

sion in to NATO (2004), adhesion to the European Union (2007). Inflation was significantly reduced (less than 10%), economic growth reached 8% thanks to strong demand in EU export markets.

In 2005 Romania rose 22 places at the top according to the Conference for United Nations for Trade and Cooperation (UNCTAD) from the point of view of performance index for direct foreign investments, reaching the 35-th place from 104 countries. The UNCTAD report appreciated that, in Romania, this indicator was determined by the introduction of the income tax of 16%.

Romania had the benefit of financial aid through the programmes PHARE, ISPA (instrument for infrastructure, transport and the environment) and SAPARD (a financial instrument dedicated to agricultural and rural development). Despite all difficulties, much progress has been recorded-the period 2001-2006 was characterized by economic growth, legislative evolution and privatization of big industrial objectives. Macroeconomic stability was accomplished and the authorities demonstrated commitment by satisfying the criteria for the adhering process.

Still, combating corruption and reinforcement of the judiciary is among the key challenges facing the authorities. Living standards are among the lowest in the EU. Having inherited a substantial industrial base from communism, Romania predominantly exports textiles and footwear, metal products, machinery, minerals and fuel.

2. Analysis of Romania's Economy during the Global Economic Crisis

Adhesion to the European Union on January 1st 2007 brought for Romania economic and social benefits, the chance to get financial influx from structural funds, favorable business prospects, economic growth, the increase of direct foreign investment, stock market development, competitiveness, increase, access to the labour market in the European Union and standard of living amelioration. Romania's economy boomed between 2001 and 2008, averaging 6.2% real growth per year even as the population decreased.

For more than a decade, emerging Europe enjoyed remarkably high growth. It was at first driven by the external sector, but from 2003 onwards, a domestic demand and credit boom increasingly took over as capital poured into the progressively more financially integrated region from highly liquid global markets. A large part of this inflow was intermediated by the local affiliates of western banks, which had come to control most local banking systems.

In such circumstances, it is therefore not unforeseen that emerging Europe was principally hard hit by the financial chaos that followed the fall down of Lehman Brothers in September 2008. Policymakers and international financial institutions responded quickly to the crisis—defusing the risk of a full-scale currency crises and financial sector meltdown. Large amounts of

external financing were made available by the IMF, the European Union, and other international financial institutions.

The financial instability generated by the United States subprime crisis which began in the summer of 2007 has led to a progressive deterioration of the economic situation. The reasons that led to the crisis are many and varied. Increased innovation in structured finance products, eagerness by lenders to take unwarranted risks, low interest rates and investors' voracity allowed complex investment products to be sold to an ever wider range of investors. The economic world has not been protected from its impact and various indicators during the first half of 2008 already suggest a down turn in world growth prospects.

After the first eight months of 2008, a brutal crisis erupted again, when first, major United States financial firms, then European financial institutions and a number of banks showed signs of insolvency. No policy maker, banker or economic and financial analyst had experienced anything as serious as this before. The crisis then expanded in magnitude, and full-scale turmoil arose in financial markets, buffeting many developed and emerging economies. The global financial and economic crisis became the worst economic setback since the Great Depression of 1929-32.

A number of emerging economies such as Hungary, Romania, Latvia and Ukraine, as well as Iceland, had then to turn to the International Monetary Fund (IMF) for assistance. The often imagined gap between the financial sector and the so-called real economy was bridged with the financial woes being transformed into real economic regression; again the world was reminded that the dichotomy between the financial and real world does not exist. The unusual magnitude of the on-going crisis is raising major concerns about the future of the world economic outlook.

In 2008, the inflow of FDI attracted by Romania registered a value of 9.024 billion euro, which was very close to the peak registered in 2006, being only 36 million less compared with the record of 9.06 billion euro.

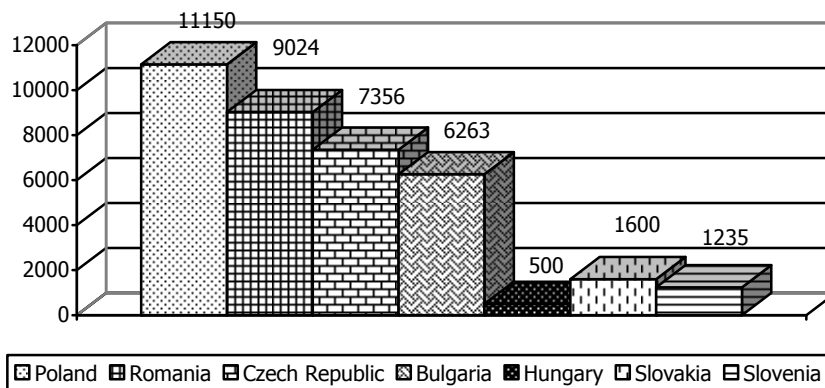


Fig. 1. FDI evolution in Romania in the regional context, in 2008 (million Euros)

Source: www.wiiv.ac.at.

