SigmaBleyzer

Romania Macroeconomic Situation

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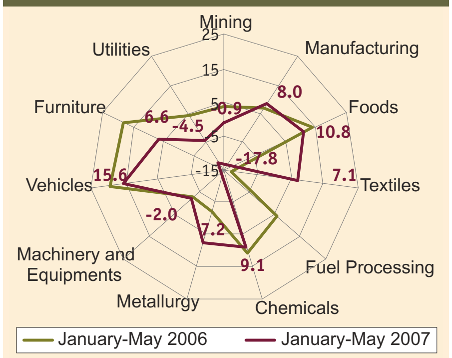
Summary

- In January-May, industrial production grew by 6.4% year-over-year (yoy).
- In 2007–2013, Romania is to receive EUR 19.7 billion from the EU cohesion and structural funds.
- The consumer price index increased by 3.8% yoy in June.
- Over 88% of all banking assets in Romania belong to banks with a foreign capital majority.
- In January-May, the trade deficit widened to EUR 7.62 billion expanding by 64.1% yoy.
- During the first five months of 2007, the current account gap increased by 104% yoy to EUR 5.9 billion. Modest FDI inflows of EUR 2.12 billion covered only 36% of the current account deficit.
- The Bucharest Stock Exchange continues to experience vigorous growth, backed by strong macroeconomic fundamentals and an improving investment climate.
- Recent data on government indicators by the World Bank reveals a pronounced trend toward better and more efficient government in Romania.

Economic Growth

During the first five months of 2007, industrial production grew by 6.4% year-over-year (yoy), marginally accelerating from 6.3% yoy in January-April of this year. This slightly higher industrial growth was achieved on the back of improving performance in the mining industry, where output shrank by only 0.9% yoy compared to a 1.6% yoy decline registered during the previous four months. In addition, output contraction rates have been decelerating in the utilities sector, where production fell by 4.5% yoy as compared to a 5.1% yoy drop in January-April. Although the growth of manufacturing steadied at 8% yoy, the gradually recovering mining and utilities sectors provided some support to the strong performance of the real sector. Nevertheless, manufacturing remains a key driving force of industrial expansion. In January-May 2007, manufacturing posted 1.7 percentage points higher growth than in the same period of the previous year, which helped offset negative trends in both mining and utilities and pushed the growth of industrial production by 0.5 percentage points above the 5.9% yoy growth in January-May 2006.

Industrial Output by Sector, % ytd yoy



Sources: INSSE

Robust performance of food processing, which increased by 10.8% yoy in January-May, continues to add a notable contribution to the sustainable output growth in manufacturing. Presumably, the strong expansion of the food processing industry relies to a large extent on the growing purchasing power of domestic consumers. Indeed, there are clear indications that the welfare of Romanian consumers has improved; in May 2007, unemployment shrank to 4.2% (5.4% in the same month of the previous year) while, on the back of outstanding disinflation developments, the average gross monthly wage increased by almost 19% yoy in real terms as compared to a much more modest increase of 10.5% yoy posted a year ago. However, if in January-May 2006 the turnover of domestic retail trade in food products surged by an impressive 31.9% yoy, during the same period of this year only a marginal increase of 1.7% yoy was achieved.

There are several factors that may account for the observed deceleration of the food processing industry as well as the changing pattern of domestic retail trade. First, the exceptional performance of the food processing industry in 2006, when its output grew on average by 16% yoy, was largely driven by the recovery of agriculture as well as rapidly growing consumer incomes. As a result, this industry has posted slower growth rates in 2007 due to a broader statistical base. Yet a more fundamental force is seen in the recent economic transformations that may have induced remarkable adjustments of consumer preferences, which are reflected in the changing pattern of consumer spending (indirectly captured in the dynamics of domestic retail trade). In particular, the wealthier population is inclined to spend a lower fraction of its income on necessities (foods), while the expenditure on higher quality goods (for example, non-food products and consumer durables) has a tendency to grow. Indirect evidence of such a shift in consumer preferences comes from the fact that in January-May 2007 the volume of retail trade in non-food items conducted through specialized shops grew by 31.9% yoy as compared to 16.6% a year ago, while the turnover of trade in vehicles, related services and fuels grew by 52.2% yoy (17.2% yoy in January-May 2006). In addition, growing wealth and incomes as well as favorable economic prospects raise the upper limit on the amount of debt that a single household can afford to finance purchases of consumer durables, cars and real estate, which tends to strengthen these shifts in consumer preferences and spending. Finally, industrial statistics reveal that turnover in the Romanian food processing industry grew faster at the external markets than at the domestic market. Interestingly, food processing is one of the few industries for which such a tendency was detected. As a result, it may imply that the export of Romanian food products is gradually increasing its role as a critical source of output growth in the domestic food processing industry.

