July 2011

Sergii Pypko, RaduMihai Balan, Edilberto L. Segura

- **In May, the index of industrial production inched up by 7.1% yoy.**
- **In the first half of 2011, the consolidated budget deficit narrowed by 37.5% yoy to EUR 2.7 billion or 2.1% of projected full year GDP.**
- **CPI grew by 7.9% yoy in June.**
- **In January-May, the merchandise trade deficit in FOB-FOB terms contracted by 24% yoy to EUR 2.0 billion.**
- **The current account deficit contracted by 38% yoy in January-May and stood at EUR 1.8 billion or 1.4% of projected full year GDP.**
- **The IMF and EC missions provided a quarterly review of the Romanian economy under the Stand-By Arrangement program.**

Executive Summary

Real growth of Romania's economy may decelerate in the second quarter according to recent data for the main real sectors. In fact, the increase in the main driver of GDP growth – industrial production – slowed down to 5.4% yoy in April-May. At the same time, the index of retail sales continued to fall but at a slower rate. On a positive note, the index of construction works advanced to 3.4 % yoy, which became the highest monthly growth rate since March 2009.

In January-June, the consolidated budget deficit shrank by 37.5% yoy and stood at EUR 2.7 billion or 2.1% of projected full year GDP. The contraction was led by growing state incomes, while rising government spending advanced at a significantly slower rate. The increase in government revenues was fueled by higher collections of indirect taxes, notably VAT and excises. Additionally, receipts from wage and income tax revived their growth for the first time this year. On the expenditure side, the growth of government spending was driven by higher capital expenditures, while lower spending on state wages and social transfers exerted downward pressure on state expenditures. At the same time, the stock of medium and long term external debt grew by 2.9% ytd to EUR 74.6 billion amid rising external public debt. As a result, the total external debt to projected full year GDP ratio reached 72%.

In June, consumer inflation decelerated to 7.9% yoy from 8.4% yoy a month ago thanks to lower growth of food prices. The dynamics of foods prices continued to preserve their leading role in driving consumer prices, with the growth of prices of non-foods and services remaining almost unchanged. Taking into account that the effect of the hike in the VAT rate will fade in July, CPI growth is expected to decelerate further in the second half of the year. At the same time, the National Bank of Romania continued to provide stable monetary policy by keeping its benchmark policy rate unchanged at 6.25% per annum.

In January-May, the current account deficit narrowed by 38% yoy and reached EUR 1.8 billion or 1.4% of projected full year GDP. The contraction was driven by a lower merchandise trade deficit, the decline in trade in services deficit and the increase in the current transfers surplus. Specifically, the trade in goods deficit in FOB-FOB terms contracted by 24% yoy to EUR 2.0 billion thanks to rising merchandise exports and relatively moderate import growth. In contrast, the expansion in the current incomes deficit partially offset the overall contraction in the current account deficit. Meanwhile, net inflows of the FDI fell by 23% yoy to EUR 0.8 billion and funded 44% of the current account deficit.

The joint mission of the IMF and European Commission visited Romania and assessed the quarterly performance of Romania's economy under the Stand-By Arrangement program.

	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	-6.5	-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

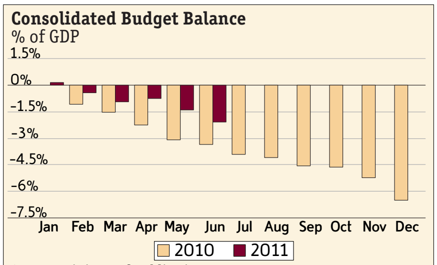
Economic Growth

Expansion of the Romanian economy will likely ease in the second quarter of 2011, according to recent real sector data. On the supply side, the increase in industrial production – the main driver for real growth – has substantially decelerated. Specifically, the index of industrial production rose by 5.4% yoy on average in April-May, while double-digit expansion was registered over the first quarter at 11.4% yoy. Likewise, the volume of retail sales remained subdued on the back of restrained disposable incomes as a result of fiscal austerity measures. On a positive note, the decline in the index of retail sales slowed slightly, falling by 4.5% yoy in April-May from 5.6% yoy during the first quarter of 2011. Concurrently, construction service demonstrated some improvement in May by posting strong monthly growth (up by 3.4% yoy) for the first time since March 2009. However, the increase in the construction works index was driven by stronger capital (up by 27.2% yoy) and current repair works (up by 11.2% yoy), while the new construction index continued to decline (down by 3.6% yoy).

