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FOCUS NOTES: ROMANIA

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Romania-Macroeconomic Outlook

A challenging year lies ahead following visible progress in macroeconomic stabilization and structural reforms in recent months

- After rising by 2.5% in 2011, real output growth is bound to slowdown this year, mainly reflecting weaker net exports and negative base effects from agriculture. Domestic demand is expected to take the lead as the primary driver of growth this year
- Inflation has declined to historically lows and is expected to ease further in the months ahead
- NBR may cut rates one again this quarter, with a further 25bp rate reduction appearing possible by the end of the year
- Attainment of this year's fiscal target requires tough austerity measures to remain in place ahead of December 2012 national elections
- The current account is expected to widen marginally this year on improved domestic demand and weaker growth in main trade-partner economies
- Market concerns shift to the sources of balance-of-payments financing; debt creating inflows have taken the lead as the main financing source of the current account

Introduction

2011 was a year of further progress in restoring macroeconomic stability for Romania. Having emerged from an earlier recession, the economy expanded by 2.5%. This was the first positive growth rate since 2008. Inflation declined to 3.1%YoY last December, a historical low, coming in well within to the NBR's respective target range (3% +/- 1%YoY). Furthermore, Romania is no longer running an unsustainable current account deficit.

Progress in the fiscal consolidation and structural reforms under the IMF precautionary agreement was also significant, with the government remaining on track to reduce its fiscal deficit to levels below 3%-of-GDP in 2012.

Overall, the Romanian economy is in a stronger position now than in the pre-crisis period to withstand external shocks. Yet, potential weaknesses exist. The country's high exposure to a number of fiscally-vulnerable economies in the region - via the trade and finance channels – could cast it vulnerable to a further significant deterioration in the euro area sovereign debt crisis (not our base-line scenario). Last but not least, the ongoing deleveraging process of the EU banking sector translates into measurable domestic macro prudential risks. In our view, a positive overall, though still challenging year lies ahead for one more reason: domestic political struggles are likely to intensify heading closer to the December parliamentary election.

Economic growth overview: domestic demand buoys the recovery

In the period following the liberalization of the capital account in 2005 and until the 2008/09 global economic and financial crisis, Romania's real GDP grew by an impressive annual average rate of 6.2%. Domestic financial deepening and increased income expectations fuelled a domestic demand boom.

Over the period 2005-2008, private consumption increased 25% in real terms, while imports and investment expanded 45% and 68% respectively. Yet, this accelerated convergence came at the expense of rising imbalances – particularly twin deficits i.e., a widening budget shortfall feeding back into the current account deficit, which reached record high levels near 14%-of-GDP in 2008. Once capital inflows dried up after the collapse of Lehman Brothers in autumn 2008, the domestic growth paradigm started to unravel.

In March 2012, Romania applied for a two-year multi-lateral lending program, co-financed by the IMF (€12.95 billion in the form of a regular Stand By arrangement) and the European Commission (€5bn). The World Bank and the EBRD each contributed (€1bn), bringing the overall funding package to around €20bn. The Romanian government made use of €12.5bn from IMF funding and €3.7bn funds from EU in six tranches (out of eight in total).

The disbursed official funds was utilized to replenish the foreign currency reserves of the Central Bank (BoP support) and to temporarily finance the budget deficit. The successful implementation of the program was conditioned on quantitative performance criteria (ie. targets on fiscal deficits) and structural benchmarks (ie, structural reforms in economy) that helped addressing macroeconomic imbalances. Upon the expiration of the program in March 2011, a new two year precautionary agreement worth €5bn (€3.6bn from IMF and €1.4bn from EU) was drafted. The new agreement aims to promote structural reforms and, at the same time, provide a cushion in case of a new financial downturn.

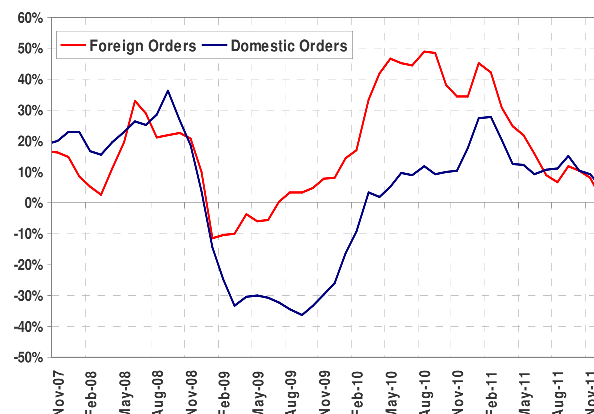
Overall, Romanian real output declined by 7.1% in 2009, followed by a further 1.3% contraction in 2010. The evolution of the domestic macro economy following the 2008 global financial crisis was the result of two opposing dynamics. On the other hand, exports recovered rather rapidly, growing by 37% from the end of 2008 to the end of 2011. On the other hand, domestic demand continued to contract in 2009 and 2010, prolonging the recession over the period.

The economy returned to positive growth in 2011, expanding by 2.5% yoy. After a tepid rise in the first two quarters, GDP experienced a growth spur in Q3. Agriculture was the main driver of the acceleration, but domestic demand also picked up over that period. Quarterly growth in construction turned positive for the first time since 2009 (2.7% qoq) while retail sales rose as well (0.4% qoq). The industrial sector continued to growth 3.2% qoq. However, the boost from agriculture was only temporary, with quarter-on-quarter real GDP shrinking by 0.2%.

