Summary

- Gross domestic product (GDP) grew by a real 5.8% yoy in the first half of 2007, amounting to RON 155.2 billion as of June 2007.
- In the first seven months of the year, industrial output continued to demonstrate robust growth, increasing by a real 6.3% yoy, marginally up from 6.1% yoy growth reported in January-June.
- Better than expected performance of budget revenues on the back of the solid growth of income taxes and revival of VAT collections caused the consolidated budget balance to register a small surplus at 0.5% of full-year GDP in January-July, compared to a minor deficit posted over January-June.
- Year-over-year inflation advanced to 4.96%, closely approaching the upper boundary of the policy inflation target, set by the NBR at 4% ±1pp.
- The broad money supply, aggregate M3, accelerated up to 27% yoy in August following the record 60.5% yoy growth of forex-denominated non-government credit, driven primarily by high loan demand from households.
- In the first seven months of the year, a visible slowdown of exports together with outperforming imports resulted in the further widening of the trade gap. Thus, the merchandise FOB/CIF trade deficit expanded by 63.9% yoy in January-July.
- The persistent deterioration of the trade balance translated into further worsening of the current account deficit, which widened by 83.8% yoy, up to EUR 8.97 billion in January-July.
- Despite good prospects for FDI inflows in the coming period, the current account financing turned out to be debt-generating and dependent on external sources of credits, which implies that the current account balance is highly vulnerable to shocks on world financial markets.
- The IMF concluded that Romania is only indirectly exposed to the international sub-prime crisis due to the high vulnerability of its current account deficit, while the financial system remains sound.

Economic Growth

GDP grew by a real 5.8% year-over-year in the first half of 2007, amounting to RON 155.2 billion as of June. Although the Romanian economy continued to demonstrate robust development, real value added growth has been decelerating steadily compared to the respective period last year. A slight slowdown of the economy in 2007 was expected due to the deteriorating external balance. However, the actual figures for January-June appeared even below general expectations. Because to this, the National Prognosis Commission has revised the forecast for the year’s real GDP growth to 6.1% yoy down from the previous forecast of 6.5% yoy.

The slowdown of real economic growth was attributed mostly to a negative 0.7 percentage point contribution of net product taxes and agriculture. Although net taxes resumed their growth in the second quarter due to increasing consumption and imports, their cumulative growth for the first six months still remained negative. At the same time, value added in agriculture sharply declined by 6.1% yoy in the first half of the year, in contrast to strong 9.2% yoy growth reported in the first quarter. Record temperature and low rainfalls this year have damaged about two thirds of crops planted in Romania, resulting in a sharp contraction of farm output. However, the visible deceleration of real economic growth does not indicate a slowdown of economic activity in general, since a decrease of agriculture and net taxes was mainly caused by external temporary shocks. Nevertheless, economic activity remained strong, underpinned by buoyant domestic demand and foreign investments. GDP growth continued to be driven by robust developments in services, industry and construction. Construction is likely to become a driver of economic growth in Romania. During January-June, construction has been growing at an outstanding pace, posting impressive 31.6% yoy growth, almost twice as high as in the respective period last year. At the same time, industry and services remained on a stable growth trend, despite decelerating slightly to 5.9% yoy and 6.3% yoy respectively, mainly due to a high statistical base.

In the first seven months of the year, industrial output grew by a real 6.3% yoy, marginally accelerating from 6.1% yoy growth in January-June. Slight improvement in growth terms as of July 2007 was achieved due to stable growth of manufacturing (7.4% yoy) and better performance of utilities (-0.9% yoy). Meanwhile, mining turned declined again (0.1% yoy) due to decreasing domestic consumption of resources (primarily energy materials) during July.

