CREDIT RATING AGENCY	**BULGARIA** **95, Evlogi Georgiev blvd.** **1142 Sofia** **Tel. (+359 2) 9876363** **www.bcra-bg.com**

Romania **December 2018**	Kalina Dimitrova, Lead Economic Analyst **k.dimitrova@bcra-bg.com**
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SOVEREIGN RATING	Initial rating	Review
Date of Rating Committee	13.01.2016	20.12.2018
Date of rating publication	15.01.2016	21.12.2018
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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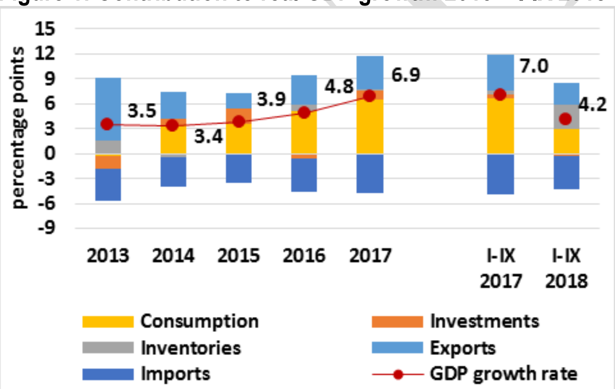
Overview

The PSD cabinet continued altering its composition as the changes in the tops of the **government** were to a great extent related to internal party struggle. Despite the coalition's majority, such tensions within the PSD may result in ongoing political uncertainty and inevitably lead to delays of important structural reforms.

The recent confrontation between the government and EU institutions has contributed to a further weakening of the government's credibility. On November 13, 2018, the European Commission released its latest Cooperation and Verification Mechanism (CVM) annual report on Romania. The last reads that Romania reversed the progress of its judicial reform and the fight against corruption as it provided new recommendations for implementation of additional measures regarding the situation. Assessing the World Bank's latest editions of the Worldwide Governance Indicators and Doing Business ranking, Romania's performance also showed deterioration against the previous period reflecting some unfavourable developments in the business environment.

Among the challenges Romania faces in the upcoming months comes the first rotating Presidency of the Council of the EU, starting January 1st, 2018, and the election votes for EP members and for a head of the state.

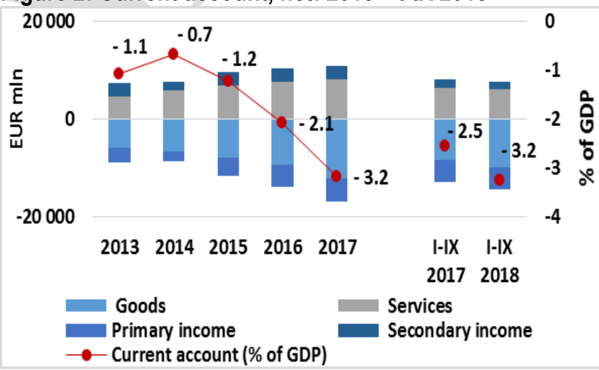
Figure 1: Contribution to real GDP growth: 2013 – I-IX 2018



Source: National Institute of Statistics

Romania has been one of the fastest growing economies in the European Union, with real **GDP growth** averaging 5.2% over the last three years and reaching a nine-year high of 6.9% in 2017. In 2018, however, economic growth has started to slow down. During the period January-September 2018, GDP growth decelerated to 4.2% year-on-year, from 7.0% in the same period of 2017. The growth was driven by the expansion of private consumption and inventory build-up. Household final consumption increased by 5.0% in the first nine months of 2018 and continued to be a key engine of economic growth, but its growth rate significantly decelerated as the inflation surged and the effects from the expansionary fiscal measures have started to weaken. Changes in inventories, which may undergo significant changes when the national accounts series are revised, marked a substantial contribution of 3.3 p.p. to the GDP growth. Gross fixed capital formation, in contrast, recorded an annual contraction of 1.1%. Simultaneously, the negative contribution of net exports to GDP growth widened, as the imports growth again outpaced the growth of exports. During the first three quarters of the year, exports of goods and services increased by 5.9% in real terms, while the imports rose by 9.1%.

