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FOCUS NOTES: ROMANIA

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Softer GDP growth in Q2 yet still in line with our full-year forecast

- **GDP growth slowed to 1.4% yoy in Q2 down from 1.7% yoy in Q1 on weaker net exports performance and still contracting domestic demand figures**
- **Romanian asset classes outperform their New Europe peers year to date despite sour financial markets sentiment**

GDP expanded at a softer pace in in the second quarter on weaker net exports while domestic demand was still in red.

Growth softened in the second quarter compared to the first. Real GDP expanded by 1.4% yoy in Q2 down from 1.7% yoy in Q1 2011 against -0.4% yoy in Q2-2010. On a seasonally adjusted basis, the GDP grew marginally by 0.2% qoq lower than the 0.5% qoq in the first quarter (revised downwards from +0.7% qoq). The estimate came little below analyst expectations (Reuter's poll: +0.3% qoq).

The slowdown was mostly felt in the industrial sector which is export-oriented and thus highly correlated with exports. The industrial sector disappointed expectations of another robust quarter, expanding by -0.4%qoq/+4.9% yoy in Q2 down from +2.5%qoq/+10.1% yoy in Q1. The most representative sector, manufacturing slowed down to 5.6% yoy in Q2 against 11.3% yoy in Q1 on the back of weaker external demand which resulted in a slowdown of exports from -5.7%qoq/+6.3% yoy in Q2 compared to +23.6% yoy in Q1). Accordingly, imports' growth slowed down to -1%qoq/+7.7% yoy in Q2 compared to +6.9%qoq/+15.2% yoy in Q1 as domestically manufactured products incorporate a significant amount of imported materials and domestic demand remained contractionary. As a result, the contribution of net exports to growth became negative by 1.1pps compared to 2.2pps positive in the first quarter.

The picture in services, the most labor intensive sector of the economy, improved marginally. Services expanded by +0.3% qoq/-0.8% yoy compared to 0% qoq/-2% yoy in Q1 against +0.5%qoq/-2.2% yoy in Q1 2010. The retail sector, the most important sector of consumption, recorded positive growth on a yearly basis for a second consecutive quarter (Q1 was the first time since the last quarter of 2008). In detail, retail services remained flat at 0%qoq/+0.9% yoy compared to 1.1% yoy in Q1 vs. -2.9% yoy in Q4. The contraction slowed in financial services, which marked an anemic +1.2% qoq/+0.3% yoy growth compared to -0.9% qoq/-3.2% yoy decline in Q1 2011. Agriculture was the sector which outperformed industry and services. Gross value in agriculture expanded by +2.5% qoq/+3.4% yoy registering a strong rebound from -4.4% qoq/-0.4% yoy.

From the demand side, private consumption and investments remained in negative territory. Households' consumption growth shrank by +0.2% qoq/-0.7% yoy in Q2, almost unchanged compared to Q1. In contrast, government consumption expanded by +8.4% qoq/-0.7% yoy compared to -3.2% qoq/-10.5% yoy in Q1. Overall, total consumption fell by -0.7% yoy, with the contraction narrowing after a -1.7% yoy decline in Q1 2010. The contraction in real gross fixed capital formation eased to -1.4%yoy compared to -2.2%yoy in Q1. Meanwhile, the rebuilding of inventories pushed gross capital formation higher by 12.1% yoy in Q2 compared to 11.5% yoy in Q1. Growth in the most illustrative sector of capital investments, construction, remained in negative territory, but with the pace of contraction slowing down even further to -1.9% yoy compared to -2.4% yoy in Q1 against -7% yoy in Q4.

