ERSTE GROUP

Romania in 2013

Lower fiscal consolidation pace, normal agricultural year and minor recovery in external demand to shape Romanian economy in 2013

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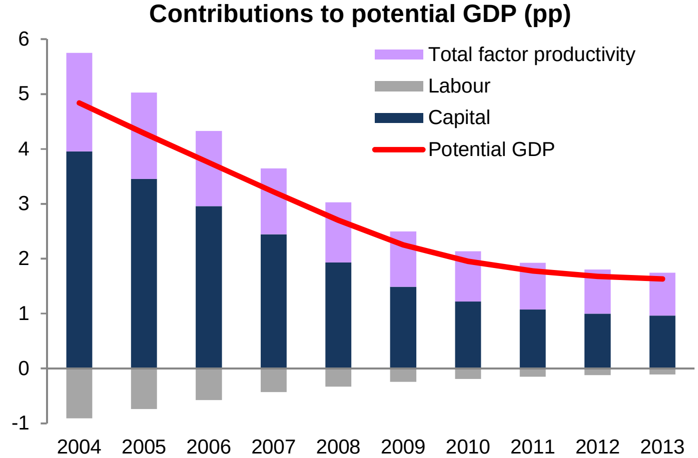
The Romanian economy will recover gradually in 2013, helped by local and international factors that look more promising compared to last year. Additional public resources injected by the government into the economy, a normal agricultural crop after the severe drought of last year and a minor recovery in external demand will lift real GDP growth to 1.1%.

Investor confidence improved worldwide at the beginning of 2013 due to the ample liquidity provided by major central banks to the markets in 2012 and a last-gasp resolution to the US fiscal cliff problem. The decisions by Barclays and JP Morgan to include Romanian local currency bonds in their emerging market indexes gave a boost to Romanian assets. The RON strengthened to a one-year high of 4.32, CDS spreads fell to below 200bp for the first time since March 2010 and 5Y government bond yields fell 80bp in less than one month.

Contributions to potential GDP (pp)

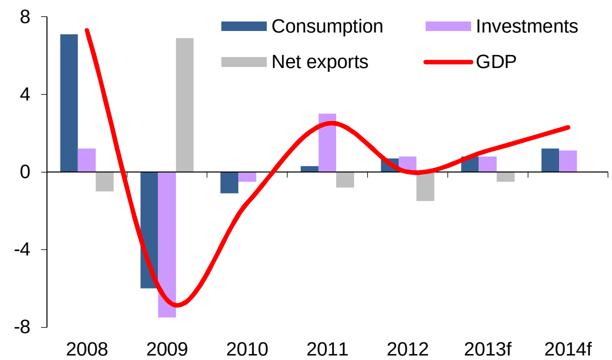


Source: NIS, BCR Research

Household consumption to support economic growth in 2013

Real GDP could go up by 1.1% in 2013, after an estimated 0% last year. The early implementation of tough austerity measures in 2010 put Romania's public finances on a more sustainable path and created fiscal space for increases in public wages and pensions. Public wages were raised by 8% in July 2012 and 7.4% in December 2012, while pensions increased by 4% in January 2013. Moreover, the government will continue to make payments (estimated at RON 640mn in 2013) to public employees following definitive court decisions in 2011. Consumer confidence improved in December for the third month in a row and created favorable conditions for retail sales and services to the population in the first part of 2013.

Contributions to real GDP growth (pp)



