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FOCUS NOTES: ROMANIA

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Romania: Surprise 25bps interest rate cut

- In the November inflation report, the Central Bank revised downwards its year end inflation forecast for 2011 at 3.3% from 4.6% previously and for 2012 at 3% from 3.5% previously
- After nineteen months of staying put, NBR surprised markets and cut interest rates by 25bps to 6% despite external environment concerns
- The Romanian industrial sector can continue to prove resilient in the months ahead. Factoring in the good harvest, it is very likely for the economy to overshoot growth expectations in 2011
- The deterioration of market conditions may push yields above 5.75% for a forthcoming EMTN issue

Sharper than expected inflation drop in September supported by seasonally lower food prices and base effects; Central Bank downgraded its year end inflation forecast to 3.3% from 4.6% previously

Consumer prices declined for a fourth month in a row. Inflation came at -0.2%/+3.5% mom/yoy in September 2011 compared to /+4.3% mom/yoy in August. The September reading was significantly lower than the market's median forecast (+0.2% mom/+3.9% yoy). In EU-harmonized terms, HICP inflation stood at 3.5% yoy in September vs. 3% yoy in the Euroarea. In terms of convergence criteria, the 12 month-average-inflation declined further to 6.9% yoy in September against 7.3% yoy in August yet still significantly higher than 2.9% yoy in the Euroarea.

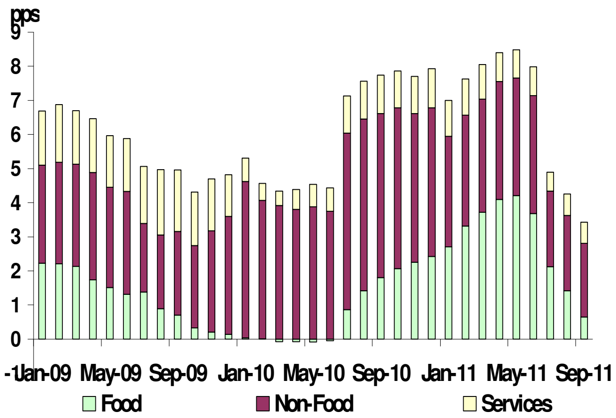
On the positive side, the September headline CPI rate was heavily influenced by the favorable base effect of the dissipation of last year's 5ppts VAT hike in July. However, disinflation gained momentum in the last three months on significantly lower food prices. Food prices (-1.2% mom/+1.7% yoy) were one of the main culprits, driven by the sharp monthly declines in the prices of vegetables (-13.3% mom) and fresh fruit (-5.7% mom). The faster-than-expected decline stems primarily from a very good agricultural harvest in the summer and favorable seasonal effects on volatile food items: the potatoes decline skyrocketed to -35.3% mom. Meanwhile, non food prices edged higher (+0.2% mom/+4.8% yoy), with fuels registering the highest increase (+1% mom). In contrast, services prices expanded moderately (+0.5% mom/+3.5% yoy), assisted by the increases in water utilities and transportation (Figure 1).

Overall, the sharp inflation decline in the recent months is not unexpected, yet to some extent its magnitude is. The 5ppts VAT hike in July 2010 (from 19% to 24%) compounded by supply side factors such as the rally in food and fuel costs, aggravated inflationary pressures in the last months of 2010, driving inflation up to 8.5% in May 2011, from 4.4% yoy in June 2010. We expressed the view in all our previous issues of New Europe Economics & Strategy that a clear disinflation trend was going to resume and gain momentum in H2-2011, when the impact of last year's VAT hike falls out of the equation.

Yet the decline in food and energy prices has exceeded our expectations resulting in significantly lower inflation readings. According to our updated forecasts, annual inflation is set to end this year around 3.5% within the boundary of the 3%+/-1% official target. However, we continue seeing some upside risks in the coming months, stemming from the risk of fiscal relaxation ahead of the parliamentary elections in 2012 and further increases in the administered prices.

A clear illustration of the above is the Central Bank revised forecast in the November inflation report. In its latest Inflation Report, the Central Bank revised its end-2011 CPI projection to 3.3% yoy, from 4.6% yoy previously in August. On an even more positive note, demand side pressures remain very weak which is in line with the negative output gap. In fact, the adjusted Core 2 inflation (CPI excluding regulated prices, fresh food, tobacco and alcohol) has even declined to 2.7% yoy in September against 4.7% in June.

