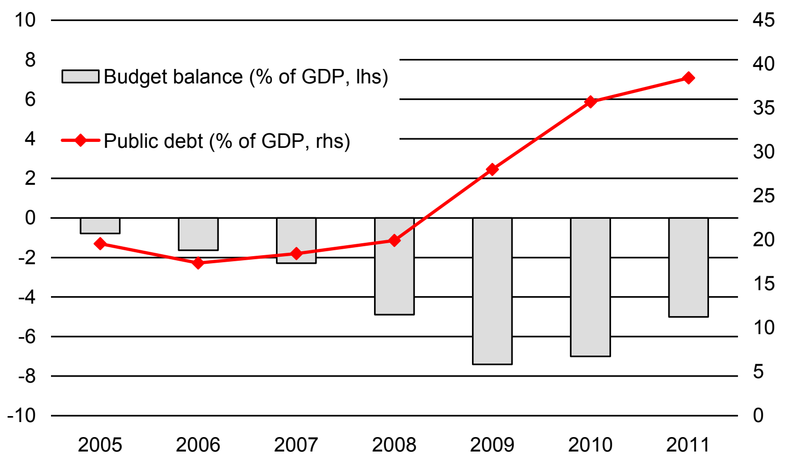
Romania macroeconomic update: slower growth & higher inflation

- Romania's Constitutional Court ruled on 25 June that some of the austerity measures to be implemented by the government are unconstitutional. To offset the ruling that pensions cannot be cut, the government decided to increase VAT from 19% to 24%. These events have prompted us to re-think some of the trends envisaged for Romania. The possible delay in a rebound of local demand – the VAT increase will directly impact on household consumption - will be reflected in a further drop in real GDP, by 2.5% yoy in 2010, a significant downward revision from our previous forecast of -0.9% yoy.

- This year will also see a one-off jump in inflation as an immediate consequence of the VAT increase: CPI will peak in August above 8% yoy (7.7% yoy eop). We believe the inflation rate will not be able to enter the target band in 2010 and the Central Bank will have to leave rates on hold during the coming months. The Romanian government's fiscal austerity measures amount to around 2% of GDP. The VAT increase should be able to fully offset the effect of the Court decision. Our modified scenario assumes that the implemented measures would be enough to bring the budget deficit close to the targeted level for this year, with further rebalancing in the coming years (deficit around 5% in 2011). However, we still see some risk of the budget deficit overshooting and weak management of additional structural changes.

- The IMF approved the disbursement of approximately EUR 900 million on Friday, following a new review of the country's performance under the Stand-By Arrangement, after the board was "very impressed" by the fiscal austerity program.

ROMANIAN FISCAL OUTLOOK



Source: UniCredit Research

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VAT increase hails new era

Romania's Constitutional Court ruled on 25 June that some of the austerity measures for which the Government received a vote of confidence in Parliament are unconstitutional. This decision and the measures adopted as a consequence has prompted us to re-evaluate the growth scenario of the Romanian economy.

VAT increase to 24% …

The provisions concerning the pensions of magistrates and lawyers, together with the 15% cut in pensions, have been ruled as unconstitutional. Wage cuts and a recalculation of special pensions (that are significantly higher than average pensions) within normal state pensions (excluding the pensions of magistrates and lawyers) have been considered constitutional and the government has already taken the necessary steps to implement these measures. **To offset the ruling that pensions cannot be cut, the government decided to increase VAT from 19% to 24%.**

… will help to fully offset the effects of the Court ruling

Based on our calculation, the revenue collected via the VAT increase from 19% to 24% (around RON 4bn) offsets the cost savings from the 15% cut in pensions, as it has been implemented immediately, i.e. in July.

Moreover, on 24 June the Romanian Government approved the Emergency Ordinance amending the Fiscal Code, **introducing a series of additional taxes and duties as of 1 July.** The adjusted Fiscal Code, according to Finance Ministry estimations, will generate additional revenue equal to 0.3% of GDP (16% tax on interest income from banking deposits, flat 25% tax on the net income from gambling, reduction to 20%, down from 40%, the level of deductible expenses for copyrighted works, increase of property tax for those who own more than one house and luxury passenger cars, while state-controlled firms must give 90% of their profit to the state budget). Separately, the Government announced on 1 July that it plans to lay off between 55,000 and 60,000 public sector employees, in line with the originally planned public sector restructuring based on which around 100,000 public sector employee cut announced at the beginning of the year (total of 350,000 redundancies in the next five years).

Fast reaction was important…

The timing of the implementation of the measures has been critical for this year's deficit outlook. **Consequently, the fast reaction of the government can be considered as a major plus, that might re-establish confidence** in the current government's capacity to bring Romania's budget deficit to a level that is sustainable in the long term. The affected measures were an important part of the modifications to the program that is being supported by the Stand-By Arrangement.