Although, consumption continues to drive aggregate demand for industrial products, the impact of investments and construction on industry became much more pronounced. Record high growth rates of investments (due to large FDI inflows and improving profitability of domestic companies) as well as unprecedented output expansion in construction (in January-May of this year, the index of construction works was up by 31.8% yoy against 15.8% a year ago) fuel demand for capital and intermediary goods. For example, in January-May 2007, output of industries producing construction materials surged by an impressive 36.9% yoy (down by 0.2% yoy in January-May 2006). The juxtaposition of output growth rates of broad industrial groups in 2007 and 2006 leaves little doubt about the growing importance of the consumers of intermediary and capital goods on industrial performance. In particular, during the first five months of this year, production of intermediary goods grew by an impressive 11% yoy (1.4% yoy in January-May 2006), output of capital goods advanced by 8% yoy (8.7% yoy a year ago), while production of durable and current use goods, which are sold to final consumers, increased by 6.5% yoy (18.3% a year ago) and 7.7% yoy (8.9% yoy a year ago) respectively. The importance of domestic businesses, consuming intermediate and capital goods, is also supported by the fact that the domestic turnover of Romanian industries such as metallurgy, wood processing, machinery and textiles expanded faster than their external turnover. As a result, in January-May 2007 metallurgy, wood processing, and textiles grew by 7.2% yoy, 27.7% yoy and 7.1% yoy respectively and were largely supported by robust domestic industrial demand. Finally, it should be mentioned that the strong performance of the automobile industry (up by 15.6% yoy) and textiles was also built on the previously noted tendencies in consumer spending. In particular, domestic turnover of trade in vehicles increased by 45.9% yoy, while the volume of trade in textiles, clothing and footwear surged by 79.3% yoy. Although it is obvious that this higher turnover reflects higher volumes of imports, it is safe to argue that increasing domestic demand for these types of products spurred internal production as well.

In addition, the strong industrial outlook is supported by consistently high gains in labor productivity. In January-May 2007, labor productivity improved by 11.2% yoy as compared to 9.9% yoy posted during the same period of the previous year.

Fiscal Policy

During the first half of this year, consolidated budget revenues grew to RON 55 billion increasing by 17.9% yoy. Accelerated growth of budget revenues was registered due to improved collection of VAT tax (up by 2.5% yoy) as well as personal income tax (up by 43.1% yoy) and corporate profit tax (up by 30.1% yoy) on the back of shrinking unemployment, increasing incomes and improving profitability of the corporate sector.

In July, the government of Romania and the European Commission concluded an agreement on the National Strategic Reference Framework (NSRF). According to the NSRF, in 2007–2013 Romania is to be given

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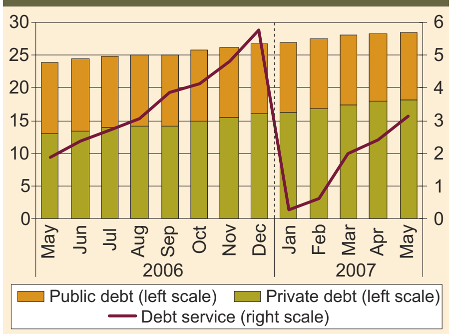
EUR 19.7 billion from the structural and cohesion funds to modernize infrastructure, improve competitiveness of the economy, advance human capital, build administrative capacity and balance regional development. Romania is expected to contribute EUR 5.5 billion to co-finance these developmental projects. In 2007, Romania must receive over EUR 1.2 billion of EU funds.

