Romania

Macroeconomic Situation

September 2011 Sergii Pypko, RaduMihai Balan, Edilberto L. Segura

- **Real GDP grew by 1.4% yoy during the second quarter of 2011.**
- **In July, the index of industrial production was up by 1.7% yoy.**
- **In January-August, the consolidated budget deficit narrowed by 38% yoy to EUR 3.1 billion or 2.4% of projected full year GDP.**
- **CPI inched up by 4.3% yoy in July.**
- **In January-July, the merchandise trade deficit in FOB-FOB terms shrank by 19% yoy to EUR 2.9 billion.**
- **In January-July, the current account deficit contracted by 24% yoy and stood at EUR 2.8 billion, or 2.2% of projected full year GDP.**
- **On September 29th, the IMF endorsed the disbursement of EUR 0.5 billion.**

Executive Summary

In the second quarter of the year, real GDP growth continued to recover, though at a slower pace. The Romanian economy expanded at a 1.4% yoy real growth rate compared with a 1.7% yoy increase in the first quarter. On the supply side, industry remained the main driver of stronger GDP growth as it rose by 4.9% yoy. At the same time, higher collections from net taxes and solid agricultural output also positively contributed to overall expansion in the Romanian economy. By contrast, weak domestic demand led to a decline in the construction sector (down by 1.9% yoy), while public services dropped by 5.5% yoy. Accordingly, the Romanian economy is expected to expand at a 1.6% yoy annual rate in 2011.

During the first eight months of the year, the consolidated budget deficit narrowed by 38% yoy and reached EUR 3.1 billion or 2.4% of projected full year GDP. The improvement reflected growing government incomes, while state expenditures rose at a significantly lower pace. Specifically, the increase in government incomes was underpinned by stronger collections from indirect taxes, while receipts from direct taxes remained weak. On the expenditures side, falling social transfers payments and the state wage bill exerted downward impact on the state spending. Meanwhile, higher capital investments and growing public spending contributed to overall growth of budget expenditures. We expect that the consolidated budget deficit reach 5.0% of projected full year GDP.

In August, the growth of consumer prices continued to decelerate to 4.3% yoy thanks to the slower rise in foods prices amid the fading of the VAT rate effect. Given the presence of the negative output gap, a favorable statistical base and moderation of international oil prices, the CPI is forecasted to grow by 4.8% at the end of the year. Concurrently, the National Bank of Romania (NBR) continued to keep its key policy rate unchanged at 6.25% per annum to provide stable monetary policy. The NBR issued a Financial Stability Report assessing the domestic financial system as robust.

In January-July, the current account deficit narrowed by 24% to EUR 2.8 billion or 2.2% of projected full year GDP, from 3.1% of projected full year GDP a year ago. The improvement was achieved thanks to a lower deficit in trade in goods and services and a higher surplus in current transfers. Specifically, the merchandise trade deficit in FOB-FOB terms contracted by 19% yoy and reached EUR 2.9 billion amid growing exports in goods. At the same time, FDI inflows covered 39% of the current account deficit after falling by 30% yoy to EUR 1.1 billion.

On September 29th, the IMF approved the disbursement of EUR 0.5 billion according to the Stand-By Arrangement program. Nevertheless, Romania continued to treat this program as precautionary and therefore, authorities would not draw these resources.

	2007	2008	2009	2010	2011f	2012f
GDP growth, % change yoy	6.3	7.1	-7.2	-1.3	1.6	2.0
Industrial production, % change yoy	5.4	0.9	-5.5	5.5	5.0	5.5
Consolidated budget balance, % of GDP	-2.4	-4.8	-7.2	-6.5	-5.0	-4.0
Unemployment, end of period	4.1	4.4	7.8	7.0	7.0	6.5
Inflation, end of period	6.56	6.30	4.75	8.0	4.8	3.8
Retail sales, % change yoy	17.8	13.0	-8.5	-5.3	-3.0	4.0
Gross forex reserves of the NBR, EUR billion, end of period	25.3	28.3	30.9	36	33.5	33.2
Current Account Balance, EUR billion	-16.68	-16.16	-5.05	-5.2	-6.3	-7.5
Total gross external debt, EUR billion	58.6	72.4	78.7	90.8	90.4	98.4
Exchange rate, RON/EUR, annual average	3.34	3.68	4.24	4.2	4.2	4.1

