Romania
Macroeconomic Situation

November 2011

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- **Real GDP increased by 4.4% yoy during the third quarter of 2011.**
- **The industrial production index grew by 5.5% yoy in September.**
- **In January-September, the consolidated budget deficit shrank by 44% yoy to EUR 3.2 billion, or 2.4% of projected full year GDP.**
- **CPI was up by 3.6% yoy in October.**
- **The National Bank of Romania lowered its policy rate by 25 b.p. to 6.00% per annum.**
- **In January-September, the merchandise trade deficit in FOB-FOB terms narrowed by 13% yoy to EUR 3.4 billion.**
- **The current account deficit contracted by 11% yoy in January-September and settled at EUR 3.8 billion, or 2.9% of projected full year GDP.**

Executive Summary

Growth of real GDP in Romania sped up to 4.4% yoy during the third quarter of the year, from a 1.4% yoy increase registered a quarter ago. The stronger pace of expansion was attributed to the fading of an unfavorable base effect caused by implementation of fiscal austerity measures. A good crop harvest also supported higher growth of the Romanian economy in July-September. On the supply side, industrial production advanced during the third quarter as the index of industrial production accelerated to 5.5% yoy from 4.0% in April-June. The construction sector positively contributed to stronger economic output by posting the first growth rate in quarter over quarter terms since January-March of 2009. As a result, the annual GDP growth rate is expected to reach 1.6% yoy in 2011, while next year Romania's economy could expand at a 2.0% yoy rate.

In January-October, the consolidated budget deficit shrank by 44% yoy to EUR 3.2 billion or 2.4% of projected full year GDP, compared with 4.6% of 2010 GDP during the same period last year. The improvement was explained by solid dynamics of government income, while state spending inched up at a significantly flatter rate. Indeed, state income rose by 8.6% yoy and settled at EUR 35.3 billion, while government expenditures increased by 0.9% yoy to EUR 38.4 billion. Given the current dynamics of state revenues and expenditures, the full year fiscal deficit is forecasted to reach 4.4% of projected full year GDP in 2011.

In October, the CPI inched up by 3.6% yoy, while its rate of growth remained within the inflation target band for the second month in a row. The moderate consumer inflation was explained by declining food prices on the back of strong crops and dissipation of the VAT rate effect. Meanwhile, the growth of non-food prices and services prices remained close to the average corresponding values registered during the last four months. The National Bank of Romania reduced its key policy rate by 0.25 p.p. to 6.00% per annum. This decision reflected the persistence of consumer price disinflation that was observed during the last six months. As a result, we expect that consumer prices should grow by 4.3% yoy at the end of the year, which is slightly higher than the upper bound of the inflationary target band (4.0%) set by the NBR.

During the first three quarters of the year, the current account deficit tightened by 11% yoy to EUR 3.8 billion or 2.9% of projected full year GDP. The contraction reflected a higher surplus in current transfers and a lower merchandise trade deficit. The latter narrowed by 13% yoy and reached EUR 3.8 billion due to the sound pace of expansion of merchandise exports. By contrast, the growth of the deficit in trade in services and current incomes partially helped to offset the contraction of the current account deficit. Meanwhile, net FDI inflows fell by 54% yoy to EUR 1.2 billion and funded 31% of the current account deficit.

IMF and European Commission teams prepared quarterly reviews of the Stand-By Arrangement program. According to their conclusion, the program remains on track, while a number of important steps still need to be taken. In particular, Romania should accelerate the privatization of state-owned companies in order to support future economic growth. Additionally, the Romanian government should restrain government expenditures next year and reduce the fiscal deficit to 3.0% of projected full year GDP under ESA standards (2.1% of GDP under the current cash methodology).

