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Weekly Report

Romania

14 August 2012

The Central Bank caps repo size to support the leu

Macroeconomics: Industrial production down 0.4% MoM in June; constructions output fell sharply by 9.9% MoM; CPI exceeded expectations and stood at 3% YoY in July (Page 3-5)

Industrial production fell in June both on annual and monthly basis: -1.4% YoY (gross data) and -0.4% MoM (seasonally adjusted data). The domestic sales index fell more than the export sales in June in annual terms, gross data shows. The July economic sentiment indicator (ESI) pointed to a further deterioration, after having declined significantly in June as well. Inflation came at 3% YoY in July, higher than analysts' expectations of 2.8% YoY. Construction dropped sharply in June to - 0.8% YoY from previous 19.2% YoY in May and ESI declined further. In June, exports' annual growth rate slipped into the negative territory (-1.2% YoY) after two consecutive months of relatively strong advance of 3-4% YoY. Net nominal wages increased by 5.4% YoY in June. In the public administration sector, the promise increase was granted: +7.9% YoY.

FX markets: liquidity squeeze boosts the leu (Page 6)

In order to stop further depreciation of the leu, the CB injected less liquidity at the weekly repo (only 40% of the offered amount) which pushed up MM rates around 30 bp and consequently triggered leu's appreciation of 1.8% last week. Higher MM rates will put higher pressure on treasuries' yields increasing country's debt burden. They will also raise interest rates for loans and deposits as well: the former will limit lending and the second stimulate saving, both measures depressing economic growth. Higher deposit cost will put further pressure on banks' profitability. This step taken by the NBR is not in line with earlier widening of the accepted collateral for the repo. Given the reasons described above, we believe the current liquidity squeeze is temporary and will not extend untill the year end.

Government securities: yields jumped up to 35 bp (6M) last week (Page 7-8)

Government securities yields jumped abruptly last week, especially at the short end of the curve. The 12M T-bills yield was up by by 34 bp, the 3Y bond yields advanced 18 bp and the 10Y gained 13 bp. This was an immediate consequence of the jump in money market rates. The CB decision to limit the size of liquidity injection basically mopped out the effect of two base rate cuts (of 25 bp) as yields are higher by 35bp (12M). Very simply put, the NBR will have to chose between the current high money market rates which will keep the leu at current levels (everything else equal) and a weaker leu (and consequenly slightly higher inflation). Probably the markets will penalize faster a higher budget deficit than a slightly higher inflation rate, given that the market alredy expects a higher inflation (3.5% YoY) than the one forecasted by NBR for the end of the year (3.2% YoY).

MM: The Central Bank capped the repo size (Page 9)

Money market rates jumped significantly last week after the Central Bank limited the weekly liquidity injection at the repo auction to only 6 bn RON, lower than that of the previous week by 6.1 bn RON. The Central Bank published its inflation report and it maintained the inflation forecast for both December 2012 and 2013: at 3.2% YoY and 3% YoY, respectively. The report emphasizes that keeping the fiscal targets and the agreement with the international financial institutions is essential in order to downsize the risks of the current inflation forecast and of the future economic growth. Unlike the previous report in May, the base scenario for the euro zone is improved for 2012 and 2013 as well: the CB sees a faster positive evolution of the debt crisis and the marginal appreciation of the euro versus the dollar in 2013, with positive consequences on the leu as well. According to our interpretation, the base rate will stay flat in 2013.

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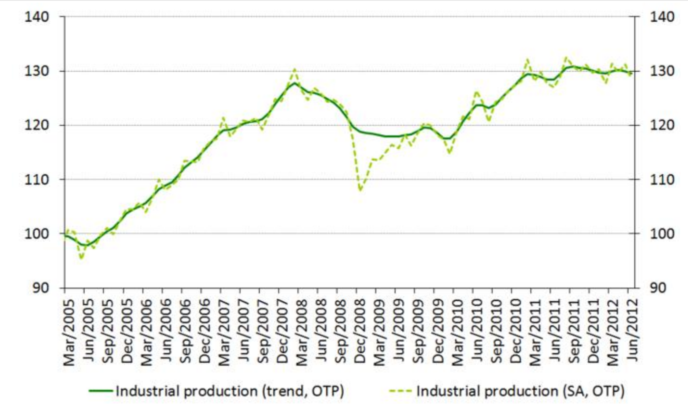
Macroeconomics: Industrial production down 0.4% MoM in June; constructions output fell sharply by 9.9% MoM; CPI exceeded expectations and stood at 3% YoY in July

