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BLACK SEA TRADE AND DEVELOPMENT BANK

ROMANIA

Country Strategy

2011-2014

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Table 1: Basic Macroeconomic Indicators at a Glance

Country Long Term Foreign Currency Sovereign Risk Rating: **S&P: BB+** | **Moody's: Baa3** | **Fitch: BB+**

INDICATOR	2007	2008	2009	2010	2011	2012	2013	2014
Population (mid-year)	21,537,563	21,504,442	21,469,959	21,431,298	na	na	na	na
Average exchange rate (RON / USD)	2.44	2.52	3.05	3.18	3.30	3.34	3.34	3.32
Inflation rate (CPI Avg.; %)	4.8%	7.9%	5.6%	6.1%	5.2%	3.4%	3.3%	2.9%
Average monthly earnings (Net; USD)	427.73	509.06	452.91	442.61	n.a.	n.a.	n.a.	n.a.
GDP at current prices (RON m)	416,006.80	514,700.00	498,007.50	513,640.80	533,300.00	585,800.00	644,000.00	712,300.00
GDP at current prices (USD bn)	170.62	204.34	163.32	161.63	161.61	175.39	192.81	214.55
GDP / capita (in crt. prices; USD)	7,921.67	9,502.00	7,606.84	7,541.73	7,544.63	8,191.93	9,010.02	10,030.30
Real GDP growth (%)	6.3%	7.3%	-7.1%	-1.3%	0.7%	3.5%	4.5%	4.9%
Unemployment rate (eop; %)	6.4%	5.8%	6.9%	7.3%	n.a.	n.a.	n.a.	n.a.
Industrial output growth (%)	5.4%	1.8%	-1.4%	5.1%	5.0%	6.0%	7.0%	5.0%
Agricultural output growth (%)	-17.7%	21.2%	-2.2%	1.6%	3.0%	2.0%	2.0%	3.0%
Remittances - Current transfers, net (USD m)	6,618.00	8,884.00	5,710.00	4,522.00	4,018.00	4,361.00	4,800.00	5,300.00
Direct foreign investment in the country (USD m)	9,925.00	13,883.00	4,847.00	3,453.00	6,000.00	8,000.00	9,000.00	10,000.00
Consolidated budget balance / GDP (%)	-2.3%	-4.8%	-7.4%	-6.5%	-4.6%	-3.3%	-2.9%	-2.7%
Gross external debt (USD m)	86,166.3	101,738.5	116,880.4	121,430.20	123,351.00	126,642.00	129,900.00	131,100.00
Gross external debt / GDP (%)	50.5%	49.8%	71.6%	75.1%	76.3%	72.2%	67.4%	61.1%
Public external debt / GDP (%)	7.8%	7.6%	11.5%	22.4%	n.a.	n.a.	n.a.	n.a.
Private external debt / GDP (%)	42.7%	42.2%	60.1%	52.7%	n.a.	n.a.	n.a.	n.a.
Goods: Exports (f.o.b.; USD m)	40,470.70	49,673.50	40,578.80	49,413.00	54,531.00	59,826.00	67,400.00	76,100.00
Goods: Imports (f.o.b.; USD m)	-64,993.90	-77,797.50	-50,160.70	-57,233.40	-63,418.00	-68,900.00	-77,100.00	-87,500.00
Trade balance (exp. f.o.b. - imp.f.o.b.; USD m)	-24,523.20	-28,124.00	-9,581.90	-7,820.00	-8,887.00	-9,074.00	-9,700.00	-11,400.00
Trade balance / GDP (%)	-14.4%	-13.8%	-5.9%	-4.8%	-5.5%	-5.2%	-5.0%	-5.3%
Current account balance (USD m)	-23,080.00	-23,719.00	-6,956.00	-6,483.00	-9,693.00	-10,855.00	-12,800.00	-14,300.00
Current account / GDP (%)	-13.5%	-11.6%	-4.3%	-4.0%	-6.0%	-6.2%	-6.6%	-6.7%
Forex reserves (excluding gold; eop; USD m)	37,194.10	36,868.40	40,756.60	46,186.00	44,088.00	44,304.00	44,534.00	43,403.00

Last updated on April 14, 2011

Sources:

Data for items 1, 3, 5-8, 11, 17-19 from National Institute of Statistics
Data for items 2, 4, 10, 12-13, 15-16, 20-23 from National Bank of Romania
Data for item 9 from the National Institute of Statistics & International Labour Organisation
Data for items 12-13, 17-18, 21 from the National Institute of Statistics and the National Bank of Romania; Data in USD for 2003 on from IFS, IMF, January 2011
Data for item 14 (1995-1996) from IMF Country Report No. 04/220 and from 1997 on from the National Bank of Romania

Data for items 23 from IFS, IMF, January 2011

Projections from EIU Country Data (Latest update - 8 December 2010) & EIU Viewswire 5-year forecast table (12 January 2011)

The redenomination of the Romanian leu on July 1st 2005 entailed the dropping of four zeroes: one new leu (RON) = 10,000 old lei (ROL).

I. Recent Economic Developments and Outlook

Since the outset of the previous decade Romania has made evident efforts to combine economic growth with structural reforms and institutional development. Romania's macroeconomic policy performance over the decade has been somewhat mixed and volatile, but successful disinflation and fiscal consolidation in the period leading to the conclusion of negotiations with the EU provided the foundation for accelerated growth. Although the positive results increased potential growth rate to 5%, actual real growth was much faster backed by increasing inflows of FDI and remittances. Romania's successful economic management, accompanied by strong growth and considerable disinflation, culminated, as expected, in EU membership on January 1, 2007. This performance reflects responsible macroeconomic management and advances in structural reforms.

