Romania
Macroeconomic Situation

May 2006

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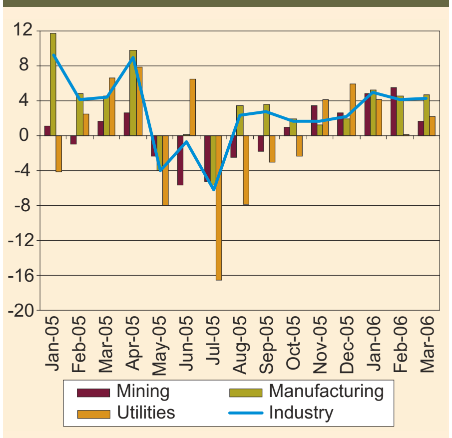
Summary

- Industrial production accelerated noticeably to 4.5% yoy in the first quarter this year, up from a modest 2% yoy growth in 2005.
- The cumulative fiscal surplus over the first quarter of the year stood at EUR 0.6 billion, which translates into 0.68% of estimated full-year GDP.
- The growth rate of consumer prices hit its lowest level in 15 years, falling in April to 6.9% due to positive developments in non-food and service prices.
- The current account gap widened to EUR 1.56 billion, growing by 59.6% yoy in the first quarter of 2006; and was fully covered by the inflow of EUR 1.7 billion FDI, which soared by 143% compared to the first quarter of 2005.
- The European Commission released the 2006 Monitoring Report on Romania, acknowledging its satisfactory progress and assessing January 2007 as a realistic date for EU accession provided that the government focuses on the urgent issues in agriculture and fiscal policy.

Economic growth

According to the National Institute of Statistics (INSSE), Romanian industry has shown signs of revival. Industrial output growth accelerated to 4.5% yoy in the first quarter (1Q) this year, up from a modest 2% yoy growth reported last year. In March alone, the growth rate was at 4.3% yoy, only marginally up from the previous month's 4.2% yoy growth. Following an observed rebound in industry, government officials announced a significant upward adjustment of the preliminary released figures for industrial production in January and February and also upgraded their expectations for the whole year. In particular, industrial output is expected to show a notable acceleration to 5% yoy in 2005, mainly due to further increases in productivity, recapitalization on recent investments and more favorable conditions on external markets.

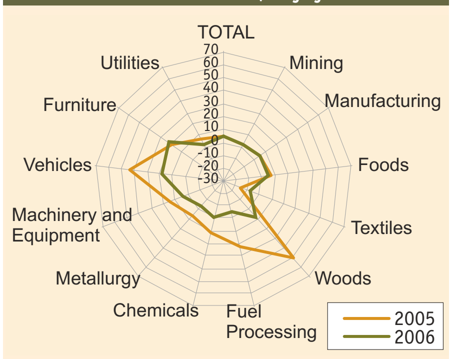
Industrial Output Growth by Sector, % yoy



Sources: INSSE, The Bleyzer Foundation

By sector breakdown, the best performing industries in January-March were food and beverage production (up by 12.5% yoy), furniture production (up by 19% yoy) and the automobile industry (21.4% yoy), propelled mainly by strong sustained domestic demand as well as persistent high external demand. In particular, there was an indication of booming exports of locally produced passenger cars, while domestic sales of Romanian cars were moderate. On the downside, metallurgy-a key industry in manufacturing sector-posted a decline in its output of 2.6% yoy over the period, down from a 1.5% yoy drop in January-February. Worsening performance of metallurgy may be attributed to falling world steel demand and accelerating energy and input materials prices. We still expect metal production to revive in the coming months, as world prices on steel products have been on an upward trend since February. Light industry, which takes a relatively small share in manufacturing production but plays a major role in employment, continued to stagnate. In particular, textiles output declined by 12.1% yoy in cumulative terms due to the toughened competition on world markets. Overall, manufacturing production accelerated to 4.8% yoy over the period, significantly up from 2.5% yoy in 2005.

