

2007-22
August 29, 2007

Romania

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

<Rating Perspective>

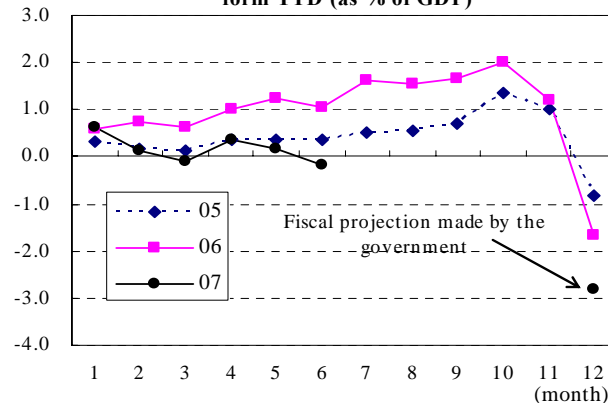
Positive Factors

- 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

Accumulated general government fiscal balance form YTD (as % of GDP)



<Update: from May 2007 to August 2007>

Positive Factors

- The European Commission, in its Progress Report released on June 27, avoided invoking the safeguard clause against Romania.
- Consumer price inflation rate in July stood at 4.0%, close to the record low.
- Growth of bank lending to consumers started declining from the beginning of 2007, falling to 62% year-on-year in June.

Negative Factors

- Real GDP growth rate decelerated to 6.0% in the January-March quarter of 2007 from 7.7% in the previous quarter on a substantial contraction of external demand. By contrast, Domestic demand continued expanding robustly.
- The current account deficit widened to 7.0% of GDP in the first half of 2007 from 3.9% in the same period the year before.
- The ratio of net FDI inflows to the current account deficit fell to 38% in the first half of 2007.
- The general government fiscal balance turned deficit in the first half of 2007, though the deficit was only a marginal 0.2% of GDP.
- The National Bank of Romania (NBR) lowered its policy rate three times by a total 100bp in May and June. The steep 175bp cut since the beginning of 2007 has given rise to concern that it may provide added fuel to the already strong domestic demand.

<Outlook and Points to Watch>

A Shift to loose fiscal policy

(1) Current account deficit continues widening amid robust private-sector demand

Real GDP growth rate slowed down to 6.0% in the January-March quarter of 2007 from 7.7% in the previous quarter on a major contraction of external demand. However, domestic demand kept on expanding, led by consumer spending and investment. The growth of consumer spending has been fueled by increased real wages, improved employment and swelling bank lending. Investment has been spurred by massive FDI inflows in recent years and EU subsidies for infrastructure development (which will total EUR 30 billion over seven years from 2007). The robust expansion of the private-sector demand has sent imports growing much faster than exports. Growth of bank lending to consumers swelled to 84% year-on-year at the end of 2006 but started declining from the beginning of 2007, shrinking to 62% in June.

Consumer price inflation stayed stable at 4.0% year-on-year in July after falling to a record 3.8% in March on appreciation of the currency and falls in food prices. The stable inflation encouraged the NBR to lower its policy rate three times by a total 100bp in

May and June. The steep 175bp reduction since the turn of 2007 could further accelerate the already strong domestic demand.

The current account deficit has continued growing since 2003 as strong domestic demand induced a strong expansion of imports. The deficit in the first half of 2007 widened to 7.0% of GDP from 3.9% in the same period the year before. As much as 91% of the current account deficit in 2006 was covered by net FDI inflows. However, the ratio fell to 38% in the first half of 2007. There is little short-term concern about the liquidity as the foreign exchange reserves stood at a level enough to cover more than five months of imports. However, an expansion of imports at the current pace could weaken the country's external financing structure.

(2) A shifted to loose fiscal policy

The general government fiscal balance in the first half of 2007 turned deficit, although the deficit was marginal at 0.2% of GDP. While revenues rose 17.8% year-on-year, expenditures surged as much as 28%. A breakdown of the balance shows that while the local governments and other special funds produced a surplus equivalent to 0.9% of GDP, the central government chalked up a 1.1% deficit. In the first half of 2006, the general government fiscal balance was in a surplus equivalent to 1.1% of GDP. The change seems to indicate that the government has now loosened its fiscal policy. The budget plan for 2007 envisages a fiscal deficit equivalent to 2.8% of GDP, signaling that the fiscal policy may further be eased, giving another boost to domestic demand.

(3) Progress on reforms likely to slow despite a lull in political instability

The smoldering feud between Prime Minister Calin Popescu Tariceanu (National Liberal Party: NLP) and President Traian Basescu (Democratic Party: DP) came to the surface, resulting in the collapse in March of the three party coalition government (NLP, DP and Hungarian Democrat Union in Romania: HDUR), which had led Romania to EU membership. This forced Prime Minister Tariceanu to reshuffle his cabinet, which was comprised of only NLP and HDUR members in the absence of DP. The new minority government (with only 73 out of 332 parliamentary seats) took office on April 3 with the backing of the 107-member Social Democratic Party (SDL), which offered non-cabinet support. Meanwhile, Prime Minister Tariceanu's attempt to force the resignation of suspended President Basescu failed as his impeachment was rejected in a referendum held on May 19.

The installation of the new coalition government may bring about a lull in political instability at least for the present. However, the feud between the prime minister and the president is likely to intensify. Moreover, there is simmering concern over the policies to be pursued by the new government because it will be forced to compromise with the opposition parties led by SDL.

(4) JCR watches the fiscal policy ahead of the general elections in 2008

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 (EC) finally endorsed Romania's EU accession in September 2006. In its Progress Report released on June 27, the EC hailed the overall reform progress made so far by Romania and stopped short of invoking the safeguard clause. However, it called for swift reforms on the judicial system and prompt actions against corruption and organized crime.

JCR thinks that the minority coalition government will not be able to make any significant progress on the reforms the country had been required to carry out upon its EU accession and that it will maintain a loose fiscal policy ahead of the parliamentary and presidential elections slated for 2008. The current account deficit may further widen as such policy and the NBR's rate cuts will make it harder to hold down the strong domestic demand. JCR will closely follow the fiscal policy to be pursued by the new minority government. Any substantial deterioration of the fiscal deficit would prompt JCR to consider a possible revision of its ratings.

Main Economic Indicators: Romania

		2002	2003	2004	2005	2006	2007f	2008f
(Convergence criteria)	Criteria							
1.CPI (annual average)	3.0%(note)	22.5	15.3	11.9	9.0	6.6	4.0	4.5
2.10 year government bond yield	5.4%(note)	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.	n.a.
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-2.0	-1.5	-1.5	-1.4	-1.9	-3.0	-3.3
4.General gov't debt/GDP(ESA95)	Below 60%	23.8	21.5	18.8	15.8	12.4	10.5	9.2
Real GDP growth rate	(%)	5.1	5.2	8.4	4.1	7.7	6.5	6.0
Unemployment Rate	(%)	8.4	7.4	6.3	5.9	5.5	5.0	4.8
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 mn)	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	35.1	35.4	39.1	41.9	45.7	49.0
Gross external debt/ Export (G&S)	(%)	94.5	97.3	98.5	118.1	129.5	137.8	144.5
Public external debt/ Export (G&S)	(%)	53.6	52.7	47.7	46.4	36.0	33.9	32.3
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: The European Commission, The NBR, Ministry of Public Finance, National Institute of Statistics. Figures for criteria 1 and 2 are average between May 2006 and April 2007. Figures for 2007 and 2008 are based on the projection made by JCR

Note: NBR introduced redenomination to new 1Leu (RON) for old 10,000Lei (ROL) in July 2005

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