



National Bank of Romania

Romania: Recent Macroeconomic & Banking System Developments

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Macroeconomic Snapshot

Before the crisis

- Fast economic growth in 2001-2008 (6.3% average annual growth) fuelled by large capital inflows:
 - ✓ Rapid wage growth and readily available credit led to a real-estate and consumption boom
 - ✓ An expansionary fiscal policy further contributed to the overheating of the economy



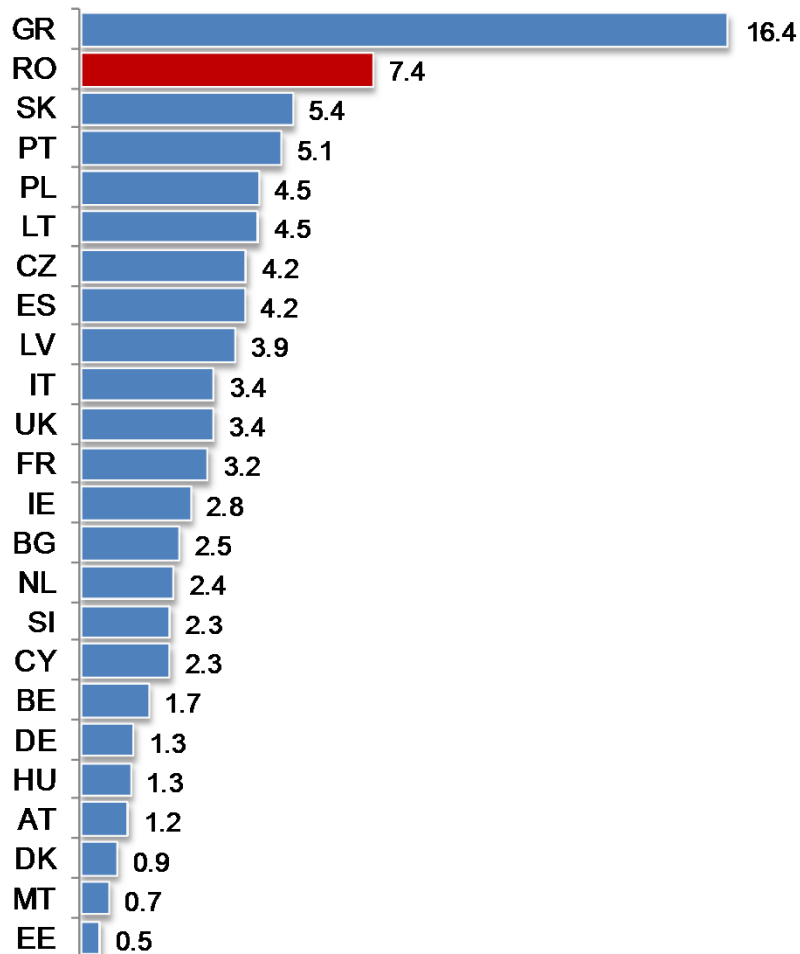
- Build-up of large imbalances in the pre-crisis period ➡ vulnerability of the economy at the crisis onset
 - ✓ Large structural fiscal imbalances ➡ no room for fiscal stimulus, consolidation unavoidable given financing constraints
 - ✓ Sizeable external disequilibrium (the current account deficit peaked at 13.4% of GDP in 2007)

Necessary adjustments already made

- The current account deficit declined to sustainable levels (4.4% of GDP in 2012, 1.1% of GDP in 2013)
- Sharp fiscal consolidation brought the deficit back into the comfort zone (below 3% in 2012, narrowing further to 2.3% in 2013, down from 9% in 2009)
 - ✓ The deadline for the adjustment of the excessive deficit (2012) was complied with
 - ✓ Despite growing rapidly during the crisis, the public debt-to-GDP ratio is still one of the lowest in the EU and is estimated to stabilize below 40% of GDP over the medium term

Cumulative structural fiscal consolidation 2010-2013

(pp. of GDP, "+" is consolidation)

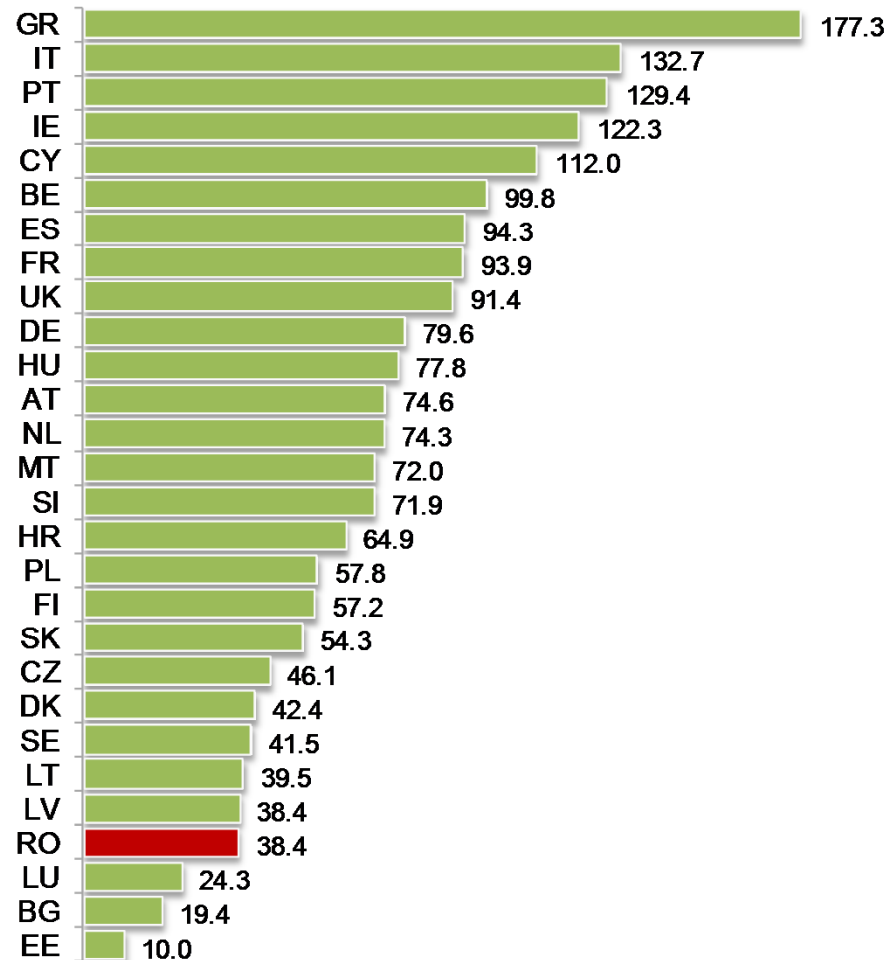


Source: AMECO

Public Debt (2013)

– according to ESA95 –

percent of GDP



Outlook for 2014 and beyond

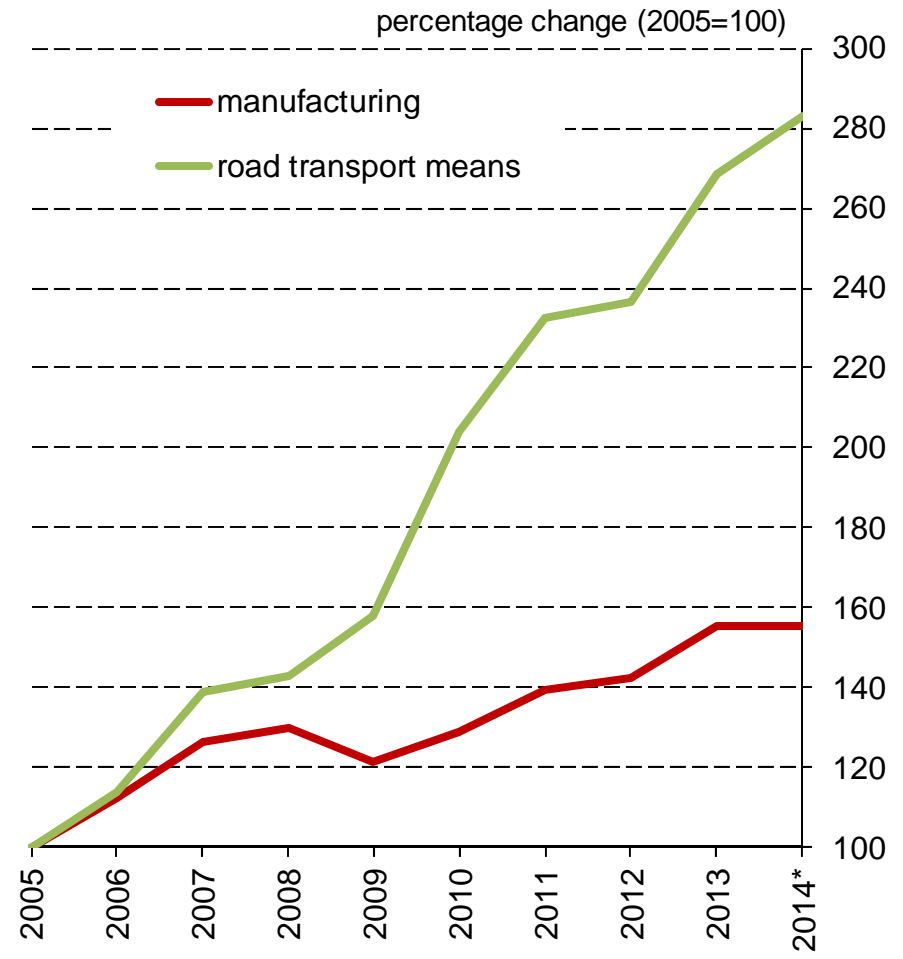
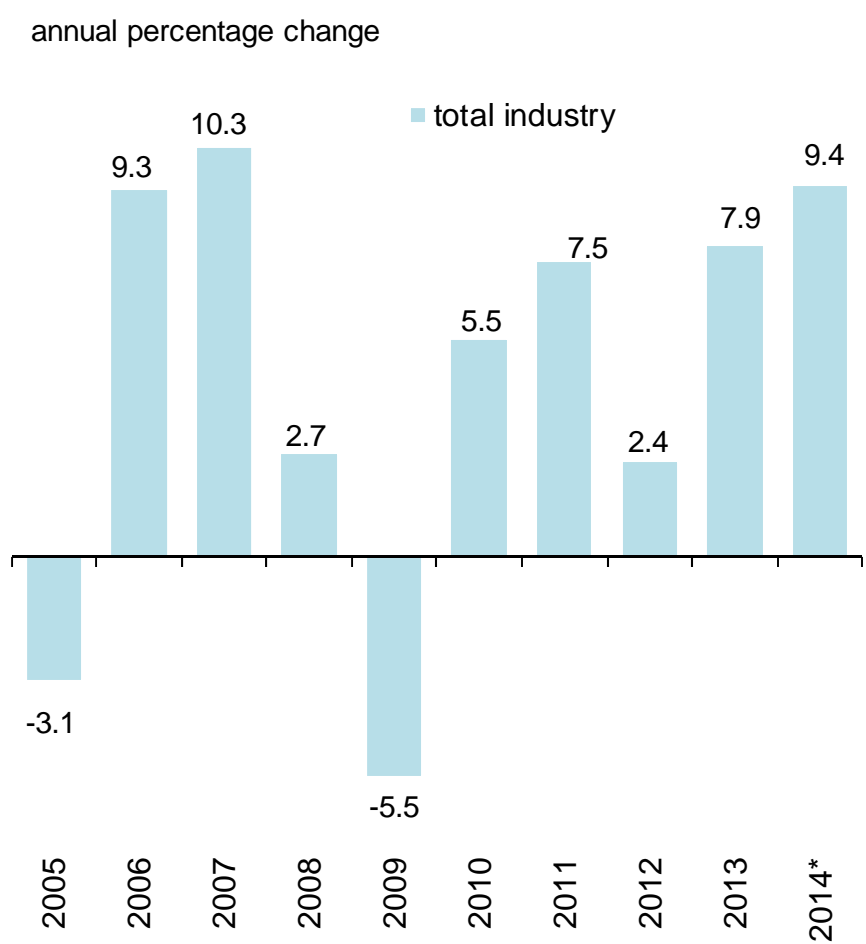
- Expected macroeconomic outcomes in 2014:
 - ✓ Economic growth looks set to continue
 - current forecasts average around 2.8%, yet recent forecasts indicate higher growth (above 3%) than earlier ones
 - as always, agricultural output may shift the actual outcome in either direction
 - ✓ Average annual inflation is estimated at around 2%, consistent with the ECB's definition of price stability
 - ✓ The fiscal deficit will stay below the Maastricht Treaty limit of 3% of GDP
 - ✓ The current account deficit is expected to stay relatively close to its 2013 level (between 1% and 2% of GDP)
- Given its macroeconomic fundamentals, Romania appears firmly embarked on a sustainable growth trend in the medium run, while actual outcomes depend on regional, European and global developments
- In this context, Romania envisages joining the Banking Union and the euro area when the appropriate conditions are in place

