SigmaBleyzer

Romania

Macroeconomic Situation

THE BLEYZER FOUNDATION

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- **During the second quarter of 2010, the Romanian economy contracted by only 0.5% yoy.**
- **In January-July 2010, budget revenues grew by 1.2% yoy to EUR 21.9 billion.**
- **In the same period, the current account deficit was 38% yoy higher than a year ago.**
- **The IMF and EU disbursed the 6th (EUR 0.9 billion) and 3rd (EUR 1.2 billion) tranches of their respective programs.**

Executive Summary

In the second quarter of 2010, the contraction of the Romanian economy eased. Indeed, GDP declined by only 0.5% yoy compared to an average contraction rate of 6.2% yoy during the previous five quarters. On the demand side, final consumption fell by 0.7% yoy, its smallest decrease since the fourth quarter of 2008. Meanwhile, gross fixed capital formation declined by 9.5% yoy. Weak domestic demand, high unemployment and tighter fiscal policy will continue to depress economic activity. As a result, the economy is anticipated to shrink this year by 2.5%.

During the first seventh months of 2010, budget revenues posted their first annual gain of 1.2% yoy, increasing to EUR 21.9 billion. In particular, stronger proceeds from excises as well as higher non-taxes revenues were the main drivers of this improvement. A higher VAT rate boosted revenues from this tax by 17.2% yoy in July. On the expenditure side, the growth in total spending was mostly led by increasing social transfers (by 11.2% yoy). On the other hand, the budget reduction policies helped cut administrative and wage bill expenses by 4.7% in January-July.

In July, the current account was virtually balanced at EUR 0.03 billion, compared to a deficit of EUR 300 million a year ago. As a result, during the first seven months of 2010, the current account deficit was 38% yoy higher than a year ago, reaching EUR 3.8 billion. Meanwhile, FDI inflows (which declined by 40% yoy to EUR 1.8 billion) covered half of the current account gap.

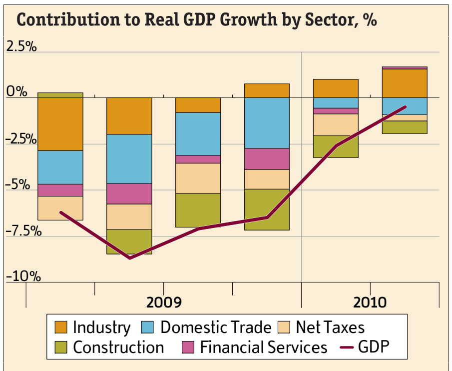
The implementation of the summer fiscal consolidation measures allowed Romania to receive two loans under the EUR 20 billion international assistance program - from the IMF and EU. On September 24th, the IMF Executive Board approved the 6th tranche in the amount of EUR 0.9 billion. Two days before, the European Union disbursed its 3rd loan (EUR 1.2 billion) under the Balance of Payments assistance program. These funds will help to mitigate the contractionary impact of tighter fiscal policy and will finance structural reforms aimed at cutting the budget deficit to less than 3% of GDP in 2012.

	2005	2006	2007	2008	2009	2010f
GDP growth, % change yoy	4.2	7.9	6.3	7.1	-7.2	-2.5
Industrial production, % change yoy	2.0	7.1	5.4	0.9	-5.5	3.0
Consolidated budget deficit, % of GDP	-0.8	-1.7	-2.4	-4.8	-7.2	-7.0
Unemployment, end of period		5.2	4.1	4.4	7.8	8.5
Inflation, end of period	8.72	4.87	6.56	6.30	4.75	7.8
Retail sales, % change yoy	17.5	13.5	17.8	13.0	-8.5	1.8
Gross forex reserves of the NBR, EUR billion, end of period	18.3	22.9	25.3	28.3	30.9	34.8
Current Account Balance, EUR billion	-6.89	-9.97	-16.68	-16.16	-5.05	-6.5
Total gross external debt, EUR billion	30.9	41.2	58.6	72.4	78.7	86
Exchange rate, RON/EUR, annual average	3.62	3.52	3.34	3.68	4.24	4.4

Source: INNSE, NBR, The Bleyzer Foundation

Economic Growth

In the second quarter of 2010, the pace of economic contraction visibly eased. GDP fell by only 0.5% yoy compared to a 6.2% yoy average during the previous five quarters. On the demand side, final consumption shrank by 0.7% yoy - its smallest decline since the fourth quarter of 2008. At the same time, gross fixed capital formation decreased by 9.5% yoy. All of this points to a gradual and slow economic recovery. Indeed, subdued domestic demand, high unemployment and weak bank lending as well as fiscal consolidation are likely to hinder economic growth in the coming quarters.



Source: INNSE, The Bleyzer Foundation

On the supply side, industry remained the main driver of improving economic conditions. In particular, industrial output grew by 5.9% yoy - the fastest rate since the third quarter of 2008. The financial sector recorded a modest gain of 0.8% yoy for the first time since the last quarter of 2008. At the same time, the pace of decline slowed in the construction industry to 8.3% yoy from 17.3% yoy the quarter before. Stronger overall economic activity helped narrow the rate of decline of net taxes to only 2.7% yoy versus 10.7% yoy in the first quarter of 2010.

