Inflation Report

May 2024

Year XX, No. 76

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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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ISSN 1582-2931 (print)
ISSN 1584-0948 (online)
ISSN 1584-0948 (HTML)

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 May 2024 and the cut-off date for the data underlying the macroeconomic projection was 2 May 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

In 2024 Q1, the CPI inflation rate temporarily stopped its downward path followed throughout the previous year, coming in at 6.61 percent in March, i.e. the same level as in December 2023. In the same month, the indicator stood only marginally (by 0.11 percentage points) above the projection in the previous *Inflation Report*; the adverse influences came especially from some energy sub-components, the prices of which saw increases in annual dynamics. Thus, in the case of electricity, the rise was driven solely by an unfavourable statistical effect related to the impact exerted by the broadening of the price capping scheme in January 2023 (so as to include all household customers, regardless of consumption) dropping out of the calculation. For fuels, the explanatory factors are associated with the relatively continuous rise in the Brent crude oil price during 2024 Q1 and the indexing of the excise duty on motor fuels.

By contrast, the annual adjusted CORE2 inflation rate remained on a downward trend to reach 7.1 percent in March 2024 (-1.3 percentage points compared to the value recorded at end-2023). Processed food prices continued to make the largest contribution to the drop in core inflation, amid the favourable conditions on the relevant commodity markets, their annual dynamics declining by 2.05 percentage points in the first three months of the current year. The prices of non-food items and market services also posted lower annual growth rates, with disinflation in the two segments featuring however a higher degree of rigidity. At the same time, the dynamics of the adjusted CORE2 index were influenced by a number of administrative measures implemented during Q1. On the one hand, the VAT rates on sugary foods and some recreational services were subject to hikes and an excise duty was introduced for high sugar-content beverages. On the other hand, the administrative decision to cap the mark-ups on basic food products was extended until the end of this year.

The average annual inflation rate, a measure with inherently higher persistence, remained on a downward trend, with the indicator calculated based on the national methodology falling to 8.5 percent in March. The indicator calculated in accordance with the harmonised structure (HICP) also went down, to 8.3 percent. However, the gap with the EU average inflation grew to 3.6 percentage points (versus 3.3 percentage points at end-2023), given the relatively slow disinflation in Romania.

The annual dynamics of unit labour costs rose again in 2023 Q4 to reach 15.4 percent (compared to 14.7 percent in the previous quarter), owing to all major sectors (industry, construction, market services). The faster increase in compensation per employee (18.5 percent, +0.9 percentage points compared to 2023 Q3) was accompanied by a near-stagnation of labour productivity growth rate (2.7 percent), with the persistence of the considerable gap between the two indicators being conducive to further inflationary pressures from labour costs. In industry, the annual

growth rate of unit wage costs stepped up to 18.1 percent in 2023 Q4, before declining slightly (to 17 percent in January-February 2024). Domestic industrial activity continues to face multiple difficulties, amid modest external demand, while wage dynamics remain significant.

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

In its meeting of 13 February 2024, 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 Q4 as a whole, the annual inflation rate decreased at a faster-than-anticipated pace, given that the dynamics of food prices and energy prices continued to decelerate at a relatively swift tempo, while the inflationary base effect in the fuels segment was fully counterbalanced by the slowdown in the growth rates of administered prices and tobacco product prices. In turn, the annual adjusted CORE2 inflation rate saw its downward trend steepen more than expected in 2023 Q4, 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 moderating consumer demand and the slower dynamics of import prices. Opposite, yet small influences came from the pass-through into some services prices of higher costs triggered by the hike in the minimum gross wage, as well as from the temporary worsening of short-term inflation expectations.

Significant uncertainties and risks to the inflation outlook stemmed from the future fiscal and income policy stance, coming from the public sector wage dynamics and the full impact of the new law on pensions, but also from the additional fiscal and budgetary measures that might be implemented in the future for the purpose of budget consolidation, *inter alia* amid the excessive deficit procedure and the conditionalities attached to other agreements signed with the EC. Moreover, 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 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 exerted by geopolitical conflicts and by the tighter economic and financial conditions worldwide. The ECB's and the Fed's prospective monetary policy stances, as well as the behaviour of central banks in the region continued to be also relevant.

Subsequently, the annual inflation rate went up in January 2024 in line with forecasts to reach 7.41 percent, from 6.61 percent in December 2023, whereas in February it declined to 7.23 percent. The advance against the end of 2023 was mainly attributable to the sharp increase in the annual dynamics of electricity prices under the impact of a base effect, as well as to the pick-up in the prices of fuels and tobacco products amid the hike in excise duties and higher crude oil prices. At the same time, the annual

adjusted CORE2 inflation rate continued to decrease in the first two months of 2024, albeit at a relatively slower pace, falling to 7.6 percent in February 2024, from 8.4 percent in December 2023. Behind the deceleration during this period further stood disinflationary base effects, corrections of agri-food commodity prices and the measure to cap the mark-ups on basic food products, alongside the decreasing dynamics of import prices. The impact of these factors was mitigated by the effects of the fiscal measures implemented at the beginning of 2024 and by higher short-term inflation expectations, as well as by the pass-through, at least in part, of the new increases in wage costs into the prices of some services and goods, *inter alia* amid the rebound in consumer demand. In turn, in 2023 Q4 economic activity weakened more than anticipated, contracting by 0.5 percent versus the previous three months, after a 1.0 percent increase in Q3, which made it likely for excess aggregate demand to narrow more visibly over this period compared to expectations. Conversely, annual GDP growth rose to 3.0 percent in 2023 Q4 from 1.9 percent in Q3. This was further bolstered in 2023 Q4 primarily by gross fixed capital formation, but household consumption also made a significantly larger contribution than in the previous quarter, following the re-acceleration of purchases of goods and services. However, the contribution of net exports saw a renewed strong contraction in 2023 Q4, given that the annual change in the imports of goods and services rebounded, re-entering positive territory and thus outpacing that of exports. Consequently, the trade deficit and the current account deficit posted an annual increase during this period – after three quarters of decline – which, in the latter's case, was amplified by the marked worsening of the primary income balance. However, in 2023 overall, both deficits narrowed visibly versus 2022.

At the time of the NBR Board meeting of 4 April 2024, the latest assessments showed that the annual inflation rate would decline further over the following months, on a slightly higher path than that shown in the February 2024 medium-term forecast, primarily due to base effects and downward corrections of agri-food commodity prices, as well as amid the deceleration in import price growth and the gradual downward adjustment of short-term inflation expectations. The previously-identified risk and uncertainty factors remained relevant.

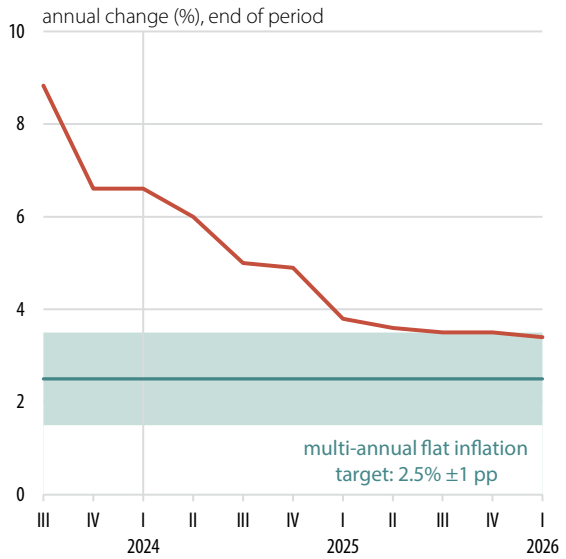
Based on the available data and assessments at that moment, as well as in light of the very elevated uncertainty, the NBR Board decided to keep the monetary policy rate at 7.00 percent per annum. The interest rates on standing facilities were left unchanged at 6.00 percent per annum (the deposit facility 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 has continued its recovery after multiple overlapping supply-side shocks. Over the past quarters, global economic growth, albeit slowing down, remained relatively resilient, while inflation rates saw further corrections, with remarkable progress compared to the apex of the crisis. Under these circumstances, at least for now, the warnings of impending stagflation or even global recession have not been

confirmed. Nonetheless, the pace of economic growth is expected to remain rather slow in the upcoming periods compared to historical standards, amid the persistent effects of Russia's invasion of Ukraine, the new flare-ups of geopolitical tensions in the Middle East, as well as increasingly pronounced trends of geo-economic fragmentation.

Inflation forecast



Source: NIS, NBR projection

In Romania as well, economic growth lost momentum in 2023, down to 2.1 percent (from 4.1 percent in 2022), a pace that remains, however, one of the fastest in the region and even across Europe. At the same time, the annual CPI inflation rate fell from the extremely elevated, double-digit levels seen in 2022. Originally, given the broad-based expectations for major central banks to start and pursue the policy rate cutting cycle at a rather swift pace, financial markets reacted exuberantly, which caused financial conditions to ease. However, the successive delays in these decisions have pointed to a monetary policy normalisation that is likely to be somewhat more atypical and to last longer. As regards both economic activity and inflation developments, the overall picture is still beset with fragility and, at the same time, many uncertainties. For instance, the outlook for Romania's trading partner economies to rebound gradually and for inflation rates to continue falling could be clouded in light of the electoral "super-cycle", with successive election rounds scheduled for this year. All these contingencies call for caution in assessing all possible implications for the configuration of the macroeconomic framework.

The moderation and even stagnation in the EU economies' activity have also had an impact on that in Romania of late. Specifically, quarterly GDP growth declined in 2023 Q4, due primarily to slacker export dynamics amid flagging external demand. However, economic growth stayed in positive territory at 2.1 percent in 2023 as a whole. The weakening of economic activity in 2023 Q4 appears, nevertheless, to be short-lived, given that sectoral developments January through March 2024 hint at a renewed positive GDP performance, possibly at a faster pace even than that expected in the past *Inflation Report*. Coupled with these developments, the positive output gap also narrowed in 2023 Q4, but is foreseen to recover at the beginning of this year and reach values close to those estimated in the previous *Report* at the end of 2024 H1. Given that, based on the currently available information that is certain, excessive budget deficits are assumed to post only a gradual correction over several years, excess aggregate demand is seen persisting throughout the eight-quarter projection.

In 2023, gross fixed capital formation posted a remarkable performance, rising at an average annual pace of 14.4 percent, well above that of the GDP, driven especially by the EU funds under the Multiannual Financial Framework 2014-2020, which is at the end of the extended budgetary period. Even though the Romanian authorities collected approximately EUR 10 billion from NRRP funds since the beginning of the programme, their actual use in the financing of investment programmes was rather

modest at an estimated 20 percent of the total figure. However, taking into account the combined effect of all available funding sources, gross fixed capital formation made in 2023 a larger contribution to economic growth than that of household consumption (3.6 percentage points compared with 2.2 percentage points) – a breakthrough in recent years. Apart from EU funds, substantial funding sources further came from foreign direct investment, yet its volume is seen shrinking over the medium term, also in conjunction with investor sentiment on Romania's persistent macroeconomic imbalances.

Against this background, as households recover and subsequently enhance their purchasing power, private consumption will become again the main driver of economic growth, perhaps as early as this year. The robust performance of households' real disposable income will be decisive in this respect, underpinned by ongoing disinflation and pay rises in both the private sector (also following the announced new minimum wage increases) and, especially this year, the public sector. At the same time, high rises in social transfers are envisaged, associated with the entry into force of the new pension law this September and then with the standard algorithm for pension indexation to be applied as of 1 January 2025. Looking ahead, it is critical to rebalance without delay the wage dynamics, which are already extremely fast, and labour productivity growth, a process that will foster not only the gradual return of inflation towards the target, but also the preclusion of external competitiveness losses of the Romanian economy.

The current account deficit-to-GDP ratio narrowed by approximately 2.2 percentage points in 2023 from the year before, standing at 7 percent. The full data set for last year reconfirms the major role of trade balance in this adjustment, to which added a slightly rising surplus on services. Looking ahead, further current account deficit cuts will hinge upon a fast recovery of trading partners' economies in Europe, the rebalancing of some services items posting deficits (travel in particular), but also on sustained progress in EU funds accession under the new Multiannual Financial Framework 2021-2027. At the same time, further stronger adjustments to the current account deficit are strictly conditional on those of the budget deficit and, in particular, on bringing the latter back in line with the targets set in the excessive deficit procedure as quickly as possible. This correction would boost Romania's fiscal buffer, which should be used to accommodate possible adverse shocks, on the one hand, and would ensure smooth EU funds absorption, formally not contingent on the pace of fiscal correction, on the other hand.

According to the updated baseline scenario, after standing at 6.61 percent at end-2023 and end-March 2024, the annual CPI inflation rate will stay on a downward track throughout the projection interval. Nevertheless, the pace of disinflation is projected to slow markedly over the next two years compared to 2023. Furthermore, the path of the indicator will show some swings, mainly driven by base effects (e.g. favourable effects related to increases in medicine prices in 2023 Q3 and indirect tax hikes at the beginning of this year or unfavourable ones deriving from lower food and fuel prices in 2023 Q4). Specifically, the annual CPI inflation rate is forecasted to revert to the upper bound of the variation band of the target no earlier than 2025 Q4, before falling to 3.4 percent at the projection horizon, i.e. March 2026. The projected values for

end-2024 and end-2025 are 4.9 percent and 3.5 percent respectively, being revised marginally higher (by 0.2 percentage points) solely for the end of this year. By contrast, the annual inflation rate at constant tax rates (by leaving aside the impact of previous and projected increases in VAT rates and excise duties) would return inside the variation band of the target as early as 2025 Q2, to 3.2 percent, a value estimated for March 2026 as well.

Both for the end of this year and beyond, the adjusted CORE2 index will further be the main determinant of the decline in the annual headline inflation rate. At the same time, the contribution of the exogenous components of the CPI basket to headline inflation will remain relatively steady at the end of this year from end-2023 and will decline by approximately 0.4 percentage points in 2025, stabilising around 1.2 percentage points towards the end of the projection horizon. The annual adjusted CORE 2 inflation rate will follow a continuously downward course, underpinned by the progressive narrowing of the output gap this year, softer inflation expectations and abating pressures from import prices. However, core inflation will exceed headline inflation over most of the projection interval, given the still strong unit labour cost pressures fuelled by both recent and anticipated pay rises. In the private sector, high wage dynamics will be driven by the persistent skilled labour shortage, the pay rises aimed at restoring employees' purchasing power, the announced minimum wage increases, but also as a result of a demonstration effect induced by higher wage earnings in the public sector. For December 2024, the annual core inflation rate was revised mildly upwards to 5.3 percent (+0.3 percentage points against the previous *Report*), amid further high pressures on the services and non-food components included in the index. Later on, in 2025, the differences compared to the previous projection become significantly smaller, given the downward revisions especially of inflation expectations and, to a much lower extent, of the output gap. Hence, in March 2026, the annual core inflation rate is seen dropping to 3.5 percent, reaching 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 past *Inflation Report*, a number of risk factors from those identified have materialised, in particular those associated with the public sector wage hikes (e.g. higher wages granted to employees in the healthcare and social security system). Moreover, geopolitical tensions in the Middle East intensified, yet their direct economic effects are further contained somewhat. Even in these circumstances, the assessed balance of risks suggests possible upside deviations of inflation from its path in the baseline scenario.

According to the characteristics of the medium-term projection, following the reversal and fading of adverse supply-side shocks that have occurred in recent years, the main determinants of inflation are expected to be associated with domestic fundamentals. In this vein, labour market developments, i.e. extremely high wage growth, together with the future fiscal and income policy configuration, are of particular importance.

On the fiscal front, at a first assessment, the latest measures announced and implemented by the authorities fall short of driving large downward corrections to the budget deficit this year and, therefore, to its magnitude over the medium term. Hence, the authorities have recently announced a new correction path for the budget deficit, which foresees its returning to the 3 percent-of-GDP threshold no earlier than 2027[1]. Unfortunately, assessing the plausibility of this new trajectory is burdened by the authorities having not mentioned either the dosage or the nature of the fiscal measures that could be adopted as of 2025: changes in direct or indirect taxes, measures for rationalising public spending, etc. Moreover, for this year, the busy electoral calendar does not rule out the risk of a fiscal slippage especially should any new expansionary measures imply persistent increases in budget spending (e.g. new rises in public sector wages). In such a case, the entire future path of budget deficits would shift upwards as against the working assumptions in the baseline scenario, based on information that is certain at the time of completing the projection. Looking ahead, risks of the same nature could come from the effects of the likely enactment of the unitary wage law, which is also one of the key milestones in the fourth payment request under the NRRP. Additional wage hikes, stemming from both the authorities' income policy and any further increases in structural labour market tensions (skilled labour shortage, aggravated demographic decline, new emigration waves) would likely entail substantial upward deviations in inflation from the projected path.

Thus far, the direct economic effects of the conflict in the Middle East have been relatively contained. Conversely, in view of the recently escalating tensions between Iran and Israel, the situation in this region may engender new developments and therefore the risk of broader geopolitical tensions has increased. Against this background, there is a higher risk of further possible disruptions in international trade, including new bottlenecks in global production chains. Furthermore, the reconfiguration of shipping routes will burden logistics and could entail additional costs for companies, which could subsequently feed through into final prices of goods and services. At the same time, the economic implications of the Russo-Ukrainian war are reconfirmed to matter. For instance, the recent bans introduced by the United States and the United Kingdom on imports of aluminium, nickel and copper from Russia could affect international metal markets, with high inflationary potential.

Monetary policy decision

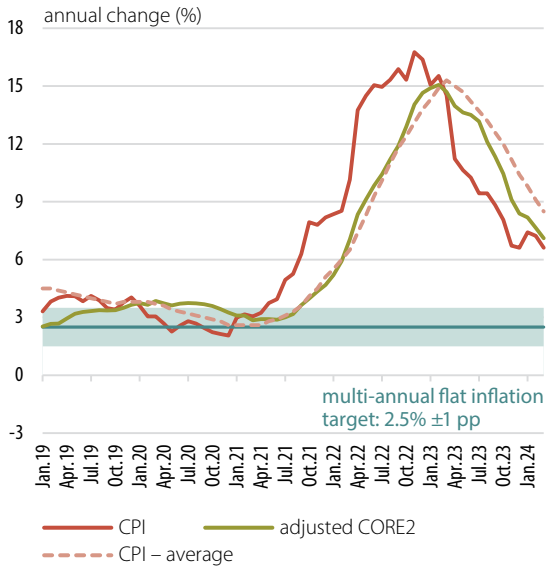
Given the prospects for the annual inflation rate to go down further over the following eight quarters much more slowly compared to 2023 and on a somewhat higher path in the short run than that shown in the previous projection, and considering the associated risks and uncertainties, the NBR Board decided in its meeting of 13 May 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] Pursuant to the Council Recommendation of June 2021 with a view to bringing an end to the situation of an excessive government deficit in Romania, the country was to correct the excessive deficit situation by 2024 at the latest.

