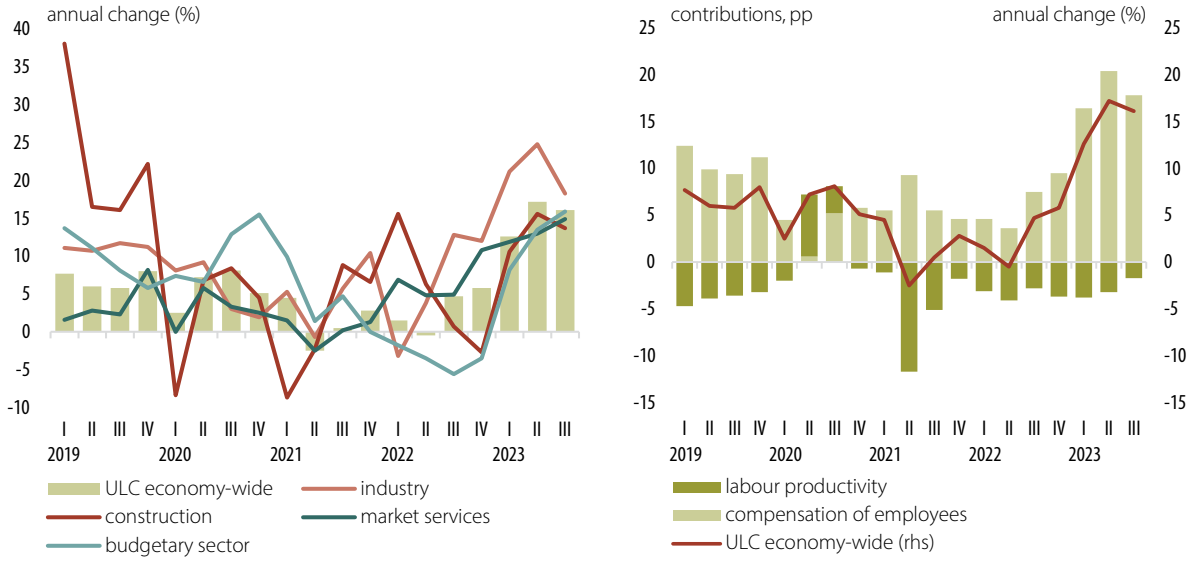
Agricultural producer prices stayed on a declining path October through November (-11.6 percent in annual terms versus -6.8 percent in Q3), the good harvests providing some easing on the supply of agricultural products and animal feed costs (Chart 2.14). Specifically, in the vegetal component, strongly negative annual dynamics were further seen in prices for grains and oleaginous plants, whereas the annual growth rates of vegetable prices remained in positive territory, though on a steep downtrend compared to the previous quarter. In the case of animal products, the rate of change of prices for pork meat lost significant momentum, amid a rise in supply driven by the lower demand from China.

Unit labour costs

The annual dynamics of unit labour costs economy-wide recorded a slowdown in 2023 Q3, but remained fast (16.1 percent, -1.1 percentage points versus the previous quarter). Most sectors contributed to this deceleration, except for market services, where the growth rate of unit labour costs stuck to an upward path. The less brisk pace of increase in compensation per employee (17.9 percent, -2.8 percentage points versus 2023 Q2) was, however, accompanied by a more moderate labour productivity growth rate (1.6 percent, -1.4 percentage points versus the previous quarter), the persistence of a considerable gap between the two indicators carrying the potential for inflationary pressures from labour costs to build up (Chart 2.15).

In industry, the annual growth rate of unit wage costs decelerated both in Q3 and October through November 2023, to 20 percent, i.e. 4 percentage points below the local peak reached in 2023 Q2. Industrial activity continued to decline (yet at a slightly slower pace versus April-June), while labour force adjustment remained slow (in terms of both wages, due also to the minimum wage hikes, and of the number of employees). The decelerating trend in the dynamics of unit wage costs was almost across the board, with significant losses of momentum (over 10 percentage points) being visible in the manufacture of wood, the chemical industry, the manufacture of electrical equipment, the food industry, beverages and the manufacture of other transport equipment.

Chart 2.15. Unit labour costs



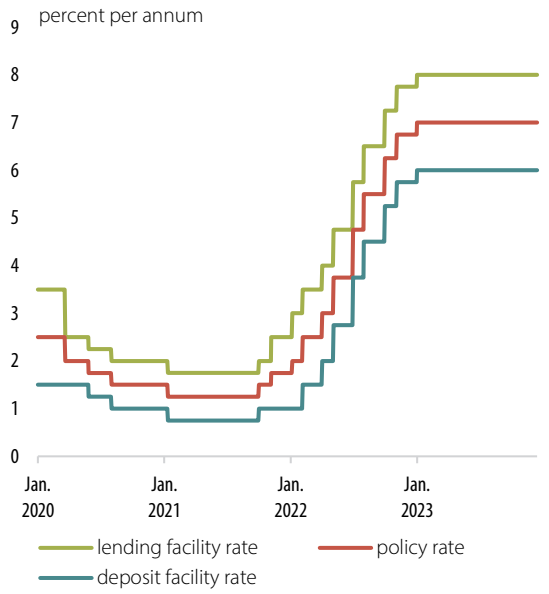
Source: NIS, NBR calculations

3. Monetary policy and financial developments

1. Monetary policy

In November 2023 and January 2024, the NBR kept the monetary policy rate at 7.00 percent and left unchanged the lending facility rate and the deposit facility rate at 8.00 percent and 6.00 percent respectively (Chart 3.1). Moreover, the central bank kept the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions at 8 percent and 5 percent respectively. The measures aimed to bring the annual inflation rate back in line with the 2.5 percent ±1 percentage point flat target on a lasting basis, *inter alia* by anchoring inflation expectations over the medium term, in a manner conducive to achieving sustainable economic growth.

Chart 3.1. NBR rates



The NBR Board decisions in November 2023 were taken in a context in which the annual inflation rate had continued to decline in September and in Q3 overall, as expected, thus remaining considerably above the variation band of the target. Moreover, the new assessments had reconfirmed the outlook for a further decrease in the annual inflation rate over the following two years, on a path that was higher than previously envisaged in 2024 and that would enter marginally into the upper half of the band at the end of the projection horizon.

Specifically, the 12-month inflation rate continued to drop in Q3 as well, in line with forecasts, albeit at a slower pace than in the previous quarters, going down to 8.83 percent in September from 10.25 percent in June, as the further sharp decreases in the dynamics of food and energy prices during this period were partly counterbalanced, in terms of impact, by the hike in fuel and medicine prices. In contrast, the annual adjusted CORE2 inflation rate saw a faster decline, falling visibly below the forecast to reach 11.3 percent in September, from 13.5 percent in June. This was driven by disinflationary base effects, downward adjustments in some commodity prices, particularly of agri-food items, as well as by the measure to temporarily cap the mark-ups on basic food products starting August, coupled with the influences of a plentiful crop domestically. Nevertheless, the developments also reflected a weaker pass-through of higher corporate costs, especially wage costs, into consumer prices,

amid the slowdown in consumer demand, as well as a lower inflationary impact of imports.

At the same time, the updated medium-term forecast reconfirmed the prospects for a further fall in the annual inflation rate over the next two years, on a higher-than-previously-envisaged path in 2024 and slightly lower afterwards. Specifically, the annual inflation rate was anticipated to shrink to 7.5 percent in December 2023, similarly to the prior forecast, but to go up at the onset of 2024, before declining gradually to 4.8 percent at end-2024 (versus the previously-projected 4.4 percent) and to 3.3 percent at the end of the projection horizon, in the upper half of the variation band of the target[27].

Behind the step-up in the annual inflation rate at the beginning of 2024 stood the impact anticipated to be exerted by the increase and introduction of some indirect taxes and charges aimed at furthering budget consolidation. At the same time, the overall action of supply-side factors was expected to become disinflationary again afterwards, mainly under the influence of base effects and the downward adjustments of some commodity prices, especially of agri-food items.

The balance of risks to inflation stemming from supply-side factors remained, however, tilted to the upside, both in the short run and over the longer horizon, given the effects potentially generated by the changes in direct taxes and by the removal of some tax breaks, as well as the possible additional tax increases called for in the future by the budget consolidation process.

Underlying inflationary pressures were expected to be only somewhat stronger in 2023 H2 than in the previous forecast, softening visibly faster afterwards, before fading away entirely towards the end of the projection horizon. Behind this stood the prospects for a relatively abrupt contraction of excess aggregate demand starting 2023 Q3, implying that the output gap would enter negative territory towards end-2024 – some quarters earlier than previously anticipated[28]. Furthermore, the dynamics of unit labour costs were seen halting their upward path at end-2023 and then embarking on a downward course, somewhat higher, however, than in the prior projection.

Notable uncertainties and risks further stemmed, nevertheless, from the future fiscal and income policy stance, given the recent actions aimed at containing budget expenditures in 2023 and the possible broadening over the next years of the package of corrective fiscal and budgetary measures – *inter alia* in light of the commitments made under the excessive deficit procedure and the conditionalities attached to other agreements signed with the EC –, but also the potential implications of the new legislation on pensions and wages in the public sector.

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27 Against 3.5 percent anticipated previously for the same moment of reference.

28 As economic growth was expected to lose visibly more momentum in 2023 than previously anticipated, amid high costs, the shrinking external demand and the monetary policy stance, before rebounding only slightly in 2024, yet more steeply in 2025, given the budget consolidation, but also the stronger absorption and use of EU funds under the Next Generation EU instrument.

Sources of significant uncertainties and risks to the prospects for economic activity, implicitly the medium-term inflation developments, remained also the war in Ukraine and the Middle East conflict, as well as the absorption of EU funds, especially those under the Next Generation EU programme. To these added the uncertainties and risks stemming from the below-expectations performance of European economies.

According to subsequently-released statistical data, the annual inflation rate posted a faster-than-expected decrease in the first two months of 2023 Q4, falling to 6.72 percent in November, under the impact of new slowdowns in the dynamics of food and energy prices, as well as following the decline in fuel prices, amid lower crude oil prices. In turn, the annual adjusted CORE2 inflation rate saw its downtrend steepen more than anticipated, shrinking to 9.1 percent in November, against the background of more widespread disinflationary base effects, downward adjustments in agri-food commodity prices and the measure to cap the mark-ups on basic food products, but also amid the slower dynamics of import prices.

Economic growth slowed down significantly in Q3[29], yet to a lower extent than anticipated, which made it likely for excess aggregate demand to narrow more moderately over this period compared to expectations. In year-on-year comparison, the GDP advance gained marginal momentum[30], remaining modest from a historical perspective, as the change in inventories increased its already very large contractionary impact and the contribution of general government consumption became slightly negative. Gross fixed capital formation saw, however, a re-acceleration in its annual growth to double-digit readings, while private consumption posted a pick-up after the stagnation in the previous quarter. At the same time, net exports continued to exert a larger expansionary impact, given the further widening, during this period too, of the positive differential between the annual dynamics of exports of goods and services, in terms of volume, and those of imports, amid the latter falling more visibly into negative territory. Consequently, the trade deficit saw a renewed slightly faster annual decline, whereas the current account deficit posted further a significant year-on-year narrowing, albeit somewhat more modest than in Q2, given the slower pace of improvement in the primary income balance, on account of reinvested earnings.

Looking at the labour market, recent data and surveys indicated a mild easing of tensions on the market. Specifically, the number of employees economy-wide stopped its monthly increase in September-October, while the steady job vacancy rate in Q3, after its plunge in the previous three months, was associated with a relative stability of the ILO unemployment rate, which persisted into the first two months of Q4. Additionally, employment intentions over the very short horizon declined at a faster pace in 2023 Q4, while the labour shortage reported by companies narrowed significantly, largely reversing the rise seen in the previous quarter. At the same time, the double-digit annual dynamics of average gross nominal wage earnings increased at a slower pace in Q3 too, posting however a re-acceleration in October, under the impact of the hike in the gross minimum wage, while the annual growth rate of unit

29 To 0.9 percent from 1.6 percent in the previous quarter.

30 To 1.1 percent versus 1.0 percent in Q2.

labour costs continued to decline slowly in industry in July-October and witnessed a drop in Q3 in the economy as a whole.

On the financial market, the main interbank money market rates posted new slight declines in the first part of November 2023, before remaining relatively stable, while yields on government securities rose abruptly in mid-Q4, but resumed and steepened their decrease afterwards, in line with developments in advanced economies and in the region. This occurred amid investors' revised expectations on the timing of the Fed's decision to start the interest rate cutting cycle, with an impact on global risk appetite as well.

Against this background, but also given the still high relative attractiveness of investments in domestic currency, the EUR/RON exchange rate remained fairly stable in November and December 2023 as well. Moreover, in relation to the US dollar, the leu strengthened during both months, as a result of the former's gradual weakening on international financial markets in this period.

