National Bank of Romania

Romania: Recent Macroeconomic & Banking System Developments

Mugur Isărescu
Governor

30 April 2014

CONTENTS

Macroeconomic Snapshot

Before the crisis

- Fast economic growth in 2001-2008 (6.3% average annual growth) fuelled by large capital inflows:
  - ✓ Rapid wage growth and readily available credit led to a real-estate and consumption boom
  - ✓ An expansionary fiscal policy further contributed to the overheating of the economy

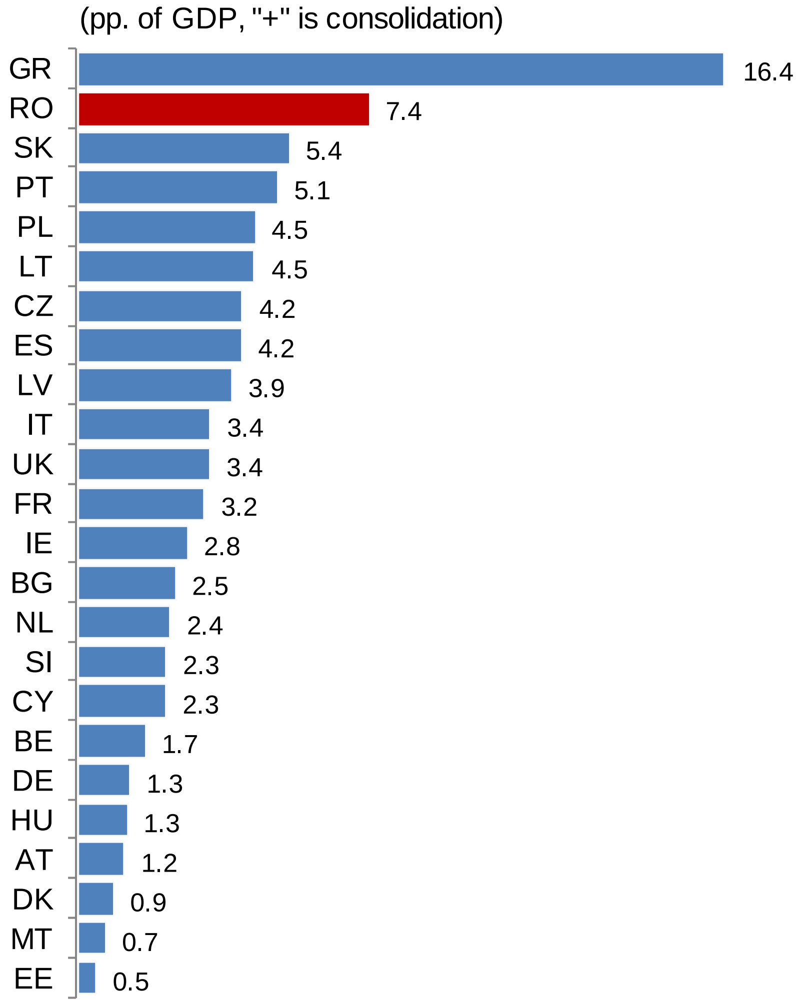
⬇

- Build-up of large imbalances in the pre-crisis period ➡ vulnerability of the economy at the crisis onset
  - ✓ Large structural fiscal imbalances ➡ no room for fiscal stimulus, consolidation unavoidable given financing constraints
  - ✓ Sizeable external disequilibrium (the current account deficit peaked at 13.4% of GDP in 2007)

Necessary adjustments already made

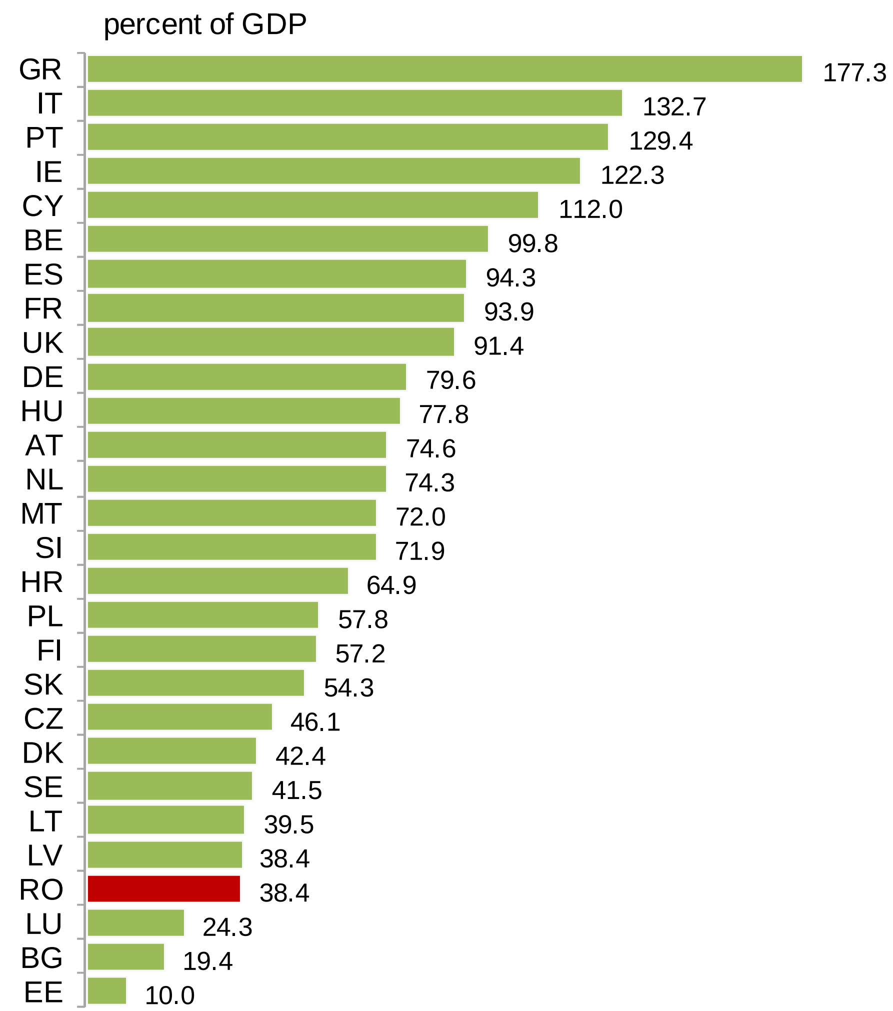
- The current account deficit declined to sustainable levels (4.4% of GDP in 2012, 1.1% of GDP in 2013)
- Sharp fiscal consolidation brought the deficit back into the comfort zone (below 3% in 2012, narrowing further to 2.3% in 2013, down from 9% in 2009)
  - ✓ The deadline for the adjustment of the excessive deficit (2012) was complied with
  - ✓ Despite growing rapidly during the crisis, the public debt-to-GDP ratio is still one of the lowest in the EU and is estimated to stabilize below 40% of GDP over the medium term

Cumulative structural fiscal consolidation 2010-2013



Public Debt (2013)

– according to ESA95 –



Source: AMECO

Outlook for 2014 and beyond

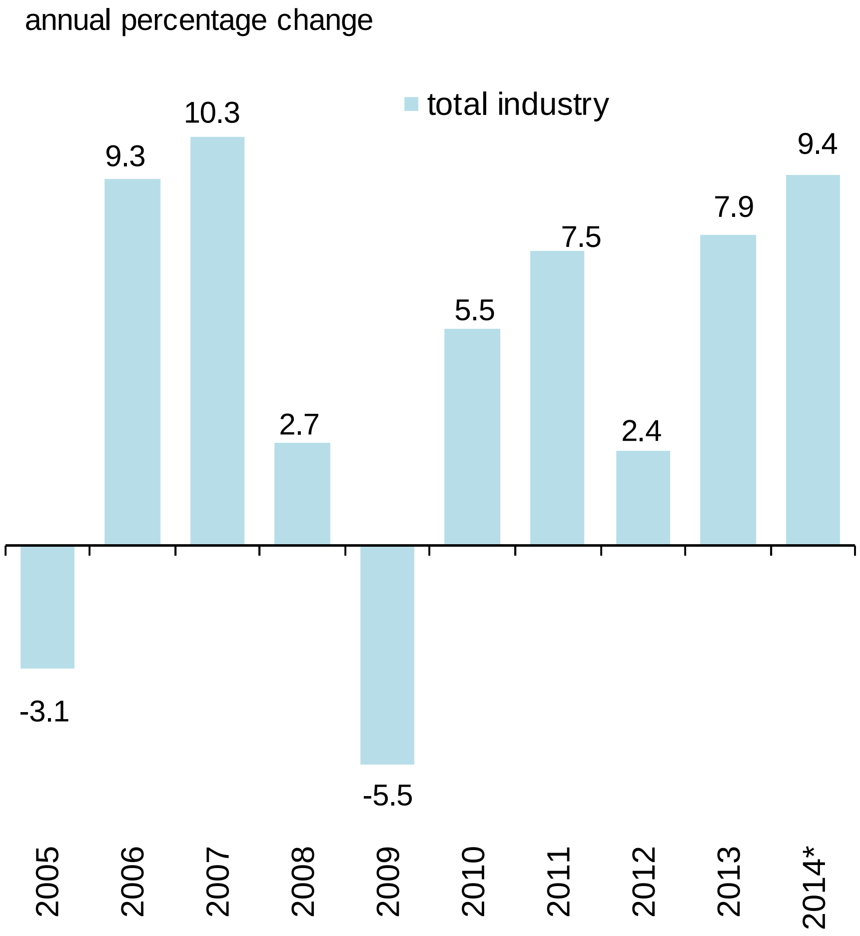
- Expected macroeconomic outcomes in 2014:
  - ✓ Economic growth looks set to continue
    - current forecasts average around 2.8%, yet recent forecasts indicate higher growth (above 3%) than earlier ones
      - as always, agricultural output may shift the actual outcome in either direction
  - ✓ Average annual inflation is estimated at around 2%, consistent with the ECB's definition of price stability
  - ✓ The fiscal deficit will stay below the Maastricht Treaty limit of 3% of GDP
  - ✓ The current account deficit is expected to stay relatively close to its 2013 level (between 1% and 2% of GDP)
- Given its macroeconomic fundamentals, Romania appears firmly embarked on a sustainable growth trend in the medium run, while actual outcomes depend on regional, European and global developments
- In this context, Romania envisages joining the Banking Union and the euro area when the appropriate conditions are in place

