



Romania: Recent Macroeconomic & Banking System Developments

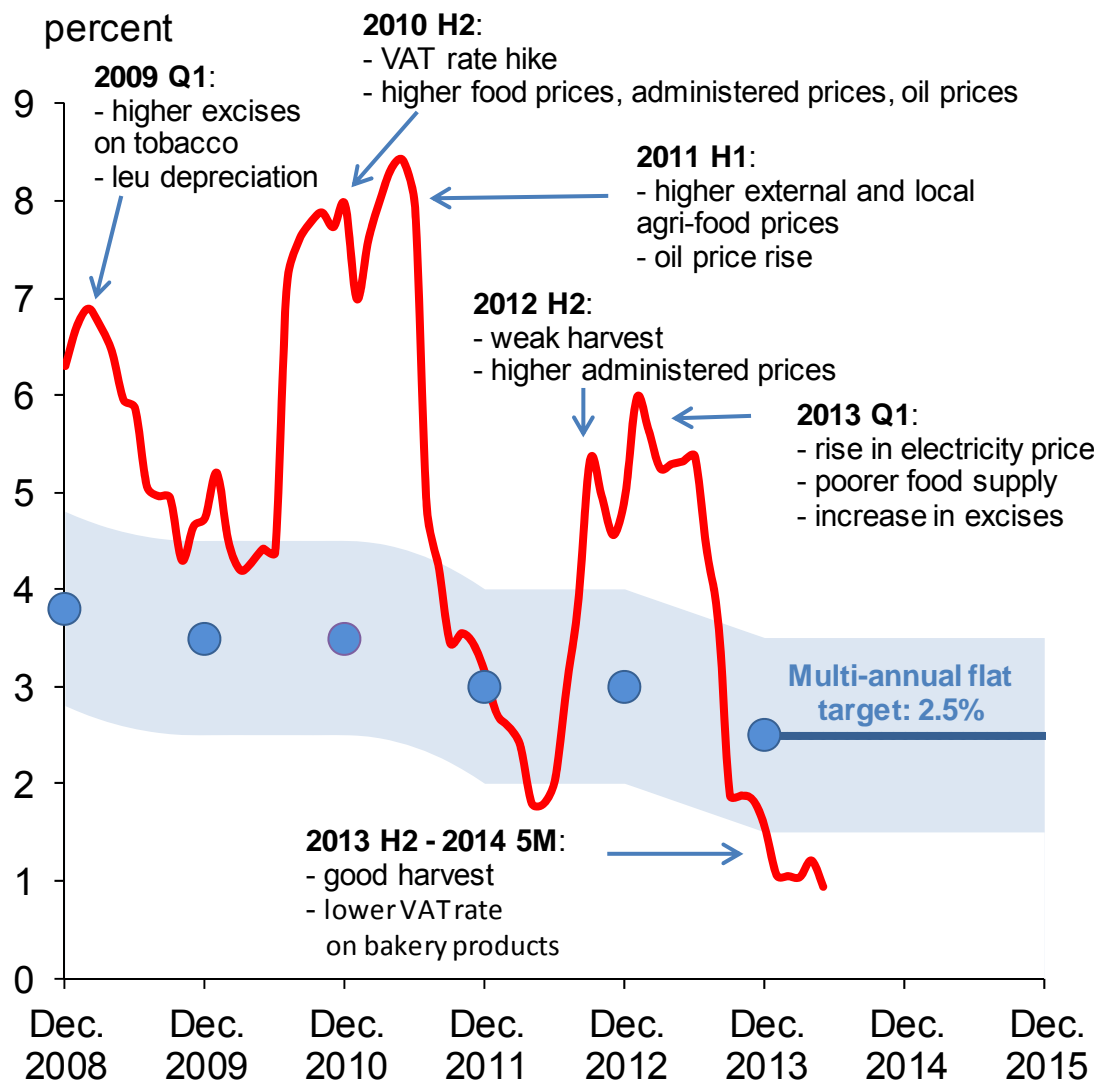
Cristian Popa
Deputy Governor

July 2014

Romania has registered an improvement across its macroeconomic fundamentals since 2008

- ✓ Substantial drop in CPI inflation (from 6.3% yoy at end-2008 to 0.66% in June 2014)
- ✓ After re-entering positive GDP growth territory in 2011, the economy rose by 3.5% in 2013 and a slightly smaller increase in GDP is seen for 2014
- ✓ Strong external adjustment, the current account deficit dropping from the double-digit levels before the crisis to 1.1% in 2013 (after staying around 4% in 2009-12)
- ✓ Sharp fiscal consolidation process that led to a reduction in the public deficit from a peak of 9 percent in 2009 to 2.3% in 2013 and further to a projected 2.2% in 2014
- ✓ Resilient banking system: high level of NPL ratio, but adequate buffers (solvency, CT1, provisions) in place; no public funds have been necessary to support the banking sector during the global financial crisis

CPI inflation fell to record lows in 2014



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

Source: National Institute of Statistics, National Bank of Romania

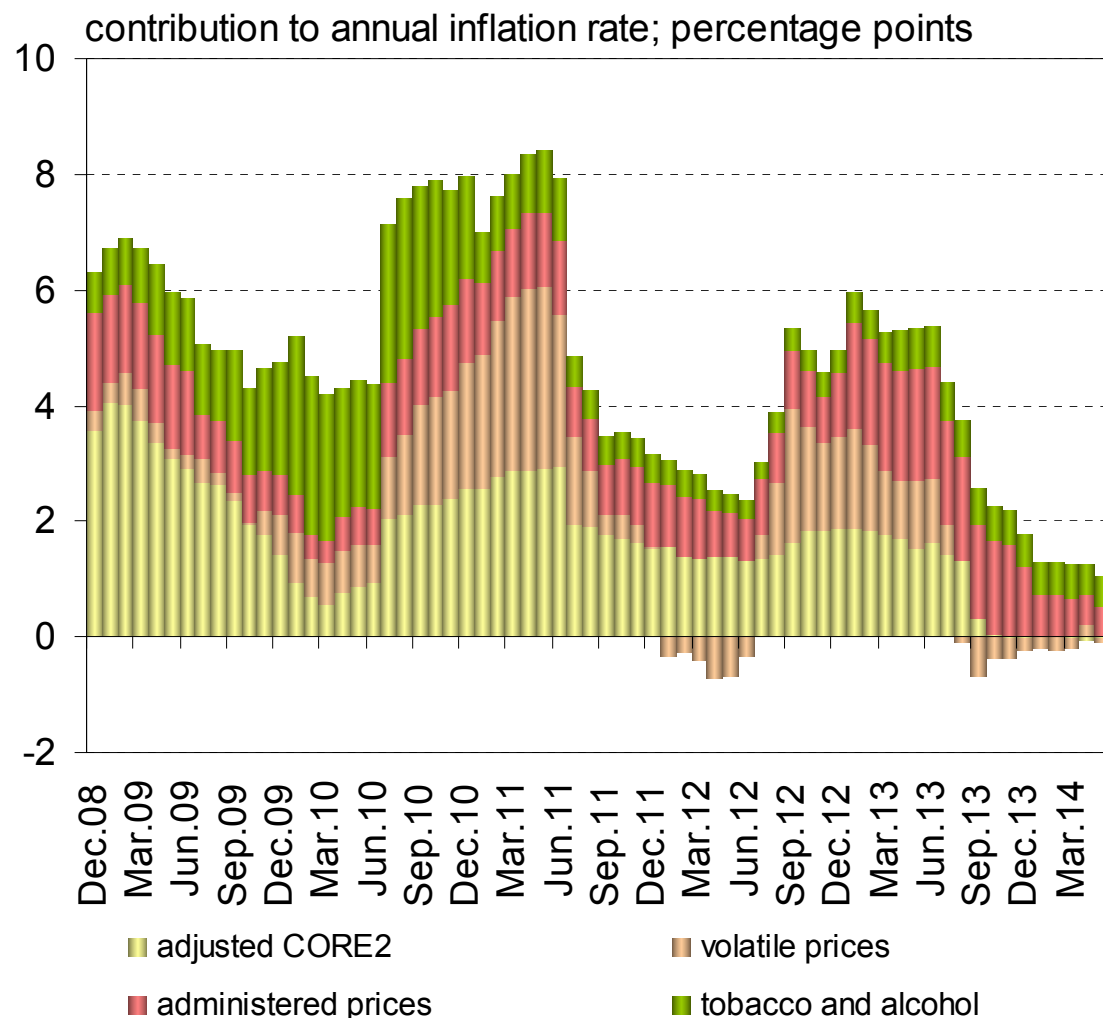
✓ Inflation developments in the post-crisis period were marked by multiple supply-side shocks

- Along with the large food share in the consumer basket (around 37%), this led to both high volatility and relatively high levels of inflation (judged by current EU standards)

✓ The significantly improved performance of CPI inflation over the last year was due to a combination of persistent and transitory factors

- Persistent: continued though shrinking negative output gap, improved inflation expectations
- Transitory: bumper crops in 2013, VAT rate cut for some bakery products, favourable developments in international commodity markets

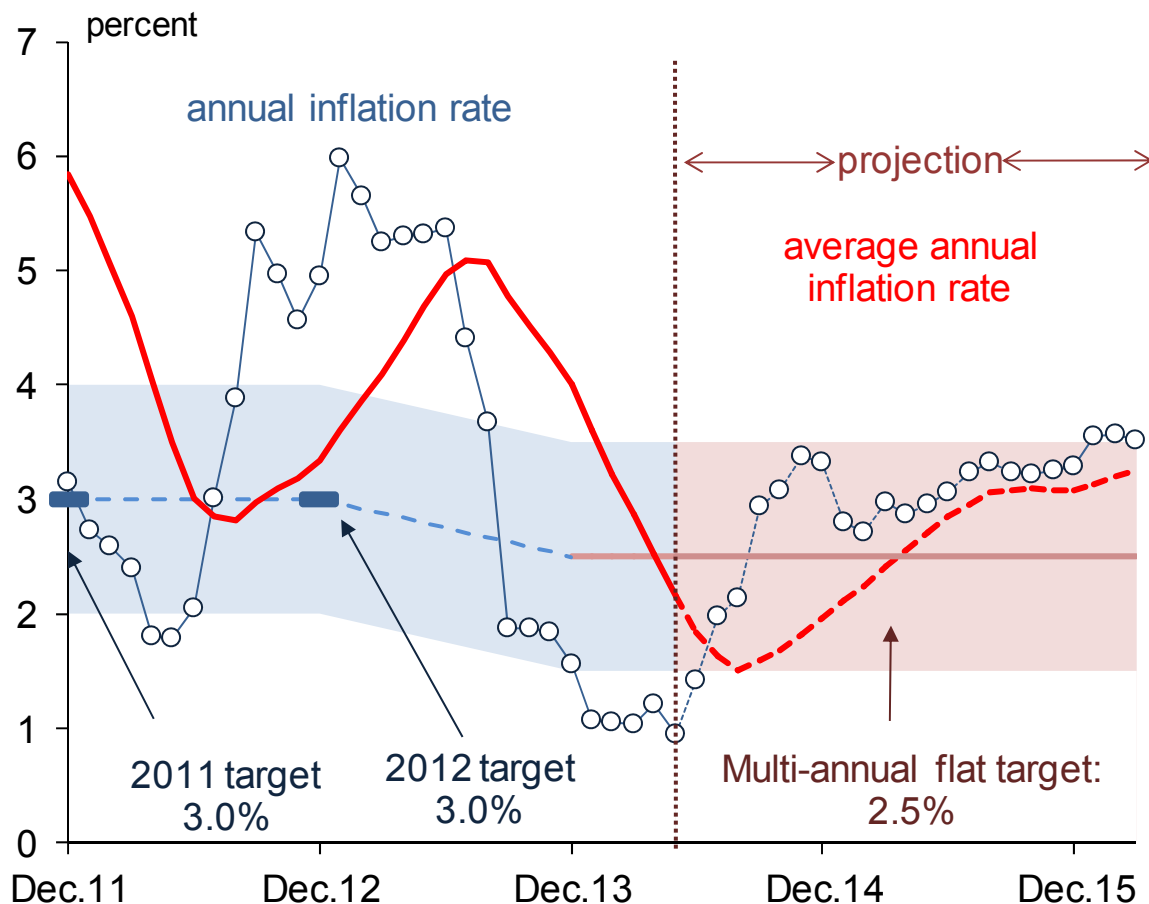
Most components supported the recent decline in inflation



