

ROMANIA

ECONOMIC & FINANCIAL OUTLOOK

ECONOMIC RESEARCH DIVISION

JANUARY 2019

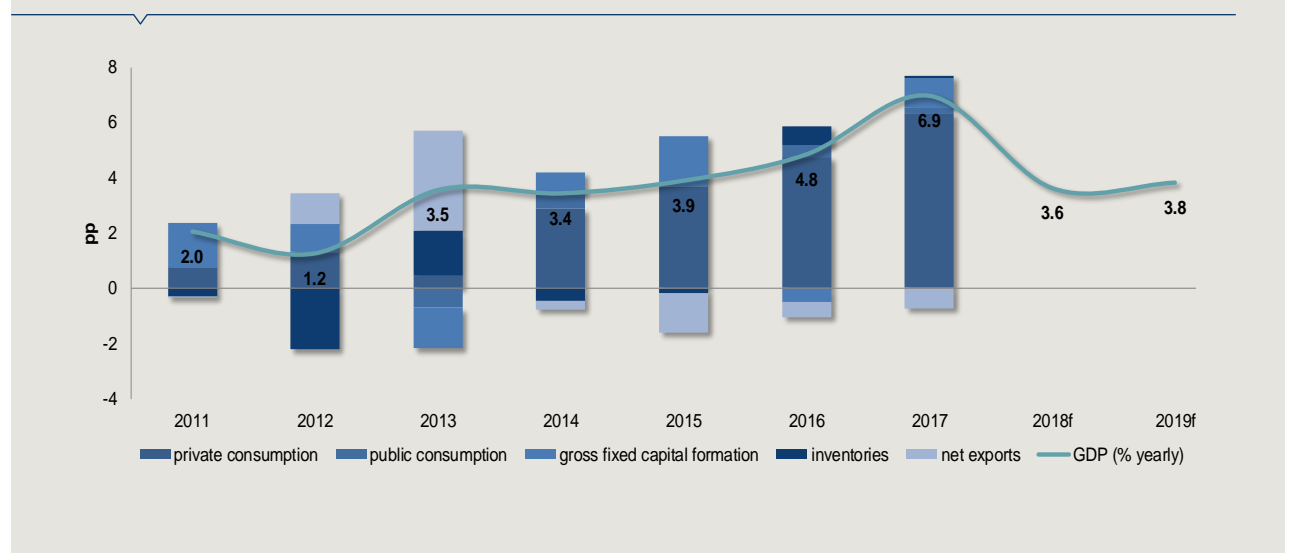
Growth decelerates but remains strong

After the recession in 2009-2010, the Romanian economy registered positive GDP reading for the seventh consecutive year in 2017, while GDP per capita reached €9,600 (corresponding to 32% of the EU average level), from €7,100 in 2008 (27.3% of the EU average). Although the convergence process - in order for the country to enter the Eurozone - advanced after 2008 and GDP per capita grew faster than the EU average, significant catching up is further needed. The remarkable GDP growth performance of the last two years (+4.8% in 2016 and +6.9% in 2017) was driven by expansionary policy measures such as minimum wage hikes, public sector salary increases and tax cuts. The above measures boosted private consumption, which increased by 7.7% in 2016 and 10.2% in 2017 in real terms. Investment returned to growth in 2017, supported by the expansion of private investment in residential construction and equipment. Public investment declined for the second consecutive year and reached its lowest post-2008 share in total investment (12.4%). Romanian exports were supported in 2017 by the recovery in the EU, the country's main trading partner. Nevertheless, imports continued to rise faster than exports resulting in the tripling of net exports on an annual base, and therefore denting 0.8pp from the overall GDP growth.

On the supply side, the positive contribution to the overall GDP growth in 2017, of industry, agriculture and services – with the exception of trade, transport, hotels, restaurants (TTHR) and Information Technology (IT) – was even larger than 2016. In particular, industry, the sector with the highest exporting activity, has an increasingly positive impact to growth since 2013. It is worth noting that Romania, a newly industrialized country, had the fourth largest industrial gross value added in total value added, after Czech Republic, Slovenia and Poland. IT services although contributed negatively in 2017, had a remarkable evolution in the last few years. During 2011 - 2017, employment in the sector increased by 50% and its share of gross value added rose from 4.3% to 5.7%, beating the EU average (5%). Although the share of the agricultural sector in total value added remained the largest among EU countries, at 4.8% in 2017, (EU average: 1.6%), is on a declining path in the last two decades. Because of the sector's considerable size and dependence on weather, the contribution of the agricultural gross value added to the overall GDP growth has fluctuated between -1.8pp and +1.6pp post-2008.

GRAPH 1

Contributions to Real GDP Growth – Demand Side



Source: INSSE

Despite that the TTHR share of GDP was smaller than that of Industry, the contribution of the gross value added from TTHR has exceeded for several years that of industry, due to the faster annual growth of TTHR. The gross value added in TTHR doubled in 2017 compared to 2010, while in industry it increased by 10% in real terms. The industry expanded with job losses, while TTHR expanded with job creation.