Figure 2: Current account, net: 2013 – I-IX 2018



Source: National Bank of Romania

The fiscal expansion has an adverse effect on economy's price competitiveness, thus increasing vulnerability to short-term external shocks. The persistent deterioration in Romania's **current account balance** continued in 2018. In the first nine months of 2018, the current account posted a deficit of EUR 6 618 mln (3.2% of the projected GDP), compared with EUR 4 779 mln (2.5% of GDP) in the same prior year period. The deterioration was mainly driven by the further widening of country's trade balance, as the deficit on trade in goods increased by 18.0% on an annual basis, reaching EUR 9 976 mln (4.8% of the projected GDP). In addition, the surpluses on services and secondary income slightly decreased, thus negatively contributing to the overall balance,

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while positive contribution came only from the lower primary income deficit.

Net foreign direct investment, according to the directional principle, totalled EUR 3 472 mln (1.7% of the projected GDP) in the first nine months of 2018, down by 8.4% compared to the same period of 2017.

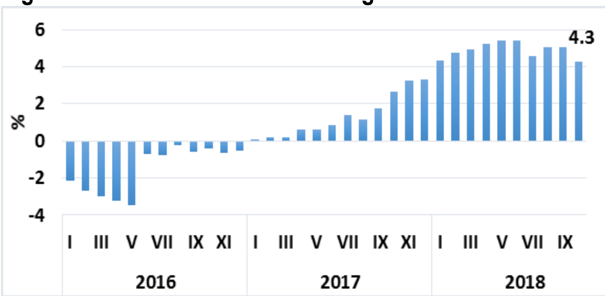
Romania has a managed floating **exchange rate** regime of the leu, which in recent years has had a relatively stable evolution. However, in 2017, the RON/EUR exchange rate started to depreciate amid unstable political situation. The exchange rate continued to fluctuate during 2018, reaching a historical high of 4.6695/1 on June 21. Afterward it tended to revert to slightly lower values. However, the increasing imbalances in the budget and external positions could further intensify the depreciation pressure on the leu.

At the end of September 2018, the country's **gross external debt** stood at EUR 97 994 mln (48.0% of the projected GDP). Compared to the end of 2017 total external debt increased by EUR 634 mln, mainly driven by changes in the intercompany lending. Long-term external debt at original maturity equalled to EUR 68 129 mln (down by 0.6% from end-2017), while short-term external debt amounted to EUR 29 866 mln (up by 3.6% from end-2017). Nonetheless, the vulnerabilities associated with short-term debt are still moderate, as its relative share in total external debt accounted for a comfortable level of 30.5%.

Romania's **net international investment position** (NIIP) stood at a negative value of EUR 89 001 mln (43.6% of the projected GDP) at the end of September 2018. While the NIIP improved as a share of GDP compared to the same period of the last years, it deteriorated in nominal terms as accumulation of liabilities was higher than accumulation of assets.

At the end of the third quarter of 2018, Romania's gross **international reserves** stood at EUR 34 825 mln (17.1% of the projected GDP), which is EUR 2 282 mln below their value at the end of 2017. However, the reserves are still comfortably above most adequacy metrics thresholds. The reserves cover over import of goods and services stood at 4.7 months, while ratio of the reserves to short-term external debt by remaining maturity came in at 72.6%.

Figure 3: CPI – annual rate of change: 2016 – IX 2018



Source: National Institute of Statistics

Following disinflation from mid-2015 to early 2017, **inflation** has quickly accelerated since mid-2017. Inflationary pressure stem from international crude oil prices, strong domestic demand and wage increases, reflecting the expansionary fiscal stance. As a result, an inflation peak was recorded in May 2018, when the annual inflation rate (measured by CPI) reached 5.41%, the highest level since February 2013. The annual inflation rate subsequently halted its upward trend, as it fell to 4.25% year-on-year in October, while the annual average inflation rate over the last 12 months (November 2017 – October 2018) reached 4.62%. However, inflation level is still well above the upper bound of the NBR target (2.5% ± 1 percentage point) and is expected to remain elevated through the end of 2018 and the beginning of 2019.

Labour market in Romania tightens further as most of the trends already observed in the comparable period of the previous year have been continued. Unemployment reduced to a new low corresponding to 4.4% of the active population on average for the first half of 2018. Employment increased in absolute terms in most of the economic sectors as its overall structure hardly changed.