The pace of domestic economic recovery is bound to slow down in 2012. Both the IMF and the European Commission are now expecting a mild contraction of the euro area economy in 2012, (by 0.5% and 0.3%, respectively, according to their most recent forecasts. Deteriorating external demand conditions are unlikely to bode well for Romanian exports this year. In fact, the aforementioned factors may have already started to weigh on domestic industrial output. Monthly indicators show that manufacturing expanded at an average rate of 4.2% yoy in the three-months to November 2011, but shrank by 4% yoy in the final month of last year. As a caveat, December was a weak month for most regional economies and has also probably reflected the interplay of negative transitory factors.

A slowdown is also evident in manufacturing new orders data. Foreign orders fell by 5.5% yoy in December 2011, following a 7.5%yoy rise in the prior month. Domestic orders have so far remained relatively resilient, but may not be sufficient to support the sector. Since the beginning of the global financial crisis, the growth rate of foreign orders has consistently outpaced that of domestic orders. However, the difference between these two components has been gradually shrinking since the beginning of 2011 and has actually reversed starting from August as shown in Figure 1.

Figure 1
Foreing orders for manufacturing are falling rapidly and are now outpaced by domestic ones



Source: Eurostat

Against this backdrop, we expect the pace of the domestic economic recovery this year to be stimulated by domestic demand. Specifically, we forecast the construction and retail trade sectors to expand by 3% yoy and 1.9% yoy, respectively. On an aggregate basis, we expect the economy to expand by around 1.0% in real terms in 2012, with a slightly higher rate looking probable, provided that absorption of EU cohesion funds improves.

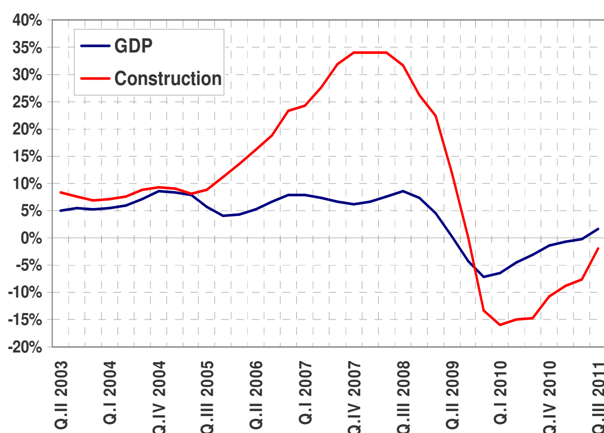
Structural changes in the construction sector

Construction has traditionally been one of the fastest growing sectors in the Romanian economy. Construction works stared to surge mid last decade, with output in the sector growing by 35% yoy in 2008 (Figure 2).

The ascent of domestic demand also resulted into higher real estate prices. This new source of wealth further leveraged the demand for construction works.

As mentioned earlier, the surge of aggregate demand in the pre-crisis period came at the expense of a widening external imbalance. Once capital stopped flowing into Romania, the domestic growth mechanism started to unravel. The construction sector shrank by 13% in 2009 and by 11% in the following year. In our view, the post-crisis recession in the sector has likely bottomed out in 2011, with return to positive growth expected this year.

Figure 2
Construction was one of the fastest developing and most volatile sectors in the economy

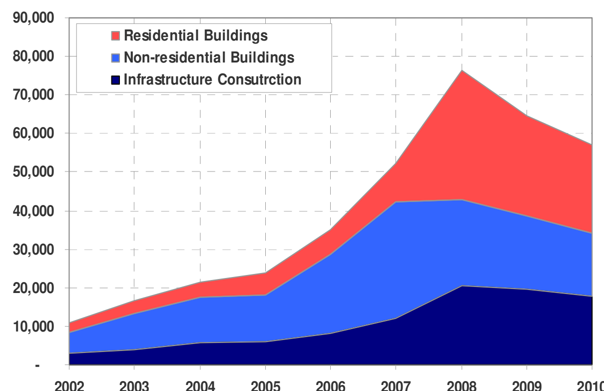


Source: National Institute of Statistics

The domestic construction sector did not only experience a protracted recession in the post global crisis period, but also underwent a significant structural change that will likely make the recovery slow and gradual. As depicted in Figure 3, in the period from 2005 to 2007, growth in the sector resulted mainly from non-residential buildings (office buildings, hotels, etc). Residential buildings works surged in 2007 and more than tripled within the year. However, this component also became very vulnerable once market conditions deteriorated.

Construction of new residential buildings shrunk by a cumulative 31% from 2008 to 2010 and failed to return to positive growth in the following year. Furthermore, non-residential buildings recorded a similar dynamic (with the distinction that they started declining since 2007). Infrastructure works faired better under these conditions, but the recovery is bound to remain slow as long as private consumers continue to deleverage.

