Summary

- In January-August, industrial output continued to accelerate growing by 7.2% year-over-year.
- On October 13th, the Government of Romania approved a draft budget for 2007, which envisions a deficit of 2.8% of GDP.
- Over the first eight months of the year, the consolidated budget surplus amounted to RON 5.27 billion (EUR 1.58 billion) or 1.58% of full year GDP. Due to optimistic growth of fiscal revenues, the year-end budget deficit is expected to be below the projected level of 2.5% of GDP.
- In September, strong disinflation dynamics persisted as consumer price inflation fell to 5.48% yoy from 6.02% a month ago.
- During the first eight months of 2006, the merchandise trade deficit (FOB/CIF) widened to EUR 8.43 billion, expanding by 44.7% yoy.
- In January-August, the current account deficit widened to EUR 5.9 billion growing by 51% yoy. Net FDI inflows in the amount of EUR 4.33 billion allowed for financing of about 73.1% of the current account gap.
- Moody's improved Romania's sovereign credit rating to investment grade.

Economic Growth

In January-August, industrial output continued to accelerate, growing by 7.2% year-over-year (yoy); however, the upward trend of the growth rate of industrial production flattened due to the deceleration of the monthly output expansion in mining and manufacturing, where growth rates have been slowing after hitting record levels in May 2006. During the first eight months of this year, output in manufacturing grew by 7.7% yoy against the same period of the previous year supported by the robust growth of the food processing industry (up by 16.3% yoy), chemical industry (19.2% yoy), automobile industry (17.9% yoy), wood processing industry and furniture production (up by 7.5% yoy and 21.4% yoy respectively). In January-August, output contraction in fuel processing was recorded for the first time since the beginning of the year as production fell by 1.2% yoy for the period. Performance in the machine building sector has been disappointing since February and continued to deteriorate in August as output fell by 1.4% yoy. Moreover, despite a modest growth of production in the leather and footwear industry by 0.6% yoy, the stagnation of light industry is unlikely to stop as production of clothes and textiles shrank by 8% yoy and 15.5% yoy respectively in January-August.

Fiscal Policy

On October 13th, the Government of Romania approved a draft budget for 2007 that envisions a deficit of 2.8% of GDP up from a projected 2.5% in 2006. In 2007, consolidated budget revenues are expected to increase to 35.18% of GDP or EUR 38 billion. The budget is based on the following projections of the fundamental macroeconomic indicators: GDP is expected to grow by 6.4% in real terms, while nominal GDP is set at EUR 108 billion. In 2007, the average inflation and exchange rate are forecasted at 4.5% and RON 3.53 to EUR 1, respectively. In addition, the inflow of EU funds to finance post-accession adjustment programs (Romania is expected to co-finance these programs in the amount of 0.56% of GDP) is anticipated to reach 2.1% of GDP in 2007, while Romania will contribute EUR 1.1 billion (1.02% of GDP) to the EU budget. Notably, the government plans to channel about 6.6% of GDP to capital expenditures, with the lion’s share of these funds absorbed by infrastructure projects.

On October 10th, the IMF issued a statement arguing that a high deficit would deepen macroeconomic imbalances as pro cyclical fiscal loosening may threaten the disinflation process and widen the current account deficit. In particular, the IMF urges the government to refrain from large wage increases and warns that the 18.2% planned hike of the minimum wage (from RON 330 to RON 390) could be a major obstacle to meeting inflation targets in 2007. Furthermore, according to the IMF, the capacity of the government to implement massive capital investments is not properly developed; as a result, unutilized funds may be spent on current expenditure exacerbating demand pressures.

In August, the growth rate of industry decelerated to 6.7% yoy from 10% yoy in July, driven by the slower output expansion in mining (up by 0.3% yoy) and manufacturing. Output in manufacturing decelerated to 7% yoy from 10.4% yoy in August due to the record high contraction rates in machine-building and fuel processing, where production dropped by 12.7% yoy and 13.9% yoy respectively. In addition, weaker performance of several other sectors exerted a downward pressure on the growth of the real sector. In particular, wood processing and furniture production has been steadily decelerating since May, though in August both sectors still grew faster than their average growth rates during the first four months of 2006. In August, output in metallurgy posted a considerably slower growth rate, increasing by only 0.7% yoy as compared to 22.4% yoy in the previous month. However, this deceleration can be explained by the especially weak performance of metallurgy during the second quarter of 2005 when the average monthly contraction rate exceeded 10%. Consequently, the exceptionally high growth rates of metallurgy in the second quarter of 2006 can be attributed to the robust recovery of domestic demand supported by the notable expansion of construction and industry. Furthermore, the rapid growth of imports of metallurgical products is additional evidence of stronger domestic demand. At the same time, a large share of these imports represents semi-processed products that will undergo final processing in Romania, as many domestic steel processing mills operate under processing arrangements with foreign contractors. Finally, in August the growth of the real sector was strongly supported by the record high expansion of the chemical industry (up by 56.2% yoy), robust growth of output in utilities (14.2% yoy) and accelerated production in the automobile industry (18.7% yoy).
To meet this target, the government should accelerate budget spending to about 30% yoy on average during the next four months. However, under Romania’s com-
mittance to prudent and transparent fiscal procedures, such acceleration is hardly feasible.