The shift in the mix of the social security contributions (35% on employees' charge from 16.5% and 2.25% on employers' charge from 22.75%), as well as the new income tax rate (10% from 16%) –the so called “fiscal revolution” implemented at the end of 2017– caused uncertainty over employees' pay, as a 20% rise in the gross wage was required for net wages to remain unchanged. Although the tight labour market (employment rate reached a 20-year high) left room for wage increases, the evolution of wages remained at risk. This uncertainty affected negatively consumer confidence, which in turn led to the fall of private consumption and resulted in GDP growth deceleration to 4.1% in the first half of 2018.

According to the European Commission (Autumn 2018 Economic forecast), real GDP is estimated to continue to grow albeit at a lower and more sustainable pace, moderating to 3.6% in 2018 and 3.8% in 2019, from 7.3% in 2017.

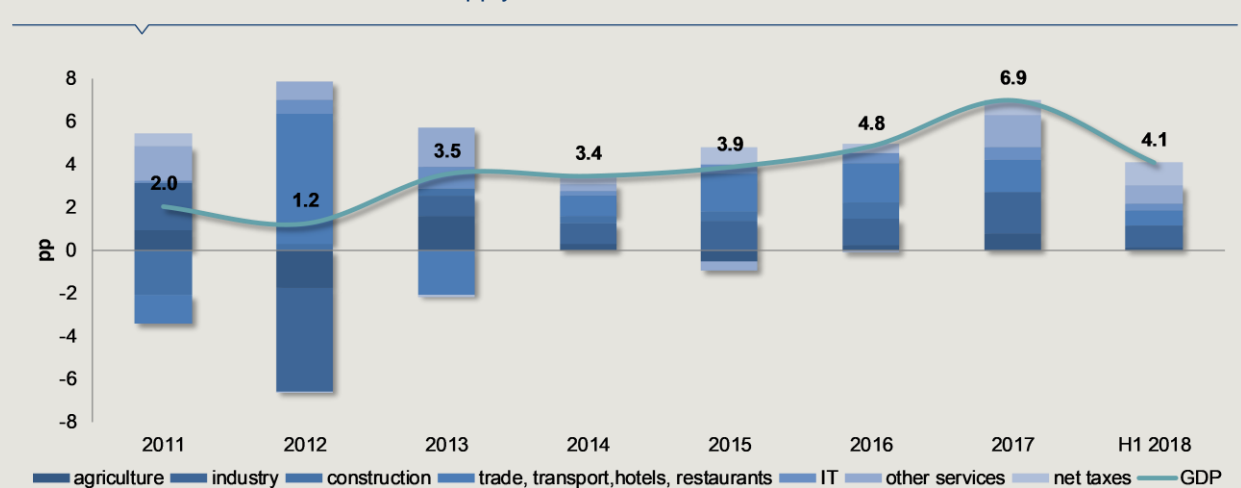
During the economic boom, the policy was focused on wage increases at the expense of investment. The fast wage growth reignited inflation and widened the current account deficit. These developments led to the tightening of the monetary policy, in order to curb inflation. Raising the interest rates at home, in opposition to the ultra-accommodative monetary policy in euro area and the neighbouring countries, could stimulate speculative capital inflows, creating appreciation pressures on the domestic currency and thereby further increasing imports and the widening of the current account deficit. Additionally, the wage growth exceeded productivity gains (the nominal unit labour costs increased by 6.1% in 2016 and 9.1% in 2017), thus hindering job creation and constraining the prospects of income increases. Finally, the policy focus on wage and pension increases at the expense of investment, undermining the growth potential of the economy and the economic and financial sustainability, increasing the magnitude of the painful adjustments that will be required later on.

Rising Wages in a Tight Labour market are Pushing Up Inflation

In 2017, net wages in the public sector surged further by 23.7% (2016: +20.9%), while in the private sector by 11.9% (2016: 11%), resulting in an overall net wages increase by 14.2% compared to 13% in 2016. Wages in the public sector were 20.1% higher than in the private sector in 2017 compared to 2015, when there was no gap between them. In November 2017, the government adopted Emergency Ordinance No 79/2017, which substantially changed the structure of social contributions by shifting the burden almost entirely to the employees, setting the new contributions at 2.25% for employers and 35% for employees, from 22.75% and 16.5% respectively.

GRAPH 2

Contribution to Real GDP Growth – Supply Side



Source:
INSSE

It also reduced the personal income tax (PIT) rate from 16% to 10% and raised the PIT-gross wage threshold from RON3000 to RON3600, for which personal deductions are allowed. These changes, that entered into force on January 1, 2018, followed the Unified Wage Law (UWL), which was adopted in the summer of 2017. The UWL legislated a 25% gross wage increase for most government employees in January 2018 and additional increases in the health and education sectors. In addition, to compensate for the shift in social contributions, the government increased the minimum gross wage by almost 33% to RON1900 (€413) and requested social partners to re-negotiate the wages in the private sector.

