INFLATION REPORT

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N O T E

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

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

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ABBREVIATIONS

AMIGO	Households Labour Force Survey
ANRE	Romanian Electricity and Heating Regulatory Authority
ANRGN	National Authority for Regulation in Natural Gas Sector
BDGF	Bank Deposit Guarantee Fund
BIS	Bank for International Settlements
CEFTA	Central European Free Trade Agreement
CIB	Credit Information Bureau
CIS	Community of Independent States
CPI	Consumer Price Index
ECB	European Central Bank
EIA	Energy Information Administration
EU	European Union
EUR	Euro
FOB	Free on board
GCF	Gross Capital Formation
GDP	Gross Domestic Product
HICP	Harmonised Index of Consumer Prices
IFS	International Financial Statistics
ILO	International Labour Office
IMF	International Monetary Fund
MPF	Ministry of Public Finance
NBR	National Bank of Romania
NEA	National Employment Agency
NIS	National Institute of Statistics
ON	Overnight
OPEC	Organisation of Petroleum Exporting Countries
PSAL	Private Sector Adjustment Loan
SDR	Special Drawing Rights
USD	United States Dollar

Overview

- **Inflation rate was quite close to the annual target**. The rate of increase in consumer prices in 2003 H2 was similar to that recorded in the same year-ago period. Against the backdrop of supply-side strains and pressures induced by surging consumer demand, the halt in disinflation did not prevent the 12-month inflation rate from staying on the projected trend.

- **Economic growth gathered momentum**. The fast-paced increase in domestic demand underpinned the good economic performance while the negative contribution of net exports to GDP growth expanded as against 2003 H1. The pick-up in investment demand was to a greater extent driven by borrowings, with foreign funds being increasingly resorted to. Household consumption stayed on an upward path, propelled by the larger incomes and increased access to bank loans.

- **External demand remained low**. Although world economy saw a turnaround, the modest economic performance of EU Member States, which are Romania's chief trading partners, as mirrored by their weak import demand, depressed the growth pace of Romanian exports, particularly in 2003 Q4, when it fell into negative territory.

- **Tightening of monetary policy dampened inflationary pressures and slowed the lending boom**. In order to preclude an overly high increase in non-government credit (that could have had detrimental effects on macroeconomic equilibrium) and to confine the inflationary pressures that might have been induced by administered price adjustment, the NBR chose to tighten monetary policy gradually. The central bank raised in three steps (each time by one percentage point) the ceiling of interest rates on its sterilisation operations. Moreover, liquidity control gained in firmness compared with 2003 H1 so that, at end-2003, key monetary indicators reached levels consistent with pushing through disinflation and ensuring sound remonetisation of the economy.

- **Fiscal policy featured budget restraints for most of the period under review**. The consolidated general government budget showed a slight surplus of 0.1 percent share-to-GDP during July-November 2003, reflecting the tight policy, supportive of meeting the annual inflation target. In December, the shift in the fiscal policy stance led to the significant widening of the annual fiscal deficit, which did not however translate into overshooting of the fiscal target.

- **The inflation outlook for 2004 is positive**. Considering the developments in 2003 and during January-March 2004, as well as the assumptions underlying the inflation forecast for 2004 (the adjustment of some administered prices and prices of products liable to excise duties, pressures engendered by both supply and demand, external shocks, seasonal influences), the inflation rate is set to follow a downward trend.

- **An adequate mix of macroeconomic policies is required to achieve the 2004 inflation target**. Cautious income and fiscal policies are needed for this purpose; from the perspective of monetary policy, firm interest-rate policy, implementation of stern monetary control and sustainable real appreciation of the domestic currency against the implicit EUR/USD basket are instrumental for underpinning disinflation.

1. Inflation developments in 2003 H2

In 2003 H2, disinflation came to a stalemate, with the rate of increase in consumer prices (7.9 percent, December 2003/June 2003) being similar to that recorded in the same year-ago period and 2.2 percentage points higher than in 2003 H1. Even though the latter half of 2003 did not witness a slowdown in the growth rate of consumer prices as the first half of the year, annual disinflation stayed within the programmed parameters. The implementation of an adequate mix of monetary and fiscal policies, as well as positive movements in some import prices and keener competition among retailers were the key factors bolstering disinflation in 2003, as shown by the inflation rate outrunning by merely 0.1 of a percentage point the 14 percent annual target.

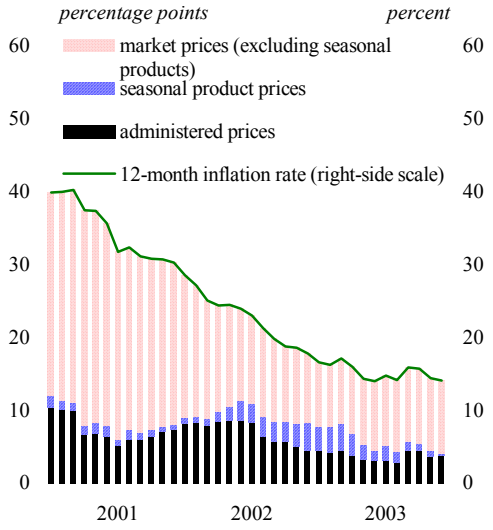
In the reported period, the growth rate of consumer prices accelerated as against the first half of 2003 in the case of non-food items and services. The adjustment of administered prices in early September (especially for natural gas, electricity, telephony and postal services) brought about inflationary pressures directly and through spillover effects.

Thus, non-food prices went up 9 percent (as against 4.8 percent in 2003 H1 and 10 percent in 2002 H2) amid higher prices of natural gas, electricity and tobacco (by 38.5 percent, 17.5 percent and 12.9 percent respectively) whereas the price of medicines rose by a meagre 1.8 percent and that of heating was left unchanged. The increase in the price of heating delivered to households has been subsidised from the government and local budgets.

The hikes in prices of natural gas were the result of the need to gradually bring these prices into line with those ruling on world markets with a view to joining the EU and of the larger contribution of imports to covering domestic consumption (see Subsection 2.5.2. *Foreign trade*). The electricity price was raised due to higher costs induced by the lower volume of electricity produced by hydroelectric power plants and the larger volume of electricity produced by coal-fired power plants, as well as to steeper prices for fuel oil, pitcoal, and fuel railway transport.

Despite escalating tensions on the agrifood market owing to scant stocks of grains and fodder, as well as to the costlier wheat on world markets, food prices were up 5.8 percent in 2003 H2, 1.7 percentage points less than in the previous 6-month

Inflation Rate



Source: NIS, NBR calculations

Administered Prices

	percentage change		
	Dec.02/ Jun.02	Jun.03/ Dec.02	Dec.03/ Jun.03
1. Inflation rate	7.8	5.7	7.9
2. Administered prices geared to inflation, of which:	13.6	10.3	11.2
- railway transport	0.0	9.2	5.2
- water, sewerage, waste disposal	18.1	10.9	12.3
3. Share in CPI basket (%)	4.7	4.5	4.5
4. Exchange rate (+ appreciation, - depreciation)			
- ROL/USD	–0.8	3.2	–1.2
- ROL/EUR	–6.8	–10.0	–6.2
5. Administered prices geared to exchange rate, of which:	12.5	1.1	10.6
- electricity *	1.1	0.6	17.5
- heating *	39.1	0.0	0.0
- telephony **	x	x	13.2
6. Share in CPI basket (%)	9.5	10.1	15.0
7. Administered prices geared to inflation and exchange rate, of which:	6.6	1.7	38.4
- telephony *	10.1	–1.1	x
- postal services ***	17.7	21.0	31.3
- natural gas *	0.0	7.5	38.5
8. Share in CPI basket (%)	5.3	7.1	2.3
9. Administered prices (total)	11.1	3.2	13.6
10. Share in CPI basket (%)	19.5	21.7	21.7
11. Contribution to inflation rate (percentage points)	2.2	0.7	3.0

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

CPI by Category of Products

	percentage change			
	Jun.02/ Dec.01	Dec.02/ Jun.02	Jun.03/ Dec.02	Dec.03/ Jun.03
Milling and bakery products	4.6	5.4	13.0	19.0
Fruit and vegetables	50.8	-1.5	23.1	-14.5
Meat and fish	2.8	2.0	0.4	3.1
Milk and dairy produce	6.2	10.4	7.8	8.2
Alcoholic beverages and tobacco	3.0	11.8	10.7	11.4
Wearing apparel and footwear	5.7	7.3	4.8	4.6
Household appliances, furniture	7.1	6.0	4.4	3.8
Fuels	10.2	16.4	5.5	6.4
Utility expenses*	12.6	12.0	4.1	15.8
Healthcare	8.3	8.8	5.3	3.4
Transport	10.5	5.6	8.9	8.5
Post and telecoms	6.2	7.4	-6.1	14.2
Leisure and culture	7.6	6.6	5.7	7.4
Other goods and services	5.8	13.6	1.4	15.0

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

Source: NIS, NBR calculations

period and only 0.6 percentage points above the same year-ago reading. The main inflation-boosting groups of food items were milling and bakery products, milk and dairy produce, and eggs[1], the prices of which rose 19 percent, 8.2 percent, and 122 percent[2] respectively. Lower price increases (3 percent on average), yet above those recorded in 2003 H1 or 2002 H2, witnessed meat and products thereof, as the steep cost of fodder and dearer utilities offset the positive impact of larger supply following the incentives granted by the authorities to stockbreeders. Such pressures were considerably alleviated by the 14.5 percent decline in the prices of fruit and vegetables as a result of a bumper output.

In the six months to December 2003, the general price level increased also because of the hike in prices for the products liable to excise duties. Thus, prices for fuel, tobacco, and alcoholic beverages went up 6.4 percent, 13 percent and 6.9 percent respectively, due to higher excise duties effective 1 July 2003 and to the nominal depreciation of the domestic currency against the euro.

In 2003 H2, prices of most services posted rises above the inflation rate recorded over the period. Prices of services grew 11.2 percent, exceeding the figures recorded both in 2003 H1 and 2002 H2. The moderate hike in railway transport prices (5.2 percent) dampened only to a small extent the effect of the increase in prices for water, sewerage and refuse collection (12.3 percent), telephony services (13.2 percent, due mainly to EUR-denominated prices of telephony services supplied by Romtelecom starting October) and postal services (31.3 percent), which made up 48.6 percent of services included in the CPI basket.

Administered prices[3], a major cause for the higher inflationary pressures in 2003 H2 compared with 2003 H1, picked up 13.6 percent, contributing 3 percentage points to headline inflation. Under the circumstances, the increase in administered prices fed through into market prices, which grew 6.3 percent, with their contribution to headline inflation staying at 4.9 percentage points, the same as in 2003 H1.

The flattening out of the trend in disinflation in 2003 H2 was induced by both supply-side constraints and pressures from consumer demand. A significant bearing on the supply side had (i) the rise in prices of electricity, heating and water, (ii) costlier imports of raw materials (oil, natural gas, grains)[4] and (iii)

[1] Accounting for a cumulative 18.4 percent share of the CPI basket
[2] December 2003/June 2003
[3] The share of products with administered prices in the CPI basket was raised to 21.7 percent in 2003 from 19.5 percent in 2002.
[4] See Subsection 2.5.3. *Imported inflation*.

larger staff costs. In the energy sector, producer prices advanced by 14.2 percent compared with 2.7 percent in 2003 H1. The price of imported wheat rose to as much as USD 200 per tonne, which is why the authorities decided to exempt such imports from customs duties and to release 150,000 tonnes of wheat from the state reserves as a loan. Furthermore, gross nominal wages rose 8.5 percent[5] economy-wide, pushing up producer prices in the labour-intensive sectors[6] and/or in the sectors where pay rises were not matched by productivity gains (see Subsection 2.4.2.1. *Wages*). The inflationary impact of the hike in staff costs on producer prices fed through only partially into consumer prices. Consumer prices were influenced by the keener competition among retailers as a result of expanding networks of hyper- and supermarkets – thanks to their dominant market positions, such retailers may negotiate more favourable purchase prices from their suppliers, on the one hand, and their development policy is basically aimed at boosting sales rather than increasing prices, on the other.

Consumer demand, particularly for durables, and real estate purchases, were spurred by pay rises during 2003 along with readily available bank loans in the latter half of the year. However, their effect on domestic prices was contained by the favourable trend in external prices[7], with imports making a significant contribution to meeting consumer demand, and by the slower depreciation rate of the ROL versus the EUR (see Subsections 2.5.3. *Imported inflation* and 2.5.4. *Exchange rate*).

The prudent conduct of monetary and fiscal policies was largely accountable for bringing inflation close to the annual target. Monetary conditions were tightened in the latter half of 2003 through a firmer monetary control than in the first half of the year, the increase in the policy rate and the slowdown in the nominal depreciation pace of the domestic currency against the implicit currency basket. Fiscal policy retained its tight stance for most of the reference period – the consolidated general government budget deficit did not exceed one percent of GDP in the first 11 months of 2003; the looser stance in December led to the significant widening of the annual fiscal deficit, which however did not exceed the projected figure.

[5] In 2003 H2 from 2003 H1.

[6] Producer prices rose 8.3 percent for textiles, 12.7 percent for wearing apparel, and 17.2 percent for leatherwear and footwear.

[7] The unit value of imports lowered by 1.4 percent compared with 2003 H1 and 3.6 percent compared with 2002 H2.

2. Determinants of inflation

2.1. Demand

Against the backdrop of stepped-up domestic demand, economic growth accelerated in the latter half of 2003, with GDP posting annual rates of 5.4 percent and 4.6 percent in 2003 Q3 and Q4 respectively[8].

2.1.1. Consumer demand

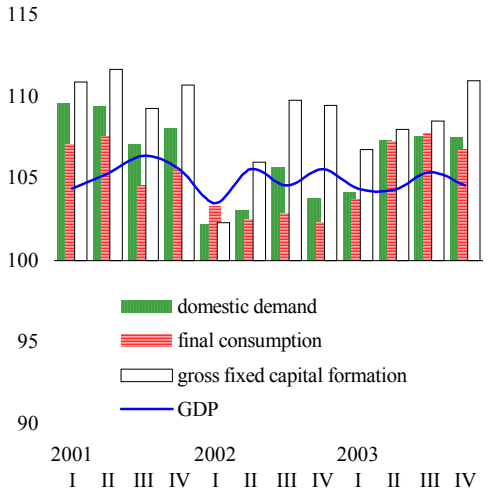
In the latter half of 2003, behind the upturn in household consumer demand stood the increase in household incomes (see Subsection 2.4.2. *Incomes*) and more readily available consumer loans (as reflected by the relatively stable interest rates charged by credit institutions to non-bank non-government clients, the fact that neither endorser nor collateral was required any longer, the curtailment or even removal of down payments) associated with more attractive delivery and service facilities provided by major suppliers of electronic and household appliances, and motorcars.

