SigmaBleyzer

Romania Macroeconomic Situation

October 2007

Larysa Koziarivska, Radu Mihai Balan, Edilberto L. Segura

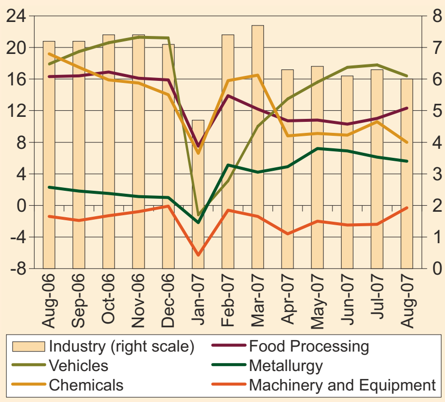
Summary

- In January-August, industry posted robust growth, increasing by 6% year-over-year (yoy).
- The consolidated budget reported a surplus at 0.32% of period GDP over the first eight months of the year.
- In September, consumer prices advanced by 6.03% yoy. Inflation has been accelerating for the second month in a row, propelled by surging prices of foods.
- Broad money supply increased by 28.2% yoy in September, while non-government credit expanded by 52.9% yoy.
- On October 31st, the National Bank of Romania (NBR) raised its policy interest rate by 50 basis points to 7.5% to curb inflationary pressures.
- The current account gap approached EUR 10.2 billion, increasing by 72.7% yoy, as the merchandise trade deficit widened to EUR 10.8 billion, up by 67.3% yoy.
- The net inflow of foreign direct investments (FDI) remained substantial, increasing by an impressive 82% yoy in August alone.
- In August, NBR forex reserves amounted to EUR 24.7 billion, increasing by 22.5% yoy.

Economic Growth

Over the first eight months of the year, industrial production continued to post robust growth, increasing by a real 6% yoy, slightly decelerating from the 7.2% yoy registered a year before. After achieving impressive 7.7% yoy growth in 1Q 2007, industrial output leveled out due to the high statistical base effect of the previous year. Industry was driven by manufacturing, which gained 7.1% yoy during January-August. Meanwhile, mining and quarrying reported a marginal gain of 0.9% yoy, while utilities declined by 1.1% yoy. Strong performance of manufacturing was led by growth of value added in automobile production, food processing, the chemical industry and metallurgy. At the same time, leading manufacturing industries reported rather uneven growth dynamics over the first eight months of the year. Automobile production continued to grow dynamically, posting impressive 16.4% yoy, on the back of buoyant domestic demand and increasing exports. High incomes of households and a favorable external environment triggered a robust 12.3% yoy growth in food processing. The performance of machine building unexpectedly revived in August, improving the cumulative dynamics of this sector to a modest decline of 0.3% yoy in January-August. Metallurgy demonstrated steady performance, increasing by 5.6% yoy during the first eight months of the year. Positive developments in metallurgy were aided by favorable conditions on external markets as well as strong domestic demand. However, growing competition from imports is likely to slow growth in chemical and light industries. Indeed, the chemical industry decelerated to 8% yoy, compared to the bright 19.2% yoy growth posted the year before, while imports of chemical products registered strong growth. Light industry continued to stagnate, as production of clothing articles declined by 19.5% yoy, and manufacturing of leather and footwear contracted by 0.1% yoy. Fuel processing continued to shrink as well, as its output contracted by 11.0% yoy in January-August.

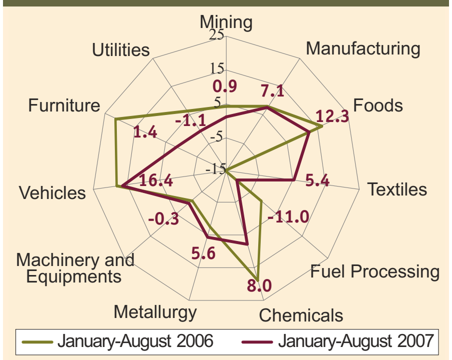
Industrial Output by Selected Industries, % yoy cumulative