On the expenditure side, developments were mainly caused by expanding domestic demand. Household consumption continued to report stable growth rates, increasing by 11.0% yoy in the first half of the year, marginally down from 11.8% yoy registered in the respective period last year. Despite this slight deceleration, private consumption is still the main driving force of value added growth. At the same time, investments have been growing more dynamically, accelerating to 18.6% yoy during January-June. Vigorous growth rates of investments resulted in doubled weight of investments in explaining real GDP growth. About half of all investment expenditures were concentrated in the booming construction industry. At the same time, excessive domestic demand put severe pressure on the trade balance, which, in its turn, contributed 8.3 percentage points to real growth deceleration. Despite the quite positive growth outlook for the Romanian economy, the current pattern of economic growth exclusively relying on domestic demand is not sustainable in the medium run. A surge of domestic consumption and imports supported by loose fiscal policy and increasing external indebtedness indicates risks of an over-heating economy and increasing vulnerability of the banking system, which may finally materialize in progressing inflation and deterioration of economic growth. However, on a positive note, the concentration of capital investments in the economy helps secure the potential of the sustainable economic growth.
served in the automobile industry (17.8% yoy), food processing (11.0% yoy) and the chemical industry (10.6% yoy). Metallurgy continued to demonstrate its revival thanks to a healthy external environment, increasing by 6.1% in January-July and contributing as well to industrial growth. On the downside, fuel processing remained in a deep recession (-13.1% yoy), while machinery and equipment decreased moderately (-2.4% yoy) along a flat downward trend. Also, light industry continued to stagnate (-7.8% yoy), suffering the most from import competition, which was reflected in the continuing contraction of ready-made clothes production (-18.2% yoy). At the same time, textile manufacturing slightly improved in 2007 compared to the deep decline reported in the respective period last year.

**Fiscal Policy**

Consolidated budget revenues amounted to RON 70.95 billion, increasing by 18.3% yoy during the first seven months of the year. At the same time, consolidated budget expenditures totaled RON 69.1 billion, up by 26.9% yoy. Better-than-expected performance of budget revenues on the back of the pronounced growth of income taxes and revival of VAT collections (attributed to increasing imports from the EU) caused the consolidated budget balance to register a small surplus at 0.5% of full-year GDP in January-July, compared with a minor deficit posted over January-June.

With regards to the robust fiscal revenues in January-July, the Cabinet endorsed the second revision of the state budget, maintaining the budget deficit target at the previously projected level of 2.8% of full-year GDP. Additional revenues are planned to be transferred for improving financing of social programs (medical services in particular) and to local budgets.

Ministry has been issuing domestic debt. In the fourth quarter of 2007, the Ministry plans to place domestic government securities with a maturity of 3, 5 and 10 years, worth 4.2 billion lei.

As of July 2007, the medium and long-term external debt of Romania had grown by 18.1% since the year beginning, amounting to EUR 32.7 billion. Accumulation of foreign debt has advanced substantially in 2007, accelerating from a modest 4.3% year-to-date in the corresponding period last year. While public external debt shrank by 4% ytd over January-July, private debt and deposits of non-residents increased by 25.7% ytd and 146% ytd respectively. Given the volatile international credit markets, deceleration of external debt growth can be expected in the second half of the year.

**Monetary Policy**

In August, supply-side shocks attributed to weather conditions and RON exchange rate dynamics pushed food inflation to 5.41% yoy, a 0.86% surge of monthly inflation that translated into the unexpected annual growth of consumer prices up to an 11-month high. Thus, year-over-year inflation advanced to 4.96%, up from 3.98% registered in July, closely approaching the upper bound of the inflation target set by the National Bank of Romania (NBR) at 4% ± 1 p.p.

During July-August, the recent disinflation trend was undermined by increasing food prices, given the large share of foodstuffs in the consumer basket. Food prices sharply accelerated to 5.41% yoy in August, up from 2.79% yoy in July and 0.95% yoy in June. Food price inflation was propelled by unfavorable weather conditions causing the poor harvest of major crops throughout Europe and resulting, therefore, in a shortfall of other agricultural products such as meat, eggs and dairy products. The major price increase in August was registered for bread (3.44% mom), vegetables (3.83% mom), fruits (2.0% mom), eggs (13.55% mom), and meat (0.24% mom).

