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Eurobank EFG
NEW EUROPE
ECONOMICS & STRATEGY
June 1st, 2012
FOCUS NOTES: ROMANIA

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Romania-Macroeconomic Outlook

New government remains committed to the precautionary IMF-EU agreement

Key points

- A new government under the leadership of Victor Ponta emerged from the successful no-confidence motion in parliament on April 27th
- The precautionary IMF-EU agreement remains on track: all but one quantitative criteria were met in the fourth programme review
- Upon negotiations with IMF, the fiscal target of 2012 has been upwardly revised to 2.2% of GDP in order for public wages to be restored to 2010 levels
- The economy slipped into technical recession in Q1-2012, contracting by 0.1% qoq
- 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
- Inflation has declined to historically lows and is expected to remain benign in the months ahead despite rising pressures from the external sector
- Against a backdrop of increased political uncertainty and financial markets volatility, the NBR paused its easing cycle in May, leaving its key policy rate at 5.25%. A further 25bps rate cut as early as in June should not be ruled out
- The current account deficit is expected to widen marginally this year on improved domestic demand and weaker growth in main trade-partner economies
- Debt creating inflows have taken the lead as the main financing source of the current account

Introduction

In our previous macro publication on Romania (March 2012), we warned about a further intensification of domestic political uncertainty heading into the November 2012 parliamentary election. Not even a full month had elapsed since that point and the government was overturned through a no confidence vote in Parliament. A new government is now in place supported by the Social Liberal Union, a coalition of three parties (PSD, PNL and PC) and headed by Victor Ponta as the new Prime Minister. The new government has vowed to remain committed to the structural reforms and fiscal consolidation program underlying the existent EU-IMF precautionary agreement.

Romania's real GDP expanded by 2.5% in last year, recording the first positive reading since 2008. The first four months of 2012 proved to be particularly difficult for the domestic economy for a number of reasons, including, among others, the impact of the deepening euro area sovereign debt crisis, increased domestic political uncertainty as well as exceptionally bad weather conditions resulting into frequent power cuts and affecting negatively manufacturing output. For the full-year 2012, we expect the pace of economic expansion to slow down to around 1%, with the balance of risks remaining skewed to the downside. On the inflation front, headline CPI has been on a downtrend since the beginning of this year. After coming in at 3.1% yoy in December 2011, domestic inflation eased further in the first four months of this year, reaching a historical low of 1.8% yoy in April and falling well within the NBR's respective target range (3% +/- 1%YoY).

On the fiscal side, following visible progress in consolidating the public finances over the past two years, the new government successfully negotiated with the IMF an upward revision to this year's deficit target to 2.2%-of-GDP, from 1.9%-of-GDP earlier so as to facilitate a restoration of public wages to their early 2010 levels *i.e.,* before the 25% horizontal reduction implemented by the previous government as part of their agreement with international lenders. On the external front, the current account position stabilized further in 2011, with the headline deficit (as % of GDP) registering a marginal decline to 4.4% from 4.5% in the prior year. In nominal (euro) terms, the current account shortfall widened by just 3% yoy to €5.7bn (Table 1).

From a structural standpoint, 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). The ongoing deleveraging process of the EU banking sector translates into measurable domestic macro prudential risks. Last but not least, the risk of fiscal slippage in view of the heavy election calendar in 2012 (local elections in June-parliamentary elections in November) remains material.

Real sector developments: past trends and outlook

In the period following the liberalization of the capital account in 2005 and until the outbreak of the 2007-2008 global 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 - in the form of, among others, growing twin deficits - with the current account shortfall reaching a record high near 14%-of-GDP in 2008. With capital inflows drying up following the collapse of Lehman Brothers in autumn 2008, the domestic growth paradigm started to unravel.

In March 2010 Romania applied for a two-year multi-lateral lending program, co-financed by the IMF (€12.95bn 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 the IMF funds and €3.7bn from the EU package in six tranches (out of eight in total). The disbursed official funds were utilized to replenish the foreign currency reserves of the Central Bank (BoP support) and to temporarily finance the budget deficit. Upon the successful completion of the program in March 2011, a new two year precautionary agreement worth €5bn (€3.6bn from IMF and €1.4bn from EU) was agreed with official lenders. The new agreement aims to promote structural reforms and, at the same time, provide a cushion in case of a new financial downturn.