GDP Dynamics

GDP growth accelerated in 2013

- After a cumulative 7.6% contraction over 2009-2010, real GDP re-entered positive territory in 2011 and grew by 3.5% in 2013
- In 2013, there was a shift in the drivers of economic growth, from domestic absorption to net exports
 - ✓ However, there was a significant one-off component of economic growth, related to the plentiful harvest (1.1 pp contribution of agriculture to real GDP growth)
- Economic activity is expected to grow further in 2014, as suggested by current developments in short-term indicators (industrial production and retail sales in particular)

Fast growth in the automotive sector has been the largest contributor to the favourable performance of the overall industrial sector

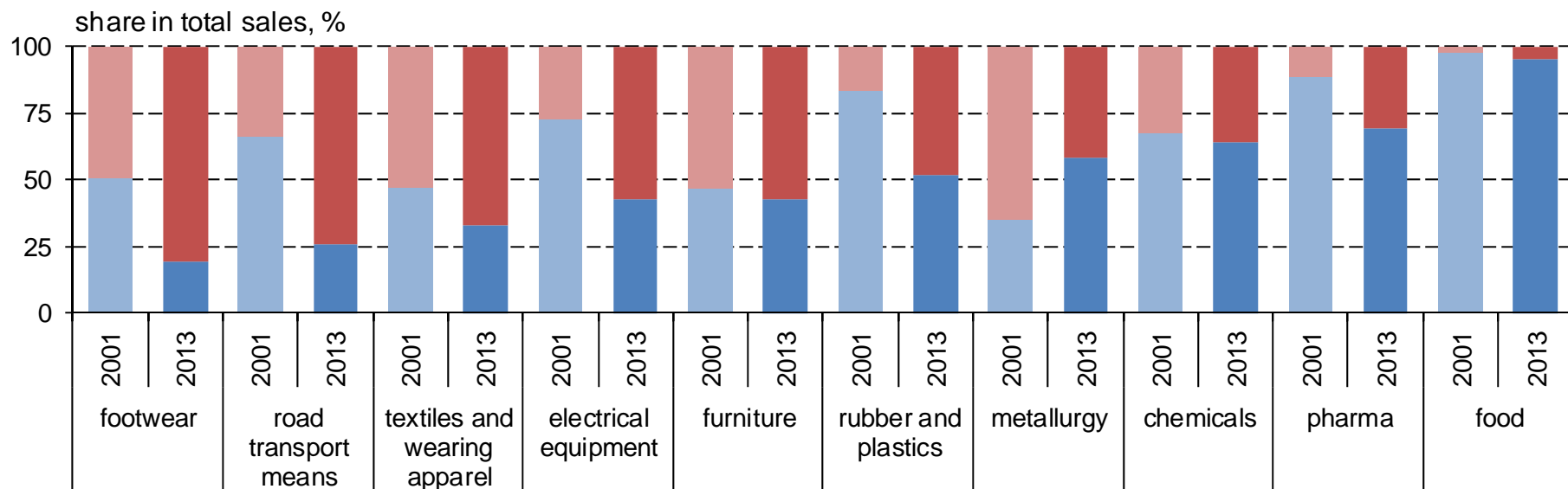
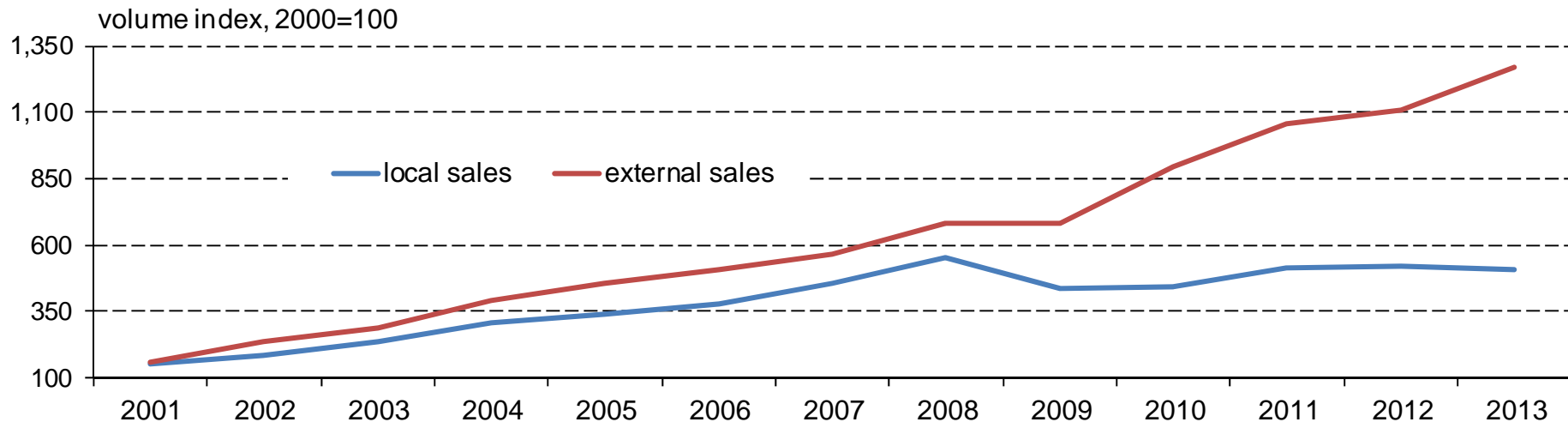


*) Jan.-Feb.

Source: NIS



Improved access to external markets favoured industrial expansion



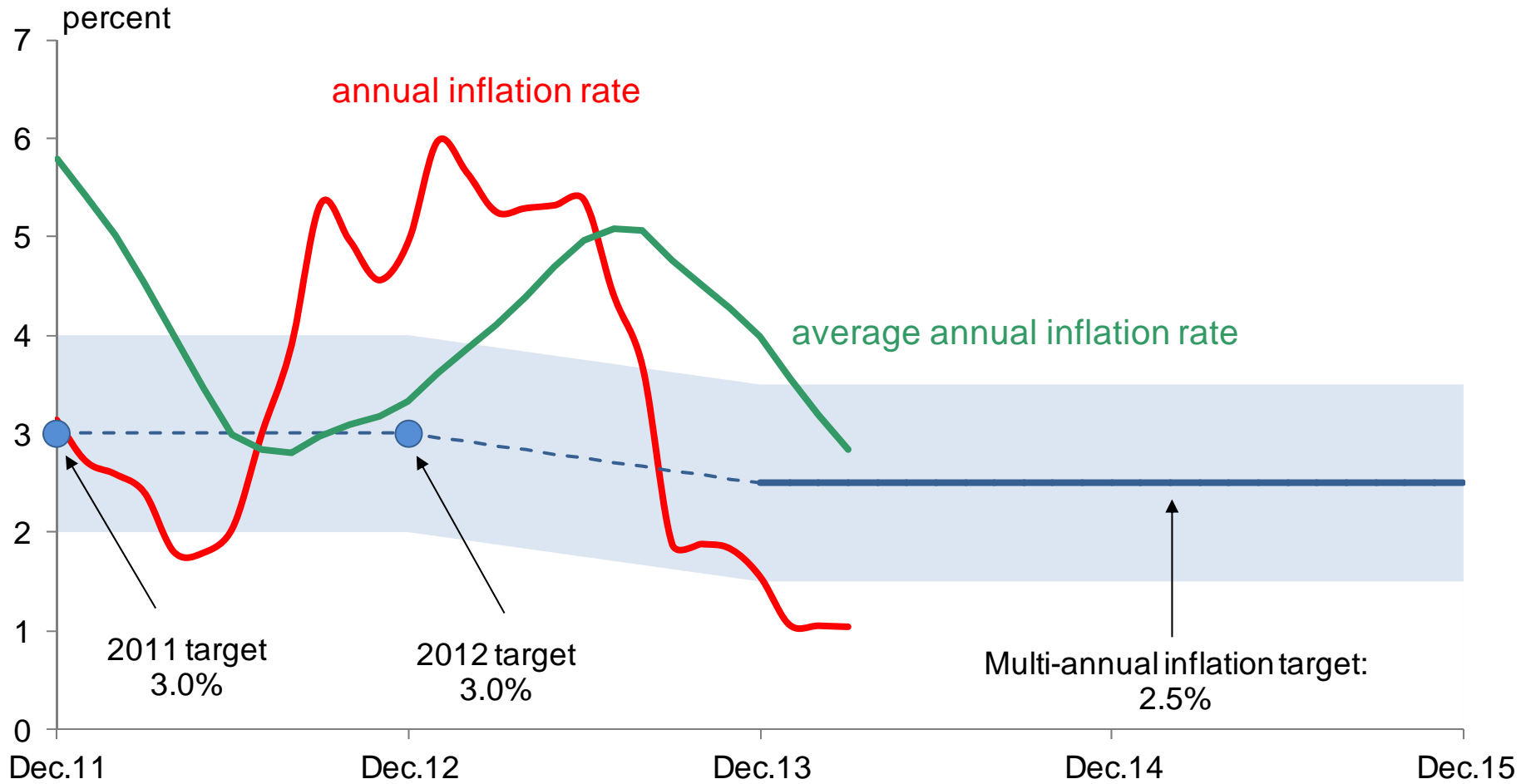
Source: Eurostat, NBR calculations

Inflation Developments

Romania joined the club of low-inflation countries

- Currently, the annual inflation rate is in line with the ECB's quantitative definition of price stability
- After staying above 5% throughout 2013 H1, annual CPI inflation fell markedly to 1.55% in December 2013 and hit a new record low of 1.04% in March 2014 in the context of:
 - ✓ Persistence of the negative output gap
 - ✓ Favourable developments in supply-side factors
 - the fall in agricultural commodity prices (as a result of good harvest in 2013)
 - the cut in the VAT rate on some bakery products from 24% to 9% as of 1 September 2013
 - the year-on-year decline in global commodity prices
 - ✓ Downward statistical base effects linked to past increases in food and administered prices
- Inflation is expected to re-enter the target band in 2014 Q3 and to remain there throughout the projection horizon

Inflation rate



Note: Variation band is ± 1 percentage point around the central target.

