Romania
Macroeconomic Situation

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Summary

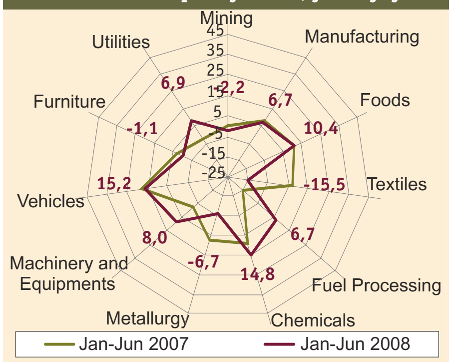
- Real GDP growth accelerated to 9.3% year-over-year (yoy) in the second quarter of the year, bringing the cumulative real growth to 8.8% yoy in January-June 2008.
- Industrial production grew by a robust 5.8% yoy in the first half of 2008, supported by healthy performance of manufacturing and utilities supply.
- The consolidated budget improved to a deficit of 0.64% of GDP as of July.
- The stock of medium- and long-term (M&LT) debt grew by 16.5% in the first half of the year.
- Consumer prices accelerated to 0.69% month-over-month (mom) in July, driving annual price growth to 9% yoy.
- In July, the local currency appreciated by 3%, approaching 3.54 RON/EUR at the end of the month.
- Monetary aggregates reported slower dynamics in July. Non-government credit decelerated to 55.8% yoy, while broad money supply (M3) slowed to 34% yoy.
- In the first half of the year, FOB exports in goods increased by 18% yoy, while CIF imports in goods grew by 15.3% yoy. The FOB/CIF merchandise trade deficit widened to EUR 10.8 billion over January-June, up by a comparatively moderate 9.2% yoy.
- The current account deficit increased to EUR 7.98 billion in the first half of the year, up by 8.5% yoy.
- The European Commission (EC) published a report devoted to the assessment of Romania's progress in judicial reform and the fight against corruption under the Cooperation and Verification mechanism.

Economic Growth

Economic growth in Romania kept developing along an upward trend in the first half of the year, contrary to previous expectations of an economic slowdown this year. According to preliminary data from the National Institute of Statistics (INSSE), real GDP growth accelerated to 9.3% yoy in the second quarter of the year, up from 8.2% yoy reported in the first quarter, bringing cumulative real growth to 8.8% yoy in January-June 2008. Buoyant economic growth was underpinned by good performance registered in all key economic sectors. Construction, the most dynamic economic driver, continued to boom, as value added in the sector grew by 33.3% yoy during the first half of the year. Impressive growth of construction was spurred by high infrastructure investments as well as by speculative housing investments in city apartments. The services sector, primarily trade and transportation, increased by 7.6% yoy, remaining the main contributor to GDP growth. The leading position of services was determined by persistent domestic consumption and high investment activity in the country. Growth in the agricultural sector rebounded to 2.6% yoy on the back of a good harvest this year and the low comparative base of the previous year.

Industrial production grew by a robust 5.8% yoy in the first half of 2008, supported by healthy performance of manufacturing and utilities supply. In particular, manufacturing output increased by 6.7% yoy in January-June. Manufacturing continued to experience structural changes with declining light industry (textiles, ready-made clothing) and the expansion of food processing, chemicals and automobile production. Meanwhile, the current year was marked with the resumption of fuel processing and machine-building and with a recession in metallurgy. Thus, food processing grew by 10.4% yoy during January-June, demonstrating almost flat growth dynamics over the last two years. Even robust performance of food processing was supported by buoyant consumption demand in the country. At the same time, the chemical industry accelerated to 14.8% yoy, significantly encouraged by growing exports of plastics and fertilizers. Automobile production remained the leading industry in terms of growth, increasing by 15% yoy in the first half of the year, driven by strong FDI inflows. At the same time, automobile production posted some deceleration due to modernization and reconstruction of major production capacities in the industry. At the same time, performance of machine building and equipment improved to 8% yoy output growth, compared to a 2.5% yoy decline registered a year ago. Investment activities in the economy aimed at a renewal of production facilities favored positive developments in machine-building. Fuel processing grew by 6.7% yoy in January-June, improving from a 15.4% yoy drop registered in the same period of last year. The industry reported a revival on the back of the technological upgrades of production capacities and increasing prices for fuels.