Following the accession however, the reform pace slowed somehow and demand and supply pressures for fiscal relaxation jeopardized, as feared, the economic stability in the medium-term. Under normal internal circumstances, the onsetting of the global financial crisis could have left Romania largely unaffected due to its organic strength:

- Balanced economic structure with strong manufacturing sector;
- Solid integration in the EU economy, but with diversified product structure and ability to redirect trade away from the EU to traditional markets in Middle East, North Africa and Latin America;
- Exports at around 35% of GDP in 2010, and strong potential for growth in the service sector, provided the internal support for overcoming the decline in foreign demand;
- Very low levels of public debt, a public foreign debt of 7.6% of GDP in 2008 and of 11.5% in 2009 – one of the best performances in the EU – and a total debt of just about 30% of GDP; Romania had none of the problems that haunted the EU periphery;
- A solid and highly capitalized banking sector of a modest size of just about 20% of GDP, a modern and effective regulatory and supervisory system, and negligible non-bank financial sector.

Unfortunately, the unnecessary fiscal stimulus at a time of economic growth above its long-term potential rate and the fast expansion in lending coupled with massive inflows of foreign exchange appreciated the currency, overheated the economy and increased both internal and external imbalances. This accumulation of vulnerabilities weighted heavier than the strengths of the economy, and turned an external shock which could have otherwise been well contained into a severe economic contraction.

This situation is well summarized in the IMF Staff Report for the 2010 Article IV Consultation approved on June 16, 2010:

"As in many other CEE countries, Romania's economy boomed in conjunction with its EU accession in 2007, but high growth rates were associated with the build-up of both external and internal imbalances. Large capital inflows stimulated domestic demand while labor constraints and fast rising public sector wages exacerbated wage inflation resulting in pressures on prices. The National Bank of Romania (NBR) adopted sharply tightened monetary policy to counteract price pressures, but inflation expectations remained high. Procyclical fiscal policy helped drive domestic demand to unsustainable levels."

a. Real Sector

The global economic and financial crisis hit Romania severely in the last quarter of 2008 and in particular in 2009. Real GDP dropped by 8.6 percent (quarter-on-quarter, annualized) in the fourth quarter of 2008, compared with previous quarters average growth of 9.1 percent.

Capital inflows suddenly dried up, exports plummeted, and domestic demand also contracted sharply, while the Leu depreciated 15% against the Euro from October 2008 to early 2009. The severe impact of the crisis and closure of the access to international capital markets determined Romania to solicit the support of the IMF, the World Bank and the EU. This materialized into a EUR 20 billion financing package supported by a Stand-by Agreement with the IMF. The program aimed at correcting fiscal and current account imbalances while avoiding excessive economic contraction. The policy instruments included (i) gradual fiscal consolidation accompanied by structural reforms to restore fiscal sustainability and boost market confidence, (ii) steps to further strengthen the resilience of the financial sector and to obtain commitments from foreign parent banks to maintain their Romanian subsidiaries capitalized and liquid, and (iii) prudent monetary policy aimed at gradually bringing inflation within the official target range.

Unfortunately, the conclusion of the agreement also had unjustified negative consequences as international investors and rating agencies saw this development as a confirmation of excessive vulnerability. Already at end-2008, prior to the conclusion of the agreement, Romania became the first EU country to see its credit risk rating downgraded to below investment grade, in spite of the fact that its economic fundamentals were stronger than those of many other EU countries whose ratings were at least two or three notches higher.

Economic activity remained weak throughout 2009, declining by 7.1%, but the government was able to finance the budget deficit from the EU and the IMF funds, without the need to access expensive and volatile capital markets. The decline in domestic consumption and investment, together with the sharp decline in FDI, helped reduce the pressure on the current account as imports declined by more than one fifth in 2009. The crisis induced external adjustment reduced the current account deficit to 4.2% of GDP in 2009 from a peak of 13.4% in 2007. From the fourth quarter of 2009 and throughout 2010 export recovered and outpaced the growth in imports, giving impetus to manufacturing. Unfortunately, despite significant public expenditure cuts and growth in industrial output, the fiscal adjustment was much lower due to falling domestic demand and subsequent decline in fiscal revenues. This result signals that a much larger underlying adjustment is needed to cut the deficit to below 3% of GDP, and this stricter austerity may be contractionary, with a dampening effect on GDP growth.

In 2010 GDP declined further by 1.3% compared to 2009, according to data recently released by the National Statistical Institute. The decline was due to a reduction in agricultural gross value added of 0.8%, a persistent decline in the demand for services of 2.3%[1] and of a severe contraction in construction activity of 10.7%. However, the gross value added in industrial activity, which increased by 5.1%, raise hopes that the contraction is over and that in 2011 the economy might stabilize before growing faster starting with 2012. Final consumption declined by 2.1% in 2010 compared to 2009, but this decline was compensated by a resumption of foreign demand resulting in a strong growth of net exports – exports of goods and services increased by 13.1% while imports increased by 11.6%.

