Summary

- In January-August, industry posted robust growth, increasing by 6% year-over-year (yoy), compared to a modest decline of 0.3% yoy in January-August. The production of ready-made clothes continued to fall (-0.5% yoy), while leather and footwear declined by 2.3% yoy, while the mining industry posted rather strong performance, increasing by 7.7% yoy.

Economic Growth

Over the first eight months of the year, industrial production continued to post robust growth, increasing by a real 6% yoy, slightly decelerating from the 7.2% yoy registered a year before. After achieving impressive 7.7% yoy growth in 1Q 2007, industrial output leveled out due to the high statistical bias effect of the previous year. Industry was driven by manufacturing, which gained 7.1% yoy during January-August. Meanwhile, mining and quarrying reported a marginal gain of 0.9% yoy, while utilities declined by 1.1% yoy. Strong performance of manufacturing was led by growth of value added in automobile production, food processing, the chemical industry and metallurgy. At the same time, leading manufacturing industries reported rather uneven growth dynamics over the first eight months of the year. Automobile production continued to grow dynamically, posting impressive 16.4% yoy, on the back of buoyant domestic demand and increasing exports. High incomes of households and a favorable external environment triggered a robust 12.3% yoy growth in food processing. The performance of machine building unexpectedly revived in August, improving the cumulative dynamics of this sector to a modest decline of 0.3% yoy in January-August. Metallurgy demonstrated steady performance, increasing by 5.6% yoy during the first eight months of the year. Positive developments in metallurgy were aided by favorable conditions on external markets as well as strong domestic demand. However, growing competition from imports is likely to slow growth in chemical and light industries. Indeed, the chemical industry decelerated to 8% yoy, compared to the bright 19.2% yoy growth posted the year before, while imports of chemical products registered strong growth. Light industry continued to stagnate, as production of clothing articles declined by 19.5% yoy, and manufacturing of leather and footwear contracted by 0.1% yoy. Fuel processing continued to shrink as well, as its output contracted by 11.0% yoy in January-August.

In August alone, industrial output grew by 4.5% yoy, decelerating from 7.1% yoy registered a month before. This slowdown is mostly related to weaker performance in manufacturing and utilities. In particular, manufacturing increased by 4.6% yoy, as compared to 8.1% yoy in the previous month. A visible deceleration of manufacturing was triggered by contraction in the chemical industry (by 10.2% yoy) and a significant slowdown in automobile production (up by a modest 0.6% yoy against 34.2% yoy a month before). In August, a decline in light industry further deepened. Production of textiles continued to fall (-9.5% yoy) after a temporary revival in the previous two months. The production of ready-made clothes contracted by a sharp 28.2% yoy, while leather and footwear decreased by 21.1% yoy. On a positive note, machinery and equipment unexpectedly grew by an unprecedented 16.3% yoy in August — the highest rate in the last three years. At the same time, utilities shrank by 2.3% yoy, while the mining industry posted rather strong performance, increasing by 7.7% yoy.

Industrial Output by Sector, ytd % yoy

The outlook for industrial growth remains quite positive. Given the good developments in the main manufacturing industries, such as automobile production and food processing, industrial output is expected to gain a real 5.8% yoy by the end of the year. Thus, industrial growth is going to slightly decelerate from the 7.1% yoy registered in 2006. A marginal slowdown of industrial growth is likely to be attributed to the deceleration of metallurgy and the chemical industry on the back of the worsening external environment.

Fiscal Policy

Since 2006, the Romanian government has been pursuing relatively loose fiscal and income policies. As a result, higher spending on social benefits, pensions and wages in the public sector increased the budget deficit in 2006 and 2007. According to the Ministry of Economy and Finance, consolidated budget expenditures grew by a nominal 27.1% yoy in the first eight months of the year, significantly accelerating from 16.25% yoy a year before. Meanwhile, budget revenues increased by a nominal 19.0% yoy, slightly slowing from 22.2% yoy registered a year ago. As a result, the consolidated budget reported a surplus at 0.32% of period GDP during January-August, decreasing from a surplus of 1.58% of GDP in the same period of 2006.

