Romania
Macroeconomic Situation

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Turning Transitions Into Prosperity

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- **Industrial production grew by 11.9% yoy in January.**
- **In January-February, the consolidated budget deficit narrowed by 60% yoy to EUR 0.6 billion or 0.43% of full year projected GDP.**
- **CPI increased by 7.6% yoy in February.**
- **In January, the trade in goods deficit was registered at EUR 0.1 billion.**
- **The current account deficit shrank by 85% yoy in January and stood at EUR 0.02 billion.**
- **On March 25th, Romania received the 8th IMF tranche, totaling EUR 1 billion. At the same day, the Executive Board of the IMF approved a new precautionary 24-month Stand-By Arrangement program (EUR 3.5 billion).**

Executive Summary

The outlook for the Romanian economy began to improve at the beginning of the year. GDP may rebound to growth in 2011 amid solid performance of its main driver – industrial production. In particular, the index of industrial production posted double-digit growth (11.9% yoy) in January. Sound expansion of industrial production was underpinned by growth of export-oriented industries thanks to favorable external demand. In addition, domestic-oriented industries supported overall expansion of industrial output. Although industrial production demonstrated solid development, domestic demand remained weak due to declining volume of retail sales and construction works.

In January-February, the consolidated budget deficit contracted by 60% yoy to EUR 0.6 billion or 0.43% of full year projected GDP. The improvement reflected growing state revenues (up by 8.3% yoy) and declining government spending (down by 4.4% yoy) as a result of fiscal austerity measures. Higher state revenues were supported by sound collections from indirect taxes – notably VAT and excises. In addition, the collections from major direct taxes – corporate profit tax and wage and income tax – declined on the back of a cut in public wages and transfers implemented last summer. Meanwhile, lower state spending reflected the decrease in the state wage bill and the drop in social transfers payments.

In February, the growth of consumer prices sped up to 7.6% yoy compared to 7% yoy a month earlier. The acceleration was primarily driven by food and fuel prices, while growth of prices of services remained moderate. By contrast, consumer prices increases are likely to decline in the second half of the year since the effect of VAT hike in July 2011 will end. Given the above developments, the growth of CPI is expected to reach 4.5% yoy at the end of 2011. Meanwhile, to mitigate the adverse effects of external risks and revive a disinflationary trend, the Board of the National Bank (NBR) continued to keep its benchmark policy rate at 6.25%.

In January, the trade in goods balance rose to a surplus in FOB-FOB terms totaling EUR 0.1 billion. The improvement was achieved on the back of solid export performance (up by 48% yoy), while the growth rate of imports was registered at 39% yoy. Due to a surplus in merchandise trade, the current account deficit narrowed by 85% yoy to EUR 0.02 billion despite a contraction of the current transfers surplus and a widening in the current income deficit. Meanwhile, net FDI inflows totaling EUR 0.24 billion completely funded the current account deficit. In March, the Romanian currency (leu) appreciated by 2% mom to RON 4.165 per 1 Euro due to foreign capital inflows.

Romania continues to cooperate with international financial institutions. In fact, on March 25th Romania received the 8th and final IMF tranche, totaling EUR 1 billion under the Stand-By Arrangement program. Moreover, the Romanian government requested a new precautionary 24-month Stand-By Arrangement program starting on March 31st. On the same day, the Executive Board of the IMF approved this new 24-month Stand-By Arrangement program. According to the program Romania might receive EUR 3.5 billion from IMF disbursements as well as a EUR 0.4 billion loan from the World Bank and a EUR 1.4 billion tranche from the European Union.

	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	36.5
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

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Where Opportunities Emerge.

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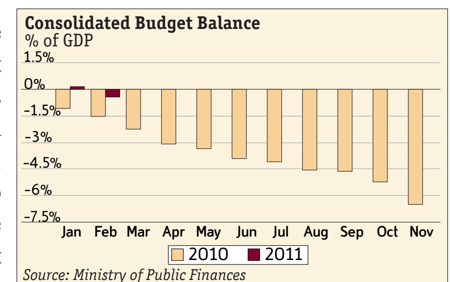
Economic Growth

