ROMANIA

Economic Outlook

Spring Report

April 2017

Motto: "We are made wise not by the recollection of our past,
but by the responsibility for our future."
George Bernard Shaw

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Executive Summary

Gross Domestic Product: Private Consumption looks set to remain the backbone of economic growth, propelled by a new round of fiscal stimulus and wage hikes. Yet, it is least likely to repeat the strong performance (+7.3% y/y) from 2016, judging by the moderating growth pace in retail sales, the smaller magnitude of the fiscal stimulus implemented this year as compared to 2016, the projected increase in inflation and slower growth in employment. On the other hand, curbing investment growth, could act ongoing uncertainties related to external and domestic developments and the shortage of skilled labor force, which might be increasingly making itself felt.

We currently expect a 4.1% GDP growth rate in 2017 and 3.8% in 2018.

Inflation: We expect headline inflation to trend upwards throughout the year heading towards the lower bound of NBR's target interval (2.5%±1%), with both core and non-core prices on the rise, propelled by changes in commodities prices, energy/food base effects, higher imported inflation, strengthening cost pressures from the labor market and growing excess demand. We envisage annual inflation rate to print at 1.5% at end-2017 and 2.7% at end-2018.

Labour market: Employment creation is bound to continue, supported by the domestic demand-driven expansion, but it could lose momentum, amid a further contraction of excess workforce supply and a growing shortage of skilled labor.

With job creation likely to keep on outpacing labor force growth, unemployment rate looks set to further drift lower. We expect it to average 5.5% in 2017 and 5.3% in 2018.

External Sector: Current account evolution shall be dictated by a growing trade deficit (due to dynamic expansion in household consumption and a gradual pick-up in private investment) and a weakening primary income position (rising profits of foreign-owned companies, coupled with high repatriation). Meanwhile, secondary income balance could benefit from higher remittances from abroad. The potential vulnerabilities created by the growing current account deficits could be diminished if these deficits continue to be financed through relatively stable means (FDI, capital transfers), which could receive a boost from a gradual increase in the absorption of EU transfers in the coming years. We project current account deficit to widen further to 3.1% this year and 3.6% in 2018, but not to exceed the conventional threshold of sustainability (5% of GDP).

Fiscal Policy and Public Debt: We think that reaching coming years' budget deficit targets is highly challenging, with the balance of risks tilted to the upside. We expect public deficit to reach 3.4% of GDP in 2017 and 2.9% of GDP in 2018, if fiscal administration will succeed in enhancing both tax collection rate and spending efficiency. Under a conservative scenario (no additional fiscal policy change), we expect public debt to rise to 39% of GDP in 2017 and 40.2% of GDP in 2018.

Money market and Monetary policy: Accumulating risks to inflation trajectory over the medium term, occurring from a network of interlinked inflation boosting factors (strengthening demand-side pressures, the upsurge in government spending, the stark mismatch between wage increases and productivity gains coupled with an increasingly tight labor market, the weakening external position, rising inflation in trading partners) call for a recalibration of monetary policy parameters. However, NBR might continue to refrain from pulling the trigger on rate hike, until clearer signs that inflation is on an upward path emerge. We see an interest rate hike to take place as early as the last quarter of this year, with a higher likelihood associated to 2018. We earmark that, in case the necessary adjustment of fiscal and income policy stance to a sustainable path is not performed, a stronger response from monetary policy would be required, raising the risk of an upswing in speculative capital inflows.

Forex market: We see risks stemming from both external and domestic developments, being more pronounced in the case of latter ones. Overall, we see limited appreciation potential for RON against the EUR and expect it to stand at 4.52, end-2017 and 4.50, end-2018.

Capital market: After ending 2016 with a modest result of 1.2% y/y, BET experienced a real take-off in the first quarter of 2017 posting 13% ytd growth. When the euphoria of dividends will be over, the stock prices should align to lower levels after the ex-dividend dates, with fundamentals gaining more attention in the second part of the year. When the euphoria of dividends will be over, the stock prices should align to lower levels after the ex-dividend dates, with fundamentals gaining more attention in the second part of the year.

Banking sector: The awaited changes for local lending activity to follow a more consistent upward path were not fulfilled, as non-governmental loans ended higher by 1.2% y/y as of end-Dec'16, while local economy ended 2016 with a GDP increase of 4.8% y/y, given the persistent structural constraints. We revised slightly upwards our non-governmental loans growth estimations for 2017 and 2018, such as: +3.2% y/y (nominal terms) end-Dec'17 (vs. +3.0% y/y, nominal terms, previously), +3.6% y/y end-Dec'18 (vs. +3.5% y/y end-Dec'18, nominal terms, previously). The major driver will remain households (+5.3% y/y in 2017, +4.3% y/y in 2018), while corporations might start to gradually increase their borrowed resources (+0.6% y/y in 2017, +2.4% y/y in 2018). Our deposits growth from our previous report to approx. +6.7% y/y (nominal terms) for end-Dec'17 (vs.-0.6% y/y, nominal terms, previously), +4.5% y/y (nominal terms) as of end-Dec'18 (vs. -2.1% y/y, previously).
Moreover, capital and liquidity ratios look very good for the local banking sector in comparison with neighboring countries.

Macroeconomic Outlook

II.1. Gross Domestic Product – Return to cruising speed?

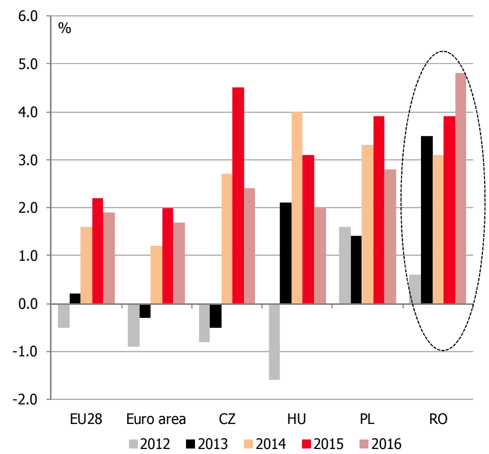
In 2016, GDP expanded by 4.8%, the strongest rate of growth seen since 2008 and one of the highest among EU member states. Economic growth was driven by private consumption (contribution +5.0pp), complemented by a positive input from inventory changes. Meanwhile, gross fixed capital formation and net exports had a negative impact on GDP growth. Turning to supply side, services sector was in the driver's seat (+3.8pp), while industry and construction made modest contributions.

GDP – breakdown by components

2016	Real growth (%, y/y)	Share in GDP (%)	Contribution to GDP growth (percentage points)
Supply side/Resources		**100**	**4.8**
Industry	**1.8**	**23.1**	**0.4**
Agriculture	**0.0**	**3.9**	**0.0**
Constructions	**1.8**	**6.0**	**0.1**
Services		**56.8**	**3.8**
Retail, Tourism, Transport	11.3	18.2	1.9
Information and communication	13.8	5.5	0.7
Financial Services	1.2	3.7	0.1
Real Estate Transactions	1.3	8.2	0.1
Professional, Scientific Activities	7.9	7.4	0.5
Public administration	3.0	10.5	0.3
Other services	6.3	3.3	0.2
Gross value added	**4.9**	**89.8**	**4.3**
Net taxes	4.1	**10.2**	**0.5**
Demand side/Uses		**100**	**4.8**
Final consumption	**6.9**	**75.9**	**5.2**
Households	7.3	68.5	5.0
Public sector	3.3	7.4	0.2
Gross Fixed Capital Formation	-3.3	**22.7**	**-0.8**
Inventories		**2.3**	**1.1**
Net exports		**-0.9**	**-0.7**
Exports	8.3	41.4	3.4
Imports	9.8	42.3	4.1

Source: NIS, BRD-GSG Research

Regional outperformer in 2016

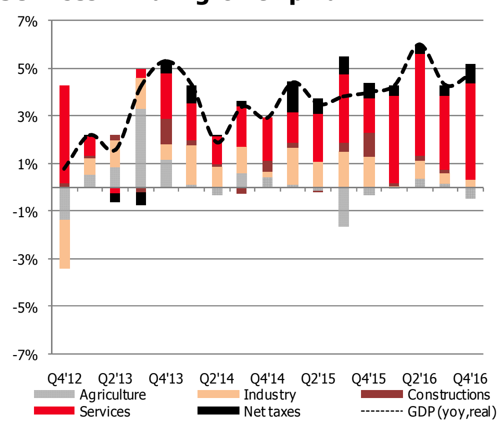


Source: Eurostat, BRD-GSG Research

Supply side

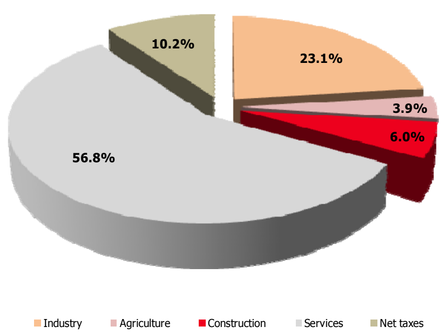
Services sector was once again the main growth pillar (+3.8pp), with positive developments being recorded across all branches, particularly in IT&C (+13.8% y/y), Trade, hotels and restaurants and transport (+11.3% y/y) and Professional, scientific, technical and administrative activities (+7.9% y/y).

Services – main growth pillar



Source: NIS, BRD-GSG Research

Supply side structure - 2016

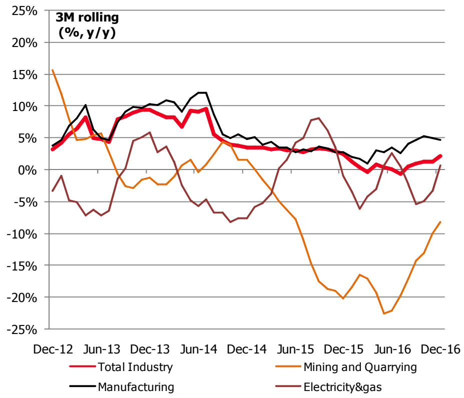


Source: NIS, BRD-GSG Research

The robust increase in consumption did not trigger similar dynamics of industrial production. **Industry** rose by 1.8% y/y and had only a modest positive impact on 2016 GDP growth (+0.4pp), being solely supported by manufacturing sector (+2.6% y/y), whereas mining activity

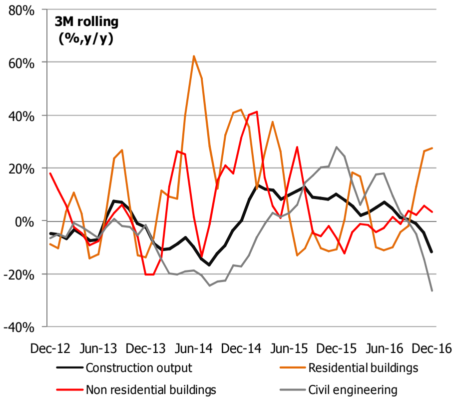
(-15.8% y/y) and energy (-1.1% y/y) recorded declines. The advance in manufacturing was mainly attributable to automotive industry, manufacture of furniture, coke and refined petroleum products and non-metallic mineral products. Conversely, industrial sectors that recorded a notable contraction in output were: chemical and pharma, fabricated metal products and wearing apparel. In terms of use, production for long-term consumption increased the most (+9.4% y/y), while production for intermediate consumption (+2.6% y/y) and of capital-goods (+2.3% y/y) posted lower gains.

Industry – weak response to consumption strength



Source: NIS, BRD-GSG Research

Construction activity – supported by residential segment



Source: NIS, BRD-GSG Research

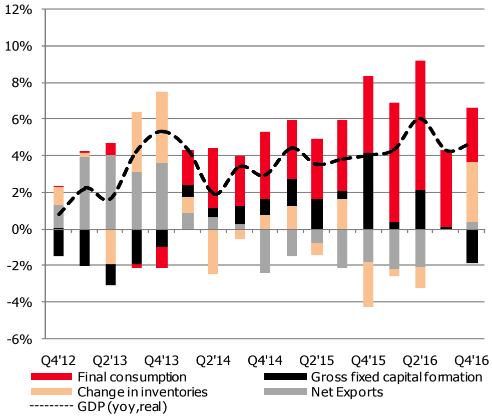
Construction sector showed an annual growth rate of 1.8% in 2016, adding a meager 0.1pp to GDP growth. The positive evolution was primarily driven by the double-digit growth in Residential buildings (+12.1% y/y), complemented by a modest increase in Non-residential buildings (+1.1% y/y). On the other hand, construction of civil engineering works witnessed a marked contraction (-11.2% y/y), as investment financed from EU funds plunged. This was owed to the complexity of legislative and administrative procedures required to implement the absorption of EU funds from the new multiannual financial framework 2014-2020, which significantly delayed the onset of large-scale absorption of structural funds. Moreover, a negative statistical base effect was at play, given the high volume of spending in 2015, when Romanian authorities attempted to maximize their drawings of EU funds before the end of the previous programming period.

Demand side

Private consumption rose by 7.3% y/y in 2016, being the biggest contributor to economic growth (+5.0pp). The expansion was fostered by the dynamic increase in household real disposable income, favorable labor market conditions as reflected in the continued rise in employment and easy financing conditions.

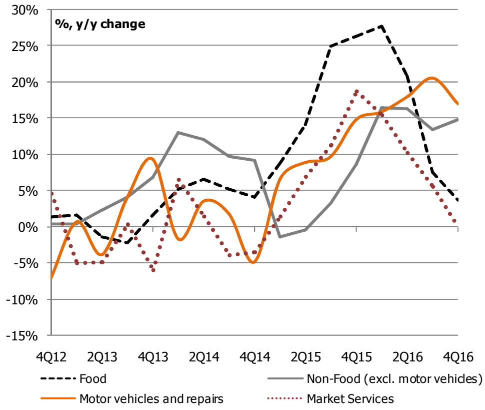
However, annual growth in retail sales witnessed a sharp deceleration during the second half of the year. This is mainly related to the wide slackening in sales of food items, due to the dissipation of the first-round effect of the Jun'15 VAT rate change. In the meantime, purchases of non-food items continued to exhibit strong growth, as sales of most categories of goods (household appliances, wearing apparel, furniture) experienced double digit advances. Motor vehicles sales remained on a solid footing as well, primarily underpinned by sales of new units.

Demand side decomposition



Source: NIS, BRD-GSG Research

Sharp deceleration in food sales growth



Source: NIS, BRD-GSG Research

Along with households' consumption expenditures, the increase in public consumption and transfers in kind from the government contributed to the expansion in final consumption. Annual growth in **real government final consumption** expenditure stood at 3.3% in 2016, bringing 0.2 percentage points to GDP growth.

Fixed capital formation declined by 3.3% in 2016. Government investment followed the EU funding cycle, recording a major setback. Meanwhile, private investment was likely contained by uncertainties related to both domestic and external environment. Net investment on machinery & equipments posted a minor increase of 0.3% in 2016, while new construction works dropped by 2.8%.

Net exports of goods and services weighed on economic activity, shaving off 0.7pp, as exports growth (+8.3% y/y) lagged behind imports' one (+9.8% y/y).

GDP prospects:

Private Consumption looks set to remain the backbone of economic growth, propelled by a new round of fiscal stimulus and wage hikes. Yet, it is least likely to repeat the strong performance from 2016, judging by the moderating growth pace in retail sales, the smaller magnitude of the fiscal stimulus implemented this year as compared to 2016, the projected increase in inflation and slower growth in employment. Government consumption is seen as a positive contributor, given the sizable increase in compensation of public sector employees.

In the meantime, positive private demand prospects, tax incentives and favorable lending conditions will most likely constitute an impetus for companies to increase investment spending. Moreover, the dynamic rise in wages could spur productivity-enhancing investments. With regards to households' investment activity, it shall continue to be supported by gains in household disposable incomes and First House Program.

On the other hand, curbing investment growth, could act ongoing uncertainties related to external and domestic developments and the shortage of skilled labor force, which might be increasingly making itself felt.

Exports may benefit from the improving global demand outlook, but rising labor costs denting into Romania's external competitiveness can act as a counterweight. As such, exports' growth pace will most likely continue to be outpaced by imports one, taking into account the traditionally high import intensity of domestic demand.

We currently expect a 4.1% GDP growth rate in 2017 and 3.8% in 2018.

II.2. Inflation – From dusk to dawn

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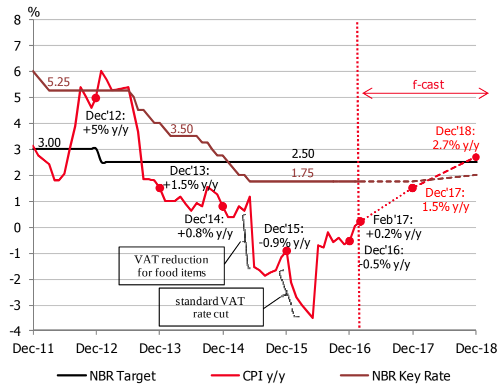
The spell of negative inflation lasting since Jun'15, which was primarily driven by indirect tax reductions, supply side/external shocks, came to an end at the beginning of 2017, as we predicted in our Autumn Report.

Annual inflation rate leapt to +0.1% in Jan'17 from -0.5% in Dec'16, owed to: i) the fading out of the transitory effect of Jan'16 standard VAT rate cut, ii) accelerating fuel price and food price inflation, linked with positive base effects (their earlier declines dropped out of the year-on-year comparison) and rising international commodity prices (energy, metals and most agri-food products), iii) building demand-pull and cost-push inflationary pressures. These have offset the opposite impact generated by the following measures, enacted as of 1 January 2017: the cut in standard VAT rate (from 20 percent to 19 percent), the reduction in electricity distribution tariffs and the removal of the special excise duty on fuels.