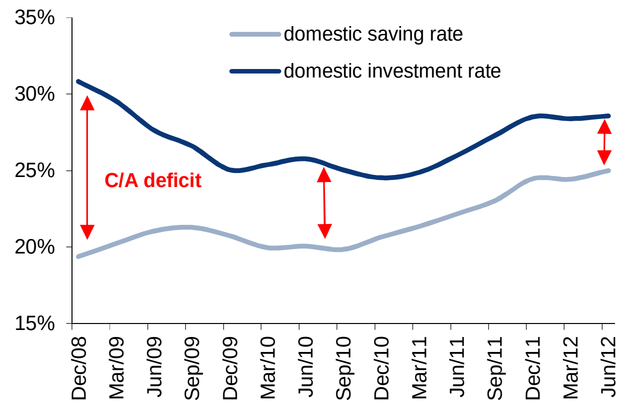
Source: NIS, BCR Research

The 2013 state budget is a pro-growth budget and we think that household consumption will be boosted by official policies. The government's road infrastructure plans are highly dependent on rapid improvement in the absorption of EU structural and cohesion funds and also on the development of PPP projects for building highways across the Carpathian Mountains. Big infrastructure projects in agriculture, such as the Siret-Baragan irrigation channel, should be preceded by passing a law to stimulate the merger of small agricultural plots into large farms. An increase in productivity in agriculture and better orientation towards consumer markets will strengthen the financial position of Romanian farmers and will enable them to support the irrigation costs. The government could consider various options for stimulating the merger of small agricultural plots, such as subsidizing the administrative expenditures made by poor peasants when selling their farms (land tenure, legal expenditures).

According to our model, potential GDP fell to 1.6% at present, from as high as 4.8% in 2004. Almost 90% thereof can be ascribed to falling investments up to 2010. Since a significant increase in investments, either public or private, is not our baseline scenario and employment will not be very supportive for future growth, we think that only a rise in total factor productivity could lift potential GDP to 3-4% after 2015. A diversification of economic growth drivers and an increase in competitiveness will improve Romania's resilience in the face of external shocks. Economic sectors, such as agriculture, transport and tourism, which were slow in attracting foreign direct investments in recent years, have the highest potential for an improvement in total factor productivity. Privatization remains a real option in transport in 2013.

Romania's future economic growth should be oriented towards a Europe 2020 strategy that pursues smart, sustainable and inclusive growth. More people at work, more money invested in R&D activities, a cleaner environment, better education and fewer people at risk of poverty or social exclusion will reduce Romania's vulnerability to future economic crisis and smooth the way towards euro adoption. Increasing employment for the age group 20-64 to 70% by 2020 remains a difficult task for Romania, bearing in mind that the employment rate was 65% in 3Q12 and a lot of structural reforms still have to be accomplished with the help of international partners. A structural shift in employment from agriculture to manufacturing and services in the midst of sluggish economic growth which produces no visible effects on the labor market is challenging. Agriculture, a sector that employed 35% of Romania's labor force ten years ago and still employs 29% at present, made a contribution of zero to Romania's economic growth, on average, over the last ten years.

C/A deficit as difference between savings and investments



Source: NIS, BCR Research

The economic and social benefits of stronger economic growth are manifold – real convergence of the Romanian economy towards Eurozone standards, an increase in domestic saving rate and a lower dependence of investments on foreign capital inflows, a rise in public resources available for capital and social expenditures. After falling between 2009 and 2010, the domestic investment rate started to rise at the beginning of 2011 and is now close to pre-recession levels, at around 29%. Boosting the investment rate significantly beyond 30% does not seem a plausible scenario in an environment in which banks must face tighter regulatory constraints and Romania will not be able to absorb all EU structural and cohesion funds earmarked for 2007-13. This is yet another reason why future economic growth should concentrate on total factor productivity.

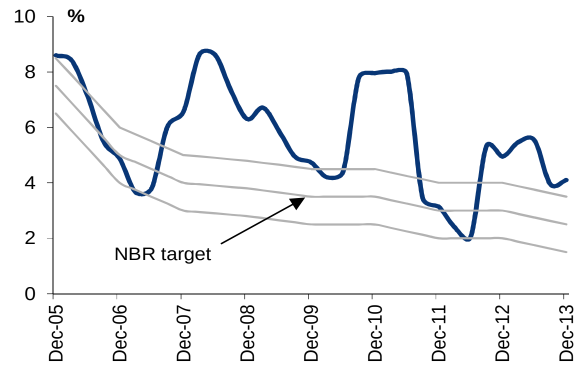
Inflation above NBR's target

The annual inflation rate increased faster than estimated in December 2012 and reached 5%, well above the NBR's target of 3%±1pp, due to hikes in the administered electricity price and the delayed effects of severe summer drought in agriculture. The food price advanced faster than headline inflation in 2012 (+6.2%), following a strong drop in agricultural output, but the spike was tempered by the persistence of a negative output gap. Adjusted CORE2 inflation[1], which is closely monitored by the NBR, remained

