

## Romania

# Weekly update

## Searching for clues

**We are concerned about economic prospects for 2010 even though 2009 is likely to post a sharp contraction. The ability of households to consume is key in this regard and the data so far is not looking good at all.**

### Recent developments

- **NBR slashes key rate by 50bp to 9%.** The move was in line with our expectations and consensus. The central bank also cut reserve requirements for both leu- and hard currency-denominated liabilities with residual maturities of up to two years from 18% to 15% and from 40% to 35%, respectively.
- **FX reserves drop about €400m in June to €26.5bn.**
- **Industrial producer price growth continued to grind lower.** PPI softened to 1.4% YoY in May from 2.9% in the previous month.
- **Nominal net wage growth slows down to 8.7% YoY.**
- **Registered unemployment rises to 6% in June; ILO unemployment jumps to 6.9%.**

### The week ahead

There are two important data releases this week: industrial output and inflation data. As regards the former, we look for an improvement in monthly data, but because of the base effect the annual rate could turn even more negative.

As for the latter, we see the annual rate of inflation staying at 6% because of significant hikes in fuel prices driven by higher crude prices and because of exchange rate depreciation during June. These two effects are likely to push for a 0.3% MoM rate of inflation and thus unchanged annual rate in spite of sharply falling demand.

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**SEE THE DISCLOSURES APPENDIX FOR IMPORTANT DISCLOSURES AND ANALYST CERTIFICATION**

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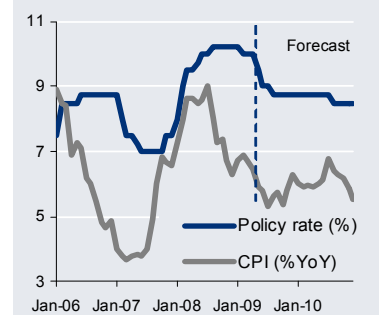
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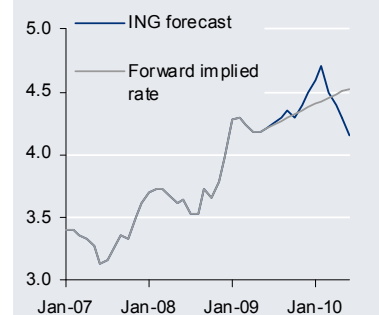
7 July 2009

### Key policy rate and CPI (%)



Source: NBR, NIS, ING estimates

### EUR/RON (eop)



Source: Reuters, ING estimates

### Core projections

	2008	2009F
Real GDP (%YoY)	7.1	-7.1
Current account (% of GDP)	-12.3	-3.8
Inflation (%YoY, avg)	7.9	6.0
Key policy rate (%)	10.25	8.75

Source: ING estimates

## Assessment

Initially Romania was affected by the global crisis through the negative impact on external demand. Yet, the main thrust of the recession was the spillover of the global crisis onto domestic demand given the dependence on financing from abroad, excessive borrowing and inappropriate policies locally (extremely loose fiscal policy in an unfavourable external environment and too tight monetary policy during 4Q08, aiming at financial stability through RON protection). In this context, we think we did not pay sufficient attention to consumer developments expected for the next year or so.

Consumer spending accounts for roughly 80% of GDP and therefore represents an important factor behind any future recovery in economic activity. Yet, this is exactly the sector that suffered the strongest contraction starting in 4Q08 and continuing in 1Q09. But this is also the sector where most of the problems lie, given the overheating of the economy during 2007 and 2008. Moreover, although there is a lot of talk about lower rates and a sharp recovery in lending activity, we see the household sector as likely to suffer even more in the coming quarters.

For this reason, any rebound in lending should take place only gradually and a pick-up in growth is likely to be a very slow process. Yet, during this time we should see the unemployment rate moving higher, thus impacting consumers' ability to spend and a rise in non-performing loans as well.

We should not expect a fast recovery in the local economy in 2010 and another year with significant negative growth should not be ruled out (please note this is not our base case yet as we expect only -0.4% for 2010). In this context we stress that a sharp fall in 2009 does not mean 2010 will bring growth by default. Careful consideration should be given to households' situation and to investment activity. This is particularly because we already have a strong positive contribution from external demand and it is likely to become less relevant during 2010 (we expect it to remain in positive territory). From this point of view, internal demand remains of top importance for any recovery in the local economy.