	2007	2008	2009	2010	2011[f]	2012[f]
GDP growth, % change yoy	6.3	7.3	-7.1	-1.3	1.6	2.0
Industrial production, % change yoy	5.4	0.9	-5.5	5.5	5.3	5.5
Consolidated budget balance, % of GDP	-2.4	-4.8	-7.2	-6.5	-4.4	-4.0
Unemployment (ILO), end of period	6.2	5.8	7.5	7.3	7.5	7.0
Inflation, end of period	6.56	6.30	4.75	8.0	4.3	3.8
Retail sales, % change yoy	17.8	13.0	-8.5	-2.0	-3.0	4.0
Gross forex reserves of the NBR, EUR billion, end of period	27.2	28.3	30.9	36	33.5	33.2
Current Account Balance, EUR billion	-16.68	-16.16	-4.9	-5.2	-5.5	-6.7
Total gross external debt, EUR billion	58.7	72.4	81.2	91.2	97.0	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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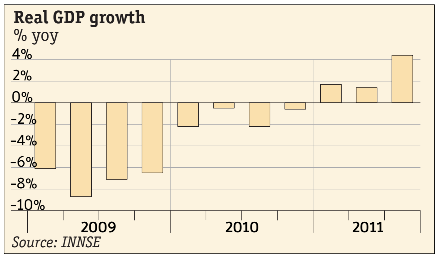
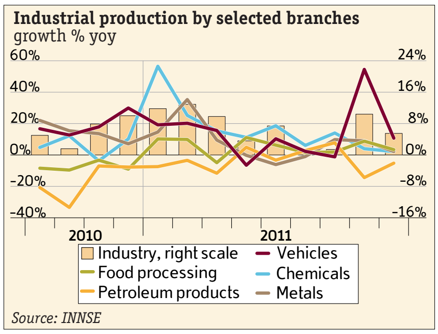
Economic Growth



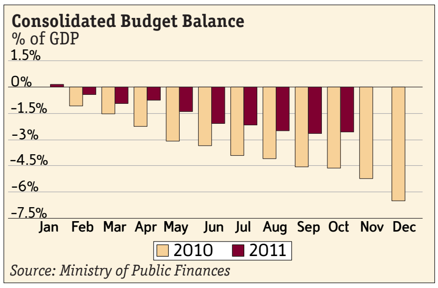


The Romanian economy continued its recovery for the third quarter in a row. Specifically, real GDP growth sped up to 4.4% yoy according to preliminary estimates of the National Institute of Statistics. In terms of seasonally adjusted growth, the 1.9% qoq GDP growth is the highest in the EU, while in yoy terms the adjusted GDP growth of 4.5% lags only behind the Baltic countries. Accordingly, the pace of GDP expansion in July-September significantly outpaced the moderate rates that were registered over the first (up by 1.7% yoy) and second quarter (up by 1.4% yoy), correspondingly. The improvement reflected dissipation of the fiscal austerity measures implemented in July 2010, especially the VAT rate effect. In fact, the increase in the VAT rate coupled with a reduction in social transfers and public wages significantly restrained disposable incomes. In addition, abundant crops positively contributed to stronger growth of the economy. Taking into account the strong dynamics of real GDP in January-September, we forecast the annual growth of Romanian economy at 1.6% yoy this year, which is close to the European Commission's official forecast (1.7% yoy). Growing exports should remain the key factor driving economic growth in the short term. However, global cooling of economic activity and the EU's sovereign debt crisis is likely to restrain Romanian exports in the coming quarters. As a result, the medium term prospects for Romania might be limited; therefore, we expect that real GDP is likely to increase by 2.0% yoy in 2012.

During the third quarter, industrial output accelerated its growth rate to 5.5% yoy from 4.0% yoy observed in April-June. The improvement was underpinned by stronger dynamics of export-oriented industries. In fact, the production of vehicles advanced to 18% yoy over the third quarter compared with a 2.2% yoy increase registered in April-June. Likewise, production of machinery grew by 15% yoy, while a 7.6% yoy increase was observed a quarter ago. In contrast, the growth of output of domestic oriented sectors was less buoyant than those that are export-oriented. In fact, food processing inched up by 4.7% yoy, down from a 6.3% yoy increase a quarter ago.

