Translation from Romanian

MINISTRY OF PUBLIC FINANCE

GOVERNMENT PUBLIC DEBT MANAGEMENT STRATEGY

2017-2019

General Directorate for Treasury and Public Debt

Bucharest 2017

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Acronyms

ATM	Average time to maturity (years)
FSA	Financial Supervisory Authority
ATR	Average time to re-fixing (years)
ECB	European Central Bank
CEB	Council of Europe Development Bank
EIB	European Investment Bank
EBRD	European Bank for Reconstruction and Development
IBRD	International Bank for Reconstruction and Development
NBR	National Bank of Romania
NCF	National Commission for Forecasting
PD	Primary dealers
EMBIG	Emerging Markets Bond Index Global of JP Morgan
FED	United States Federal Reserve
EAGF	European Agricultural Guarantee Fund
IMF	International Monetary Fund
GMTN	Global Medium Term Note Program for the Eurobonds issuances on the foreign markets
IFIs	International Financial Institutions
NIS	National Institute of Statistics
MoPF	Ministry of Public Finance
NSRF	National Strategic Reference Financing Facility
GDP	Gross Domestic Product
NPRD	National Programme of Rural Development
EU	European Union

1. Introduction

This Government Public Debt Management Strategy for the period 2017-2019 (hereinafter called „Strategy”) continues the 2016-2018 Government Public Debt Management Strategy and it was prepared in accordance with the good international practices fined in the WB-IMF Guidelines for debt strategy design[1] and in consultation with the NBR.
As it has been the case with previous editions, the Strategy updated for 2017-2019 is consistent with the budget indicators[2] of the Fiscal-Budgetary Strategy 2017-2019 it focuses solely on the government public debt portfolio composition, in particular on the aspects which fall under the authority and mandate of the government public debt manager[3]. Therefore, the Strategy provides the direction in which the authorities intend to steer the funding and the structure of the debt portfolio to secure the financing and to meet the *government public debt management objectives of the Ministry of Public Finance*, namely:

- Cover the funding needs of the central government and the payment obligations, while minimizing medium and long term costs;
- Limit the risks of the government public debt portfolio; and
- Develop the domestic market for government securities.

The implementation of the Public Government Debt Management Strategy for 2016
In 2016, all risk indicators remained within the targets set out in the public government debt management strategy for 2016 – 2018, as reflected in the presentation of financial indicators in the table below:

Table 1: Risk indicators at the end of 2015 and 2016

Indicators *	**31/12/2015 ****	**31/12/2016 *****	**Indicative targets according to the Strategy 2016-2018**
A. Currency risk			
Share of domestic currency debt in total (% of total)	42.7%	45.7	40% (minimum) – 60%
Share of EUR denominated debt in foreign currency denominated debt (% of total)	80.6%	80.8	80% (minimum) – 95%
B. Refinancing risk			
Debt maturing in 1 year (% of total)	18.0%	13.0%	15% - 25% (maximum)
Local currency debt maturing in 1 year (% of total)	28.0%	22.0%	20% - 30% (maximum)
ATM for total debt (years)	5.7	5.8	5.5 years (minimum) –7.0 years
ATM for local currency debt (years)	3.4	3.8	3.0 years (minimum) –5.0 years
C. Interest rate risk			
Debt re-fixing in 1 year (% of total)	23.0%	16.0%	15% - 25% (maximum)
Local currency debt re-fixing in 1 year (% of total)	28.0%	20.0%	20% - 30% (maximum)
Average time to re-fixing for the total debt (years)	5.7	5.9	5.0 years (minimum) – 6.5 years
Average time to re-fixing for the debt in domestic currency (years)	3.4	3.8	3.0 years (minimum) – 5.0 years

*Without loans from the cash balance of the State Treasury General Current Account. **For 2015 the indicative targets set forth in the Government Public Debt Management Strategy were taken into account 2015 -2017. *** Preliminary data.
Source: MoPF

[1] Refer to the “Medium Term Public Debt Management Strategy”- a guide to government authorities prepared by the World Bank and the International Monetary Fund, February 24, 2009.
[2] Calculated based on the projection of the main macroeconomic indicators of the NCF 2017 spring forecast.
[3] Subsequently, this document will avoid committing to fiscal policy targets such as debt share to GDP or debt cost to GDP, since the former depends on the budget deficit targets and the latter depends on the budget deficit targets and the market performance, therefore both of them are outside the control of the public debt managers.

Strategic guidelines for 2017-2019

The following principles shall guide the government funding decisions during 2017-2019:

1. The net financing in local currency is to be favored as a move to further facilitate the development of the domestic market of government securities and help mitigate foreign currency exposure, at the same time considering the domestic market absorption capacity and, in general, the demand for debt instruments denominated in lei[4].
2. Obtain an even redemption profile, avoiding to the extent possible the concentration of principal repayments/refinancing of government securities in the short-term.
3. Mitigate the refinancing risk and the liquidity risk by maintaining a foreign currency buffer [5] and possibly other instruments depending on the terms and conditions thereof.
4. Maintain presence on the international capital markets, through issuance of Eurobonds mainly in EUR and access the USD market or other foreign currency markets on an opportunistic basis, considering the extension of the debt portfolio average maturity, and the cost/risk ratio associated thereto and the diversification of the investment base.
5. In the process of external financing, the considered debt will be mainly in EUR.
6. The issuances in Euro on the domestic market can be considered solely by considering the specific demand of the local investors, in the absence of alternative investment instruments, considering a favorable maturity/cost ratio.
7. Maintain exposure to interest rate risk under control by monitoring the domestic debt refixing within the next year and the average time to refix for the total portfolio.
8. Use financing instruments offered by the international financing institutions to benefit of the favorable terms and conditions attached to those instruments.

These principles are expressed as indicative target ranges[6] for key risk indicators that allow flexibility in managing government public debt to respond to the changes of the conditions in the financial markets, as follows:

- *to manage foreign currency risk*:

1. keep the share of local currency denominated debt in total government public debt between 45% (minimum) and 60%.

2. keep the share of debt denominated in EUR in total foreign currency debt between 80%(minimum) and 95%.

- *to manage refinancing risk*

1. keep the share of debt maturing in the next year between 20% and 30% (maximum) for the local currency debt and between 10% and 20% (maximum) for total debt.

2. the average maturity remaining should be maintained between 3.5 years (minimum) and 5.0 years for local currency denominated debt and between 5.5 years (minimum) and 7.0 years for total debt.

3. keep a foreign currency buffer[7] at a comfortable level, in order to mitigate the risks corresponding to high volatility times on the financial markets.

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[4] In addition to the domestic demand for the government securities denominated in lei, non-resident investors could play an important part regarding amounts placed on the domestic market and, in particular, with respect to the structure of maturities in the financing process, given those investors' preference for government securities with medium and long maturities.

[5] The currency buffer should cover a number of months relating to the gross funding needs; at present, it is set at 4 months of the gross borrowing needs.

[6] The limit referred to as the minimum or maximum can't be exceeded during the period covered by the strategy (hard bound), while the other limit is the one to be achieved and can be exceeded (soft bound).

[7] The foreign currency buffer represents the funds in foreign currency available to the State Treasury - the current buffer level covers 4 months of gross borrowing needs.

- *to manage interest rate risk*

1. debt re-fixing its interest rate in the next year should stay between 20% and 30% (maximum) for local currency debt and between 10% and 20% (maximum) for total debt.
2. keep the average maturity remaining until the next refixing between 3.5 years (minimum) and 5 years for local currency debt and between 5.5 years (minimum) and 7.0 years for total debt.

2. Objectives and scope

This Strategy is the debt management policy document and the Ministry of Public Finance seeks to achieve the related objectives as follows:

- Cover the funding needs of the central government and the payment obligations, while minimizing the medium and long term debt costs;
- Limit the risks of the government public debt portfolio; and
- Development of the domestic market of government securities.

The first two objectives are stated in the GEO 64/2007 and are complemented by the government securities domestic market development objective which was formulated in the previous strategies as well. The development of a liquid market of government securities and the construction and consolidation of a yield curve in national currency are important objectives both for the purpose of the first two objectives of the strategy, and for the development of the Romanian financial market.

The scope of this Strategy is limited to directly contracted debt or debt that is guaranteed by the Government, through the Ministry of Public Finance, but it does not include the borrowings from the State Treasury General Current Account ("temporary financing"). Temporary financing is a cash management instrument and cannot be viewed as a medium-term financing instrument. Nevertheless, considering that it is important to coordinate the government public debt management strategy with the cash management policy, including through temporary financing, as well as the interference between them, the cash management strategy is presented in Annex 2[8].

3. Description of the public government debt portfolio[9]

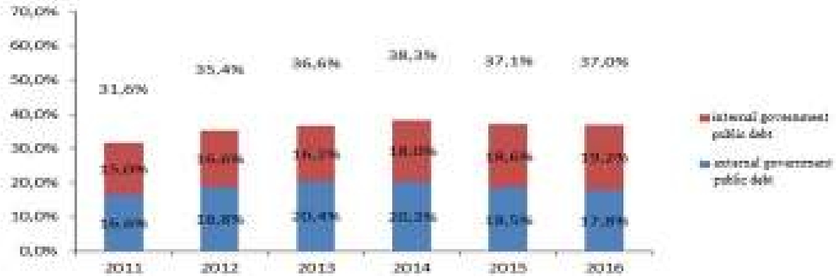
Evolution of government public debt

At the end of 2016, government public debt amounted to 281.8 billion lei, i.e. 37.0% of GDP, against an economic growth of 4.8% of GDP and given a deficit of the general consolidated budget of 2.4% of GDP.

Following the strategy adopted in the last years, to finance the budget deficit mainly by issuing government securities on the domestic market, but also given the growth of resident investors' demand of Romanian Eurobonds, the structure of government debt according to the residence criterion has changed significantly in favor of internal government debt in 2013-2016, and, at the end of 2016, the existing government public debt was 52.0% contracted by resident creditors and 48.0% by non-resident creditors.

[8] It shall be noted, however, that drastic changes in the level of temporary financing may have an impact on the issuance of government securities and may impair the plans for developing the domestic market of government securities.
[9] Preliminary data according to national legislation, not including temporary financing.

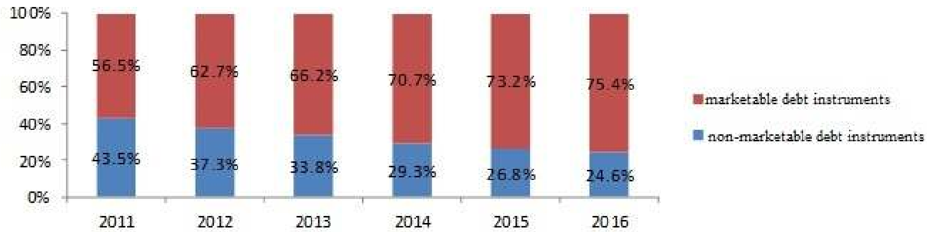
Graph 1: Government Public Debt composition according to creditor residency criterion (% of GDP)



Source: MoPF

As shown in graph 2, the structure of the public government debt has continuously improved from a portfolio comprising mainly non-marketable debt (external loans contracted with IFIs) until 2009, to one with more marketable debt instruments (with a growing share issued in local currency).

Graph 2: Marketable debt instruments vs non-marketable debt instruments



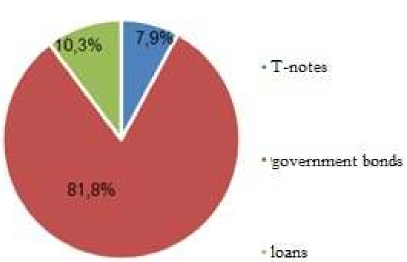
Source: MoPF

While the government borrowings' share to total government public debt was 24.6%, the government securities issued on the domestic and foreign markets accounted for 75.4% of total government public debt, of which 45.6% are government securities issued on the domestic market and 29.8% on the external market.

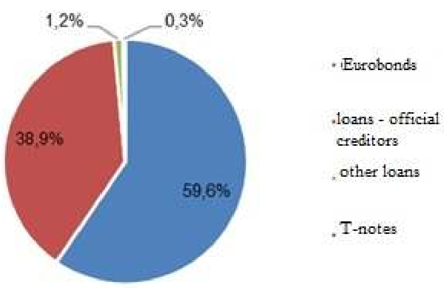
As suggested in graph 3, the bulk of the domestic debt is represented by government securities, namely T-notes and T-bonds whereas the external debt is mainly represented by bonds issued on the foreign capital markets and loans contracted with International Financial Institutions. The structure of external debt incudes government securities issued on the domestic market, held by non-residents, while the structure of internal debt includes Eurobonds held by residents.

