

Romania economic update: Time to take a breath

13 February 2008

One year after its entry into the EU, the Romanian economy continues to grow strongly, but some observers are concerned that this strength may turn to overheating and that structural weaknesses could emerge, threatening one of the more robust and energetic Eastern European markets. Many forecasters' figures for inflation, deficits and the currency now look unrealistic, adding to investor concerns.

On the positive side, Romania's economy benefits from several factors which are missing in other CEE markets:

- The risks of a debt-led housing crisis (as in the UK, Spain, Ireland and the US) are low, given the immature state of the market and low debt levels.
- Romania is the second-largest CEE accession country after Poland but has a more regionalised economy which has created several centres of growth outside the capital: Brasov, Constanta, Craiova, Iasi and Timisoara, for example.
- The EU and other supranational bodies have made substantial infrastructure investments, supporting inward investment by companies such as Nokia, Ford, Mercedes and Continental. These are all productivity-enhancing investments which take some time to feed through but provide a strong long-term platform.
- Lower-skilled workers are an issue, but many have moved abroad to work or are employed increasingly in textiles, supermarkets, agriculture and other sectors.
- The banking sector is substantially in foreign hands, which gives a strong capital and knowledge base and helps to mitigate against "local" crises.
- There is a huge pent-up demand for improved housing, as new construction activity was so limited until 2006; coupled with the equity in "old" apartments and rising wages, there are many Romanians who are positioned to upgrade to new accommodation.

On the negative side, four main threats can be identified:

1. Economic growth will drive **inflation**, as wages continue to climb and commodity prices rise; a weakening currency could worsen the situation, if imports continue to flow in; higher interest rates will be required, hurting the domestic economy.
2. The **trade account deficit**: Romanians continue to buy foreign cars, import an estimated 70% of their food but have seen a downward trend on oil products exports.
3. State finances are under pressure, with a **budget deficit** estimated at 2.9% of GDP in an election year, when public sector workers and pensioners are eyeing the rising living standards of those working in the private sector and demanding equalisation.
4. **Asset price inflation**, as seen in other CEE markets, threatens the economy, if the housing bubble bursts, with Bucharest particularly exposed.

Along with these specific issues, there is the more general question of how Romania can deal with its increasingly two-tier economy, where the urban middle class - employed in the private sector or as entrepreneurs - is thriving, while state employees, those in rural areas and pensioners are seeing living standards fall.

For investors, the main risks stemming from these structural issues are that asset prices will stall or decline and/or that the currency will weaken, jeopardising investment values. This paper seeks to identify areas where the economy is vulnerable and to quantify these threats.

1. Inflation and overheating

The Central Bank, in contrast to counterparts in the US and UK, has been raising interest rates to hold down inflation, such that the headline rate is now 9% (latest adjustment on February 7th, 2008). It now appears that the inflation rate target of 2.8-4.8% for 2008 is an optimistic range. On the negative side, private sector wage inflation continues to grow and is spilling into the public sector, threatening the state budget balance. The strong currency also has to some degree helped to hold down imported inflation but a weakening could reverse this effect, unless the trade balance improves.

However, some pressures in the economy may now have reached the point where their impact should ease. First, food prices were the main inflation component last year (weighting 24% in the CORE2 index), with a rise of 9.14% in the 12 months to end December. Romania suffered one of the worst harvests in 2007 and has seen a shift in spending from staples to value-added items, as supermarkets opened across the country, replacing more traditional markets. This trend has exacerbated the underlying food price rise.

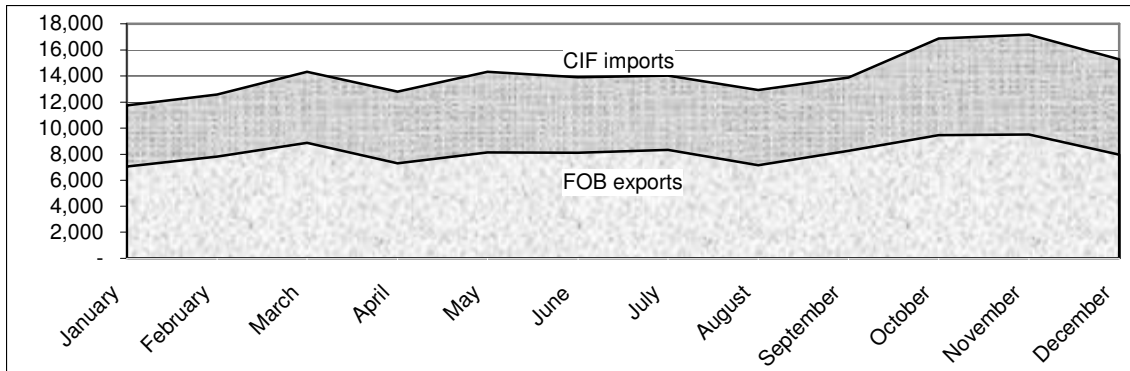
Second, Romanians are more exposed to rising fuel prices, as a larger share of their spending than in Western Europe, and suffered accordingly last year. Both of these key cost components now appear to be reaching peaks, even if declining prices cannot be guaranteed at the moment.

