

## Macroeconomic Situation

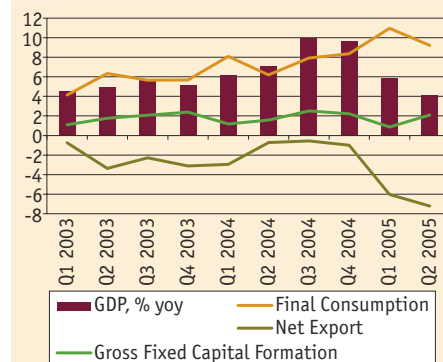
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### Summary

- Over the second quarter (2Q) of 2005, the Romanian economy slowed to 4.1% yoy growth due to sharp deceleration of exports and slower consumption growth.
- The consolidated budget reported a 0.56% of GDP surplus over January-August; September, however, showed deterioration of consolidated budget revenues.
- Inflation continued to decline, reaching 8.5% yoy in September.
- The National Bank of Romania (BNR) reduced its policy rate to discourage speculative inflow of foreign currency and introduced regulations to contain robust growth of credit to the private sector and improve the private lending structure.
- The current account deficit expanded by 55% yoy, reaching EUR 3.2 billion over the first eight months of the year;
- The European Commission released its annual comprehensive monitoring report on Romania. Accession on January 2007 is still possible, depending on reform speed.
- At the end of October, the IMF mission arrived in Bucharest to discuss the status of the Precautionary Stand-By Arrangement.

compared with a 12.1% yoy increase in the previous quarter. The deceleration may be attributed to slower growth of real wages in 2Q 2005. On a positive note, investments continued to recover, expanding by 9% yoy from 5.2% yoy in 1Q 2005 and a modest 2.7% yoy in 4Q 2004.

Contributions to GDP Growth, percentage points



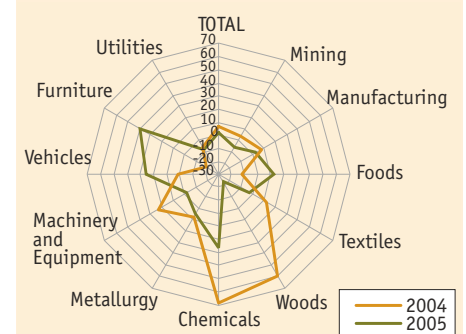
Sources: INSSE, The Bleyzer Foundation

On the supply side, the economic growth slowdown is explained by a contraction in agriculture and weaker performance of the industrial sector. Agriculture, affected by the spring floods, lost 10.4% yoy in the second quarter. Unfavorable export conditions and high energy prices resulted in an industrial growth slowdown. Value added growth in industry decelerated to a modest 2.6% yoy in 2Q 2005, down from a 5% yoy increase in the previous quarter. On the upside, services (accounting for about 50% of the gross value added) advanced by 7.1% yoy in 2Q05, compared to 6.8% yoy growth in 1Q 2005 and a 6.1% yoy increase last year.

Following a three month decline, industrial output rebounded in August, reporting 1.5% yoy growth. As a result, cumulative growth accelerated slightly to 1.4% yoy, up from a modest 1.3% yoy over January-July. The reversal of the downward trend occurred thanks to a rebound in the food industry and metallurgy, and faster growth in fuel processing and wood. After contracting for three months in a row, food processing advanced by about 5%

yoy in August. On the back of stabilized world prices for steel, metallurgical output increased by about 5% yoy in August compared with a 17.5% yoy decline in the previous month. Benefiting from high world commodity prices, the growth in fuel and wood processing accelerated to 30% yoy and 26% yoy in August vs. 11% yoy and 4% yoy respectively in July. On the downside, chemicals and utilities continued to contract, declining by 24% yoy and 8.5% yoy, respectively. Textiles and apparels kept declining, facing stronger competition on the EU markets.

