SigmaBleyzer

Romania

Macroeconomic Situation

THE BLEYZER FOUNDATION

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- **Industrial production grew by 5.3% yoy in January-August 2010.**
- **During the first eight months of 2010, budget revenues rose by 2.9% yoy to EUR 25 billion.**
- **On September 29th, the Central Bank kept its benchmark policy rate unchanged at 6.25%.**
- **During the first eight months of 2010, the current account deficit was 48% higher than a year ago.**

Executive Summary

In January-August, the industrial production index rose by 5.3% yoy on higher output in utilities, chemicals and manufacturing of base metals and vehicles. Growing exports remained the main source of strength behind many industrial sectors. At the same time, industries, which depend more on domestic demand, posted uneven results. In particular, food processing and apparel manufacturing declined on the back of a low harvest and weak domestic demand. Meanwhile, textiles and manufacturing of wood products were on the upward trend. Industry should remain a strong driver of economic growth in the coming months.

As a result of the implementation of the summer fiscal austerity programs, in January-August the budget deficit fell by 6.3% yoy. This was the first decline of such magnitude in 2010. Moreover, budget revenues grew at the highest pace in 2010 (2.9% yoy), while the growth of spending decelerated to 1.3% yoy from 3.2% yoy a month ago. Improving collection of main taxes (in particular, VAT and excises) as well as stronger non-tax proceeds contributed to higher budget revenues. Meanwhile, a reduction of public sector pay and cuts of public investments helped restrain the growth of budget expenditures.

In August, headline inflation (CPI) accelerated slightly to 7.8% yoy due to the one-shot effect of the recent hike in the VAT tax rate (by 5 p.p. to 24%). At the same time, the National Bank of Romania (NBR) expects that the CPI will gradually move back to its inflation target (2.0%-4.0%) in 2011 thanks to a tighter budget and weak domestic demand. As a result, the NBR maintained its key policy rate unchanged at 6.25%.

In January-August, the current account deficit was 48% higher than a year ago. In particular, a 40% drop of the current transfers worsened the current account gap. On a positive note, the eased decline of FDI inflows (down by 36% yoy) allowed Romania to cover half of the current account deficit.

	2005	2006	2007	2008	2009	2010f
GDP growth, % change yoy	4.2	7.9	6.3	7.1	-7.2	-2.5
Industrial production, % change yoy	2.0	7.1	5.4	0.9	-5.5	3.0
Consolidated budget deficit, % of GDP	-0.8	-1.7	-2.4	-4.8	-7.2	-7.0
Unemployment, end of period		5.2	4.1	4.4	7.8	8.5
Inflation, end of period	8.72	4.87	6.56	6.30	4.75	7.8
Retail sales, % change yoy	17.5	13.5	17.8	13.0	-8.5	1.8
Gross forex reserves of the NBR, EUR billion, end of period	18.3	22.9	25.3	28.3	30.9	34.8
Current Account Balance, EUR billion	-6.89	-9.97	-16.68	-16.16	-5.05	-6.2
Total gross external debt, EUR billion	30.9	41.2	58.6	72.4	78.7	81.2
Exchange rate, RON/EUR, annual average	3.62	3.52	3.34	3.68	4.24	4.6

Source: INNSE, NBR, The Bleyzer Foundation

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Economic Growth

Industrial recovery appears to be stabilizing in Romania. In fact, in January-August the industrial production index rose by 5.3% yoy - the same rate of growth as in the first seven months. Exports remained the main source of improvement in industrial activity. At the same time, growing manufacturing supported higher demand for utilities. Indeed, over the first eight months of 2010, output of the utility sector was up by 10.4% yoy, while chemicals, manufacturing of base metals and vehicles - grew by 12% yoy, 35% yoy and 36% yoy respectively. Unlike export-dependent industries, sectors that rely more on domestic demand posted mixed results. On the one hand, the production of textiles (up by 9.6% yoy) and manufacturing of wood products (up by 13% yoy) recovered over the last six months. On the other hand, food processing declined by 6.2% yoy as a consequence of the weak harvest caused by unfavorable weather conditions (floods) this summer. Weak consumer spending continued to decrease output in apparel manufacturing (down by 3.5% yoy) and leather goods and footwear production (down by 0.1% yoy). As a result, foreign demand will be the main determinant of the industrial recovery. By contrast, domestic demand will be constrained by tight budgets amid fiscal consolidation.