Figure 1: Inflation declined rapidly in the last months on favorable base effects, declining food prices and muted demand side pressures



Source: NBR, Eurobank Research

Central Bank surprised markets in early November cutting rates by 25bps after a long period of unchanged interest rates

After a long period-19 months- of staying put, the NBR delivered a rate cut in its November meeting. On November 2nd, the NBR decided to cut its key policy rate further by 25 bps to 6%. At the same time, the Central Bank decided to leave unchanged the minimum reserve requirements ratio for RON (15%) and FX-denominated liabilities (25% for maturities less than 2 years-20% for maturities over 2 years).

After cutting interest rates by 175bps cumulatively in the beginning of 2010, the NBR was forced to terminate its easing policy cycle in late June 2010 to address rising inflation risks stemming from a steep hike in main VAT rates. Ever since, the Central Bank remained on hold, leaving its key policy rate at 6.25%. According to the Reuters poll conducted ahead of the policy meeting, the majority of participants polled (11 out of 15) anticipated no change in rates while the rest expected a 25bps cut. This is illustrative of the surprise of the financial markets which broadly were not expecting this move.

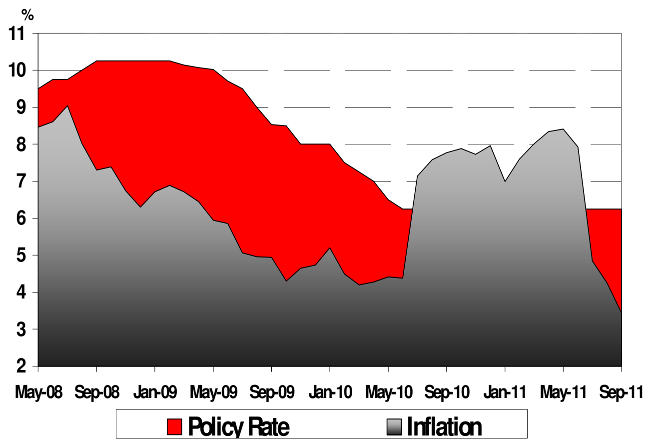
In the statement released, the Central Bank appears motivated by three factors to ease monetary conditions: the improvement in the short-term inflation outlook, the persisting negative output gap and the modest rebound in private credit. Firstly, the Central Bank emphasized the strong improvement in the short-term inflation outlook. The strong disinflationary impact of the drop in food inflation and the favorable base effects from phasing out last year's dramatic increase in the VAT rate.

In our view, this rate cut is a strong signal from the Central Bank. From an inflation targeting perspective, it reveals that the targets of 2011-2012 are not at stake. Inflation will not only remain low until the end of 2011 but also will retreat further towards the target in 2012. Vice Governor Christian Popa was quoted as saying on September 29th that inflation will most probably slow to 3% in 2012, within the 2-4% Central Bank band.

Secondly, the persisting negative output gap allows the Central Bank to be more accommodative. The Central Bank notes that industrial production and exports are performing relatively well despite the mounting negative signals from the main export markets. Romania was among those economies in New Europe which exited recession last. In fact, growth recovery has been so far only modest in 2011. Eurobank Research GDP forecast stands at 1.7%-this is short of sustainable growth. To make things worse, downside risks have increased because of the negative growth outlook in the Euroarea -the main trade partner of Romania. If another external shock materializes it is going to put more strain on the recovery momentum in 2012. Last but not least, credit conditions remain relatively tight even after three years in the post- Lehman environment.

More importantly, it is important to take note that the cut takes place in midst of volatile and unfavorable external financing conditions from tumbling markets because the deepening Euroarea sovereign crisis. Yet, that implies that the Central Bank doesn't necessarily feel less comfortable with a weaker exchange rate. To some extent this is owed to the revival of the carry trade in the domestic currency given that real interest rates are now positive (Figure 2).

Figure 2: Real interest rates are positive again in Romania after the sharp inflation decline



Source: National Bank of Romania, Eurobank Research

Additionally, there is one more important factor which weighs on the domestic macro-outlook: the new precautionary IMF agreement. The new precautionary IMF agreement provides a financing cushion in case of a new global downturn thus reducing the sovereign risk premium of the country. The third review of the new agreement was completed by the IMF mission on November 7th. The assessment contained a positive note over the fulfillment of the criteria of the program for September end. However, additional emphasis should be given to the implementation of structural reforms particularly in the area of state-owned enterprises.