In 2017, employment growth was robust and the employment rate of people aged 20-64 increased to 68.8%, almost reaching the “Europe 2020” national target of 70%. The activity rate (working age population / total population) has also been increasing steadily since mid-2016, yet remains one of the lowest in the EU. Romania is facing unfavorable demographics, as the population is on a declining trend for almost three decades and continued emigration poses an additional challenge (3.6 million Romanians were living abroad in 2017). Despite recent improvements, labour force participation rates, particularly for women and people over 50, remain well below the respective EU average. If the activity rate of people aged 20-64 in Romania rose to the EU average level, then its active population would increase by 700 thousand people (nearly 8pp).

The skills shortage and the rising labour cost put a halt on job creation, despite the historically low unemployment. The number of vacancies remained virtually unchanged in 2017 and declined in the first two quarters of 2018 (by 5.2% on average) compared to the first two quarters of 2017. The only sectors which continued to create jobs were IT, TTHR and industry (in the second quarter of 2018).

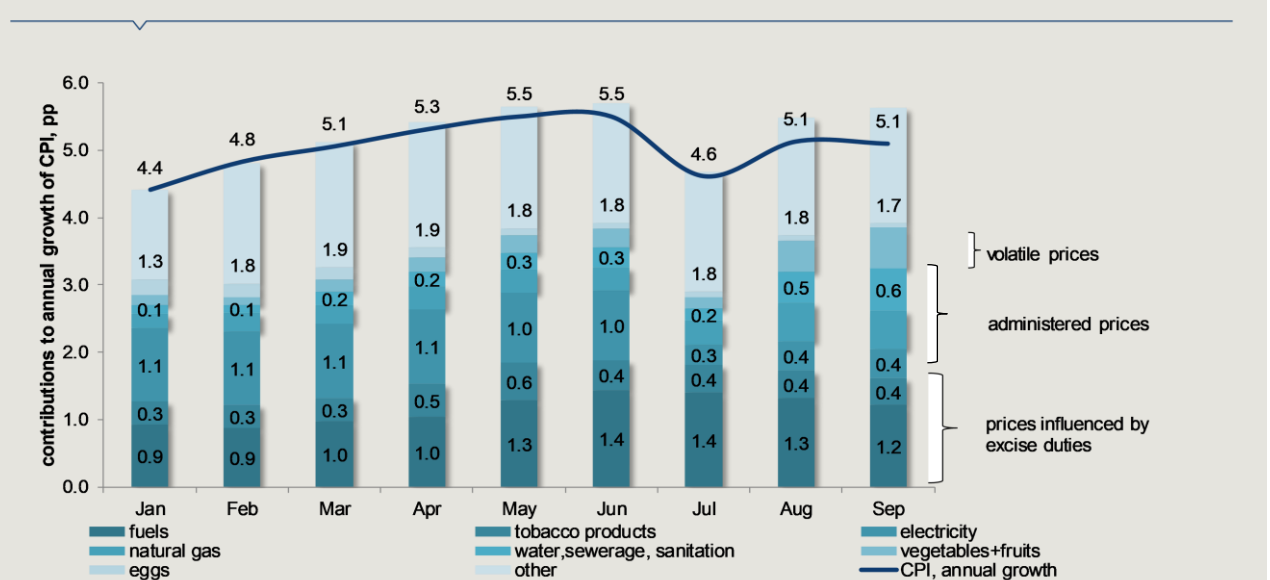
CPI inflation accelerated in Q4 2017, remaining, however, within the targeted range by the National Bank of Romania (NBR) (2017: 1.34%). However, since the beginning of 2018, CPI inflation exceeded the upper bound of the targeted interval ($2.5\% \pm 1\%$), standing at 5.0% in March, 5.4% in June and 5.0% in September 2018, respectively. The boost in inflation was due to the reintroduction of an additional excise tax on fuel (in two waves, on September 15 and October 1, 2017), the liberalisation of the electricity price in October 2017 and sustained increase in oil prices. Inflation pressures are expected to be limited, as base effects will fade away. According to the last available projections by the National Bank of Romania (Inflation Report, November 2018), CPI inflation is expected to reach 3.5% in the fourth quarter of 2018 and to further decelerate progressively, approaching 2.9% in the last quarter of 2019.