In January-May, the stock of total external debt grew to EUR 25.83 billion, slightly decelerating to 19.2% yoy on the back of slower growth of private external debt (up by 39.8% yoy to EUR 18.15 billion). Public external debt shrank by 5.3% yoy to EUR 10.4 billion.

Medium and Long-term External Debt, EUR billion

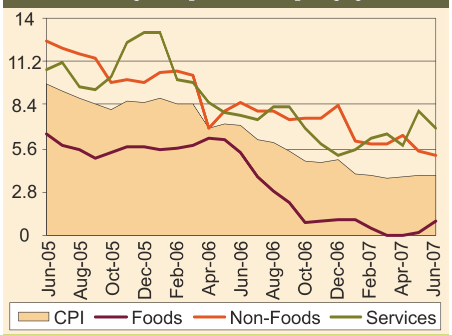


Source: NBR

Monetary Policy

In June, the consumer price index (CPI) increased by 3.8% yoy. As a result, inflation has settled below 4% in the first half of this year. However, due to a budding upward trend for food prices as well as increasing world prices of fossil fuels (which may end the disinflation of prices of non-food commodities), the CPI is likely to post higher gains throughout the rest of this year.

CPI by Components, eop % yoy

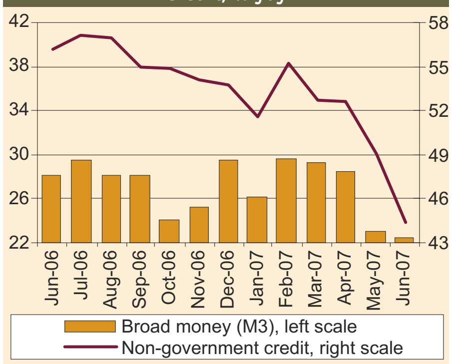


Source: INSSE

During the first six months of 2007, food prices increased by 1% yoy. Although, prices of foods grew 6 times slower in June 2007 than in June 2006, there is a striking difference between the sources of inflation of food prices. Food price inflation was mainly shaped by the rapidly growing prices of vegetables (up by 24.7% yoy) and sugar in June 2006, while increasing prices of mill and bakery products (up by 6% yoy) were the major source of inflation of food prices in June 2007. Taking into account the fact that abnormally dry weather conditions in spring 2007 and recent heavy rains may result in lower yields of basic crops both in Romania and some other key agricultural regions of Europe, there is a substantial risk that an upward trend in food prices will persist, since commodities classified as mill and bakery products comprise more than one fifth of the consumer basket of foods.

In June, prices of non-foods continued to decelerate, growing by 5.12% yoy as compared to 8.6% yoy in June 2006. Higher prices of tobacco, fuels and utilities still remain the principle drivers of prices of non-food commodities. However, on the back of a more even evolution of prices of these three commodities, the price index of non-foods followed a moderate disinflation trend. The medium-term sustainability of this process largely depends on the magnitude of the economy's response to the recent hikes of world prices of fossil fuels as well as on the continuation of this uptrend on the international market. On a positive note, a stronger Euro and appreciating national currency helps to partially alleviate the inflationary impact of higher world energy prices. Finally, in the first half of 2007, service tariffs grew by 7% yoy. Since this inflation was mostly triggered by the sharp upward adjustment of administered rents for public housing (as a result, rents grew by 106.5% yoy in June 2007), provided that additional radical increases of administered tariffs are not implemented before the end of this year, the price index of services may continue to slow due to steady disinflation developments observed for all major groups of services. As a final point, the inflationary outlook for the second half of this year will be strongly influenced by the developments of world prices of basic crops and fossil fuels as well as the magnitude of the national currency appreciation.

