October 2014 Valentyn Povroznyuk, Radu Mihai Balan, Edilberto L. Segura

- **Industrial output growth decelerated to 5.7% yoy in July 2014.**
- **The consolidated budget deficit remained low at 0.24% of GDP in January-August 2014.**
- **Consumer inflation was equal to 0.84% yoy in August 2014.**
- **The foreign trade balance amounted to EUR 520.3 million in July 2014.**
- **The current account deficit reached EUR 781 million by the end of July 2014.**

Executive Summary

Industrial output further decelerated in July due to negative developments in demand and some industry specific factors. The negative developments were observed mostly in manufacturing. At the same time, mining and quarrying not only recovered from a significant drop in June but also posted decent growth in July. The energy sector, though, continued to decline at an almost stable pace during the reporting month. The trade and services sector posted decent performance in July despite some deceleration in growth, which was caused mainly by drops in fuel sales and in services provided to the population. In addition, sales of non-food products experienced significant deceleration in the reporting period.

The general consolidated budget deficit did not expand much in August. The government policy of compensation for uncollected revenues through cuts in investment expenditures helped keep the deficit low. In fact, the deficit of January-August 2014 was more than five times lower than that over the same period last year. As for general trends in budget revenues and expenditures, they remained almost unchanged as revenues continued to grow at a rate around 4% yoy, while expenditures slightly declined compared to January-August 2013.

In August, consumer inflation decelerated again but did not reach the record low of 0.64% observed in June. Deflation in the food goods sector continued, while prices in non-food and services sectors grew at slightly decelerated rates.

National currency lending grew at a high rate in August, but this was not enough to overcome the decline in forex-denominated loans. As a result, deleveraging of the banking sector continued. Taking into account low inflation and in order to further stimulate national currency lending, the NBR decided to lower its policy rate to 3.0% starting from October 1st. The NBR also cut the minimum reserve requirements ratio on the national currency liabilities of credit institutions and narrowed the symmetrical corridor of interest rates on its standing facilities.

Foreign trade in goods dynamics improved in July 2014. Growth of exports remained almost the same compared to June, while growth of imports was almost two times lower. Despite these developments, total imports were still higher than exports in July. But the deficit of foreign trade in goods dropped almost one third. The current account balance for the first seven months of 2014 significantly worsened compared to the same period in 2013. The positive balance of foreign trade for the period was supported by a significant but decreased surplus of the secondary income account. However, this was not enough to overcome the deficit of the primary income account deficit, which more than doubled in January-July 2014 compared to the first seven months of the previous year.

Main Macroeconomic Indicators	2009	2010	2011	2012	2013	2014
GDP growth, % yoy	-6.6	-1.6	2.5	0.2	3.5	2.5
GDP per capita, USD	7,649	7,667	8,863	8,030	8,080	8,100
Industrial production, % yoy	-5.5	5.5	5.6	0.0	7.0	5.0
Retail sales, % yoy	-10.3	-5.3	-2.5	2.9	0.5	2.0
Budget balance in cash methodology, % GDP	-7.3	-6.4	-4.3	-2.5	-2.5	-2.4
Government external debt, % GDP	23.6	30.5	34.7	37.8	38.0	38.5
Inflation, eop	4.7	8.0	3.1	5.0	3.1	3.2
Gross international reserves, EUR billion	30.9	36.0	37.3	36.4	37.0	37.0
Current account balance, % GDP	-4.2	-4.4	-4.5	-4.0	-1.0	-1.5
Gross external debt, % GDP	68.7	74.4	75.2	75.1	75.0	75.0
Unemployment (ILO methodology), % eop	6.9	7.3	7.4	7.2	7.3	7.0
Exchange rate RON/EUR, annual average	4.24	4.21	4.24	4.45	4.5	4.5

