INFLATION REPORT

November 2024

Summary

Developments in inflation and its determinants

The annual CPI inflation rate went down to 4.62 percent at the end of 2024 Q3, i.e. 0.32 percentage points below the June level. Behind the downward path stood mainly exogenous components of the consumer basket, amid some favourable statistical effects, but also benign oil market developments. Conversely, factors such as the severe drought or some incidental problems affecting the regional electricity market, alongside fast wage dynamics that fuel cost pressures, led to a slower disinflationary process. The slowdown was particularly visible in core inflation, with the annual rate of the indicator standing at 5.6 percent in September versus 5.7 percent three months before. The average annual inflation rate remained on a downward trend in Q3, with the indicator calculated based on the national methodology (CPI) falling to 6.1 percent and the indicator calculated in accordance with the harmonised structure (HICP) going down to 6.4 percent. Thus, during Q3 the correction was approximately 1 percentage point for each indicator. However, the differential against the EU average came in at 3.6 percentage points, only 0.1 percentage points lower than at the end of the previous quarter, reflecting further a slightly slower disinflation in Romania.

After rising to 5.8 percent in August, the annual adjusted CORE2 inflation rate resumed its decrease in September, when it stood at 5.6 percent. Thus, for the quarter as a whole, the indicator recorded a modest decline of only 0.1 percentage points. Q3 witnessed divergent developments in core inflation sub-components, with visible decelerations in the annual inflation rate of non-food and services, whereas the annual pace of increase of food prices recorded a slight re-acceleration. However, the differential between the levels of the three sub-components has remained significant. While the annual growth rates of non-food and services prices have continued to be close to or even exceed 7 percent, that of food prices, i.e. 3.4 percent, stayed inside the variation band of the target in September. For services and non-food sub-components, this reflects still elevated wage inflationary pressures and only gradually abating pressures from import prices. At the same time, while economic agents' inflation expectations increased mildly in the past months, primarily over the short time horizon, pressures from excess aggregate demand eased amid the visible slowdown in economic activity in the first three quarters of the year.

The annual dynamics of unit labour costs economy-wide remain brisk from a historical perspective, although slightly decelerating to 19.5 percent in Q2 (-2.3 percentage points

versus the previous quarter), mainly amid the slower pace of increase of compensation per employee (to 16.2 percent, -1.5 percentage points), as well as a more moderate decline in labour productivity (from -3.4 percent in the first three months of the year to -2.7 percent in Q2). Most economic sectors contributed to the slowing of the aggregate dynamics of unit labour costs, except for the public sector. In industry, the annual growth rate of unit wage costs accelerated to 17.6 percent July through August (from 15.8 percent in Q2), with wage dynamics remaining high (also amid the hike in the gross minimum wage in July), despite the annual contraction in the industrial output and the projected staff cuts.

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

In its meeting of 7 August 2024, the NBR Board decided to cut the monetary policy rate to 6.50 percent per annum from 6.75 percent per annum. The interest rates on standing facilities were also lowered, i.e. the deposit facility rate to 5.50 percent per annum and the lending (Lombard) facility rate to 7.50 percent per annum. The annual inflation rate continued to decline in June 2024, down to 4.94 percent, below the forecast, as a result of the decreases in core inflation and fuel price dynamics, which were partly counterbalanced, in terms of impact, by the increase in natural gas prices. In turn, the annual adjusted CORE2 inflation rate fell at a faster pace in Q2, also compared with the forecasts, down to 5.7 percent in June. Behind the deceleration stood, during this period as well, disinflationary base effects and downward corrections of commodity prices. Additional influences stemmed from the decreasing dynamics of import prices and the short-term inflation expectations resuming a slight downward trend. A moderate opposite impact had the hikes in unit labour costs recorded in the first months of 2024, which were passed through, at least in part, into some consumer prices, *inter alia* amid a robust demand for goods.