Inflation was also fired by lower productivity gains (9.9%), which have not kept pace with net average wage growth of 15.2%. However, productivity has strong ongoing support from substantial inward investments made by supranational agencies in roads, ports and other productivity-enhancing infrastructure in the past 2-3 years. These will continue to feed in positive effects to the economy. At the same time, international companies have invested in production facilities, retail outlets and increasing R&D and service centres. Better wages in these value-added jobs reflect the internationalisation of a section of the economy.

And, compared to other EEC countries, Romania ranks in terms of 2007 inflation rate well below countries like Hungary (app 7.6%), Bulgaria (above 12%) or the Baltics.

2. Trade account deficit

The preliminary data for 2007 show that the trade account deficit registered a record EUR 21.5bn, equal to around 18% of estimated 2007 GDP and up 36% on 2006 (expressed in RON).

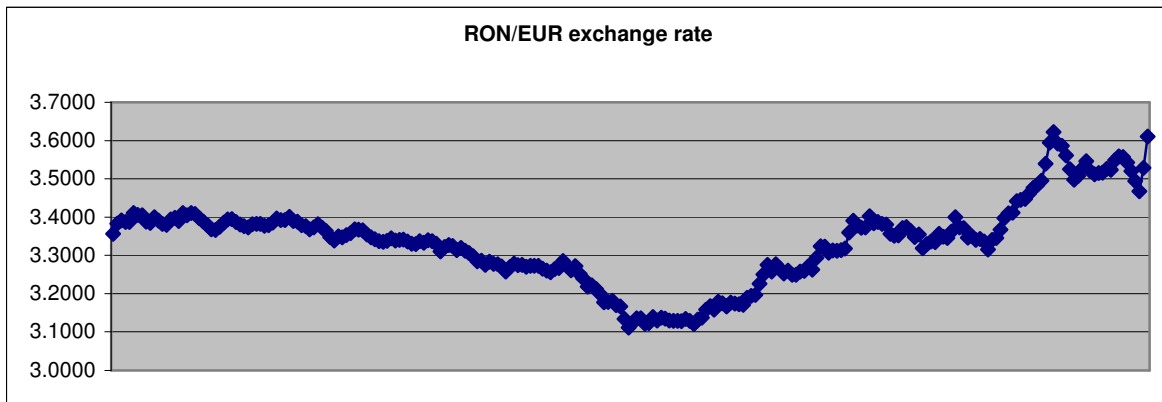


The main import drivers relate to new technology and equipments followed by commodities and transport vehicles. At least the former of these should contribute to productivity gains in 2008 and onwards.

In addition to imports, foreign investors appear to have repatriated capital, locking in gains on the rising Leu and closing out positions on the Romanian stock exchange. Data for these items is limited, but anecdotal evidence suggests that these outflows were material. It could be argued that this swing factor is now less of a threat and is balanced by the more steady inward investment flows. For 2008, the Foreign Investment Agency estimates FDI will reach EUR 7bn.

This flood of cash out of the country is compensated for in part by remittances from Romanians working abroad; these expats contributed an estimated EUR 5bn in 2007. Together, these inward capital flows are substantial and likely to remain strong.

A positive impact in 2008 also could come from agriculture which had a downward effect on economic growth in 2007, due to the drought slashing harvest yields. Romania needs to increase output to reduce food imports and there are signs that strong grain prices are encouraging foreign investments in agriculture.



The strengthening of RON during the first part of 2007 has put pressure on the trade account with imports growing 17.9% compared to 2006.

In the second part of the year, international credit turbulence put pressure on Romania's Leu exchange rate, according to a report of the International Monetary Fund (IMF). Exchange rates in Turkey, Hungary and Romania suffered pressure amid the global credit crisis, the "Regional Economic Outlook" report shows.

2. State finances

The budget deficit has been identified by the European Commission (through the voice of Joaquin Almunia) as a threat, not least because of the limited fiscal room for manoeuvre. Having implemented a 16% flat tax rate, tax receipts have been growing modestly while spending has grown faster. Major privatisations during the past few years mean that the remaining state assets for sale have dwindled, with farmland the main remaining asset class available for divestment. Again, there are signs that the government is now releasing large-scale farm sites to the private sector as well as re-tendering land which have been rented to people who had become unable to service rental contracts after last year's poor harvest.

In 2008, parliamentary elections mean that the government has been adding to the list of spending commitments, seeking to keep public sector employees and pensioners on side in a period when these more vulnerable people have been hit hard by food and fuel cost rises. These political measures are likely to increase inflation as well as worsening the internal balance.

According to the prime minister, Romania will use to the maximum the limit of 3% of the Maastricht criteria on the budget deficit and will continue to finance infrastructure, environment and agriculture projects to reduce the gap between Romania and EU. However, the European Commission is concerned that unless there is some policy tightening the budget deficit will reach 3.2% in 2008 and 3.9% in 2009 putting Romania at the risk of being penalised for breaching the Maastricht criteria. Total expenses for 2008 amount to RON 183.2 billion while estimated total revenue amounts to RON 171.3 billion, placing Romania last in the EU in terms of total revenue.

