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FOCUS NOTES: ROMANIA

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Sovereign upgrade to investment grade by FITCH

- Fitch upgraded Romania's long-term foreign currency rating by one notch to investment grade BBB-
- Current account deficit declined by 44% yoy in Jan-April on higher current transfers

Fitch upgraded Romania's long-term foreign currency rating by one notch to investment grade BBB-

On July 5th, Fitch upgraded the sovereign ratings of Romania by one notch. More specifically, Fitch upgraded Romania's long-term foreign currency rating to 'BBB-' from 'BB+' and the long-term local currency rating to 'BBB' from 'BBB-'. At the same time, the agency upgraded the country ceiling to 'BBB+' from 'BBB' and the short-term foreign currency rating to 'F3' from 'B'. The sovereign report assessed that 'the upgrade is an evidence of Romania's progress in the process of recovery after the effects of the world financial crisis, visible in the GDP growing once again, the solid export performance and the lower budget deficit. On the whole, there is a palpable lower risk associated to Romania, representing a comeback to an 'investment grade' type of rating'. The Fitch upgrade puts Romania on par with Hungary (which lacks access to IMF funding after the collapse of its program), Latvia (which suffered worse output contraction and fares much worse in external susceptibility metrics) and Croatia (which is still in recession). Finally, ratings are still supported by income per capita above the BBB median

The upgrade doesn't come as a surprise to us. In our March issue of New Europe Economics & Strategy, we argued that the next move by rating agencies on the assessment of the sovereign risk of Romania will probably be to the upside, provided the government minimized uncertainties with respect to the 2011 budget execution. The Romanian government has come a long way since late 2009 when both Fitch and Standard& Poors had downgraded the sovereign rating of Romania to junk status amid conditions of political collusion. Ever since, the minority government has implemented a very ambitious fiscal consolidation plan during conditions of economic recession. The plan entailed public wage cuts (-25% on wage bill), public sector lay offs (broader public sector employment declined by 130,000 between 2009-Q12011) and a sharp VAT increase by 4pps (from 19% to 24%). Provided that the measures stay in place there will be a further reduction in the fiscal deficit to 4.4% of GDP in 2011against 7.3% in 2009. In addition, the government made steady progress in promoting important structural reforms (e.g. new business friendly labor market law, the uniform public wage law, the fiscal responsibility law) thus fulfilling IMF requirements, despite increased tension in the domestic political landscape. Last, a new precautionary IMF stand-by agreement is in place to shield the country in case of an emergency.

More rating action from S&P should be on the cards until the end of 2011

In contrast Standard and Poors has maintained the sovereign of Romania below investment grade. Standard and Poors has assigned Romania a BB+, only one notch above the sovereign rating of Serbia. However, Romania ranks very low by regional standards in the S&P rating system, taking in mind it is an EU member, a potential EMU candidate and is running a precautionary program with IMF. Yet

Standard and Poor's choice was to affirm the current sovereign rating on June 9th. According to S&P, the ratings on Romania balance the view of the country's substantial economic growth potential and moderate general government debt against its limited administrative capacity, relatively low prosperity and high, if declining, levels of external debt. However, S&P has left the choice of a sovereign upgrade open, if the government maintains the momentum of its current structural reforms, building a sustained track record of fiscal prudence and maintaining stability in the financial sector. In conclusion, we anticipate Standard and Poors to move on and upgrade the rating by the end of this year. On the other hand, Moody's maintained Romania's rating at investment grade throughout 2008-2011 and intends to leave them unchanged for at least one more year.

The initial FX market reaction towards the upgrade was slightly positive yet it proved short-lived. On July 5th, RON traded intraday only 1% higher at 4.19/€. However, RON has been losing ground from its year low at 4.07/€ in late April. Concerns over potential spillover from the ongoing Greek sovereign crisis led to a trimming of RON gains (RON stood at 4.27/€ in the beginning of 2011). In addition, 5Y-CDS traded at 244bps, the highest level in the last three months. There are two good reasons for this trend. Firstly, prices have already reflected the improvement in the macroeconomic fundamentals. Secondly, the Euroarea periphery crisis weighs negatively on the currencies of the region at this stage.

