
ROMANIAN MACROECONOMIC INSIGHT

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MacroAnalitica provides independent macroeconomic analysis of the Romanian economy. It issues regular reports on the economic outlook and monetary policy prospects. The analyses are performed by a team of experienced economists with an international experience and exposure and are forward-looking. A competitive edge of our analyses is that they consider the potential implications for market developments.

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Editorial and Research Direction: Laurian Lungu

Board of Trustees: Florin Citu, Daniel Daianu, Patrick Minford, Radu Vranceanu

Research Team: Ruthira Naraidoo, Juan Paez-Farrell, Prakriti Sofat, David Meenagh, Silvia Toma, Anca Gherman, Vo Phuong Mai Le

Contact

www.macroanalitica.com, Tel: + 40 728 865 351, E-mail: office@macroanalitica.com

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GLOBAL OUTLOOK

While the fears of the liquidity crisis appear to start receding, confidence looks set to return slowly in the financial markets. With more banks and financial institutions starting to have an idea about the size and prospects of their losses, the credit markets look set to start functioning again. However, there are reasons to believe that the worst may be far from over yet. According to the Case-Shiller home price index, the battered US housing market dropped by almost 13% in the year ending February. And the future looks gloomy enough, with US house prices expected to maintain their downward trend for at least another year. Such a protracted effect would almost certainly impact more strongly on the EU housing market. In the UK, Halifax, the country's largest mortgage lender, announced that house prices fell at an annual rate of 0.9% in April and that the housing market correction is in its early stages.

The fall in house prices reduces households' wealth and has a negative impact on consumer spending. It has become now clearer that both the US and the UK would face an economic slowdown. In its spring economic forecast, the European Commission slashed its economic growth

forecasts for the EU by 0.5 points to 2% in 2008 and 1.8% in 2009. While the EU economy is still better prepared to deal with the crisis, the transmission lags adds to the uncertainty of how large would eventually turn out to be the effects of the US crisis on the EU economic growth.

Over the last months the Fed, the ECB and the Bank of England injected vast amounts of liquidity in the money markets. These actions have managed to provide the necessary liquidity to ensure the functioning of the money market. However, in conjunction with increased food and energy prices, these interventions have had a major setback, namely they have been done at the costs of rising inflation.

The aggressive interest rate cut by the Fed has pushed the US real interest rates into negative territory and triggered a flight away from the US dollar. In contrast, in the euro-zone interest rates have risen since August and, although they were left unchanged at ECB's last meeting, currently stand at 4%. But, facing with the prospects of a slowdown the ECB might well start cutting rates back soon.

ROMANIAN ECONOMIC DEVELOPMENT

So far, the Romanian economy seems to have shrugged off the effects of the current global crisis with growth in the first quarter expected, by some government officials, to be over 6.5%. There are indeed signs that the economy is firing on all cylinders. The growth of the construction sector does not show any sign of abating, its annual real rate has expanded by over 32% in the first quarter of 2008. The share of construction in GDP has been growing continuously from 5% at the end of 2000 to over 9% at the end of last year. With the economy expanding fast, there is a strong demand for residential construction and office spaces.

At the same time, there are encouraging signs from the performance of other sectors of the economy. Provisional figures show that industrial production has grown by 5.4% in the first quarter of 2008 while excess demand has still been strong.

Over the last years domestic consumption has been the main engine of economic growth. Early signs tend to indicate that this trend has continued in the first three months of the year when retail sales grew at an annualised rate of almost 16%. For years now doomsayers have predicted a slowdown in consumption and a correction to economic growth.

While it is true that consumption's share in GDP is larger than the values observed in other countries (or what economic theory would predict for that matter), this could be easily rationalised if one took into account the initial low level of capital formation the Romanian economy started from. A large part of the household consumption is channelled towards purchases of durable goods. Financing demand for these goods has been possible by higher level of household incomes.