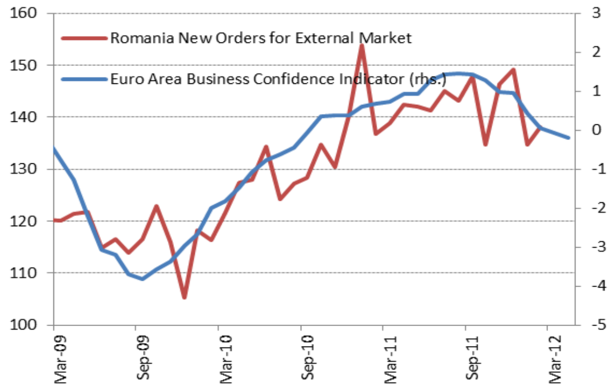
Notwithstanding the external financial assistance, Romania's real output declined by 7.1% in 2009, followed by a further contraction of 1.3% in 2010. The evolution of the domestic macro economy following the 2008 global financial crisis was the result of two opposing dynamics. On the one hand, exports recovered rather rapidly, growing by 37% cumulatively from the end of 2008 to the end of 2011 in real terms. 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 (+1.4%), GDP experienced a growth spur in Q3 (+4.4%). 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 grow by 3.2% qoq. However, the boost from agriculture was only temporary, with quarter-on-quarter real GDP shrinking by 0.2% in Q4. The economy experienced a further shock in the first quarter of 2012. The Romanian winter turned particularly harsh starting from February 2012. Heavy snowfalls and snowstorms as well as low temperatures took their toll on infrastructure and significantly slowed down economic activity in the first quarter of 2012. Given these factors, the economy is estimated to have contracted 0.1% qoq in Q1-2012, which would translate into an annual pace of expansion of 0.3%.

Looking forward, external demand now poses the biggest risk for the recovery process. The near-term outlook remains mildly contractionary given the lingering sovereign debt crisis in the euro area – both the IMF and the European Commission are now expecting a 0.3% contraction of the Eurozone economy in 2012. Weakened demand from main trade partner economies has already started to take a toll on Romanian exports. The annual growth rate of new orders for the external market has been on a downtrend since Q3-2011 and has now fallen to negative levels for the first time since January 2009: -1.3% in February (Figure 1).

On an aggregate basis, we expect the economy to expand by around 1.0% in real terms in 2012, with risks broadly balanced. On the one hand, the heavy snowfalls and rainfalls in the first five months of the year may have affected the 2012 harvest. Also, a deterioration of euro area growth may exert downward pressures on Romanian exports. On the other hand, growth may receive a boost provided the absorption of EU cohesion and structural funds improves.

Figure 1
The outlook for external new orders remains broadly negative as Europe slips further into recession

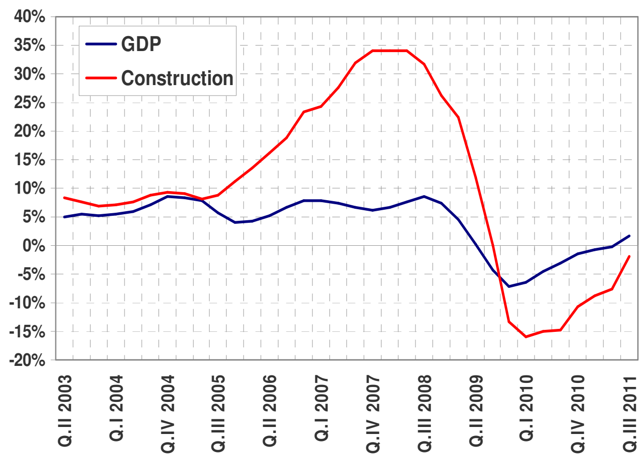


Index, 2005=100, seasonally adjusted data, 6-month lagged data for BCI
Data Source: Eurostat, European Commission

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).