Our view on the second quarter is not necessarily negative. Growth has been adversely affected by the slowdown in major exports partners. In addition, domestic demand is slowly and unsuccessfully that far creeping out of recession, with contraction only becoming thinner. The safest conclusion is that even when domestic demand grows out of recession, it will not be able to support as much as in the past growth in the future. On the other hand, the good news is that agriculture is performing well so that will give a solid boost to growth in 2011. In addition, third quarter high frequency indicators signal that a more robust GDP growth reading should be expected for that period. As a result, our full year forecast remains unchanged at 1.7% in 2011. This year's growth prospects looked relatively improved for Romania which lagged behind in 2010. Romania was one of the last countries to exit recession in the New Europe space. Yet this is short of sustainable growth since, this year will be a transitional year for Romania. Inter allia, this means that growth will be negatively impacted from agriculture in 2012 due to the high base effect. For that reason, we have downgraded our forecast for next year to 3% against 3.5% in our previous issue of New Europe Economics & Strategy, with risks skewed to the downside.

RON remains relatively stable year to date despite deepening EU sovereign crisis concerns and increased global markets risk aversion

The negative global markets sentiment has had a negative impact on the domestic macroeconomic environment and financial markets since early August. Fears of a slowdown in external demand have shown up worldwide both in advanced and emerging economies as growth is losing steam in US and EU. On top of that, financial markets have come under stress worldwide over fiscal and debt sustainability concerns in Euro area periphery.

However, in a global context of risk aversion, Romanian asset classes still outperform their regional peers on a year to date basis:

- **Leu**: The local currency was on a steady appreciation trend until May. The leu reached multi-month highs near 4.07/€ in late April, having appreciated by almost 4% since the beginning of the year. Ever since, leu came under depreciating pressure which intensified in August towards the threshold of 4.3/€ but never surpassed it until September 22. On September 22, Leu stood at 4.308/€ marginally lower (ca. 1%) since the beginning of 2011. In contrast, Turkish lira and Polish Zloty have been the underperformers of the entire region. Turkish Lira and Polish Zloty have depreciated vs. Euro by 19% and 12.7% respectively. The outlook ahead until the end of the year is to trade within 4.25/€-4.35/€ on high volatility given that the Central Bank could intervene to avoid further depreciation.
- **CDS:** Romanian credit has been more resilient than its peers in the recent bout of risk aversion. Romanian 5Y-CDS started climbing since early August from 240bps to above 350bps (373bps on September 22), thinner than Hungary (472bps on September 22) or Croatia (405bps on September 22) who enjoy a better sovereign rating
- **Yields**: Yields for government paper climbed north yet they held up relatively well on a regional comparison. The 10yr bond yields increased by 13bps whereas 12 month treasuries by 50bps. The high public financing needs until the end of the year may push the Ministry of Finance to organize another EMTN issue (more extensive coverage on the focus note

In our view, the better than peers performance of asset classes is not totally unjustified. There are two fundamental drivers behind that. Firstly, the government has made steady progress in promoting important structural reforms and fulfilling IMF requirements, despite increased tension in the domestic political landscape. That progress has been rewarded with a new precautionary IMF agreement. The new agreement (€5bn multilateral lending, duration: 24months) serves as an anchor for the implementation of sound policies while providing a safety net for the country's financing needs. Secondly, macroeconomic fundamentals have improved as macroeconomic imbalances (the twin deficits: current account and fiscal deficits) are on a steady decline in the last three years.

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Inflation reverses course in summer months due to sharp consecutive drops in food prices

The dynamic of inflation during the past three months has been very abrupt. CPI recorded the sharpest monthly fall since 2000 in June, only to be surpassed by the July and August figures (both -0.35% m-o-m). These consecutive monthly drops coupled with the elimination of the base effect from last year's VAT hike have resulted in an annualized inflation figure of 4.3% (from 8.4% in May).

Food prices have been the main driver of this decline. A good harvest has influenced this dynamic heavily, but we believe exogenous factors have also played an important role. To be more precise, food disinflation has followed a very singular pattern in 2011. Whereas during other years, we would observe a broad based fall in prices of different product categories (vegetables, fruits, meat, eggs, milk, etc.), current disinflation has been almost entirely driven by vegetable prices. The latter have fallen -14.7% m-o-m in July and -11.2% in the previous month, the highest monthly drops recorded since 2000. Moreover, vegetable prices recorded similarly sharp drops throughout CEE and Eurozone countries. We believe this pattern may be related to a food import ban instated by the Russian Government in June regarding European vegetables. The embargo is currently being lifted and should lead to a normalization in vegetable prices as we exit the third quarter of the year.