The annual growth rate of credit to the private sector halted its downtrend seen in the previous five quarters, posting mild pick-ups in October and November[31], as the new sizeable declines in the dynamics of the foreign currency component were more than offset by the re-acceleration of the pace of increase of credit in lei. Under the circumstances, the share of leu-denominated loans in credit to the private sector resumed its advance, climbing to 68.5 percent in November from 68.1 percent in September.

The assessments updated in this context reconfirmed the previous forecasts on very short-term inflation behaviour. Specifically, the annual inflation rate was expected to go up in January 2024 and then resume its gradual decline, on a lower path than that indicated in the November 2023 medium-term projection.

The near-term inflation outlook continued to be mostly attributable to supply-side factors, as the January 2024 step-up was driven by the increase and introduction of some indirect taxes and charges aimed at carrying on budget consolidation, while the subsequent fall in the inflation rate, on a relatively lower trajectory, was further primarily due to disinflationary base effects and downward corrections, beyond expectations in the recent period, of agri-food commodity prices and crude oil prices, alongside the decreasing dynamics of import prices.

Uncertainties and risks to this inflation outlook stemmed, however, from the full package of fiscal and budgetary measures implemented recently for underpinning the budget consolidation process, as well as from the measure to cap the mark-ups on basic food products, due to end in February 2024.

At the same time, the cyclical position of the economy was expected to exert more modest inflationary pressures than in the prior forecast, albeit easing more gradually over the near-term horizon, as the new assessments indicated for 2023 Q4 and

31 To reach 5.4 percent from 4.5 percent in September.

2024 Q1 overall a more solid-than-previously-projected economic growth, whose quarterly pace would slow down slightly versus 2023 Q3. The outlook rendered it likely for the positive output gap to narrow somewhat more moderately during this period than previously anticipated.

Uncertainties and risks to the outlook for economic activity, implicitly the medium-term inflation developments, continued to arise, however, from the war in Ukraine and the Middle East conflict, as well as from below-expectations economic performance in Europe, especially in Germany, but also from the absorption of EU funds, mainly those under the Next Generation EU programme.

Heightened uncertainties and risks to the forecasts stemmed, nevertheless, from the future fiscal and income policy stance, given the characteristics of the 2023 budget execution and the coordinates of the budget programme approved for 2024, as well as the implications of the new legislation on pensions and the wage dynamics in the public sector, which could call for prospective add-ons to the package of corrective fiscal and budgetary measures, *inter alia* amid the excessive deficit procedure and the conditionalities attached to other agreements signed with the EC.

The overall context warranted keeping the monetary policy rate unchanged, with a view to bringing the annual inflation rate back in line with the 2.5 percent ±1 percentage point flat target on a lasting basis, *inter alia* by anchoring medium-term inflation expectations, in a manner conducive to achieving sustainable economic growth.

Thus, the NBR Board decided in its meeting of 12 January 2024 to keep the monetary policy rate at 7.00 percent. Furthermore, it decided to leave unchanged the lending facility rate at 8.00 percent and the deposit facility rate at 6.00 percent. In addition, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions (8 percent and 5 percent respectively).

2. Financial markets and monetary developments

During 2023 Q4, the daily average interest rate on interbank transactions[32] fluctuated somewhat more visibly, shrinking marginally over the period as a whole, while longer-term rates on the interbank money market witnessed new mild declines in mid-quarter. The EUR/RON exchange rate remained relatively stable at the higher readings recorded towards end-Q3. The annual growth rate of liquidity across the economy regained momentum in October-November 2023, while that of credit to the private sector halted its downward trend, posting slight pick-ups in the first two months of Q4.

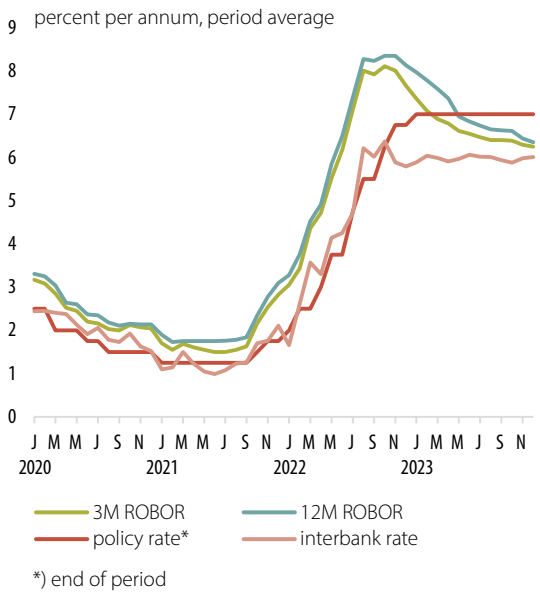
32 The average interest rate on transactions in deposits on the interbank money market, weighted by the volume of transactions.

2.1. Interest rates

The daily average interest rate on interbank money market transactions saw somewhat stronger fluctuations during 2023 Q4, falling relatively more frequently and more markedly below the lower bound of the interest rate corridor in the first half of the period. Thus, its quarterly average[33] shed 0.04 percentage points, to 5.96 percent.

Behind these developments stood primarily the behaviour of very short-term rates, amid the considerably wider liquidity surplus on the money market during this period[34], which the central bank further mopped up via the deposit facility[35].

Chart 3.2. Policy rate and ROBOR rates



The 3M-12M ROBOR rates tended to remain constant during Q4, except for mid-quarter, when they witnessed new mild declines[36], due *inter alia* to the performance of ON rates. Consequently, their quarterly averages went down further, albeit more slowly, reaching 6.31 percent for the 3M rate (down 0.11 percentage points), 6.38 percent for the 6M maturity (down 0.14 percentage points) and 6.48 percent for the 12M rate (down 0.20 percentage points) (Chart 3.2).

As for the domestic government securities market, the developments in long-term government bond yields in advanced economies remained, in Q4 as well, the prevailing factor. These yields saw a turning point in mid-October[37], reverting to a steeply downward path, under the impact of investors' considerably revised expectations on the timing of the Fed's decision to start the interest rate cutting cycle[38]. On the domestic front, the influence of this evolution weakened temporarily, however, given the adoption of the new law on the public pension system, with possible implications for the budget consolidation process.

Under the circumstances, medium- and long-term reference rates on the secondary market[39] halted their rise in the first 10-day period of October and then embarked

33 Weighted by the volume of transactions.

34 Under the impact of Treasury operations.

35 The average daily stock of these deposits increased to lei 40.5 billion in 2023 Q4 from lei 26.0 billion in the previous quarter.

36 Hitting 18-month lows in terms of daily readings.

37 They extended their upward course in October, amid investor expectations on the Fed keeping policy rates higher for longer, given the better-than-anticipated performance of the US economy. Under the circumstances, long-term (10-year) government security yields in the US peaked at a 16-year high in October. Concerns over the escalating geopolitical tensions in the Middle East were also relevant in terms of influence in the first part of October, even though they softened relatively quickly afterwards.

38 Amid the larger-than-expected decline in the inflation rate and the slower pace of economic growth, but also in light of the Fed's signals in the context of the monetary policy decision on 13 December 2023. Thus, 10-year government bond yields in the US fully corrected in November-December the rise accumulated during the previous four months.

39 Bid-ask averages.

Chart 3.3. Reference rates on the secondary market for government securities

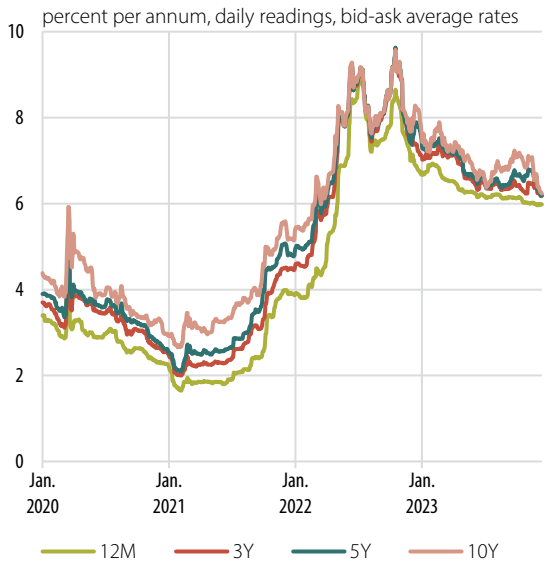
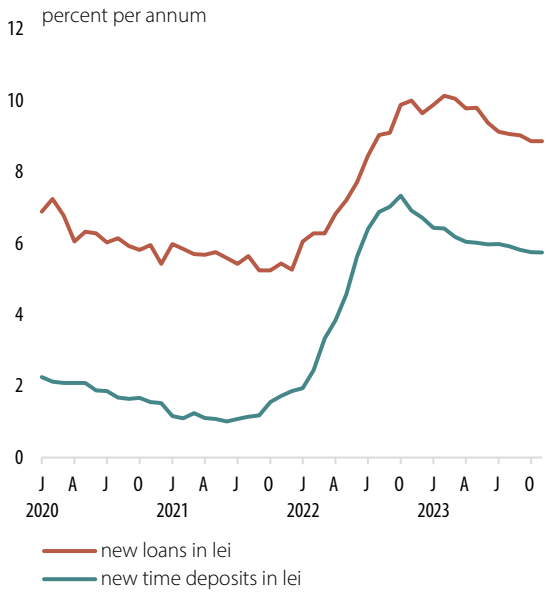


Chart 3.4. Bank rates



on a downward course, which reversed abruptly in mid-quarter, but resumed and steepened in December (Chart 3.3). Rates at the shorter end of the maturity spectrum tended to remain relatively stable during this period, witnessing however two episodes of mild decreases at end-October and in the first half of December[40]. Compared to the closing month of Q3, the monthly averages of these rates shrank visibly in December for the 10-year maturity (down 0.39 percentage points, to 6.46 percent), yet more moderately for 6- and 12-month securities (by 0.09 percentage points and 0.15 percentage points to 5.97 percent and 5.98 percent respectively) and only marginally for the 3- and 5-year maturities (to 6.30 percent and 6.40 percent respectively). Against this backdrop, the yield curve moderated its positive slope, reverting to a configuration close to that seen in mid-2023.

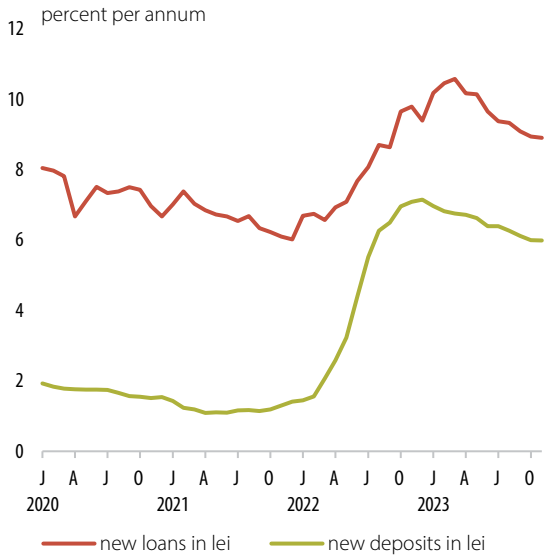
The average accepted rates on the primary market[41] recorded partly different developments during Q4. Specifically, they declined slightly in December versus the September readings for the 6-month maturity (to 6.04 percent) and more steeply over the longer maturities (to 6.45 percent for 7-year securities and to 6.37 percent for 10-year ones), but posted small increases for the 3-5 year maturities (to 6.57 percent and 6.68 percent respectively)[42]. The revival in December of investor appetite for this type of investments, compared with the first two months of the quarter, was also reflected by developments in the ratio of the amounts of bids submitted by primary dealers to the announced volume at MF auctions, as well as in the ratio of the volume of issues to the announced volume by

40 Against this background, the daily values of government security yields hit in December the lowest readings for the past approximately 20 months across the entire maturity spectrum.

41 During Q4, the "Tezaur" programme saw the monthly issuance of government securities with 1- and 3-year maturities, at rates of (i) 6.25 percent and 7.10 percent respectively in October, (ii) 6.25 percent and 7.25 percent respectively in November, and (iii) 6.15 percent and 7.25 percent respectively in December. Moreover, in October and December, the MF issued government securities for households under the "Fidelis" programme, both in domestic currency, with 1- and 3-year maturities, at rates of 6.25 percent/7.10 percent in October and 6.10 percent/7.20 percent respectively in December, worth around lei 1.5 billion, and in euro, with 1- and 5-year maturities, at rates of 3.9 percent/5.3 percent in October and 4.0 percent/5.5 percent respectively in December, totalling about EUR 500 million. In addition, the MF issued on the domestic market EUR-denominated securities with 12-month and 2-year maturities, at rates of 4.18 percent and 4.50 percent respectively (in November), and 14-month and 3-year maturities, at rates of 4.11 percent and 4.50 percent respectively (in December), jointly worth approximately EUR 1 billion.

