

2005-08
May 26, 2005

Romania

Foreign LT: **BB+/Positive**, Local LT: **BBB-/Positive** (Affirmed on November 15, 2004.)

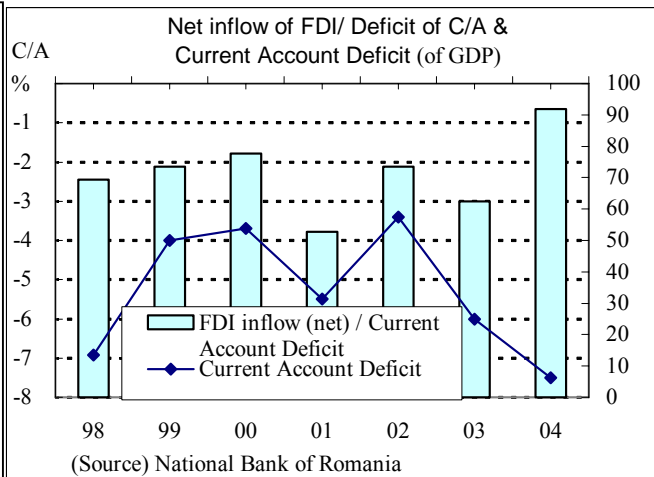
<Rating Perspective>

Positive Factors

- Stronger possibility of the country becoming a member of the EU
- Generally improving macroeconomic trend
- Maintenance of fiscal discipline
- Reduced public debt-service payments brought by extended loan terms and falling interest rates

Negative Factors

- Existence of corruption and human rights issues
- External vulnerability due mainly to large current account deficit



<Update: from March to May 2005>

Positive Factors

- Approval of Romanian accession to EU by European Parliament (Apr. 13). Signature to the Accession treaty simultaneously with Bulgaria (Apr. 25).
Once significant delay in structural reform has been confirmed, accession will be put off for a year till 2008. However, it is highly probable that the country will become a member of EU in 2007.
- Real GDP growth was accelerated to 8.3% in 2004, the highest since the collapse in 1989 of Ceausescu's dictatorship. (Mar. 11) Negative impacts of oil price hikes and avian flu were smaller than expected.
As agricultural production increased markedly after a drought in the previous year, improved income levels in rural areas gave a major boost to personal consumption.

Negative Factors

- C/A deficit to GDP ratio worsened to 7.5% in 2004 from 6.0% in 2003, due to a bigger trade deficit (Feb. 21). The trade deficit expanded 151.7% (y/y) in the first two months of 2005 and remains on an expansionary trend.
- The appreciation of the lei could have an adverse impact on exports. There is concern that competition from China in the EU market will stiffen following the EU's lifting of import tariffs on textile products from China. (Jan. 1) Textiles/clothing ornament are Romania's biggest export products. Since the abolition of import tariffs on Chinese imports in January 2005, it is reported that the EU's import of such products from China has significantly increased.

<Outlook and Points to Watch>

It is highly likely to become an EU member in 2007 following signature to the Accession treaty

(1) Signature to the Accession treaty

President Traian Basescu signed the Accession treaty on April 25 following the approval on April 13 of the country's accession by the European Parliament. A safeguard clause in the treaty calls for postponement of the accession by one year to 2008 when structural reforms have been found stagnant. However, it is highly likely that Romania will become an EU member in 2007. Both chambers of the parliament ratified the treaty on May 17.

Romanian population totaled 21.67million in mid-2004. It will be the seventh biggest country in terms of population in 2007, when the EU will be composed of 27countries. Its abundant labor force, lower wage levels (national average in 2004 was Euro147.2 in net terms) and reduction of the corporate tax rate implemented at the beginning of 2005 (from 25% to 16%) will attract an increasing volume of FDI in the medium to long term from both inside and outside of the EU. However, the country is still required to improve its judicial system, push anti-corruption measures and take environmental protection measures among others. EU Competition Commissioner Neelie Kroes warned on May 12 that any violation of the antitrust rules, particularly the official subsidies to the steel industry, could lead to a delay in Romania's scheduled accession in 2007. Romania has a number of other issues that need to be resolved urgently.

(2) Real GDP grew 8.3% in 2004, the highest since the transition

Romania's real GDP grew 8.3% in 2004, far beyond 4.9% in 2003, for the highest expansion since the fall of the dictatorship in 1989. It was the second highest after Latvia's 8.5% among the EU25 countries and the three candidate countries (Romania, Bulgaria and Turkey).