Average labour earnings in the economy affirmed their overall upward movement reinforced by both active income policy of the Romanian government and boosted economy. Minimum wages continue to grow as it is envisaged their step of increase to differentiate from 2019 depending on education and seniority.

GDP per capita reached EUR 9 600 in 2017 preserving the process of convergence within the EU. Romania marked the highest growth rate for the year but remained at the second to last position in terms of income within the Union.

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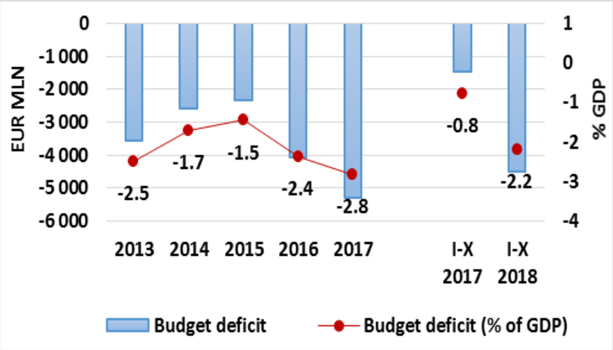
Figure 4: Consolidated budget balance: 2013 – I-X 2018



Source: Ministry of Public Finance

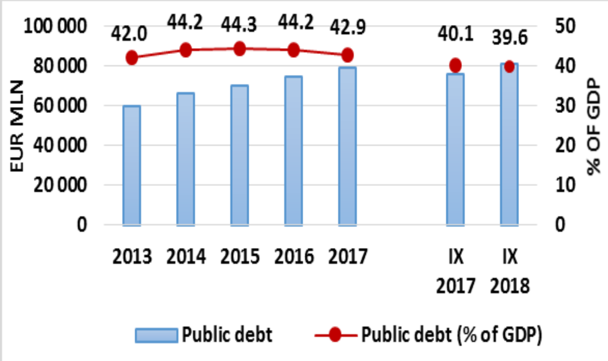
The **fiscal loosening** poses risks to macro-economic stability, as the gap between fiscal revenues and expenditures has increased significantly following frequent tax cuts and expenditures increases over the past few years. As a result, country's consolidated budget deficit deteriorated from 1.5% of GDP in 2015 to 2.4% in 2016 and further to 2.8% in 2017.

The beginning of 2018 brought additional fiscal relaxation measures. However, the budget for 2018 targets a consolidated gap equivalent to 2.97% of GDP on a cash basis, just below the 3% EU ceiling.

In the period January – October 2018, consolidated budget revenues increased by 11.8% on an annual basis, while the expenditures surged by 18.1%, mainly due to salary hikes in the public sector. As a result, Romania's consolidated budget deficit widened to EUR 4 485 mln (2.2% of the projected GDP) in the first ten months of 2018, up from EUR 1 449 mln (0.8% of GDP) a year earlier, making it more difficult for the government to maintain the fiscal gap below the target of 3% of GDP in the absence of compensatory measures such as capital expenditures cut offs.

To prevent growing deficits from threatening the fiscal sustainability, medium-term consolidation should be considered, backed by broad structural reforms to enhance the effectiveness of the public sector. The EC has warned Romania on several occasions that the ongoing policies of decreasing tax rates and other non-tax revenue generating categories alongside increasing expenditures would lead to a failure of meeting the medium-term objectives in the following years, thus threatening the country of undergoing an excessive deficit procedure. In addition, the mentioned development could also result in a gradual increase in public debt as means of financing the growing budget gap.

Figure 5: Public debt: 2013 – IX 2018



Source: Ministry of Public Finance

At the end of September 2018, country's **public debt,** according to national methodology, stood at EUR 80 798 mln. As a share of GDP, public debt decreased to 39.6% from 42.9% at the end of 2017 due to the rapid growth of the economy, while in nominal terms, the debt level posted an increase of EUR 1 727 mln. In recent years, the structure of public debt has changed in favour of domestic debt, but the public debt remains vulnerable to exchange rate risk with foreign currency denominated debt accounting for about half of total public debt.

Romania's gross government debt, according to EU methodology, equalled to 35.0% of GDP at the end of September 2018, well below the 60% ceiling of the Maastricht Treaty. Although the country's indebtedness remains moderate and compares favourably to peers, the debt trajectory is exposed to risks, as a future rise may stem from the ongoing fiscal stimuli and the expected growth deceleration, unless a prudent policy mix is implemented.