Source: National Institute of Statistics, National Bank of Romania calculations

- ✓ Amid further favourable developments in agricultural output and the still active statistical effect from the VAT rate cut, core inflation and volatile prices stood out as the main contributors to the recent lows in headline inflation
- ✓ The present marginally negative values of annual core inflation do not reflect deflationary pressures, as this indicator is seen reverting to positive levels consistent with the CPI target once the above-mentioned statistical effects fade away

Inflation is seen staying inside the multi-annual target band ($2.5\% \pm 1$ pp) over the projection horizon



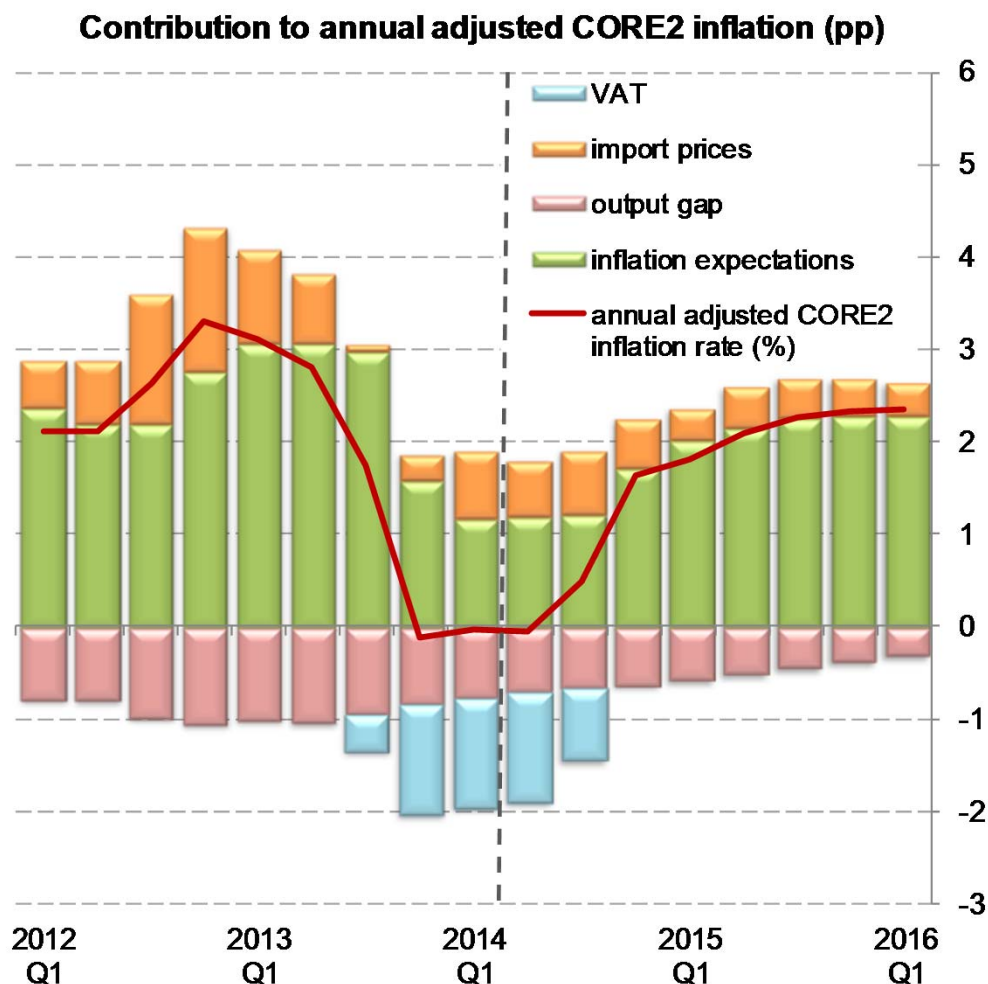
Note: Variation band of the target is ± 1 percentage point.

Source: NIS, NBR

- ✓ In the May 2014 Inflation Report the annual inflation rate was projected to reach 3.3% at end-2014 and at end-2015
- ✓ Although the performance to date suggests that CPI inflation would follow a lower path than that foreseen in the May projection, the current inflation rates below 1% are not seen persisting throughout the 8-quarter projection horizon
- ✓ Partially updated estimates based on currently available information (without a full new forecasting round) place the annual inflation rate at around 2% in December 2014

Determinants of annual adjusted CORE2 inflation projection

- Inflation expectations* will experience a temporary rebound, as a result of higher excise duties in 2014 and the gradual fading away of favourable effects associated with the 2013 supply-side shocks, but will remain inside the variation band of the target
- The negative output gap exerts disinflationary pressures throughout the projection interval, which are however seen abating gradually, amid the expected pick-up in domestic economic activity
- The dynamics of import prices have a relatively small and slightly declining contribution to the annual adjusted CORE2 inflation



Note: The annual adjusted CORE2 inflation is calculated as a quarterly average, in line with its econometrically-modelled determinants.

