Country report **ROMANIA**

Summary

Romania's economy was severely impacted by the global crisis and only started to recover last year, reporting a 2% growth rate. We expect growth to slow in light of the eurozone recession and deleveraging by eurozone banks (which have a large presence in Romania). Pressure on Romania's financial sector will also come from heavily indebted households, as increasing debt repayments costs and high unemployment could force them to default. Consequently, we expect non-performing loans (NLP) to go up. Meanwhile, Romania's government will implement another round of austerity measures. However, in light of slowing growth (expected to drop to 0.5% this year) we do expect more protests, both from the public and the parliament.

Things to watch:

- Eurozone banks deleveraging and the impact thereof on Romania's financial sector
- Eurozone recession and the impact thereof on demand for Romanian exports
- Exchange rate leu vis-a-vis the euro, Swiss franc and yen in light of FX loans held by households.

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Romania

National facts		
Type of government	Republic	
Capital	Bucharest	
Surface area (thousand sq km)	238	
Population (millions)	21.5	
Main languages	Romanian (91%)	
	Hungarian (6.7%)	
Main religions	Eastern Orthodox (86.8%)	
	Potestant (7.5%)	
	Roman Catholic (4.7%)	
Head of State (president)	Traian Basescu	
Head of Government (prime-minister)	Emil Boc	
Monetary unit	Leu (RON)	
Economy		**2011**
Economic size	*bn USD*	*% world total*
Nominal GDP	178	0.26
Nominal GDP at PPP	262	0.33
Export value of goods and services	73	0.34
IMF quotum (in mln SDR)	n.a.	n.a.
Economic structure	*2011*	*5-year av.*
Real GDP growth	2.0	2.6
Agriculture (% of GDP)	12	11
Industry (% of GDP)	39	37
Services (% of GDP)	51	54
Standards of living	*USD*	*% world av.*
Nominal GDP per head	8279	77
Nominal GDP per head at PPP	12229	99
Real GDP per head	5294	65

Social and governance indicators			rank / total
Human Development Index (rank)			50 / 187
Ease of doing business (rank)			72 / 183
Economic freedom index (rank)			63 / 179
Corruption perceptions index (rank)			75 / 183
Press freedom index (rank)			52 / 178
Gini index (income distribution)			31.15
Population below $1.25 per day (PPP)			2%
Foreign trade			**1905**
Main export partners (%)		*Main import partners (%)*	
Germany	18	Germany	17
Italy	14	Italy	12
France	8	Hungary	9
Turkey	7	France	6
Main export products (%)			
Machinery & equipment			27
Basic metals & products			12
Textiles & products			8
Minerals & fuels			6
Main import products (%)			
Machinery & equipment			29
Minerals & fuels			11
Chemical products			10
Textiles & products			9
Openness of the economy			
Export value of G&S (% of GDP)			41
Import value of G&S (% of GDP)			46
Inward FDI (% of GDP)			1.2

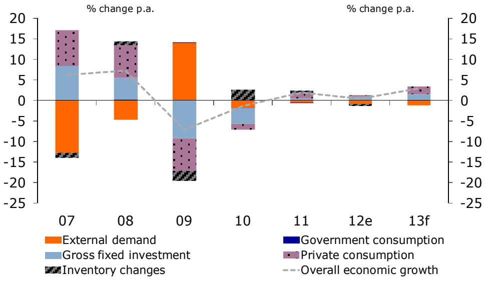
Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Economic structure and growth

Romania is the ninth-largest country in the European Union in terms of geographical size, but it is also the second-poorest in the region. When the economic crisis hit Central and Eastern Europe at the end of 2008, Romania was among the first and worst hit. Already in November 2008, it was forced to turn to the IMF for emergency support. The crisis especially took a toll on the country's automotive industry, while inward direct investment flows, which stood at 5.8% of GDP before the crisis (2007), dried up. As a result, the economy contracted by more than 7% in 2009 and by 1.3% in 2010. In 2011, we saw a slow recovery, with economic growth at 2%. GDP growth was mainly driven by increased demand for Romanian exports, causing industrial production to expand somewhat. Both private and public consumption remained below pre-crisis levels and contributed marginally to economic growth (see chart 1 below). In fact, a high level of household indebtedness will depress domestic demand for some time to come, while the austerity measures enforced by the IMF will keep public spending low as well. In addition to low domestic demand, we expect export growth and investments to fall as a result of the forecasted recession in the eurozone (Romania's main export market). Consequently, GDP growth is expected to fall to a low 0.5% in 2012. In addition, large downside risks remain present. These include a possible banking crisis brought on by eurozone bank deleveraging and a highly indebted private sector (see below), and the possibility of a eurozone break-up. In the medium term, Romania's economic progress is challenged by a number of structural problems. These include an unproductive business climate (made worse by a high level of corruption), a rigid labour market, resulting in high wage levels, and an underperforming education system. However, despite these challenges, Romania can rely

