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Summary

- Romania's leading economic sectors, such as construction, services and industrial production, continued to report robust growth in August 2008. Industrial output grew by 4.9% year-over-year (yoy) in January-August.
- The consolidated budget deficit deepened to 1.08% of full-year projected GDP over January-August 2008.
- The Cabinet approved a program for public debt policy for 2008–2010.
- Growth of medium- and long-term (M&LT) foreign debt accelerated to 40% yoy as of August 2008.
- Headline inflation gradually decelerated to 7.3 % yoy in September 2008.
- Non-government credit growth slowed to 50.4% yoy and 50.5% yoy in August and September, driving down growth of the broad money supply (M3) to 30% yoy and 31% yoy respectively.
- The FOB/CIF trade deficit widened by 26.5% yoy, amounting to EUR 14.6 billion as of August 2008.
- Following a significant slowdown of merchandise trade deficit growth, the current account deficit reported a contraction in January-August 2008 for the first time in the last few years, shrinking by 2.2% yoy.
- The international agency Fitch downgraded Romania's sovereign ratings to "BB+" from "BBB" for long-term foreign currency loans and to "BBB-" from "BBB+" for long-term lei-denominated loans.

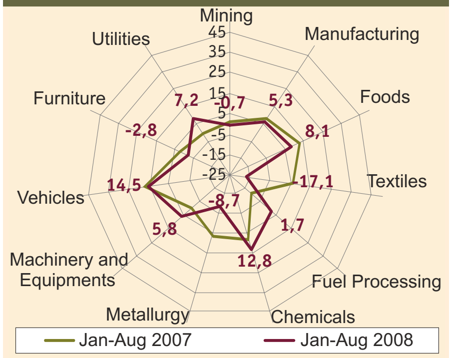
Economic Growth

In the first half of 2008, the Romanian economy demonstrated rather impressive resilience to international liquidity turmoil and economic slowdown in Europe. Real value added growth accelerated to 8.8% yoy in January-June, which is the highest growth rate in Europe. The still high inflow of long-term foreign capital, on-going credit expansion and fiscal loosening continued to spur domestic investment and consumption demand, the main drivers of economic growth in Romania. On the supply side, economic growth was underpinned by robust developments in construction, services and industrial production.

According to the National Institute of Statistics (INSSE), construction maintained its high rate of growth in August 2008. The volume of construction works skyrocketed by 28% yoy, with increases in all types of construction works. At the same time, the services sector, which contributes about half of nominal GDP, kept reporting healthy developments backed by vigorous domestic demand. In particular, retail trade grew by 13.3% yoy in August.

At the same time, industrial production has been gradually decelerating. After picking up to 7.3% yoy during January-April, growth of industrial output slowed to 4.9% yoy in January-August, which is the lowest rate of industrial growth since 2005. The slowdown was determined by worsening performance of manufacturing, which continued to post robust growth but decelerated to 5.3% yoy, down from 7% yoy reported a year ago. This was attributed mainly to a continuing contraction in metallurgy, which declined by 5.8% yoy in the first eight months of the year. At the same time, other leading Romanian industries remained in good shape or even improved their performance. Food processing and automobile production registered robust growth of 8.1% yoy and 14.5% yoy respectively, although slightly decelerating from the previous year. Production of machinery and equipment grew by 5.8% yoy in January-August, recovering from a 0.3% yoy decrease in the respective period of last year. Fuel processing improved to 1.7% yoy, though reporting rather volatile and ambiguous dynamics. The chemical industry accelerated to 12.8% yoy, favored by growing exports. Industrial growth was also restrained by an output decline in mining, which fell by 0.7% yoy during January-August. On a positive note, utilities supply has obviously recovered from a recession in the previous year, increasing by 7.2% yoy.

Industrial Output by Sector, ytd % yoy



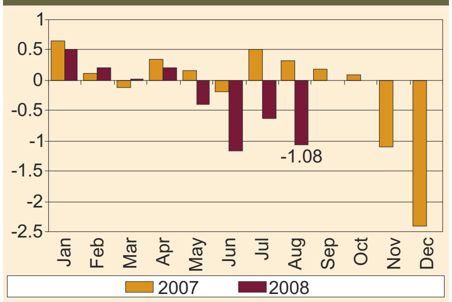
Source: INSSE

Strong economic growth in Romania was combined with one of the highest inflation rates in Eastern Europe and an unsustainable current account deficit of around 15% of GDP, which signals economic over-heating and inevitable growth deceleration. Moreover, the worsening international liquidity crisis, a reduction of foreign capital inflow related to this and further slowdown of the world economy will seriously challenge economic growth in the second half of the year. All of this implies that real GDP is likely to grow around 7% yoy at the end of 2008, compared to 8.8% yoy in the first half of the year.

