Ministry of Public Finance

Report on the government debt

December 31, 2017

General Directorate for Treasury and Public Debt

Contents:

1. Developments in the Romanian economy in 2017

In 2017, the economy witnessed a 6.9% growth, at the best pace since 2008, against the background of an individual consumption dynamics supported by tax reductions and salary increases, thus achieving the highest annual economic growth within the EU.

The labour market conditions improved, in line with the economic growth, in 2017, the unemployment rate (4.0%) reaching its lowest level for the past 20 years.

After two consecutive years of a downward-evolving consumer-price index, inflation turned positive in 2017, displaying an accelerated pace during the second half of the year, primarily due to price increases for food and energy, Romania concluding 2017 with an *inflation rate of 3.32%*[1].

In 2017, the current account deficit increased to 3.4% of GDP, against a background of a significant acceleration of consumption, reaching its highest level since 2011.

Macroeconomic indicators

Indicators	2016	2017
GDP		
- billion lei	762.3	858.3
- actual increase, %	4.8	6.9
Current account balance (% of GDP)	-2.1	-3.4
Consumer-price index (CPI)		
- end of year	-0.54	3.32
- annual average	-1.55	1.34
Average currency exchange rate		
- Leu/Euro	4.4908	4.5681
- Leu/USD	4.0592	4.0525

Source: NCP (National Commission of Prognosis)

In 2017, the *general consolidated budget deficit*, in terms of cash, was 2.83% of GDP, whereas the budget deficit calculated according to the EU methodology (ESA2010) accounted for 2.91% of GDP. Due to the relatively minor budget deficits, the gross financing needs were determined primarily based on the refinancing amount required by the government debt, as indicated in the table below:

Financing requirements

Indicator	2016	2017
Central government revenues[2] (billion lei)	173.7	195.2
Central government expenditure[3] (billion lei)	194.7	221.1
Budget deficit pertaining to the central government[4] (I) (billion lei)	21.1	25.9
Government debt refinancing[5] (II) (billion lei)	50.7	40.3
Gross refinancing needs (I+II) (billion lei)	71.8	66.2

Source: MPF

[1] Source: NIS (National Institute of Statistics)
[2] Calculated as per the cash methodology by applying the EU methodology
[3] Calculated as per the cash methodology by applying the EU methodology
[4] Calculated as per the cash methodology by applying the EU methodology
[5] The amount of capital ratio reimbursements and government security refinancings for the account of the government debt, according to the national legislation, calculated based on the debt balance at the end of 2017 (it includes the guarantees, but excludes the temporary financing).

During 2017, the *rating agencies reconfirmed the ratings issued to Romania,* relying on the perspectives of a solid economic growth and the low public debt share within GDP, and indicated the factors that might affect over the following period the government rating, such as the continuation of procyclical fiscal relaxation policies.

The ratings issued to Romania are Baa3 with a stable perspective from Moody`s, BBB-/A-3 with a stable perspective from Standard&Poor`s, BBB- with a stable perspective from Fitch and BBB/BBB+ from JCRA.

2. The budget deficit financing and government debt refinancing strategy for 2017

2.1. Budget deficit financing

Budget deficit financing in 2017 used primarily internal sources (56%), which were supplemented by external sources. The sources required to refinance the government debt were provided by the markets these debts were issued on, we well as by the foreign currency financial reserve available to the State Treasury, which amounted, at the end of 2017, to 5.2 billion Euros, representing approximately 2.8% of GDP.

The debt instruments employed in order to finance the budget deficit and refinance the public debt were:

a) issues of government securities in lei, and discounted treasury bills and benchmark government bonds, respectively, on the domestic market, with medium- and long-term maturities of up to 15 years.

In order to fulfil the objective of developing the domestic market of government securities, as well as build and consolidate the yield curve specific to the government securities on the domestic market, government securities in lei, amounting to 39.9 billion lei, were issued on a regular basis in 2017.

b) *issues of government securities in Euros on the domestic market*

MPF issued sovereign bonds with a 5-year maturity, denominated in Euros, with a total value of 340 million Euros.

c) issues of Eurobonds in Euros on international capital markets

In 2017, MPF raised from the international financial markets a total amount of 2.75 bn Euros, by launching in April an issue of Eurobonds denominate in Euros, with a 10-year maturity and a volume of 1 bn Euros, concurrently with raising the amount of 750 million Euros by reopening an issue with a 20-year maturity, launched in 2015, the latter issue reaching a total volume of 2 bn Euros. In October, an amount of 1 billion Euros was raised by reopening the issue launched in April 2017, with the initial 10-year maturity, this issue reaching a total volume of 2 bn Euros.

d) *inflows from external loans* for the financing of projects.

e) *loans contracted by administrative-territorial authorities.*

To optimise the public debt management and avoid seasonal pressures in securing financing sources for the budget deficit and refinancing sources for the government debt, as well as to decrease the refinancing and liquidity risks, attention was paid to maintaining the foreign currency financial reserve (buffer) available to the State Treasury, the value of which was sufficient to cover the budget deficit financing and public debt refinancing requirements for approximately 4 months.

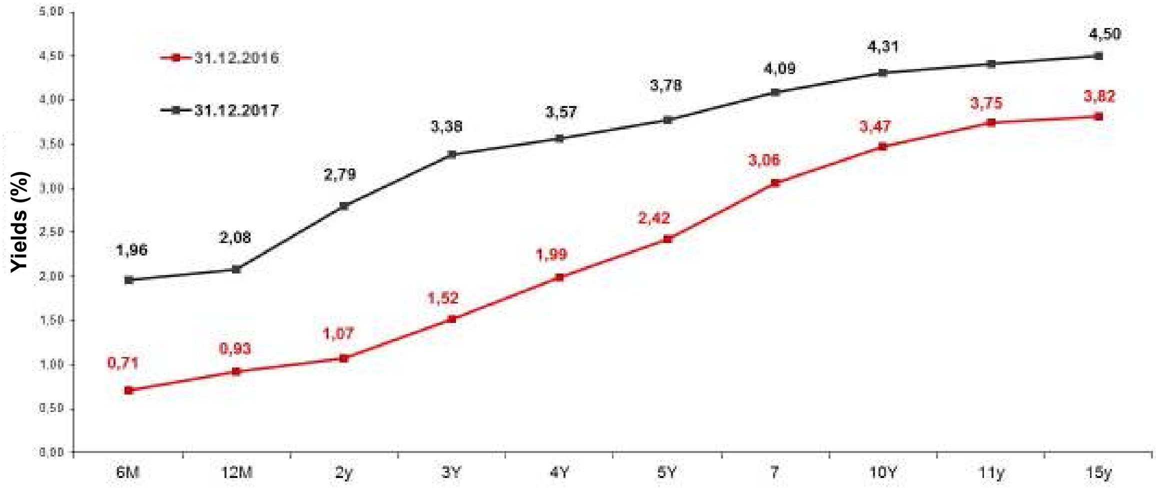
2.2. Domestic market of government securities

The primary market

Following a consistent development strategy for the government security market over the past years, in conjunction with a favourable market context during the first nine months of 2017, the domestic market of government securities continued to witness positive developments, demonstrating resilience during volatility periods generated by external factors, with yields of Romanian government securities showing a downward tendency. Over the last 3 months of 2017, the market context featured changes in liquidity, as well as expectations of inflation increase, factors that generated yield increased for all the maturities issued by MPF, more visibly for the short end of the yield curve.

