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Summary

- In the first half of the year, real GDP declined by 7.6% year-over-year (yoy), which was more than expected.
- The budget deficit amounted to RON 14.4 billion (2.7% of GDP) as of June, still in line with the target previously agreed with the IMF.
- During January-June 2009, Romania's total external debt increased by 2.8% year-to-date (ytd), amounting to EUR 57.2 billion, mostly due to the arrival of the EUR 4.8 billion IMF loan in May.
- Headline inflation gradually decelerated to 5.1% yoy in July.
- The exchange rate of the Romanian leu against the Euro remained relatively stable around RON/EUR 4.2 in April-July.
- Growth of non-government credit decelerated to 10.8% yoy in July.
- As of June, the current account had posted a cumulative deficit of EUR 2.4 billion, improving by 3.7 times yoy.
- Net FDI stood at EUR 2.9 billion over January-June, down by 40% yoy.

Economic growth

In the first quarter of 2009, Romanian GDP dropped by 6.2% yoy on the back of falling private consumption and a deeper cutback in inventories. Meanwhile, gross fixed capital formation remained at almost the same level as a year ago, government consumption slightly increased, but the trade balance markedly improved. The downturn in the first quarter was more severe than expected and even deepened in the second quarter due to an adverse combination of tighter external financing and weak foreign demand. According to preliminary data, real GDP fell by 8.8% yoy in the second quarter of 2009 and by 7.6% yoy in the first half of the year.

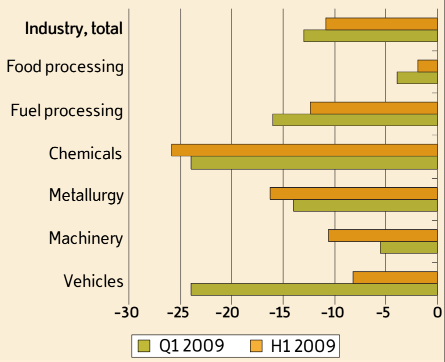
Indicators of economic performance 1

	2008	1Q 2009	1H 2009
Industrial output, % yoy	0.9	-13	-10.8
Retail trade turnover, % yoy	13	-5.2	-9.7
Trade*, % yoy	15.7	-37.3	-38.4
Services to population, % yoy	-0.3	-5.4	-13.4
Construction works, % yoy	26	4.4	-8.6
	Dec 2008	**Mar 2009**	**Jun 2009**
Real net wage index, % mom	9.1	2.7	1.5
Real net wage index, % yoy	10.6	10.2	2.3
Unemployment rate, %	4.4	5.6	6

*Wholesale, retail trade and repair works
Source: INSSE

Weak economic activity was reported by all major sectors. Trade, which accounts for one fourth of the economy, dropped by 38% yoy. A decline in construction sectors deepened to 9% yoy in January-June. Meanwhile, industrial production contracted by 11% yoy. On the upside, industry has been gradually regaining its footing during the last few months thanks to growing exports of cars to EU countries. Indeed, the fiscal stimulus introduced in many EU countries to support the automobile industry boosted production of cars in Romania. Thus, we expect that industrial production may decline by only 5% yoy in 2009. At the same time, continued weaknesses in other economic sectors imply that GDP is likely to decrease by 6% in 2009.

Industrial Output Trends by Sector, ytd % yoy 2



Source: INSSE

Fiscal Policy

A rapid deterioration of public finances on the back of a shrinking economy is the major concern for the government and international authorities. In the first half of this year, the budget deficit amounted to RON 14.4 billion (2.7% of GDP) as of June, although this deficit was still in line with the target previously agreed on with the IMF (RON 14.5 billion). On a positive note, the European Commission (EC) approved the EUR 5 billion loan to Romania to finance the budget deficit. The first tranche of this loan (EUR 1.5 billion) has been already released. The government and the EC signed a Memorandum of Understanding that outlines an adjustment program to fix external and internal imbalances. In particular, the budget deficit should not exceed 5.1% of GDP (4.6% cash-based) this year.

