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FOCUS NOTES: ROMANIA

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Q4 GDP data suggest end of domestic recession is probably in sight, but higher-frequency indicators still call for caution

- According to preliminary estimates, Romania's real GDP contracted 1.2% YoY in 2010, less than our -1.8% forecast and market expectations (-2.0% in the Thomson Reuters poll). On seasonally adjusted data, GDP grew by 0.1% QoQ in Q4 2010. The news is positive, signalling a likely bottoming out of domestic recession in the period ahead

- Based on the aforementioned data and taking into account recent reading in a number of high frequency indicators, we expect an economic recovery to take place around mid-year 2011. i.e., a quarter later than presently expected by both the government and the IMF

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… but higher-frequency indicators still call for caution

Exiting recession is often described as two consecutive quarters of positive (seasonally adjusted) real GDP growth. The National Bureau of Economic Research, the official tracker of recessions in the US, has a more nuanced definition for recessions: "a significant decline in economic activity spread across the country, lasting more than a few months, normally visible in real GDP growth, real personal income, employment (non-farm payrolls), industrial production, and wholesale-retail sales."

Based on the aforementioned criteria and taking into account a number of recent domestic high frequency data, we still expect an economic recovery to take place around mid-year 2011, i.e., a quarter later than presently expected by both the government and the IMF.

A. Timing of sustained GDP recovery remains uncertain

The marginally positive quarter-on-quarter GDP growth print in Q4 is insufficient by itself to call for an outright economic recovery. Let alone that the figure may be actually revised downwards, once additional domestic macro data becomes available (because of the inevitable end-point problem affecting the extraction of unobserved time series). Nevertheless, quarterly dynamics show the economy will bottom out soon.

B. Wages, pensions and remittances to record positive growth this year after contracting in 2010

1. The average real wage has declined by 4% YoY in 2010 and by 1.6% QoQ in Q4:2010 (seasonally adjusted data);
2. The new pension law has trimmed down higher pensions and social security benefits. In 2010, social security expenditure shrank 0.7% YoY when adjusted for inflation;
3. Remittances have fallen from their

historical high of 6.6 billion euros in 2008 to 4.4 billion euros in 2009 and to just 3.8 billion euros in 2010.

Leading indicators:

Positive: The spectre of general elections in 2012 will probably drive public sector wages and pensions higher this year. In January 2011, public sector wages have already risen by 15% compared to their October 2010 level. Note that public wages were cut by 25% on 1 July 2010, as part of the government's austerity package.

Positive: Italy and Spain look to be exiting recession, meaning remittances could bottom out in early 2011.

C. Strong performance in industry

Domestic industrial production was first hit in Q1 2009, being severely affected by the global economic downturn and the financial crisis. By Q1 2010, positive year-on-year growth of industrial output resumed, driven by higher exports. In 2010, industrial production was 0.3% lower in real terms from its peak in 2008, but 5.5% higher than in 2009, while annual exports valued in euros shrank by 5.9% in 2010 compared to their 2008 highs, but grew 14.5% YoY from their 2009 trough.

Leading indicators:

Positive: the European Commission (EC) survey shows expectations regarding export orders, employment, production trends and competitive position on foreign markets just below the levels of October 2008, before industrial production collapsed;

Positive: foreign demand for Romanian manufactured goods is increasing, as shown by the volume of foreign orders (+40.2% YoY in 2010) and by the improvement of export order books according to the EC survey.

D. Rising expectatrions for a bounce in retail sales

Retail sales fell by 5.3% YoY in 2010. Sales recorded a tentative recovery in H1 2010 (+4.6% YoY in June 2010 vs -12.4% YoY in January 2010) to only resume their downward trend in the second half of last year (-9.0% YoY in December 2010). The main culprits were tightening fiscal measures (public wage cuts and VAT hike). Throughout 2010 and in the first two months of 2011, the EC survey constantly recorded inventories as being slightly higher than needed, meaning wholesale and retail sales have been falling at a broadly similar pace.

Leading indicators:

Negative: consumer pessimism in Romania is historically persistent. 73% of consumers surveyed by the EC in February 2011 were pessimistic, down from 81% in July 2010 (when fiscal reforms were implemented), but up from 56% in September 2008. Moreover, just 20-25% of consumers surveyed between June 2010 and February 2011 had the intention to make major purchases over the next 12 months, with potential reasons including:

a. wage and pension cuts;
b. declining consumer lending (-4.8% YoY in 2010, euro equivalent);
c. the negative wealth effect from lower asset prices: the majority of banks surveyed by the NBR in January 2011 were expecting Q1 2011 to be the 11th consecutive quarter of falling home prices. Faced with a negative net worth, many households sacrifice major purchases;

Positive: consumer pessimism is appeased by higher revenues and falling unemployment. The unemployment rate declined from a seven-year high of 8.36% in March 2010 to a 17-month low of 6.74% in January 2011;

Positive: February 2011 PMI for retail and services improved dramatically, to levels last seen in January 2009 (optimistic views came from 51% and 53% of respondents respectively, still down from 62% and 64% respectively in H1 2008, at the pinnacle of the boom).

