

## Romania – Sustained growth prospects in view of EU membership next year with risks of overheating

### H1 2006 Growth

Economic activity accelerated to a real 7.4 % yoy in H1, above market expectations, supported by post-flood reconstruction activity, recovery in industry and sound growth in services. After the 6.9 % yoy growth registered in Q1, the current fast pace of growth (7.8 % in Q2) is raising increasing concerns in terms of sustainability. This is mainly connected to the fast expansion in private consumption which speeded up to a real 12.7 % from 10.9 % in Q1. Growth was also backed by investment activity up by 12.2 % yoy, bolstered by the restoration of flood-damaged infrastructure. By contrast, poorer performing exports together with higher imports resulted in some deterioration of the net external demand.

The significant acceleration in the pace of growth observed in H1 due to favourable weather conditions as well as the base effect from 2005 flooding support bright expectations for the rest of the year and indicate full-year growth of 7.2 %.

### 2007 Forecasts

Growth prospects remain positive next year on the back of EU accession with a gradual slowdown due to lowering consumption. Investment is expected to remain the fastest-growing component, following the strong stimulus coming from foreign direct investments, the chan-

neling of additional budget resources and the unfolding of a larger number of programs co-financed by the EU. Export growth is expected to recover slightly. Together with slower growth of imports, this will translate into some slight improvement in the net export contribution, although it remains negative. Overall, we forecast that full-year GDP growth will decelerate to 5.7 % next year.

### Leading indicators

After the outstanding performance observed in recent months, industrial production slowed-down its pace of growth in Aug – increasing by 6.7 % yoy – but remains at an encouraging level. The rebound in industrial activity registered so far was mainly driven by faster growth rates in capital goods and durables. We expect this positive trend to continue over the rest of the year, fostered by Romania's approaching integration into the EU and expected pick-up in foreign direct investment.

Sustained by fast expansion in economic activity, the unemployment rate further decreased in Sep to 5.0 % after having dropped gradually since the beginning of the year. In view of the planned lay-offs in state-owned companies, we expect some deterioration in the unemployment rate to stay on average at 5.7 % for the whole year.

### Monetary policy

The consumer price index reached its lowest level in more than 16 years, dropping to a 0.05 % monthly rate in Sep, after having posted a 0.07 % decrease in Aug for the first time since price liberalization in 1990. Annualized inflation thus eased to 5.5 % from the 6.0 % yoy registered in August. The seasonal drop in food prices – following last year's hike due to repeated floods – made the strongest contribution to disinflation over recent months. The lower growth in food prices even compensated for the hike in service prices resulting from higher excise taxes on certain energy items (electricity, natural gas) and the booming real estate market. A significant contribution in the disinflation process also came from the fiscal side, as the budget balance constantly posted a surplus over the first eight months resulting in lower pressures from the demand side.

In the coming months, the lower than projected impact of supply-side factors due to delayed administrative price adjustments originally planned for Q4 and favourable developments of some volatile food prices will support further disinflation. By contrast, the large and persistent excess demand due to continued robust growth in consumption and the considerable fiscal deficit that may build up in the last months of the year (considering the

## Macroeconomic trends

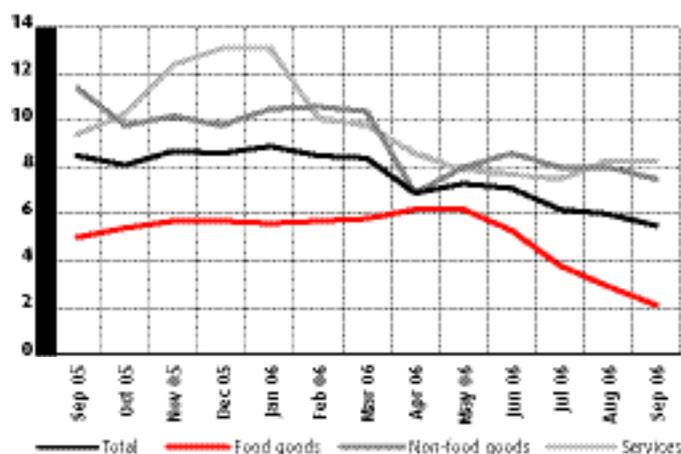
	Sept-05	Oct-05	Nov-05	Dec-05	Jan-06	Feb-06	Mar-06	Apr-06	May-06	Jun-06	Jul-06	Aug-06	Sept-06
Real GDP, yoy (%) <sup>1</sup>	3.6	-	-	4.1	-	-	6.9	-	-	7.4	-	-	-
Industrial production adj, yoy (%)	2.7	1.7	1.6	9.4	5.4	4.3	4.3	8.5	12.0	10.7	10.0	6.7	-
Inflation (CPI), yoy	8.5	8.1	8.7	8.6	8.9	8.5	8.4	6.9	7.3	7.1	6.2	6.0	5.5
Unemployment rate (%)	5.6	5.7	5.7	5.9	6.2	6.3	6.2	5.9	5.5	5.3	5.1	5.1	5.0
Exchange Rate/EUR, eop.	3.56	3.65	3.65	3.68	3.62	3.48	3.52	3.47	3.54	3.57	3.55	3.53	3.53
Cum Pub Balance, mn RON	2,061	3,850	2,879	-2,254	2,038	2,587	2,198	3,432	4,187	3,608	5,569	5,297	-
1M Buber, avg.	7.52	5.55	6.44	7.48	7.49	8.36	8.54	8.54	8.57	8.70	9.11	9.58	9.16
Export (Fob), mn EUR	2,072	1,941	2,029	1,819	1,774	2,105	2,338	1,868	2,307	2,281	2,214	2,001	-
Import (Cif), mn EUR	2,847	3,078	3,317	3,107	2,420	2,866	3,289	2,942	3,531	3,479	3,447	3,347	-
Trade balance, mn EUR	-774	-1,137	-1,288	-1,288	-645	-761	-951	-1,074	-1,224	-1,198	-1,233	-1,345	-
Cumulated CA, mn EUR <sup>2</sup>	-4,363	-4,891	-6,023	-6,891	-351	-893	-1,569	-2,349	-3,276	-4,170	-4,878	-	-

