



MINISTRY OF PUBLIC FINANCE

**GOVERNMENT PUBLIC DEBT
MANAGEMENT STRATEGY**

2018-2020

General Directorate for Treasury and Public Debt

Bucharest 2018

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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
NCSF	National Commission for Strategy and 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 2018-2020 (hereinafter called „Strategy”) continues the 2017-2019 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 design¹ and in consultation with the NBR.

As it has been the case with previous editions, the Strategy updated for 2018-2020 is consistent with the budget indicators of the Fiscal-Budgetary Strategy 2018-2020 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 manager². 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:

- Secure the funding needs of the central government, given the minimized medium and long term debt 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 2017

In 2017, all risk indicators remained within the targets set out in the public government debt management strategy for 2017 – 2019, as reflected in the presentation of financial indicators in the table below:

Table 1: Risk indicators at the end of 2017 and 2016

Indicators *	31/12/2016 **	31/12/2017 ***	Indicative targets according to the Strategy 2017-2019
<i>A. Currency risk</i>			
Share of domestic currency debt in total (% of total)	45.8%	46.5%	45% (minimum) – 60%
Share of EUR denominated debt in foreign currency denominated debt (% of total)	80.8%	84.0%	80% (minimum) – 95%
<i>B. Refinancing risk</i>			
Debt maturing in 1 year (% of total)	13.0%	12.0%	10% - 20% (maximum)
Local currency debt maturing in 1 year (% of total)	22.0%	18.0%	20% - 30% (maximum)
ATM for total debt (years)	5.8	5.9	5.5 years (minimum) – 7.0 years
ATM for local currency debt (years)	3.8	3.7	3.5 years (minimum) – 5.0 years
<i>C. Interest rate risk</i>			
Debt re-fixing in 1 year (% of total)	16.0%	15.0%	10% - 20% (maximum)
Local currency debt re-fixing in 1 year (% of total)	20.0%	17.0%	20% - 30% (maximum)
Average time to re-fixing for the total debt (years)	5.9	5.9	5.5 years (minimum) – 7.0 years
Average time to re-fixing for the debt in domestic currency (years)	3.8	3.7	3.5 years (minimum) – 5.0 years

*Without loans from the cash balance of the State Treasury General Current Account. **For 2016 the indicative targets set forth in the Government Public Debt Management Strategy were taken into account 2016 -2018.

Source: MoPF

Strategic guidelines for 2018-2020

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

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 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.

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 lei³.
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 buffer⁴ at a comfortable level 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 ranges⁵ 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%. When the derivative financial instruments are used, this indicator shall be calculated after the debt assessment as a result of using currency swaps.

- *to manage refinancing risk*

1. keep the share of debt maturing in the next year between 15% and 25% (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 at a comfortable level, in order to mitigate the risks corresponding to high volatility times on the financial markets.

- *to manage interest rate risk*

1. debt re-fixing its interest rate in the next year should stay between 15% and 25% (maximum) for local currency debt and between 10% and 20% (maximum) for total debt.

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.

³ with medium and long maturities.

⁴ The currency buffer should cover a number of months relating to the gross funding needs; (set at a level which shall cover 4 months of the gross borrowing needs).

⁵ 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).

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:

- Secure the funding needs of the central government, at the same time with minimizing the medium and long term debt costs;
- Limit the financial 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 2⁶.

3. Description of the public government debt portfolio⁷

Evolution of government public debt

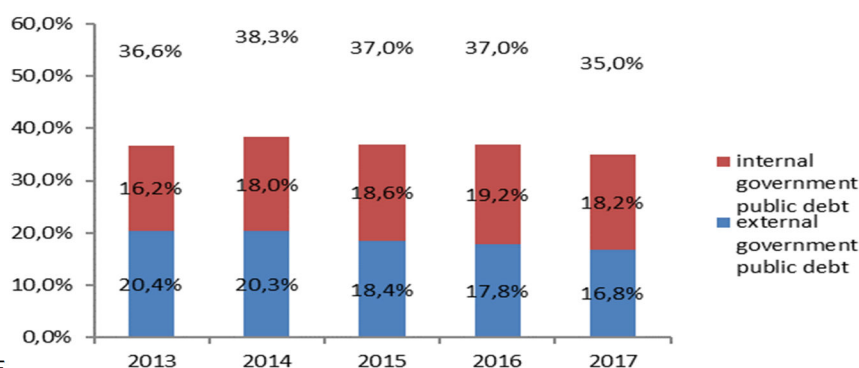
At the end of 2017, government public debt amounted to 300.6 billion lei, i.e. 35.0% of GDP, against an economic growth of 6.9% of GDP and given a deficit of the general consolidated budget of 2.83% of GDP.

Following the strategy adopted in the last years, with regards to financing 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 in favor of internal government debt as of the year 2015, and, at the end of 2017, the existing government public debt was 51.8% contracted by resident creditors and 48.2% by non-resident creditors.

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

⁶ 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.

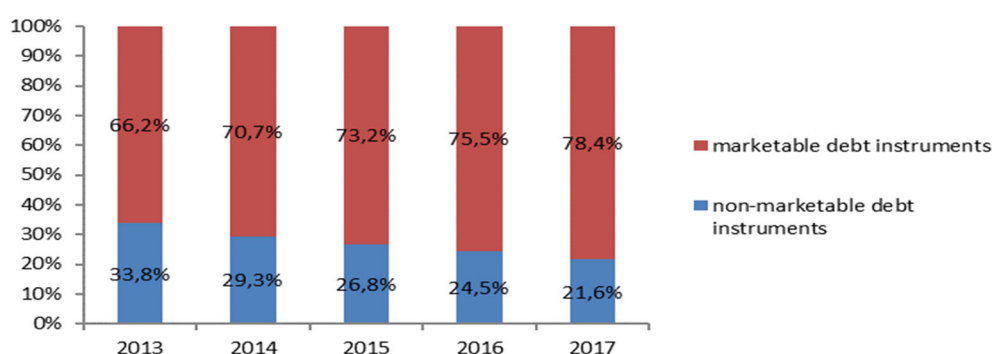
⁷ Preliminary data according to national legislation, not including temporary financing.



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

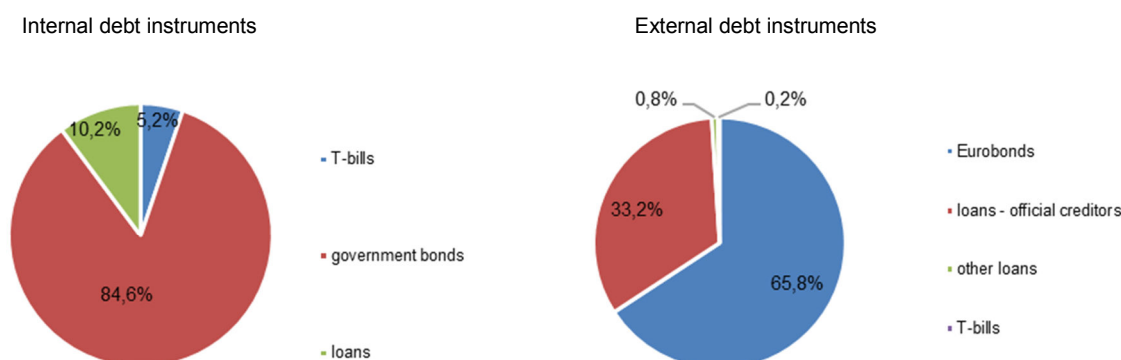


Source: MoPF

While the government borrowings' share to total government public debt was 21.6%, the government securities issued on the domestic and foreign markets accounted for 78.4% of total government public debt, of which 46.5% are government securities issued on the domestic market and 31.7% 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 includes 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



Source: MoPF

Costs, expressed as average interest rates⁸, dropped in 2017 driven by lower interest rates especially of internal debt. Debt in local currency at the end of 2017 remains more expensive than foreign currency debt⁹ as illustrated in table 2.

