
ROMANIA
MARCH 2010

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Monthly Risk Brief Contents

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01 MARCH RISK OUTLOOK AT A GLANCE

TOP 3 POLITICAL RISKS

- 01 There is an increased risk of a deadlock in the decision-making process at local authority level as a result of the recent changes in party leadership structures at national level.
- 02 The negotiations to change the Constitution to allow for a reduction in the number of parliamentarians are expected to be fraught and to result in further schisms within the main political parties.
- 03 The planned re-organisation of government agencies and ministries risks to upset the balance in the partly political coalitions at local level.

TOP 3 ECONOMIC RISKS

- 01 There is some uncertainty as to how the government will achieve a 2% reduction in public spending in 2010 to comply with the terms of the IMF loan.
- 02 Complacency in implementing public sector reforms remains the largest risk in the short-term, especially if economic growth returns and investor sentiment improves.
- 03 We expect further interest rate cuts to support an economic recovery as well as to prevent the currency from over-appreciating.

02 POLITICAL RISK

02.1

The recent wave of defections from the main opposition parties, the Social Democrats (PSD) and the National Liberals (PNL), to the independent parliamentary grouping will have a ripple effect in the local party structures. As a result, there is an increased risk of a deadlock in the decision-making process at local authority level. Both main opposition parties held party conferences in the last month, which resulted in a new leadership team at PSD (Victor Ponta, in a surprise win, backed by key party decision-makers such as Ion Iliescu and Adrian Nastase, who withdrew his candidacy) and the consolidation of Crin Antonescu's leadership position at the helm of the PNL. Although the defections appear to play in the hands of the governing Liberal-Democrats (PDL) as most of the defectors have joined the independents, this development can in fact weaken the efficacy of the present coalition government as it is more difficult to gauge their voting pattern on key policies. The leader of the independents' group in the Deputies' Chamber, Gabriel Oprea, is an experienced PSD politician, former minister in previous PSD governments. He enjoys significant influence at local level due to his previous role as interior minister and is likely to seek more influence within the Parliament.

02.2

The president, Traian Basescu, is set to start the political negotiation for changing the Constitution to reduce the number of members of Parliament. The negotiations are expected to be fraught and to result in further schisms within the main political parties. The move to reduce the number of members of Parliament has been strongly backed by the population in a November 2009 referendum. However, both the PNL and PSD have continued to delay the start of negotiations and Basescu is likely to push for the changes more forcefully. This could mark his return to a more hands-on leadership style on the domestic political scene.

03 ECONOMIC RISK

03.1 Structural reform is key to curbing public deficit

In February 2010 the International Monetary Fund (IMF) released the third and fourth tranches of the EURO12.95 bn loan agreement it has in place with Romania, leaving 28% of the loan still outstanding and subject to further monitoring. The release of the remaining tranches is scheduled for June 2010, September 2010, December 2010 and March 2011. Despite the success in securing the release of funds, the government has had to agree to a new Letter of Intent from the IMF (see below for key new terms). The terms of the letter are designed to help with the future monitoring of Romania's compliance with the loan agreement. At the February review, Romania met all but one of the quantitative performance criteria

(the targets for government arrears were missed) as well the structural benchmarks (less on pension reform legislation). Pension reform remains a key target for future IMF lending, as the effect of the new legislation would be to reduce the total number of pensioners from the current 6.5 million to nearly 6 million. Likewise, structural reform - especially in the state-run enterprise sector- has been pushed up the list of priorities in order cut losses and thus plugs the deficit gap.

The 4 new safeguards in the IMF letter of intent:

- By 1 April 2010: the IMF has included a deadline for the adoption of the Fiscal Responsibility Law by the Parliament. This condition was intended to end the erratic current expenditures in the public sector.
- By 1 April 2010: the government has to set indicative targets for the fiscal balance of the largest state owned enterprises.
- By end of June: the government has to approve a strategy to implement new wage legislation
- By end of June: the government has to adopt further measures to enhance the funding regime of the deposit guarantee fund. The IMF agreed to a longer deadline for the adoption of the pension reform law.

3.2 Government risks unions' wrath in push to freeze state wages

The Government announced a two-tier approach to reducing public expenditure to achieve a saving of 0.5% of GDP. The two measures are a freeze of public sector wages (amounting to 0.3% of GDP) and a stop on re-filling public sector vacancies (with some exceptions), which the government calculated would bring a further saving of 0.2% of GDP.

Although salutary, the two measures are likely to jeopardise the government's efforts to reform the public sector. Firstly, there is an increased risk that public sector trade unions will resist such measures and will seek every legal route to delay their introduction. Secondly, the policy not to re-fill vacancies is likely to deliver short-term savings but, if applied as a blanket policy, will cause problems in delivering administrative services to the public or the private sector in the medium term. Pension reform - which is said to generate a modest 0.1% of GDP savings - has led to heated debates in the Parliament due to the politically sensitive nature of the reform. The IMF extended the deadline for the adoption of the new pension reform legislation to 1 July 2010.

