INFLATION REPORT

November 2020

Summary

Developments in inflation and its determinants

In 2020 Q3, the annual CPI inflation rate remained on the downward trend seen since the beginning of this year, coming close to the mid-point of the flat target in September, i.e. 2.45 percent, compared to 2.58 percent in June. This slightly disinflationary path reflected primarily the effects of the bumper fruit and vegetable crops this year, both domestically and across the EU. Meanwhile, the simultaneous occurrence of demand and supply shocks, with the latter being associated with the measures adopted to keep the pandemic under control, lent stability to the annual adjusted CORE2 inflation rate, which continued to hover around 3.7 percent. Given the lower-than-expected trend of volatile prices, in September the annual CPI dynamics stood 0.3 percentage points below the latest macroeconomic projection (the August 2020 *Inflation Report*). At the same time, during Q3, the average annual HICP inflation rate decreased marginally compared to the EU average, falling to 2.8 percent.

The annual adjusted CORE2 inflation rate continued to post high dynamics in July-September, reporting a level similar to that seen in June. Thus, the significant recovery of consumer demand during Q3 may have eased the disinflationary pressures, after the opening of the output gap to significant negative values in the previous quarter. This evolution was also supported by the government financial aid for employment being further granted beyond 1 June, which continued to act as a buffer to consumer demand. Moreover, the inflationary pressures posed by the health crisis management (for instance, the costs of sanitary materials, disinfectants, etc.), remain further relevant, affecting especially those areas where direct human contact prevails (accommodation and food service activities, cultural and leisure activities, passenger transport). Looking ahead, uncertainties surround the net impact of demand-side and supply-side shocks on the dynamics of adjusted CORE2 inflation, whereas, in the short run, the September reading is in line with the projection in the previous *Inflation Report*.

Given the significant contraction in economic activity in Q2, as well as companies' propensity to maintain labour surplus in periods affected by negative shocks (a prevalent behaviour in the previous crisis too)[1], the annual growth rate of unit labour costs economy-wide took a leap in 2020 Q2 (to almost 11 percent). A slightly slower acceleration (to around 8 percent) is also noticeable even after removing from

[1] Although it may be sub-optimal in the first phase, the strategy may turn out to be beneficial in the longer run, by subsequently avoiding recruiting and training costs and guaranteeing existing jobs.

the calculation the furloughed employees whose benefits were paid by the government (an adjustment that is meant to capture more accurately the pressure from labour costs on companies).

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

In its meeting of 5 August 2020, the NBR Board decided on another prudent cut in the monetary policy rate by 0.25 percentage points to 1.50 percent; moreover, the deposit facility rate and the lending (Lombard) facility rate were lowered to 1.00 percent and 2.00 percent respectively. Furthermore, the NBR Board decided to maintain the existing levels of minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions. In addition, given the liquidity shortfall on the money market, it was decided that the NBR further conduct repo transactions and continue to purchase leu-denominated government securities on the secondary market, while preserving financial market stability. Considering the transmission lags of the policy rate impulses, such a calibration of the monetary policy conduct was meant to provide an underpinning to the recovery of economic activity over the projection horizon, with a view to bringing and strengthening over the medium term the annual inflation rate in line with the inflation target, while safeguarding financial stability.

The decisions were taken in a context in which incoming statistical data after the May monetary policy meeting showed, in line with expectations, a severe economic impact of the coronavirus pandemic, with a peak in April, starting however to fade in the following month, amid the gradual lifting of physical mobility restrictions, as well as the government's support programmes and the NBR's monetary policy measures.

Thus, the annual inflation rate followed a downward path in Q2 as well, even steeper than anticipated, falling to 2.58 percent in June versus 3.05 percent in March, as a result of the markedly larger decline in fuel prices in annual terms. The annual adjusted CORE2 inflation rate saw only a minor deceleration to 3.7 percent in June from 3.86 percent in March, further reflecting pre-pandemic underlying inflationary pressures, to which added the influences of changes in the consumption structure brought about by the pandemic, as well as the impact of cost increases associated with bottlenecks in production and supply chains and with the measures to prevent the coronavirus spread.