Table 2: Cost of direct Government (through MoPF) debt, according to type of instrument¹⁰

	31.12.2016	31.12.2017
Average interest rate of public government debt (%)	3.7	3.4
1. in national currency, of which	4.1	3.5
a. T-Bills with 1 year maturity	0.8	1.1
b. T-Bonds fixed with 1 - 5 year maturity	4.0	3.8
c. T-Bonds fixed with 5 - 10 year maturity	5.5	5.6
2. in foreign currencies, of which:	3.3	3.3
a. EUR bonds with 10-year maturity	3.6	3.3
b. EUR bonds with 3-5 year maturity	4.2	4.2
e. EUR multilateral	2.5	2.0
f. USD bonds with 30-year maturity	5.7	5.7
g. USD multilateral	1.8	1.4

Source: MoPF

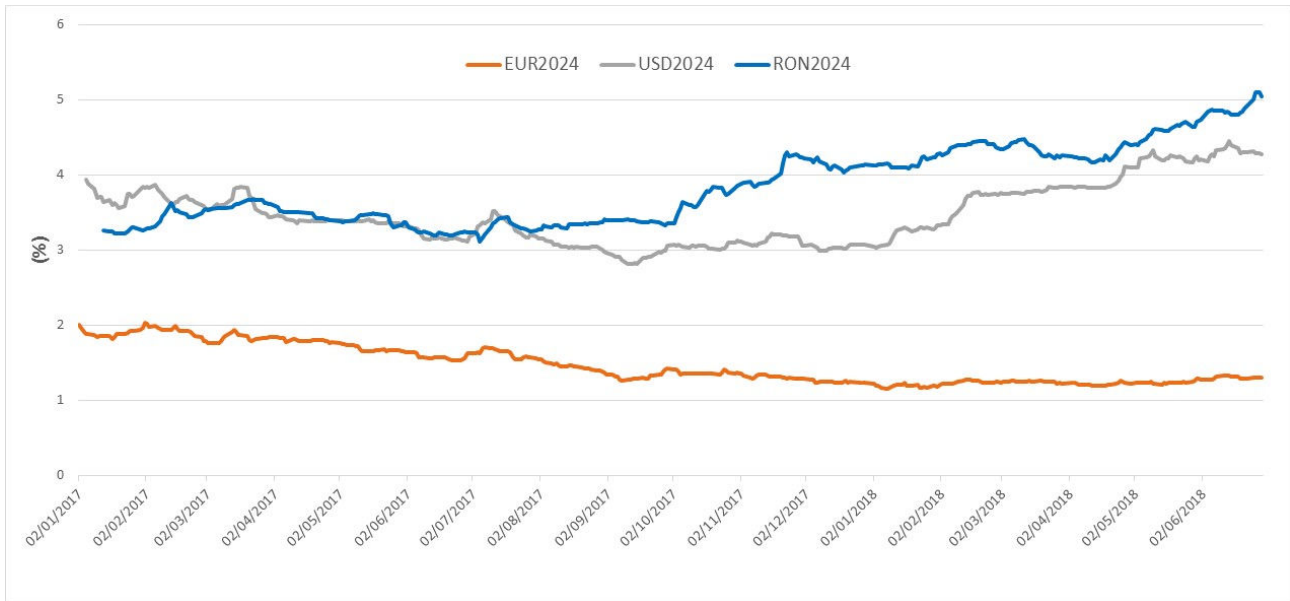
The continued significant portion of loans contracted from IFIs at favorable rates explains the lower cost of external funding. In addition, bonds denominated in EUR placed in the international capital markets are usually issued at nominal yields (without considering the impact of currency risk on the costs) lower than local currency securities as illustrated in graph 4. Until July 2017, the costs relating to RON financing on the domestic market were kept close to the levels of the USD financing costs for the same maturities. Subsequently, as of September, the yields of government securities in ron registered increases, more accentuated on the short maturities segment, due to a narrow liquidity period on the market and to increased inflation expectations. 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 2017 were exclusively in EUR.

⁸ Calculated as interest payments forecast for 2018 and the existing balance at the end of 2017 per debt instrument.

⁹ 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.

¹⁰ The table shows the average interest rates for selected debt instruments, aggregated as all debt instruments forming the government public debt portfolio.

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



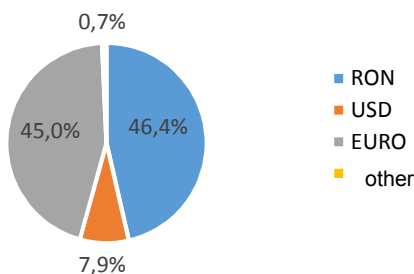
Source: MoPF

Risks of the public government debt portfolio at the end of 2017

Foreign exchange risk

At the end of 2017, 53.6% 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 EUR¹¹ 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

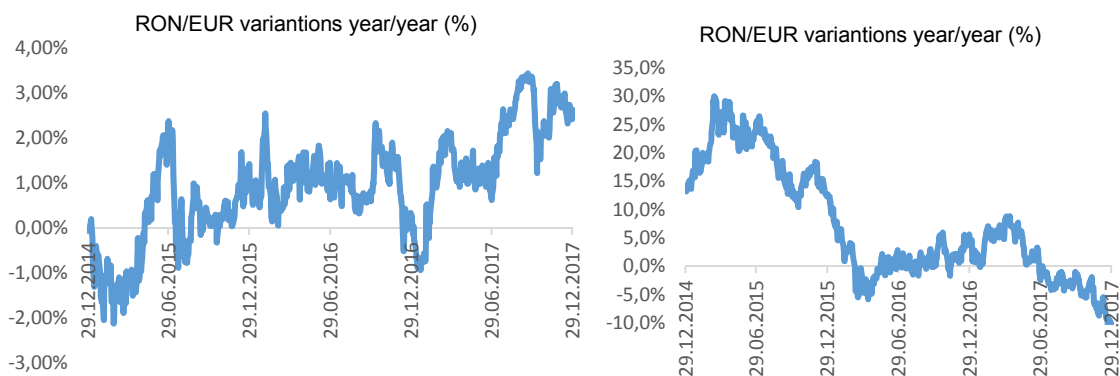


Source: MoPF

¹¹ 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.

As suggested by graph 6, in the last 3 years, the volatility of the RON/USD exchange rate was approx. three - four time higher than the one of the RON/EUR exchange rate, which means that USD debt is significantly riskier than the EUR debt.

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 5% and against USD by 15%, in 2018 would increase the debt stock by RON 19.2 billion or with 2.1% of GDP and the debt service payments (including the repayment of principal and the refinancing of government securities and interest payments) by RON 2.6 billion or 1.1% of central government revenues¹². Accordingly, the exposure to exchange rate risk may be deemed moderate.

Refinancing risk

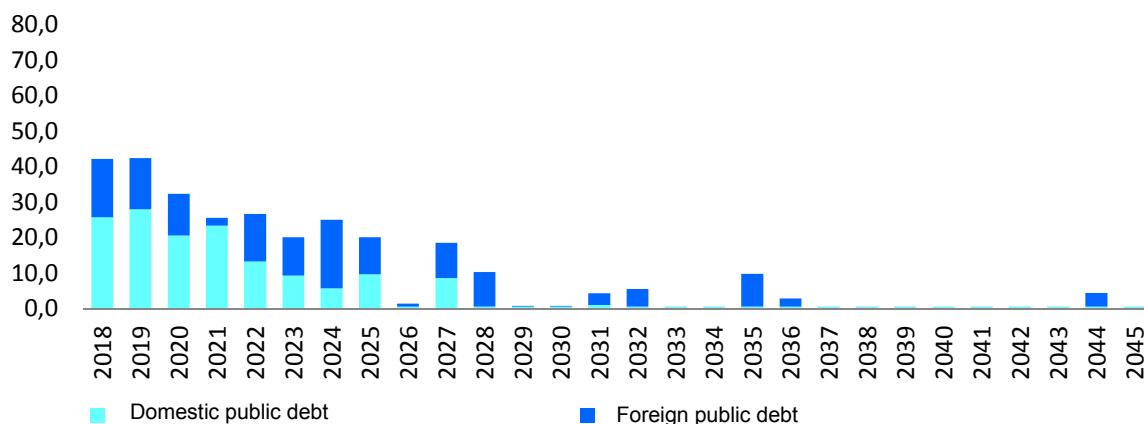
The structure of principal repayments and refinancing of government securities presented in graph 7 shows some accumulation of repayments in the first 3 - 5 years, although the trend is to adjust the reimbursement graph, leading to the decrease of the medium- and long-term refinancing risk. The concentration of repayments over the first 4 years is particularly noticeable in the domestic debt¹³ and reflects the importance of Treasury-bills in the government funding reaching RON 8.2 billion at the end of 2017, but also the investors' preference for government securities with a 3-5 year remaining maturity. 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 approximately EUR 2 billion. For example, in June-July 2017, two issuances of benchmark bonds matured, with a worth of approx. RON 16 billion. The refinancing of such obligations, although decreasing, could have posed 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. Concurrently, 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

¹² Budget revenues calculated based on cash data, by applying EU methodology.