Saving rates have been constantly falling, since 2001 and this has encouraged consumption. Between 2003 and 2007, Romanian average net wages grew by 11.4% (see next section). In contrast, consumption expanded by 10% and GDP by only 6.3%. Moreover, higher incomes increased household's ability to borrow more by being able to provide more collateral. Clearly, these discrepancies among the growth rates cannot last forever. But, the Romanian – EU wage differential shows that domestic wages still have some room to grow before hurting decisively firms' competitiveness.

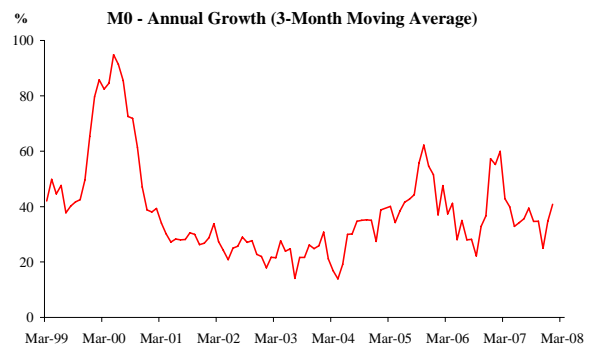
The downside of wage increases is their pressure on inflation. The disinflation trend reached a low of 3.8% sometime in the spring of 2007 and since then it has started to reverse. However, problems to control domestic inflation are mostly structural in nature. Competition in several sectors of the economy is still weak and this leads to inefficiency which then spills over into higher prices. But

Selected Macroeconomic Variables*

	2005	2006	2007	2008	2009	2010
GDP Growth	4.1	7.7	6.0	5.5	5.3	5.0
Inflation						
CPI	8.7	4.9	6.0	6.3	5.5	4.1
RPI	10.3	11.7	10.5	13.9	11.1	9.7
Unemployment Rate (%)	5.9	5.2	4.1	4.0	4.2	4.3
Exchange Rate (RON/EUR)**	3.7	3.4	3.6	3.5	3.4	3.3
Current Account	-8.6	-10.3	-14.2	-12.8	-10.9	-9.7
Public Debt	16.3	17.9	18.9	20.6	21.3	23.1
Government Budget Deficit	1.4	1.9	2.4	2.8	3.2	3.3

* percentages of GDP, unless otherwise specified

** end of period



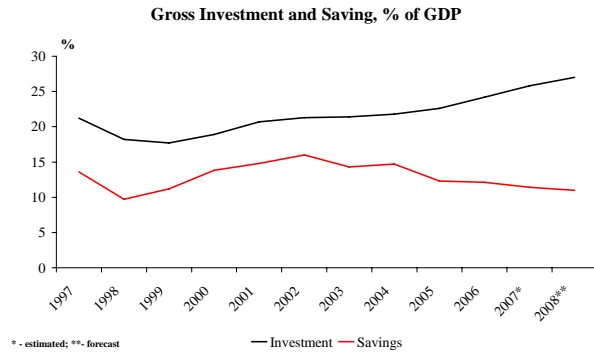
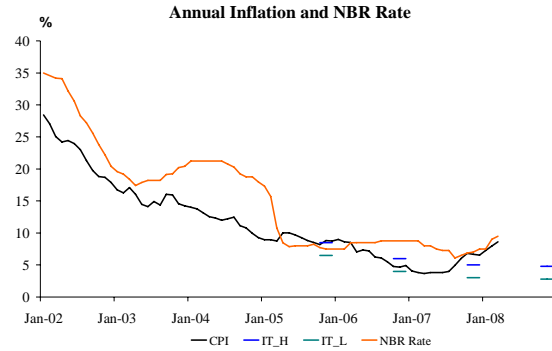
trade unions have also added to worries on inflation pressures. Recent strikes demanding higher wages at Renault and Mittal Steel could be just the beginning. With the local and general elections looming ahead this year, other trade unions could follow suit. And government's economic wage policies towards its own employees do not provide much support in reigning in wage inflation.

