Romania
Macroeconomic Situation

SigmaBleyzer

THE BLEYZER FOUNDATION

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- **In 2009, real GDP dropped by 7.1% yoy, after four years of a 6.4% yoy average growth per year.**
- **The consolidated budget deficit deteriorated to 7.2% of GDP last year.**
- **Headline inflation eased to 4.75% yoy in 2008. In February 2010, annual inflation slowed to 4.5% yoy.**
- **The current account gap adjusted to 4.4% of GDP, from 14% of GDP in the previous year.**

Executive Summary

The economic downturn reached its bottom in the second half of 2009, and external finances strains have eased. In the third quarter of 2009, the economic downturn started to moderate gradually helped by recovering external demand. The rate of GDP decline eased from 8.4% yoy in the second quarter to 7% yoy in the third quarter. And the contraction in industrial production moderated from 11% yoy in the first half of 2009 to 5.5% yoy at the end of 2009. In 2010, economic growth is forecast to continue reviving, though gradually. Real GDP is forecast to grow by about 1.5% yoy. The recovery of the Romanian economy will be driven by a stronger rebound of foreign demand and foreign capital inflow.

Contraction of economic activities squeezed budget revenues, while the government authorities were restricted in their austerity measures due to the presidential election, held in November-December 2009. As a result, the consolidated budget deficit reached 7.2% of GDP in 2009. The IMF/EU loan program, secured by the government at the end of 2008, helped to avoid a deterioration of forex reserves and contained depreciation pressure on the Romanian currency (RON) in 2009. The stock of gross forex reserves of the National Bank of Romania (NBR) even grew by 9% to EUR 31 billion at the end of 2009. Also, the national currency stabilized at about RON 4.22 per EUR in 2009, weakening by only 6% for the whole year, after a13% depreciation in September-December 2008.

In mid-January 2010, the Parliament approved a 5.9% of GDP deficit for 2010. This year, the reforming of public finances to bring the deficit to more sustainable levels will remain the main challenge for the new government.

Following the stabilization of the RON and weakening domestic demand, inflation eased to 4.7% yoy in 2009 and then to 4.5% yoy in Feb 2010. Thus, inflation closely approached the target boundaries of the NBR (2.5-4.5%). Moderation of inflation and a stable situation in the forex market allowed the NBR to lower its policy interest rate from 10.25% in Jan 2009 to 6% starting from March 30th, 2010, which should support economic recovery.

In 2009, the stock of bank non-government loans grew by only 0.9% yoy, compared to an average growth of 50% yoy over 2005-2008. The recovery of credit activity will be rather moderate, as commercial banks are likely to be restricted in foreign financing and will continue to clean their balance sheets. In particular, the system's liquidity remains tight with an overall loan-to-deposit ratio of more than 110% at the end of 2009. At the same time, the capital adequacy ratio of the banking system is relatively sound at over 14% as of Dec 2009, with foreign parent banks expected to provide additional capital funds in case of need.

The financial crisis caused a notable adjustment in Romania's large external imbalances, in particular, through adjustment of the foreign trade gap. The almost two-fold adjustment of the trade deficit caused the current account gap to narrow to 4.4% of GDP in 2009, compared to 12% in 2008. Although net FDI inflows dropped by 46% yoy in 2009, they remained quite robust at EUR 4.9 billion. The current external deficit looks more sustainable, as net FDI inflows covered the 2009 deficit almost in full. In 2008, the respective coverage was only 54%.

	2005	2006	2007	2008	2009	2010f
GDP growth, % change yoy	4.2	7.9	6.3	7.1	-7.2	1.5
Industrial production, % change yoy	2.0	7.1	5.4	0.9	-5.5	1.8
Consolidated budget deficit, % of GDP	-0.8	-1.7	-2.4	-4.8	-7.2	-5.9
Unemployment, end of period		5.2	4.1	4.4	7.8	6.5
Inflation, end of period	8.72	4.87	6.56	6.30	4.75	4.2
Retail sales, % change yoy	17.5	13.5	17.8	13.0	-8.5	3.5
Gross forex reserves of the NBR, EUR billion, end of period	18.3	22.9	25.3	28.3	30.9	32
Current Account Balance, EUR billion	-6.89	-9.97	-16.68	-16.16	-5.05	-3.48
Total gross external debt, EUR billion	30.9	41.2	58.6	72.4	78.7	83
Exchange rate, RON/EUR, annual average	3.62	3.52	3.34	3.68	4.24	4.15

Source: INNSE, NBK

Where Opportunities Emerge.