The same as in 2003 H1, households were particularly interested in buying durables. This trend was mirrored, on the one hand, by the real increase in turnover of retail sales of furniture, lighting and household appliances (53.7 percent) and retail and wholesale figures for motor vehicles, motorcycles and accessories (15.9 percent). On the other hand, sales of foodstuffs, beverages, tobacco products and the receipts from the sub-sector of market services delivered to households witnessed lower increases (0.6 percent and 4.5 percent in real terms) whilst sales of textiles, wearing apparel and footwear dropped 0.7 percent from the same year-ago period.

In the final two quarters of 2003, general government final consumption rose faster than in the first two quarters of the year, i.e. 4.2 percent and 4.8 percent respectively. This owed much to the following: (i) redundancy payments to staff laid off in the public sector (chiefly in railway transport and healthcare); (ii) grants-in-aid to farmers holding farmland plots of five hectares at most; (iii) allowances for heating granted to low-income families; (iv) subsidisation of heating prices; (v) the amounts destined to bridge the healthcare system deficit, and

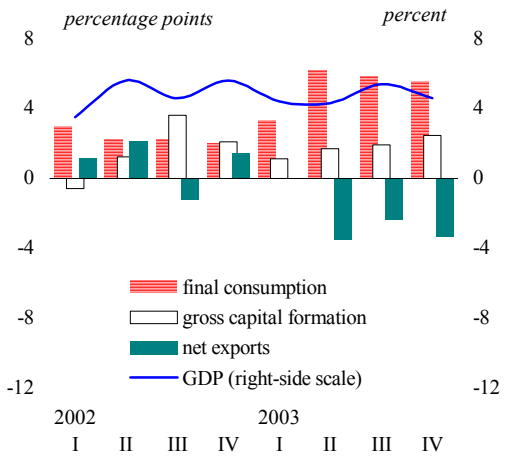
Domestic Demand

index compared to the same year-earlier period



Source: NIS

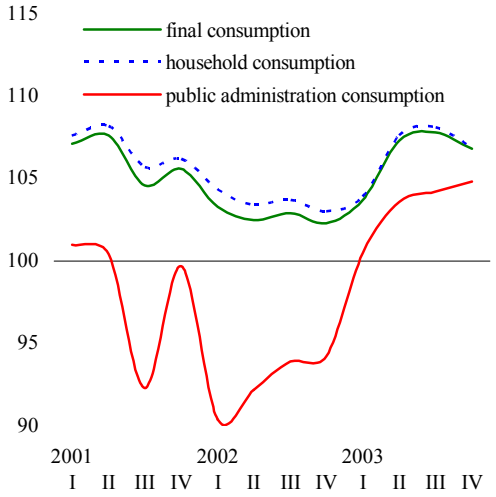
Contribution of the Main Components of Demand to GDP Growth



Source: NIS, NBR calculations

Actual Final Consumption

index compared to the same year-earlier period



Source: NIS

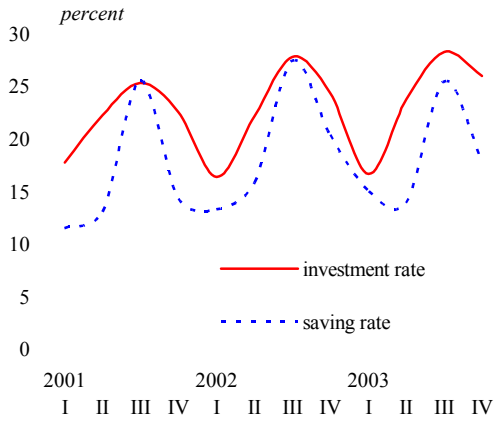
[8] In the absence of an express specification, through all of Section 2. *Determinants of inflation*, growth rates are calculated against the same year-earlier period.

(vi) outlays for organising the national referendum on the country's Constitution.

2.1.2. Investment demand

Gross fixed capital formation remained the fastest-growing constituent of domestic demand in the latter half of 2003 as well. The expenses for equipment and real-estate purchase were funded to a larger extent from borrowings[9]. In this context, it is noteworthy the increased resort to foreign borrowings, as illustrated by (i) the considerably faster growth of non-government credit compared to that of broad money in the latter half of 2003 over the first-half performance; (ii) fast-paced increase in banks' foreign liabilities in 2003 H2 in conjunction with the steady contraction in their foreign investments (see Subsection 3.4. *Main monetary developments*), and (iii) larger inflows of foreign private debt.

Investment Rate and Saving Rate



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

Source: NIS, NBR calculations

In July-December 2003, most capital outlays in the economy as a whole were earmarked for equipment purchase, transport means included. In order to meet investment requirements, purchases were made from both domestic and foreign markets – as a result, turnover of companies manufacturing capital goods and transport means, as well as the value of imports of such goods exhibited swifter rates of increase in the latter half of 2003.

New construction works rose at a faster clip, helping to revert the downward trend in output of building materials and other non-metallic mineral products[10]. Domestic supply was supplemented by purchases from the foreign market, increases being detected mainly for products made of pig iron, iron, steel, as well as for ceramic products and glassware.

Investment

change against the same year-earlier period, %

	Years	Q1	Q2	Q3	Q4
Total	2002	2.8	6.2	8.7	8.7
	2003	6.7	7.0	7.5	10.3
- new construction works	2002	0.1	6.1	7.0	5.6
	2003	0.1	6.3	7.2	6.3
- equipment	2002	5.5	7.4	12.2	11.9
	2003	13.1	14.3	3.9	15.9

Source: NIS

Both public and private sectors contributed to the increase in investment during the latter half of 2003. The slower growth of private investment, consisting widely in purchases of equipment, including transport means, was offset by the rebound in investment of majority state-owned companies.

2.1.3. Net external demand

In 2003 H2, foreign trade of goods and services featured stepped-up increase in imports (especially in 2003 Q4) amid the stronger domestic demand (boosted by both private

[9] Data supplied by the CIB show that the average real rates of increase in loans for equipment and real-estate purchase reached 34 percent, 7.6 percentage points higher than in 2003 H1, and 160 percent, almost double the figure seen in 2003 H1.

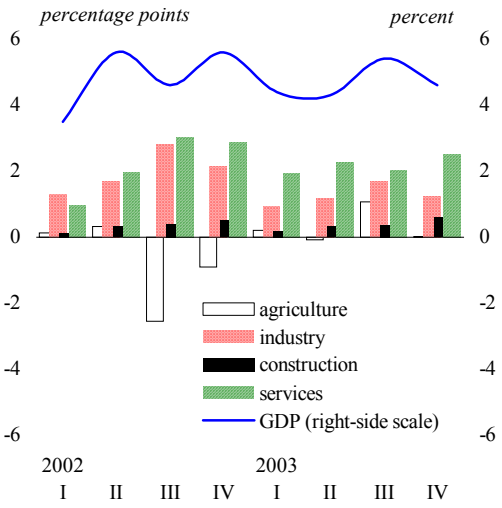
[10] After having fallen ever since 2001, the output of this sector rose by a real 3 percent in 2003 H2.

consumption and investment), while exports failed to match the pick-up in imports, due largely to the flat performance of economies of EU Member States (see Section 2.5. *External environment*). Given the circumstances, GDP growth in 2003 H2 was affected by the negative contribution of net exports, which expanded as against 2003 H1.

2.2. Supply

The accelerated economic growth in 2003 H2 was underpinned by the four key sectors of the economy.

Contribution of the Main Components of Supply to GDP Growth



Source: NIS, NBR calculations

Gross value added in **agriculture** made a positive contribution to GDP growth in spite of bad weather conditions – the protracted drought and the cold season. This performance can be attributed to bumper crops of sunflower, maize, soybean, fruit and vegetables, which offset the losses in grain crops. The stockbreeding sub-sector also fared better in terms of the number of livestock and the output of products of animal origin. This performance was underpinned by the subsidies and aids granted by the authorities to stockbreeders.

In the reference period, gross value added in **industry** showed a higher rate of increase than in 2003 H1. In 2003 as a whole, its growth in real terms stood at 4.6 percent, adding one percentage point to the first-half performance.

Surprising as it may seem, this performance was not accompanied by a higher growth rate in industrial production, whose 1.7 percent rise in 2003 H2 was almost 3 percentage points lower than in the previous half-yearly period. The explanation lies, on the one hand, with the methodological manner in which initial year-end data[11] were revised following the change in the reference year for calculating the industrial production index and, on the other, with the scopes of the two indicators being different, as the value added provided by home industry and the informal sector is left out of account in determining industrial production.

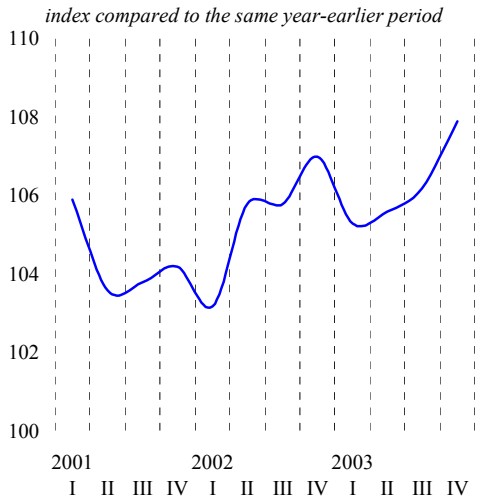
Statistical data on turnover in industry give a better view on the structural developments in industrial activity. The latter half of 2003 saw improved sales figures under all commodity groups, with durables and capital goods posting notable acceleration of growth rates of 2 percentage points and 1.1 percentage points versus the first half of 2003. The fast increase in private consumption and investment translated into stronger sales numbers for both categories of goods concomitantly with lower

[11] See Statistical Bulletin No. 12/2003 edited by NIS.

stocks (either in absolute terms or in terms of dynamics), the slower pace of export growth notwithstanding.

Construction further reported the sharpest growth rate in 2003 H2, entirely on account of the private sector. The performance can be ascribed largely to the accelerated rise in value of new construction works[12], as well as capital repairs, amid the advance in real-estate loans and the erection of new facilities for the big retailers, warehouses and office space buildings, etc. Although the implementation of government-led programmes aimed at maintaining and upgrading road and railway transport, water supply systems in the rural area, and at building sports facilities carried on, the volume of construction works funded by the state-owned sector decreased in the final two quarters of 2003 by 2.9 percent and 1.5 percent respectively.

Construction Works



Source: NIS

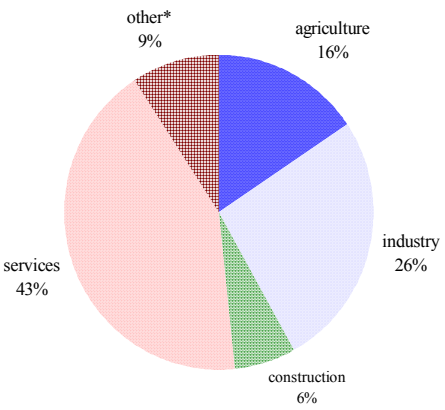
Services sector also posted fast-track increase in value added. Yet, its contribution to GDP formation shed 5.4 percentage points compared with 2003 H1, reaching 44.6 percent in 2003 as a whole, due mainly to the strong increase in the contribution of agriculture and, to a lesser extent, in the construction sector.

Activity in the retail sector, reporting a doubling of the real rate of increase in sales of non-food items, was the main contributor to the uplift in gross value added in the services sector in 2003 H2. More precisely, once specialised shops have expanded their networks, they started luring customers via aggressive promotional campaigns for durable goods. Moreover, new foreign hypermarkets entered the Romanian market and the already existing chains developed new outlets, thus boosting retail sales.

A positive growth rate showed the sales of motor vehicles, motorcycles, spare parts and accessories, and maintenance and repair of motor vehicles, i.e. some 16 percent. It must be pointed out that the sales of domestically manufactured motor vehicles outpaced imports in 2003 as a whole, for the first time in 14 years.

The expansion of the services sector was also fostered by the developments in the road transport sub-sector, as suggested (in the absence of data on this sub-sector) by the larger volume of trade and the higher retail sales of automotive fuel. This owed much to the lower prices for both passenger and freight transport compared to those for railway transport services.

GDP Formation in 2003 H2



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

Source: NIS, NBR calculations

[12] Their share in total construction works widened from 56.6 percent in 2003 H1 to 65.1 percent in 2003 H2.

The slowdown in the increase in turnover of market-determined services delivered to households by 1.1 percentage points as against the preceding 6-month period was the result of weaker performance in the tourism sector. The final two months of 2003 were an exception – weather conditions in Romania, favouring winter sports, and the prolonged year-end holidays gave tourist services a boost. The 3.3 percentage point cut in turnover of tourist agencies in the latter half of 2003 and the slower growth pace of turnover of hotels and restaurants (as a result of the drop in July-August by as low as 4.9 percent) were attributed to flagging demand induced by households' sharper bias towards the purchase of real-estate and durables, on the one hand, and to the inadequate domestic supply of tourist services because of unsatisfactory quality/price ratio, on the other.

The jump in gross value added in public administration, education, healthcare and social assistance may be attributed to the wage hikes, applied in all three sectors at times even faster than in the first half of 2003, combined with further increase or marginal cutback in the number of employees.

Unlike in 2003 H1, banking activity painted a brighter picture during July-December 2003, as reflected by the real increase in gross value added of financial intermediation services indirectly measured. Behind this development stood the advance in interest collections following the enhanced upward course in non-government credit and the decline in interest paid on deposits engendered by the lower propensity for saving.

2.3. Budgetary and fiscal developments

The MPF retained its tight fiscal stance for most of the second half of 2003. In December however the Ministry's stance shifted, the slightly positive balance of the consolidated general government budget for July-November 2003 being outrun by the December deficit, accounting for nearly two-thirds of the full-year figure.

Consolidated Budget Revenues*)

%

	2002 H2	2003 H1	2003 H2
Revenues	100.0	100.0	100.0
Tax revenues, of which:	93.2	92.8	93.3
Profit tax	6.8	7.2	7.8
Income tax	9.2	9.5	9.5
Social security contributions	35.1	33.1	32.1
VAT	24.5	23.6	24.1
Customs duties	2.2	2.2	2.3
Excise duties	7.9	9.3	10.7
Non-tax revenues	6.3	6.9	6.4
Capital revenues	0.1	0.3	0.3
Non-redeemable funds	0.3	0.0	0.2

*) transfers between budgets were removed

Source: NBR calculations based on MPF data

Moreover, the dynamics of budget parameters in 2003 H2 was influenced by the enforcement of some provisions envisaging implementation of several measures aimed at improving the living standard of low-income earners and promoting some activities, as well as by the alteration of some categories of taxes and prices for certain goods. Thus, at the beginning of the 6-month period under consideration, public pensions were subject to the fourth stage of realignment whilst in September and December public pensions, public pensions of the military and some household incomes were subject to indexation. Furthermore, farmers were grant-aided for the farmland plots of

5 hectares at most and the subsidies for increasing meat production and livestock were upped, companies were granted financial assistance for heightening competitiveness of agrifoodstuffs, whereas export bounties for several such goods were granted in late 2003. On the other hand, excise duties on diesel oil, mineral oils, tobacco products and alcohol were raised starting 1 July 2003 while towards the end of the year import duties for some commodities were temporarily removed or cut down.

