# Ministry of Public Finance

## Report on the Government Public Debt Management

**in line with the 2011-2013 Government Public Debt Strategy**

***December 31, 2011***

General Directorate for Treasury and Public Debt

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## Acronyms:

AVAS : Authority for State Assets Capitalization

CDS : Credit Default Swap

EBRD: European Bank for Reconstruction and Development

EC: European Commission

EIB: European Investment Bank

EU: European Union

Fitch: Fitch Ratings Agency

GDP: Gross Domestic Product

IBRD: International Bank for Reconstruction and Development (part of the World Bank Group)

IMF: International Monetary Fund

JCRA: Japan Credit Rating Agency

Moody's: Moody's Investors Service Rating Agency

MoPF : Ministry of Public Finance

NBR: National Bank of Romania

NPC: National Prognosis Commission

SEC 95: European System of Accounts

S&P's : Standard & Poor's Rating Agency

**Measurements:**

EUR : European currency
DST: special drawing rights
Leu (plural :lei): Romanian currency

1. **Macroeconomic background in Romania and the fiscal and budgetary policy in 2011**

In 2011, the real economic growth in Romania was 2.5% of GDP, mainly driven by the very good performance of the farming sector (value added up by 11.3%) and of the industry (value added up by 5%), via exports. The current account of the balance of payments saw a deficit of 6 billion Euros, higher by 8.7% compared to 2010, mainly as a result of the increase in the deficit of the balance of revenues by 23.9%. In 2011, 32% of the current account deficit was financed by direct investments of non-residents, amounting to 1.9 billion Euros, lower by 13.5% compared to 2010.

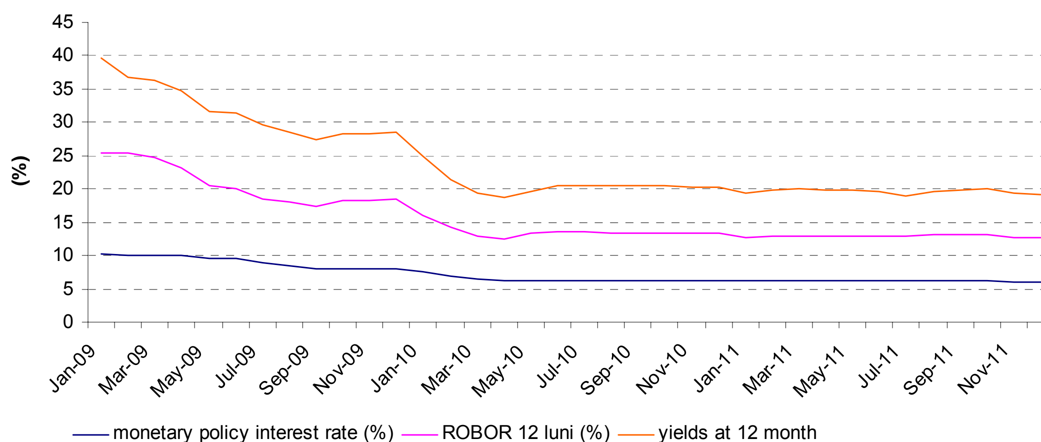
Hence, in 2011, the general government deficit (in cash) was 23.9 billion RON (4.1% of GDP), down by 9.7 billion RON as compared to 2010. The adjustment from 6.4% of GDP in 2010 was due to high revenues (mainly VAT collections, personal and corporate income tax collections) and expenditure cuts (wage bill and social protection). In 2011, the budget deficit according to EU methodology (ESA95) amounted to 5.2% of GDP.

Throughout 2011, the domestic currency's exchange rate fluctuated between 4.1 – 4.4 RON for 1 Euro, and 2.7 – 3.4 for 1 US Dollar.

The annual inflation rate went down to 3.14% at end-2011, decreasing by 4.82 percentage points from 7.96% in December 2010, close to the core point of 3% of NBR's target band. The fact cvasi-total dissipation of the first round VAT hike effect of July 2010, the decreasing trend of volatile prices, primarily for food products and the decrease of the core inflation helped the convergence of the annual inflation rate with the target set by NBR for 2011. The core inflation rate has been the reflection of a persisting large deficit of aggregated demand, as well as of an improvement of inflation expectations, supported including by a still prudential monetary conduct.

As of November 2011, following a consolidation of the disinflation process, NBR initiated a decreasing trend of the monetary policy interest rate, from 6.25% to 6.0%. The cut in the reference interest rate was reflected in the interbank market interest rates as well, and in the yields of short term government securities.

Chart 1. Government securities yields at 12 months / ROBOR at 12 months / monetary policy interest rate



The prudential fiscal and budgetary policy promoted by the Government and the correct monetary policy of the National Bank of Romania, the obvious positive outcome of the fiscal adjustment measures adopted by the Government and the anchor provided by the IMF Stand-By Agreement helped attenuating the impact of the financial crisis at domestic level and allowed, at the same time, a good macroeconomic performance with positive consequences on the debt refinancing and budget deficit financing costs.

The rating agencies confirmed these good economic results. Thus, Fitch decided to raise Romania's credit rating to investment grade in July 2011, with Moody's and Standard & Poor's at the end of last year reaffirming Romania's ratings, outlook remaining stable.

Ratings by rating agencies as at December 31, 2011

| S&P's | Fitch | Moody's | JCRA |
|---|---|---|---|
| BB+<br>(reaffirmed November 29, 2011)<br>outlook stable | BBB+<br>outlook stable | Baa3<br>(reaffirmed December 22, 2011)<br>outlook stable | BBB-<br>(reaffirmed December 28, 2011)<br>outlook stable |

| Scale - S&P, Fitch and JCR | Scale - Moody's |
|---|---|
| » Investment grade: from BBB-, BBB, BBB+, A- to AAA<br>» Speculative: from D to BB-, BB and BB+ | » Investment grade: from Baa3, Baa2, Baa1, A3 to Aaa<br>» Speculative: from D to Ba3, Ba2 and Ba3 |

In line with the Council Decision[1] of July 7, 2009, Romania is subject to excessive deficit procedure and has to cut the deficit according to SEC95 under 3% of GDP until 2011. Taking into account the fact the Romanian authorities properly implemented the recommendations made by EU, as well as the higher negative impact of the international environment on the domestic economy compared to what was initially expected, in February 2010 the European Council issued a revised recommendation requiring that the budget deficit go down below the 3% of GDP by 2012.