Fiscal Policy

In the first eight months of the year, the Romanian government's loose fiscal policy led to further deepening of the consolidated budget deficit to 1.08% of full-year projected GDP (RON 5.1 billion). According to the Ministry of Finance and Economy, expenditures grew by a nominal 41% yoy in January-August, amounting to RON 113 billion, while revenues increased by 33% yoy, totaling RON 107 billion. Fiscal expansion was stimulated primarily by growing current expenditures, in particular by a 41% yoy increase in social transfers. Despite growing macroeconomic imbalances, the Romanian government continued to run loose fiscal policy mainly under political pressure from the largest opposition party of the Social Democrats (PSD). Moreover, social support expenses are expected to continue to grow, as the government introduced a 20% pension hike on October 1st, a month earlier than planned.

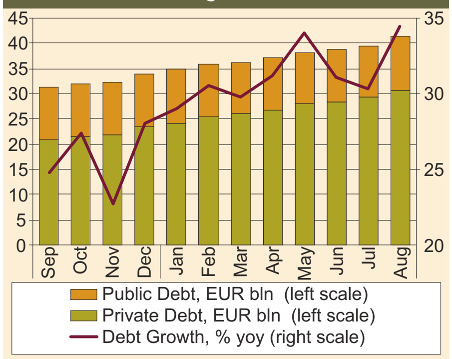
Consolidated Budget Balance, % of full year GDP



Source: Ministry of Economy and Finance

Over January-August, consolidated revenues growth was spurred by increasing nominal tax collections, in particular by a hike in VAT proceeds. Tax collections grew by a nominal 33.5% yoy in the first eight months of the year, almost twice as high as in the same period of last year. VAT income surged by 50% yoy in the first eight months of the year (up strongly from 7.3% yoy in the respective period 2007). High growth of domestic trade, monetary expansion and accelerating inflation led to a significant improvement in nominal VAT proceeds. Meanwhile, collections from the enterprise profit tax (EPT) and personal income tax (PIT) increased by 31% yoy and 35% yoy respectively, reporting some year-over-year deceleration due to a high comparative base.

Medium and Long-term External Debt



Source: Ministry of Economy and Finance

The Cabinet approved a public debt policy program for 2008–2010. The program specifies maximum shares in the total public debt for securities issued in local and foreign currencies (55% for debt in RON, 40% for debt in EUR), a gradual increase of domestic currency debt maturity to 30 years and the issue of Yen-denominated bonds in 2009–2010. According to the program, the government is planning to raise the public debt stock gradually, maintaining an almost unchanged ratio of public debt to GDP. However, the realization of the program and issue of new securities will likely be restrained by tightening of both the domestic and international money market.

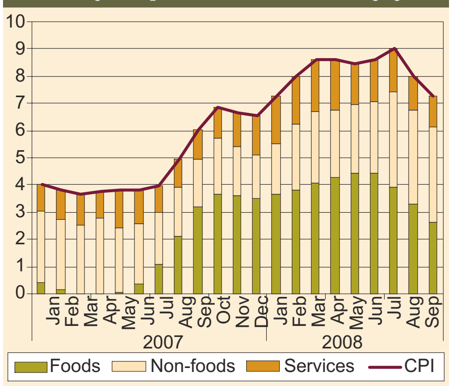
Romania significantly increased their external long-term borrowings in 2007 to finance its rapidly widening foreign trade gap, which was accompanied by shrinking FDI inflows. In 2008, growth of medium- and long-term (M&LT) foreign debt even accelerated to 40% yoy as of August 2008, up from 31% yoy reported a year ago, as the private sector continues to intensively attract foreign debt capital. Inflow of foreign debt was helped by Romania's solid economic performance in 2008 and rising domestic interest rates. Thus, private sector debt surged by 50.5% yoy, while public and publicly guaranteed debt increased by a modest 3% yoy in August. The stock of M&LT external debt amounted to EUR 47.5 billion, with an increasing share of the private sector to 65%. Despite rather impressive debt growth, the ratio of M&LT external debt to GDP remained one of the lowest in Southern and Eastern Europe, slightly exceeding 20% of GDP. The relatively low level of external debt suggests good chances for Romania to service its external liabilities and weather the international financial turmoil. Moreover, low indebtedness also suggests good future prospects for attracting foreign debt.

