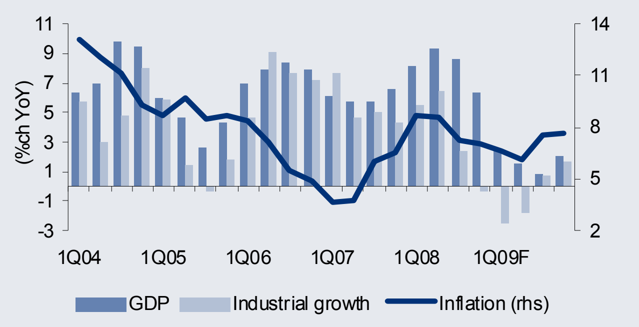
Romania: fundamental drivers

Activity:	- (+)	**Fiscal trend:**	**Looser (looser)**	**Monetary trend:**	**Tighter (tighter)**	**Ratings (M/S&P/F):**	**Baa3/BB+/ BB+**	**Import cover (mths):**	**5.6 (6.9)**	**Political stability:**	**Low (low)**

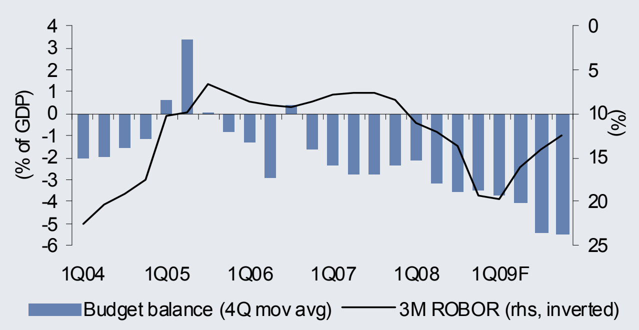
Activity and inflation



Uncharted waters

We always talked about 2009 as an adjustment year, but now we are revising economic growth sharply lower to about 2% vs about 4% previously on the back of negative Eurozone growth and a gradual deceleration in credit growth to below 5% towards end-2009. All these also imply sluggish profits and wages growth that could lead to a deterioration in consumer and business confidence, shifting policymakers' attention away from inflation to the real economy. While inflation should decelerate in such a scenario, unfriendly external financing conditions could pressure the currency and push annual inflation above the 2009 inflation target (add to this the current lax income and fiscal policies). The good news is that the abrupt fall in domestic demand implies a quick adjustment in the external shortfall (below 9% of GDP in 2009).

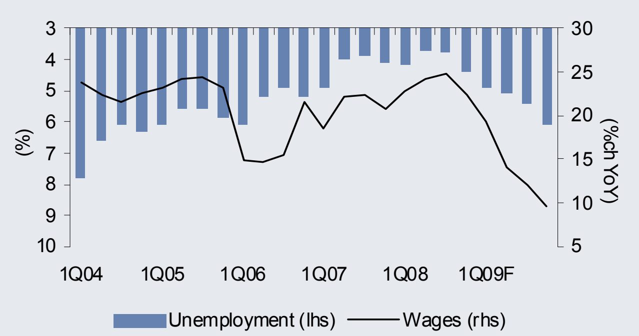
Fiscal stance and yields



Forecasts

	2Q08	3Q08F	4Q08F	1Q09F	2Q09F
GDP (%YoY)	9.3	8.7	6.3	2.5	1.6
PPI (%YoY) end-q	19.4	18.7	14.9	12.0	8.3
CPI (%YoY) end-q	8.6	7.3	7.0	6.6	6.1
M2 growth (%YoY) end-q	39.0	31.2	24.7	24.8	25.1
Trade balance (% of GDP)	-16.0	-13.0	-14.0	-15.2	-12.5
Current account (% of GDP)	-14.9	-12.7	-15.9	-13.3	-11.0
International res (US$bn)	39.3	36.7	32.3	31.5	29.9
Import cover (mths)	6.3	5.6	5.0	5.0	5.2

