Romania
Macroeconomic Situation

October 2011

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- **The industrial production index grew by 10.3% yoy in August.**
- **In January-September, the consolidated budget deficit shrank by 41% yoy to EUR 3.3 billion, or 2.5% of projected full year GDP.**
- **CPI was up by 3.5% yoy in September.**
- **In January-August, the merchandise trade deficit in FOB-FOB terms narrowed by 11.6% yoy to EUR 3.4 billion.**
- **The current account deficit contracted by 20% yoy in January-August and settled at EUR 3.3 billion, or 2.5% of projected full year GDP.**
- **Romania was ranked 72nd out of 183 countries in the World Bank's *Doing Business* report.**

Executive Summary

In August, the growth of industrial production reached double-digits, registering at 10.3% yoy after temporarily slowing down over the previous two months. Stronger dynamics of industrial output were fueled by external demand as export-oriented sectors enjoyed a solid pace of expansion. In contrast, domestic oriented industries demonstrated uneven dynamics, which put downward pressure on the overall growth of industrial output. On a positive note, the construction sector is likely to post its first growth in quarter over quarter terms since January-March of 2009, given the solid expansion observed in July and August. At the same time, domestic demand continued to remain weak as volume of retail sales dropped by 3.9% yoy in August.

In January-September, the consolidated budget deficit narrowed by 41% yoy and stood at EUR 3.3 billion or 2.5% of full year GDP, compared with 4.5% of 2010 GDP during the same period of last year. The improvement was led by stronger growth of state revenues (up by 9.3% yoy) that exceeded the pace of expansion of government spending (up by 1.1% yoy) thanks to fiscal retrenchment. Specifically, rising proceeds from indirect and direct taxes, coupled with stronger transfers from the EU budget, explained higher government income. On the expenditure side, the increase in state expenditures was supported by an increase in spending on infrastructure projects and goods and services. Meanwhile, a declining state wage bill and social transfers payments helped offset the overall growth of state expenditures. As a result, the annual consolidated budget deficit is forecasted to reach 4.6% of projected full year GDP this year, with contraction to 3% of projected full year GDP in 2012.

In September, the growth of consumer prices continued to slow down and reached 3.5% yoy. The deceleration reflected flatter growth of food prices (up by 1.7% yoy) on the back of abundant crops and dissipation of the VAT rate effect. On the contrary, the growth of prices of non-foods and services showed opposite dynamics as the latter remained almost stable at 4.8% yoy, while the former grew by 3.5% yoy. Taking into account the dissipation of a favorable base effect and the negative output gap, consumer prices are projected to increase by 4.6% yoy at the end of the year, which is higher than the upper bound of the inflation target (4.0% yoy). To provide stable monetary policy, the National Bank of Romania continued to maintain its key policy rate unchanged at 6.25% per annum for the seventeen month in a row.

During the first eight months of the year, the current account deficit shrank by 20% yoy and settled at EUR 3.3 billion, or 2.5% of projected full year GDP compared with 3.4% of 2010 GDP during the same period of last year. The contraction was driven by a lower merchandise trade deficit in FOB-FOB terms, which narrowed by 12% yoy and reached EUR 3.4 billion. Additionally, the growth of current transfers also contributed to the lower current account deficit. By contrast, the widening deficit in trade in services and current incomes partially offset the contraction of the current account deficit. Meanwhile, net FDI inflows fell by 48% yoy to EUR 1.1 billion and covered 34% of the current account deficit.

Romania moved down by 7 spots in the "Doing Business" ranking and was 72nd among 183 countries. The deterioration reflected worse performance in starting a business, trading across borders, registering property, paying taxes, enforcing contracts, protecting investors, obtaining electricity, and dealing with construction permits. On a positive note, improvement was seen in the insolvency proceedings category.

	2007	2008	2009	2010	2011f	2012f
GDP growth, % change yoy	6.3	7.1	-7.2	-1.3	1.6	2.0
Industrial production, % change yoy	5.4	0.9	-5.5	5.5	5.3	5.5
Consolidated budget balance, % of GDP	-2.4	-4.8	-7.2	-6.5	-4.6	-4.0
Unemployment (ILO), end of period	6.2	5.8	7.5	7.3	7.5	7.0
Inflation, end of period	6.56	6.30	4.75	8.0	4.6	3.8
Retail sales, % change yoy	17.8	13.0	-8.5	-5.3	-3.0	4.0
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	-5.5	-6.7
Total gross external debt, EUR billion	58.6	72.4	78.7	90.8	97.0	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

Where Opportunities Emerge.