¹³ According to market of issuance.

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 2017 (RON bn.)



Source: MoPF

The redemption profile of the debt portfolio results in an average time to maturity (ATM) of 5.9 years: 3.7 years for local currency denominated debt and 7.7 years for debt denominated in foreign currency.

Table 3: Refinancing risk indicators

Indicators	2016			2017		
	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)	22.0	6.0	13.0	18.0	10.4	12.0
Average time to maturity (years)	3.8	7.0	5.8	3.7	7.7	5.9

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 2017, was EUR 5.2 billion, i.e. 2.8% of GDP, covering approx. 3.9 months of the gross financing needs associated to the year 2018

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

	2014	2015	2016	2017
Gross government public debt (% GDP)*	38.3	37.0	37.0	35.0
Financial buffer (%GDP)	4.6	3.7	3.6	2.8
Net government public debt (% GDP)	33.7	33.3	33.4	32.2

*) 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-2017. Thus, a 1 pp increase of interest rates in 2018 will lead to the increase of payments for the debt service with RON 1.4 billion, i.e. 0.6% of the central government revenues¹⁴ for local currency debt, and with RON 1.6 billion, i.e. 0.7% of the central government revenues for foreign currency debt.

Table 5: Interest rate risk indicators

Indicators	2016			2017		
	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)	93.8	86.3	89.7	93.3	86.8	89.9
Share of debt re-fixing in 1 year (% of total)	20.0	14.0	16.0	17.0	8.0	15.0
Average time to re-fixing interest rate (years)	3.8	7.2	5.9	3.7	7.8	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. By comparison, the exposure to foreign exchange risk is easier to manage, however, it must be correlated with the third objective of the Strategy for public debt administration on the medium term, respectively that of the domestic market for government securities. With regards to the financing risk and the liquidity risk, the policy of maintaining a foreign currency financial buffer continues with the purpose of limiting them.

4. Internal and external financing in the context of domestic and foreign financial markets performance in 2017 and first 6 months of 2018 and medium-term expectations

Domestic market

Domestic market performance in 2017 and in the first 6 months of 2018

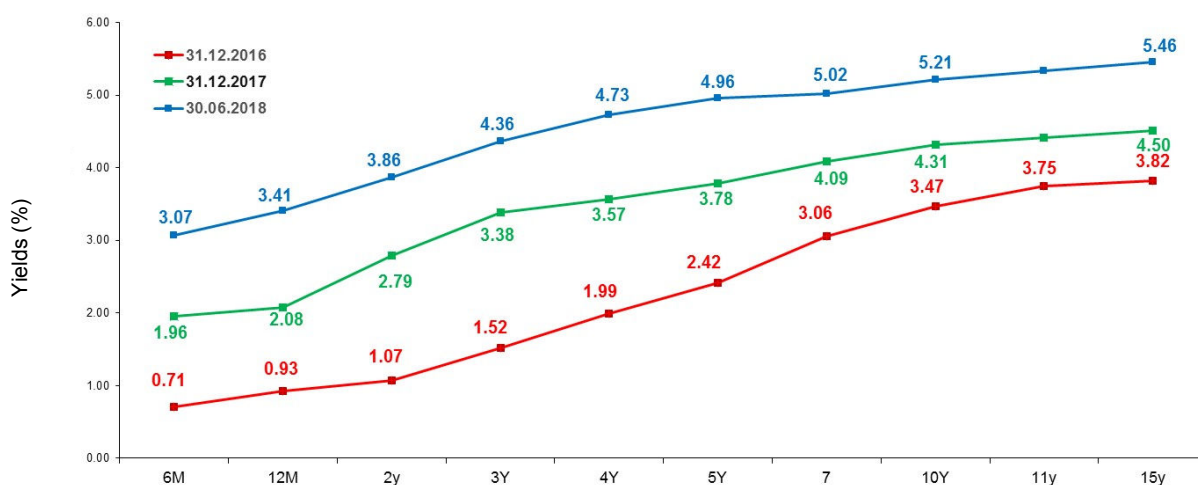
Following the consistent strategy in the last years, for the development of the government security market, linked with a favorable market context, in the first nine months of 2017, the domestic market of government securities showed positive evolution, proving its resilience

¹⁴ Budget revenues computed based on cash data, by applying EU methodology.

in times of volatility generated by foreign factors, the yields of Romanian government securities registering a descending trend. In the last 3 months of 2017, the market context was marked by changes at the level of liquidity, as well as by the expectations regarding an increase in inflation, factors which influenced the increase of yields for all maturities issued by the MPF, more so for the short segment of the government securities curve

As suggested by graph 8, at the end of 2017, the interest rates to the Romanian government securities in RON were below the levels of end-2016, in the first 6 months of 2018 maintaining an upward trend, as compared with end-2017.

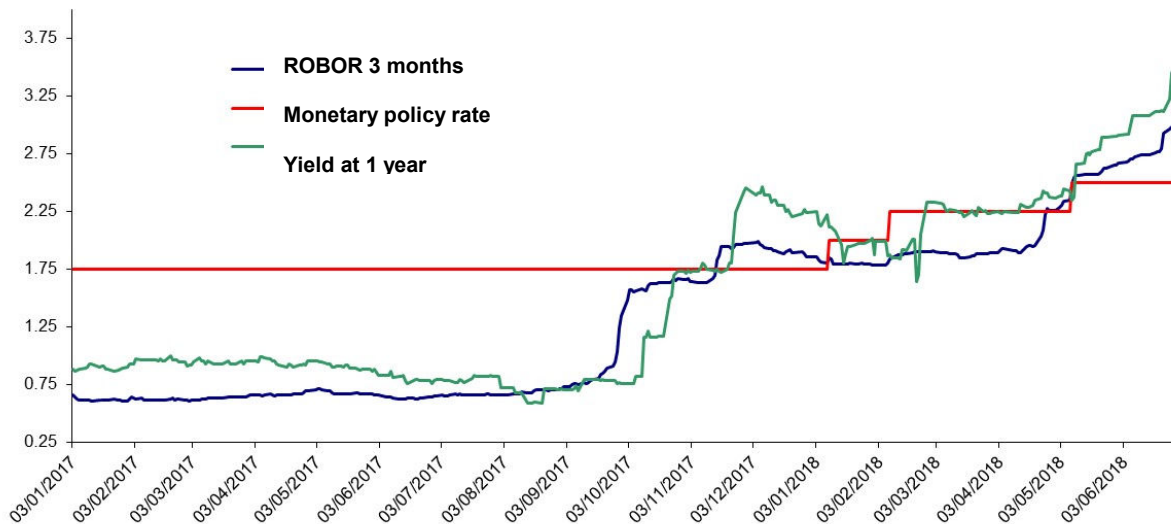
Graph 8: Performance of yields on the domestic secondary market



Source: Bloomberg

During 2017, the NBR kept the monetary policy rate at 1.75%, performing two operations of narrowing the corridor in November by 0.25 percentage points each from 3.25 (lending facility) and 0.25% (deposit facility) to 2.75% (lending facility) and 0.75% (deposit facility). In May 2017, the rate of the minimum mandatory reserve for foreign currency liabilities was reduced from 10% to 8%. In January, February and May the RNB increased the monetary policy rate by 0.25 percentage points each, from 1.75% to 2.5%, the symmetric corridor composed by the standing facilities' rates being maintained at around the monetary policy rate at +/- 1 percentage point.