	PERIOD	INDICATOR	FACT	CONSENSUS	PRIOR
06 Aug	June	Net wage growth rate (y-o-y, %)	5,4		4,9
08 Aug	June	Construction works index (y-o-y, %)	-0,8		19,2
09 Aug	June	Exports (y-o-y, %)	-1,1		3,9
	June	Imports (y-o-y,%)	-0,4		-1,9
09 Aug	June	Industrial trade turnover index (y-o-y, %)	1,5		7,3
09 Aug	June	Index value of new orders in manufacturing (y-o-y, %)	2,1		4,4
10 Aug	June	Wholesale services turnover index (y-o-y, %)	7,5		8,3
10 Aug	June	Households services turnover index (y-o-y, %)	-3,0		-1,9
10 Aug	July	Consumer price index (y-o-y,%)	3,0	2,8	2,0
10 Aug	June	Industrial Production Index (y-o-y, %)	-1,4		3,1
13 Aug	June	CA balance (EUR mn, YTD)	-2.411		- 1.920
14 Aug	Q2 2012	Flash GDP growth rate (q-o-q, %, seasonally adjusted)	0,5	0,2	0,1

Industrial production fell in June both on annual and monthly basis: -1.4% YoY (gross data) and -0.4% MoM (seasonally adjusted data). The annual rhythm is explained by a decline in manufacturing production (-2.7% YoY) while the energy production and the mining & quarrying were up by 7.2% YoY and 5.2% YoY, respectively. Although the sales index remained in the positive territory in June (+1.5% YoY), it declined significantly from the previous 7.3% YoY in May. **The domestic sales index fell more than the export sales in June in annual terms, gross data shows.** The new orders index which is a leading indicator maintained positive +2.1%YoY in June down from 4.4 YoY in May. However, **the capital goods new orders fell by 6.4% YoY which announces a future downfall in production of these goods whereas in the past two months seasonally adjusted data already pointed to a decline. This means that firms decreased the pace of capital investments, in line with weaker lending flows and a deteriorated perception of future business activity. The July economic sentiment indicator (ESI) pointed to a further deterioration, after having declined significantly in June as well.** Lending flows proved weaker at the European level in Q2 (negative flows), not only in Romania and Romania's main trading partner, Germany gives signs of slowdown too.

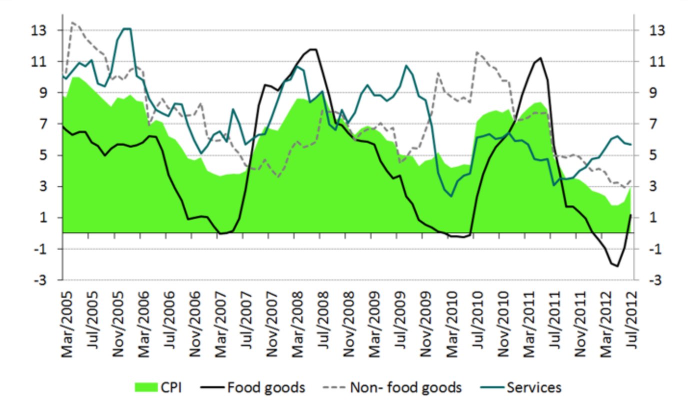
Inflation came at 3% YoY in July, higher than analysts' expectations of 2.8% YoY. Food goods prices spiked to 1.2% YoY after a previous negative rate. Non-food goods were up at 3.4% YoY, also advancing compared to June. The services prices jumped as well 5.7% YoY in July, but

Industrial production index (2005 =100)



Source : Eurostat, OTP Research
Note: in house seasonally adjusted data

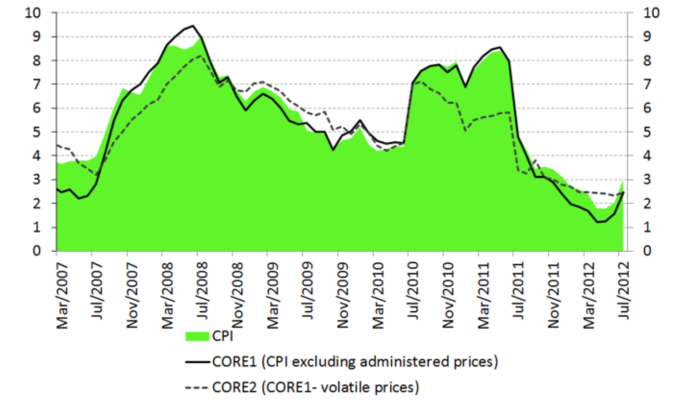
Inflation (YoY, %)



Source : NIS, OTP Research

they were down from 5.8% YoY in June. Core2 adjusted inflation, which is being monitored by the Central Bank and mentioned at each base rate decision, increased its pace significantly to 2.3% YoY from previous 2.1% YoY and deviated from CB's forecast which was seeing it around the 2% YoY level. **Risks to the current forecast come from leu's depreciation and the hike of agro food prices due to draught.**

