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ROMANIA

COUNTRY RISK
MONTHLY BRIEF: DECEMBER 2009

PRIVATE AND CONFIDENTIAL

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The Risk *Brief* contents

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About the author

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

01. DECEMBER RISK OUTLOOK AT A GLANCE

TOP 3 POLITICAL RISKS

- 01** There is a high risk that a new government will not be sworn in earlier than January 2010.
- 02** Romanian politics will remain highly volatile into 2010 irrespective of who wins the presidential contest on 22 November 2010. The new president will have a key role in brokering a new government.
- 03** It is unlikely that any of the presidential candidates will secure a first round presidential victory.

On the political front the situation is difficult to predict. The result of the presidential election on 22 November 2009 is much more uncertain and a winner will only emerge after the second round, on 6 December 2009. A return to political stability is unlikely before Q1 2010 as whoever wins the presidential vote is conditioned in successfully nominating a new government by the parliamentary coalition he can secure.

It is difficult to imagine that Romania will avoid early parliamentary elections in 2010. Early elections will prolong the period of immediate political instability but in the medium-term new elections could clarify the medium-term political allegiances given that one variable will be known, the new President. Some negative aspects will remain such personal rather than policy attacks characterising the political debate and the continued interference of the President with the Government's agenda.

TOP 3 ECONOMIC RISKS

- 01** We do not expect signs of an economic recovery in Romania before the first quarter of 2010.
- 02** We should not be too worried by relatively high budget deficits in 2009 and 2010, as long as they are under control.
- 03** The government's financing needs for 2009 cannot be met due to the delay in the release of the third instalment of the IMF loan.

On the economic front, the present situation remains bleak despite some signs of recovery, mainly export-led.

Our assumption is that the economic recovery in Romania will not be visible before Q1 2010 as there is a two-quarter lag between the euro-zone and Romania.

02. POLITICAL RISK

02.1 SECOND ROUND PRESIDENTIAL CONTEST UNAVOIDABLE

We do not expect an outright winner in the presidential election on 22 November 2009. A second, decisive round is scheduled for 6 December 2009.

Opinion polls place the current president, Traian Basescu (Basescu), and his main opponent, Mircea Geoana (Geoana), in the lead and neck and neck at around 30% of the vote. Nine candidates have registered for the contest but only four have chances to enter the second round, including Basescu and Geoana¹.

Electoral turnout is expected to be low, especially in light of the recent government crisis which has caused apathy amongst the voters. Both leading candidates should benefit from their parties' disciplined electorate to secure their votes. It is the undecided voters, however, that are likely to cast a negative vote against Basescu in the second round and decide the outcome of the presidential election.

There are signs of a possible crack in the present parliamentary opposition² that may result in a surprise candidate – probably the Liberal's Crin Antonescu - entering the second round.

02.2. CANDIDATES' STANCE ON KEY POLICIES

The presidential electoral debate has cantered on two key policies – the need to reduce the size of the Parliament size and whether the current 16% flat tax rate, introduced in 2005, should be scrapped.

Traian Basescu is in favour of replacing the current two-chamber Parliament with a one-chamber Parliament. To this end, he has called a referendum on the date of the presidential contest to validate this policy. He is also in favour of maintaining the current flat tax rate. Basescu may find himself in a difficult position of winning the referendum and yet losing the election as the opinion polls suggest that the electorate favours a downsizing of the Parliament.

¹ The top contestants are as follows (in alphabetical order): Crin Antonescu (National Liberal Party, PNL), Traian Basescu (Democrat-Liberal Party, PDL, the incumbent), Mircea Geoana (Social Democratic Party, PSD) and Sorin Oprescu (independent, current mayor of Bucharest).

² The parliamentary opposition includes: PSD in coalition with the Conservative Party (PC), the Hungarian minority party (UDMR) and PNL. Together they control 201 seats in the Chamber of Deputies and 86 in the Senate. The governing party is the Liberal Democratic Party (PDL).

Mircea Geoana supports a two-chamber parliamentary system as currently in place. However, he supports the abolition of the flat tax and a return to tiered taxation on corporate profits and income tax.

Crin Antonescu is in favour of further tax cuts. He supports a two-chamber parliament and would consider a reduction in the number of parliamentarians.

Sorin Oprescu has centred his campaign on an anticorruption agenda. He is in favour of reducing VAT rates for selected items such as medicine and supports the referendum to downsize the Parliament. However, he objected to the timing of the referendum as coinciding with the presidential vote.

02.3 EARLY PARLIAMENTARY ELECTIONS UNAVOIDABLE

Romania's political deadlock deepened after the collapse of the government in October 2009. We consider that an early parliamentary election is unavoidable to resolve this political deadlock. The country is currently governed by a caretaker cabinet, led by the deposed prime minister Emil Boc.

The Parliament ousted the Boc administration over the laws which represent structural benchmarks in the programme agreed with the International Monetary Fund (IMF). The third IMF loan tranche of EURO1.4 billion will not be disbursed as a result in December 2009, as initially agreed. In a surprise move, the Parliamentary opposition voted in favour of legislation allowing the caretaker cabinet to have legislative powers in order to present the 2010 budget to the Parliament.

