Summary

- The economy demonstrated robust 5.9% yoy growth over the first quarter (1Q) of 2005; however, the growth will continue to slow down due to the worsening external opportunities and massive floods in the country.
- Favorable fiscal data for the first half (1H) of 2005 may signify the success of the flat tax rate policy introduced at the beginning of the year; however, consolidated budget performance remained unclear as budget expenditures for the period were not released.
- The government amended this year’s budget, widening the 2005 consolidated fiscal deficit to 1% of GDP, above the target of 0.75% of GDP agreed with the IMF; this may complicate IMF negotiations scheduled for August.
- In June, inflation returned to single digit numbers, reporting a 9.7% yoy increase;
- The current account deficit widened to EUR 2.2 billion over January-May, 71.5% higher than in the corresponding period last year.
- The National Bank of Romania (BNR) has been taking measures to contain buoyant growth of aggregate demand, tightening regulations on credit to the private sector.
- The central bank introduced direct inflation targeting at the beginning of August.
- The government withdrew its plans to resign and initiate early elections in the country.

Economic Growth

Although slowing down from impressive 8.3% yoy growth in 2004, the Romanian economy demonstrated robust 5.9% yoy growth over 1Q05. At the same time, the Romanian economy will continue decelerating through the rest of the year following central bank efforts to curb credit growth, the worsening of external opportunities and the recent massive floods in the country. By tightening consumer credit regulations, the central bank is trying to contain the vigorous expansion of domestic consumption. While the latter was the primary driver of GDP growth in 1Q05, it stimulates the acceleration of imports, thereby increasing external imbalances. At the same time, domestic industry is negatively affected by stronger competition on the EU market, decelerating foreign demand and high production costs. In addition, agriculture reported modest 1.8% yoy growth in 1Q05 and will be negatively affected by recent floods in the country. Most likely, the floods will impact not only agriculture but overall macroeconomic performance as transports were severely disrupted and infrastructure was damaged. According to government officials, the flood damages are estimated to reach EUR 1.2 billion (about 1.6% of expected full-year GDP). This will translate into slower GDP growth, and larger fiscal and current account deficits.

In May, industrial output declined by 4.7% yoy, putting the cumulative growth at 3.8% yoy, down from 5.9% yoy over the first four months. In May, the slowdown was observed for all industries, which may be explained by the loss in productivity, stabilization of world prices on metals, deceleration of world prices on chemicals, high energy prices, the appreciating national currency and stronger foreign competition. At the same time, the growth in wood processing, chemicals manufacturing, metalurgy, production of vehicles and furniture remained broad-based with their outputs expanding by a cumulative 46.8% yoy, 8.3% yoy, 7.2% yoy, 39.5% yoy and 24% yoy respectively over January-May. On the downside, the textiles, apparel and footwear industries continued to deteriorate, reporting 5.8% yoy, 18.1% yoy and 10.5% yoy declines in their respective outputs on the back of stronger competition on the EU market (their main export destination) from Chinese goods. However, in mid-June the EU and China reached an agreement limiting Chinese textile imports to the EU to agreed growth levels until the end of 2008. Although the agreement allows for 8%-12.5% yoy growth of Chinese textile imports to the EU each year through 2005-2007 (compared with 51%-530% yoy growth just for January-May 2005), it may prompt recovery of Romanian light industries.

Fiscal Policy

According to the National Fiscal Administration Agency (ANAF), the revenues for four principal budgets (state, social security, unemployment and health) expanded by about 7% yoy in real terms over the period to RON 37.8 billion (EUR 10.4 billion). The increase in budget revenues was achieved thanks to improved tax collections from corporate profit tax and indirect taxes (value added tax and excises). Collections from the personal income tax declined moderately; however, the deterioration was in line with expectations. At the same time, budget expenditures and, correspondingly, the fiscal balance for the period were not released.

Despite the encouraging budget revenues reported for 1H05, maintaining prudent fiscal parameters for this year remains a challenge for Romanian authorities. Following the massive floods in May and July, the government amended this year’s budget, widening the deficit by RON 717 million (EUR 200 million). According to government officials, additional funds are required to finance reconstruction projects and to provide social protection to the people affected by the floods. As a result of budget revision, the official fiscal deficit target was increased to 1% of full year GDP. The IMF officials insisted on a deficit below 0.5% of GDP, considering the rapid widening of the current account deficit due to slowing economic growth and the need to further reduce inflation. However, following tough negotiations with the IMF in June, the consolidated budget deficit for 2005 was agreed at 0.74% of GDP. Moreover, the government announced that the wages in the budget sector will be increased by 6% in October because of higher-than-expected budget revenues. This decision, however, was in contrast to the agreement with the IMF to freeze public sector wages for the whole year. Moreover, the government decided to allocate RON 250 million (EUR 69 million) and RON 39 million (EUR 11 million) for subsidies to farmers and households using natural gas for heating. Altogether, these decisions by Romanian authorities may jeopardize the negotiations with the IMF scheduled for August.

