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

| | |
|---|---|
| **Romania**<br><br>**June 2019** | Kalina Dimitrova, Lead Economic Analyst<br>**k.dimitrova@bcra-bg.com**<br>Radostina Stamenova, Economic Analyst<br>**stamenova@bcra-bg.com**<br>Ventzislav Petrov, Financial Analyst<br>**v.petrov@bcra-bg.com** |

| SOVEREIGN RATING | Initial rating | Review |
|---|---|---|
| **Date of Rating Committee** | **13.01.2016** | **13.06.2019** |
| **Date of rating publication** | **15.01.2016** | **14.06.2019** |
| **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 (https://www.bcra-bg.com/files/Sovereign_Methodology_2014_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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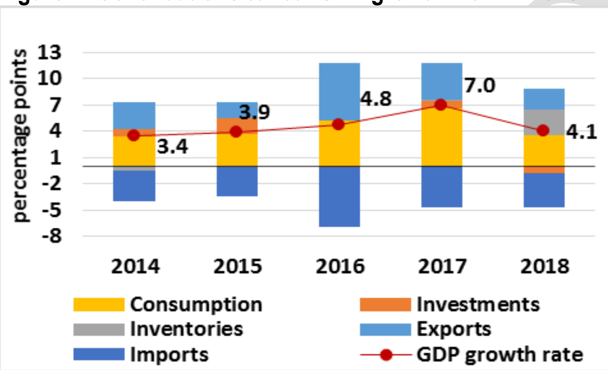
## Overview

By the time Romania has been rotating EU Presidency (H1 2019), the **political situation** in the country remains tense especially in relation to the justice system reforms. These continued to provoke street protests within the country as well as warns about taking eventual legal measures by the EU institutions for infringing the rule of law.

Long-lasting insisting on amending justice legislation by the SDP government culminated in the President-initiated referendum held together with the EP election in May 2019. Romanians said “yes” to the ban on amnesty and pardons for corruption-related crimes; on the government to pass emergency ordinances related to crimes, penalties and judicial organisation; and for an expansion of the right to challenge ordinances directly to the Constitutional Court. EP 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.

**Figure 1: Contributions to real GDP growth: 2014 – 2018**

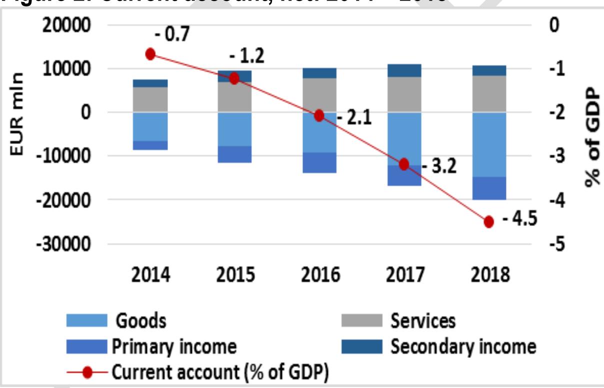



Source: National Institute of Statistics

Romania has been one of the fastest growing economies in the EU, with real **GDP growth** averaging to 4.6% over the last five years. In 2018, economic growth decelerated from a peak of 7% in 2017 but remained robust at 4.1%. Household consumption continued to be the main driver on the demand side, however, its growth rate slowed down substantially to 5.3% from 10.1% in 2017, as the effect of the tax breaks and wage increases began to fade and the inflation surged. The inventory build-up marked a sizeable positive contribution of 2.9 pp. to the GDP growth rate in 2018. By contrast, gross fixed capital formation decreased by 3.2% compared to 2017, dragging down the GDP growth by 0.7 pp. and further weakening its sustainability. Simultaneously, the negative contribution of net exports has expanded to 1.7 pp., as the growth of exports decelerated markedly to 5.4% in real terms (from 10% in 2017), while imports rose by 9.1% (11.3% in 2017).

EU countries as major trade partners of Romania had their position strengthened in the last five years. Their aggregate share in the export of goods reached 76.7% in 2018. That is why the slower pace of economic growth in the EU (2.0% on average for 2018) rises concerns about further absorbing Romanian exports by the single market.

