Summary

- In January-May, industrial production in Romania continued to demonstrate robust performance, increasing by 6.3% yoy, on the back of high domestic and external demand.
- In the election year of 2008, fiscal policy remained excessively loose, as the consolidated budget balance worsened to a deficit of 1.2% of full-year GDP in the first half of the year.
- The stock of medium- and long-term external debt increased by 12% ytd in January-May, despite continuing international financial turmoil, increasing risk-aversion of foreign investors and high volatility of short-term capital flows.
- The annual CPI advanced to 8.6% yoy in June, gaining an additional 2 percentage points (p.p.) since the beginning of the year.
- As of July 2008, the RON had depreciated against the EUR by a nominal 16% yoy due to increasing risk-aversion of investors and a significant outflow of short-term capital.
- The NBR continued to pursue restrictive monetary policy. From August 1st, the NBR raised the key policy interest rate to 10.25% yoy.
- Nevertheless, credit expansion in Romania remained high, as non-government credit accelerated to 63.4% yoy, driving growth of broad money supply to 39% yoy in July.
- During the first five months of the year, the deterioration of the external balances visibly slowed, mostly favored by the depreciating RON. The FOB/CIF trade deficit widened by 15% yoy up to EUR 8.8 billion during January-May, substantially decelerating from 64% yoy reported for the same period of last year.
- The annual account deficit grew by a comparatively moderate 9.8% yoy in January-May, amounting to EUR 6.5 billion.
- Romania still remains one of the most attractive destinations for investments in the region. Net inflows of foreign direct investments (FDI) almost doubled during the first five months of the year against the same period of last year and totaled EUR 4.1 billion.
- Romania was recognized as one of the most attractive emerging markets for the placement of investment funds, according to international investment analysts.
- As the IMF states, Romania remains rather vulnerable to the recent global financial crisis. The Fund recommended maintaining a budget deficit for this year at 1.5% of GDP.

Economic Growth

During the first five months of the year, industrial production in Romania continued to demonstrate robust performance backed by high domestic demand, both consumption and investments, as well as by growing exports. According to preliminary data of the National Institute of Statistics (INSSE), industrial output increased by 6.3% year-to-year (yoy) in January-May, only marginally decelerating from 6.4% yoy growth reported a year ago. Industrial growth was supported by a 7% yoy increase in manufacturing and a 8.7% yoy increase in the supply of water, gas and electricity. On the downside, mining declined by 2% yoy over January-May.

Output growth in manufacturing was underpinned by increasing production in such leading industries as food processing, chemicals, and automobile production. Food processing continued to post steady growth, increasing by 11% yoy in the five months on the back of high household spending (meanwhile expenditures on foods account for 37% of the general consumer basket) and growing prices for food-stuffs. The chemical industry grew by 14% yoy, accelerating from 9% yoy reported in the respective period last year, driven significantly by growing prices for fertilizers on global markets. Automobile production remained the most dynamic industry, posting a 17% yoy increase in January-May. Robust performance of the industry was supported by large FDI placement and improving competitiveness of products on international markets. Industrial growth was also backed by a recovery in production of machinery and equipment and in fuel processing. Machinery and equipment grew by 5.3% yoy in January-May, picking up from a 2% yoy decline reported in the same period last year. Recovery of the industry was favored mostly by high domestic and external demand for capital goods. Fuel processing has continued recovery for the second month in a row, following completion of modernization of production capacities in this industry. On a negative note, industrial growth was restrained by continuing decline in light industry and metallurgy. Metallurgy has been declining since the beginning of the year. In January-May, production of metal processing fell by almost 7% yoy on the back of decreasing imports of metaliferous ores compounded with a stoppage of domestic extraction.

Labor productivity grew by 9.7% yoy in January-May, slightly decelerating from 11.2% yoy registered a year ago. At the same time, total revenues of the consolidated budget grew by 37% yoy in nominal terms, totaling RON 80 billion (EUR 22 billion), on the back of sound economic performance and accelerating inflation. Proceedings from major taxes reported considerable 37% yoy growth during January-June, strongly accelerating from 16% registered a year ago. Growth of tax receipts in the first half of the year was spurred by 1.7 times increase in collections of VAT from the low statistical base of the previous year. Likely, a surge in VAT collections was also favored by out-performing retail trade and growing prices. Meanwhile, proceeds from income taxes, enterprises profit tax (EPT) and personal income tax (PIT) maintained almost the same growth rates, increasing by 14% yoy and 19% yoy respectively, backed by increasing company profits as well as by the high income of households and low unemployment.

