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Romania

December 2019

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SOVEREIGN RATING	Initial rating	Review
Date of Rating Committee	13.01.2016	12.12.2019
Date of rating publication	15.01.2016	13.12.2019
Long-term rating	BBB- (ns)	BBB- (ns)
Outlook	Stable	Negative
Short-term rating	A-3 (ns)	A-3 (ns)

● (ns) – not solicited rating

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"BCRA - CREDIT RATING AGENCY" AD rates Romania with unsolicited sovereign long-term rating BBB- (ns) and short-term A-3 (ns) with negative outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied (https://www.bcra-bg.com/files/Sovereign_Methodology_2019_en.pdf).

The report has been prepared and the rating – assigned, based on public information, made available by the National Institute of Statistics, National Bank of Romania, Ministry of Public Finance, the World Bank, the International Monetary Fund, the European Commission, BCRA's database etc. BCRA uses sources of information, which it considers reliable; however, it cannot guarantee the accuracy, adequacy and completeness of the information used.

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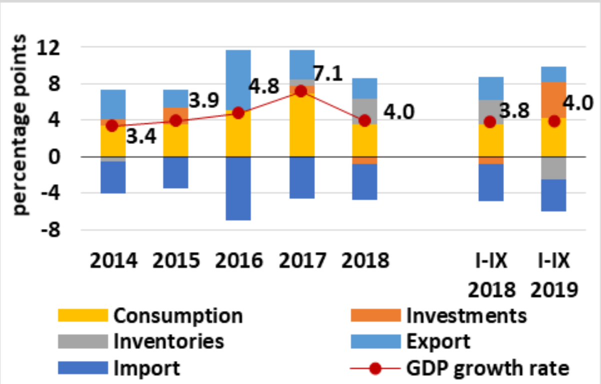
Overview

Romanian **politics** has had a dynamic and eventful year (2019). A series of ambiguous legislative initiatives of the ruling PSD (concerning justice system, pension system, administrative code etc.) continued to destroy public trust in the majority and provoke street protests within the country. The last Cooperation and Verification Mechanism (CVM) report has confirmed these factors as having a clear negative impact on the advance of judicial reform and the fight against corruption. Also, the EU institutions have warned about taking eventual legal measures for infringing the rule of law.

The 2019 European Parliament election results witnessed markedly reduced support for the ruling PSD (to 22.5% of the vote), which was replaced by PNL (with 27%) as a leading political party. The following presidential election in October-November 2019 affirmed the change in the political balance, as the PNL nomination – incumbent Klaus Iohannis, won greater election support (66.1%) than Viorica Dăncilă (33.9%), the PSD candidate.

In the context of the political turmoil the national government also has changed its leadership. After the PSD cabinet lost parliamentary majority by ALDE quitting the coalition, the Parliament has passed a confidence vote in the minority government of Prime Minister Ludovic Orban at November 4, 2019. Orban, the leader of the previously oppositional PNL, was appointed as the fourth Prime Minister during 2016-2020 mandate of the Parliament. Local elections will follow in May-June 2020, with parliamentary elections in November-December 2020, so domestic politics uncertainties still pose the risk of instability.

Figure 1: Contribution to real GDP growth: 2014 – I-IX 2019

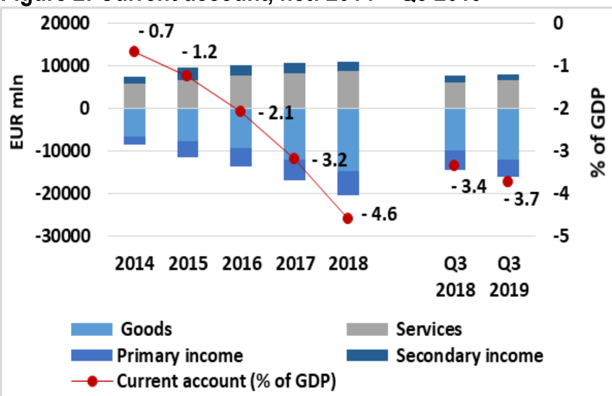


Source: National Institute of Statistics

Romania has been among the fastest growing EU-economies in the last years and **economic activity** in 2019 remained robust as well. Driven by strong consumer demand and investment upswing, real GDP rose by 4% on average in the first three quarters of 2019. Annual growth of consumption accelerated to 5.4% from 4.5% in the same prior-year period, fuelled by the persistently increasing labour incomes. Following a drop in 2018, fixed investment expanded by 18.1% in real terms, thus adding a sizeable contribution to the economic growth in the first nine months of 2019. This was chiefly related to the rapid upsurge in construction activity. Contrary to 2018, inventories dragged down the GDP growth rate. Simultaneously, the negative contribution of net exports slightly expanded, due to further deterioration in the trade balance. Both real exports and imports decelerated in January-September 2019, however, imports grew at faster rate (of 7.3%) than exports (3.9%). Imports are still elevated on domestic demand stimulus, while exports are affected by a slowdown in external demand.

