

August 2011
Sergii Pypko, RaduMihai Balan, Edilberto L. Segura

- Real GDP grew by 1.4% yoy during the second quarter of 2011.
- In January-July, the consolidated budget deficit shrank by 43% yoy to EUR 2.7 billion or 2.1% of projected full year GDP.
- CPI was up by 4.9% yoy in July.
- In the first half of the year, the merchandise trade deficit in FOB-FOB terms contracted by 22% yoy to EUR 2.5 billion.
- The current account deficit narrowed by 29% yoy over the first quarter and settled at EUR 2.6 billion, or 2.0% of projected full year GDP.

Executive Summary

Real GDP continued its recovery and posted 1.4% yoy growth for the second consecutive quarter after two years of contraction. The pace of expansion was lower than in the previous quarter (up by 1.7% yoy) due to weaker dynamics of the main growth driver – industrial output. Specifically, the index of industrial production slowed to 4% yoy in April-June from a 11.4% yoy increase during the first quarter. The deceleration reflected weaker global demand, which supported export-oriented industries. At the same time, the construction sector and retail sales continued to decline and therefore negatively impacted the real economy. On a positive note, the end of fiscal austerity measures in the second half of the year should support a stronger pace of the real GDP growth due to a favorable base effect. As a result, the Romanian economy is expected to expand at 1.6% yoy annual growth in 2011.

In January-July, the consolidated budget deficit shrank by 43% yoy and stood at EUR 2.7 billion or 2.1% of projected full year GDP. The improvement was achieved thanks to rising government incomes, while state expenditures remained almost unchanged. Stronger government revenues were fueled primarily by rising receipts from VAT, excises and higher transfers. At the same time, the government increased capital expenditures and spending on goods and services. In contrast, lower spending on the state wage bill and social transfers payments helped to partially offset the overall expansion in government expenditures.

In July, the growth of consumer inflation decelerated to 4.9% yoy from a 7.9% yoy-increase a month ago. The disinflation was achieved thanks to the fading of the VAT rate effect, a strong harvest and weak domestic demand. Taking into account

the expected easing of consumer inflation in the second half of the year, the CPI is projected to reach about 4.8% yoy at the end of 2011. Meanwhile, the National Bank of Romania (NBR) continued to provide stable monetary policy to anchor inflationary expectations and mitigate domestic and external risks for the inflationary outlook. The NBR kept its key policy rate unchanged at 6.25% pa for the sixteenth consecutive month.

In the first half of the year, the current account deficit contracted by 29% yoy and reached EUR 2.6 billion or 2.0% of projected full year GDP. The narrowing was supported by a lower merchandise trade deficit and a stronger surplus in current transfers. Specifically, the deficit in trade in goods in FOB-FOB terms shrank by 22% yoy and stood at EUR 2.5 billion amid rising merchandise exports. However, the higher deficit in trade in services and current incomes exerted upward pressure on the current account deficit. The net inflows of FDI totaling EUR 1.0 billion fell by 17% yoy and covered 39% of the current account deficit. Concurrently, the total external debt grew by 6.5% ytd to EUR 97.1 billion or 73.7% of projected full year GDP amid rising public external debt.

Fitch pointed out the main risks of the Romanian sovereign rating, which has been recently upgraded to investment grade BBB-. The list of risks includes the rebound of lending in foreign currency, potential deviation of the implementation of fiscal consolidation heading into 2012 elections and rising risks associated with the exchange rate. In addition, the agency mentioned that higher consumer inflation could be a main obstacle for the adoption of the exchange rate mechanism (ERM II) in 2012.