The National Bank of Romania is committed to target inflation and it should continue to use its benchmark interest rate to do so. The inflation target for this year looks almost certainly to be missed, even the NBR expecting the end-year inflation rate to be at 6%. Although the interest rate channel is not yet fully-fledged and the monetary transmission mechanism is rather slow, eventually, the effects of monetary policy decisions will filter through the markets. Already, the banking system reacts much faster compared to a couple of years ago to changes in interest rates. Since June 2007, the NBR raised its benchmark interest rate by five times from 7% to 9.5%. The resulting increase in the interest rate differential with the euro-area has compensated – to some extent – the demand for a higher premium on the RON requested by foreign investors in the wake of the global liquidity crisis.

The NBR's tightening cycle looks set to be reaching its peak for now. The interbank market has moving closer towards stabilising with the spread of its 3-month rate over NBR's benchmark rate of less than 1%. However, the danger of another inflation push remains. High food, energy and commodity prices, if persistent, could spill over into domestic goods and services markets. The producer price index (PPI) has jumped to 15.6% at the end of March and has been growing at a rate much faster than the CPI since last year. This would have a direct impact on company's operating costs and could even reduce their profits.

The planned 47% increase in public pensions by the end of 2008 would put the government's budget under increased strain. The authorities' decision to go for such an astonishing figure is irresponsible and has all the hallmarks of luring election votes. With over 6.5 million, pensioners are currently the largest voting segment of the Romanian population. However, the rise in inflation has already cancelled out a part of that increase. And, the achievement so far, has been only to raise inflationary expectations.

Moreover, the costs of pension increases will force the government to borrow more, raising the prospects for higher budgetary costs in servicing the debt. This could create a potentially risky situation where falling budgetary revenues, due to lower than forecast economic growth for instance, and higher expenditures, would lead to a widening budgetary deficit and could overshoot the government's target for this year.



ROMANIAN ECONOMIC FOCUS

Should We Be Concerned Over Romania's Rapid Credit Growth?

Over the last years, the speed of Romanian credit growth has made domestic and foreign institutions alike to constantly question whether its expansion is sustainable or not. The National Bank of Romania (NBR) started to impose measures to curb domestic credit growth as early as 2004, soon after it became clear that the restrictions on capital account had to be removed – a condition Romania had to fulfil in order to complete its EU accession talks. Are these fears over credit growth entirely justified?

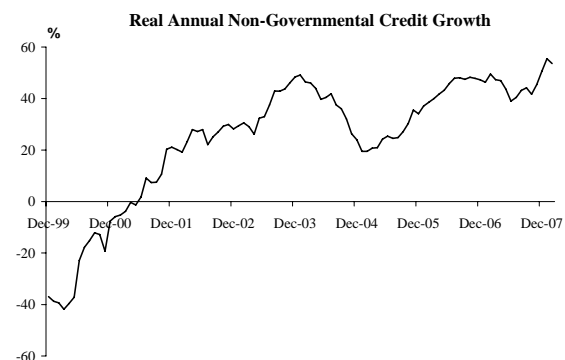
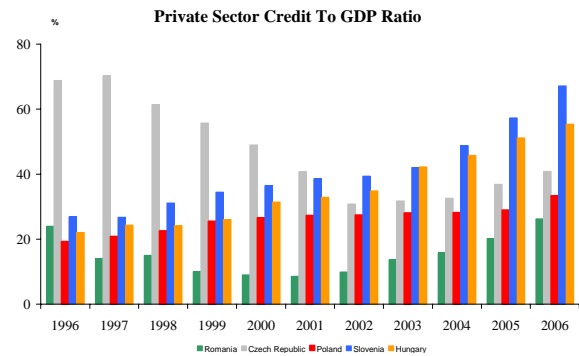
Clearly, as history has shown, excessive rates of credit expansion, if unchecked, could have destabilising macroeconomic effects. The problem is, of course, the difficulty of identifying, *ex ante*, whether the rate of credit growth is sustainable or not. Analysing past credit booms events, a recent paper by the IMF⁽¹⁾ has shown that the average episodes duration of rapid credit growth could be as long as six to ten years. This proves that economies can sustain rapid real credit growth for extended periods of time.

Romania is not alone in having to deal with accelerating domestic credit rates. A global environment of low inflation and interest rates that have prevailed for more than a decade encouraged borrowing throughout Eastern European countries. Starting from late 2001, the region's private sector credit to GDP ratios has been on a rising trend.

