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Romania

July 2017

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SOVEREIGN RATING	Initial rating	Review
Date of Rating Committee	13.01.2016	29.06.2017
Date of rating publication	15.01.2016	14.07.2017
Long-term rating	BBB- (ns)	BBB- (ns)
Outlook	Stable	Stable
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 stable outlook.

BCRA's officially adopted Sovereign Rating Methodology has been applied (http://www.bcra-bg.com/files/file_330.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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Over the first half of 2017 political tensions in the country are not overcome despite the successfully held early elections and the successive constitution of the new government. Grindeanu Cabinet demonstrated continuity in state politics with ambitions to fulfil the new crime and fiscal codes, as well as the Unitary wage law. Government actions, however, are perceived ambiguously. Institutions like EC and the president, Iohanis, publicly criticize them while Romanian society reacted through mass protests on dubious decisions concerning the changes in the Criminal Code.

As regards the international integration and policy towards key geopolitical issues, there are no considerable changes observed in the first six months of 2017 – Romania remains stable regarding two of the most crucial topics for the region - the Ukrainian crisis and the Middle East refugee wave. Ten years after the EU accession of Romania, the country is still involved in the EC monitoring mechanism (CVM) and should solve problems in areas like the rule of law; fight against corruption; ineffective bureaucracy; integration of minority groups; legal and judicial unpredictability.

Generally, possible political instability could not affect dramatically the current state of the country in short run.

During 2016, Romanian economy reports the highest value for real growth over the years after the financial crisis – respectively, 4.8% and accelerates to 5.7% during the first quarter of 2017. The growth is supported mainly by strong consumption of the households. Meanwhile, the contribution from net exports is negative. Both exports and imports accelerates throughout 2016, but the imports' growth outruns the exports rate, thus generating a deficit in the trade balance of the country. The capital formation hesitates with the beginning of the new programing period financed by EU-funds, which need technical time until the projects can be constructed, approved and undertaken.

The category of services continues to be a main contributor for the growth in gross value added (GVA) of the country in 2016. Industrial sectors in aggregate remain key in country's production. Construction sector decelerates, while agriculture is the only sector with negative contribution to growth.

The major partners in the international trade in goods remain similar with the EU holding the biggest share in net exports. There are changes in the shares of some of the partners though resulting mainly from geopolitical processes over the past years. An important factor that should be considered is the Brexit. The stemming effects from the upcoming process of separation may affect Romania in a negative way, considering the corresponding shares of said leaving member in the country's trade relations – 4.0-4.4% of the exports and 2.2-2.5% of its imports, which is a considerable share for a single territory unit.

The dynamics in international trade are also reflected in the current account balance, where the deficit is widening to 2.3% of GDP at the end of 2016 compared to 1.2% of GDP a year prior. The groups contributing negatively for the balance are the goods balance and primary income, whereas services and secondary income generate surpluses. The deficit on trade in goods is widening from 0.6% of GDP in 2015 to 0.9% of GDP at the end of 2016, due to strong domestic demand and respective imports growth.

The financial account surplus accumulated in 2016 decreases when compared to the preceding year, reflecting the growth in foreign liabilities. In 2016 foreign direct investment liabilities (FDI inflows into Romania) increase on an annual basis to 2.9% of GDP or EUR 4 857 mln. in absolute value (from EUR 3 884 mln. in 2015). The instruments' structure remains similar to that observed in 2015 – mainly equity and reinvested earnings, with the second gaining a larger share. A positive effect may be generated by the continuation of the tax exemption policy on reinvested earnings, which may stimulate foreign investors to keep their resources within the economic unit.

Foreign exchange reserves increase significantly during 2016 despite repayments to creditors. Romania's official gross foreign reserves held at the central bank stand at EUR 37 905 mln. (22.4% of GDP) and increase by another EUR 520 mln. in Q1 2017. This value ensure more than 6 mounts coverage over imports, enough adequate to reduces the risk of inability to respond to unexpected events occurring on international markets.

The labour market development reflects real sector dynamics, leading to further reduction in the unemployment and surge in incomes. What rises concern is the decline in the activity rate of population (aged 15 years and over) for the second consecutive year in 2016.