Barring any unforeseen external shocks stemming from the Euroarea sovereign debt crisis, we see further rate cuts but from 2012 onwards. The rapid deterioration of growth prospects and the envisaged disinflation trend next year weighs additionally on the motives of such a decision. The Central Bank anticipates that disinflation should continue and that inflation could reach as low as 2% or even lower by March 2012.

The dovish comments of the NBR governor Mr. Isarescu at the press conference of the new inflation report point to the same direction. The governor stated that the current market conditions provide important room for additional rate cuts. Yet those cuts should be delivered in small steps so that there is no disruption for the local currency.

Those comments only served to strengthen expectations of further rate cuts and have already been discounted more or less by market participants. Thus comments didn't trigger any major moves in the FX market. On November 7th, Leu traded at 4.35/€ having depreciated approximately 2% year to date outperforming many of its regional peers. On the other hand, maintaining positive real domestic interest rates either to stimulate domestic saving or to attract capital inflows for the external financing gap is another concern to bear in mind. In conclusion, additional easing should come in bringing the key policy rate to 5.50%-5.75% at the end of Q2 2012.

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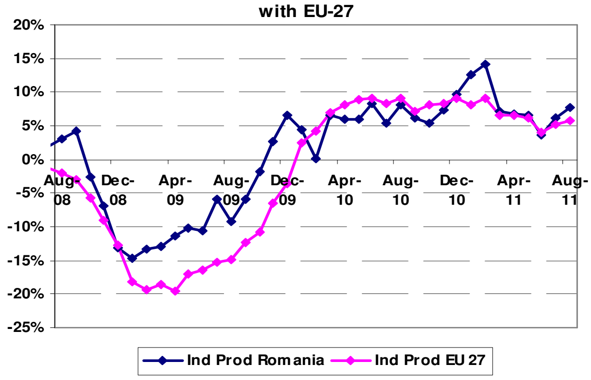
Industrial Production Outlook

For the past 2 years, the recovery of the Romanian economy has been predominantly driven by the industrial sector. Industrial production in Romania has been closely correlated with exports and industrial production in the Eurozone (as can be seen in Figure 1).



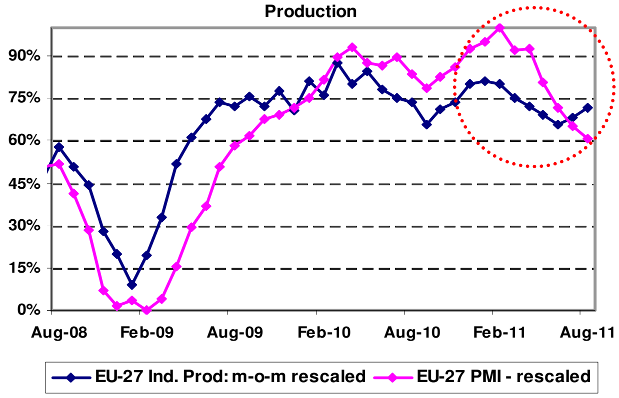
Source: Eurostat, National Statistics, Bancpost

However, as conditions in the external economy are showing signs of deterioration, analysts have come to expect a sharp slowdown in the Romanian recovery. While we agree this relationship invariably holds in the longer term, we believe there is a fair chance that growth will surprise to the upside in the short term.

Leading indicators have been the main sign that economic conditions in the European Core are worsening. EU-27 PMI fell from 54 points in May to 49 points in September, the lowest level since September 2008 (figures below the 50 threshold indicate contraction in the manufacturing sector); This trend has also been confirmed by other sentiment indicators such as the ZEW or IFO indices. While industrial production has slowed down (+5.7% in August vs. +6.1% in May on a yearly basis), the rate of deceleration has been smaller than the PMI would have otherwise indicated. This diverging dynamic is most apparent in our PMI-based forecasting models (where the forecasting error increased to approximately 1.5pp), but can also be observed in Figure 2 (which rescales EU-27 PMI and Industrial Production for the past 2 years).