On September 21, 2010, the European Commission concluded a review and announced the achievement by Romania of the main commitments taken in respect of the deficit targets, considering that the government took the proper measures in line with the recommendations made by the Commission regarding the budget deficit cut under 3% of GDP by the agreed deadline (namely the end of 2012), therefore the excessive deficit procedure has been pending until the fulfillment of the commitments.

**2. Budget deficit financing strategy in 2011**

After joint consultations with IMF, EU and WB and in line with the provisions laid down in the supplementary letters of intent and in the memoranda of understanding agreed with IMF[2] and EU[3] and ratified in normative acts having the power of laws, in order to improve the debt management and avoid seasonal pressure with a view to provide the sources to finance the budget deficit and

[1] The excessive deficit procedure is governed by Article 126 of the Treaty and the Council Regulation on speeding up and clarifying the implementation of the excessive deficit procedure.

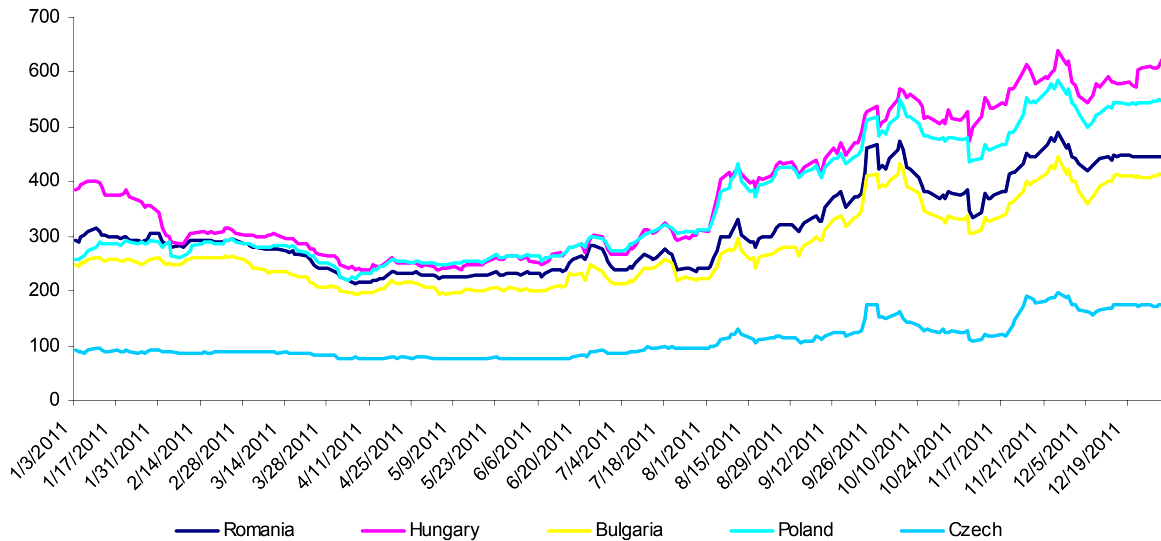
[2] GEO10/2010, Law.257/2010 , Law 84/2011 and Law 285/2011

3 GEO.11/2010, GEO 81/2010 and GEO 108/2011

refinance the government public debt, MoPF decided to establish a financial buffer in foreign currency equivalent to around 4 months of financing needs.

The debt crisis in the Eurozone, particularly in Greece, and the worsened ratings issued for some EU Member States by the rating agencies influenced in a negative way both the CDS quotations and the margins of the benchmark bonds issued by the emerging countries, Romania included. In their attempt to secure the financing sources, the countries tried to take advantage of some windows of opportunity, with some European states even securing in advance their financing for the year 2011.

Chart 2. Comparison CDS at 5 years for the countries in the region




In 2011, the budget deficit was financed and the public government debt was refinanced 62% from domestic sources, topped up from foreign sources, by using the following instruments:

- *Government securities in lei, namely discounted T-Bills and Benchmark Bonds issued on the domestic market, with medium and long term maturities of 2, 3, 5 and 10 years, and reopening of benchmarks with initial maturities if 3, 5 and 10 years.*

To achieve the objective related to the development of the government securities market and building an yield curve for the government securities issued on the domestic market, government securities were issued with regularity on the domestic market, in line with the published calendar. In 2011, government securities issuances amounted to 57.2 billion lei, of which 67% in T-Bills with maturities of 5, 6, 7, 9, 11 and 12 months, and the difference in new benchmark bonds maturing in 2, 3, 5 and 10 years and the reopening of benchmarks with initial maturities 3, 5 and 10 years. Compared to the yield of government securities issued in December 2010, the yield of government securities issued in December 2011 went down in average by 0.2% reaching around 6.7%.

- *Government securities in Euro, on the domestic and foreign markets*

On the domestic market, in 2011, MoPF launched issued 2 bonds in Euro, as follows:

- May 2011, a 3-year bond in Euro in amount of 939.2 million Euro,
- end of July 2011, a 4-year bond denominated in Euro in amount of 462.6 million Euro.

On the foreign market, the 2011-2013 framework program for the issuance of medium term government securities in amount of 7 billion Euro. The first issuance under this program, on June 9, 2011, amounted to 1.5 billion Euro (the highest amount ever issued by Romania on the foreign capital markets) and was issued for a maturity of 5 years and a 5.25% coupon. MTN was improved in the second half of 2011, to allow access in both Euro and USD on the foreign capital markets.

- *Drawings from the new loans contracted with IMF, the European Community and IBRD under the foreign financial package approved for Romania, and drawing from foreign loans intended for project funding*

From the foreign financial package concluded with IMF, EU and IBRD in 2009, 1.35 billion Euro was drawn from the EC loan and 700 million Euro from IBRD 's DPL 2 and DPL 3; the funds were aimed at financing the budget deficit, refinance the public debt and consolidate the foreign currency buffer of MoPF.

