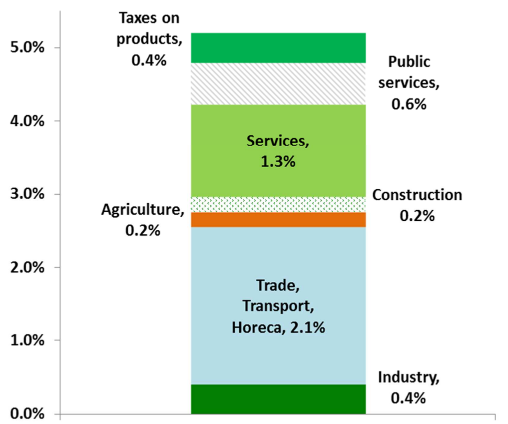
QUARTERLY MACROECONOMIC REPORT ROMANIA – Q3 2016

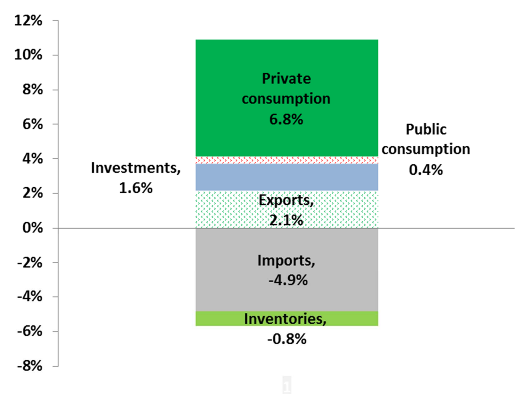
Economic Growth Softens

Moody's: Baa3 positive / S&P: BBB-stable / Fitch: BBB- stable

TRADE/TRANSPORT IS THE MAIN DRIVER, H1 2016 GDP PP CONTRIBUTION



CONSUMPTION THE DRIVER OF THE GROWTH; SOME INVESTMENTS ACCELERATION, H1 2016 GDP PP CONTRIBUTION



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Outlook – The Romanian GDP expanded by 4.9% in the first nine months of 2016, strongly driven by private consumption amid fiscal stimulus. Nevertheless, trade started already to decelerate in Q3 and this trend will continue for the last quarter of the year. Service sector remains the engine of the growth while the machinery and car industry just received a positive boost from external demand and a recovery is expected for the Q4.

Annual inflation in Romania is expected to end this year at zero but to enter the target band during next year. Given also the very low interest rate environment on the European level, NBR will probably keep its interest rate through the whole next year, with the first rate hike only in 2018.

At the parliamentary elections in December none of the political parties have the majority, so a coalition government will be needed. The race is quite tight and the new and smaller parties will play an important role in the negotiations for the power.

Despite some worsening of budget and external balance, macro fundamentals of Romania remain still strong. The main risk area is related to next year's budget deficit and domestic legislative changes impacting the financial system. Still, Romania is viewed as being stable by the rating agencies, reflected also by the relatively stable RON and CDS evolution.

The pace of lending stagnated so far. Prospects for 2017 retail lending are good, especially given the proposal to extend the First Home program by 5 years. Company lending is still stiff, but the investment component is revived.

Main Topics:

- Politics – Parliamentary election fixed on the 11th of December
- Economic Growth – Consumption to decelerate in Q3
- Country risk profile – Stable country risk amid still good fundamentals
- Monetary stance – Low interest rate environment to persist amid historically low inflation
- Fiscal Policy and Public Finance – The budget deficit could finish the year below target
- External Accounts and Financing – The current account deficit is deepening
- Bank flows – The pace of lending stagnates, but demand for investment loans increases

Politics

Parliamentary election fixed on the 11th of December

We consider three alternative scenarios for the parliamentary election in December: 1) the Social Democratic Party (PSD) forms the coalition with the Alliance of Liberals and Democrats for Europe (ALDE) and the Hungarian ethnic minority, the Democratic Union of Hungarians in Romania (UDMR); 2) the Liberal PNL forms the coalition partner with the new Union for the Salvation of Romania (USR) and UDMR; or 3) in case that none of the two major parties has sufficient votes to form a coalition, there will be no choice than to collaborate and to form a national union government.

