Romania Macroeconomic Situation

November 2007

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Summary

- Industrial output grew by a robust 5.8% yoy in January-September.
- The consolidated budget had a surplus of 0.19% of period GDP over January-September compared to a 1.7% surplus a year ago.
- On November 19th, the government approved the third revision of the state budget for 2007, decreasing the budget deficit from 2.7% to 2.4% of period GDP.
- In October, annual inflation of consumer prices skyrocketed to 6.84% yoy, a 16-month high.
- Monetary developments in October remained dynamic, as money supply grew by 28.8% yoy, while non-government credit expanded by 51.4% yoy.
- The interbank foreign exchange market continued to report high volatility of the domestic currency in October-November.
- The National Bank of Romania revised its medium term inflation outlook drastically, raising the forecast of year-end inflation from 3.9% yoy to 5.7% yoy, above the target band of 3-5%.
- Continuing deterioration of the merchandise trade balance pushed the current account deficit to EUR 11.8 billion over January-September, an expansion of 76.2% yoy.
- Net inflow of foreign direct investment (FDI) posted a record high of EUR 954 million in September, which is the highest monthly level since 1990.
- Standard & Poor's downgraded its outlook on Romania's sovereign rating from stable to negative.

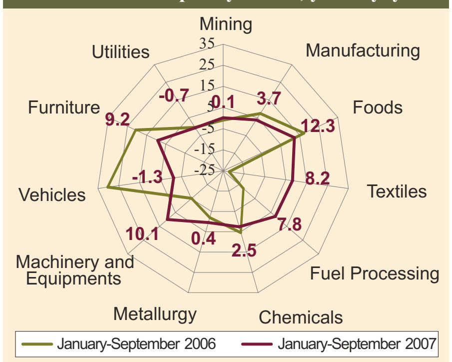
Economic Growth

Romanian industrial production kept demonstrating good overall performance, registering a robust 5.8% yoy growth in the first nine months of the year. Growth of industrial output was primarily shaped by developments in the manufacturing industry, which gained 6.7% yoy over January-September. Despite a marginal slowdown of the pace of growth this year, industry still reported healthy developments that were stimulated by vigorous domestic and external demand. In particular, industrial dynamics were strongly supported by double-digit growth of leading manufacturing industries such as food processing (12.4% yoy) and automobile production (13.9% yoy). Positive developments in manufacturing were also spurred by a revival of value added growth in metallurgy (4.8% yoy) and machinery production (0.9% yoy) as well as by the sound 7.4% yoy growth in chemical industry.

At the same time, industrial production stayed on a gradual deceleration trend during the last few months of the year, which cannot be explained exclusively by a high comparative base. The changing international environment affected industries sensitive to international resource prices such as chemical, metallurgy, mining and supply of utilities, which form a significant part of Romanian industrial output. Notably, the negative impact of import expansion was enhanced in 2007 with the accession to the EU. The simplified trade regime and the expensive RON resulted in substitution of tradable domestic goods with more competitive imports. Thus, the slowdown of growth rates registered in some manufacturing industries is likely to be attributed to increasing competitive pressure. Furthermore, the unstable political situation and ineffective privatization policy are still the major risks for privatization deals in automobile and electricity generating sectors, which may impede investment in these industries.

