Romania
Macroeconomic Situation

April 2008

Larysa Koziarivska, Radu Mihai Balan, Edilberto L. Segura

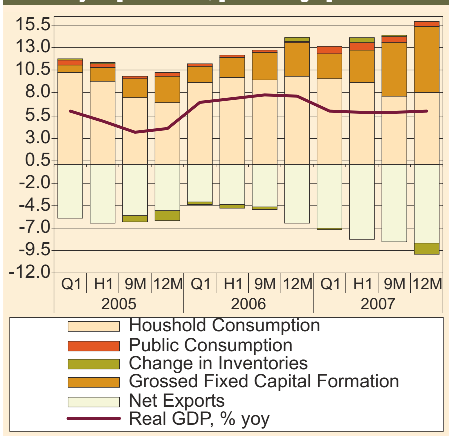
Summary

- Real GDP posted 6% yoy growth in 2007, driven by domestic demand, both private consumption and investments.
- In January 2008, the industrial sector posted a good performance with a robust 6% yoy production growth.
- The government managed to maintain a 0.21% of period GDP surplus of the consolidated budget over January-February 2008 thanks to robust performance of budget revenues.
- Medium- and long-term external debt continued to grow in January 2008, driven by increasing debt of both private and public sectors.
- At the beginning of 2008, annual inflation resumed its acceleration growth pace, as consumer prices advanced by 8% yoy in February 2008 against 6.6% yoy at the end of 2007.
- In January, broad money supply (M3) surged by 38% yoy driven by a record 67% yoy hike in non-government credit. In February, growth of M3 reported a marginal deceleration to 37% yoy, while growth of non-government credit slightly decelerated to 66% yoy on the back of further tightening of the monetary policy.
- The monetary authority continued a series of increases in the key policy interest rate, up to 8% in January and then to 9% in February.
- In January 2008, the growth rate of (FOB) exports exceeded (CIF) imports for the second month in a row, likely due to continuing devaluation of the RON.
- Net inflow of FDI totaled EUR 695 million in January, increasing by a strong 76% yoy.
- In March 2008, the Parliament approved a new electoral law calling for the establishment of a combined majority-proportional election system instead of a proportional one.

Economic Growth

Growth of gross domestic product (GDP) in real terms accelerated to 6.6% yoy in the fourth quarter of 2007, up from 5.6% yoy and 5.7% yoy registered in the second and third quarters respectively. Thus, real GDP posted 6% yoy growth in 2007, exceeding preliminary projections, and amounted to RON 404.7 billion (EUR 118 billion). On the demand side, economic growth was driven primarily by domestic demand, both private consumption and investments. Consumption of households, increasing by 8% yoy in 2007, remained the main contributor to the real GDP growth, accounting for 77% in the formation of GDP. Persistent private consumption was supported by continuing bank credit expansion and growing wages. Notably, growth of investments into the gross fixed capital accelerated significantly in 2007 up to 29% yoy and turned to be the second important driver of the economic growth. A sharp rise in investments was the main factor behind acceleration of the GDP growth above expectations in the fourth quarter of 2007. Buoyant investment activity was spurred mainly by growth of construction-oriented investments (31.1% yoy) and investments in capital goods (26.8% yoy). At the same time, economic growth at 6% yoy in 2007 posted a deceleration against 7.7% yoy registered in the previous year. A slowdown of economic growth was stipulated first of all by continuing deterioration of net exports, as imports surged by an impressive 26% yoy in 2007, while exports grew by a rather moderate 8.7% yoy. Thus, absorption of internal demand by merchandise imports is increasing, restraining economic growth in the country, as rapidly growing domestic consumption cannot be appropriately matched by growth of industrial production.