on a large (though poor) domestic market. In addition, with help of EU funds, Romania could report high growth rates in years to come, as it catches up with the rest of the region.
Romania's financial sector will feel the impact of the eurozone bank deleveraging that has been set in motion by the crisis and new, higher capital requirements. Italian, Greek and Austrian banks have a large presence in Romania and recent developments suggest that especially Austrian banks will become more hesitant in providing funds to their Eastern European subsidiaries. In addition, the combination of household indebtedness and increased unemployment could translate in an increasing number of defaults, which would put further pressure on banks. The fact that 65% of all household debt is held in foreign currencies, combined with a sharp depreciation of the leu, only adds to the debt burden. Nonperforming loans already reached a high 14% in September 2011, but are expected to climb further. In addition, the enormous downside risks (discussed above) could lead to a banking crisis.

Figure 1: Growth performance



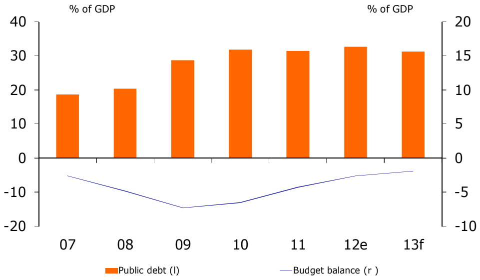
Source: EIU

Political and social situation

Romania's political and social situation remains unstable as well. Deteriorating economic conditions revealed the many institutional weaknesses, which have spiked anger among Romania's population. Especially rampant corruption, both within and outside the government and judicial system, is a great cause for concern. Meanwhile, Romania's performance on other institutional indicators is also worrisome. The Economist Intelligence Unit's (EIU) 2011 Democracy Index ranked Romania only 59th out of 167 countries, which is low as compared to neighbouring countries. The low rank is partly explained by the high level of dissatisfaction with the government among Romanians, as well as a low level of trust in public institutions and a low level of public participation, meaning that there are relatively few channels to voice concerns over public policy. Still, protests are becoming more commonplace in Romania and the current level of discontent threatens to obstruct the government's attempt to implement various much-needed reforms.
The government itself remains unstable as well. As the ruling coalition does not hold a majority in parliament, it relies on ad hoc partnerships with non-coalition parties and is very vulnerable to votes of confidence. So far, the government survived all confidence votes and it appears the government will remain in place until parliamentary elections this November. Given the popular discontent with the ruling government and the ruling Democratic Liberal Party (PD-L), we do not expect it to survive the elections, placing the IMF program at risk. International politics are centred on Romania's planned further integration into the European Union. The planned accession to the Schengen area was blocked last year, but Romania is expected to gain access mid-2012. In addition, Romania hopes to join the Eurozone by 2015. This, however, is deemed overly ambitious. For one, Romania still has to bring its legislature in line with EU regulation. In addition, given the current turmoil in the eurozone, as well as its experience with Greece, it is not hard to imagine that

new entrants will be considered more carefully than before. The Greek experience also holds an important message for Romania: by entering the eurozone it will forego its competitive edge as it can no longer devalue its currency to lower the price of its exports.

