ROMANIA

Economic Outlook

Spring Report

April 2010

BRD

Table of Contents

I. Executive summary

The Romanian economy is presumed to emerge out of recession during the second semester of 2010 but the ***recovery will be fragile***. Poor Consumer Confidence is holding back prospects for a rebound in Consumption as the Public Sector restructuring remains a plan to be further implemented. As a result, the domestic-oriented sectors (like Retail or Constructions) will have no fuel to surface in 2010.

On the opposite corner stand exports – riding the ripples of economic upturn in Europe. They have been recording positive growth since Q4'09 and are expected to maintain growth in line with the recovery of the European market. The Central Bank saw this opportunity in 2009 and embraced a weak RON policy to shape ***a new growth model for Romania*** based on exports. Investments in new export capacities should also be expected to lead economic growth in 2010 and beyond as low asset prices, low labor costs and the weak RON will be accommodative. At this point in our discussion come Imports – which are expected to return to positive growth in 2010. There are preliminary data pointing towards a rise in imports – a natural consequence of an insufficiently restructured economy with insufficient supply capacities. This is why we expect the rise in exports and investments to bring along a comeback in imports. Consequently, the ***Current Account deficit is expected to increase slightly***, but will remain moderate at around 6% of GDP.

All in all we have lowered our expectations for GDP growth in 2010 from 1.5% to 1% based on revised 2009 statistical figures and worse than expected incipient 2010 data. In fact, the true economic activity as measured by Gross Value Added will be so small (+0.5% FY 2010) as it can easily slip into negative territory. Growth (if any) will probably arise from Industry and Net Taxes while the Service sector is expected to stabilize at most.

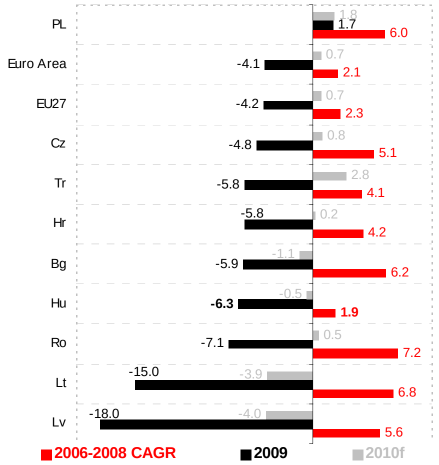
The presumed sluggish economic recovery and Consumer Confidence is good news for disinflation and further monetary easing. Although ***pressure on the CPI will arise from oil and administrated prices***, CORE inflation will remain subdued at about 2% meaning that plenty of space remains for further rate cuts. We expect successive rate cuts to continue by Q2'11 likely to a bottom of 5% given a CPI scenario of 2.5% at that time and persistent negative output gap.

As far as the exchange rate is concerned, NBR embraced a weak RON policy. To achieve this purpose it made use of its entire available tools: moral suasion, FX interventions and rate cuts. Nevertheless peer comparison, fundamentals and expected FX inflows indicate short-term appreciating potential that will boost further the FX reserves and lower the domestic interest rates. However, this weak RON approach might become problematic at some point when inflation returns and excess liquidity becomes a burden. ***The EURRON has the potential to fall below 4.0*** by the end of 2010 but in the long run pressures mounting from the enlarging Trade Gap and Debt Service are expected to bring it back above this milestone. We also have reasons to expect the Central Bank to hold onto its weak RON policy all the way up to EURO adoption in order to propel external competitiveness beyond the EMU doorstep. Exchange rate stability remains the most important tool for price stability.

The ***fiscal consolidation will remain a desiderate*** as long as the Romanian government will not improve tax collection. In 2009 it missed by a narrow margin the deficit target agreed with the IMF while preliminary 2010 data look delicate. The concrete steps to limit public expenditure face stiff opposition both in Parliament and in the streets. Most probably, the current Expenditure oriented approach will be replaced by a Revenue approach and Tax hikes probably in 2011. In fact all European nations that resorted to IMF help (Iceland, Hungary, Latvia, Ukraine, Belarus, Serbia) took into consideration the consolidation of their fiscal systems via tax hikes but their political response was different.

All in all, the year 2010 remains difficult and noisy. The policymaking response is crucial in 2010 for a wide range of variables spanning from employment and consumer confidence, GDP growth, disinflation trend, fiscal consolidation and debt, investor perception, EURRON trajectory, financial intermediation and many other variables strictly dependant on such response. Beyond 2010 the correlation with the Eurozone and the whole catching up process is expected to strengthen and convergence to be resumed.

GDP growth: comparison, %



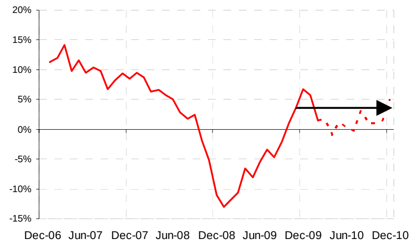
Source: Eurostat (CAGR - Compounded Average Growth Rate)

Sources of GDP %, real terms

y/y, %	'07	'08	'09	'10f	'11f	'12f
Agr.	-16.5	21.4	-0.4	5.0	-5.0	5.0
Ind.	5.3	1.3	-4.3	2.5	3.0	3.0
Constr.	33.6	26.1	-13.6	-10.0	5.0	5.0
Serv.	7.3	5.1	-6.8	1.0	3.0	3.0
GVA	**6.8**	**7.3**	**-6.5**	**0.5**	**2.5**	**3.5**
Net taxes	**1.8**	**5.8**	**-12.4**	**5.0**	**5.0**	**5.0**
GDP total	**6.2**	**7.1**	**-7.1**	**1.0**	**3.0**	**3.5**

Source: The Romanian Statistics Institute, BRD forecast

Industrial output: y/y, monthly figures



Source: The Romanian Statistics Institute, BRD forecast

II. Macroeconomic Outlook

II.1. Gross Domestic Product

The Romanian GDP contracted 7.1% in real terms in 2009 to RON 491.2 bln (EUR 116 bln). No particular sector escaped this widespread contraction with the exception of the *Consumption of the Public Administration* that increased 1.2% in 2009 – in line with the increase in Public Expenditure.

The magnitude of 2009 contraction resembled the growth figure in 2008. Although in absolute terms the 7.1% contraction figure is one of the highest in the EU, in terms relative to previous periods it looks less severe than 5% in the Eurozone for example. When we look at the *Gross Value Added* alone we see that the relative decline figure in 2009 was even smaller (-6.5%). Nevertheless, the contraction was painful in Romania as it brought along 300,000 lay-offs in 2009.

The *External Demand* compensated part of the contraction as exports contracted less than imports. The external sector prevented the Romanian GDP from contracting by 14% in 2009 as *Net Exports* brought a positive contribution of over 7 percentage points to total GDP formation. Export-driven recovery is a key aspect for the current and forthcoming monetary decisions.

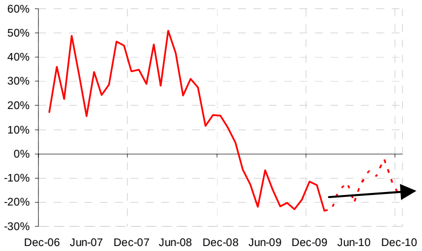
Net taxes fared much worse than the general economic activity as indicated by poor fiscal performance. Recent MoF reporting of increased arrears to and from the State Budget confirms expectations of recrudescent tax evasion during the liquidity shortages of 2009.

Quarterly figures confirm previous expectations for highly inconsistent trends among sectors which are expected to perpetuate in 2010.

The **Industrial** sector was the first to emerge out of recession on the back of External Demand. The positive combination between higher volumes and higher prices are the prerequisites for improving financials for those export-oriented industrial companies. Further on we expect improved creditworthiness and a pick up in loans for the corporate segment.

Industrial rebound is driven not only by Inventories (Intermediate Goods +12% y/y in Dec.09) but mostly by Capital Goods (+ 36% y/y in Dec.09). However, the positive base effect from 2009 is consumed and the growth rates are expected to moderate as preliminary data already confirm. We envisage a 2-3% growth figure y/y for the Industrial Output in the forthcoming years due to rebounding external and domestic demand and previous FDIs.

