Romania Macroeconomic Situation

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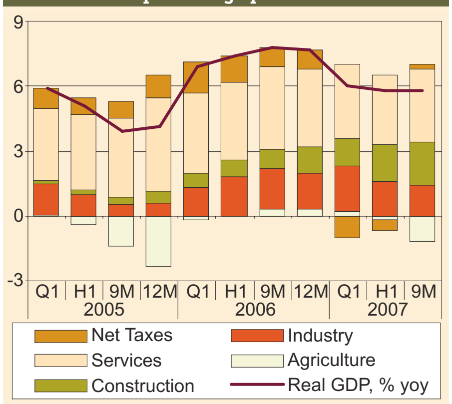
Summary

- Romania continued to demonstrate solid economic performance, registering a real 5.8% year-over-year (yoy) growth of gross domestic product (GDP) in January-September.
- The consolidated budget reported a surplus at 0.12% of GDP in the first ten months of 2007.
- On November 20th, the Romanian parliament approved a law on the state budget for 2008 with a budget deficit of 2.7% of GDP.
- In the first ten months of 2007, the total stock of medium and long-term external debt increased by 22.8% ytd, driven by private borrowings and inflow of non-resident deposits.
- Consumer prices grew by 0.93% month-over-month (mom) in November, translating into a 6.67% yoy increase in annual inflation.
- Money supply (measured as aggregate M3) grew by 34.6% yoy in November, following a 55.1% yoy increase in non-government domestic credit.
- Over January-October, the merchandise (FOB/CIF) trade deficit widened by 53.24% yoy, approaching EUR 17.2 billion.
- A surge in imports left the current account deficit highly unsustainable, as only 44.5% of the gap was financed by net FDI inflow.

Economic Growth

Contributions to Real GDP Growth by Sector, percentage points

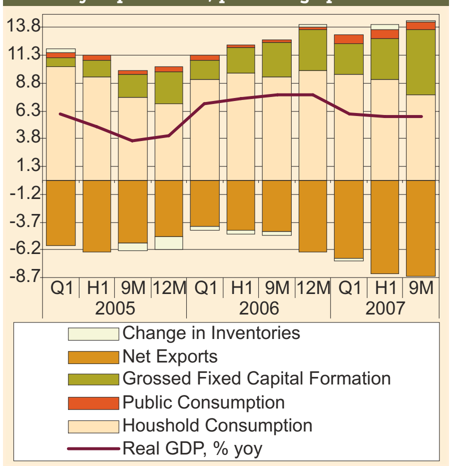


Sources: INSSE

In the first nine months of the year, the Romanian economy continued to demonstrate solid performance, as the gross domestic product (GDP) in real terms reported robust growth of 5.8% yoy. Notably, the third quarter was marked with better than projected real GDP growth at 5.7% yoy, accelerating from 5.6% yoy in the second quarter. The economic growth remained generally broad-based, underpinned by increasing value added in all sectors, except agriculture. Meanwhile, domestic-oriented sectors such as construction and services continued to develop at outpacing rates, increasing their contribution to the formation of the GDP. Services were the most significant driver of economic growth, contributing 58.6% to a real increase in gross value added. The role of construction in the Romanian economy has been strengthening rather rapidly, increasing by a striking 34.4% yoy in January-September 2007. Thus, the weight of the construction sector in GDP extended to 34.5% compared to 11.5% in the respective period last year. On the downside, economic growth was restrained by low proceeds from product taxes in the first quarter of the year and by decreasing value added in agriculture. Agriculture demonstrated rather poor performance this year, as gross agricultural output dropped by 18.3% yoy in January-September on the back of unfavorable weather conditions.

