

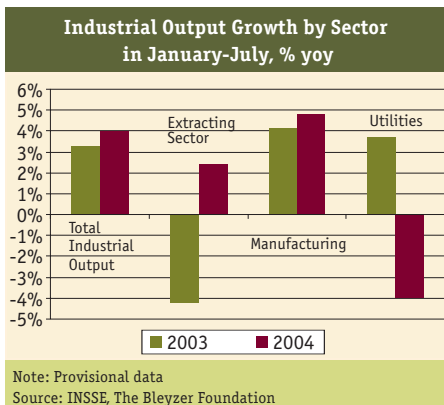
Macroeconomic Situation

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Summary

Romania has continued to demonstrate robust economic growth during the second quarter (Q2) of 2004. Gross domestic product (GDP) expanded by 7.0% year-over-year (yoy), boosted by fast growing consumption and investment. Since the beginning of the year, industrial production increased by 4.0% yoy underpinned by growing productivity (+10.9% yoy) and the shift to more value added (capital intensive) industries. Considering the outstanding performance of the construction sector and higher-than-expected agricultural yields, the Prime Minister (PM) estimated GDP growth to reach 7.5% this year. Since the beginning of the year, the general consolidated budget deficit has decreased to 0.1% of forecasted full-year GDP. Just four months before the end of the year, yearly inflation increased to 12.4%, making the year-end target of 9% quite a challenge to achieve. However, the government and the National Bank of Romania (BNR) are confident in meeting the target; despite accelerating inflation, the BNR reduced its intervention rate for the fourth time this year to 18.75%. The central bank's gross currency reserves (including gold) crossed the EUR 10 billion mark. Despite encouraging exports, the trade deficit continued to widen due to considerable imports. In mid-September, the World Bank (WB) approved a disbursements of EUR 123.4 million under its programmatic adjustment loan in order to finance the continuation of structural reforms.

Economic Growth



According to data recently released by the National Statistical Board (INSSE), Romania continues developing at an accelerating pace — GDP grew by 7.0% yoy in Q2, up from 6.1% in Q1. Consumption (up 9.4% yoy) and investments (up 12.9% yoy) were the main driving forces of economic growth in the second quarter. An increase in the population's revenues (7.9% yoy in July, slightly down from 8.9% yoy in the first half (H1) of the year), a rise in employment and further expansion of credit to households enhanced private consumption by 9.5% yoy (compared to 8.4% yoy in Q1). Gross fixed capital formation accounted for 24.1% of GDP in Q2 (16.7% in Q1). The largest growth was registered in investments in new equipment (+26.4% yoy) and construction (up 9.6% yoy). The prospects for stable

GDP growth are quite encouraging considering the continuous growth of investments and strong development of more value added industries.

In July, despite a slight 1.5% month-over-month (mom) increase, industrial production growth slowed to 1.9% yoy, down from +2.2% in June and a peak of 9.5% yoy in March. The slow rebound of the industrial sector could be partly attributed to fewer working days in July (industrial production in workday adjusted terms increased 5.3% yoy in July) and seasonal factors. Since the beginning of the year, industrial production increased by 4.0% yoy thanks to 10.9% yoy growth in work productivity and the shift to more value added industries. By product breakdown, the sector growth leaders were metallurgy, chemicals, wood processing and the auto industry, while light industry has been stagnating. Driven by strong external demand, metallurgy continued its fast recovery — metals productions expanded by 14.3% yoy in January-July (-20.6% yoy in the corresponding period last year). Since the beginning of the year, chemicals and wood processing (excluding furniture production) have been registering steady growth rates of 26.2% yoy and 26.8% yoy, respectively. Automobile production expanded by 27.2% yoy boosted by strong domestic and external demand. Textiles and apparel, which account for 22.8% of total exports, registered a 2.9% yoy decline and 0.1% yoy growth during January-July, respectively. The food and beverage sector has negatively contributed to overall growth in industry, declining by 5.6% yoy. However, the food industry is expected to improve given the rich crop output this year. The extractive industry continued its below average performance, prompted by declines of 12% and 25.8% yoy in coal and metallic ore mining, respectively, for the first seven months of the year. In July, utilities posted a 13.1% mom increase, continuing the upward monthly trend started in June and bringing the annual figure to -4% since the beginning of the year.