Graph 3: Debt structure according to the investor residency criterion and debt instruments

Internal debt instruments



External debt instruments



Source: MoPF

Costs, expressed as average interest rates[10], dropped in 2016 driven by lower interest rates especially of internal debt. Debt in local currency at the end of 2016 remains more expensive than foreign currency debt[11] as illustrated in table 2, but the decrease of the average cost of interest relating to national currency debt is much more accentuated, at approx. 20% as compared with end-2015, given the acute drop of yields for government securities in lei issued on the domestic market.

Table 2: Cost of direct Government (through MoPF) debt, according to type of instrument[12]

	31.12.2015	31.12.2016
Average interest rate of public government debt (%)	*4.1*	*3.7*
1. in national currency, of which	5.0	4.1
a. T-Bills with 1 year maturity	1.2	0.8
b. T-Bonds fixed with 1 - 5 year maturity	5.0	4.0
c. T-Bonds fixed with 5 - 10 year maturity	5.9	5.5
2. in foreign currencies, of which:	*3.6*	*3.3*
a. EUR bonds with 10-year maturity	4.2	3.6
b EUR bonds with 3-5 year maturity	4.0	4.2
e. EUR multilateral	2.6	2.5
f. USD bonds with 30-year maturity	5.9	5.7
g. USD multilateral	1.7	1.8

Source: MoPF

The continued significant portion of loans contracted from IFIs at favorable rates explains the lower cost of external funding. In addition, bonds denominated in EUR placed in the international capital markets are usually issued at nominal yields (without considering the impact of currency risk on the costs) lower than local currency securities as illustrated in graph 4. For the most of 2016, the costs relating to RON financing on the domestic market were kept slightly above the levels of the USD financing costs for similar maturities, and the tendency was reversed toward the end of the year, given the FED decision to increase the interest. Given the favorable yields offered by Eurobonds, linked with the MoPF objective to maintain the Euro denominated share of the total foreign currency debt in the range 80-95%, issuances on external markets in 2016 were exclusively in EUR.

Graph 4: Domestic benchmark bond yield vs Eurobonds issued on the external market in Euro and USD

Source: MoPF

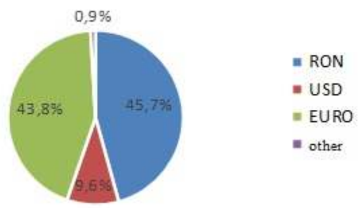
[10] Calculated as interest payments forecast for 2017 and the existing balance at the end of 2016 per debt instrument.
[11] Excluding influences due to currency risk which can significantly change the cost of debt in foreign currency (interests corresponding to debt in foreign currency), in case of a depreciation of the national currency.
[12] The table shows the average interest rates for selected debt instruments, aggregated as all debt instruments forming the government public debt portfolio.

Risks of the public government debt portfolio at the end of 2016

Foreign exchange risk

At the end of 2016, 54.3% of the government public debt portfolio was denominated in foreign currencies. This share is higher compared to other EU Member States which have not joined the Euro, as well as to similarly rated states at worldwide level. While this ratio would suggest a significant exposure to foreign currency risk, the relative low volatility of the RON/ EUR rate and the share of long-term foreign currency debt denominated in EUR[13] make the risk related to this exposure easier to manage. Moreover, the policy of maintaining a currency buffer considers the limitation of the foreign exchange risk linked with the reimbursement of foreign currency debt, this buffer being used directly in the payments of the government public debt in foreign currency.

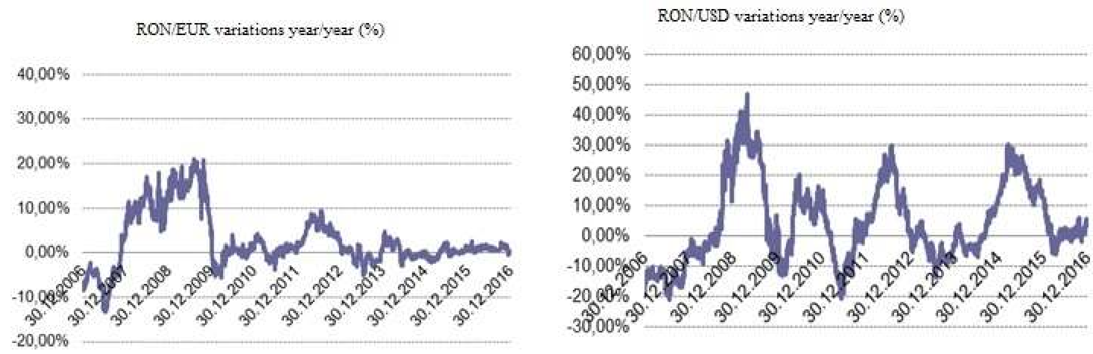
Graph 5: Debt structure according to type of foreign currency



Source: MoPF

As suggested by graph 6, in the last 3 years, the volatility of the RON/USD exchange rate was approx. four time higher than the one of the RON/EUR exchange rate, which means that USD debt is significantly riskier than the EUR debt. In 2016, USD appreciated strongly in relation to the other currencies and especially to EUR, and, by the end of 2016, reached the maximum level of 2002, backed up by signs of consolidation of American economy and by the investor's increased interest in American assets. In the last part of the year, following the FED decision to increase intervention rate interval with one quarter of percentage point[14], market expectations are at 1:1 parity, until the end of 2017, this evolution being influenced by the signals of economic policy of the Trump administration.

Graph 6: Annual change of RON/EUR and RON/USD exchange rates



Source: MoPF, NBR

In the case of a pessimistic scenario, for example, a depreciation of the local currency against EUR by 10% and against USD by 30%, in 2017 would increase the debt stock by

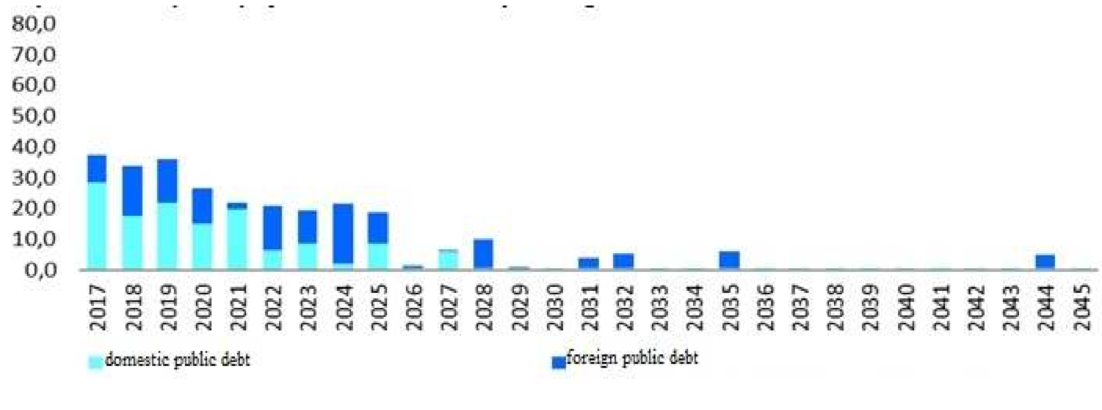
[13] Long-term euro denominated debt issued with a bullet structure implies a redemption of the principal within a time-horizon in which euro adoption is feasible and therefore a reduced implied currency risk.
[14] In March 2017, FED increased the intervention interest with another 0.25 pp, in the range 0.75 – 1.0%.

RON 21.5 billion or with 2.6% of GDP and the debt service payments (including the repayment of principal and the refinancing of government securities and interest payments) by RON 1.9 billion or 1.0% of central government revenues[15]. Accordingly, the exposure to exchange rate risk may be deemed moderate.

Refinancing risk

The structure of principal repayments and refinancing of government securities presented in graph 7 shows some accumulation of repayments in the first 4 - 5 years, although the trend is to adjust the reimbursement graph, leading to the decrease of the medium- and long-term refinancing risk. The concentration of repayments over the short term is particularly noticeable in the domestic debt[16] and reflects the importance of Treasury-bills in the government funding reaching RON 11.7 billion at the end of 2016. Furthermore, the policy of constructing liquid series of benchmark bonds, on a medium and long maturity range, which supports the consolidation and extension of the RON yield curve, leads to a refinancing risk at their maturity, since such series are reopened until the consolidation of an amount of up to the equivalent of EUR 2 billion. For example, in June-July 2017, two issuances of benchmark bonds will mature, with a worth of approx. RON 16 billion. The refinancing of such obligations, although decreasing[17], may pose a challenge in the financing process from the domestic market if the banks, which continue to be the most important investment segment for government securities in RON (holding approx. 48% of the market of government securities in lei, relating to more than 20% of the banking system assets) were to find alternative and more profitable placements with the revival of demand for credit from the private sector. On the other hand, we note the downward trend of the commercial banks' holdings in relation to the increase of holdings of other classes of institutional investors, such as the private pension funds. We also need to emphasize the fact that government securities are by far the most liquid instrument available on the domestic financial markets, and also the most liquid instrument eligible for monetary market operations. On the foreign side, refinancing risk is low mainly as a result of the repayment structure of the loans contracted with the international financial institutions, but also as a result of the extension of the average remaining maturity for the external debt portfolio following the issuance of Eurobonds with long and very long maturities (up to 30 years).

Graph 7: Principal repayment schedule on public government debt at the end of 2016



Source: MoPF

[15] Budget revenues calculated based on cash data, by applying EU methodology.
[16] According to market of issuance.
[17] Share of refinancing needs in GDP, at government level, has been dropping constantly in the last years, reaching 6.7% of GDP at end-2016.

The redemption profile of the debt portfolio results in an average time to maturity (ATM) of 5.8 years: 3.8 years for local currency denominated debt and 7.0 years for debt denominated in foreign currency.

Table 3: Refinancing risk indicators

Indicators	2015			2016		
	Debt denominated in national currency	Debt denominated in foreign currency	Total	Debt denominated in national currency	Debt denominated in foreign currency	Total
Debt maturing in 1 year (% of total)	28.0	13.0	18.0	22.0	6.0	13.0
Average time to maturity (years)	3.4	6.6	5.7	3.8	7.0	5.8

Source: MoPF

The management of the refinancing/liquidity risk of bond issuance in RON and in foreign currency is also performed by the policy of keeping a foreign currency buffer sized at 4 months of the gross financing needs.

In order to improve the public debt management and avoid seasonal pressures to secure sources to finance the budget deficit and refinance the government public debt, in 2010 MoPF set out the financial buffer in foreign currency, which, at the end of 2016, was EUR 6.0 billion, i.e. 3.6% of GDP, covering approx. 4.8 months of the gross financing needs.

Table 4: Evolution of gross and net government public debt brute (% of GDP)

	2013	2014	2015	2016
Gross government public debt (% GDP)*)	36.6	38.3	37.1	37.0
Financial buffer (%GDP)	3.9	4.6	3.7	3.6
Net government public debt (% GDP)	32.7	33.7	33.4	33.4

*) exclusive of temporary financing
Source: MoPF

Interest rate risk

Given the small portion of debt contracted at floating rates and following the strategy of extending the debt portfolio time (see Table 5), interest rate and refinancing risks are moderate, with different characteristics indicated by the specific risk indicators, if the debt portfolios in RON and in foreign currency are considered separately. On the one hand, the still significant share of short-term debt of the total government debt leads to a higher refinancing and interest rate risk for this portfolio. On the other hand, exposure to interest rate risk is decreased for the foreign currency debt portfolio following the fact that Eurobond issuances and loans from IFIs with maturities on long and very long terms and a fixed interest rate were the majority of this debt at end-2016. Thus, a 1 pp increase of interest rates in 2017 will lead to the increase of payments for the debt service with RON 1.3 billion, i.e. 0.6% of the central government revenues[18] for local currency debt, and with RON 1.5 billion, i.e. 0.8% of the central government revenues for foreign currency debt.

[18] Budget revenues computed based on cash data, by applying EU methodology.