Heightened uncertainties and risks stemmed from the fiscal and income policy stance, given on one hand the budget execution in the first six months of the year, the public sector wage dynamics and the full impact of the new law on pensions, and on the other hand the fiscal and budgetary measures that could be implemented in the future to carry on budget consolidation, in the context of the *National Medium-Term Fiscal-Structural Plan*. Labour market conditions and wage dynamics in the economy also remained a source of sizeable uncertainties and risks. At the same time, significant uncertainties were associated with developments in energy and food prices, amid the legislative changes and the protracted drought this year, as well as with the future path of crude oil prices in view of geopolitical tensions. Uncertainties and risks to the outlook for economic activity, implicitly the medium-term inflation developments, also continued to arise from the war in Ukraine and the Middle East conflict, as well as from the economic performance in Europe. Furthermore, the absorption of EU funds, especially those under the Next Generation EU programme, is conditional on fulfilling strict milestones and targets. However, this is essential for carrying out the necessary structural reforms, energy transition included, as well as for counterbalancing, at least in part, the contractionary impact exerted by geopolitical conflicts. The ECB's and the Fed's monetary policy decisions, as well as the stance of central banks in the region, were also relevant.

Subsequently, the annual inflation rate went up to 5.42 percent in July, from 4.94 percent in June, and then fell to 5.10 percent in August. The advance from end-H1 owed to the faster rise in food and energy prices amid the severe drought and the pick-up in the distribution tariffs for natural gas, which outweighed the impact of the new decreases in the dynamics of administered prices and fuel prices, under the influence of base effects and the fall in crude oil prices. At the same time, the annual adjusted CORE2 inflation rate saw a halt in its downward trend, climbing to 5.8 percent in August from 5.7 percent in June. This was attributable to an unfavourable statistical effect in the processed food segment and to the hike in some agri-food commodity prices, as well as to higher wage costs passed through, at least in part, into some consumer prices, *inter alia* amid still high short-term inflation expectations and a robust demand for goods. These factors were largely offset by the disinflationary base effects in non-food sub-components and by the decrease in import price dynamics. In turn, in 2024 Q2 the economic activity posted a slower pace of increase compared to the expectations in the previous *Report*, probably reflecting a further narrowing of excess aggregate demand over this period, contrary to forecasts. Annual GDP growth stepped up however in 2024 Q2, to 0.9 percent from 0.5 percent in the previous quarter, mainly as a result of the surge in the annual dynamics of household consumption. At the same time, the growth rate of gross fixed capital formation remained robust, although it continued to slow down compared to the prior quarter. By contrast, net exports exerted a markedly larger contractionary influence, given that the volume of imports of goods and services recorded a faster increase, while the volume of exports continued to decline in annual terms. Consequently, the trade deficit and the current account deficit reported significantly faster dynamics, spurred in the latter case by the moderation of the favourable developments coming from the secondary income balance, reflecting the inflows of EU funds to the current account.

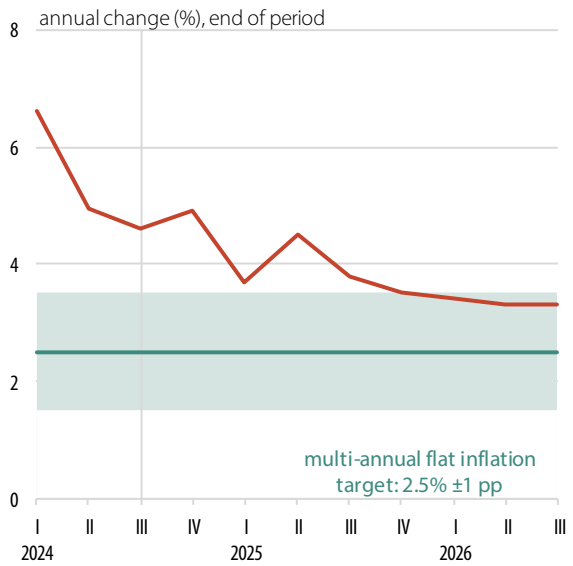
At the time of the NBR Board meeting of 4 October 2024, the latest assessments showed that the annual inflation rate would decline until end-2024 on a fluctuating and higher path than that shown in the August 2024 medium-term forecast. The decrease would result primarily from base effects and the deceleration in import price growth, whereas in the opposite direction would continue to act this year's unfavourable weather conditions and the increase in some commodity prices, mainly via the effects exerted on food and energy price dynamics. The previously identified risk and uncertainty factors remained relevant.

