Romania
Macroeconomic Situation

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- **Real GDP grew by 1.6% yoy over the first quarter of 2011, supported by an ambitious 11.4% yoy surge in industrial production.**
- **In January-March, the consolidated budget deficit narrowed by 38% yoy to EUR 1.2 billion or 1% of full year projected GDP.**
- **CPI grew by 8% yoy in March.**
- **In January-February, the international merchandise trade deficit was almost balanced, showing a negligible deficit of EUR 5 million.**
- **The current account deficit narrowed by 94% yoy in January-February and settled as low as EUR 40 million.**
- **On May 9th, a joint mission from the IMF, European commission and World Bank reached a staff level agreement about disbursement of the second tranche (EUR 0.5 billion).**

Executive Summary

The Romanian economy started to show serious signs of recovery during the first quarter of 2011. Indeed, real GDP increased by 1.6% yoy for the first time since the fourth quarter of 2008, according to the National Institute of Statistics' preliminary press release. Industrial production continued to remain the driving factor for economic activity thanks to its solid performance. In particular, the industrial production index was up by 11.4% yoy in January-March. Despite the strong industrial output, domestic demand remained subdued since the construction and domestic trade sectors continued to decline.

In January-March, the consolidated budget deficit contracted by 38% yoy and reached EUR 1.2 billion or 1% of full year projected GDP. The consolidation of the state budget deficit was driven by growing government revenues (up by 10.2% yoy) totaling EUR 9.8 billion. Stronger state revenues reflected higher receipts from VAT and excises, while collections from direct taxes, namely income and corporate profit taxes, continued on a downward trend. Concurrently, state expenditures inched up by 1.3% yoy and settled at EUR 11.1 billion amid a rise in spending on capital investments and servicing of public debt.

In March, the growth of consumer prices accelerated to 8% yoy on the back of growing food prices. Meanwhile, increasing international oil prices supported growth of consumer prices, while weak domestic demand and RON appreciation acted in the opposite direction. The National Bank of Romania (NBR) continued to provide prudent and stable monetary policy, aiming to anchor inflationary expectations and restore the disinflationary pace of consumer prices. For this purpose, the NBR kept its key policy rate unchanged at 6.25% per annum. In addition, the NBR cut the minimum reserve requirement ratio on liabilities denominated in foreign currency by 5 p.p. to 20%.

In January-February, the merchandise trade deficit in FOB-FOB terms significantly shrank to EUR 0.005 billion from EUR 0.7 billion a year ago. The contraction reflected sound performance of exports in goods, which grew by 42% yoy to EUR 6.92 billion. Similarly, imports in goods advanced but with a flatter growth rate (25% yoy) and settled at EUR 6.92 billion. Strong exports were the key factor for the contraction of current account deficit (down by 94% yoy to EUR 0.04 billion). The deficit was fully funded by net FDI inflows, which reached EUR 0.3 billion.

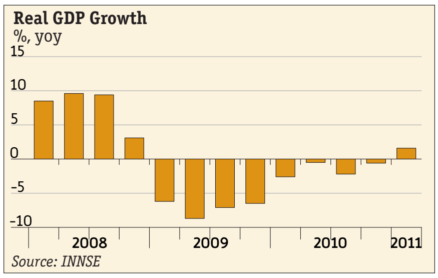
On May 9th, a mission from the IMF, World Bank and European Commission reached a staff level agreement with government about a second loan totaling EUR 0.5 billion. The tranche will be disbursed pending approval by the Executive Board.

	2006	2007	2008	2009	2010	2011f
GDP growth, % change yoy	7.9	6.3	7.1	-7.2	-1.3	1.6
Industrial production, % change yoy	7.1	5.4	0.9	-5.5	5.5	5.0
Consolidated budget balance, % of GDP	-1.7	-2.4	-4.8	-7.2	-6.5	-5.0
Unemployment, end of period	5.2	4.1	4.4	7.8	6.9	7.2
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	-5.3	3.0
Gross forex reserves of the NBR, EUR billion, end of period	22.9	25.3	28.3	30.9	36	33.5
Current Account Balance, EUR billion	-9.97	-16.68	-16.16	-5.05	-5.2	-6.8
Total gross external debt, EUR billion	41.2	58.6	72.4	78.7	90.8	92.0
Exchange rate, RON/EUR, annual average	3.52	3.34	3.68	4.24	4.2	4.4

Source: INNSE, The Bleyzer Foundation

Economic Growth

The Romanian economy demonstrated the first signs of recovery at the beginning of the year. Indeed, real GDP grew by 1.6% yoy over the first quarter according to the National Institute of Statistics' preliminary press release. This was the first registered positive increase in GDP after eight quarters of contraction. The initial rebound in GDP growth could be supported in the coming months by brisk exports dynamics and expected revival of domestic consumption. Specifically, the recovery of domestic demand is anticipated in the second half of the year when the effect of fiscal consolidation implemented in July 2010 should dissipate. Meanwhile, prospects for Romania's exports should be primarily supported by the EU's economic growth given the deep trade relationships with other EU members. Under these conditions, real GDP growth is forecast to reach around 1.6% yoy in annual terms in 2011.

