SigmaBleyzer

Romania
Macroeconomic Situation

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Summary

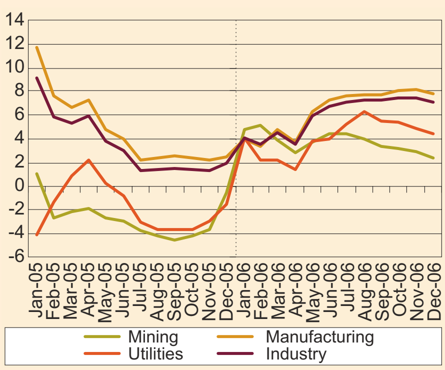
- The Romanian economy grew by an impressive 7.7% in 2006 on the back of strong industry, booming construction and a robust recovery in agriculture.
- After hitting a 1.23% surplus during the first eleven months of 2006, the consolidated budget balance slipped to a year-end deficit of 1.65% of GDP.
- In January, consumer prices continued to decelerate due to the slower growth rates of prices of non-food commodities.
- In 2006, a record high merchandise trade deficit (FOB/CIF) in the amount of 15% of GDP was registered on the back of appreciating national currency and buoyant demand for imports.
- Last year, the current account gap widened to EUR 9.97 billion or 10.3% of GDP, yet 91% of this deficit was covered by FDI inflows.
- According to the IMF, loose pro-cyclical fiscal policy is a major risk for financial stability and economic growth in Romania.

Economic Growth

According to the National Institute of Statistics, nominal GDP amounted to RON 342.42 billion (EUR 97.2 billion) in 2006, growing by 7.7% year-over-year (yoy) in real terms up from 4.1% yoy in 2004. As a result, EUR denominated nominal per capita GDP grew by almost 22.3% yoy approaching EUR 4,500 in 2006.

In 2006, industrial production staged a remarkable recovery, largely supported by the positive trends in manufacturing, where output grew by 7.8% yoy as compared to 2.5% yoy in 2005. Although output growth in mining and quarrying sectors was on a steady downtrend during the second half of last year, the extracting industry still managed to post year-end positive performance increasing by 2.4% yoy after falling by 0.5% yoy in 2005. Output in the utilities sector followed a similar trend, gaining 4.4% yoy in 2006.

Industrial Output by Sector, % ytd yoy



Sources: INSSE

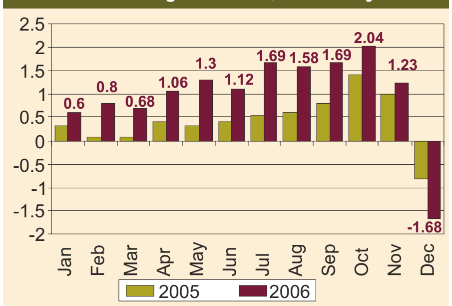
The manufacturing sector, which accounts for about 80% of industrial production, was supported by the robust growth of output in food processing (up by 15.9% yoy in 2006 from 3.5% yoy in 2005) and the chemical industry (up by 14% yoy in 2006 from 3.1% yoy in 2005). These two sectors alone generated 40% of the 7.8% yoy growth in manufacturing or about 1/3 of the overall industry expansion. At the same time, the performance of metallurgy, where production grew by only 1% yoy in 2006, was somewhat weaker than in 2005. Other sectors that exerted a downward pressure on industry growth were machine building, fuel processing and light industry. In particular, the upward trend in the oil processing industry reversed in August 2006 and by year's end this sector posted a 3.5% yoy reduction. On a positive note, despite the fact that the output in machine building was on a steady downtrend, this sector posted only a marginal decline in 2006 falling by 0.1% yoy.

In December alone, industrial production continued to decline on a month-over-month (mom) basis, shrinking by 11.2% mom. This decline was mostly driven by the weaker performance of manufacturing sectors on the back of falling production in light industry. In December, output in textiles, ready-made clothing and footwear declined by 1.4% yoy, 16.8% yoy and 1.3% yoy respectively.