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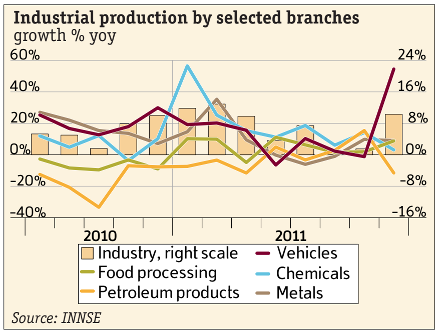
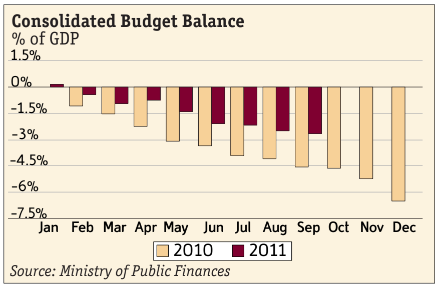
Economic Growth



In August, industrial output resumed its sound double-digit rate of expansion after a temporary slow-down over the previous two months. Indeed, the index of industrial production grew by 10.3% yoy, compared with a 1.5% yoy average increase in June-July. The improvement was supported by buoyant performance of export-oriented sectors thanks to a sound 24% yoy expansion in merchandise exports. As a result, the production of vehicles and machinery and equipment surged by 55% yoy and 25% yoy, respectively. In contrast, weaker performance of domestic oriented sectors restrained the growth of industrial output during the month. Indeed, production of chemicals inched up by a mere 3.1% yoy from 10.1% yoy growth in June-July, while production of petroleum products dropped by 12% yoy compared with an average 9.1% yoy expansion registered during these months. On a positive note, the increase in food processing accelerated to 8.8% yoy and positively contributed to stronger growth of industrial production.

In August, the construction sector continued to support domestic demand, although at a slower rate. In fact, the index of construction works inched up by 6.3% yoy and, together with the 16% yoy growth observed in July, should produce the first expansion in quarter over quarter terms since January-March of 2009. During the month, all components posted growth – new construction works (up by 6.7% yoy), repair works (up by 4.6% yoy) and maintenance works (up by 6.5% yoy). The improvement reflected higher capital spending from the state budget on infrastructure projects. At the same time, domestic demand remained subdued as the volume of retail sales fell by 3.9% yoy. The decline was driven by lower sales of foods (down by 9.2% yoy), despite the strong harvest of fruits and vegetables, and non-foods (down by 2.7% yoy).

Fiscal Policy



During the first three quarters of the year, the consolidated budget posted EUR 3.3 billion or 2.5% of projected full year GDP, a 41% yoy contraction from the same figure last year, when the deficit for the period stood at 4.5% of the 2010 GDP. The implementation of fiscal austerity measures remained the key factor explaining the contraction of the state budget deficit. Specifically, the growth of government revenues totaling EUR 31.3 billion (up by 9.3% yoy) outpaced the increase in state expenditures in the amount of EUR 34.6 billion (up by 1.1% yoy) thanks to fiscal retrenchment. However, the favorable base effect should dissipate in the coming months and therefore should restrain growth of government income and promote expansion in state spending. Accordingly, the consolidated budget deficit is expected to reach about 4.6% of projected full year GDP, compared with a 6.5% of GDP fiscal deficit registered in 2010. Romania needs to reduce its consolidated budget deficit to 3.0% of projected full year GDP in the next year according to the Stand-By Arrangement program with IMF. However, this task might be challenging since the government is likely to restrain further fiscal austerity measures due to the local elections in 2012. The government has delayed the presentation of the 2012 Budget Law in order to discuss the budget with the IMF at the meeting planned for the end of October. The 2012 budget will mark the move to ESA95 for the general government accounts from the current cash system. While at the previous IMF review the government committed to a 3.0% budget deficit under ESA95 it remained to be determined at the end-October review what would it represent in terms of a cash budget deficit. According with the IMF, it is likely that the cash deficit would be 0.5%-1.0% of the GDP below the ESA95 deficit.

In January-September, the growth of state income was underpinned by the solid performance of collections from indirect taxes. In fact, proceeds from the VAT and excises posted 25% yoy and 13% yoy growth, respectively, even though the VAT rate effect dissipated in July. On a positive note, receipts from direct taxes began to resume their growth after the implementation of the new labor legislation. Indeed, collections from wage and income tax, social security and health care contributions, coupled with proceeds from the corporate profit tax, inched up by 3.4% yoy, 8.7% yoy and 1.9% yoy, respectively. In addition, transfers from the EU budget continued to surge, notably by 53% yoy, and also contributed to the overall growth of state revenues. On the expenditure side, growing state expenditures reflected higher capital investments on public infrastructure (up by 16% yoy). In addition, budget spending on goods and services grew by 6% yoy, while spending on the servicing on the public and publicly guaranteed debt increased by 26% yoy. Meanwhile, social transfers payments and the state wage bill continued to fall by 1.2% yoy and 14.1% yoy, respectively, although the pace of decline has significantly changed. Indeed, social transfers payments dropped by 2.4% yoy over the first half of the year, but grew by 1.2% yoy in July-September, since the base effect of the reduction in state transfers by 20% dissipated in July. Similarly, spending on the state