In order to include the new measures into the budget and to bring the size of the budget parameters into line with the other macroeconomic indicators, the budget estimates for 2003 were revised in August. Following the revision, the deficit of the consolidated general government budget was marginally raised, from 2.65 percent to 2.68 percent of GDP. According to the new projections for full-year 2003, both revenues and expenditures saw their shares in GDP rising by 0.3 percentage points and 0.4 percentage points respectively, their composition remaining broadly unchanged. Projected revenues from direct taxes further held the largest share in total revenues, albeit their share in GDP was 0.4 percentage points lower, ahead of those from indirect taxes, whose share in GDP widened by one percentage point. The new projections envisaged increases under most items of expenditures in a range from 0.2 percentage points to 0.4 percentage points as a share of GDP, except for interest payments for public debt, which were cut by 0.6 percentage points, and capital outlays, which were left at the level recorded in 2003 H1.

Consolidated Budget Expenditures*)

%

	2002 H2	2003 H1	2003 H2
Expenditures, of which:	100.0	100.0	100.0
Public authorities	4.8	5.0	5.2
National security and defence, and public order	9.9	9.7	9.8
Education	9.0	10.8	9.5
Health	10.9	12.0	11.9
Social activities and culture	37.6	38.6	38.9
Economic activities	18.4	14.9	18.7
Interest related to public debt	7.2	7.2	5.5

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

Source: NBR calculations based on MPF data

The consolidated general government budget ended the latter half of 2003 on a ROL 26,931 billion deficit, constituting 1.4 percent of GDP compared with 1.5 percent in the same year-ago period and almost 62 percent of the full-year deficit against 55 percent in the corresponding period of 2002. The constituents with the heaviest bearing on the consolidated general government budget deficit were, with few exceptions, the same as in the latter half of 2002, namely the balance of government budget, that of foreign loans to ministries and that of the National Road Administration budget. Nevertheless, two of the constituents of consolidated general government budget posted atypical developments. The social security budget showed, for the first time ever, a surplus of about ROL 4,381 billion compared to a deficit of ROL 4,377 billion in 2002 H2 while the health budget ended the latter half of 2003 on a deficit of nearly ROL 5,649 billion, down year on year from a surplus of ROL 4,864 billion. Government subsidies earmarked for the social security budget doubled their share in GDP compared with the same year-ago period, reaching 0.4 percent, and the amount of spending on medicines and medical services included

Balance of Consolidated Government Budget

percent of GDP

	2002 H2	2003 H1	2003 H2
Conventional deficit	-1.45	-0.89	-1.42
Primary surplus (+)/ deficit (-)	-0.01	0.33	-0.53

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

in the health budget exceeded, for the very first time, the amount of receipts from public social security contributions.

In 2003 H2, revenues to the consolidated general government budget inched up year on year from 16.1 percent to 16.2 percent of GDP, but their share in full-year revenues shrank somewhat, from 54.2 percent to 54.1 percent. Taxation augmented, from 15 percent to 15.2 percent, solely on account of revenues from indirect taxes, whose share in GDP rose from 6.3 percent to 6.8 percent, whereas receipts from direct taxes fell from 8.7 percent share-to-GDP to 8.4 percent share-to-GDP. Value added tax remained the main source of indirect revenues, yet the revenues from excise duties posted the highest increase (from 1.3 percent to 1.9 percent of GDP) as a result of the hike in excises in 2003 H2. The decline in revenues from direct taxes was chiefly triggered by lower receipts from public social security contributions, as the material effect of the curtailment in such contributions earlier in the year.

The share of consolidated general government budget expenditures in GDP virtually stayed at the level seen a year earlier, i.e. 17.6 percent compared with 17.5 percent, whereas their weight in full-year expenditures grew from 54.3 percent to 54.6 percent. In 2003 H2 too, transfers and subsidies made up the bulk of public spending, with their shares in GDP posting divergent developments from 2002 H2 – the share of transfers narrowed from 7.1 percent to 6.3 percent of GDP while the share of subsidies widened from 0.7 percent to 1.3 percent of GDP. The year-on-year decline in interest payments for public debt (approximately 0.5 percent of GDP) was accompanied by larger outlays on other goods and services (0.6 percent of GDP) and capital expenditures (0.1 percent of GDP).

Therefore, the trend of the consolidated general government budget to display a negative primary balance, which had also been manifest in 2002 H2, sharpened in 2003 H2. This budget posted a primary deficit of 0.5 percent of GDP in July-December 2003 compared with 0.01 percent of GDP in the corresponding year-ago period, thereby wiping out the primary surplus of 0.3 percent of GDP recorded in the first half of 2003.

In 2003 H2 too, both domestic and foreign resources helped cover the gap between public revenues and expenditures. Foreign funding comprised loans granted directly to ministries by international financial institutions and a 7-year Eurobond issue launched on foreign capital markets whereby the MPF raised EUR 700 million at an interest rate of 5.75 percent per annum.

From the domestic market the public authority raised both ROL- and foreign-exchange-denominated funds, yet the increase in domestic debt was a paltry one, with non-banks being solely accountable for the rise.

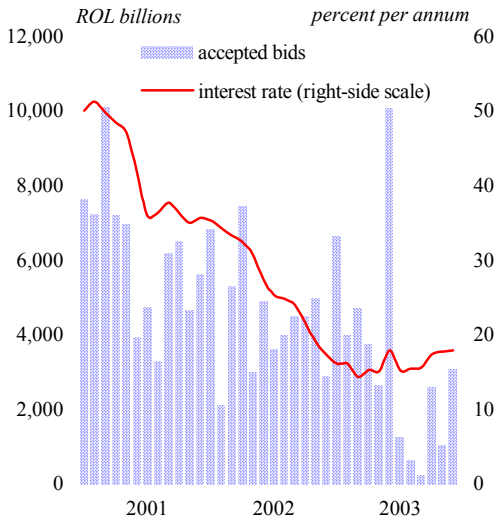
ROL-denominated funds raised via issues of government securities to be acquired by banks and their customers were scant. The amount of newly-issued government paper was nearly three times lower than that launched in the same year-ago period, touching the lowest half-yearly level in the past several years. Government securities issued in 2003 H2 ran at roughly ROL 9,810 billion, covering 36 percent of the value of the paper coming to maturity – it is worth noting that the period under review witnessed the largest redemption of Treasury bills and bonds in recent years, approaching ROL 17,482 billion. With the exception of December, the volume of government paper falling due outran that of newly-issued bills, with a record high of redemptions worth ROL 11,945 billion for 2003 H2 in July.

The latter half of 2003 witnessed shifts in the term structure of ROL-denominated Treasury bills and bonds sold at auction. In October 2003, issues of government securities with 2-year and 3-year maturities were virtually discontinued; although the MPF further had on offer securities with such maturities, no bids were accepted for those bonds. On the other hand, towards the end of the year, the public authority issued for the first time ever 5-year CPI-linked bonds in domestic currency.

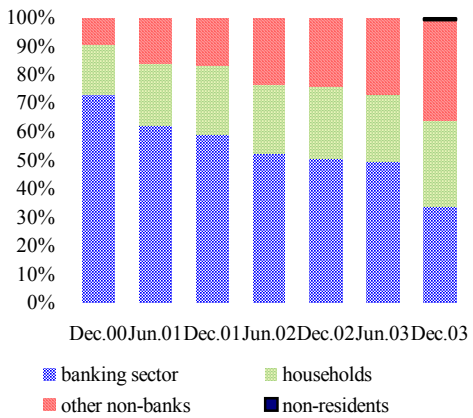
The MPF raised fresh funds from individuals almost on a monthly basis; however, their total volume dropped 27 percent year on year to almost ROL 302 billion. On offer were Treasury certificates with 3- and 6-month maturities, the attached yields being left unchanged until November, when they were lifted by one percentage point. The upward thrust in interest rates did little to boost investor interest in such investments, as December redemptions exceeded the volume of newly-launched issues. Over the period, the average yield on such government paper moved slightly ahead of the average rates on time deposits of households. At year-end, the bills outstanding with the public edged up 2 percent over the year before, 3 percent short of their best showing in 2003.

Foreign-exchange-denominated funding also added to the domestic currency resources the public authority raised from the domestic market. September saw the first issue of EUR-denominated government securities ever to be issued on the domestic market whereby the MPF raised about EUR 69 million. The maturing government securities launched under the

Government Securities Issues (Treasury Bills)



Composition of Government Securities Outstanding by Holder



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

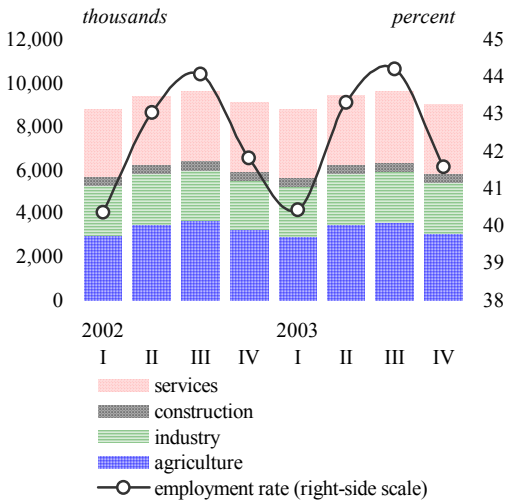
bank restructuring process worked out at merely USD 37 million in 2003 H2.

As of end-December 2003, domestic public debt[13] shed ROL 13,744 billion against mid-2003 to ROL 114,942 billion. Direct domestic public debt[14] also followed a downward drift, dropping roughly 11 percent from end-June 2003 to ROL 106,775 billion at end-December 2003. Government collateral for domestic credit in domestic and foreign currency fell some 10 percent from mid-2003 to ROL 8,166 billion. Domestic public debt was little changed from the previous 6-month period. Government securities issued to ensure deficit financing held the largest share in total domestic public debt (down from 70 percent to 65 percent), followed by bridge loans, the share of which widened from 28 percent to 34 percent. The government securities issued in virtue of special laws to transfer some non-performing loans to the public debt accounted for barely one percent of the total figure.

2.4. Labour market

2.4.1. Labour force

Employment by Sector and Employment Rate



Source: NIS - AMIGO, CANSTAT No. 3/2003

Data on labour market indicators provided by the AMIGO survey for the final two quarters of 2003[15] are indicative of a narrowing disparity between demand and supply, compared with the final two quarters of 2002, following the retrenchment by 140 thousand in the number of unemployed. The reduction in the supply of labour appears to have been driven by a part of active population becoming inactive, given the relatively flat number of people employed in 2003 Q3 and its slight decrease in 2003 Q4 (since the rise in demand for labour would have brought about higher employment). Against this background, the activity rate of population aged 15 years or more[16] lowered from 56.3 percent in 2002 H2 to 55.1 percent in 2003 H2.

The flat performance of employment rate[17] (stuck at about 43 percent in 2003 H2) and the inconsequential inter-sector shifts in the people employed over the same year-ago period

[13] Defined pursuant to Art. 1, para. 3 of Law No. 81/1999 on public debt, i.e. the total of the government's domestic and foreign liabilities, at a given time, contracted by the MPF, the government's borrowing agent.
[14] Calculated as the difference between domestic public debt and the collateral for domestic loans
[15] Data for 2002 and 2003 on key labour market indicators are based on the outcome of the Population and Housing Census conducted in March 2002. The complete data series on the labour force for 1996-2001 is to be recalculated consistent with the census outcome.
[16] Ratio of labour force to population aged 15 years or more.
[17] Percentage ratio of total number of the employed and total population.

(composition by main economic sector remained unchanged) hint at the following:

i) the companies on an expansion path either could not find properly qualified staff or avoided hiring new staff, aiming at boosting labour productivity through investment in new technologies and equipment; and

ii) sub-optimal use of labour force (most notably in agriculture) stuck to about 13 percent of the employed, as mirrored by the steady share of people on a full-time schedule, who usually worked less than 40 hours per week.

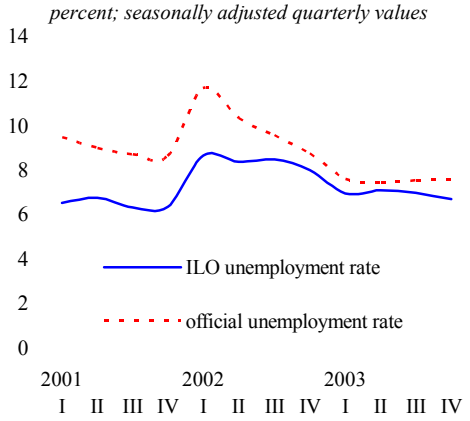
In year-on-year comparison, the unemployment rate calculated by ILO[18] for the 6 months to December 2003 dropped 1.3 percentage points on average, reaching 6.7 percent in 2003 Q4. In accordance with statistical data on the change in the labour status of population aged 15 years or more against the corresponding period of 2002, the slide in unemployment rate was attributed: (i) in a proportion of roughly 54 percent, to job seekers taking up the positions left vacant by the people who became inactive (by attending courses, going on maternity leave, going into retirement, etc.) or who were likely to be hired abroad and (ii) in a proportion of 46 percent, to former job seekers being considered as inactive population[19].

With the economy on a growth path, losing a job was no longer the driver of unemployment, as the number of jobless who had been working in 2002 H2 was two times lower than the number of jobless who had been part of inactive population in the same period. The sharply downward course in short-term unemployment (less than one year) is also indicative of the above-mentioned assertion.

As a result of the faster decline in short-term unemployment compared with long-term unemployment, the share of the latter in the total number of jobless widened to 64.6 percent in 2003 H2, taking the average unemployment duration to 25.2 months; the 386 thousand discouraged workers[20] can be added to the 416 thousand people registered under long-term unemployment. The figures suggest that part of the available labour meets neither training nor mobility requirements on the labour market – therefore, social policies should prompt job seekers to attend retraining courses and foster the development of small- and medium-sized enterprises with a view to boosting employment.

Official Unemployment Rate and ILO Unemployment Rate

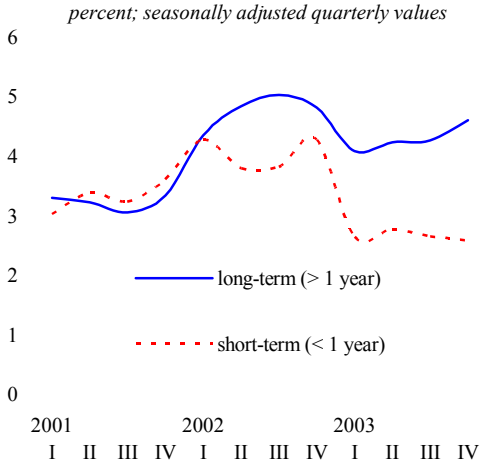
percent; seasonally adjusted quarterly values



Source: NIS - AMIGO

Unemployment Rate by Duration

percent; seasonally adjusted quarterly values

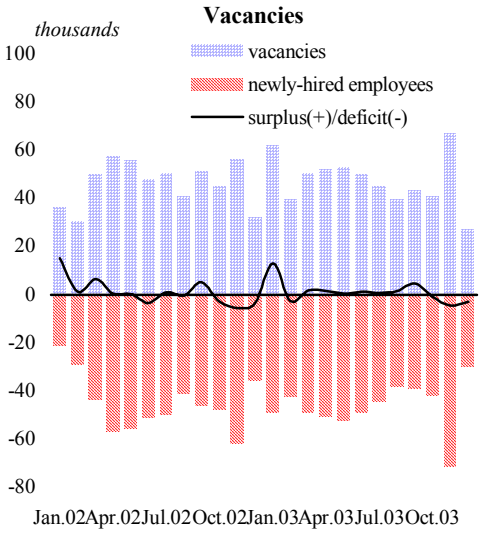


Source: NIS - AMIGO

[18] International Labour Office.
[19] Inactive working age population (15-64 years) grew by 189 thousand on average as against the same year-ago period.
[20] Inactive persons who are not employed and not seeking employment because they believe that none is available.

