INFLATION REPORT

August 2022

Summary

Developments in inflation and its determinants

The annual CPI inflation rate surged in 2022 Q2 to reach 15.05 percent in June, i.e. 4.9 percentage points above the level in March. The advance was largely attributable to the relatively more restrictive conditions of the new energy bills support scheme as well as to persistent or even stronger tensions on commodity markets, affected by the protraction of the Russia-Ukraine war. The broad-based inflationary pressures in the economy reflected also in the swift upward movement of adjusted CORE2 inflation (its annual dynamics came in at 9.8 percent in June versus 7.1 percent in March); this trend was visible in all its main components. Compared to the forecast published in the May 2022 *Inflation Report*, the annual CPI inflation rate recorded at the end of Q2 was 0.9 percentage points higher (15.05 percent compared to 14.2 percent), mainly on account of an annual growth rate above expectations for the energy group. The average annual inflation rate calculated based on the national methodology saw a fast increase (2.8 percentage points) in Q2 against end-Q1, up to 9.3 percent. At the same time, the average annual inflation rate calculated based on the Harmonised Index of Consumer Prices (HICP) posted a relatively lower advance of 2.3 percentage points to 7.9 percent. At the European level, in the reviewed period, the average annual HICP inflation rate in Romania lagged behind those reported by Czechia, Poland, Latvia, Lithuania and Estonia, closely nearing those in Hungary and Bulgaria.

Against the backdrop of a multitude of adverse supply-side shocks, namely the energy crisis, the supply chain bottlenecks, the effects of the war in Ukraine on agri-food commodity prices, alongside the swifter growth rate of labour costs, as well as of the relatively favourable demand conditions in the first half of the current year, the annual adjusted CORE2 inflation rate continued to rise at a faster pace in the course of 2022 Q2. In the period under analysis, more than three quarters of the advance in core inflation stemmed from the processed food component, given, on the one hand, the less elastic demand for such goods, and, on the other, the sector's high exposure to developments in commodity prices. The still significant differential between the dynamics of producer prices and those of final goods prices, visible in the quasi-majority of adjusted CORE2 inflation sub-components, indicates further price increases in the coming months too. This pass-through is favoured by economic agents in all sectors maintaining their short-term inflation expectations at elevated levels, as well as by only gradually fading pressures from excess aggregate demand seen in early 2022.

The annual dynamics of unit labour costs economy-wide (measure adjusted for the structural break in 2021) accelerated to 5.3 percent in 2022 Q1 (versus 3.9 percent in 2021 Q4, remaining however below the pre-pandemic values), with productivity growth (around 5 percent) only partially covering the increase in compensation of employees (10.5 percent). The annual growth rate of unit wage costs in industry gained momentum in April-May 2022 to almost 14 percent from around 10 percent in 2021 Q4-2022 Q1 due to wage hikes, but also to the dampening effect on output of high commodity and energy prices and bottlenecks in global supply chains.

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

In its meeting of 10 May 2022, the NBR Board decided to raise the monetary policy rate to 3.75 percent per annum from 3 percent and to maintain firm control over money market liquidity. Furthermore, the symmetric corridor of interest rates on standing facilities around the monetary policy rate was kept at ±1 percentage point. The annual inflation rate surged again in March 2022, to 10.15 percent from 8.53 percent in February, mainly on the back of a stronger pick-up in processed food and fuel prices, under the impact of the sharp rise in agri-food commodity and crude oil prices, following Russia's invasion of Ukraine and the imposition of international sanctions. The significant and higher-than-expected increase in the annual CPI inflation rate during Q1 occurred amid a modest contribution from exogenous CPI components, given the capping schemes for households' energy bill. Thus, the slower growth rates of electricity and natural gas prices in Q1 overall largely offset the influences of the strong rises in fuel and VFE prices. In turn, the annual adjusted CORE2 inflation rate followed a notably sharper upward path in 2022 Q1, also compared to forecasts, going up from 4.7 percent in December 2021 to 7.1 percent in March. The evolution of this component continued to reflect the effects of almost across-the-board surges in commodity prices, mainly agri-food prices, and of elevated energy and transport costs, alongside the influences of production chain bottlenecks, compounded domestically by high short-term inflation expectations, the resilience of demand in certain segments, as well as by the significant share of food items and imported goods in the CPI basket. The latest forecast, which was based on the available data and the regulations in force, showed a renewed considerable worsening of the inflation outlook, under the strong impact of global supply-side shocks, compounded and protracted by the war in Ukraine and by the sanctions imposed on Russia.