However, domestic conditions have been the main driver of Romanian credit expansion. The strong demand for loans by households has reflected, in part, a trend of falling interest rates, lower inflation and raising incomes. Starting with 2004, expectations of EU accession played an important role by creating a greater confidence in the economy thus making people to borrow against future income.

Between 2002-2007 Romanian real private credit growth averaged 39%. This mirrors to a great extent the initial level of small private sector lending; total credit stock as percentage of GDP was a dismal 10% in 2001. Since then it has been raised steadily to 37% at the end of 2007 - which is still about a third of the average value observed in the Euro-area. Moreover, as Figure 1.1 shows, it is also one of the lowest ratios among Eastern Europe countries.

One reason why credit growth has been so fast in Romania is due to the ongoing financial deepening process. Although the share of total assets in GDP of credit institutions have risen from 36.6% in 2004 to 62.5% in 2007, it is much lower than values observed in developed



countries. Moreover, the banking sector accounts by far for the largest share of financial intermediation, provisional figures put the total banking assets' share in GDP to 53% in 2007. Compared to this, the Bucharest stock exchange together with Rasdaq, its over-the-counter counterpart, account for around half of the figure, some 27% of GDP. Other financial intermediaries' assets, such as insurance companies, mutual funds, and such accounted for 10% of GDP in 2006.

In general, both supply and demand factors have encouraged borrowing. The improved Romanian macroeconomic performance has brought about more stability. This, in turn, has reduced household uncertainty over future income, leading to more predictable consumption patterns. Increased competition in the Romanian financial sector has facilitated easier access to credit via an increase in the supply of credit available at lower borrowing costs.

Real annual non-governmental credit has continued to grow at high speed, reaching 55% at the end of January 2008. This strong performance seems to be at odds with credit developments in international markets, where the credit crunch has imposed stringent restrictions on credit availability.

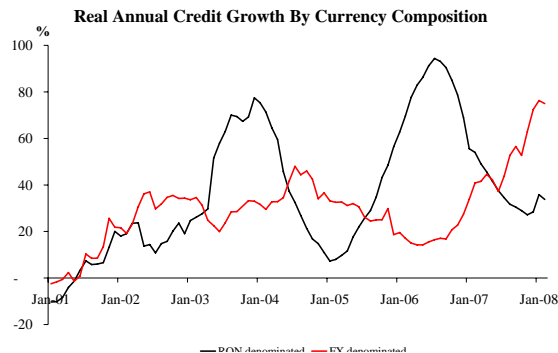
Part of the explanation lies with the fact that commercial banks operating in Romania are still fighting for market share. In doing so they take advantage of increasing household demand for borrowing funds. Another reason is that between 2003 and 2007 average real wage growth rate has outpaced household consumption growth by 1.4%. And, a higher level of income increased household credit affordability. Moreover, GDP/capita, expressed in PPP terms, has been going up continuously over the last years. A higher GDP/capita, associated with increased economic development, usually leads to a higher ratio of credit to GDP.

True, there are several risks associated with the current level of credit expansion. One of them pertains to credit currency composition. With the opening of the capital account in 2004, household preferences started to switch away from RON denominated to foreign exchange denominated loans. At the end of January 2008, the share of borrowing in domestic currency for both firms and households fell to around 45% of total credit. The latest rapid rise in foreign currency lending to households could leave banks exposed indirectly to the exchange rate risk. This happens because households are, in general, unhedged, more the same in Romania where financial markets are relatively shallow. In terms of annual growth rates, household demand for RON-denominated credit seem to have been influenced to some extent by changes in regulatory measures imposed by the NBR.

Most of the household credit, over three quarters of the total, is aimed at financing consumption needs. Mortgage accounts for only 20% of total household credit, a figure which is less than three times with those observed in developed countries. The source of financing domestic credit growth is particularly important as it addresses sustainability issues. Borrowing from external source leaves domestic firms and households exposed to the exchange rate risk. So far, in Romania, domestic credit has been financed largely by domestic deposits with nominal annual growth rates of both being quite close to each other over the last years.

