UniCredit Bank

Macroeconomic and Strategic Analysis

Quarterly Report

UniCredit Bank

22 March 2016

"The thrill is gone from Romanian assets"

Outlook – The reform momentum is stalling ahead of local and parliamentary elections. We expect a widening of the budget and C/A deficits, with the former threatening to exceed 3% of GDP in 2017 in the absence of tax increases. Private consumption and agriculture are likely to drive growth above 4% this year. Growth may slow in 2017 due to strong imports and weak exports. We expect inflation inside the target range and the NBR on hold in 2016 and 2017. In the short term, the central bank will remain hawkish due to lax fiscal policy.

The information contained in this report represents UniCredit Group's view upon Romania, as it was included in the CEE Quarterly report, distributed on 21 March 2016.

The thrill is gone from Romanian assets

No major risks in 2016 but no reform momentum either

The technocratic government that will lead Romania through two rounds of elections this year has managed to rein in public spending and to avoid democratic slippages. More is needed, though, to provide momentum to Romanian assets. That said, a selloff is not very likely either.

The Social Democrats are favoured to win both local and general elections…

… but the liberals may still manage to form a governing coalition in December

Local elections, to be held on 5 June, will set the tone for general elections in November-December 2016. A one-round, first-past-the-post system currently in place gives a big advantage to the Social Democrat PSD, the former ruling party. The opposition has limited time to contest the constitutionality of the system and force a return to elections held in two rounds. Victory in local elections usually gives an edge in parliamentary polls, but transfers from the central to local governments to be handed out to voters may be curtailed this year by the technocratic government. PSD (in coalition with small populist parties) may win general elections, despite trailing the liberal PNL in polls, as its electorate is more disciplined. Moreover, PNL fails to attract part of the pro-reform, protest vote that carried President Klaus Iohannis to his surprise win in December 2014. That said, a narrow loss would still allow PNL to form a governing coalition with the Hungarian minority party UDMR and maybe the Popular Movement (PMP) of former President Traian Băsescu. Mr. Băsescu is trying to capture the protest votes that usually go to populist and nationalist parties.

The next government will have to tighten fiscal poli-cies…

… in order to keep the deficit below 3% of GDP

In terms of economic policies, the differences between a PSD and a PNL-led coalition are likely to be small. The next government will inherit a budget that is heavy on pro-cyclical spending, with a deficit expected to exceed 3% of GDP in 2017 without additional tightening measures. While the budget deficit could be capped at 3% of GDP this year, a similar result in 2017 would require economic growth to exceed 4.5% and tax collection to improve markedly. Authorities count on both but their forecasts are probably too optimistic.

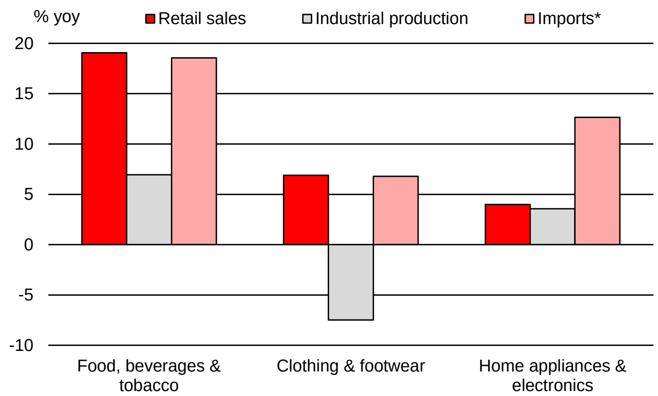
Growth is likely to exceed 4% in 2016 only to slow in 2017…

