Summary

- During January-September 2008, Romania reported excellent economic performance. Real GDP soared by 8.9% yoy in this period, spurred by increasing domestic and external demand.
- In October, industrial production declined by 3% yoy, followed by an even deeper 11.5% yoy drop in November.
- We expect that real GDP growth will slow down to 7-7.5% yoy in 2008 and decline by 2% yoy in 2009.
- By November 2008, the consolidated budget deficit grew to 2.94% of full-year projected GDP.
- Private external debt surged by 54% yoy in November, while public and publicly guaranteed debt increased by a marginal 0.3% yoy. At the same time, the ratio of gross external debt to GDP remained at a manageable level.
- Inflation gradually decelerated to 6.3% yoy at the end of 2008.
- At the end of 2008, the RON depreciated to 3.99 RON/EUR, having lost 10% of its nominal value against the Euro.
- In 2008, improving foreign trade dynamics on the back of the weaker RON led to slower widening of external gaps (the current account gap widened by 8% yoy during January-November 2008). However, the current account deficit still remained at an unsustainably high level of about 13% of GDP at the end of 2008.

Economic Growth

Romania's economy had two distinctive phases in 2008 -- the first nine months of the year, when the economy performed well, and the fourth quarter, when the deepening of the global crisis began to influence the Romanian economy. During January-September 2008, Romania reported excellent economic performance contrary to expectations about soft-lending in the economy during 2008. An economic slowdown was originally anticipated due to the continuing global credit squeeze. Economic growth in Romania, like in many other emerging markets, was accompanied by high inflow of foreign capital and growing external imbalances, making the economy rather vulnerable to global financing. However, inflow of long-term capital remained robust in 2008. The high presence of foreign assets in Romania, the favorable investment and business environment inside the country, as well as good macroeconomic potential secured robust long-term capital up to November 2008, which helped spur economic growth in January-September.

Thus, in the first nine months of 2008, domestic demand remained strong, backed by growth of manufacturing and by improvement in utilities supply. Industrial production grew by a still solid 5% yoy, slightly moderating from the 5.8% yoy reported in the respective period of last year. Manufacturing turned to a gradual deceleration, primarily driven by a continuing stagnation of metallurgy. At the same time, all other leading industries posted good performance on the back of high domestic and external demand in the first nine months of the year. The chemical industry, production of machinery and automobiles accelerated to 12.8% yoy, 5.7% yoy and 15.7% yoy respectively. Food processing decelerated to 7.8% yoy, however remaining in a good shape.

However, by October, Romania revealed the first signs of the economy cooling off, being affected by the deepening of the world crisis in mid-September 2008. As in the last several years, the Romanian economy was over-heated by significant foreign capital, pushing economic growth above a sustainable trend. And a growth slowdown to more fundamentally justified rates was expected. In the current situation, the economic slowdown is likely to be sharper and more painful than predicted, as it was hastened by the recent unfavorable global developments. All told, the Romanian real sector will be hurt through the following channels: decreasing demand for Romanian exports, shrinking capital inflow, and worsening economic expectations of firms and households. Growing exports favored growth of the leading industries such as automobile production, production of machinery and equipment, and the chemical industry in 2007-2008. Thus, economic slowdown in the European Union, the major trade partner of Romania, caused a rather sharp decline in demand for Romanian exports. On the other hand, domestic demand relied heavily on foreign capital. Soaring investment growth was fueled by remarkable inflows of FDI and debt capital in 2007-2008, while persisting final consumption was strongly backed by impressive banking credit expansion, which was supported by injection of foreign capital as well. The drying-out of external capital will dampen domestic demand significantly. Furthermore, firms and households are expected to decrease their propensity to consume, worrying about the crisis.
its stagnation, falling by 24.5% yoy in October and by 44% yoy in November. Machinery and equipment appeared more resilient, keeping its growth at 5% yoy in October and declining by a marginal 0.2% yoy in November. As a result, cumulative growth of industrial output visibly decelerated from 5% yoy in January-September to 2.5% yoy in January-November.

By December 2008, cumulative industrial growth slowed to 0.9% yoy, compared to 5.4% yoy reported in 2008.

Signs of a starting recession were observed in other sectors as well. Retail and wholesale trade significantly slowed in October-November, reflecting falling domestic aggregate demand. Thus, turnover volume of enterprises, operating in the retail trade sector, slowed to 2.8% yoy in November. Also, construction works significantly decelerated to 13.4% yoy in November. A slowdown was registered primarily in residential building (4% yoy) and in civil engineering (7% yoy).

