

## Romania

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

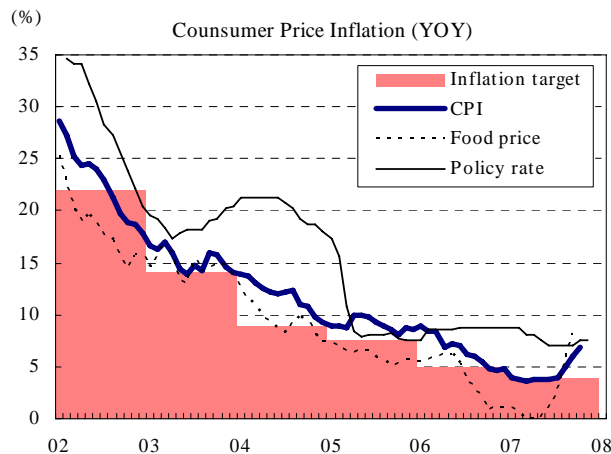
### <Rating Perspective>

#### 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



### <Update: from August 2007 to October 2007>

#### Positive Factors

- The National Bank of Romania (NBR) at last raised its policy rate by a 50bp on October 31, taking into account the rising inflation expectation.

#### Negative Factors

- The European Commission pointed out the serious shortcomings in Romania's administration and financial control system of farm subsidy from the EU on October 10. The EC will cut its farm subsidy to Romania without significant improvement.
- Consumer price inflation rate in October rose to 6.8% year-on-year on the surge in food prices.
- Real GDP growth rate decelerated to 5.6% in the April-June quarter of 2007 from 6.0% in the previous quarter on a substantial contraction of external demand. By contrast, Domestic demand continued expanding robustly.
- The current account deficit widened to 8.8% of GDP in the first eight of 2007 from 5.6% in the same period the year before.
- The ratio of net FDI inflows to the current account deficit fell to 41% in the first eight months of 2007.
- The general government fiscal surplus narrowed to 1.5% of GDP in the first eight months of 2007 from 1.6% in the same period the year before.
- Substantial increase in pensions was brought forward to November 2007 from 2008.

### <Outlook and Points to Watch>

#### Focusing on refinancing of growing C/A deficit

##### **(1) Current account deficit continues widening amid robust domestic demand**

The robust acceleration of the Romanian economy since the beginning of 2006 lost some steam later on, with a real GDP growth rate in the first half of 2007 slowing down to 5.8% year-on-year, a level closer to the country's potential growth rate. However, domestic demand kept on accelerating led by consumer spending, investment and government spending while net exports dragged down the economy considerably as the growth of imports outpaced that of exports. Consumer price inflation, which fell to a record low 3.7% year-on-year in March, rose to 6.8% in October on higher food prices caused by the summer drought. The National Bank of Romania (NBR) moved to raise its policy rate by 50 basis points to 7.5% at the end of October after cutting the rate four times by a total 175bp between March and June. The growing inflation pressure stemming from wage increases and tightening supply-demand gap may force NBR to carry out another rate hike in the coming months.

##### **(2) Fiscal policy looks likely ineffective in curbing excessive domestic demand**

The general government fiscal deficit (ESA95), which had been narrowing since 2000, began widening moderately in 2006, with its ratio to GDP rising to 1.9%, up from 1.4% in 2005. Much of the deterioration came from increased spending on higher wages

for public employees and infrastructure investment. Revenues were in line with what had been envisaged in the initial budget plan. The general government fiscal balance (cash accounting) in the first eight months of 2007 produced a marginal surplus equivalent to 0.5% of GDP, though smaller than the 1.6% logged a year earlier. The fiscal balance in 2007 as a whole is likely to end in a deficit equivalent to around 2.7% as planned by the government, given the substantial increase in pension benefits starting in November and the usual year-end spending pattern in recent years. The government has estimated the fiscal deficit in 2008 at 2.7% of GDP under its budget plan for the year. Indications are that the budget plan will have only a limited effect in curbing the excessive domestic demand as in 2007. Moreover, there is concern that budget spending will be expanded to win votes in the 2008 elections. In contrast, the government fiscal debt has continued narrowing since 2002. It stood at an extremely low 12.4% of GDP at the end of 2006.

