Summary

- Industrial output gained a modest 2.0% year-over-year (yoy) in 2005, slowing down from 5.3% yoy in 2004.
- In January, total fiscal revenues increased by 16% yoy. The main source for this increase was a 52% yoy surge in VAT collections, generated by growing private consumption.
- In January, consumer price inflation accelerated slightly to 8.9% yoy, up from 8.6% yoy in the previous month, driven primarily by an administrative adjustment in gas prices.
- In 2005, the current account (CA) deficit expanded by 35% yoy to reach EUR 6.9 billion, or 9.2% of estimated full-year GDP. Strong FDI inflows covered a substantial part of last year's CA gap.
- In its preliminary conclusions on the Article IV consultations, the IMF strongly recommends that the Romanian government adopt tighter fiscal and monetary policies to maintain disinflation and support economic growth.

Economic growth

According to the National Institute of Statistics (INSSE), performance of Romanian industry, the major contributor to GDP growth, deteriorated last year. Industrial output grew by a modest 2.0% yoy in 2005 compared to 5.3% yoy growth recorded for the previous year. Such a slowdown in industrial activity is primarily attributed to the sizeable real appreciation of the Romanian Leu with respect to the Euro, which reached 20% yoy, coupled with stronger competition faced by Romanian producers on major export markets and increased production costs, primarily energy. Though private consumption was expanding vigorously over the year (by about 9%), it apparently had a minor effect on industrial production but mainly stimulated imports. This may indicate the low competitiveness of local manufacturers on domestic markets and the remaining structural weaknesses of the economy.

By product breakdown, the growth-leaders in 2005 were primarily the automotive industry, wood processing, furniture and fuel processing, which advanced by 34.9% yoy, 22.5% yoy, 17.1% yoy and 13.4% yoy respectively. The automotive industry is expected to maintain its current high growth rates, provided that domestic and external demand for Romanian cars remains strong. Metallurgy and chemicals, which are mostly export-oriented, posted a meager growth of 2.0% and 3.1% yoy, due to the worsening conditions on external markets. Some sectors reversed their positive development and posted a decline. The deepest decline was observed in production of ready-made clothes (by 15.9% yoy), footwear (by 11.9% yoy), and textiles (by 10.9% yoy), negatively affected by increased competition from Chinese producers.

The projections for industrial output in 2006 are still optimistic. The government forecasting agency expects industrial activity to recover to 2.4% yoy in the first quarter of this year.

Fiscal Policy

According to preliminary data released by the Ministry of Public Finance, January's revenues to the general government budget reached RON 8.1 billion (EUR 2.2 billion), expanding by 16% yoy in nominal terms. VAT receipts, accounting for 28% of consolidated budget revenues, remained the fastest-growing item in the budget, driven primarily by buoyant private consumption. By the end of January, VAT receipts totaled RON 2.3 billion, up by almost 52% as compared to the same period last year. Revenues from excises also increased, but at a slower rate of 17% yoy. On the opposite side, the collection of corporate profit tax dropped by 11% yoy due to a high base year effect, since companies were still paying 25% tax on profits related to the fourth quarter of 2004 in January 2005 (whereas currently they pay 16% tax.) Income tax revenues saw similar developments, driven by the introduction of a 16% flat tax rate in 2005. In nominal terms, income revenues decreased by about 7% yoy. The data on budget expenditures execution and the budget balance in January have not yet been released by the government fiscal authority.

Monetary Policy

Driven by an adjustment in administered prices, consumer inflation accelerated slightly to 8.9% yoy in January, up from 8.6% yoy in December. This acceleration is mainly attributed to an increase in the price of natural gas by 17.6%, which contributed 0.5 percentage points (pps) to the total 0.3% mom inflation. The government plans another 16% increase in the gas price by the end of 2006 under the price adjustment calendar agreed upon with EU officials. Prices for non-food products, accounting for 42% of the total consumer basket, grew by 10.5% yoy, up slightly from 9.8% yoy in December. Food prices posted a small reduction in their rate of growth. In annualized terms, it inched down to 5.6% yoy in December against 5.7% yoy in the previous month. Services prices, with a 16.5% share in the consumer price index, kept growing at the previous month's rate of 13.1% yoy.

In mid-February, the National Bank of Romania (BNR) released its quarterly inflation report under the inflation targeting regime. The report states that the BNR decided to maintain its inflation target at 5% +/- 1% for 2006, but revised upwards its forecast from the previously announced 6% to 6.6% yoy. For 2007, the inflation target is set at 4% with a +/- 1% band around it and is regarded by the BNR as quite attainable.
In order to achieve ambitious targets, the BNR committed to continue tightening monetary policy and to use the whole array of available instruments. Previously, the BNR used mainly open-market operations to absorb liquidity on the money market and credit controls to contain buoyant private consumption. Following the release of the inflation report, the central bank is expected to more actively sterilize its forex purchases on the interbank market and also turn to other anti-inflationary tools, including increases in interest rates and less intervention conducted on foreign exchange market. Pursuing the declared disinflation policy, the BNR already adopted its first measures in February. It raised the intervention interest rate by 1pp to 8.5% p.a. and tightened the required reserves for foreign currency liabilities to 40% from the previous 35%. Also, it continued to conduct open-market operations and attracted RON 5.2 billion (EUR 1.5 billion) as one-month deposits.