…also for IMF decision to disburse EUR 0.85 bn

The IMF approved the disbursement of around EUR 900 million to Romania, following a new review of the country's performance under the standby agreement. The funds has been announced to be transferred to Romania by July 7.. The moneygo into the central bank's reserve to cover the balance of payments deficit. It is a signal of support for Romania's planned reforms and of trust for the planned austerity measures. IMF representatives consider that Balancing the fiscal adjustment between expenditure cuts and tax increases will help cushion its social impact. They also lauded Romania's initiative to amend its fiscal responsibility legislation with pension, public sector wage, healthcare and local government finance reforms, public sector layoffs, and efforts to improve its tax collection rate.

So far, Romania has received around EUR 9.2 bn in IMF money and another EUR 2.5 billion from the Commission. The Commission is expected to disburse a third tranche worth EUR1.15 billion to Romania in September. Joint teams from the IMF and EU are scheduled to visit the country for a new review mission in the period July 26- August 4.

Moreover, the board of the International Monetary Fund approved Friday to increase Romania's 2010 standby agreement inflation target from 3.5% to 7.9%, following the VAT hike to 24%.

The Romanian economy is still suffering the effects of the international crisis while second half of the year will be hit by the austerity measures. Indeed, it remained in recession in 1Q10. Our new scenario incorporates the negative impact of the VAT increase on consumption and indirectly on investments, which are expected to be visible in the second half of 2010. The delay in the rebound in local demand will be reflected in **a further drop in real GDP by 2.5% yoy in 2010, a significant downward revision from our previous forecast of -0.9% yoy real growth.**

Negative impact of the VAT increase visible in H2 10 …

… pushing us to revise the GDP drop in 2010

This year will be marked by a one-off jump in inflation due to the VAT increase (5 percentage point hike) in July 2010. We believe **the inflation rate will not be able enter the target band in 2010 and it will peak in August above 8% yoy (7.7% yoy eop)** but it is expected to return to its normal range in the second part of 2011 decelerating towards 4% yoy.

ROMANIAN ECONOMIC OUTLOOK

	2007	2008	2009	2010E	2011E
GDP, nominal (EUR bn)	123.7	136.9	115.9	122.3	129.1
Per capita GDP, EUR	5,745	6,391	5,439	5,766	6,116
Real GDP, yoy (%)	6.2	7.1	-7.1	-2.5	1.7
Inflation (CPI), yoy, Dec (%)	6.6	6.3	4.7	7.7	4.0
Inflation (CPI), yoy, avg (%)	4.8	7.9	5.6	6.2	5.8
Unemployment rate (%)	4.3	4.0	6.3	8.5	8.0
Exchange rate/EUR, eop	3.61	3.99	4.23	4.35	4.20
Exchange rate/EUR, avg	3.34	3.68	4.24	4.25	4.30
Reference rate, Dec	7.50	10.25	8.00	6.25	5.00
Interest rate (Dec)	8.12	15.58	10.71	6.83	5.08
Interest rate (Avg)	7.85	13.03	11.71	6.60	6.05
Current Account/GDP (%)	-13.5	-12.3	-4.4	-5.7	-7.6
FDI/GDP (%)	5.8	6.6	4.2	3.5	4.0
Budget balance/GDP (%)	-2.3	-4.9	-7.4	-7.0	-5.0
Public Debt/GDP (%)	18.4	19.9	28.0	35.7	38.4

Source: UniCredit Research

Monetary easing has been put on hold for the short-term as a consequence and will remain so, in our view, until the second half of 2011. The refinancing rate will probably be kept at the current level of 6.25% until the end of the year, despite the fact that in the short-term inflation might exceed this level (resulting in negative real interest rate). Moreover, the interbank interest rates might fluctuate again above the key rate during this year. Despite this, the medium-term outlook is likely to argue in favor of keeping rates on hold and restarting monetary easing in the second half of 2011.

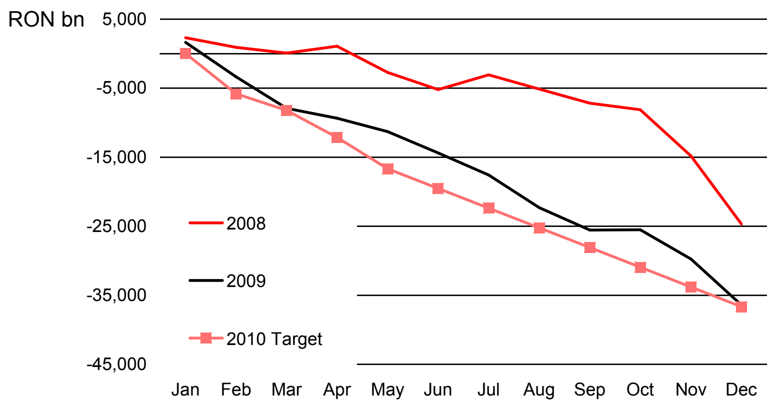
As regards the currency, the likelihood of deficit overshooting (on the back of the deteriorating growth outlook) and some political risk might result in a weaker RON this year. Consequently we slightly increase our **FX forecast to 4.35 RON/EUR for end-2010** (still modest 3% yearly depreciation).

