

2010-022
August 31, 2010

Romania

Foreign LT: BBB-/Negative, Local LT: BBB/Negative

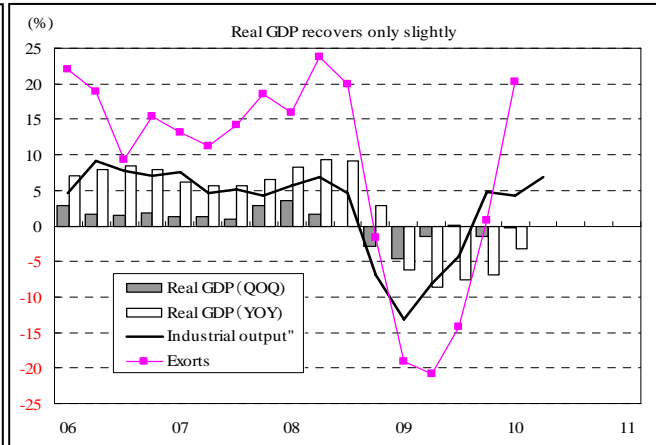
<Rating Perspective>

Positive Factors

- The country's improved external financing position backed by an IMF financial aid package
- Low-level government debt
- Increased production capacity rendered by massive investments on the foreign direct investment and EU subsidies

Negative Factors

- Increasing external debt stemming from persistent current account deficit
- Sharply increased fiscal deficit amid falling revenues
- Transformation of industrial structure still at a primary stage



<Update: from May 2010 to August 2010>

Positive Factors

- The joint European Commission, IMF and World Bank mission carried out the fifth review of the IMF Standby Arrangement and reached a provisional agreement on August 4
- Prime Minister Emil Boc survived a no-confidence vote by eight votes on June 15
- The general government fiscal deficit in the first six months of 2010 was 3.1% (cash base) of GDP, in line with the annual target of 6.8%
- The Romanian banks remains well capitalized as the capital adequacy ratio at the end of June 2010 was 14.3%
- The economic contraction in real GDP terms eased to 0.3% in the January-March quarter of 2010 from 1.5% the previous quarter. Industrial output in April-June quarter of 2010 grew 6.8% year-on-year for the third consecutive quarters
- International banks reaffirmed support for their subsidies in Romania on July 23

Negative Factors

- Widespread flooding in July may cause negative impact on both economy and public finance
- Increase in VAT in July push up inflation sharply to 7.3% year-on-year, significantly above the 3.5% plus/minus 1pp inflation target set by the National Bank of Romania
- The current account deficit in the first six months of 2010 increased 3.0% of GDP from 2.1%
- The unemployment rate in June declined for three consecutive months to 7.4%.
- The EU warned Romania about "important shortcomings" in its efforts to tackle corruption in July 20

<Outlook and Points to Watch>

Additional fiscal tightening measures adopted

(1) Economic recovery may slow on additional fiscal tightening measures

As its real GDP contracted 7.1% in 2009, Romania faced the worst recession since the latter half of the 1990s amid the credit squeeze triggered by the global financial woes and the subsequent economic downturn in its major European trading partners. Real GDP has been continuing to shrink (on a quarter-on-quarter basis) since the July-September quarter of 2008 except the July-September quarter of 2009 when it grew modestly. However, the contraction eased to 0.3% in the January-March quarter of 2010 from 1.5% the previous quarter. While deterioration of domestic demand such as investment and private consumption moderated, the recovery of external demand led by exports pushed up the whole economic growth. Exports kept growing for eight straight months since November 2009 and industrial production also grew 6.8% year-on-year in the April-June quarter for a third quarterly gain. While the unemployment rate declined for the three consecutive months to 7.4%, retail sales grew for the first time over one and a half year in June. Year-on-year bank lending to the private sector expanded for two consecutive months from May. On the other hand, increase in VAT in July push up inflation sharply to 7.3% year-on-year, significantly above the 3.5% plus/minus 1 pp inflation target set by the National Bank of Romania (NBR). The NBR has cut its policy rate by a total 400 bps since February 2009 in anticipation of stable inflation development. Nonetheless, recent rising inflation pressure is likely to put the NBR on hold the current policy rate at 6.25%.

The Romanian economy is likely to grow in 2010 and 2011, with exports leading the way helped by a weaker leu and an economic pickup in its major trading partners. However, JCR holds that the recovery will be slow as domestic demand will remain

weak on additional fiscal tightening measures to rein fiscal deficit and negative effect derived from widespread flooding. Any direct impact of the Greek financial crisis on Romania will be limited as its exports to the country account for only 2% of the total, but its indirect impact in the context of the entire European economic and financial situation needs to be carefully watched.

