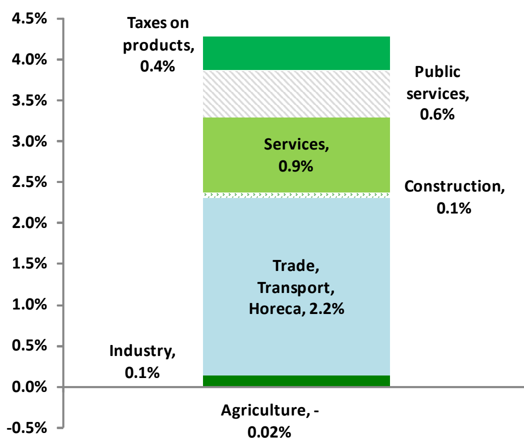
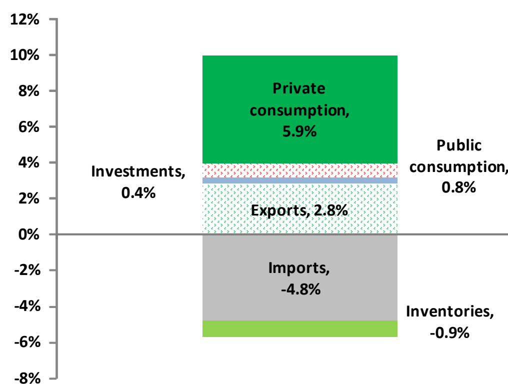
Is the current growth sustainable?

Moody's: Baa3 positive / S&P: BBB-stable / Fitch: BBB- stable

TRADE/TRANSPORT IS THE MAIN DRIVER, Q1 2016 GDP PP CONTRIBUTION



CONSUMPTION AND IMPORTS ACCELERATES; INVESTMENTS BELOW EXPECTATIONS, Q1 2016 GDP PP CONTRIBUTION



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Outlook – Romanian GDP expanded by 4.3% in the first quarter of 2016, strongly driven by private consumption amid fiscal stimulus. The picture is less favourable on other components of the GDP, especially for investments that are lagging much behind the desired level for sustainability. Moreover, external demand is already decelerating and outlook is sober in the current international vulnerabilities.

Annual inflation in Romania is expected to stay still below the target this year but to jump higher at the beginning of 2017. Given the current international context, NBR will probably keep for longer the current low-interest rate environment, at least for a half a year, by postponing the narrowing of the interest rate corridor in 2017 while the first key rate hike is expected in mid-2017.

BREXIT event will likely trigger a shift in the global monetary conditions through a delay in Fed's interest rate hikes while in the euro-zone and UK further relaxation and lower euro interest rates are expected. Romania's investing grade rating was not affected by the international turbulences since the current macro stability parameters are still in good shape. Romania's direct ties with UK are not very strong but the indirect impact through the whole EU might be tough and it will depend on the scenario that will result from the political negotiations.

PSD was the clear winner of the local election but it lost its coalition partner for the parliamentary elections, which means there will be a stronger fight to form a coalition government.

Main Topics:

- Politics – Results of the local election and some hints for the parliamentary election
- Economic Growth – Strongly relying on consumption
- Country risk profile – First round resilience to adverse external shocks but instability persists
- Inflation – To re-enter positive territory in the second half of the year
- Monetary policy – Loose monetary stance to be prolonged
- Fiscal Policy and Public Finance – 2016 budget deficit target in line, but 2017 bears risks
- External Accounts and Financing – The current account deficit is deepening
- Bank flows – The pace of lending stagnates, companies need more incentives

GarantiBank

QUARTERLY MACROECONOMIC REPORT ROMANIA – Q1 2016

Politics

Results of the local election and some hints for the parliamentary election

The results of the local election held on the 5th of June might give hints of the possible outcome of the parliamentary elections scheduled at the end of this year. The Social Democrat party (PSD), together with his socio-democrat coalition partner UNPR[1] (in some cases having common candidates) won the election with 41.3% of votes for mayors and 42.3% of total votes for county councils. The clear success is seen in the number of mandates won by the socialists which was 54.1%, more than half. The participation rate at the local election was rather small at 48.4%[2]. Starting in 2012, the majority of votes in the current parliament has been in the hands of the socialist PSD with UNPR and the Alliance of Liberals and Democrats (ALDE) and this was actually the previous government's coalition before the technocrats government that took power in November 2015.

The date of the parliamentary election has not been yet announced and it is expected to take place at the end of November. The number of seats in parliament will be also reduced by around 120 according to the new electoral law[3].

As a turning point, after the common candidacy at the local elections, PSD and UNPR announced to run on separate list for the parliamentary elections[4]. This means that negotiations will be quite tough after elections and based on the size of the two major political parties (socialist PSD and the National Liberal Party PNL) the success of any of them will depend on their ability to form the coalition with smaller parties. The second biggest party, PNL was definitely favoured by the UNPR -PSD separation, but again, they would also need to attract more than one coalition partner to form the majority.

Based on the results of the local election, a new political party, the People's Movement Party (PMP) announced its intention to merge with UNPR. It is an interesting move which will boost both parties, especially since PMP managed to reach close the 5% threshold (required to enter the parliament) at the local elections.

LOCAL ELECTION'S RESULT

	PSD	UNPR	ALDE	PNL	PMP	UDMR	Independents	Others
MAYORS: % OF VOTES	39.0%	2.5%	5.7%	31.5%	3.6%	3.7%	5.7%	8.3%
MAYORS: NO. OF MANDATES (FROM TOTAL OF 3184)	1708	26	64	1081	18	195	53	39
COUNTY COUNCILS: % OF VOTES	39.6%	2.7%	6.3%	30.6%	4.5%	5.0%	0.6%	10.7%

Note: * Comon candidates for PSD- UNPR or PSD- ALDE are counted under PSD

CURRENT PARLIAMENT STRUCTURE

AS OF 06/07/2016	PSD	UNPR	ALDE	PNL	UDMR	Independents	Minorities	TOTAL
NUMBER OF SEATS	192	40	35	169	24	46	17	523
% IN PARLIAMENT	36.7%	7.6%	6.7%	32.3%	4.6%	8.8%	3.3%	100%

Source: cdep.ro, GarantiBank Research

Economic Growth

Strongly relying on consumption

[1] National Union for Romania's Progress

[2] http://prezenta.2016bec.ro/index.html

[3] On 24 February 2015, the Electoral Code Commission decided in principle for the future electoral law to return to party-list proportional representation. With a representation norm of one deputy per 73,000 inhabitants and one senator per 168,000 inhabitants a total of 308 deputies will be elected, to which are added the 18 deputies of minorities, 134 senators and 6 MPs of diaspora (two senators and four deputies). This totals to a number of 466 MPs, five fewer than in 2008 and 122 fewer than in 2012.