Another inflationary driver became RON depreciation, boosting the prices of some services that are denominated in euros, such as post and telecommunications (2.26% mom), transport (0.31% mom), and rent (0.31% mom). As a result, service prices doubled month-over-month, bringing yearly inflation of services to 6.0% yoy, up from 5.7% yoy a month ago.

Also, consumer prices experienced upward pressure from growing consumer demand. Thus, the CORE2 index, measuring a level of consumer prices excluding volatile prices, accelerated to 3.82% yoy in August, up from 3.19% yoy in July, indicating risks of the economy over-heating stemming from nominal income growth ahead of productivity and rapid bank credit expansion.

**Where Opportunities Emerge.**
The broad money supply, aggregate M3, accelerated up to 27% yoy in August, following the record 60.5% yoy growth of forex-denominated non-government credit, driven primarily by high loan demand from households. Household credit in foreign currency surged by 100.5% yoy. Meanwhile, credit to the real sector denominated inRON slightly decelerated from the previous month. Therefore, the share of forex-denominated credit exceeded 50% of total non-government credit as of August 2007, thus increasing exposure of the banking system to foreign exchange risks.

The recent depreciation of the local currency, which strengthened against the euro by 34.8% yoy underpinned by favorable external conditions. Strong merchandise import growth was determined primarily by vigorous imports of mechanical devices, equipment and transport means. On the upside, exports of metallurgical products increased by 34.8% yoy underpinned by favorable external conditions.

Disinflation and the appreciation of the RON in the first half of the year justified four consecutive cuts in the policy interest rate in 2007. However, since June, the NBR has been maintaining the base policy rate unchanged at 7% due to accelerating inflation and the recent depreciation of the local currency. Also, high budget expenditures and credit expansion strengthen the risks of accelerating inflation above the year’s target. Thus, the NBR is likely to tighten its monetary policy in the second half of the year.

In the first seven months of the year, a visible slowdown of exports together with outperforming imports resulted in further trade gap widening. FOB exports grew by 12.4% yoy, amounting to EUR 16.7 billion in January-July, while CIF imports, continuing to outpace exports, increased by 28.6% yoy to EUR 28.3 billion.

In August, the National Bank of Romania raised its foreign exchange reserves by a record high of EUR 2.26 billion mainly due to the outstanding inflow of income on the NBR’s foreign assets and increasing value of government bonds held in the NBR’s portfolio. As a result, forex reserves climbed to EUR 24.7 billion as of August 2007.

Other Developments Affecting the Investment Climate

According to the recently published report by the World Bank entitled ‘Doing Business 2008’, Romania was ranked 48th out of 178 countries in the ease of doing business. The report highlighted some improvements in the Romanian tax system, particularly the lowering of several labor taxes paid by the employer, including social security, unemployment and health fund contributions. However, in...
general, Romania did not succeed significantly in reforming the business environment compared to the previous year.

The international rating agency Fitch highlighted the risk of an overheating Romanian economy prompted by loose fiscal policy, problems with financing the widening current account deficit in light of turbulent financial markets and decreasing investor appetite for risk. To secure reliable economic development in the unstable financial environment, the agency recommended pursuing tighter fiscal policy and promoting structural reforms. Nevertheless, Fitch has confirmed a long-term sovereign rating for Romania at BBB/stable with all other ratings.

IMF experts visited Romania during September 26 — October 2 for consultations with the government on volatile macroeconomic developments. The IMF concluded that Romania is only indirectly exposed to the international sub-prime crisis due to the high vulnerability of its current account deficit, while the financial system remains in sound and demonstrates good resistance to external shocks. To safeguard financial stability and macroeconomic balances, IMF experts recommended avoiding procyclical budgetary and income policy and closely monitoring the banking sector’s capacity to absorb adverse shocks.

Romanian pension reform has been proceeding quite successfully. The reform has already advanced to the 2nd and the 3rd pillars, namely compulsory and voluntary private funds, which are in the process of implementation.