At the same time, domestic demand has started to recover gradually according to data from other real sectors. Indeed, the construction sector positively contributed to GDP growth in quarter over quarter terms for the first time since January-March of 2009. In particular, the index of construction works rose by 7.2% yoy from a 4.7% yoy decline in the previous quarter. The improvement reflected growth within all components, notably capital repairs (up by 22% yoy), current maintenance (up by 8.5% yoy) and new construction works (up by 3.8% yoy). The latter was primarily underpinned by stronger government capital investments into infrastructure projects. Meanwhile, the volume of retail sales continued to decline, although at slower pace. In particular, the index of retail sales fell by 2.8% yoy from a 5.8% yoy decline registered in the previous quarter amid lower purchases of foods (down by 5.1% yoy).

Fiscal Policy



During the first ten months of the year, the fiscal austerity measures continued to bear fruit. In fact, the consolidated budget deficit narrowed by 44% yoy and stood at EUR 3.2 billion or 2.4% of projected full year GDP, compared with 4.6% of 2010 GDP during the same period last year. The improvement was driven by a stronger pace of expansion of state revenues, while government expenditures inched up at a significantly flatter rate. Indeed, state incomes rose by 8.6% yoy and settled at EUR 35.3 billion, while government expenditures increased by 0.9% yoy to EUR 38.4 billion. Nevertheless, the dynamics of the state deficit should be less buoyant for the last few months since the favorable statistical base has dissipated since July. Accordingly, we expect that the full year consolidated budget deficit will reach 4.4% of projected full year GDP in 2011, which is in line with the IMF target.

In January-October, the growth of state revenues was underpinned by stronger collections from indirect taxes. Even though the favorable VAT rate effect dissipated in July, the cumulative growth of proceeds from the VAT grew by 21% yoy. In addition, higher receipts from excises (up by 13% yoy) also supported the overall growth of government incomes. At the same time, the proceeds from direct taxes also added up to growing state incomes. In particular, the collections from corporate profit tax were up by 1.8% yoy, while proceeds from wage and income tax – up by 4.4% yoy. At the same time, transfers from the EU budget surged by 46% yoy, while social security and health care contributions were up by 9.2% yoy. On the expenditure side, the moderate growth of government expenditures was driven by capital investments directed to public infrastructure (up by 14% yoy). The latter should positively contribute to stronger

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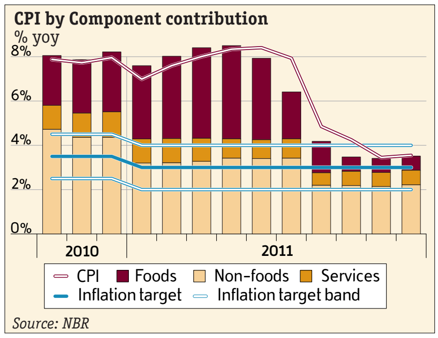
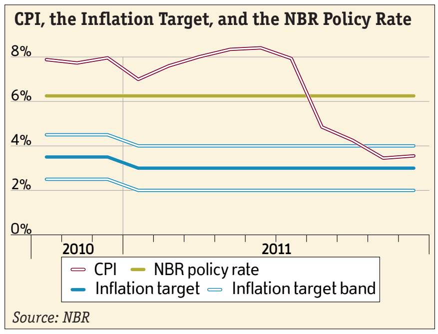
economic growth in the medium term. At the same time, the higher spending on goods and services (up by 4.4% yoy) also fueled government expenditures. On a negative note, the servicing of public and publicly guaranteed debt advanced at a 24% yoy pace. However, lower social transfers payments (down by 1.1% yoy) and spending on the state wage bill (down by 13% yoy) helped to offset the overall growth of total government spending. In fact, these two categories continued to decline (though at a slower pace) given the dissipation of the favorable base effect since July.

Monetary Policy

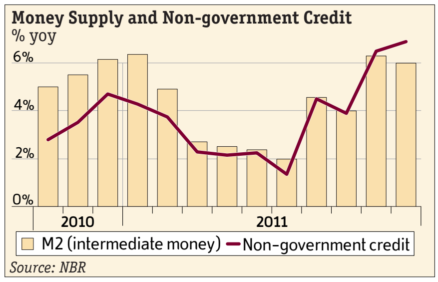
In October, the growth of consumer prices slightly accelerated but continued to remain within the inflation target band for the second month in a row. In particular, the rise in CPI marginally sped up to 3.6% yoy from 3.5% yoy in the previous month. The acceleration primarily reflected rising non-food prices and growing prices of services, while the growth of food prices remained flat and at the lowest level among all components within the consumer basket. In fact, abundant crops and fading of the VAT effect explained the major drop in food prices as they inched up by 1.7% yoy in September-October, compared to the double digit expansion in April-May (up by 11% yoy). Moreover, the prices of foods on the international markets also started to exert disinflationary pressure on domestic food prices. Specifically, the FAO index, which measures changes in foods prices of essential foodstuffs, dropped by 4% from the previous month and rose by 5.4% in year over year terms from a 20% yoy increase in September.