Uncertainties associated with the inflation outlook stemmed from the presumed impact, but also the duration of energy price capping schemes, extended until March 2023. Notable risks were seen coming from developments in agri-food and energy commodity prices, as well as from the worsening/persistence of bottlenecks in production and supply chains, amid the war in Ukraine and the associated sanctions. Another major source of uncertainties and risks remained the absorption of EU funds, especially those under the Next Generation EU programme, which is conditional on the strict fulfilment of performance criteria. Moreover, the fiscal policy stance was also a source of risks and uncertainties, given the requirement for further fiscal consolidation amid the excessive deficit procedure and the overall tightening trend of financing

conditions, yet in a challenging economic and social environment domestically and globally. Particularly relevant were also the ECB's and the Fed's prospective monetary policy stances, as well as the level and pace of increase of key rates by central banks in Czechia, Poland and Hungary.

Subsequently, the annual inflation rate went up faster than expected in the first two months of 2022 Q2, jumping in April to 13.76 percent from 10.15 percent in March and rising moderately in May to 14.49 percent. Most of the increase came again from exogenous CPI components, especially from the hefty and larger-than-anticipated hikes in electricity and natural gas prices – given the changes made to the price capping schemes in April – and, to a small extent, from the pick-up in fuel prices, following the advance in crude oil prices amid the war in Ukraine and the related sanctions. The annual adjusted CORE2 inflation rate rose more steeply in the first month of Q2, also compared to forecasts (particularly under the influence of new significant increases in processed food prices), with its upward trend however softening afterwards, and reached 9.1 percent in May, from 7.1 percent in March. The evolution of this component continued to reflect the effects of the previously-identified factors. In 2022 Q1, annual GDP dynamics advanced to 6.5 percent from 2.4 percent in 2021 Q4, well above expectations. However, behind the strengthening in GDP growth rate stood mainly the change in inventories, while the contribution of private consumption – coming second in terms of size – owed to some sub-components other than purchases of goods and services, which reported a markedly lower increase in annual terms during this quarter, *inter alia* amid a base effect. A notable contribution was also made by gross fixed capital formation, as a result of the strong re-acceleration against the same year-earlier period of both net investment in equipment (transport equipment included) and new construction works. At the same time, during this quarter, net exports no longer made a negative contribution to annual GDP dynamics, as the increase in the annual change in the export volume of goods and services outpaced that in the import volume. However, the annual increase in the negative trade balance re-accelerated, primarily amid the relatively more unfavourable developments in import prices, while the current account deficit saw a considerably faster deepening trend against the same period of the previous year, *inter alia* as a result of the strong worsening in the dynamics of the primary income balance, on account of outflows of reinvested earnings and distributed dividends.

In the NBR Board meeting of 6 July 2022, the latest assessments showed that the annual inflation rate would stick to an upward path until mid-Q3, under the impact of supply-side shocks, yet at a visibly slower pace, thus climbing moderately above the values forecasted in May over the short time horizon. Behind the worsening of the near-term inflation outlook stood the higher dynamics anticipated for the prices of fuels, natural gas and electricity in the following months – even amid the support schemes in place and some base effects –, as well as for processed food prices. This was mainly ascribable to the stronger advance in crude oil, energy and agri-food commodity prices, induced by the war in Ukraine and the associated sanctions. Additional inflationary effects were also expected from administered prices, *inter alia* as a result of the Romanian National Railway Company raising ticket prices, as well as