Chief Economist Edilberto L. Segura
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Economic growth

The downturn of the Romanian economy started to moderate during the second half of 2009 on the back of a low statistical base and gradual rebound of external markets. The drop in GDP reached 7.1% yoy in 2009, less than the 7.6% yoy decline during the first half of 2009. The contraction in real value-added decelerated from a bottom of 8.7% yoy in the second quarter to 7.1% yoy and 6.5% yoy in the third and fourth quarters respectively. Revival of external markets as well as stimulating fiscal programs in Romania's main trading partner countries favored the slight recovery of exports and, therefore, export-driven industrial branches, (in particular, production of vehicles.) In contrast to external demand, consumption and investment activity, which used to be the main economic growth drivers, were dampened significantly by anemic bank lending. Private consumption fell by almost 13% yoy in the second quarter. In the third and fourth quarters, a drop in private consumption slowed to 10% yoy and 4.5% yoy respectively mainly as the result of a low-base effect. Nevertheless, final consumption remained rather week, being restrained also by a decline in real wages and growing unemployment. Indeed, real wages dropped by 5.3% yoy in December 2009, compared to a 10.6% yoy growth registered a year ago, even despite easing inflation. The unemployment rate increased from 4.4% in December 2009 to 7.8% in December 2009.

In 2009, gross fixed capital investment deteriorated significantly due to persisting risks, worsening expectations and stagnation of international capital markets. A decline of gross fixed capital formation deepened to 31% yoy in the fourth quarter from a meager growth of 2.7% yoy in the first quarter.

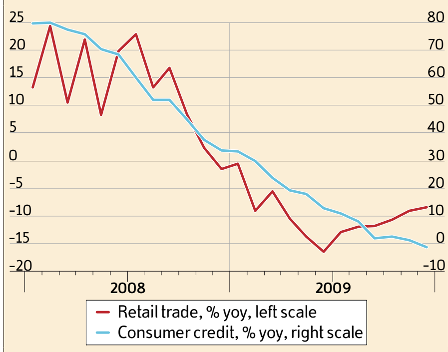
Performance of agriculture and industry started to improve in the third quarter, supported by relatively stronger external demand. Indeed, agriculture grew by 2.4% yoy in the third quarter compared to a 9.5% yoy contraction in the first half of the year. At the same time, value-added produced by the industry improved to 4% yoy growth from a 9% yoy decline in the first half of the year, benefiting from growing export of cars. In particular, production of motor vehicles grew by 11% yoy in 2009, due to exports, as several EU countries introduced "cash for clunkers" type programs. However, economic sectors oriented on domestic consumers as well as capital dependent sectors continued to stagnate heavily. Thus, construction dropped by 17% yoy in the third quarter and then slowed marginally to 16% yoy in the fourth quarter. Trade, transportation and communication declined by 12.5% yoy in the fourth quarter, gradually worsening from a 7.6% yoy contraction in the first quarter of 2009.

In 2010, real GDP is forecast to grow by about 1.5% yoy. A recovery of the Romanian economy will be tightly related to a rebound of foreign demand and foreign capital inflows. Recovery of credit-dependent sectors will remain subdued, as bank lending is not likely to revive this year. Export will be the principal driver of economic growth in 2009, while domestic demand will recover relatively slowly.

Fiscal Policy

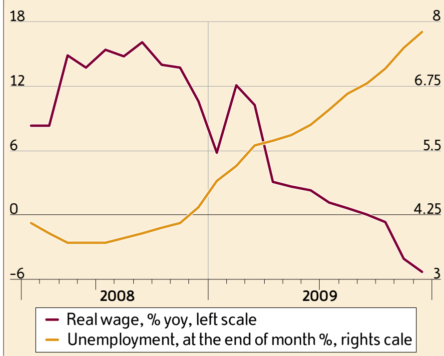
Contraction of economic activities squeezed budget revenues, while the government authorities were restricted in their austerity measures due to the presidential election, held in November-December 2009. Consolidated budget revenues declined by 5.4% yoy to RON 156.6 billion in 2009, mainly due to lower revenue from the value-added tax, corporate profit taxes and customs duties. On the other hand, total expenditures rose by 1.4% yoy to RON 193 billion in 2009. Despite significant weakening of public finances, social assistance costs rose by RON 9.8 billion in 2009, following an increase of the pension point and the introduction of a minimum social pension as of April last year. More-