Excess aggregate demand remained significant in 2020 Q1, witnessing only a modest contraction, as quarterly GDP dynamics ran further in positive territory, although in annual terms economic growth decelerated considerably to 2.4 percent from 4.3 percent in the previous quarter. At the same time, the widening of the trade deficit re-accelerated markedly in this period, while the current account deficit coverage by foreign direct investment and capital transfers deteriorated further. However, the cyclical position of the economy shifted abruptly in Q2, in line with expectations, with incoming data and assessments pointing to a severe contraction of the economy for the period overall, but also to a partial recovery in the following quarter, as high-frequency indicators pointed to a massive economic downturn in

April, which started to be reversed in May. The evolution implied the sudden opening of a large negative output gap in Q2, as well as its near-halving in the following three months, relatively in line with the previous forecast.

Financial market conditions continued to improve as a result of the monetary policy rate cut in May, as well as amid the significant liquidity injected by the NBR through bilateral repo operations and through purchases of leu-denominated government securities on the secondary market. Thus, key interbank money market rates consolidated their decline and afterwards their lower levels, with longer-term government securities yields featuring a relatively similar evolution. In turn, the average lending rate on new business followed a clear-cut downtrend in 2020 Q2, while the average remuneration of new time deposits fell only slightly, with the related spread narrowing considerably.

The exchange rate of the leu against the euro was, nevertheless, further quasi-stable, with the domestic currency tending even to appreciate slightly versus the euro in July and more visibly against the US dollar. The deterioration of the fiscal position and its outlook alongside the external imbalance continued, however, to put pressure on the sovereign risk premium, with possible consequences on the volatility of the exchange rate of the leu and implicitly on inflation and confidence in the domestic currency, and ultimately on the financing costs and the pace of economic recovery following the downturn.

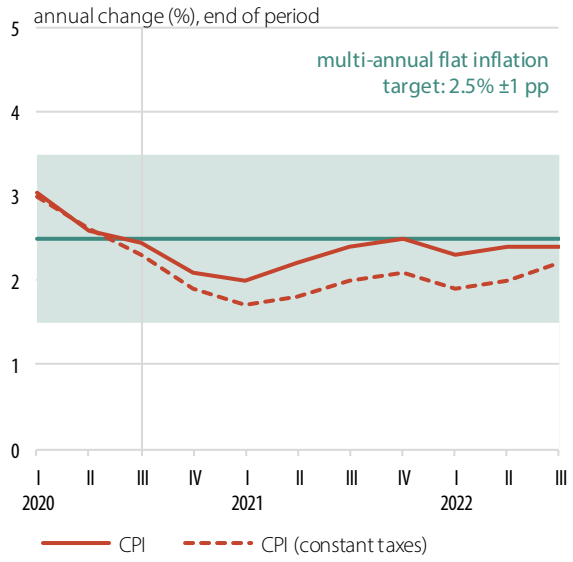
Against this background, the new medium-term forecast reconfirmed the inflation outlook highlighted in the previous projection, with a slightly downward revision over the short-term horizon. Specifically, the annual inflation rate was anticipated to go up again slightly in July and remain relatively flat until December 2020, before declining and converging towards the mid-point of the target over the policy-relevant horizon, amid the lagged action of disinflationary effects from the aggregate demand deficit; this was expected to open up markedly in 2020 Q2, but then to narrow gradually and somewhat faster than in the previous forecast.

The uncertainties surrounding the new macroeconomic projections continued to be extremely elevated, triggering two-way risks to the inflation outlook. Their major source remained the coronavirus pandemic – which resurged in July – and the associated containment measures that weighed on the speed and path of economic recovery. Heightened uncertainties and risks stemmed from the fiscal and income policy stance, given the possibly larger widening of the budget deficit in 2020, as well as the prospects of a fiscal consolidation to be initiated in the near run, likely to be however partly counterbalanced in terms of economic impact by the funds allocated to Romania via the EU's recently-agreed economic recovery package and multiannual budget. Significant uncertainties and mixed risks also stemmed from the external environment, given the somewhat more encouraging signals on the developments in Europe's economies, but also amid the recent resurgence of the pandemic.