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



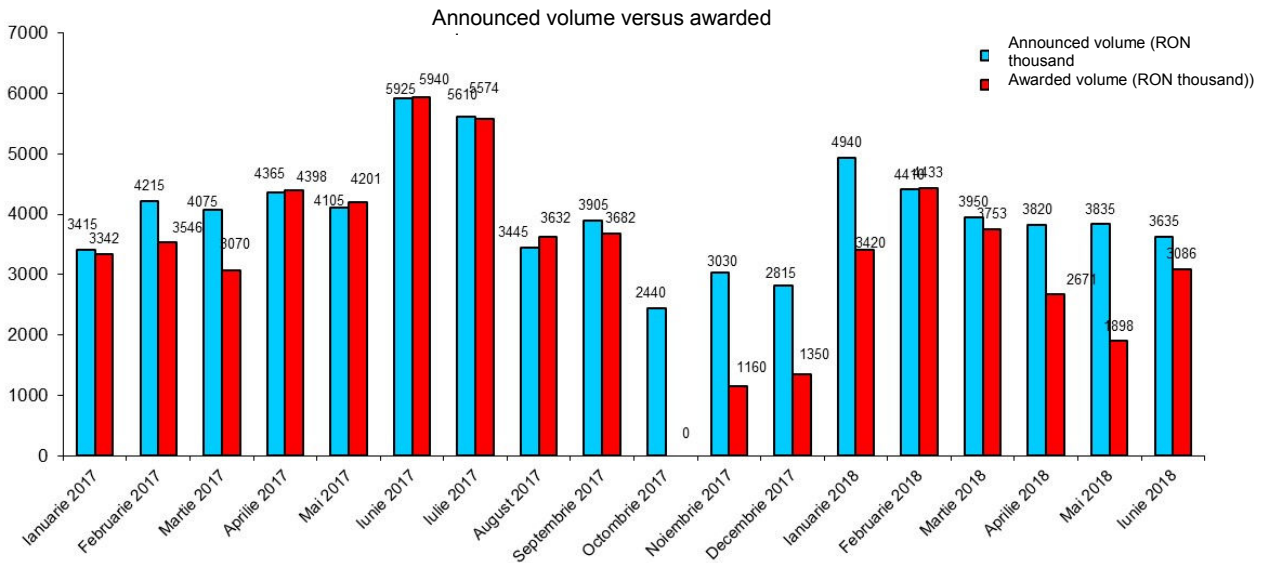
Source: MoPF, NBR

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 foreign investors' interest. At end-June 2018, 12 series of Romanian government bonds were included in the GBI-EM Global Diversified Investment Grade index, at weight of approx. 3.84%, and 13 series in the Barclays EM Local Currency Government Index, at 1.19%, at the end of June 2018.

The policy of government security issuance was predictable and flexible, adjusted to the investment environment requirements. In the first nine months of 2017, 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 and consolidating liquidity at those maturities.

As of October 2017, the interbanking monetary policy interest rates registered increases due to the amendment of the liquidity requirements, the increase in inflation (the inflation rate being 3.32% at the end of 2017), but also due to expectations regarding the adjustment of the monetary policy conduct by the RNB, factors which have influenced the increase of yields, as well as the degree of award at the level of government securities auctions.

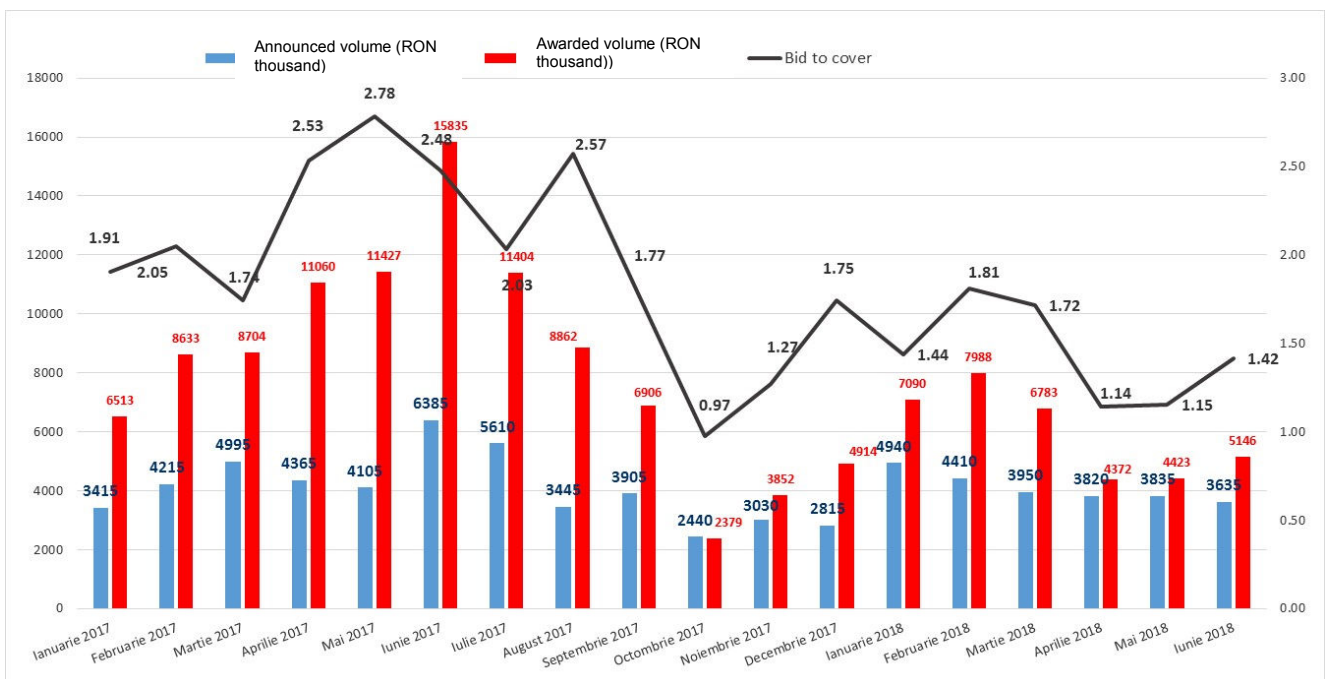
Graph 10: Announced volume vs awarded volume in January 2017 - June 2018



Source: MoPF

As suggested by graph 11, throughout 2017, the government securities auctions were over-subscribed on average approximately 2 times over the announced volume, with the exception of the IV quarter.

Graph 11: Primary market demand and offer of government securities in January 2017 - June 2018



Source: MoPF

Investor base

Given a moderate advance of the financial institutions' crediting activity during 2017 and the episodes of existing cash surplus on the market, the commercial banks continued to be the

main investors on the domestic market of government securities, holding in the portfolio, at the end of the year 2017, 48.4% of the total volume of government securities issued on the domestic market, followed by non-resident investors who kept relatively constant holdings at around 18%, while the pension funds saw an increase of holdings from 15.3%% at end-2016 to 16.5% at end-2017, as to reach 16.8% at the end of March 2018. At the end of April 2018, the commercial banks held 47.8% of the total number of government securities issued on the domestic market, being followed by non-resident investors registering an increase compared to the end of 2017, to 18.2%. The increase was registered by the pension funds as well, which, at the end of April 2018 represented 17.7% of the total government securities issued on the domestic market.

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

Graph 12: Performance of government securities by type of holders

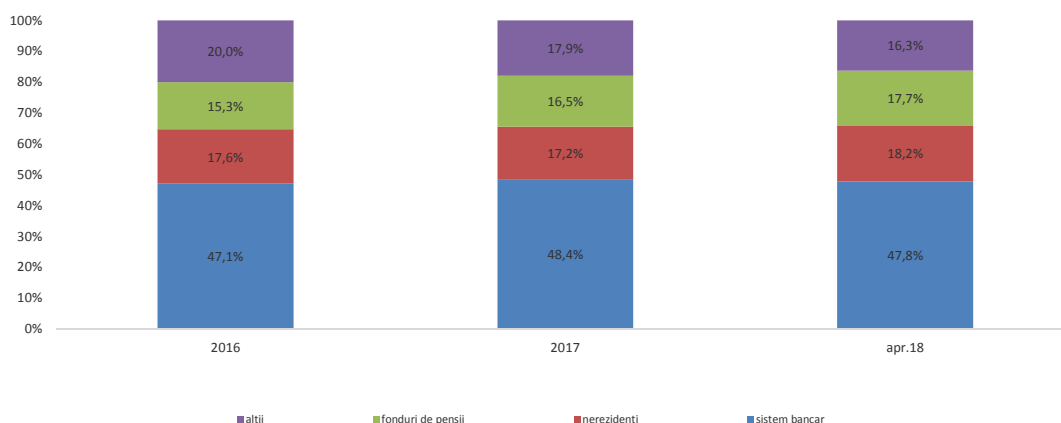


Image translation (from left to right): banking system; non-residents; pension funds; other
 Source: NBR

As institutional investors, local asset managers and private pension funds have a relatively small share in the government securities, however they generally have a significant potential to support state funding activities and the development of the local government securities domestic market. Total net assets of private pension funds (pillar II+III) increased significantly from RON 10.2 billion in 2012 to RON 41.5 billion at end-2017 and, respectively, RON 44.86 billion at end-May 2018, most of them being invested in government securities – if, at the end of 2016, the government securities holdings were approx. RON 22.8 billion, at end-May 2018, at approx. RON 27.04 billion.