1) Cumulated up to end of the year; 2) Reinvested profit included

Sources: Central Bank, Central Statistical Office

## CPI inflation

yoy growth



Source: Statistical office

track record of recent years) continue to represent major inflationary risks in the near term. Overall, we estimate year-end inflation will be around 6.2% (slightly above the revised NBR target of 6.1%). In the first half of 2007, inflationary pressures are expected to resume due to a more sluggish decline in the output gap and further increases in prices for tradables and non-tradables as a result of EU entry. Given the uncertainty surrounding the magnitude and calendar of administrative price adjustments, we reckon next year inflation will gradually converge toward the upper edge of the target band pointing to a year-end forecast of 5.0%.

In the first 9M of the year, the NBR has continued to maintain a rather restrictive monetary policy stance in order to prevent any significant deviation from the current disinflationary path. Although the short-term inflation outlook has improved, the current pace of expansion of non-governmental credit may seriously threaten the achievement of the medium-term target. So far, the increases in reserve requirements on RON credits and in the policy rate (by 25 bps) implemented in June has proved to be quite ineffective in slowing-down credit growth with a new record high registered in August.

In the near term, persistent excess demand against the background of high growth rates in household consumption and an anticipated increase in budget

spending require a firm monetary policy stance. In this context, more efficient actions are needed in order to cushion household credit demand and boost household savings, creating space for further rate hikes of an overall 25 bps by year-end. Further tightening may also materialize in the first half of 2007, especially in the case of major deviations in the time profile of price adjustments, which would entail unexpected inflationary pressures on the supply side.

### Fiscal policy

In the first 8M of the year, the consolidated budget reached a surplus of 5.3 bn lei, corresponding to around 1.6% of the gross domestic product. Following several revisions made through the year, the government nearly tripled its 2006 budget deficit target to 2.5%. The last budgetary revision made in August provides for an increase in expenditures by RON 2,176 bn (or 0.66% of the GDP) for investments, education and healthcare and a RON 1,747 bn (0.53% of GDP) increase in estimated revenues. In the first 8M, revenues to the general aggregate budget topped RON 68 bn, slightly exceeding 20% of the projected GDP and far below the 40% average level registered in the EU Member States. Under the prospect of EU accession, Romania will need additional budget revenues to cover its contribution to the community budget (around 1.1 bn in 2007) as well as the co-financing of EU projects.

Given the fiscal surplus that has built up so far and poor budget planning, we still have doubts as to whether the planned target can be reached. Instead we believe that the year-end deficit will end up at some 2.2% of the GDP. Over the medium term, the need to boost infrastructure investments and increase absorption of EU funds will keep the budget deficit in the range of 2-3%. According to the draft budget for next year to be submitted to the Parliament by mid October, the deficit is expected to reach 2.8% of the GDP with substantial resources designated for road and rail infrastructure projects. IMF experts have recently reiterated the need for Romania to run a balanced budget this year and next. In this respect, the IMF asked the government to continue to implement prudent salary and tax policies in order to avoid missing the inflation targets and more importantly, to control the rising pressures on the external balance.