Headline inflation continued to creep higher to 0.2% in Feb'17, spurred by accelerations in volatile food prices (due to unfavorable seasonal effects & growing agricultural commodity prices in the global markets), which outweighed the deepening decline in services prices, following the scrapping of the subscription for national radio-TV services.

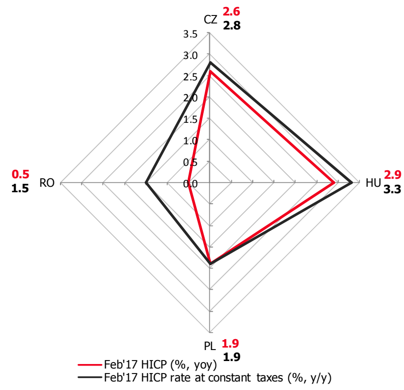
Taking a closer look at the breakdown by components, we notice that food prices (particularly volatile ones) are the largest contributor to headline inflation, with their annual growth rate more than doubling since end-2016 (+1.43% y/y in Feb'17 vs. +0.68% y/y in Dec'16). Non-food inflation quickened and turned positive, but stands just shy of zero mark (+0.11% y/y in Feb'17). In the meantime, services inflation remained slanted into the negative (-1.71% y/y in Feb'17).

Annual CPI – bouncing into positive territory



Source: NBR, NIS, BRD-GSG Research

HICP inflation – lowest in the region

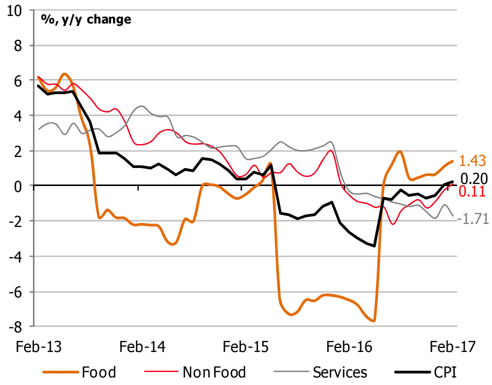


Source: Eurostat, NIS, BRD-GSG Research

The average annual inflation rate posted less negative values, standing at -1.1% in Feb'17, whereas the EU harmonized measure (12m cumulative) climbed to -0.7% in Feb'17, registering a negative gap versus the EU-wide average inflation of 1.2 percentage points.

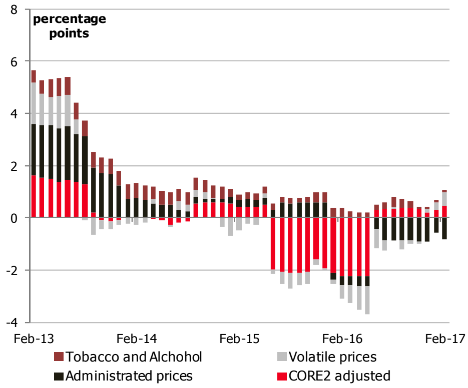
Adjusted CORE2 inflation rate, which better mirrors underlying inflationary pressures, gathered steam, picking up to 0.9% y/y in Feb'17 (vs. +0.3% y/y at end-2016), propelled by the dissipation of the direct impact of VAT reduction implemented in Jan'16 and the gradual rebound in imported inflation.

Food prices – main contributor to annual inflation rate



Source: NIS, BRD-GSG Research

Administered prices – sole drag on annual CPI

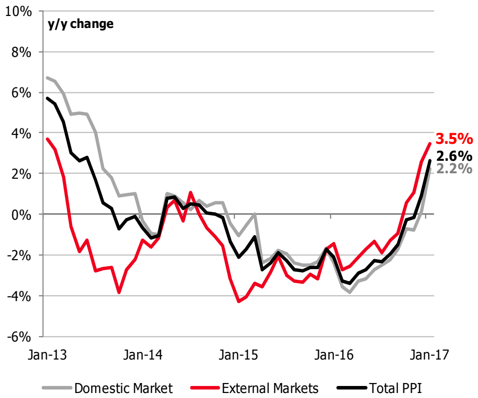


Source: NIS, BRD-GSG Research

End of 2016 - beginning of 2017 marked a turning point for **producer price inflation (PPI)**, which crossed into positive territory after a 2 year streak of negative dynamics, recording a modest 0.9% y/y increase in Dec'16 and accelerating afterwards to 2.6% y/y in Jan'17. It is worth noting that cost-push factors from producer price inflation may permeate more easily to consumer prices, given the current strength of domestic demand.

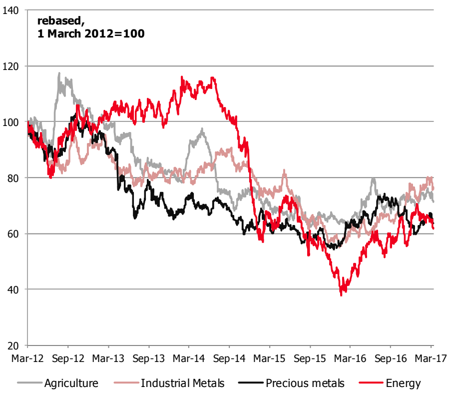
The evolution of PPI was determined by the prices for sales in both domestic (+2.2% y/y in Jan'17) and non-domestic markets (+3.5% y/y in Jan'17). Analyzing the breakdown by industrial groups, the upswing is mainly attributable to developments in energy (+6.7% y/y in Jan'17 vs. -0.1% y/y in Dec'16) and intermediate goods (+1.5% y/y in Jan'17 vs. +0.5% y/y in Dec'16), in line with the trend in commodities prices. Consumer goods prices showed a steady advance as well (Durables: +3.1% y/y in Jan'17, Non-durables: +1.7% y/y in Jan'17), amidst strong domestic demand and higher unit labor costs.

Producer prices in industry rebounded



Source: NIS, BRD-GSG Research

... pushed by the uptrend in commodities



Source: Bloomberg spot indices, BRD-GSG Research

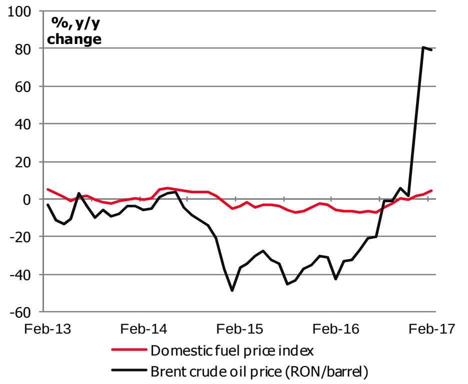
We conjecture inflation trajectory to be subject to several risks on the short-term, stemming from both internal and external developments.

With regards to **oil price evolution**, the end-2016 rally, sparked by the agreed production cuts by OPEC and several non-OPEC members, which were thought to help perform a balancing act in the oil market, was followed by a stabilization period in the first months of the year. Brent oil price has moved within a relatively narrow bandwidth of about USD 53-58/bbl throughout Jan-Feb'17, being caught between two opposing forces: on the one hand, growing demand and the agreed reduction going on as planned, with producers largely sticking to their pledges; on the other hand, piling US oil inventories and the steady increase in US shale production, buoyed by price recovery. In March, oversupply concerns flared up, exerting downward pressure on prices, with Brent crude trading between USD 49-53/bbl. Growing non-OPEC supply, mainly in the US, threatens to undermine OPEC's efforts to ease the glut of crude and could make it reluctant to extend output cuts beyond June, as it would further lose market share to higher-cost producers. Oversupply could also worsen, if Libya and Nigeria, which have been excluded from OPEC deal, manage to deliver on production goals, provided that domestic situation in these countries stabilizes. Last, but not least, less strict environmental regulation in the US could give an extra-boost to U.S. oil supply.

Beginning of April brought a spike in oil prices amid mounting geopolitical tensions over Syria, with Brent climbing up to USD 56/bbl.

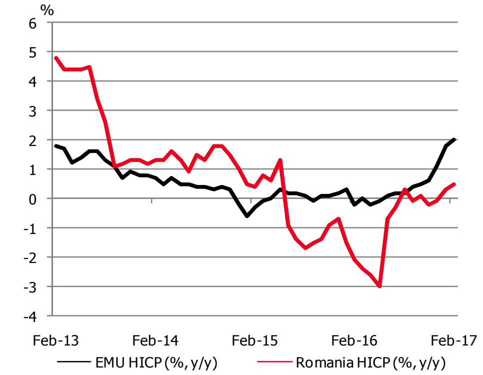
According to SG analysts, ICE Brent price is forecast (as of Apr 11 2017) to average USD 57.5/bbl in Q2'17 and to gradually increase to USD 62.5/bbl in Q4'17, recording a yearly average of USD 58.9/bbl in 2017 (vs. an avg. of 45.4/bbl in 2016). Hence, there is little probability to witness an upsurge in oil prices stirring domestic fuel inflation, but, perhaps a more noteworthy risk is posed by USD/RON trajectory.

Domestic fuel prices and crude oil prices



Source: EIA, NIS, BRD-GSG Research

Imported inflation – switching roles



Source: NIS, Eurostat, BRD-GSG Research

External price pressures are emerging, with stronger price dynamics being recorded in surrounding economies. Euro area inflation picked up markedly, reaching 2% y/y in Feb'17, primarily owed to increases in food and energy prices, amid sizeable upward base effects in the case of latter ones. However, underlying inflationary pressures remained contained, with Euro area HICP inflation excluding food and energy maintaining stable at below 1% (+0.9% y/y in Feb'17), reflecting still weak demand and cost pressures. According to March ECB staff macroeconomic projections, HICP inflation is estimated to average 1.7% in 2017 (up from 0.2% in 2016) and 1.6% in 2018. As such, imported inflation is bound to switch roles, from taming domestic inflation to pushing it up. Moreover, its impact could be augmented by renewed bouts of RON weakness.

Other major unknown variables in external outlook equation, represented by political events in Europe (elections in France, Germany), the coordinates of the new administration's economic policy in the US, the shape of the agreement on Brexit, the future monetary policy stance of ECB/FED bring additional risks to domestic inflation path, as they could impact local economy through various channels (growth, financial, trade).

On domestic front, main risks which could cause inflation to deviate from the projected path, in case they materialize, are associated with:

i) a loose stance of fiscal policy causing aggregate demand to exert higher inflationary pressures, and consequently a wider-than forecasted budget deficit or a change in the structure of consolidated general government budget expenditures, with funds initially assigned to public investment projects being redirected towards covering current expenses.

ii) wage hikes overtaking productivity gains, putting pressure on corporate costs and on aggregate demand – Wage pressures stem from major increases in the incomes of public sector employees, exerting a demonstration effect on private sector wages, alongside a sharp rise in the minimum wage. They are further amplified by labor market tightening, particularly as regards skilled staff, amid declining unemployment and workforce migration.

iii) the timing and magnitude of the adjustments in administered prices, with greater risks linked with the domestic prices of natural gas, where uncertainties are related to future developments in import prices.

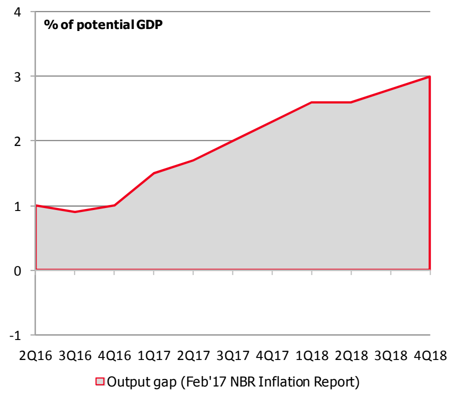
iv) food prices, which are highly dependent on weather conditions. The main risk is posed by a sharper reversal of recent year's downward trend in inflation for volatile food items, with base effects likely to play an important role in this regards.

v) uncertainties related to exchange rate movements,

vi) worsening inflation expectations.

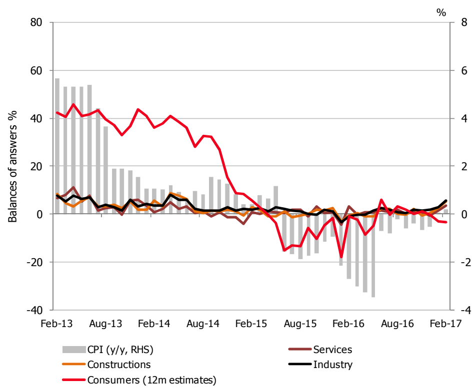
On balance, the assessment of the uncertainties taken into consideration reveals significant risks of higher-than-expected inflationary pressure.

Demand-pull inflation – set to rise



Source: NBR, BRD-GSG Research

Upward trending inflation expectations



Source: Eurostat, BRD-GSG Research

<u>CPI prospects</u>:

Encompassing the above mentioned, we expect headline inflation to trend upwards throughout the year heading towards the lower bound of NBR's target interval (2.5%±1%), with both core and non-core prices on the rise, propelled by changes in commodities prices, energy/food base effects, higher imported inflation, strengthening cost pressures from the labor market and growing excess demand. First quarter of 2018 should see inflation spiking towards the target, following the fading-out of the impact of indirect tax cuts introduced in January 2017. It then shall gradually head towards the upper bound of the variation band throughout our projection horizon, driven by core inflation.

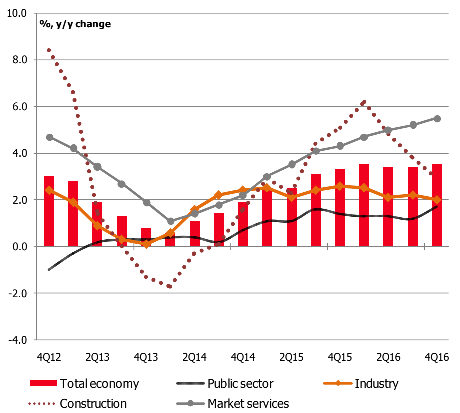
We envisage annual inflation rate to print at 1.5% at end-2017 and 2.7% at end-2018.

II.3. Labour market – The good, the bad and the ugly

Ongoing economic expansion fostered steady job growth, with the correlation being strengthened by the sustained development of the more labor intensive service sector, linked with the real convergence of domestic economy.

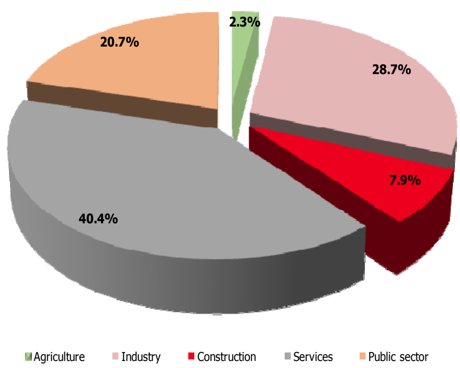
The average number of employees economy-wide increased by 3.0% y/y in 2016 to 4.75 million, with service sector being accountable for over 60% of job creation. In the meantime, labor absorption in industry was rather modest, its contribution to the overall increase in the number of employees standing at 17%. This is partially explained by technological progress that increases labor productivity, greater competition from abroad and skilled labor shortages. As regards construction sector, it brought around 7% to the overall growth in payrolls, but the pace of hiring slowed markedly in the second part of last year, in line with the fading momentum in activity.

Job creation - mainly owed to services



Source: NIS, BRD-GSG Research

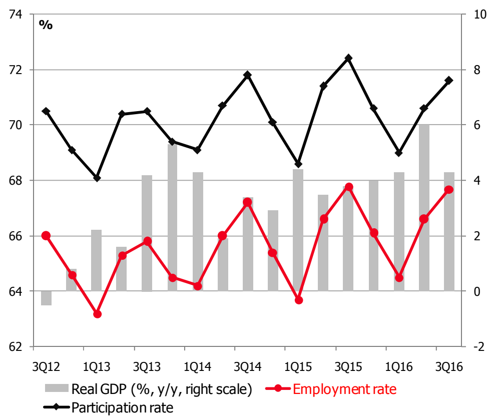
Employment structure (Dec'16)



Source: NIS, BRD-GSG Research

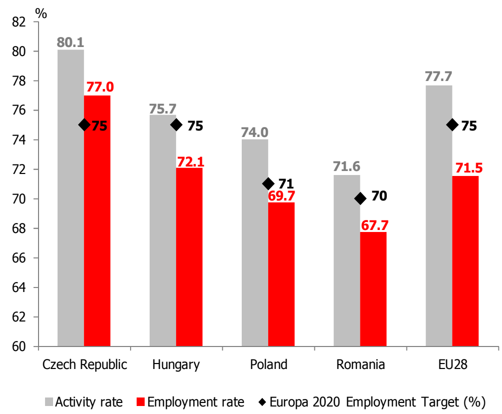
Employment rate for the age group 20-64 years rose to 67.7% in Q3 (up from 66.6% in Q2'16), but remained below EU average (71.5%) and the national target (70%) under Europe2020 Strategy. Labor force participation rate has also been picking up, to 71.6% in Q3'16 from 70.6% in Q2'16, underpinned by growth in labor force (inflow into the labor force of inactive persons closely tied to the labor market, emboldened by high wage dynamics), coupled with the long-running decline in population aged 20-64.