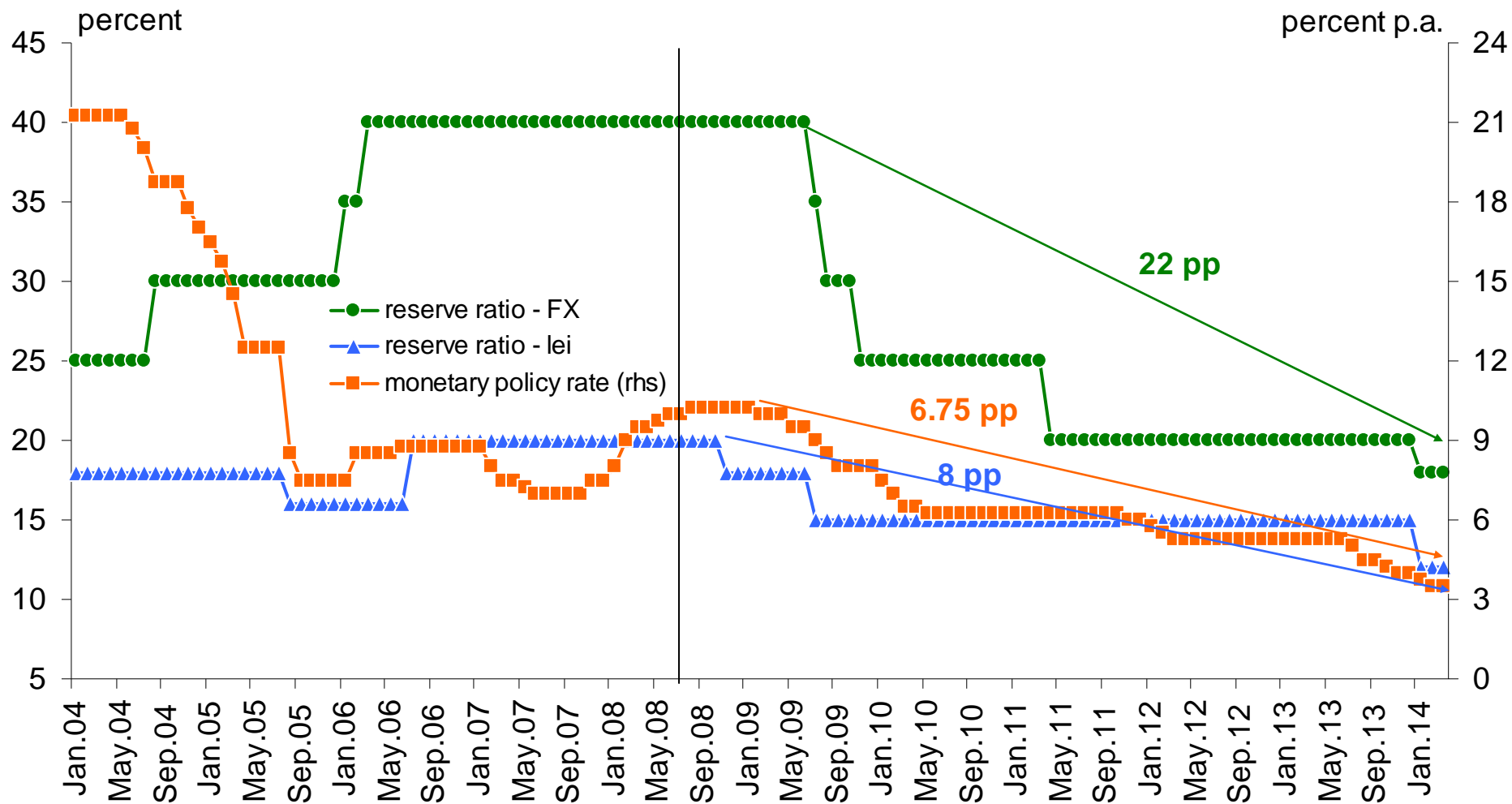
Source: NIS, NBR

Monetary Policy

Monetary policy conduct brought credit market parameters into line with regional levels

- Over the past years, the NBR has maintained a prudent stance of monetary policy, by gradually reducing the policy rate:
 - ✓ Between February 2009 and March 2012, the NBR cut the policy rate by a cumulative 500 basis points, to 5.25%
 - ✓ Rapid decreases in the annual inflation rate made it possible for the NBR to resume the downward adjustment of the policy rate: between July 2013 and February 2014, the NBR cut the policy rate by a cumulative 175 basis points, to 3.5%
- Current policy and money market rates, as well as lending and deposit rates for non-bank customers, are broadly in line with regional levels
- In January 2014, in order to support sustainable lending, but also to bring the minimum reserve requirements mechanism closer to ECB standards, the NBR cut the MRR:
 - ✓ On leu-denominated liabilities to 12% from 15%
 - ✓ On foreign currency-denominated liabilities to 18% from 20%

Monetary policy conduct was countercyclical both before and after the crisis outbreak

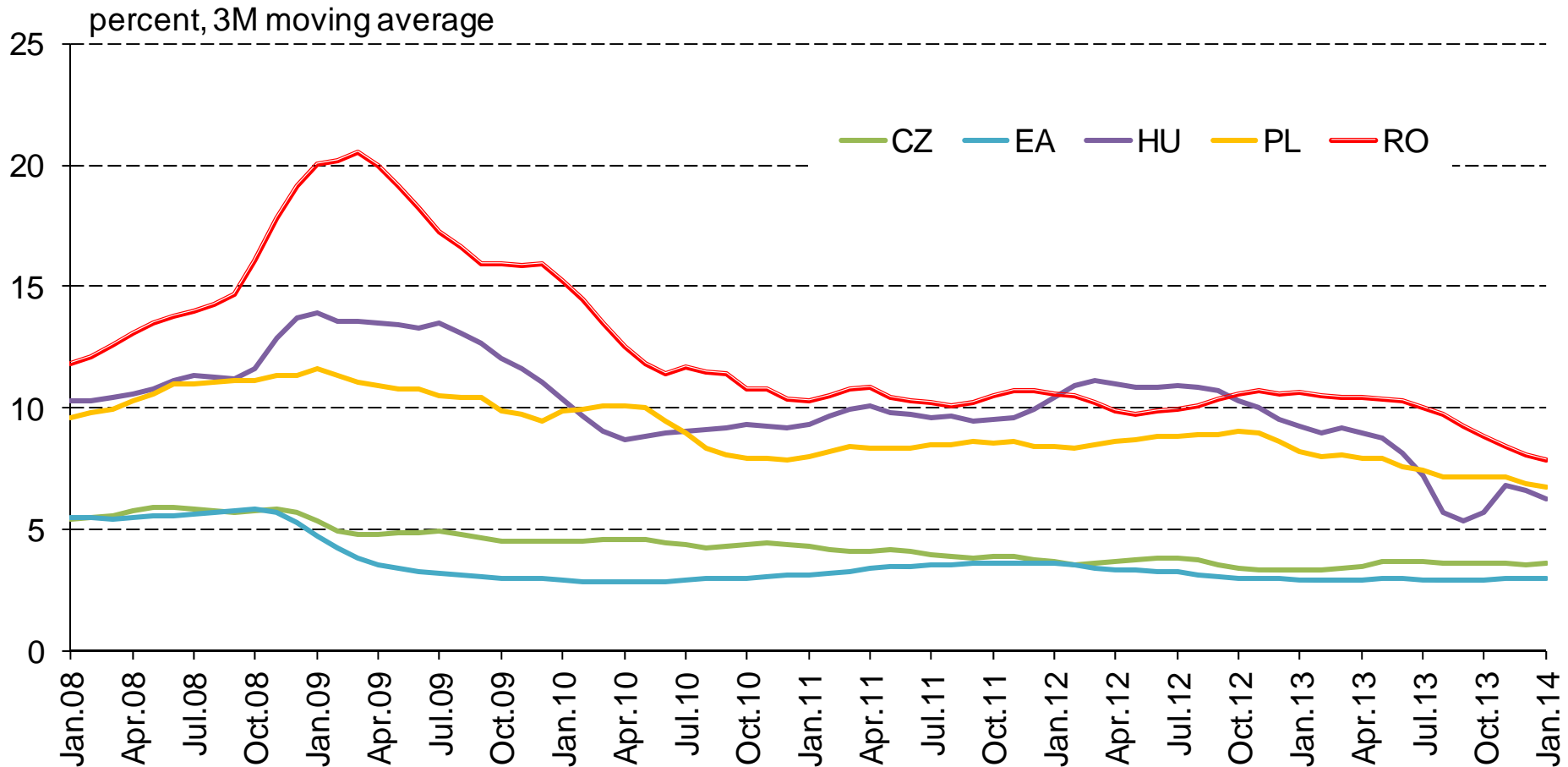


Source : National Bank of Romania



Lending rate on new business got closer to regional levels, albeit with a certain lag ...

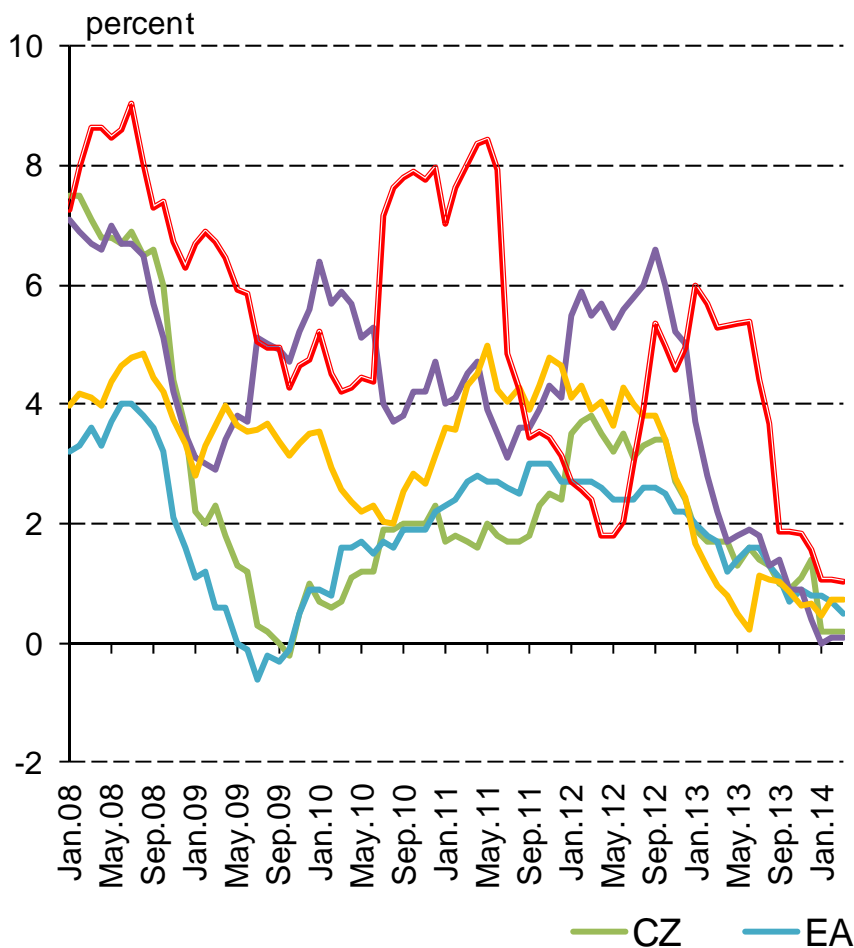
Average lending rate on new business, all sectors



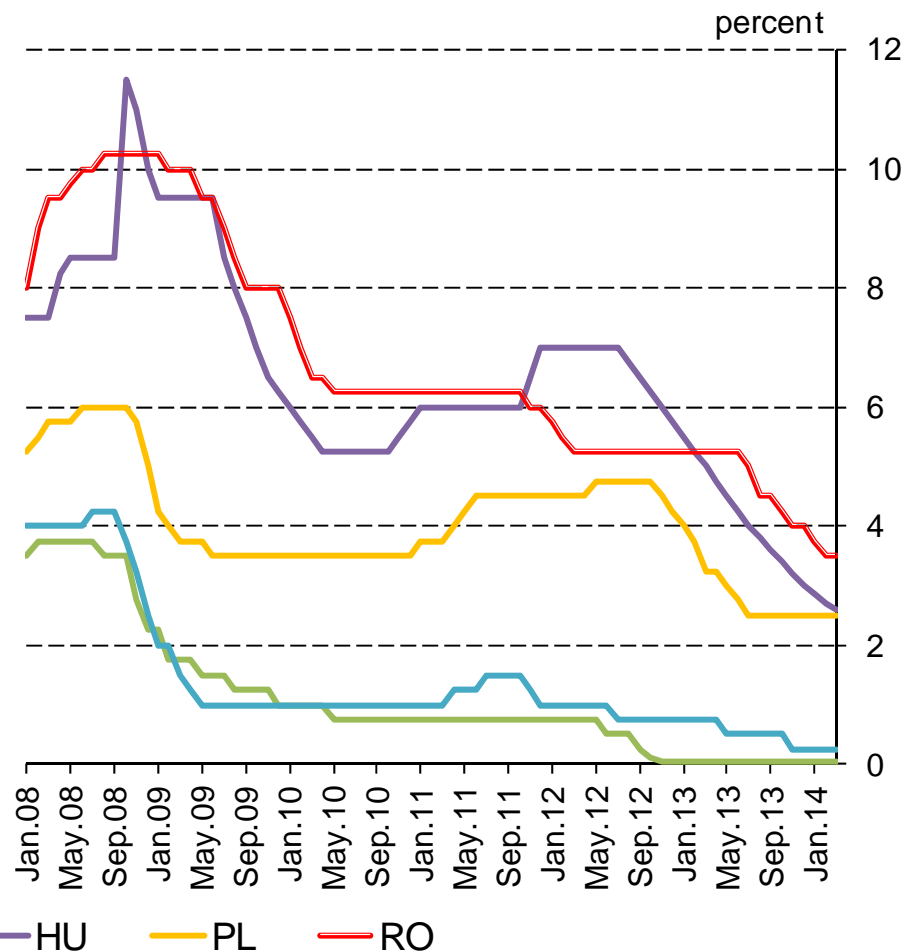
Source: ECB, national central banks

... as higher inflation delayed the start of the policy rate-cutting cycle in Romania