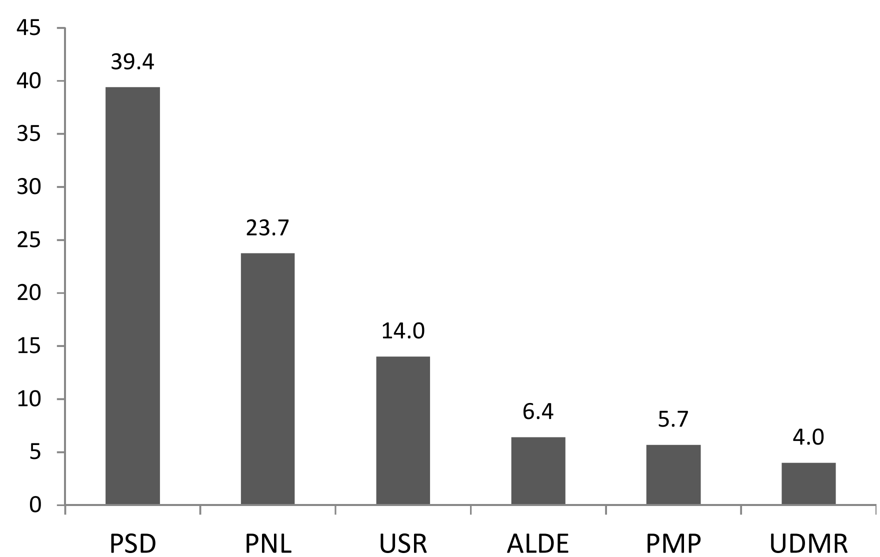
The race for PM already took shape. PNL nominated Dacian Ciolos, the current PM, and USR intends to do the same. Most likely, PSD would nominate its party leader Liviu Dragnea for the PM position.

USR is the new element in this election. It is a new arrival and fast growing party originating from the Union for the Salvation of Bucharest, a party created for the 2016 local election and which received 25% votes in Bucharest at local elections for General Council. USR is a reformist group formed mainly by newcomers in the political life who are committed to rooting out corruption. According to the polling data, USR is close to its goal of getting 10% of votes.

The right-leaning People's Movement Party is another newcomer with chances to enter to the parliament. In July 2016, they took over the left-wing National Union for the Progress of Romania (UNPR), one of the former allies of PSD.

Based on the new electoral law, enforced in 2015, the 2016 parliamentary election rule will be the party-list proportional representation as it was in 2004. A total of 466 MPs will be elected, five fewer than in 2008 and 122 fewer than in 2012. For the first time the Romanian electors living abroad will be able to vote via mail, in a reaction to the difficulties faced at the 2014 presidential election.

AVERAGE POLLING SCORE (NOVEMBER)*



Source: Grayling, GarantiBank Research
*Average pooling score is calculated based on the 3 polls in November: Avangarge, CCSB and Kantar -TNS

QUARTERLY MACROECONOMIC REPORT ROMANIA – Q3 2016

Economic Growth

Consumption to decelerate in Q3

GDP advanced by 4.9% yoy in the first nine months of 2016, strongly driven by consumption that deepened also the trade deficit through the stronger import growth. Details on GDP contribution are not yet available, but the higher frequency data gives us hints. Private consumption represents 6.8 percentage points from the overall real GDP growth in H1and reached its peak in Q2 after which it started to decelerate in Q3. This turn is correlated with the retail trade data which decelerated as well as for two reasons: the base effect of the food VAT cut (as of June 2015) and the drop in fuels and energy prices disappeared in Q3. This trend is expected to continue in Q4, since the base effect of the wage hikes implemented in the last quarter of 2015 will also vanish. Overall, consumption dynamic is expected to revert to pre-stimulus levels and consequently the GDP growth rate could decelerate towards 3.7% next year.

From the production side, industry was the weakest, but we see a recovery starting in August, driven by external demand, mainly for machinery and transport equipment (export growth of this category stood at 11.8%yoy for the first nine months). This recovery would stabilise also the trade deficit, that deteriorated significantly (net export contribution to the GDP growth of -3.4 percentage points in Q2 2016 from -1.5 percentage points in 2015). The low commodity prices are still negatively impacting the oil extraction and metallurgy subsectors, while wood, chemicals and textiles are contracting due to legislative/structural changes. On the positive side, services, especially the IT and business support activities kept the good dynamic of previous quarters and are expected to remain the engine of the growth after trade deceleration.

