Romania Macroeconomic Situation

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Summary

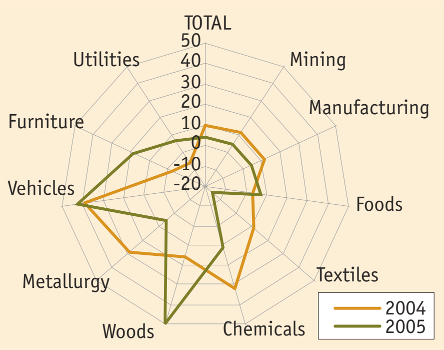
- In the first quarter of 2005, the Romanian economy continued to expand at a robust, although slower pace;
- Encouraging fiscal performance over January-May may help to resume the talks with the IMF scheduled for mid-June;
- Following administered price increases, consumer inflation returned to double-digit numbers in April;
- On the back of a worsening trade balance and modest FDI performance, the 86% year-over-year (yoy) widening of current account deficit over first quarter raises concerns;
- The international rating agency S&P confirmed Romania's positive sovereign rating outlook at the end of May.

Economic Growth

After GDP showed impressive 8.3% yoy growth in 2004, first quarter of 2005 (1Q05) growth rates showed deceleration to 5.9% yoy. On the demand side, GDP growth was primarily driven by strong domestic demand. Consumption expanded by an impressive 12.1% yoy, up from 10.3% yoy in 2004. At the same time, gross fixed capital formation decelerated to just 5.2% yoy, down from 10.1% yoy in 2004. On the supply side, the largest contributions to GDP growth were made by services and industry. Services, which account for more than half of the total value added, advanced by 6.9% yoy in 1Q05. Industry, accounting for one third of the value added, expanded by 5% yoy. Still, impressive growth rates in 1Q05 are expected to be followed by further deceleration, especially in the second half of the year. The deceleration can be primarily attributed to the high base effect after the outstanding performance of the agricultural sector in the respective period last year. GDP growth in 2005 is forecasted at 5.5-6% yoy by Romanian officials and various international organizations.

In March, industrial output expanded by 4% yoy, bringing the cumulative growth to 5.3% yoy. Slight deceleration from the 5.8% yoy growth over January-February may be attributed to high production costs caused by the increase in utility prices, declining competitiveness of several export-oriented industries and the high base effect. High input costs and base effect, and declining world prices for metals may be the primary reasons for the growth slowdown in metallurgy in March. Deceleration to 5% yoy growth that month (down from 16% yoy in February) contributed to the modest 9.5% yoy performance over January-March. Because of unfavorable external market conditions, textile and apparels continued to sharply contract. In March alone, textiles showed a drastic 16% yoy decline compared to an almost 17% yoy increase just two months ago. Apparels, contracting by 22% yoy in March, showed a 19.2% yoy decline since the beginning of the year. On the upside, wood processing and the automobile industry advanced 56.5% yoy and 44% yoy respectively for January-March, stimulated by robust domestic and external demand. Furniture, fuels and chemicals showed 23% yoy, 13% yoy and 14% yoy increases over 1Q05. Benefiting from utility price adjustments to cost recovery level, utilities showed almost 6% yoy growth in March. The extractive sector saw a 2.2% yoy decline over 1Q05 on the back of increased cost of inputs and the high base effect.