1. Inflation developments

In 2024 Q1, the CPI inflation rate temporarily stopped its downward path followed throughout the previous year, coming in at 6.61 percent in March, i.e. the same level as in December 2023, primarily amid developments in energy prices, associated with strong unfavourable base effects, higher excise duties, as well as the increase in oil prices. These influences were partly offset by the relatively benign evolutions on global agri-food markets, which led to further disinflation in the case of food items. Consequently, adjusted CORE2 inflation continued to follow a downtrend (7.1 percent at end-2024 Q1), yet non-food items and market services had a lower disinflationary contribution. However, the disinflationary process in Romania is slow due to pressures from labour costs, whose pass-through into prices is facilitated by the resilience of demand in the economy (Chart 1.1).

Chart 1.1. Inflation developments

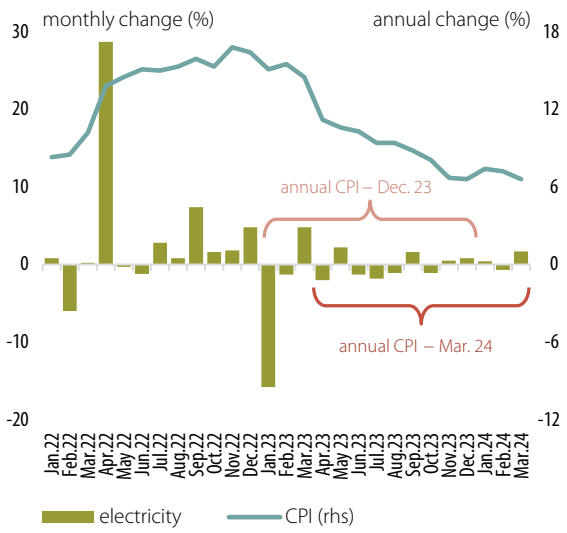


Source: NIS, NBR

Energy prices made a decisive contribution to halting the disinflationary trend in 2024 Q1, as the annual dynamics of both electricity and fuel prices increased. In the former case, the sole driver was an unfavourable statistical effect (with an impact of around +0.7 percentage points on CPI inflation), related to the dropping out of the calculation of the January 2023 month, when the decision to include all household consumers in the electricity price capping scheme came into force. In the current period, the monthly inflation rates in this segment are marginal, corresponding only to the migration of households between consumption brackets with different ceilings (Chart 1.2).

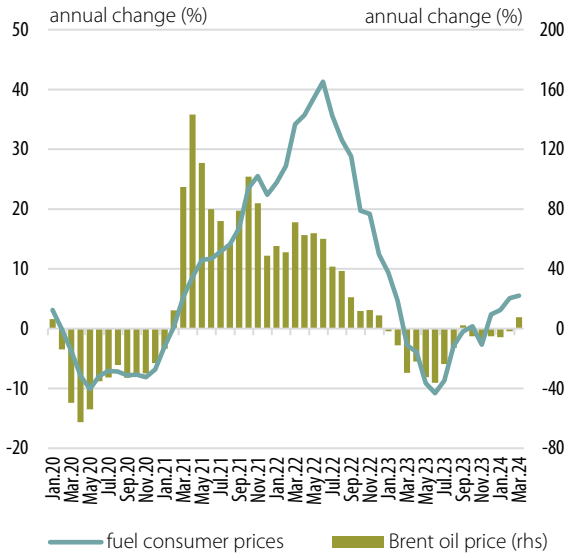
As for fuel prices, the Brent oil price followed an almost uninterrupted upward path in the period under review, from approximately USD 75/barrel at the beginning of the year to almost USD 90/barrel at the end of the quarter and even higher in April. Influences stemmed in particular from supply, amid rising tensions in the Middle East and the further voluntary oil production cuts by OPEC+ (Chart 1.3). The uptrend in motor fuel prices was compounded by the first stage of the indexation of the excise duty on motor fuels (with an estimated impact of around +0.17 percentage points on CPI), the other stage being scheduled to take place in mid-2024. Also within the realm of fiscal changes, the rise in excise duty on tobacco as of 1 January 2024 led to the price increase in the packet of cigarettes by leu 1, adding another approximately 0.25 percentage points to CPI dynamics.

Chart 1.2. Base effects in electricity price dynamics



Source: NIS, NBR calculations

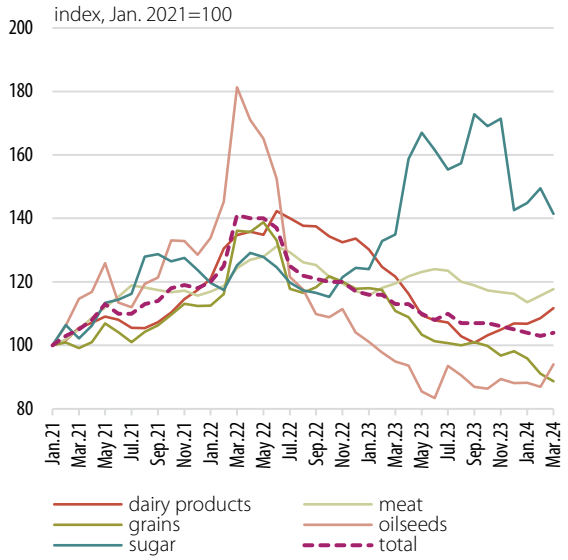
Chart 1.3. Fuel prices



Source: NIS, Bloomberg, NBR calculations

By contrast, food prices further contracted their annual dynamics, benefiting from the favourable context on agri-food commodity markets – international prices returned to the levels recorded in 2021 H1, amid large stocks and the positive outlook for global crops (Chart 1.4). The annual dynamics of volatile food prices (vegetables, fruit, eggs) declined markedly, to nil (from 6.7 percent in December 2023), while the annual growth rate of processed food prices slowed down to 3.3 percent, bringing about a new decrease in adjusted CORE2 inflation (7.1 percent in March 2024, 1.3 percentage points below that recorded at end-2023).

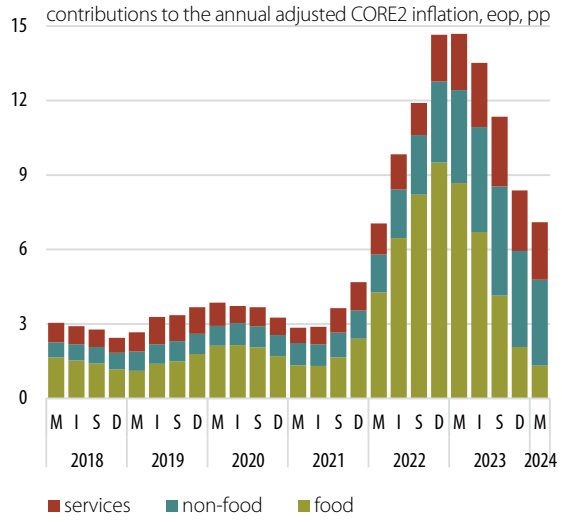
Chart 1.4. Main agri-food commodity prices



Source: FAO

The annual rates of change of prices of non-food items and market services also posted corrections, the two segments of core inflation featuring however a higher degree of rigidity (Chart 1.5) – in the former case, the annual pace of increase remained in the two-digit territory (10.2 percent at end-2024 Q1), whereas in the latter case, it slightly fell below this threshold (9.6 percent). Even amid the declining dynamics of prices of some imported goods and the limited influence of the costs of commodity inputs (commodities, energy), disinflation on these segments is further low; the significant rise in labour costs is a deterrent, the pass-through into final prices being eased by solid consumer demand, as indicated by the recent values of retail activity indicators.

Chart 1.5. Adjusted CORE2 inflation components



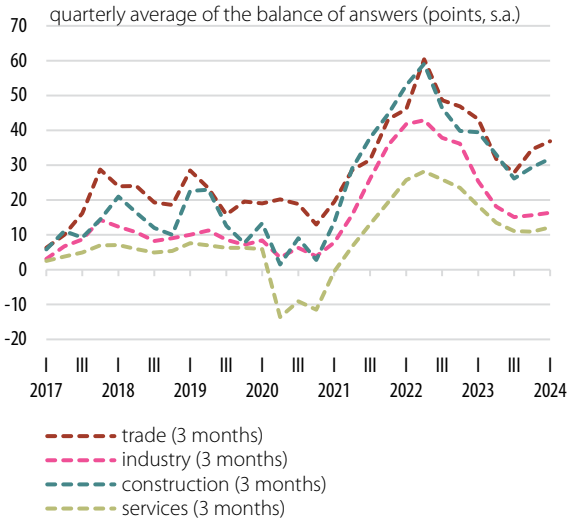
Note: Contributions include VAT rate changes.

Source: NIS, NBR calculations

With respect to administrative measures directly affecting core inflation, in 2024 Q1 the authorities decided to hike the VAT rates on sugary foods and some recreational services and to introduce an excise duty on high sugar-content beverages (with a total estimated impact on CPI dynamics of around +0.15 percentage points and on adjusted CORE2 dynamics of approximately +0.24 percentage points). At the same time, the package of measures to cap the mark-ups on basic food products (including to limit mark-ups on some imports that are not additionally processed in Romania) was further extended to end-2024. From the market (i.e., processors, retailers) perspective, this administrative intervention entails profit erosion, which may be offset by raising the final prices of certain products not subject to the measure, especially amid lenient demand conditions. The current situation, characterised by a favourable context in agri-food commodity prices, would be an opportunity to normalise this market's mechanisms.

Short-term inflation expectations of economic agents in all sectors increased from the previous quarter, in correlation with the recovery of economic activity and with the recent fiscal consolidation measures implemented in 2023 Q4 or in early 2024, which have had an inflationary impact (Chart 1.6). By contrast, financial analysts' expectations on the annual CPI inflation rate one and two years ahead were revised downwards, with the latter indicator nearing the upper bound of the variation band of the flat target.

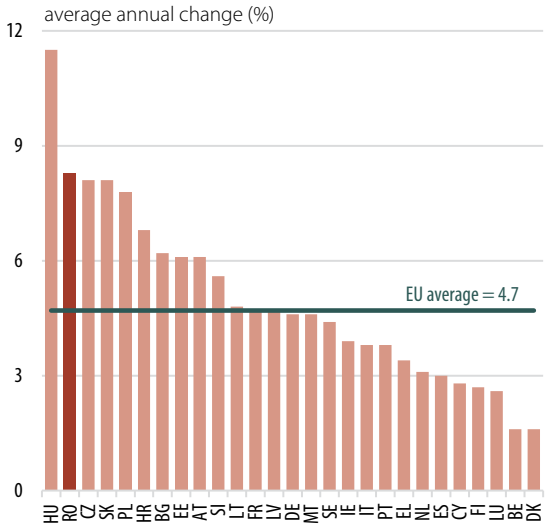
Chart 1.6. Expectations on price developments



Note: The series for industry and services were revised.

Source: EC-DG ECFIN

Chart 1.7. Average annual HICP in the EU – March 2024



Source: Eurostat

The average annual inflation rate further declined in 2024 Q1, reaching 8.5 percent for the indicator calculated based on the CPI methodology and 8.3 percent for that calculated in accordance with the HICP structure (-1.9 percentage points and -1.4 percentage points respectively compared to 2023 Q4). However, the gap with the EU average inflation grew to 3.6 percentage points (versus 3.3 percentage points at end-2023), given the relatively slow disinflation in Romania (Chart 1.7).

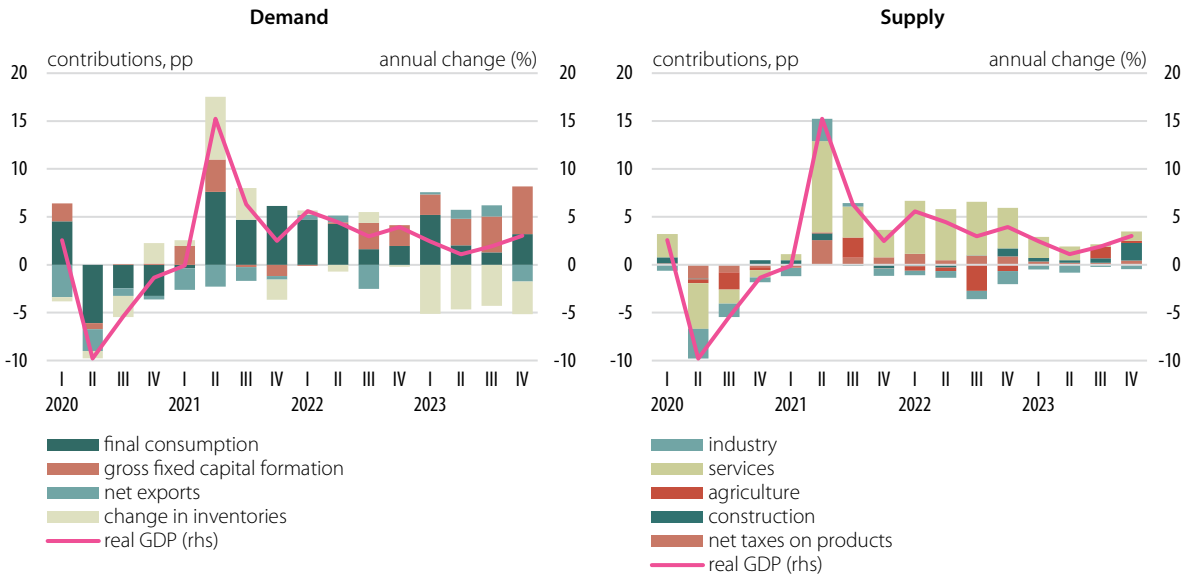
The annual CPI inflation rate at end-2024 Q1 stood marginally above the forecast in the February 2024 *Inflation Report* (+0.1 percentage points).

2. Economic developments

1. Demand and supply

In 2023 Q4, real GDP growth[2] picked up to 3 percent (annual change), as compared to the Q1-Q3 average of 1.8 percent, being driven by both private consumption and investment. On the supply side, the step-up in economic activity was visible in non-industrial segments, whereas manufacturing continued to be dampened by weak external demand (with an annual rate of change of -2 percent, the GVA in industry went down for the ninth quarter in a row), Chart 2.1.

Chart 2.1. Contributions to economic growth



Source: NIS

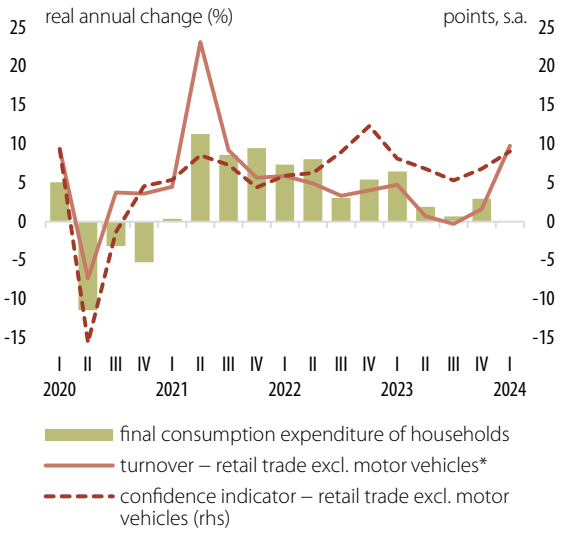
The annual dynamics of household consumption accelerated to 2.5 percent, the trajectory being largely supported by the successive rises in net real wage during 2023, as well as by the improved lending conditions. Sales increased for most groups of goods, special mention deserving the step-up in trade in food items (to 4.2 percent). In this case, market signals hint at the additional impulse given by the more frequent promotions, which consumers were also increasingly interested in finding. This triggered a change in consumer behaviour – more frequent purchases, but somewhat lower in terms of volume, the net effect being that of larger retail receipts in real terms. Sales of ICT equipment and household appliances posted faster annual

2 In this section, GDP analysis relies on the annual changes calculated based on volume series expressed in the prices recorded in the corresponding quarter of the previous year.

dynamics as well, amid the Black Friday price cuts in November 2023[3], whereas motor fuel sales dropped further.

Consumer demand will probably remain on an upward path in the first part of 2024 too, under the impact of the expected rise in household real income, given the increases as of 1 January 2024 in the pension point and public sector wages, as well as the gradual slowdown in inflation. Actual data on the turnover volume of retail trade show a step-up in activity to 9.8 percent (annual change) in January-February 2024, with sales of clothing and footwear, pharmaceuticals and cosmetics expanding markedly (by over 20 percent). In addition, companies operating mostly online also reported a surge in sales (14 percent). Moreover, the short-term expectations of retailers improved, the confidence indicator going up to 9.1 points in 2024 Q1 (with a significant contribution from food retailers), Chart 2.2. The annual growth rate of trade in motor vehicles decreased to 3.5 percent in January-February 2024, a recovery in this segment being however expected towards end-March, given households' strong interest in purchases via the two car fleet renewal programmes ("Rabla Clasic" and "Rabla Plus") that started on 19 March 2024; additionally, car dealers' expectations captured by the DG ECFIN survey on the short-term evolution of automotive sales show an improvement in January-March 2024 as against 2023 Q4.

Chart 2.2. Household consumption



*) Jan.-Feb. for the latest period

Source: NIS, EC-DG ECFIN

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)[4], compared to lei 39.1 billion (2.8 percent of GDP) in 2022 Q4. The increase versus the previous quarter was due to higher total budget spending[5], also on account of capital expenditure and spending on goods and services[6], as well as staff costs[7,8]. The main contributor was nevertheless the considerable growth of spending for projects financed from non-repayable external funds[9]. Yet, this had a lower impact on the budget balance[10]. Total budget revenues picked up as well[11], albeit less sharply than

3 Which were more effective from a multiannual perspective.

4 From lei 19.2 billion (1.2 percent of GDP) in 2023 Q3.

5 Its real annual dynamics re-entered positive territory (to 4.0 percent from -0.5 percent in the previous quarter).

6 However, the magnitude of the increase was smaller than that in 2022 Q4, also due to the capping of these expenditure categories in the last months of 2023 (according to GEO No. 90/2023), which thus declined in real annual terms.

7 The real annual dynamics of these expenses stepped up to 10.6 percent, a post-2019 high.

8 An opposite impact had the decrease in spending on subsidies (especially given the lower spending on the compensation scheme for the consumption of electricity and natural gas by non-household users), as well as in interest expenses, both posting a stronger real annual decline.

9 Primarily ascribable to spending for projects financed under the Multiannual Financial Framework 2014-2020 that is ending soon; projects financed from grants under the NRRP also made a minor contribution.

10 Given the relatively similar evolution of disbursements from the EU. In 2023 Q4, however, spending for projects financed from the lending component of the NRRP also went up and further exceeded those funded from NRRP grants.

11 In addition, the real annual growth rate of revenues re-entered positive territory, climbing to 11.3 percent from -0.1 percent in the previous quarter.

budget spending, and mainly on the back of disbursements from the EU, given that the rise in receipts from VAT, social contributions and personal income taxes was largely offset by the decline in revenues from other taxes and fees on goods and services[12].

In 2023 as a whole, the budget execution posted a deficit of lei 89.9 billion, significantly higher than the one recorded in the prior year (lei 80.8 billion) and much larger than the approved ceiling (lei 68.3 billion), accounting however for 5.6 percent of GDP compared to 5.8 percent of GDP in 2022.