The money supply, measured by monetary aggregate M2, marked the lowest growth rate of 34% yoy in December, while its average annual rate is estimated at 41% yoy. December’s money supply expansion primarily reflects domestic credit growth and to a lesser extent the currency issue, generated by the central bank’s purchases of foreign currency at the interbank market. By the end of the year, the BNR foreign reserves amounted to EUR 16.8 billion, up slightly from EUR 16.7 billion at the end of November.

Though bank lending to the private sector slowed somewhat in December, its growth rates remain extraordinarily high. In particular, the stock of bank credits to the non-government sector grew by 45% yoy, compared to almost 50% in November. Following the central bank policy measures aimed at containing bank lending in foreign currency, foreign-denominated loans grew by 29% yoy, compared to a much higher growth rate of 41% yoy recorded the month before. However, it looks like forex lending is being replaced by local currency loans, as the latter surged by a high 70% yoy in December compared to 62% yoy in November. Because of the high need to curb credit growth and support disinflation, the BNR is likely to introduce further measures to tighten consumer credit.

International Trade and Capital

In 2005, the merchandise foreign trade deficit (FOB/CIF) reached EUR 10.3 billion, up by 40% yoy. The estimated deficit represents a gap of 13.7% of projected full-year GDP against 9% in 2004. The gap widened despite strong export performance, but due to a superior import expansion. Exports increased at a robust 17.5% yoy, but imports accelerated at a faster rate of 23.9% yoy. Both exports and imports were affected by domestic currency appreciation, while imports were also largely stimulated by growing domestic consumption.

The main destinations of Romanian exports in 2005 were the EU-25 countries, which accounted for 67.6% of all exports. The region also remained the major supplier of goods and services to Romania, with a 62.2% share of total Romanian imports.

International Programs

Following the 2006 Article IV consultation discussions held in Romania in February, the IMF Mission released its preliminary report on the visit. In its report, the IMF notes the continuation of convergence with the EU and high confidence in the country’s prospects, but also points to some weaknesses, including a slowdown in economic growth and disinflation, strong credit growth and expansion of the current account deficit. The mission sees economic growth at a sustainable 5-6% yoy, provided that appropriate policies are pursued by state authorities. In particular, the IMF recommends a significant tightening of fiscal policies, with a balanced budget for the current year and small surpluses over the medium term. The major challenge for the government at this stage, according to the IMF, is to strengthen the revenue side of the budget, given that Romania will have to finance contribution to the EU budget and co-finance EU projects. Ways to achieve higher fiscal revenues, in the IMF’s view, include increasing the VAT rate, revisiting flat tax rates, broadening the tax base, increasing administrative fees, increasing property taxes, and improving revenue administration. In the monetary policy area, the IMF considers the 5% official inflation target for 2006 as unrealistic. In order to support the current disinflation trend, the IMF strongly recommends that the BNR immediately tighten monetary policy and apply other administrative anti-inflationary instruments, including higher interest rates and greater allowance for exchange rate appreciation. Also, in order to reach sustainable economic growth, the government needs to renew its structural reform efforts in the privatization area, price adjustment policy for domestic producers and judicial reforms, to name a few. The overall tone of the IMF report is quite optimistic. The dialogue will be continued in the month ahead, when the possibility of resuming the Stand-By Arrangement will be considered.

Other Developments and Reforms Affecting the Investment Climate

In February, the parliament rejected the Emergency Ordinance1 for the creation of the National Anticorruption Department. The Emergency Ordinance issued

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1 According to Romanian legislation, for urgency reasons, the government can issue Emergency Ordinances for a one year term, which must be passed by the Parliament and then approved by the President.
last year created the National Anticorruption Department, intended to investigate large corruption cases, by transforming the National Anticorruption Prosecutor's Office. This year's rejection by the Parliament of the Emergency Ordinance caused the President, Mr. Traian Basescu, to send it back to the Parliament for re-examination, after consulting with parties for a new, generally acceptable form. According to the new form, the institution named as the National Anticorruption Directorate would be subordinated, yet with a high degree of independence, to the General Prosecutor. The need to introduce these legislative changes comes on the back of repeated EU claims for the need to take decisive action against corruption, especially related to the high level cases. In May 2006, the EU will issue its final decision on Romania's EU accession. The progress in the fight against corruption will influence the Commission's decision on whether to recommend postponement of accession to 2008.