Industrial Output by Sector, ytd % yoy



Source: INSSE

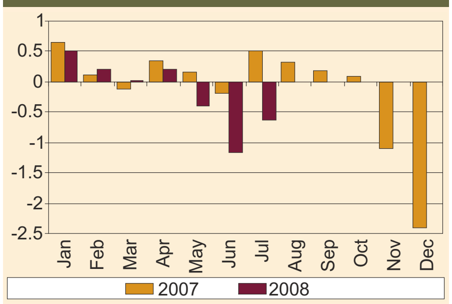
On the downside, light industry continued to stagnate, as textile manufacturing decreased by 15.5% yoy in the first half of the year, while clothing production fell by 2.7% yoy. Metallurgy, one of the most important industries of the Romanian economy, has been contracting since the beginning of the year. Over January-June, metallurgy fell by 6.7% yoy against a healthy 6.9% yoy increase reported for the respective period of last year. The recession in metallurgy has been occurring contrary to increasing domestic demand for metal products of booming construction and machine-building. A decline of metallurgy can be attributed primarily to scaled modernization of obsolete technologies in the industry and to stricter environmental requirements of the EU. Besides, metallurgy in Romania highly depends on imports of raw materials such as metalliferrous ore and coking cole due to very small domestic resources. High international prices on energy and raw materials seriously affected the competitiveness of domestic production of low-valued metal products. Although soaring global prices prompted increasing exports of metallurgical products, Romania turned into a net importer from a net exporter of metals.

Thus, economic growth remains strong despite monetary tightening and the fragile external environment, as the Romanian economy continues to enjoy advantages from the presence of foreign assets. On a negative note, robust economic growth on the back of the widening current account deficit and accelerating inflation clearly signals over-heating. Thus, further economic developments depend highly on labor shortages, growing internal and external imbalances.

Fiscal Policy

In 2008, Romania's fiscal performance, as the consolidated budget deficit deepened to 1.2% of full-year projected GDP for the first half of the year. However, at the end of July, the consolidated budget improved to a deficit of 0.64% of GDP. Fiscal loosening and monetary expansion led to significantly accelerating growth of both revenues and expenditures. Thus, budget expenditures grew by a strong 43.9% yoy in nominal terms during January-July, amounting to RON 96.4 billion, while budget revenues increased by 35.7% yoy and totaled RON 96.3 billion.

Consolidated Budget Balance, % of full year GDP



Source: Ministry of Economy and Finance

As of June 2008, the stock of medium- and long-term (M&LT) debt grew by 16.5% from the beginning of the year. Despite unfavorable developments on international financial markets, Romania remained sufficiently supplied with long-term financial resources from abroad. Investors' diminished risk aversion, better than expected macroeconomic performance in the first quarter of the year, and higher money market yields attracted strong foreign capital inflows to Romania during April-June. Legal entities and financial groups with foreign capital, which represent a prevailing part of the domestic market, have been taking opportunities to attract more capital from the global debt markets during the continuing credit crunch. The private sector, which holds 63.5% of Romanian long-term foreign liabilities, raised their M&LT exter-

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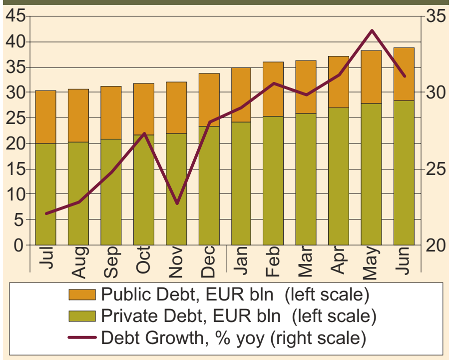
nal debt by 14% year-to-date (ytd), providing more than half of the increase in total M&LT debt stock. The government also increased its external debt to secure enough financing of the budget deficit and servicing of existing public debt. Public external debt grew by 3.7% ytd in the first half of the year, contributing almost one fifth to the accumulation of Romanian external debt. Meanwhile, M&LT deposits of non-residents in the Romanian banking system surged by 85% ytd in January-June, resulting in a doubled share of foreign deposits in the M&LT debt stock (13% as of June 2008).