Table 5: Interest rate risk indicators

Indicators	2015			2016		
	Debt denominated in national currency	Debt denominated in foreign currency	Total	Debt denominated in national currency	Debt denominated in foreign currency	Total
Share of fixed interest rate debt (% of total)	89.1	81.0	84.7	93.8	86.3	89.7
Share of debt re-fixing in 1 year (% of total)	28.0	10.0	23.0	20.0	14.0	16.0
Average time to re-fixing interest rate (years)	3.4	7.3	5.7	3.8	7.2	5.9

Source: MoPF

Given the above, we may conclude that the refinancing and interest rate risks for debts denominated in the local currency, although continuing their downward trend, are still risks inked with the government public debt portfolio, which should not be neglected, while the exposure to foreign exchange risk is easier to manage. We also note that the policy of keeping a foreign currency buffer considers the limitation of refinancing and cash risks, but also the interest rate and foreign exchange risk for maturities in foreign currency.

4. Internal and external financing in the context of domestic and foreign financial markets performance in 2016 and first 4 months of 2017 and medium-term expectations

Domestic market

Domestic market performance in 2016 and in the first 4 months of 2017

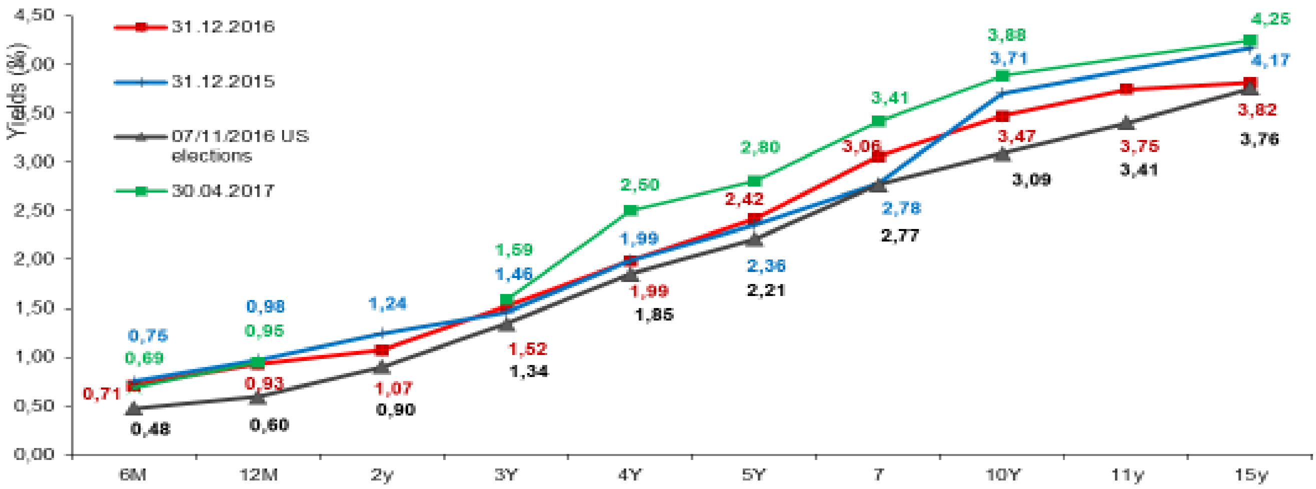
Following the consistent strategy in the last years, for the development of the government security market, linked with a favorable market context, in 2016, the domestic market o government securities continued to show positive evolution, proving its resilience in times of volatility generated by foreign factors.
In the first semester of 2016, Romanian government security yields followed a downward trend, given, on the one hand, the favorable Eurozone context characterized by the keeping of the accommodating policy from the ECB, which continued the asset procurement programme in the attempt to relaunch economic activity in the Eurozone, the interest of reference bonds in the Eurozone reaching negative territory, and, on the other hand, the local context characterized by the improvement of macroeconomic bases.

The effects of the Brexit decision of 23 June 2016 were short-lived and later the yields, especially those on the medium- and long-term, saw accentuated decreases. Thus, immediately after the publication of the Great Britain referendum results, medium- and ng-term maturity yields saw a slight decrease of approx. 10 basis points, but in one week their levels were at approx. 20 basis points below those seen before the referendum.

The USA November election results and the announcement of significant measures of fiscal incentivizing by the Trump administration, for the stimulation of economic growth, which would generate inflation growth, led to the increase of interest rates on the American market and globally, which was also seen in the increase of Romanian government security yields toward the end of 2016.

As suggested by graph 8, at the end of 2016, the interest rates to the Romanian government securities on medium and long term were below the levels of end-2015, but in the first 4 months of 2016 there is an upward trend, as compared with end-2016.

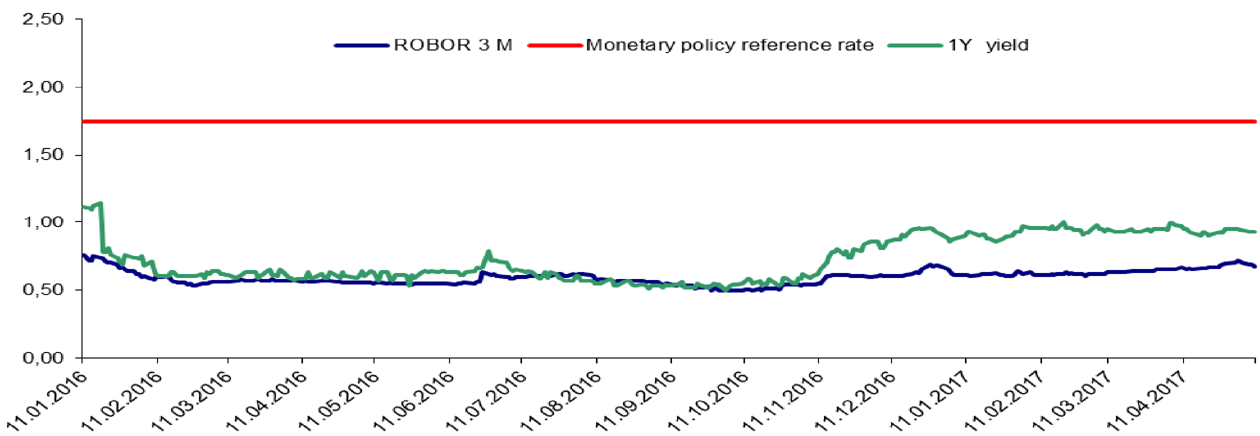
Graph 8: Performance of yields on the domestic secondary market



Source: MOPF

During 2016, the NBR kept the monetary policy rate at 1.75%, but decreased in two stages the rate of the minimum mandatory reserve for foreign currency liabilities, in January from 14% to 12% and in September to 10%, in May 2017 being reduced to 8%.

Graph 9: Monetary policy interest rate vs 3-month ROBOR and 1-year yields

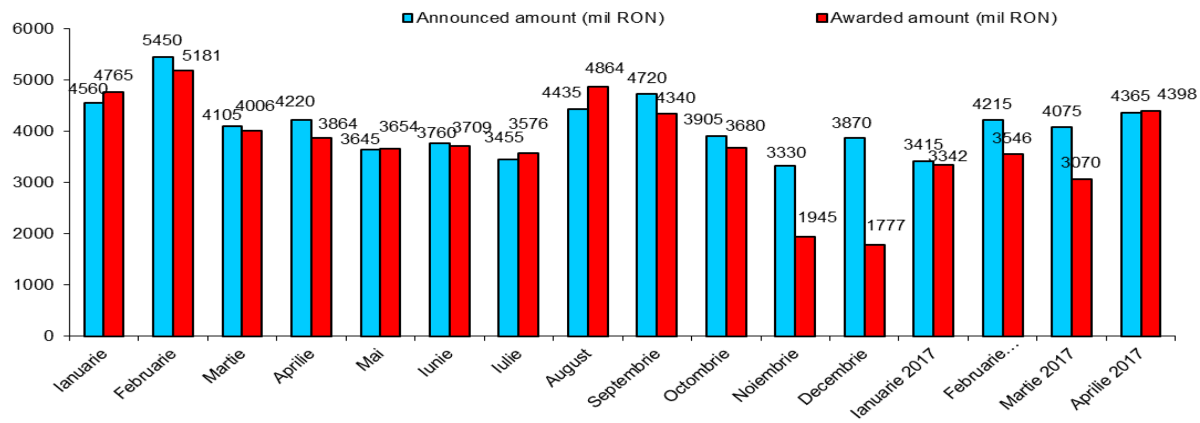


Source: MoPF, NBR

The presence of Romanian government securities in the JPM Morgan and Barclays indexes continues to have a positive influence on the local market and the increase of investors' interest. At end-April 2017, 10 series of Romanian government bonds were included in the GBI-EM Global Diversified Investment Grade index, at weight of approx. 4.68%, and 14 series in the Barclays EM Local Currency Government Index, at 1.22%.

The policy of government security issuance was predictable and flexible, adjusted to the investment environment requirements. Most auctions were fully awarded (see graph 10), long-term auctions accepting even volumes higher than those announced, by using the opportunity windows characterized by favorable yields for the extension of the residual average maturity of the government public debt portfolio. November and December 2016 were marked both by foreign events (USA election, FED increase of the baseline interest with 0.25%, the Italy referendum on constitutional reforms) and by domestic ones (11 December parliamentary elections), which generated periods of volatility and, thus, a series of auctions were partially awarded or rejected, thus avoiding short-term pressures on the yield curve. Moreover, in February and March 2017, mainly because of conjectural short-term factors independent of the local financial market, a series of issuances were rejected or partially awarded, while at others the awarded amounts were higher than those initially announced in the auctions.

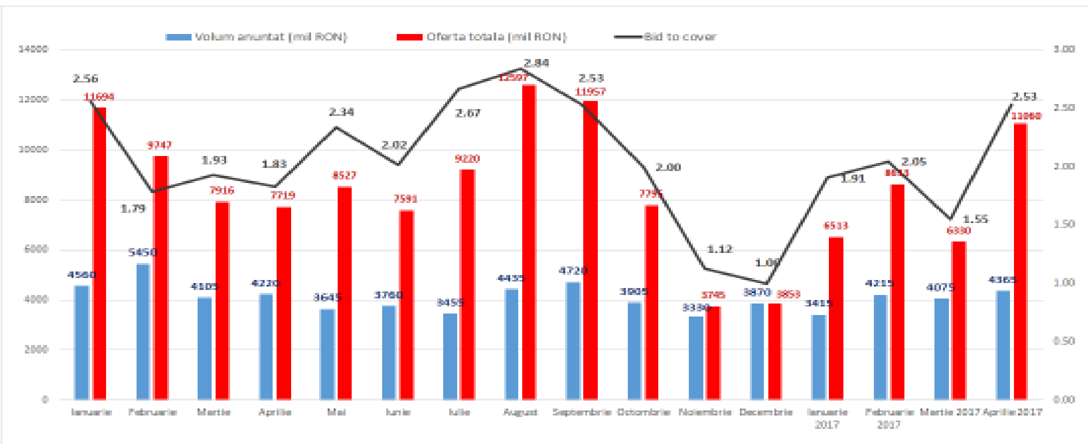
Graph 10: Announced amount vs awarded amount in January 2016 - April 2017



Source: MoPF

As suggested by graph 11, in general, the investors' total demand was approx. 2 times higher than the announced volume, thus confirming their interest in Romanian government securities, except for the two months of 2016, later the investors' appetite returning gradually in 2017.