Source: INNSE, The Bleyzer Foundation

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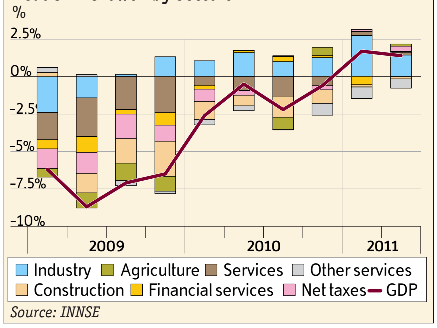
September 2011

Economic Growth

In the second quarter of the year, the Romanian economy continued its recovery although at a slower pace. Specifically, real GDP growth decelerated to 1.4% yoy from a 1.7% yoy increase observed over the first quarter. On the supply side, stronger industrial output remained the main driver of economic growth. Specifically, industrial production advanced to 4.9% yoy, which was significantly lower than the double-digit expansion during the first quarter (up by 10.1% yoy). The deceleration primarily reflected weaker performance of export-oriented industries on the back of cooling external demand. Meanwhile, stronger proceeds from taxes and sound agricultural output also supported the overall expansion of the Romanian economy. While higher collections from VAT and excises led to growing receipts from net taxes (up by 3.1% yoy), agricultural production advanced to 3.4% yoy thanks to a strong harvest. On the negative side, subdued domestic demand continued to restrain the construction sector, which fell by 1.9% yoy. In addition, weaker government expenditures (down by 5.5% yoy) amid fiscal consolidation also exerted downward pressure on the economy.

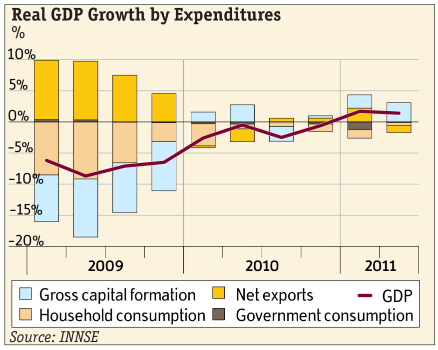
Real GDP Growth by Sectors



Source: INNSE

On the expenditure side, real GDP growth was driven by growing exports. In fact, exports inched up by 6.3% yoy, which was significantly lower than 24% yoy growth registered in January-March. On a positive note, growth of imports also decelerated considerably to 7.7% yoy from 15% yoy expansion in the previous quarter. Moreover, total consumption demonstrated some improvements. Even though it continued to fall (down by 0.7% yoy), the rate of decline was 2.3 p.p. lower than a quarter ago. This deceleration reflected a slower rate of decline for both individual consumers (down by 0.7% yoy) and government (down by 1.2% yoy) – from 1.7% yoy and a 14% yoy contraction registered in the first quarter, respectively. Finally, gross fixed capital formation continued to stabilize (down by 1.4% yoy) after significant contraction since the second quarter of 2009, when the average rate of decline totaled 18.4% yoy.

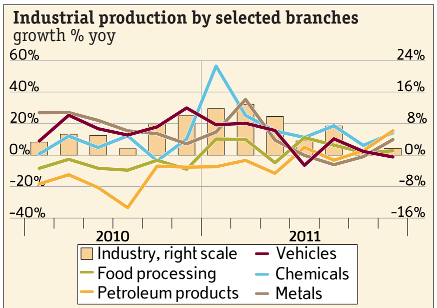
Real GDP Growth by Expenditures



Source: INNSE

The Romanian economy is expected to expand at a 1.6% yoy annual rate in 2011 after two consecutive quarters of recovery. Our projection is close to the official forecasts of the IMF (1.5% yoy) and Romanian state forecasting agency CNP (1.7% yoy). Economic growth should be shaped by rising exports in the short term. However, the current slow-down in the world economy, especially in the European Union amid a sovereign debt crisis, will likely restrain the export potential of the Romanian economy. At the same time, stronger global demand and more efficient use of EU funds should underpin economic expansion in the medium term. Accordingly, the IMF estimated the growth potential of the Romanian economy at a 4.1% yoy annual rate in 2016.