In 2024 Q1, the budget deficit atypically continued to widen from the previous quarter, reaching lei 35.9 billion (2.1 percent of GDP) and thus considerably exceeding the level recorded in the first three months of 2023, i.e. lei 22.8 billion (1.4 percent of GDP).

With an annual advance of 21.4 percent, gross fixed capital formation consolidated its position as the engine of economic growth (contribution of 5 percentage points in 2023 Q4). This trend may continue in the near run, due to the further favourable context in terms of financing sources. Specifically, net FDI inflows in the form of equity[13] (estimated value for 2023) were close to those recorded in 2021-2022 (albeit on a decline as a share of GDP), while reimbursements from structural and investment funds under the Multiannual Financial Framework (MFF) 2014-2020 gained momentum towards end-2023. Additionally, in 2024, more than EUR 3 billion are estimated to be absorbed under the MFF 2021-2027 (funds earmarked under the cohesion policy and the agricultural development policy), while EUR 2.7 billion allocated under the NRRP are about to be disbursed provided that the European Commission issues a positive assessment of the third payment request submitted by Romania in December 2023. In the latter case, the amount will add to the funds received so far under the Recovery and Resilience Facility (EUR 9.4 billion), out of which, however, only 20 percent[14] had been used until March 2024.

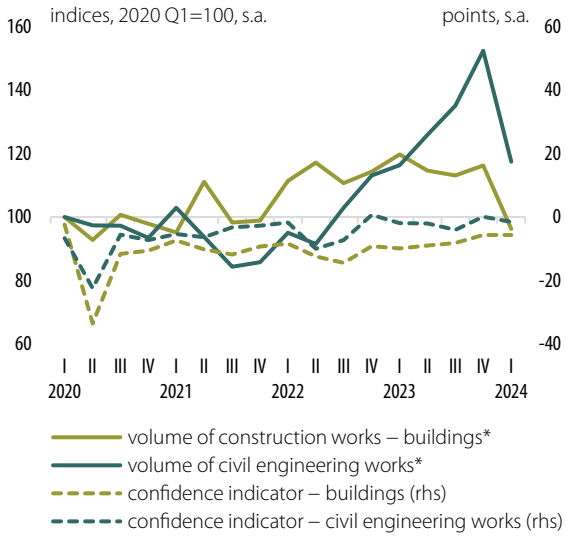
Construction works were the main contributor to the expansion of investment, their volume standing approximately 24 percent higher than that recorded in 2022 Q4. Infrastructure projects (up by 34 percent) were further the main driver. The end of 2023 and the first part of 2024 saw the completion or the initiation of large-scale projects, particularly in what concerns the network of national motorways and major roads, whereas the election calendar will probably give an additional impulse to construction works for local road transport and utility networks. The construction of buildings rose by 5.8 percent, but the construction area stipulated in building permits remained on a downward trend (-19 percent over the past 12 months until February 2024), especially for dwelling projects. Given the signs of rebound in demand in the latter segment (amid increases in real income and new loans to households), the negative

12 This category also includes state budget receipts from the taxation of economic agents in the energy sector.

13 Including reinvestment of earnings.

14 According to the statement of the Minister of Investments and European Projects.

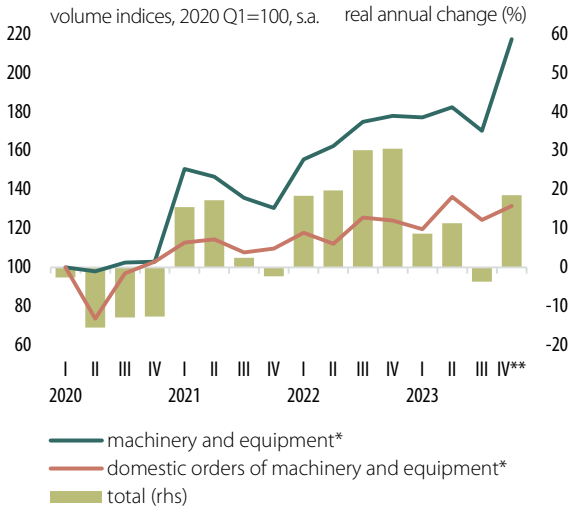
Chart 2.3. Construction



*) Jan.-Feb. for the latest period

Source: NIS, EC-DG ECFIN

Chart 2.4. Investment, excluding construction



*) excl. transport equipment

**) Oct.23 – Feb.24 for domestic orders

Source: Eurostat, NIS, NBR calculations

performance of building permits seems to stem from the persistence of supply constraints in the market of new real estate projects, due *inter alia* to delays in solving some legal and legislative issues (Chart 2.3).

Purchases of machinery and equipment (IT and military included) also posted brisk dynamics (about 19 percent in annual terms[15]). Strong interest is further directed towards investment in expanding the production capacity of renewable energy via new, large-scale projects, solar parks in particular, and green energy projects for the own consumption of companies, public institutions and households. Investment in the latter category is also stimulated by the resumption in January 2024 of the Photovoltaic Green Home programme, whereby households can receive financing of up to lei 20,000. Starting in 2024, the amount can be supplemented with a voucher of lei 25,000, according to a provision stipulated in the revised NRRP. Moreover, the ongoing investment projects in manufacturing also include those targeting electromobility, with a focus on both urban public transport and the manufacture of motorcars (Chart 2.4).

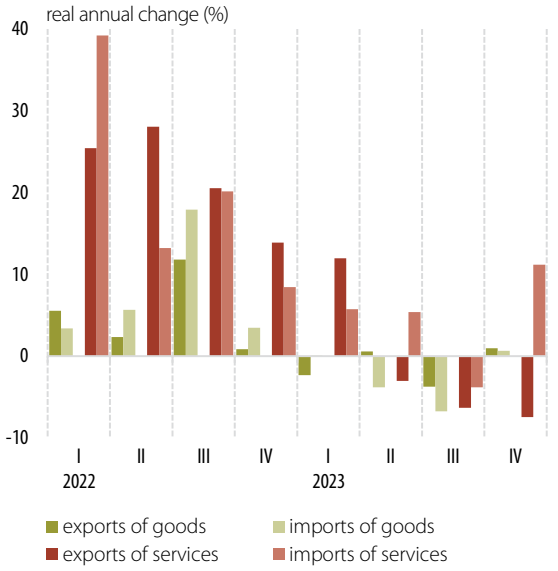
Net exports of goods and services made a negative contribution (-1.8 percentage points) to GDP dynamics for the first time in 2023. This outcome was due to the balance on trade in services, while trade in goods made a neutral contribution. In the former case, the prevailing negative effect was visible in travel services, with the balance-of-payments data (nominal values) indicating an annual rise in payments for residents' travels abroad (in line with the pick-up in domestic consumer demand), as well as a decline in receipts from foreign tourists' travels to Romania, due *inter alia* to the base effect generated by the inflow of Ukrainian nationals following Russia's invasion of Ukraine, the influence of which was largely felt during most of 2022[16].

In the goods segment, annual growth rates turned positive for both exports and imports, but they were modest (Chart 2.5). In the case of exports, the 1 percent

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

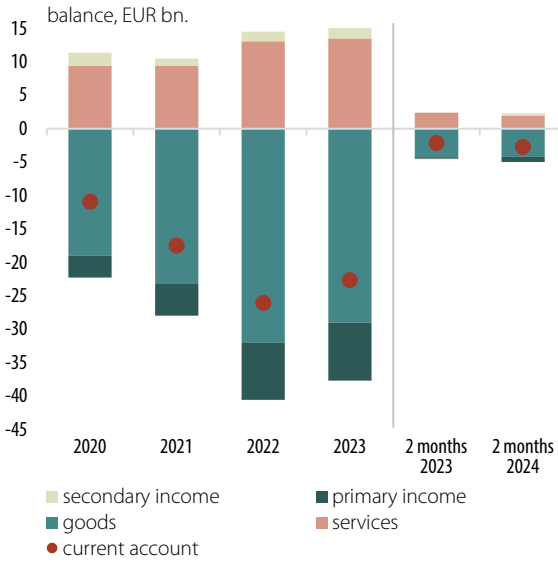
16 Payments made in Romania using cards issued by banks that do not operate in the local market are recorded in the balance of payments as exports of travel services.

Chart 2.5. Foreign trade



Source: NIS

Chart 2.6. Current account



Source: NBR

increase owed to the relatively high grain and oilseed production, leading to a jump of over 80 percent in export quantities. Conversely, the sluggish manufacturing activity in the euro area reflected in a negative evolution of exports of industrial goods, namely intermediate goods and final capital and consumer goods; more visible exceptions were exports of motor vehicles and selected groups of fabricated metal products, to which added exports of edible oil (+64 percent), due to the above-mentioned plentiful crop. The weak external demand also affected imports of intermediate goods, but their path was countered by the rebound in purchases of capital and consumer goods (up by 14.3 percent and 0.6 percent respectively), in line with the increase in domestic absorption.

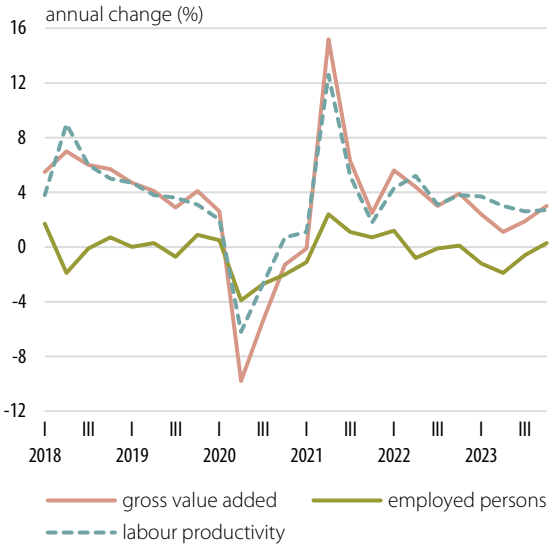
In 2023 as a whole, the volume component of trade balance fared better, which also reflected in the balance of payments[17]. The deficit on trade in goods narrowed to EUR 29 billion (-9.5 percent, nominal change), while the services surplus expanded by 3.2 percent. As a result, current account deficit fell by 13.1 percent from 2022 (EUR 22.6 billion). At the beginning of 2024, the deficit on trade in goods contracted further (by 0.9 percent in January-February as compared to the similar year-earlier period), but the current account deficit widened by 24.6 percent to EUR 2.7 billion, a contribution coming from the reduction of the services surplus, ascribed primarily to international travel activity (Chart 2.6).

Labour productivity

In 2023 Q4, the annual growth rate of labour productivity economy-wide remained relatively unchanged from the previous quarter, i.e. at 2.7 percent (Chart 2.7). The construction activity further showed a robust performance, amid the path of civil engineering works, whereas trade, transportation and accommodation and food service activities witnessed a rebound, in line with the trend in household consumption, which fuels large retailers' ambitious expansion plans.

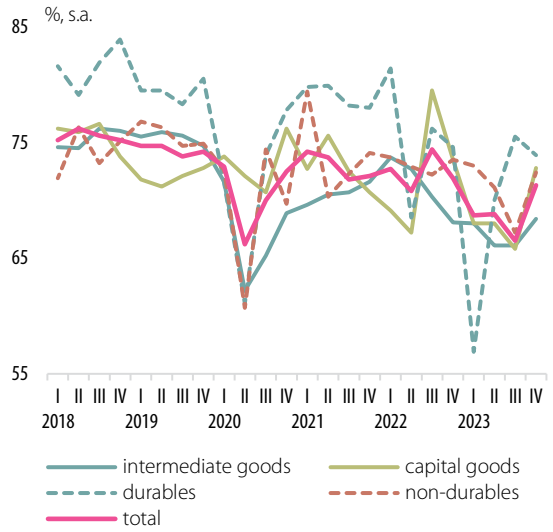
17 The price component also made a minor contribution to the narrowing of the goods trade deficit, given that the decrease in unit value index of imports was slightly steeper than that of exports.

Chart 2.7. Labour productivity economy-wide



Source: NIS, NBR calculations

Chart 2.8. Capacity utilisation rate in manufacturing



Source: EC-DG ECFIN

Although the annual rate of change of labour productivity in industry continued to be negative, it improved in 2023 Q4 and in the first two months of 2024 to -1.5 percent and -2.8 percent respectively (against -3.4 percent in 2023 Q3), amid an upward trend that had emerged in new domestic orders over the past months and a certain recovery of the capacity utilisation rate (yet from historical lows), Chart 2.8. Nevertheless, the spur from the domestic market was offset, at least partially, by the developments in the major trading partners. Business and confidence indicators for end-2023 and early 2024 show a sluggish industrial activity in the largest European economies. Industrial companies cite the almost constant decline in new orders over the past year, the still high inflation from a historical perspective, persistently high interest rates and, more recently, disruptions in global value chains, in the broader context of worsening conditions for the transit of goods in the Middle East (impacting also some commodity prices). The confidence indicators in the Purchasing Managers' Index (PMI) survey for March signal a slight moderation in industrial activity decline in the euro area, yet insufficient to trigger the recovery of domestic manufacturing.

As far as investments are concerned, some large-scale projects are under way (for instance, in the building materials sub-sector, ICT and the manufacture of electronic products, pharmaceuticals and the food industry). However, their coming into operation is expected to exert noticeable effects only in the latter half of 2024. The defence industry has recently received special attention at the EU level, being allocated substantial funds for the next years. In Romania, collaboration projects between some domestic factories and relevant manufacturers in the US and Germany have already been announced. The automotive industry may also witness a period of expansion. Specifically, January and February marked the best start of the year in terms of motor vehicle production, and the new models launched during 2024, including hybrid and electric cars, will most likely leave their mark on productivity indicators.

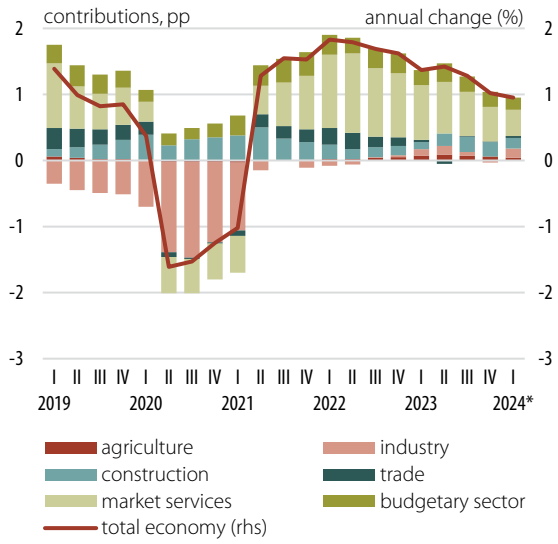
Labour market developments

The labour market has recently showed some persistent signs of loosening, namely a drop in the job vacancy rate, a slower pace of hiring and the stabilisation of the unemployment rate. Nonetheless, the shortage of skilled labour seems to be a steady

feature of the labour market in Romania, irrespective of the position in the business cycle, under the impact of structural problems: the elevated emigration rate over the past two decades, the ageing of the population, the low labour force participation rate, and the skill mismatch. Under the circumstances, the limited labour supply leads to further relatively tight labour market conditions and any easing will likely be gradual. Early 2024 witnessed a slowdown in private sector wage dynamics, which remained, however, high; at aggregate level, the deceleration in the private sector was offset by the pay rises in the budgetary sector.

The annual growth rate of the number of employees in the economy slowed down markedly in 2023 Q4, to 1 percent (down 0.3 percentage points from the previous quarter), remaining unchanged January through February 2024 as well (Chart 2.9). This trend was visible particularly in services, agriculture and, to a more moderate extent, construction and trade. Apart from the impact of the deceleration in economic activity on recruitment, behind the slacker pace of hiring in IT, construction and agriculture may have also stood the removal of tax breaks in November, the relevant companies citing an increase in labour costs and the postponement of hiring decisions for financial reasons. Conversely, the food industry was less affected by the elimination of these tax breaks, experiencing an expansion of production, which reflected in a slight recovery in hiring in January-February 2024. This – together with the slower decline in headcount in the light industry, the manufacture of furniture, but also in energy-intensive industries (partly under the influence of the stabilisation of energy markets) – favoured the return to positive territory of the annual rate of change of the number of employees industry-wide, to 0.6 percent January through February 2024 from -0.1 percent in 2023 Q4. In the budgetary sector, the annual growth rate of the number of employees decelerated to 0.9 percent in the first two months of 2024 (down 0.3 percentage points from the last quarter of 2023).

Chart 2.9. Number of employees economy-wide

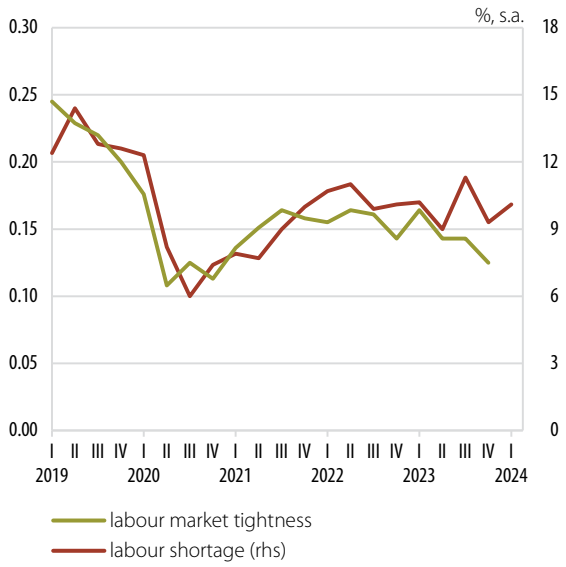


*) Jan.-Feb.
Source: NIS, NBR calculations

The job vacancy rate fell to 0.7 percent in 2023 Q4, from 0.8 percent in 2023 Q2-Q3. At the same time, the ILO unemployment rate remained unchanged at 5.6 percent October through December 2023, the same as in the previous two quarters; nevertheless, the provisional data for January-February 2024 reveal a marginal increase, to 5.7 percent.

However, the results of the DG ECFIN survey on employment are suggestive of a resumption of recruitment in the first part of this year, the indicator standing at 106 points in January-March 2024 (up 0.7 points from 2023 Q4). At the same time, the share of companies citing labour shortage as a factor that constrains their activity widened in 2024 Q1 (Chart 2.10). The breakdown shows that labour shortage is a major deterrent for construction firms (even though this seems to have been

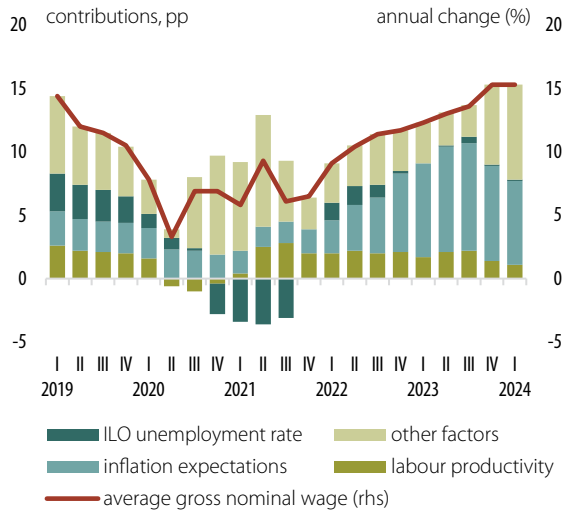
Chart 2.10. Labour market tightness



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.