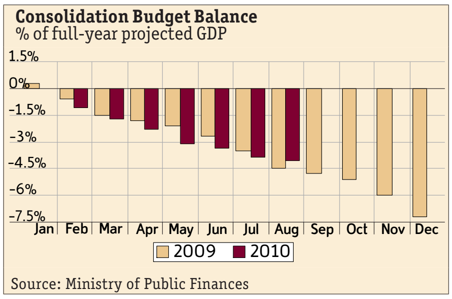
In August alone, industrial production accelerated to 5.7% yoy (from 3.3% yoy in the previous month) on robust growth in manufacturing (up by 6.2% yoy) and utilities (up by 8.5% yoy). In contrast, output in the mining sectors declined by 6.4% yoy compared to 1.2% yoy growth a month ago. Among the industrial sectors that contributed most to overall growth were manufacturing of vehicles (up by 25% yoy), production of base metals (up by 27% yoy) and chemicals (12% yoy).

In August, the volume of retail sales declined by only 2% yoy compared to 8.2% yoy a month before as automobile fuel sales jumped by 10.1% yoy. At the same time, the sales of foods and non-foods goods demonstrated a downward trend, notably dropping by 6.2% yoy and 5.1% yoy respectively. The main reasons for these declines were the summer fiscal austerity programs - state wages and transfers were cut by 25% and 20%, while VAT rate increased by 5 p.p. to 24%. As a result, the dynamics of retail sales will likely persist in the coming months.

Given the above developments, the Romanian economy is expected to decline by 2.5% in 2010. Meanwhile, GDP growth may recover next year (by about 2% yoy) on the back of stronger exports and a gradual return of domestic demand.

Fiscal Policy

Romania's fiscal consolidation measures are starting to bear fruit. Indeed, in January-August budget revenues in nominal terms increased by 2.9% yoy to EUR 25 billion. This was the highest growth rate during the past eight months. At the same time, the increase in budget spending visibly eased. Total expenditures grew by only 1.3% yoy compared to 3.2% yoy a month ago and stood at EUR 29.9 billion. As a result, the consolidated budget deficit settled at EUR 4.9 billion (or 4% of full year projected GDP). More importantly, this was the first time in 2010 that the deficit was lower than a year ago (down by 6.3%).



During the first eight months of 2010, the rise in cumulative revenues was achieved on the back of improving collection of VAT (up by 4.5% yoy), excises (up by 11.7% yoy) and higher non-tax revenues (up by 22.3% yoy). In particular, proceeds from VAT together with excises, which contributed one third of total budget revenues, increased their growth rate by 2 percentage points. The improvement in VAT collection was explained by implementation of a higher tax rate on July 1st (by 5 p.p.). At the same time, proceeds from the corporate profit tax (down by 2% yoy), wage and income tax (down by 5.1% yoy), and insurance contributions (down by 5.7%) remained on a downward trend as a consequence of summer fiscal austerity measures.

On the expenditure side, the public sector wage bill was 6.8% lower than a year ago, while public investments were reduced by 23% yoy. Meanwhile, government spending on public debt service increased - interest payments were up by 28% yoy. Another factor that fueled public expenditures was the hike in social transfers payments (up by 10% yoy) coupled with the high unemployment rate, which amounted to 7.4%.

In August, the stock of medium and long term external debt increased by 7.5% since the beginning of the year (ytd) and stood at EUR 70.6 billion. The growth was mostly driven by public and publicly guaranteed external debt (up by 30% ytd) totaling EUR 24.9 billion. Meanwhile, private external debt slightly declined by 2% ytd to EUR 38.4 billion. The increase in external public debt was explained by two IMF loans that were disbursed in February and June.

Monetary Policy

In August, headline inflation (CPI) continued to surpass the upper bound of the inflation target. Consumer prices grew by 7.8% yoy compared with 7.6% yoy a month ago, bringing cumulative inflation (in January-September) to 6.3% ytd. This increase was mainly explained by the one-off and non-monetary effect of the VAT rate hike, introduced on July 1st. In fact, the prices on foods and services accelerated to 4.8% yoy and 6.4% yoy, while the prices on non-foods decelerated to 10.8% yoy. Meanwhile, the tight budget coupled with potential fiscal consolidation will be key factors putting downward pressure on prices in the following months. As a result, according to a forecast by the National Bank of Romania, the CPI will fall back within the target band in 2011.

At the last meeting of the Board of the NBR, the key policy rate was kept unchanged at 6.25%. In particular, the Board aims to maintain stable monetary policy, which is essential to formation of correct inflationary expectations. Tighter fiscal policy will help reduce uncertainties related to the budget deficit. Under such circumstances, a temporary rise in prices will be dissipated and the inflationary target will be met without tight monetary policy.

In August, the growth rate of money supply (measured as intermediate monetary aggregate M2) slowed down for the fourth straight month. In particular, money supply grew by only 5.4% yoy compared with 5.8% yoy a month ago due to a decline in RON-denominated loans (down by 2.4% yoy). By contrast, both households (up by 7.4% yoy) and the corporate sector (up by 9.8% yoy) accumulated more EUR-denominated credit, which positively affected banking lending. As a result, non-government credit rose by 4.5% yoy and reached EUR 48.7 billion.