Strong Credit Expansion amid Monetary Policy Tightening

In order to slow down the mounting inflationary expectations, the NBR decided to tighten its monetary policy stance and therefore raised the interest rate three times between January and May 2018 by 0.75pp in total,

GRAPH 3

Significant Contribution of Exogenous factors to Price Inflation, Jan-Aug 2018



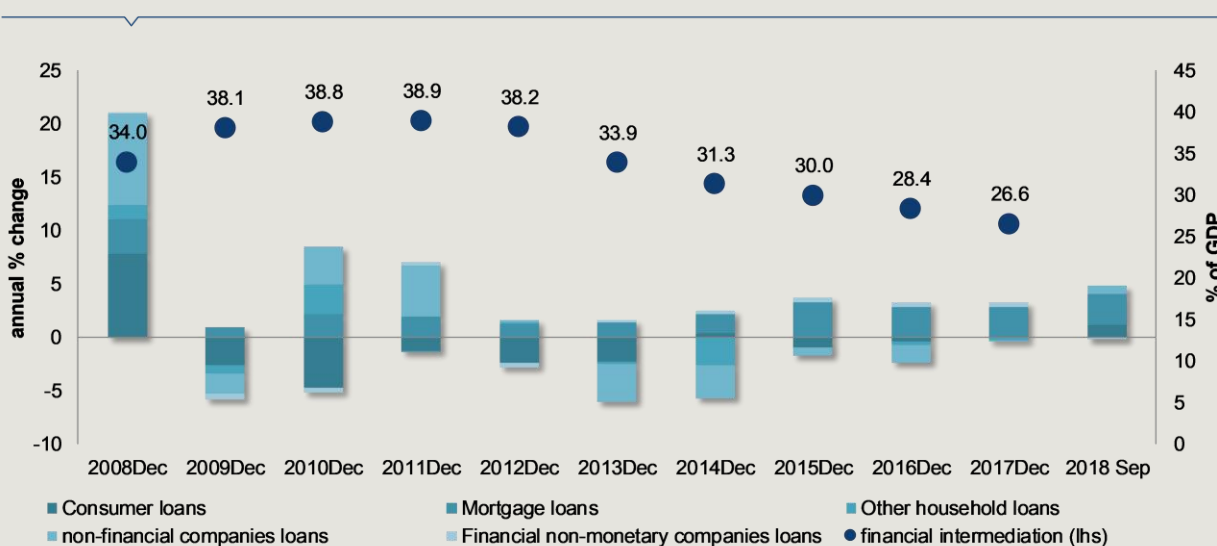
Sources:
INSSE

from 1.75% in December 2017 to 2.5%. Interest rates for households and companies increased by 1.7pp and 1.1pp respectively for new loans, and by 0.7pp and 1.2pp respectively for new deposits, between December 2017 and August 2018. The efficacy of the monetary policy change is due to the fact that since 2014 banks have been lending almost entirely in domestic currency, thus the share of domestic currency, non-government credit as a percentage of total non-government credit rose to 65.4% in September 2018 from 39.1% in December 2013. In addition, the share of new loans denominated in domestic currency, with floating rates or with fixed interest rates that are set for a period of less than one year remains high, i.e. 62% in September 2018, from 72% in December 2017, despite the fact that there is a tendency to increase the fixed interest rate period.

In spite of the interest rates increase, lending has strengthened: annual growth exceeded 6% after August 2017, putting an end to a period of two years of sluggish lending. After 2011, the only driver of non-government credit expansion was the disbursement of housing loans, that was supported significantly by the “Prime Casa” programme, an action launched in mid-2009, that boosted government guaranteed loans for first-home buyers. Despite the double-digit growth however, it was only in the period between 2015-2017, that the expansion of mortgage loans not only offset, but also exceeded the contraction of consumer loans and of non-financial corporate loans. Nevertheless, housing loans as a percentage of GDP remained the lowest in the EU, standing at 7.6% in 2017, while financial intermediation, i.e. the ratio of private sector credit to GDP, entered a declining trend in 2008 and remains the lowest in the EU ever since.

In 2018, the credit growth drivers were diversified, representing a turning point in the evolution of credit. Alongside housing loans, consumer loans as well as non-financial corporate loans contributed positively to credit expansion. It is estimated that the expansionary credit cycle will continue and further strengthen, putting an end to the declining financial intermediation which reached 26.5% in 2017.

The Romanian banking system has a strong capital base and adequate liquidity. In June 2018, the capital adequacy ratio stood at 20.07% (19.97% in Dec 2017). The system-wide average liquidity coverage ratio stood at 248% in July 2018, exceeding the EU-wide average of 148.5% (Dec. 2017), while the immediate liquidity ratio stood at 37% in May 2018. The ratio of nonperforming exposures (according to the European Banking Authority’s definition) reached 5.5% in August 2018, down from 6.4% in December 2017. The banking sector registered profits in 2017 for the third consecutive year, with the Return on Assets ratio (ROA) standing at 1.3% (1.66% in June 2018) and Return on Equity (ROE) at 12.51%, from 15.71% in June 2018. The loans-to-deposit ratio declined to 0.77 in December 2017 (0.79 in September 2018) from 0.8 in December 2016. Finally, it is worth noting that the funding of the banking sector, which is mainly short-term, relies on financing sources from the domestic market.

