Summary

- In January-September, real GDP declined by 7.4% year-over-year (yoy).
- The downturn in industry decelerated to 8.5% yoy in the first nine months of the year.
- The budget deficit increased to 5.1% of full-year projected GDP in January-October 2009.
- International financial institutions (IFIs) have postponed disbursement of the third tranche to Romania, scheduled for November-December, thus making the central bank's policy critical for the government's financing.
- During February-November 2009, the RON/EUR exchange rate demonstrated only small fluctuations around 4.2 RON/EUR.
- Headline inflation decelerated to 4.3% yoy in October, turning back to the 3.5±1% band set under the inflation targeting regime.
- Credit to the non-government sector grew by a modest 4.2% yoy in October, slightly accelerating from 2.4% yoy in the previous month.
- In January-September, the FOB/CIF trade deficit decreased by 2.4 times yoy to EUR 7 billion.
- On December 6th, 2009, Trian Basescu won the presidential elections with 50.33% of the votes.

Economic growth

Romania’s real GDP fell by 7.1% yoy in the third quarter of 2009, moderating from an 8.7% yoy contraction reported in the previous quarter. External demand was the main factor behind this improvement. Exports recovered from an average 20% yoy plunge during the first half of the year to a lower decline of 15% yoy in the third quarter. As a result, the contraction of industrial production moderated to 4.2% yoy in the third quarter, against 8.2% yoy and 13% yoy drops in the previous two quarters. Further strengthening of external demand backed by fiscal stimulus is expected to lead to slight industrial growth in the next quarter.

Domestic demand has remained weak, restrained by anemic bank lending and growing unemployment. In contrast to the improved performance of export-driven industries, the service and construction sectors continued to report large declines. Retail sales shrunk by 12% yoy in the third quarter, only slightly better than the 14% yoy drop in the second quarter, reflecting a dramatic contraction of domestic consumption. The volumes of construction activities declined by 21% yoy in the third quarter, deteriorating further from a 15% yoy contraction posted in the previous quarter.

In the first nine months of the year, the cumulative contraction of real GDP totaled 7.4% yoy, compared to 7.6% yoy in the first half of the year. Given the low-base effect for the fourth quarter, the GDP decline is likely to approach 7.5% yoy in 2009, which is better than the 8-8.5% yoy negative correction expected by the government and the IMF.

Fiscal Policy

Fiscal budget consolidation remained a critical policy issue, as the consolidated budget deficit for January-October 2009 increased to 5.3% of projected full-year GDP and is likely to increase further above the targeted 7.3% of GDP in 2009. The widening of the fiscal deficit was due to high public spending, propelled by public debt servicing and social security spending, and to shrinking budget revenues.

However, in October, fiscal performance reported some improvements, as the budget balance returned to a small surplus on the back of stronger tax collections and some cuts in expenditures. Total budget revenues shrank by real 8.1% yoy in October (from an 8.9% yoy drop in January-September). At the same time, consolidated budget expenditures decreased by real 13.6% yoy in October following a 25% yoy cut in public investments. Social spending remains high due to a pension hike on the eve of the previous year’s parliamentary elections, which continues to exert heavy pressure on the expenditure side of the budget.

Growing budget financing needs spurred the stock of public debt, which surged by 35% yoy in euro equivalent as of September, up to EUR 33.4 billion (28% of full-year projected GDP). The stock of external public debt picked up by 27% yoy in September on the back of a EUR 1.5 billion transfer from the European Union received in July and a EUR 0.9 billion transfer from the IMF received in September as a part of
of the second tranche under the stand-by agreement. The external financing of the budget gap helped to temporarily ease the pressure of higher domestic debt and the crowding out of banking lending.

At the same time, the further widening of the budget deficit in the fourth quarter demands significant additional financing, as the budget gap is expected to exceed 7.3% of GDP in 2009. And the additional financing is most likely to be provided domestically, as the IMF, the EU and the World Bank postponed the disbursement of the third tranche, expected in November-December, until the political situation allows for full compliance with performance targets. The main impediment for the disbursement is the inability of the interim government to commit to the targets agreed with the IMF.

The Democrat Liberal Party (PD-L) - Social Democrat Party (PSD) ruling coalition broke up in October, with PSD ministers resigning from the government. Lacking the PSD support the PD-L government fell in parliament following a non-confidence vote. Moreover, majority of the Parliament formed an alliance around the PSD. The president appointed a new Prime Minister, but, with only PD-L support in parliament the new government was rejected. Since appointing the Prime Minister is a presidential prerogative, the situation remained to be clarified by the already scheduled presidential elections on December 6th. Until the new president is appointed and the new Government is endorsed by Parliament, the current business remained to be managed by the interim government, formed by the PD-L ministers remaining in power following the split with PSD.

