

February 2011

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- In 2010, Romanian real GDP shrank by 1.3% yoy and stood at EUR 122 billion.
- The index of industrial production grew by 5.5% yoy in 2010.
- In 2010, the consolidated budget deficit contracted by 8.6% yoy and reached 6.5% of GDP.
- In January, consumer prices grew by 7.0% yoy.
- In 2010, the current account deficit widened to 4.2% of GDP or EUR 5.2 billion.

Executive Summary

In 2010, contraction of the Romanian economy eased to 1.3% yoy from a 7.1% decline a year ago. The negative growth was explained by a drop in final consumption and gross fixed capital formation, while exports remained the main factor driving the economy and partially offset the overall decline.

In 2010, the consolidated budget deficit narrowed by 8.6% yoy to EUR 7.9 billion or 6.5% of full-year GDP. As a result, Romania met the IMF fiscal deficit target of 6.8% of GDP. The improvement was achieved thanks to summer fiscal austerity measures that supported higher state revenues and lower expenditures. In particular, state incomes grew by 7.2% yoy and settled at EUR 40.0 billion due to higher proceeds from indirect taxes, especially receipts from VAT and excises. On the expenditure side, government spending increased by 4.2% yoy to EUR 48.0 billion amid higher social transfer payments, while spending on public wages dropped.

In January 2011, the growth rate of consumer prices decelerated to 7% yoy from 8% yoy a month ago. CPI reflected higher prices on foods and non-foods, while increases in prices on services remained moderate. Given the fading effect of VAT in the second half of the year, the end-of-period inflation rate is expected to reach 4.5% yoy. The National Bank of Romania continued to maintain its policy rate unchanged at 6.25% per annum.

In 2010, the current account deficit expanded by 5% yoy and

settled at EUR 5.2 billion or 4.2% of GDP. The widening of the current account deficit was driven by a decline in surplus in current transfers and a rise in the services deficit. Meanwhile, contraction of the merchandise trade deficit by 15% yoy helped partially offset the overall expansion of the current account deficit. A lower trade deficit in goods was explained by growing exports, which posted solid 28% yoy-growth and reached EUR 37.3 billion. At the same time, imports of goods totaling EUR 43.1 billion demonstrated lower growth of 20% yoy.

	2006	2007	2008	2009	2010	2011 ¹
GDP growth, % change yoy	7.9	6.3	7.1	-7.2	-1.3	1.6
Industrial production, % change yoy	7.1	5.4	0.9	-5.5	5.5	5.0
Consolidated budget balance, % of GDP	-1.7	-2.4	-4.8	-7.2	-6.5	-5.0
Unemployment, end of period	5.2	4.1	4.4	7.8	6.9	7.6
Inflation, end of period	4.87	6.56	6.30	4.75	8.0	4.5
Retail sales, % change yoy	13.5	17.8	13.0	-8.5	-5.3	-3.0
Gross forex reserves of the NBR, EUR billion, end of period	22.9	25.3	28.3	30.9	36	34
Current Account Balance, EUR billion	-9.97	-16.68	-16.16	-5.05	-5.2	-7.0
Total gross external debt, EUR billion	41.2	58.6	72.4	78.7	90.8	92.0
Exchange rate, RON/EUR, annual average	3.52	3.34	3.68	4.24	4.2	4.3

Source: INNSE, The Bleyzer Foundation

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Economic Growth

In the last quarter of 2010, the Romanian economy's contraction slowed. Indeed, during the fourth quarter, the decline in real GDP decelerated to 0.6% yoy compared with a 2.2% yoy drop a quarter ago. As a result, in 2010 real GDP contracted by 1.3% yoy and reached EUR 122 billion (RON 513.6 billion). On the demand side, final consumption fell by 2.1% yoy amid budget constraints as a consequence of summer fiscal retrenchment. Similarly, gross fixed capital formation posted a 13.1% yoy decline. Growing exports remained the major factor driving the Romanian economy, posting 13.1% yoy growth on the back of favorable external demand.