A positive evolution of the GDP was achieved primarily on the back of strong domestic demand, growing in total by a real 13.3% yoy. Household consumption remained the main driver of economic growth. However, private consumption also remained rather unsustainable, being supported mainly by increasing bank debt and growing incomes ahead of productivity growth. In the first nine months of the year, real wages grew by 14% yoy, while growth of labor productivity advanced by only 10.3%. The contribution of investments to the economic development of the country has been increasing due to high investment activity Thus, gross capital formation continued to accelerate its growth pace, climbing by a striking 25.3% yoy during January-September. Investments grew by an impressive 29.1% yoy in the first nine months of the year. However, investments stimulated primarily the development of domestic sectors rather than export-oriented ones, which is ineffective from the perspective of generating economic growth in the medium run. The major beneficiaries of investments were new construction and equipment. In particular, new construction absorbed 48.9% of total investments. On the other hand, persistent domestic consumption also spurred demand for imports, which created a significant downward pressure on economic growth. Net exports negatively contributed 8.6 percentage points to 5.8% yoy growth of GDP.

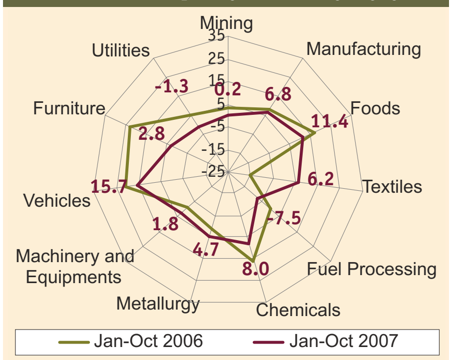
Contributions to Real GDP Growth by Expenditure, percentage points



Sources: INSSE

Over January-October, industrial production stayed in good shape, increasing by 5.8% yoy. In October alone, industrial production grew by 5.9% yoy, accelerating from a modest 3.2% yoy reported last month. Sound industrial performance was maintained by gains in food processing, chemical industry, metallurgy, automobile production, and in machinery and equipment, which compensated for the decline in output in light industry, fuel processing and utilities supply. Strong private consumption favored increasing production of food processing, which added 11.4% yoy in the first ten months of the year. At the same time, high investment activity in the country as well as external demand stimulated consistent development of automobile production and of machinery and equipment, which grew by 15.7% yoy and 1.8% yoy respectively. Favorable conditions on international commodity markets supported robust growth in chemical production and metallurgy, posting 8% yoy and 4.7% yoy respectively.

Industrial Output by Sector, % ytd yoy



Sources: INSSE

Fiscal Policy

Robust economic growth in January-October provided a good base for successful performance of fiscal revenues. Growing nominal incomes of households and firms as well as persisting domestic consumption stimulated an increase in tax receipts and, therefore, in consolidated budget revenues. Thus, budget revenues grew by a nominal 21.2% yoy over the first ten months of the year, totaling RON 105.8 billion. At the same time, the Romanian government continued to run rather expansive fiscal policy, devoted mainly to generous social programs. Consolidated budget expenditures increased by a nominal 30.9% yoy, amounting to RON 105.4 billion. A major part of state expenditures was directed at social assistance (28% of total budget spending) and to paying wages for state employees (19.5%).

Thanks to strong tax proceeds, the budget balance was still in surplus, totaling RON 450 million (0.12% of GDP) in the first ten months of the year, despite expansionary income and social policies. As budget revenues were growing at a slower pace than expenditures, and taking into account that the government projected a significant increase in expenditures in the last

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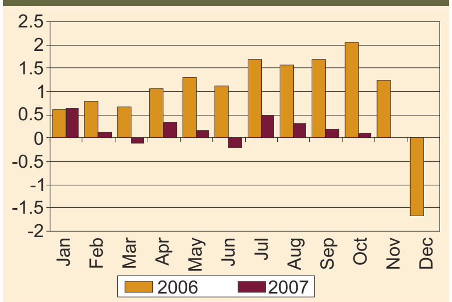
two months of the year, the budget balance is going to turn into a rather significant deficit at the end of 2007.