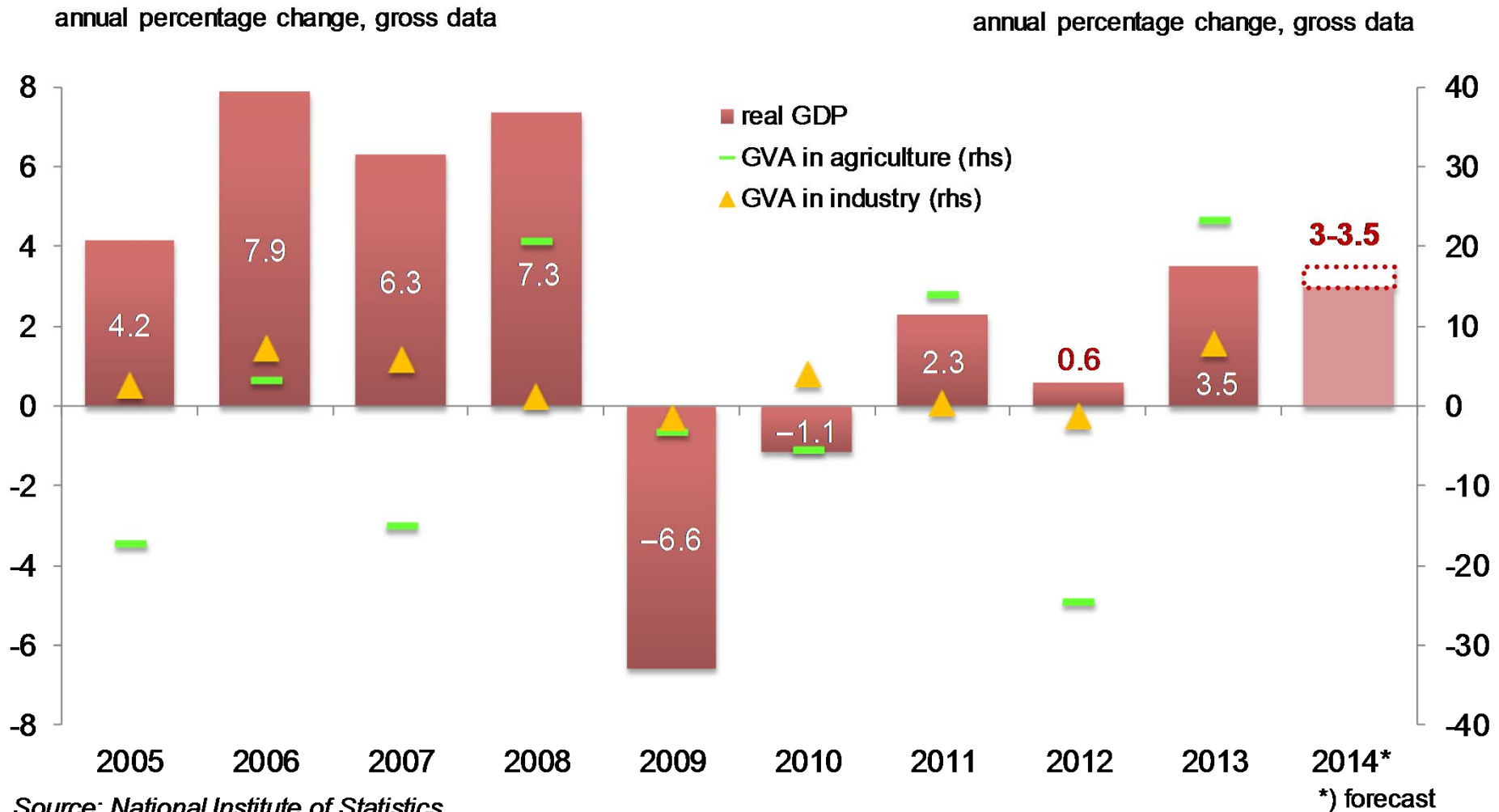
Source: NIS, NBR calculations

*) backward- and forward-looking

Potential causes for inflation to deviate from the projected path

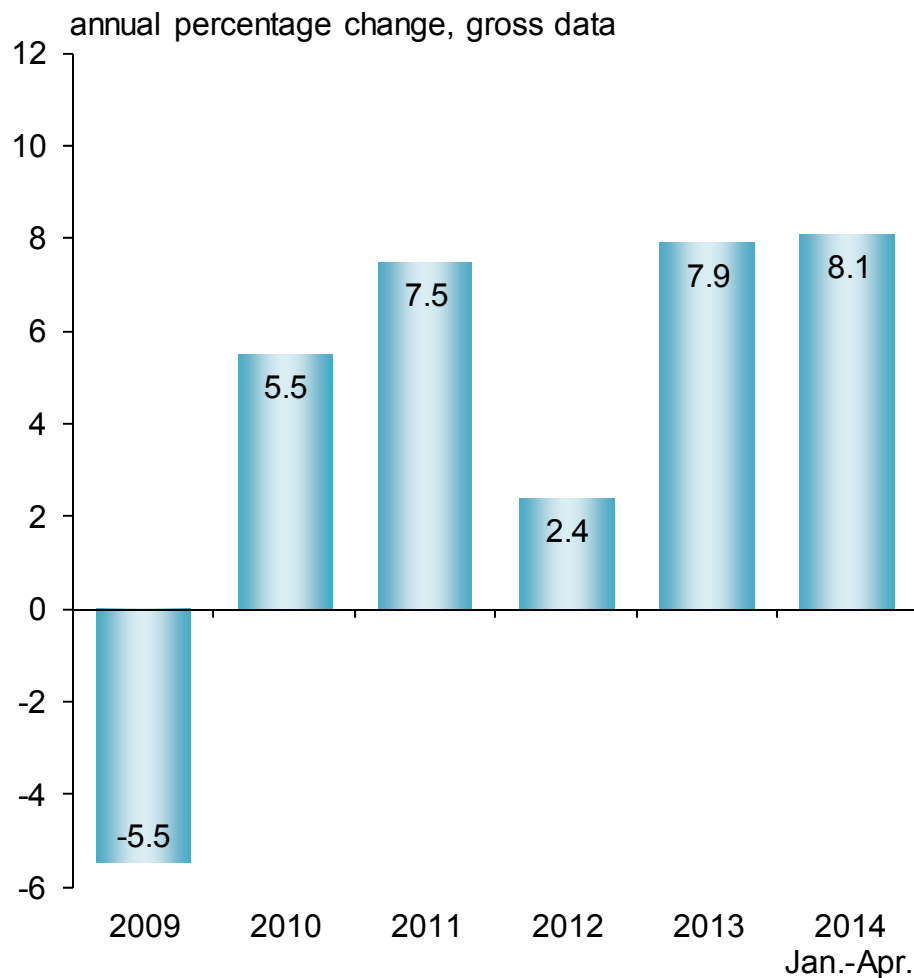
Causes	Balance of risks
External coordinates:	Relatively balanced, but heightened uncertainty
– volatility of capital flows channelled to emerging economies, in the context of geopolitical and regional developments, the ongoing cross-border deleveraging and the possible adjustments by major central banks of their monetary policy conduct	
– growth outlook for major emerging economies	
– performance of the euro area economy	
Uncertainties about the firm and consistent implementation of structural reforms, in line with the calendars agreed with the international institutions (EU, IMF and the World Bank), in the context of the 2014 election year	Tilted to the upside
Global commodity prices (agri-food products, oil) and domestic food prices (weather conditions)	Short term: in equilibrium Medium term: upside risk
Administered price dynamics (assessment conditional upon currently available data)	Balanced
The materialisation of any upside risks might rekindle inflation expectations, with adverse effects on consumer prices.	

The pick-up in GDP growth has been supported by good performance in industrial and agricultural sectors



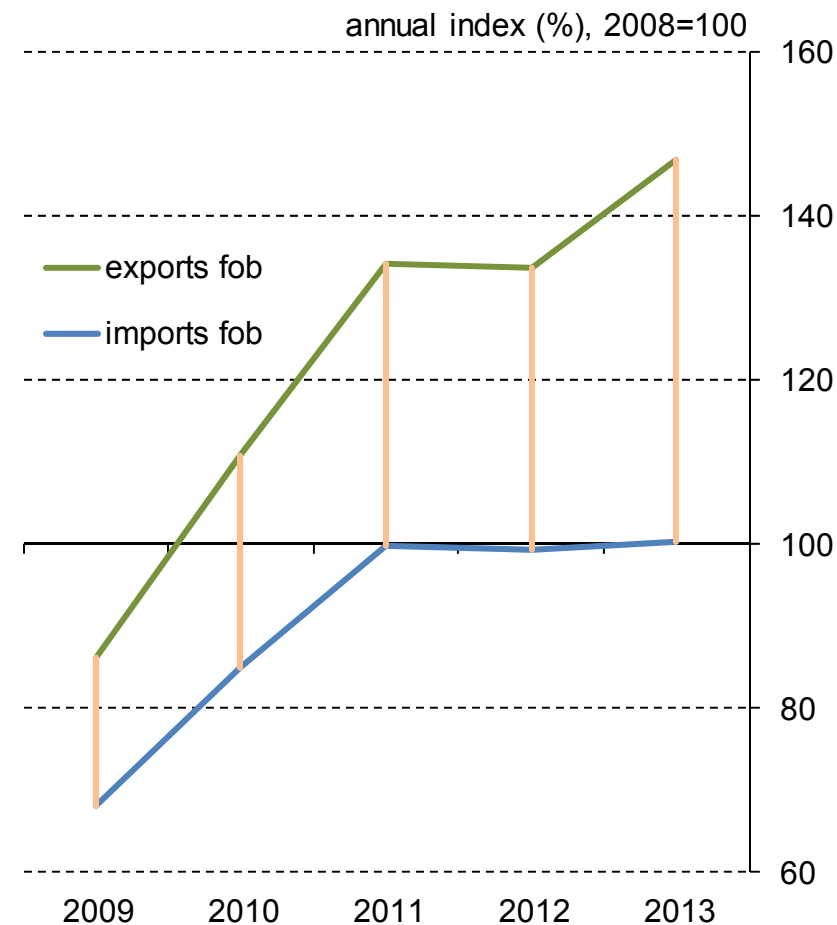
Export-led advance in industrial output

Industrial output



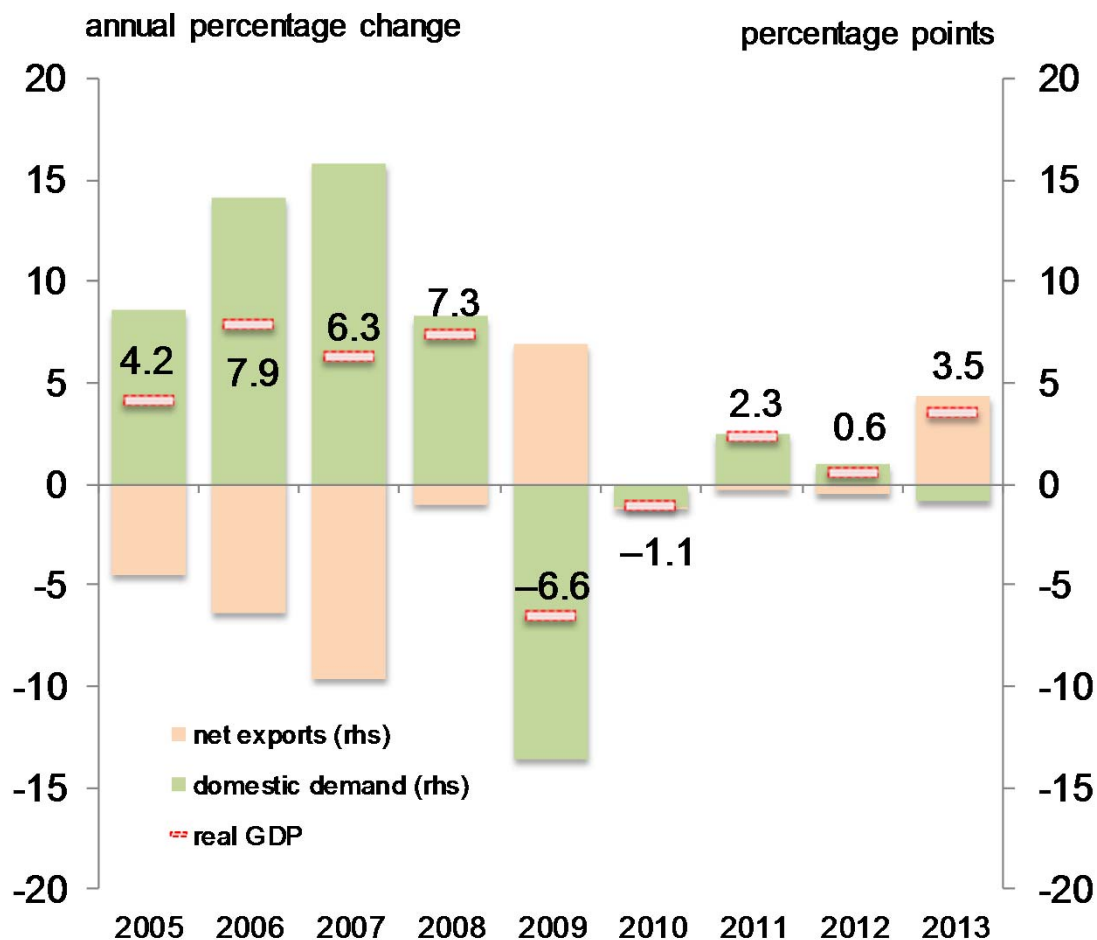
Source: National Institute of Statistics

Trade balance



In Jan.-Apr.2014, yoy growth of exports and imports was 8.1% and 7.7%, respectively.

Signs of recovery in domestic absorption

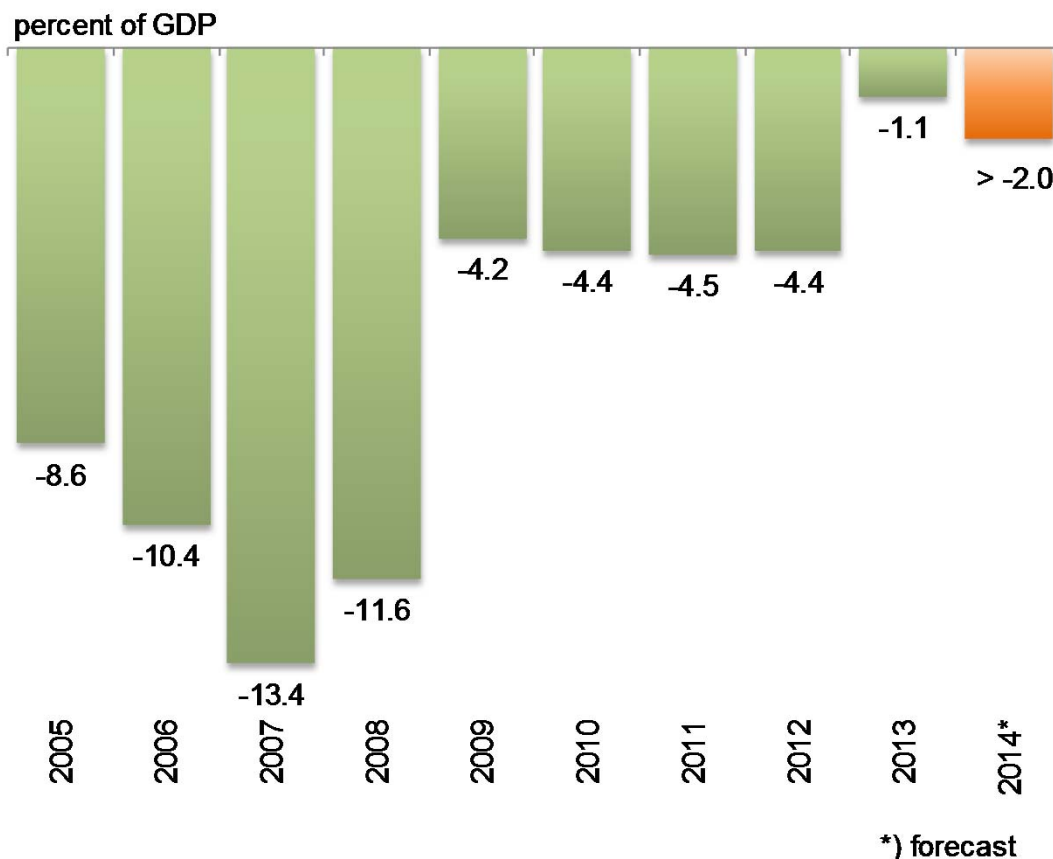


Source: National Institute of Statistics

- ✓ Modest but steady recovery in private consumption seen recently
- ✓ Still negative growth rates for investment, despite better absorption of structural and cohesion EU funds
- ✓ Domestic absorption is slowly recovering, but consolidation of this trend depends on the improvement in confidence in the economy and the balance-sheet adjustment coming to an end in the countries of origin of capital, especially the EU, as well as in the Romanian economy

