Main Economic Developments in 2007

In 2007, Romania obtained full membership in the European Union, which reflected the country’s outstanding progress in structural reforms as well as good macroeconomic performance. With accession to the EU, further improvements occurred in some areas of the business environment, as practices became further aligned with EU norms. Despite escalating political tensions in 2007 and, therefore, some slowdown in structural reforms, recent EU membership has significantly contributed to an improved investment climate, as the EU’s anchor is a guarantee in the sense of a stable business environment and prudent economic policies.

Romania’s economic performance remained solid in 2007, as real GDP growth reported a robust 6% above expectations. The persisting consumption boom and high investment activity supported by rising external debt and bank credit expansion continued to drive real economic growth in 2007. However, Romanian industrial production is not yet competitive enough to absorb booming domestic demand, in particular, demand for luxury and high-tech goods. Thus, excessive domestic consumption translated into surging imports, supported by the relatively expensive RON.

The deteriorating CA balance, driven by import expansion, remained one of the principal challenges for Romanian policy-makers. The large and constantly growing external imbalances made Romania rather vulnerable to shocks on world markets. The global credit squeeze in the second half of 2007 caused investors to reassess their risk strategies with respect to emerging markets. With a large and growing current account deficit, Romania was affected the most with unanticipated outflow of foreign capital. As a result, the RON reversed its appreciation trend, losing its nominal value by 15.2% against the Euro during the last six months of the year. The recent tightening of international liquidity caused downgrading of Romania’s international rating outlook by leading rating agencies. At the same time, the international financial turmoil did not have a visible effect on economic growth in 2007. Romanian companies as well as the banking sector remained in good shape, well as the banking sector remained in good shape, as total income grew by an impressive 25% yoy in January-December. High investment activities continued to drive real economic growth in 2007. The large and growing current account deficit, Romania’s sovereign rating.

In December 2007, annual CPI inflation accelerated to 6.6% yoy, being stirred by economic imbalances and shocks to the global economy beyond the control of the monetary authority.

Outlook for 2008

Economic developments will continue to be underpinned by active investment activity and strong domestic consumption in 2008. However, both consumption and investment expenditures may slow down due to a likely deceleration of banking credit expansion, restrained by the growing costs of borrowing on world financial markets. Therefore, we forecast that real GDP growth will decelerate slightly to 5.6% yoy in 2008. On the supply side, real economic growth will continue to be spurred by robust performance in services, trade, and construction as well as by a revival in agriculture on the back of the expected good harvest. Growth of industrial output is likely to decelerate further, suffering from tough competition pressure from European imports.

The government will continue to run a rather expansionary fiscal policy, significantly increasing social spending and minimum wages before the parliamentary election in 2008. Growing incomes, large budget expenditures and banking credit expansion will continue to fuel domestic demand, causing pressure on inflationary development as well as on macroeconomic balances. In 2008, most of the inflationary factors of 2007 are likely to persist. Thus, maintaining the inflation target at 3.8% ±1% in 2008 seems to be a challenging task. We expect that annual inflation will decelerate slightly to 6% yoy at the end of 2008, down from 6.6% reported in 2007. In the second half of 2008, the dynamics of Romania’s currency may stabilize following expected improvement of credit conditions on world financial markets. At the same time, the current account deficit, the most risky factor of Romania’s economic growth, is expected to deteriorate to 16% of GDP. Although the weaker RON and high foreign investment may favor growing exports from Romania, domestic spending will still remain high to further stimulate import expansion and put heavy pressure on the trade balance.

Economic Growth

The Romanian economy continued to report sound performance in 2007. Real economic growth registered a robust 6% yoy at the end of 2007, which is well above the 2.9% yoy posted by the European Union on average. The growth rate in Romania is ranked 7th in the EU, following Bulgaria with 6.3% yoy and Poland with a 6.5% yoy. Economic growth was mainly domestically driven, as total internal consumption grew by 13.3% yoy in the first nine months of the year. Household consumption remained the most important growth engine for Romania, as average household spending will still remain high to continue stimulating import expansion and put heavy pressure on the trade balance.