Employment, participation improving



Source: Eurostat, BRD-GSG Research

...but still lagging behind (Q3'16)

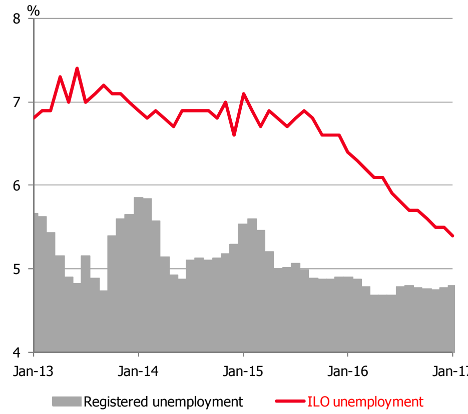


Source: Eurostat, BRD-GSG Research

Nonetheless, **participation rate still lags significantly behind levels seen in western developed economies**, Romania confronting with one of the highest inactivity rates of working age population in the EU. This situation derives from a mixture of socio-cultural and economic factors: ***i) low female employment rates (58.5% in Q3'16)*** strongly linked with parenthood and reflecting shortfalls in terms of affordability, accessibility and quality of child and long term care and afterschool facilities. Romania is recording one of the highest gender gaps across EU member states (18.3pp vs. 11.9pp EU avg.), ***ii) a high NEET rate*** (neither in employment nor in education or training), of 18.1% in 2015 vs. 12% EU avg. ***iii) fewer employment opportunities for low-skilled individuals*** (employment rate for this group was 55.6% in Q3'16), ***iv) an important share of persons taking part in early retirement schemes***, ***v) heightened regional disparities in terms of economic development***, leading to strong regional differences regarding the labor demand/supply ratio, ***vi) the ethnic dimension – low insertion of Roma people***. Moreover, labor force participation rate is further constrained by the existence of a large informal sector, negative demographics and workforce migration.

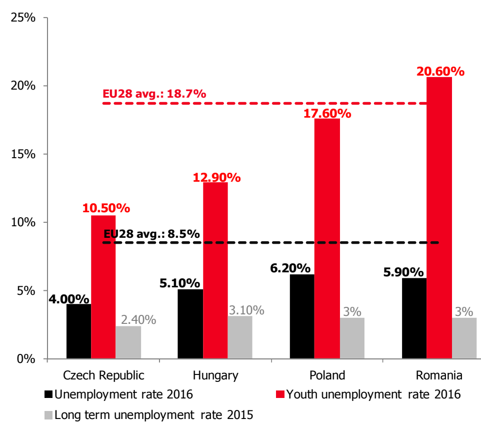
The increase in headcount employment has been mirrored in a steady fall of both registered unemployment rate and seasonally adjusted ILO unemployment rate. The latter one averaged 5.9% in 2016, as compared to 6.8% in 2015. According to latest available data, it continued to edge down, standing at 5.4% in January 2017, the lowest level since Sep'08. The figure is well below Euro area and EU averages, of 9.6% and 8.1%, respectively. Total number of unemployed persons amounted to 487,904, recording an annual drop of 94,228 persons (vs. 582,132 in Jan'16). Male unemployment rate printed at 5.8%, 0.9pp higher than the female unemployment rate (4.9%).

ILO unemployment rate – steep drop



Source: NIS, BRD-GSG Research

Youth unemployment - still high

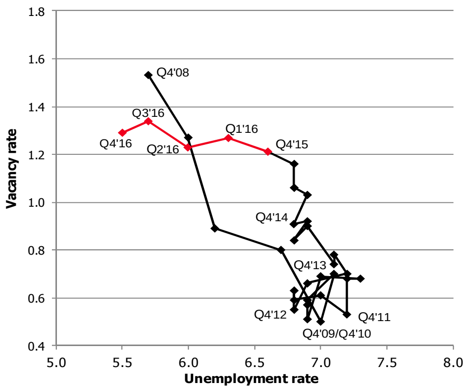


Source: Eurostat, BRD-GSG Research

On a less positive note, **youth unemployment rate declined but continued to stay at an elevated level**, of 20.6% in 2016 (vs. 21.7% in 2015), above EU average (18.7%) being less responsive to cyclical improvements. However, interpretation of this statistic could be misleading, in the sense that it does not reflect the proportion of all young adults who are unemployed, but only of those who are in the labor market (employed+unemployed). What's more, youth unemployment rate could be high, although the number of unemployed persons is actually limited. Such a case appears when the denominator, represented by the young labor force is small. Hence, in order to get a better grasp of youth labor market situation, an alternative indicator – **youth unemployment ratio**, can be used in parallel. This represents an unemployment-to-population measure, eliminating the influence induced by the size of the young labor force. With regards to this indicator, Romania fares better, recording a value of 6.8% in 2015, below EU avg. of 8.4%.

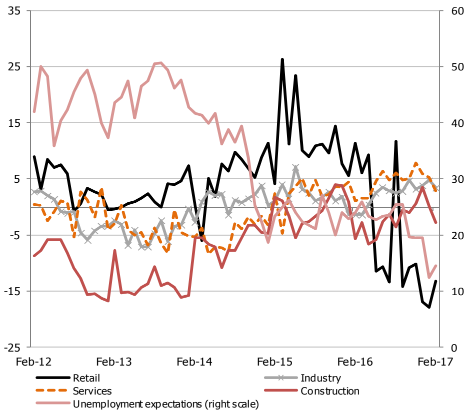
Turning to **long term unemployment (LTU)**, those unemployed for more than a year represented 48.7% of overall unemployment in Romania in Q3'16, which is slightly above EU average of 46.2%. Given that the persistence of a large number of long-term unemployed persons over prolonged periods of time implies significant social and economic costs, reduction of LTU spells shall constitute a priority for both policymakers and citizens alike. As such, initiatives to curb LTU, by anticipating future skills needs and offering retraining, work experiences and job search support for the long-term unemployed should be encouraged.

Economic expansion under way, as depicted by Beveridge curve…



Source: NIS, BRD-GSG Research

…with positive hiring expectations in services and industry



Source: DG ECFIN, BRD-GSG Research

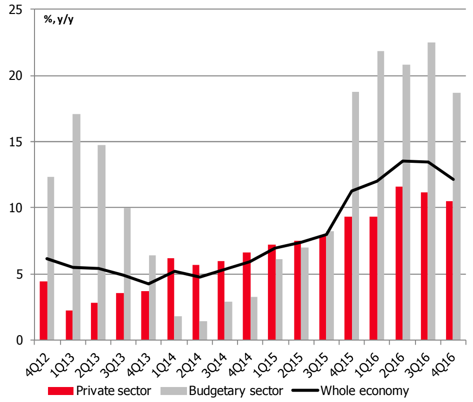
Given the increasingly limited labor reserves in the face of rapidly expanding activity in certain sectors, companies are dealing with rising problems in filling in vacant posts. These are being amplified by: ***i) limited internal labor mobility, ii) an inadequate alignment between education curricula and labor market requirements**, **coupled with poor performance of VET system (Vocational education and training***), ***iii) low involvement of adult population in 'lifelong learning'*** (1.4% of persons aged 25-64 in 2016, lowest in EU). Embracing 'lifelong learning' at a greater scale, both by employers and employees, could help accommodate rising demand for skills and bridge the wage-productivity gap, ***iv) business policies oriented towards the development of sale/distribution networks, rather than on staff recruitment/training***, ***v) migration of workforce abroad***, spurred by the still significant wage differentials vis-à-vis western developed economies.

- *Incomes and labour productivity*

Net average wage economy-wide continued to post a brisk annual growth pace in January 2017 (+18.4% y/y) reaching RON 2,300, underpinned by the strong evolution of wages in both the business and non-business sectors. The annual dynamics of net real wages stood at +18.3% y/y.

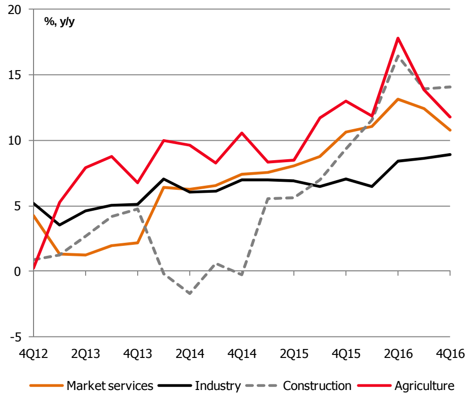
High wage growth was fuelled by the easing of income policy (public sector wage hikes and the rise in minimum wage) and growing mismatches in the labor market, triggering an increase in wage competition both among companies and sectors in order to recruit and retain high-skilled workforce.

Public sector earnings growing two times quicker than private sector ones



Source: NIS, BRD-GSG Research

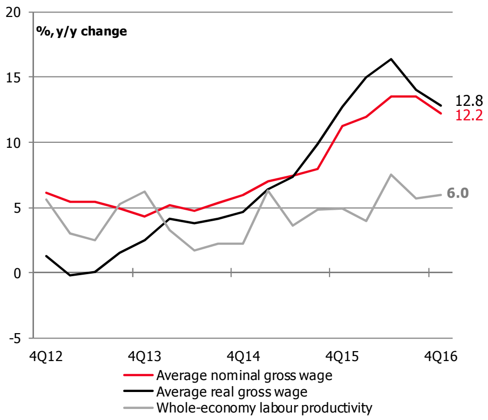
Evolution of private sector wages - breakdown by economic sector



Source: NIS, BRD-GSG Research

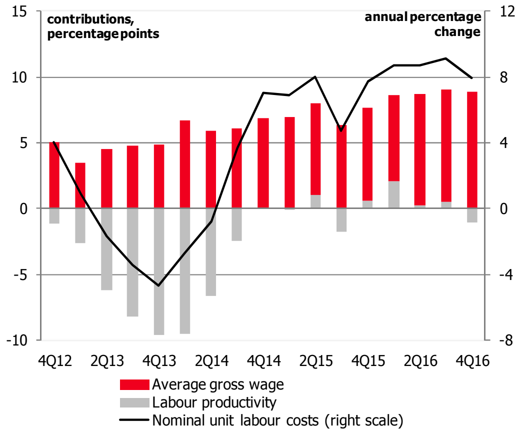
Fast rising wages are accompanied by more moderate gains in terms of productivity, with whole-economy labor productivity increasing by 6% y/y in Q4'16. As a result, a marked pick-up in nominal unit labor costs is being recorded.

Wage dynamics outpacing productivity gains



Source: Eurostat, NIS, BRD-GSG Research

Steady rise in unit labor costs in industry



Source: NIS, BRD-GSG Research

Encountering higher wage costs, companies can resort to various channels in order preserve by as much as possible profit margins. As such, they could invest in technology in order to enhance productivity, or they could opt to pass cost increases through price hikes. The latter option suits better for companies operating in a sector characterized by lower elasticity of demand (i.e. services sector).

Labour market prospects:

Employment creation is bound to continue, supported by the domestic demand-driven expansion, but it could lose momentum, amid a further contraction of excess workforce supply and a growing shortage of skilled labor. Our assumption is strengthened by European Commission's survey data on employment expectations, which point towards sustained job creation at the beginning of 2017. Furthermore, consumer's unemployment fears receded.

Above depicted labor market developments, coupled with further increasing demand within the private sector, renewed growth in domestic prices, recently implemented pay rises in the budgetary sector and the new increase in gross minimum wage shall maintain wage growth apace throughout the year.

With job creation likely to keep on outpacing labor force growth, unemployment rate looks set to further drift lower. We expect it to average 5.5% in 2017 and 5.3% in 2018.

II.4. External Sector – Shadow cast

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Current account deficit witnessed a strong expansion in 2016, standing at EUR 4.12bln or 2.4% of GDP, as compared to EUR 1.94bln or 1.2% of GDP in 2015. As depicted in the table below, the evolution of C/A balance was being shaped by the marked deterioration in goods trade balance, coupled with the worsening weakness in primary income balance and the reduction in secondary income surplus.

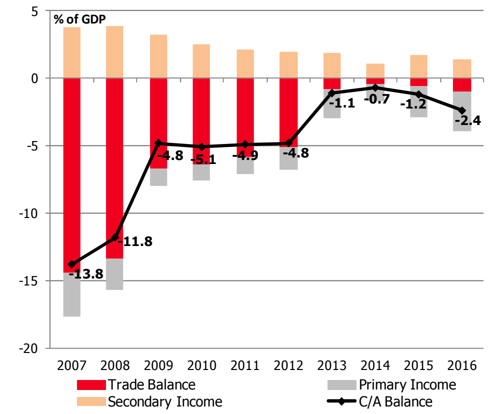
	2015		2016		y/y
	EUR mil	% of GDP	EUR mil	% of GDP	
Current Account Balance	**-1,943**	**-1.2%**	**-4,118**	**-2.4%**	**111.9%**
A.Trade Balance	**-1,000**	**-0.6%**	**-1,743**	**-1.0%**	**74.3%**
Goods	**-7,794**	**-4.9%**	**-9,299**	**-5.5%**	**19.3%**
- Exports (FOB)	49,099	30.7%	52,101	30.8%	6.1%
- Imports (FOB)	56,893	35.6%	61,400	36.3%	7.9%
Services	**6,794**	**4.2%**	**7,556**	**4.5%**	**11.2%**
B. Primary Income	**-3,738**	**-2.3%**	**-4,825**	**-2.9%**	**29.1%**
C. Secondary Income	**2,795**	**1.7%**	**2,450**	**1.4%**	**-12.3%**
- Inward	5,115	3.2%	4,674	2.8%	-8.6%
- Outward	2,566	1.6%	2,434	1.4%	-5.1%

Source: NBR, NIS, BRD-GSG Research

Trade balance ran a gap of 1% of GDP, up from 0.6% in 2015, as the fast rising trade deficit in goods was just partially accommodated by the increase in services surplus.

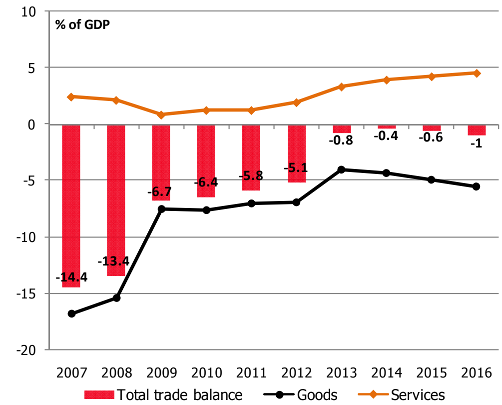
Goods trade deficit went up by 19.3% y/y, **totaling EUR 9.3bln in 2016**, owed to the fact that imports rose at a swift pace, outpacing export dynamics, given local producers' limited ability to adjust production facilities for the spike in consumer demand, heightened price competition from imported goods and shifts in consumer behavior (increasing quality consciousness, preference for diversity and more sophisticated products). An additional upward influence was exerted by the positive differential between domestic economic growth rate and the one of the main export market (the EU).

C/A balance – widening gap due to dynamic consumption and primary income deficit



Source: Eurostat, BRD-GSG Research

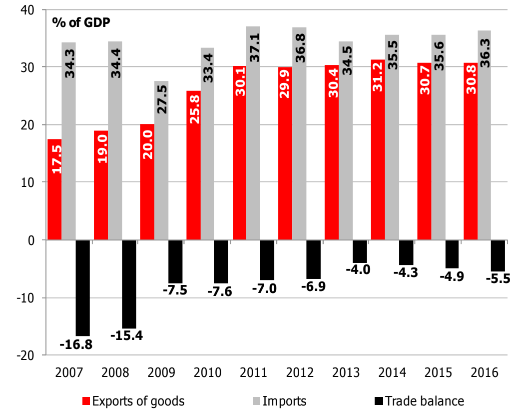
Services surplus - acting as a counterweight to growing goods deficit



Source: Eurostat, BRD-GSG Research

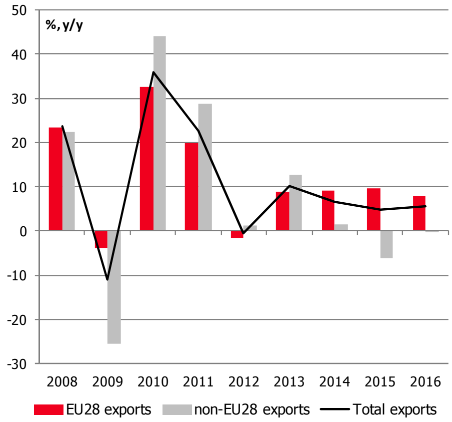
By geographical breakdown, intra-EU trade was almost entirely accountable for the goods trade deficit. Exports growth (based on the "change in economic ownership" criterion) was supported solely by demand coming from EU countries (+7.7% y/y in 2016, 74% of total exports), while non-EU28 exports were almost at a standstill (-0.3% y/y). In terms of imports, intra-EU imports rose by 7.9% y/y in 2016 and accounted for 77% of total imports, while extra-EU imports increased by 6.9% y/y.

Imports of goods – on an upward trajectory in recent years



Source: Eurostat, BRD-GSG Research

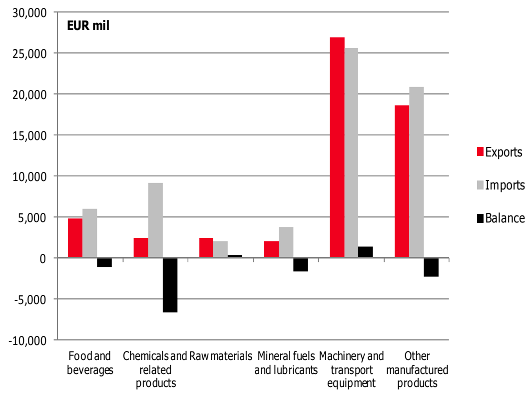
Falling demand from non-EU trading partners



Source: Eurostat, BRD-GSG Research

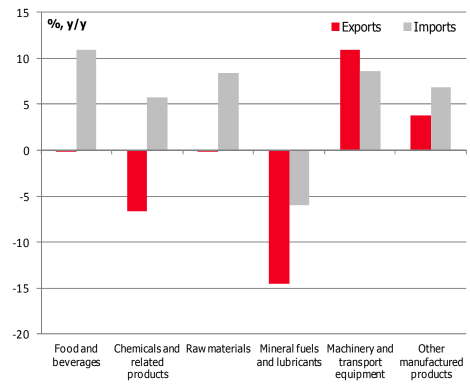
Looking at exports breakdown by product group, growth was mainly underpinned by Machinery and transport equipment (+11.0% y/y in 2016, 46.9% of total exports) and Miscellaneous manufactured articles (+6.6% y/y, 15.9% of total). Turning to imports, with the exception of Fuels and lubricants (-6.0% y/y), all other main categories recorded an increase in volumes, particularly Food and beverages (+10.9% y/y, 8.8% of total imports) and Machinery and transport equipment (+8.7% y/y, 37.9% of total). Trade surpluses were posted only by Machinery and transport equipment (EUR 1.39bln in 2016) and Raw materials (EUR 355.2m).