Fiscal Policy

In 2006, consolidated budget revenues amounted to RON 106.97 billion (or 31.24% of GDP) growing by 23% yoy in nominal terms, while consolidated budget spending increased by 26.3% yoy to RON 112.63 billion (or 32.89% of GDP). As a result, the year-end consolidated budget deficit settled at RON 5.65 billion (EUR 1.6 billion) or about 1.65% of GDP. This budget deficit was generated through the large deficit of the state budget, which during the twelve months of 2006 approached RON 10.54 billion, increasing by more than eight times in December alone. According to the Ministry of Public Finance, the bulk of state budget expenditures in December (about EUR 3 billion) represented transfers to ministries and other state entities for various investment projects. Although these developments corresponded to the seasonal pattern built into the government expenditure process, this unusually large fiscal loosening raises concerns about the high possibility of excessive aggregated demand pressure on inflation and external imbalances.

Consolidated Budget Balance, % of full year GDP



Source: Ministry of Public Finance

In January 2007, the consolidated budget returned to surplus as budget revenues exceeded budget spending by RON 2.43 billion (EUR 715 million), thus bringing the consolidated budget surplus to 0.64% of projected full-year GDP. The performance of personal income tax collection continued to march ahead of other principle taxes. In January, collection of this tax improved by 54.9% yoy in nominal terms against the first month of the previous year. Proceeds from the profit tax and excises grew by 47.3% yoy and 48.2% yoy respectively. At the time, the collection of VAT and custom duties notably deteriorated as the amounts of taxes collected in January declined by 20.7% yoy for VAT and 59.5% yoy for custom duties. However, in January 2007 VAT collection actually outperformed initial projections by 12.7%, thus this decline is mostly attributed to the changes in tax payment schedules. For example, the deadline to pay the VAT for products imported in January is now the 25th day of the next month.

In 2006, the stock of medium and long-term external debt increased by 13% yoy to EUR 26.75 billion. Although public and publicly guaranteed debt declined by 5.3% yoy, private external debt gained almost 30% yoy, increasing to EUR 16.1 billion. Total gross external debt approached EUR 41.2 billion in 2006, growing to 42.4% of full year GDP.

Total Goss External Debt in 2006

	EUR million	Debt to GDP ratio
Total Gross External Debt	**41,162.6**	**42.37%**
1. General Government	9,691.3	9.98%
Long Term	9,669.3	9.95%
Bonds	2,676.0	2.75%
Loans	6,958.3	7.16%
2. Monetary Authority	78.6	0.08%
3. Banks	11,606.6	11.95%
Short Term	5,460.2	5.62%
Long Term	6,146.4	6.33%
4. Other Sectors	12,193.2	12.55%
Short Term	6,126.0	6.31%
Long Term	6,067.2	6.24%
Gross External Debt (1+2+3+4)	33,569.7	34.55%
Direct Intercompany Lending	7,592.9	7.82%

Source: BNR, The Bleyzer Foundation

Short-term debt, one of the issues the BNR has started monitoring more closely, reached EUR 13.4 billion (or about 13.8% of GDP) at the end of 2006, increasing by more than two times from its 2005 level of EUR 6.5 billion. For comparison, the stock of medium and long term debt, including foreign entities deposits, stood at EUR 27.7 billion in 2006 growing by only 12.5% yoy. The BNR estimates that 1/3 of the short-term debt in 2006 was accumulated due to the administrative measures taken by the central bank to limit the growth of forex-denominated credit. In September 2005, the BNR imposed an upper boundary on the amount of forex-denominated credit issued by financial institutions, which was set to three times the value of the creditors' own capital. As a response, Romanian branches of the foreign banks transferred a fraction of the forex-denominated credit portfolio