Consolidated Budget Balance, % of full year GDP



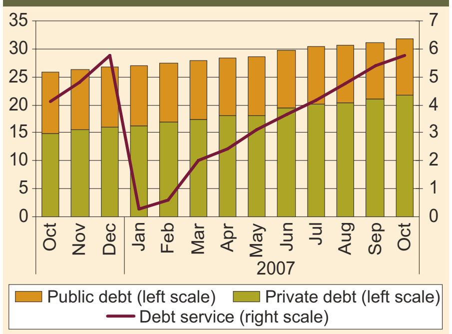
Source: Ministry of Public Finance

On November 20th, the Romanian parliament approved a law on the state budget for 2008, drafted by the Liberal-led government. The law projects a budget deficit of 2.7% of GDP, up from 2.4% of GDP set for 2007. Meanwhile, total budget revenues are planned at RON 172.8 billion (up by 21.6% compared to the budgeted amount in 2007), and total budget expenditures are set at RON 184.7 billion (up by 21.8%), including payments to the EU budget. The budget is based on macroeconomic forecasts anticipating 6.5% yoy real GDP growth, 3.85% annual inflation and a current account deficit at 13% of GDP. To finance the extended state budget deficit, the government plans to borrow RON 11 billion (EUR 3.45 billion) on the domestic market, to issue Eurobonds worth EUR 500 billion, and to privatize state property. The weak minority government is obviously failing to remedy procyclical fiscal loosening that is to compound macroeconomic imbalances, fuel inflation processes and to contribute to the accumulation of state debt.

In the first ten months of 2007, the total stock of medium and long-term external debt increased by 22.8% ytd, up to EUR 35 billion. Foreign borrowings of the private sector provided about two-thirds of the increase, while growing non-resident deposits in the Romanian banking system contributed another one-third. The private sector (primarily, commercial banks with foreign capital) continued to borrow heavily from abroad in October. Thus, external debt of the private sector reported a strong 29.5% ytd growth in January-October 2007, despite escalating international financial turmoil. In 2007, non-resident deposits began to play an important role in the structure of external debt, as they were attracted by good developments in the banking system and recent EU membership. On a negative note, the increased a share of short-term foreign deposits contributed to excessive volatility of Romanian external debt and its vulnerability to speculative sentiments of foreign investors. In the third quarter of 2007, the attraction of short-term foreign deposits by commercial banks brought to 44.2% increase of the total external debt of Romania, which climbed up to EUR 53.2 billion.

Monetary Policy

Medium and Long-term External Debt, EUR billion

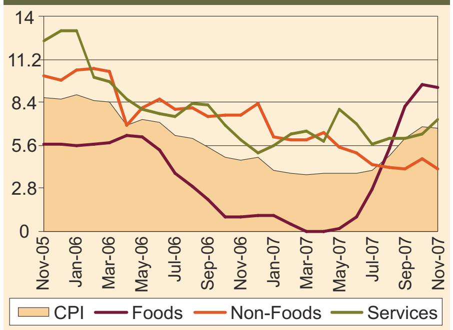


Source: NBR

In November, the consumer price index (CPI) continued to advance under the influence of both supply and demand-side factors. On the supply side, a rise in real wages and industrial producer prices drove up manufacturing costs, which inevitably passed-through to consumer prices. Also, the evolution of consumer prices followed a general upward growth trend of prices for foods and energy resources on the world markets. The depreciating Romanian leu caused service tariffs to increase, as some tariff rates are denominated in euro. Meanwhile, growing incomes of households and expansion of banking credits further created demand pressure on consumer prices. The recent depreciation of the RON partially switched domestic demand from imports consumption to domestic consumption. Strong domestic demand affected primarily food prices, as foods take up about 40% of the consumer basket, and the most of the demand for foods is usually satisfied domestically. Nevertheless, inflation reported a marginal slowdown of monthly growth in November after continuing acceleration during the previous three months in a row. Thus, consumer prices grew by 0.93% month-over-month (mom), translating into a 6.67% yoy increase in annual inflation. As in the previous month, inflation was mostly spurred by growing prices for foods, registering at 1.17% mom. Prices of non-food stuffs posted a 0.61% mom increase, mainly due to growing prices for fuel (1.63% mom). Growth of service tariffs accelerated to 1.21% mom, driven by a 2.47% mom increase in tariffs for post and telecommunication. At the same time, growth of consumer prices switched to a deceleration trend in November, as food prices in all product groups grew at a slightly lower rate than the month before, likely due to a high base effect.