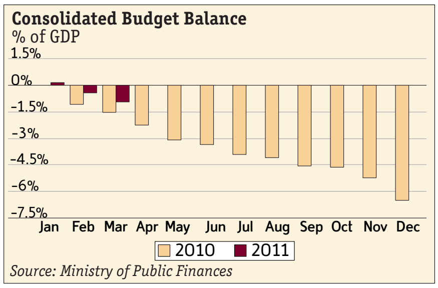


Industrial production is still the driving factor supporting GDP development and continued to outperform other sectors. The industrial production index inched up by 9.8% yoy in March after posting double-digit growth rates over the first two months of the year – up by 11.8% yoy in January and by 12.9% yoy in February, respectively. Given such impressive monthly dynamics, cumulative growth over the first quarter was registered at 11.4% yoy. The stronger industrial output was primarily underpinned by sound performance of export-oriented industries. In particular, buoyant foreign demand supported stronger production of vehicles (up by 18.1% yoy), machinery (up by 21.3% yoy), chemicals (up by 29.6% yoy), and basic metals (up by 18.9% yoy). In contrast to the previous year, domestic oriented industries also supported overall expansion of industrial output, although at a slower pace. In particular, the manufacture of wood products advanced to 14.4% yoy, while food processing posted 4.1% yoy-growth.

During the first quarter, domestic demand remained constrained in spite of the brisk performance of industrial production. Indeed, construction and domestic trade still experienced a decline and therefore continued to hinder economic growth. Specifically, the index of construction works fell by 4.4% yoy due to a decline in indexes of new construction works (down by 6.1% yoy) and current repair works (down by 11.4% yoy), respectively. At the same time, the index of retail sales fell by 5.5% yoy, although at a lower growth rate. The revival of the domestic trade sector could occur in the second half of the year, when effect of fiscal austerity measures restraining disposable incomes will fade.

Fiscal Policy

Romanian public finance continued to be adjusted after implementation of fiscal retrenchment. Indeed, the consolidated budget deficit shrank by 38% yoy during the first quarter of the year and settled at EUR 1.2 billion, which corresponds to 1% of full year projected GDP. The contraction of the budget deficit was achieved thanks to rising government incomes, which outpaced state expenditures – up by 10.2% yoy (to EUR 9.8 billion) and by 1.3% yoy (to EUR 11.1 billion), respectively. Given the current dynamics of state incomes and spending, the consolidated budget deficit is expected to reach 5.0% of the full year projected GDP at the end of 2011.

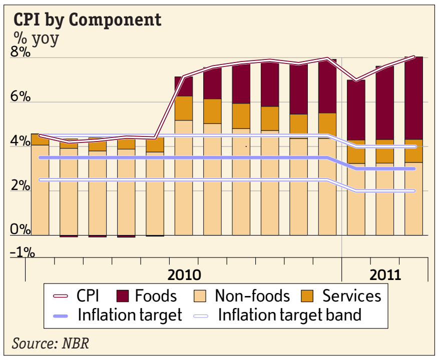


In January-March, the sound performance of state revenues reflected strong proceeds from indirect taxes, while collections from direct taxes continued to fall. Specifically, receipts from VAT and excises advanced to 36% yoy and 20.4% yoy and contributed more than half of overall state revenues. These buoyant dynamics were explained by a hike in the VAT rate by 5 p.p. implemented last summer; this effect should fade in the second half of the year. Additionally, the Romanian government implemented several measures to improve absorption of EU funds, which should explain the latter's two-fold growth (to EUR 0.3 billion). By contrast, the main group of direct taxes – income and corporate profit taxes – continued to decline by 13.3% yoy and 4.5% yoy, respectively, amid constrained incomes.