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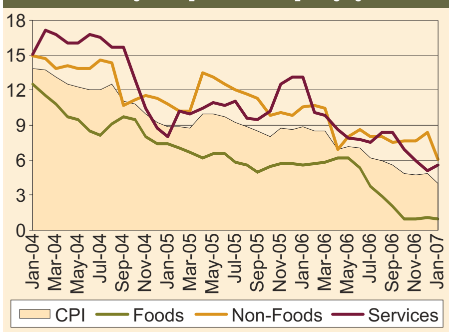
from their balance sheets into the balance sheets of the parent banks in order to be able to issue new forex-denominated credit in Romania. However, after EU accession in January, this administrative restriction was eliminated.

Monetary Policy

In January, consumer prices continued to decelerate as consumer price inflation (CPI) fell to 4.01% yoy or more than two times below CPI inflation of 8.9% yoy registered in January 2006. A robust disinflation trend was supported by the slower growth rate of prices of non-food commodities — up by only 6.12% yoy. In fact, deflation of prices of non-food commodities on a month-over-month (mom) basis was registered for the first time in January. In the first month of 2007, falling prices of utilities, fuels, cosmetics, and cultural and sports products (goods that account for more than 60% of the consumer basket of non-foods) kept inflation of non-foods relatively low. In the same month, service tariffs gained 1% mom due to a 2.87% mom increase of water supply tariffs. Due to its relatively high weight in the consumer basket of services (about 14%), rapidly increasing water supply tariffs explain more than ½ of year-over-year inflation of service tariffs. For example, in January 2.8% of the 5.6% yoy inflation of service tariffs was driven by 20.5% yoy higher tariffs of water supply. At the same time, favorable developments of postal and telecommunication tariffs (with a weight of more than 40% in the index of service tariffs) tend to mitigate these upward trends of tariffs of other services. Although postal and telecommunication tariffs grew by 0.3% mom in January, they posted a 1.94% yoy decline against January 2006 supporting relatively slow growth of service tariffs in the first month of this year.

CPI by Components, eop % yoy



Source: INSSE

In February the National Bank of Romania (BNR) released its quarterly inflation report, marginally reducing the year-end inflation forecast for 2007 to 4.6% yoy from the previously set projection of 4.7% yoy. The BNR has also revealed its year-end inflation forecast for 2008, according to which CPI inflation is expected to hit 4.1% yoy. The official BNR inflation targets for 2007 and 2008 are set at 4.0% yoy and 3.8% yoy respectively.

New inflationary projections resulted from the assessment of the recent evolutions of economic factors influencing price inflation. On one hand, the seasonal supply volatility at the domestic food markets as well as excess aggregate demand are expected to exert a higher upward pressure on inflation in 2007. On the back of impressive output recovery in agriculture in 2006 and its favorable impact on CPI inflation, in the best case scenario, the price volatility of food commodities in 2007 will stay at the same level. Thus, the price dynamics of foods remains a key risk to the steady disinflation trend. Excess demand pressures are expected to persist if economic growth accelerates above expectations. On the other hand, continuing appreciation of the national currency (with a deflationary impact on the prices of imported consumer goods and services as well as industrial inputs and equipment) and more conservative than previously expected upward adjustments of administered prices will make a stronger contribution to restrict the growth of consumer prices. February's inflation report has also highlighted major risks to the disinflation process and achievability of the updated inflation forecast: (i) excessive wage growth, especially if uncorrelated with productivity growth, (ii) excessive pro-cyclical relaxation of fiscal policy, and (iii) rapid expansion of domestic credit. Finally, the fourth principle risk to price stability is linked to uncertainties rooted in the future developments of food prices, world prices of oil and natural gas as well as movements of the foreign exchange rate.