We expect that real GDP growth will slow to 7.7-5.5% yoy in 2008. We forecast that real GDP will decline by about 2% yoy in 2009, following a significant decrease in credit, investment and capital inflow. At the same time, contracting domestic demand and the depreciating currency are expected to gradually bring large macroeconomic imbalances, accumulated during the last several years, to sustainable levels. A recovery of the Romanian economy is closely related to a recovery in the global economy, and is amplified by monetary and fiscal policies of the government.

Fiscal Policy

The consolidated budget deficit of the Romanian government was consistently growing over 2006-2007 from 0.8% of GDP in 2005 to 1.7% and 2.4% of GDP in 2006 and 2007 respectively. In 2008, the fiscal position deteriorated drastically, in particular, during the two last months of the year. By November 2008, the consolidated budget deficit grew to 2.94% of GDP, from 0.8% of GDP in 2005 to 1.7% and 2.4% of GDP in 2006 and 2007 respectively. In 2008, the fiscal position deteriorated drastically, in particular, during the two last months of the year. By November 2008, the consolidated budget deficit grew to 2.94% of full-year projected GDP, and it is likely to reach 5.5% of GDP by the end of the year, according to preliminary official estimates. Such a surge in the budget deficit can be explained by expansionary government expenditures on growing wages in the budget sector and social assistance transfers on the eve of parliamentary election in November. Moreover, some increases in social spending, planned for early 2009, were implemented in advance of the schedule. In addition, the effect of fiscal loosening was amplified by the likely weakening revenues side of the budget over November-December in the worsening economic environment. Thus, consolidated budget expenditures increased by a nominal 30% yoy in January-November, while spending on wages and social transfers contributed more than half to the increase. At the same time, budget revenues grew by a still vigorous 25.5% yoy in nominal terms, supported by impressive performance of the real sector in the first nine months of the year.

In 2009, nominal fiscal revenues are expected to decelerate substantially, as the economy is going into a recession. In these circumstances, the government will have to cut some planned fiscal expenditures, including social program spending, in order to prevent uncontrolled widening of the budget gap this year. Nevertheless, the budget deficit is unlikely to attain a level below 3% of GDP.

Monetary Policy

According to expectations, reviving agricultural output coupled with moderating global fuel prices allowed consumer prices to return to a downward trend in the second half of the year. After peaking at 9% yoy in July, inflation gradually decelerated to 6.3% yoy at the end of 2008, a level slightly below a year ago. Both food and non-food components of the consumer basket reported a slowdown in price growth in October-December and both reached 6% yoy as of 2008. Disinflation of food and non-food helped to partially compensate rising costs of services. Services prices grew by 7.7% yoy in 2008, driven, in particular, by increasing utility tariffs as well as by a renewed depreciation of the RON in the fourth quarter of the year. In addition, slower dynamics of monetary aggregates in August-December also favored disinflation tendencies.

However, despite the recent easing of inflation, the inflation outlook for 2009 remains rather uncertain. On the one hand, the expected economic slowdown and falling aggregate demand this year suggests continuing disinflation processes. Significant deceleration of monetary aggregates, following rather modest growth of banking credit to the economy, will completely compensate for the possible inflationary effect of fiscal loosening. Also, declining prices on the global commodities markets will cause disinflation in prices for some imported commodities, in particular, for fuels. However, on the other hand, continuing depreciation of the Romanian leu will spur prices for other imported goods as well as tariffs for communications services.

Over 2006-2008, increasing external deficits were accompanied by growing foreign liabilities of the private sector. In November, the gross external debt of medium- and long-term maturity amounted to EUR 49.7 billion, increasing by 40% yoy, up from 31% yoy a year ago. Private external debt surged by 54% yoy in November, while public and publicly guaranteed debt increased by a marginal 0.3% yoy. At the same time, the ratio of gross external debt to GDP remained at a manageable level, slightly exceeding 53% of GDP as of September 2008. A substantial part of the debt is attributed to banks’ obligations to their main foreign offices, trade relations and inter-company investments. Meanwhile, the total external public debt is one of the lowest in Central and Eastern Europe, around 20% of GDP. All of this suggests good chances for Romania to service its external liabilities and weather the international financial turmoil, although a sharp depreciation of the Romanian leu signifies increasing risks of servicing the external debt. A mitigating factor is that Romania may have access, if needed, to alternative sources of financing such as credit lines of international financial institutions (IMF, EIB, EBRD, WB), as well as to EU structural funds.