Figure 3
Construction of residential buildings suffered the sharpest drop during the recession

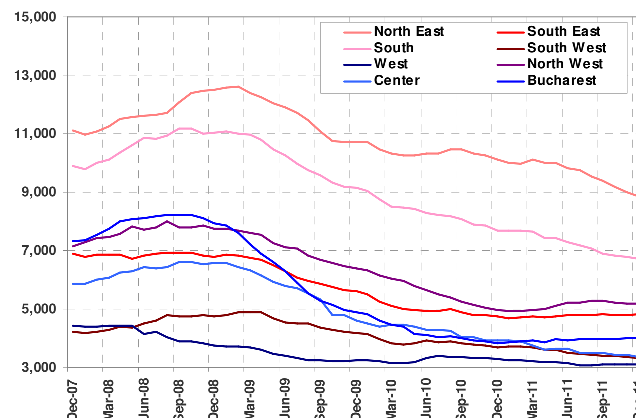


Source: National Institute of Statistics

High frequency real activity and sentiment indicators suggest that a gradual recovery is already underway in the domestic construction sector. Over the past three years, the number of building permits shrunk across all regions of the country, but there have been some tentative signs of stabilization in some areas in recent months (Figure 4).

Building permits shrank by 36% in the North West region from 2008 to 2010, and appear to have bottomed out in 2011, rebounding by 5% within that year. A similar trend was recorded in the South East and Bucharest regions. Aggregate surface approved for construction has also been contracting in annual terms starting from 2008, but the rate of decline has decelerated considerably in 2011. We expect a return to positive growth rates starting from 2012.

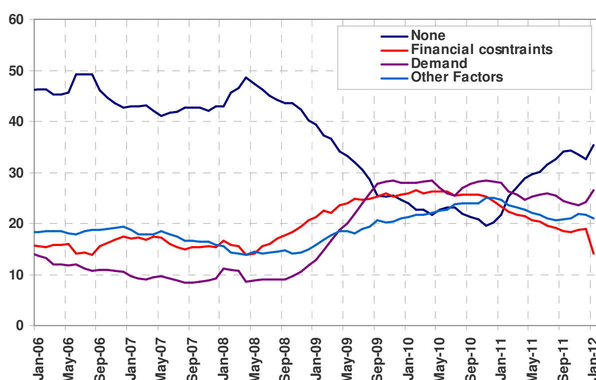
Figure 4
The number of new building permits is starting to stabilize in the North West, South East and Bucharest regions



Source: National Institute of Statistics

Further sings of improvement are apparent when analyzing the structure of demand. In the period from 2007 to 2008, approximately 50% of construction managers questioned by the European Commission replied that there were no significant factors deterring their activity (Figure 5). This situation changed starting from 2008. Financial difficulties and weak demand became the most important factors to limit new building works (accounting for a cumulated 55%). However, starting from 2011, demand factors have started to normalize. By the end of January 2012, 42% of managers answered there were no significant factors deterring their construction activity.

Figure 5
Demand factors have started to normalize in 2011



Source: European Commission, EFG Research

Managers' order books provide further signs of amelioration. At the height of the recession in June 2010, only 19% of managers reported growing order books. The indicator has steadily improved from that point and reached 34% in January 2012.

However, the speed at which the aforementioned adjustments have been taking place indicates growth is likely to remain slow. Furthermore, building costs are relatively high. Wages for construction workers shrank 25% starting from October 2008 to April 2010, but have rebounded 13% from that point. The price of building materials has increased 27% from October 2008 to November 2011.

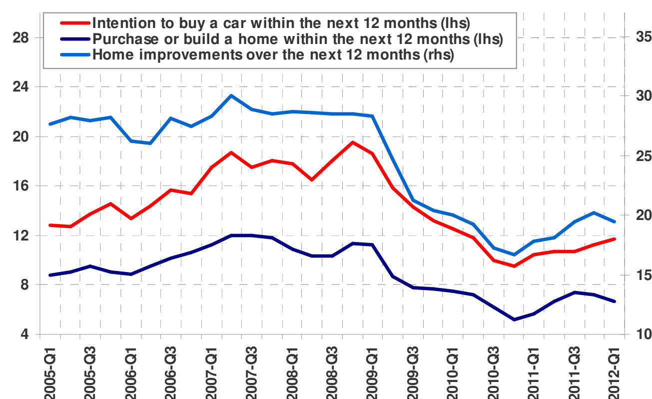
Sales of durable goods bolster the recovery in the retail sector

Retail trade has also been one of the hardest-affected domestic sectors due to the economic recession. Similarly to the situation in the construction sector, consumers changed their consumption patterns. As income fell, consumers spent more of their wages on necessities (sales of food, pharmaceuticals, clothing and fuel increased an average of 17% from December 2008 to December 2012) and less on durable goods (sales of electronics, house equipment and recreational goods fell an average of 23% from December 2008 to December 2010). Falling sales in the latter component pulled down the retail sector (despite modest increases in sales of goods with low price elasticities), severely denting the prospects for recovery.

However, durable goods returned to positive growth rates starting from the first quarter of 2011 and expanded by around 10% yoy throughout the year. Given the perennial nature of these acquisitions, we expect the recovery in the sector to continue.

These trends are also reflected in the most recent readings in a range of retail-sector leading indicators. Consumers' intention to purchase a car and to make home improvements over the next 12 months have both increased by 15% in Q1.2012 compared with Q1.2011 on seasonally adjusted data (Figure 6).

