Romania
Macroeconomic Situation

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- **Industrial production rose by 5.1% yoy in January-November 2010.**
- **During the first eleven months of 2010, the consolidated budget deficit contracted by 10% yoy and reached 5.2% of GDP. According to the preliminary official data the full year budget deficit might settle at 6.5% of GDP.**
- **In December, consumer prices grew by 8.0% yoy.**
- **In January-September, the current account deficit expanded to 4.3% of GDP or EUR 5.2 billion.**
- **On January 7th, the IMF disbursed a 7th tranche in the amount of EUR 0.9 billion.**

Executive Summary

The annual decline of Romania's economy in 2010 could be registered at 2% yoy based on cumulative data for real sectors. In particular, both retail sales and construction sectors dropped amid summer fiscal retrenchment. On the other hand, industry continued to remain as the main driver for economic growth, posting a cumulative 5.1% yoy growth rate in the first 11 months of 2011. Thus, the future performance of Romania's industry will play a crucial role in restoring economic growth this year. At the same time, the expected rebound of domestic demand should provide additional support for economic growth. As a result, GDP could grow by about 1.6% yoy in 2011.

The consolidated budget deficit reached 5.2% of GDP compared with 6% of GDP in 2009, as the January-November state budget gap contracted by 10% yoy due to fiscal austerity measures. Since further spending adjustments will be introduced in 2011, the state budget deficit could reach 4.4% of GDP in 2011 and below 3% of GDP in 2012. Under these circumstances, Romania should satisfy the Maastricht criteria for a fiscal deficit in two years. On the revenue side, higher state revenues were led by solid proceeds from indirect taxes, while collections from direct taxes continued to decline. Meanwhile, the growth rate of state expenditures decelerated on the back of a reduction in the state wage bill and a drop in capital investment.

In December, the growth of consumer prices accelerated to 8% yoy and reached the highest level since August 2008. The CPI exceeded the upper bound of the National Bank's inflation targeting (4.5% yoy). Since the hike in consumer prices was caused by a non-monetary effect, the CPI is expected to fall within the inflation target band (2.0% - 4.0%) at the end of 2011. To reverse the inflationary trend, the National Bank of Romania maintained stable monetary policy, notably keeping its benchmark policy rate at 6.25%.

In January-November of 2010, the current account deficit deteriorated amid expansion of the deficit in incomes and contraction of surplus in current transfers. By contrast, the trade deficit in goods shrank due to solid growth of merchandise exports. As a result, the current account deficit expanded to 4.3% of GDP or EUR 5.2 billion. Meanwhile, FDI inflows totaling EUR 2.3 billion covered almost half of the current account deficit, despite falling by 25% yoy.

To stabilize the state budget deficit and revive economic growth, Romania continues to cooperate with international financial institutions. On January 7th, the Executive Board of the IMF approved a 7th disbursement totaling EUR 0.9 billion. At the same time, Romania still has several challenging tasks that should be solved in the coming months. Implementation of structural reforms (pension and public wage reform), control of tight fiscal policy and boosting productivity are on the list of major policy tasks.

	2006	2007	2008	2009	2010f	2011f
GDP growth, % change yoy	7.9	6.3	7.1	-7.2	-2.0	1.6
Industrial production, % change yoy	7.1	5.4	0.9	-5.5	3.6	4.5
Consolidated budget balance, % of GDP	-1.7	-2.4	-4.8	-7.2	-6.8	-5.0
Unemployment, end of period	5.2	4.1	4.4	7.8	8.0	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	-2.0	-3.0
Gross forex reserves of the NBR, EUR billion, end of period	22.9	25.3	28.3	30.9	33	34
Current Account Balance, EUR billion	-9.97	-16.68	-16.16	-5.05	-6.3	-7.8
Total gross external debt, EUR billion	41.2	58.6	72.4	78.7	83.5	85.0
Exchange rate, RON/EUR, annual average	3.52	3.34	3.68	4.24	4.4	4.3