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

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

somewhat less of a challenge over the past quarters), whereas for industrial companies demand is the main impediment to production, while labour shortage ranks second; in services, both factors are seen as relevant to restraining activity, with a slight focus on demand.

The annual dynamics of the average gross wage economy-wide further followed an upward path, climbing to 16.7 percent January through February 2024 (from 16.4 percent in 2023 Q4 and 14.1 percent in 2023 Q3). This uptrend was ascribable to the pay rises in education and public administration, which pushed the annual growth rate of budgetary sector wages to 19.2 percent in January-February 2024 (from approximately 16 percent in 2023 H2). By contrast, in the private sector, even though annual wage growth remained brisk, January through February 2024 it decelerated by 0.4 percentage points versus 2023 Q4, to 16 percent. This starts to gradually mirror the declining contribution of inflation expectations and the lower support from labour productivity, in the context of slower economic activity over the previous quarters. While the specification of the wage Phillips curve (unadjusted for the impact of government measures) captured wage dynamics with relatively high accuracy until recently, in 2023 Q4 and for the first part of 2024 fundamentals have markedly underestimated the trajectory of income; nevertheless, exogenous factors, related chiefly to the decisions to raise the minimum wage economy-wide and budgetary sector wages, made an increasing positive contribution (Chart 2.11).

Unlike the step-up in gross wage dynamics, the annual growth rate of average net wage economy-wide decelerated noticeably in the first two months of 2024, to 14.2 percent (-1.7 percentage points from 2023 Q4). The slowdown is attributable solely to wage developments in the private sector, given the change in the tax treatment of food vouchers for employees (as of January 2024, health insurance contributions are paid for such benefits), as well as a base effect (the fading away of the influence from the hike in the minimum wage economy-wide and from the lei 200 tax exemption for employees earning the minimum gross wage as of 1 January 2023).

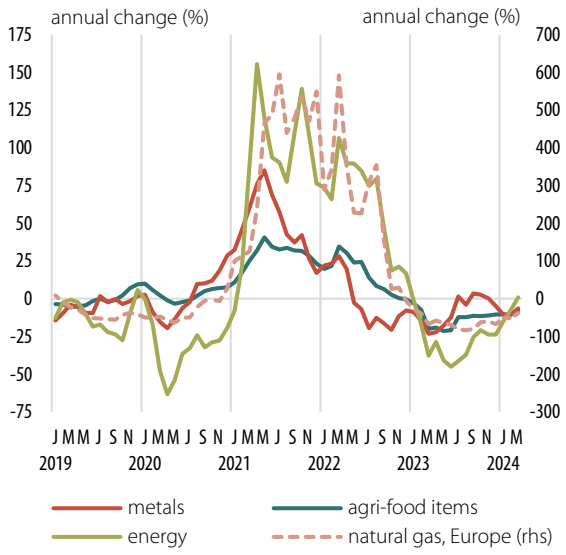
2. Import prices and producer prices on the domestic market

In 2023 Q4, the relatively favourable conditions in commodity markets contributed to the further negative annual changes in import prices, as well as in industrial and agricultural producer prices on the domestic market. Developments January through February point to a strengthening of this trend, the correction in electricity and natural gas prices offsetting the impact of the oil market tightening.

2.1. Import prices

Against the backdrop of the still subdued outlook for global activity, international commodity prices further recorded negative annual dynamics in 2024 Q1 (Chart 2.12); however, the -6.9 percent level exceeded the 2023 Q4 value (-17.3 percent), which reflected the steep downward trend in natural gas prices on the European market in early 2023[18].

Chart 2.12. International commodity prices



Source: World Bank, FAO, NBR calculations

Energy prices fell by 7.7 percent in annual terms in the first three months of 2024, with a significant contribution from natural gas. In this instance, the pick-up seen in October-November 2023, fuelled by the geopolitical turmoil, proved temporary, as prices re-embarked on a downward path, due to high storage levels and moderate demand associated with mild weather conditions and weak industrial activity. Conversely, the Brent oil price resumed its advance in 2024 Q1, driven by heightening geopolitical tensions and production cuts implemented by the OPEC+ group.

Metal prices (including mineral products) posted relatively steady developments, their faster annual rate of decline (-10.4 percent versus -5.3 percent in 2023 Q4) owing to a base effect. An exception was iron ore, which returned to a steep downward path, the market being marked by excess supply and unfavourable demand prospects (linked also to signs of overproduction from China).

Similarly, turning to agri-food commodities, the annual rate of change in the FAO food price index remained in negative territory in 2024 Q1 (-9.7 percent), with values well below those recorded in the same year-ago period for cereals, particularly wheat, in line with the favourable expectations for global output and the strong competition among exporters. The annual dynamics of prices for meat and milk further posted negative readings, while sugar prices rose at a more moderate pace than in 2023 Q4,

18 Source: World Bank

the downward corrections in March owing to improved estimates for crops India and larger exports from Brazil.

In 2023 Q4, import prices continued to exert a favourable impact on domestic price dynamics, with the unit value index of imports remaining below one, albeit at a slightly higher level compared to the previous quarter (98.3 percent versus 96 percent in 2023 Q3). At the same time, the leu strengthened further in annual terms against the US dollar, yet at a slacker pace.

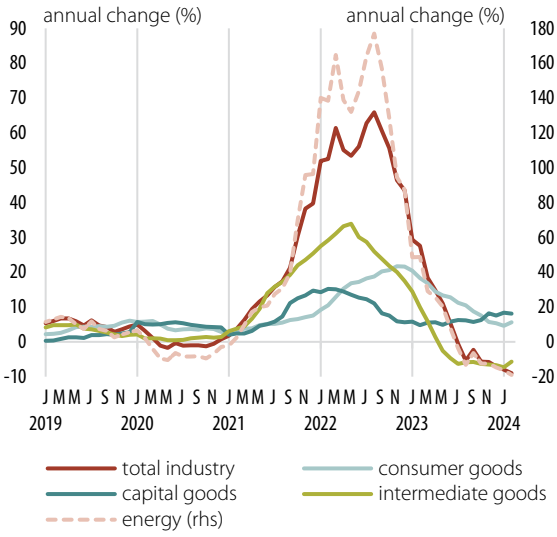
Behind the 2.3 percentage point slowdown in the annual decline in import prices versus 2023 Q3 stood primarily mineral products, although in the same direction acted also other groups, such as base metals or chemicals; however, the UVIs of all these categories remained significantly below one.

Looking at the prices of some imported goods holding a relatively high share in the CPI basket, mention should be made of the favourable developments in some food items, such as meat, fruit or sugar, whose annual dynamics decelerated, in correlation with the downward trend in external prices of agri-food commodities. Similar developments were visible also for some non-food items (clothing, pharmaceuticals).

2.2. Producer prices on the domestic market

In January-February 2024, the annual dynamics of industrial producer prices on the domestic market continued to decline, reaching -8.5 percent (-2.3 percentage points versus 2023 Q4), Chart 2.13. The slower annual pace of change in prices for most groups of goods may be linked with the easing of tensions in the natural gas and electricity markets, but also in non-energy commodity markets. These trends will persist into the period ahead as well, given that the results of the DG ECFIN survey for March 2024 point to a further decrease in the balance of answers for future developments in producer prices.

Chart 2.13. Industrial producer prices on the domestic market



Source: NIS, Eurostat

The breakdown shows that the dynamics of energy producer prices witnessed the largest fall in January-February 2024 (-4.4 percentage points to -17.6 percent), solely on account of electricity, gas, steam and air conditioning supply (-20.2 percent). Spot prices for natural gas and electricity on the domestic wholesale markets dropped markedly versus the same year-ago period, in line with the trend in external prices. On the domestic front, the demand-to-supply ratio is favourable. On the one hand, consumption in the economy has remained low, due *inter alia* to the only partial recovery of energy-intensive industries. On the other hand, supply benefited from the rise in hydropower output (the Danube flow rates stood above their multi-annual average in January-February) and from

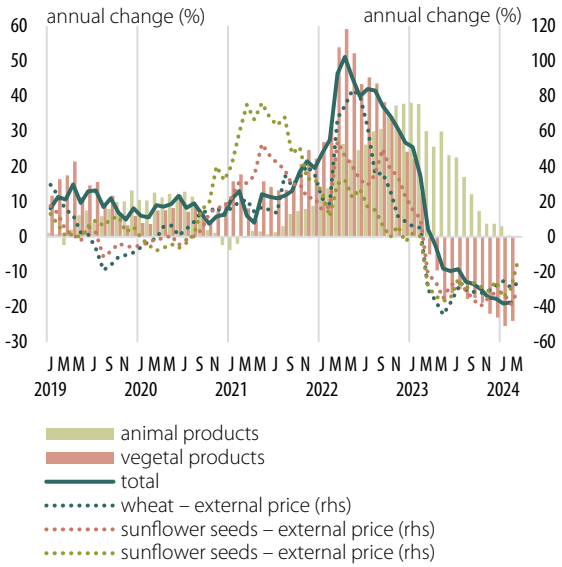
the comfortable gas storage levels. Furthermore, there are visible effects of the development of other renewable energy segments, i.e. wind and solar power (where new production facilities have recently become or are set to become operational in the near future, including due to the rapid increase in the number of prosumers). An opposite marginal influence on prices came from the rise in transmission and distribution tariffs for electricity, as well as from the increase in the contribution for cogeneration as of 1 January 2024.

At the same time, crude oil processing saw a sharp pick-up in the annual rate of change in prices (+19.4 percentage points to 1.1 percent), as the tensions in the Middle East and the decision by OPEC+ members to extend voluntary oil output cuts put crude oil prices on an upward trajectory.

Negative annual dynamics persisted for intermediate goods, i.e. -6.5 percent (a level similar to that recorded in 2023 Q4), with a sizeable contribution from the manufacture of building materials and the chemical industry. In the latter case, the lower energy costs led to higher domestic supply, as a major fertiliser producer gradually resumed operations.

The annual growth rate of producer prices for consumer goods decelerated (-1.1 percentage points to 5.1 percent), yet the trend incorporated favourable base effects, particularly in the durables segment (price hikes for household appliances in the same year-ago period, amid the protracted shortage of semiconductors). In the food industry, pressures from agri-food commodity costs remained contained, producer prices witnessing relatively stable developments in the period under review. The mild increase in their annual growth rate (to 0.8 percent) was also due to a base effect, but in this case acting in the opposite direction (a strong decline in prices for grains and oleaginous plans a year ago, the Black Sea Grain Initiative ensuring the fluidity of grain exports from Ukraine).

Chart 2.14. Agricultural producer prices



Source: NIS, Bloomberg, NBR calculations

The annual dynamics of producer prices for capital goods picked up slightly (by 1 percentage point to 8 percent), with a contribution from the manufacture of machinery and equipment, a possible driver of the step-up being the favourable developments in domestic demand, as related investments showed a robust performance in 2023.

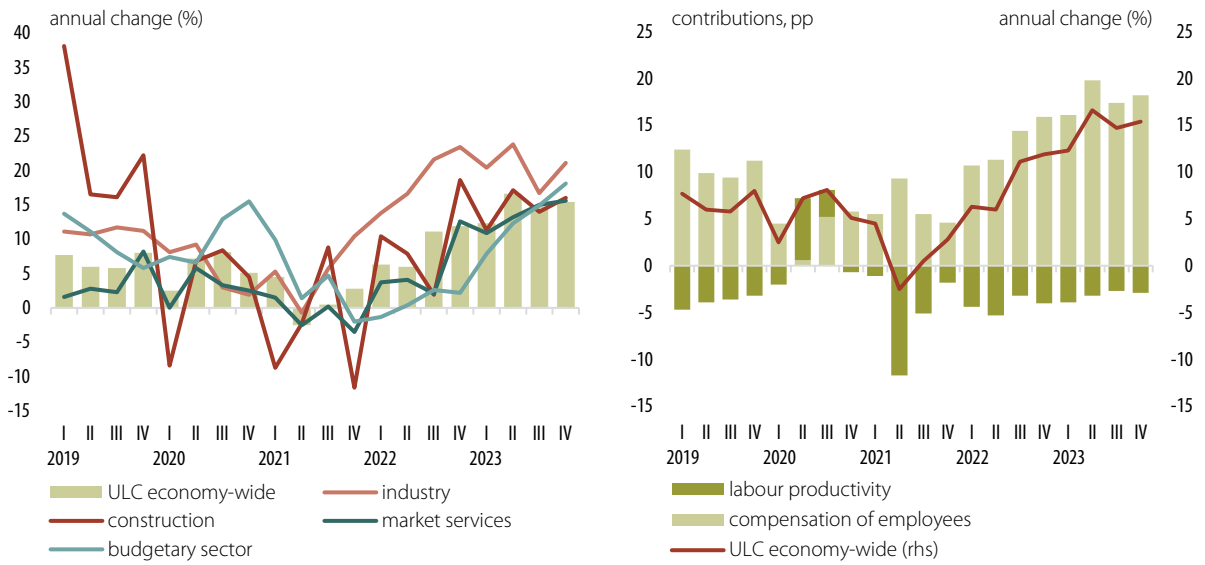
In January-February 2024, agricultural producer prices continued to exhibit negative annual rates of change, slightly more pronounced than in the previous quarter (-18.9 percent versus -16.6 percent in 2023 Q4), Chart 2.14. The same as in the preceding period, the main contribution came from vegetal products (-24.7 percent), following a steep decline in prices for grains and industrial plants (down to -36 percent), owing also to some base effects. The annual growth rates of vegetable prices gained

momentum, especially for onions, possibly due to the lack of storage facilities, as well as to the supply shortages on the external market. At the same time, the lower production costs (animal feed, utilities) fuelled the decrease in the annual change in prices for animal products (-3.2 percentage points to 1.7 percent).

Unit labour costs

The annual dynamics of unit labour costs economy-wide rose again in 2023 Q4 to reach 15.4 percent (compared to 14.7 percent in the previous quarter), owing to all major sectors (industry, construction, market services). The faster increase in compensation per employee (18.5 percent, +0.9 percentage points compared to 2023 Q3) was accompanied by a near-stagnation of labour productivity growth rate (2.7 percent), with the persistence of the considerable gap between the two indicators being further conducive to inflationary pressures from labour costs (Chart 2.15).

Chart 2.15. Unit labour costs



Source: NIS, NBR calculations

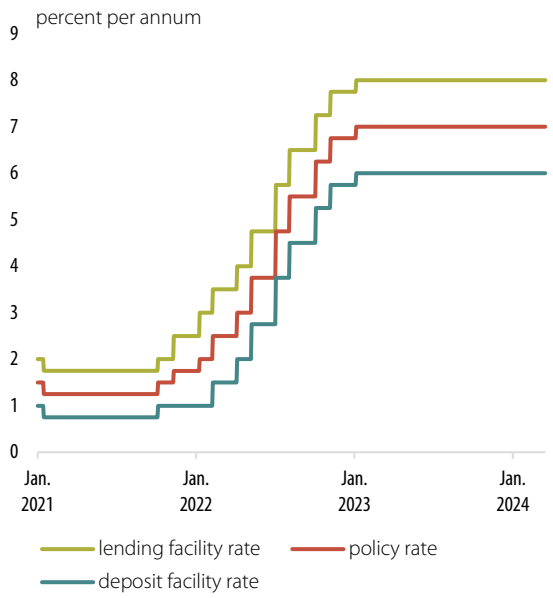
In industry, the annual growth rate of unit wage costs stepped up to 18.1 percent in 2023 Q4, before returning to 17 percent in January-February 2024. Domestic industrial activity continued to face difficulties amid the lack of traction from external demand, while wage dynamics remain significant, despite witnessing a slight downward adjustment January through February 2024. Most industries reported a slowdown in the pace of increase in unit wage costs in early 2024, but there were exceptions as well. Faster changes in unit wage costs (to over 20 percent) were visible in some export-oriented sub-sectors, such as the automotive industry, the manufacture of electronic products and machinery and equipment. Beverages and tobacco products also posted swifter growth rates, and, to a lesser extent, the chemical industry – in the latter case, the production has recovered as of late, but wages have also increased, possibly due to the resumption of activity of some of the employees who had been on furlough until recently.

3. Monetary policy and financial developments

1. Monetary policy

In February and April 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 February were taken in a context in which the annual inflation rate had decreased further in December 2023 and during 2023 Q4 overall, remaining however considerably above the variation band of the target, while the new assessments had reconfirmed the outlook for it to pick up at the onset of 2024 and resume its decline at a slower pace compared to 2023 and to the earlier forecast.

Specifically, the 12-month inflation rate fell to 6.61 percent in December 2023, i.e. below the forecast, from 8.83 percent in September, decreasing at a faster-than-anticipated pace in 2023 Q4. This occurred as the dynamics of food and energy prices continued to decelerate at a relatively swift tempo, while the faster growth rate of fuel prices on account of a base effect was fully counterbalanced, in terms of impact, by the slowdown in the growth rates of administered prices and tobacco product prices.

In turn, the annual adjusted CORE2 inflation rate saw its downward trend steepen more than expected. It went down to 8.4 percent in December 2023 from 11.3 percent in September, 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[19], but also in the context of moderating consumer demand and the slower dynamics of import prices. The action of these factors was only to a low extent mitigated by the pass-through into some services prices of higher costs triggered by the hike in the minimum gross wage in 2023 Q4, as well as by the temporary worsening of short-term inflation expectations[20].

At the same time, the new medium-term forecast reconfirmed the outlook for the annual inflation rate to pick up at the onset of 2024 and resume its decline at a slower pace compared to 2023 and to the earlier forecast. Specifically, after probably climbing in January to a lower-than-previously-projected level, the annual inflation rate was expected to go down more slowly afterwards[21] and to fall to the upper bound of the variation band of the target no sooner than at end-2025 – visibly later than in the November 2023 forecast, which had seen it drop to 3.3 percent in September 2025.

Behind the temporary step-up in January 2024 stood primarily the impact exerted by the increase and introduction of some indirect taxes and charges aimed at furthering budget consolidation. The impact was particularly manifest in the fuels and tobacco products segments and to a lower extent in core inflation. However, the overall action of supply-side factors was to become disinflationary again afterwards, but almost exclusively over the short term and with a gradually abating strength, amid the softening influences expected from base effects and downward adjustments of commodity prices. Moreover, the balance of risks to the inflation outlook stemming from these factors remained tilted to the upside both in the short run and over the longer horizon. This was due to the potential direct/indirect effects from the measures underpinning budget consolidation, as well as to the uncertainties associated with the capping of the mark-ups on basic food products and of electricity and natural gas prices.

