Romania
Macroeconomic Situation

June 2008

Larysa Koziarivska, Radu Mihai Balan, Edilberto L. Segura

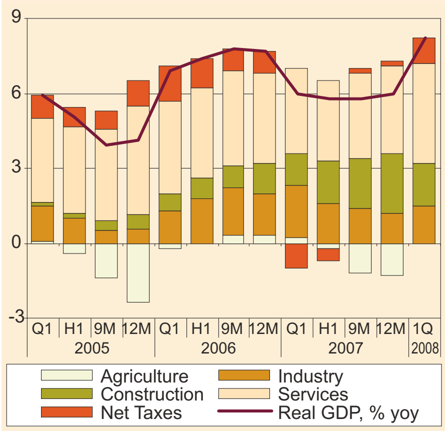
Summary

- In the first quarter of the year, the Romanian economy continued to demonstrate solid performance, as growth of the gross domestic product (GDP) in real terms accelerated to an impressive 8.2% yoy.
- In January-April 2008, industrial production reported robust 7.3% yoy growth.
- Fiscal performance was improved in January-April 2008 with a 0.2% of full-year GDP surplus.
- A solid increase in budget proceeds was provided by buoyant growth of fiscal revenues, mostly spurred by impressive VAT collections.
- At the beginning of the year, foreign medium- and long-term borrowings continued to grow at an accelerating pace of 39% yoy in April.
- Annual inflation advanced by 8.6% yoy in April.
- In January-May 2008, the National Bank of Romania (NBR) continued to pursue restrictive monetary policy aimed primarily at containing credit expansion. The NBR raised the policy rate to 9.75% on May 7th.
- Growth of non-government credit remained high — 64% yoy in April, principally led by foreign currency lending to households.
- Following credit expansion, the broad money supply grew by 39% yoy in April.
- In the first four months of the year, foreign trade performance in Romania improved, as FOB exports grew by 17% yoy, while CIF imports increased by 16% yoy. The FOB/CIF foreign trade balance widened to EUR 6.9 billion as of April 2008.
- In January-April, the current account deficit grew by 8.9% yoy, strongly decelerating from a two times increase reported a year ago. The current account gap reached EUR 4.8 billion as of April 2008.
- Net FDI inflow doubled in January-April and financed 66.5% of the current account gap.
- The EBRD and IMF revised their projections for economic growth in Romania in 2008 downwards.

Economic Growth

In the first quarter of the year, the Romanian economy continued to demonstrate solid performance, as growth of the gross domestic product (GDP) in real terms accelerated to an impressive 8.2% yoy, well above preliminary expectations. The economic growth remained generally broad-based, underpinned by increasing value added in all sectors, except agriculture. Meanwhile, domestic-oriented sectors such as construction and services continued to develop at outpacing rates, increasing their contribution to the formation of the GDP. Services were the most significant driver of economic growth, contributing 48.8% to a real increase in gross value added. The role of construction in the Romanian economy continued to strengthen rather rapidly, increasing by a striking 32.4% yoy in January-March 2008. On a negative note, agriculture demonstrated still poor performance, as gross agricultural output dropped by 0.5% yoy in the first quarter due to a prolonged effect of unfavorable weather conditions last year. At the same time, a negative contribution of the agricultural sector visibly diminished compared to the second half of the previous year.