As such, during the first nine months of 2017, the yields of Romanian government securities followed a downward path, given, on the one hand, the favourable context within the Euro Area, characterised by an accommodative policy implemented by ECB, which continued its asset purchasing programme in the effort to relaunch economic activities within the Euro Area, with interests of Euro Area benchmark bonds remaining negative, and the local context marked by an improvement of macroeconomic fundamentals, on the other hand.
As indicated by the diagram below, at the end of 2017, the interest rates pertaining to Romanian government securities exceeded the same figures at the end of 2016.

Evolution of yields on the domestic secondary market at the end of 2017 vs. yields the end of 2016



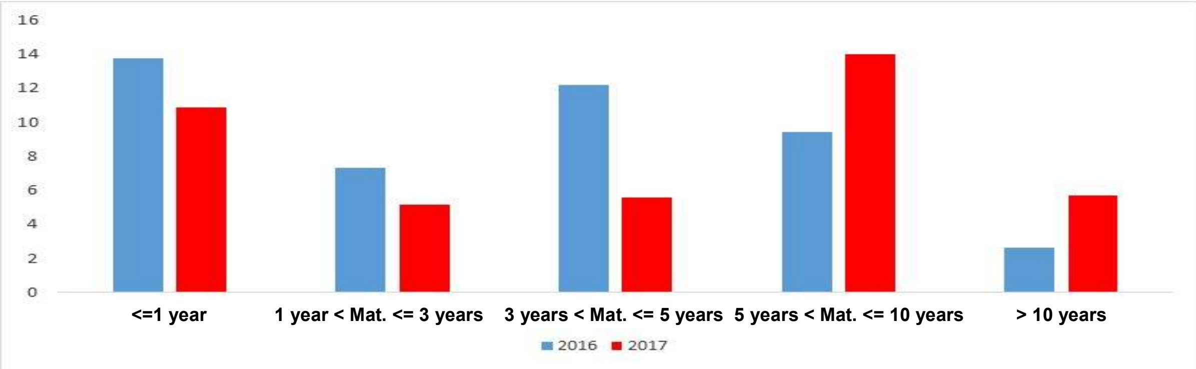
Source: MPF

During 2017, MPF made efforts to secure its constant and continuous presence on the domestic market, by organising on a regular basis tenders for government securities, both in order to satisfy the demands of investors, as well as to avoid any possible pressures it might incur while attracting financial resources.

In 2017, the government securities issued on the domestic market amounted to 39.9 billion lei, and 340 mil. Euro, respectively, representing approximately 62.7% of the central government's gross financing requirements[6], with the following structure: a) 26.4% accounts for issues of discounted treasury bills with a maturity of up to 12 months and issues of benchmark bonds with residual maturities of up to 1 year; b) 44.4% accounts for issues of benchmark bonds with residual maturities between 1 and 5 years; and c) 29.2% accounts for issues of benchmark bonds with residual maturities between 5 and 14 years. Benchmark government bonds denominated in lei, with maturities of 3, 5 and 7 years, were issued and reopened almost on a monthly basis. MPF's efforts continued in order to extend the average maturity of government securities, a significant portion of issues featuring medium- and long-term maturities.

[6] Presented in ch. 1

Structure of issues of government securities by maturity (initial mat., bn lei)



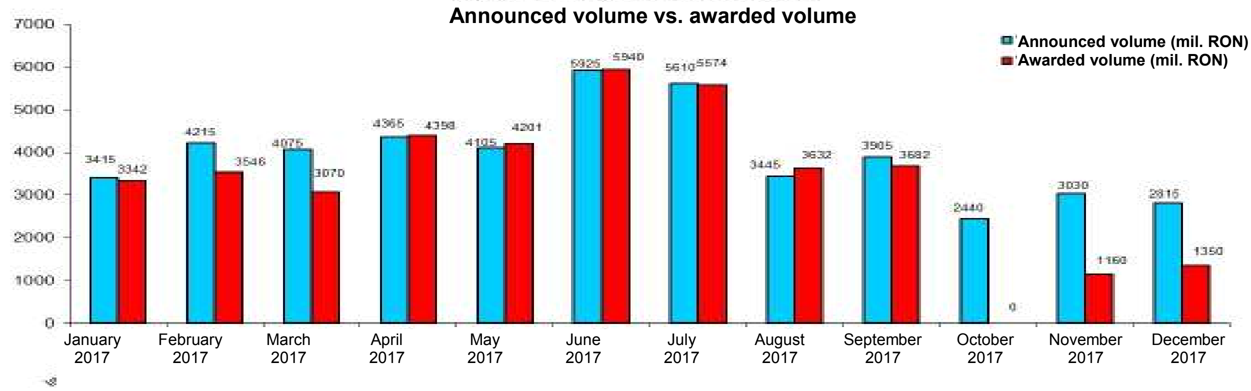
Source: MPF

The presence of Romanian government securities among JPMorgan and Barclays indices continues to positively influence the local market and maintain foreign investors' interest. At the end of December 2017, 12 series of Romanian sovereign bonds were included in the GBI-EM Global Diversified Investment Grade index, with a share of approximately 4.41%, and 14 series in the Barclays EM Local Currency Government Index, with a share of 1.30%.

The policy of government security issues was a predictable and flexible one, adapted to the investment environment requirements. During the first nine months of the year, most tenders were fully awarded (see the diagram below), and the volumes accepted in the case of long-term maturity tenders were even larger than the announced ones, making use of opportunity windows with favourable yields so as to extend the average residual maturity of the government debt portfolio and consolidate liquidities along those maturities.