Industrial Output Growth by Sector in March, % yoy



Source: INSSE, The Bleyzer Foundation

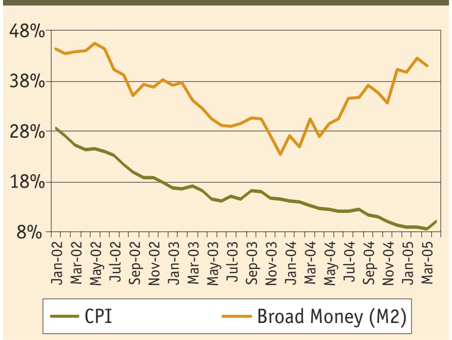
Fiscal Policy

According to the National Fiscal Administration Agency (ANAF), revenues to the State budget, social security budget, unemployment fund and National Health Security Fund (the four major budgets) grew by 6% yoy in real terms over January-May. According to the fiscal authority, the rise in revenues is attributed to improved tax administration and to forced execution operations to collect overdue receivables to the budgets. The first five months' favorable revenue performance after introduction of the 16% flat income and profit tax at the beginning of this year should convince the IMF officials that the proposed 0.7-0.75% of GDP consolidated budget deficit for 2005 is realistic. At the same time, the Ministry of Public Finance (MPF) does not release detailed information on the consolidated budget expenditures and, hence, the exact level of the consolidated budget deficit since the beginning of the year is unclear. Moreover, measures to recover the debts from bad payers may not be considered a reliable source of budget revenues for a long period of time. In addition, January-April's data shows that about 45% of all tax revenues can be attributed to VAT collections. Higher VAT collections, in turn, were obtained thanks to robust domestic demand. At the same time, the latter also stimulates imports, which worsens trade and current account balances. Although not very successful so far, the government's efforts to moderate consumption may reduce budget revenues. Considering the above, the talks with the IMF mission, scheduled for mid-June, will be tough.

Romania's external debt has grown by 13% since the beginning of the year (ytd) and exceeded EUR 20 billion at the end of the first quarter. This represents about 28% of expected full-year GDP for 2005, among the lowest in transition peers. The largest increase of 15% ytd was registered in private debt. As a result, commercial debt amounted to EUR 8.8 billion, increasing its share in total external debt to 43.2% at the end of March. Public and publicly guaranteed debt grew by a moderate 6% since the beginning of the year to EUR 10.6 billion. The share of public and publicly guaranteed debt continues to decline, accounting for 52% of total external debt at the end of 1Q05, down from 55.5% at the end of 2004. Due to lower average monthly debt service payments this year and robust export performance, the external debt service ratio increased to 33% over 1Q05, up from 21.9% in 2004.

Monetary Policy

CPI and Broad Money (M2), yoy % change



Source: INSSE, BNR

Over the first quarter of 2005, annual consumer inflation continued its gradual deceleration, reaching 8.7% yoy in March; however, it returned to double-digits in April. The consumer price index (CPI) showed 1.8% month-over-month (mom) growth in April, higher than expected by the BNR, due to a sharp increase in several regulated prices. In turn, annual CPI soared to 10.0% yoy. April's upturn in the downward trend of consumer inflation occurred mainly as a result of the acceleration of non-food prices and service tariffs. After stabilizing at 10.3% yoy over February-March, non-foods showed a 13.5% yoy increase in April. Gas and fuel prices made the largest contribution to the 3.6% mom growth in non-food prices. Gas prices, representing 6.5% of the non-food index, advanced 26.9% mom. Fuel prices, accounting for 16% of the non-food basket, grew by 4.2% mom. At the same time, a planned 12% increase in electricity prices did not affect this month's price indices. During April, service tariffs gained 1.5% mom, bringing the annual index to 10.4% yoy. The largest tariff increases of 4.6% mom and 2.9% mom were registered in water supply and inter-city transportation, respectively. Food prices continued to decelerate and reached 6.3% yoy in April (down from 6.6% yoy in March and 7.4% yoy at the end of 2004).

For the first four months of the year, consumer prices grew by 3.5%, representing half of the year-end inflation target. At the same time, BNR officials remain optimistic about achievement of the 7% target, although admitting possible deviations. The central bank is developing two scenarios for inflation targeting, the introduction of which is scheduled for the second half of 2005. Scenarios differ just in the width of the safety band — 1 and 1.5 percentage points (pps), symmetrically around the official target. The relatively large band indirectly signifies that this year's inflation target may be missed.

In previous months, strong national currency appreciation and robust money demand were among the major factors helping to further reduce inflation. However, the nominal ROL exchange rate remained almost flat during April; the average monthly exchange rate appreciated by just 0.1% mom, while over January-March each month's appreciation amounted to about 2% on average. At the same time, this situation may be temporary considering the robust capital inflows. As the population's earnings increase and access to credit continues to improve, strong aggregate money demand allows the rapid monetary expansion to have a minor impact on inflation. However, recent acceleration of the money supply may turn into strong inflationary pressure.