Source: INNSE, The Bleyzer Foundation

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Economic Growth

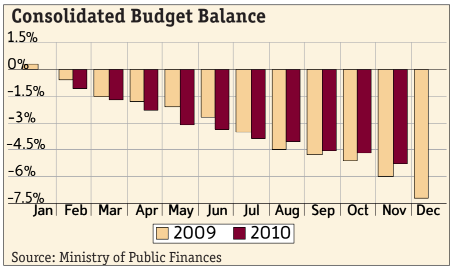
Romania's economy could fall by about 2% yoy in 2010 based on 11 month data for real sectors. In particular, retail sales continued to decline in the aftermath of the VAT rate hike from July 2010. Specifically, the index of retail sales stayed on a decelerating pace during the last 5 months, notably dropping by 4.9% yoy in January-November. This might indicate that domestic consumption is still subdued since fiscal austerity measures were introduced. Moreover, the drop in the index of construction works accelerated to 17.1% yoy in November, bringing the cumulative rate of decline over 11 months to 15% yoy. This poor performance reflects the lack of public orders on the back of fiscal consolidation and shortage in investment into the construction sector. On a positive note, the recent launch of projects by the Ministries of Transport and Development coupled with hopes for better absorption of EU funds should positively contribute to a rebound of the sector in 2011.

Growing industrial production partially offset the negative impacts of retail sales and construction. In particular, in November industrial production rebounded from the temporary slowdown in October. Indeed, the index of industrial production posted solid 7.9% yoy-growth compared with the 1.6% yoy increase a month ago. As a result, the cumulative growth rate of the industrial production index over 11 months reached 5.1% yoy. Future outlook for Romania's industry will be highly dependent on increase of global demand, especially in Europe. Under these circumstances, resolution of the current EU sovereign debt turmoil will play a crucial role in supporting demand for Romania's industrial output. At the same time, the expected recovery of domestic demand could prompt stronger performance of domestic-oriented industries, which suffered from subdued demand due to tight budgets in 2010. Given these favorable factors, annual GDP growth is expected to reach 1.6% yoy in 2011.

In November alone, the sound performance of industrial activity was primarily shaped by solid output in manufacturing (up by 9.3% yoy). Utilities increased 2.4% yoy, while production in the mining and quarrying sector declined by 3.8% yoy for the fourth month in a row. At the same time, export-oriented industries preserved their leading role in overall expansion of manufacturing production. In particular, higher production of vehicles (up by 17.8% yoy), machinery (up by 16.6% yoy) and basic metals (up by 13.6% yoy) was underpinned by solid exports of these commodities in January-November. Meanwhile, domestic-oriented industries demonstrated uneven dynamics. Food processing continued to decline, notably by 3.7% yoy amid subdued domestic demand. On the other hand, manufacture of apparel and textiles was improved, growing by 9.9% yoy and 13.1% yoy, respectively.

Fiscal Policy

In November, the summer fiscal austerity measures continued to curb the consolidated budget deficit. Indeed, state budget deficit was kept on a robust deceleration pace for the fourth month in a row. In January-November, the state budget gap contracted by 10% yoy compared with a 25.6% yoy widening in the first half of 2010. As a result, the consolidated budget deficit reached EUR 6.2 billion or 5.2% of full-year projected GDP. The annual fiscal deficit may settle at around 6.8% of GDP, which is in line with the IMF target. More importantly, given further spending adjustments (by 2.2% of full-year projected GDP in 2011), the state budget deficit is expected to reach 4.4% of GDP in 2011 and below 3% of GDP in 2012. Thus, Romania should satisfy the Maastricht criteria for a fiscal gap in two years – notably fixing the fiscal gap below 3% of GDP.



During the first eleven months of the year, stronger state revenues (up by 4.9 % yoy to EUR 35.2 billion) were promoted by sound proceeds from indirect taxes. In fact, higher collections from VAT (up by 13.2% yoy) and excises (up by 10.7% yoy) remained the key drivers of overall growth of state revenues. This was mostly explained as a consequence of fiscal consolidation policies, namely by the rise in the VAT rate by 5 p.p. Non-tax revenues also positively contributed to higher revenues, posting 18.5% yoy growth. By contrast, collections from direct taxes were kept on a downward trend. Indeed, proceeds from corporate profit tax (down by 5.6% yoy) as well as wage and income tax (down 3.5% yoy) dropped amid budget constraints due to summer spending adjustments. In addition, lower labor income caused a decline in healthcare contributions and social security (down by 5.7% yoy). This was accompanied by a reduction in the number of employers working in the public sector to 1.3 million from 1.4 million in 2009.

On the expenditure side, government spending rose in January-November, though at a slower pace. In particular, state expenditures rose by 2.4% yoy and reached EUR 41.5 billion. Slower growth of total expenditures was related to a decline in the state wage bill by 8.5% yoy. In addition, the decline in capital investment (down by 17.4% yoy) reflected the reduction of government spending into state infrastructure. Meanwhile, the rise in total expenditures was mostly backed by higher social transfer payments (up by 7.5% yoy) as a consequence of the 6.9% unemployment rate.