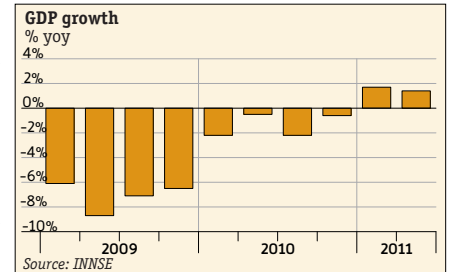
	2007	2008	2009	2010	2011 ^f	2012 ^f
GDP growth, % change yoy	6.3	7.1	-7.2	-1.3	1.6	3.3
Industrial production, % change yoy	5.4	0.9	-5.5	5.5	5.0	5.5
Consolidated budget balance, % of GDP	-2.4	-4.8	-7.2	-6.5	-5.0	-4.0
Unemployment, end of period	4.1	4.4	7.8	6.9	7.0	6.5
Inflation, end of period	6.56	6.30	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	-6.3	-7.5
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

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Economic Growth

The Romania economy continued to expand for the second consecutive quarter after two years of recession. In fact, real GDP grew by 1.4% yoy during the second quarter according to the National Institute of Statistics' preliminary press release. The rise in GDP decelerated from the 1.7% yoy increase that was registered in the previous quarter. Despite the slow-down, the dynamics of GDP growth is expected to be more buoyant in the third and fourth quarters due to the favorable base effect as fiscal austerity measures will dissipate in the second half of the year. On a negative note, the slow-down of the Eurozone growth in the second quarter and the consequences of the sovereign debt turmoil should exert downward pressure on Romanian exports in the coming months. Accordingly, real GDP is forecasted to increase by 1.6% yoy in 2011, which is close to the IMF (1.5% yoy) and EBRD (1.9% yoy) projections.

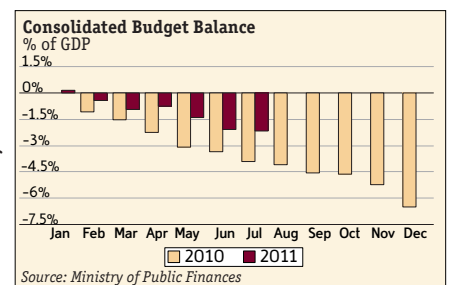


In the second quarter, slower GDP growth reflected weaker dynamics of its main driver, notably industrial production. Indeed, the index of industrial production posted mild 4.0% yoy growth compared to the sound double-digit (11.4% yoy) expansion registered in January-March. The decelerated growth of industrial output was explained by weaker dynamics of export-oriented industries amid restrained global demand for Romanian goods. Indeed, the growth of production of vehicles, chemicals and machinery in April-June was registered at 2.2% yoy, 11.9% yoy and 7.6% yoy in April-June, respectively, and was significantly lower than during the first quarter. By contrast, domestic oriented sectors were more resilient to the slowdown of industrial production during the second quarter. In particular, food processing posted 6.4% yoy in April-June – despite being on the downward trend since April – compared with 4% yoy growth during the first quarter. Finally, both non-manufacturing sectors, namely mining and quarrying and utilities advanced at stronger growth rates than the manufacturing sector (up by 3.2% yoy) – up by 11.9% yoy and 7.8% yoy, respectively.

In April-June, the construction sector and retail sales continued to lag behind last year's levels. Specifically, the index of construction works declined by 5.4% yoy compared with a 4.4% yoy fall in the previous quarter. The deterioration was led by a weaker index of new construction (down by 9.2% yoy), while a rising index of maintenance and current repairs works (up by 5.1% yoy) partially offset the overall contraction of the index of construction works. Despite recent attempts by the Ministers of Transport and Regional Development to stimulate public projects, their efficiency could remain low. Thus, the construction sector will likely decline in the coming months in spite of local elections in 2012. Similarly, the volume of retail sales declined at a steeper rate than in the first quarter. In particular, the index of retail sales dropped by 5.9% yoy from the 5.7% yoy decline registered in January-March. The decrease was driven by lower sales of foods and non-foods – down by 8.7% yoy and 4.9% yoy, respectively.