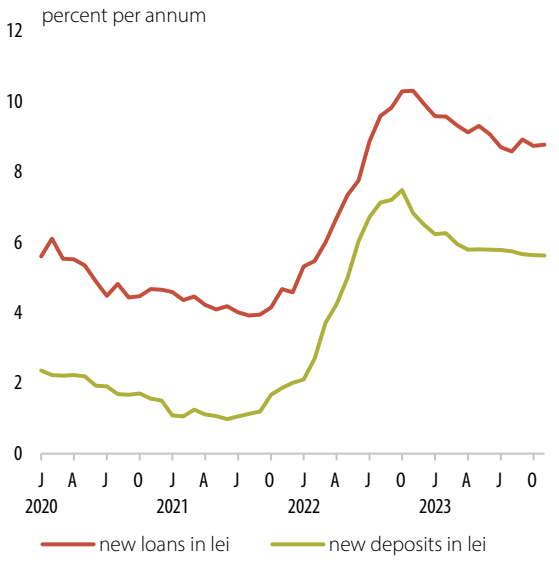
42 The auctions for 7- and 10-year securities were held in the second part of December, while the other tenders were carried out in the first half of the month.

Chart 3.5. Interest rates for households*



*) households and non-profit institutions serving households

Chart 3.6. Interest rates for non-financial corporations



the MF[43]. In terms of quarterly values, the two indicators decreased, however, slightly in Q4 against the previous three months (to 1.95, from 2.11, and 1.24 from 1.46 respectively). Under the circumstances, the total volume of securities issued in the closing three months of 2023 diminished visibly versus the previous quarter, to lei 16.8 billion, whereas the value of net issues increased to lei 9.7 billion, given the sizeable drop in the volume of maturing securities, to lei 11.1 billion[44].

Amid the mild decline in relevant interbank money market rates and the quasi-steady IRCC, the average interest rate on new loans to non-bank clients moderated its decrease October through November compared to the previous quarter (down 0.20 percentage points, to an average of 8.86 percent)[45], while the remuneration of new time deposits stuck to the slowly downward path, shedding 0.15 percentage points to 5.75 percent (Chart 3.4).

Developments were relatively similar across the major customer categories. Specifically, the average interest rate on new loans to households went down at a slower pace, i.e. 0.34 percentage points below the Q3 reading, to 8.93 percent. This was due to the quasi-halt in the downtrend of the average interest rate on new housing loans (-0.10 percentage points against Q3, to an average of 6.90 percent)[46] and to the slightly steeper downward path of the average interest rate on new consumer credit, which shrank 0.33 percentage points to 11.48 percent (Chart 3.5).

At the same time, the average interest rate on new loans to non-financial corporations stopped its downward course, increasing marginally October through November overall, to an average of 8.75 percent, amid diverging developments across the major types of loans (Chart 3.6). Specifically, the average interest rate on high-value loans (above EUR 1 million equivalent) went up for the first time in the past four quarters (+0.35 percentage points, to 8.33 percent), whereas that on low-value loans

43 The ratio of the amounts of bids submitted to the announced volume stood still in October and November (at around 1.7), but went up to 2.6 in December, while the ratio of the volume of issues to the announced volume remained quasi-constant during both months (at values marginally above 1) and rose to 1.74 in December.

44 They were concentrated in October, when government securities worth lei 10.5 billion matured.

45 In terms of monthly developments, it continued to go down slightly in October and then held steady.

46 The monthly values of the indicator stood still in both October and November.

(below EUR 1 million equivalent) declined further at a pace similar to the one seen in Q3 (-0.20 percentage points, to 8.96 percent).

Chart 3.7. Nominal exchange rate

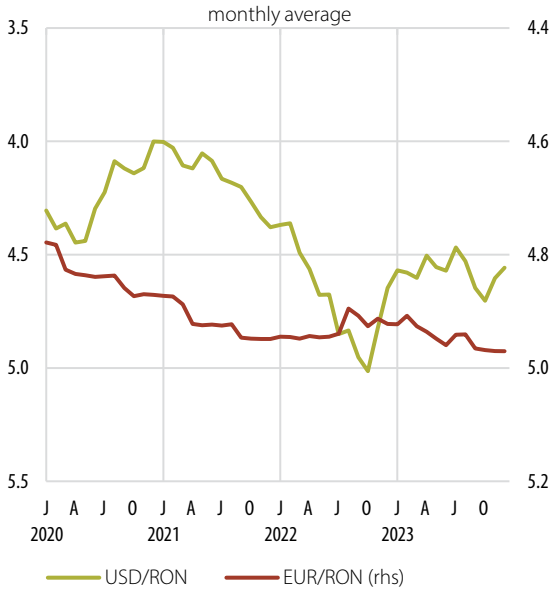
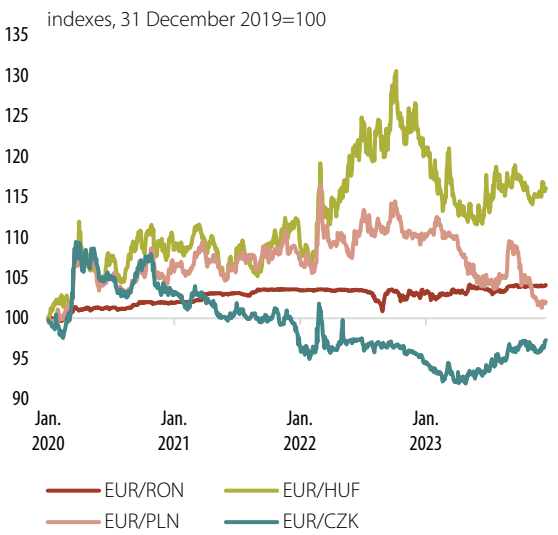


Chart 3.8. Exchange rate developments on emerging markets in the region



Source: ECB, NBR

Looking at new time deposits, the average remuneration continued to decrease slowly in the case of both households (-0.27 percentage points versus Q3, to 5.99 percent) and non-financial corporations (-0.10 percentage points, to an average of 5.63 percent).

2.2. Exchange rate and capital flows

The EUR/RON exchange rate remained relatively stable in 2023 Q4 at the higher readings recorded towards the end of the previous quarter (Chart 3.7).

The EUR/RON quasi-stabilised in October, amid the divergent influences stemming, on one hand, from the deterioration of the global risk appetite – under the impact of expectations on the Fed keeping policy rates higher for longer[47] and of the conflict that broke out in the Middle East – and, on the other hand, from the consolidation of expectations on the near-term outlook for the NBR's monetary policy rate in a regional context. The exchange rates of the major currencies in the region posted mixed developments during this month[48], reflecting the strong action of local factors.

Global financial market sentiment improved again in November, against the backdrop of the larger-than-envisaged decline in the inflation rate in advanced economies and the corresponding revision of investor expectations on the prospects for major central banks' key rates. The EUR/RON exchange rate remained, however, at the relatively higher readings, given the adoption of the new law on pensions domestically, with possible consequences on the pace of budget consolidation, as well as amid the halt in the trade balance improvement trend against the same year-earlier period. Hence, EUR/RON developments diverged from those of the exchange rates

47 Given the higher-than-anticipated growth of the US economy.

48 Specifically, the Czech koruna depreciated further vis-à-vis the single currency, as the sharper-than-anticipated drop in the annual inflation rate fuelled expectations on the central bank starting to cut the monetary policy rate in the forthcoming period. At the same time, the forint and the zloty recovered the ground lost in the previous month, amid the improved prospects for accessing EU funds, underpinned in Poland by the outcome of parliamentary elections as well.

versus the euro of the major currencies in the region, which resumed or continued their downward course in November (Chart 3.8).

The relative stability of the leu's exchange rate extended until end-Q4, amid the Fed's new signal on the future monetary policy stance[49], conducive to a strengthening of the favourable global financial market sentiment, but also in the context of uncertainties about the prospects for fiscal consolidation. Looking at the regional financial market, the zloty continued to appreciate versus the euro, whereas the forint and the Czech koruna depreciated slightly, *inter alia* amid the monetary policy decisions taken by the respective central banks in December.

In relation to the US dollar, the leu halted the previous months' weakening trend in October and then appreciated in nominal terms. This occurred as the US currency stopped its strengthening trend on international financial markets at the onset of Q4 and depreciated against the euro in November-December, amid a more pronounced revision of investor expectations on the Fed's prospective monetary policy stance and an improvement in global risk appetite.

Table 3.1. Key financial account items

EUR million

	11 mos. 2022			11 mos. 2023		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	8,843	22,971	-14,129	14,789	24,354	-9,565
Direct investment	2,126	10,421	-8,295	948	7,222	-6,274
Portfolio investments	947	5,593	-4,646	54	14,514	-14,460
Financial derivatives	348	x	348	229	x	229
Other investment	202	6,957	-6,755	756	2,618	-1,862
– currency and deposits	-1,767	2,046	-3,812	867	-461	1,328
– loans	-52	2,053	-2,104	-165	833	-998
– other	2,021	2,858	-839	54	2,246	-2,192
NBR's reserve assets, net	5,219	0	5,219	12,801	0	12,801

*) "+" increase/"-" decrease

During Q4 overall, the interbank forex market turnover increased significantly from the previous period, while the overall foreign currency deficit widened, given the balance of residents' transactions (Table 3.1).

In the closing quarter of the year, the domestic currency weakened against the euro by 0.1 percent in nominal terms[50,51] and strengthened 0.7 percent in real terms. In relation to the US dollar, the leu appreciated 2.0 percent in nominal terms and 2.8 percent in real terms, given the former's weakening versus the euro. Looking at the average annual exchange rate dynamics, the leu steepened its depreciation against the euro and diminished significantly its appreciation vis-à-vis the US dollar.

2.3. Money and credit

Money

The annual growth rate of broad money (M3) regained momentum to 10.6 percent October through November 2023 from 8.9 percent in 2023 Q3, given that, after the

49 In the communication associated with the monetary policy decision of 13 December, the Fed Chair suggested that further policy rate increases became less and less likely and indicated that the FOMC meeting had discussed potential rate cutting paths. The ECB, in its turn, signalled the end of the current key rate hiking cycle, but also the keeping in place of a more restrictive stance of monetary policy.

50 Based on the September and December exchange rate averages respectively.

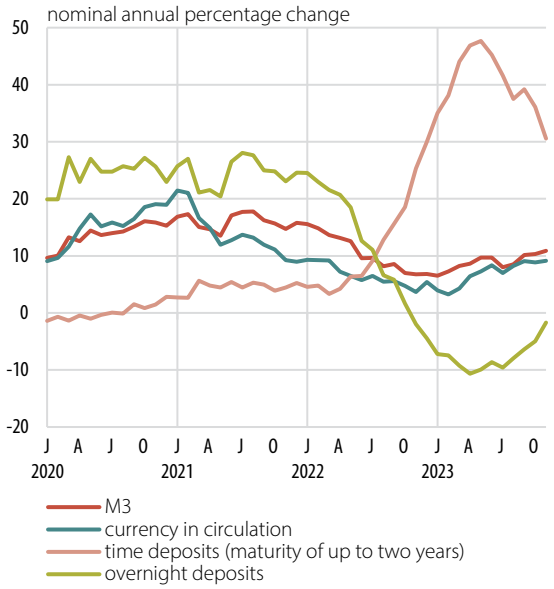
51 During the same period, the Czech koruna depreciated 0.4 percent against the euro, whereas the forint and the zloty strengthened 1.2 percent and 6.1 percent respectively.

Table 3.2. Annual growth rates of M3 and its components

nominal percentage change

	2022	2023				
	IV	I	II	III	Oct.	Nov.
	quarterly average growth					
M3	6.9	7.3	9.3	8.9	10.3	10.9
M1	-0.1	-5.1	-5.6	-4.0	-1.5	1.1
Currency in circulation	4.6	3.8	7.4	8.1	8.9	9.1
Overnight deposits	-1.6	-8.0	-9.7	-8.0	-5.0	-1.7
Time deposits (maturity of up to two years)	24.6	39.1	46.6	39.4	36.1	30.5

Chart 3.9. Main broad money components



step-up in September, it continued to rise, albeit more slowly, in correlation with the characteristics of budget execution (Table 3.2).

The pick-up in M3 dynamics was driven by the most liquid component of broad money (M1), which nearly halted its decline from the same year-ago period[52], given the significantly faster increase in leu-denominated overnight deposits, as well as following the slower decrease in foreign currency-denominated overnight deposits, primarily on the non-financial corporations segment (Chart 3.9).