For financing the budget deficit, the foreign financial package concluded with IMF, EC and the World Bank was the optimal solution at the time, as it avoided a high refinancing risk accumulation by the issuance of high amounts in short term government securities. The cost of financing was diminished taking into account the comparative advantage of the cost of lending by international financial institutions. The foreign financial package also provides comfort to the investors' environment and ensures the implementation of political reforms aimed at the fiscal consolidation.

To supplement the foreign loan proceeds, in 2011, foreign loans intended for project funding in amount of 3.1 billion lei were used in 2011 to finance the budget deficit:

- *loans contracted by the local public administration authorities*
- *amounts recovered by AVAS in non-performing banking assets and by the Ministry of Economy under the provisions of GEO 249/2000.*

### 2.1. Government securities issued on the primary and secondary markets

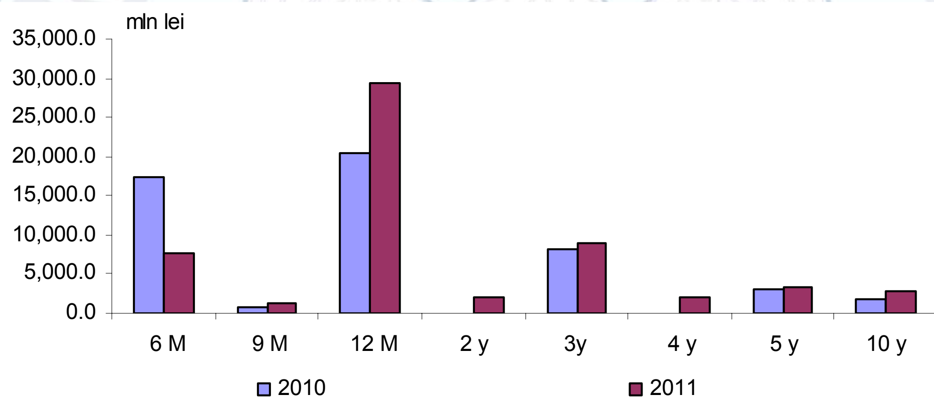
Primary market

Under the economic and financial circumstances described above, the amount of government securities issued on the primary market in 2011 went up to 57.2 billion lei compared to 51.9 billion lei in 2010, in instruments denominated in domestic and foreign currency.

The government securities issued to cover the financing gap in 2011 included:

- Treasury Bills in lei with maturities of 5, 6, 7, 9, 11 and 12 months, in amount of 38.3 billion lei
- Benchmark Bonds in lei with maturities of 2, 3, 5 and 10 years, in amount of 13.1 billion lei
- Government securities in Euro, with maturities of 3 and 4 years in amount of 5.8 billion lei (1.4 billion Euro)

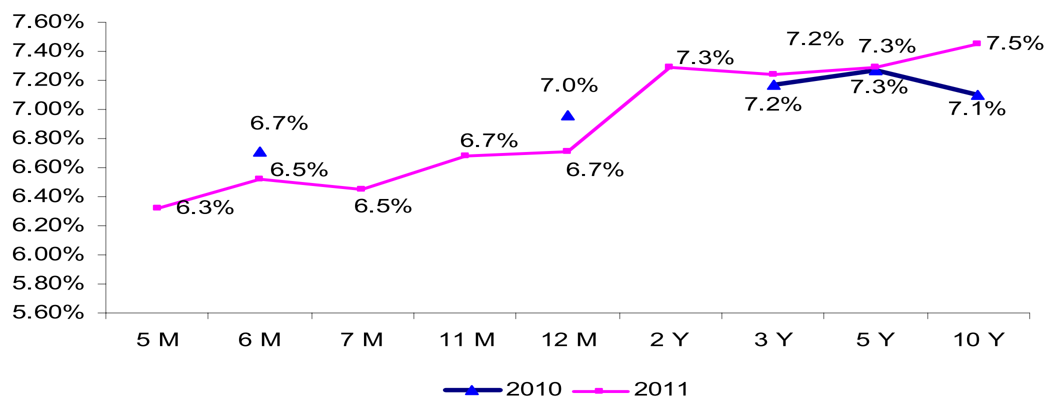
Chart 3. Government securities issued on the primary market in 2010 compared to 2011




The maturity composition of the government securities improved in 2011 with 67% short term and 33% medium and long term debt issued, compared to 2010 when 75% was short term debt and 25% medium and long term debt.

The average yield of government securities in lei in 2011 as against end-2010 is as follows:

Chart 4. Average yields (awarded) of government securities



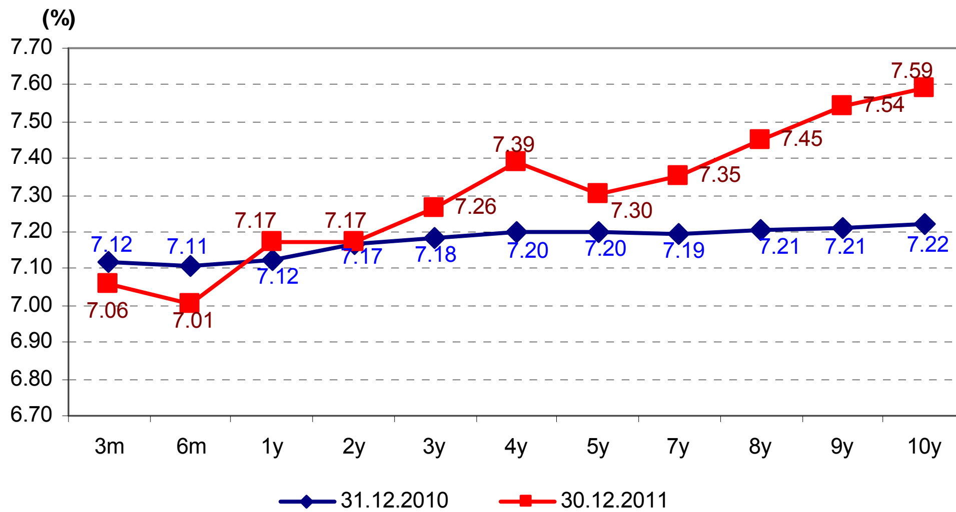
The government securities were denominated in both lei and Euro after a dialogue with primary dealers and considering the liquid foreign currency on the market.