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



Source: National Institute of Statistics

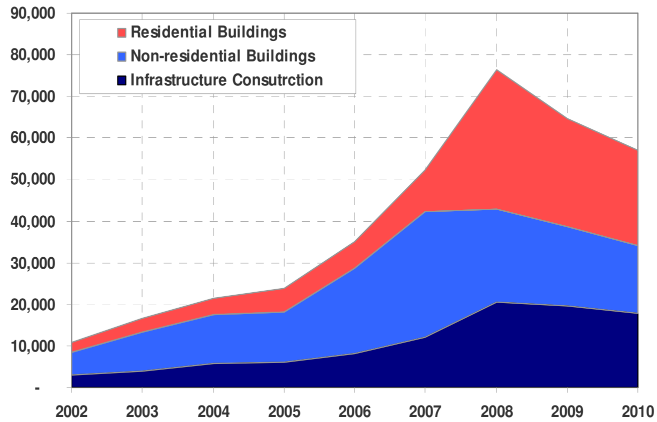
The ascent of domestic demand also resulted into higher real estate prices. This new source of wealth further leveraged the demand for construction works.

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.

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 fared better under these conditions, but the recovery is bound to remain slow as long as private consumers continue deleveraging.

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

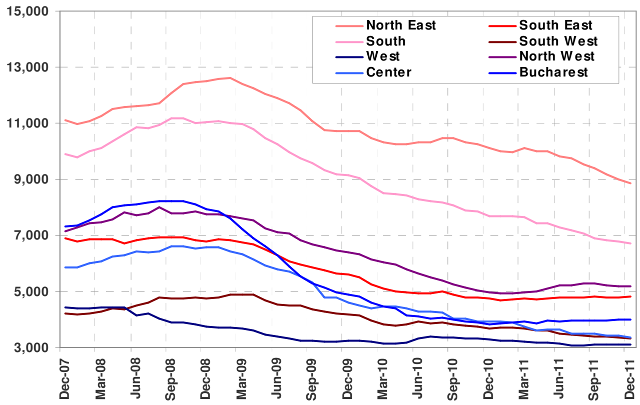


Source: National Institute of Statistics

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, with the decline appearing 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.

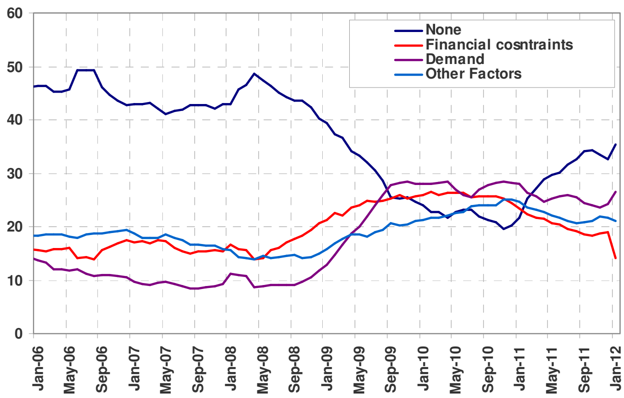
Figure 4
The number of new building permits is starting to stabilize in the North West, South East and Bucharest regions



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).

Figure 5
Demand factors have started to normalize in 2011



Source: European Commission, EFG Research

This situation changed starting from 2008. Financial difficulties and weak demand became the most important factors limiting 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 that there were no significant factors deterring their construction activity. 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. Most probably construction works have been affected by the negative weather conditions during the first quarter of 2012. Subsequently, new residential buildings came in at -10.25% yoy in March from 3% yoy in January 2012.

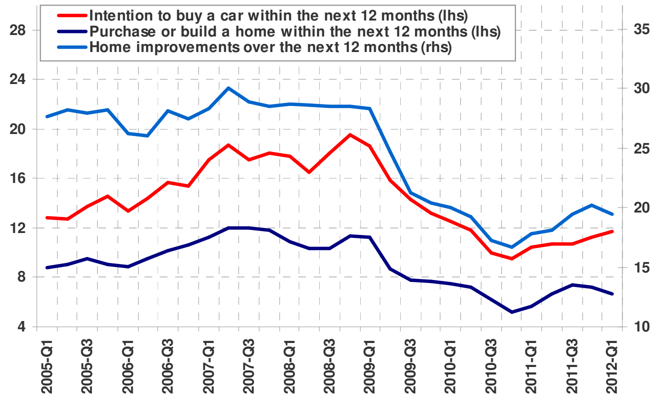
Recovery of retail sector remains timid, but improvements of durable goods sales are encouraging

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 grew by an average 17% yoy from December 2008 to December 2010), whereas sales of durable goods (electronics, house equipment and recreational goods) fell by an average of 23% yoy during the same period.