Inflation outlook

The current baseline scenario continues to be fraught with multiple interlinked sources of risks and especially of uncertainty, stemming primarily from public health developments. After the unprecedented second-quarter contraction, as the authorities' severe measures were lifted, economic activity gradually returned to normal levels, also supported by the diminishing volatility on international financial markets. At the same time, global value chains' activity gradually regained momentum, resulting in a fading-out of supply-side shocks prevalent in the first phase of the medical crisis, and, hence, paving the way for a gradual normalisation of financial and trade ties among economies. Nevertheless, the recent resurgence of the pandemic crisis, especially in Europe, prompted a new peak in uncertainty about the near- and medium-term outlook for economic activity. Against this backdrop, the authorities had to introduce new restrictions on social distancing, with the very likely consequence of reversing, in the immediate period ahead, the robust recovery trend posted by most economies in 2020 Q3. Given the resurgence of infection cases, many questions arise about the resilience of many of these economies, especially those where the room for manoeuvre of macroeconomic policies was, to a great extent, eroded by efforts to counter the effects of the first pandemic wave. On this background, until the medical and economic situation returns to normalcy, downside risks to economic activity are expected to prevail further. Specifically, future – even potentially significant – reconfigurations of the baseline scenario coordinates are likely, insofar as the current sources of uncertainty are progressively clarified.

Inflation forecast



Source: NIS, NBR projection

The updated baseline scenario is built on the assumption that the domestic epidemic situation is kept under control by applying quasi-generalised restrictions nationwide. Nonetheless, these measures are expected to be substantially less severe than those taken in the first wave of the pandemic – otherwise, the coordinates of the baseline scenario could be completely different. For 2020 Q4, given the current medical context, the economic recovery that started in the previous quarter is envisaged to come to a halt. Specifically, the average annual GDP growth in 2020 is foreseen to post a significant negative value, albeit smaller than the forecast in the previous *Inflation Report*. More favourable influences on GDP dynamics come from the significantly swifter recovery of the economy in 2020 Q3. Opposite influences emerge from the adverse supply-side shock that depressed this year's grain crops. Similarly to the previous projection, the pandemic-related aggregate income loss is further assessed to be recovered slowly, within at least a year.

The breakdown shows that, for 2020, the average annual GDP dynamics are projected to mirror the significant negative contribution from final consumption, to which adds

the negative contribution of net exports. As for consumption, despite the marked upswing in demand shortly after the March-May lockdown was eased, the key factor for its near-term outlook remains the contraction of households' disposable income, as well as their extremely cautious behaviour typical of turmoil episodes. On the external front, these disruptive shocks led to a more than 25 percent fall in Romania's exports in 2020 Q2, and the ground appears set to be regained gradually and strictly conditional on the dynamics of external demand. Against the background of shrinking global trade, a more significant correction of the current account deficit in Romania is, however, dampened by the prospects that appear to put this year's general government deficit projection significantly above the prudential limits defined at European level; the chief driver stems from the increase in the volume of public spending meant to mitigate the effects of the health crisis, as well as in that caused by the action of automatic fiscal stabilisers. Consequently, the current account deficit is expected to persist for the third successive year at values above 4 percent of GDP.

Gross fixed capital formation stood out as the notable exception from the adverse developments associated with the pandemic, as it avoided a contraction during 2020 Q2, surprisingly posting even a slightly positive annual growth rate. Looking ahead, this component may see a deceleration as well, especially given the recent heightening of uncertainty about the duration and outcome of the medical crisis. At the same time though, the string of government programmes aimed to support corporate financing, the sizeable public investment spending, as well as the prospects of a large amount of European funds for economic recovery becoming available as of next year, are likely to preserve the favourable investment path over the medium term as well.

The downturn in economic activity in 2020 is expected to be mainly reflected in the output gap variation, yet, assuming a setback in the economic recovery pace during the fourth quarter, it becomes increasingly likely that potential GDP dynamics will also be affected in a persistent manner. The output gap opened widely at negative values in 2020 Q2 and is expected to fully close at a slow pace, over a period of probably more than eight quarters. The path of this indicator will experience some short-term swings associated with the much stronger-than-expected recovery of economic activity in the third quarter, on the one hand, and the new peak of SARS-CoV-2 infections in the final months of this year, on the other hand. The time profile of the output gap is strictly conditional on the implementation of the authorities' package of stimulative measures, with the monetary and fiscal policy stance having a favourable, stronger impact in the course of this year.

Since the release of the August 2020 *Inflation Report*, more significant disinflationary pressures have materialised, induced mostly by exogenous components of the consumer basket, namely volatile food prices and fuel prices. Hence, the annual CPI inflation rate is anticipated to fall to 2.1 percent at the end of this year, i.e. a significant 0.6 percentage point revision compared with the previous forecast. At the same time, under the impulse of the aggregate demand deficit in the economy and the gradual weakening of labour market resilience, sharper corrections will be reflected in the dynamics of the annual core inflation rate as well, which is seen reaching 2 percent

at the projection horizon (2022 Q3). For the end of next year, the current baseline scenario reconfirms the previously projected value for the annual CPI inflation rate (2.5 percent), whereas the annual core inflation rate forecast was revised slightly downwards (by 0.1 percentage points to 2.1 percent).