GRAPH 4
Contribution to Credit Expansion


Sources:
NBR, INSSE

The capital adequacy, the sufficient liquidity levels and the declining non-performing loans ratio are indicative of the capacity of the Romanian banking sector to accelerate lending. Unfortunately, there are risks as well. Several legislative proposals aimed at protecting debtors were initiated during 2017, with significant potential impact on the banks' business practices. These proposals refer to (i) the intention to cap the average effective annual rate of housing and consumer loans, (ii) the attempt to limit the recoverable amount of non-performing household loans sold by credit institutions, (iii) the obligation to obtain a court sentence in order to initiate enforcement procedures.

Current account deficit is widening

Fast-growing consumption led to the rising deficit in the trade balance and was the main cause of the current account deficit widening. Nevertheless, the current account deficit to GDP ratio remained below the alert level of 4% defined by the European Commission in its Macroeconomic Imbalance Procedure. The accelerated wage increases in the 2016-2017 period led to a considerable loss of the gains in competitiveness achieved before 2016, when the real effective exchange rate was depreciated in terms of unit labour cost by 15% compared to 2010. Despite the fall of the country's competitiveness, the export market share continued to grow. It should be noted though, that exports' growth might be at risk, if the policy of wage increases continues. Moreover, a significant impact on exports might come from the deceleration of growth in Germany, France and Italy, as projected in the European Commission's latest forecasts. The above countries are actually considered Romania's three largest export partners (accounting for 40% of the country's total exports).

Most of the increase in the trade balance deficit was generated by consumption goods, while the size of the trade balance of capital goods and intermediate goods was maintained. Part of that deficit was offset by the surplus in the trade of services (transport, IT and manufacturing services).

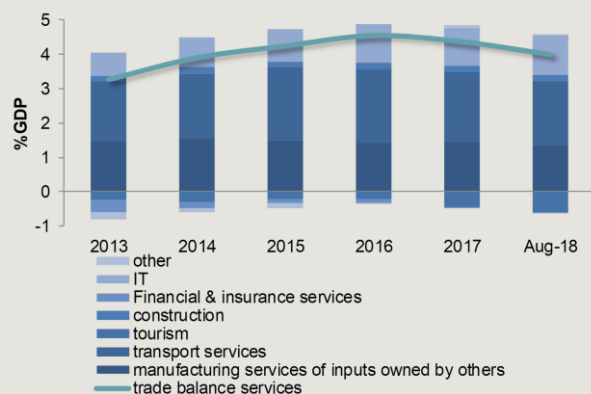
The widening of Romania's current account deficit raises the financing needs. In the first eight months of 2018, besides the net capital inflows, additional €2.6 billion from the international reserves were required to finance the current account shortfall. Net inflows of foreign direct investment (FDI) were down by 6.3% y-o-y, while portfolio investments dropped by 30.9% y-o-y, despite the central bank's tighter monetary policy and the consistent interest rate differential in favor of the Romanian leu (RON) relative to other Central and Eastern European currencies.

GRAPH 5
GRAPH 6

Structure of Trade Balance with Goods

Structure of Trade Balance with Services

(% of GDP)



Note: The figures for July 2018/ August 2018 represent the sum of the previous 12 months divided by the estimated GDP for 2018 of European Commission available in the AMECO database.

Sources:
INSSE

RON evolution shaped by the monetary policy

The Romanian Leu (RON) has remained stable supported by (i) Romania's central bank (NBR) tighter monetary policy compared to its Central Eastern Europe (CEE) peers and (ii) the managed floating exchange rate, based on significant foreign exchange reserves (H1 2018: average imports cover slightly exceeding 5 months). The NBR's rate hikes in conjunction with its strategy to absorb the liquidity in the interbank market mitigated the impact of sizeable currency fluctuations comparing to other regional currencies (PLN, HUF, CZK).

Nevertheless, the impact of the NBR's monetary policy stance will begin to fade away, as central banks in the region, as well as the ECB, start to tighten their monetary policy. Meanwhile, the NBR is clearly keen determined to prevent a sharp appreciation of the Leu (RON), which could exacerbate Romania's external imbalances. Last April, the NBR Governor emphasized that an overly aggressive monetary policy and the subsequent appreciation on the currency stimulate capital inflows easily reversible associated with consequences for the economy. In that context, the NBR could tolerate a more depreciated domestic currency.