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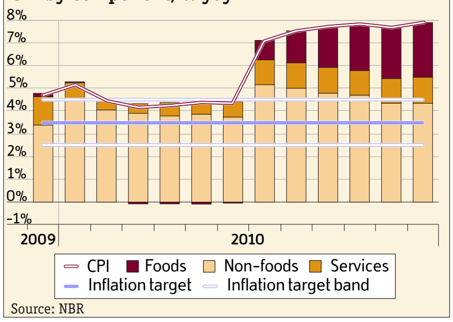
By November, the stock of medium and long term external debt had increased by 10% since the beginning of the year (ytd) and reached EUR 72.4 billion. While private external debt (including non-residents' deposits) fell by 2% ytd, public and publicly guaranteed debt posted 39% ytd growth. The growth of the latter was led by IMF disbursements and EU tranches according to the Balance of Payments assistance program.

Monetary Policy

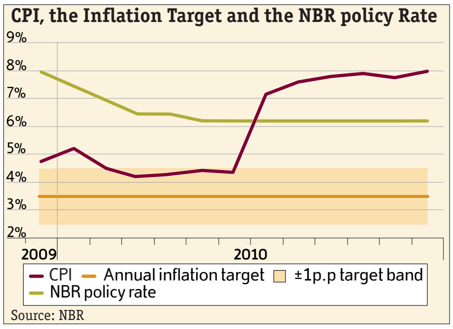
In December, consumer prices continued to grow despite downward pressure exerted from demand-side factors. In particular, CPI peaked to 8% yoy, which is the highest level since August 2008. This was significantly above the upper bound of the National Bank's inflation targeting (4.5% yoy) but less than the NBR's official forecast (8.2% yoy).

CPI by Component, % yoy



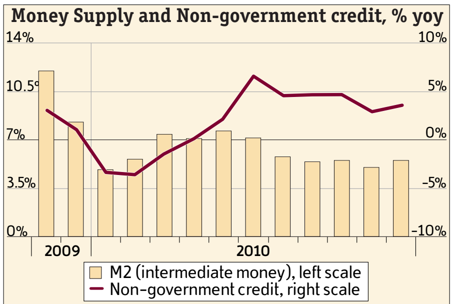
Source: NBR

CPI, the Inflation Target and the NBR policy Rate



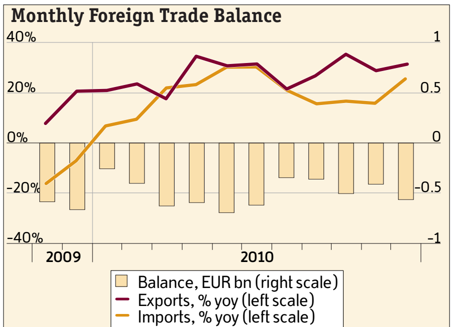
Source: NBR

Money Supply and Non-government credit, % yoy



Source: NBR

Monthly Foreign Trade Balance



Source: NBR

As a one-off and non-monetary reason for the surge in prices, the hike in VAT rate is going to fade, and CPI may return within the inflation target band (2.0% - 4.0%) at the end of 2011. To combat inflation, mitigate a second round effect of the VAT rate and reduce uncertainties related to the rise in food prices, the National Bank has provided prudent monetary policy. In particular, the NBR aimed to anchor inflationary expectations by keeping its benchmark interest rate unchanged at 6.25% for nine month in a row. Additional downward pressure on consumer prices will be exerted due to tight fiscal policy.

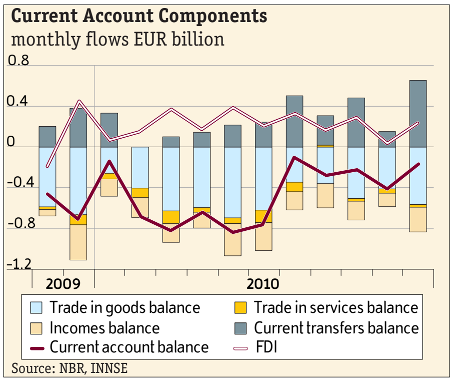
In November, the rate of growth of money supply (measured as intermediate money M2) slightly accelerated to 5.5% yoy from 5% yoy in October. This growth was supported by an increase in loans denominated in EUR (up by 8.7% yoy), while the corporate sector and households reduced their accumulations of RON-denominated loans (down by 3.8% yoy). Given the sound performance of EUR-denominated loans, non-government credit posted 3.5% yoy growth for the seventh month in a row.