Amid growing concerns regarding the sustainability of public finances and the volatile political environment, Romanian **bonds yield** has been generally on the rise since the second half of 2016. Romania's sovereign 10-year bonds yield, a barometer for the cost of financing in the economy, reached a new four years high of 5.05% in July 2018, afterward it dropped slightly to 4.78% in November. However, Romania is the EU member state which pays the highest interest rates for its debt, which rises concerns, as higher borrowing cost can quickly translate into higher public debt.

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Romanian **banking system** continued to grow fast in terms of assets. At end-September 2018, total assets reached EUR 95 460 mln. Financial intermediation as measured by asset-to-GDP ratio, however, remained low at the level of 48.3%, while the system continued to consolidate. The assets' structure has remained dominated by non-financial sector loans, which barely accumulated 0.9% nominal growth in 2016. In the course of 2017, their value accrued, thus supporting the asset growth, and reached 6.6% for the period January – September 2018. The share of the non-performing exposures shrank to 5.6% at the end of the period, with appropriate provision coverage. Most of the main quality indicators for Romanian banking system successfully covered the EBA-defined prudential thresholds in 2017 and showed further improvement during the first three quarters of 2018.

Outlook:

The stable outlook of the Sovereign Rating of Romania reflects broadly balanced risks to the rating. The tensions within the ruling coalition create risk to the political stability and deteriorate the institutional strength of the country. Romania's economy is among the fastest growing in the EU with record low unemployment and an improving financial sector, while the expansionary fiscal policy has weakened the public finances. However, the sovereign's rating is supported by the still moderate public debt level.

Positive pressures on the Sovereign Rating and/or the Outlook would be considered:

- Reversal of the current fiscal relaxation and implementation of fiscal consolidation measures;
- Institutional and political stability improvements;
- Sustained reduction in external imbalances;

Negative pressures on the Sovereign Rating and/or the Outlook would be considered:

- Continued deterioration of fiscal performance;
- Increasing political uncertainty;
- Re-emergence of current account imbalances;
- Capital outflow related to changes in investors' sentiment towards future economic developments.

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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 2018, with some exceptions, for which data is released more frequently.

Summary of the minutes of the Rating Committee:

On the 20th of December 2018 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, the macroeconomic sustainability and the effects of the pro-cyclical fiscal policy. The economic growth, its sectoral dynamics and expenditure components were taken into account. The external imbalances were assessed as a potential risk.

The committee members voiced concern about the fiscal balance deterioration and noted the need for consolidation measures. The assessment took into account the improved performance of the banking system and the adequate level of foreign reserves maintained by the country.

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)

MAIN MACROECONOMIC INDICATORS							
	I-IX 2018	I-IX 2017	2017	2016	2015	2014	2013
Gross domestic product (EUR mln):	142 582	131 684	187 969	170 878	160 312	150 428	143 802
Final consumption	111 734	103 819	146 029	131 761	121 025	113 958	108 129
Gross fixed capital formation	30 927	29 652	42 390	38 979	39 711	36 538	35 619
Change in inventories	3 643	271	3 544	1 665	573	594	1 173
External balance of goods and services	-3 723	-2 058	-3 995	-1 527	-996	-662	-1 119
Exports of goods and services	62 814	57 840	77 873	70 168	65 757	61 922	57 338
Imports of goods and services	66 537	59 898	81 868	71 696	66 753	62 584	58 457
GDP (real growth rate, %)	4.2	7.0	6.9	4.8	3.9	3.4	3.5
GDP per capita (EUR, current prices)	-	-	9 600	8 600	8 100	7 600	7 200
Unemployment rate[1] (%)	4.4*	5.2*	4.9	5.9	6.8	6.8	7.1
Average net monthly wage (EUR)	583	516	531	465	416	384	367
CPI, annual average rate of change (%)	4.5	0.4	1.3	-1.5	-0.6	1.1	4.0
Average exchange rate RON/EUR	4.65	4.55	4.57	4.49	4.45	4.44	4.42
Average exchange rate RON/USD	3.89	4.10	4.05	4.06	4.01	3.35	3.33