A relative improvement in labour market functioning is illustrated by the decrease[21] in the number of respondents who, notwithstanding their being enrolled with employment agencies, were included in the total number of people in work inasmuch as this trend can be associated with the shrinkage of the informal labour market.

Number of Vacancies Reported by Employers and Number of Filled Vacancies



Source: NEA

Data released by NEA for July-December 2003 confirm the tightening of labour market conditions. Unemployment rate lowered year on year by 1.5 percentage points to 7 percent[22], with approximately 265 thousand persons being hired in 2003 H2. Nevertheless, labour force absorption diminished 6.2 percent from the same year-ago period amid the contraction by 13 thousand, or 4.7 percent, in the number of vacancies sent to NEA by company managers, failing to materialise in a significant rise in the number of wage earners reported by employers.

In 2003 H2, the number of employees[23] was barely 0.3 percent higher than in the same period a year earlier, with new hires in construction and most services slightly outrunning the number of redundancies. Layoffs were reported particularly in industry, as well as in education, healthcare, transport, telecommunications and postal services.

External migration further affected employment. The acceleration of this phenomenon is suggested by the data released by the Office for Labour Force Migration, according to which in 2003 the number of people who left the country to work abroad doubled year on year to reach nearly 40 thousand. Hence, the drop in unemployment rate may also be attributed to the fact that some of the job seekers left the country to work elsewhere.

The main developments against the same year-ago period, as highlighted by the data released by NEA, are also manifest when compared to 2003 H1. Unemployment rate went down 1.2 percentage points on average despite the slowdown in labour force absorption, the number of newly hired workers dropping 9.4 percent in 2003 H2 versus 2003 H1. To sum up, it may be asserted that during the latter half of 2003 the trend of tightening in labour market conditions put pressures on wages and therefore on inflation.

[21] By nearly 20 percent, bearing in mind that revised data for 2002 are not available.
[22] Average values.
[23] NIS data.

2.4.2. Incomes

2.4.2.1. Wages

In the latter half of 2003, wage policy was little changed from the first half of the year, but it remained looser compared with the same year-ago period. In the public sector, the highest pay rises, i.e. 9 percent month on month, were recorded in October, once the second stage of wage indexation was implemented. In order to cap the effect of wage policy loosening, the government had decided one month earlier that end-of-year bonuses in the companies monitored in accordance with Decision No. 866/2001 could only be paid from the already approved wage bills[24]. It is to be noted that a relatively strict control over gross wages was achieved in the energy sector where pay rises ran at only 1.3 percent[25] in real terms. Nevertheless, in the transport sector – where the presence of state-owned companies is prevalent – the annual rate of increase in real wages accelerated in 2003 H2 compared with 2003 H1. Real wages in the private sector stayed above the year-ago level, due to the 43 percent hike (in nominal terms) of the gross minimum wage in the economy as a whole starting 1 January 2003 and to the constraints arising from labour market tightening.

Real Net and Gross Wages

change against the same year-earlier period, %

	Gross		Net	
	2002 H2	2003 H2	2002 H2	2003 H2
Whole economy	2.3	7.2	3.2	8.6
Agriculture, hunting and related services	-0.6	3.2	0.2	6.1
Industry	-0.7	3.9	0.7	5.6
of which:				
Mining	0.2	6.1	2.0	7.0
Manufacturing	0.4	4.6	1.5	6.4
Energy	-2.6	1.3	-0.6	3.3
Construction	9.5	7.0	9.5	8.1
Services*	3.9	9.7	4.4	11.1
of which:				
Public administration	0.5	16.7	-0.4	17.7
Education	9.8	7.1	10.3	8.5
Healthcare	-4.5	12.4	-3.2	14.1

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

Source: NIS, NBR calculations

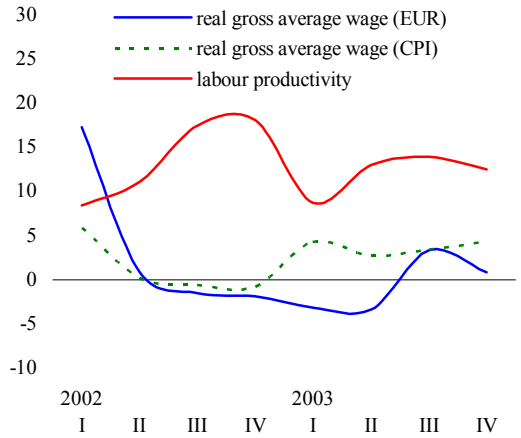
The year-on-year 7.2 percent real increase in gross wages owed more to the pay rises in construction and services sectors (7 percent and 9.7 percent respectively) rather than to those in industry (3.9 percent).

The appropriateness of the above-mentioned wage hikes in respect of their effects on consumer prices cannot be grasped otherwise than by taking into account the developments in labour productivity. Given that statistical data available were provided by industry alone, the extent to which pay rises in the other sectors brought about inflationary pressures by failing to keep pace with productivity is unaccounted for. The likelihood of slippages is high in the services sector where real wages rose above 10 percent, for instance 12.8 percent in transport and warehousing, 16.7 percent in public administration. The hotels and restaurants sub-sector is another case in point, with gross wages climbing 10.4 percent and the ratio of real turnover index and the staff index, a substitute for labour productivity index, shedding 5.9 percent.

[24] Pursuant to Decision No. 1135/2003 issued by the Government of Romania.
[25] 2003 H2/2002 H2.

Gross Wage and Labour Productivity in Industry

change against the same year-earlier period, %



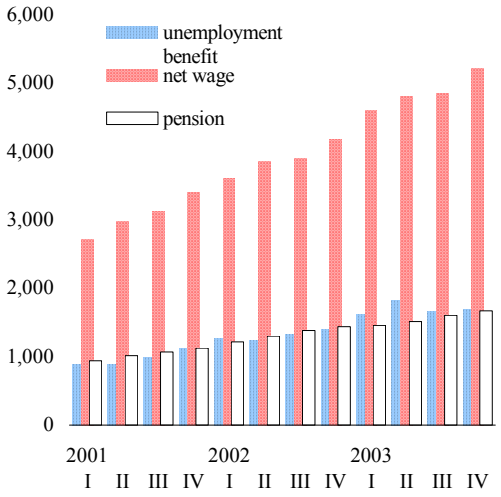
Source: NIS, NBR calculations

In industry, where external competition plays a major role[26], even though the annual rate of increase in productivity slowed 1.8 percentage points to 10.3 percent in 2003 H2 versus 2003 H1, it was further significantly higher than the real growth in gross wages. The consumer goods processing sub-sectors saw divergent developments: the disparity between productivity gains and real pay rises was positive in food, tobacco products, and textiles sub-sectors, but negative in wearing apparel and footwear, electrical machinery and apparatus, equipment, radio and television and communications. In the latter sub-sectors, producer prices went up in a range from 8 percent to 17.2 percent[27] – as a result, given the stiffer competition between retailers, domestically-produced goods were increasingly replaced by foreign goods, thereby containing spillover effects of higher producer prices on consumer prices (see Subsection 2.5.3. *Imported inflation*).

In the economy as a whole, real net wages stayed virtually flat against 2003 H1 (up a paltry 0.5 percent) but leapt 8.6 percent year over year, further acting as an incentive on household consumption. These pressures stymied disinflation, as illustrated by the 6 percent increase in prices of goods not subject to administrative measures or incidental and seasonal influences[28], 2.5 percentage points lower than in the same year-ago period, but 1.9 percentage points higher than in the first half of 2003.

Household Incomes

ROL thousands, monthly average



Source: NIS, NEA

2.4.2.2. Other incomes

Over the period, the movements in pensions, unemployment and other social security benefits did not induce inflationary pressures. Underlying this assertion is the fact that, while pensions and unemployment benefits posted slight real increases year on year, the related spending from the social security budget, other social allowances included, remained broadly unchanged.

The fourth stage of public pension realignment in July along with September and December indexations (up 2.65 percent and 3.1 percent)[29] helped preserve the purchasing power of pensions

[26] In contradistinction to the services sector, where companies are not hit by pressures deriving from competition on foreign markets and therefore they are less concerned with enhancing their economic performance by raising labour productivity.

[27] December/June 2003.

[28] Goods with administered prices (see Section 1. *Inflation developments in 2003 H2*), seasonal goods (vegetables and tinned vegetables, fruit and tinned fruit), milling and bakery products (the prices of which were strongly influenced by the drop in grain supply) and radio and TV subscriptions (radio subscription was raised in February and August by way of a Government Decision) are left out of account.

[29] Pursuant to Decisions Nos. 731, 1006 and 1383 issued by the Government of Romania in 2003.

(up by a real 1.1 percent year on year[30]) but eroded the ratio of pensions and wages. The average pension in 2003 H2 accounted for 32.5 percent of net average wage, 2.4 percentage points below the year-ago reading. The still high dependency ratio, i.e. 1.43 retired persons to 1 employee, calls for linking the increase in pensions to employment growth and informal sector compression.

Unemployment benefit in the latter half of 2003 advanced by a real 6.8 percent, constituting 33.3 percent of net average wage, 0.6 percentage points lower than in the same period of 2002. The potential inflationary impact arising out of the real growth of unemployment benefit was stifled by the setback in the number of registered unemployed, down nearly 28 percent to 270.7 thousand persons (calculated as the average of the reported 6-month period).

However, there were some categories of income whose development hints at inflationary pressures: (i) redundancy payments to workers affected by mass dismissals, the number of which rose 43.3 percent in 2003 against 2002, (ii) the growing resort to luncheon vouchers, (iii) remittances from nationals working abroad in amount of EUR 860 million in 2003 H2, 7.2 percent above the year-ago figure[31], (iv) heating allowances, the monthly average number of recipients of such benefits increasing in the winter of 2003-04 by 27 percent in the case of end-users connected to the heating system[32], 5.5 times in the case of end-users of natural gas for heating and 81 percent in the case of end-users of wood, coal and petroleum derivatives.

2.5. External environment

2.5.1. External demand

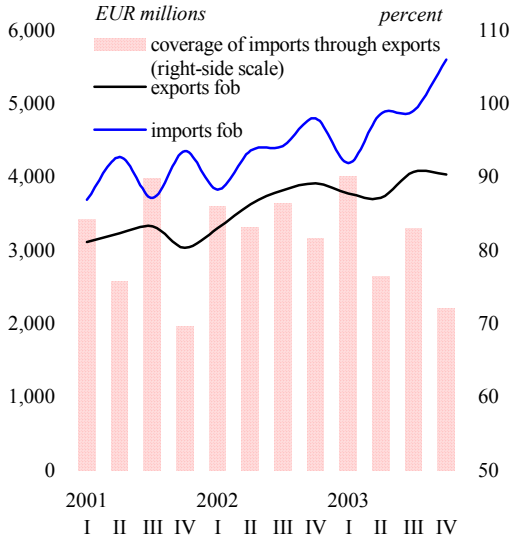
After having been plagued by the impact of geopolitical tensions and the severe acute respiratory syndrome in 2003 H1, the external environment painted a brighter picture in 2003 H2, mainly on the back of improved performance of the US and Asian economies. The US economy raced ahead in the final two quarters of 2003 at year-on-year rates of 3.6 percent and 4.3 percent respectively, chiefly on the account of domestic demand boosted by attractive interest rates and lower taxes.

[30] Showing an understated change as, starting January 2003, the healthcare social security contribution is no longer included in the amount of pensions.
[31] According to balance-of-payments data.
[32] In November-December 2003, the amounts handed out to this social group, which holds the largest share in total recipients, surpassed by nearly 30 percent the year-ago figure.

Albeit on the mend, the EU economy posted limp growth. In the final two quarters of 2003, year-on-year GDP growth rates rose 0.6 percent and 0.9 percent respectively, sending the full-year figure to 0.8 percent. The advance in private and government consumption offset but partially the weakening investment whereas the contribution of net exports to GDP growth reverted to positive levels no sooner than the final quarter of 2003[33]. In 2003 H2, the EU demand for imports stayed virtually flat (-0.1 percent) compared with 2002 H2, whereas the value of imports from outside the EU inched down 0.2 percent.

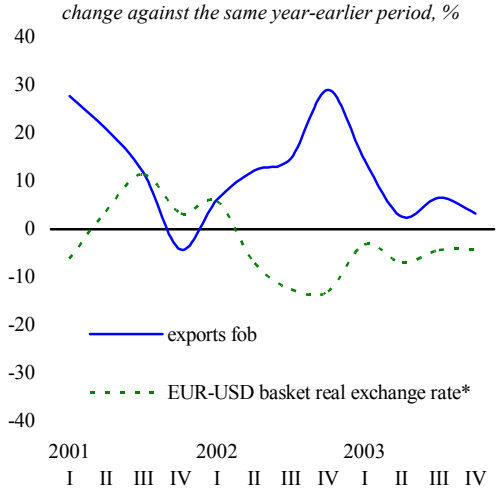
The economies joining the EU in 2004 reported positive growth rates (averaging out at 3.6 percent in 2003 against 2.4 percent in 2002, according to estimates of the European Commission) driven widely by either domestic demand or net exports. A sizeable part of consumer spending was covered by larger imports of goods manufactured outside the EU, which moved up 6.2 percent year over year (compared to the 4.6 percent rise in total merchandise imports).

Trade Balance



Exports and Real Exchange Rate

change against the same year-earlier period, %



**) deflated by the unit labour cost index*

Source: NIS, NBR calculations

2.5.2. Foreign trade[34]

The latter half of 2003 saw the worsening of Romania's external balance, with the trade gap widening 61.4 percent from the corresponding year-ago period. Over the period, the negative gap between the growth rate of exports and that of imports, i.e. 4.9 percent and 14 percent respectively, widened. This development was manifest particularly in the final quarter of 2003 when exports dipped 0.8 percent whilst imports surged 14.2 percent versus the previous quarter amid strong imports of raw materials, most notably energy commodities, and consumer goods.