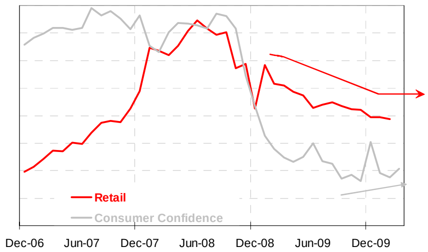
Constructions: y/y, monthly figures



Source: The Romanian Statistics Institute, BRD forecast

The **Constructions** sector continues to collapse (-18% y/y in 2M.10), especially in the residential sector (-51% y/y in 2M.10) and we see no prospects for improvement in 2010. However, engineering works and repairs may give a boost, as indicated by latest Constructions data (+13% y/y in 2M10). Infrastructure works may help Fixed Capital Formation figures but fiscal constraints cannot accommodate a spectacular take-off. However, we must not forget that Demand for housing units still exists but in 2010 remains insolvent. Latent demand for housing and the need to upgrade the energy efficiency of the Romanian housing stock are keeping the residential demand in stand-by until credit becomes available and affordable. On top of the residential sector, the need for infrastructure upgrade retains the long term bright prospects for the Constructions sector. In this context, a 5% growth figure per annum can be considered moderate beyond 2010. Until then, the Constructions market is expected to plunge by 5-10%.

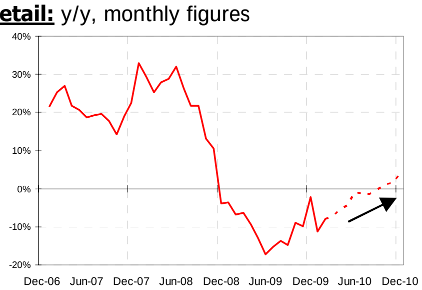
Retail and Consumer Confidence: nominal indexes



Source: The Romanian Statistics Institute

We maintain our cyclical view over the **Agriculture** sector that alternates the "good" and "bad" years. Preliminary data and official statements support expectations for a slightly better output in 2010 but things can change easily due to weather conditions. However, the size of the sector is too small (7% in total) to matter in the overall GDP.

Retail: y/y, monthly figures



Source: The Romanian Statistics Institute, BRD forecast

Services contracted sharply in 2009 in line with the crippled Consumer Confidence (which explains the fall in Retail and Financial Services) and with falling domestic and foreign trade (which explains the fall in Transportation Services). However, latest data show some signs of stabilization in Consumer Confidence and Retail, but further evidence is needed to confirm that observation. Therefore it is difficult to say if the components of the Service sector will surface in 2010 and we face the impossibility to foresee a particular trend for 2010. In the long run however, the trend can only slope upwards due to the relative small size of Services in GDP (below 50%). A moderate 3% growth is envisaged under normal circumstances for Consumer Demand.

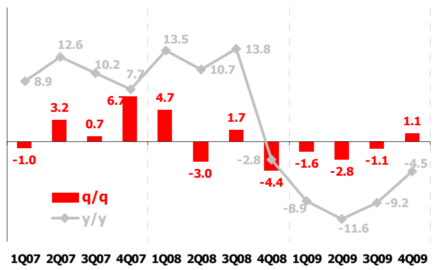
All in all, the true economic activity as measured by the **Gross Value Added** will be small in 2010 (less then 1%) and can easily slip into negative territory if conditions remain adverse (e.g unexpected deterioration in Industry, harder than anticipated decline in Constructions. **Net Taxes** are

Uses of GDP y/y, %, real terms

	'07	'08	'09	'10f	'11f	'12f
Final Cons.	*9.6*	*8.0*	***-8.2***	*2.0*	*5.0*	*5.0*
Gross Fixed Cap Form	*28.3*	*7.5*	***-24.7***	*3.0*	*10.0*	*10.0*
D Dem	***14.0***	***7.9***	***-12.8***	***2.2***	***6.2***	***6.2***
GDP total	**6.2**	**7.1**	**-7.1**	**1.0**	**3.0**	**3.5**

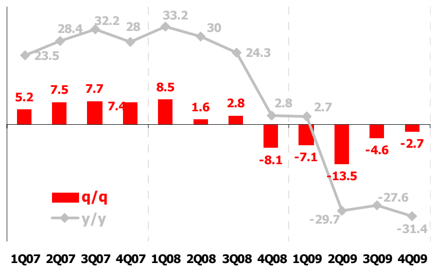
Source: The Romanian Statistics Institute, BRD forecast

Final Consumption:



Source: The Romanian Statistics Institute

Gross Fixed Capital Formation:



Source: The Romanian Statistics Institute

expected to give a boost to total GDP and sling it above zero in 2010 considering on the recent hike in excise duties and the cut in subsidies.

Beyond 2010, economic growth should set in but moderately. The growth engine remains the same as in the 2004-2008 boom period as it can't be replaced in just 2 years, the catching-up process in both its shapes: living standards and infrastructure. However, this time the growth pace would be slower as the fuel (namely external financing) will be less available and more carefully distributed.

The uses of GDP revealed a widespread collapse in Consumption and Investments that could have pushed the economic contraction far beyond 10% (please notice the Domestic Demand at -12.8% FY 2009).

Poor Consumer Confidence and massive lay-offs in the private sector shrank **Consumption** 12% y/y in 9M and 8% FY2009. It was good to notice a comeback in Q4 Consumption figure (+1.1% q/q) but spectacular improvement cannot be envisaged further on. First because the lay-offs in the Public Sector are still unclear as official statements diverge, and secondly, because NBR favors a growth model lead more by Net Exports and less by Consumption, which is translated in an undervalued RON and a relative high real interest rate.

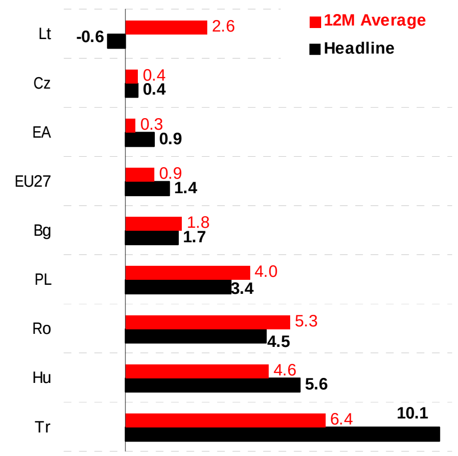
Investments have been hit hardest in 2009 as revealed by Gross Fixed Capital Formation (-31.4% y/y in Q4). However, they cannot remain at such low levels for long as the need for restructuring will push on. We expect them to return as an important economic growth driver both in 2010 and beyond.

Net Exports played a crucial role in avoiding a double digit economic contraction in 2009 as they had a positive contribution in GDP formation of 7 percentage points. However, it is important to outline that the positive role did not came out as a result of positive Net Exports, but rather as a result of a declining negative Trade Balance. As long as the prospects for a reversal in the Current Account take shape, imports will pick-up in line with economic recovery and exports thus boosting the negative figure of Net Exports.

We expect up to 1% GDP growth in 2010 then a robust catching up of 3% in 2011 and 3.5% in 2012. Industry will lead the way out of recession (+2.5% in 2010 and 3% thereafter) on the back of external demand. Constructions output will collapse in 2010 by 5-10% but infrastructure projects and still existing housing demand will push it ahead by around 5% beyond 2010. Consumption is expected to stabilize in 2010 and pick-up from 2011 as the main growth driver. Investments will recover as early as 2010 (+3%) and should pick up robustly (+10%) as economic growth sets in. Consequently, the negative Net Exports will resume growth, in line with the expected widening deficit of Current Account.

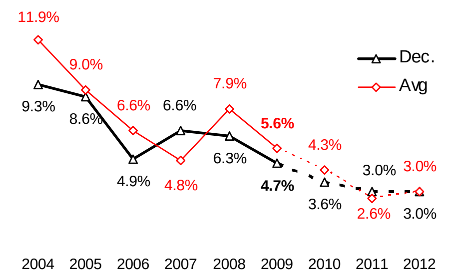
II.2. Inflation

Inflation: one of the most stubborn in the EU (February data)



Source: Eurostat

CPI projection



Source: The Romanian Statistics Institute, BRD forecast

Romania has one of the most stubborn inflation in EU in spite of the huge contraction in Demand and GDP. However the current CPI figure still contains the effects of a hefty increase in Tobacco Prices in Q4 (+39%) that brought alone 1.8 points in total end-2009 figure of 4.7%. Prices took-off as well in January as the excise duties and the exchange rate used to denominate them in RON have been revised upwards but in February and March moderated faster than expected.