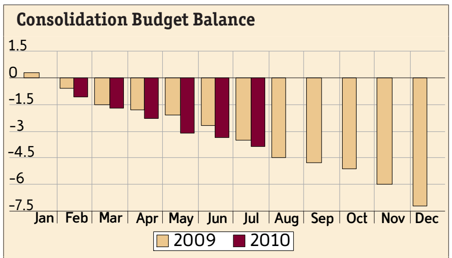
Industry continues to be the solid driver for economic recovery. Despite slower growth (3.4% yoy in July as compared to 6.8% yoy in June), industrial production rose by 5.3% yoy in January-July 2010. The growth of industrial production was achieved thanks to electric machinery, wood products, vehicles, and utilities by 37.8% yoy, 8.3% yoy, 8.7% yoy, and 3.5% yoy respectively. At the same time, manufacturing of foods declined by 8.2% yoy, reflecting weak domestic demand.

Retail sales dropped after a hike in the VAT rate by 5p.p. to 24% in July 2010. In fact, the decline in July was 8.9% yoy compared to 4.6% yoy growth a month before. As a result, sales of food and non-food products plunged by 12% yoy and 11.8% yoy respectively. Retail sales will likely decline further due to a tight budget (after reductions of state wages and transfers by 25% and 20%) and additional austerity measures announced by the government.

Given the current developments, real GDP is forecast to decline by 2.5% yoy in 2010. However, the Romanian economy is likely to perform better next year with GDP recovering by about 2% yoy.

Fiscal Policy

In January-July, the rate of consolidated budget deficit widening eased. The deficit expanded by only 14% yoy to 3.9% of forecasted GDP, as compared to 25.6% yoy growth in the first half of the year.



Source: Ministry of Public Finances

During the first seven months of the year, cumulative total revenues in nominal terms grew for the first time in 2010, increasing by 1.2% yoy to EUR 21.9 billion. Higher proceeds from excises (up by 7.7% yoy) and stronger non-taxes revenues (up by 22.6% yoy) were the main drivers of this improvement. At the same time, VAT revenues slightly declined by 0.8% yoy as compared to the 4% yoy drop in the first half of 2010, reflecting the hike in the VAT rate (by 5 p.p. to 24%) implemented on July 1st. In fact, VAT collections rose by 17.2% yoy in July. On the other hand, contributions and wage and income tax decreased by 5.3% yoy and 5.4% yoy respectively as a consequence of the government consolidation programs - state wages and transfers were cut by 25% and 20% respectively.

In January-July, total expenditures grew at the smallest rate since March 2010, increasing by 3.2% yoy to EUR 26.7 billion as compared to 4% yoy growth in the first half of this year. The growth in total spending was driven by higher social transfers (by 11.2% yoy), which accounted for 35.9% of the total budget spending. Due to public sector wage reduction, the government managed to reduce its wage bill by 4.7% in January-July.

To reduce the budget deficit and create conditions for sustainable economic growth, the Romanian authorities are going to enforce additional fiscal consolidation programs with a focus on optimizing budget spending. Otherwise, all borrowed money will be directed to consumption with no resources for investment, which are vital to sustain economic growth. In particular, the IMF recommends cutting the state salary expenditures in the next year to the 2005 level of 7.4% of GDP. This is an important step for fiscal consolidation, since during the last 5 years the wage bill in the public sector as a percentage of GDP increased from 7.4% in 2005 to 9.2% in 2009. However, tighter fiscal policy still has to gain broader public approval. Otherwise, heightened social tension and political instability may jeopardize the implementation of urgent structural and budget reforms.

In July, the gross public debt rose by 21% since the beginning of the year and settled at EUR 42 billion or about 35% of GDP. This increase was mainly due to the IMF, World Bank and EU assistance program. The expectation is that the debt-to-GDP ratio might reach 37% of GDP at the end of the year.

Monetary Policy

Headline inflation (7.6% yoy in August) continues to exceed the upper limit of the inflation target. This is mostly due to the VAT rate hike that was implemented in July. Indeed, prices on foods, non-foods and services grew by 4% yoy, 11% yoy and 6% yoy respectively. However, the one-off and non-monetary nature of this VAT rate hike will likely dissipate in the coming months, prompting the CPI to move back to the inflation target band in 2011. In addition, ongoing fiscal tightening and weak domestic demand will continue to restrain inflationary pressure, pushing inflation lower in the last quarter of this year.

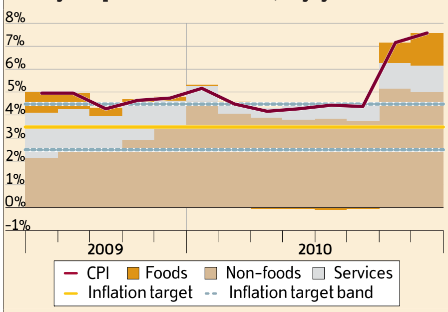
In August, the National Bank of Romania (NBR) kept the key policy rate unchanged at 6.25% per annum. Indeed, the NBR expects that the current increase in prices will be temporary and, therefore, medium-term inflation targets will be met without tight monetary policy. At the same time, bank lending grew for the fourth straight month, mostly thanks to increasing non-government credit (by 4.5% yoy).

