

July 2010

Larysa Koziarivska, Radu Mihai Balan, Edilberto L. Segura

- The IMF Board decided to grant Romania the 5th tranche of the EUR 13.6 billion loan. The value of the tranche is EUR 913 million.
- In January-April, industrial growth advanced to 5.2% yoy.
- The budget deficit was at 3.1% of full-year projected GDP in January-May.

Executive Summary

In the first quarter of the year, GDP declined by a real 2.6% yoy to RON 96.7 billion (EUR 23.3 billion). On the utilization side, domestic demand continued to contract, as final consumption decreased by 4% yoy and gross fixed capital formation dropped by 29% yoy. On the formation side of GDP, industrial activity was the only one to improve relative to the first quarter of 2009, while construction reported the largest decline. Indeed, in January-April, industrial growth advanced to 5.2% yoy, from 4.1% yoy registered in January-March, led by growing production of chemicals, basic metals, and motor vehicles. External demand continued to support export and export-oriented industrial branches. On the opposite side, domestic-oriented food processing keeps shrinking. A continuing GDP decline in January-March makes prospects of economic recovery this year uncertain.

While industry performs well above average, the domestic-demand oriented sectors will continue to contract affected by fiscal corrective measures. Therefore, we have revised our forecast for 2010 GDP decline from previous 0.5% to 2%-3% yoy.

The consolidated budget deficit widened by 47% yoy in the first five months of the year, totaling EUR 4 billion as of May 2010, as revenues inched down by 1.6% yoy and expenditures increased by 5.7% yoy. Thus, the budget deficit amounted to 3.1% of full-year projected GDP, up from 2.3% of GDP posted a year ago.

On July 2nd, the IMF Board convened and decided to grant Romania the 5th tranche of the EUR 20 billion loan from the IMF, World Bank, EBRD and the EU. The value of the tranche is EUR 913 million, and it will be used entirely to increase the reserves of the National Bank of Romania. The IMF agreed to the modification of the inflation target for Romania for 2010 to 7.9% from 3.5%. At the moment of review, the IMF did not modify its estimate of a 0.5% real GDP decline for 2010. The budget deficit target of 6.8% of GDP agreed with the IMF was maintained.

Despite the fiscal consolidation, the pressure on public financing is likely to raise the cost of domestic financing, since access to foreign debt markets will probably remain problematic. However, the agreement with the IMF should speed up the structural reform in the public sector, which will improve the government's credibility, smoothing the cost of public financing. At the same time, public debt will increase significantly this year on the back of a moderate base of some 35% of GDP at the end of March 2010.

The consumer price index inched up by 0.16% mom in June, while headline inflation slightly decelerated to 4.38% yoy from 4.42% yoy one month earlier. However, the VAT rate hike from 19% to 24% will predictably spur headline inflation in the second half of the year above the target band of 3.5% yoy \pm 1 p.p. But domestic demand is likely to remain weak and will drive down inflation within the target boundaries through the end of 2011.

	2005	2006	2007	2008	2009	2010f
GDP growth, % change yoy	4.2	7.9	6.3	7.1	-7.2	-3 to -2
Industrial production, % change yoy	2.0	7.1	5.4	0.9	-5.5	4.0
Consolidated budget deficit, % of GDP	-0.8	-1.7	-2.4	-4.8	-7.2	-6.5
Unemployment, end of period		5.2	4.1	4.4	7.8	7.5
Inflation, end of period	8.72	4.87	6.56	6.30	4.75	6 to 7
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	-6.9
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

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Economic growth

In the first quarter of the year, GDP declined by a real 2.6% yoy to RON 96.7 billion (EUR 23.3 billion). On the utilization side, domestic demand continued to contract, as final consumption decreased by 4% yoy and gross fixed capital formation dropped by 29% yoy. Final consumption remained subdued by still anemic bank lending and unemployment. At the end of April, the unemployment rate decreased to 8.1% after increasing each month for the past 20 months from 3.7% in July 2008 to 8.4% in March 2010. However, the number of employees decreased in April to 4,290 thousand from 4,303 thousand in March 2010.

On the formation side of GDP, the construction sector plunged by 17% yoy in the first quarter of the year, and despite its relatively small share in total GDP (some 6%), the sector made an important contribution to the overall dynamics: negative 1.2 percentage points (p.p.) of the total 2.6% yoy GDP decline. The largest contributor to the country's GDP, the services sector, decreased by 2.2% yoy, adding a negative 1.2 p.p. to the total GDP contraction as well. In contrast, industry demonstrated better performance in the first quarter, increasing by 4.2% yoy in value added terms.