**Figure 2: Current account, net: 2014 – 2018**




Source: National Bank of Romania

The **current account** deficit widened further from EUR 5 970 mln (3.2% of GDP) in 2017 to EUR 9 162 mln (4.5% of GDP) in 2018. The persistent deterioration is largely related to the fiscal-led consumption boom, which has fuelled a strong rise in imports of consumer goods. In 2018, the deficit on trade in goods increased by 21.8% on an annual basis, reaching EUR 14 841 mln (7.3% of GDP). In addition, the secondary income surplus slightly decreased to EUR 2 375 mln (1.2% of GDP), while the primary income deficit increased to EUR 5 021 mln (2.5% of GDP) in 2018. Services, which are one of the offsetting factors of the trade deficit, recorded a positive balance of EUR 8 327 mln (4.1% of GDP) compared with a surplus of EUR 8 210 (4.4% of GDP) in 2017.

Romania’s current account deficit compares unfavourably with CEE peers. Financing sources raise concerns as well. **Foreign direct investment** inflows remained almost flat in 2018, totalling to EUR 4 977 mln (2.5% of GDP). Until 2016, net FDI inflows covered the annual shortfalls in full, however, the coverage deteriorated to only 54.3% in 2018, down from 81.8% in 2017. Hence the reliance on debt-creating capital inflows for

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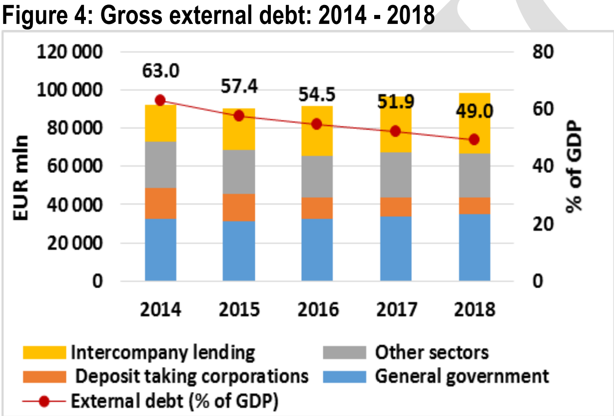
financing the external deficits is rising. At the same time, **capital account** surplus increased marginally - from EUR 2 216 mln (1.2% of GDP) in 2017 to EUR 2 241 mln (1.2% of GDP) in 2018, indicating for a still low accumulation of EU funds in the new programming period.

**Figure 3: EUR/RON – monthly average: 2016 – April 2019**


Source: National Bank of Romania

The Romanian currency has gradually depreciated over the past 2 years, reflecting the large current account and fiscal deficits, as well as uncertainties in the domestic economic policy. In January 2019, the **leu exchange rate** exceeded the psychological threshold of 4.70 against the euro, hitting an all-time low of 4.7648 on the 25th of January 2019.

**Figure 4: Gross external debt: 2014 - 2018**




Source: National Bank of Romania

At the end of 2018, country's **gross external debt** stood at EUR 99 416 mln, accounting for 49.0% of GDP. Compared to the end of 2017, gross external debt increased by EUR 634 mln (2.1%) in absolute terms, due to higher intercompany lending, as well as higher public debt.

Romania's **international reserves** amounted to EUR 36 800 mln (18.1% of GDP) as of end-2018, down from EUR 37 107 mln (19.8% of GDP) at the end of 2017. The ratio of the reserves to short-term external debt by remaining maturity dropped from 79% in 2017 to 74.6% in 2018, as the short-term debt advanced. However, reserves level remained broadly adequate, covering 4.9 months of goods and services imports.

The net debtor position of Romania is in line with CEE peers, although not without risks. Romania's negative **net international investment position (**NIIP) stood at EUR 90 190 mln or 44.4% of GDP at the end of 2018. Compared to the previous year, the NIIP improved by 2.4 pp. as a share of GDP, but it deteriorated by EUR 2 321 mln in absolute terms, as accumulation of liabilities was higher than accumulation of assets.