Romania's improved external position

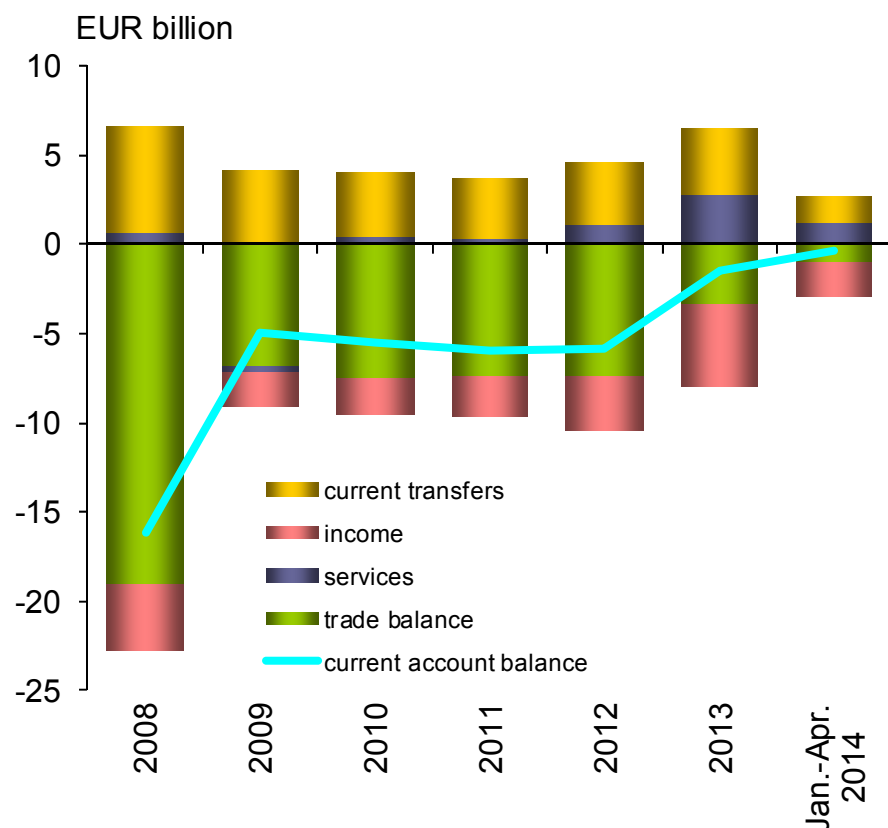
Current Account Balance



- ✓ The current account deficit dropped from a peak of 13.4% of GDP in 2007 to 4.2% in 2009
- ✓ After hovering around 4% of GDP in the following three years, the current account deficit further improved to 1.1% in 2013 and is seen to stay below 2% over the medium-term

Source: National Bank of Romania, National Institute of Statistics

Trade balance contributed most to the adjustment in current account balance



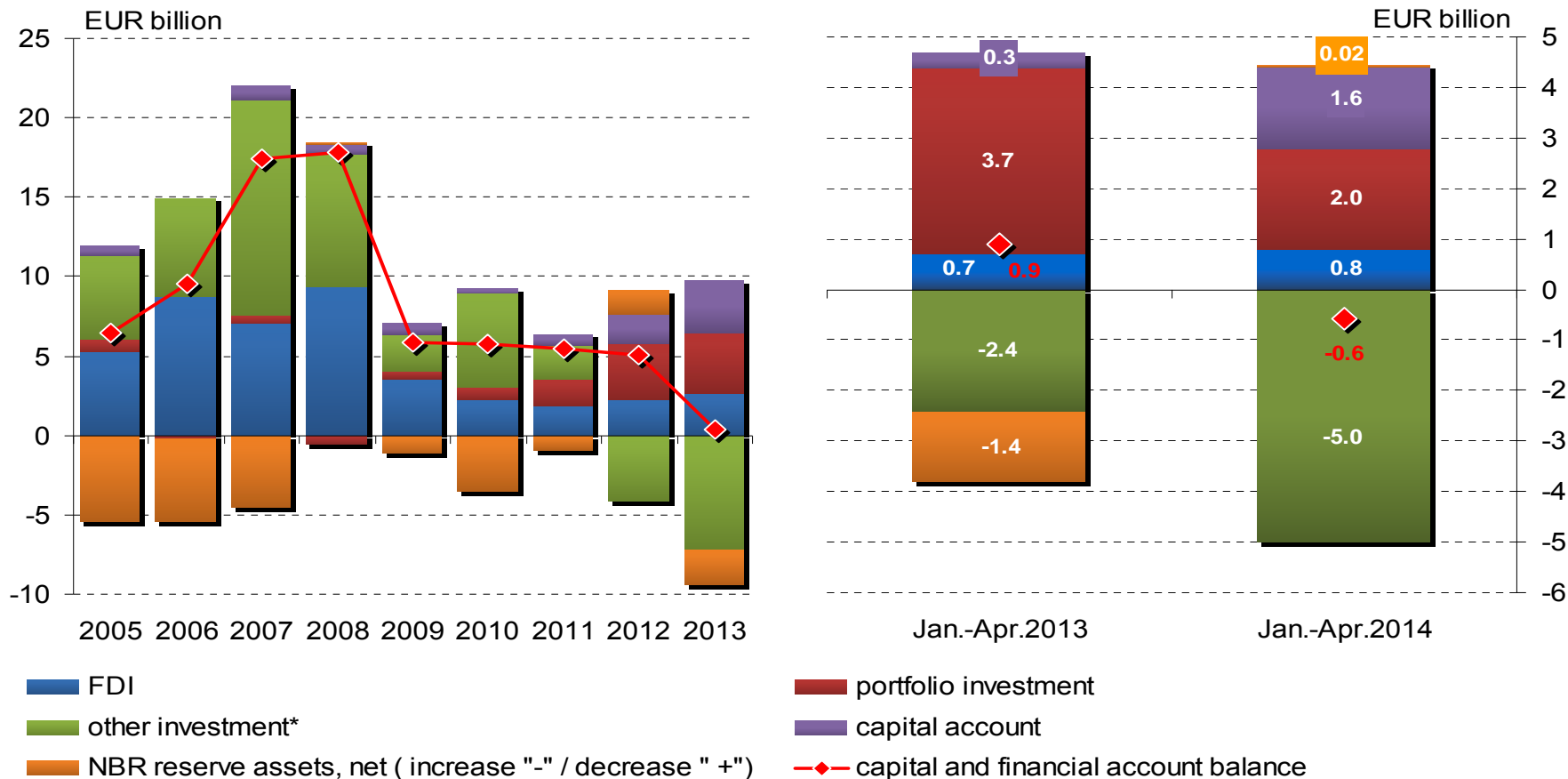
Note: The current account posted a deficit of EUR 297.4 mn in Jan.-Apr. 2014 against a deficit of EUR 240.9 mn in Jan.-Apr. 2013.

Source: National Bank of Romania

- ✓ Fast export growth was recently supplemented by sharp deceleration in import dynamics
- ✓ Exports of goods expanded owing to both sales on the EU market and the faster rise in exports outside the EU, mainly driven by exports of transport means and equipment
- ✓ The muted import performance was largely prompted by structural factors:
 - lower import content of exports
 - a larger share of the global value added chain captured into the domestic economy
 - decreasing energy intensity of the economy, increased reliance on renewable energy sources → lower vulnerability to shocks stemming from geopolitical tensions in the region (in 2013, Romania imported around 15% of its natural gas consumption, far less than most other EU countries, especially advanced ones)

Larger capital inflows, including portfolio investment, were directed to Romania,
as country fundamentals improved