It is hard to expect a strong recovery in investment activity given the global environment and poor outlook of the Romanian economy. Moreover, there is a strong crowding-out effect currently underway and any additional state spending not directed towards investment could complicate matters even more.

Data so far (retail sales, net wages and unemployment) is indicating demand could contract further against a backdrop of falling household net worth. Future household income is the key to any recovery, but we do not see any good signs in this regard. Actually, the opposite might be true given the labour market outlook and the fact that more painful adjustments are likely in this regard. Re-structuring in state spending would imply – at some point in future – cutting wages in the public sector and/or laying off employees. Although this might be required, it should be detrimental to consumption and to the recovery story.

Households with a low level of revenues are likely to suffer more during the crisis. This is particularly true if they also borrowed a lot in recent years. Moreover, households in general borrowed larger and larger amounts in recent years for longer periods – given that asset prices grew sharply – which means the biggest share in monthly rates is

represented by interest and not principal repayments. This actually accentuates the problem of future debt servicing.

Additionally, during 2007 and 2008 banks offered lending with low fixed rates for short periods – one, two or three years mainly – and with extended maturities (25, 30 years or even more) in their attempt to make it possible for households to borrow bigger amounts. Once rates are reset in future periods, the pressure on households is prone to increase, making them less likely to spend money on new goods or unable to repay loans.

Given the depressing prospects of future incomes and likely rising unemployment, it is quite reasonable to expect increased difficulty in debt servicing, which would actually push non-performing loans higher.

We believe the peak in NPLs should be towards the end of 2010. It is closely related to the peak in unemployment – a lagging indicator – which continues to rise about a year after the economy enters a recovery phase. Since we expect this to happen in 4Q09, we also look for the unemployment rate to increase until the end of 2010. We see a declining unemployment rate only starting in 2011.

On top of the above, we should add the fear of tax hikes in 2010 given expanding budget deficits and the need to bring those below 3% of GDP by the end of 2011 (this is necessary to achieve sustainable long-term growth and it is also included in the IMF/EU agreement). This factor argues at least for a weak recovery, if not for a considerable negative impact on demand.

## Main developments

### **NBR slashes key rate by 50bp to 9%**

The move was in line with our expectations and consensus. The central bank also cut reserve requirements for both leu- and hard currency-denominated liabilities with residual maturities of up to two years from 18% to 15% and from 40% to 35%, respectively.

#### ***We believe the NBR made the right decision***

Almost all the reasons we based our forecasts on were amongst the reasons cited by the NBR for their decision. We believe the NBR made the right decision by opting for a prudent approach in its attempt to restore growth in Romania, while still keeping an eye on inflation. As we highlighted in our reports, a more aggressive easing would bear substantial risks for the local economy (financial stability and stagflation risks).

#### ***We expected the NBR to cut the RON reserve requirement by 2-3pps***

We expected the NBR to cut the RON reserve requirement by 2-3pps, so the move was in line with our view but it was not expected by the market. Yet, we could say the cut on foreign currency liabilities came a bit as a surprise for us as well, even though for about two months NBR officials have suggested sharp cuts in hard currency reserve requirements during 2009. After the cuts in reserve requirements, market liquidity should increase by about €1.4bn and circa RON3bn starting with 24 July to 23 August. We believe cuts in the reserve requirement for RON liabilities will continue and we maintain our forecast presented in March 2009 for a 10% level by the end of the year.

#### ***Lending rates to fall significantly in a few months***

We prefer to attach an increased importance to the cut in the reserve requirements for local currency liabilities as such a move has the potential to stimulate local currency

lending without reducing the attractiveness of the RON. Further cuts in the reserve requirements should see lending rates falling significantly in a few months. Additionally, such a move was required in the context of falling reserve requirements for hard currency and falling Euribor, as hard currency lending means exchange rate risk. We believe this should be avoided in the current delicate environment. As a result of the NBR's decisions, we should see some downward pressure on interest rates which should help lending activity towards year-end and/or early 2010.

***The NBR prefers to base its decisions on past inflation instead of expected (forecasted) inflation***

The NBR also talked about a 3% real rate and, taking into consideration its forecast of about 2.5% YoY inflation for June 2010, this implies a key rate of 5.5%. Yet, the NBR set the key rate at 9% based on past inflation, which is not characteristic of an inflation targeter. This is a sign that even the central bank views its forecast with a high degree of uncertainty and prefers to base its decisions on past inflation instead of expected (forecasted) inflation. We see June 2010 inflation marginally above 6% and find the decision appropriate from this point of view as well.