Furthermore, underlying inflationary pressures were seen persisting throughout the forecast horizon and abating much more gradually than previously anticipated, given the prospects for the very slow contraction of excess aggregate demand and its remaining significant at end-2025[22], compared with the prior forecast that had seen the output gap enter negative territory in 2024 Q4 already. In turn, the increase in unit labour costs in the private sector was expected to moderate only mildly during the current year, remaining relatively more alert.

At the same time, heightened uncertainties and risks were associated with the future fiscal and income policy stance, stemming in the short run from the public sector wage dynamics and the full impact of the new law on pensions. Conversely, over the

19 Amid the extension until 31 January 2024 of the measure to temporarily cap the mark-ups on basic food products and the broadening of its scope.

20 Under the circumstances, considerable, albeit on the wane, disinflationary influences continued to come from processed food prices, while the price dynamics of non-food and services sub-components posted declines in 2023 Q4, after an almost continuous upward trend for more than two years.

21 The annual inflation rate was expected to decline to 4.7 percent in December 2024, only marginally below the prior forecast.

22 Having as underlying premises the prospects for a more pronounced acceleration of economic growth in 2024 and 2025 than in previous forecasts, amid the slowdown in inflation and the recovery of external demand, as well as in the context of the fiscal policy stance given the new law on pensions and of the broader use of European funds under the Next Generation EU instrument.

longer term, they referred to the fiscal and budgetary measures that could be implemented to put the budget deficit onto a sustainable downward path, compatible with the requirements of the excessive deficit procedure and with the conditionalities attached to other agreements signed with the EC.

Nevertheless, significant uncertainties and risks to the outlook for economic activity, implicitly the medium-term inflation developments, also continued to arise from the war in Ukraine and the Middle East conflict, alongside the economic performance in Europe, as well as from the absorption of EU funds, especially those under the Next Generation EU programme.

According to subsequently-released statistical data, the annual inflation rate went up in January 2024 to 7.41 percent, in line with forecasts, whereas in February it declined to 7.23 percent. The advance against the end of 2023 was mainly attributable to the sharp increase in the annual dynamics of electricity prices under the impact of a base effect, as well as to the pick-up in the prices of fuels and tobacco products amid the hike in excise duties and higher crude oil prices.

At the same time, the annual adjusted CORE2 inflation rate continued to decrease January through February 2024, albeit at a slacker pace than in the previous two quarters, falling to 7.6 percent in February, amid the slowdown/near-stagnation of the decrease in dynamics for processed food and market services. Specifically, the deceleration of core inflation continued to reflect, during this period, the disinflationary influences, albeit on the wane, stemming from base effects, downward adjustments in agri-food commodity prices and the measure to temporarily cap the mark-ups on basic food products, alongside the impact of the falling dynamics of import prices. A moderate opposite impact had the direct and indirect effects of the fiscal measures implemented at the beginning of 2024 and the higher short-term inflation expectations, as well as the new increases in wage costs recorded towards the end of the previous year, which were passed through, at least in part, into the prices of some services and goods, *inter alia* amid the rebound in private consumption.

Economic activity weakened much more than anticipated in 2023 Q4, contracting by 0.5 percent versus the previous three months, after a 1.0 percent increase in Q3, which made it likely for excess aggregate demand to narrow more visibly over this period compared to expectations in February 2024. Conversely, annual GDP growth rose to 3.0 percent in 2023 Q4[23], with household consumption making a significantly larger contribution than in the previous quarter, although still trailing behind the major contribution further recorded from gross fixed capital formation. The contribution of net exports saw, however, a renewed strong contraction in 2023 Q4, given that the annual change in the imports of goods and services rebounded, re-entering positive territory and thus outpacing that of exports. Against this background, the trade deficit and the current account deficit posted an annual increase in 2023 Q4 – after three quarters of decline – which, in the latter's case, was amplified by the marked worsening of the primary income balance, on account of developments in reinvested earnings and distributed dividends.

[23] From 1.9 percent in the previous quarter.

On the labour market, the latest data and surveys confirmed the easing of market tensions in 2023 Q4 – given *inter alia* the notable fall in the job vacancy rate –, while sending out mixed signals on the developments in the specific parameters in 2024 Q1 and possibly in the near future. Thus, the ILO unemployment rate advanced slightly at the beginning of 2024[24], whereas the number of employees economy-wide resumed its monthly increase in December 2023 and went up at a similar pace in January 2024. Moreover, employment intentions over the very short horizon saw an upturn in February-March 2024, while the labour shortage reported by companies widened in 2024 Q1 overall, on account of developments in services and construction. At the same time, the double-digit annual dynamics of the average gross nominal wage posted a renewed pick-up in 2023 Q4 – mainly under the impact of the rise in the gross minimum wage economy-wide – and the growth rate of unit labour costs saw a re-acceleration over the same period, both economy-wide as well as in industry, where it increased in January 2024 too.

On the financial market, the main interbank money market rates remained relatively stable in February and in the first part of March, but then posted new mild declines, whereas long-term yields on government securities stayed on a markedly upward, yet strongly fluctuating path, similarly to developments in advanced economies and in the region. This occurred amid the revision and subsequent consolidation of investor expectations for the timing and magnitude of interest rate cuts by the Fed, with an impact on global risk appetite as well.

Against this background, the EUR/RON exchange rate stuck in February to the higher readings reached in mid-January, but then witnessed a slight downward correction, returning and stabilising in March close to the values prevailing in 2023 Q4. Moreover, in relation to the US dollar, the leu depreciated further until mid-Q1, before recovering some of the lost ground, *inter alia* amid developments in the EUR/USD exchange rate on international financial markets.

The annual growth rate of credit to the private sector re-embarked on a downward course at the beginning of 2024, falling to 4.9 percent in February from 6.4 percent in December 2023, amid developments in loans to non-financial corporations, whereas the dynamics of household credit picked up further, albeit from a very low level. Under the circumstances, the share of leu-denominated loans in credit to the private sector widened to 68.7 percent in February 2024[25].

The assessments updated in this context showed that the annual inflation rate would continue to decline over the following months, at a slower pace compared to 2023 and on a slightly higher path than that anticipated in the February 2024 medium-term forecast.

The decrease would be further driven to a large extent by supply-side factors, whose disinflationary action was expected to weaken however gradually, amid the softening

24 After three quarters of relative stagnation at an average 5.6 percent level.

25 From 68.4 percent in December 2023.

influences from base effects and from downward corrections of commodity prices, especially of agri-food items. The disinflationary action was anticipated to be moderated in the near run by the steeper upward path of fuel price dynamics, also in relation to the previous forecast, due to the larger-than-expected increase in oil prices over the past months.

Moreover, the balance of risks to the inflation outlook stemming from supply-side factors remained tilted to the upside, given the fiscal measures implemented recently, but possibly also in the future, for underpinning the budget consolidation process, as well as the measure for capping the mark-ups on basic food products, extended until end-2024, but also the potential future evolution of crude oil prices, *inter alia* amid geopolitical tensions.

At the same time, underlying inflationary pressures were anticipated to be only somewhat more modest than in the prior forecast and slightly increasing in the near run, as the new assessments indicated more solid quarterly increases in economic activity in the first part of 2024 than envisaged earlier, implying a mild widening of the positive output gap during this period, after the above-expectations contraction in 2023 Q4[26]. Furthermore, near-term prospects pointed to swifter-than-previously-projected dynamics of unit labour costs[27].

In addition, the budget execution in the first two months of the year, as well as the public sector wage dynamics and the implications of the new law on pensions compounded in the short run the uncertainties and risks associated with the future fiscal and income policy stance.

Uncertainties and risks to the outlook for economic activity, implicitly the medium-term inflation developments, also continued to arise, nevertheless, from the war in Ukraine and the Middle East conflict, as well as from the economic performance in Europe, particularly in Germany.

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 4 April 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.

26 The annual GDP growth rate was, however, expected to decline against the level reached in 2023 Q4.

27 Conversely, sizeable disinflationary influences were anticipated to stem from the slacker growth rate of import prices and the gradual downward adjustment of short-term inflation expectations.

2. Financial markets and monetary developments

During 2024 Q1, the daily average interest rate on interbank transactions[28] continued to fluctuate slightly, while longer-term rates on the interbank money market witnessed new mild declines in January and towards end-March. The EUR/RON exchange rate climbed at the onset of the quarter and stuck for several weeks to higher readings, but then saw a slight downward correction, returning and stabilising close to the levels prevailing in 2023 Q4. The annual growth rate of liquidity across the economy quasi-halted its upward path January through February 2024, while that of credit to the private sector resumed the downward course.

2.1. Interest rates

The daily average interest rate on interbank money market transactions followed a relatively fluctuating path in 2024 Q1 as well, falling more markedly below the lower bound of the interest rate corridor in the first part of the period. Thus, its quarterly average[29] continued to decline slightly, shedding 0.07 percentage points versus the previous quarter, to 5.89 percent.

Behind these developments stood the behaviour of shorter-term rates, of up to one week, amid the particularly wide liquidity surplus on the money market[30], which the central bank further mopped up via the deposit facility[31].

In turn, the 3M-12M ROBOR rates witnessed new mild declines in January and towards end-Q1 – probably also amid credit institutions' expectations on the outlook for the NBR's key rates –, remaining however relatively constant in February and for most of March. Their quarterly averages, nevertheless, went down slightly more visibly than in the prior quarter, reaching 6.11 percent for the 3M rate (down 0.21 percentage points), 6.14 percent for the 6M maturity (down 0.24 percentage points) and 6.15 percent for the 12M rate (down 0.33 percentage points)[32] (Chart 3.2).

On the government securities market, the developments in government bond yields in advanced economies remained, however, the prevailing factor of influence, especially for long maturities, with reference rates on the secondary market[33] posting over this period mixed behaviours across the major maturities (Chart 3.3).

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

29 Weighted by the volume of transactions.

30 It expanded more steeply in January, under the impact of increased liquidity injections by the Treasury, and then shrank significantly, despite sticking to high values.

31 The average daily stock of these deposits increased to lei 50.9 billion January through March 2024 overall, from lei 40.5 billion in the previous quarter.

32 Marking seven-quarter lows.

33 Bid-ask averages.

Chart 3.2. Policy rate and ROBOR rates

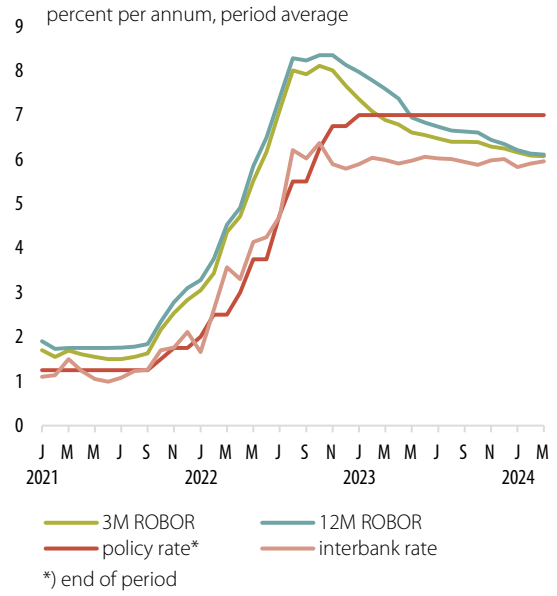
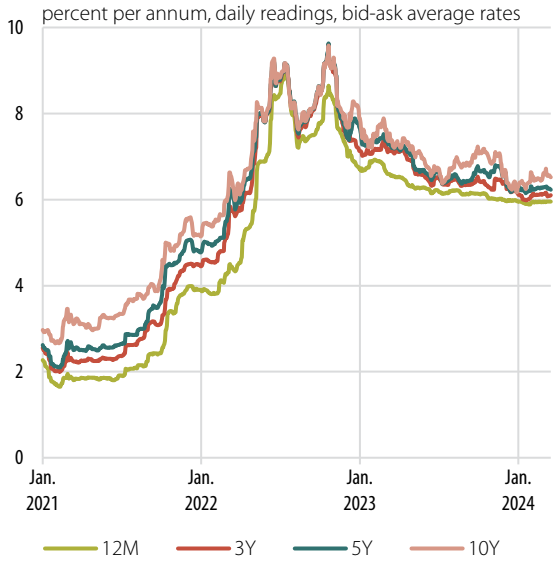


Chart 3.3. Reference rates on the secondary market for government securities



Specifically, 10-year rates re-embarked in January and remained over the next two months on a markedly upward, yet strongly fluctuating path – similarly to developments in the US, euro area and in the region –, amid the revision and subsequent consolidation of investor expectations for the timing and magnitude of interest rate cuts by the Fed[34]. Medium-term rates (5 years) also witnessed fluctuations in the first part of the quarter, albeit modest, and then rose gradually, stabilising towards the end of the period slightly above the end-2023 readings. Conversely, rates at the shorter end of the maturity spectrum (3 years and 6-12 months) continued to decline gradually until the first part of February and, after a mild increase recorded subsequently, stayed below the end-Q4 values. Therefore, the monthly averages of the rates saw a renewed slight advance in March compared to the closing month of the previous quarter for the 10-year maturity (up 0.08 percentage points, to 6.54 percent), but shrank further across the other maturities – more visibly for the 3- and 5-year maturities (to 6.11 percent and 6.27 percent respectively) and marginally for 6- and 12-month securities (to 5.94 percent in both cases). Against this backdrop, the yield curve saw its positive slope steepen again.

The average accepted rates on the primary market[35] recorded relatively similar developments. Specifically, they increased mildly in March against the December readings for the 7- and 10-year maturities (to 6.58 percent and 6.54 percent respectively), yet dropped visibly for 3- and 5-year securities (to 6.13 percent and 6.37 percent respectively) and stayed almost still for the 6-month maturity (at 6.02 percent). The appetite for this type

34 Given the higher-than-expected dynamics of economic activity and inflation in the US, shown by the new data, but also the signs of prudence from the Fed.

35 During Q1, the "Tezaur" programme saw the monthly issuance of government securities with 1- and 3-year maturities, at rates of (i) 6.10 percent and 7.10 percent respectively in January, (ii) 6.10 percent and 7.00 percent respectively in February, and (iii) 6.00 percent and 6.75 percent respectively in March. Moreover, in February, the MF issued government securities for households under the "Fidelis" programme, both in domestic currency, with 1- and 3-year maturities, at rates of 6.00 percent and 6.75 percent respectively, worth around lei 850 million, and in euro, with 1- and 5-year maturities, at rates of 4.00 percent and 5.00 percent respectively, totalling about EUR 190 million. In addition, in January the MF issued on the external market USD-denominated Eurobonds with 5- and 10-year maturities, at rates of 6.00 percent and 6.50 percent respectively, totalling USD 4.0 billion. In February it issued green Eurobonds, with a 12-year maturity and at a 5.73 percent rate, worth EUR 2.0 billion and 7-year Eurobonds at a 5.4 percent rate, worth EUR 2.0 billion, both issues being denominated in euros.

of investments remained strong during the quarter, even amid the temporary sell-off that affected the local market as well in January[36]. During the period overall, the total volume of securities issued added lei 7.0 billion against the previous three months, to lei 28.5 billion, while the value of net issues increased by lei 15.7 billion, to lei 26.1 billion, given the sizeable drop in the volume of maturing securities.

The average interest rate on new loans to non-bank clients went up in January-February 2024 after three quarters of decrease (+0.19 percentage points versus the previous three months, to an average of 8.97 percent), but primarily as a result of the changed composition of the credit flow, whereas the remuneration of new time deposits stuck to the slowly downward path, shedding 0.19 percentage points to 5.52 percent (Chart 3.4).

Chart 3.4. Bank rates

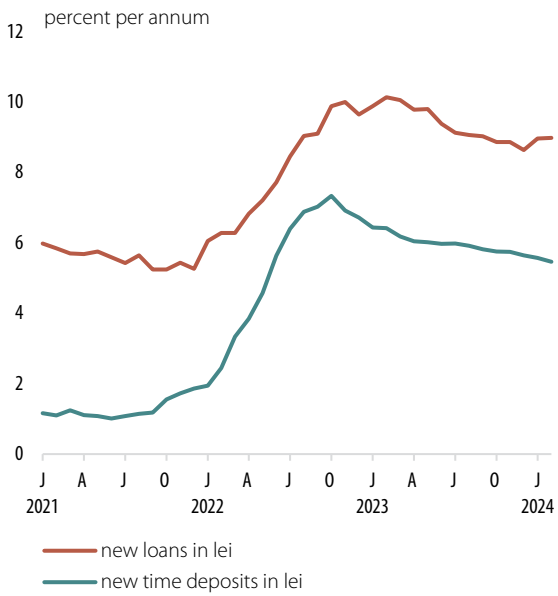
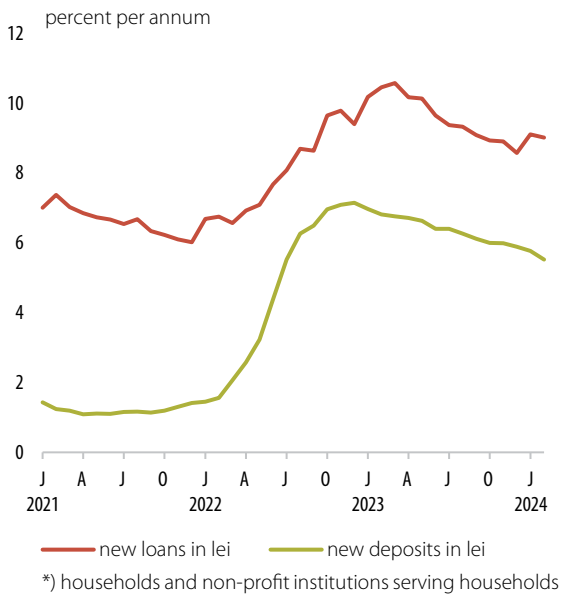


Chart 3.5. Interest rates for households*



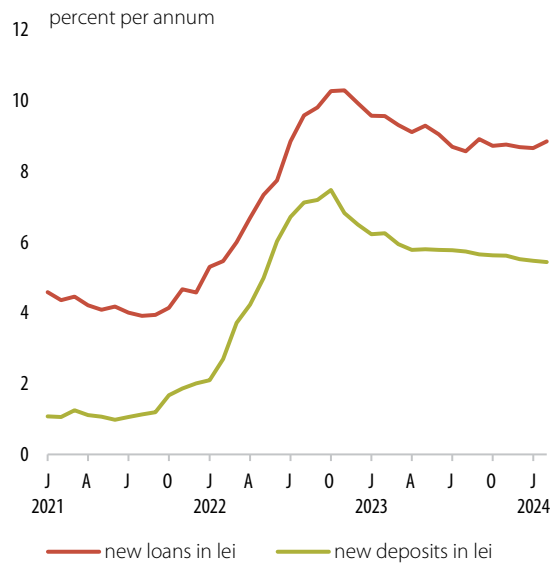
From a sectoral perspective, average interest rates posted mixed changes in the case of new loans, yet moved in the same direction for new time deposits. Specifically, after declining for three quarters, the average interest rate on new loans to households increased January through February overall (+0.25 percentage points from a quarter earlier, to an average of 9.07 percent). Yet, this was mainly due to the larger share of new consumer loans in total, *inter alia* amid the step-up in renegotiation operations in the case of this category as well (Chart 3.5). Their average interest rate regained only slight momentum (+0.06 percentage points, to 11.63 percent), while that on new housing loans stayed practically unchanged at 6.89 percent.