During the first month of the year, the outlook for the Romanian economy began to improve. Indeed, the key driving factor for real GDP growth, industrial production posted sound two-digit growth in January. Specifically, the index of industrial production advanced to 11.9% yoy from a 9.9%increase in the previous month. The expansion of industrial output was primarily supported by export-oriented industries on the back of buoyant external demand. In fact, the rise in output of machinery and vehicles was registered at 23% yoy and 19.1% yoy, respectively. In addition, the growth in production of chemicals (up by 57% yoy) and basic metals (up by 14.5% yoy) reflected stronger foreign demand for these commodities groups. Given strong trade relations with EU countries, future prospects for Romanian industry will be tightly connected to their performance. At the same time, domestic-oriented industries also supported overall expansion of industrial production, while they demonstrated mixed results in the previous year. Thus, the food processing, and manufacture of wood products grew by 10% yoy and 25% yoy, respectively. Finally, the mining and quarrying sector posted 1.6% yoy growth, while output in utilities grew by 3.5% yoy.

Despite the strong performance of industrial production, domestic demand remained subdued since the volume of retail sales and construction works continued to decline. In particular, the index of retail sales dropped by 5.7% yoy in January, slightly better than 9% yoy contraction a month ago. This improvement was achieved thanks to minor 0.5% yoy growth in sales of non-food items, while sales of food products and car fuels fell by 7.4% yoy and 15.4% yoy, respectively. Similarly, the index of construction works declined by 8.5% yoy mainly due to a fall in the index of new construction works (down by 16.2% yoy).

Fiscal Policy

During the first two months of the year, fiscal austerity measures continued to curtail the budget deficit. In particular, in January the consolidated budget rose to a surplus in the amount of EUR 0.2 billion or 0.15 % of full year projected GDP. Despite the seasonal effect of this surplus, the full-year projected budget deficit could be around 5.0% of full year projected GDP as a consequence of fiscal retrenchment. In fact, after the first two months of the year, the cumulative budget balance slipped to a deficit. Specifically, the consolidated budget gap narrowed by 60% yoy and reached EUR 0.6 billion or 0.43% of full year projected GDP. The contraction was achieved on the back of growing state revenues and declining government spending.



Source: Ministry of Public Finances

In January-February, government revenues grew by 8.3% yoy and reached EUR 6.5 billion primarily due to strong receipts from indirect taxes. In particular, collections from VAT and excises remained key factors of a sound expansion of budget revenues. While proceeds from VAT increased by 33.5% yoy, collections from excises rose by 12.9% yoy. Taking into account that fiscal austerity measures were implemented in July 2010, strong performance of receipts from VAT taxes will be supported during the first half of the year. In addition, non-fiscal revenues positively contributed to overall growth of state revenues by posting 15.7% yoy growth. By contrast, the decline in collections from major direct taxes was caused by reduction in public wages and transfers implemented last summer. In fact, receipts from corporate profit tax (down by 16.7% yoy) and wage and income tax (down by 6% yoy) declined on the back of constrained budgets. Meanwhile, the government is focusing not only on enhancing state revenues but on creation of new workplaces and improving the business environment. For this purpose, the government announced gradual reduction of social security and health care contributions, which could be adopted in the second half of the year.

During the first two months of 2011, state expenditures declined by 4.4% yoy and stood at EUR 7.0 billion. The reduction was mainly led by a lower state wage bill (down by 22.5% yoy) and a drop in social transfers payments (down by 4.1% yoy). Low spending on public wages and transfers will be preserved until the second half of the year, when the effects of fiscal austerity measures dissipate.

By January, the stock of medium and long term external debt had increased by 1.2% since the beginning of the year (ytd) and stood at EUR 72.9 billion. The growth was driven by higher public external debt (up by 2.5% ytd to EUR 27.3 billion), while private external debt (including non-residents' deposits) remained virtually unchanged at EUR 45.6 billion.

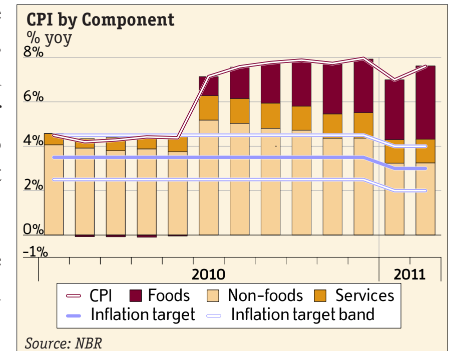
Monetary Policy

In February, consumer prices accelerated their rate of growth. In fact, growth of CPI advanced to 7.6% yoy compared to 7% yoy a month ago. The increase was primarily driven by food prices (up by 8.8% yoy) and fuel prices (up by 14.2% yoy), while gains in the prices of services (up by 6% yoy) remained moderate. Global food prices were kept on an upward trend thanks to booming world demand. Indeed, the composite food price index provided by the Foods and Agriculture Organization (FAO) increased for the eighth month in a row and reached the highest level since January 1990 (when it was introduced). Meanwhile, the hike in fuel prices was

