INFLATION REPORT

May 2021

Summary

Developments in inflation and its determinants

The annual CPI inflation rate increased considerably in 2021 Q1, i.e. up 0.99 percentage points to 3.05 percent, nearing the upper bound of the variation band of the target. The hike was ascribed to the energy component of the consumer basket, amid the liberalisation of the electricity market for households as of 1 January 2021 and the steeper upward path of crude oil prices. Conversely, the annual adjusted CORE2 inflation rate declined further in 2021 Q1, down 0.4 percentage points to 2.8 percent from December 2020 to March 2021. Compared to the previous *Inflation Report*, the annual CPI inflation rate in March stood 0.11 percentage points above the projected level, whereas the adjusted CORE2 inflation rate confirmed the forecast. The average annual CPI inflation rate stabilised at around 2.6 percent during Q1, whereas the average annual inflation rate calculated based on the Harmonised Index of Consumer Prices (HICP) dropped 0.2 percentage points versus December 2020 to 2.1 percent in March. Nevertheless, Romania further ranks among the EU Member States with the highest average HICP inflation rate.

The annual adjusted CORE2 inflation rate continued to decrease at a relatively swift pace in the first three months of 2021, more than half of this decline being attributed to a statistical effect on the food component. Looking at the fundamentals, the aggregate demand deficit in the economy and the more moderate annual pace of depreciation of the domestic currency against the euro further exerted disinflationary influences, while the build-up of cost pressures persisted. A look at the breakdown shows that the components of the adjusted CORE2 index recorded mixed developments. Specifically, market services, which involve longer physical interaction, have remained the most affected by mobility restrictions, seeing stronger decelerations in 2021 Q1. As for the food component, the unfavourable evolution of demand from the hospitality industry and, to a smaller extent, from the retail segment also fuelled a disinflationary trend, albeit more moderate, across this group. The redistribution of a part of household income (that could not be spent for services) to the acquisition of durables and semi-durables contributed to the robust dynamics of sales, which resulted in slightly stronger inflationary pressures on the non-food segment.

In the latter half of 2020, the annual growth rate of unit labour costs slowed down, remaining however robust (approximately 10 percent in 2020 H2 from roughly 12 percent in Q2), with values above the economy-wide average in the business sectors that require human interaction. The indicator adjusted for the impact of firms' recourse to government support measures recorded lower dynamics (of about

8 percent). Looking at the industrial sector, the annual growth rate of unit wage costs neared 3 percent in the period from August 2020 to February 2021, but the analysis by sub-sector shows further mixed developments. Some areas (metallurgy, fabricated metal products) continued to record productivity gains, while the automotive industry and the related sub-sectors reported worsening dynamics of unit wage costs in the first months of 2021. As for the sub-sectors with relevant shares in the CPI basket, the annual growth rates of ULC remained high at the beginning of 2021, going above 15 percent in the light industry and the pharmaceutical sub-sector and posting somewhat more moderate values (about 6 percent) in the food and furniture industries.

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

In the recent period, the monetary policy stance was calibrated with a view to preserving price stability over the medium term in line with the 2.5 percent ±1 percentage point flat inflation target, in a manner supportive of the recovery of economic activity in the context of fiscal consolidation, while safeguarding financial stability.

In its meeting of 15 March 2021, the NBR Board decided to keep unchanged the monetary policy rate at 1.25 percent per annum, the deposit facility rate at 0.75 percent per annum and the lending (Lombard) facility rate at 1.75 percent per annum. Moreover, the minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions were maintained at 8 percent and 5 percent respectively.

The decisions were taken in an environment in which the annual inflation rate had risen to 2.99 percent in January 2021, from 2.06 percent in December 2020, and to 3.16 percent in February, well above the previously-expected level, under the transitory impact of the liberalisation of the electricity market for household consumers and following the rise in fuel prices driven by higher oil prices. Conversely, the annual adjusted CORE2 inflation rate continued to decrease slowly over this period, falling to 3.1 percent in January and staying at this level in February, from 3.3 percent in December 2020. Behind this stood mainly the disinflationary base effects associated with the developments in some processed food prices, to which added the modest influences of the aggregate demand deficit. Moreover, the annual adjusted CORE2 inflation rate in February confirmed the level in the previous projection.

