23 September 2022 Sovereign and Public Sector

Romania
Rating Report

SCOPE BBB- STABLE OUTLOOK

Credit strengths

- Strong medium-run growth potential
- EU membership, access to substantial EU investment fund inflows
- Still-moderate public debt

Credit challenges

- Rigid budget structure and comparatively weak tax base
- Persistent current-account deficits
- Moderate reserve coverage

Rating rationale:

Romania's BBB- ratings consider several credit strengths, including i) strong medium-run growth potential; ii) EU membership with resulting access to significant EU structural and recovery fund inflows in the coming years; as well as iii) Romania's still-moderate levels of public debt.

Despite these credit strengths, significant challenges remain affecting Romania's BBB- ratings. Firstly, a rigid budget structure and comparatively weak tax base significantly constrain the budgetary outlook and result in structural budget deficits. Secondly, Romania observes elevated current-account deficits, due, in part, to fiscal imbalance and weaker competitiveness compared to regional trading partners, as well as increased import bill in the current period. Lastly, Romania's available reserves are moderate in covering foreign-currency liabilities under more stressed economic scenarios, representing an ongoing balance of payment risk.

Romania's sovereign rating drivers

Risk pillars		Quantitative scorecard		Reserve currency adjustment (notches)	Qualitative scorecard	Final rating
		Weight	Indicative rating		Notches	
Domestic Economic Risk		35%	a+		+1/3	
Public Finance Risk		25%	bb		-2/3	
External Economic Risk		10%	ccc		-2/3	
Financial Stability Risk		10%	aaa		0	BBB-
ESG Risk	Environmental Risk	5%	aaa		0	
	Social Risk	5%	bb-		-1/3	
	Governance Risk	10%	b		0	
Overall outcome		**bbb**		**0**	**-1**	

Note: The sum of the qualitative adjustments, capped at 1 notch per rating pillar, is weighted equally and rounded to the nearest integer. The reserve currency adjustment applies to currencies in the IMF's SDR basket. For details, please see Scope's 'Sovereign Ratings' methodology. Source: Scope Ratings GmbH

Outlook and rating triggers

The Stable Outlook balances the risks from still-elevated budget and current account deficits against strong growth prospects and ongoing access to EU structural and recovery fund inflows.

Positive rating-change drivers

- Sustained and strengthened adjustment of fiscal policies results in a stabilisation in debt through the cycle
- Sustained reductions in net external debt, build-up of reserves and/or tangible steps in the longer-run adoption of the euro curtail external sector risks
- Romania's institutional weaknesses are redressed, political stability is enhanced more durably and/or the government's capacity for reform were improved

Negative rating-change drivers

- Elevated budget deficits or a reversal in fiscal consolidation result in substantive deterioration in medium-run debt sustainability
- Curtailed capacity to absorb EU investment funds undermines growth and public finance outlooks
- Deterioration in market conditions and/or shrinking official reserves raise the likelihood of a balance-of-payments crisis

Ratings and Outlook

Foreign and local currency

Long-term issuer rating	BBB-/Stable
Senior unsecured debt	BBB-/Stable
Short-term issuer rating	S-2/Stable