Over the last three months of 2017, interest rates on the interbank money market increased against a background with a temporary decrease of liquidities and inflation increase (a 3.32% inflation rate at the end of 2017), but also with higher expectations towards NBR adjusting the monetary policy conduct. In this context, in October, MPF totally dismissed tenders for government securities.

Announced volume vs. awarded volume in 2017

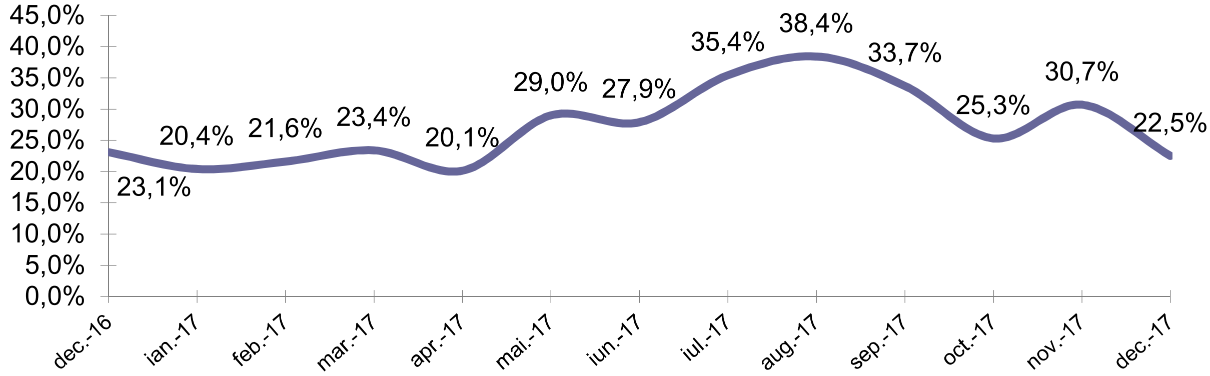


Source: MPF

The secondary market

The liquidity of government securities on the secondary market is a significant indicator for the government security market development level. The degree of liquidity, calculated as a ratio between the total volume of monthly transactions on the secondary market and the total volume of government securities, saw a constant increase during the first 8 months of 2017, then a decrease to a level similar to the beginning of the year, against an increase of the government security stock on the market by 9.9 bn lei. Nevertheless, its levels are still low in relation to international standards. A major increase took place in August, the degree of liquidity reaching 38.4%, following a government security balance reduction due to the reimbursement of two benchmark-type series with an aggregate volume of 15.8 bn lei.

Evolution of the degree of liquidity of active government securities between December 2016 and December 2017



Source: MPF

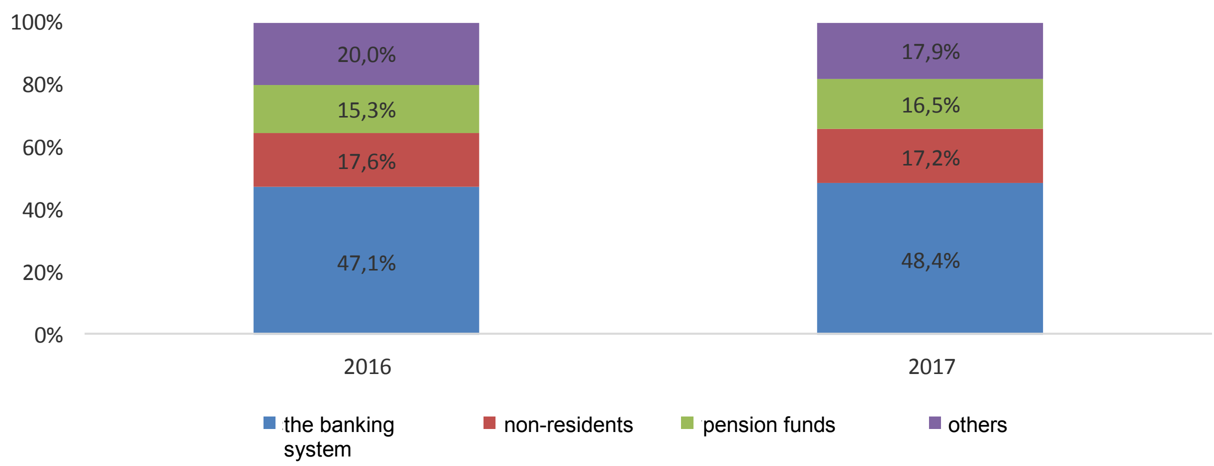
The relatively low levels of transactions on the secondary market of government securities, seen in 2017, might reflect the specific market conditions, but also structural deficiencies, such as internal limitations of commercial banks on particular maturities that can exist in their trading portfolios, as well as the scant use secondary market instruments, such as repo-type operations, and the lack of MPF active participation in repo, reverse repo, buy back, bond exchange operations or the poor development of the swap market, particularly for medium- and long-term maturities.

As of January 2017, primary dealers are bound to enter firm quotations on the electronic platform for listing and trading Romanian government securities, provided Bloomberg (E-Bond), while meeting certain minimum requirements in terms of volume, maturity, listing time, margin between the selling price (BID) and the purchase price (ASK), their performance reflecting over the periodic assessment of their activity on the government security market. At the end of the first operation year we see its positive impact on the government security market in a reduced the bid/ask margin, a gradual increase in the number of listed securities and the average listed volume/average listing time by each primary dealer/for each series of government securities.

In the context of a moderate progress in terms of loans provided to financial institutions during 2017 and liquidity surplus present on the market, commercial banks continued to be the main investors on the domestic market of government securities, holding in their portfolio at the end of 2017 48.4% of the total volume of government securities issued on the market, followed by non-resident investors, whereas pension funds saw an increase of their holdings from 15.3% at the end of 2016 to 16.5% at the end of 2017.

The local investors' demand mainly focused on maturities of up to 7 years and marginally for maturities longer than 10 years, especially for series of securities included in regional indices.

Evolution of government securities by holder type



Source: NBR

Within the segment of institutional investors, local asset management funds and private pension funds, although holding a relatively low share on the government security market, display a significant potential for supporting the local market development over the following period. The total net assets held by private pension funds (pillars II+III) increased significantly from 10.2 billion lei at the end of 2012 up to 33.0 billion lei at the end of 2016, and up to 41.5 billion lei at the end of 2017, respectively, the government security holdings at the end of 2016 accounting for approx. 22.8 billion lei, remaining unchanged at the end of 2017, at approx. 22.6 billion lei.