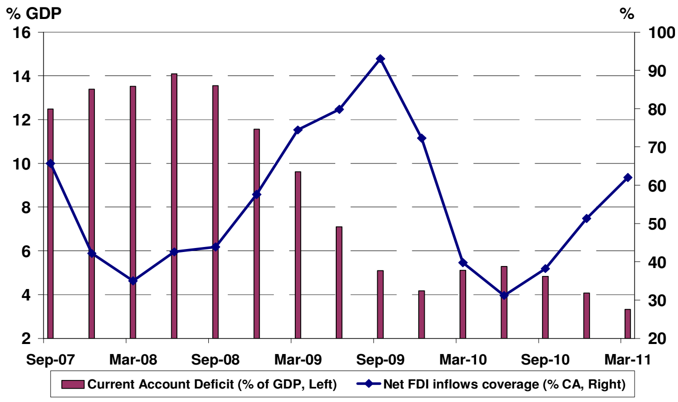
In our view, the sovereign upgrade of Romania is expected to have a more medium-term impact. More specifically, will help mitigate the adverse market impact from the ongoing Euroarea sovereign crisis alleviating concerns of contagion from the Euroarea periphery. In addition, it will make the Romanian market a more attractive destination for capital inflows (both FDI and portfolio investment), which have declined during the 1H-2011. The market reaction towards the rating upgrade was slightly positive in the first debt auction. The Ministry of Finance sold 3Y-Tbonds RON 0.7bn vs. RON 0.5bn planned at an average yield of 7.09% compared to 7.18% in the previous auction. Yet, total demand on behalf of the banks was three times as large compared to supply.

Current account deficit declined by 46.4% in Jan-April driven by higher current transfers

Current account dynamics continue to improve in Jan-April albeit at a slower pace vs. the first quarter. The current account deficit declined by 46.4% yoy to €1.1bn in the first four months vs. 58.9% yoy in Q1. Overall, the current account deficit on a twelve month rolling basis improved modestly to 3.2% of GDP in Jan-April against 4.1% at the end of 2010 and 5.2% in Jan-April 2010.

Figure 1

Current account dynamics improved in 2008-2011



Source: BNR, Eurobank Research

The improvement in trade deficit was the main driver behind that. The trade deficit improved to €1.1bn in Jan-April compared to €1.8bn in Jan-April last year. However, the decline in the trade deficit narrowed down to 41.2% yoy in Jan-April against 64.6% yoy in Q1. This was the combined result of a softer reading in exports and imports. Exports continue their robust rebound by 33.3% yoy down from 39.4% in the first three months. In contrast, imports picked up by 22.2% in Jan-April against 24.8% in Q1. The revival of imports is closely tied to the rebound in exports. A large part of imported materials is used as inputs for exported goods because of insufficient domestic industrial capacity.

Table 1

Balance of Payments Jan-April 2010-2011

mn Euros	Jan - Apr 2010			Jan - Apr 2011			%
CURRENT ACCOUNT	14,531	16,680	**-2149**	18,716	19,868	**-1,152**	**-46%**
A. Goods & Services	12,666	14,866	**-2,200**	16,452	17,925	**-1,473**	**-33%**
a. Goods (exports fob - imports fob)	10,798	12,679	-1,881	14,392	15,497	-1,105	**-41%**
b. Services	1,868	2,187	-319	2,060	2,428	-368	**15%**
- transport	549	618	-69	606	789	-183	**165%**
- tourism - travel	238	335	-97	287	377	-90	**-7%**
- other	1,081	1,234	-153	1,167	1,262	-95	**-38%**
B. Incomes	299	826	**-527**	332	1,108	**-776**	**47%**
C. Current transfers	1,566	988	**578**	1,932	835	**1097**	**90%**

Source: BNR, Eurobank Research

The pattern of the deteriorating balance of services and income extended during the first four months. The BoP deficit in services and income deteriorated by 15% yoy and 47% yoy respectively. The good news is that current transfers recorded a €1.1bn surplus, which is 89.8% yoy higher. The current transfers' surplus traditionally provides a buffer to the current account deficit in Romania. However, lower remittances from abroad (-18% yoy in 2010) had put pressure on the surplus of current transfers last year. The latest statistics point to a reversal of the trend because of increased EU funds absorption, which is expected to be illustrated in an improvement in investments as well.