By contrast, time deposits with a maturity of up to two years reduced their particularly fast dynamics for the second quarter in a row, amid a further substantial deceleration in the growth of the leu-denominated component, accompanied by the decline, for the first time in the last year and a half, in the annual change in foreign currency deposits (expressed in euro). Nevertheless, the share of M1 in M3 continued to narrow, to 60.8 percent in November (a 5-year low) from 61.6 percent at end-2023 Q3.

The breakdown by holder shows that the step-up in M3 dynamics was mainly ascribable to the re-acceleration in the increase in corporate deposits, in correlation with the rise in receipts from EU funds[53] and with the slight rebound in retail trade and market services to households. In turn, the annual rate of change of household deposits included in M3 further went up, amid the leap recorded by the dynamics of real disposable income – particularly due to higher wages and income from social security[54] –, but also as a result of the slowdown in the growth of households' holdings of government securities.

From the perspective of M3 counterparts, the stronger momentum was in line particularly with the evolution of net credit to central government, as well as with that of the banking system's net foreign assets, whereas the contribution of credit to the private sector to M3 dynamics stopped its downward trend from the previous five quarters and held steady.

52 Its annual dynamics returned to positive territory in November, after staying for 12 months in negative territory.

53 According to the monthly data on public spending for projects financed from non-repayable external funds (from the general government budget execution).

54 On account of financial aid payments to some categories of pensioners.

Chart 3.10. Credit to the private sector by currency

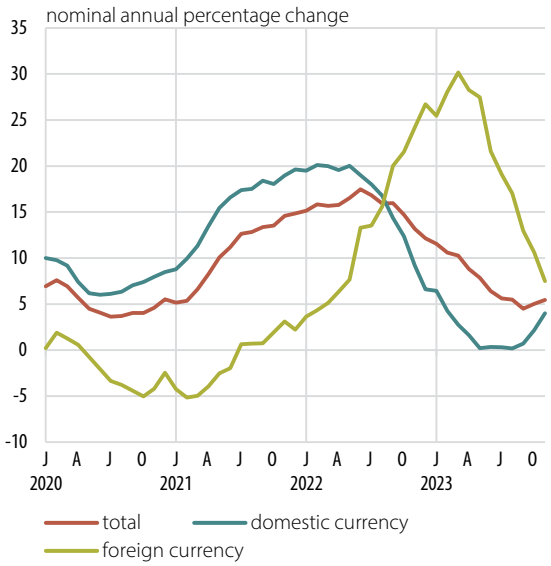
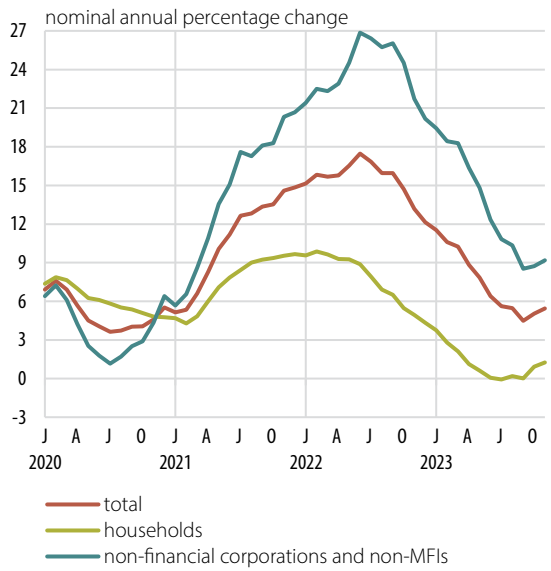


Chart 3.11. Credit to the private sector by institutional sector



Credit to the private sector

The annual growth rate of credit to the private sector halted its downtrend from the previous five quarters, posting mild pick-ups in October and November 2023. However, its average remained flat for the period overall, at 5.2 percent, given that the renewed increase in the dynamics of the leu-denominated component, after six quarters of ongoing loss of momentum, was offset, in terms of impact, by the further sharp decline in the dynamics of the foreign currency-denominated component (Chart 3.10). Therefore, the share of leu-denominated loans in credit to the private sector resumed its advance, to reach 68.5 percent in November from 68.1 percent in September.

Developments were relatively similar across the major institutional sectors (Chart 3.11). Specifically, the annual dynamics of household loans returned to positive territory, following the re-acceleration in the growth of the leu-denominated component – after six quarters of continuous slowdown –, strongly supported by consumer credit and other loans, as well as by housing loans, given that the annual dynamics of the flows of both types of credit increased significantly[55]. By contrast, the annual decline of households' foreign currency loans (expressed in EUR) deepened, almost solely on the back of developments in housing loans.

In turn, the annual dynamics of loans to non-financial corporations halted their decrease and returned to a slight upward path in October. In the first two months of 2023 Q4 as a whole, these saw a quasi-standstill, however, given the opposite influences coming, on the one hand, from the growth rate of leu-denominated loans re-entering positive territory – mainly due to medium- and long-term loans, and in spite of the relatively modest contribution of government support programmes – and, on the other hand, from the further swift loss of momentum of foreign currency loans.

55 Assessment based on the volume adjusted for renegotiation operations.

4. Inflation outlook

The annual CPI inflation rate is expected to continue its overall downward trend almost throughout the projection interval. Compared to the sharp declines seen in 2023, disinflation will progress at a significantly slower pace in 2024 and 2025, so that the annual headline inflation rate will reach the upper bound of the variation band of the central target (3.5 percent) only at the forecast horizon, i.e. 2025 Q4. CPI disinflation will be driven chiefly by core inflation, which is anticipated to fall continuously over the projection interval, yet more gradually in 2025 in particular. Having benefited from extremely favourable base effects over the preceding year, the exogenous components of the CPI basket will temporarily reverse their contribution to disinflation in 2024 Q1, but will resume it in Q2, albeit to a much lower extent than recently. Under these conditions, the annual CPI inflation rate is projected to stand at 4.7 percent at the end of this year and 3.5 percent at end-2025. Compared to the November 2023 *Inflation Report*, the updated path is lower until the end of this year (more significantly until 2024 Q3, only -0.1 percentage points in December), owing to more favourable developments in 2023 Q4, which will be persisting for four quarters in the annual rate of the indicator. Starting in the first quarter of 2025, however, mainly amid the upward revision of the output gap, the annual growth rate of CPI is foreseen to be slightly higher (+0.3 percentage points in 2025 Q3, the horizon of the previous forecast).

At the current junction, marked by the recent heightening of geopolitical tensions, the balance of supply-side risks to the expected annual inflation rate remains tilted to the upside against the path in the baseline scenario. Nevertheless, in the event of such risks materialising, the sluggish global economic activity is envisaged to exert a chiefly disinflationary traction.

1. Baseline scenario

1.1. External assumptions

Compared to the previous *Report*, the outlook for trading partners' economic activity has worsened overall. The short-term forecast points to only slightly positive quarterly rises in external demand (EU effective GDP) in 2023 Q4 and 2024 Q1, amid factors such as restrictive financial conditions, underperformance of exports (given the loss of competitiveness as the euro strengthened vis-à-vis the US dollar), and weak confidence. Thereafter, growth in economic activity is expected to pick up, amid the gradual improvement in the real income of households and the advance in external demand. The average annual dynamics of EU effective GDP was revised slightly downwards for 2024, due to the persistent effects of weaker quarterly growth in the

Table 4.1. Expected developments in external variables

	annual averages	
	2024	2025
EU effective GDP growth (%)	0.9	1.5
Euro area annual inflation (%)	2.6	2.2
Euro area annual inflation excluding energy (%)	2.7	2.4
Annual CPI inflation rate in the USA (%)	2.9	2.3
3M EURIBOR (% p.a.)	3.3	2.4
USD/EUR exchange rate	1.09	1.13
Brent oil price (USD/barrel)	77.4	72.9

Source: NBR assumptions based on data provided by the European Commission, Consensus Economics and Bloomberg

latter part of 2023 and amid projected lower rates of increase during 2024; revisions in the same direction of economic growth were carried out for 2025 as well (Table 4.1).

The deviation of effective external demand was reassessed slightly upwards, including for recent quarters, amid favourable revisions of data series (particularly in 2023 H1). Despite upward adjustments of the indicator over the short term, the slightly weaker expected performance of EU effective GDP in 2024 means that the external output gap at the end of this year converges to the values estimated in the previous *Inflation Report*. The EU effective GDP gap is envisaged to remain in negative territory until the forecast horizon and to exert a restrictive impact, which is seen abating as from mid-2024, on the domestic output gap.

The euro area average annual inflation rate (HICP) was revised downwards for 2024 (-0.6 percentage points against the previous *Report*), based on recent historical data on energy prices in particular, but also on lower energy futures prices. Specifically, the indicator is projected this year to come in at 2.6 percent and next year at 2.15 percent, which is very close to the figure in the previous *Report*. The quasi-stagnant dynamics in early 2024 are ascribable to softer fiscal stimuli and to base effects associated with energy prices. Subsequently, the decline in the inflation rate mirrors the abating cost pressures and the effect of the ECB's further tight monetary policy. The annual inflation rate is foreseen to reach the ECB's 2 percent benchmark no earlier than 2025 Q3, similarly to the previous forecasting round.

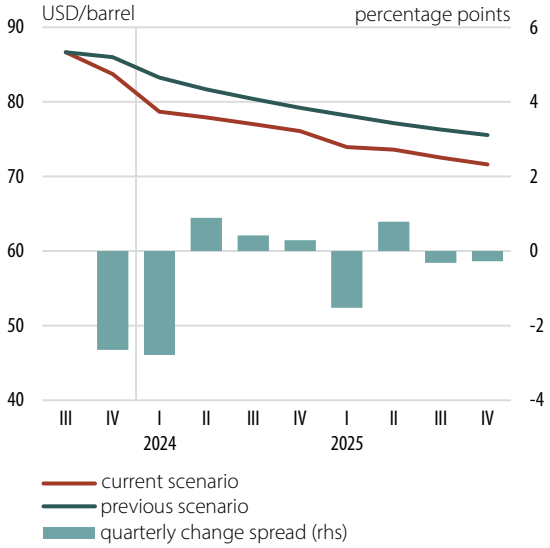
Compared to the previous *Report*, the forecast of euro area HICP inflation excluding energy[56] was revised marginally downwards to 2.7 percent for 2024 (by -0.1 percentage points) and mildly upwards to 2.4 percent (by +0.2 percentage points) for 2025. Looking by quarter, it will follow a downward track, albeit on a somewhat sharper slope in the short run than headline inflation, also as a result of the recent gradual fade-out of favourable base effects related to past increases in energy prices. The pay rises in the euro area are seen playing an important part in the evolution of this indicator amid the still tight labour market. Wage pressures are anticipated, however, to ease over the next two years. In the medium term, profit margins, which widened markedly in 2022, are expected to mitigate the pass-through of labour costs to final prices of goods and services. At the projection horizon, the HICP inflation rate excluding energy will run slightly above headline inflation (2.3 percent compared to 2 percent).

Having posted a new advance in positive territory in 2023 Q4, the nominal 3M EURIBOR rate is foreseen to fall gradually over the projection interval. In turn, the real 3M EURIBOR rate is expected to remain in positive territory, following however a

56 A measure of core inflation.

downtrend throughout the forecast interval. Hence, it will exert a restrictive impact on the euro area economy, albeit stronger in the short term, owing mainly to the more favourable-than-anticipated inflation rate and, implicitly, the downward revisions to inflation expectations.

Chart 4.1. Brent oil price scenario



Source: U.S. Energy Information Administration, NBR assumptions based on Bloomberg data

The path of the EUR/USD exchange rate continues to be surrounded by broad uncertainty. For 2024 H1, the euro appears set to strengthen slightly vis-à-vis the US dollar. This trend is envisaged to carry on, amid expectations regarding the ECB's and the Fed's monetary policy.

The scenario for the Brent oil price is based on futures prices and foresees a moderately downward path in view of the prospective slowdown in global economic activity. Specifically, at the forecast horizon, the Brent oil price is projected at around USD 72/barrel (Chart 4.1). On the demand side, concerns about worsening global economic conditions prevail over the short and medium term, thus containing expectations of stronger oil demand. On the supply side, the main influences are seen to come from the rise in global crude oil inventories, on the one hand, and, on the other hand, from fears about the escalation of the Middle East conflict, fuelling concerns about potential disruptions to oil supplies from the region. At the same time, over the near run at least, developments in crude oil prices could be affected by fast-changing weather conditions, which have recently brought about low temperatures across Europe. The oil price projection is thus further fraught with elevated uncertainties, also corroborated by the high volatility of the historical data series.