Non-resident investors continue to represent a major segment, providing additional demand to that of local investors, given their main focus on long-term maturities, and helping diversify the investor base. Although 2017 commenced against a background with expectations of diverging monetary policies between the main central banks (ECB and FED), ECB maintained its reference rate the entire year, whereas FED operated consecutive interest rate increases, from 0.75% early in the year to 1.5% at the end of the year, these international events affecting the local market of government securities with a decreased demand from non-resident investors.

2.3. Issues of Eurobonds and external loans contracted in 2017

During 2017, the developments on the sovereign bond market were largely influenced by the initiation of Brexit negotiations, the organisation of elections in several EU member states and increased expectations of increased reference interest rates especially on the USA market.

On the USA market, in December 2017, the US Federal Reserve (FED) increased the reference interest rate 25 basis points, up to 1.25%-1.50%. As of last October, FED commenced the sale of assets and indicated the short-term continuation of the post-crisis monetary cycle, against a background with a positive climate of the labour market and prospects of inflation moving towards the target level.
As of April 2017, the European Central Bank (ECB) has been gradually reducing the level of monthly purchases of securities issued by states in the Euro Area, from 80 bn Euros to 30 bn EUR, and to 15 bn EUR, respectively, effective September 2018, the massive stimulation programme awaiting conclusion by the end of this, whereas interest rates are to be maintained until the summer of next year.

In 2017, MPF raised from external markets a volume of 2.75 billion Euros by means of two transactions included in the MTN Programme.
In April 2017 the amount of 1.75 billion Euros was raised following an issue of Eurobonds in two instalments, of which 1 billion Euros as a new issue with a 10-year maturity, a 2.375% coupon interest rate, and 750 million Euros by reopening the issue launched in October 2015, with an initial 20-year maturity and a 3.875% coupon interest rate, the two instalments being subscribed to minimum historic yields.

In October 2017, the issue of Eurobonds denominated in Euros, with a 10-year maturity, launched in April 2017, was reopened for a volume of 1 billion Euros, at a yield 30 basis points below the yield at the time of the initial launch.

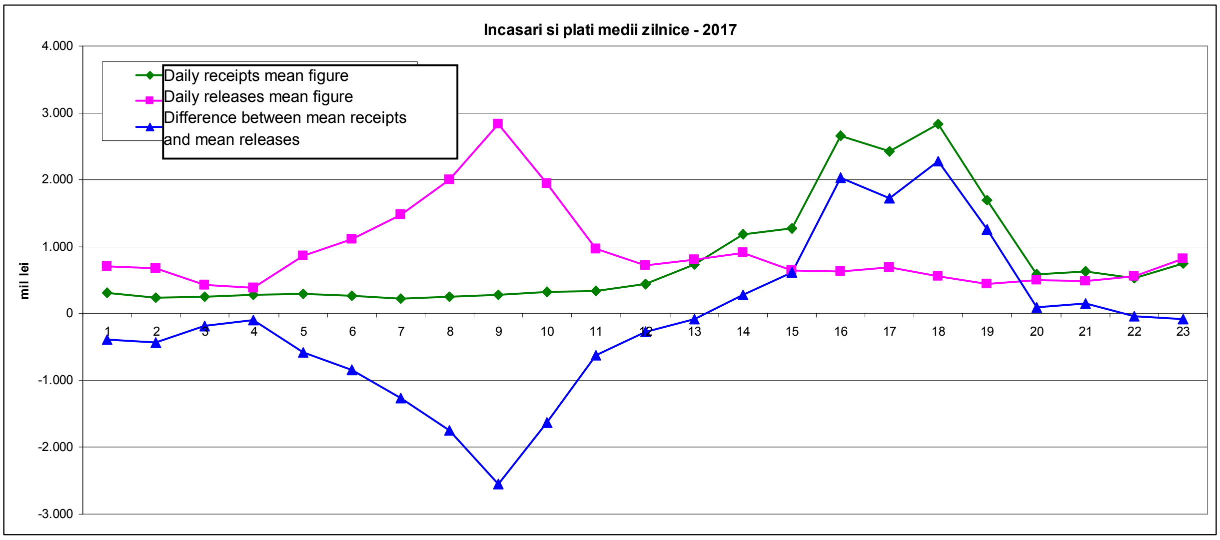
The operations on the market also included drawdowns amounting to approx. 606 million Euros, pertaining to loans contracted from international financial institutions.

The raised amounts were used to finance the budget deficit, refinance the public debt and consolidate the foreign currency financial reserve (buffer) available to the State Treasury.

2.4. Liquidity management in 2017

Cash management operations are carried out by the State Treasury in order to cover temporary cash deficits occurring during the year as a result of a gap between receipts and releases into/from the general current account of the state treasury, as revealed by the diagram below:

Mean figures of daily receipts and releases over the course of month, in 2017



Source: MPF

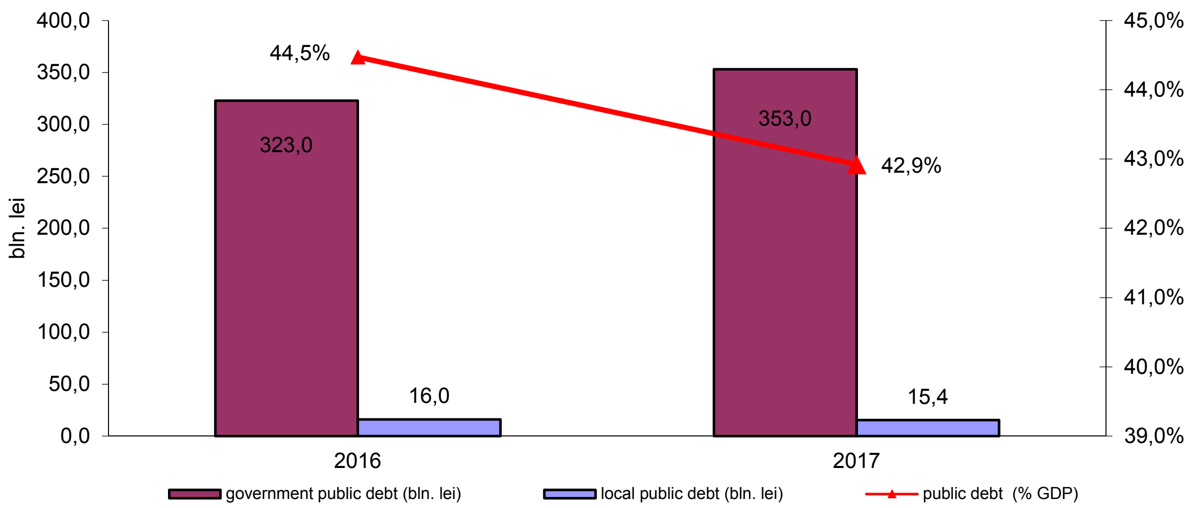
Due to the balanced evolution of the budget deficit in 2017, as well as the foreign currency operations carried out by the Ministry of Public Finance (the Back Office department, for the reimbursement of outstanding government securities, and the Certification and Payment Authority, respectively, for various managed Operational Programmes) and the Ministry of Agriculture and Rural Development (representing the EC contribution pertaining to the various programmes managed by MARD), the evolution of the State Treasury general current account balance was marked by credit balances over the entire course of the year, which is why in 2017 there was no need for cash-management operations to cover the temporary cash deficits, or collections of deposits or foreign exchange transactions, respectively.

