

## Romania

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

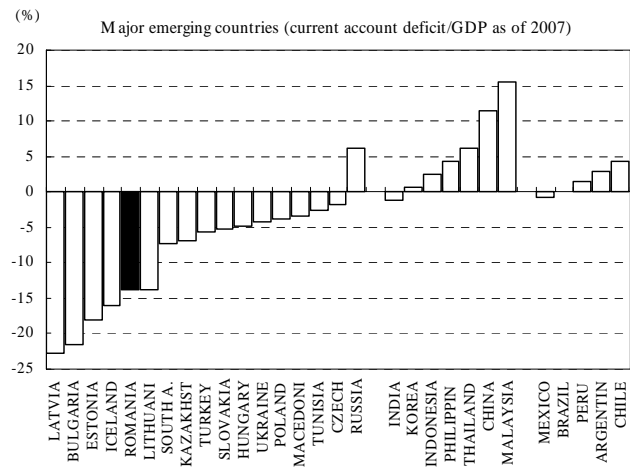
### <Rating Perspective>

#### 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 August to October 2008>

#### Positive Factors

- Foreign exchange reserves totaled EUR27.3 billion at the end of October 2008, up from EUR26 billion the month before
- The current account deficit/GDP ratio in the first eight months of 2008 fell to 7.7% from 8.2% in the same period the year before
- The growth of bank lending to the private sector in August 2008 moderated further to 50.4% year-on-year on substantial deceleration of foreign currency-denominated loans
- The inflation rate in September decelerated to 7.0% year-on-year from a peak 9.1% in July due mainly to lower food prices
- On October 30, the National Bank of Romania (NBR) decided to lower the minimum reserve requirement ratio on Romanian currency (RON)-denominated liabilities of credit institutions to 18% from 20% in a bid to stabilize liquidity on the interbank money market

#### Negative Factors

- The spillover effect of the global financial turmoil forced the Romanian currency to depreciate by 27% against the US dollar and 2.3% against the euro in the three months to the end of October 2008
- Wages continued to rise faster than productivity improvement
- The general government fiscal balance in the first eight months of 2008 ended in a deficit equivalent to 1.1% of GDP in a turnaround from a surplus equivalent to 0.3% of GDP the year before
- Industrial production in August 2008 contracted 1.5% year-on-year for the first setback in three years

### <Outlook and Points to Watch>

#### Growing concern over the external financing

**(1) The deepening global financial crisis takes a heavy toll on currencies of the Central and East European countries (CEECs)**

The currencies of some emerging countries fell sharply as the global financial crisis intensified. The exchange rates of the CEEC currencies, which had strengthened over the past years, started weakening in July on the growing concern over the external financing, falling more steeply against the US dollar than those of other emerging economies since September following the collapse of Lehman Brothers. This is apparently because as the global financial turmoil deepened, foreign investors moved to reprice their risks inherent in the CEECs whose current account deficits are prominently larger than those of other emerging countries. Like other currencies in the CEECs, the Romanian RON sank to the lowest level in almost three years to around RON2.9 against the US dollar, depreciating 27% (2.3% against the euro) from July to the end of October. Adding fuel to the plunge were growing concerns over the country's heavy current account deficit and widening fiscal deficit following increased expenditures prior to general elections scheduled on November 30. Stock prices (BSE index) also plummeted to the lowest level in four years. The interbank rates fluctuated violently, staying substantially higher than the NBR's policy rate (the overnight rate stood at 15.93% at the end of October).

**(2) Policy responses by government and NBR**

The government revised its fiscal estimate for 2008 twice in July and September. While increasing expenditures by RON11.4

billion (0.002% of GDP), the government kept its deficit estimate unchanged at 2.3% of GDP. On September 24, the government decided on a partial suspension of the capital gains tax on profit from stock trading in 2009 in a bid to stimulate the slumped stock market. Furthermore, the planned increase in pension benefits initially scheduled for January 2009 was brought forward to October 2008. On November 13, the government announced a fiscal stimulus package totaling EUR10 billion (7.5% of GDP) in fresh investment over the next four years. However, it did not clarify how the additional investment will be funded.

On the other hand, the NBR raised its policy rate from 10.0% to 10.25% on August 1. It has since kept the rate intact on the assumption that inflation has already peaked out. On October 30, the NBR decided to lower the minimum reserve requirement ratio on RON-denominated liabilities to 18% from 20% in a move to stabilize liquidity on the interbank money market.