At the same time, the average interest rate on new loans to non-financial corporations witnessed a quasi-standstill as an average during this period, for the second

36 During Q1 overall, both the ratio of the amounts of bids submitted by primary dealers to the announced volume at MF auctions and the ratio of the volume of issues to the announced volume by the MF rose versus the previous three months (to 2.26 from 2.02 and to 1.50 from 1.28 respectively).

consecutive quarter, at 8.77 percent, amid new diverging developments across the major types of loans. Specifically, the average interest rate on high-value loans (above EUR 1 million equivalent) added 0.22 percentage points, to 8.58 percent, whereas that on low-value loans (below EUR 1 million equivalent) declined, albeit more moderately, i.e. -0.10 percentage points, to 8.85 percent (Chart 3.6).

Chart 3.6. Interest rates for non-financial corporations

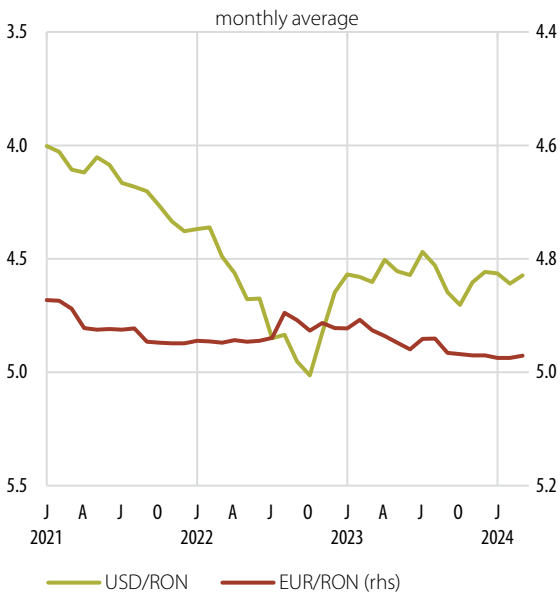


Looking at new time deposits, the average remuneration continued to decrease however, at a somewhat brisker pace for households (-0.31 percentage points versus 2023 Q4, to 5.65 percent), but more slowly in the case of non-financial corporations (-0.13 percentage points, to 5.46 percent).

2.2. Exchange rate and capital flows

The EUR/RON exchange rate climbed at the onset of the current year and stuck for several weeks to higher readings, but then saw a slight downward correction, returning and stabilising in March close to the levels prevailing in 2023 Q4 (Chart 3.7).

Chart 3.7. Nominal exchange rate



The EUR/RON witnessed a small leap in mid-January 2024 and pressures on the exchange rate remained high afterwards, amid the sell-off entailed during this period, also on financial markets in the region, by the decline in the global risk appetite, under the impact of the new revision of investor expectations on the outlook for the major central banks' key rates[37]. The evolution was broadly synchronised with that of the exchange rates against the euro of the major currencies in the region, which went up even more markedly, under the influence of some local factors as well.

The EUR/RON exchange rate stuck in the first 10-day periods of February to the higher readings reached previously, amid a new episode of deterioration in global financial market sentiment generated by expectations on the outlook for the Fed's policy

37 Financial investors reconsidered their expectations on the forthcoming launch of the policy rate cutting cycle by major central banks, given the signals conveyed by the latter, but also the resilience of the US economy confirmed by the new statistical data.

rate[38,39]. Then, it witnessed a slight downward correction, reverting and stabilising in March close to the values prevailing in 2023 Q4. This behaviour reflected primarily the influences from the reconsideration by investors of the probable paths of major central banks' key rates – resulting *inter alia* in the EUR/USD exchange rate re-entering an upward path. To these added the still high relative attractiveness of investments in domestic currency, also amid improved expectations on the evolution of the EUR/RON exchange rate (Table 3.1).

Table 3.1. Key financial account items

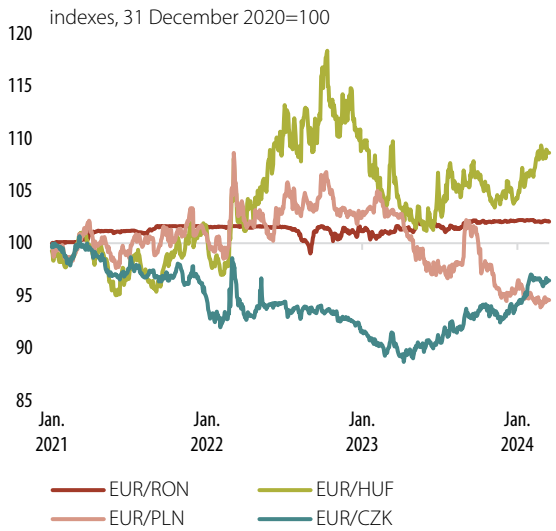
EUR million

	2 mos. 2023			2 mos. 2024		
	Net acquisition of financial assets*	Net incurrence of liabilities*	Net	Net acquisition of financial assets*	Net incurrence of liabilities*	Net
Financial account	8,608	10,435	-1,827	5,461	8,411	-2,950
Direct investment	804	2,159	-1,355	200	1,425	-1,225
Portfolio investments	-711	8,722	-9,432	-41	6,702	-6,743
Financial derivatives	83	0	83	56	0	56
Other investment	2,970	-445	3,415	1,899	284	1,615
– currency and deposits	2,756	-405	3,160	2,040	-465	2,505
– loans	124	-382	506	-33	770	-804
– other	91	341	-251	-108	-22	-86
NBR's reserve assets, net	5,461	0	5,461	3,347	0	3,347

*) "+" increase/"-" decrease

Looking at forex markets in the region, developments were however mixed during this period. Specifically, the exchange rate of the Czech koruna versus the euro stuck to an upward course until mid-February and tended to remain stable afterwards, while that of the forint rose almost steadily until the first part of March, whereas that of the zloty embarked in February on a downtrend that extended until towards mid-March (Chart 3.8).

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



Source: ECB, NBR

In relation to the US dollar, the leu halted its appreciation in January and started a weakening trend, which extended into mid-Q1, before recovering some of the ground lost, *inter alia* amid the evolution of the EUR/USD exchange rate on international financial markets.

During Q1 overall, the interbank forex market turnover stayed high from a historical perspective, diminishing however slightly from the previous quarter, while the overall foreign currency deficit widened to a two-year high.

During this period, the leu saw its value remain unchanged against the euro in nominal terms[40,41] and continued to strengthen in real terms (by 0.4 percent). In relation to the US dollar, the domestic currency weakened 0.3 percent in nominal terms[42] and appreciated marginally in real terms.

38 In the context of signs of prudence from the Fed as regards the timing and magnitude of interest rate cuts, alongside the higher-than-expected dynamics of economic activity and inflation in the US, shown by the new data.

39 Against this background, the EUR/USD remained on the downward path it had embarked on at end-2023, touching a three-month low in mid-February (USD 1.071 per euro).

40 Based on the March 2024 and December 2023 EUR/RON exchange rate averages respectively.

41 During the same period, the forint and the Czech koruna depreciated 3.4 percent and 3.2 percent respectively against the euro, whereas the zloty strengthened 0.6 percent.

42 After having strengthened 2.0 percent in the previous quarter.

Looking at the average annual exchange rate dynamics in 2024 Q1, the leu saw a slightly faster pace of depreciation against the euro, while halting its appreciation vis-à-vis the US dollar.

2.3. Money and credit

Money

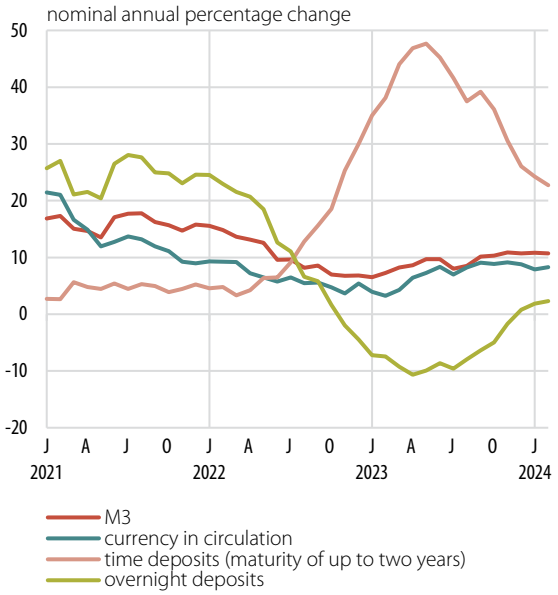
The annual dynamics of broad money (M3) nearly discontinued their upward path in January-February 2024, standing at an average of 10.8 percent (10.6 percent in 2023 Q4). This occurred as the effects of budget execution in this period were almost fully offset by the worsening of the balance on trade in goods and services and the decline in the rate of change of credit to the private sector (Table 3.2).

Table 3.2. Annual growth rates of M3 and its components

	nominal percentage change					
	2023				2024	
	I	II	III	IV	Jan.	Feb.
	quarterly average growth					
M3	7.3	9.3	8.9	10.6	10.8	10.7
M1	-5.1	-5.6	-4.0	0.8	3.5	3.9
Currency in circulation	3.8	7.4	8.1	8.9	7.9	8.3
Overnight deposits	-8.0	-9.7	-8.0	-2.0	1.9	2.3
Time deposits (maturity of up to two years)	39.1	46.6	39.4	30.9	24.3	22.7

The near standstill of the growth rate of broad money, albeit at a two-digit level, was the result of the diverging developments of the main M3 components, which nevertheless improved somewhat in this period. Specifically, the annual dynamics of narrow money (M1) further increased in the period under review, although more slowly than in the previous quarter, amid the significantly slacker advance in the rate of change of leu-denominated overnight deposits[43], as well as the deceleration in the growth rate of currency in circulation, for the first time in three quarters. Their impact was only partly counterbalanced by the faster narrowing of the decline in foreign currency-denominated overnight deposits (Chart 3.9).

Chart 3.9. Main broad money components



By contrast, time deposits with a maturity of up to two years significantly reduced their particularly fast dynamics once again, only slightly less than in the previous quarter. This was mainly due to the further deceleration of domestic currency deposits – albeit at a slower pace than in 2023 Q4 –, but also to the sizeable decrease, for the second quarter in a row, in the rate of change of the foreign currency component (expressed in EUR). However, the share of M1 in M3 continued to narrow compared to the last month of the previous quarter, reaching 59.7 percent in February, from 61.3 percent in December 2023.

43 Particularly on the back of non-financial corporations' deposits.

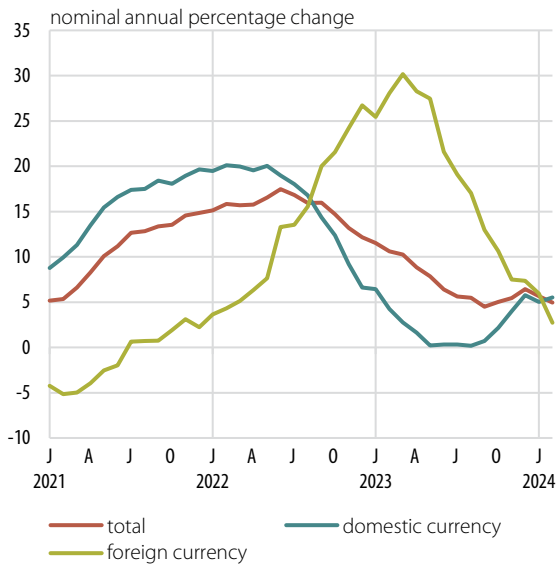
The breakdown by holder shows that the virtual status quo of M3 dynamics was also ascribable to heterogeneous developments. Specifically, the annual growth rate of M3 deposits of non-financial corporations continued to pick up, while somewhat more slowly, mainly on the back of higher disbursements from the government budget[44] and of the considerable increase in the turnover volume of retail trade. By contrast, the dynamics of similar household deposits almost halted their step-up, in correlation with the strong rebound in purchases of goods, yet amid the rate of increase of real disposable income declining only marginally and consumer credit posting a faster growth, as well as amid the lower dynamics of this sector's investments in government securities.

From the perspective of M3 counterparts as well, the developments in broad money dynamics reflected the opposite influences in this period. Thus, on the one hand, the growth rate of net credit to the central government surged to a notable positive value, while on the other hand, the dynamics of the banking system's net foreign assets[45] declined significantly and the rate of change of credit to the private sector moderated.

Credit to the private sector

The annual dynamics of credit to the private sector resumed their downtrend in January 2024, decreasing to 5.3 percent in the first two months overall from 5.6 percent in 2023 Q4, given that the growth rate of leu-denominated loans went up at a slower pace, while that of foreign currency-denominated loans (expressed in EUR) further declined swiftly (Chart 3.10). Against this backdrop, the share of leu-denominated loans in total continued to widen slightly, to 68.7 percent in February from 68.4 percent in December 2023.

Chart 3.10. Credit to the private sector by currency



The mild deceleration in the dynamics of credit to the private sector was solely due to corporate loans, whose annual growth rate resumed its downtrend. Behind this movement stood a new sharp drop in the rate of change of the foreign currency component[46], primarily ascribable to the further significant decline in the dynamics of short-term loans[47,48], likely correlated with the evolution of firms' working capital financing needs, also associated with the corrections of commodity costs.

44 According to general government budget execution data.

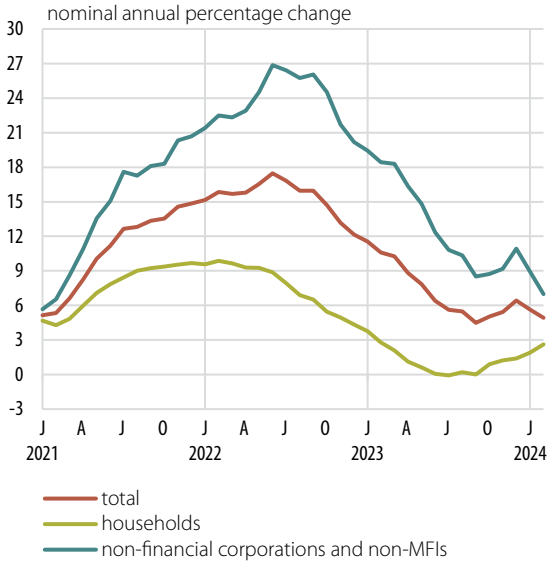
45 Also due to a base effect, associated with the significant increase in commercial banks' foreign assets in January 2023, *inter alia* amid the rise in non-residents' purchases of government securities.

46 Thus returning to a one-digit level for the first time in the past two years.

47 To a slightly negative value, from a two-digit average in 2023 Q4.

48 More modest influences were exerted by the decline, albeit more moderate than in the previous quarter, in the annual dynamics of medium- and long-term loans.

Chart 3.11. Credit to the private sector by institutional sector



At the same time, the rate of change of leu-denominated credit to this sector decreased from December 2023, whereas its average went up at a slower pace compared to the previous quarter, entirely on account of medium- and long-term loans. These saw their growth rate come to a stop, *inter alia* amid the lower contribution of government support programmes[49], whereas the contraction of short-term credit slowed down (Chart 3.11).

Conversely, the pace of increase of household loans continued to pick up slightly, albeit from a very low level, solely due to the leu-denominated component. Behind the latter's new step-up primarily stood consumer credit and other loans, as well as housing loans, given that the flows of both categories of loans maintained or even accelerated their very high annual growth rate[50] in January and February. However, households' foreign currency loans (expressed in EUR) saw their year-on-year contraction deepen, almost solely on the back of developments in housing loans.

49 The "IMM Plus" programme extends the pandemic support measures set under the "IMM Invest Plus" scheme until 30 June 2024. The guarantee ceiling is approximately lei 11 billion (versus a ceiling of lei 24 billion valid for 2023 as a whole).

50 Assessment based on the volume adjusted for renegotiation operations. In the case of new housing loans, the annual dynamics of the flow of credit went up in February to a 2½-year high.

4. Inflation outlook

The annual CPI inflation rate will stay on a downward track over almost the entire projection interval, yet the pace of disinflation is projected to slow markedly, particularly in the latter half of the period. The decline in headline inflation will be driven chiefly by core inflation, which is seen falling throughout the projection interval, yet at a more sluggish pace next year. At the same time, the contribution of exogenous components to CPI inflation will remain virtually unchanged in the course of this year compared to its end-2023 level, before going down in 2025. The path of the annual CPI inflation rate will also be affected by base effects associated with past price changes: favourable influences in 2024 Q3 and 2025 Q1 and unfavourable ones in 2024 Q4, when disinflation is anticipated to reach a near-stalemate. Under these conditions, the indicator is expected to come in at 4.9 percent at end-2024, 3.5 percent at end-2025 and 3.4 percent at the projection horizon, i.e. March 2026. As for the pace of disinflation, the projected evolution envisages a correction of about 2.8 percentage points between March 2024 and March 2025, and of merely 0.4 percentage points over the following 12 months. Compared to the previous projection round, the expected inflation rate was revised upwards by 0.2 percentage points for the end of this year, mainly on the back of a larger contribution of the fuel component and, to a lower extent, core inflation and tobacco products and alcoholic beverages, while the forecast for the end of next year remained unchanged.

Similarly to the previous *Report*, the balance of risks to the annual inflation rate projection is assessed as being tilted to the upside compared to the path in the baseline scenario, reflecting the potential unfavourable impact of new supply-side shocks the likelihood of which has increased amid geopolitical tensions mounting worldwide. On the domestic front, the future fiscal and income policy stance could have diverging consequences on the inflation rate, depending on the future configuration of the fiscal consolidation packages adopted by the authorities. Conversely, against the background of further fragile global economic activity, demand-side risk factors retain a rather disinflationary potential.

1. Baseline scenario

1.1. External assumptions

The economic activity of external partners, as proxied by EU effective GDP, stalled on a quarterly basis at end-2023. Over the short term, economic growth remains contained by the tight financial conditions. Specifically, for 2024 Q1 and Q2, a relatively tepid quarterly growth in external economic activity (EU effective GDP)

Table 4.1. Expected developments in external variables

	annual averages	
	2024	2025
EU effective GDP growth (%)	0.9	1.7
Euro area annual inflation (%)	2.3	2.0
Euro area annual inflation excluding energy (%)	2.8	2.2
Annual CPI inflation rate in the USA (%)	2.7	2.3
3M EURIBOR (% p.a.)	3.5	2.5
USD/EUR exchange rate	1.09	1.11
Brent oil price (USD/barrel)	85.9	80.0

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

is anticipated. Subsequently, its pace is expected to gradually pick up, amid further rises in households' real income (given the still tight labour market, along with lower inflation), public consumption and rebounding external demand. The projected average annual growth rate of EU effective GDP was maintained at 0.9 percent for this year, while for 2025 it was revised upwards from 1.5 percent to 1.7 percent (Table 4.1).