Graph 11: Primary market demand and offer of government securities in January 2016 - April 2017



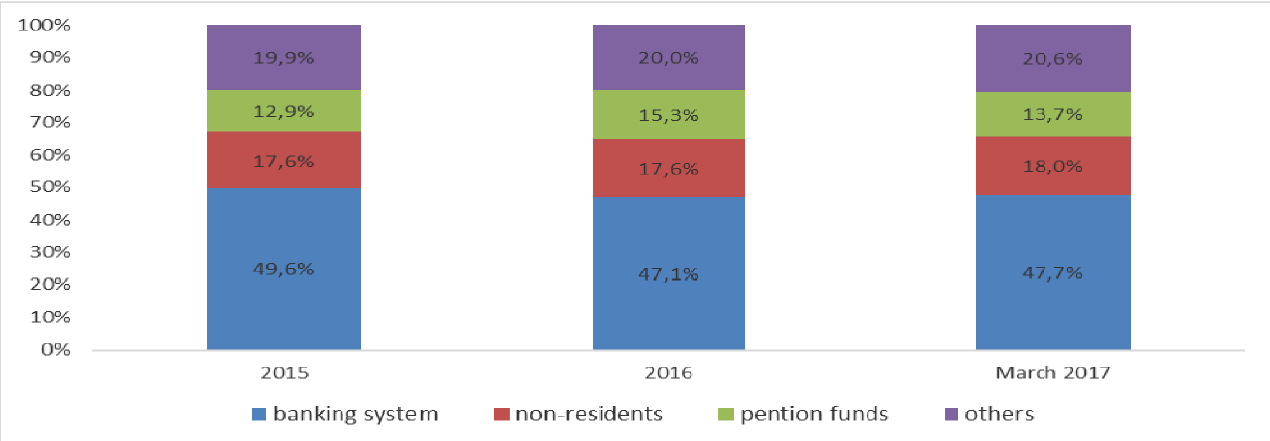
Source: MoPF

Investor base

Given a moderate advance of the financial institutions' crediting activity during 2016 and the existing cash surplus on the market, commercial banks continued to be the main investors on the domestic market of government securities, but with a weight lower with 2.3% than 2015, holding in the portfolio, at the end of March 2017, 47.7% of the total volume of government securities issued on the market, followed by non-resident investors who kept a slightly upward weight of 18.0% as compared with end-2015, while the pension funds saw an increase of holdings from 12.9% at end-2015 to 15.3% mid-2016.
In the first 3 months of 2017, a similar weight of financial institutions, in relation to the one of end-2016, was seen, and pension funds kept their level of exposure at around 15%.

The local investors' preference was mainly for maturities up to 7 years, and marginally for maturities longer than 10 years, especially for security series included in regional indices.

Graph 12: Performance of government securities by type of holders

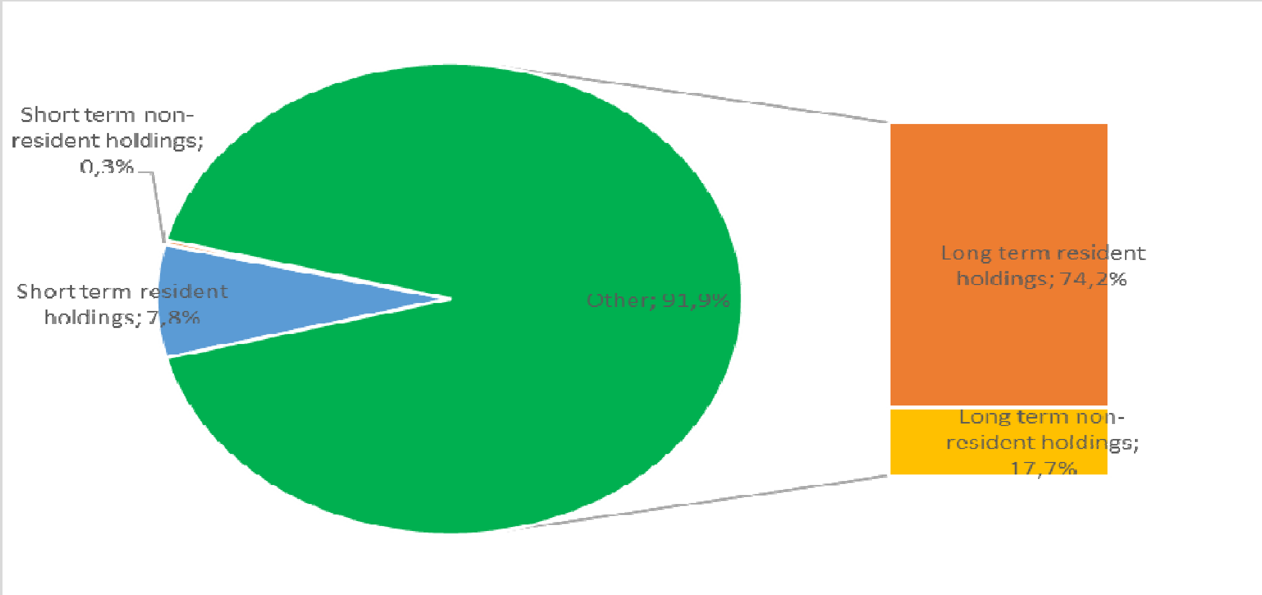


Source: NBR

As institutional investors, local asset managers and private pension funds have a relatively small share in the government securities, however they have a significant potential to support the development of the local government securities market in the upcoming period. Total net assets of private pension funds (pillar II+III) increased significantly from RON 10.2 billion at end-2012 to RON 33.0 billion at end-2016 and, respectively, RON 35.6 billion at end-March 2017, the government securities holdings at end-2016 being approx. RON 22.8 billion, with a slight decrease at end-March 2016, at approx. RON 21.3 billion.

Non-resident investors continued as an important segment of investors in government securities, offering a complementary demand besides the demand of local investors, given the preference for long maturities leading to the diversification of the investor base. The behavior of non-resident investors is slightly volatile, being influenced by international foreign market performance and the perception of country risk. Although 2016 began with expectations of divergent monetary policies from the main central banks (ECB and FED), the postponement of interest increase in the USA for the last session of December led to the preservation of the investors' interest in the more attractive yields offered by the emerging countries, such as Romania, in the absence of alternative investment sources.

Graph 13: Composition of holdings of resident and non-resident investors on the domestic market, active at the end of March 2017



Source: NBR

In 2016 and in the first 4 months of 2017, non-residents' holdings were at 17-19% of total government securities issued on the domestic market, but below the level seen in comparable countries (e.g. Poland and Hungary). Relatively low holdings of non-residents limited the domestic market's vulnerability to volatility periods, when investors tend to liquidate/reduce their exposure on emerging markets, the yield curve being relatively stable in such periods.

The increase of the non-resident investors' presence is influenced by a number of internal factors such as: development of a more liquid swap market in Romania for longer maturities, increase of government security liquidity, introduction of secondary market operations, weight of Romanian government securities in international indexes (JP Morgan/Barclays), since many institutional investors have an investment policy related to the structure of such indexes.

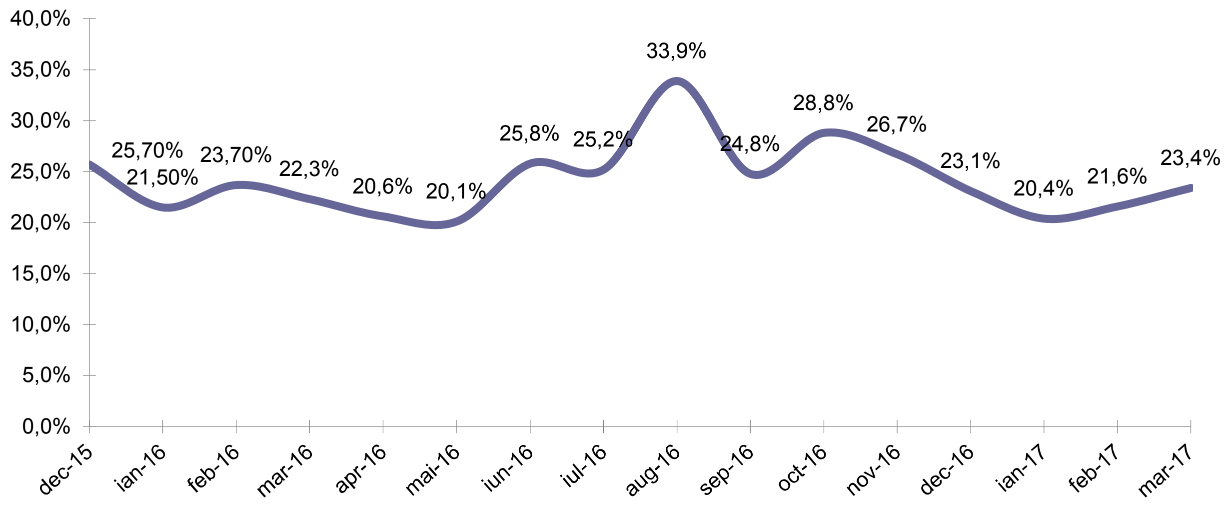
Secondary market

Liquidity on the secondary market is an important indicator about the level of development of the market of government securities. The degree of liquidity, calculated as the ratio of the amount of monthly transactions in the secondary market and the total amount of government securities, was relatively constant during 2016 and in the first 4 months of 2017, given the growth of the existing government security stock on the market, with RON 15.5 billion; however, it is still at low levels as compared with the international standards. In August, a significant growth was seen, the degree of liquidity reaching 33.9%, following the decrease of the government security balance by the reimbursement of a benchmark series with an accumulated volume of RON 7.5 billion.

The relatively low levels of secondary market transactions of government securities may reflect the specific market conditions, but also structural deficiencies, such as internal limitation of commercial banks in holding in their trading portfolio specific maturities, as well as the weak use of secondary market instruments such as repo operations and the absence of the active participation of the MoPF in repo, reverse repo, buy back, bond exchange operations or the weak development of the swap market, especially for medium and long maturities.

In 2016, important progress in this direction was achieved by the development of the electronic quotation and trading platform for Romanian government securities, supplied by Bloomberg (E-Bond), which helps increase liquidity and establish, transparently and competitively, the prices for the government securities on the secondary market. On the platform, starting from 2017, primary dealers are required to supply firm quotations for a number of government securities, and to fulfil minimum requirements relating to volume, maturity, quotation time, margin between the selling price and the purchase price, their performance being reflected in the periodic evaluation on the government security market.

Graph 14: Performance of the degree of liquidity of government securities in RON, active in December 2015 – March 2017



Source: MoPF

Implementation of the financing plan on the domestic market in 2016 and in the first 4 months of 2017

During 2016, MoPF sought to ensure a constant and continuous presence on the domestic market, by regularly organizing government security auctions, both to satisfy investor demand and to avoid potential pressures in attracting financial resources.

In 2016, the government securities issued on the domestic market amounted to RON 45.36, respectively EUR 775 mil., i.e. approx. 68.2% of the gross financing needs of the central government[19], with the following structure: a) 28.1% issuances of T-bills with maturity of up to 12 months and issuances of benchmark bonds with residual maturities of up to 1 year; b) 38.6% are issuances of benchmark bonds with 1 and 5-year residual maturities; and c) 33.3% are issuances of benchmark bonds with 5 and 14-year residual maturities. Benchmark government bonds in RON, with 3, 5 and 7-year maturities were issued and reopened almost every month. The efforts of MoPF to extend the average maturity of government securities, the international context characterized by low yields and

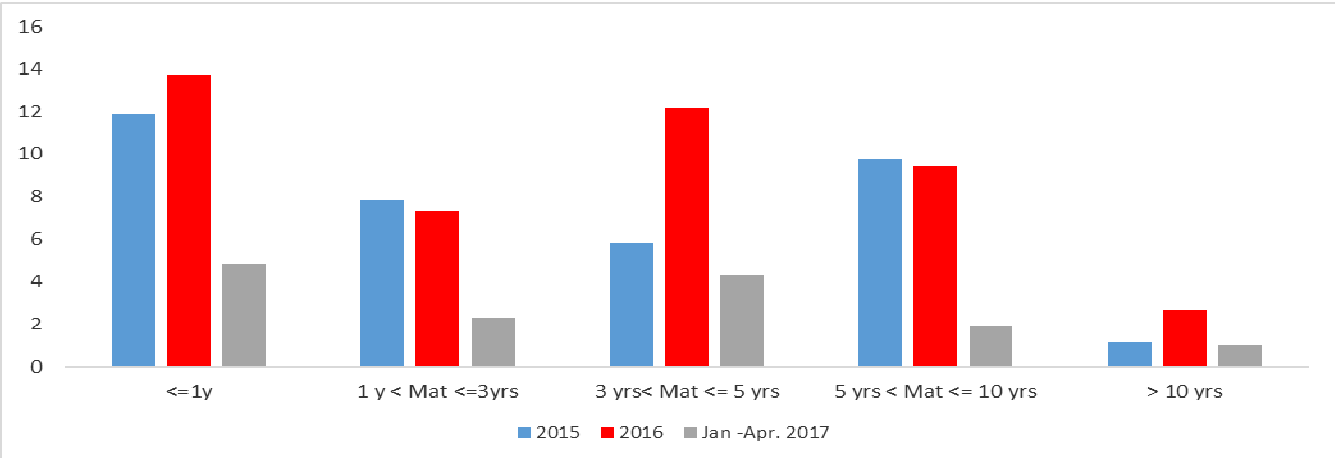
[19] Described in chapter 5

the increase of non-resident investors' interest in long maturities led to the doubling of the volume of long-term government security issuances, as compared with 2015.