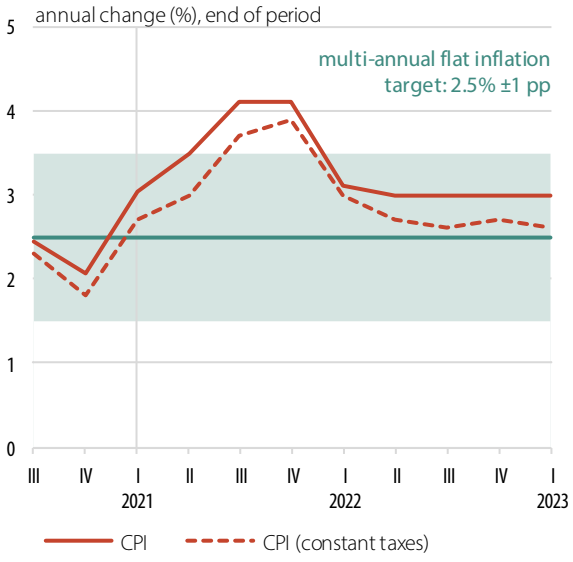
The new medium-term forecast pointed to a change in the pattern of future inflation, as its updated path was revised significantly upwards in the short run and to a smaller extent over the medium term. Specifically, the annual CPI inflation rate was expected to pick up gradually during 2021, until nearing the upper bound of the variation band of the target, under the impact of supply-side shocks. Further on, after a sizeable downward correction at the beginning of next year, it was anticipated to climb again and remain slightly above the mid-point of the target, amid the earlier reopening of the positive output gap and its subsequent slow widening.

High uncertainties and risks to the new outlook stemmed, however, from the evolution of the pandemic and of the associated restrictive measures – amid the spread of the third pandemic wave. Other major sources of uncertainties and risks referred to the fiscal policy stance, in the context of the budget consolidation presumed to be carried out gradually over the medium term, to the synchronised uptrends in many commodity prices, as well as to the recent heightening of international financial market volatility, accompanied by a broad-based increase in government bond yields.

Inflation outlook

The current baseline scenario is further fraught with multiple interlinked sources of risks and especially of uncertainty, stemming primarily from public health developments. The COVID-19 pandemic produced the strongest effects during 2020 Q2. Following the gradual normalisation of economic activity in 2020 Q3, the medical situation worsened again last autumn and winter, which called for the reintroduction of some more targeted mobility restrictions. Meanwhile, international financial market volatility subsided, along with local and global production and distribution chains resuming operation under almost normal conditions. In this context, economic activity in both Romania and several other European countries proved to be more resilient than expected in 2020 Q4, in spite of further visible differences in the economic performance across sectors. This episode confirmed the presence of non-linearities in the relationship between the stringency of mobility restrictions and the dynamics of economic activity, accounted for by a more careful tailoring of social distancing measures by the authorities and an increasingly efficient adaptation of economic agents to the epidemiologic context.

Inflation forecast



Source: NIS, NBR projection

Against this backdrop, the granular data on the economic parameters in 2021 Q1 seem to indicate a further robust domestic economy, the start of the third pandemic wave notwithstanding. The particular features of the medical situation, namely the emergence of new viral mutations, on the one hand, and the progress in the vaccination campaign, on the other, make it difficult to foresee how persistent social distancing restrictions will be over time. For this reason, the downside risks to the economic activity prospects in the baseline scenario are expected to prevail further, especially in the short run, until the medical situation returns to normality.

