Romania
Macroeconomic Situation

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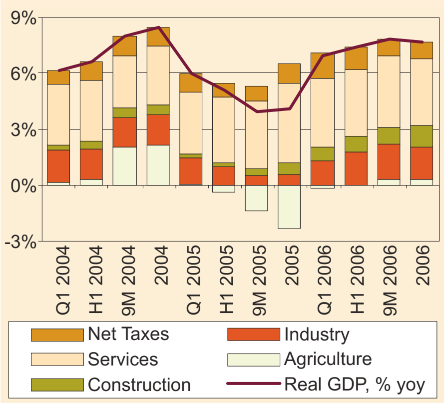
Summary

- GDP growth in 2006 was supported by robust expansion of private consumption and booming investments.
- The central bank cut the monetary policy interest rate on the back of optimistic disinflation trends.
- In January, the foreign trade deficit grew by 66.8% yoy against the same month of the previous year.
- In January, the current account deficit widened by 162.3% yoy as the trade in goods deficit expanded by about two times compared to the first month of the previous year.
- In the first month of this year, net FDI amounted to EUR 394 million covering only 51.6% of the current account gap.
- Moody's issued a new report on Romania.
- The minority government was approved in April.

Economic Growth

In 2006, the Romanian economy grew by 7.7% year-over-year (yoy) in real terms compared to 4.1% yoy growth posted in 2005. Agriculture staged an encouraging recovery, increasing by 3.3% yoy against a 18.7% yoy decline in 2005. Industry, driven by the recovery of manufacturing on the back of buoyant domestic demand and favorable external conditions, registered a strong acceleration as well, increasing by 6.9% yoy (2.3% yoy in 2005). Although the growth rate of services slightly decelerated to 7.3% yoy in 2006 from 9.8% yoy in 2005, the contribution of this segment of the economy to GDP growth remains critical. At the same time, the impact of construction on GDP expansion has strengthened. If in 2005 construction grew by 9.8% yoy, explaining less than 1/7 of GDP growth, output in this sector climbed by 19.4% yoy in 2006 generating more than 16% of annual GDP growth.

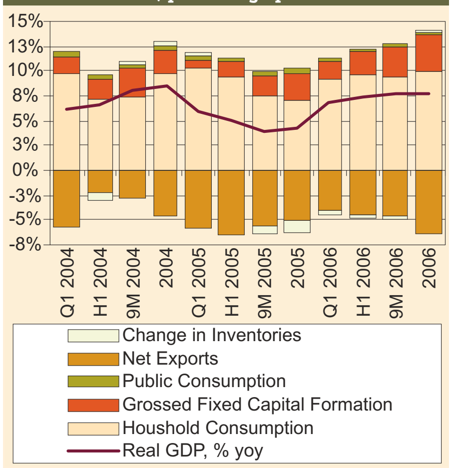
Contributions to Real GDP Growth by Sector, percentage points



Source: INSSE, The Bleyzer Foundation

On the expenditure side, GDP growth was driven by increasing final consumption and flourishing domestic investments. Final consumption accelerated to 11.5% yoy during 2006, up from 9.5% in the previous year on the back of booming household consumption, which grew by 14.1% yoy (up from 9.7% yoy in 2005). In 2006, gross fixed capital formation posted an impressive 16.1% yoy growth, moving up from 12.6% yoy in 2005. Notably, gross fixed capital formation has been outperforming (in terms of growth rates) final consumption since the last quarter of 2005. The gap between these two growth rates has been widening as well. In 2006, gross fixed capital was largely determined by accelerated investments into new construction (more than 40% of all domestic investments), which posted average quarterly growth of 18.5% yoy as compared to only 9% yoy average growth in 2005. Investments into new equipment, which account for about half of all investments, slightly decelerated from the 13.5% yoy average quarterly growth rate in 2005, yet managed to achieve a robust 10.5% yoy average growth in 2006. Although a stronger external demand for Romanian products supported moderate acceleration of exports to 10.6% yoy from 8.1% yoy in 2005, vigorous consumer and investment demand for imports continued to put pressure on GDP growth. In 2006, imports jumped by 23.0% yoy (16.6% yoy in 2005), thus net exports exerted a sizable negative impact on economic growth in the amount of about 6.5 percentage points.

