Summary

- In 2005, the Romanian economy is expected to continue expanding at a robust but slower pace;
- Fiscal performance was encouraging in January-March;
- Although consumer inflation declined to 8.7% year-over-year (yoy) in March, price dynamics may reverse as a result of April's administered price increases;
- Following the first step of capital liberalization, the foreign currency market remains calm;
- Despite strong export growth, faster expansion of imports contributed to the widening of the trade deficit and worsening of the current account;
- Romania signed the EU Accession Treaty; however, EU membership could be delayed by one year should Romania fail to enforce reforms in key areas.

Economic Growth

The Romanian economy showed impressive real GDP growth of 8.3% yoy in 2004. In 2005, it is expected to continue expanding at a robust, although slower, pace. Spurred by strong credit growth and an increase in the population's wages, domestic demand is likely to be the major driving force of GDP growth in 2005. Following the fiscal relaxation at the beginning of the year and further progress in reducing inflation, real wages increased by about 15% yoy and 13% yoy in January and February 2005, respectively. The demand for loans remains strong, pushing credit to the private sector to grow at 33% yoy on average during the first quarter (Q1) of 2005. At the same time, lending growth is less than half this year compared to the 68% yoy increase in Q1 2004; this could be one of the reasons for a GDP growth slowdown in 2005. According to the official forecast, real GDP growth is estimated to reach 5.5% yoy in 2005. However, the National Prognosis Commission of Romania expects GDP to grow by 6%. International organizations' estimates are more modest — 5.5% yoy by the IMF and European Commission and 5.8% yoy by the Economic Intelligence Unit. Industry, one of the main contributors to GDP growth, demonstrated robust performance in 2005. Over January-February 2005, industry expanded at 5.8% yoy, the highest pace in the past two years. However, in February alone industrial production growth decelerated to 3.2% yoy, down from 8.6% yoy in January 2005 and 6.9% in February 2004. This deceleration may be explained by slower productivity growth compared to last year, high production costs and declining competitiveness of several export-oriented industries. Textiles and apparel contracted by 7.3% yoy facing stronger competition on the foreign markets. The rise in utility prices, the main component of production costs, may be one of the main reasons for the output contraction in food processing, leather and footwear and other light industries. Despite increased input costs, metals grew by an impressive 14.2% yoy in February, benefiting from high world prices for metals. On the back of robust demand, wood processing expanded by 50% yoy and the furniture industry by 27% yoy. The market success of the new car brand (Logan) allowed the automobile industry to remain among the best performers in manufacturing. In February, its output expanded by 42.5% yoy. After remaining stagnant since the second half of 2004, utilities showed 2% yoy growth in February. To some extent, this can be explained by the administrative adjustment of utilities prices to cost recovery level carried out in January of this year. Unlike in last year, the extractive sector contracted by 3.3% yoy.

Fiscal Policy

Following prudent fiscal policy through 2004 and higher than expected GDP growth, the achieved consolidated budget deficit of 1.1% of GDP was significantly lower than the year-end target of 1.64% of GDP. However, the fiscal relaxation at the beginning of 2005 and the high CA deficit may jeopardize budget balancing. The introduction of a 16% flat-rate income and profit tax is estimated to result in approximately 1.2% of GDP loss in revenues. At the same time, the government is facing pressure for fiscal tightening to cope with the increasing external imbalances. The budget deficit target is set at 0.7% of GDP. The IMF, which had insisted on setting the target at 0.5% of GDP, has agreed upon a 0.7% of GDP level. However, even this target may be rather challenging to achieve, despite encouraging budget figures for the first quarter.

According to the Ministry of Public Finance (MPF), the IQ05 state budget incomes are 2.6% higher than initial estimates and 1.9% yoy higher in real terms. However, the MPF did not release information on state budget expenditures. Moreover, the consolidated budget figures have not been available to the public since the beginning of this year. Yet the state budget parameters for January-February show that the state budget deficit was almost twice as large as in the corresponding period last year. According to the MPF, IQ 2005 data reveals a significant increase in receipts from profit tax (up 12.5% over the same period last year), excises (up 8.7% yoy) and customs duties (up 26.9%). At the same time, VAT collections, the largest contributor to state budget revenues, showed a modest 0.8% yoy increase in receipts. Moreover, revenues from income tax declined by 14.2% yoy. At the same time, the budget adjustment, earlier expected to take place in March or April, was postponed until June. This means that despite announcing significant cuts in expenditures for some ministries, the cabinet is actually operating according to the budget adopted last autumn. As time passes, it may be very difficult to reduce budget expenditures.

