

2007-09
May 28, 2007

Romania

Foreign LT: BBB—→BBB/Stable, Local LT: BBB →BBB+/Stable (Upgraded on November 29, 2006)

<Rating Perspective>

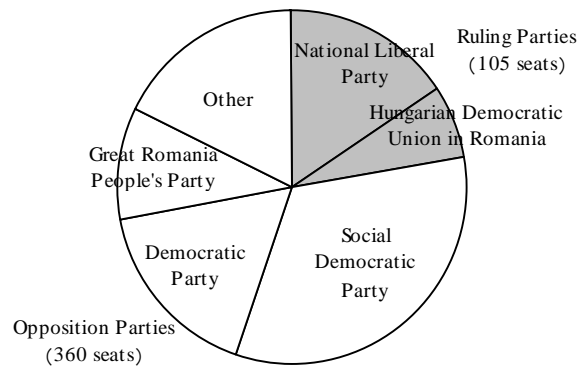
Positive Factors

- High economic growth prospects following the EU accession
- Substantial reduction of government debts
- Increasing exports on expanding production capacity rendered by massive inflows of foreign direct investment

Negative Factors

- Deteriorating current account deficit resulting from strong imports spurred by robust private-sector demand
- Transformation of industrial structure still at primary stage

The Lower and Upper House Parliamentary seats by Political Parties as of end April 2007



<Update: from February 2007 to April 2007>

Positive Factors

- Real GDP growth rate accelerated to 7.7% in 2006 from 4.1% in 2005
- Consumer price inflation in 2006 fell to 6.6%, renewing the lowest level on record.
- The general government fiscal debt (ESA95) at the end of 2006 narrowed to 12.4% of GDP, the lowest on record.
- The net inflow of foreign direct investments in 2006 doubled from 2005 to EUR 9.0 billion or 9.3% of GDP

Negative Factors

- The longstanding feud between Prime Minister Calin Popescu-Tariceanu and President Tarian Basescu finally came to the fore, resulting in the collapse of the center-right coalition government in March
- The IMF cautioned the Romanian government to tighten its fiscal and wage policies in response to the widening current account deficit on March 6
- The current account balance in 2006 hit a record EUR 9.97 billion deficit or 10.3% of GDP
- The general government fiscal deficit (ESA95) in 2006 widened to 1.9% of GDP from 1.4% in 2005

<Outlook and Points to Watch>

Reform momentum weakening

(1) Progress on reforms likely to slow amid unfavorable political developments

The longstanding feud between Prime Minister Tariceanu (National Liberal Party: NLP) and President Basescu (Democratic Party: DP) over Constitutional amendment and military deployment in Iraq finally came to the surface, resulting in the collapse of the center-right coalition government, which had led Romania to EU membership. This forced Prime Minister Tariceanu to reshuffle his cabinet to bar out DP. The new minority government took office on April 3 with the backing of the 150-member Social Democratic Party (SDL), which offered noncabinet support. Meanwhile, a parliamentary attempt of the prime minister to force the resignation of suspended President Basescu failed as his impeachment was rejected in a referendum on May 19.

The installation of the new coalition government appears to halt any further political instability at least temporarily. However, the feud between the prime minister and the president is likely to intensify further. Moreover, there is simmering concern over the policies to be pursued by the new government. Since the coalition government of NLP and the Hungarian Democratic Union in Romania commands only 105 out of 465 parliamentary seats, it will be forced to compromise with the opposition parties led by SDL on the ongoing structural reforms. The president will continue to press the prime minister for an early election, now scheduled for the end of 2008. This unfavorable political situation may inevitably slow the progress on structural reforms, which had been required by the European Commission prior to Romania's EU entry.

(2) Current account deficit deteriorating amid robust domestic demand in private sector

While the economy is growing faster than the country's growth potential on robust private-sector demand, the current account deficit continues widening amid economic expansion. GDP growth rate accelerated to a real 7.7% in 2006 from 4.1% in 2005 on strong consumer spending and investment. While consumer spending has been fueled by increased real wages, improved employment and swelling bank lending to the private sector, investment has been spurred by massive FDI inflows in recent years and EU subsidies for infrastructure investment (which will total EUR 30 billion over the seven years from 2007). The strong private-sector demand pushed up the current account deficit to 10.3% of GDP in 2006 from 8.7% in 2005. A further expansion of bank lending to households has been halted by a series of monetary tightening steps such as an increase of the reserve requirement ratio and interest rate hikes which have been implemented since the beginning of 2006. However, the growth of such lending remained high at 83% year-on-year in February 2007. By contrast, consumer price inflation in 2006 fell to 6.6%, the lowest on record. It slowed down further to 3.7% year-on-year in February 2007 on appreciation of the currency and falls in food prices. Wary of the deflationary trend, the National Bank of Romania cut its policy rate twice in February and March by a total 125bp to 7.5%.