Removing the administratively “distressed” components we obtain an adjusted inflation of less than 3% that reflects better the economic contraction and the subsequent contraction in Cash (M1 -15% y/y in Q4’09; -10% y/y in Feb.10)

Perspectives for disinflation remain optimistic but moderate. It will be supported by the negative output gap and RON stability/appreciation. However, inflationary pressures will emerge from regulated prices, fuel prices, the negative base effect of food prices and the cut in farm subsidies. The recovery in industrial prices will also put upward pressures on the CPI.

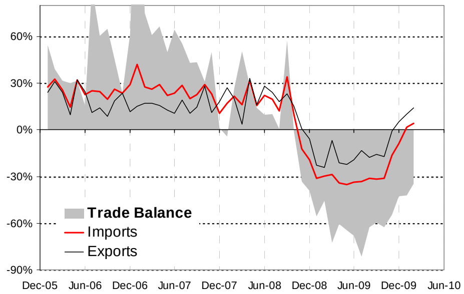
At this moment we expect a CPI consistently above 4% in Q1-Q3 2010. The positive base effect will depress inflation below 4% in Q4’2010 and below 3% in Q1’2011.

We expect the 3% inflation figure to be a long-term challenge for NBR as the potential to fall consistently below it is undermined by a series of factors: incomplete economic restructuring, competition disturbances, huge investment needs for Utilities requiring constant rise in prices, phasing-out administrative prices. On the upside we trust that EURO adoption efforts and the improvements to the domestic economic environment will tame inflationary pressures.

We expect the long term inflation to stabilize at around 3% although occasionally it will break below.

II.3. External Sector

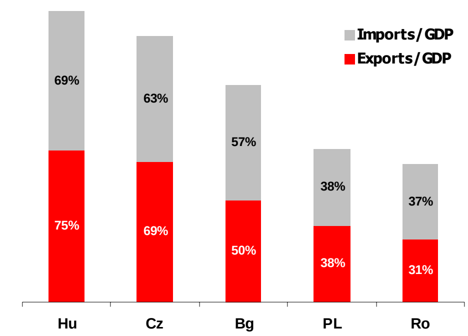
Foreign Trade Dynamics: y/y, monthly data



Source: National Bank of Romania, BRD calculation

2009 brought an abrupt adjustment of previous external imbalances as the Trade Gap contracted 62% in 2009 to EUR 7 bln. The main reason comes from the difference in magnitude between the collapse in domestic and external demand (-12.8% in Romanian Domestic Demand vs -3.4% in the Euro Area FY2009) resulting in faster declining Imports (-29% Imports vs -15% Exports, y/y, FY2009). However the Romanian foreign trade remains imbalanced and will stay so by 2012. This means that the growth model for Romania cannot shift towards a Net Exporter status and previous imbalances can only be adjusted but not reversed until 2012. Romania has a low foreign trade to GDP ratio (please see table) and this state of facts cannot be improved easily. Consumption plays an important role in the local GDP (about 80% in total formation) and dictates its trajectory as outlined both in 2008-2009 boom-bust cycle. In case of Romania Exports can only help the recovery and compensate for temporary slowdowns but in the long run recovery is expected to remain driven by Consumption.

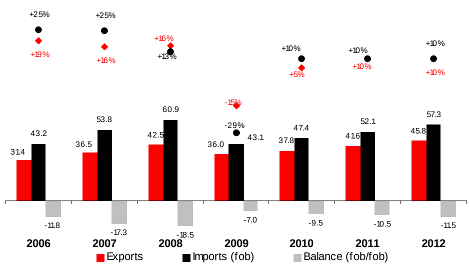
Relative trade openness - 2009



Source: Eurostat, National Bank of Romania, BRD calculation

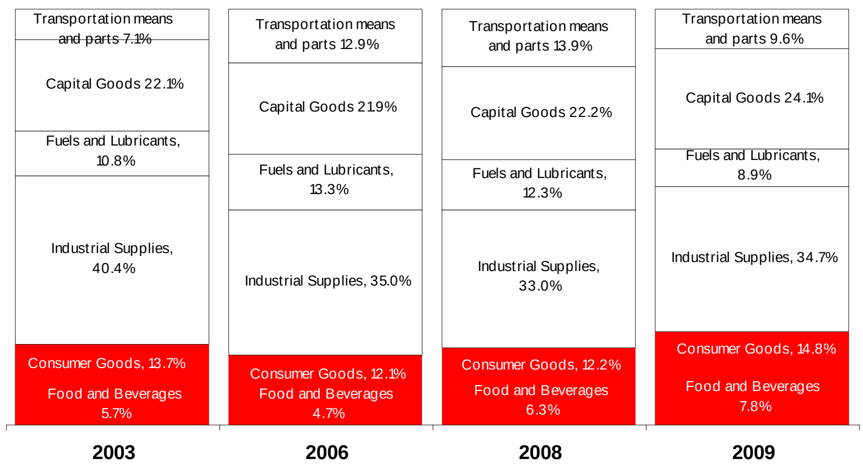
The collapse in Consumption and Investments brought along a 29% decline in total imports in 2009. However the imports of *Consumer Goods* (-18% y/y 11M'09) were less affected than *Capital Goods* (-27%), *Transportation Means and Parts* (-55%) or *Fuels and Lubricants* (-52%) meaning that consumer imports actually increased as a share in total imports from 19% in 2008 to 23% in 2009.

Foreign Trade prospects



Source: The Romanian Statistics Institute, BRD forecast

Components of Romanian imports: % in total (Industrial vs Consumer)

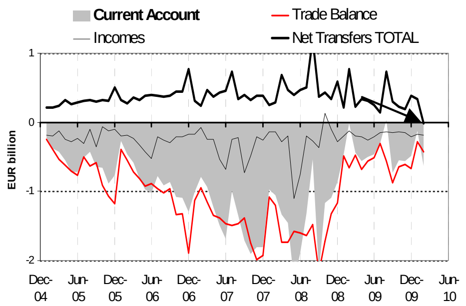


Source: The Romanian Statistics Institute, BRD calculation

We reiterate here the symbiotic link between economic growth and imports which cannot be broken. Romania does not have enough supply capacities

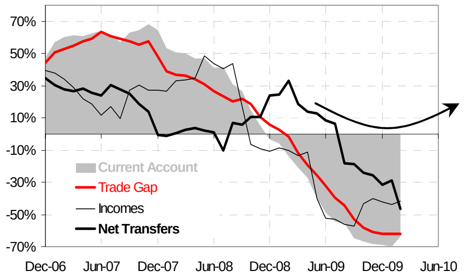
The Current Account Deficit

EUR billion, monthly



Source: National Bank of Romania, BRD calculation

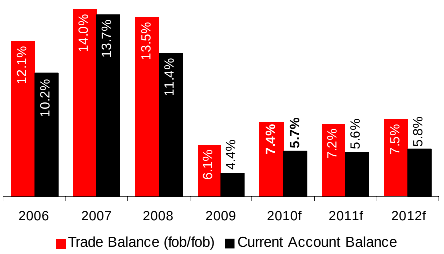
12M rolling, y/y, %



Source: National Bank of Romania, BRD calculation

Trade Balance and Current Account

prospects, % of GDP



Source: National Bank of Romania, BRD forecast

to fulfill its Domestic Demand. When the latter will eventually recover Imports have no other option but to pick-up again. In fact, preliminary 2010 data confirm that imports resumed growth in y/y terms.

Exports outperformance can be explained by lesser volatility of External Demand and by the substitute effect of lower value added products inherent in times of crisis. However, we should mention the positive effect of previous FDIs which are expected to return eventually and push exports forwards in line with the External Demand.

The Current Account Deficit contracted even more than the Trade Gap in 2009 as it fell by 68% y/y to EUR 5 bln or 4.4% of GDP (against EUR 15.7 bln or 11.4% of GDP in 2008).

The combination between a booming *Fiscal Deficit* (-7.4% of GDP) and an imploding *Current Account Deficit* (CAD) (-4.4% of GDP) may look peculiar knowing that those two are closely and directly related. This outlines the drama of the other two variables that made possible such divergent trends: the increase in Private Savings as depicted by the 18% increase in Household deposits and the decline in Investments (-25% y/y FY 2009). In other words we say that in spite of a galloping fiscal deficit, the collapse in Consumer Spending and Investments made possible this severe adjustment in the Current Account Deficit.