Two scenarios can be envisaged with regards to the likelihood of an early parliamentary election:

Traian Basescu

is re-elected: the parliamentary opposition can continue to reject Basescu's nomination for prime minister. The president has the power to call an early election after two failed nominations.

Mircea Geoana

is elected: there is no guarantee for a new government as a majority coalition is necessary to support any candidate. The PNL, one of the coalition members, has already indicated that it may consider supporting a PDL government and further cracks in the current parliamentary opposition may reduce Geoana's chances of successfully nominating a new cabinet.

03. ECONOMIC RISK

03.1 BUDGET FINANCING DIFFICULTIES REMAIN

Romania's political uncertainty has resulted in an increase in economic risk as the financial support from the IMF and European Union was discontinued³. This has left Romania's financing needs until the end of 2009 – of some EURO 3 billion - uncovered. The financing requirements of the budget deficit will keep interest rates over 10% in Q1 2010.

The IMF third tranche will not be disbursed in December 2009 as agreed in the Stand-By Arrangement (SBA). The review of the government's compliance with the SBA was not completed in the IMF's visit in early November 2009.

In the absence of a government and with politicians locked in an electoral race, it has been left to the Romanian National Bank (BNR) to find a solution to the budget financing difficulties. Thus, in a surprise move on 16 November 2009, BNR cut by 5 pps the minimum reserve requirements for forex denominated liabilities from 30% to 25%, releasing around EURO 1.2 billion quoting the delayed external finance.

03.2 KEY MACROECONOMIC INDICATORS

INFLATION: the disinflation process continued and we expect the 2009 target of 3.5% +/- 1 pp will be reached.

CURRENT ACCOUNT DEFICIT: The downward adjustment in the private sector of around 12% has axed 76% of the 2009 current account deficit.

BUDGET DEFICIT: The budget deficit at the end of October 2009 was 5.2% of GDP. However, we expect the deficit to end the year at 8%, higher than IMF target of 7.3%. This sharp increase is due to higher government spending on the unreformed public sector and an unsustainable state pension system.

We expect a painful adjustment in order to reign in public spending and bring the budget deficit within the IMF target. An increase in interest rates on the money market in Q1 2010 is very likely.

ECONOMIC GROWTH: Despite a sharp contraction in Q3 GDP of 7.1% yoy, this economic performance is in better than 8.6% expected. We expect an export-led recovery in Q1 2010. Q3 figures showed a strong performance in the manufacturing sector related to exports to Germany.

³ In May 2009 the IMF approved a 24-month loan of EURO 12.9 billion under a Stand-By Arrangement for Romania available in instalments subject to quarterly reviews.

MONEY MARKET: The difficulties of the budget will keep the money market rates higher than 200 bps above the BNR base rate. There is sufficient liquidity in the market but the banks holding most of it have reached their exposure limits with the budget. We expect the central bank to contain the volatility of the exchange rate allowing for a small depreciation.

KEY MACROECONOMIC INDICATORS

01 GDP figures for 2008 and 2009 underline de depth of the recession.

02 The budget deficit is not highest in the EU. Romania's public debt remains one of the lowest in the EU.

03 The adjustment of the current account deficit in 2009 has been extraordinary considering that it decreased by 76%.

04 Foreign direct investment dropped by 25% in 2009 compared to 2008.

	2004	2005	2006	2007	2008	2009*
GDP growth rate (%)	8.5	4.1	7.9	6.2	7.1	- 7.6
Nominal, RON (bln)	247.4	289.0	344.7	412.8	504.0	497,00
Nominal, EUR (bln)	61.0	79.7	97.8	123.7	137.1	117,00
Per capita EUR	2815.9	3687.9	4530.4	5742.5	6364.8	5 571,00
CPI (yoy, %)						
Average	11.9	9.0	6.6	4.8	7.8	5.0
E.o.p.	9.3	8.6	4.9	6.6	6.3	4.5
Budget deficit (% of GDP)	-1.5	-1.4	-1.9	-2.5	-5.3	- 8.0
Total public debt (% of GDP)	22.5	20.5	18.4	20.2	21.6	28,00
Current account balance (% of GDP)	-8.4	-8.6	-10.4	-13.6	-12.3	-4.3
Net FDI (% of GDP)	8.8	6.5	9.3	5.7	6.6	5,00
Forex reserves (excl. gold, EUR bln)	10.8	16.8	21.3	25.3	26.2	28,00
Gross external debt (% of GDP)	35.2	38.8	42.0	47.6	52.9	60,00
Central bank key interest rate (%) eop	17.31	7.50	8.75	7.50	10.25	8.00
Broad money supply (yoy %)	39.9	33.9	29.4	33.9	17.5	11,00
Exchange rate (RON/EUR)						
Year end	3.97	3.68	3.38	3.61	3.99	4.31

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

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