In January-September, fiscal revenues remained on a robust uptrend, increasing by 18.59% yoy. Collections of personal and corporate income taxes advanced by 44.01% yoy and 33.73% yoy respectively, supported by gains in incomes and employment. At the same time, proceeds from indirect taxes, VAT (up by 10.2% yoy) and excises (up by 8.7% yoy) decelerated due to a simplified trade regime after accession to the EU.

On October 10th, the government drafted the 2008 budget law and passed it to the parliament for discussions and final endorsement. According to the law, the budget deficit is to be increased to 2.7% of GDP in 2008, which is in line with the expansionary and socially oriented fiscal policy. The consolidated budget expenditures are expected to grow by 21% yoy. The budget project assumes significant spending on social programs such as education, social security, health care and transportation. In particular, pensions and social expenditures are planned to grow by 11.9% yoy. At the same time, taxes are not to be raised, as fiscal policy is declared to be stimulating. The projections of strong 6.5% yoy real GDP growth (to a nominal EUR 138 billion) and modest inflation (3.8% yoy) are anticipated to widen the tax base, which will allow for a 20% increase in consolidated budget revenues in 2008.

The central bank and international organizations judged the 2008 budget law as too expansionary and questioned the assumptions of its macroeconomic projections. Essentially, a massive growth of social payments and increasing minimum wages will fan domestic demand, threatening macroeco-
nomic balances and the inflationary outlook. Moreover, the budget deficit is set alarmingly close to the upper limit imposed by the EU (3% of GDP), while budget revenue projections are heavily conditional on the unlikely strong growth of nominal incomes. As a result, the budget deficit may become unsustainable, which risks pushing the economy on a path toward an explosion of public debt above the target.

The NBR petitioned for fiscal tightening to contain the inflationary processes. Recently, widening external imbalances and soaring inflation prompted the Ministry of Economy and Finance to revise this year’s budget by lowering the budget deficit from 2.7% to 1.1-1.2%. However, under political pressure from the opposition, a 30% hike in pensions in November followed by another 7.4% increase in January was approved. Thus, the target for the 2007 budget deficit may be feasible only if spending on 2007 infrastructure projects is significantly curtailed. Apparently, pressure on the government to grant concessions to the opposition has serious implications for macroeconomic stability. Indeed, fiscal policy measures are frequently justified by political pressures rather than by prudent economic sense.

In August, the stock of public debt declined to 16.4% of GDP (down from 18.9% at the end of 2006) due to the strong performance of budget revenue. However, the first Eurobond placement since 2006 due to the strong performance of budget revenue projections is being considered by the Ministry of Economy and Finance to revise this year’s budget by lowering the budget deficit from 2.7% to 1.1-1.2%. However, under political pressure from the opposition, a 30% hike in pensions in November followed by another 7.4% increase in January was approved. Thus, the target for the 2007 budget deficit may be feasible only if spending on 2007 infrastructure projects is significantly curtailed. Apparently, pressure on the government to grant concessions to the opposition has serious implications for macroeconomic stability. Indeed, fiscal policy measures are frequently justified by political pressures rather than by prudent economic sense.

### Monetary Policy

In September, strong inflationary dynamics persisted, as consumer prices (CPI) soared to 6.03% yoy, the highest inflation level of the past 12 months. The annual evolution of the CPI gained an additional percentage point against the previous month, following the record high monthly inflation reported at 1.08% mom in September. At the same time, Romania still managed to achieve the lowest inflation in Central and Eastern Europe.