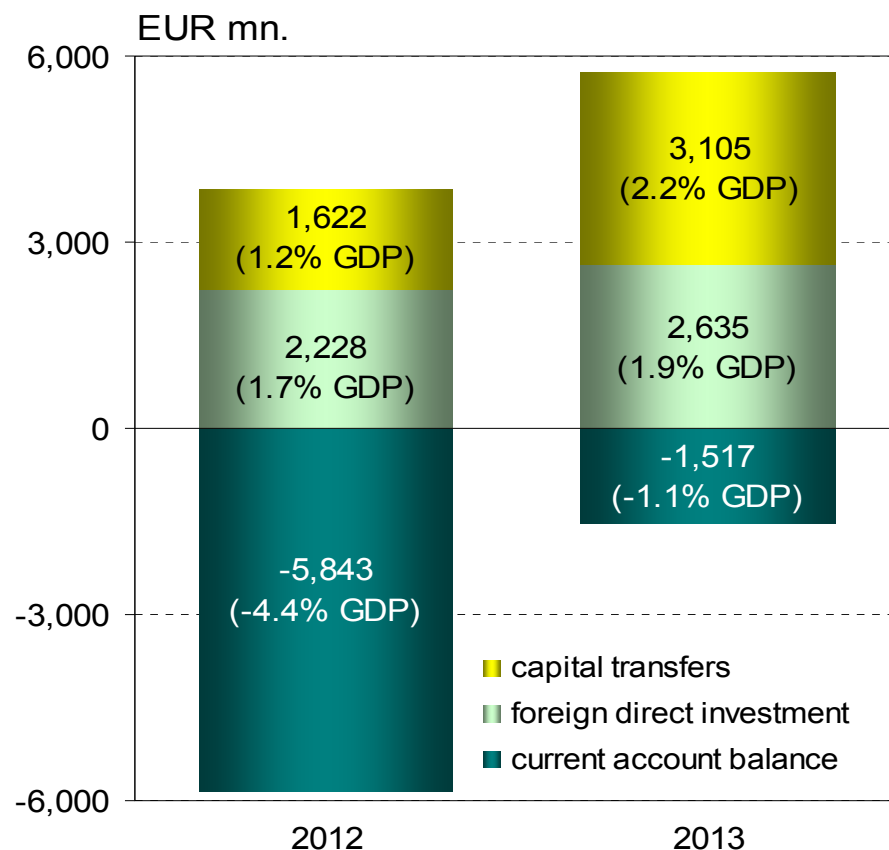
Capital and Financial Account



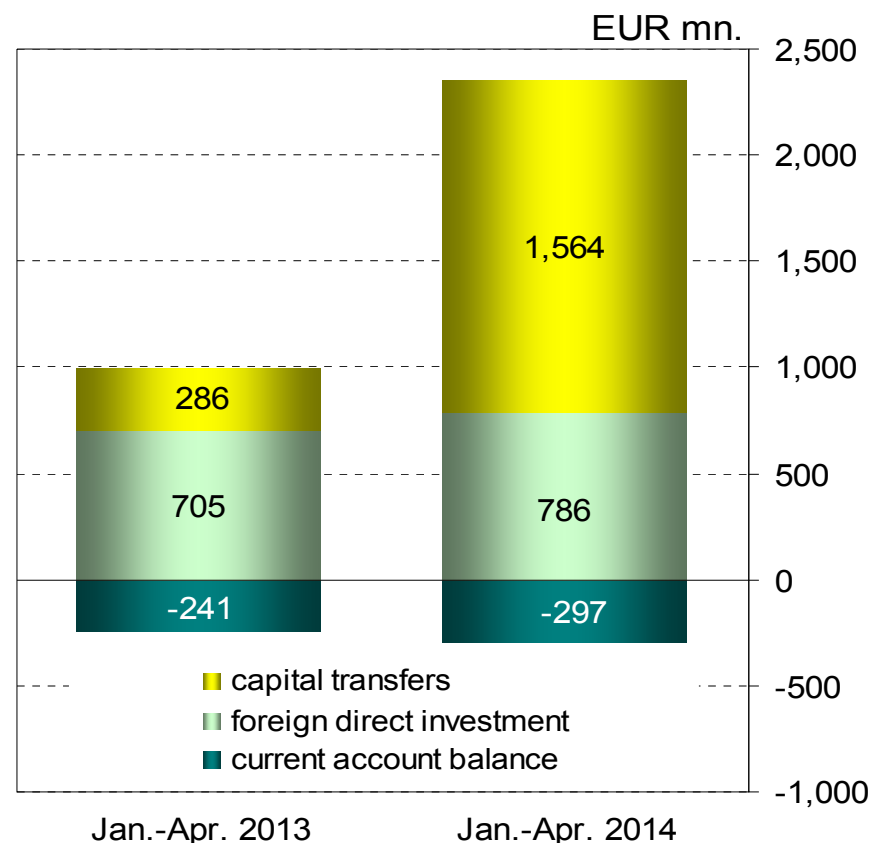
* including net flows related to loans taken under the multilateral financial arrangement concluded with the EU, the IMF and the IFIs.

Source: National Bank of Romania

As regards long-term capital, lower FDI inflows than in the pre-crisis period were offset by improved EU funds absorption and CAD financing has been entirely covered from non-interest-bearing sources in 2013-14



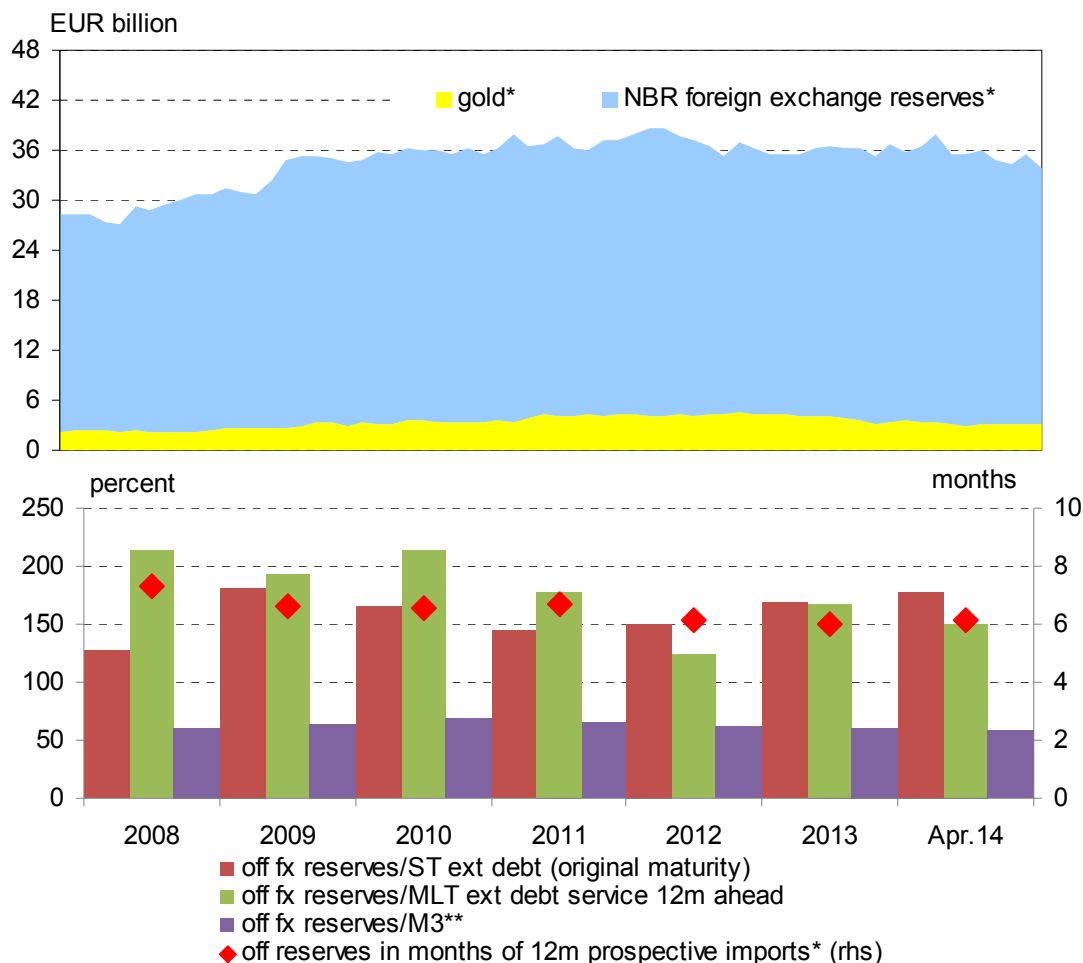
Current account financing via FDI and capital transfers amounted to 378.4% in 2013 vs 65.9% in 2012.
In 2013, net FDI increased 18.3% yoy.



Current account financing via FDI and capital transfers amounted to 790.2% in Jan.-Apr. 2014 vs 411.4% in Jan.-Apr. 2013.
In Jan.-Apr. 2014, net FDI increased 11.5% yoy.

Source: National Institute of Statistics, National Bank of Romania

Even though most of the 2009-10 IMF loan has already been repaid, international reserves remain at a comfortable level



* Latest figure: June 2014

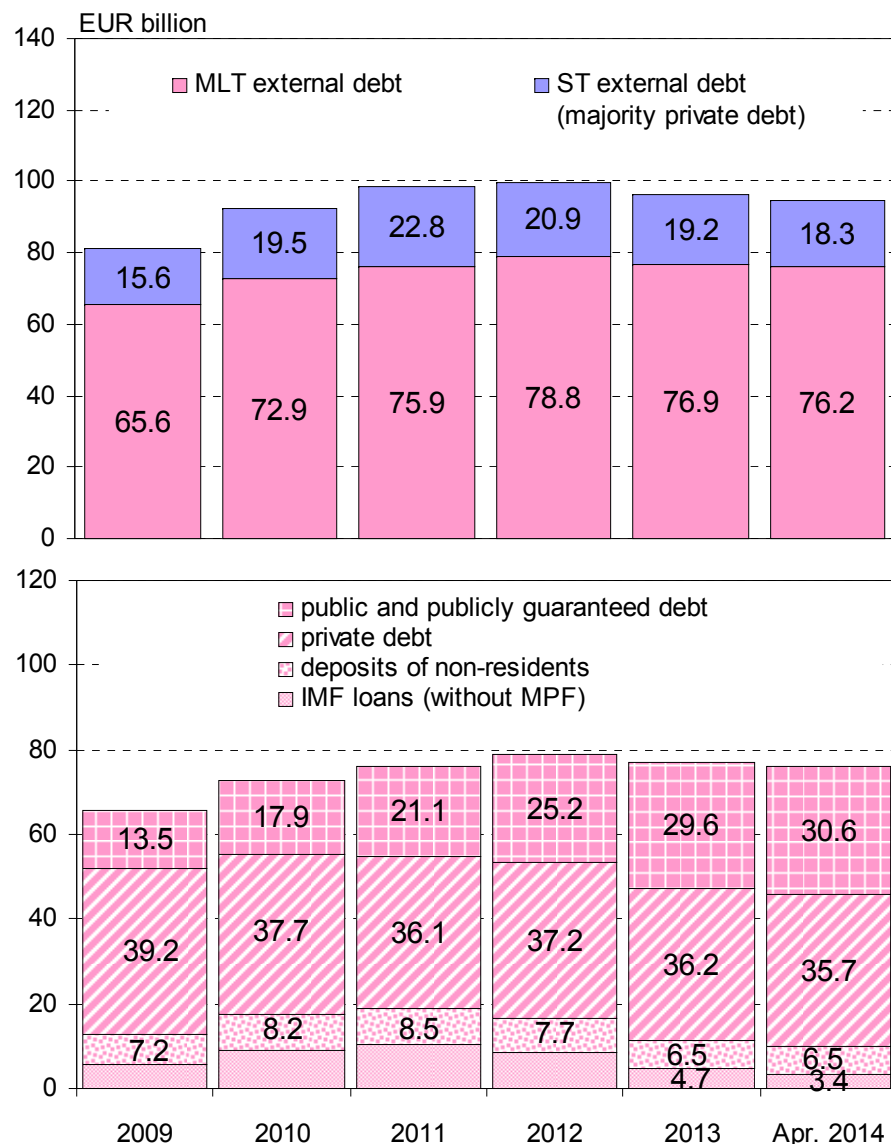
** Latest figure: May 2014

Source: National Bank of Romania

Adequate reserve coverage as reflected by most traditional metrics:

- Over 6 months of prospective imports of goods and services in June 2014
- Guidotti ratio (April 2014)
 - official forex reserves/ST external debt (original maturity): 177.1%
 - official forex reserves/MLT external debt service 12m ahead: 150.1%
- Official forex reserves to M3 ratio (almost 60% in May 2014) is well above the 20% threshold usually considered for capturing the risk of capital flight