Budget revenues continued to fall drastically on the back of the deepening economic downturn. Indeed, budget revenues declined by a real 7% yoy in May, and by a real 10% yoy in January-May, driven by both direct and indirect taxes. Tax receipts dropped by a real 20% yoy in Jan-May and by a real 30% yoy in May alone. At the same time, public spending kept rising and grew by a real 3% yoy in January-May with a marginal decline reported for the first time in May. However, it is still uncertain whether the government is taking concrete steps to curb its spending. Notably, government expenditures by structure remained rather pro-cyclical, as the payroll in the budgetary sector expanded by 51% yoy to RON 21 billion (EUR 5 billion) in the first five months of the year, while capital expenses shrank by 16% yoy to RON 6.4 billion (EUR 1.5 billion). Wages and employment keep rising in the public sector in contrast to the rest of the economy. The government seems unable to pursue fiscal consolidation policies in response to a visible drop in budget revenues. Indeed, wages in the budgetary sector still increased above the economy average by a real 3.6% yoy in May, even if they moderated from a real 14% yoy in 1Q and 6.5% yoy in April.

The government is going to apply to the IMF, asking for acceptance of a 5.5% of GDP deficit. However, even this level seems unrealistic without the substantial projected cuts in wages and personnel. These significant political actions, leading to the laying-off of employees of the budgetary sector, seem unlikely as they may have negative implications ahead of the coming presidential elections. But they are urgently needed as budget revenues have been deteriorating abruptly and public borrowing is rather problematic despite low public indebtedness (about 20% of GDP). Another solution considered by the government is forced unpaid holyday for the public employees. Ahead of the presidential elections this would be preferred from political point of view, although it would only be a delay of the problem, not a solution. So, there is a significant risk that the budget gap will hit and possibly exceed 7% of GDP in full year.

The budget deficit, which is the main target for the IMF's first quarterly review, remained below the ceiling set under the stand-by agreement (SBA) in 1H according to preliminary data. The IMF has highlighted that the government should concentrate its efforts on tax collections and prioritization of public spending under circumstances where tax revenues are behind expectations. The Romanian government is committed to meeting a budget deficit of 2.73% or lower for the first half of the year, 3.5% in January-September, and 4.58% of GDP for the whole year. If the government misses quarterly targets set under the SBA with the IMF because of its own policies, the Fund will not disburse the second EUR 1.9 billion tranche.

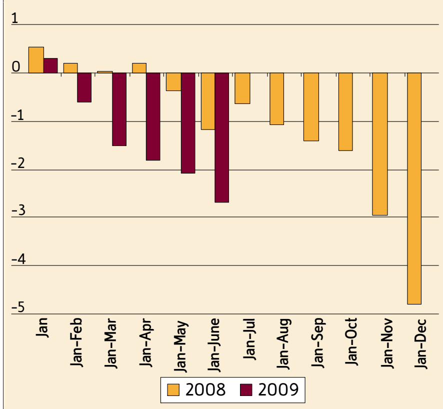
The council of EU economy and finance ministers (EcoFin) opened the excessive deficit procedures for five EU states including Romania and issued recommendations on measures to be taken in order to correct the budget deficit below the 3% of GDP threshold. The EcoFin council set January 7th, 2010 as a deadline for taking corrective measures. The council called on Romania to reduce its deficit below the 3% of GDP threshold by 2011.

The Fund would urge the government to approve and speed up the convergence to a unitary pay system across the budgetary sector. The pension system will be another key issue during the talks with the IMF, as the pension fund's deficit already reached the full-year projection in 1H.

The public debt grew by 10% ytd during the first five months of the year, to RON 120.7 billion as of May. Since the end of September 2008, when the public debt began to grow because of falling revenues, the stock of local currency public debt has soared by 46% or by nearly RON 24 billion (EUR 5.7 billion). Meanwhile, forex-denominated debt has stayed at almost the same level.