Also, the sluggish external demand had an adverse effect on the local industry, as the **value-added** generated by the sector annually declined by 1% on average for the first three quarters of 2019. Industry's contribution to gross value added has been thus negative for the first time since 2012. Agriculture also contributed negatively, while services remained robust and construction marked a strong performance. Construction was recognised as a priority economic sector by the government and has been subject to a series of tax exemptions, applicable between 2019 and 2028 to both employers and employees. As a result, construction activity expanded by 16.6% in real terms.

Figure 2: Current account, net: 2014 – Q3 2019



Source: National Bank of Romania

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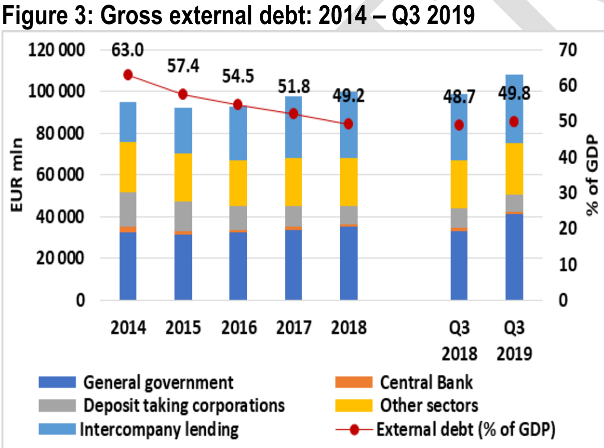
Romania's **current account** deficit has been widening markedly since 2015 underpinned by the fiscal-led consumption boom. The negative balance deteriorated to 4.6% of GDP in 2018 and continued to widen in 2019. The deficit recorded in January - September 2019 amounted to EUR 8 104 mln (3.7% of the projected GDP), being 19.2% wider than in the same period of 2018. This was mainly due to the worsening of trade in goods deficit, which picked up by 23.9% on an annual basis to EUR 12 128 mln. Besides, the secondary income surplus slightly decreased to EUR 1 481 mln, from EUR 1 533 in the same prior-year period. Services and primary income were among the offsetting factors as the surplus in the trade with services increased by 5.5% to EUR 6 586 mln and the deficit of the primary income narrowed by 15.6% to EUR 4 043 mln.

Romania's current account deficit compares strongly unfavourably with CEE peers, while the financing sources raise concerns as well. **Foreign direct investmen**t inflows remained almost flat in the first nine months of 2019, totalling to EUR 4 249 mln (2.0% of the projected GDP). Until 2016, net FDI inflows covered the annual current account shortfalls in full, however, the coverage deteriorated to only 53% in 2018. Hence the reliance on debt-creating capital inflows for financing the external deficits is rising.

Figure 3: Gross external debt: 2014 – Q3 2019



Source: National Bank of Romania

In January - September 2019, country's **gross external debt** increased on an annual basis by EUR 9 440 mln (9.6%) to EUR 108 238 mln or 49.8% of the projected GDP. The increase came mainly from the debt of the general government, which picked up by EUR 8 011 mln following several Eurobond issues. Short-term external debt advanced to EUR 34 408 mln, while its relative share in total external debt reached 31.8%

Romania's **international reserves** totalled EUR 39 963 mln at the end of September 2019, adding EUR 3 163 mln up to their value at the end of 2018. Reserves remain broadly adequate as their goods and services import cover came at 5 months.

Figure 4: EUR/RON – monthly average: 2016 – XI 2019

Source: National Bank of Romania

The Romanian currency has gradually depreciated over the past 2 years, reflecting the large twin deficits, as well as uncertainties in domestic politics. The leu **exchange rate** against the euro exceeded the psychological threshold of 4.70 in January 2019 and recorded a new all-time low of 4.78 on 21st of November. However, the average leu weakening since the beginning of the year is still moderate compared to some regional peers.