On the supply side, the fall in real GDP was driven by subdued construction and services. In fact, the former's decline was registered at 10.7% yoy due to the shortage of investments in Romania's economy. Moreover, the volume in the service sector contracted by 4% yoy amid summer fiscal consolidation – reduction of both public wages and transfers coupled with the rise in the VAT rate. Agricultural output also declined by 0.8% yoy reflecting a weaker than expected harvest caused by summer rainfalls. On the contrary, industry continued to maintain its leading role and partially offset the overall GDP decline by posting 5.1% yoy growth.

In 2010, the index of industrial production renewed its upward trend. In fact, the index of industrial production advanced to 5.5% yoy compared with a 5.5% yoy decline a year ago. Industrial output was primarily shaped by sound performance in manufacturing (up by 6% yoy) and utilities (up by 8.2% yoy). In particular, manufacturing production improved on the back of strong external demand. At the same time, output in the mining and quarrying sectors fell by 6.9% yoy.

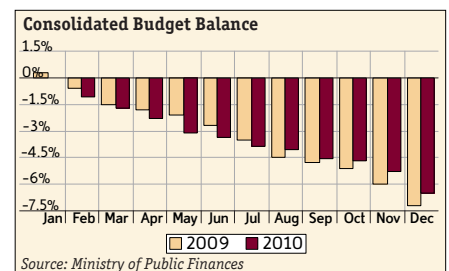
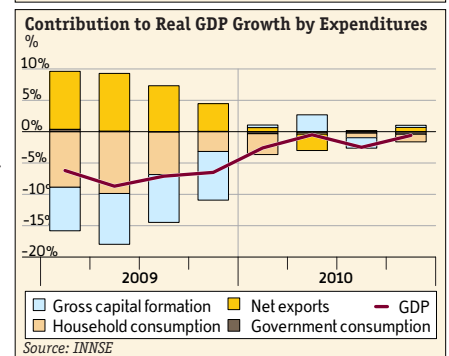
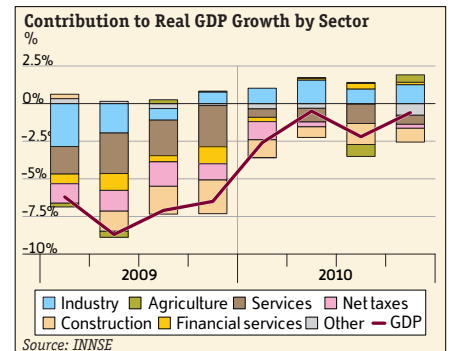
Fiscal Policy

In 2010, summer fiscal retrenchment really curtailed the consolidated budget deficit. Indeed, the state budget deficit contracted by 8.6% yoy and settled at EUR 7.9 billion according to data from the Ministry of Public Finances. Thus, the budget deficit narrowed to 6.5% of full-year projected GDP compared with 7.4% of GDP in 2009. Taking into account 6.1% yoy average growth of consumer prices, the real contraction of the budget deficit was 13.8% yoy. Thus, Romania easily satisfied the IMF's fiscal deficit target of 6.8% of full-year projected GDP. This year, the government will continue to implement additional fiscal austerity measures aiming to curb the state budget deficit to 4.4% of full-year projected GDP.

During the year, state revenues demonstrated uneven results. Though in the first half of 2010 they remained almost unchanged (down by 0.1% yoy), state revenues were significantly better off in the second half (up by 14% yoy). Given this improvement, state revenues posted 7.2% yoy annual growth and settled at EUR 40.0 billion. Sound performance of state revenues reflected higher collections from indirect taxes and lower proceeds from direct taxes due to summer fiscal retrenchment. Indeed, stronger collections from VAT (up by 14.3% yoy) and excises (up by 11.5% yoy) led to a higher by 5 p.p. VAT rate since July 2010. Meanwhile, lower receipts from corporate profit tax (down by 4.9% yoy) and wage and income tax (down by 3.2% yoy) were prompted by constraint budgets. In fact, domestic demand remained subdued after a 25% cut in public salaries and 20% decrease in transfers implemented as a part of the summer fiscal austerity measures. Similarly, the decline in social security and health care contributions was backed by lower labor income – down by 4.5% yoy.