Unemployment and earnings

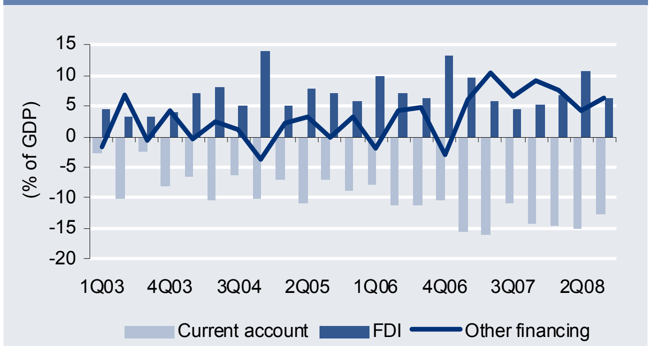


Take the rough with the smooth

The anticipated economic growth slowdown implies a technical recession at least (two quarters with negative growth rates, QoQ, sa), but we do not look for a sharp rise in unemployment given the tension on the labour market (we forecast it at 6% for end-2009 and see a full-fledged recession as a risk only if EU growth comes out even worse). We see the construction, industrial and financial sectors as being the most affected. The positive news is that the faster closing of the output gap should remove some of the strain on inflation and allow a further reduction in the C/A deficit. Property prices are likely to tumble as FX credit restrictions and higher external costs are likely to work in this direction. Real estate price deflation could have a severe impact on household consumption through the wealth effect. Support in the longer term should come from a sustainable convergence process towards Eurozone entry, helped by about €30bn in EU funds until 2013, though this requires essential structural reforms (for the labour market and business environment) and the development of transport infrastructure.

On the political front we expect little improvement even after the 30 November elections as the instability could even increase as a political majority is not expected and the president stated that only he may choose the next PM if no party gains more than 50% of votes (highly likely). Therefore, a new impeachment procedure against the president could be launched. Hence, forming a new government might be a lengthy process. Likewise, given that 2009 is a presidential election year, the likelihood that a new government would adopt the fiscal measures needed to restore confidence in Romania is low.

Current account and financing

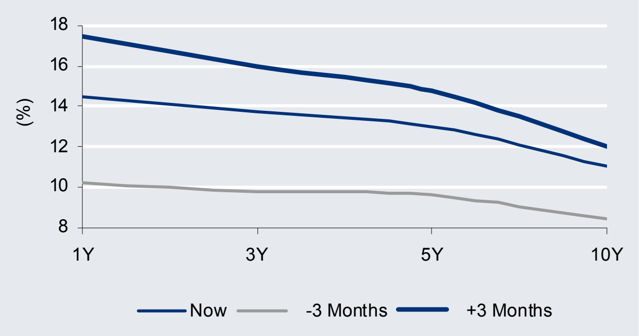


Source: National sources, ING estimates

Romania: market directions

Domestic debt: Rich (fair)	External debt: Fair (fair)	Forex: Rich (fair)	Equities: Rich (fair)

Yield curve dynamics

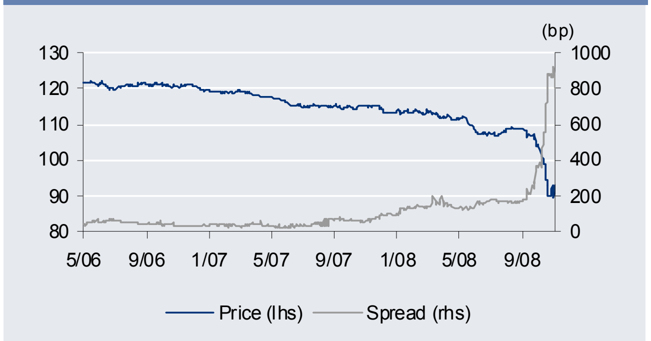


Even more steepening on the radar

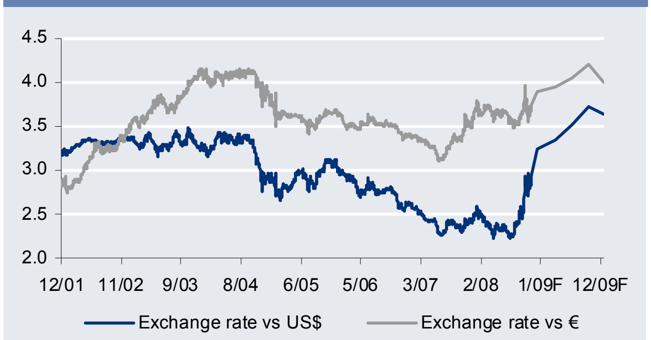
After tapping the market for modest amounts compared to its issuance plan in the first three quarters of the year, the MoF has switched strategies, grabbing liquidity with both hands. This has put strong upside pressure on the yield curve, especially stressing the front end. As we expect the budget shortfall to considerably surpass the Maastricht threshold in both 2008 and 2009, the MoF's demand for liquidity will be high going forward. This will strongly impact yields in the already squeezed money market. Supply will probably be focused on short-term instruments, given the overall elevated yield levels, though we do not think it will follow Hungary's example of cutting all T-bond tenders. This seems the least expensive option since the sub-investment grade rating of Romania almost prohibits access to international credit markets.