***Another rate cut at the 4 August rate-setting meeting***

The continuation of the disinflation process until August should favour another rate cut at the 4 August meeting given the backward-looking approach of the central bank. Our forecast since May is for a 25bp cut in August – with risks for another 50bp cut – and unchanged rates in September (with risks for a 25bp cut). This view is based on inflation falling to about 5.5% in July. The latter would call for a monetary policy rate of about 8.5% given the 3% real rate often cited by NBR officials. If we are right and inflation climbs again starting in August, the NBR might find itself in a position to stop cutting the key rate. However, we believe the cautious approach adopted would prevent the NBR from a situation in which it might be forced once again to hike the monetary policy rate towards end-2009 and/or early 2010.

***Key rate to stay above 8%***

In this context, we stress once again that it is very hard to see rates falling below 8% by year-end as many analyses suggest rates as low as 7%. This would imply inflation of about 4% in 2H09 (or in 2010), but such an outcome has a very low probability. Moreover, there is no help from fiscal policy and this means pressure is to remain on monetary policy. We stick to our view for rates ending 2009 at 8.75%, with risks for an 8% low.

***We see increased risks for a weaker RON towards year-end and/or early 2010***

The RON had almost no reaction after the decision was announced. We believe the local currency should continue to be influenced mainly by global developments in the short term, but see increased risks for a weaker RON towards year-end and/or early 2010. Given the massive public funding needs and the dwindling credit demand of the private sector, it is likely that RON rates are headed lower and that the NBR will prevent sharp upside moves. This narrows its room for manoeuvre for FX interventions.

Contingent on further monetary policy easing, market interest rates should fall with the economy benefiting in 2010. The cost of this could be a weaker RON, which we expect later this year and/or in early 2010.

**FX reserves drop about €400m in June to €26.5bn**

The press release provides little detail on the reasons behind this decrease, leaving room for speculation. The sizeable drop comes as a surprise since FX moves do not prompt any sizeable revaluations, the FX swap deals through which the NBR injected RON in the market were reversed before the end of May and Eurozone bonds enjoyed a month of nice gains.

**Drop likely caused by lower FX reserves from credit institutions**

Although the central bank seemed to be active in the FX market, the thinly traded volumes would suggest it did not spend significant ammunition. This leaves the explanation behind the drop as lower FX reserves from credit institutions. The latter may have decided to switch short-term liabilities to liabilities with maturities in excess of 2Y for which the reserve requirement has been cut to zero. Unfortunately, detailed FX reserves data that would test this hypothesis will be released only towards the end of this month.

**This fall does not bode well for the RON**

This fall does not bode well for the RON, especially during these benign market times. Central bank reserves should record an even steeper fall in July as reserve requirements for FX liabilities have been eased, which would lead to an outflow of about EUR1.3bn.

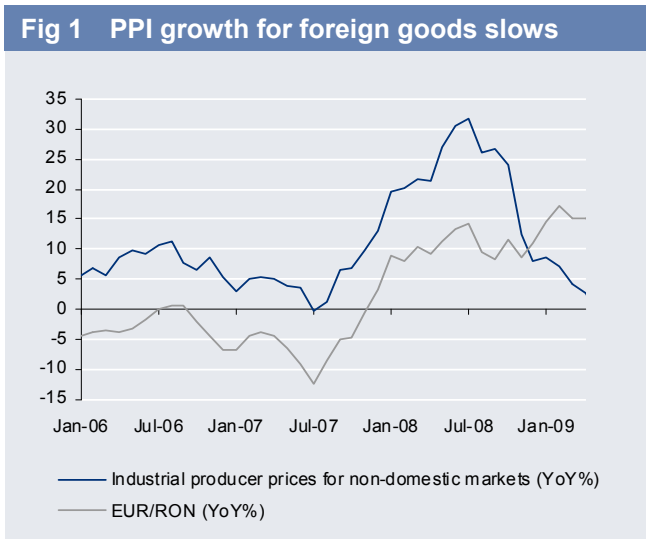
**Industrial producer price growth continued to grind lower**

PPI softened to 1.4% YoY in May from 2.9% in the previous month.