In February and March 2016, following the increase of foreign currency resources available for credit institution, and the NBR decision to decrease the minimum mandatory reserves in foreign currency, EUR government bonds were issued on the domestic market, amounting to EUR 775 mil., with 5-year maturity, against advantageous costs and a backdrop of significant demand from the investment environments.

In the first four months of 2017, on the domestic market, government securities in RON, amounting to RON 14.36 billion, and government securities in EUR amounting to EUR 240 mil., were issued. On the domestic market, financing occurred according to the calendar announced at the beginning of the year, except for brief period of volatility in the first part of March, which led to the rejection of two auctions, given the requirement of high yields from the investors, against the amplification of expectation of interest rate increase by FED.

Graph 15: Structure of government security issuances, according to maturities (initial mat., billion lei)



Source: MoPF

External market

Performance of external markets and Romanian Eurobonds in 2016 and in the first 4 months of 2017

The beginning of 2016 was characterized by the deceleration of Chinese economy growth rate, the decrease of prices of goods and mixed results of American economy, which led to postponing the decision to increase the interest rate, to the end of the year. In the first half of the year, the yields of the bonds issued by the EU Member States saw low values, thus, German bonds with 10-year maturity entered for the first time in negative territory. The Brexit referendum at the end of the first semester generated volatility on the markets, but the effect was short-lived. The bond yields perceived as certain by the investors, such as those issued by Germany, Japan and the USA, saw historical minimum values after the Brexit referendum, but returned to pre-referendum quotations by the end of July. Toward the end of 2016, the nearing of the USA elections and the expectations that FED decide to increase the interest led to a slight trend of increasing Eurozone yields.

The USA election results generated volatility on the international markets, the US Treasuries yields seeing growth of 50-60 bps, which reflected also in growth of benchmark bonds in the Eurozone, including sovereign bonds on emerging markets.

The quantitative easing measures taken by the ECB in 2016 and which are also kept in the first months of 2017 created the premises for the decrease of yields of bonds issued by Eurozone countries and for the launching of issuances with very long maturities.

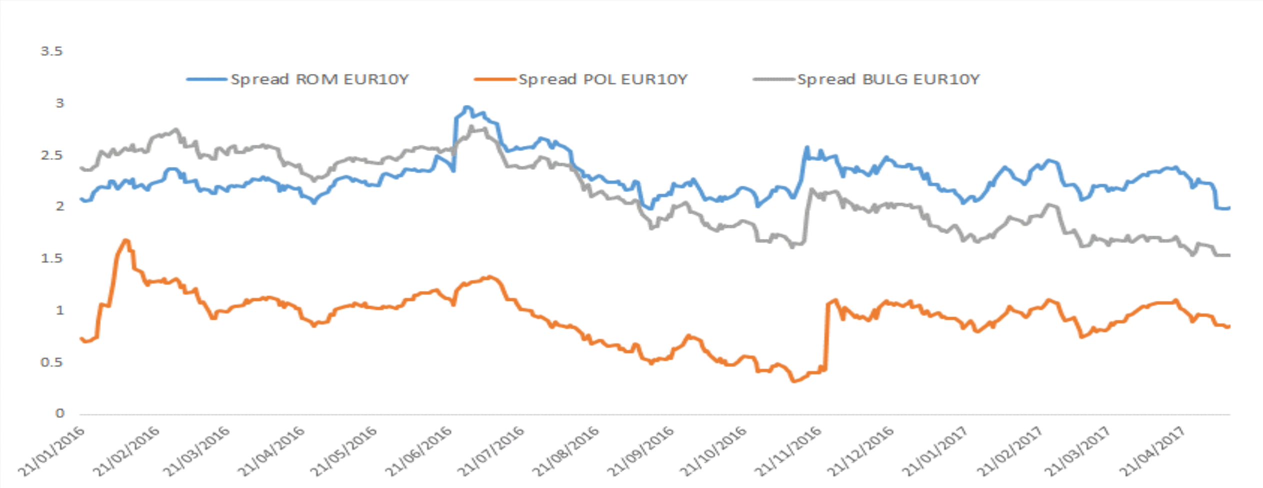
In the USA, in December 2016, FED decided to increase the monetary policy interest, with 25 basis points from 0.25% to 0.50%, the first increase in the last ten years, against the significant improvement of economic grounds and the significant economic growth perspective and an inflation rate nearing 2%. FED officials declared that three new interest increase are possible in 2017, if American economy confirm the positive evolution, the first decision of increasing the interest rate with another 0.25% being already made in the March 2017 meeting. The long-awaited FED decision also had an impact on the yield curve and quotation of the sovereign bonds issued by the emerging markets.

The first 4 months of 2017 were subject to the volatility of international financial markets and to uncertainty, expecting the results of elections in a series of Eurozone countries, the Netherlands and France, the triggering of Article 50 by the Great Britain, which occurred in March, in order to leave the EU.

In 2016, efforts focused on domestic market development measures, by the improvement, both at MoPF and at NBR levels, of the regulatory framework for the government securities and for the evaluation of primary dealers' performances, on the creation of benchmark bonds that should satisfy the requirements of their inclusion in the regional reference indexes, on the improvement of the secondary market infrastructure by the development or primary dealers' trading platform (E-Bond), on which their performances as market makers have been monitored since January 2017; also on the increase of transparency in the dissemination of information and statistic data regarding public debt, by launching the website www.datoriepublica.mfinante.gov.ro, and on the organization and participation in various events, with international participants, meant to improve Romania's visibility in the investment environment.

The yields of Eurobonds issued by Romania saw an evolution similar to the trends noted also in other countries of the region, which proves that the main determinants were global and, thus, the effects were perceived similarly in the countries of the region. The spread between the yields of Eurobonds issued in Romania and the German ones saw a slight increase in the 2nd quarter, and then decreased significantly after the Brexit decision.

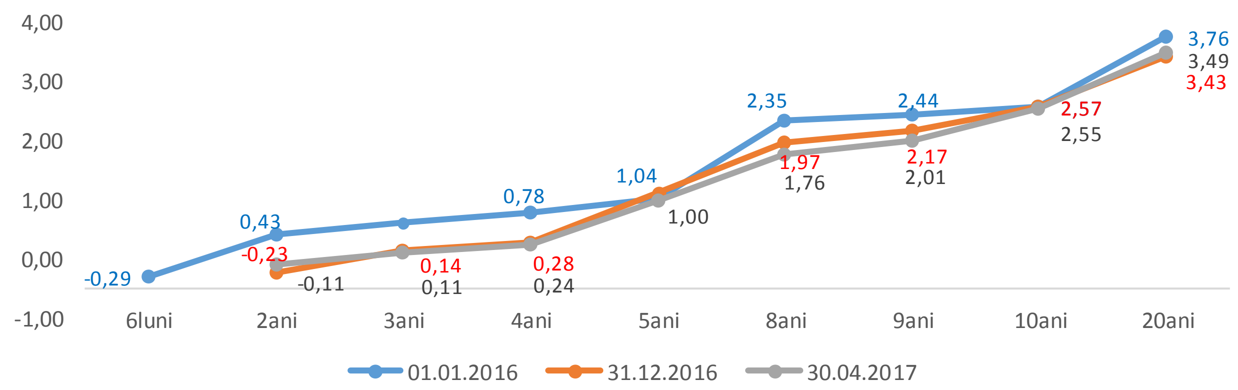
Graph 16: Performance of spreads of Romania, Poland and Bulgaria EUR Eurobonds with 10-year maturity, calculated in relation to the German Bund



Source: MoPF

Given the international context and the investors' perception of the Romanian economy's evolution, the yields of government bonds denominated in foreign currencies were decreasing for the most part of the year, with a minimum seen in September, followed by a slight increase toward the year end. In the first four months of 2017, the yields of government bonds denominated in EUR saw volatility periods in February and March, but they later returned to levels close to those at the beginning of the year. Eurobonds in EUR had performances higher than those in USD and were kept attractive for the investment environment, offering higher yields in relation to comparable countries, e.g. in the same rating category.

Graph 17: Evolution of EUR-issued Romanian Eurobonds on the external market



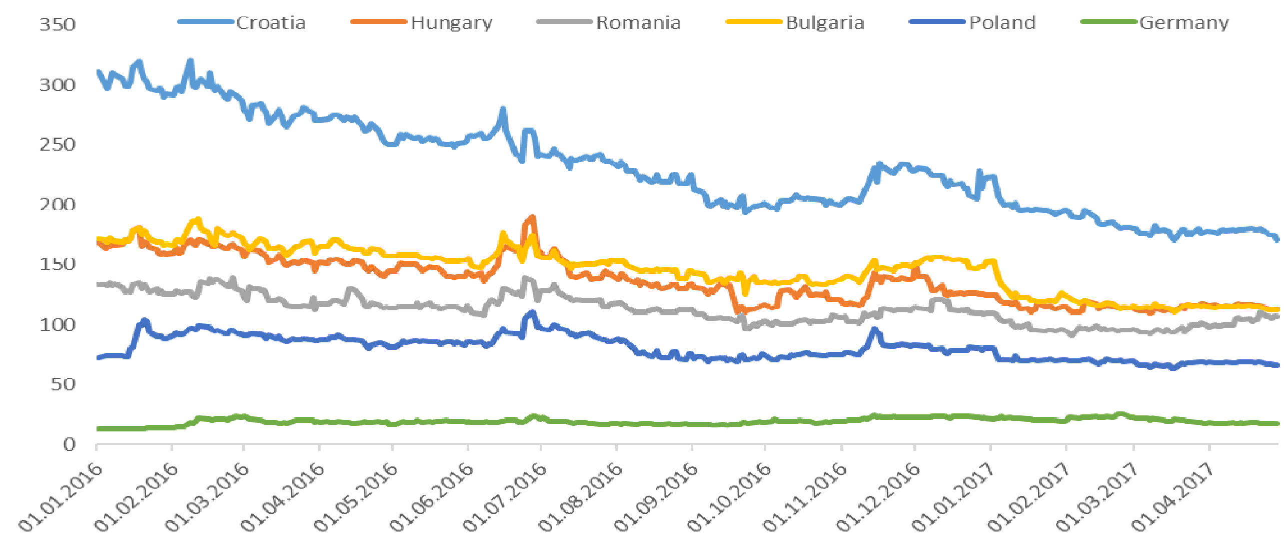
Source: MOPF

Graph 18: USD-issued Romanian Eurobonds on the external market, with maturity 2023 and 2024

Source: MoPF

In a context dominated by very low and even negative yields of baseline bonds, the uncertain situation generated by Brexit outcomes and in the absence of investment alternatives, investors increased their exposures toward the emerging markets. Romania's CDS (credit default swap)[20] quotations, as price of insurance against the risk of default, saw a decrease of approx. 20 p.p. during the year, below the levels of other countries in the region such as Bulgaria and Hungary.

Graph 19: CDS (Credit Default Swaps) performance for 5 years



Source: Bloomberg

Implementation of the plan of financing from the external markets in 2016 and in the first 4 months of 2017

In 2016, the MoPF raised from the external markets EUR 3.25 billion through three issuances in the MTN Programme. In the first issuance of February 2016, the two series f bonds in EUR issued in October 2015 were reopened, amounting overall to EUR 1.25

[20] CDS performance reflects the investors' perception of the country risks and has an impact on the related country's financing costs.

billion, of which EUR 750 million with maturity of 10 years and EUR 500 million with maturity of 20 years. The issuance was oversubscribed approx. 2 times, with yields decreasing as compared with the initial issuance, from 2.845% to 2.55% for the 10-year instalment, and from 3.93% to 3.90% for the 20-year instalment.

In May 2016, a new issuance, with a maturity of 12 years, was launched, amounting to EUR 1 billion, at a yield of 2.992%, which was also oversubscribed approx. 2 times, thus a new maturity being added on the yield curve.