Figure 6
Intention to make long term purchases is improving



Source: European Commission, EFG Research

Domestic demand risks

Downside risks for domestic demand in 2012 stem mainly from a further slowdown in private-sector credit as well as an intensifying labor market pressures. However, a better absorption of structural and cohesion funds may provide some offset, exerting a positive impulse to GDP growth.

Inflation falls to record lows and it is likely to descend further in the coming months

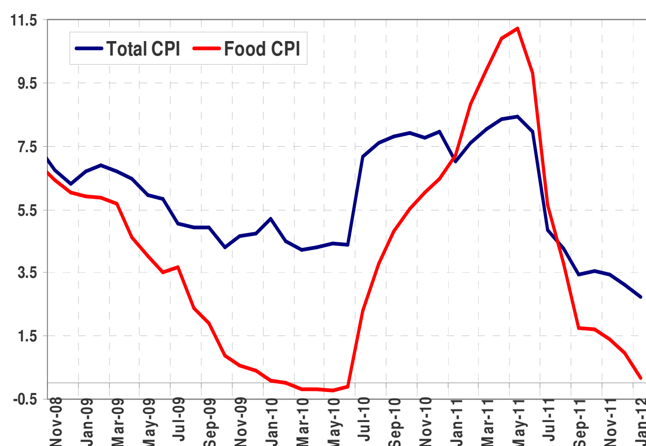
Romanian consumer prices have experienced high volatility throughout the past 2 years. Inflation jumped in the second half of 2010 due to an increase in VAT by 5 ppts (from 19% to 24%) – we estimate the net impact on inflation was an increment of 2.5 ppts.

Inflationary pressures continued to accentuate in the first half of last year, primarily driven by higher food prices, (+11.3%yoy in May 2011). However, an exceptional agricultural harvest helped reverse this trend starting from May. Disinflation accelerated further in July, also assisted by the fading out of base effects stemming from the VAT rate hike in the summer of 2010.

Subsequently, headline inflation eased from 8.43%yoy in May to 4.25%yoy in August (Figure 7).

Food prices remained very low throughout the 4th quarter, helping to drive inflation further down to 3.14% yoy at the end of the year, within the Central Bank's target of 3% ±1pp. The attainment is even more impressive if one considers that heating prices rose by a cumulative 20% in the three months to December 2011.

Figure 7
Consumer prices have fallen rapidly due to an exceptionally good harvest and the elimination of the base effect from the VAT rate hike in mid-2010



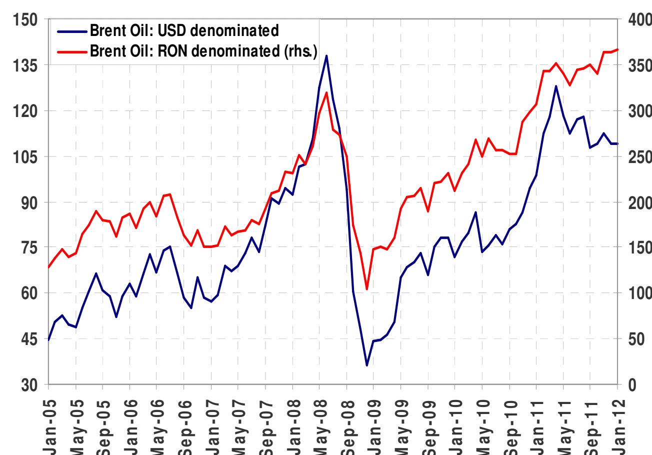
Source: National Institure of Statistics

Food prices remained very low in January 2012 (0.1% yoy) and headline inflation declined to 2.7%yoy. We expect this disinflation trend to continue throughout the first quarter of the year, thanks to, among other factors, favorable base effects. As we mentioned earlier, food prices were at high levels in the first months of 2011 and this should help drive inflation to as low as 2.2% yoy in March.

The NBR's current projection sees consumer prices rising mildly from that point onwards ending the year at 3.2%yoy i.e., within the Bank's target range of 3%±1pp. We have a slightly more pessimistic forecast, expecting headline inflation to reach 3.4%yoy by the end of the year. Our own assessment incorporates a number of exogenous risks related to e.g. the future evolution of international fuel and commodity prices.

In our opinion, the major risk for inflation in 2012 stems from oil prices. Geopolitical tensions in the MENA REGION have risen recently and are expected to remain elevated for some time. Both the US and the EU have instated economic sanctions against Iran and urged other Asian countries to diversify their oil import sources. While the direct impact on Romania is going to be minimal (oil imports from Iran stood at a mere €1mn. for the first 11 months of 2011), the indirect impact will be more substantial as oil prices are expected to remain high in spite of slowing global demand. Further risks arise from adjustments in administered prices and a rebound in wage cost dynamics (Figure 8).

Figure 8
Oil prices denominated in RON have been rising since January 2009 and have exceeded the peak of 2008



Source: Thomson Ruters, Natinal Bank of Romania

Decelerating domestic inflation suggests the NBR's rate easing cycle may not be over yet

The Romanian Central Bank has pursued a very stable monetary policy throughout the past years. The Bank decided to keep the reference rate at 6.25% for 16 consecutive months since May 2010 in spite of the VAT hike, which pushed headline inflation above the policy target in 2010.