Progress in reducing external indebtedness



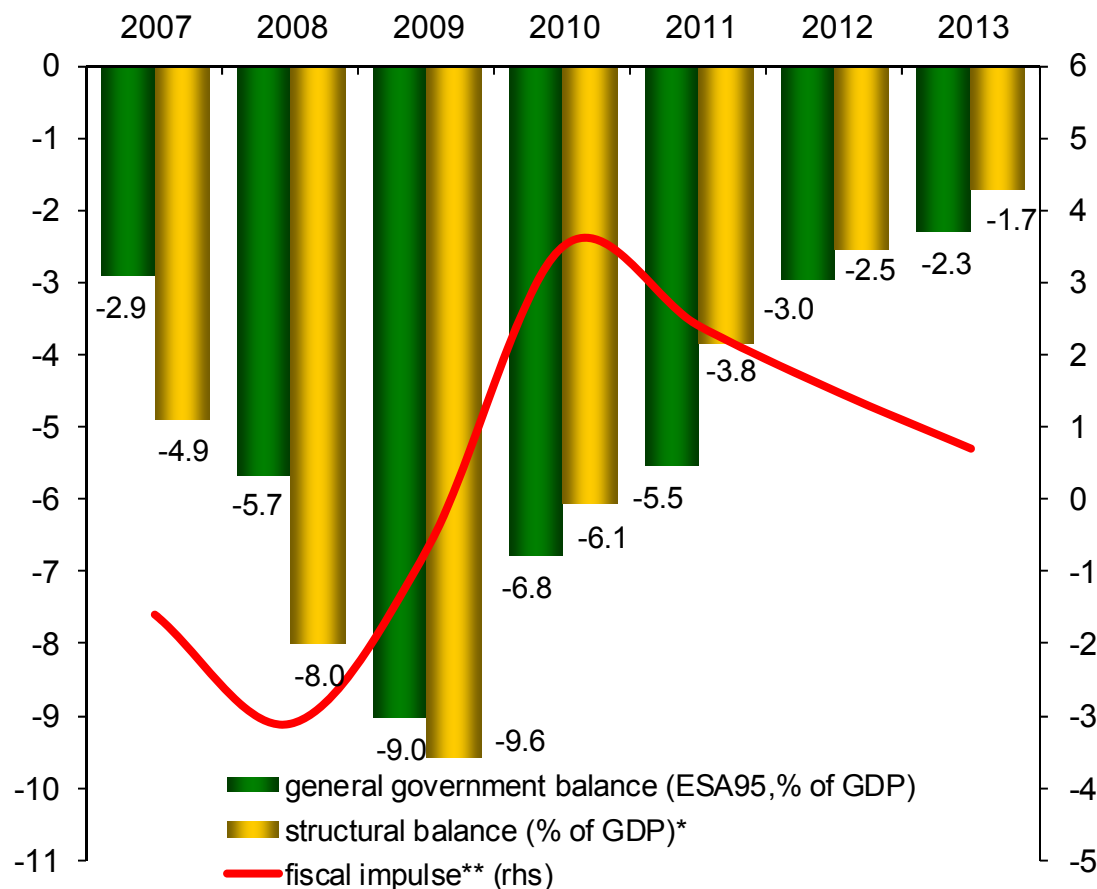
✓ Total external debt dropped from a peak of EUR 99.7 billion in 2012 to EUR 96.1 billion in 2013 and EUR 94.5 billion in April 2014

✓ The downturn owed primarily to:

- ✓ the lower amount of foreign funding provided by foreign parent banks to credit institutions in Romania, against the backdrop of faster cross-border deleveraging at the level of large European banking groups
- ✓ the debt service payments relating to the Stand-By Arrangement that the Romanian government signed with the IMF in 2009

Source: National Bank of Romania

After several years of consolidation, the budget balance is back below 3 percent



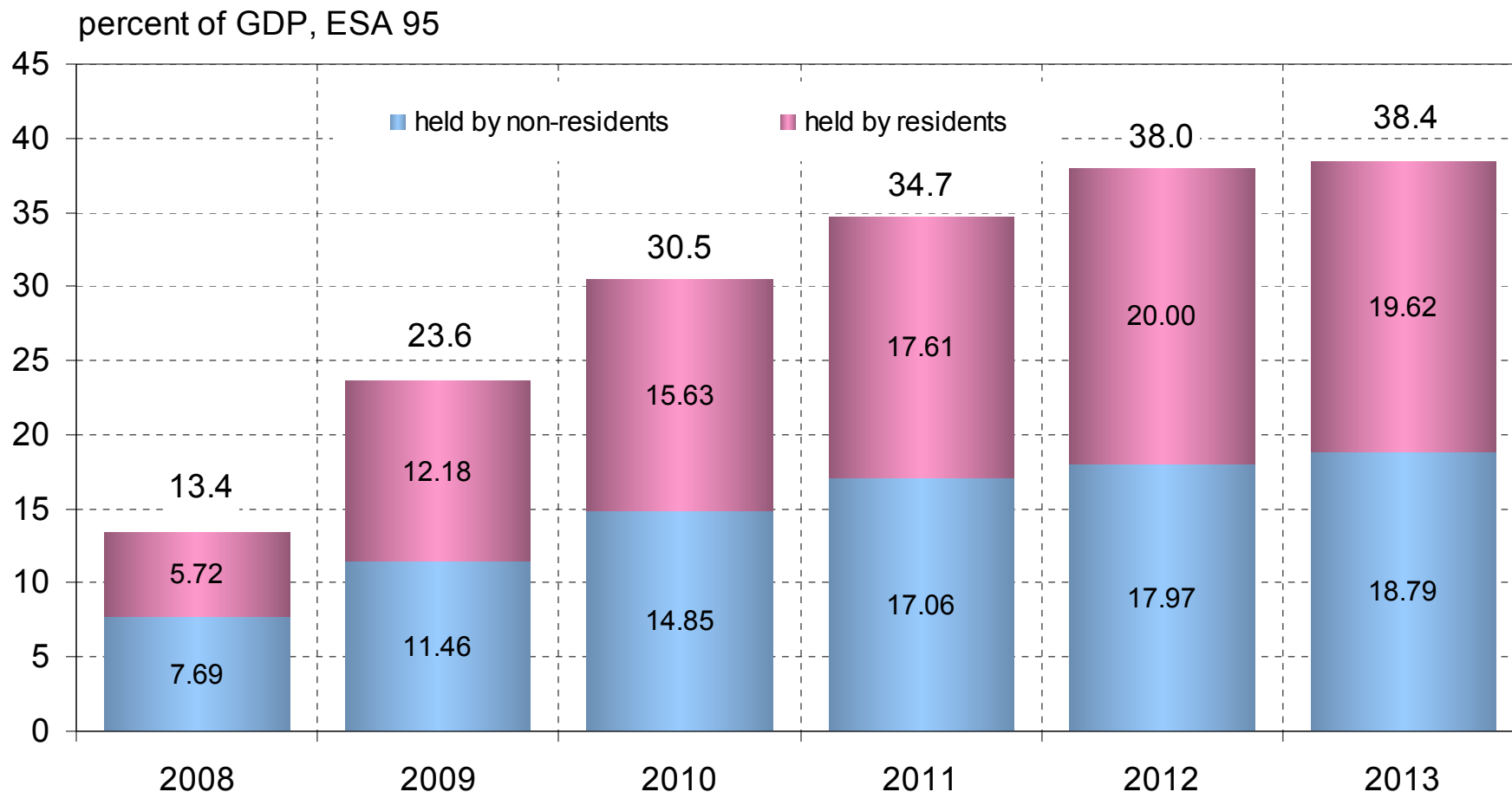
* defined as cyclically-adjusted balance net of one-off and temporary measures

** defined as the change in the structural primary budget balance
 ("- " is stimulus, "+" is tightening)

- ✓ Second largest fiscal consolidation in the EU, which is commensurate with the size of the structural deficit at the onset of the crisis
- ✓ Largely expenditure-driven consolidation effort led to the excessive deficit being corrected by end-2012
- ✓ A comparatively smaller structural adjustment effort remains to be implemented in the coming years in order to ensure that the medium-term structural deficit objective of 1% of GDP is met from 2015 onwards

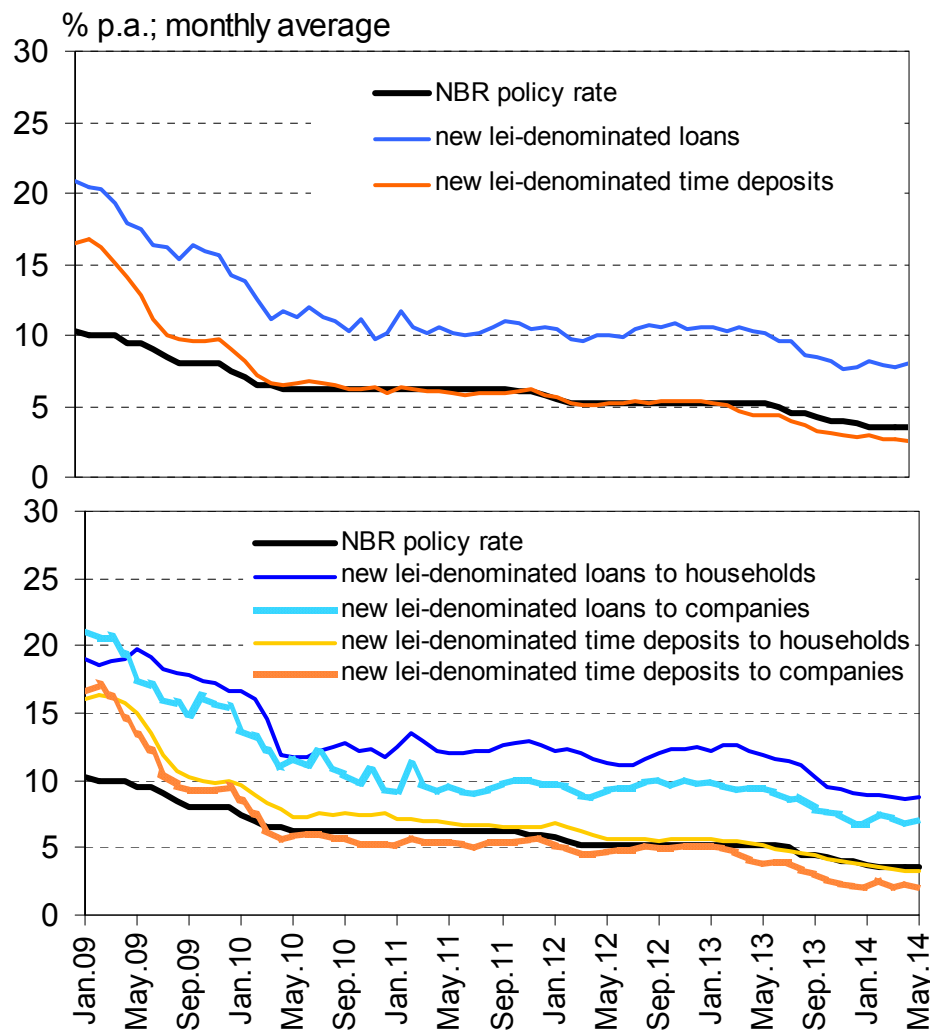
Source: AMECO, Ministry of Public Finance, European Commission