(2) IMF financial aid continues to help stabilize Romania's external liquidity position

The IMF and EU financial aid program totaling EUR20 billion continued to help stabilize Romania's external liquidity position. The program, officially approved in May 2009, remains effective over the next two years. Its loan disbursement is conditional on progress to be made in the government's comprehensive reform initiatives. Following the collapse of the former coalition government in late 2009, the enforcement of the reforms was suspended temporarily. However, it was resumed by the new coalition government elected in January 2010. Until May 2010, the fourth reviews under the Standby Arrangement completed, bring total disbursements to EUR 9.32 billion. On August 4, the joint EC, IMF and World Bank mission carried out the fifth review of the IMF Standby Arrangement and reached a provisional agreement reflecting the appropriate measures taken to rein the fiscal deficit. The measures include increasing the VAT rate to 24% from 19% and cutting public wages by 25%. Including EUR 900 million that can be disbursed upon official approval of the agreement, around 50% of the pledged financial program will be disbursed. A part of the assistance was put into Romania's foreign exchange reserves, which as of the end of July 2010 swelled to reach EUR 31.6 billion. In contrast, the short-term external debt, which had risen to EUR20.6 billion at the end of 2008, shrank nearly 30% to EUR 15.8 billion at the end of June 2010. This meant that the foreign exchange reserves covered twice the short-term debt.

(3) Government's weak political base leaves future progress on fiscal reforms uncertain

The general government fiscal deficit (ESA95) in 2009 widened to 8.3% of GDP from 5.4% in 2008 due mainly to revenue shortfalls and the fiscal stimulus implemented to counter the severe economic downturn. The government had initially agreed with the IMF that the deficit will narrow to 6.4% of GDP in 2010, but deteriorating economic conditions forced the government to revise the target ratio to 7.3%. The new projection is conditional on introduction of additional spending cuts. Romania is currently under the EC's excessive deficit procedure and is required to bring down the fiscal deficit to below 3% of GDP by 2012. *The Convergence Program* submitted to the EC in March 2010 envisages cutting the deficit to 4.4% in 2011 and to 3.0% in 2012. The reduction of the deficit requires the government to push reforms on both revenues and expenditures in keeping with its agreement with the IMF, but the government made some progress on implementing the reforms as planned. In June, the Prime Minister narrowly survived no-confidence vote from the opposition on the proposed measures cutting public employee and pensions. However, additional fiscal tightening measures forced to fall its opinion poll sharply. Uncertainty remains over whether the coalition government led by the Democratic Liberal Party can carry out its reform initiatives by enlisting support from its partners, the Hungarian Union of Democrats in Romania, minority groups and independent deputies.

(4) Risks remain with banking system

Romania's banking system has regained its stability. At the initiative of the IMF, the parent banks of the nine largest banks in the country reaffirmed with the NBR to retain the exposure of their subsidiaries and keep their capital adequacy ratios higher than 10% in July. The banking system still has enough capacity to absorb possible risks as its capital adequacy ratio (tier 1) stood high at 14.3% at the end of June 2010, albeit a reduced net income caused by bigger expenses needed to deal with increased nonperforming loans. However, possible deterioration of their asset quality due to slower economic recovery and rising unemployment could adversely affect their capital adequacy. JCR will also attentively watch the liquidity condition of Alpha Bank Romania, the subsidiary of Greece's Alpha Bank, which ranks fifth in terms of assets (accounting for 4% of the Romanian banking sector's total assets).

Main Economic Indicators: Romania

		2005	2006	2007	2008	2009	2010f	2011f
(Convergence criteria)	Criteria							
1.CPI (annual average)	-0.3%(note)	9.1	6.7	3.9	8.1	5.6	4.3	3.0
2.10 year government bond yield	4.6%(note)	7.0	7.2	7.1	7.7	9.7	n.a.	n.a.
3.General gov't fiscal balance/GDP(ESA95)	Below -3%	-1.2	-2.2	-2.5	-5.4	-8.3	-7.5	-6.0
4.General gov't debt/GDP(ESA95)	Below 60%	15.8	12.4	12.6	13.3	23.7	28.6	32.5
Real GDP growth rate	(%)	4.2	7.9	6.2	7.1	-7.1	1.0	2.5
Unemployment Rate	(%)	7.2	7.3	6.5	5.9	7.0	8.0	7.5
Current account balance/ GDP	(%)	-8.7	-10.4	-13.5	-12.4	-4.4	-4.9	-5.4
Trade balance/GDP	(%)	-9.8	-12.0	-14.5	-13.4	-5.8	-4.2	-4.7
Net FDI inflows/GDP	(%)	6.6	8.9	5.7	4.8	4.1	4.7	5.2
Foreign exchange reserve (FOREX)	(EUR mn)	16,796	21,310	25,307	26,220	28,481	33,600	37,800
Net FDI/CA	(%)	76.0	85.9	42.1	52.1	94.4	95.4	97.8
Gross external debt/ GDP	(%)	38.8	42.1	47.6	51.9	67.8	69.3	73.3
Gross external debt/ Export (G&S)	(%)	117.3	131.0	160.7	173.0	218.2	234.3	252.4
Public external debt/ Export (G&S)	(%)	46.3	36.8	36.8	38.2	73.3	99.4	113.0
FOREX/monthly imports	(months)	5.8	5.9	5.6	5.2	7.9	9.2	9.3
FOREX/short-term external debt	(times)	2.7	1.7	1.3	1.2	2.0	2.5	2.6
Debt service ratio	(%)	20.1	20.7	23.2	31.6	31.6	33.1	31.3

Note: Figures for criteria 1 and 2 are moving average between August 2009 and July 2010. Figures for 2010 and 2011 are based on the projection made by JCR

Source: The European Commission, the NBR, Ministry of Public Finance and National Institute of Statistics

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