EXTERNAL SECTOR							
EUR millions	I-IX 2018	I-IX 2017	2017	2016	2015	2014	2013
Current account balance	-6 618	-4 779	-5 970	-3 548	-1 973	-1 012	-1 540
Goods and services	-3 723	-2 040	-3 972	-1 583	-995	-667	-1 113
Goods	-9 776	-8 283	-12 183	-9 305	-7 788	-6 536	-5 816
Services	6 054	6 243	8 210	7 723	6 794	5 868	4 702
Primary income	-4 460	-4 583	-4 637	-4 467	-3 772	-2 029	-3 112
Secondary income	1 564	1 845	2 640	2 501	2 795	1 685	2 688
Official reserves assets	34 825	36 959	37 107	37 905	35 485	35 506	35 434
Gross external debt	97 994	94 531	97 360	92 909	92 068	94 744	98 069
NIIP	-89 001	-86 134	-86 429	-83 264	-84 247	-86 233	-88 700
% of GDP[2]							
Current account balance	-3.2	-2.5	-3.2	-2.1	-1.2	-0.7	-1.1
Goods and services	-1.8	-1.1	-2.1	-0.9	-0.6	-0.4	-0.8
Goods	-4.8	-4.4	-6.5	-5.4	-4.9	-4.3	-4.0
Services	3.0	3.3	4.4	4.5	4.2	3.9	3.3
Primary income	-2.2	-2.4	-2.5	-2.6	-2.4	-1.3	-2.2
Secondary income	0.8	1.0	1.4	1.5	1.7	1.1	1.9
Official reserves assets	17.1	19.7	19.7	22.2	22.1	23.6	24.6
Gross external debt	48.0	50.3	51.8	54.4	57.4	63.0	68.2
NIIP	-43.6	-45.8	-46.0	-48.7	-52.6	-57.3	-61.7

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PUBLIC FINANCE							
EUR millions	I-IX 2018	I-IX 2017	2017	2016	2015	2014	2013
Consolidated budget revenues	44 076	39 500	55 126	49 818	52 543	48 219	45 344
Consolidated budget expenditures	47 682	40 992	60 437	53 892	54 874	50 805	48 918
Budget balance	-3 606	-1 493	-5 311	-4 074	-2 331	-2 586	-3 574
Public debt[3]	80 798	75 674	79 071	74 669	69 827	65 964	59 569
Government consolidated gross debt	-	-	64647	62911	59494	58489	53429
% of GDP[2]							
Consolidated budget revenues	21.6	21.0	29.3	29.2	32.8	32.1	31.5
Consolidated budget expenditures	23.3	21.8	32.2	31.5	34.2	33.8	34.0
Budget balance	-1.8	-0.8	-2.8	-2.4	-1.5	-1.7	-2.5
Public debt[3]	39.6	40.1	42.9	44.2	44.3	44.2	42.0
Government consolidated gross debt	-	-	35.1	37.3	37.8	39.2	37.6

BANKING SYSTEM							
	IX 2018	IX 2017	2017	2016	2015	2014	2013
Assets (EUR mln)	95 460	88 371	91 725	86 686	83 365	81 244	80 777
Deposits of non-financial sector (EUR mln)	63 738	58 639	61 210	56 955	52 650	48 737	44 709
Loans and advances to non-financial sector (EUR mln)	51 700	49 250	48 503	47 274	47 030	46 314	48 071
Loan-to-deposit ratio (%)	76.4	80.3	74.7	79.1	85.4	91.3	104.6
Non-performing loans ratio (%)	5.6	8.0	6.4	9.6	13.5	20.7	-
Capital adequacy (%)	20.0	19.0	20.0	19.7	19.2	17.6	15.5

[1] Data Unemployment rate of population aged 15 years and over, Labour Force Survey.; * Data average for Q1 and Q2 of the respective year;
[2] The GDP ratios for 2018 are calculated on the basis of GDP amounting to RON 949 600 mln (forecast).
[3] Public debt according to Romanian national legislation (the GEO no 64/2007) includes:
-public government debt representing indebtedness incurred directly or guaranteed by the Romanian Government trough MoPF , including the amounts advanced temporary from the State Treasury accounts and debt contracted by the line ministries.
- local public debt representing indebtedness incurred directly or guaranteed by the local administration unit.

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