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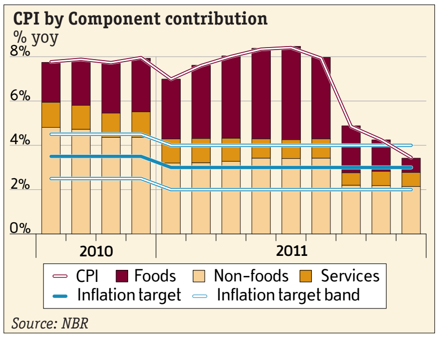
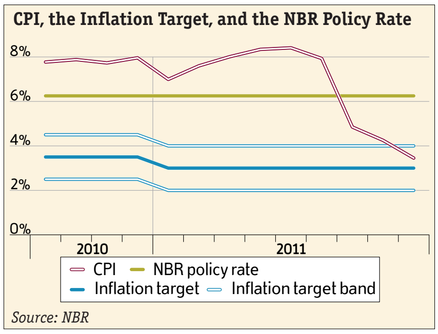
wage bill fell by 2.3% yoy during the last three months, while they shrank by 19% yoy in the first half of the year as the government cut public wages by 25% in July 2010.

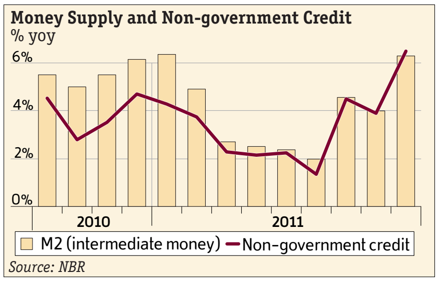
Monetary Policy

In September, consumer disinflation continued to be registered for the fourth month in a row. Indeed, the rise in CPI significantly decelerated to 3.5% yoy from an 8.4% yoy peak observed in May. The slowdown was underpinned by flatter growth of food prices as their pace of expansion dropped by 8 p.p. to 1.7% yoy in September. Even fixing the dissipation of the VAT rate effect, the growth of food prices continued to decelerate thanks to an abundant domestic harvest, especially for vegetables, and weak domestic demand. Accordingly, food prices made up only 19% of overall growth of consumer prices in September, compared with 50% in May. In contrast, prices of non-foods and services demonstrated opposite dynamics. In particular, the non-foods prices remained almost flat after the VAT rate effect faded in July, as they posted 4.8% yoy growth in September amid strong industrial prices. At the same time, the prices of services inched up by 3.5% yoy, which is close to the third quarter monthly average level.





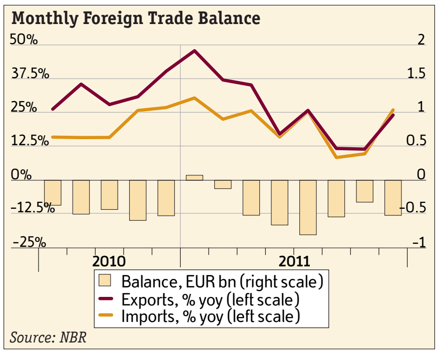
Consumer prices should bounce back to growth in the coming months as the favorable difference between domestic and international food prices is likely to diminish. In contrast, the presence of the negative output gap and a fading VAT rate effect remain major factors that should exert downward pressure on consumer prices and therefore limit further growth. Accordingly, consumer inflation is expected to reach 4.6% yoy, which is above the upper band of the inflation target set by the National Bank of Romania (4.0% yoy). At the same time, the NBR kept its key policy rate unchanged at 6.25% per annum for the seventeenth consecutive month, aiming to provide stable monetary policy to anchor inflationary expectations. Despite a relatively high interest rate, the National Bank of Romania argued that its reduction was hampered by uncertainty stemming from the Eurozone sovereign debt turmoil and administered prices.



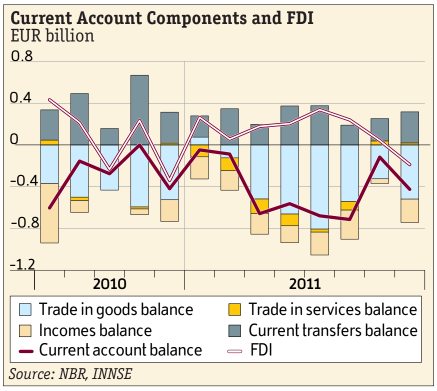
In September, the increase in monetary aggregates measured as M2 sped up to 6.3% yoy, from 4.0% yoy growth observed in the previous month. The steeper pace of expansion reflected stronger growth of deposits with maturity up to two years (up by 8.7% yoy) and currency in circulation (up by 9.8% yoy). Likewise, the stock of non-government credit advanced at a higher rate of 6.5% yoy due to stronger dynamics of forex (up by 8.3% yoy) and domestic denominated loans (up by 3.5% yoy).