Industrial production by selected branches



Source: INNSE

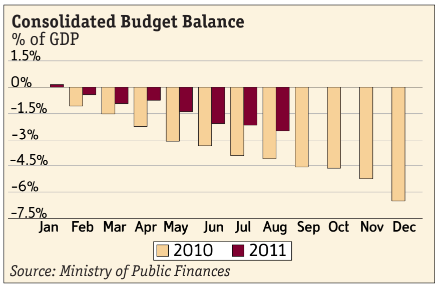
For 2012 we review downwards our GDP growth forecast to 2.0% yoy, due to the combined influence of several factors:

- as the Eurozone crisis continues, and the politicians seem unable to act decisively, growth prospects of major countries, as Germany, France and Italy are reduced. These countries are among Romania's main trading partners, thus a slowdown in their growth will affect the exports, one of the main growth factors in Romania. Also, as the situation in Greece worsens, contagion risks for the Romanian economy increase;
- Parliamentary and local elections in 2012 will likely cause the government to "buy" votes by increasing spending. We expect this to be translated in the economy through larger social spending, that will support consumption, and through an increase in the investments. In terms of the GDP resources this electoral spending will support industrial growth (for internally oriented industries) and constructions;
- The mobile producer Nokia announced the closure of its Romanian factory, with the loss of 2,200 jobs, and with the likely effect on reducing exports by an estimated EUR 1.6 billion or 4.3% of 2010 FOB exports. It is unlikely that such an important cut in exports would be compensated by other exporters. One company that may compensate the loss of exports is Ford, which owns a factory in Craiova, that is expected to strongly increase production next year, mostly for export. Yet the increase in production and exports may be hampered by the lack of good infrastructure connecting Craiova (South Romania) with Western Europe and with Constanta port. Moreover, the factory uses the same export routes as Dacia-Renault, the other auto producer;

- Agriculture likely negative influence for 2012 due to the base year effect, as 2011 harvest was very good.

In July, the dynamics of industrial production slightly improved. Specifically, the index of industrial production advanced to 1.7% yoy from 1.1% yoy registered in the previous month. Nevertheless, the pace of expansion of industrial output remained significantly lower than in the second (up by 4.0% yoy) and first quarter (up by 11.4% yoy), respectively. The deceleration reflected weaker performance of export-oriented sectors on the back of restrained external demand. Indeed, the production of vehicles fell by 1.2% yoy compared with 2.2% expansion during the second quarter. At the same time, domestic oriented sectors like food processing (up by 2.7% yoy) also added up to cooling industrial activity in July compared with the second quarter. By contrast, production of chemicals and machinery posted stronger growth as the corresponding output rose by 16.5% yoy and 14.1% yoy. At the same time, the construction sector and retail sales demonstrated stronger monthly dynamics, but it might be explained by the favorable base effect. In fact, the volume of retail sales advanced by 0.3% yoy for the first time since June 2010. However, domestic demand still remained subdued, while the improvement occurred primarily due to the dissipation of the VAT rate effect. Similarly, the index of construction works posted sound double-digit growth – up by 13.6% yoy after 10% yoy contraction that was observed a month ago.

Fiscal Policy

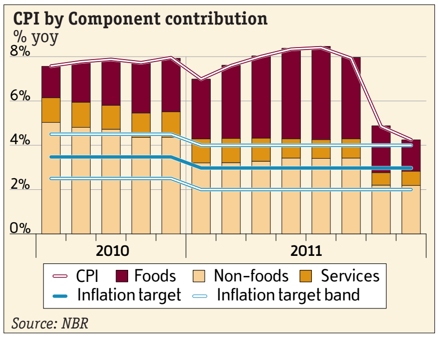


In January-August, the consolidated budget deficit continued to narrow although at a slower pace. In fact, the consolidated budget deficit shrank by 38% yoy and stood at EUR 3.1 billion or 2.4% of projected full year GDP. The contraction was driven by stronger state revenues, while the growth of government revenues remained moderate. In fact, state incomes inched up by 9.5% yoy and stood at EUR 27.7 Billion. Meanwhile, the growth of government expenditures totaling EUR 30.8 billion sped up to 1.7% yoy from a minor 0.1% yoy expansion registered in January-July as fiscal austerity measures started to dissipate. Given the above developments, the consolidated budget deficit is expected to reach around 5.0% of projected full year GDP.

During the first eight months of the year, stronger collections from indirect taxes continued to support growing state revenues. In fact, the proceeds from VAT and excises advanced at sound double digit growth rates – up by 28% yoy and up by 16% yoy, correspondingly. However, these receipts should be less buoyant after the VAT rate effect fades in the coming months. At the same time, collections from the main group of direct taxes remained weak on the back of restrained disposable incomes. Indeed, proceeds from wage and income tax were up by 3.2% yoy, while proceeds from corporate profit tax posted a mere 0.6% yoy growth. Meanwhile, the EU's transfers continued to support stronger government revenues as the former inched up by 45% yoy. Moreover, Romania's parliament approved setting of a new ministry aiming to enhance the efficiency of funds coming from the EU budget. At the same time, social security and health care contributions rose by 8% yoy amid decrease in the number of registered unemployed by 36% yoy to 435,961 as of the end of July 2011.