Developments of monetary aggregates also contributed to increasing inflationary pressure. Money supply in the economy (measured as aggregate M3 according to a broad definition) grew by 34.6% yoy in November, visibly accelerating from 28.8% yoy reported a month ago. Expansion of money supply was driven by a 55.1% yoy increase in non-government domestic credit, as high demand for banking loans, from households in particular, persisted in November.

CPI by Components, eop % yoy

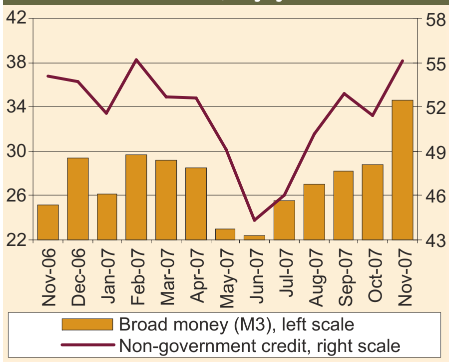


Source: INSSE

Steady, high incomes, improving standards of living and standards of banking services have been stimulating Romanians to apply for banking loans. Households built up the stock of their banking debt by 76.7% over the last twelve months. At the same time, money supply in terms of the major components expanded primarily due to the increasing amount of currency behind the banking system and demand deposits rather than to increasing term deposits. In November, the amount of liquid money grew by 69.9% yoy, while term deposits rose by only 9.3%, compared to a respective 44.8% yoy and 18.4% yoy growth reported a year ago. As a result, the share of liquid money (cash and demand deposits) extended to 53.5% of broad money supply from 30% a year ago. This tendency indicates that individuals preferred to borrow and spend rather than save, thus increasing demand pressure on current prices. Moreover, individuals borrowing from banks increased their current expenditures rather than investment spending (like on either real estate or durable goods), which further stressed inflation pressure. Thus, according to the NBR, around 70% of loans to households are consumer credits, and only 30% are mortgage credits. Another risky factor of continuing bank credit expansion is related to the increasing share of forex-denominated credit in total non-government credit. The share of forex-denominated credit expanded to 53% in November 2007 compared to 47% a year ago, thus spurring exposure to exchange rate risks. These risks are further strengthened by the very likely depreciation of the RON.

The RON continued to experience depreciation pressure in November, as the RON/EUR exchange rate rose by 4.8% mom in nominal terms at the end of the period on the back of worsening sentiments of foreign investors. Investors remained rather risk-averse considering the unsustainable external deficits of Romania in the context of the persisting credit squeeze around the world. A rise in the policy interest rate of the National Bank of Romania (NBR) by 50 basis points on October 31 was not powerful enough to correct the downward trend of the RON. Only indirect interventions of the central bank prevented the Romanian leu from even sharper depreciation in November. The national currency remained very exposed to further depreciation due to the size of the current account deficit and liquidity constraints on international financial markets. Nevertheless, depreciation of the national currency seems to be the only remedy for balancing large external deficits. And there is a risk of a sharp depreciation of the local currency in the medium term, which may negatively impact economic developments and spur inflation.