Fiscal Policy

Over 2006–2007, the consolidated budget balance has been increasingly deteriorating due to the acceleration of government expenditures. As 2008 is an election year, fiscal policy has remained excessively loose, contributing to growing macroeconomic imbalances. The consolidated budget balance worsened to a deficit of 1.2% of full-year GDP in the first half of 2008 against a deficit of 0.2% of GDP in the same period of 2007, according to data of the Ministry of Economy and Finance. Fiscal loosening was attributed primarily to increasing current budget expenditures (which account for nearly 90% of total expenditures), in particular social assistance and wages in the public sector. Thus, total expenditures surged by a nominal 44% yoy over January-June, amounting to RON 85 billion (EUR 23 billion), with current and capital spending increasing by 40% yoy and 85% yoy respectively. On a positive note, the share of capital expenditures in total budget expenditures have doubled in the last two years, expanding to 12% as of June 2008.

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The consolidated budget balance for 2008 was initially planned with a deficit of 2.7% of GDP. However, according to the methodology of ESA95, the deficit target is estimated at around 3.2% of GDP. As a response to critics from the European Commission (EC) and the National Bank of Romania (NBR), the Romanian authorities revised the budget plan in March and reduced the deficit target to 2.3% of GDP. On July 16th, the government approved the second revision of the budget plan for 2008, maintaining the projected deficit at 2.3% of GDP. Amendments to the budget called for updating budget indicators according to upwardly revised forecasts of annual inflation and nominal GDP. The budget revenues were in...
In the first half of 2008, Romania continued to report robust inflow of long-term foreign borrowed capital in spite of continuing international financial turmoil, increasing risk-aversion of foreign investors and the high volatility of short-term capital flows. The stock of medium- and long-term (M&LT) external debt increased by 12% year-to-date (ytd) in January-May 2008, accelerating by more than twice against the respective period of 2007. As of May 2008, total M&LT external debt amounted to EUR 43 billion, up by 44% yoy. The accumulation of external debt was driven mainly by borrowings of the non-government sector from abroad (commercial banks and large companies, mostly foreign-owned.) Thus, M&LT external debt of the private sector surged by 52% ytd up to EUR 28 billion as of May 2008. At the same time, external public debt grew by 23% yoy, while publicly guaranteed debt declined by 43% yoy. Besides, the amount of medium- and long-term deposits of non-residents in the banking system increased by 3.5 times on a year-over-year comparative basis. The high inflow of non-resident deposits was attracted by growing domestic interest rates on the back of the tight monetary policy of the central bank. Therefore, a share of non-resident deposits in the M&LT debt rapidly advanced to 11% as of May 2008, up from 5% posted a year ago.

Monetary Policy

In June 2008, high inflation remained the major concern for the monetary authority in Romania. In the first half of 2008, high inflation continued to persist, as the annual CPI advanced to 8.6% yoy in June, thus gaining additional 2 percentage points (p.p.) since the beginning of the year. Unlike the last few years, when the most important disinflation factor was low food prices, food prices turned out to be the major driver of inflation in 2007, being adversely affected by a poor harvest last year as well as by a pass-through of high prices on the global food markets. In the first half of 2008, annual growth of food prices continued to soar on a high statistical base effect from the previous year, speeding up to 11.8% yoy in June. Accounting for 37.5% of the structure of the CPI, growing food prices explained more than 50% of the total growth in consumer prices. At the same time, accelerating prices for non-food contributed 30% to CPI growth as of June. Growth of non-food prices was spurred mainly by increasing fuel (14.4% yoy) and utilities (5.6% yoy) prices, following high record prices for fuel and energy resources on global markets.

Except supply-side shocks, such as a poor harvest in 2007 and high energy prices, domestic inflation was also propelled by a depreciating RON, excessive domestic demand and worsening inflationary expectations. Exchange rate dynamics and inflation are closely related in Romania. As of July 2008, the RON had depreciated against the EUR by a nominal 16% yoy following the increasing risk-aversion of investors and significant outflow of short-term capital. The depreciation of the local currency translated into growing domestic prices through the two major channels. One of them is tariffs for post and telecommunication services, which are denominated in Euros. With the depreciation of the RON, telecommunications tariffs grew by 9.6% yoy in June. As a result, service tariffs advanced to 8.7% yoy in June, explaining 18% of CPI growth. Also, a weakening RON prompted the increasing costs of imported goods.

At the same time, high domestic demand, stemming from loose fiscal policy and credit expansion, continued to exert pressure on consumer prices. The inflation effect from demand-side factors was reflected in the accelerating rise in the CORE2 index, which advanced by 8% yoy in June.