In September, the third 2016 issuance on the external market was launched, with a volume of EUR 1 billion, by reopening the 12-year maturity issuance launched in May 2016. The investors' interest was shown both by the size of the subscribed offers, with an oversubscription of 2.5 times, and by the 2.15% yield, down 0.842% from the initial issuance, being the lowest cost ever obtained in Romania for this maturity.

In April 2017, EUR 1.75 billion was raised by a two-instalment Eurobond issuance, of which EUR 1 billion by a new 10-year maturity issuance, warrant 2.375% and EUR 750 million by reopening the issuance launched in October 2015, with the initial 20-year maturity, warrant 3.875%, the two instalments subscribed at minimum historical yields.

The operations on the external market also included drawings of approx. EUR 59 million relating to loans obtained from International Financial Institutions.

Table 6: Issuances of mature Eurobonds launched on external capital markets

ISIN	Issue date	Curerncy	Maturity	Amount	Coupon (%)	Issue spread	Initial Yield	Current yield (May 09,2017)
XS0371163600	18.06.2008	EUR	18.06.2018	0.75 bl.	6,5	+213.10bp vs DBR 4 ¼ 18	6,698	-0,119
	11.09.2012			0.75 bl.		+404bp vs Mid Swap	5,100	
US77586TAA43 US77586RAA86	07.02.2012	USD	07.02.2022	1.5 bl.	6,75	506.60bp vs T 2 02/15/22	6,875	3,093
	06.03.2012			0.75 bl.		453.70+UST	6,450	
XS0852474336	07.11.2012	EUR	07.11.2019	1.5 bl.	4,875	+370bp vs Mid Swaps	5,040	0,094
US77586TAC09 US77586RAB69	22.02.2013	USD	22.08.2023	1.5 bl.	4,375	+235.5bp vs Mid Swaps	4,500	3,308
XS0972758741	18.09.2013	EUR	18.09.2020	1.5 bl.	4,625	+295bp vs Mid Swaps	4,769	0,218
	28.10.2013			0.5 bl		+250bp vs Mid Swaps	4,150	
US77586RAC43 US77586TAE64	22.01.2014	USD	22.01.2044	1 bl.	6,125	+245.00bp vs T 3 ⅝ 08/15/43	6,258	4,540
US77586RAD26 US77586TAD81	22.01.2014	USD	22.01.2024	1 bl.	4,875	+215.00bp vs T 2 ¾ 11/15/23	5,021	3,366
XS1060842975	24.04.2014	EUR	24.04.2024	1.25 bl.	3,625	+200bp vs Mid Swaps 223.10bp vs DBR 1 ¾ 02/15/24	3,701	1,625
XS1129788524	28.10.2014	EUR	28.10.2024	1.50 bl.	2,875	+185bp vs Mid Swaps 209.90bp vs DBR 1 08/15/24	2,973	1,709
XS1312891549 XS1313005818	29.10.2015	EUR	29.10.2025	1.25 bl.	2,75	+190bp vs Mid Swaps 227.10bp vs DBR 1 08/15/25	2,845	1,989
	25.02.2016			0,75 bl.		239.2bp vs DBR 1 08/15/25	2,550	
XS1313004928 XS1312891895	29.10.2015	EUR	29.10.2035	0.75 bl.	3,875	+245bp vs Mid Swaps 283.50bp vs DBR 4 ¾ 07/04/34	3,930	3,485
	25.02.2016			0,50 bl.		322.9bp vs DBR 4 ¾ 07/04/34	3,900	
	19.04.2017			0.75 bl.		+235bps vs Mid Swaps +297.6 vs DBR 4.75% 2034	3,550	
XS1420357318	26.05.2016	EUR	26.05.2028	1 mld.	2,875	+225bp vs Mid Swaps	2,992	2,542
	05.10.2016			1 mld.		+177bp vs Mid Swaps +229.5 vs Bund	2,15	
XS1599193072 XS1599193403	19.04.2017	EUR	19.04.2027	1 mld.	2,375	+170bps vs Mid Swaps +220.60bp vs DBR 0 ¼ 02/15/27	2,411	2,401

Source: MoPF

Sovereign rating

Rating agencies' risk assessments confirmed the positive performances of the general economic framework, with an emphasis on the efforts in the process of fiscal-budgetary strengthening and sustained economic growth, including by comparison with other similarly

rated countries in the region. Thus, in March 2016, JCRA improved the rating relating to foreign currency and local currency debt on the long term, with one step from BBB-/BBB to BBB/BBB+. Both Moody`s and Standard & Poors reconfirmed the Baa3/A3, and, respectively, BBB-/BBB rating for Romania’s long-term government debt in foreign currency and local currency. Fitch maintained the long-term foreign currency rating at BBB, but changed Romania’s local currency long-term debt rating from BBB to BBB-, with a stable perspective, this change being announced because of methodology adjustments, influencing also the rating of other countries in the same rating category as Romania.
In the first 4 months of 2017, Standard&Poor’s, JCRA and Fitch reconfirmed the existing ratings, and Moody’s only changed the rating perspective from positive to stable, reconfirming the existing country ratings.

Expectations regarding the evolution of financial markets in 2017 -2019

On the medium term, the financing of the state budget deficit and the refinancing of government debt shall be obtained mainly from domestic sources and, as supplementation, from foreign sources. The MoPF shall continue to keep a flexible approach of the financing process, seeking to secure the predictable and transparent nature of the government security offer, to be able to respond promptly and adequately to potential changes of market trends and investor behavior.

On the domestic market, to reduce funding costs and promote a better functioning of the secondary market the MoPF intends to continue building liquid benchmarks across the yield curve with a transparent issuance policy up to amounts equivalent to 2 billion Euro, announcing the amounts, the frequency of issuing/reopening of some maturities to the market in advance. MoPF may reopen periodically EUR denominated government bond issuances on the domestic market if there is significant demand for such instruments from local investors, in the absence of alternative instruments, thus creating the premises of an advantageous maturity/cost ratio.
In addition, depending on the framework of secondary market specific procedures and operations that is to be completed by NBR[21], consideration is given to using specific secondary market operations, such as buy-backs or switches, to facilitate refinancing the high amounts that have been accumulating and are now to mature and to speed up the process of creating the liquid benchmark bonds. Likewise, the plans are to use reverse repos for efficient cash management, after consultations with NBR aimed at coordinating the financing policies and the cash management policies with the monetary policies.
To increase the individuals’ access to the purchase of government securities, the “Fidelis” programme shall continue for the population, via the stock exchange market. Additionally, starting from the 4th quarter of 2017, the Tezaur Programme shall be introduced, through which the population shall be able to subscribe T-bills through the territorial units of the state treasury. In the remaining months of 2017, high volatility periods are expected in the context of Brexit negotiations and Germany presidential elections (September).
Furthermore, in 2017, the American market shall be the focus of investors. While, last year, FED operated the first interest rate increase in the last ten years, and in March 2017 the interest was raised with 0.25 pp, in the 0.75-1.00% range, new increases are expected in 2017, if American economy maintains its positive evolution. Markets are on hold, expecting

[21] Auctions for buy backs and switches shall be conducted through the e-platform developed by NBR for the primary market auctions.

details on how the Trump administration programme will be implemented and its impact on American economy.

MoPF intends to maintain its presence in the international capital markets, particularly with bonds denominated in EUR, depending on market conditions. Issuances denominated in USD on foreign markets, or in other foreign currencies, shall be launched as a financing alternative, in advantageous cost conditions, in case of external events that may limit access to some segment of maturity at the financing on the European market, considering the provided advantages, by the extension of maturity, the increase market's capacity of absorption of new issuances and the diversification of the investor base.
MoPF will remain flexible about the time of accessing external international markets and the amount of foreign issuances, taking into account the associated costs, risk considerations, the potential implications for the central bank's objectives and policies, as well as local market developments.

Thus, on the medium term, MoPF intends to continue its partnership with international financial institutions to benefit from the advantages of their products, such as IBRD Development Policy Loans (DPLs) and those obtained to finance the budget deficit and refinance government public debt public, with funds made available depending on the implementation of certain measures and/or other actions necessary to sectoral reforms.

Table 7: Financing sources relating to the estimate financing needs

	Maturity/ grace period (years)	**Value (foreign currency billion)**		
Domestic market		**2017**	**2018**	**2019**
1. T-bills	6 months to 1 yea	14-15	14-15	14-15
2. Benchmark bonds in RON	up to 15 years	32-35	32-35	32-35
3. Benchmark bonds in EUR	5 years	0 – 0.5	0-0.5	0-0.5
External market				
1. Issuance of Eurobonds in the MTN Programme				
- EURO -USD	up to 15 years between 10 and 30 years	2.5 0	4.0 0	3.5 0
2. Loans from IFIs:				
a) EIB loans (incl. NSRF and SPL), IBRD, EBRD and CEB	vary according to investor and to the loan stage (some of them already undergoing reimbursement, while for others terms are established at the drawing, according to the MoPF option) on average 15/20 years of which 4-5 years grace period	0.05-0.140	0.1 – 0. 27	0.1-0. 35
b) DPL loan	up to 20 years	0.5 *)	0-0.5	0-0.5

*) the 500 mil Euro to be drawn in 2017 are reimbursed in bullet conditions in 2036
Source: MoPF

5. Macroeconomic framework in Romania

In 2016, the economy saw a 4.8% economic growth, the best rate since 2008, given the domestic demand dynamics sustained by salary increases, indirect tax decreases and low interest rates, thus obtaining one of the largest annual economic growths in the EU.

Given the international economic environment and the economic and financial developments in the Eurozone, as well as the evolution of the economic growth potential, we estimate, for 2017-2019, that Romanian economy will accelerate its growth, with an expected average growth of the GDP with approx. 5.5% per year[22], the preliminary data for the first quarter of 2017 (growth of 5.7% Q12017/Q12016) confirming the expectations.

Romania closed 2016 with a *negative inflation rate of -0.5%,* owing mainly to the decrease of the standard VAT rate starting from 1 January 2016. On the medium term, it is estimated that the annual inflation rate shall converge to values close to 2.5%, upward for the entire forecast interval, from -0.5% at end-2016 to 2.2% at end-2019, for the end of 2017 expecting an inflation rate of 1.9%.[23]

The current account of the balance of payments saw a deficit of EUR 3.97 billion in 2016, i.e. 2.3% of GDP, *the highest level since 2012,* driven by the deterioration of the commercial balance, given the rise of private consumption. *Foreign direct investment* increased for the 2nd consecutive year in 2016 (EUR 4.1 billion), *highest level since 2009*.
The macroeconomic framework[24] configured for 2017-2019 considered the budgetary measures adopted in 2015-2016, represented by the new Tax Code requirements, incentivizing both the population and the investment and business environment, the salary increases with an impact on consumption and investment, the regulatory acts adopted by the new Government at the beginning of 2017 which were the basis of the budgetary indicators for 2017, thus ensuring their predictable and sustainable nature. The fiscal easing measures, as those in the sector of budgetary expenses, adopted in 2015 - 2016, led to a forecast of the general consolidated budget that shows deviations from the medium-term objective (MTO) set for Romania, i.e. the structural deficit should not exceed 1% of GDP, starting from 2016, but the gradual return to a trajectory converging with the MTO is expected starting from 2019. Given the budgetary deficits of up to 3% of GDP on medium term, the gross financing needs continue to be determined by the volume of government debt refinancing, approx. 55%-60% of the gross financing needs, as seen in the table below:

Table 8: Financing needs forecast

Indicator	2016	2017 forecast	2018 forecast	2019 forecast
Central government revenues (billion lei)[25]	173.6	199.9	218.7	239.6
Central government expenses (billion lei)[26]	194.5	226.4	247.6	264.1
Budgetary deficit relating to the central government (I) (billion lei)[27]	20.9	26.5	28.9	24.5
Government debt refinancing[28] (II) (billion lei)	50.7	37.4	33.7	35.9
Gross financing needs (I+II) (billion lei)	71.6	63.9	62.6	60.4

Source: MoPF

[22] Source NCF.
[23] *Idem* 22
[24] Source: Fiscal-Budgetary Strategy 2017-2019
[25] Computed based on cash data, by applying EU methodology.
[26] *Idem* 25
[27] *Idem* 25
[28] Volume of capital rate reimbursements and government security refinancing for government debts, according to national legislation, computed based on the debt balance at end-2016 (includes state guarantees, but does not include temporary financing).