… as import growth offsets part of the rise in consumption…

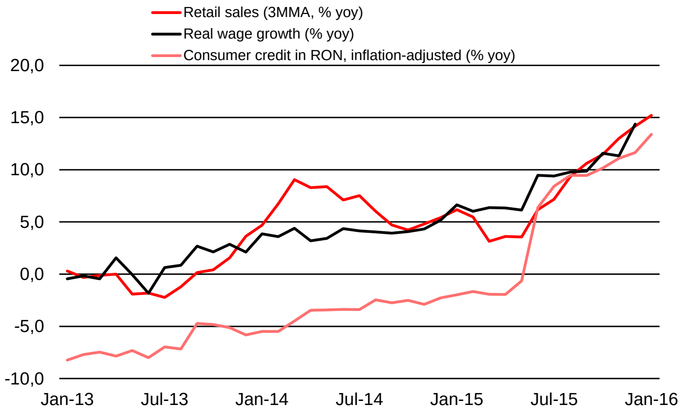
GDP growth will exceed 4% this year if the 2016 harvest will be a bumper one, but will slow in 2017 as a growing share of consumption will be covered by imports. Rapid credit and real wage growth as well as VAT cuts will support the brisk expansion in retail sales. However, local production fails to benefit fully from strong demand, with the domestic production of consumer goods and food contracting or growing much slower than sales. Moreover, export growth will probably fall behind that of other central European countries amid a dearth of new production capacities. Growth risks affect services as well. Transport, one of the largest contributors to C/A inflows, may suffer if the Schengen area is suspended and border controls are reinstated. While banks expect a recovery in activity, the giving in payment law may increase loan down-payments and costs, leading

GROWTH WILL BE DRIVEN BY DOMESTIC DEMAND

Strong consumption boosts imports more than domestic production



Wages and RON lending are growing at the fastest pace since 2008



*For home appliances and electronics, imports include machinery

Source: NIS, NBR, UniCredit Research

… while exports and investment lag

to a slowdown in mortgage lending that may cool off the recovery in residential construction.

The giving in payment law may tighten financial conditions

While the giving in payment law[1] may lead to tighter financial conditions, the impact on outstanding loans could be smaller than feared. The law may be declared unconstitutional since it retroactively changes loan contracts. If not, those who decide to use it may lose access to the mortgage market for a long time.

The budget and C/A deficits are expected to widen this year…

… with tax increases possible in 2017…

… and a reduction in the net external financing capacity in 2016…

… that may weigh on the RON

For the first time since the financial crisis, Romania is facing a widening of budget and external deficits at a time when countercyclical policies would require caution. Lacking a framework to improve tax collection like in Bulgaria or Hungary, Romania may have to increase taxes in 2017 to keep the deficit below 3% of GDP. At the same time, the trade deficit will widen this year due to strong consumption and weak exports. While the larger C/A deficit may be covered by FDI and EU fund inflows, the net external financing capacity will fall in 2016. Adding volatile risk appetite worldwide, EUR-RON could trade in the upper half of the 4.40-4.50 range for most of the year, with the NBR likely to intervene if FX volatility increases.

We expect the NBR to remain on hold in 2016 and 2017…

…the impact of stronger domestic demand on the policy stance being offset…

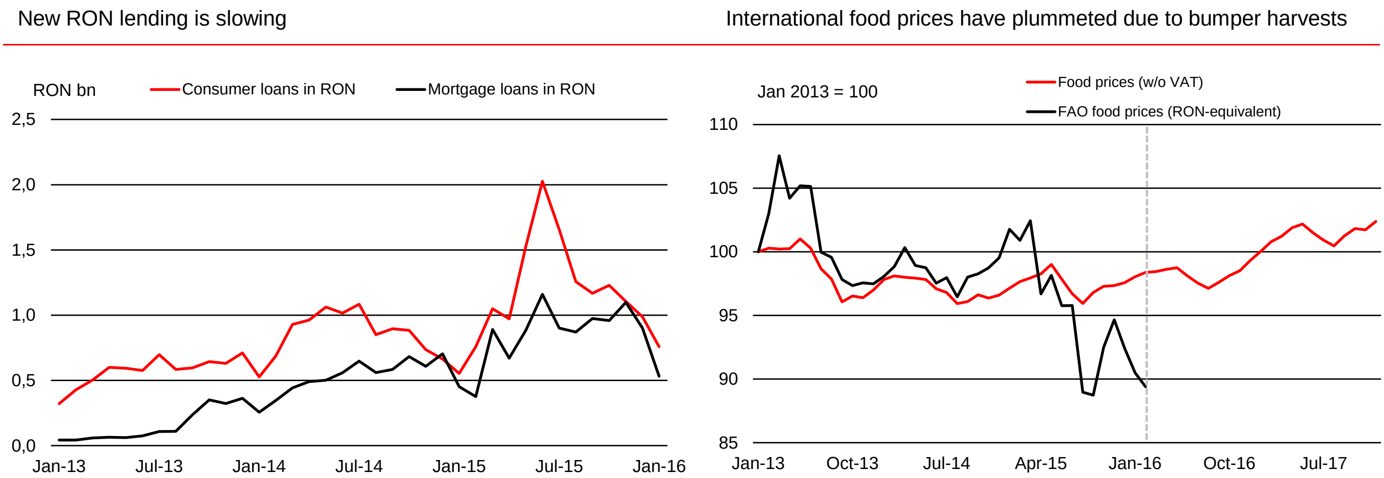
…by ECB easing and low imported inflation