Industrial Output Growth by Sector in January-August, % yoy



Sources: INSSE, The Bleyzer Foundation

In September, the National Commission for Prognosis (CNP) downgraded the GDP forecast for this year to 5.7% yoy, down from the previous 6% yoy. However, considering current real sector performance, even this forecast looks too optimistic. The GDP growth slowdown may endanger execution of budget parameters and raises concerns regarding the country's growing external imbalance.

### Fiscal Policy

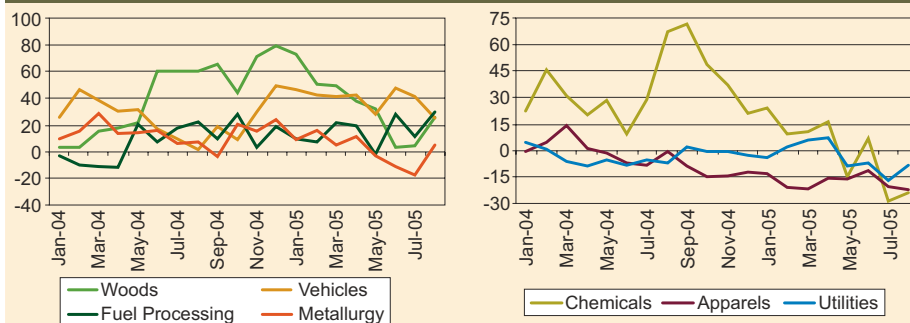
According to the National Fiscal Administration Agency (ANAF), the consolidated budget reported a surplus of about RON 1.58 billion (EUR 450 million), representing 0.56% of expected full-year GDP. For the same period last year, the consolidated budget showed a deficit of about 0.2% of GDP. Favorable budget performance so far was achieved thanks to improved tax collections and tight control over expenditures. Over the period, the latter grew by a moderate 13% yoy to RON 52.3 billion (about EUR 15 billion). Budget revenues grew by 14.7% yoy to RON 54 billion (EUR 15.4 billion). As in previous periods, the largest increase was reported for VAT receipts. VAT, accounting for about 25% of total budget revenues, grew by 31% yoy over the period reflecting strong consumption.

Preliminary data for September showed that nine-month consolidated budget revenues grew by 14.5% yoy. This figure suggests fairly poor revenue performance in the third quarter. In real terms, budget revenues growth declined from

### Economic Growth

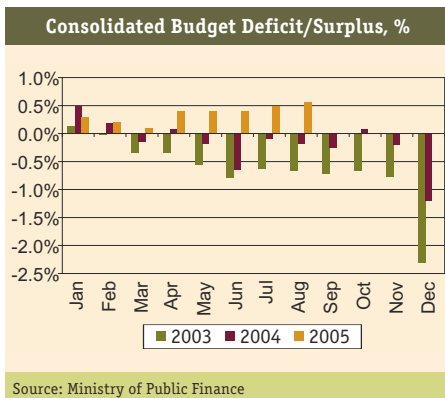
According to the National Institute of Statistics (INSSE), Romanian economic growth slowed to 4.1% yoy in 2Q 2005, down from 5.9% yoy growth in 1Q 2005 and a 7% yoy increase in 2Q 2004. The slowdown should be primarily attributed to larger negative contribution of net exports and descending consumption. Over the second quarter, exports decelerated to a modest 3.3% yoy compared with explosive 24.6% yoy growth in the respective period last year. Poor export performance may be explained by local currency appreciation, higher costs of production (due to high energy prices) and increased competition on external markets for such industries as textiles and apparels and metallurgy. Consumption, which remained the main driver of economic growth, slightly lost its growth speed, decelerating to 10.5% yoy in 2Q 2005 as

Industries — the Main Contributors and Subtractors of Industrial Output Growth, % yoy



Source: INSSE

10% yoy in 1H 2005 to 6.5% yoy in 3Q 2005. Deceleration in budget revenues in the third quarter may be explained by smaller receipts from enterprise profit tax, which is consistent with the industrial output decline over May-July and is in line with expectations due to introduction of a flat 16% tax rate (down from previous 25%).



