Economic Growth

In the first half of the year, industrial production gained 6.1% year-over-year, marginally decelerating from the 6.4% yoy registered in January-May. Despite visible improvement in the year-to-date performance of mining (which posted a positive 0.4% yoy, recovering from the contraction in the previous months) and utilities (which declined by only 2.3% yoy against a contraction of 4.5% yoy in January-May), industrial production slowed due to some deceleration of growth in manufacturing to 7.3% yoy. Output growth in manufacturing was slightly dampened by the marginal deceleration observed in almost all manufacturing industries — except fuel processing, which saw decreasing rates of contraction, and automobile production, which remained the leading industry in terms of growth.

However, in comparison with the respective period last year, mining and utilities stayed on a decelerating trend, while manufacturing continued to grow steadily. As in January-June of last year, the growth of manufacturing production was driven primarily by the strong performance of the food industry, chemicals, and automobile production. However, all leading industries registered some deceleration of growth on a year-over-year basis. Thus, the food industry grew by 10.5% yoy in January-June, down from 15.7% yoy mainly due to a statistical base effect and stagnation of agriculture on the back of a poor harvest this year. Worsening foreign trade terms caused byRON appreciation, increasing competition pressure from imports and decreasing exports from exports finally led to decelerating growth in chemical and automobile production to 8.9% yoy and 17.5% yoy respectively. On the downside, manufacturing growth was restrained by significant contraction in fuel processing at 15.4% yoy and by a continuing decline in production of machinery and equipment at 2.5% yoy. At the same time, a strong recovery in textiles (which grew by a robust 6.4% yoy in contrast to a severe decline of 13.8% yoy last year) as well as improved growth in metallurgy (which posted 6.9% yoy growth against a marginal contraction of 0.2% registered in January-June 2006) helped not only to preserve steady growth in manufacturing but also to gain an additional percentage point against the respective period last year.

Fiscal Policy

During the first half of the year, the consolidated budget balance turned into a minor deficit at 0.19% of full year GDP. Consolidated budget revenues grew by a nominal 17.8% yoy, amounting to RON 58.6 billion, while consolidated budget expenditures increased by a nominal 28.8% yoy to RON 59.3 billion. Despite robust performance, budget revenues were below government expectations. In this regard, the government postponed a planned cut in the projected budget deficit for this year from 2.8% of GDP to 2.4-2.6%.

In January-July, consolidated budget revenues continued to grow along an accelerating trend, increasing by a nominal 19.1% yoy, with better performance of all individual components. Taxes on personal income and corporate profit remained the strongest drivers of budget revenue dynamics, posting accelerated growth rates of 44.2% yoy and 36.7% yoy respectively. Thus, a share of direct taxes in fiscal revenues expanded to 35.1%, up from 29.2% in the corresponding period last year, at the expense of shrinking a share of indirect taxes, such as VAT, excises, and custom duties. Indirect taxes continued to demonstrate downward dynamics against the previous year after simplifying the trade regime with the EU. However, VAT demonstrated a return to positive growth rates for the second month in a row, increasing by a marginal 4.1% yoy in the first seven months of the year. Consistent improvement in VAT proceeds may be partially explained by brisier domestic retail trade, accelerating to 16.0% yoy in June, up from 11.6% yoy in May.

The ministry of economy and finance has presented a preliminary budget draft for 2008. The revised budget plan stipulates an expanding budget deficit from 2.5% to 2.7% of GDP. According to the preliminary draft, budget revenues are projected at 39% of GDP (up from 35.6% of GDP for 2007), while budget expenditures are planned at 41.7% of GDP (up from 38.3% of GDP for 2007). The government includes a 43% average increase in pensions for the next year with further growth in 2009. Financing of the pension hike is tightly linked to the prospects of growing incomes, which caused serious concerns in terms of balance sustainability of the pension system. Additionally, this pension increase is highly criticized by the National Bank of Romania in regards to increasing inflationary pressure and further worsening of external imbalances. The final draft of the budget will be presented to the government on September 30th.