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[1] Decline in wholesale and retail trade, repair of motor vehicles and household goods, hotels and restaurants; transport and communications is of 4%

Historically, economic growth has been largely driven by investment, and not by labor input or consumption. The accumulation of capital explains most of output increases from 2000 up to end 2008. Medium-term economic growth is expected to follow the same historical pattern with capital accumulation being the main source of growth. Therefore, looking forward, as the financial crisis affected investment and productivity, the deep economic crisis of 2009 may have permanent effects due to a permanent slowdown in potential output growth.

The IMF estimates that under current conditions the potential growth declined to around 3%, from 4 to 5% in the period 2004 – 2008. This limitation is expected to have persistent effects, at least up to 2015, mostly because the recent increase in unemployment may become structural as the economic structure changes, and the decline in FDI and domestic investment may be permanent. However, even if investment recovers somehow and productivity grows faster than anticipated on the back of successful reforms in the labor and product markets, the additional increase in potential growth induced by such improvements would only be marginal, resulting in a long-term potential growth rate of at most 4%. In order to return in the long-run to a potential growth rate of 5 to 6%, Romania would need to implement substantial structural reforms, adopt measures conducive to a significant increase of the savings rate, invest in R&D and infrastructure, and find sources of competitiveness in areas either repressed or overlooked until recently.

b. Public Sector and Fiscal Policy

Fiscal Policy

Since 2000 the budget deficit declined year after year to reach only 0.8% at end 2005. However, the pro-cyclical fiscal loosening during the course of 2006, and 2007 in particular, have resulted in an increase in the deficit from 1.6% of GDP in 2006 to 2.3 % in 2007, 4.8% in 2008 and, also due to the fact that initially the crisis was not addressed by corrective policy response, 7.4% in 2009. During the period, net public debt increased from 15.4% of GDP in 2006 to 28.2% in 2009.

In order to reduce the deficit, in 2010 the Government implemented a tight income policy coupled with indirect tax increases. Public-sector wage costs fell to 8.4% of GDP, compared with 9.5% in 2009, and capital investment fell to 3.8% of GDP in 2010, compared with 4.6% in 2009, while due to increased unemployment social insurance payments rose from 13% of GDP in 2009 to 13.4% in 2010.

Thus, as savings in the wage bill were nullified by increases in social transfers and lower income tax receipts, the improvement in public finances was mainly the result of increased VAT revenue and cuts in public-sector investment.

Recent data from the Ministry of Finance indicate that in 2010 revenues grew by 7.2% (to 33% of GDP) and expenditures increased by 4.2% (to 39.5% of GDP). Consequently, in 2010 the budget deficit fell to 6.51% of officially estimated annual GDP, a better outcome than the deficit target agreed with the IMF of 6.8% of GDP.

In December 2010 the Parliament approved an austerity budget for 2011 underpinned by a package of deep structural reforms, under which the consolidated budget deficit would be reduced to 4.4% of GDP, paving the way for a planned further reduction to 3% in 2012.

Public Policy

The Government adopted in 2010 a series of policy measures aimed at improving the business environment, increasing competitiveness, expanding the tax base and rationalizing public expenditures. Public-sector wages were cut by 25%, social transfers were cut by 15%, and VAT increased from 19% to 24%. Also, the Government decided to reduce public-sector employment by up to 25%. Furthermore, in December the Parliament enacted the remaining legislation required to comply with the obligations under the IMF stand-by arrangement. The main elements of the new legislation are the following:

- A law on public-sector wages which allows for growth in public-sector wages of 16% in 2011 from the reduced base established in the second half of 2010, when wages were cut by 25%, resulting in an overall permanent cut by 13% from the pre-July 2010 levels.
- A law on public sector salary scheme, which introduces a single spine for all public-sector employees.
- A revised pension law which consolidates all state pensions into a single basic pension point based system, while also moving gradually to inflation adjustment of pension payments, and away from the current link to increases in average wages.

The 2011 draft budget relies on the full-year impact of the adjustment measures taken in 2010 and adoption of further deficit reduction measures, including: (i) elimination of the holiday bonuses and of the 13th salary; (ii) replacement of only one for every seven public employees leaving the system; (iii) extension of the 2010 pension freeze; (iv) increase of the base for healthcare contributions; and (v) elimination of heating subsidies. Although the net impact of the measures adopted in 2010 are estimated to be large, the optimistic growth assumption and the excessive vulnerability of the Romanian economy to external shocks, make both the implementation of new far reaching reforms, and the achievement of the budgetary target problematic.

c. ***Monetary and Financial Sector***

Monetary Policy & Inflation

In 2010 inflation reached the highest level since August 2008, due to the increase in VAT by 5 percentage points in July, and rising food prices. The consumer price inflation accelerated to 8.0%, within the 8.2% revised projection of the NBR, but way above the 3.5% +/-1pps band set under the inflation targeting policy.

The NBR policy was focused on controlling inflation, while also allowing a gradual easing of monetary conditions and supporting a fall in economy-wide interest rates in response to the credit crunch induced by the crisis. The NBR cut the monetary policy interest rate by a total of 175 basis points between January and May 2010, to 6.25%, the main argument behind the decisions being the outlook for consolidation of disinflation in the medium term, in line with the expected magnitude and duration of the negative output gap. The monetary policy interest rate was kept unchanged at 6.25% since May 2010 through the first quarter of 2011, with a view to preventing potential second-round effects of the VAT rate hike from materializing and to counter the possible detrimental impact of other supply-side shocks - arising mainly from the pick-up in the prices of food and fuels and the adjustment of some administered prices – on inflation expectations. The NBR also decided to maintain the existing levels of minimum reserve requirement ratios on both local and foreign currency-denominated liabilities of credit institutions to 15% and 25%, respectively.