### Trade, CA and FDI

The foreign trade deficit has continued to advance over recent months, widening by 45% in August (around EUR 1.4 bn), on the back of an accelerated rate of imports. In the first 8M of the year, Romanian exports increased by 17%, totalling EUR 16.9 bn. Imports recorded a faster annual increase going up by 25% to reach EUR 25.3 bn. This acceleration is partly associated with the removal/reduction of customs duties for some agricultural and industrial products starting from February and the persistently high demand of investment goods. As a result of the widening trade gap, the current account deficit further deteriorated in Jan-Jul to EUR 4.9 bn, marking a robust 43% increase compared to last year. In the following months, pressures arising from robust investment growth in view of EU membership and loose fiscal performance will keep the trade deficit higher than expected. All in all, we reckon the current account deficit will deteriorate slightly beyond the initial projection to reach 10% of the GDP for the full year. Gradual improvement in the export capacities and lower appreciation of the RON over the forecasting horizon will help the external balance, which is expected to slow down gradually to 8.5% in 2008.

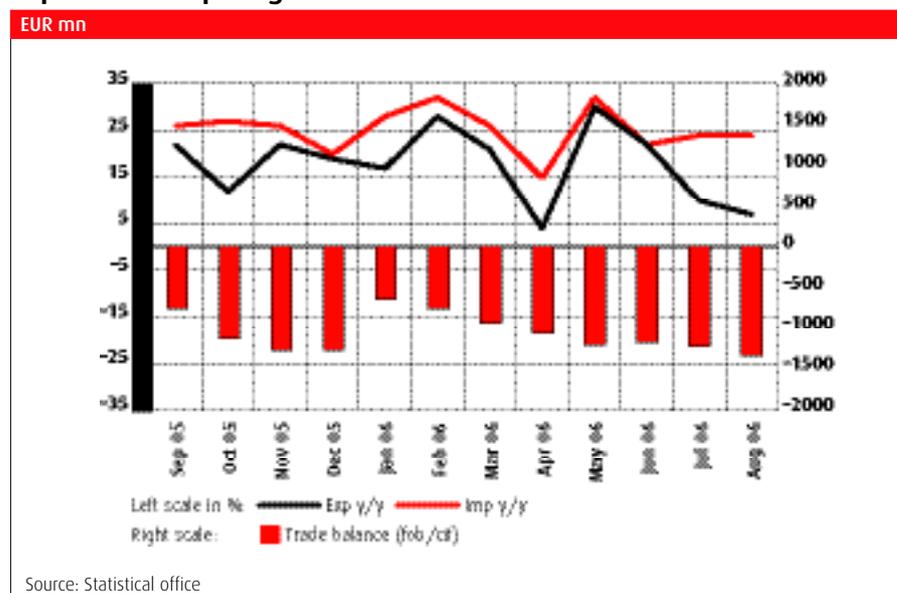
# Romania

FDI figures for the first 6M provide an indication of booming investment projects in the country. According to National Bank data, in the Jan-Jun period, FDI reached EUR 3.2 bn, amounting to over 50 per cent more than in the first half of last year. The improved business prospects in preparation for EU membership, the appealing tax system and the new investment act (still under discussion) to come into force from January 2007 create the conditions for increased FDI inflows expected to top EUR 7.6 bn this year (if the 2.2 bn from the BCR privatization to be finalized by the end of the year is included). The continual improvement in the Romanian economic/business environment and the reform progress made in view of EU accession in 2007 were the reasons for the recent upgrade in the country's ratings made by Moody's. As a result of the upgrade, the government's long-term and short-term foreign and local ratings were increased to Baa/P-3 with a stable outlook.

## EU Convergence

On 26 September the EU Commission finally gave Romania the green light to join the EU in 2007. In its long-awaited monitoring report the Commission acknowledged the progress made so far in reforming the economy, but at the same time set out a number of measures to ensure full compliance with EU standards. They include the possibility of withholding EU funding, the temporary suspension of EU rights, banning the sale of unsafe food and

## Export and import growth and trade balance



the non-recognition of certain civil and criminal judgments or arrest warrants. Among the main areas of concern to be closely monitored are corruption (particularly within local governments), the reform of the judicial system, food safety, financial management and control of future structural funds. As stressed by the EU Commission, particularly in the latter area there are real risks that the paying agencies and integrated administration and control system (IACS) will not function properly by the time of accession and it requires a tight timetable to meet deadlines due to the late start of preparations. So far, Romania was one of the main beneficiaries of EU pre-accession funds (some

EUR 2 bn in 2004–2006) though it did encounter problems as regards absorption and management (mainly for SAPARD). For 2007–2013 Romania is expected to benefit from some EUR 31 bn in structural funds, but the efficiency related to using this funding remains an open issue.

Following the accession, Romania will regularly report (twice a year) on the progress made in resolving these specific objectives. The first report is expected to be sent by 31 March 2007 with the Commission then reporting to the EU Parliament and Council by June on the progress made. This system will continue until all the objectives are attained.

Event	Date	Reading
NBR Board	November	NBR may decide on further tightening in monetary policy.
Consumer prices	Oct 11, Nov 10, Dec 12	Rising demand side pressures resulting from continued fast growth in private consumption and fiscal easing in the last months of the year will make further rate hikes still possible.