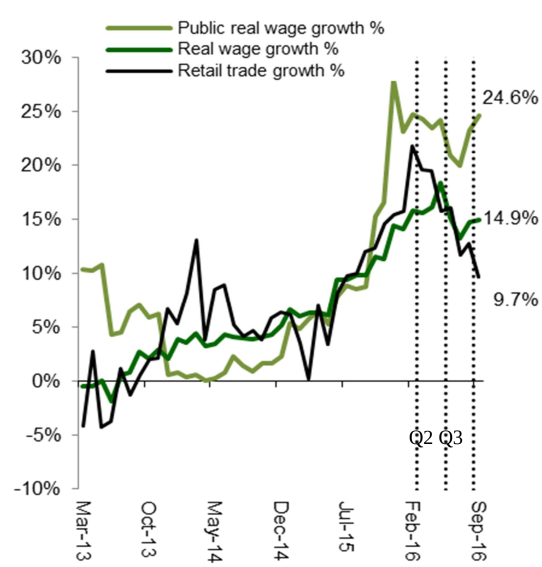
Agriculture had a good evolution of 10.1% yoy growth in H1 due to bumper rape and spring barley crop but recently, yield forecasts were revised slightly downwards for wheat at 2.6% yoy, still around 14% above the average of last 5 years.[1] Constructions had a moderate half year evolution (4.8%) but turned negative in Q3. Overall, infrastructure works is still 9% below pre-crisis level, while buildings' construction shrank in Q3 2016 at a level 24% below the pre-crises level (-2.4% yoy).

SHORT-TERM INDICATORS

	12M avg	Mar	Jun	Jul	Aug	Sep
Industrial prod	1.6%	2.6%	1.1%	-3.4%	5.4%	3.4%
Industry conf.	0.2	-0.8	1.0	0.8	0.9	2.1
Services for comp.	9%	7.4%	10.8%	8.2%	13.4%	10.7%
Service conf.	10.2	9.7	7.6	9.0	9.8	8.1
Retail Trade	14.4%	19.6%	16.0%	11.8%	12.8%	9.7%
Retail conf.	10.3	8.6	3.4	7.0	15.9	-2.8
Car sales	23.6%	27.4%	36.5%	24.1%	28.2%	35.0%
Construction	6.3%	-3.0%	2.4%	-1.6%	-4.5%	0.8%
Buildings conf.	-12.7	-12.7	-14.2	-12.6	-13.2	-11.9
Economic sent.	103.9	102.8	103.2	103.6	104.2	103.5
Real wage	13.3%	15.6%	15.1%	13.3%	14.7%	14.9%
Private Loans	1.5%	2.8%	1.2%	1.8%	0.7%	1.2%
Export	4.0%	2.7%	3.7%	-4.6%	13.4%	6.7%
Import	8.1%	5.0%	2.7%	-4.2%	14.6%	6.5%
real GDP % yoy	**4.6%**	**4.3%**	**6.0%**			**4.4%**

Source: NIS, Eurostat, European Commission, GarantiBank Research

TRADE CORRELATED WITH WAGES



Source: EUROSTAT, EC, GarantiBank Research

[1] European Commission, MARS Bulletin Vol. 24 No. 9 – 26 September 2016.

Country risk

Stable country risk amid still good fundamentals

The main risks in the short term are the budget deficit and the impact of legislative changes. In the first case, exceeding the 3% Maastricht level in 2017 would put the country in the excessive deficit procedure around April- May 2018. Consequently, for 2017, the impact on yields and FX rate should be not visible yet.

The second risk, stemming from new banking legislation has so far not affected Romania's investing grade rating. The giving in payment law and the CHF conversion law are both retroactive and estimations regarding the possible loss to the banking system vary widely. However, official institutions estimated the loss for the first one in the range of 1.3-3.3 bn RON (IMF) while for the second one, NBR estimated RON 1.7[2] bn in the case in which the law would not apply to contracts which were already converted. The overall impact of these laws would be lower than similar actions in other countries[3], even in the current more aggressive form.