Contributions to Real GDP Growth by Sector, percentage points

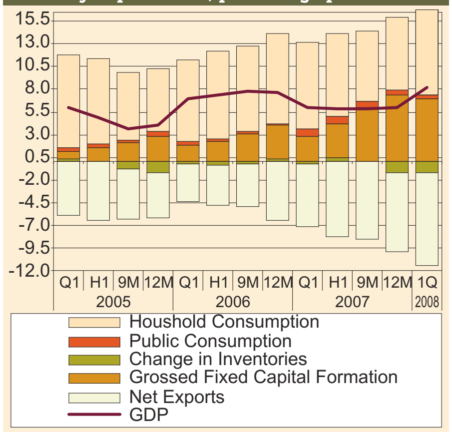


Source: INSSE

On the demand side, a positive evolution of the GDP was achieved primarily on the back of strong domestic consumption, growing by a real 14% yoy in the first quarter of 2008. Household consumption remained the main driver of economic growth, however, rather unsustainable at the same time, as it was supported mainly by increasing bank debt and growing incomes ahead of productivity growth. Meanwhile, the contribution of investments to the economic development of the country has been increasing due to high investment activity. Thus, gross capital formation continued to accelerate its growth pace, climbing by a striking 33% yoy during January-March. Investments grew by an outstanding 35% yoy in the first quarter of the year, turning to be a locomotive of economic growth in Romania. On a negative note, investment structure is not diversified, as about 50% of all investments into the fixed capital are concentrated in new construction. On the one hand, construction investments are necessary for developing of an infrastructure base. However, on the other hand, a substantial share of investments in construction was absorbed by swelling prices for real estate. At the same time, persistent domestic demand also spurred demand for imports, which continued to exert a significant downward pressure on economic growth.

Over January-April, industrial production growth accelerated to 7.3% yoy, following 8% yoy growth of manufacturing and 9.8% yoy growth in supply of gas, water and electricity. On the downside, mining and quarrying declined by 1.7% yoy. Industrial growth was principally driven by such export-oriented industries as production of road vehicles (21% yoy), machinery and equipment (7% yoy) and chemical production (13.2% yoy), mainly fertilizers. Also, food production, the locomotive of industrial growth in 2006–2007, reported robust 10% yoy, still meaningfully contributing to industrial growth. High investment demand in the country significantly underpinned positive developments in industries producing capital goods, such as machinery and transport means. Thus, in those four months, industrial production of capital goods increased by an impressive 25% yoy, significantly outpacing 6% yoy growth of current goods production and 5% yoy growth of durable goods production. On the downside, growth of manufacturing production was restrained by decreasing output in metallurgy and light industry. Metallurgy declined by 5.4% yoy over January-April against 5% yoy growth reported for the same period last year due to decelerating growth of global metal prices. Light industry continued its stagnation, decreasing by 2.8% yoy since the beginning of the year, mainly due to decreasing exports of textiles.

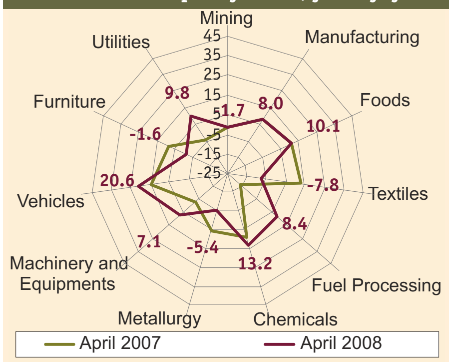
Contributions to Real GDP Growth by Expenditure, percentage points



Source: INSSE

In general, the growth potential of Romanian industry looks quite promising thanks to its large domestic market, friendly business environment, high investment activity, high inflow of long-term foreign capital and increasing productivity of labor. However, we believe that industrial growth may decelerate slightly in 2008 compared to 5.4% yoy in the previous year, being restrained by tightening monetary policy and increasing uncertainties of the global economy.

Industrial Output by Sector, ytd % yoy



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Fiscal Policy

Fiscal performance was improved in January-April 2008. Robust economic developments provided

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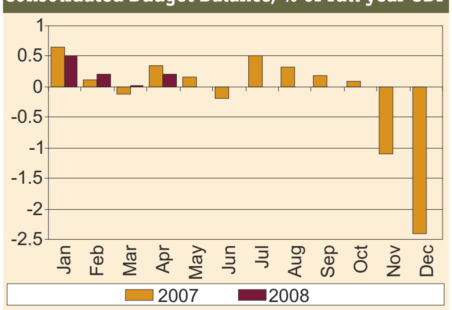
Chief Economist Edilberto L. Segura
Editor Rina Bleyzer Rudkin