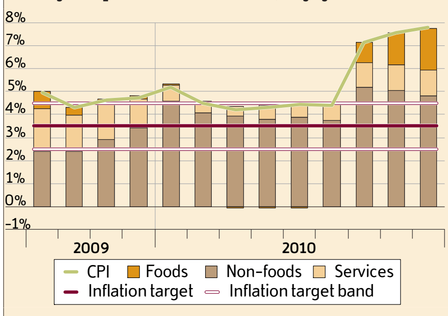
International Trade and Capital

In August, exports of goods soared by 25% yoy and reached EUR 2.8 billion, accelerating from 20% yoy growth in July. At the same time, the growth of imports of goods (13.4% yoy) decelerated for the fourth month in a row, bringing imports to EUR 3.1 billion. As a result, the monthly trade deficit narrowed by 36% yoy and stood at EUR 0.3 billion - the smallest deficit since January 2010.

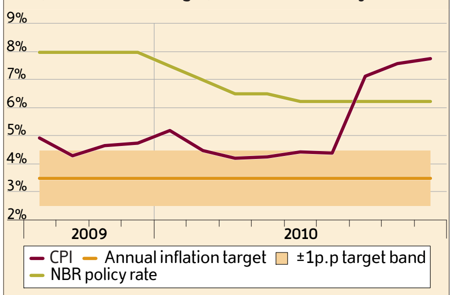
In January-August, the growing exports of goods (up by 25% yoy to EUR 23.3 billion) outpaced rising imports (up by 19% yoy to EUR 27.1 billion). Thus, the cumulative trade deficit during the first eight months contracted by 8% yoy and settled at EUR 3.8 billion or around 3% of projected full year GDP. Meanwhile, on the back of currency depreciation (almost 3/4 of overall imports were shipped from the European Union), fiscal austerity measures and weak domestic demand, imports are likely to decelerate, prompting gradual reduction of the trade deficit in the following months.

The positive developments in exports were driven by higher shipments of transport equipment and vehicles (up by 26% yoy), chemicals (up by 55% yoy) and industrial raw materials (up by 22% yoy). In particular, these three commodities contributed 86% to the overall growth of exports. At the same time, the imports were led by transportation equipment and vehicles (up by 27% yoy), fuels (up by 25% yoy) and industrial raw materials (up by 16% yoy). Taking into account the relatively high dependence on Europe (89% of overall exports and 84% of overall imports, respectively) further economic development in Romania will be linked with Europe's recovery.

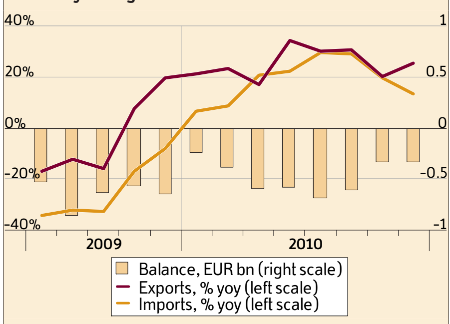
In January-August, the current account deficit amounted to EUR 4.1 billion and was 48% yoy higher than a year ago. The widening of the current account gap was mostly driven by the deterioration of current transfers, which declined by almost 40% yoy to EUR 1.8 billion. On a positive note, the decline in FDI inflows was eased - it fell only by 36% yoy as compared to a 40% yoy decline a month ago. As a result, FDI still funded almost half of the current account deficit.

CPI by components contribution, % yoy


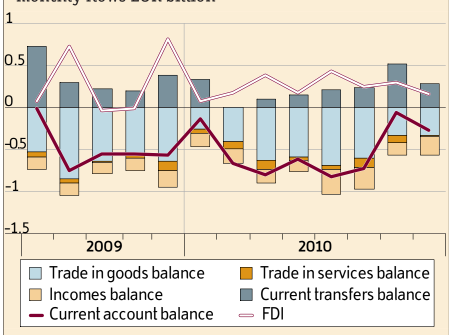
Source: NBR

CPI, the Inflation Target, and the NBR Policy Rate


Source: NBR

Monthly Foreign Trade Balance


Source: NBR

Current account components
monthly flows EUR billion


Source: NBR, INNSE

In September, the international reserves of the National Bank of Romania grew by 3% mom to EUR 35.8 billion, reflecting substantial inflows of forex. In particular, inflows (EUR 2.57 billion) outpaced outflows (EUR 1.5 billion) thanks to the 6th IMF tranche under the Stand-by Arrangement. Finally, the Romanian currency (leu) remained virtually stable.