Romania
Macroeconomic Situation

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Summary

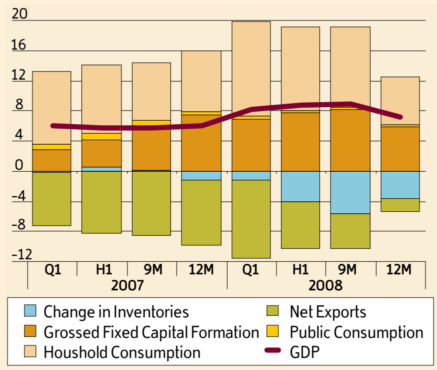
- At the beginning of 2009, economic performance continued to worsen. Industrial output dropped by 17% year-over-year (yoy) in January 2009.
- The consolidated budget reported a deficit of 0.3% of full-year projected GDP.
- In 2008, total gross external debt grew by 24% yoy, advancing to 57% of GDP.
- Headline inflation picked up to 6.9% yoy in February.
- At the end of February, the Romanian Lei depreciated by a nominal 15%, approaching RON/EUR 4.28.
- As of February, non-government credit decelerated to 31% yoy, down from 66% yoy reported a year ago.
- The FOB/CIF merchandise trade deficit shrank by 2.5 times in January.
- In January, the current account gap was cut in half compared to the respective period of last year, totaling EUR 525 million.
- In 2009, Romania is expected to receive nearly EUR 20 billion in the framework of a stabilization economic program under supervision of international financial organizations like the IMF, World Bank, EBRD and others.

Economic Growth

The deteriorating global economic environment starting in September 2008 triggered a sharp economic slowdown in Romania in October-December 2008, which continued to deepen at the beginning of 2009. Real GDP growth decelerated abruptly to 2.9% yoy in the fourth quarter of 2008, brining cumulative growth in 2008 down to 7.1% yoy.

Significantly tightening access to external capital and to banking credits, falling incomes and growing uncertainty about the global economy forced firms and households to adjust their current spending downwards. Final private consumption, which accounts for almost 60% of GDP in Romania, dropped by 4.7% yoy in the fourth quarter, compared to a 15% yoy increase posted in the first nine months of the year. At the same time, gross fixed capital formation, which contribution to GDP growth in 2008 was comparable to the contribution of private consumption, decelerated sharply to 2.8% yoy, down from 28% yoy reported for January-September. Imports fell by 10% yoy, against 28% yoy growth in January-September, due to weakening domestic demand and the depreciation of the local currency. Meanwhile, worsening economic conditions in Romania's trade partners, primarily in the European Union, cooled external demand for Romanian exports, which slowed harshly to 1.6% yoy, down from 26% yoy posted in the first nine months of the year.

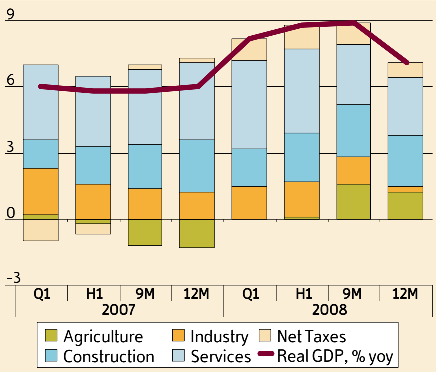
Contributions to Real GDP Growth by Sector, percentage points 1



Source: INSSE

In the fourth quarter, all of Romania's economic sectors, except agriculture, reported a visible slowdown. Thus, value added produced by export-driven industry dropped by 7.7% yoy, despite the depreciation of the Romanian Lei, supported favorable terms of foreign trade. Construction and services, which jointly generated almost 70% of real GDP growth in 2008, also posted a significant deceleration compared to the first nine months of 2008. Construction slowed to 18.9% yoy, while trade, transportation and communication eased to 3.4% yoy. On the upside, agriculture grew by a robust 35% yoy and 18% yoy in the third and fourth quarters respectively, contributing 17% to GDP growth in 2008.