The bulk of the savings - at 1.1% of GDP - is expected to be generated by freezing spending on goods and services across ministries and the reorganisation of state agencies. There is a high risk that the reorganisation of state agencies will transform into local budgets issues. Most of the

state agencies are decentralised and are dominated by interests built on local majorities that do not always replicate the political alignment at the level of central government. Under these circumstances, the central level intentions will be resisted at local level and will block the execution of local budgets. There will be a two-stage impact flowing from such cuts. Firstly, the quality of the services to be delivered by these agencies will decrease. Secondly, the measures will lead to both political tensions and a cut in investment expenditure.

03.3 Interest rates reduction to stave off currency appreciation

The IMF has demanded serious cuts in the volume of government arrears from RON 1.5bn million at the end of 2009 to almost RON 480 million at the end of 2010. There is a high risk that the target for 2010 will be missed, which in turn will have two serious consequences for Romania. Firstly, if arrears are not brought under control to a sustainable level, the IMF will ask for alternative measures to achieve this result. Most certainly the measures will be aimed at sectors where the government is even less capable to deliver. Secondly, arrears point to a financial bottleneck and can become a source of inflation. Should this become significant, the exchange rate will be the first to react by depreciating.

However, for the time being the exchange rate is stable although the Central Bank (BNR) governor, Mugur Isarescu, has raised the possibility of an over-appreciation of the currency as a risk earlier this month. The main reason given for the risk of the currency over-appreciation is the economic recovery and a general improved investor sentiment toward Romania. To manage the economic recovery we expect a further cut of 50bps in the interest rate at the next BNR board meeting at the end of March.

03.4 Romania well placed to minimise the impact of the Greek crisis

Investor confidence in Romania remained unaffected thus far by Greece's economic crisis and we expect a medium to low risk of contagion. Most of the underlying negatives in relation to Romania are due to the country's perception as a fragile economy among investors. A worsening in the Greek economic position could also risk spreading regionally and to Romania.

Compared to Greece, however, Romania's position is less vulnerable. Comparatively, the country still has a small public debt level (some 25% of Greece's public debt) and, crucially, Romania is already operating within the framework of international financial assistance and monitoring. Moreover, further EU and IMF support for Romania is conceivable because it will be not be viewed as a bail out as long as the government shows the strongest possible determination to meet its international commitments.

KEY MACROECONOMIC INDICATORS

- 01 GDP growth is set to accelerate in Q2 2010 compared to Q1 2010 to reach 1%. The pace of growth will remain subdued compared to the peak growth period 2006 – 2008, when average annual GDP growth was 7%. We forecast GDP annual growth for 2010 at 2%.
- 02 BNR is expected to cut further the key interest rate in March 2010 to 6.5%. Further cuts are expected in Q2 to bring interest rates down to 5.5%. Improved investor sentiment and some signs of economic recovery are the main drivers of BNR's policy of easing interest rates.
- 03 The budget deficit will record a small reduction mainly as a result of external financing. We continue to expect a budget deficit of 6.1% of GDP for 2010.
- 04 Inflows of net foreign direct investments are set to grow in Q2 2010 compared to Q1 2010 to end the year at 5% of GDP.

	2007	2008	2009 F*	2010	Q1 2010 F*	Q2 2010 F*
GDP growth rate (%)	6.2	7.1	-7.4	2	0.2	1
Nominal, RON (bln)	412.8	504.0	497	538.7	96.7	121.1
Nominal, EUR (bln)	123.7	137.1	117	130.4	22.5	30
Per capita EUR	5742.5	6364.8	5571	-	-	-
CPI (yoy, %)						
Average	4.8	7.8	5.0	4.7	4.8	4.6
Eop	6.6	6.3	4.8	4.5	4.6	4.3
Budget deficit (% of GDP)	-2.5	-5.3	-8.0	-6.1	-2.5**	-3.2**
Total public debt (% of GDP)	20.2	21.6	28	-	-	-
Current account balance (% of GDP)	-13.6	-12.3	-4.4	-	-	-
Net FDI (% of GDP)	5.7	6.6	5	5	1**	3**
Forex reserves (excl. gold, EUR bln)	25.3	26.2	28	32	30	32
Gross external debt (% of GDP)	47.6	52.9	60	-	62	-
Central bank key interest rate (%) eop	7.50	10.25	8.00	5.50	6.50	6.00
Exchange rate (RON/EUR) (eop)						
Year end	3.61	3.99	4.31	4.15	4.26	4.11

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

*Marker Global forecast

**Quarterly figure