Retail Sales and Consumer Credit, % yoy



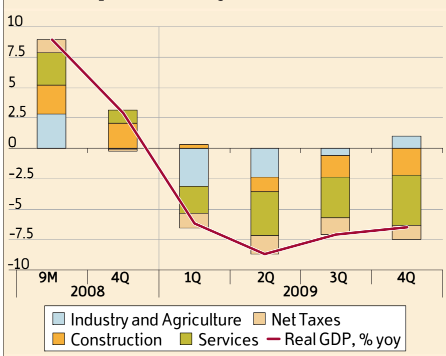
Source: INNSE, NBR

Real wage and Unemployment



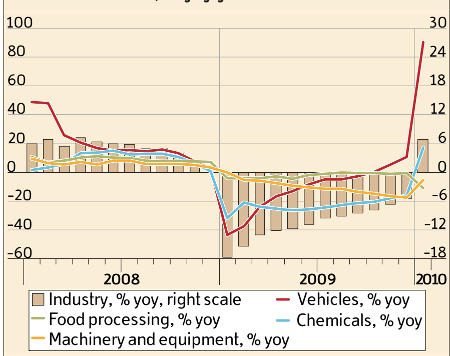
Source: INNSE

Economic performance by sectors



Source: INNSE

Industrial trends, % yoy ytd



Source: INNSE

over, in order to cushion the impact of the economic and financial crisis on vulnerable social categories, the government adopted a series of sheltering measures for the low-income population. On the other hand, the costs of goods and services in the public sector dropped by 12.6% yoy in 2009, following a series of government measures in the sector. As a result, the consolidated budget deficit reached 7.2% of GDP in 2009.

Nevertheless, the 7.2% of GDP budget gap was in line with the IMF agreement. In mid-January 2010, the Parliament endorsed the budget law, envisaging a 5.9% of GDP deficit for 2010, fully in accordance with the requirements of multilateral creditors. The IMF/EU loan program was suspended in November due to politics ahead of the elections. However, a stabilization of the political situation and approval of the budget law for 2010 allowed the IMF to resume the financing program for Romania in February. The Fund has disbursed the third and the fourth tranches together, worth EUR 2.45 billion in total. Half of this amount will be allocated to budget deficit financing, which will provide significant support for strained public finances. At the same time, the reforming of public finances to bring the deficit to more sustainable levels will remain the main challenge for the new government.

During March, Romania issued EUR 1.0 billion Eurobonds, maturing 2015. The bond, issued at 5.17% yield, and more than 4.5 times oversubscribed, was considered a success, by officials from the Ministry of Public Finances. The issue benefited from a rating outlook improvement from negative to stable by the rating agencies Fitch and S&P. Still, both Fitch and S&P rate Romania one notch below investment grade, at BB+, while Moody's is the only large agency rating Romania as investment grade, at Baa3.

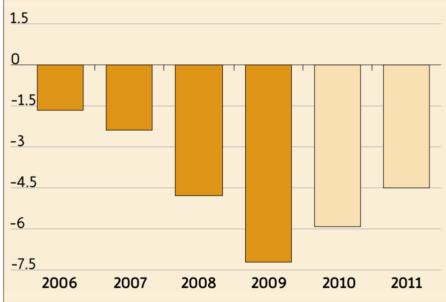
Monetary policy

The IMF/EU loan program, secured by the government at the end of 2008, helped to avoid a deterioration of forex reserves and contained the depreciation pressure on the Romanian currency (RON) in 2009. The stock of gross forex reserves of the National Bank of Romania (NBR) even grew by 9% to EUR 31 billion at the end of 2009. The national currency stabilized at about RON 4.22 per EUR in 2009, weakening by only 6% for the whole year, after a 13% depreciation in September-December 2008. Currently, the pressure of external financing diminished substantially, as the external gaps adjusted even more sharply than was anticipated. Moreover, inflows of foreign capital remained quite strong thanks to IMF support and less-than-expected shrinking of private capital inflows.

During January-March 2010, the Romanian leu posted slight strengthening versus the Euro on the back of a stabilization of the political environment and the resumption of the IMF/EU loan program. The RON appreciated by 3% in nominal terms to 4.1 per 1 EUR as of March.