During the BNR's board meeting in February, a 0.75 percentage point cut of the key monetary policy interest rate was approved, reducing its level to 8.0%. This monetary policy loosening coincides with the forecasted slowdown of CPI inflation during the first two quarters of this year. According to the BNR, inflation is expected to decelerate to 4.3% yoy at the end of the first quarter of 2007 and to 4.2% yoy in the first half of this year. However, this disinflation trend is anticipated to reverse in the last two quarters of 2007 as CPI inflation is expected to increase to 4.7% yoy and 4.6% yoy at the end of the third and fourth quarter of 2007 respectively.

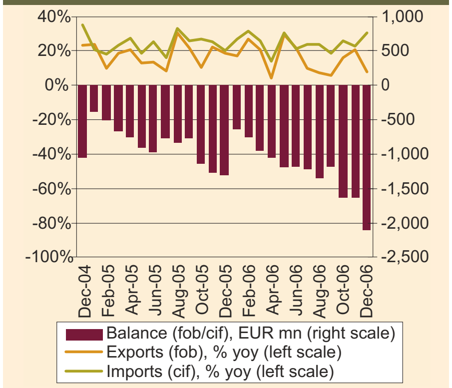
There were several reasons for the BNR to approve a 0.75 percentage point monetary policy interest rate cut. First, on the back of the recent successful disinflation process, including achievement of the inflation target in 2006, the restrictiveness of the monetary policy (the key monetary policy interest rate has been kept at 8.75% since June 2006) has become relatively excessive in terms of its economic impact as well as costs for the monetary authority. However, the key motivation for the BNR to undertake interest rate cuts was its intention to lessen appreciation pressures on the national currency. A high interest rate differential between the local and international money markets, further expanded by the recent RON appreciation, has exposed the stability of the domestic financial markets to the unnecessary risk of the inflow of short-term speculative capital. The BNR has recently started paying closer attention to the issues of short-term capital flows and short-term debt as well as their impact on financial stability in the country. Finally, an important driver of the monetary policy loosening (although not explicitly claimed by the BNR, but obviously reflected in its policy measures) is the central bank's intention to restrict the widening of external imbalances through the elimination of appreciation pressures on the national currency. Despite large foreign trade deficits, the Romanian national currency strengthened against the Euro in 2006 by 8% in nominal terms on the back of strong inflows of foreign capital as well as high real interest rates (due to both high nominal interest rates and moderate inflation).

Money supply (measured with the broad money aggregate M3) grew by 29.4% yoy in 2006 to RON 111.7 billion. Although this growth rate was below the 33.9% yoy increase of money supply in 2005, the ratio of M3 to GDP inched up to 32.6% in 2006 from 30% in 2005. The growth of money supply was fueled by rapidly expanding non-government domestic credit, which amounted to RON 93.3 billion, increasing by 53.7% yoy at the end of 2006 (45.14% yoy in 2005). The high growth rate of domestic credit continued to improve the financial deepening of the economy as the ratio of non-government domestic credit to GDP increased to 27.24% from the relatively modest 21.13% in 2005. Long-term RON-denominated credit was the most dynamic component of credit expansion as it increased by more than two times in 2005, followed by 81% yoy growth posted by long-term forex-denominated credit. Furthermore, due to the faster growth rates of RON-denominated credit, the aggregate credit portfolio of financial institutions is now less heavily loaded with forex-denominated credit as the share of RON-denominated credit in total domestic credit grew to 53.1% from 46% in 2005. In 2006, domestic credit issued to households continued to outperform (in terms of growth rates) the credit issued to other economic agents. At the end of last year, RON and forex-denominated credit to households gained 77.3% yoy and 33.7% yoy respectively, while the ratio of credit issued to households to GDP enlarged to 11.5% from 7.4% in 2005. Consumer loans, in turn, almost doubled increasing by 94% yoy to 8.9% of GDP from less than 5% of GDP in 2005. Obviously, this rapid expansion of domestic credit is a clear indication of the increasing demand for money on the back of rapid economic growth. At the same time, it implies growing sophistication of the Romanian financial sector, which calls for broader and deeper control and supervision by the monetary authority.