As a consequence, it can be stated that before 2009, the main foreign capital in Romania consisted of direct foreign investment (especially capital ownership as a result of privatization), and other investments (loans and grants borrowed from parent banks), while investment portfolio were generally low. After the global financial crisis, the contribution of FDI was drastically reduced as reflected by Figure 1, despite the fact that Romania has remained an attractive business destination.

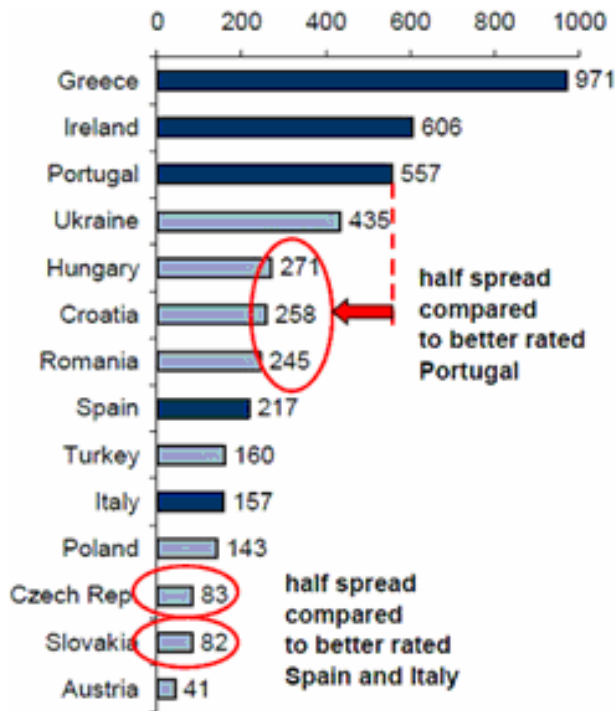


Fig. 2. FDI evolution in the regional context, in 2010
Source: Bloomberg, Erste Group Research.

Romania was among the last seven EU members on the basis of this decline. On the other side, international developments confirm that this crisis, which began as a financial one, has become an economic one and it is characterized by lower GDP.

In 2008 and 2009, the cumulative effects of the crisis based on relative change in real GDP, provides the following recorded values (see Figure 3).

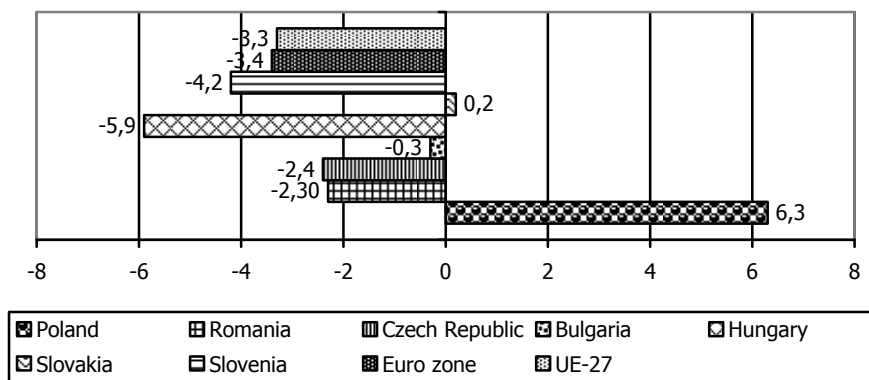


Fig. 3. Relative change in real GDP in 2010 for EU developing countries
Source: European Commission.

In the years preceding the current financial and economic crisis, the value of many companies had risen to unreasonable levels. After 2008, there was a sharp reduction of their value. This was a global trend and, unfortunately, the Romanian stock market confirmed these developments.

After September 2008, when the global crisis hit Romania, the influx of capital stopped, GDP fell more than 7% in 2009, unemployment nearly doubled and the exchange rate weakened by more than 15 percent against the euro. Also the government started to have troubles in paying current expenses, especially salaries for public servants and pensions, and they received a €12.9 billion loan from the IMF in March 2009, as part of a coordinated financial support package of €20 billion. Since then, Romania's country risk has declined. Moody's was the only major rating agency that evaluated Romania on a stable, investment friendly recommendation, but Fitch and Standard & Poor's placed Romania's rating in "junk" category in the fall of 2008.