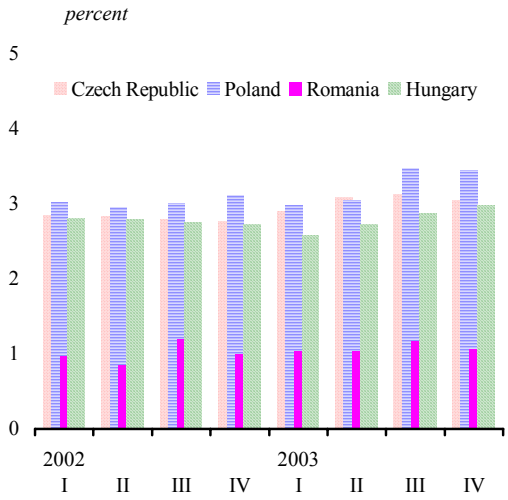
The improvement in export composition – which was manifest in the first half of 2003 – continued, albeit at a far slower pace. The share of exports of high value-added goods, specifically machinery and apparatus, including transport means, in total exports rose by a mere 0.1 of a percentage point while the share of definitive exports in the total figure narrowed by 0.2 percentage points against the same year-ago period (to 45 percent of total exports) in favour of exports of goods manufactured under OPT agreements. Exports of low value-added goods further held the largest share in total exports, with textiles, wearing apparel and footwear contributing the most to the increase in exports, i.e. by 2.1 percentage points. Nonetheless, the export volume of this group of merchandise to the major outlets tended to flatten out, with

[33] Versus the same year-ago period.
[34] Figures showed in this section are calculated based on balance-of-payments data expressed in euro.

producer prices for the foreign market going up year on year in a range from 23 percent to 33 percent. The explanation for the above-mentioned developments may lie with both higher wage costs and larger exports of goods entirely manufactured in Romania (wearing apparel in particular), which require higher production costs, associated mainly with imports of raw materials.

Given the current exports composition, the efforts aimed at keeping Romanian products competitive have become an increasingly daunting task amid fiercer competition from the Asian economies and the countries seeking EU membership. Despite the downtrend in unit labour costs across manufacturing (6.3 percent lower on the year), Romania's market share in the EU, expressed as a proportion of total imports from non-Member States, rose fractionally (0.08 percentage points to 1.1 percent) whilst the market shares of countries joining the EU in 2004 and China edged up 0.9 percentage points and 1.4 percentage points respectively.

Market Share* in EU



*) EU imports from non-Member States

Source: Eurostat

The fast-paced increase in imports was accompanied by shifts in composition owing mostly to the higher share of capital and consumer goods to the detriment of intermediate goods and raw materials. Several domestic and external factors acted to bring about the rise in imports, as follows:

i) further streamlining and upgrading of the economy that boosted import demand for capital goods (which contributed more than 3 percentage points to import dynamics) whereas the share of machinery and equipment, including transport means, in total imports widened by nearly 2 percentage points;

ii) heavier reliance on imports of agrifoodstuffs[35] (because of the scant domestic grain production) and the steep upturn in world prices (amid poor crops in Europe and strong demand from China);

iii) pick-up in imports of durables (32.6 percent from the corresponding year-ago period) in the context of more readily available consumer loans;

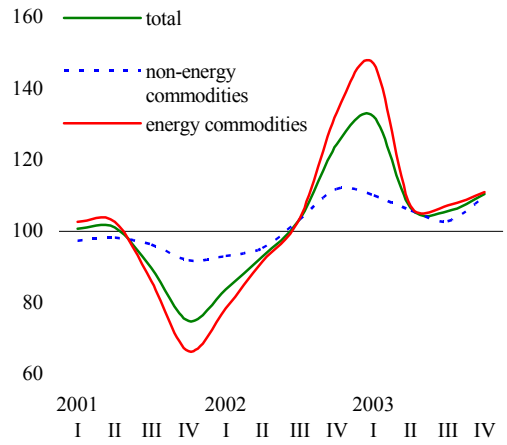
iv) the significant contribution of natural gas to the advance in imports of energy[36] that was largely offset by the 28.7 percent fall in crude oil imports. The expansion in domestic consumption of natural gas (that may be ascribed to the

[35] Imports of agrifoodstuffs in 2003 H2 added one third to their first-half performance, rising 37.2 percent year on year.

[36] In the second half of 2003, the value of natural gas imports grew 49.8 percent on the same year-ago period.

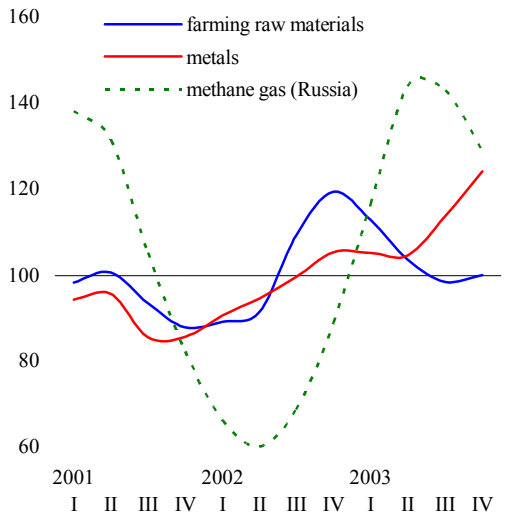
Prices of Raw Materials (a)

index compared to the same year-earlier period



Prices of Raw Materials (b)

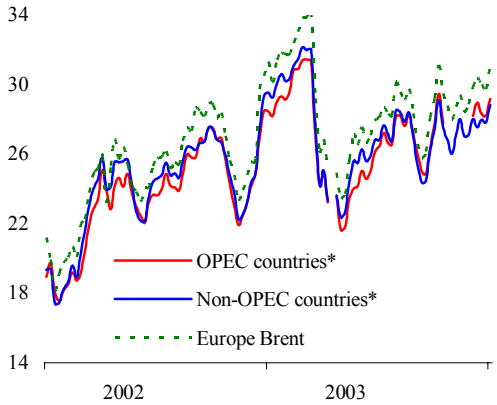
index compared to the same year-earlier period



Source: IMF

World Crude Oil Prices

USD per barrel; average weekly spot price FOB



**) Averages weighted by estimated export volume.*

Source: EIA

larger number of consumers) against the backdrop of weak output, the growth rate of which accelerated no sooner than towards the end of the year, called for larger imports[37]. The decline in crude oil imports can largely be attributed to the lower amount of export orders of petroleum products. Moreover, the energy bill showed that electricity imports soared by a stunning 215 percent against the same year-ago period as a result of the detrimental effect protracted drought had on domestic hydroelectricity production.

2.5.3. Imported inflation

In the second half of 2003, inflationary pressures induced by hikes in prices of major commodities continued to make their presence felt. The oil price stayed high even after the end of the warfare in Iraq amid lingering geopolitical tensions and the hardships encountered in resuming production in the war-torn region. Over the reference period, the price of Brent oil averaged USD 28.7 per barrel, up 7.4 percent compared with the corresponding period in 2002. Mid-October saw a record high of USD 31.1 per barrel amid the OPEC's decision to lower the daily production quota starting in November, social tensions in the oil-processing sector in Nigeria and fears for scant stocks during the winter period.

Imported inflation via the natural gas from Russia remained high in the reported period, as illustrated by the 35.6 percent year-on-year increase in price. This owed much to the investment requirements needed to enlarge the external distribution network of the main Russian supplier, the financing of which is rendered difficult given the administrative measure to limit domestic prices to 10 percent of export prices and the delayed bill collection.

In contrast to the first half of 2003, the movements in prices of imported agrifoodstuffs failed to offset inflationary pressures exerted by energy prices. The combination of higher world consumption and poor grain crops in Europe (which plunged 10.7 percent on average against 2002) caused producer prices of products of vegetal origin to rise by a real 8.1 percent[38] year on year. Romanian imports of agrifoodstuffs from EU Member States, calculated as a share of total agrifood imports, dropped in 2003 H2 by 4.5 percentage points to 33.5 percent. Covering

[37] In 2003, against the backdrop of the 11 percent rise in natural gas consumption and the 0.3 percent decrease in domestic production (shown in cubic meters), the share of imports in domestic consumption widened from 22 percent to 30 percent.

[38] Prices for grains, vegetables and fruit were up 13.3 percent, 12.8 percent and 10.4 percent respectively. Nominal indices are deflated by the CPI reported by each Member State in order to remove distortions caused by different inflation rates among countries.

the rest were the larger imports of agrifoodstuffs from CEFTA members yet export prices had to be kept elevated because of the difficulties those countries were facing in the vegetal sector. In late 2003, Romania's main wheat suppliers decided either to restrict their exports (Hungary and Bulgaria discontinued such exports or upped export prices markedly) or targeted certain markets (the Russian Federation gave priority to CIS members to buy wheat). Under the circumstances, Romania had to buy grains from Central and North America[39] – in this case, the positive effect of lower prices was mitigated by the higher transport costs.

The inflationary pressures arising out of the scant grain supply were partly alleviated by trade policy measures the authorities have implemented ever since July 2003, namely discontinuation of exports and exemption from import duties for strictly-determined wheat and grain amounts to be used as fodder by the end of 2003, whereas for milling wheat until the new crop. As a result, the upward trend in prices was alleviated and thus conditions were in place for the smooth provision of raw materials and lower prices for processors.

Imports from the EU, whose unit value receded 2.3 percent in 2003 H2 as against 2002 H2, helped curb imported inflation. Although domestic statistical data are available only in aggregate format, the change in the unit value of eurozone exports proves that such a positive performance was accounted for by every category of industrial goods – intermediate goods (-3 percent), capital goods (-3.4 percent) and consumer goods (-2.3 percent[40]).

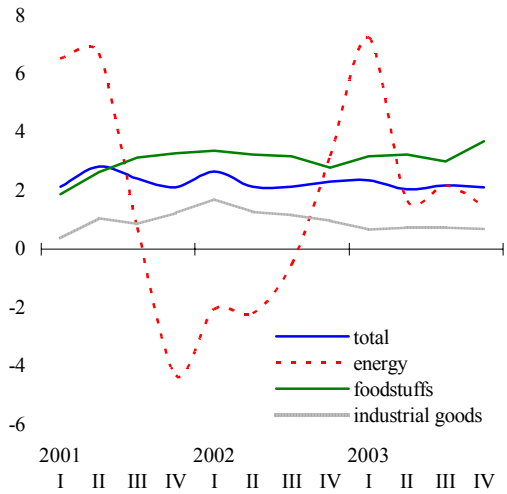
2.5.4. Exchange rate

In 2003 H2 too, both domestic and external factors weighed on the movements in the exchange rate, i.e. the persistent foreign exchange shortfall on the domestic market amid mounting imports combined with the fast-paced growth of medium- and long-term forex loans and the depreciation of the US dollar versus the major currencies as a result of widening of the twin deficits and the lingering geopolitical tensions.

In year-on-year comparison, the domestic currency strengthened by a real 14.6 percent against the US dollar and softened by 1.8 percent versus the euro, translating into a 4.2

HICP and its components

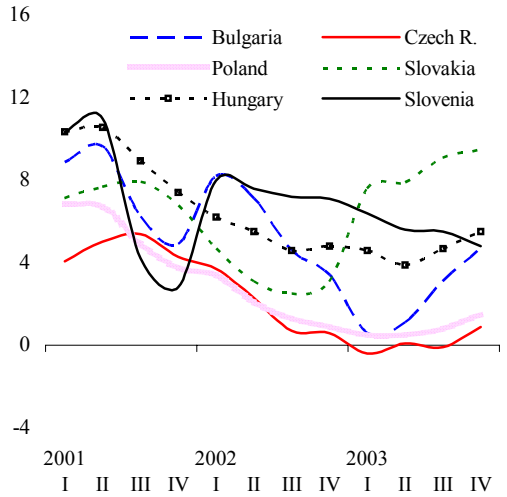
change against the same year-earlier period, %



Source: Eurostat

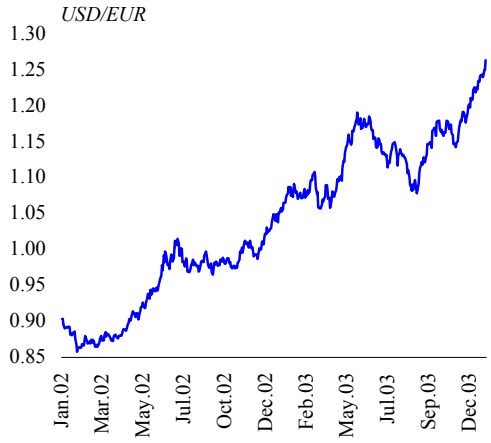
Inflation Rate in CEFTA Countries

change against the same year-earlier period, %



Source: central banks

Euro Exchange Rate against US dollar

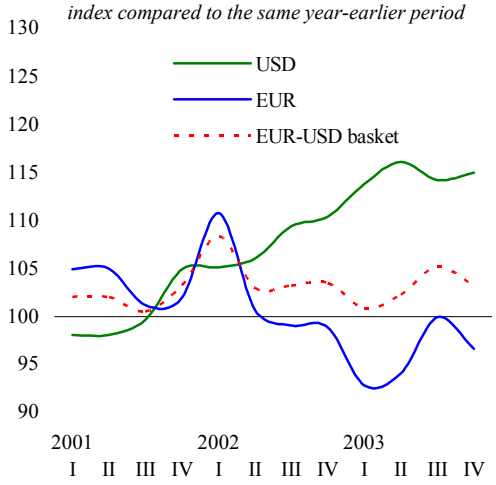


Source: ECB

[39] According to the Food and Agricultural Organisation (FAO), those countries reported a 41.9 percent increase in output in 2003 while world output subsided by 2.7 percent.
[40] July-November 2003/July-November 2002.

Developments of ROL Exchange Rate*)

index compared to the same year-earlier period



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

Source: NIS, NBR

percent appreciation to the implicit currency basket[41]. The opposite developments the Romanian currency experienced versus the two currencies produced positive effects on the trade gap given that 64.7 percent of exports were denominated in euro while imports of energy and raw materials were settled in US dollars. Even though the inflationary impact of a weaker ROL/EUR rate was still manifest due to merchandise imports and the prices geared to exchange rate movements (for fixed telephony), as well as to the effects on the final price of goods liable to excise duties, its magnitude was lower than that seen in 2003 H1 (nominal depreciation declined from 9.6 percent to 5.4 percent[42]).

[41] Average values.
[42] Average values calculated against the previous 6-month period.

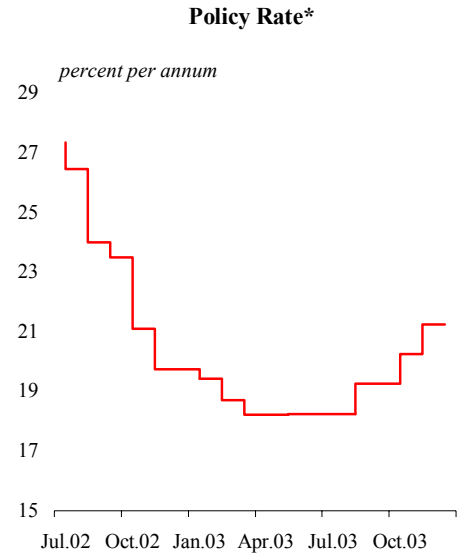
3. Monetary policy

3.1. General features

In the latter half of 2003, the central bank proceeded to the gradual tightening of monetary policy as the fast increase in household consumer demand and investment demand brought to the fore the danger of a rise in aggregate demand above the limits that are consistent with progress in disinflation and with keeping the current account deficit at sustainable levels.