Annual inflation rate



Policy rate



Source: ECB, national central banks

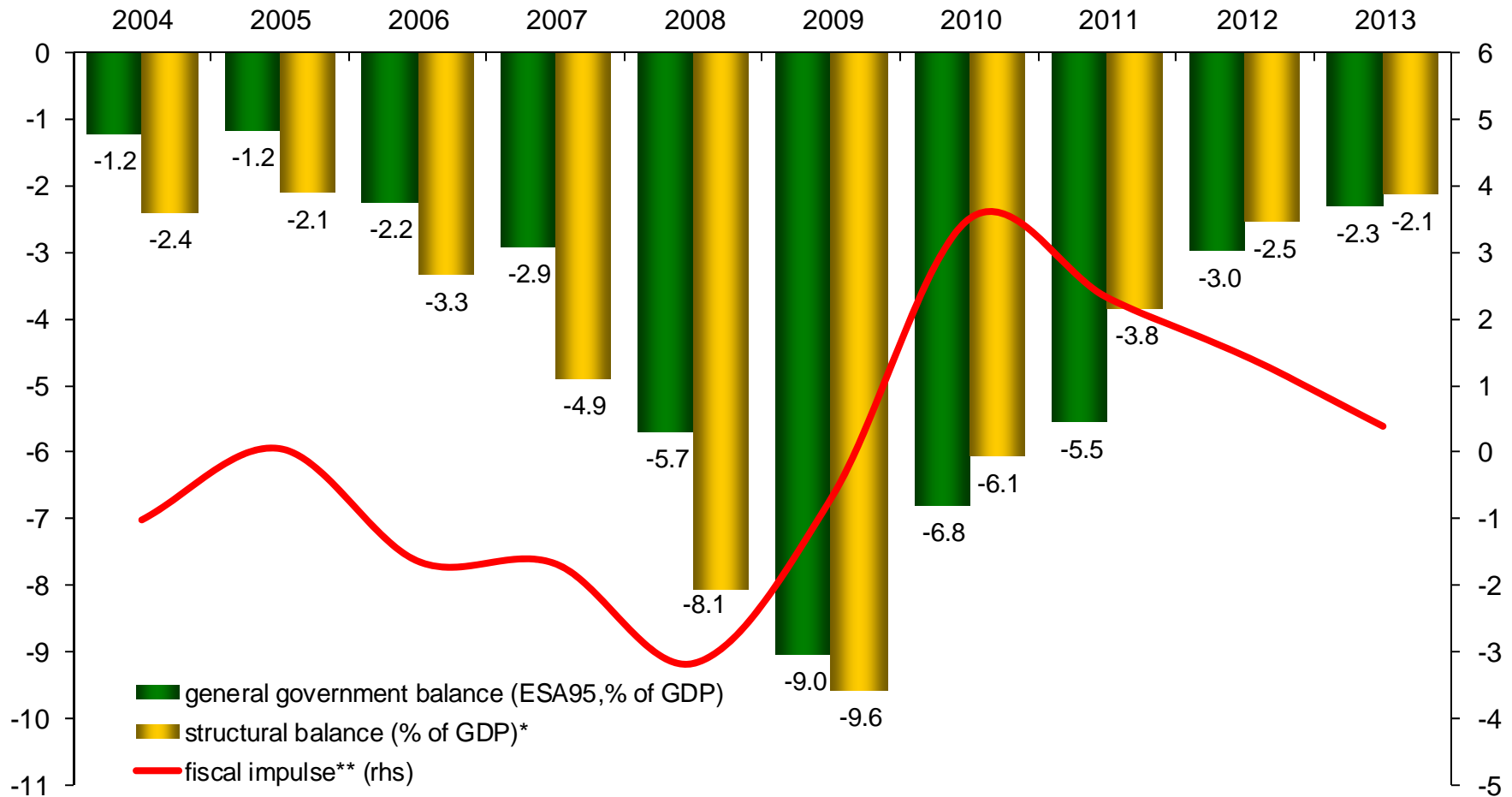


Fiscal Policy

Fiscal consolidation largely completed

- After years of pro-cyclical fiscal policy, Romania was left with a **large structural fiscal gap at the onset of the economic crisis** (-8.1% of GDP at the end of 2008) and with no other choice but to embark on a **sharp fiscal consolidation process**
- After peaking at 9% of GDP in 2009, the public deficit was successfully brought down to just below 3% as of end-2012, thus complying with the deadline under the excessive deficit procedure; the deficit declined further to 2.3% of GDP in 2013
- The **structural adjustment effort** amounted to a cumulative 7.4 pp of GDP during 2010-2013 (the second largest in the EU) and it was achieved through a mix of revenue and expenditure measures, with the latter accounting for the larger share
- A comparatively smaller structural adjustment effort remains to be implemented over the coming two years (1.1 pp of GDP) in order to ensure that the **medium-term structural deficit objective** of 1% of GDP is met in 2015, thus complying with commitments under the Fiscal Compact

After three years of sharp consolidation, the budget balance is back into the comfort zone



* defined as cyclically-adjusted balance net of one-off and temporary measures

** defined as the change in the structural primary budget balance

Source: AMECO, Ministry of Public Finance, European Commission

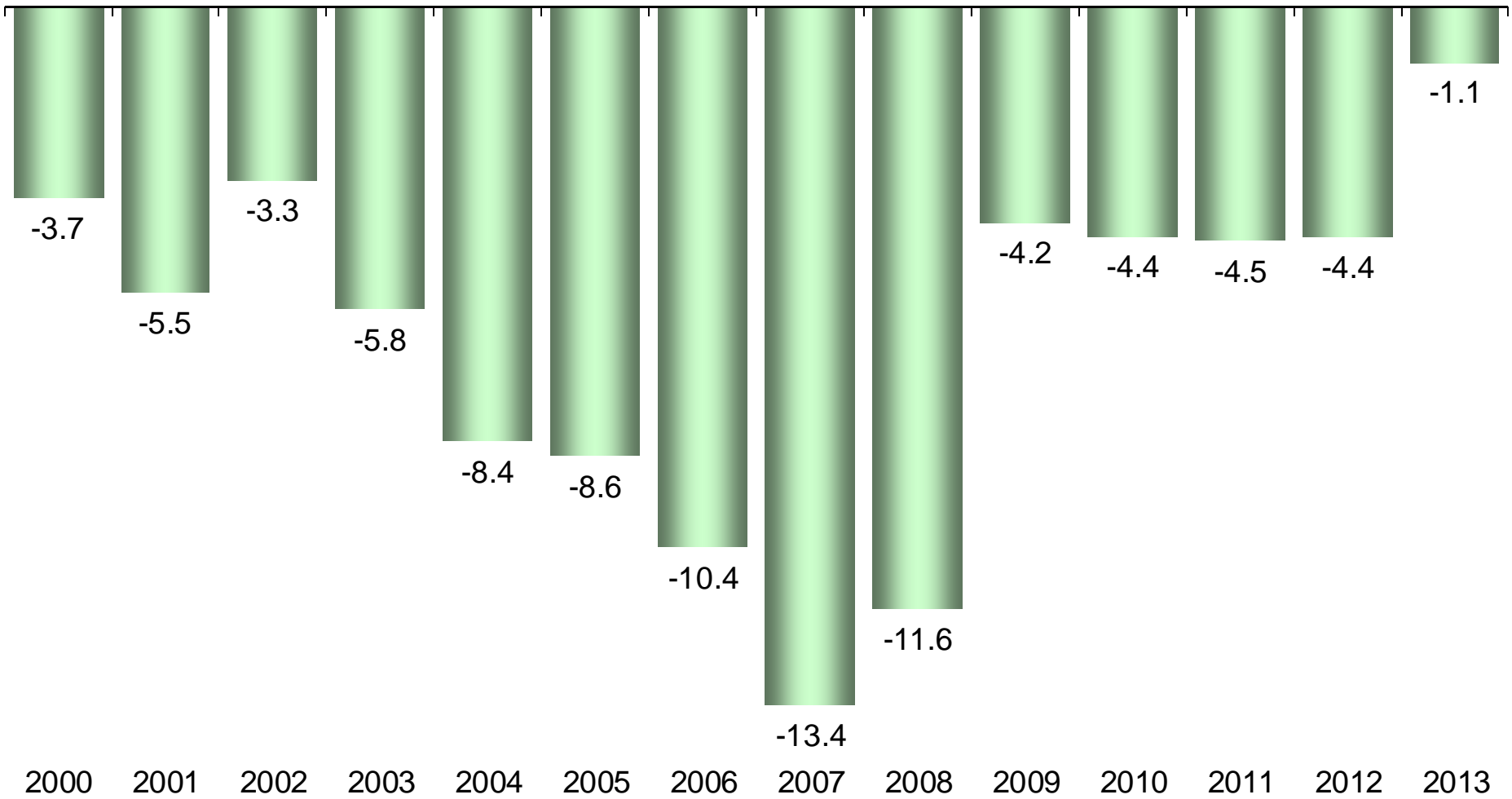
Current Account

Significant adjustment of the external imbalance

- The current account deficit narrowed markedly from a peak of 13.4% of GDP in 2007 to 4.2% in 2009, driven by the private sector and supported by fiscal consolidation
- After hovering around 4% of GDP in the following three years, the current account deficit further fell to 1.1% of GDP in 2013 amid
 - ✓ The trade deficit narrowing by 53.6% yoy
 - ✓ The larger services surplus, prompted particularly by receipts from transport services (in correlation with higher exports of goods)
- Recent projections for 2014 and 2015 point to levels below 2% of GDP, in line with the gradual consolidation of domestic demand
- At end-March 2014, international reserves stood at EUR 34.4 bn (out of which EUR 31.3 bn forex), covering over 6 months of prospective goods and services imports