The adjustment of the external shortfall has been supported not only by the narrowing Trade Gap but also by still robust private remittances.

All in all the adjustment could not go indefinitely and a reversal is already noticed. Firstly because Consumer Demand and Investments cannot remain subdued for long. Further need for higher living standards and for better infrastructure will eventually boost imported consumer and capital goods altogether. Romania cannot change spectacularly its growth model and cannot become a net exporter in the foreseeable time horizon. Financing will continue to come from abroad because returns earned in Romania will probably remain attractive. Domestic Demand and Consumption remain the long term growth drivers; although in 2010 growth may arise in those export-oriented sectors. Secondly, because at this point in time Romania needs more imported capital goods and raw materials to boost its exports, so the growth rates of exports and imports will eventually equalize.

What we expect is that excessive deficits of 10% of GDP will not be able to occur again in the foreseeable time horizon. Consumer Confidence will recover eventually but will be far from being exuberant. An undervalued RON will play its role in limiting Consumption while a fiscal tightening via future rise in taxes (to meet the 3% fiscal target in 2012 as imposed by the EC) becomes a working scenario for suppressed Consumption. Secondly, because the External Sector will not finance anymore excessive deficits in this part of the World due (probably) to the lessons learned in the past.

As a conclusion we expect the adjustment of the Romanian Current Account Deficit to have come to an end and pick-up gradually in 2010 and 2011 in line with the (moderate) increase in Consumption and Investments. In the coming years we expect the CAD to pick up slightly towards 6% of GDP.

After the severe adjustment of 2009 the Trade Balance should resume moderate growth in 2010 – in line with the pick up in Imports. By 2012 the Current Account deficit will reverse to moderate levels of around 6% of GDP – inherent to a catching-up economy.

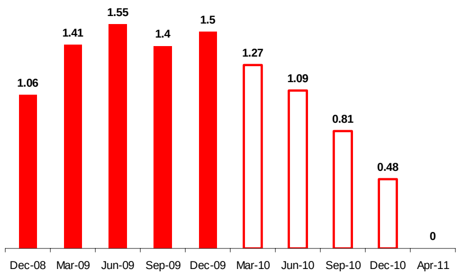
II.4. Fiscal Policy and Public Debt

Budget Stance (% of GDP)

	Rev.	Exp.	Bal.
2005	32.2	33.6	-1.4
2006	32.9	34.8	-1.9
2007	31.4	33.9	-2.5
2008	32.0	36.8	-4.8
2009	31.9	39.3	-7.4
2010f	31.8	37.7	**-5.9**
2011f	30.6	34.9	**-4.3**
2012f	30.7	34.1	**-3.4**

Source: Ministry of Finance / IMF staff projections

Stock of arrears RON billion



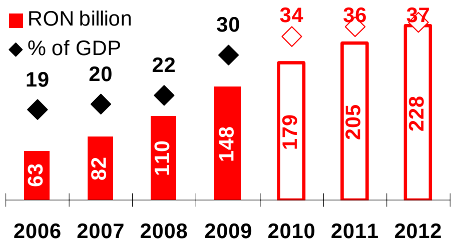
Source: IMF staff report – Feb.2010

Beginning with 2008 Romania adopted excessive deficit policies that raised the consolidated fiscal gap from 1.5-2.5% of GDP in 2001-2007 to 5% in 2008 and 7.4% in 2009. Such evolution can easily be considered “slippage” as it arises from lack of response, accumulation of arrears, higher debt service and ultimately tax evasion.

- Lack of response to the fiscal slippage is outlined by rigid Personnel expenses in 2009 (+2%y/y) and dwindling Capital expenditure (-13%y/y). Preliminary 2010 data shows that the same trend continues. Social assistance could only remain rigid in times of economic slump as Personnel and Social expenditure account for almost 60% in total Public Expenditure, thus make the tough core of the long-term rebalancing process.
- 2009 brought along a spiraling accumulation of Government arrears to and from the Private sector. Either if we mention VAT reimbursements or overdue payments for public procurements, they propelled arrears at the inter-corporate level. Moreover, companies tried to offset their Tax Assets with the Government by accumulating Tax Liabilities. As a result, VAT collection for example declined by 16% in 2009 while the GDP declined by only 7.1% which suggests a problem of increased tax evasion. The problem of State arrears became a troublemaker as Romania failed to meet the arrears issue of the Stand-By Agreement and requested a waiver in Feb.2010. The Romanian Government took a new commitment to phase out arrears by April 2011 (see chart).
- Higher debt service increased the interest payments by 66% in 2009 to 1.2% of GDP. Further on, interest payments are expected to remain at hefty 1.7-1.5% of the GDP according to IMF projections

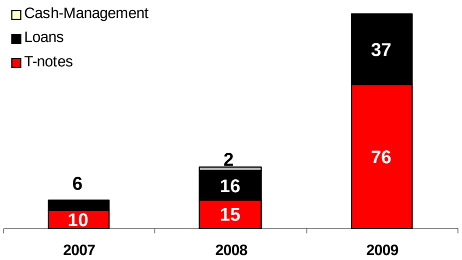
Returning to a balanced position by 2012 will be a difficult and social sensitive task. Although the IMF projects a cut in expenditure from 40% of GDP to 34% in 2012 we believe such an adjustment difficult to implement due to the afore-mentioned rigidities. We expect the Government to pursue a much easier approach via raising revenues and taxes. Preliminary data already indicate difficulties in meeting the current fiscal milestones for 2010 and the issue of raising taxes will become increasingly discussed. In our opinion Romania will take more into consideration giving up its flat tax regime in 2011 and returning to a progressive (counter-cyclical) taxation

Stock of Debt IMF projections



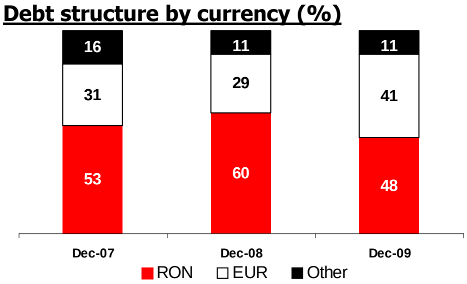
Source: Ministry of Finance

Debt issues RON billion



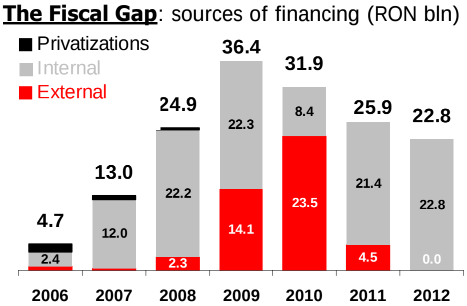
Source: Ministry of Finance

Debt structure by currency (%)



Source: Ministry of Finance

The Fiscal Gap: sources of financing (RON bln)



Source: Ministry of Finance / IMF Staff projections

system as economic growth sets in. Raising the flat tax to a higher level is also an option but it will not discriminate between low and high income. Raising the VAT rate would probably appear as the most effective option at the first glance but, in reality, it will entice for further tax evasion with hard adverse effects on actual tax collection. The size and the combination of fiscal tightening measures are difficult to anticipate at this moment but the current expenditure-cut approach failed to reveal fiscal rebalancing progress.

The Consolidated fiscal deficit amounted to RON 36.4 bln or 7.4% of the 2009 GDP – slightly above the 7.3% target agreed with the IMF. Consolidated revenues declined by 5.4% to 31% of GDP. There are some discrepancies that suggest increased tax evasion in 2009: while the GDP (Gross Value Added) declined by around 7% (6% respectively) and Corporate Income Tax collection declined by 9%, it is difficult to understand why VAT collection declined by 16% ! Total Expenses advanced in 2009 by 1.4% to 38.2% of GDP. Personnel expenses advanced by 2.4%, Social assistance advanced by 18% while Capital expenditure declined by 13% y/y.

