

2005-25  
August 24, 2005

## Romania

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

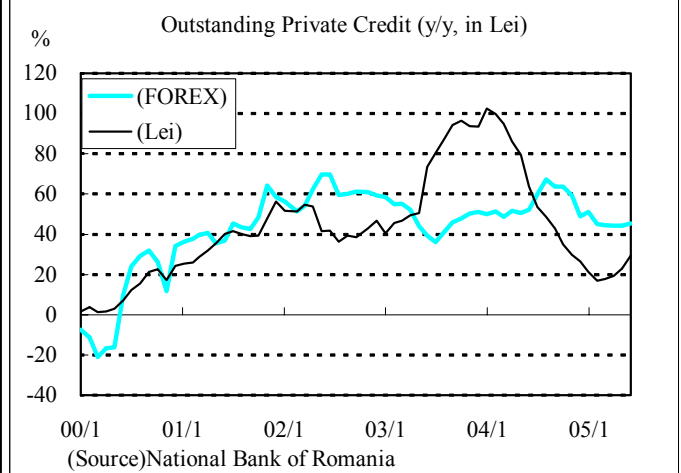
### <Rating Perspective>

#### 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 May to July 2005>

#### Positive Factors

- PM Tariceanu withdrew his intention (July 7) to resign and call a general election, citing the urgent need to push post-flood rehabilitation programs (July 20). This has reduced the risk of the European Commission invoking the safeguard clause\* and putting off Romania's EU accession to EU by one year to January 2008 for reasons of delay in preparations due to political turmoil.  
The rule allows the European Commission to recommend postponing the country's accession by one year to 2008, once significant delay in structural reform has been confirmed.
- The country's economy remains strong, although real GDP growth rate decelerated to 5.9% in 1Q/05 from 8.3% in 2004 (June 7).

#### Negative Factors

- C/A deficit in the first five months of 2005 widened 71.5% (y/y) on increased trade deficit (July. 21). Due to accelerated imports caused by post-flood rehabilitation, C/A deficit in 2005 as a whole may exceed the government target of 7.75% of GDP.

### <Outlook and Points to Watch>

*As the prime minister withdrew his resignation, parliamentary dissolution and general election have been averted, with the possibility of a delay in EU accession reduced.*

#### (1) Political turmoil headed off, government may seek compromise over judicial reform

Prime Minister Calin Popescu-Tariceanu's withdrawal (on July 20) of his intention to resign has reduced the possibility of the European Commission recommending a one-year postponement of Romania's accession to the EU till 2008 for reasons of delays in reforms in the fields of "competition," "judicial system" and "internal affairs." The prime minister cited the urgent need to implement rehabilitation measures following the country's worst floods in 50 years as the reason for this decision. He made his announcement upon returning from a trip to Brussels. This touched off speculation that the European Commission had told him it might be compelled to recommend a one-year postponement of the country's EU accession should judicial and other reforms be delayed due to a general election. Earlier on July 7, Prime Minister Tariceanu had linked his resignation to the Constitutional Court's decision to reject the legislative bills on judicial reforms approved by parliament. He said he had no choice but to seek voter response through a general election. Tariceanu noted that the judicial reforms as required by the European Commission would be difficult to carry out as a majority of the Constitutional Court judges have been appointed by the former PSD government. JCR considers that there is the good possibility of progress being made in judicial reforms. Now that the prime minister has decided to stay in office, his government will explore avenues for compromise with the Constitutional Court and some headway may be made in that process. Meanwhile, support for a further expansion of the EU has been declining among the member countries. However, the supporting rate for Romania's EU

membership is far higher than that for Turkey's membership. Rejection by the member countries of the ratification of Romania's accession treaty appears to be a remote possibility. It is still possible for Romania's accession to be put off by one year due to delay in reforms. However, JCR does not think that such a development would change the basic direction of Romania's eventual integration with the EU.

### **(2) Real GDP growth decelerated to 5.9%(y/y) in 1Q/05 from 8.3% in 2004**

Romania's real GDP growth rate decelerated to 5.9% (y/y) in 1Q/05 from 8.3% in 2004 (June 7), but the economy still remains solid. The 1Q growth was led by a 12.1% expansion of consumption (specific figures for private and public sectors were not made available). In contrast, growth of gross fixed capital investment slowed to 5.2% (y/y) in 1Q from 10.1% in 2004.

For 2005 as a whole, JCR assumes that private consumption will post a solid growth, given the improved income levels brought by expanded employment and reduction of the income tax rate (from 18-40% to a uniform 16%), the declining interest rates, and positive lending by banks. On the other hand, a decline in the agricultural, forest and fishery production due to the flood damage will give negative impact on economic growth. In 2004, the agricultural production surged 22.2% on a record farm crop, pushing up the annual economic growth rate by 1.6 points.