	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08F	1Q09F	2Q09F	3Q09F	4Q09F
Central bank key rate (%) end-q*	7.00	7.00	7.50	9.50	10.00	10.25	10.25	9.75	9.50	9.00	9.00
3mth rates (%) end-q	7.7	7.6	8.4	11.0	12.0	13.7	19.3	19.8	16.0	14.0	12.5
3yr rates (%) end-q	7.2	7.4	8.8	9.6	9.8	10.4	16.0	16.3	15.3	14.0	13.5
5yr rates (%) end-q	7.2	7.4	8.3	9.4	9.6	10.1	14.8	15.0	14.3	13.8	13.3
5yr-3yr rates (bp) end-q	0	0	-50	-20	-20	-30	-125	-125	-100	-25	-25
3mth interest rate spread vs Euribor (bp)	350	277	370	623	705	842	1,475	1,585	1,270	1,110	970
Real interest spread vs 3mth Euribor (bp)	160	-140	6	97	211	493	1,053	1,154	849	515	399
RON/US$ end-q	2.31	2.35	2.47	2.36	2.32	2.65	3.25	3.35	3.52	3.72	3.64
RON/€ end-q	3.13	3.36	3.61	3.73	3.65	3.73	3.90	3.95	4.05	4.20	4.00
Real exch rate index RON/€ (1/1/99 = 100)	47.9	48.8	49.8	51.0	49.2	48.1	49.6	49.5	49.4	50.1	46.6
Exch rate vol (ann, 90-day, % vs €)	5.0	7.1	11.0	10.1	7.7	9.8	N/A	N/A	N/A	N/A	N/A

Romania 2012



Exchange rates



Source: National sources, ING estimates

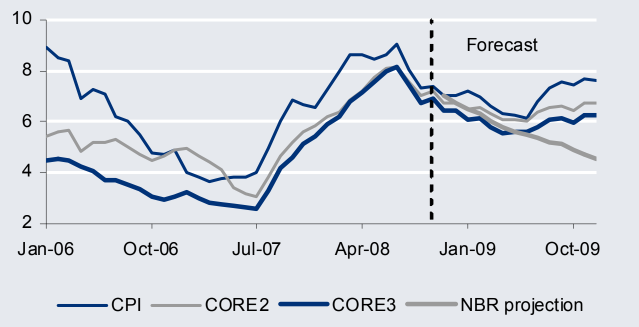
Recovery still out of sight

In the current adverse environment, the Romanian equity market has come under severe pressure. De-leveraging and redemptions have triggered the steepest monthly fall in the last ten years which has dragged the main indices down 75% from July 2007's peaks. Although valuations may seem reasonable at the moment, the outlook is far from optimistic. Romania's weak fundamentals and sub-investment grade rating will probably weigh heavily as Romanian banks and corporates are likely to face difficulty in the credit markets. A recovery seems distant and it may come only after the global situation improves and, if it does, it may well be slow.

Unwinding exposures in emerging markets amplified by FX speculation has squeezed the Romanian currency in recent months. The RON almost touched 4/EUR, but the weakening trend has been turned around by NBR intervention. This has had a two-fold effect as it also pushed interest rates into triple-digit territory, offering additional support for the RON. However, capping the exchange rate through FX interventions is likely to be expensive in the medium run given it puts pressure on interest rates. Therefore, we expect the NBR to attempt to prevent sharp swings in the exchange rate, but to try to find a balance between growth and currency weakening throughout the coming year. The RON could come under renewed weakness in 1Q09 after the budget deficit data for 2008 is released. Consequently, we see a likely test of RON4.2/EUR. Risks to our baseline view remain skewed to the upside; nonetheless, an unexpected improvement in the global markets might increase the appetite for risk and thus offer support to the RON.