Given that the expansion in non-government credit was one of the factors behind the tendency of worsening macroeconomic conditions, the central bank took measures to dampen consumer demand and bolster saving. Yet another reason underlying the extensive resort to monetary policy levers was the attempt to optimise the macroeconomic policy mix used in addressing domestic demand factors amid limited flexibility of wage policy and the expected loosening of fiscal policy at the end of the year[43].

The decisions made by the National Bank of Romania to further tighten monetary policy were also aimed at stifling the inflationary pressures induced by the adjustment in administered prices that was resumed in September 2003. Tightening of monetary conditions alleviated inflationary pressures caused by the increase in aggregate demand and put a brake on spillover effects of price adjustment; moreover, reinvigoration of the inertial component of inflation and of inflation expectations associated with such an economic framework was avoided. Nevertheless, the direct impact of adjustment in administered prices on the general price level was sizeable, the magnitude of price corrections being significantly higher than in the previous 6-month period. Under the circumstances, after having followed a winding trajectory during the latter half of the year, the 12-month inflation rate stood at 14.1 percent in December, slightly higher than in June 2003, merely 0.1 of a percentage point above the target set for 2003.



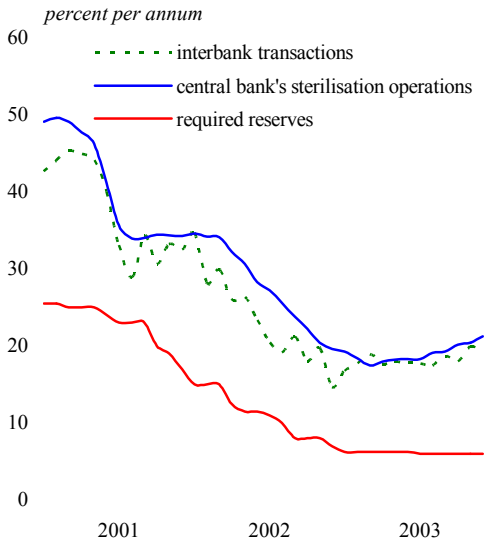
*) maximum interest rate on one-month sterilisation operations

The interest rate policy was the main lever the central bank employed to tighten monetary conditions, the maximum accepted interest rate on sterilisation operations being raised in three steps, each time by one percentage point; as a result, the real average interest rate on mopping-up operations was higher

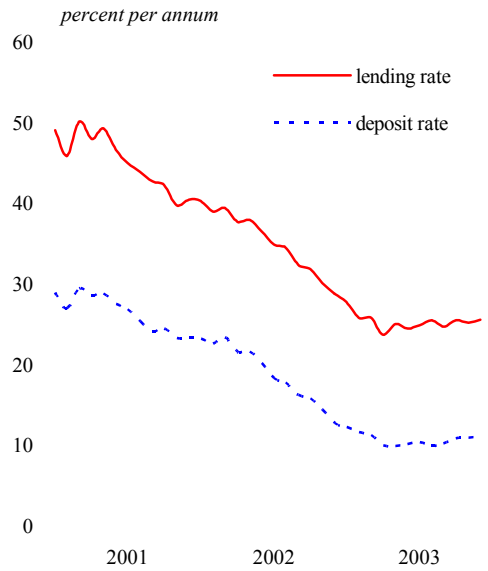
[43] During January-November 2003, fiscal policy featured an austere stance, so that a year-end loosening was likely.

than in the first six months of 2003 despite inflation bouts recorded at midst of the period under review. In order to enhance the impact of adjustment in the policy rate, the central bank increased the transparency of monetary policy; to this end, starting August 2003, the monetary authority pre-announced the new interest rate ceilings, presenting the general public, by means of press releases and press conferences, the reasons behind the adoption of the new ceilings. Furthermore, the NBR made wide resort to liquidity policy, as reflected by tighter monetary control than in the first six months of 2003. The same as in the previous periods, efficiency of monetary control was temporarily affected by banks' demand for excess reserves boosted by incidental and seasonal exogenous factors.

Interest Rates on the Interbank Money Market and on Required Reserves



Interest Rate Applied to Non-Banks



Against this background, the rise in the NBR's interest rates was unevenly passed through to the average interbank rates; thus, the spread[44] between the average interest rate on sterilisation operations and the average interbank rates widened slightly as a result of lower overnight rates at the end of most reserve maintenance periods. The average interest rates on government securities went up almost instantly in response to the hike in interest rate on sterilisation operations; originally, the former increased to a smaller extent, the spread between the two types of interest rates narrowing slightly towards the end of 2003 H2.

The impact of the tightening of the central bank's interest rate policy on banks' interest rates to non-government non-bank clients was uneven. Banks' average interest rates on new time deposits proved more elastic, their cumulative 6-month increase nearing the rise in average interest rate on sterilisation operations. On the other hand, the interest rates on new short-term loans saw the most sizeable rise, whereas interest rates on new medium- and long-term loans stayed put. The movements in lending rates resulted in an altered term structure of bank loans; the rate of increase in total bank credit was not however affected, but it is expected to subside over the period ahead.

The uplift in the NBR's interest rate on soaking-up operations had a significant bearing on the trajectory of the exchange rate of the domestic currency, thereby enhancing its role of an implicit anti-inflationary anchor. In the wake of lower forex market imbalance in 2003 Q3, real depreciation of the domestic currency slowed down, yet the central bank had to intervene decisively in the market towards year-end in order to prop up the ROL. In real terms, the domestic currency appreciated versus the euro after having weakened considerably in 2003 H1

[44] Under comparable terms as concerns maturity.

and continued to strengthen at a swift tempo versus the US dollar.

At year-end, the developments in key monetary indicators were illustrative of the cautious monetary policy capable of keeping inflation rate on a downward course along with ensuring sound remonetisation of the economy.

3.2. Conditions surrounding monetary policy implementation

The central bank tightened its monetary policy stance in the six months to December 2003 in response to the tendency of widening of some macroeconomic disequilibria jeopardising the achievement of its primary objective in short run as well as medium and long run.

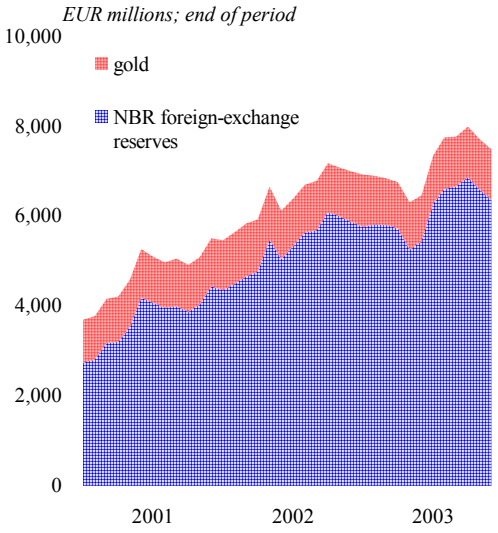
The major threat in the reference period was the fast-paced climb in imports boosted by stepped-up domestic demand. Behind the increase in imports stood household consumer demand and investment demand – the strong rebound in the former may have been the consequence of subdued consumption in the past few years when household incomes and access to bank loans had been lower. The shift in the propensity to consumption was the result of joint action of several factors, as follows: (i) rise in household incomes (see Subsection 2.4.2. *Incomes*); (ii) growing upbeat expectations of households in respect of their future incomes; (iii) diversification of the loan range and looser lending criteria; (iv) increase in popularity of credit cards and expansion of the system of paying wages by debit cards[45].

The upturn in imports became a matter of concern for the central bank the more so as, in the reference period, the growth rate of exports slowed year on year causing the trade deficit to widen. The slowdown in exports owed much to the dismal performance of Romania's chief trading partners; in addition, some exports of industrial goods became less competitive due to the lack of correlation between productivity growth and wage hikes, as well as to slower pace of depreciation of the domestic currency to the euro. Moreover, the relative deterioration of the terms of trade also contributed to widening of the trade gap in the latter half of 2003.

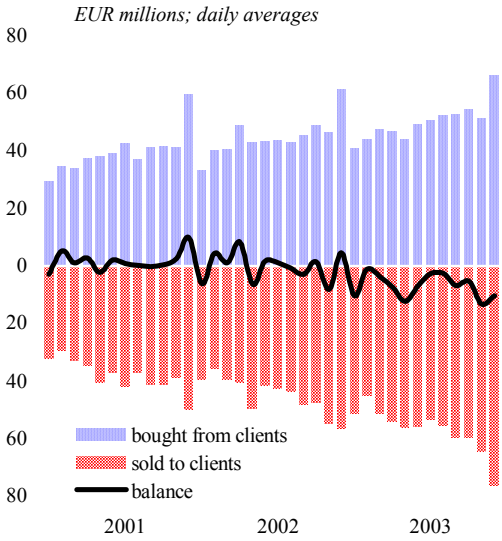
Behind the decision to tighten monetary policy were two reasons. First, in the short run, the central bank's measures were aimed at precluding pressures on the domestic currency to weaken, which might have fuelled inflation both directly and via expectations. Besides, the central bank avoided the resort to foreign exchange

[45] Having overdraft facilities attached to.

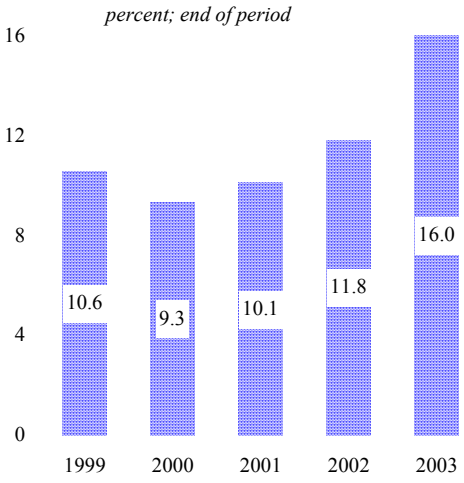
Official Reserves



Clients' Demand and Supply on FX Market



Non-Government Credit (Share of GDP)



Source: NIS, NBR

reserves, a development that had occurred in 2003 H1 also as a result of the short-lived reversal in the trend of capital flows[46]. The slowdown in the aforesaid reversal and the resumption of foreign funding in 2003 H2, driven also by the MPF's launch of a EUR 700 million Eurobond issue, helped fend off the emergence of severe disruptions on the currency market; as a result, in July-October 2003, the NBR reverted to the net foreign currency buyer position, its purchases amounting to EUR 744.6 million. In November-December 2003 however, the NBR had no choice but to sell EUR 239.4 million in order to stem the fast depreciation of domestic currency, due largely to the action of seasonal factors.

Second, in the medium and long run, the NBR sought to put a damper on the expansion in domestic demand, the protraction of which would have undermined the efforts to ensure balance-of-payments sustainability and to continue disinflation. In addition, the worrisome widening of the disparity between saving and investment, particularly in the first half of the year, might have hit the achievement of robust economic growth. The above-mentioned disparity alleviated somewhat in the latter half of 2003, albeit it remained above its 2002 H2 level, due to both higher gross accumulation (as a proportion of GDP) and lower share in GDP of gross national saving as against the same year-ago period. The weaker propensity for saving was also mirrored by the decline to a 3-year low of real increase in gross financial saving of households[47] and to a larger extent by the sluggish rise in the net value of this indicator[48].

Under the circumstances, the hike in the policy rate was the lever the central bank employed to quell the fast increase in bank loans, viewed as a significant incentive for domestic demand. The expansion in lending combined with the declining trend in saving pinpointed the need to re-correlate monetary conditions with real-sector developments, although the credit boom may have been partly driven by the natural tendency to bridge the gap separating the financial intermediation and monetisation of the Romanian economy from the levels in most EU candidate countries.

As expected, lending failed to capture instantly the effect of monetary tightening, building up steam in 2003 H2 compared with 2003 H1, owing widely to medium- and long-term current loans. The real increase in current loans in ROL remained virtually unchanged from 2003 H1 at 33.6 percent (December versus June)

[46] The second quarter of 2003 saw one-off capital outflows, namely profit repatriation and portfolio diversification induced by liberalisation of some capital operations, and lower capital inflows amid the shift in direction of capital flows worldwide.
[47] Estimates are based on savings with banks and on the value of government securities bought by households.
[48] Household loans are left out of account.

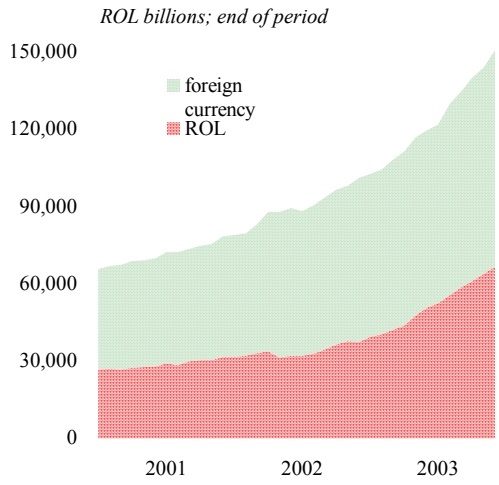
whereas the growth rate of forex loans (expressed in euro) was more than three times over the previous 6-month period.

Demand for loans was subject to changes, and the most significant deserve mention, namely increased household bias towards medium- and long-term forex loans (the balance of which doubled in December versus June) and higher recourse of the state-owned sector to bank loans. Credit to households – the most rapidly expanding sector in terms of borrowings, albeit its real growth rate slowed somewhat from 2003 H1 – was intended to meet demand for consumer goods and for buying and/or erecting buildings. The advance in public-sector current loans can be ascribed mainly to the need to ensure funding of some infrastructure projects via medium-term loans in ROL.

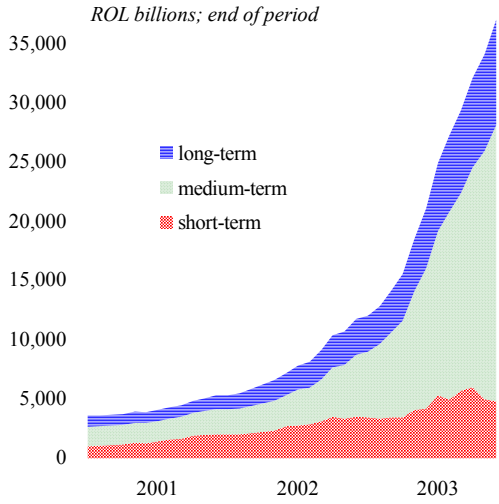
The credit supply also grew at a swifter pace than in the prior 6-month period, largely as a result of fiercer bank competition[49], which entailed looser lending criteria, thereby cushioning the impact of tougher monetary conditions. Moreover, the constraints depressing the NBR's capability to have a bearing on the credit supply tightened as banks became far less reliant on domestic financing sources; in 2003 H2, external liabilities of credit institutions edged ahead some EUR 536 million compared with EUR 251 million in 2003 H1. In contrast to the first half of 2003, liabilities with maturity of less than two years prevailed, granting required reserves a greater role in the successful partial sterilisation of such flows. The credit supply was also fuelled by further alteration of the composition of banks' portfolios, with the fall in external investments (much sharper than in 2003 H1[50]) being accompanied by the decline in banks' government securities.