The NBR's recent hawkishness contrasts with the stance of other CE central banks. The NBR adjusted its inflation forecast higher[2] and signaled it may tighten monetary policy due to a positive output gap and lax fiscal policy. While the NBR may tighten the corridor by 1pp, we believe it should postpone rate hikes for several reasons: 1. The interest rate transmission mechanism is weak. Tighter prudential requirements would be more effective in cooling credit growth; 2. Higher interest rates will slow the conversion of FX loans into RON but not new consumer lending, which depends on credit availability and consumer confidence, rather than the cost of borrowing; 3. Past sources of consumption growth are weakening. New lending is slowing and the giving in payment law may tighten financial conditions. At the same time, wage growth will slow in the absence of repeated minimum wage hikes; 4. Romanian asset prices may become more volatile. The higher carry vs. the eurozone risks accelerating volatile short-term capital inflows. At the same time, bonds may suffer outflows if investors start pricing in a bear flattening of the curve. 5. Low imported inflation will anchor domestic inflation.

Appointments in the judicial system are important for the anticorruption campaign

Before the parliamentary elections, a string of crucial appointments will be made in the judicial system. Justice Minister Raluca Prună is likely to appoint pro-reform judges and prosecutors, if backed by Mr. Iohannis. Mrs. Prună has already recommended the

THERE ARE REASONS WHY THE NBR SHOULD NOT RUSH INTO TIGHTENING



Source: NBR, NIS, FAO, UniCredit Research

[1] The law stipulates that an individual borrower may give the purchased property to the bank to settle his/her debt, regardless of whether the property's value covers the outstanding value of the loan. The law is applicable to existing loans, including those granted with a state guarantee under the "First Home" programme.

[2] The forecast for headline inflation is 3.4% yoy for the end of 2017, close to the upper bound of the 1.5-3.5% target range. At the same time, core inflation is expected to rise to 4.3% by December 2017, the highest level since June 2011.

reappointment of Laura Codruța Kövesi, the head of the National Anticorruption Directorate. More importantly, three Constitutional Court judges will have to be appointed this year for nine-year mandates, with Mr. Iohannis, the Senate and the Chamber of Deputies choosing one judge each.

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MACROECONOMIC DATA AND FORECASTS