Romania: what's hot

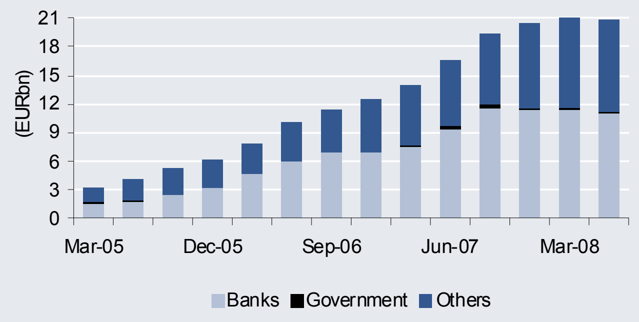
Inflation developments (%YoY)



Tough times ahead for the NBR

Although our economic growth forecast implies that the output gap would be negative in 2Q09, we revised our inflation forecast upwards significantly as, besides the lagged effects from the current loose income and fiscal policies, we see the exchange rate depreciating gradually towards RON4.2/EUR. This should impact core inflation strongly. Given the high exchange rate pass-through and the impact on expectations, we stress that a more pronounced weakening could lead to double-digit inflation. However, RON strengthening towards 3.5/EUR might bring inflation within the target band. The 2010 inflation target may perhaps be announced only after the new government is formed and we suspect a target higher than 3.5% would be realistic given the poor outlook for emerging markets.

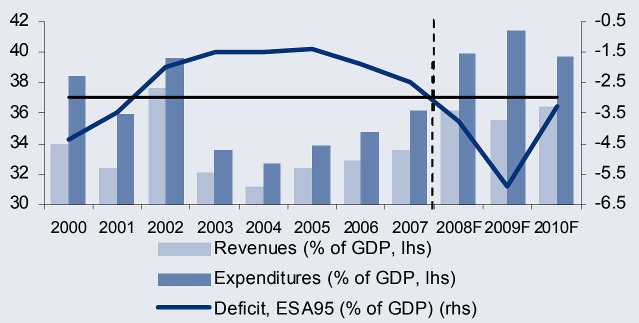
Structure of short-term debt



Financing the gap – possible IMF support?

The current level of NBR reserves (€27bn) is short by about €3.5bn to cover the short-term debt (€21bn) and the C/A deficit less FDI (€9.5bn). However, since bank debt accounts for roughly €11bn, we think a sudden stop in financing is less likely to occur when funding comes from a parent bank than from the international money market. So, the reserves could cover the rest, but at the cost of high interest rates and (probably) negative GDP growth. Therefore, a request for IMF help would be positively interpreted by the markets in the current context of heightened risk aversion and could also dampen the possible switch from RON deposits into EUR deposits. Moreover, the implementation of potential IMF conditionalities would mean sustainable future GDP growth.

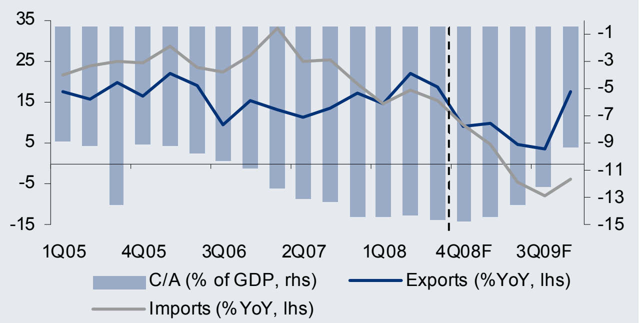
Public budget execution



Is fiscal policy the bad apple?

In spite of rising macroeconomic imbalances, fiscal policy was loosened in this election year and more public sector wage increases were approved than initially agreed. The deficit might be amplified in 2009 since lower economic growth implies significantly less revenues, while spending (pension and wages account for the bulk) are permanent in nature. This could create a crowding-out effect, putting more upwards pressure on interest rates. Even though the 50% increase in teachers' wages was delayed, it still counts for next year's ESA95 budget deficit. The new government might have to hike some taxes to restore the fiscal position (this may be requested by the European Commission as well), which means a private consumption recovery could take longer than expected.