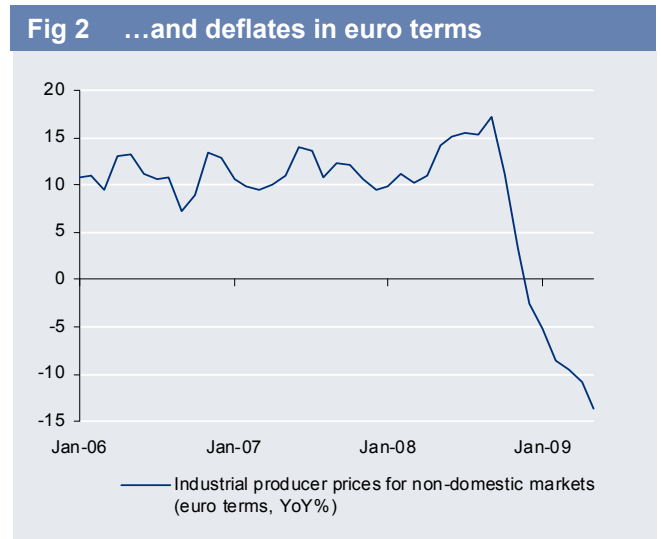
The PPI-CPI gap, which climbed into the double digits during the summer months of last year providing worrying prospects for consumer prices, continued to sink into negative territory.

**PPI continued to soften**

The annual pace for goods designed for both the domestic and the foreign markets continued to soften. Producers of goods for non-domestic markets no longer adjust their prices in RON to compensate exchange rate movements. In euro terms, the prices of these goods have decreased by about 13.5% YoY in May after recording an average expansion of more than 10% over the past three years. This price action resembles an aggressive run down in inventories.



Source: NIS, NBR, ING estimates



Source: NIS, NBR, ING estimates

PPI for goods designed for the external markets has already fallen into negative territory. The headline figure could follow in the next month due to a heavy base effect, but this may be compensated by high energy prices. These have led to a significant revision in April PPI from 2.5% YoY to 2.9% and could provide further support going forward.

**Nominal net wage growth slows down to 8.7% YoY**

Nominal net wage growth fell from 9.8% in April to 8.7% YoY in May due to the negative base effect, once there was no impact coming from bonus payments. This is

**This is the second month with wage growth in the single digits**

the second month with wage growth in the single digits, a situation not seen since 2000 (the lowest growth rate was registered in January 2007 and it was 11.1% YoY).

***There are signs of additional wage falls in the later months***

If we analyse the seasonally adjusted data – not published by the NIS, but computed by us – we observe that, with the exception of February, all the other months during 2009 posted negative growth so far. This is a sign of additional wage falls in the later months given the poor outlook for the Romanian economy and other indicators released so far, though we stress that any falls on seasonally adjusted data are likely to be limited given wage rigidity is high.

***High pressure on the ability of households to consume***

Anyway, wage growth is likely to move towards 5% YoY during 3Q09 and to fall into negative territory in 4Q09. Developments so far are slightly worse than we expected and we remind you that our forecast for 2009 is for average wage growth of about 6.5%, which would imply negative real growth taking into account our inflation forecast. This puts tremendous pressure on the ability of households to consume in the future. For this reason, we expect only a very slow revival in lending activity towards the end of 2009 and/or early 2010. This also speaks for a gradual recovery in economic activity during 2010.

**Registered unemployment rises to 6% in June; ILO unemployment jumps to 6.9%**

***Another sharp rise on the seasonally adjusted unemployment rate***

The unemployment rate grew from 5.8% in May to 6%, sharply higher than the 3.7% registered in June 2008. Although it seems a small increase vs May, it is actually a strong increase looking at seasonally adjusted data (0.4pps, the same as in May and April 2009). This is supportive for our year-end forecast of 8.5% and we believe, given the bleak outlook for the local economy, it is an indicator that in 2010 the registered unemployment rate could surpass 10%.

***ILO unemployment for 1Q09 also jumped***

The ILO (International Labour Office) unemployment rate for 1Q09 jumped to 6.9% vs 5.8% at the end of 2008 and 6.3% in 1Q08. This indicator is closer to the actual unemployment situation as it is based on surveys.