In 2007, industrial growth was restrained by simultaneous deceleration in both the mining and manufacturing industries as well as by a slight contraction of the gas, water and electricity supply. Mining posted a visible slowdown to a marginal 0.8% yoy growth, down from 3.4% a year ago. The supply of water, gas and electricity contracted by 1% yoy against a 5.5% increase posted a year ago. A deceleration of the manufacturing was linked to some slowdown in food processing, chemicals and in automobile production, and also to continuous stagnation in light industry and fuel processing. Despite a marginal slowdown of growth rates, automobile production remained one of the most attractive industries. A favorable geographic location and the still relatively cheaper labor force made the industry rather attractive for large foreign investments. A marginal deceleration of food processing was partially attributed to temporary difficulties in the agricultural sector due to the prolonged drought this year. At the same time, the chemical industry posted a significant deceleration, decreasing its growth rate by more than twice compared to the strong 17.5% yoy growth reported during January-September 2006. Performance of the chemical industry was likely to be affected by unfavorable foreign trade terms and by growing prices of oil and natural gas on world commodity markets. Metallurgy has continued to show slight deceleration of growth since June, prompted by unfavorable tendencies on European metal markets. Light industry demonstrated mixed performance, as production of ready-made clothes declined by 19.9% yoy, while manufacturing of textile products grew by 5.7% yoy.

Industrial Output by Sector, ytd % yoy



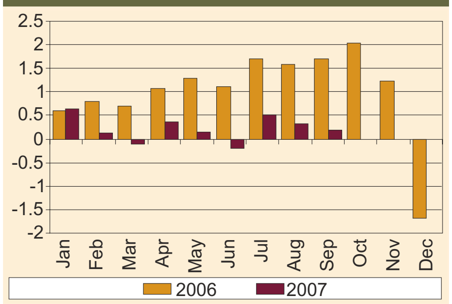
Sources: INSSE

Industrial growth was at a modest 3.2% yoy in September, which is the lowest rate since April. The deceleration of growth in industry was attributed mostly to a slowdown in manufacturing to 3.7% yoy from 7.3% yoy a year ago. The unexpected decline of automobile production, the continuing stagnation of light industry and deceleration in food processing and the chemical industry failed to be compensated for by the revival in fuel processing and machinery.

Fiscal Policy

Over January-September, the Romanian government continued to enjoy good performance of fiscal revenues, which increased by a nominal 20.0% yoy to RON 92 billion. Proceeds from direct taxes gained 39.3% yoy on the back of a growing economy and higher household incomes. Increased domestic consumption maintained relatively high income from indirect taxes, although they declined by 0.42% yoy after abolishment of some trade taxes with the recent EU membership. At the same time, fiscal spending remained rather loose, increasing by a nominal 28.8% yoy up to RON 91.3 billion as a result of extremely generous social policy favored by the unstable political environment and coming parliamentary election. Thus, the consolidated budget was at a surplus of 0.19% of period GDP over January-September compared to a 1.7% surplus a year ago.

Consolidated Budget Balance, % of full year GDP



Source: Ministry of Economy and Finance

On November 12th, the government negotiated a single minimum wage with trade and labor unions at RON 500 per month for the next year. Currently, the government has set two separate minimum wages agreed with trade and labor unions, at RON 390 and RON 440 respectively. The recent update to the minimum wage is a 28% growth for wages in the budgetary sector and a 14% growth for the rest of the economy. Such a significant growth of nominal wages will likely exceed the productivity growth of labor, which may result in worsening macroeconomic imbalances and accelerating inflation.

On November 19th, the government approved the third revision of the state budget for 2007, decreasing the budget deficit from 2.7% to 2.4% of period GDP. The International Monetary Fund (IMF) criticized the Romanian government highly for rather

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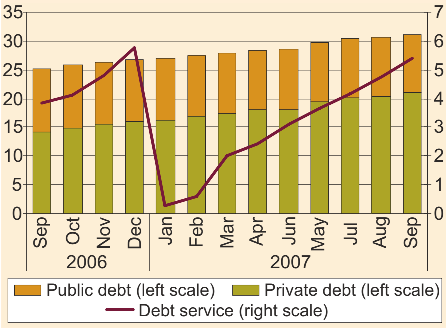
loose fiscal and income policies as contributing to the risks of persistent inflationary processes and macroeconomic imbalances. Meanwhile, the IMF recommended to cut the budget deficit in 2007 to 1-1.5%.