In the first half of 2011, with foreign currency liquidity on the interbank market, for the purpose of covering the financing gap and compensate for the non-subscribed amounts in the recent auctions, MoPF issued on the domestic market two government bonds denominated in Euro, with maturities of 3 and 4 years, respectively, and a total amount of 1.4 billion Euro. These were an alternative that, on medium term, was less risky than the short term financing in lei. At the same time, the foreign currency issuances on the domestic market allowed low financing costs under difficult market circumstances.

<u>Secondary market</u>

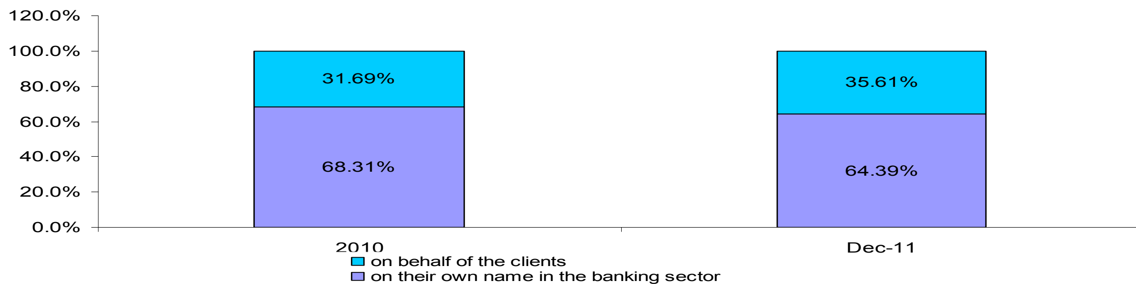
The yield curves of government securities in 2010 compared to 2011 is as follows:

Chart 5. Yield curve on December 31, 2010 compared to December 31, 2011




In term of investors in government securities, the holdings[4] of government securities by the local commercial banks went down to the benefit of non-financial institutions in 2011 compared to 2010.

Chart 6. Government securities holdings in December 2011 vs. December 2010




[4] Source : NBR

While at end 2010 the holdings of commercial banks amounted to 68.3 % of the total government securities, at end-2011 these amounted to only 64.4%, with the share of non-residents' holdings going up to around 11.7% (government securities deposited in Clearstream not included) of the total amount of government securities in domestic currency issued in 2011, as against 2010 when they amounted to 10.5% of the total amount of government securities issued in lei.

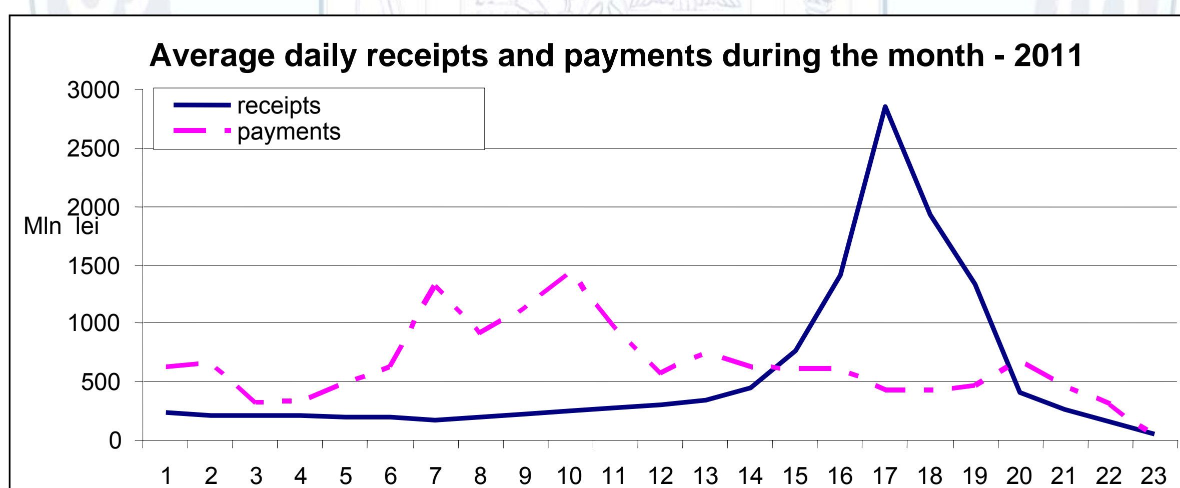
### 2.2 Foreign loans contracted in 2011

In 2011, against a favorable background (enough liquidity and reasonable margins on the financial markets) several windows of opportunity opened in the market benefitting other sovereign issuers; MoPF launched the first medium term framework program for government securities in amount of 7 billion Euro. Under this program, the first issuance in amount of 1.5 billion Euro was launched on June 9, 2011. The high interest in the Romanian government securities issued in Euro on the foreign capital markets was confirmed when the Eurobond issuance was oversubscribed around 2 times. The funds collected were used to finance the budget deficit and refinance the public debt.

In addition, the two IBRD loans in amount of 700 million Euro (DPL 2 and 3), were used to finance the budget deficit, refinance the debt and consolidate the financial buffer of the MoPF.

### 2.3 Cash management

Cash management operations were required by the high gap between the collections and payments of the state treasury general current account as presented in the Chart 7 below:




Temporary deficits in the state treasury general current account were covered by short term deposits from several lenders of the interbank market and currency exchange operations.

The very short term (less than 2 weeks) deposits from the interbank market lenders in 2011 amounted to 44,0 billion lei at an average interest rate of 4.66%.

Currency exchange operations were applied to proceeds drawn from the foreign loans and government securities issued in Euro on the domestic and foreign markets.

