

Romania

Foreign LT: BBB-/Stable, Local LT: BBB/Stable (Affirmed on December 13, 2005)

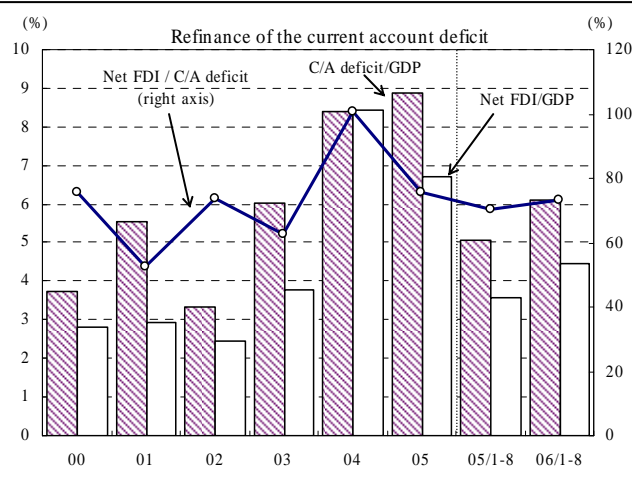
<Rating Perspective>

Positive Factors

- Progress on political, economic and budgetary reforms in pursuit of EU entry in 2007.
- Reduced government debt burden brought by restrained fiscal deficit
- High economic growth prospects

Negative Factors

- Deteriorating external balance due to strong domestic demand led by consumer spending
- Transformation of industrial structure still at primary stage



<Update: from August 2006 to October 2006>

Positive Factors

- On September 26, the European Commission (EC) endorsed EU accession of Bulgaria and Romania in January 2007 with accompanying measures.
- Real GDP growth rate accelerated to 7.4% year-on-year in the first six months of 2006.
- Consumer price inflation in September 2006 eased to 5.5% year-on-year on mainly drops in food prices.
- The general government fiscal balance in the first eight months of 2006 recorded a surplus equivalent to 1.6% of GDP.
- The net inflows of foreign direct investment in the first eight months of 2006 rose by 56.9% year-on-year to EUR 4.3 billion or 4.5% of GDP.

Negative Factors

- The current account deficit in the first eight months of 2006 widened 82.4% year-on-year to EUR 5.9 billion or 6.1% of GDP.
- Bank credit to consumers continued expanding 88.1% year-on-year in August 2006.

<Outlook and Points to Watch>

EU accession in January 2007

(1) European Commission confirmed EU accession in January 2007

On September 26, the European Commission (EC) confirmed EU accession of Romania and Bulgaria in January 2006 with accompanying measures. The confirmation was based on the EC's monitoring report which had concluded that both countries should be prepared for EU membership in January 2007, provided they properly addressed a number of pending issues. Romania's remaining issues include reform of the justice system, fight against corruption, fully operational paying institutions for agricultural subsidy, food safety and motor vehicle insurance. The accompanying measures that may require submission of a progress report, reduction of agricultural subsidy and a ban on export of some products are aimed to guarantee continued reforms on the remaining issues. JCR believes that such remedial measures will not be invoked since the Romanian coalition government will continue to promote reforms on the pending issues in an effort to enjoy full benefits of EU accession such as EU subsidy. Formal EU accession will require a approval by the European Council and ratification of the Accession Treaty by the EU member countries (Germany and Denmark have yet to ratify it). These remaining procedures are likely to be cleared by the end of the year.

Following the confirmation of EU accession, JCR will consider possible upgrading of the ratings mainly reflecting Romania's high economic growth prospects secured by its sophisticated political, economic and budgetary systems and a substantial amount of subsidy it will receive from the EU.

(2) Current account deficit continues deteriorating amid robust domestic demand in private sector

The Romanian economy has continued expanding amid stabilizing inflation. Currently, the economy is growing faster than the

country's potential growth rate on robust private-sector demand. The current account deficit continues widening through surging imports. Real GDP growth rate accelerated to 7.4% year-on-year in the first six months of 2006 from 4.1% in 2005 on expanding consumer spending and investment. While consumer spending is fueled by increased real wages, improved employment and swelling bank lending to the private sector, investment is spurred by massive FDI inflows in recent years. The robust private-sector demand pushed up the current account deficit in the first eight months of 2006 to a level in excess of 6% of GDP. Despite the monetary tightening measures such as increases in the reserve requirement ratio and interest rate hikes since the beginning of the year, bank lending to consumers swelled 88.1% year-on-year in August 2006, showing no signs of deceleration. On the other hand, consumer price inflation slowed down to 5.5% in September 2006 on appreciation of the currency and falls in food prices. At this pace, the inflation rate at the end of the year is likely to be held below the upper end of the target (5.0%±1%) set by the National Bank of Romania (NBR).