C/A deficit developments



Looking for an adjustment in the external gap

For 2008 we maintain our forecast for a mild widening in the external shortfall, which could prove negative for the RON given worries on emerging markets. Taking into account our forecast for an abrupt fall in domestic demand in 2009 and projected RON depreciation, we now look for a considerable improvement in the C/A deficit from 12% previously to below 9% of GDP at the end of 2009. Yet, significant profit repatriation might push for a larger external shortfall. Even though the exchange rate is weakening, we still forecast a sharp deceleration in exports growth as demand from the EU is likely to fall as well and its impact should outweigh the exchange rate effect. Nevertheless, we expect imports growth to turn negative. For this reason, the financing of the C/A can improve in spite of a forecasted halving for FDI in 2009.

Source: National sources, ING estimates

Romania: key economic forecasts

	2000	2001	2002	2003	2004	2005	2006	2007	2008F	2009F	2010F
Activity											
Real GDP (%YoY)	2.1	5.7	5.1	5.2	8.5	4.2	7.9	6.0	8.1	1.7	3.9
Private consumption (%YoY)	-0.8	6.8	4.7	8.2	13.0	9.5	11.7	10.5	11.5	2.1	3.9
Government consumption (%YoY)	12.3	-0.2	6.0	8.5	-9.3	11.8	-9.9	7.4	5.0	6.4	-0.8
Fixed investment (%YoY)	5.5	10.1	8.2	8.5	11.1	12.7	19.3	28.9	25.8	3.8	6.8
Industrial production (%YoY)	3.6	8.3	4.4	3.1	5.3	2.0	7.1	6.0	3.6	-0.5	4.3
Unemployment rate year-end (%)	10.5	8.8	8.4	7.4	6.3	5.9	5.2	4.1	4.4	6.1	5.6
Nominal GDP (RONbn)	80.4	117	151	198	246	288	345	405	497	555	628
Nominal GDP (€bn)	40.3	44.9	48.5	52.6	60.8	79.5	97.8	121.3	135	140	167
Nominal GDP (US$bn)	37.1	40.2	45.7	59.5	76.0	98.4	124	166	199	162	183
GDP per capita (US$)	1,652	1,793	2,100	2,620	3,377	4,445	5,723	7,708	9,226	7,516	8,531
Gross domestic saving (% of GDP)	13.8	14.8	16.0	14.3	14.7	12.5	14.4	15.3	16.9	19.1	21.4
Prices											
CPI (average %YoY)	46.2	34.8	22.8	15.3	11.9	9.0	6.6	4.8	7.9	7.0	6.5
CPI (end-year %YoY)	40.7	30.3	17.8	14.1	9.3	8.6	4.9	6.6	7.0	7.6	5.1
PPI (average %YoY)	53.4	38.1	23.2	19.3	19.1	10.5	11.6	8.1	16.9	11.1	7.9
Wage rates (%YoY, nominal, average)	49.6	40.5	27.1	25.4	22.5	23.7	16.8	21.0	23.5	13.5	12.5
Fiscal balance (% of GDP)											
Consolidated government balance, cash basis	-4.0	-3.2	-2.6	-2.2	-1.1	-0.8	-1.0	-2.3	-3.5	-5.5	-3.2
Consolidated primary balance	N/A	N/A	0.4	-0.2	0.2	0.3	-1.4	-1.8	-2.5	-4.6	-2.4
Total public debt	31.4	28.7	28.9	26.0	22.5	20.5	18.4	20.2	19.6	20.4	20.0
External balance											
Exports (US$bn)	10.5	11.4	14.1	18.0	23.7	27.5	32.8	40.4	49.7	42.8	47.0
Imports (US$bn)	12.2	14.3	16.8	22.6	30.5	37.0	47.8	64.7	78.1	60.0	62.7
Trade balance (US$bn)	-1.7	-2.9	-2.7	-4.6	-6.7	-9.5	-15.0	-24.3	-28.4	-17.2	-15.7
Trade balance (% of GDP)	-4.7	-7.3	-5.8	-7.8	-8.9	-9.7	-12.2	-14.6	-14.3	-10.6	-8.6
Current account balance (US$bn)	-1.4	-2.2	-1.6	-3.6	-6.5	-8.4	-12.7	-23.3	-28.1	-14.2	-14.1