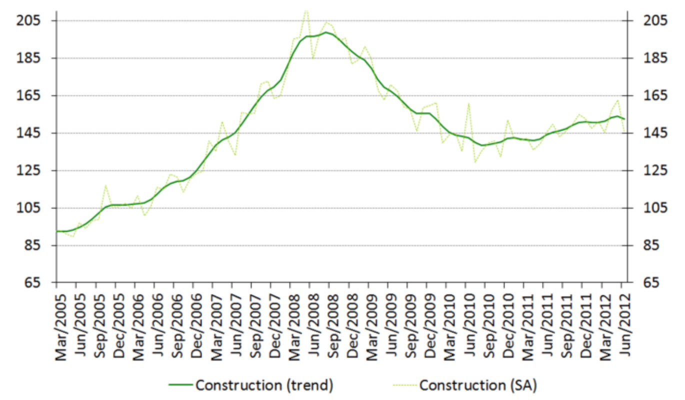
Core inflation (YoY)



Source : NIS, OTP Research

Construction dropped sharply in June to - 0.8% YoY from previous 19.2% YoY in May. On a monthly basis, the decline was 9.9% MoM (seasonally adjusted data) and it came after three months of consecutive growth. **Construction of residential buildings was down by 2.3% MoM (SA data) but most of the impact came from the slump in civil engineering: -11.4% MoM (SA). We correlate the latter with the reduction in public capital expenditure noticed in June. Construction is a major driver of Q2 GDP growth. For July, the economic sentiment points to a further decrease.**

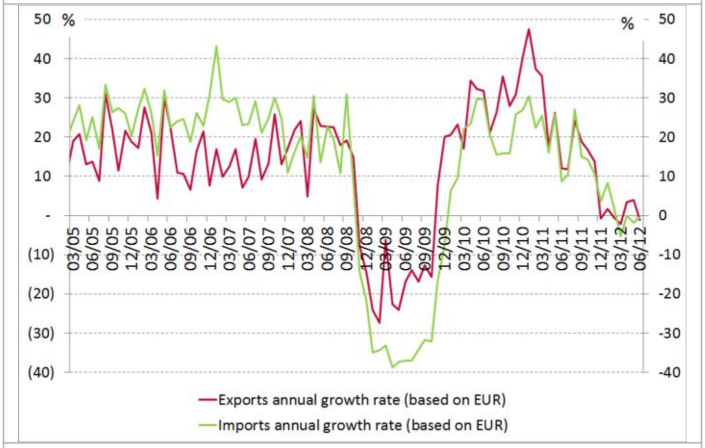
Constructions (2005 =100)



Source : NIS, OTP Research

In June, exports' annual growth rate slipped into the negative territory (-1.2% YoY) after two consecutive months of relatively strong advance of 3-4% YoY. Imports continued the decline started in March and fell another 0.4% YoY in June. 71% of Romania's exports are intra EU. According to the latest poll operated by Reuters, Q2 GDP growth in the euro zone is expected at -0.3% QoQ and increasing in the following quarters: -0.1% QoQ in Q3 and +0.1% QoQ in Q4 2012. Overall growth rate estimated for 2012 stands at -0.4% YoY and +0.6% YoY in 2013. Most relevant for Romania is however GDP growth in Germany and from this point of view, the Reuters poll sees a much slower improvement in GDP growth rate: 0.2% QoQ in Q2 & Q3 2012 and 0.3% QoQ in Q4 2012.

External trade



Source : NIS, OTP Research

Net nominal wages increased by 5.4% YoY in June. In the public administration sector, the promise increase was granted: +7.9% YoY. We expect this hike to boost retail trade in the following months.