Figure 5: CPI – annual rate of change: 2016 – XI 2019

Source: National Institute of Statistics

The CPI **inflation** accelerated rapidly in the course of 2018, to reach an annual average of 4.6% - well above the upper limit of the NBR's target band (2.5% ± 1 pp.). Inflation pressure in 2019 remained elevated, fuelled by wage increases, fiscal stimulus and leu exchange rate depreciation. As a result, annual inflation rate moved above the NBR's target band for most of 2019, reaching 3.8% in November.

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The rate calculated using the HICP is 3.7%, once again being the highest among the EU-countries.

Labour market in Romania remained tight in the first quarters of 2019. Unemployment dropped to a new low corresponding to 4.0% of the active population on average for the first half of 2019, while employment rate slightly increased.

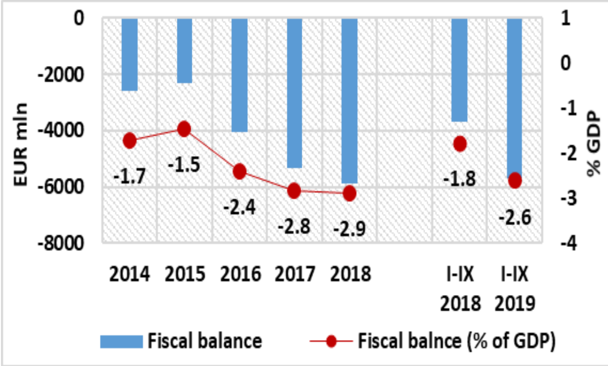
The acceleration of labour incomes economy-wide has been continued in January-September 2019. The average net monthly wage grew nominally by 15.4% on average for that period. As it was envisaged, minimum wages continued to grow in support of the rising trend, as their step of increase became differentiated depending on education and seniority starting 2019. The gross base remuneration was raised to RON 2 080 (EUR 447) and to RON 2 350 (EUR 505) for employees with university education, having seniority of at least one year. The most significant increase, however, concerned the earnings of employed in the sector of *Construction*, where another minimum wage was set at the level of RON 3 000 (~EUR 645 as of the beginning of 2019), which equalled to 90% of average gross wage in the sector over 2018. Accordingly, the annual growth rate of nominal wages in *Construction* reached the impressive 46.0% during the three quarters of 2019, along with an accelerated employment in the sector.

Starting 2020, new hike in the base minimum wage is expected as the new government announces that annual indexation sum will result from a particular formula as well as the differentiation will be removed.

GDP per capita amounted to EUR 4 760 in H1 2019 preserving the high growth (9.4% on an annual basis). However, Romania remained at the second to last position in terms of income within the European Union.

The procyclical **fiscal policy** poses growing risks to country's macroeconomic stability. Amid additional tax cuts and public wage increases, the consolidated budget deficit widened to 2.9% of GDP in 2018, while the gap calculated according to the EU methodology reached 3% of GDP - the upper limit of the Maastricht Treaty. The EC has warned Romania on several occasions that maintaining the current stance might trigger an Excessive Deficit Procedure against the country, however, the Romanian authorities had taken no effective actions in response.

Figure 6: Consolidated budget balance: 2014 - IX 2019



Source: Ministry of Public Finance

Consolidated budget revenues surged by 11.6% in the first nine months of 2019, but expenditures recorded a higher growth rate of 15.3%, fuelled by public payroll and social security transfers. As a result, the cash deficit in September picked up to 2.6% of the projected GDP, compared to a gap of 1.8% of GDP a year earlier.

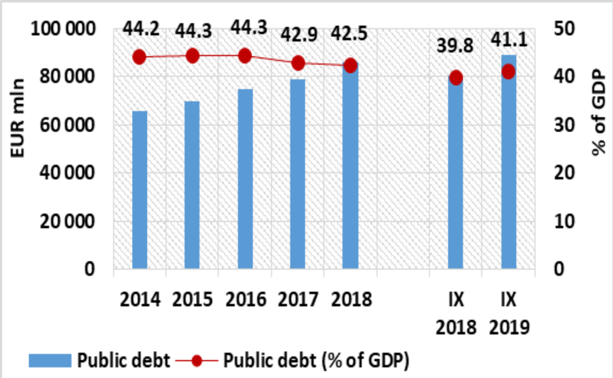
The initial budget for 2019 envisaged a deficit target of 2.76% of GDP in cash terms and of 2.8% according to EU-methodology. These targets, however, turned out impossible to meet, which was why the new Romanian government approved a major budget revision just weeks after it took office. The revision envisages a widening of the cash deficit to 4.4% of GDP. The substantial increase is mainly attributable to the reduction in the estimated revenues, which are negatively impacted by the non-materialization of the expected tax compliance and EU funds absorption, as well as by the slower advance of real GDP. At the same time, the negative revision of budgetary expenditures is much more limited and concerns mainly investment spending, while planned wages and social benefits are maintained. The new government declared that the wage and pension laws will remain in place, which will put additional pressure on Romania's public finance in the following years.