Non-resident investors continue to represent 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 year 2017 began with expectations of divergent monetary policies from the main central banks (BCE and FED), and indeed, BCE has maintained the reference rate throughout the year, while FED operated consecutive interest rate increases, from 0.75% at the beginning of the year, to 1.5% at the end of the year. These monetary policy decisions have also affected the local market for government securities due to the fluctuations of demand on the part of non-residing investors.

Source: NBR

In 2017, non-residents' holdings were at 17-19% of total government securities issued on the domestic market. 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 of government securities being relatively stable in such periods.

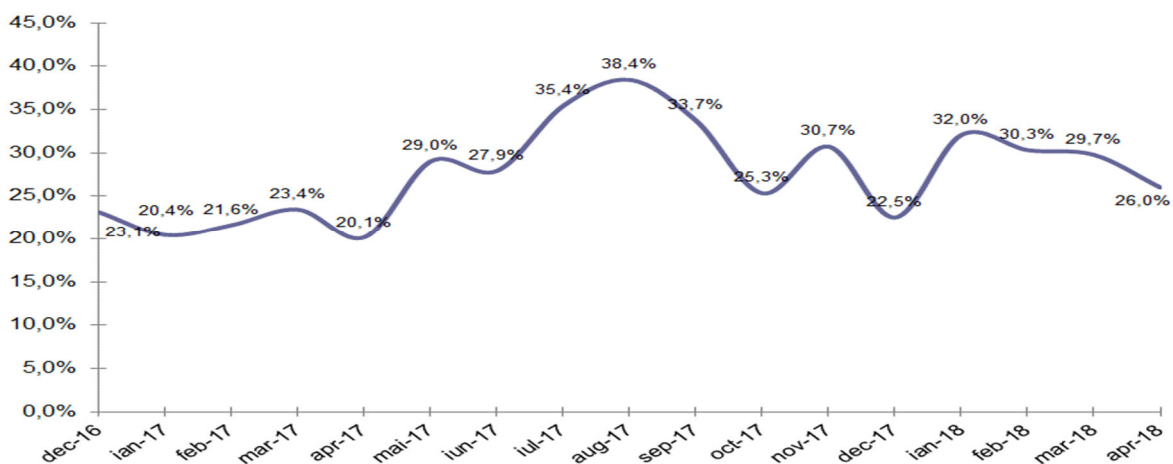
The increase of the non-resident investors' presence is influenced by a number of internal factors such as: development of a more liquid swap market in Romania for longer maturities, increase of government security liquidity on all segments, introduction of secondary market operations, increase of the 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, registered a relatively constant increase during the first 8 months of 2017, then decreased to a level similar to that registered at the beginning of the year, given the growth of the existing government security stock on the market, with RON 9.9 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 38.4%, following the decrease of the government security balance by the reimbursement of a benchmark series with an accumulated volume of RON 15.8 billion.

As of January 2017, the primary dealers are required to provide firm quotations on the electronic quotation and trading platform for Romanian government securities, supplied by Bloomberg (E-Bond), and to fulfil minimum requirements relating to volume, maturity, quotation time, margin between the selling price (BID) and the purchase price (ASK), their performance being reflected in the periodic evaluation on the government security market. At the end of the first year of functioning, the positive impact of this platform can be observed on the government securities market, by the reduction of the bid/ask margin, by the gradual increase in the number of listed securities and in the average volume listed /the average quotation time taken by each primary dealer/series of government securities.

Graph 14: Performance of the degree of liquidity of government securities in RON, active in December 2016 – April 2018



Source: MoPF

Implementation of the financing plan on the domestic market in 2017 and in the first 6 months of 2018

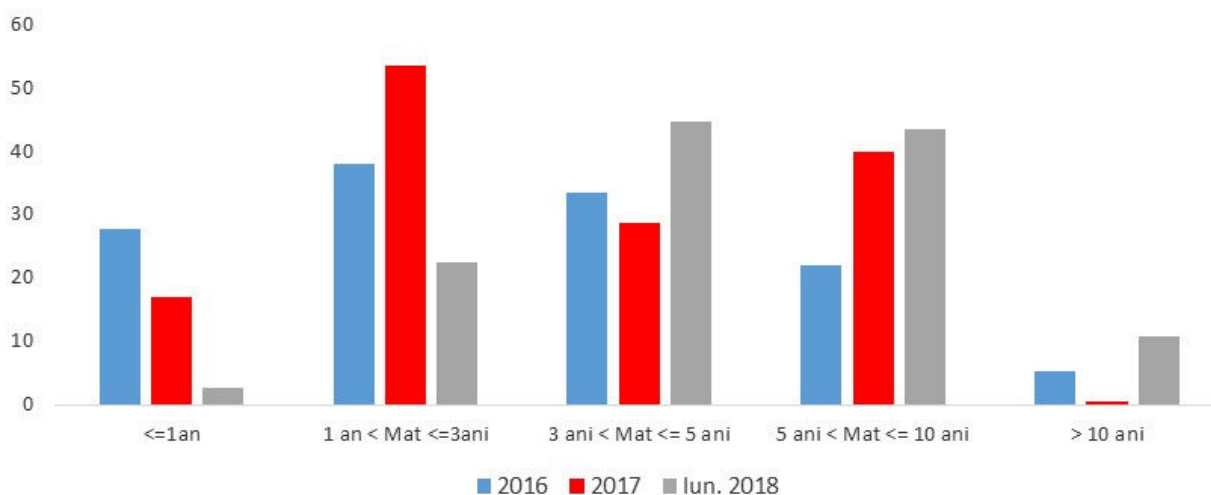
During 2017, MoPF sought to ensure a constant and continuous presence on the domestic market, by regularly organizing government security auctions, both to satisfy investor demand and to avoid potential pressures in attracting financial resources.

In 2017, the government securities issued on the domestic market amounted to RON 39.9, respectively EUR 340 mil., i.e. approx. 62.7% of the gross financing needs of the central government¹⁵, with the following structure: a) 26.4% 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) 44.4% are issuances of benchmark bonds with 1 and 5-year residual maturities; and c) 29.2% 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 continued as to extend the average maturity of government securities, most securities being issued on the medium and long maturities segment.

In the first six months of 2018, government bonds were issued on the domestic market, amounting to RON 19.2 billion, of which EUR denominated government securities amounting a total of EUR 251 million.

Graph 15: Structure of government security issuances, according to maturities (initial mat., billion lei) – 2016, 2017 and the first 6 months of 2018

¹⁵ Described in chapter 5



Source: MoPF

As of 2017, efforts focused on by the improvement primary dealers' performances, on the development 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 updating 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.

External market

Evolutions of external markets and Romanian Eurobonds in 2017 and the first 6 months of 2018

Throughout the year 2017, the evolution of the sovereign bonds market was, to the largest extent, influenced by the initiation of Brexit negotiations, the organization of elections in several Member states of the EU, the intensification of expectations regarding the increase of reference interest rates, especially on the USA market.

On the USA market, in December 2017, the USA Federal Reserve (FED) increased the reference interest rate by 25 base points. In March and June 2018, the monetary policy rate increased once again, currently reaching the level of 1.75% - 2.00%.

As of April 2017, the European Central Bank (BCE) gradually reduced the level of monthly acquisitions of securities issued by states in the Eurozone from EUR 80 billion to EUR 30 billion and respectively EUR 15 billion as of October 2018, the massive stimulation program being presumed to conclude by the end of this year, levelling off, though, the interest rates until the summer of next year.