Medium-term macroeconomic forecast

Main macroeconomic indicators	Fact						Forecast	
	2006	2007	2008	2009	2010	2011	2012	2013
Real GDP	7,9%	6,3%	7,3%	-6,6%	-1,6%	2,5%	**1,4%***	**2,8%***
Final consumption of households	12,9%	12,0%	9,0%	-10,4%	-0,4%	1,4%	**2,3%**	**2,9%**
Households consumption expenditure	12,7%	11,9%	9,0%	-10,1%	-0,4%	1,3%		
Government consumption	-11,5%	2,5%	6,2%	9,5%	-10,0%	-3,4%	**-0,7%**	**1,7%**
Gross fixed capital formation	19,9%	30,3%	15,6%	-28,1%	-2,1%	6,3%	**5,2%**	**6,2%**
Exports	10,4%	7,8%	8,3%	-6,4%	14,0%	9,9%	**3,3%**	**8,4%**
Imports	22,6%	27,3%	7,9%	-20,5%	11,9%	10,5%	**4,2%**	**8,8%**
Consumer prices (avg.)	6,6%	4,8%	7,8%	5,6%	6,1%	5,8%	**3,5%**	**3,0%**
Budget Balance (GDP%, ESA 95)	-2,2%	-2,9%	-5,7%	-9,0%	-6,8%	-5,2%	**-3,6%**	**-3,3%**
Public debt (GDP %)	12,4%	12,8%	13,4%	23,6%	31,0%	33,3%	**35,3%**	**36,7%**
CA balance (% GDP)	-10,5%	-13,4%	-11,6%	-4,2%	-4,4%	-4,2%	**-4,4%**	**-4,6%**
CA balance (bn EUR)	-10,2	-16,8	-16,2	-4,9	-5,5	-5,7	**-6,0**	**-6,4**
Unemployment	7,3%	6,4%	5,8%	6,9%	7,3%	7,4%	**6,8%**	**6,6%**
Nominal wage growth	18,4%	21,8%	26,1%	4,8%	3,1%	6,5%**	**4,5%**	**4,4%**
Real wage growth	9,0%	14,7%	16,5%	-1,5%	-3,7%	0,5%**	**1,0%**	**1,4%**
Key interest rate (avg.)	8,6%	7,5%	9,7%	9,1%	6,5%	6,2%	**5,33%**	**5,25%**
Key interest rate (e.o.p.)	8,8%	7,5%	10,3%	8,0%	6,3%	6,0%	**5,25%**	**5,25%**
EUR/RON (avg.)	3,52	3,34	3,68	4,24	4,21	4,24	**4,44**	**4,60**
EUR/RON (e.o.p.)	3,38	3,61	3,99	4,23	4,28	4,32	**4,50**	**4,59**

Source: Eurostat, OTP Research
Note: *under revision; ** forecast

FX markets: liquidity squeeze boosts the leu

The Central Bank's Governor presented the inflation report last Monday and commented that the current political events put pressure not only on the exchange rate, but on the future borrowing cost of the country as well. **In order to stop further depreciation of the leu, the CB injected less liquidity at the weekly repo (only 40% of the offered amount) which pushed up MM rates around 30 bp-40 bp and consequently triggered leu's appreciation of 1.8% last week.** This move has the effects described below:

- the base rate is at 5.25% while the ON rate is at 5.7%; this means that banks which would not normally go to the NBR for repo because they could borrow (many times cheaper) from the interbanking market have an incentive to go the repo auctions, thereby diminishing the liquidity that would go to banks for which the only option is the repo auction;
- there is a structural deficit of liquidity in the banking system which already took its toll on the MM rates; this would trigger a further increase in deposit rates offered by banks, thereby stimulating savings to the detriment of consumption, which is anyway weak;
- higher cost of deposits would put extra pressure on banks' profitability and therefore capital requirements
- another immediate effect would be felt on lending in local currency which saw an advance in the past few months; furthermore, the end result would be negative on the economy as well
- the higher MM rates prompt banks to ask for higher yields at the Treasury's bonds auctions which increases the debt burden for the country, especially in a period when Romania has a tight target of the budget deficit
- the move is not in line with the many steps taken by Central Bank to enlarge the type of colalteral accepted for the repo operations.

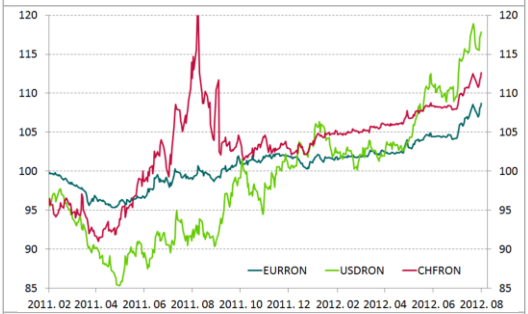
Given the reasons described above, we believe the current liquidity squeeze is temporary and will not extend untill the year end.

Last data: 09.08.2012

FX BID	Value	Weekly chg. (%)	YTD chg. (%)
EURRON	4,54	-1,84	5,05
USDRON	3,69	-2,68	10,72
CHFRON	3,78	-1,67	6,41
RONJPY	4,70	-3,11	8,47
RONPLN	1,12	-0,12	8,59
100HUFRON	1,64	-0,03	20,03
RONCZK	0,18	-0,66	7,48
RONRUB	0,12	0,21	12,51
RONRSD	0,04	-1,08	-3,97
RONBGN	2,32	-1,71	5,33

Source: Reuters

Major RON FX rates (03.01.2011=100)