Chart 8. Deposits in 2010 compared to 2011

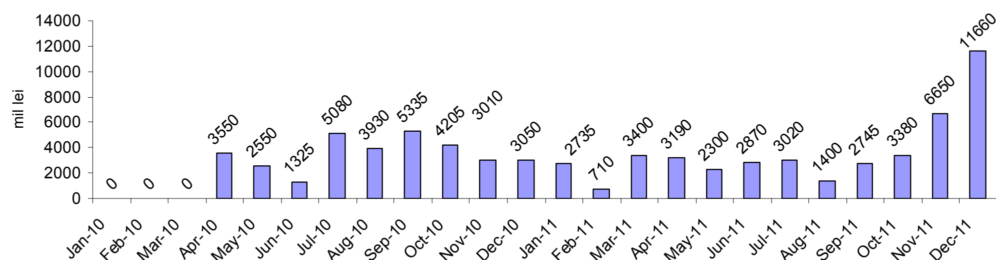
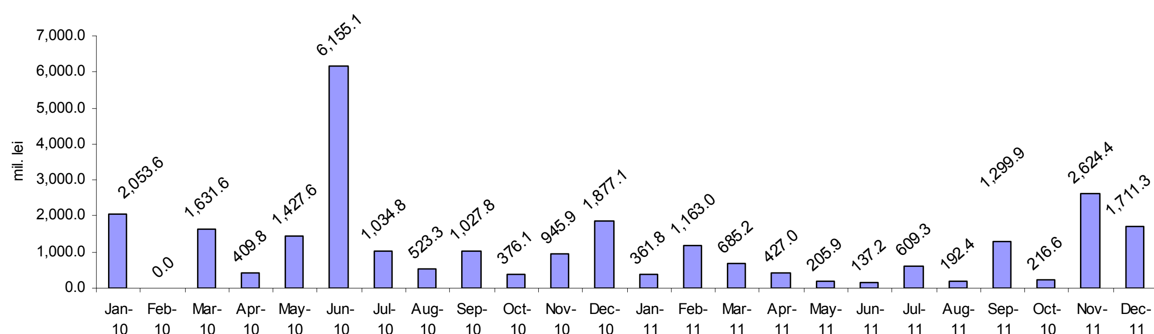



Chart 9. Foreign currency sale




**3. Government debt portfolio risks and risk assessment**

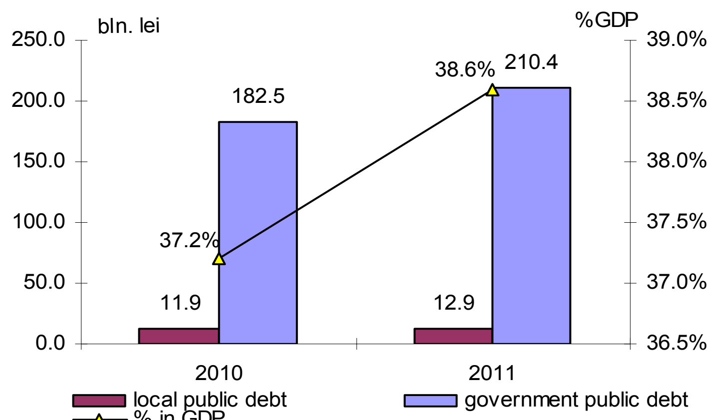
The main objectives according of the 2011 – 2013 Government Public Debt Management Strategy (Debt Strategy) planned for implementation in 2011 were as follows:

1. controlled increase of the government public debt;
2. reduction of the long term debt with a reasonable risk level in the debt portfolio;
3. limitation of risks attached to the debt portfolio;
4. development of the government securities market.

**Driven by macroeconomic developments and the domestic and international financial markets, the debt contracted according to the provisions of the Government Emergency Ordinance 64/2007 regarding the public debt,** amounted on December 31, 2011 to 223.3 billion lei, out of which 210.4 billion lei in government public debt was (accounting for 94.2% of total debt) and 12.9 billion lei in local debt (5.8% of the total public debt).

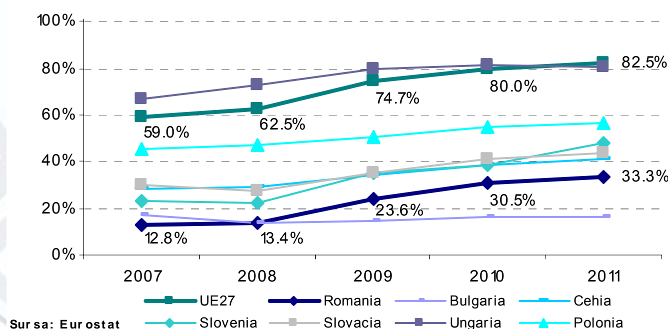
The increase of the public debt in 2011 compared to the end of 2010 by 28.8 billion lei, namely 1.4 percentage points of GDP was driven primarily by the debt committed in order to cover the financing gap to pay the budget deficit and refinance the government public debt.

Chart 10. The performance of the government public debt




At the end of 2011, the government debt according to EU methodology[5] accounted for 33.3% of GDP, comfortably below the 60% ceiling required by the Maastricht Treaty, out of which the domestic debt amounted to16.9% of GDP, with the foreign debt accounting for 16.4% of GDP. Thus, Romania has one of the lowest indebtedness levels in the European Union, after (6.0%), Bulgaria (16.3%) and Luxembourg (18.2%).

Chart 11. Indebtedness level in the Central and East European Countries in 2007-2011




## Government Debt Composition

The government debt at December 31, 2011 amounted to 210.4 billion lei, accounting for 36.4% of GDP, higher by 1.5% of GDP compared to the end of 2010.

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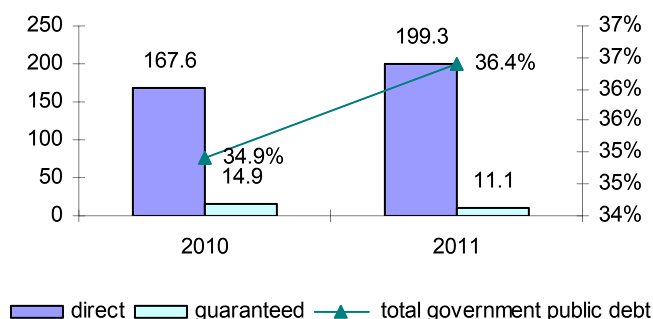
[5] This is the public adminsitration debt at nominal value, aggregated in the sub-sectors of the public adminsitration and does not include the guarantees issued by the central government and by the local governments except for those paid from the state budget or those for the account of which the guarantor made 3 successive payments.