[1] Headline inflation less administered prices, volatile prices, tobacco and alcohol

unchanged in December at 3.3%, but we see it as too high for the beginning of a monetary easing cycle in the near future.

Inflation and the NBR's target (%)



Source: NIS, NBR, BCR Research

Inflation will peak at 5.6% in 2Q13 and decline slowly towards 4.1% in December 2013, while remaining above the NBR's target. Hikes in the administered electricity price (+6% in January and +2% in July) and in the natural gas price (+8% in July and +2% in October) will make a contribution of 0.8pp to headline inflation estimated at 4.1% in December 2013. Our model shows that a supply shock such as the decrease in agricultural output in 2012 (of around -18% in real terms) produces immediate negative effects on headline inflation in the form of rising consumer prices, but the shock is absorbed after 7 months and headline inflation converges to CORE2 inflation in a 12-month horizon. Household inflation expectations decreased for two consecutive months in November and December, but a lot depends on the potential second-round effects of the hikes in the administered energy price at the beginning of 2013. **In a nutshell, our inflation outlook for 2013 is slightly more positive compared to three months ago, due to a stronger RON, good prospects for higher agricultural output and the persistence of a negative output gap.**

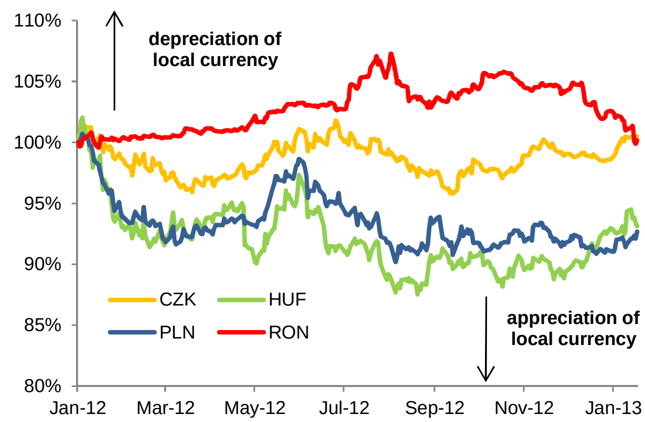
3M ROBOR to fall to 5.5% by December 2013

At the beginning of January, the NBR kept rates unchanged at 5.25% as expected, but replaced the wording 'firm liquidity management in the banking system' with 'adequate liquidity management in the banking system' in its press release available after the monetary policy decision. Soon after, the NBR increased the volume of liquidity provided to banks at its weekly repo auctions to RON 6bn. A complete removal of the cap is not in the cards in the next few months, but the unexpected appreciation of the RON opens up new opportunities for the NBR for increasing the liquidity in the market through unsterilized euro-buying operations. According to the NBR, the formation of a new government and adherence to the fiscal targets agreed with the IMF and EU improved investors' risk perception and alleviated pressures on the RON and money market rates. Governor Isarescu said that monetary policy will be 'normal' in 2013 and implied that additional tightening is not an option on the table at present.
We think that the key rate will be kept flat at 5.25% throughout 2013 and that the first move will be a cut in 1Q14. Money market rates will nevertheless decline due to an increase in liquidity provided by the NBR to the market.