In line with fiscal consolidation, the growth in public debt has slowed down markedly



Source: Ministry of Public Finance, National Institute of Statistics

Downtrend in interest rates



Source: National Bank of Romania

- ✓ In line with the policy rate cuts (by a cumulative 175 basis points to 3.5%, between July 2013 and July 2014), bank interest rates on new lei-denominated loans followed a downward path



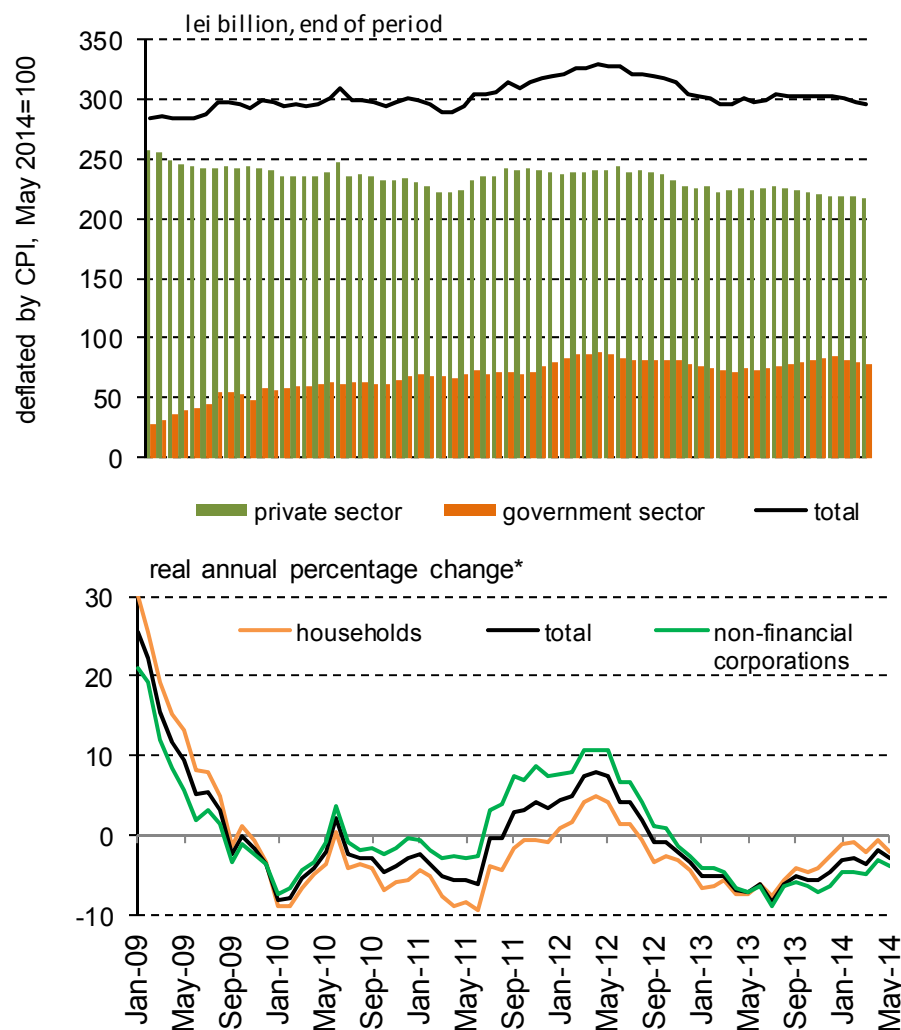
- ✓ Interbank rates have tended to stay below the policy rate amid structural though volatile excess liquidity in the banking system



- ✓ Conditions for a revival of lending, especially in domestic currency and to the corporate sector, while observing prudential requirements

Weak lending activity, in line with developments at European level, ...

Domestic credit (outstanding)



*) based on CPI

Source: National Institute of Statistics, National Bank of Romania

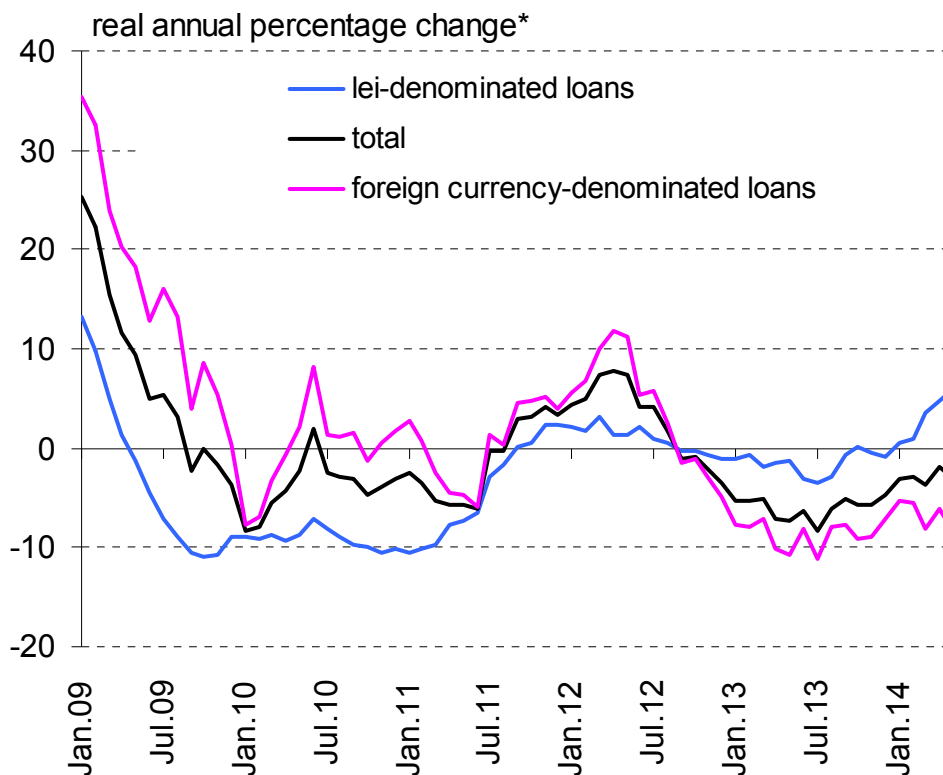
✓ ...reflecting:

- Balance sheet adjustment of both households and companies
- Persistence of risk aversion
- Faster cross-border deleveraging mirrored by the decline in credit lines from parent banks to their subsidiaries in various host countries, including Romania

✓ Financial intermediation (calculated as loans to the private sector/GDP) shrank from 38.5% in 2008 to 34.8% in 2013

... owing to the foreign exchange credit component

Loans to the Private Sector – stock –

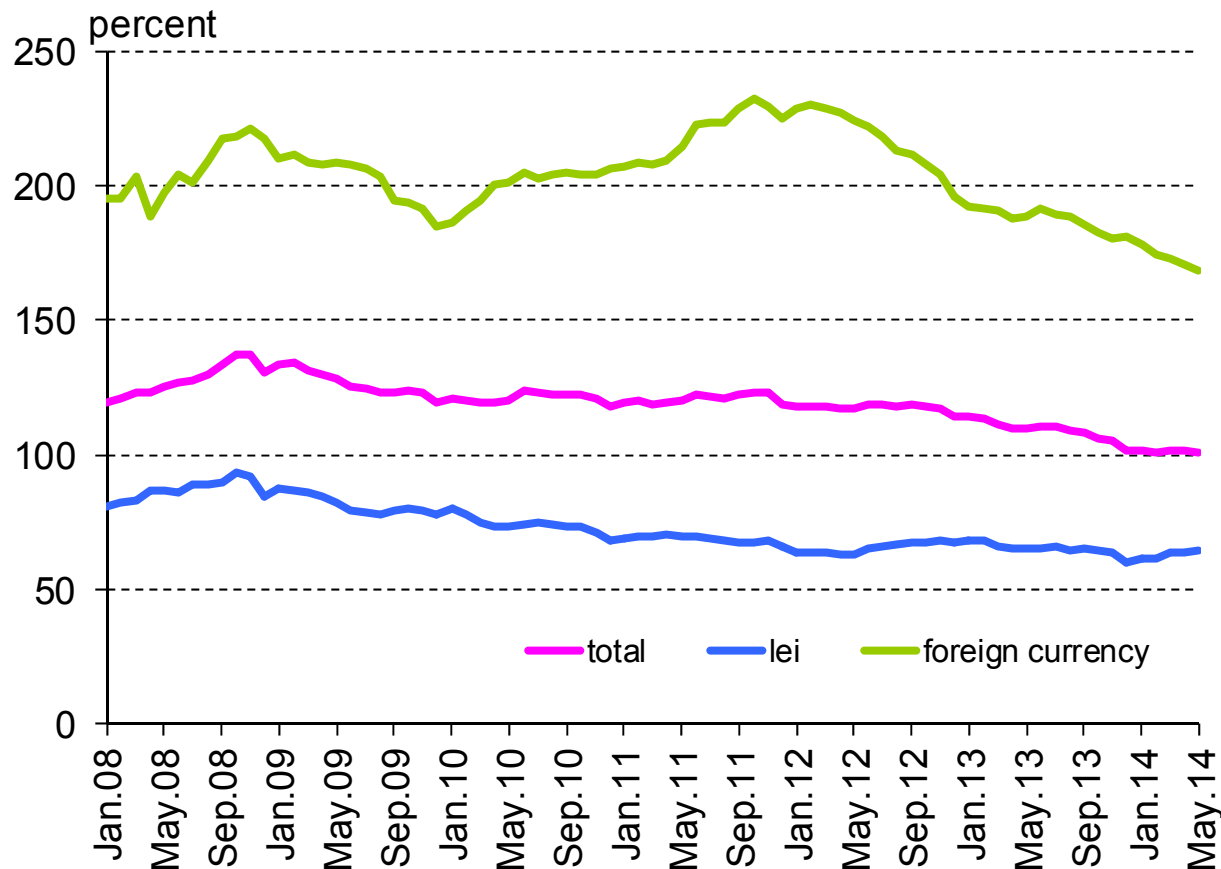


*) based on CPI

Source: National Institute of Statistics, National Bank of Romania

- ✓ LCY-credit is currently undergoing a revival (7% yoy in May 2014), but the overall stock of loans is still falling due to a sped-up contraction in the forex component (-7.7% yoy)
- ✓ Besides the faster cross-border deleveraging, to the decline in forex credit contributed:
 - NBR regulations addressing unhedged borrowers, which are fully compliant with ESRB recommendations on lending in foreign currencies
 - Similar principles were applied by the NBR in 2004-06, during the credit boom
 - Changes in the government-supported programme for house purchases (only lei-denominated credit since August 2013)