Output Growth in Selected Industries in March 2006, % yoy



Sources: : INSSE, The Bleyzer Foundation

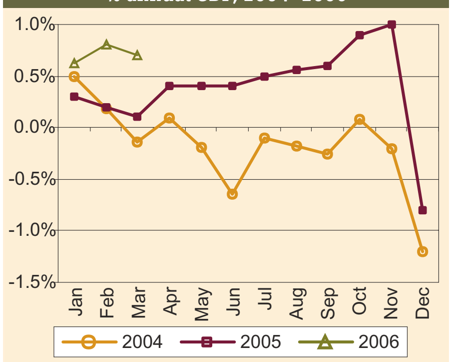
Following the world energy prices increases and strengthened demand for locally produced energy resources, the extractive industry and utilities accelerated significantly against 2005. Mining output advanced by 3.9% yoy in the first quarter, whereas it dropped by 0.5% yoy by the end of 2005. Similarly, utilities exhibited a positive development (2.2% yoy) this year against last year's contraction.

Fiscal Policy

The Ministry of Public Finance reported that consolidated budget revenues increased by 26% yoy in nominal terms to RON 24 billion (EUR 6.8 billion) in the first quarter 2006, which translates into 7.4% of estimated full-year GDP. This is an improvement from 6.6% of GDP revenues collected in the first quarter (1Q) last year. Expenditures grew at a slower pace of 16.8% yoy to RON 21.8 billion (EUR 6.2 billion). As a result, the general budget registered a surplus of about RON 2.2 billion (EUR 625 million) over the period, representing 0.68% of expected full-year GDP. For the corresponding period last year, there was a reported surplus of RON 371 million, or 0.1% of GDP.

This year's favorable fiscal performance was achieved due to improved tax collections and better control over budget expenditures. Robust domestic consumption and strong imports continued to spur tax revenues, as VAT and excise collections advanced by 35% and 23% yoy, respectively. Indirect tax receipts remained the largest source of consolidated budget revenues with a cumulative 35% share held in the general government budget. At the same time, collections of direct taxes also improved despite the radical changes introduced into the Romanian tax regime last year. Income tax revenues exhibited a positive development this year (up by 22.5% yoy) after they declined by 5.3% yoy in 2005, caused by the adoption of the 16% flat income tax rate, which replaced the previous progressive 5-bracket taxation scheme for individuals. Corporate profit tax receipts moved up modestly (by 8% yoy) over the period, which is still an encouraging development, provided that taxes collected in 1Q 2006 were based on 4Q 2004 profits taxed at 25% (whereas at present the tax rate is 16%).

Cumulative Consolidated Budget Balance, % annual GDP, 2004–2006



Sources: Ministry of Public Finance

Despite the favorable fiscal performance in 1Q 2006, the trend is likely to reverse by the end of the year due to the cyclical pattern. The government expects to end 2006 with a fiscal deficit at 0.9% of GDP, while the IMF insists on a balanced budget this year and small surpluses over the medium term. The need to tighten Romania's fiscal policy is determined by the anticipated increases in fiscal expenditures due to EU accession, which could not be supported by current level of the Romanian budget revenues at 28% of GDP (2005), the lowest level in the region. The draft fiscal code, to be discussed at end-May by the government, envisages the preservation of the main direct taxes next year at the current rates, while raising property taxes and levying the standard 16% profit tax on micro-enterprises instead of the current 3% sale charge. At the same time, the drafted fiscal code contains a lower mandatory contribution to social security funds and abolition of the tax levied on interest from deposits up to RON 10,000. The proposed fiscal code amendments are very preliminary and shall undergo further changes.

By the end of March, total medium and long-term external debt declined to EUR 23.9 billion, down from EUR 24.6 billion in the previous month. This decline

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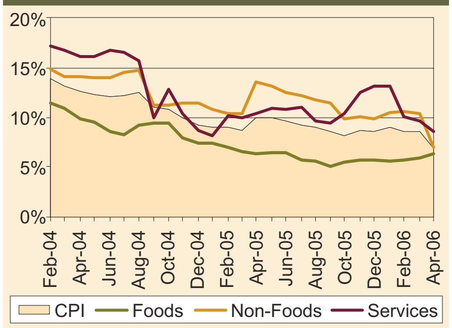
is mainly due to a further reduction in public and publicly-guaranteed debt stock by about EUR 117 million over the month. On the other hand, private debt increased slightly to EUR 12.7 billion, which translates in the larger share held by private debt (53%) in total external debt stock. Over the first quarter, the medium and long-term external debt service ratio stood at 16.9% against 18.2% at the end of 2005.