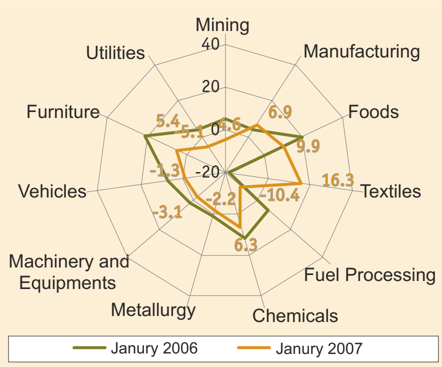
Contributions to Real GDP Growth by Expenditure, percentage points



Source: INSSE, The Bleyzer Foundation

In January 2007, industrial production gained 4.9% yoy accelerating from the 3.9% yoy in December 2006 and posting only marginally lower growth than in the same month of the previous year. Due to falling output in the non-energy materials extracting sector, the mining industry continued to decline for the third month in a row as output in this sector contracted by 4.9% yoy during the first month of 2007. At the same time, this contraction was largely offset by the robust growth of output in manufacturing, which increased by 6.9% yoy. Despite a deceleration in food processing to 9.9% yoy, in January manufacturing expanded on the back of output growth in light industry (production of textiles was up by 16.4% yoy while leather and footwear gained 15.2% yoy), wood processing (up by 20.1% yoy) and a 6.3% yoy growth in the chemical industry. Output reduction in the automobile industry (down by 1.3% yoy in January) was registered for the first time in three years. Output in metallurgy, machine building, fuel processing and utilities declined as well, falling by 2.2% yoy, 3.1% yoy, 10.4% yoy and 5.1% yoy respectively.

Industrial Output by Sector, % ytd yoy

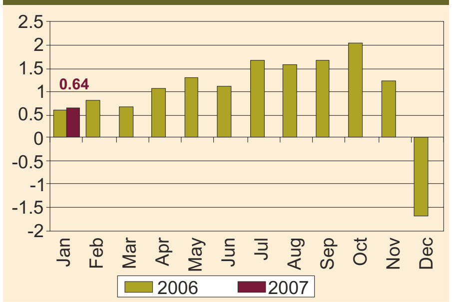


Sources: INSSE

Fiscal Policy

The Ministry of Public Finance made a decision to modify the Fiscal Code and reintroduce the VAT at customs for imports, after having eliminated this system in January 2007. Starting January 2007, the Fiscal Code allowed delaying payments of VAT on imports to the 25th of the next month after the delivery of imported goods. The new amendment that removes this provision was mostly motivated by the unsatisfactory performance of VAT collection during the first months of 2007 as well as increasing concerns over rising tax evasion. Starting April 2007 and through December 2008, importers from non-EU countries will be required to pay VAT at customs unless proof that the goods are delivered to another EU country is presented.

Consolidated Budget Balance, % of full year GDP



Source: Ministry of Public Finance

In January, the stock of medium and long-term external debt inched up by 0.65% ytd to EUR 26.93 billion. This increase was observed on the back of growing public and publicly guaranteed external debt (up by 0.6% ytd) as well as increasing private external debt (up by 0.68% ytd).

According to the Ministry of Public Finance, Romania will issue RON 5 billion (EUR 1.47 billion) worth of government securities in the second quarter of

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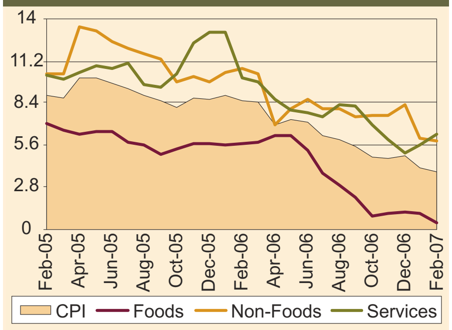
2007 to finance and re-finance public debt. About RON 2.9 billion of these securities will be issued in the form of government bonds with maturities of three, five and ten years, while the rest of the debt will be accumulated through one-year discount T-bills. Romania has also raised its target for RON-denominated domestic borrowing from eight to twelve billion in 2007. In addition, an issue of at least EUR 500 million worth of Eurobonds is projected in 2007. According to the regulations of Romanian capital markets, foreign investors are granted free access to buy government securities issued on the international and domestic markets. However, these regulations set a ceiling on the amount of public debt that can be purchased by foreigners at EUR 4.4 billion for foreign borrowing and RON 19 billion (EUR 5.6 billion) for domestic borrowing in 2007.

