Romania facing heat of regional conflict

Radu Craciun
Chief Economist

Dumitru Dulgheru
Senior Analyst

Heightened rumors about a potential debt restructuring of Ukraine as well as commercial sanctions on Russia raise questions on the magnitude to which Romania could be affected by such developments. Only to a very limited extent, in our opinion. The main challenge is to secure over the next eight months an alternative to the gas supply coming from Russia.

Regional political context

After President Yanukovych, in late November, turned down the European Union by not signing an association agreement, tens of thousands of protesters overran the streets of Kiev and Lviv. In justifying his decision, President Yanukovych said that the country could not afford to abandon trade with Russia, trumping the EU's offer to lend Ukraine EUR 610mn. Instead, he added, Ukraine needs around EUR 20bn to bring the economy up to European standards.

Without elaborating on the conflict, we limit ourselves to noticing that protests flared up again in February, when violent clashes between protesters and security forces resulted in a significant number of deaths and casualties. The whirlwind of political events culminated in Yanukovych fleeing to Moscow and an interim cabinet settling in under President Turchynov. Meanwhile, Moscow sent military forces to protect ethnic Russians living in Crimea.

Is Ukraine going to default?

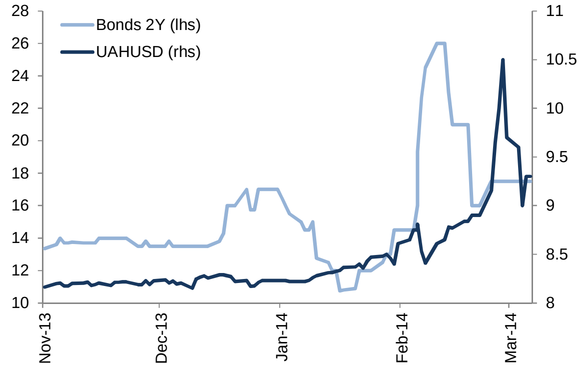
The first seeds of doubt regarding a potential default were planted by the Russian deputy finance minister in late February, after stating that the risk is low of Ukraine defaulting on USD 3bn in Eurobonds bought by Russia.

Some macro numbers are not too encouraging. FX reserves (gold not included) plunged quickly to around USD 12-14bn in only two months (from USD 19bn in December 2013), while the level of external debt completely overshadows the FX reserves.

Capital flight becomes highly volatile during such turbulence. If the central bank is unable to stop it, then the UAH crisis could accelerate. After spiking to 11 against the USD on February 27, the UAH has caught its breath, but even so it has still shed around 13% since the beginning of the year, trading currently at 9.3. Central bank Chairman Stepan Kubiv reassured recently that the bank was taking measures to stop capital flight from Ukraine, which has jumped since protesters took to the streets in November.

Ukraine is now looking to the International Monetary Fund (IMF) for support, while assistance from Russia is conditional. Meanwhile, the European Union has offered a much bigger aid package of around USD 15bn in loans and grants over the next several years, but the funds will only be disbursed jointly with an IMF agreement. The European Commission said that the assistance would also entail extensive reforms, which most likely could affect economic growth in the period going forward. Main donors under this facility would be the EU budget and EU international financial institutions (European Investment Bank, European Bank for Reconstructions and Development, etc.)..

UAH and 2-year government bond development



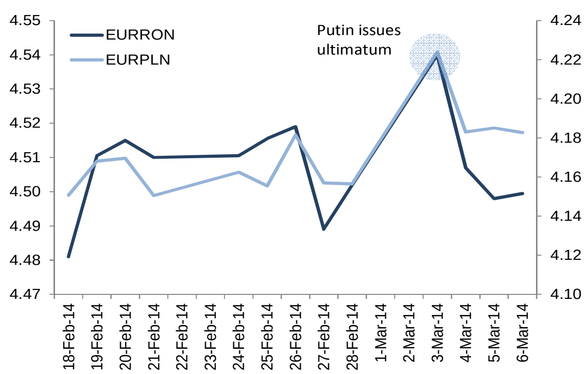
Source: Central bank, BCR Research

Ukrainian bond prices have come under pressure, despite prospects of a multi-billion dollar international bailout; the state of the country's economy and the sheer weight of debt repayments make restructuring pretty likely, with or without a joint IMF-EU bailout. Apart from that, increasingly tenuous relations with Moscow could bring additional retaliation from the Russian side, such as a significant increase in the natural gas price. Markit estimates the probability of default at around 50%.

What would be the implications for Romania of Ukraine defaulting?

So far, we have witnessed rather limited short-term contagion in the region, mainly last Monday, after President Putin issued an ultimatum to the Ukraine forces to withdraw from Crimea. The RON and PLN were quick to react, but then climbed back after Putin backtracked on his previous warlike statement.

RON and PLN developments vs euro



Source: Central bank, BCR Research

For the period to come, for a number of reasons listed below, we see a limited impact on Romania from a possible default by Ukraine, but further saber-rattling from Russia will echo much more loudly among investors, as we have already seen.

(i) **Quality differentiation**. Romania is an EU and NATO member with a stable economy and no macro imbalances (small C/A deficit, budget deficit and public debt fully in line with Maastricht criteria). Romania has successfully completed two IMF/EU programs and entered into another precautionary arrangement as of 2013. Romania has made big steps towards public finance consolidation, which resulted in an impressive reduction in the budget deficit to 3%, from 9% just a few years ago. Romania is rated as investment grade by two major rating agencies (Moody's and Fitch). Moreover, Romania's trade and investment ties with Ukraine are weak.