E. Financial intermediation to improve further

1. The credit risk ratio has stabilised below 21% in Q4 2010 and the NBR expects it to decline in 2011.
2. Lending has resumed in 2010 (+3.4% YoY in December 2010, euro equivalent), with the main recipients being companies (+7.7% YoY in December 2010, euro equivalent) and mortgage buyers (+17.8% YoY in December 2010, euro equivalent), the latter supported by state guarantees. The selective rise in lending is expected to continue in 2011 along the same lines.
3. At the end of 2010, the private sector held the equivalent of 2 billion euros in additional deposits compared to December 2009 (a 4.7% YoY increase). Households added the equivalent of 1.14 billion euros in deposits. Attractive interest rates drove households to switch from demand deposits to time deposits, while firms chose to divide money between the two types of deposits.

F. Low foreign investments unable to help the economy out of recession

1. Foreign direct investments in Romania peaked at 9.5 billion euros in 2008, but plunged to just 3.5 billion euros in 2009 and to 2.6 billion euros in 2010 (comparable to levels last seen between 2000 and 2003, when Romania was not a member of NATO or the EU). In September 2009, the United Nations Conference on Trade and Development (UNCTAD)

estimated world FDI flows at 1.114 trillion USD for 2009 and 1.122 trillion USD for 2010 (an increase of 0.7% vs. 2009, but a decrease of 46.6% vs. the all-time high in 2007). Among the possible explanations for Romania's incapacity to keep pace with international FDI flows are the following:

a. An inability so far to exit recession; as opposed to other Emerging market economies in the region
b. Unquenched risk aversion and investors' demand for liquid financial markets;
c. Red tape and the failure of the political class to decisively simplify the fiscal code. Between 2009 and 2011, Romania slipped 11 places to 56 in the world ranking of most attractive investment destinations according to the Doing Business project of the International Financial Corporation. It lost ground on all categories but property registration and closing businesses;
d. Poor infrastructure.

A rapid improvement with respect to all aforementioned hindrances is not foreseen presently, so we expect FDI inflows in Romania to amount to no more than 4 billion euros in 2011, below official and market expectations of 5 billion euros.

2. Capital flows to Romania excluding FDI and tranches from the IMF and the EC totalled just 244 million euros in 2010 (outflows amounted to 5.5 billion euros in 2009, according to NBR data).

G. Labour market developments

1. According to Eurostat data, the number of people employed by industrial firms in December 2010 was just 49.3% of that in January 1998. A similar decline was registered by the number of employees in manufacturing (-50.5% in December 2010 vs. January 1998). Meanwhile, imported technology allowed for a 91.3% increase in the volume of production (and thus for productivity gains).
2. The number of employees in services peaked in January 2009 (24.4% higher than in January 1998), subsequently declining 13.6% by November 2010.
3. The seasonally adjusted employment figure for constructions was highest in March 2008 (1.5% higher than in January 1998), but dropped by a third by December 2010.

All the aforementioned employment measures show no sign of bottoming out. One cause could be the potential for further productivity gains. Other explanations are the steady increase of the underground economy and the number of workers migrating abroad.

Leading indicators:

Positive: employment expectations in the February 2011 EC survey in industry are highest on record (since January 1992);

Positive: in February 2011, employment expectations in constructions were back at levels last seen in late 2008 (the sector peaked in March 2009);

Positive: employment expectations in retail and services surged in February 2011 back to where they stood at the beginning of 2009.

Slow exit from recession: *Potential implications for the leu and domestic interest rates*

1. A EUR/RON bounce to 4.25 or higher (from levels around 4.21 currently) could materialise in a scenario under which:
   a. Q2 data disappoint market expectations for an end of the domestic recession in Q1 2011;
   b. from a longer-term perspective, the pace of domestic economic recovery proves too slow (the IMF expects the economy to grow by 3.5% YoY in 2012; our present forecast is for growth of just 1.5%);
2. Money market interest rates (maturities longer than 3 months) could stay above 5% for the greater part of this year in a scenario under which:
   a. the bulk of FX inflows comes from International Financial Institutions rather than private investors;
   b. treasury yields could remain over 6.5% up to one year and over 7% for longer tenors if the MoF misses its revenue targets, because of slower growth and too optimistic budget planning.

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