In fact, industrial activity was the only one to improve relative to the first quarter of 2009, while construction reported the largest decline.

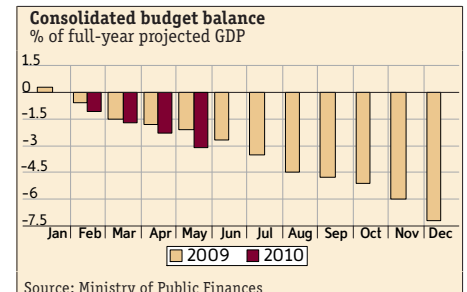
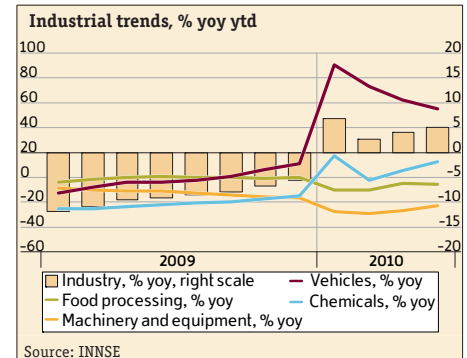
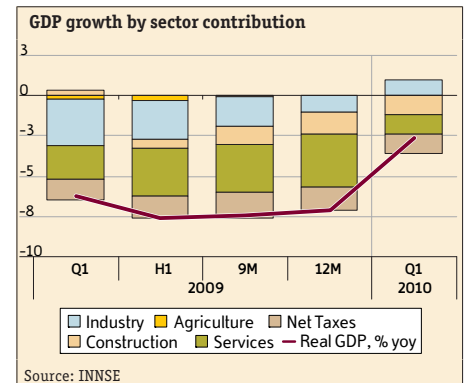
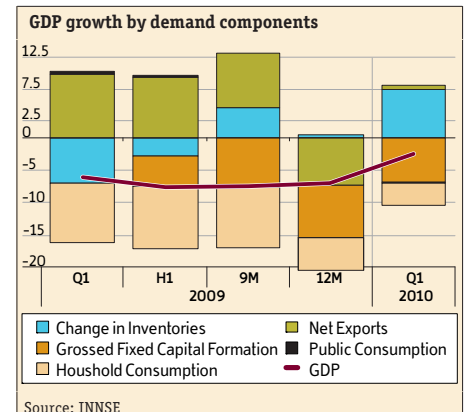
At the beginning of 2010, industry was performing well above average economic performance. Indeed, in January-April, industrial growth advanced to 5.2% yoy from 4.1% yoy reported in the first quarter, led by growing production of chemicals, basic metals, and motor vehicles. External demand continued to support export and export-oriented industrial branches. In particular, chemical production grew by 12.2% yoy in January-April, soaring from a 5.3% yoy increase in January-March. Meanwhile, production of basic metals revived to 32% yoy growth after almost three years of recession in this industry. Production of motor vehicles remained the locomotive of industrial growth in Romania, increasing by 55% yoy in the first four months. On the opposite side, domestic oriented food processing continued to shrink and fell by 6% yoy in January-April.

A continuing GDP decline in January-March has led to uncertain prospects of economic recovery this year. Therefore, we have revised our forecast for 2010 GDP development to a 2%-3% yoy decline from 0.5% yoy in the previous month. While industry performs well above average, the sectors that revealed unsustainable growth in 2007-2008, such as construction, real estate, retail trade and financial services, will continue to contract. Gradual recovery of the Romanian economy will remain strongly dependent on the performance of the global economy.

Fiscal Policy

The consolidated budget deficit widened by 47% yoy in the first five months of the year, totaling EUR 4 billion as of May 2010, as revenues inched down by 1.6% yoy and expenditures increased by 5.7% yoy. Thus, the budget deficit amounted to 3.1% of full-year projected GDP, up from 2.3% of GDP posted a year ago. It remains to be seen whether the mid-year target negotiated with the IMF of RON 18.2 billion will be met or not.