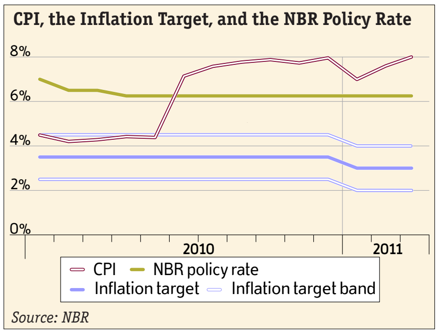
During the first quarter, state spending restored its growth for the first time this year, though at mild rate. On a positive note, the increase was supported by higher capital investments (up by 11.9% yoy), which should support future economic growth. On the negative side, the servicing of public debt inched up by 34.8% yoy. Meanwhile, the rise in purchasing of goods and services (up by 18% yoy) also contributed to overall growth of state spending. In addition, the Romanian government substantially increased funding of projects – up by 272% yoy to EUR 0.5 billion. Concurrently, the decline in social transfers payments (down by 2.8% yoy) and a lower state wage bill (down by 20.6% yoy) partially offset the overall expansion of state expenditures. However, these favorable dynamics should be reversed in the second half of the year when the base effect will disappear.

By March 31st, the stock of public debt had increased by 7.3% since the beginning of the year (ytd) to EUR 48.4 billion or 36.7% of full year projected GDP compared with EUR 45.1 billion in 2010. The increase in public debt was driven by higher government public debt – up by 7.1% ytd to 45.6 EUR billion. Meanwhile, local debt grew by 3.5% ytd and stood at EUR 2.8 billion. Taking into account the current cooperation with international financial institutions, especially the recent start of a new Stand-By Arrangement program with IMF, the public debt to full-year projected GDP ratio could reach 36% at the end of 2011.

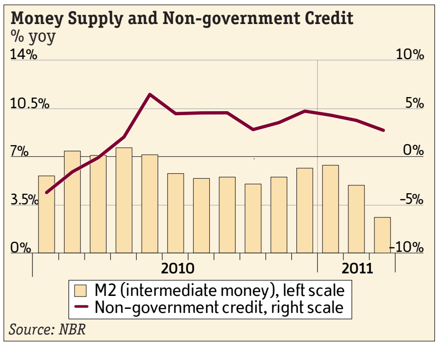
Monetary Policy



Source: NBR



Source: NBR



Source: NBR

In March, consumer prices continued on an upward pace. In fact, the CPI rose by 8% yoy from 7.6% yoy and 7% yoy in February and January, correspondingly. The increase in consumer prices was mainly fueled by rising food prices coming from international markets. Due to the aforementioned shock, the contribution of food prices to overall CPI growth became more pronounced. Indeed, growing food prices made up 46% of overall CPI expansion in March, while they made up 39% of overall growth in January. Meanwhile, the contributions of prices of non-foods and services remained virtually unchanged during the first quarter of 2011. As a result, the rise in CPI by 1 p.p. in January-March was by 99% explained by higher food prices.

At the same time, the evolution of non-food and services prices was uneven. On the one hand, weak domestic demand (as a consequence of negative output gap) and appreciation of RON (against EUR and dollar) exerted downward pressure on both components of consumer prices. On the other hand, political unrest in the Middle East and North Africa supported growth of oil prices and therefore had an opposite effect on non-food prices. In addition, the potential adjustment in dynamics of administered prices might become an additional domestic risk, which should lead to an increase in consumer prices. Under such circumstances the consumer prices could fall in the second half of the year since the VAT effect will fade. Thus, the growth of CPI is expected to reach 4.5% yoy at the end of the year, which is higher than the upper inflation target band (4.0%) set by the National Bank of Romania (NBR).

To firmly anchor inflationary expectations amid presence of several external risks, which stem from vulnerable commodity markets, and revive disinflationary dynamics of consumer prices, the NBR continued to ensure stable monetary policy. Specifically, the National Bank of Romania maintained its key policy rate unchanged at 6.25% per annum. Meanwhile, the NBR reduced the minimum reserve requirement ratio on liabilities denominated in foreign currency by 5 p.p. to 20% starting on April 24th. This decision was made in order to provide convergence of Romanian banks to European Central Bank standards according to the Inflationary Quarterly Report released for May. Additionally, this NBR decision should encourage forex-denominated credits in the short and medium terms.

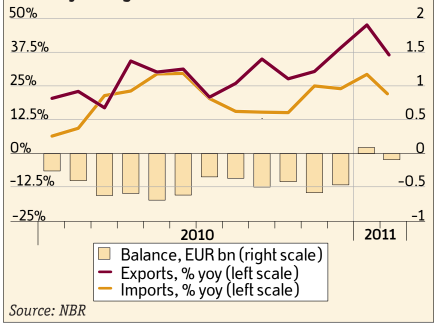
In March, the growth of money supply measured as intermediary money (M2) continued to slow down. In fact, M2 inched up by 2.7% yoy compared with 4.9% yoy-growth a month ago. The rise in EUR-nominated loans (up by 7.0% yoy) supported the growth of money supply, while domestic issued loans fell by 2.9% yoy. As a result, the growth rate of non-government loans was registered at 2.3% yoy.

