2008-07
May 28, 2008

Romania

Foreign LT: BBB/Stable, Local LT: BBB+/Stable

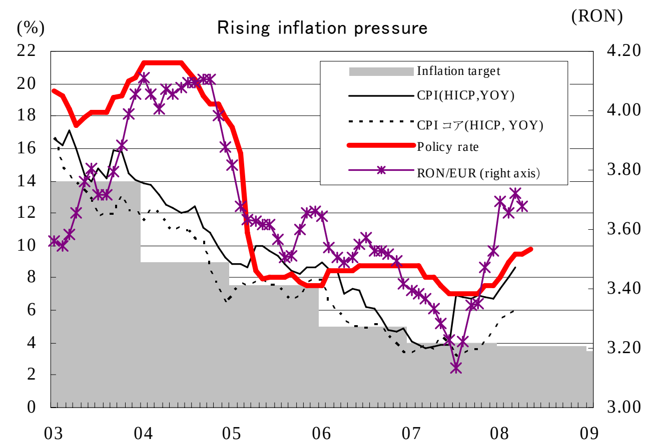
<Rating Perspective>

Positive Factors

- Better economic growth prospects following EU accession
- Substantial reduction of government debt
- Expanding production capacity rendered by massive inflows of foreign direct investment

Negative Factors

- Concern over further deterioration of the fiscal deficit prior to general elections
- Surging current account deficit stemming from strong imports amid robust private-sector demand
- Transformation of industrial structure still at primary stage



<Update: from February 2008 to April 2008>

Positive Factors

- The National Bank of Romania (NBR) raised its policy rate by a total 175 bps to 9.75% on February 4, March 27 and May 7 amid prospects that prices may rise faster than its inflation target at the end of 2008 (3.8%±1pp). The policy rate has been raised five times, by a total 275bps, since the current series of monetary tightening began in November 2007
- In response to a warning from the European Commission, the government revised downward its fiscal deficit target under the 2008 budget plan from 2.75% of GDP to 2.3% on March 5
- NBR decided in February to increase the provision for foreign currency-denominated bank loans
- Increased exports following currency depreciation contributed to moderating the growth pace of the current account deficit. In the first two months of 2008, the current account deficit grew a moderate 5% to EUR 2,193 million or 1.7% of GDP

Negative Factors

- Consumer price inflation surged to 8.7% year-on-year in March 2008 on higher food and energy prices, currency depreciation and increased wages. Core inflation rate excluding food and energy prices also accelerated to 6.1% year-on-year
- Domestic demand continued expanding robustly, as the real GDP growth rate in the October-December quarter of 2007 accelerated to 6.6% year-on-year from 5.8% in the previous quarter
- General government fiscal deficit (ESA95) in 2007 widened slightly to 2.5% of GDP from 2.2% in 2006
- Growth of bank lending to the private sector remained high at 65.6% year-on-year in March 2008

<Outlook and Points to Watch>

Fragile financing structure of C/A deficit

(1) Despite economic slowdown, domestic demand remains robust

Domestic demand remained robust led by consumer spending and investment, although the real GDP growth rate in 2007 slowed down to 6.0% from 7.9% in 2006. While the growth of consumer spending in 2007 throttled down to 10.2% from 11.4% in 2006, investment expanded a robust 28.9% after a 19.3% gain the previous year. As a result, the growth of the whole domestic demand sped up to 13.1% from 12.5%. In contrast, economic expansion was held down considerably by a major contraction of net exports as imports grew faster than exports on strong domestic demand. The bank lending to the private sector, which fueled consumer spending, kept swelling by 65.6% year-on-year in March 2008. Consumer price inflation started accelerating from the beginning of 2007, surging to 8.7% year-on-year in March 2008 on higher food and energy prices, currency depreciation and increased wages. Against this backdrop, the NBR raised its policy rate by 25 bps to 9.75% on May 7 amid prospects that prices may go up faster than its inflation target at the end of 2008 (3.8%±1pp). The policy rate has been raised five times, by a total 275 bps, since the current series of credit tightening began in November 2007. In February, the NBR took an additional measure to increase the provision for foreign currency-denominated bank loans with the aim of reining in the strong credit growth rate. The growing inflation pressure stemming from wage increases and currency depreciation may force the NBR to carry out another rate hike in the

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coming months. While a rapid increase in foreign currency-denominated loans to households and a modest gain in nonperforming loans may be a source of concern, the country's banking system remains well positioned to absorb adverse shocks, with the key banking indicators kept sound.