Money Supply and Non-Government Domestic Credit, % yoy



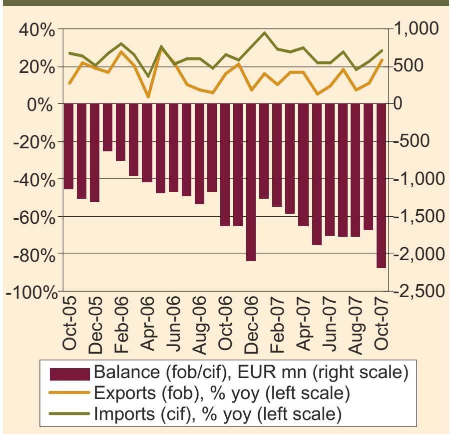
Source: BNR

Although the annual inflation rate remained one of the lowest in Eastern Europe, attaining the inflation target is an important task for the NBR in the framework of the program of convergence to the Euro zone. The disinflation process that was successfully maintained since 2000 was suspended in the third quarter of the year due to shocks from both supply and demand sides. It became quite obvious that the disinflation efforts of the central bank alone are not enough to successfully reach the inflation target due to the depreciation of the RON, exogenous shocks of world commodity markets and imprudent income and fiscal policy of the government. Furthermore, the NBR introducing measures for tighter monetary policy faces a serious trade-off between inflation on the one side and appreciation of the national currency and economic growth on the other side.

International Trade and Capital

In October, international trade reported an acceleration of growth rates of both exports and imports compared to the previous month. Thus, (FOB) exports grew by an impressive 23.4% yoy, a record monthly growth rate for the year, accelerating by more than twice from the 11.1% yoy registered in September. At the same time, (CIF) imports accelerated to 28.1% yoy, up from 22.5% yoy a month ago. Despite visible improvement of export performance in October, persisting import expansion, coming mostly from the European Union, drove a (FOB/CIF) trade deficit to a monthly historical wide gap at EUR 2.2 billion. Over the total period of January-October, merchandise (FOB/CIF) trade deficit widened by 53.24% yoy, approaching EUR 17.2 billion. In terms of a foreign trade deficit, Romania ranks fifth in the European Union.

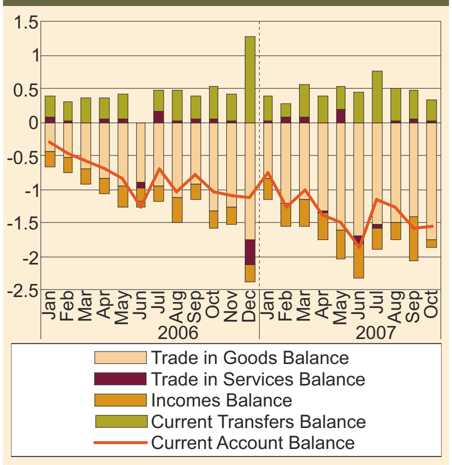
Monthly Foreign Trade Balance



Source: INNSE

Under the downward pressure of the consistently deteriorating merchandise trade balance, the current account deficit widened to EUR 13.3 billion as of October, up by 71.8% yoy. A surge of imports left the current account deficit highly unsustainable, as only 44.5% of the gap was financed by net FDI inflow. Moreover, about 10% of the current account gap was covered by short-term foreign debt, which made the external imbalance rather vulnerable to international credit terms. In short, it is high time to introduce a good mixture of tight monetary and fiscal policies.

Current Account Components, monthly flows EUR million



Source: NBR, The Bleyzer Foundation

In October, net inflow of foreign direct investments (FDI) was at EUR 923 million, only slightly below the previous month's level, when FDI reported a record high inflow. In January-October, net FDI inflow amounted to EUR 5.9 billion, declining by 25% yoy due to a high statistical base in October 2006. Romania remained quite attractive for placement of foreign investments thanks to still comparatively cheap labor force, the favorable business environment, low taxes, and a large domestic market. The most attractive sectors for investors are those demonstrating the most dynamic developments such as industry, energy production, construction and services.

Strong inflow of foreign capital in October helped not only to finance the current account gap but also to slightly replenish the foreign exchange reserves of the NBR. The forex reserves increased by EUR 4.1 million, amounting to EUR 25.2 billion as of October. The stock of the forex reserves was at a level high enough to finance 6.1 months of imports.