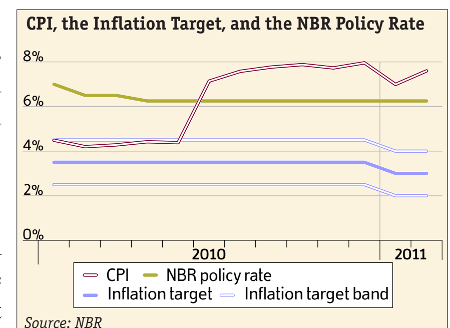
caused by risks of crude oil supply disruptions as a result of political turmoil in the Middle East. Given the unstable situation in a number of countries, specifically in Libya, oil prices might remain high and therefore support further growth of consumer prices. Under such circumstances, consumer prices increases will likely decline in the second half of the year since the VAT rate effect will dissipate. As a result,growth of CPI is forecasted to reach 4.5% yoy at the end of 2011, which is slightly higher than the upper band for the inflation target (4.0%).

The Board of the National Bank (NBR) continued to keep its benchmark policy rate unchanged at 6.25% for the tenth consecutive month. This stable monetary policy is essential to combat inflation and mitigate adversary effects of external risks.

In February, the growth of money supply measured as intermediate money (M2) decelerated. In particular, M2 increased by 4.9% yoy from 6.4% yoy in the previous month. The rise was supported by EUR-nominated loans (up by 6.9% yoy), while domestic issued loans dropped (down 5.6% yoy). Thus, non-government loans posted 3.7% yoy-growth thanks to sound performance of EUR issued loans.



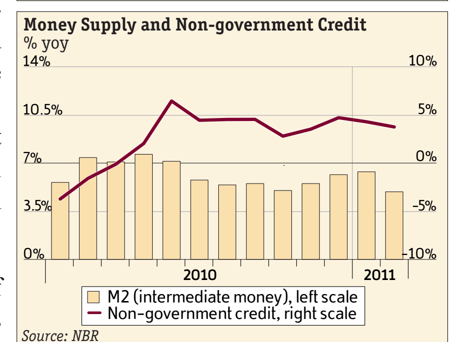
Source: NBR



Source: NBR

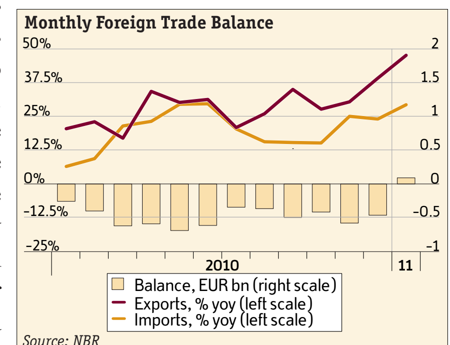
International Trade and Capital

In January, the merchandise balance rose to a surplus in FOB-FOB terms totaling EUR 0.1 billion, while the last monthly surplus was registered in February 2000. The positive development in the external balance was achieved due to strong merchandise exports that were kept on a solid upward trend. Indeed, exports in goods surged by 48% yoy to EUR 3.4 billion compared to 39% yoy in the previous month. Meanwhile, imports in goods increased at a flatter growth rate – 29% yoy – and stood at EUR 3.3 billion. The positive balance in goods reflected strong external demand coupled with stabilization of domestic demand. However, taking into account the expected rebound in domestic consumption and investment during the year, the trade in goods balance could slip to a deficit. In addition, rising global food and fuel prices are likely to support growth of imports and exert additional pressure on the trade balance towards a deficit.



