Romania
Macroeconomic Situation

June 2006

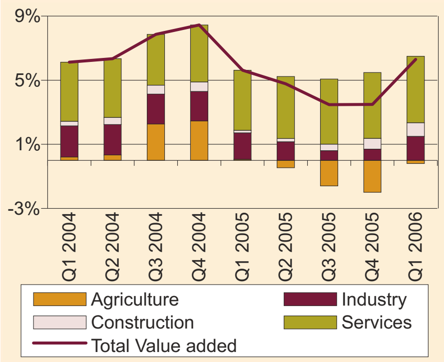
Sergiy Kasyanenko, Radu Mihai Balan, Edilberto L. Segura

Summary

- Real GDP growth accelerated to 6.9% yoy in the first quarter of 2006, outpacing the 4.3% growth rate in Q4 of 2005. Industrial output growth for January-April decelerated to 3.5% yoy from 4.5% yoy in the first quarter of 2006.
- In January-May, fiscal revenues posted strong growth, expanding by 23.3% year-over-year or 14.9% yoy CPI adjusted. The consolidated budget surplus increased to RON 3.4 billion in January-April and amounted to 1.06% of projected full year GDP.
- The consumer price index increased by 0.34 percentage points and reached 7.26% yoy in May. Rising prices of tobacco and fuel were the principle cause of the slowing disinflation, responsible for at least ¾ of the monthly inflation.
- In January-April, the trade deficit (FOB/CIF) slightly decelerated to 46.18% yoy from 51.7% yoy in the first quarter of 2006 and amounted to EUR 3.41 billion. Foreign direct investments totaled EUR 2.3 billion and covered 91% of the EUR 2.49 billion current account deficit.
- According to the Romania-World Bank Country Partnership Strategy, the World Bank intends to extend to Romania loans of USD 450-550 million a year from 2006 until 2009.
- Moody's placed Romania's sovereign rating on review for an upgrade, which may bring the country into the investment-grade group.

Economic Growth

Contributions to Value Added Growth, percentage points

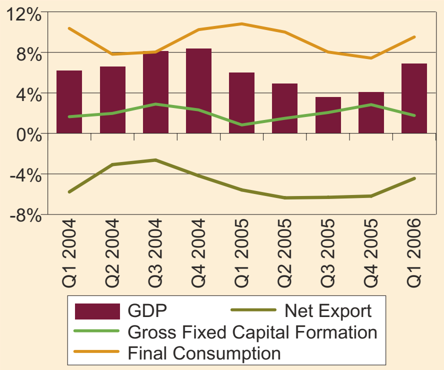


Sources: INSSE, The Bleyzer Foundation

Real GDP growth accelerated to 6.9% yoy in the first quarter of 2006, outpacing 4.3% growth in Q4 of 2005. The service sector continues to be the most important source of the improving economic outlook. In Q1 2006, the value added generated in this sector expanded by 6.8% yoy in real terms; taking into account that the weight of services in value added exceeds 50%, this translated into 3.65 percentage points of quarterly GDP growth. In addition, strong economic performance was supported by the dynamically growing construction sector where value added is up by 20.4% yoy in Q1 2006 as well as positive developments in the industry.

On the expenditure side, GDP growth is traditionally supported by the expansion of final consumption due to growing private consumption, which surged by 10.90% yoy in Q1 2006 fueled by booming consumer credit and increasing household incomes. Investment demand remained strong as gross fixed capital formation increased by 11.4% yoy in the first quarter of 2006. Although the growth rate was below the average for 2005, gross capital formation nevertheless grew twice as fast as in the first quarter of 2005.