Despite the income tax cut and the reduction of the corporate tax rate (from 25% to 16%) since the beginning of 2005, tax revenues expanded on booming business, helping to turn the government general budget balance from a deficit in 2004 to a modest surplus in the first four months of 2005. JCR forecasts that the fiscal deficit/GDP ratio will slightly improve from the previous year, even after allowing for the impact of post-flood reconstruction costs and a chronic year-end increase in budget spending. However, an IMF delegation that visited Bucharest in June pointed to a lack of medium-term alternative revenue sources to make up for the tax cuts and reportedly suggested either raising the VAT rate or trimming the income tax cut. Later on July 29, President Traian Basescu called a hike of the VAT rate "inevitable." He estimated the costs Romania would have to pay in the initial year of its EU accession at more than Euro1 billion and said: "We need to secure an additional source of revenues by the time our EU accession (scheduled for 2007)," adding that the government will consider raising the VAT rate from the current 19% to 22% possibly in 2006. JCR believes that the Romanian government will not only increase the VAT rate probably next January to secure an alternative revenue source make up for the income and corporate taxes but also take some steps to decelerate overheated private consumption.

### **(3) NBR implemented measures to restrict lending and to lift for substantial lending rate in forex to constrain economic overheating**

The current account deficit the first five months of 2005 surged 71.5% year-on-year to Euro2.18 billion as the trade deficit widened on a 22.4% jumps in imports (July 21). The improved income levels attributable to the expanded employment and income tax cut combined with lower interest rates and aggressive lending by banks to send domestic demand surging. Alarmed by the situation, the government revised its forecast for 2005 current account deficit/GDP ratio from 6.9% to 7.75%. However, JCR holds that the revised forecast will be surpassed as materials needed for post-flood rehabilitation will have to be additionally imported.

NBR put stricter restrictions on lending by commercial banks in February 2004. But this has proved hardly effective in curbing the outstanding balance of credits and the current account deficit. Then on July 8, NBR announced a reduction in the monthly debt service ceiling from 40% of net income to 30% (for consumer loans) and 35% (for mortgages). Simultaneously, NBR lowered the minimum reserve ratio (MMR) on leu-denominated bank liabilities from 18% to 16% and decided to apply a minimum requirement reserve on all foreign currency-denominated bank liabilities irrespective of their maturities. (The reserve ratios were initially set at 15% for liabilities longer than two years and 30% for others to raised to a uniform 30% on August 24). JCR assumes that NBR took these measures to check any further overheating of the economy. Since the expansion of private credits has been led by growth of foreign currency-denominated loans (which carry lower interest rates than leu-denominated loans), the central bank attempted to stem the surge of credits by making foreign currency funds costlier to procure and encouraging the banks to raise the interest rates on their foreign currency-denominated loans.

**Romania: Main Economic Indicators**

		2000	2001	2002	2003	2004	2005f	2006f
Real GDP growth rate (y/y)	(%)	2.1	5.7	5.0	4.9	8.3	5.4	5.5
Unemployment Rate (year-end)	(%)	10.5	8.6	8.1	7.2	6.2	6.5	7.8
CPI Growth (annual average)	(%)	45.7	34.5	22.5	15.3	11.9	8.8	7.8
Nominal wage growth (net, annual average)	(%)	40.5	41.2	25.5	27.7	23.3	18.0	15.5
Commercial lending rate	(%)	53.21	45.74	36.65	26.19	25.81	19.75	15.00
General Gov. Fiscal balance/GDP	(%)	-4.0	-3.2	-2.5	-2.3	-1.1	-1.0	-1.3
Gross General Gov. Debts/GDP	(%)	29.9	28.7	28.8	26.9	23.1	20.0	18.9
Merchandise Trade balance/GDP	(%)	-4.6	-7.3	-5.8	-7.8	-9.0	-9.8	-10.2
Current account balance/ GDP	(%)	-3.7	-5.5	-3.4	-6.0	-7.5	-8.5	-9.0
Net inflow of FDI	(Euro mln)	1,161	1,312	1,194	1,910	4,042	3,250	4,000
Foreign exchange reserve (excl. Gold)	(US\$ mln)	2,470	3,923	6,125	8,040	14,616	19,500	21,400
Import coverage (G&S)	(Months)	2.1	2.9	3.9	3.8	5.2	5.8	5.3
Debt to service ratio	(%)	21.1	24.1	24.2	20.8	21.9	19.5	18.8
Gross external debt/ GDP	(%)	28.7	31.3	32.0	33.1	33.5	36.0	35.5
Gross external debt/ Export (G&S)	(%)	87.5	93.7	90.4	91.6	90.4	77.5	73.3
Public external debt/ Export (G&S)	(%)	56.7	58.5	53.6	53.0	46.0	37.2	34.4
Short term external debt/ Total	(%)	3.7	3.9	4.7	6.4	10.4	12.2	12.5
Exchange Rate (period average) Note	(Lei/ US\$)	2.17087	2.90608	3.30554	3.32001	3.26366	2.80000	2.75000

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

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

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