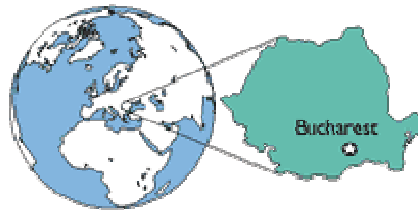


# COUNTRY REVIEW

## Romania



23 May 2011

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**EULER HERMES COUNTRY RISK GRADE: C**

Country Risk Grades are on a scale of AA, A, BB, B, C, D  
where AA is the lowest and D the highest risk.

## Strengths

- EU membership and fairly good international relations.
- Moderate systemic political stability risk.
- Generally adequate investment climate.

## Weaknesses

- Government instability has often affected sound policymaking and reform process.
- Failure to make progress on EU-required judicial reform and anti-corruption measures.
- After overheating and a hard landing, economic recovery from a deep recession is taking a long time to arrive.
- History of lack of sound monetary and fiscal policies.
- Significant public sector arrears.
- Substantial external liquidity risk.
- High external debt burden.
- Exchange rate volatility and vulnerability to shocks.
- Banking sector vulnerabilities.

## Country Risk Assessment

Ratings	Romania		Median Grade C	Hungary	Peers Latvia	Bulgaria
	Latest	Previous				
<b>Systemic Political Risk:</b>	<b>P2-</b>	<b>P2-</b>	<b>P3+</b>	<b>P2-</b>	<b>P2+</b>	<b>P2+</b>
<b>Systemic Economic Risk:</b>	<b>E5</b>	<b>E5</b>	<b>E5</b>	<b>E5</b>	<b>E5</b>	<b>E4</b>
ME rating:	ME5	ME5	ME5	ME5	ME5	ME4
<i>Structure</i>	3.3	3.3	5.8	2.3	4.0	4.0
<i>Policy</i>	3.6	5.2	5.2	5.3	5.6	2.8
<i>Solvency</i>	5.2	4.8	3.3	3.9	5.9	4.2
<i>External Liquidity</i>	5.3	6.0	4.2	6.0	3.8	3.9
SBE rating:	SBE3	SBE3	SBE4	SBE2	SBE2	SBE3
<b>COUNTRY GRADE:</b>	<b>C</b>	<b>C</b>		<b>C</b>	<b>C</b>	<b>B</b>

**Nomenclature:**

Political Risk Ratings are on a scale of P1 (lowest risk), P2+, P2-, P3+, P3-, P4 (highest risk).

Economic Risk Ratings are on a scale of E1 (lowest risk), E2, E3, E4, E5, E6 (highest risk).

ME (Macro-Economic) ratings are on a scale of ME1 (lowest risk), ME2, ME3, ME4, ME5, ME6 (highest risk).

The constituent parts of the ME rating are on a scale of 1.0 (best) to 6.0 (worst).

SBE (Structural Business Environment) ratings are on a scale of SBE1 (best), SBE2, SBE3, SBE4, SBE5, SBE6 (worst).

Country Grades are on a scale of AA, A, BB, B, C, D where AA is the lowest and D the highest country risk.

Source: Euler Hermes Economic Studies

## ECONOMIC STRUCTURE

<b>Country Profile</b>	
Capital city:	Bucharest
Population:	21.43 mn (2010)
GDP:	USD 161522 mn (2010)
Currency:	New leu (RON; since 1 July 2005)
Form of state:	Presidential / parliamentary republic
Head of government:	Prime Minister Emil BOC (since December 2008)
Next elections:	Legislative: end of 2012 / Presidential: end of 2014

<b>Major Industries (% of GDP at 1998 prices, 2009)</b>	<b>Global Assumptions</b>	2010	2011	
Services	55.2%	Real GDP grth (% yr/yr)	3.3	2.9
Trade	16.1%	Inflation (% av) *	1.2	1.4
Industry	34.5%	Dated Brent (USD/b)	80	115
Construction	10.3%	* Major economies		
Agriculture & forestry	10.3%			

<b>Main Exports (% of total, 2010)</b>		<b>Main Imports (% of total, 2010)</b>	
Transport equipment & vehicles	42.4%	Transport equipment & vehicles	35.3%
Other manufactured products	33.3%	Other manufactured products	30.9%
Raw materials	6.9%	Chemicals & products thereof	13.2%
Food, beverages and tobacco	6.3%	Fuel, lubricants, etc.	10.1%
<b>Lead Export Markets (% of total exports, 2010)</b>		<b>Lead Import Markets (% of total imports, 2010)</b>	
EU-27	72.2%	EU-27	72.5%
Germany	18.1%	Germany	16.7%
Italy	13.8%	Italy	11.6%
France	8.3%	Hungary	8.7%
Turkey	6.9%	China, P.R.	5.5%