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Bloomberg: RESP SCOP

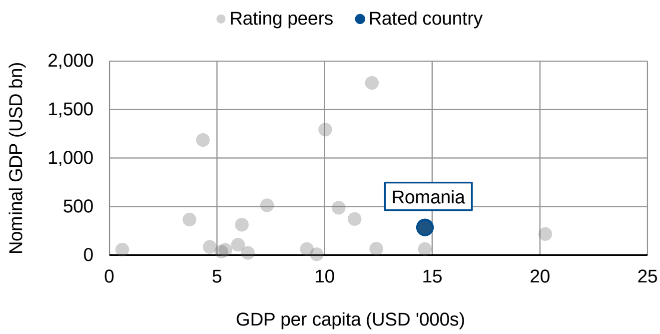
Domestic Economic Risks

- **Growth outlook:** Romania's ratings are supported by strong growth potential in the medium-term, estimated at around 4% annually, raised by the considerable allocation of EU investment funds. Under the EU long-term 2021-27 Budget, Romania has been allocated structural funds of around EUR 50bn (21% of 2021 GDP) under the Cohesion Policy and Common Agricultural Policy, plus another EUR 29.2bn (12% of GDP) via the Recovery and Resilience Facility, of which EUR 14.2bn are in grants with the remaining EUR 14.9bn in concessional loans. This allocation of EU monies helps anchor strategic medium-run investment projects, including development of physical infrastructure, and reduce near-term pressure on public finances. Still, historically weak absorption rates of EU funds (of only 55% over the previous 2014-20 EU budget as of end-2021) remain a continued growth bottleneck. Scope projects Romanian economy to grow 6.7% in 2022, as the strong performance in the first half will keep average economic growth elevated. Scope sees a stagnation during the second half of the year. Its impact will mostly be felt in 2023; still, Romania's GDP growth could reach 3.7% next year.
- **Inflation and monetary policy**: Headline inflation (HICP) has likely peaked at 13% Y-o-Y in July 2022. However, Scope expects elevated inflationary pressures to persist in the near-term due to highly volatile European energy and commodity prices and prolonged supply-chain bottlenecks because of the Russia-Ukraine war. Scope projects average headline inflation (HICP) of 11.1% this year and 7.1% in 2023. The Romanian government extended the cap on electricity and natural gas prices for households until end-August 2023 to mitigate the pressure on their budgets. To anchor medium-term inflation expectations and to mitigate second round effects from supply-side shocks, the Romanian central bank (NBR) initiated a rate-hiking cycle since October 2021, raising the policy rate in three steps of 0.25pps in October, November 2021, and January 2022 to 2%. The NBR increased the step of hiking the policy rate to 0.5pps in February, April 2022, to 2.5% and to 3% respectively, followed by 0.75pps in May, 1pps in July and 0.75pps in August to 5.5%. Scope sees the NBR to slow down the pace of rate hikes because of stabilizing inflation trend.
- **Labour markets**: While labour shortages have intensified in some sectors following the recovery from the Covid-19 crisis, the unemployment rate stabilized at 5.2% as of July 2022, slightly above the pre-crisis level of 4.9% in 2019. Scope does not expect major pressures in the labour market in 2022 and 2023. However, emigration and ageing population remain key constraints on labour-market performance in the long-term.

Overview of Scope's qualitative assessments for Romania's *Domestic Economic Risks*

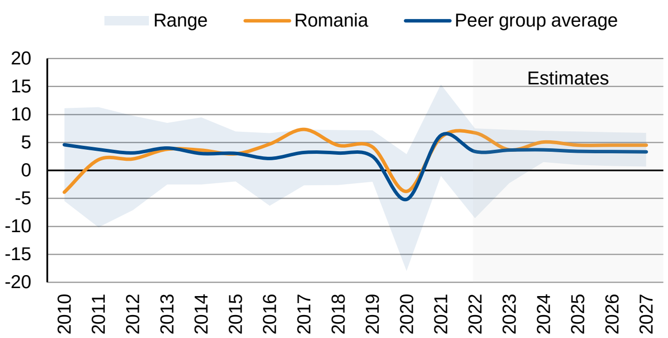
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
a+	Growth potential of the economy	Strong	+1/3	Strong growth potential, but challenges from adverse demographics and slow progress on structural reform
	Monetary policy framework	Neutral	0	Adequate monetary policy response during the current crisis
	Macroeconomic stability, sustainability	Neutral	0	Diversified industrial sector; skilled labour shortages