The recent high level of credit growth has, as expected, deteriorated the net foreign assets position of the banking system. With foreign borrowing becoming an increasingly important source of financing the credit expansion, the banks' net foreign assets position dropped from EUR 11.4 bn in 2006 to around EUR 8 bn in 2007, an equivalent of 2.8% of GDP.

Clearly, the speed of private credit stock adjustment to its long-run equilibrium matters, but to a great extent this is driven by economic growth and financial liberalisation. By ensuring that fiscal and monetary economic policies are coherent and coordinated towards achieving similar goals, the private credit adjustment on its long-run path would be done naturally.



The NBR should use only the interest rate to control inflation and, indirectly, credit growth. The pursuance of sound lending standards and credit management by commercial banks together with more informed borrowers would minimise the risks associated with loans default. Other measures aimed at limiting credit growth, apart from generating economic inefficiency, are likely to be circumvented eventually.

For instance, regulatory measures to restrict foreign currency housing lending risk have proved to be particularly counterproductive in transition economies, as they could slow down the pace of financial deepening or could drive business either abroad or to the non-bank sector. In the coming years, interest rates could be expected to converge to the euro-zone levels so that incentives for foreign-currency lending are likely to diminish.

Annual Real Growth of GDP, Wage and Household Consumption (%)

	2003	2004	2005	2006	2007*	Avg. 03-07
GDP	5.2	8.4	4.1	7.7	6	6.3
Household Consumption	6.3	12.8	9.4	11.4	10.2	10.0
Net Average Wage	9.4	11.5	12.8	10.7	12.7	11.4

(1) – IMF (2004), ‘Are Credit Booms In Emerging Markets A Concern?’, World Economic Outlook, April.

POINT OF VIEW

The World Economy Refuses to Lie Down

By Patrick Minford

The consensus of the financial pundits is that the credit crunch is bringing a worldwide recession. The argument has gone that the big banks of the West have made huge losses on the sub-prime market that have eaten away their capital reserves and so they are doing much less lending; this in turn is leading to a shortage of loans for business and consumers and so a downturn in investment and consumption.

There are two problems with this finance-fed story. The first is theoretical: what reasons of self-interest would cause financial intermediaries to stop lending, i.e. intermediating? Would such behaviour not simply compound the original felony of losing a huge amount of money on sub-prime loans?

The second problem with the great financial pundit story is that the facts are refusing stubbornly to oblige. Take the UK where key banks like RBS and Santander (owners of Abbey) have racked up big losses- February's retail sales volumes were up a solid 5.5% on a year earlier and unemployment is continuing to fall.

Or take the US which is reviewed above; yes, there is definitely a slowdown, possibly already a recession, with the surveys showing a lot of fear and low confidence. But the economy, though fragile, is so far not falling off a cliff. Or take a look at commodity prices- now bursting through the roof. Or at China and India, whose growth remains unrestrained.

So the list could go on. The truth is that the world economy is nowhere near recession. On the contrary at the world level there is substantial inflationary pressure, which is driving up world raw material and food prices. This pressure is fed by the absence of any serious monetary discipline in many of the key emerging market economies, especially China and India.

Faced with this rise in their import prices, western central banks do seem to be succeeding in keeping domestic inflation under control- the growth of wages for example, the key component of domestic costs has been pretty constant over the last decade and has not flickered recently. This is allowing central banks some freedom to respond to the banking crisis by lowering interest rates.

Unfortunately, the Bank of England has not so far properly taken advantage of this freedom and has failed to maintain the liquidity of the UK banking system. As a result three month money market rates have risen to nearly 6%, against Bank Rate now of 5%; monetary policy has effectively been allowed to tighten unintentionally. It has belatedly now in the past week or so taken action with its new scheme for large-scale swaps of Treasury Bills for the banks' mortgage assets for a period of up to three years. This should help to unfreeze three months money markets; why did it take so long for the Bank to produce it?