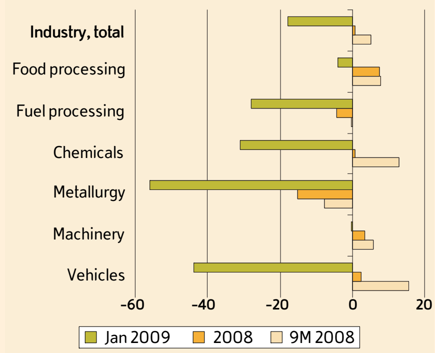
Contributions to Real GDP Growth by Expenditure, percentage points 2



Source: INSSE

In January 2009, economic performance continued to worsen. In particular, retail trade fell by 0.6% yoy following moderated household consumption. Wholesale and retail trade and repair works jointly dropped by 29% yoy, reflecting a general cooling-off of business activity in the country. Construction works decelerated strongly to 6% yoy, compared to 26% yoy in 2008. Meanwhile, construction works in capital and current repair segments declined by 1.5% and 1.9% yoy respectively, while works in the new building segment still maintained positive growth, although visibly decelerating to 9.9% yoy. A contraction of industrial output deepened in January as well, decreasing by 17.7% yoy. A deepening recession in industry was caused primarily by a fall in the leading, export-oriented industrial sectors, such as metallurgy, chemical production, machinery and equipment, and production of vehicles, which declined by 56% yoy, 20% yoy, 31% yoy, and 44% yoy respectively. At the same time, food processing, which is primarily domestic market-oriented, declined by a comparatively low 4% yoy.

Industrial Output Trends by Sector, ytd % yoy 3



Source: INSSE

In 2009, positive trends in Romania's economic development are closely related to a recovery of international financial markets and the global economy as a whole. As strong capital inflows to the Romanian economy are un-

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Editor Rina Bleyzer O'Malley

Indicators of economic performance 4

	9M 2008	2008	Jan 2009
Retail trade turnover	16.6	13	-0.6
Trade, repair works	26.6	15.7	-28.8
Market services to population	5.3	-0.3	-4.2
Construction works	31	26	6
new construction	31.1	22	9.9
maintenance and repair	31	32.6	-1.9
capital repair	30.6	30.9	-1.5
	Sep 2008	Dec 2008	Jan 2009
Real net wage index, % mom	1.1	9.1	-10.1
Real net wage index, % yoy	16.1	10.6	5.8
Unemployment rate	3.9	4.4	4.9

Source: INSSE

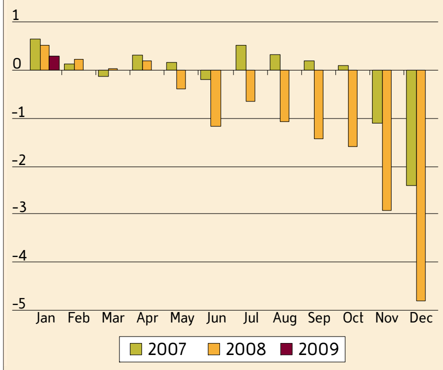
likely to return to their former volumes in 2009, investments and consumption, which used to be heavily fueled by borrowed external capital, will significantly decline. On a positive note, the weak Romanian currency will favor an improvement in the trade balance, so the negative contribution to GDP growth of the net export will substantially diminish. However, this will not compensate for the fall in value added generated by domestic demand of the private sector. Government expenditures are also expected to decline, which stems from a commitment of the government to tighter fiscal policy. Thus, GDP is most likely to drop in real terms this year. Our preliminary forecast for real GDP for 2009 is a 4% yoy decline.

Fiscal Policy

In 2008, Romania's fiscal position deteriorated abruptly, as the consolidated budget deficit of surged to 4.8% of GDP, compared to 2.3% of GDP reported a year ago. The sharp widening of the budget gap occurred in November-December. In that period, tax receipts lowered on the back of an unfavorable economic environment, leading to the under-execution of planned budget revenues in 2008 by 5.6%. At the same time, government expenditures increased substantially in the fourth quarter, ahead of November parliamentary election, mainly for spending on wages and social protection.

In January 2009, consolidated budget revenues fell by a nominal 6.4% yoy, which was attributed mainly to the contraction of corporate income tax receipts, VAT and taxes on foreign trade. In particular, tax on corporate profit declined by 30.6% yoy in January, while VAT collections dropped by 8% yoy due to falling trade sales. Receipts from taxes on foreign trade decreased by 48% yoy on the back of a significant contraction of foreign trade turnover. On a positive note, excises rose by 22% yoy due to increases in excise rates. And personal income tax revenue increased by 15% yoy, reflecting nominal growth of wages, although visibly decelerating from 28% yoy reported in 2008.

Consolidated Budget Balance, % of full year GDP 5



Source: Ministry of Economy and Finance

At the same time, government expenditures declined by 2.8% yoy, following a two-times shortfall in capital expenditures. Meanwhile, current spending grew by 3.6% yoy, primarily due to increases in expenditures on wages in the budget sector (6.9% yoy) and on social protection (21% yoy). The consolidated budget posted a deficit at 0.3% of full-year forecasted GDP in January.