Bank lending rates did not fall much though, as lending margins were increased to cover additional provisioning costs due to rising non-performing loans (NPLs). NPLs (loans overdue by 90 days or more) rose sharply in the third quarter of 2010, reaching 11.7 percent, and the prospect of further deterioration of bank asset quality is an issue of concern.

Banking & Financial Sector

Generally speaking, Romania's banks are well-capitalized and liquid. Financial soundness indicators and stress tests suggest that banks possess the ability to withstand extraneous shocks quite well. The banking system's average capital adequacy ratio was 14.6 percent at end-September 2010 and all banks were above 11 percent (compared to the statutory minimum of 8 percent). Banks' capital adequacy ratios, which exceed BIS standards by large margins, provide comfort, as does the fact that reputable foreign banks own most of the country's banking sector assets.

Lending to the private sector has been flat since end 2008, when the credit crunch occurred, prompting the Central Bank to seek an arrangement with the foreign banks operating locally. Under the agreement, the foreign banks are supposed to maintain their exposure to the local market at not less than 95%, plus a capital adequacy of above 10%. The nine largest foreign banks under the European Bank Coordination Initiative (EBCI) have maintained at end October 2010 an aggregate exposure of 98% compared to end March 2009.

Although the stock of credit to the private sector remained constant, the local currency lending declined while being offset by an increase in foreign currency lending that both reflects the statistical effect of domestic currency depreciation and the repatriation of offshore loans. The National Bank of Romania monitors the foreign currency lending and takes the needed steps in order to make sure that the credit pricing accurately and transparently reflects the risk of lending to unhedged borrowers Lending to the government, on the other hand, increased to account for 20 percent of total bank loans compared to 8 percent at the end of 2008.

d. External Sector

Foreign Trade

The current account deficit improved from 13.5% of GDP in 2007 to 4.0% of GDP in 2010 and rising to near 6% in 2011, slightly above its long-term estimated sustainable level. The CA gap expansion occurred despite a 8.7% year on year contraction in the deficit of the trade with goods and services. In 2010, export growth outpaced import growth, and the merchandise trade deficit in Euro terms shrank, with the increase in imports due mostly to the purchase of intermediary goods used in the production of exportables, rather than finished goods for domestic consumption. The surplus on current transfers fell from 2009, with remittances declining due to the recession and high unemployment in host economies. Net FDI inflows fell by about 29% in 2010, and covered only about 53% of the current-account deficit. However, due to currency movements, the current-account deficit increased by 1.1% year on year in Euro terms, but shrank in US dollar terms to an estimated 4.0% of GDP. The deficit is forecast to stabilize at around 5% of GDP in 2011-15, as the surplus on current transfers improves as a result of increased EU flows, renewed FDI, and workers' remittances.

External debt

The total external debt increased at end December 2010, on an year-on-year basis, by 11.9% to EUR 90.8bn, or about 75.1% of GDP, compared to 71.6% at end 2009. Total external debt is expected to

peak at 76.3% of GDP in 2011, but will fall to more manageable levels as economic growth takes hold in 2012-15.

The public debt increased to about 34% of GDP, with debt denominated in foreign currency reaching 25% of GDP, from 28.2% and 15.2%, respectively at end 2009. The rise in the public foreign debt is attributable to the support program agreed between Romania and the IMF, the EC and the WB. A formal review of the Government's debt management strategy, with the assistance of the IMF the EC, and the World Bank, is planned for 2011.

The private sector's external debt increased by only 2.8% to EUR 63.5bn, with its share in total external debt decreasing to 70% from 76.2% in 2009.

e. Forecast for 2011-2014

Romania's economic growth prospects for the period ahead are quite positive over the medium term, benefiting from a return to more favorable consumer and investor sentiment rooted in positive expectations for its main trading partners.

Based on recent economic developments and the prospects thereby implied, the centre of Romania's macroeconomic policies over the period covered by this country strategy will likely include a stronger stance as regards disinflation and concerted efforts to contain the fiscal and external deficits. While such policy tightening is likely to constrain the growth of real wages and private consumption, stronger external demand and improved economic competitiveness are likely to assist economic growth, as should a moderate resumption of credit growth.

Export led recovery is supportive in the short to medium-term to sustained economic growth, but structural vulnerabilities persist. Therefore, the trend must be supported by additional policies conducive to sustainable growth. These may include reconsideration of the presumptive minimum taxation, additional measures for administrative capacity building, and increase in public investment for improvement of absorption of EU funds. In order to maintain the budgetary target within achievable limits, some balancing tax base broadening, reassessment of property taxes, and possibly even a 2 pps increase in the income tax rate may be necessary.

An initial export based output recovery would have additional positive implications for the stabilization of foreign debt levels initially, and reduction subsequently in the medium to long-term. As achievement of external and internal balance would be accompanied in such case by lower inflation, higher savings rate and productivity gains, and would thus support risk rating upgrades, renewed foreign capital inflows are expected.

Such flows would appreciate the currency, would support the disinflation process, would reduce interest rates further, would increase investment and employment, and thus would reinforce fiscal revenue increases and would also ease the servicing of foreign debt. In addition, currency appreciation to the level of Lei 3.8-3.6 for EUR 1 by mid 2013 (a real appreciation of about 10-12%) would ease concerns about currency risk associated with the large proportion of foreign currency denominated credits. Eventually, accession to ERM II would come naturally.