A relatively quick devaluation of the national currency against the euro is observed since March 2017, affected by the internal political

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tensions. The RON/EUR exchange rate reaches a new high since 2012 of RON 4.5987/ EUR 1 on 21st June 2017 (the no-confidence vote day), but starts to normalise afterward as the tensions lower.

Romania continues to register deflation (measured by the average annual CPI), albeit narrowing, for the last 6 months (October 2016 – March 2017). As of end-2016 it reaches 1.5%, with food goods contributing the most for the decreasing price level. Inflation is expected to face upward pressures from strong demand (higher local income levels, as well as competitively cheaper currency) and supply (pressed up by increasing costs of the production factors).

Pro-cyclical fiscal policy, initiated in previous years, is continued in 2017. Romanian fiscal relaxation measures (started in 2015-2016) aiming to stimulate economic growth, are putting at risk not only the country's budget but also the economy's future development and hard-won stability. The changes in general taxes and expenditures have created a considerable gap between the expected balance and medium term objectives.

The budget balance deficit (as % of GDP) has been decreasing steadily in the previous years, achieving commendable results – from a balance of -4.3% of GDP (2011), the government has reduced the imbalance to -1.5% of GDP in 2015. During 2016, however, the hard-reached improvement shows significant deterioration as a result of the fiscal stimuli. The recorded balance for 2016 is in negative territory of 2.4% of GDP.

With the beginning of 2017 new changes come and will come into force, which will also have negative effects on the government budget, additionally fanning the increase in the deficit. The more important of which include the following:

- Reduction in the standard VAT rate from 20% to 19% (as of January 1, 2017);
- Rise in the minimum salary by RON 200 to RON 1 450 (February 1, 2017);
- Increase of the minimum guaranteed social pension from RON 400 to RON 520, (March 1, 2017) as well as in the pension point value by 9% RON 1 000 starting from (July 1, 2017);
- Elimination of health contribution payment for pensioners; etc.

The cited and number of similar measures have conflicting effects on the economy – most of them are intended to stimulate the economic activity of households and firms, but on the other hand, the budgetary balance, and mostly its revenue side, is burdened by the decreases in tax rates and other reliefs extended to the private sector, leading to lower receipts. The expected positive effect on government revenues from the undertaken measures are mostly aimed at its secondary effects – increased economic activity and growth, achieving higher voluntary compliance and better collectability in due obligations. Furthermore Romanian government expresses a general intention of respecting the 3% threshold for country' budgetary deficit for 2017 mostly through improved tax collection.

Despite the budget threats over the country's indebtedness, public debt remains relatively steady in the recent months. As a fraction of GDP it moves within bounds of 2 - 3 p.p. (44.5% at the end of 2016 and 41.9% in April 2017). Future rise of the country's indebtedness may stem from the ongoing fiscal stimuli if no actions in either the revenue or expenditure side are made to correct the process.

As regards the Balance of Payments Assistance Programme, negotiated after the financial crisis between Romania, on one side, and the European Community, the IMF, the World Bank (WB), and a combined participation of the European Investment Bank and the European Bank for Reconstruction and Development, on the other, the last payments (according to the schedule) was met with no particular difficulties.

In addition to international financing, at the end of 2016 Romania has negotiated another DPL (Development Policy Loan) with the World Bank at a nominal value of EUR 500 mln, aimed at improving economic efficiency and growth, and more precisely – enhance the country's growth potential, reduce poverty and social exclusion and develop a strategy on addressing climate change.

The general government debt structure is characterised by prevalence of domestic over external debt. Domestic debt stands for 59.4% of total debt in April 2017 and accordingly external debt stands for 40.3%, whereas long- and medium-term debt account for more than 85% of total government debt. In terms of currency, the total RON and EUR denominated debt comes to a share above 90% of total debt, distributed among both currencies with a prevalence of RON-denominated debt. According to the Government public debt management strategy, the external debt will be contracted mainly in EUR. Given the small share of debt contracted at floating rates, the refinancing and interest rate risks for the debt denominated in lei continue to be the most

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important risks associated to public government debt portfolio

The 10-year bond yield marks a volatile dynamic range. It has stayed below 4% on a monthly basis, but has been on the rise since October 2016 (from 2.7% in September 2016 to 3.7% in June 2017), in light of increasing populist talks and impending government elections. Furthermore there are possible external shocks linked to FED monetary policy with expectations of higher rates while the ECB decided to extend the monetary easing programme with nine months, until December 2017. This may affect negatively the volatility and yields of Eurobonds issued by emerging economies.