The key tax revenues to the consolidated budget surged by 11.2% yoy to RON 11.23 billion in June, according to the tax collection agency ANAF. In January-May, revenues to the consolidated budget inched down by 1.6% yoy to RON 64 billion on the back of a 7.8% yoy decline of VAT collections and 6.4% yoy decrease in income tax collections. The VAT collections reportedly surged by 18% yoy in June, more likely due to an active tax evasion fight rather than to increasing retail sales. Although sales reportedly in-



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creased significantly in the second half of June as an effect of the VAT rate hike, probably the key element of this growth was stricter tax collection discipline, which may explain the rise in June in general. The government has recently endorsed an ordinance on tax evasion and the tax collection agency turned visibly more active.

On Friday, June 25th, the Romanian Constitutional Court ruled that the 15% pension cut stipulated in the Government Ordinance is not constitutional and as such cannot be applied. The pension cut, along with a 25% salary cut for public officers, were the two main measures agreed with the IMF to reduce the budget deficit for this year. They were compulsory measures for receiving another tranche of the IMF loan that was due on July 1st. Shortly after the decision, the IMF Board postponed the review meeting regarding the release of the tranche that was scheduled for June 30th.

The Government reacted swiftly on June 26th, deciding to increase the VAT from 19% to 25% starting July 1st. The 25% salary cut for public officers together with other measures of lower impact on the budget, such as increasing property taxes and applying the 16% flat tax rate to both bank interest and to gains from short term capital transactions (instead of the previous 1% rate) were also enforced starting July 1st.

On July 2nd, the IMF Board convened and decided to grant Romania the 5th tranche of the EUR 20 billion loan from the IMF, World Bank, EBRD and the EU. The value of the tranche is EUR 913 million; it is expected to be received on July 5th and will be used entirely to increase the reserves of the National Bank of Romania.

IMF representatives stated that the Board was impressed with the fast reaction of the Government to the decision of the Constitutional Court and implied that a mix of increasing taxes and reducing expenditures had been the favoured solution of the IMF at the last review.

The IMF agreed to the modification of the inflation target for Romania for 2010 to 7.9% from 3.5%. The IMF did not modify its estimate for the change in GDP for 2010, maintaining the forecast of a 0.5% decrease. The budget deficit target of 6.8% of GDP agreed with the IMF was maintained.

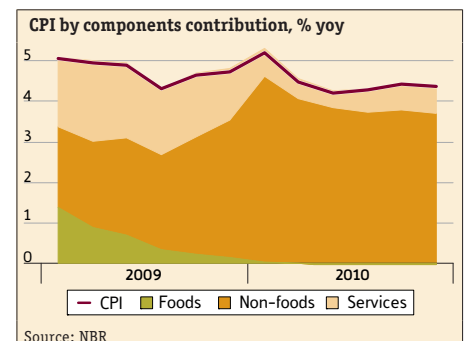
The government will also reduce 59,000 jobs in the budgetary sector (or some 4.5%), out of which half of the jobs are in local administration and the rest in the ministries of interior and administration, labor, education and agriculture. The government pledged to observe a public payroll ceiling for the next year under the SBA with the IMF (RON 39 billion, however it is likely to be a subject to revision during July's visit of the Fund's expert team) and also pledged to bring down public sector employment down to 1.29 million by the end of 2010 (from 1.36-1.37 million).

The public debt surged by 37% yoy to EUR 40.3 billion at the end of March, as the Ministry of Finance has reported. It amounted to 34.8% of last year's GDP. The debt increased by 7% mom in March alone on the back of the EUR 1 billion disbursed by the EU and another EUR 1 billion raised by the government under a Eurobond issue. Public foreign debt rallied by 117% yoy over the past year on the back of the disbursements under the multilateral support programme of the IMF and the EU to EUR 22.3 billion, while the domestic debt decreased by 6% yoy to EUR 18 billion. Issuing another Eurobond later this year might be necessary for safe financing of the budget deficit. However, this significantly depends on further political developments.

Monetary policy

The consumer price index inched up by 0.16% mom in June, while headline inflation slightly decelerated to 4.38% yoy from 4.42% yoy one month earlier. Food prices continued to decrease on a year-over-year comparative basis for fourth months in a row, falling by 0.12% in June, witnessing weak domestic demand. Meanwhile, the rise in prices for non-food, such as tobacco due to higher excise rates and fuels due to higher oil prices, to 8.4% yoy, drove the overall growth in consumer prices. Tariffs for services also advanced by 3.8% yoy in June.