The sizeable fiscal slippage brought along a fast rising public debt. Although at the current level of around 30% of GDP the debt figure may seem moderate, it is worrisome that this figure almost doubled in nominal terms since 2007, most notably via short term papers (please notice the 7x increase in debt issues). What is most worrying is that new debt incurred financed almost exclusively current expenses with little positive impact in the future (infrastructure upgrade, pension reform)

As the fiscal gap in 2010 is poised to remain excessive at 5.9% of GDP (or RON 31.9 bln) the stock of debt can only increase accordingly. However, for 2010 the IMF projects an unusual high degree of external financing, much higher than in 2009 (74% in total financing needs in 2010 vs. 39% in 2009). FX implications can be material in 2010 as the Central Bank will have to sterilize almost EUR 6 bln worth of fiscal gap financing (see chart).

Composition of Romanian debt:

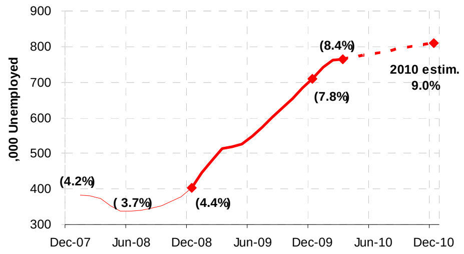
% of GDP	2006	2007	2008	2009	2010f	2011f	2012f
Public Internal	8	12	13	19	20	22	24
Public External	10	8	8	11	14	14	13
Total Public	17	20	21	30	34	36	37
Total External	**43**	**49**	**54**	**63**	**68**	**65**	**57**

Source : MinFin, NBR, IMF projections

Romania should enforce fiscal consolidation by 2012 to a fiscal gap below 3% of GDP and the probability to raise taxes in 2011 is high. The stock of public debt will jump at 34% of GDP in 2010 and 37% in 2012, according to IMF forecasts.

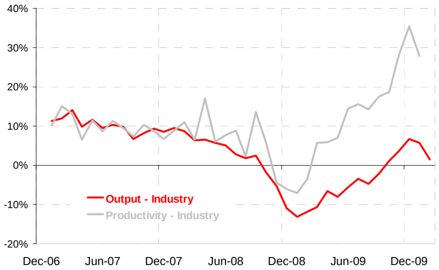
II.5. Unemployment

Unemployment



Source: Romanian Employment Agency, BRD forecast

Industry: output vs. productivity



Source: The Romanian Statistics Institute

Unemployment soared to 760,000 people or 8.4% rate in March. Over 300,000 people lost their jobs in 2009 mostly in the private sector and another 56,000 in the first two months of 2010. Due to the announced restructurings in the public sector we expect additional 50,000 lay-offs (both from the public and the private sector) in 2010 or a revised end-year unemployment rate of 9%. Latest data confirms that the previous rate of job destruction in the private sector could not be maintained for longer as labor productivity cannot be lifted indefinitely. This is why we estimate a diminishing lay-off rate by the end of the year, in line with the pick-up in economic activity. Economic growth and further lay-offs will coexist in 2010 until local business confidence will reach comfortable levels to allow job creation. It is important to stress out the need for a clear official message about the Public Sector restructuring. The process is still expected as significant divergence exists between IMF declarations and official statements about lay-offs in the public sector. Until this issue is clarified Consumer Confidence and Household Demand remains crippled.

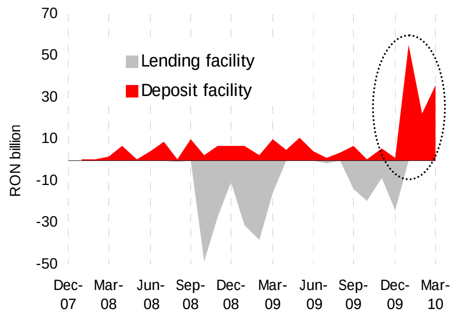
Unemployment is expected to peak at 9% in 2010 then moderate towards 7% by 2012 in line with the expected recovery. The number of lay-offs in the public sector is still unknown.

III. Financial Market

III.1. Monetary policy and Money Market

Keeping both eyes on the exchange rate

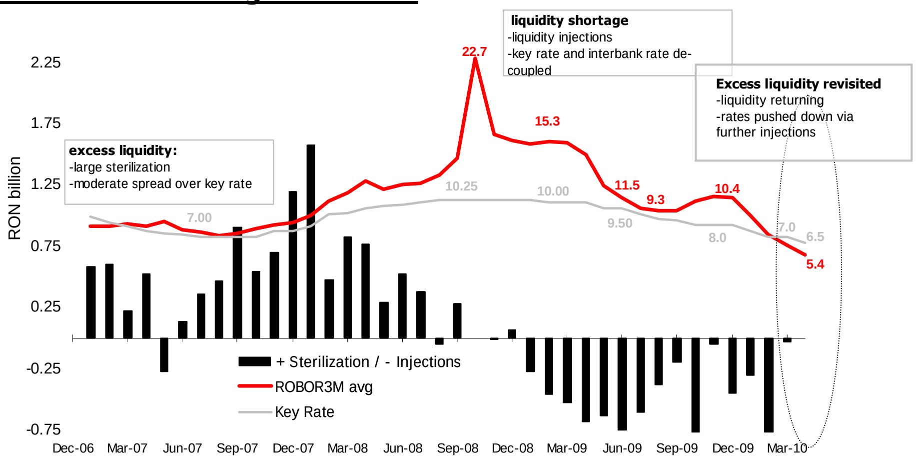
Resuming the net debtor status ?
NBR operations with local banks – recrudescence of deposit –taking activities



Source: National Bank of Romania, BRD calculation

The monetary policy was driven mainly by exchange rate considerations and continues to remain so. As long as the negative output gap kept a lid on inflation NBR afforded to control both inflation and the exchange rate all in the context of free capital flow. As the impossible trinity reigns in, NBR could not lower interest rates as demanded by the dwindling economy. Consequently, the monetary policy rate was kept high relative to inflation while inter-bank rates were even higher until the end of 2009.

From flood to drought and back



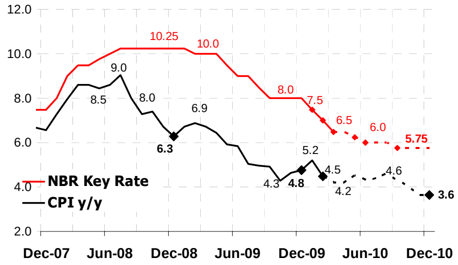
Source: National Bank of Romania, BRD calculation

The crowding-out effect induced by the excessive fiscal gap of 7.4% of GDP played an important role in calibrating the monetary policy in 2009. Besides the interest rate tool (with limited impact in 2009) NBR used a more powerful tool to control liquidity: the ratios of required reserves for FX and RON liabilities. By lowering these ratios and using written agreements to maintain exposure, NBR released EUR 3-4 billion from its reserves which have been funneled into the fiscal gap.

The context changed significantly after the Presidential elections and after the nomination of a functioning Government. The Stand-By agreement with IMF returned on track, greatly improving risk perception. External funds rushed-in to seize the opportunity of substantial carry potential squeezing 350 bps from interest rates and 4% from the EURRON in Q1'10.

CPI and Key rate scenario

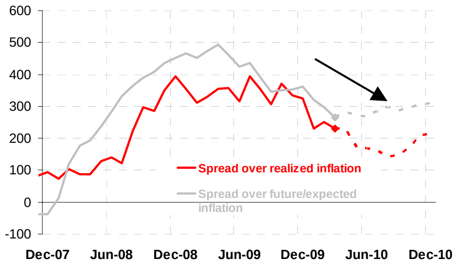
Plenty of space for more rate cuts



Source: National Bank of Romania, National Statistics Institute, BRD forecast

Key rate spread over inflation

Still restrictive at the current levels – comparable with hawkish levels from 2008



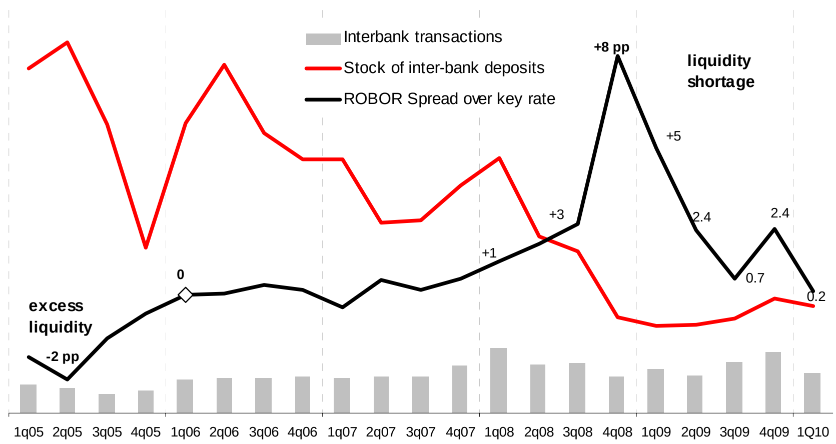
Source: National Bank of Romania, National Statistics Institute, BRD forecast