If the budget deficit reaches the assumed target, the country would likely fall under the Excessive Deficit Procedure. The Maastricht deficit criterion is expected to be violated also in 2020, driven by the legislated pensions increases[1], thus, the Romanian

[1] The pension point, which is the main parameter used for pension indexation, is set to increase by new 40% in September 2020, following the 15% increase in September 2019.

government has no more room to manoeuvre. To prevent growing deficits from threatening fiscal sustainability, strong medium-term consolidation should be considered, backed by broad structural reforms to enhance the tax compliance and public sector effectiveness. Besides, a rebalancing of the budget structure is needed to reduce the share of rigid spending, but significant fiscal tightening is unlikely before next years' parliamentary elections, in our view.

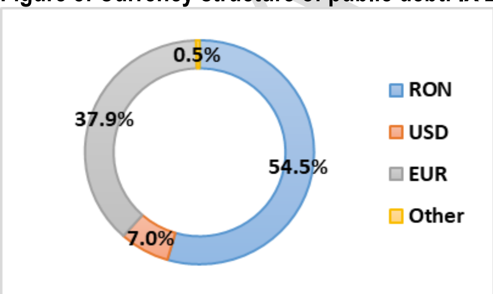
Figure 7: Public debt: 2014 – IX 2019



Source: Ministry of Public Finance

Strong nominal GDP growth facilitated the improvement in public debt-to-GDP ratio over the past years, despite the continuous increase in debt volume. However, the rising financing needs threaten the medium-term sustainability of public debt. As of end-September 2019, public debt amounted to EUR 89 200 mln (41.1% of the projected GDP), increasing by EUR 3 237 mln compared to the end of 2018.

Figure 8: Currency structure of public debt: IX 2019



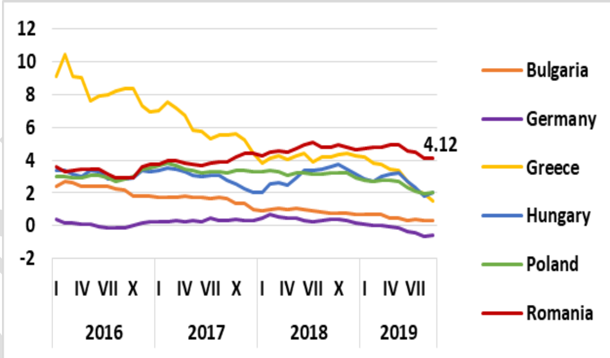
Source: Ministry of Public Finance

In recent years, the public debt structure has changed in favour of domestic debt, but it remains vulnerable to exchange rate movements with foreign currency-denominated debt accounting for 45.5% of total debt at the end of September 2019.

Given the small relative share (20.7%) of debt contracted at floating rates, the exposure to interest rate risk remains moderate.

Romania's gross government debt, according to EU methodology, accounted for 35.0% of GDP in Q3 2019 - well below the 60% ceiling of the Maastricht Treaty. Although the country's indebtedness is still moderate and compares favourably to EU-peers, the debt trajectory is exposed to risks, as a future rise may stem from the loose fiscal stance and the expected growth deceleration, unless a prudent policy mix is implemented.

Figure 9: Long-term interest rates in Romania and selected countries: 2016 – IX 2019



Source: Eurostat

At the same time, the financing cost of public debt have been increasing since 2017 amid growing twin deficits and domestic political tensions. **Long-term interest rates** in Romania, measured by the secondary market yields of 10-year government bonds, have been the highest within the EU since the beginning of 2018, which raises concerns, as higher borrowing cost can quickly translate into higher public debt.

Over the nine months of 2019, Romanian **banking system** continued to grow steadily in terms of assets, with the major contribution of the non-financial sector loans. Households borrowed by 7.4% more than in Q1-Q3 2018 and NFC loans gained 6.9% for that period as RON-denominated credit remained the most preferred in the currency structure. The share of the non-performing loans in total loans shrank further to 4.6% as of end-September 2019. At the same time, bank system remained profitable and solvent with capital adequacy of 19.7% as of Q3 2019 against the background of rising uncertainties and risks the macroeconomic environment has been facing.