On the production front, agriculture registered a steep 22.2% surge in net terms (accounting for 1.6% of the GDP growth) on a bumper crop following the drought that hit the country the previous year. Construction also grew 9.0% amid a property boom triggered by declining interest rates. On the expenditure side, private consumption gained 10.8% in 2004, up from 7.2% in 2003, on farmers' increased income brought by the recovery of agricultural production as well as the effect of improved employment and declining interest rates. Gross fixed capital formation grew 10.1% in 2004, up from 9.1% in 2003, as renewal of equipment proceeded amid the growth of domestic and external demand. In contrast, contribution of net exports to GDP growth deteriorated to minus 2.7% in 2004 from minus 2.8% in 2003.

JCR forecasts that real GDP will grow more than 5% in 2005, as private consumption particularly by high-end income earners will gain momentum, buoyed by the rate cuts by NBR, the tax reduction through the introduction of a flat 16% rate (for both income and corporate tax), solid FDI inflows and continuing falls in interest rates.

(3) C/A deficit widened due to surge in trade deficit on import growth

The C/A deficit to GDP ratio further deteriorated to 7.5% in 2004 from 6.0% in 2003, as the trade deficit widened to 9.0% from 7.8% due to a rapid increase in imports of both capital and consumption goods. Though the transfer account surplus improved on increased remittances by emigrants, the expansion was not big enough to offset the trade deficit. This trend is continuing into 2005, with the C/A deficit widening 151.7% year-on-year (in Euro in nominal terms) in the first two months. JCR expects that deterioration of the C/A balance due to a bigger trade deficit will continue for the rest of 2005, as a net increase in personal income, especially in the high-income group, brought by the income tax reduction (from 18-40% to a uniform 16%) will inevitably push up imports. Additionally, the growth of exports will decelerate, as the Romanian currency of lei has appreciated by more than 10% against the euro since last autumn. However, the country's persistent concern about how to finance its chronic C/A deficit has retreated. In 2004, as much as 91.8% of the deficit was covered by net inflow of FDI, sharply up from 62.4% in 2003.

The EU's textile imports from China have been surging since the removal of tariffs at the beginning of 2005. European Trade Commissioner Peter Mandelson met representatives of the European Apparel and Textile Organization (EURATEX) on April 14 and expressed an intention to look into the possibility of imposing an emergency import curb on Chinese textile products. Textiles accounted for 28.8% of Romanian merchandise exports in 2004, the EU being the biggest single market.

Increased Chinese textile exports to the EU could harm Romanian exports. JCR will watch whether the European Commission will decide to take a safeguard action against Chinese textile imports.

Romania: Main Economic Indicators

		2000	2001	2002	2003	2004p	2005f	2006f
Real GDP growth rate (y/y)	(%)	2.1	5.7	5.0	4.9	*8.3	5.5	5.2
Unemployment Rate (year-end)	(%)	10.5	8.6	8.1	7.2	*6.2	6.1	6.0
CPI Growth (annual average)	(%)	45.7	34.5	22.5	15.3	*11.9	8.5	5.5
Nominal wage growth (net, annual average)	(%)	40.5	41.2	28.5	25.4	*22.5	15.3	10.5
Commercial lending rate	(%)	53.21	45.74	36.65	26.19	*25.81	17.50	13.5
General Gov. Fiscal balance/GDP	(%)	-4.0	-3.2	-2.5	-2.3	*-1.1	-1.5	-1.0
Gross General Gov. Debts/GDP	(%)	29.9	27.4	26.8	26.2	19.6	18.0	16.5
Merchandise Trade balance/GDP	(%)	-4.6	-7.3	-5.8	-7.8	*-9.0	-10.0	-10.5
Current account balance/ GDP	(%)	-3.7	-5.5	-3.4	-6.0	*-7.5	-8.3	-8.7
Net inflow of FDI	(Euro mln)	1,161	1,312	1,194	1,910	*4,042	3,250	4,063
Foreign exchange reserve (excl. Gold)	(US\$ mln)	2,470	3,923	6,125	8,040	*14,616	17,025	19,238
Import coverage (G&S)	(Months)	2.1	2.9	3.9	3.8	*5.2	5.0	5.2
Debt to service ratio	(%)	19.0	18.1	18.4	13.4	10.3	8.2	7.5
Gross external debt/ GDP	(%)	29.7	31.7	32.0	33.8	*36.5	34.5	33.8
Gross external debt/ Export (G&S)	(%)	90.1	96.4	82.7	84.6	*90.1	79.1	78.1
Public external debt/ Export (G&S)	(%)	56.6	57.3	58.9	58.8	*51.4	48.5	47.0
Short term external debt/ Total	(%)	3.4	3.6	3.2	5.4	9.5	10.4	11.0
Exchange Rate (period average)	(Lei/ US\$)	21,708.7	29,060.8	33,055.4	33,200.1	*32,636.6	26,500.0	26,500.0

Source: NIS, NBR, National Commission of Forecast, IMF, European Commission and EIU

Note: Data for 2004; *Actual figures, otherwise JCR estimate