Monetary policy

The consumer price index (CPI) continues to show a steady tendency toward deceleration. The growth rate of consumer prices hit its lowest level in 15 years, falling in April to 6.92% from 8.41% yoy in March. The declining volatility of food prices and a slowdown of the upward revision of administered prices are principle drivers improving the inflation outlook. Monthly inflation dynamics worsened as month-over-month CPI in April increased by 0.4%, breaking the 0.2% mom trend of the previous two months. Prices of non-food commodities and services rose by 0.5% and 0.4% mom, respectively. However, a continual appreciation of the national currency and relative stability on world commodity markets supported a slowdown in the prices of services to 8.6% from 9.8% yoy, and non-food commodities to 6.9% from 10.4% yoy. Stable prices of fuels and a 0.8% mom drop in the prices of pharmaceuticals contributed to the notable decline in the growth rate of non-food prices. A weak US dollar and a moderate 1.3% mom nominal appreciation of the RON against the Euro continue to exert downward pressure on the price index of services, with telecommunications and post industries leading in price reduction -0.8% mom in April.

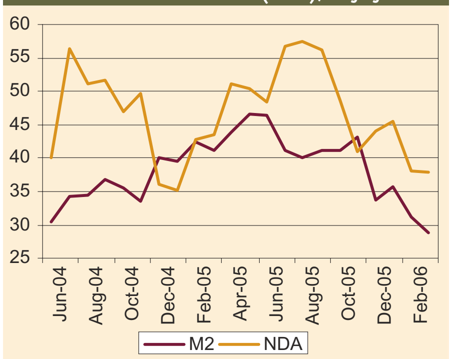
CPI by Components, eop % yoy



Source: INSSE

It is unlikely that the central bank will be able to maintain the inflation rate within the bounds of the inflation target as pending increments in administered prices and indirect taxes on tobacco and alcohol fuel inflationary expectations. The inflation forecast for 2006 has already been revised upward by 0.2%, increasing the central bank's projections for the CPI inflation rate to 6.8%. May's decision to keep the monetary policy rate at 8.5 falls in line with the central bank's commitment to proceed with tight monetary policy. However, the effect of monetary tightening might still be weak as the growth rate of domestic non-government credit accelerated to 51.7% yoy in March from 50% in February. RON-denominated domestic credit continued to expand even more aggressively with year-over-year growth speeding up to 93% in March from 84% in February.

Money Supply (M2) and Net Domestic Assets (NDA), % yoy



Source: INSSE, BNR

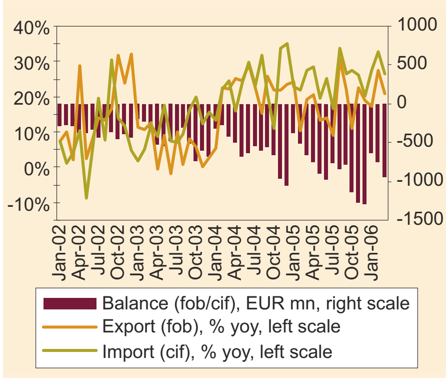
Though increasing by 2.16% mom for the first time since the beginning of the year, the money supply continued to decelerate as the growth rate of monetary aggregate M2 declined in March to 29% yoy from 31% in February. Gradually responding to the tighter monetary policy, the expansion rate of domestic assets continued to slide along the trend begun at the beginning of 2006, slowing down to 37.9% yoy. Net foreign assets declined by 0.63% mom and the annual growth rate decelerated to 21.4%.