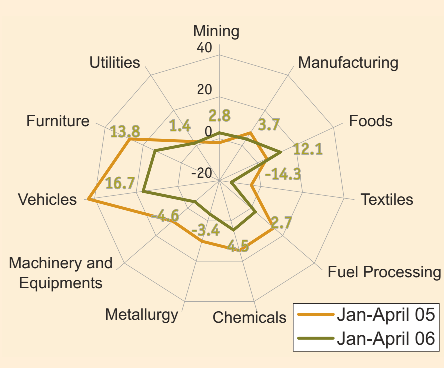
Contributions to GDP Growth, percentage points



Sources: INSSE, The Bleyzer Foundation

The growth of cumulative industrial output in January-April decelerated to 3.5% yoy from 4.5% yoy in Q1 2006, while monthly industrial output inched up by only 0.5% yoy following an unexpected industry rebound in March when industrial production grew by 4.3% yoy. Due to the lower number of working days because of holidays and continuing adjustment of the industry to higher energy and input prices, all major sectors posted a considerable slowdown of growth rates; output in mining and manufacturing decelerated to 0.3% yoy and 0.6% yoy respectively from 0.9% yoy and 4.6% yoy in March, while utilities declined by 1.2% yoy. In metallurgy, output continued to shrink at an accelerating pace contracting by 6% yoy in April compared to 4.6% yoy in May. In April, the stagnation in light industry intensified as the output contraction rate in textiles jumped to 21% yoy.

Industrial Output by Sector in January-April, % yoy

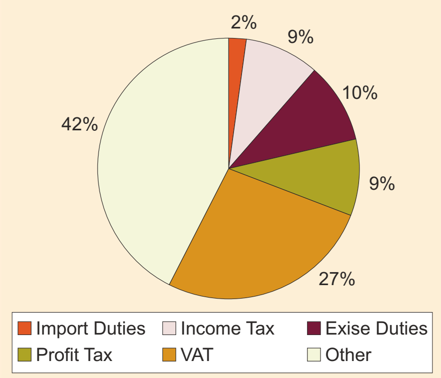


Sources: INSSE, The Bleyzer Foundation

Fiscal Policy

During the first five months of 2006, the consolidated budget tax revenues grew by 23.3% yoy in nominal terms or by 14.9% yoy weighted by monthly CPI. According to the Ministry of Public Finance, the value added tax and income tax registered the highest growth rates, together contributing to more than 75% of fiscal revenue expansion, increasing in January-May by 29% yoy and 33% yoy respectively or by 23.6% yoy and 19.9% yoy CPI adjusted. These positive developments may be attributed to expanding retail sales and the robust growth of earnings. In addition, the excise tax collection sped up to 18% yoy in nominal terms from 13% yoy in January-April of 2005. The growth rate of excise tax revenues may experience further acceleration due to the introduction of higher indirect taxes on tobacco and spirits.

Total Revenues to the General Budget by Major Components in January-May 2006



Sources: Ministry of Public Finance

The nominal growth rate of consolidated budget spending continued to slow and amounted to 12% yoy in January-April while total revenues grew by 20.2% yoy in the same period, which expanded the consolidated budget surplus to RON 3.4 billion (EUR 988 million).

The Ministry of Public Finance announced a plan to widen the 2006 fiscal deficit to 2.5% of GDP (EUR 2.25 billion), which is an upward revision from the previous projection of 0.9%. A larger deficit is anticipated due to the increasing spending on infrastructure projects, health and education. T-Bills sold on the local market in the second half of 2006 will be the primary source to fund the budget deficit. In addition, the ministry of finance might issue the euro-denominated bonds, which were not sold by the Treasury during the last three years. While the issue of government debt on the local market was suspended in the first half of the year due to the treasury surplus, the Ministry of Finance intends to sell an estimated RON 4.15 billion of T-Bills and bonds in the fall. Even though increasing public spending is driven by higher infrastructure investments, the widening fiscal deficit poses a threat for the disinflation policy and it may exacerbate imbalances in the current account. Furthermore, in an environment of tight monetary policy and

Where Opportunities Emerge.

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer Rudkin

rising world interest rates, increasing debt imposes high debt service costs on the government.