	Giving in payment	CHF conversion
notifications to banks	5366	57298
stock of loans affected	bn 1.6 RON (1.4% of retail loans)	bn 5.7 RON[4] (5% of retail loans)
estimated loss for the banking system	RON 1.1 bn - RON 3.3 bn (IMF)	RON 1.7 bn (NBR)

Both laws, the giving in payment law and the Swiss Franc conversion law are currently subject to revision. The Constitutional Court decided that the retroactivity of giving in payment law, enforced in May, is not constitutional and the law can be applied for existing contracts only after a court decision and analysis of the hardship condition[5], while the Swiss Franc conversion law voted by the parliament was challenged by the Government at the Constitutional Court (decision expected in November).

The rating agencies reaction is mixed. Moody's presented its opinion on Swiss Franc conversion law as credit negative for Romanian banks through the possible losses and for the future "development of the country's covered bond market because it increases uncertainty for investors that rely on the collateral value of mortgage pools". The biggest riskwould be the adoption of a similar law of conversion for EUR denominated loans (39% of household loans) which would undermine the financial stability by wiping out 80% of banks' capital. .For the moment this is a very low probability event. Meanwhile, at its regular country evaluation, the S&P rating agency kept unchanged Romania's sovereign ratings at "BBB-" with a "stable" outlook. The current macro stability parameters are still in good shape but there are clear signs of deficit widening (both fiscal and current account balance). However, they are not reaching unsustainable level in the short to medium term.

Bottom line, despite some worsening of deficits and some remaining risk related to legislative changes, Romania is still viewed as being stable, reflected also by the relatively stable RON and CDS evolution.

[2] The banking system profit stood at RON 2.4 bn in H1 2016.

[3] Hungary converted of all foreign-currency retail loans in 2015, which accounted for 55% of total retail loans.

[4] By July 2016

[5] Cases in which unforeseen events occur that fundamentally alter the equilibrium of a contract resulting in an excessive burden being placed on one of the parties involved.

Monetary stance

Low interest rate environment to persist amid historically low inflation

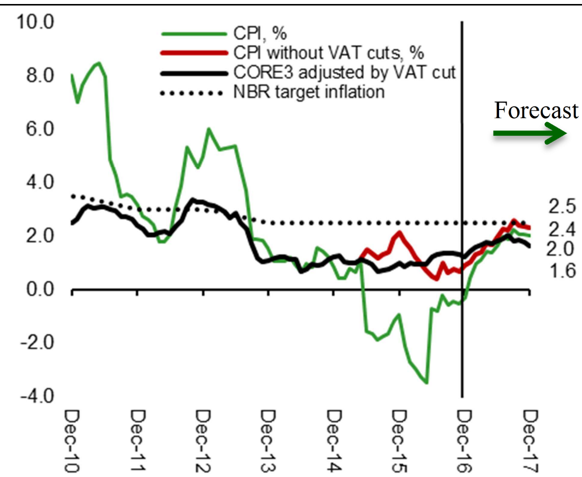
Annual inflation remained negative at -0.4% in October 2016. The food VAT cut base effect has been eliminated in June, while the effect of the general VAT cut[6] is still present in the price evolution. The latter counts around 1.2 percentage points in the headline inflation, therefore the VAT corrected CPI stood at 0.8%, still below the target band of the NBR (at 2.5% +/-1). Beside the VAT cuts, inflation was impacted by the energy price decline (-6.4 % yoy) and lower volatile food prices (fruits -2.7% yoy). Nevertheless, the monthly price evolution shows some higher than expected increase of vegetables (+4% mom) and recovery in the oil prices (+1.9% mom).

Headline inflation is expected to end this year at 0% and to increase towards 2% till the end of 2017. Moreover, the core inflation[7], which is showing the demand side pressures and which is more relevant for policy decisions, is expected to remain at around 1.2% in 2017. Based on this outlook, the inflation will move above target only during 2018 and that should prompt NBR to implement the first rate hike. The low interest rate environment is expected to persist in most of the European countries[8] while for Eurozone the negative interest rate is projected for two more years.

In its latest meeting on the 4th of November, the last meeting this year, the Board of the National Bank of Romania decided to keep unchanged the monetary policy rate and to maintain the existing levels of minimum reserve requirement ratios (MRR) on both leu- and foreign currency-denominated liabilities at 8% and 10%, respectively. During the year the MRR on foreign currency denominated liabilities has been reduced by 4 percentage points and in both cases the timing was connected with a Eurobond emission.