As a conditioning input for the macroeconomic projection, the monetary policy conduct is configured so as to ensure price stability and macroeconomic stability, as well as the smooth functioning of the banking system and financial markets supportive of households and local companies.

Even with the partial confirmation of the risk scenario in the previous *Inflation Report* as regards the evolution of the public health crisis, the main restraint on the baseline scenario remains the medical one. It refers to the dynamics of virus spread, on the one hand, and to the time when a vaccine will become broadly available, on the other hand. The particular nature of this crisis makes it difficult to even formulate risk scenarios on the biunivocal relationship between medical and economic developments. Thus, it is difficult to assess the duration and intensity of the medical crisis, the calibration of the authorities' response measures or the degree of their synchronisation and, ultimately, the level of asymmetry of recovery in various economies. Some countries are very likely to continue to recover the crisis-related losses in a linear or possibly even accelerated manner, while others may face a number of difficulties; in the latter case, a further escalation of medical developments might boost both the pre-existing vulnerabilities and imbalances, as well as those accumulated after the first pandemic wave. For this reason, the sources of risk from the domestic and external environment appear to be relatively plausible at this juncture, and the balance of risks to the annual inflation rate projection is seen to be tilted to the upside as against the values forecasted in the baseline scenario, especially over the medium term.

On the domestic front, fiscal and income policies continue to be relevant sources of uncertainty. Specific risks stem further from a possibly larger volume of budget expenditures, directly correlated with how long the public health crisis is going to last. Any tightening by the authorities of the package of administrative measures to improve the management of healthcare risks would entail additional costs – with a view to supporting the economic agents directly hit by social distancing measures –, as well as possible losses of budget revenues, given the broader contraction in economic activity. In the particular case of Romania, the medium-term impact of such measures, via the increase in public expenditures, and, hence, in the budget deficit, would be opposite to that implied by the need to continue the fiscal adjustment as envisaged by the initial scheduling of the excessive deficit procedure.

Given also the prospective evolution of the current account deficit in the baseline scenario, the absence of a fiscal correction or its late onset could imply further vulnerabilities associated with the persistence of twin deficits. This carries the potential to weaken the resilience of Romania's economy over the medium term in the event of adverse shocks and, in the near run, it could impede the financing of these deficits in adequate volumes and at reasonable costs.

One of the sources of uncertainty that is yet to be clarified at empirical level relates to the potential longer-term prevalence of adverse supply-side shocks, associated with the pandemic crisis, with an impact mostly on the adjusted CORE2 index. This is particularly relevant, all the more so as the baseline scenario foresees a new peak of the public health crisis in the run-up to the end of the year. The slower fading of these shocks would lead to additional inflationary pressures that would have an immediate impact on the prices of essential goods and services and, over the medium term, as the health crisis is resolved, could be visible in most sectors hit by closure/reduction of activity.

At the same time, the net impact on the annual CPI inflation rate from other types of risk factors is marked by considerable uncertainty: electricity prices could further go up following structural changes amid market liberalisation; the expansion of African swine fever could bring about higher rises in the price of pork; adverse weather conditions could affect the harvest of farm produce both domestically and internationally, and hence the prices thereof; and a slowdown in economic recovery amid the resurgence of the pandemic crisis could keep fuel prices at considerably lower levels than those in the baseline scenario.

Monetary policy decision

In view of the characteristics of the new medium-term inflation forecast and the elevated uncertainty and risks triggered by the coronavirus pandemic, but especially by the outlook of the fiscal and income policy stance, in the absence of the draft budget for 2021 and in the electoral context, the NBR Board decided in its meeting of 12 November 2020 to keep the monetary policy rate at 1.50 percent per annum. Moreover, it decided to leave unchanged the deposit facility rate at 1.00 percent and the lending (Lombard) facility rate at 2.00 percent. The NBR Board also decided to maintain the minimum reserve requirement ratio on credit institutions' leu-denominated liabilities. Given the developments in foreign currency lending and the adequate level of forex reserves, the NBR Board decided to cut the minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions to 5 percent from 6 percent starting with the 24 November – 23 December 2020 maintenance period. The measure also aimed to continue the harmonisation of the minimum reserve requirements mechanism with the relevant standards and practices of the European Central Bank and the major central banks across the European Union.