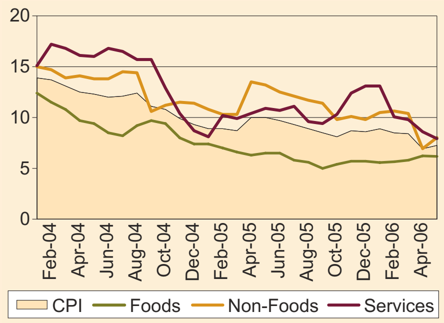
In January-April the budget surplus amounted to 1.06% of projected full year GDP which implies that 2.5% budget deficit will result from higher spending during the second half of this year. The Ministry of Finance expects a limited effect of this higher deficit on inflation outlook since increased expenditure is primarily absorbed by the public investment projects. However, disinflation dynamics may suffer since this fiscal expansion, if approved, will be the second largest pro-cyclical measure implemented by the government in the last two years, after the introduction of lower flat income tax in 2005.

According to the National Bank of Romania, the stock of medium and long-term external debt (excluding foreign entities' deposits) fell by 0.89% month-over-month (mom) from EUR 23.87 billion in March to EUR 23.67 billion in April. Total public and publicly guaranteed external debt decreased by 1.9% mom to EUR 10.98 billion or 8.2% of projected full year GDP. External debt issued by the private sector increased slightly and accounts for 52% of the total external debt (43.8% in April 2005). In January-April, the medium and long-term external debt service ratio settled at 16.7% compared to 18.2% in December 2005.

Monetary Policy

The consumer price index (CPI) increased by 0.6% mom in May with 0.52 percentage points of the monthly inflation coming from the rising prices of non-food commodities. Higher excise duties due to the introduction of a 9% and 0.5% vice tax on cigarettes and sprits respectively are responsible for a hike in the growth rate of the non-foods price index. This increasing contribution of mom non-food price inflation to CPI makes the inflation outlook particularly sensitive to price developments in the non-food sector. As a result, potential inflationary threats are rooted in the rising inflationary expectations caused by further increases in indirect taxes and upward adjustments of administered prices.

CPI by Components, eop % yoy



Source: INSSE

Year-over-year CPI accelerated by 0.34 percentage points in May compared to the previous month and reached 7.26%. The largest increase was registered for the non-food price index, which increased by 1.09% mom, while price indexes of foods and services continued to decelerate. Rising prices of tobacco and fuels were the principle source of the slowing disinflation; in May, the prices of tobacco and fuels grew by 8.94% mom and 1.03% mom respectively.

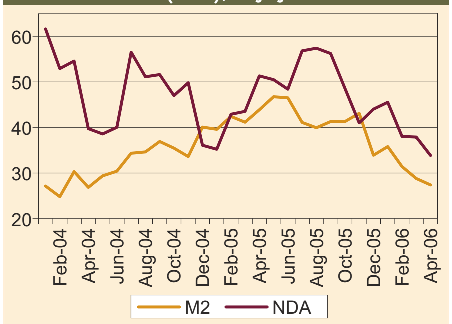
A persistent downward trend in pharmaceuticals prices (which continued to decline for the third month in a row) and flat prices of utilities partially offset inflationary pressures generated by the higher indirect taxes. At the same time, more than half of the year-over-year increase in the non-foods price index in 2006 was generated by the growing prices of utilities, which hit 15.3% yoy growth in May. The National Natural Gas Regulating Authority (ANRGN) has announced a 1.65% price increase for natural gas starting July 1st as well as a 5% increase in the price of heating paid by residential end-users. This upward revision of utilities prices will continue to decelerate disinflation in the non-food sector. An increase in electricity tariffs is likely to follow, but on the positive side, strong domestic currency mitigates upward price adjustments in imported energy resources. Finally, a deceleration of the services price index was supported by the declining tariffs for postal and telecommunication services, which fell by 0.67% mom in May following a 0.8% decrease in April.