Source: INSSE

In August alone, industrial output grew by 4.5% yoy, decelerating from 7.1% yoy registered a month before. This slowdown is mostly related to weaker performance in manufacturing and utilities. In particular, manufacturing increased by 4.6% yoy, as compared to 8.1% yoy in the previous month. A visible deceleration of manufacturing was triggered by contraction in the chemical industry (by 10.2% yoy) and a significant slowdown in automobile production (up by a modest 0.6% yoy against 34.2% yoy a month before). In August, a decline in light industry further deepened. Production of textiles continued to fall (-0.5% yoy) after a temporary revival in the previous two months. The production of ready-made clothes contracted by a sharp 28.2% yoy, while leather and footwear decreased by 21.1% yoy. On a positive note, machinery and equipment unexpectedly grew by an unprecedented 16.3% yoy in August — the highest rate in the last three years. At the same time, utilities shrank by 2.3% yoy, while the mining industry posted rather strong performance, increasing by 7.7% yoy.

Industrial Output by Sector, ytd % yoy



Sources: INSSE

The outlook for industrial growth remains quite positive. Given the good developments in the main manufacturing industries, such as automobile production and food processing, industrial output is expected to gain a real 5.8% yoy by the end of the year. Thus, industrial growth is going to slightly decelerate from the 7.1% yoy registered in 2006. A marginal slowdown of industrial growth is likely to be attributed to the deceleration of metallurgy and the chemical industry on the back of the worsening external environment.

Fiscal Policy

Since 2006, the Romanian government has been pursuing relatively loose fiscal and income policies. As a result, higher spending on social benefits, pensions and wages in the public sector increased the budget deficit in 2006 and 2007. According to the Ministry of Economy and Finance, consolidated budget expenditures grew by a nominal 27.1% yoy in the first eight months of the year, significantly accelerating from 16.25% yoy a year before. Meanwhile, budget revenues increased by a nominal 19.0% yoy, slightly slowing from 22.2% yoy registered a year ago. As a result, the consolidated budget reported a surplus at 0.32% of period GDP during January-August, decreasing from a surplus of 1.58% of GDP in the same period of 2006.

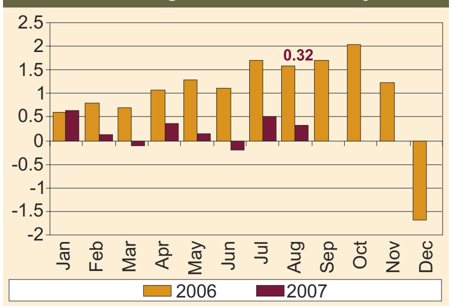
In January-September, fiscal revenues remained on a robust uptrend, increasing by 18.59% yoy. Collections of personal and corporate income taxes advanced by 44.01% yoy and 33.73% yoy respectively, supported by gains in incomes and employment At the same time, proceeds from indirect taxes, VAT (up by 10.2% yoy) and excises (up by 8.7% yoy) decelerated due to a simplified trade regime after accession to the EU.

On October 10th, the government drafted the 2008 budget law and passed it to the parliament for discussions and final endorsement. According to the law, the budget deficit is to be increased to 2.7% of GDP in 2008, which is in line with the expansionary and socially oriented fiscal policy. The consolidated budget expenditures are expected to grow by 21% yoy. The budget project assumes significant spending on social programs such as education, social security, health care and transportation. In particular, pensions and social expenditures are planned to grow by 11.9% yoy. At the same time, taxes are not to be raised, as fiscal policy is declared to be stimulating. The projections of strong 6.5% yoy real GDP growth (to a nominal EUR 138 billion) and modest inflation (3.8% yoy) are anticipated to widen the tax base, which will allow for a 20% increase in consolidated budget revenues in 2008.

The central bank and international organizations judged the 2008 budget law as too expansionary and questioned the assumptions of its macroeconomic projections. Essentially, a massive growth of social payments and increasing minimum wages will fan domestic demand, threatening macroeconomic balances and the inflationary outlook. Moreover, the budget deficit is set alarmingly close to the upper limit imposed by the EU (3% of GDP), while budget revenue projections are heavily conditional on the unlikely strong growth of nominal incomes. As a result, the budget deficit may become unsustainable, which risks putting the economy on a path toward an explosion of public debt above the target.

