Summary

- The performance of the real sector remains strong; in January-February industrial production grew by 7.4% yoy or more than twice as fast as in the same period of the previous year.
- In the first quarter of 2007, the consolidated budget slipped to a deficit of RON 450 million or about 0.12% of projected full year GDP.
- Consumer prices inflation has been evolving into a robust disinflation trend, slowing down to 3.66% yoy and prompting the central bank to revise its inflation outlook and cut the monetary policy interest rate.
- During the first two months of this year, the trade deficit (FOB/CIF) expanded by 83.3% yoy to EUR 2.57 billion.
- The current account gap widened to EUR 2.05 billion, increasing by 166% yoy.
- EUR 870 million of net foreign direct investments financed only 42.5% of the current account deficit.
- On April 19th, the Parliament of Romania suspended President Traian Basescu. Whether Basescu is to keep his post or not is to be decided at a national referendum to be held in May.

Economic Growth

At the end of April, the National Committee of Progress of Romania (CNP) released an update of its economic growth forecast for 2007–2013. According to the CNP, real GDP is expected to grow by 6.5% yoy in 2007, which exactly mirrors IMF projections. GDP growth is expected to fall below 6% yoy starting in 2009 and then level out to 5.7%. The key assumption built into this forecast is the expectation that both the growth rates of final consumption and gross fixed capital formation will decline, which will be compensated by the diminishing negative contribution of net exports. At the same time, the forecast for the current account deficit was lifted to 11.5% of GDP in 2007. Although the current account gap is projected to shrink, it is anticipated to stay above 10% of GDP in 2013.

The performance of the real sector continues to evolve along the strong upward trend. In January-February, industrial production grew by 7.4% yoy or by more than two times faster than in the same period of the previous year. Although the mining industry posted negative growth rates for the second month in a row, robust expansion of manufacturing persists in driving industrial output. During the first two months of 2007, output in manufacturing increased by 9.6% yoy on the back of high growth in food processing (up by 13.9% yoy), the chemical industry (15.8% yoy), metallurgy (5.1% yoy — the record growth rate in two years) as well as exceptionally good performance of light industry. In particular, production of textiles and leather and footwear gained 22% yoy and 17.1% yoy respectively. Obviously, these high growth rates in light industry are observed on the back of a significant contraction experienced a year ago. Manufacturing was also driven by improving performance of other key industries. The automobile industry staged a modest recovery increasing by 3.1% yoy in January-February — up from a 1.2% yoy contraction registered in the first month of this year. Although the production of machinery was on a downtrend, falling by 0.6% yoy, the data reveals some signs of improvement as this industry decreased by 6.3% yoy in the first month of this year. Finally, output in utilities continued to decline, falling by 5.8% yoy.

Fiscal Policy

During the first two months of 2007, consolidated budget revenues amounted to RON 17.5 billion increasing by 9.5% yoy in nominal terms while consolidated budget expenditures expanded by 27.1% yoy to RON 17 billion. The consolidated budget surplus stood at RON 458 million (EUR 135 million) or 0.12% of projected full year GDP. This deceleration of budget revenues was observed on the back of weaker collection of VAT and customs duties as in January-February 2007 the proceeds from these taxes declined by 26% yoy and 64% yoy respectively against the same period of the previous year. It may be reasonable to assume that lower VAT collection is rooted in declining volumes of retail trade, which has been on a downtrend since December 2006. In January-February, the volume of retail trade (excluding trade in vehicles) declined by 2.2% yoy. At the same time, it is safe to argue that lower retail trade and VAT collection is an inconclusive evidence of decelerating consumer incomes. On the contrary, the optimistic data on revenue collection from personal income tax suggests that household incomes expand at a relatively fast speed. In January-February, the collection of income tax remained particularly strong, growing by 46.8% yoy. Thus, shrinking VAT collection could have been largely attributed to the regulatory transformation that took place after Romania joined the European Union, which affected VAT issues arising from extra- and intra-community trade, including the adoption of the Common Customs Tariff. This argument can also be supported by the observed co-movements in the performance of VAT collection and collection of custom duties. Finally, proceeds from the profit tax and excises registered comparatively modest growth rates, gaining 11.1% yoy and 7.8% yoy respectively.

Monetary Policy

In March, consumer prices inflation (CPI) was kept on a robust deceleration trend, slowing down to 3.66% yoy from 3.81% yoy in the previous month. Persistent disinflation is largely supported by favorable developments of prices of foods, which declined by 0.03% yoy. Inflation of prices of non-food commodities remained relatively flat, amounting to 6% yoy, while inflation of service tariffs was marginally higher, increasing to 6.5% yoy in March from 6.3% yoy in February. The deflation of prices of foods was observed on the back of slower growth rates of prices of all food groups and was driven by the falling prices of vegetables (down by 16.3% yoy) and sugar (down by 3.1% yoy). In March, the evolution of prices of non-foods closely mirrored price developments registered in the previous month with a strong inflation restricting impact of falling prices of fuels (down by 0.7% yoy) and moderately increasing prices of utilities (up by only 9.45% yoy — principally due to more conservative dynamics of the adjustment of administered prices). Finally, a reversal of the deflation trend of telecommunication tariffs

In February alone, industrial production increased by 10.2% yoy supported by the growth of the majority of industries, namely, food processing (up by 20.5% yoy), textiles (27.7% yoy), the chemical industry (26.6% yoy), metallurgy (1.4% yoy) and machinery (4.2% yoy). Mining, fuel processing, ready made clothes and utilities were the only sectors that posted declines.
In the first quarter of this year, CPI increased by only 0.31% year-to-date (ytd) or almost five times slower than in the same quarter of 2006. At the beginning of May, the National Bank of Romania (BNR) issued its regular quarterly inflation report reducing the year-end inflation outlook to 3.7% yoy (0.3 percentage points below the 2007 inflation target) due to faster than expected disinflation progress during the first three months of this year. Furthermore, on the back of more rapid disinflation, appreciating national currency and certain signs of economic growth deceleration at the end of 2006, the BNR cut its key monetary policy rate by 25 basis points to 7.25% on May 2nd. This is the third consecutive interest rate cut introduced by the central bank this year. The BNR has also been gradually increasing sterilization. In addition, the share of credit issued to households in total credit increased to 43.3% in February from 36.3% a year ago.

