In January-September, real GDP grew by 7.8% year-over-year (yoy) on the back of robust economic performance in the third quarter of 2006. Industrial production continued to accelerate in January-October, increasing by 7.4% yoy — its highest growth rate in 2006. Over the first ten months of the year, the consolidated budget surplus grew to RON 6.87 billion (EUR 1.95 billion) or 2.04% of projected full year GDP. In December, the Parliament of Romania adopted the Budget Laws for 2007, which envisages a consolidated budget deficit of RON 8.7 billion or 2.8% of full year GDP. In November, the consumer price index (CPI) slightly decelerated to 4.67% yoy from 4.8% yoy in the previous month. However, monthly inflation hit its highest level in 2006. During the first ten months of the year, the merchandise trade deficit widened to EUR 11.24 billion or about 12.1% of projected full-year GDP. In January-September, the current account gap totaled EUR 7.75 billion and was fully covered by the inflow of foreign direct investments in the amount of EUR 7.9 billion. In December, the Government of Romania cancelled the privatization of the Casa de Economii si Consommături (CEC) — the eighth largest bank in the country.

### Economic Growth

Outstanding economic performance in 2006 is built on several factors. First, brisk domestic consumption is fueled by rapidly growing real consumer incomes (on the back of lower inflation and faster GDP growth), expanding domestic credit and loose fiscal policy. Second, the expansion of aggregate supply is supported by stronger external demand, more stable weather conditions that helped avoid disruptions of the supply of agricultural products, as well as less volatile world prices of oil and energy resources. Finally, favorable transformations of Romania’s investment climate and the country’s accession to the European Union have notably improved Romania’s attractiveness for foreign investors contributing to the vast inflow of foreign direct investments — about EUR 8 billion during the first ten months of 2006.

In January-October industrial production continued to accelerate increasing by 7.4% yoy — its highest growth rate in 2006. Although the growth rate of output in the mining sector was on a downward trend, slipping to 3.2% yoy from 3.4% yoy in January-September, the output expansion in manufacturing remained strong as production in manufacturing grew by 8% yoy — up from 7.7% yoy in January-September. Food processing (up by 16.9% yoy in January-September), chemical industry (up by 15.9% yoy) and automobile industry (up by 20.6% yoy) were the key sectors that supported strong performance of manufacturing. In January-October, the output recovery in metallurgy was sluggish (up by only 1.5% yoy), while the machine building industry continued to shrink (by 1.3% yoy), though at a slower speed. On a positive note, stagnation of light industry decelerated slightly as the production of textiles and ready-made clothes declined by 15.2% yoy and 8.2% yoy respectively — down from 16.3% yoy and 8.6% yoy declines posted in January-September. Finally, the output in the utilities sector grew by 5.4% yoy supported by the better performance of this sector in October.

### Industrial Output by Sector, % yoy

In October, industrial production notably accelerated to 10.2% yoy from 6.2% yoy in September, driven by output growth in food processing (up by 20.7% yoy), automobile industry (up by 29.5% yoy), wood processing and furniture production (up by 14.8% yoy and 33.6% yoy respectively). Although positive output growth in fuel processing (up by 19.4% yoy) was registered for the first time since June, it can be largely explained by the weak performance of this sector a year ago (up by only 1.9% yoy in October 2005) as on a month-over-month (mom) basis output in fuel processing grew by only 2.7% mom against September 2006. On a positive note, the performance of machine building in October revealed potential signs of recovery as output in this sector increased by 3.5% yoy against October 2005 and by 6.4% mom as compared to September 2006.

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**Macroeconomic Situation**

December 2006

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Fiscal Policy

In January-October, consolidated budget revenues grew by 21.4% yoy to RON 87.34 billion, outpacing the growth rate of consolidated budget expenditures, which increased by 18.7% yoy to RON 80.5 billion. The consolidated budget surplus further increased to RON 6.87 billion (EUR 1.95 billion) or 2.04% of projected full year GDP.

According to the Ministry of Public Finance, consolidated budget revenues amounted to RON 90.05 billion in November increasing by 22% yoy in nominal terms. The robust performance of fiscal revenues is a principle driver of budget revenues as proceeds from all principal taxes continue to increase at fast growth rates, fueled by the growing economy, increasing incomes and corporate profits. In particular, the collection of income tax continued to be the most dynamic component of fiscal revenues setting another record in terms of the growth rate, as the proceeds from the income tax grew by 42.2% yoy in nominal terms in November. Two other principle sources of budget revenues — VAT and profit tax — registered strong performance as well, both growing faster than by 20% yoy (in January-November, VAT collection is up by 22.8% yoy and profit tax collection is up by 22% yoy). However, the proceeds from excise taxes and custom duties decelerated to 10% yoy and 17.6% yoy respectively.