In mid-October, the government approved the draft budget for 2006. The draft foresees a 0.5% of GDP fiscal deficit next year with quite optimistic forecasts for inflation, GDP growth, and the CA deficit -5.5% yoy, 6% yoy and 6.9% of GDP, respectively. Budget revenues are forecasted to increase to 31.3% of GDP, up some 0.3% of GDP versus the expected figure for this year of 31.0% of GDP. The increase in budget revenues is due to improved collection and a larger tax base. The forecast for budget revenues was developed based on the current tax system. Budget expenses are planned to decrease to 31.8% of GDP, down from the expected 32.0% of GDP this year. However, the budget parameters may be reconsidered in response to IMF recommendations and adoption of the new Fiscal Code.

Over the first eight months of the year, medium and long-term foreign debt (MLT) increased by 22.7% year-to-date (ytd) to EUR 22.3 billion at end-August. The increase is mainly due to private debt, which expanded by 34.5% ytd to EUR 10.9 billion. As a result, the share of private debt grew from 44.7% of total MLT to almost 50%. At the same time, public and publicly guaranteed debt advanced at a more moderate 13.4% ytd. Due to smaller debt service payments on the back of good export performance over July-August, the external debt service ratio declined from 35.7% in June to 15.1% in August.

### Monetary Policy

BNR measures aimed at slowing credit growth, consumption and appreciation of the national currency supported the disinflation trend. Over August-September, the consumer price index (CPI) continued to decelerate to 8.5% yoy, down from

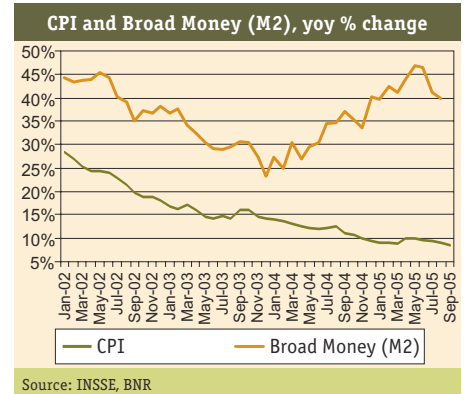
9.3% yoy in July. At the same time, due to the subsequent increases in regulated prices, inflation may accelerate slightly in November. Most likely, however, year-end inflation will not exceed the upper limit of the inflation target band (8.5%) set when the BNR officially introduced the inflation targeting regime. As in previous months, food prices reported the lowest increase, decelerating to 5% yoy in September. Affected by high international energy prices, domestic fuel prices continued to grow over August-September, expanding by 3.3% month-over-month (mom) in September. However, the non-food price index continued to decelerate in annual terms to 11.4% yoy in September, down from 12.1% yoy in July. Following stable prices in August, prices for services surged by 1.2% mom in September. After accelerating to 11.1% yoy in July, the disinflation trend for services recovered in August and continued in September; service prices decelerated to 9.6% yoy and 9.4% yoy, respectively.

After the encouraging price performance in August, the BNR decided to reduce its main policy interest rate by 1 percentage point in mid-September to 7.5%. The main purpose of lowering domestic interest rates is to discourage speculative foreign currency inflows and reduce the cost of BNR sterilization operations. In addition, the BNR cut the interest rate on deposit facility to 1.0%, down from the previous 4.0%, and the lending facility to an annual 14% down from previous 20%.

Moreover, in order to limit foreign exchange credit, the BNR issued a new regulation in September limiting forex-denominated credit exposure of banks to three times their own capital. At the same time, it decreased the penalty rate for deficits in RON-denominated minimum reserves to 21% from the previous 30%. The major reason for these regulations is that the BNR is trying to improve the structure of non-government lending. According to BNR data, foreign currency denominated credit accounted for almost 60% of total domestic credit. Moreover, its growth rate considerably outpaced that of credit denominated in national currency: non-government forex-denominated credit expressed in euros grew by 58.1% yoy at the end of August, while RON-denominated credit expanded by 40.4% yoy.