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The deposit base kept expanding at high annual rates (10.5% as of September 2019), thus supporting the constant growth of the broad money aggregate. This was also ensuring ample liquidity resources with domestic origin counter to the continued process of foreign deleveraging.

Outlook:

The **negative** outlook of the Sovereign Rating of Romania reflects growing macroeconomic imbalances, as well as political uncertainty. The current account deficit is set to continue to widen, while Romania is unlikely to avoid the EDP with the expected magnitude of the fiscal slippage. At the same time, volatile political environment in the pre-electoral context delays the needed reforms and undermines the predictability of economic policy in the following years.

Positive rating factors would be considered:
- Strengthening policy predictability;
- Credible medium-term fiscal consolidation;
- Sustained reduction in external imbalances;

Negative rating factors would be considered:
- Further fiscal loosening, leading to a rapid increase of public debt;
- Continued deterioration of external imbalances;
- Capital outflows and stronger leu depreciation amid shift in investors' sentiments;
- Diminishing foreign reserve buffer;

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Regulatory announcements:

Rating initiative

This is an unsolicited sovereign rating. Neither the rated entity, nor a related third party has participated in the credit rating process. BCRA did not have access to the accounts, management and other relevant internal documents for the rated entity or a related third party.

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Clarifying Notes:

There may be some differences in the stated values and changes in the analysed indicators due to the conversion of those values in another currency (namely in EUR). The used exchange rate is the publically announced by the National Bank of Romania for the corresponding period (i.e. yearly, quarterly, and monthly). There may also be some differences stemming from using average values for the period rather than end-period values. The cited growth rates in the current report are based on changes in national currency, with the exception of data recorded in EUR (i.e. Balance of payments, External debt, Net international investment position). The data on which the current report is based includes the public data available until December 2019, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On the 12th of December 2019 Rating Committee of BCRA – CREDIT RATING AGENCY (BCRA) had a session, on which was discussed the Report regarding the affirmation of an **unsolicited sovereign rating** of **Romania.**

The members of the Rating Committee discussed the grades of numerous credit rating factors included in the **Rating Model** and analysed in the **Credit Rating Report** according to the **Sovereign Rating Methodology**.

The committee members discussed in detail the political developments in Romania, the shift in the ruling party within the current mandate of the Parliament, and the ensuing significant revision of the 2019 budget. The deepening of the twin (government budget and current account) deficits was viewed as a negative development. The economic growth, its sectoral dynamics and expenditure components in 2019 were taken into account as well as a number of key macro-economic indicators.

The current sovereign rating affirmation and the related outlook change have been determined based on the above discussion.

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Tables:

Country	Development classification
Romania	Emerging and Developing Europe (IMF classification)