Rising interest rates and international credit spreads will exacerbate the problem of weak state finances, increasing borrowing costs at a time when tax revenues are likely to grow less rapidly and spending commitments remain.

3. Asset price inflation

Investors have looked at the bubble effects in the Baltic States and other CEE capitals, when property prices rose rapidly, sucking in capital which subsequently evaporated and assessed if Romania is as exposed.

The market in Romania, however, differs in several respects:

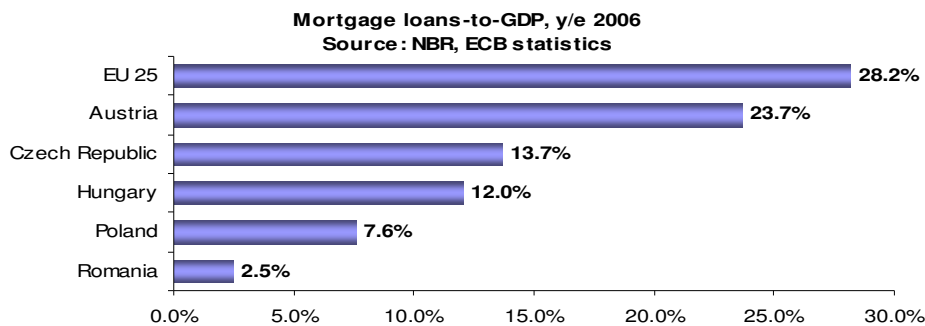
- Romanians already own their own apartments and so have equity, albeit in the form of communist-era blocks, which has a firm open market value.
- The economy has grown strongly in the regions, giving more balance than in other markets where the capital cities have sucked in most real estate investments.
- Wage growth has been strong, while household borrowing has been low, creating a positive base for funding assets, compared with markets such as the Baltics where a

limited number high value assets in the capital cities have been driven up by virtue of being in short supply.

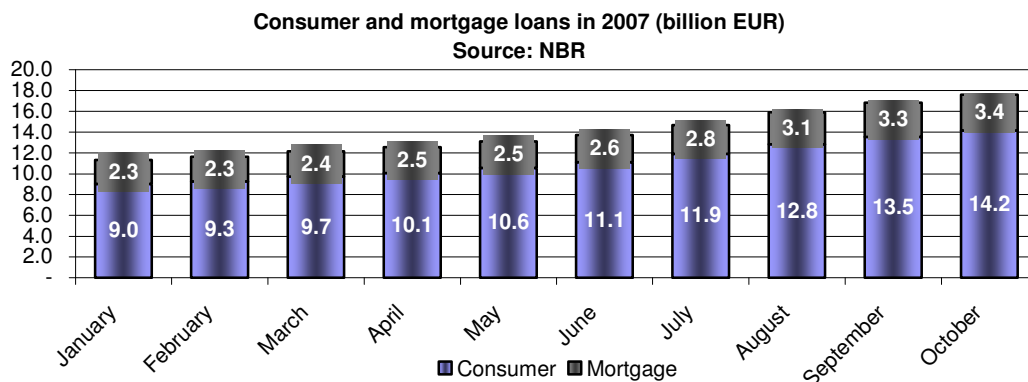
And, in parallel to these investments, supranational and corporate investments have contributed to more sustainable capital formation in Romania, with infrastructure and industrial investments helping to support asset price increases in certain cities along with improved wages.

Romanians also remain substantially under-g geared, compared with the rest of Europe, and have limited exposure to other asset classes, such as shares and bonds. Moreover, as demand continues to exceed supply, while the middle class's income levels grow, it could be argued that demand for new apartments will remain solid, unless the economy weakens greatly. Many Romanians also own their own Communist era properties, which provide them with equity capital for new apartments.

The mortgage market in Romania is still undersupplied as compared to other CEE markets.



The value of mortgages reached RON 12bn (EUR 3.4bn) at the end of October, 4 times lower than the balance of consumer loans. That is still very low as a percentage of GDP compared with other CEE countries.



Conclusions

Investors looking for signals on the two main risks, declining asset prices and a weaker currency, will look for the following measures and indicators for comfort or as a warning:

- Continued FDI to help sustain the Leu, along with cash sent home from abroad;
- Taking the heat out of the economy to reduce the trade imbalance and reduce inflation;
- Fiscal discipline along with further privatisations, to improve productivity; in agriculture asset sales also would help trim the trade imbalance and mitigate a key inflation factor;
- An easing of asset price growth, particularly in the Bucharest housing market, to allow for continued uptake of new properties by the growing middle class;
- Continued investment by international companies, in offices, logistics centres, retail sites and other commercial properties

Among with these measures, the Central Bank's recent increase in interest rates and reports of EUR 7.2bn of further corporate FDI for 2008, plus completion of infrastructure programmes like the Corridor IV motorway stand on the positive side.

Our conclusion is that the long-term picture remains strong, even if short-term factors such as construction costs, rising interest rates and currency swings, speak for a pause in growth.

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