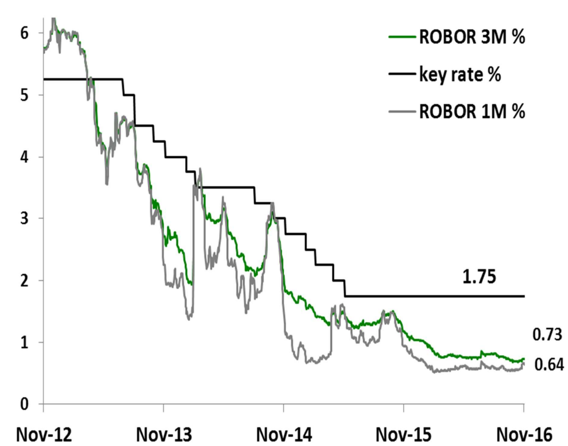
The easing monetary conditions are expected to be kept during the whole next year through inter-bank rates below the key rate. NBR may not sterilize yet the abundant liquidity (facility deposits kept at the NBR stood at RON 5.7 bn at the end of October) but it could narrow of the interest rate corridor (currently at +/-1.5%) and this should bring the interbank rates closer to the key rate.

DEEPENING DEFLATION AFTER SECOND VAT CUT, ANNUAL INFLATION OF CPI BY ITS COMPONENTS



Source: NIS, GarantiBank Research

VAT ADJUSTED CPI UNDER THE MONITOR OF NBR



Source: NBR, GarantiBank Research

6 from 24% to 20% implemented as of January 2016

7 prices excluding fruits, vegetables, fuels, administrated prices, tobacco and alcohol

8 Average CEE policy interest rate at 1.14% in 2017. Source: Focus Economics.

Fiscal policy

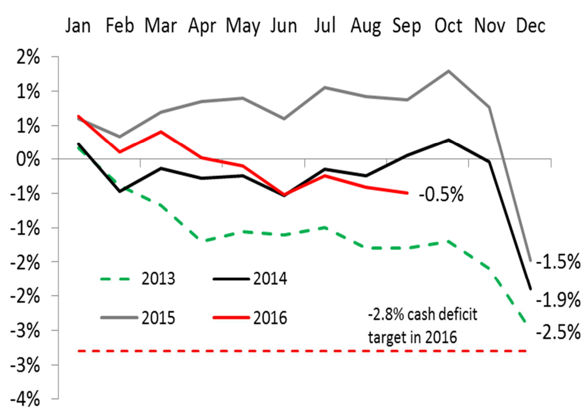
The budget deficit could finish the year below target

More signs point to the possible underrealization of the planned budget deficit of 2.8%. During the first 9 months, the budget deficit came at 0.5% whereas the target stood at 2.3%. The expenditure side has the largest deviation from the plan by RON 23.6 bn less[9], while revenues were lower by RON 9.6 bn. Considering the expected dynamics for the end of the year, the gaps seem to be concentrated in two items: capital and goods and services expenditures. The lower capital expenditure is partially explained by the low EU funds absorbtion rate, as the procedures for drawing from the 2014-2020 allocation have just been put in place. Also, from the political point of view, 2016 has been a transition year, with focus on local and parliamentary elections with less focus on investment decisions.

The risks for the budget deficit are higher for next year as there were several budgetary decisions taken by the parliament after the completion of last year's budgetary strategy. Some of them were already implemented, such as the increase in public wages by 5% in August 2016 with an annual impact of 0.3% in GDP. More measures are on the pipeline, adopted already by the parliament but blocked by president or the government, asking the opinion of Constitutional Court, arguing that they are not consistent with the fiscal responsability law. These blocked measures refers to the package of the elimination of 100 non-fiscal taxes which is estimated at 0.2% in GDP, further wage hikes of 15%yoy in health and education to be applied in 2017 (0.6% in GDP) and 33%yoy increase in pensions (1.5% in GDP). Still, the risk of adapting at least part of the measures exists and we could therefore see some efforts to counterbalance the effect of the above decisions. Investments could be reduced or we may witness increased tax base for certain tax payer categories next year.