Medium and Long-term External Debt, EUR billion



Source: BNR

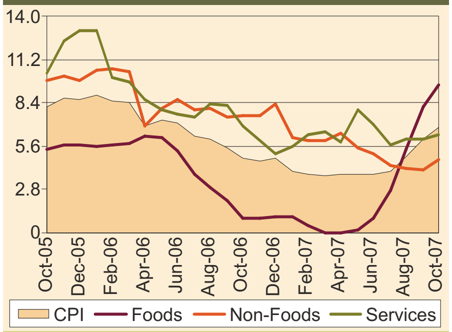
In September, commercial banks and large corporations continued to borrow intensively from abroad, despite persisting turmoil on international financial markets. In total, the private sector attracted EUR 574 million of medium and long-term foreign debt in one month. Borrowed foreign capital was needed to finance bank credit expansion and investment activities in the country. Also, private companies increased their foreign borrowing, anticipating further worsening credit conditions on world markets in the next year. At the same time, non-resident deposits in Romanian banks declined by EUR 518 million, as foreign investors' sentiments worsened due to increasing risks related to deepening external imbalances and the international credit crunch. Because of the large outflow of non-resident deposits and a marginal decrease in public foreign debt, total medium and long-term debt declined by EUR 21 million in September. Nevertheless, during the first nine months of the year, strong external private borrowing together with the inflow of non-resident deposits prompted unprecedented growth of medium- and long-term external debt at 18.9% year-to-date (ytd).

Monetary Policy

In October, annual inflation of consumer prices skyrocketed to 6.84% yoy, a 16-month high. After a rather short but successful history of the NBR's policy of inflation targeting, bringing Romanian headline inflation from double-digit levels to within the boundaries of a one-digit target (one of the lowest in Eastern Europe), growth of consumer prices surged above the policy target in the last two months. Unlike 2006, when inflation dynamics were mainly driven by increasing prices for tobacco and utilities, current inflation was propelled by prices for foodstuffs, soaring by 9.52% yoy in October on the back of high world prices for crops. Meanwhile, non-food prices and services tariffs advanced to 4.7% yoy and 6.4% yoy respectively, moderately accelerating from 4.1% yoy and 6% yoy reported a month ago.

On a month-over-month (mom) comparative basis, consumer prices posted a 0.97% increase, switching to a gradual deceleration trend after three months of steep growth. In October, pressure from increasing food prices diminished, as food price growth slightly decelerated to 1.3% mom from 1.94% mom registered last month. A deceleration in food inflation was achieved due to slower growth in prices of almost all foodstuffs. Also, service tariffs decreased their contribution to inflationary developments, as prices for post and telecommunication, the main inflationary component in the previous month, decelerated significantly to 0.61% mom from 2.42% mom in September. At the same time, prices for non-foods continued to increase on an uptrend, registering 0.69% mom growth against 0.19% mom a month ago. The most significant drivers of non-food prices in October were the growing prices for utilities (1.41% mom) and fuel (0.74% mom) driven by increasing prices for oil and natural gas on the world commodities markets.

CPI by Components, eop % yoy

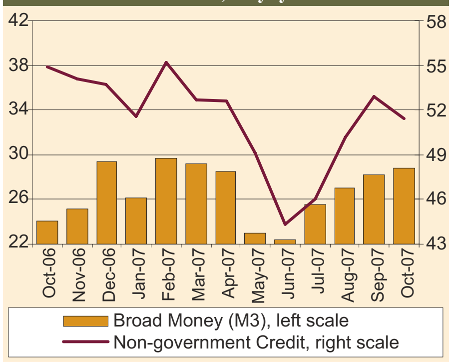


Source: INSSE

Monetary developments in October remained dynamic, as money supply (measured as monetary aggregate M3) grew by a strong 28.8% yoy, amounting to RON 128.87 billion, while non-government credit increased by 51.4% yoy, totaling RON 142.2 billion. However, growth of money supply and private credit modestly decelerated compared to September, as the pace of bank lending to legal entities lost its speed, while bank lending to households remained at almost the same level. The population's demand for banking loans persisted, in particular, for loans in foreign currency, despite the rather high volatility of exchange rates observed in the last few months.