Source: NBR

In January, growth in merchandise exports was driven by higher foreign purchases of Romanian transport equipment and vehicles (up by 43% yoy), and industrial raw materials and manufactured goods (up by 38% yoy). Thus, exports of these two commodities groups contributed about 60% to overall exports expansion. On the other side, Romanian exports were primarily driven by shipments to EU countries (up by 28.5% yoy), which made up 72% of overall exports, while exports to non-EU countries advanced to 73% yoy. As a result, further prospects for Romanian exports will be tightly connected with growth in the Eurozone and the consequences of the sovereign debt turmoil. Since the beginning of the year, the RON appreciated by 4%, which might increase imports and restrain exports. Until now, the RON appreciation had limited effect on the trade deficit, as the imports were negatively affected by the still low domestic consumption, and exports are generally under longer term contracts. Meanwhile, the increase in merchandise imports was led by stronger demand for foreign transport equipment and vehicles (up by 29% yoy), and industrial raw materials and manufactured goods (up by 32% yoy).



Source: NBR

During the first month of the year, the current account was almost balanced. Indeed, the current account deficit contracted by 85% yoy and stood at EUR 0.02 billion. The improvement reflected a surplus in the merchandise trade deficit, which completely offset the rise in the income deficit (up by 63% yoy) and the narrowing of the current transfers surplus (down by 38% yoy).The lower current transfers surplus was explained by a decline in wage remittances and transfers from the EU budget. At the same time, net FDI inflows totaling EUR 0.24 billion covered the current account deficit since they posted 674% yoy growth.

In March, Romanian international reserves marginally grew by 1.8% mom and stood at EUR 36.1 billion. The increase was explained by higher currency inflows in the amount of EUR 1.7 billion, which included the fourth tranche from the European Commission.

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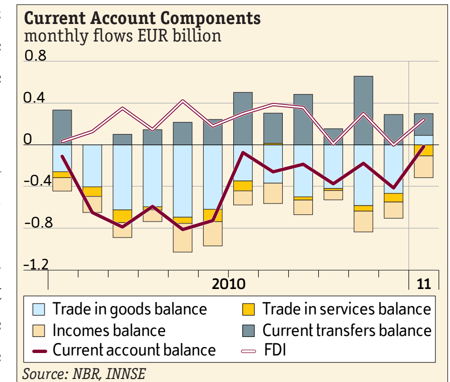
Meanwhile, outflows of foreign currency reached EUR 1 billion due to servicing of public and publicly guaranteed external debt. In addition, depreciation of the US Dollar and the Pound Sterling against the Euro reduced the market value of foreign reserves, which are denominated in these currencies.



Finally, the Romanian currency (leu) appreciated in March to RON 4.165 per 1 Euro from EUR 4.247 due to foreign capital inflows. Moreover, during the first three months of the year, the Romanian currency gradually appreciated against the Euro as a result of additional factors. Among them were sound inflows of foreign currency thanks to cooperation with international financial institutions, stronger investor confidence after implementation of fiscal retrenchment and contraction of the current account deficit. Although the leu has appreciated by 4% since the beginning of the year (ytd) against the Euro, its further significant strengthening will be unlikely.

Other Developments Affecting the Investment Climate

To promote economic growth, support implementation of structural reforms and reduce the fiscal budget deficit, Romania continues to cooperate with international financial institutions. In particular, on March 25th Romania received the last IMF tranche totaling EUR 1 billion under the Stand-By Arrangement program. Since the current program ended on March 30th, authorities asked the IMF for a new precautionary agreement starting on March 31st. As a result, the Executive Board of the IMF approved a new 24-month Stand-By Arrangement program, which implies disbursement of EUR 3.5 billion. In addition, the World Bank and the European Union will provide EUR 0.4 billion and EUR 1.4 billion loans, respectively.

Given a new IMF program, Romania will be able to implement several structural reforms to promote economic growth and cope with fiscal retrenchment. In particular, to reduce the fiscal deficit to 3% of GDP in 2012, the country should be focused on more efficient absorption of EU funds, reforming the social health care system and improving the tax system. Moreover, to enhance economic efficiency, officials should advance governance of state-owned enterprises and implement labor market reforms to support productivity growth.

The government has launched a Secondary Public Offering (SPO) for OMV Petrom, the national oil company, which is controlled by Austrian OMV. Through the SPO, the government intends to sell 9.84% of Petrom, which, at the current trading prices is worth around EUR 600 million. The intermediary of the offer is the consortium led by Russian Renaissance Capital and including also BT Securities, Romcapital and EFG Securities. The consortium was chosen from a total of six offers. We believe this is a positive development, as it draws international investors' attention to Romania and increases liquidity on the stock exchange.