Summary

- A notable rebound in industry was registered in May as industrial output accelerated to 15.7% yoy. In January-May, industrial production posted strong growth increasing by 5.9% yoy, supported by growing production in manufacturing as well as increasing labor productivity.
- In January-May, the consolidated budget surplus amounted to RON 4.19 billion (EUR 1.19 billion) which is about 1.3% of projected full year GDP.
- In June, monthly CPI inflation hit its lowest level of 0.15% month-over-month (mom) in 2006. Consumer prices have increased by 2.67% since the beginning of the year and CPI inflation has decelerated to 7.11% yoy.
- The National Bank of Romania continued to pursue tight monetary policy with an intention to restrict the expansion of RON-denominated non-government credit, which has doubled in nominal terms since May 2005. RON-denominated household credit increased by 125% yoy in May.
- In January-May, the current account deficit stood at EUR 3.34 billion or 3.7% of projected full year GDP, increasing by 53.2% yoy. Net foreign investments in the amount of EUR 2.9 billion allowed for financing of 86% of this deficit.
- The privatization of the state-owned bank, the National Savings Bank (the fifth largest bank in Romania), is advancing.

Economic Growth

In January-May, industrial output posted strong growth increasing by 5.9% year-over-year (yoy) over the same period of the previous year. In May alone, industrial production accelerated to 15.7% yoy from 0.6% yoy in April. Though a shift in the business day schedule due to the Easter holidays influenced statistical differentials in the monthly output dynamics, in April-May 2006, the growth rate of gross fixed capital formation outpaced the growth rate of final consumption.

Manufacturing continues to be the principle sector supporting positive performance of industry. In May, production in manufacturing grew by 16.5% yoy, pushed by growth in the chemical industry of 39.7% yoy, automobile manufacturing by 29.4% yoy, fuel processing industry by 18.9% yoy, utilities by 16.7% yoy, and wood and food processing by 18.6% yoy and 21.1% yoy respectively. A negative trend was reversed in metallurgy, where output had been declining since February. In metallurgy and machine building, where production declined by 5.9% yoy in April, positive growth rates of 2.2% yoy and 4.1% yoy respectively were recorded in May. However, output contraction in both sectors continued, though at a slower speed; in January-May production in metallurgy and machine building declined by 2.3% yoy.

There are signs of improvement in light industry, where output contraction rates decelerated in the textiles sector from –14.3% yoy for the first four months of this year to –12.9% yoy in January-May, in ready-made clothes from –8.8% yoy to –6.7% yoy and in leather and footwear from –2.4 yoy to –1.5 yoy.

Fiscal Policy

In January-May, consolidated budget revenues amounted to RON 41.24 billion increasing by 22% yoy or by 14% yoy (CPI adjusted). Consolidated budget expenditures totaled RON 37.04 billion, growing by 13% yoy or 5% yoy CPI adjusted. As a result, the consolidated budget surplus for the first five months of 2006 grew to RON 4.19 billion (EUR 1.19 billion) which is about 1.3% of projected full year GDP.

In the first half of 2006, consolidated budget revenues increased by 20.4% yoy or by 12.4% yoy CPI-adjusted, reaching RON 46.7 billion (EUR 13.2 billion).

Monetary Policy

The consumer price index (CPI) registered the lowest monthly inflation since the beginning of the year in June. Despite a 0.81% month-over-month (mom) increase in the prices of services, CPI inched up by only 0.15% mom decelerating from 0.6% mom in the previous month. A positive monthly inflation outlook is supported by declining prices of food products, which dropped by 0.45% mom in June due to the seasonal adjustments in the prices of vegetables (~2.0% mom) and a continuing downward trend in the prices of milk and meat (which decreased by 0.96% mom and 0.78% mom respectively.) The price index of non-food commodities grew by 0.45% mom, decelerating from 1.2% mom in May. As in the previous month, higher prices of tobacco and fuels in June, growing by 3.13% mom and 0.22% mom respectively, generated at least 1% of the monthly inflation in the prices of non-food commodities. The accelerated growth rate of service...
prices is mainly driven by the increasing tariffs of water supply, railroad transportation and telecommunications by 1.57% mom, 2.71% mom and 1.1% mom. In June, the growth in telecommunications tariffs was registered for the first time since the beginning of the year and contributed 0.077 percentage points to monthly CPI inflation.