Monetary Policy

Tighter monetary policy, appreciation of the RON and a good harvest this year caused annual inflation to switch to a downward trend. After reaching a 3-year high of 9% yoy in July, headline inflation gradually decelerated to 7.3% yoy in September 2008.

The deceleration of consumer price growth was attributed mainly to food disinflation in July-September. Food prices slowed to 7% yoy in September following a good harvest and, therefore, lower prices for vegetables, fruits and oil. On a monthly comparative basis, food prices declined in July, but renewed their growth in August and September, due to growing prices for meat, dairy products and eggs. On a negative note, non-food and service prices increased by

CPI by Component Contribution, % yoy

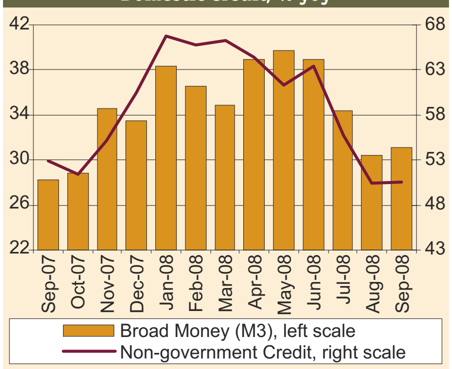


Source: INSSE

7.8% yoy and 6.6% yoy respectively in September, as high global energy prices passed through to internal fuel and utilities costs. Thus, despite its recent easing, inflation still remained well above the 4.8% yoy target of the NBR, propelled by substantial annual growth of food and fuel prices.

Apart from supply-side shocks, inflation was also spurred by rapid monetary expansion. Though decelerating in July-September, growth of non-government credit kept its rather high pace — at an average 60.5% yoy over the first nine months of the year, driving expansion of broad money supply. Anti-inflation efforts of the National Bank of Romania (NBR) were concentrated mainly on restraining growth of monetary aggregates through raising the key policy interest rate. However, the growing reference rate did not influence credit costs and therefore credit growth in the country, since credit expansion was funded mainly from external sources. Only since July, credit and, therefore, money supply, started to decelerate, triggered by the appreciation of the RON, observed through April-August month-over-month and stricter requirements for borrowers, introduced in August. Thus, non-government credit growth slowed to 50.4% yoy and 50.5% yoy in August and September, driving down growth of broad money supply (M3) to 30% yoy and 31% yoy respectively.

Money Supply and Non-Government Domestic Credit, % yoy

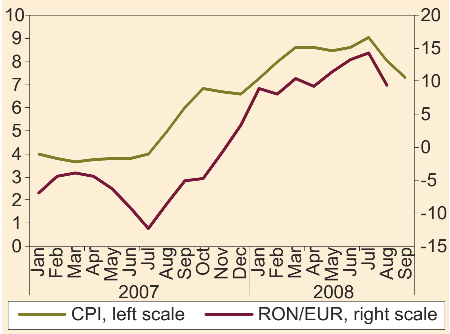


Source: NBR

Inflation developments were also positively affected by the recent changes in the RON/EUR exchange rate through the other two channels: directly affecting tariff growth of phone services, which is denominated in Euros, and affecting relative demand for domestic and imported goods. Although the RON remained weaker against the EUR by 8.3% yoy in September, it appreciated by 2.6% compared to March 2008, thus contributing to taming inflation during the last several months.

Regarding the last positive inflation developments, the NBR set a forecast for consumer price growth at 6.6% yoy at the end of 2008. However, a new cycle of the world financial crisis is likely to trigger significant outflow of short-term capital, exerting deprecia-

CPI and RON/EUR exchange rate, % yoy



Source: INSSE, NBR

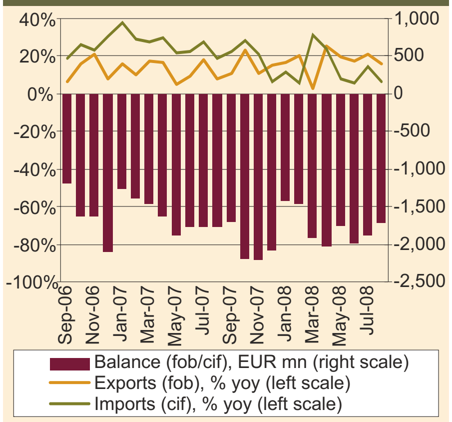
tion pressure on the Romanian currency. Thus, the rapid RON depreciation is expected to spur price growth and deteriorate the current inflation outlook. Serious inflation risks also stem from excessive fiscal expansion. On a positive note, inflationary processes will be restrained by decelerating credit and money supply growth.