International Trade and Capital

In 2006, exports FOB increased by a moderate 16.2% yoy to EUR 25.9 billion while imports CIF expanded by 25.1% yoy to EUR 40.7 billion. As a result, a record high merchandise trade deficit (FOB/CIF) in the amount of EUR 14.9 billion (up by 44.4% yoy) or about 15% of GDP was registered.

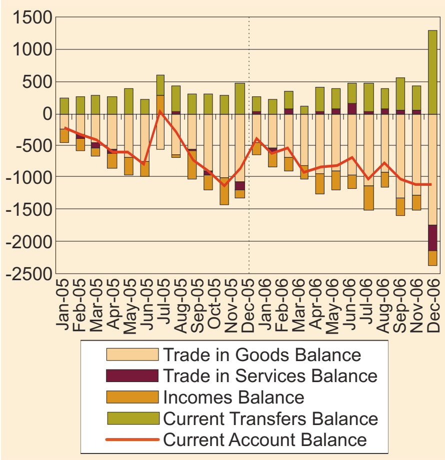
Monthly Foreign Trade Balance



Source: BNR

In 2006, exports were driven by the robust growth of exports of machinery (33.1% yoy), strong performance of exports of metal products (up by 17.6% yoy) on the back of more favorable external demand, and buoyant demand for transportation means produced in Romania (exports up by 44% yoy). At the same time, due to the weak world prices of oil, exports of mineral products were on a deceleration trend during the second half of 2006 and posted only a modest 9.6% yoy year-end growth (as compared to 81% yoy growth in 2005). With the exception of exports of mineral products, imports of all other major commodity groups registered higher growth rates in 2005 than in 2006 fueled by strong economic growth, appreciating national currency and rapidly increasing domestic demand (both of companies and households) for imports.

Current Account Components, monthly flows EUR million



Source: NBR, The Bleyzer Foundation

In 2006, the current account gap widened by 44.8% yoy to EUR 9.97 billion or 10.3% of full year GDP. While the trade in services balance registered only a tiny surplus of EUR 6 million, the trade in goods deficit grew to EUR 11.8 billion. Although the pressure on the current account gap was somewhat alleviated by the record inflow of transfers from abroad which grew by 33.43% yoy, the record high outflow of incomes to foreign countries has offset more than half of that impact. On a positive note, the inflow of net foreign direct investments (FDI) hit another record in 2006 as FDI amounted to EUR 9.05 billion posting almost 73% yoy growth. As result, about 91% of the current account deficit was covered by FDI.

In January, international foreign exchange reserves of the central bank increased by EUR 395 million to EUR 23.4 billion.

Other Developments Affecting the Investment Climate

In March, a statement of the IMF mission in Romania was published. The key point of this release is the necessity for the government of Romania to strengthen the coherency of its fiscal policy. Pro-cyclical fiscal loosening combined with poorly managed wage growth in the public sector may seriously jeopardize price stability and exacerbate aggregate demand pressures with an immediate impact on external imbalances. Other principle challenges include the call for the central bank to reduce the reliance on the strong national currency as a caution against inflation, as RON appreciation damages the competitiveness of domestic producers. According to IMF, the central bank has to reunify headline and effective policy interest rates, by increasing the effective interest rate towards the headline rate which will improve the signaling role of the official policy rate as well as moderately tighten monetary policy. The government is also urged to accelerate structural reforms in the country and minimize the sensitivity of economic growth to volatilities on external markets, by encouraging investments into human capital and innovative technologies.

The European Commission has also raised concerns about fiscal policies in Romania and advised the government to tighten its fiscal policies in order to not overshoot the budget deficit ceiling of 3.0% GDP. Romania targets a consolidated budget deficit of 2.8% of GDP this year as compared to a 1.7% budget deficit in 2006. However, the IMF has warned Romania that under the current fiscal policy, the budget gap may widen to 3.7% of GDP.