Monetary policy has also been marked by uncertainty and a complete failure to communicate what the Bank thinks could drive inflation and therefore its own interest rate policies. We have had speeches from members of the Bank's Monetary Policy Committee saying that because commodity prices have been raising sharply the MPC will be unwilling to cut interest rates as much as otherwise. By what logic? Commodity prices are world prices affecting the UK's terms of trade; they are not indicators of UK inflationary pressure!

The question the Bank needs to address is whether UK costs and prices will rise steadily faster than the 2% target as a result of recent events. Yet the Bank's statements reveal a vacuum of theory; only nervousness about anything that goes up or down.

Of course at the centre of that theory is its own prescribed behaviour: it is mandated to react to inflationary pressure and this in turn conditions behaviour in the labour market. The main other factor is the prospective state of the UK business cycle. On both counts the MPC should at present be lowering interest rates; domestic inflation is under control and the UK banking crisis could produce a recession if not brought to an end both by the injection of liquidity and by the cutting of rates.

COMMODITIES MARKETS

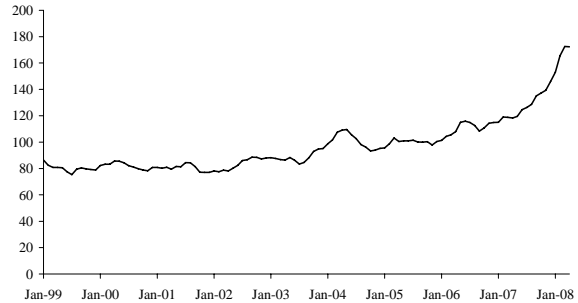
Oil prices have continued to advance, breaching through the \$126/bbl barrier and creating the impression that there is no end in sight for the current bull run. In April, the IEA has made its largest downward revision to oil demand growth since the 11 September attacks. This has had to be expected to some extent as the combination of slower economic growth in the developed countries and persistent high oil prices is likely to result in a sluggish demand. On the supply side, the limited spare capacity in the OPEC countries together with heightened geopolitical and supply risks has led to a reduced likelihood of increasing production.

The abrupt changes in food prices are causing a wide range of problems, especially in developing countries. Recent increases in rice prices, for instance, are feared to bring about outbreaks of social unrest notably in Asia, where a third of the global population is dependent on cheap food. Some Asian countries, such as Thailand, are already thinking to resort to protectionist measures in order to prevent the domestic production of staple food to be exported. In a stark statement the IMF warned that the raise in food prices could have powerful destabilising effects in the global economy.

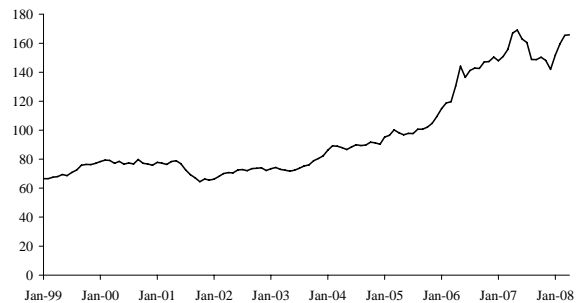
Clearly, a weak US dollar is partly to blame for the rise in oil, food, and commodity prices. The US economy needs a weak dollar and, as commodities are priced in US dollars, it means that their price will have to rise. However, increased volatility and volume trades in these markets' futures tend to suggest that speculative money is having its share of explanation for the current bullish run.

Short run outlook for oil prices put these at over \$100/bbl. Similarly, food prices are expected to remain high, at least until the summer when new harvest will become available on the market.