**Fig 3 Economic forecast summary**

	Last	2Q09	3Q09F	4Q09F	2009F	1Q10F	2Q10F	3Q10F	4Q10F	2010F
EUR/RON*	4.21	4.2067	4.35	4.50	4.27	4.50	4.15	4.00	4.10	4.25
3M ROBOR (%)*	9.61	10.30	9.25	9.75	10.94	9.75	9.25	9.00	8.75	9.19
5Y bond yield (mid, %)*	10.53	10.55	10.75	11.00	11.06	10.75	10.50	10.25	10.00	10.38
CPI (%YoY)*	5.95	6.0 (F)	5.7	6.3	6.0	6.0	6.1	6.3	5.5	6.1
GDP (%YoY)*	-6.2	-8.6 (F)	-9.3	-4.5	-7.1	-2.6	-0.7	0.2	0.7	-0.4
NBR key policy rate (%)	9.00	9.00	8.75	8.75	8.75	8.75	8.75	8.50	8.50	8.50

Source: NBR, NIS, and ING estimates

\*Quarterly forecasts are eop; yearly forecasts are average over the year

## Economic outlook

**Fig 4 Key economic forecasts**

	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009F	2010F	2011F
<b>Activity</b>												
Real GDP (%YoY)	2.1	5.6	5.0	5.3	8.5	4.1	7.9	6.2	7.1	-7.1	-0.4	2.6
Private consumption (%YoY)	0.2	8.4	5.3	8.4	13.6	9.7	12.0	10.5	8.7	-11.8	-2.3	2.1
Government consumption (%YoY)	20.5	-9.6	-6.6	10.5	-9.9	2.2	-11.5	7.7	3.8	2.9	-0.7	3
Fixed investment (%YoY)	5.5	9.9	8.9	8.7	11.0	15.3	19.9	28.9	19.3	-4.1	1.7	4.5
Industrial production (%YoY)	7.1	8.3	4.3	3.1	5.3	2.0	7.2	5.4	0.9	-7.5	1.1	5.3
Unemployment rate year-end (%)	10.5	8.8	8.4	7.4	6.3	5.9	5.2	4.1	4.4	8.5	10.5	9
Nominal GDP (RONbn)	80.4	116.8	152.0	197.4	247.4	289.0	344.7	412.8	504.0	521.5	562.0	625.7
Nominal GDP (€bn)	40.3	44.9	48.6	52.6	61.0	79.7	97.8	123.7	137.1	122.0	132.2	158.4
Nominal GDP (US\$bn)	37.1	40.2	46.0	59.5	75.8	99.2	122.7	169.5	201.7	163.5	167.3	193.6
GDP per capita (US\$)	1650.1	1791.4	2106.4	2731.2	3491.1	4578.8	5677.7	7861.5	9369.5	7596.4	7780.9	9006.6
Gross domestic saving (% of GDP)	13.8	14.8	16.4	14.5	14.7	13.1	14.4	17.1	16.9	18.8	22.2	24.9
<b>Prices</b>												
CPI (average %YoY)	45.7	34.5	22.5	15.3	11.9	9.0	6.6	4.8	7.8	6.0	6.1	4.9
CPI (end-year %YoY)	40.7	30.3	17.8	14.1	9.3	8.6	4.9	6.6	6.3	6.3	5.5	4.5
PPI (average %YoY)	53.4	38.1	23.0	19.5	19.1	10.5	11.6	8.1	15.8	1.9	7.2	6.7
Wage rates (%YoY, nominal, average)	39.8	40.5	27.1	25.4	22.5	23.7	16.8	21.0	22.9	6.4	8.0	10.5
<b>Fiscal balance (% of GDP)</b>												
Consolidated government balance, (ESA95)	-4.4	-3.5	-2.0	-1.5	-1.5	-1.4	-1.9	-2.5	-5.3	-6.9	-3.8	-2.8
Consolidated primary balance	N/A	N/A	0.4	-0.2	0.2	0.3	-1.4	-1.7	-4.5	-5.4	-2.7	-2.1
Total public debt	31.4	28.7	28.9	26.0	22.5	20.5	18.4	20.2	21.6	26.8	24.0	22.0
<b>External balance</b>												
Exports (US\$bn)	10.4	11.4	13.9	17.7	23.6	27.7	32.5	40.5	49.3	33.4	32.4	35.0
Imports (US\$bn)	12.1	14.4	16.5	22.2	30.2	37.4	47.3	64.9	76.2	41.1	39.2	43.2
Trade balance (US\$bn)	-1.7	-3.0	-2.6	-4.5	-6.6	-9.7	-14.8	-24.4	-26.9	-7.7	-6.8	-8.1