Industrial production demonstrated sustainable growth of 5.4% yoy during 2007, remaining one of the most important drivers of the economy last year with a share of 25% in gross value added. Positive developments in industry in 2007 were caused by buoyant household and investment consumption, vigorous external demand, in particular on commodit-y markets for metal and chemical products, strong foreign direct investments bringing capital and qualified management to the country, as well as by an improving business environment highly attributed to commitments to the EU’s requirements. Industrial output was shaped primarily by robust performance in food processing, chemical industry, metal-lurgy, automobile production, and in production of machinery and equipment.

Strong private consumption continued to drive growth of food processing output, which gained 10% yoy in January-December. High investment activity in the country and external demand stimulated consistent development of automobile produc-

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Fiscal Policy

The government continued to run a rather expansionary fiscal policy in 2007, which resulted in further growth of the state budget deficit. Pro-cyclical budget policy was caused by the fragile political environment, as the minority government had to implement a socially-oriented budget imposed by the socialist opposition holding majority in the Parliament. During 2007, consolidated budget expenditures increased by 22% yoy, amounting to RON 137 billion (EUR 41 billion), which is 34% of period GDP. Meanwhile, budget revenues grew by a comparatively modest but still robust 19% yoy, supported by strong economic performance, totaling RON 127 billion (EUR 38 billion), which is 31.4% of period GDP. As a result of a substantial increase in social spending in November-December, the consolidated budget turned into a deficit of 2.3% of period GDP as of December 2007 (compared to a 1.5% of period GDP deficit registered in 2006) down from a marginal surplus demonstrated for some months. Given a significant increase in social payments in the two last months, a budget deficit at 2.3% of period GDP was likely achieved by suspending some government infrastructure programs.

Tax revenues grew by a robust 19% yoy in 2007, providing about 60% of all consolidated budget revenues. In particular, taxes on enterprise profits increased by 33% yoy, driven by buoyant economic growth. Proceedings from personal income tax accelerated to 47% yoy, favored by continuing growth of wages and low unemployment. At the same time, receipts from indirect taxes decelerated in 2007 mainly due to further liberalization of the trade regime with EU members after full EU membership. Particularly, VAT and excises posted 12.5% yoy and 18% yoy growth respectively during the year. Also, worsening performance of taxes on products may be attributed to poor fiscal discipline favored by continuing political turmoil in the country.

In 2008, the consolidated budget deficit is projected at 2.7% of period GDP with expected real GDP growth at 6.0% yoy and inflation at 3.85% yoy. Although macroeconomic forecasts of the government seem to be too optimistic, the budget deficit is likely to reach the projected level, as higher inflation will provide a higher nominal value of GDP even with lower real growth.

Growth of external debt in Romania posted a significant acceleration in 2007 on the back of large foreign borrowings of private companies and of the banking sector. The stock of medium- and long-term debt surged by 29% ytd in 2007, accelerating from a comparatively modest rate of 16% ytd reported a year ago. Meanwhile, the stock of public debt declined by 3.8% ytd. Despite impressive growth, the total stock of external debt stayed at a manageable level, estimated at 48% of GDP as of December 2007. Growth of foreign debt is expected to decelerate next year due to increasing costs of external borrowings attributed to the continuing world credit squeeze.

Monetary Policy

In 2007, monetary policy was challenged by increasing inflation pressure threatening the inflation target and by flows of short-term foreign capital exerting pressure on the RON exchange rate. In December 2007, annual CPI inflation accelerated to 6.6% yoy, approaching an 18-month high. Thus, the NBR’s inflation target set at 3.8±1% yoy was missed by almost 2 percentage points. Although the NBR failed to confine inflation developments in the targeted boundaries, the headline CPI inflation leveling single digits is one of the lowest in Eastern Europe, below that of the Baltic states, Hungary, and Bulgaria.