Based on the data and assessments available at that time, as well as in light of the elevated uncertainty, the NBR Board decided in the meeting of 4 October 2024 to keep the monetary policy rate at 6.50 percent per annum. Moreover, it decided to leave unchanged the lending (Lombard) facility rate at 7.50 percent per annum and the deposit facility rate at 5.50 percent per annum. Furthermore, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.

Inflation outlook

Global economic activity continues to recover from multiple supply-side shocks in recent years, yet the growth rate stabilised at a rather low level. Nevertheless, developments by region were mixed – for instance, while domestic demand remained robust in the US, advanced economies in Europe face a slowdown in industrial output and high indebtedness. Additionally, economic growth is still relatively unevenly distributed across sectors, being affected in a differentiated manner by the tight financial conditions and significant geopolitical uncertainties. At the same time, global inflation stayed on a downward trend, benefiting from well-anchored expectations and adequate monetary policy calibration. In Europe, however, the convergence of inflation towards the target will be gradual, amid persistent supply chain disruptions and geopolitical tensions, such as the conflicts in Ukraine and the Middle East. Moreover, this convergence will be differentiated: while goods prices largely stabilised, services inflation is still elevated, especially in sectors facing labour shortages and, against this background, high wage pressures.

Inflation forecast



Source: NIS, NBR projection

In Central and East European economies, Romania included, inflation dynamics were influenced by both global factors and local policies. In particular, Romania is in urgent need of fiscal consolidation to avoid the deepening of macroeconomic imbalances, especially in light of the official excessive deficit procedure. Structural reforms and a credible fiscal adjustment are of the essence to achieve a sustainable budget deficit and improve medium-term growth prospects. This would also minimise the risks of a potential volatility of capital flows in our economy, which could have an adverse effect on price developments as well. For all these reasons, a cautious approach to managing economic policies is critical to ensure sustainable economic recovery and to achieve the inflation target in the medium term.

In the first part of this year, economic activity in Romania slowed down significantly, posting annual dynamics of only 0.9 percent in Q2 (after 0.5 percent in Q1), compared with an average annual growth rate of 2.4 percent in 2023 as a whole. Looking at components, however, this performance was marked by wide divergences. Specifically, the strongly positive contribution to economic growth chiefly from household consumption and, to a lower extent, from gross fixed capital formation was almost fully offset by the unfavourable developments in net exports and the change in inventories. This reflects a very loose income policy on the part of the authorities this year, on the one hand, and a series of persistent structural problems of the Romanian economy, implying short domestic supply versus solvent demand, on the other hand. Hence, during the period under review, the bulk of domestic demand continued to be accommodated by imports; against this background,

the positive output gap as well stayed on the downward trend followed also in 2023 and is seen reaching over the next two quarters similar and even slightly lower values compared to those estimated in the previous *Report*. The baseline scenario was built strictly based on information that was certain by the time of its completion. Under these circumstances, although a fiscal correction from 2025 onwards is envisaged by the authorities as well, the lack of concrete details on the package of measures to be applied prevented the introduction of this assumption into the baseline scenario. Thus, in the absence of a countercyclical fiscal policy over the next two years, the output gap will remain in positive territory.

In the first two quarters of 2024, gross fixed capital formation reported a significant slowdown from 2023 levels. Behind this deceleration stood primarily the weaker-than-expected developments in construction, as well as in industry and services to businesses, which make up large shares of gross value added in the economy. Another contributing factor to the path of gross fixed capital formation was that EU funds under the 2014-2020 financial framework were nearly used up, with an absorption rate of more than 90 percent already reached in mid-2024. This also reflected in the dynamics of public investment, mainly funded from own and borrowed sources (including NRRP loans) and, to a much lower extent, from EU funds in the form of grants, which have a neutral impact on the budget deficit. Furthermore, even though the Romanian authorities collected approximately EUR 9.4 billion from NRRP funds since the beginning of the programme, their actual use in the financing of investment programmes was rather modest at an estimated 50 percent of the total figure based on budget execution data. By contrast, foreign direct investment (FDI) remained a large funding source, yet its amount, although still substantially higher than in the pre-pandemic period, does not exceed that recorded in the similar year-ago period.