Trade balance (% of GDP)	-4.6	-7.4	-5.7	-7.5	-8.7	-9.8	-12.0	-14.4	-13.3	-4.7	-4.1	-4.2
Current account balance (US\$bn)	-1.4	-2.2	-1.5	-3.5	-6.3	-8.6	-12.8	-23.1	-24.8	-6.2	-5.7	-4.2
Current account balance (% of GDP)	-3.7	-5.5	-3.3	-5.8	-8.4	-8.6	-10.4	-13.6	-12.3	-3.8	-3.4	-2.2
Net FDI (US\$bn)	1.1	1.2	1.1	2.2	6.7	6.5	11.4	9.7	13.3	5.2	4.9	5.5
Net FDI (% of GDP)	3.0	3.1	2.5	3.6	8.8	6.5	9.3	5.7	6.6	3.2	2.9	2.8
Current account balance plus FDI (% of GDP)	-0.7	-2.5	-0.9	-2.2	0.5	-2.1	-1.1	-7.9	-5.7	-0.6	-0.5	0.6
Export volume (%YoY, ESA95)	23.4	12.1	17.5	8.4	13.9	7.7	10.4	8.8	18.9	-19.0	2.0	19.0
Import volume (%YoY, ESA95)	27.1	18.4	12.0	16.0	22.1	16.0	22.6	26.1	17.1	-25.9	1.7	22.0
Foreign exchange reserves (ex gold, US\$bn)	2.5	4.0	6.2	8.1	14.7	19.9	28.1	36.9	37.6	36.5	37.3	32.4
Import cover (months of merchandise imports)	2.4	3.4	4.1	3.9	5.4	6.7	6.8	6.4	6.2	11.0	11.5	9.2
<b>Debt indicators</b>												
Gross external debt (US\$bn)	11.4	13.2	17.0	22.4	29.2	36.6	54.1	85.9	101.3	95.9	89.9	93.5
Gross external debt (% of GDP)	30.0	33.0	33.3	33.9	35.2	38.8	42.0	47.6	52.9	60.5	54.4	49.2
Gross external debt (% of exports)	107	116	110	114	114	139	159	199	216	296	281	272
Total debt service (US\$bn, includes ST)	2.6	3.3	4.1	4.9	5.9	16.4	24.0	38.0	45.6	31.4	23.4	26.8
Total debt service (% of GDP)	6.4	7.3	8.4	9.3	9.7	20.6	24.5	30.7	33.2	25.7	17.7	17.0
Total debt service (% of exports)	56.8	57.2	57.1	59.7	51.1	92.4	94.9	104.0	99.1	103.1	69.2	59.1
<b>Interest &amp; exchange rates</b>												
Central bank key rate (%) year-end	47.84	34.37	19.63	21.25	17.31	7.50	8.75	7.50	10.25	8.75	8.50	8.50
Broad money supply (%YoY)	38.0	46.2	38.2	23.3	39.9	33.9	29.4	33.9	17.5	11.6	16.7	21
3-month interest rate (ROBOR avg %)	55.4	43.7	29.8	19.9	20.7	9.8	8.8	7.8	13.0	10.9	9.4	8.9
3-year yield (avg %)	N/A	N/A	22.0	14.8	15.5	7.4	7.4	7.6	11.5	11.0	10.9	9.7
5-year yield (avg %)	N/A	N/A	N/A	N/A	N/A	7.3	8.1	7.5	11.0	11.1	10.4	9.5
Exchange rate (RON/US\$) year-end	2.59	3.13	3.33	3.27	2.93	3.11	2.56	2.47	2.85	3.46	3.28	3.17
Exchange rate (RON/US\$) annual average	2.17	2.91	3.31	3.32	3.26	2.91	2.81	2.43	2.50	3.19	3.36	3.23
Exchange rate (RON/€) year-end	2.41	2.79	3.49	4.11	3.97	3.68	3.38	3.61	3.99	4.50	4.10	3.80
Exchange rate (RON/€) annual average	2.00	2.60	3.13	3.76	4.05	3.62	3.52	3.34	3.68	4.27	4.25	3.95
EUR/USD (eop)	0.94	0.89	1.05	1.26	1.36	1.18	1.32	1.46	1.40	1.30	1.25	1.20
EUR/USD (annual average)	0.92	0.90	0.95	1.13	1.24	1.24	1.26	1.37	1.47	1.34	1.265	1.22

Source: National sources, ING forecasts

# Disclosures Appendix

## **ANALYST CERTIFICATION**

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