In the total government debt at end-2011, *direct debt was* 94.7%, higher as compared to 91.9% in 2010, with the difference in the guaranteed public debt. In 2011, against the background of a narrower fiscal room agreed with the international financial institutions (a budget deficit of 4.1% of GDP compared to 6.4% of GDP in 2010), and considering the revised terms of the guarantees issued under various government programs, the government contingent liabilities continued to decrease and push down the default risk for the Ministry of Public Finance in its capacity as guarantor.

Chart 12. Government Public Debt by type of debt



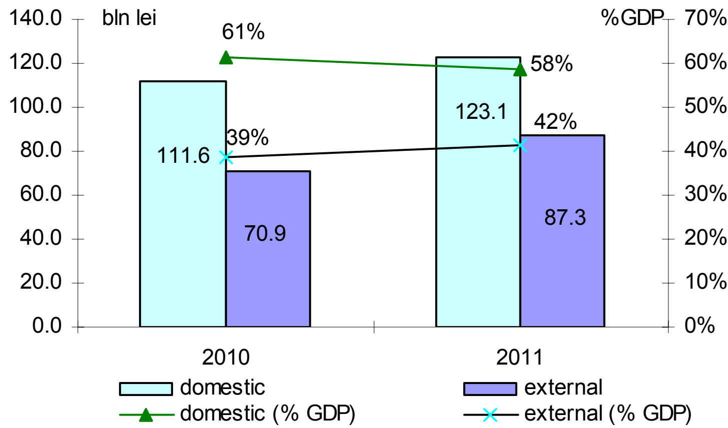

In 2011, the guaranteed government debt share in total government debt went down by 2.9% compared to 2010, after the exposure under the “First Home” program decreased after the guarantees committed to commercial banks were cut to 50% as a move to provide a proportional risk sharing between the government and the lenders.

The guarantees issued in 2011 amounted to 1,745.6 million lei, as follows:

- guarantees issued under the “First Home” Program – 1,670.7 million lei;
- guarantees issued under the building envelopment program – 4.1 million lei;
- guarantees issued under the program aimed at supporting the beneficiaries of projects implemented in priority areas of the domestic economy which are funded by EU Structural Instruments – 53.7 million lei;
- the government guarantee issued for the Mihail Kogălniceanu Program – 17.1 million lei.

With regard to the market on which the government debt was issued, the trend of the past three years has been preserved, with a decreasing share of the debt contracted on the domestic market, a path that is consistent with the objectives of the debt management strategy regarding the diversification of financing sources and issuances under the MTN Program.

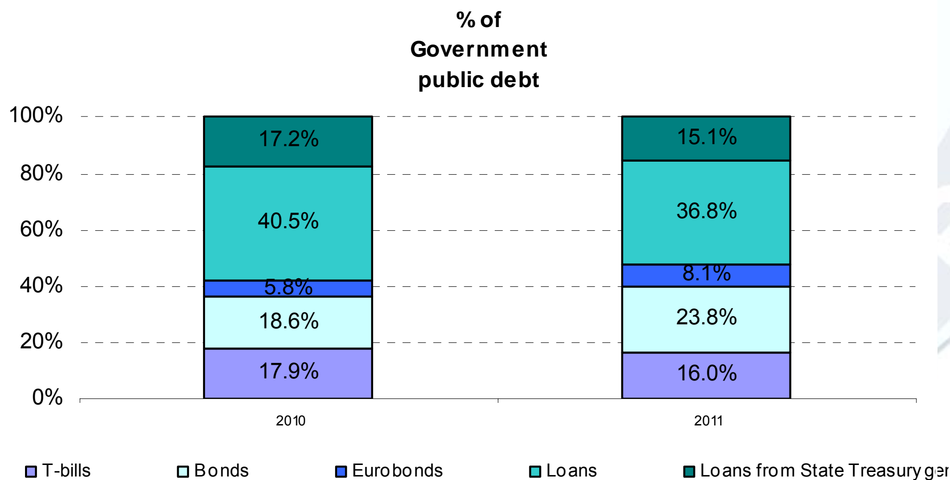
Chart 13. Government Public Debt by the market of issuance




At the end of 2011, *the tradable debt* (government securities) accounted for 47.9% of the total government debt, of which 39.8% in government securities issued on the domestic market, higher by 3.3% compared to 2010.

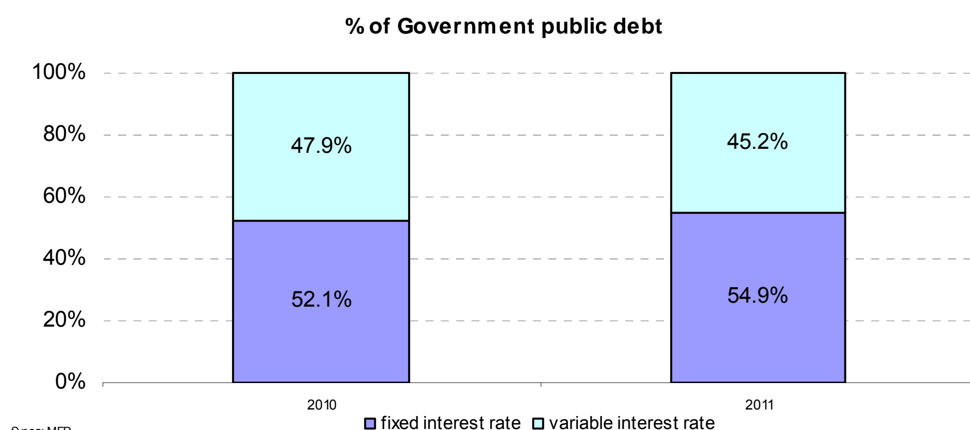
Considering the debt composition by type of instruments, in 2011 the borrowings from the state treasury general current account accounted for an important 15.1% share of the total debt and amounted to 31.8 billion lei, higher by 0.4 billion lei compared to the end of 2010.