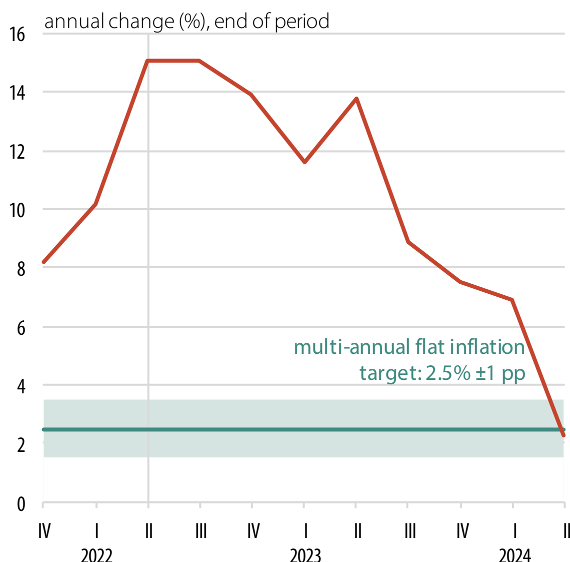
from tobacco product prices, following the increase in the specific excise duty. The previously-identified risk and uncertainty factors remained relevant.

Based on the assessments and data available at that time, as well as in light of the very elevated uncertainty, the NBR Board decided to increase the monetary policy rate to 4.75 percent per annum from 3.75 percent per annum. It also decided to maintain firm control over money market liquidity and the width of the symmetric corridor of interest rates on standing facilities around the monetary policy rate (±1 percentage point). The NBR Board underlined its aim to anchor inflation expectations over the medium term, as well as to foster saving through higher bank rates, so as to bring back the annual inflation rate in line with the 2.5 percent ±1 percentage point flat target on a lasting basis, in a manner conducive to achieving sustainable economic growth.

Inflation outlook

Since the publication of the May 2022 *Inflation Report*, which had already pointed to an unusually high level of uncertainty, associated with economic, social and geopolitical developments, part of the risks identified at that moment have materialised. Thus, global market sentiment worsened further, also amid the unexpected, ongoing and across-the-board inflation spike, which spurred *inter alia* the continuation of the monetary policy normalisation cycle in both emerging and advanced economies. At the same time, economic activity in Europe and worldwide has recorded a slowdown, so far at a gradual pace but with risks of a structural change, while geopolitical tensions related to Russia's invasion of Ukraine have kept rising, affecting particularly the countries located in the immediate proximity of the warfare. Against this background, the projection of key macroeconomic variables was once again revised towards a less favourable outlook, i.e. higher inflation rates and weaker economic activity. Even under these circumstances, multiple sources of uncertainty persist, with the probability of occurrence for each category of the identified risks being difficult to estimate at this time, much less their net outcome, which appears rather to fall within the category of extreme events labelled as "radical uncertainty".

Inflation forecast



Source: NIS, NBR projection

The previous *Report* estimated a relatively small direct economic impact of the armed conflict on our country, justified by Romania's low trade and financial exposures from bilateral relations with Russia and Ukraine, yet risks of more substantial indirect effects were not ruled out but rather considered probable. Subsequently, statistical data surprised on the upside, showing very fast growth of the economy in 2022 Q1. Even if significantly more modest developments in economic activity are expected starting 2022 Q2, the first-quarter GDP advance, although reflecting a large contribution of residual components (without explicit economic content), leads to an

economic growth forecast for this year that will most likely exceed the value projected in May.

Under the current baseline scenario, the strongest economic effects of the war in Ukraine are anticipated to occur this year, yet at a faster-than-previously-foreseen pace, with further prospects of gradually fading in 2023 and 2024. Conversely, the sanctions imposed on Russia and other countries that encourage or support military aggression will remain in place until 2024 at least, with broader consequences for European economies – on an intensity scale – compared to previous baseline scenario assumptions. Against this backdrop, the annual GDP dynamics were revised upwards for 2022 given the unforeseen first-quarter performance and downwards for 2023. In turn, the positive output gap was estimated at higher values in the short term, but it will see thereafter a more significant correction in view of the stronger effects of the war in Ukraine, the ongoing monetary policy normalisation and the probable progress of fiscal consolidation in the medium term. The output gap may fully close by mid next year and then widen in negative territory until the projection horizon, i.e. 2024 Q2.