Machinery and transport equipment – main export/import category in 2016



Source: NIS, BRD-GSG Research

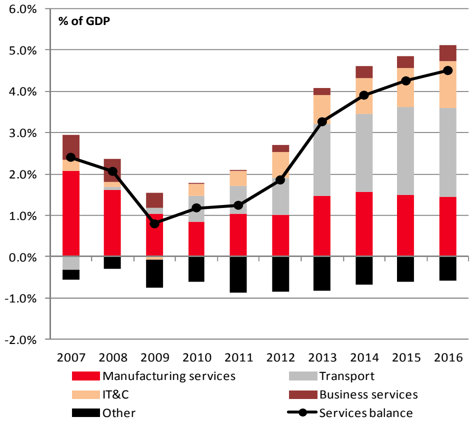
Export/Import dynamics by product group in 2016



Source: NIS, BRD-GSG Research

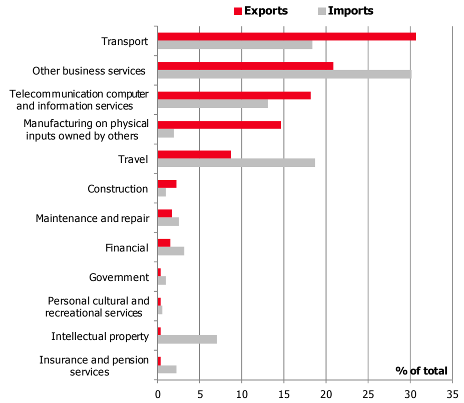
Services surplus increased by 11.2% y/y and amounted to EUR 7.56bln in 2016. Exports of services totaled EUR 17.63bln (+5.9% y/y), while imports stood at EUR 10.07bln (+2.3% y/y). Strength in services was largely driven by: Transportation services (trade surplus of EUR 3.63bln, +6.5% y/y), linked with the development of export-oriented industries and Romania becoming an increasingly important logistics hub in the region, Manufacturing services on physical inputs owned by others (EUR 2.43bln, +1.5% y/y), Telecommunications, computer, and information services (EUR 1.92bln, +28.3% y/y) and Business services (EUR 652m, +41.4% y/y).

Services surplus – steady growth, with transport services playing a leading role



Source: NBR, BRD-GSG Research

Structure of services exports and imports



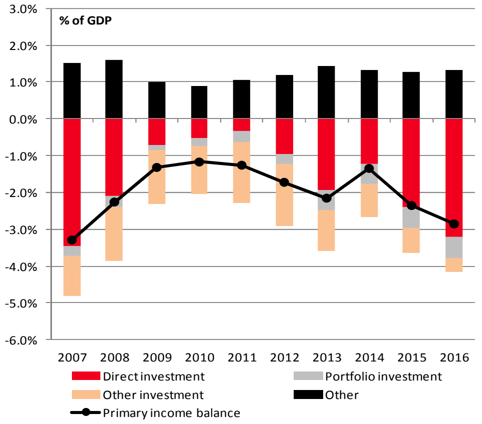
Source: NBR, BRD-GSG Research

During the last three years, the deterioration in the current account balance has become less attributable to the trade balance and more related to the deepening shortfall in the primary income balance, which largely depends on the relative quantities of assets held by Romanian investors overseas and overseas investors in Romania, and the relative rates of return that they earn on their respective portfolios.

Primary income deficit surged by 29.1% y/y and reached EUR 4.82bln in 2016. The evolution was chiefly owed to a larger negative contribution from investment income balance (deficit of EUR 6.77bln, higher by 20.3% y/y), by far the largest component of overall balance, given the steep increase in foreign direct investors income (reinvested earnings, dividends, interest on debt instruments) on their capital involvement in Romanian companies (+44.7% y/y to EUR 5.47bln), topped by a scarcity of outward direct investment. Negative balance of investment income was also influenced by non-residents income from portfolio investment (+9.1% y/y to EUR 1.1bln). Meanwhile, interest due to other debt instruments reported in other investment, mostly loans received by Romanian entities, recorded a significant decrease (-35.4% y/y to EUR 714m), evolution attributable to the low interest rate environment.

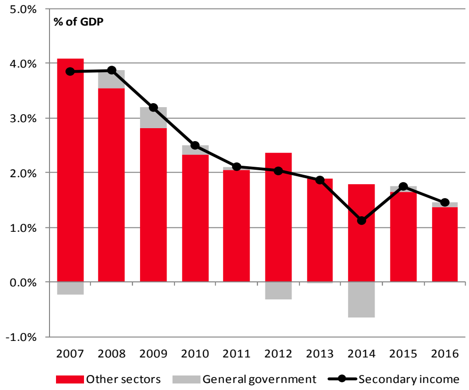
Earnings on other primary income (non-refundable EU funds in the form of subsidies), compensation of employees (income of migrants who have lived in the host country for less than a year) and income on reserve assets underwent notable increases, offsetting to some extent the wider gap in investment income balance.

Deterioration in primary income balance - mainly owed to direct investment income



Source: NBR, BRD-GSG Research

Workers' remittances – on a downward trend



Source: NBR, BRD-GSG Research

Secondary income balance posted a surplus of EUR 2.45bln in 2016, down by 12.3% y/y. The balance on secondary income of the general government, comprising net EU transfers (EU fund inflows under current transfers, Romania's contribution to the EU budget), recorded a fairly stable surplus. Meanwhile, the balance on private secondary income, composed mainly of remittances from Romanians working abroad, has diminished compared with the previous year (-12.4% y/y) amounting to EUR 2.31bln.

<u>Financing of current account</u>

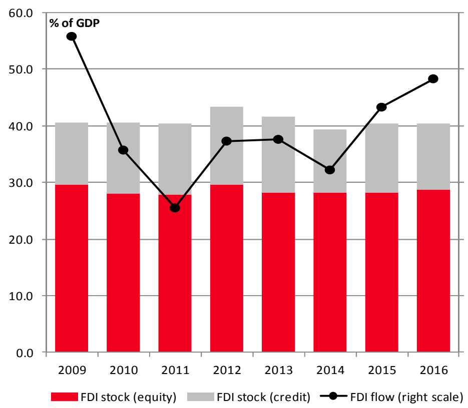
Current account deficit has been further covered entirely on the account of non-debt generating capital flows, in the form of direct foreign investment and capital transfers, hence not posing risks in terms of financial stability.

Capital Account surplus increased by 8.6% y/y in 2016 and amounted to EUR 4.24bln, being almost entirely composed of funds received from the EU.

Foreign direct investments in Romania continued the positive trend of recent years and rose by 18.6% y/y in 2016, summing EUR 4.08bln, out of which capital investments amounted to EUR 3.9bln, while intra-group loans recorded a net value of EUR 182m. The most important two components of the flow of equity participation into FDI enterprises are represented by corporate development and corporate restructuring. In the meantime, Greenfield investments (entering local market by building a new enterprise), which, among different types of FDI inflows, are deemed to contribute the most to job creation, stirring economic growth, knowledge transfer and enhancing competitiveness have remained subdued ever since the crisis (i.e. EUR 96m in 2015, 3.1% out of the total equity participation in FDI enterprises).

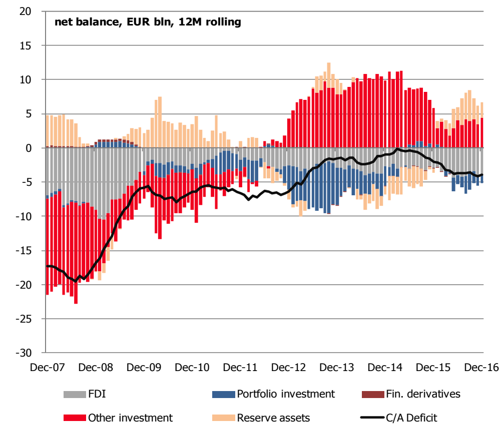
Direct investment by residents abroad totaled EUR 218m, including mainly intercompany lending (EUR 163m, in net terms)

FDI flows – on the rise



Source: NBR, BRD-GSG Research

Ensuring a stable financing structure



Source: NBR, BRD-GSG Research

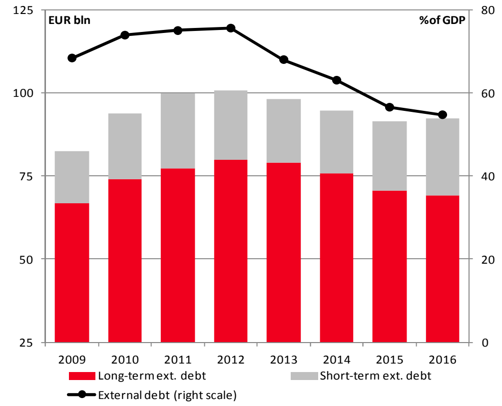
Portfolio investment transactions showed a net inflow of EUR 1.19bln in 2016, compared to EUR 4m in 2015. Portfolio investment by non-residents registered a net inflow of EUR 1.55bln, considerably higher than EUR 306m in the preceding year. Foreign investors holdings of domestic equity and investment fund shares decreased by EUR 190m, while those of debt securities picked up by EUR 1.74bln. Residents, mainly investment funds, increased their external assets under portfolio investment by EUR 360m (vs. EUR 302m in 2015), both in equity and investment fund shares (EUR 136m) and in debt securities (EUR 224m).

Other investment recorded net outflows worth EUR 4.4bln, lower than EUR 5.86bln in the previous year. Assets increased by EUR 1.04bln, while liabilities declined by EUR 3.36bln. The reduction in net liabilities is mainly associated with a decline in deposits made by non-residents with resident monetary financial institutions.

External debt & FX reserves

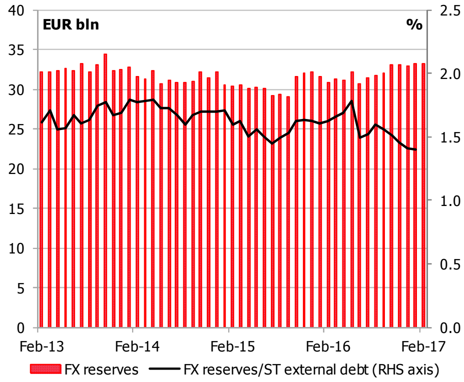
Romania's gross external debt edged higher by 2.3% y/y to EUR 92.5bln at end-2016. As a share of GDP, it further declined, standing at 54.7%, as compared to 56.5% in the previous year. Long-term external debt ran at EUR 69.1bln at end-2016, down 2% against end-2015, owed to the 5.2% reduction in private external debt and the 8.7% drop in central bank's external debt. On the other hand, short-term external debt climbed up 17.8% y/y and reached EUR 23.4bln, accounting for 25.3% of total external debt.

External debt (% of GDP) – downward adjustment



Source: NBR, BRD-GSG Research

FX reserves/Short-term debt at a comfortable level



Source: NBR, BRD-GSG Research

International reserves are broadly adequate, exceeding indicators of reserve adequacy and comparing favorably to countries in the region. Romania's international reserves (gold and foreign currency) amounted to EUR 38.4bln as of Feb'17. The coverage of short debt through FX reserves stood at 1.4x. Meanwhile, goods and services import cover (foreign exchange including gold to average monthly imports of goods and services) stood at 6.7 months as of end-Jan'17, up from 6.4 months at end-2016. These figures reveal a good macroeconomic capacity to weather potential adverse developments coming from the external sector.

C/A balance (BMP6) prospects:

Current account evolution shall be dictated by a growing trade deficit (due to dynamic expansion in household consumption and a gradual pick-up in private investment) and a weakening primary income position (rising profits of foreign-owned companies, coupled with high repatriation). Meanwhile, secondary income balance could benefit from higher remittances from abroad. The potential vulnerabilities created by the growing current account deficits could be diminished if these deficits continue to be financed through relatively stable means (FDI, capital transfers), which could receive a boost from a gradual increase in the absorption of EU transfers in the years to come. Nonetheless, domestic fiscal derailments and inherent risks in the external environment may negatively impact capital inflows and financing terms.

We project current account deficit to widen further to 3.1% this year and 3.6% in 2018, but not to exceed the conventional threshold of sustainability (5% of GDP).

II.5. Fiscal Policy and Public Debt – Starry eyed

Fiscal policy

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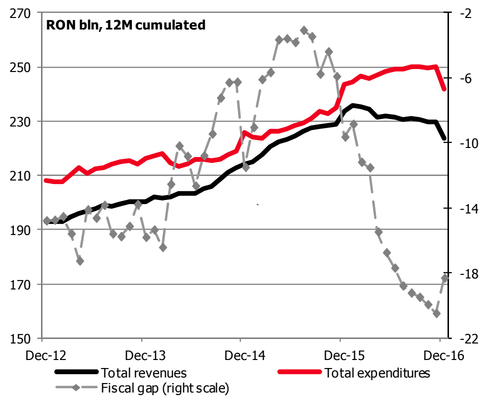
While Romania demonstrated its capacity to undertake fiscal consolidation, willingness to pursue responsible fiscal behavior during 'good' times figures as a challenging goal.

Beginning with 2016, Romania deviated from the disciplined approach to fiscal policy that characterized previous years, embarking on a spending splurge, mainly related to personnel and social expenditures, combined with significant tax reductions. Hence, the medium-term objective of attaining a balanced budgetary position, in line with the fiscal responsibility law and European treaties of which Romania is signatory, was discarded, the focus being shifted to the avoidance of breaching the Maastricht ceiling of 3% of GDP.

The twist in fiscal policy stance was reflected in a sharp widening of consolidated budget deficit, which stood at RON 18.3bln or 2.4% of GDP in 2016, below the annual target of 2.8% of GDP under Romanian accounting terms, yet double the level recorded in 2015 (RON 9.63bln or 1.35% of GDP). The deterioration was due to the contraction in budget revenues (RON 223.7bln or 29.5% of GDP, -4.3% y/y), offset only to a marginal extent by the decrease in spending (RON 242bln or 31.9% of GDP, -0.6% y/y).

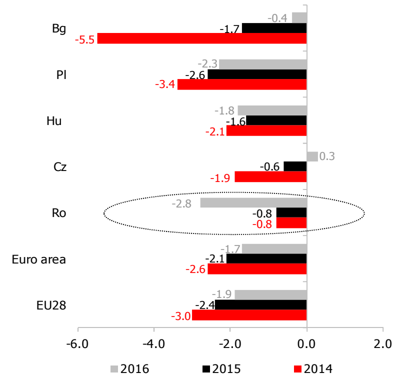
Investment spending (including expenditures of programs funded with non-refundable post-accession foreign funds, capital expenditures and expenditures of programs funded from loan proceeds) amassed RON 29.5bln or 3.9% of GDP, which is 76.5% of the amount initially planned. The usual pattern of budget execution of the past years repeated, with a considerable share of budget expenditures being carried out in the final months of the year.

Fiscal deficit doubled amid the pro-cyclical fiscal stance



Source: MinFin, BRD-GSG Research

Romania diverges from the regional trend of fiscal consolidation



Source: EC Winter Report, BRD-GSG Research

The adjustment in the structural deficit (fiscal imbalance stripped from cyclical and one-off effects) was reversed, with the deficit growing substantially in 2016 – to 2.57% of GDP, up from only 0.5% of GDP in 2015.

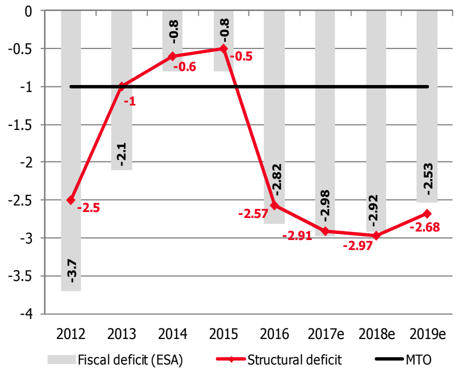
Going on, according to the three year economic program of the Government presented in the Budget for 2017 and the Fiscal Strategy 2017-2019, budget deficit is projected to expand further, stabilizing just shy of the 3% of GDP threshold level in 2017-2018. Consequently, the prospect of reaching again the medium-term budgetary objective (MTO) of a 1% of GDP structural deficit has become more distant. Structural deficit is pencilled in to remain relatively stable throughout 2017-2018, close to 3% of GDP, and to decrease to 2.7% of GDP in 2019, a level still remote from the MTO. It is worth noting that MinFin projections are built upon a very optimistic assessment of economic growth trajectory coming from the National Commission for Prognosis, with GDP growth rates higher than 5% being estimated for the entire forecast horizon.