Chart 14. Government debt composition by type of instruments



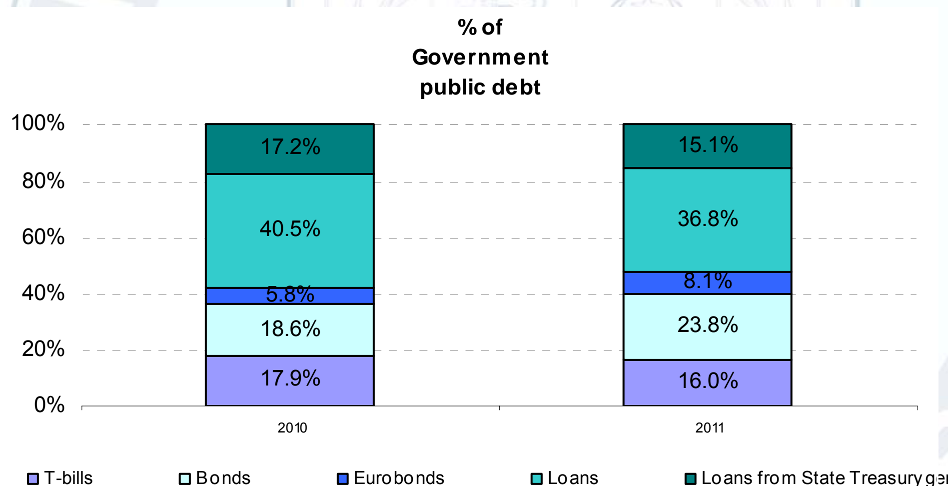

The debt composition by interest rates shows a slight increase of the fixed debt from 52.1% at end-2010 to 54.9% at end-2011, primarily due to the bonds issued on the domestic market and the Eurobonds issued on the foreign capital markets.

Chart 15. Government debt composition by interest rates




Considering the initial loan maturity the highest share of 67.8% has been in the medium and long term loans (over 1 year). The high share of the short term debt (32.2% in total government debt) comes from T-Bills and the borrowings from the state treasury general current account.

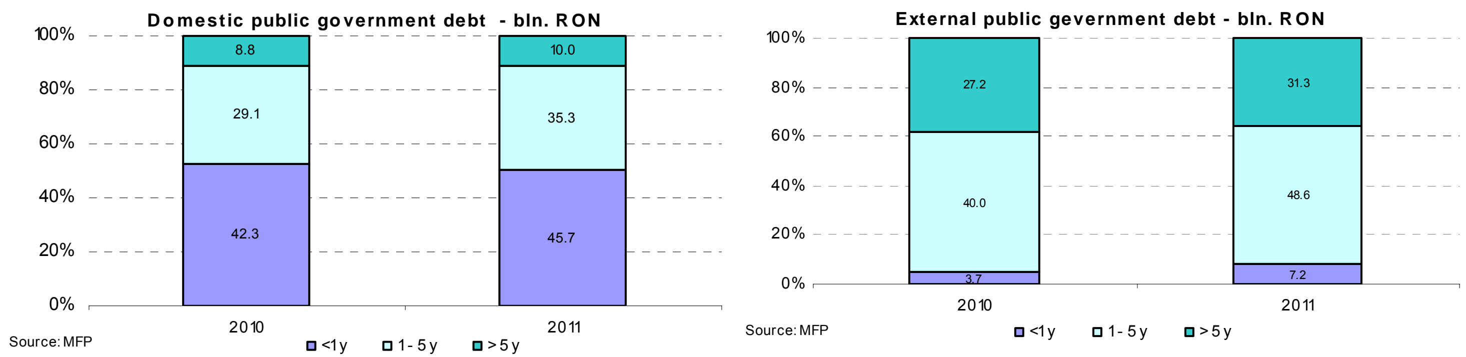
Chart 16. Government debt composition by initial maturity




In terms of residual maturity of the domestic government debt, at the end of 2011 as against 2010, 10% of the domestic debt had a remaining maturity over 5 years, as compared to 8.8% at end-2010, with the debt having a residual maturity under 1 year increasing from 42.3% to 45.7% over the same time interval.

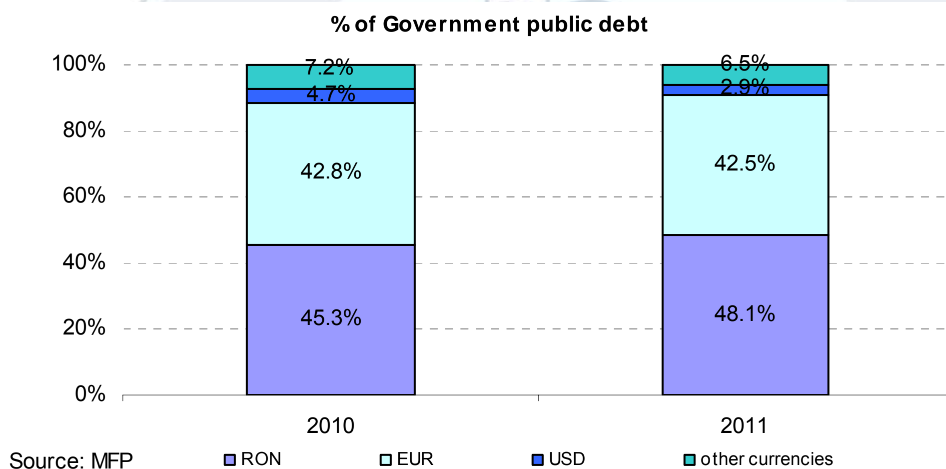
The composition by remaining maturity of the foreign debt remained roughly unchanged in 2011, with around 55% in the 1-5 years segment and less than 10% under 1 year. The remaining maturity over 5 years increased compared to 2010 as a consequence of the Eurobond issued on the foreign capital market under the MTN Program in the first half of 2011.

Chart 17. Domestic*) and foreign government debt composition by remaining maturities
*) borrowings from the state treasury general current account not included.