CPI by Components, % yoy

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The deepening of the global financial crisis in September 2008 provoked the increasing risk-aversion of investors, drying out capital from emerging markets. Afterwards, countries with large external imbalances and a high share of short-term foreign liabilities experienced significant depreciation pressures on their local currencies. Thus, starting September, the RON returned to its depreciation path, following the same trend as in peer countries. At the end of 2008, the RON depreciated to 3.99 RON/EUR, having lost 10% of its nominal value against the Euro. In 2009, we should expect further depreciation, as significant external gaps (the current account deficit around 13% of GDP in 2008) call for their radical adjustment amidst global liquidity tightening.

A sharp weakening of the Romanian leu poses serious risks to the stability of the banking system, as more than half of all non-government banking loans are denominated in foreign currency. Because of this, the National Bank of Romania (NBR) concentrated its management of banks, introducing stricter prudential requirements for bank loans to the private sector. At the same time, the monetary authority tried to maintain liquidity in the banking sector, granting refinancing loans to banks and decreasing reserves requirements for RON-denominated deposits. As inflation began to decelerate, the NBR maintained the key policy rate at 10.25% through September-December 2008. Tighter NBR regulations and liquidity constraints on the global markets as well as a growing exposure to depreciation risks prompted the increase of banking interest rates and a drastic deceleration of banking credits to the non-government sector during July-November. Thus, non-government credit slowed to 38% yoy in November, visibly down from 63% yoy reported in June. The banking sector still remained fundamentally sound, despite some increase in the share of non-performing loans.

In 2008, improving dynamics of foreign trade on the back of the weaker RON led to slower widening of external gaps (the current account gap widened by 8% yoy during January-November 2008, compared to a 68% surge reported a year ago). However, the current account deficit still remained at an unsustainably high level of about 13% of GDP at the end of 2008.

Exports of goods accelerated their growth pace above import growth in 2008, while imports of goods slowed significantly. In January-November, FOB exports grew by 16% yoy, accelerating from 13% yoy reported a year ago. Meanwhile, CIF imports increased by 12% yoy, significantly down from 27% yoy in the respective period of last year. Thereafter, the FOB/CIF foreign trade balance widened by only 7.8% yoy against a 52% yoy surge reported a year ago and approached EUR 21 billion as of November 2008. Robust growth of exports in goods was supported by substantial FDI placement to the Romanian industry in previous years and by improving Romanian export competitiveness. By commodity group, merchandise exports were driven mainly by high external demand for Romanian vehicles, machinery and electrical appliances, and also by a recovery of petroleum products exports, which helped to compensate for the significant deceleration of ferrous metal exports. At the same time, imports decelerated to the lowest growth rates since 2003, driven down by a visible slowdown of imports of the major commodity groups such as machinery, vehicles, metal and chemicals. Moderating import growth can be explained by lower demand for imports on the back of the depreciating local currency and restrained access to banking credits.

Notably, in November, both exports and imports declined on the back of weakening external and domestic demand. FOB exports shrank by 9% yoy in November, while CIF imports dropped by 17% yoy, which prompted a 24% yoy decline in the FOB/CIF trade deficit.

The current account gap approached EUR 16 billion as of November 2008, determined by the EUR 16.9 billion FOB/FOB merchandise trade deficit and by the EUR 5.2 billion deficit of the income balance. Foreign direct investment (FDI) grew by 32% yoy during these eleven months and covered 54% of the current account gap. The rest of the CA deficit was financed with long-term borrowings. However, by November, inflow of FDI declined by 21% yoy. Nevertheless, the still robust inflow of foreign capital in 2008 helped to not only finance the external gap but also to replenish NBR forex reserves, which grew by 15% yoy in November, amounting to a historical high of EUR 29.3 billion.

In 2009, we predict that external imbalances will continue to adjust at an accelerating pace, pushing the RON to a new equilibrium level. Falling FDI and debt capital inflows may force a rather sharp adjustment of the current account balance through depreciation of the local currency and further improvement of the trade balance. The current account gap will tighten below 10% of GDP in 2009.