CPI by Component contribution
Source: NBR



CPI, the Inflation Target, and the NBR Policy Rate
Source: NBR



Money Supply and Non-government Credit
Source: NBR

Taking into account the slow-down of the global economy, demand for foods on the international market should be also subdued in the coming months. Accordingly, this pressure should lead to lower global food prices and therefore should also help to contain the growth of Romanian consumer prices. At the same time, the prices of non-foods were up by 5% yoy, while their pace of growth remained stable after dissipation of the VAT rate effect (in July). As a result, the growth of this component of the consumer basket oscillated at about 4.9% yoy during the last four months. Finally, prices of services slightly inched up by 3.6% yoy from 3.5% yoy observed a month ago.

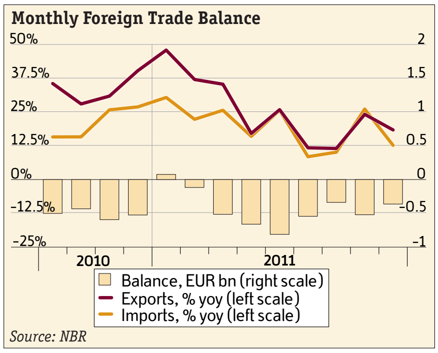
The consumer price index is projected to reach 4.3% yoy at the end of the year, which is slightly above the upper band of the inflationary target (4.0%) set by the National Bank of Romania (NBR). We have downgraded the inflationary outlook given the presence of the negative output gap and the significant slow down in volatile foods price growth thanks to an abundant harvest (especially of fruits and vegetables). In addition, the fading of the VAT rate effect should help to restrain further growth of consumer prices in the coming months.

At the same time, the NBR issued the recent Inflation Report, where it assessed the stance of monetary policy and behavior of consumer prices. Specifically, then National Bank of Romania estimated end-of period consumer inflation at 3.3% yoy, which is 1.3 p.p. lower than in the previous quarter's Inflation Report. The NBR discussed the main external risks that could hamper the disinflation pace of consumer prices. Among these risks are worries about Greece and the Eurozone sovereign debt crisis, which might increase investors' risk aversion and could lead to depreciation pressure on the Romanian currency. In addition, upcoming local elections in 2012 could prevent the implementation of fiscal austerity measures next year, which could lead to exceeding fiscal deficit targets. This might imply higher interests rates for borrowing and again possible depreciation pressure on the leu. Given the above developments in consumer prices, particularly the slowdown in CPI growth, the National Bank of Romania lowered its key policy rate by 0.25 p.p. to 6.0% per annum. Nevertheless, the minimum reserve requirement ratios were left unchanged on both leu and foreign currency-denominated liabilities.

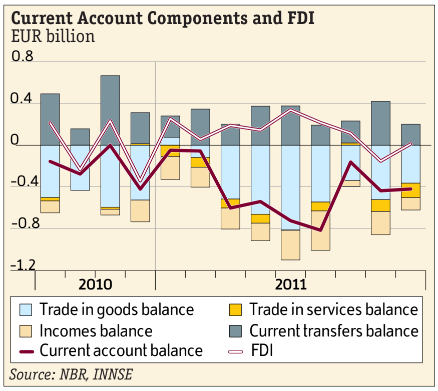
In October, the growth of monetary aggregate measured as M2 slightly slowed down by 0.3 p.p. and reached 6.0% yoy. The deceleration was driven by a slower pace of growth of deposits with maturity up to two years (up by 5.2% yoy). In contrast, the narrow money aggregate M1 expanded at a steeper rate, notably 7.2% yoy. At the same time, the growth of non-government credits accelerated to 6.9% yoy from a 6.5% yoy increase observed in the previous month.