The macroeconomic hypotheses of the 2017-2019 Strategy are shown in the table below.

Table 9: Basic scenario of macroeconomic projections

Indicators	2016	2017forecast	2018forecast	2019 forecast
Nominal GDP (billion lei)	761.5	816.5	879.5	946.7
GDP growth (%)	4.8	5.2	5.5	5.7
Budgetary deficit relating to the central government[29] (% of GDP)	-2.75	-3.25	-3.3	-2.6
Current account deficit (% of GDP)	-2.3	-2.4	-2. 4	-2.2
Inflation (year end %)	-0.54	1.9	2.3	2.2
Inflation (annual average %)	-1.55	1.1	2.5	2.3
RON/EUR average exchange rate	4.4908	4.49	4.49	4.49
RON/USD average exchange rate	4.0592	4.24	4.20	4.20

Source: NCF, MoPF, NIS

Risks relating to initial projections

Deviations from the macroeconomic projections in the baseline scenario described above could come from global uncertainties triggered by the evolution of the Eurozone and of the main emerging economies (China in particular), the implications of the USA monetary policy on world capital flows and of the Trump administration programme implementation, EU future uncertainties after the Great Britain referendum[30]; all these may lead to investment appetite volatility regarding financial assets issued by emerging economies.

These factors may generate high volatility on international financial markets, in the conditions of divergent decisions of monetary policy of FED and ECB; such volatility may lead to temporary increases of worldwide aversion to risk, which affects emerging economies. In this context, USA macroeconomic projections show that new interest rate increases are expected in 2017[31], after, at end-2016, the monetary policy interest rate was increased at a range between 0.5% and 0.75%, and in March 2017, the interest rate was raised with 0.25 pp, in the range of 0.75-1.0%, while the ECB decided to extend the quantitative monetary easing programme with nine months, until December 2017, at the same time with decreasing the monthly volume of the same, from EUR 80 bln to EUR 60 bln, starting from April 2017. External shock linked with such risks may lead to the decrease of economic growth, by the decrease of exports of capital outflows[32], and may determine the increase of the financing needs in less advantageous conditions, confirmed by the significant risk of change of the investors' feeling.

The domestic market will be influenced both by the macroeconomic and financial performance at international level, and by domestic (economic and political) performance.

Some of the domestic risk factors are the fiscal-budgetary policy conduct, in the context of uncertainties regarding the impact that the adopted fiscal easing measures may have on the medium-term macroeconomic imbalances, the increase of the medium-term budgetary deficit and the possibility of delaying structural reforms, while the main foreign risks are linked with fears of global economic growth delicacy, in the context of political decisions in the wake of France and Germany elections and of the impact of the Trump administration programme on the economic growth and financial markets. In fact, rating agencies have

[29] *Idem* 25
[30] Activation in March of Article 50 of the Lisbon Treaty for the triggering of the procedure for Great Britain leaving the EU.
[31] Most analysts expect new decisions of increase of the FED monetary policy interest rate.
[32] Exposure to capital flow volatility may also increase because of the presence of Romanian bonds denominated in RON in the Barclay's and JP Morgan reference indexes, following the increase of non-residents' access to government securities issued on the local market of bonds.

signaled the intensification of pressures on the country rating, following the adopted measures of fiscal easing.
If budget deficits will be high in the medium term (up to 3 % of GDP), the issuance of new debt to cover these needs in the domestic market should take into account the absorption capacity of the domestic market and the characteristics of holders of government bonds issued on this market (the banking sector still holds about 50% of government securities). This risk factor will be reduced in the long term by increasing the demand from institutional investors, particularly pension funds due to a growth in the assets of such funds, as well as other participants to the capital market, such as local asset management funds and insurance companies.

Policy implications at macroeconomic level

Macroeconomic projections in the baseline scenario indicate diminishing financing needs and stabilizing government debt to GDP in the future. This means that financing strategies should be implemented taking into account both the amount of refinancing debt and the increasing budget deficits compared to previous years, with a higher tolerance for financial risk. In the medium-term financing process, MoPF will consider achieve its specific objectives, namely to increase funding in domestic currency and extend the maturity of government securities issued in domestic currency on the domestic market and the foreign markets, and will take account of the macroeconomic context and demand changes in terms of investment base both internally and externally.

To conclude, the main risks linked with the macroeconomic hypotheses in the baseline scenario show that, through the anticipated/expected monetary policy decisions, both domestically and internationally, the market context estimated for 2017 is less favorable as compared with 2016. Domestically, given the return to the positive inflation rate (the NBR inflation report of May estimates an inflation rate, for end-2017, at 1.6%, and 3.1% at the end of 2018), market expectations converge to short-term interest rate increases that also have an impact on the yield curve of government securities. Externally, other decisions of FED for the increase of the reference interest rate are expected; they will affect the yield curve on the core markets (the American market and the one in the Eurozone) and implicitly they will have a negative impact on volatility and yield of bonds issued by emerging countries.

6. Analysis and strategic guidelines

The strategic guidelines for managing public government debt in Romania reflect the cost-risk tradeoffs in the current debt portfolio[33], the plans to develop the domestic market of government securities and the medium-term macroeconomic framework.

Analysis implications for the existing government public debt portfolio, for the macroeconomic background and the market context on management of government debt

Although declining compared to previous years the exposure to refinancing risk and interest rate risk in the domestic market continue to be the main sources of risk for the

[33]At end- 2016.

existing government debt portfolio. The currency exposure is still significant but is mitigated by the share of long-term foreign currency debt (denominated in Euro) and the maintaining of the foreign currency financial buffer available to the State Treasury. Longer tenors and a more diverse investor base continues to justify the Eurobonds issued in USD, but the analysis shows that, currently, with the framework for managing the risks associated to other foreign currencies lacking, USD funding is both more expensive and riskier compared to funding in EUR [34]. Besides, FED monetary policy with expectations of higher reference rates[35] will affect negatively the volatility and yields of Eurobonds issued by emerging economies and the parity reaching of the EUR/USD exchange rate.

The market background forecast for the 2017-2019 time horizon involves considerably more challenges, given the anticipated domestic and foreign monetary policy decisions.
Whereas forward yield curves indicate that both external and domestic interest rates are expected to increase in the future they both continue reaching historical lows. The quantitative easing policy initiated by the ECB in 2015 and the new measures for economic stimulation of the Eurozone, taken in December 2016, are likely to preserve the low interest rates in the long term. With lower yields in the euro area, Romania could continue benefiting from the investor interest in getting profits from assets denominated in Euro, which could help keep interest rates both in RON and EUR at relatively low levels, albeit going up, because of the FED divergent policy of increasing the interest rates, which also affects the other markets.
Starting from the second half of 2017, the intent is to use specific secondary market instruments, such as buy backs and/or switches, according to the completion of the NBR procedure and operational framework, for the decrease of the refinancing risk and improvement of liquidity, by the refinancing of large accumulated volume series and by the consolidation of the investors' demand for securities in local currency.

Some of the domestic risk factors are the fiscal-budgetary policy conduct, in the context of uncertainties regarding the impact that the adopted fiscal easing measures may have on the medium-term macroeconomic imbalances, the increase of the medium-term budgetary deficit and the possibility of delaying structural reforms, but also the market expectations regarding the increase of interest rates in the short term in the context of positive inflation return. Therefore, MoPF evaluated the financing alternatives that enable the limitation of exposure to refinancing and interest rate risks. Two approaches were used: first relying more on as long as possible maturities of government securities in domestic currency and second replacing the financing in short-term T-bills by long-term bonds denominated in EUR. Moreover, to examine the cost-risk tradeoff raised by the issuance of long-term bonds in USD, several borrowing strategies were simulated, with different structures of foreign currencies (EUR versus USD).

Alternative funding strategies were compared according to the projections of debt service under different scenarios of exchange rates and interest rates. The baseline scenario, as the most likely one, was used to compute the expected cost of the different strategies. The risk was measured as the increase in cost resulting from applying shocks to the market rates used in the baseline scenario. Two indicators of cost and risk were used: debt-to-GDP ratio and interest-to-GDP ratio, both computed at the end of the third projection year, 2019. The results of the cost-risk analysis are then complemented by macroeconomic

[34] The current yields relating to Eurobonds in EUR, maturing in 2028, being approx. 2.60%, while those for Eurobonds in USD, maturing in 2024, are at approx. 3.70%.
[35] Most analysts expect new decisions of monetary policy interest rate increase.

considerations and considerations related to the domestic market development, as explained below.

Results of the analysis regarding the alternative strategies of public debt management

<u>Extension of average time to maturity (ATM) for local currency debt:</u> Managing the refinancing exposures in domestic currency debt using more RON denominated instruments on medium and long term maturity is becoming more favorable, considering relatively low yields of government securities during the interval under review. Under these circumstances, the cost of extending ATM is relatively small in terms of debt-to-GDP and interest-to-GDP. Thus, the scenario analysis supports strategies that raise ATM, since the cost increase is relatively small compared to the improvement in the redemption profile and the protection offered against sudden and sustained increase in short-term interest rates.

This strategy may help develop the market, by increasing the liquidity of government securities with an impact on the development of the secondary market. Improving liquidity can come both through increasing the weight of Romanian government securities in the regional reference index and particularly by introducing the electronic trading platform for the secondary market and the use of instruments of secondary market (buy-backs and bond exchanges) after MoPF in a joint effort with NBR complete the framework allowing the use of these instruments. Nevertheless, the cost simulations regarding this strategy fail to capture the limitation given by the capacity of absorption of an increased volume of government securities in the medium and long term by the domestic market, especially in a context characterized by the increasing likelihood of monetary policy measures that may affect the market demand for short and medium-term securities. Thus, this scenario should consider a reasonable increase of the net volume of government security issuances in the medium and long term, on the domestic market.

<u>Decrease refinancing risk by rollover of T-bills denominated in lei using Euro-denominated government securities</u>: Addressing refinancing risk in the local currency debt with Euro funding is advantageous when looking at the debt servicing flows. Thus, when interest-to-GDP is used as the cost indicator, the strategies with more Euro funding have a similar cost but a lower associated risk. Risk differential analysis responds to the fact that domestic interest rates are significantly more volatile. But if the analysis focuses on stocks, the foreign currency risk dominates and increasing the share of the EUR debt amplifies the exposure of the debt portfolio to a potential correction of the domestic currency.

<u>Structure of the foreign currency portfolio</u>: Simulation results indicate a clear preference for borrowing in EUR over USD. A quantitative analysis shows that at the current and implied forward yield curves, USD financing involves the increase of both the cost and the risk compared to the case in which Euro financing is used. This reflects expectations about interest rates higher in USD and a RON/USD exchange rate significantly more volatile than the RON/EUR, with the appreciation of the US currency against the EUR. Market expectations for the end of 2017 regard a 1:1 parity.

Even if the USD market is more liquid and allows Romania to borrow on very long maturities (up to 30 years) adding to the diversification of the investor base, the favorable terms on the Euro market which allowed extending the maturity of the Romanian government securities up to 20 years are additional pros to issuing Eurobonds mostly on the Euro market. But in case of opportunities in terms of cost/maturity at issuance of Eurobonds denominated in other currencies, along with managing the risk of exposure to these currencies, using currency swaps, the possibility to use such instruments while maintaining the main exposure in Euro may be considered.

In order to use financial derivatives (currency swaps and interest rate swaps), for the creation of the procedural and technical framework, MoPF, through the General Directorate of Treasury and Public Debt receives technical assistance from the World Bank Treasury, for 18 months, in the project themed “Development of the public debt management capacity, by the use of financial derivatives”, code SIPOCA 10. The project is funded from the European Social Fund in the Operational Programme Administrative Capacity 2014-2020 and its implementation is in progress.

To conclude, with budget deficits lower than 3% of GDP in the medium term, the MoPF sees the bulk of net lending denominated in local currency, as a move to continue to develop the domestic market, while accessing foreign capital markets in Euro and borrowing from IFIs in order to ensure robust funding sources, but not casting out any opportunistic access to international capital markets in currencies other than EUR, under a cost/risk ration favorable to the Romanian state.

The authorities will continue to promote the development of the domestic market of government securities, by applying the measures and actions described in Annex no.1.