On the expenditure side, government expenditures grew by 4.2% yoy in nominal terms and reached EUR 48.0 billion. The increase in state revenues was fueled by higher social transfers payments (up by 7.3% yoy) that made up around 1/3 of overall spending. By contrast, summer fiscal consolidation led to a decline in the wage state bill (down by 8.6% yoy). In addition, the decrease in government capital investment (down by 11.7% yoy) was explained by lower government spending in state infrastructure.

In 2010, the stock of medium and long term external debt had grown by 9.4% since the beginning of the year to EUR 72 billion. The increase was led by higher domestic public and publicly guaranteed debt, which demonstrated 37% ytd growth and reached EUR 26.6 billion. During the year, this growth was driven by IMF disbursements and EU and World Bank tranches. By contrast, private external debt (including non-residents' deposits) dropped by 2.6% ytd and settled at EUR 45.5 billion.



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Monetary Policy

In January, consumer prices slowed down their rate of growth. In fact, growth of CPI decelerated to 7% yoy from 8% yoy a month ago mainly because of a lower statistical base effect. The increase in CPI was explained by growing prices on foods (up by 7.2% yoy) and non-foods (up by 7.2% yoy), while growth of prices on services remained moderate (up by 5.9% yoy). As a result, given the substantial weights of the first two categories, they contributed more than 80% to the overall growth of consumer prices.

In 2011, end-of-period inflation is expected to reach 4.5% yoy, which is consistent with the survey of banks analysts' association AAFRBR (4.3% yoy). Meanwhile, the National Bank of Romania (NBR) expects a slightly lower inflation rate. In fact, they revised the official inflation forecast to 3.6% yoy (up by 0.2 p.p.) in the recent quarterly report. According to the NBR's projection, the CPI might return to inflation target band (2.0% – 4.0%) in the second half of this year. In particular, the rate of growth of consumer prices should post a steeper decline in the third and fourth quarters due to fading of the VAT rate effect and weak domestic demand. By contrast, several internal and external risks remain valid and are likely to fuel domestic prices in 2011. Among important domestic factors are social tension related to fiscal austerity measures and higher-than-projected increases in administered prices. Given the fiscal retrenchment for local authorities, the subsidies provided by them to the local public services companies might decline causing an increase in the price of these services. In addition, several risks connected to the external environment might lead to a rise in consumer prices above projected values in the coming months. Indeed, the current turmoil in the Middle East has prompted higher oil prices, while food and commodities prices are on a growing trend as well.

During the last meeting, the Board of the National Bank decided to maintain its benchmark policy rate unchanged at 6.25%. The decision reflected the prudent monetary policy of the NBR, which is aiming to mitigate potential internal and external risks and restore the disinflationary trend.

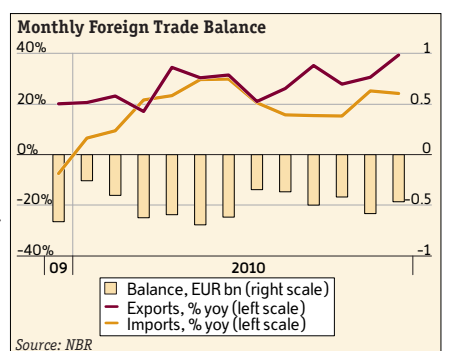
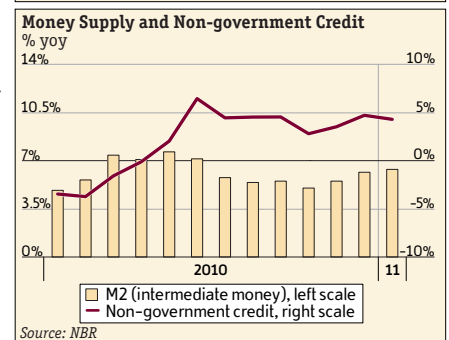
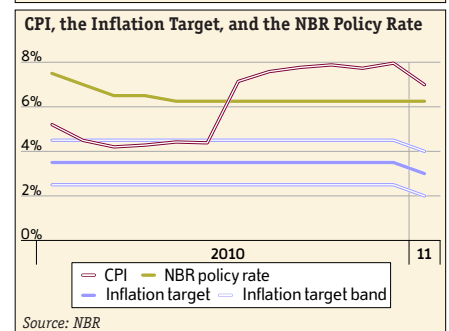
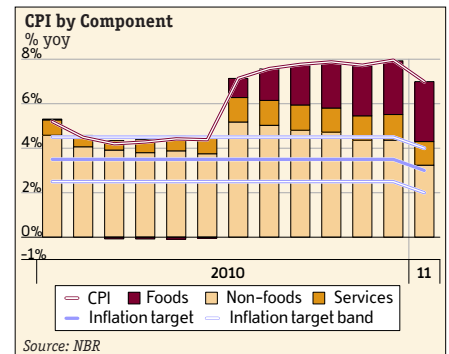
In January, the rate of growth of money supply measured as intermediate money (M2) accelerated to 6.4% yoy from 6.2% yoy a month ago. The increase was driven by EUR-issued loans (up by 8.1% yoy), while loans denominated in domestic currencies continued to decline (down by 7.1% yoy). Given the solid performance of EUR-denominated loans, non-government credit demonstrated 4.3% yoy growth.