The restraint in banks' investments in government securities was less the result of a decision made by those institutions, and more the result of the deficit financing and public debt refinancing strategy pursued by the MPF, which is systematically subservient to its interest cost cutting objective. As was the case in 2003 H1, fiscal dominance components posted divergent movements. In the period under review, the fiscal dominance made the liquidity policy more difficult to implement, whereas the interest-rate policy of the public authority was largely in step with that of the central bank. Thus, the MPF's decision to redeem nearly 64 percent of total ROL-denominated government securities falling due put additional pressure on liquidity-draining operations; similar effects had the heavy recourse to the amounts deposited with the Treasury's foreign exchange account (stemming widely from the Eurobond issue settled in July) in order to

Non-Government Credit in Real Terms
(deflated by CPI; 2000=100)



Credit to Households in Real Terms
(deflated by CPI; 2000=100)



[49] Including new entrants to the loan market, i.e. institutions specialising in granting mortgage loans.
[50] Foreign assets of banks dropped by EUR 233 million in 2003 H2 compared with EUR 50 million in 2003 H1.

cover most of public spending. Consequently, the Treasury's net injection in the latter half of 2003 was upwards of ROL 5,400 billion[51].

In line with interest-rate movements in the money market, the MPF lifted the maximum yields on auctioned government securities. Even though the initial increase in interest rates for the 3-month maturity was moderate, the cumulative 6-month rise outran slightly that of the policy rate[52], which may be regarded as a correction to the exceedingly low level touched by those yields in the first half of the year. By contrast, the maximum accepted interest rates on government securities with 6-month and 12-month maturities stayed flat in the first part of the reference period but climbed in October, after the central bank's second hike in the reference rate; the cumulative 6-month increase of such rates was well below that of the policy rate. However, the new ceilings were not accepted by most participants in the primary market for government securities and therefore volumes traded shrank; in 2003 H2, the public authority raised funds in a range from 6.3 percent to 65 percent of the pre-announced volume (averaging out at 34.8 percent compared with 69.1 percent in 2003 H1). Apart from rejecting the bids that did not match the pre-set yields, the MPF refrained from further issuing bonds with 2-year and 3-year maturities in the final quarter of the year. Still, the public authority retained its stance in favour of extending maturities and chose to prolong the maximum maturity attached to government paper sold at auction. In an attempt to reconcile this goal with the cut in domestic public debt costs, the Treasury launched, for the first time ever, 5-year CPI-linked bonds, with an accepted real margin well above the margins of other securities.

Aside from traditional autonomous factors, banks' approach to reserve management still affected liquidity conditions. Sterilisation operations were temporarily suppressed by the demand for excess reserves. During the reference period, behind the demand for excess reserves stood banks' expectations of the time and the magnitude of the NBR's interest-rate changes, the uncertainties surrounding TransFonD taking over the settlement of Treasury operations, as well as those associated to steeper seasonal swings in autonomous factors. Nevertheless, the latter half of 2003 saw a more homogenous behaviour of banks, except two reserve maintenance periods.

Against this background, the money market provided insufficient support in conveying monetary policy stimuli the more so as turnover of the interbank market (the NBR

[51] Against a net absorption of more than ROL 16,000 billion in 2003 H1.
[52] Under comparable terms as concerns maturity.

excluded), as well as turnover of the market for government securities – on both segments[53] – took a plunge[54], with turnover of the interbank market (the NBR excluded)[55] posting the lowest half-yearly level in seven years. Compression of interbank turnover was offset by the longer average maturity attached to contracts following the increased resort to 2-week contracts and the taking of deposits with maturities longer than those offered by the NBR (six months at most).

Interbank rates further displayed low volatility, as they stayed almost entirely within an extremely narrow margin, very close to the central bank's rate. Average daily interbank rates seldom departed from the above-mentioned margin, namely when they entered a downturn prior to the end of the reserve maintenance periods (in December, daily interest rates hit an all-time low). Interest rates on overnight and one-week operations were more volatile owing to their higher sensitivity to liquidity conditions, whereas average rates on longer-dated operations followed steadily the upward path in the central bank's rates.

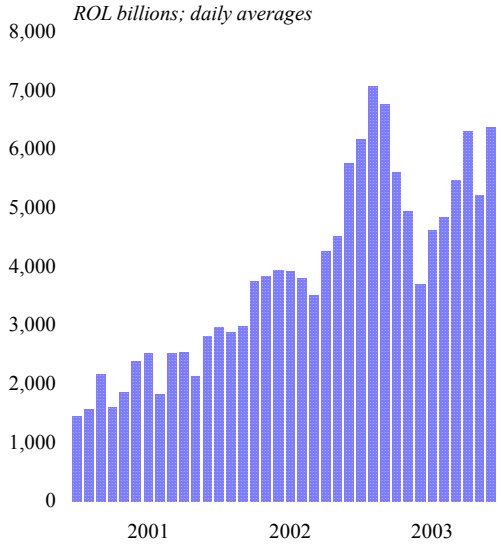
In contrast to money market developments, turnover on the interbank foreign exchange market resumed its upward course, which led to the widening of the disparity in respect of depth between the two market segments. The upsurge in trading was driven by the swifter pace of increase in foreign trade and the advance in current transfers between residents and non-residents[56], as well as by larger flows from the balance-of-payments financial account.

The contribution of bank operations[57] to the interbank foreign exchange market expansion was relatively low, declining sharply in the final two months of 2003 when the reduction in volumes traded by banks[58] grew out of heightened uncertainties on the movements in the EUR/USD rate and steadier money-market yields.

The same as in the first half of 2003, operations performed by bank clients, which rose to a record high in December, further

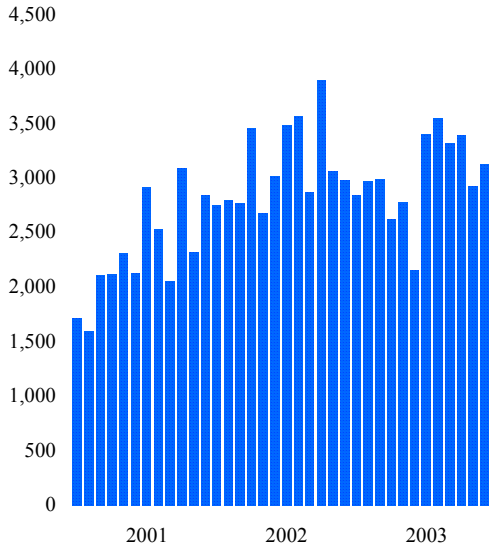
Transactions on Interbank Money Market

ROL billions; daily averages



Transactions on FX Market

EUR millions; daily averages



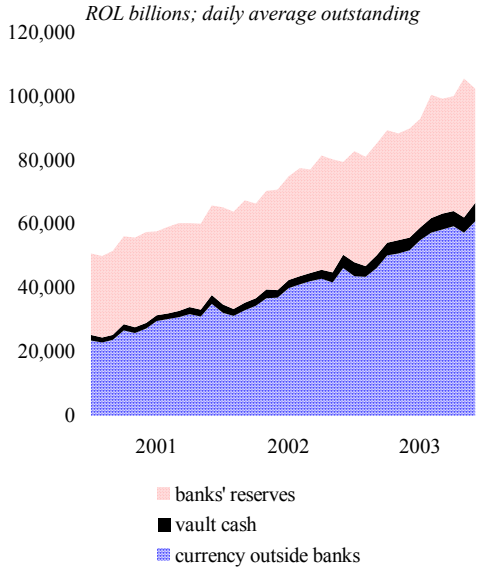
[53] The significant improvement in the ratio of secondary market turnover and primary market turnover (from 5 to 16) can be ascribed to the cut by two thirds in primary market turnover.
[54] Against the same year-ago period.
[55] Calculated as a proportion of GDP of interbank operations.
[56] In 2003 H2, the flow of current transfers between residents and non-residents expanded by EUR 199 million against 2003 H1.
[57] Excluding the central bank's intervention, banks' demand grew by EUR 776 million and their supply climbed EUR 1,262 million against 2003 H1 (while demand from their clients picked up EUR 1,384 million and related supply jumped EUR 1,397 million).
[58] In the final months of 2003, the value of banks' transactions lagged behind that of their clients quite frequently.

boosted trading on the interbank foreign exchange market[59]. The relatively similar magnitude of developments in supply and demand from clients caused the half-yearly interbank foreign exchange deficit to stay broadly unchanged at EUR 851 million.

The slightly abating volatility of the EUR/USD rate together with the increase in terms of magnitude and frequency of NBR's interventions lowered marginally the movements in the domestic currency versus the euro compared with the first half of 2003. The persistent uncertainties about the future direction of the euro made banks behave cautiously as regards ROL/EUR quotations, thus pushing down the relative spread between minimum bid and maximum ask rates in the latter half of the year.

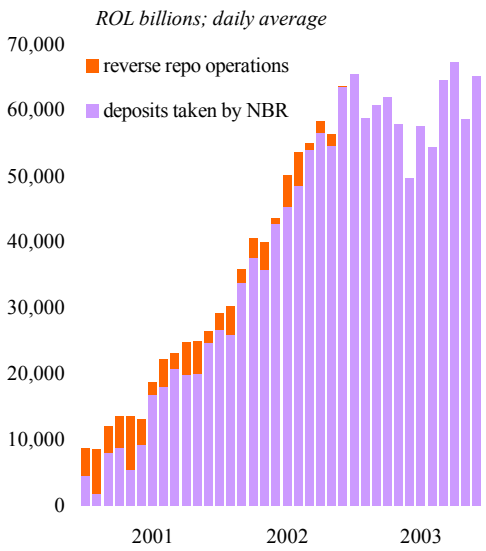
Reserve Money

ROL billions; daily average outstanding



Sterilisation Operations

ROL billions; daily average



3.3. The mix of monetary policy tools

Reserve money[60] rose at a slower pace as against the first half of 2003, up a meagre 5.4 percent in real terms. The main driver of the increase in reserve money was currency outside the NBR, whose real 10.9 percent rise offset the real 3.5 percent decline in banks' average holdings on current accounts with the NBR. Unlike the first half of 2003, the rise in reserve money was fuelled solely by the good performance of central bank's net foreign assets as its net domestic assets were on the wane.

The pick-up in the volume of sterilisation operations made monetary control grow firmer in spite of the seasonally-induced increased banks' bias to holding excess reserves. At the end of the reserve maintenance periods in 2003 H2, the spread between their reserve holdings and the required level of reserves was lower, ranging by and large from 0.2 percent to 0.4 percent.

The main operations performed by the central bank, with significant impact on liquidity in the six months to December 2003, were the following:

1. Liquidity-absorbing open-market operations. In an attempt to offset the impact of the increase in its foreign exchange purchases and the Treasury's liquidity injections, the NBR stepped up its sterilisation operations in the latter half of 2003. To this end, the central bank resorted solely to taking deposits with one-month maturity. The average daily volume of NBR's new deposits more than doubled in December against

[59] Even though the growth of transactions performed by bank clients outran that of banks, the share of volumes traded by bank clients in total turnover was little changed from the first-half performance due to more far-reaching NBR interventions in 2003 H2.
[60] Monthly average (December 2003/June 2003).

June 2003, whereas the average daily balance on deposits taken by the NBR stood 31 percent higher; half-yearly average values also increased by 13 percent in the former case and 3.7 percent in the latter.

In the six months ended December 2003, the NBR raised in three successive steps the maximum accepted interest rates on sterilisation operations by one percentage point (on 7 August, 6 October, and 20 November) to as much as 21.25 percent at year-end.

Banks' expectations of a third increase in the ceiling of interest rate on deposits taken from the money market were more manifest than on the other two occasions. At all nine auction sessions preceding the one when the ceiling was raised there were bids with interest rates higher than the maximum accepted level[61], and the volume accepted by the NBR ranged from 98.5 percent to 67.9 percent of the total figure. It is noteworthy the temporary increase in the number of such bids submitted to an auction session, from 1-2 in the previous months to 3-5 in the reference period. The average interest rate on sterilisation operations was closer to the above-mentioned ceiling, rising from 18.25 percent to 21.25 percent in the July-December period.

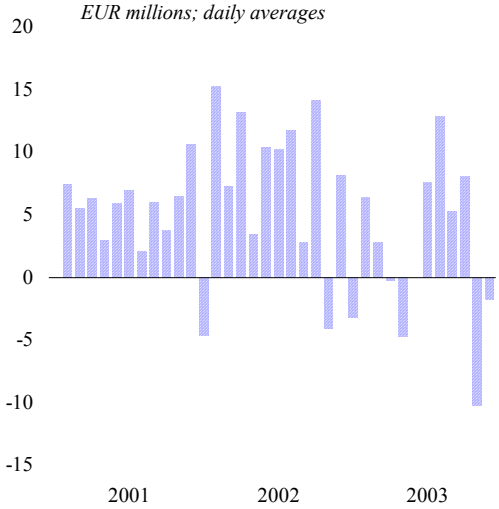
2. Interventions in the foreign exchange market were more frequent than in 2003 H1, and the central bank increased either the demand for or the supply of foreign currency. Thus, the NBR purchased EUR 744.6 million during the July to October period; towards the end of the latter half of 2003, it sold EUR 239.4 million amid the widening of the foreign exchange deficit.

3. Repayment of some special credit lines. Partial repayment of some loans granted by the National Bank of Romania to the Bank Deposit Guarantee Fund and Credit Bank was further supportive of the sterilisation operations. In the six months to December 2003, the central bank drained liquidity to the tune of ROL 663 billion.

4. Standing facilities. Banks resorted to the deposit facility far more frequently than in the first half of 2003, which is indicative of their greater cautiousness relative to reserve management. As a result, 21 credit institutions (compared with 10 in 2003 H1) made recourse to the deposit facility 57 times (compared with 14 times in 2003 H1). The amounts deposited with the NBR ranged from ROL 7 billion to ROL 1,445 billion

Net Interventions* by the NBR in the FX Market

EUR millions; daily averages

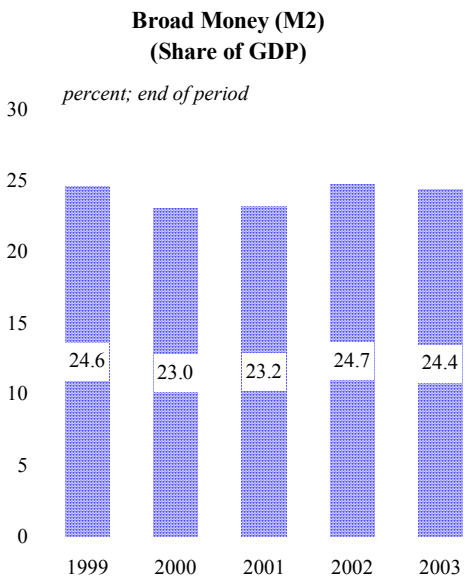


**) purchases (+), sales (-)*

[61] However, maximum interest rates on submitted bids during the June to December period were below the new ceiling set by the NBR.

and the average deposit placed with the NBR ran at some ROL 251 billion against ROL 178 billion in the first half of 2003.