Fiscal deficit projected to be kept in check, but under overly optimistic economic auspices

Public finances	2017e	2018e	2019e
Government revenues (% of GDP, cash)	31.2%	32.4%	32.9%
Government revenues (RON bln, cash)	254.7	284.3	311.7
Government expenditure (% of GDP, cash)	34.2%	35.3%	35.5%
Government expenditures (RON bln, cash)	278.8	310.3	335.9
Fiscal balance (% of GDP, cash)	-2.96%	-2.96%	-2.56%
Fiscal balance (% of GDP, ESA)	-2.98%	-2.93%	-2.53%
Fiscal structural balance (% of GDP)	-2.91%	-2.97%	-2.68%
Public debt (% of GDP)	37.7%	37.9%	37.7%
Real GDP growth rate	5.2%	5.5%	5.7%

Source: Fiscal Strategy 2017-2019, BRD-GSG Research

Converging back to MTO – likely only beginning with 2019

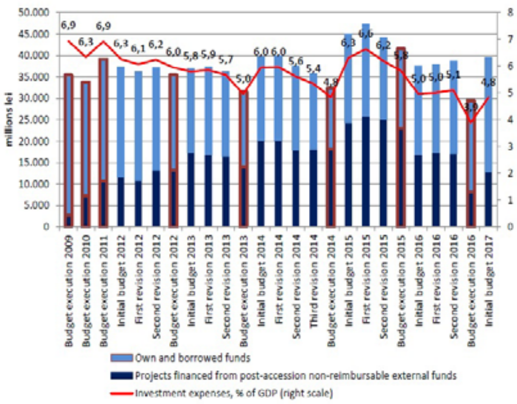


Source: Fiscal Strategy 2017-2019, BRD-GSG Research

Focusing on this year Budget Act, MinFin expects general government receipts to reach RON 254.7bln (31.2% of GDP) and expenditure RON 278.8bln (34.2% of GDP), both posing significantly higher levels compared with previous year and resulting in a corresponding general government deficit of RON 24.1bln (2.96% of GDP). These increases derive largely from an expected sizeable pick-up in the utilization of EU funds assuming a proper and timely implementation of the institutional, procedural and legal framework for the new budgeting period 2014–2020 (estimated at EUR 22.3bln in 2017 – out of which RON 12.4bln on agricultural policy and RON 9.9bln on cohesion policy and other programs – up from RON 6.9bln in 2016).

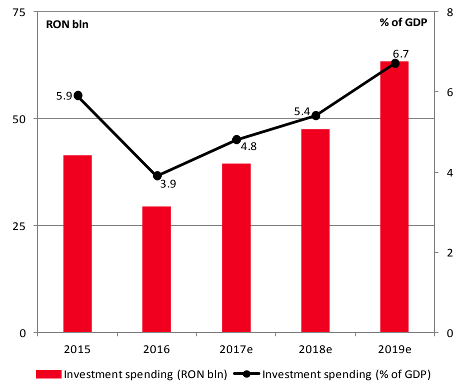
Investment spending is envisaged to witness a robust increase (+RON 9.9bln) as compared to previous year execution and amount to RON 39.43bln or 4.8% of GDP. However, these figures must be taken with a pinch of salt, as a failure to achieve planned budget revenues could see some amounts initially destined to viable investment projects being redirected towards consumption and government transfers to households. In addition, the assumed improvement in the absorption of EU funds may not fully materialize.

The tendency to record significant downward deviations from initial budgeted amounts…



Source: Fiscal Council

implies a dose of skepticism with regard to investment spending projections



Source: Fiscal Strategy 2017-2019, BRD-GSG Research

On the revenue side, fiscal policy measures enacted by the government this year are expected to have an overall negative impact of RON 7.17bln, according to MinFin computations. Main changes are represented by: **i)** the reduction of standard VAT rate from 20% to 19% (as of January, 1st), **ii)** the removal of the special construction tax and of the extra-excise duty on fuels (as of January, 1st), **iii)** the scrapping of 102 non-fiscal taxes beginning with February, 1st (including radio-TV tax, the environmental tax on motor vehicles, consular and citizenship taxes, taxes for the commerce registry), **iv)** the elimination of the cap of five national average salaries for the tax base related to contributions to the public pension system, **v)** the amendment of the tax regime for microenterprises (changing the annual turnover ceiling to EUR 500.000 from EUR 100.000 and the standardization of the tax rate of 1% on turnover), **vi)** the unlimited application in time of the fiscal incentive to exempt the reinvested profit (previously it was designed to cease by end-2016), **vii)** the exemption of pensions below RON 2,000 from the payment of the income tax and the removal of healthcare contribution for pensioners.

On the expenditure side, major increases in terms of personnel spending and social assistance are deemed to have a negative budgetary impact of RON 10.47bln, according to MinFin computations. They are mainly composed of: **i)** the hike in the minimum guaranteed social pension from RON 400 to RON 520 starting with March, 1st, **ii)** the increase of the pension point from RON 917.5 to RON 1,000 from July, 1st, **iii)** 20% increase in gross wage and bonuses for personnel from local administration and 50% for actors, starting Feb, 1st, **iv)** 15% increase in gross wages and bonuses for public employees in the health sector, social assistance system and education system, **v)** free rail transport on internal routes for students enrolled in full-time education, in accredited higher education institutions, **vi)** the amount allocated to the fund for scholarships and social protection of students raised to RON 201/student/month from RON 83.

While fiscal easing measures are plenty, compensatory measures to contain deficit expansion are rather scant, consisting of the above mentioned removal of the maximum tax ceiling on social security contributions, the temporary increase in the percentage distributed as dividends from the profit of state-owned companies, a tight control of goods and services expenditures and the cyclical broadening of the tax base.

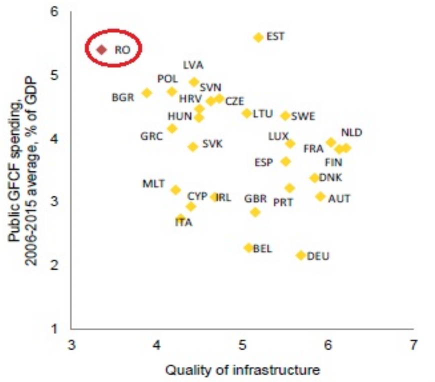
The current discretionary loosening of fiscal policy comes at odds with the criteria set forth by the European Commission for assessing whether a Member State has the capacity to reduce taxes safely without jeopardizing the Stability and Growth Pact Commitments, which are: **i)** uncompensated tax reductions can only be envisaged in Member States that meet the medium-term budget target of 'close-to-balance or in surplus', **ii)** tax reductions must not be pro-cyclical, **iii)** account must be taken of the level of government debt and long-term budget sustainability, **iv)** tax reductions should form part of a comprehensive reform package.

Running a high deficit could be accepted temporarily if it emerges from the financing of important investment projects or if the economy is working its way out of recession, but Romania is currently neither in any of these situations. At the current juncture, characterized by continuing economic growth, falling unemployment and emerging challenges arising from ageing population, **testing the boundaries of fiscal space in order to cover rising**

current expenses, while no major investment projects are being undertaken, can be defined as an opportunity missed or a slippery choice.

Pro-cyclical fiscal policy fails to act as a business cycle stabilizer and instead, amplifies the magnitude of cyclical fluctuations. As such, it raises the risk of overheating and fuels inflationary pressures during the upswing, while it worsens employment and output losses during the downturn. Moreover, financing constraints could quickly emerge, as widening domestic imbalances may prompt foreign investors to reassess the degree of risk associated with local economy, entailing an increase in financing costs and a scarcity of adequate financing sources. Even more worrying is that, whereas Romania is no stranger to this situation, the experience of the latest boom-bust cycle speaking for itself, it looks prone to repeat the same mistakes. **Pursuing a prudent approach instead**, by controlling expenditure growth and redirecting government spending to boost productivity and workforce participation, would have helped ensure a sustainable growth path, bolster the economy capacity to cope with adverse shocks, forge credibility with investors and international institutions, reduce the fiscal burden on future generations and create space to meet demographic and other significant spending pressures.

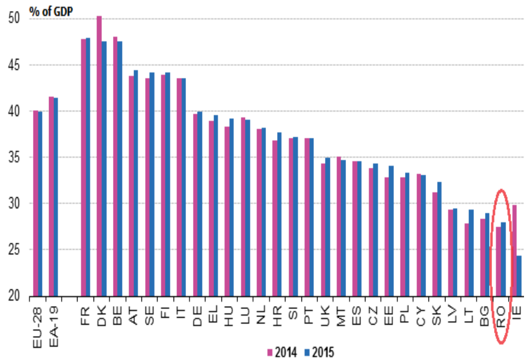
The improvement of the spending efficiency is a MUST, not an OPTION



Note: Respondents rate 1 (worse) to 7 (best)
Source: European Commission and World Economic Forum: the Global Competitiveness Index 2015-2016

Source: EC Country Report Romania 2017

The improvement of tax collection is a MUST, not an OPTION



Source: Eurostat

The inadequacy of the current fiscal policy stance underlined, we now shift attention to the avenues to ensure public finance sustainability in the medium term. In this regard, we think that the government should ***strive to improve tax collection,*** Romania currently recording the lowest share of fiscal revenues in GDP among EU member states, being at the same time faced with the largest Value–Added Tax Compliance gap in the EU. ***Increasing efficiency in spending money*** through more rigorous investment planning and control should also figure high on government's agenda. Capital expenditure was highest in the region over the last decade, but Romania still ranks last in terms of perceived quality of infrastructure. Also, efforts aimed at ***broadening the tax base, reforming public pensions system, tax administration modernization, simplifying tax code, speeding-up privatization and restructuring of state-owned companies*** should be put forth.

Failure to make visible progress in terms of aforementioned measures would make it impossible for the government to keep expenses at the current level and at the same time to lower budget deficit. Such a situation would call for either a hike in taxation or a certain recalibration of public spending.

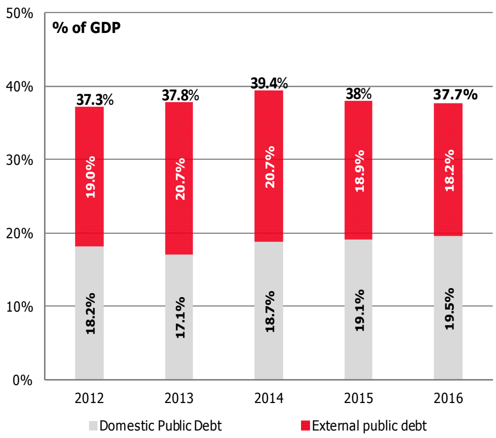
Fiscal deficit prospects: We think that reaching coming years budget deficit targets is highly challenging, with the balance of risks tilted to the upside, on account of: i) increased likelihood of lower than expected government revenues, amid a slower than projected economic growth curtailing the increase in tax base or a weaker than expected impact of some income boosting decisions, ii) potential overshooting of the projected level of expenditures (with a risk factor being represented by unified wage law which is currently under discussion). Furthermore, under these circumstances, a change in income tax framework (the end of the flat tax system) could not be ruled out.

We expect public deficit to reach 3.4% of GDP in 2017 and 2.9% of GDP in 2018, if fiscal administration will succeed in enhancing both tax collection rate and spending efficiency.

Public debt

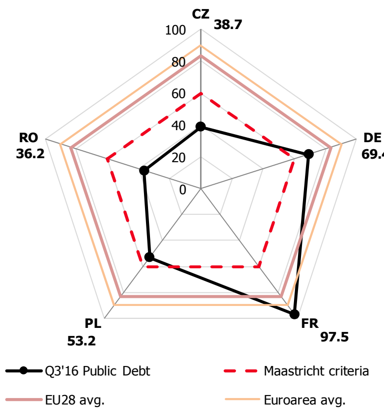
Public debt (ESA terms) amounted to 37.7% of GDP at end-2016, marginally lower as compared to 38.0% in 2015. External debt further recorded a notable decline, from 18.9% of GDP at end-2015 to 18.2% at end-2016, whereas domestic debt increased, from 19.1% at end-2015 to 19.5% at end-2016. Current debt level is at a safe distance below Maastricht threshold level, but closer to the critical level of 45% of GDP computed by NBR (above which the probability of recession reaches approximately 50 percent). Romania's debt-to-GDP ratio remains one of the lowest in the EU and CEE regions.

Public debt quasi-stable



Source: MinFin, BRD-GSG Research

Public debt (% of GDP) in Q3'16 – low by regional comparison



Source: Eurostat, BRD-GSG Research

Recent years brought a strengthening of debt sustainability indicators:

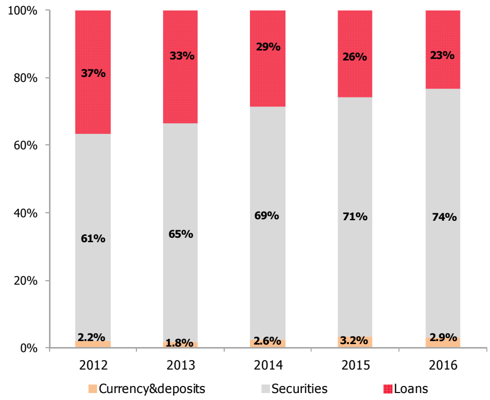
- the average time to maturity of total debt extended to 5.8 years in Dec'16, up from 3.7 years in Dec'09. Residual maturity for locally-issued government securities is of 3.5 years, whilst for the securities issued on external markets stands at 8.0 years (weighted average, Dec'16).

- public debt financing cost (computed as interest expenses to public debt stock, ESA) has reduced to 4.3% in 2015, down from a peak of 6.5% in 2009. Yet, total interest payments held relatively steady, standing at 1.6% of GDP in 2015.

- the composition of the investor base has diversified.

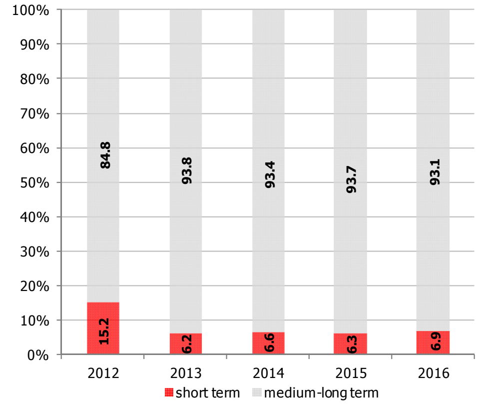
Public debt remains sensitive to exchange rate risk, given the fact that over half of debt denominated in foreign currency, predominantly in euro. However, taking into account the relative stability manifested by EUR/RON exchange rate and the fact that a great share of EUR-denominated debt is represented by long-term debt, we view the foreign exchange rate risk as being manageable for now.

Rising weight of marketable debt instruments



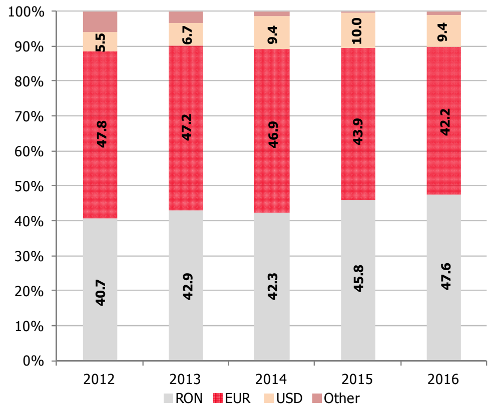
Source: MinFin, BRD-GSG Research

Low share of short-term debt



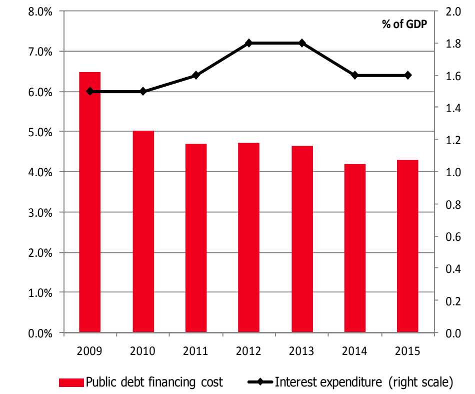
Source: MinFin, BRD-GSG Research

Large volume of foreign denominated debt



Source: MinFin, BRD-GSG Research

Declining public debt financing cost



Source: Eurostat, BRD-GSG Research

Moving forward, according to MoF debt-management strategy, the main objectives are: i) to respect Maastricht threshold level (60% of GDP) and maintain the public debt even below 45% of GDP (level considered being sustainable), while minimizing medium and long-term costs, ii) to extend the weighted average maturity of government debt portfolio, iii) to access external capital markets in a flexible manner, iv) to consolidate the FX financial buffer of the State Treasury, v) to extend and diversify investor base.

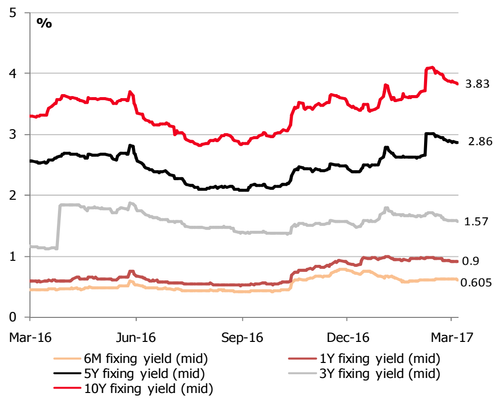
According to government assessments, public debt is expected to maintain relatively stable throughout 2017-2019, close to, but below 38% of GDP. These estimates are based on the materialization of the buoyant economic growth scenario taken into account by MinFin, which would allow keeping deficit levels below 3% of GDP and on the perpetuation of the relative stability manifested by EURRON exchange rate. However, if the high rate of economic growth rate is not sustained, as assumed and interest rates on the public debt continue to edge higher, amid rising inflation and FED tightening, a significant narrowing of the differential between these two could easily see public debt level climbing above 40% of GDP, as early as this year. Moreover, according to European Commission, under a stress test scenario involving a 30% depreciation of RON in 2017 and 2018, general government debt would increase rapidly to almost 51% of GDP in 2018. Consequently, in order to ensure a safe path for the public debt, Romania should strive to achieve a primary surplus of public finance, yet it is heading in the completely opposite direction.