Due to rapid widening of the CA deficit, the higher fiscal deficit and strong inflationary pressure, the IMF suggestion to raise the VAT rate to 22% (up from current 19%) is getting support among Romanian officials. However, the prospects of such a move remain unclear as there is no common agreement regarding the issue inside the ruling coalition itself. Although the VAT rate increase will improve budget collections, it may require upward revision of the inflation target for next year.

External medium and long-term debt has increased by 16.4% since the beginning of the year to reach EUR 21.1 billion at the end of May. The foreign debt accounted for about 29.5% of expected full-year GDP. Since the beginning of the year, external debt grew by 20%, primarily driven by rapidly increasing private debt. The latter, accounting for about 43% of total external debt, advanced by 20.3% year-to-date (ytd). Public and publicly guaranteed debt showed a moderate increase of 8.4% ytd over the period. On the back of large debt service payments (EUR 773 million) in April and May, the debt service ratio increased to 34.2% over January-May, up from 22.7% in 2004.

Monetary Policy

In June, the consumer price index (CPI) returned to a single digit number, reporting a 9.7% yoy increase. Due to a 0.1% month-over-month (mom) decline in non-food prices caused by a 3.4% decline in gas prices and a 1.6% mom decline in drug prices, monthly CPI growth was maintained at a low 0.3% mom. Despite slight acceleration to...
0.4% mom in June, the annual growth of the food price index (6.5% yoy) remained the lowest in the consumer basket. On the upside, the largest monthly increase in prices was registered for services (up by 1% mom) on the back of a further increase in postal and city transportation tariffs. At the same time, in annual terms the service price index decelerated to 10.7% yoy (down from almost 11% yoy in May). For the first half of the year, cumulative consumer inflation amounted to more than 4% ytd.

Choosing instruments to achieve the target, and the sophistication of the macroeconomic model used to forecast inflation. Since monetary policy actions usually have considerable time lags, the latter is required to develop and introduce necessary measures before the inflation rate begins to rise.

The loose monetary policy of cutting interest rates ahead of the first step of capital liberalization in April resulted in rapid acceleration of money supply growth in the first half of the year. However, the increase had a minor impact on inflation due to buoyant money demand and the appreciating national currency. Despite this, the BNR has taken measures to restrict buoyant growth of money supply. The upward trend of money supply growth reversed in June as broad money (M2) growth decelerated to 46.5% yoy (down from 46.7% yoy in May). The slow down is attributed to the growth deceleration of domestic credit below 20% yoy, down from a 24.7% yoy increase in May. The latter occurred on the back of a 40.4% mom increase in the negative balance of net government credit to RON 7.5 billion (approximately EUR 2 billion). At the same time, the growth of non-government credit continued to accelerate, registering 39.3% yoy in June (up from 35% yoy in the previous two months).

Rapid expansion of loans to the private sector stimulates household consumption, which in addition to appreciating national currency and growing disposable income induces the growth of imports. Moreover, there are growing concerns over the quality of banks’ credit portfolios. To address these issues, the BNR has tightened credit regulations, effective in August, which set a ceiling for the total monthly loan service payments at 40% of net monthly income for an individual or of his/her family. The ceiling applies to all commitments made under all types of credit, including mortgagge, real estate, consumer credit, and leasing. Furthermore, the BNR took a number of measures to stimulate lending in domestic currency. Despite declining interest rates on RON-denominated credits and March’s tightening of reserve requirements on foreign currency, the growth of demand deposits decelerated slightly to 56.3% yoy, down from an impressive 57.4% yoy in May, while that of currency outside the banking system expanded to 39.1% yoy during the period, up from 33.4% yoy a month ago. The stock of bank deposits, or quasi money, decelerated to 46.3% yoy in June, down from almost 47.5% yoy in May. Despite appreciating national currency, forex-denominated deposits gained popularity, advancing by 40.2% yoy from 36% yoy in the previous month. The trend, however, may reverse following the renewal of the disinflation process. Although decelerating, the growth of ROL-denominated corporate deposits considerably outpaced that of forex ones, advancing by 78% yoy in June. At the same time, household savings continued decelerating, reflecting to declining interest rates. In June, the growth rate of household savings declined to 33.1% yoy, down from 36.2% yoy a month ago.

International Trade and Capital

Despite continuing appreciation of the national currency and stronger competition on external markets, Romania’s export performance remained fairly good during 1H 2005. Although decelerating, FOB exports grew by a robust 16.6% yoy to EUR 10.5 billion. In June alone, exports registered almost EUR 1.9 billion, the second largest amount over the last 15 years. However, driven by continuing credit expansion and appreciating national currency, imports outpaced that of exports. Over January-June, CIF imports grew by almost 23% yoy to EUR 14.7 billion. Moreover, recent floods may further enhance imports, thus exacerbating the situation with high trade and CA deficits. The cumulative FOB/CIF trade deficit exceeded EUR 4.2 billion for January-June, up by about 51% yoy.