In May, industrial production growth rebounded (up by 7.1% yoy) after a temporary slowdown registered in April (up by 3.6% yoy). The rise in industrial output was underpinned by the stronger performance of export-oriented sectors. Specifically, production of machinery, vehicles and chemicals advanced to 11.3% yoy, 9.7% yoy and 18.6% yoy, respectively on the back of rising external demand. However, taking into account the consequences of the EU sovereign debt crisis, industrial production in the core Eurozone countries should be restrained. Accordingly, the dynamics of export-oriented sectors are likely to be less buoyant in the coming months than during the first quarter of 2011. At the same time, domestic oriented industries continued to support the overall expansion in industrial output, though at a slower growth rate. In particular, food processing posted 6.1% yoy growth, while manufacturing of wood products inched up by 12.1% yoy. Finally, the solid dynamics of non-manufacturing sectors, notably mining and quarrying (up by 18.5% yoy) and utilities (up by 7.6% yoy) allowed them to exceed the growing manufacturing sector (up by 6.5% yoy) for the first time this year.

Fiscal Policy

During the first half of the year, the fiscal austerity measures continued to bear fruits. In fact, the consolidated budget balance slipped to a deficit in the amount of EUR 2.7 billion or 2.1% of projected full year GDP, which was 37.5% lower than a year ago. The improvement was achieved thanks to a sound expansion in government revenues, while state expenditures posted significantly milder growth. In particular, government incomes inched up by 9.6% yoy and reached EUR 20.3 billion, while state spending increased by 0.7% yoy and stood at EUR 23 billion. However, the growth rate of government revenues is likely to slow in the second half of the year when the favorable base effect due to the implementation of austerity measures (especially the hike in the VAT rate) will dissipate. Under such circumstances, the full year consolidated budget deficit is forecasted to reach around 5.0% of projected full year GDP in 2011.



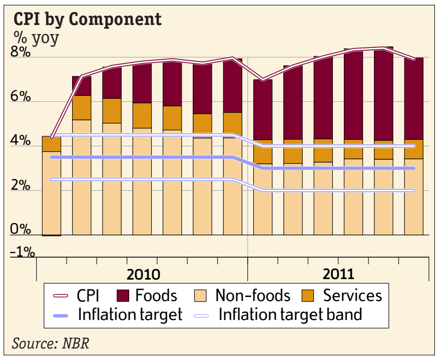
Source: Ministry of Public Finances

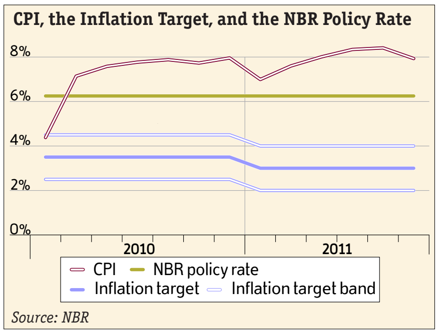
In January-June, stronger budget revenues were registered due to stronger receipts from indirect taxes. In particular, higher proceeds from VAT (up by 31.5% yoy) and excises (up by 27.1% yoy) were registered on the back of implementation of fiscal austerity measures. In addition, the collections from the main direct taxes, notably corporate profit tax (up by 1.4% yoy) and wage and income tax (up by 0.4% yoy), also positively contributed to the overall expansion in state revenues. More importantly, the increase in proceeds from wage and income tax rebounded for the first time this year. In addition, social security and health care contributions grew by 4.7% yoy amid increase in employment numbers by 53,400 from end-2010 to May 2011.

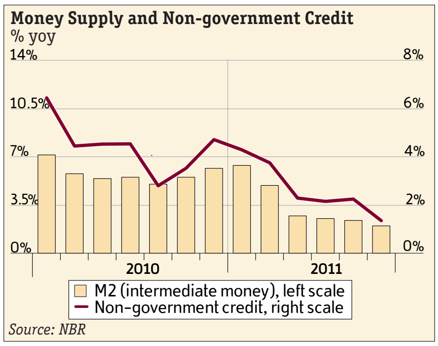
On the expenditure side, the rise in state expenditures was underpinned by higher spending on goods and services (up by 14.6% yoy) and stronger capital expenditures. Capital expenditures returned to growth at 29.1% yoy, and they could positively affect economic growth in the coming months. On a negative note, the servicing of public and publicly guaranteed debt increased by 29.3% yoy. By contrast, spending on the state wage bill and social transfers payments fell by 18.9% yoy and 2.4% yoy, respectively due to the implementation of fiscal austerity measures last summer.