While a subset of such inflows – foreign direct investment – are beneficial to sustained growth through their associated transfer of technology and know-how in addition to supplementing domestic savings, there are also other types of capital inflows – the volatile ones – which can induce risks to macroeconomic and financial stability.

Notwithstanding the positive impact of an initial boost to economic growth brought about through external channels, in the longer-run however, a more broad based growth would be necessary, and therefore the export demand must be complemented by supporting growth in the supply of goods and services for the satisfaction of an increased domestic demand for both investment and consumption.

The medium term Government Economic Strategy is focused on the following objectives:

(a) promote the economic recovery and create new jobs;

(b) adjust the current account and public deficits, continue the disinflation process;

(c) protect the population categories most affected by the economic crisis;

(d) improve the medium-term predictability and performance of the fiscal policy, maximize and improve efficiency of the use of the European Union funds;

(e) ensure the long term public finance sustainability;

(f) restructure and improve the efficiency of the public administration

(g) firmly implement the commitments assumed by the multilateral financial agreement with the International Monetary Fund, the European Commission, the World Bank, and the other international financial institutions.

The Government development priorities are detailed in the Convergence Programme 2009-2012. The fourth edition of the Convergence Programme describes Romania's ability of diminishing the structural deficit to less than 1% of the GDP up to 2014, and creating a safety margin to avoid exceeding the 3% level on the longer run. The underlying assumption is that the structural deficit will reach 0.7% of GDP in 2014.

However, such a scenario of a virtual circle is based on the assumption that vulnerabilities are diffused, and risks are well contained. To this end, the Government is contemplating the conclusion of a precautionary agreement with the IMF and further support from the World Bank and the EC.

Challenges

The principal challenge for Romania in the short-to-medium term lies in the ability of the Government to consolidate public finances and to achieve the target for structural deficit of 0.7% of GDP.

Other challenges are related to the market perception of Romania's risk, the availability of foreign funding, and the sustainability of foreign demand associated with the strength of economic recovery in Romania's trading partners.

Continued foreign exchange volatility would contribute to increasing the exposure and vulnerability of the Romanian economy to global fluctuations, in particular if foreign exchange portfolio investment and non-resident bank deposits are initially large.

A final vulnerability is related to the increase in the price of oil and other commodities, which may increase inflationary pressures and derail the incipient recovery.

An undesirable outcome of any of the challenges, such as widening current account deficits and renewed inflationary pressures, associated with pro-cyclical fiscal contraction increases the risk of a loss in market confidence and may threaten macroeconomic stability and long-term growth prospects.

Opportunities

Despite the challenges that remain a distinct possibility, intensified economic relations with the EU, which is now Romania's main trading partner, as well as continued cooperation with international financial institutions provides an anchor for policy consistency and credibility.

Structural reforms should continue to focus on further improving the business environment, increasing incentives for job creation, and developing the capacity for the effective utilization of EU funds. Improving business sentiment would provide favorable conditions for growth.

An additional and potentially important opportunity for growth is represented by the increased trade, investment, and economic cooperation, including policy coordination, with neighboring countries members of the BSEC organization.

The economic sectors with best prospects for growth, and where Romania appears to have in some cases underutilized competitive advantage are:

- IT, computers, office machinery, and communications equipment
- Energy production, mainly nuclear and renewables (wind, hydro etc.)
- Transport Infrastructure
- Agriculture, food processing and beverages
- Healthcare sector
- Oil and gas, extraction, processing, transportation
- Motor vehicles
- Wood products, pulp and paper
- Rubber and plastics
- Chemicals and pharmaceuticals
- Manufacturing of basic metals
- Electrical machinery
- Machinery, equipment, appliances
- Public utilities

Two industries in particular, the electrical machinery and the motor vehicles, trailers and parts, have already shown in 2010 strong growth both in output and exports, leading the recovery in manufacturing.

II. Overview of BSTDB Portfolio

The Bank has made significant efforts to identify suitable operations for Bank financing. When necessary, BSTDB financing has been made available via the financial sector.

From the beginning of operations, the Board of Directors of BSTDB has approved 22 operations for USD 294 million, representing 10.14% of total approved operations.

As of end-December 2010 the Bank's portfolio of operations in Romania amounts to USD 124.5 million in 6 BoD approved operations, representing 8.2% of the Bank's active portfolio of operations.

Table 2: Current BSTDB Portfolio - BoD Approved Operations[2]

USD

No.	Operation	Type	Amount approved	BoD Approval	Signing Date	Amount signed	Outstanding amount
1	Trans-Balkan SME Equity Fund – note 5	Equity investment / Financial Institutions / Private sector	1,333,333	16/6/2000	20-Jul-00	1,333,333	0
2	Balkan Accession Fund* - note 1	Equity investment / Financial Institutions / Private sector	8,888,100	10/08/06	4-Oct-06	8,888,100	5,698,689
3	Transgaz Equity* & ***& note 4	Equity	53,000,000	01/12/07	5-Dec-07	1,584,143	1,584,143
4	Petrom Environmental Loan*	Loan	33,125,000	25/04/09	27-Apr-09	33,125,000	33,125,000
5	Turceni Environmental Loan	Loan	26,500,000	01/06/09	21-Jul-09	26,500,000	0
6	Emerging Europe Accession Fund*	Equity	1,555,108	25/09/09	21-Jun-10	1,545,833	18,426
	Total		**124,401,541**			**72,976,409**	**40,426,258**

**Operations in EURO; exchanged to USD for the rate as of 31 December 2010 - 1.325(Reuters)*
****Operation in RON; exchanged to USD for the rate as of 31 December 2010 - 0.312(Reuters)*
Note1: Operation approved through voting without a meeting
Note 4: Transgaz Equity Operation was approved at BoD in Euro but the Subscription amount is in RON and the total amount keeps changing on monthly basis based on the evaluation by Bank Post
The amount approved was for subscription, amount signed is the result6 of allocation
Note 5: Realised equity gain: USD 760,605.12

[2] As of December 31, 2010.