Monetary Policy

In February, consumer price inflation (CPI) slightly decelerated to 3.8% yoy from 4% yoy in the previous month. This deceleration continues to be supported by slower growth rates of prices of non-food commodities, which registered deflation on a month-over-month (mom) basis in the first two months of this year. In February, prices of non-foods grew by 5.9% yoy or by about two times slower than in the same month of the previous year (10.3% yoy in February 2006). In January-February 2007, prices of non-food commodities declined by 0.2% year-to-date (ytd) due to the falling prices of fuels (down by 1.9% ytd) and utilities (down by 0.9% ytd) — commodities that occupy about 40% in the consumer basket of non-foods or more than 17% in the entire consumer basket. As a result, modest inflation of prices of non-food commodities as well as decelerating CPI were largely driven by the relatively flat prices of fuels (down by 0.9% yoy in February 2007 as compared to 9.9% yoy growth in February 2006) and slower growth of utilities tariffs (up by 9.5% yoy in February 2007 as compared to 23.2% yoy growth in February 2006). Since the beginning of 2007, prices of foods gained a modest 0.25% ytd on the back of stable prices of foods in February (down by 0.03% mom). Although the evolution of prices across various food groups was not uniform, falling prices of vegetables (down by 14.7% yoy in February) and flat prices of oils, meat and fruits have well compensated increasing prices of other foods. Finally, the inflation of services tariffs accelerated to 6.3% yoy in February from 5.6% yoy in the fist month of this year. Although in February tariffs of all types of services grew slower than a year ago, consistently high inflation of water supply tariffs maintains relatively high inflation of prices of services. On a positive note, falling telecommunication tariffs (down by 0.32% yoy in February) have a strong potential to restrict inflation in the service sector due to the high weight of telecommunication tariffs in the consumer basket (about 40% in the consumer basket of services or 7% in the entire consumer basket).

In January, broad money (M3) amounted to RON 106.97 billion (down from RON 111.7 at the end of

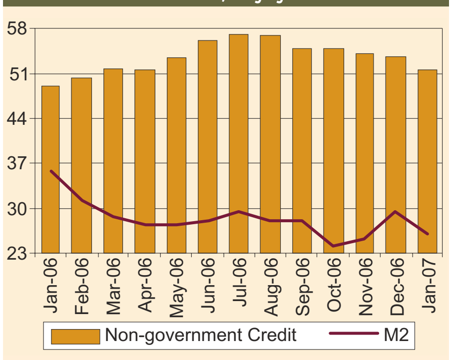
CPI by Components, eop % yoy



Source: INSSE

2006) increasing by 26.1% yoy. A deceleration of the money supply was observed on the back of slower growth of non-government domestic credit, which grew by 51.6% yoy. In January, non-government credit lost 0.3% month-over-month (mom) due to declining RON-denominated credit (down by 2.7% mom) on the back of 7.2% mom contraction of RON-denominated credit issued to corporations. At the same time, forex-denominated credit gained 2.1% mom driven by growing credit to both households and the corporate sector.

Money Supply and Non-Government Domestic Credit, % yoy



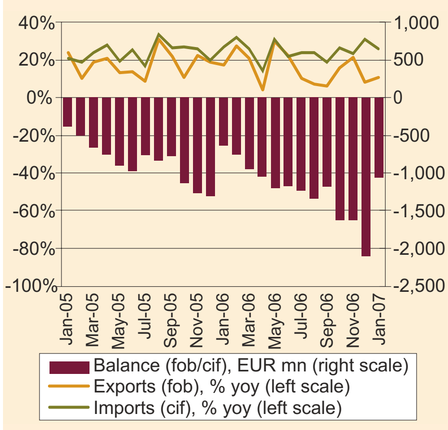
Source: BNR

At the end of March, the board of the National Bank of Romania (BNR) made a decision to reduce the headline policy rate to 7.5% from 8%. This is the second consecutive cut of the interest rate after a 0.75 percentage point decrease implemented at the beginning of February 2007. According to the BNR, the inflation outlook has improved allowing for less strict monetary policy. At the same time, the BNR will maintain tight control over the liquidity on the money markets through open market operations to wipe excessive inflationary pressures that may arise from fiscal loosening and economic overheating. Romania's central bank has a challenging task to maintain price stability in an environment of loose fiscal policy and a rapidly growing economy. At the same time, excessive monetary tightening generates an unnecessary burden on the economy by increasing appreciation pressures on the national currency and through this exacerbating external imbalances. Obviously, the tight monetary policy conducted by the BNR has considerably facilitated the disinflation process, yet it did have a negative impact on external imbalances as well due to the inflows of short-term private capital to take advantage of higher domestic interest rates. Although it is reasonable to assume that large inflows of foreign capital into Romania are mostly composed of long-term strategic investments, the impact of speculative foreign capital on the foreign exchange rate cannot be ignored. Thus, it is safe to argue that one of the key motivations behind these interest rate cuts is the intention of the BNR to ease appreciation pressures on the national currency.