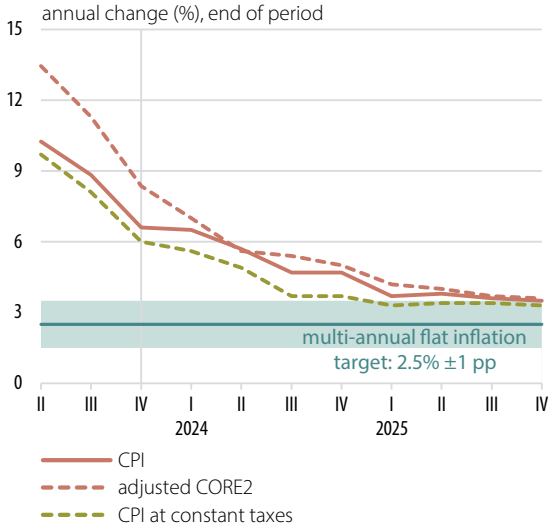
1.2. Inflation outlook

Following a significant decline of 2.2 percentage points in 2023 Q4, the CPI inflation rate is estimated to have witnessed a short-lived upswing in January 2024. This was mainly due to increases in indirect taxes (VAT rates and excise duties[57]), to the changes in the corporate tax regime[58], and the unfavourable base effects associated particularly with the fall in electricity prices in January 2023, amid the extension of the price capping scheme. Subsequently, the annual CPI inflation rate will stay on a downward path almost throughout the projection interval, yet the pace of disinflation is projected to ease markedly as from mid-2025 (Chart 4.2). The return of CPI inflation to the upper bound of the variation band of the target is expected no earlier than at

57 Excise duties on tobacco and fuels were raised (amid the expiry of the temporary facility capping the motor fuel excise duty to the minimum level Europe-wide in 2023) and an excise duty on sugary non-alcoholic beverages was introduced, their cumulative impact on the CPI coming in at 0.5 percentage points in January (and at 0.2 percentage points in February – assuming a phased-in pass-through for tobacco products). Moreover, the VAT rate increased from 9 percent to 19 percent for certain sugary foods, and from 5 percent to 19 percent for a number of recreational and sporting activities, with a 0.2 percentage point cumulative impact on the annual CPI rate in January.

58 The contribution to the CPI inflation rate is assessed at approximately 0.1 percentage points.

Chart 4.2. CPI and adjusted CORE2 inflation forecasts



Source: NIS, NBR projection

the projection horizon, i.e. 2025 Q4. Specifically, the forecasted values for end-2024 and end-2025 are 4.7 percent and 3.5 percent respectively. The total contribution of changes in indirect taxes to the annual CPI inflation is assessed at 0.9 percentage points at end-2024, before shrinking to 0.2 percentage points at end-2025, the annual inflation rate at constant tax rates re-entering the variation band of the target as early as 2025 Q1, when it is foreseen to reach 3.3 percent (Chart 4.2).

Similarly to the previous forecasting round, CPI disinflation will be mainly driven by developments in core inflation, which is seen declining throughout the projection interval, yet at a slower pace in 2025 (Chart 4.2), remaining above the variation band of the target and exceeding headline inflation. After benefiting from highly favourable base effects over the course of last year, the exogenous components[59] of the consumer basket will temporarily reverse their contribution to CPI disinflation in 2024 Q1, before resuming it as of Q2, albeit at a much more subdued pace compared to recent trends. The overall annual dynamics of exogenous components are anticipated to return inside the variation band of the target in 2025 (except for Q2).

Compared to the previous baseline scenario, the annual CPI growth rate released by the NIS was significantly lower in December 2023[60] (-0.9 percentage points), given the more favourable developments in prices for processed foods and fuels. This led, *inter alia*, to a revision of the forecasted trajectory of the annual CPI inflation rate for 2024. Starting 2025 Q1, the updated path of CPI inflation is revised upwards compared to the previous *Report*, mainly on the back of slightly higher projected values of core inflation. Specifically, the upward revision is of -0.1 percentage points at end-2024 and +0.3 percentage points in 2025 Q3 (the previous forecast horizon).

Table 4.2. CPI and adjusted CORE2 inflation in the baseline scenario

annual change (%), end of period

	2024				2025			
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4
Target (mid-point)	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	6.5	5.7	4.7	4.7	3.7	3.8	3.6	3.5
CPI projection*	5.6	4.9	3.7	3.7	3.3	3.4	3.4	3.3
Adjusted CORE2 projection	7.0	5.6	5.4	5.0	4.2	4.0	3.7	3.6

*) calculated at constant taxes

In turn, the annual core inflation rate fell at a faster pace in 2023 Q4, from 11.3 percent in September to 8.4 percent in December. Subsequently, it is expected to remain on a continuously downward path until the forecast horizon. However, the correction will be more gradual and significantly slower next year, the indicator being seen to decline by 3.4 percentage points in 2024, to 5 percent in December 2024 and by merely 1.4 percentage points in 2025,

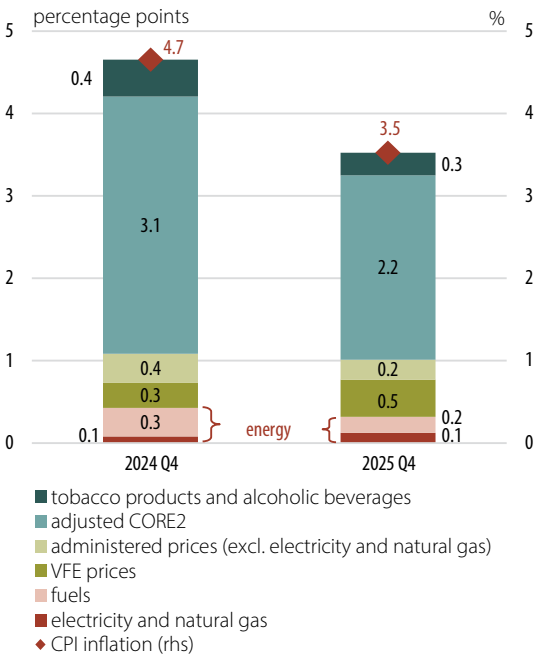
59 The components of administered prices (including electricity and natural gas prices), volatile food prices (VFE), prices of fuels, tobacco products and alcoholic beverages are considered exogenous to the scope of monetary policy.

60 Box 2 assesses the accuracy of NBR projections for the annual CPI inflation rate at end-2023.

to 3.6 percent in December 2025, standing marginally above the variation band of the central target (Chart 4.2, Table 4.2).

Over the projection interval, the pass-through of the favourable influences visible along food value chains is expected to carry on (as reflected by developments in producer prices in the food industry). Moreover, the persistent impact of the hikes in firms' production costs, other than wage costs, will continue to fade out gradually. For wage costs, this process is anticipated to be slower, given the recent step-up in the pace of wage growth (fuelled, *inter alia*, by new raises in the minimum wage), the accommodation of higher wage costs entailing also a progressive correction of corporate profit margins. These developments are underpinned by the projected narrowing of the output gap (more visible in 2024), so that the pass-through of costs into final prices will be supported to an increasingly lesser degree by demand conditions. At the same time, starting from elevated levels, financial analysts' inflation expectations follow a downward track, yet standing above the variation band of the target, including at longer horizons, yet mainly on account of the current and future fiscal policy stance. The annual growth rate of import prices will decline in the first part of 2024, stabilising thereafter, in line with the projected dynamics of euro area HICP inflation excluding energy. In early 2024, the rise in indirect taxes and the change in the corporate tax regime[61] will slightly mitigate the fall in core inflation.

Chart 4.3. Components' contribution to annual CPI inflation rate*



*) end of period; values have been rounded off to one decimal place

Source: NIS, NBR projection

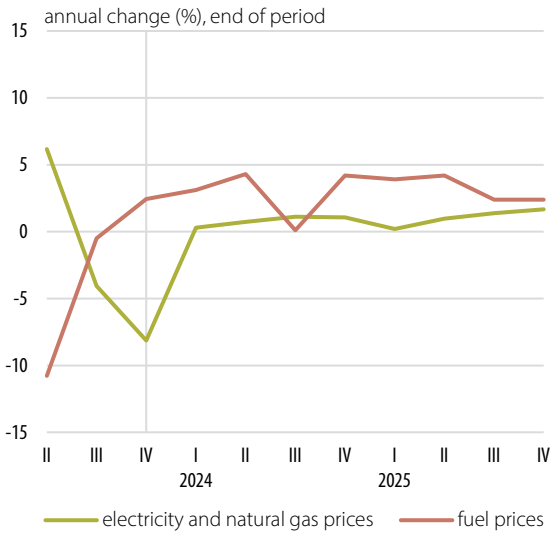
Compared to the previous round, the annual adjusted CORE2 inflation rate stood lower at end-2023 and was revised downwards for 2024, but upwards for 2025. The significant downward revision (of around 1 percentage point) until 2024 Q3 is due to the much better-than-anticipated performance of food prices over the recent period. This owes to the transmission of disinflationary influences along the production chain, concurrently with the implementation and, subsequently, the extension by the authorities of the application period of the measure to cap the mark-ups on basic food products and the broadening of the food categories covered by the capping scheme. This influence will fade out, being counterbalanced in 2025 by the projection of the output gap at positive, only marginally smaller values (in contrast to the negative values seen in the earlier round). Moreover, an impact in the same direction, albeit weaker, will be exerted by the upward revision of inflation expectations and of imported goods inflation. Against this backdrop, the updated forecast for annual adjusted CORE2 inflation was revised downwards by 0.2 percentage

61 The estimated impact is of around 0.3 percentage points for indirect taxes and 0.2 percentage points for the change in the tax regime.

points for December 2024 and upwards by 0.4 percentage points at the horizon of the previous projection, i.e. 2025 Q3.

The cumulative contribution of the exogenous components of the consumer basket to the annual CPI inflation rate is projected at 1.5 percentage points at end-2024 and at 1.3 percentage points at the projection horizon (December 2025), accounting for 33 percent[62] and 37 percent, respectively, of the annual inflation rate (Chart 4.3). The values for end-2024 and 2025 Q3 (the horizon of the preceding forecast) remained unchanged from the previous *Report*.

Chart 4.4. Inflation of fuel prices and of electricity and natural gas prices



Source: NIS, NBR projection

Table 4.3. Inflation of CPI exogenous components

annual change (%), end of period

	Dec. 2023	Dec. 2024	Dec. 2025
Energy prices	-3.2	2.7	2.0
Fuel prices	2.4	4.2	2.4
Electricity and natural gas prices	-8.1	1.1	1.7
VFE prices	6.7	5.1	7.5
Administered prices (excl. electricity and natural gas)	14.3	4.8	3.2
Tobacco products and alcoholic beverages prices	8.3	5.6	3.5

Source: NIS, NBR projection

After returning to positive territory at end-2023, the annual rate of change of fuel prices is anticipated to run above the central target throughout most of 2024, as well as in 2025 H1 (Chart 4.4, Table 4.3). This is chiefly attributable to the announced two-phased increase in the excise duty[63] this year, set for January and July. For the remainder of the projection interval, the annual dynamics of fuel prices are seen declining to values inside the variation band of the target, owing to the fading out of the impact of the second phase of the excise duty hike, as well as to the favourable trend in oil futures prices. The trajectory of the annual fuel price growth was revised significantly downwards for 2024. This was due to the change in the implementation of the new excise duty regime, with an impact in 2024 H1 (a single-phase excise duty increase was assumed in the previous projection, planned for January 2024), as well as to the recent correction in international oil prices, a trend expected to continue in the period ahead. For 2025 Q3 (the horizon of the previous forecast), the annual growth rate of fuel prices also witnessed a downward, yet marginal revision.

The annual pace of increase of electricity prices is forecasted to stay in positive territory throughout both 2024 and 2025, running below the central inflation target (Chart 4.4, Table 4.3). This trend is shaped, until end-March 2025, by the effect of the price capping scheme for household consumers and, subsequently, by the assumption of no further shocks leading to significant changes in energy

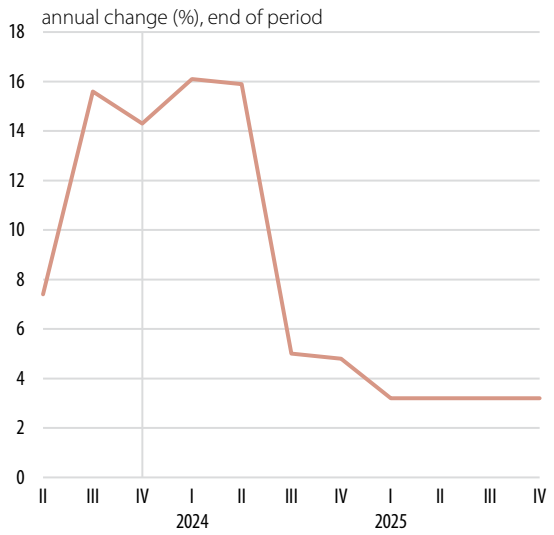
62 This figure has not changed significantly from the previous projection. Compared to the average for the 2021-2022 period, which displayed high volatility in global energy markets, induced by both the pandemic shock and the unfavourable effects associated with Russia's invasion of Ukraine, the share of inflation components exogenous to the scope of monetary policy is twice as low, and this trend is expected to persist over the entire projection interval.