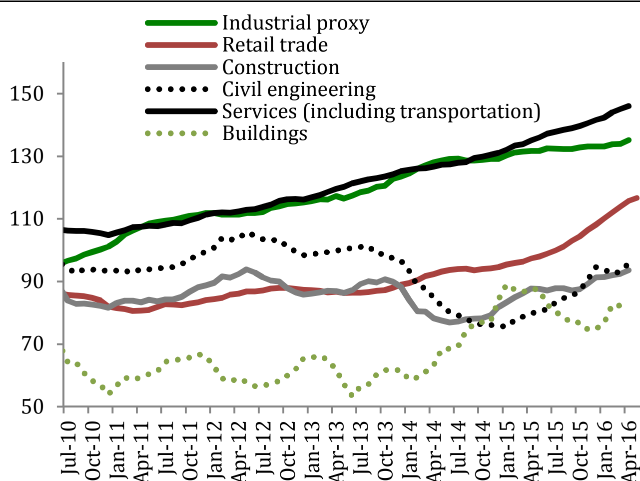
[4] UNPR was upset by their coalition partner after 12 members of parliament moved from UNPR to PSD, which was against their protocol signed in February.

GDP advanced 4.3% yoy in Q1 16 strongly driven by consumption. This is just equal the growth rate in the first quarter of 2015 and is close to the whole 2015 growth excluding agriculture (4.4% yoy). Nevertheless, further shifts in the GDP composition have been visible, increasing the share of domestic consumption and trade while external demand and industrial production shares retreated. Private consumption accelerated further at 8.3% yoy (6.6 pp from total growth). The significant wage increases, the VAT cuts and lower fuels and energy prices stay behind the accelerated private consumption. Moreover, the strong domestic demand was reflected also by the accelerated imports and negative net export contribution.

The average wage growth in Romania accelerated to a six-year high at 14.2% annually, while the real growth rate was even higher at 18.3% (a seven year peak) due to deflation[5]. The higher wages give an additional stimulus for consumption but they also translate into costs for the companies that might endanger their competitiveness. Therefore we could witness some negative side effects. Based on our calculations, there is an immediate impact of raising costs for companies of around 0.6% of GDP or RON 4.7 bn on a yearly basis, that would result either in 1) first, lower profit margin, which could translate into lower capital investments or 2) second, higher prices of produced goods which would result in increasing inflation; or 3) last but not least, shift of the workers into informal sector or unemployment. All these factors erode the sustainability of the current growth rate. The employment expectations for the next three months turned negative starting in May, after two years of positive evolution.

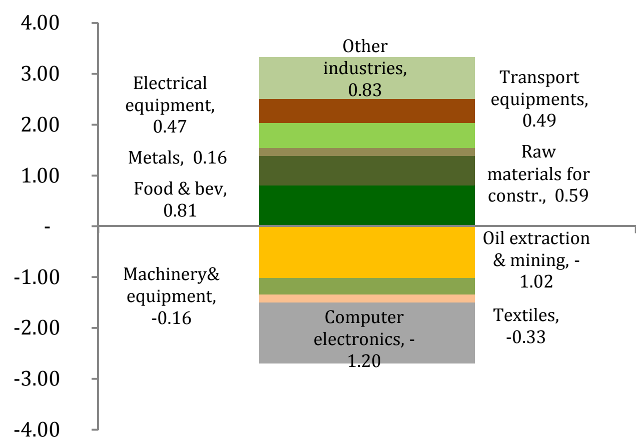
The weaker export performance (just +5.5% yoy in Q1 2016 compared to the average annual growth of 9% in the last three years) can be explained by lower external demand hit by international geo-political tensions, low commodity prices and decelerating global growth. Additionaly, the export of cereals dropped (-17.2% yoy in Q1) due to the lower domestic crop production last year.

SERVICE SECTORS-THE BEST PERFORMER POST CRISES, 6M MA INDEX, 2008=100



Source: NIS, GarantiBank Research

INDUSTRIAL PRODUCTION HIT BY COMMODITY PRICES, CONTRIBUTION TO THE GROWTH



Source: NIS, GarantiBank Research

[5] The public wages were lifted by around 20% on average (year over year) and additional 5% increase will be implemented as of August to balance the wages among different public servants. The minimum wage in Romania started to increase in 2011 from the level of RON 600. The latest hike of +19% led the minimum wage up from 1050 RON to 1250 RON and it was implemented on 1st of May.

Investments were very weak in Q1 with a yearly growth of 2.3% compared to the 8.8% registered in 2015 and they are lagging much behind the desired level that would be needed for the sustainability of the current economic growth. What is more, given the infrastructure deficit, we would need more intensive spending. However,nearly one third of investments were represented by cars and vehicles.[6]

Looking at the contribution of the biggest economic sectors, the major driver is by far the domestic trade&transportation, which brings half of the total growth of 4.3% , reflecting the strong consumption seen on the demand side. We will see a slowdown in the second half of the year due to the elimination of the base effect from the VAT impact as of June 2015.The retail confidence indicator supports this view in Q3.

The good news is that private services continued to performe well in the Q1 with an overall contribution of 0.9 pp from the total growth, as the IT and Business services remained the best performers. Moreover, further potential can be developed, helped by the labour competitiveness and also by the state stimulus offered to these industries for research and development and job creation. Still, the growth rate is on the decelerating pattern starting in Q2.

Industry was weak with only 0.1 pp contribution to the GDP in Q1 while during 2013-2014 it was among the major drivers of the economic recovery. Industry is strongly related with the higher value added and export oriented sectors, among which the car (+6% yoy) and electrical equipment are still growing (+12% yoy), while the computer electronic (mainly car components) dropped strongly by 20.8%yoy. The extraction of crude petroleum was impacted by the low oil prices. Romania is net importer with 43% of the consumption needs covered by local production. On the other hand, the food industry (+4% yoy) benefited from the accelerated domestic consumption.The prospects for industry are not seen improving significantly in the short run, in the vulnerable international context. Still, the latest industry confidence indicator suggests some improvement in the second half of the year.