III. Review of Country Strategy

The current evaluation was performed by the Bank's Evaluation Office as per the respective Evaluation Policy. It reveals the performance of the Bank's 2007-2010 Country Strategy for Romania. Its goal is to provide accountability to the Board of Directors and Board of Governors as well as facilitate the decision-making by the Bank's Management and Boards on the eventual update of the country strategies.

The evaluation of the respective country strategy compares the stated targets with actual results as of end of 2010, and provides a country-oriented analytical picture. A mid-term evaluation of the Country Strategy was conducted in early 2009 and reported to the Board of Directors and Board of Governors in June 2009, as part of the Annual Evaluation Overview, issued by the Evaluation Office.

The 2007-2010 Country Strategy was approved by the Board of Directors in early 2007, reflecting an in-depth independent evaluation of the implementation of the BSTDB's earlier strategies, conducted by the Evaluation Office in late 2006. It was aligned with the objectives of the Bank's Business Plan 2007-2010 and was therefore evaluated in that context.

Overall, the implementation of the Country Strategy was consistent with the Business Plan implementation. The performance of the strategy is rated as Partly Unsatisfactory, as the targets were implemented at about 50%, including the intended sector coverage, as illustrated in the following table.

TABLE 3: PERFORMANCE OF ROMANIA COUNTRY STRATEGY 2007-2010

Post Evaluation of 2007-2010 Country Strategy Romania (approved 04.02.2007)				
2007- 2010 TARGETS			RESULTS (end of 2010)	
General	**Sectors**	**Target operations: Number approved/ number signed; USD approved/ USD signed (million)**	**Actual operations: Number approved/ number signed; USD approved/ USD signed (million)**	**Evaluation Summary**
Large and medium sized companies, with focus on export generating activities, infrastructure and financial sector Joint ventures with strategic partners from BSEC countries,	***1. Infrastructure*** ▪ Co-financing in infrastructure, energy and transport with EU, EBRD and EIB ▪ Special attention to municipal infrastructure ▪ Energy sector, with focus on oil and gas industry (upstream and downstream). **2. *Transport*** ▪ transportation infrastructure and shipping	17/14 148/NA	4/4 114/63	***1. Volume: below target*** Approved number: 24% Approved volume: 77% Signed number: 29% Signed volume: N/A

as well as other bankable projects with high development impact	***3. Manufacturing*** ▪ Long-term financing to strategic investors in sectors related to food and steel industry ***4. Financial sector*** ▪ Cooperate with other IFIs and offer mortgage credit lines to eligible partner banks and provide financing to banks supporting their institutional consolidation ▪ Further contribute to the development of equity funds ***5. SME sector*** ▪ As per the Bank's SME Strategy, using a diversity of products and instruments ***6. Trade finance*** ▪ Short and medium term trade financing for regional trade			***2. Sector coverage:*** ▪ Transgaz Equity (Energy/Equity) ▪ Petrom Environmental Loan (Energy) ▪ Turceni Environmental Loan (Energy) ▪ Emerging Europe Accession Fund (Equity/SME) ***3. Performance:*** Partly Unsatisfactory**.** Targets generally achieved at 50% levels, including sector coverage.

IV. Priorities for 2011 – 2014

Over the period covered by the previous Country Strategy the Bank made sustained efforts to identify business opportunities consistent with the development priorities of Romania and in line with the objectives set in the Country Strategy 2007-2010.

Unfortunately, very few of these efforts lead to fruition. In the period 2006-2008, in particular, it was difficult for BSTDB to agree with potential clients on terms and conditions for specific operations, as the terms of financing offered by the Bank were not attractive. At that time in Romania liquidity was ample, credit, both from domestic and foreign sources, was growing rapidly, and interest rates were unrealistically low.

The changing conditions, characterized by increased risk aversion and tightening of the credit markets, provide confidence that over the coming years financing provided by BSTDB will be in higher demand. The increased attractiveness of Bank funding and the greater capacity of the Bank to respond to clients' needs are an expression of the risk rating upgrade to A3 by Moody's, and of the doubling in the subscribed capital of the Bank. BSTDB would be in a position to offer qualifying clients larger amounts for longer maturities at suitable interest rates. In order for this potential to materialize, not only in Romania but in other Members as well, the Bank would need to continue to enjoy the strong support of shareholders, demonstrated in particular by payment of the capital subscriptions in due time.

BSTDB will strive to mobilize both foreign and domestic financial resources for investments in Romania. In this respect the Bank will explore co-financing possibilities with other MDBs and DFIs, in particular those who hold observer status in the Bank, involving financing facilities, guarantees, or in any other adequate ways.