However, as the inflation environment improved, the NBR has adjusted its policy accordingly. The Bank cut the reference rate in November. The easing cycle was continued with two consecutive rate cuts of 25bp each, driving the policy rate to 5.5% at the end of February. Interbank interest rates suffered in the first three quarters of the year from a constrained liquidity environment coupled with volatility in the exchange rate. These issues were later addressed when the NBR started conducting 1-week REPO operations on a regular basis. 3-month ROBOR averaged 5.8% in 2011, before easing to 5.3% in the first two months of this year.

The Bank has since indicated that inflation risks remain skewed to the downside due to a persisting negative output gap and a muted recovery of bank lending. Against this backdrop, the NBR may cut rates one again this quarter, with a further 25bp reduction appearing possible by the end of the year (contingent on domestic and external market developments).

Visible fiscal consolidation progress in 2011

The execution of the 2011 budget was in line with the requirements of the IMF precautionary agreement. In fact, the fiscal deficit in cash terms marginally undershot the 4.4%-of-GDP official target. The outgoing Romanian government delivered strong fiscal consolidation in an admittedly challenging domestic economic environment. Importantly, this was not achieved at the expense of cutting down on capital expenditures. The budget execution over the last couple of years put particular emphasis on changing the structure adjustment, favoring reductions in *current* rather than *capital* spending in order to achieve the fiscal targets.

The full-year consolidated budget deficit reached RON 23.8bn, declining by 29% yoy. As a percentage of GDP, the consolidated budget deficit narrowed to 4.35%, from 6.5% a year earlier. Total revenue was up by 7.6% yoy whereas total expenditure grew by just 1.5% yoy over the same period. Total revenue reached RON 181bn (33.1%-of-GDP), slightly outperforming the corresponding budget target (RON 179.2bn). Notwithstanding the recessionary conditions in the domestic retail sector, VAT collections and excise taxes increased by 22.1% yoy and 10.4% yoy, respectively. Furthermore, income tax receipts and social contributions grew by 4.1% yoy despite weak labor market conditions.

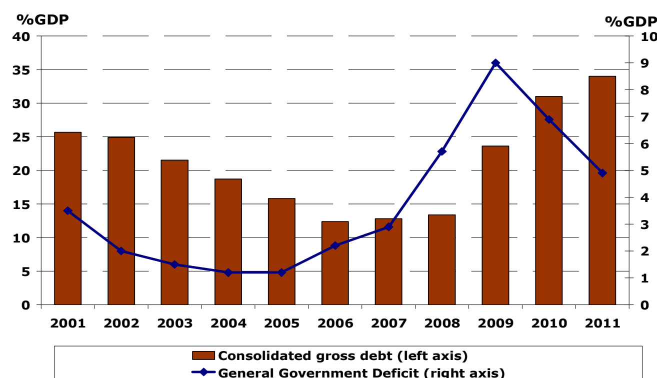
On the spending side, total expenditure reached RON 205.4bn, not far from the original target of RON 203.2 bn. Payroll expenses decreased by 10.6% yoy as a result of aggressive fiscal consolidation measures taken in June 2010 (25% cut in public wages) and the freeze in of public wages thereafter. As a percent of GDP, the overall bill for public wages came down to 7% in 2011, from 8.3% in 2010.

On a more positive note, capital expenditure and co-financing for European projects expanded by 18.6% yoy in 2011. In ppt-of-GDP terms, capital expenditure rose to 4.2% in 2011, from 3.8% in 2010. In addition, the rise in government outlays for goods & services was contained at 7.5% yoy, little above the average inflation, reflecting authorities' efforts to contain current spending. Social protection costs (ca one-third of total budget expenditure), remained almost unchanged (-0.9% yoy), reflecting broadly flat pension payments vs. the same period a year earlier. In contrast, the cost of servicing public debt increased notably (+22.1% yoy) as public debt (national methodology) climbed slightly above 40%-of-GDP at the end of 2011 from 37.8%-of-GDP at the end in 2010.

Attainment of the current year's fiscal target requires tough austerity measures to remain in place ahead of December 2012 elections.

Looking ahead, the fiscal performance to date sends a positive signal to markets and allows optimism over the attainability of the future fiscal targets envisioned in the present precautionary IMF programme. Overall, domestic authorities have accomplished to reduce the general government deficit on a cash basis from 7.3%-of-GDP in 2009 to 4.35%-of-GDP year in a highly uncertain domestic economic environment. The adjustment was even more impressive in ESA-95 accounting terms, with the government deficit having declined by 4ppt-of-GDP from 9% of GDP in 2009 to 5%-of-GDP last year (Figure 9).

Figure 9
Government reduced ESA-95 fiscal deficit by 4ppts-of-GDP in 2009-2011



Source: Eurostat, Eurobank Research

The fiscal target for 2012 is deemed to be challenging and ambitious. The outgoing coalition government had targeted a general government deficit of 1.9% of GDP on a cash basis (2.1% including IMF approved off-budget expenditures). However, the short-term fiscal outlook is clouded by significant uncertainties and risks. First, it is important to note that authorities have already done significant work in containing budgetary expenditure by implementing politically-sensitive measures (e.g. more than 100k lay-offs in the broader public sector, public wage cuts etc). However, the risk of fiscal slippage may increase as we get closer to the date of the next parliamentary election (December 2012).