During the first half of 2009, Romania's total external debt increased by 2.8% ytd, amounting to EUR 57.2 billion. The major part of the increase occurred in May and was attributed to the EUR 4.8 billion loan from the IMF. Had it not been for this loan, total external debt would have further shrunk by EUR 2.6 billion in May, following a EUR 2.1 billion outflow of short-term capital and a EUR 0.6 billion drop in medium- and long-term deposits of non-residents. However, already in June, net inflow of foreign capital to Romania other than international financial support picked up by 2.3%, as investor sentiment was encouraged by the stand-by agreement with the IMF. Thus, M&LT deposits of non-residents grew by 19% in June, while M&LT private debt and short-term debt increased by 0.7% and 1.3% respectively.

Consolidated Budget Balance, % of full year GDP 3

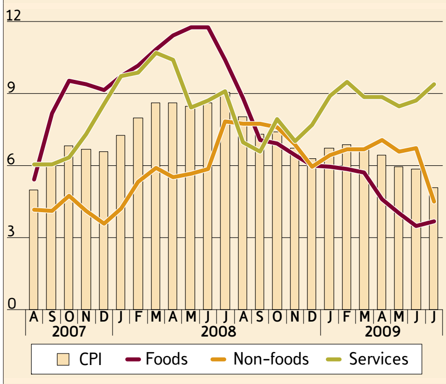


Source: Ministry of Economy and Finance

Monetary policy

In June-July 2009, consumer inflation remained on the downtrend due to still weak demand and the stabilization of the exchange rate. Headline inflation gradually decelerated to 5.1% yoy in July, down from to 6.3% yoy in 2008. Continuing disinflation was registered primarily for prices of goods, while tariffs for services kept rising. Prices of food and non-food items slowed to 3.7% yoy and 4.5% yoy respectively. Meanwhile, service price growth accelerated to 9.4% yoy, driven by the depreciation of the RON and increases in administrated tariffs.

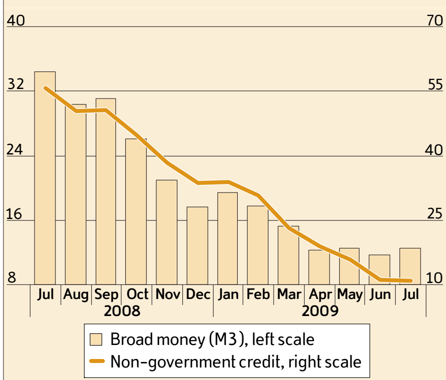
CPI by Components, % yoy 4



Source: INSSE

The exchange rate of the Romanian leu against the Euro remained relatively stable during April-July, marginally fluctuating around RON/EUR 4.2. This stability was mostly supported with the financial assistance provided to Romania by the international financial institutions.

Money Supply and Non-Government Domestic Credit, % yoy 5



Source: NBR

The National Bank of Romania (NBR) focused its monetary policies on the financial sector by supporting liquidity in the banking system, facilitating credit intermediation and ensuring stability of the financial system. In particular, the NBR has already cut its reference interest rates four times since the beginning of the year - from 10% in 2008 to 8.5% in August 2009. In addition, it lowered the required reserve ratios for domestic and foreign currency liabilities. Nevertheless, bank lending to the private sector continued to moderate (growing by only 11% yoy in June) as lack of funding and elevated credit risks greatly reduced banks' capacity and willingness to create new credit.

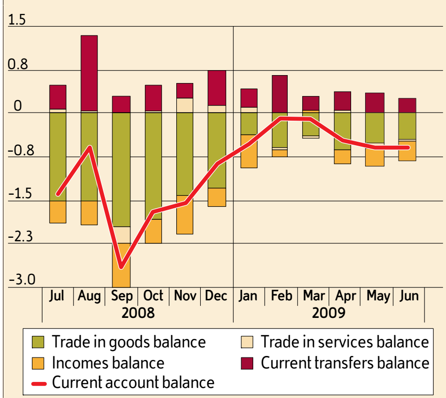
The quality of the banks' credit portfolios has visibly worsened since last September when the non-performing loans[1] were 11% of total debt. The total stock of non-performing loans surged by 78% and amounted to 19.5% as of June. Growth of non-government credit continued to decelerate on the back of persisting credit risks in the economy as well as still tight global credit markets, and reported 10.8% yoy in July.