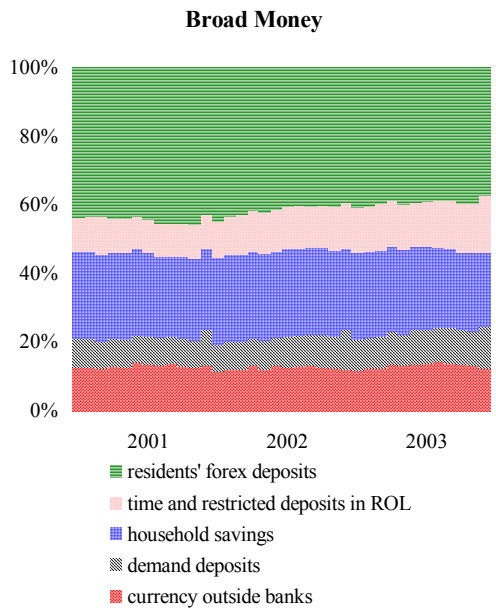
3.4. Main monetary developments



Source: NIS, NBR

In the latter half of 2003, broad money (M2) grew at a faster pace compared with the first half of the year, up 9.8 percent in real terms. The real rise in broad money reflected the differences between demand for money of companies and that of households, with corporate deposits covering 85.7 percent of the rise and households accounting for 11.3 percent. As far as money supply was concerned, the real increase in M2 was chiefly bolstered by the pick-up in reserve money, the average of which grew by a real 5.4 percent in the six months ended December 2003.

The real 6 percent decline in ROL-denominated government securities outstanding with non-banks against June 2003 was partly offset by the 56 percent expansion in their foreign-exchange-denominated government paper (when expressed in EUR) following the launch of a foreign-exchange-denominated issue of government securities[62] in September 2003. As a result, in the latter half of 2003, the balance of Treasury bills and bonds held by non-banks contracted by a real 0.9 percent while the pseudo-monetary aggregate M2T went up by only 8.8 percent in real terms.



Moreover, in 2003 H2, the share of narrow money in M2 reached 24.1 percent (6-month average), the highest reading for the corresponding period over the last 5 years. Nonetheless, the real growth of **M1** lagged behind the half-yearly values seen in the previous years (13.8 percent versus 27.2 percent in 2002 and 23.2 percent in 2001). The advance in narrow money was largely driven by the 29.3 percent surge in **demand deposits** which, after having recorded a winding course, posted a robust, seasonally-induced growth at year-end, mostly on the back of demand deposits of privately owned companies.

Currency in circulation recorded high values, especially after August 2003, when the contraction in the number of NBR branches[63] weighed on the developments of this indicator. The effects of wages and social security benefits paid in the July to October period (hike in net public-sector wages, redundancy payments, indexation and realignment of pensions, subsidies to farmers) were partly offset by the larger number of working days at the beginning and at the end of certain months.

[62] The first domestic issue ever to be denominated in EUR, amounting to EUR 68.62 million.
[63] Initiated on 1 September 2003.

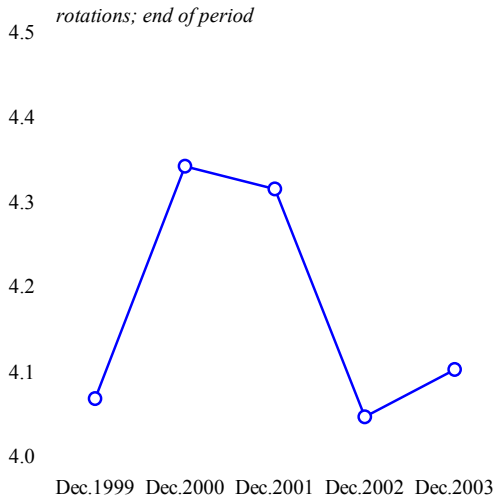
Furthermore, the postponement of some yearend-specific payments from the government budget helped contain the real 6-month rise in currency outside banks to a meagre 2.2 percent (compared with 6.7 percent in 2002 and 6 percent in 2001).

Quasi-money climbed 8.6 percent in real terms versus June, largely on account of **time deposits** (in ROL) of companies. These deposits leapt by a real 53.6 percent in the latter half of 2003, with steep growth rates in August and particularly in December, when they posted one of the highest monthly real rises on record (except the increases seen in March 1993 and January 1994). The pick-up in time deposits in the six months to December 2003 was also driven by the fact that ROL-denominated Treasury bills became less popular with legal entities (down 6.1 percent in real terms).

Household savings (including certificates of deposit) dropped by a real 0.3 percent against June despite being spurred by the higher deposit rates (particularly in 2003 Q4), the real decline in the portfolio of ROL-denominated government securities outstanding with households (6 percent), payment of 12-month interest and the increase in net real wages (mainly in December, when they increased by 11 percent, the highest rise for this month in three years). The sharp worsening in household saving in domestic currency can be attributed, *inter alia*, to the uplift in instalments and down payments relating to the noticeable volume of loans granted to individuals in 2003 and to the shift of part of household resources to foreign exchange investments[64]. The impact the two developments mentioned above had on saving was only partly offset by the upward path in average interest rates on new time deposits, which rose in each month of the reference period, gaining on average 3 percentage points in December versus June.

Forex deposits of households and companies posted different growth rates in the six months to December 2003. While forex deposits of households stood 4.9 percent higher, those of companies edged up barely 0.5 percent (when expressed in euro), with corporate deposits partly reflecting the widening trade gap in 2003. In the latter half of 2003, residents' forex deposits, when expressed in foreign exchange, went up merely 2.7 percent, and their share in M2 averaged out at 38.7 percent, touching a 4-year low and hinting at further de-dollarisation of bank liabilities. Foreign-exchange-denominated government securities outstanding with households and companies

Money Velocity

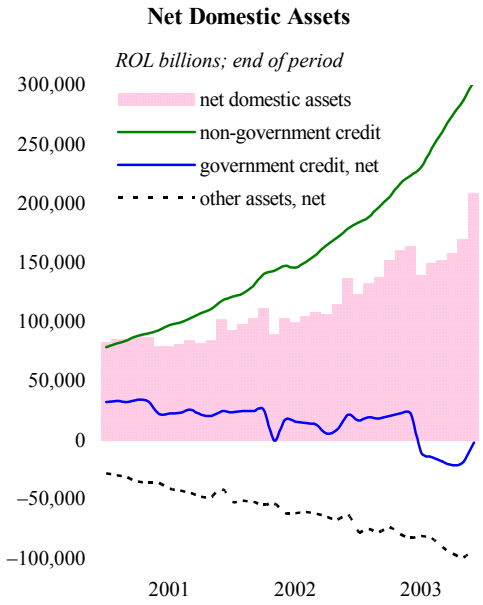


Source: NIS, NBR

[64] The latter half of 2003 saw the seasonally-induced lower propensity for saving in the summer months and in early autumn, a fact that also fostered the rise in currency in circulation.

(expressed in euro) leapt against mid-2003 by 46 percent and 62.2 percent respectively.

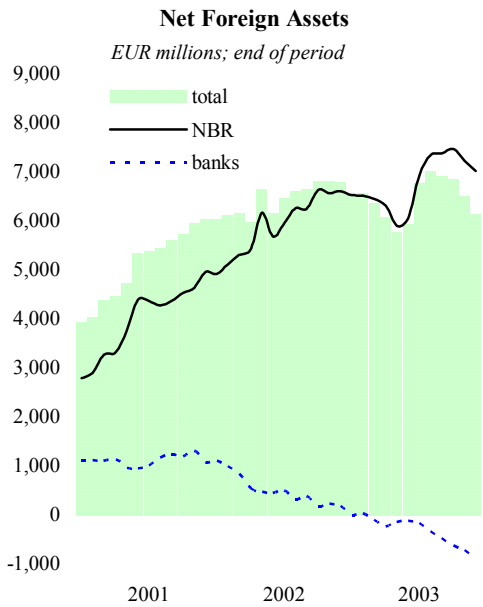
In the reference period, the drivers of monetary expansion were non-government credit and net foreign assets of the central bank.



Domestic counterpart of broad money augmented 17.7 percent in real terms in 2003 H2. The development is illustrative for the pick-up in **net domestic credit (**13.2 percent) and the wider credit balance of "**other net domestic assets**" (4 percent).

After having stayed in positive territory in the first half of 2003, **net government credit** fell into negative territory starting July, with a dampening effect on broad money. At end-2003, the government held a net creditor position against the banking system (ROL 1,924 billion), largely as a result of lower bank financing requirements of the government sector. While the government securities outstanding with banks dropped sharply, the balance of the General Account of the Treasury, extra-budgetary funds and government deposits in foreign exchange were on the increase – settlement of the Eurobond issue in July stood behind the advance in government deposits in foreign exchange.

Non-government credit exhibited a real 25.5 percent growth versus June 2003 and remained the main driver of monetary expansion. Over the reference period, non-government credit in domestic currency moved up by a real 31.5 percent while that in foreign currency rose by a real 19.8 percent (when expressed in euro). The share of forex credit in total non-government credit stayed on a downward drift, its half-yearly average dropping to a 5-year low of 56.2 percent in the July to December period. Current loans increased by a real 26.5 percent despite the upturn in average interest rates applied by banks. The interest rates on short-term current loans surged markedly, i.e. by 3.2 percentage points on average. As for medium- and long-term current loans, the positive dynamics in interest rates on loans granted to individuals (up 1.7 percentage points) was mitigated by the decline in interest rates on loans granted to legal entities. In the latter half of 2003, the average interest rate on medium- and long-term loans inched up 0.1 of a percentage point.

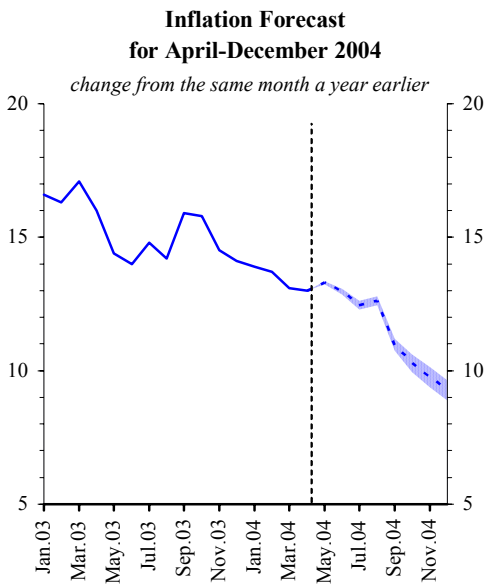


Net foreign assets of banks moved ahead 3.4 percent during July-December 2003 (when expressed in euro), as a result of divergent developments in foreign assets of central bank and commercial banks. Even though net foreign assets of the central bank were on the slide in late 2003, they rose 16 percent (when expressed in euro) in the latter half of 2003. In October, the funds released as the last tranche under the Stand-by

Arrangement concluded with the IMF in 2001[65] were channelled into the accounts of the central bank. Net foreign assets of banks (when expressed in euro) saw their credit balance widening due mostly to larger borrowings from international financial institutions, but also to lower investments abroad.

[65] In amount of EUR 135.2 million.

4. Outlook for inflation



The inflation forecast for April-December 2004 was drawn up by considering the following influential factors:

- further adjustment of administered prices,
- adjustment of prices for some food and non-food items liable to excise duties,
- supply-side pressures,
- demand-side pressures,
- external shocks,
- inertial component,
- seasonal developments.

For the purpose of achieving the inflation target – set for the first time at a single-digit rate, i.e. 9 percent, December/ December –, the authorities will take a cautious monetary stance. Thus, control over liquidity will remain tight, while the interest-rate policy will stay firm, allowing however in the latter half of 2004 a gradual decrease in the ceiling of interest rates accepted by the NBR on mopping-up operations in order to confirm the disinflationary trend.

The 12 percent hike in the gross minimum wage at the start of 2004 is expected to allow the growth rate of the average wage to stay in line with that of labour productivity. It is essential to avoid any further unjustified wage increases, which may translate into inflationary pressures by feeding through to production costs and affecting consumer demand.

The rise in public sector revenues amid further economic growth, tougher financial discipline and the change in excise duties regime is seen helping keep the budget deficit within prudent limits, although the run-up to the elections might cause fiscal policy to loosen up.

The upsurge in international oil and gas prices and the sharp strengthening of the US dollar against the major currencies would put considerable pressure on prices given Romania's heavy reliance on (USD-settled) imports of energy products. Conversely, the appreciation of the euro against the US dollar would affect administered prices geared to the euro, those of products liable to excise duties and the prices of products incorporating EUR-denominated imports of materials. Such risks can, to a certain extent, be cushioned by the exchange rate policy, which pursues a sustainable real appreciation of the domestic currency (2-4 percent) against the implicit EUR/USD

basket, thereby entailing a slower pace of nominal depreciation of the ROL against the EUR amid the rise in the share of the euro to 75 percent from 60 percent.

In light of the authorities' commitment to the International Monetary Fund, prices of energy and natural gas will be subject to periodical adjustment. Thus, the price of electricity will be adjusted on a half-yearly basis, while that of heating will be liable to adjustment on a quarterly basis, with a view to keeping them at a level that should ensure cost recovery. The adjustment of electricity prices will be implemented in July, when a slight increase is likely, whereas the adjustment of heating prices will contribute to headline inflation in the fourth quarter of the year when heating starts to be provided to households. The price of natural gas will be adjusted on a quarterly basis, with rises by 4 percent being expected in April, July and October. The increase in the price of gas is the result of the need to gradually bring the prices of domestically-produced natural gas in line with those on world markets, as well as of the domestic market liberalisation and the accession to the Single European Gas Market with a view to Romania's joining the EU in 2007.

Further increases in other administered prices are likely; the adjustment is made in accordance with legal provisions (on a quarterly or monthly basis, as appropriate, in step with the movements in exchange rate and inflation).

The adjustment pursuant to the calendar of raising the excise duties by Romania's accession to the EU is to have a bearing on prices of products liable to excise duties such as alcohol and spirits, fuels, tobacco and cigarettes. In 2004, excise duties on alcohol and spirits will be upped by EUR 130 per hectolitre (87 percent), excise duties on leaded petrol and diesel oil will increase by EUR 10 per tonne and EUR 20 per tonne (2.5 percent and 9 percent), while excise duties on cigarettes will add 11 percent to EUR 16.5 per 1,000 pieces. Moreover, fuel prices may rise in order to come closer to EU prices.

Achieving the inflation target is also contingent upon the alleviation in the latter half of 2004 of the imbalance on the agrifood market by yielding the expected grain crops. The forecasts on wheat output worldwide published by FAO in April 2004 show significant rises in wheat output in Europe, amid favourable weather conditions in winter, larger planted areas, and the incentive of good price prospects. Under normal weather conditions, wheat production in Romania is estimated to grow from 2.5 million tonnes in 2003 to 6.1 million tonnes in 2004.