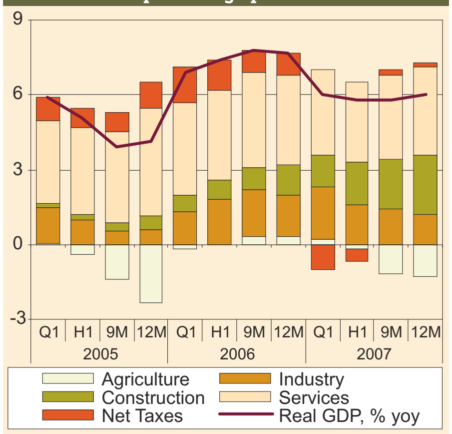
Contributions to Real GDP Growth by Expenditure, percentage points



Source: INSSE

On the supply side, GDP growth was underpinned by domestic market-oriented sectors such as trade, transportation and construction, which together formed 59% of GDP. Value added produced by the service sector grew by 7% yoy in 2007. Meanwhile, construction was the most dynamically developing sector last year with a growth of 33.6% yoy. As result, a contribution of construction to economic growth expanded to 2.4 percentage points (p.p.) of 6%, exceeding the share of industry. Construction demonstrated brisk performance on the back of double-digit growth rates observed in all sub-sectors of construction, including engineering (34% yoy), non-residential (37% yoy) and residential building (29% yoy), which was spurred by high inflows of domestic and foreign investments. The construction sector is the major attractor of investments due to soaring prices for real estate in Romania. At the same time, a slowdown of value added growth rates on the supply-side was related to a shortfall in agriculture, poor performance of net taxes on products and to a deceleration of industrial output growth. Value added in agriculture declined by 17% yoy on the back of unfavorable weather conditions. After a decline in the first quarter of 2007, attributed to eliminating the last trade barriers with EU members, growth of net taxes improved to 1.6% yoy at the end of the year favored by high domestic consumption. Industrial growth decelerated to 5% yoy, down from 7% yoy reported a year before, mainly under the pressure of increasing import competition.

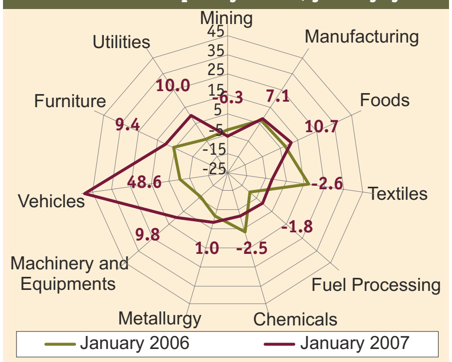
Contributions to Real GDP Growth by Sector, percentage points



Source: INSSE

The government forecasting committee CNP predicts that real GDP growth will accelerate to 6.5% yoy this year, marginally up from 6% yoy registered in 2007. However, we expect that real GDP growth is more likely to decelerate slightly in 2008 to 5-5.5% yoy, as private consumption as well as investments are expected to slow down due to a high statistical base of the previous year and increasing costs of bank credit. On a positive note, the negative pressure of net exports is likely to decrease following further devaluation of the RON.

Industrial Output by Sector, ytd % yoy



Source: INSSE

In January 2008, industry reported robust 6% yoy growth of value added, driven by improving performance in manufacturing and supply of utilities compared to the same month last year. Manufacturing increased by 7% yoy, spurred by growth acceleration in food processing, metallurgy, machinery and equipment as well as by significant progress in automobile production. High consumption and growing food prices provoked growth of food processing by 10.7% yoy, up from 7.5% yoy a year ago. A flat growth trend of prices on international metal markets help to achieve a 1% yoy growth in metallurgy, compared to a decline in January 2007. Buoyant external and domestic investment demand stimulated growth in automobile production and machinery and equipment. Thus, machinery and equipment grew by 9.8% yoy

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer Rudkin

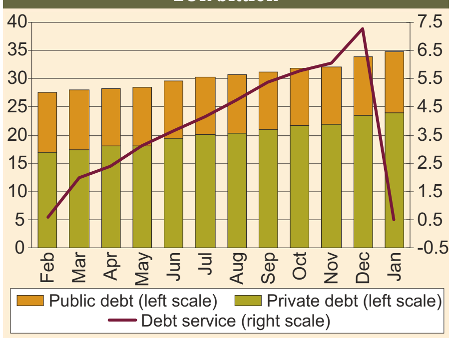
against a low statistical base in January 2007. At the same time, automobile production strongly accelerated to an impressive 48.6% yoy. On the downside, light and chemical industries declined in January by 3.2% yoy and 2.5% yoy correspondingly, suffering mainly from growing import competition.

