
MONTHLY RISK *BRIEF*:
JANUARY 2010

About the author

Giovanni Ravasio is the former president of the Supervisory Board at the Restitution Fund, Eastern Europe's largest state – owned investment fund. He has extensive experience working in Romania, having closely advised successive governments since 1999 to prepare Romania's European Union accession in 2007. At present he is Board president at the European Investment Fund. Previously he worked as a director general in the European Commission.

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The Risk Brief Contents

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Marker Global Limited
Finsgate
5-7 Cranwood Street
London EC1V 9EE
Email: briefings@markerglobal.com

01 JANUARY RISK OUTLOOK AT A GLANCE

TOP 3 POLITICAL RISKS

- 01 The new administration is supported by the slightest parliamentary majority. The cabinet is formed around a Liberal Democrat (PDL) core with ethnic minorities and independent parliamentarians co-opted. Some technocrats have also been nominated for office. However, such a government will ensure stability only until Romania secures the external financial support from the International Monetary Fund (IMF) in early 2010.
- 02 Once the effects of unpopular decisions start biting in Q2 2010, the political instability is likely to return with the result that reform efforts will become subordinated to various interest groups as well as pressure from the opposition Social Democrats (PSD) and Liberals (PNL), still railing from their failed presidential contest on 6 December 2009 which returned Traian Basescu (Basescu) in office for a second term.
- 03 The opposition parties – PSD and PNL – are likely to maintain the anti-presidential coalition they formed around Mircea Geoana ahead of the presidential contest. However, the intra-party fight will exacerbate, as the leadership will be challenged at the spring party congresses. This in turn will result in the break up of the coalition between PSD and PNL. Once Crin Antonescu is removed from the leadership of PNL, the party is likely to reconsider supporting a PDL administration.

TOP 3 ECONOMIC RISKS

- 01 There is an increased risk that the much – needed public sector reform will slow down once the IMF funds are released by February 2010 as vested interest groups oppose the implementation of the IMF austerity programme. The adoption of the new budget is also a pre-condition for the release of external financing.
- 02 All the reforms requested in exchange for external financing will bear a much higher social cost in 2010 compared to them being introduced in Q4 2009. The delays were caused by the non-confidence vote against the government led by Emil Boc in October 2009, followed by the political deadlock surrounding the presidential contest. One of the biggest challenges for 2010 is a steady rise in unemployment.
- 03 The government will be forced to make use of all extra-budgetary funds that until recently were for the exclusive use of some government agencies.

02 POLITICAL RISK

02.1 Financing needs cloud over political divisions

The immediate risk of an early election in 2010 was averted by the re-election of Traian Basescu as Romania's president on 6 December 2009. Once re-confirmed as president, Basescu swiftly re-appointed the deposed premier, Emil Boc (BOC), to the post, and a new crisis government is now to be in place by the year – end. PDL, Basescu's party, has negotiated the support of the minorities and independents within the Parliament to secure a 2-vote majority government. The support comes amid fears that the IMF lending criteria would not be met by mid-January 2010, when the IMF monitoring mission is due, resulting in further delays in the release of external finance. This shaky coalition is not sustainable in the long term as it is only coagulated by the wish to form a new government and adopt the budget as quickly as possible. Furthermore, by re-appointing Boc, who was deposed following a non-confidence vote from the PNL and PSD, Basescu has ensured some continuity in the reform pace set by the Boc administration, which also ensured the caretaker government during the elections.

02.2 Boc government's reform record

Basescu's re-election opens a period of political uncertainty and instability mainly due to his divisive management style. However, he has acknowledged the importance of the IMF programme in helping Romania out of its worst recession since the communist overthrow in 1989. This acknowledgement at the start of his second mandate is positive, as is the reappointment of Boc as prime minister to continue the public sector reform started in its first year in office. Both PSD and PNL refuse to support the reform efforts of the government: PSD, a left-wing party, will oppose measures that involved job cuts in the administrative apparatus. They also support the re-introduction of tiered income tax and income redistribution. For its part, the PNL economic agenda is very closed to that of the PDL. However, Crin Antonescu (Antonescu), PNL's leader, has locked the party into a deep-rooted feud with the PDL, mostly as an anti-Basescu rather than an anti-PDL move. His stance is likely to cause a rift within the party by Q2 2010.