Romania was one of the most badly affected European countries in 2009. Neither the status of NATO member, nor the umbrella of the EU offered sufficient solutions to retain the flows foreign capital into the country during the crisis. The effects will really visible at the end of 2008 and spring 2009. Most liquid shares were devalued by 70-80%. To worsen the situation, many factories were turned into piles of rubble by various real estate developers, industry being thus unable to produce enough, while import dependence rose to incredibly high levels. A large segment of the population is socially assisted. Although the share of unemployment is still within acceptable limits, the growth rate drop in 2008-2010 put serious question marks over the economy's ability to absorb the labour force.

The evolution of trading volume and value at Bucharest Stock Exchange during 2008-2010 is illustrated in Figure 4. Few investors made their presence felt on the domestic stock market. Trading volumes have returned to levels of damage; the market came back to a zone of uncertainty.

The market liquidity has been characterized by high volatility, with periods of very low transaction values. BET sharply fluctuated, both in 2009 and 2010. The most dramatic decrease was recorded in the first two months of 2009, when BET decreased by 34.5%. BET then reverted to an upward trend to 61,7% higher than a year earlier.

The perception of investors towards the risk associated with investments in the capital market deteriorated in 2010 due to concerns about sovereign debt. In the first half of 2010, market capitalization increased by 37%, reaching a total of 93.7 billion lei, on 30 June 2010 (source: NBR). Meanwhile, the liquidity of the stock was characterized by a high volatility. In the first half of 2010, BET had seen significant fluctuations, increasing by 27% in the first three months and decreased by 20% over the next three.

The Romanian capital market during the crisis had similar developments as other emerging markets in the region, i.e. a small number of issuers, low liquidity, few investors, high vulnerability to external shocks and pronounced segmentation. BET followed similar trends with those of the regional stock market dynamics (such as Hungary and Poland); thankfully a contagion effect from the Greek stock exchange is not detected.

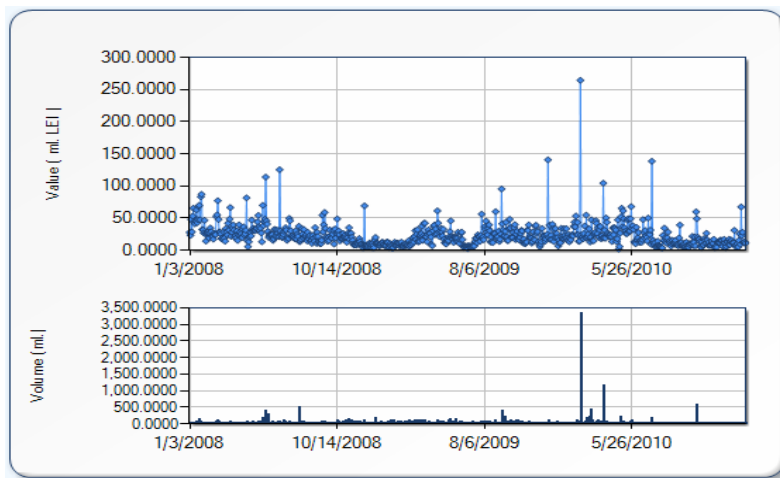


Figure 4. The evolution of trading volume and value at Bucharest Stock Exchange during 2008-2010

Source: www.bvb.ro.

Most likely, the credibility of Romania rose after the agreements with international financial institutions and therefore, the decline of Greece's market did not affect the BET index, as Figure 5 clearly confirms.

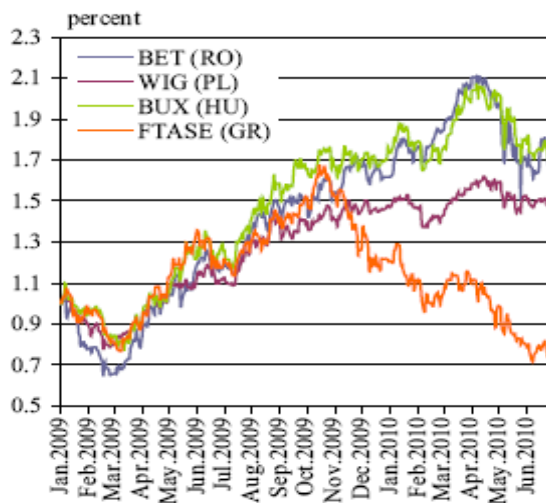


Fig. 5. Regional stock market dynamics (reference period Jan. 2009 - Jun. 2010)
Source: Bloomberg.