SHORT-TERM INDICATORS

	12M avg	2015	2016					
		Dec	Jan	Feb	Mar	Apr	May	Jun
Industry index	2.4%	4.0%	-1.8%	0.5%	2.6%	3.8%	1.5%	
Industry confidence	-0.1	0.1	0.3	-1.1	-0.8	-0.1	-0.3	1.0
Services for companies	8.4%	12.6%	5.6%	10.5%	7.4%	7.0%	9.1%	
Services for population	13.7%	22.8%	15.8%	19.1%	12.0%	9.8%	10.4%	
Service confidence	10.5	11.8	11.7	9.1	9.7	11.6	8.9	7.6
Retail Trade	14.5%	15.5%	15.6%	21.7%	19.6%	19.4%	15.8%	
Retail confidence	12.8	6.2	6.4	12.9	8.6	4.8	10.0	3.4
Car sales	22.1%	28.8%	27.8%	24.8%	27.4%	24.3%	24.8%	
Construction	8.2%	14.2%	-1.1%	4.8%	-3.0%	12.3%	8.9%	
Buildings confidence	-12.8	-8.2	-11.3	-15.6	-12.7	-14.0	-15.8	-14.2
Civil engineering	16.4%	41.2%	-1.7%	-4.6%	2.2%	29.3%	9.5%	
Consumer confidence	-17.9	-20.6	-17.9	-20.3	-20.2	-17.6	-18.6	-19.6
Economic sentiment	103.9	103.3	104.5	102.4	102.8	104.0	103.6	103.2
Employees 3M expectations	2.6	4.2	2.4	1.3	0.8	1.1	-2.5	-0.9
Real salary growth	13.0%	14.4%	14.1%	15.8%	15.6%	16.1%	18.3%	
Private Credit Growth	1.6%	3.0%	2.8%	2.4%	2.8%	3.0%	2.4%	
Export	4.0%	3.8%	-1.6%	9.5%	2.7%	7.0%	4.1%	
Import	9.0%	12.4%	3.1%	13.4%	5.0%	9.8%	12.2%	
real GDP % yoy	**3.8%**	**3.8%**			**4.3%**			

Source: NIS, Eurostat, European Commission, GarantiBank Research

EMPLOYMENT EXPECTATIONS DECREASING

Source: EUROSTAT, EC, GarantiBank Research

[6] In Q1, investments were oriented towards equipment that includes also transport equipment (RON 6.5 bn in equipment out of total of RON 12.8 bn in Q1). Looking at the domestic car sales, of which 89% are bought by companies, it results that around 28% of investments in equipment were actually cars and vehicles.

Agriculture dropped slightly (-1.2% yoy) in Q1 but this does not really matter for the full year, having a slow contribution in Q1 due to seasonality. Based on the EC forecast, a better agricultural year is in the cards.[7] In our base scenario, we expect around 9% yearly growth of the value added in agriculture, following a 9.4% drop in 2015.

The construction sector continued its modest recovery from the bottom reached in 2014 but its output is still below the 2008 level and its annual growth rate decelerated at only 1.8% in Q1 compared to 8.8% in 2015. In Q2 we could notice some acceleration of the civil engineering works. Public investments might face some constraints towards the year-end when dealing with reduced funding in order to keep deficit under the 3% of GDP ceiling. The buildings construction lost its speed of recovery seen at the beginning of 2015 and some further negative impact on the residential market might arise from the giving in payment law.

Country risk

First round resilience to adverse external shocks. Instability persists

Romania's investment grade rating was not affected by the international turbulences since the current macro stability parameters are still in good shape while the short-term financial impact was less visible locally. Meanwhile, the UK's rating was downgraded by two notches by S&P and EU's rating by one notch after the UK referendum on the 23rd of June tipped the balance towards exit from the European Union.

The share of non-residents' holdings in Romania was at 17% (May 16) from the total domestic state securities or EUR 4.4 bn[8] and the net outflow was not that significant to push the RON towards depreciation (the daily volatility of the EURRON between +/-0.5% and a monthly depreciation of just 0.2% in June). Nevertheless, the immediate effect on 10 year bond yields was an increase of around 10bps in Romania, still less than in some other European markets like 15 bps in Spain and Italy, around 30 bps in Portugal and 70 bps in Greece. Afterwards, because of announced plans of liquidity injections by Central Banks, the final effect was a general decrease of 20 up to 60 bps in 10y bond yields. Equities mimiqued this move as BET dropped 3.5% on the 24th of June and it recovered almost entirely by the end of the month (+0.1% as of 29th of June compared to the 23th of June). So overall, despite the increasing risk aversion on the global market, Romania was viewed through a better lens, reflected also by the CDS evolution (compared to other countries like Poland or Italy, Greece, Spain). Compared to the beginning of the year, CDS is lower by 10 bps while the RON yields on 10 year bonds have dropped 50 bps.

From the point of view of the financial conditions, BREXIT event will trigger a global change which implies a delay in Fed's interest rate hikes while in the Eurozone and in the UK are expected further relaxation and lower euro interest rates.. On the one hand, as the Fed will postpone further tightening we will see less reallocation to US, so more liquidity for the rest of the world. On the other hand, the future portfolio flows might be affected in some respect, as in the past years, 20% to 30% of Romanian Eurobonds was bought by UK investors and overall the risk-off sentiment means less short term investments inflows to any emerging markets.

Romania's direct ties with UK are not very strong as the external trade shares are 4.4% in total exports and 2.5% in total imports, the UK as FDI investor (2.5% in GDP) ranks the 10th and there is no investment in the banking system. UK hires 3%[9] of Romania's total employees which in turn sends home 3% of total remittances inflow. Nevertheless, the indirect ties are stronger as the UK is the second largest economy in Europe and structural shifts will impact

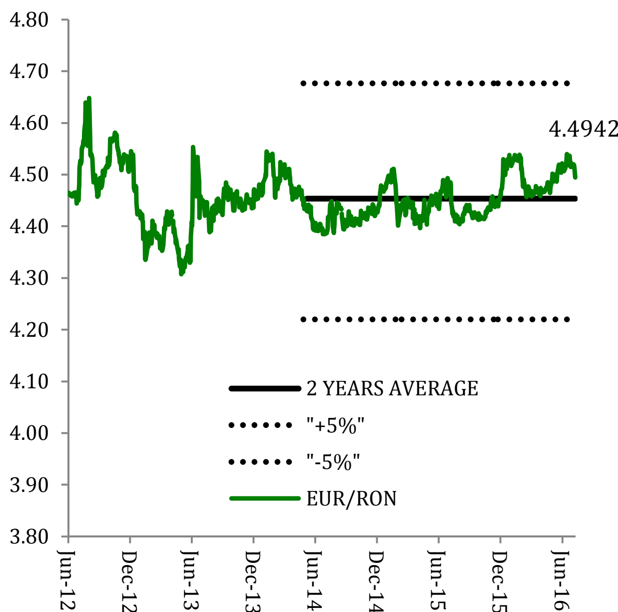
[7] According to the Crop Monitoring in Europe done by Eurostat as of June 2016 the average crop yield is expected to increase as follows: Wheat +3%, maize +40%, sunflower +19% and potato 7.6%.
[8] Source: Ministry of Finance's Public Debt Report at 31st of May 2016
[9] Significantly lower than Romanians working in Spain and Italy.