Fiscal Policy

During the first seven months of the year, the consolidated budget balance slipped to a deficit. Specifically, the consolidated budget deficit narrowed by 43% yoy and reached EUR 2.7 billion or 2.1% of projected full year GDP. The contraction was driven by stronger state revenue dynamics, which substantially outpaced government expenditures. While state income advanced to 9.4% yoy and settled at EUR 24.4 billion, government spending totaling EUR 27.1 billion was just 0.1% higher than a year ago. However, the pace of contraction of the budget deficit should ease in the coming months as the fiscal retrenchment effects fade in the second half of the year. In addition, the government adopted the amendments to the state budget to promote investments and reduce the arrears of state companies. As a result, the annual consolidated budget deficit is projected to reach 5.0% of projected full year GDP, which is somewhat higher than the IMF's target 4.4% of GDP.



In January-July, proceeds from indirect taxes preserved their leading role in driving the growth of government revenues. In fact, receipts from VAT and excises advanced to 31% yoy and 22% yoy, respectively. The former benefitted from implementation of fiscal austerity measures, notably the hike in the VAT rate. At the same time, the stronger proceeds from excises reflected the convergence of domestic rates with Eurozone excises rates. However, given the dissipation of the VAT rate effect, their contribution is expected to be less buoyant in the second half of the year, while stronger proceeds from excises should be preserved. By contrast, collections from the main group of direct taxes stood at the same level as last year. In addition, stronger transfers from the European Union (up by 37% yoy) supported overall growth of state incomes. Meanwhile, social security and health care contributions were up by 4.1% yoy due to a decrease in the number of registered unemployed by 36% yoy to 435,961 as of the end of July 2011.

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

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In January-July, the mild growth of state expenditures was underpinned by higher capital expenditures (up by 16.5% yoy) and rising spending on goods and services (up by 11.5% yoy). On a positive note, the government supported investment into infrastructure projects, which should support economic growth. Concurrently, the servicing of public and publicly guaranteed debt increased by 27% yoy, which also contributed to higher overall government spending. On the contrary, government spending on the state wage bill (down by 17.8% yoy) and social transfers payments (down by 2.4% yoy) declined as a consequence of the fiscal retrenchment.

Monetary Policy

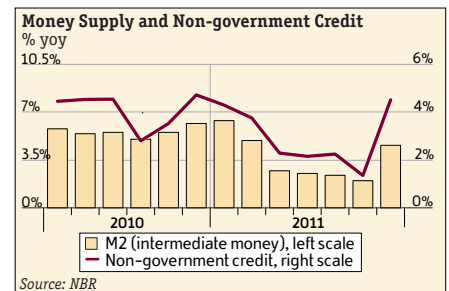
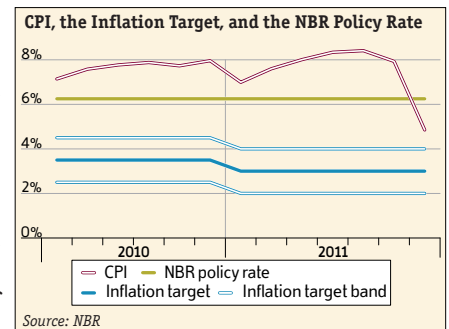
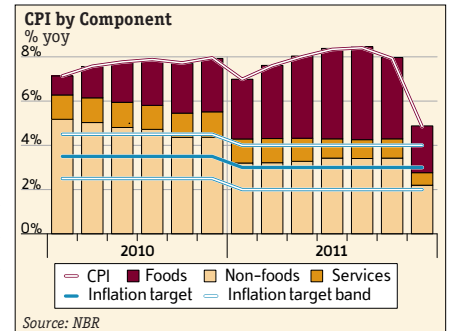
In July, the growth of consumer prices significantly decelerated. Specifically, CPI inched up by 4.9% yoy compared with a 7.9% yoy-increase registered in the previous month. The slow down primarily reflected the dissipation of the VAT rate effect, since the government raised the VAT rate by 5 p.p. in July 2010. Accordingly, consumer inflation reached approximately the same level as was registered before implementation of this one-off policy – in June 2010 CPI was up by 4.4% yoy. Food prices remained the major driver of consumer prices, since they made up 43% of the overall CPI expansion. In fact, the rise in food prices decelerated to 5.7% yoy from 9.8% yoy thanks to a favorable statistical base effect, strong harvest and subdued domestic demand. Accordingly, food prices have been on a disinflationary trend since May 2011 despite upward pressure from the international markets. Indeed, the FAO index – which measures the international prices of the most essential foodstuffs – remained around the historical high, which was registered in February of 2011, and grew by 39% yoy in June 2011. Meanwhile, the increase in prices of non-foods and services also slowed after the end of the VAT rate effect. In particular, the former inched up by 5.0% yoy compared with 7.7% yoy a month ago. Likewise, the prices of services posted the slowest growth rate, notably at 3.1% yoy, which was significantly lower than the 4.8% yoy growth that was registered in June.