**Figure 5: CPI – annual rate of change: 2016 – 2018**


Source: National Institute of Statistics

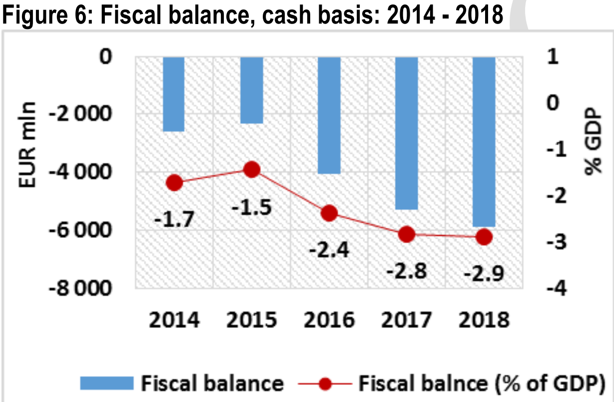
The CPI **inflation** accelerated rapidly in the course of 2018, to reach an annual average of 4.6% - well above the upper limit of the NBR's target band (2.5% ± 1 pp.). Inflation peaked to 5.41% in May 2018 and eased to 3.3% towards the end of the year, helped by the moderation of global crude oil prices in the second half of 2018. Additional fiscal stimuli, sharp increases in public and minimum wages and stronger consumer lending fuelled inflationary pressures on the demand side. As a result, Romania recorded the highest annual inflation rate (measured by HIPC) among the EU member states in 2018.

**Labour market** in Romania tightened further in 2018 as most of the trends already observed have been continued. Unemployment reduced to a new low corresponding to 4.2% of the active population on average for 2018, while employment slightly increased.

Labour incomes across all the economic sectors accelerated for the fourth consecutive year in 2018. The average net monthly wage grew nominally by 13.1% in 2018 and by 16.5% on average for Q1 2019. 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 starting January 1, 2019. 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), which equalled to 90% of average gross wage in the sector over 2018. Construction was declared a priority sector for the next 10 years by the government in pursue of boosting economic growth through enhanced investment and coping with respective labour shortage in that particular branch. Accordingly, the annual growth rate of nominal wages in *Construction* reached the impressive 42.7% during the first quarter of the 2019.

**GDP per capita** amounted to EUR 10 400 in 2018 marking another year of high growth rate (8.3%). However, Romania remained at the second to last position in terms of income within the European Union.

**Figure 6: Fiscal balance, cash basis: 2014 - 2018**




Source: Ministry of Public Finance

The procyclical fiscal and wage policies pose risks to macroeconomic stability. The **fiscal deficit**, in cash terms, widened further from 2.8% of GDP in 2017 to 2.9% in 2018, due to new tax cuts and increases in public wages, social transfers and pensions.

Consolidated budget revenues surged by 17.2% on an annual basis in 2018 to EUR 63 419 mln or 31.3% of GDP. The most significant positive effect on revenue rise came from social contributions, which increased by 36.8% compared to 2017. Meanwhile, the strongest negative effect on revenue was the personal income tax cut[1], as the income tax revenues fell by 24.8% year-on-year. Consolidated budget expenditures, totalling EUR 69 293 mln (34.2% of GDP) in 2018, were 16.8% higher than in the previous year. Payroll and social security payments accounted for 58.1% of the total public expenditures in 2018. Compensation for employees increased by 23.7%, reflecting the Unified Wage Law adopted in summer 2017, while social security spending expanded by a more moderate rate of 9.5%. Public investment increased by 22% in nominal terms, but their proportion in GDP (2.5%) remained significantly below pre-crisis levels. At the same time, interest payment rose sharply by 27.8% to EUR 2 781 mln or 1.4% of GDP in 2018, fuelled by rising borrowing costs.

Romania's budget deficit, calculated according to the EU methodology (ESA 2010), accounted for 3% of GDP in 2018 - the limit of the reference level of the Stability and Growth Pact. Country's fiscal gap was five times wider than the average in the EU (0.6% of GDP), whereas only Cyprus posted a higher budget deficit (4.8% of GDP) than Romania.

With the fiscal deficit reaching the threshold of 3% of GDP, the Romanian government has no more room to manoeuvre. To prevent growing deficits from threatening 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 may lead to a failure of meeting the medium-term objectives in the following years, thus threatening the country of undergoing an excessive deficit procedure.