In such a context with a persistent negative output gap (and ongoing disinflation perspective) with treasury yields and interbank rates falling below the key rate, with appreciating pressure over the RON we can only expect further monetary easing, beyond the levels previously thought of. The perspective for a CPI declining below 4% by the end of 2010 brings into discussion a key rate below 6%. As far as the ratios of required reserves are concerned we expect them both to remain unchanged in 2010 due to the following considerations:

- RON liquidity conditions do not call for liquidity injections (e.g. cuts in RON reserves)
- FX lending remains unwelcome and further FX supplies would pour more gas into the fire. FX reserve requirements are also a tool in limiting capital shifts (although an imperfect one) strengthening our belief for keeping them at current levels (25% maintenance ratio for FX liabilities with maturities shorter than 2 years)

ROBOR levels got closer to the key rate (falling below it at the shorter end of ROBOR curve) as liquidity stance became oversaturated.

Inter-bank liquidity and interest rates



Source: National Bank of Romania

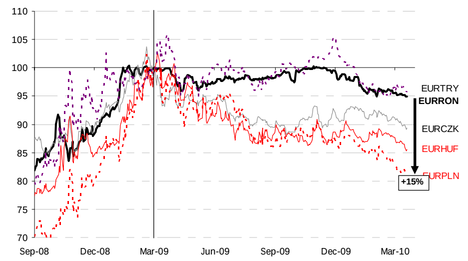
As NBR successfully restored the transmission mechanism for its monetary policies we expect the ROBOR levels to track closer future rate decisions. However long-term inflation drivers (like competition distortions, regulated prices, eventual recovery in Domestic Demand) still lurk behind the current, temporary negative output gap and cautiousness remains paramount for NBR. Most of the monetary easing decisions have been frontloaded and much of the rate cuts have already been experienced. As mentioned before, we do expect further rate cuts but in Q1 or Q2'11 this process will eventually come to an end. Given our current projections we do not expect interest rates below 4.5-5% by the end of 2011 meaning that this bottom figure will be kept flat for a long period of time. Of course this projection can be easily overrun by an outbreak in inflation or unexpected economic tempo (further recession). Until then we expect ROBOR 6-12M levels at around 6% by the end of 2010 and between 5-6% throughout 2011.

We expect a key rate below 6% at the end of 2010 to bottom out at 4.5-5% in H1'2011 if our current scenario for the CPI, GDP and FX proves valid.

III.2. Forex Market

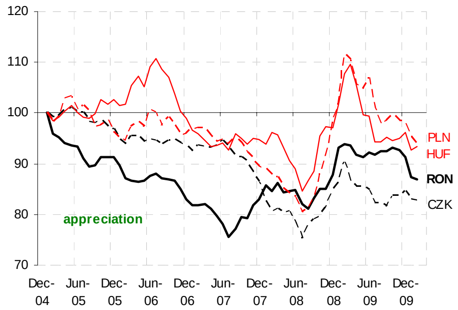
The regional context post Lehman

Indexed on Mar.1, 09



Source: National Bank of Romania, BRD calculation

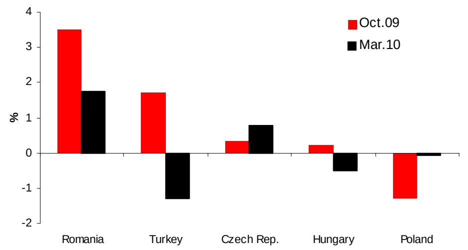
Real Exchange Rate: indexed on Jan.05



Source: National Bank of Romania, BRD calculation

Real interest rate differential vs. EURO

Still attractive in case of Romania



Source: Thomson Reuters, BRD calculation

Much has been written and said about EURRON evolution in 2009 and few aspects remained uncharted. After the Lehman collapse tectonics moved asset prices into abyss throughout the World and Governments took whatever measures they considered necessary to support their economies and financial sectors.

In case of Romania NBR limited EURRON volatility via high interest rates and covered interventions in the FX market. When fiscal constraints demanded, NBR released further FX from its reserves (by lowering the ratio of FX reserves) to cover the fiscal gap and tame depreciating pressures as well. Later on, by sterilizing the FX inflows NBR seized the opportunity to proceed to a long-term weaker RON policy as suggested by many verbal interventions. As a consequence, NBR did its best to limit RON appreciation in line with the recovery of Romanian or other CEE assets starting with Q2'09. And it wasn't difficult to adopt such a stance, as the political turbulence inherent to presidential elections and the subsequent departure from the IMF conditions brought a lot of FX unrest. To strike the desired balance and achieve its weaker RON policy, NBR prevented FX inflows from IMF/ EC/ local banks to flood into the market and sterilized them by using huge amounts of RON that now swamp the market. As a result, FX reserves increased by over EUR 2 billion in 2009 in spite of cuts in the ratio of required reserves.

The situation changed completely after the political debacle sorted out a functioning Administration that complied positively with the IMF's second and third review. The perception about Romania has improved significantly, enticing investors to grab 10% Government bond yields under the circumstance of 3.5% inflation expectations and proven IMF support. In such a context the demand for Romanian treasuries skyrocketed thus pushing yields lower by 350 bps (to 6.5%) by March and forcing NBR to turn 180 degrees and fend-off RON appreciation.

At this moment we consider the RON undervalued based on the following considerations:

- A sizeable lag behind Central European currencies that will eventually be discovered and exploited on a larger scale
- Still appealing carry potential despite recent rate cuts

- Much improved fundamentals: export-driven recovery, huge productivity gains (+35% y/y in Dec.09), perspectives for lower labor costs
- Still robust financing inflows to cover a fiscal gap of roughly EUR 8 bln under the circumstance of a stable outlook for the sovereign credit rating

Given these considerations we believe that the RON does have potential resources to firm beyond 4.0 in an orderly fashion by the end of 2010. Nevertheless, the Central Bank proves serious commitment to limit RON appreciation and holds tight onto its weak RON policy. In plain language we can only say that in the 12 month horizon the RON remains managed floating within boundaries considered “fair” by the Central Bank. Empirical evidence points towards this fair range between 4.10-4.30.

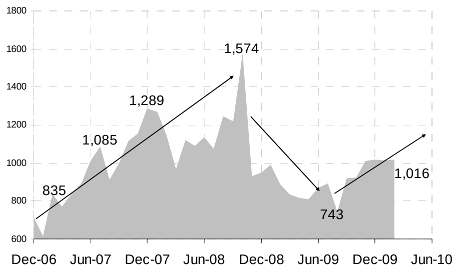
However, the long term perspectives cannot be spectacular for the RON:

- First of all because FX inflows comparable with the 2005-2007 period are difficult to imagine
- Imports are expected to accompany economic recovery. Although not spectacularly, the trade gap is expected to resume moderate growth in 2010. There is some empirical evidence that already reveals increasing demand for FX: positive Imports dynamics, higher sales of FX to clients, a pick-up in FX corporate loans. They are expected to put pressure over the RON starting with 2011
- debt roll-overs from 2009 (and possible 2010) are expected to become due from 2011 onward. Almost EUR 8 bln worth of short term debt has been serviced or rolled over in 2009 and part of it is expected to become due in the coming years
- The payback obligations arising from the Stand-By Agreement will put pressure on the Central Bank reserves in 2012-2015 as a total of SDR 11.6 bln have to be returned
- An undervalued RON can be expected prior to EURO adoption as a means to propel export competitiveness beyond the doorstep of the EMU.