3. Analysis of the government debt portfolio and the risks associated to this debt

In the context of macroeconomic evolutions and the internal and external financial markets, the amount of public debt contracted in accordance with the provisions of Government Emergency Ordinance no. 64/2007 on the public debt, as subsequently amended and supplemented, was, as at December 31, 2017, 368.4 billion lei, of which the government debt was 353.0 billion lei (representing 95.8% of the total public debt), whereas the local public debt was 15.4 billion lei (representing 4.2 % of the total public debt).

The public debt increase by 29.4 billion lei from 2016 to 2017 was determined mainly by the debt accrued in the attempt to cover the budget deficit financing and the government debt refinancing requirements, but also by the consolidation of the foreign currency financial reserve available to the State Treasury.

Evolution of the public debt



Source: MPF

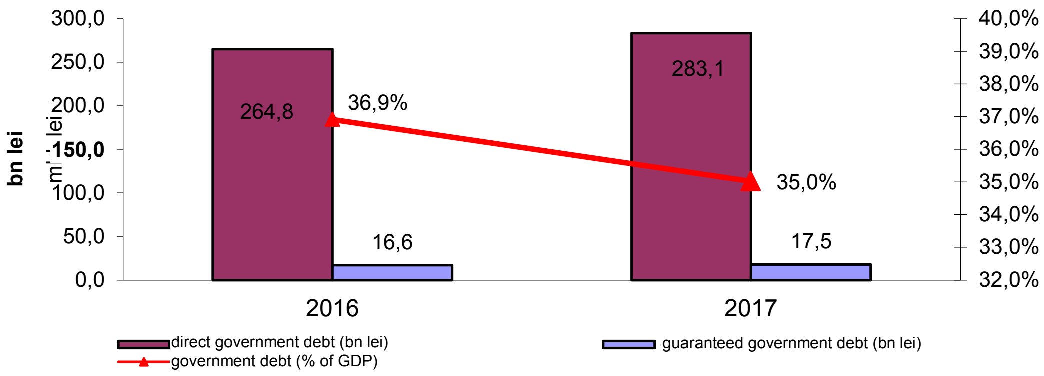
3.1. The government debt portfolio and the risks associated to it [7]

The government debt as at December 31, 2017 amounted to 300.6 billion lei, representing 35.0% of GDP.

Breaking it down, the highest share within the total government debt belonged to the direct government debt (94.2%), whereas the difference was provided by the guaranteed government debt. During 2017, the guaranteed government debt remained at relatively the same level (5.8% of the total government debt), following the guarantees granted as part of the government programmes.

[7] It does not include temporary financing, in line with the 2017-2019 government debt management strategy

Government debt by type of debt



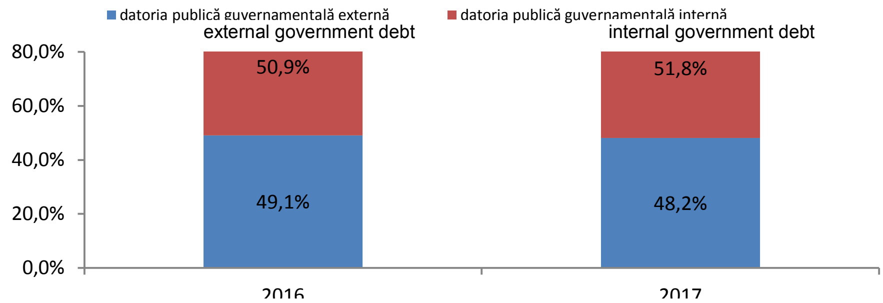
Source: MPF

The state guarantees granted in 2017 amounted to 2,196.19 million lei, for the following government programmes:

- “First Home” government programme (2,195.14 million lei);
- The programme designed to stimulate the purchase of new motor vehicles (1.05 million lei).

Of the government debt as at the end of 2017, *51.8*% represented *debts contracted by resident creditors* and 48.2% by non-resident creditors. Most of the *internal government debt* was represented by government securities, whereas the external debt comprised Eurobonds issued on international capital markets and external loans contracted from official creditors.

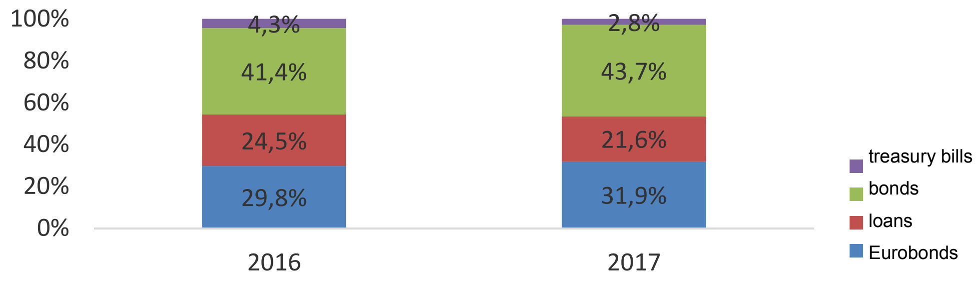
Government debt by the creditor residence type (% of the total debt)



Source: MPF

In 2017, as well, MPF continued the policy of issuing mainly debt *negotiable instruments*, which caused, at the end of 2017, an increase in the share of government securities to 78.4% of the total government debt, as opposed to 75.5% at the end of 2016. Concerning short-term government securities, they were 2.8% of the total government debt, which determined a refinancing risk decrease, this being the main risk associated to the government debt portfolio.