The budget plan for 2019, which was approved only in February 2019, envisages the ESA budget deficit at 2.8% of GDP, an adjustment of 0.2 pp. compared to 2018. GDP. The Convergence programme for the period 2019-2022 sees the deficit reaching 2.0% of GDP in 2022. However, the programme does not specify the measures which would support the planned consolidation targets. Additional taxes are necessary to cover the government's already announced plans for wage and pension increases. The budget plan relies on a number of new revenue sources - banking, energy

[1] The flat personal income tax rate was cut from 16% to 10%, starting from January 2018.

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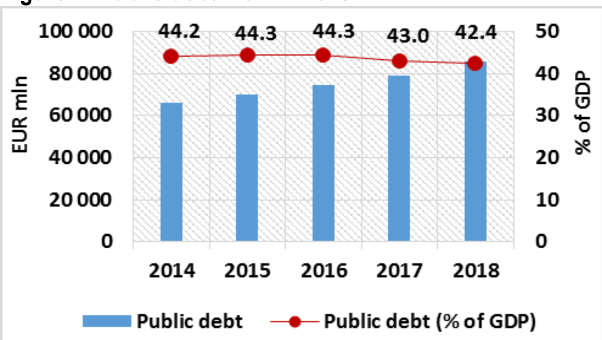
and telecoms taxes introduced via emergency decree in late December 2018 without an impact assessment or public debate. These measures, along with the frequent amendments to the fiscal code, could have negative effects on lending and investment decisions in the country as a result of the significant increase in the unpredictability of the business environment.

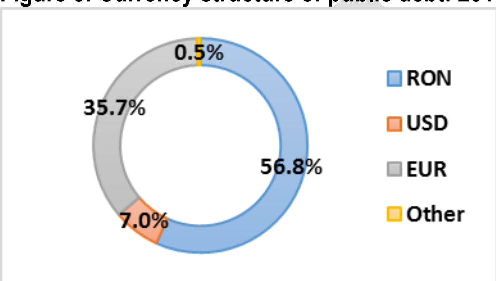
**Figure 7: Public debt: 2014 – 2018**




Source: Ministry of Public Finance

At the end of 2018, country's **public debt,** according to national methodology, stood at EUR 85 932 mln. As a share of GDP, public debt decreased by 0.6 pp. to 42.4% due to the rapid growth of the economy, while in nominal terms, the debt level posted an annual increase of EUR 6 820 mln or 8.7%.

**Figure 8: Currency structure of public debt: 2014 – 2018**

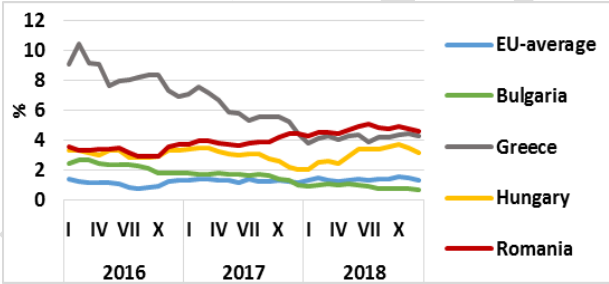



Source: Ministry of Public Finance

In recent years, the structure of public debt has changed in favour of domestic debt, however, it remains vulnerable to exchange rate risks with foreign currency-denominated debt accounting for 43.2% of total public debt at the end of 2018. Given the small relative share (22.9%) 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 2018, well below the 60% ceiling of the Maastricht Treaty. Romania ranked 7th (5th place in 2017) among the EU member states with the lowest government debt ratio after Estonia, Luxembourg, Bulgaria, Czechia, Denmark and Lithuania. 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 loose fiscal stance and the expected growth deceleration, unless a prudent policy mix is implemented.

**Figure 9: 10-Y government bond yield: Romania and selected countries: 2016 – 2018**




Source: Eurostat

At the same time, the financing cost of public debt have been steadily increasing since 2017 to levels well above those observed for peer countries. Amid growing twin deficits and domestic political tensions, Romania's sovereign 10-year **bonds yield** reached a four years high of 5.05% in July 2018. Long-term interest rates in Romania 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.