<u>Public debt prospects</u>: Under a conservative scenario (no additional fiscal policy change), we expect public debt to rise to 39% of GDP in 2017 and 40.2% of GDP in 2018.

Bond Market

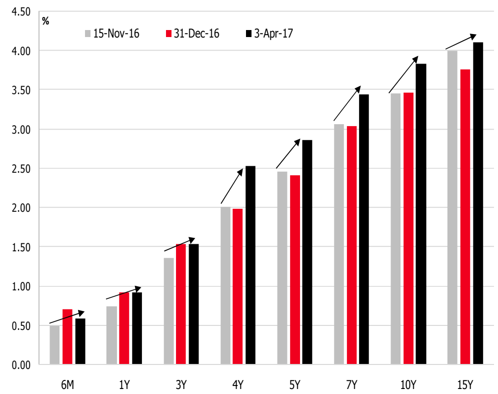
A cumulus of factors laid the groundwork for a substantial upward adjustment in RON-denominated government bond yields and lower secondary market transaction volumes since our Autumn report. Among them we recall: i) the monetary policy tightening by the Fed, ii) the upbeat Eurozone economic growth outlook determined by generally improving economic conditions in the region, combined with the jump in headline inflation to ECB's medium term objective (below, but close to 2%), which fed market expectations for a more hawkish turn from ECB, iii) uncertainties in Europe (fears of growing political instability as anti-EU parties are gaining ground, French elections being in the spotlight; unfolding of Brexit; tough Greek debt negotiations), iv) domestic uncertainty over governmental policies (the fiscal and wage measures adopted, likely to lead to a re-emergence of internal/external imbalances).

Upward adjustment in RON-denominated government bond yields



Source: NBR, BRD-GSG Research

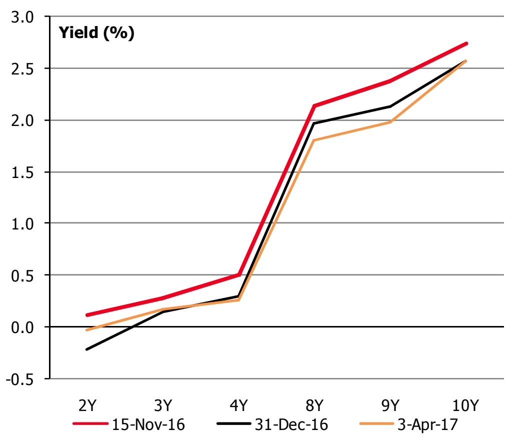
...particularly of longer maturities



Source: Bloomberg, BRD-GSG Research

Meanwhile, **Romania's eurobond yields declined** during the same period. The decline of ROMANI yields together with rising yields for German bonds has led to lower spreads for longer maturities between ROMANI and Bunds.

EUR Romanian Gov't Bond Yields declined



Source: Bloomberg, BRD-GSG Research

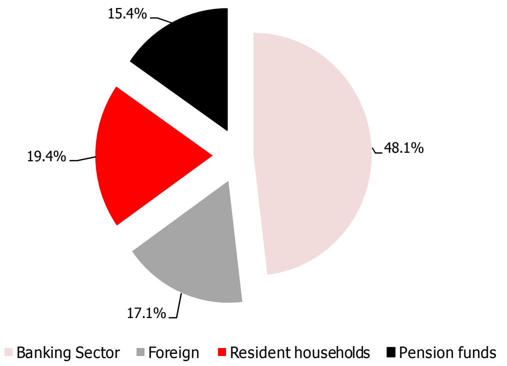
Spread (bps) between ROMANI and EUR German Gov't Yields

	15-Nov-16	31-Dec-16	3-Apr-17
2Y	74.46	58.26	78.81
3Y	87.89	93.83	90.13
4Y	96.87	98.85	86.34
8Y	213.60	210.98	185.96
9Y	223.26	212.61	187.43
10Y	243.90	236.90	230.02
20Y	287.93	276.68	266.34

Source: Bloomberg, BRD-GSG Research

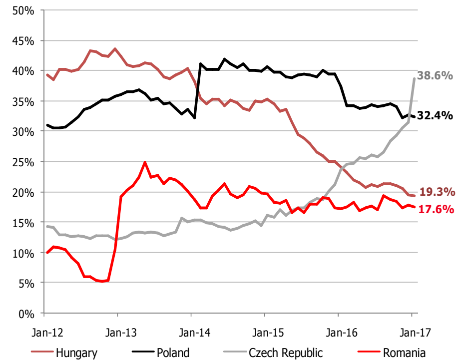
Investors' base is still highly concentrated towards commercial banks. Bank exposure to the government is large (around 20 percent of total bank assets, the highest level in the EU), which flags reduced ability to increase exposure to the sovereign in times of stress. In the meantime, the share of non-resident investors in total locally-issued government securities is low, trailing behind other countries in the region, translating into a lower degree of vulnerability to shifts in risk appetite in global markets.

Who's holding the debt? (Jan'17)



Source: MinFin, BRD-GSG Research

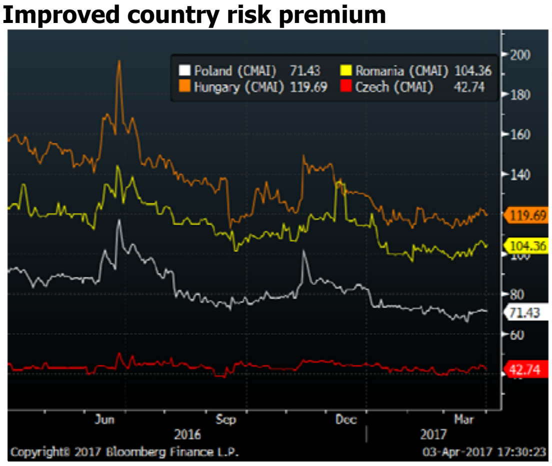
Foreign participation in local currency bond market – lowest in the region



Source: MinFin, BRD-GSG Research

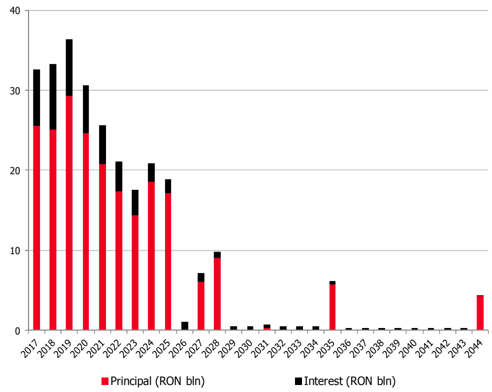
Country risk premium as measured by Ro 5Y USD CDS is currently close to historical lows, standing at 104.36 (as of Apr, 3rd). The country risk premia swings are triggered by the external shocks and likely by the internal inappropriate strategic vision. Hence, a balanced macroeconomic policy mix is a prerequisite for safeguarding Romania's creditworthiness and maintaining CDS spreads around current levels.

Improved country risk premium



Source: BBG, BRD-GSG Research

Redemption schedule of government securities



Source: BBG, BRD-GSG Research

Based on MinFin estimates, Romania's financing requirement for 2017 amounts to RON 68.6bln to cover the fiscal deficit (RON 24.1bln) and debt service (RON 44.5bln). By comparison, MinFin issued around RON 63.5bln in 2016 as follows: i) RON 45.4bln and EUR 775m on domestic market, ii) EUR 3.25bln on external markets.

So far this year (Apr, 4th), debt managers were able to raise RON 10.1bln and EUR 240m on domestic debt market, representing around 16.3% of the financing needs. Due to the increase in financing costs, there were several auctions throughout Q1'17 at which Ministry of Finance rejected fully or partly the bids submitted. This was partially compensated by the fact, that, in the case of some long term issuances, debt managers sold more than initially planned, as to take advantage of high demand and advantageous costs, while at the same time aiming at extending the average remaining maturity.

Bond market prospects: For the coming months, we expect issuance to remain tilted towards medium and long-term maturities, as this should release some supply pressure on the yield *curve next year. It is likely that MinFin will search for windows of opportunity to tap foreign markets later this year.*

Going forward, uncertainty on the external markets, considerable risks of fiscal slippages, potential tighter liquidity conditions and anticipated higher inflation could lead to upside movements of country risk premium and yields.

Financial Market

III.1. Money market and Monetary policy – Steady, but watchful

Monetary policy decisions

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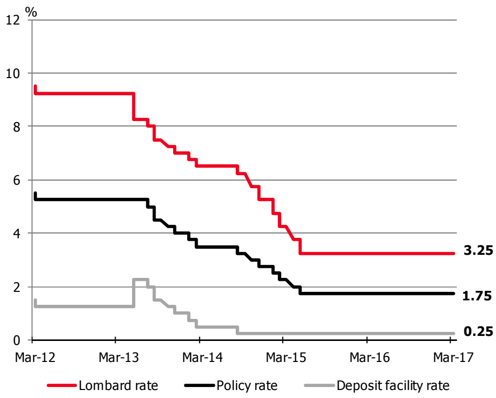
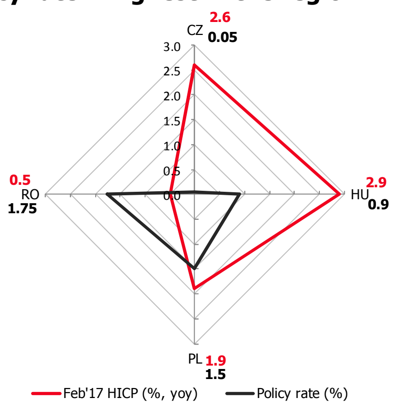
Taking account of the divergence between short-term developments and the medium-term inflation outlook and of the heightened uncertainties surrounding the short-term economic and financial developments both domestically and internationally, **NBR pursued a prudent monetary policy stance, maintaining policy rate unchanged at the historical low of 1.75%**. The symmetrical corridor between the interest rate on the permanent credit facility and the interest rate on the permanent deposit facility was also preserved at 150bps. Moreover, NBR continued to ensure adequate liquidity management in the banking system, while maintaining unchanged the level of the minimum reserve requirements ratio (MRR) on both RON and FX denominated liabilities of credit institutions at 8% and 10%, respectively.

NBR maintained the status quo



Source: NBR, BRD-GSG Research

Inflation –lowest in the region
Policy rate – highest in the region



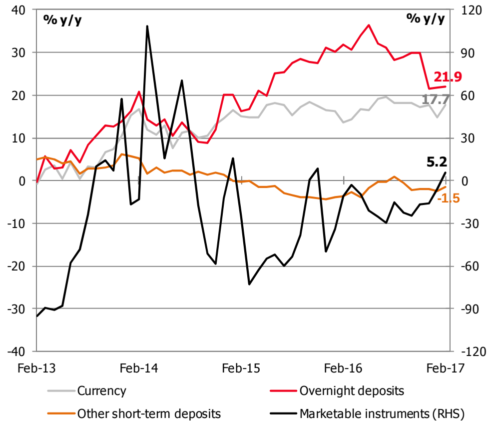
Source: Eurostat, BBG, BRD-GSG Research

Money supply

Money supply continued to expand at a fast pace. The annual growth rate of M3 stood at 10.1% in Feb'17. The prevailing role in M3 growth was played by its most liquid component, narrow money (M1), amid the sustained economic activity and the low opportunity cost of holding liquid assets. M1 increased by 20.6% y/y in Feb'17, with both major components contributing to the advance, as Overnight deposits expanded at a swift pace of 21.9% y/y, while currency in circulation rose by 17.7% y/y. Meanwhile, deposits with a maturity of up to two years recorded negative dynamics (-1.5% in Feb'17).

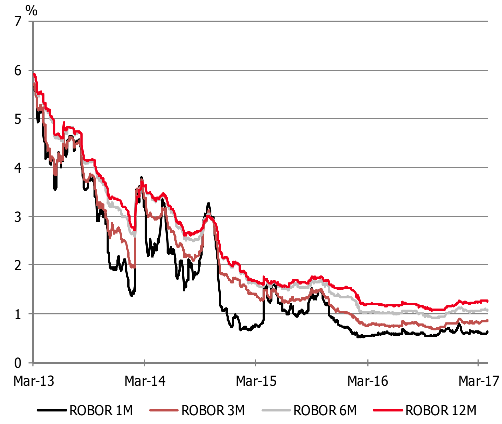
Turning to the creation of money, the M3 growth reflects high growth in net external assets (+26.5% y/y), while net domestic assets witnessed a contraction (-0.8% y/y).

Money supply – expanding at a swift pace



Source: NBR, BRD-GSG Research

Interbank rates – around historical lows



Source: NBR, BRD-GSG Research

Interbank rates

Interbank rates remained at very low levels across the maturity spectrum, recording marginal fluctuations, while standing well below policy rate. Excess interbank liquidity, which is hold by the banks at the Central Bank deposit facility, makes it very easy to borrow funds in short-term (O/N, 1 week, or even 1-month). The average level for O/N rates was 0.45% in Q1'17, while average ROBOR 3M was also very low at 0.83%.

Monetary policy prospects:

Accumulating risks to inflation trajectory over the medium term, occurring from a network of interlinked inflation boosting factors (strengthening demand-side pressures, the upsurge in government spending, the stark mismatch between wage increases and productivity gains coupled with an increasingly tight labor market, the weakening external position, rising inflation in trading partners) call for a recalibration of monetary policy parameters.

However, NBR might continue to refrain from pulling the trigger on rate hike, until clearer signs that inflation is on an upward path emerge. In the meantime, with a view of strengthening the monetary policy framework and taking into account that the impact of a rate hike becomes manifest with a lag, NBR could preemptively narrow the interest rate corridor and exert a tighter control over money market liquidity. Such a move would reduce the gap between policy rate and interbank rates, enhancing the latter ones role within the monetary policy transmission mechanism. Moreover, NBR shall continue to closely monitor developments in macroeconomic and financial variables both domestically and externally, with gradually fading uncertainty likely to allow for a more proper assessment of their impact on the future path of inflation.

We see an interest rate hike taking place as early as the last quarter of this year, with a higher likelihood associated to 2018. We earmark that, in case the necessary adjustment of fiscal and income policy stance to a sustainable path is not performed, a stronger response from monetary policy would be required, raising the risk of an upswing in speculative capital inflows.

III.2. Forex market – Nothing endures but change

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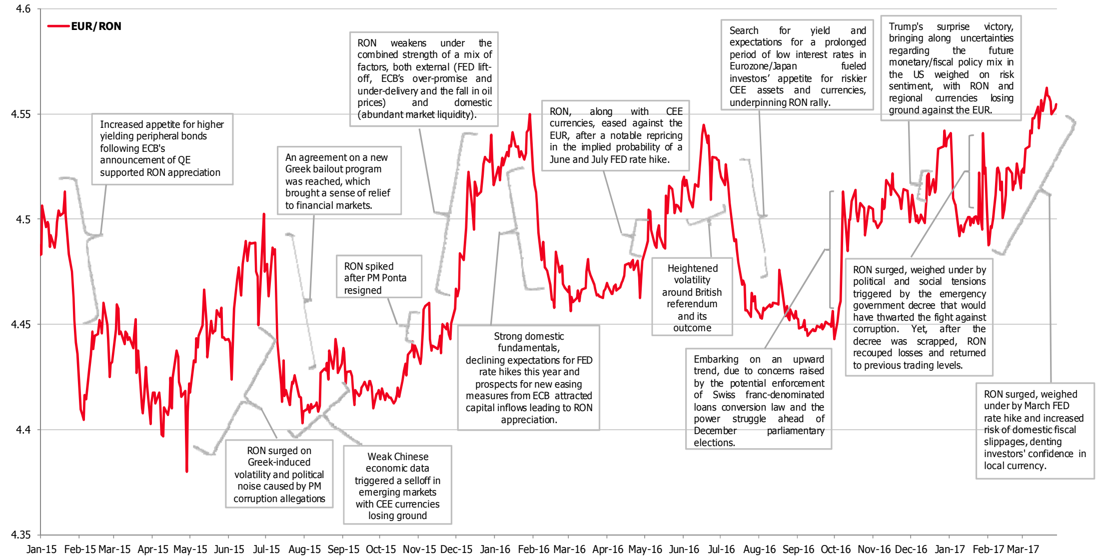
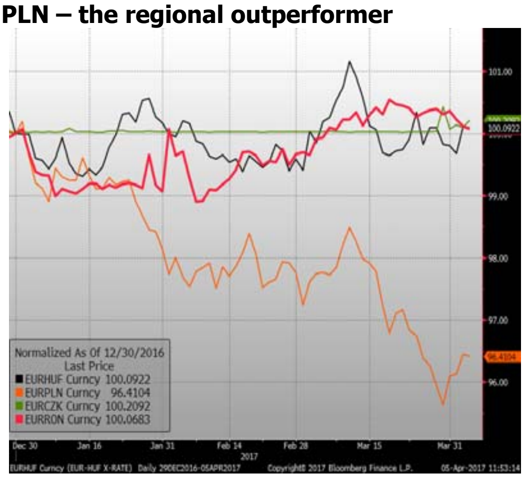
Since our Autumn report, **EURRON exchange rate witnessed some episodes of higher volatility than usual**, its dynamics being shaped by external developments (FED policy tightening, Europe market jitters, uncertainties about an array of Trump policies) and shifts in investors' sentiment towards local economy and financial market, triggered by domestic factors (political bickering, social unrest ignited by the passed and then repealed graft law, the considerable loosening of fiscal income policy combined with the pro-cyclical stance of fiscal policy leading to a worsening outlook on Romania's macroeconomic standing).