## Basic indicators

<b>Selected economic indicators</b>	2007	2008	2009	2010	2011f
Nominal GDP (USD mn)	170,495	204,246	163,281	161,522	185,352
Population (mn)	21.54	21.50	21.46	21.43	21.39
GDP per capita (USD)	7,916	9,498	7,608	7,537	8,667
Real GDP growth (% yr/yr)	6.3	7.3	-7.1	-1.3	1.5
Inflation (% eop)	6.6	6.3	4.8	8.0	5.0
Fiscal balance (ESA 95, % of GDP)	-2.6	-5.7	-8.5	-6.4	-4.7
Current account balance (% of GDP)	-13.5	-11.6	-4.3	-4.2	-4.8
External debt/GDP (%)	52.1	50.5	73.1	76.7	72.8
External debt/Exports of goods & services (%)	177.5	164.7	236.4	214.4	207.7
Debt-service ratio (%)	21.9	25.9	32.3	31.3	28.9
Foreign exchange reserves (USD mn)	37,194	36,747	39,344	42,303	44,000
Import cover (months)	6.0	4.9	7.8	7.6	7.0
Exchange rate assumption, RON:USD (av)	2.44	2.52	3.05	3.18	3.00
Exchange rate assumption, RON:EUR (av)	3.34	3.68	4.24	4.21	4.13
f: CRU central forecast					

Sources: National sources, IMF, ECB, European Commission, IHS Global Insight, Euler Hermes Economic Studies

## Political Stability

The first decade after the overthrow of communism in late 1989 saw little progress on political and economic reform, which resulted in economic decline and a poor international reputation. During 2000-2006, policymaking and administration, along with Romania's international standing, improved significantly, facilitating NATO membership in March 2004 and EU accession in January 2007. However, once the cross-party goal of EU membership was achieved, government instability resurfaced, reflected in coalition collapses in April 2007 and October 2009 and resulted in a general slowdown of progress on the still considerable, unfinished economic and structural reform agenda. The latter has drawn continued criticism from the European Commission whose semi-annual progress reports on Romania have repeatedly criticised the lack of action on judicial reform and the fight against corruption. This could result in below-potential EU funding, although the EU has so far restrained itself from imposing such punitive measures.

Moreover, government ineffectiveness resulted also in occasional temporary suspensions of aid funding under the IMF- and EU-led EUR20bn international support package which the Romanian authorities secured in May 2009. The large funding (equivalent to about 15% of GDP) was attached to an economic programme under a two-year IMF Stand-By Arrangement (SBA) and intended to cushion the domestic economic downturn in the wake of the global economic crisis, the impact of which had hit Romania hard. Meanwhile, that programme has ended broadly on track and has been succeeded by a new EUR5.3bn international support package under a new two-year SBA that came into effect in March 2011. The Romanian authorities intend to treat the new arrangement as precautionary. While this development is generally positive, it should be noted that failure to meet programme targets and another potential suspension of the SBA could again cause nervousness in financial markets as it did in Q4 2009 and in mid-2010.

## Economic Stability

The World Bank classified Romania as an upper middle income country in a survey from January 2011, based on GNI per capita of USD8,330 in 2009. Services contribute about 55% to GDP, industry 35% and agriculture 10%. The export structure shows strong dependencies on fellow members of the EU-27, which together account for around 72% of merchandise exports, and the transport equipment and automotive sector, which contributes 42% to exports, making the economy vulnerable to the European and global business cycles. Real GDP grew by an average annual 7.2% in 2006-2008, however, in large part this was due to an overheating of the economy, which was reflected in mounting macroeconomic imbalances such as an excessive credit boom that fuelled domestic demand and caused a housing bubble, elevated inflation and unsustainably high current account deficits. In the wake of the global financial and economic crisis, this growth model collapsed and the economy fell into a deep, prolonged recession.

Real GDP declined by 7.1% in 2009 and 1.3% in 2010. Domestic demand remained particularly weak in 2010, with private consumption contracting by 2%, public consumption 3.2% and investment 13.1%. Inventory re-stocking mitigated the decline as it caused a 2.7% increase in gross capital formation. Exports and imports grew by 13.1% and 11.6%, respectively, in 2010. Quarterly data suggest that investment and net trade are gradually improving while tough austerity measures continue to restrain private and public spending. "Flash" estimates for Q1 2011 indicate that real GDP grew by 1.6% in unadjusted yr/yr terms, the first such increase after eight consecutive quarters of decline, and by 0.6% qtr/qtr, seasonally adjusted. We expect modest full-year growth of about 1.5% in 2011.

Monetary policy continues to appear ineffective and inefficient. Loose policy contributed significantly to the overheating in 2006-2008 and measures to curb excessive credit growth and rising inflation were ineffective or taken too late. The official monetary policy strategy of the National Bank of Romania (NBR; the central bank) is direct inflation targeting. But although headline inflation has risen from a temporary low of 4.2% yr/yr in March 2010 to 8.3% in April 2011—admittedly in part due to a VAT hike in mid-2010 but also because of increases in global food and energy prices—the NBR has kept its key policy interest rate unchanged at 6.25% since May 2010. The official exchange rate regime of the domestic currency, the leu (RON), is that of a managed float. Following the substantial cumulative 40% depreciation of the RON against the EUR between mid-2007 and early 2009 in the wake of the global economic crisis, the RON/EUR rate has been relatively stable in the range 4.06-4.37, but volatility within this range used to increase sharply in response to occasional negative economic news. Overall the exchange rate remains vulnerable to shocks.