Gradual tightening of the fiscal outlook in sight

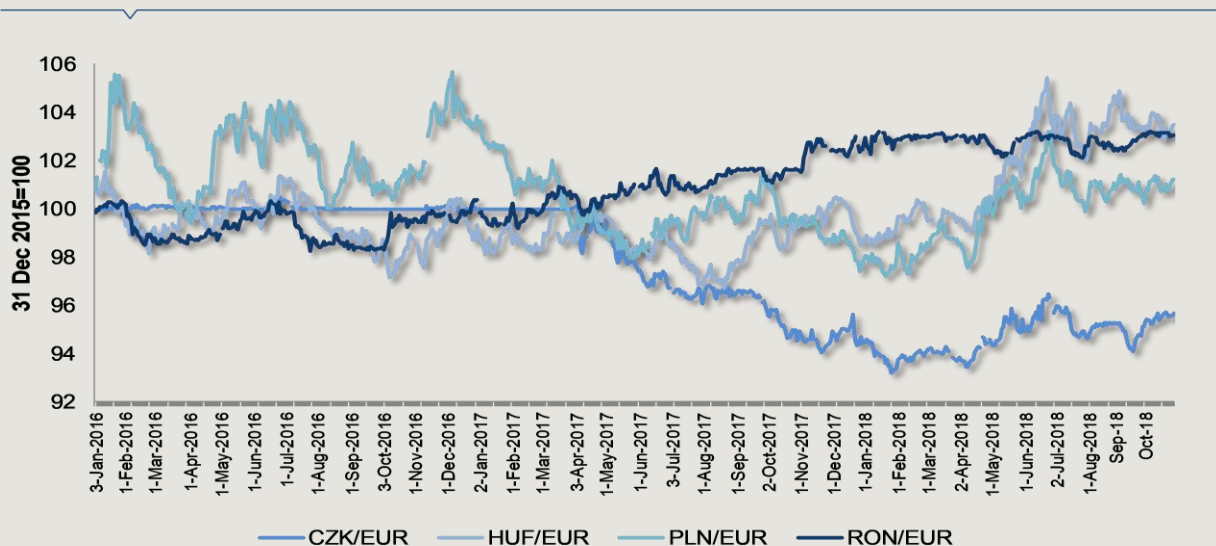
The deficit of the general consolidated budget approached the maximum level of 3% of GDP stipulated in the Stability and Growth Pact (2017: 2.9%, 2016: 3.0%), for a second year in a row. Nevertheless, the gross public debt to GDP ratio declined, for the third consecutive year in 2017, to 35% of GDP, the fifth lowest ratio in the EU and below the level of 60% stipulated by the Maastricht Treaty.

In 2017, Romania had the lowest budget revenue as a percentage of GDP for the 2006-2017 period, which is the second lowest among the EU countries. According to the Romanian Fiscal Council, this is due not only to the low tax rates (16% corporate tax, 10% personal income tax, 19% VAT) but also to the low tax collection efficiency.

According to the European Commission (Autumn 2018 Economic Forecast), government deficit is expected to widen to 3.3% in 2018 and to rise slightly to 3.4% in 2019, while gross public debt (as a share of GDP) is expected to remain almost stable in 2018 to 35.1% (2017: 35%) and increase to 35.9% in 2019. The execution of the general consolidated budget in the first nine months of 2018, seems to back the European Commission's anticipation that the year-end target will be missed, as expenses are growing faster than revenues by 4.8pp.

GRAPH 7

Evolution of currencies in the region



Sources:
National
Central Banks

Moreover, the GDP registered a real growth annual rate of 4.1% for H12018, signaling a lower rate for the whole year than the projected 5.5% upon which the budget was constructed.

According to the government's convergence programme for 2018-2021 (April 2018), a gradual reduction of the general consolidated budget deficit in GDP (in ESA terms) is intended in the medium term, to 2.38% in 2019, 1.82% in 2020 and 1.45% in 2021. Budget revenues are projected to increase gradually up to 32% of GDP in 2021, based mainly on the expansion of social security contributions, from 9.3% of GDP in 2017 to 12.3% of GDP in 2021. On the expenditure side, the gross fixed capital formation of the General Government is projected to reverse the trend recorded in the last years and to gradually increase up to 5% of GDP in 2021.

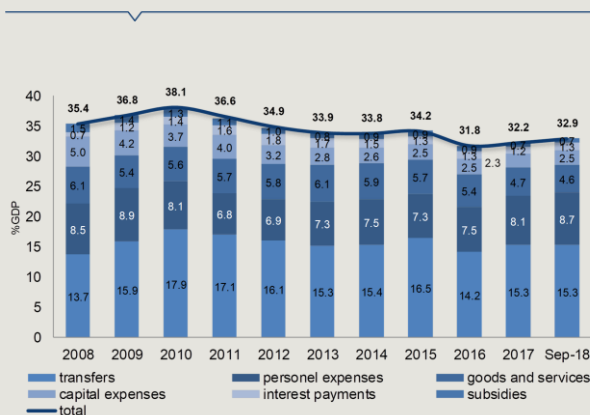
Growth potential: drivers, opportunities and risks ahead

Despite real GDP growth peaking in 2017, Romania's economy is expected to remain one of Emerging Europe's outperformers in the years ahead, suggesting that the country is expected to make further progress on its EU convergence. The fulfilment of this expectation depends on the degree of success in effectively addressing the fiscal reform, the continuously growing migration flows and the bad demographics as well as the institutional inefficiency.