Current Account Balance

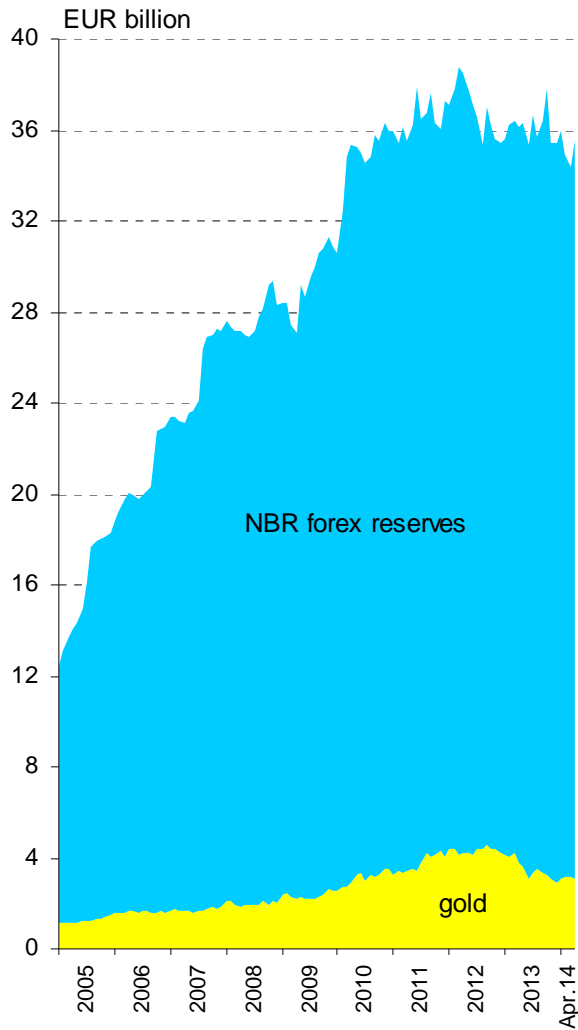
percent of GDP



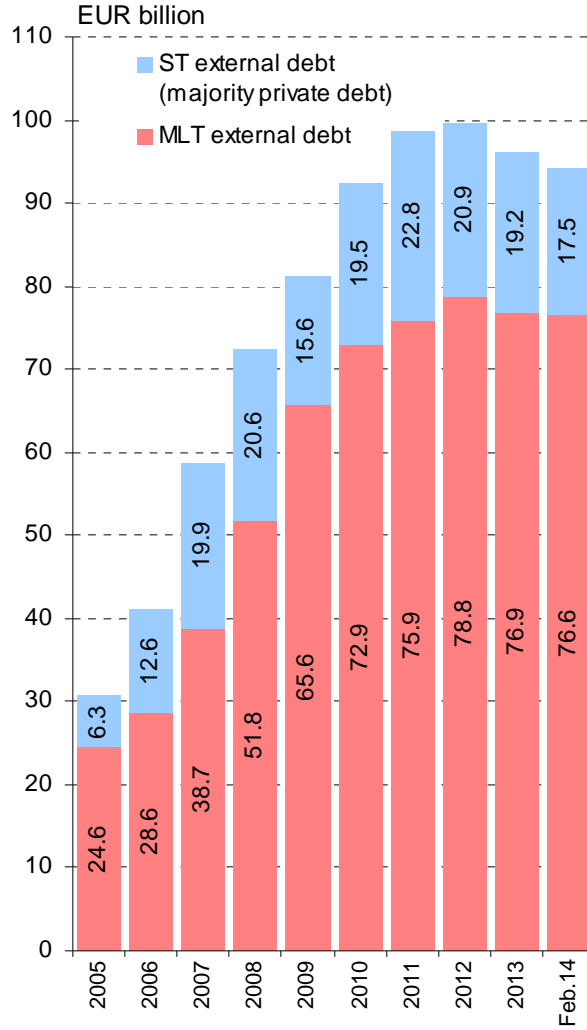
Source: National Bank of Romania, National Institute of Statistics

International reserves and external debt

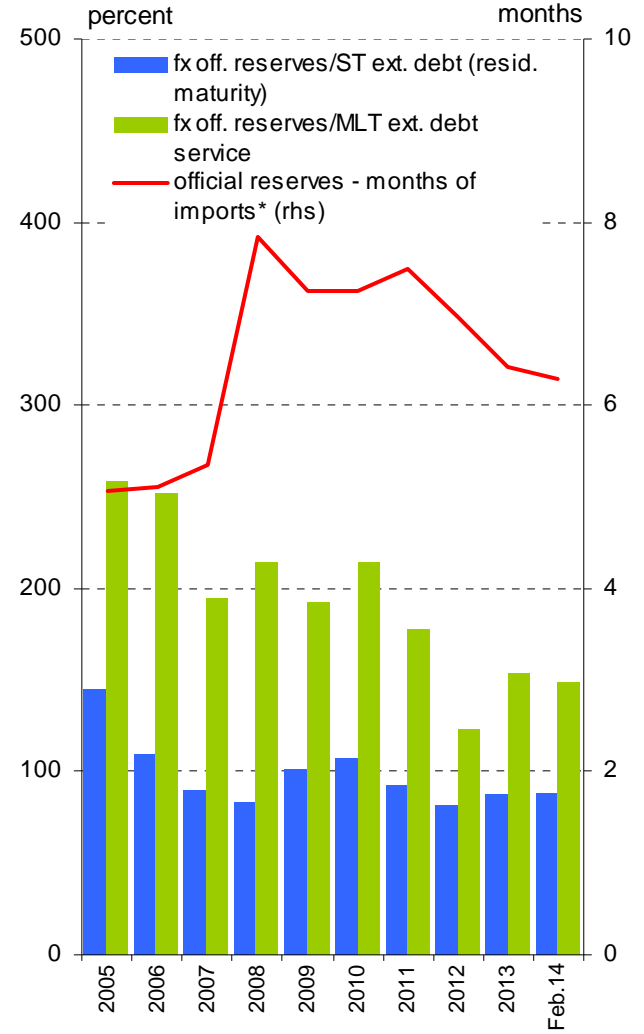
International reserves



Total external debt



Reserve adequacy



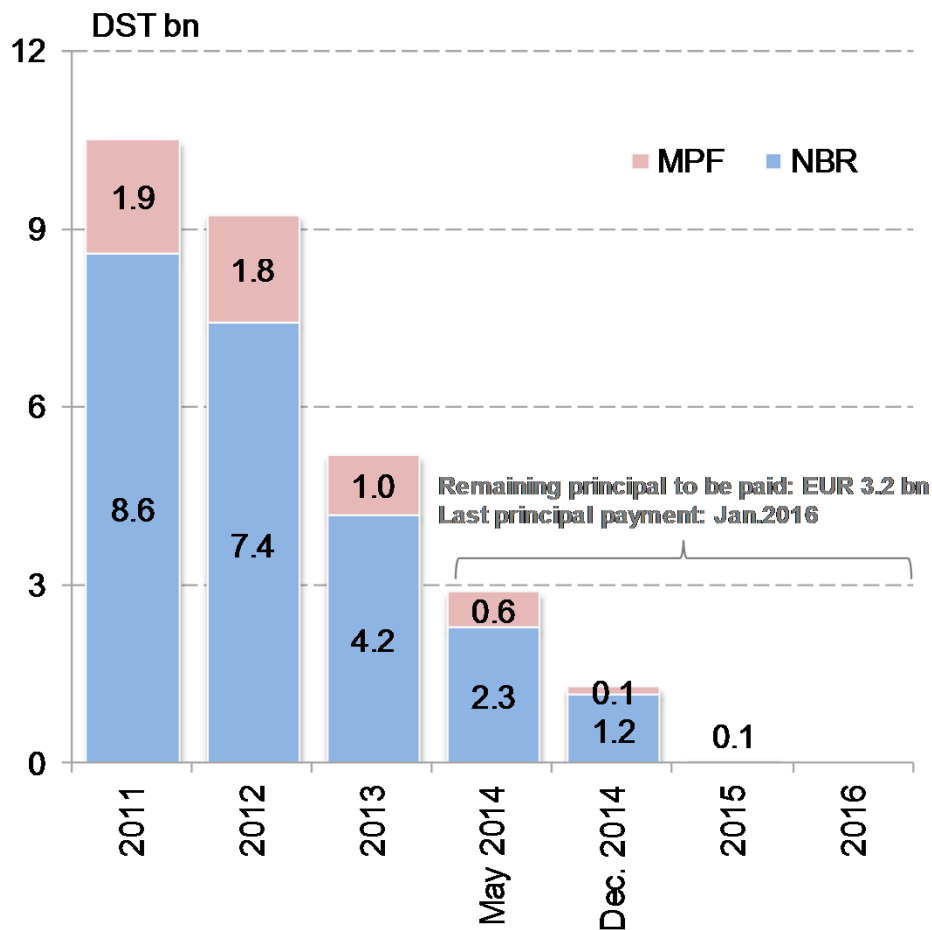
*) prospective imports of goods and services