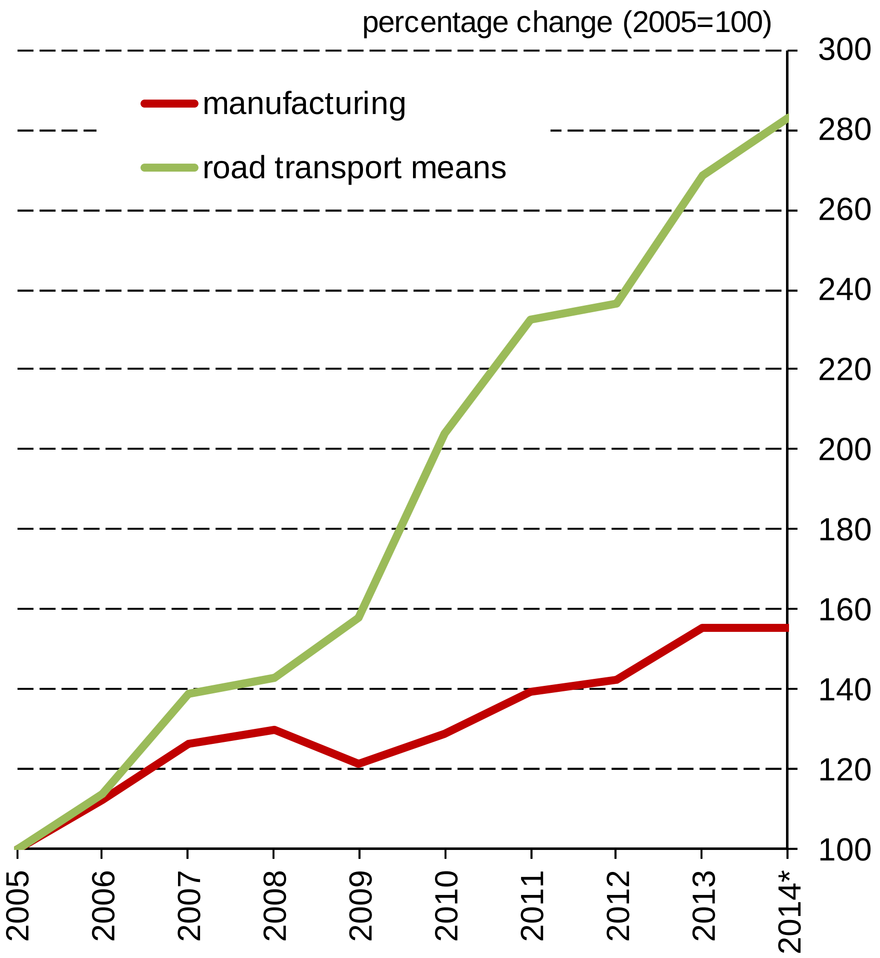
GDP Dynamics

GDP growth accelerated in 2013

- After a cumulative 7.6% contraction over 2009-2010, real GDP re-entered positive territory in 2011 and grew by 3.5% in 2013
- In 2013, there was a shift in the drivers of economic growth, from domestic absorption to net exports
  - ✓ However, there was a significant one-off component of economic growth, related to the plentiful harvest (1.1 pp contribution of agriculture to real GDP growth)
- Economic activity is expected to grow further in 2014, as suggested by current developments in short-term indicators (industrial production and retail sales in particular)

Fast growth in the automotive sector has been the largest contributor to the favourable performance of the overall industrial sector

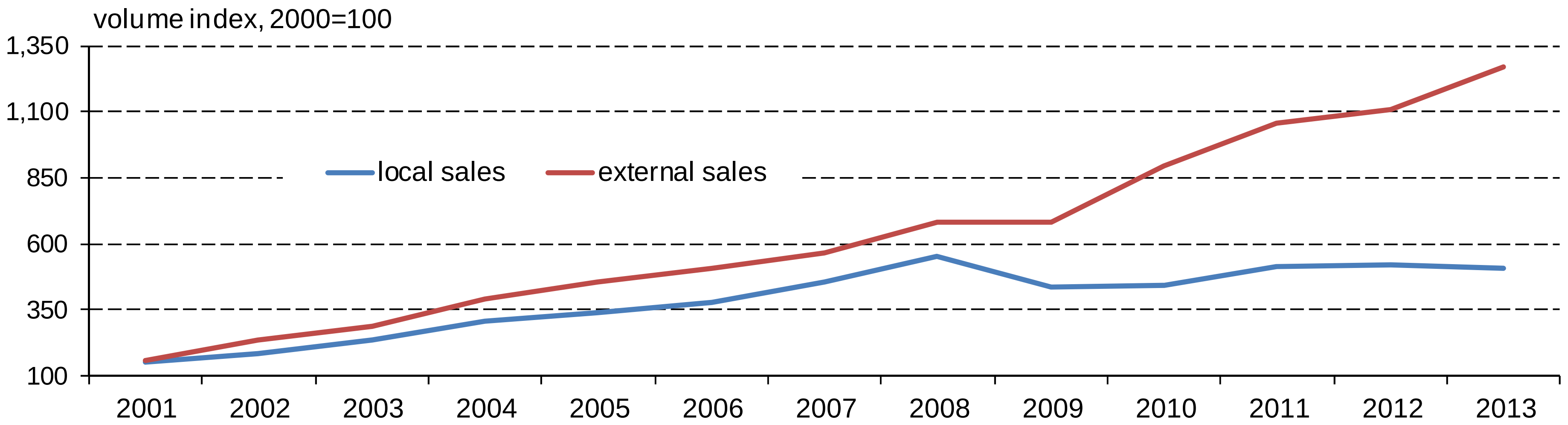


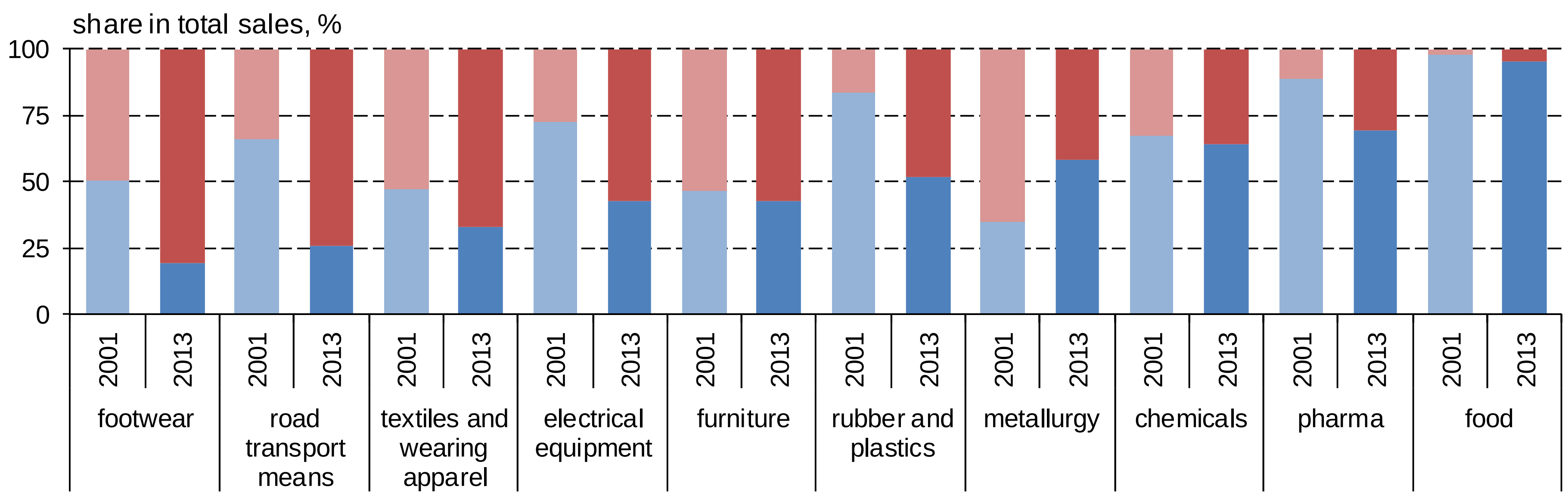


*) Jan.-Feb.