Source: Bloomberg, BRD-GSG Research

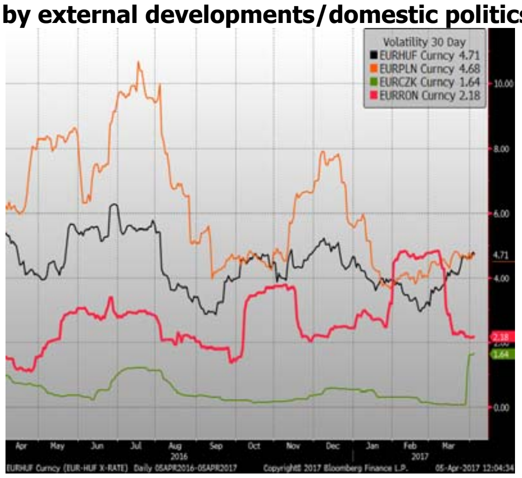
Accordingly, the first quarter of the year saw EURRON trading in the range of 4.50-4.55 for most of the time, recording an average level of 4.5206, as compared to 4.5072 in the final quarter of 2016.

RON – almost flat performance ytd
PLN – the regional outperformer



Source: Bloomberg, BRD-GSG Research

Episodes of heightened volatility triggered by external developments/domestic politics



Source: Bloomberg, BRD-GSG Research

<u>FX prospects</u>:

We see risks stemming from both external and domestic developments, being more pronounced in the case of latter ones. Emerging inflation, the worsening trend in the external position and the likely increase in financing costs, deriving from economic policy slippages (fiscal/income), *would entail subsequent downward pressure on the RON and could see it climbing beyond current levels. In addition, the uncertainty-riddled global environment could trigger renewed bouts of risk aversion, negatively impacting emerging currencies.*

Under these conditions, preserving the quite low FX volatility through a sound and effective policy mix is paramount to macroeconomic and financial stability. More than protecting a level, we believe NBR will act through the judicious use of liquidity management instruments to limit excessive movements either way, as they could amplify domestic imbalances, by encouraging speculative flows (in case of appreciation) or raising inflationary pressures (in case of depreciation). The still significant percentage of FX denominated loans also asks for a vigilant monitoring. Judging by the comfortable level of FX reserves, NBR has sufficient firepower to intervene in the FX market to alleviate such movements.

Overall, we see limited appreciation potential for RON against the EUR and expect it to stand at 4.52, end-2017 and 4.50, end-2018.

III.3. The Capital Market – All that glitters is not gold

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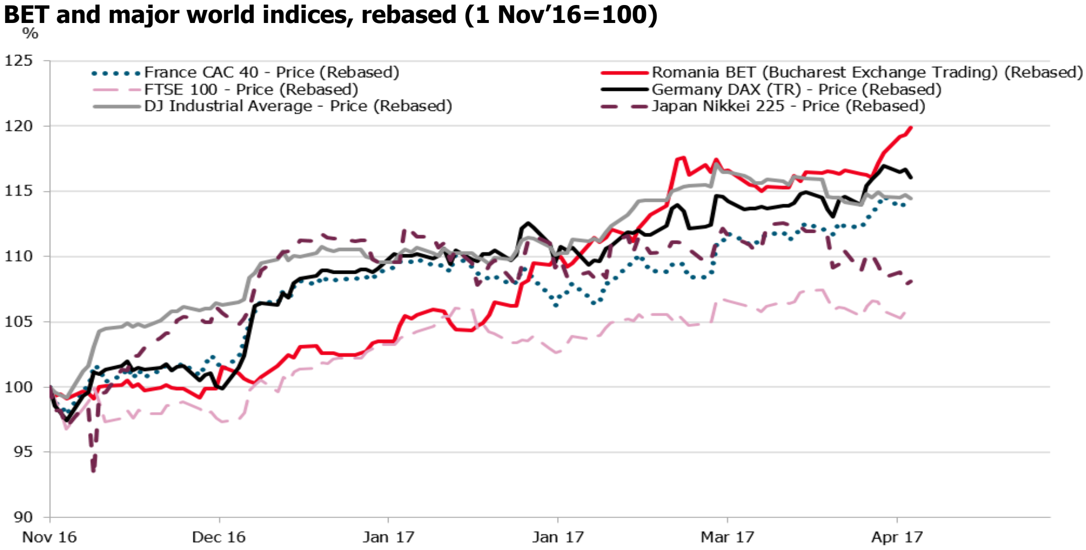
BET had a quiet evolution in the last two months of 2016, in spite of parliamentary elections, and of discussions regarding the appointment of a new Government. The situation changed in the first three months of the year, as local events (i.e.: 2016 preliminary financial results announcements, dividends proposal, shareholders meeting agenda) and regulations amendments brought a wave of optimism for local stocks, triggering BET index to outperform major world indices since Nov'16.

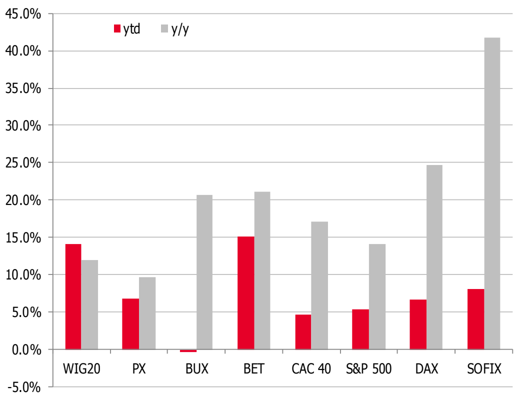
BET and major world indices, rebased (1 Nov'16=100)



Source: FactSet, BRD-GSG Research

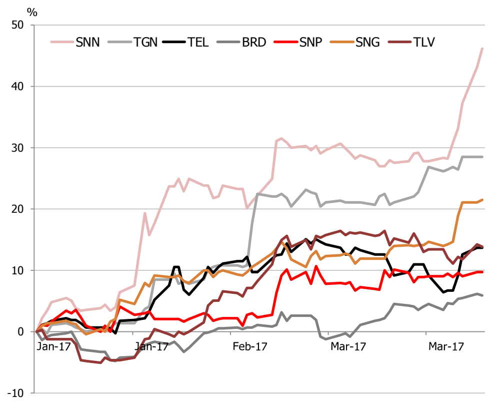
Thus, after ending 2016 with a modest result of 1.2% y/y, BET experienced a real take-off in the first quarter of 2017 posting 13% ytd growth. Analyzing index constituents, all stocks had positive ytd performances with majority-state owned companies leading the gains. In January, the newly appointed Government issued a memorandum imposing a 90% dividend pay-out ratio from 2016 net result for all companies where the state is a majority shareholder, instead of the legal minimum of 50%. Most of the energy companies (i.e.: Nuclearelectrica, Transelectrica, Transgaz, Romgaz) which historically were known as high dividends payers (70-80% rates), posted double digits growth ytd. Moreover, the gains enlarged after a decision of the Government published at the end of Mar'17, allowing majority state–owned companies to distribute additional dividends from the retained earnings of previous years included in company's reserves and from the current year retained earnings. Most of those companies are keeping reserves from previous years' retained earnings for covering future financing needs and some of them hold a significant position of cash&cash equivalents as of end-Dec'16. In CEE region, BET (+15.1% ytd) was the best performer from year beginning up to date, followed closely by the Polish WIG20 (+14.1% ytd), while Czech PX and Bulgarian Sofix evolution was also positive, but their gains were at half when compared with the two leaders. Hungarian BUX which ended 2016 with a remarkable advance of 33.8% y/y, showed a very modest Q1'17 performance with -0.3% ytd.

BET and other CEE indices performance ytd and y/y



Source: Bloomberg, BRD-GSG Research

BET main constituents performance ytd, rebased (31 Dec'16=100)

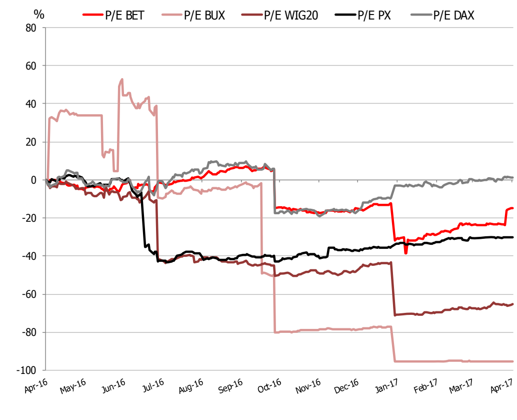


Source: Bloomberg, BRD-GSG Research

When compared to regional peers, valuations of the Romanian stocks included in BET index started to increase with March 2016, driven by generous dividend announcement. Although the value of P/E declined in Oct'16 and then at the beginning of the year, Romanian blue chips are still expensive vs. region's stocks, but cheaper when compared to German stocks.

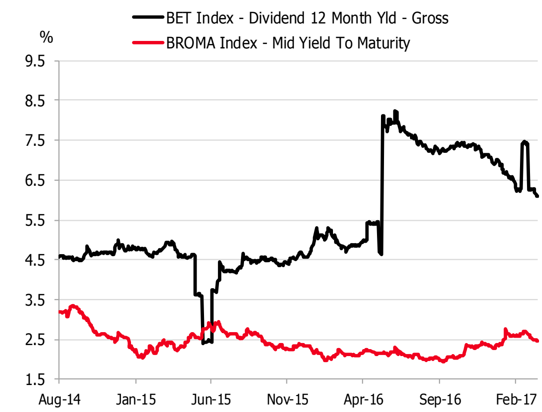
At the same time, the return of Romanian stocks measured as 12M gross dividend yields of BET constituents continued to outperform the T-bonds yields, amid low interest rate environment and hefty dividends paid in 2015, but also proposed for 2016 net profit.

P/E for regional indices, rebased (4 Apr'16=100)



Source: Bloomberg, BRD-GSG Research

Capital vs. bonds market performance



Source: Bloomberg, BRD-GSG Research

Most important events on local capital market during Nov'16 – Mar'17

In Dec'16, Bucharest Stock Exchange (BSE) added a new issuer, when MedLife, the leader of domestic private healthcare services industry, was listed on the main category at BSE via an SPO. Two minority shareholders of the company, namely the private equity funds V4C and IFC, sold 44% of company's shares in an offer worth RON 228m. The company's shares were listed on main market and started trading on 21 Dec'16. The company was included in BET, BET-XT, BETPlus and BET-BK indices starting with 20 Mar'17.

Following BSE Index Committee decision from 10 Mar'17, BET index comprises 12 issuers instead of 10, for the first time since its initiation. Conpet and MedLife were included in BET basket, and the weights valid from 20 Mar'17 are: Banca Transilvania (19.99%), Fondul Proprietatea (19.98%), OMV Petrom (16.3%), BRD-GSG (10.61%), Romgaz (10.51%), Electrica (7.7%), Transgaz (6.78%), Transelectrica (3.92%), Nuclearelectrica (1.22%), Bursa de Valori Bucuresti (0.73%), Conpet (1.35%), MedLife (0.92%).

During 15 Feb'17 – 20 Mar'17, Fondul Proprietatea (FP) ran its fourth public tender offer and acquired 640m own shares paying RON 583m. This offer was part of the seventh shares buy-back programme launched by the Fund, as its strategy for the last years was to use available resources to buy back own shares, attempting at narrowing the discount between FP's NAV and share price.

The financial calendar of listed companies in near future includes the annual general shareholders meetings (GSM) where the shareholders are called to approve the 2016 financial statements and profit distribution. Most of the blue-chips proposed higher dividends vs. previous years' levels. Apart from majority state-owned companies, issuers such as OMV Petrom (SNP) proposed higher payout ratio, 81.4%, than 38.7% - 3y avg. '12-'14.

The decline of dividend tax rate to 5% from 16% starting with Jan'17 is another advantage for investors and an incentive for shareholders to request higher dividends in the upcoming shareholders meetings. The table below presents the current available gross dividend per share proposal and the estimated gross dividend yield (gross DY) for BET components:

BSE blue-chips potential DY

Company	Sector	Proposed gross DPS	Gross DY (%)
OMV Petrom	Oil&gas	0.015	4.8%
Romgaz	Oil&gas	2.49	8.1%
Fondul Proprietatea*	Financial	0.05	5.5%
Electrica	Utilities	0.7415	5.3%
BRD	Banking	0.73	5.7%
Banca Transilvania	Banking	0.06	2.2%
Transgaz	Utilities	46.33	12.3%
Nuclearelectrica	Utilities	0.33	4.7%
Transelectrica	Utilities	2.257	6.8%
Conpet	Utilities	8.067	7.1%
MedLife	Health services	0.000	0.0%
Bursa de Valori Bucuresti	Financial	0.920	3.0%

**Special cash distribution*
Closing prices as of 5 Apr'17
Source: Companies' website, BRD-GSG Research

When the euphoria of dividends will be over, the stock prices should align to lower levels after the ex-dividend dates, with fundamentals gaining more attention in the second part of the year.

III.4. Banking sector – Twinkle, twinkle, little star

Lending activity continues to lag economic growth

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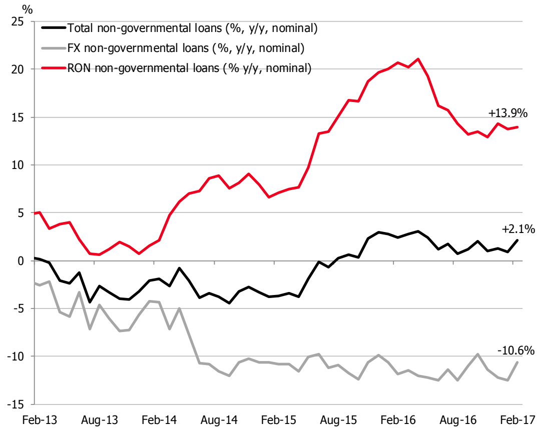
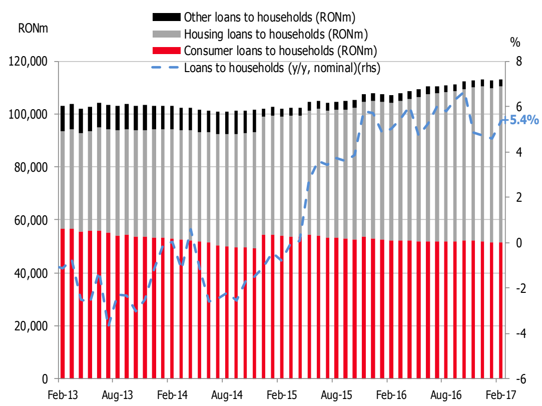
The awaited changes for local lending activity to follow a more consistent upward path were not fulfilled, as non-governmental loans ended higher by 1.2% y/y as of end-Dec'16, while local economy ended 2016 with a GDP increase of 4.8% y/y, the largest growth rate in our neighboring region. Of course, structural constraints related to - i/ the lowest financial intermediation rate in the region (loans/GDP is 29.9% in 2015 vs. 39.6% average of neighboring region); ii/ the significant cash&cash equivalents position owned by some large companies (mostly state-owned companies); iii/ the preference of export-oriented companies to borrow money from abroad - require more time to be addressed in order for lending activity to follow economic growth rate.

Non-governmental loans growth driven by RON lending



Source: Thomson Reuters Datastream, BRD-GSG Research

Housing loans gained weight, owning 52.2% of households loans stock (Feb'17)



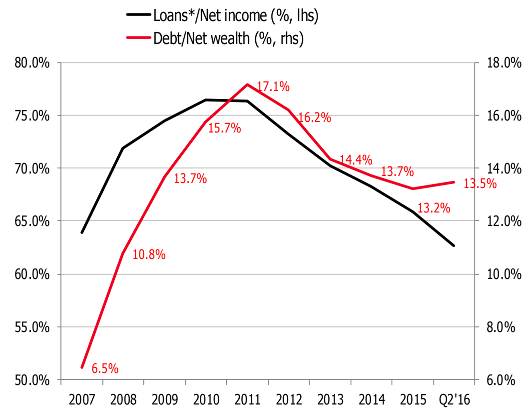
Source: Thomson Reuters Datastream, BRD-GSG Research

The picture depicted by the new non-governmental loans statistic database (including restructured loans, refinanced loans, conversion from FX to RON denominated loans, other loans) hasn't changed much since our previous report. Thus, **loans generation process slowed down in 2016 vs. 2015 (total non-governmental loans went up 10.8% y/y vs. +29.5% y/y in 2015), as borrowing appetite of households and non-financial corporations eased in 2016 vs. 2015.** The largest weight of new loans for households is held by consumption loans (59.1% in 2016 vs. 56.6% in 2015), which increased by 20% y/y in 2016 vs. +40.8% y/y in 2015. New mortgage loans went up by 10.4% y/y in 2016 vs. +56.8% y/y in 2015. Otherwise, the annual evolution of new loans to non-financial corporations turned positive since our Autumn report, increasing by 6.9% y/y in 2016 vs. +17.1% y/y in 2015.

As a result, the non-governmental loans balance amounted to RON 220.1bln as of end-Dec'16, up 1.2% y/y exceeding our estimation of +1.96% y/y, mostly due to a lower decline of non-financial corporation loans than anticipated by us (-3.1% y/y end-Dec'16 vs. our estimation of -4.6% y/y), while households loans balance advanced by 4.7% y/y as of end-Dec'16 (vs. our estimation of +6.4% y/y).