02.3 The anti-Basescu opposition will continue into Q1 2010

PNL, the most likely coalition partner for PDL, has so far refused to support the new government either from the sidelines, to create a safer majority, or through an active participation in the administration. They have yet to renege on their coalition agreement with PSD, the party whose candidate they supported for the presidency in the second round of elections. However, during the negotiation over the participation in government, evident cracks appeared in the top echelons of the party suggesting that in spring the leadership of Antonescu, another presidential hopeful, is likely to be challenged. A contender might be Calin Popescu-Tariceanu, who showed a willingness to help form a majority government coalition with the PDL. In its current format and tainted by its collaboration with the PSD, PNL has failed to secure a future as a power broker in Parliament, a

position that Tariceanu hoped to achieve by introducing the first-past-the-post electoral system ahead of the 2008 parliamentary elections. No clear candidate has appeared to challenge Mircea Geoana, PSD's presidential candidate although a name mooted is that of Ion Iliescu, the two-times Romanian president, a heavyweight figure in the PSD.

03 ECONOMIC RISK

03.1 Public sector reform is crucial

There is little choice for any Romanian government but to address two key issues in the first part of 2010. First, it has to ensure that the external financial support from the IMF and the EU to the tune of EURO1.5bn is released no later than February 2010. Without it, honouring the country's financial obligations will be difficult. The government is also forced to make use of all extra-budgetary funds that until recently were in the exclusive use of some government agencies.

Second, the increase in arrears forces the new administration to prioritise budgetary spending. In particular, the cuts in spending should accelerate public sector reform, including downsizing the state apparatus that has remained large and largely unreformed since 1989. Similarly, the new administration has to address the inefficiencies within state-owned companies and implement cuts as agreed, for instance, at the Romanian Railways Company, which has a redundancy programme for up to 10,000 employees by March 2010.

03.2 Unemployment is set to rise

Unemployment continues to rise with official records showing the October rate at a record 7.3%. This increase is mainly the result of private sector job losses, as the sector continued to adjust to lower consumer demand. The highest increases were recorded in the retail trade and building materials sectors.

There is little chance that the increase in the jobless numbers will stave off in early 2010. On the contrary, forthcoming public sector job cuts starting with state-owned companies and gradually reaching the central administration will further add to the increase in unemployment. The overall, immediate effect on the public purse will be negative as severance payments and unemployment benefits will have to be paid.

03.3 Macroeconomic indicators worsening

INFLATION: Official figures for November 2009 showed the inflation rate rising slightly above the upper margin (4.5%) of the target band (3.5% +/- 1%). The unfavourable base effect that caused the November inflation rate to reach 4.65% continued into December with the effect that year-end inflation will be 4.5%.

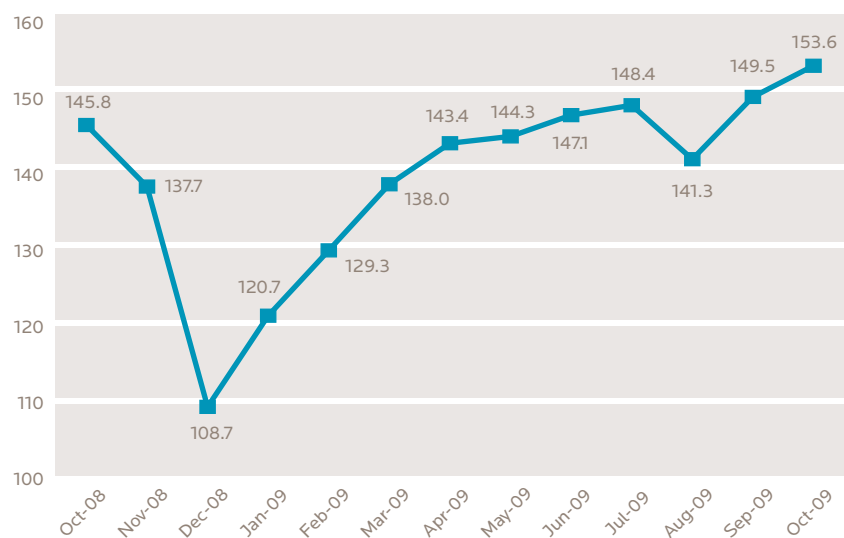
INTEREST RATES: As a result, we expect that the Romanian Central Bank (BNR) will maintain interest rates at 8% at its meeting on 5 January 2009. The decision to maintain the interest rate at the current level is the result of the upward inflationary movements as well as difficulties in public deficit financing.