On the expenditures side, the rise in government spending reflected stronger capital investments (up by 14% yoy) and public spending on goods and services (up by 12% yoy). At the same time, the servicing of public and publicly guaranteed debt increased by 25% yoy, which added up to growing government expenditures. On the contrary, lower social transfers payments (down by 1.5% yoy) and state wage bill (down by 15% yoy) due to the implementation of fiscal retrenchment last summer partially offset the overall expansion in state spending.

Monetary Policy



In August, consumer prices continued their deceleration trend of the last four months. In fact, the growth of CPI slowed down to 4.3% yoy from an 8.4% yoy peak registered in May. Slower growth of consumer prices was primarily driven by a significantly lower rise in food prices amid dissipation of the VAT rate effect. Specifically, the increase in food prices slowed down to 3.8% yoy from 5.7% yoy growth, which was observed a month ago, despite the upward pressure from the international markets. Indeed, the FAO Food Price Index (which measures changes in the basket of the main foodstuffs) was up by 26% yoy in August, supported by sound demand mainly from emerging markets. By contrast, the prices of non-foods and services demonstrated different dynamics. On the one hand, the price of non-foods advanced at the highest pace among other components (up by 4.9% yoy) on the back of rising industrial prices, which accelerated to 9.3% yoy. On the other hand, the growth of prices of

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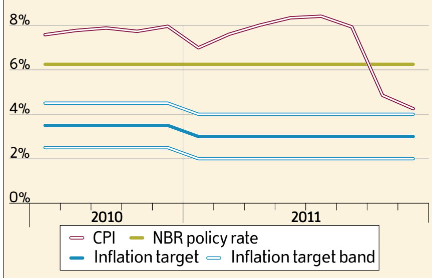
services slightly sped up to 3.5% yoy, while it remained the lowest among all components due to weak domestic demand and a stable exchange rate.

CPI, the Inflation Target, and the NBR Policy Rate



Source: NBR

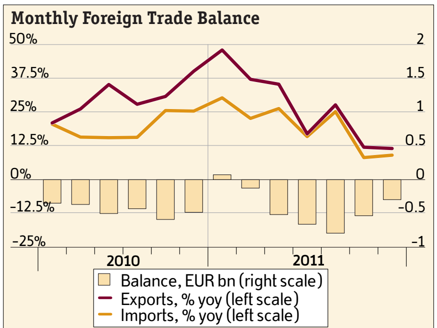
The negative output gap, favorable statistical base due to dissipation of the VAT rate effect and easing of the oil prices on the international markets are the main factors that should restrain the further growth of consumer prices in the coming months. Specifically, the CPI is forecasted to grow by 4.8% at the end of the year, which exceeded the upper bound of the inflation target band (4.0% yoy). The National Bank of Romania (NBR) continued to provide stable monetary policy to firmly anchor inflationary expectations. Specifically, the NBR kept its main policy rate unchanged at 6.25% per annum for seventeen consecutive months. At the same time, the National Bank of Romania assessed the stance of the financial system as robust according to the recent Financial Stability Report. According to the Report, the signing of the new precautionary Stand-By Agreement with the IMF, World Bank and EU should strengthen the position of the Romanian financial system. Meanwhile, the quality of credits remained the main risks for the banking system. Among other potential concerns that might materialize, the NBR pointed out the consequences of the sovereign debt turmoil in the European Union and slow-down of economic growth in the developed countries. Under such circumstances, the National Bank of Romania will continue to monitor the banking system, improve regulation, provide liquidity and require raising capital in a pro-active way. On a positive note, the gradual recovery of economic growth and stronger risk management by banks should start to reduce pressure on the quality of bank assets in the coming months.

In August, the growth of monetary aggregate measured as M2 decelerated to 4.0% yoy from a 4.6% yoy increase registered a month ago. The growth was supported by rising currency in circulation (up by 6.5% yoy) and deposits with maturity up to two years (up by 5.3% yoy). At the same time, the stock of non-government loans advanced at a slower pace, notably 3.9% yoy compared with 4.5% yoy expansion observed in the previous month. The deceleration reflected weaker growth of foreign denominated credits (up by 4.7% yoy), while loans issued in RON posted stronger growth than a month ago – up by 2.5% yoy.