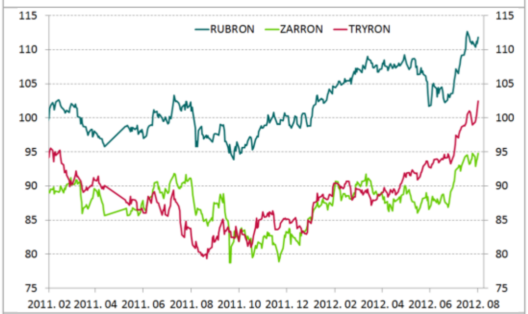


Sources: Reuters, OTP Research

Regional RON FX rates I. (03.01.2011=100)

Sources: Reuters, OTP Research

Regional RON FX rates II. (03.01.2011=100)



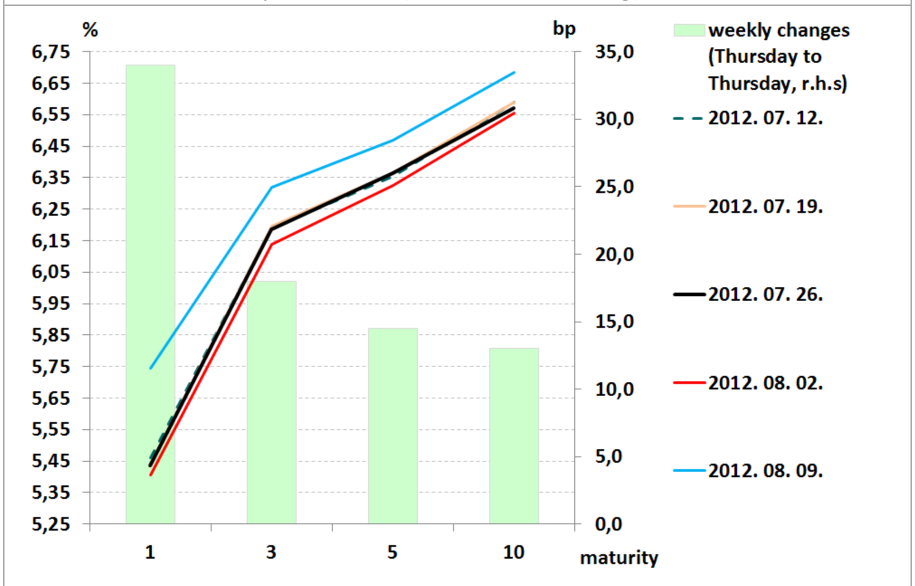
Sources: Reuters, OTP Research

Government securities: yields jumped up to 35 bp (6M) last week

Government securities yields jumped abruptly last week, especially at the short end of the curve. The 12M T-bills yield was up by by 34 bp, the 3Y bond yields advanced 18 bp and the 10Y gained 13 bp. This was an immediate consequence of the jump in money market rates. As the **Central Bank limited the amount of the liquidity injection, the volumes of bills and bonds traded on the secondary market droped last week**.

Up to last week, government securities with a maturity up to 3Y had yields lower by 100 bp than the end of the last year. **The CB decision to limit the size of liquidity injection basically mopped out the effect of two base rate cuts (of 25 bp) as yields are higher by 35bp (12M).** The CB cut the base rate three times this year which in turn was felt in the drop of government securities yields during the first 4M of the year. If these high yields maintain, there will be an impact on the budget deficit (accrual base) given that in Q4 the Treasury will have to go on the markets for refinancing, as the current buffer is decreasing. If the Treasury does not go at all on the market for refinancing it will exhaust completely its existing buffer by the end of this year, which is probably not the base scenario (especially since redemptions in Q1 2013 are much higher than quarterly average in 2012). **Very simply put, the NBR will have to chose between the current high money market rates which will keep the leu at current levels (everything else equal) and a weaker leu (and consequently slightly higher inflation). Probably the markets will penalize faster a higher budget deficit than a slightly higher inflation rate, given that the market alredy expects a higher inflation (3.5% YoY) than the one forecasted by NBR for the end of the year (3.2% YoY).** Meanwhile, the risks of exceeding the deficit target increased as GDP forecast is lower than what was established for 2012: according to local media the IMF reduced the GDP growth forecast from 1.5%YoY to slightly below 1% without modifying the budget deficit target.