Nominal GDP and GDP per capita



Source: IMF, Scope Ratings GmbH

Real GDP growth, %



Source: IMF, Scope Ratings GmbH

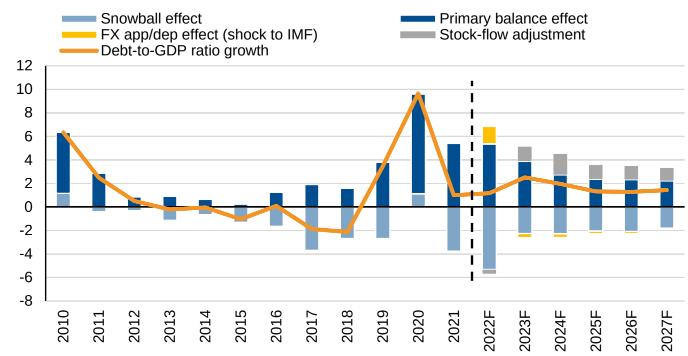
Public Finance Risks

- **Fiscal outlook:** The fiscal policy risks have been reduced due to moderate but vital consolidation measures introduced in the budget since 2021, mostly on the expenditure side in respect to public sector pensions and wages. This implicitly pulls back on multiple years of strongly expansionary fiscal policy. The budget deficit is planned to be reduced to 6.2% of GDP (in ESA terms) in 2022, to 4.4% of GDP in 2023 and further to 3% of GDP in 2024. Scope expects a more gradual narrowing of budget deficit and projects deficits of 6.8% of GDP in 2022 and 5.5% of GDP in 2023 due to the impact of energy cap and subsidy scheme. In the medium-term, a rigid budget structure constrains the budgetary outlook. Spending on state pensions and wages alone uses up around 90% of overall tax collections. In the absence of more significant fiscal reform, including an expansion of the tax base (Romania's tax revenues, at 26.2% of GDP in 2020, are the EU's second lowest after that of Ireland), the medium-run fiscal outlook remains overly contingent upon sustained high economic growth and unsustainable prudence of expenditure policy. In addition, uncertainty over the pace of future pension hikes remains in the context of ageing population, representing a risk for the budgetary outlook.
- **Debt trajectory:** Under Scope's baseline, the gradual deficit reduction results in a measured increase in Romania's government gross debt-to-GDP ratio, to 50% by end-2022, from 48.8% in 2021 before stabilising at close to but below a euro convergence ceiling of 60% in the medium-term. Public debt net of liquid financial assets is estimated to stabilise at around 50% in the medium-term. Scope thus assumes a scenario largely consistent with medium-run fiscal consolidation plan of authorities, although with official forecasts conversely envisaging gross public debt medium run remaining at around 50% of GDP.
- **Debt profile and market access:** Romania's ratings are helped by the sovereign's access to domestic and external financing on relatively favourable terms. This is underpinned by its EU membership and the resulting access to sizeable EU fund inflows, which help finance external deficits, as well as by a mostly foreign-owned and sound banking system, which holds almost half of all Romanian government securities. While the Romanian central bank has shown readiness in the past to absorb extra government debt via secondary market purchases in exceptional cases, any such purchase has been modest in size, mindful of added pressure on the currency, given a high share of FX borrowing by private and public sectors.

Overview of Scope's qualitative assessments for Romania's *Public Finance Risks*

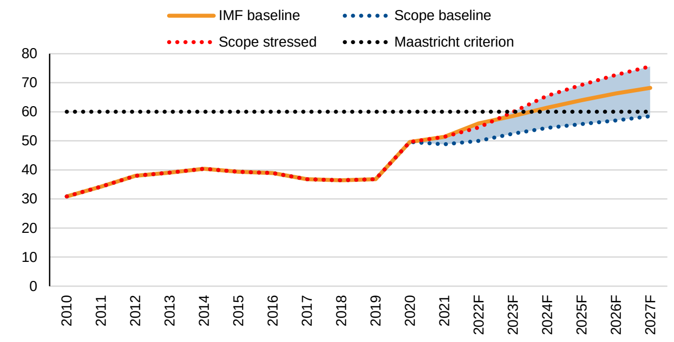
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb	Fiscal policy framework	Weak	-1/3	Track record of expansionary fiscal policies and excess deficits, rigid budgetary structure; recent introduction of fiscal consolidation
	Debt sustainability	Weak	-1/3	Rising debt burden and elevated structural deficits pose debt sustainability risk; reduced near-term risk due to introduction of fiscal consolidation
	Debt profile and market access	Neutral	0	Access to funding on favourable terms; nonetheless higher financing rates than some peers, risk from FX share of government debt and comparatively lesser access to lenders of last resort as a non-EMU EU state