In July 2007, after a prolonged period of successful disinflation, inflation processes turned to an upward trend, affected mainly by hardly predictable external factors, causing acceleration in the whole European region. One of the most influential drivers of global inflation was rising food prices. The poor harvest of crops on the back of unfavorable weather conditions caused tightening of world supply of foods compounded by a continuing increase in world demand. Thereafter, global prices for foods, in particular, for bread and baked products, vegetables and fruits, began to soar. In Romania, food prices grew by a strong 9.14% yoy, accelerating from a modest 1.07% yoy reported a year ago. Given the outstanding growth in prices for domestically produced and imported foodstuffs and a 40% share of foods in the consumer basket, food inflation explained more than half of the headline CPI growth.

As in the previous year, growing international prices for energy resources, such as oil and natural gas, translated into domestic prices for fuels and utilities. Increasing excises for tobacco products also contributed to growth of non-food prices. However, the impact of these factors was not as strong as a year ago. Thus, non-food prices decelerated to 3.6% yoy in 2007. On the services side, prices accelerated to 8.55% yoy, driven by an almost doubling in rent prices following EU membership.

Another powerful factor that notably affected monetary developments in Romania in 2007 was the global credit squeeze in the second half of 2007. This caused investors to re-assess their risk strategies with respect to emerging markets. The change in investor perception particularly affected coun-

Consolidated Budget Balance, % of full year GDP

Source: Ministry of Economy and Finance

Fiscal Revenues, %

Source: Ministry of Economy and Finance

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tries with large and growing external imbalances. With the current account deficit at nearly 14% of GDP, covered only by half with FDI, Romania was affected the most with unanticipated outflow of foreign capital. As a result, the Romanian Leu reversed its appreciation trend, losing its value by 15.2% against the Euro during the last six months of the year. At the end of 2007, the local currency approached 3.6 RON/EUR, a level registered for the last time in January 2006. With depreciating national currency starting in August 2007, the strong domestic consumption that had been persisting for the last few years began to put visible pressure on consumer prices. The central bank implemented active interventions on the interbank forex market in order to prevent too sharp depreciation of the RON. Given a significant deficit of the current account, the RON exchange rate is expected to depreciate further at least in the first half of 2008. However, in the second half of 2008, the Romanian currency may stabilize following expected improvement of credit conditions on world financial markets.

In 2007, growth of monetary aggregates accelerated compared to the previous year, which also added to the deepening of the inflationary processes. Improving standards of banking services and growing competition made credit more available for companies and households. Non-government credit continued to grow at an increasing pace, accelerating to 60.4% yoy in December 2007, against 53.7% yoy posted last year. On the back of a continuing credit boom, broad money supply (M3) grew by 33.5% yoy, up from 29.4% yoy a year ago. Growing macroeconomic imbalances stimulated households to increase their holdings of currency and demand deposits against term deposit. As a result, the share of money available for transactions in the structure of broad money supply surged to 53.3%, up from 31.7% reported a year ago, which inevitably puts strong upward pressure on consumer prices.

Despite a prolonged credit boom, the Romanian banking sector remained in good shape. As the NBR reported, the main indicators of banking solvency and stability still remain at high levels. A prevailing share of foreign capital in the banking system (assets of banks with foreign capital constituted 88.6% of the total assets in 2006) provides transfer of banking technology and best modern risk-management practices, which favors further deepening of financial intermediation. At the same time, banking sector vulnerability to various risks also rose during 2007. In particular, growth of banking credit was accompanied by growing mismatches in the term and currency structures of assets and liabilities of the banking sector. Thus, risks of too sharp depreciation raise concerns of solvency and stability of the banking system. In 2008, commercial banks are expected to restrain their lending activity due to continuing credit turmoil and tighter monetary policy.