Source: National Bank of Romania

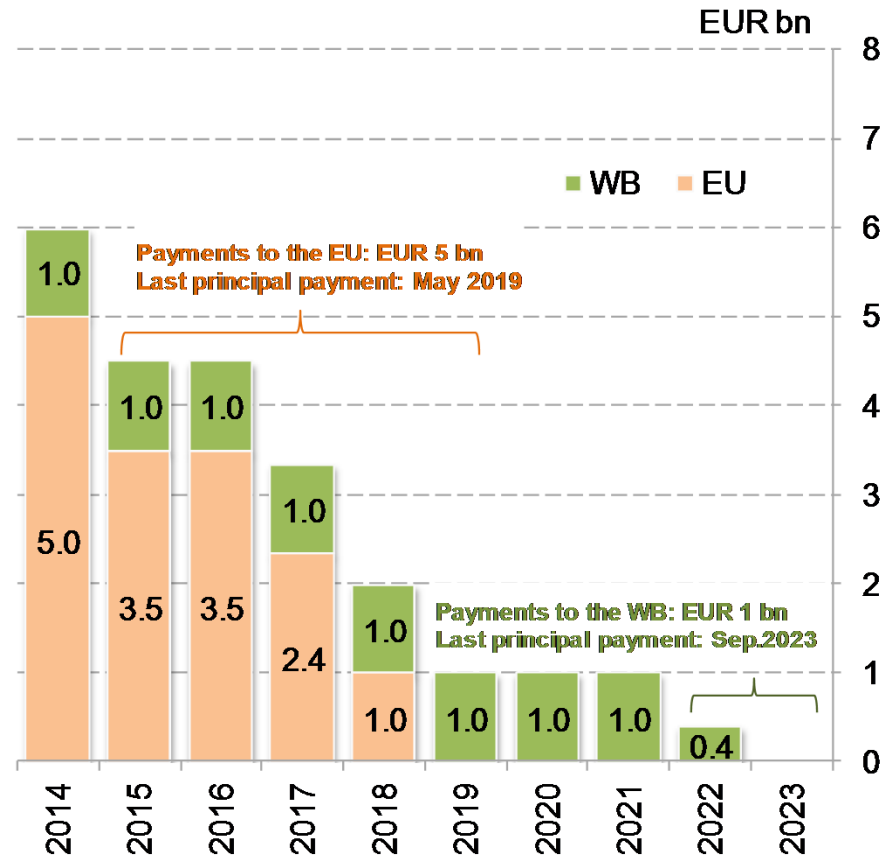


Most of the IMF loan already repaid

Outstanding debt to the IMF



Outstanding debt to the EU and World Bank



Source: NBR, MPF

Banking System

The banking system remains sound

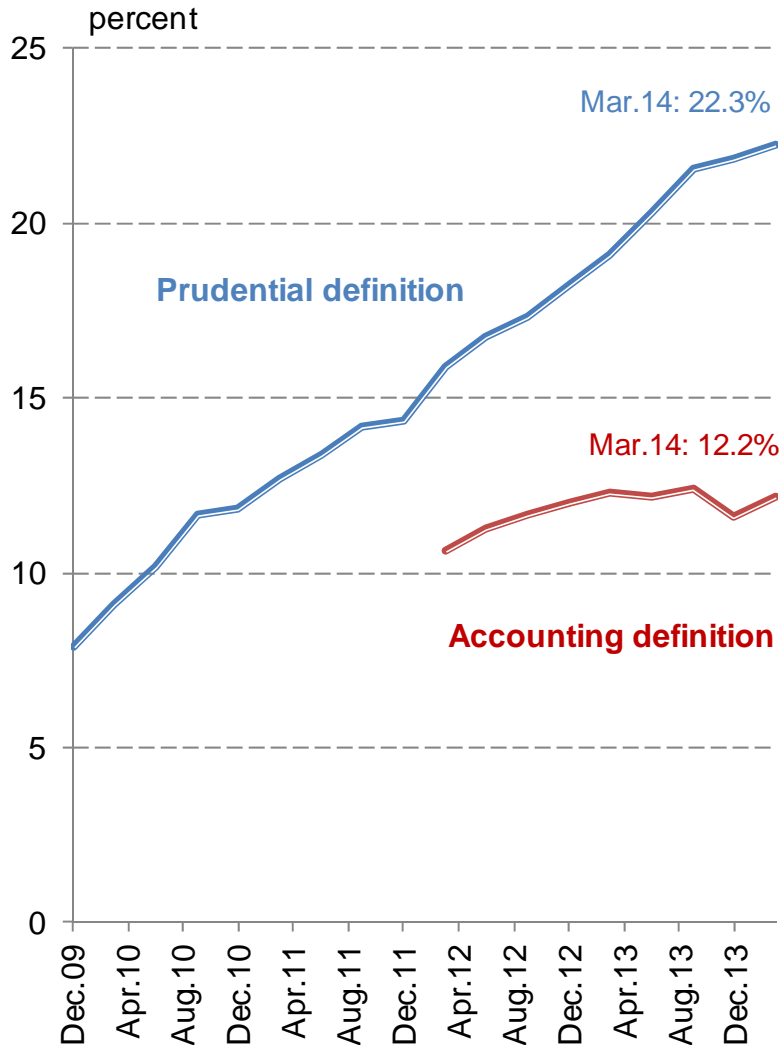
- The banking system is well capitalized, with the average capital adequacy ratio at 15% (headline) and 13.7% (CT1) at end-2013
 - ✓ The NBR is exercising tight oversight of prudential indicators, with a focus on capital adequacy dynamics and banks' efforts to raise additional capital
 - ✓ Most banks exceed the conservative 10% threshold recommended by the NBR (against the required level of 8%)
 - ✓ No public funds have been used so far to support the banking sector
- The liquidity ratio (effective liquidity/required liquidity) remained adequate (1.5 in February 2014)
- In 2013 the banking system profitability re-entered positive territory and remained positive in early 2014

The banking system remains sound (2)

- NPLs continued to increase in 2013 and early 2014, albeit at a slower pace than in previous years, mainly due to
 - ✓ Revaluation of the quality of previously-restructured loans
 - ✓ Constraints on customers' financial standing

- Provisioning of NPLs is adequate
 - ✓ NPL coverage with IFRS provisions and prudential filters remained at a comfortable 89.9% at end-March 2014
 - ✓ If only IFRS provisions are taken into account, the degree of NPL coverage was 67.6% at end-March 2014

NPL ratios currently used by the NBR



Source: NBR

PRUDENTIAL DEFINITION*

Ratio of

Gross exposure of loans and related interest overdue for more than 90 days and/or for which legal proceedings were initiated

To

Total classified loans and interest for non-bank **non-government** customers, except off-balance-sheet items

- The ratio is compiled for banks applying standard approach (banks using internal models are not included)

The level of NPL net of IFRS provisions is 7.2% in March 2014 (representing the 33.4% of NPLs not-covered by IFRS provisions)

* This definition is compliant with the provisions of the IMF's Compilation Guide on Financial Soundness Indicators and allows international comparisons

ACCOUNTING (IFRS) DEFINITION

Ratio of

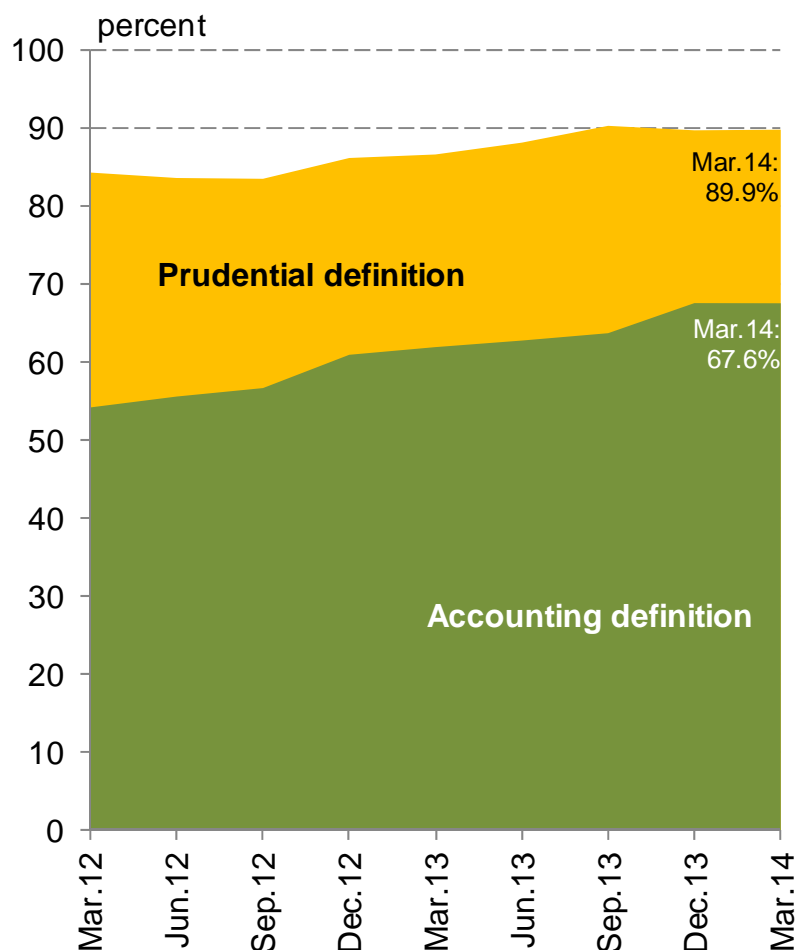
Impaired loans to non-bank clients** (net value)

To

Total non-banking loan portfolio (net value)

** According to IAS 39 – Financial Instruments – Recognition and Measurement, a financial asset is impaired and impairment losses are incurred if there is objective evidence of impairment as a result of one or more events that occurred after the initial recognition of the asset and that loss event (or events) has an impact on the estimated future cash flows of the financial asset or group of financial assets that can be reliably estimated

NPLs coverage with provisions



Source: NBR

PRUDENTIAL DEFINITION

IFRS provisions and prudential filters for NPLs / NPLs

- ❖ Including prudential filters in the calculation of the indicator is warranted by the fact that the prudential filter is an amount deducted from own funds in order to increase banks' capacity to absorb losses from credit risk
- ❖ Prudential filters will be gradually phased out during 2014-18 (by 20% per year), in the context of implementing the new Basel III capital requirements in the Romanian banking system via the CRDIV/CRR package

ACCOUNTING DEFINITION

IFRS provisions for NPLs / NPLs

EBA new indicator of asset quality analysis: non-performing exposures ratio

➤ Overall estimated value as at 31 December 2013: **17.4%**

➤ New definition:

Ratio of

- (i) Material exposures which are more than 90 days past-due **and**
- (ii) Exposures incurring the risk of not being paid in full without realisation of collateral, regardless of the existence of any past-due amounts or of the number of days past due

To

All debt instruments (loans, advances and debt securities) entered in the balance sheet and in off-balance sheet accounts, as well as in the trading portfolio

- The EBA definition covers **both government and non-government exposures**

➤ **Methodological details:**

- ✓ All debt instruments (loans, advances and debt securities) recorded in the balance sheet and in off-balance sheet accounts, as well as in the trading portfolio, are included
- ✓ All on- and off-balance sheet exposures to a certain debtor are considered as non-performing exposures in case that the debtor has a more than 90 days past-due exposure accounting for at least 20% of all its total exposures or that the overdue amounts of the debtor hold at least 5% of the bank's total exposure to the debtor
- ✓ Exposures are considered to have ceased being non-performing when the following conditions are met simultaneously: 1) the situation of the debtor has improved to the extent that full repayment of all amounts due according to the original or when applicable the modified conditions is likely to be made and 2) the debtor does not have any past-due amounts

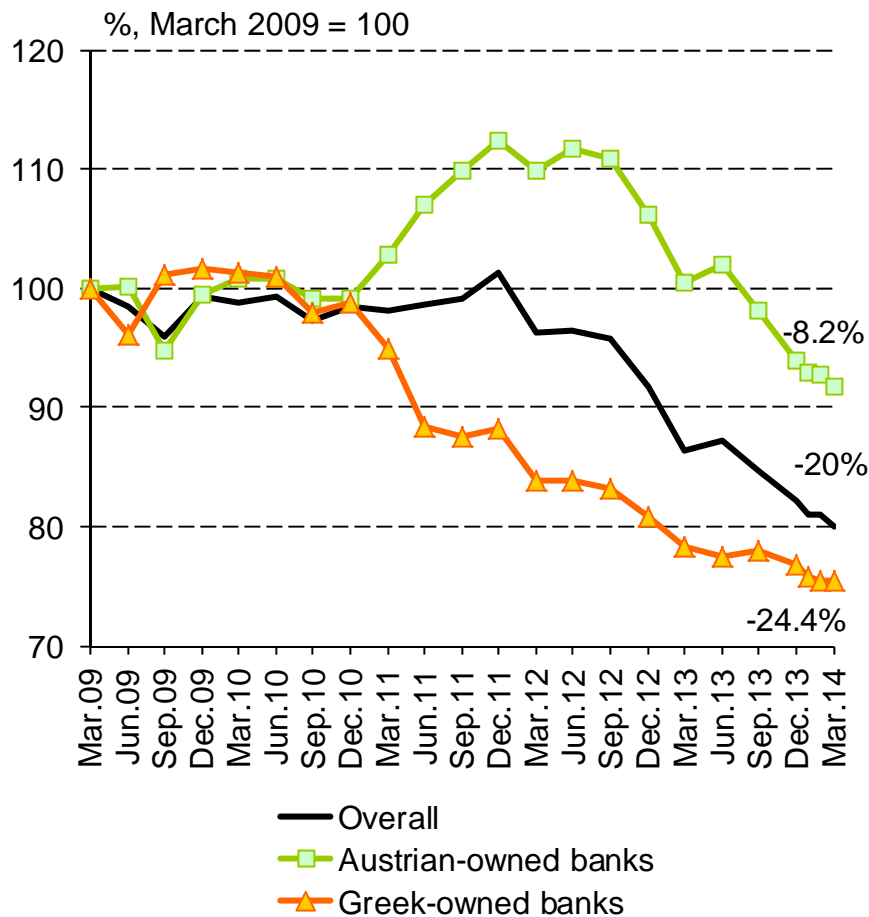
➤ **Reporting:** frequency: quarterly; first reference date: 30 September 2014;
first reporting deadline to the NBR: 31 December 2014

