Romania
Macroeconomic Situation

June 2011

Sergii Pypko, RaduMihai Balan, Edilberto L. Segura

- **Real GDP was up by 1.7% yoy during the first quarter of 2011.**
- **In January-April, the consolidated budget deficit shrank by 55% yoy to EUR 1.8 billion or 1.4% of projected full year GDP.**
- **CPI inched up by 8.4% yoy in May.**
- **Romania issued EUR 1.5bn in 5 years sovereign bonds at 5.298% average yield.**
- **In January-March, the merchandise trade deficit in FOB-FOB terms contracted by 41% yoy to EUR 1.1 billion.**
- **The current account deficit shrank by 46% yoy over the first quarter and settled at EUR 1.2 billion.**
- **The IMF and the World Bank approved the disbursement of two tranches – each EUR 0.5 billion.**

Executive Summary

Romanian real GDP growth rebounded over the first quarter of 2011, rising by 1.7% yoy after two years of contraction. On the demand side, the growth of GDP was supported by stronger exports, while final consumption declined by 3% yoy as a result of fiscal retrenchment. At the same time, gross fixed capital formation was down by 2.2% yoy. Taking into account the growth rebound in the first quarter, annual GDP growth could reach about 1.6% yoy in 2011 based on export focused industrial activity.

In January-May, the consolidated budget deficit contracted by 55% yoy to EUR 1.8 billion or 1.4% of projected full year GDP. The improvement was driven by growing government revenues and declining state spending. In fact, state incomes inched up by 10.1% yoy due to stronger proceeds from indirect taxes, especially VAT and excises. Meanwhile, government expenditures dropped by 3.4% yoy amid decreases in the state wage bill and social transfers payments. Nevertheless, the favorable dynamics of the fiscal gap should continue until July 2011, when the effect of fiscal consolidation will dissipate.

Given the successful implementation of fiscal austerity measures as well as a revival of GDP growth and narrowing of the current account deficit, Fitch upgraded the country's sovereign rating to investment grade BBB-. Moody's also rates Romania as investment grade, at Baa3, while Standard & Poor's rating is BB+, one notch below investment grade. During June, Romania launched a successful Eurobond issue, raising EUR 1.5 billion in 5 year bonds with an average yield of 5.298%.

In May, consumer prices were up by 8.4% yoy on the back of rising food prices as a consequence of surging international food prices. At the same time, the prices of non-foods and services demonstrated more moderate dynamics – the latter's growth remained unchanged, while the increase in prices of services slightly decelerated. Despite persistent increases in consumer prices, their growth rate is expected to slow down significantly in the second half of the year due to the presence of a negative output gap and dissipation of the effect of the hike in the VAT rate. In addition, the National Bank of Romania continued to maintain its key policy rate unchanged at 6.25% per annum in order to provide stable monetary policy.

During the first four months of the year, the deficit in trade in goods in FOB-FOB terms shrank by 41% yoy and reached EUR 1.1 billion. The improvement reflected rising merchandise exports, which grew by 33% yoy to EUR 14.4 billion, although the growth rate slowed down from 39% yoy over January-March. At the same time, imports in goods were up by 22% yoy and stood at EUR 15.5 billion. Given the contraction in the merchandise trade deficit, the current account deficit narrowed by 46% yoy and reached EUR 1.2 billion. In addition, the wider current transfers surplus positively contributed to overall contraction in the current account deficit. By contrast, the growth of deficits in trade in services and current income acted in opposite directions. Finally, net FDI inflows declined by 29% yoy to EUR 0.4 billion and covered 39% of the current account deficit.

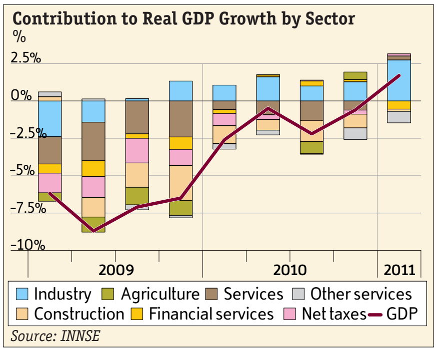
Romania continued to cooperate with international financial institutions to support implementation of structural reforms, limit the consolidated budget deficit and promote economic growth. Specifically, the Executive Board of the IMF endorsed the disbursement of EUR 0.5 billion according to the new Stand-By Arrangement Program. However, Romanian authorities did not draw money from the Fund because they treated this program as precautionary. In addition, the Board of the World Bank approved the payout of EUR 0.5 billion, which will finance the modernization of Romania's social assistance system.