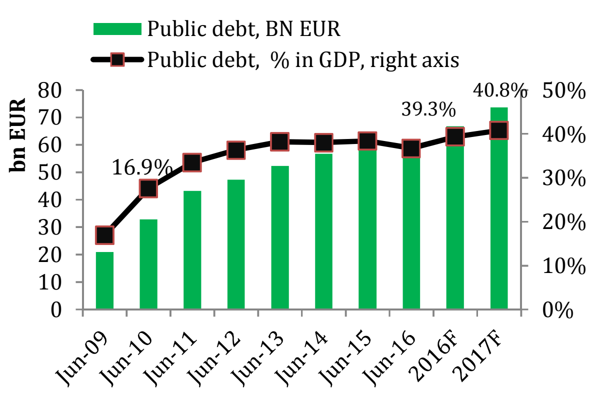
The planned higher deficit that will be recorded this year is not fully financed by additional debt, so public debt may not rise as fast. The Treasury used some funds from its existing buffer during the first 8M of the year the public debt to GDP dropped from 37.9% in the end of December, to 36.4% in August 16 as a result of fast GDP growth but also due to debt management strategy. We expect public debt to increase up to 39.3% in 2016 and reach 40.8% at the end of 2017, if a 2.9% budget deficit is realized. For the moment, there is no danger of an overshooting, as the country's internal and external imbalances are not significant.

BUDGET DEFICIT IS BELOW TARGET



Source: Ministry of Finance, GarantiBank Research

PUBLIC DEBT IS MANAGEABLE



Source: Ministry of Finance, GarantiBank Research

[9] First budget revision

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External Accounts and Financing

The curent account deficit is deepening

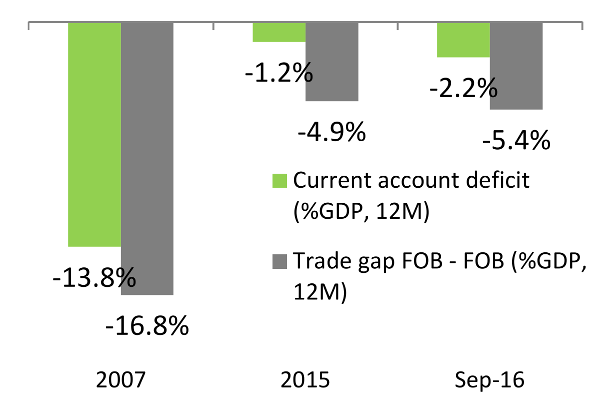
During the first 9M the CA deficit rose (EUR 2.7 bn) due to higher trade gap (+ EUR 6.4 bn), a direct effect of relaxed fiscal policy that stimulated consumption. We do not expect a deterioration next year as consumption pace will decelerate while the RON should be relatively stable. Higher inflow of EU funds could be supportive, while this year inflows from the 2014-2020 allocation were weak and procedures were just put in place.

The CA deficit was more than 100% covered by FDI which reached EUR 3 bn (+21%yoy) due to hikes in equity and as well as due to increased reinvested earnings. The latter shows that FDI financed firms recorded higher profitability so far this year. Unlike in 2015 which witnessed net portfolio outflows, during the first 9M there were some hot money net inflows as the international conditions and domestic monetary policy allowed further easing and therefore resulted in gains in holding long term debt (10 y yields dropped 85 bps in Jan- Sep). We noticed an increase in non-residents holdings of Romanian debt [10].

External debt increased during the first 9M to EUR 90.7 bn (+0.2 bn EUR) exclusively due to the public external debt (higher by 2.8% year to date at EUR 32.5 bn) in order to finance the higher budget deficit[11] while the private sector continues deleveraging. Banks' domestic sources are enough to fund new lending which is anyway mostly RON denominated so banks continue to reduce external financing; the process is also helped by the reduction in FX mandatory reserves. Companies appetite for new loans is not high enough so they do not tap external funds. Compared to 2008 levels intercompany lending flows (part of FDI) are insignificant: in 2008, there were EUR 4.2 bn net inflows while in 2015 there were EUR 0.8 bn net outflows. During the first 9M of 2016, intercompany lending slowely picked up, with net inflows of EUR 0.26 bn.