RON to appreciate by 2% on average in 2013

The size of RON appreciation in early-2013 after the swift formation of a new government with a strong majority in Parliament took market participants by surprise. The decisions taken by Barclays and JP Morgan to include Romania in their emerging market local currency bond indices as of March 2013 boosted demand for RON-denominated government debt. The RON was a laggard compared to its regional peers in 2012 – due mainly to local factors – and failed to capture the gradual improvement in global risk appetite after the generous monetary stimulus provided by major central banks. The situation changed for the better in early-January when non-residents increased their profile on local FX and fixed income markets.

Local currencies in CEE (January 2012=100%)



Source: Reuters, BCR Research

We forecast the EURRON at 4.35 in March 2013 and 4.40 in December 2013 and think the rally on local financial markets will gradually run out of steam. The NBR and MinFin should meet combined payments worth EUR 5.2bn to the IMF, while the MinFin should repay EUR 1.8bn to private investors due to the maturing of EUR-denominated bonds issued on the local market. All these should put a floor under the appreciation of the RON. At the same time, we think that the NBR will stick to its managed floating FX regime and will not allow the strengthening of the RON to below 4.3 due to its unsustainable nature.

According to our Behavioral Equilibrium Exchange Rate models (BEER), the variables with the strongest influence on equilibrium FX rate are the CDS spreads, foreign direct investments and the openness degree of the economy measured as (exports+imports)/GDP. We expect CDS spreads to remain below 250bp for most of 2013, with foreign direct investments marginally up at a three-year high of EUR 1.9bn and a higher average inflation rate as compared to 2012. Under these circumstances, the equilibrium FX rate is estimated at 4.4 in 2013 from 4.3 in 2012.

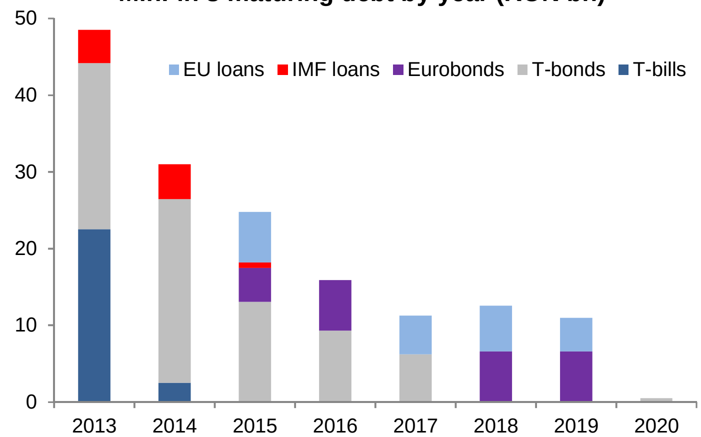
Less fiscal consolidation, more support for economy

The early implementation of severe cuts in public expenditure and hikes in the taxation level in 2010 put public finances on a more sustainable path. Romania reduced its budget deficit by RON 10bn/year on average in 2010-11, with sizable negative effects on domestic demand. In 2013, the budget deficit (cash standards) will remain roughly unchanged in nominal terms, which implies the better capacity of the government to support growth.

We estimate the gross funding needs of the MinFin at RON 70bn (11.3% of GDP) in 2013, roughly unchanged from 2012 due to sizable maturing debt.

The average residual maturity of government debt issued on the local market is only 1.7 years, which leads to a frontloading of maturing debt in the next 1-2 years. 47.5% of the paper issued on the local market matures in less than one year, while only 3.4% matures in more than five years. An extension of maturities to above five years and an increase in the size of bond issues on the primary market should be top targets for debt managers in 2013. Higher liquidity at the long end of the yield curve would support a gradual shift in non-government lending from FX loans to RON loans in future years, because it would be a useful benchmark for pricing long-term loans in the domestic currency. More Eurobond issues are also greatly needed to counterbalance the outflow of FX reserves associated with the repayments to the IMF.

MinFin's maturing debt by year (RON bn)



Source: Reuters, BCR Research
Data as of January 16, 2013

The share of RON-denominated government bonds and bills held by nonresidents fell strongly in 2012 due to political instability and Romania's economic ties with southern Eurozone countries. In October 2012, nonresidents owned only 5.3% of total stock of RON-denominated government paper (RON 4.1bn) which left plenty of room for an increase in their holdings at the beginning of 2013.