### (3) The economy may sharply slow down in the latter half of 2008

The fast growing Romanian economy has taken a steep downturn in recent months. Real GDP growth rate in the April-June quarter of 2008 accelerated further to 9.3% year-on-year from 8.2% in the previous quarter. By contrast, however, the industrial production in August 2008 fell 1.5% year-on-year for the first contraction in three years. The robust growth of bank lending to the private sector, which had fueled strong personal consumption, decelerated to 50.4% year-on-year in August from a peak 66.8% in January 2008. The growth of exports also slowed to 16.9% year-on-year in August amid a sharp slowdown of the European economies, Romania's major export markets. These indicate that the economy is rapidly losing steam at the moment. Even considering the positive effect of the economic stimulus package, the growth rate is likely to decelerate to the 4% level in 2009. The consumer price inflation, which surged to 9.1% year-on-year in July 2008, improved to 7.0% in September on stabilization of food prices. The financial system has been disturbed by the global financial crisis. The growing volume of nonperforming loans and rising funding costs are highly likely to squeeze the profitability of banks in the future. In particular, as foreign currency-denominated loans to households account for 55% of the total private-sector lending, nonperforming loans will inevitably expand further due mainly to increased debt burdens brought by the depreciation of the Romanian currency.

### (4) External financing remains worrisome amid deepening global financial crisis

The current account deficit, a cause for major concern, improved to 7.7% of GDP in the first eight months of 2008 from 8.2% in the same period the year before. Net foreign direct investment (FDI) inflows in the same eight-month period increased to 4.9% of GDP from 3.9% the year before due mainly to the influx of foreign capital following privatization of an electricity company. As a result, the ratio of net FDI inflows to the current account deficit during the period improved to 65% from 42.4% in 2007. With regard to short-term liquidity, Romania will be able to finance its fund requirements for 2008 (current account balance - net FDI inflows + debt service expenses) estimated at around EUR18 billion, considering its increased foreign exchange reserves which totaled EUR27.3 billion at the end of October 2008. However, as Romania had short-term external debt totaling EUR17.8 billion as of the end of June, it might face financing difficulties should the deepening global financial turmoil prompt foreign investors to withdraw their short-term funds from the country. JCR will consider a revision of its ratings after reviewing the worsening economic and financial conditions as well as developments in the country's external financing.

### (5) Next government looks likely to be a coalition led by SDP and NLP

The two main opposition parties, the Social Democratic Party (SDP) and the Democratic Liberal Party (DLP), had a neck-and-neck battle in the local elections held in June. This may mean that the ruling National Liberal Party (NLP) will hold the key to the formation of a new coalition government after the general elections scheduled for November 30. 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
<b>(Convergence criteria)</b>	<b>Criteria</b>							
1.CPI (annual average)	4.0%(note)	15.3	11.9	9.0	6.6	4.9	7.8	4.5
2.10 year government bond yield	5.7%(note)	n.a.	n.a.	7.0	7.2	7.1	n.a.	n.a.
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-1.5	-1.2	-1.2	-2.2	-2.6	-3.6	-2.8
4.General gov't debt/GDP(ESA95)	Below 60%	21.5	18.8	15.8	12.4	12.9	14.5	15.7
Real GDP growth rate	(%)	5.2	8.5	4.2	7.9	6.0	6.5	4.5
Unemployment Rate	(%)	7.0	8.1	7.2	7.3	6.4	6.0	6.3
Current account balance/ GDP	(%)	-6.0	-8.4	-8.7	-10.4	-13.7	-13.4	-12.7
Trade balance/GDP	(%)	-7.8	-8.8	-9.8	-12.0	-14.3	-14.2	-12.4
Net FDI inflows/GDP	(%)	3.8	8.4	6.6	8.9	5.8	6.0	3.2
Foreign exchange reserve (FOREX)	(EUR mn)	6,374	10,848	16,796	21,310	25,307	27,500	23,500
Net FDI/CA	(%)	62.4	100.5	76.0	85.9	42.4	44.6	25.3
Gross external debt/ GDP	(%)	35.2	34.7	39.1	42.7	45.6	48.0	51.5
Gross external debt/ Export (G&S)	(%)	97.7	96.5	118.1	132.8	152.4	143.4	147.4
Public external debt/ Export (G&S)	(%)	53.0	45.8	46.3	38.0	36.3	36.8	45.9
FOREX/monthly imports	(months)	3.4	4.8	5.8	5.9	5.6	5.3	4.1
FOREX/short-term external debt	(times)	3.2	3.4	2.6	1.6	1.4	1.5	1.2
Debt service ratio	(%)	16.9	16.4	20.1	20.7	21.8	19.2	16.6

Note: Figures for criteria 1 and 2 are moving average between October 2007 and September 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

(Toshihiko Naito, Senior Analyst)