	2013	2014	2015	2016F	2017F
GDP (EUR bn)	144,3	150,2	159,8	168,8	181,7
Population (mn)	20,0	19,9	19,9	19,8	19,8
GDP per capita (EUR)	7.205	7.532	8.037	8.513	9.192
Real economy, change (%)					
GDP	3,5	3,0	3,7	4,3	3,8
Private Consumption	0,7	3,8	6,1	6,0	4,3
Fixed Investment	-5,4	2,5	7,5	5,4	6,0
Public Consumption	-4,6	0,3	1,8	1,4	1,2
Exports	19,7	8,6	4,7	4,7	4,6
Imports	8,8	8,9	8,4	7,9	7,0
Monthly wage, nominal (EUR)	507	531	576	616	654
Real wage, change (%)	1,0	4,2	9,1	8,6	2,1
Unemployment rate (%)	7,1	6,8	6,8	6,7	6,5
Fiscal accounts (% of GDP)					
Budget balance	-2,2	-1,4	-1,1	-2,9	-3,1
Primary balance	-0,5	0,1	0,3	-1,6	-1,9
Public debt	38,0	39,8	37,9	39,8	39,5
External accounts					
Current account balance (EUR bn)	-1,5	-0,7	-1,8	-3,0	-3,7
Current account balance/GDP (%)	-1,1	-0,5	-1,1	-1,8	-2,0
Extended basic balance/GDP (%)	3,0	3,9	3,0	1,1	1,1
Net FDI (% of GDP)	2,0	1,8	1,7	1,8	1,9
Gross foreign debt (% of GDP)	67,8	63,1	56,9	54,1	46,9
FX reserves (EUR bn)	32,5	32,2	32,2	34,5	33,4
Months of imports, goods & services	6,7	6,2	5,8	5,9	5,4
Inflation/Monetary/FX					
CPI (pavg)	4,0	1,1	-0,6	-0,8	3,2
CPI (eop)	1,6	0,8	-0,9	1,1	3,1
Central bank target	2,50	2,50	2,50	2,50	2,50
Central bank reference rate (eop)	4,00	2,75	1,75	1,75	1,75
3M money market rate (Dec avg)	2,58	1,69	1,03	1,38	1,88
USD/FX (eop)	3,26	3,69	4,15	4,02	3,77
EUR/FX (eop)	4,48	4,48	4,52	4,50	4,45
USD/FX (pavg)	3,33	3,35	4,01	4,13	3,86
EUR/FX (pavg)	4,42	4,44	4,44	4,48	4,45
Real effective exchange rate, 2000=100	123,80	125,48	123,35	119,03	122,56
Change (%)	4,0	1,4	-1,7	-3,5	3,0

GOVERNMENT GROSS FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**11,7**	**15,1**	**13,8**
Budget deficit	2,3	4,9	5,6
Amortization of public debt	9,4	10,2	8,2
Domestic	6,7	8,6	7,0
Bonds	4,7	6,3	3,6
Bills	1,7	2,0	3,1
Loans	0,3	0,3	0,3
External	2,7	1,6	1,2
Bonds and loans	1,0	1,5	0,0
IMF/EU/Other IFIs	1,7	0,1	1,2
Financing	**11,7**	**15,1**	**13,8**
Domestic borrowing	7,9	11,1	11,2
Bonds	5,5	8,9	8,9
Bills	2,1	2,1	2,2
Loans	0,3	0,1	0,1
External borrowing	2,0	4,0	1,5
Bonds	1,5	2,5	1,0
IMF/EU/Other IFIs	0,5	1,5	0,5
Privatization/Other	0,0	0,0	0,0
Fiscal reserve change (+ stock decline/- stock increase)	1,8	0,0	1,1

GROSS EXTERNAL FINANCING REQUIREMENTS

EUR bn	2015	2016F	2017F
Gross financing requirement	**32,5**	**30,5**	**29,8**
C/A deficit	1,8	3,0	3,7
Amortization of medium and long term debt	19,7	14,6	13,2
Government/central bank	6,2	3,4	3,0
Banks	6,4	5,0	4,0
Corporates/Other	7,1	6,2	6,2
Amortization of short-term debt	11,0	12,9	13,0
Government/central bank	0,4	0,1	0,1
Banks	3,5	4,9	4,9
Corporates/Other	7,1	7,9	8,1
Financing	**32,5**	**30,5**	**29,8**
FDI (net)	2,8	3,1	3,5
Portfolio equity, net	0,1	0,1	0,1
Medium and long-term borrowing	14,4	15,8	11,6
Government/central bank	2,8	6,2	3,0
Banks	4,8	4,3	3,3
Corporates/Other	6,8	5,3	5,3
Short-term borrowing	11,8	12,0	11,4
EU structural and cohesion funds	3,7	1,9	2,1
Other	0,0	0,0	0,0
Change in FX reserves (- = increase)	-0,3	-2,4	1,2
Memoranda:			
Nonresident purchases of LC govt bonds	1,3	2,2	2,0
International bond issuance, net	0,5	1,0	1,0

Data Source: NIS, NBR, MinFin, UniCredit Research

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