Macroeconomic Situation

Summary
- Industrial output grew by a robust 5.8% yoy in January-September.
- The consolidated budget had a surplus of 0.19% of period GDP over January-September compared to a 1.7% surplus a year ago.
- On November 19th, the government approved the third revision of the state budget for 2007, decreasing the budget deficit from 2.7% to 2.4% of period GDP.
- In October, annual inflation of consumer prices skyrocketed to 6.84% yoy, a 16-month high.
- Monetary developments in October remained dynamic, as money supply grew by 28.8% yoy, while non-government credit expanded by 51.4% yoy.
- The interbank foreign exchange market continued to report high volatility of the domestic currency in October-November.
- The National Bank of Romania revised its medium term inflation outlook drastically, raising the forecast of year-end inflation from 3.9% yoy to 5.7% yoy, above the target band of 3-5%.
- Continuing deterioration of the merchandise trade balance pushed the current account deficit to EUR 11.8 billion over January-September, an expansion of 76.2% yoy.
- Net inflow of foreign direct investment (FDI) posted a record high of EUR 954 million in September, which is the highest monthly level since 1990.
- Standard & Poor's downgraded its outlook on Romania's sovereign rating from stable to negative.

Economic Growth
Romanian industrial production kept demonstrating good overall performance, registering a robust 5.8% yoy growth in the first nine months of the year. Growth of industrial output was primarily shaped by developments in the manufacturing industry, which gained 6.7% yoy over January-September. Despite a marginal slowdown of the pace of growth this year, industry still reported healthy developments that were stimulated by vigorous domestic consumption and higher household incomes. Increased disposable income maintained relatively high consumption from indirect taxes, although they declined by 0.42% yoy after abolishment of some trade taxes with the recent EU membership. At the same time, fiscal spending remained rather loose, increasing by a nominal 28.8% yoy up to RON 91.3 billion as a result of extremely generous social policy favored by the unstable political environment and coming parliamentary election. Thus, the consolidated budget was at a surplus of 0.19% of period GDP over January-September compared to a 1.7% surplus a year ago.

Industrial growth was restrained by simultaneous deceleration in both the mining and manufacturing industries as well as by a slight contraction of the gas, water and electricity supply. Mining posted a visible slowdown to a marginal 0.8% yoy growth, down from 3.4% a year ago. The supply of water, gas and electricity contracted by 1% yoy against a 5.5% increase posted a year ago. A deceleration of the manufacturing was linked to some slowdown in food processing, chemicals and in automobile production, and also to continuous stagnation in light industry and fuel processing. Despite a marginal slowdown of growth rates, automobile production remained one of the most attractive industries. A favorable geographic location and the still relatively cheaper labor force made the industry rather attractive for large foreign investments. A marginal deceleration of food processing was partially attributed to temporary difficulties in the agricultural sector due to the prolonged drought this year. At the same time, the chemical industry posted a significant deceleration, decreasing its growth rate by more than twice compared to the strong 17.5% yoy growth reported during January-September 2006. Performance of the chemical industry was likely to be affected by unfavorable foreign trade terms and by growing prices of oil and natural gas on world commodity markets. Metallurgy has continued to show slight deceleration of growth since June, prompted by unfavorable trends on European metal markets. Light industry demonstrated mixed performance, as production of ready-made clothes declined by 19.9% yoy, while manufacturing of textile products grew by 5.7% yoy.

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- On November 19th, the government approved the third revision of the state budget for 2007, decreasing the budget deficit from 2.7% to 2.4% of period GDP. The International Monetary Fund (IMF) criticized the Romanian government highly for rather conservative policies and recommended fiscal consolidation. The government vowed to adhere to IMF guidelines for the sake of achieving European Union membership. However, the future remains uncertain due to external factors such as the global financial crisis. The government announced plans to increase social spending, including pensions and unemployment benefits, in order to mitigate the impact of the crisis on households. This move could help cushion the effects of the downturn on consumption, but it may also add to the fiscal burden and increase the risk of inflation. Therefore, balancing the need for short-term stimulus with long-term fiscal sustainability will be a key challenge for policymakers. The government also announced measures to support the export sector, such as tax breaks and reduced import duties, in order to maintain the country's competitiveness in global markets. However, these measures may face implementation challenges due to administrative constraints and the complexity of the regulatory framework.

Fiscal Policy
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loose fiscal and income policies as contributing to the risks of persistent inflationary processes and macroeconomic imbalances. Meanwhile, the IMF recommended to cut the budget deficit in 2007 to 1-1.5%.