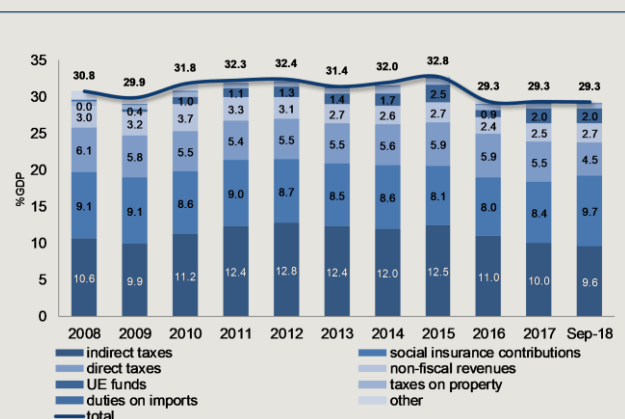
The recent fiscal expansion could jeopardize Romania's impressive fiscal performance in the 2013-2015 period, which resulted in reduced public sector deficit and debt. A failure to pursue contractionary fiscal policy in the years to come, could lead to higher borrowing costs and reduced incentives for foreign companies to locate operations in the country. At present Romania's large population is an advantage, but this is set to change over the next decade unless measures are taken to address the declining population and massive emigration. The ageing population will place additional burden on the country's healthcare system and, coupled with the significant migration of working-age Romanians to other EU countries, could reduce the stock of available working-age adults to shoulder the costs. Finally, with respect to the institutional convergence, despite the progress made, Romania had large gaps in terms of governance indicators compared to the rest of the EU (2016 data provided by the World Bank), particularly in government effectiveness, control of corruption and rule of law. The weak governance is reflected in poor competitiveness, as according to the latest Global Competitiveness Report 2017-2018 Romania is ranked 68th out of 137 countries, behind most EU countries except Croatia and Greece. Among the competitiveness factors, infrastructure and innovative capacity were those in which Romania lagged the most compared to the EU average performance.

GRAPH 8
GRAPH 9

General Government:
Structure of Budget Expenses



General Government:
Structure of Budget Revenues



Sources:

Ministry of
Public
Finances

It is critical for Romania in order to continue its EU convergence process to stimulate GDP growth. Therefore, measures need to be taken to stimulate demand, to accelerate investments both public and private, with focus on raising human capital according to market requirements and improving the transport infrastructure and the digitalisation of the economy. It is worth noting that effective absorption of EU funds is expected to strengthen public investment. Romania has at its disposal €8.3 billion from the European Investment Fund and €22.6 billion from the EU Multiannual Financial Framework (MFF) 2016-2020, for which the absorption rate (in terms of amounts received from the European Commission) stood at 18.52% in June 2018.

Romania's competitive advantages, making the country an attractive destination for foreign direct investment are (i) its large consumer market in terms of population, (ii) its relatively low unit labour cost combined with well-educated workforce, and (iii) its geographic location, as it is cited on the south-eastern frontier of the EU, allowing improved access to eastern markets and acting as a major route for goods entering the Single Market. There sectors that could attract investors' interest are the following:

Agriculture

Agriculture accounted for 4.8% of the gross value added and 23.7% of employment in 2017, well above the respective EU averages of 1.6% and 4.4% respectively. Romania is well endowed with farmland. The size of the cultivation areas (13.9m hectares) rank Romania in the 7th position across the EU. Countries with comparable farmland size in the EU are Poland (16.2m hectares), Italy (16.5m hectares) and Germany (18.4m hectares). What singles out Romania, however, is the large number of small holdings with little earnings.

From 2007 to 2013, more than €8 billion of public funds (both EU and national) were invested via rural development programmes, in a range of different activities, supporting agricultural production and benefitting Romania's rural areas by preserving their diversity and enhancing their economic strength, cultural and social cohesion. Nevertheless, Romania has some way to go before reaching the level of efficiency and of productivity of the countries with a comparable farmland endowment. In the next few years it is crucial for the sector to absorb productively the EU funds allocated to Romanian agriculture under the MFF 2016-2020, including €8.1 billion from Pillar 2 of the Common Agricultural Policy and €12.5 billion from Pillar 1 (direct payments to farmers). In addition, it is important to reinforce the sector's exporting activity, taking advantage of the proximity to Middle Eastern markets and the increasing integration with the markets of the EU.

Manufacturing

During the 2008-2016 period, manufacturing had the third largest share (24%) of the total gross value added in the EU, after Ireland (26%) and the Czech Republic (25%). Due to the low labour costs relative to its peers and to its educated workforce, Romania is likely to maintain its growing competitive advantage in manufacturing.

In general, the manufacturing industry in Romania is considered concentrated. Four sectors –manufacture of food, beverage and tobacco products (22%), manufacture of motor vehicles (12%), manufacture of coke and refined petroleum products (10%), manufacture of wearing apparel/ clothing, textile and leather products (9%)– produce more than half of the total gross value added generated by manufacturing. All these sectors have the above-mentioned competitive advantages.

The manufacture of food, beverage and tobacco has promising development potential in the domestic market compared to the foreign markets, as the share of food items¹ in total exports was 8.2% in 2017. It is noted that households in Romania have larger share of food items in their consumer basket than the EU average². In addition, growth in agriculture which serves as the input to the sector might contribute significantly in its growth.