International Trade and Capital

In 2010, the rate of contraction of the merchandise trade deficit significantly slowed. Indeed, the deficit of trade in goods shrank by 15% yoy compared with a 64% yoy narrowing in 2009. As a result, the merchandise trade deficit reached 4.8% of GDP or EUR 5.9 billion.

During the year, the contraction of the merchandise deficit was explained by growing exports, especially in the fourth quarter. Indeed, in annual terms, exports of goods grew by 28% yoy to EUR 37.3 billion, while they posted an impressive 32% yoy growth in October-January amid buoyant external demand. Moreover, in December alone, the growth rate of merchandise exports was registered at a solid 39% yoy. Given the high dependency on the EU (around ¾ of overall exports were shipped to these countries), the elimination of the consequences of the recent sovereign debt crisis among EU periphery countries will play a crucial role for export dynamics in 2011.

At the same time, imports of goods were kept on a flatter growing trend during the year. Indeed, imports posted 20% yoy annual growth and settled at EUR 43.1 billion, specifically due to some acceleration in the last quarter. In fact, growth of the merchandise imports sped up to 21% yoy in the fourth quarter from 17% yoy in the third quarter. The effect may be partially explained by higher exports of goods that were produced from imported resources. Taking into account the expected recovery of domestic demand this year, merchandise imports are likely to continue their growing pace. In addition, the current Middle East turmoil could lead to a hike



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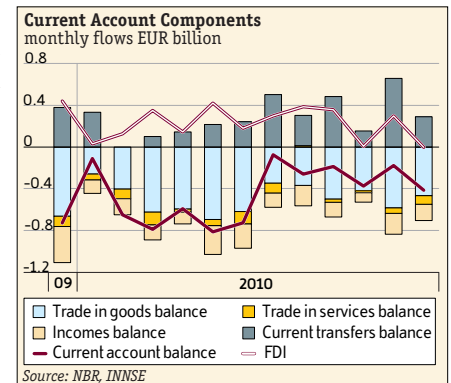
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in oil prices and therefore increase Romanian imports through higher transportation costs and price of energy resources.

In 2010, the current account deficit widened by 5% yoy to EUR 5.2 billion, but still settled at 4.2% of GDP as it was a year ago. The expansion of the current account deficit was led by a lower surplus in current transfers (down by 18% yoy) and a growth in the services deficit (up by more than twofold). In particular, the decline in current transfers was explained by smaller wage remittances. Meanwhile, FDI inflows covered half of the current account deficit since they fell by 26% yoy in 2010.

In February, Romania's international reserves slightly decreased by 1% mom and reached EUR 35.5 billion. The reduction reflected higher currency outflows (EUR 1.4 billion) due to payments for servicing public and publicly guaranteed external debt. At the same time, inflows of foreign currency were registered at EUR 0.8 billion. Finally, Romanian currency (leu) marginally appreciated in February to RON 4.247 per 1 Euro from RON 4.262 per 1 Euro due to recent sovereign debt turmoil in the Eurozone.



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