The NBR petitioned for fiscal tightening to contain the inflationary processes. Recently, widening external imbalances and soaring inflation prompted the Ministry of Economy and Finance to revise this year's budget by lowering the budget deficit from 2.7% to 1-1.2%. However, under political pressure from the opposition, a 30% hike in pensions in November followed by another 7.4% increase in January was approved. Thus, the target for the 2007 budget deficit may be feasible only if spending on 2007 infrastructure projects is significantly curtailed. Apparently, pressure on the government to grant concessions to the opposition has serious implications for macroeconomic stability. Indeed, fiscal policy measures are frequently justified by political pressures rather than by prudent economic sense.

Consolidated Budget Balance, % of full year GDP



Source: Ministry of Economy and Finance

In August, the stock of public debt declined to 16.4% of GDP (down from 18.9% at the end of 2006) due to the strong performance of budget revenues. However, the first Eurobond placement since October 2003 (up to EUR 0.5-1.0 billion in the last two months of this year) is being considered by the government to secure funds for an unscheduled increase in social payment at the end of 2007.

Stock of Medium and Long-Term External Debt

	8M 2006		8M 2007	
	Share, % of TED	Growth, % ytd	Share, % of TED	Growth, % ytd
Private sector	53.0%	15.5%	58.7%	27.0%
Public sector	43.7%	-2.8%	31.9%	-2.6%
Non-resident deposits	3.3%	0.87%	9.4%	3.29 times
Total M&LT external debt	100.0%	4.9%	100.0%	22.2%

Source: NBR, The Bleyzer Foundation

As of August, the stock of medium and long-term external debt amounted to EUR 33.87 billion, increasing by 22.2% since the beginning of the year. Private external debt grew by 27.0% year-to-date (ytd), while the public sector diminished its foreign debt by 2.6% ytd. In addition, high interest rates and the recent EU membership improved the attractiveness of Romanian banks, prompting a 3.29 times surge of the stock of non-resident deposits compared to the end of 2006. As a result, the share of non-resident deposits in total external debt sharply expanded to 9.4% during the first eight months of the year.

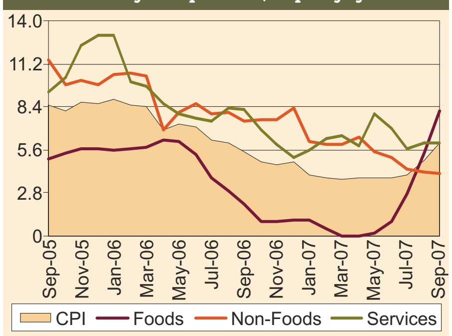
The recent global liquidity tightening is likely to restrict foreign borrowing by the private sector in 2008. At the same time, the growth of public external debt will be spurred by the planned Eurobond placement.

Monetary Policy

In September, strong inflationary dynamics persisted, as consumer prices (CPI) soared to 6.03% yoy, the highest inflation level of the past 12 months. The annual evolution of the CPI gained an additional percentage point against the previous month, following the record high monthly inflation reported at 1.08% mom in September. At the same time, Romania still managed to achieve the lowest inflation in Central and Eastern Europe.

September's annual inflationary developments were primarily driven by a rapid 8.17% yoy evolution of food prices, spiking for the third month in a row on the back of a shortfall in agricultural output. In particular, prices of bread and vegetables, the heaviest inflationary components in the food basket, skyrocketed by 12.02% yoy and 22.98% yoy respectively. Inflation of utility tariffs (up by 9.58% yoy) stood as the second most significant inflationary driver. In general, prices of non-foods have been on a smooth downtrend since the beginning of the year, decelerating from 8.33% yoy at the end of 2006 to 4.1% yoy in September. Finally, service tariffs changed insignificantly in the past several months, growing by 6.03% yoy in September mostly due to increasing rents and water supply prices.