Retail sales also appear to have slowed down in the first three months of the year. The largest contraction was recorded in February (-2.5% m-o-m on a seasonally adjusted basis). Moreover, we have observed a sharp divide between food sales, which increased by 3% mom, and non-food products, which shrank by 4.9% mom. This pattern was most likely formed by consumers stockpiling food ahead in anticipation of the snowfalls. Retail sales rebounded slightly in March (1.2% mom).

However, purchases of durable goods returned to positive growth rates starting from the first quarter of 2011 and expanded by around 10% yoy throughout that year. Given the perennial nature of these purchases, we expect the recovery in the sector to continue in the months ahead. These trends are also reflected in the most recent readings of a range of high-frequency indicators of consumer demand. 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



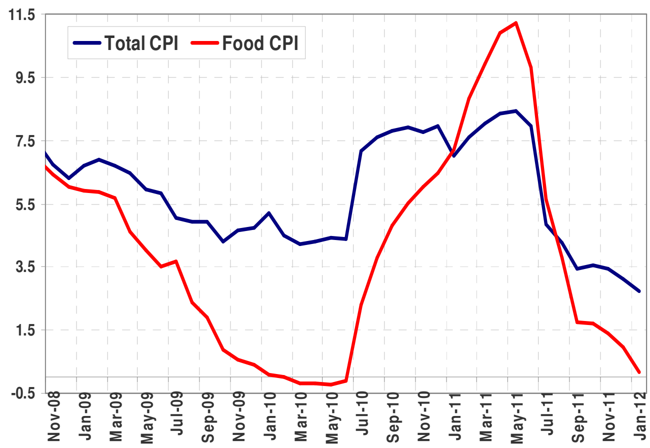
Source: European Commission, EFG Research

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

Domestic consumer prices have experienced increased volatility in 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%), which we estimate to have added some 2.5ppts to headline CPI.

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 and the fading out of base effects stemming from the earlier VAT rate hike helped to reverse that trend. (Figure 7).

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 Institute of Statistics

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

Adverse weather conditions boosted, temporarily, food prices early this year (up by 1.2% mom in February, the sharpest rise in the past 12 months), but headline inflation declined to 1.8% yoy April (from 2.4%yoy in the prior month) on the back of favorable base effects and weak demand-side dynamics.

The disinflationary process continues to be driven primarily by food prices, which resumed their declining trend in April, falling by 1.9% yoy Subsequently, CORE3 inflation surpassed headline inflation in April (2.1% vs. 1.8%) for the first time since the indicator first started being computed. The outlook for consumer prices remains benign in spite of the adverse shocks from the first months of the year. The NBR has maintained its end-of-year inflation forecast at 3.2%, firmly within the target interval of 3% ±1pp.

Decelerating domestic inflation suggests NBR's rate easing cycle is probably not over yet

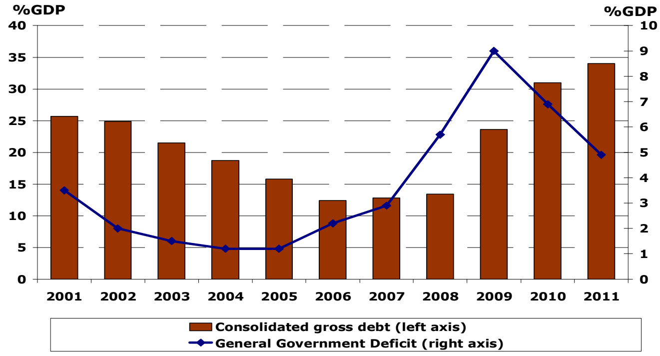
The Romanian Central Bank had kept its key policy rate stable at 6.25% for 16 consecutive months since May 2010. This was in spite of the mid-2010 VAT rate hike, which temporarily pushed headline inflation above the NBR's tolerance range. Encouraged by a subsequent improvement in the domestic inflation outlook, the Central Bank embarked on a new easing cycle in November 2011, driving its policy rate down to 5.25% by February 2012. 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 4.5% in the May 2012.

The official statement accompanying the Bank's no-rate-change decision in May 2012 signaled an increasing focus on maintaining domestic financial stability. In effect, the Central Bank has recently adopted a wait-and-see stance so as to contain exchange rate volatility and prevent excessive shifts in hot money inflows. Should these pressures on the RON recede we see a significant chance for the NBR to resume its rate cutting cycle as early as June.