Medium and Long-term External Debt



Source: Ministry of Economy and Finance

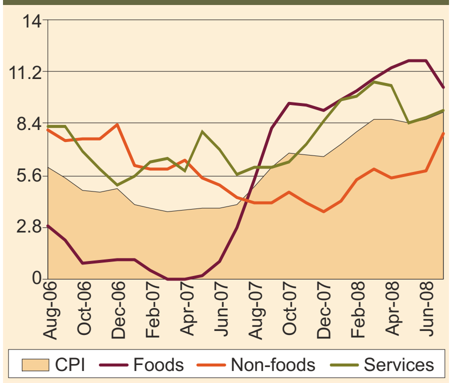
Monetary Policy

In July 2008, consumer prices grew by 0.69% mom. Thus, monthly inflation more than doubled in July, compared to 0.28% mom registered a month before. July's inflation was spurred by a 2.3% mom increase in non-food prices, which achieved a 3-year high and outweighed the deflation effects of foods and services. A surge in non-food prices was caused by a scheduled increase in administratively regulated prices for utilities, and growing prices for fuels and tobacco. At the same time, food prices deflated by 0.68% mom, mainly due to a seasonal decline in prices for fruits and vegetables. Services tariffs fell by 0.3% mom, as the recent appreciation of the RON led to declining tariffs for phone services.

In July, annual price growth advanced to 9% yoy. Food prices declined to 10.4% yoy, while non-food prices and service tariffs continued to grow and reached 7.8% yoy and 9% yoy respectively. Meanwhile, food inflation remained the major contributor to the overall growth of consumer prices in Romania due to the high statistical base of the previous year. Prices for non-foods and services accelerated, significantly driven by high world prices for energy resources and the RON, weakening by 12% yoy as of July. Domestic consumption, backed by growing incomes and credit expansion, continued to stimulate inflationary developments on the demand side.

Annual price growth was more than double the NBU's inflation target despite monetary tightening. Increasing the key policy interest rate to 10.25% in August and sterilization of excess liquidity on the money market resulted mostly in growing lending rates in local currency. However, credit expansion remained spurred by loans in foreign currency. Thus, the monetary authority decided to concentrate its policy efforts on stricter regulations of bank lending in foreign currency, in particular, to households. From mid-August, the central bank strengthened requirements for income levels and collateral of individual borrowers.

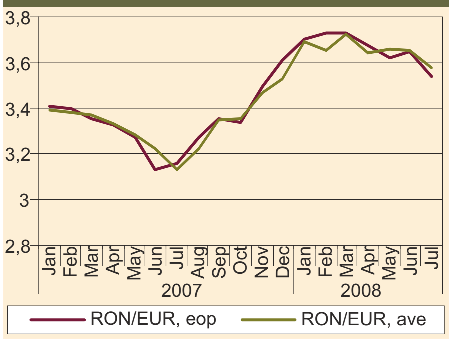
CPI by Component % yoy



Source: INSSE

High capital inflows and moderately deteriorating external gaps led to the appreciation of the Romanian leu by 5% during April-July. In July alone, the local currency appreciated by 3%, approaching 3.54 RON/EUR at the end of the month. Thus, the RON returned to the level it held in December 2007.

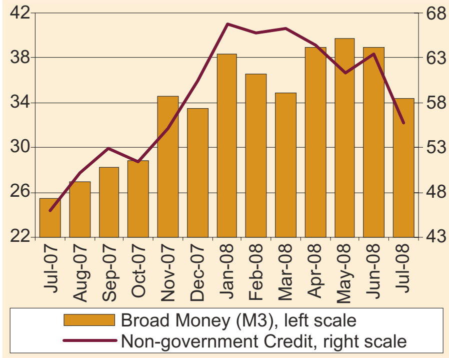
RON/EUR Exchange Rate



Source: NBR

The notable appreciation of the RON in July is likely to be the main reason behind slower dynamics of monetary aggregates in the month. Thus, growth of forex-denominated non-government credit grew by 73% yoy in July, visibly decelerating from 89% yoy reported in the previous month, which can be explained to a significant extent by valuation adjustment. Meanwhile, growth of RON-denominated credit remained at almost the same level - 39% yoy, being restrained mostly by tight monetary policy. Therefore, non-government credit slowed to 55.8% yoy in July, down from 63.4% yoy in June, driving broad money supply (M3) to 34% yoy growth, decelerating from 39% yoy a month before. On another positive note, slower growth of money supply occurred primarily on the back of the deceleration of narrow money (to 42% yoy in July, down from 52% yoy a month before), while term deposits maintained the same growth rate (25.6% yoy in July compared to 25% yoy in June), which implies lighter monetary pressure on inflationary developments.

Money Supply and Non-Government Domestic Credit, % yoy



Source: NBR

International Trade and Capital

According to preliminary data of the INNSE, FOB exports in goods grew by a vigorous 21.2% yoy in June, while CIF imports in goods increased by 17% yoy in June, remaining slightly below exports. In the first half of the year, merchandise exports increased by 18% yoy, up from 11.4% yoy registered in the respective period of last year. At the same time, merchandise imports grew by 15.3% yoy, strongly decelerating from 29% yoy reported a year ago. Some improvement of export performance combined with a significant slowdown of import growth resulted in the deceleration of the trade deficit deterioration. Over January-June, the FOB/CIF merchandise trade deficit widened to EUR 10.8 billion, up by 9.2% yoy.