strong growth of consolidated budget revenues over the first four months, which reported a 48% yoy increase in nominal terms. At the same time, consolidated budget expenditures grew by 50% yoy, a slightly higher rate than for revenue growth. As a result, in January-April, the consolidated budget reported a surplus of 0.2% of full-year GDP, declining marginally from a 0.3% surplus posted a year ago. A solid increase in budget proceeds was provided by buoyant fiscal revenues, which account for 58% of the total. Tax receipts grew by nominal 43.5% yoy, mostly spurred by impressive VAT collections, which posted more than a two-fold surge on the back of a low statistical base from the previous year. Proceeds from income taxes were another important source of fiscal revenues. Thanks to persistent growth of household nominal income, PIT collections grew by a robust 35% yoy in January-April. Meanwhile, receipts from taxes on corporate profit grew by 25% yoy on the back of buoyant economic growth. Excises and taxes on international trade operations also reported positive growth rates against a decline a year ago after the final simplification of the trade regime with EU members.

Also, there were some positive changes in the structure of budget expenditures. Although current spending remained the major part of all budget expenditures, accounting for 90% of the total with one third dedicated to social assistance, the amount of government capital expenditures surged by almost three times. As a result, the share of government investments in the budget expenditures structure almost doubled. Nevertheless, current government expenditures are still high, contributing significantly to growing aggregate demand.

Consolidated Budget Balance, % of full year GDP



Source: Ministry of Economy and Finance

The loose, socially-oriented fiscal policy of the Romanian government due to worsening macroeconomic imbalances and rapid inflation developments caused serious concerns during 2006–2007. Recognizing the need to run tighter fiscal policy, the government revised a budget plan for 2008 in March, cutting the initially planed budget deficit from 2.75% to 2.25%.

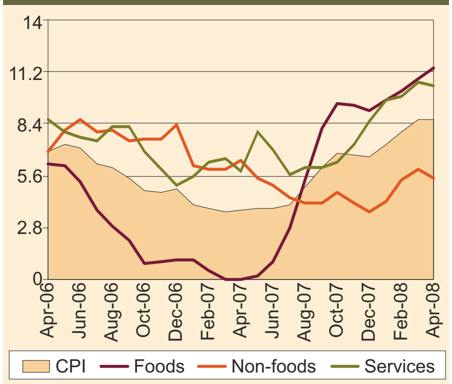
At the beginning of the year, medium- and long-term foreign borrowings continued to grow at an accelerating pace. The stock of medium- and long-term debt increased by 39% yoy as of April 2008, up from 23% yoy reported a year ago, despite the continuing global credit squeeze. As in 2007, foreign debt was driven by private sector borrowings. At the same time, Romania continued to experience a significant outflow of short-term capital, as it is rather sensitive to investment sentiments, still worsening worldwide. For the same reason, deposits of non-residents, a relatively small but the dynamic part of the foreign debt, declined in the period. However, long-term debt was growing at a higher rate than short-term in the first quarter, as large private banks and companies operating in Romania, which are mostly foreign-owned, have relatively easier access to international capital markets. Thus, Romania is quite easily provided with the borrowed foreign capital necessary for financing its widening external gap, despite worsening macroeconomic balances and a rather unstable political environment.

Monetary Policy

Consumer prices in Romania continued to grow in January-April of 2008 above the upper-limit of the inflation target boundary (4.8% yoy) of the NBR, as annual inflation advanced by 8.6% yoy in April. Accelerating inflation was driven by supply-side shocks as well as persistent aggregate demand. On the supply side, the prolonged summer drought in 2007 caused a sharp decline in agricultural output, which resulted in soaring food prices enhanced by increasing consumption. Thus, the food price index accelerated to 11% yoy, spurred by growing prices for all major foodstuffs. In particular, increasing prices for bread (12% yoy), vegetables (22% yoy), milk and diary products (11% yoy), and fruits (23% yoy) together explained almost one third of the annual growth in consumer prices. At the same time, growing international prices for energy resources, such as crude oil and natural gas, passed through to domestic prices for fuel (13% yoy) and utilities (5% yoy). Prices for tobacco, another inflationary component in the non-food product group, increased by 11% yoy due to increasing excise tariffs. Thereafter, prices for non-food grew by 5.5% yoy in April, contributing another third to the annual growth of inflation. Services tariffs grew by 10.4% yoy, following rent prices that almost double and increasing tariffs for post and telecommunication services (7% yoy) on the back of a depreciating RON.