MAIN MACROECONOMIC INDICATORS							
	I-IX 2019	I-IX 2018	2018	2017	2016	2015	2014
Gross domestic product (EUR mln):	153 473	141 596	202 905	187 801	170 378	160 312	150 428
Final consumption	124 826	113 820	160 396	147 795	132 202	121 025	113 958
Gross fixed capital formation	36 631	29 857	43 054	42 083	38 966	39 711	36 538
Change in inventories	-2 445	1 723	5 971	1 913	789	573	594
External balance of goods and services	-5 538	-3 804	-6 516	-3 989	-1 579	-996	-662
Exports of goods and services	66 421	62 786	84 494	77 881	70 171	65 757	61 922
Imports of goods and services	71 960	66 590	91 009	81 870	71 750	66 753	62 584
GDP (real growth rate, %)	4.0	3.8	4.0	7.1	4.8	3.9	3.4
GDP per capita (EUR, current prices)			10 420	9 580	8 650	8 090	7 550
Unemployment rate[1] (%)	4.0	4.4	4.2	4.9	5.9	6.8	6.8
Average net monthly wage (EUR)	646	570	579	522	465	416	384
CPI, annual average rate of change[2] (%)	3.8	4.5	4.6	1.3	-1.5	-0.6	1.1
RON/EUR - period average	4.74	4.65	4.65	4.57	4.49	4.45	4.44
RON/USD - period average	4.15	3.89	3.94	4.05	4.06	4.01	3.35
EXTERNAL SECTOR							
EUR mln	Q3 2019	Q3 2018	2018	2017	2016	2015	2014
Current account balance	-8 104	-6 798	-9 334	-5 970	-3 548	-1 973	-1 012
Goods	-12 128	-9 786	-14 842	-12 183	-9 305	-7 788	-6 536
Services	6 586	6 244	8 702	8 210	7 723	6 794	5 868
Primary income	-4 043	-4 789	-5 575	-4 637	-4 467	-3 772	-2 029
Secondary income	1 481	1 533	2 381	2 640	2 501	2 795	1 685
Capital account	1 724	1 282	2 516	2 216	4 261	3 900	3 954
Net FDI inflows	4 250	4 284	4 945	4 882	4 514	2 954	2 701
Official reserves assets	39 963	34 825	36 800	37 107	37 905	35 485	35 506
Gross external debt	108 238	98 799	99 841	97 361	92 910	92 068	94 744
Net international investment position	-95 411	-90 844	-89 300	-87 869	-82 583	-86 014	-85 477
% of GDP[3]							
Current account balance	-3.7	-3.4	-4.6	-3.2	-2.1	-1.2	-0.7
Goods	-5.6	-4.8	-7.3	-6.5	-5.5	-4.9	-4.3
Services	3.0	3.1	4.3	4.4	4.5	4.2	3.9
Primary income	-1.9	-2.4	-2.7	-2.5	-2.6	-2.4	-1.3
Secondary income	0.7	0.8	1.2	1.4	1.5	1.7	1.1
Capital account	0.8	0.6	1.2	1.2	2.5	2.4	2.6
Net FDI inflows	2.0	2.1	2.4	2.6	2.6	1.8	1.8
Official reserves assets	18.4	17.2	18.1	19.8	22.2	22.1	23.6
Gross external debt	49.8	48.7	49.2	51.8	54.5	57.4	63.0
Net international investment position	-43.9	-44.8	-44.0	-46.8	-48.5	-53.7	-56.8

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PUBLIC FINANCE							
EUR mln	**IX 2019**	**IX 2019**	**2018**	**2017**	**2016**	**2015**	**2014**
General government revenues	48 260	45 032	63 419	55 126	49 818	52 543	48 219
General government expenditures	53 953	48 716	69 293	60 437	53 892	54 874	50 805
Interest payments	2 050	2 133	2 781	2 216	2 229	2 153	2 295
General government budget balance	-5 693	-3 684	-5 874	-5 311	-4 074	-2 331	-2 586
Public debt	89 200	80 561	85 963	79 071	74 669	69 827	65 964
Government consolidated gross debt (ESA 2010)	75 951	67 204	70 861	64 630	62 882	59 488	58 498
% of GDP[3]							
General government revenues	22.2	21.7	31.3	29.4	29.2	32.8	32.1
General government expenditures	24.8	23.5	34.2	32.2	31.6	34.2	33.8
Interest payments	0.9	1.0	1.4	1.2	1.3	1.3	1.5
General government budget balance	-2.6	-1.8	-2.9	-2.8	-2.4	-1.5	-1.7
Public debt	41.1	39.8	42.5	42.9	44.3	44.3	44.2
Government consolidated gross debt (ESA 2010)	35.0	33.2	35.0	35.1	37.3	37.8	39.2
BANKING SYSTEM							
	Q3 2019	**Q3 2018**	**2018**	**2017**	**2016**	**2015**	**2014**
Assets (EUR million)	99 527	95 460	96 737	91 807	86 686	83 365	81 244
Asset-to-GDP ratio (%)	45.9	47.1	47.8	49.9	51.4	52.9	54.5
Deposits of non-financial sector (EUR million)	69 125	63 738	66 682	61 117	56 955	52 650	48 737
Loans and advances to non-fin. sector (EUR million)	54 376	51 697	52 251	48 496	47 274	47 030	46 314
Non-performing loans ratio (%)	4.6	5.6	5.0	6.4	9.6	13.5	20.7
Capital adequacy (%)	19.7	20.0	20.7	20.0	19.7	19.2	17.6
Liquidity Coverage Ratio (%)	223.7	225.2	237.8	239.2	229.4	n/a	n/a

[1] Unemployment rate of population aged 15 years and over, Labour Force Survey. Data in the first two columns are average for the first half of the respective year;
[2] Annual average rate of change for the last 12 months;
[3] The GDP ratios for 2019 are calculated on the basis of GDP amounting to RON 1 031 000 mln (forecast);

Source: National Institute of Statistics, National Bank of Romania, Ministry of Public Finance, Eurostat, the International Monetary Fund, BCRA's database