The government approved a draft of the budget project for this year, which envisaged the narrowing of the budget gap to 2% of GDP at the end of the year from the almost 5% reported in 2008. Afterwards, the government has revised the initial draft of the budget project in line with requirements of the IMF, worsening projections for GDP to a 4% decline and lowering revenues and expenditures targets to 7% yoy growth and 1.3% yoy decline respectively. At the same time, the government kept the budget deficit target at an initial 2% of GDP for 2009. Fiscal consolidation during an economic downturn is a challenging and ambitious task for the government. Thus, the government has to implement tighter fiscal policy, which is also pre-determined by the stand-by agreement with the IMF. For this reason, the government raised some tax rates on the one hand, and restrained some expenditures, on the other hand. In particular, the budget draft includes raising social security payments by 3 percentage points (p.p.) and increasing the excise rates on tobacco. On the expenditures side, the government tied pensions and wages in the budget sector to the inflation rate and decreased the planned share of some current spending, in particular, wages of the budget sector and spending on goods and services. Nevertheless, risks for implementation of the budget are rather high and attributed to: (1) a deteriorating revenue side of the budget on the back of the weakening real sector of the economy, (2) the high share of social assistance in budget expenditures (pensioners, the unemployed), and (3) the need for capitalization of state-owned banks. Accordingly, it is very likely that a deficit of the consolidated budget is going to significantly exceed the projected 2% of GDP in 2009.

During 2005-2007, Romania's total gross external debt was growing at an average 40%

Total Gross External Debt 6

	2007			2008		
	EUR mln	% GDP	% yoy	EUR mln	% GDP	% yoy
Total Gross External Debt	**58 602.2**	**52.3%**	**42.3%**	**72 496.6**	**57.3%**	**23.7%**
Gross External Debt	46 668.7	41.6%	40.3%	56 420.4	44.6%	20.9%
General Government	9 629.0	8.6%	-2.2%	10 267.0	8.1%	6.6%
Monetary Authority	144.9	0.1%	-	303.4	0.2%	7.4%
Banks	19 477.3	17.4%	63.8%	24 939.3	19.7%	28.0%
Other Sectors	17 417.5	15.5%	52.2%	20 910.7	16.5%	20.1%
Direct Investment Intercompany Lending	11 933.5	10.6%	50.3%	16 076.2	12.7%	34.7%
Short-term debt	17 464.5	15.6%	60.7%	18 710.8	14.8%	7.1%
Long-term debt	29 204.2	26.1%	30.4%	37 709.6	29.8%	29.1%

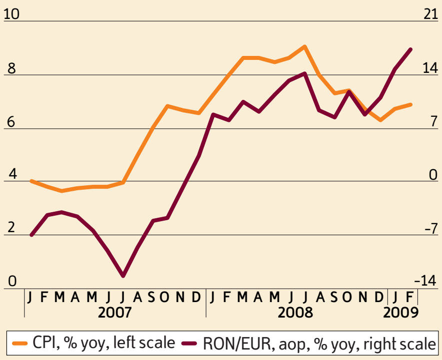
Source: NBR

yoy due to increasing financing needs of corporate and banking sectors. At the end of 2007, total gross external debt advanced to 52% of GDP. In 2008, external debt growth slowed to 24% yoy, amounting to 57% of GDP at the end of the year. This level of external debt can be regarded as quite manageable; however, its ratio to GDP can further advance due to the depreciation of the RON and an economic slowdown. Another positive point here is that short-term accounts for a moderate 7% of total gross external debt. At the same time, the amount of foreign obligations to be repaid in 2009 may appear higher than short-term debt due to long-term obligations maturing in 2009.

Monetary Policy

In the first two months of the year, consumer price growth accelerated, despite some easing of inflation tensions at the end of the previous year. In January-February, a depreciation spill-over to inflation increased, and monthly inflation grew by 1.24% and 0.88% month-over-month (mom) respectively. In Romania, consumer prices are rather sensitive to changes in the exchange rate due to high weights in the consumer basket of imported goods as well as of some communication services, the rates for which are expressed in the EUR. However, for January-February, inflation was developing at a lower rate than the exchange rate was, as inflationary developments were restrained by the cooling economy and weakening domestic demand. On the supply side, inflation was also contained by moderating of global commodity price.

