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FOCUS NOTES: ROMANIA

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Romania: Disappointing full year output performance in 2012

- Full year growth performance disappointed: GDP came at 0.2% yoy in 2012 vs. 2.2% yoy in 2011
- The non-residents' risk appetite for Romanian assets remained strong in Jan-Feb 2013
- The Romanian government was granted a three month extension in the current precautionary IMF agreement framework in order to take corrective action needed to achieve the objectives of the program and wrap up structural reforms in the area of state-owned enterprises

The economy returned to marginal positive growth in Q4-2012. Full year growth performance slowed down to 0.2% in 2012 vs. 2.2% in 2011

According to the flash estimate, output growth returned to marginal positive territory. GDP expanded by +0.2% qoq/+0.3% yoy in the last quarter up from -0.4% qoq/-0.5% yoy in Q3-2012. The reading was still above that of Euroarea who was gripped in recession in Q4 (Figure 1).

Full year GDP growth slowed down to a mere 0.2% yoy in 2012 down from 2.2% yoy in 2011. After registering moderate growth in the 1H, downside risks to growth prevailed in the 2H-2012. The revised real GDP growth came at -0.5% yoy in Q3 (marginally upgraded from -0.6% yoy previously) on severe negative contribution from agriculture and external environment headwinds from the Euroarea sovereign debt crisis (70% of total exports head to EU-27).

Although the detailed break down is still not available, growth was largely driven by anemic domestic demand dynamics. Domestic demand displayed feeble improvement in Q4 after the slump recorded in Q3. Despite the negative surprise in December (-3.2% mom/-2.3% yoy), retail sales in volume terms (seasonally adjusted) were still up by 0.2% yoy in Q4. The improvement trend in retail trade and consumer confidence indicators in the run up to the holiday season give the picture of a further boost to retail activity (Figure 2).

After a short-lived improvement in November (+5.1% mom/-1.5% yoy), construction activity plunged by -2.8% mom/-9.5% yoy in December. In the post-crisis period, construction activity derives support from non-residential building activity and civil engineering. Those areas are more or less tied to capital budget expenditures on behalf of the government sector. As a result, the underperformance of construction activity reflects two facts. Firstly, the government's effort to cut funds earmarked for public construction in the budget of capital investments in an attempt to consolidate expenditures. Secondly, the low EU funds absorption rate. Improved EU funds absorption or increased spending allocations for public investments in the budget have the potential of scaling up construction activity.

To make things worse, the recession in Euroarea impacts exports negatively. Exports have been performing poorly in 2H. The latter translates into a weakness in domestic industrial dynamics in Q4. Industrial production dynamics remained in negative territory for a fifth consecutive month in December. Industrial production-on a seasonal and working day adjusted basis-remained broadly stagnant +0.0% mom/-0.6% yoy in December vs. -0.9% qoq/-1.3% yoy in November on deteriorating mining sector performance. Similarly, manufacturing sector confidence headed south again in December (-4.1 in December vs. -3.5 in November), remaining visibly lower than in the 1H-2012.

Near term growth prospects remain weak on negative spillovers from Euroarea sovereign debt crisis. Medium term outlook depends on the implementation of structural reforms

In any case, the latest macroeconomic data releases fail to impress and suggest that recovery is still fragile. Looking ahead, we anticipate growth prospects to improve moderately in 2013. Our current growth forecast stands at 1.2% in 2013, which is still very decent given that Euroarea will most probably be in recession for most of 2013. Our forecast stands below that of IMF-1.6% in the latest review and European Commission-2.2% in the autumn forecasts). Risks are skewed to the downside. Short term growth prospects are clouded by the Euroarea sovereign debt crisis, which is going to be a drag on net exports and capital inflows until at least 1H-2013. However, domestic demand is going to be the main growth driver in 2013. The contraction of private consumption in the post-Lehman period has bottomed out. As an illustration of this, retail sales in volume terms posted the first- since 2008-annual positive reading in 2012 (+2.9% yoy). In addition, fiscal and monetary policies are expected to be more growth supportive in 2013. The hike of public wages to the 2010 levels and the indexation of pensions are going to support household balance-sheets this year. Last but not least, economic activity will most probably receive a positive boost from agriculture in 2013. Provided that the negative performance of Q3-2012 will most likely not be repeated, we anticipate agriculture to be a positive contributor to growth in 2013.

In contrast, investments could take the lead as the primary engine of growth in Romania in the medium-term. The required elements are there: political stability after long time, an attractive large domestic market, a competitive from a relative wages point of view labor force etc. The implementation of structural reforms in the broad government sector could provide a catalyst for the boosting medium-term growth potential. There is room for significant improvement in two key areas: EU funds absorption (the lowest in EU-27) and public sector efficiency.