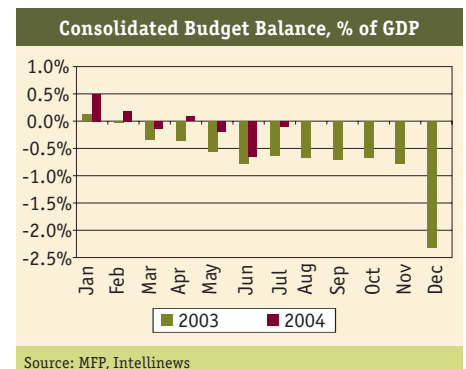
In Q2, construction remained the fastest growing sector (8.9% yoy), encouraged by high demand for mortgages and commercial facilities. According to the results of a managers survey carried out by INSSE in August, construction activities are expected to increase further in the next three months both in terms of production volumes and the stock of contracts and orders. In Q2, agriculture reported more modest growth of only 5.3% yoy. However, considering this year's higher-than-expected wheat crop (according to the minister of agriculture, total output reached 7.8 million tons, up from just 2.45 million in 2003), growing investments, and the improving performance of more value added industries, the PM now estimates GDP growth to reach 7.5% this year. However, given decelerating industrial output growth, this figure looks too optimistic.

Fiscal Policies

According to the Ministry of Public Finances (MFP), since the beginning of the year, the general consolidated budget deficit decreased to 0.1% of forecasted full-year GDP, down from 0.65% of GDP in H1.

Boosted by robust economic growth and improved tax collection, revenues increased 26.7% yoy during January-July (58.5% of projected full-year revenues.) Corporate profit tax revenues totaled ROL 42 trillion (EUR 1 billion), 54.1% yoy higher due to strong economic growth and an increase in the tax rate on exports from 12.5% to 25%. Value-added tax (VAT) payments amounted to ROL 93.1 trillion (EUR 2.3 billion), 25.7% yoy higher than during H1, while excise duties totaled ROL 42.8 trillion (EUR 1 billion), a rise of 42.6% yoy due to 10.6% yoy depreciation of the ROL/EUR exchange rate (excise duties are set in EUR) as well as the increase in excise duties for a number of strategic products: oil, tobacco, ethyl alcohol and liquor and some others. Customs duties totaled ROL 8.5 trillion (EUR 206 million), marking a 22.1% yoy increase due to growing imports.

The government maintained a prudent fiscal policy with the growth of fiscal expenditures (23% yoy) below the growth of revenues (26.7% yoy) in January-July. The lower growth rates of expenditures could be partly attributed to the lower cost of financing the public debt. Due to decreasing domestic interest rates since last year, the government used part of privatization receipts to buy back some of the government securities denominated in the national currency. Also considering the real appreciation of the national currency, these measures led to a decrease in the cost of servicing the public debt. Primary fiscal expenditures (excluding the cost of public debt servicing) increased 27.8% yoy during the first seven months of the year. The reduction of the consolidated budget deficit (by more than four times) should be attributed to favorable consolidated budget performance in July. A consolidated budget surplus of ROL 7.3 trillion (about EUR 270 million) offset almost 80% of H1 deficit (ROL 14 trillion, approximately EUR 345 million).



According to the current precautionary stand-by agreement with the IMF, the year-end target for the fiscal deficit was set at 2.1% of GDP. However, observing strong budget revenues, higher-than-expected GDP growth in H1 and improved fiscal discipline, the government reduced its deficit projection to 1.64% of GDP. The year-to-date (ytd) deficit of 0.1% of GDP makes the government's fiscal expectations quite realistic.

The MFP announced that the maturity of its domestic bonds would be increased from less than one year to

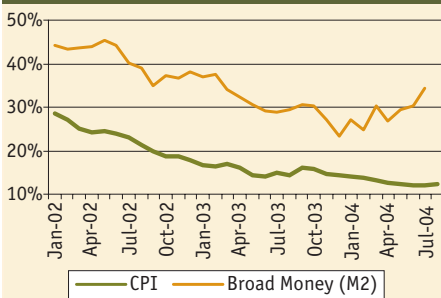
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five years. The decision was made considering the small fiscal deficit registered during the first seven months of the year and recent improvements in the country's international credit rating. At the same time, due to the surge in privatization receipts from the sale of a stake in Banca Comerciala Romana (BCR), privatization of SNP Petrom and the Electrica branches, MFP postponed the issue of Eurobonds worth EUR 600 million planned for this year.

Monetary Policy

Monthly inflation in August decelerated to 0.5% mom, down from a peak of 1.3% mom in July, thus putting the ytd figure at 5.6%. Just four months before the end of the year, the yearly inflation rate is 12.4% (up from 12% yoy in June), making the year-end target of 9% quite a challenge to achieve. Food prices made the lowest contribution to both the monthly and yearly consumer price indices (CPI): 0.2% mom and 9.2% yoy. Such lower figure should be attributed to the better farm crop this year and a high-profile government campaign that resulted in freezing the price of bread. Although prices for vegetables and fruits declined in July by 3.6% mom and 0.4% mom respectively, monthly prices on milling and bakery products remained flat in July. Considering the high yearly growth rates of milling/bakery products and meat (about 18.5% yoy and 11% yoy, respectively), the government pressed for lower prices in these industries. In mid-September, the government reduced some of the import duties on meat and announced that bread prices should decline by about 20% to reflect state subsidies.