In terms of currency composition, the highest share remained, as in 2010, the domestic currency debt accounting for 48.1%, followed by EURO at 42.5%, with the other currencies with an aggregate share of 9.4% in total government debt. In 2011, in order to use foreign sources to finance the budget deficit, the loans were contracted mainly in Euro, on a medium and long term, to reduce the currency risk in view of the adoption of the European currency.

Chart 18. Government debt composition by currencies




The debt servicing in 2011 amounted to 59.5 billion lei, of which 56.8 billion lei in direct debt and 2.7 billion lei in contingent liabilities. Of the whole sum, 51.0 billion lei account for capital payments (including refinancing of government securities) and 8.5 billion lei in interest and fees.

Out of the total government debt servicing, the domestic market debt share amounted to 53.5 billion lei, with the difference in the payments related to the debt contracted on the foreign markets. The higher debt servicing for the debt contracted on the domestic market by 16.0 billion lei compared to 2010 was mainly driven by the repurchase of the government securities in amount of 2.4 million EUR issued in 2010, and the higher amount in refinancing of government securities amounting to 35.2 billion lei as against 31.5 billion lei in 2010.

Other indicators of the government debt include:

| | 2010 | 2011 |
|---|---|---|
| 1. Foreign government debt servicing /Exports of goods and services [6] | 4.6% | 2.7% |
| 2. Interest/ Exports of goods and services [7] | 3.8% | 3.8% |
| 3. Interest payments from the state budget | | |

[6] This indicator shows the extent to which the payments representing the government public debt servicing are covered by collections from exports of goods and services.
[7] This indicator shows the extent to which the cost of interest attached to the government public debt is covered by the collections from exports of goods and services.

| | | |
|---|---|---|
| /Budget revenues[8] | 4.2% | 4.7% |
| 4. Interest payments from the state budget /Budget expenditures[9] | 3.5% | 4.1% |

The higher interest payments from the state budget in 2011 compared to 2010 comes from both the newly contracted debt intended to cover the excessive budget deficits in 2009 and 2010, and the mostly short term government securities (under 1 year) with the discount payable on the maturity date.

Considering the macroeconomic and financial market developments described in the above sections, the achievement of the main debt strategy objectives in 2011 can be summarized as follows:

| OBJECTIVES | 2011 | 2010 | Ceilings set by the Strategy |
|---|---|---|---|
| 1. Controlled increase of the government debt (%GDP) | 36.4% | 35.5% | |
| 2. Reduce the long and medium term government debt costs while controlling the risks associated to the debt portfolio (% interest payments to GDP) | 1.5% | 1.4% | |
| 3. Limit financial risks attached to the government debt by | | | |
| A. Currency risk | | | |
| a. Increase the lei government debt share in total government debt (%) | 48.1% | 45.3% | **minimum 45%** |
| b. Increase the share of the government debt in Euro [10] in total debt denominated in foreign currency (%) | 81.9% | 78.2% | **minimum 75%** |
| c. Decrease the share of government debt in Euro in total debt (%) | 42.5% | 42.8% | **maximum 50%** |
| B. Refinancing risk | | | |
| d. Reduce the debt refinancing gap (share of short term debt in total debt) (%) | 32.2% | 35.1% | |
| e. Average remaining maturity of the debt portfolio (years)[11] | 4.1 | 3.7 | |
| C. Interest rate risk | | | |
| f. Increase of the fixed debt share in total debt (%) | 54.9% | 52.0% | |
| g. increase of the negotiable debt in total debt (%); | 48.0% | 42.4% | |
| 4. develop the government securities market (billion lei)<br>- government securities issued in this interval, less for refinancing the maturing securities (net issuances) | 22.0 | 20.0 | |

[8] The indicator shows the coverage of interests payments attached to the government public debt by the revenues collected to the state budget.
[9] This indicator shoes the share of interest payments attached to the government public debt in total general government budget.
[10] Only short and long term loans in Euro to reduce the currency risk, taking into account the intention to adopt the single European currency.
[11] Borrowings from the state treasury general current account not included.

1. In 2011, due to the fiscal consolidation measures which helped the achievement of the major targets agreed in the financing agreement with IMF, EU and other IFIs, the budget deficit went down from 6.4% in 2010 to 4.1% of GDP. The fiscal adjustments aimed at reducing the budget deficit in line with the medium term calendar helped reducing the risk of a rapid increase of the government debt in 2011.

Hence, the government debt in 2011 was pushed up by the loans contracted to finance the budget deficit and refinance the public debt, as well as by the guarantees issued for lending under the “First Home” Program, the building enclosure program and the support program dedicated to projects implemented in priority areas  of the Romanian economy which are financed by EU Structural Funds.

2. The cost of debt contracted in 2011 through government securities issued on the domestic market to finance the budget deficit and to refinance the public debt, is reflected in the indicator “interest payments share to GDP (1.5% of GDP) higher as compared to 2010 (1.4% of GDP). It is worth mentioning that the foreign financial package came in good interest terms, i.e. 2.375% and 3.125% for installments 4 and 5 of the EC loan and around 2.3% for IBRD’s DPLs 2 and 3.

3. In 2011, the indicator “share of debt in domestic currency in total government debt (48.1%)” increased compared to 2010, under the 50% ceiling established in the Strategy.

In respect of the refinancing level reflected in the indicator “share of short term debt in total government debt” the situation improved in 2011 when the indicator went down to 32.2% from 35.1% at the end of 2010, due to a higher amount of medium and long term debt in the total amount of government securities issued on the domestic market.

4. The maturity composition of the government securities issued on the domestic market improved in 2011, with 67% short term and 33% medium and long term debt compared to 75% short term and 25% medium term debt in 2010 when investors preferred short term maturities.

*5. Credit risk and operational risk*

In respect of the credit risk triggered by the budget risk attached to government guarantees and on-lending, in 2011 the payments from the risk fund on the account of guarantees and sub-loans to companies accounted for 0.03% of GDP.

In March 2011, the medium term debt management strategy for the interval 2011-2013 was approved, after consultations with NBR (in accordance with GEO 64/2007),  and the International Monetary Fund, the European Commission and the World Bank.

MINISTER
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