MARKER GLOBAL

MONTHLY RISK *BRIEF*

ROMANIA
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Monthly Risk *Brief* Contents

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01 JUNE RISK OUTLOOK AT A GLANCE

TOP 3 POLITICAL RISKS

01 The sharp political divisions surrounding the implementation of unpopular austerity measures risk to further delay the introduction of the economic reform package. However, there is little risk that the coalition of Liberal Democrats (PDL) and the Hungarian Democratic Union (UDMR) will disintegrate.

02 We expect a new prime minister and a cabinet reshuffle once the IMF “Letter of Intent” was adopted on 26 May. President Traian Basescu will continue to be the chief communicator and broker of the anti-crisis programme. This stance weakens the government’s negotiation power with the unions as Romania is facing a summer of discontent.

03 The opposition parties – the Social Democrats (PSD) and the Liberal Party (PNL) – are likely to act on their threat to try to unseat the government. However, they are unlikely to succeed as the coalition can rely on the independent and ethnic minority parliamentary groups to defeat a non-confidence vote by a narrow margin. This is significant, as it will political crisis of 2009, when Romania had not government in place for 4 months.

TOP 3 ECONOMIC RISKS

01 The risk of non-compliance with the International Monetary Fund (IMF) lending conditions remains high as Romanian governments have a track record of back peddling when faced with social opposition to drastic measures. However, we expect the IMF board to release the next instalment of EURO850m scheduled for mid – June.

02 We expect unemployment to rise substantially, especially if the government acts on implementing the public administration reform programme. However, as there is no strategy in place to re-train and re-skill the unemployed, there is an increased risk of protests and social unrest, further destabilising the government’s agenda to cut the budget deficit.

03 The biggest risk remains the delay in acting to reform the public sector. We expect the delays to force the government to raise taxes from September onwards, in addition to the cuts announced in public sector wages and pensions.

02 POLITICAL RISK

02.1 PRESIDENT RE-EMERGES AS POWER BROKER

The President, Traian Basescu (Basescu), is taking an increasingly central role on the domestic political scene, especially in relation to the anti-crisis measures of the government. His centre stage role has reignited the opposition's personal attacks against the president after a period of relative calm in the aftermath of last year's presidential contest. This development will lead to further political volatility at a time when unity is required to adopt and implement a drastic austerity package to stave off the country's economic collapse. Basecu is likely to emerge as an immediate political winner from his hand-on approach to the negotiations with the IMF, especially as he is able to articulate the opposition's lack of an alternative programme to redress the country's economy. Furthermore, the prime minister, Emil Boc, who is also the leader of the ruling PDL, seems to be willing to take responsibility for the hostility caused by the austerity measures, at a personal political cost to him.

02.2 NEW PM AND CABINET RESHUFFLE IMMINENT

We expect a new prime minister to be appointed once the government adopted the IMF "Letter of Intent" on 26 May. There are a number of reasons for the change, including the acute lack of popularity of the Boc administration and Basescu's need to re-assert himself within the governing PDL, ahead of the forthcoming changes in the party's internal structures. Basescu will seek to secure appointments for his closest allies and, with it, to ensure his political future within the party. We therefore expect some high profile casualties in the reshuffle – perhaps leading PDL figures such as the economy minister Adriean Videanu or Vasile Blaga, the interior minister. Taking aim at the top echelons of the party would allow Basescu to re-align his base at the local party level. Therefore, it is unlikely that Basescu's recent rhetoric against political corruption – such as urging politicians to elect between politics and their private businesses – will translate into more than half-hearted measures being introduced.

02.3 POLITICAL REFORM SHELVED

The recent emphasis on Romania's economic crisis has distracted the attention from one of Basescu's main reform proposals – a reduction of the number of parliamentarians and the introduction of a one-chamber legislature. Despite ensuring that his immediate credibility is not in tatters, the effect of his involvement with pushing through an austerity agenda will generate less goodwill among politicians and the electorate in support of the proposed constitutional changes. We expect further delays in political reforms in the short-term.

03 ECONOMIC RISK

03.1 EARLIER REFORM DELAYS LIMIT OPTIONS

The government adopted the economic reform package agreed with the IMF by government ordinance on 26 May. The wage and pension cuts envisaged in the IMF agreement have to come into force from 1 June. It is unlikely that the opposition will succeed in blocking the measures from being adopted by the Parliament. At least for now, the government has acted with a sense of urgency in addressing the country's economic woes and seems determined to put into practice the reforms agreed with its institutional lenders. However, bringing in measures to curb the budget deficit by a reduction in public sector wages and pensions will not suffice to bring Romania's public finances into the comfort zone for investors. The biggest challenge for the government remains the reduction of the personnel in the public sector and, in this matter, the government is unlikely to find an easy negotiating partner in the public administration unions. Protracted negotiations with the unions and the threat of further general strikes will reduce the government's resolve to cut the size of the public sector, thus endangering the reform agenda and Romania's standing as a borrower in the international markets.