In September, commercial banks and large corpora-
tions continued to borrow intensively from abroad, despite persisting turmoil on international financial markets. In total, the private sector attracted EUR 574 million of medium and long-term foreign debt in one month. Borrowed foreign capital was needed to finance bank credit expansion and investment ac-
tivities in the country. Also, private companies in-
creased their foreign borrowing, anticipating fur-
ther worsening credit conditions on world markets in the next year. At the same time, non-resident de-
posits in Romanian banks declined by EUR 518 mil-
lion, as foreign investors’ sentiments worsened due to increasing risks related to deepening external im-
balances and the international credit crunch. Be-
cause of the large outflow of non-resident deposits and a marginal decrease in public foreign debt, total medium and long-term debt declined by EUR 21 million in September. Nevertheless, during the first nine months of the year, strong external private bor-
rowing together with the inflow of non-resident deposits prompted unprecedented growth of medium- and long-term external debt at 18.9% year-to-date (ytd).

Monetary Policy

In October, annual inflation of consumer prices sky-
rocketed to 6.84% yoy, a 16-month high. After a rather short but successful history of the NBR’s pol-
icy of inflation targeting, bringing Romanian head-
line inflation from double-digit levels to within the boundaries of a one-digit target (one of the lowest in Eastern Europe), growth of consumer prices surged above the policy target in the last two months. Unlike 2006, when inflation dynamics were mainly driven by increasing prices for tobacco and utilities, current inflation was propelled by prices for foodstuffs, soaring by 9.52% yoy in October on the back of high world prices for crops. Meanwhile, non-food prices and services tariffs ad-
vanced to 4.7% yoy and 6.4% yoy respectively, moderately accelerating from 4.1% yoy and 6% yoy reported a month ago.

On a month-over-month (mom) comparative basis, consumer prices posted a 0.97% increase, switch-
ning to a gradual deceleration trend after three months of steep growth. In October, pressure from increasing food prices diminished, as food price growth slightly decelerated to 1.3% mom from 1.94% mom registered last month. A deceleration in food inflation was achieved due to slower growth in prices of almost all foodstuffs. Also, service tariffs decreased their contribution to inflationary develop-
ments, as prices for post and telecommunication, the main inflationary component in the previous month, decelerated significantly to 0.61% mom from 2.42% mom in September. At the same time, prices for non-foods continued to increase on an up trend, registering 0.69% mom growth against 0.19% mom a month ago. The most significant driv-
ers of non-food prices in October were the growing prices for utilities (1.41% mom) and fuel (0.74% mom) driven by increasing prices for oil and natural gas on the world commodities markets.

Monetary developments in October remained dy-
namic, as money supply (measured as monetary ag-
gregate M3) grew by a strong 28.8% yoy, amounting to RON 128.87 billion, while non-government credit increased by 51.4% yoy, totaling RON 142.2 billion. However, growth of money supply and private credit modestly decelerated compared to September, as the pace of bank lending to legal entities lost its speed, while bank lending to households remained at almost the same level. The population’s demand for banking loans persisted, in particular, for loans in foreign cur-
rency, despite the rather high volatility of exchange rates observed in the last few months.

The interbank foreign exchange market continued to report high volatility of the domestic currency in October-November. Given the high share of short-term non-resident deposits, the national currency is very sensitive to speculative movements. The Romanian leu lost value, as speculative senti-
ments worsened on the back of an unsustainable cur-
rent account deficit, international liquidity con-
straints, and appreciation of the EUR on the world forex market. Although the national currency gained 7.3% against the EUR in the first half of the year, the RON began to depreciate in July and lost about 12% at the end of November. However, the depreciation of the national currency was still not excessive, accounting for the significant gap of the current account balance. At the same time, it is ex-
pected that large amounts of foreign capital will flow into the country at the end of the year, which will lead to further appreciation of the RON.

Regarding the missed inflation target, the National Bank of Romania (NBR) revised its medium term in-
flation outlook drastically, raising the forecast of year-end inflation from 3.9% yoy to 5.7% yoy, above the previous target band of 3-5%. However, an acceleration of inflation to 6.8% yoy in October made its forecast doubtful. At the same time, the tar-
get band for 2008, set at 2.8-4.8%, was not changed, while the inflation outlook for 2008 was corrected upwards to 4.3% yoy, compared to a 3.7% forecast presented in the second quarterly report. Responding to accelerating inflation and deprecia-
tion of the local currency, the NBR ran tighter mone-
tary policy by exploiting all relative policy tools, in-
cluding the policy interest rate and interventions on the money and foreign exchange markets. Since commercial banks continued their credit expansion supported by borrowed funds from abroad and the government pursued rather loose fiscal and income policy, the monetary authority appeared to be rather limited with effective tools for regulating inflation-
ary developments. According to estimates of the CNP, the government forecasting agency, headline inflation may converge to the inflation target through the end of 2009.