Fiscal Policy

At the beginning of 2008, the government continued to pursue expansive fiscal policy aimed at improving social assistance in the year of parliamentary and local elections. The Romanian government was highly criticized for imprudent fiscal policy that contributed significantly to growing macroeconomic imbalances and accelerating inflation. Thus, in March, the government decided to curb the fiscal deficit for 2008 from the initially planned 2.7% of GDP to 2% of GDP (according to EU methodology).

Consolidated budget expenditures grew by a strong 55.4% yoy in nominal terms during January-February 2008, visibly accelerating against 27% yoy reported in the respective period last year. Meanwhile, the government managed to maintain a 0.21% of period GDP surplus of the consolidated budget over January-February 2008 (compared to 0.12% registered a year ago) thanks to robust performance of budget revenues. Consolidated budget revenues increased by 56.5% yoy in January-February, marginally outpacing a growth rate of budget expenditures. Execution of the income side of the consolidated budget significantly improved in the two months of 2008 against the respective period of the previous year, being favored by strong growth of fiscal revenues, which contributed about 57% to total budget revenues.

Medium and Long-term External Debt, EUR billion



Source: NBR

In January-February 2008 in particular, fiscal revenues surged by 58.6% yoy on the back of a 2.5 times increase in VAT receipts, which provided almost half of all tax revenues in the period. Buoyant growth of VAT proceeds occurred because of a low statistical base of the previous year and persisting domestic consumption. Collections of other taxes also demonstrated solid growth. Thus, proceeds from the corporate profit tax reported a robust 27% growth in nominal terms on the back of sound economic performance and increasing corporate earnings. Receipts of personal income tax grew by 35% yoy, benefiting from growing wages and high employment.

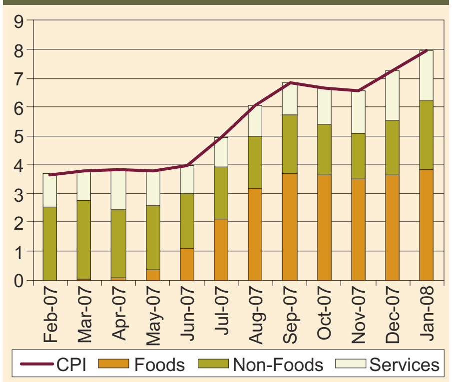
Medium- and long-term external debt continued to grow in January 2008, driven by increasing debt of both private and public sectors. A stock of external debt grew by 2.5% ytd in January, against a 4.4% ytd increase a month ago, and amounted to EUR 38 billion. A 2.4% ytd growth in private sector debt provided 2/3 of an increase in total external debt. Commercial banks, most of which are foreign owned, remained the main drivers of external debt growth. Another 1/3 was contributed by increasing debt of the government. Direct public debt had been growing for the third month in a row at an accelerating pace starting November 2007.

Monetary Policy

At the beginning of 2008, annual inflation resumed its acceleration growth pace after some leveling off in the last two months of 2007, as consumer prices advanced by 8% yoy in February 2008 against 6.6% yoy at the end of 2007. Although the upward inflation trend was still supported by continuing growth of prices for a certain range of food items, the main drivers of re-surging inflation in January-February were soaring fuel prices and service tariffs on the back of unfavorable world market developments. Thus, in January, inflation was spurred mainly by a 4.4% month-over-month (mom) hike in tariffs for phone services, most likely due to weakening of the RON. In February, the next increase in prices was provoked by a surge in prices of gas (8.2% mom) resulting from growing international prices. Besides, fuel prices increased by 2% in the two months. High fuel prices translated as well to increasing tariffs for water supply (4.2% ytd) in January-February and to transport tariffs (3.5% mom) in February.

Since the second half of 2007, a disinflation trend of the CPI was drastically reversed under the total influence of some external shocks as well as of structural problems of the economy. In September 2007, inflation processes brought evolution of the annual CPI and the core indexes above the upper-limit of the inflation target band. On the supply-side, a shortfall in agricultural output and surging food prices on world markets provoked a persistent increase in domestic prices for a wide range of food-stuffs including bread, vegetables, fruits, oil, meat, eggs and dairy products, which together accounted for 28% of the total consumer basket. Thus, prices were growing not only for foods with volatile prices but also for some products accounted for in the CORE2 basket. Additionally, increasing world prices for crude oil and natural gas caused growth of fuel prices and services tariffs. Moreover, the devaluation trend of the RON starting in the second half of 2007 also contributed to accelerating inflation processes, as weakening national currency implies a foreign-exchange pass-through of world inflation to domestic prices. However, the major risk for inflation developments from the supply-side is persistent growth of wages above gains in labor productivity, which lead to a constant increase in production costs and may afterwards result in a spiral of wages-prices.