Romanian **banking system** continued to grow steadily in terms of assets, yet, financial intermediation as measured by the asset-to-GDP ratio, remained low at the level of 47.8% by the end of 2018. The assets' structure has remained dominated by non-financial sector loans, as households borrowed by 9.2% more than in 2017 and NFC loans gained 6.2% for 2018. RON credit has increasingly prevailed the currency structure in the last three years (2016-2018), whereas the interest rates applied in that particular credit segment have seen an uptrend. The annual policy rate retained its 2018 level (2.50%).

At the same time, the share of the non-performing loans shrank to 5.0% at the end of 2018, with appropriate provision coverage. By bringing the net loan loss expenses significantly down as well as

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increased net interest income, profitability of the banking system maintained its favourable tendency in 2018. The deposit base kept expanding at high annual rates over the year, thus supporting the constant growth (8.9% in 2018) of the broad money aggregate. This was also ensuring ample liquidity resources with domestic origin counter to the continued process of foreign deleveraging.

Most of the main quality indicators for Romanian banking system successfully covered the EBA-defined prudential thresholds in 2018. However, in their last Financial Stability Report released June 2019, the NBR pointed out to an elevated risk for the financial system amid global and domestic (especially legislative) developments.

## Outlook:

The stable outlook of the Sovereign Rating of Romania reflects broadly balanced risks to the rating. Romania's economy is among the fastest growing in the EU with record low unemployment and moderate public debt level. On the other hand, fiscal policy in recent years poses a risk to the public finance sustainability, while current account deficit has been widening markedly. At the same time, political tensions and policy uncertainties deteriorate the business climate in the country.

**Positive** pressures on the Sovereign Rating and/or the Outlook would be considered:
- Well-targeted structural reforms and stronger governance, which improve the business environment;
- Implementation of fiscal consolidation;
- Sustained reduction in external imbalances;

**Negative** pressures on the Sovereign Rating and/or the Outlook would be considered:
- Reform reversal, weakening the anti-corruption framework and the rule of law;
- Widening twin deficits:
- Capital outflows related to sudden shift 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.*

Please, visit www.bcra-bg.com to review BCRA's full policy on unsolicited credit/sovereign ratings.

## 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 June 2019, with some exceptions, for which data is released more frequently.

## Summary of the minutes of the Rating Committee:

On the 13th of June 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, 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 viewed as a potential risk. The committee members negatively assessed the fiscal balance deterioration and noted the need for consolidation measures.

**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 | | | | | |
|---|---|---|---|---|---|
| | 2018 | 2017 | 2016 | 2015 | 2014 |
| Gross domestic product (EUR million): | 202 905 | 187 546 | 170 378 | 160 312 | 150 428 |
| Final consumption | 160 396 | 147 683 | 132 202 | 121 025 | 113 958 |
| Gross fixed capital formation | 43 054 | 42 022 | 38 966 | 39 711 | 36 538 |
| Change in inventories | 5 971 | 1 829 | 789 | 573 | 594 |
| External balance of goods and services | -6 516 | -3 989 | -1 579 | -996 | -662 |
| Exports of goods and services | 84 494 | 77 881 | 70 171 | 65 757 | 61 922 |
| Imports of goods and services | 91 009 | 81 870 | 71 750 | 66 753 | 62 584 |
| GDP (real growth rate, %) | 4.1 | 7.0 | 4.8 | 3.9 | 3.4 |
| GDP per capita (EUR, current prices) | 10 400 | 9 600 | 8 600 | 8 100 | 7 600 |
| Unemployment rate[1] (%) | 4.2 | 4.9 | 5.9 | 6.8 | 6.8 |
| Average net monthly wage (EUR) | 579 | 522 | 465 | 416 | 384 |
| CPI, annual average rate of change (%) | 4.6 | 1.3 | -1.5 | -0.6 | 1.1 |
| Average exchange rate RON/EUR | 4.65 | 4.57 | 4.49 | 4.45 | 4.44 |
| Average exchange rate RON/USD | 3.94 | 4.05 | 4.06 | 4.01 | 3.35 |
| EXTERNAL SECTOR | | | | | |
| EUR million | 2018 | 2017 | 2016 | 2015 | 2014 |
| Current account balance | -9 162 | -5 970 | -3 548 | -1 973 | -1 012 |
| Goods | -14 841 | -12 183 | -9 305 | -7 788 | -6 536 |
| Services | 8 327 | 8 210 | 7 723 | 6 794 | 5 868 |
| Primary income | -5 021 | -4 637 | -4 467 | -3 772 | -2 029 |
| Secondary income | 2 375 | 2 640 | 2 501 | 2 795 | 1 685 |
| Capital account | 2 441 | 2 216 | 4 261 | 3 900 | 3 954 |
| Net FDI inflows | 4 977 | 4 882 | 4 514 | 2 954 | 2 701 |
| Official reserves assets | 36 800 | 37 107 | 37 905 | 35 485 | 35 506 |
| Gross external debt | 99 416 | 97 360 | 92 909 | 92 068 | 94 744 |
| Net international investment position | -90 190 | -87 869 | -82 583 | -86 014 | -85 477 |
| % of GDP | | | | | |
| Current account balance | -4.5 | -3.2 | -2.1 | -1.2 | -0.7 |
| Goods | -7.3 | -6.5 | -5.5 | -4.9 | -4.3 |
| Services | 4.1 | 4.4 | 4.5 | 4.2 | 3.9 |
| Primary income | -2.5 | -2.5 | -2.6 | -2.4 | -1.3 |
| Secondary income | 1.2 | 1.4 | 1.5 | 1.7 | 1.1 |
| Capital account | 1.2 | 1.2 | 2.5 | 2.4 | 2.6 |
| Net FDI inflows | 2.5 | 2.6 | 2.6 | 1.8 | 1.8 |
| Official reserves assets | 18.1 | 19.8 | 22.2 | 22.1 | 23.6 |
| Gross external debt | 49.0 | 51.9 | 54.5 | 57.4 | 63.0 |
| Net international investment position | -44.4 | -46.9 | -48.5 | -53.7 | -56.8 |