Strong fiscal consolidation progress in 2009-2011

Romania's fiscal position improved significantly in the past three years, with the general government deficit on a cash basis declining to 4.35%-of-GDP last year from 7.3%-of-GDP in 2009. The adjustment was even more impressive in ESA-95 accounting terms, with the deficit having declined by nearly 4ppt-of-GDP from 9% of GDP in 2009 to 5.2%-of-GDP last year (Figure 9).

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



Source: Eurostat, Eurobank Research

The execution of the 2011 budget was in line with the requirements of the precautionary IMF 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 of adjustment, favoring reductions in current expenditure over capital spending cuts as a means of achieving the fiscal targets.

In 2011, 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 introduced 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.

Upward revision to 2012 fiscal deficit target

The new government recently presented its economic programme to receive parliamentary backing. The document reflected the government's commitment to a continuation of the IMF-EU precautionary programme. Romania earlier completed successfully three reviews under the present precautionary programme without making any use of the designated funds. The fourth review of the existing programme incepted on April 24 and was about to finish on May 7. Yet, its completion was delayed until May 10 to account for the formation of the new government. The IMF mission assessed that all quantitative criteria were met with the exception of central government arrears, which was missed by a small margin. On the negative side, the privatization program has remained sidetracked following a series of unsuccessful auctions of a number of state-owned companies.

The outgoing coalition government had targeted a general government deficit of 1.9% of GDP on a cash basis in 2012 (or 2.1%-of-GDP after a number of IMF-approved off-budget expenditure items). However, following the formation of the new cabinet, an agreement was reached with the IMF to revise upwards the 2012 deficit target to 2.2% of GDP, from 1.9% so as to create room for an increase in public wages to their early 2010 levels. This is estimated to increase this year's shortfall by ca 0.4ppts-of-GDP, with a further 0.1ppts-of-GDP coming from a return of health contributions paid earlier by pensioners. Public sector wages will rise in two installments. The first will take place in June (wages will rise by 8%) and the second will take place in January (wages will rise by another 7.4%). Nevertheless, in ESA95 terms, the fiscal deficit target for 2012 remains unchanged at 3%-of-GDP.

The budget execution data for Q1-2012 revealed an overall deficit figure of RON 3.40bn (or 0.6%-of-projected GDP), which is broadly in line with the revised full year target. Consolidated budget revenues grew by 0.9% yoy to RON 45.7bn in January-March 2012, while consolidated budget expenses stood at RON 49.1bn, up by 4.9% yoy.

As an overall assessment, domestic authorities have already done significant work in containing budgetary expenditure over the past three years, by implementing politically-sensitive measures (e.g. more than 100k lay-offs in the broader public sector in 2010, raising VAT rate from 19% to 24%). Yet, the near-term fiscal outlook continues to be clouded by significant uncertainties and risks.

For 2012, the risk of fiscal slippage in view of this year's heavy election calendar remains material (local elections in June-parliamentary elections in December). Rating agencies (Fitch and Moody's), have already warned about the risks of a downgrade in the long term credit rating if fiscal slippages are generated in the future.

Secondly, there are risks related to the domestic growth outlook. The budget is built upon a forecast range for GDP growth between 1.8%-2.3%. Even if headline GDP turns out to be in line with the budget forecasts, the realized growth mix (balance between domestic and external demand) will be a key determinant for 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 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 only in Q3-2011 for the first time since the inception of the IMF programme (precautionary and regular Stand By Arrangement).

Domestic authorities have already done a lot of work both on an institutional and managerial level to contain arrears. In Q3-2011, the overall arrears at the central government level and in the health sector was lower than 0.2%-of-GDP. In contrast, the level of outstanding arrears in state-owned enterprises remains significant (ca. 3.4% of GDP in Q3-2011, according to the latest IMF assessment issued in January 2012).

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, to €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.

