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Romania Macroeconomic Situation

January 2005

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Summary

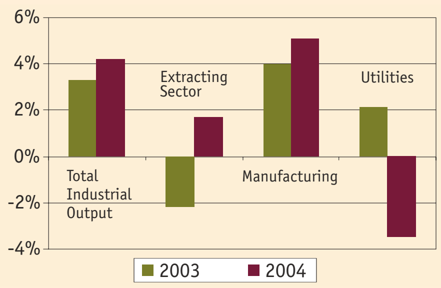
In the second half of December, the National Liberal Party (PNL) and the Democratic Party (PD) alliance formed an absolute majority in Parliament, thus securing the endorsement of the new government on December 28th. The Romanian economy continues to grow at a robust pace. In the third quarter (Q3) of 2004, real gross domestic product (GDP) soared by 10% year-over-year (yoy), which makes the government's expectations of 7.6% yoy real GDP growth for the whole year realistic. During October, the government maintained prudent fiscal policy in spite of the general and presidential elections at the end of November. Over January-October, the consolidated budget posted a surplus of 0.1% of expected GDP. The fiscal budget for 2005 was prepared taking into account the tax reform, which reduced the enterprise profit tax from 25% to 19% and the income tax from 18% to 14% for the lowest bracket and from 40% to 38% for the highest. However, the new government has recently introduced a 16% flat income and profit tax. As a result, the fiscal deficit for 2005 may increase to 2.5% of GDP, well above the target of 1.5% of GDP agreed with the IMF. The new government will need to reduce planned expenditures to maintain the agreement with the IMF. Regarding inflation, consumer prices decelerated to 9.9% yoy in November, the first time that the country has had a one-digit inflation rate since 1989. The size of the current account (CA) deficit remains a major concern. Just in November, the trade deficit widened by 57% yoy. Although it was admitted that the CA deficit target of 5.5% of GDP for 2004 will not be achieved, the government expected to contain it to within 6%. However, due to a worsening merchandise trade deficit, the CA deficit may also exceed this ceiling. On the international front, Romania closed accession negotiations with the EU, and was invited to sign the Accession Treaty in April 2005.

Economic Growth

The Romanian economy demonstrated an outstanding growth rate of 10% yoy in Q3 2004, driven by robust consumer demand and investments. During January-September, real GDP growth reached 8.1% yoy. Through January-October, the startling growth of credit to private sector (by 46.3% yoy), a moderate increase in population revenues (the average monthly wage grew by 7.3%) and declining unemployment (from 7.6% in January to 6.2% in October) enhanced private consumption by 9.8% yoy. Domestic consumption expanded by 12.2% yoy in Q3 alone. Retail trade, which also reflects the population's propensity to consume, grew by 12.5% yoy during the period. Despite presidential and parliamentary elections this fall, government consumption increased at a modest rate of 2% yoy (compared to 7.5% yoy in Q2 and 6% yoy in the first half of the year). Following booming domestic credit to the private sector (up by 46.3% yoy in October), gross fixed capital formation grew by an impressive 17.4% yoy in Q3, accounting for 26.6% of GDP (compared to 16.7% of GDP in Q1 and 24.1% of GDP in Q2). On the supply side, the largest contributors to GDP growth in Q3 were agriculture (up by 26.1% yoy), construction (up by 10.8% yoy) and industry (up by 6% yoy), which account for about 52.6% of total GDP. The recent solid economic performance makes the government's expectations of 7.6% yoy real GDP growth for the year realistic. Moreover, growth for the year could be slightly higher, since the 7.6% yoy figure implies quite moderate GDP growth of about 6.5% yoy in Q4 compared to 10% yoy in Q3.

In October, industrial output increased at a modest rate of 0.8% month-over-month (mom). However, in yearly terms it picked up 4.2% yoy, bringing the cumulative figure to 4.2% yoy. The industrial processing sector (the main contributor to industrial growth) expanded by 5.1% during January-October, compared to 4% yoy in the corresponding period last year. During the period, favorable external demand encouraged the rapid expansion of output of wood (up 36% yoy), chemicals (up 35.5% yoy), and metallurgy (12.3% yoy). The car industry remained one of the growth leaders, with its output expanding by 26% yoy in January-November. Car sales went up by about 35% yoy. At the same time, the growth outliers over January-October were still food (down by 6.5% yoy) and textile and apparels (down by 2.4% yoy). The growth trends of the extractive sector and utilities have changed this year. For ten months last year, the extractive sector declined by 2.2% yoy, while this year it showed a 1.7% yoy increase. In contrast, utilities, which grew at 2.1% yoy last year, saw a decline of 3.5% yoy this year. However, utilities have shown positive development in the last two months; in September, the reduction decelerated to 0.3% mom, followed by a 10.9% increase in October.