Over January-June, minerals, vehicles and metalurgical products were the fastest growing export groups, advancing by 59% yoy, 44% yoy and 29.5% yoy, respectively. Impressive growth of minerals products was driven primarily by high world energy prices, while that of transport vehicles by robust external demand. The slowdown of metals exports, which accounts for about 16.5% of total exports, may be attributed to weaker Chinese demand on metals following the introduction of new domestic capacities for production of steel and stabilization of world prices for metals, and a high base effect. Exports of textiles and apparel, which showed negligible 0.8% yoy growth over the period, may increase through the rest of the year to 2005 China agreement restricting Chinese imports to the EU. Textiles and apparel comprise about 20% of total Romanian exports and faced strong competition from Chinese textiles multiplier which the BNR was required to stimulate taxes over two years (earlier they were not subject to a minimum reserve requirement).

After being stable at 44.2% yoy during March-May, the growth of narrow money (M1) accelerated to 47% yoy in June. In its structure, however, the growth of demand deposits decelerated slightly to 56.3% yoy, down from an impressive 57.4% yoy in May, while that of currency outside the banking system expanded to 39.1% yoy during the period, up from 33.4% yoy a month ago. The stock of bank deposits, or quasi money, decelerated to 46.3% yoy in June, down from almost 47.5% yoy in May. Despite appreciating national currency, forex-denominated deposits gained popularity, advancing by 40.2% yoy from 36% yoy in the previous month. The trend, however, may reverse following the renewal of the disinflation process. Although decelerating, the growth of ROL-denominated corporate deposits considerably outpaced that of forex ones, advancing by 78% yoy in June. At the same time, household savings continued decelerating, reflecting to declining interest rates. In June, the growth rate of household savings declined to 33.1% yoy, down from 36.2% yoy a month ago.

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performers were mineral products (up by 46% yoy), vehicles (up by 46.5% yoy), and metallurgy (up by 33.8% yoy). However, the large share of investment goods in total imports is encouraging. Thus, stimulated by robust domestic demand for investment goods, imports of machinery and equipment continued expanding. Over 1H 2005, machinery imports accelerated to 19.5% yoy, up from 18.4% yoy in January-May and 16% yoy at the beginning of the year. On the downside, closely related to export performance and domestic production, imports of textiles and apparels reported a 0.6% yoy decline in 1H 2005. The European Union remained the largest trading partner, accounting for 69% of Romania’s exports and 63% of imports.

On the back of the rapidly widening trade deficit, the current account (CA) continued worsening over January-May. The CA deficit reached EUR 2.2 billion over the period, 71.5% yoy larger than in the same period last year, and representing more than 3% of expected full-year GDP. Loose fiscal policy, robust growth of credit to the private sector and increased import needs on the back of worsening export capacities may further contribute to the widening CA deficit, thus jeopardizing the year-end target of 7.75% of GDP and raising concerns over the country’s external balance. However, the upward trend of FDI inflow is encouraging. According to the Romanian Agency for Foreign Investments (ARIS), FDI inflows totaled about EUR 540 million, up by just less than 10% yoy. Despite a moderate record over 1H 2005, FDI performance should improve through the end of the year due to several large privatization deals (like privatization of electricity distribution company Electrica Muntenia Sud and gas producer Romgaz).

Other Developments and Reforms Affecting the Investment Climate

Early July, the Prime Minister (PM), Mr. Tariceanu, announced that the government would resign in few days and called for early elections. The decision came after the Constitutional Court sent the legislative package on judiciary reform back to parliament. However, Mr. Tariceanu retracted his decision on July 19th, citing the need to concentrate on flood relief efforts and to speed up reforms necessary to secure European integration in 2007. Early elections, if initiated, would have diverted government efforts away from EU-needed reforms towards a political fight. In turn, lack of reform progress would trigger the safeguarding clause, delaying accession by one year to January 2008. The PM’s decision took place the same day that Constitutional Court validated the amended bills on judicial reform.

July’s floods, which were declared the worst in last 50 years, affected 31 counties out of 41. According to the latest government estimates, flood damages amount to RON 2.4 billion (EUR 670 million). Earlier in May, western Romanian regions were already hit by floods causing damages estimated at RON 1.8 billion (EUR 504 million). Thus, the combined cost of the two floods accounts for 1.6% of expected full-year GDP. International financial institutions expressed their readiness to support Romania in its reconstruction works in the regions affected by floods. In particular, the World Bank and EBRD are planning to allocate EUR 26.8 million and EUR 7.2 million correspondingly for infrastructure repair, including road transportation and water supply. The US government has also declared its intention to give $2.5 million to support people affected by the floods.