According to the baseline scenario, the public health crisis is envisaged to start loosening its grip in 2021 Q2 and fade away at a faster pace during Q3, with a significant contribution anticipated to come from reaching a critical vaccination threshold at national level during this summer. Against this background, in 2021 Q1, GDP is foreseen to remain close to the (high) level recorded at end-2020. The economic

growth rate is expected to gain moderate momentum in Q2 and see an acceleration no sooner than the second part of the year (Q3 and Q4). In 2021, the annual GDP growth rate is forecasted at a significant positive level, with the previous year's carry-over effects acting as a notable stimulus. Favourable influences are also linked to the likely transition to a normal year in terms of weather conditions, as well as to the incorporation, for the first time, into the baseline scenario of an assumption of committing EU funds under the Next Generation EU programme. The premises underlying the incorporation of this assumption and the expected favourable impact refer, on the one hand, to the sizeable volume of funds allocated to Romania (of which grants under the Recovery and Resilience Mechanism in amount of 6.4 percent of 2019 GDP, cumulated 2021 through 2026) and, on the other, to the European Commission's firm intention to start allocating this year a pre-financing of up to 13 percent of the total volume of the available funds.

The third pandemic wave, as well as the rollout of the vaccination campaign over several quarters caused households to show additional caution in their consumption behaviour in early 2021. At the same time, the still high uncertainty about the length and a possible future resurgence of the medical crisis carries also the potential to hamper a faster increase in private investment. This could be, however, offset by the set of government programmes aimed to smooth access to corporate financing, the announcement of a significant volume of public investment expenditure, as well as by the expected initiative to commit EU funds under the Next Generation EU programme. These are seen as additional sources or, as the case may be, funds which would replace the investment expenditure already planned by the authorities. Under the circumstances, investment is further likely to stay on the favourable path (observed ever since the previous year) in the medium term, which would also implicitly translate into a significant contribution of gross fixed capital formation to the recovery of the economy's growth potential.

After having resumed at a fast pace the recovery of losses induced by the first pandemic wave, Romania's exports are expected to have recorded a deceleration at the onset of this year, in light of developments in external demand. In turn, imports of goods and services are seen to post a slower growth rate, in conjunction with the developments in domestic demand components and the slight loss of momentum of exports. Under the circumstances, the current account deficit in 2021 could remain close to the 2020 level; although its evolution is going to benefit from the start of the fiscal correction ahead, the foreign partners' economic recovery pace remains of the essence.

Similarly to the assessment included in the previous *Inflation Report*, GDP could possibly return to the level seen in 2019 Q4 already in the course of 2021. In addition, a good absorption of EU funds allocated through both the Next Generation EU programme and the new 2021-2027 Multiannual Financial Framework is likely to make a notable contribution to the recovery of the Romanian economy, which could thus well converge, by the end of the NGEU budgeting period (2026), towards a GDP level similar to that expected to prevail at this horizon in the projections completed prior to the pandemic outbreak. The cyclical component of economic activity saw a notable correction of its negative value ever since the second part of the previous

year, with a shift to neutral and, subsequently, positive values being expected to occur in the second part of 2021. However, the anticipated investment momentum, through its significant contribution to potential GDP dynamics, is expected to contain, over the coming years, the speed of output gap widening, in spite of a further fast-paced economic recovery. Together, these assumptions seem to indicate a slight acceleration, in the medium run, of the Romanian economy's real convergence, while keeping under control consumer price dynamics.

Since the release of the *Inflation Report* in March 2021, some significant inflationary pressures have materialised, induced mostly by components of the consumer basket, the prices of which are beyond the scope of monetary policy, especially fuel prices, but also the other items of the energy price component, i.e. electricity and natural gas prices. Conversely, the annual adjusted CORE2 inflation rate has seen relatively minor revisions, being forecasted to reach 2.8 percent in December 2021 and 3 percent in December 2022. Thus, the annual CPI inflation rate is expected to enter a steep upward path during the coming months and reach 4.1 percent in December. The mainly temporary nature of the shocks anticipated for this year will then imply some favourable base effects, with the annual CPI inflation rate projected to go down to 3 percent at end-2022. Moreover, the correction from slightly above 4 percent in 2021 to levels comfortably staying in the variation band of the target, i.e. close to 3 percent, is expected to take place as soon as 2022 Q1. Compared to the March 2021 *Inflation Report*, the revisions of the annual CPI inflation rate are significant for end-2021, i.e. +0.7 percentage points, amounting to 0.2 percentage points for December 2022 (mainly owing to a higher contribution from the adjusted CORE2 index).