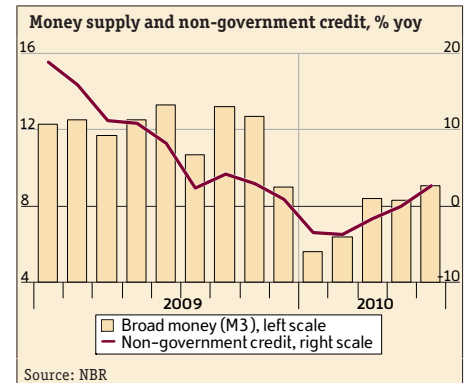
The VAT rate hike from 19% to 24% will predictably spur headline inflation in the second half of the year above the target band of 3.5% yoy \pm 1 p.p. But domestic demand is likely to remain weak and will drive down inflation within the target boundaries through the end of 2011.



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On June 30th, the central bank decided to maintain the monetary policy interest rate at 6.25% a year, breaking off the string of four consecutive cuts made since the beginning of the year, showing it prefers to wait and see what the effect of the VAT increase will be on the prices before making its next move.

The stock of forex loans issued by banks to the private sector increased by 6.7% yoy to EUR 30 billion in May, compared to a 4.9% yoy increase one month earlier and 3.9% yoy two months earlier. Thus, the stock of bank loans denominated in foreign currency increased by EUR 144 million in May alone, accumulating a EUR 1.7 billion advance over the last twelve months. On the other hand, the stock of loans denominated in local currency keeps shrinking, diminishing by 4.7% yoy to RON 78 billion (EUR 18.6 billion) as of May.

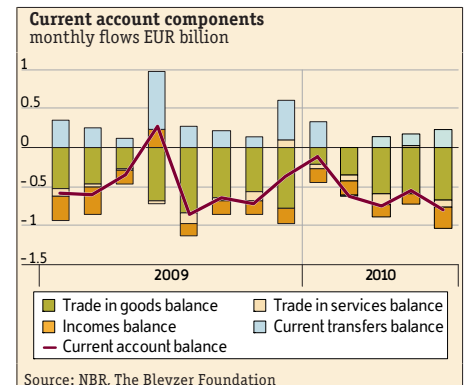


In May, bank credit to the government surged by 59% yoy to EUR 12.7 billion (RON 53.2 billion), while credit to the private sector inched down by a mere 1.4% yoy to EUR 48 billion. Thus, the share of government credit in total domestic credit extended to 21% from 14% a year ago and from 6% two years ago.

Broad money supply (M3) increased by 8.8% yoy in May to RON 193 billion on the back of a 184% yoy surge in Net Foreign Assets prompted by loans under the multilateral agreement with the IMF, EU and WB (to which EUR 1 billion Eurobond was added.) At the same time, the banks were compelled under a special agreement to keep their resources within the country. Also, the CA gap narrowed significantly, which contributed to the rise in NFA to RON 31.4 billion (EUR 7.6 billion) at the end of May. On the other hand, Net Domestic Assets shrunk by 3.1% yoy to RON 160 billion. The change in the structure of M3 in favor of NFA partly explains the local currency stability. However, this stability is not quite sustainable given both short-term volatile political prospects as well as the longer-term macroeconomic outlook.

International Trade and Capital

The current account deficit widened by 40% yoy to EUR 2.1 billion in January-April, which is 1.7% of full-year projected GDP, up from 1.3% of GDP a year ago. The deterioration of the CA balance was prompted by lower current transfers - EUR 604 million in January-April this year from EUR 1.55 billion in the respective period of last year, which is attributed to lower current transfers in both private and government sectors. At the same time, the FOB/FOB trade balance keeps shrinking on the back of lower domestic demand, decreasing by 12% yoy to slightly above EUR 2 billion. Net FDI inflows continued to contract, decreasing by 37% yoy to EUR 1.14 billion in January-April. However, this level of foreign investments is still quite robust given slower economic recovery than expected.



Thus, in January-April, sustainability of the current account in terms of its gap financing with net FDI inflows worsened. Indeed, net FDI covered only 55% of the current account deficit in the first four months of the year, against 122% coverage in the respective period of last year. At the same time, the rest of the deficit was easily financed with net portfolio investments.

NBR forex reserves decreased by EUR 362 million in June to EUR 31.6 billion, which is equivalent to 26% of GDP, nearly two times the country's short-term external debt or 36% of the country's total external debt. Although forex reserves decreased by EUR 759 million in the past two months, as no disbursement from multilateral lenders took place, they remained at quite strong.