International Trade and Capital

During the first two months of the year, the merchandise trade in FOB-FOB terms remained almost balanced. Indeed, the deficit in trade in goods was registered at EUR 0.005 billion compared with EUR 0.7 billion a year ago. The improvement was achieved on the back of strong merchandise export dynamics. Specifically, exports in goods surged by 42% yoy in January-February and settled at EUR 6.92 billion, which was significantly higher than the rise in exports over the fourth quarter of 2010, notably 33% yoy. This buoyant export behavior was driven by strong external demand, specifically from the Euro zone. At the same time, the imports in goods advanced at a flatter rate (up by 25% yoy) and reached EUR 6.92 billion. Despite the impressive increase in exports at the beginning of the year, merchandise trade might slip to a deficit in the following months. Indeed, the deficit in merchandise trade was registered at EUR 0.5 billion during the first quarter of 2011 according to the provisional data provided by the NBR.

In January-February, stronger merchandise exports were fueled by growing foreign demand for Romanian transport equipment and vehicles (up by 39.6% yoy), and industrial raw materials and manufactured goods (up by 33% yoy). As a result, these commodity groups made up about 62% of the overall expansion in merchandise exports. On the other side, the sound development of merchandise exports were shaped by strong exports inside the EU (up by 37% yoy) amid brisk performance of the main trading partners, especially Germany. Since Romania shipped about 73% of overall exports to the EU, further prospects for the country's exports will be tightly connected with Euro area performance. Given a number of potential risks, the dynamics of EU's growth may be adjusted in the coming months. Specifically, the current worry about Greek debt and its potential restructuring remains one of the major risks that could affect economic growth of the entire Euro zone. Meanwhile, Romanian exports outside the EU enjoyed 56% yoy-growth, which was mainly explained by a favorable base effect.

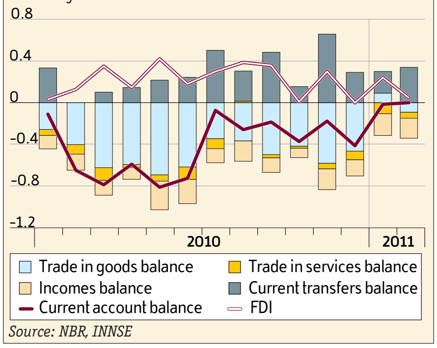
Monthly Foreign Trade Balance



Source: NBR

In January-February, the rise in imports in goods reflected the higher demand for foreign industrial raw materials and manufactured goods (up by 29.5% yoy), and transport equipment and vehicles (up by 25% yoy). The sound dynamics of merchandise imports amid weak domestic demand might be partially addressed by the substantial amount of imported goods that supported exports activity.

Current Account Components
monthly flows EUR billion



Source: NBR, INNSE

During the first two month of the year, the current account deficit substantially improved. In fact, the current account deficit was registered at EUR 0.04 billion after contraction by 94% yoy. The narrowing occurred amid a substantial fall in the merchandise trade deficit (down by 99% yoy) and expansion of the current transfers surplus (up by 61% yoy). Concurrently, the rise in deficit in services (up by 11% yoy) together with the widening of current incomes deficit (up by 52% yoy) partially offset the overall contraction in the current account deficit. As a result, the current account deficit was fully covered by growing net FDI inflows totaling EUR 0.3 billion, which posted two-fold growth.

In April, the international reserves of the National Bank of Romania slightly fell by 1.7% mom and stood at EUR 35.5 billion. The decline reflected EUR 1.5 billion outflows due to servicing of public and publicly guaranteed debt. Also, the depreciation of the U.S. dollar and the Pound Sterling against the Euro cut the value of foreign reserves denominated in those currencies. Meanwhile, the inflow of foreign currency was registered at EUR 0.8 billion. Finally, the Romanian currency (leu) appreciated by 1.6% mom to RON 4.1 per 1 Euro from RON 4.16.

Other Developments Affecting the Investment Climate

Romania continues cooperation with international financial institutions in order to support implementation of structural reforms and stabilize fiscal deficit. Specifically, a mission from the IMF, World Bank and European Commission reached a staff level agreement with the government on May 9th about a second tranche under a new precautionary Stand-By Arrangement program. Since all performance targets were met, Romania might receive about EUR 0.5 billion in case of approval by the Executive Board, which is expected in late June. However, the Romanian authorities will not draw the money since the program was treated as precautionary. Similarly, the last tranche (EUR 1 billion) that had been approved by the Executive Board on March 25th under the previous Stand-By Arrangement program was not disbursed.