Money Supply and Non-Government Domestic Credit, % yoy



Source: BNR

In June, money supply (measured by monetary aggregate M3) continued to decelerate, increasing by only 22.4% yoy — its lowest growth rate in more than two years. Non-government domestic credit amounted to RON 109.03 billion, growing by only 44.3% yoy. This deceleration of non-government domestic credit was supported by the slower growth of both RON and forex-denominated credit, which slipped to 45.8% yoy and 42.6% yoy respectively from 50.3% yoy and 47.8% yoy in the previous month. Although credit issued to both households and the corporate sector tended to grow slower for loans denominated in either national or foreign currencies, starting February 2007, Ron-denominated credit to households stopped increasing at the fastest rate, while forex-denominated credit to households accepted the leadership in terms of growth, expanding by 77.6% yoy in June 2007. This tendency reflects a shift in borrowers' preferences toward forex-denominated liabilities, as appreciating national currency reduces expected service costs of the forex-denominated loans. Furthermore, the elimination of administrative restrictions on the exposure of credit institutions to forex loans starting January 1st 2007 allowed commercial banks to expand their portfolio of forex-denominated credit.

The National Bank of Romania (NBR) has issued its regular Financial Stability Report. According to the NBR, the Romanian financial system is dominated by banking institutions that have amassed about 84% of all assets of the financial system in 2006, while the presence of other financial intermediaries (for example, insurance and leasing companies) is rather narrow. Furthermore, concentration of the banking system remained relatively high, as the top five banks controlled 60.3% of all banking assets in 2006. On a positive note, the current structure of the banking sector allows one to conclude that market competition is at an adequate level, since in 2006 94.5% of all banking assets were held by banks with a majority of private capital and 88.6% of assets belonged to banks with majority foreign capital.

Structure of the Romanian financial system, % of GDP

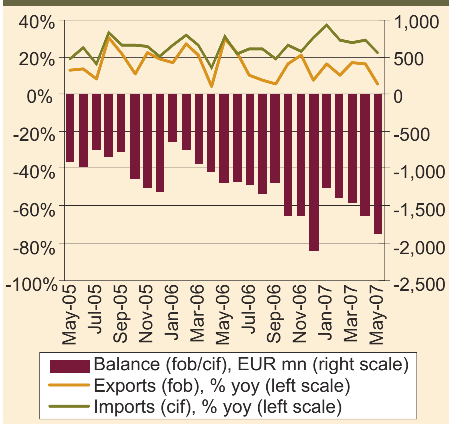
Financial Intermediation Institutions	2002	2003	2004	2005	2006
Net assets of credit institutions	31	30.8	36.6	44.6	50.6
Assets of insurance companies	1.5	1.8	1.9	2.2	2.5
Assets of investment funds	0.1	0.1	0.2	0.2	0.3
Net assets of financial investment companies	1.4	1.4	1.3	1.8	2.3
Net assets of leasing companies	1.5	1.8	3	3.6	3.4
Assets of other institutions	0.4	0.4	0.6	0.9	1.3
Total	35.9	36.3	43.6	53.3	60.4

Source: NBR, Financial Stability Report 2007

International Trade and Capital

During the first five months of 2007, exports (FOB) grew by 12.7% yoy to EUR 11.72 billion, while imports (CIF) amounted to EUR 19.34 billion, increasing by 28.6% yoy. As a result, the trade deficit widened to EUR 7.62 billion, expanding by 64.1% yoy. In May alone, exports (FOB) posted the lowest growth rate within the last 12 months, increasing by only 5% yoy. At the same time, imports (CIF) continued to enjoy a buoyant pace of growth, advancing by 22% yoy. The monthly trade deficit rose to its highest level in 2007, hitting EUR 1.9 billion.

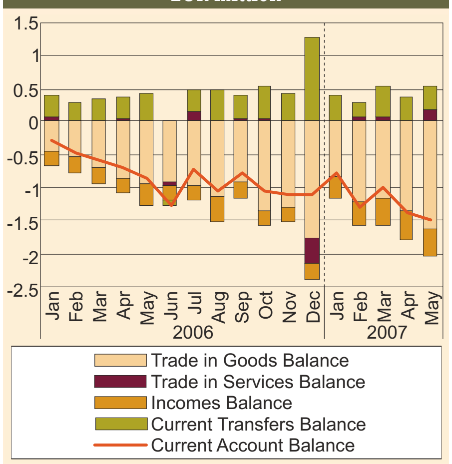
Monthly Foreign Trade Balance



Source: INNSE

In January-May, the current account gap stood at EUR 5.9 billion. Although growth of the current account deficit dropped to 104% yoy from 116% yoy during the previous four months, fast expansion of the incomes deficit, which widened by 56.2% yoy, as well as a rapidly growing trade in goods deficit (up by 75.9% yoy) continued to support further deepening of the current account deficit. In addition, current account data shows a rather pronounced trend towards a weakening current transfers surplus, which grew by only 9.9% yoy during the first five months of 2007.