During 2007, the NBR board conducted active monetary policy, balancing between containing inflationary developments and smoothing excessive exchange rate movements. In the first half of the year, the monetary policy was aimed primarily at decreasing interest rate spreads in the country, which attracted large inflows of speculative capital and provoked unsustainable appreciation of the RON. Thus, the NBR introduced several consecutive cuts in the key policy interest rate, decreasing it from 8.5% at the beginning of 2007 to 7% as of June 2007. In the second half of the year, the monetary authority switched to restrictive monetary policy, aimed at combating accelerating inflation and preventing a sharp depreciation of the national currency. Therefore, the NBR raised the policy interest rate to 7.5% in October 2007. In addition, the central bank undertook active interventions on money and forex markets to strengthen the effects of its policy actions. However, the NBR has limited power to impact monetary developments in Romania, as the monetary transmission mechanism (MTM) still remains rather weak. First of all, the central bank's ability to affect the money supply is restricted due to the large presence of foreign banks (the major share of the banking sector), which have comparatively easier access to cheaper resources on international financial markets. Furthermore, the power of the MTM is weakened by the increasing share of currency outside the banking system.

In 2008, most of the inflationary factors of 2007 are likely to persist. Loose fiscal policy and continuing credit expansion will further drive strong domestic demand above the labor productivity growth rate. The expected depreciation of the local currency will continue to contribute to inflation. In addition, inflation will be further stimulated by expected increases in excise rates on a range of products including tobacco and energy, as well as by growing prices for oil and natural gas. Thus, maintaining inflation at 3.8 ± 1% in 2008 seems to be a challenging task. However, in the second half of 2008, the expected good harvest and improving liquidity conditions on world markets may cause deceleration of inflation. Hence, annual inflation is forecasted to be about 6.3% yoy at the end of 2008, slightly decelerating from 6.6% in 2007.

Significant external imbalances remained the most fragile side of the Romanian economy. Strong domestic demand backed by relatively expansive Romanian currency continued to stimulate import expansion in 2007. Moreover, further liberalization of the trade regime with the EU and new adopted standards of production prompted increasing competition with European imports. In 2007, (CIF) imports grew by 25% yoy driven by accelerating imports of goods from the EU, particularly from Germany and Italy. Although (FOB) exports continued to report a sound growth rate, increasing by 14% yoy, the outpacing growth rate of imports resulted in a significant widening of the (FOB/CIF) foreign trade deficit, which deepened by almost 1.5 times compared to last year. At the same time, the export potential of the Romanian economy remains bright due to the qualified labor force, favoring economic growth and export competitiveness.
able geographic location, and large inflows of foreign investments. Furthermore, export dynamics are expected to improve in 2008 on the back of a depreciating RON.

Mainly driven by soaring merchandise imports from the EU, the current account balance deteriorated strongly in 2007. The current account gap surged by 70% yoy during 2007, compared to a 45% yoy widening last year. Thus, the deficit amounted to EUR 17 billion as of December 2007, approaching 14% of full year GDP. Before 2007, the current account deficit of Romania was fully financed by large inflows of foreign direct investments (FDI), which is non-debt-generating capital. However, in 2007, the current account gap deteriorating at an accelerating pace turned out to be rather debt-financed, as net FDI inflows covered only 42% of the external gap. Foreign debt as a major source of financing implies increasing vulnerability of the Romanian economy to international conditions of borrowing, as a sudden stop of borrowing may provoke sharp and destructive devaluation of the national currency. Therefore, the recent tightening of international liquidity caused the downgrade of Romania’s international rating outlook by leading rating agencies. In 2008, the current account deficit is expected to extend to 16% of GDP.

In 2007, the net inflow of FDI remained substantial, amounting to EUR 7 billion. At the same time, the amount of FDI inflow declined to 78% of the level reported in the respective period last year, likely due to some deceleration of large-scale privatization compared to 2006. Robust inflows of foreign capital, including borrowed capital as well as FDI, helped the NBR to increase its stock of foreign exchange reserves by 10% ytd up to EUR 25.3 billion, despite significant deterioration of the current account.