International Trade and Capital

In January, the merchandise trade deficit (FOB/CIF) amounted to EUR 1.06 billion increasing by 66.8% yoy against the same month of the previous year. The performance of exports was relatively weaker than in the first month of the previous year as exports (FOB) grew by only 10.7% yoy (16.9% yoy in January 2006). At the same time, the growth of imports remained steadily strong as imports CIF expanded by 25.4% yoy.

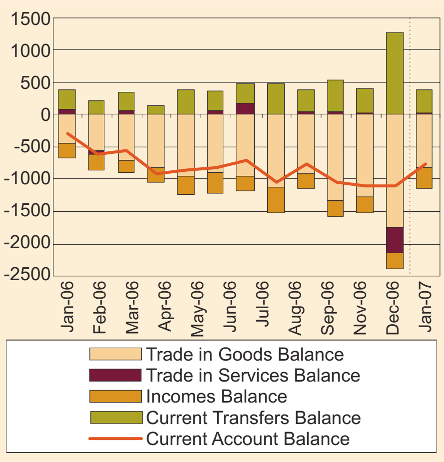
Monthly Foreign Trade Balance



Source: BNR

In January, the current account deficit widened by 162.3% yoy to EUR 766 million as the trade in goods deficit expanded by about two times against the first month of the previous year. Although the current transfers balance registered a strong surplus of EUR 370 million (up by 19.7% yoy against January 2006), it was largely offset by the widening income deficit, which grew by 43.4% yoy to EUR 324 million. In January, FDI inflows (EUR 394 million) covered only 51.6% of the current account gap, falling by 43.2% yoy against the same month of the previous year. According to the Romanian Agency for Foreign Investments (ARIS), reinvested profits represented about 48% of inward FDI in January; intercompany lending amounted to 40%, while equity investments contributed 12%. Reliable inflows of foreign capital are crucial for the sustainability of external imbalances. The Romanian Senate has recently adopted a law that guarantees tax-free status for reinvested profits. Although this law still has to be approved by the lower chamber of the Romanian Parliament, it is a strong indication that the government is willing to further liberalize regulatory treatment of foreign investors in order to maintain adequate financing of the widening current account gap.

Current Account Components, monthly flows EUR million



Source: NBR, The Bleyzer Foundation

Undoubtedly, the capacity of the country to attract foreign investments is shaped by the international competitiveness of the domestic economy. Despite a growing current account deficit, Romanian industry managed to maintain relatively high growth rates of output and productivity (labor productivity in industry was up by 10.3% yoy in January). Thus, growing external imbalances are mostly driven by the strong domestic demand for imports coming from both households and companies rather than by the deteriorating competitiveness of the Romanian economy. This argument is also present in the recently published report by Fitch, which claims that growing current account deficits of South and Eastern European countries are mostly built on strong domestic demand.

In February, international foreign exchange reserves of the central bank remained relatively flat, falling by EUR 57 million to EUR 23.38 billion.

Other Developments Affecting the Investment Climate

Moody's issued a statement arguing that economic overheating risks are still high. According to the agency, annual inflation is projected to move up to 5.2% yoy at the end of 2007 from 4.9% yoy last year. In addition, the current account gap is anticipated to widen to 10.9% of GDP, while the consolidated budget deficit is expected at 2.9% of GDP. Fiscal loosening is considered to be the major restriction for further cuts of the monetary policy interest rates; eventually, the central bank may be required to raise interest rates if government spending continues to grow at the projected speed. At the same time, Moody's "Baa3" investment-grade rating and stable outlook for Romania reflects the low level of government debt, macroeconomic stability, strong economic growth and good progress with structural reforms in the country. Further rating upgrades are conditional on the ability of the government to manage the rapid growth of domestic credit and external debt as well as the widening of external imbalances.

At the beginning of April, the President of Romania endorsed the new government approved by the Parliament. The new National Liberal Party (PNL) — Hungarian Democratic Union (UDMR) cabinet was also supported by the main opposition party — the Social Democrat Party (PSD). Calin Popescu Tariceanu is to keep his post as the Prime Minister. Although, the new cabinet was approved by the President, the political situation remains rather fragile due to the reliance of the government on the support by the opposition. The new government will not include representatives of the Democratic Party (PD) due to the breakdown of the rulings coalition supported by the PNL-PD alliance (which won the last Parliamentary elections in 2004) on the back of a conflict between the Prime Minister and the President (ex-leader of PD).

Moody's and Fitch international rating agencies have not changed their outlooks on Romania, however S&P rating agency modified the outlook on Romania's sovereign rating from positive to stable due the lack of political stability since the beginning of the year.

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