Summarizing all these considerations we expect the EURRON to fall temporarily below 4.0 in 2010 and 2011. Volatility will remain carefully harnessed by the Central Bank which is expected to pursue weaker RON policies all the way until EURO adoption. Moderate pressures are expected

Recovering domestic demand for euros

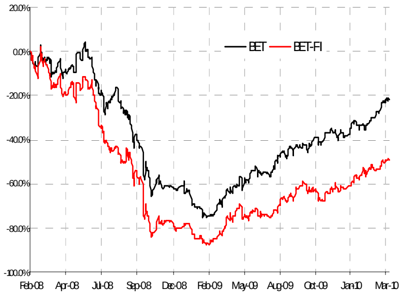
Bank sales of EUR to clients, EUR million, daily avg.



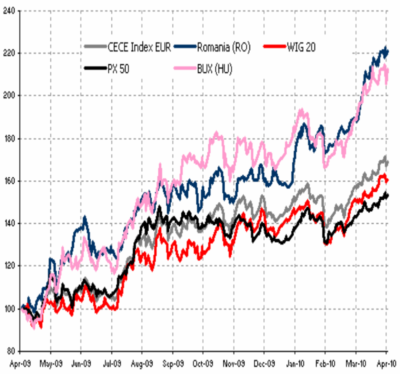
Source: National Bank of Romania, BRD calculation to re-emerge both from the Current and the Capital Account in 2011 and 2012 to bring the EURRON above the 4.0 milestone.

The RON has the potential to firm beyond 4.0 in 2010 but NBR is expected to manage its floatation within boundaries considered “fair” (empirically proven within 4.10-4.30). In the long run, depreciation pressures will emerge from the moderate rise in Imports and debt repayment efforts thus keeping the EURRON above 4.0. A weaker RON policy is expected to be pursued all the way up to EURO adoption.

III.3. The Capital Market



Source: FactSet, BRD calculation

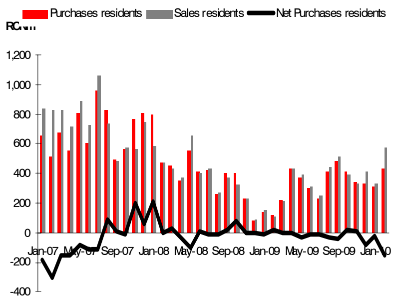


Source: FactSet

	CECE	RO	WIG20	PX 50	BUX
CECE	1.00				
RO	0.58	1.00			
WIG20	0.95	0.53	1.00		
PX 50	0.85	0.57	0.70	1.00	
BUX	0.85	0.51	0.72	0.71	1.00

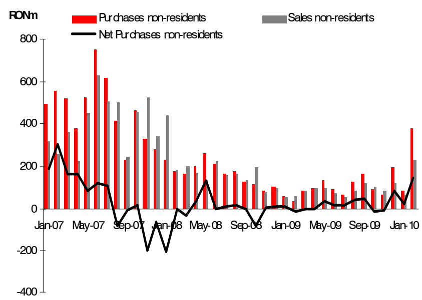
Source: FactSet

BSE – residents' investment flows



Source: BSE, BRD calculation

BSE – non residents' investment flows



Source: BSE, BRD calculation

The evolution of the stock markets in the last two years showed the intrinsic relation between macro environment performance and micro ones along with the investors' behavior features and reactions to newsflow.

For BSE, during 2008, the economic trough wiped out money from all stock markets and indexes plunged to their minimums, as BET and BET-FI dived as low as 1,887 and 7,861 respectively (down from 7,615 and 63,118.94 on April 2008). Starting with the second half of 2009, the evolution of indices turned to positive grounds, on the back of increasing risk tolerance exhibited by (mostly local) investors. The momentum has driven BET and BET-FI up by 152% and 127% yoy respectively as of March 31, 2010.

The outlook indicates that valuations are looking a bit stretched. Even though signs of a recovery have spurred investor's enthusiasm and pushed stock prices to considerable increases ytd, it's the question of magnitude that's got us a little bit cautious on fundamentals, as we wait for evidence of sustainability and stability of companies' earnings.

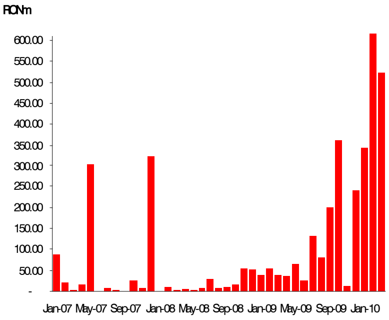
Considering the yoy return in EUR, it appears that BSE has outperformed our neighboring stock exchanges, with an annual appreciation of 121% compared to 69% registered by the CECE index of companies from Poland, Czech Republic and Hungary.

However, all countries exhibited almost the same pattern of evolution during last year, a fact also evidenced by the corresponding correlation matrix. Still, it looks like BET has the lowest correlation with its peers among our group of indexes, probably a cause of lower liquidity and lack of investment opportunities on BSE (e.g sector depth) compared to its peers.

In terms of funds flowing through BSE, the trend has shown consistent declines yoy since 2007, strongly correlated with the investor's raise in risk aversion. Apart from falling volumes, the total invested amounts in the last years show a changed distribution between residents and non-residents. Out of total purchases of RON 13.8bn in 2007, 60% have been reported by residents, while in 2009, the weight of domestic investors has climbed to 76% out of a total of RON 5bn. The same pattern is exhibited by sales volumes, with local investors more active on local capital market as non-residents have been reluctant in investing in frontier markets as available funds have been either diminished by global crisis or risk aversion halted such investments.

The search of investors for an optimal risk-return allocation in times of economic downturn shifted capital markets participants' interests towards bonds. The demand for fixed-income instruments was met by a significant supply of local government looking for financing its fiscal deficits.

BSE –value of bonds transaction



Source: BSE, BRD calculation

Apart from the two local peaks in 2007 (IPO for EIB14), the trend displayed by bond trades is exponentially ascending. Last months have seen a surge in T-notes deals, most probably caused by investment funds entering specific structure trades. The trend should to continue as bonds are expected to be a preferable asset class and more packages such as the EUR 500m T-notes should hit the market.

Public authorities made some legal changes to increase market liquidity by allowing new types of operations, expanding price limit variations, etc., but the main issue on their agenda remains new listings on BSE.

Subsequently, there is a brief summary of main legal changes that drew our attention during 2009 and the first three months of 2010. On 22 Jun '09, The National Securities Commission (NSC) made public its approval of the Instruction no. 3/2009 regarding the direct and indirect holdings in public companies. According to the Instruction, the shareholders (individuals or legal persons) holding directly and/or indirectly more than 33% of the total voting rights issued by a company listed on BSE and who hadn't run a mandatory takeover bid base on the provisions of art. 203 from the Law 297/2004, have the obligation to launch a mandatory takeover bid within two months from the enforcement date (29 Jun' 09) of Instruction no. 3/2009. Following the approval of this Instruction, several expected mandatory takeover bids took place, namely: Sanofi-Aventis Europe launched a mandatory takeover bid for Zentiva shares (SCD) and The Rompetrol Group N.V. launched other two for Rompetrol Well Services shares (PTR) and for Rompetrol Rafinare shares (RRC).

As of 13 Aug '09, the NSC approved the modifications of BSE's Code proposed by BSE. Among the main changes we mention:

- The extension of the variation limits from +/- 15% to maximum +/- 40%, in three successive stages (first stage from +/- 15% to +/- 25; the second stage from +/- 25% to +/- 35% and the third stage from +/- 35% to +/- 40%) if the shares' price is at the highest level of variation more than 15 minutes;

- An increased standard block trade, from 100 units to 500 units;
- The introduction of the “stop loss” and “take profit” orders to control losses, as well as the “if touched buy” and “if touched sell” orders that target profit making;
- The calculation of a theoretical share price, in the first trading day, for shares that where suspended for stock splits or reverse splits. The share’s quotation may vary within a range of +40% of this theoretical price;
- The cancelation of the requirement according to which the trading session is automatically suspended in case BET decreases by 12%.

As of 9 Mar ‘10, the NSC approved also the Regulation no. 5 regarding the setting-up of the global accounts and short-selling operations. In the first stage, the short–selling will be made only with a pre-validation (with the exception of Erste Bank’s shares and of bonds) and only for some companies nominated by BSE. The implementation of the global accounts will simplify the brokerage houses’ activities, especially in relation to the institutional clients, whilst short-selling will increase the capital market liquidity and provide investors with an opportunity to profit from stocks that might decline in value.