Such improvement in foreign trade dynamics cannot be completely attributed to favorable developments of the Romanian leu. The changing structure of foreign trade by commodity can shed some light on trade dynamics. According to the INNSE, export growth in the first five months of the year was principally driven by mineral products, in particular, by petroleum and petroleum products. Exports of minerals accelerated to a strong 82% yoy growth during January-May, up from a 40% decline in the respective period of last year, contributing around half of the export increase. Almost completed modernization of production capacities in the fuel processing industry spurred exports of petroleum benefited from high world prices for fuels. Exports of machinery and equipments remained another significant driver of export growth, increasing by 23.5% yoy in the first five months of the year. Meanwhile, exports of vehicles

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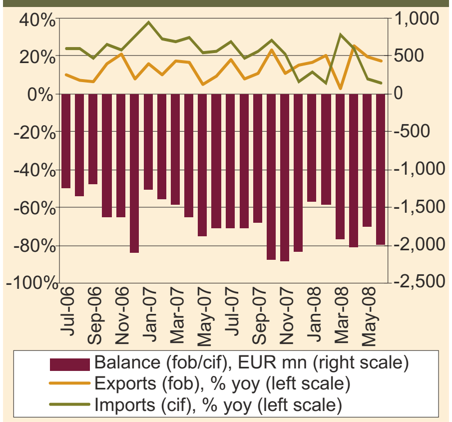
and metallurgical products significantly decelerated compared to the same period of the previous year. Thus, exports of vehicles slowed to 10.5% yoy, down from 30% yoy a year ago, due to some slowdown of automobile production. Meanwhile, export of metallurgy contracted in volume, following an output decline in the industry, but grew by 11.5% yoy in nominal terms thanks to growing prices on global metal markets. Although metallurgical products still accounted for 17% of total merchandise exports, Romania turned into a net importer of metal products from a net exporter. However, the worsening performance of traditional Romanian exports should be regarded as temporary, as the country possesses a high export potential due to high FDI concentration.

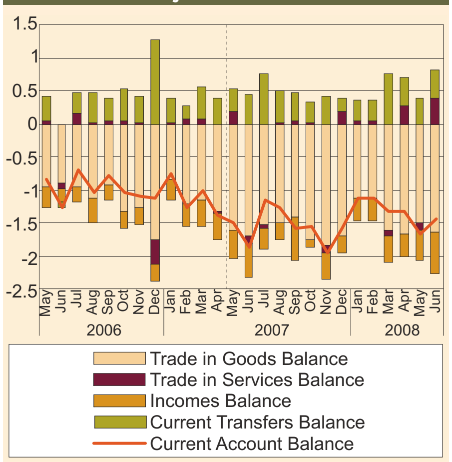
Monthly Foreign Trade Balance



Source: INNSE

On the imports side, growth was primarily supported by mineral products (in particular, by fuels and gas) surging by 42% yoy in January-May due to historical highs on global fuel markets. At the same time, growth of other major imports such as machinery and equipment, vehicles, high-value metal articles, and chemical products (mainly pharmaceuticals) visibly decelerated compared to the same period of the previous year, dampening the overall growth of merchandise imports.

Current Account Components, monthly flows EUR billion



Source: NBR, The Bleyzer Foundation

The widening foreign trade deficit was the main reason behind Romania's deteriorating external balances. According to the NBR, the current account deficit increased to EUR 7.98 billion in the first half of the year, up by 8.5% yoy. The deficit was completely covered by long-term resources, with FDI financing 61% of the gap. However, the current account deficit remained rather unsustainable due to a high ratio to GDP and a significant reliance on external debt financing.

Other Developments Affecting the Investment Climate

The European Commission (EC) published a report devoted to the assessment of Romania's progress in judicial reform and the fight against corruption under the Cooperation and Verification mechanism. According to the report, Romania has achieved little progress in the reforms, as the performance of the judicial system is hampered by a range of factors, including selective application of law and the excessive use of emergency decrees. Thus, the implementation of the reforms still requires further monitoring. The Commission recommended that government complete a new Criminal Procedure Code and make progress on the draft Criminal Code. Also, the Commission harshly criticized amendments to the Criminal Procedure Code proposed by the Parliament's opposition and recommended these amendments be dropped as they undermine legal certainty in the country.