Government debt structure by type of instrument
(% of the government debt)



Source: MPF

The government debt service

The government debt service pertaining to 2017 decreased by 10.3 billion lei, as indicated by the table below:

bn lei

	2016	2017
Government debt service out of which: - direct [8] - guaranteed	 60.3 58.8 1.5	 50.0 48.6 1.4
Government debt service out of which: - capital rates - interests and commissions	 60.3 50.7 9.6	 50.0 40.3 9.7

Other indicators[9] *related to the government debt service* are as follows:

	2016	2017
1. External government debt service /Exports of goods and services[10]	4.9%	3.9%
2. Interest pertaining to the external government debt /Exports of goods and services [11]	1.5%	1.4%
3. Interests and commissions/Revenues to the general consolidated budget[12]	4.3%	3.9%
4. Interests and commissions/Expenditures from the general consolidated budget[13]	4.0%	3.5%

[8] It does not include reimbursements from loans granted from resources available in the State Treasury general current account and those for the account of cash management instruments.
[9] The expenditure of and the revenues to the general consolidated budget for 2017 are definitive figures, whereas the indicators at items 1 and 2 took into account the exports of goods and services published in the spring forecast of the National Commission of Prognosis 2018-2021
[10] The indicator shows the extent to which the payments for the account of the external government debt service are covered by receipts from exports of goods and services.
[11] The indicator shows the extent to which the interest-related costs of the external government debt is covered by receipts from exports of goods and services.
[12] The indicator shows the extent to which the interests and commissions pertaining to the government debt are covered by revenues to the general consolidated budget.
[13] The indicator shows the share of payments of interests and commissions related to the government debt within the total expenditures from the general consolidated budget.

3.2 Implementation of the 2017-2019 government debt management strategy

In June 2017, the **2017-2019 government debt management strategy (Strategy)** was approved, being elaborated upon consultations with NBR (as per the provisions of GEO 64/2007 on the public debt, as subsequently amended and supplemented), and in accordance with the good practices defined in the World Bank and International Monetary Fund Guidelines regarding the elaboration of public debt strategies.

The main objectives set forth in the Strategy for 2017 were:

1. securing the financing requirements for the central government and the payment obligations, while minimising the medium- and long-term costs,
2. limiting the risks associated to the government debt portfolio, and
3. developing the domestic market of government securities.

At the same time, the principles that underpinned the financing decisions in 2017 were expressed as target intervals[14] relevant for the main risk indicators associated with the government debt portfolio.

The performance of risk indicators in 2017 [15]

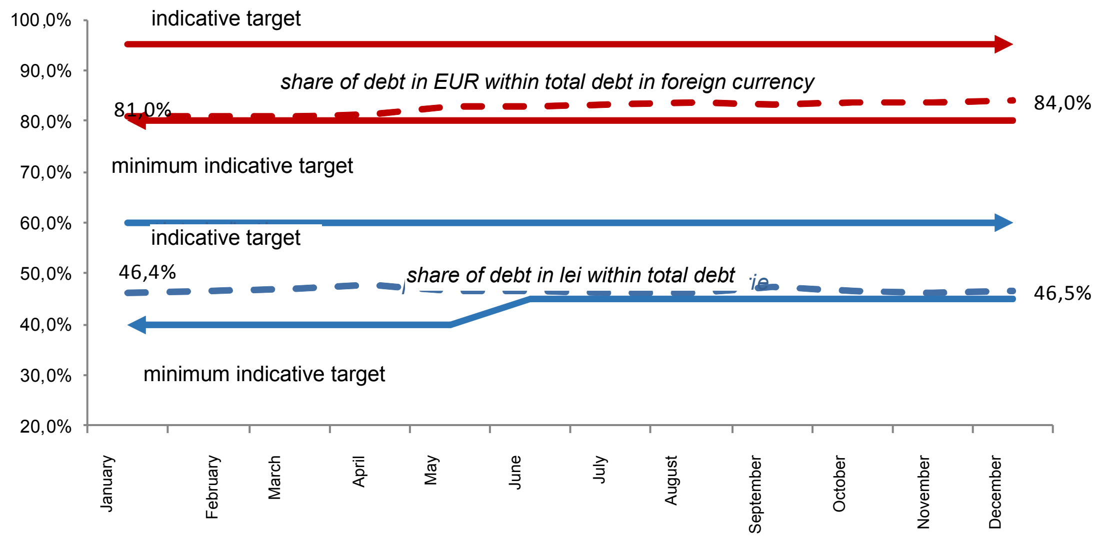
a. Evolution of indicators concerning the foreign currency risk

The share of the Euro-denominated government debt within the total government debt in foreign currency fell within the target interval set forth in the Strategy. At the end of December 2017, this indicator was 84.0% as a result of contracting foreign currency debts from external sources, as well as issues of Eurobonds from international capital markets and drawdowns from external loans intended to finance projects. On the other hand, the *share of the government debt denominated in lei within the total government debt* remained the entire year within the indicative targets set forth in the Strategy (it slightly increased from 46.4% in January to 46.5% in December 2017) following the issuance of mainly benchmark government bonds with medium- and long-term maturities.

[14] The limit mentioned as minimum or maximum may not be exceeded during the period covered by the Strategy (hard bound), whereas the other limit represents the limit that is being pursued and may be exceeded (soft bound)

[15] For the January – May 2017 period, the focus was placed on the indicative targets set forth in the 2016-2018 government debt management strategy. The limit mentioned as minimum or maximum may not be exceeded during the period covered by the Strategy (hard bound), whereas the other limit represents the limit that is being pursued and may be exceeded (soft bound)