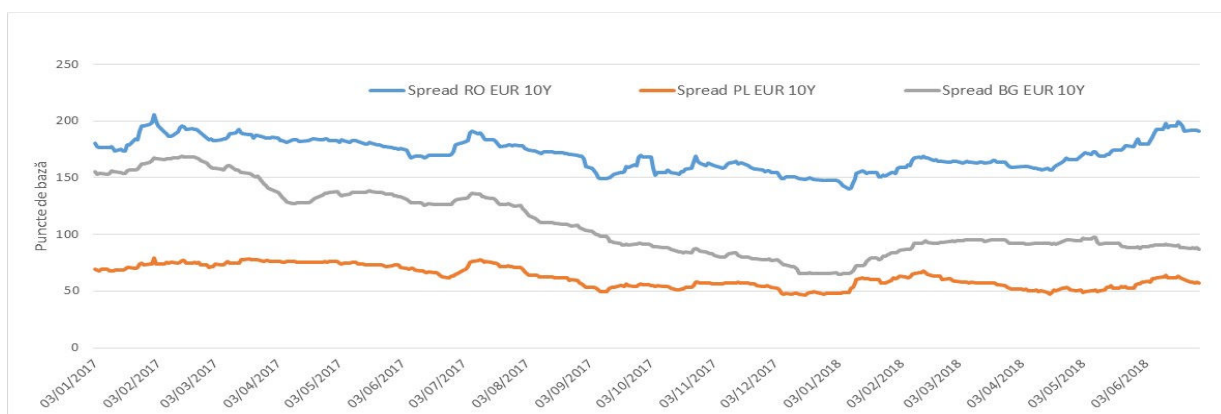
The first 6 months of the year 2018 presented periods of uncertainty, a first signal being the significant drop in the exchange indices¹⁶ due to the market correction and the increase in

¹⁶ During February 5th of the Dow Jones Industrial Average by 1500 points

the yields of the sovereign bonds¹⁷, the investors anticipating that the higher inflation in the United States shall determine the Federal Reserve (FED) to accelerate the increase in the interest rates.

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 with a maturity at 10 years saw an ascending trend throughout the year, varying within the 150-200 base points interval.

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 Eurobonds denominated in EUR and USD registered a decreasing trend throughout 2017, however as of 2018 the yields registered an upward trend. 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, in the same rating category.

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

¹⁷ The yield of American treasury securities with a maturity at 10 years increased over the level of 2.85% for the first time in January 2014, and that of German securities with the same maturity increased by 0.05 percentage points to 0.77%, the highest level in two years.



Source: MOPF

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

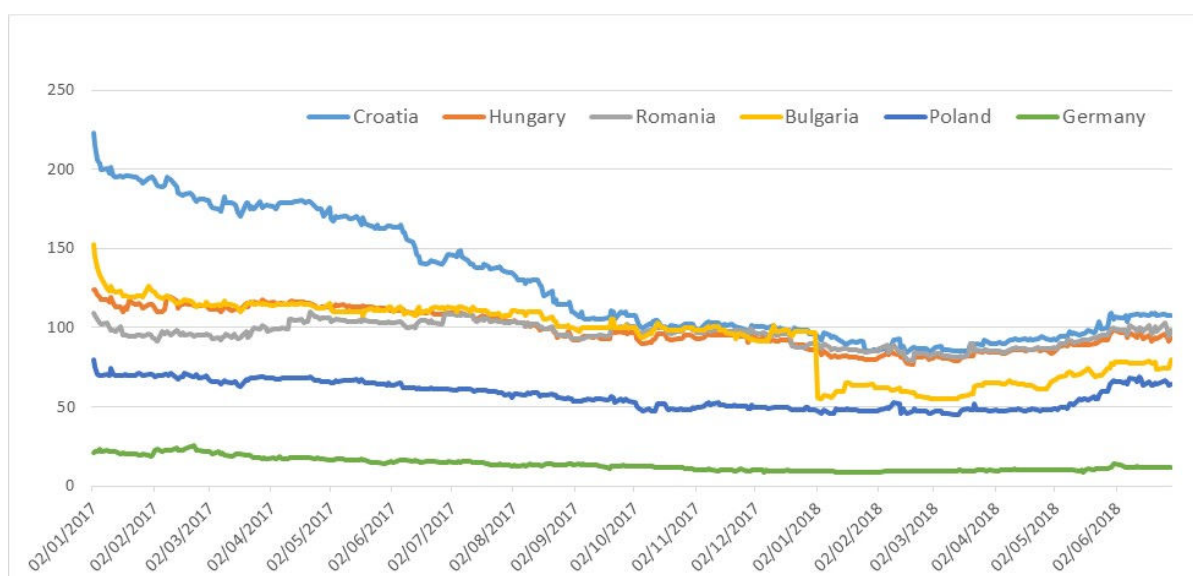


Source: MoPF

In a context dominated by very low and even negative yields of baseline bonds throughout 2017, 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)¹⁸ quotations, as price of insurance against the risk of default, saw a decrease of approx. 15 base points during the year, the level at the end of 2017 being comparable with the levels of other countries in the region such as Bulgaria and Hungary.

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

¹⁸ CDS performance reflects the investors' perception of the country risks and has an impact on the related country's financing costs.



Source: Bloomberg

Implementation of the plan of financing from the external markets in 2017 and in the first 6 months of 2018

In 2017, the MoPF raised from the external markets EUR 2.75 billion through two transactions in the MTN Programme.

In April 2017, EUR 1.75 billion was raised by a two-installment 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.

In October 2017, the issuance of Eurobonds denominated in EUR with maturity at 10 years, launched in April 2017, was reopened for a volume of EUR 1 billion, at a yield of 30 base points below the one registered at the time of the initial launch.

The implementation of the external financing plan for the year 2018 started at the beginning of February 2018 with the launch of the first external issuance, in two installments, denominated in EUR, with maturities at 12 and 20 years, coupons of 2.500% and 3.375%, with a total value of EUR 2 billion, of which EUR 0.75 billion for the 12-year installment and EUR 1.25 billion for the 20-year installment.

The operations on the external market in 2017 also included drawings of approx. EUR 606 million relating to loans obtained from International Financial Institutions.

In June 2018, a new issuance was launched in USD with maturity at 30 years and a 5.125% coupon, amounting to USD 1.2 billion, together with the first partial buyback transaction anticipated for existing bonds in USD with maturity in 2022, 6.75% coupon, created by the Romanian State.

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

Issuance date	Currency	Maturity	Awarded value (thousand)	Coupon (%)	Initial yield	Yield 29.06.2017
07.02.2012	USD	07.02.2022	1.500	6,75	6,875	4,009
06.03.2012			750		6,450	
15.06.2018			-231			
07.11.2012	EUR	07.11.2019	1.500	4,875	5,040	-0,119
22.02.2013	USD	22.08.2023	1.500	4,375	4,500	4,166
18.09.2013	EUR	18.09.2020	1.500	4,625	4,769	0,034
28.10.2013			500		4,150	
*hz22.01.2014	USD	22.01.2044	1.000	6,125	6,258	5,239
22.01.2014	USD	22.01.2024	1.000	4,875	5,021	4,270
24.04.2014	EUR	24.04.2024	1.250	3,625	3,701	1,182
28.10.2014	EUR	28.10.2024	1.500	2,875	2,973	1,278
29.10.2015	EUR	29.10.2025	1.250	2,75	2,845	1,666
25.02.2016			750		2,550	
29.10.2015	EUR	29.10.2035	750	3,875	3,930	3,688
25.02.2016			500		3,900	
19.04.2017			750		3,550	
26.05.2016	EUR	26.05.2028	1.000	2,875	2,992	2,640
05.10.2016			1.000		2,15	
19.04.2017	EUR	19.04.2027	1.000	2,375	2,411	2,344
08.02.2018	EUR	08.02.2030	750	2,5	2,585	2,924
08.02.2018	EUR	08.02.2038	1.250	3,375	3,45	3,754
15.06.2018	USD	15.06.2048	1.200	5,125	5,2	5,362

Source: MoPF

Sovereign rating

The ratings attributed to Romania are Baa3 with a stable perspective from Moody's, BBB-/A3 with a stable perspective from Standard&Poor's, BBB – with a stable perspective from Fitch and BBB/BBB+ from JCRA.

Throughout 2017 and the first 6 months of 2018, the rating agencies reconfirmed the ratings attributed to Romania, based on the perspectives of a solid economic growth and the small weight of the public debt in GDP, signalling the factors which may affect the sovereign rating, such as the continuation of pro-cyclical policies of fiscal easing.