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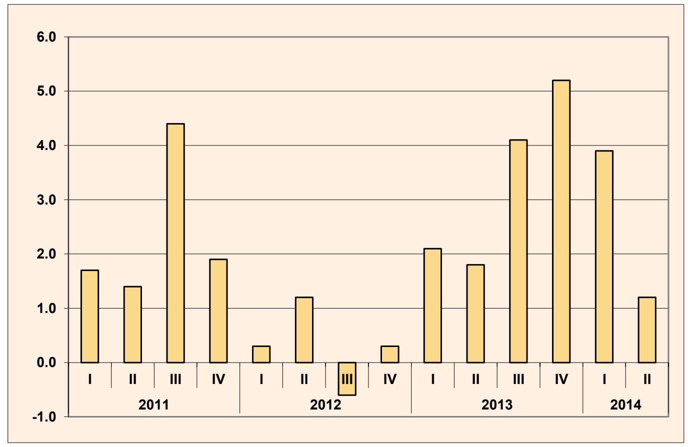
Economic Growth

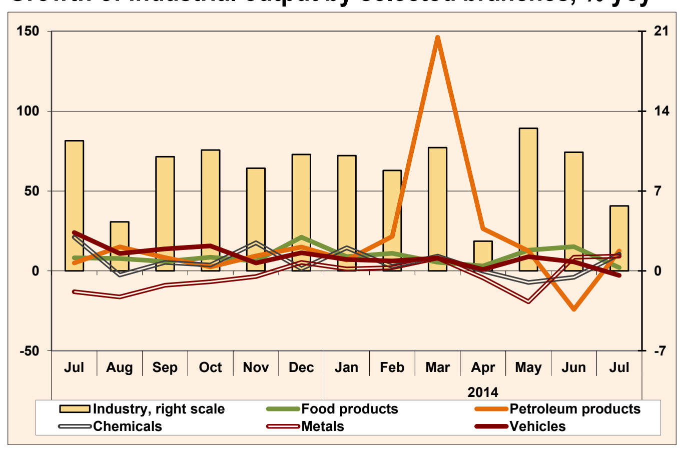
Weaker demand and some specific factors caused further deceleration of industrial output growth in July. The growth rate decelerated to 5.7% yoy due to slowing dynamics in manufacturing, which is the main driver of industrial production growth. Growth of manufacturing of 6.8% yoy was negatively affected by weaker demand in light industry and in the manufacture of furniture accompanied by the adverse effect of ad hoc factors in several other industries. Among those factors were technical inspection in the automobile industry (caused a decline of growth by 8.5 percentage points to -2.8% yoy), closure of one of the pharmaceutical industry leaders (caused a decline in growth by 20.2 percentage points to -19.1% yoy), and financial difficulties in the food industry (caused deceleration in growth to 2.0% yoy from 15.2% yoy observed in June). Growth in other sub-sectors remained more or less close to that observed in June. Mining and quarrying recovered from the decline registered in June and even posted decent 5.7% yoy growth in July. Progress was achieved thanks to still high (though significantly decelerated) growth in mining of coal (30.8% yoy versus 61.2% yoy in June), which was supported by growth in mining of metal ores (5.0% yoy) and in mining support services activities (12.2% yoy). The energy sector continued to decline at 6.0% yoy, the same as in the previous month.

GDP growth, % yoy



Source: INSSE, The Bleyzer Foundation

Growth of industrial output by selected branches, % yoy



Source: INSSE, The Bleyzer Foundation

The trade and services sector sustained some negative developments in July. Trade slowed its growth mainly due to negative contributions on the side of fuel trade. In particular, fuel sales experienced a major trend reversal from 2.1% yoy growth in June to a -3.0% yoy decline in July. This, together with declines in several other trade sub-sector components, led to a 3.9 percentage points decline in growth to 6.3% yoy in total trade. The most significant decline was registered by "other non-food products traded in specialized shops", mainly by information technology and communication products. Negative influence from the decline in sales of furniture and of household appliances was less significant. Overall, growth of sales of non-food products decelerated to 8.7% yoy from 14.0% yoy observed in June. Dynamics of sales of food products remained virtually unchanged compared to June. Growth of automotive sales dropped 2.3 percentage points to 6.8% yoy despite quite high growth of motor vehicle sales, causing an additional adverse effect on total trade. The sub-sector of services to the population saw a major trend reversal after six consecutive months of growth. Total services to households dropped 2.1% yoy due mainly to the contribution from activities of travel agencies and tour operators, whose decline accelerated to 21.3% yoy from 9.4% yoy in June, and from hotels and restaurants, the growth of which dropped 3.5 percentage points to 4.2% yoy. These negative developments could have been caused by less favorable weather conditions in Romania in July 2014 compared to the same period in 2013.