63 A 34 percent increase, following the expiry of the temporary facility introduced by Government Emergency Ordinance No. 16/2022, setting the motor fuel excise duty to the minimum level Europe-wide in 2023. The impact of the higher excise duty is 4.5 percentage points on the fuel price inflation and 0.4 percentage points on the CPI inflation rate.

prices. Compared to the November 2023 *Inflation Report*, the path of the electricity price dynamics was revised upwards over most of the projection interval. From 2024 until end-March 2025, the revisions come from the updated technical assumptions on the shares of consumers in the three consumption brackets defined under the capping scheme. For the end of 2025, the revision is marginal. In the case of natural gas prices, given the price capping ordinance, the assumptions on a rather steady path until March 2025, when the measure expires, remained valid. Subsequently, in the absence of relevant information, the baseline scenario includes minor monthly changes for both electricity and natural gas prices, assuming a relative stabilisation of the energy markets at that horizon.

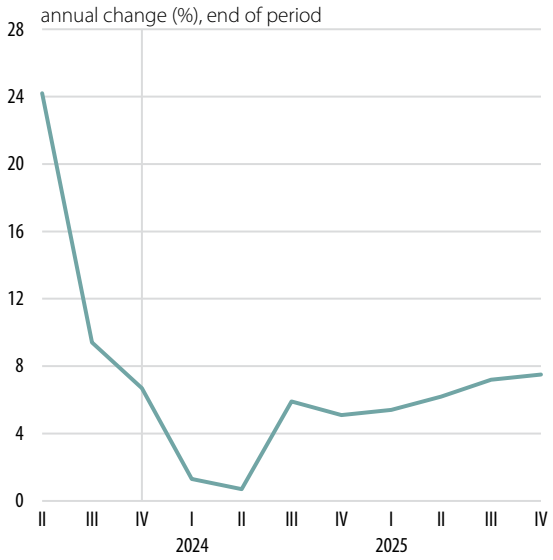
The exogenous scenario for administered prices, other than electricity and natural gas[64], foresees a significant slowdown, from two-digit annual growth rates in 2024 H1, to single-digit values over the remainder of the projection interval (Chart 4.5, Table 4.3). Behind the disinflationary path stands primarily the dropping out of the annual rate calculation of the significant price increase of prescription medicinal products in August 2023. Compared to the previous *Inflation Report*, the annual growth rate of administered prices was adjusted upwards for 2024, chiefly amid the recent hike in prices of water, sewerage, sanitation services. However, for 2025, its trajectory is foreseen close to that shown in the previous round, based on the historical pattern of changes to the prices of the main items in this group.

Chart 4.5. Administered price inflation (excl. electricity and natural gas)



Source: NIS, NBR projection

Chart 4.6. VFE price inflation



Source: NIS, NBR projection

The annual pace of increase of volatile food prices (VFE) is expected to embark on a downward path until 2024 Q2 (Chart 4.6, Table 4.3). This owes mainly to the more modest rises in vegetable prices over the recent period, on the back of larger crops on the domestic front and across the major trading partners, as well as of the favourable effects associated with Government Emergency Ordinance No. 67/2023

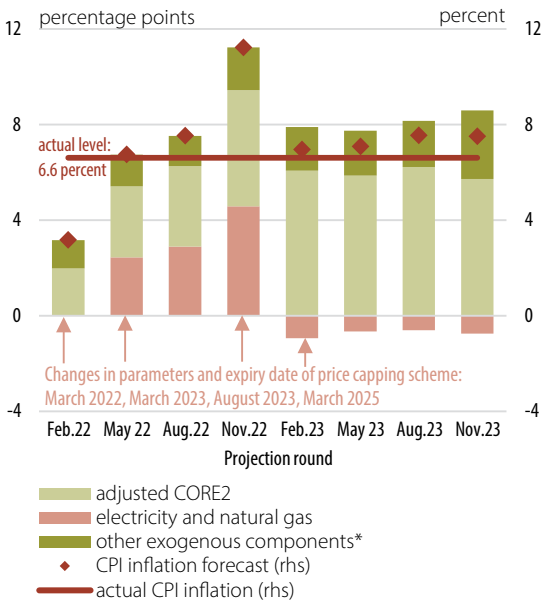
64 The main items included in this group are heating, water, sewerage, sanitation services and medicines.

on capping mark-ups. Over the remainder of the projection interval, the annual growth rate of this group is projected to pick up gradually, reflecting the assumption of normal agricultural years[65]. Nevertheless, it should be noted that the forecast for this component depends almost entirely on weather conditions, which have recently become highly unpredictable. Compared to the previous round, the levels for December 2024 and for the preceding projection's horizon were revised only marginally upwards.

The path of the annual growth rate of tobacco product and alcoholic beverage prices is shaped primarily by higher excise duties provided for in the legislation, but also by the behaviour of companies in this field as regards the final price adjustment. The annual dynamics of this group are anticipated to decelerate until 2025 Q1, before stabilising inside the variation band of the target over the remainder of the forecast horizon (Table 4.3). The projection was revised marginally upwards for end-2024, while for September 2025 it remained unchanged.

Box 2. Assessment of the accuracy of macroeconomic forecasts on the December 2023 annual CPI inflation rate[66]

Chart A. Forecasts on the December 2023 annual CPI inflation rate – breakdown by CPI components



*) administered prices excluding electricity and natural gas, volatile prices (of vegetables, fruit, eggs, fuels), prices of tobacco products and alcoholic beverages

Source: NIS, NBR projections

This Box is part of the annual exercise designed to assess the accuracy of NBR projections on the annual CPI inflation rate at the end of the prior year, i.e. December 2023 in this case. The December 2023 annual CPI inflation rate was subject to eight forecasting rounds corresponding to the *Inflation Reports* published February 2022 through November 2023. Except for the February 2022 round, the projected values ran above the actual level (6.6 percent), indicating mainly overestimations.

The first part of 2022 was marked by the shock wave sent by the outbreak of the Russia-Ukraine war to commodity markets, particularly energy and agri-food markets, whose effect overlapped with that of the energy crisis that emerged in mid-2021[67]. The rise in production costs reflected in substantial increases in inflation rates worldwide[68] and implicitly in the inflation forecasts made after the onset of the war (in the NBR's case, starting with the May 2022 projection round). With a view to containing the negative effects of energy market

65 Relative to their multiannual averages.

66 Forecast errors are defined as the difference between the forecast and the actual outcome, a positive value representing an overestimation and a negative value an underestimation.

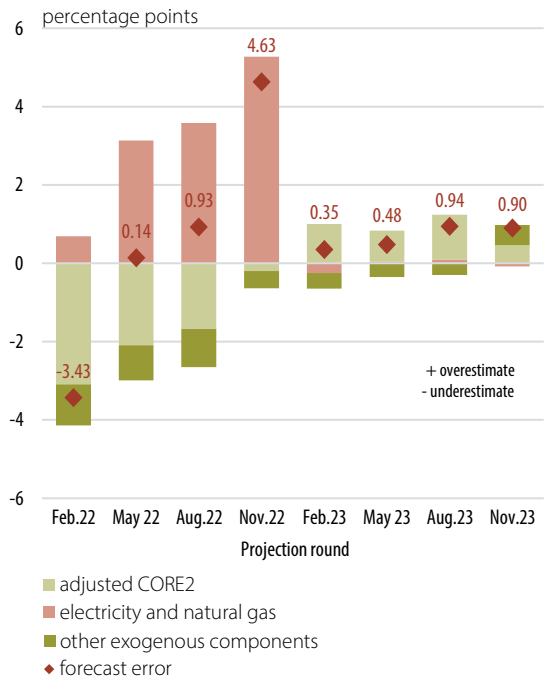
67 The energy crisis broke out against the background of disruptions in supply chains in the pandemic context.

68 On the domestic front, the annual CPI inflation rate more than doubled (rising from 8.2 percent to 16.8 percent) between December 2021 and November 2022, when the disinflationary cycle started.

developments on household consumers, the Romanian government introduced, on 1 November 2021, support schemes aimed at capping and compensating final electricity and natural gas prices, which were subsequently amended several times. Apart from the broadly favourable revision of the conditions for beneficiaries, the changes also referred to the extension of the applicability period (the expiry month of the scheme was postponed successively from March 2022 to March 2023, August 2023 and March 2025 in the current version). These provisions were incorporated into NBR forecasts at the time they were enacted into law, in line with the standard practice of including in the baseline scenario solely information that is certain (Chart A).

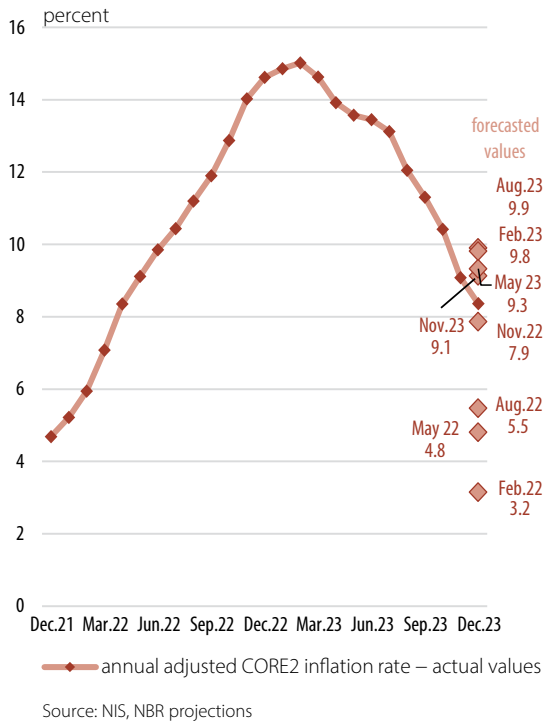
At the same time, the "Risks associated with the projection" section in *Inflation Reports* constantly emphasised the high uncertainty surrounding the future configuration of support schemes for household consumers, while the November 2022 *Inflation Report* included an impact estimation of an extension of the scheme in force at that time, which resulted in a 4.1 percentage point lower CPI growth rate at end-2023 as compared with the forecast at that moment. Under the circumstances, the contribution of the electricity and natural gas component to the forecast errors for the December 2023 annual CPI inflation rate (Chart B) declined significantly, to near zero, starting with the February 2023 projection round, when the set of information available at the time the forecast was prepared included the information on the support scheme being extended until 31 March 2025 (versus 31 August 2023 in the previous legal provision).

Chart B. Forecast errors for the December 2023 annual CPI inflation rate – breakdown by CPI components



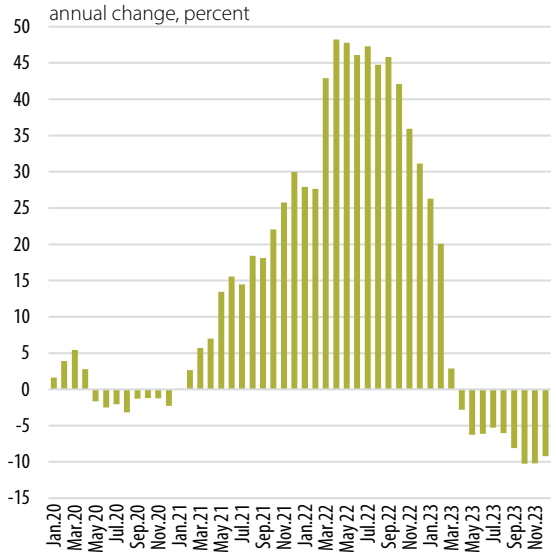
Source: NIS, NBR projections and calculations

Chart C. Annual adjusted CORE2 inflation rate – historical developments and forecasted values for December 2023



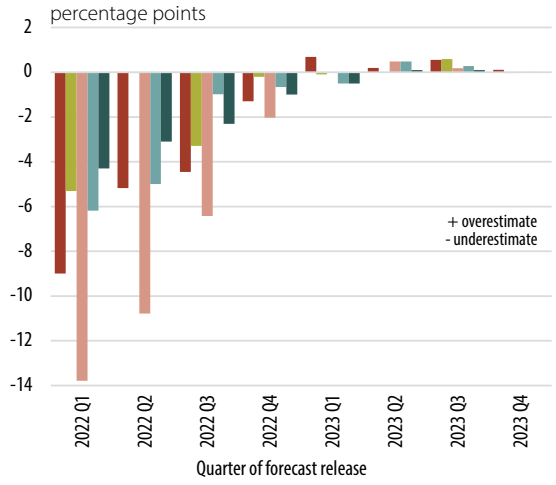
Source: NIS, NBR projections

Chart D. Agricultural producer price index



Source: ECB (farm-gate and wholesale market prices)

Chart E. Some central banks' forecast errors for the core inflation rate*, annual average in 2023



*) indicator with a specific scope defined by each central bank

**) Poland releases only three forecasts per year (March, July, November)

***) taking into consideration the average value of the forecast interval

Source: websites of central banks and of national institutes of statistics, NBR calculations

Alongside the electricity and natural gas component, the adjusted CORE2 index made an important contribution to explaining forecast errors. Over the first five forecasting rounds under review, the projections on the December 2023 annual adjusted CORE2 inflation rate were subject to successive upward revisions (Chart C), amid the sizeable increases in corporate costs driven by the developments in commodity markets, particularly agri-food markets (Chart D). Once commodity prices stabilised and, subsequently, embarked on a downward path, the forecast errors for this component declined markedly, the underestimation trend in the course of 2022 being followed by a much more moderate overestimation trend in absolute terms during 2023, *inter alia* amid the measures to cap the mark-ups on some basic food products. The pattern of errors for the core inflation component is relatively similar to that in the forecasts made by the ECB and other central banks in the region (Chart E).