International Trade and Capital

In 2008, the weakening RON favored improving dynamics of merchandise foreign trade, as exports in goods have been outpacing import growth. FOB merchandise exports grew by 18.3% yoy in January-August 2008, while CIF merchandise imports increased by 14.6% yoy according to preliminary data of the National Institute of Statistics (INNSE). At the same time, it seems that the depreciating currency contributed to dampening of imports rather than to spurring of exports. During the first eight months of the year, exports grew by an average 17% yoy per month versus 12.5% average monthly growth reported in the corresponding period of the previous year. Meanwhile, imports increased by an average 12% yoy per month, down from 27% yoy. A possible explanation is that many imported commodities compete with locally produced goods. This means that a depreciation of the national currency increases costs of imports, which weakens sales.

Robust merchandise export performance was underpinned primarily by a 24% yoy increase in exports of machinery and equipment, 78% yoy in mineral products, and 17% yoy in vehicles. A substantial slowdown of merchandise imports occurred on the back of a visible deceleration of imports of all major imported commodities. Imports of machinery and equipment, accounting for 23% of total imports, grew by 6.4% yoy in January-July, significantly down from a vigorous 36.5% yoy registered in the respective period of last year. Imports of metal products decelerated to 15% yoy, strongly down from 61% yoy. Imports of minerals shrank their growth rate by almost twice — to 48% yoy. Imports of vehicles slowed to 17% yoy, down from 66% yoy. Remarkably, the deceleration occurred primarily for groups of investment and consumer goods, while imports of intermediate goods slowed only marginally. Thereafter, the FOB/CIF trade deficit widened by 26.5% yoy, amounting to EUR 14.6 billion as of August 2008.

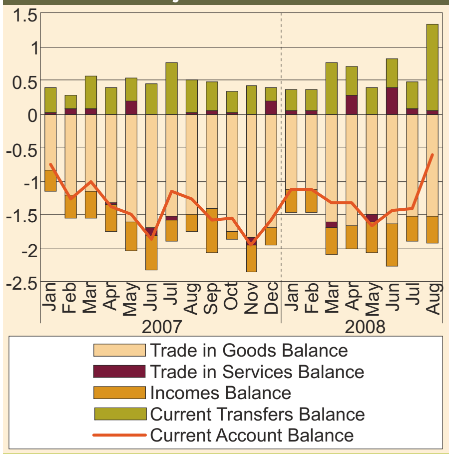
Monthly Foreign Trade Balance



Source: INNSE

Following a significant slowdown of merchandise trade deficit growth, the current account deficit reported a contraction in January-August 2008 for the first time in the last several years. The current account gap shrank by 2.2% yoy versus an 11.9% yoy widening in January-July. This visible improvement was also supported by significant growth of services and current transfer surpluses. Services surplus surged by 4.6 times over the first eight months of the year, amounting to EUR 688 million as of August. Inflows of current transfers posted almost $1.5 billion in August alone due to a regular tranche of EU funds, which spurred the cumulative surplus of current transfers up by 26% yoy over January-August. Although the depreciating currency led to improving of external balances, the current account deficit remained rather unsustainable, accounting for around 15% of GDP.

Current Account Components, monthly flows EUR billion



Source: NBR, The Bleyzer Foundation

Over the first eight months of the year, high investor interest in Romania, a favorable business climate and good macroeconomic performance provided a large inflow of foreign capital to Romania, which helped finance the current account gap with long-term resources. In particular, net inflow of foreign direct investments (FDI) grew by 60% yoy in January-August, financing 65% of the current account gap. Thanks to a moderating current account gap and still substantial inflows of foreign capital, the NBR increased its forex reserves by 5.4% yoy to EUR 25.9 billion as of August 2008.

Other Developments Affecting the Investment Climate

The international agency Fitch downgraded Romania's sovereign ratings to "BB+" from "BBB" for long-term foreign currency loans and to "BBB-" from "BBB+" for long-term lei-denominated loans, citing vulnerabilities in the emerging markets, spurred by the global crisis and the countries' high current account deficits. The rating Outlook is Negative. The rating agency also downgraded Romania for short-term foreign currency debt to "B" from "A3" and the country ceiling to "BBB" from "A-". Thus, Romania was switched from the category of countries with an "investment grade" and to the "speculative grade" category.