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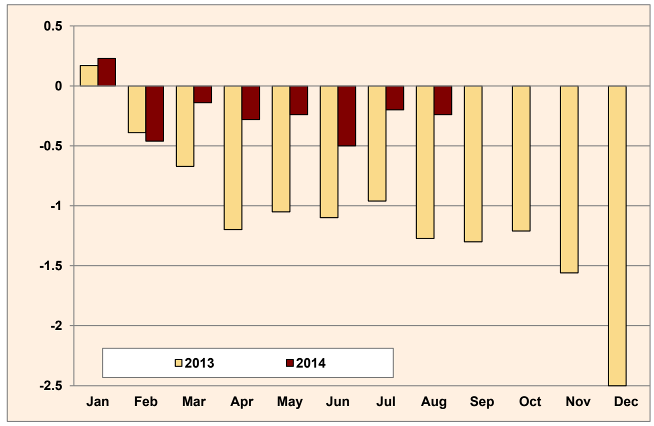
Fiscal Policy

The response of the government to the current challenges with collection of general consolidated budget revenues helped keep the budget deficit low over the first eight months of the year. As of August 31st, the general consolidated budget was executed with a deficit of RON 1.59 billion (EUR 359.6 million) or 0.24% of GDP. This is a major improvement over the same period of 2013, when the deficit was at a level of 1.3% of GDP. Moreover, the primary balance remained positive at 0.98% of GDP over January-August, proving the fiscal policy to be prudent and sustainable.

Consolidated budget balance, % of GDP



Source: Ministry of Public Finance of Romania

The government continued to gradually improve collection of general consolidated budget revenues in August. It managed to collect RON 136.8 billion (EUR 30.9 billion) as of August 31st. This was a 4.3% yoy increase and a tiny improvement over the January-July period with its 4.1% yoy growth. As a share of GDP, general government revenues reached 20.7% in January-August 2014. All the major tax and non-tax revenue receipts posted increases except for use tax on goods. Furthermore, even use tax on goods revenues posted some positive developments as the pace of decline decelerated from 80% yoy observed at the end of July to 48.9% yoy at the end of August. Collected proceeds from major taxes were significantly higher in January-August 2014 compared to the same period last year. In particular, the government collected RON 2.066 billion (EUR 467.3 million) more in social security contributions, RON 1.516 billion (EUR 342.9 million) more in excise tax revenues, RON 1 billion (EUR 226.2 million) more in taxes on property, RON 943.8 million (EUR 213.5 million) more in income taxes, and RON 345.4 million (EUR 78.1 million) more in VAT. The amounts reimbursed by the EU finally posted an increase after months of decline. The growth rate was 2.9% yoy. At the same time, the reimbursed amounts remained relatively low, accounting for just 0.7% of GDP. At the local level, authorities managed to secure growth in revenues, though this growth slightly decelerated. In particular, revenues from property taxes grew by 5.0% yoy, revenues from use taxes on goods increased by 2.8% yoy, and non-tax revenues expanded by 1.5% yoy in January-August.

General government expenditures continued to decline in August 2014. As of August 31st, the government had spent RON 138.3 billion (EUR 31.3 billion), which is a 0.5% yoy decline. As a share of GDP, total general government expenditures were equal to 20.93%. Growth of the wage bill was still around 3% yoy in January-August. One of the factors ensuring growth was an increase in the gross minimum wage from RON 800 (EUR 181) at the end of 2013 to RON 900 (EUR 203.6) as of July 2014. In addition, the government had to execute some wages related payment entitlements established by court decisions. Growth of expenditures on goods and services significantly decelerated in August. As a result, the 4.0% yoy increase in these expenditures observed in January-July shrank to just 0.3% yoy in January-August. At the same time, lower benchmark yields at sovereign bond auctions helped decrease interest payment expenditures by 2.3% yoy. Investment expenditures posted negative dynamics again. Total government investments equaled 2.1% of GDP or RON 14.1 billion (EUR 3.2 billion) over the first eight months of the year. However, government investments were 18.5% higher during the same period last year.