At the end of March, RON-denominated loans accounted for almost half (up from 46% at the beginning of 2006) of all loans issued to the non-government sector, which rose by 8% yoy in the first quarter of 2006. The growing share of loans issued in the national currency was strengthened by 18% ytd growth in RON-denominated loans and a slight 0.28% ytd decline in the amount of forex-denominated loans, which is attributed to a nominal appreciation of RON and the effect of actions undertaken by the central bank to restrict the expansion of financial assets denominated in foreign currencies. Consumer loans grew by 17% ytd, increasing by 11.3% mom in March. The year-to-date expansion in RON-denominated mortgages approached 29%, while forex-denominated mortgages declined by 0.76% ytd.

International Trade and Capital

A slowdown of the growth rate of imports (CIF) to 26.3% yoy in March from 32% yoy in February supported a deceleration of the monthly trade balance to 42.3% yoy from 50% yoy in the previous month. The cumulative trade balance deficit (FOB/CIF) amounted to EUR 2.35 billion in the first quarter of 2006, accelerating by 50% yoy. Exports (FOB) grew by 22% yoy in the first quarter of 2006 with almost two thirds of this growth supported by expansion in the exports of machinery, automobiles and mineral products including fuels. About half of the 28.9% yoy growth of imports (CIF) in the first quarter of 2006 comes from increasing imports of mineral products and machinery, supported by surging investment demand and accelerated industrial production.

Foreign Trade Balance



Source: INSSE, The Bleyzer Foundation

In the first quarter of 2006, the current account deficit reported by the National Bank of Romania (BNR) amounted to EUR 1.56 billion, expanding by 59.6% yoy. The cumulative FOB/FOB trade deficit grew by 60% yoy and totaled EUR 1.69 billion. The inflow of foreign direct investments (FDI) for the first three months of 2006 was equal to EUR 1.7 billion, or 2.4 times higher than the EUR 0.7 billion of FDI received for the same period of the previous year; this allowed the country to securely finance the current account gap without a depletion of foreign assets or debt accumulation. According to the foreign investment agency ARIS, 42% (EUR 729 mill) of net FDI consisted of loans issued by the foreign companies to their Romanian branches and 32% (EUR 534 mill) were generated by re-invested profits of the foreign-owned companies. Forex reserves of the central bank increased to EUR 18.23 billion in April and the import cover improved to 6.6 months.

International Programs

On May 16th, the European Commission approved the 2006 Monitoring Report on Romania's preparations for EU accession. According to this report, Romania has made considerable progress in addressing many of the previously outlined 14 areas of serious concern. January 1, 2007 is considered a realistic date for EU accession provided that the government maintains the current pace of progress and focuses on the remaining urgent issues primarily in agriculture and fiscal policy. A satisfactory degree of alignment with EU codes, *acquis*, is expected to be achieved upon serious improvements in the following four areas: 1) a creation of the operational system of payment distribution in agriculture, 2) establishing an integrated administration and control system (IACS) in agriculture, 3) creating facilities for appropriate control and management of the TSE and animal by-products, 4) improving inter-operability of the national IT tax administration system with the rest of EU. Quality control in agriculture is a pressing item on the current agenda as recent unsatisfactory management of bird flue cases in Romania raised serious concerns from EU officials.

According to a report published by Standard & Poor's, the rating of Romania is more sensitive to the developments in fiscal and monetary policies and EU accession rather than to the precise timing of this accession. The agency raised concerns about the ability of Romania to maintain its macroeconomic balance as EU accession may expose the economy to fiscal risks associated with additional financial contributions to EU funds. Recommendations to increase the share of the budget revenues in GDP include prudent control of fiscal expenditures, improving the functioning of state companies and expanding the taxation base.

On May 25th, Moody's Investors Service increased the ceiling of the long term sovereign rating granted to Romania from "Ba1" to "A2." The revision followed a methodological change that eliminates an automatic link between the payment incapacity of the government and the ability of the other domestic entities to serve forex denominated debts. The purpose of the amendment is to account more accurately for the degree of integration of the domestic economies into the international financial markets. Two rating agencies, S&P's and Fitch, have already granted Romania the rating "BBB minus" for long term debts in foreign currency. An upward revision of the credit ratings given to non-government agents may follow.