Budget already surpassed 3% of GDP in the first 5 months of this year

The fiscal side remains the more delicate and also more important for the stability of the Romanian economy. Romania ran a consolidated budget deficit of 3.09% of GDP (RON 16.7bn) in the first five months of 2010, deepening from the previous month's deficit of 2.25% and reaching a level significantly higher than the 2.3% of GDP during January-May 2009. The revenues to the general government budget shrunk by 1.6% yoy to RON 64.2bn (EUR 15.6bn) in the first five months. On the expenditure side, further acceleration has been registered (+5.7% yoy) driven by the still high social security spending, mainly pensions (up

13.4% yoy in May).

BUDGET DEVELOPMENT



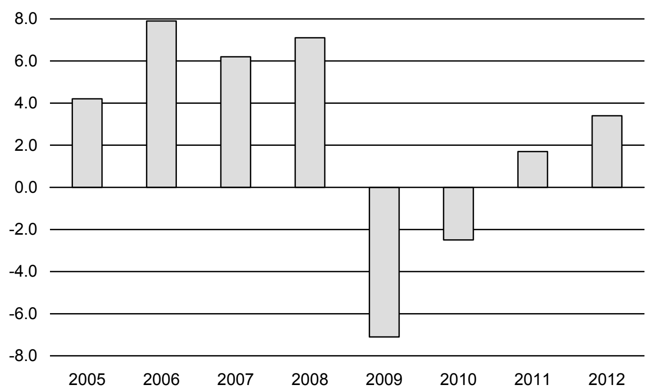
Source: UniCredit Research

The measures amount to 2% of GDP; thanks to these measures the deficit will not be extremely different from the target

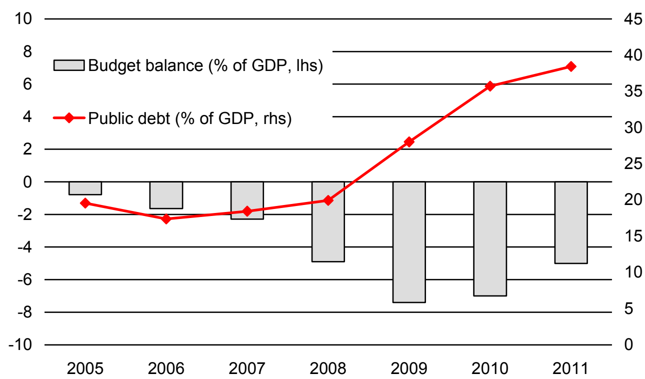
The IMF mission agreed in May to a wider fiscal deficit target for Romania of 6.8% of GDP this year (4.4% for 2011). The Romanian government's fiscal austerity measures amount to around 2% of GDP, which means that without these changes the deficit might have reached around 9% of GDP. **Our modified scenario assumes that the implemented measures will be enough to bring the budget deficit close to the targeted level for this year, with further rebalancing in the coming years; however, we still see some risk of budget deficit overshooting upon delays in implementing the planned measures and weak management of additional structural changes (efficiency measures, pension system reform, personnel cutback, etc.)**.

ROMANIA: THE GROWTH OUTLOOK AND THE FISCAL SIDE

Real GDP growth, %



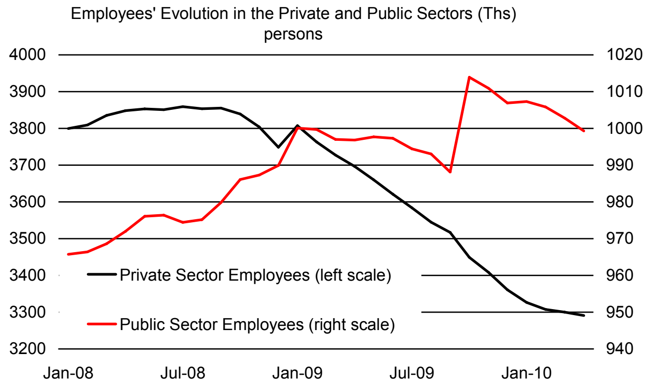
Evolution of fiscal metrics in Romania (% of GDP)



Source: UniCredit Research

ROMANIAN LABOUR MARKET

Public and private sector



Public / private wage ratio

Source: UniCredit Research

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