Expectations regarding the evolution of financial markets in 2018-2020

In the following period, the economies of the states in the region and the financial markets shall continue to be influenced by the monetary policies' conduct both at international level and at local level, but under the impulse of the global economic growth. FED is expected to decide to continue increasing the reference interest rate, BCE to reduce the asset acquisition program, actions which shall have a great impact upon the yield curve of the government securities, both on the core markets (the American market and the one in the Eurozone) and on the emergent market.

As such, by comparison with 2017 – during which the downward trend of the rates during the first 9 months and the liquidity requirements had a favorable influence upon state financing, the market context estimated for the following period is a less favorable one from the point of view of uncertainties and the anticipated or estimated monetary policy decisions, both domestically and externally, but also from the point of view of commercial policies and geopolitical tensions more and more mentioned in the reports on the sensitiveness of financial markets.

Internally, according to the Convergence Program approved for 2018-2021, it is expected that Romania's economy continue to perform, the gross domestic product following to increase on average by 5.6% annually, slightly over the potential, following its pace deceleration trend from 6.1% in 2018 to 5% in 2021. The estimations regarding the budget deficit for 2018 do not exceed the 3% of GDP limit, following that as of 2019 the budget deficit shall adjust up to 1.45% in 2021. The level of inflation estimated for the end of 2018 is of 3.6% year/year, according to the most recent RNB report on inflation from May 2018, and of 3% at the end of 2019.

Taking into account the domestic and international context as well as the historical evolutions until now, consideration must be paid to the fact that the sudden changes of the risk aversion on the financial market represent an extremely important risk factor for the following period. As such, reactions of the government securities yield curve may be expected during the execution of the medium-term financing process, but also adjustments of the participation of categories of local investors (such as private pension funds) to the domestic financing process as a result of the international markets' climate and the internal economic and political evolutions, given the fact that the market expectations converge toward increases in the level of interest rates.

Medium-term financing process

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 of amounts equivalent to 2,5 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 NBR¹⁹, 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 over the level accumulated until now. 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.

Within the financing process, a flexible structure of the maturities shall be considered, but which shall allow the further extension of the debt portfolio duration and the reduction of the refinancing risk. In this respect, the structure of the local investment basis is important, in which the weight of government securities holdings of commercial banks is still maintained at a high level. According to the RNB report on financial stability from June 2018, the banking sector holds approximatively half of the public debt issued on the domestic market, government securities representing approximatively 22% of their assets.

As such, in the predictable scenario regarding the increase in the interest rates or in the risk premium for emerging markets, category in which Romania is also included, government securities holdings may have a negative effect upon the profitability and capitalization of the banks, as a result of the acknowledgement of losses from the market marking of held fixed income instruments which shall most likely generate a mitigation of banks' demand at government securities auctions, even though the government securities holdings represent another important liquidity source for the banking system, being accepted as assets eligible for monetary policy operations.

To the same extent, of importance is the evolution of the level of participation to the government securities market of other categories of local investors, respectively investment funds and private pension funds, with an important potential in supporting the development of the domestic market of government securities.

In this context, in implementing the medium-term financing plan, the MoPF is considering measures to diversify government securities holdings with an effect upon the reduction of the concentration risk and of the pressure on primary market yields. With this purpose but also in order to increase the accessibility of individuals and the diversification of sales channels for government securities as savings instruments, a program is currently carried out for the distribution of the government securities for the population, both through operative units of the State Treasury and through the network of units of the Comania Nationala Posta Romana (Romanian Post Office).

With regards to accessing the *external market*, given the fact that new interest increases are expected on the American market in 2018, if American economy maintains its positive evolution and the European market offers advantageous financing conditions, the MoPF intends to maintain its presence in the international capital markets, particularly with bonds denominated in EUR, the issuances denominated in USD on foreign markets, or in other foreign currencies, shall be considered as a financing alternative, under the condition of

¹⁹ Auctions for buy backs and switches shall be conducted through the e-platform developed by NBR for the primary market auctions.

obtaining advantageous costs or in the case of external events that may limit access to some segments of maturity on the European market. Furthermore, after a first exercise performed in June 2018 by the partial buyback of USD bonds due in 2022, due consideration is paid to the continuation of performing asset management operations, if the market conditions are favorable, for example, by means of the buyback/exchange of issuances denominated in USD on the external markets with new issuances denominated in EUR or USD, with a very long maturity.

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/or other similar instruments) 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 (years)	Value (billion)		
		2018	2019	2020
Domestic market				
1. T-bills	6 months to 1 year	14-15	10-12	8-10
2. Benchmark bonds in RON	up to 15 years	32-35	38-40	35-37
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 (EUR equiv.)				
- EURO/USD	Over 10 years	4.75	4.0	3.0
2. Loans from IFIs:				
a) EIB loans (incl. SPL), IBRD, CEB etc.	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	0.1-0.25	0.2 – 0.36	0.2-0.42
b) DPL loan	up to 20 years	0.2	0-0.2	0-0.3

Source: MoPF

5. Macroeconomic framework in Romania

In 2017, the economy saw a 6.9% economic growth, the best rate since 2008, given the dynamics of the individual consumption sustained by tax cuts and salary increases, thus obtaining the largest annual economic growth 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

2018-2020 it is estimated that the gross domestic product shall increase at an annual average pace of approximately 5.8%.²⁰

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

After two consecutive years in which the consumption price index decreased, inflation became positive in 2017, when its rhythm accelerated in the second half of the years, mainly because of the increase in food-stuffs and energy prices. Romania concluded the year 2017 with an inflation rate of 3.32%²¹ and for the year 2018²², due to the disappearance of the basic effect of measures adopted throughout the year 2017, it is estimated that inflation shall increase, reaching 3.2% at the end of the year. Between 2019-2020²³, a gradual decrease of inflation is expected, to 2.8% in 2019, respectively 2.5% at the end of 2020.

In the year 2017, the current account deficit increased to 3.4% of GDP on the basis of the significant acceleration of consumption, registering the highest level since 2011. On the medium-term, it is estimated that the current account deficit shall be maintained within sustainable limits, dropping from 3.1% of GDP in 2018 to 2.6% in 2020.²⁴

The macroeconomic framework configured for 2018-2021 considered: (i) the positive impact of measures stipulated within the Governing Program and adopted by the executive with regards to the business environment and the population's purchasing power, (ii) the evolutions regarding the European and Global contexts emphasized within the European Commission's winter prognosis, characterized by the tendency to mitigate uncertainties, (iii) the economic-social achievements of 2017 and the first months of the year 2018.

The fiscal easing measures which started in 2015-2016 with the purpose of stimulating economical growth and continued through the normative acts adopted in the year 2017, as those in the sector of budgetary expenses, 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, which was achieved in 2015 whereas in 2016 a deviation from it was registered, and further, a gradual reduction of the structural deficit should start in 2019 as to achieve the MTO within a certain time horizon. 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. 65% of the gross financing needs, as seen in the table below:

Table 8: Financing needs forecast

Indicator	2017	2018 forecast	2019 forecast	2020 forecast
Central government revenues (billion lei) ²⁵	195.2	241.9	264.1	284.9
Central government expenses (billion lei) ²⁶	221.1	271.4	291.8	307.3

²⁰ Source: NCSP, spring April 2018 prognosis

²¹ Source: NSI

²² Idem 20

²³ Idem 20

²⁴ Idem 20

²⁵ Computed based on cash data, by applying EU methodology.

²⁶ Idem 25

Budgetary deficit relating to the central government (I) (billion lei) ²⁷	25.9	29.5	27.7	22.4
Government debt refinancing ²⁸ (II) (billion lei)	40.1	42.3	42.5	32.5
Gross financing needs (I+II) (billion lei)	66.0	71.8	70.2	54.9

Source: MoPF

The macroeconomic hypotheses of the 2018-2020 Strategy are shown in the table below.