Monetary Policy

In August, consumer inflation decelerated a bit on the back of positive developments in all of its components. In particular, prices of food goods declined again at a slightly accelerated rate. Deflation in food prices almost reached 2% yoy. Prices of both non-food goods and services grew in August, but at a decelerated rate compared to the previous month. Non-food goods saw growth of prices of 2.38% yoy, which is a tiny deceleration from 2.52% yoy observed in July. Growth of services prices inched down by 0.1 percentage points to 2.74% yoy. As a result, total consumer inflation stood at 0.84% yoy in August.

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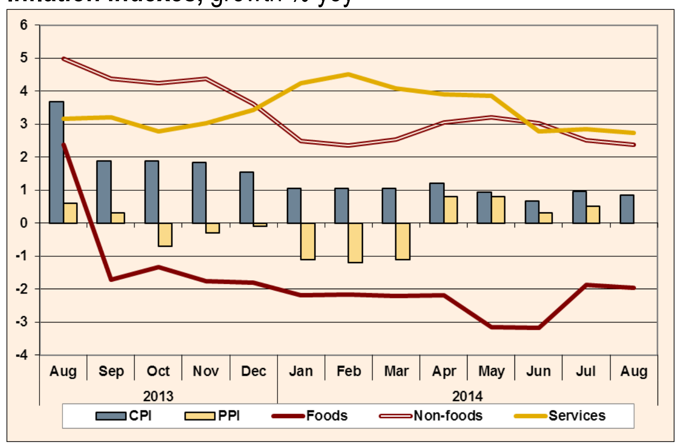
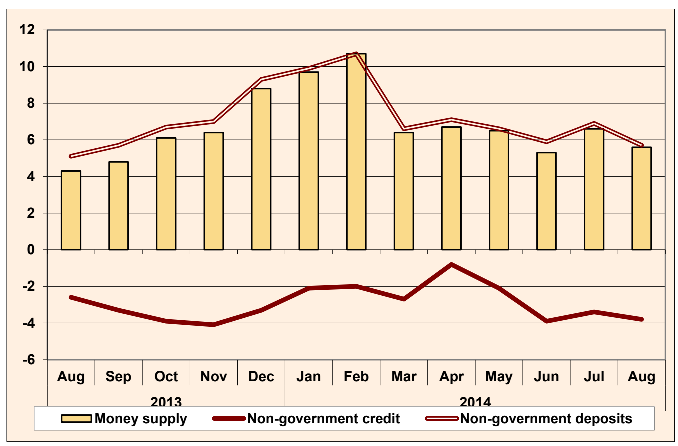
The NBR decided to further push stimulation of national currency lending, taking into account the dynamics of banking sector deleveraging. Data shows that total non-government loans dropped 3.8% yoy in August 2014, which was a slight acceleration compared to July. National currency loans grew by 9.0% yoy mainly on the back of household loans expansion (which grew by 12.6% yoy). Growth of corporate loans was almost twice as low as that of household loans. At the same time, forex-denominated loans declined by 11.5% yoy because of negative dynamics in both household and corporate loans. However, corporate loans decreased faster (13.7% yoy against 9.4% yoy for household loans). Based on the information on real sector development, inflation and on dynamics of non-government loans, on September 30th, the NBR decided to lower the monetary policy rate to 3.0% starting on October 1st. In addition, the NBR decided to cut the minimum reserve requirements ratio on the national currency liabilities of credit institutions to 10% from 12% stating with the October 24th-November 23rd maintenance period and to maintain the minimum reserve requirements ratio on foreign currency denominated liabilities at 16%. Finally, the NBR also decided to narrow the symmetrical corridor of interest rates on its standing facilities around the policy rate to ±2.75% from ±3.0% in order to mitigate interbank money market rate volatility and to consolidate the transmission of the policy rate signal. Therefore, the interest rate of the NBR's lending facility (Lombard) will be lowered to 5.75% starting on October 1st, while the interest rate of the NBR's deposit facility will remain at 0.25%. Amid creating of favorable conditions for sustainable recovery of lending, the latest decisions of the NBR were meant also to ensure price stability over the medium term within the 2.5%±1 percentage point flat target.