(2) Financing of the current account deficit remains fragile

The current account deficit has kept widening since 2003 on strong import growth spurred by robust domestic demand. It reached 14.0% of GDP in 2007. Increased exports following currency depreciation contributed to moderating the growth pace of the current account deficit. In the first two months of 2008, the deficit grew a slower 5% to EUR 2,193 million or 1.7% of GDP. Nonetheless, the ratio of net FDI inflows to the current account deficit in the same period remained low at 55.5%, although somewhat improved from 42.3% at the end of 2007. The country's financing of the current account deficit is rather fragile as it heavily depends on the inflows of deposits and loans from overseas investors. Therefore, its financial market is susceptible to a global credit crunch. In fact, the value of its currency and bond and stock prices dropped substantially since last summer. JCR holds that there is little short-term concern about the country's external liquidity as its foreign exchange reserves at the end of 2007 stood at a level enough to cover more than five months of imports. However, it will carefully watch the financing of the current account deficit.

(3) The government revises 2008 fiscal deficit downward

The general government fiscal deficit (ESA95), which had been narrowing since 2000, widened moderately to 2.2% and 2.5% of GDP in 2006 and 2007, respectively. The bigger deficit in 2007 was due mainly to a substantial increase in pension benefits prior to the general election. The government had initially envisioned a fiscal deficit equivalent to 2.75% of GDP in its 2008 budget plan. Following a warning from the European Commission, however, it revised the deficit estimate downward to 2.3% on March 5. The revision focused on spending cuts. JCR appreciates the government decision, but considers that a further reduction of expenditures is necessary to rein in the excessive domestic demand. The revenue projection in the 2008 budget plan is rather optimistic. Moreover, the budget plan envisages another increase in pension benefits and a cut in social security contributions.

The government unveiled the utilization of the EU subsidy in 2007. Romania was entitled to receive EUR 2.03 billion or 1.7% of GDP in 2007 from the EU. However, the country actually used only EUR 0.44 billion or 21.7% of the total. As a result, it became a net contributor to the EU budget, making contributions equivalent to 0.36% of GDP in the year. New EU member countries receive a significant amount of subsidy from the EU to help finance infrastructure investment and regional development. It is imperative for Romania to accelerate its economic growth by making an effective use of the subsidy.

(4) Spending pressure may grow ahead of November elections

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 2007 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 332 parliamentary seats. Since taking office in April 2007, it has depended on non-cabinet support from the Social Democratic Party (SDP), the largest opposition force with 103 parliamentary seats. Romania is set to have local elections in June 2008, general elections in November 2008 and presidential election in early 2009. With both the coalition parties and the SDP struggling with their slumped approval ratings, the government finds it hard to promote a restrictive fiscal policy aimed at curbing the excessive domestic demand. JCR will watch how the government will execute the revised 2008 budget plan. It will initiate a review of the rating outlook if the fiscal deficit deteriorates drastically.

Main Economic Indicators: Romania

		2003	2004	2005	2006	2007	2008f	2009f
(Convergence criteria)	**Criteria**							
1.CPI (annual average)	2.8%(note)	15.3	11.9	9.0	6.6	4.8	7.8	4.5
2.10 year government bond yield	5.7%(note)	n.a.	n.a.	7.0	7.2	7.1	7.5	7.2
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-1.5	-1.2	-1.2	-2.2	-2.5	-3.2	-2.8
4.General gov't debt/GDP(ESA95)	Below 60%	21.5	18.8	15.8	12.4	13.0	14.5	15.0
Real GDP growth rate	(%)	5.2	8.5	4.2	7.9	6.0	5.8	5.5
Unemployment Rate	(%)	7.4	6.2	5.8	5.4	4.3	4.4	4.5
Current account balance/ GDP	(%)	-6.0	-8.4	-8.7	-10.4	-14.0	-16.5	-13.8
Trade balance/GDP	(%)	-7.8	-8.8	-9.8	-12.0	-14.6	-17.3	-14.7
Net FDI inflows/GDP	(%)	3.8	8.4	6.6	8.9	6.0	4.9	5.1
Foreign exchange reserve (FOREX)	(EUR mn)	6,374	10,848	16,796	21,310	25,307	28,500	31,500
Net FDI/CA	(%)	62.4	100.5	76.0	85.9	42.4	29.7	36.9
Gross external debt/ GDP	(%)	35.2	34.7	39.1	42.7	46.5	52.4	53.9
Gross external debt/ Export (G&S)	(%)	97.7	96.5	118.1	132.8	151.6	158.5	157.8
Public external debt/ Export (G&S)	(%)	53.0	45.8	46.3	38.0	36.8	32.9	29.0
FOREX/monthly imports	(months)	3.4	4.8	5.8	5.9	5.6	5.2	5.0
FOREX/short-term external debt	(times)	3.2	3.4	2.6	1.6	1.4	1.3	1.1
Debt service ratio	(%)	16.9	16.4	13.5	13.4	11.5	10.4	8.7

Note: Figures for criteria 1 and 2 are moving average between April 2007 and March 2008. Figures for 2008 and 2009 are based on the projection made by JCR
Source：The European Commission, the NBR, Ministry of Public Finance and National Institute of Statistics

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