CPI and Broad Money (M2) Growth, yoy % change



Source: INSSSE, BNR

In August, the price of services jumped 1.4% mom — the highest increase in nine months — prompted by a sharp increase in regulated prices (water up 3.4%, urban transportation up 2.3%, rail transportation up 3.1% and postal services up 49.9%). Prices of services are not expected to grow significantly in the coming months. The current increases in regulated prices were to reflect the earlier increase in costs associated with higher prices of energy inputs and are unlikely to change again until the year-end. Non-food prices grew by 0.6% mom to 14.4% yoy. An alarming note is the further acceleration of producer price inflation — the producer price index (PPI) grew by 21.1% yoy in July

(up from 20.4% yoy in June and a low of 17% yoy in March). The increase was mainly caused by a 28.4% yoy growth in utilities.

Despite the increase in annual inflation during July-August and the social pressure to raise public sector wages and pensions, the government and BNR officials are confident about bringing year-end inflation down to a target of 9%. Moreover, at the end of August, the BNR reduced its intervention rate for the fourth time this year, from 19.25% to 18.75%. Announcing withdrawal from exchange rate targeting, the achievement of the 9% target is seen as a measure of the central bank's "readiness" for inflation targeting. Moreover, reducing inflation will allow the central bank to keep cutting the interest rates to decrease the interest rate spread between domestic and foreign currency. Achieving the small spread is essential, considering the full capital liberalization planned for next year. According to the BNR governor, the current 10-percentage point spread would allow for the inflow of speculative funds into the country.

According to the BNR, money supply (M2) expanded to ROL 525 trillion (EUR 15.4 billion) in July. The 3.7% mom increase resulted in a record of 34.3% yoy, the highest growth rate in a year and a half. Narrow money (M1) continued expanding at a fast pace, by 4.7% mom (slightly down from 5.9% mom in June) mainly due to slower growth of demand deposits to 2.7% mom (down from 6.2% mom in June). Quasi money advanced 3.3% mom to ROL 393.2 trillion (EUR 9.6 billion), with household savings and corporate deposits growing by 3.1% mom and 5.6% mom, respectively. Foreign currency deposits expressed in national currency reported a 2.4% increase to ROL 185.2 trillion (EUR 4.5 billion) further reducing their share of total deposits to 47.1% (down from 47.5% in June and almost 49% in May). Net foreign assets jumped 10.8% mom (22% yoy) to ROL 306.7 trillion (EUR 7.5 billion) due to the 13% increase in the BNR's convertible currency position. Net domestic assets declined 5% mom in July but are still 56.5% higher than in July 2003.

As of the end of July, domestic credit declined by 2.7% mom to ROL 336.7 trillion (EUR 8.2 billion), although the yoy figure of 52.8% remains well above the official ceiling of 35% growth of domestic credit for 2004. The advance is even more pronounced in non-government credit, which grew 59.2% yoy (up from 57.2% yoy in June) to ROL 367.3 trillion (EUR 8.9 billion). The stock of foreign denominated credit increased 67.2% yoy in July (up from 59.9% yoy in June), while the share of foreign currency loans in bank portfolios reached 59.6% (56.8% a year ago). The modest increase in credit denominated in national currency should be attributed mainly to high real interest rates charged for this kind of credit. Credit to the government recorded a decline of ROL 30.6 trillion (EUR 745 million). The almost five-fold decline, being net credit to the government, was mainly the result of considerable increases in the general account of the treasury re-

sulting from larger tax payments (primarily VAT and profit tax) at the end of H1.

In August, the flow of the BNR's hard currency reserves (excluding gold) amounted to EUR 715.8 million due to the central bank's purchases of EUR 392.3 million on the foreign exchange market, reserve management income of EUR 24.5 million, and other net inflows of EUR 342.4 million. The main outflows were EUR 43.4 million of principal and interest repayments on external public and publicly guaranteed debt. Including the gold stock, international reserves exceeded the EUR 10 billion mark, representing about 4.6 months of imports.

International Trade and Capital

Romania's FOB exports reached EUR 1.83 billion in July, advancing 11.9% mom, and representing a 22.5% yoy increase — the largest increase in the last 14 years. Although CIF imports reported a modest 4.4% growth to EUR 2.37 billion in monthly terms, the yearly growth rate of 23.2% yoy outperformed that of exports. As a result, the monthly trade deficit widened to EUR 538 million, up 25.8% yoy. For the January-July, FOB exports amounted to EUR 10.8 billion, 20.6% higher than in the corresponding period last year, while CIF imports grew by 22.2% yoy to EUR 14.3 billion. Thus for the first seven months of the year, the cumulative trade deficit reached EUR 3.5 billion, up by 27.1% yoy. The structure of the exports revealed the shift toward more value added products. During January-July, the share of textiles and apparel declined to 22.8% of total exports, down from 25.4% in January-July 2003. On the other hand, the share of machinery, appliances and equipment increased to 17.9% from 16.3% last year, and the share of metallurgical products in total exports more than doubled (15% in January-July 2004 compared to 7.4% in January-July 2003). The share of machinery, appliances and equipment in total imports remained nearly unchanged compared to the corresponding period last year (23.1%). The EU markets accounted for 73.7% of Romanian exports and 65.1% of imports during the same period. Italy remains the top-trading partner with 22.2% of total exports and 18.4% of total imports, followed by Germany (14.9% and 14.7%, respectively) and France (8.9% and 7.4%, respectively).