MONEY MARKET: The liquidity in the money market is sufficient. However, the BNR's move to ease minimum reserve requirements does not help the financial stability and increases Forex risk.

3.4 Improvements in the real economy

CAPITAL GOODS: The capital goods output index exceeded the pre-crisis levels in October 2009. This evolution is the result of an increased external demand for products in three sub-industries (metal goods, computer and electronic products and medical equipment) and higher domestic demand for sectors related to repairs and maintenance of machinery. Romanian exporters have regained access to markets in the Middle East and some former Soviet republics, especially for wood processing and leather products.

CG Output Index (2005 = 100)



CONSUMER GOODS: Most of the recent rise in the consumer goods industry output is linked to the increased domestic demand. The economic crisis has resulted in a 30% drop in imported goods in 2009, with the result that locally produced consumer goods have gained ground. As profit margins are high in the food and beverage sectors, this is a positive development for local manufacturers. A further boost to the sector was the announcement that the new government will maintain the current flat income tax at 16% as well as the 19% VAT.

INTERMEDIARY GOODS: The demand for intermediary goods – which also underpins the rise in the capital goods output – is likely to stabilise in the coming months. Romania enjoys some comparative advantages in its commercial relations with non-EU countries where the supply of raw materials necessary for intermediary goods is cheaper (Ukraine, Turkey, Moldova). However, production prices in Romania are low compared to the EU.

KEY MACROECONOMIC INDICATORS

- 01 GDP is set to grow in Q1 2010 albeit at a very slow 0.2%. This, together with figures for 2009, underline the depth of the recession.
- 02 The budget deficit is not the highest in the EU. Romania's public debt remains one of the lowest in the EU.
- 03 The adjustment of the current account deficit in 2009 has been extraordinary considering that it decreased by 76%.
- 04 Net foreign direct investment in Q1 2010 is set to continue its decline to amount to 1% of GDP, a slight drop on 2009.

	2005	2006	2007	2008	2009 F*	Q1 2010 F*
GDP growth rate (%)	4.1	7.9	6.2	7.1	-7.4	0.2
Nominal, RON (bln)	289.0	344.7	412.8	504.0	497	96.7
Nominal, EUR (bln)	79.7	97.8	123.7	137.1	117	22.5
Per capita EUR	3687.9	4530.4	5742.5	6364.8	5571	
CPI (yoy, %)						
Average	9.0	6.6	4.8	7.8	5.0	4.8
E.o.p.	8.6	4.9	6.6	6.3	4.8	4.6
Budget deficit (% of GDP)	-1.4	-1.9	-2.5	-5.3	-8.0	-2.5
Total public debt (% of GDP)	20.5	18.4	20.2	21.6	28	
Current account balance (% of GDP)	-8.6	-10.4	-13.6	-12.3	-4.4	
Net FDI (% of GDP)	6.5	9.3	5.7	6.6	5	1
Forex reserves (excl. gold, EUR bln)	16.8	21.3	25.3	26.2	28	30
Gross external debt (% of GDP)	38.8	42.0	47.6	52.9	60	62
Central bank key interest rate (%) eop	7.50	8.75	7.50	10.25	8.00	7.50
Broad money supply (yoy %)	33.9	29.4	33.9	17.5	11	5
Exchange rate (RON/EUR)						
Year end	3.68	3.38	3.61	3.99	4.31	4.26
Average	3.62	3.52	3.34	3.68	4.25	4.3

Source: All data from the BNR or the National Institute of Statistics unless otherwise states.

*Marker Global forecast.