Current Account Components, monthly flows EUR million



Source: NBR, The Bleyzer Foundation

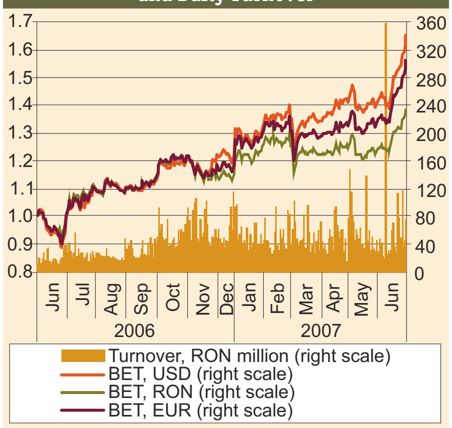
In January-May, the net inflow of foreign direct investments (FDI) amounted to EUR 2.12 billion, falling by 24% yoy against the same period of the previous year. As a result, FDI financed only 36% of the current account gap (FDI inflows covered 97% of the current account gap in January-May 2006). About two thirds of FDI inflows came from equity stakes and reinvested earnings while inter-company lending accounted for the rest of FDI.

During the first half of 2007, the foreign exchange reserves of the NBR stood at EUR 23.6 billion growing by 18.3% yoy or by only 3% since the beginning of the year. Falling FDI inflows on the back of a deepening current account gap allowed the central banks to increase its forex reserves by only EUR 690 million, while foreign exchange reserves swelled by EUR 1.52 billion during the first six months of last year.

Other Developments Affecting the Investment Climate

Favorable developments of the country's investment climate, good economic prospects and improving profitability of the domestic corporate sector have nurtured vigorous growth of the Bucharest Stock Exchange (BSE). In June 2007, BSE capitalization reached EUR 28.1 billion or about 22.5% of projected full year GDP; in June 2006, BSE capitalization was at 16.1% of full year GDP. Furthermore, monthly market turnover surged by more than three times to EUR 419 million in June 2007. Although, the core BSE market index (BET) was depressed by several episodes of political turmoil in 2007, it nevertheless posted solid gains, increasing by 38.5% yoy or by 20.1% since the beginning of this year. Furthermore, due to appreciating national currency, the BET index priced in USD and EUR had increased by 64.9% yoy and 56.2% yoy respectively by the end of the first half of 2007.

BSE BET Index (rescaled, June 1st 2006=1) and Daily Turnover



Source: BSE, The Bleyzer Foundation

In the middle of July, the American company Delphi (with about USD 26 billion in global sales) announced a decision to expand its production capacities in Romania by investing EUR 100 million into a new diesel-engine plant, which will be built in Iasi (a city located in the north-eastern region about 255 mile from Bucharest, with a population of about 306,000.) This decision represents a strategic step to further develop the company's operations in Central and Eastern Europe, where the booming automobile industry continues to attract substantial attention from global automotive components manufacturers. Apparently, Delphi's selection of Iasi is a clear indication that Romania possesses strong competitive advantages over other countries in the region to attract large global businesses.

The US automaker Ford expressed its intention to take over the Daewoo Craiova car factory. The Romanian government, in turn, is prepared to pass a special law that will facilitate this takeover providing that an improved financial offer is received from Ford by August 15th.

According to recent government indicators released by the World Bank, despite a slight deterioration of the political stability index, indexes measuring control of corruption, government effectiveness and regulatory quality registered improved performance. These trends may reflect the fact that regardless of political tensions, the government maintains a firm commitment to better the quality of public administration and continue economic and structural reforms.

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