The effective external output gap was reassessed mildly upwards, especially for 2025, amid slightly more favourable prospects. It is projected to reach values close to nil in the run-up to the end of this year, and thereafter, until the forecast horizon, the EU effective output gap will post slightly positive values (unlike in the past *Report*, when the indicator was assessed to stay in negative territory).

The euro area average annual inflation rate was revised downwards for 2024 (-0.3 percentage points from the previous *Report*), due mainly to the energy component, following the recent developments and lower natural gas and electricity prices on wholesale markets. Specifically, the indicator is projected to come in at 2.3 percent this year and at 2 percent next year, down 0.1 percentage points against the preceding *Report*. The swings in the annual inflation rate in the course of 2024 reflect base effects triggered primarily by the energy component. The dynamics of the annual HICP inflation rate will be driven mainly by core inflation, amid easing pressures from supply-side shocks and the pass-through of the impact of the ECB's monetary policy. The annual inflation rate is foreseen to fall below the ECB's 2 percent benchmark in 2025 Q3 (1.9 percent), similarly to the previous forecasting round.

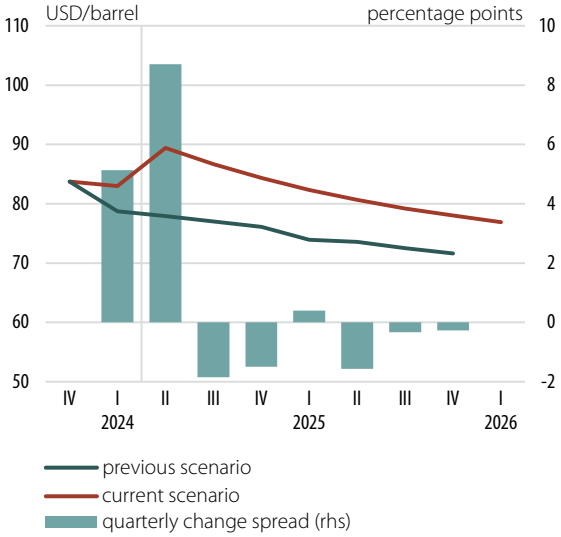
Compared to the past *Report*, the forecast of the euro area HICP inflation rate excluding energy[51] was revised marginally upwards to 2.8 percent (+0.1 percentage points) for 2024 and mildly downwards to 2.2 percent (-0.2 percentage points) for 2025. This indicator is estimated to further outpace the HICP inflation rate by 0.4 percentage points and 0.2 percentage points for this year and next year respectively. The pay rises in the euro area are seen playing an important part in the evolution of the HICP inflation rate excluding energy, amid the still tight labour market. Wage pressures are anticipated, however, to ease over the next two years. In the medium term, profit margins are foreseen to moderate and act as a buffer for the pass-through of labour costs to final prices of goods and services. At the projection horizon, the HICP inflation rate excluding energy is expected to run slightly above headline inflation, at 2.1 percent compared to 1.8 percent.

Having advanced further into positive territory in 2023 Q4 to as high as 4 percent, the nominal 3M EURIBOR rate is foreseen to fall gradually over the projection interval. In turn, the real 3M EURIBOR rate is anticipated to remain in positive territory, edging

[51] A measure of imported inflation in the case of Romania.

higher in 2024 H1 and then lower until the end of the forecast interval. Hence, it will exert a stronger restrictive impact on the euro area economy than that assessed in the previous projection rounds. Acting in this direction are both the upward revision of the nominal 3M EURIBOR rate and the downward revision of the euro area inflation outlook.

Chart 4.1. Brent oil price scenario

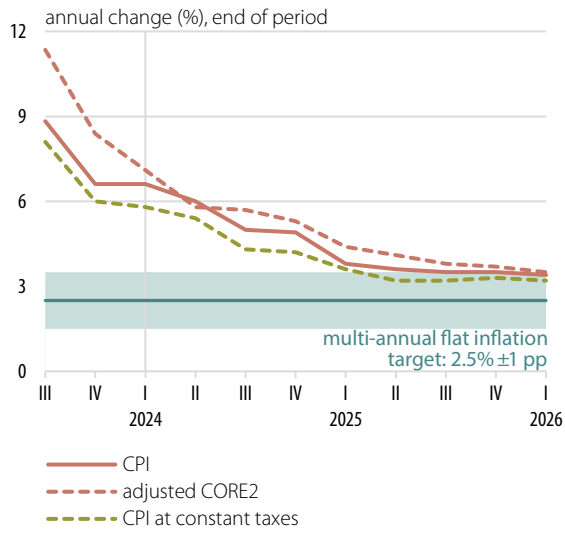


Source: U.S. Energy Information Administration, NBR assumptions based on Bloomberg data

The path of the EUR/USD exchange rate continues to be surrounded by broad uncertainty. In the near term, the euro is seen posting rather steady developments vis-à-vis the US dollar, amid expectations regarding the ECB's and the Fed's monetary policy, ahead of strengthening over the projection interval.

The scenario for the Brent oil price is based on futures prices and foresees a downswing, given the prospective slowdown in global economic activity. Specifically, at the forecast horizon, the Brent oil price is projected at around USD 77/barrel (Chart 4.1). On the demand side, concerns about worsening global economic conditions prevail over the short and medium term, weighing on oil demand as well. On the supply side, the determinants include an expected more robust output of non-OPEC members, on the one hand, and adverse effects of the escalating Middle East conflict, on the other hand. The latter fuels concerns about potential disruptions to oil supplies from the region and the extension of the OPEC agreement to cut production. The oil price projection is thus further fraught with broad uncertainty, also corroborated by the high volatility of the historical data series.

Chart 4.2. CPI and adjusted CORE2 inflation forecasts



Source: NIS, NBR projection

1.2. Inflation outlook

Following a rise in January 2024, in line with the forecast in the previous round, the annual CPI inflation rate resumed its downward path in February, coming in at 6.61 percent in March, i.e. the same level as in December 2023. Behind the evolution of this indicator in 2024 Q1 stood primarily the increase in the dynamics of fuel prices (due to hikes in oil prices and excise duty) and electricity prices (amid some unfavourable base effects), counterbalanced by the decline in the annual adjusted CORE2 inflation rate and in VFE price inflation.

Looking ahead, the annual CPI inflation rate will stay on a downward track over almost the entire projection interval, yet the pace of disinflation is forecasted to slow markedly, particularly in the latter

half of the period (Chart 4.2). Specifically, this indicator is seen declining by about 2.8 percentage points between March 2024 and March 2025, and then by merely 0.4 percentage points over the following 12 months. Under these conditions, the projected values are 4.9 percent for end-2024, 3.5 percent for end-2025 and 3.4 percent at the forecast horizon, i.e. March 2026.

The breakdown shows that the decline in headline inflation will be driven chiefly by core inflation, which is anticipated to fall throughout the projection interval, albeit at a more sluggish pace during 2025. At the same time, the contribution of exogenous components of the CPI basket[52] to headline inflation will remain relatively steady at the end of this year from end-2023 and will shrink by about 0.4 percentage points in 2025, stabilising at around 1.2 percentage points towards the end of the projection horizon. The path of the annual CPI inflation rate will also be shaped by a number of base effects associated with past price changes, i.e. favourable influences in 2024 Q3 (related to price increases for medicines, fuels, non-food items in 2023) and in 2025 Q1 (related to hikes in VAT rates, excise duties, fuel prices as of 1 January 2023), and unfavourable ones in 2024 Q4 (deriving from lower food and fuel prices in 2023 Q4).

Compared to the forecast in the February 2024 *Inflation Report*, the annual CPI inflation rate was revised slightly higher, i.e. by 0.2 percentage points, for the end of this year, mainly due to the faster dynamics of fuel prices and, to a lower extent, of the adjusted CORE2 index and prices of tobacco products and alcoholic beverages. These changes were partly counterbalanced by the downward revision of contributions from administered prices, as well as prices of VFE and electricity. For end-2025, the forecast of the annual CPI inflation rate is the same as in the previous round.

Unlike the CPI, the annual core inflation rate continued its downward trend also during 2024 Q1, dropping from 8.4 percent in December 2023 to 7.1 percent in March 2024. Looking ahead, it is forecasted to decline steadily until the projection horizon, while remaining above headline inflation, except for 2024 Q2. The anticipated correction will be overall gradual and will lose significant momentum, the indicator being expected to shed 2.7 percentage points in the first part of the projection interval (March 2024 – March 2025) and only 0.9 percentage points in the latter half of the interval. Specifically, core inflation is seen falling to 5.3 percent at end-2024, 3.7 percent in December 2025, and 3.5 percent in March 2026, thus reaching the upper bound of the variation band of the target at the projection horizon (Chart 4.2, Table 4.2).

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

annual change (%), end of period

	2024			2025				2026
	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1
Target (mid-point)	2.5	2.5	2.5	2.5	2.5	2.5	2.5	2.5
CPI projection	6.0	5.0	4.9	3.8	3.6	3.5	3.5	3.4
CPI projection*	5.4	4.3	4.2	3.6	3.2	3.2	3.3	3.2
Adjusted CORE2 projection	5.8	5.7	5.3	4.4	4.1	3.8	3.7	3.5

*) calculated at constant taxes

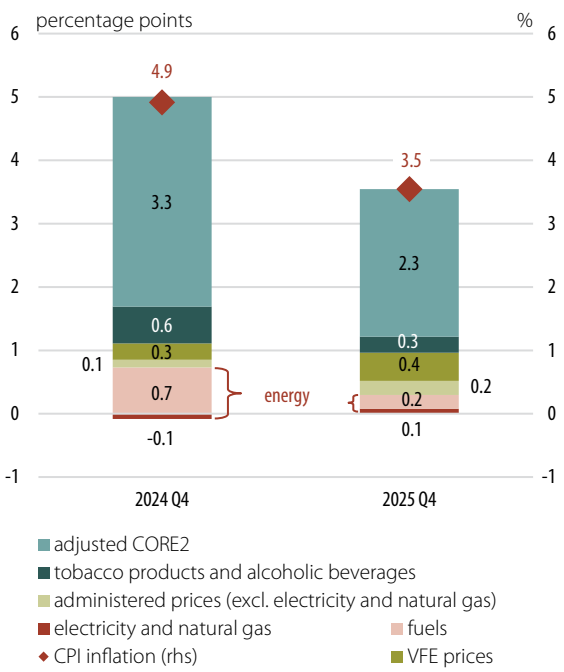
The anticipated evolution of the annual adjusted CORE2 inflation rate will reflect the gradual fading of pressures exerted by the previous hikes in firms' production costs,

52 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.

especially those related to commodities, energy, and transport. The processed food sub-component will continue to benefit from the favourable conditions on the relevant commodity markets. Nevertheless, the pace of disinflation will slow down due to the relatively high dynamics of wage costs, compounded also by the successive increases in the minimum wage, both those implemented of late and those anticipated over the next eight quarters. In fact, pressures from labour costs are also reflected in the strong persistence of services inflation in the recent period, given *inter alia* the large share of wage costs in the total costs of this segment. Other determinants of the slow rate of decline in core inflation will be the output gap, which is seen to stay in positive territory, and inflation expectations, which are forecasted to follow a steadily downward course, remaining however above the variation band of the target. The annual growth rate of import prices is expected to fall in the first part of 2024 and stabilise thereafter, in line with the projected dynamics of euro area HICP inflation excluding energy, an indicator that is higher than the headline HICP inflation.

Compared to the previous *Inflation Report*, the annual core inflation rate was revised mildly upwards throughout the forecast interval. The projected values of the indicator are higher by 0.3 percentage points at the end of this year and by 0.1 percentage points in December 2025. The revision was made due to the higher-than-expected persistence of pressures in the non-food and market services segments.

Chart 4.3. Components' contribution to annual inflation rate*



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

Source: NIS, NBR projection

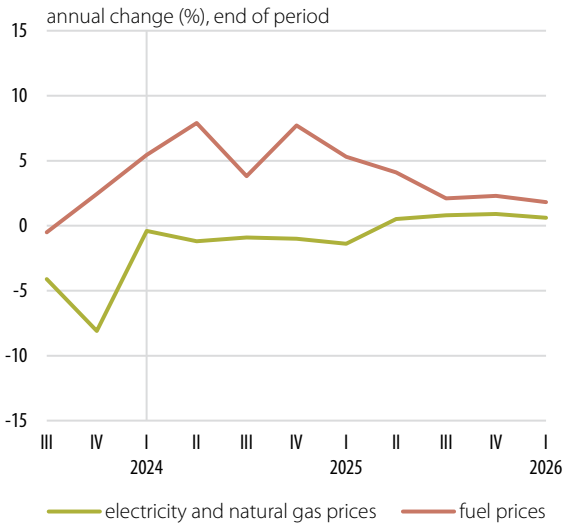
The cumulative contribution of the exogenous components of the consumer basket to the annual CPI inflation rate is projected at 1.6 percentage points at end-2024 (versus 1.7 percentage points in December 2023) and at 1.2 percentage points both in December 2025 and at the projection horizon, i.e. March 2026 (Chart 4.3). Compared to the previous *Report*, the group was subject to marginal corrections (+0.1 percentage points for December 2024 and -0.1 percentage points for December 2025). For December 2024, the swifter growth of fuel prices and the unexpected hike in tobacco product prices are foreseen to be almost fully offset by the more favourable developments in administered prices and electricity prices, but also volatile food prices (VFE).

The annual inflation rate for fuels is forecasted to run above the central target until 2025 Q2 (Chart 4.4, Table 4.3). The projected path is driven, on the one hand, by the actual and expected increases in oil prices[53] and, on the other hand, by the two-step hike (in January and July) in the excise

53 For further details, see Section 1.1. External assumptions.

duty on fuels[54]. Subsequently, the annual inflation rate for fuels will decelerate markedly, running mildly lower than the inflation target as of 2025 Q3, amid the fading-out of the impact of the aforementioned factors and the anticipated slightly downward trend in the oil price. The trajectory was revised upwards compared to the prior *Inflation Report* in the first half of the projection interval, as a result of the less favourable developments in the oil price.

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



Source: NIS, NBR projection

Under the impact of the price capping scheme for household consumers, the annual rate of change of electricity and natural gas prices[55] is forecasted to be negative until the end of March 2025, when the measure expires (Chart 4.4, Table 4.3). The group is afterwards foreseen to follow a moderately upward path, under the assumption of a normal functioning of the relevant markets. Compared to the February 2024 *Inflation Report*, the path of the electricity and natural gas price dynamics was revised downwards, more visibly until March 2025, as a result of the updated technical assumptions on the electricity component[56].

Table 4.3. Inflation of exogenous CPI components

annual change (%), end of period

	Dec. 2023	Dec. 2024	Dec. 2025	Mar. 2026
Energy prices	-3.2	3.6	1.7	1.2
Fuel prices	2.4	7.7	2.3	1.8
Electricity and natural gas prices	-8.1	-1.0	0.9	0.6
VFE prices	6.7	4.4	7.5	8.2
Administered prices (excl. electricity and natural gas)	14.3	2.0	3.6	3.6
Tobacco products and alcoholic beverages prices	8.3	7.9	3.4	3.4

Source: NIS, NBR projection

After the fading-out of the base effect associated with the substantial price increase of prescription medicinal products in August 2023, which resulted in the double-digit dynamics of administered prices, other than electricity and natural gas[57], in the first part of 2024, the exogenous scenario for this group foresees a significant slowdown, via favourable base effects, to single-digit values over the remainder of the projection interval (Chart 4.5, Table 4.3). Compared to the previous *Report*, the contribution to the CPI inflation is slightly lower at end-2024 and similar in December 2025.

The projected annual pace of increase of volatile food prices (VFE) was adjusted downwards throughout this year, benefiting from the more favourable recent developments in the prices of the

54 Assessed to have a 3.8 percentage point impact on the annual dynamics of fuel prices.

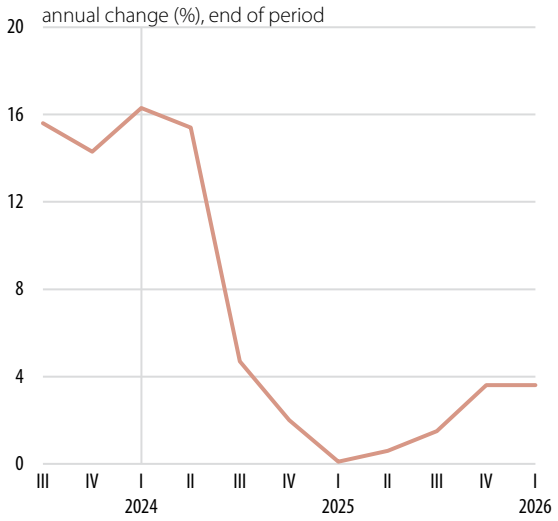
55 According to NIS Press Release No. 37/14 February 2023, electricity and natural gas were re-included in the group of administered price items of the CPI basket, following the changes made to the energy price capping and compensation schemes as of 1 January 2023.

56 The aggregate price calculated by the NIS depends on the household distribution by consumption bracket, which varies over the course of the year.

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

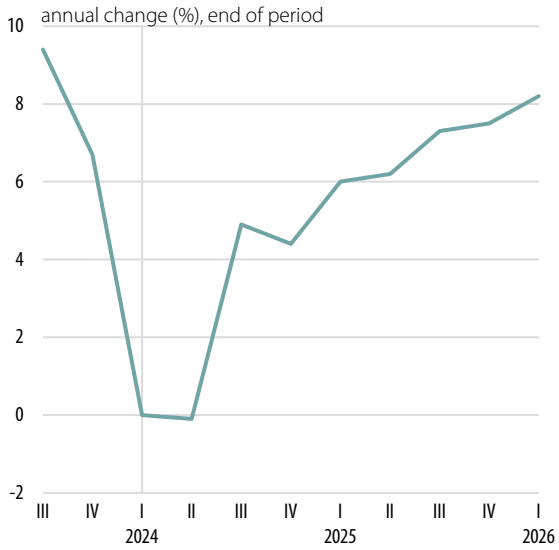
group (Chart 4.6, Table 4.3). Over the remainder of the forecast interval, the expected levels are relatively similar to those previously projected, reflecting the assumption of normal agricultural years[58].

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 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 Q2, before stabilising inside the variation band of the target over the remainder of the forecast horizon (Table 4.3). For this year, the annual pace of increase of the group is influenced by an unexpected price hike in the packet of cigarettes in April, which was not justified by the tax regime. Under the circumstances, the projection for the end of the current year was revised upwards; however, adjustments are marginal for December 2025.

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

The output gap

According to the NIS Press Release No. 86 of 09 April 2024, in 2023 Q4 real GDP witnessed a decline in quarterly terms (-0.5 percent), which was not foreseen in the previous *Report*. On the demand side, exports posted an unanticipated fall, thus leading to a larger-than-expected negative contribution of net exports[59]. While both final consumption and GFCF recorded above-expectations positive dynamics, the residual component (statistical discrepancy and the change in inventories) made a significant negative contribution. Therefore, throughout 2023, real GDP growth went

58 Relative to their multiannual averages.

59 Against this background, in Q4 net exports of goods and services made a negative contribution (-1.8 percentage points) to annual GDP dynamics for the first time in 2023.

down to 2.1 percent, i.e. close to the forecast in the prior *Report*. The GDP advance owed to domestic absorption (among whose components GFCF stood out, as a first in recent years, with its prevailing contribution), whereas net exports made a close-to-nil contribution (with both imports and exports contracting in annual terms)[60].