Source: NIS

Improved access to external markets favoured industrial expansion





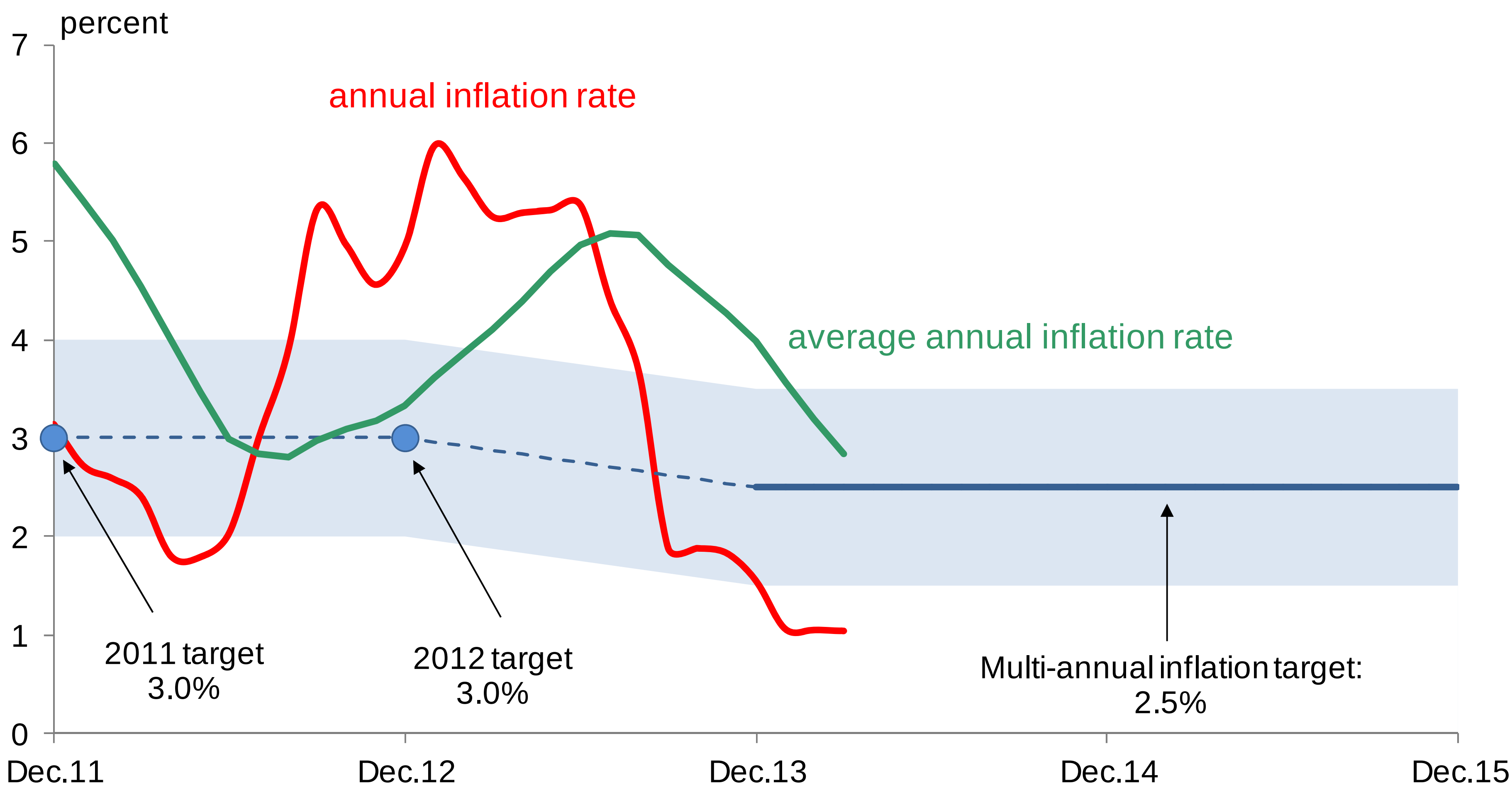
Source: Eurostat, NBR calculations

Inflation Developments

Romania joined the club of low-inflation countries

- Currently, the annual inflation rate is in line with the ECB's quantitative definition of price stability
- After staying above 5% throughout 2013 H1, annual CPI inflation fell markedly to 1.55% in December 2013 and hit a new record low of 1.04% in March 2014 in the context of:
  - ✓ Persistence of the negative output gap
  - ✓ Favourable developments in supply-side factors
    - the fall in agricultural commodity prices (as a result of good harvest in 2013)
    - the cut in the VAT rate on some bakery products from 24% to 9% as of 1 September 2013
    - the year-on-year decline in global commodity prices
  - ✓ Downward statistical base effects linked to past increases in food and administered prices
- Inflation is expected to re-enter the target band in 2014 Q3 and to remain there throughout the projection horizon

Inflation rate



Note: Variation band is ±1 percentage point around the central target.

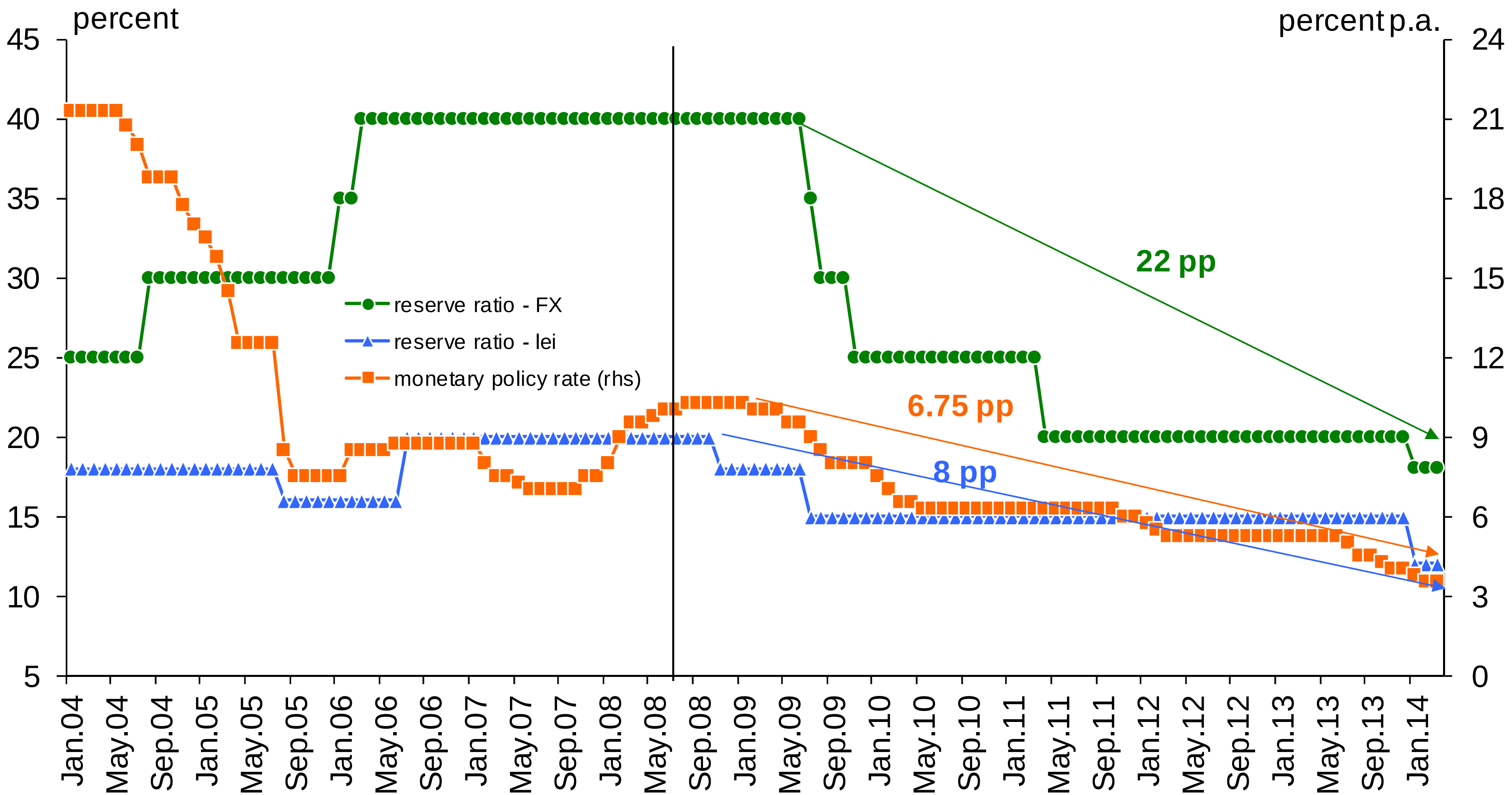
Source: NIS, NBR

Monetary Policy

Monetary policy conduct brought credit market parameters into line with regional levels

- Over the past years, the NBR has maintained a prudent stance of monetary policy, by gradually reducing the policy rate:
  - ✓ Between February 2009 and March 2012, the NBR cut the policy rate by a cumulative 500 basis points, to 5.25%
  - ✓ Rapid decreases in the annual inflation rate made it possible for the NBR to resume the downward adjustment of the policy rate: between July 2013 and February 2014, the NBR cut the policy rate by a cumulative 175 basis points, to 3.5%
- Current policy and money market rates, as well as lending and deposit rates for non-bank customers, are broadly in line with regional levels
- In January 2014, in order to support sustainable lending, but also to bring the minimum reserve requirements mechanism closer to ECB standards, the NBR cut the MRR:
  - ✓ On leu-denominated liabilities to 12% from 15%
  - ✓ On foreign currency-denominated liabilities to 18% from 20%

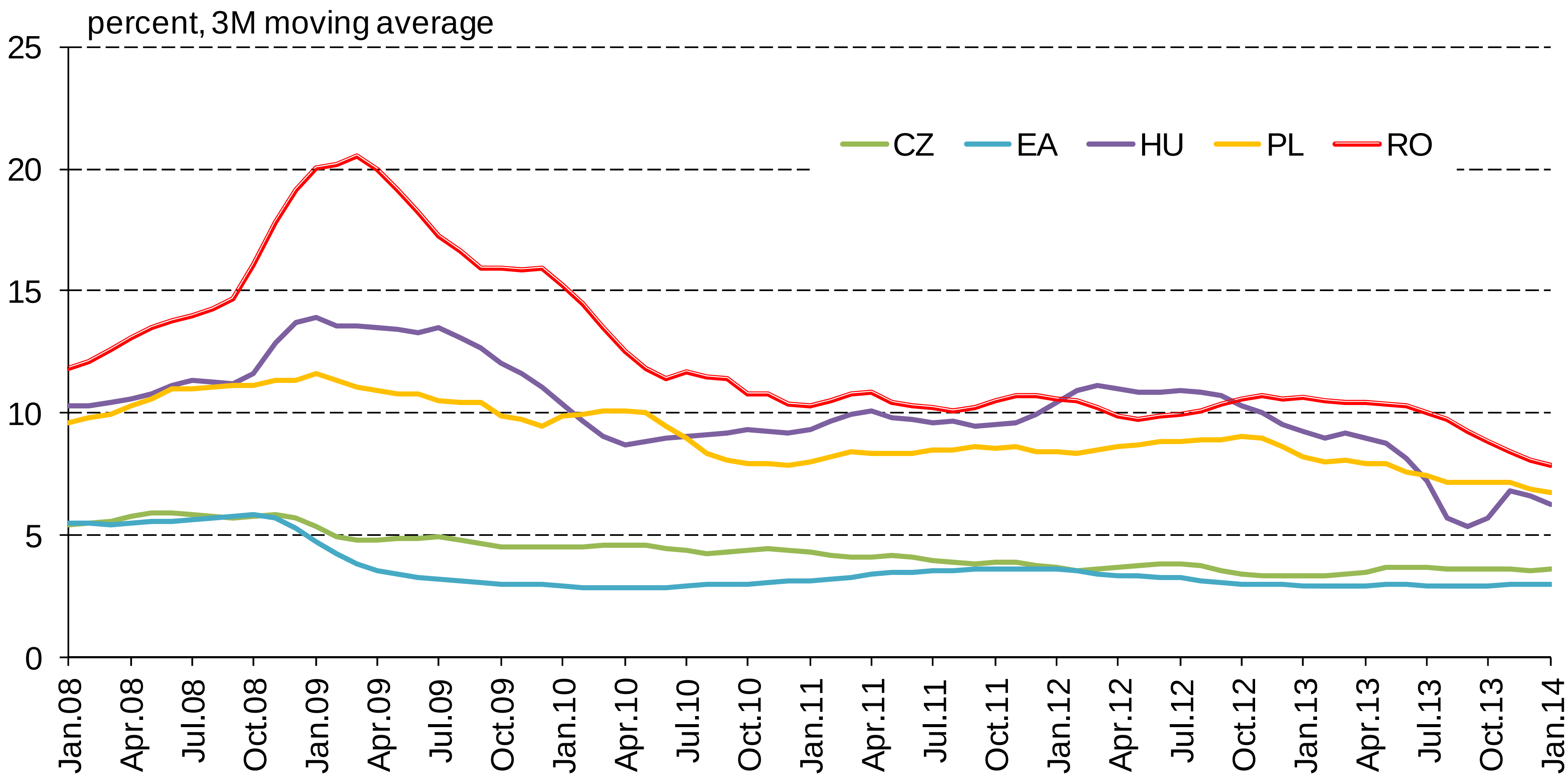
Monetary policy conduct was countercyclical both before and after the crisis outbreak



Source: National Bank of Romania

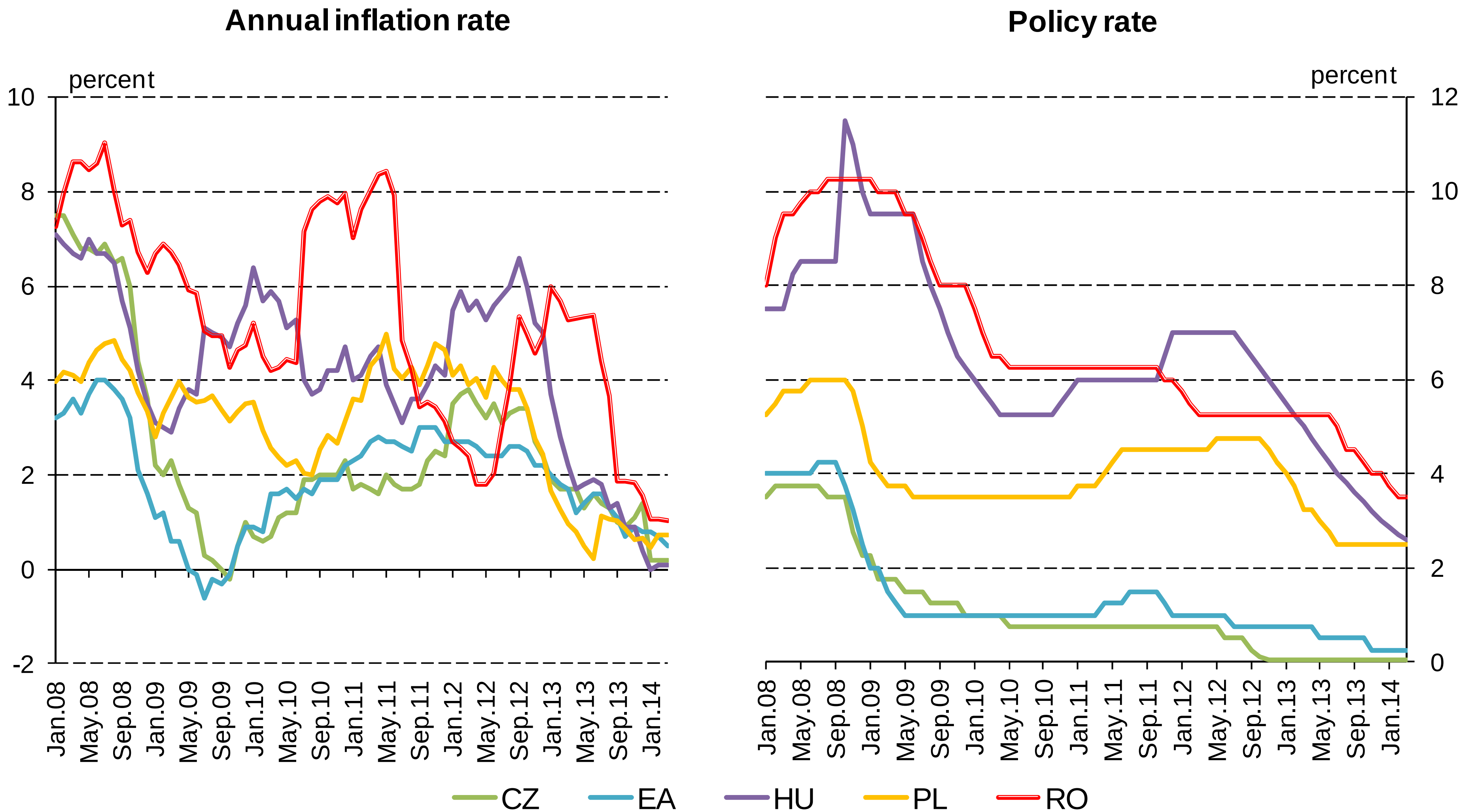
Lending rate on new business got closer to regional levels, albeit with a certain lag …

Average lending rate on new business, all sectors



Source: ECB, national central banks

... as higher inflation delayed the start of the policy rate-cutting cycle in Romania



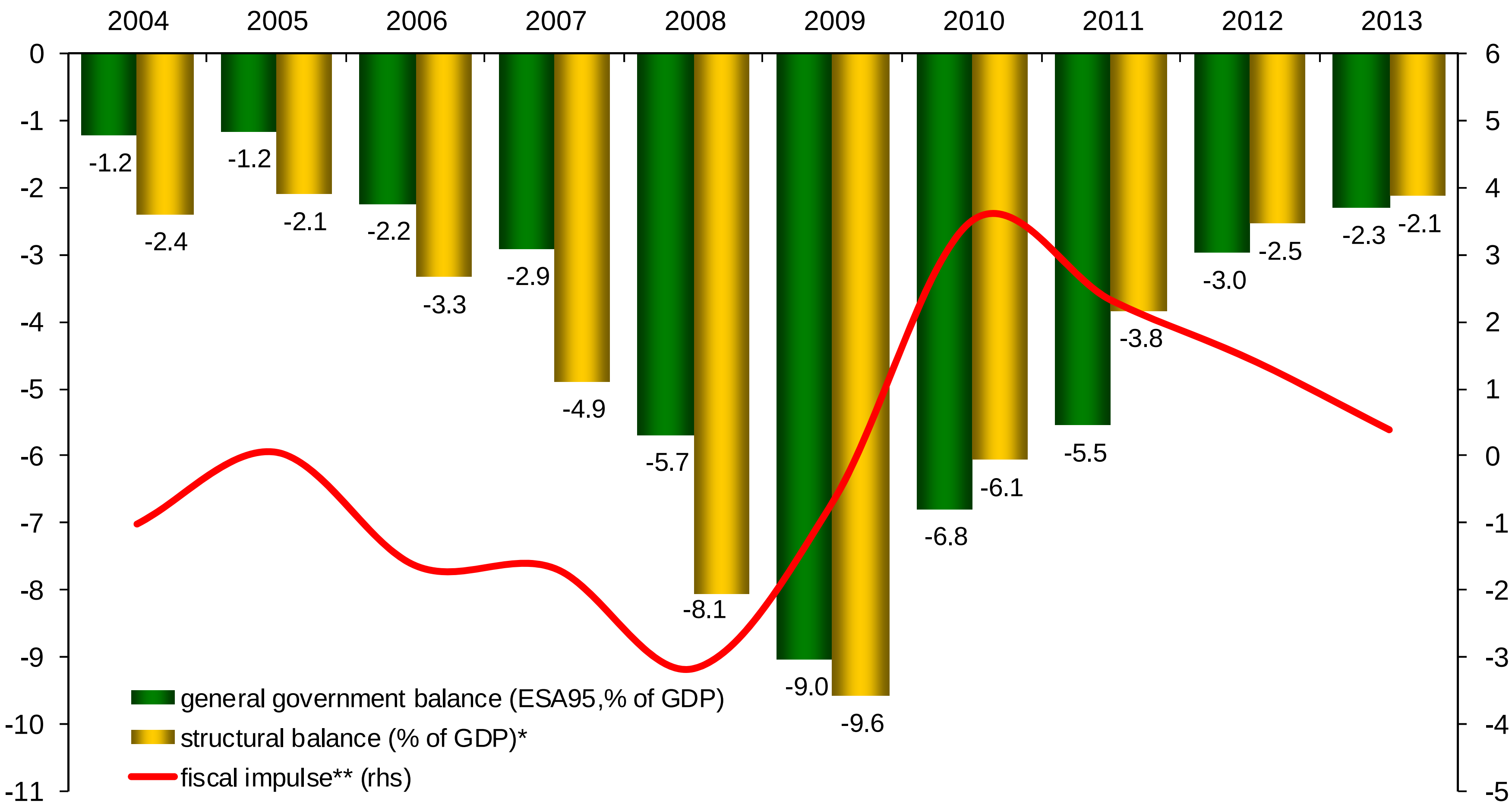
Source: ECB, national central banks

Fiscal Policy

Fiscal consolidation largely completed

- After years of pro-cyclical fiscal policy, Romania was left with a **large structural fiscal gap at the onset of the economic crisis** (-8.1% of GDP at the end of 2008) and with no other choice but to embark on a **sharp fiscal consolidation process**
- After peaking at 9% of GDP in 2009, the public deficit was successfully brought down to just below 3% as of end-2012, thus complying with the deadline under the excessive deficit procedure; the deficit declined further to 2.3% of GDP in 2013
- The **structural adjustment effort** amounted to a cumulative 7.4 pp of GDP during 2010-2013 (the second largest in the EU) and it was achieved through a mix of revenue and expenditure measures, with the latter accounting for the larger share
- A comparatively smaller structural adjustment effort remains to be implemented over the coming two years (1.1 pp of GDP) in order to ensure that the **medium-term structural deficit objective** of 1% of GDP is met in 2015, thus complying with commitments under the Fiscal Compact

After three years of sharp consolidation, the budget balance is back into the comfort zone



* defined as cyclically-adjusted balance net of one-off and temporary measures

** defined as the change in the structural primary budget balance

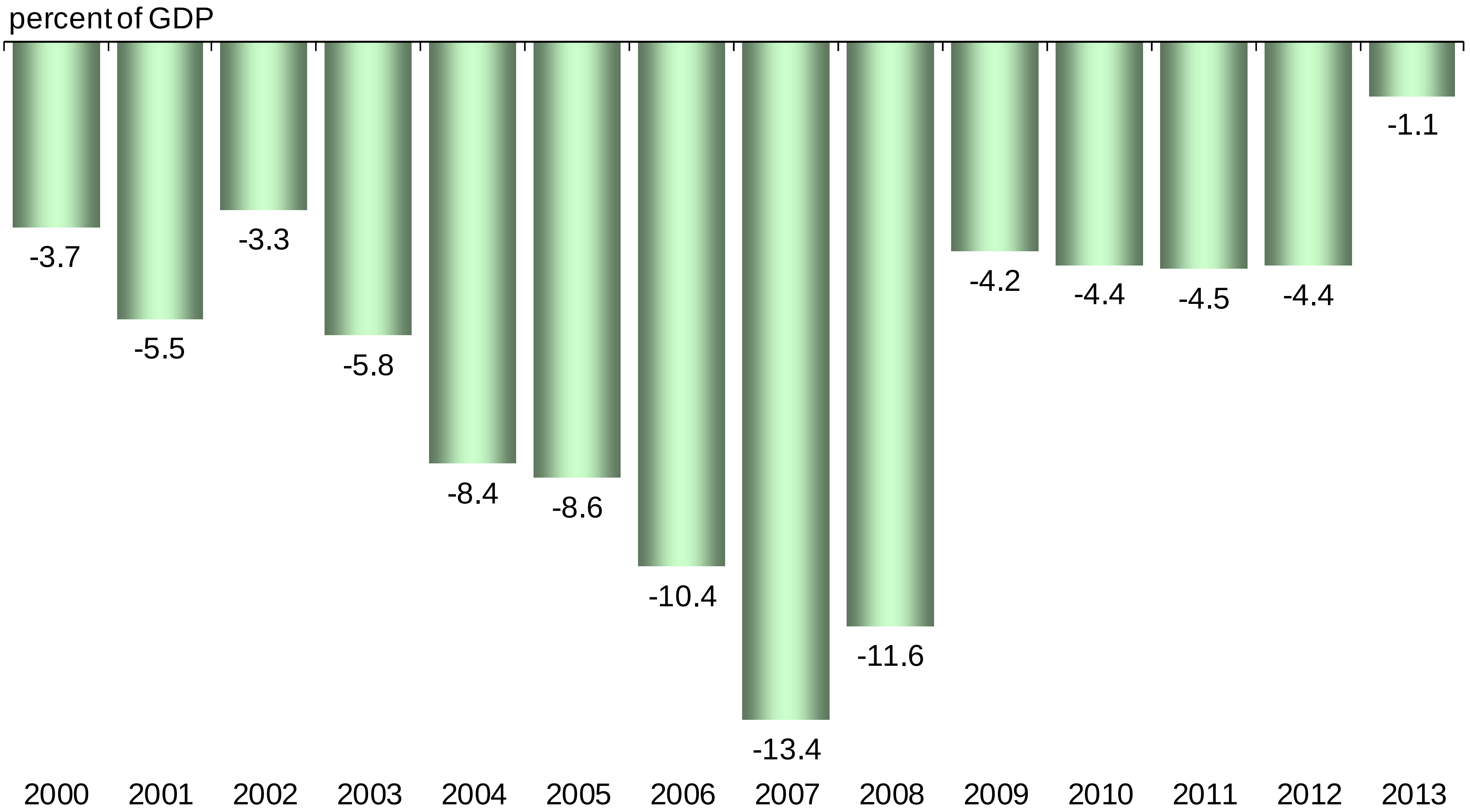
Source: AMECO, Ministry of Public Finance, European Commission

Current Account

Significant adjustment of the external imbalance

- The current account deficit narrowed markedly from a peak of 13.4% of GDP in 2007 to 4.2% in 2009, driven by the private sector and supported by fiscal consolidation
- After hovering around 4% of GDP in the following three years, the current account deficit further fell to 1.1% of GDP in 2013 amid
  - ✓ The trade deficit narrowing by 53.6% yoy
  - ✓ The larger services surplus, prompted particularly by receipts from transport services (in correlation with higher exports of goods)
- Recent projections for 2014 and 2015 point to levels below 2% of GDP, in line with the gradual consolidation of domestic demand
- At end-March 2014, international reserves stood at EUR 34.4 bn (out of which EUR 31.3 bn forex), covering over 6 months of prospective goods and services imports

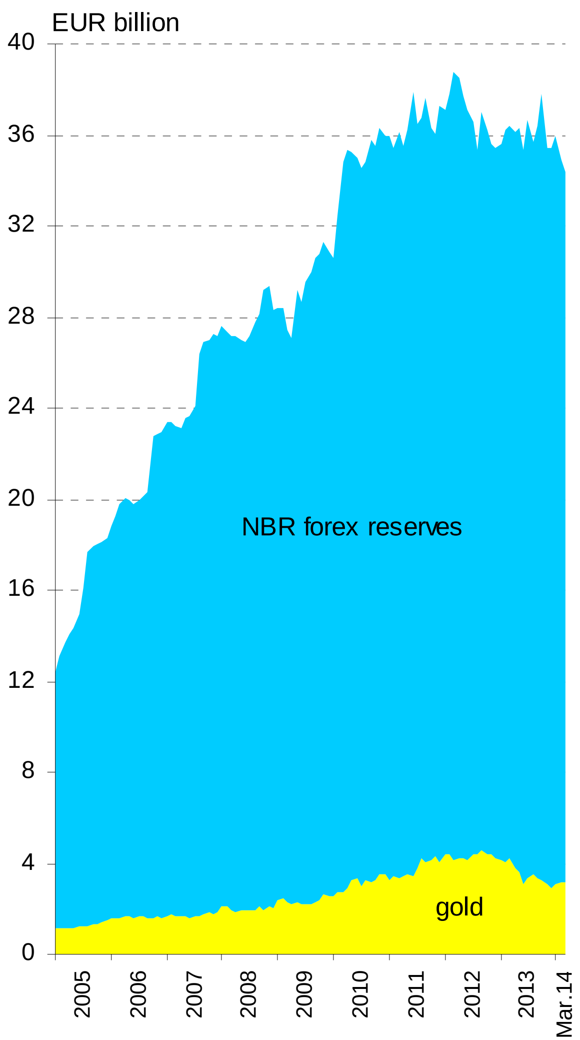
Current Account Balance



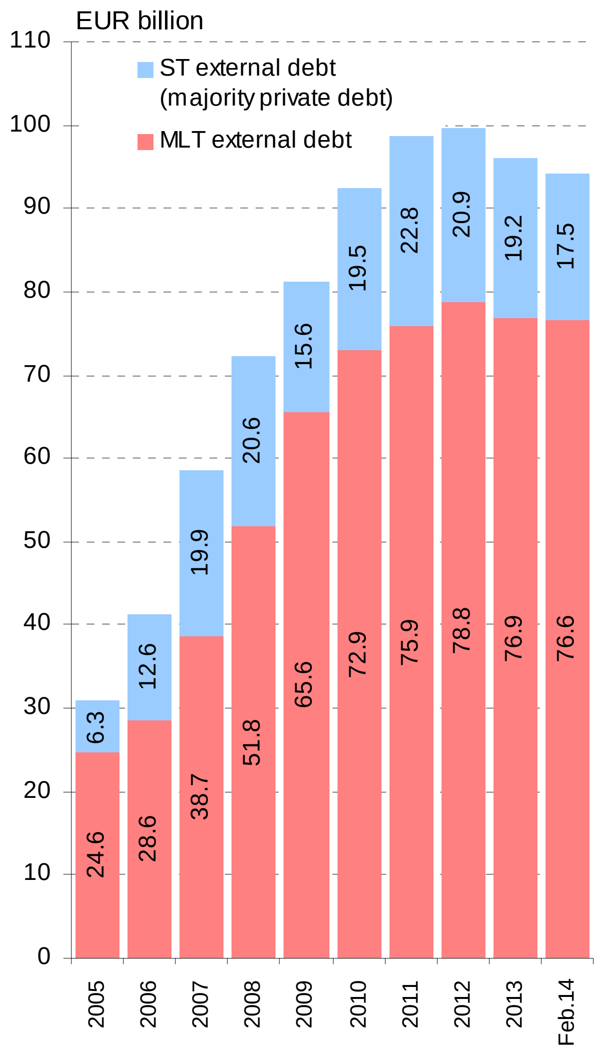
Source: National Bank of Romania, National Institute of Statistics