International Trade and Capital

In November alone, the merchandise trade deficit shrank mostly on the back of growing exports. In particular, the deficit of trade in goods contracted by 4% yoy and reached EUR 0.6 billion, while exports of goods (EUR 3.6 billion) posted sound 31% growth. More importantly, during the last four months, exports of goods surged by an average 30% yoy rate of growth. Meanwhile, growth of merchandise imports (EUR 4.2 billion) advanced to 25% yoy from 15% yoy a month ago. This acceleration is likely to reflect a higher share of imported intermediary goods that will be used for further exports. At the same time, subdued domestic demand is unlikely to make these temporary imports rebound.

During the first eleven months of 2010, the merchandise trade deficit contracted. Improvement was achieved on the back of growing exports and imports, while the former had a higher growth rate. Indeed, 27% yoy growth of merchandise exports (EUR 34 billion) outpaced the 19% yoy growth of imports (EUR 39.4 billion). As a result, the cumulative deficit of trade in goods reached EUR 5.4 billion, which was 14% less than in the previous year.

In January-November, higher exports of goods were supported by stronger foreign demand for industrial raw materials and manufactured goods (up by 25% yoy), and transport equipment and vehicles (up by 26% yoy). As a result, exports of these two commodity groups remained key drivers, since they contributed almost ¾ to overall growth of total merchandise exports. Meanwhile, stronger imports of goods were led by higher overseas shipments of industrial raw materials and manufactured goods (up by 17% yoy), fuels (up by 26% yoy), and transport equipment and vehicles (up by 25% yoy). Given the fact that additional austerity measures will be implemented in 2011, merchandise imports will be set to grow moderately. As a result, the deficit of trade in goods will likely continue to shrink this year.



During the first eleven months of 2010, the current account deficit worsened to 4.3% of GDP from 3.6% of GDP in 2009. Although the merchandise trade deficit declined, the surplus in current transfers dropped and the negative income balance increased. In particular, the former fell by 17% yoy and settled at EUR 3.1 billion, while the latter widened to 45% yoy and reached EUR 2.3 billion. Specifically, the decline in current transfers reflected problems with absorption of EU funds as well as reduction in wage remittances. All of this contributed to the widening of the current account deficit, which reached EURO 5.2 billion in 2010. Thus, the expected annual current account deficit might reach about EUR 6 billion or 6% of GDP. FDI inflows in the amount of EUR 2.3 billion funded 44% of the current account deficit, even after falling by 25% yoy. Meanwhile, this corresponding coverage ratio was 73% in 2009.

In January, Romania's international reserves remained virtually the same, notably settled at EUR 35.9 billion. Despite substantial inflows of forex (EUR 1.8 billion) due to disbursement of the 7th IMF tranche, comparable outflows of forex (EUR 1.5 billion) partially offset this contribution. Outflows reflected servicing of public and publicly guaranteed external debt, and depreciation of dollar and pound sterling against EUR, which led to reduction of the corresponding foreign reserves. In addition, reduction in international prices of gold caused some decline in the value of gold reserves. Finally, the Romanian currency (leu) slightly appreciated in January to RON 4.262 per Euro from RON 4.293 per Euro amid EU sovereign debt turmoil.

Other Developments Affecting the Investment Climate

To stabilize its fiscal budget deficit, reduce external risks and set growth to resume, Romania continues to cooperate with international financial institutions. Specifically, on January 7th, the Executive Board of the IMF approved a 7th disbursement totaling EUR 0.9 billion. Although Romania did not meet all IMF quantitative targets (general government domestic arrears, inflation) the tranche was disbursed. Given IMF support, Romania has a credible path to reduce its fiscal deficit to sustainable levels – notably below 3% of GDP in 2012. As a consequence of deficit reduction, medium and long term fiscal goals will likely be met.

Meanwhile, there are current challenging issues that Romania should solve during this year. In particular, the government should implement all structural reforms (pension and public wage reform) and provide vigilant control of tight fiscal policy. With regard to fiscal retrenchment, Romania's government should control state expenditures, especially in the health care sector and public enterprises. On the other hand, improving tax collections and absorption of EU funds will be important drivers for higher state revenues. In addition, the IMF recommends implementation of labor and social safety net reforms to enhance productivity.

The IMF and the World Bank met with Romanian officials at the beginning of February in order to negotiate a new agreement for a period of two years. The new agreement with the IMF is tentatively worth EUR 3.6 billion and will be supported by EU preventive assistance of EUR 1.4 billion and a World Bank loan worth EUR 0.4 billion.