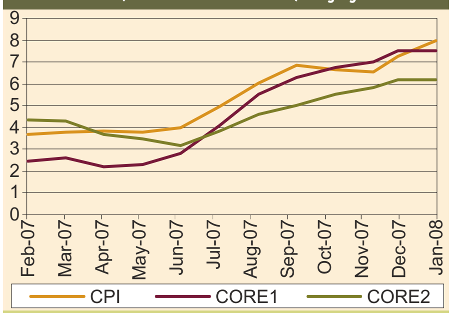
CPI by Component Contribution, % yoy



Source: INSSE

The inflationary pressure of supply-side factors was largely enhanced by persisting excess internal demand, supported by growing income of households, bank credit expansion, and a high budget deficit combined with the inefficient structure of budget spending and unreasonable income policy in the pre-election period. In this fragile inflationary environment, price growth easily produces inflationary expectations, which further strengthen inflationary pressure. The CORE2 index, a consumer price index excluding administered and volatile prices, gradually climbed up to 6.2% yoy in February 2008, accelerating from 5.8% yoy at the end of 2007, reflecting increasing demand pressure on prices. The persistent increase in CORE2 is a warning signal for the monetary authority, whose prime goal is to confine inflation by restraining excessive domestic demand.

CPI, CORE1 and CORE2, % yoy



Source: NBR

Rapid expansion of monetary aggregates also favored accelerating inflation. In January, broad money supply (M3) surged by 38% yoy driven by a record 67% yoy hike in non-government credit. In February, growth of M3 reported a marginal deceleration to

37% yoy, while growth of non-government credit slightly decelerated to 66% yoy on the back of further tightening of monetary policy. Over the last twelve months, bank credit expansion continued on the back of almost doubled growth pace of commercial loans in foreign currency. Forex-denominated credit remains more preferable for borrowers than RON-denominated in terms of interest rates, although further depreciation of the national currency implies higher costs of banking debt servicing. Thus, bank lending in foreign currency strongly accelerated to 89% yoy in February, up from 46.5% yoy reported a year ago, while lending in RON decelerated to 44.4% yoy from 64% yoy. Therefore, forex-denominated credit extended to 55% in the total stock of non-government credit as of February, compared to 48.5% a year ago. In February, forex-denominated term deposits of households accelerated to 36.4% yoy, against a 30% yoy growth reported for RON-denominated deposits. For the last few months, the share of term deposits in foreign currency grew to 34%. This increased vulnerability of the banking system, given that most Romanians earn income in local currency, which continued to depreciate. Credit expansion in Romania reported high rates on the back of accumulating net foreign bank liabilities, despite further tightening liquidity constraints at world financial markets, as most commercial banks are foreign-owned and have comparatively easier access to international funding. From the demand side, bank credit has been becoming more available for households, since real loan interest rates declined in 2007 due to increasing bank competition and accelerating inflation. Nevertheless, we expect that growth of non-government credit will slow down in the second half of the year because of growing costs of lending on international markets and the restrictive policy of the NBR.

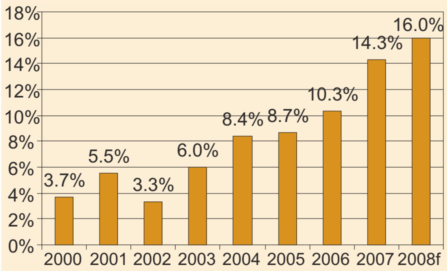
In response to unwrapping inflationary processes, the National Bank of Romania (NBR) further tightened monetary policy in January-February 2008. First of all, the monetary authority continued a series of increases in the key policy interest rate, up to 8% in January and then to 9% in February. To strengthen the effect of an increase in the interest rate, the NBR also pursued firm control over money market liquidity via large sterilization operations during November 2007-January 2008. As a result, the spread between the policy interest rate and interest rates on the money market began to narrow during January-February 2008. The NBR has revised upwards its forecast of the annual inflation rate for the end of 2008 to 5.9% yoy, expecting that the good harvest of 2008 would positively affect evolution of consumer prices and help to contain inflation developments. The annual inflation rate is projected to converge into the boundaries of the inflation target band (3.8±1%) in the second quarter of 2009, accounting for the lagged effect of monetary policy.