(3) Improved fiscal deficit and substantial reduction of the government debt

The fiscal deficit has been improving since 2001. In 2005, it shrank to a mere 0.8% of GDP as tax revenues increased on economic expansion and enlarged tax base despite the tax cuts brought by the introduction of a 16% flat tax rate. The fiscal balance in the first eight months of 2006 improved significantly compared with the year before to register a surplus equivalent to 1.6% of GDP. If the current fiscal policy is maintained, the fiscal deficit in 2006 as a whole will prove smaller than the year before, even after allowing for a chronic yearend increase in budget spending. The improved fiscal deficit and debt repayment with the proceeds from privatization schemes have reduced the government debt by half in the past six years in terms of GDP ratio. The debt stood at an extremely low 15.7% of GDP at the end of July 2006.

In this favorable fiscal development, however, the government revised its deficit target for 2006 from 0.5% of GDP to 0.9% in April and then to 2.5% in late June. It attributed much of the change to an upward adjustment of expenditures. The increased expenditures, if fully disbursed, would signal a shift in the fiscal policy from restrictive to loosening to demand, which could lead to a further deterioration of the current account deficit. The government has said that much of the increased expenditures will be for investment in education, environment and transportation projects aimed to make full use of EU subsidy. JCR holds that it will be rather difficult for the government to disburse all the supplemented expenditures during the latter half of the year and that the fiscal deficit for the year will turn out smaller than the revised target. The 2007 budget plan approved by the Cabinet envisages a fiscal deficit equivalent to 2.8% of GDP, primarily citing an increase in expenditures.

(4) Regardless of widening current account deficit, refinance risk of the deficit remains mitigated

For the present, there is little concern about refinancing of the current account deficit, which is expected to reach more than 10% of GDP in 2006, given the continuing FDI inflows prompted by the country's EU accession, large-sized privatization schemes and strong external liquidity position. More than 70% of the current account deficit was covered by net FDI inflows in the first eight months of 2006. Foreign exchange reserves are enough to pay for monthly imports. Furthermore, the financial system remains sound as the bad loan ratio is kept low despite the surging bank lending to the private sector.

However, JCR considers that the current policy mix will not be sufficient to curb the excessive domestic demand. It is crucial for Romania to tighten monetary policy and maintain fiscal tightening.

Main Economic Indicators: Romania

| | | 2001 | 2002 | 2003 | 2004 | 2005f | 2006f | 2007f |
|------------------------------------|----------|--------|--------|--------|--------|--------|--------|---------|
| Real GDP growth rate | (%) | 5.7 | 5.1 | 5.2 | 8.4 | 4.1 | 6.5 | 6.2 |
| CPI (annual average) | (%) | 34.5 | 22.5 | 15.3 | 11.9 | 9.0 | 6.6 | 5.8 |
| Unemployment Rate | (%) | 8.8 | 8.4 | 7.4 | 6.3 | 5.8 | 5.5 | 5.2 |
| General Gov. Fiscal balance/GDP | (%) | -3.2 | -2.6 | -2.3 | -1.2 | -0.9 | -1.3 | -2.0 |
| Gross General Gov. Debts/GDP | (%) | 28.7 | 28.8 | 26.9 | 22.4 | 19.9 | 15.6 | 13.3 |
| Current account balance | (EUR mn) | -2,488 | -1,623 | -3,060 | -5,099 | -6,891 | -9,794 | -12,939 |
| Current account balance/ GDP | (%) | -5.5 | -3.3 | -6.0 | -8.4 | -8.9 | -10.1 | -11.1 |
| Trade balance/GDP | (%) | -7.4 | -5.7 | -7.8 | -8.8 | -10.1 | -11.6 | -12.4 |
| Net FDI inflows | (EUR mn) | 1,312 | 1,194 | 1,910 | 5,127 | 5,208 | 6,530 | 7,550 |
| Net FDI inflows/GDP | (%) | 2.9 | 2.5 | 3.8 | 8.4 | 6.7 | 6.7 | 6.4 |
| Foreign exchange reserve (FOREX) | (EUR mn) | 4,445 | 5,877 | 6,374 | 10,848 | 16,795 | 19,800 | 23,500 |
| FOREX/monthly imports | (months) | 2.9 | 3.5 | 3.4 | 4.8 | 5.9 | 5.6 | 5.5 |
| FOREX/short-term external debt | (times) | 4.0 | 4.8 | 3.2 | 3.4 | 2.6 | 2.6 | 2.3 |
| Gross external debt/ GDP | (%) | 30.1 | 30.8 | 31.2 | 30.4 | 39.6 | 40.7 | 42.3 |
| Gross external debt/ Export (G&S) | (%) | 97.5 | 94.4 | 97.3 | 99.3 | 117.4 | 124.1 | 134.0 |
| Public external debt/ Export (G&S) | (%) | 58.5 | 53.6 | 52.7 | 46.0 | 41.8 | 38.1 | 36.6 |
| Short term external debt/ Total | (%) | 7.6 | 7.6 | 11.1 | 14.8 | 21.1 | 19.8 | 20.0 |
| Debt service ratio | (%) | 24.1 | 24.2 | 20.8 | 21.9 | 18.2 | 20.0 | 20.0 |

Source : NBR, Ministry of Public Finance, National Institute of Statistics, Figure between 2006 and 2007 are based on JCR forecast

Note: NBR introduced redenomination to new 1Leu (RON) for old 10,000Lei (ROL)

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