

Romania

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

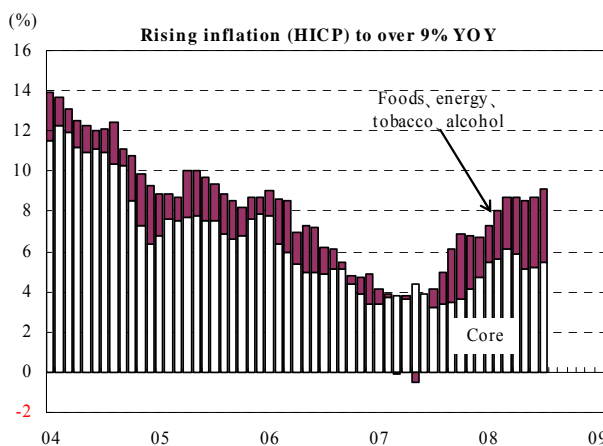
<Rating Perspective>

Positive Factors

- High 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 May to July 2008>

Positive Factors

- The National Bank of Romania (NBR) raised its policy rate by a total 75 bps to 10.25% on May 7, June 27 and August 1 amid prospects that price increases may prove higher than its inflation target at the end of 2008 (3.8%±1pp). Policy rate has been raised seven times, by a total 325 bps, since the current cycle of monetary tightening began in November 2007
- Increased exports following currency depreciation contributed to moderating the growing pace of the current account deficit as the deficit widened a moderate 3.8% year-on-year to EUR6,526 million or 5.0% of GDP in the first five months of 2008
- Net foreign direct investment (FDI) in the first five months of 2008 increased 48.3% year-on-year to EUR4,114 million or 3.1% of GDP following privatization of an electricity company
- The ratio of net FDI to the current account deficit in the first five months of 2008 improved to 63% from 42.4% in 2007
- Growth of bank lending to the private sector decelerated slightly to 61.3% year-on-year from a peak 66.8% in January 2008

Negative Factors

- The European Commission (EC) criticized Romania in a report published on July 23 for delayed progress in judicial reforms and fight against corruption
- Consumer price inflation (Eurostat) surged to 9.1% year-on-year in July 2008. Core inflation rate excluding foods and energy also rose to 5.5% year-on-year

<Outlook and Points to Watch>

Growing spending pressure ahead of general elections

(1) Continued economic expansion driven by domestic demand amid rising inflation

Romania's real GDP growth rate in the January-March quarter of 2008 accelerated to 8.2% year-on-year from 6.0% in 2007, as robust domestic demand combined with the effect of the leap year. Domestic demand grew a strong 15.9% year-on-year, paced by the expansion of consumer spending and investment as well as government expenditures apparently tied to the general elections scheduled for November. In contrast, the economic growth was contracted considerably by a steep fall of net exports as imports grew faster than exports on strong domestic demand (contribution to the GDP growth rate was -10.3% year-on-year). Fueling personal consumption was a robust growth of bank lending to the private sector and real wages. While the growth of bank lending decelerated slightly to 61.3% year-on-year in May from a peak 66.8% in January 2008, the increase of real wages in the same month remained high at 17% year-on-year. The consumer price inflation, which started accelerating from the beginning of 2007 on higher food and energy prices, currency depreciation and rising wages, surged to 9.1% year-on-year in July 2008 following hikes of electricity and gas rates and tobacco tax rates. Against this backdrop, the NBR raised its policy rate three times by a total 75 bps to 10.25% on May 7, June 27 and August 1 amid prospects that prices may soar above its inflation target at the end of 2008 (3.8%±1pp). The policy rate has been raised seven times, by a total 325 bps, since the current cycle of monetary tightening began in November 2007.

The growing inflationary pressure stemming from wage increases and currency depreciation may force NBR to carry out another rate hike in the coming months. While a rapid expansion of foreign currency-denominated loans to households and growing nonperforming loans may be a source of concern, the country's banking system remains well positioned to absorb possible adverse shock as bank management indicators stay at sound levels.

(2) Fragile financing structure somewhat improves

The current account deficit has kept widening since 2003 on a strong import growth spurred by robust domestic demand, reaching 14.0% of GDP in 2007. Increased exports following currency depreciation contributed to moderating the growing pace of the current account deficit. The deficit in the first five months of 2008 came to EUR6,526 million, up a moderate 3.8% year-on-year or 5.0% of GDP. Net foreign direct investment (FDI) grew 48.3% in the same five-month period to EUR4,114 million or 3.1% of GDP due mainly to the influx of foreign capital following privatization of an electricity company. As a result, the ratio of net FDI to the current account deficit during the period improved to 63% from 42.4% in 2007. There is little short-term liquidity concern as the foreign exchange reserves stood at a level enough to cover more than six months of imports. However, the current financing of the current account deficit is rather fragile as it is highly dependent on deposits by and loans from overseas investors. In this sense, it should be noted that Romania's financial structure remains susceptible to changes in the global financial market.

(3) Growing spending pressure ahead of general elections in November 2008

The government announced a downward revision of its fiscal deficit estimate for 2008 from 2.75% of GDP to 2.3% following a caution by the European Commission in March. The revision took the form of cuts in budget expenditures. The general government fiscal deficit in the first half of 2008 widened to 1.3% of GDP from 0.2% the year before. With expenditures accelerating since the beginning of the year ahead of the general elections and with increases in pension benefit and cuts of VAT on foods in the pipeline, there is the greater possibility that the fiscal deficit in 2008 will exceed the revised estimate. JCR will watch how the government will execute its revised 2008 budget plan. A review of the current ratings will be initiated if the fiscal deficit deteriorates drastically.

(4) NLP holds the key to formation of next coalition government

The three-party coalition government (National Liberal Party: NLP, Democratic Liberal Party: DLP 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 (DLP) finally came to the fore. The current two-party minority government, comprising the NLP and HDUR, controls only 75 out of the 332 parliamentary seats. Since taking office in April 2007, it has depended on outside support from the Social Democratic Party (SDP), the largest opposition force with 103 parliamentary seats.

The opposition SDP and DLP won the local elections held in June 2008. They came top and second, respectively, by winning around 28% of the votes. The ruling NLP came third, but managed to gain better-than-expected voter support as it fought the elections in cooperation with SDP. The local elections had been seen as a touchstone of the general elections scheduled for November and the presidential election slated for early 2009. The fact that SDP and DLP had a neck-and-neck battle in the local elections may mean that NLP will hold the key to formation of a new coalition government after the general elections. Given the continuing feud between their leaders, chances of an NLP-DLP coalition will be rather remote. NLP may rather choose to team up with SDP.

Main Economic Indicators: Romania

		2003	2004	2005	2006	2007	2008f	2009f
(Convergence criteria)	Criteria							
1.CPI (annual average)	3.5%(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	6.5	6.0
Unemployment Rate	(%)	7.0	8.1	7.2	7.3	6.4	6.0	5.5
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	5.7	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	34.4	36.9
Gross external debt/ GDP	(%)	35.2	34.7	39.1	42.7	46.5	50.9	53.9
Gross external debt/ Export (G&S)	(%)	97.7	96.5	118.1	132.8	151.6	146.1	149.9
Public external debt/ Export (G&S)	(%)	53.0	45.8	46.3	38.0	36.8	30.3	27.6
FOREX/monthly imports	(months)	3.4	4.8	5.8	5.9	5.6	5.1	4.9
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	9.8	8.2

Note: Figures for criteria 1 and 2 are moving average between July 2007 and June 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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