Since the interim government represents only a temporary solution, it cannot endorse the IMF targets, which include, among others, the budget deficit target for 2010 and commitment to cut wage expenses for the state employees. Thus IMF cannot complete the review and disburse the current tranche, yet the it mentioned that the third tranche might be disbursed together with the fourth one in mid-March after completing discussions with the new government. In these circumstances, the central bank remains critical for the government's financing. The monetary authority has cut the required reserve ratio for forex liabilities to allow banks to lend more funds to the government.

In January-September 2009, the stock of total medium- and long-term (M&LT) external debt increased by 22.2% ytd, while the stock of total short-term debt declined by 26% ytd. Contrary to previous years, when external debt growth was driven by borrowings of the private sector, the current increase in the external debt stock was attributed primarily to increasing long-term foreign liabilities of the government, which is related to the abrupt widening of the budget deficit and financial support provided by international institutions.

**Monetary policy**

The sharp correction of the current account gap this year (the CA deficit narrowed by 75% yoy in January-September, and is likely to be below 5% of GDP) combined with the significant financial aid provided by the international institutions prompted the exchange rate to stabilize. During February-November 2009, the RON/EUR exchange rate had only small fluctuations around 4.2 RON/EUR. During this period, the Romania Leu appreciated by 0.09% against the Euro, compared to a 21% depreciation during September 2008 - January 2009. This stability prevented further deterioration of banking assets, maintaining financial system stability in the country.

The stable exchange rate and weak consumer demand favored further disinflation. Indeed, headline inflation decelerated to 4.3% yoy in October, down from a 6.9% yoy peak registered in February, thus turning back to the 3.5±1% band set under the inflation targeting regime.

The National Bank of Romania (NBR) cut the monetary policy interest rates five times during this year - from 10.25% at the beginning of the year, down to 8% since the end of September 2009. In November, the monetary authority left its policy rate unchanged at 8% and the required reserve ratio at 30% and 15% for liabilities denominated in foreign and local currency respectively. However, afterwards, in an extraordinary meeting, the NBR monetary board cut the required reserve ratio on forex liabilities by 5 percentage points (p.p.) to 25% to release some additional EUR 1 billion to commercial banks. This will help provide more domestic resources for to finance the budget deficit since the IMF, EC and WB have decided to postpone the disbursement of the tranches scheduled for November-December.
Credit to the non-government sector grew by a modest 4.2% yoy in October, slightly accelerating from 2.4% yoy in the previous month, which was more an effect of the RON depreciation than a real expansion of bank credit. Actually, the stock of bank loans issued in the Romanian leu dropped by 7% yoy in October, compared to a 6% yoy decline one month earlier, while the stock of loans issued in foreign currency shrank by 3.5% yoy, compared to a 3% yoy contraction reported in September. Nevertheless, banks extended their stock of credit by nearly EUR 6 billion during the last twelve months, which is almost the same amount as one year earlier. However, banks shifted almost all this amount from financing of the private sector to the government.

**International Trade and Capital**

The foreign merchandise trade balance continued to improve in September 2009 on the back of some deceleration in the export decline and a stable contraction of imports. Indeed, FOB exports in goods fell by 13% yoy in September, compared to 18% yoy and 15% yoy declines registered in August and July respectively. This improvement in monthly export dynamics has been favored by the strengthening of external demand on the back of fiscal stimulus in European countries. At the same time, CIF import in goods kept contracting by 34% in September, compared to 36% yoy and 37% yoy posted in the two previous months, as domestic demand remained weak. Therefore, the FOB/CIF merchandise trade gap narrowed by 2.2 times yoy in January-September, down to EUR 7 billion.

A significant adjustment of the trade deficit caused the current account deficit to decrease by almost 4 times yoy in January-September 2009, to EUR 3.3 billion. This external gap was still completely covered by net FDI inflows, which stood at EUR 3.5 billion in the first nine months of the year, contracting by nearly half against the respective period of last year.

**Other Developments Affecting the Investment Climate**

On November 22nd, 2009, the first round of the presidential elections was held in Romania. And, thereafter, a run-off round between the incumbent Traian Basescu (formally independent, but supported by PD-L and the official fraction of PNT-CD) and the President of the Parliament Mircea Geoana (PSD) was held on December 6th, 2009. Although most exit polls favored Geoana in the runoff, Basescu won the elections with 50.33% of the votes. The opposition contests the results, citing a “high number of void ballots, modified voting protocols, and massive electoral tourism”, and challenged the result in the constitutional court. At the same time, OSCE declared that the election “was held generally in line with OSCE commitments”, but also urged the authorities to investigate claims of fraud. However, on December 14th, the Constitutional Court validated the presidential election and found that Traian Basescu was elected President in the second round of voting on December 6th, with 50.33% of the votes cast. On December 16th, the Constitutional Court validated Traian Basescu for the position of President for the second five-year mandate.