International Trade and Capital

In July, the trade in goods deficit widened by 10% yoy to EUR 0.3 billion. Exports of goods grew by 19% yoy to EUR 3.4 billion, with July being the ninth consecutive month of the recovery of exports. As a result, in January-July, exports of goods rose by 25% yoy and totaled EUR 20.6 billion. In particular, exports grew on the back of higher overseas shipments of transport equipment and vehicles (up by 28% yoy), chemicals (up by 57% yoy), manufacturing goods and raw materials (up by 21% yoy).

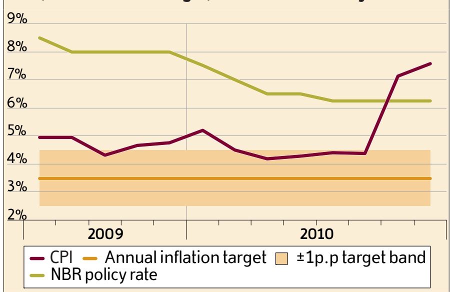
At the same time, imports of goods have been growing every month in 2010. Indeed, in July the imports of goods jumped by 18% yoy to EUR 3.6 billion, bringing cumulative imports (in January-July) to EUR 23.9 billion (up by 19% yoy). Higher imports were mostly driven by the purchase of foreign transport equipment and vehicles, minerals and manufacturing goods and raw materials (by 31% yoy, 37% yoy and 17.6% yoy respectively). However, given the increase in prices (following the VAT rate hike), tight household and government budgets, and the additional austerity measures, the trade in goods deficit is likely to level out (or even slightly shrink) by the end of 2010.

CPI by components contribution, % yoy



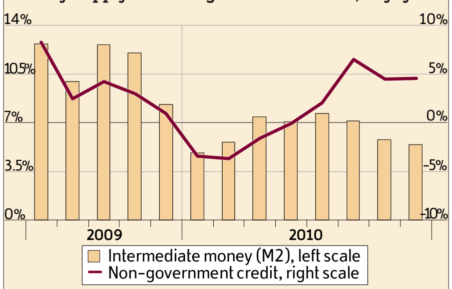
Source: NBR

CPI, the Inflation Target, and the NBR Policy Rate



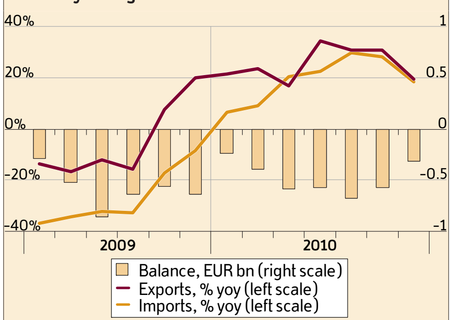
Source: NBR

Money Supply and Non-government Credit, % yoy



Source: NBR

Monthly Foreign Trade Balance

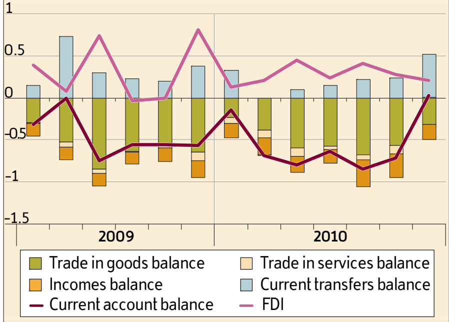


Source: NBR

In July, the current account was balanced at EUR 0.03 billion, while a year ago the current account deficit stood at EUR 0.3 billion. As a result, in January-July the current account deficit reached EUR 3.8 billion or up by 38% yoy (in the first half of 2010, the current account deficit widened by nearly 60% yoy). The widening of the current account gap was prompted by cuts in current transfers by 32% yoy to EUR 1.5 billion. Despite the decline of FDI inflows by 40% yoy to EUR 1.8 billion, they still funded half of the current account gap.

Given the implementation of the summer consolidation measures, Romania received two loans under the EUR 20 billion international assistance program. In particular, on September 22nd, the EU disbursed EUR the 1.2 billion 3rd tranche under the Balance of Payments assistance program. Two days later, the IMF Executive Board approved a 6th loan (EUR 0.9 billion), bringing the total disbursements to EUR 11.3 billion under the Stand-By Arrangement (SBA) program. These loans will help mitigate the contractionary impact of tighter fiscal policies. In addition, they will provide funds to support structural reforms aimed at cutting the budget deficit to less than 3% of GDP. Under this assistance program, the Romanian economy is increasingly likely to return to modest growth in 2011.

Current account components
monthly flows EUR billion



Source: NBR, INNSE

During the month, forex inflows and forex outflows remained virtually balanced. However, the NBR's international reserves slightly grew on higher gold prices and stood at EUR 34.8 billion. Lastly, the Romanian currency (leu) remained relatively stable.