Although the government targets the year-end consolidated budget deficit at 2.5% of GDP, the year-end consolidated budget deficit might fall below its projection due to slow growth of government expenditures and strong performance of fiscal revenues. However, if the government decides to meet its target deficit in November, a significant increase in government spending at the end of the year poses a risk of inefficient utilization of public funds. In addition, the implied acceleration of spending on pensions, wages and salaries in the public sector exacerbates demand pressures, jeopardizing price stability and widening external imbalances in 2007.

In December, the Parliament of Romania adopted the Budget Law for 2007, which envisions a consolidate budget deficit in the amount of RON 8.7 billion or 2.8% of full year GDP. The approved law closely resembles a draft budget prepared by the Ministry of Public Finance with some modifications of the budget of the Ministry of National Defense and the Ministry of Education. The expenditure on national defense was increased by RON 841 million (EUR 240 million) through cuts in the budget of the Ministry of Administration and Internal Affairs and the Ministry of Public Finances. A reallocation of RON 420 million (EUR 120 million) from investment expenditure items to salaries and wages expenditure items was approved for the budget of the Ministry of Education. According to the macroeconomic projections built into the budget, 2007 real GDP is expected to grow at 6.4% in the next year (about EUR 100 billion) while annual inflation will not exceed 4.5%. Romania’s contributions to the EU budget are estimated at 1.1% of GDP and co-financing of various EU adjustment programs should reach 1.6% of GDP. At the same time, Romania is to receive EU funds in the amount of 2.1% of full year GDP.

In December, two electronic systems (VAT International Exchange System and System of Exchange of Excise Data) that allow tracking and exchange of information on VAT and excise collection became operational in Romania. Upon accession, the Romanian tax administration will be able to exchange VAT and excise information with all member states. The integration of Romania’s informational systems on direct taxes into the EU network is crucial because the common market has strict regulations on VAT and excises, which are used as a basis for calculating the contribution of each member state to the EU budget.

In October, the stock of total medium and long term external debt stood at EUR 25.8 billion, increasing by 2.8% month-over-month (mom). While the stock of public and publicly guaranteed external debt continued to decline, the stock of private external debt grew to EUR 15 billion — up by 5.3% mom or 23% since the beginning of the year. In January-September, the stock of gross external debt, including short term debt, stood at EUR 36.8 billion with EUR 6.23 billion in the form of direct investment intercompany lending.

Monetary Policy

In November, the consumer price index (CPI) slightly decelerated to 4.67% yoy from 4.8% yoy in the previous month. The price indexes of food products and non-food commodities leveled out and stood at 1% yoy and 7.6% yoy respectively while the price index of services prices continued to slow for the fourth month in a row, settling at 5.9% yoy in November. Due to higher prices of tobacco (up by 28.1% yoy in November) and utilities (up by 13.9% yoy), year-end inflation of non-food commodities is unlikely to fall below 7%. On a positive note, falling telecommunication tariffs (down by 0.5% yoy in November) mitigate inflation of service tariffs, almost half of which is driven by higher prices of water supply (up by 1.7% yoy in November). As a result, year-end CPI of 5% appears to be a feasible target for the National Bank of Romania.

In November, the monthly inflation outlook worsened as CPI grew by 1.1% month-over-month (mom) — its highest level in 2006. Faster monthly inflation was driven by the record monthly growth of prices of foods (up by 1.3% mom due to higher prices of new crops and upward seasonal movements of prices of meat and milk) and higher prices of non-food commodities (up by 1.23% mom as a result of a 5.1% mom increase in prices of utilities). On a positive note, declining prices of fuels (down by 1.25% mom in November) and falling telecommunication tariffs (down by 1% mom) diminished the negative impact of unfavorable developments in monthly inflationary dynamics.