(3) Fiscal policy loosened amid substantially reduced government debt

The general government fiscal deficit (ESA95) widened to 1.9% of GDP in 2006 from 1.4% in 2005. The government had initially targeted its deficit for 2006 at 0.5% of GDP, but revised it upward to 0.9% in April and then to 2.5% in late June. This upward revision stemmed from increased expenditures on investment in education, environment and transportation projects aimed to make full use of EU transfers. The actual fiscal deficit for 2006 proved somewhat smaller than the revised government projection. But it looks that the government has shifted its fiscal policy from restrictive to loosening. This loose fiscal policy is expected to be maintained in fiscal 2007, as the budget plan for the year envisages a fiscal deficit equivalent to 2.8% of GDP on increased expenditures. Meanwhile, the general government fiscal debt (ESA95) at the end of 2006 was reduced to a record 12.4% of GDP from 15.8% the year before.

(4) Despite widening current account deficit, refinance risk is mitigated on massive FDI inflow

The large current account deficit in 2006 was mainly covered by massive FDI inflows spurred by the country's EU accession and large-scale privatization. Foreign exchange reserves swelled to EUR 21.3 billion at the end of 2006, a level enough to cover 5.9 months of imports. Given the strong external liquidity position and the financing structure for the current account deficit, refinancing risk is largely mitigated. Furthermore, the country's financial system remains sound as the bad loan ratio is kept low despite the surging bank lending to the private sector.

(5) JCR watches progress on structural reforms and fiscal policy

In the run-up to the EU accession, the four-party coalition that took office in November 2004 went all-out to promote reforms. However, the momentum weakened after the European Commission finally endorsed Romania's EU accession in September 2006. In December 2006, the Conservative Party withdrew from the coalition and 29 MPs bolted from NLP to create the Liberal Democratic Party. In March 2007, the coalition government fell to a minority status after the exclusion of the DP from the coalition partners. JCR does not think that the current political situation will immediately affect its rating. But it will closely follow the policies to be pursued by the new minority government. The current policy mix is insufficient to curb the excessive domestic demand and that the government needs to adopt a restrictive fiscal policy to ensure sustainable economic expansion.

Main Economic Indicators: Romania

		2002	2003	2004	2005	2006	2007f	2008f
Real GDP growth rate	(%)	5.1	5.2	8.4	4.1	7.7	6.5	6.0
CPI (annual average)	(%)	22.5	15.3	11.9	9.0	6.6	4.0	4.5
Unemployment Rate	(%)	8.4	7.4	6.3	5.9	5.5	5.0	4.8
General gov. fiscal balance/GDP (ESA95)	(%)	-2.0	-1.5	-1.5	-1.4	-1.9	-2.5	-3.0
Gross general gov. debts/GDP(ESA95)	(%)	23.8	21.5	18.8	15.8	12.4	11.5	12.0
Current account balance/ GDP	(%)	-3.3	-6.0	-8.4	-8.7	-10.3	-11.8	-10.6
Trade balance/GDP	(%)	-5.7	-7.8	-8.8	-9.8	-12.1	-13.0	-11.4
Net FDI inflows/GDP	(%)	2.5	3.8	8.4	6.6	9.3	7.7	5.2
Foreign exchange reserve (FOREX)	(EUR)	5,877	6,374	10,848	16,795	21,300	24,500	27,500
Net FDI/CA	(%)	73.6	62.4	100.5	76.0	90.8	65.2	48.8
Gross external debt/ GDP	(%)	33.4	35.2	35.4	39.1	42.3	43.9	45.6
Gross external debt/ Export (G&S)	(%)	94.5	97.3	98.5	118.1	130.8	132.3	134.5
Public external debt/ Export (G&S)	(%)	53.6	52.7	47.7	46.4	37.2	28.5	24.6
Short term external debt/ Total	(%)	7.6	11.1	14.9	20.9	32.2	37.9	40.9
FOREX/monthly imports	(months)	3.5	3.4	4.8	5.8	5.9	5.8	5.8
FOREX/short-term external debt	(times)	4.8	3.2	3.4	2.6	1.6	1.3	1.2
Debt service ratio	(%)	24.2	20.8	21.9	18.0	20.0	20.0	21.0

Source: NBR, Ministry of Public Finance, National Institute of Statistics, Figures between 2007 and 2008 are based on JCR forecast
 Note: NBR introduced redenomination to new 1Leu (RON) for old 10,000Lei (ROL) in July 2005

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