The contributions of the other CPI components to the forecast errors for the December 2023 annual CPI inflation rate were much smaller. Fuel prices tended to be overestimated over the eight projection rounds under review, amid lower-than-expected oil price dynamics at end-2023 (concerns about worsening global economic conditions contained the adverse effects of heightening geopolitical tensions). The overestimation of fuel prices was more than offset by the underestimation, except for the November 2023 forecasting round, of administered prices (excluding electricity and natural gas), under the impact of the August 2023 hikes in medicine prices due to the update in the National Catalogue of Prices of Prescription Medicinal Products for Human Use. Volatile food prices (VFE) and prices of tobacco products and alcoholic beverages made marginal contributions to the forecast errors under analysis.

1.3. Demand pressures in the current period and over the projection interval

Output gap

According to the NIS Press Release No. 12 of 12 January 2024, in 2023 Q3 real GDP growth lost momentum in quarterly terms, reaching 0.9 percent. However, this deceleration was slower than that forecasted in the previous *Report*, amid the higher-than-expected contributions coming from both domestic demand and net exports.

Near-term forecasts point to a slowing quarterly rate for real GDP in 2023 Q4 compared to Q3, against the backdrop of mixed signals coming from high-frequency indicators[69]. Thus, favourable influences were shaped by: (i) the continued robust pace of investment, reflected in the historically high values of net foreign direct investment inflows, (ii) the rebound in trade and market services (after a previously weaker performance), bolstered by lower inflation and the wage rises across the economy (including the minimum wage hike as of 1 October 2023), as the turnover volumes of the two sectors conveyed relevant signals in this respect in the first two months of the quarter, (iii) the improved economic agents' confidence according to the DG ECFIN survey, along with signs of temporary easing of uncertainty to historical average levels. Conversely, less favourable signals came from: (i) the further declines in domestic[70] and external industrial production in October and November 2023, (ii) the still fragile path of external demand, (iii) a certain resurgence of the bottlenecks in global supply chains, also amid extreme weather conditions and geopolitical tensions, and (iv) the increase in the restrictiveness of real monetary conditions, in the context of an ongoing gradual pass-through of monetary policy decisions.

For 2024 Q1, quarterly economic growth is expected to benefit from the favourable paths of consumption (due to the rise in real disposable income, including the public wage bill and social transfers) and investment (in particular the construction activity, but also the equipment component)[71]. However, the factors that stood behind the slowdown in real GDP dynamics at the end of last year are envisaged to linger in 2024 Q1 as well, and adding to these are signals of rising uncertainty, given the escalation of the Middle East conflict.

For 2023, similarly to the prior *Report*, the baseline scenario of the macroeconomic projection foresees a slowdown in economic activity versus the previous year. The real GDP deceleration to values in the vicinity of 2 percent mirrored the inflationary environment, the still high uncertainty from a historical perspective, the weakening of external demand and the effects of fiscal consolidation and of the

69 Looking at a wider range of unconventional high-frequency indicators, signals have been mixed as well. Favourable ones came from the number of company and freelancer registrations, the value of rejected debit payment instruments and the Google searches for the keyword "crisis", while unfavourable signals were sent by electricity consumption, the number of nights spent at tourist accommodation establishments and the Google searches for the keyword "unemployment".

70 Against the background of structural weakness in the sector, marked by a level of production still below that recorded in 2019.

71 For details regarding the signals conveyed by a series of conventional high-frequency indicators, see Chapter 2 –"Economic developments", section "Demand and supply" in this *Inflation Report*. As for the unconventional indicators available for January 2024, most of them hinted at an improvement in the economic environment. Among these are the Google searches for the keywords "gas" and "crisis" and the VIX and Sentix indices.

decisions implemented in the context of the past monetary policy normalisation. For the current and following year, GDP dynamics are expected to gradually pick up on the back of the fading out/reversal of the influences from the aforementioned factors, except for real monetary conditions (having an increasingly restrictive nature up to the middle of the forecast interval, before becoming quasi-steady, also amid further disinflation). Moreover, a positive contribution to economic growth, albeit slightly diminishing compared to previous periods, is envisaged to come from turning European funds from multiple sources to good account, a process which has already recorded some delays in its pace of absorption[72].

The breakdown shows that, throughout the forecast interval, the real GDP path is shaped by domestic demand. For 2023[73], the economic slowdown may be attributed to a moderation in final consumption dynamics, while GFCF is assessed to have significantly increased its contribution to growth. Starting this year, final consumption is projected to become again the main driver of economic growth (due to a slightly accelerating trend), whereas the GFCF contribution is likely to be below that of last year, yet still robust (under the assumption of European funds absorption and foreign direct investment inflows). The contribution of net exports to GDP advance is assessed to have been positive in 2023 as a whole (a one-off case over the past decade), but it is projected to turn slightly negative again as of 2024, amid a pick-up in the growth rate of imports of goods and services close to the projected annual dynamics of exports.

The average annual dynamics of potential GDP are projected to post robust values over the projection interval, slightly gaining momentum in the current year, mainly due to capital accumulation. However, compared to the previous *Report*, this indicator's growth rate was slightly revised downwards, mainly towards the end of the forecast interval.

Amid the notable developments in investments in the domestic economy over recent years, as well given their expected further resilient path, capital stock will remain the key driver of potential GDP growth. In this context, both foreign direct investment and European funds, which are important funding sources for gross fixed capital formation, play a decisive role. Nonetheless, as regards the disbursements under the Next Generation EU programme, there is a number of risks to smooth progress and completion by 2026, primarily due to the delays recorded so far in the absorption of amounts. At the same time, swift investment dynamics also lead to a rise in the efficient use of production factors, which means a significant contribution is made by total factor productivity (the TFP trend). The contribution of labour is envisaged to remain positive (but visibly lower than those of the other two factors), reflecting, on the one hand, the prospects for a higher number of employees, and on the other hand, the anticipated unfavourable demographic developments in Romania[74], in particular the rather fast-paced decline in the working-age population. The persistent adverse effects triggered by increases in commodity prices remain relevant to

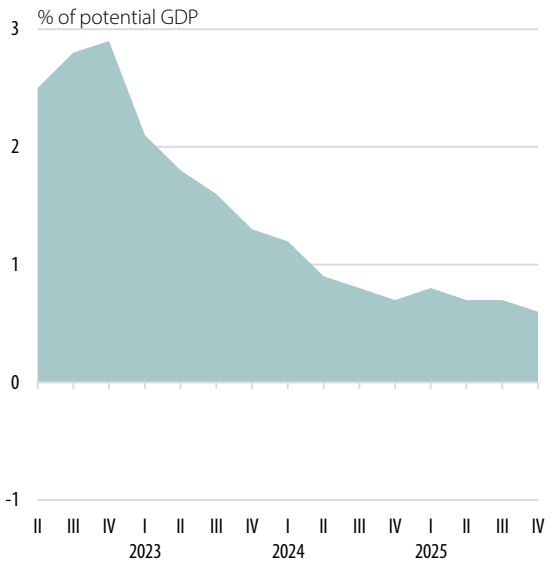
72 The Multiannual Financial Framework 2021-2027, the Next Generation EU programme (2021-2026).

73 The contribution of the change in inventories, a component with limited economic content, is assessed to be negative and high throughout 2023, suggesting uncertainties regarding the composition of GDP growth and potentially significant revisions of statistical data series in the future.

74 However, they could be mitigated in the event of favourable net labour migration flows.

potential GDP, alongside the geopolitical tensions that give rise to uncertainty regarding the smooth functioning of global production and distribution chains.

Chart 4.7. Output gap



Source: NBR assessments based on data provided by the NIS

The downward path of the output gap assessed for 2023 (at the end of which the indicator stands close to the value in the previous *Report*[75]) continues in 2024 as well, but it will be much softer compared to the prior *Report*. Thus, at the end of this year, the indicator is projected to be mildly positive (versus the marginally negative value in the past forecast). Subsequently, further progress in correcting excess demand would be extremely limited during 2025 (Chart 4.7)[76].

The persistently positive values of the output gap over the medium term are mainly driven by the revised impact of the fiscal impulse on the economy, both for the current and next year. They reflect the materialisation of some risks to the fiscal and income policy that have been highlighted in the previous *Report*, especially the already announced significant increases in pensions. Similarly to the previous projection, among the output gap fundamentals, monetary policy remains countercyclical throughout the forecast interval, while the external demand deficit (with a narrowing impact on the domestic output gap) is seen to gradually close until the forecast horizon.

Aggregate demand components

Following last year's slowdown, final consumption growth is anticipated to rebound over the forecast period[77]. The developments in the component are supported by the swift rise in real disposable income, which benefits from the measures taken by the authorities to boost income earnings[78], and also from the gradual decline in inflation throughout the projection interval. However, the path of final consumption is further surrounded by a number of uncertainties associated with the persistent effects of the war in Ukraine, as well as with other domestic and external risk factors, both of an economic and geopolitical nature.

Gross fixed capital formation is projected to post robust annual dynamics over the entire forecast interval (outpacing consumption), mainly subject to further

75 Compared to the previous *Report*, the recent pattern of the output gap is less volatile, mainly due to the revision of official statistical data and the revised impact of fundamentals.

76 From the perspective of aggregate demand components, the output gap path is shaped by those of domestic demand (with household individual consumption having the highest one over the forecast interval as a whole), whereas the aggregate gap of net exports is negative (mainly due to the gap of imports of goods and services).

77 However, for 2024, the *EY Consumer Index* (December 2023) shows a certain moderation trend in consumer behaviour as households are adapting to the increase in the cost of living, to which add this year's higher taxes and charges.

78 The measures that entered into force as of 1 January 2024 refer primarily to: (i) the raise in the state allowance for children, in the pension point and in the minimum pension; (ii) the hike in public sector wages, followed by an additional indexation in June. Other anticipated measures, with an impact over the entire forecast interval, are the increase in the minimum wage economy-wide (as of 1 July 2024), the pension recalculation (starting 1 September 2024) and the distribution of social cards.

EU funds disbursements from multiple sources, to the full implementation of budgeted investment projects by the authorities and to the pick-up in domestic and external activity. However, compared to the 2023 dynamics, the growth pace of the component is expected to be slightly slower, with the outlook for the indicator's path being strictly conditional on investor confidence. The Next Generation EU programme plays a key role in the investment financing process, yet it is lagging behind in terms of effective implementation of raised funds, given that allocations may be used only until the end of 2026. At the same time, the GFCF dynamics could also be hampered by potential cuts or adjustments made by private companies to their financial resources for investment, as a result *inter alia* of tighter lending conditions and tax reforms involving a series of increases in taxation, pursuant to the measures included in the fiscal consolidation package adopted in late 2023.

Trade flows are envisaged to recover in the current year, returning to robust annual rates. Nevertheless, they will be further governed by the still high uncertainty worldwide. Exports of goods and services could be affected by commodity price shocks, as well as by renewed bottlenecks in global supply chains, *inter alia* amid a possible escalation of tensions in the Middle East and extreme weather conditions (e.g. El Niño). These could have a significant impact on the freight transport logistics and thus on global prices. Moreover, the dynamics of unit labour costs are expected to remain relatively high in 2024 (albeit below the peak reached in 2023 domestically), with a likely negative effect on the price competitiveness of Romanian products. Nevertheless, the increase in ULC is projected to gradually abate over the medium term, until the forecast horizon, also amid the improvement in labour productivity growth, which could benefit from the resilient investment rate, for instance via the absorption of EU funds. After the 2023 decline, the dynamics of imports of goods and services are foreseen to rebound, reflecting the developments in domestic demand components and exports.