In order to balance the budget, an emergency ordinance on amending and supplementing the Fiscal Code was discussed in the Senate on May 5th. Following amendments in Parliament, the emergency ordinance will be adopted as a law. However, the changes adopted by the Senate may not be final, as the legislative process has not been closed and the new law was not published in the Official Gazette. The amendments were largely in line with the changes previously endorsed by the government:

- increase in 1% to 10% on tax on interest and capital earnings for individuals (effective June 1);
- introduction of tax on earnings from speculative transactions (sales of houses owned for less than three years and shares held for less than one year — effective June 1);
- increase in excises on alcohol, cigarettes, fuels, electricity, automobiles, electronic equipment, yachts (already in effect since April 1);
- introduction of VAT on several services (like cable TV, shows organized for profit purposes by other than public specialized institutions). There are, however, a few modifications in the emergency ordinance. First, the increase in the taxes on interest and capital gains and earnings obtained from speculative transactions will come into force on June 1, instead of the previously scheduled May 1. Second, the 10% tax will be levied on earnings from deposits made and the sales of stocks purchased after June 1. Third, starting January 1, 2006, the tax on net capital market earnings will be levied on entire portfolios, while only stock transactions are taxed at present.

At the end of February, Romania's external debt grew by 7.9% yoy to EUR 19.1 billion, or 6.9% in one month. Due to a 12.8% month-over-month (mom) acceleration, the share of private debt increased to 45.4% of total foreign debt, up from 42.7% last month. Public and publicly guaranteed debt reached EUR 10.4 billion, advancing by a modest 1.1% mom. Domestic currency strengthening favors foreign debt development, reducing the burden of forex-denominated debt on the national economy. The external debt service ratio increased to 19.1%, up from 16.9% in January but still less than 21.9% in 2004.

Monetary Policy

The consumer price index (CPI) increased moderately by 0.3% mom in March, while it further declined to 8.7% in annual terms. Food prices decelerated to 6.6% yoy in March, down from 7.0% yoy in the previous month. Service tariffs grew by 9.9% yoy in March compared with 10.2% yoy in February. The slowdown occurred mainly as a result of phone rate cuts, which are set in foreign currency. Strong ROL appreciation, thus, reduces the cost of telecommunications services. The
growth of the non-food price index remained unchanged from the previous month at 10.3% yoy. Despite March’s favorable performance, the year-end inflation target of 7% may be jeopardized as several administered prices were increased in April. In particular, the prices for heating and gas were raised by 20%; excises on a number of products (fuels, alcohol, cars, electronic devices, etc.) were increased on April 1st, three months earlier than was initially planned. These price hikes may have a significant impact on April’s CPI as well as on annual inflation, as higher energy prices may translate into other goods’ prices through the rest of the year. The BNR announcement that an inflation targeting regime will be introduced in the second half of 2005 with a relatively large safety band may signify that this year’s inflation target may not be met.

On April 11th, the BNR gave non-residents access to ROL deposits under the first step of capital liberalization. To protect the market from expected large short-term capital inflows after the liberalization, the BNR has established safeguard clauses. However, contrary to expectations, the first weeks did not bring massive speculative capital into the country. This can partly be explained by the central bank policy of cutting interest rates since the summer of last year. The policy was adopted to narrow the spread between domestic and foreign currency rates, thus alleviating the effects of large short-term capital inflows. On April 7th, two working days ahead of the capital account liberalization, the BNR cut its intervention interest rate by 2 percentage points (pps) to 12.5%. Since last summer, the interest rate has been gradually cut by a total of 875 basis points. The next two steps of capital liberalization — granting non-residents access to government bonds and T-bills and the central bank’s certificates of deposits — are scheduled for January and September 2006, respectively. At the same time, household savings decelerated slightly in March compared to February, reacting to declining interest rates.

After declining to 17.1% yoy, the growth of net domestic credit resumed its upward trend in February and reached 20.2% yoy in March. Non-government credit growth accelerated slightly to 33.2% yoy in March, up from 32.3% yoy in January. Declining interest rates also increase attractiveness of ROL-denominated loans. In March, they posted a 19.3% yoy increase, up from 18.1% yoy in February and 16.9% yoy in January. At the same time, foreign-denominated loans remain popular. The declining trend of foreign exchange-denominated loans expressed in national currency (44.3% yoy growth rates for February and March, down from 48.2% yoy in January) may turn into a strong inflationary factor. The nominal interest rate on deposits is dropping. In April, the average interest rate on deposits dropped to 8%. Considering that current rate of inflation is at above this level, real interest rates are approaching zero. The declining attractiveness of national currency deposits may worsen the private sector (saving-investment) balance. Together with robust growth of credit to the private sector, this may negatively affect the external balance of the country.