In August, total public debt amounted to EUR 20.5 billion, up by 9.6% ytd. Despite an increase in absolute values of debt, the public debt ratio fell below 17% of full year GDP, the lowest level registered in recent years. The rise in public debt was caused by the issuing of domestic government securities, while the external public debt dropped by 3.7% ytd to EUR 10.7 billion.

Consolidated Budget Balance, % of full year GDP

The National Committee of Prognosis of Romania (CNP) projected the real growth of industrial production at 5.9% yoy in the first nine months of the year. At the same time, labor productivity is forecasted to increase by a significant 10.6% yoy in January-September.

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In January-June, industrial production grew 10.5% yoy, down from 15.7% yoy in June, up by 66.38% yoy. As a ratio to GDP, the current account deficit reached a high of 16.8% of GDP in the first half of the year, compared with 10.3% of GDP at the end of last year.

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Medium and Long-term External Debt, EUR billion

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borrowings, increased by 5.4 times against the respective period last year, driven by increasing deposits of non-residents and heavy external borrowings of the private sector on the back of the expensive RON and widening of the current account gap. In June alone, the private sector boosted its net external borrowings to a record high of EUR 1.19 billion. As a result, medium and long-term external debt amounted to EUR 31.57 billion as of July.

Monetary Policy

In July, growth of consumer prices doubled to 0.29% mom compared to June, pushed mainly by hikes in food prices, particularly vegetables and fruits. Moreover, prices for many other foodstuffs registered an increase in July in contrast to the disinflation typical for the previous months, which resulted in accelerating rate of food inflation to 0.59% mom, up from 0.32% mom a month ago. It seems that risks of food inflation due to bad weather conditions have begun to materialize. A prolonged drought this summer caused a widespread surge in prices for wheat on international commodity markets. Particularly, wheat prices per ton nearly doubled this year in Europe. As the agricultural sector begins to pass the cost escalation on the consumers, prices for bakery products are rising in many European countries. In Romania, the price for milled products rose by 0.62% mom over a decrease of 0.04% mom in June, while bread prices grew by 0.25% mom, accelerating from 0.05% mom. Moreover, the extended drought has begun to affect prices for other agricultural products, such as meat and dairy products, which stopped decelerating in July. Due to a bad harvest of crops, farmers had to feed granger’s cattle with a rather nutritionally poor diet. As a result, the supply of meat products as well as milk and diary products decreased, which led to price growth in these product groups to 0.03% mom and 0.15% mom respectively. Obviously, food prices will determine the inflation trend of the previous two months, increasing by 50.5% mom, from 22.4% mom in June. The revival of money supply growth was caused by buoyant expansion of bank credit to the non-government sector at 46.0% yoy, accelerating from 44.3% yoy in the previous month. Bank lending expansion is driven mainly by households, since retail loans have been growing at much higher rates than those for businesses. Therefore, corporate and household credits have an almost equal contribution in the total stock of non-government credit. At the same time, both businesses and households obviously changed their preferences in favor of loans denominated in foreign currency on the back of appreciation of the domestic currency, which persisted in July. Thus, forex-denominated credit surged by 49.7% yoy from 42.6% yoy in June, while RON-denominated credit continued to decelerate resulting in an increased share of forex-denominated credit to 49% in total non-government credit. Extending the share of forex-denominated credit creates increasing risks of bank credit default if the RON begins to depreciate.

International Trade and Capital

In June, exports (FOB) grew by 9.2% year-over-year, recovering after deceleration to 5.0% yoy in May and amounted to EUR 2.49 billion. Imports (CIF) soared by 22.2% yoy, approaching EUR 4.25 billion. Due to some recovery of export dynamics and a preserved steady growth rate of imports, the trade deficit (FOB/CIF) slightly improved to EUR 1.76 billion from EUR 1.89 billion in May.