CPI and RON/EUR exchange rate, % yoy 7

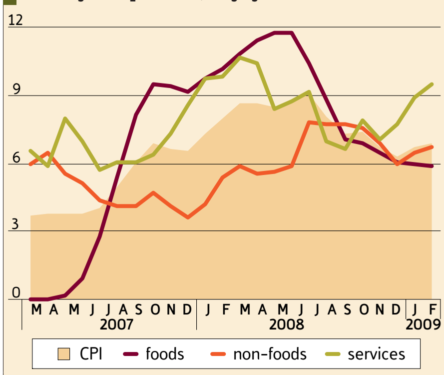


Source: INSSE, NBR

Prices of many imported goods, such as cosmetics and medical articles, cultural and sport products, and fuels, driven up by the depreciation, jointly contributed 15% in January and 57% in February to monthly inflation. Also, the depreciation significantly spurred prices for communication services, denominated in Euros. Increasing tariffs for post and telecommunication explained 36% and 10% of monthly inflation in January and February, respectively.

In annual terms, inflation was 6.9% yoy as of February, gaining an additional 0.6 p.p. compared to the end of 2008. Prices for food-stuffs slowed to 5.9% yoy, mostly because of a favorable comparative base effect. At the same time, prices for non-food stuffs accelerated to 6.7% yoy, up from 6% yoy in 2008, while services tariffs surged by 9.5% yoy, up from 7.7% yoy.

CPI by Components, % yoy 8



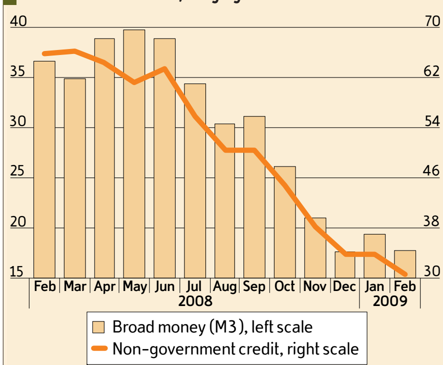
Source: INSSE

In September 2008-January 2009, depreciation pressure on the RON increased substantially following the general trend of depreciation of local currencies in emerging markets due to foreign investors' growing risk aversion. High macroeconomic imbalances (CA gap at 13% of GDP in 2008), political instability related to the parliamentary elections and a formation of the new government, as well as the budget deficit at almost 5% of GDP, contributed to higher depreciation pressure on the RON, making Romanian currency one of the most volatile in the region. As of February, the RON depreciated by a nominal 15% yoy, approaching RON/EUR 4.28 at the end of the month.

However, expected financial support from international organizations (IMF, World Bank, EBRD, etc.) and from foreign banks to their subsidiaries in Romania will secure enough capital inflow to service Romania's foreign debt obligations. Besides, stabilization of the political situation and strengthening coordination of fiscal and monetary policies will positively impact investors' sentiments toward Romania. So the RON/EUR exchange rate is likely to stabilize at a relatively flat trend in the coming months. Therefore, we believe that inflation will decelerate for the rest of the year, being favored by a more stable Romanian Lei as well as by continuing weak consumer demand. So, the government forecast of inflation at 5% yoy at the end of the year seems quite realistic.

In January-February, credit of the real economy continued to slow dramatically, due to tight liquidity of the banking system and restrained lending policy. As of February, non-government credit decelerated to 31% yoy, down from 66% yoy reported a year ago. During October 2008-February 2009, volumes of non-government credit denominated in local and foreign currency dropped by 1.8% and 1.6% respectively, indicating a significant decrease in new loans to both households and legal entities. The total stock of non-government credit grew by 6.5% during October -February only because of RON depreciation. On the back of sluggish lending, the money supply slowed to 17.7% yoy in Feb-

Money Supply and Non-Government Domestic Credit, % yoy 9



Source: NBR

ruary. Although growth of deposits denominated in both local and foreign currency visibly decelerated, there was no observed net deposit flight from the banking system, as stock of RON- as well as Forex-deposits grew by around 1% over October-February.

Capital outflow in the fourth quarter led to liquidity scarcity on the domestic money market. The NBR had to inject an additional RON 49 billion into the banking system in November 2008 and RON 28 billion in January-February 2009 to support liquidity. Regarding disinflation observed in the fourth quarter of 2008, the NBR lowered the reference rate to 10% in February from 10.25% and kept it unchanged in March.