In October, the growth rate of the money supply notably decelerated to 24.1% yoy and monetary aggregate M2 amounted to RON 100.6 billion, marginally up from RON 99.35 billion in September. Slower growth of money supply was driven by increasing net government credit (RON 21.4 billion in October as compared to RON 11.5 billion in September) due to the increased balance of the General Account of the Treasury (up by RON 1.91 billion as a result of quarterly tax collection) and higher foreign currency holdings at the National Bank of Romania by the Ministry of Public Finance (up by RON 7.9 billion as a result of proceeds from the privatization of Banca Comerciala Romana (BCR)).
In addition, the growth rate of non-government domestic credit leveled out and stood at 55% yoy, contributing to the deceleration of money supply. In October, non-government credit increased to RON 89 billion from RON 85.3 billion in September on the back of faster growth of forex-denominated credit, which expanded by 26.4% yoy in October up from 23.2% yoy in September. In October, short-term and long-term credit issued to households were the most dynamic components of forex-denominated credit, increasing by 170.5% yoy and 67.1% yoy respectively.

At the same time, the stock of medium-term forex-denominated credit declined by 4.3% yoy due to the decreasing holdings of this type of credit by households — down by 16.5% yoy. Finally, the growth rate of RON-denominated credit decelerated to 93.9% yoy — down by 16.5% yoy. Notably, the share of RON-denominated credit in total non-government domestic credit increased by 10 percentage points from 42% in October 2005 to 52% in October 2006.

International Trade and Capital

In October, exports FOB amounted to EUR 2.25 billion, notably accelerating to 15.8% yoy from 6.10% yoy in September. Imports CIF grew by 26% yoy, totaling EUR 3.88 billion. As a result, the merchandise trade deficit (FOB/CIF) widened to EUR 1.63 billion in October — its highest level in 2006.

In January-October, exports FOB totaled EUR 21.35 billion growing by 16% yoy, while imports CIF amounted to EUR 32.59 billion increasing by 24.7% yoy. Thus, during the first ten months of the year, the merchandize trade deficit grew by 42.3% yoy, widening to EUR 11.24 billion or about 12% of projected full year GDP. The growing trade deficit is driven by strong growth rates of the main imported commodities: imports of machinery, vehicles, metallurgical and mineral products, which account for over 60% of all imports, posted average growth rates of over 27% yoy during the first ten months of 2006. On the back of appreciating national currency, rapidly growing consumption and investments as well as likely fiscal loosening at the end of the year, the growth rates of imports of these commodities are not expected to decelerate. As a result, year-end imports (CIF) may exceed EUR 40 billion, bringing the year-end merchandise trade deficit to about 15% of GDP. On a positive note, exports of metallurgical products continued to accelerate, growing by 14% yoy in January-October. Exports of machinery and vehicles, exports groups that posted the highest growth rates in 2006, slightly decelerated yet still registered outstanding growth of 35.2% yoy and 49.2% yoy respectively.

In January-October, the growth rate of the current account deficit accelerated to 48.3% yoy from 46.7% yoy in January-September, and the current account gap amounted to EUR 7.75 billion or about 7.5% of full year GDP. The widening of the current account deficit is driven by the growing incomes deficit, which speeded up by 20% yoy increasing to EUR 2.52 billion. At the same time the performance of the current transfers balance slightly improved as current transfers surplus accelerated to 12.5% yoy, totaling EUR 3.13 billion. Although the surplus of trade in services (EUR 370 million in January-October) slightly mitigates a growing current account deficit, a widening trade in goods deficit will bring the current account deficit to more than 10% of full year GDP in 2006.

In January-October, the inflow of foreign direct investments (FDI) amounted to EUR 7.9 billion (including EUR 2.2 billion proceeds from BCR privatization), up by 88.1% yoy against the ten months of the previous year. About 1/3 of FDI inflows represented intercompany lending, while 2/3 of FDI came in the form of reinvested profits and equity investments. As a result, the current account gap was fully covered by FDI inflows. Finally, in November, foreign exchange reserves (including monetary gold) of the National Bank of Romania increased to EUR 22.9 billion.

Other Developments Affecting the Investment Climate

On December 22nd, the Government of Romania cancelled the privatization of the Casa de Economii si Consensmatiuni (CEC) bank due to the lower than anticipated offer received from the National Bank of Greece (NBG) — the only buyer that submitted a qualifying bid. NBG offered EUR 560 million for CEC, which is the eighth largest bank in Romania in terms of assets with market share of about 4% at the end of September. In addition, following the termination of CEC privatization, the Prime Minister of Romania announced plans to increase the capital of the bank by about EUR 150 million.