Although headline inflation remained high, consumer prices began to decelerate slightly on a month-over-month comparative basis in February, making annual inflation switch to a flat growth trend over March-June. As of June, inflation had slowed to 0.32% month-over-month (mom). This monthly slowdown was mostly caused by the deceleration of administrative prices and prices for a range of food-stuffs, as well as by temporary appreciation of the RON on the back of good economic performance in Romania. However, inflation developed above projections of the NBR highlighted a range of serious systemic inflation risks, such as the continuing increase in wages above productivity gains, further loosening of income and fiscal policies in the election period, and continued deterioration of inflationary expectations. Thus, the central bank continued to pursue restrictive monetary policy, aimed at tightening credit conditions and curbing domestic demand. As of August 1, the NBR raised the key policy interest rate to 10.25% yoy. Since the beginning of the year, the monetary authority has increased the reference rate by 275 basis points in several steps.

Strong inflows of foreign capital fueled high domestic demand and therefore created inflationary pressure. Although expectations of a good harvest this year and tight monetary policy suggests the deceleration of the year-end annual inflation below the level registered last year, the inflationary environment in Romania remains rather fragile. High volatility of the...
exchange rate and likely further depreciation of the RON during the continuing global financial crisis creates significant inflationary uncertainty in the second half of 2008.

International Trade and Capital

During the first five months of the year, the deterioration of external balances (the major challenge for the Romanian economy over the last several years) visibly slowed down, mostly due to the depreciating RON. A significant deceleration of merchandise imports against some improvement in export performance led to a visible slowdown in the widening of the merchandise trade balance over the period, which resulted in some stabilization of growth of the current account deficit.

In January-May 2008, FOB merchandise exports were growing at rates that outpaced the growth of CIF merchandise imports, as exports in goods grew by 17.2% yoy while imports advanced by 14.6% yoy. Thus, performance of exports in terms of growth slightly improved compared to the previous year. At the same time, expansion of merchandise imports strongly decelerated compared to the respective period of last year. On a negative note, the deceleration of imports occurred primarily on the back of a slowdown in imports of capital and intermediate goods, while imports of consumer goods maintained almost the same high rate as a year ago, supported by high bank lending to households as well as pro-cyclical income and fiscal policies. Therefore, the FOB/CIF trade deficit widened by 15% yoy to EUR 6.8 billion during January-May, substantially decelerating from the same high rate as a year ago, supported by high credit conditions on the global markets.

The current account deficit grew by 9.8% yoy in January-May, amounting to EUR 6.5 billion. This is a rather moderate worsening of the current account balance compared to a two-fold surge of the CA gap registered in the corresponding period of the previous year. The FOB/FOB trade deficit, which expanded by 15% yoy to EUR 6.8 billion, remained the main contributor to the current account deficit. The gap in the income balance widened by 1.4% yoy and totaled EUR 1.9 billion, driven mainly by repatriation of investment income. At the same time, the surplus of current transfers grew by 26% yoy, accelerating from 10% yoy a year ago due to transferred funds from the EU. The current transfers surplus at EUR 2.3 billion compensated for almost 26% of the gaps in the trade and income accounts. Despite the recent positive dynamics of the current account, the size of the CA deficit remained unsustainable and highly dependent on credit conditions on the global markets.

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Other Developments Affecting the Investment Climate

Romania was recognized as one of the most attractive emerging markets for the placement of investment funds, according to the report "Private Equity in Emerging Europe", prepared jointly by Mergermarket, KPMG, investment bank Unicredit and law firm Baker & McKenzie. The report ranks Romania as the second country behind Poland benefiting from private equity in Emerging Europe. The investment market in Romania expanded significantly in 2007, as the size of the market almost doubled compared to the previous year. At the same time, the country still has great investment potential, particularly in the infrastructure building and financial sector. The report also outlined the main obstacles for investments such as problems with the tax system and a shortage of qualified work force.

As the IMF states in the concluding remark on Article IV Consultations, Romania remains rather vulnerable to the recent global financial crisis. Large inflows of foreign capital compounded by pro-cyclical fiscal policy spurred a boom in domestic demand, which led to growing imbalances and a high dependency on external credit constraints. The IMF highlighted the need to pursue restrictive and well-balanced fiscal and monetary policies as well as to enhance structural reforms in order to counteract widening macroeconomic imbalances. In particular, the Fund recommended maintaining a budget deficit for this year at 1.5% of GDP instead of the 2.3% of GDP projected by the government.