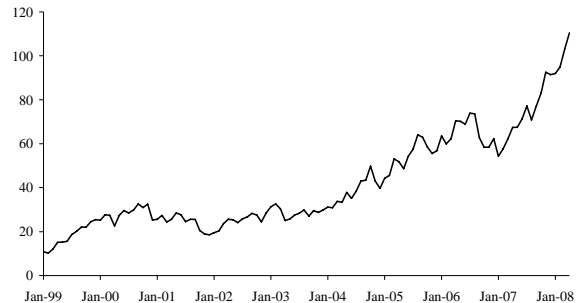
Food Price Index 2005=100



Industrial Input Price Index 2005=100

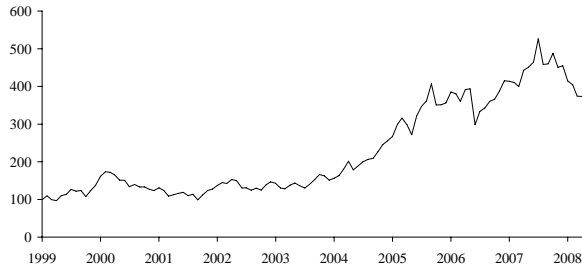


Crude Oil Price Brent, US\$/barrel

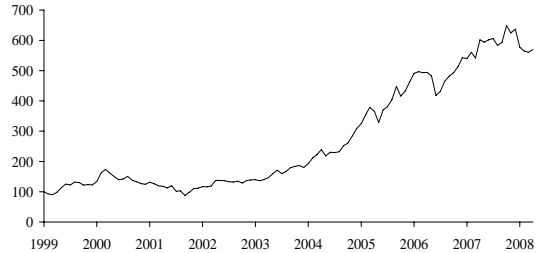


EASTERN EUROPE STOCK MARKETS

Hungary: BUX Index (Jan 1999=100, EUR Terms)



Czech Republic: PX50 Index (Jan 1999=100, EUR Terms)



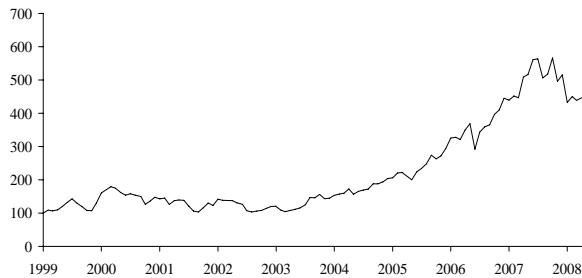
Hungary

	06	07	08	09	10
GDP (%p.a.)	3.9	1.3	1.8	2.5	2.6
Inflation (%p.a.)	6.5	7.4	4.7	3.0	2.9
Current A/c(US\$ bill.)	-7.4	-7.8	-8.6	-8.3	-8.0
HUF/EUR (eop)	252	253	254	252	248

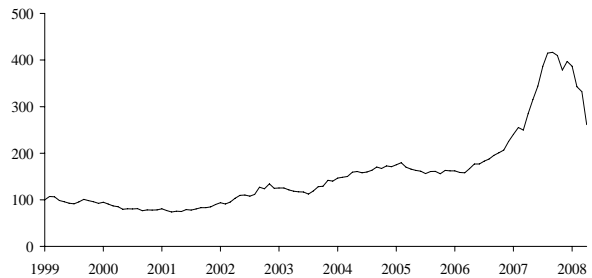
Czech Republic

	06	07	08	09	10
GDP (%p.a.)	6.4	6.5	4.2	4.7	4.8
Inflation (%p.a.)	1.8	5.4	5.5	3.5	3.2
Current A/c(US\$ bill.)	-4.5	-4.4	-6.4	-6.4	-6.3
CZC/EUR (eop)	27.5	26.6	26.5	26.0	25.5

Poland: WIG Index (Jan 1999=100, EUR Terms)



Slovenia: SBI 20 Index (Jan 1999=100, EUR Terms)



Poland

	06	07	08	09	10
GDP (%p.a.)	6.2	6.5	4.9	4.5	4.5
Inflation (%p.a.)	1.4	4.0	3.9	3.7	3.6
Current A/c(US\$ bill.)	-11	-15.5	-22.7	-27.2	-28.2
PLN/EUR (eop)	3.8	3.6	3.7	3.6	3.6

Slovenia

	06	07	08	09	10
GDP (%p.a.)	5.7	6.1	4.1	3.5	3.6
Inflation (%p.a.)	2.8	5.6	2.5	2.4	2.4
Current A/c(US\$ bill.)	-1.1	-2.2	-2.6	-2.8	-2.9

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