The general government's (GG) deposits demonstrate analogous dynamics for 2016 as in 2015 with notable decreases at year's last quarter and recent recovery thereafter. It is related to increased government budget spending (1/3 of the expenditures of 2015 consolidated budget were carried out in the last 2 months of the year). However, risks of another considerable decrease are present and additional weight may stem from possible increase of financing costs on international markets following the government instability and in case of lax fiscal discipline thus enhancing growing debt service payments.

Gross foreign debt is moving upwards as a nominal value since the second quarter of 2016, driven by the direct public debt, while private debt, on the other hand, continues to shrink. The volatility, however, remains round within bounds of EUR 91-94 bln. for June 2016 – April 2017. As a ratio to GDP gross external debt amounts to 54.5% at the end of 2016 (56.5% of GDP in 2015).

With respect to the term-structure the share of long-term external debt has been decreasing on account of short-term debt, which has grown for 2016 and until April 2017 both as a share (25.4% of the gross external debt in April 2017, against 20.8% in the corresponding period of 2016) and in nominal terms. Service of short-term debt has also been on the rise, but the level of foreign-exchange reserves for April 2017 is enough adequate to cover almost 170% of short-term external debt.

Over the last six months (Q4 2016 – Q1 2017) recent trends on Romanian banking sector affirm. Banking sector qualitative indicators are maintained at appropriate levels. The main risks the system faces are of various character. There is still some uncertainty about the legislative framework regulating the system on the one hand, and possible economic deteriorations, on the other.

Outlook:

The stable outlook of the Sovereign Rating of Romania reflects the BCRA's opinion that the upside and downside risks to the rating are currently balanced. The economy is characterised by stable development in key economic and financial indicators, while public finance developments are raising some concerns pertaining mostly for risks emerging in the long-run, which currently do not affect the country's creditworthiness.

BCRA would consider upgrading the Sovereign Rating and the Outlook for Romania if the country marks an enduring stabilization in its political situation and continues to record stable positive dynamics in key economic indicators, namely high GDP growth. Improvement in the external balance, steady changes in the price level, fiscal consolidation and effective management of public debt are other key factors that may upgrade the rating.

Negative pressures on the Sovereign Rating and the Outlook would be considered to be further deterioration of budget balance, resulting in higher public debt. Additional factors will be considered slow-down in economic growth, prolonged and intensifying deflationary processes, deterioration in the labour market and possible problems stemming from the banking system (including spill-over effects).

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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, 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 for the first quarter of 2017, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On the 29th of June 2017 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 **Model for grading** and analysed in the **Credit Rating Report** according to the **Sovereign Rating Methodology**.

The members of the committee discussed the alteration in political environment related to the key figure changes within the ruling majority (as a result of a successful no confidence vote). Fiscal and non-fiscal incentives have been commented on as parts of an ongoing economic policy, as well as their impact on the real sector of the economy. The measures taken stimulate the consumption, which helps to maintain high economic growth. On the other hand, the performance of the public finances is deteriorating and the members of the committee have expressed concerns about their future development. The assessment also took into account the stable performance of the labour market and the banking system