EU investors' confidence and investment decisions, with immediate effects on the EU's GDP and consequently on Romania's GDP as well.

In our baseline scenario we assume that after some negotiations an agreement will be reached with conditions close to the current situation. Under this softer scenario, despite of the lower changes on the trade and labor conditions on the long term, we still should consider the market volatility, increasing risk aversion and lower investments driven by risk-off mood in the whole Europe given that negotiations are only starting. Moreover, there is a direct price impact on the trade, even if conditions are still the same, through the depreciation of the British pound[10]. In this case we expect a 0.4 percentage point negative impact on the GDP growth.[11] GDP growth is lower reflecting mainly by the slower industrial production (cars and electrical machinery mostly affected) and slower advance in services (especially IT services that are export related). Moreover, the economic sentiment indicator in Romania is strongly correlated with the economic sentiment indicator of EU, and this way any negative impact on EU is transferred also to other sectors even if they are focusing mainly on domestic demand (such as the construction, real estate or financial sectors).

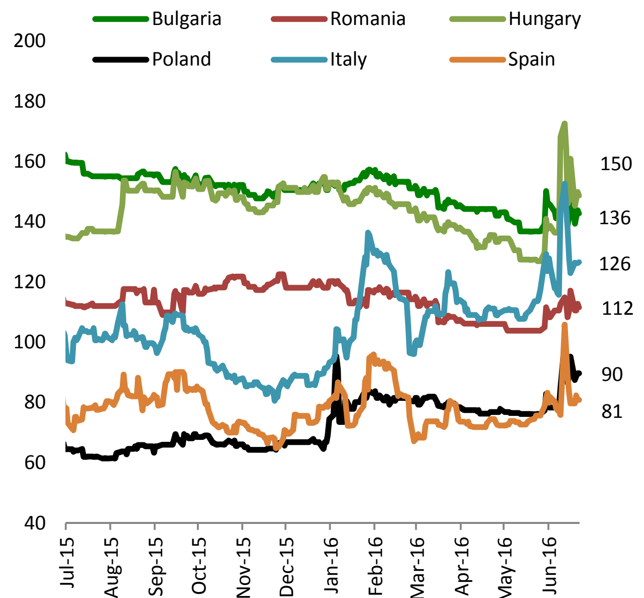
If we consider a "harsher" scenario, the main difference would be the political decision not to give in to EU's rules, loss of access to the single market under the current form and ultimately, the UK's isolation. This would trigger a deeper loss to EU's GDP, of around 0.9% per year and 1.3% lower GDP growth in Romania, according to our calculations. The same channels would be affected, but with a more ample and long lasting effect.

FX VOLATILITY STILL MUCH BEYOND THE +/-5% BAND AMID INTERNATIONAL VULNERABILITY



Source: Reuters, Garanti Bank Research

ROMANIAN COUNTRY RISK LESS AFFECTED; 5Y EUR CDS



Source: NBR, Garanti Bank Research

[10] British pound lost 9% after referendum and it does not seem to recover.

[11] Romania is strongly connected with the EU (76% of the total international trade) and under this scenario we assume that EU is affected by 0.3%.

Inflation

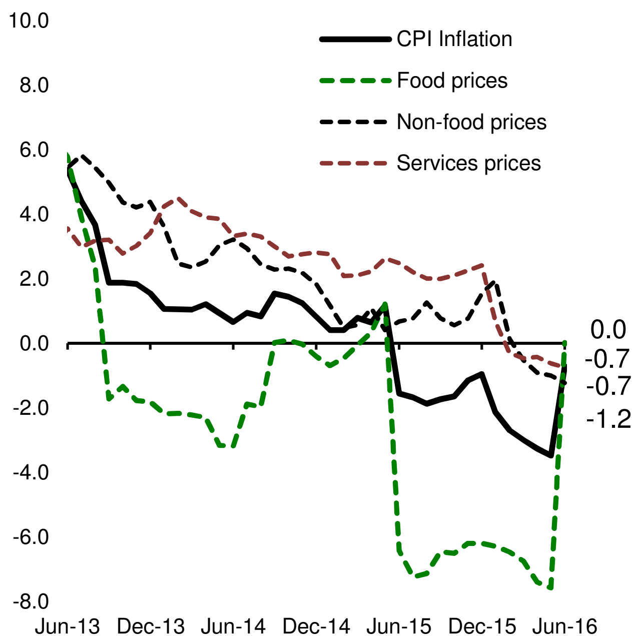
To re-enter positive territory in the second half of the year

Annual inflation moved higher at -0.7% in June 2016 as the effect of the VAT cut on food prices that took place last year in June, from 24% to 9% was eliminated (7.6 percentage points jump in food prices). Nevertheless, the effect of the general VAT cut[12] is still present in the price evolution on all remaining products, which counts around 1.2 percentage points in the headline inflation (VAT corrected CPI in June is at 0.5%, based on our calculations).

It is even more interesting to observe that the VAT adjusted core inflation that is currently at around 1.2% will probably stay at this level untilthe end of the year. Therefore, in the absence of a visible and lasting uptrend, the key policy rate should not suffer changes for the moment. Headline inflation will also stay at around 1% until the year-end but then to accelerate even above 3% at the beginning of 2017, when the base effect of the general VAT will be eliminated.