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| PUBLIC FINANCE | | | | | |
|---|---|---|---|---|---|
| EUR million | **2018** | **2017** | **2016** | **2015** | **2014** |
| Budget revenues | 63 419 | 55 126 | 49 818 | 52 543 | 48 219 |
| Budget expenditures | 69 293 | 60 437 | 53 892 | 54 874 | 50 805 |
| Budget balance | -5 874 | -5 311 | -4 074 | -2 331 | -2 586 |
| Budget balance (ESA 2010) | -6 123 | -5 059 | -4 621 | -1 114 | -1 888 |
| Public debt[2] | 79 071 | 79 071 | 74 669 | 69 827 | 65 964 |
| General government gross debt (ESA 2010) | 70 772 | 64 647 | 62 911 | 59 494 | 58 489 |
| % of GDP | | | | | |
| Budget revenues | 31.3 | 29.4 | 29.2 | 32.8 | 32.1 |
| Budget expenditures | 34.2 | 32.2 | 31.6 | 34.2 | 33.8 |
| Budget balance | -2.9 | -2.8 | -2.4 | -1.5 | -1.7 |
| Budget balance (ESA 2010) | -3.0 | -2.7 | -2.7 | -0.7 | -1.3 |
| Public debt[2] | 43.0 | 43.0 | 44.3 | 44.3 | 44.2 |
| General government gross debt (ESA 2010) | 35.0 | 35.2 | 37.3 | 37.8 | 39.2 |

| BANKING SYSTEM | | | | | |
|---|---|---|---|---|---|
| | **2018** | **2017** | **2016** | **2015** | **2014** |
| Assets (EUR million) | 96 737 | 91 807 | 86 686 | 83 365 | 81 244 |
| Asset-to-GDP (%) | 64.7 | 63.3 | 61.6 | 57.0 | 54.5 |
| Deposits of non-financial sector (EUR million) | 66 682 | 61 117 | 56 955 | 52 650 | 48 737 |
| Loans and advances to non-financial sector (EUR million) | 52 251 | 48 496 | 47 274 | 47 030 | 46 314 |
| Non-performing loans ratio (%) | 5.0 | 6.4 | 9.6 | 13.5 | 20.7 |
| Capital adequacy (%) | 20.7 | 20.0 | 19.7 | 19.2 | 17.6 |
| Liquidity Coverage Ratio (%) | 237.8 | 239.2 | 229.4 | - | - |

[1] Data Unemployment rate of population aged 15 years and over, Labour Force Survey.
[2] 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*