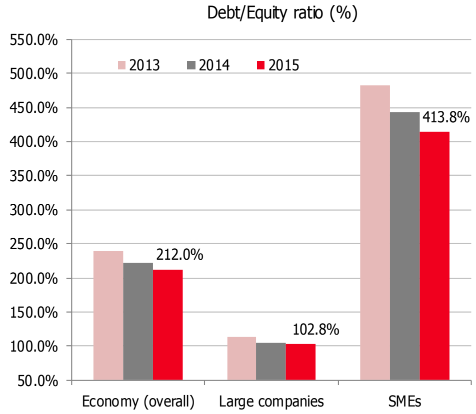
To assess the future developments of loans, we have to consider the following: **i/** the anticipated slow-down of balance sheet cleaning process for banks, because in the first nine months were written-off loans worth approx. RON 17bln and NPLs dropped by 28% y/y down to RON 25.9bln, according to latest *NBR Financial Stability Report* published in Dec'16; **ii/** the relatively high indebtness ratio of households if we analyze debt/net wealth and loans/disposable income ratios; **iii/** the significant vulnerabilities of corporations related to balance sheet structure, especially for SMEs, whose debt/equity ratio was higher than 400% in 2015.

Debt/net wealth of households increased slightly in 2016



** Sum of loans granted by banks (sold loans included) and of loans granted by local NBFIs*
Source: Dec'16 NBR Financial Stability Report, BRD-GSG Research

The highest debt/equity ratio for SMEs



Source: Dec'16 NBR Financial Stability Report, BRD-GSG Research

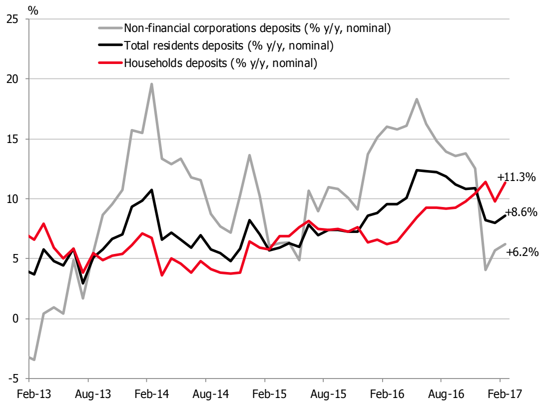
Consequently, we revised slightly upwards our non-governmental **loans growth** estimations for 2017 and 2018, such as: +3.2% y/y (nominal terms) end-Dec'17 (vs. +3.0% y/y, nominal terms, previously), +3.6% y/y end-Dec'18 (vs. +3.5% y/y end-Dec'18, nominal terms, previously) and +3.7% y/y (nominal terms) end-Dec'19. The major driver will remain households (+5.3% y/y in 2017, +4.3% y/y in 2018, +3.8% y/y in 2019), while corporations might start to gradually increase their borrowed resources (+0.6% y/y in 2017, +2.4% y/y in 2018, +2.9% y/y in 2019).

<u>Households' deposits continue to grow by a double-digit figure</u>

Deposits represent the largest part of financial assets held by households (29.3% of financial assets as of end-Jun'16, according to the data presented in *Dec'16 NBR Financial Stability Report*), with only a small fraction of persons, 5.6% of total depositors (566,138) owning deposits higher than RON 50,000, but which own cumulatively 73.4% of the total value of deposits. Apart from financial assets, households' net wealth is comprised mostly by real estate assets, which increased by 5.7% y/y in 2015 up to RON 592bln.

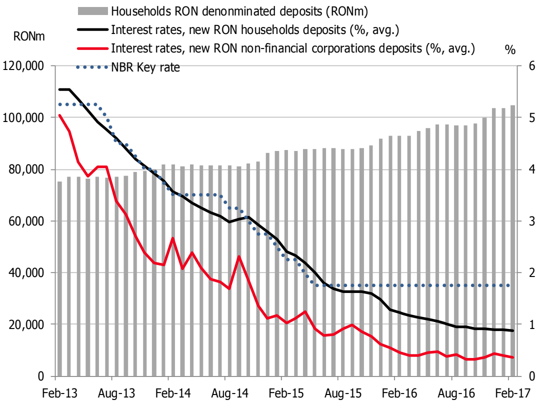
As a result, non-government residents' deposits advanced by 8.2% y/y as of end-Dec'16, exceeding once again our estimation of +5.1% y/y for end-Dec'16, with households deposits increasing by 11.4% y/y for the same period.

Households deposits – slightly reduced the annual growth pace in H2'16



Source: Thomson Reuters Datastream,BRD-GSG Research

RON households deposits returns continue to decrease



Source: Thomson Reuters Datastream, BRD-GSG Research

Moreover, loans to deposits ratio drifted below 0.8 as of end-Dec'16, as inefficiency in utilization of financial resources increased for banks.

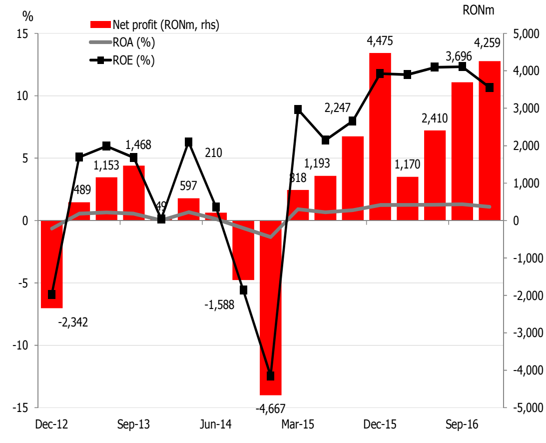
Consequently, we reviewed upwards our **deposits growth** from our previous report to approx. +6.7% y/y (nominal terms) for end-Dec'17 (vs.-0.6% y/y, nominal terms, previously), +4.5% y/y (nominal terms) as of end-Dec'18 (vs. -2.1% y/y, previously). For 2019, we estimate an upside of 3.0% y/y for deposits, as we expect loans to deposits ratio to reach 0.79 in 2019, compared to 0.78 in 2017.

<u>Profitability improved in the past two years</u>

2016 marked another year with strong profitability for banking sector, as aggregated bottom line amounted to RON 4.26bn (-4.8% y/y), mainly as a result of a slowdown in provisioning policy of banks and a slight improvement in lending activity. **The questions are: i) Will net profit growth continue to be solid in the years ahead?** and **ii) What will be driving growth?**.

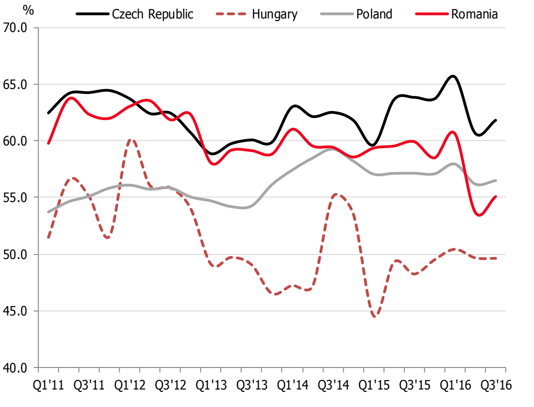
Considering the anticipated development of interest rate environment, along with a slight advance of non-governmental loans, we see a slight reverse of the recent interest margin weight in gross income trend.

Local banking sector net result in the black…



Source: NBR,BRD-GSG Research

…while interest margin weight into gross income is below 2011 level for local banking sector



Source: Financial Soundness Indicators (FSI),BRD-GSG Research

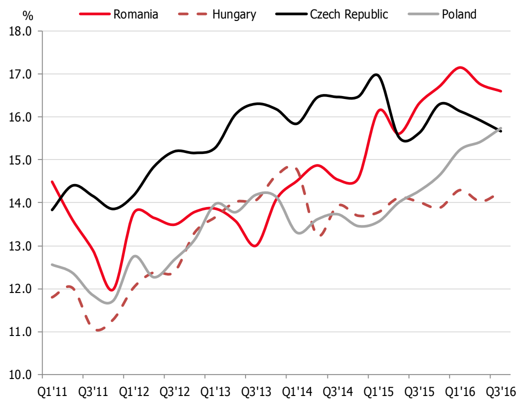
A potential risk to banking sector performance might come from the rising yields, given that government bonds account for 21.6% of total banking sector assets as of end-Sep'16 (*Dec'16 NBR Financial Stability Report*) significantly higher than other countries in the region. On the flip side, government bonds provide liquidity to the balance sheet of the banks.

Capital ratios improved, while liquidity remains high

The capital ratios, used in assessing the health and soundness of a bank, look very good for the local banking sector in comparison with neighboring countries, but also with other large banks which tapped the market for additional capital (i.e.: Unicredit increased its capital by EUR 13bln –through an operation finalised on 3 Mar'17, Deutsche Bank completed share capital increase by EUR 8bln through rights issue between 21 Mar'17 and 4 Apr'17 and plans to raise additional EUR 2bln over the next two years from asset disposals and an IPO of Deutsche Asset Management). Given that the capital is more than adequate, local banks should find ways to use better the excess capital.

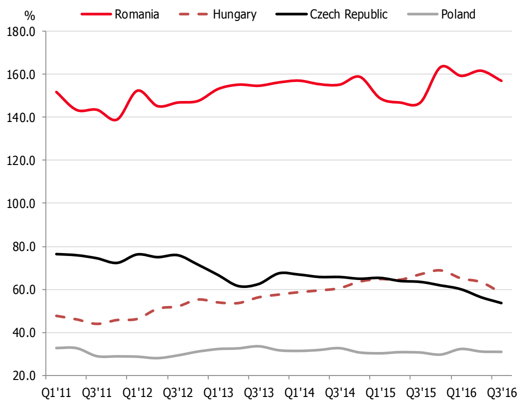
Given that our local banking market is moderately concentrated as compared with European peers (top 5 banks held a market share of 58.1% as of end-Sep'16 vs. 30.6% in Germany), and financial inclusion (namely, access to the financial services and their quality) is rather low in Romania, we anticipate a new round of M&A activity, aiming at increasing the efficiency of excess capital owned by local banks and fostering future growth.

Tier 1 Capital to RWA ratio…the highest in the region



Source: Financial Soundness Indicators (FSI), BRD-GSG Research

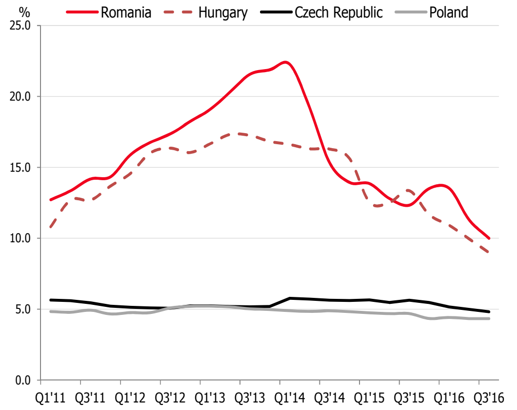
…and the most liquid in the region (ST assets/ST liabilities)



Source: Financial Soundness Indicators (FSI), BRD-GSG Research

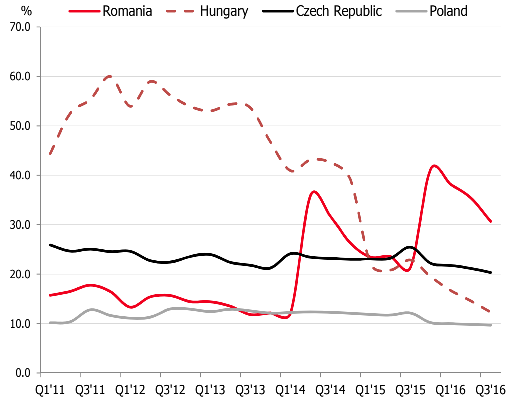
NPLs ratio (using EBA definition for NPLs) dropped to 9.46% as of end-Dec'16 (vs. our estimation of 9.8% as of end-Dec'16) from 10.56% as of end-Aug'16, the available figure at the date of our previous report released in Nov'16. It is very little to the European Banking Authority (EBA) threshold of 8% in order to obtain an improved ranking from this point of view. If economic growth proves to be supportive for preventing a new build-up in NPLs, NPL ratio it's likely to reach 8.0% by the end of this year (vs. 9.0%, previously) and 7.5% as of end-Dec'18 and 7% as of end-Dec'19.

NPLs ratio declined for Romania…



Source: Financial Soundness Indicators (FSI), BRD-GSG Research

…but, NPLs net of provisions to capital remains elevated



Source: Financial Soundness Indicators (FSI), BRD-GSG Research

"Walk-away" mortgage law and CHF conversion law – a thing of the past?

Since our previous report, some clarifications have been released regarding the "walk-away" mortgage law ("*datio in solutum*" law), as the Constitutional Court published its reasoning in Jan'17 regarding the decision of unconstitutionality of some articles of the "walk away" law. At the present, the debtor must prove: i/ he/she entered into default because of unpredictable circumstances (the debtor can't pay); ii/ and the debtor tried to settle with the bank the overdue debt; and a law court must decide that. Therefore, the loss event for the bank will happen on a case-by-case basis, when a law court decides that. Nevertheless, it hasn't been decided how the debt is going to be repaid. An immediate potential effect for banks might be the decision to reverse part of provisions already booked for this law. Moreover, this is highly dependent on each bank's provision policy and risk assessment procedures.

As for the CHF denominated loans conversion at historical FX rate, the Constitutional Court decided in Feb'17 that law is not constitutional, even after it has been adopted by the Parliament. The NBR sustained that a negotiation between banks and debtors with CHF loans is recommended, as it should bring favorable results.

For the time being, the most recent effects of the two laws should be analysed, but we believe that the original risks associated with the enforcement of the two laws eased to some extent since their first release. It's likely that the result of the analysis to be included in the upcoming Asset Quality Review (AQR).

In addition to these two laws, the implementation of new IFRS 9 Financial instruments starting with Jan'18 and the developments in the area of banks' capital regulations will be key drivers in banks' performance.

Forecast: Main Macroeconomic and Financial Market Indicators

BRD-GSG Research Forecasts

	2012	2013	2014	2015	2016	2017 (f)	2018 (f)	2019 (f)
Real sector								
GDP (real, %)	0.6%	3.5%	3.1%	3.9%	4.8%	4.1%	3.8%	3.6%
Final consumption expenditure (real, %)	1.1%	-0.3%	4.0%	4.9%	6.9%	4.9%	4.0%	3.5%
Gross fixed capital investment (real, %)	0.1%	-5.4%	3.2%	8.3%	-3.3%	3.5%	5.0%	6.0%
Exports (real, %)	1.0%	19.7%	8.0%	5.4%	8.3%	8.5%	8.0%	7.0%
Imports (real, %)	-1.8%	8.8%	8.7%	9.2%	9.8%	9.2%	8.9%	8.0%
CPI (eop, y/y)	5.0%	1.6%	0.8%	-0.9%	-0.5%	1.5%	2.7%	3.0%
ILO unemployment	6.8%	7.1%	6.8%	6.8%	5.9%	5.5%	5.3%	5.0%
Public finance (ESA 2010)								
Fiscal balance (% of GDP)	-3.7%	-2.1%	-0.8%	-0.8%	-2.8%	-3.4%	-2.9%	-2.4%
Government revenue (% of GDP)	33.6%	33.3%	33.6%	34.9%	33.7%	33.5%	34.0%	34.3%
Government expenditure (% of GDP)	37.2%	35.4%	34.4%	35.7%	36.5%	36.9%	36.9%	36.7%
Public debt (% of GDP)	37.3%	37.8%	39.4%	38.0%	37.7%	39.0%	40.2%	39.5%
External sector								
Current account balance (% of GDP)	-4.8%	-1.1%	-0.7%	-1.2%	-2.4%	-3.1%	-3.6%	-4.0%
Trade balance (% of GDP)	-5.1%	-0.8%	-0.4%	-0.6%	-1.0%	-1.3%	-1.7%	-2.2%
FDI (EUR bln)	2.1	2.7	2.4	3.4	4.1	3.9	4.2	4.5
Secondary income (% of GDP)	2.0%	1.9%	1.1%	1.7%	1.4%	1.6%	1.7%	1.8%
Monetary and financial sector								
Key interest rate (%, eop)	5.25%	4.00%	2.75%	1.75%	1.75%	1.75%	2.00%	2.50%
Private sector credit (eop, nominal y/y)	1.3%	-3.3%	-3.3%	3.0%	1.2%	3.2%	3.6%	3.7%
NPLs (% of total loans)*	18.3%	21.9%	20.7%	13.6%	9.5%	8.0%	7.5%	7.0%
Loan-to-deposits	1.2	1.0	0.9	0.85	0.79	0.78	0.77	0.79
Financial markets								
EURRON (eop)	4.43	4.48	4.48	4.52	4.54	4.52	4.50	4.52
EURRON (avg)	4.46	4.42	4.44	4.445	4.49	4.53	4.51	4.51
EURUSD (avg)	1.29	1.33	1.33	1.11	1.11	1.08	1.12	1.15
USDRON (avg)	3.47	3.33	3.35	4.01	4.06	4.21	4.03	3.92
ROBOR 3M (eop)	6.05%	2.44%	1.70%	1.02%	0.90%	0.95%	1.20%	1.70%
EURIBOR 3M (eop)	0.19%	0.29%	0.08%	-0.13%	-0.32%	-0.30%	-0.20%	-0.05%
Memo items								
GDP (nominal, bln RON)	595.4	637.5	668.1	711.1	761.5	811.3	862.0	914.6
GDP (nominal, bln EUR)	133.5	144.3	150.3	160.0	169.6	179.1	191.1	202.8

*Source: Eurostat, MinFin, NIS, NBR, forecast: BRD-GSG Research, *based on NBR methodology for NPLs between 2011 and 2013, based on EBA definition for NPLs for the period 2014-2018e.*

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