International Trade and Capital

During the first seven months of the year, the merchandise trade balance in FOB-FOB terms slipped to a deficit. In fact, the trade deficit in goods shrank by 19% yoy and stood at EUR 2.9 billion or 2.2% of projected full year GDP. The improvement was driven by rising merchandise exports, while growing imports in goods expanded at a slower pace. Specifically, exports in goods grew by 26% yoy and reached EUR 25.8 billion despite the falling growth rate observed since May of 2011. Indeed, the cumulative growth of exports in January-July was primarily supported by strong dynamics during the first quarter (up by 40% yoy), while the growth of exports substantially slowed down in the second quarter (up by 19% yoy) and July alone (up by 11.5% yoy). At the same time, imports continued to closely follow export dynamics. In particular, merchandise imports posted 19% yoy to EUR 28.7 billion cumulative growth during January-July thanks to stronger performance in the first quarter – up by 26% yoy.

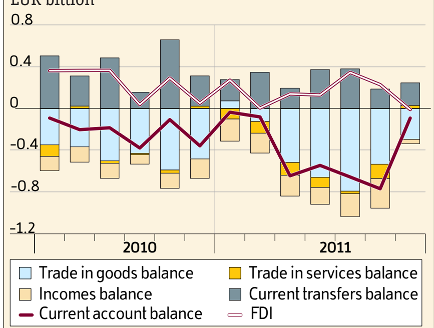
Monthly Foreign Trade Balance



Source: NBR

In January-July, the current account deficit continued to narrow. In fact, the current account deficit contracted by 24% to EUR 2.8 billion or 2.2% of projected full year GDP from 3.1% of projected full year GDP a year ago. A lower trade deficit in goods and services, and stronger surplus in current transfers were the factors that led to contraction in the current account deficit. While the surplus of current transfers grew by 23% yoy to EUR 1.9 billion thanks to higher transfers from the EU's budget, the trade deficit in services fell by 8.3% yoy to EUR 0.6 billion. On the contrary, the rising deficit in current incomes helped offset the overall contraction of the current account deficit. In particular, the deficit in current incomes expanded by 16% yoy to EUR 1.3 billion on the back of rising incomes from equity and debt earned by foreign investors. Meanwhile, the net inflows of FDI dropped by 30% yoy and reached EUR 1.1 billion, which was enough to cover 39% of the current account deficit.

Current Account Components and FDI
EUR billion



Source: NBR, INNSE

In July, the international reserves of the National Bank of Romania rose by 0.9% mom and stood at EUR 36.8 billion. The increase reflected the higher international price of gold, which led to greater value of gold stock. Accordingly, the rise in gold reserves offset

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the minor decline in the net inflows of the foreign currency as the outflows (EUR 1.2 billion) exceeded inflows (EUR 1.1 billion). At the same time, the Romanian currency remained stable at RON 4.22 per Euro at end-August 2011.

In July, the stock of medium and long-term external debt had grown by 4.2% since the beginning of the year (ytd) and stood at EUR 75.8 billion. The rise was primarily driven by rising public external debt (up by 11.7% ytd to EUR 30 billion) amid the issuing of Euro-denominated bonds. On the contrary, private external debt (including non-residents' deposits) marginally declined by 0.2% ytd and settled at EUR 45.9 billion. Given the rising short term debt (up by 10.2% ytd) totaling 20.3 billion, the total external debt increased by 5.4% ytd and reached 96.1 billion or 73% of projected full year GDP.

Other Developments Affecting the Investment Climate

Romania continued to cooperate with the international financial institutions. Specifically, on September 29th, the Board of Directors of the IMF completed the second review of the new 24-month Stand-By Arrangement Program, which was started in March. According to the review, the Fund endorsed the payout of EUR 0.5 billion, however Romanian authorities would not draw these resources since they treated the program as precautionary. The IMF pointed out that implementation of the Stand-By Arrangement Program remained crucial for the country, as it would help restore economic growth and market confidence. Among the major challenges for the country would be achievement of the fiscal deficit for next year, especially on the eve of 2012 local elections, better absorption of EU funds and enhancing efficiency of state-owned companies.

During September, the international mobile producer Nokia announced the closing of its Romanian factory from Jucu (Cluj county) with the loss of 2,200 jobs. The factory, opened in 2008 produced low-end mobile phones, mostly for export. According to the Ministry of Finance data, the Nokia's Romanian operation had a EUR1.6 billion turnover in 2010, so we estimate its share in 2010 FOB exports at approximately 4.3%.

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