CPI by Components, eop % yoy

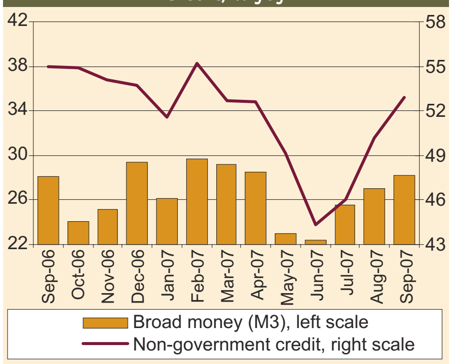


Source: INSSE

The acceleration of consumer price growth for the second month in a row was propelled mainly by continuing food inflation. Food prices increased by 1.94% mom, up from 0.86% mom in August, pushed by a 14.47% mom surge in prices of vegetable oil, and by continuing increases in prices of bread (1.75% mom), vegetables (2.66% mom), and eggs (15.11% mom). Service tariffs continued to grow for the second month in a row as well on the back of a 2.42% mom increase in post and telecommunication tariffs prompted by the recent RON depreciation. At the same time, an increase in prices for transport services was observed.

Notably, volatile prices affected by supply-side shocks are not the exclusive factors for the deteriorating inflation environment in the last two months. Booming domestic demand, growing at rates almost twice as high as the rates of real GDP growth, has been recently absorbed primarily by import expansion on the back of the appreciation of the domestic currency. However, since the weakening of the RON in August, excessive consumer demand has begun to exert upward pressure on domestic prices. Thus, the core CPI, the indicator calculated excluding all volatile and regulated prices, advanced by 1.12% mom in September, accelerating from a 0.8% mom increase in August.

Money Supply and Non-Government Domestic Credit, % yoy



Source: BNR

Monetary developments also contributed to accelerating inflationary tendencies. Broad money supply (aggregate M3) advanced by 28.2% yoy, amounting to RON 126.679 billion, marginally accelerating from 27.0% yoy in August. The evolution of money supply followed steep growth of non-government credit, which expanded by 52.9% yoy in September, up from 50.2% yoy in August. The credit expansion was driven primarily by increasing loans granted to households, which grew by 44.6% yoy and 66.2% yoy, denominated in RON and in forex respectively. By major components, broad money supply increased due to growing currency in circulation (31.1% yoy) and overnight deposits (72.3% yoy), while term deposits increased by a modest 6.2% yoy. As a result, expanding cash and overnight deposits explained about 70% of the total growth of money supply compared to a 40% contribution last month. It is likely that households increased their borrowings to finance current consumption, as higher inflation put a downward pressure on real interest rates.

Annual inflation, accelerating to 6.035% yoy in September, overshot the NBR inflation target of 3-5%. As growth of food prices is expected to persist and continue to promote further inflationary developments, the NBR's inflation target is unlikely to be achieved in 2007. Furthermore, ability to maintain low inflation in the targeted boundaries is important for the NBR in order to join the Euro zone in 2012. Thus, on October 31st, the National Bank of Romania (NBR) raised its policy interest rate by 50 basis points to 7.5% to curb inflationary pressures.

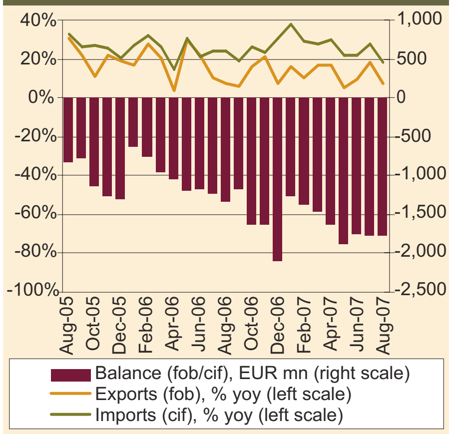
International Trade and Capital

Over January-August, the foreign trade balance (FOB/CIF) continued to deteriorate, reporting a trade deficit of EUR 11.5 billion. Although exports (FOB) posted robust growth in the first eight months of the year, increasing by 11.8% yoy, imports (CIF) continued to outpace them at 27.5% yoy, exerting a downward pressure on the trade balance. As a result, the trade gap widened by 36.7% yoy in January-August.

Good performance of exports in January-July was supported by increasing deliveries of such major product groups as machinery and mechanical appliances (22.6% yoy), ferrous metals (33.3% yoy), vehicles and transport equipment (35.1% yoy), accounting together for 51% of total exports. On the downside, exports of textiles and mineral products continued to decline, contracting by 2% yoy and by 36.8% yoy respectively in the first eight months of the year. At the same time, sustained investment and consumer demand on the back of strong domestic currency prompted rapid import expansion. In particular, imports of machinery/mechanical appliances and vehicles/transport equipment, which together account for 38.6% of total imports, grew by 36.5% yoy and 66% yoy respectively in January-July. Imports of the other substantial product groups, ferrous metals (61.1% yoy) and chemical products (32.8% yoy), have been expanding in response to the needs of growing industry.