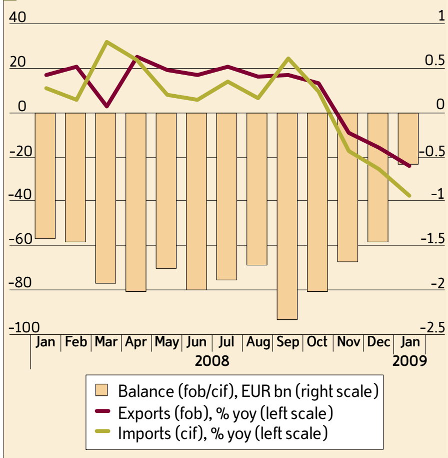
International Trade and Capital

Decreasing external and domestic demand dampened foreign trade volumes in Romania during November 2008-January 2009. FOB exports in goods deepened their decline in January to 24% yoy, while CIF imports in goods dropped by 37% yoy. Therefore, the FOB/CIF merchandise trade deficit continued to shrink in 2009, decreasing by 2.5 times in January 2009.

As data on foreign trade for the last quarter of 2008 revealed, exports slowed mostly due to commodities such as refined petroleum, chemical products and machinery and equipment, which account together for 35% of total merchandise exports, as well as by decreasing exports of light industry products, such as textiles, apparel and leather, which jointly explain 15% of exports. On a positive note, growth of merchandise exports was maintained by a 121% growth of agricultural products, primarily, cereals, which explained one third of the export growth in 2008. It seems that agricultural products may turn out to be the main export commodity in 2009.

Meanwhile, a slowdown in imports was triggered primarily by drastically decelerating imports of capital goods, which grew by 4.3% yoy in 2008, compared to 11.4% yoy in January-September 2008. Domestic demand for imported consumer goods was adjusting more slowly, decelerating to 16% yoy in 2008, down from 19.6% yoy in the first nine months of the year. Nevertheless, consumption demand for imports will inevitably decline in 2009. A contraction in merchandise imports is

Monthly Foreign Trade Balance 10

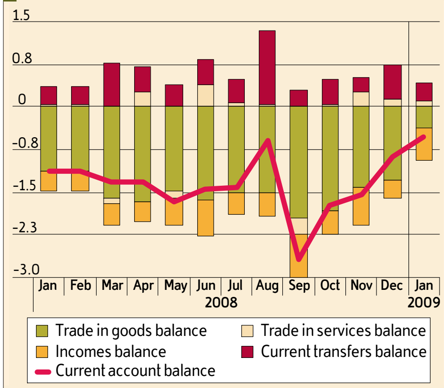


Source: INSSE

expected to continue in the coming months, likely pushing the trade balance into surplus.

In January 2009, the current account gap dropped in half compared to the respective period of last year, totaling EUR 525 million. The FOB/FOB trade deficit shrank by almost three times, while the income deficit increased by 56% yoy, exceeding the merchandise trade deficit. The external gap caused by trade and income deficits was partially compensated for by higher surpluses of services trade balance and current transfers. Net FDI inflow grew by 31% yoy, posting EUR 912 million as of January, and completely financed the current account gap. At the same time, according to preliminary NBR data, the financial account balance posted EUR 450 million. Despite an increase in net FDI, a three-time fall in long term borrowings and net outflow of short-term capital caused the financial account to be cut in half in January as well. As a result, the balance of payments reported a deficit of EUR 75 million, causing a 7% mom increase in the RON/EUR exchange rate.

Current Account Components, monthly flows EUR billion 11



Source: NBR, The Bleyzer Foundation

The current gap may adjust sharply in 2009, likely below 10% of GDP. The main factor of balancing external gaps will be lower domestic demand on the back of significant tightening of access to debt financing. At the same time, a fall in nominal GDP is most likely to not allow the current account gap to decrease below 5% of GDP.

Other Developments Affected the Investment Climate

On March 25th, the International Monetary Fund (IMF) announced an agreement with the Romanian authorities on a EUR 12.95 billion loan under a two-year Stand-By Agreement. The reason for the IMF stabilization loan is significant external imbalances and outflow of private debt capital, which imply risks of currency and banking crises for the country. The IMF is going to work in close coordination with the European Union, the World Bank and other international organizations. Thus, depending on approval of the program by the IMF, the EU stands ready to provide a loan of EUR 5 billion, while the World Bank will provide another EUR 1 billion. In addition, other financial institutions, including the European Bank for Reconstruction and Development (EBRD) will also supply EUR 1 billion. In total, Romania is expected to receive nearly EUR 20 billion in the framework of the economic stabilization program.

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