Contributions to changes in debt levels, pps of GDP



Source: Scope Ratings GmbH

Debt-to-GDP forecasts, % of GDP



Source: Scope Ratings GmbH

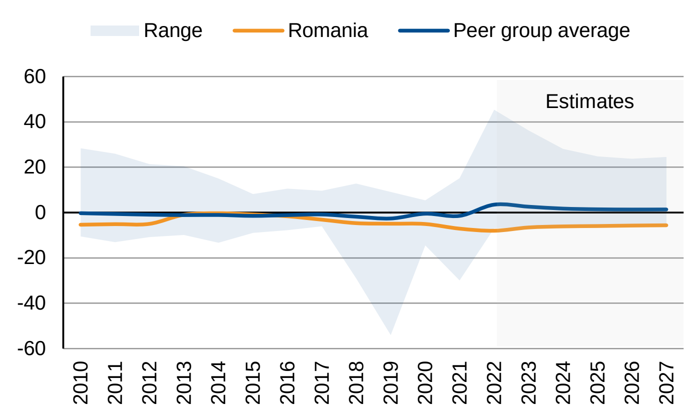
External Economic Risks

- **Current account:** Romania has posted elevated current-account deficits in the past, in part, because of fiscal imbalance as well as of weaker competitiveness as compared with that of regional trading partners because of the economy's comparatively higher inflation in the past. Scope projects the current-account deficit to widen to 9.2% of GDP in 2022, from 7% of GDP last year, due to an increased import bill related to elevated international commodity prices. In the past three years, the current-account deficit has been increasingly covered by debt-financing inflows, which Scope expects to continue this year. However, Scope projects non-debt-financing inflows to cover most of current-account deficit in the medium-term, due to a front-loaded absorption of EU grants and resumed FDI flows.
- **External position:** As a result of persistently large structural current-account deficit, Romania's net external debtor position (negative net international investment position) at 42% of GDP as of Q2 2022 remains higher than that of other central and eastern European EU member states. However, more than half of Romania's gross external liabilities relate to inward foreign direct investment. This curbs the risk of external balance sheets deteriorating markedly during periods of global stress and supports long-term sustainability of Romania's external position.
- **Resilience to shocks:** Romania's foreign-exchange reserves stood at near-all-time high of EUR 42.9bn in August, compared to EUR 41.6bn a year before. While the foreign-exchange reserves cover 76.6% of short-term (by remaining maturity) external debt as of end-July, the Covid-19 and the geopolitical crises have exposed Romania to higher exchange rate risk as well as risk of capital outflows. Romania's available reserves, thus, could come under pressure under more stressed economic scenarios, representing an ongoing balance of payment risk. Scope notes constructively, that a euro liquidity line agreed between the European and Romanian central banks, of up to EUR 4.5bn until March 2022, had served as a buffer for addressing possible liquidity needs in the presence of market instability due to the COVID-19 pandemic.

Overview of Scope's qualitative assessments for Romania's *External Economic Risks*

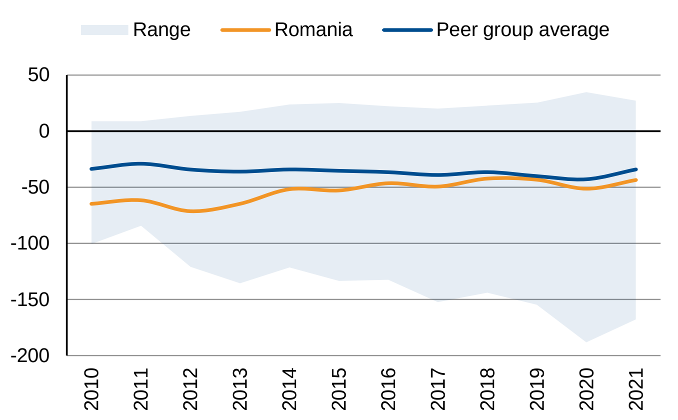
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
ccc	Current account resilience	Weak	-1/3	Persistently large structural current-account deficit, external competitiveness weaknesses vis-à-vis trading partners
	External debt structure	Neutral	0	Sizeable share (over 50%) of direct investments in total external liabilities
	Resilience to short-term shocks	Weak	-1/3	Moderate available reserves to cover foreign currency liabilities under stressed scenarios