International Trade and Capital

During the first three quarters of the year, the merchandise trade balance slipped to a deficit in FOB-FOB terms. In fact, the trade in goods deficit contracted by 13% yoy and settled at EUR 3.8 billion. The narrowing of the merchandise trade gap was underpinned by solid expansion of exports of goods, while imports of goods advanced at a flatter rate. In fact, exports of goods grew by 24% yoy and reached EUR 33.5 billion, primarily due to strong dynamics observed over the first quarter (up by 40% yoy). Moreover, the growth rate of exports has gradually decelerated since the beginning of the year to the third quarter when it stood at 18% yoy. At the same time, imports in goods closely followed exports dynamics, given the significant share of goods used for further re-export. Indeed, merchandise imports expanded at a sound 26% yoy in January-March, while they increased by 16% yoy over the third quarter. As a result, cumulative imports in goods rose by 19% yoy in January-September and settled at EUR 37.2 billion.



In January-September, the current account deficit narrowed by 11% yoy and stood at EUR 3.8 billion or 2.9% of projected full year GDP. Meanwhile, the current account deficit during the same period last year was registered at 3.5% of 2010 GDP. The improvement was driven by a higher surplus in current transfers and a lower merchandise trade deficit. In particular, the current transfers surplus inched up by 8.6% yoy to EUR 2.5 billion thanks to stronger EU transfers. On the contrary, a rising deficit in trade in services and current incomes partially offset the overall contraction of the current account deficit. In fact, the current incomes deficit grew by 11% yoy to EUR 1.8 billion amid growing incomes from equity and debt earned by foreign investors. At the same time, the trade in services deficit expanded by 26% yoy and reached EUR 0.7 billion. Concurrently, net inflows of FDI continued to deteriorate since they fell by 54% yoy to EUR 1.2 billion. As a result, net FDI inflows covered only 31% of the current account deficit compared with 61% during the same period last year.



In October, the international reserves of the National Bank of Romania dropped by 3.6% mom and stood at EUR 36.3 billion. The decline was explained by higher outflows of foreign currency than inflows. Indeed, the outflows of foreign currency reached EUR 1.8 billion during the month on the back of the servicing of public and publicly guaranteed external debt. At the same time, the inflows of foreign currency in the amount of EUR 0.4 billion was significantly lower than the average monthly level. In addition, the depreciation of the US dollar against the Euro during the month also lessened the value of the international reserves. The Romanian currency (leu) marginally appreciated by 0.7% mom to EUR 4.32 per Euro 1.

In September, medium and long-term external debt grew by 3.4% since the beginning of the year (ytd) and settled at EUR 75.3 billion. The increase was primarily driven by rising public external debt, up by 13% ytd to EUR 30.2 billion, amid the issuance of EUR 1.5 billion Euro-dominated bonds in July. By contrast, private external debt contracted by 1.9% ytd and reached EUR 45.1 billion. Given the growth of short-term external debt (up by 23% ytd), total external debt inched up by 7.4% ytd and settled at EUR 97.9 billion or 76% of projected full year GDP.

Other Developments Affecting the Investment Climate

Romania continued to collaborate with international financial institutions. Specifically, IMF and European Commission teams prepared a quarterly review of the Stand-By Arrangement program. According to the review, the Romanian government satisfied all criteria set by the IMF as of the end of September to solidify economic recovery, enhance the country's credibility and sped up implementation of structural reforms. The IMF team pointed out the importance of further fiscal retrenchment to reduce the consolidated budget deficit to 3.0% of projected full year GDP in 2012 under the ESA methodology (accrual). Under the current cash methodology, the 2012 deficit, including the National Development and Infrastructure Program should stand at 2.1% of the GDP. At the same time, the teams assessed the Romanian banking sector as resilient despite the presence of global financial tensions stemming from the Eurozone crisis. Furthermore, the IMF advised Romania to accelerate the modernization of state owned enterprises to increase their efficiency. In particular, the Romanian government should sell assets of these companies and introduce professional management to boost their productivity, and therefore promote stronger GDP growth rather than restrain it.

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