2004-55
February 28, 2005

Romania

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

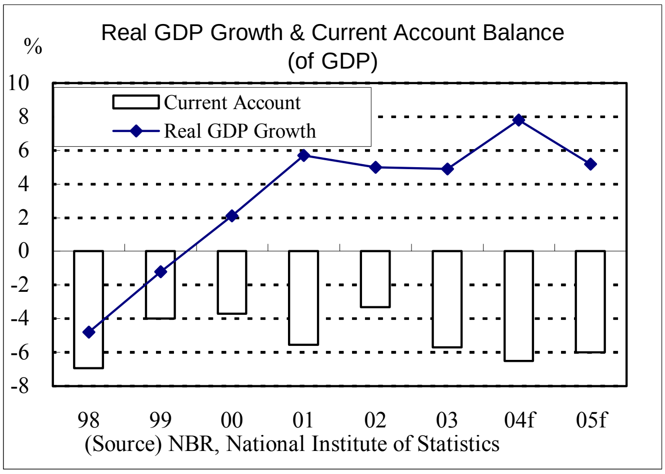
<Rating Perspective>

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 November 2004 to January 2005>

Positive Factors

- European council confirmed the conclusion of accession talks with Romania in December 2004. Accecion treaty shall be signed in April 2005. It is estimated that Romania will become a member of the EU in January 2007, at earliest.
- Real GDP growth accelerated to 8.1% (y/y) in first 9months of 2004 from 4.9% in 2003, underpinned by higher growth in private consumption and gross fixed capital formation. Income circumstances also improved through a record of agricultural production, reported this autumn. JCR estimates that it grew nearly 8% through 2004.
- Encouraged by bigger-than-expected tax revenues on economic recovery and enhanced tax collection, the government estimates the budget deficit to narrow to 1.6% of GDP in 2004 from 2.3% in 2003. The government plans to cut the ratio further to 1.5% under its draft budget for 2005.

Negative Factors

- Current account deficit expanded by 31.5% (y/y) in the January-November period of 2004 on a steep increase in merchandise trade deficit. JCR expects the current account deficit will expand to 6.5% of GDP from 5.7% in 2003 and formal governmental target of 5.5% of GDP.
- Short-term concern for weaker taxation base, reflecting tax reduction in corporate and income tax, introduced by new government formed in December 2004.

<Outlook and Points to Watch>

New coalition government consists of 4parties, formed in December 2004 after presidential and general election

(1) Although ruling government was replaced, its stability has declined

As a result of the general and presidential elections on November 28th 2004, the former center-left ruling Social Democrat Party (PSD) and Humanist Party (PUR) won the largest number of seats and the PM Nastase, the PSD's presidential candidate was placed on the first place and the opposition DA's candidate, Mr. Basescu, the mayor of Bucharest was placed second. DA (Justice and Truth) consists of the National Liberal Party (PNL) and Democratic Party (PD). According to the pre-election opinion polls, it was commonly perceived that Mr. Nastase would be elected as the president by the run-off election held on December 12th and PSD will remain in power in cooperation with UDMR (Hungarian Democratic Party). Consequently, PSD began the negotiation with UDMR and other minor parties to form the coalition, immediately after the

general election.
However, DA's Mr. Basescu was unexpectedly elected as a president by the run-off election, because many votes of floating group and the supporter of the Greater Romanian party (GRP) flew into Mr. Basescu. As the president is entitled to nominate the candidate of Premier, President Basescu nominated Mr. Tariceanu to form an administration. President Basescu warned of the dissolution if Mr. Tariceanu lose the confidence. Consequently, DA succeeded the negotiations on formation of the coalition with UDMR and PUR and secured the majority seats with additional support of minority groups. Through the ratification of both chambers, the coalition government, consists of 4parties was formed on December 29th, 2004.

However, some members of DA, core of the coalition, repeatedly denounce PUR, because it originally shared common list with PSD for the general election and cooperated to elect the chairmen of both chambers from PSD. Furthermore, UDMR also urged to vote for Mr. Nastase in the run-off presidential election and opened the talks on forming coalition with PSD. Therefore, its participation in the coalition is perceived as an expedient to avoid reelection. If PUR will break away from the coalition, DA has to secure the support of UDMR and most of the minorities seats and it is concerned that the political base would become fragile.