3. Evolution of country risk for Romania during the crisis

Country risk is a relatively new concept in economical reasoning, which entered researchers' attention only in the '70s. The assessment of country risk by the international financial institutions has extended at the same time with the increase of external activities of private commercial banks in the course of development.

Country risk refers to the risk of investing in a country, reliant on changes in the business environment that may adversely affect operating profits or the value of assets in a specific country. Financial factors such as currency controls, devaluation or regulatory changes, social factors such as demography or social unrest such as strikes, riots, civil war and other potential events contribute to companies' operational risks. Country risk is also occasionally referred to as political risk, however country risk is a more general term, which commonly only refers to risks affecting all companies operating within a particular country.

Political risk analysis providers and credit rating agencies use different methodologies to assess and rate countries' comparative risk exposure. Credit rating agencies are inclined to use quantitative econometric models and focus on financial analysis, while political risk providers tend to use qualitative methods, focusing on political analysis.

The most important credit risk rating agencies are: Fitch, Moody's, Standard & Poor's (U.S), Business Monitor International, CTRISKS, whereas the most famous political risk analysis organizations are, among others: Business Monitor International, Country Risk Solutions, Economist Intelligence Unit, Eurasia Group, The Legion Group, The PRS Group, Inc.

After 2006, Moody's issued annual reports about Romania, maintaining a constant level of rating, including in 2009, as seen in Table 1.

Table 1. Evolution of country risk for Romania before the crisis according to Moody's

| Data | Rating for long term loans | Trend | Rating for bank deposits | Trend |
|------------|----------------------------|-----------|--------------------------|-----------|
| 06.03.1996 | Ba3 | | - | |
| 23.12.1996 | Ba3 | staționar | B1 | |
| 14.09.1998 | B1 | ▼ | B2 | ▼ |
| 06.11.1998 | B3 | ▼ | Caa1 | ▼ |
| 19.12.2001 | B2 | ▲ | B3 | ▲ |
| 16.12.2002 | B1 | ▲ | B2 | ▲ |
| 11.12.2003 | Ba3 | ▲ | B1 | ▲ |
| 06.10.2006 | Baa3 | ▲ | B1 | staționar |

Source: Moody's investors' service.

Similar ratings accorded Fitch and Standard & Poor's, demonstrating that Romania was on ascending tendency, reflecting an improving business environment.

Unfortunately, after the crisis outburst in 2008, the ratings of Romania have deteriorated. In November 2008, Fitch and Standard and Poor's credit agencies cut Romania's rating to "junk", worried by its large current account deficit and reliance on short-term borrowing. Only Moody's has maintained the same rank of rating for Romania.

In a survey released by us between September 15-December 31, 2009, we scrutinized the greatest risks taken into account by 40 managers, economists and analysts, which could have affected the prospective for development of the companies they were working for. The results showed that most of them feared a shrinking in the market share (40%), followed by default or incapacity to pay debts (32%) and other risks with lesser significance: asset price collapse (15%), oil and gas prices volatility (6%) and pandemic risk (7%).

Hopefully, after one year and a half, in April 2010, Fitch Ratings raised the outlook on its BB+ credit rating to "stable" from "negative". In March 2010- Romania's credit rating outlook was raised to stable by Standard & Poor's after the International Monetary Fund resumed a bailout loan to the country and the government passed an austerity budget.¹ Moody's Investors Service, remained the only agency to rate Romania as investment grade.

¹ Bloomberg Business week, March 10, 2010.