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

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Tables

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

BASIC MACROECONOMIC INDICATORS							
Indicators	2017 Q1	2016 Q1	2016	2015	2014	2013	2012
(in billion EUR[1])							
GDP	**35,3**	**32,6**	**169,6**	**160,0**	**150,3**	**144,3**	**133,6**
GDP (annual real rate of change, %)	***5,7%***	***4,3%***	***4,8%***	***3,9%***	***3,1%***	***3,5%***	***0,6%***
Final consumption	28,5	26,6	128,7	121,0	113,9	108,5	104,4
Gross fixed capital formation	5,9	5,7	38,4	39,6	36,5	35,6	36,5
Change in inventories	1,3	0,4	4,0	0,3	0,6	1,2	-0,7
External balance of goods and services	-0,4	0,0	-1,6	-1,0	-0,7	-1,1	-6,6
Exports of goods and services	18,9	16,7	70,2	65,8	61,9	57,3	50,1
Imports of goods and services	19,2	16,7	71,8	66,7	62,6	58,5	56,7
GDP per capita (EUR) [2]	**-**	**-**	**8600**	**8100**	**7500**	**7200**	**6700**
Total average net monthly wage (EUR)	**507**	**441**	**441**	**416**	**384**	**367**	**347**
Inflation (CPI, %)	**-1,1%**	**-1,1%**	**-1,5%**	**-0,6%**	**1,1%**	**4,0%**	**3,3%**
Unemployment rate (in %, population 15+)	**5,4%**	**6,6%**	**6,6%**	**6,8%**	**6,8%**	**7,1%**	**6,8%**
Average exchange rate RON/EUR	**4,52**	**4,49**	**4,49**	**4,45**	**4,44**	**4,42**	**4,46**
Average exchange rate RON/USD	**4,25**	**4,08**	**4,06**	**4,01**	**3,35**	**3,33**	**3,47**
BALANCE OF PAYMENTS							
(in million EUR)	I-III 2017	I-III 2016	2016	2015	2014	2013	2012
Net export of goods and services	**-359**	**-46**	**-1591**	**-984**	**-662**	**-1119**	**-6645**
Current account	**-690**	**-315**	**-3966**	**-1978**	**-1012**	**-1540**	**-6386**
as % of GDP	**-1,95%**	**-0,97%**	**-2,34%**	**-1,24%**	**-0,67%**	**-1,07%**	**-4,78%**
Goods and services	-349	-50	-1595	-1000	-667	-1113	-6792
Primary income	-580	-821	-4829	-3772	-2029	-3112	-2305
Secondary income	239	557	2460	2795	1685	2688	2711
Capital account	**184**	**1310**	**4238**	**3900**	**3954**	**3039**	**1880**
Financial account	**489**	**1071**	**1576**	**2280**	**3068**	**1673**	**-3306**

PUBLIC FINANCES								
(in billion EUR)		I-V 2017	I-V 2016	2016	2015	2014	2013	2012
Consolidated general government budget	Revenues	21,7	20,3	49,8	52,6	48,2	45,3	43,4
	Expenditures	22,2	20,5	53,9	54,9	50,8	48,9	46,7
	Budget balance	-0,5	-0,2	-4,1	-2,3	-2,6	-3,6	-3,3
	Surplus | Deficit (as % of GDP)	***-0,3%***	***-0,1%***	***-2,4%***	***-1,5%***	***1,7%***	***-2,5%***	***-2,5%***

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(in billion EUR)		Q1 2017	Q1 2016	2016	2015	2014	2013	2012
General government debt	**Public debt**	**75,3**	**71,5**	**74,7**	**69,8**	**66,0**	**59,6**	**54,4**
	as % of GDP	*42,0%*	*40,7%*	*44,5%*	*44,4%*	*44,3%*	*41,9%*	*40,5%*
Gross external debt [3]		**93,2**	**90,9**	**92,4**	**90,4**	**94,7**	**98,1**	**100,9**
as % of GDP		*52,1%*	*53,3%*	*54,5%*	*56,5%*	*63,0%*	*68,0%*	*75,5%*
Foreign currency reserves		**38,6**	**34,9**	**37,9**	**35,5**	**35,5**	**35,4**	**34,5**
Net international investment position		**-80,4**	**-83,3**	**-82,9**	**-81,7**	**-85,5**	**-89,0**	**-90,6**

[1] The values in EUR are calculated by using the average exchange rate of the RON/EUR for the corresponding period.
[2] Current prices
[3] Includes direct public, publically guaranteed debt and private debt (non-publically guaranteed).

Source: National Institute of Statistics, National Bank of Romania, Ministry of Public Finance, Eurostat.