Diagram: Performance of foreign currency risk indicators



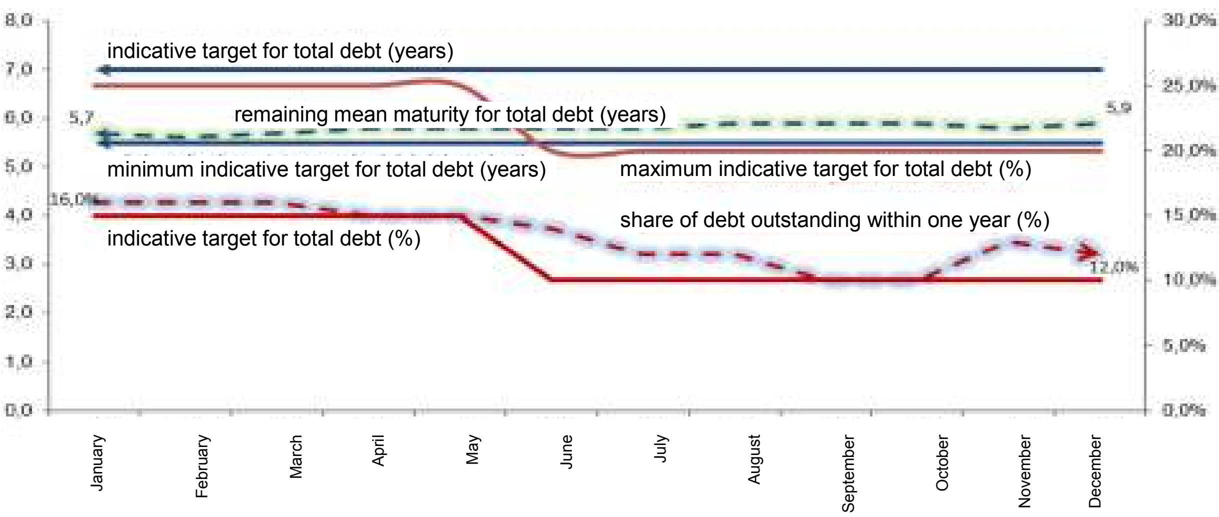
Source: MPF

b. Evolution of refinancing risk indicators

The indicators of the refinancing risk for the entire government debt portfolio fell, throughout 2017, within the target intervals set forth in the Strategy.

The “*remaining mean maturity of the government debt portfolio*“ indicator remained relatively constant throughout 2017, reaching in December 5.9 years, a level due mainly to issues of medium- and long-term government securities with, but also to contracted long-term foreign currency loans, whereas the “*share of debt outstanding within 1 year from the total government debt*“ reached 12% at the end of 2017.

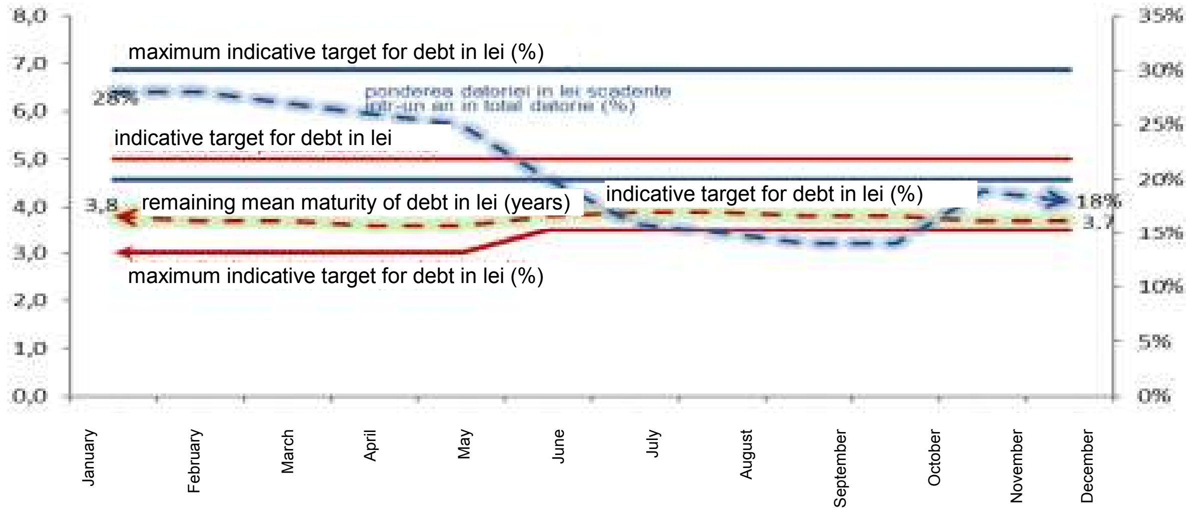
Performance of refinancing risk indicators for the total government debt



Source: MPF

At the end of 2017, the *remaining mean maturity of the government debt in lei* reached 3.7 years, and the *share of government debt in lei* outstanding within one year fluctuated throughout the year and had a favourable evolution, reaching 18% at the end of 2017, below the limit set forth in the Strategy.

Performance of the refinancing risk indicators for the debt denominated in lei



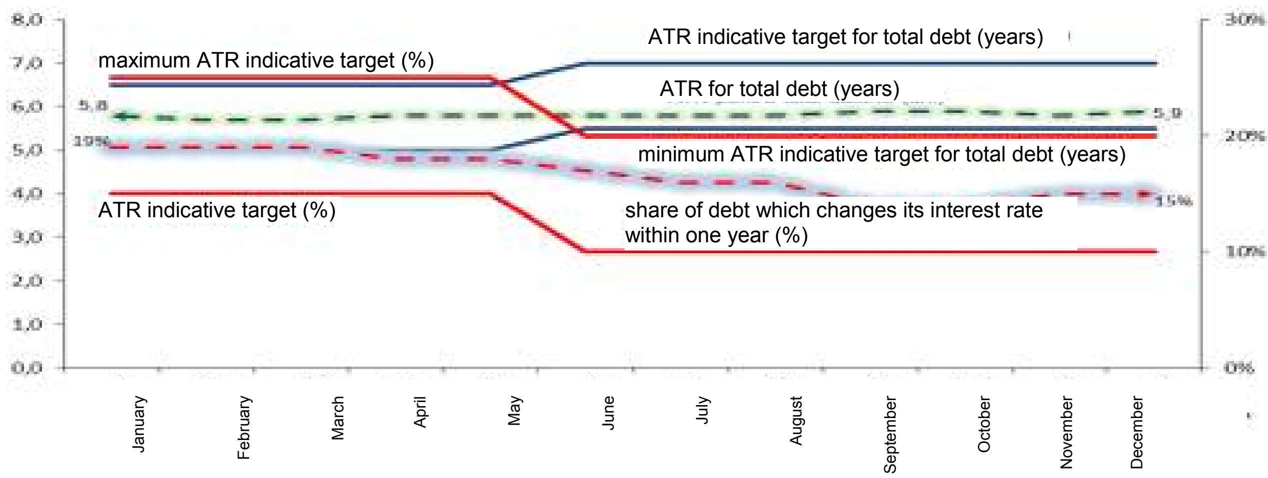
Source: MPF

c. Evolution of the interest rate risk indicators

The diagram below illustrates the government debt management performance in terms of exposure to the interest rate risk.

The indicators for the entire government debt portfolio fell, at the end of 2017, within the indicative targets set forth in the Strategy, as the *average time to re-fixing* (ATR) was 5.9 years, whereas the *share of debt which changes its interest rate within one year* was 15%.