The National Bank of Romania kept the reference rate at 8.5% for June and continued to peruse restrictive monetary policy by absorbing excess resources on the inter-bank market including the money obtained by banks from the central bank's matured operations. The total volume of the open market operations undertaken by the NBR amounted to RON 18.1 billion (EUR 5.2 billion) and RON 15.34 billion (EUR 4.4 billion) in April and May, respectively.

On June 27th the Board of the National Bank of Romania (NBR) made a decision to proceed with further tightening of the monetary policy. According to NBR booming non-government RON-denominated credit fuels unsustainable consumption growth and poses potential inflationary threat. To restrict the expansion of non-government credit NBR raised its monetary policy rate by 25 base points to 8.75%. In addition, the minimum reserve requirement ratio on RON-denominated liabilities was increased to 20% from 16%.

In April, monetary aggregate M2 increased slightly in nominal terms, though the deceleration trend of the money supply continued as its nominal growth rate slipped to 27.41% yoy in April from 28.8% yoy in March. Restrictive monetary policy continues to exert downward pressure on the expansion of net domestic assets (NDA) as the nominal growth rate of NDA has been decelerating since the beginning of the year and declined to 34% yoy in April.

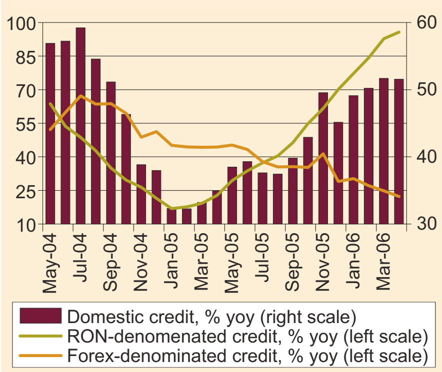
Money Supply (M2) and Net Domestic Assets (NDA), % yoy



Source: INSSE, NBR

Domestic non-government credit amounted to RON 68.1 billion in nominal terms registering a 51.56% yoy growth rate in April. Noteworthy, about 75% of this expansion comes from the considerable growth of RON-denominated credit, which almost doubled in nominal terms compared to April 2005 accelerating to 96% yoy in April 2006. The growth rate of forex-denominated credit fell to a moderate 22.3% yoy in April (expressed in euros, the increase of credit in foreign currency was 27.4% yoy) hitting its lowest level since January 2003. Significant growth of RON-denominated credit may be explained by the low-base effect, as well as by the the regulatory restrictions on the issue of forex-denominated loans. Furthermore, the bias toward forex-denominated credit in the structure of domestic credit has faded away as the share of RON-denominated credit in non-government credit increased to 51.5% in April 2006, as compared to 40% a year ago.

Non-government Domestic Credit, eop



Source: INSSE, NBR

Consumer loans grew by 7.2% mom in April while real estate mortgages inched by less than 1% mom. Rising indebtedness of households due to surging consumer credit transformed them from a net bank creditor into a net bank debtor. Though the position of the net bank creditor was still maintained for the RON-denominated loans and deposits, it was more than offset by net bank claims (loans less deposits) for the loans and deposits denominated in foreign currencies.

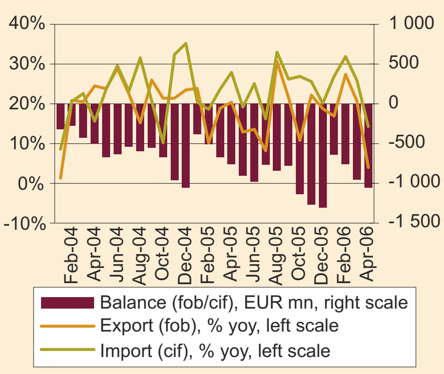
Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: (1-713) 621-3111 Fax: (1-713) 621-4666
E-mail: sbleyzer@sigmableyzer.com