At the same time, credit to the government more than tripled on a year-over-year basis, totaling RON 45 billion (EUR 10.7 billion) at the end of July. Since the beginning of the year, bank lending to the government increased by EUR 6.3 billion (adjusted with the exchange rate depreciation). By comparison, government debt increased by only EUR 2 billion in 2008. However, the money supply grew visibly slower, expanding by only 12.5% yoy in July. The government made an agreement with eight Romanian banks in July on a joint banking loan totaling EUR 1.2 billion. This amount is roughly equal to those released after the lowering of reserve requirements on foreign currency liabilities. The foreign exchange reserves of the NBR decreased by 1.4% (EUR 0.4 billion) in June, to EUR 26.5 billion, after they surged by EUR 2 billion in May, spurred by the EUR 4.8 billion tranche of the IMF. A EUR 2 billion drop in reserves in June was attributed to changes in banks reserve requirements, changes in prices for securities in the NBR's portfolio, as well as to interest payments on public debt. Approximately half of the NBR forex reserves (nearly EUR 13 billion) is composed of the required reserves of commercial banks liabilities' in foreign currency. Thus, the monetary board's decision to cut the required reserve ratio for foreign currency liabilities directly impacted the central bank forex reserves. Afterwards, in July, forex reserves amounted to EUR 29.5 billion, supported by the EC loan to the Romanian government.

International Trade and Capital

In the first half of the year, the current account posted a deficit of EUR 2.4 billion, improving by 3.7 times compared to the first half of the previous year. This substantial improvement, from an excessive 16% of GDP to a mere 3% of GDP, occurred abruptly and reflected a sharp decline in domestic demand. In particular, this correction was triggered by the rapid narrowing of the foreign trade gap, which shrank by 3 times yoy, to EUR 3 billion in January-June. Meanwhile, the income of foreign investors dwindled - by 87% yoy, while current transfers (primarily attributed to remittances of Romanians working abroad) fell by a comparatively lower 18% yoy. The current account deficit in the first half of 2009 was fully covered by net FDI inflows, against only 61% a year ago. Despite tight global liquidity and elevated risk aversion, the FDI inflows remained fairly robust. Net FDI stood at EUR 2.9 billion over January-June, down by 40% yoy. We expect that the current account deficit will continue to narrow through the rest of the year and should settle at 5% of GDP in 2009. Net FDI is likely to finance about 70% of this gap, while the rest will be covered by the IMF and EU loans.

Current Account Components, monthly flows EUR billion 6



Source: NBR, The Bleyzer Foundation

During May-June 2009, volumes of foreign trade continued to fall with rates of export and import contraction stabilizing at nearly 20% yoy and 38% yoy per month, respectively. Exports were still undermined by weak external demand, despite competitive advantages of the depreciation. According to the National Institute of Statistics (NIS), FOB export in goods declined by a cumulative 20% yoy in the first half of the year, to EUR 13.6 billion, driven by a significant drop in export of fuels (-49% yoy), chemicals (-44% yoy), and raw materials, mainly ferrous metals (-27% yoy). On a positive note, the decrease in exports of vehicles, accounting for 42% of total merchandise exports, decelerated to 1.6% yoy. The production of automobiles obviously continued to enjoy the preferences to automobile producers granted to them in some EU countries.[2] At the same time, exports of food surged by 57% yoy in January-June, spurred by favorable dynamics on international markets.

Imports of goods continued to deteriorate at a deeper rate, as domestic demand appeared rather sensitive to exhaustion of external financial flows and the weakening of the domestic currency. Since the beginning of the year, CIF imports fell by 37% yoy, amounting to EUR 4.3 billion as of June 2009, with significant contraction in all major commodities groups. Therefore, the FOB/CIF merchandise trade gap shrank by 2.5 times yoy in January-June, down to EUR 4.3 billion.

[1] According to methodology of the IMF, non-performing loans consist of loans, classified as substandard, doubtful and loss.
[2] A range of European countries (Germany, France, Italy, Romania, etc) introduced special programs, aimed at stimulating of automobile production industry. According to the programs, consumers may replace their old car with a new one at a reduced price.

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