Inflation indexes, growth % yoy



Source: INSSE, The Bleyzer Foundation

Selected monetary indicators, growth % yoy



Source: NBR

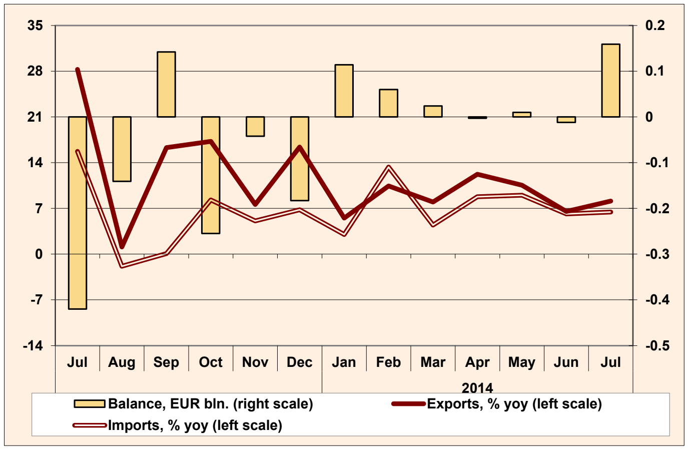
In August, broad money (M3) returned to a growth rate comparable to that observed in June after one month of acceleration. The growth rate was equal to 5.6% yoy, which is 1 percentage point lower compared to growth in July. The whole growth was ensured by net foreign assets, as domestic assets continued to decline. Net foreign assets grew by 45.1% yoy, while net domestic assets dropped 7.8% yoy. At the same time, the volume of the net domestic assets was still almost two times larger than that of net foreign assets (RON 158.113 billion or EUR 35.764 billion against RON 84.681 billion or EUR 19.154 billion). Therefore, the dynamics of net domestic assets had a more significant impact on the dynamics of broad money as a whole.

International Trade and Capital

Foreign trade experienced further improvements in July. Growth in exports of goods accelerated, while that of imports decelerated. In particular, FOB exports amounted to EUR 4776.9 million which is a 6.6% yoy increase compared to 5.54% increase in June. Both intra-EU and extra-EU exports posted positive developments. The highest growth rates of exports were registered for crude oil processing, textiles, manufacturing of electronic appliances, electrical equipment, and transport means industry. At the same time, imports grew by 4.8% yoy, which is almost two times lower than growth in June. However, since imports were equal to EUR 5297.2 million, the foreign trade in goods balance was still negative at EUR 520.3 million. On the positive side, though, is the decline in the foreign trade in goods deficit by 30.9% compared to July 2013.