	2007	2008	2009	2010	2011f	2012f
GDP growth, % change yoy	6.3	7.1	-7.2	-1.3	1.6	3.3
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	6.9	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	5.0
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	-6.8	-8.0
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

Chief Economist Edilberto L. Segura
Editor Rina Bleyzer O'Malley

Economic Growth



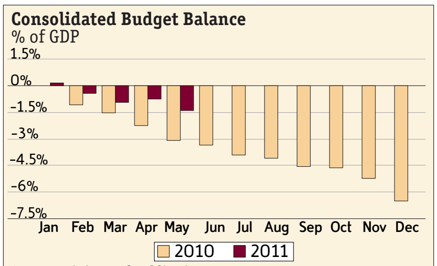
Source: INNSE

The Romanian economy returned to growth after two years of recession. Specifically, real GDP increased by 1.7% yoy compared with a 1.4% yoy average rate of decline during the previous year. On the demand side, final consumption remained subdued, since it fell by 3% yoy on the back of low household incomes and lower government spending as a consequence of fiscal retrenchment. However, the decline was primarily driven by lower government spending (down by 14% yoy), while household consumption fell by only 1.7% yoy. Similarly, gross fixed capital formation dropped by 2.2% yoy, but the rate of decline was significantly lower than the corresponding average rate in 2010 – 14% yoy. Accordingly, rising exports continued to be the major driver of economic growth, posting 23.6% yoy growth, which outpaced the 15.4% yoy expansion in imports.

On the supply side, industry continued to play a leading role in overall expansion in real GDP, since it posted double digit growth – up by 10.1% yoy. The sound dynamics of industrial production reflected favorable external demand, which underpinned buoyant growth of export-oriented industries like vehicles, machinery, chemicals, and basic metals. However, the recent easing of the index of industrial production in April (up by 3.6% yoy) as a result of slower growth of exports should restrain contribution of industrial output in the second quarter. In addition, the higher volume in service sectors (up by 1.1% yoy) and stronger proceeds from net taxes (up by 1.3% yoy) also positively contributed to overall real GDP growth. More importantly, the last expansion in service was registered two years ago, which might provide the first signs of recovery of domestic demand. In contrast, financial services and construction continued to decline – down by 3.2% yoy and down by 2.4% yoy, respectively. However, the biggest negative contribution to GDP growth came from other services activities (down by 6.1% yoy), which includes different public activities, due to implementation of fiscal austerity measures.

The Romanian economy is forecast to increase by around 1.6% yoy annually in 2011 given the positive expansion over the first quarter. Specifically, rising exports are expected to remain the main driver of economic growth in the short run. However, future prospects for Romanian exports are likely to be determined by the outlook for Eurozone growth due to tight trade relationships with other EU members.

Fiscal Policy



Source: Ministry of Public Finances

During the first five months of the year, the fiscal retrenchment continued to improve Romania's fiscal balance. In fact, the consolidated budget deficit narrowed by 55% yoy to EUR 1.8 billion or 1.4% of projected full year GDP, while it was registered at 3.2% of full year GDP a year ago. The contraction was achieved on the back of rising state incomes and falling government expenditures. Specifically, state revenues advanced to 10.1% yoy and stood at EUR 16.9 billion, while government spending declined by 3.4% yoy and reached EUR 18.7 billion. However, sound dynamics of the fiscal gap should continue until July 2011, since then the favorable statistical base thanks to the fiscal austerity measures will fade. Taking into account the current dynamics of state revenues and spending, the full year consolidated budget deficit is expected to reach about 5% of projected full year GDP in 2011.

Successful implementation of fiscal consolidation and therefore narrowing of the fiscal gap, together with recovery of economic growth and contraction of the current account deficit, has helped improve the credibility of Romania's economy. Indeed, Fitch upgraded the country's sovereign rating (long-term foreign currency issuer default rating) to investment grade BBB- with a stable outlook for the first time since November 2008. Moody's rates Romania as investment grade, at Baa3, while Standard & Poor's rating is one notch below investment grade.