### (3) Refinancing of widening current account deficit depends more on foreign capital

The current account deficit has continued growing since 2003 to reach 10.3% of GDP in 2006 as strong domestic demand induced a robust expansion of imports. With the deficit in the first eight months of 2007 already reaching 8.8% of GDP, up from 5.6% in the same period the year before, a full-year deficit is likely to widen to around 13%. In 2006, as much as 91% of the current account deficit was covered by net FDI inflows. However, as the ratio fell to 40% in the first eight months of 2007, the country had to depend more on debt-creating foreign capital induced through banks. 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 and the foreign debt was kept low at around 45% of GDP in August 2007 despite a recent rise in the private-sector debt. The banking sector remains well positioned to absorb adverse shocks, with more than 80% of bank capital controlled by foreign banks, although there is a growing concern over the rapid increase in foreign currency-denominated loans and household loans.

### (4) Ahead of 2008 elections, concern growing over spending pressure and delay in structural reforms by the minority government

The three-party coalition government (National Liberal Party: NLP, Democratic Party: DP and Hungarian Democrat Union in Romania: HDUR), which had led Romania to EU membership, collapsed in March after the smoldering feud between Prime Minister Calin Popescu Tariceanu (NLP) and President Trian Basescu (DP) finally came to the fore. The current two-party minority government, comprising the NLP and HDUR, controls only 75 out of 322 parliamentary seats. Since taking office in April, it has depended on non-cabinet support of the Social Democratic Party (SDP), the largest opposition force with 103 parliamentary seats. Romania is set to have local elections in the middle of 2008, general elections in late 2008 and presidential election in early 2009. With both the coalition parties and the SDP struggling with their slumped approval ratings, there is growing concern that spending pressure may mount as the elections draw nearer.

### (5) Current credit standing could be maintained at least in the short-term

With general elections slated in 2008, the minority coalition government finds it harder to promote a restrictive fiscal policy aimed at reining excessive domestic demand. In this situation, a large current account deficit induced by expanding imports is likely to persist, forcing the country to refinance the deficit with more debt-creating foreign capital in addition to FDI inflows. Given its ample foreign exchange reserves and relatively small foreign debt, however, the country should be able to manage its external finance at least in the short-term. The impact on the economy of the ongoing credit crunch in industrialized countries has been rather limited so far as the depreciation of the Romanian lei has been only moderate. JCR will closely monitor the fiscal policy to be taken by the minority coalition government.

## Main Economic Indicators: Romania

		2002	2003	2004	2005	2006	2007f	2008f
<b>(Convergence criteria)</b>	<b>Criteria</b>							
1.CPI (annual average)	2.4%(note)	22.5	15.3	11.9	9.0	6.6	4.6	5.0
2.10 year government bond yield	5.5%(note)	n.a.	n.a.	n.a.	7.0	7.2	7.3	7.5
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-2.0	-1.5	-1.5	-1.4	-1.9	-3.0	-3.0
4.General gov't debt/GDP(ESA95)	Below 60%	23.8	21.5	18.8	15.8	12.4	11.2	10.6
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	5.8	5.4	4.5	3.8
Current account balance/ GDP	(%)	-3.3	-6.0	-8.4	-8.7	-10.3	-13.4	-14.2
Trade balance/GDP	(%)	-5.7	-7.8	-8.8	-9.8	-12.1	-14.4	-14.8
Net FDI inflows/GDP	(%)	2.5	3.8	8.4	6.6	9.3	6.4	5.6
Foreign exchange reserve (FOREX)	(EUR mn)	5,877	6,374	10,848	16,795	21,310	26,500	28,500
Net FDI/CA	(%)	73.6	62.4	100.5	76.0	90.8	47.6	39.6
Gross external debt/ GDP	(%)	33.4	35.1	35.4	39.1	41.9	43.2	44.5
Gross external debt/ Export (G&S)	(%)	94.5	97.3	98.5	118.1	129.5	136.9	146.7
Public external debt/ Export (G&S)	(%)	53.6	53.0	45.8	42.9	34.0	28.0	29.0
FOREX/monthly imports	(months)	3.5	3.4	4.8	5.8	5.9	5.9	5.4
FOREX/short-term external debt	(times)	4.8	3.2	3.4	2.6	1.6	1.7	1.6
Debt service ratio	(%)	21.1	16.9	16.4	13.5	13.4	11.6	10.6

Source: The European Commission, The NBR, Ministry of Public Finance, National Institute of Statistics, Figures for criteria 1 and 2 are average between October 2006 and September 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

(Toshihiko Naito, Senior Analyst)