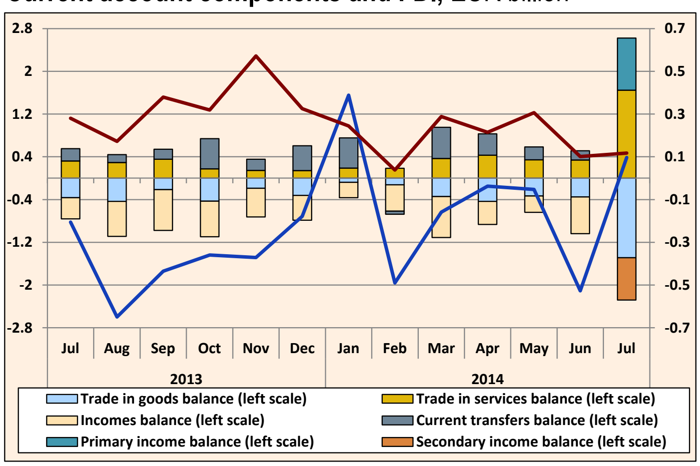
The NBR introduced new methodologies to report the balance of payments and external debt data. The first data reported in accordance with the new standards was the January-July 2014 data. Therefore, we cannot provide the current account data for July as data for January-June 2014 was not adjusted to the new standards by the NBR. In addition, the NBR does not report incomes and current transfers but reports primary and secondary income instead. According to the NBR report, the FOB-FOB foreign trade balance calculated under the change in economic ownership criterion was in surplus of EUR 352 million in January-July 2014 compared to a deficit of EUR 123 million over the same period of time in 2013. However, primary income deficit grew by more than two times to EUR 1998 million over the reporting period as outflows of primary income grew much faster than inflows (44.1% yoy against 10.4% yoy). Situation with the secondary income also worsened a bit. In particular, inflows of secondary income declined by 10.3% yoy to EUR 2695 million in January-July 2014, while outflows remained almost unchanged at EUR 1830 million. As a result, the secondary income surplus dropped 26.3% yoy and was equal to EUR 865 million in the first seven months of the year. All the mentioned developments led to significant worsening of the current account balance. The current account was in deficit of EUR 781 million in January-July 2014 compared to EUR 92 million over the same period in 2013.

Monthly foreign trade balance



Source: NBR

Current account components and FDI, EUR billion



Source: NBR, INSSE

The situation with FDI slightly improved in July compared to June. However, monthly net FDI inflows of EUR 117 million were significantly below average over the first six months of the year of EUR 198.67 million. The total amount of net FDI, received from the beginning of the year, was equal to EUR 1.309 billion at the end of July which is a 13.8% yoy decline. As for the FDI structure, equity stakes amounted to EUR 1.385 billion, meaning that intragroup loans turned negative at EUR 76 million.

After several months of decent declines, the external debt of Romania experienced a trend reversal in July. The total external debt of the country grew by 2.71% mom to EUR 95.479 billion. The increase was the result of growth in both of its components. However, medium- and long-term external debt grew faster. It increased by 3.1% mom to EUR 77.64 billion on the back of all its subcomponents. Short-term external debt expanded just by 1% mom to EUR 17.657 billion. Because of the lower growth rate and size of the short-term external debt, its share within the total external debt declined a bit in July. It inched down by 0.3 percentage points to 18.7%. Despite the reported growth of external debt of Romania in July, it still remained below the level observed at the end of 2013.

International reserves of the National Bank of Romania remained almost unchanged in August 2014. The inflows of reserves were equal to EUR 1.128 billion and represented mainly changes in the foreign exchange reserve requirements of the credit institutions, inflows into accounts of the Ministry of Public Finance, and inflows into the European Commission's account. Inflows into accounts of the Ministry of Public Finance included EUR 250 million received from the issuance of sovereign bonds. Outflows of reserves were slightly higher at EUR 1.161 billion and represented mainly changes in the foreign exchange reserve requirements of the credit institutions and interest and principal payments on foreign currency public debt. The later included interest and principal installments on Romania's SBA with the IMF of EUR 321 million equivalent. As a result, foreign exchange reserves stood at EUR 30.875 billion as of August 31st, which is just 0.1% lower compared to the amount a month ago. The gold stock of the country remained the same in terms of weight but slightly increased in terms of value thanks to changes in international gold prices. The gold stock value grew by almost 1% to EUR 3.254 billion. As the increase in the value of gold almost fully compensated for a tiny decline in foreign exchange reserves, the international reserves of the country stayed virtually unchanged at EUR 34.129 billion at the end of August.

Other developments affecting the investment climate

During October, Romania tapped the bond market with a EUR 1.5 bln, 10 years issue. The issue was oversubscribed, with orders of more than EUR 4 bln, and it was priced to yield 2.973%. The issue was managed by Société Générale, HSBC, Raiffeisen Bank and UniCredit.

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