In the short –term, however, the IMF will release the next instalment of the EURO850m loan to give the Romanian government the chance to start implementing reforms as a last resort. In their latest review of the compliance with the lending conditions, the IMF found that the Romanian authorities continued to fail to meet the quantitative targets agreed such as a rise in arrears and no restructuring of public spending.

KEY REFORM STEPS AGREED WITH THE IMF

By 1 June 2010:	
Measure	Benefits for 2010
25% cut in public sector wages	CUT spending by 1% of GDP
15% cut in pensions and all other social benefits	CUT spending by 1% of GDP
Reduced transfers to local authorities	CUT spending by 0.3% of GDP
Reduce the state apparatus	CUT
Reduced heating subsidies	CUT spending by 0.3% of GDP
Increase the tax base for income tax and for social contribution by taxing capital income, including the income from interest on saving accounts as well as severance payments.	INCREASE in taxes and budget revenues
Introducing a claw back tax for drugs distributors	INCREASE in revenues

03.2 UNEMPLOYMENT SET TO RISE

One of the biggest challenges faced by the current administration is implementing a reduction of 100,000 jobs in the state apparatus, representing a cut of nearly 10% in public sector jobs. To date, the government made cuts in the state owned enterprises but is now facing strong opposition from powerful trade unions such as those representing the public administration or the education sectors.

Although the most efficient move for the public sector expenditures would be to cut jobs from the costly bureaucracy, politically this is a difficult decision to take. Since 2004 the number of employees in the public administration almost doubled (both at the central and local levels). Apart from its large size, Romania's bureaucracy is characterised by a lot of conflicts of interests stemming from family connections which will make across the board cuts very difficult to implement.

03.3 MONETARY POLICY RESTRICTED BY EURO ACCESSION TARGETS

The Romanian economy is affected by a drop in demand that affected Europe in the first quarter as well as the structural imbalances that have not been addressed since the country joined the European Union in 2007. As a result, we lowered our growth projection for 2010 and we now expect the economy to stagnate despite a surge in agricultural output in the summer months, contributing to positive growth.

Under these circumstances, the Central Bank (BNR) has room for a further 25 – 50 bps cut in June. The Q2 GDP recovery could trigger a 50 bps cut, but, since the previous three cuts were not followed by the commercial banks, the BNR may opt to reduce the speed of the monetary policy relaxation. The disinflation process continues gradually, albeit not as fast as the recession would indicate. Therefore, the central bank can also opt to ease the policy by reducing the minimum reserve requirements.

The main issue for the BNR in June would be to decide how it would pursue its policy, given that the disinflation process will halt, but the GDP recovery is not yet in sight. Minimum reserve requirements (MRR) have to be reduced in order to prepare Romania joining the ERM II in 2012, but there is a problem of timing and pace. There is already over-liquidity on the money market as credit growth is only slowly recovering and additional liquidity from an MRR cut would endanger both the inflation rate and the exchange rate. Postponing the MRR cut is not an option if accession to the Euro zone is sought for 2015.

KEY MACROECONOMIC INDICATORS

01 Agriculture will be the main driver of economic growth in Q3 and there are indications of strong performance in this sector. This should alleviate the impact of the decline in the construction sector on growth and we still expect economic stagnation for 2010.

02 The inflation rate is likely to accelerate in Q3 due to the unfavourable base effect from food products.

03 The effect of the announced cuts in public sector wages and pensions will be a narrowing of the budget deficit in Q3. This should stabilise the level of public debt, which has become a key concern for investors.

04 The draw down of the fifth IMF tranche will temporarily stabilise the total amount of forex reserves.

05 The recovery in household consumption remains sluggish with the result that we do not expect the money supply to accelerate.

	2008	2009	2010*	Q1	Q2*	Q3*
GDP growth rate (%)	7.3	-7.10	0.0	-2.6	0.0	1.7
Nominal, RON (bln)	514.7	491.3	510.6	97.0	107.3	139.1
Nominal, EUR (bln)	139.7	115.9	123.0	23.5	26.0	33.5
Per capita EUR	6499.9	5427.9	5668.2	1082.9	1198.2	1543.8
CPI (yoy, %)						
Average	7.9	5.6	4.7	4.6	4.3	4.7
Eop	6.3	4.7	4.5	4.2	4.3	4.6
Budget deficit (% of GDP)	-5.4	-8.3	-7.2	-1.5	-3.0	-1.0
Total public debt (% of GDP)	13.3	23.7	28.0	27.0	28.0	28.0
Current account balance (% of GDP)	-11.6	-4.5	-6.5	-6.4	-6.9	-6.6
Net FDI (% of GDP)	6.7	3.8	4.0	3.2	3.5	2.1
Forex reserves (excl. gold, EUR bln)	26.2	28.3	30.0	32.0	32.0	32.0
Gross external debt (% of GDP)	52.9	56.5	65.0	298.3	273.1	213.9
Central bank key interest rate (%) eop	10.25	8.00	5.50	6.50	6.00	6.00
Broad money supply (M3, yoy %)	17.5	9.00	8.0	8.4	8.2	8.00
Exchange rate (RON/EUR) (eop)						
Year end	3.99	4.31	4.15	4.12	4.19	4.16

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

**Marker Global forecast*