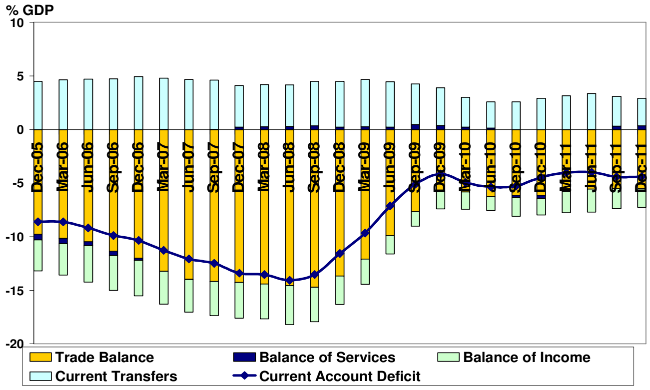
Table 1: Balance of Payments 2011

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 last year's 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 by 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 0.1ppts 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 9.5ppts 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 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 are expected to be driven by four major trends.

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.

The current account data published in the first quarter of 2012 may not be illustrative of the full year trends. The current account deficit came in at €0.5bn in Q1, 44% lower on a yearly basis (Table 2).

Table 2: Balance of Payments Q1 2012

mn Euros	Q1 2011			Q1 2012			%
CURRENT ACCOUNT	14,230	15,197	**-967**	14,814	15,358	**-544**	**-44%**
A. Goods & Services	12,515	13,526	**-1,011**	12,650	13,789	**-1,139**	**13%**
a. Goods (exports fob - imports fob)	11,045	12,035	-990	10,998	12,165	-1,167	**18%**
b. Services	1,470	1,491	-21	1,652	1,624	28	**-233%**
- transport	458	296	162	449	320	129	**-20%**
- tourism - travel	210	273	-63	222	290	-68	**8%**
- other	802	922	-120	981	1,014	-33	**-73%**
B. Incomes	260	956	-696	286	817	-531	**-24%**
C. Current transfers	1,455	715	**740**	1,878	752	**1,126**	**52%**

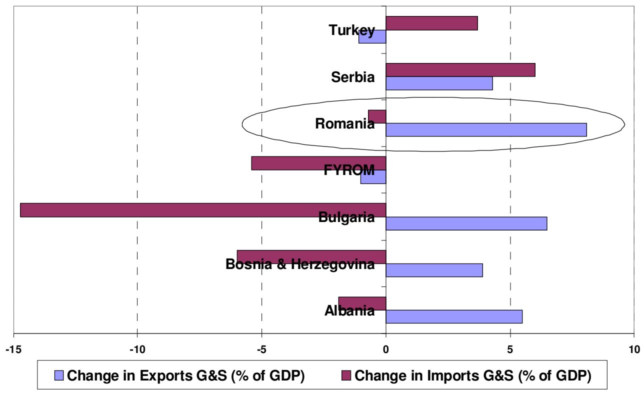
Source: NBR

Its dynamics are heavily influenced by the volatility in public transfers which boosted the current transfers' surplus. This is a pattern witnessed in the past years as well. The improvement in net current transfers (by 52.2% yoy to €1.1bn) was the major driver behind the current account improvement. The deterioration in the trade deficit (by 17.9% yoy to €1.2bn) partially offset the current account improvement. Exports fell by 0.4% yoy, while imports barely inched up by 1.1% yoy against a backdrop of a weak euro area macro environment.

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

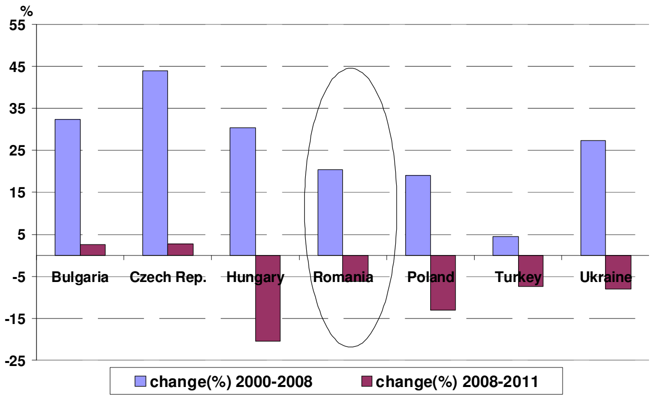


Source: Eurobank EFG Research, Eurostat, IMF, National Authorities

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 2011 their 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 stands behind from that point of view.