Yield curve over the past weeks (Central Bank fixing)



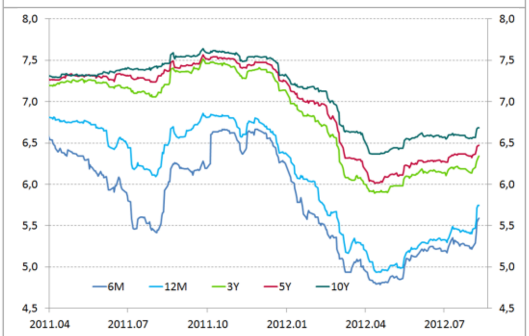
Sources: NBR, OTP Research

Last data: 09.08.2012

RON GOVERNMENT SECURITIES	Value (%)	Weekly chg. (bp)	YTD chg. (bp)
6M	5,57	35,0	-68
12M	5,75	34,0	-64
3Y	6,32	18,0	-82
5Y	6,47	14,5	-78
10Y	6,69	13,0	-65
SPREADS	**Value (bp)**	**Weekly chg. (bp)**	**YTD chg. (bp)**
GERROM 3Y	635	21,6	-51
GERROM 5Y	617	19,8	-32
GERROM 10Y	542	23,0	-9
3Y -5Y	15	-3,5	4
5Y -10Y	22	-1,5	14
3Y-10Y	37	-5,0	18
FLY 3-5-10	6	2,0	9
CDS MID SPREADS	**Value (bp)**	**Weekly chg. (bp)**	**YTD chg. (bp)**
3Y EURO	310	-13,8	-62
5Y EURO	359	-15,2	-43

Source: Reuters

Central bank benchmark fixing yields (%)

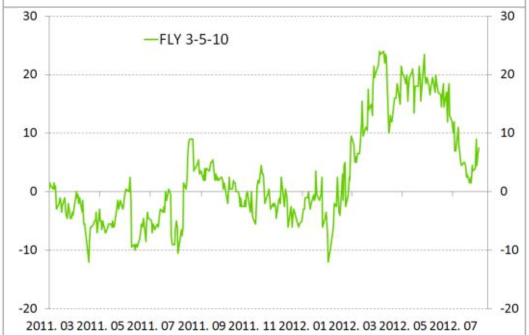


Sources: NBR, OTP Research

Slope of the yield curve (bp)

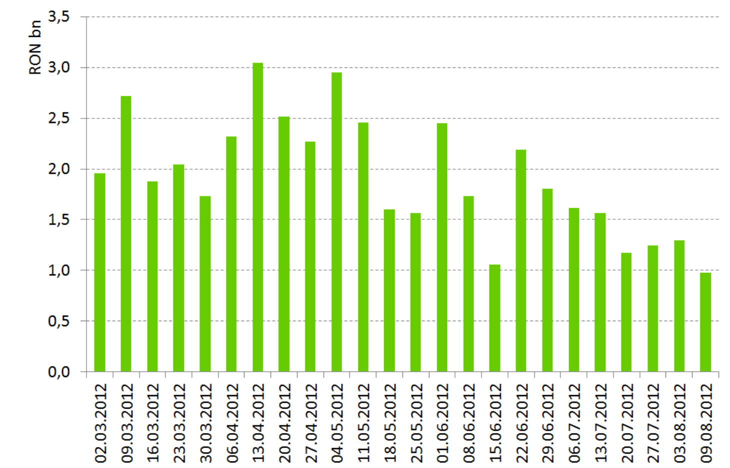
Sources: NBR, OTP Research

FLY 3-5-10 (bp)



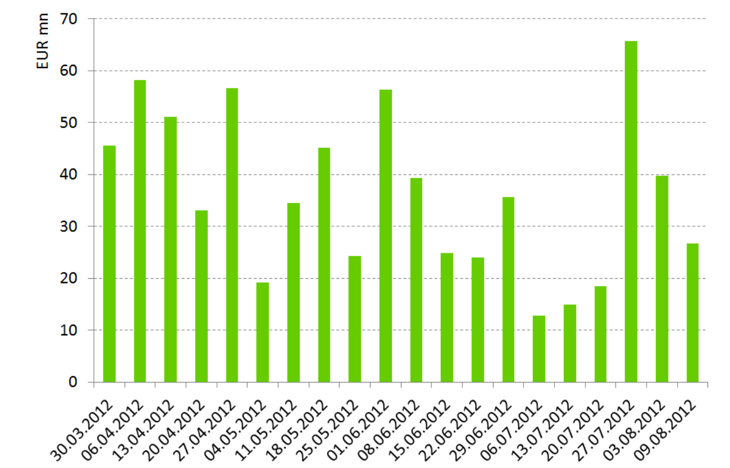
Sources: NBR, OTP Research

RON denominated securities (avg. daily volume) traded on the secondary market dropped again as repo size diminished



Sources: NBR, OTP Research
Note: the average for the current week does not include Friday;

EUR denominated securities (avg. daily volume) traded on the secondary market declined last week