This divergence may be attributed to different sensitivities of the indicators to conditions in financial markets. Leading indicators have an important sentiment component and thus are more susceptible to adverse movements in the markets. While the real economy is also influenced by conditions in the financial markets, the response is more lagged. Therefore, we expect this divergence to remain with us for the next months of the year.

Figure2
PMI has been deteriorating more quickly than Industrial Production



Source: Eurostat, Bancpost

Manufacturing in Romania shrank -1.47% on a monthly basis in June, but resumed growth shortly (+2.32% in July and +1.75% in August). This dynamic has been helped by a pickup in exports, but also by resilient domestic orders. The latter have been hovering around +11% y-o-y for the past 5 months (Polish New Domestic Orders have been similarly stable, as opposed to Hungarian and Czech ones). Managers' expectations for production in the months ahead have had a similar dynamic and remained stable around the 53 level for the past 5 months (the index shows the balance of positive answers).

Cumulatively, we believe the Romanian industrial sector can continue to prove resilient in the months ahead. By also factoring in the good harvest, it is very likely for the economy to overshoot growth expectations in 2011 (market consensus currently stands at 1.5%)

Fiscal Policy and Financing Outlook

The Romanian budget execution continues to remain comfortably within the targets agreed with the IMF. The year-to-date deficit reached 2.5% in September (-41% less than during the similar period of 2010). While the budget for 2012 still hasn't been presented to the Parliament, it is increasingly likely that the Government will face severe headwinds in meeting its targets.

The fiscal strategy for 2012 initially saw a budget deficit of 3% of GDP and was relying on a rate of expansion for the economy of +3.5%. However, adverse developments in the external economy will force the Government to revise the rate of expansion downwards (Government officials were recently quoted referring to the figure of +2.1%).

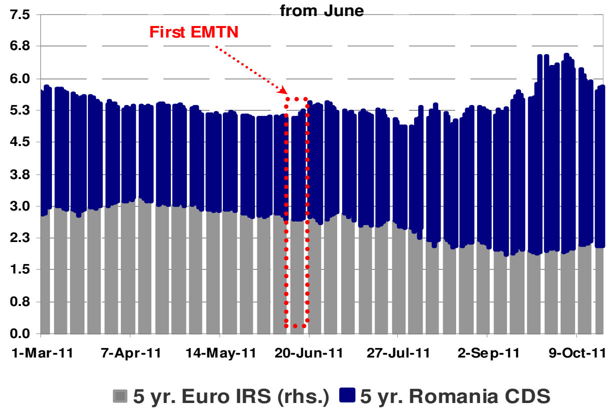
Both the President and PM have recently asserted the deficit will be lower than 3% in order to comply with the Maastricht treaty conditions and avert the excessive deficit procedure from the European Commission. This however, will be a very tall order and will call for new and significant spending cuts in the budget; On the upside, the better than expected budget execution in 2011 will create space for the Government to bring forward some of the 2012 spending.

Funding conditions for public debt have become more stringent during the past three months. In this period, the MoF has rejected 4 tenders in the primary market cumulatively worth RON 2.3bn (€ 1.6bn). Moreover, the average rate of collection for new issues also fell to 50% from an average of 99% for the first 8 months of the year. As we asserted in the October New Europe Bulletin, the MoF recently announced its intention to tap international markets in November. Deputy Finance Minister B. Dragoi has also confirmed the Treasury plans to access the US market. Recently, the MoF has made public the list of eight banks picked to manage and the two legal advisers for the €7bn programme.

Market conditions for this type of issue have fluctuated wildly for the past two months. The Romanian 5yr CDS stood at 254bp. in June (at the time of the first EMTN), spiked to 462bp. at the beginning of October, and later dropped to the current levels of 380bp. The 5-yr. Euro IRS fell from 1.8% in June to a minimum of 1.03% at the end of September, and stands currently at 1.4%. Market conditions are pictured in Figure 3.

Cumulatively, we believe these conditions set the stage for a relatively expensive issue and may push yields above 5.75%. Despite these higher costs, we expect the Government to try push through a larger amount of debt than at the first EMTN (€1.5 bn) due substantial risks that lie ahead.

Figure 3
Market conditions for a new EMTN issue have deteriorated from June



Source: BNR, Bloomberg, Bancpost

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