Conversely, private consumption displayed higher-than-expected quarterly and annual growth rates in 2024 H1, being envisaged to become again the main driver of economic growth in the year as a whole. Its marked boost mirrored, subsequent to the signals already visible last year, the further strengthening of households' purchasing power. Behind this stood the ongoing disinflation, the effects generated by a further relatively tight labour market, as well as the substantial contribution from public sector wage policies, from increases in the minimum wage and social transfers (pensions in particular). Even though the anticipated increase in real income will render households' consumption expenditure more flexible, looking ahead, it is essential to rebalance as fast as possible wage growth, which is already extremely strong, with productivity dynamics, as well as the solvent domestic demand with the productive capacity of the economy. Only the compliance with these correlations will allow the gradual return of inflation towards the target over the medium term, but also the preclusion of further external competitiveness losses of the economy.

After the current account deficit-to-GDP ratio narrowed by 2.2 percentage points in 2023 from the year before, statistical data indicate a new widening of the external deficit this year, with a set of less favourable contributions from most sub-components, but especially from the trade balance. Looking at the dynamics, even though recent developments in this indicator may partly be associated with incidental factors – such as,

for instance, this year's more significant rises in households' purchasing power, impacting the volume of imports as well –, quantitative assessments point to the prevalence of structural causes for the external deficit. Noteworthy in this sense are both the worsening of some issues linked to the external competitiveness of Romanian products and the considerably larger payments associated with accommodating the government's financing requirements (e.g., payments related to portfolio investment). All these developments overlap a visible decline in stable external financing sources, particularly non-repayable EU funds. Obviously, the resumption of the current account deficit correction as soon as possible is conditional on a sizeable adjustment of the budget deficit, as well as on a rebound in the EU trading partners' economic activity, yet the progress made so far in both cases is insufficient.

According to the updated baseline scenario, after standing at 4.6 percent in September 2024, the annual CPI inflation rate will follow a mostly downward path, yet the pace of disinflation is expected to slow both in 2024 and especially in 2025 and 2026. In addition, until 2025 Q2, the path of the annual CPI inflation rate will be marked by some two-way swings, mainly driven by base effects. For example, the indicator will see a slight pick-up in the latter part of this year (following base effects from lower fuel prices October through December 2023) and declines early next year, as the VAT and excise duty hikes in January 2024 drop out of the calculation. Starting in 2025 Q3, the inflation rate will run below 4 percent, falling to 3.5 percent in December 2025 and in 2026 Q1 it will re-enter and then remain inside the variation band of the target (3.3 percent in both July and September 2026). For end-2024, the inflation forecast was revised upwards to 4.9 percent, given the more unfavourable developments and prospects for food items, VFE in particular, following adverse weather conditions (protracted drought), also with an impact on processed food items in the adjusted CORE2 index. Moreover, stronger-than-previously-projected pressures stemmed from faster wage dynamics in the economy and, implicitly, higher labour costs, affecting particularly prices of services, a labour-intensive component.

The above-mentioned developments resulted in the upward revision of the annual adjusted CORE2 inflation rate as well, somewhat heftier for December 2024 (5.1 percent from 4.6 percent in the prior forecast) and only moderate over the medium term (3.5 percent in December 2025 versus 3.4 percent previously). However, the adjusted CORE2 index will remain the main driver of the projected decline in the annual headline inflation rate over the next eight quarters. Unlike the CPI index, affected by the influence of exogenous components of the basket, the annual adjusted CORE2 inflation rate will follow a steadily downward path, supported by the correction of inflation expectations and the gradual waning of pressures from import prices. At the same time, as the positive output gap has already almost closed this year, its contribution to the dynamics of core inflation will narrow accordingly. In the opposite direction, wage growth economy-wide will stay high, slowly losing momentum over the projection interval, amid structural weaknesses in the labour market. The breakdown shows that the dynamics are anticipated to accelerate in 2024 versus 2023 for public sector wages and to decelerate slightly for the average net wage in the private sector (albeit at annual rates still above 10 percent this year as well). A relevant indicator of the annual CPI inflation rate is that calculated at constant taxes by removing the increases in excise duties and VAT rate introduced

by the authorities. This would mean considerably lower annual inflation rates, especially for end-2024 (4 percent against 4.9 percent), while in 2025 the indicator would re-enter the variation band of the target at year-end (3.3 percent in December).