On the demand side, persisting aggregate demand exerting constantly increasing pressure on inflation is causing greater concern than supply-side shocks. Growing bank debt supported by intensive foreign borrowings, the high inflow of remittances from Romanians working abroad and increasing nominal wages drive high household consumption. At the same time, continuing devaluation of the RON also contributed to accelerating inflation, as weaker local currency prompted consumers to prefer comparatively cheaper domestic goods. The Romanian leu depreciated by 1.8% in nominal terms against the Euro over January-April and reached 3.68 RON/EUR at the end of April. Moreover, current government consumption remained high (11% of full-year GDP in January-April 2008), also adding to aggregate demand pressure on consumer prices. Thus, the primary task of confining inflation in Romania is curbing excessive domestic demand as well as switching to prudent fiscal policy with a more effective structure of budget expenditures.

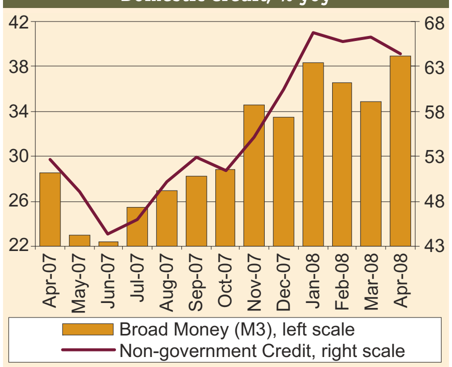
CPI by Component % yoy



Source: INSSE

In January-April 2008, the National Bank of Romania (NBR) continued to pursue restrictive monetary policy aimed primarily at containing credit expansion. Thus, the NBR has been implementing consecutive increases in the key policy interest rate (starting November 2007) and maintaining firm control over liquidity on the money market via open-market operations. The NBR set the policy rate at 9.75% on May 7th, the highest level since August 2005. The considerable outflow of short-term capital allowed the NBR to raise the key policy interest rate drastically without the risk of excessive appreciation of the Romanian leu. The NBR's policy actions coupled with worsening borrowing conditions on global financial markets finally resulted in gradually rising interest rates on the money market and banking deposit/credit interest rates. However, the growth of non-government credit remained high, marginally decelerating to 64.4% yoy

Money Supply and Non-Government Domestic Credit, % yoy



Source: NBR

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

Where Opportunities Emerge.

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

in April, up from 66% yoy in March. Strong credit growth was still principally led by foreign currency lending to households, which further added to growing currency mismatches of household balance-sheets and increased their vulnerability to exchange rate fluctuations. At the same time, NBR indicators showed that the financial stance of the banking system remained in good shape. Following credit expansion, the broad money supply grew by 39% yoy in April, up from 28.5% yoy registered a year ago.

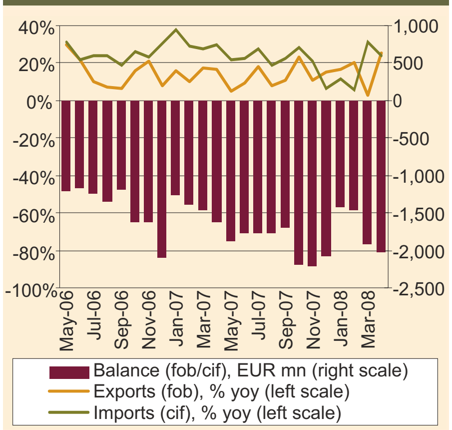
Nevertheless, we expect that policy efforts of the NBR enhanced by the positive influence of the good harvest expected this summer will result in decelerating inflation in the second half of 2008. The inflation trend is likely to return to the NBR's target boundaries in 3Q 2009.