The global supply/demand imbalance for many commodities, chiefly energy (natural gas, electricity), increased in the past few months, triggering – given their large share in companies' production costs – an erosion effect on economic activity. In conjunction with the disruptions in agri-food commodity markets, quasi-dominated by Russia and Ukraine, as well as with the visibly lower demand of external partners in Europe, a relative stagnation of Romania's economy is foreseeable over the coming quarters. The consequences are reflected in households' consumption, in the form of mounting uncertainty that weighs on consumer decisions, yet the adverse effects also depress private sector investment amid widespread tightening of financing conditions. Nonetheless, the overall set of determinants of households' consumption points to diverging influences on the component's dynamics. On the one hand, the ongoing inflation spike diminishes the purchasing power of their income, while the tighter financial conditions will probably prompt them to delay major purchases, instead fostering savings at a more sustained pace. On the other hand, the authorities' temporary stimulus packages addressing the most financially vulnerable households are likely to ensure the resilience of consumption, in the short term at least.

The imposition of trade and financial sanctions on Russia, together with the persistent bottlenecks in global supply chains will probably put a damper on the growth rate of both international trade and Romania's imports this year. Conversely, via adverse price effects – following the protracted energy and commodity crisis – and volume effects, given the flagging foreign demand, the trade deficit is seen widening further in terms of value this year as well. Therefore, in 2022, the current account deficit-to-GDP ratio could exceed last year's reading of 7 percent. Over the medium term, a resumption of the external deficit correction is conditional, on the one hand, on the fading away of bottlenecks in global value chains, aggravated by the warfare in Ukraine, and, on the other hand, on the probable progress of fiscal consolidation, the pace of economic recovery in Romania's trading partners, and on addressing as fast as possible the persistent structural issues of the domestic economy.

A possibly more sustained resumption of economic activity in Romania is postponed for the end of this year or the beginning of the next and is strictly conditional on significant progress regarding the armed conflict in Ukraine. Over the medium term, the conditions for economic growth to gather momentum remain in place, since Romania was allocated – both in absolute terms and as a percentage of GDP – substantial amounts of funds via various European financing facilities, Next Generation EU in particular. Turning these funds to good account would make it possible for the dynamics of gross fixed capital formation to exceed those of consumption at this horizon, thus having the potential to change the traditional drivers of consumption-led growth.

The war in Ukraine kept fuelling supply-side issues in some key commodity markets, where developments continued to surprise on the upside over the past few months. This led to a new upward revision of the path of the annual inflation rate in the current baseline scenario. Pressures triggered mainly by the armed conflict will remain elevated, with the outlook for the annual headline inflation rate pointing to a levelling-off in 2022 Q3. In the case of energy (especially natural gas and electricity), a slowdown in annual growth will become manifest in the final part of this year, owing, on the one hand, to the persistent influence of the authorities' price capping measures, and, on the other hand, to a favourable base effect, given that market prices of these goods rose significantly last year. As a reflection of these developments, the annual CPI inflation rate will also embark on a gradual downward path starting in Q4. A new sizeable, albeit temporary, leap is anticipated for April 2023, when the extension of electricity and natural gas price cap schemes expires. Even though the realignment of prices of these goods to those prevailing on the markets is expected to take place mostly during April 2023, in light of how the indicator is built, the impact on the annual CPI inflation rate will persist over 12 months until the end of 2024 Q1. Specifically, the projected annual CPI inflation rate will reach 13.9 percent in December 2022 (compared to 12.5 percent in the May 2022 *Inflation Report*), 7.5 percent in December 2023 (against 6.7 percent in the May 2022 *Inflation Report*) and 2.3 percent in June 2024 (mirroring strong base effects).

At the same time, heftier inflationary pressures have already become visible, as a result of the Russia-Ukraine war, also in the case of the annual adjusted CORE2 inflation rate, especially the processed food component. Upward pressures on all categories of inputs used by companies favour the further pass-through of higher production costs into the final prices of consumer goods over the next periods. Thus, the annual adjusted CORE2 inflation rate will continue to rise towards the end of this year (11.4 percent in December 2022 versus 10.9 percent in the previous *Report*). For December 2023, the annual core inflation rate stands 0.7 percentage points higher at 5.5 percent, compared to 4.8 percent previously, before falling to 3.8 percent in 2024 Q2. At this horizon, the effects of monetary policy normalisation will be felt more strongly, implicitly the gradual downward correction of economic agents' inflation expectations, as well as weakening inflationary pressures from imported goods prices.