In January-May, the growth of state revenues was driven by stronger receipts from indirect taxes. In particular, stronger proceeds were registered from VAT (up by 35.6% yoy) and excises (up by 28.2% yoy) as a result of implementation of fiscal austerity measures implemented in July 2010, notably a hike in the VAT rate by 5 p.p. to 24%. In addition, higher transfers from the EU budget (up by 17.2% yoy) and growing social security and healthcare contributions (up by 3.2% yoy) also supported the rise in government incomes. Meanwhile, collections from main direct taxes demonstrated uneven results. On the one hand, the proceeds from wage and income tax continued to fall, although at a lower pace (down by 1.2% yoy) amid tight budgets. In contrast, the collections from the corporate profit tax grew by 0.2% yoy.

During the first five months of the year, the decline in government expenditures occurred due to a decrease in the state wage bill (down by 19.9% yoy) and a decline in social transfers payments (down by 3.1% yoy). The contraction reflected fiscal consolidation implemented in July 2010 (a reduction in wages and transfers), and therefore their favorable dynamics should be preserved until the second half of the year. Concurrently, the decline in capital expenditures was registered at 5.4% yoy, which could restrain future economic growth. In contrast, higher spending on servicing public and publicly guaranteed debt (up by 34.7% yoy), and spending on goods and services (up by 10.5% yoy) partially offset the overall decline in government expenditures.

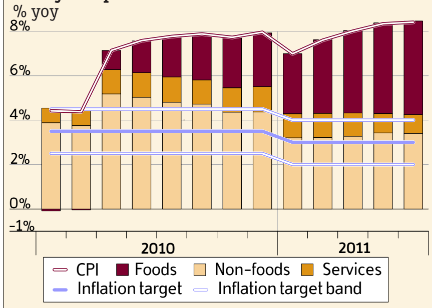
In April, the stock of medium and long term external debt had risen by 1.7% since the beginning of the year (ytd) and settled at EUR 73.7 billion. The increase was supported by stronger public debt, which was 4.6% ytd higher and reached EUR 28 billion. Meanwhile, private external debt (including non-residents' deposits) remained stable at EUR 45.7 billion. Taking into account the short term external debt, total external debt has grown by 2.3% ytd to EUR 93 billion or 70.6% of projected full year GDP.

During June, Romania launched a 5 years Eurobond issue, raising EUR 1.5 billion from the international markets. The bonds were launched at an average yield of 5.298% and the issue managers were Erste Group and Societe Generale.

Monetary Policy

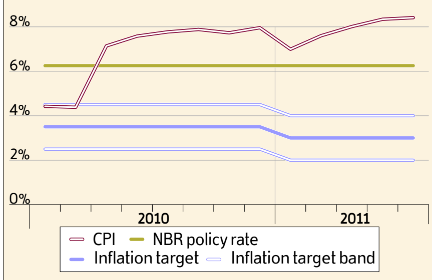
In May, consumer prices continued on the upward trend that had been started in January 2011. Indeed, the growth of CPI accelerated slightly to 8.4% yoy from 8.3% yoy growth registered in the previous month. The rise was mostly fueled by growing prices of foods as they posted 11.2% yoy growth compared with 10.9% yoy a month ago. The latter's double-digit growth reflected the significant surge in international foods prices since they grew by 37% yoy according to the FAO Food Price Index, which measures price changes for essential foodstuffs. Despite the surging international food prices, their growth rate has started to moderate, which should contain further increases in domestic food prices. Taking into account the robust growing dynamics of food prices, they made up 4.2 p.p. of the overall growth of consumer prices. In contrast, the growth of prices of non-foods and services demonstrated mixed performance. While the increase in prices of non-goods remained unchanged at 7.7% yoy, the rise in prices of services slowed down to 4.7% yoy.

CPI by Component



Source: NBR

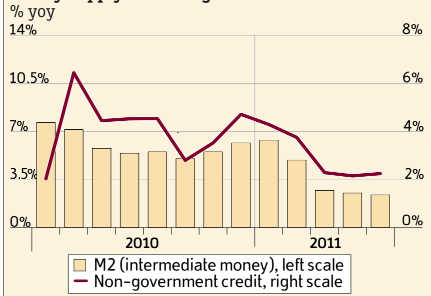
CPI, the Inflation Target, and the NBR Policy Rate