International Trade and Capital

In the first four months of the year, the performance of foreign trade in Romania visibly improved, as FOB merchandise exports continued to grow in April at a rate outpacing the growth of CIF merchandise imports. Positive developments in foreign trade of goods were likely favored by the depreciation of the local currency against the Euro. In January-April, FOB exports grew by 17% yoy, accelerating from 13.7% yoy reported at the end of 2007. At the same time, CIF imports increased by 16% yoy, down from 25% yoy in 2007. Thereafter, the FOB/CIF foreign trade balance widened by only 22% yoy against an 66.4% yoy surge reported a year ago and approached EUR 6.9 billion as of April 2008.

According to preliminary data from the National Institute of Statistics, FOB exports in January-March were principally driven by exports of machinery and equipment (21% yoy), vehicles and transport means (13% yoy), mineral products (67.5% yoy) and ferrous metals (4% yoy). Exports of base metals, primarily iron and steel, strongly decelerated compared to the previous year on the back of flat growth of metal prices on European markets. Exports of mineral products showed significant revival in terms of growth. This was mostly attributed to a surge in exports of petroleum from a low statistical base following a decline of petroleum production last year. At the same time, growth of CIF imports was supported by increasing imports of machinery — for both investment and consumer purposes (5.6% yoy), vehicles and transport equipment (21% yoy), minerals — mainly fuel — (26% yoy), chemicals — primarily pharmaceuticals — (19% yoy) and metal products (7.6% yoy). Although CIF merchandise imports reported a significant decrease in growth at the beginning of the year, this deceleration occurred mainly due to a slowdown of imports of capital and intermediate goods. Meanwhile imports of consumer goods maintained their growth rate compared to the respective period of last year. It is likely that importing enterprises found themselves more sensitive to fluctuations in the exchange rate than households, who are backed by constantly growing nominal incomes and bank credit. Thus, the devaluation of the local currency that, in general, favors foreign trade, dampened imports of capital goods rather than imports of consumer goods, which negatively affects the import structure.

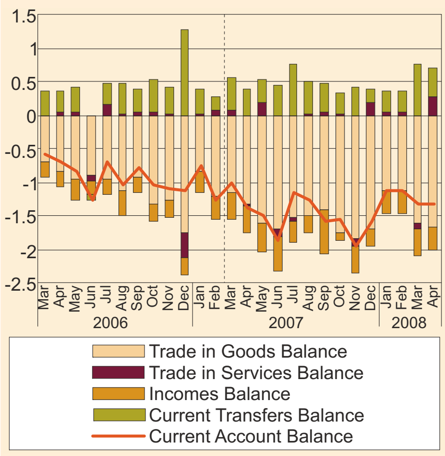
Monthly Foreign Trade Balance



Source: INNSE

Thanks to the moderate widening of the merchandise trade deficit over January-April, the current account deficit grew by 8.9% yoy, which is a strong deceleration from the 2 time increase reported a year ago. The current account gap reached EUR 4.8 billion as of April 2008, determined by the EUR 5.5 billion FOB/FOB merchandise trade deficit and by the EUR 1.5 billion deficit of the income balance. The net inflow of foreign direct investment (FDI) doubled during the first four months compared to the respective period last year. Impressive improvement of FDI dynamics was spurred by high investment and M&A activities at the beginning of the year. As a result, an FDI coverage ratio increased to 66.5% as of April. The rest of the CA deficit was financed with long and short-term borrowings. Following strong foreign capital inflow, the NBR's forex reserves grew by 7.5% ytd since the beginning of the year. The NBR's reserves remained at a relatively high level, covering 5.6 months of imports compared to 6 months at the end of 2007.

Current Account Components, monthly flows EUR billion



Source: NBR, The Bleyzer Foundation

Other Developments Affecting the Investment Climate

The European Bank for Reconstruction and Development revised downwards growth forecasts for Romania, Ukraine, and Kazakhstan because of difficulties arising from the global credit crunch and mounting inflation. Romania's growth forecast was decreased from 6.5% to 5%, which was explained by rapid monetary tightening attributed to consecutive increases in the NBR's policy rate.

The International Monetary Fund (IMF) worsened its short-term projections for Romania's economic development, but preserved an optimistic outlook for the medium run. The IMF revised its forecast of real GDP growth down to 5.5% in 2008. The major concerns behind the forecast revision were the widening current account gap, rapid inflation development and growing credit exposures.