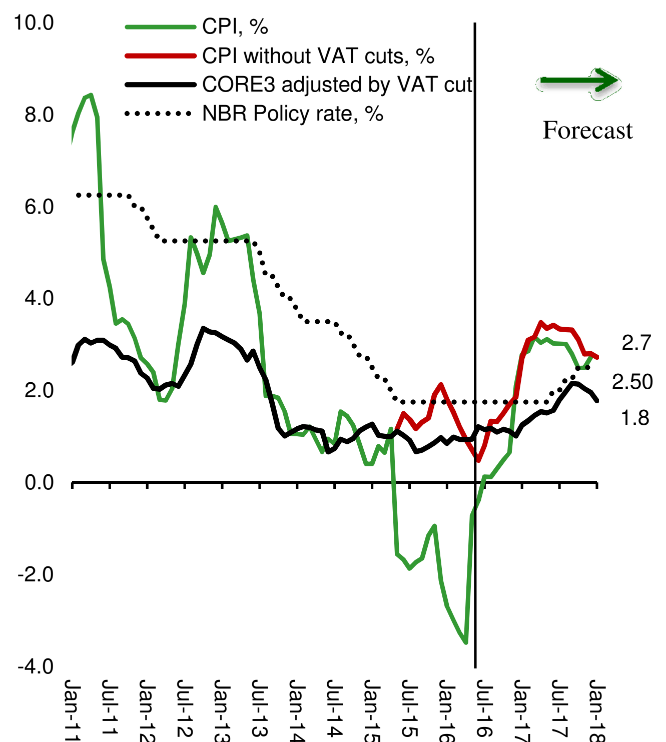
Overall, the demand-pushed inflation, given the strong wage hikes and fiscal stimulus, will start to become visible starting 2017. The VAT adjusted core inflation reveals these pressures. According to our expectations, this core inflation is expected to accelerate in 2017 closer to the 2.5% inflation target while the headline CPI will position above this level.

DEEPENING DEFLATION AFTER SECOND VAT CUT, ANNUAL INFLATION BY ITS COMPONENTS



Source: NIS, GarantiBank Research

VAT ADJUSTED INFLATION UNDER NBR RADAR



Source: NIS, GarantiBank Research

[12] from 24% to 20% implemented as of January 2016

Monetary Policy

Loose monetary stance to be prolonged

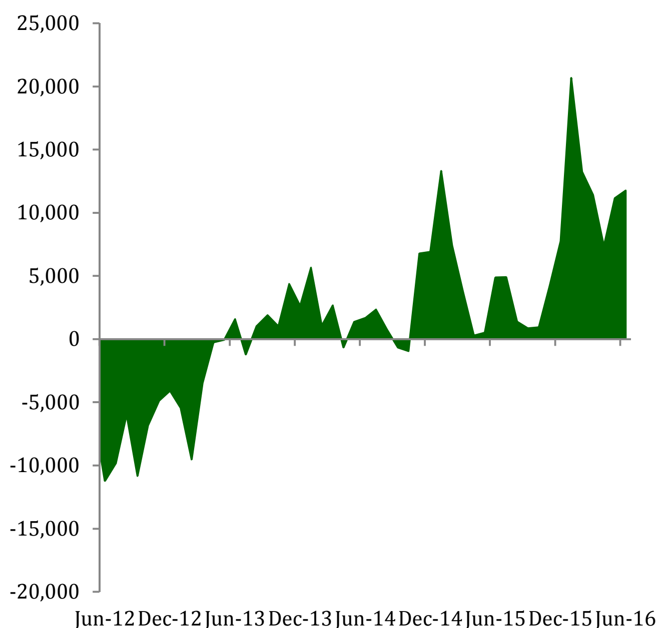
In its latest meeting on the 30th of June, the Board of the National Bank of Romania decided to keep unchanged the monetary policy rate and to maintain the existing levels of minimum reserve requirement ratios (MRR) on both RON and foreign currency-denominated liabilities.

The easing monetary conditions are expected to be kept during the whole year through significantly lower inter-bank rates. NBR is expected not to sterilize yet the abundant liquidity and probably will delay untill the beginning of next year the narrowing of the interest rate corridor (currently at +/-1.5%). This should bring the interbank rates closer to the key rate.

Beside the persistently low inflation rate this year, there are even more arguments for the maintenance of the relaxed monetary conditions. Here we look at the shifts in the global monetary policy expectations after Brexit and at the fact that Fed might likely postpone the rate hikes while from the ECB and BE more stimulus is expected.

According to the IMF conclusion after their visit at the beginning of the year, "the policy rate can be left unchanged until projected inflation moves more clearly above target". As showed by our CPI forecast, this will happen starting 2017.Bearing in mind the international monetary stance and relatively lower adjusted core inflation that is actually monitored by the NBR in its decisions, we see the first NBR rate hike in the second half of 2017.

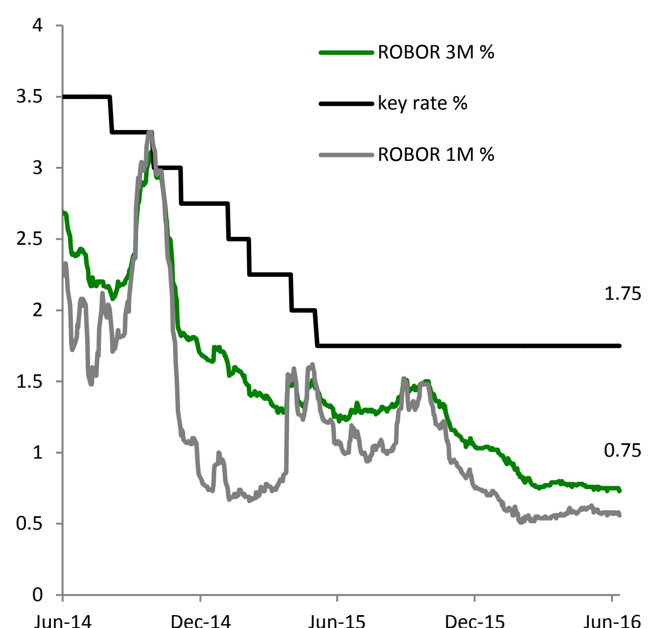
NET LIQUIDITY POSITION OF BANKS VERSUS NBR (+ MEANS NBR IS NET DEPOSITOR), RON MN



Source: BNR, GarantiBank Research

Note: net liquidity position includes permanent facilities and repo.