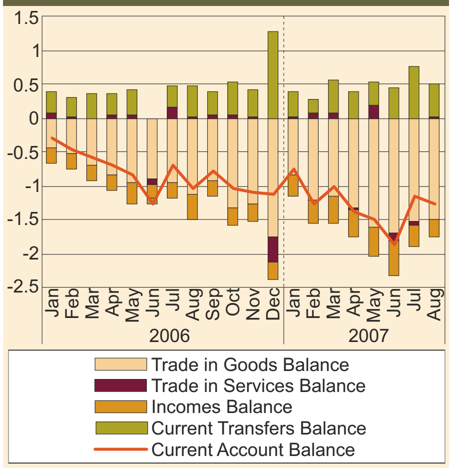
During the first eight months of the year, external imbalances continued to worsen under the pressure of the widening trade deficit. The current account gap approached EUR 10.2 billion, increasing by 72.7% yoy over the respective period last year, as the merchandise trade deficit widened to EUR 10.8 billion, up by 67.3% yoy. At the same time, the income balance deteriorated as well due to increasing interest payments on the growing stock of foreign debt and direct investments. Thus, the income gap deepened by 48.0% yoy in January-August, compared to 20.6% yoy registered in the same period a year ago. On a positive note, current transfers grew at an outpacing 50.6% yoy rate, strongly accelerating from 7.1% yoy reported a year ago. On the back of increasing transfers of Romanians working abroad, a surplus of current transfers amounted to EUR 3.5 billion over the first eight months of the year, compensating for the income balance deficit of EUR 3 billion.

Monthly Foreign Trade Balance



Source: INNSE

Current Account Components, monthly flows EUR million



Source: NBR, The Bleyzer Foundation

The net inflow of foreign direct investments (FDI) remained substantial, increasing by an impressive 82% yoy in August alone. Over the first eight months of the year, net FDI inflow amounted to EUR 4.1 billion, which is 93.7% of the FDI amount registered a year ago. Robust inflow of foreign capital consisting of both debt and direct investments provided the accumulation of foreign exchange reserves with the NBR despite strong deterioration of the current account. Thus, NBR forex reserves amounted to EUR 24.7 billion as of August 2007, up by 22.5% yoy over the first eight months of the year, which is even higher than the 14.5% yoy increase reported in the previous year.

Other Developments Affecting the Investment Climate

On October 31st, the World Economic Forum released its new Global Competitiveness Report 2007-2008. Romania's competitiveness rank was downgraded to 74th (of 131 countries rated this year) from 68th (of 125 countries rated in 2006). Uncompetitive tax rates and tax regulation, inefficient government bureaucracy, corruption, and access to financing are judged as the most problematic factors that damage the country's business environment.

Fitch confirmed the Banking System Indicator (BSI) for Romania at D with a stable outlook. Fitch explained that the current rating corresponds to some weaknesses in the banks' intrinsic stance. The future trend for the banking sector's rating is driven by potential system risks, balanced by credible improvements in operating and structural indicators. The bank credit expansion is expected to continue, since the ratio of banking assets to GDP remained at a rather low 50% and due to continuing economic development.

The international rating agency Coface has confirmed Romania's rating at "A4", however worsening its outlook from stable to negative. The negative outlook reflects rapid external leveraging by Romania's private sector, during a period of relatively high short-term capital outflows. Coface expressed concerns that the recent depreciation of the RON may negatively affect the payment behavior of corporations that accumulated a substantial debt in foreign currency.

October was marked with a new round of aggravating political tensions. The government survived a no-confidence vote initiated by the Social Democratic Party, its former supporter in the parliament. However, the pressure to make concessions to the parliamentary opposition parties remains rather substantial. Furthermore, the latest corruption scandals in the Cabinet spurred tensions between the government and the president. Although the political environment remained fragile, EU membership and strong commitments of Romanian politicians to accelerate the country's convergence with EU economic and institutional standards ensures the continuation of prudent economic reforms and market-oriented policy.

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