In May, domestic non-government credit maintained its upward trend, increasing by 53.5% yoy as compared to May 2005. This expansion is supported with the rapid growth of RON-denominated non-government credit, which has doubled in nominal terms since May 2005 and amounts to RON 37.64 billion (EUR 10.64 billion), representing 52% of non-government credit (40% in May 2005). The 100% yoy growth rate of RON-denominated credit is largely attributed to the significant expansion of RON-denominated credit issued to households, which increased by 125% yoy in May. The total amount of loans denominated in both domestic and foreign currencies and issued to households increased by 88% yoy to RON 27.9 billion (EUR 7.9 billion) and accounts for 39% of total domestic non-government credit (31% in May 2005). About 40% of the growth of non-government credit is generated by increasing RON-denominated consumer credit (this contribution is almost three times higher than in May 2005). The impact of the growth of total RON-denominated credit is even more dramatic — expanding domestic RON-denominated credit accounts for at least 3/4 of the growth in total non-government credit.

In May, nomination money supply (measured with the monetary aggregate M2) increased to RON 91.7 billion and posted a 27.5% year-over-year (yoy) growth rate, which is slightly higher than the 27.4% yoy growth rate recorded in April. Net domestic assets (NDA) increased by 9.55% mom to RON 47.23 billion driven by the expansion of non-government credit. In May, the growth rate of NDA accelerated to 41.5% yoy from 33.9% yoy in April.

International Trade and Capital

In May, exports (FOB) amounted to EUR 2.3 billion accelerating to 29.7% yoy from 4.1% yoy in the previous month. The growth of imports continues to outpace the growth of exports, with imports (CIF) increasing to 30.9% yoy from 15.7% yoy in April and totaling EUR 3.5 billion. As a result, the merchandise trade deficit (FOB/CIF) increased to EUR 1.2 billion in May or EUR 4.64 billion since the beginning of the year, which is approximately 5.1% of projected full year GDP. At the same time, the strong performance of exports supported a notable deceleration in the growth rate of both the monthly and cumulative trade deficit. The growth of the trade deficit (FOB/CIF) decelerated to 33% yoy in May, which is 1.5 lower than the average growth rate for the first four months of 2006. In January-May, the growth of the trade deficit (FOB/CIF) slowed to 43.3% yoy from 46.2% yoy in January-April.
In May, the notable growth of exports was driven by the increasing export of machinery, mineral products and transportation means, which expanded by 50.9% yoy, 45.6% yoy and 97.4% yoy respectively. Higher export volumes of these three commodity groups, supported by the strong external demand and the high price of oil, account for approximately ¼ of the export growth in May and contribute 84% to the 19.8% yoy growth of exports in January-May. In addition, the export of textiles and metallurgical products posted positive growth rates in May accelerating to 6.4% yoy and 6.8% yoy from –17.3% yoy and –9.6% yoy respectively in April. In January-May, imports (CIF) accelerated to 26.2% yoy and amounted to EUR 15.02 billion. The principle contributing commodity groups, generating 19 percentage points of this growth rate, are mineral products, machinery, vehicles and metallurgical products, the imports of which increased by 39.7% yoy, 33.7% yoy, 30.5% yoy and 24.8% yoy respectively. The European Union continued to be Romania’s main trading partner, with exports to the EU increasing by 16.6% yoy and imports from the EU by 23% yoy in January-May.

### Other Developments Affecting the Investment Climate

The Romanian government is advancing with the privatization of the state-owned bank, the National Savings Bank (CEC). The CEC is the fifth largest bank in Romania with RON 6 billion in assets and RON 17.6 million (EUR 4.88 million) net profits earned in the first half of 2006. Bids for a 69.9% stake in CEC were submitted by three bidders: OTP Bank, the National Bank of Greece and Austria’s Raiffeisen. Following the first phase of CEC privatization, the government decided to continue negotiations with OTP Bank and National Bank of Greece. Final offers are expected to be submitted on August 31st.

The World Bank and the International Bank for Reconstruction and Development (IBRD) agreed to grant Romania a EUR 106 million loan for developing infrastructure and water and sewage facilities.

Standard & Poor's issued a report on the Romanian banking sector acknowledging the high potential of the banking sector for growth and development. The report recognizes significant improvements in bank management and the regulatory environment as well as increased participation of the foreign banks in the Romanian banking sector, and calls for further reforms that would harmonize Romanian banking regulations with European standards and facilitate EU accession.

The Precautionary Stand-By Arrangement with the International Monetary Fund (IMF), signed two years ago, expired in July. According to the IMF, the program had been missing its targets since Fall 2005 and the principle disagreement between the government and the IMF was the level of the budget deficit. While the Fund advocated a balanced budget, the Romanian government approved a 2.5% of GDP budget deficit in June.