RELAXED MONETARY CONDITIONS TO PERSIST TILL THE YEAR-END



Source: NBR, GarantiBank Research

Fiscal policy

2016 budget deficit target in line, but 2017 bears risks

The current fiscal stance does not indicate an overshot of the 2.8% yearly target so far, despite the changes that are already in effect. The budget deficit was 0.1% in GDP during the first 5 months as opposed to a surplus of 0.9% last year in the same period. The negative fiscal balance was driven by the implementation of the new fiscal code (reduction in VAT) and public wage hikes. According to the 2016 budget plan, revenues categories which were the most sensitive to the cuts are those from the VAT (less by 1.1 pp in GDP compared to 2015 execution) and corporate tax (lower by 0.4 pp in GDP compared to the 2015 figures) with an overall impact of -1.5% of GDP on budget balance. So far, according to our calculation, the VAT revenues appear to be just in line with the plan. If we look at the VAT realization, 42.5% of the yearly target was recorded so far, and usually, during the first five months between 39%-42.3% of the yearly VAT revenues are collected. Therefore, we do not see a risk of not reaching the VAT target.

Overall, the budget deficit is smaller than planned, considering that the half year plan is 1.9%. One of the reasons could be the under-realization of public investments, considering that they are at only 24% of the yearly plan. However, there is still a yearly advance of 13% yoy due to the small basis and this has been visible in the increase of public spending on infrastructure related projects.

Even if this year's target could be under control, there are risks of exceeding 3% level in 2017[13] as more measures were adopted in 2016 and some are in the pipeline. There will be a 5% increase for the public wages as of 1st August, meant to standardize the public sector wages and reduce inequalities. The annual calculated impact is 0.3% in GDP. Another measure with is the VAT cut from 20% to 9% for fertilizers and agricultural services but it has no significant impact in GDP.

There is an initiative which could derail the budget deficit by 1% in GDP. The Senate approved in May the decrease of social contributions (CAS) by 5 percentage points (3 pp to the employee and 2pp for the employer) starting January 2017. However, the proposal was rejected for the moment by the budget committee and the Ministry of Finance.

The IMF warned that the budget deficit could climb to 3.3% in 2017 and recommended that for 2016, only a 2.5% deficit should be recorded, with a fiscal consolidation to continue with 2% in 2017 and 1.5% in 2018. One of the indicated measures was the postponement of the further VAT cut from 20% to 19% planned for 2017.

[13] The budget deficit target is 2.8% in 2017 and 2.3% in 2018.

External Accounts and Financing

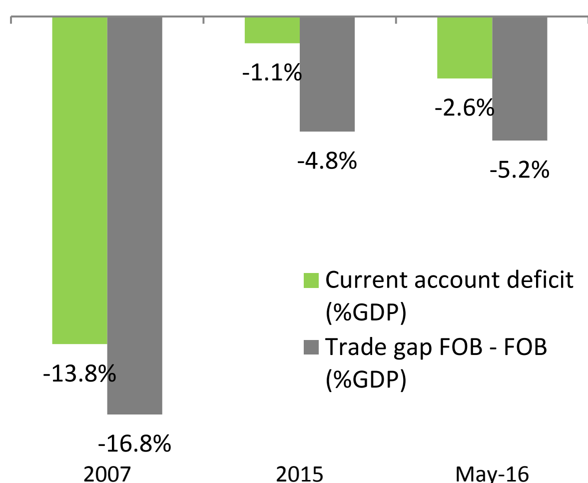
The curent account deficit is deepening

The pro-cyclical expansion of the trade gap reflects the high paced consumption and led to the widening of the CA deficit. On a 12 months rolling basis, the deficit is at 2.6% in GDP (May 16), more than double than the last year (1.1% in GDP). The goods trade deficit is no longer covered by the services' surplus. Besides the larger trade gap, we also noticedhigher deficit of primary income balance, reflecting the higher profitability of foreign owned companies in Romania. Given that the highest impact of the fiscal stimulus on consumption growth takes place in the first year of the application of new regime and that wage hikes are expected to normalize (public wages were significantly increased since January 2015), from 2017 on, the CA deficit we expect not to expand as fast as in 2016.

FDI (EUR 1.1 bn) is advancing (+17%yoy) but from the funding point of view it does not cover the CA deficit anymore, so it will be requered funding from the FX reserve. The FX reserve (EUR 30.8 bn in June 16)[14] is under good parameters, as it covers 6 months of imports (April 16)[15] and also it covers also short term external debt 1.7 times (April 16).

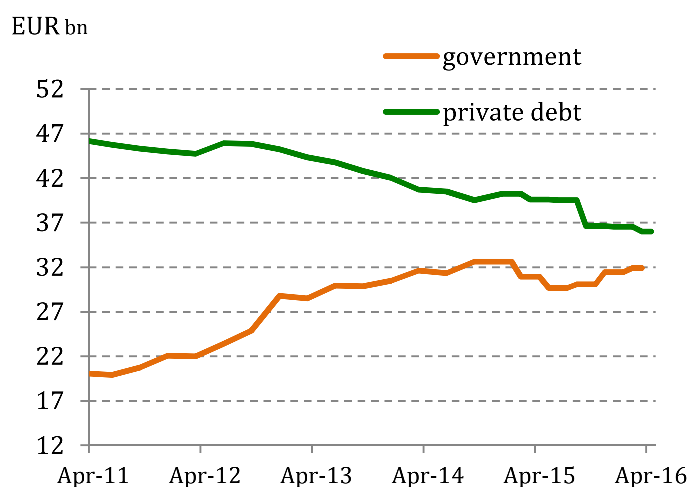
The deleveraging private sector (EUR 37 bn in external debt) lead by banks is pushing Romania's total external debt (EUR 88.4 bn) lower, on all the maturity spectrums. Banks can rely on domestic sources, especially since lending activity is still weak. The public sector external debt is going against the general trend as it has grown post crisis. After slowing down last year, in the context of continuous fiscal consolidation which required less funding, it will likely pick up again in the mid-term.

CURRENT ACCOUNT DEFICIT MORE THAN DOUBLED



Source: NBR, GarantiBank Research

EXTERNAL DEBT: THE PRIVATE SECTOR CONTINUES DELEVERAGING WHILE PUBLIC DEBT BUILDS UP



Source: NBR, GarantiBank Research

[14] The FX reserve was little changed between Dec 15 –May 16 and in dropped in June by EUR 1.5 bn when a EUR 1.6 bn Eurobond came to maturity.

[15] The minimum levels for these parameters are 100% of short term debt and 3M of imports.