In August, broad money (M2) growth continued to slow, although it remained fairly high at 39.9% yoy. At the same time, the declining trend may reverse considering recent interest rate cuts. However, the increase in monetary aggregates may have a minor impact on inflation due to high money demand. So far, M2 growth was due to both net foreign and domestic asset expansion. In August, net foreign assets growth decelerated to 27.8% yoy from 30% yoy in June, while net domestic asset growth accelerated to 57.2% in July from

56.6% yoy in the previous month. Net foreign assets should continue to decelerate due to



BNR measures to limit the inflow of foreign currency. Already in September, BNR hard currency reserves grew by a modest EUR 215 million (compared to EUR 1.5 billion a month ago), reaching EUR 16.6 billion at the end of September. Following tightening of the consumer, real estate and mortgage credit regulations imposed in August, credit to the private sector continued its gradual deceleration, advancing by 37.4% yoy from 37.6% yoy in the previous month. At the same time, this growth rate is still very high, causing concerns since it stimulates imports and may negatively affect the quality of bank credit portfolios.

The growth of narrow money (M1) accelerated slightly to 45.6% yoy in August, up from 45.3% yoy in July. In its structure, the growth of demand deposits reached another record of 60.6% yoy, while that of currency outside the banking system continued to decelerate to 32.6% yoy, down from 33.5% yoy a month ago. The stock of bank deposits slowed to 38% yoy, down from a 39.7% yoy increase in July. The deceleration was observed for all bank deposits, which may be attributed to declining deposit rates. In particular, the growth of corporate deposits in domestic currency slowed to 66.3% yoy, down from 70.6% yoy a month ago, while household savings and forex-denominated deposits decelerated to 29.6% yoy and 29% yoy, down from 30.8% yoy and 30.7% yoy respectively.

### International Trade and Capital

Despite exports' rebound in August, Romania's foreign trade performance continued to deteriorate. The growth of merchandise exports accelerated to 30.6% yoy, up from a modest 8.2% yoy in July. However, import growth also accelerated to 33% yoy, up from 16.2% yoy in the previous month. FOB exports grew by almost 17% yoy cumulatively for January-August to EUR 14.4 billion, accelerating from 15.2% yoy over January-July 2005. At the same time, the growth of CIF imports considerably outpaced that of exports, advancing

#### Headquarters

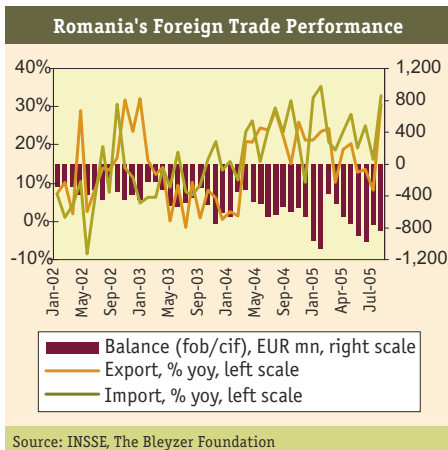
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by 23.3% yoy to EUR 20.2 billion. As a result, the cumulative FOB/CIF trade deficit approached EUR 6 billion, up by more than 42.5% yoy. The worsening of foreign trade performance may be explained by appreciating national currency that favors imports and discourages exports, stronger competition on external markets and robust domestic demand.



Improvement of export performance in August should be primarily attributed to the rebound of metallurgical exports, acceleration of mineral products exports and vehicles. Following several months of deceleration and reporting a 10.2% yoy decline in July, exports of metallurgical products rebounded to 32.5% yoy growth in August. Benefiting from high external demand, exports of mineral products and vehicles expanded by 77.5% yoy and 30.8% yoy over January-August. On the downside, export volumes of textiles and apparels continued to decline, contracting by 0.4% yoy over January-August. By import breakdown, the best performers were mineral products (up by 47.4% yoy), vehicles (up by 44.1% yoy), and metallurgy (up by 32.1% yoy). Driven by robust domestic demand for investment goods, imports of machinery and equipment accelerated to 19.4% yoy over the period. The European Union remained the largest trading partner, accounting for 67.8% of Romania's exports and 62.4% of imports.