Source: NBR

Despite persistent rising dynamics of consumer prices, their growth rate is expected to slow down significantly in the second half of the year. In fact, the presence of a negative output gap and favorable statistical base as consequences of the dissipation of increased VAT rate effect should restore the disinflationary trend in July. Consumer inflation is expected to reach about 5.0% yoy at the end of 2011, which is significantly above the upper bound of the inflationary target (4.0% yoy) set by the National Bank of Romania (NBR). Meanwhile, the NBR continued to provide stable monetary policy aiming to anchor inflationary expectations and therefore mitigate potential risks, which might affect inflation outlook. Among major risks are uncertainty related to administered price adjustments, European sovereign debt turmoil and its implications for financial markets, and dynamics of the prices of commodities on the international markets. Thus, the Central bank kept its benchmark policy rate unchanged at 6.25% per annum for the fifteenth month in a row.

Money Supply and Non-government Credit



Source: NBR

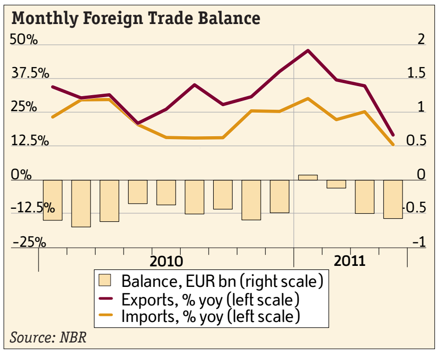
In May, the growth of money supply measured as M2 continued to decelerate since January 2011, although at a slower pace. Specifically, the increase in M2 slowed down to 2.4% yoy from 6.4% yoy-growth in January. This was explained by a decline in monetary aggregate M1, which includes currency in circulation and overnight deposits (down by 0.7% yoy). In addition, the easing of growth of deposits with maturity up to two years (up by 4.5% yoy) led to a slow-down in overall expansion in money supply. Concurrently, the stock of non-government loans inched up by 2.2% yoy amid positive development of forex-denominated non-government loans (up by 3.4% yoy), while domestic issued loans remain unchanged. Specifically, the former was led by higher credit accumulation of both households (up by 2.8% yoy) and the corporate sector (up by 4% yoy). However, given the higher growth rate of consumer prices, the nominal expansion in credit activity should be adjusted into negative real growth of non-government credit.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111   Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

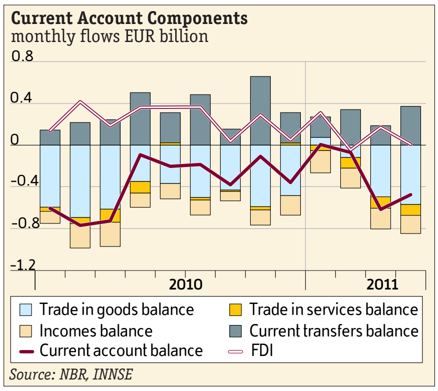
Where Opportunities Emerge.

Bucharest Office, Romania
12Bis, Dr. Draghiescu St., Sect. 5,
Bucharest , 050579
Tel: +40 (21) 4101000   Fax: +40 (21) 4102222
Email: bucharest.office@sigmableyzer.com

International Trade and Capital



In January-April, the merchandise trade deficit in FOB-FOB terms continued to improve. Specifically, the deficit in trade in goods contracted by 41% yoy and settled at EUR 1.1 billion amid growing merchandise exports in goods. In fact, exports in goods posted impressive 33% yoy growth and reached EUR 14.4 billion, despite being kept on a downward path over the last four months. Accordingly, the increase in merchandise exports slowed down to 16.7% yoy in April from 39.4% yoy growth registered during the first quarter. At the same time, the dynamics of imports in goods closely followed the exports trend. Specifically, merchandise imports inched up by 22% yoy to EUR 15.5 billion in January-April, while their growth rate substantially decelerated in April – to 13% yoy. Given the aforementioned developments, merchandise trade slipped to a wider deficit in April (EUR 0.6 billion) than the overall deficit recorded during the first quarter (EUR 0.5 billion).