Secondly, there are risks related to the domestic growth outlook. The budget is built upon a forecast range for GDP growth between1.8%-2.3%. Even if headline GDP turn out to be in line with the budget forecasts, the realized growth mix (balance between domestic and external demand) will be a key determinant of the evolution of a range of budget revenue categories (e.g. VAT revenue).

Third, the level of arrears is another important source of concern. The problem of arrears to the private sector (contractors, suppliers etc) has been a focal point in all previous assessments of the multilateral lending program. Although the outgoing government has made significant progress last year in reducing outstanding debts to various suppliers, it did not manage to completely eradicate them. It is worth noting that the respective

performance criterion was met in Q3-2011 for the first time since the inception of the IMF programme (precautionary and regular Stand By Arrangement).

Apparently, the government has done a lot of work both on an institutional and managerial level to contain arrears. As a result, it has minimized the level of arrears in central government and the health sector (the approximate level stood below 0.2% of GDP in Q3). In contrast, the level of arrears was such a significant problem within State-Owned Enterprises that could endanger the long-term fiscal sustainability.

From that point of view, the data captured in the general government statistics may not provide a complete and accurate picture. It is important to note that Eurostat had initially expressed its reservations on the impact of some public enterprises on the government deficit in April 2011. However, those reservations were withdrawn at a later stage. In the latest assessment of the IMF program issued in January 2012, the approximate number stood at 3.4% of GDP in Q3-2011 for the state owned enterprises monitored.

Current account dynamics stabilized further in 2011, with focus shifting to BoP financing

The external accounts stabilized further in 2011, with the current account deficit widening by just 3%yoy, reaching €5.7bn (Table 1). As a percentage of GDP, the current account shortfall registered a marginal decline to 4.4% from 4.5 in 2010.

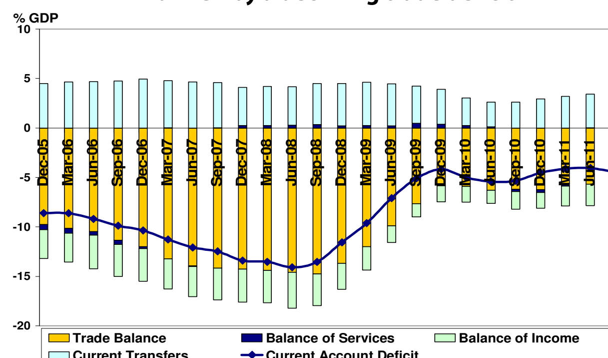
Table 1: Balance of Payments 2011

mn Euros	2010			2011			%
CURRENT ACCOUNT	50,911	56,429	**-5,518**	59,611	65,293	**-5,682**	**3%**
A. Goods & Services	43,990	51,186	**-7,196**	52,292	59,375	**-2,301**	**-68%**
a. Goods (exports fob - imports fob)	37,368	44,968	-7,600	45,017	52,482	-7,465	**-2%**
b. Services	6,622	6,218	404	7,275	6,893	382	**-5%**
- transport	1,928	1,156	772	2,272	1,343	929	**20%**
- tourism - travel	860	1.238	-378	1,018	1,407	-389	**3%**
- other	3,834	3,824	10	3,985	4,143	-158	**-1680%**
B. Incomes	924	2,838	**-1,914**	1,237	3,573	**-2,336**	**22%**
C. Current transfers	5,997	2,405	**3,592**	6,082	2,345	**3,737**	**4%**

Source: NBR

The main driver behind the current account stabilization was again the concomitant improvement in the trade deficit. The latter declined slightly, to €7.4bn from €7.6bn. This translated into an improvement in the trade balance from 6.2% of GDP in 2010 to 5.7% of GDP in 2011. More specifically, exports increased by 20.5% yoy (vs. 28.5% yoy in 2010) to €45bn, while imports expanded +16.7% yoy (vs. 25.1% yoy) to €52.5bn. The services surplus remained almost flat at €0.4bn or 0.3% of GDP in 2011. On the other hand, the slight deterioration in the balances of incomes and current transfers offset some of the improvement in the trade balance (Figure 10).

Figure 10
The improvement in the current account position has been driven by a declining trade deficit



Source: NBR, Eurobank Research

The income deficit deteriorated further by 0.2pps to 1.8% of GDP, reflecting higher repatriated profits and increased debt service payments. The surplus of current transfers declined by 0.1pps to 2.8% of GDP, reflecting two opposite dynamics: improved EU funds absorption and lower remittances by Romanian immigrants abroad.

The minor correction recorded in the past year adds further to the three year-long period of adjustment, which begun in September 2008, when the current account deficit reached unsustainable levels. The period following the Lehman Brothers collapse (and the subsequent deepening of the global financial crisis) saw a rapid unwinding of Romania's macroeconomic imbalances, with the current account shortfall correcting by as much as 9.5pps of GDP in 2009. Overall, after reaching a peak of €16.7bn in 2007 (13.7% of GDP) the corresponding deficit declined to €4.7bn in 2009 (4.2% of GDP), before inching up to €5.5 bn (4.5% of GDP) in 2010.