### Stock of Medium and Long-Term External Debt

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<th>Source: NBR, The Bleyzer Foundation</th>
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<td>Jan</td>
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Monetary developments also contributed to accelerating inflationary tendencies. Broad money supply (aggregate M3) advanced by 28.2% yoy, amounting to RON 126.679 billion, marginally accelerating from 27.0% yoy in August. The evolution of money supply followed steep growth of non-government credit, which expanded by 52.9% yoy in September, up from 50.2% yoy in August. The credit expansion was driven primarily by increasing loans granted to households, which grew by 44.6% yoy and 66.2% yoy, denominated in RON and in forex respectively. By major components, broad money supply increased due to growing currency in circulation (31.1% yoy) and overnight deposits (72.3% yoy), while term deposits increased by a modest 6.2% yoy. As a result, expanding cash and overnight deposits explained about 70% of the total growth of money supply compared to a 40% contri
International Trade and Capital

Over January-August, the foreign trade balance (FOB/CIF) continued to deteriorate, reporting a trade deficit of EUR 11.5 billion. Although exports (FOB) posted robust growth in the first eight months of the year, increasing by 11.8% yoy, imports (CIF) continued to outpace them at 27.5% yoy, exerting a downward pressure on the trade balance. As a result, the trade gap widened by 36.7% yoy in January-August.

Good performance of exports in January-July was supported by increasing deliveries of such major product groups as machinery and mechanical appliances (22.6% yoy), ferrous metals (33.3% yoy), vehicles and transport equipment (35.1% yoy), accounting together for 51% of total exports. On the downside, exports of textiles and mineral products continued to decline, contracting by 2% yoy and by 36.8% yoy respectively in the first eight months of the year. At the same time, sustained investment and consumer demand on the back of strong domestic currency prompted rapid import expansion. In particular, imports of machinery/mechanical appliances and vehicles/transport equipment, which together account for 38.6% of total imports, grew by 36.5% yoy and 66% yoy respectively in January-July. Imports of the other substantial product groups, ferrous metals (61.1% yoy) and chemical products (32.8% yoy), have been expanding in response to the needs of growing industry.

During the first eight months of the year, external imbalances continued to worsen under the pressure of the widening trade deficit. The current account gap approached EUR 10.2 billion, increasing by 72.7% yoy over the respective period last year, as the merchandise trade deficit widened to EUR 10.8 billion, up by 67.3% yoy. At the same time, the income balance deteriorated as well due to increasing interest payments on the growing stock of foreign debt and direct investments. Thus, the income gap deepened by 48.8% yoy in January-August, compared to 20.6% yoy registered in the same period a year ago. On a positive note, current transfers grew at an outgoing 50.6% yoy rate, strongly accelerated from 7.1% yoy reported a year ago. On the back of increasing transfers of Romanians working abroad, a surplus of current transfers amounted to EUR 3.5 billion over the first eight months of the year, compensating for the income balance deficit of EUR 3 billion.

Other Developments Affecting the Investment Climate

On October 31st, the World Economic Forum released its new Global Competitiveness Report 2007-2008. Romania’s competitiveness rank was downgraded to 74th (of 131 countries rated this year) from 68th (of 125 countries rated in 2006). Uncompetitive tax rates and tax regulation, inefficient government bureaucracy, corruption, and access to financing are judged as the most problematic factors that damage the country's business environment.

Fitch confirmed the Banking System Indicator (BSI) for Romania at D with a stable outlook. Fitch explained that the current rating corresponds to some weaknesses in the banks’ intrinsic stance. The future trend for the banking sector’s rating is driven by potential system risks, balanced by credible improvements in operating and structural indicators. The bank credit expansion is expected to continue, since the ratio of banking assets to GDP remained at a rather low 50% and due to continuing economic development.

The international rating agency Coface has confirmed Romania’s rating at “A4”, however worsening its outlook from stable to negative. The negative outlook reflects rapid external leveraging by Romania’s private sector, during a period of relatively high short-term capital outflows. Coface expressed concerns that the recent depreciation of the RON may negatively affect the payment behavior of corporations that accumulated a substantial debt in foreign currency.

October was marked with a new round of aggravating political tensions. The government survived a no-confidence vote initiated by the Social Democratic Party, its former supporter in the parliament. Although the political environment remained fragile, EU membership and the president. Although the political environment remained fragile, EU membership and strong commitments of Romanian politicians to accelerate the country’s convergence with EU economic and institutional standards ensures the continuation of prudent economic reforms and market-oriented policy.