The interbank foreign exchange market continued to report high volatility of the domestic currency in October-November. Given the high share of short-term non-resident deposits, the national currency is very sensitive to speculative movements. The Romanian leu lost value, as speculative sentiments worsened on the back of an unsustainable current account deficit, international liquidity constraints, and appreciation of the EUR on the world forex market. Although the national currency gained 7.3% against the EUR in the first half of the year, the RON began to depreciate in July and lost about 12% at the end of November. However, the depreciation of the national currency was still not excessive, accounting for the significant gap of the current account balance. At the same time, it is expected that large amounts of foreign capital will flow into the country at the end of the year, which will lead to further appreciation of the RON.

Money Supply and Non-Government Domestic Credit, % yoy



Source: BNR

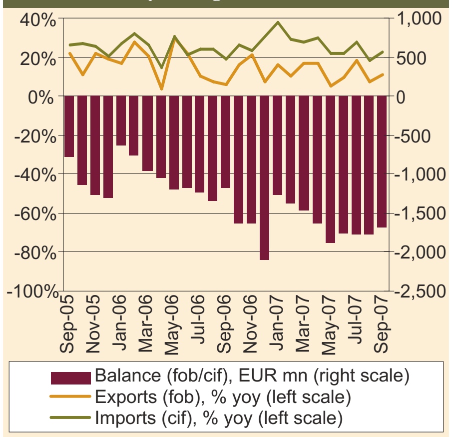
Regarding the missed inflation target, the National Bank of Romania (NBR) revised its medium term inflation outlook drastically, raising the forecast of year-end inflation from 3.9% yoy to 5.7% yoy, above the previous target band of 3-5%. However, an acceleration of inflation to 6.8% yoy in October made its forecast doubtful. At the same time, the target band for 2008, set at 2.8-4.8%, was not changed, while the inflation outlook for 2008 was corrected upwards to 4.3% yoy, compared to a 3.7% forecast presented in the second quarterly report. Responding to accelerating inflation and depreciation of the local currency, the NBR ran tighter monetary policy by exploiting all relative policy tools, including the policy interest rate and interventions on the money and foreign exchange markets. Since commercial banks continued their credit expansion supported by borrowed funds from abroad and the government pursued rather loose fiscal and income policy, the monetary authority appeared to be rather limited with effective tools for regulating inflationary developments. According to estimates of the CNP, the government forecasting agency, headline inflation may converge to the inflation target through the end of 2009.

International Trade and Capital

In September, the trade gap continued to widen, which was attributed to rather rapid expansion of imports, while exports continued to demonstrate good performance. High imports were stimulated by high domestic investment activity and high consumption supported by growing nominal incomes of households and fast domestic credit expansion. Thus, (FOB) exports grew by a robust 11.1% yoy amounting to EUR 2.5 billion, while (CIF) imports increased by an impressive 22.5% yoy to EUR 4.1 billion. As a result, the (FOB/CIF) trade deficit widened by 43.1% yoy to EUR 1.69 billion in September alone. The recent depreciation of the RON was still not enough to significantly affect the terms of foreign trade and trade tendencies. However, the trade deficit stayed at a steady level each month.

In the first nine months of the year, (FOB) exports grew by 11.7% yoy approaching EUR 21.4 billion. (CIF) imports increased by 27%, doubling the growth of exports and amounting to EUR 36.5 billion. As a result, the (FOB/CIF) trade balance deteriorated to a deficit of EUR 15.1 billion or by 56.83% yoy.