First company that broke the ice in terms of listings in 2010 was The Sibiu Stock Exchange (Sibex). As of 22 Jan ‘10, Sibex launched its own spot market and listed its own shares.

The units issued by OTP Green Energy (GRE), a closed-end fund managed by OTP Asset Management Romania SAI, started trading on BSE as of 1 Apr ‘10. In December 2009, the fund issued 43,583 units with a face value of RON 200, and lifespan of 42 months. On 6 Apr ’10, Cemacon Zalau (CEON), the bricks in baked clay producer was transferred from RASDAQ segment of BSE to the main segment of the market.

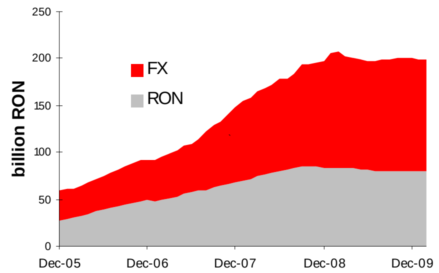
Another company which is expected to be listed this year is the Bucharest Stock Exchange. On 19 Feb’ 10, the Extraordinary Shareholders Meeting of BSE approved the listing of BSE’s shares on its own market within six months and the changing of the company’s bylaws accordingly.

However, the most discussed topic related to listings in the past months has been Fondul Proprietatea (FP). Since the beginning of 2010, more legal steps towards the listing of FP were employed, including the signing of management contract with Franklin Templeton Investments and FP registration at NSC as closed-investment fund. Until FP's shares will be available for trading on a regulated market, some intermediaries (e.g.: Wood Company) issued a warrant type derivative product having FP shares as underlying and which is currently traded on Vienna Stock Exchange.

BET index changed its composition on 1 Apr '10, as Condmag shares (COMI) replaced Rompetrol Rafinare shares (RRC) in BET basket, whilst in BET-XT index Oltchim (OLT) and Turbomecanica (TBM) shares substituted Rompetrol Rafinare (RRC) shares and Zentiva shares (SCD), respectively.

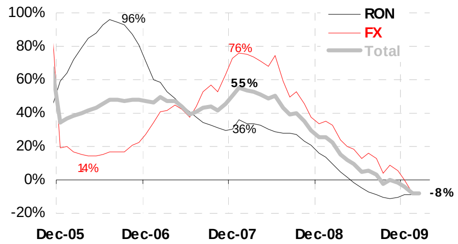
IV.Financial Intermediation

Non Government Loans by currency:
-Absolute values (RON denominated)



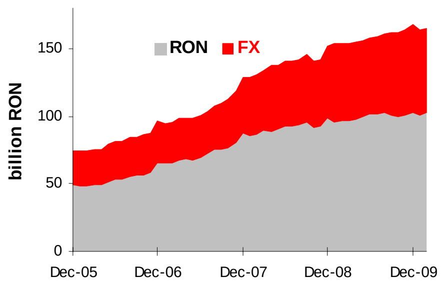
Source: National Bank of Romania, BRD calculation

-y/y, real terms, %



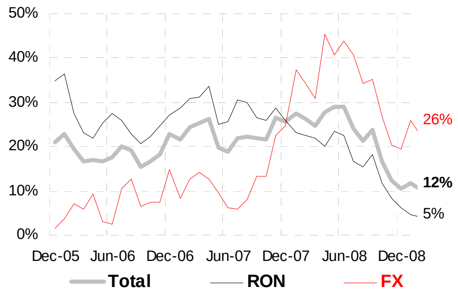
Source: National Bank of Romania, BRD calculation

Non Government Deposits by currency:
-Absolute values (RON denominated)



Source: National Bank of Romania, BRD calculation

-y/y, real terms, %



Source: National Bank of Romania, BRD calculation

Financial Intermediation remains flat in nominal terms meaning that new loans broadly match debt repayments. However, these RON denominated figures are influenced by FX fluctuations but overall lending stood flat in nominal terms.

The pressure on the lending activity came from 2 directions:

- From the Supply side the cost of risk and the crowding out routed funds towards the Public sector
- From the Demand side the economic contraction had adverse effects on creditworthy projects while poor Consumer Confidence had devastating effects over consumer borrowing

As a result, the latest figures indicate a 3.5% decline (y/y, nominal terms, RON denominated figures) in February. Lending in RON was sinking further by 1.0% m/m, both to the Households (-1.7% m/m) and the Corporate sector (-0.3% m/m).

FX lending shows some signs of recovery (+0.6% m/m in February, RON denominated) driven by the Corporate sector (+1.1% m/m, RON denominated). Lending to the Corporate sector picks up consistently especially in FX and confirms previous trends.

Non Government deposits continue to pick-up (+0.5% m/m, +7% y/y, nominal terms, RON denominated) but a few discrepancies deserve to be outlined. The Household sector continues to set money aside, both in RON (+2.6% m/m) and in FX (+0.1% m/m, RON denominated figures). The Corporate sector instead shows divergent trend as FX savings declined by additional 4.3% m/m in February (-2.6% m/m in Jan).

The evidence that corporations shift money from FX to RON deposits due to expectations for RON appreciation and better remuneration provides only a partial explanation. The combined evidence about higher FX lending and shrinking FX savings in the Corporate sector cement out expectations for an increased import activity in the coming period.

V. Forecast

		2007	2008	2009	2010(f)	2011(f)	2012(f)
Nominal GDP	RON bn	416	515	491	520	561	610
Nominal GDP	EUR bn	125	140	116	128	144	153
- real growth		6.3%	7.3%	-7.1%	1.0%	3.0%	3.5%
Industrial production	yoy	5.4%	1.9%	-4.3%	2.5%	3.0%	3.0%
Unemployment	yoy	4.1%	4.4%	7.8%	9.0%	8.0%	7.0%
CPI	eop	6.6%	6.3%	4.7%	3.6%	3.0%	3.0%
CPI	avg	4.8%	7.9%	5.6%	4.3%	2.6%	3.0%
Exchange rate EUR/USD	eop	1.47	1.41	1.44	1.28	-	-
Exchange rate EUR/RON	avg	3.34	3.69	4.24	4.05	3.90	4.00
Exchange rate EUR/RON	eop	3.61	3.99	4.23	3.95	4.00	4.10
Exchange rate USD/RON	avg	2.44	2.52	3.05	3.00	-	-
Exchange rate USD/RON	eop	2.46	2.83	2.94	3.09	-	-
Exports (fob)	EUR bn	36.5	42.5	36.0	37.8	41.6	45.8
Imports (fob)	EUR bn	53.8	60.9	43.1	47.4	52.1	57.3
Trade balance (g&s, fob/fob)	EUR bn	-17.3	-18.5	-7.0	-9.5	-10.5	-11.5
Trade balance	% GDP	-13.9%	-13.2%	-6.1%	-7.4%	-7.3%	-7.6%
Current account balance	EUR bn	-16.9	-15.7	-5.1	-7.3	-8.1	-8.9
Current account balance	% GDP	-13.6%	-11.2%	-4.4%	-5.7%	-5.6%	-5.8%
Net FDI flows	EUR bn	7.1	9.0	4.9	4.0	7.0	9.0
Fiscal gap	% GDP	-2.5%	-4.8%	-7.4%	-5.9%	-4.3%	-3.4%
Foreign debt (medium and long term)	EUR bn	33.5	51.2	64.2	71.0	76.0	80.0
Foreign debt (medium and long term)	% GDP	27%	37%	55%	55%	53%	52%
FX reserves	EUR bn	25.3	26.2	28.3	37.0	-	-
Imports cover	months	5.6	5.2	7.9	9.4	-	-

BRD-GSG - Research		+40 21 301 6850	research@brd.ro
Florian LIBOCOR	Chief Economist Head of Research	+40 21 301 6869	florian.libocor@brd.ro
Carmen LIPARĂ	Head of Financial Markets Research	+40 21 301 4370	carmen.lipara@brd.ro
Angeliu URSACHE	Senior Economist	+40 21 301 6858	angeliu.ursache@brd.ro
Monica NANIA	Economist	+40 21 301 6858	monica.nania@brd.ro
Florin HANŢILĂ, CFA	Equity Analyst	+40 21 301 4472	florin.hantila@brd.ro
Dana MUNTEANU	Equity Analyst	+40 21 301 4982	dana.munteanu@brd.ro