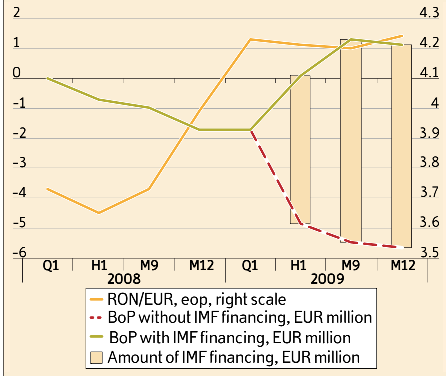
Despite some depreciation of the national currency, inflation tensions eased considerably in 2009. Due to much weaker domestic demand, annual inflation decelerated to 4.7% yoy in December 2009, down from almost 7% yoy in February 2009. Headline inflation was very close to the upper bound of the inflation target band (3.5±1%). The main reason for missing the target was consecutive increases in excise rates on tobacco during the last two months of 2009. In January 2010, headline inflation lifted up again to 5.2% yoy, still driven by increasing excises for tobacco products. But already in February, consumer price growth slowed to 4.5% yoy, as regulated prices remained unchanged during this month.

Consolidated Budget Balance, % of GDP



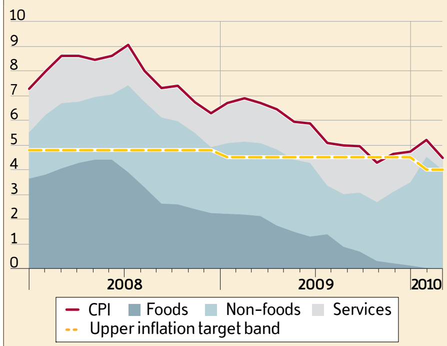
Source: Ministry of Public Finances, The Bleyzer Foundation

The RON/EUR exchange rate (eop) and the financing of the Balance of Payments (EUR bln)



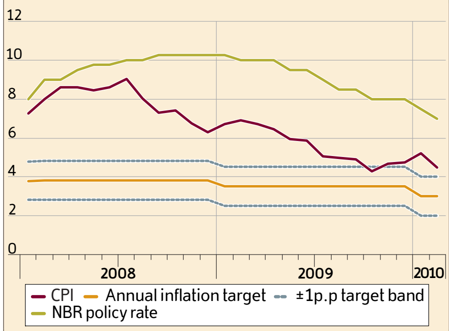
Source: NBR, The Bleyzer Foundation

CPI by Components contribution, % yoy



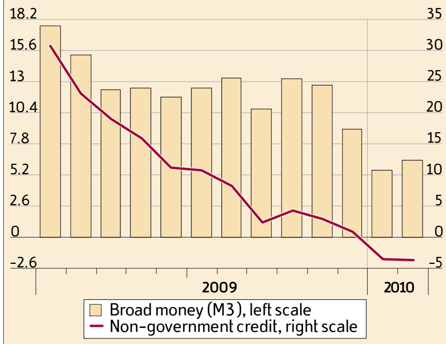
Source: NBR

CPI, the Inflation Target, and the NBR policy Rate, % yoy



Source: NBR

Money Supply and Non-government Credit, % yoy



Source: NBR

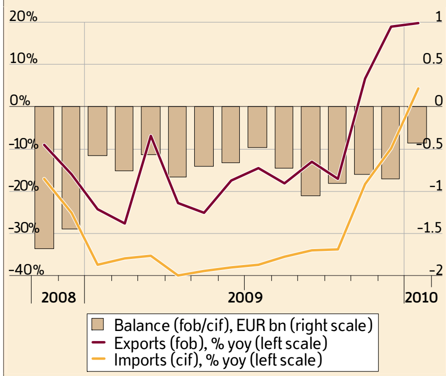
Moderation of inflation and a relatively stable situation on the forex market allowed the NBR to further lower its policy rate. During January-March 2010, the policy rate was reduced by several steps from 8% at the end of 2009 to 6% starting from March 30th, 2010. As real interest rates remain positive, with this move the NBR is trying to maintain banking liquidity and to stimulate bank lending. Experiencing high credit growth in the past few years, the Romanian economy is suffering from stalled credit activity.

In 2009, the stock of bank non-government loans grew by a meager 0.9% yoy, compared to an average growth of 50% yoy over 2005-2008. In addition, adjusting for the national currency depreciation (loans denominated in foreign currency account for more than half of total loans), the stock of credit actually declined in 2009. In January-February 2010, bank lending activity remained rather weak. The stock of non-government credit dropped by 3.5% yoy in January and by 3.7% yoy in February. Bank lending activity is still significantly restricted by tight liquidity of the system as well as by the worsening quality of bank loan portfolios. Indeed, the system's liquidity remains rather tight with an overall loan-to-deposit ratio of slightly more than 110% at the end of 2009. Meanwhile, the amount of loss loans surged by 2.7 times as of December 2009, compared to the respective period of the previous year, totaling RON 22.8 billion. The share of non-performing loans (including loans qualified as substandard, doubtful and loss) extended to 24% of the credit portfolio, compared to 13.8% posted a year ago. Nevertheless, thanks to sufficient capital injections from foreign parent banks, this level of non-performing loans is unlikely to be a systemic risk factor for the banking sector. The capital adequacy ratio of the banking system is relatively sound at over 14% as of December 2009, with foreign parent banks expected to provide additional capital funds if needed.