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

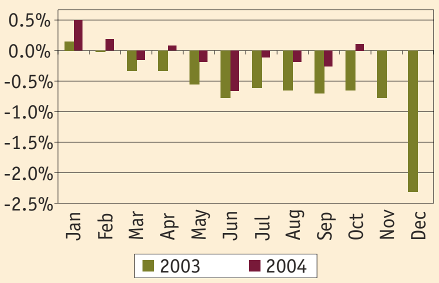


Source: INSSE, The Bleyzer Foundation

Fiscal Policy

According to the Ministry of Public Finance (MFP), in January-October the general consolidated budget recorded a surplus of ROL 1.7 trillion (around EUR 43 million) or 0.1% of forecasted full-year GDP in contrast to the deficit of 0.26% of GDP registered in January-September. According to its international agreements, Romania has a fiscal deficit ceiling of 3% of GDP. During 2004, the deficit target was reduced twice: first, from 3% of GDP at the beginning of the year to 2.1% of GDP in early July (according to the IMF precautionary stand-by agreement), and then to 1.64% of GDP in late July-early August. The current consolidated budget surplus was achieved by a combination of prudent fiscal policy during the period in spite of the coming parliament and presidential elections, increased revenues due to higher-than-expected GDP growth and improved tax collection, and circumstantial factors like larger profit tax payments in Q3. Moreover, considerable local budget surpluses also helped the consolidated budget. At the same time, since budget expenditures tend to increase at the end of the year and the deficit target is set at 1.64% of GDP, considerable fiscal policy loosening during the last two months of the year will not favor inflationary developments at the beginning of 2005 (the disinflation trend is expected to reverse in Q1 2005 and inflation will again exceed the 10% level).

Consolidated Budget Balance, % of GDP



Source: MFP, Intellinews

According to the 2005 Budget Law, the consolidated budget deficit for 2005 was set at 1.5% of GDP. The budget was adopted based on a 5.3% forecast for GDP growth, 7% for inflation and 5.4% of GDP for the CA deficit. It also took into account the tax reform, which reduced the enterprise profit tax from 25% to 19% and cut the income tax rate from 18% to 14% for the lowest income bracket and from 40% to 38% for the highest. However, just after the PNL-PD led government was endorsed by the parliament, it introduced a 16% flat tax for next year, which implies a reduction of the income and profit taxes to 16%. The respective amendments to the budget may cause the budget deficit to increase to 2.5% of GDP next year. Although necessary, the government may find it hard to cut expenditures due to the increase in the minimum wage by 10.7% to ROL 3.1 million and pension indexation starting January 1, 2005. Necessary amendments to the budget should be settled with the IMF, which is expected in Romania on January 25th for the second quarterly review under the stand-by agreement. IMF representatives have already stated that Romania cannot afford a fiscal deficit wider than 1.5% of GDP. Hence, to balance the budget, either budget revenues should be increased or expenditures should be lowered. The government has foreseen certain measures to offset lower tax revenues. In particular, the micro-enterprise tax on turnover will be increased from the current 1.5% to 3% in 2005. However, this would be insufficient to meet a 1.5% of GDP fiscal deficit.

At the end of October, Romania's medium and long-term debt remained almost unchanged compared to the previous month. This debt stands at EUR 17.5 bil-

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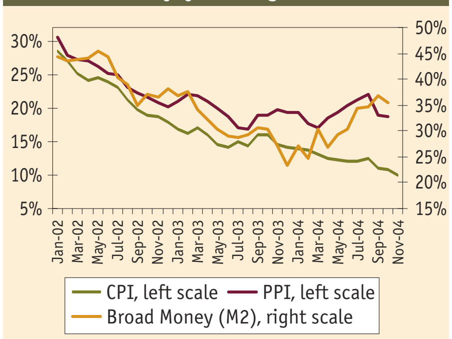
lion, which represents an increase of 11.7% year-to-date (ytd). This is approximately 31.2% of expected full-year GDP. Public and publicly guaranteed debt, accounting for 58.2% of total debt, expanded by 5.4% ytd. Commercial external debt increased by 21.8% ytd, reaching EUR 7.3 billion at the end of October. The external debt service ratio continued to grow; after reaching its minimum of 18% at the end of August, it registered 19% over January-October, though this is less than the 20.6% ratio in 2003.