In September, the trade gap continued to widen, which was attributed to rather rapid expansion of im-
ports, while exports continued to demonstrate good
Macroeconomic Situation

November 2007

performance. High imports were stimulated by high domestic investment activity and high consumption supported by growing nominal incomes of households and fast domestic credit expansion. Thus, (FOB) exports grew by a robust 11.1% yoy amounting to EUR 2.5 billion, while (CIF) imports increased by an impressive 22.5% yoy to EUR 4.1 billion. As a result, the (FOB/CIF) trade deficit widened by 43.1% yoy to EUR 1.69 billion in September alone. The recent depreciation of the RON was still not enough to significantly affect the terms of foreign trade and trade tendencies. However, the trade deficit stayed at a steady level each month.

In the first nine months of the year, (FOB) exports grew by 11.7% yoy approaching EUR 21.4 billion. (CIF) imports increased by 27%, doubling the growth of exports and amounting to EUR 36.5 billion. As a result, the (FOB/CIF) trade balance deteriorated to a deficit of EUR 15.1 billion or by 56.83% yoy.

Continuing deterioration of the merchandise trade balance (EUR 12.1 billion) pushed the current account deficit to EUR 11.8 billion over January-September, an expansion of 76.2% yoy. Although the income deficit was still covered by a surplus of current transfers, the income balance gap deepened by 61.5% yoy, while current transfers grew by only 13.5%. The other parties that managed to overtake 28.8% of the vote. The leftist PSD received 23.1% of the vote, enjoying the greatest support of the population with 28.8% of the vote. The leftist PSD received 23.1% of the vote, the other parties that managed to overtake 28.8% of the vote. The leftist PSD received 23.1% of the vote, enjoying the greatest support of the population with 28.8% of the vote. The leftist PSD received 23.1% of the vote, enjoying the greatest support of the population with 28.8% of the vote. The leftist PSD received 23.1% of the vote, enjoying the greatest support of the population with 28.8% of the vote. 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In September, FDI reported growth on a year-over-year basis for the first time in the year, increasing by 43.1% yoy to EUR 1.69 billion in September alone. The recent depreciation of the RON was still not enough to significantly affect the terms of foreign trade and trade tendencies. However, the trade deficit stayed at a steady level each month.

Net inflow of foreign direct investment (FDI) posted a record high of EUR 954 million in September, which is the highest monthly amount since 1990. In September, FDI reported growth on a year-over-year basis for the first time in the year, increasing by 2.31% yoy up to 5.013 billion. According to the NBR, FDI covered 42% of the current account gap, improving from the 39% reported a month ago.

The large inflows of foreign capital allowed the NBR to replenish its forex reserves by EUR 510.4 million in September up to EUR 25.2 billion.

Other Developments Affecting the Investment Climate

The European Bank for Reconstruction and Development (EBRD) improved Romania's rating of the banking system from "3" to "3-" according to the 2007 report on transition economies. According to the EBRD, the progress achieved in the banking sector was based on the rapid expansion of credit to the private sector and improvement of the regulatory system. Furthermore, the EBRD upgraded the rating for the capital market and non-financial banking institutions from "2-" to "3-" due to the development of the stock exchange and especially of the bond segment. The EBRD report emphasized that the development of the financial sector in Romania was largely based on reforms and privatizations. The EBRD also improved Romania's rating for its electricity infrastructure, from "3+" to "4-", which was due to successful privatization of Electrica Muntenia Sud, the country's largest electricity distribution company.

In November, elections to the European Parliament took place in Romania. The official results of the elections revealed that the center-right PD party enjoyed the greatest support of the population with 28.8% of the vote. The leftist PSD received 23.1% of the vote, while the center-right ruling party PNL drew only 13.5%. The other parties that managed to overcome a threshold of 5% were PLD (7.8%) and UDMR (5.5%). Despite political competition among their leaders, three center-right parties (PLD, PLD and PNL have pretty similar political programs, which create the grounds for forming a majority coalition after parliamentary elections in late 2008.