Orderly financial deleveraging in the crisis aftermath

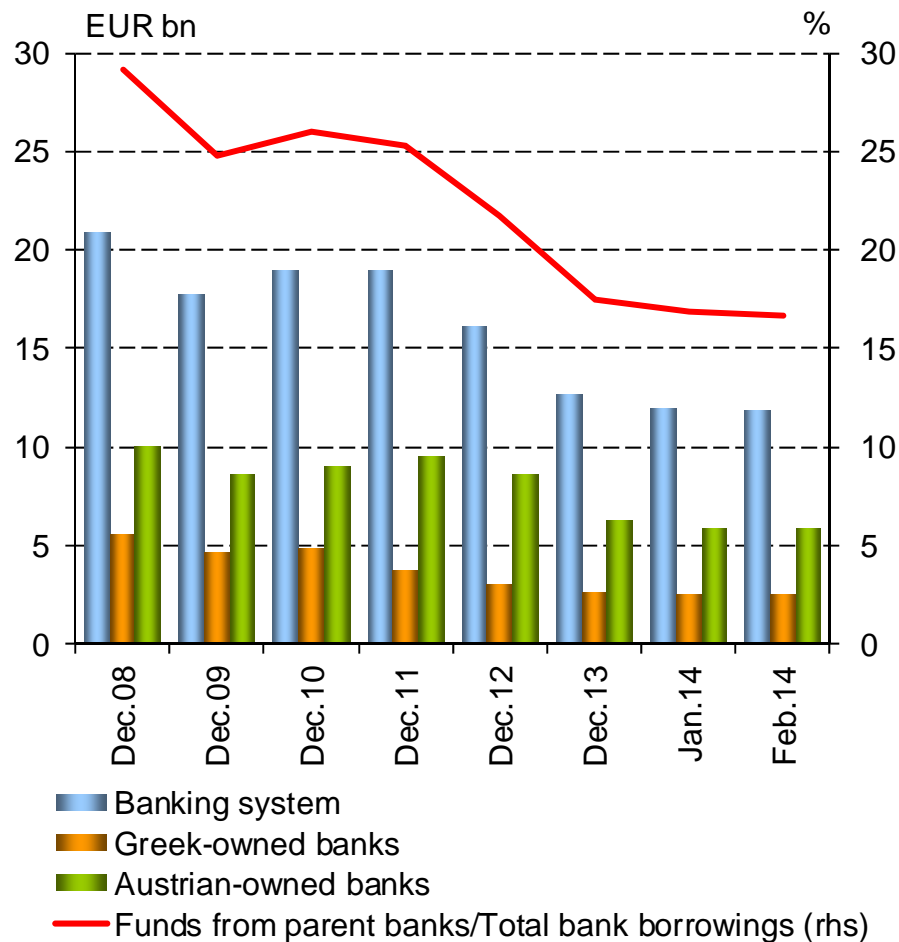
- The loan-to-deposit ratio fell to 101.8% in March 2014, underpinned by credit to the private sector declining by 3.7% yoy in real terms and bank deposits increasing by 5.5% yoy
- Foreign banks participating in the Vienna Initiative reduced their exposure to Romania by 20% between end-March 2009 and March 2014
 - ✓ The decline in parent banks' exposure was largely confined to Greek-owned banks
- The adverse effects of the deleveraging process initiated by large European banking groups have so far not significantly impacted Romania, also due to the balanced macroeconomic policy under the EU-IMF-WB arrangements and the strategies of leading banking groups operating in Romania, which contemplate preserving local capital outlays

Orderly financial deleveraging in the crisis aftermath (2)

Exposure to Romania of foreign banks participating in the Vienna Initiative



Funds from parent banks*



Source: National Bank of Romania

* subordinated loans excluded

Challenges Ahead

- Firm progress in structural reforms
- Euro adoption
- Joining the Banking Union
- Geopolitical tensions in the region

Challenges Ahead

Firm progress in structural reforms

Firm progress in structural reforms

- Project prioritization in EU funds absorption and public investment planning (with a focus on infrastructure development)
- Improving the functioning of the energy sector
 - ✓ Full liberalisation of the gas and electricity market
 - ✓ Development of gas and electricity trading platforms; improved cross-border integration of energy networks and provide for security-of-supply measures
- Continuation of the corporate governance reform of state-owned enterprises (SOEs)
 - ✓ Strengthen authorities capacities to monitor operational performance and budgets of SOEs
 - ✓ Ensure the sale of stakes in major SOEs in energy and transportation
- Promoting SMEs exports and development
- Review of labour taxation with a view to reducing the effective tax burden on labour

Challenges Ahead

Euro adoption

Near-term prospects for cumulative fulfilment of nominal convergence criteria

Nominal Convergence Indicators	Maastricht Criteria	Romania	Difference from the criteria
Inflation rate (HICP) (percent, annual average)	<1.5 pp above -0.3%* (average of the three best performing Member States)	2.3 (March 2014)	+1.1pp
Long-term interest rates (percent per annum)	<2 pp above 3.4%** (average of the three best performing Member States in terms of price stability)	5.3 (March 2014)	✓
Exchange rate (vs. euro)*** (percentage change)	±15 percent	+1.6 / -5.9	✓
General government deficit**** (percent of GDP)	below 3 percent	2.3	✓
Government debt**** (percent of GDP)	below 60 percent	38.4	✓

*) reference level, March 2014 (Cyprus, Latvia, Bulgaria).

***) reference level, March 2014 (Bulgaria, Latvia).

****) Maximum percentage deviations of the bilateral exchange rate against the euro from its April 2012 average level in May 2012 to April 2014 based on daily data at business frequency. An upward/downward deviation implies that the currency was stronger/weaker than the average exchange rate in April 2012.

****) 2013; ESA95 methodology.

Source: Eurostat, National Institute of Statistics, National Bank of Romania, European Commission

According to the NBR's current projection, the present level of the inflation criterion will be reached in May 2014. Mention should be made however that the present reference value, depending on the Member States' inflation rates, could be subject to change.

Although in most non-EA NMS nominal convergence criteria are fulfilled or within reach, a wait-and-see approach seems to prevail

	Initial target	Date of setting the initial target	Current position
BG	2010	2004 – Pre-accession Economic Programme	No target date
CZ	2009/2010	2003 – Czech Republic’s Euro Accession Strategy	No target date
HU	2008	2003 – Pre-accession Economic Programme	No target date
PL	2008/2009	2003 – Pre-accession Economic Programme	No target date
RO	2014	2007 – Convergence Programme	No target date

Source: European Commission

Recent statements regarding euro adoption in non-euro EU countries

Poland

“I think we should say publicly, that [the ERM II] is a very serious barrier that would prevent a country like Poland from joining the euro area [...] We have a big currency market and we should just say: We’re not entering ERM II. If you want us in, invite us without that requirement”. (Marek Belka, NBP Governor, Bloomberg, April 2013)

Czech Republic

“Even if the elections create a political coalition of forces seeking a quick euro-zone entry, it seems to me that they are more likely to file the application no earlier than in 2016 ... Therefore, the earliest entry date would be 2019”. (Miroslav Singer, CNB Governor, Bloomberg, May 2013)

Hungary

“Hungary cannot seriously consider joining the euro zone until the country’s average economic development reaches 90 percent of the level of euro states”. (Viktor Orbán, Prime Minister, April 2013)

Bulgaria

“If I start the path of entry, I don’t know exactly what I’m entering and we are basically going to wait”. (Simeon Djankov, ex-Finance Minister, Washington, February 2013)

Euro adoption in NMS: move towards a more prudent and comprehensive approach

- Romania, like other NMS, is closer than ever to fulfilling the Maastricht criteria, yet it has become obvious that an approach based exclusively on their achievement is insufficient
- The “put your house in order” approach by each country prior to euro adoption is seen as an essential prerequisite for the success of euro area enlargement
 - ✓ Only in this way will euro adoption by new EU Member States entail benefits both for themselves and for the monetary union as a whole

“Europe will be forged in crises, and will be the sum of the solutions adopted for those crises”.

Jean Monnet

Romania: despite recent progress, overall preparedness still needs improving

- Romania has made significant progress towards fulfilling the convergence criteria
 - ✓ Only the inflation rate is still above the reference value of the Maastricht criterion, yet the latest projections point to compliance in 2014
 - ✓ The macroeconomic imbalance procedure scoreboard shows that the net international investment position remains the only indicator outside the “comfort area”, but its correction is unavoidably the outcome of a lengthy process

- Looking at the broader range of relevant elements in terms of the appropriate timing (real convergence and political economy), it is essential to:
 - ✓ Complete institutional reforms in the euro area
 - ✓ Avoid domestic slippages and complete structural reforms
 - ✓ Make visible progress towards real convergence
 - ✓ Achieve political consensus on the domestic front

Challenges Ahead

Joining the Banking Union

The Single Supervisory Mechanism: current stage of implementation

- In November 2013, the Regulation on the Single Supervisory Mechanism entered into force and the ECB was granted a 12-month period to put it into place
 - ✓ In April 2014, the ECB published the SSM framework regulation, which lays the groundwork for supervisory activity
 - ✓ The ECB's accountability in the field of supervision will start on 4 November 2014
- The SSM has been designed as a system of banking supervision, based on the co-operation between the ECB and the national competent authorities (NCAs)
 - ✓ The ECB will directly supervise the “significant” banks, while the “less significant” banks will be subject to supervision by the NCAs, unless the ECB deems necessary to supervise such institutions
- The ECB in co-operation with the NCAs has initiated the comprehensive assessment of the banking system, in view of achieving a clear picture of the quality of assets of credit institutions
- Supervision shall be governed by the SSM Supervisory Manual that includes:
 - ✓ A risk assessment system (RAS)
 - ✓ A supervisory review and evaluation process (SREP quantification)
 - ✓ An approach to integrate the RAS, the SREP quantification and the stress test outcomes

The Single Resolution Mechanism (SRM): principles, objectives, implementation

➤ Principles:

- ✓ Decisions are taken at European level, but involve national resolution authorities (NRAs) in view of the significance of bank resolution for national economies
- ✓ Responsibility for supervision, resolution and funding is aligned at EU level

➤ Objectives:

- ✓ Orderly exit of banks in distress from the market
- ✓ Avoiding resort to bail-outs



Discontinuation of the vicious circle of sovereign risk and financing costs for credit institutions

The Single Resolution Mechanism (SRM): principles, objectives, implementation (2)

➤ Stages of SRM implementation:

- ✓ 15 April 2014: the European Parliament adopted three key texts to complete the legislative work underpinning the Banking Union: Single Resolution Mechanism, Bank Recovery and Resolution Directive, and Deposit Guarantee Schemes Directive
- ✓ The SRM Regulation shall be implemented in two stages:
 - 1 January 2015: Enforcement of provisions regarding the preparation of the SRM, the collection of information and the co-operation with NRAs
 - 1 January 2016: Full entry into force, including of the bail-in rules (provided that conditions on paying up contributions to the Single Resolution Fund are met)

Romania intends to join the Banking Union

- Romania supports the establishment of the Banking Union and aspires to be a part of it by participating in its 3 pillars:
 - ✓ the Single Supervisory Mechanism (SSM)
 - ✓ the Single Resolution Mechanism (SRM)
 - ✓ the network of deposit guarantee schemes (DGS)

- Adhering to the Banking Union will:
 - ✓ strengthen financial stability
 - ✓ further increase confidence in the national banking sector (through the harmonisation of supervisory practices and deposit guarantee schemes)
 - ✓ support a sustainable resumption of lending and economic growth (by reducing the fragmentation of the European financial markets)

- The National Bank of Romania intends to align the stress testing framework for credit institutions, which will remain under the supervision of the national competent authority, with the methodology used by the ECB