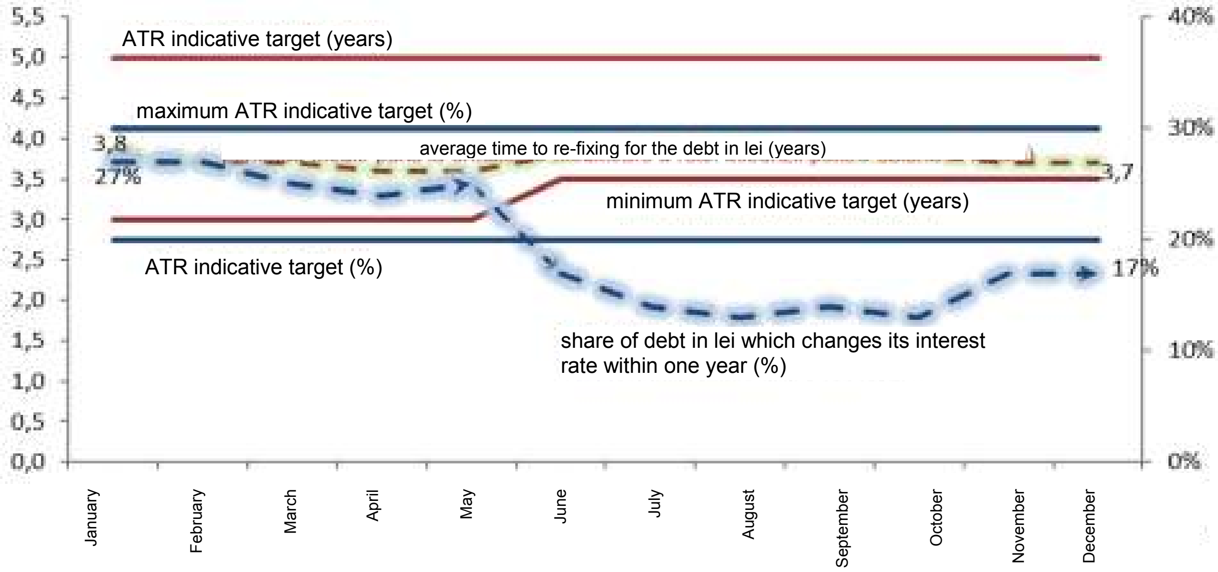
Performance of interest rate risk indicators for the total debt



Source: MPF

Regarding the indicators of the interest rate risk for local currency debt level, these started fluctuating during the 2nd quarter, following the evolution shown by the indicators of the refinancing risk for the debt in lei. However, at the end of the year, the indicators fell within the indicative targets set forth in the Strategy, as the *share of the debt in lei changing its interest rate within one year* was 17%, whereas the *average time to re-fixing* (ATR) *for the debt in lei* was 3.7.

Performance of interest rate risk indicators for the debt in lei



Source: MPF

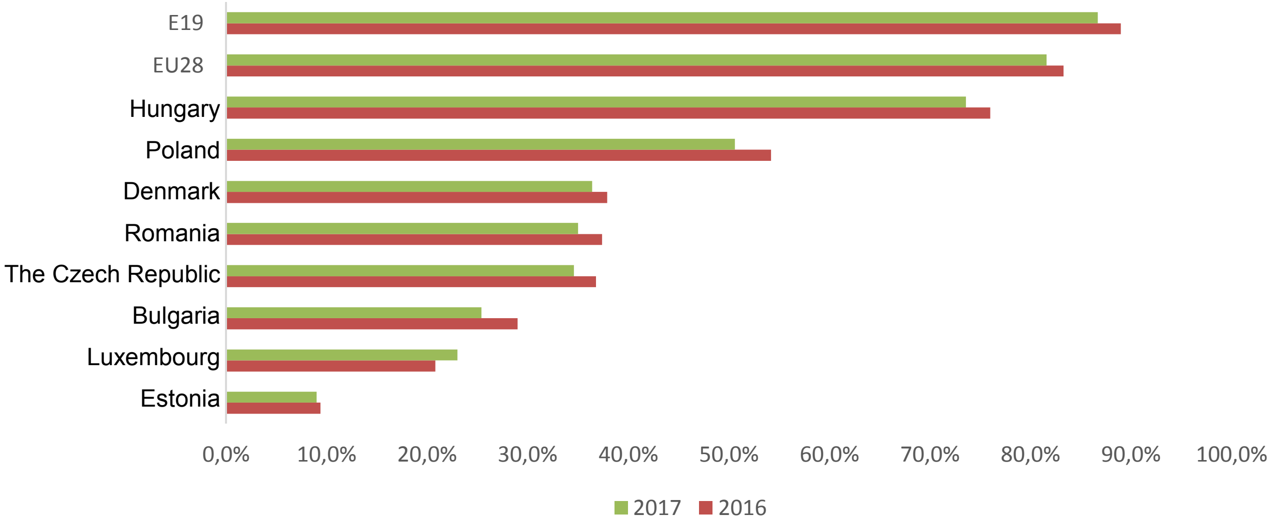
4. ***Government debt according to the EU methodology***

With regard to the government debt in accordance with the EU, at the end of 2017, the gross government debt[16] continued to remain at a sustainable figure of 35.0% of GDP, below the 60% ceiling set forth in the Maastricht Treaty, and if one considers the liquid financial assets[17], the net government debt figure was 26.1% of GDP.

With reference to the European Union member states, at the end of 2017[18], Romania ranked 5th among the EU member states with the lowest level of indebtedness after Estonia (9.0%), Luxembourg (23.0%), Bulgaria (25.4%) and The Czech Republic (34.6%), below the mean government debt for the Euro Area - EA19 (86.7% of GDP), but also below the EU28 mean government debt (81.6% of GDP).

[16] It represents the public administration debt as a nominal value, consolidated within the public administration subsectors, and does not include the guarantees granted by the state and the administrative-territorial units, except for those paid from the budget or for which 3 successive payments were made to the guarantor.
[17] FA1 (gold and SDR), FA2 (deposits and cash), FA3 (securities, other than shares), FA5 (shares and other shareholdings, if listed at the stock exchange, including units of mutual funds).
[18] Source: Eurostat news release Euroindicators 69/2018 – April 23, 2018

EU28 comparisons (% government debt within GDP)



Source: Eurostat

EUGEN ORLANDO TEODOROVICI

MINISTER OF PUBLIC FINANCE

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