Monetary Policy

CPI, PPI and Broad Money (M2), yoy % change



Source: INSSE, BNR

November saw further progress in the downward trend of inflation, with deceleration in the growth of the consumer price index (CPI) to 0.6% mom (from 1.2% in October). CPI increased by 9.9% yoy. As a result, Romania had a one-digit annual inflation rate for the first time since 1989. The deceleration of CPI was due to the lower growth of non-food prices (up by 1% mom in November compared to 1.5% mom in the previous month) and a decline of service prices by 0.7% mom compared to 1.4% mom growth in each of the last three months. The latter decline is attributed to cheaper telecommunication services, the prices of which are set in foreign currencies (Euro for fixed lines and US dollars for mobile phones) and which have the largest share in the basket of services. These services, as well as consumer goods and other services, benefited from stronger currency appreciation, a result of the National Bank of Romania's (BNR) decision to relax the exchange rate policy by limiting the central bank interventions on the foreign exchange market. The prices of foods grew at the same rate as in the previous month, by 0.9% mom. Food prices made the smallest contribution in annual terms, picking up by 8% yoy compared to 11.5% yoy for non-foods and 10.5% for services.

Since the beginning of the year, CPI has grown by 8.6%, which is too high to meet the 9% official inflation target for 2004. But inflation for 2004 will not exceed 10% and may end up at about 9.4%. For 2005, the inflation target is 7%. But this target may be in jeopardy due to the 10.7% minimum wage increase at the beginning of 2005, and the already approved increase in regulated prices (electricity up by 4.6% and natural gas up by 5%) starting January 1, 2005. Moreover, the introduction of the 16% flat tax may also negatively influence the 7% inflation target, pushing consumption through higher household disposable income and companies' investment resources.

Just after the BNR twice cut interest rates in November by a total of 1.0 percentage point, the BNR Board cut its intervention interest rate by additional 0.75% in the middle of December to 17.0%. These actions are designed to mitigate the impact of speculative short-term capital inflow after full capital account liberalization takes place in 2005.

According to BNR data, money supply (M2) growth decelerated slightly in October to 35.4% yoy from an 18-month record of 36.9% yoy in September, reaching ROL 573.9 trillion (EUR 14.0 billion). The monthly M2 increase was exactly the same in October as monthly CPI — 1.2% mom. During the month, narrow money (M1) advanced by a modest 0.2% to ROL 143.1 trillion, as a result of a 1.4% mom increase in currency outside banks, and a 1.2% decrease in demand deposits. Quasi-money gained 1.5% mom on the back of 2.1% mom expansion in household savings and a 3.5% mom increase in corporate deposits. ROL-denominated foreign currency deposits remained stable at ROL 198.3 trillion (EUR 4.9 billion).

Net foreign assets moved up by 1.4% mom to ROL 341.8 trillion (EUR 8.4billion) due to a 1.6% mom increase in the BNR's convertible currency position. Net domestic assets reached ROL 232.2 trillion (EUR 5.7 billion), rising 47.0% yoy (slightly lower than the 51.6% yoy growth in September) as domestic credit decelerated to 40.2% yoy, down from 46.4% yoy in September. Non-government credit gained 2.2% mom in October, putting annual growth at 46.3% yoy (down from 51.1% yoy in the previous month). Net government credit posted a negative balance of ROL 46.3 trillion (EUR 1.1 billion) mainly due to an increase of government deposits at the Treasury.

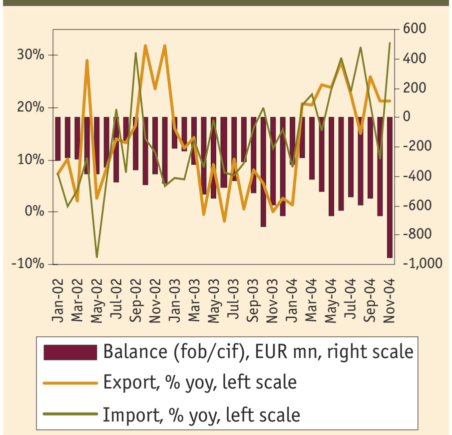
At the end of November, the BNR's hard currency reserves remained around EUR 10.0 billion since there were no BNR purchases on the foreign exchange market. The EUR 28.1 million decrease in reserves during the month was due to EUR 98.7 million of principal and interest payments on external public and publicly guaranteed debt and EUR 53.0 million of net other outflows. The inflow of EUR 17.6 million is due to income from international reserve management. Including the gold stock, international reserves remained at EUR 11.07 billion at the end of September, representing 5 months of imports.

International Trade and Capital

November saw an acceleration of import growth to 32.4% yoy from 10.2% yoy in October. At the same time, Romania's merchandise exports increased by 21.4% yoy, the same rate as in October. As a result, after almost a 10% yoy decline in October, the fob/cif trade deficit widened by about 57% yoy in November, amounting to EUR 956 million. Over January-October, the growth rate of imports reached 22.6% yoy, outpacing a 20.9% yoy export increase. The cumulative trade gap widened to EUR 6.3 billion, about 28% higher than in January-November 2003.

