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Structural reforms are urgently required to boost the medium term growth prospects of Romania

- **Inflation eased further to 5.25% yoy in March vs. 6% yoy in January. The Central Bank left interest rates unchanged at 5.25% on March 28th, hinting that the next move will be a rate cut**
- **The implementation of structural reforms in the broad government sector could work as a catalyst for releasing the growth potential in the medium-term.**
- **Romania is about to exit the Excessive Deficit Procedure in 2013**

Inflation eased further to 5.25% in March vs. 6% in January. The Central Bank kept interest rates unchanged in March, hinting that the next move will be a rate cut.

Consumer prices slowed to 0.04%/5.25% mom/yoy in March compared to 0.3%/5.65% mom/yoy in February, against a 12 month high at 0.6%/6.0% mom/yoy in last January. The reading stood below the consensus poll (0.3% mom). Inflation dynamics have been driven by higher food and energy prices since last August. The summer drought had a negative impact on domestic agricultural output. The negative base effects from last year's very good performance augmented the impact on food prices. As a result, food prices, which carry a significant weight (37.5%) in the consumption basket, more than doubled to 7.2% yoy in January 2013 up from 3.3% yoy in last August. However, food prices have started to moderate in the last couple months reaching -0.1%/+5.5% mom/yoy in March.

Non-food items, which also had a positive contribution in the past months, moderated too. Non food items edged down to 5.8% yoy in March compared to 6.2% in January helped by the downtrend of international energy prices and the lower domestic energy consumption. Services, the only group that posted a rise, expanded by +0.5%/+3.5% mom/yoy in March against +3.1%

mom/yoy in January. The hike in regulated prices of water and sewage (+1.9% mom) and urban transportation (+0.8% mom) were the main drivers behind the rise in services inflation. In contrast, weak domestic demand has helped contain core inflation within the 2.5+/-1% target band. The Core2 adjusted inflation declined further to 3.0% yoy in March vs. 3.2% yoy in January and 3.5% yoy in last December.

Looking ahead, we see upside risks to inflation. Risks for higher inflation stem from the ambitious liberalization plan of energy prices. The plan provides for both electricity and natural gas prices for residential and non residential segments to be liberalized. The first wave of hikes in energy prices took already place in January (10.3% yoy rise in residential electricity prices). The rise explained 0.55pps out of the 1.34pps of the month on month inflation in January.

Meanwhile, the Central Bank maintained interest rates unchanged at 5.25% on March 28th for a ninth time in a row. At the same time, the minimum reserves requirements were maintained unchanged (at 15% on RON liabilities and 20% on FX liabilities for maturities below 2 years). The move was in line with Bloomberg consensus (21 analysts). The Central Bank has kept interest rates unchanged since March 2012 when it last cut interest rats by 25bps from 5.75% to 5.25%.

The Central Bank governor, Mr. Mugur Isarescu, hinted in the press briefing that the next policy move will most probably be a rate cut provided that there is no deterioration in inflation expectations. Given that inflation and inflation expectations will most probably stay elevated until late Q3, we anticipate rates to remain unchanged until at least then. According to the latest inflation report in February, inflation will only enter the Central Bank target band in late Q3-early Q4 on favorable base effects, negative output gap. That leaves room for a rate cut to take place by the end of 2013 or early 2014.