Strategic guidelines

The following principles shall form the basis of the financing decisions in 2017 -2019:

1. The net financing in local currency is to be favored as a move to further facilitate the development of the domestic market of government securities and help mitigate foreign currency exposure, at the same time considering the domestic market absorption capacity and, in general, the demand for debt instruments in lei[36].
2. Obtain an even redemption profile, avoiding to the extent possible the concentration of principal repayments/refinancing of government securities in the short term.
3. Mitigate refinancing risk and liquidity risk by maintaining a foreign currency buffer[37] and perhaps other instruments, according to the terms and conditions thereof.
4. Maintain presence on the international capital markets, by issuances of Eurobonds mainly in EUR and access the USD market or other foreign currency markets on an opportunistic basis, giving consideration to the extension of the debt portfolio average maturity and taking into account the cost/risk ratio associated thereto and the diversification of the investment base.
5. In the process of external financing, debt will be obtained mainly in EUR.
6. Issuances on the domestic market in EUR shall be considered solely in case of special demand expressed by local investors, in the absence of alternative investment instruments, in the conditions of a favorable maturity/cost ratio.
7. Keep exposure to interest rate risk under control by monitoring the domestic debt refixing within the next year and the average time to refix for the total portfolio.
8. Use financing instruments offered by IFIs to benefit of the favorable terms and conditions attached to those instruments.

These principles are expressed as indicative targets for the main risk indicators, which reflects the targeted structure of the debt, as follows:

[36] Apart from the domestic demand for government securities in lei, non-resident investors may have an important role for amounts placed on the domestic market and, in particular, the structure of maturities in the financing process, given their appetite for government securities with medium and long maturities.
[37] Foreign currency risk should cover a number of months relating to the gross financing needs, currently set at 4 months of the gross financing needs.

Foreign exchange risk:

1. Assuring net financing more from domestic sources[38] and keeping the share of local currency debt in total government public debt in the 45% (minimum) - 60% range. This strategy will consider the absorption capacity of the domestic market of government securities and the related cost.
2. Maintaining the share of debt denominated in EUR in total foreign currency debt between 80% (minimum) and 95%.

Refinancing risk

1. Keeping the share of debt maturing within one year in the 20% - 30% (maximum) range for the local currency debt and 10%-20% (maximum) for the total debt.
2. Maintaining ATM in the range of 3.5 years (minimum) – 5.0 years for local currency debt and 5.5 years (minimum) – 7.0 years for total debt.
3. Maintaining keep a foreign currency buffer[39] at a comfortable level, in order to mitigate the risks corresponding to high volatility times on the financial markets.

Interest rate risk

1. Maintain the share of debt maturing in the next year between 20% and 30% (maximum) for the local currency debt and between 10% and 20% (maximum) for total debt.
2. Maintain the average time to refixing between 3.5 years (minimum) and 5 years for local currency debt and between 5.5 years (minimum) and 7.0 years for total debt.

Table 10: Targets for the main risk indicators

Exposure to risk	Indicator	Indicative targets for 2017-2019
Foreign exchange risk	Share of domestic currency debt in total debt (% of total) Share of EUR denominated debt in total foreign currency denominated debt (% of total)	45% (minimum) - 60% 80% (minimum) - 95 %
Refinancing risk	Debt maturing in 1 year (% of total) Local currency debt maturing in 1 year (% of total) ATM for total debt (years) ATM for local currency debt (years)	10% - 20% (maximum) 20% - 30% (maximum) 5.5 years (minimum)– 7.0 years 3.5 years (minimum) – 5.0 years
Interest rate risk	Debt re-fixing in 1 year (% of total) Local currency debt re-fixing in 1 year (% of total) Average time to re-fixing for the total debt (years) Average time to re-fixing for the debt in domestic currency (years)	10% - 20% (maximum) 20% - 30% (maximum) 5.5 years (minimum) – 7.0 years 3.5 years (minimum) – 5.0 years

Source: MoPF

The implementation of the 2017-2019 Strategy shall be monitored on a month-by-month basis, by focusing on the compliance of the debt indicators with the set targets and by publishing them in the MoPF Monthly Report on the website of the Ministry of Public Finance. According to GEO no. 64/2007 regarding public debt, as further amended and supplemented, the strategy may be revised annually or any time required by the market conditions and/or financing needs.

[38] Approximately 70% of the deficit will be financed from domestic sources in the Strategy-covered period.
[39] The foreign currency buffer represents the funds in foreign currency available to the State Treasury - the current buffer level covers 4 months of gross borrowing needs.

Annex no. 1

Development of the domestic market of government securities

The medium-term strategic objectives for the development of the domestic market of government securities aim at increasing its efficiency by the improvement of its liquidity, transparency and the consolidation of the yield curve. To obtain the aforementioned objectives MoPF has planned a set of actions, some of which will be implemented in the near future, as follows:

1. *Increase efficiency on the market of government securities*:
   - 1.1. Consolidate and extend yield curve on the domestic government security market:
     - 1.1.1. Define a policy for the creation and maintenance of liquid benchmark securities, in amount of around 2 billion euro equivalent, as key financing instrument on the domestic market;
     - 1.1.2. Use operations specific to the secondary market of government securities to accelerate the creation of liquid benchmarks (following consultations with NBR as a move to coordinate funding and cash management policies with the monetary policies), in parallel with managing the refinancing risk and supporting the implementation of the Strategy;
     - 1.1.3. Issue T-bills on short term for management of liquidities.
   - 1.2. Diversification and enlargement of the investor base by:
     - 1.2.1. Furthering the FIDELIS programme of issuances for the population, via the Romanian Securities Exchange, according to the interest of the concerned investor category;
     - 1.2.2. Introducing the Tezaur (Treasury) Programme, whereby the population will be able to subscribe T-bills through the territorial units of the State Treasury;
     - 1.2.3. Issuing a range of debt instruments as large as possible, with different maturities and taking into account the investment needs of the domestic and international investment environments;
     - 1.2.4. Balancing the rights and obligations of primary dealers and increase the competitiveness among primary dealers by attracting new primary dealers (including IFIs) to increase the distribution, intermediation and trading of government securities simultaneously with improving the pricing transparency;
   - 1.3. Analyze the opportunity of issuing new debt instruments required by market participants (such as index-linked or floating interest bonds), as the market of government securities develops and while avoiding the fragmentation of this market;
   - 1.4. Explore the opportunity to reduce the individual nominal value of government securities, to ensure the widest access of small investors to these instruments.
   - 1.5. Furthering the organization of promotional tours for investors of the type “non-deal roadshow”.

2. *Measures to increase the liquidity of government securities market*:
   - 2.1. Monitoring the electronic quotation and trading platform of government securities by the primary dealers, as a move to improve liquidity and transparency of pricing and diminish the risks associated with trading activity;

2.2. Concentrate the liquidity of government securities in a small number of benchmarks equivalent of around EUR 2.0 billion, per issuance, according to maturity;
2.3. Use secondary market operations (such as bond exchanges or buy-backs) to reduce the refinancing risk and build up the liquid benchmark bonds, increase liquidity and support MoPF measures for the implementation of the government public debt management strategy;
2.4. Conduct reverse repos and security lending for cash management purposes and to support the activity of the market makers, based on consultations with NBR, to coordinate the government financing and cash management policy with the monetary policy.

3. *Measures considered for the increase of the transparency and predictability of the government securities market* include:
   3.1. A transparent issuance policy by releasing the annual calendar of issuance, the quarterly announcements and the monthly prospectuses of issuance, and, where appropriate, presenting flexibly and timely any amendments caused by changes in market conditions;
   3.2. Constant dialogue with the domestic market players, to ensure the timely communication of actions considered by the MoPF;
   3.3. Regular posting on the new www.datoriepublica.gov.ro page of the information investors may find relevant in relation to the value and structure of public debt
   3.4. Management of the MoPF-related Bloomberg page, considering its wide use by domestic and foreign investors.

Annex no. 2

Cash management improvement policy and the measures to be taken

Based on the recommendations under WB Technical Assistance project aimed at the "Improvement of the public debt management", implemented in 2014 in order to improve cash (liquidity) management the MoPF seeks to implement the following measures:

1. Continue to develop the State Treasury's cash flow forecasting by extending the daily cash flow forecast for the current general account of the state treasury *for a period of three months in advance* and improve cooperation with other entities for the supply by the same of the forecast information.

2. *Adopt a more active management of cash (liquidities)* for the decrease of balance fluctuations, both by the issuing of T-bills on the short and very short term, according to the budget execution and the performance of the budgetary deficit, and by the active management of current surplus balances, either in the form of term deposits or, preferably, by reverse repos.
Thus, according to the evolution of the budgetary execution in 2017, the State Treasury intends to issue T-bills on the short term and to pursue a more active conduct relating to reverse repos[40], based on a prior consultation with the NBR, for the coordination of the financing policies and cash management policies with the ones of monetary policy. The introduction of T-bills on short and very short term shall be performed in a way that will not impair the key-objective regarding the development of the domestic market of government securities, the extension of the average maturity of the government public debt portfolio described in the Government Public Debt Management Strategy on the short term.

3. For the recommendation regarding the *strengthening of the institutional framework* for improved coordination of the debt and cash management process, in MoPF, the *Commission for the planning of the financial flows of the State Treasury* was established, with participation of ANAF and NBR representatives, to secure the improved coordination of the budgetary deficit financing, the management of government public debt and of state liquidities.

4. Another short-term instrument of the deficit is given by *borrowings from the State Treasury General Current Account balance amounting to* RON 42.15 billion at the end of December 2016, obtained in accordance with the provisions of the Government Emergency Ordinance 146/2002 on the establishment and use of resources through the State Treasury, as revised, requiring the use of available balance funds of the State Treasury General Account to finance through temporary borrowings, budget deficits from previous years.
In spite of the advantage of using this instrument, such as the low-cost financing of the state budget deficit, since the interest rate of these borrowings was around 0.06% in 2016 this instrument has a number of disadvantages as well, such as:

- it is an atypical instrument, as other European Treasuries use the state loans/government securities to integrally finance the budget deficits, with the liquidity surpluses placed in cash management instruments;

[40] The reverse repo has the advantage of easy execution and automatic collateralization, contributing to the activity of the monetary market.

- depends on the funds available in the account, and in case of low available funds other solutions are used, such as attracting market deposits from credit institutions or selling the hard currency proceeds available in the foreign currency buffer of MoPF.

Therefore, the use of this debt instrument brings uncertainty and refinancing risk (even when no deadline for repayment of the borrowed funds is established) impacting negatively on the government public debt management. Accordingly, MoPF intends to gradually refinance this instrument, in the long run, by issuing government securities.

A very important aspect is that the funds currently available in the State Treasury General Current Account include revenues in RON from privatization, and the more this revenue is used the less available funds are left in this account.

In order to stimulate the absorption of the structural funds, a mechanism was created allowing a temporary allocation of the privatization proceeds sitting in the State Treasury account to the primary budget users which are managing authorities and to the Ministry of Agriculture and Rural Development; so that:

- Under art.5 of the Government Emergency Ordinance no. 40/2015 regarding the financial management of European Funds for the programming period 2014 - 2020 Government Decisions may allocate temporarily amounts from the lei and foreign currency privatization proceeds, registered in the general current account of the State Treasury and the current foreign currency account of the Ministry of Public Finance open with National Bank of Romania, the main credit release authorities that act as managing authorities, to secure the payments relating to the reimbursement/disbursement requests for the eligible reimbursable expenses from European funds, within the maximum 5 billion lei or EUR equivalent ceiling.
- In accordance with art.3 para.(2) of the Government Emergency Ordinance no. 49/2015 regarding the financial management of non-refundable European funds relating to the common agricultural policy, the common fishing policy and the EU integrated maritime policy, as well as the funds allocated from the state budget for the programming period 2014 - 2020 and for the amendment and supplementation of regulatory acts in the field of guarantee, approved with amendments and supplementations by Law no.56/2016, as further amended and supplemented, Government Decisions may allocate temporarily amounts from the lei and foreign currency privatization proceeds, registered in the general current account of the State Treasury and in the foreign currency account of the Ministry of Public Finance open with the National Bank of Romania, MADR, in order to ensure the amounts provided in the budget of the external non-refundable funds, annex to the budget of MADR, relating to the direct support schemes and measures financed from EAGF.

The mechanism requires that the amounts temporarily allocated from the privatization proceeds should be replenished from the amounts received from the European Commission as a result of the transmission to the same of the payment applications corresponding to the operational programs.