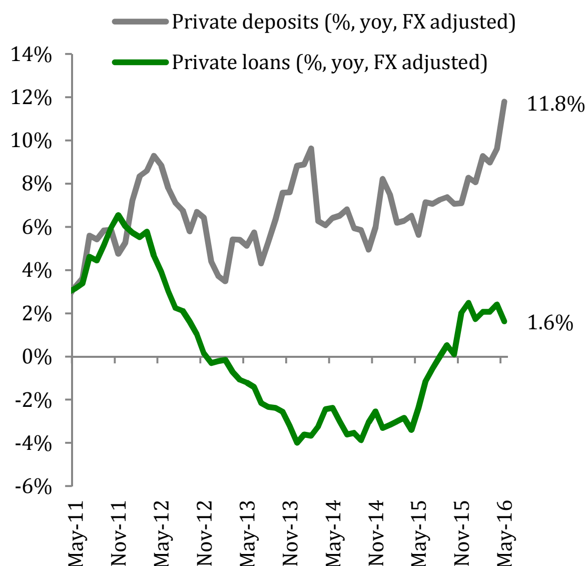
Nevertheless, for 2016 we see it rather stable at the level reached in April[16]. The longer term uptrend in public external debt is understandable given that Romania is constantly generating public deficits. The Treasury continues to tap international markets at a sustained pace in order to assure that Romanian Eurobonds market is liquid. Establishing a market for Romanian Eurobonds is crucial especially in the current context of financial and geopolitical instability. This alleviates a possible upward pressure on yields. Luckily, the low euro yields and the country rating still allow easy financing just showed by the latest issuance in May of EUR 1 bn in 12year Eurobonds, at 2.88%[17].

Total public debt is increasing (EUR 61.8 bn) due to domestic component (EUR 31.4 bn) but it is still under manageable levels. In relative terms, it grew from 38.4% in Dec 15 to 38.5% in May but it could cross over 40% in GDP in the midterm if the public deficit trajectory is not adjusted downward. In the first 6M, 55% of the gross financing needs of 9.3% in GDP were already covered and the domestic issuance share was 74% (RON 28.7 bn).

Bank flows

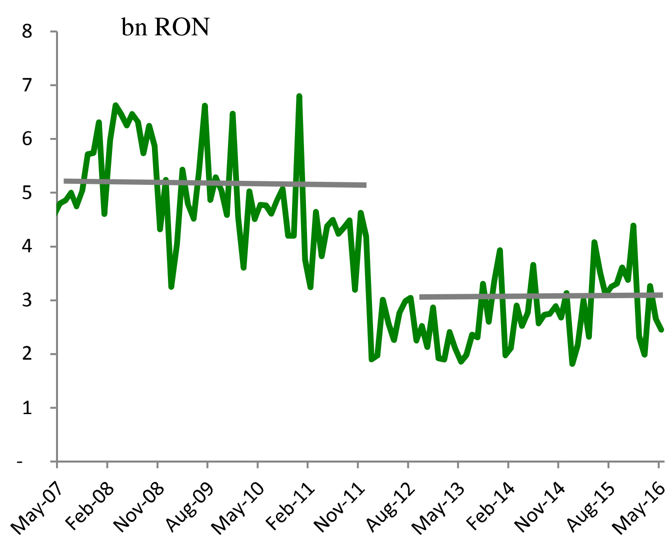
New loans advanced by only 2.1%yoy in April –May 16, down from 28.8%yoy in Q1 2016. The deceleration was witnessed first of all by the corporate segment due to a May base effect but retail lending also saw a slowdown.

LENDING ADVANCE STABILIZED



Source: NBR, GarantiBank Research

COMPANIES MONTHLY LOANS FLOW IS CLOSE TO THE LAST 4 YEAR'S AVERAGE



Source: NBR, GarantiBank Research

[16] After April it was a EUR 1 bn issue in May but the EUR 1.6 Eurobond repayment in June might decrease the public external debt. Most of the amount planned of Eurobonds has already been issued, EUR 2.25 bn out of EUR 3 bn and one more issue of less than one billion is possible in September – November.

[17] In February, it sold 10y bonds at a yield of 2.55% and 20y bonds at 3.9%

In the case of new retail loans, although there is a deceleration due to a less dynamic pace in consumer loans, we can see still an overall growth of 35% yoy in April-May. Nevertheless, some of the new lending is just a one-time event, triggered by the new regulation that changed the mortgage lending picture and which lead to the acceleration from 48% yoy in Q1 16 to +60% yoy in April-May 16. The rush was caused by clients seeking to avoid the higher down payments and also the exhaustion of the state guarantees for First Home and this lending was mainly in RON. The impact of the new legislation pressured mortgage euro lending, due to significantly higher down payments in euro reaching up to 30%, up from 15% and much higher than the 5% for First Home. The giving in payment law entered into force on 13th of May and by the end of the month, 15 banks had already increased the required advance.

Given the legislative changes, the future may not be so bright for mortgage lending. So far, the credit terms of First Home (interest rates, down payment) were close to other credit products in the market. At this moment, the First Home gains importance as the size of the down payment is a crucial factor for most homebuyers in Romania. The issue is that the allocated funds nearly ended in April (81% of loan mortgages went to First Home in Jan-April). On 4th of May, only RON 182 mn in guarantees were available out of the RON 1.7 bn ceiling. The funds were supplemented by RON 0.5bn in mid-May which means that by the end of June the funds may have ended. Therefore, either we see a further increase in the ceiling or we could start see a drop in in new mortgage flows with possible impact also on the apartment prices (NBR expects a 10% drop, as an impact of the giving in payment law).

The Giving in payment law

It was approved on 13th May. Under the law, home owners which funded the house acquisition by loan can submit the house to the bank and its debt be cleared. The First Home program is excluded from this rule, following NBR recommendation. The maximum loan ceiling is 250.000 EUR (150.000 EUR was NBR recommendation). It applies only to owner occupied dwellings (NBR recommendation was accepted) or land for this purpose. The law is retroactive and it is also applicable in the cases where the properties are under foreclosure. Several financial institutions reacted to this proposal. The IMF estimated that the potential of write-offs under this law would be 5-13 bn RON and that the overall loss to the financial system would be in the range of 1.3-3.3 RON bn (4% of commercial banks total capital). Rating agency Moody’s has a much severe scenario and considers that 14% of the banking system total capital (at June 15) could be affected by this law. For this calculation, they consider all mortgage loans with LTV>100%.