Despite the NBR measures and relatively strong stance of the banking system, a recovery of credit activity is forecast to start only in the second half of the year and is expected to be rather moderate. Commercial banks will remain restricted in foreign financing and continue to clean their balance sheets.

International Trade and Capital

Monthly Foreign Trade Balance

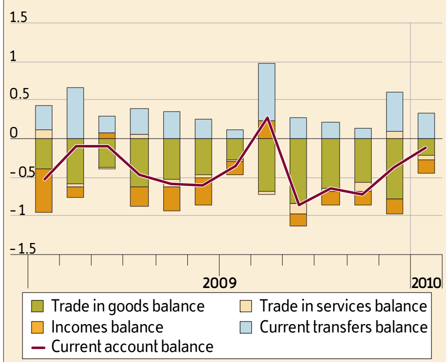


Source: INNSE

The financial crisis caused a notable adjustment in Romania's large external imbalances, in particular, through adjustment of the foreign trade gap. In 2009, FOB exports dropped by 14% yoy, driven down by the world economic slowdown. Meanwhile, CIF imports shrank by 32% yoy on the back of correction of domestic demand and the abrupt depreciation of the RON. The drastic decline in imports led to a lower FOB/CIF merchandise trade deficit of EUR 9.7 billion in 2009, down by 2.3 times yoy.

In the fourth quarter, dynamics of foreign trade in goods improved remarkably, as exports turned to positive growth, while imports posted a visibly slower rate of decline. Indeed, FOB exports grew by 6.7% yoy and 19% yoy in November and December respectively, after twelve months of decline. At the same time, CIF import growth decelerated to 18% yoy and 10% yoy respectively, compared to a monthly average 37% yoy decrease posted during the first ten months of the year. The improvement in the two last months of the year can be attributed to a large extent to a low statistical base effect. Also, the improvements in export dynamics were favored by the rapid growth of export of vehicles - by 26% yoy in January-December 2009. The fiscal stimulus program, initiated in some European countries, favored growth of exports of comparatively cheap Dacia cars.

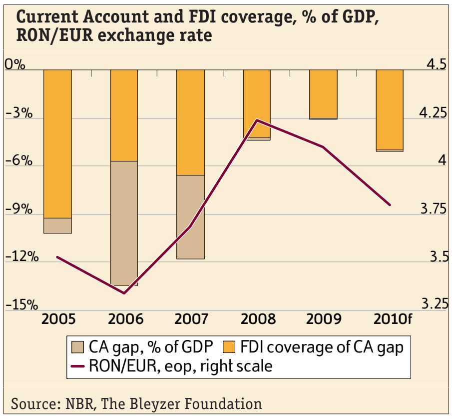
Current Account Components, monthly flows EUR billion



Source: NBR, The Bleyzer Foundation

In January 2010, a recovery of the foreign trade dynamics continued on the back of a significant contraction in the previous year and moderate recovery of the global economy. Thus, FOB exports in goods grew by almost 20% yoy, while CIF imports increased by a meager 4.4% yoy, resulting in a FOB/CIF trade gap of EUR 0.4 billion.

In 2009, the current account gap narrowed to less than 5% of GDP, down from 14% of GDP in 2007, following a more than two-fold decrease in the trade deficit. The current external deficit looks more sustainable, as net FDI inflows covered almost 100% of the 2009 deficit. In 2008, the respective coverage was only 54%.



Although net FDI inflows dropped by 46% yoy in 2009 to EUR 4.9 billion, they are forecast to improve notably in 2010 with the end of political turmoil, resumption of the IMF program, and a revival of foreign investors' appetite for emerging markets. In addition, medium-term investment prospects for Romania remain quite favorable due to a cheap labor force and the high growth potential of the domestic market.

In January 2010, the current account deficit was at EUR 123 million, down by almost 4 times yoy. Net FDI inflows totaled EUR 302 million, easily covering the current account gap. At the same time, FDI inflows shrank by three times yoy.