According to the ministry of Public Finance, consoli-
date budget revenues totaled RON 71.43 billion in Jan-
uary-September or 22% higher against the same period of the previous year. On the back of rapid growth of
wages and household incomes, the growth of income
tax revenues accelerated to 39.3% yoy from 38.8% yoy
in January-August. Despite slight deceleration, the col-
lection of VAT remained strong as well, growing by 25.2% yoy to RON 19.7 billion (EUR 5.6 billion). However, with the exception of proceeds from cus-
toms duties (which increased by 19% yoy), revenues
from profit tax and excises continued to slow, growing by 14.6% yoy and 11.4% yoy respectively.

According to the National Bank of Romania, the stock of medium and long-term external debt grew at a slower rate, increasing by only 0.46% month-over-
month (mom) to EUR 25 billion in August. Public and
publicly guaranteed debt continued to decline (falling by EUR 40 million), while private external debt expe-
rienced a moderate increase in the amount of EUR 155 million.

Monetary Policy

In September, strong disinflation dynamics persisted as consumer price inflation (CPI) fell to 5.48% yoy from 6.02% a month ago. Favorable developments
were registered in all three components of the CPI as price indexes of foods, non-foods and services posted slower growth rates than in August. The prices of
foods increased by only 2.08% yoy as compared to 5% yoy growth registered in September 2005. In 2006, modest price increases of food commodities
were supported by the relatively stable supply of agri-
cultural products due to the stronger performance of
agriculture (thanks to more favorable weather condi-
tions.) While prices of vegetables, meat, milk and
bread (commodities that account for more than 2 of
the consumer basket) surged by 30.7% yoy, 8.7% yoy,
8% yoy and 6.4% yoy respectively in September
2005, in the same month of this year prices of vegeta-
tbles, meat and milk fell by 1.2% yoy and 0.8% yoy while
prices of milk and bread grew much slower, increas-
ing by 5.3% yoy and 2.1% yoy.

In September 2006, prices of non-food commodities
decelerated to 7.5% yoy from 8% yoy in August. Higher prices of utilities and tobacco (up by 12% yoy
and 29% yoy in September) are key factors influenc-
ing the evolution of the non-food price index. Further-
more, the contribution of these factors to year-end
CPI is likely to be around 3 percentage points, as fur-
ther upward adjustments of excise duties and adminis-
terated tariffs (which had the highest impact on the
prices of these two commodities) will probably be
postponed until 2007. In addition, decelerating prices
of fuels (up by 2% yoy in September) due to declining
world oil prices could mitigate the impact of higher
prices of other non-food commodities on CPI. Finally, service tariffs slightly decelerated to 8.26% yoy in September. At the same time, the resistance of
the service price index to losing speed is due to steadily increasing tariffs of all service categories, as
their prices grew on average by 8% yoy in September.
In particular, water supply tariffs increased by 20.3% yoy, telecommunication tariffs by 4.2% yoy and trans-
portation fares by 7% yoy.

In September, CPI inched up by 0.1% month-over-month (mom) driven by accelerated infla-
tion of service tariffs, which grew by 1.2% mom —
the highest monthly increase in 2006. Higher tariffs
of telecommunication services (up by 2.2% mom in
September) contributed about 3% of the monthly in-
crease of the service price index. A downward trend
in phone tariffs, which supported strong deceleration
of service tariffs during the first five months of the
year, reversed in June and a record growth rate of
phone tariffs of 3.06% mom was registered in Septem-
ber. Notably, in January-September, CPI increased by
only 2.76% since the beginning of the year as com-
pared to 5.8% inflation registered for the same period
of the previous year. As a result, relatively moderate
inflation during the first nine months of 2006 allows to
predict the year-end inflation target of 5% ±1% is
likely to be feasible for the central bank.