The BSTDB will focus in the next four years on providing financial support in particular to companies involved in export generating activities, infrastructure and regional development, with a focus on SMEs. To this end, the Bank would explore possibilities to cooperate with the Agency for SMEs and to participate in the JESSICA – Joint European Support for Sustainable Investment in City Areas – initiative of the European Commission in cooperation with the European Investment Bank (EIB) and the Council of Europe Development Bank (CEB), in order to promote sustainable investment, support economic growth and help create jobs. In addition, the Bank will support initiatives which promote regional development and cooperation between Romania and other BSEC member countries.

Areas for BSTDB Financing:

The Bank's role and priorities are defined (i) in accordance with the priorities and targets laid out in its *Medium-term Strategy and Business Plan 2011-2014* and (ii) country needs and objectives, as well as (iii) available resources, strategies and policies of BSTDB. In this respect, BSTDB will seek viable opportunities and will continue closely monitoring the developments in the Romanian economy in order to stand prepared to support bankable projects in all sectors pertaining to the Bank's field of action. In addition the Bank shall seek co-financing opportunities with IFIs, public sector institutions and private partners.

The BSTDB will focus in the next four years on providing support for the implementation of the Government program and priorities, while responding to market demand. The Bank will consider undertaking activities and providing services as may advance its purpose, paying special attention to activities promoting export of goods and services, and development of infrastructure, including energy efficiency. In addition, through selected intermediaries, the Bank would attempt to expand its financing programs in favor of SMEs.

Based on the 2011- 2014 BSTDB Medium Term Strategy and Business Plan (MTSBP), the Bank would expect to approve about 4 new operations per annum during this period, for approximately EUR 47.3 million per year. Over the four year period, this implies around 14 to 18 approved operations for approximately EUR 166.5 million to EUR 212 million. This scenario would involve a substantial expansion of activities in Romania during the 2011-2014 period. With the Bank determined to raise the level of commitments (signed operations) to approved operations to over 85%, the Bank expects signings for 2011-2014 to be on the order of 13 to 16 operations for EUR 167 million (a range of EUR 147 million to EUR 187 million).

These indicative targets are based on the Base Case Scenario of the MTSBP, and given appropriate circumstances and sufficient operational opportunities the Bank would make efforts to exceed this level. In case of higher regional economic growth rates, increased demand for Bank funding, and an improved situation in financial markets, a phased increase in the average number and size of operations would allow the Bank to move towards achieving the targets envisaged under the High Case Scenario. Moreover, at the Mid-Term Review, depending upon performance and prospects, the above targets may be revised upwards[3].

The Bank will also consider providing, as may advance its purpose:

- facilities in the form of well-balanced debt-equity finance and convertible loans;
- a range of products aimed at promoting the access of Romanian public or private enterprises to the international and domestic capital markets;
- capital markets operations.

Trade Finance and Financial Institutions

BSTDB's Development Programs and Financial Sector Strategy have been created in order to develop a network of financial intermediaries, through whom to deliver its trade finance and SME finance products.

Since BSTDB began its operations, the following products have been introduced through selected financial intermediaries in Romania for the purpose of Trade Finance, Micro Finance, and SME development:

- Combined Trade Finance (export/import) product
- Medium –Term Micro and SME Finance product
- Leasing Facility for SMEs & Trade Finance

Financial sector

The substantial funding provided to companies through parent companies of foreign banks in Romania may limit the Bank's ability to expand its operations through financial intermediaries. However, the Bank will explore cooperation possibilities since export promotion is a priority for the Romanian Government. Consequently, development of non-bank financial institutions, e.g. leasing, would constitute a priority, as further development of leasing, and other non-bank financial activities offer good prospects. The Bank will consider the possibility to cooperate with other IFIs and offer credit lines

[3] Under no circumstances would targets be revised downwards unless the lower case scenario of the 2011-2014 BSTDB Business Plan were to be followed.

to eligible partner banks for on-lending purpose and provide financing to banks supporting their institutional consolidation.

SME sector

SMEs are in greater need of medium term finance than larger companies, which would promote modernization of equipment and diversification of products and services. Today SMEs are an integral part of the economy in terms of production and employment. However, the difficulty of having access to medium to long term credits as well as lack of sufficient equity capital are major problems that SMEs face in general.

Therefore, local financial institutions are used to help channel funds to productive enterprises involving in trade and to the SME sector. However, in the past years credit tightening measures adopted by the National Bank of Romania; 40% mandatory reserve requirement for foreign exchange liabilities of Romanian banks (which is now reduced to 25%) somehow limited access to, and intermediation of, credit facilities extended by IFIs to local financial institutions for the purpose of development of SME sector.

Unfortunately, there is no exception in the regulation for foreign exchange liabilities to IFIs, which may otherwise decrease the borrowing cost of financial intermediaries by ¼ of their borrowing cost from IFIs. Without intermediation of financial institutions small enterprises faces difficulties to reach additional medium-term funding of IFIs, due to the reason that financing directly a small scale of operation is not efficient from an IFI point of view. Financing may be offered in conformity with the Bank's SME Strategy and Program, using a diversity of products and instruments. It would be welcomed therefore, in order to increase the effectiveness of SME finance, if the NBR could consider waiving reserve requirements for funds lent to banks by multilateral development banks, or providing alternative supporting actions.

Trade finance

It is necessary to provide financing for increasing exports and expanding regional trade. Financing to exporting companies may help improve competitiveness and content of value added in exports. Within the framework of its trade finance program the Bank aims to promote import and export activities in the region, support increased production, increase competitiveness of exporters, create employment, help service foreign debt and increase regional trade and co-operation. The Bank will continue to seek new opportunities to provide short and medium term trade financing for companies transactions involving regional trade under its Trade Finance Program.