Although, the growth of credit issued to the corporate sector was comparatively moderate, it still maintained a high speed as its RON-denominated component expanded by 50.2% yoy while forex-denominated corporate loans increased by 30.4% yoy.

International Trade and Capital

In February, exports (FOB) decelerated to 10.2% yoy from 15.3% yoy in the first month of this year totaling EUR 2.32 billion. Despite a similar trend in the dynamics of imports, the growth rate of imports remained strong as imports (CIF) amounted to EUR 3.65 billion or up by 27.5% yoy. The monthly merchandise trade deficit (FOB/CIF) widened to EUR 1.34 billion, increasing by 76.5% yoy.

During the first two months of this year, exports (FOB) posted a moderate growth of 12.5% yoy and amounted to EUR 4.36 billion. At the same time, imports tend to register consistently strong growth rates, as imports (CIF) enlarged by 31.3% yoy to EUR 6.93 billion expanding the trade deficit (FOB/CIF) to EUR 2.57 billion or by 83.3% yoy. Furthermore, the ratio of trade deficit to projected full-year GDP stood at 2.3% in January-February 2007 as compared to 1.5% posted during the first two months of the previous year. Notably, the growth of imports is primarily driven by imports of EU origin. During the first two months of this year, Romania shipped to and bought from the EU about 72% of its exports and imports. While, the growth rate of exports to EU member states (12.3% yoy in January-February) was marginally lower than the growth rates of exports to other countries (13.1% yoy), there is a more apparent and opposite relationship for imports. Romanian imports from the EU community expanded by 43.5% yoy on the back of a modest growth of imports from other countries (7.9% yoy).

In January-February, the current account gap widened to EUR 2.05 billion, increasing by 166% yoy. Growing trade and income deficits (up by 114.7% yoy and 52.5% yoy respectively) continue to fuel the current account deficit on the back of a fairly small trade in services surplus and a relatively flat current transfers surplus. Although the net inflow of foreign direct investments (FDI) slightly improved, falling by only 17.5% yoy in February as compared to a decline of 43.2% yoy in the first month of the year, EUR 870 million of FDI covered only 42.5% of the current account deficit (FDI financed 100% of the current account gap in the first two months of the last year). According to estimates of the National Commission for Prognosis of Romania, year-end net FDI inflows are projected to settle around 5–6% of GDP in 2007. However, as the current account gap is expected to hit 11.5% of GDP, the required external financial resources to cover the current account gap of FDI will amount to 5–6% of GDP. As a result, the exposure of Romania to foreign indebtedness as well as the pressure on the central bank to shed foreign exchange reserves may considerably deepen. This argument can be further strengthened by the fact that although the current account deficit net of FDI fell bellow 1% of GDP in 2006, foreign external debt accumulated by the private sector grew by more than 3% of GDP, which signals a relatively high exposure of the Romanian private sector to foreign borrowing.

In March, international foreign exchange reserves (including monetary gold) of the National Bank of Romania continue to shrink for the second month in a row, declining by EUR 170 million to EUR 23.2 billion.
Other Developments Affecting the Investment Climate

On April 19th, 2007, the Parliament of Romania suspended the President, Traian Basescu, on allegations of abuse of authority. This decision was also endorsed by the Constitutional Court, despite its previous non-binding ruling that there was inconclusive evidence of Basescu violating the law. However, the previous ruling of the Constitutional Court has also recognized that the Parliament should be the ultimate judge of whether the President abused his authority or not.

A national referendum is to be organized on May 19th for the voters to decide whether the President should be removed from his post or not. According to the recent amendment adopted by the Parliament and approved by the Constitutional Court, the President can be ousted by the simple majority of voters present at the referendum. Previously and under stricter conditions, a majority of listed votes was required for a legitimate decision. Until the referendum is organized and its outcome is accepted as valid, the Senate’s speaker Nicolae Vacaorui (Social Democratic Party — PSD) will serve as interim President of Romania.

The current political crisis has been developing since the breakdown of the ruling coalition, formed by the National Liberal Party (PNL)-Democratic Party (PD) alliance. After the EU accession in January 2007, political relations between the President (supported by PD) and the Prime Minister (PNL leader) notably deteriorated, weakening the government’s positions. Faced with corruption allegations brought against several of its ministers, PC-the smallest member of the coalition-stepped down from the government in December 2006. As the conflict between the Prime Minister and the President escalated, Prime Minister Tariceanu dismissed all PD ministers, replacing them with PNL and Hungarian Democratic Union (UDMR) ministers. On March 3rd, 2007, the minority PNL-UDMR government was endorsed by the Parliament, with the support of PSD — the main opposition party.

Despite rather complex political situation in the country, major international investment rating agencies are not expected to downgrade Romania’s ratings due to consistently strong economic growth, sound monetary policy and low levels of external debt. Furthermore, according to the statements of these agencies, current ratings already reflect recent political developments.