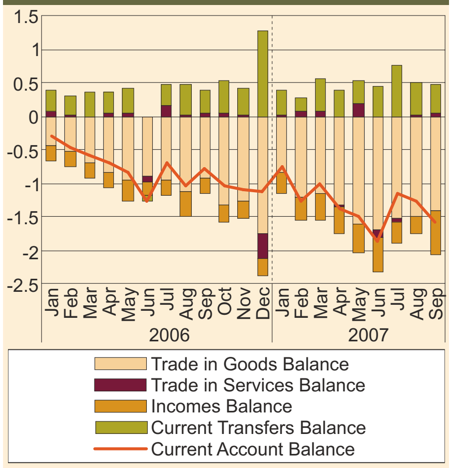
Monthly Foreign Trade Balance



Source: INNSE

Continuing deterioration of the merchandise trade balance (EUR 12.1 billion) pushed the current account deficit to EUR 11.8 billion over January-September, an expansion of 76.2% yoy. Although the income deficit was still covered by a surplus of current transfers, the income balance gap deepened by 61.5% yoy, while current transfers grew by only 48.8% yoy. The negative income gap is driven by interest payments for foreign borrowings and interest on foreign direct investments. Large inflows of foreign capital stimulate a continuous widening of the income gap, which is unlikely to be compensated for by current transfers for a long time. The income balance is already going to increase its negative pressure on the current account balance in 2008 given foreign investors' interest in the Romanian economy. Under the assumption of moderate expansion of the current account gap, the CA deficit is forecasted to reach EUR 16 billion or 14% of GDP at the end of 2007. The current account balance is continuing to deteriorate under the pressure of excessive domestic consumption and large inflows of foreign capital. In the medium term, such a significant current account deficit is not sustainable and could be balanced through either a sharp decline in domestic consumption or in a sharp devaluation of the national currency.

Current Account Components, monthly flows EUR million



Source: NBR, The Bleyzer Foundation

Net inflow of foreign direct investment (FDI) posted a record high of EUR 954 million in September, which is the highest monthly amount since 1990. In September, FDI reported growth on a year-over-year basis for the first time in the year, increasing by 2.31% yoy up to 5.013 billion. According to the NBR, FDI covered 42% of the current account gap, improving from the 39% reported a month ago.

The large inflows of foreign capital allowed the NBR to replenish its forex reserves by EUR 510.4 million in September up to EUR 25.2 billion.

Other Developments Affecting the Investment Climate

Standard & Poor's downgraded its outlook on Romania's sovereign rating to negative from stable. The main reasons for the rating revision were rapid worsening of external balances and an inadequate fiscal policy, which causes further deepening of imbalances. At the same time, S&P affirmed the outlook and the rating of five state infrastructure companies — Transelectrica, CFR Marfa, CFR SA, Hidroelectrica and natural gas transporter Transgaz.

The European Bank for Reconstruction and Development (EBRD) improved Romania's rating of the banking system from "3" to "3+" according to the 2007 report on transition economies. According to the EBRD, the progress achieved in the banking sector was based on the rapid expansion of credit to the private sector and improvement of the regulatory system. Furthermore, the EBRD upgraded the rating for the capital market and non-financial banking institutions from "2+" to "3–" due to the development of the stock exchange and especially of the bond segment. The EBRD report emphasized that the development of the financial sector in Romania was largely based on reforms and privatizations. The EBRD also improved Romania's rating for its electricity infrastructure, from "3+" to "4–", which was due to successful privatization of Electrica Muntenia Sud, the country's largest electricity distribution company.

In November, elections to the European Parliament took place in Romania. The official results of the elections revealed that the center-right PD party enjoyed the greatest support of the population with 28.8% of the vote. The leftist PSD received 23.1% of votes, while the center-right ruling party PNL drew only 13.5%. The other parties that managed to overcome a threshold of 5% were PLD (7.8%) and UDMR (5.5%). Despite political competition among their leaders, three center-right parties PD, PLD and PNL have pretty similar political programs, which create the grounds for forming a majority coalition after parliamentary elections in late 2008.