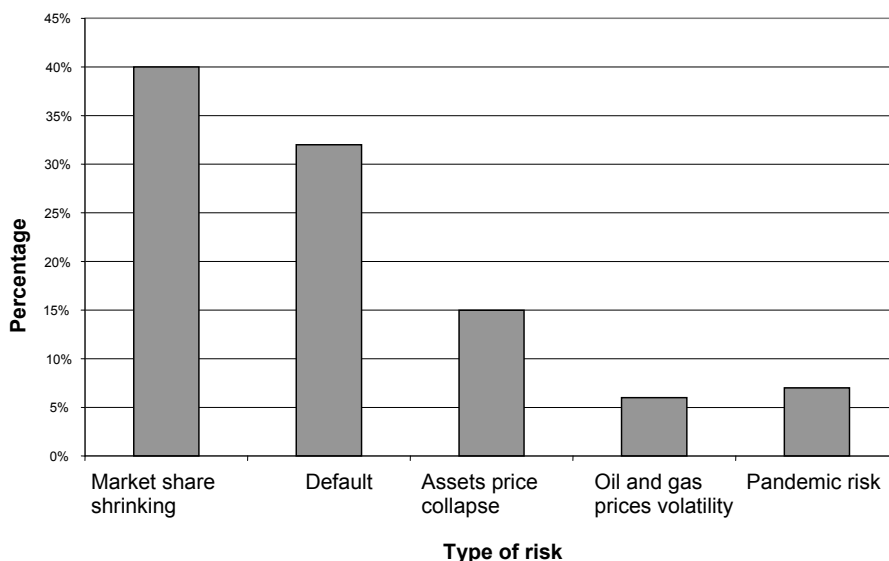


Fig. 6. Managers viewpoint on the highest risks most likely to affect their companies
(December 2009 survey)

Source: Anda Gheorghiu, a survey realised between September 15-December 31, 2009².

Recently, the government's structural reform agenda was anchored by a new €3.6 billion 24-month precautionary IMF loan agreement, which replaced the expired €20 billion standby programme in April 2011. The measures, seen as vital for meeting the 2011 budget deficit target of 4.4% of GDP, include a 25% reduction in public wages, 15% cuts to social benefits and a large-scale layoffs in the public sector.

Table 2. Evolution of country risk for Romania according to major rating agencies in Q1 2011

| Agency | Rating |
|-----------------------------|--------------|
| Standard & Poor's | BB+ Negative |
| Moody's | Baa3 - |
| Fitch | BB+ Stable |
| Economist Intelligence Unit | BB Stable |

Source: S&P, Moody's, Fitch, EIU.

Euromoney has also issued an objective report on country ratings in February 2011 which ranks Romania at 72-nd place in the world. As such,

² Anda Gheorghiu, a Poll realised on <http://polls.linkedin.com/p/56818/gokpq> (*What is the greatest risk for your company in 2010?*), 40 answers.

the evaluation done worldwide, having as month of reference September 2010, reveals this outlook:

Table 3. Country ranking assessment for Romania according to Euromoney

| Current rank of Romania | 72 |
|--|-----------|
| Current score | 49.09 |
| Economic (% score, 30% weighting) | 49.78 |
| Political (% score, 30% weighting) | 44.79 |
| Structural (% score, 10% weighting) | 45.19 |
| Credit rating (score out of 10, weighting 10%) | 3.96 |
| Debt indicators (score out of 10, weighting 10%) | 6.99 |
| Access to capital markets (score out of 10, weighting 10%) | 5.25 |

Source: ECR-Euromoney Country Risk (euromoney.com).

According to Bloomberg, Romania has been among the best performers in the world in terms of reducing the country risk in the third quarter of 2010. Thus, Romanian sovereign bond risk fell by 21.5 points, reaching a lower than 300 points psychological level. In comparison, several European Union countries have experienced increases in country risk, such as Ireland and Greece, which recorded increases of up to 640, 1023 points respectively.

4. Conclusions

How deep and long will the slow-down be; when can the Romanian economy expect an end to the decline associated with the recession and what are the country risk prospects for the future? This is a complicated question which cannot be answered with any degree of confidence. Firms and households that face uncertain economic conditions, that have no access to credit and lack confidence in financial institutions will not invest and consume.

A specific policy goal is the restoration of the credit system in which banks are the principal actors. Restoring confidence in the financial system and credit flow and increasing government expenditure typically do not have an immediate impact and will take time to work through to real economic activity, including growth in the demand for Romania's export commodities. But demand management has to be complemented by maintaining and expanding open trade and investment strategies and a serious commitment to assist the developing world in coping with the reversal in international capital flow.

As the global economy recovers from recession, Romania could benefit from new contributions of FDI in areas such as industrial goods, agriculture and food industry, the IT sector and renewable energy, while the current account decrease reduced external vulnerability in Romania in the future.

Romania's return to growth may come more rapidly than that of other countries in the region, because the Romanian private sector is less lever-

aged, and because of the flexible exchange rate which is easing the adjustment in the trade balance. Economic growth is questionable to reach pre-crisis rates for continuous periods, especially if European economic growth remains low.

A more normal long-term growth rate for the country is perhaps 3-4% per annum, considering that there are still a number of obstacles to rapid growth in Romania, particularly a heavy structural reform agenda and underdeveloped infrastructure.

Although it is hard to believe that the volume and value of transactions at Bucharest Stock Exchange will reach the levels before the crisis too soon the structural adjustments made by the Romanian government in 2009-2010 may be considered as the prerequisite for attracting investors to trading at BVB.

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