The rise in consumer prices is expected to moderate in the second half of the year and reach around 4.8% yoy as of the end of 2011. Indeed, the dissipation of the VAT rate effect, presence of the negative output gap, better outlook for domestic harvest and the easing of oil prices should exert downward pressure on domestic prices. Accordingly, the National Bank of Romania (NBR) downgraded end-of period inflation by 0.5 p.p. to 4.6% yoy, which is close to our forecast. On the other hand, there are a few domestic and external risks, which might exert upward pressure on the CPI in the coming months. Among major domestic risks, the NBR pointed out potential hikes in administered prices and possible deviation from fiscal austerity measures on the eve of the 2012 local elections. On the other hand, the consequences of the EU's sovereign debt crisis might create uncertainties regarding capital flows to Romania. Moreover, the surging demand for international commodities coming from the emerging markets might exert upward pressure on domestic consumer prices as well. Under these circumstances, the NBR tried to anchor inflationary expectations by providing stable monetary policy. For this purpose, the National Bank of Romania maintained its key policy rate unchanged at 6.25% per annum for the sixteenth month in a row. However, the NBR might switch to loose monetary policy and cut interest rates in the coming months if the disinflationary trend persists.

In July, the growth of the money supply measured as M2 accelerated for the first time this year, inching up to 4.6% yoy compared with a 2.0% yoy increase observed in June. Stronger growth was fueled by rising currency in circulation (up by 5.8% yoy), overnight deposits (up by 1.7% yoy) and deposits with maturity up to two years (up by 5.6% yoy). Similarly, the rise in the stock of non-government loans sped up to 4.5% yoy from 1.3% growth in June, primarily due to stronger dynamics of loans denominated in foreign currency (up by 6.2% yoy).

International Trade and Capital

During the first six months of the year, the trade in goods deficit in FOB-FOB terms continued to shrink. In fact, the merchandise trade deficit contracted by 22% yoy and stood at EUR 2.5 billion. The narrowing reflected rising exports in goods, which outpaced growing merchandise imports. Specifically, the merchandise exports were up by 28% yoy and reached EUR 22.0 billion thanks to



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sound expansion over the first quarter (up by 40% yoy). By contrast, the growth of exports in goods significantly decelerated to 19% yoy during the second quarter. At the same time, the imports in goods behaved similarly to merchandise exports and increased by 20% yoy, reaching EUR 24.5 billion.