In February, broad money supply (M2) growth accelerated to 42.4% yoy. Although its growth slowed to 41.1% yoy in March, it is among the highest for the last several years. Up to now, rapid monetary expansion had a minor impact on inflation due to robust demand for money and national currency appreciation. However, in combination with administered price adjustments, it may turn into a strong inflationary factor. The growth of narrow money (M1) reached 42.6% yoy in February and further accelerated to 44.3% yoy in March. Acceleration took place on account of the 33.1% yoy and 56.2% average growth in demand deposits and currency outside the banking system, respectively, during the period. Despite continuing deceleration of forex-denominated deposits to 22.3% in March, down from 29% yoy in February and 32% in January, quasi-money rebounced at 41.3% yoy growth during February-March on average. Acceleration occurred due to growing household savings and ROL-denominated corporate deposits. At the same time, household savings decelerated slightly in March compared to February, reacting to declining interest rates.

Over January-February, the CA deficit widened to EUR 1.2 billion, up EUR 555 million since February. The increase is due to inflows of EUR 934 million from purchases on the foreign exchange market, incomes from international reserve management, and changes in reserve requirements for banks. The outflows of EUR 379 million are due to foreign debt repayment, change in membership quotas and bank commissions.

International Trade and Capital

Despite strong appreciation of the national currency, March’s FOB exports showed impressive 19% yoy growth (up from 10.2% in February). However, driven by high demand for investment goods, CIF imports grew even faster, by around 24% yoy. For Q1, exports increased by 17.4% yoy, while imports advanced 21.2% yoy. Export growth may decelerate through the end of the year due to the impact of ROL exchange rate appreciation against foreign currencies and a high basis effect. Due to higher relative prices and stronger competition from Chinese goods, Romanian textiles and footwear, accounting for the largest share in total exports, ended Q1 with a 0.7% yoy decline. Benefiting from high world prices, exports of mineral products and metalurgy expanded 62% yoy and 38% yoy, respectively. Increasing by 27% yoy, export of transportation means gained a 6.6% share in the structure of total exports (up from 6.3% in 2004). In the imports breakdown, mineral products, transportation means and metallurgical products showed the highest rates of growth — each by about 40% in annual terms. Over Q1, the cumulative FOB/CIF deficit expanded almost 36% yoy and exceeded EUR 1.5 billion. On the back of strong domestic demand and appreciating national currency, the European Commission forecasts Romania’s trade deficit to increase from 9% of GDP in 2004 to almost 10% of GDP in 2005 and 10.5% of GDP in 2006.
merchandize trade deficit stood at EUR 574 million, 44% higher in yoy terms. The balance of services posted a negative EUR 77 million, compared to the surplus of EUR 6 million in the corresponding period last year. Incomes reported a negative balance of EUR 242 million, an almost 85% yoy increase. The worsening of the income balance can be attributed to larger reinvested amounts of foreign companies’ profits. Concerns over the growing CA deficit could have softened considering large foreign direct investment inflows. However, the FDI level was very modest over January-February as compared to the corresponding period last year. According to BNR data, FDI declined by 17% yoy over the period. Although FDI inflow should increase on the back of privatization of several energy companies and EU-membership prospects, structural reforms directed at improving investment climate may further enhance the flow of FDI to the country.

International Programs
In the second half of April, top IMF officials paid a short visit to Romania. Despite the encouraging fiscal data for Q1 presented by the government, the directors of the Fund were not convinced of the favorable budgetary developments this year. At the same time, the Ministry of Public Finance declared that an agreement with the IMF on a 0.7% of GDP budget deficit target for 2005 was reached. The regular IMF team that will assess budget performance and complete second and third quarterly reviews under the stand-by agreement is expected in June. However, since the director of the IMF board representing countries including Romania stated that more time is needed to assess the impact of the flat tax, negotiations could be tight. Among the measures proposed by the IMF to balance the budget are increasing either the flat tax from 16% to 19% or the VAT rate from 19% to 21%.

Following the April 13th approval by the European Parliament, Romania and Bulgaria official signed the Accession Treaty on April 25th. According to the Treaty, both countries should join the EU on January 1, 2007. However, the document contains a safeguard clause, according to which the accession date could be delayed by one year. The clause could be applied in case Romania fails to enforce key reforms required by EU. The EU stresses the need for further progress in judiciary reforms, protecting rights of minorities, fighting corruption and organized crime.

Other Developments and Reforms Affecting the Investment Climate
President Basescu has repeatedly urged early elections. Following the last parliamentary elections, the winning PNL-PD coalition gained the majority in the parliament and managed to form the current parliament with the help of the small Humanist Party (PUR) and the party of ethnic minorities (UDMR). The four-party coalition has turned out to be unstable. Thus, early elections may lead to the formation of a more solid majority in the parliament. However, it may also create political instability in the country. As a result, important accession-related reforms may be delayed. Moreover, with the newly elected leader of current opposition Social Democratic Party (PSD) Mr. Geoana, the party may gain votes in response to the declared conversion of the PSD to a EU-style social democratic party.