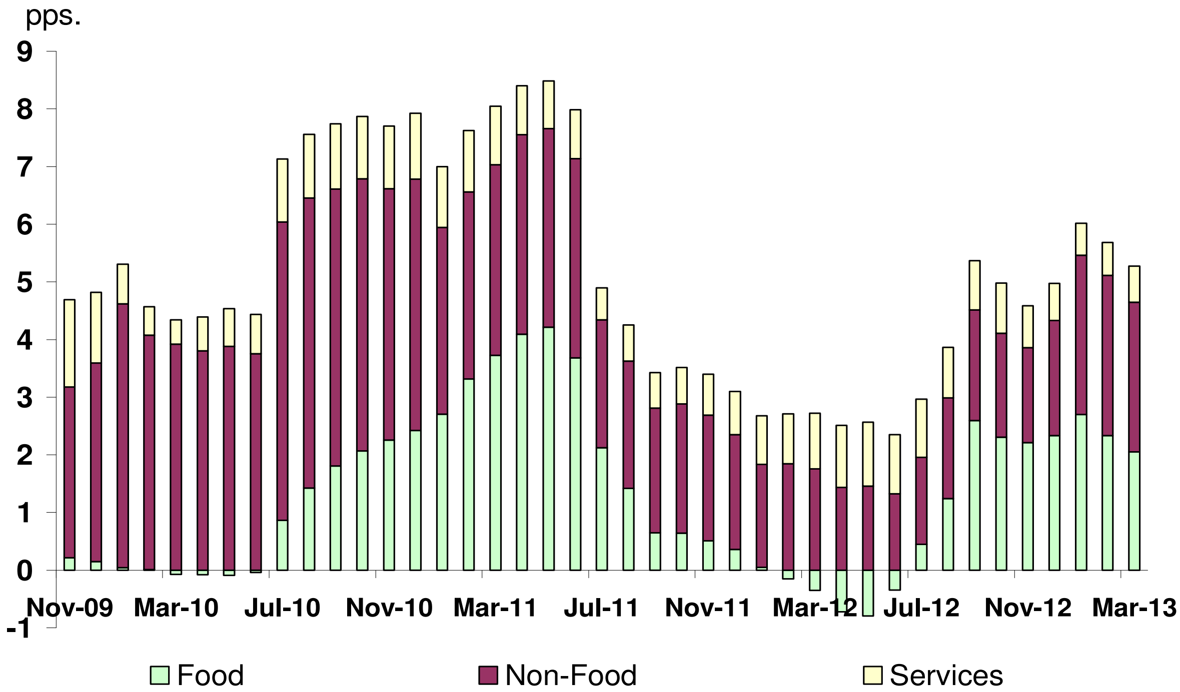
The government accomplished to reduce the fiscal deficit in ESA-95 terms below 3% of GDP in 2012. Medium term challenges remain unattended.

The fiscal consolidation has yielded impressive results in 2012 in a heavy election calendar year. According to the full year data, the consolidated budget deficit in ESA-95 terms ended at RON 17.4bn or 2.8% of GDP in 2012 against a 3% of GDP target compared to 5.2% of GDP in 2011. This is still an impressive adjustment given that both parliamentary and local elections took place in the past year. The government envisages a further reduction to 2.4% of GDP in 2013. In any case, Romania will most probably no longer be subject to the Excessive Deficit Procedure (EDP), when Eurostat validates the budget execution data for Romania.

On the negative side, the government reform agenda is lagging behind. The government was granted a three month extension (until June) in the current precautionary IMF agreement framework in order to take corrective action. The corrective actions are needed to achieve the objectives of the program with respect to the elimination of arrears and the budget implementation of 2013. On top, the government is lagging behind with the implementation of the privatizations in the area of state-owned enterprises. The implementation of structural reforms in the broad government sector could work as a catalyst for releasing the growth potential in the medium-term. According to IMF, the medium term growth (next 3-5 years) could reach 3.5-5% if the government accelerates the structural reforms implementation.

In addition, there is room for significant improvement in two key areas: EU funds absorption and public sector efficiency. The EU funds absorption rate remains at relatively low levels. The absorption rate stood at 12.2% in February out of the €19.6 bn earmarked in 2007-2013. Although some progress has been made during the PM Ponta administration, this is still the lowest in EU-27. Six of the seven operational programs have been frozen after the EU audit teams' investigation spotted incidents of mismanagement at the national level. To make things worse, Romania has a limited time to absorb the rest of the funds. Romania operates under the n+2 years rule for 2011-2013. That means that the funds earmarked in a year, have to be spent and certified by EC within 2 years.

Figure 1: Inflation climbed higher during the summer months on food and energy prices



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