International Trade and Capital

In January 2008, the growth rate of (FOB) exports exceeded (CIF) imports for the second month in a row, likely due to continuing devaluation of the RON. According to preliminary estimates of the National Institute of Statistics, (FOB) exports grew by 17% yoy, amounting to EUR 2.4 billion as of January 2008, while (CIF) imports went up by 11% yoy, totaling EUR 3.8 billion. As a result, the (FOB/CIF) trade deficit increased by a comparatively modest 15% yoy against an impressive 93% yoy registered a year ago. The (FOB/FOB) trade balance expanded by only 32% yoy in January 2008, visibly decelerating from a 117% yoy surge reported a year ago, thus bringing the current account deficit to EUR 1.1 billion, up by 48% yoy compared to 117% yoy in January 2007.

The persistent external imbalances reflected in constant augmenting of the current account deficit remained the most fragile side of the Romanian economy and recently turned out to be a major risk for achieving a sustainable path of the economic growth. During the last two years, the current account gap deteriorated strongly to a level above 10% of GDP, approaching 14.3% of GDP at the end of 2007. The main factor causing sharp widening of the current account gap is excess domestic demand, supported by strong inflow of foreign capital. On the back of rapidly appreciating Romanian currency in 2005 — the first half of 2007 and strong domestic demand supported by credit expansion, (FOB) exports of goods was growing along a flat trend since 2005, while (CIF) imports of goods was increasing at an accelerating pace, thus exerting downward pressure on the merchandise trade balance. High import growth is justified in conditions of a developing and growing economy with high investment activity. However, an important problem of a fast deteriorating external balance is actually a problem of financing. Coverage of the current account deficit with FDI dropped roughly by a half in 2007 to 42% from 91% in 2006 following a rather sharp widening of the current account gap. In the context of the global credit squeeze, the debt-dependent external deficit implies increasing vulnerability of the Romanian economy to external shocks. Because of this, foreign investor sentiments towards Romania deteriorated in the second half of 2007, which was reflected in the downgrading of Romania's ratings by international agencies. It also resulted in significant outflow of short-term capital and sharp devaluation of the local currency.

Current Account Deficit, a share of GDP (%)



Source: NBR

At the same time, the inflow of long-term capital, both borrowed capital and foreign direct investments, continued to post solid growth, which demonstrates good investors' perception of Romania's economic growth in the medium-run. Thus, net inflow of FDI totaled EUR 695 million in January, increasing by a strong 76% yoy. FDI inflow financed 61% of the current account deficit in January, compared to 51% a year ago. The beginning of 2008 was also marked with the number of promising M&A deals, which may serve as a sign of another year of robust FDI inflow. The most important were the finalization of Ford's purchase of the former Daewoo car plant and Heineken's purchase of beer marker Bere Mures. Also, General Motors and Daimbler included Romania in their short-list for placement of production capacities. Therefore, the government's expectation that net FDI inflow in 2008 will reach at least the level registered in the previous year (EUR 7 billion) is likely to be realized.

Other Developments Affected Investment Climate

In March 2008, the Parliament approved a new electoral law calling for the establishment of a combined majority-proportional election system instead of a proportional one. According to the new electoral law, elections are carried out in a single round. Independent candidates should win more than 50% of the votes in an electoral college (electoral area) to enter the Parliament. Political parties should overcome a 5% threshold and win more than 50% of votes in at least six electoral colleges to enter the Chamber of Deputies and at least three colleges to enter the Senate. The new electoral law is a kind of compromise between the President and the government, which is expected to diminish political tensions. However, as many experts claim, the new electoral system is unlikely to significantly affect the outcome of the coming parliamentary election scheduled for fall 2008 and thus to improve political stability in the country.