Our baseline scenario sees inflation at 4.0% at the end of the year, but the figure may be revised upwards due to changes in administered prices

Taking into account these very sudden changes in inflation, we have revised our baseline estimates downward to 4.0% for 2011. As a caveat, the figure is bound to change as the effect of alterations in administered prices remains unclear. The Government has recently decided to replace a general heating subsidy with one targeting solely individuals with low incomes. Matters are complicated further by the fact that some local authorities (such as Bucharest or Cluj-Napoca) have decided to offset the effects of the subsidy cuts. Estimates on the impact range from +0.1pp to +0.7pp to the final inflation figure.

The NBR will most likely keep interest rates unchanged in September, but could shift towards a more relaxed policy as early as November

We believe the NBR will not ease its monetary policy in the short term as disinflation is currently driven solely by price changes in volatile goods and expect a wait-and-see position at the September meeting. Should the growth outlook continue to aggravate, it could trickle down into inflation in 2012 and we may see a rate cut as early as November. Moreover, imported inflation risks are skewed to the downside as sluggish growth in the developed economies will exert downward pressures on the prices of oil and other commodities.

Romanian budget execution remains adequate to meet 2011 deficit target, but Government will face severe headwinds in 2012

The y-t-d budget deficit has remained broadly flat in July at 2.09% of projected GDP vs. 2.07% in June. As a caveat, the attainment was helped by seasonal factors, namely quarterly collection of profit tax. Aggregate budget income increased RON +3bn. over the previous month, while total spending ebbed down RON -0.8bn. In spite of the positive headline, the structure of spending remains rather worrying (the reduction in spending was achieved through cuts in capital spending, while signs of public sector inefficiencies remain). Nevertheless, the budget execution remains adequate to meet the 2011 target.

Deteriorating risk environment makes debt servicing more difficult

However, the government is finding it increasingly difficult to service its debt. Local market conditions have deteriorated in August due to a bout of risk aversion at a global level. The yield curve has shifted upward for all maturities. The yield for shorter maturities increased most prominently (12-month T-bills yield increased approximately 50bp, while 10-yr. bond yields increased approximately 13bp.) The bid-to-cover ratio has also deteriorated to 1.83 in August (average rate) from 2.73 in July. Moreover, the Government rejected all bids on two separate tenders (a 5-yr T-bonds debt tender worth RON 500mn. and a 1-yr T-bills issue worth RON 900mn.)

The MoF may resort to a new EMTN issue this year

Cumulatively, the MoF has failed to raise the amount of funds it had initially planned and may be forced to resort to another EMTN issue this year. Deputy Finance Minister B. Dragoi has confirmed this intention and mentioned a possible USD issue.

Market conditions for this type of issue are currently mixed, with risks of worsening contingent on risk environment. Romania's CDS is higher than it was during the initial EMTN on June 17th 2011 (345bp vs. 254bp). On the positive side, the Euro 5yr IRS has sharply decreased from 2.7 to 1.8, historically low levels. These circumstances make for relatively accommodative conditions in the short term. However, these conditions may deteriorate significantly if the crisis in the Eurozone deepens. This means that the longer the issue will be postponed, the higher the associated risks will be.

<u>The slowdown in economic growth makes the 2012 deficit target increasingly unattainable</u>

The outlook for 2012 is also worsening. The deficit target of 3% looks increasingly unattainable as the economic growth looks poised to undershoot the government's forecast of +3.5% (our current baseline scenario sees an expansion of +2.75%). Thus, the Government may be forced to resort to new spending cuts in an electoral year. Nevertheless, should market conditions worsen substantially in 2012, the MoF may fall back to the IMF Precautionary Agreement.

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