Foreign trade with Ukraine (FY12)

Export	EUR mn.	%	Import	EUR mn.	%
Minerals	392	0.9	Minerals	141	0.3
Chemicals	68	0.2	Wood, excluding	60	0.1
Vegetals	57	0.1	Chemicals	22	0.0
Plastic & rubber	45	0.1	Vegetals	13	0.0
Wood, excluding fu	42	0.1	Plastic & rubber	4	0.0
TOTAL	**842**	**1.9**	**TOTAL**	**501**	**0.9**

Source: INS

(ii) **Financial markets**: Except for belligerent statements or a conflict escalation between Russia and Ukraine, which is less likely, bearing in mind the huge difference in the balance of military forces, we do not see significant risks to the price of Romanian assets. The RON could take a short knock, shedding no more than 1-2%, if indeed things take a turn for the worse. The exit of foreign investors from local bonds might put some pressure on the FX rate, but the central bank should stand guard and make use of its managed floating regime in the case of volatilities running high. Romanian bond prices should be affected short-term, moving by no more than 20-30bp, but so far no major moves on the local market have been reported. The fact that Romania has turned from the periphery into an emerging market for fixed income investors and the solid macro picture should provide sufficient confidence.

Impact on Romania from eventual EU embargo on Russia

A few days ago, the European Union warned Russia of possible sanctions if Moscow refuses to call back its troops from Ukraine, and offered to mediate between the two parties, alongside other international bodies. The reaction from Germany, France and Britain seemed a bit more placatory, throwing the emphasis on mediation possibly via the Organization for Security and Cooperation in Europe (OSCE), but did not rule out tougher measures if Moscow does not relent. The US threatened Moscow with suspending trade talks and all military engagements over Ukraine.

Under a worst-case scenario, the main risks for Romania stemming from potential economic restrictions on Russia could be transmitted directly or indirectly via a number of channels:

a) Shrinking exports
b) Cutting natural gas supply
c) Impact on global commodity market (e.g. oil price)

The share of Romanian exports to the Russian Federation currently stands at 2.8% (rank 9), while the share of imports is 4.1% (rank 6). Trade deficit with the Russian Federation amounts to EUR 0.7bn. Main exporting industries are 'transport equipment' (34%; in this case, we would suspect Dacia as the main contributor), 'electric equipment' (21%) and 'chemical products' (14%). As for imports, natural gas takes the lion's share in terms of volumes, accounting for no less than 88% of total imports from Russia.

Foreign trade with Russia (FY12)

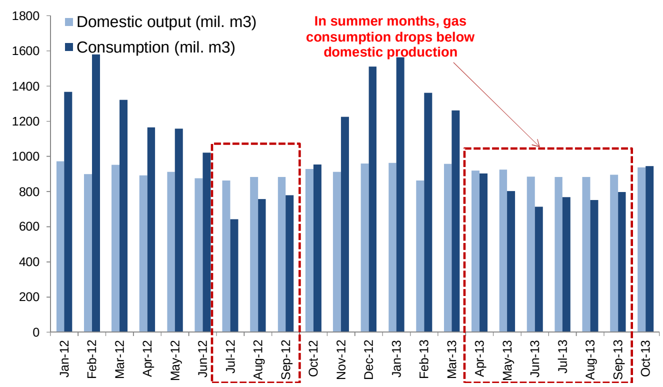
Export	EUR mn.	%	Import	EUR mn.	%
Transport eqpt.	357	0.8	Minerals	2,108	3.9
Chemicals	151	0.3	Plastic & rubber	91	0.2
Electric eqpt.	226	0.5	Basic metals	66	0.1
Basic metals	68	0.1	Paper	29	0.1
Plastic & rubber	62	0.1	Electric eqpt.	26	0.0
TOTAL	**1,052**	**2.3**	**TOTAL**	**2,392**	**4.4**

Source: INS

Regarding an eventual natural gas shutoff, it is worth emphasizing that it could be triggered not only by a commercial embargo on Russia, but potentially sooner (and more likely) by a Russian decision to stop deliveries to Ukraine, due to the unpaid USD 2bn bill, a repeat of the 2009 scenario. The impact of such a development on the energy security of Romania should be judged in the following context:

(i) The annual natural gas consumption of the country stands at 145 TWh, of which 80% is covered by domestic resources.
(ii) Romania is the third least energy-dependent country in the EU.
(iii) The consumption of natural gas shows a high seasonal profile, making it possible for Romania to entirely draw upon its own resources to meet consumption needs.

Gas consumption vs production (2012-2013)



Source: INS

In an emergency, black oil and coal can be substitutes for the natural gas, as far as the production of electricity is concerned.

As for the impact on global commodity prices, one should bear in mind that Russia is the second largest oil exporter, right after Saudi Arabia. Therefore, an embargo on oil could have an impact on the global oil price and on Romania's import prices as well. Although other producers would be ready to increase production, the disruption could still trigger some fuel price adjustment and, consequently, some inflationary pressures in Romania, albeit from an already low level.

Conclusions:

On balance, the impact on Romania should be rather limited, given the rather weak commercial relationship between Romania on one hand and Ukraine and Russia on the other hand. The 'automotive' industry could to a certain point be affected (5% of exports are bound for Russia), as well as 'electric equipment' (6% exports to Russia), but not in a dramatic way. The energy security of Romania could be impacted to a small extent in the short run. Also, until next winter sets in, alternative solutions could be found, such as ‘accumulation of new reserves’, the ‘use of alternative resources’ and ‘finding additional suppliers’. At the same time, as Romania is perceived to be in a different ‘economic league’ than Ukraine, an eventual default of Ukraine is likely to have a limited impact on Romania. Of course, open war between the two countries would dramatically change the whole picture.