International Trade and Capital

In January-August, the merchandise trade deficit in FOB-FOB terms shrank by 12% yoy and settled at EUR 3.4 billion. The contraction was driven by growing exports of goods, which expanded at a steeper pace than merchandise imports. Specifically, exports in goods advanced at a 25% yoy cumulative growth rate and reached EUR 29.3 billion, thanks to strong dynamics over the first quarter (up by 40% yoy), while export performance during second quarter was less buoyant (up by 18% yoy). In August alone, exports in goods posted solid 24% yoy growth on the back of rising demand from Eurozone countries (up by 28% yoy) despite the sovereign debt crisis. However, the uncertain outlook for external demand remained given the high share of Romanian exports shipped to other EU members – 71% of total merchandise exports. Taking into account the potential consequences of sovereign debt turmoil on the real sectors of the economy, the prospects for the EU's demand remain restrained in the short-term. Meanwhile, the rise in exports outside the EU decelerated to 17% yoy from 23% yoy expansion registered during the second quarter. At the same time, the imports of goods rose by 20% yoy and stood at EUR 32.7 billion during the first eight months of the year. Specifically, imports closely followed exports' dynamics, given the significant share of goods used for further re-export.



During the first eight months of the year, the current account balance slipped into a deficit. In fact, the current account deficit narrowed by 20% yoy and settled at EUR 3.3 billion, or 2.5% of projected full year GDP, compared with 3.4% of 2010 GDP during the same period of last year. A shrinking merchandise trade deficit continued to be a major factor for this improvement. In addition, the rising surplus in current transfers also contributed to the contraction of the current account deficit. The current transfers surplus rose by 20% yoy and reached EUR 2.2 billion amid rising funds from the EU budget. On the contrary, the rising trade in services deficit (up by 5% yoy to EUR 0.5 billion) partially offset the overall contraction of the current account deficit. Similarly, the deficit in current incomes totaling EUR 1.1 billion remained almost stable – down by 1% yoy. On a negative note, net inflows of FDI declined by 48% yoy to EUR 1.1 billion and covered 34% of the current account deficit.



Source: NBR, INNSE

In September, the stock of international reserves of the National Bank of Romania increased by 2.4% mom and stood at EUR 37.6 billion. The growth was explained by stronger inflows of foreign currency in the amount of EUR 2 billion, while outflows reached EUR 1 billion. In fact, strong inflows of foreign currency reflected appreciation of the U.S. dollar, the Japanese yen and the pound sterling against the Euro. In addition, lower payments for servicing public and publicly guaranteed debt helped reduce the outflows of foreign currency during the month. At the same time, the Romanian currency (leu) depreciated against the Euro by 3.1% mom amid turmoil in the region stemming from the concerns over Greece.

In August, medium and long-term external debt was up by 3.9% since the beginning of the year (ytd) and settled at EUR 75.6 billion. The growth was supported by public and publicly guaranteed external debt totaling EUR 29.7 billion, which was higher by 11% than in December. Specifically, the rise in public external debt was fueled by the issuing of EUR 1.5 billion Euro-dominated bonds in June. In contrast, private external debt remained stable (marginally down by 0.2% ytd) and stood at EUR 45.9 billion. Given the rising short-term external debt (up by 14% ytd to EUR 21.1 billion), total external debt inched up by 6% ytd and settled at EUR 96.7 billion, or 75% of projected full year GDP.

Other Developments Affecting the Investment Climate

The conditions for doing business in Romania deteriorated, according to the latest *Doing Business* ranking released by the World Bank. In fact, Romania moved down by 7 spots from the previous year to 72nd place among 183 countries. This decline was explained by worse performance in such categories as starting a business (down by 32 spots to 63), trading across borders (down by 23 spots to 72), registering property (down by 6 spots to 70), paying taxes (down by 3 spots to 154), enforcing contracts (down by 2 spots to 56), protecting investors (down by 2 spots to 46), obtaining electricity (down by 1 spot to 165), and dealing with construction permits (down by 1 spot to 123). Meanwhile, Romania remained one of the world's leaders in obtaining credit, as the 8th place ranking remained unchanged. On a positive note, Romanian officials lowered the duration of insolvency proceedings, which led to better performance in the resolving insolvency category – up by 12 spots to 97.

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