Forecasts

	2007	2008	2009	2010	2011	2012	2013f	2014f	2015f
Real economy									
Real GDP - %, y/y	6.3	7.3	-6.6	-1.1	2.2	0.0	1.1	2.3	2.9
GDP - RON bn	416	515	501	524	557	586	617	654	696
GDP per capita - EUR tsd	5.8	6.5	5.5	5.8	6.1	6.1	6.6	7.0	7.4
Household consumption - %, y/y	10.3	8.9	-9.1	0.2	1.1	0.7	1.4	2.2	2.8
Investments - %, y/y	30.3	15.6	-28.1	-1.8	7.3	3.5	4.4	5.0	5.6
Industrial production - % y/y	10.3	2.7	-5.6	5.6	5.6	-0.4	1.4	2.4	3.0
Retail sales - %, y/y	16.4	19.9	-14.1	-0.4	4.4	2.5	3.0	4.2	5.0
External sector									
Exports (FOB) - EUR bn	29.5	33.7	29.1	37.4	45.0	44.8	46.0	48.3	51.4
Imports (FOB) - EUR bn	47.4	52.8	36.0	45.0	52.5	52.2	53.4	56.5	60.5
Trade balance - % of GDP	-14.3	-13.7	-5.8	-6.1	-5.7	-5.6	-5.3	-5.5	-5.8
C/A balance - % of GDP	-13.4	-11.6	-4.1	-4.4	-4.3	-3.5	-3.5	-3.6	-3.7
FDI (inflows) - EUR bn	7.0	9.3	3.5	2.2	1.8	1.6	1.9	2.3	2.8
Prices									
CPI - y/y (%)	6.6	6.3	4.7	8.0	3.1	5.0	4.1	3.9	3.4
CPI - average (%)	4.8	7.9	5.6	6.1	5.8	3.3	5.0	3.8	3.6
IPPI - y/y (%)	10.5	15.3	1.9	6.3	8.9	5.4	4.6	3.8	3.6
Labour market									
Unemployment rate - average %	6.4	5.8	6.9	7.3	7.4	7.0	6.9	6.7	6.5
Gross wages - RON	1,396	1,761	1,845	1,902	1,995	2,119	2,225	2,336	2,453
Real gross wages - %, y/y	16.2	16.9	-0.8	-2.8	-0.9	2.8	0.0	1.2	1.4
Public sector									
Fiscal deficit - % of GDP (ESA95)	-2.9	-5.7	-9.0	-6.8	-5.7	-3.3	-2.8	-2.4	-2.3
Public debt - % of GDP (ESA95)	12.8	13.4	23.6	30.4	34.7	35.3	35.8	35.7	35.3
Interest rates									
Key rate	7.50	10.25	8.00	6.25	6.00	5.25	5.25	5.00	4.75
ROBOR 3M - % eop	8.4	15.5	10.7	6.2	6.1	6.1	5.5	5.1	4.8
ROBOR 3M - % average	7.8	13.0	11.7	6.8	5.8	5.3	5.8	5.5	5.2
5Y yields - % eop, mid		13.2	9.9	7.0	7.1	6.1	5.3	5.0	4.7
5Y yields - % average, mid		10.3	11.1	7.3	7.2	6.1	5.4	5.1	4.8
FX rates									
EUR/RON eop	3.61	3.99	4.23	4.28	4.32	4.43	4.40	4.40	4.40
EUR/RON average	3.34	3.68	4.24	4.21	4.24	4.46	4.38	4.40	4.40
USD/RON eop	2.46	2.83	2.94	3.20	3.34	3.36	3.61	3.61	3.61
USD/RON average	2.44	2.52	3.05	3.18	3.05	3.47	3.53	3.61	3.61

Source: NIS, Eurostat, NBR, BCR Research

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