In the manufacturing of motor vehicles, Renault and Ford have a significant presence in the country, which has attracted part suppliers. The facts that Romania provides road transport services to Europe, that car

¹ The cumulative share of the "Food and live animals", "Beverages and tobacco", and Animal and vegetable oils, fats and waxes" Sections of the Standard International Trade Classification (SITC Rev.4).

² According to the Household Budget Survey 2010, food items and non-alcoholic beverages as a share of the mean consumption expenditure per household, expressed in purchasing power standard, represented 31.5% in Romania and 15.1% in the EU, while alcoholic beverages and tobacco represented 5.9% in Romania and 2.3% in the EU.

ownership levels are still relatively low in the country (approximately half of the EU average), and that future public investments are expected to improve the road infrastructure, are all reasons to believe that demand for vehicles will increase internally. The sector is currently the country's largest exporter, as the exports of machinery and transport equipment represent almost half of Romania's exports.

Regarding the manufacture of coke and refined petroleum products, Romania is the fifth largest oil producer in the EU and has some large legacy oilfields. Unlike other Eastern European nations, Romania's history of oil production means that the country has well established oilfield service companies. Black Sea developments are providing positive extraction potential for gas and possibly oil. As of early 2018, ExxonMobil and OMV Petrom have successfully completed the second drilling campaign in the Black Sea, from which has emerged that there are significant natural gas deposits. The resource estimates are being finalized and will most likely support interest in exploration.

Computer programming, consultancy, and information service activities

This sector has been very dynamic since 2008. Romania became a popular destination for outsourcing/nearshoring, with international firms such as Hewlett-Packard, Microsoft, Oracle, SAP, Intel and Wipro all investing in local facilities. The sector's growth was stimulated by exempting IT workers from the income tax. This preferential treatment was first introduced in 2004 for university graduates and a few specialisations only, and was extended gradually until 2017 to include high school graduates. Between 2005 and 2016, the share of gross value added generated in the sector increased at the fastest rate compared to all others.

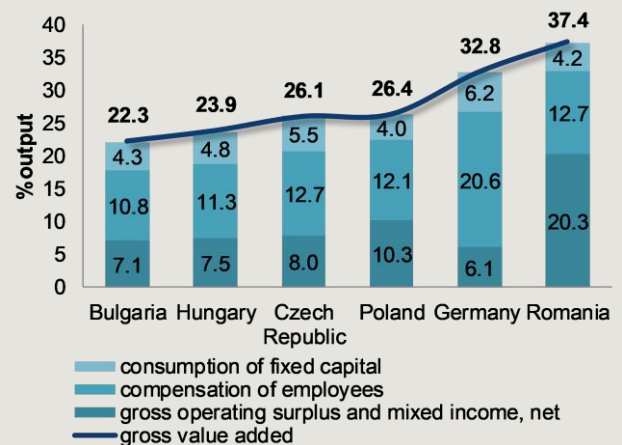
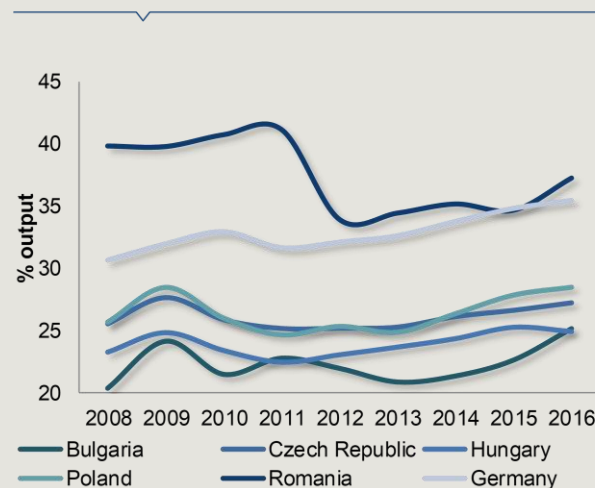
Specifically, the number of employees in the sector increased almost 5 times, while the sector remained most appealing for investors, due to its high share of net gross operating surplus and mixed income in the total output.

The sector's potential for expansion is significant, from both the demand and the supply side. For the last two years, a total of 12,000 university students graduated with IT specialisations, while the proportion of those among them who are willing to migrate has been decreasing, given that the remuneration in the sector is on average the highest across the economy (in H1 2018, the average net monthly wage in the sector was 2.4 times higher than the average net monthly wage in the economy). However, demand for IT services is expected to be picking up gradually, as the digitalisation of the economy is in its infancy. According to the Digital Economy and Society Index (DESI) 2018, Romania was ranked last in the EU in 2017.

GRAPH 10
GRAPH 11

Manufacturing: Gross Value Added

Manufacturing: Gross Value Added by Components, 2008-2016 avg.



Sources:
ELSTAT

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