Challenges Ahead

Geopolitical tensions in the region

Tensions between Russia and Ukraine: manageable economic risks

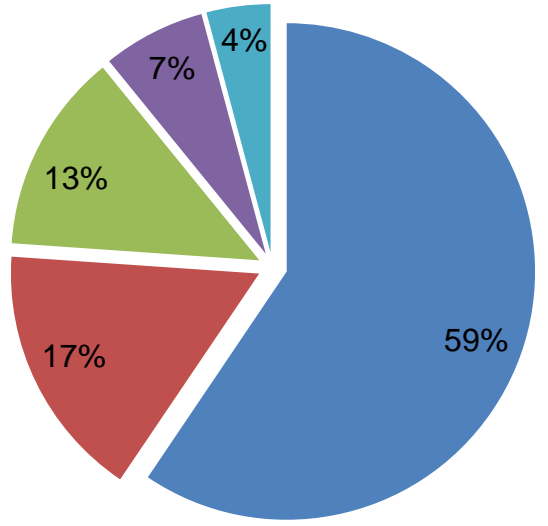
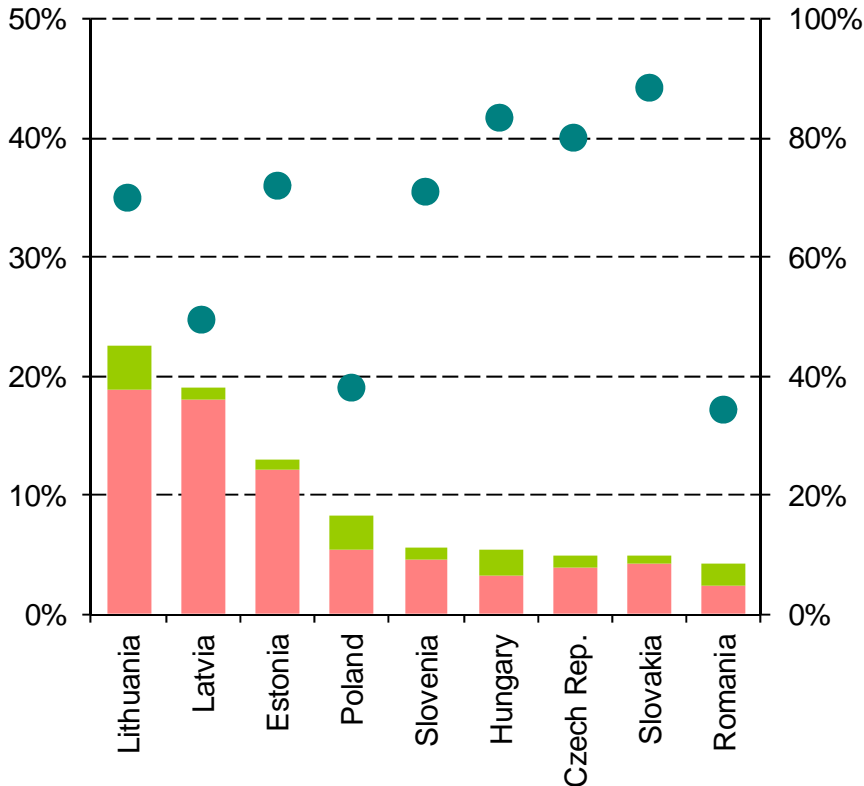
- Trade restrictions or disruptions may affect exports and/or energy supply, yet the risks appear manageable
 - ✓ Exports to Russia and Ukraine account for only 4.7% of total Romanian exports ➔ a 10% fall in the value of exports to these countries, assuming no replacement, would shave 0.16 pp off the growth rate of Romania's GDP
 - ✓ While virtually all imported natural gas comes from Russia via Ukraine, Romania is able to cover on average around 80% of its own consumption from domestic sources
 - Romania ranks the third least imported-energy-dependent country in the EU
 - imported natural gas accounted for only 15% of total consumption in 2013
 - even a total shutdown in gas imports may be weathered without tangible disruptions at least until November-December

Tensions between Russia and Ukraine: manageable economic risks (2)

- Russian capital has a significant presence (directly or via holding companies based in other EU countries) in the iron and steel (TMK), metallurgy (ALRO Slatina and ALOR Oradea) and oil refining (Lukoil) sectors, yet none of the Russian-owned companies may be deemed to be of systemic importance
- Financial sector:
 - ✓ No direct links between the Romanian banking system and those of Russia and Ukraine
 - no Russian or Ukrainian capital in the Romanian banking system
 - negligible exposures of Romanian banks to Russian or Ukrainian entities
 - ✓ Potential for spillovers through the common lender channel via the exposure of Austrian and French banks to Russia and Ukraine
 - the comfortable solvency and liquidity buffers in the Romanian banking system should help alleviate such spillovers in case they materialize
 - ✓ So far the impact of regional tension flare-ups on the capital and forex markets has been moderate and short-lived

Exports to Russia and Ukraine account for a comparatively small share of Romania's exports

Romania's exports to Russia - breakdown by product -



- the share of exports to Ukraine in total exports of each country
- the share of exports to Russia in total exports of each country
- the share of exports in GDP (rhs)

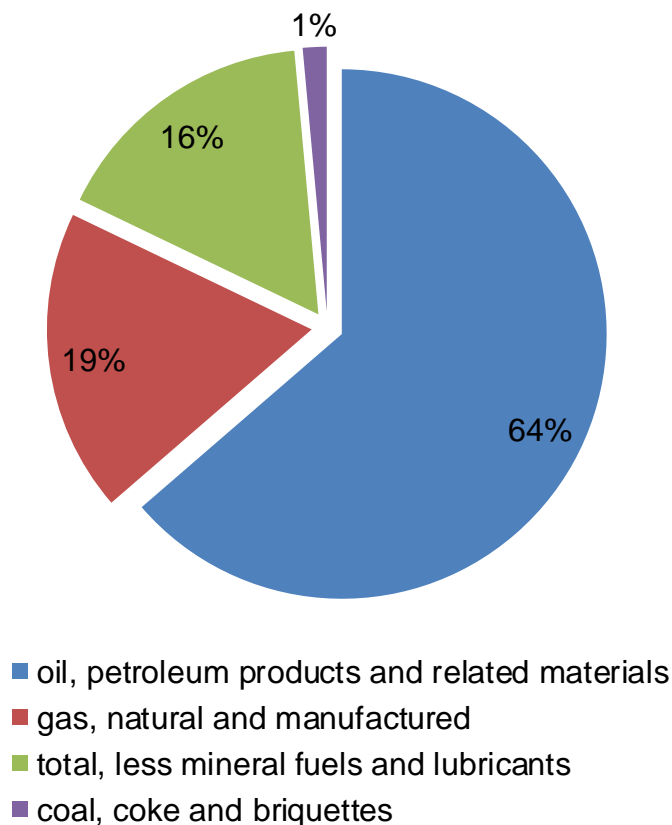
- machinery and transport equipment
- manufactured goods classified chiefly by material
- chemicals and related products n.e.s.
- miscellaneous manufactured articles
- other

Source: Eurostat

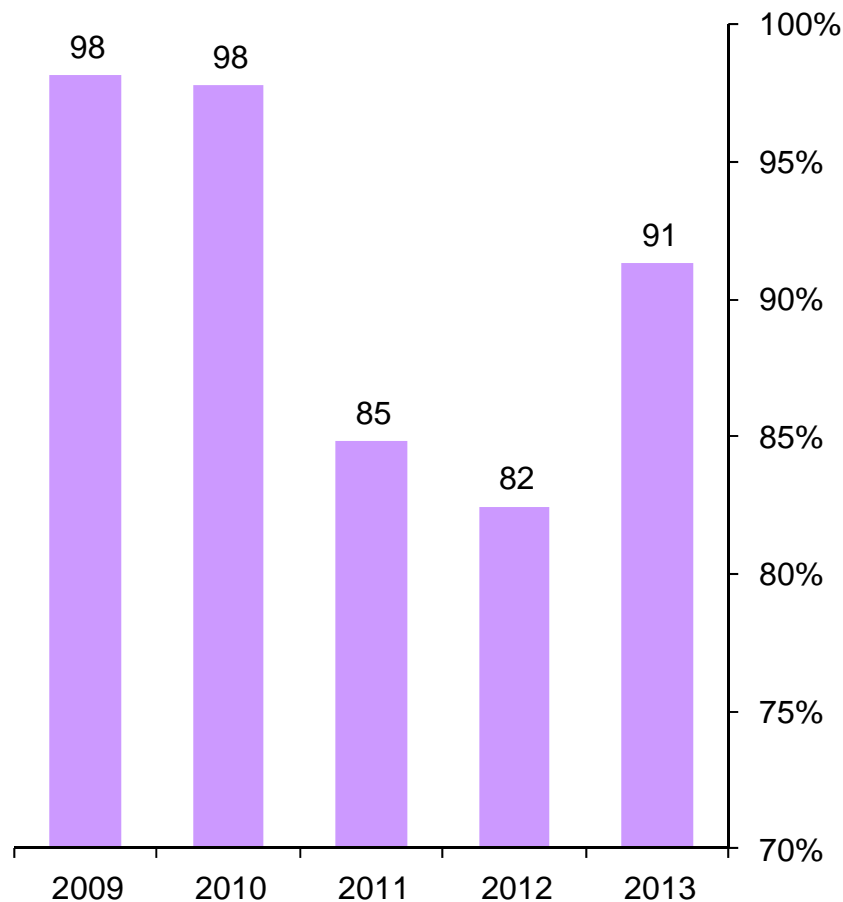


Energy products form the bulk of Romania's imports from Russia, with virtually all imported natural gas coming from there ...

Romania's imports from Russia - breakdown by product -



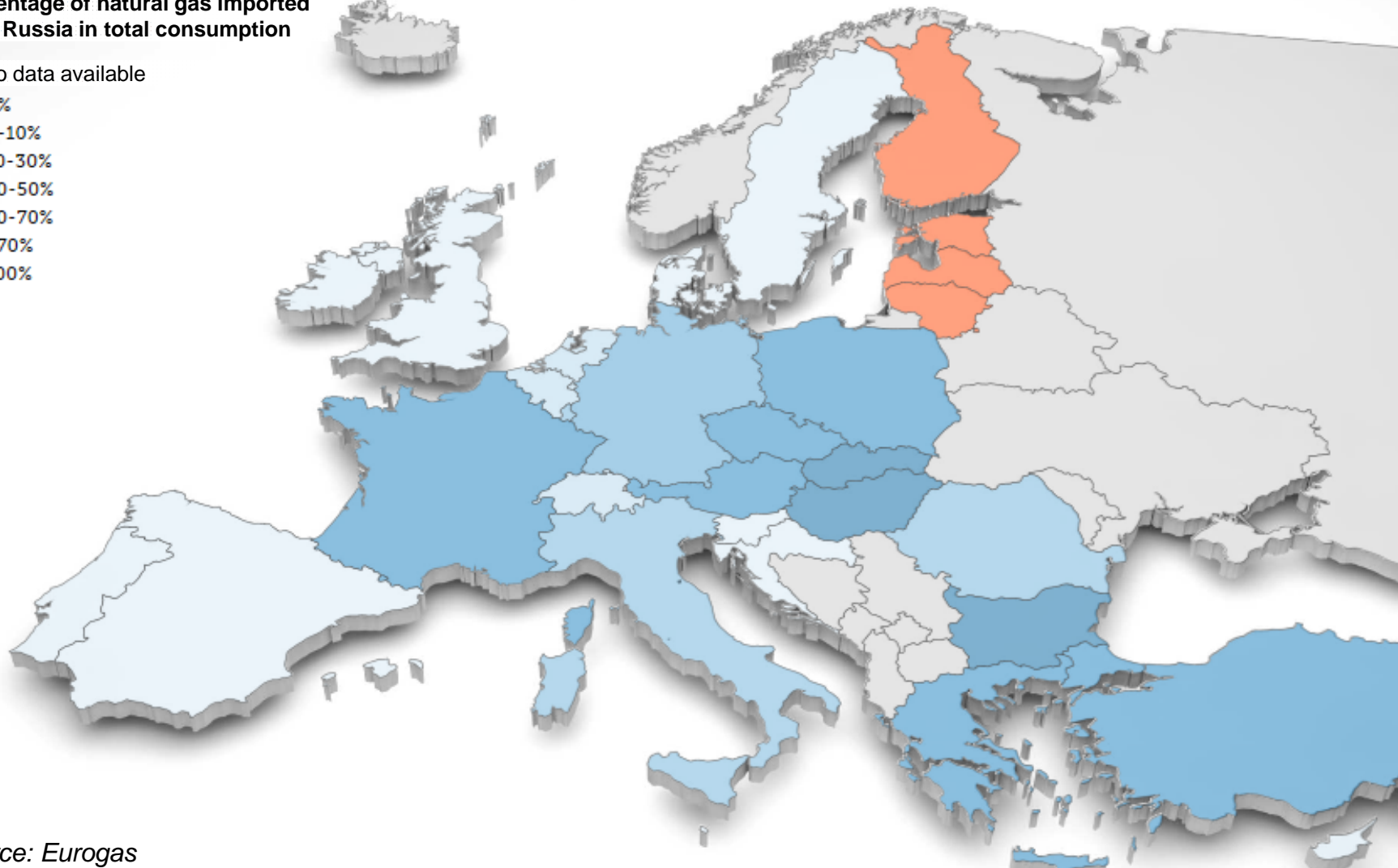
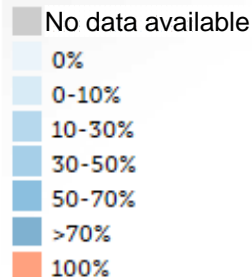
The share of gas imports from Russia in total Romanian gas imports



Source: Eurostat

... yet Romania ranks among the most self-sufficient countries in Europe as regards its gas consumption

Percentage of natural gas imported from Russia in total consumption



Source: Eurogas