The current account (CA) deficit reached EUR 3.2 billion over the first eight months of the year, ex-

panding by about 55% yoy, which is a significant deceleration compared to 71.5% yoy over January-May and 60.2% yoy over January-June. The worsening of the CA balance is mainly due to the large trade deficit, which in FOB terms widened by 51% yoy over January-August. The deceleration should be primarily attributed to considerable growth of the current transfer surplus (primarily wage remittances from abroad). Over January-August, current transfers expanded by an impressive 70.3% yoy to EUR 2.3 billion. Although decelerating, the deficit, which already represents more than 4.5% of expected full-year GDP, remains of major concern. However, following recently introduced BNR regulations aimed at containing robust growth of credit to private sector, the worsening of the CA balance may slow down. Another positive sign is acceleration of FDI inflows over May-July. Cumulatively, FDI inflows grew by 21% yoy over January-July, covering almost 60% of the CA gap. The Romanian Agency for Foreign Investments (ARIS) forecasts FDI at EUR 3.8 billion. This figure may be high unless Banca Comerciala Romana (BCR) is privatized by the end of the year. However, even if the bank is privatized, it is unlikely that the money will be paid this year.

### International Programs

On October 25<sup>th</sup>, the European Commission (EC) released its annual accession progress report for Romania. The report recognizes Romania's achievements in the areas of justice reform, competition policy and the overall level of alignment. Although the current report is written with a view on full European Union (EU) membership starting in January 2007, the final decision regarding the accession date will be known in April-May 2006. In spring, the EC will review the report deciding whether to apply the safeguarding clause, thus delaying accession by one year to January 2008. The decision will crucially depend on Romania's reform progress. Based on the EC report and recommendation, the Council of the European Union will make the final decision with respect to the accession date. The report identifies the following areas where further reform efforts are required:

- public administration reform;
- fight against corruption, especially high ranking;
- ill-treatment in psychiatric hospitals;

- the legal and administrative business environment;
- structures and mechanisms for participation in European structural funds;
- industrial pollution;
- food safety;
- implementation of customs rules; and
- financial control.

At the end of October, IMF officials arrived in Bucharest to discuss the status of the Precautionary Stand-By Arrangement with Romanian officials. The arrangement was frozen at the beginning of 2005 due to the introduction of the flat tax rate, which in the IMF's view would result in a higher budget deficit than was agreed. During this round of negotiations, there are two sensitive issues in the talks with the IMF that could lead to the termination of the arrangement: the 2006 budget deficit level and the use of funds from privatization. The IMF supports a very low 2006 budget deficit, or even a budget surplus, as a means to curb CA deficit growth. Romanian officials contend that the link between the consolidated budget deficit and the CA deficit is rather weak, with the argument that the CA deficit stems mainly from private consumption. So far, the CA deficit expanded by 55% over the first eight months of the year, although the consolidated budget recorded a surplus of about 0.56% of GDP over the same period. Regarding the use of privatization funds, the IMF insists on using these funds only for foreign debt repayment. At the same time, referring to rather low public debt as a percent of GDP, the Romanian government would like to use the proceeds from privatization to finance infrastructure projects, the budget deficit due to pension reform, and only marginally to repay debt.

### Other Developments and Reforms Affecting the Investment Climate

In the second half of September, a new wave of floods hit the South and South-Eastern regions of Romania, affecting 17 counties out of 41 in the country. According to government officials, the damages to agriculture are estimated at EUR 200 million, with 0.5 million hectares affected by the latest floods.

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