The Romanian government was granted a three month extension in the precautionary IMF agreement in order take corrective action needed to achieve the objectives of the program

The government was granted a three month extension on the precautionary IMF agreement. In principle, the two year existing precautionary agreement will expire in March. The Romanian government has already completed successfully six reviews in the existing framework. The final review (7th and 8th combined) took place in January 15th-29th. According to the preliminary findings of the IMF and EU missions, the quantitative targets of general government cash deficit, public sector (both on the local government and state budget level) arrears and the target of central bank's net foreign assets were missed.

The general government cash deficit came at 2.5% of GDP in 2012 slightly above the revised target of 2.2% of GDP. However, the revised cash deficit target was missed, mainly due to suspensions of reimbursements for some EU-funded projects because of past irregularities discovered by the Romanian audit authorities**.** In contrast, preliminary estimates suggest that the budget deficit in accrual terms was maintained below the 3% of GDP threshold in 2012. Provided that the final data in April confirm the original findings, then Romania will no longer be subject to the Excessive Deficit Procedure. On the positive side, both the government and the authorities agreed upon the corrective action needed to achieve the objectives of the program. For that purpose, the government asked for an extension of the program for two more months in order to take both corrective action with respect to arrears and the budget implementation of 2013. At the same time, the government has reaffirmed its intention to push for structural reform in the area of state owned enterprises.

The structural reform agenda has been lagging behind even before the parliamentary elections. The privatization of Oltchim (state owned chemical company), which together with the sale of a 15% stake in Transgaz was a prior action for the approval of the 6th review, turned out to be a highly political and controversial issue. During that period, the government will wrap up the restructuring and privatization of three state-owned companies. The secondary public offering of 15 percent Transgaz will be finalized in the coming months. In addition, a majority share in the state railway company CFR Marfa will be sold to a strategic investor. Oltchim will be put into insolvency. Finally, efforts to appoint professional boards and managers in public enterprises will be stepped up.

Appetite for Romanian assets remained strong in the first two months of 2013

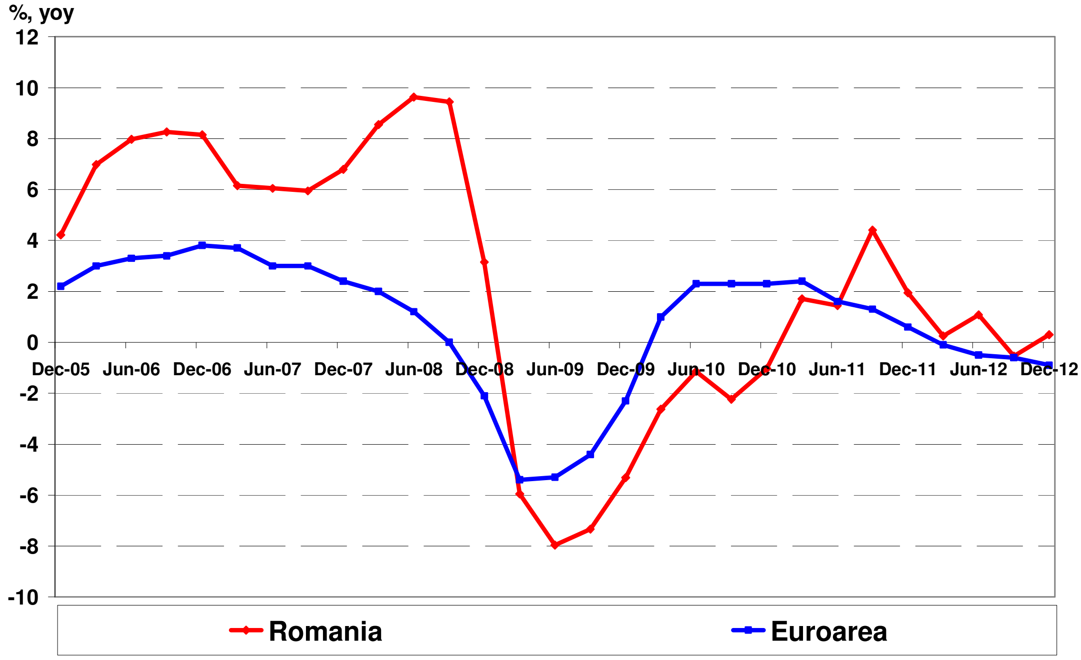
Risk appetite for Romanian assets has improved substantially since Q4-2012. Romanian assets have received a lot of market attention particularly after the election results in December. The strong elections results for the ruling coalition who gained constitutional majority increased the prospects of political stability and expectations of accelerating structural reforms. In addition, the rhetoric of the new government on changing macro-policies in the context of the expiring precautionary IMF agreement softened. Therefore, the perceived risk premium declined thereby making government bond yields more appealing.