Moderate widening in the current account is expected in 2012 on improved domestic demand prospects, weakening conditions in main trade-partner economies

Our baseline macroeconomic scenario entails a moderate widening of the current account shortfall this year Balance of payments developments in 2012 will likely be characterized by four major trends, (under the assumption of no abrupt currency movements).

The first is the realized depth of expected recession in the euro area, by far the major trade partner of Romania. The Romanian economy is particular sensitive in that respect, given that EU-27 absorbed as much as 70% of total Romanian exports in 2011.

Secondly, the magnitude of domestic demand rebound in 2012. Under our baseline macroeconomic scenario, domestic demand is likely to take the lead over next exports as the primary GDP growth driver this year. In turn, the domestic demand rebound

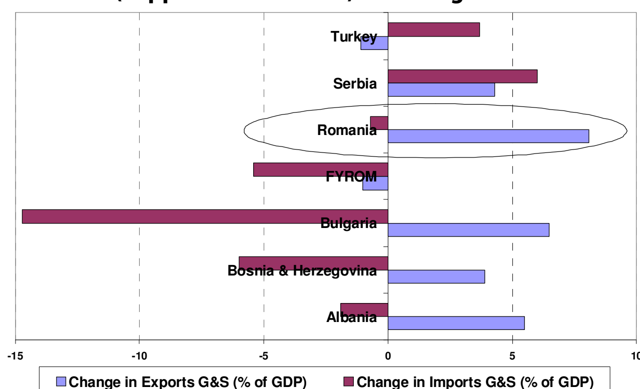
will lead to a further expansion of imports. That is going to be reflected directly on imported consumer goods (around 20%) and indirectly on imported intermediate goods (around 50%) used as inputs in the manufacturing process. The two aforementioned trends will likely lead to widening pressure on the trade deficit.

Third, the rate of EU funds absorption. In principle, EU funds boost current transfers which traditionally offset some of the trade deficit. The outgoing government has promised to step up EU funds absorption by at least EUR 6bn (~5ppts-of-GDP) in each of the coming four years. However, EU funds are channeled to infrastructure projects which necessitate even more imports of raw materials and capital equipment. At the same time, the public investment program targets spending equivalent of 6.5% of GDP that will have a strong positive impact on investments but also a negative impact on the balance of payments.

Improvement in the trade balance came mainly through higher exports rather than decreased imports

Romania was the only economy in the SEE region to realize an improvement in its trade balance over the past three years that was primarily the result of higher exports rather than a sharp contraction in imports (Figure 11).

Figure 11
Romania registered the highest increase in exports of goods & services (in ppts-of-GDP terms) in SEE region in 2008-2011

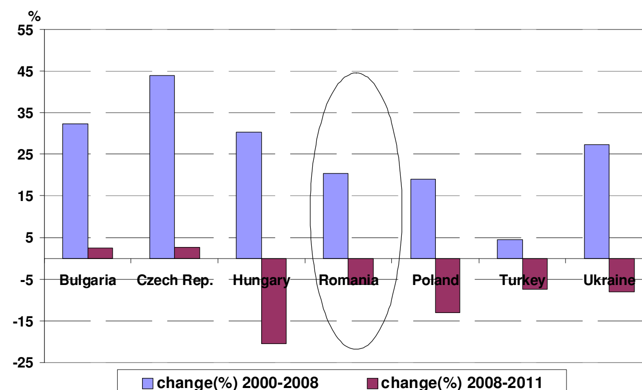


Source: Eurobank EFG Research, Eurostat, IMF, National Authorities

In no other case within the SEE region, the post-crisis recovery of exports as a percentage of GDP was that significant. Exports of goods have already exceeded their pre-crisis levels. They reached 34.5% of GDP in 2011, from 24.1% of GDP in 2008. This translated into a cumulative increase in the nominal level of exports of around 33.5% yoy in 2008-2011. The recovery of Romanian exports appears to have been underpinned by gains in price competitiveness (Figure 12).

On the other hand, imports reached in 2011their pre-crisis nominal levels. Imports of goods reached €52.4bn last year, coming slightly lower than their 2008 nominal level of €52.8bn. Yet their relative size as a percentage of GDP increased slightly, to 40.2% of GDP, from 37.8% of GDP in 2008.

Figure 12
Romania's REER depreciated by 6% in 2008-2011



Source: IIF, Eurobank Research

Another repercussion of the aforementioned developments was the concomitant increase of trade openness. Trade openness (measured as the ratio of the sum of imports and exports to nominal GDP) improved significantly from 61.9% of GDP in 2008 to 74.7% of GDP in 2011. Yet by regional comparison, Romania fares behind from that point of view.

Debt creating flows have taken the lead as the primary source of in current account financing in 2011

On the financing side, Romania has been no exception from the regional pattern of capital inflows drying up in the aftermath of the international financial crisis. The surplus of the capital and the financial account has declined from €17.8bn in 2008 to €5.6bn in 2011.