The fiscal position is improving but remains a cause of concern. The fiscal deficit (cash basis, the preferred measure of the IMF) narrowed from 7.3% of GDP in 2009 to 6.5% in 2010, slightly better than the IMF-agreed 6.8% target, and is currently on course to meet the 4.4% target for 2011. However, these figures do not take into account additional quasi-fiscal losses of state-owned

enterprises (SOEs), estimated at 2-3% of GDP annually. Therefore the IMF continues to urge the government to restructure and/or privatise the SOEs. Private-sector financing will probably not be sufficient to cover this year's fiscal deficit, especially if the government remains reluctant to accept relatively high domestic borrowing yields demanded by the market and the scope for Eurobond issues remains limited with regard to elevated risks in the Euro-zone. In this context, the new (precautionary) IMF-led SBA will at least reduce immediate financing problems. Gross public debt, including guarantees, has risen from 21% of GDP in 2008 to about 35% in 2010 and is set to increase further. While such a level is still moderate by EU standards, the pace of increase is worrisome. About 45% of public debt is denominated in foreign currency.

It should be noted that public sector arrears have become a serious problem. In particular, key SOEs have accumulated arrears of around 4% of GDP (RON18.8bn at end-2010) to private sector firms. Progress has been made in reducing central government and social security arrears (RON190mn at end-2010), but arrears from local governments continue to pose a challenge (RON910mn at end-2010), though this is partly because of a lack of funding from the central government. Arrears on principal or interest due on external obligations are estimated at about USD200mn or less than 0.2% of total external debt.

Romania's external position remains a cause of concern, even though the current account deficit fell from 13.5% of GDP in 2007 to 4.2% in 2010. However, financing of the external deficit through net foreign direct investment inflows declined again to 46% in 2010 after it had increased to a healthy 71% in 2009. The growing external financing gap was largely covered by new external borrowing which has increased again the reliance on short term capital inflows. Disbursements under the IMF-led SBA in 2009-2010 have propped up FX reserves which stood at about EUR31bn April 2011. This is sufficient to cover more than seven months of imports and almost the entire external debt payments falling due in 2011. The international financial support package has provided Romania, in principle, with the ability to meet its short-term external financing needs. Nonetheless, the refinancing or repayment of maturing external debt may still prove difficult for individual companies and banks amid still tight credit markets. Any potential reversal of capital inflows in the event of another shock would again increase the risk. Continued vigilance is required.

Gross external debt has risen sharply in recent years and stood at unfavourable levels as a proportion of GDP (77%) and exports earnings (214%) at end-2010. External debt-servicing has become more difficult, having risen from 19% of export earnings in 2006 to more than 30% per year since 2009.

## Structural Business Environment

The structural business environment is generally adequate, ranking above average in our assessment of 211 countries and has improved significantly in recent years as a result of a fairly liberal trade regime, the removal of most restrictions on capital transactions, gradual banking sector restructuring and the passing of important legislation aimed at improving the public administration and legal system. In line with continued criticism from the EU (see Political Stability section), however, our assessment also shows remaining weaknesses with regard to corruption and inefficiencies in the legal and regulatory frameworks.

The banking sector has weathered the impact of the global financial crisis relatively well and remained well-capitalised and liquid. However, profitability was still negative in 2010 and risks remain. The continued rapid expansion of private sector credit until early 2009, in particular the large and increasing share of FX-denominated loans in total loans (62% in March 2011) continues to expose lenders to high credit and exchange rate risks and leaves the banking system dependent on foreign funding. Currency mismatches in corporate and household balance sheets are high, causing vulnerability to exchange rate volatility. Household exposure, which is typically unhedged, has created particular credit risks for banks. The intensification of the global financial crisis in H2 2008 aggravated and exposed all these risks. But appropriate central bank action and pledges of major foreign parent banks owning about 70% of the banking system to continue to provide adequate financing to their subsidiaries in the wake of the IMF-led SBA—a commitment that was re-affirmed in March 2011—helped maintain adequate capitalisation of banks and liquidity in domestic markets and ensured banking sector stability. However, overall bank profitability ratios declined sharply in 2009 and the share of non-performing loans in total loans has continued to rise to 12.7% in March 2011 (2.8% end-2008, 7.9% end-2009, 11.9% end-2010). As a result, private sector credit growth, standing at 4.3% yr/yr in February 2011, is expected to remain subdued for some time. Risks to the banking sector also include contagion from any potential deterioration of the sovereign debt/banking crisis in the Euro-zone.

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**Charts**