In April, broad money supply (M2) growth accelerated to 44% yoy (up from 41.1% yoy in March), one of the highest rates for the last several years. During April, the yearly growth of money demand (M1) decelerated slightly compared to the previous month; however, it remained above 44% yoy. The deceleration may be explained by the growth slowdown of demand deposits to 53% yoy (down from 55.4% in March). At the same time, the growth of cash outside the banking system accelerated to 37.2% yoy (up from 34.8% yoy in March and 30% yoy at the end of the year). The stock of bank deposits, or quasi money, grew by 43.8% yoy in April, up from 40.2% yoy in March. Acceleration occurred thanks to a more than double yearly increase in ROL-denominated corporate deposits and continued growth of household savings. The attractiveness of the ROL-denominated deposits may be attributed to the appreciating national currency and progress in reducing inflation over January-March. At the same time, household savings continue to decelerate gradually, reacting to declining interest rates. In April, the growth rate of household savings declined to 38.8% yoy, down from 41.6% yoy in February. Following the BNR policy of cutting its intervention rate and the resulting excess liquidity in the banking sector, the average nominal interest rate on deposits declined below 8% in April-May. Realizing that real interest rates are approaching zero due to much higher current inflation, the central bank decided to leave its main policy interest rate unchanged at 12.5% in mid-May.

After growth of net domestic credit resumed its upward trend in February, it accelerated to 23.1% yoy in April due to higher growth of non-government credit. The latter reached EUR 12.4 billion at the end of April, expanding by 35% yoy, up from 32% yoy in January. The ROL-denominated loans continue to expand rapidly, rising by 22.8% yoy in April, up from 16.9% yoy in January. Recent acceleration of ROL-denominated loans may be explained by their increasing attractiveness due to declining interest rates. At the same time, forex-denominated loans also remain popular. Expressed in national currency, foreign exchange-denominated loans grew by 44.4% yoy in April, the same rate as in the previous two months. Stabilization of the trend may be explained by slower appreciation of the national currency during April. In euro terms, forex-denominated credit continues to expand at a robust pace, increasing by 61.2% yoy, up from 57.2% yoy in January. The negative balance of net government credit increased to ROL 51.5 billion in April, up from ROL 43 billion in March. The expansion is attributed to the increase in the balance of the General Account of the Treasury and issuance of ROL-denominated government securities launched on the domestic market.

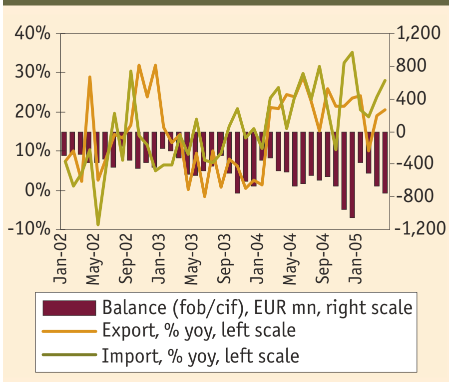
During April-May, the BNR's hard currency reserves grew by EUR 674 million and reached EUR13.3 billion at the end of May. The increase was due to inflows of EUR 1.8 billion during April-May, mainly on account of purchases on the foreign exchange market, incomes from international reserve management, and other inflows. The outflows of EUR 1.1 billion were due to foreign debt repayments, changes in membership quotas and bank commissions. The BNR's gross international reserves reached EUR14.4 billion at the end of May, up from EUR 14 billion in April and 13.7 billion in March.

International Trade and Capital

Continuing appreciation of the national currency had a minor impact on Romania's export performance in April. Thanks to strong external demand, April's FOB exports growth accelerated to 20.4% yoy (up from 19% yoy in March). However, driven by high domestic demand for investment goods and energy resources, the CIF imports growth rate outpaced that of exports, advancing by an impressive 28% yoy. Over January-April, exports increased by 18.2% yoy, while imports advanced 23% yoy. By exports breakdown, the best performers were mineral and metallurgical products and vehicles, which together account for about 44% of total exports. On the back of high world prices, exports of mineral products grew by 67% yoy. Exports of metallurgy continue expanding at a robust, though slower, pace. Over April, metals exports decelerated to about 20% yoy, down from an almost 30% yoy increase in March. The deceleration may be attributed to declining world prices of metals and a high base effect. The cumulative export of metals has expanded by about 33% yoy over January-April. Exports of vehicles accelerated as well, bringing cumulative growth to 30.6% yoy. For January-April, textiles and apparels which account for about 20% of total exports, showed a modest 2% yoy increase. In addition to the appreciating national currency, exports of textile and apparels are affected by stronger competition from Chinese goods on the EU market.