Following a relatively large decrease estimated for 2023 (around 2 percentage points of GDP), the current account deficit is projected to continue its adjustment trend this year as well, although at a considerably more subdued pace. By contrast, in 2025 the current account deficit is envisaged to temporarily pause its correction, reflecting the anticipated sluggish fiscal consolidation process. In this context, the current account deficit coverage by stable, non-debt-creating capital flows is anticipated to embark on a downward path over the projection interval. Capital transfers are foreseen to record a more modest performance, considering the end of the 2014-2020 Multiannual Financial Framework[79] and the possible persistence of a slow absorption of funds under the Next Generation EU programme, partially counterbalanced by the improvement, in the medium term, of the absorption via the Multiannual Financial Framework 2021-2027. In addition, the relatively fragile international macroeconomic environment, marked by the recent escalation of geopolitical tensions, and the persistent twin deficits in Romania's economy are likely to lead to a slowdown in direct investment inflows. However, these are anticipated to

[79] Moderate inflows are anticipated to occur in 2024 as well under the 2014-2020 Multiannual Financial Framework, based on the payment requests submitted in 2023, the last year for eligible expenses. Similar developments were also noted in the case of the 2007-2013 Multiannual Financial Framework.

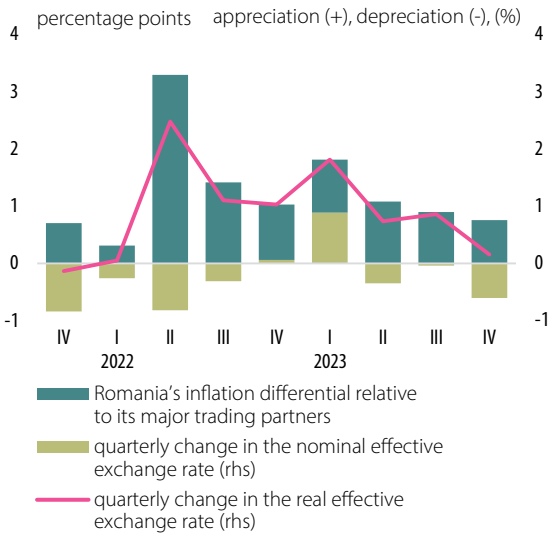
remain higher (expressed in absolute nominal terms) than those recorded in the pre-pandemic period.

Broad monetary conditions

According to the transmission mechanism, broad monetary conditions capture the cumulative impact exerted on future developments in aggregate demand by the real interest rates applied by credit institutions on leu- and foreign currency-denominated loans and deposits of non-bank clients, and by the real effective exchange rate of the leu. The exchange rate exerts its influence via the net export channel, as well as via the effects on the wealth and balance sheets of economic agents.

The baseline scenario of the projection envisages an increase in the restrictiveness of real broad monetary conditions over the current year and a continuation of this trend in the latter half of the forecast interval as well. This will occur amid a gradual pass-through into the economy of the monetary policy decisions made by the NBR Board, which aim to bring the annual inflation rate back in line with the target on a lasting basis, *inter alia* via the anchoring of inflation expectations over the medium term, in a manner conducive to achieving sustainable economic growth.

Chart 4.8. Quarterly change in the effective exchange rate



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

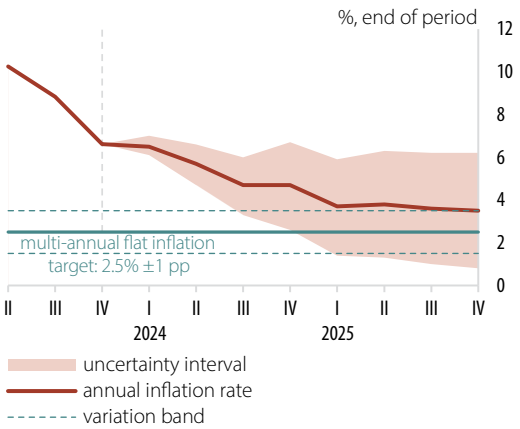
Looking by component, real interest rates on both new loans and new time deposits in lei are anticipated to see a gradual fade-out in their stimulative influence, before reaching close-to-neutral cumulative values towards the end of the projection interval. This reflects the pass-through of monetary policy decisions to nominal interest rate dynamics, along with a downward trend of inflation expectations. The real effective exchange rate (Chart 4.8) is foreseen to exert a restrictive impact via the net export channel until the forecast horizon. The contribution of the real effective exchange rate is estimated in the context of a further appreciation trend of the domestic currency in real terms, associated with the prevailing effect of the higher domestic inflation rate compared to those of Romania's trading partners.

In its turn, the wealth and balance sheet effect is assessed to further post restrictive values, albeit slightly diminishing throughout the projection interval. The breakdown shows that its dynamics mainly reflect the downward path of the real foreign interest rate (3M EURIBOR), given the gradual decline of the nominal rate, the effect of which is partly offset by the falling inflation expectations in the euro area. At the same time, the sovereign risk premium is projected to have an increasingly larger restrictive influence over the coming quarters, mainly reflecting the imbalances associated with the twin deficits in the economy. The dynamics of the leu's real effective exchange rate gap via the wealth and balance sheet effect are seen to exert a quasi-neutral impact.

2. Risks associated with the projection

The balance of risks to the annual inflation rate is assessed to remain tilted to the upside compared to its path in the baseline scenario, in light of the multitude of potential adverse supply-side factors (Chart 4.9). At the current juncture, with the growing sources of geopolitical tensions, the associated risks engendering a mainly inflationary traction have intensified considerably. Downward pressures on inflation could stem, however, from a weakening in global economic activity.

Chart 4.9. Uncertainty interval associated with inflation projection in the baseline scenario



Note: The uncertainty interval was calculated based on the annual CPI inflation forecast errors in the NBR projections during 2005-2023. The magnitude of forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR calculations and projections

So far, the economic impact of the conflict in the Middle East has been limited. Nevertheless, the recent involvement of non-state actors (e.g. Yemeni Houthi rebels) and the possible further escalation of tensions in the area could have relatively far-reaching consequences. Thus, the attacks in the Red Sea, a major sea route connecting Asia and Europe (via the Suez Canal), have already led to a transformation of the traditional shipping lanes. Should these tensions persist, the additional costs incurred by companies, as well as the logistics issues could feed through into higher final prices of goods, thereby causing new inflationary bouts. At the same time, one cannot rule out the risk of a possible blockage of the Strait of Hormuz, a critical chokepoint through which oil covering more than 20 percent of the daily global consumption is transported; such an event would seriously disrupt the smooth functioning of energy markets and generate strong inflationary pressures, especially through rising oil prices.

Upside risks to energy prices are also associated with the implementation of the policies designed to combat climate change. Recently emerged sources of risk refer to the decisions of the US authorities, with possible adverse effects on the volume of exports of liquefied natural gas, also used to reduce the dependence of European economies on gas imports from Russia. Domestically, new turmoil in energy markets would be temporarily mitigated by the validity, until 31 March 2025, of the scheme designed to compensate and cap electricity and natural gas prices. However, depending on the nature and magnitude of a potential adverse shock on energy markets, keeping this scheme in place until the expiry date could trigger an increase in the compensatory costs that need to be settled by the authorities, hence putting pressure on the current parameters of the compensation scheme.

Negative supply-side shocks could also stem from sources independent of geopolitical conflicts. New bottlenecks in global value chains could be induced by adverse weather conditions, especially in the event of an increased incidence of extreme weather events. Thus, the persistence and intensity of the El Niño phenomenon, with potential adverse effects on food production, are particularly relevant. In the longer run, risks are also associated with climate change and related

mitigation measures. The potential adoption of more restrictive industrial policies aimed at a fast-paced green transition are also likely to lead to a stronger inflationary trend.

In parallel, disinflationary pressures coming from demand-side factors are increasingly likely to materialise. With the mounting tensions and the emergence of new sources of geopolitical risks, the uncertainty about the global outlook is expected to rise, possibly dampening economic activity. Therefore, poor economic developments such as those recently recorded by Germany, Romania's main trading partner, could extend over longer periods of time, denting, *inter alia* Romania's economic growth. Aggregate demand could also shrink as a result of further fragmentation of international trade, especially in the event of an escalation of Sino-American tensions. Overall, given the fragile international economic environment, the future calibration of monetary policy by major central banks and those in the region will be among the decisive factors in response to possible large-scale shocks.

On the domestic front, the future fiscal and income policy stance remains a significant source of uncertainty surrounding the inflation outlook, considering that the recent values of the budget deficit make its compliance with the initial targets under the excessive deficit procedure unlikely. Over the medium term, a potential insufficiency of consolidation measures already in place could call for the introduction of a new adjustment package, a possibility also envisaged by the authorities. This risk increased considerably after the adoption of the new pension law, as the recalculation of pensions involves large-scale government spending. However, at this juncture, the nature, magnitude and applicability of new measures are unknown and this implicitly leads to a significant degree of uncertainty about the future evolution of the annual inflation rate compared to the path in the baseline scenario. By contrast, in 2024, given the tight electoral calendar, the risk of adopting new expansionary measures persists, the most relevant referring to wages, which could bring about a new easing of budget constraints as compared to the trajectories foreseen in the latest version of the Fiscal Strategy.

Disruptions in the orderly fiscal correction process could adversely impact the sovereign rating and could complicate the smooth adjustment of macroeconomic imbalances, *inter alia* through inflationary bouts generated by potential offsetting adjustments via the exchange rate. At the same time, the regulations on the 2021-2027 cohesion policy and the Recovery and Resilience Facility provide for the possibility of partial suspension of European funds to Member States unless they have taken effective measures to correct the excessive deficit. In this context, uncertainties are also attributed to the implications of the new configuration of the economic governance framework[80] for Romania's excessive deficit procedure, as the revision of the EU's fiscal rules was agreed at the end of 2023 at the meeting of the Economic and Financial Affairs Council of the European Union (ECOFIN).

80 The legislative process for the new fiscal rules will be concluded after negotiations with the European Parliament. While the deficit and public debt thresholds are kept in place (at 3 percent of GDP and 60 percent of GDP respectively), alongside a minimum annual structural adjustment of 0.5 percent of GDP required under the excessive deficit procedure, the new governance framework focuses on the sustainability of public debt. Member States will submit to the Council medium-term fiscal-structural plans (for a 4-year period, with the possibility of an extension to 7 years), calibrated so as to comply with a net expenditure indicator.

The effectiveness of the fiscal measures adopted by the authorities also depends on the adjustment behaviour of economic agents to the set of measures implemented. Depending on the time in the business cycle when the fiscal measures are signed into law, on their nature (direct taxes, indirect taxes, measures to the rationalise budget expenditure, etc.), as well as on the period of applicability, they could influence to a lesser, or as the case may be, a greater extent the evolution of some key variables also included in the baseline scenario of the projection (economic growth, inflation, exchange rate, etc.). In the recent period, a case in point refers to the measure to cap the mark-ups on basic food products, given that its recent extension[81] could determine firms (especially large retailers) to adopt a potentially different business pattern to accommodate such measures compared to the previous periods.

Future labour market developments have become more relevant. Faster wage dynamics in the public sector than in the baseline scenario are not ruled out against the backdrop of the intensification of wage claims, in the context of the electoral year. Accommodating higher wage increases than expected at this moment and targeting wider labour force categories would also be likely to induce demonstration effects in the private sector. In addition, uncertainties are also attributed to the future staggered hike in the minimum wage, an important milestone in the calibration of wage policies in the private sector, in the context of the gradual implementation of EU Directive 2022/2041 on adequate minimum wages in the EU. Over the medium term, the potential risks posed by the persistent structural deficiencies in the labour market remain also elevated and an increasing mismatch between labour supply and demand is not ruled out, especially in high-skilled segments, where developments could be highly inflationary.

81 At the Government meeting of 31 January 2024, a GEO was adopted setting forth the extension by two months of the mark-up capping scheme, the parameters of which were also amended.

Abbreviations

CPI	consumer price index
DG ECFIN	Directorate General for Economic and Financial Affairs
EC	European Commission
ECB	European Central Bank
EU	European Union
Eurostat	Statistical Office of the European Union
FAO	Food and Agricultural Organization of the United Nations
GDP	gross domestic product
GFCF	gross fixed capital formation
GVA	gross value added
HICP	Harmonised Index of Consumer Prices
ILO	International Labour Office
IRCC	benchmark index for loans to consumers
MF	Ministry of Finance
NBR	National Bank of Romania
NIS	National Institute of Statistics
OPEC	Organisation of the Petroleum Exporting Countries
ROBOR	Romanian Interbank Offer Rate
TFP	total factor productivity
UVI	unit value index
VAT	value added tax
VFE	vegetables, fruit, eggs
WB	World Bank
1W	1 week
3M	3 months
12M	12 months
3Y	3 years
5Y	5 years
10Y	10 years

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