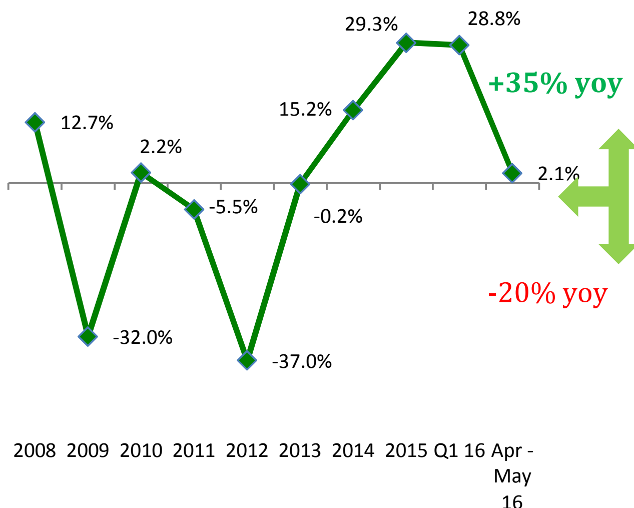
The main reason for the weak figure of new loans is due to the 20%yoy drop in new corporate loans, mainly dragged down in May. Loans denominated in both currencies were affected. Fundamentally there was no change and the drop is the result of a base effect[18].

[18] Last year in May, interest rates for both RON and EUR dropped significantly (40-50 bps in a month) which could have triggered some re-pricings through refinancing, visible in the new loans flow but not in the stock. In the case of RON, we

Otherwise, the monthly loan flow was in line with the monthly average of the last 4 years (RON 2.7 bn since Jan 12- May 16). In fact, the slack in corporate lending is a wound that does not heal. The stock level is lower by RON 13 bn compared to December 12, the year when we started to see a downtrend. At the core of the problem is that a large number of companies have balance sheet problems and therefore they cannot further access bank loans. According to NBR, there are 187,000 undercapitalized companies, which need EUR11 bn to get back on track. These firms have losses and they are disinvesting. They should either be recapitalized or exit.

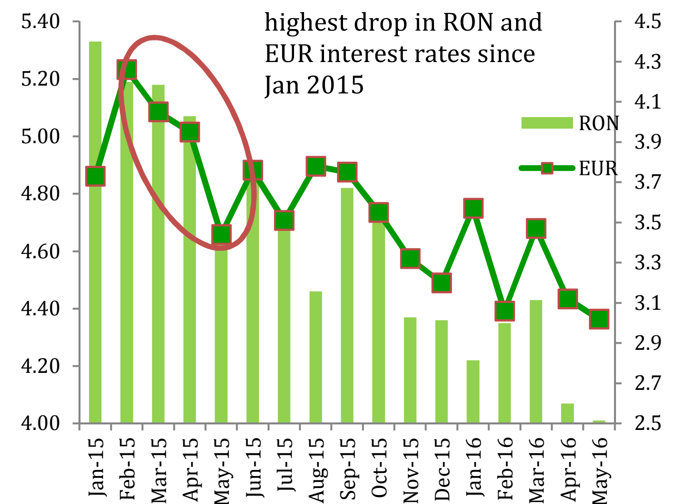
According to the half year credit survey operated on companies, most companies intend to maintain or reduce banking exposure, irrespective of the interest rate levels. Internal financing remains the most important funding source. [19] However, the companies which applied for credit reported they were most sensitive to the collateral requirements and interest rate level. The new legislation approved in July 2016 could help to some extent with the problem of collateral as the state aid extended to companies with over 1 mn EUR in their production units, down from 10 mn EUR previously. With respect with the interest rate issue, the Brexit event possible will determine the preservation of the current low interest rate environment (both for Euribor and ROBOR) and this will be a stimulus for corporate lending.

NEW LOANS DECELERATE DUE TO COMPANY LENDING, WITNESSING A BASE EFFECT



Source: NBR, GarantiBank Research

INTEREST RATES FOR COMPANIES DROPPED 40-50 BPS IN MAY 2015, BOOSTING LOAN DEMAND



Source: NBR, GarantiBank Research

The current report was completed as of 21st of July.

witnessed larger liquidity and lower money market rates due to lowering of the mandatory reserves from 10% to 8%. Also, the last rate cut was operated, to 1.75% in May 2015.

[19] The ones with loans have a RON interest rate between 3%-5% and EUR interest rate between 2-4%.

GarantiBank

Macroeconomic Data and Forecasts

	2013	2014	2015	2016F
Economy				
Nominal GDP, (EUR bn)	144.3	150.2	160.4	171.0
GDP per Capita (EUR)	7,205	7,532	8,055	8,605
Real GDP, (% yoy)	3.5	3.0	3.8	3.7
Population, (mn)	20.0	19.9	19.9	19.9
Avg net monthly wages (EUR, nominal)	352	379	408	464
Avg net monthly wages (% yoy, RON)	4.8	7.5	8.9	11.2
Unemployment rate, ILO, avg	7.1	6.8	6.8	6.6
External Accounts				
Current Account (EUR bn)	-1.5	-0.7	-1.8	-4.1
Current Account (% of GDP)	-1.1	-0.5	-1.1	-2.4
Export (EUR bn)	49.6	52.5	54.6	57.9
Import (EUR bn)	55.3	58.5	63.0	68.6
Export (% yoy)	10.1	5.8	4.1	6.0
Import (% yoy)	1.1	5.9	7.6	9.0
Trade balance FOB-CIF (EUR bn)	-5.7	-6.1	-8.4	-10.8
Trade balance FOB-CIF (% of GDP)	-4.0	-4.0	-5.2	-6.3
Net FDI (EUR bn)	2.9	2.7	2.8	3.9
Net FDI (% of GDP)	2.0	1.8	1.7	2.3
Internat. reserves incl. Gold (EUR bn)	35.4	35.5	35.5	34.5
Gross Foreign Debt (EUR bn)	98.1	94.7	90.9	96.1
Gross Foreign Debt (% of GDP)	68.0	63.1	56.7	56.2
Fiscal Accounts				
Budget Balance (% of GDP)	-2.5	-1.9	-1.5	-2.9
Public Governmental Debt (% of GDP)	38.0	39.8	38.4	39.8
Inflation/Monetary/FX				
Inflation (CPI) yoy, eop	1.6	0.8	-0.9	1.4
Inflation (CPI) yoy, yearly average	4.0	1.1	-0.6	-0.7
Central bank reference rate, eop	4.00	2.75	1.75	1.75
Central bank inflation target	2.50	2.50	2.50	2.50
1M Robor, eop	1.88	0.91	1.05	1.10
1M Robor, avg	4.05	1.88	1.19	1.02
EUR/RON, eop	4.48	4.48	4.52	4.43
EUR/RON, avg	4.42	4.44	4.45	4.46

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