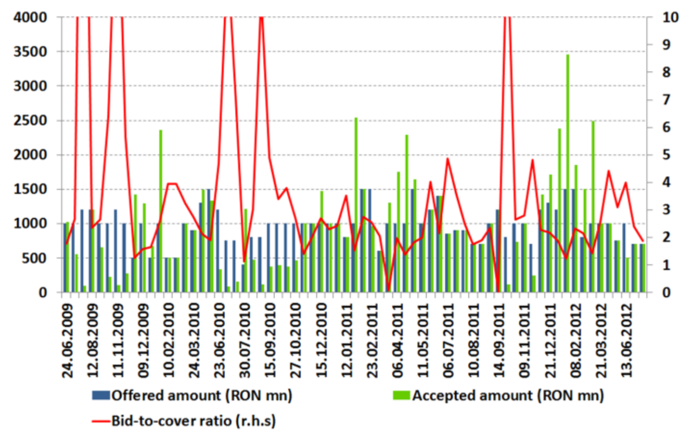


Sources: NBR, OTP Research
Note: the average for the current week does not include Friday;

Auctions

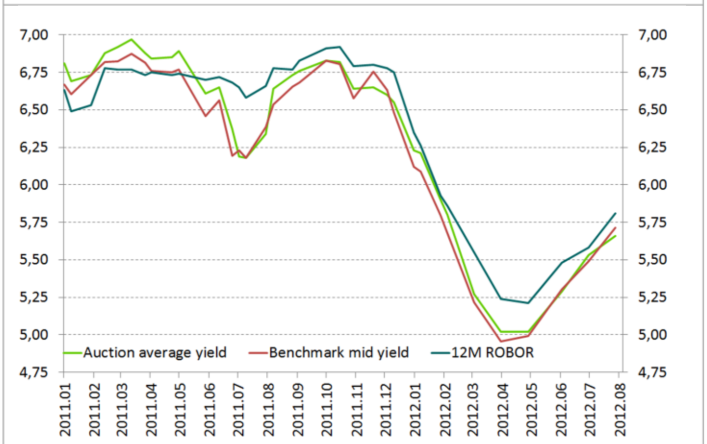
There were two auctions last week. The Finance Ministry rejected all bids at the second auction on Thursday for 2Y bonds but it sold the entire planned amount (700 mn RON) in 12M T-bills on Monday. The average accepted yield stood at 5.66 higher by 13 bp compared to the previous tender for 11M T-bills and by 37 bp compared to the previous tender for 12M T-bills in June.

12M auctions data



Sources: NBR, OTP Research

12M interest rates



Sources: NBR, OTP Research

Results of last week's auction

	RO1213CTN0F6
Offered amount (RON mn)	700
total bids (RON mn)	1307
accepted amount (RON mn)	700
average accepted yield (%)	5,66
coupon	-

Sources: NBR, OTP Research

T –bills auction in August

ISIN	Auction date	Settlement date	Maturity	Months	Indicative target amount (RON)
RO1213CTN0F6	06.08.2012	08.08.2012	07.08.2013	12	700.000.000
RO1213CTN0G4	13.08.2012	16.08.2012	24.04.2013	8	700.000.000
RO1213CTN0H2	20.08.2012	22.08.2012	21.08.2013	12	500.000.000

Source: Ministry of Finance, OTP Research

Bonds auctions in August

ISIN	Auction	Settlement	Maturity	Years	Cupon %	Indicative target amount (RON)
RO1214DBN068	09.08.2012	13.08.2012	28.07.2014	2	5,85	400.000.000
RO1216DBN030	23.08.2012	27.08.2012	27.01.2016	4	5,75	200.000.000

Sources: Ministry of Finance, OTP Research

The MinFin decreased the weight of bonds issue in August

	Jan-12	Feb-12	Mar-12	Apr-12	May-12	Jun-12	Jul-12	Aug-12
Planned targeted amount (RON bn)	4,5	5,0	5,0	4,3	3,8	3,5	2,3	2,5
% of bonds	33%	44%	54%	76%	80%	49%	69%	24%

Source: Ministry of Finance, OTP Research

MM: The Central Bank capped the repo size

Money market rates jumped significantly last week after the Central Bank limited the weekly liquidity injection at the repo auction to only 6 bn RON, lower than that of the previous week by 6.1 bn RON. The CB alloted only 40% of the offered amount, in order to cause leu's apprreciation. Given that currently the political turmoil has pushed the leu down rapidly, the measure taken by the CB to lift it may last in the coming weeks, but we do not foresee it to last until the end of the year mainly because it would hit interest rates for both loans and deposits and secondly because it would keep government securities yields high.