Figure 2: Government finances



Source: EIU

Figure 3: Current account

Source: EIU

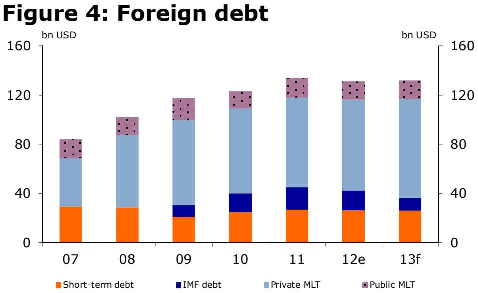
Economic policy

Romania's public policy is guided by the conditions imposed by the IMF. At the beginning of November 2011, the IMF approved a third review of the USD 4.9bn, 24-month, precautionary stand-by agreement. Still, despite this approval and even though the country is entering its fourth year of fiscal austerity and reforms, much remains to be done. The most pressing matter is the reform of the public sector, including the privatization of large state-owned enterprises and the restructuring of the transport and energy enterprises. Although the government does in fact seem willing to implement these reforms, it needs to convince both the parliament and the public of their merits, which will prove difficult. Despite the various austerity measures, we do expect the fiscal balance will remain in deficit in 2012. In 2011, the deficit was lowered to 4.4% of GDP (from 6.6% of GDP in 2010) and we expect a further contraction to 3.1% of GDP in 2012, which is needed to keep public debt stable at around 35% of GDP. Assuming that the economy will continue to grow in the coming years, this level of debt is deemed sustainable. However, a slightly larger deficit, for instance as a result of pre-election spending, could easily undo this fragile balance. Monetary policy centres on two conflicting goals. In light of the recession, monetary stimulus measures were implemented to stimulate domestic demand. At the same time, the interest rate cannot be set too low, as this would cause Romania's currency to depreciate against other currencies, which would in turn raise the debt burden for households that hold mortgages denominated in foreign currencies. Moreover, Romania struggles with a relatively high and volatile inflation rate. Lower inflation expectations and a more stable leu allowed the central bank to lower the policy rate by 75bps in the last three months, to 5.5%. Whether the central bank will be able to introduce further rate cuts will mostly depend on the strength of the leu. For 2012, we expect inflation to fall to roughly 4%, from 6.2% in 2011. This forecast is based on the assumption that global commodity prices will not increase. Furthermore, we expect that, as domestic demand remains subdued, a weaker currency should not necessarily result in imported inflation, as importers may find it difficult to pass on price increases to consumers. Finally, with output still below pre-crisis levels, wage pressures will be limited. The leu took a dive against most other currencies, and most notably the euro, as investors fled Romania. The Central Bank's attempts to strengthen the currency, mainly through FX interventions, did have some effect and we expect that it will be able to maintain a more stable exchange rate in 2012. Still, much depends on the overall economic and political stability and, closely linked, developments in the Eurozone, as both will continue to influence investor confidence.

Balance of Payments

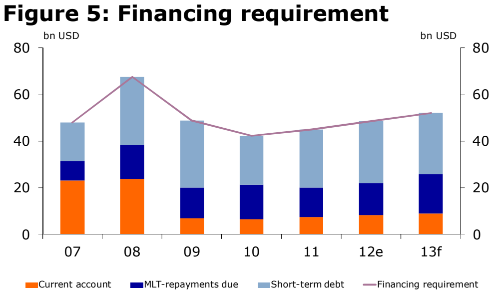
Before the crisis, Romania reported large deficits on the trade balance, as imports of capital goods and fuels far exceeded exports. As the crisis especially hit the economy on the demand-side, import demand dried up, resulting in lower deficits. For 2012, we expect the trade deficit to remain close to its 2011 level of 3.4% of GDP. However, slowing demand in the eurozone for Romanian exports could translate in a higher deficit. The crisis negatively affected the services balance, as especially tourism and demand for transport services slowed. The result is a small deficit of less than 1% of GDP. The income balance generally reports a deficit, which is associated with the repatriation of profits by foreign businesses. Finally, large inflows of remittances from Romanians working abroad and EU transfers translates into a surplus on the transfer balance. As a result of the crisis, this surplus shrank by roughly one third, which still leaves a surplus of roughly 2% of GDP. As a result of an expected increase of the services deficit and a small increase of the trade deficit, we expect the current account deficit to increase to 4.4% of GDP this year, from 3.8% of GDP in 2011. The current account deficit is financed with a mixture of debt and foreign inward investments. In light of the crisis, the latter fell sharply, as investors pulled out. For the coming years we fear that inflows on foreign direct investments will remain below their pre-crisis levels, on account of sluggish domestic demand and an unfriendly business climate. A smaller current account deficit did cause a reduction of net debt flows and for 2012 we expect a further reduction to USD 4.6b, from USD 8.7bn in 2011. After falling by USD 498mln in 2009, FX reserves have been rebuilt and now cover 6.5 months of imports. Moreover, the IMF/EU stand-by agreement gives Romania access to another EUR 5.3bn.

Figure 4: Foreign debt



Source: EIU

Figure 5: Financing requirement



Source: EIU

External position

In 2011, foreign debt stood at a high 76% of GDP. Although roughly one-third of all external debt is inter-company debt, this still leaves a substantial 50% of GDP, which is shared between households and the government. Especially the former have felt the negative consequences of a falling leu against the euro and Swiss franc. Half of all private debt is denominated in foreign currencies, which makes the private sector vulnerable to exchange rate shocks. The government holds roughly 25% of all external debt, but is still a net external creditor. As the government will start to repay its loan with the IMF/EU and since households are unlikely to accumulate more foreign debt, we expect the level of external debt to decrease to 73% of GDP. Short term debt generally accounts for a relatively small percentage (roughly 20%) of total foreign debt. Moreover, short term debt, as well as total debt service due, is more than covered by the of FX reserves.