The NBR's recent monetary policy stance was shaped in a prudent manner, in order to bring the annual inflation rate back in line with the 2.5 percent ±1 percentage point flat target and keep it there over the medium term, *inter alia* via the anchoring of

inflation expectations over the medium term, and to foster domestic saving in a manner conducive to achieving sustainable economic growth.

The uncertainty surrounding global macroeconomic developments has heightened since the previous *Report*. The longer the armed conflict, the more compounded and less predictable its effects. Against this background, the risks to the domestic economy also increased in 2022 H1. The main threat is that the war in Ukraine would further fuel strains in global production and supply chains or push up uncertainty to levels that could depress markedly both consumption and investment, or would entail a further upward spiral in commodity prices. Moreover, at the current juncture, the overriding concerns refer to the possibility of Russia cutting off energy supplies, which would require the rationing of consumption in EU Member States and would most likely lead to a renewed rise in commodity prices to higher levels for a longer period. Risks to commodity prices also stem from climate conditions, especially the soil and atmospheric drought battering Romania and other European countries, which could result in a marked drop in crop yield this year, also with potential knock-on effects on livestock production. Eventually, all these factors would be reflected in protracted and stronger inflationary pressures in the economy, along with additional declines in economic activity, which could prompt the materialisation of the stagflation risk. Romania's facing such risks would be challenging in terms of the absolutely necessary, as-fast-as-possible and orderly correction of domestic and external imbalances, which could entail suboptimal solutions that may weigh on the prospects of a sustainable economic recovery in the medium term.

In order to counter the adverse effects of rising commodity prices on the economy, the national authorities could decide to carry on some of the existing support schemes or, where appropriate, introduce new ones, the design of which is difficult to anticipate at this time. Considering the available information, it is hard to assess the degree of persistence of adverse shocks in the medium term, implicitly to estimate the duration or design of various support packages. However, as these would be predominantly publicly funded, the fiscal and income policy stance would continue to be saddled with many risks, and possible deviations from the deficit adjustment path committed to under the excessive deficit procedure due for completion in 2024 should not be ruled out.

Romania benefits from quite generous EU funds allocations that boost productive capital, consisting in a medium-term buffer for adverse shocks and, at the same time, a counterpoise to the inevitable trend of rising labour costs. In addition, attracting such funds also facilitates fiscal consolidation, ensuring financing at much lower costs than those prevailing in financial markets, severely hit by the fast normalisation of monetary policies. Furthermore, absorbing EU funds acts as a catalyst for other stable investment sources (e.g. foreign direct investment) and both channels also facilitate the financing of twin deficits without increasing the existing debt stock. They are also a buffer for situations where capital currently placed in Romania could be incentivised, in the future, to seek investments that, adjusted for risk (given Romania's quite elevated domestic and external deficits), would earn higher returns. Despite every potential benefit, Romania's track record in EU funds absorption, alongside stricter access criteria

for some of the programmes, Next Generation EU in particular, poses a number of risks to the smooth running and completion of this process by 2026.

The broad-based price hikes that already materialised, as well as those expected for the period ahead, will continue to erode households' purchasing power and could put stronger pressure on wages, albeit varying, in terms of magnitude and accommodation potential, across economic sectors. Hence, future developments in the labour market remain important as a risk factor, although they will inevitably reflect both direct and indirect effects of the war in Ukraine. In an economy such as Romania's, affected by both the negative natural population change and the negative net migration, the exacerbation, over the medium term, of skilled labour shortages should not be ruled out, especially in sectors shifting to a green economy and a high level of digitalisation (segments that look set to be boosted by significant funds allocations at European level).

Monetary policy decision

Given the prospects for the annual inflation rate to level off in 2022 Q3 and gradually decline later on, yet on a path revised moderately upwards, implying its staying well above the variation band of the target and double-digit inflation rates until mid-2023, the NBR Board decided in its meeting on 5 August 2022 to increase the monetary policy rate by 0.75 percentage points to 5.50 percent. Moreover, it decided to raise the lending (Lombard) facility rate by 0.75 percentage points to 6.50 percent and the deposit facility rate by 0.75 percentage points to 4.50 percent, as well as to maintain firm control over money market liquidity. 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.