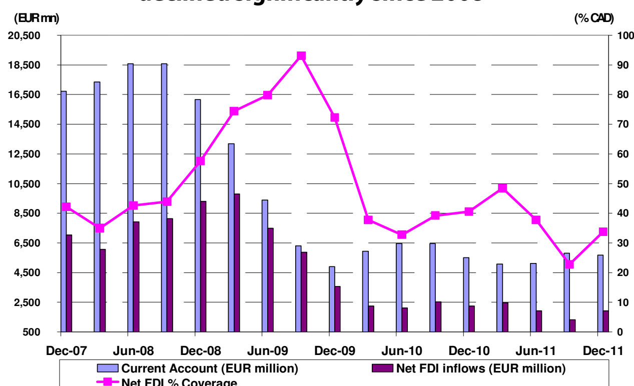
The most important component during the boom times, net FDI inflows lost significant ground. Net FDI inflows declined from an all time high at €9.6bn in 2008 to €2.2bn in 2010 and to €1.9bn last year. In 2011 net FDI inflows covered only 33.8% of the corresponding current account deficit against 40.5% in the prior year and 72.3% in 2009 (Figure 13).

There is a two fold explanation for this. Firstly, FDI inflows declined as part of the overall declining trend of capital inflows to the region. Secondly, this declining trend can be partly attributed to a visible change in the composition of capital inflows towards portfolio and other debt-creating inflows.

Portfolio inflows, climbed to €2.1bn in 2011, from €875mn in the prior month. Their relative share in the financial account surplus has increased from 3% in 2007-2008 to 16% in 2010 and to 43% in 2011. The rise can be broadly attributed to increased public

debt issuance. Last but not least, net other capital investments-which comprises of new and rolled-over loans to the government and private sector-has come down to €1.89bn last year, from €5.83bn in 2010 as the government didn't make any use of IMF funding in 2011

Figure 13
The coverage of the current account by FDI inflows has declined significantly since 2008



Source: Eurobank EFG Research, NBR

External debt as a percentage of GDP has stabilized at high levels

The pace of deterioration of the international investment position has slowed down significantly after the eruption of the crisis. Gross external debt climbed to €98.6bn in 2011 compared to €92.4bn in 2010. As a percentage of GDP, gross external debt edged higher at 77.5%-of-GDP in 2011, compared to 75.4%-of-GDP in 2010 and 47.1%-of-GDP in 2007.

There are two major related trends taking place in the post-Lehman period. The most worrying of these is that short-term external debt has been growing more rapidly than medium and long-term in nominal terms. Short term external debt surged by 17.6% yoy in 2011 compared to medium and long term growing by 3.7% yoy. As a result, the share of short term external debt has been creeping up in the last three years (from 19% in 2009 to 23% in 2011). That part may prove harder to refinance in a difficult external financing world environment. On the positive side, the main share of external debt (~76.7%) is comprises medium- and long-term maturities.

A second trend is the sharp rise in the relative share of public-sector indebtedness (in the form of both direct and government guaranteed debt) within the medium-and long-term maturities spectrum. Public sector external debt expanded by 20.8% in 2009-2011, while private sector external indebtedness shrunk by 4.8% over the same period.

After the expiration of the regular Stand-By arrangement in 2010, the Romanian government endorsed a new precautionary agreement. The aim of the new agreement is to shield the country in case of a new global financial downturn. The program is providing a cushion for the heavy external financing needs of the country in 2012. According to IMF calculations, the gross external financing requirement of Romania (rollover of maturing gross external debt *plus* projected current account deficit) is expected to reach 30.2%-of-GDP (in 2012, being among the heaviest in the region.

Romania: Eurobank EFG Forecasts				
	2009	**2010**	**2011f**	**2012f**
Real GDP (yoy%)	-6.6	-1.6	2.5	1.0
Private Consumption	-10.6	-1.5	0.7	0.7
Govern. Consumption	1.2	-3.2	-3.4	-0.5
Gross Capital Formation	-21.7	7.8	6.3	5.5
Exports	-5.0	14.3	9.9	5.0
Imports	-21.4	12.4	10.5	6.5
Inflation (yoy%)				
CPI (annual average)	5.6	6.1	5.8	3.5
CPI (end of period)	4.8	8.0	3.1	3.4
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-9.0	-6.9	-4.4	-3.0
Gross Public Debt	30.0	37.8	40.1	41.0
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	6.9	7.3	7.0	6.5
Wage Growth (total economy)	8.4	2.5	5.3	5.8
External Accounts				
Current Account (%GDP)	-4.2	-4.5	-4.4	-4.7
Net FDI (EUR bn)	3.6	2.2	1.9	2.5
FDI / Current Account (%)	72.3	45.5	33.7	37.0
FX Reserves (EUR bn)	30.9	36.0	33.2	35.0
Domestic Credit *(end of period)*	**2009**	**2010**	**Q2 11**	**Q3 11**
Total Credit (%GDP)	50.2	52.7	52.7	52.3
Credit to Enterprises (%GDP)	19.6	20.4	20.5	20.8
Credit to Households (%GDP)	20.4	19.9	19.1	19.0
FX Credit/Total Credit (%, private)	60.1	63.0	62.9	63.6
Private Sector Credit (yoy)	0.9	4.7	1.3	6.5
Loans to Deposits (%)	130.6	137.7	134.9	140.0
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	5.50	5.25	5.00	5.00
EUR/RON	4.37	4.35	4.40	4.40

Source: Source: National Sources, Eurostat, IMF, Eurobank Research & Forecasting

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