Romania

Selection of economic indicators	2007	2008	2009	2010	2011	2012e	2013f
Key country risk indicators							
GDP (% real change pa)	6.3	7.3	-7.1	-1.3	2.0	0.5	3.0
Consumer prices (average % change pa)	4.8	7.8	5.6	6.1	6.2	4.0	3.3
Current account balance (% of GDP)	-13.5	-11.6	-4.3	-4.0	-3.8	-4.4	-5.6
Total foreign exchange reserves (mln USD)	37194	36868	40757	43361	44036	48630	52610
Economic growth							
GDP (% real change pa)	6.3	7.3	-7.1	-1.3	2.0	0.5	3.0
Gross fixed investment (real % change pa)	30.3	15.6	-25.3	-13.1	2.5	4.0	8.0
Private consumption (real % change pa)	10.2	8.9	-8.7	-1.6	0.8	3.2	3.9
Government consumption (real % change pa)	2.4	6.2	1.3	-3.2	-2.0	2.0	2.3
Exports of G&S (real % change pa)	8.7	19.4	-5.5	13.1	16.3	7.2	11.4
Imports of G&S (real % change pa)	26.1	17.5	-20.6	11.6	11.3	7.9	11.7
Economic policy							
Budget balance (% of GDP)	-2.6	-5.7	-8.5	-6.4	-4.4	-3.1	-3.0
Public debt (% of GDP)	19	21	31	34	35	34	33
Money market interest rate (%)	7.0	10.4	10.9	7.2	8.0	7.0	6.0
M2 growth (% change pa)	34	17	8	6	8	7	9
Consumer prices (average % change pa)	4.8	7.8	5.6	6.1	6.2	4.0	3.3
Exchange rate LCU to USD (average)	2.4	2.5	3.0	3.2	3.0	3.1	3.3
Recorded unemployment (%)	4.1	4.4	7.8	6.9	4.8	4.3	4.0
Balance of payments (mln USD)							
Current account balance	-23080	-23719	-6955	-6480	-6764	-8140	-10980
Trade balance	-24566	-28182	-9606	-7805	-6109	-6320	-7950
Export value of goods	40555	49760	40672	49411	63650	68510	75630
Import value of goods	65121	77942	50278	57216	69759	74840	83570
Services balance	530	951	-422	-836	-1614	-2710	-3140
Income balance	-5662	-5372	-2635	-2361	-3722	-3640	-4270
Transfer balance	6618	8884	5708	4522	4681	4540	4370
Net direct investment flows	9647	13606	4934	3263	2000	3300	5750
Net portfolio investment flows	623	-943	731	5157	17	960	440
Net debt flows	25318	17420	11842	8105	8708	4590	3870
Other capital flows (negative is flight)	-2763	-6853	-5913	-6077	-3050	3990	4960
Change in international reserves	9745	-488	4639	3968	911	4700	4040
External position (mln USD)							
Total foreign debt	84166	102491	117511	122783	134670	135880	136870
Short-term debt	29330	28664	21032	24947	27398	28460	30000
Total debt service due, incl. short-term debt	28409	47630	45242	38934	40530	43860	47700
Total foreign exchange reserves	37194	36868	40757	43361	44036	48630	52610
International investment position	-79692	-97031	-107683	-105757	n.a.	n.a.	n.a.
Total assets	54184	54893	62950	67802	n.a.	n.a.	n.a.
Total liabilities	133876	151924	170633	173559	n.a.	n.a.	n.a.
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	-14.4	-13.8	-5.9	-4.8	-3.4	-3.4	-4.1
Current account balance (% of GDP)	-13.5	-11.6	-4.3	-4.0	-3.8	-4.4	-5.6
Inward FDI (% of GDP)	5.8	6.8	3.0	2.1	1.2	1.9	3.1
Foreign debt (% of GDP)	49	50	72	76	76	73	70
Foreign debt (% of XGSIT)	133	130	191	183	163	155	143
International investment position (% of GDP)	-46.7	-47.5	-65.9	-65.4	n.a.	n.a.	n.a.
Debt service ratio (% of XGSIT)	45	60	74	58	49	50	50
Interest service ratio incl. arrears (% of XGSIT)	5	5	5	5	4	3	2
FX-reserves import cover (months)	6.0	4.9	8.1	7.8	6.5	6.7	6.5
FX-reserves debt service cover (%)	131	77	90	111	109	111	110
Liquidity ratio	93	81	97	105	103	103	100

Source: EIU