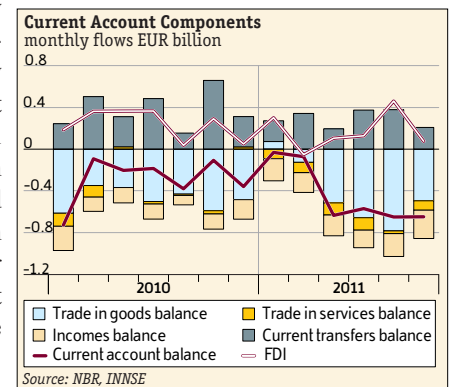
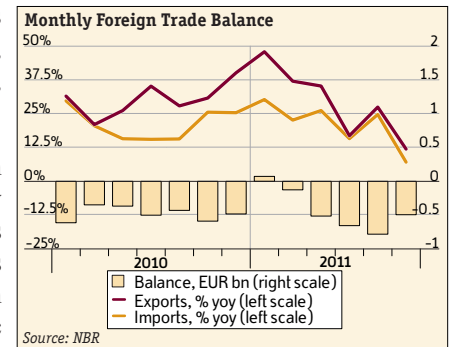
In the first half of the year, stronger exports in goods were underpinned by higher foreign demand for Romanian transport equipment and vehicles (up by 25% yoy), and industrial raw materials and manufactured goods (up by 25% yoy). On the geographical side, Romania's exports continued to be primarily shaped by Eurozone demand, since almost three quarters of overall exports were shipped to other EU members. Accordingly, the growth of Romanian exports decelerated on the back of the sovereign debt crisis, which impacted the economic growth of core EU members, especially Germany. Indeed, Germany's economy inched up by a mere 0.1% yoy during the second quarter compared with 1.3% yoy expansion in January-March. By contrast, Romanian exports outside the Euro area enjoyed higher growth, notably 37% yoy, compared with 25% yoy growth of exports shipped inside the Euro area. This might be explained by a higher pace of expansion in emerging countries and a favorable statistical base. Meanwhile, imports of goods closely followed merchandise exports' growth pattern since the main drivers were used for further export. In particular, industrial raw materials and transport equipment and vehicles increased by 20% yoy and by 16% yoy, respectively. In addition, appreciation of the Romanian currency against the Euro during the second quarter (down by 1.1% yoy) should also support the growth of imports in goods. However, the tight incomes of households restrained domestic demand and therefore exerted downward pressure on merchandise imports.

In January-June, the current account balance slipped to a deficit. Specifically, the current account deficit stood at EUR 2.6 billion or 2% of projected full year GDP, which was 29% yoy lower than a year ago. The improvement was achieved thanks to a lower merchandise trade deficit and rising current transfers surplus. The latter advanced to 63% yoy and reached EUR 1.7 billion on the back of higher transfers from the EU budget. By contrast, the rising deficit in the trade in services and current incomes partially offset the overall contraction of the current account deficit. While the deficit in trade in services was up by 7.3% yoy and settled at EUR 0.5 billion, the deficit in current incomes grew by 27% yoy to EUR 1.3 billion. The latter's growth was supported by stronger incomes from equity and debt, which were earned by foreign investors amid recovering economic growth. Concurrently, lower inflows of FDI (down by 17% yoy to EUR 1.0 billion) funded 39% of the current account deficit, compared with 34% in the previous year.

In June, the stock of medium and long-term external debt had increased by 4.0% since the beginning of the year (ytd) and reached EUR 75.7 billion. The growth was led by higher public external debt, which rose by 12.1% ytd to EUR 30.1 billion. In particular, higher direct public debt was driven by the recent issuing of Euro-denominated bonds in the amount of EUR 1.5 billion. By contrast, private external debt, which includes non-residents' deposits, marginally declined by 0.8% ytd and reached EUR 45.6 billion. Taking into account short-term external debt in the amount EUR 21.5 billion, total external debt was up by 6.5% ytd and stood at EUR 97.1 billion or 73.7% of projected full year GDP.

Other Developments Affecting the Investment Climate

Fitch issued a report indicating the main risks that might adversely affect the sovereign country rating after the recent upgrade to investment grade BBB-. Among these factors was the revival of lending in foreign currency, potential slippage of the implementation of fiscal austerity measure before the election in 2012 and growing risks associated with the exchange rate. Moreover, Fitch pointed out that the high level of consumer inflation might lead to a rise in the interest rate as the National Bank of Romania will try to mitigate inflationary pressure. Accordingly, the high level of inflation could prevent implementation of the exchange rate mechanism (ERM II) in 2012 as a necessary step toward Euro adoption. Similarly, IMF officials, notably IMF desk chief Jeffrey Frank, mentioned that the NBR might increase its key policy rate to curtail rising prices.



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