Close-to-balance LTD ratio*

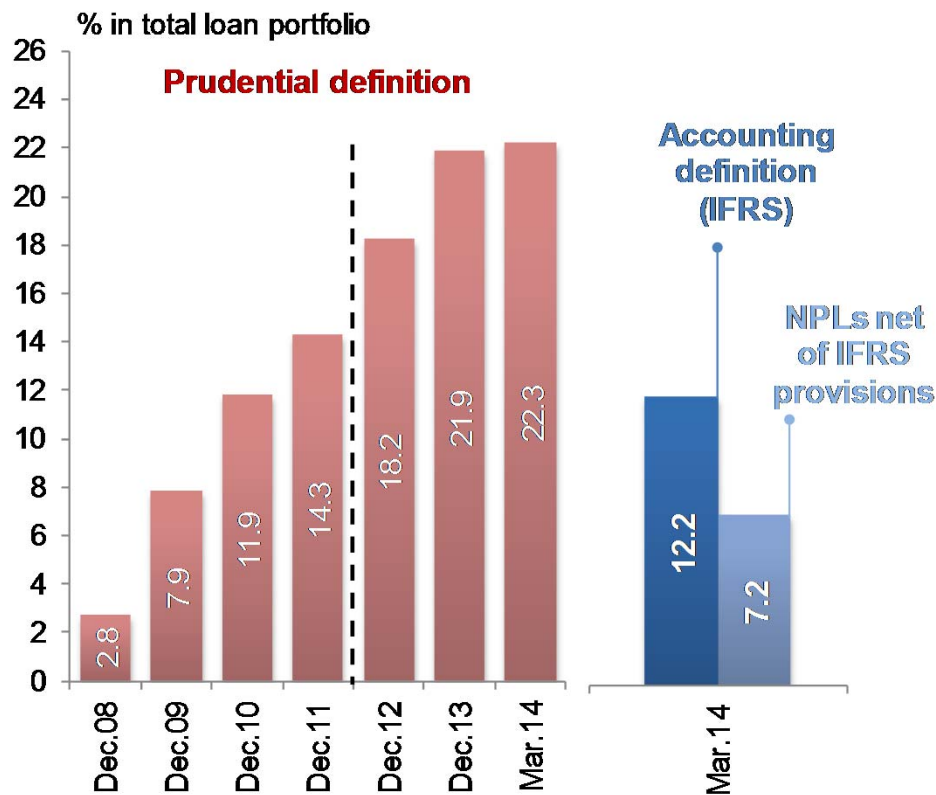


✓ LTD ratio has improved markedly in recent years, reaching 100.8 percent in May 2014, due both to lower lending to the private sector as well as an increase in the local deposit base, as a result of precautionary saving by both households and companies (where larger deposits supply working capital and substitute for new loans)

* based on monetary survey data

Source: National Bank of Romania

The banking sector remains resilient despite increased pressure on asset quality in the post-crisis period

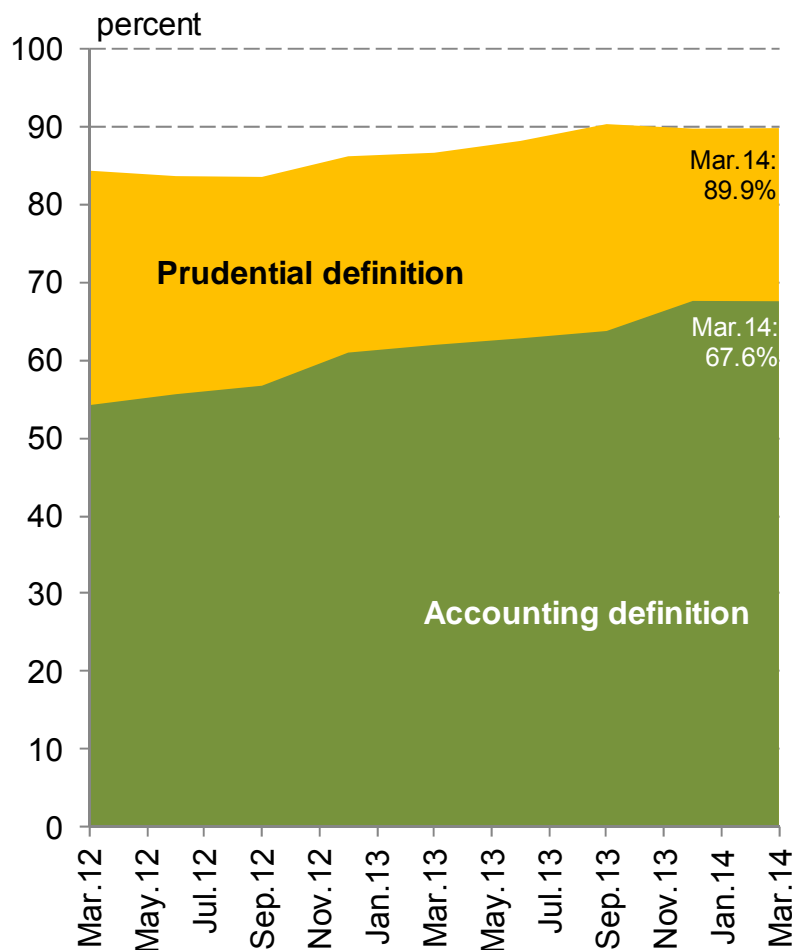


Note: Starting 1 January 2012, Romanian credit institutions apply the IFRS. The NPLs represent gross exposure of loans and related interest overdue for more than 90 days and/or for which legal proceedings were initiated. In compliance with the NBR prudential framework, the classification rule applies only to loans for which banks determine, at individual level, the minimum capital requirements for credit risk according to the standardized approach, other loan portfolios being excepted from classification statements (banks using the internal ratings based approach for assessing credit risk).

Source: National Bank of Romania

- ✓ High NPL ratios, reflecting negative credit growth and poor financial condition of debtors, but also low forbearance of the supervisory authority
 - Significant reduction in NPL accumulation pace over the last two years
 - Lower NPL ratio when considering:
 - The accounting definition (IFRS)
 - The NPLs net of IFRS provisions (representing 32.2% of total NPLs)
- ✓ Appropriate capital buffers, enhanced liquidity, and provisioning
 - Solvency ratio above 16% in March 2014, markedly higher than the 10% prudential threshold recommended by the NBR
 - High quality of own funds, as reflected by the CT1 ratio of 14.5%
 - High degree of NPL coverage with IFRS provisions and prudential filters (around 90%)
- ✓ As the NBR intends to join the Single Supervisory Mechanism as soon as possible, an asset quality review (AQR) of banks with local capital is underway
 - An AQR for the entire banking system is envisaged for 2015

NPLs coverage with provisions



Source: NBR

PRUDENTIAL DEFINITION

IFRS provisions and prudential filters for NPLs / NPLs

- ❖ Including prudential filters into the calculation of the indicator is warranted by the fact that the prudential filter is an amount deducted from own funds in order to increase banks' capacity to absorb credit risk loss
- ❖ Prudential filters will be gradually phased out during 2014-18 (by 20% per year), in the context of implementing Basel III capital requirements in the Romanian banking system via the CRD IV/CRR package

ACCOUNTING DEFINITION

IFRS provisions for NPLs / NPLs

BANKING INDICATORS*

(Banks, Foreign Bank Branches and CREDITCOOP)

		percent								
	Indicators	Dec.10	Dec.11	Dec.12	Mar.13	Jun.13	Sep.13	Dec.13	Mar.14	Apr.14
Capital adequacy**										
1	Solvency ratio (>8%)	15.02	14.87	14.94	15.03	14.67	13.92	15.46	16.32	x
2	CT1 ratio (Tier 1 capital / Risk weighted assets)	12.13	11.97	13.79	13.86	13.57	13.00	14.09	14.51	x
3	Leverage ratio (1)	8.11	8.07	8.02	8.20	8.02	7.49	7.96	8.55	8.52
Asset quality										
4	Overdue and doubtful loans to non-bank clients / Total loan portfolio (net value) (2)	2.28	2.33	...	...	...	...	...	...	...
5	Overdue and doubtful loans to non-bank clients / Total loan portfolio (gross value) (2)	7.08	8.82	...	...	...	...	...	...	...
6	Overdue and doubtful claims to non-bank clients / Total assets (net value) (2)	1.47	1.50	...	...	...	...	...	...	...
7	Impaired loans to non-bank clients (gross value) / Total non-banking loan portfolio (gross value)	...	...	21.88	22.74	23.25	23.97	24.27	24.98	25.04
8	Impaired loans to non-bank clients (net value) / Total non-banking loan portfolio (net value)	...	...	12.00	12.28	12.16	12.42	11.64	12.17	12.11
9	Impaired loans to non-bank clients (net value) / Total assets (net value)	...	...	7.05	7.29	7.21	7.32	6.50	6.91	6.89
10	IFRS provisions and prudential filters for NPLs / NPLs (3)	...	...	86.26	86.71	88.24	90.39	89.78	89.91	90.20
11	IFRS provisions for NPLs (not applying prudential filters) / NPLs (3)	...	...	61.00	61.99	62.83	63.77	67.77	67.64	67.81
Profitability										
12	ROA (Net profit / Total assets, average)	-0.16	-0.23	-0.64	0.55	0.65	0.55	0.01	0.67	0.63
13	ROE (Net profit / Own capital, average)	-1.73	-2.56	-5.92	5.08	5.96	5.04	0.13	6.30	5.91
Liquidity										
14	Immediate liquidity (4)	37.82	37.17	35.88	37.60	37.77	38.23	41.49	40.36	40.05
15	Liquidity ratio (effective liquidity / required liquidity) (5)	1.35	1.36	1.42	1.46	1.48	1.48	1.53	1.53	1.52
16	Loans to clients / Deposits from clients	113.46	116.65	117.37	114.30	113.71	111.50	104.59	105.36	104.87

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

** In the absence of prudential filters, the solvency and CT1 ratios would be 4-5pp higher.

Note:

(1) Tier 1 capital / Total average assets (net value).

(2) These ratios are based on balance sheet data and include overdue loans / claims with maturity shorter than 30 days and those under legal proceedings. After shift to IFRS, indicators from 4 to 6 are no longer available and have been replaced by those from 7 to 9.

(3) The NPLs represent gross exposure of loans and related interest overdue for more than 90 days and/or for which legal proceedings were initiated. The definition is in line with the IMF's recommendations and allows international comparisons.

(4) The numerator of this ratio is represented by cash, demand and term deposits with banks at net value plus government securities free of pledge, while the denominator includes total

(5) Starting January 2012, NBR Rules 25/2011 on credit institutions' liquidity replaced the former NBR Rules 24/2009.

x = it is not the case because the frequency is quarterly; "..." = missing data

Source: National Bank of Romania