Over January-April, imports were driven by rapid growth of imported mineral products (up by 43.7% yoy), vehicles (up by 44.2% yoy), and metallurgy (up by 40% yoy). Together these goods account for 34% of total imports. Driven by robust domestic demand, imports of machinery and equipment continue to increase, resulting in 17.6% yoy growth for January-April. On the downside, textiles and apparels showed a 0.7% yoy decline over the respective period. The European Union remained the largest trading partner, accounting for about 70% of Romania's exports and 63% of imports. Rapid acceleration of imports in April resulted in an over 50% yoy increase in the FOB/CIF trade deficit. Over January-April, the deficit increased by an impressive 41% yoy to EUR 2.3 million.

Romania's Foreign Trade Performance



Source: INSSE, The Bleyzer Foundation

Over the first quarter of 2005, the current account (CA) posted a deficit of EUR 0.9 billion, representing almost 1.3% of expected full-year GDP. The deficit is 86% higher than in the corresponding period last year. The worsening of the CA is mainly attributed to the increase in foreign trade and service deficits. Over January-April, the FOB/FOB trade deficit reached EUR 1 billion during 1Q05, 43% yoy larger than in the same period last year. Unlike in 1Q04 when services posted a small surplus in the amount of EUR 5 million, services showed a deficit of EUR 132 million over 1Q05. Faster growth of the CA deficit raises concerns considering the modest FDI performance over January-April. According to the Romanian Agency for Foreign Investments (ARIS), FDI in Romania will range from EUR 3.2 billion to EUR 3.8 billion in 2005, down form EUR 4.1 billion in 2004. Moreover, the National Trade Registry Office (ONRC) and the BNR have also reported a downward trend in FDI this year. According to the ONRC data, FDI, which is calculated as the paid-up capital of companies running on foreign capital in Romania, declined by 27.5% yoy over January-April 2005. The situation may improve due to promising privatization deals in the banking sector.

International Programs

On June 14th, IMF team arrived in Romania to complete the second and third quarterly reviews under the stand-by agreement (SBA). The agreement was signed in July 2004 and frozen in the run up to the general and parliamentary elections in the fall of 2004. At the beginning of 2005, talks were resumed since the IMF and Romanian officials had not reached agreement on the size of the consolidated budget deficit for 2005. On the back of lowered income taxes, robust domestic demand and a high current account deficit, the IMF insisted on a fiscal deficit not higher than 0.5% of GDP. However, according to Romanian officials, favorable fiscal performance in the first quarter led to a preliminary agreement with the IMF on a 0.7% of GDP consolidated budget deficit. Another discussion with the IMF team will be devoted to the use of privatization receipts. Thus far, privatization proceeds have been used to repay Romania's public debt. At the same time, at the end of May, Romanian officials declared that considering the low level of public debt, privatization proceeds may be used to finance healthcare and pension systems, and environmental programs. After completion of the talks, the Romanian government intends to present the revised 2005 budget in the parliament.

Other Developments and Reforms Affecting the Investment Climate

At the end of May, S&P confirmed its BB+/positive grade for Romania. The decision was made due to the good prospects for economic growth, low public debt, EU accession and government commitments to speed up the reforms. Accomplishment of the latter will be crucial for Romania's sovereign rating improvement to BBB- during the next 12 months. A 'BBB-'rating will place Romania in the category of low-risk investments. S&P experts have also stated that possible delay of Romania's accession to the EU by one year would not directly affect the country's rating. Concerns, however, were raised about the rapid and significant deterioration of the current account on the back of lower-than-expected FDI performance.

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