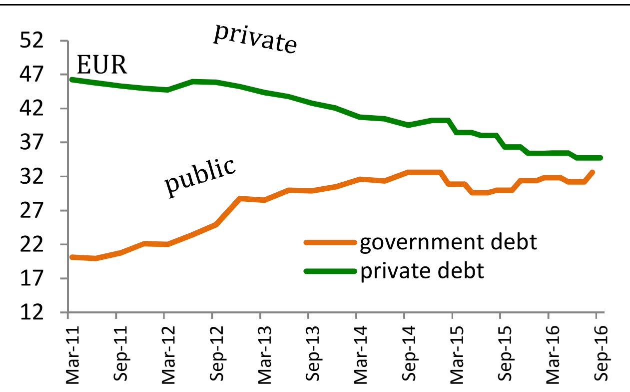
We expect public external debt to increase next year as the budget deficit needs will be at least at this year's level. However, due to tightening of Fed's policy, the appetite for RON debt could decrease and it might be compensated by higher Eurobond issuance compared to this year, when it stood at EUR 3.25 bn.

CURRENT ACCOUNT DEFICIT MORE THAN DOUBLED,



Source: Ministry of Finance, GarantiBank Research

THE PRIVATE SECTOR CONTINUES DELEVERAGING WHILE PUBLIC DEBT BUILDS UP



Source: Ministry of Finance, GarantiBank Research

[10] From 20.8 bn RON in Dec 15 to RON 22.6 bn in Aug 16.

[11] The Treasury tapped the external market for the third time at the end of September for EUR 1 bn in 2028 eurobonds at an yield of 2.15%.

Bank Flows

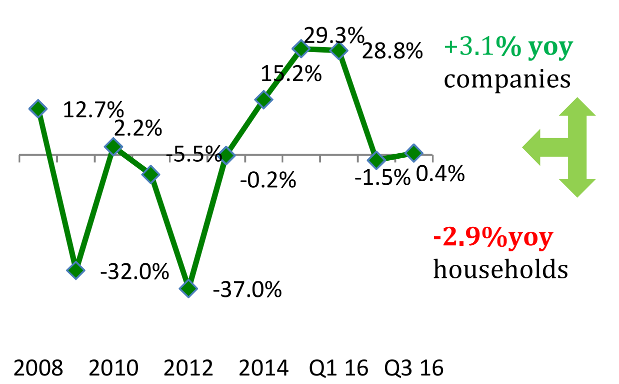
The pace of lending stagnates, but demand for investment loans increases

The third quarter witnessed a stagnation in lending activity, as loans grew by 0.8%yoy (FX adjusted), nearly like in Q2. Investment in the economy started to rise faster only this year and given the phase of the economic cycle, it is only expected to continue in the midterm. However, investment loan demands comes from large corporates, while SMEs are still struggling[12]. Sectorwise, it looks that construction firms are deleveraging while industry and agro firms are stagnating. Aparently, the appetite for lending to the real estate corporate segment is still not reignited, seven years after the crisis but real estate prices have just started to pick up, suggesting that demand is growing for residential segment and also for the retail spaces as consumption was strongly stimulated. Banks are still cautious in lending to construction firms and financing real estate projects in the context of tougher capital requirements (Basel 3) and unexpected change in legislation.

Looking at new loan flows, Q3 relatively weak activity (+0.4%yoy) was influenced by the scarcity of "First Home" funds, which were only supplemented in September, by another RON 500 mn, bringing the total guarantees at RON 2.7 bn (to fund RON 5.4 bn in loans). Otherwise, the incumbent trends show healthy advance in RON consumer loans (+12.7%yoy) legislation and price trends[13]. New corporate loans also picked up in Q3 (+3.1%yoy), continuing the trend that started in Q4 2013.