(2) Tax reform shall threaten the taxation revenue in a short period

The incoming coalition government issued an emergency ordinance on December 29th, 2004 for the tax reform to introduce a flat tax of 16% for both corporate profits and income. Corporate tax was 25% and income tax ranged from 18% to 40%. To the contrary, it will raise the tax for dividend of deposit from 1% to 10%, introduce a new 10 percent tax on profit from real estate sales and bring forward the period to hike the excise tax from initially planned July 2005 to April. The government remarked that the tax reduction will stimulate the economy through the increasing inflow of FDI and disposable income, and reduce dark economy and tax evasion and tax base will be broadened for a medium-term. On the budget for 2005, which was approved by PSD government last autumn, also planned tax reduction. But, its size is smaller than the current tax reform and mainly focused on the low-middle income earners. Additionally, its size of tax reduction was smaller than the current tax reform. Although JCR expects that it will broaden the taxation base in a medium term, it shall probably threaten the taxation revenue in a short period. Thus, JCR carefully observe the development of taxation revenue.

According to media reports, tax reform will reduce the taxation revenue by 1% of GDP in 2005. Consequently, it is reported that IMF requests to hike VAT rate from current 19% to 20% to secure substitutive source of taxation and constrain economic overheating. Although the government declined the possibility to hike the VAT rate, JCR assume that it will be considered according to coming consultation with IMF and developments of taxation revenue.

The ratio of general budget deficit to GDP is estimated to have shrunk 1.2% in 2004 from 2.3% in 2003, due mainly to increased tax revenues amid a good economic performance. According to media reports, government committed to IMF to reduce it to 1.5% of GDP in 2005, underpinned by current positive developments.

(3) Estimated real GDP growth is nearly 8% in 2004, it would decelerate to sustainable level, around 5% in 2005

GDP grew 8.1% year-on-year in real terms in the first nine months of 2004, primarily underpinned by the expansion of private consumption (9.8% year-on-year) on improved employment and income circumstances and lower interest rates, and the growth of gross fixed capital investment (10.4%) amid export growth (16.2%). Improvement in income circumstances of local areas, due to the recovery in record-breaking agricultural productions, was presumably one of a factor in increase in private consumption. As these developments continued in the last three months of 2004, it is estimated that real GDP grew by nearly 8% through the year. JCR forecasts that it will decelerate to a sustainable level, around 5% in 2005, as growth in private consumption and private investments will slightly weaken, amid normal agricultural production level and slightly modest growth in private credit.

Although a year-on-year rise in CPI was above the initial governmental target of 9.0% at the end of 2004, it was in line with the objective, grew by 9.4%. JCR regards that it is required to constrain domestic demand to achieve the governmental plan to reduce it to 7% at the end of 2005.

The current account deficit grew by 31.5% year-on-year for the first 11months of 2004, as trade deficit widened by 30.0% with import growth (22.6%) overcame the export growth (20.9%). However, it was almost fully financed by net inflow of FDI, as large privatization was materialized, e.g. Petrom, the largest state-owned oil company. JCR estimates that current account deficit will remain high, due to expansion of private consumption and capital investment with effect of tax reduction. Although large privatization has passed, JCR expects that inflow of FDI will gradually increase for a medium-term, through the reduction in corporate tax and the signatory of its affiliation with EU in this April.

Romania: Main Economic Indicators

		2000	2001	2002	2003	2004e	2005f
Real GDP growth rate	(%)	2.1	5.7	5.0	4.9	7.8	5.2
Unemployment rate (year-end)	(%)	10.5	8.6	8.1	7.2	6.5	6.1
CPI (annual average)	(%)	45.7	34.5	22.5	15.3	*12.4	8.5
Nominal wage growth (average)	(%)	40.5	41.2	28.5	25.4	*22.5	15.3
Commercial lending rate	(%)	53.21	45.74	36.65	26.19	25.25	20.0
General Gov.Fiscal balance/GDP	(%)	-4.0	-3.2	-2.6	-2.3	-1.3	-1.5
General Government debt/GDP	(%)	29.9	27.4	25.8	26.2	20.5	21.5
Merchandise Trade balance/GDP	(%)	-4.6	-7.3	-5.6	-7.8	-8.0	-7.6
Current account balance/GDP	(%)	-3.7	-5.5	-3.3	-5.7	-6.5	-6.0
Net inflow of FDI	(US$ mln)	1,161	1,312	1,194	1,591	3,450	2,950
Forex reserves (excl. Gold)	(US$ mln)	3,922	5,442	7,211	9,002	14,763	17,025
Import coverage (G&S)	(Months)	3.4	4.0	4.6	4.3	5.6	5.7
Debt to service ratio	(%)	13.3	17.4	18.4	14.9	14.4	13.7
Gross external debt/GDP	(%)	28.5	31.2	30.8	30.9	25.0	22.0
External debt/Export (G&S)	(%)	87.5	93.7	89.9	91.6	74.7	63.2
Public external debt/Export (GS)	(%)	56.5	57.2	59.2	58.9	42.5	37.5
Short term external debt/ Total	(%)	3.7	3.9	4.7	6.4	9.5	12.3
Exchange rate (average)	(Lei/ US$)	21,708.7	29,060.8	33,055.4	33,200.1	*32,636.6	26,500.0

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

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