The Bank intends to use the leasing product not only for financing capital expenditure of SMEs but also for other companies as an effective financing tool for the promotion of regional trade. Medium-term credit lines opened to leasing companies for trade related purpose will enable them to offer their customers finance for capital expenditures on imports from other countries in the region.

The Bank will also consider the option to take equity participations in selected financial institutions and funds, and will also seek to develop quasi-equity products, such as subordinated loans.

The Bank will also keep in regular contact with complementary international financial institutions (IFIs) such as EBRD and IFC to seek ways to coordinate activities and share experiences, given the opportunities which exist for joint involvement.

The Bank will place emphasis on providing financial support to large and medium sized companies engaged in particular in export generating activities, and to infrastructure projects with high developmental impact. The financial support will be in the form of loan, quasi equity, and/ or equity,

depending on circumstances. The Bank will give priority to cross-border projects and projects with high regional cooperation impact.

Being one of the largest economies of Central and Eastern Europe, Romania offers good business potential in various sectors. EU requirements also oblige the country to materialize several energy efficiency and environmental projects within limited timeframe.

Energy, Power and Infrastructure

The Bank will give priority to corporate and project financing operations in infrastructure, telecoms, power and energy sectors in Romania.

In pursuing its mandate BSTDB will be seeking to finance projects, which are considered to have adequate developmental effect for the country. In particular, projects where BSTDB's participation will bring about attracting financial sources from outside of Romania will be strongly encouraged and supported.

The Bank will continue to ensure that all BSTDB operations in Romania meet sound banking principles and comply with the Bank's Environmental Rules and Procedures and incorporate, where appropriate, Environmental and Social Action Plans.

The Bank will work in cooperation with EBRD, IFC, EIB, other IFIs and commercial banks in joint energy and infrastructure sector projects as an important source of institutional knowledge transfer.

BSTDB supports the economic development in Romania, in particular by providing financial assistance in the following areas, although the Bank will pay due attention to other areas as well:

Infrastructure

Romania has a strong need to improve its infrastructure, including telecommunications, municipal infrastructure and transport networks with strong environmental and other positive externalities. The Bank will also focus on the projects supporting upgrade and modernization of the water supply and sewage sector as well as transactions designed to improve waste management. In order to increase the development impact of its financing operations, the Bank will attempt to participate in co-financing projects in infrastructure and telecoms sectors with other IFIs.

Energy

The Bank will stand prepared to react adequately to any energy sector opportunities, either with regional or local development impacts. The Bank's attention will be spread on all the aspects of Romanian oil and gas industry, from the exploration and production of crude oil and natural gas (upstream) to the refining, distribution, storage and transportation of refined petroleum products and natural gas, including liquefied petroleum gas (downstream).

The Bank will also seek to support the projects that envisage upgrade, modernization and expansion of the conventional energy infrastructure in order to facilitate electricity generation, distribution and sale in and outside Romania. The Bank will also focus on economically viable projects in the renewable energy sector such as solar, wind and hydropower plants.

Transportation

The modernization of the country's road and rail networks, and improved competition in the provision of road and rail transport facilities are key priorities for the government.

Given the very high investment needs for developing the transportation infrastructure in Romania, and the important development impact of such investments, BSTDB will carefully consider investment opportunities in this area. Co-financing opportunities with other commercial and development financial institutions will be looked for.

Romania has ports on the Black Sea coast and on Danube river, which have strategic importance for the country's transportation network. The Bank will follow closely the new port investments, and try to be involved in such projects, where it is feasible.

The Bank will seek to provide long-term financing for bankable projects in the *shipping industry* in cases where Bank's funding will bring additionality.

Manufacturing:

Romanian industry faces challenges due to the single EU market and the increasing competitiveness of Asian countries. The Bank's priority will be to support projects that aim at increasing the competitiveness of Romanian industries in EU markets.

In addition to loans, the Bank will also provide equity and mezzanine debt to general industry clients, sometimes in combination with syndicated senior debt, depending on the needs of the company.

A new dynamic industry focused on producing components for the automotive industry has developed. The machinery, appliances and electric equipment sectors are growing at a high rate. Information technology related industries have a very high growth rate. Further, the processing activities in the textile industry could assimilate upstream operations turning thus into genuine textile industry and offering thus good opportunities for investment.

Agribusiness, food processing and beverages

Agribusiness industry is one of the fastest growing industries in Romania in last years. The country has very rich cultivable land, which allows this sector, and some local companies operating in this sector grow fast. Although the *food industry* is one of the sectors that benefited from a rapid privatization, the development of the Romanian food sector is still lagging behind potential. The food sector, although diary products and food processing have recovered and are now exported in a number of EU countries, is still in need of financing for acquisition of modern equipment and expansion of capacities. The Bank will also seek to provide long-term financing to strategic investors in the sectors mentioned above. In food industry, the sub-sectors such as food retail and grain-related infrastructure (storage facilities, grain terminals), considering the positive spill-over effects of these sectors on primary agriculture and on food processing chains, will be supported.

In the *steel industry*, the Bank will seek to provide long-term financing to strategic investors in niche sectors with good development potential.

Real Estate and Tourism

Due to the contraction in the construction and real estate sectors, the Bank will be very selective in financing projects in these sectors. Logistics centers, warehouse facilities, and tourism facilities that would contribute to the development of this sector in the country, would be the possible areas for potential BSTDB financing within the next four year period.