Despite the EUR 538 million trade deficit in July, the current account (CA) deficit amounted to only EUR 137 million, helped by EUR 302 million of current transfers (wage remittances, EU funds). For January-July, the CA deficit reached EUR 1.75 billion (24% higher yoy), amounting to about 3.2% of forecasted full-year GDP (2.8% of GDP in the same period last year, reaching 5.8% of full-year GDP). The CA deficit dynamics make maintaining the 5.5% of GDP target for this year a challenge. However, encouraging export performance (exports continued growing despite real appreciation of the national currency and a tougher fiscal regime) and growing current transfers (+39.3% yoy in January-July) may allow the government to

Headquarters

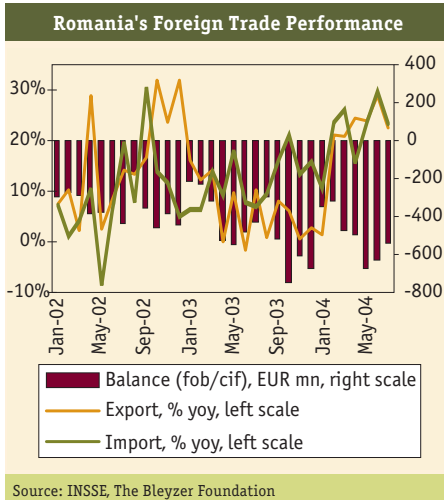
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keep the deficit within target. The government expects to cover almost 70% of the deficit by growing foreign direct investment (FDI). FDI grew by 39% yoy to EUR 1.24 billion in January-July and is expected to increase further due to some large privatization deals.



At the end of July, medium and long term debt reached EUR 17 billion, up 8.4% since the beginning of the year. Public and publicly guaranteed debt grew to EUR 10.1 billion; however, its share of total external debt decreased from 61.7% at the beginning of the year to 59.3% at the end of July. The external debt service ra-

tio was 18.4% in the first seven month of the year, down from 20.6% last year. Gross international reserves of the BNR represented 4.5 months of imports at the end of July, compared to 4.1 months for all of 2003.

International Programs

On October 6th, the European Commission (EC) released its regular report on Romania's progress in the adherence process. Following the privatization push this year (BCR, SNP Petrom, two Electrica branches, two Distrigaz companies), the EC granted the "functioning market economy" status to Romania, which it failed to reach last year. The EC recognized Romania's progress in achieving macroeconomic stability, economic reforms and meeting commitments to EU accession. The document stated that Bulgaria and Romania are expected to sign accession treaties next year and to join the Union at the beginning of 2007. At the same time, the report contains criticism mainly for slow and inefficient judicial reforms, weak administrative capacity, and corruption. The EC still does not consider the Romanian economy fully capable of meeting competitive pressures from the EU. This "safeguard clause" was formulated in a way that would allow the EU to delay the membership date to 2008 if reform commitments were not fulfilled.

Romania is making considerable efforts to finalize the EU entry negotiations by the end of 2004. At the end of September, it finalized two out of five remain-

ing EU accession chapters: Chapter 3 "Free movement of services" and Chapter 21 "Regional policy and structural instruments," and advanced significantly in closing Chapter 22 "Environment" and Chapter 31 "Other provisions."

In mid-September, the WB approved disbursement of EUR 123.4 million under its programmatic adjustment loan to Romania, in order to finance the continuation of structural reforms. The loan is the first in a new series of programmatic adjustment loans aimed at financing medium-term programs to accelerate economic reforms. The program will support the judiciary and public administration reforms, reforms in the financial sector (the privatization of banks BCR and Casa de Economii si Consemnatii) and programs aimed at reforming critical sectors like energy, mining and railways.

Other Developments

Just after Fitch increased the outlook for Romania's sovereign rating from stable to positive at the end of August, Standard & Poor's (S&P) raised Romania's long-term foreign exchange sovereign credit rating to BB+ from BB in mid-September. According to S&P, the upgrade was a result of this year's progress in reforming state owned enterprises and prospects of EU membership. At the same time, it cautioned against prevailing institutional weaknesses and external imbalances.