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

Since the past *Inflation Report*, a number of risk factors from those identified have materialised, in particular those associated with a relative heightening of geopolitical tensions in the Middle East. On the domestic front, the rising value (and significantly higher than the initial target) of this year's budget deficit was confirmed following the September budget revision, while the influence of weather conditions on agricultural crops proved more unfavourable. Even in these circumstances, the assessed balance of risks suggests possible upside deviations of inflation from its path in the baseline scenario, particularly should new adverse supply-side shocks materialise.

The features of the labour market in Romania, with a still relatively high tightness, continue to pose a major risk to the inflation projection. The swift wage growth, fuelled by the successive increases in the minimum wage and by the significant pay rises in the public sector, entails the risk of persistent inflationary pressures, passed through via demonstration effects to the private sector as well and possibly compounded additionally in the sectors facing a more pronounced labour shortage. A detailed analysis in the *Report* indicates that, in the future, private non-financial corporations might absorb into profit margins part of the pay rises granted to their employees, *inter alia* amid the envisaged contraction of excess aggregate demand in the economy. Nevertheless, a correction of the extremely high wage dynamics in the public sector is absolutely crucial both for carrying out the budget adjustment in the period ahead and for enabling, via the demonstration effect, the realignment of labour cost dynamics to productivity growth.

In this vein, the macroeconomic policy mix should pursue an effective control and a rebalancing among the various components of domestic demand, currently dominated by the buoyancy of consumer demand. Therefore, it is of the essence particularly to start correcting the excessive budget deficit and hence to calibrate a countercyclical fiscal policy, but which should include *inter alia* the implementation of structural reforms, especially those aimed at supporting government revenue growth and, at the same time, ensuring a cut in public expenditures. By the time the baseline scenario of the projection was completed, the authorities had not explicitly announced either the dosage or the nature of the fiscal measures that could be adopted as of 2025, although a government-approved version of the *National Medium-Term Fiscal-Structural Plan* indicated a budget adjustment path over a seven-year period as highly likely. Achieving the correction over a long time horizon implies, *ceteris paribus*, that the average annual fiscal consolidation effort would diminish accordingly, whereas numerous international bodies recommend that the national fiscal space be swiftly restored to safeguard long-term stability in a complex global economic environment. Looking ahead, in the case of Romania, the budget

deficit adjustment is strongly called for so that Romania should comply with its commitments to the European Commission and ensure a balanced mix between the fiscal policy stance and the monetary policy stance over the medium term.

Risks stemming from external developments are a major source of uncertainty when assessing the inflation outlook and the NBR closely monitors their impact on the economy. Geopolitical tensions, in particular the prospects for a potential escalation of tensions in the Middle East, but also the lingering war in Ukraine, may add to the volatility of energy prices, impacting the inflation rate directly through higher production and transport costs. In addition, climate change amplifies the frequency of extreme weather events, which puts lasting strains on critical markets, such as the energy and food markets. Moreover, via their effects on supply chains, both geopolitical tensions and extreme weather events can heighten inflation volatility in the EU and, implicitly, in Romania as well, calling for a prudent approach *inter alia* to economic policy formulation.

Monetary policy decision

Given the prospects for the annual inflation rate to pick up slightly in the closing months of 2024 and to stay above the variation band of the target and at higher values than previously anticipated until end-2025, and considering the associated risks and uncertainties, the NBR Board decided in its meeting of 8 November 2024 to keep the monetary policy rate at 6.50 percent. Moreover, it decided to leave unchanged the lending (Lombard) facility rate at 7.50 percent and the deposit facility rate at 5.50 percent. Furthermore, the NBR Board decided to keep the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions.