NATIONAL BANK OF ROMANIA

Romania's economic outlook

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Romania: Overview

Macroeconomic snapshot

- 2015 – the fifth year in a row with positive economic growth
  - ✓ After GDP dynamics of 2.8% in 2014, current forecasts for 2015 cluster around 3.5%, again well above EU average growth
- The output loss incurred in 2009 and 2010 has been made up for
- The growth outlook is favourable, yet growth sustainability is conditional upon preserving macroeconomic equilibria

Macroeconomic snapshot (2)

- Inflation rate declined in recent years, reaching record lows in 2015
  - ✓ The average annual HICP inflation rate (0.2% in September) is compliant with the specific Maastricht criterion
- The current account deficit is expected to remain below 1.0% of GDP in 2015, well under the MIP scoreboard benchmark (4%)
- International reserves remain at a comfortable level despite the almost full repayment of the IMF loan

Macroeconomic snapshot (3)

- Excessive general government deficit corrected as of 2012
- The MTO of 1% of GDP structural deficit has been reached in 2014, thus complying with the provisions of the preventive arm of the Stability and Growth Pact
  - ✓ A significant deviation from the MTO looks likely in the coming years given forthcoming tax cuts and wage increases in the public sector
- Despite growing rapidly during the crisis years, the public debt to GDP ratio remains below 40% of GDP (the 4th lowest in the EU)

Macroeconomic snapshot (4)

- The banking system is resilient to shocks
  - ✓ High capital adequacy indicators (comfortably above the 8% threshold)
  - ✓ Adequate liquidity
  - ✓ Decreasing NPL ratio amid intensified balance sheet clean-up
  - ✓ Solid provisioning of NPLs
- Exposure to Greek banking system is limited
  - ✓ The four banks with Greek capital in Romania are not branches, but subsidiaries (subject to NBR direct supervision)
  - ✓ These banks are well capitalised

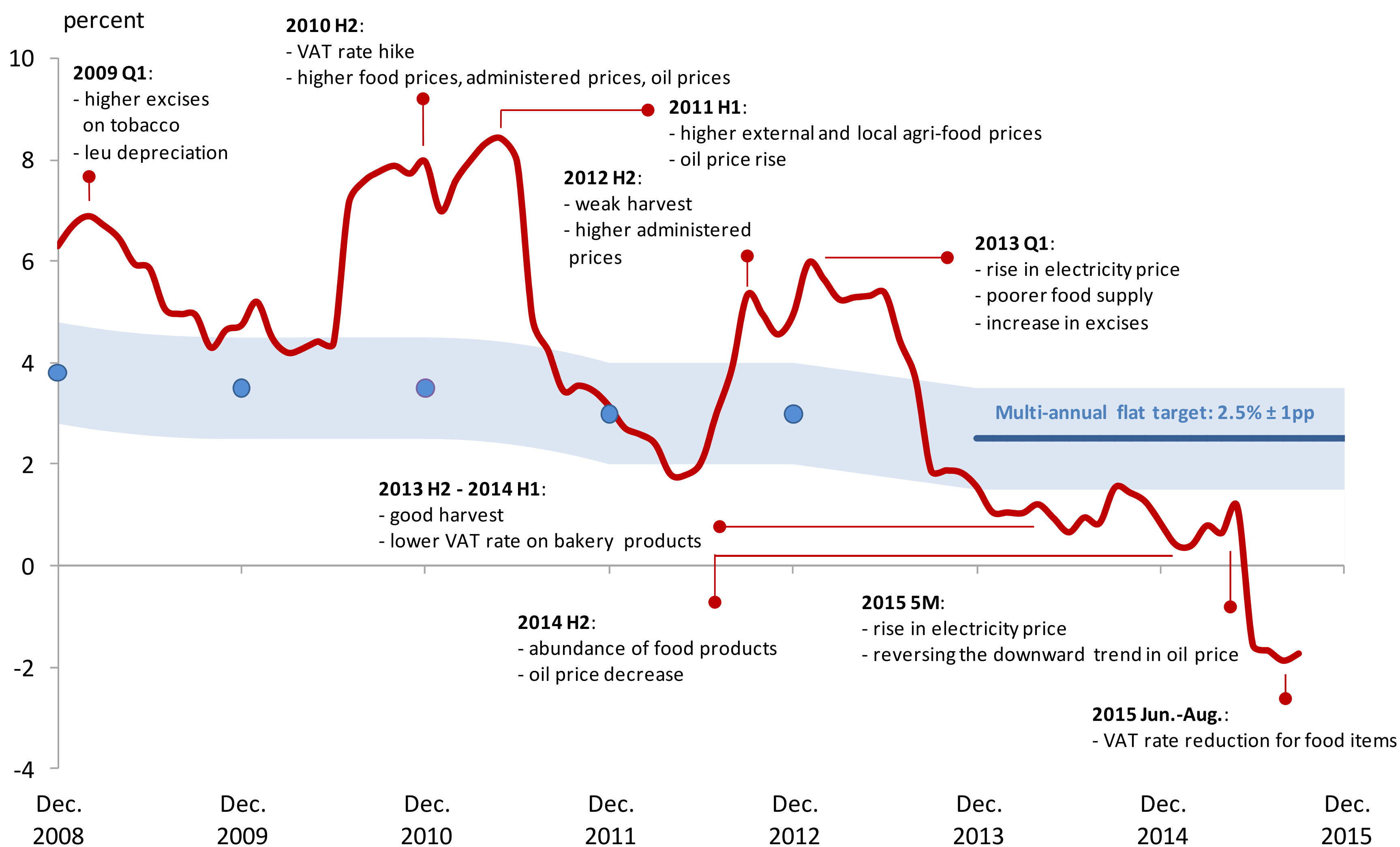
Map of risks to financial stability

	No severe systemic risk
↑	Externally, risk generated by uncertainty surrounding global economic growth, the state of the international financial system, a possible reversal of the downward trend in interest rates worldwide and shifts in investor sentiment
→	Domestically, the risk of returning to pro-cyclical economic policies
→	Risk of further modest dynamics of loans to non-financial corporations, despite the sustainable growth potential
→	Contagion risk from the banking sector in Greece
↓	Credit risk associated with the stock of loans, amid the widening share of domestic currency loans
↑	Risk triggered by the geopolitical situation in the Middle East, with possible consequences on the European single market

- severe systemic risk
- high systemic risk
- moderate systemic risk
- low systemic risk

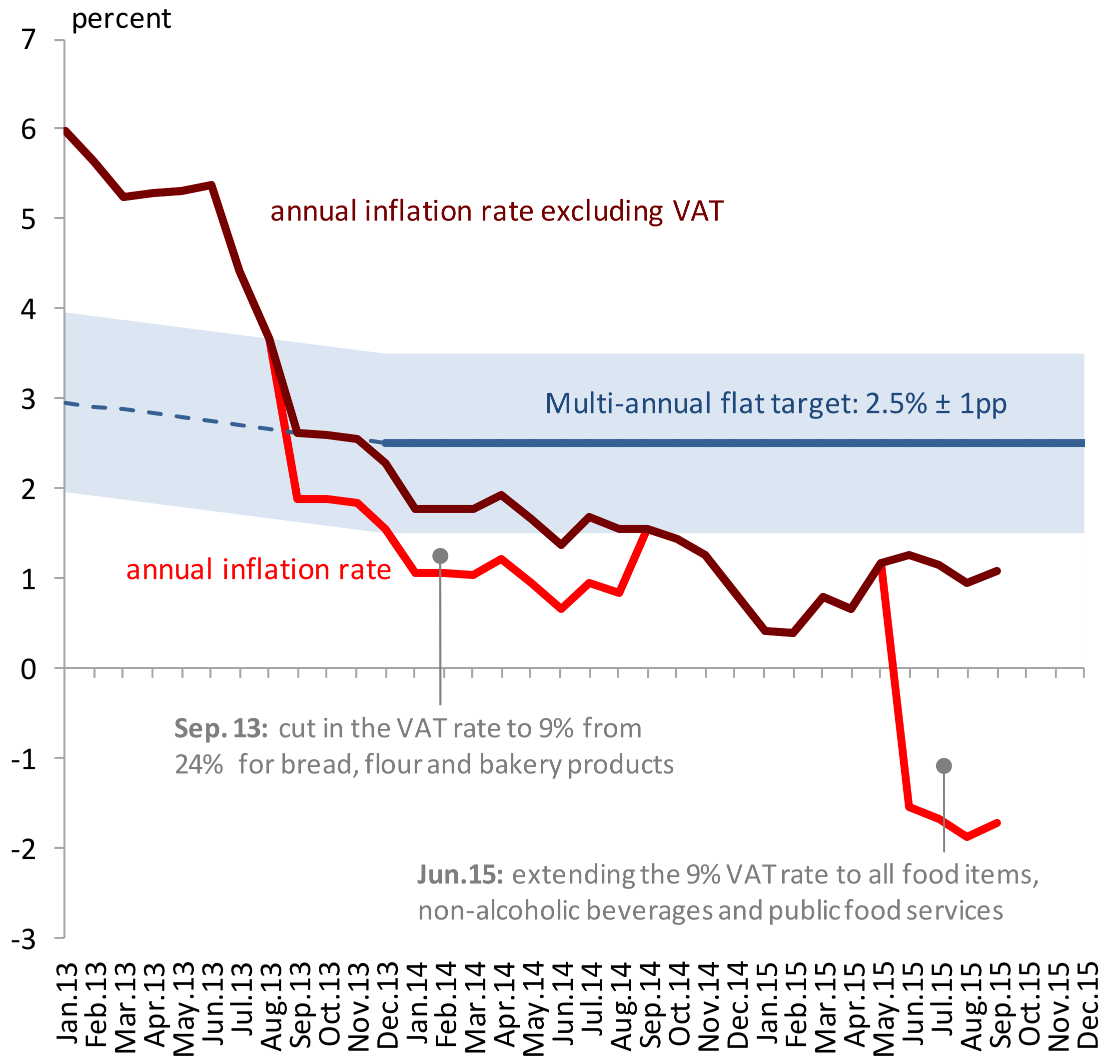
Inflation

Clear disinflationary trend despite volatility induced by supply shocks



Source: NIS, NBR calculations

Record low inflation over the last two years

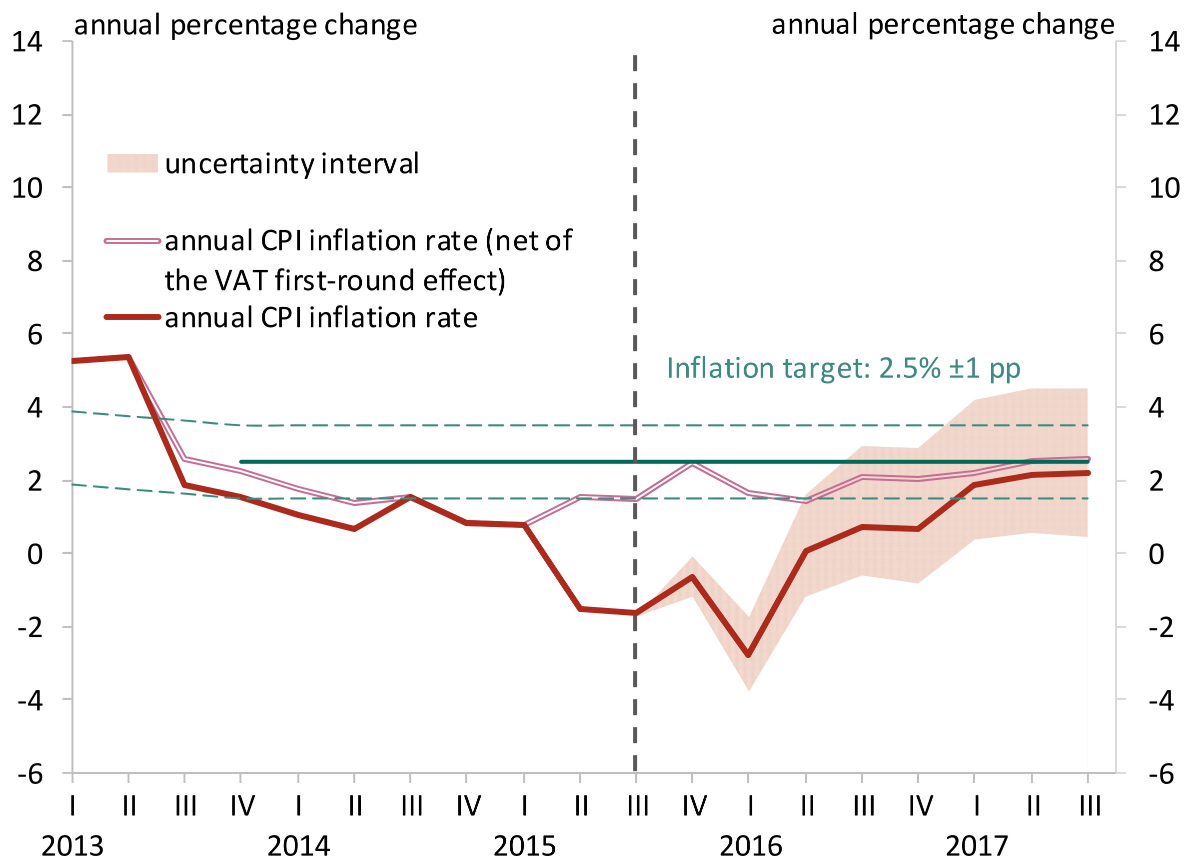


Source: NIS, NBR

- After following a broad-based downward trend in 2014, the annual CPI inflation rate remained below the variation band of the inflation target until June 2015, when it fell sharply into negative territory due solely to extending the reduced VAT rate to all food items, non-alcoholic beverages and public food services

- Leaving aside the VAT rate cut, a low inflation environment has been prevalent throughout 2015 on account of both persistent and transitory factors:
  - ✓ Low oil prices
  - ✓ Still low domestic agricultural prices despite this year's poorer harvest
  - ✓ Downward trend in inflation expectations
  - ✓ The lingering, although narrowing, negative output gap

Annual inflation is seen returning inside the variation band of the target starting Jan. 2017 as the direct influence of the 4 pp cut in the standard VAT rate fades out

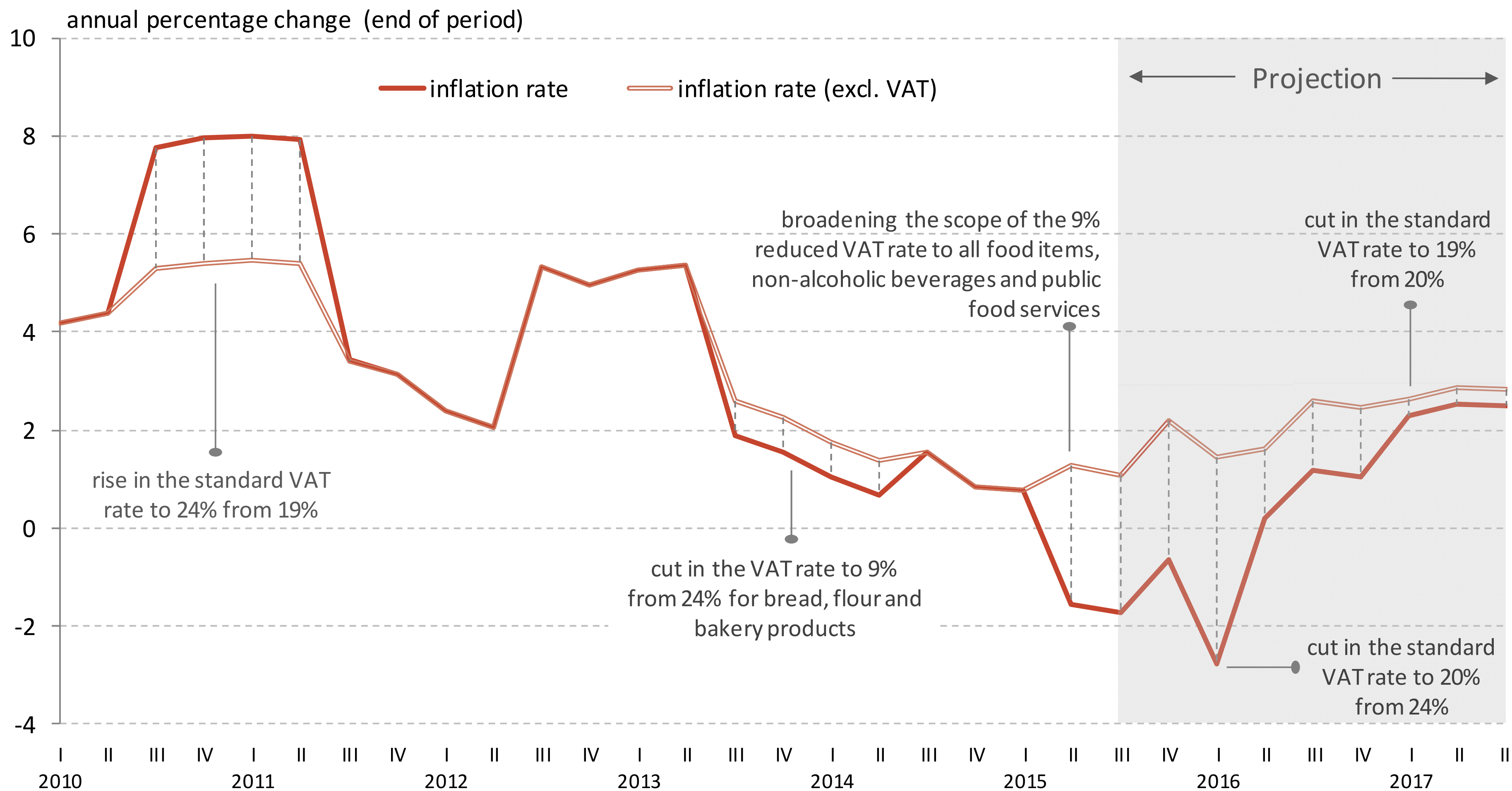


Note: The assessment presented above is part of the ongoing projection exercise, and thus subject to revisions, that will be included in the November 2015 Inflation Report. The uncertainty interval was calculated based on the forecast errors in the NBR projections during 2005-2014. The magnitude of the forecast errors is positively correlated with the time horizon they refer to.

Source: NIS, NBR projections and calculations

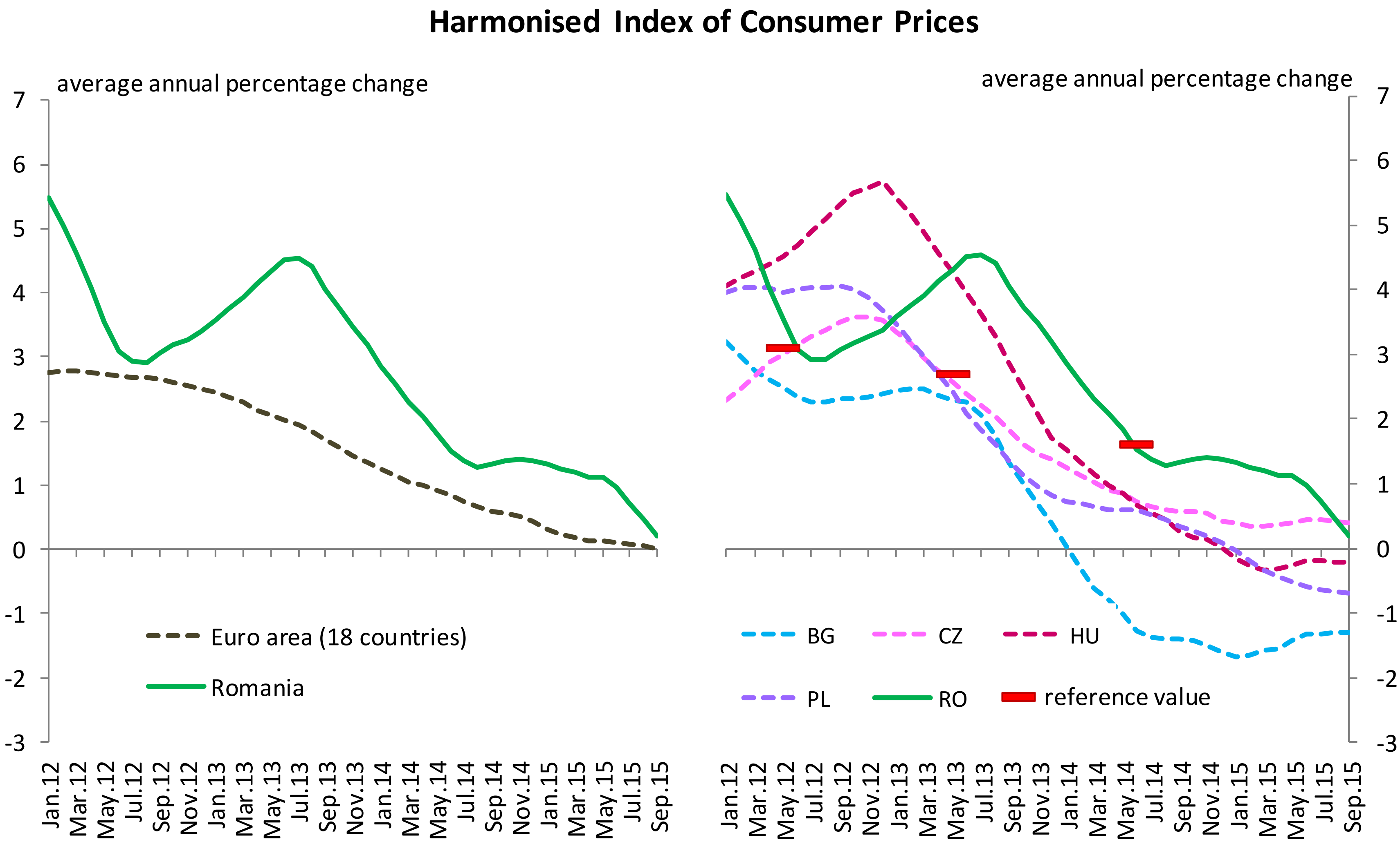
- The annual CPI inflation rate is expected to:
  - ✓ Post negative values until May 2016
  - ✓ Register positive values (yet below the lower bound of the variation band) until the end of 2016
  - ✓ Return inside the band starting 2017 Q1 and remain there until the forecast horizon
- The projected trajectory is largely shaped by the impact of the new Tax Code provisions, such as:
  - ✓ The two-step cut in the standard VAT rate: from 24% to 20% as of 1 Jan. 2016 and further to 19% as of 1 Jan. 2017
  - ✓ The reduction in fuel excise duties as of 1 Jan. 2017

Over most of the forecast interval, the annual inflation rate will be marked by the successive VAT rate cuts



Source: NIS, NBR calculations and projections

Downward trend in inflation across the region; all non-euro area NMS meet the Maastricht criterion for price stability



Source: Eurostat

Romania fulfils all the nominal convergence criteria…

Maastricht Criteria

(Nominal Convergence Indicators)

Nominal Convergence Indicators	Maastricht Criteria	Romania	Fulfilment of the criteria
Inflation rate (HICP) (percent, annual average)	≤1.5 pp above -0.6% (average of the three best performing Member States*)	**0.2** (September 2015)	Yes
Long-term interest rates (percent per annum, annual average)	≤2 pp above 2.0% (average of the three best performing Member States in terms of price stability*)	**3.5** (September 2015)	Yes
Exchange rate (vs. euro)** (percentage change)	±15 percent	**+1.8/ -1.8**	Yes
General government deficit*** (percent of GDP)	below 3 percent	**1.5**	Yes
Government debt*** (percent of GDP)	below 60 percent	**39.9**	Yes

*) Lithuania, Poland, Spain.

**) Maximum percentage deviations of the bilateral exchange rate against the euro from its September 2013 average level in October 2013 to September 2015 based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than the average exchange rate in September 2013.

***) 2014; ESA2010 methodology.

Source: Eurostat

… and observes 10 out of the 11 reference values in the scoreboard

Macroeconomic Imbalance Procedure Scoreboard*

		Current account balance	Net international investment position	Real effective exchange rate (based on HICP)	Share of world exports of goods and services	Nominal unit labour cost index	House price index	Private debt	Private credit flow	Public sector debt	Unemployment rate	Financial sector liabilities (non-consolidated)
		% of GDP 3 year average	% of GDP	3 years % change	5 years % change	3 years % change	1 year % change	% of GDP	% of GDP	% of GDP	% 3 years average	1 year % change
		-4%/+6%	-35%	±5% (EA) ±11% (non-EA)	-6%	+9% (EA) +12% (non-EA)	6%	133%	14%	60%	10%	16.5%
Bulgaria	**2013**	0.8	-75.0	-1.0	4.4	15.3	0.4	132.2	7.3	18.3	12.2	4.3
	2014	0.9	-72.4	-2.6	6.7	12.5	1.5	124.3	-0.3	27.6	12.2	7.2
Croatia	**2013**	-0.1	-88.5	-4.0	-22.7	-3.0	-18.1	119.5	-0.6	80.6	15.7	3.2
	2014	0.4	-88.6	-0.9	-18	-5.9	-2.0	120.6	0.3	85.0	16.9	0.9
Czech Republic	**2013**	-1.4	-41.5	-3.1	-8.9	4.2	-0.7	74.1	4.4	45.0	6.9	11.3
	2014	-0.5	-35.6	-10.0	-5.0	3.8	1.8	72.7	1.8	42.6	6.7	4.4
Hungary	**2013**	2.2	-84.1	-4.0	-20.4	6.3	-4.6	95.2	-1.1	77.3	10.7	-1.0
	2014	2.7	-73.8	-7.0	-14.9	6.7	3.1	91.3	-0.5	76.9	9.6	8.5
Poland	**2013**	-3.4	-68.7	-4.3	0.03	3.7	-4.2	75.2	3.2	55.7	10.0	7.4
	2014	-2.3	-67.4	-1.3	4.8	…	1.2	77.5	4.8	50.1	9.8	0.7
Romania	**2013**	-3.4	-61.7	0.3	14.8	-3.9	-3.8	66.6	-1.5	38.0	7.0	3.0
	2014	-2.0	-57.0	-1.1	21.5	2.3	-3.6	62.6	-2.4	39.9	6.9	0.7

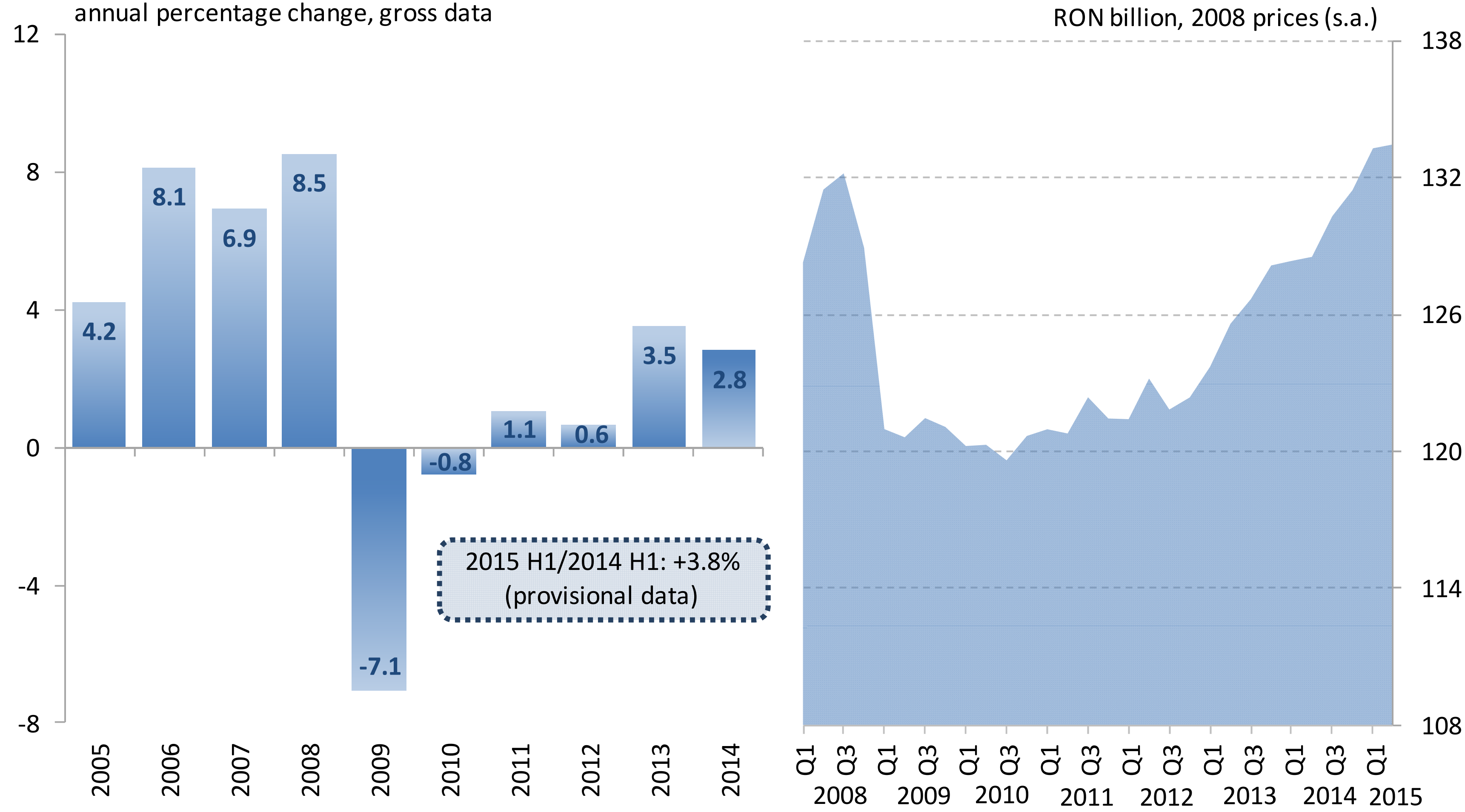
*) last update: 13 October 2015

… not available

Source: Eurostat, NIS, NBR

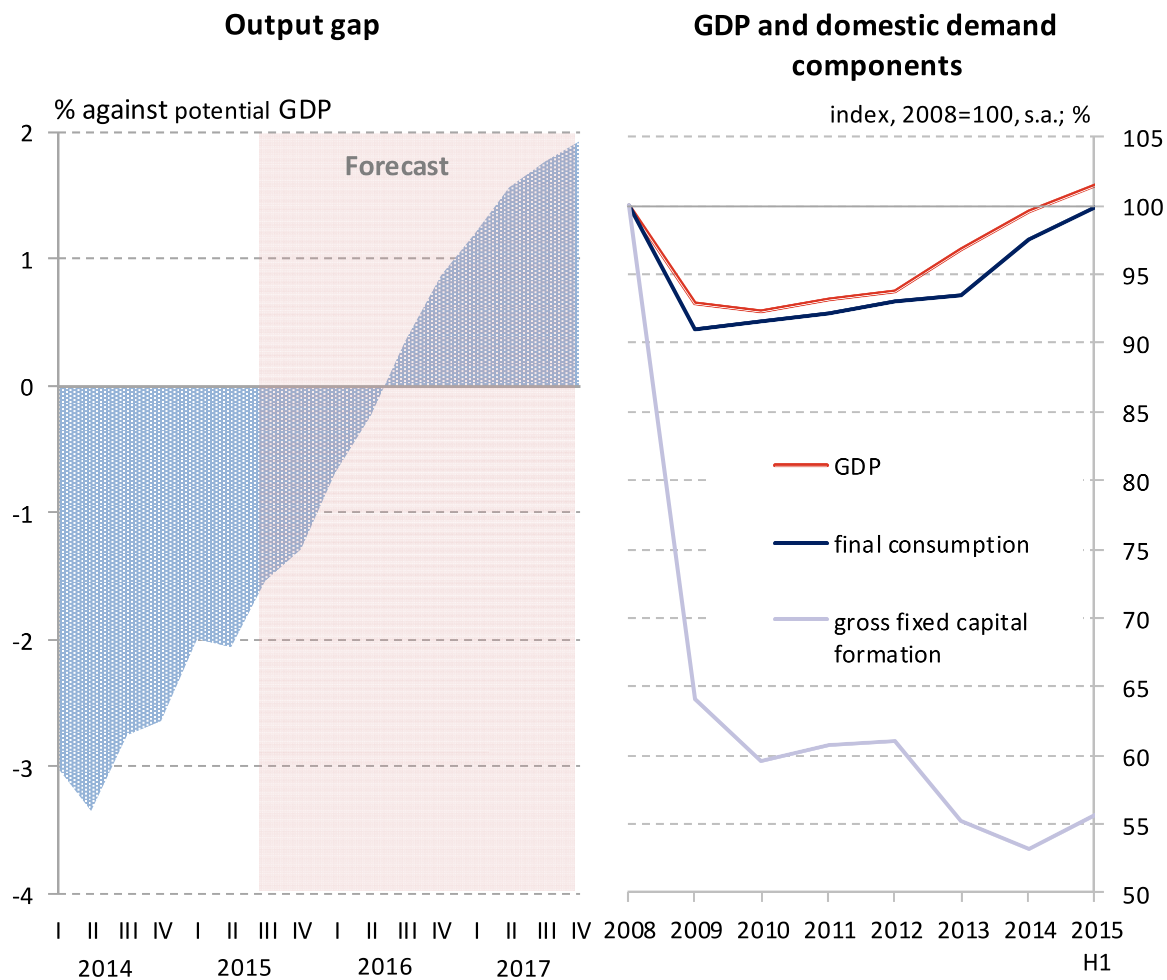
Growth

Romania's GDP made up entirely for the output loss incurred after the outbreak of the global financial crisis



Source: National Institute of Statistics, National Bank of Romania

The output gap is closing rapidly on the back of consumer demand

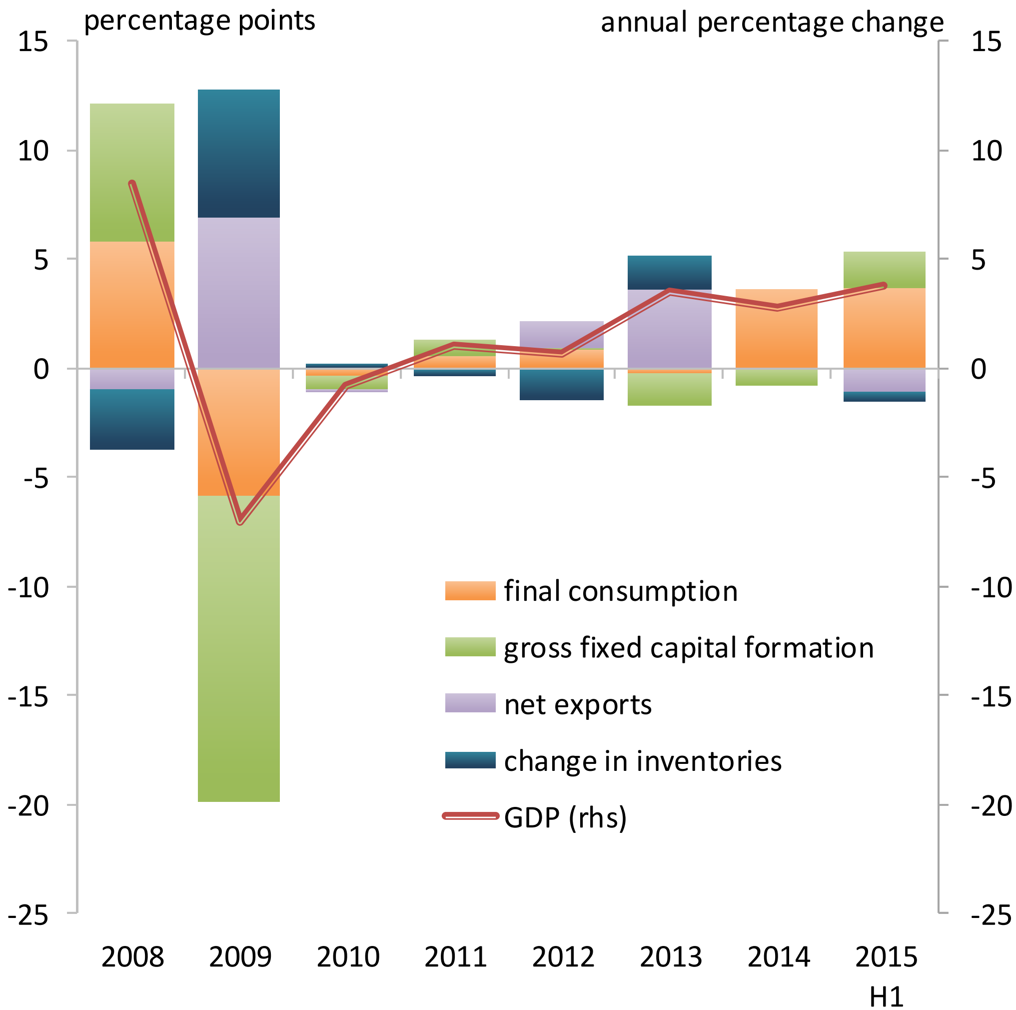


- Based on the most recent data, the output gap will turn positive in 2016 H2

- The room for further stimulating consumer demand is very limited

Source: NIS, NBR calculations

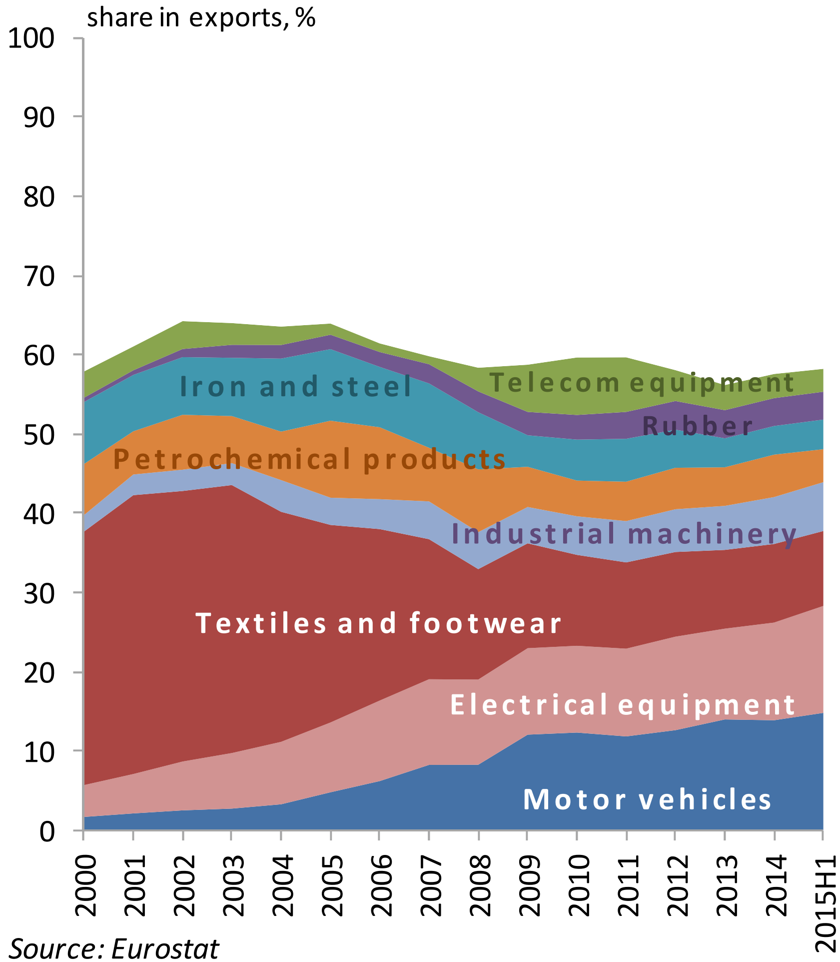
Drivers of GDP recovery

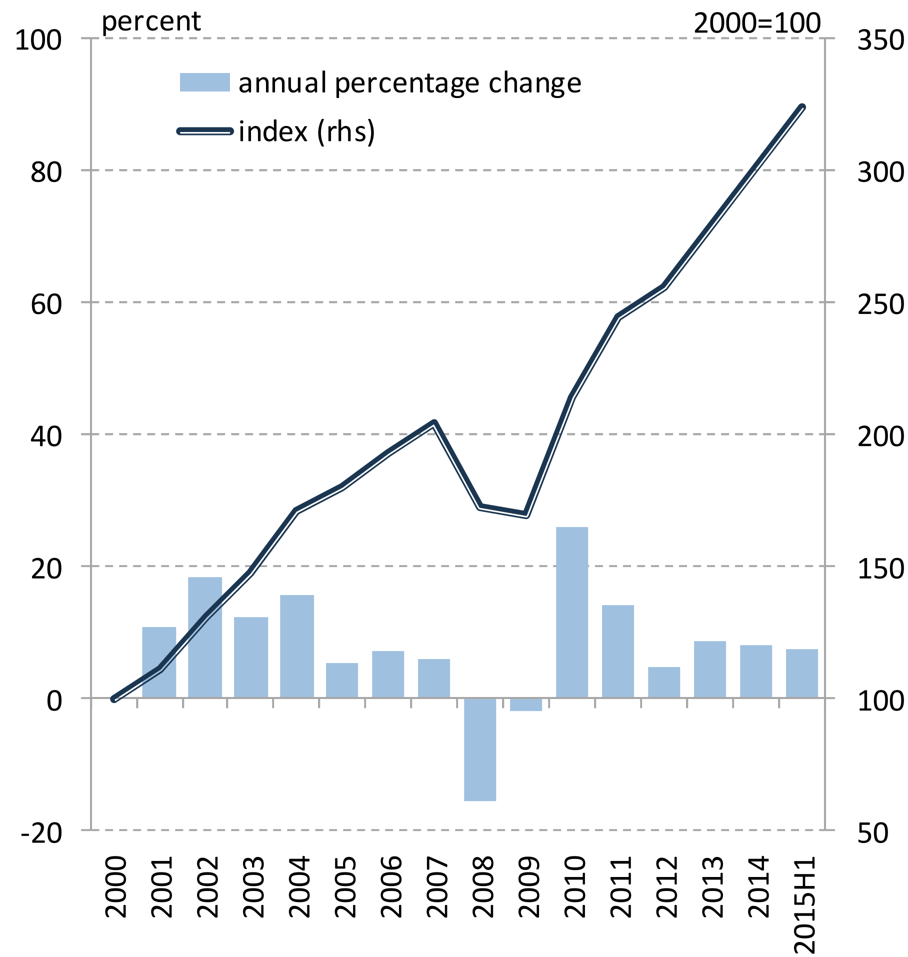


Source: NIS

- Economic recovery after 2010 was initially driven by net exports
- Since 2014, domestic demand has replaced net exports as growth driver due to a pick-up in final consumption and a recent rebound in gross fixed capital formation

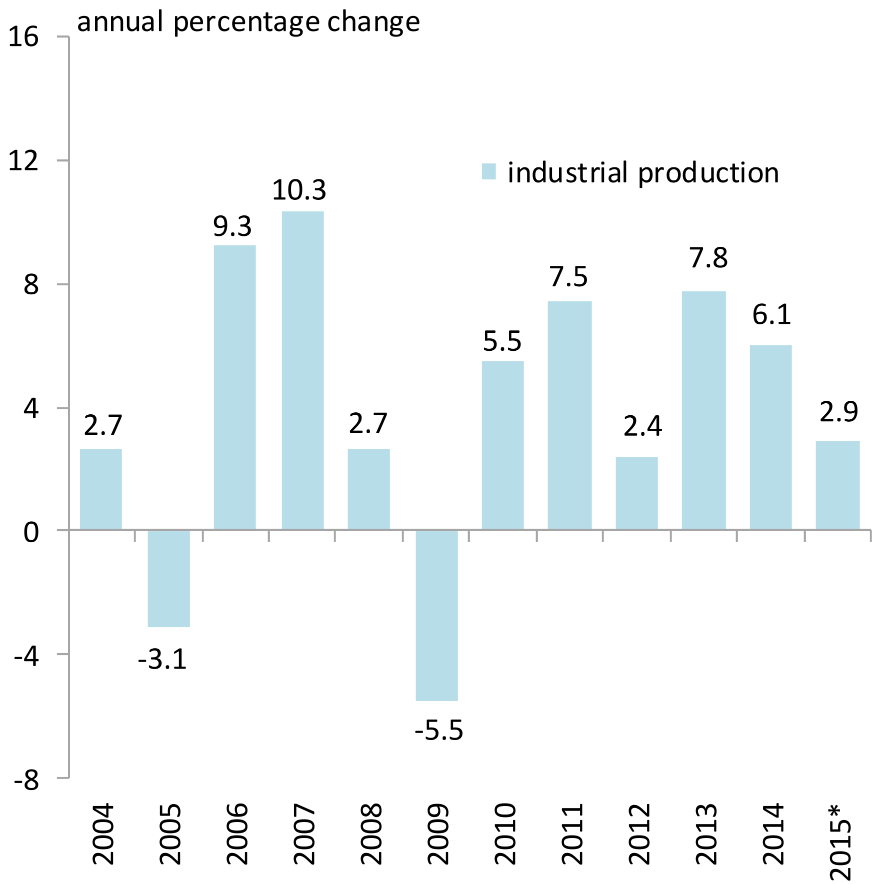
Exports of goods returned to the growth trend recorded before the outbreak of the crisis, posting robust increases in the last five and a half years

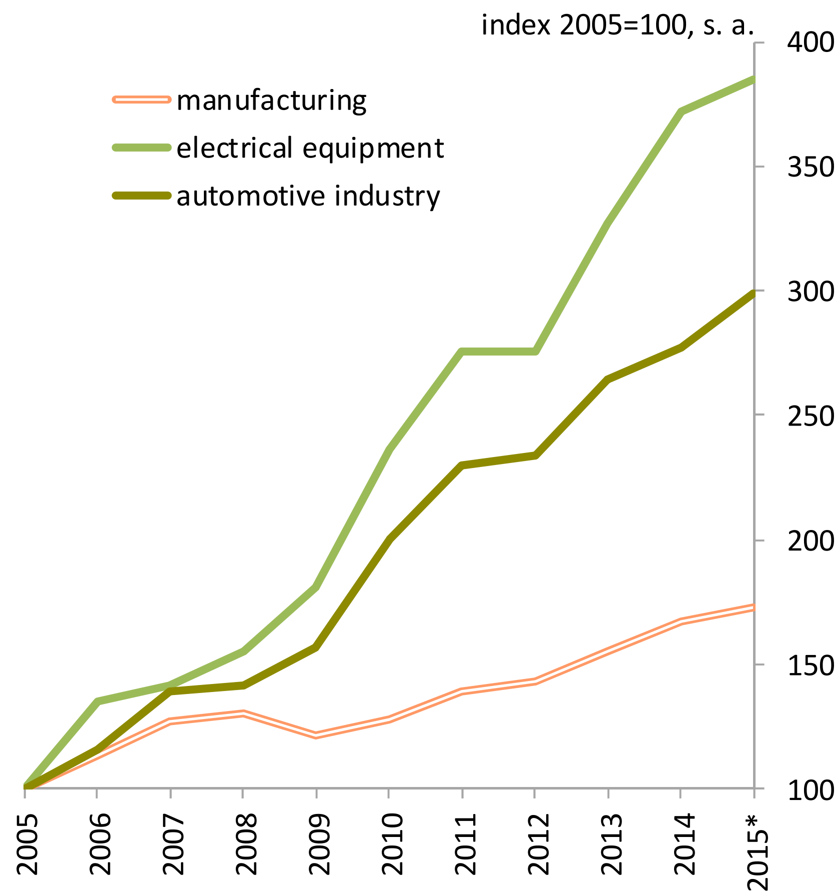




Source: Eurostat

Fast growth rates in the electrical equipment and automotive sectors have been the largest contributors to the favourable performance of industry

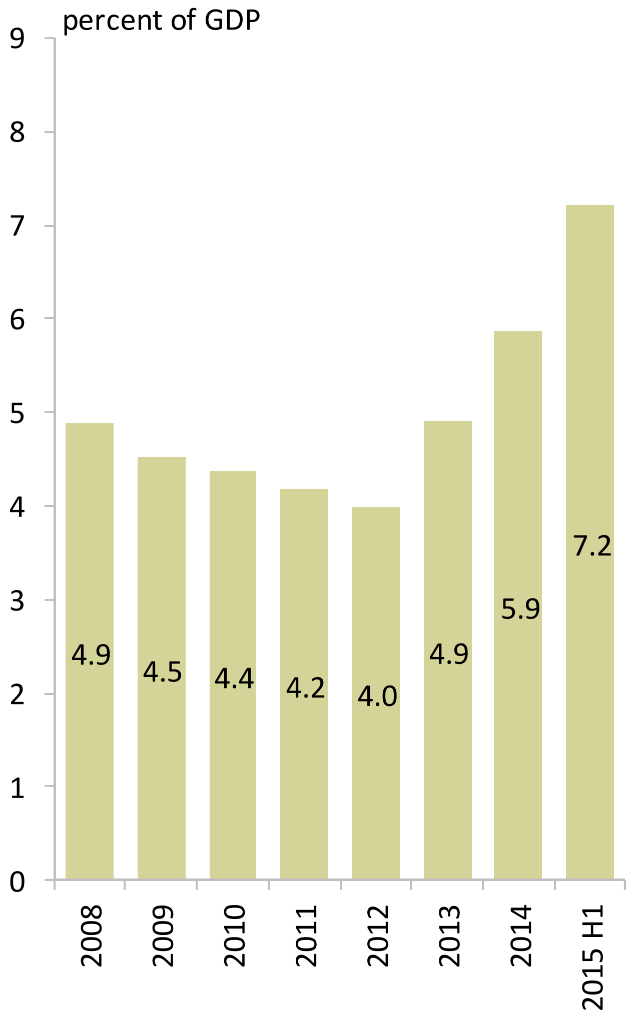


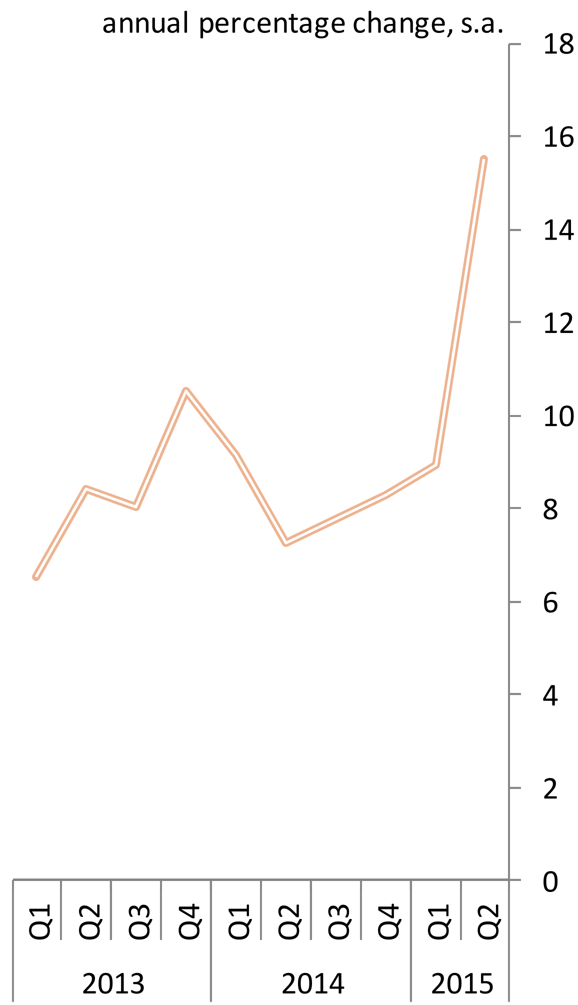


*) Jan.-Aug.

Source: NIS

Lately, IT&C services have emerged as a new star sector of the economy





Source: NIS

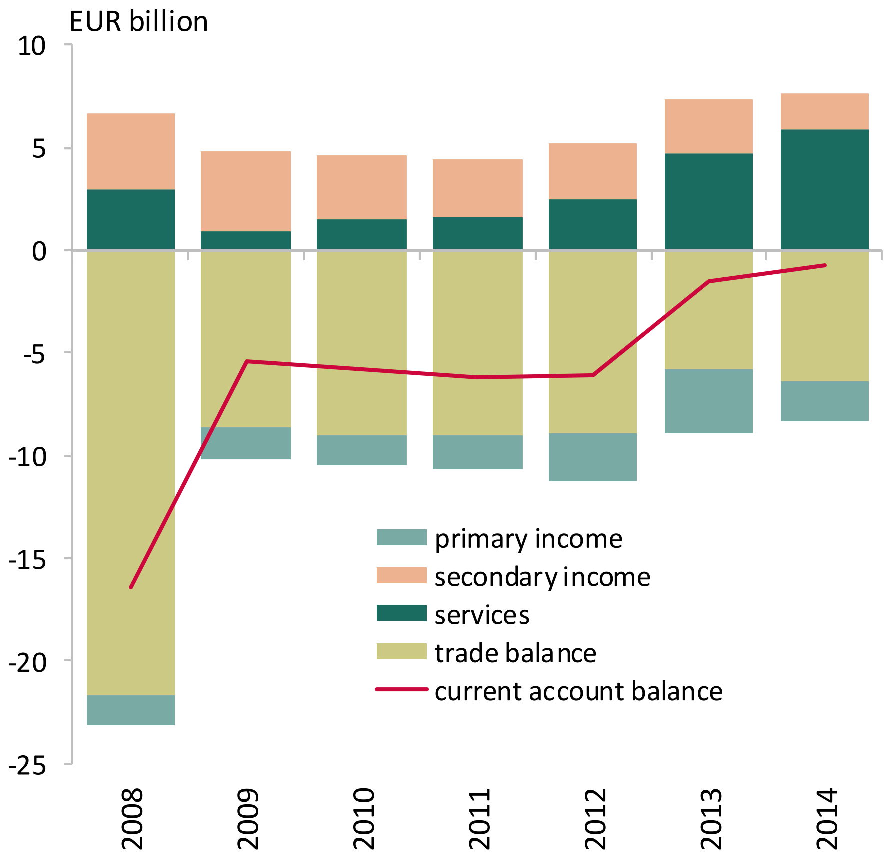
- The share of IT&C in total GDP has exceeded that of agricultural sector since 2014 and is currently close to the share of construction
- The sector accounts now for more than 22% of the surplus of trade in services (from around 3% in 2005)
- Development of the sector is supported by a lower labour tax wedge
  - ✓ Employees of IT&C companies are exempt from paying income taxes on wages, provided that the firm has a turnover of over USD 10,000 per employee

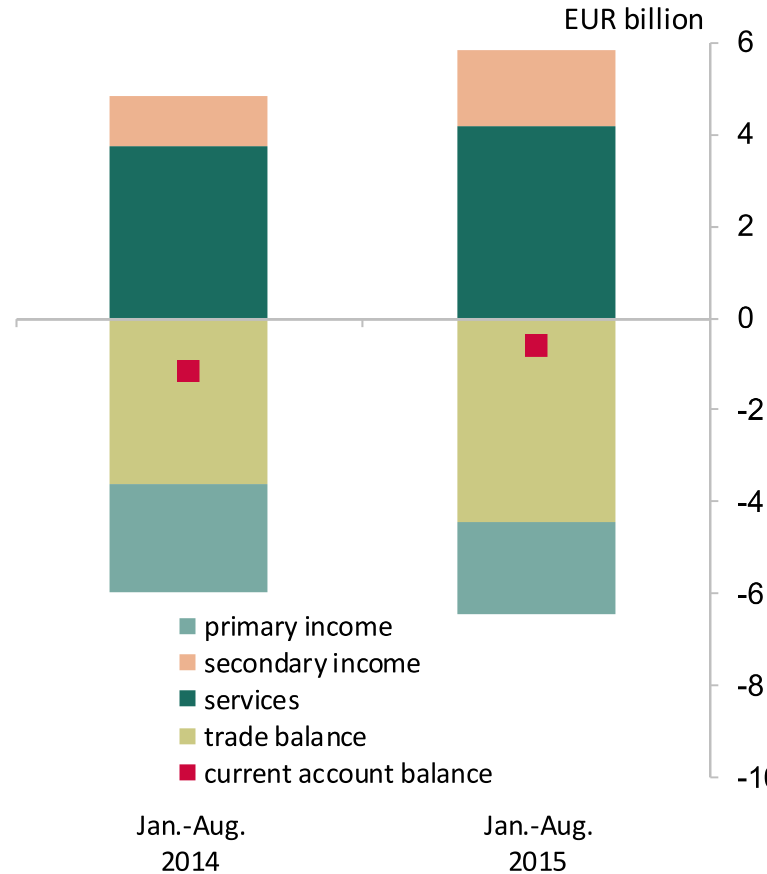
External sector

Significant adjustment of the external imbalance

- The current account deficit narrowed markedly from a peak of 13.4% of GDP in 2007 to 4.5% 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 34.9% yoy
  - ✓ The larger services surplus, prompted particularly by receipts from transport services (in correlation with higher exports of goods)
- Current account performance further improved in 2014 (deficit of 0.5% of GDP) and came close to balance in 2015 H1 (-0.02% of GDP)
  - ✓ Projections for 2015 point to a deficit below 1% of GDP (slight widening, in line with growing domestic demand)
- At end-September 2015, international reserves stood at EUR 32.5 bn (out of which EUR 29.1 bn forex), covering about 6 months of prospective goods and services imports

Virtually balanced current account in Jan.-Aug. 2015, with the services surplus offsetting the slight widening in the balance of trade in goods





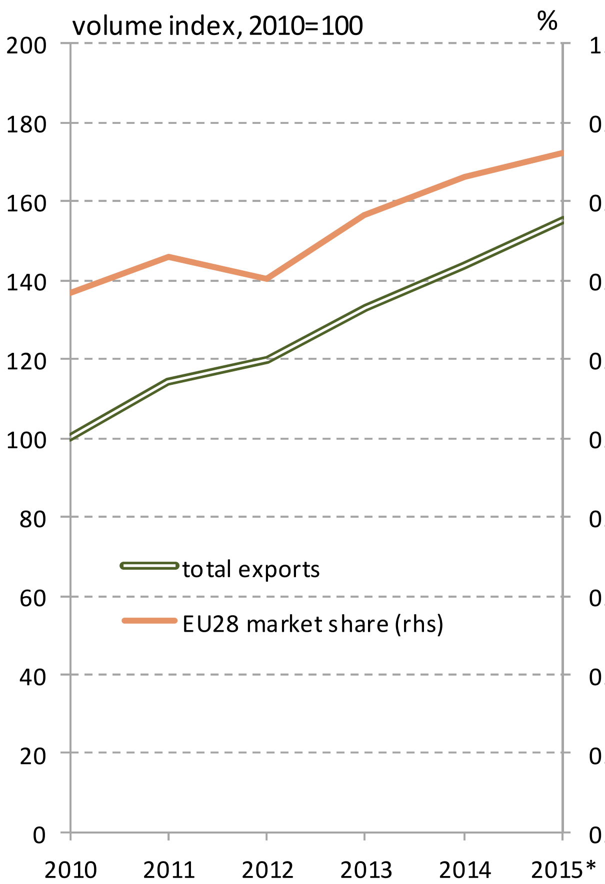
Primary income: mainly interest income, dividends, reinvested earnings, labour income, EU subsidies

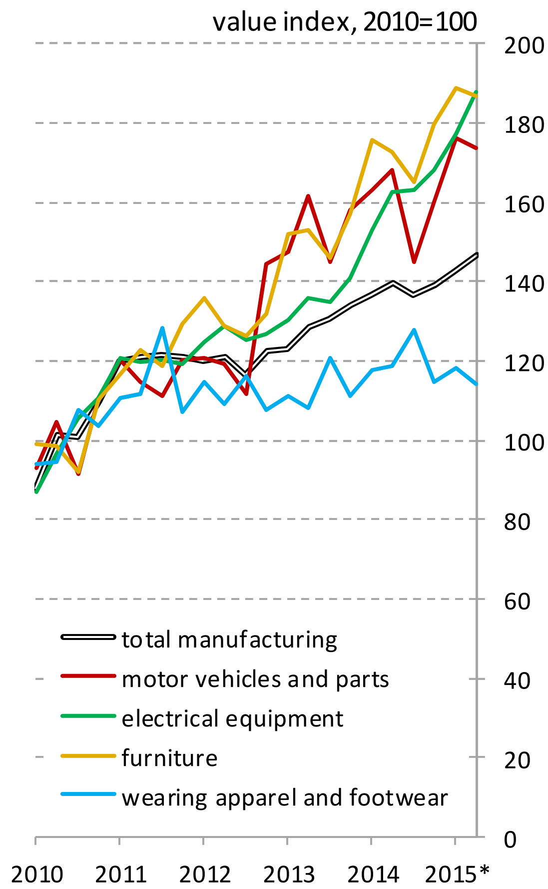
Secondary income: current transfers (private and non-investment European funds, contributions to the EU budget)

Source: National Institute of Statistics, National Bank of Romania

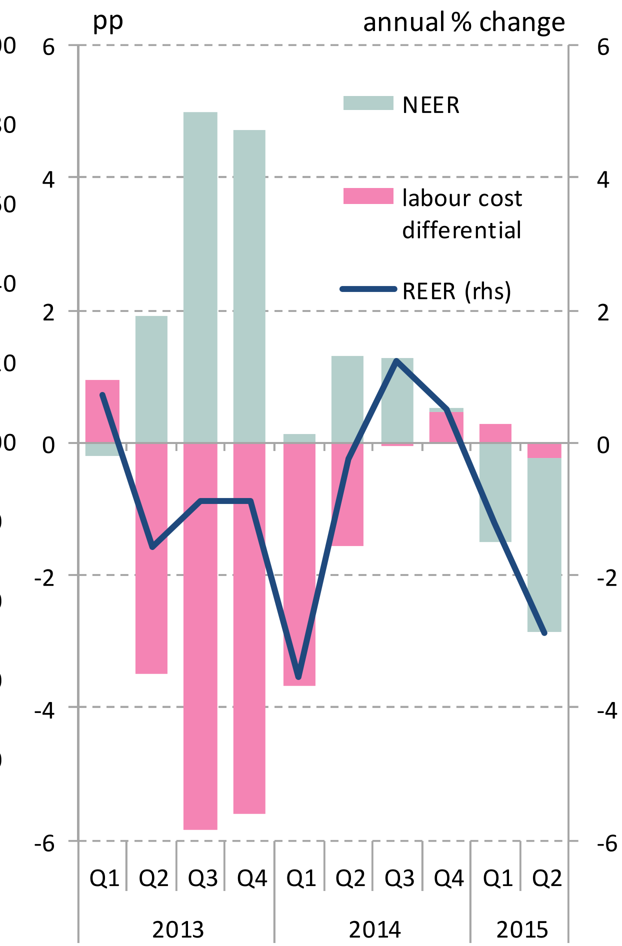
Export performance remains robust, however price competitiveness may be hampered by recent and forthcoming wage increases, especially in low-tech (labour-intensive) sectors

Exports of goods





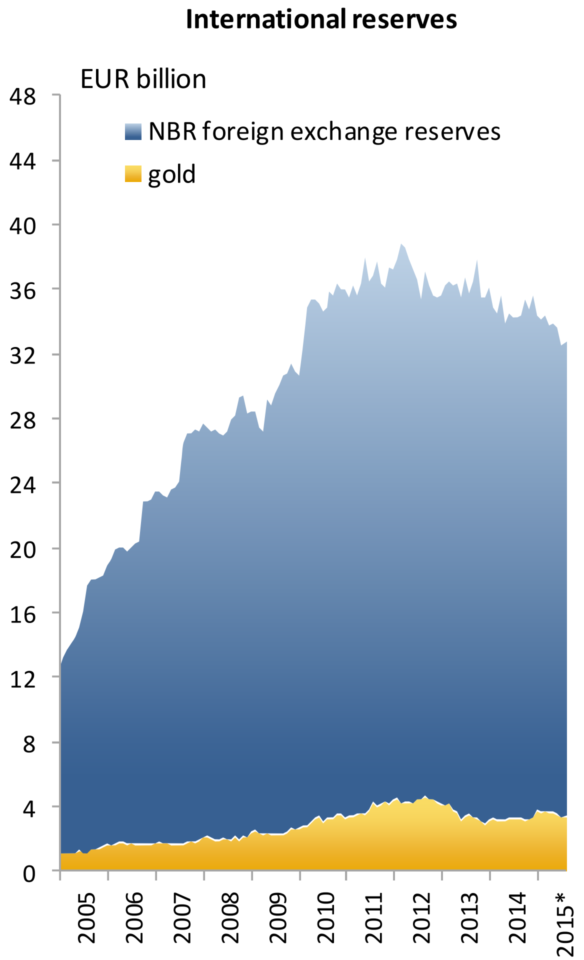
REER
– ULC in manufacturing –

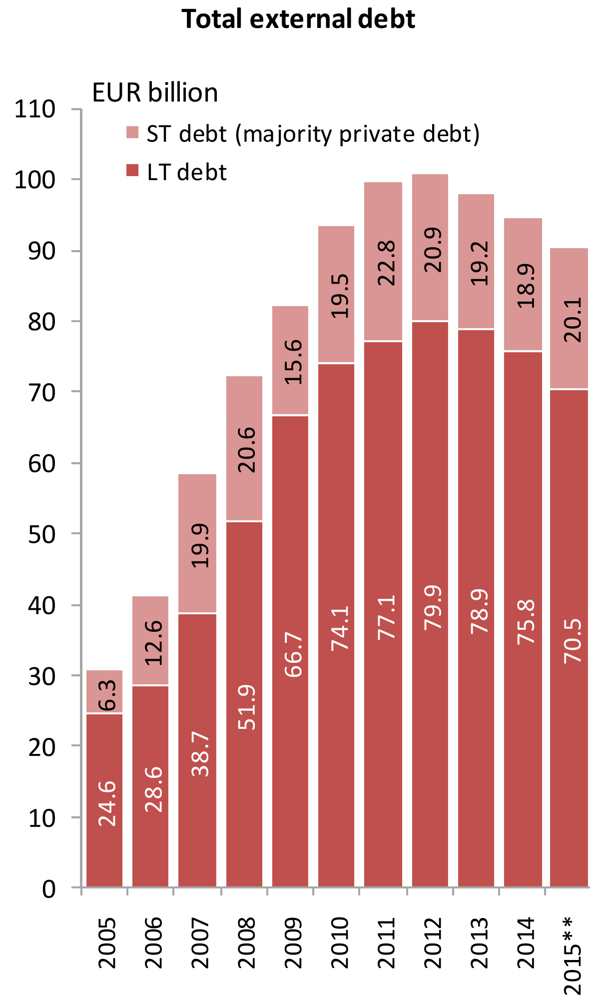


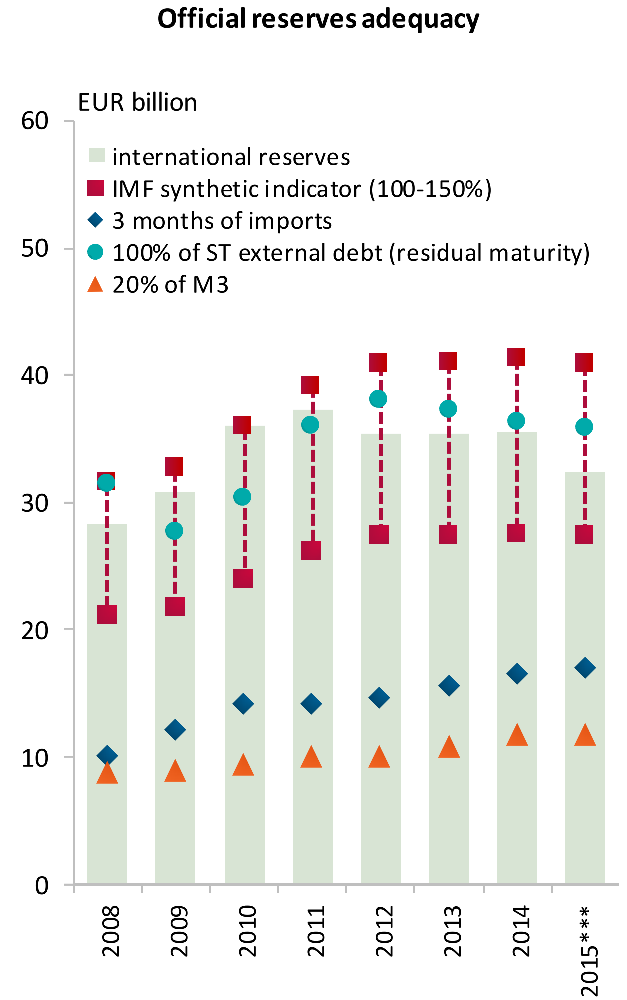
*) based on 2015 H1 data

Source: Eurostat, EC

Decreasing external debt and comfortable level of international reserves



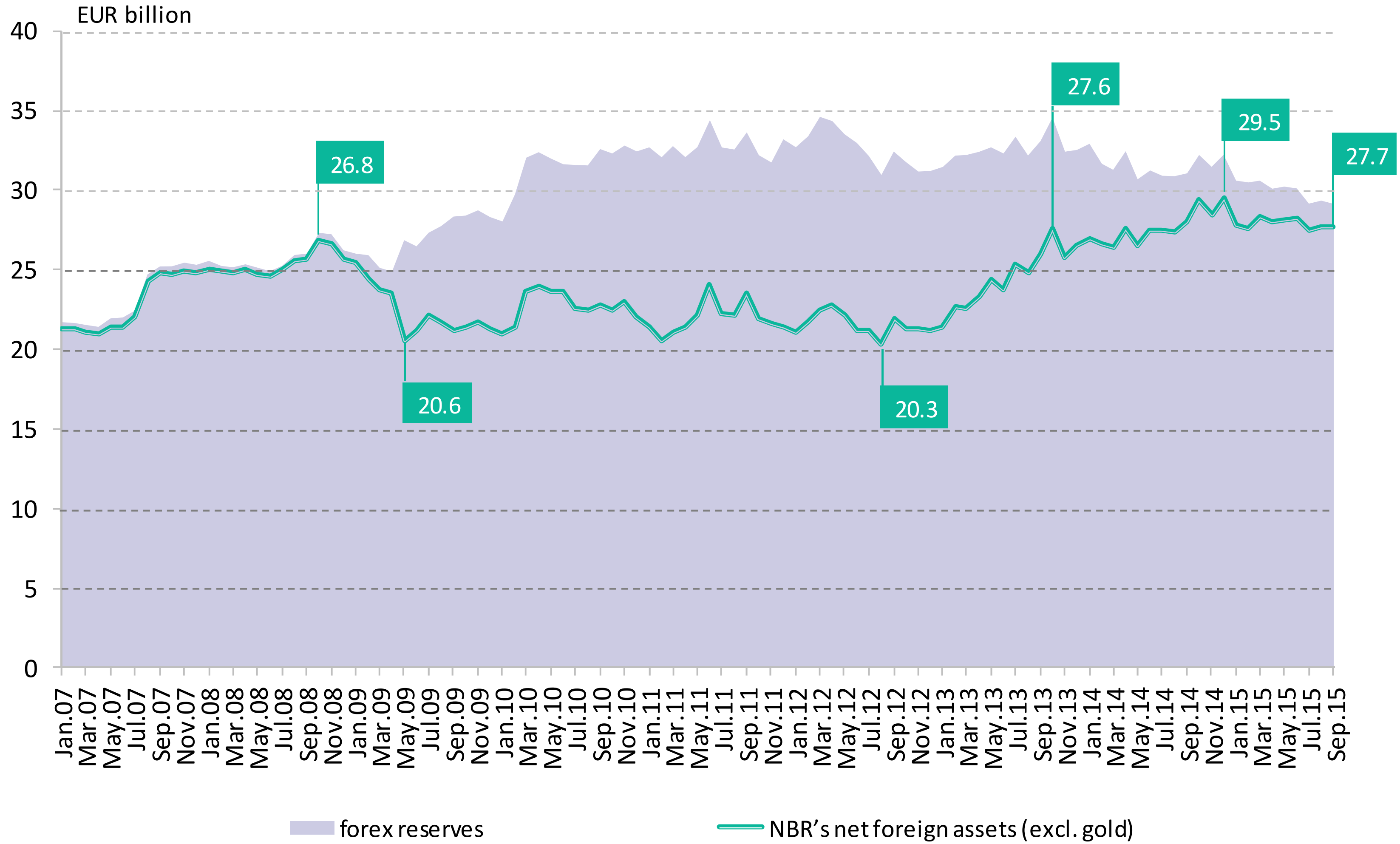




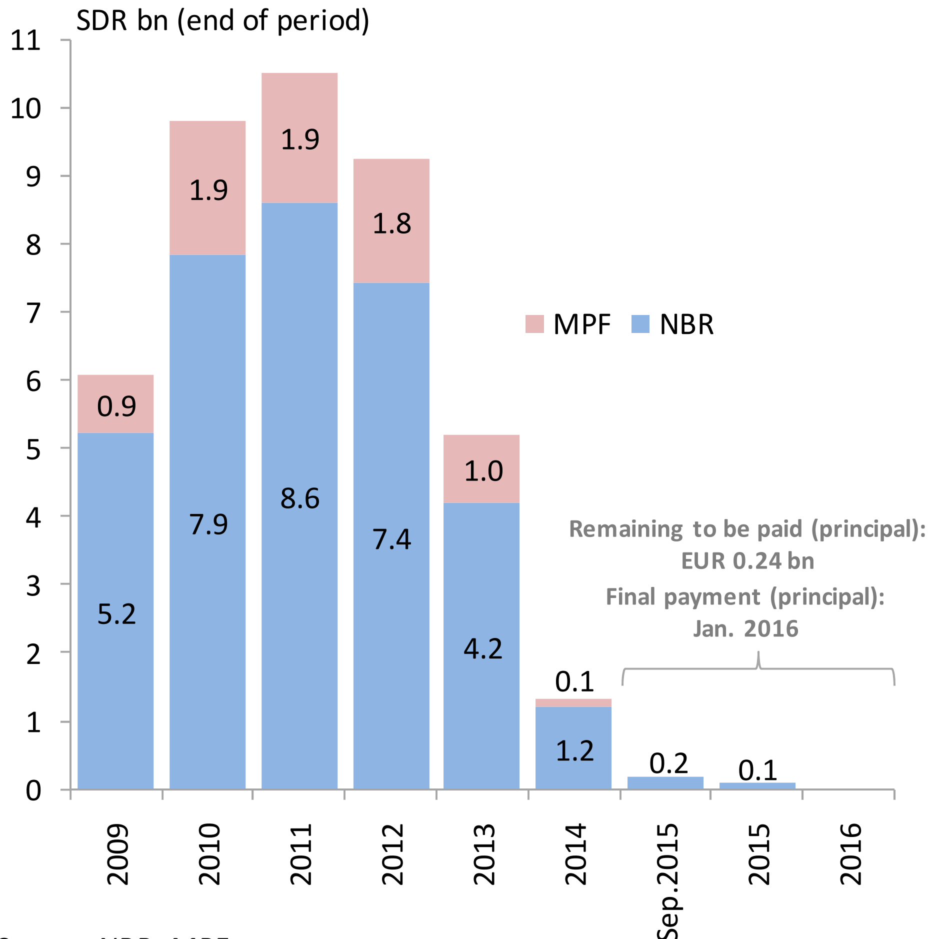
* Sep.; ** Jul.; *** Jan.-Jul.

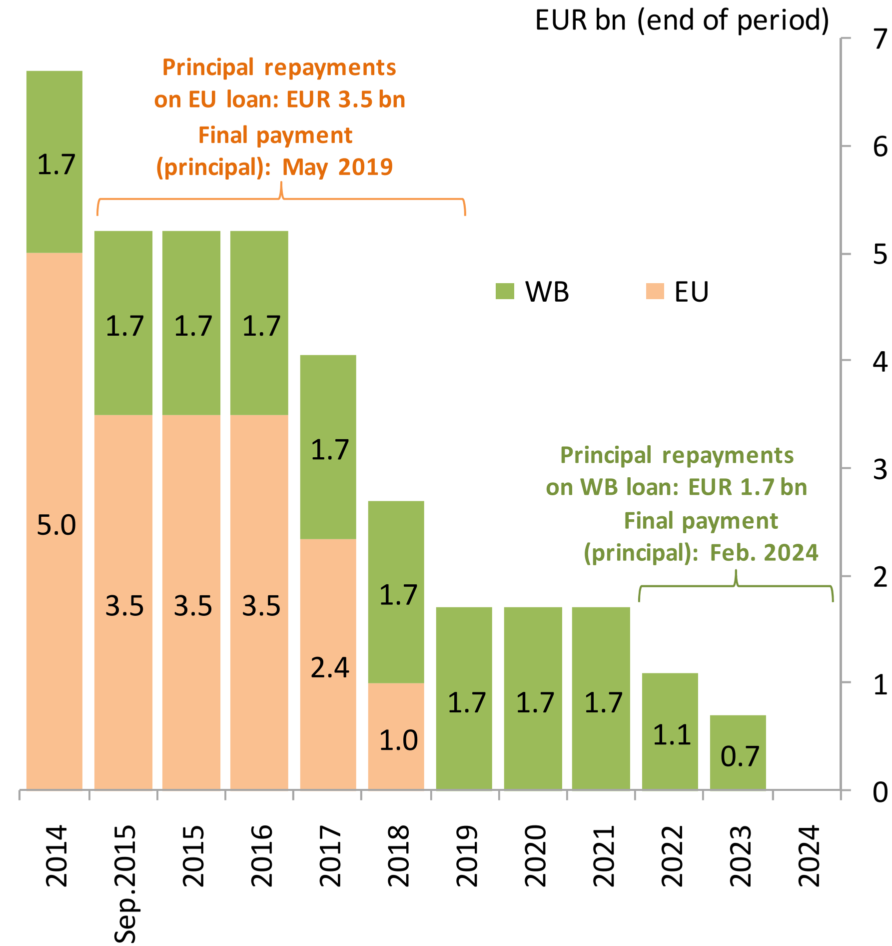
Source: NBR, NCP, IMF

Forex reserves above the pre-crisis level and uptrend in NBR's net foreign assets …



… despite the IMF loan being repaid almost completely





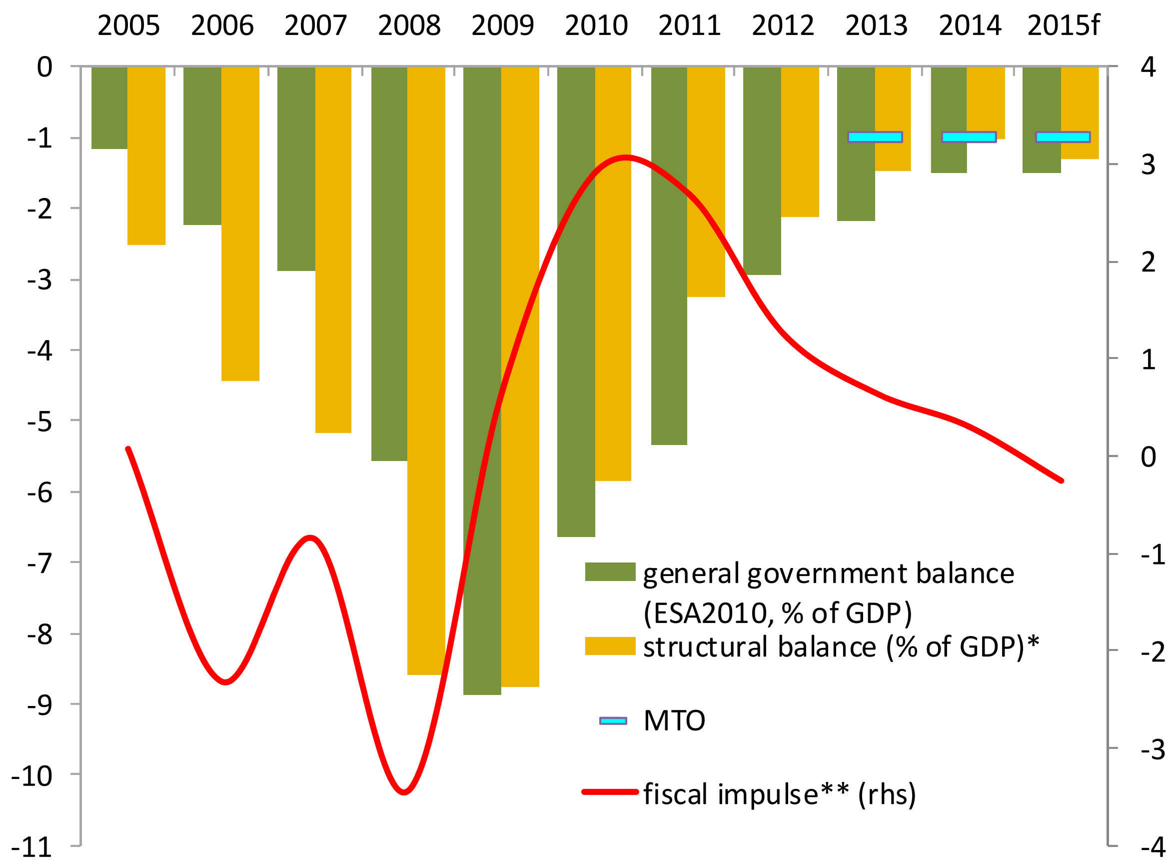
Source: NBR, MPF

Fiscal policy

Fiscal consolidation required by the preventive arm of the SGP was completed

- After peaking at 8.9% 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 1.5% of GDP in 2014 and is projected to remain close to this level in 2015
- The structural adjustment effort amounted to a cumulative 7.7 pp of GDP during 2010-2014 (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
- The medium-term objective – set by the Fiscal Compact at 1% of GDP structural deficit – was reached in 2014
  - ✓ While the deficit in 2015 is seen to remain close to the MTO, a significant deviation looks likely in the coming years given forthcoming tax cuts and wage increases in the public sector

Headline and structural general government balance



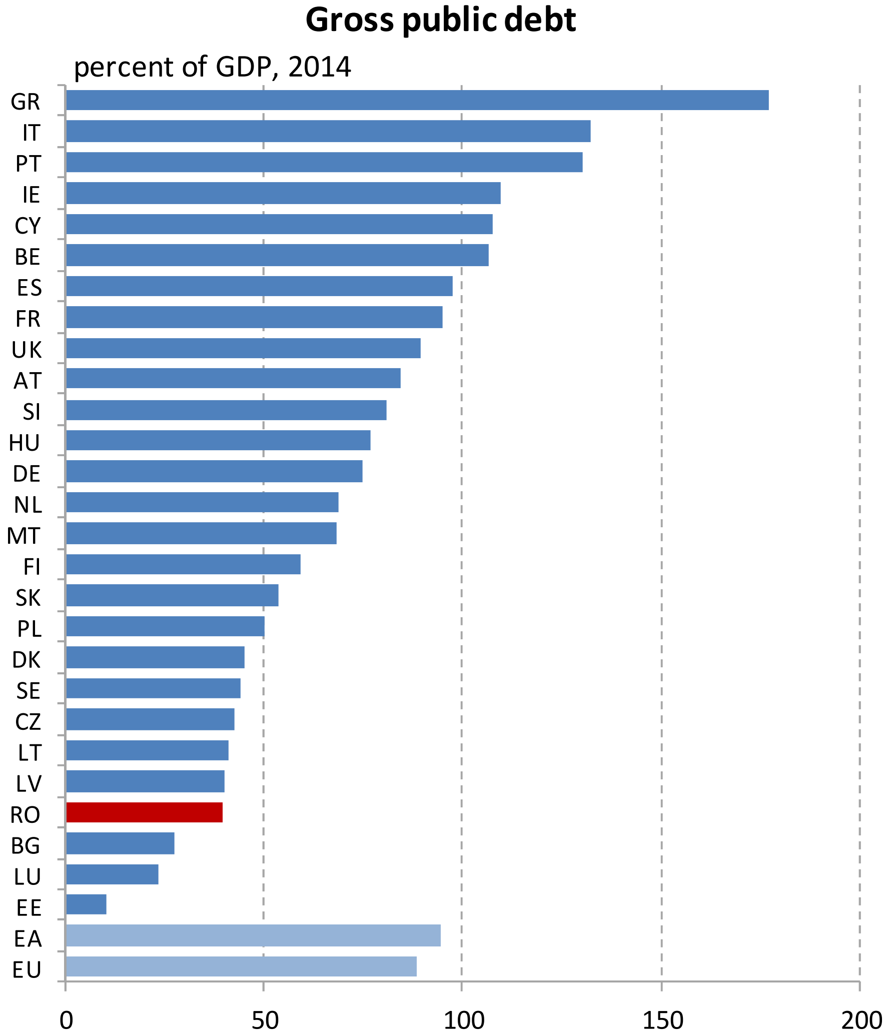
* cyclically-adjusted balance net of one-off and temporary measures

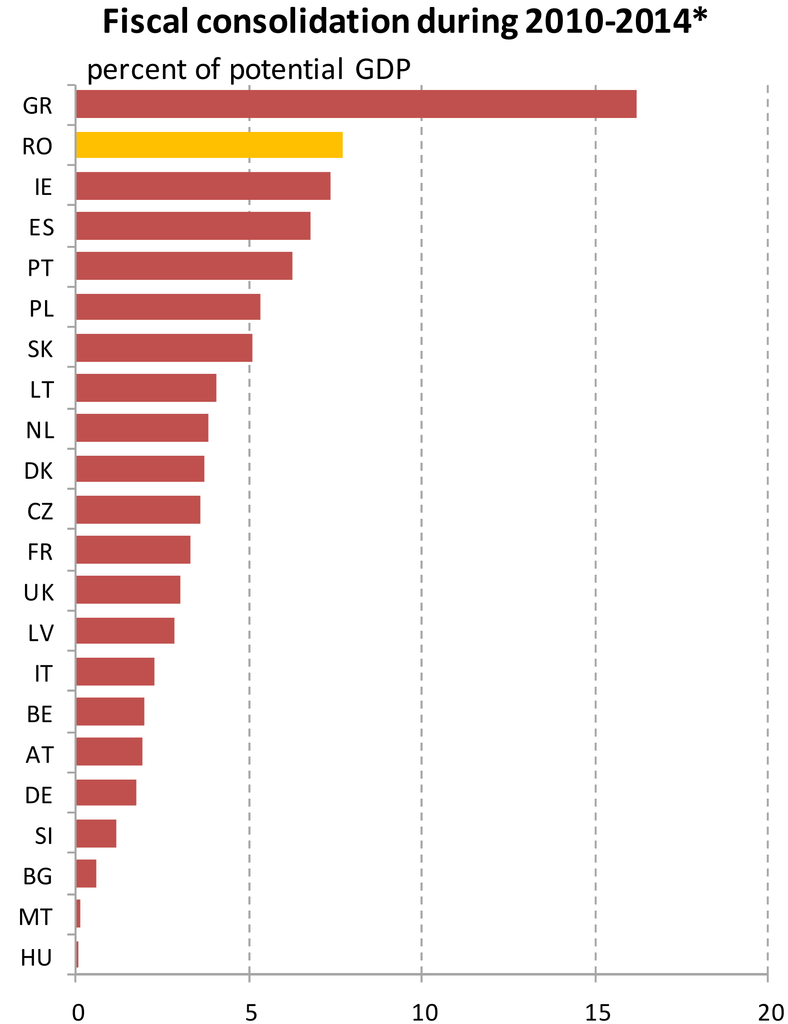
** change in the structural primary budget balance; a negative (positive) figure indicates fiscal stimulus (tightening)

Source: AMECO

- Fiscal policy has recently become slightly countercyclical, yet this stance is likely to be short-lived given the announced stimulative measures and the envisaged closing of the output gap during 2016

2nd largest fiscal consolidation effort in the EU; 4th smallest stock of public debt



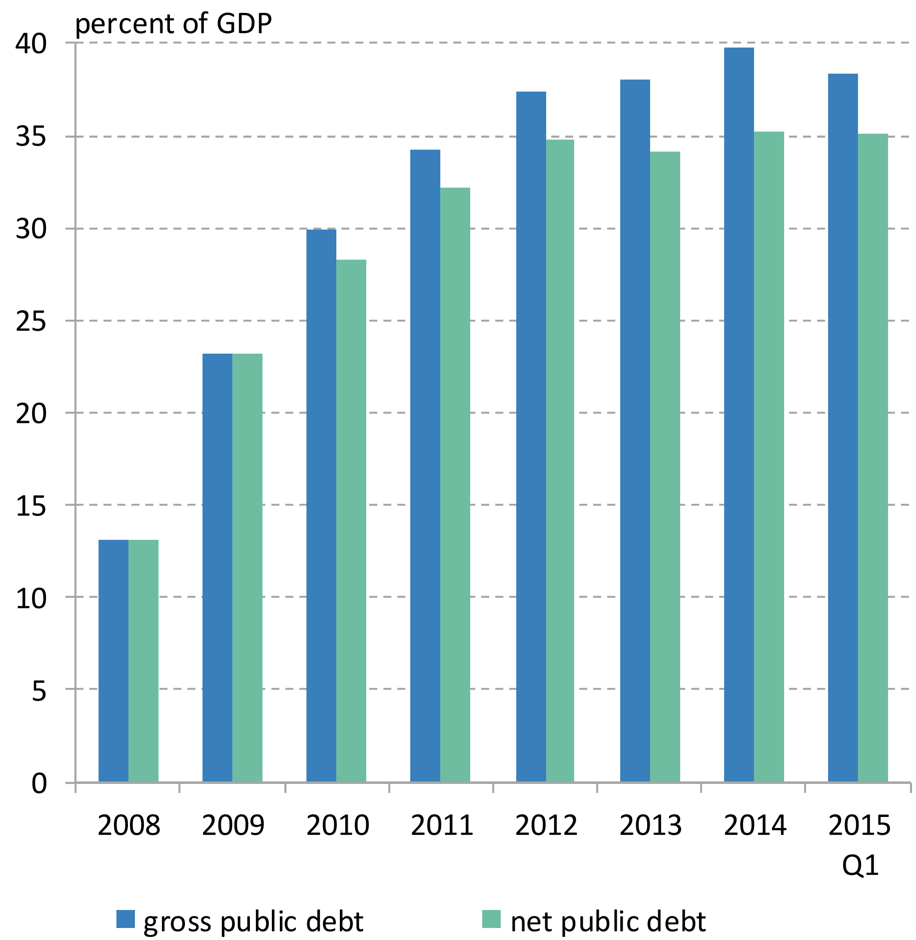


*) cumulative change in cyclically-adjusted net lending against 2009

Source: AMECO

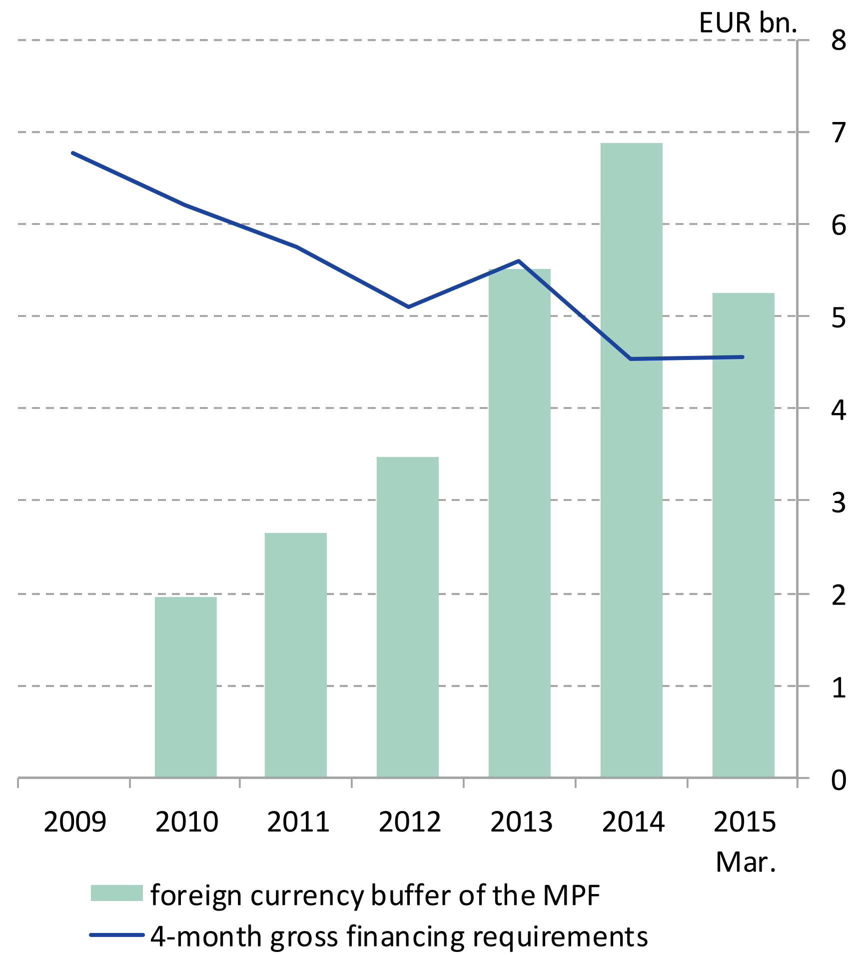
Net public debt ratio has been virtually stable since 2012, the increase in the gross measure being due to the build-up of a foreign currency buffer

Public debt



Source: NBR, MPF, FSA

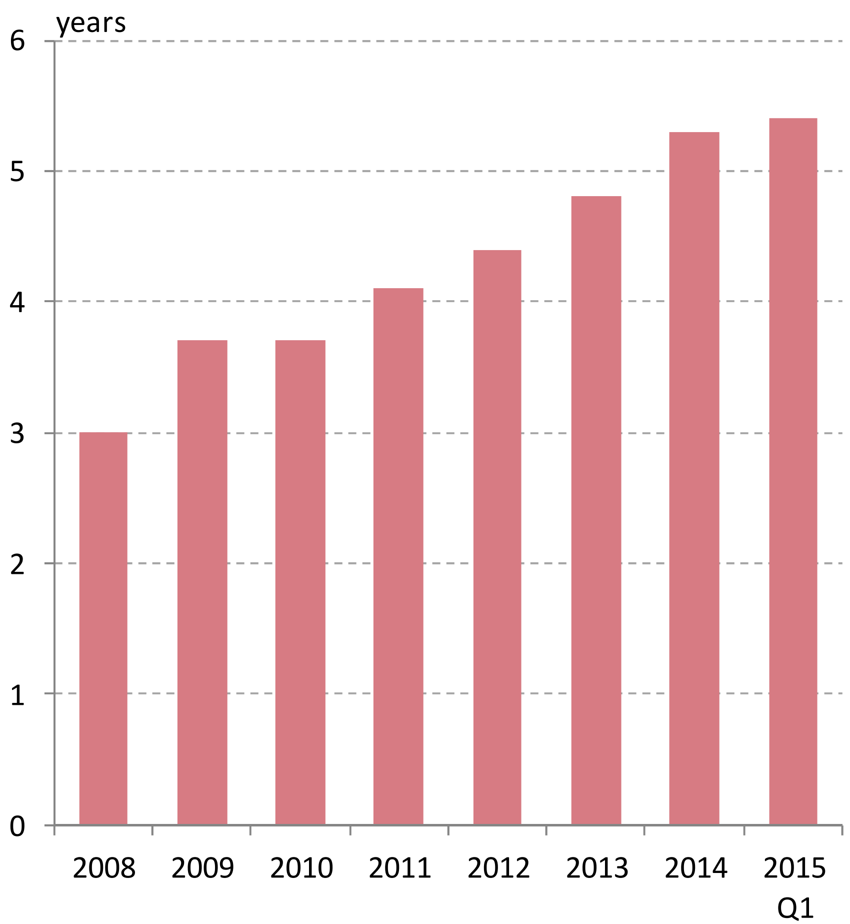
Foreign currency buffer of the MPF



Source: MPF

Improved maturity profile of public debt and decreasing borrowing costs, in line with fiscal consolidation performance

Average residual maturity of total public debt



Public debt stock-related cost relative to government debt

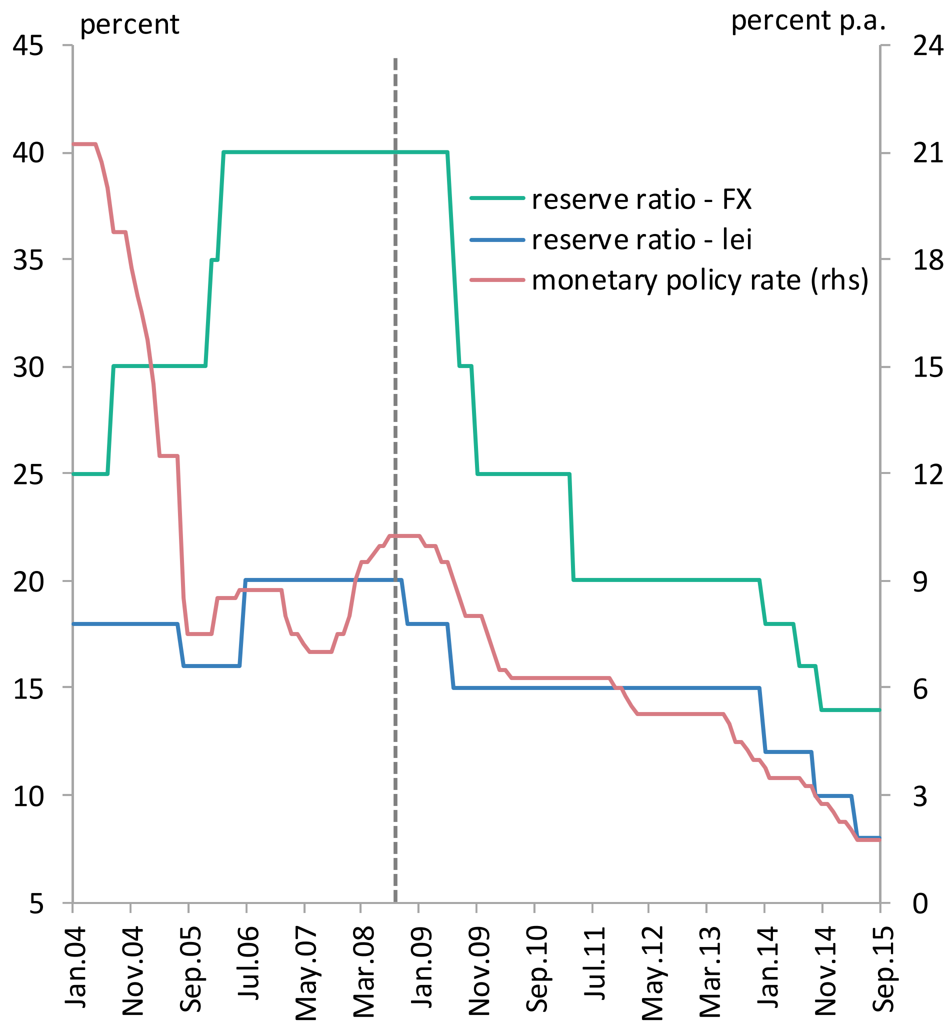
Source: NBR, MPF, FSA

Assessing public debt sustainability

- The current level of public debt is comfortable, yet relatively close to the estimated critical threshold of 45% of GDP
  - ✓ A debt-to-GDP ratio above the threshold would increase the probability of recession over 50% and have a detrimental impact on borrowing conditions
- Maintaining the deficit within the limits set by the MTO would allow for a steady decrease in the debt-to-GDP ratio, however:
  - ✓ A persistent deviation from the MTO as implied by recent policy measures would keep the public debt ratio on an upward trajectory
  - ✓ Even assuming that the current public debt costs are kept in place and the economy grows at potential, a budget deficit of around 3% of GDP per annum would mean exceeding the public debt critical threshold within the next three years

Monetary policy

Countercyclical monetary policy both before and after the outbreak of the global crisis



Source: NBR

- During the boom years, the NBR tightened the policy stance by increasing the reserve requirements ratios for both RON and forex liabilities
  - ✓ The use of the policy rate was constrained by massive capital inflows
- As demand pressures subsided, the NBR gradually reduced the policy rate and the reserve requirements ratios
- Rapid decline in the actual and expected annual inflation rate over the last two years warranted further easing of monetary policy

Countercyclical monetary policy both before and after the outbreak of the global crisis (2)

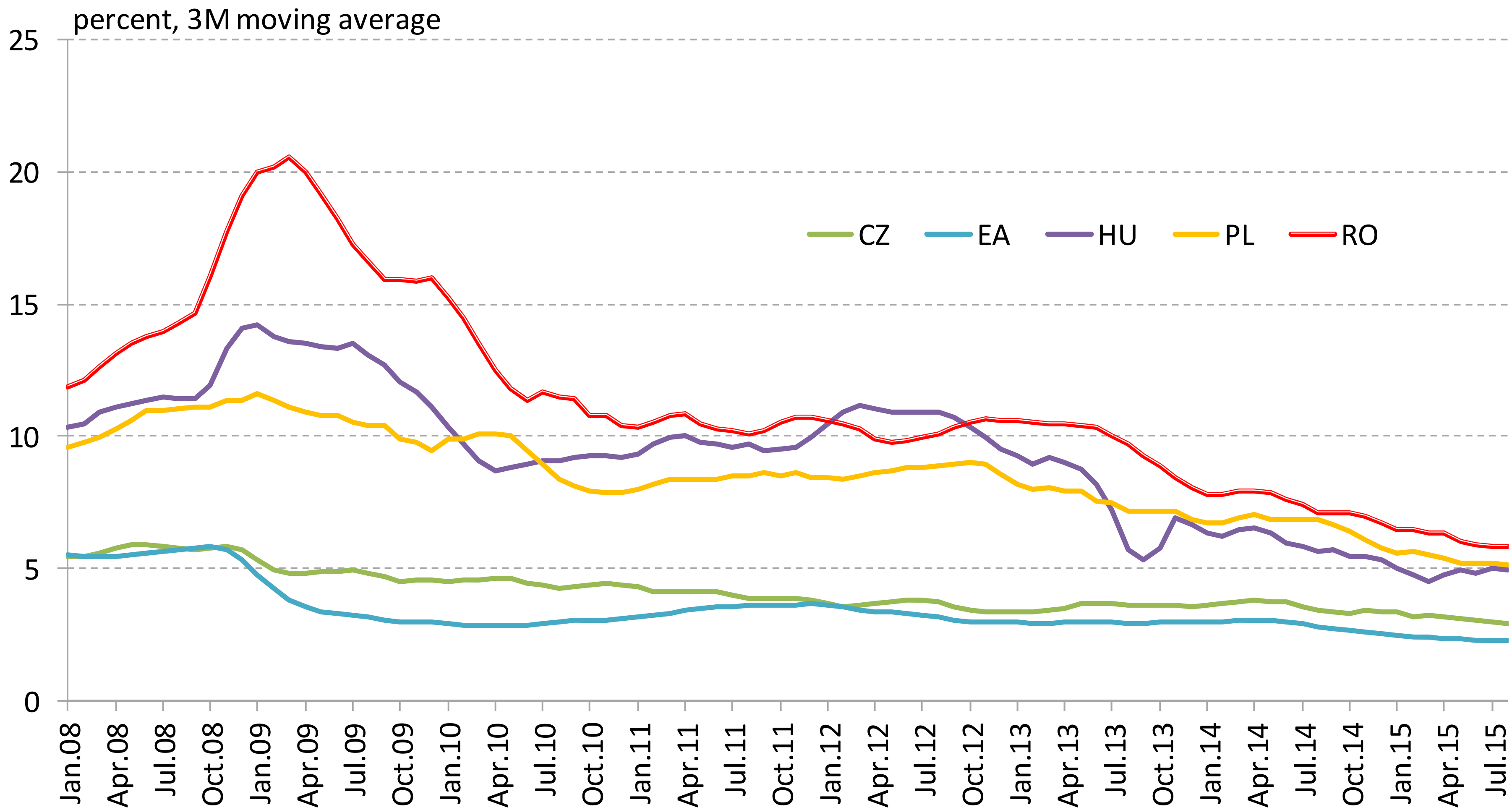
- Given the low inflation and the still negative output gap, there may still be some room for monetary policy easing, but such a decision is conditional upon the magnitude of the fiscal stimulus

- Several steps towards harmonising the operational framework of monetary policy with the EU standards have been taken

  - ✓ The NBR will continue to seek the right timing to gradually reduce reserve requirements ratios – currently at 8% and 14% for lei- and forex-denominated liabilities respectively – towards the prevalent level in the EU

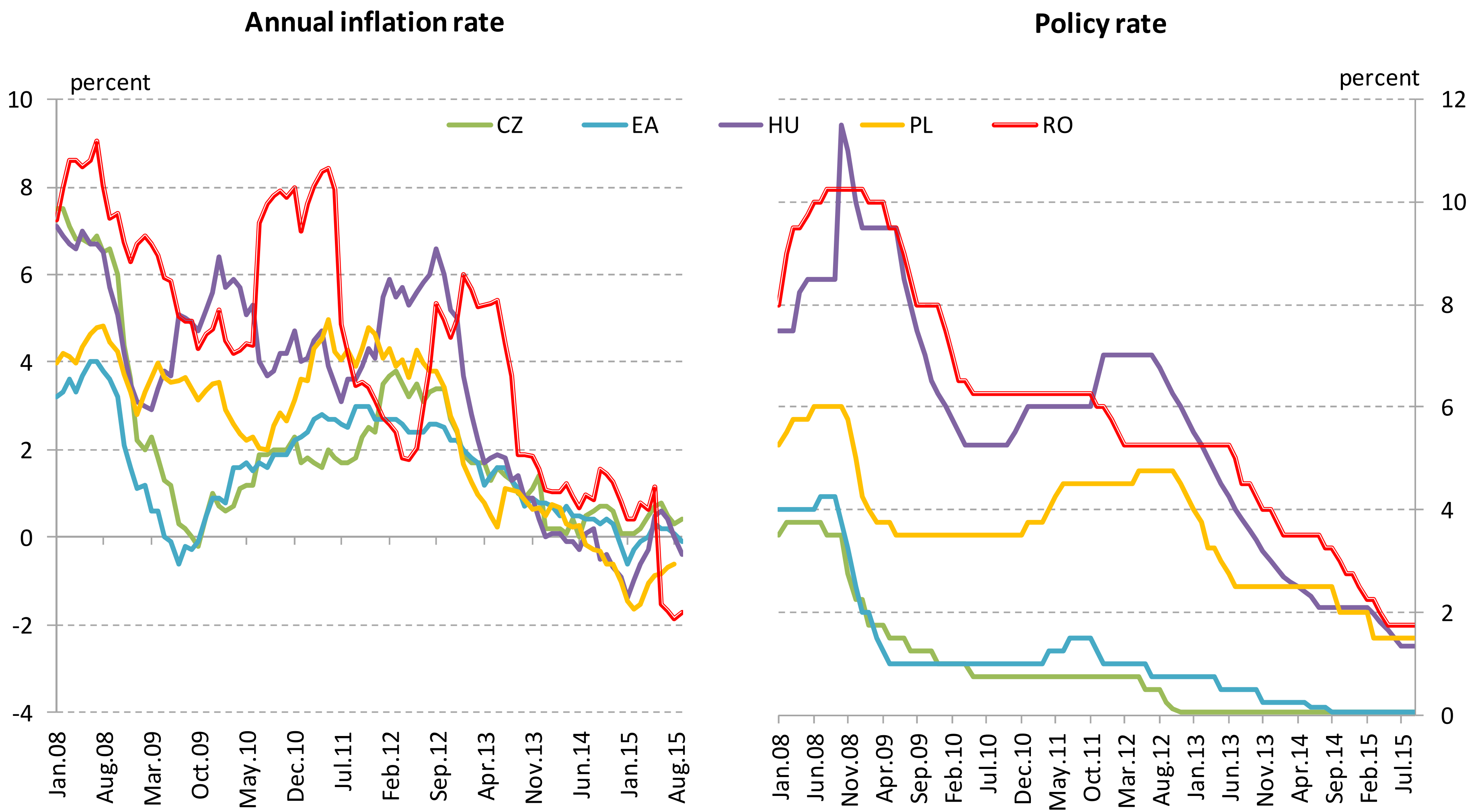
  - ✓ The interest rate corridor has been narrowed from ±4 pp in 2008-2013 to ±1.5 pp, a width close to the ±1 pp standard

Lending rate on new business neared regional levels, although with a certain lag ...



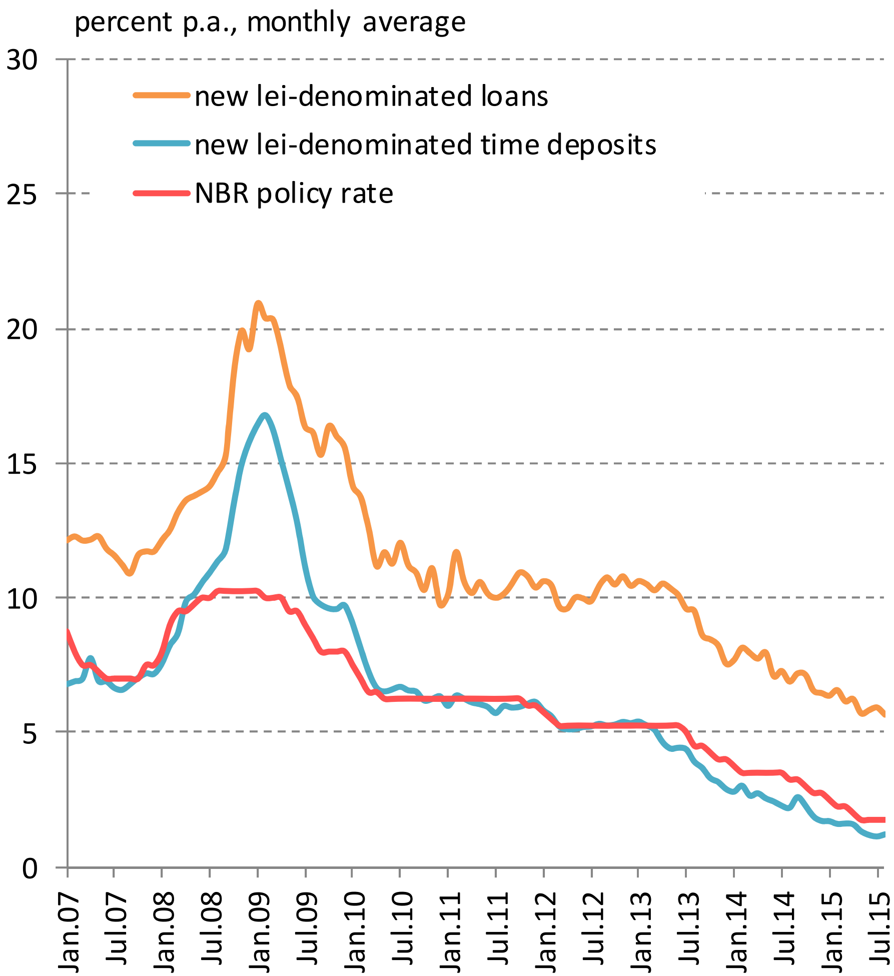
Source: ECB, national central banks

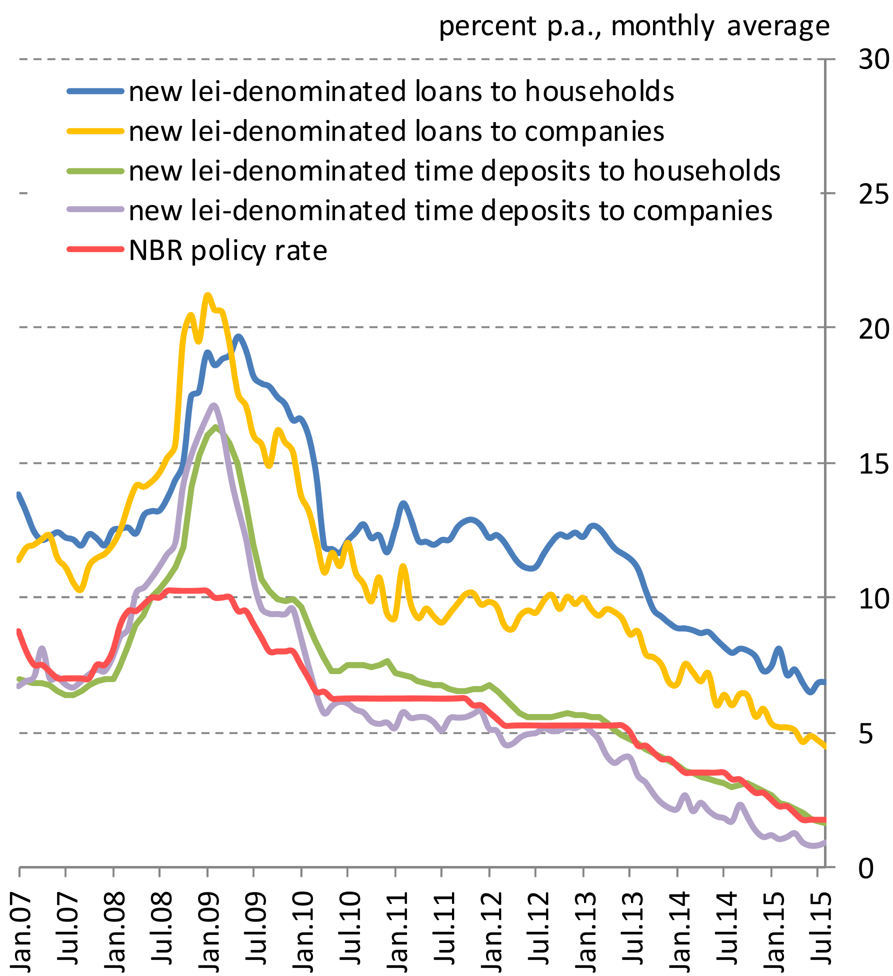
... as the persistently higher inflation rate slowed the pace of the policy rate-cutting cycle in Romania



Source: ECB, national central banks

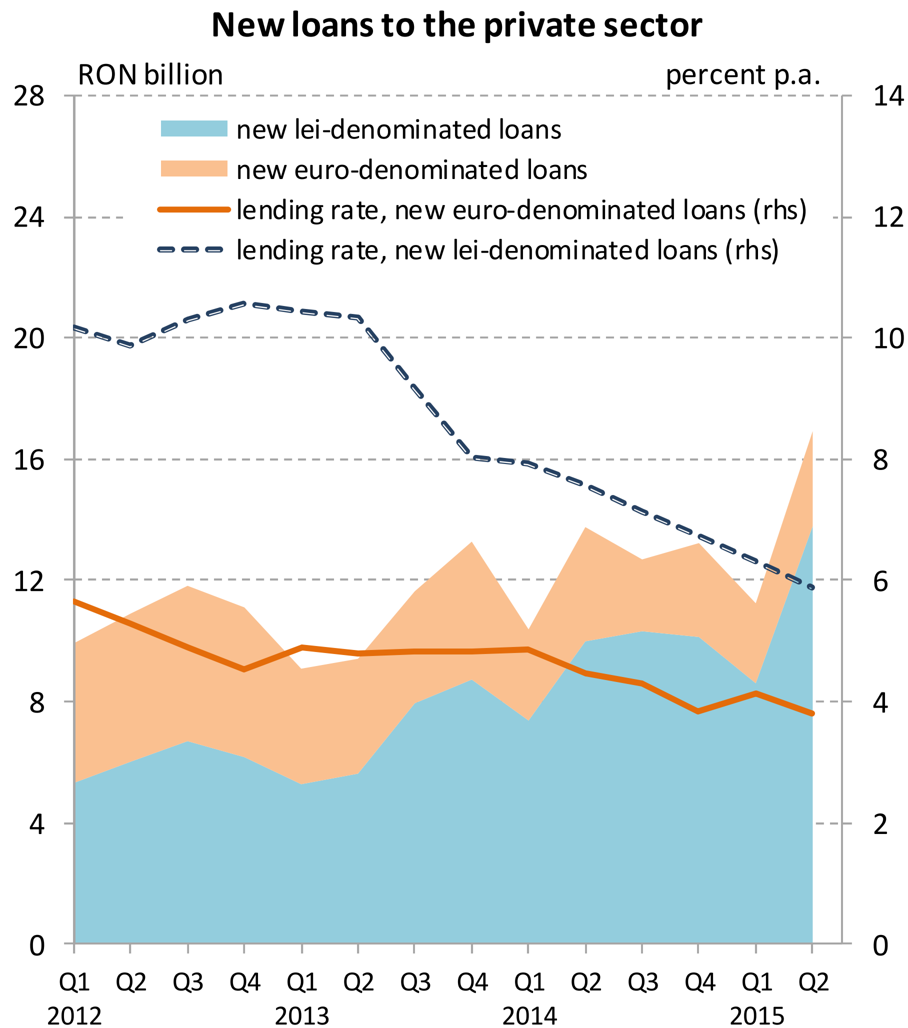
Downward path of bank interest rates to non-bank clients amid the NBR's successive policy rate cuts

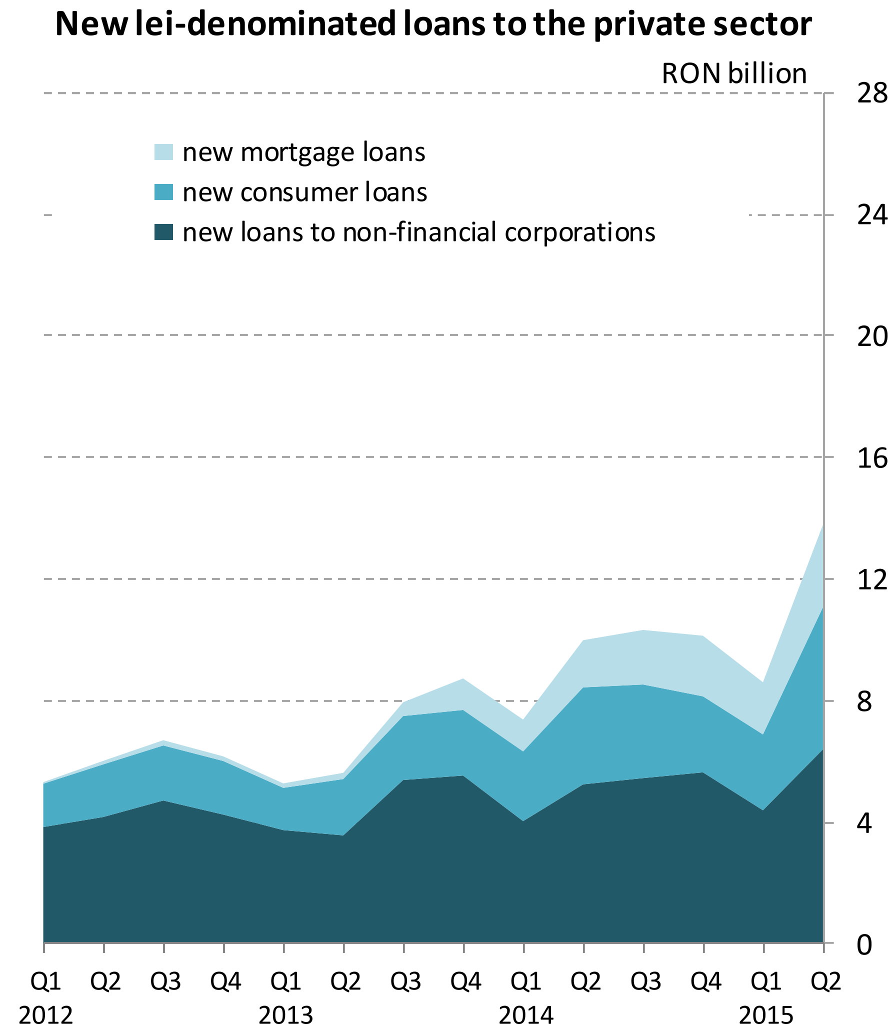




Source: NBR

Steady recovery in lending to the private sector in 2015, driven by lei-denominated loans

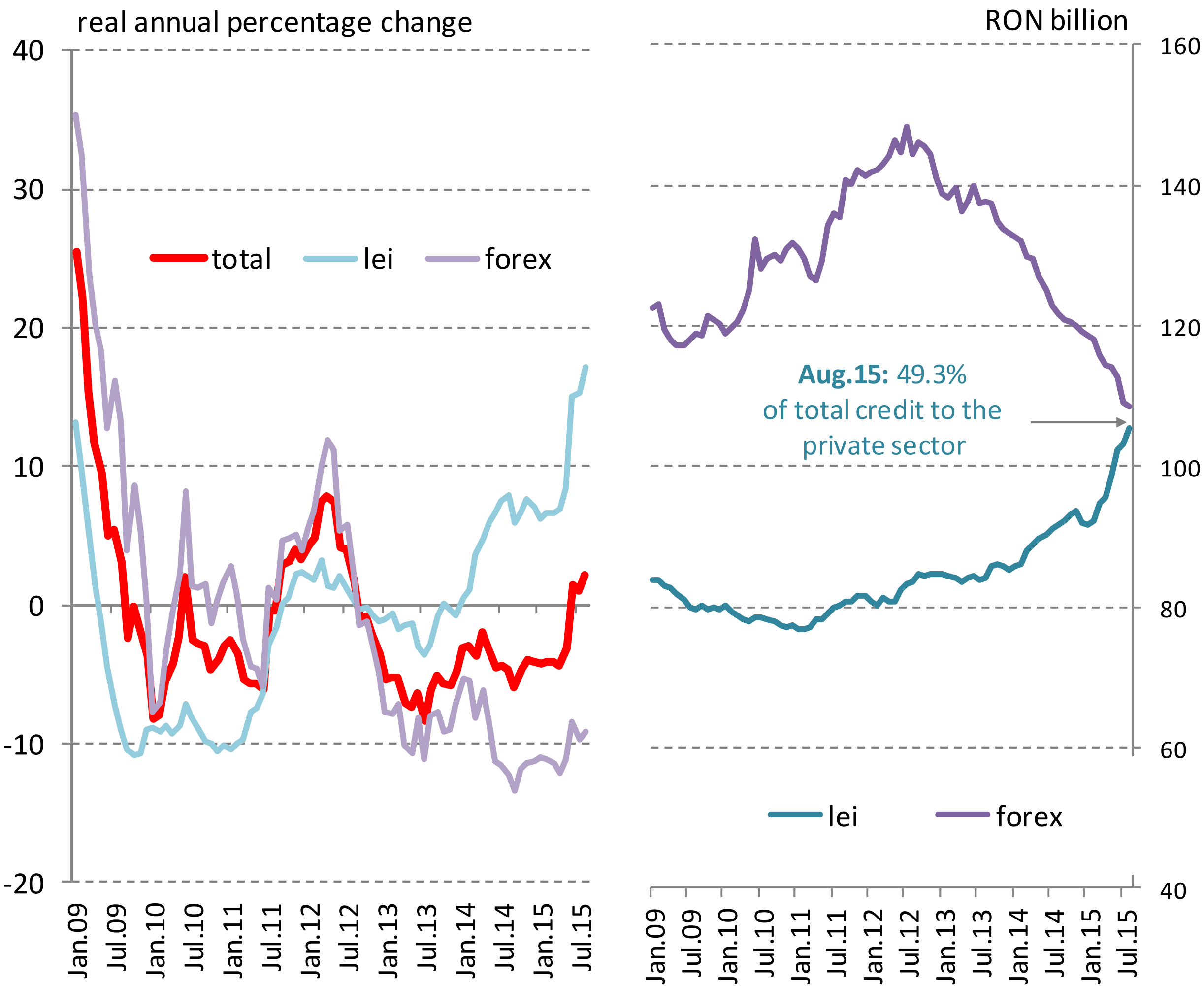




Source: NBR

The historical prevalence of forex loans subsided sharply in recent years

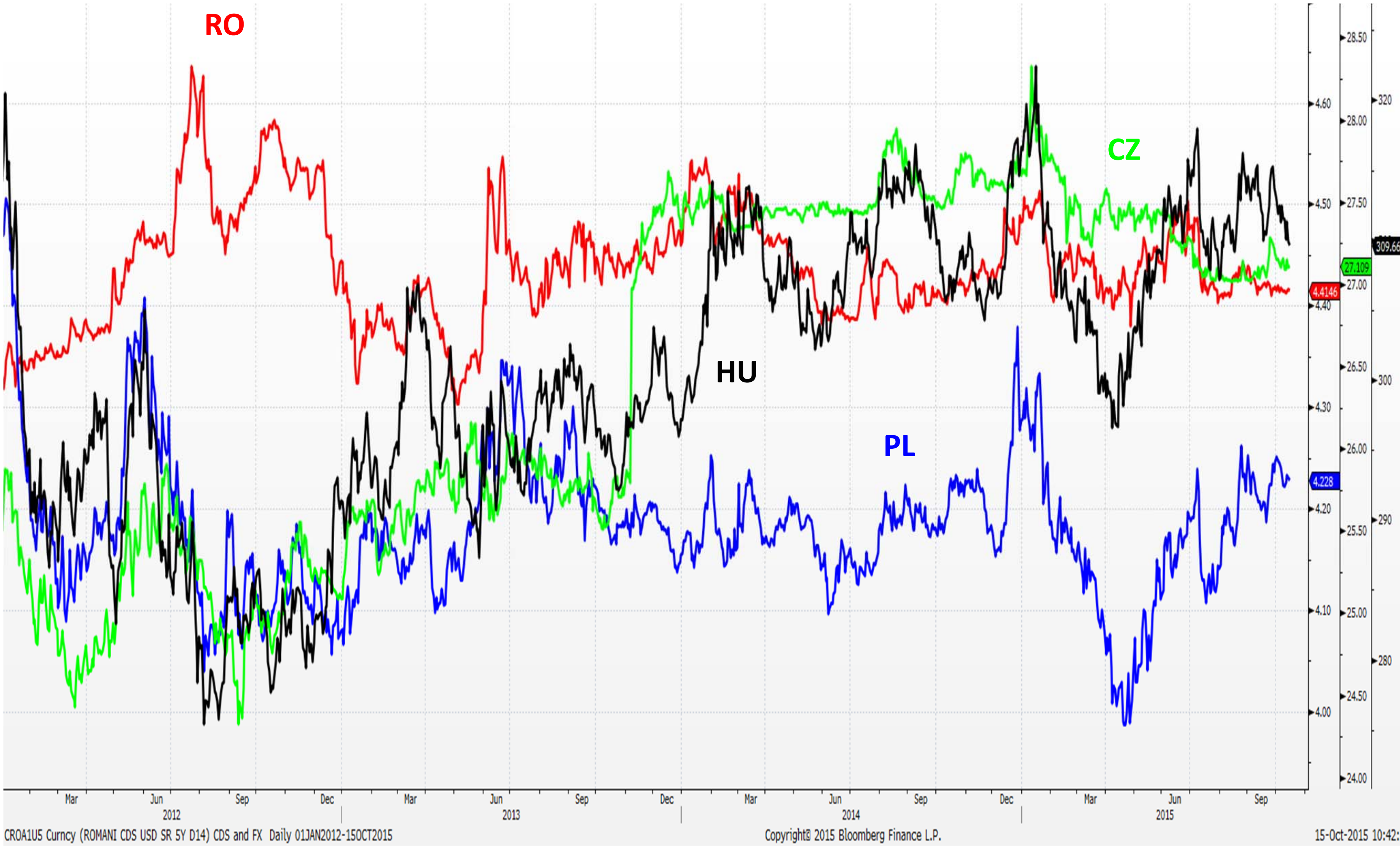
Loans to the private sector, outstanding



Source: NBR

- Decline in forex credit amid:
  - ✓ Faster (yet orderly) cross-border deleveraging
  - ✓ NBR regulations addressing unhedged borrowers, which are fully compliant with ESRB recommendations on lending in foreign currencies
  - ✓ Changes in the government-supported programme for house purchases (only lei-denominated credit since Aug. 2013)
- Increased demand for lei-denominated loans was prompted by historically low lending rates
  - ✓ In the case of mortgages, interest rates on loans in lei dropped below those on loans in euro

Less volatile exchange rate as compared to regional peers

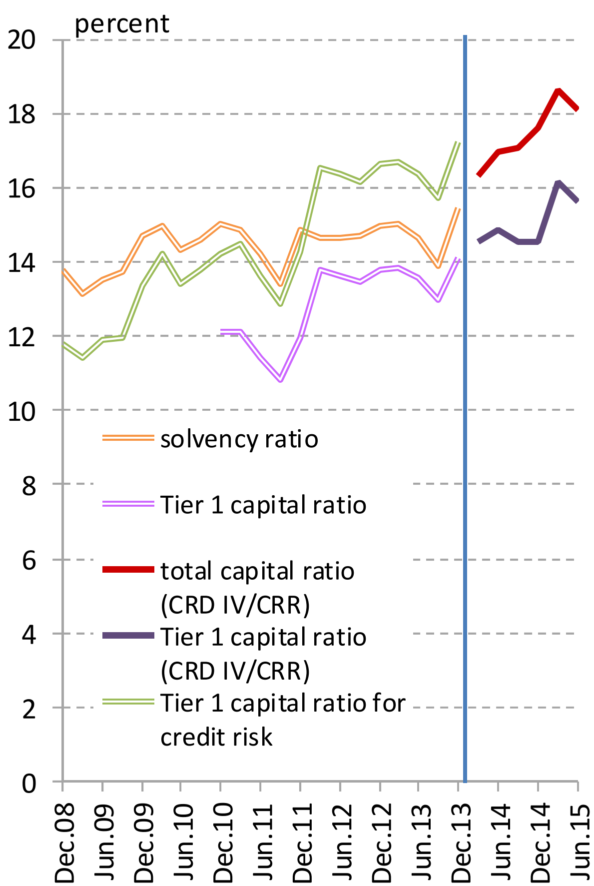


Source: Bloomberg

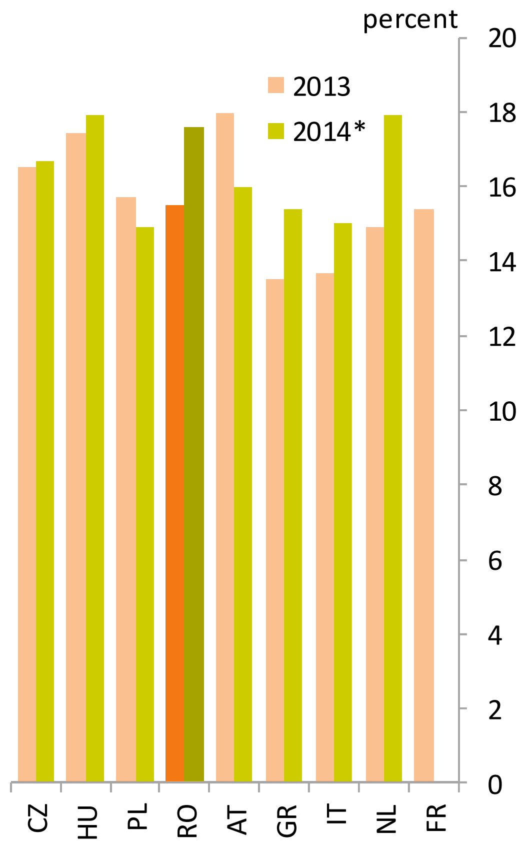
Banking sector

The banking system is sound

Capital adequacy indicators



Solvency ratio in selected EU countries



* Sep.14: AT, GR, PL
Jun.14: IT

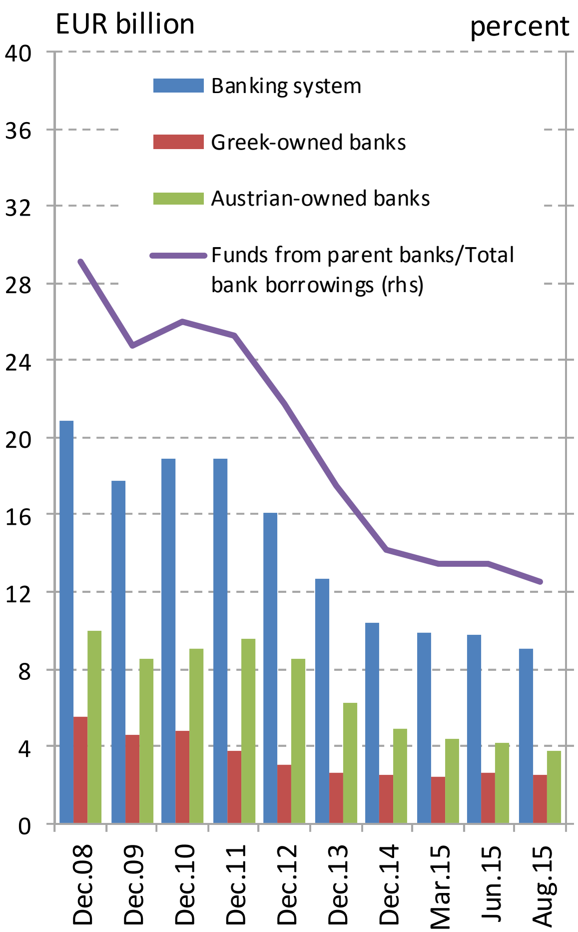
RO: 18.1% in Jun.15

Source: National Bank of Romania, International Monetary Fund (Financial Soundness Indicators, FSI Tables, April 2015)

- The banking system is well capitalised, having a high capacity to absorb potential shocks
  - ✓ Total capital ratio stood at 18.1% at end-June 2015, well above the 8% threshold set forth by the CRD IV/CRR regulatory framework
  - ✓ High quality of own funds, as reflected by the Common Equity Tier 1 ratio of 15.6% at end-June 2015
  - ✓ The NBR is exercising tight oversight of prudential indicators, with a focus on capital adequacy dynamics and banks' efforts to raise additional capital
  - ✓ No public funds have been used so far to support the banking sector
- The liquidity ratio (effective liquidity/required liquidity) remained adequate (1.7 in August 2015)

Orderly deleveraging after the outbreak of the crisis, presently slowing down

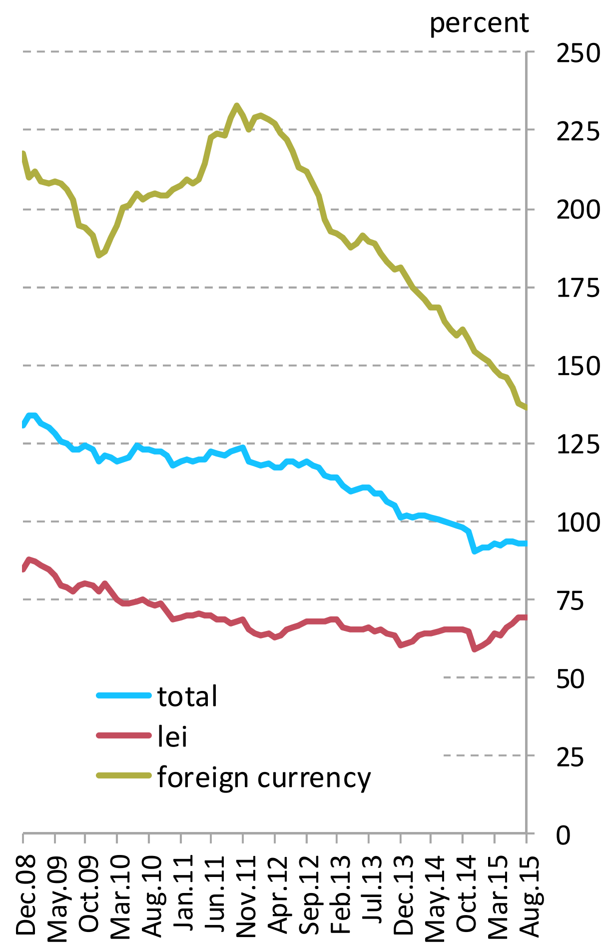
Funds from parent banks*



* subordinated loans excluded

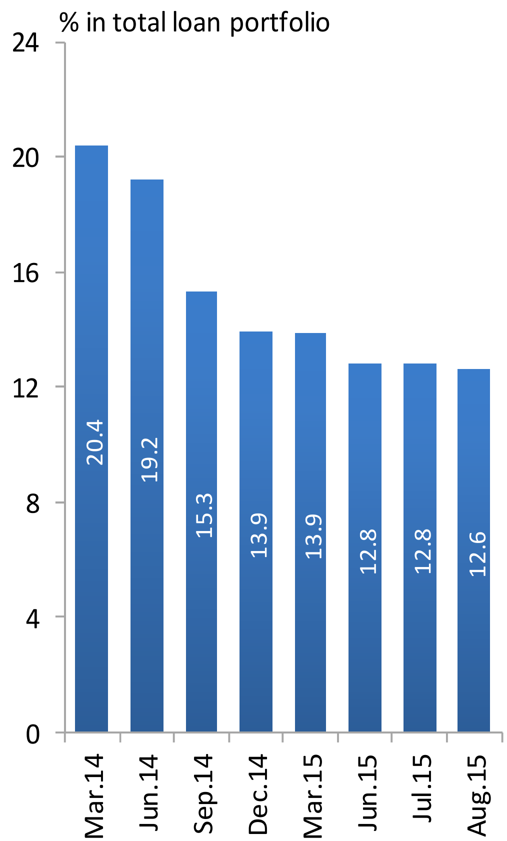
Source: NBR

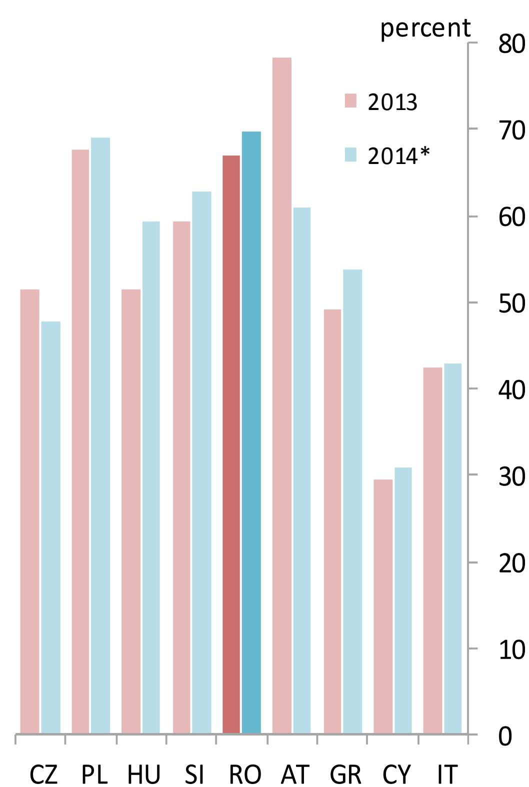
Loan-to-deposit ratio



- ❑ Low level of LTD ratio in the banking system as a whole, reflecting the lack of pressures from a macroprudential standpoint
- ❑ LTD ratio has improved markedly in recent years, reaching 92.5% in August 2015
  - ✓ The reduction in foreign financing was offset by the substantial rise in the local deposit base, as a result of precautionary saving by both households and companies (+9.5% yoy in August 2015, change in real terms)

Steady decrease in NPL ratio and high degree of coverage with IFRS provisions





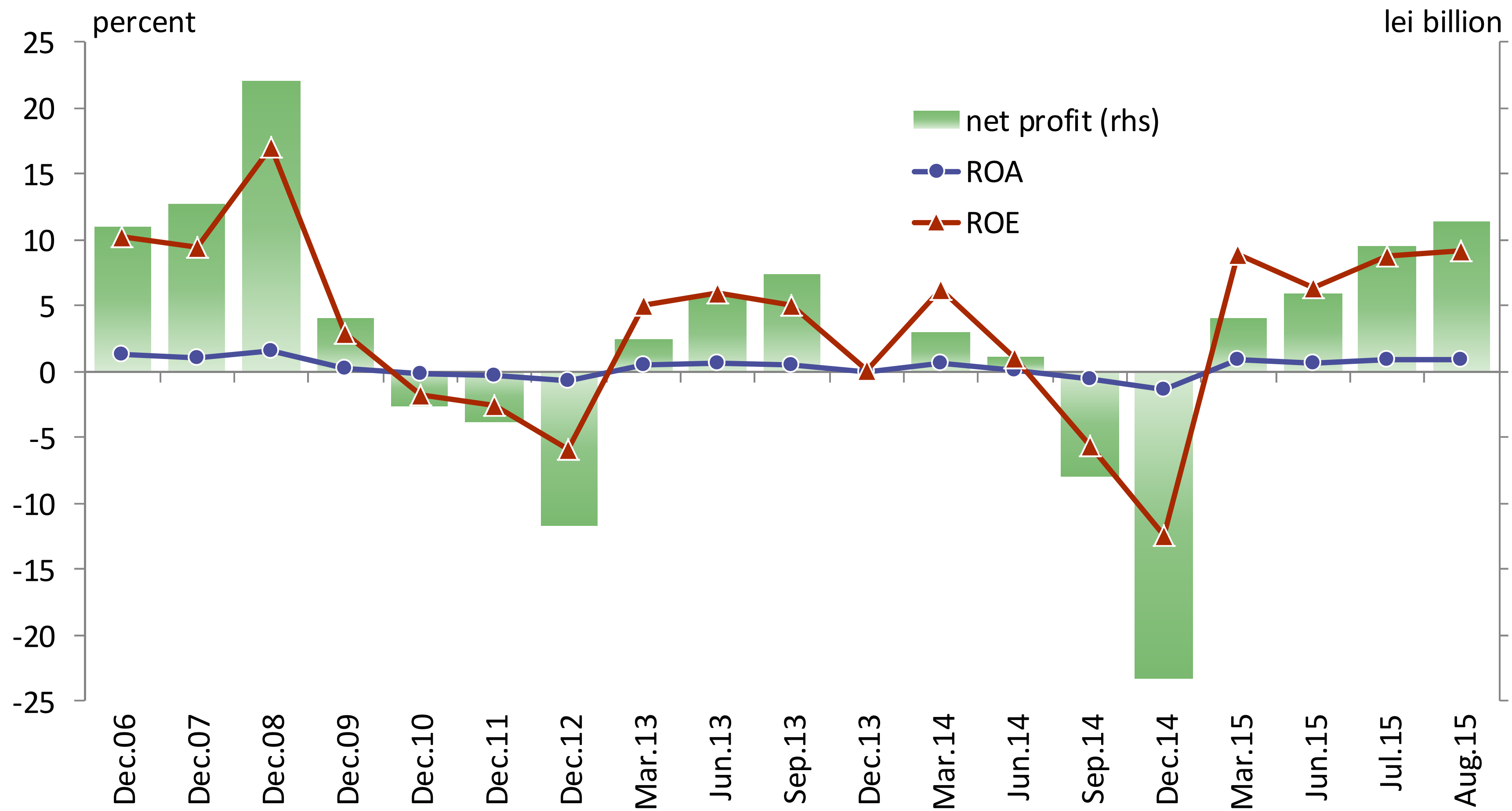
*) Sep.14: AT, GR, CY, PL
Jun.14: IT

RO: 69.2% in Aug.15

Source: National Bank of Romania, International Monetary Fund (Financial Soundness Indicators, FSI Tables, April 2015), NBR

- Banks' efforts to improve loan portfolio quality have strengthened starting 2014 at the NBR's recommendation, based on a four-step plan
  - ✓ The removal of fully-provisioned NPLs from the balance sheet
  - ✓ Full provisioning and removal from balance sheets of loans overdue for more than 360 days
  - ✓ Full provisioning and removal from balance sheets of loans to insolvent companies
  - ✓ The conduct of an external audit of IFRS provisions on the loan portfolio outstanding at end-June 2014 and of collateral assessment

Banking sector profitability turned positive in 2015



Note: Starting 1 January 2012, Romanian credit institutions apply the IFRS for accounting purposes.

Source: National Bank of Romania

Impact of regional tensions

Conflict between Russia and Ukraine: manageable economic risks

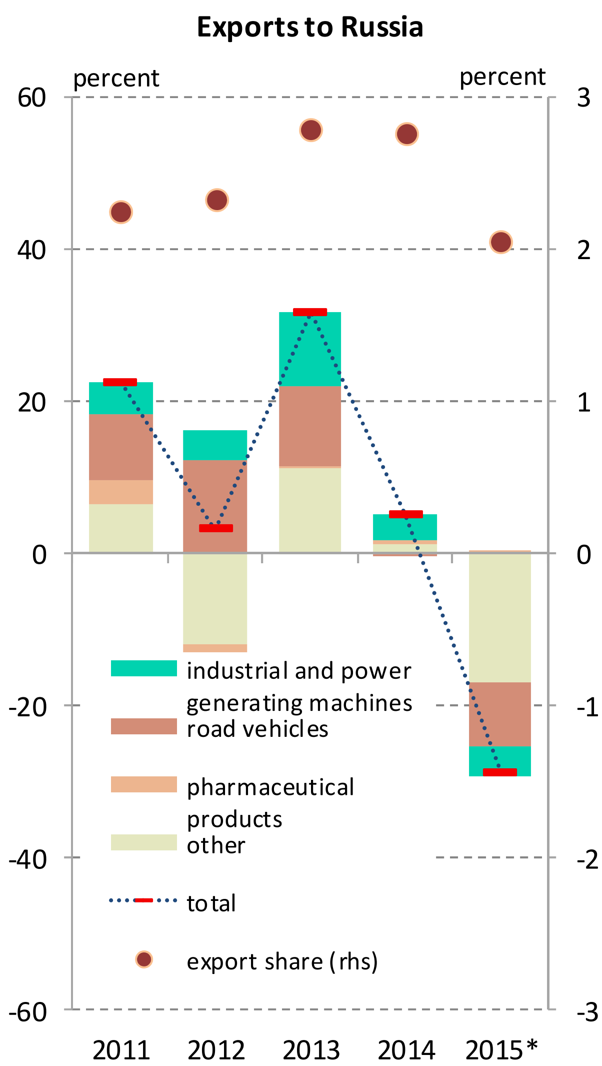
Real sector:

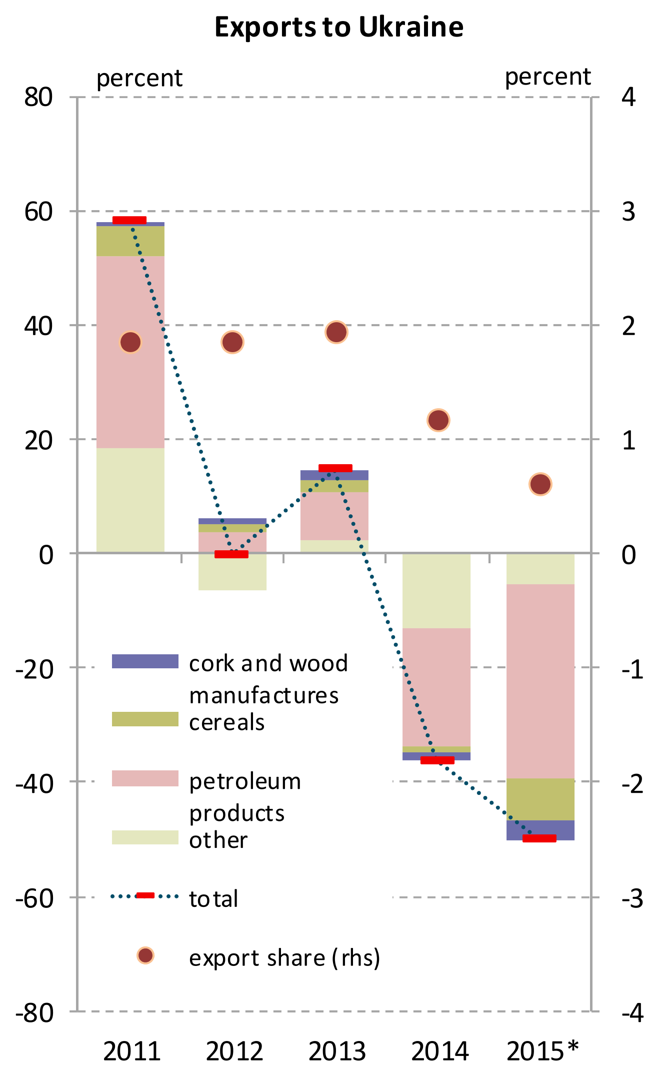
- Energy: the share of imports from Russia is limited (around 4%), most of them consisting of energy products
  - Romania is able to cover on average around 92% of its own natural gas consumption from domestic sources (2014)
  - The weight of imported natural gas further decreased to 1.8% in Jan-May 2015 and is expected to become negligible in 2016
  - Romania ranks the third least imported-energy-dependent country in the EU (2013, after Estonia and Denmark)
- Russian capital is present (directly or via holding companies based in other EU countries) in the iron and steel (TMK), metallurgy (ALRO Slatina) and oil refining (Lukoil) sectors, but none of the Russian-owned companies may be deemed of systemic importance

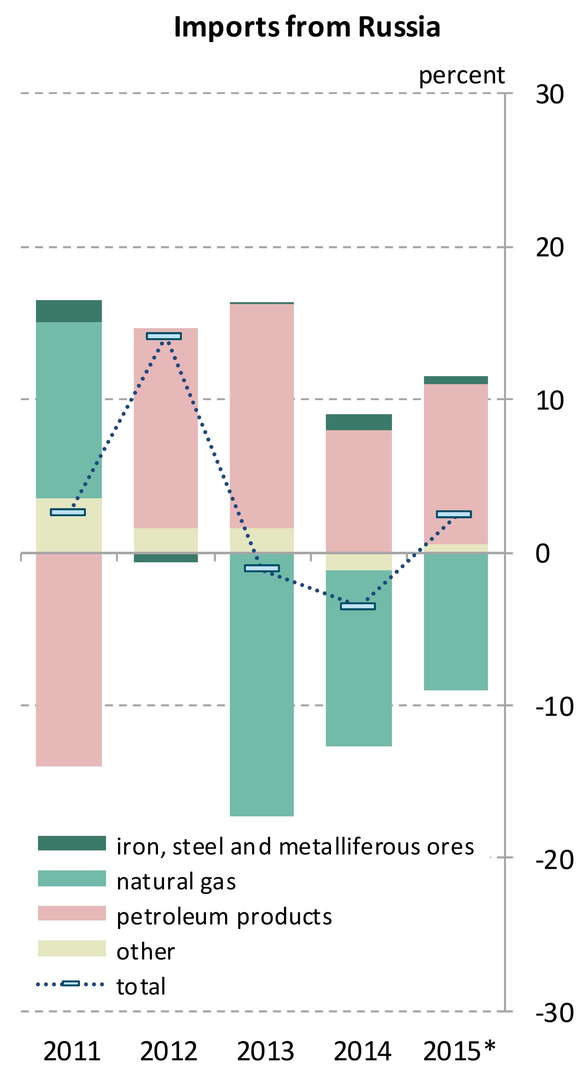
Financial sector:

- No direct links between the Romanian banking system and those of Russia and Ukraine
  - No Russian or Ukrainian capital in the Romanian banking system
  - No exposure of Romanian banks to Russian or Ukrainian entities

Decreasing trade exposure to Russia and Ukraine



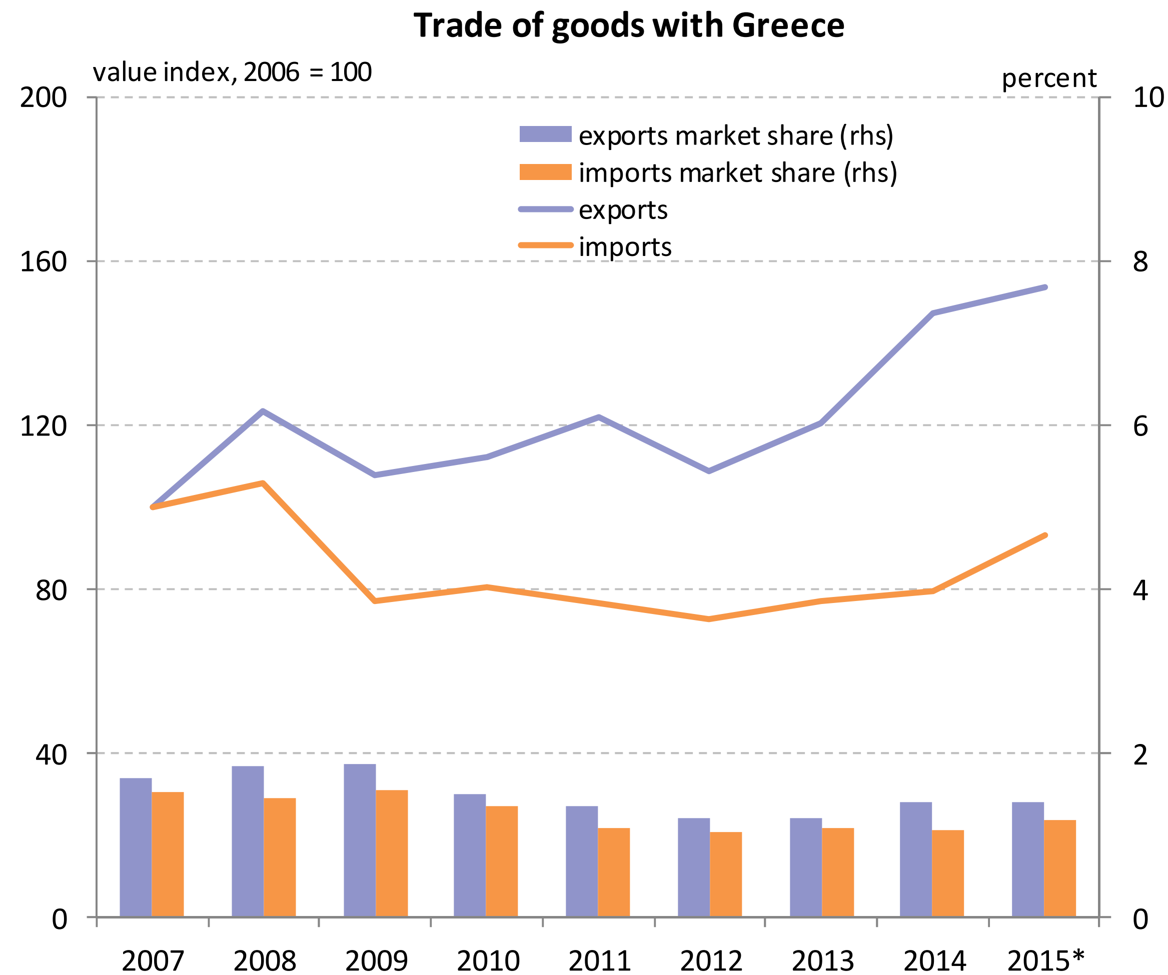




Source: Comext

*) Jan.-Jun.

Limited external trade exposure to Greece



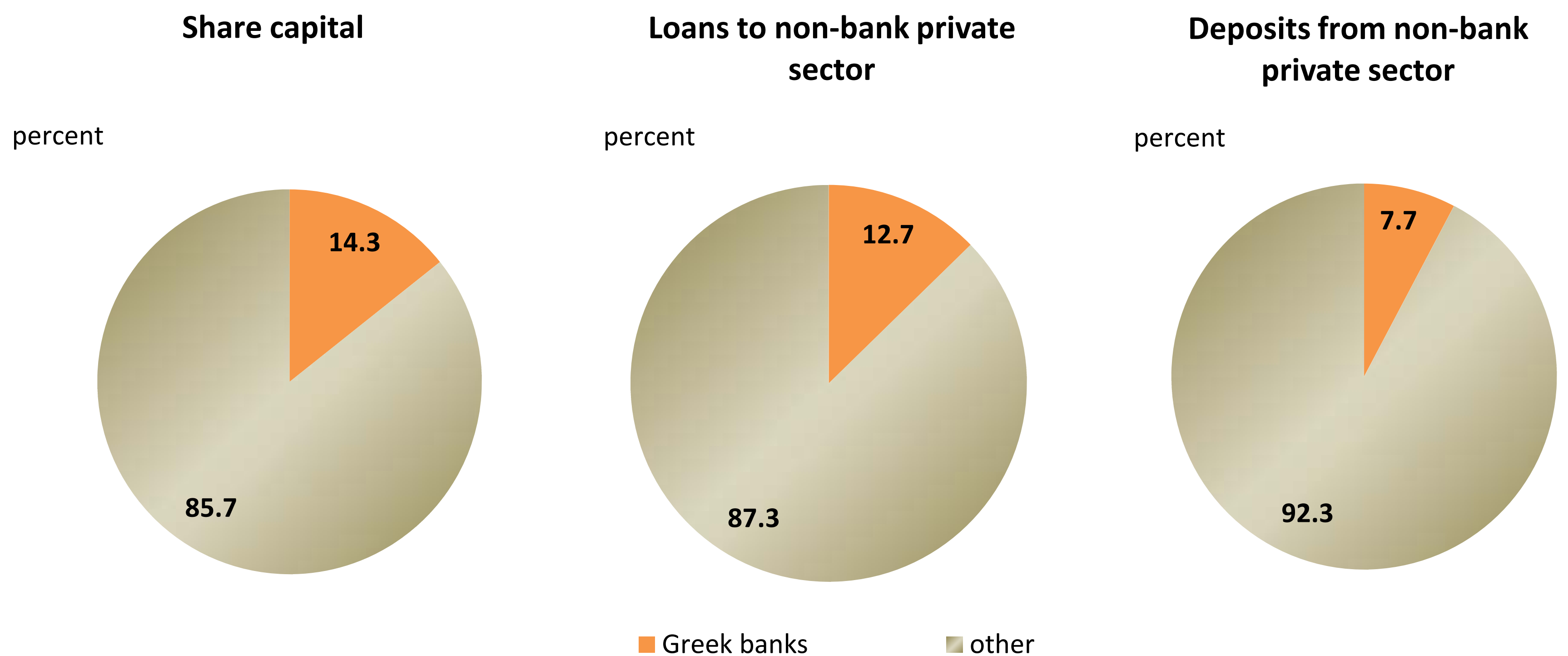
*) based on 2015 H1 data

Source: Eurostat, NBR calculations

- With a share slightly higher than 1%, Greece ranks below top 15 export destinations
- The share is similar for imports
  - ✓ Vegetables and fruits, non-ferrous metals and iron and steel represent the main categories – all of these products have low value added and are easily substitutable

Moderate share of banks with Greek capital in the Romanian banking system (August 2015)

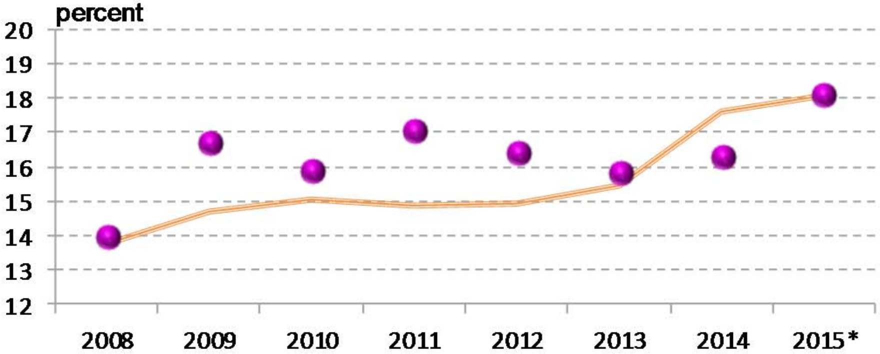
- The four banks with Greek capital in Romania are not branches, but subsidiaries fully incorporated under Romanian law and thus subject to NBR supervision



Source: NBR

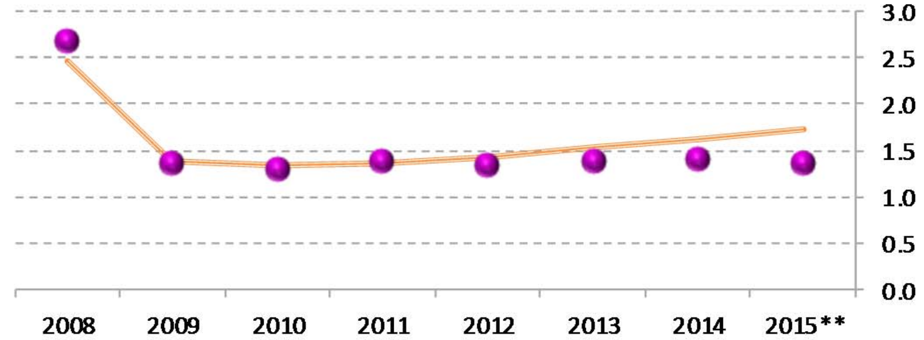
Broadly adequate levels of prudential indicators of banks with Greek capital

Total capital ratio[1)]



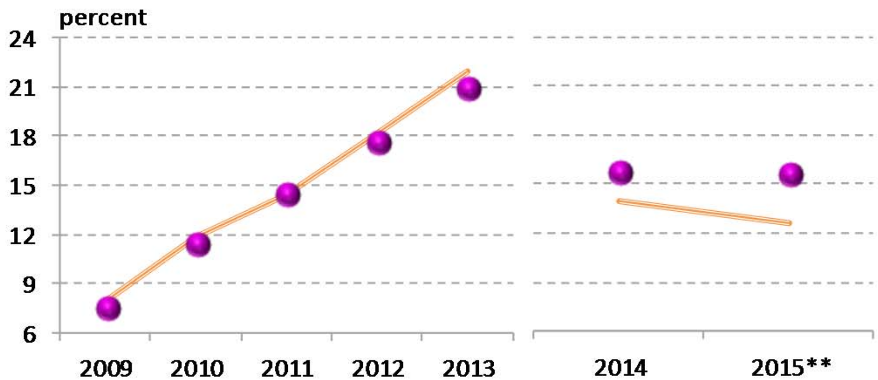
[1)] Own funds/Total risk exposure amount

Liquidity ratio[2)]



[2)] Effective liquidity/Required liquidity

NPL ratio[3)]

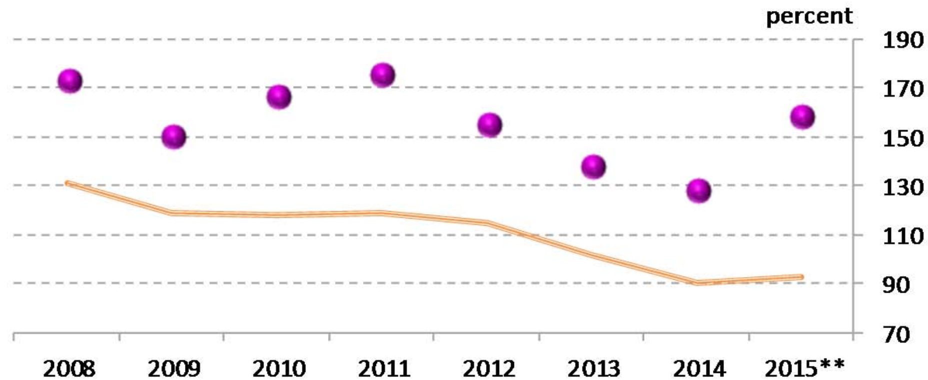


[3)] Gross exposure of loans and related interest overdue for more than 90 days and/or for which legal proceedings were initiated/Total portfolio (gross value)

2009-2013: Based on data reported only by the banks that calculate the minimum capital requirement for credit risk according to the standardised approach.

2014-2015: Based on data reported by all banks (both those using the standardised approach and those applying internal rating models).

LTD ratio



banking system   Greek-owned banks

*) Jun.; **) Aug.

Source: NBR