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

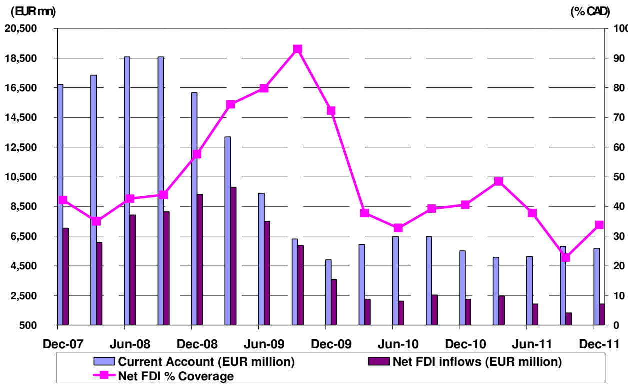
On the financing side, Romania has been no exception from the regional pattern of capital inflows drying up in the aftermath of the international financial crisis. The surplus of the capital and the financial account has declined from €17.8bn in 2008 to €5.6bn in 2011.

Net FDI inflows, the most important source of balance-of-payments financing during the boom times, lost significant ground in the aftermath of the crisis. 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 31.7% of the corresponding current account deficit against 40.6% in the prior year and 72.3% in 2009 (Figure 13).

There is a twofold 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 year. 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 comprise 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

Looking ahead, we anticipate this pattern of financing to be repeated in 2012. The prospect of a significant rebound in capital inflows is limited in the foreseeable future, especially taking into account the lingering sovereign debt crisis in the euro area. Yet, the government's privatization program may provide some support. We forecast net FDI inflows to amount to €2.5bn in 2012. The financial account data in the first quarter showed that net FDI inflows came in at €425mn in Q1 down by only 4.3% yoy, a rather encouraging sign considering that no privatization took place at that period and that FDI inflows are traditionally stronger in the 2H.

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 €98.4bn in 2011 compared to €92.4bn in 2010. As a percentage of GDP, gross external debt edged lower at 72.2%-of-GDP in 2011, compared to 74.5%-of-GDP in 2010 vs. 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%) comprises of 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.

In conclusion, Romania's external financing requirement in 2012 is one of the heaviest in the broader EM region. According to IMF calculations, the country's gross external financing requirement (rollover of maturing gross external debt *plus* projected current account deficit) is expected to reach €36.2bn or 26.7%-of-projected GDP.

On the positive side, the current precautionary stand-by agreement will shield the country in case of a new global financial downturn. In principle, the program provides a safety net to investors which effectively reduces the sovereign premium and allows both the private and the public sector to roll over the existing debt stock.

Romania: Eurobank EFG Forecasts				
	2009	**2010**	**2011**	**2012f**
Real GDP (yoy%)	-6.6	-1.6	2.5	1.0
Real Domestic Demand	-12.0	-1.5	2.8	0.7
Consumption	-7.4	-1.3	0.4	-0.5
Investment	-28.1	-2.1	2.6	5.5
Exports	-6.4	14.0	11.7	5.0
Imports	-20.5	11.9	11.2	6.5
Inflation (yoy%)				
CPI (annual average)	5.6	6.1	5.8	2.8
CPI (end of period)	4.9	8.0	3.1	3.2
Fiscal Accounts (%GDP, Cash Basis)				
General Government Balance	-7.3	-6.4	-4.2	-2.2
Gross Public Debt	30.0	37.9	40.0	39.4
Labor Statistics (annual avg,%)				
Unemployment Rate (% of labor force)	7.8	7.0	5.1	6.5
Wage Growth (total economy)	8.4	2.5	4.9	5.8
External Accounts				
Current Account (%GDP)	-4.2	-4.4	-4.3	-4.7
Net FDI (EUR bn)	3.6	2.2	1.9	2.5
FDI / Current Account (%)	72.3	40.5	31.7	37.0
FX Reserves (EUR bn)	30.9	36.0	37.3	35.0
Domestic Credit *(end of period)*	**2009**	**2010**	**Q3 11**	**Q4 11**
Total Credit (%GDP)	50.2	52.7	52.3	50.6
Credit to Enterprises (%GDP)	19.6	20.4	20.8	19.9
Credit to Households (%GDP)	20.4	19.9	19.0	18.0
FX Credit/Total Credit (%, private)	60.1	63.0	63.6	63.4
Private Sector Credit (yoy)	0.9	4.7	6.5	6.6
Loans to Deposits (%)	130.6	137.7	140.0	141.9
Financial Markets	**Current**	**3M**	**6M**	**12M**
Policy Rate	5.25	5.00	5.00	5.00
EUR/RON	4.46	4.45	4.45	4.40

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

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