On the back of a flatter upward trend of the growth
rate of non-government credit, money supply deceler-
ated slightly in August as monetary aggregate M2
grew by 28.10% yoy to RON 98.3 billion, compared
to the 29.4% growth rate registered in July. The
growth rate of non-government credit failed to accel-
erate for the first time since April, though it still re-
mained high, falling to 56.9% yoy from 57.1% yoy in
July. Though the growth of RON-denominated credit
decelerated slightly to 104.9% yoy from 106.5% yoy
in July, forex-denominated credit resumed accelera-
tion, growing by 24.13% yoy in August. Although the
central bank managed to curb rapid expansion of for-
ex-denominated credit (as the growth rates of for-
ex-denominated credit has been falling since April
2005), the growth rate of forex-denominated credit
leveled out and exhibited a slight tendency to increase
starting May 2006. Driven by the robust growth of
loans denominated in foreign currencies and issued to
households, which grew on average by over 50% yoy
in 2006, and the slight acceleration of forex loans is-
sued to other economic agents, the growth rate of for-
ex-denominated credit is likely to follow an upward
trend through the rest of the year.

International Trade and Capital

In August, the share of consumer loans and mortgages
in the total volume of loans amounted to 40.9%. Con-
sumer loans expanded by 101% yoy in August sup-
ported by the brisk growth of RON-denominated con-
sumer loans, which gained 131% yoy against the
same month of the previous year. Though real-estate
mortgages constitute only 20% of all loans issued to
households, their volume increased by 52.8% yoy in
August due to the rapid growth of RON-denominated
mortgages (up by 167% yoy) and forex-denominated
mortgages (42.6% yoy).

In August, exports (FOB) continued to decelerate in-
creasing by 7.4% yoy — the second lowest growth
rate registered in 2006, while imports (CIF) slightly
accredited to 24% yoy, growing to EUR 3.35 billion. Driven by the slower growth of exports, the monthly merchandise trade deficit (FOB/CIF) hit another record high level, widening to EUR 1.35 billion.

Strong domestic demand for imports grew by the slower growth of exports, the monthly merchandise trade deficit (FOB/CIF) hit another record high level, widening to EUR 1.35 billion. Driven by the slower growth rate of exports of mineral products (due to the declining world prices of oil), which increased by only 19.3% yoy in January-August compared to 33.1% yoy in January-July. At the same time, the growth rates of exports of machinery and textiles were only marginally below the levels posted in the previous month. On a positive note, exports of metals have been accelerating for the fifth month and grew by 10.3% yoy in January-August. In addition, transportation continued to be the most dynamic component of exports, as exports of vehicles grew by 65% yoy. In January-August, imports of vehicles, metallurgical products and chemicals accelerated while the imports of textiles, machinery and mineral products posted slightly lower growth rates than in January-July.

In January-August, the current account deficit widened further to EUR 5.9 billion, increasing by 51% yoy over the same period of 2005 fueled by the accelerated growth of the trade in goods deficit to 51.8% yoy from 46.9% in January-July. During the first eight months of the year, the current transfer balance improved, posting a 7.1% yoy gain as compared to a -2.6% yoy loss registered in January-July. However, the incomes deficit deepened, growing by 20.6% yoy to EUR 2.03 billion. On the positive side, about 73.1% of the current account gap was covered with FDI inflows, which amounted to EUR 4.33 billion in January-August. Finally, foreign exchange reserves (including monetary gold) of the central bank grew by EUR 167 million in September to EUR 20.3 billion and the imports cover ratio settled at 6 months.

Other Developments

In October, Moody’s improved Romania’s sovereign credit rating to investment grade (Ba3) from speculative (Ba1). According to the agency, this upgrade was prompted by improvements in economic institutions and a reduction of the government’s debt burden.

The Ministry of Public Finance signed a memorandum with the European Investment Bank (EIB) under which the EIB is expected to finance projects in Romania with a total value projected at EUR 1 billion per year. Additionally, the EIB agreed to lend Romania EUR 63 million for the third stage of the Bucharest underground upgrade. In 1990–2005, the EIB issued loans to Romania in the amount of EUR 4.3 billion for programs facilitating EU accession, including transportation, environmental, health and education projects.

The board of the European Bank for Reconstruction and Development approved a credit facility in the amount of EUR 40 million for small and medium enterprises in Romania, as part of a EUR 82.5 million loan.

In October, France and Belgium endorsed Romania’s EU accession treaty, increasing the number of EU member states that have ratified this treaty to 23. Germany and Denmark are expected to ratify Romania’s EU accession treaty by the end of the year.

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

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