Bucharest Office, Romania
12Bis, Dr. Draghiescu St., Sect. 5,
Bucharest , 050579
Tel: 40 (21) 410-1000 Fax: 40 (21) 410-2222
E-mail: bucharest.office@sigmableyzer.com

International Trade and Capital

During April the growth rates of imports and exports slowed down. The imports (CIF) amounted to EUR 2.91 billion increasing by 14.1% yoy, decelerating from 26.3% yoy in March. The exports (FOB) totaled to EUR 1.86 billion slowing to 3.7% yoy down from 20.7% yoy in the previous month. The monthly trade balance deficit (FOB/CIF) continued to grow, though at a slower year-over-year rate, and amounted to EUR 1051 million in April decelerating to 38.7% yoy growth rate from 42.3% yoy in March.

Foreign Trade Balance



Source: NBR, The Bleyzer Foundation

In January-April, the trade deficit (FOB/CIF) decelerated slightly to 46.18% yoy from 51.7% yoy in the first quarter of 2006 and amounted to EUR 3.41 billion. Exports (FOB) reached EUR 8.1 billion increasing by 17.2% yoy and imports (CIF) amounted to EUR 11.5 million, up 24.6% yoy. Machinery, mineral products and vehicles are the principle commodities generating 15.26 percentage points of 17.2% yoy growth of exports in the first four months of 2006. About 67.8% of total exports were shipped to the EU with Italy (18.7% of total exports) Germany (14.7%), France (7.5%), Turkey (7.3%) and Hungary (4.9%) absorbing more than 50% of total exports. At least half of the 24.6% yoy increase in imports (CIF) was supported by the growing imports of machinery (30.8% yoy) and mineral products (42% yoy) caused by the strong investment demand and higher prices of energy resources. Italy (14.5% of total imports), Germany (14.0%), Russia (10.2%), France (6.8%), and Turkey (4.7%) generated 50% of imports while 60.5% of total imports came from the EU.

The current account deficit in January-April amounted to EUR 2.49 billion, which is 57.2% yoy growth over the same period of 2005. The widening of the current account deficit is driven by the increasing merchandise trade deficit (FOB/FOB), which grew by 57% yoy. On the positive side, the expanding current account deficit is primarily financed with a stable inflow of foreign direct investments. FDI increased by 130% yoy in the first four months and totaled EUR 2.3 billion, thus allowing 91% of the current account deficit to be covered. The inflow of FDI in April exceeded EUR 600 million compared to EUR 246 million in the same month of the previous year.

In May, foreign exchange reserves of the National Bank of Romania declined by EUR 80.1 million to EUR 18.2 billion. By the end of May, the total value of the central bank's reserves, including monetary gold, was EUR 19.92 billion or 0.42% lower than in the previous month. In April, the import cover ratio stood at the same level of 6.6 months, as compared to the previous month.

Other Developments Affecting the Investment Climate

The World Bank intends to extend to Romania loans of USD 450-550 million a year from 2006 until 2009 in line with the Romania-World Bank Country Partnership Strategy (CPS). The primary purpose of the CPS is to enhance economic developments achieved by the country during the last few years. The strategy includes projects that will be focused on institutional and structural reforms, public sector, tax administration and judicial reforms, social inclusion, poverty reduction and minimization of the impact of the EU accession on the most vulnerable categories of the population. Since 1991, the World Bank has extended loans of around USD 5 billion to Romania.

In June, the Netherlands, Finland, and Ireland ratified the Treaty of Accession of Romania increasing the number of EU members that support the treaty to 20. The European Commission will issue its next monitoring report on Romania in September, one month ahead of schedule. At the beginning of September, a meeting will be held with EU representatives to inform them about the final stage of the measures taken by the Romanian authorities to meet the EU accession criteria.

Moody's placed Romania's sovereign Ba1/positive rating on review for an upgrade, citing current improvements in the country's credit profile and the government's reduced debt burden. The purpose of this review is to assess whether recent positive developments are sustainable. This upgrade, if positive, would bring Romania into the investment-grade group.