In April alone, stronger exports in goods were supported by higher foreign purchases of transport equipment and vehicles (up by 11% yoy), and industrial raw materials and manufactured goods (up by 19% yoy). Meanwhile, the substantial slow-down in exports' growth rate was primarily explained by easing of exports within the Eurozone – up by 17.4% yoy from a 35% yoy increase in January-March. Indeed, since Romania shipped almost 3/4 of overall merchandise exports to other EU members, the growth outlook of the Eurozone should affect prospects of Romanian exports in the coming months. Specifically, the current Euro crisis led by worries about Greece's debt restructuring could adversely influence industrial activity in the core Eurozone and therefore restrain the potential of Romania's exports. At the same time, the rise in merchandise imports was driven by higher purchases of foreign transport equipment and vehicles (up by 9.8% yoy), and industrial raw materials and manufactured goods (up by 19.6% yoy). Accordingly, the aforementioned commodity groups made up almost 75% of the overall expansion in imports. Hence, the growth of imports reflected the substantial share of goods used for further exports, since domestic demand remained subdued on the back of restrained budgets.

During the first four months of the year, the current account deficit improved substantially. Indeed, the current account deficit contracted by 46% yoy and stood at EUR 1.2 billion. The improvement was achieved on the back of contraction in the merchandise trade deficit and expansion in the current transfers surplus. Specifically, the latter posted 89% yoy growth and reached EUR 1.1 billion due to the higher volume of EU funds to the government budget. Thus, the EU funds should not only promote economic growth, but also drive the contraction of the current account deficit. Concurrently, the rise in deficits in trade in services and current income partially offset the overall contraction in the current account deficit. In particular, the deficit in trade in services expanded by 15% yoy and reached EUR 0.4 billion, while the deficit in current incomes was up by 47% yoy and settled at EUR 0.8 billion. The latter's growth might reflect higher incomes on equity and debt earned by foreign investors. Meanwhile, net FDI inflows funded 39% of the current account deficit after they fell by 29% yoy to EUR 0.4 billion.

In June, the international reserves of the National Bank of Romania were up by 4.4% mom and stood at EUR 37.9 billion. The increase was driven by strong inflows of foreign currency (EUR 2.5 billion), which included the issuing of Euro denominated bonds totaling EUR 1.5 billion with 5 years maturity. Meanwhile, the outflows of foreign currency in the amount of EUR 0.8 billion reflected servicing of public and publicly guaranteed external debt. Finally, the Romanian currency (leu) depreciated by 2.7% mom to RON 4.23 per 1 Euro at end-June from RON 4.12 at end-May on the back of contagion fear stemming from Greece's debt crisis. The significant share capital of the financial institutions with Greek majority shareholders (25.5% of total share capital as of end of 2010) might be a risk for the entire system, despite close supervision by the NBR. However, recent approval of new austerity measures by Greece's parliament and subsequent endorsement of a new bailout for Greece by Eurozone finance ministers, together with the recent Fitch upgrade of sovereign rating to investment grade should calm the Romanian forex market.

Other Developments Affecting the Investment Climate

Romania continued to cooperate with international financial institutions to curtail its fiscal deficit, implement structural reforms and support economic growth. In particular, the Executive Board of the IMF approved on June 27th the disbursement of EUR 0.5 billion according to the new Stand-By Arrangement Program. Taking into account that Romanian authorities treated this program as precautionary, they did not draw money from the Fund. In other words, the government and the NBR will rely on the IMF's tranche only in emergency cases, while otherwise relying on financing from domestic and external markets. In fact, Romania scheduled the issuing of Euro and Dollar denominated bonds in the second half of the year on the back of strong external demand.

In addition, the Board of the World Bank endorsed a payout of EUR 0.5 billion, which will be directed toward financing modernization of Romania's social assistance system. The goal of this project is to improve the performance of Romania's social assistance system during the next three years by enhancing administrative efficiency, reducing errors and strengthening management performance. Accordingly, implementation of this program should allow cutting government expenditures on the social assistance program and supporting their sustainability in the medium term.

Headquarters
123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
Tel: +1 (713) 6213111 Fax: +1 (713) 6214666
Email: sbleyzer@sigmableyzer.com

Bucharest Office, Romania
12Bis, Dr. Draghiescu St., Sect. 5,
Bucharest , 050579
Tel: +40 (21) 4101000 Fax: +40 (21) 4102222
Email: bucharest.office@sigmableyzer.com

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123 N. Post Oak Ln., Suite 410
Houston, TX 77024 USA
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Email: sbleyzer@sigmableyzer.com

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Bucharest , 050579
Tel: +40 (21) 4101000   Fax: +40 (21) 4102222
Email: bucharest.office@sigmableyzer.com