Table 9: Basic scenario of macroeconomic projections

Indicators	2017	2018forecast	2019forecast	2020 forecast
Nominal GDP (billion lei)	858.3	930.0	1,001.3	1,078.3
GDP growth (%)	6.9	6.1	5.7	5.7
Budgetary deficit relating to the central government ²⁹ (% of GDP)	-3.03	-3.2	-2.8	-2.1
Current account deficit (% of GDP)	-3.4	-3.1	-2.8	-2.6
Inflation (year end %)	3.32	3.2	2.8	2.5
Inflation (annual average %)	1.34	4.3	2.8	2.6
RON/EUR average exchange rate	4.5681	4.65	4.62	4.6
RON/USD average exchange rate	4.0525	3.78	3.76	3.74

Source: NCSF, MoPF, NIS

Risks relating to initial projections

Deviations from the macroeconomic projections in the baseline scenario described above could come from the quicker than expected toughening of the American monetary policy, the BCE's withdrawal from the quantitative easing policy, the high level of the prices of certain assets, the uncertainties triggered by the negotiations regarding Brexit, the geopolitical tensions, as well as the external events (such as the international commerce's trend as a result of the adoption of the protectionist policy at the level of the USA economy), all these may lead to volatility affecting the investment appetite regarding financial assets issued by emerging economies.

These factors may generate high volatility on international financial markets, in the conditions of the toughening of the current monetary policy of FED³⁰ and ECB³¹; such volatility may lead to temporary increases of worldwide aversion to risk, which affects emerging economies..

External shock linked with such risks may lead to the decrease of economic growth, by the decrease of exports of capital outflows³², 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.

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).

²⁹ *Idem* 25

³⁰ The federal reserve started the consolidation cycle of the monetary policy, increasing the interest rate of the monetary policy 3 times, in 2017. In March and June 2018, FED increased the monetary policy interest rate, and it is currently between 1.75%-2.00%.

³¹ BCE decided to reduce the asset acquisition program and petitioned that it anticipates the closure of the program until the end of the current year.

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.

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 increase of the inflation rate over the forecast level, due to the occurrence of certain unfavorable weather conditions with impact on the contribution of the agricultural production to the achievement of the GDP, while the main foreign risks are linked with fears regarding the fast deterioration of the investors trust in emergent economies and the international events which amplify the recent geopolitical tensions which could lead to the exchange rate depreciation.

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, such as pension funds or 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 2018 is less favorable as compared with 2017. Domestically, given the increase in inflation, 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 correlated with the BCE's withdrawal from the quantitative easing program and the expectations regarding the increase of the reference rate.

6. Analysis and strategic guidelines

The strategic guidelines for managing public government debt in Romania reflect the cost-risk tradeoffs in the current debt portfolio³³, the plans to develop the domestic market of government securities and the medium-term macroeconomic framework.

³³At end- 2016.

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 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. The analysis shows that, currently, with the framework for the use of derivative financial instruments for managing the risks associated to other foreign currencies lacking, USD funding is both more expensive and riskier compared to funding in EUR³⁴. However, the cost associated to the long and very long term use of hedging instruments must be taken into consideration. Besides, FED monetary policy with expectations of higher reference rates³⁵ will affect negatively the volatility and yields of Eurobonds issued by emerging economies and shall influence the parity of the EUR/USD exchange rate.

The market background forecast for the 2018-2020 time horizon involves considerably more challenges, given the anticipated domestic and foreign monetary policy decisions, especially from the point of view of the BCE's relinquishment of the quantitative easing, on the basis of increasing inflation expectations and the inevitable increase of reference rates.

Starting from the second half of 2018, 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 market risk factors are the conduct of the fiscal-budgetary policy, the adjustment of the structural deficit to the 1% target in the medium term, 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 and increasing interest rates, given the FED and BCE policies.

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 by reporting the cost resulting from applying shocks to the market rates used in the baseline scenario to the cost 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, 2020. The results of the cost-risk analysis are then complemented

³⁴ The current yields (on 5 July) relating to Eurobonds in EUR, maturing in 2028, being approx. 2.60%, while those for Eurobonds in USD, maturing in 2024, are at approx. 20%.

³⁵ FED increased the monetary policy rate three times in 2017 and twice in 2018 until it reached an interval between 1.75% and 2.00%..

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

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

Extension of average time to maturity (ATM) for local currency debt: 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 by using the electronic trading platform for the secondary market (E-bond) implemented in the year 2017 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.

Decrease refinancing risk by rollover of T-bills denominated in lei using Euro-denominated government securities: 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.

Structure of the foreign currency portfolio: 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.

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, given the cost associated to the use of long and very long term hedging instruments, 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, received technical assistance from the World Bank Treasury, for 25 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, following that MoFP improve the legal framework regarding the use of derivative financial instruments and elaborate internal work norms and procedures.

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, maintaining any opportunistic access to international capital markets in currencies other than EUR, under a cost/risk ration favorable to the Romanian state and the diversification of the investor database.

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 2018 -2020:

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 lei³⁶.
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 at a convenient level 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.

Foreign exchange risk:

1. Securing net financing more from domestic sources³⁷ 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. Keep the share of debt denominated in EUR in total foreign currency debt between 80% (minimum) and 95%. Upon the use of these derivative financial instruments, this indicator shall be calculated after the assessment of the debt as a result of the currency swaps.

Refinancing risk

1. maintaining the weight of the debt due within 1 year within the interval 15% and 25% (maximum) for the debt in the national currency and between 10% and 20% (maximum) for the total debt.
2. Maintaining the average maturity remaining within the interval of 3.5 years (minimum) and 5.0 years for the debt in the national currency and between 5.5 years (minimum) and 7.0 years for the total debt.
3. Maintaining a foreign currency reserve³⁸ at a convenient level, so as to reduce the risks associated to the periods characterized by high volatility on the financial markets.

Interest rate risk

1. Maintain the share of debt maturing in the next year between 15% and 25% (maximum) for the local currency debt and between 10% and 20% (maximum) for total debt.
2. Maintain the average time to re-fixing 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 2018-2020
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) 15% - 25% (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) 15% - 25% (maximum) 5.5 years (minimum) – 7.0 years 3.5 years (minimum) – 5.0 years

Source: MoPF

The implementation of the 2018-2020 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

³⁷ Approximately 75% of the deficit will be financed from domestic sources in the Strategy-covered period.

³⁸ The foreign currency financial reserve represents the resources under foreign currency available to the State Treasury, and currently, is established at a level which shall cover 4 months of the gross funding need.

supplemented, the strategy may be revised annually or any time required by the market conditions and/or financing needs.

**Eugen Orlando TEODOROVICI
MINISTER OF PUBLIC FINANCE**

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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, simultaneously with the increase in the value of benchmark securities up to equivalent EUR 2.5 billion;
- 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, the Romanian Post Office and the interested credit institutions;
- 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 or of EUR 2.5 billion upon the introduction of the exchange and in-advance buy-back operations of government securities;
 - 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 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 (liquidity) 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. Further maintaining the desideratum 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. Concurrently, it must also be noted that the recent legislative amendments in the fiscal sector implemented at the beginning of 2018 shall lead, at least throughout 2018, to certain uncertainties with regards to predicting the monthly receipts and payment flows, with an impact upon the time period needed for the realization of the prognosis of the general current account of the State Treasury.

2. *Adopt a more active management of cash (liquidities)* for the decrease of balance fluctuations, both by the issuing of T-bills or by contracting loans on the 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 2018, the State Treasury intends to issue T-bills or to contract loans on the short term³⁹. Concurrently, the possibility of adopting a more active conduct with regards to placing resources, predominantly as reverse repo transactions⁴⁰, based on a prior consultation with the RNB, for the coordination of the financing policies and cash management policies with the ones of monetary policy. The introduction of T-bills and loans on 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. As to *consolidate the institutional framework*, to secure the improved coordination of the budgetary deficit financing, the management of government public debt and of state liquidities, in the year 2017, monthly meeting were held by the *State Treasury's Financial Flows Planning Commission*, with the participation of the MoPF, ANAF and NBR representatives. The debates within the monthly meeting were registered under minutes, which were subsequently sent to inform the MoPF and, respectively, ANAF management. Concurrently, so as to improve the transmission of information between the institutions, the order through which the Commission was created suffered amendments by enhancing its composition, thus inviting as well representatives of the National Prognosis Commission and the National Institute for Statistics.

4. Another short-term instrument of the deficit is given by *borrowings from the State Treasury General Current Account balance amounting to RON 52.4 billion* at the end of December 2017, 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 0.05% in 2017 this instrument has a number of disadvantages as well, such as:

³⁹ Under a year

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

- 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;
- 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.