In addition, the government bonds inclusion in two major emerging market bond indices only propelled interest further. Barclays announced in last November that it would include local T-bonds starting from April 2013 to its indices. JP Morgan announced in early January that local T-bonds were eligible to be included in the relevant popular index. However, the decision for the inclusion or not will be taken in next spring (between March 1st and May 1st). Both decisions are important because those indices serve as a benchmark for the asset class allocation choices of institutional investors. The re-allocation will put Romania on the radar of portfolio flows. This is particularly important because non-residents had decreased their exposure in the local market because of the escalating political crisis in the past summer and the escalating Euroarea periphery sovereign debt crisis.

On the other hand, the Ministry of Finance has demonstrated a great success in tapping the local market. The successful issuances enabled the government to start covering the hefty financing needs of 2013 in the last months of 2012. The public financing requirement amounts to 13.6% of GDP in 2013, one of the largest in the region. In addition, the eligibility of longer-term maturities for inclusion in the bond indices provides an incentive for the Ministry of Finance to prefer issuing such local currency instruments. In essence, this results in developing the primary bond market further but also improves the maturity profile of the domestic debt.

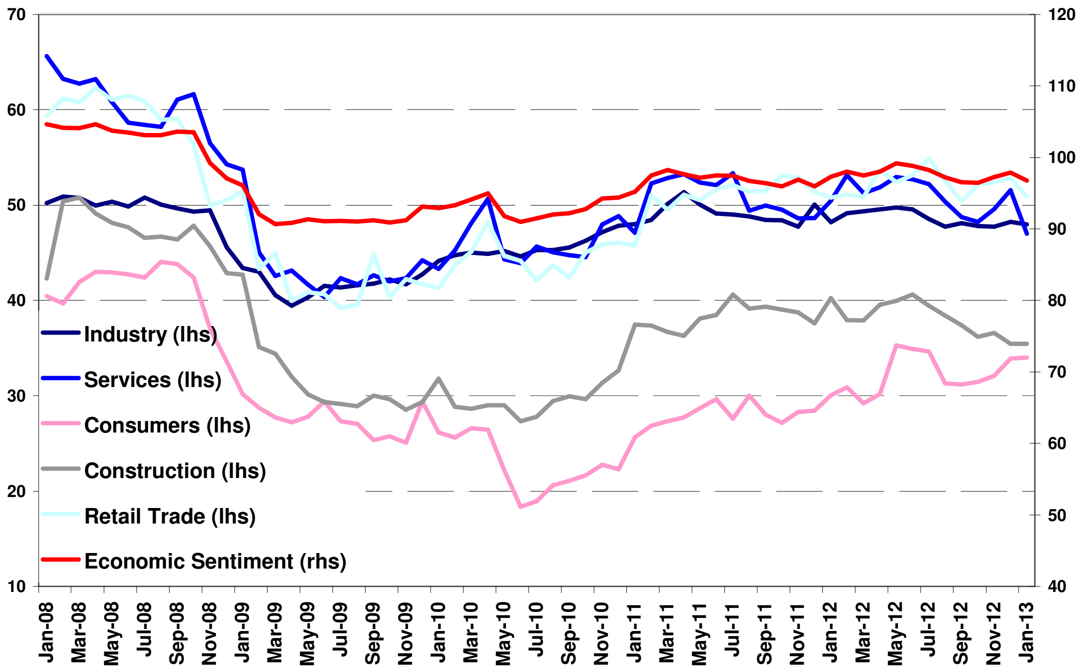
The renewed interest for long-term government securities on behalf of non-residents continued in the first two months of 2013. The Ministry of Finance raised 11.4bn in local currency denominated bonds, twice as much than the initial plan of 4.6bn in January. Although demand was less strong in February, the Ministry of Finance raised 4.0bn vs. a plan of 3.7bn. Strong demand in the auction of 10-year local currency bonds led to an oversubscription and subsequently yields lower. The average yield came at 5.71%, the lowest recorded since 2005 and much lower than 6.75% recorded in the relevant auction of March2012. In the first international auction of 2013, the Ministry of Finance raised USD 1.5bn from a 10Y-USD denominated bond. Total bids reached USD7bn (bid to cover ratio 4.6) an illustration of strong demand. Thus, yield came much lower at 4.5% vs. 6.9% in the spring of 2012. Meanwhile, NBR left the policy rate unchanged at 5.25% in January and February 2013. Instead, the Central Bank opted to utilize liquidity management in order to impact monetary conditions. After tighter liquidity conditions in late 2012, NBR opted for looser liquidity conditions in the first two months of 2013. On the other hand, the leu appreciation trend which begun in last October came to a halt in mid-February 2013. Leu traded at 4.37/€ on February 20th vs. a year low at 4.32/€ on January 16th.

Figure 1: In contrast to the Euroarea, growth in Romania was still marginally positive in Q4



Source: National Statistics, Eurostat

Figure 2: Consumer sentiment was on an improvement trend in the last months of 2012



Source: Eurostat, Eurobank Research

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