International reserves and external debt

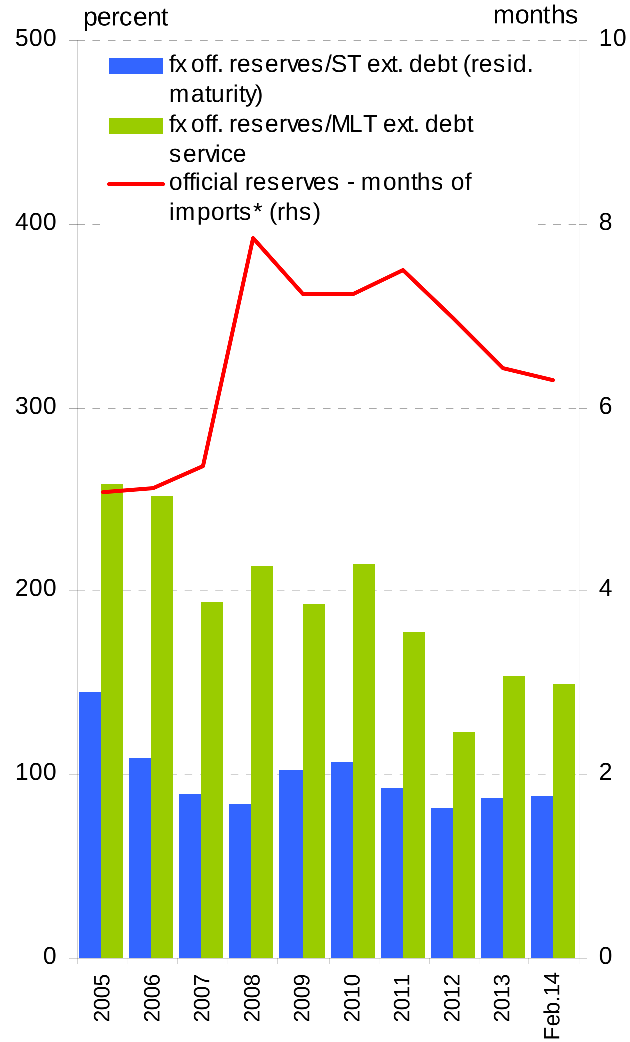
International reserves



Total external debt



Reserve adequacy



*) prospective imports of goods and services

Source: National Bank of Romania

Banking System

The banking system remains sound

- The banking system is well capitalized, with the average capital adequacy ratio at 15% (headline) and 13.7% (CT1) at end-2013
  - ✓ The NBR is exercising tight oversight of prudential indicators, with a focus on capital adequacy dynamics and banks' efforts to raise additional capital
  - ✓ Most banks exceed the conservative 10% threshold recommended by the NBR (against the required level of 8%)
  - ✓ No public funds have been used so far to support the banking sector
- The liquidity ratio (effective liquidity/required liquidity) remained adequate (1.5 in February 2014)
- In 2013 the banking system profitability re-entered positive territory and remained positive in early 2014

The banking system remains sound (2)

- NPLs continued to increase in 2013 and early 2014, albeit at a slower pace than in previous years, mainly due to
  - ✓ Revaluation of the quality of previously-restructured loans
  - ✓ Constraints on customers' financial standing
- Provisioning of NPLs is adequate
  - ✓ NPL coverage with IFRS provisions and prudential filters remained at a comfortable 89.7% at end-February 2014
  - ✓ If only IFRS provisions are taken into account, the degree of NPL coverage was 67.6% at end-February 2014

Orderly financial deleveraging in the crisis aftermath

- The loan-to-deposit ratio fell to 101.8% in March 2014, underpinned by credit to the private sector declining by 3.7% yoy in real terms and bank deposits increasing by 5.5% yoy

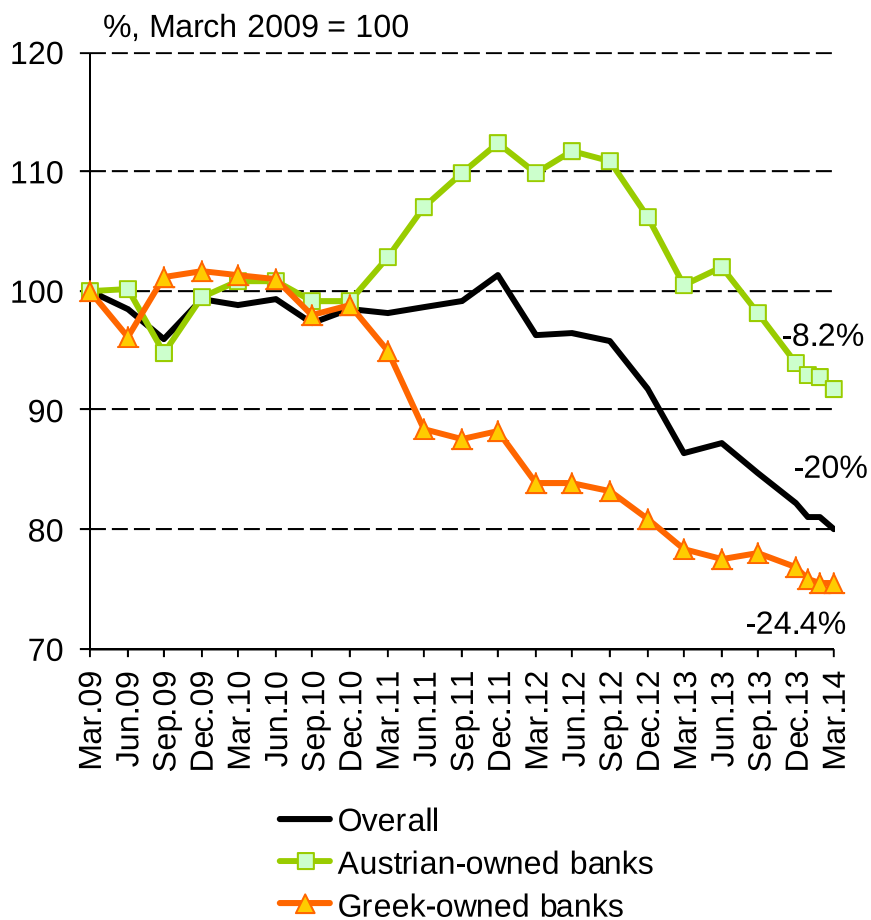
- Foreign banks participating in the Vienna Initiative reduced their exposure to Romania by 20% between end-March 2009 and March 2014

  - ✓ The decline in parent banks' exposure was largely confined to Greek-owned banks

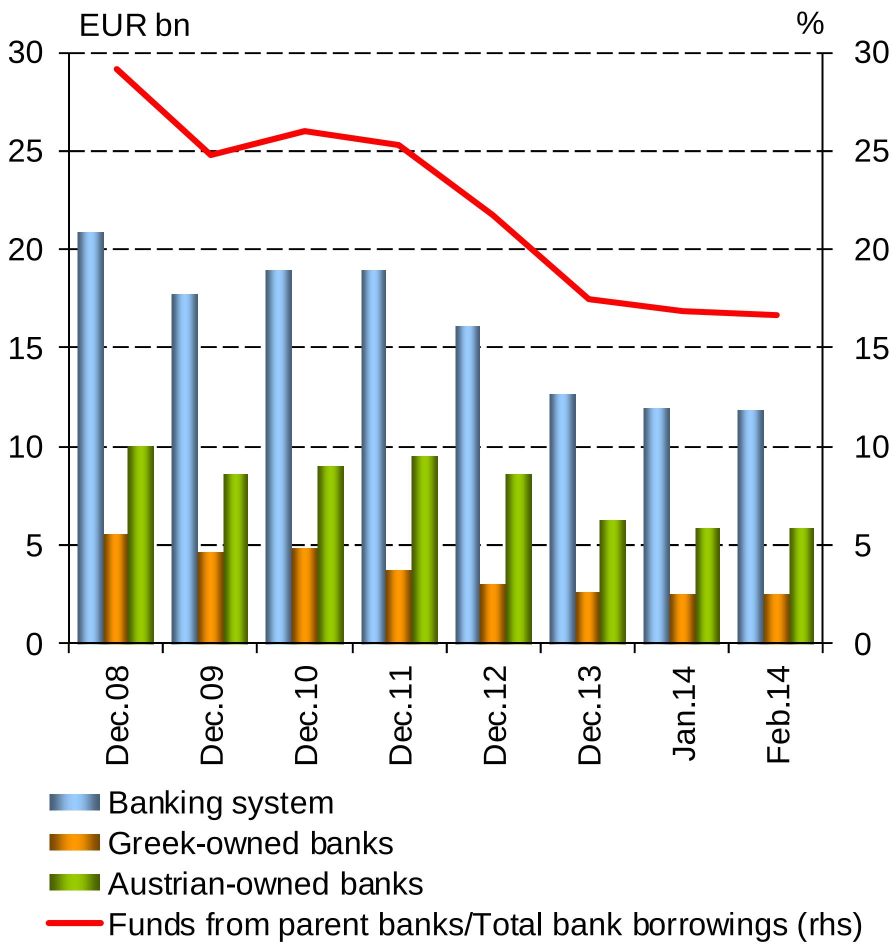
- The adverse effects of the deleveraging process initiated by large European banking groups have so far not significantly impacted Romania, also due to the balanced macroeconomic policy under the EU-IMF-WB arrangements and the strategies of leading banking groups operating in Romania, which contemplate preserving local capital outlays

Orderly financial deleveraging in the crisis aftermath (2)