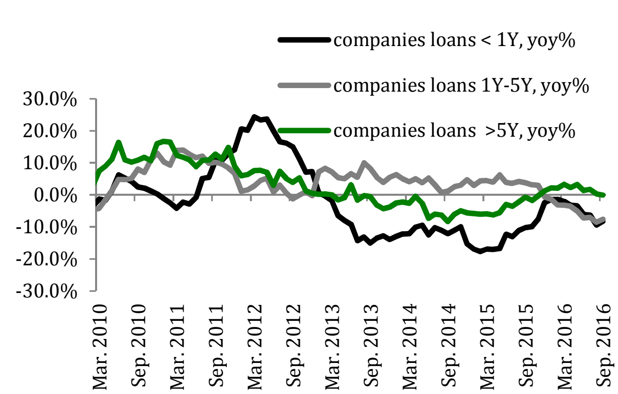
Looking forward, while the factors that support growth in retail lending are there, the VAT cut from 20% to 19% may postpone house acquisitions in December which is to be felt in RON mortgage lending, but overall trend remains positive. Prospects for 2017 are good, especially if the proposal to extend the First Home program by 5years passes through Parliament. Company lending is still stiff, but the investment component is already revived and the prospect of richer EU fund inflows correlates well with company loan demand. Overall, stock data may not be affected by write-off such as in the past[14], although the cleanup will continue in the next year.

NEW LOANS FOR COMPANIES PUSH UP LENDING FLOWS, WHILE RETAIL DROPS



Source: NBR, GarantiBank Research

INVESTMENT LOANS ARE GROWING BUT PORTFOLIO CLEAN UP CONTINUES



Source: NBR, GarantiBank Research

[12] August 2016, NBR lending survey
[13] In Q3, average DAE for RON mortgage loans was lower by 50 bps compared to EUR mortgage loans.
[14] NPL ratio hit 10.56% in August, while NBR expects it to be brought down to 10%.

Macroeconomic Data and Forecasts

	2013	2014	2015	2016F	2017F
Economy					
Nominal GDP, (EUR bn)	144.3	150.2	160.4	168.8	179.4
GDP per Capita (EUR)	7,205	7,532	8,055	8,495	9,051
Real GDP, (% yoy)	3.5	3.0	3.8	4.3	3.7
Population, (mn)	20.0	19.9	19.9	19.9	19.8
Avg net monthly wages (EUR, nominal)	352	379	408	455	492
Avg net monthly wages (% yoy, RON)	4.8	7.5	8.9	11.2	8.0
Unemployment rate, ILO, avg	7.1	6.8	6.8	6.1	5.8
External Accounts					
Current Account (EUR bn)	-1.5	-1.0	-1.8	-4.7	-6.1
Current Account (% of GDP)	-1.1	-0.7	-1.1	-2.8	-3.4
Export (EUR bn)	49.6	52.5	54.6	57.3	60.8
Import (EUR bn)	55.3	58.5	63.0	68.6	73.4
Export (% yoy)	10.1	5.8	4.1	5.0	6.0
Import (% yoy)	1.2	5.8	7.6	9.0	7.0
Trade balance FOB-CIF (EUR bn)	-5.8	-6.1	-8.4	-11.3	-12.7
Trade balance FOB-CIF (% of GDP)	-4.0	-4.0	-5.2	-6.7	-7.1
Net FDI (EUR bn)	2.9	2.7	2.8	3.6	4.3
Net FDI (% of GDP)	2.0	1.8	1.7	2.1	2.4
Internat. reserves incl. Gold (EUR bn)	35.4	35.5	35.5	35.8	38.0
Gross Foreign Debt (EUR bn)	98.1	94.7	90.9	90.4	95.5
Gross Foreign Debt (% of GDP)	68.0	63.1	56.7	53.4	53.4
Fiscal Accounts					
Budget Balance (% of GDP)	-2.5	-1.9	-1.5	-2.9	-2.9
Public Governmental Debt (% of GDP)	37.7	39.4	37.9	39.3	40.8
Inflation/Monetary/FX					
Inflation (CPI) yoy, eop	1.6	0.8	-0.9	0.0	2.0
Inflation (CPI) yoy, yearly average	4.0	1.1	-0.6	-1.4	1.9
Central bank reference rate, eop	4.00	2.75	1.75	1.75	1.75
Central bank inflation target	2.50	2.50	2.50	2.50	2.50
1M Robor, eop	1.88	0.91	0.69	0.60	1.30
1M Robor, avg	4.05	1.88	1.11	0.60	0.98
EUR/RON, eop	4.48	4.48	4.52	4.52	4.51
EUR/RON, avg	4.42	4.44	4.45	4.49	4.52

Completed on 23rd November 2016.

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