In May, the stock of medium and long-term external debt had grown by 2.9% since the beginning of the year (ytd) and stood at EUR 74.6 billion. The increase was driven by higher public external debt, while private external debt remained almost unchanged. Specifically, the former posted 6.4% ytd growth and reached EUR 28.5 billion, while private external debt (including non-residents deposits) marginally grew by 0.8% ytd and settled at EUR 46 billion. Accordingly, total external debt – including short term external debt totaling EUR 20.2 billion – inched up 4.2% ytd and reached EUR 94.7 billion or 72% of projected full year GDP.

Monetary Policy







In June, the growth of consumer prices decelerated for the first time since the beginning of the year. In particular, the rise in the CPI slowed down to 7.9% yoy from a 8.4% yoy increase registered in the previous month. The deceleration was primarily explained by lower growth of food prices, while the increase in prices of non-foods and services remained almost unchanged. Indeed, despite the surge in international food prices – up by 39% yoy according to the FAO Food price index, which measures prices of bundles of major food commodities – domestic food prices decelerated to 9.8% yoy from double-digit expansion, notably 11.2% yoy in May. Specifically, the disinflation in food prices reflected subdued demand and sound domestic production. Meanwhile, the growth of price of non-foods remained stable at 7.7% yoy, while rise in prices of services slightly accelerated to 4.8% yoy from 4.7% yoy in May. In spite of minor acceleration, prices of services continued to post significantly lower growth than at the end of 2010, which might be explained by some appreciation of the RON against the Euro (down by 1.2% ytd).

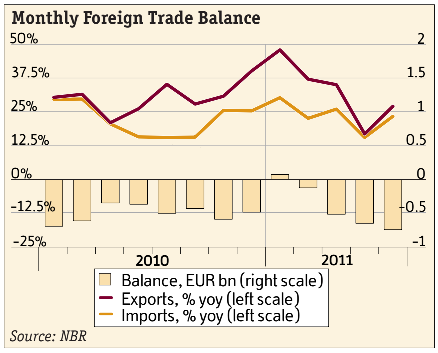
Given current dynamics of consumer prices and the favorable base effect as a result of the fading of the VAT rate effect since July, the growth of consumer prices should decelerate in the coming quarters. In addition, the presence of a negative output gap should exert additional downward pressure on domestic consumer prices and should therefore help to restore the disinflationary trend in the second half of the year. Accordingly, the CPI is expected to reach 4.8% yoy at the end of the year, which is in line with the National Bank of Romania (NBR) official forecast of 4.6% yoy. At the same time, the expected consumer inflation exceeded the upper bound of the inflationary target (4.0% yoy) set by the NBR. The National Bank of Romania continued to provide stable monetary policy aiming to anchor inflationary expectations and thus revive the disinflationary trend. Accordingly, the NBR kept its policy rate unchanged at 6.25% per annum for the sixteenth consecutive month.

The growth of money supply measured as M2 was kept on a downward trend since the beginning of the year. In fact, the rise in M2 decelerated to 2.0% in June compared with 6.4% yoy growth registered in January. The slow-down occurred on the back of a fall in narrow money aggregate M1 (down by 0.6% yoy), which consists of currency in circulation and overnight deposits. Likewise, slower growth of deposits with maturity up to two years (up by 3.8% yoy) also led to deceleration in overall expansion in M2. At the same time, the stock of non-government loans posted mild 1.3% yoy growth amid rising credit accumulation in both domestic (up by 0.9% yoy) and foreign currency (up by 1.6% yoy), respectively. Nevertheless, the growth rate of non-government loans in nominal terms was exceeded by higher consumer inflation, which should translate into negative real expansion in credit activity.

International Trade and Capital

During the first five months of the year, the merchandise trade in FOB-FOB terms continued to contract. In particular, the trade deficit in goods shrank by 24% yoy and settled at EUR 2.0 billion or 1.5% of projected full year GDP. The improvement was achieved thanks to sound dynamics of merchandise exports and relatively moderate import expansion. Specifically, exports in goods were up by 32% to EUR 18.2 billion in January-May even though the rate of export growth was kept on a downward trend during the first four months of the year. However, the rise in exports rebounded in May and accelerated to 27% yoy from a 17% yoy increase a month ago. Likewise, merchandise imports closely followed the pattern of export dynamics and grew by 23.2% yoy during the first five months of the year and reached EUR 20.2 billion.