Exposure to Romania of foreign banks participating in the Vienna Initiative



Funds from parent banks*



* subordinated loans excluded

Source: National Bank of Romania

Challenges Ahead

– Firm progress in structural reforms

– Euro adoption

– Geopolitical tensions in the region

Challenges Ahead

Firm progress in structural reforms

Firm progress in structural reforms

- Project prioritization in EU funds absorption and public investment planning (with a focus on infrastructure development)
- Improving the functioning of the energy sector
  - ✓ Full liberalisation of the gas and electricity market
  - ✓ Development of gas and electricity trading platforms; improved cross-border integration of energy networks and provide for security-of-supply measures
- Continuation of the corporate governance reform of state-owned enterprises (SOEs)
  - ✓ Strengthen authorities capacities to monitor operational performance and budgets of SOEs
  - ✓ Ensure the sale of stakes in major SOEs in energy and transportation
- Promoting SMEs exports and development
- Review of labour taxation with a view to reducing the effective tax burden on labour

Challenges Ahead

Euro adoption

Near-term prospects for cumulative fulfilment of nominal convergence criteria

Nominal Convergence Indicators	Maastricht Criteria	Romania	Difference from the criteria
Inflation rate (HICP) (percent, annual average)	<1.5 pp above -0.3%* (average of the three best performing Member States)	**2.3** (March 2014)	**+1.1pp**
Long-term interest rates (percent per annum)	<2 pp above 3.4%** (average of the three best performing Member States in terms of price stability)	**5.3** (March 2014)	✓
Exchange rate (vs. euro)*** (percentage change)	±15 percent	**+1.3 / -6.1**	✓
General government deficit**** (percent of GDP)	below 3 percent	**2.3**	✓
Government debt**** (percent of GDP)	below 60 percent	**38.4**	✓

*) reference level, March 2014 (Cyprus, Latvia, Bulgaria).

**) reference level, March 2014 (Bulgaria, Latvia).

***) Maximum percentage deviations of the bilateral exchange rate against the euro from its March 2012 average level in April 2012 to March 2014 based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than the average exchange rate in March 2012.

****) 2013; ESA95 methodology.

Source: Eurostat, National Institute of Statistics, National Bank of Romania, European Commission

According to the NBR's current projection, the present level of the inflation criterion will be reached in May 2014. Mention should be made however that the present reference value, depending on the Member States' inflation rates, could be subject to change.

Although in most non-EA NMS nominal convergence criteria are fulfilled or within reach, a wait-and-see approach seems to prevail

	Initial target	Date of setting the initial target	Current position
BG	2010	2004 – Pre-accession Economic Programme	No target date
CZ	2009/2010	2003 – Czech Republic's Euro Accession Strategy	No target date
HU	2008	2003 – Pre-accession Economic Programme	No target date
PL	2008/2009	2003 – Pre-accession Economic Programme	No target date
RO	2014	2007 – Convergence Programme	No target date

Source: European Commission

Recent statements regarding euro adoption in non-euro EU countries

Poland

"I think we should say publicly, that [the ERM II] is a very serious barrier that would prevent a country like Poland from joining the euro area [...] We have a big currency market and we should just say: We're not entering ERM II. If you want us in, invite us without that requirement". (Marek Belka, NBP Governor, Bloomberg, April 2013)

Czech Republic

"Even if the elections create a political coalition of forces seeking a quick euro-zone entry, it seems to me that they are more likely to file the application no earlier than in 2016 ... Therefore, the earliest entry date would be 2019". (Miroslav Singer, CNB Governor, Bloomberg, May 2013)

Hungary

"Hungary cannot seriously consider joining the euro zone until the country's average economic development reaches 90 percent of the level of euro states". (Viktor Orbán, Prime Minister, April 2013)

Bulgaria

"If I start the path of entry, I don't know exactly what I'm entering and we are basically going to wait". (Simeon Djankov, ex-Finance Minister, Washington, February 2013)

Euro adoption in NMS: move towards a more prudent and comprehensive approach

- Romania, like other NMS, is closer than ever to fulfilling the Maastricht criteria, yet it has become obvious that an approach based exclusively on their achievement is insufficient

- The “put your house in order” approach by each country prior to euro adoption is seen as an essential prerequisite for the success of euro area enlargement
  - ✓ Only in this way will euro adoption by new EU Member States entail benefits both for themselves and for the monetary union as a whole

“Europe will be forged in crises, and will be the sum of the solutions adopted for those crises”.

Jean Monnet

Romania: despite recent progress, overall preparedness still needs improving

- Romania has made significant progress towards fulfilling the convergence criteria
  - ✓ Only the inflation rate is still above the reference value of the Maastricht criterion, yet the latest projections point to compliance in 2014
  - ✓ The macroeconomic imbalance procedure scoreboard shows that the net international investment position remains the only indicator outside the “comfort area”, but its correction is unavoidably the outcome of a lengthy process

- Looking at the broader range of relevant elements in terms of the appropriate timing (real convergence and political economy), it is essential to:
  - ✓ Complete institutional reforms in the euro area
  - ✓ Avoid domestic slippages and complete structural reforms
  - ✓ Make visible progress towards real convergence
  - ✓ Achieve political consensus on the domestic front

Challenges Ahead

Geopolitical tensions in the region

Tensions between Russia and Ukraine: manageable economic risks

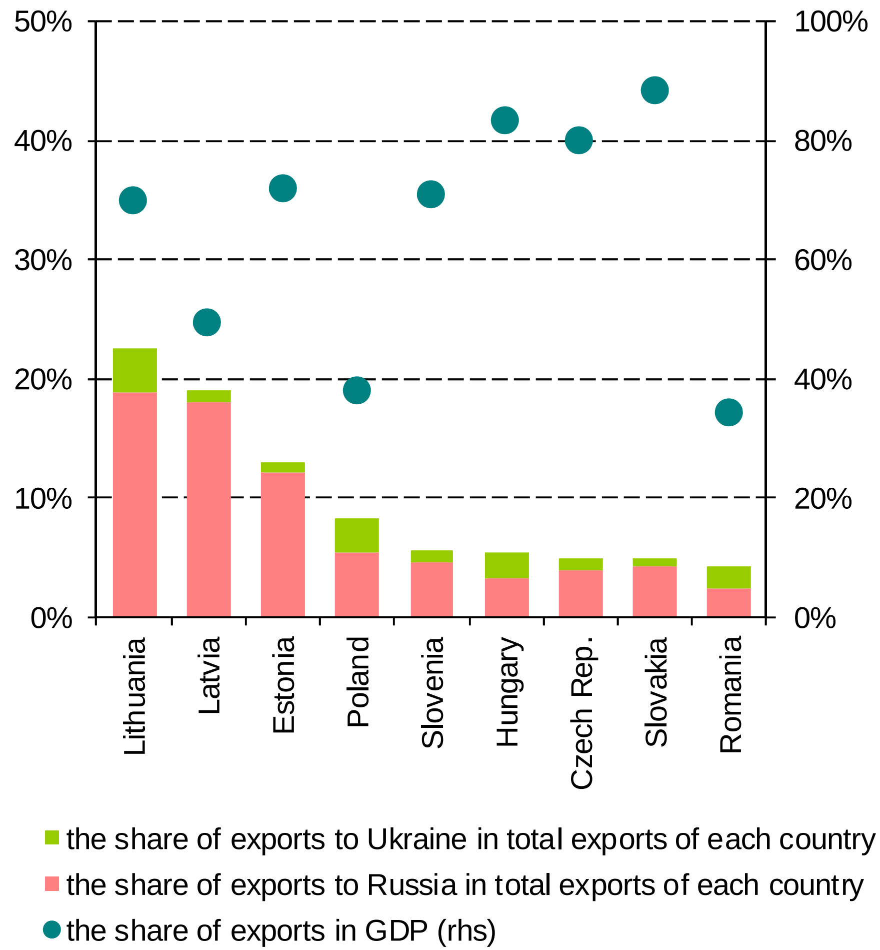
- Trade restrictions or disruptions may affect exports and/or energy supply, yet the risks appear manageable
  - ✓ Exports to Russia and Ukraine account for only 4.7% of total Romanian exports ➡ a 10% fall in the value of exports to these countries, assuming no replacement, would shave 0.16 pp off the growth rate of Romania's GDP
  - ✓ While virtually all imported natural gas comes from Russia via Ukraine, Romania is able to cover on average around 80% of its own consumption from domestic sources
    - Romania ranks the third least imported-energy-dependent country in the EU
    - imported natural gas accounted for only 15% of total consumption in 2013
    - even a total shutdown in gas imports may be weathered without tangible disruptions at least until November-December

Tensions between Russia and Ukraine: manageable economic risks (2)

- Russian capital has a significant presence (directly or via holding companies based in other EU countries) in the iron and steel (TMK), metallurgy (ALRO Slatina and ALOR Oradea) and oil refining (Lukoil) sectors, yet none of the Russian-owned companies may be deemed to be of systemic importance