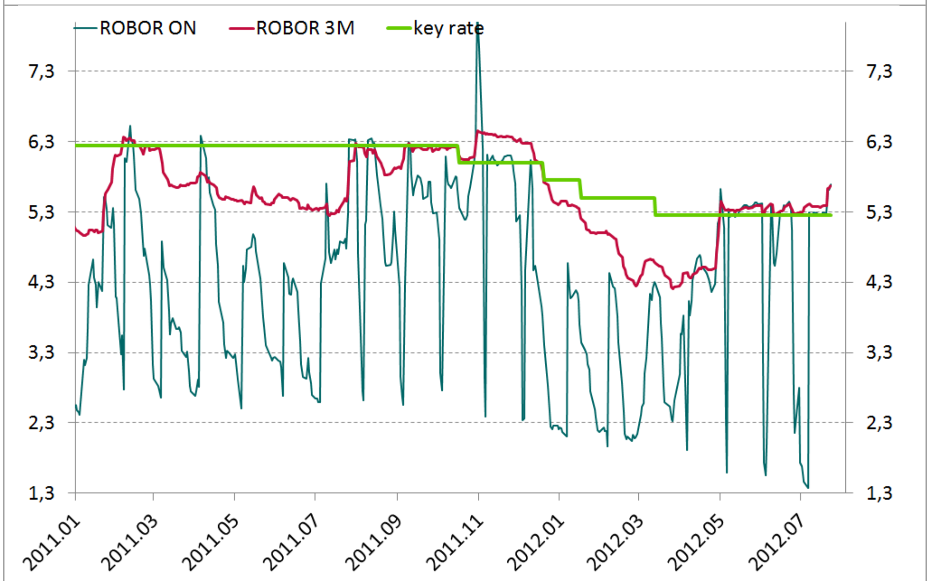
The Central Bank published its inflation report and it maintained the inflation forecast for both December 2012 and 2013: at 3.2% YoY and 3% YoY, respectively. The report emphasizes that keeping the fiscal targets and the agreement with the international financial institutions is essential in order to downsize the risks of the current inflation forecast and of the future economic growth. Unlike the previous report in May, the base scenario for the euro zone is improved for 2012 and 2013 as well: the CB sees a faster positive evolution of the debt crisis and the marginal appreciation of the euro versus the dollar in 2013, with positive consequences on the leu as well. According to our interpretation, the trajectory of the base rate in 2013 is going to remain flat at 5.25%.

Last data: 09.08.2012

MID INTEREST RATES	Value (%)	Weekly chg. (bp)	YTD chg. (bp)
repo rate	5,25	0	-75
ROBOR ON	5,71	42	118
ROBOR 3M	5,70	31	-35
ROBOR 6M	5,81	20	-72
ROBOR 9M	5,82	20	-79
ROBOR 1Y	5,83	17	-83
REPO	**Value (mn RON)**	**Wly chg. (mn RON)**	**YTD chg. (mn RON)**
repo amount	5.999,8	-6079,3	-711,2
INTERBANK DEPOSITS	**Value (mn RON)**	**Wly chg. (mn RON)**	**YTD chg. (mn RON)**
outstanding	2.821,6	225,5	-1205,9
MID SWAP POINTS	**Value (bp)**	**Weekly chg. (bp)**	**YTD chg. (bp)**
USDRON 1W	37	2	13
USDRON 1M	165	5	15
USDRON 3M	468	68	222
EURRON 1W	47	1	6
EURRON 1M	195	-5	50
EURRON 3M	627	48	116
MID EUR BASIS SWAPS	**Value (bp)**	**Weekly chg. (bp)**	**YTD chg. (bp)**
EURRON 1Y	-60	0	95
EURRON 3Y	-60	0	95
EURRON 5Y	-55	0	95

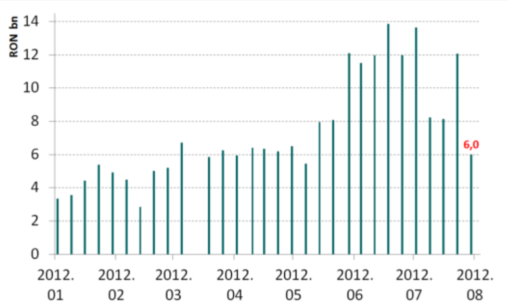
Source: Reuters

Most important MM instruments from 2011 (%)



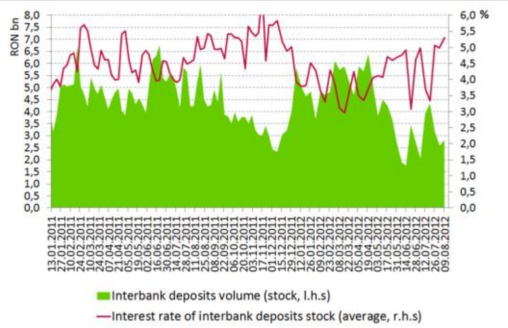
Sources: NBR, OTP Research

Repo operations during 2012



Sources: NBR, OTP Research

Interbank deposits stock and average interest rate



Sources: NBR, OTP Research

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