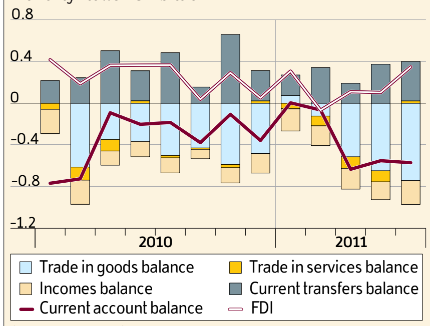
In January-May, the rise in merchandise exports reflected higher demand from foreign buyers for domestic transport equipment and vehicles (up by 30.5% yoy), and industrial raw materials and manufactured goods (up by 27% yoy). These two groups of goods maintained their leading role in exports' overall expansion since they made up 67% of the total increase in merchandise exports. Romanian exports were primarily affected by Eurozone demand, since the country shipped 72% of its total exports to other EU members. Accordingly, the consequences of sovereign debt turmoil in the Eurozone might hinder the demand of its core members and therefore constrain Romania's export potential in the coming months. Meanwhile the growth of exports outside the EU was registered at a steeper rate of 40% yoy, however it could be explained by a favorable statistical base effect. In January-May, stronger imports in goods were fueled primarily by those groups of products that were used for further exports, since merchandise imports closely followed export dynamics, while domestic demand remained weak. Indeed, higher purchases of foreign transport equipment and vehicles (up by 21% yoy), and industrial raw materials and manufactured goods (up by 22% yoy) made up about 58% of the overall rise in imports.



Monthly Foreign Trade Balance

Source: NBR

During the first five months of the year, the current account balance slipped to a deficit totaling EUR 1.8 billion or 1.4% of projected full year GDP. In particular, the current account deficit narrowed by 38% yoy thanks to a lower deficit in both trade in goods and services, respectively, coupled with a higher surplus in current transfers. Specifically, the latter posted 86% yoy growth and settled at EUR 1.5 billion on the back of stronger inflows of current transfers from the government sector. Meanwhile, the deficit in trade in services fell by 10% yoy and stood at EUR 0.3 billion. By contrast, the deficit in current incomes widened by 31% yoy to EUR 1 billion amid higher incomes from equity and debt earned by foreign investors due to the recovering economy. At the same time, net inflows of FDI covered 44% of the current account deficit compared with 36% a year ago, even though the former declined by 23% yoy to EUR 0.8 billion.



Current Account Components
monthly flows EUR billion

Source: NBR, INNSE

In July, the international resources of the National Bank of Romania dropped by 3.8% mom and stood at EUR 36.4 billion. The decline was led by stronger outflows of foreign currency (EUR 3.1 billion), which exceeded inflows (EUR 1.4 billion). Specifically, the higher than average outflows reflected the servicing of public and publicly guaranteed debt, especially EUR 2.6 billion of payments for internal public debt denominated in Euro. Finally, the Romanian currency (leu) remained stable at RON 4.24 per Euro after 2.7% mom depreciation, which was registered a month ago amid fears of financial uncertainty coming from Greece.

Other Developments Affecting the Investment Climate

Romania continued to cooperate with international financial institutions. Specifically, under the Stand-By Arrangement program, IMF and European Commission teams visited Romania to assess the performance of the program and provide its quarterly review. According to the teams' conclusion on August 1st, the implementation of structural reforms – which should help reduce the consolidated fiscal deficit and support economic growth this year – remained on track. Meanwhile, the joint mission emphasized the further reduction of the fiscal gap to 3% of projected full year GDP in 2012 as an important prerequisite for the improvement of the country's credibility. To achieve this goal, the mission advised the Romanian government to focus on enhancing revenue collections, optimizing state expenditures and improveming social transfers directed to the poor and vulnerable. Additionally, the team recommended modernizing state-owned enterprises to upgrade their efficiency so that those companies will support economic growth rather than restrain it.

During July, the Government attempted, unsuccessfully, a Secondary Public Offer for 9.84% of OMV Petrom, the largest industrial company on the Bucharest Stock Exchange, with a market capitalization of EUR 5.1 billion. In order to be successful, the offer should have closed with the sale of at least 80% of the shares. The offer was affected by the turbulence on the international financial markets and by small discount to the market price of the offer price. At the minimum price fixed by the government, of RON 0.3708 per share, the discount to the market was only 2.7%. The offer was managed by a consortium led by Russian investment bank Renaissance Capital and was part of privatization plans in the energy sector agreed by the government with IMF as part of the Stand-By Agreement.