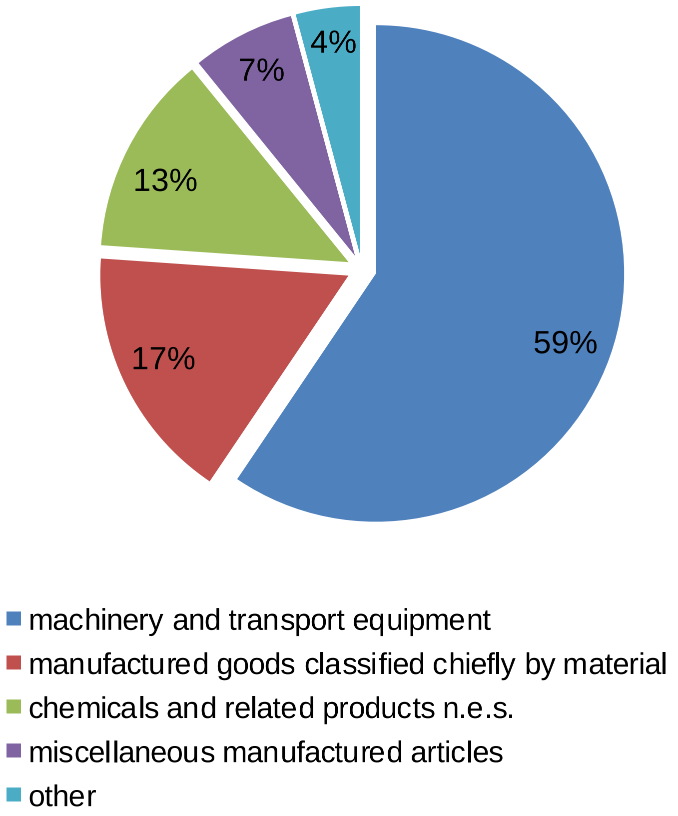
- Financial sector:
  - ✓ No direct links between the Romanian banking system and those of Russia and Ukraine
    - no Russian or Ukrainian capital in the Romanian banking system
    - negligible exposures of Romanian banks to Russian or Ukrainian entities
  - ✓ Potential for spillovers through the common lender channel via the exposure of Austrian and French banks to Russia and Ukraine
    - the comfortable solvency and liquidity buffers in the Romanian banking system should help alleviate such spillovers in case they materialize
  - ✓ So far the impact of regional tension flare-ups on the capital and forex markets has been moderate and short-lived

Exports to Russia and Ukraine account for a comparatively small share of Romania's exports



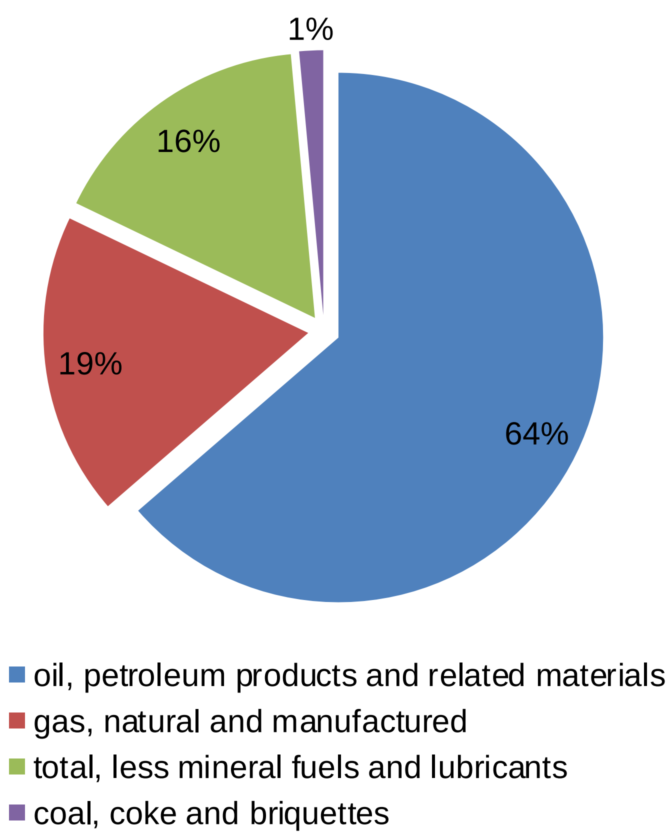
Source: Eurostat

Romania's exports to Russia - breakdown by product -

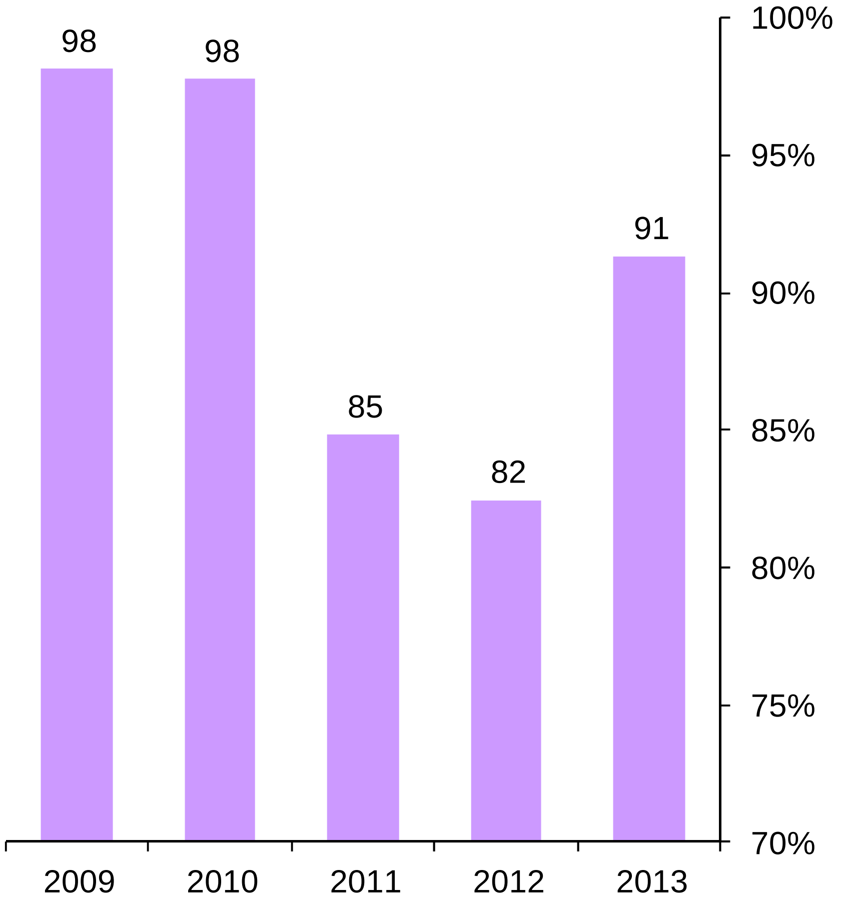


Energy products form the bulk of Romania's imports from Russia, with virtually all imported natural gas coming from there …

Romania's imports from Russia - breakdown by product -

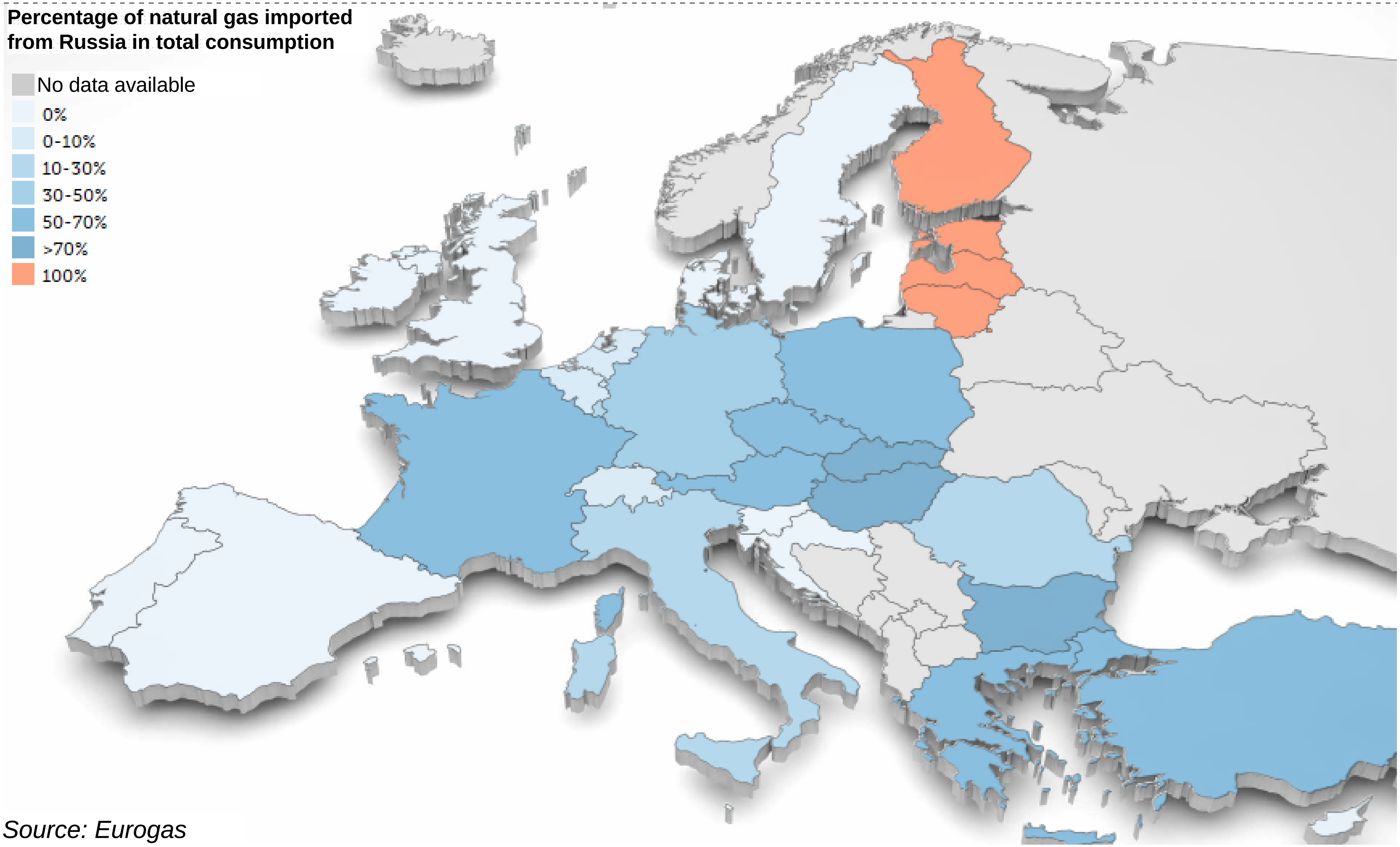


The share of gas imports from Russia in total Romanian gas imports



Source: Eurostat

… yet Romania ranks among the most self-sufficient countries in Europe as regards its gas consumption



Source: Eurogas