Fast national currency appreciation does not favor Romanian exports. Despite high world prices on metals, export of metallurgical products slowed to 44.3% yoy during the ten months (from 44.8% yoy in January-October). Growth deceleration was also observed for other strategic goods: machines (33.1% yoy growth, down from 33.6% yoy in the respective periods) and transport vehicles (33.4% yoy, down from 34.6% yoy). In the structure of imports, transport means recorded the highest growth at 80.4% yoy. The European Union remains the largest trading partner, accounting for 73.2% of exports and 65.2% of imports.

Romania's Foreign Trade Performance



Source: INSSE, The Bleyzer Foundation

Over January-October, due to the worsening deficits in trade (up 24.3% yoy) and income accounts (up 20.2% yoy), the CA deficit widened to EUR 2.6 billion, or 4.7% of expected full-year GDP (up from 4.1% of GDP during nine months of the year). The deficit was 24.7% higher than in the corresponding period last year. Although the CA deficit target of 5.5% of GDP for 2004 will not be achieved, the government had hoped to contain the deficit within a ceiling of 6% of GDP. At the same time, recent trade performance suggests a considerable widening of CA deficit through the end of the year, which may exceed the ceiling. The financing of the CA deficit remains favorable due to record high levels of FDI. The net inflows of FDI may reach a record EUR 3.4 billion in 2004 on the back of privatization deals. A significant inflow of FDI is expected to continue next year given the improving investment climate and supported by privatization of several Electrica branches, Distrigaz and others.

International Programs

On December 14th, Romania formally finalized accession negotiations after closing the last two negotiation chapters, "Justice and Home Affairs" and "Competition". On December 16–17, the European Council invited Bulgaria and Romania to sign the Accession Treaty in April 2005. Full membership was confirmed for the beginning of 2007. At the same time, Romania has to closely adhere to all commitments taken during the EU accession talks, especially in the areas of "Justice and Home Affairs," "Competition" and "Environment". Otherwise, the Accession Treaty will have safeguard clauses that may delay accession by one year. To support and speed up the accession preparations for Romania, the EU allocated EUR 407 million under the PHARE 2004 Program and the Nuclear Safety program in the middle of December, 50% higher than the funds allocated through similar programs in 2003. The EU funds supported by other financing (EUR 100 million from Romania's budget, other funds from the Cross-Border Cooperation programs and the Initiative on Good Neighborhood) will be directed to reform public administration, the legal system, rights of minority shareholders, agriculture, environment protection, border management, public finance and others. At the same time, recent statements of re-opening several accession chapters by newly elected President Basescu were softened in response to concerns from EU officials.

In December, the World Bank Board approved two loans with a combined value of $200 million for Mine Closure and Environmental and Socio-Economic Regeneration (MCESER) and for Health Sector Reform. Both programs will be implemented during the next five years. In addition to mine closure and rehabilitation, the MCESER program aims to create 25,000 new jobs and to support local development through financing infrastructure and social services. The Health Sector Program is designed to improve maternity and newborn, emergency and rural health care.

Other Devlopments and Reforms Affecting the Investment Climate

Following the December 12th second round of elections, Mr. Traian Basescu became President of Romania on December 21st. Despite threats from the Socialist Democratic Party (PSD) to boycott Parliament if President Basescu and the PNL-PD Justice and Truth alliance insisted on appointing a PNL-PD led government, Mr. Tariceanu, a PNL representative, was nominated as Prime Minister on December 22nd. According to Romanian legislation, the new Prime Minister has to form and present a government to the Parliament within 10 days. Since no political party obtained clear majority in the Parliament in the general elections on November 28th, endorsement of the PNL-PD led government was required to form a coalition with other parties. Following closed door negotiations, PNL-PD formed a 51% majority in the Parliament obtaining formal support from the ethnic Hungarians (UDMR) and the Humanist Party (PUR).

The PNL-PD-UDMR-PUR government was endorsed on December 28th. With the PNL representative Prime Minister, the PD, UDMR and PUR each has a State Minister. Out of the other 20 ministers, PNL is represented by 8, PD by 7, UDMR by 3 and PUR by 2 members in the government. The new government is expected to continue reforms in the country and to comply with all commitments made during the EU accession talks. Moreover, by avoiding the possibility of early elections in case the PNL-PD led government would have been failed to be endorsed by Parliament, the effects of recent political uncertainties on business activities were reduced. In addition, the new Romanian President's pledges to reduce corruption in the country may lead to anti-corruption initiatives that would improve public governance.

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