In the first half of the year, exports (FOB) grew by 11.3% yoy, continuing to follow a decelerating trend, and stood at EUR 14.4 billion. Meanwhile, imports (CIF) surged by 28.3% yoy to EUR 23.77 billion, maintaining a rather steep growth trend; however, they’ve demonstrated slight deceleration since the year beginning. As imports continued to grow at more than twice the rate of exports, the trade deficit (FOB/CIF) posted further deepening and reached EUR 9.66 billion, up by 66.38% yoy. Robust growth of imports in contrast to rather flat exports was caused by continuing domestic
currency appreciation in January-June and buoyant domestic demand, which was fueled by the need for industrial modernization and supported by bank credit expansion with good prospects of income growth. Import growth was significantly boosted by better access to industrial products from EU countries due to the abolishment of customs duties for a range of products (vehicles, electric machines, devices and equipments, etc). Thus, imports to the EU surged by 36.4% yoy against the 10.9% yoy to other counties, expanding to 72.5% of the total CIF imports.

The National Prognosis Commission forecasted the trade deficit at EUR 17.87 billion at the end of this year, with exports at EUR 30.25 billion, up 17% yoy, and imports totaling EUR 48.12 billion, up 18.1% yoy.

In June alone, the current account registered a record 43.8% yoy growth, the joint positive contribution of the service balance and current transfers posted robust 87.3% yoy growth compared to January-June last year. Although the service balance improved in June against the same period last year thanks to foreign exchange reserves by 1.5 times more in January-May, and stood at EUR 2.97 billion. As a result, the current account coverage by FDI slightly increased by the government agency for foreign investments (ARIS) in absolute terms during the first half of the year declined by only 8.57% yoy, significantly improving from the 24.32% yoy contraction in January-May, and stood at EUR 2.97 billion. As a result, the current account coverage by FDI slightly increased in 1H up to 38% from 36% in January-May; however, it dropped compared with the 87% coverage ratio in the respective period last year. According to estimates by the government agency for foreign investments ARIS, the inflow of FDI is expected to reach EUR 6-7 billion in 2007. However, the FDI to CA ratio is likely to decline drastically, as the CA deficit is expected to widen further due to a steep rise in imports.

Despite strong deterioration of the CA balance, the National bank of Romania managed to replenish the foreign exchange reserves by 1.5 times more in January-July against the same period last year thanks to the significant inflow of foreign capital, in particular, those increasing external debt and payments from the EU budget. As of July 2007, the forex reserves of the NBR amounted to EUR 24.1 billion, up by 5.0% since the beginning of the year.

Other Developments Affecting the Investment Climate

The international rating agency Standard & Poor’s released a cross-country report on the Liquidity Vulnerability Index, an integrated index based on indicators relevant in an emerging debt crisis. According to the report, Romania is ranked among the five countries in Europe, the Middle East and Africa (EMEA) with the highest exposure to liquidity risks stemming from the world financial markets. Because of a sharp widening of the current account deficit, financed mainly by accumulation of external debt due to relatively flat FDI dynamics, Romania possesses a rather high risk of being strongly affected if current conditions on world capital markets persist. However, on a positive note, the inclusion of the country in the vulnerable group is not a predictor for a negative rating action by S&P.

The World Bank expressed its concern about the progress of Romania in carrying out judiciary reforms, as was stated in a monitoring report on the efficiency of the Bank’s support programs in the judiciary area. However, despite the number of setbacks highlighted, the overall progress in judiciary reforms was deemed ‘satisfying’.

The privatization contract for Automobile Craiova is to be signed with Ford on September 12 in Frankfurt. Ford declared its intent to invest EUR 675 million in upgrading the plant in order to start production within the next three months.

Another large US automaker, General Motors, included Transylvania city of Cluj on the list of possible locations for a EUR 500 million car plant, with the final decision on the investment being tabled for October or November.