Current account balance (% of GDP)	-3.7	-5.5	-3.4	-6.1	-8.5	-8.6	-10.3	-14.0	-14.1	-8.8	-7.7
Net FDI (US$bn)	1.3	1.5	1.1	2.2	6.9	6.4	11.7	9.7	13.6	6.3	7.2
Net FDI (% of GDP)	3.6	3.7	2.5	3.7	9.1	6.5	9.4	5.8	6.8	3.9	3.9
Current account balance plus FDI (% of GDP)	-0.2	-1.7	-0.9	-2.4	0.6	-2.1	-0.9	-8.2	-7.3	-4.9	-3.8
Export volume (%YoY, ESA95)	23.4	12.1	17.5	8.4	13.9	7.7	10.4	8.7	22.5	5.4	8.3
Import volume (%YoY, ESA95)	27.1	18.4	12.0	16.0	22.1	16.0	22.6	26.1	24.8	2.8	7.8
Foreign exchange reserves (ex gold, US$bn)	2.5	4.0	5.9	7.6	14.0	20.0	27.5	37.2	32.3	28.9	29.2
Import cover (months of merchandise imports)	2.4	3.3	4.2	4.0	5.5	6.5	6.9	6.9	5.0	5.8	5.6
Debt indicators											
Gross external debt (US$bn)	11.4	13.2	17.0	22.4	29.2	36.6	54.1	85.9	86	75	84
Gross external debt (% of GDP)	31	33	37	38	38	37	44	51.7	43.5	46.3	45.6
Gross external debt (% of exports)	109	116	121	125	123	133	165	213	174	175	178
Total debt service (US$bn, includes ST)	2.6	3.2	4.5	4.8	6.7	16.1	26.1	38.8	40.8	49.5	52.8
Total debt service (% of GDP)	7	8	10	8	9	16	21	23	21	31	29
Total debt service (% of exports)	25	29	32	27	28	59	80	96	82	116	112
Interest & exchange rates											
Central bank key rate (%) year-end	47.8	34.4	19.6	21.3	17.3	7.50	8.75	7.50	10.25	9.00	8.50
Broad money supply (%YoY)	38.0	46.2	38.2	23.3	39.9	33.9	29.4	33.9	24.7	16.8	24.0
3-month interest rate (ROBOR avg %)	55.4	43.7	29.8	19.9	20.8	9.8	8.8	7.9	14.0	15.6	10.5
3-month interest rate spread over Euribor (ppt)	51.0	39.5	26.5	17.5	18.7	7.7	5.7	3.6	9.7	12.3	7.4
2-year yield (avg %)	N/A	N/A	22.0	14.8	15.5	7.4	7.4	7.6	11.5	14.4	9.8
5-year yield (avg %)	N/A	N/A	N/A	N/A	N/A	7.3	8.1	7.5	11.0	14.1	9.5
Exchange rate (RON/US$) year-end	2.59	3.13	3.33	3.27	2.93	3.11	2.56	2.47	3.25	3.64	3.41
Exchange rate (RON/US$) annual average	2.17	2.91	3.30	3.32	3.26	2.91	2.81	2.43	2.50	3.44	3.43
Exchange rate (RON/€) year-end	2.41	2.79	3.49	4.11	3.97	3.68	3.38	3.61	3.90	4.00	3.75
Exchange rate (RON/€) annual average	2.00	2.60	3.13	3.76	4.05	3.62	3.52	3.34	3.68	3.96	3.77

Source: National sources, ING estimates

Disclosures Appendix

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Paris	ING Belgium S.A., Succursale en France, Coeur Défense, Tour A, La Défense 4, 110 Esplanade du Général de Gaulle, Paris La Défense Cedex, 92931. *l'Autorité des Marchés Financiers*
Prague	ING Bank N.V. Prague Branch, Nadrazni 25, 150 00 Prague 5, Czech Republic. *Czech National Bank*
Sao Paulo	ING Bank N.V. Sao Paulo, Av. Brigadeiro Faria Lima n. 3.400, 11th Floor, Sao Paulo, Brazil 04538-132. *Securities and Exchange Commission of Brazil*
Singapore	ING Bank N.V. Singapore Branch, 19/F Republic Plaza, 9 Raffles Place, #19-02, Singapore, 048619. *Monetary Authority of Singapore*
Sofia	ING Bank N.V. Sofia Branch, 12 Emil Bersinski Str, Ivan Vazov Region,1408 Sofia, Bulgaria. *Bulgarian Central Bank and Financial Supervision Commission*
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