From the financing side, both FDI inflows and portfolio investment disappointed. FDI inflows declined to €443mn against €623mn, down by 28.7% yoy in Jan-April. At the moment, net FDI inflows cover only 38.5% the current account shortfall compared to 60% in Q1, yet still higher than 29% in Jan-April. However, FDI inflows should register a small increase by the end of the year inflows should receive a small support by the privatization program of the government. At the same time, net portfolio investment was down by 31% yoy to €1bn. Finally, total external debt rose by €5.5m to €93bn in Jan-April, driven primarily by the IMF tranches approximately 70% of GDP. The majority of the total external debt was of medium- and long-term duration (79.2% of total) and private-sector denominated (69.9% of total).

Monetary policy outlook: No tightening bias

The NBR has kept the key interest rate unchanged at 6.25% in its monetary policy meeting on June 29th. In its report, the bank signaled no bias towards tightening interest rates, as long as the output gap remains negative. Tightening risks, which stem from commodity prices increases, second round effects of supply side shocks and administered prices pressures, have eased in the past month. The IEA recently took action to curtail oil prices, while the Government decided to postpone cuts in thermal energy subsidies for consumes until 2012.

The IMF concludes its first review

The IMF completed its first review of the Romanian economy under the 3.5 bln euro precautionary stand by agreement. The institution concluded that all program targets were met and accordingly disbursed the first tranche of 481 million euro. The local authorities decided not to draw any funds and treat the arrangement as precautionary.

The report stressed that further efforts would be needed to reach the 2012 monetary and fiscal targets. The local authorities' main point of focus should be state-owned enterprises, arrears, fiscal efficiency and absorption of EU funds.

Budget deficit accelerates in May, but remains adequate for mid-year target

The Budget execution deteriorated in May compared to the previous month. The deficit has risen from 0.8% in the first four months of the year to 1.4% of projected GDP in the first five months of the year. We are particularly apprehensive about the current structure of spending.

Outlays for goods and services has been one of the quickest growing components of budget spending, rising 11% in the first five months of the year over the same period of 2010. This sector is usually indicative of public spending inefficiencies.

Although capital spending was described as a priority for the government, this component has actually decreased 5% in the first five months of the year over the equivalent period of 2010. The situation improves slightly if we would take into account spending on co-financing programs (+15%), but things should have been further ahead.

Rising short-term debt will prompt the Government to issue more bonds under the EMTN program

Another fiscal policy issue is Romania's mounting short-term debt, which increased 3.7% in Q1 2011 over the previous quarter and reached 19.1 billion euros. Although the short/long term financing ratio (3/10) remains far from the pre-crisis peak (6/10), the dynamic does raise some concerns especially as the increase was driven exclusively by government borrowing.

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During the first 6 months of the year, the Romanian treasury has issued around 8 billion Euros in the local market, 80% of which being in short-term debt instruments. Partly, this has resulted from higher demand of local banks. The Treasury has been able to place more titles in the local market at a lower average yield than the previous year (6.79% vs 7.27%). Although the majority of short term debt is owned by local banks (72%), thus limiting the risk of rollover crises, Romania currently has the shortest debt maturity structure in the region. Matters are further aggravated by the country's poor growth performance.

The government plans to change this arrangement in two ways: issue longer maturity debt in the local market and issue Eurobonds in the international markets. The latter will most likely become the preferred option, as local banks' demand for longer term instruments is limited.

The MoF plans to issue Eurobonds through an EMTN program with a maximum value of 7 billion euros. The first issue under the program was launched in June and successfully managed to raise Eur 1.5 bln at a yield of 5.3%. Although the accepted yield was slightly higher than for a 5Y Eurobond from March 2010, this was not due to lack of investors' interest. Market conditions between the two periods have changed. The 5Y CDS for Romania in June 2011 was 30bp higher than in March 2010, while the 5Y swap rate for euros increased from 2.4% to 2.8% (as the ECB started to tighten interest rates). Moreover, the issue was oversubscribed more than two times.

The architecture of the EMTN program makes is very flexible and will allow the MoF to tap the international markets at any time during the next three years. The Government is also planning a Dollar-bond counterpart to the program.

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