For 2024 Q1 and Q2, updated short-term forecasts point to a quarterly recovery in economic activity. This reflects the generally favourable signals coming from high-frequency indicators, although some divergences between sectors are discernible. Trade and services are envisaged to expand, these developments being underpinned by the stronger momentum in the corresponding turnover volumes (January-February) and the more optimistic responses to confidence surveys. These are corroborated by the positive dynamics expected for real disposable income (fostered by nominal wage rises, alongside a further slowdown in inflation) and by the generic level of uncertainty, which on the domestic front is assessed to be close to the average level in historical terms. In addition, in 2024 Q1 the ESI (Economic Sentiment Indicator) continued to capture a favourable overview of Romania's economy (along with only a slight improvement of that in the euro area). By contrast, the outlook for industry continues to be somewhat depressed, as suggested by the drop in the domestic industrial production index (similar to euro area developments) during the first two months of 2024 as a whole, by the lower confidence of economic agents operating in this sector, as well as by the further weak external demand[61]. Moreover, the growing restrictiveness of real broad monetary conditions, the expected low pace of employment and a certain retightening of global supply chains[62] are all acting towards a slowdown in economic growth over the short term.

The deceleration of real GDP during the past year mirrored the inflationary environment, with a direct impact mainly on household consumption, to which added the high level of uncertainty from a historical perspective, as well as the weakening of external demand, together with the restrictive effects of the fiscal impulse and the gradual pass-through of past decisions to tighten monetary policy (both globally and domestically). For the current and next year, GDP dynamics are expected to gradually pick up on the back of the fade-out/reversal of the above-mentioned influences, with the exception of those coming from real monetary conditions, which are assessed to maintain their restrictive nature throughout the forecast interval. An additional contribution to economic growth is envisaged to stem from turning European funds from multiple sources to good account, although this process has already recorded some delays in the absorption pace and in the actual use of these amounts within projects[63].

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60 The contribution of the change in inventories, a component with limited economic content, was negative and high throughout 2023, suggesting uncertainties regarding the final composition of GDP growth (which results after the NIS makes all revisions of statistical data).

61 As for the construction sector, it should be noted that the construction works index declined in January 2024 (approximately -36 percent versus December 2023) reaching a historical low. However, it is difficult to explain these developments in the context of other available evidence for this sector, but they may be partly associated with the start of the NIS changing the base for the historical series of monthly indicators (the transition from base year 2015 to 2021). Additional evidence in this regard is brought by the particularly swift recovery of the index in February (monthly dynamics of almost +18 percent).

62 An exacerbation of these tensions cannot be ruled out, in the context of the recent escalation of the Middle East conflict. For further details, see Section 2. Risks associated with the projection.

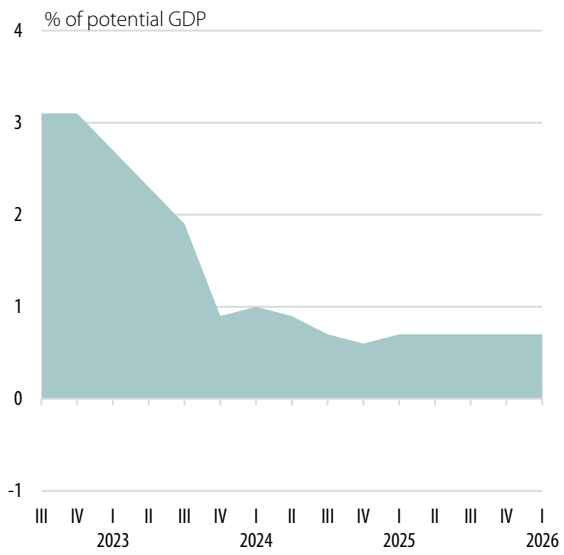
63 The Multiannual Financial Framework 2021-2027, the Next Generation EU programme (2021-2026).

Over the projection interval, the real GDP path is further shaped by domestic demand. Starting this year, final consumption is projected to become again the main driver of economic growth (due to its high share in GDP and its slightly accelerating dynamics in 2024, followed by a steady annual growth), to which adds the contribution of the GFCF increase, which is likely to slow down compared to last year, yet remain robust (under the assumption of European funds absorption, but also foreign direct investment inflows). After the close-to-nil value overall the past year, the contribution of net exports is projected to turn negative again, amid the dynamics of imports of goods and services expected to rebound faster than those of exports.

The average annual dynamics of potential GDP are projected to post robust values over the projection interval, slightly gaining momentum both in the current and following year, mainly due to more substantial capital accumulation (its revision in the recent period also resulting in a slightly upward shift of the indicator's path over the medium term against the previous *Report*).

The remarkable performance of investments over the past few years and their expected further resilient path assign to capital stock the role of key factor of the current and future dynamics of potential GDP. However, the favourable investment evolution is envisaged to slow down, *inter alia* amid gradually more restrictive financial conditions and the impact of the fiscal measures taken by the authorities on the balance sheet of private firms. In this context, both foreign direct investment and European funds will particularly remain the decisive funding sources for GFCF. The total amount of EU funds is likely to be affected by the end of the 2014-2020 programming period[64]; on the other hand, a gradual step-up in inflows under the 2021-2027 Multiannual Financial Framework is anticipated. Investment performance also helps improve the efficient use of resources, which means a notable contribution is made by total factor productivity (the TFP trend)[65]. Conversely, the contribution of labour is foreseen to remain slightly positive, but significantly lower than those of the other two factors, given a relatively slower growth of the number of employees economy-wide and, over the medium term, the persistently unfavourable demographic developments in Romania (in particular, the decline in the working-age population, aged 15 to 74). The adverse effects of uncertainty associated with global geopolitical tensions remain relevant to the potential GDP path.

Chart 4.7. Output gap



Source: NBR assessments based on data provided by the NIS

64 Within this framework, expenses are eligible until end-2023, yet invoices can also be settled throughout 2024. According to the Net Financial Balance, the amounts received in 2024 Q1 under the 2014-2020 MFF decreased by more than 50 percent versus the same year-ago period.

65 The McKinsey *Investing in productivity growth Report* of March 2024 highlights the need to raise investment in areas such as digitization, automation, and artificial intelligence in order to fuel new waves of productivity growth that could also foster the green energy transition and the reconfiguration of supply chains.

After the downward adjustment over the past year (more pronounced especially in Q4, given the temporary contraction in GDP), in 2024 H1 the output gap returns to values close to those in the previous *Report*[66]. The indicator's short-term dynamics are related to the anticipated recovery of GDP, due *inter alia* to developments in private consumption. In a manner similar to the previous assessment, the output gap is slightly declining in 2024 H2. Subsequently, however, also correlated with the outlook for the budget deficit path, there will be almost no further progress in correcting excess demand (Chart 4.7)[67].

From the perspective of output gap fundamentals, the fiscal impulse is expected, similarly to the forecast in the previous *Report*, to contribute to the persistently positive values of the indicator over the course of 2025. Moreover, the negative external output gap is expected to close at the beginning of next year, unlike the prior assessment when this indicator stayed in negative territory for longer. By contrast, monetary policy remains countercyclical throughout the entire forecast interval.

Aggregate demand components

The growth rate of final consumption is projected to slightly accelerate during the current year[68], before stabilising over the remainder of the forecast horizon. These developments are supported by the swift rise in real disposable income, which benefits from both wage increases (reflecting also the measures taken by the authorities to boost income earnings[69]) and the gradual decline in inflation. However, household resources intended for consumption are affected to some extent by the relatively high level of bank lending rates, which impacts both the costs of new loans and, to a lesser extent and only gradually, those of outstanding credit agreements. At the same time, the uncertainties surrounding the medium-term developments in inflation (and implicitly in real disposable income) further arising from the war in Ukraine and the Middle East conflict remain relevant.

Over the forecast interval, gross fixed capital formation is expected to see robust average annual growth rates, higher-than-those of final consumption. However, compared to 2023, the component's dynamics are envisaged to gradually decelerate. The prospects of a strong performance of GFCF are strictly conditional on investor confidence, further EU funds disbursements from multiple sources, the timely implementation and completion by the authorities of the budgeted projects – which would also generate stimulative effects on those carried out in the private sector –, as well as on the pick-up in both domestic and external economic activity. In this context, the Next Generation EU programme plays a key role, yet its progress is expected,

66 Amid the persistent volatility of official statistical data, some adjustments continued to be applied in the assessment of the economy's cyclical position.

67 From the perspective of aggregate demand components, the output gap path is shaped by those of domestic demand (with household individual consumption and GFCF having high contributions), whereas the aggregate gap of net exports is foreseen to be negative (mainly due to that of imports of goods and services).

68 Nevertheless, 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.

69 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.

at least based on the latest developments, to be slow when it comes to the actual implementation of the allocated and transferred amounts. At the same time, the GFCF dynamics could also be affected by potential cuts or adjustments made to investment resources, amid restrictive financial conditions and tax reforms involving a number of increases in corporate taxation. Generally, the implementation of fiscal reforms that are not predictable and reasonable in scope is likely to even cause some reversals of companies' previous investment plans.

Throughout 2024, exports and imports are envisaged to recover, being expected to return to robust annual growth rates. Nevertheless, these flows continue to be marked by the effects of global uncertainty, in particular those referring to the potential further fragmentation of trade relations between countries. They could also be affected by renewed bottlenecks in global supply chains against the backdrop of escalating geopolitical tensions; however, in the baseline scenario, the effects from this source are assessed to be relatively low at the moment. In terms of real monetary conditions, the real effective exchange rate (calculated by deflating by the consumer price indices in Romania and its trading partners) is anticipated to further generate certain restrictive influences on the price competitiveness of Romanian products. After the 2023 decline, imports of goods and services are foreseen to recover, reflecting the rebound in the dynamics of domestic demand components and exports, as well. The annual pace of imports is projected to marginally exceed that of exports, pointing to the resumption of net exports having a negative contribution to GDP growth as of this year.

At end-2023, the current account deficit stood at 7 percent of GDP, receding by 2.2 percentage points compared to 2022. In 2024, the adjustment of the external imbalance is assessed to carry on, but at a considerably slower pace. Subsequently, the external imbalance might remain at high levels, amid a limited capacity of domestic production to accommodate excess demand and as a result of the expected fiscal policy stance. The projected path of external deficit is conditional on the absence of new bottlenecks in global value chains. However, it cannot be ruled out that unfavourable developments in this regard may stem from a potential escalation of geopolitical tensions, with a possible adverse impact on prices of imported goods and, implicitly, on the current account deficit. Conversely, a corrective contribution could come from the implementation of a new fiscal consolidation package in 2025. After having slightly expanded in 2023, the current account deficit coverage by stable, non-debt-creating capital flows is assessed to abate starting with 2024. As for capital transfers, the decrease in European funds reimbursements under the 2014-2020 MFF is only partially counterbalanced by the assumption of improved inflows under the 2021-2027 MFF. With regard to foreign direct investment, although its extremely buoyant dynamics in 2021-2022 have been slowing down, it is expected to remain at robust levels, standing in absolute terms above those in the pre-pandemic period.

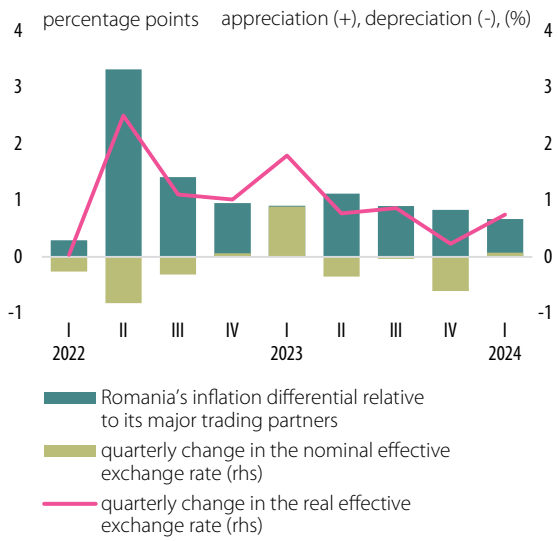
Broad monetary conditions

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 that real broad monetary conditions will continue to be restrictive over the entire forecast interval. This will occur amid a further pass-through into the economy of the monetary policy decisions made by the NBR Board, which aim to help narrow the positive output gap and thus 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.

Looking by component, real interest rates on both new loans and new time deposits in lei have visibly reduced their stimulative influence over the past quarters, with their gaps being anticipated to gradually close, reaching almost neutral values in the second half of the projection interval. This will take place as monetary policy decisions pass through to nominal interest rates, along with a downward trend of inflation expectations. The real effective exchange rate (Chart 4.8) will further generate restrictive effects on the price competitiveness of Romanian products via the net export channel (nevertheless, these effects are relatively weaker compared to the previous *Report*). The contribution of the real effective exchange rate is estimated in the context of an appreciation 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.

Chart 4.8. Quarterly change in the effective exchange rate



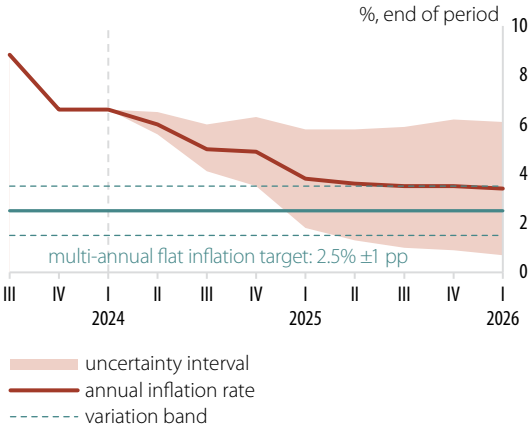
Source: Eurostat, U.S. Bureau of Labor Statistics, NBR, NBR calculations

The wealth and balance sheet effect is assessed to further post restrictive values, albeit slightly diminishing over the projection interval. The breakdown shows that its dynamics mainly reflect the downward path of the real foreign interest rate (3M EURIBOR), after having recently reached a peak, 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 for Romania is projected to have a restrictive impact, mirroring the imbalances associated with the twin deficits in the economy and the effects of the war in Ukraine on investor perception. 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 be tilted to the upside compared to its path in the baseline scenario, reflecting primarily the potential unfavourable impact of new supply-side shocks (Chart 4.9), the likelihood of which increased in the context of geopolitical tensions mounting worldwide. By contrast, a potential contraction in global economic activity is envisaged to exert a disinflationary traction. On the domestic front, significant risks stem from the future fiscal and income policy stance.

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 direct economic effects of developments in the Middle East have been relatively contained. Conversely, with the recent escalation of tensions between Iran and Israel, the conflict in this area took on new significance, and therefore the risk of expanding geopolitical tensions increased. Against this background, a significant disruption in the functioning of international markets is not ruled out, *inter alia* amid new bottlenecks in global value chains. In addition, the reconfiguration of transportation routes would pose logistics issues and could lead to additional costs for companies, which could pass through, depending on their magnitude and persistence, into the final prices of goods and services.

The upheavals or disruptions in the shipping routes through the Red Sea (the Bab el-Mandeb Strait) and the Persian Gulf (the Strait of Hormuz) would affect particularly energy commodity prices, with oil prices being probably the first to be the hardest hit. Possible supply-side shocks are also attributed to developments in Iran (either following the introduction of stricter EU or US sanctions or in the event of Israeli raids on energy infrastructure). Hence, the future decisions of OPEC+ on oil production come to weigh more heavily in the new context. By contrast, the risks associated with developments in natural gas prices mitigated, amid the mild temperatures that helped stocks stay at high levels at the end of the cold season.

At the same time, the importance of the economic implications of the Russian-Ukrainian war is reconfirmed. The recent introduction of sanctions by the US and the UK on imports of metals (aluminium, nickel and copper) from Russia could have a disruptive effect on the relevant international markets, with a potential inflationary impact.

Shocks from natural factors add to those stemming from multiple geopolitical tensions. It is not ruled out to see a relatively fast transition from the El Niño phenomenon to the La Niña phenomenon, likely to induce extreme weather conditions, with an adverse impact on the production of agri-food items (particularly cereals). In the medium term, risks are associated with climate change, both with the related direct effects and, in particular in Europe, with the active measures to combat it, carrying an inflationary potential at least during the implementation of these measures. For example, further inflationary pressures could be exerted by more restrictive policies aimed at accelerating the green transition, which could entail additional production costs passed through into the final prices of goods and services.

Demand-side factors are assessed to exert further a rather disinflationary traction. Given the international context that remains characterised by a certain fragility, the uncertainty facing consumers and investors may increase and international trade may even post a fragmentation, which could ultimately lead to a contraction of global aggregate demand. In the regional context, wider spillover effects on the domestic

economy would come from Germany, Romania's main trading partner, should the recent weak economic developments persist. Overall, uncertainties are associated with progress in the disinflationary process, acting as constraints on the future calibration of monetary policy by major central banks and those in the region.

On the domestic front, the future fiscal and income policy stance is a major source of risks to the inflation path, with risks increasing especially this year when several successive election rounds overlap. The adoption of new fiscal consolidation measures to ensure the excessive deficit correction seems to be likely, but at this point specific details are not available on their composition, parameters and timing that would allow their incorporation into the baseline scenario. In the medium run, irrespective of the content of the fiscal consolidation package, the effects on the macroeconomic framework would most likely consist of a contraction in economic activity and a mitigation of inflationary pressures compared to the baseline scenario. However, in the short run, i.e. up to one year, favouring a certain mix of measures, such as further hikes in indirect taxes (VAT, excise duties), would induce additional inflationary pressures to those in the baseline scenario. In the immediately forthcoming period, these could also emerge due to the adoption of expansionary measures in the context of the busy 2024 electoral calendar.

The coordinates of a possible fiscal consolidation package could be linked to the new path of deficit adjustment currently negotiated by the Romanian government with the EU authorities. In this context, the transposition of the new fiscal governance framework for Romania, which has already been undergoing an excessive deficit procedure ever since 2020, is of particular relevance. Over the medium term, the deviation of the deficit from a sustainable downward path, compatible with EU requirements, could affect the sovereign risk premium, *inter alia* as a result of possible sanctions implying restricted access to EU funds, with adverse effects on the exchange rate of the leu and, implicitly, on the inflation rate. In addition, uncertainties are also associated with economic agents' behaviour to adapt to possible new fiscal measures.

In the current round as well, labour market coordinates, particularly those concerning the dynamics of wage earnings, reconfirm their increased importance. While some of the risks highlighted in the previous round have materialised, further hikes in wages cannot be ruled out, especially in the context of both direct and demonstration effects, in particular on developments in private sector wages, triggered by the rises already granted in the public sector. In the medium term, inflationary pressures may stem from the possible increase in the degree of the skills mismatch in certain sectors, especially those financed significantly from EU funds, such as those related to the greening of the economy or digitalisation.

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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