In the particular context of the health crisis persisting, the monetary policy stance of the NBR has been tailored to preserve price stability over the medium term in line with the 2.5 percent ±1 percentage point flat target, in a manner supportive of the recovery of economic activity in the context of fiscal consolidation, while safeguarding financial stability.

After the release of the previous *Report*, the third pandemic wave intensified. Under the circumstances, it became obvious that up to date, in Europe, the epidemic spread has outpaced vaccination campaigns. However, the authorities' commitment to step up the vaccination process, the prospects of implementing comprehensive programmes to support the European economies, further extremely stimulative fiscal and monetary policy stances on the continent, as well as the spillover effects from the large fiscal stimulus implemented by the US Administration pave the way for a faster economic recovery in the EU in the second half of 2021, which may be reflected in strong dynamics of external prices. At the same time, the brighter outlook for an economic upturn has also caused international commodity prices to pick up in tandem, which may additionally drive inflation up, yet with a still uncertain magnitude over the short and especially medium term. For this reason, in the current round, the sources of risk from the domestic and external environment continue to be substantial; based on the presently available information, the balance of risks to the annual inflation rate projection is assessed to be on the upside as against the values forecasted in the baseline scenario, especially in the short run.

On the domestic front, one of the relevant risks refers to the future evolution of some energy prices. Thus, the recent developments in international crude oil prices have passed through, as usual, into higher import prices of natural gas on the domestic market. This trend could become more pronounced because of the declining gas reserves, given that a number of European countries faced extremely low temperatures last winter. These pressures could translate into higher natural gas prices on the domestic market as, in mid-2021, the contracts between natural gas suppliers and end-users are expected to be renewed. Under the circumstances, inflationary pressures of a higher magnitude than those in the baseline scenario are not ruled out for the second part of the current year.

Looking ahead, the recovery of EU economies could significantly benefit from the funds allocated through the Next Generation EU programme, thanks to the unprecedented joint effort by EU economies. In the case of Romania, the fruition of this programme is all the more relevant, as, on the fiscal front, the coming years are seen to be marked by the budget consolidation effort, and implicitly by a lower contribution from this macroeconomic policy mix component to giving a boost to the economy. On the other hand, the absorption of the largest possible amount of mutual funds under such programmes could give the necessary impetus to a rapid recovery of domestic economic activity. Given that the National Recovery and Resilience Plan for Romania is to be officially submitted for analysis to the European Commission by the end of May 2021, the current baseline scenario was built based on the conservative assumption of a moderate fund absorption when measured against the allocations benefiting Romania. From this perspective, the risks induced by this factor to the macroeconomic coordinates, especially in the longer run, seem to be rather favourable. Such an outlook is, however, strictly conditional on the authorities' selection of an investment project portfolio meeting the formal requirements of pan-European authorities: on the one hand, it should be based on the vulnerabilities specific to the Romanian economy, identified in the context of the specific country recommendations of the European Commission, and, on the other hand, it should ensure an optimal dosage between investment projects and structural reforms. Subsequently, also of the essence will be the capacity to ensure an early implementation of these projects likely to create horizontal and vertical economic synergies and thus enable the completion of these investment projects until the horizon of the Next Generation EU programme, more exactly 2026.

Monetary policy decision

Given the characteristics of the new inflation outlook, as well as the related uncertainty and risks, stemming from the coronavirus pandemic, the fiscal policy stance and EU funds absorption, but also from labour market conditions and the uptrend in commodity prices, the NBR Board decided in its meeting on 12 May 2021 to keep the monetary policy rate at 1.25 percent. Moreover, it decided to leave unchanged the deposit facility rate at 0.75 percent and the lending (Lombard) facility rate at 1.75 percent. 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.