Current account balance, % of GDP



Source: IMF, Scope Ratings GmbH

NIIP, % of GDP



Source: IMF, Scope Ratings GmbH

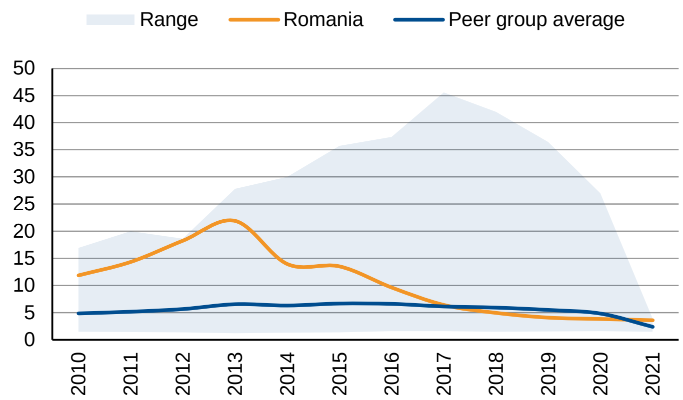
Financial Stability Risks

- **Banking sector:** In Scope's view, Romania's mostly foreign-owned banking sector presents a moderate contingent liability risk for the sovereign balance sheet. The banks are well-capitalized, with system-wide Tier 1 capital of around 18.9% of risk-weighted assets as of Q2 2022, higher than the EU average of 16.4% (Q1). However, the fact that the banking sector holds almost half of all Romanian government securities increases sovereign-bank nexus. Furthermore, despite significant recent reduction in foreign-currency exposure in the banking system, the share of foreign-currency denominated loans in total loans remains substantial at around 27% as of Q1 2022, nonetheless, down from around 50% in end-2015.
- **Private debt:** Private-sector (non-financial corporations and households) debt stood at 47.2% of GDP as of end-2021, the lowest in the EU, and only slightly above end-2019 lows (46.7%) but below peaks of 75% of GDP in 2010. Debt of the private sector increased slightly during the Covid-19 crisis in part due to the government's discretionary support measures to households and businesses. However, credit risk in the corporate sector could rise due to build-up of structural vulnerabilities and uncertainty over future economic developments. Such vulnerabilities stem from large number of undercapitalised non-financial corporates in Romania, high reliance of the corporate sector on energy-intensive activities as well as relatively small share of high-tech companies in the economy.
- **Financial imbalances:** The financial intermediation of the Romanian banking sector is among the lowest in the EU, with loans to the private non-financial sector at only around 26% of GDP as of Q2 2022. As a result, there is a sizeable share of underbanked Romanian market, which weighs on economic activity. Nonetheless, the banking system benefits from low non-performing-loan ratio, at 3% as of June 2022, after a downward trend posted during 2021. Some deterioration in asset quality is likely due to a negative impact of the current crisis on the financial standing of firms and households.

Overview of Scope's qualitative assessments for Romania's *Financial Stability Risks*

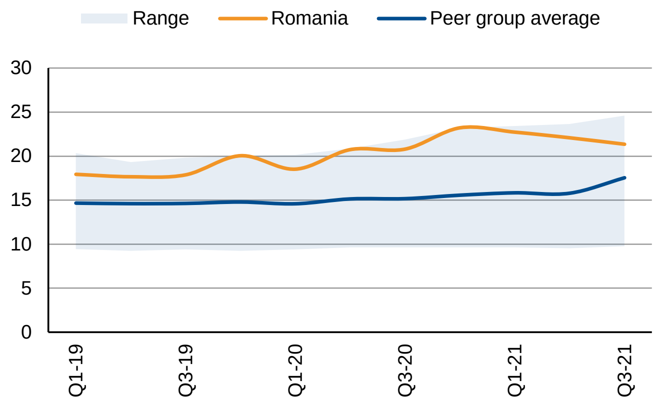
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
aaa	Banking sector performance	Neutral	0	Well-capitalised and liquid banking sector; profitability and asset quality likely to be impacted by the ongoing crisis
	Banking sector oversight	Neutral	0	Effective supervision; timely and comprehensive regulatory measures taken
	Financial imbalances	Neutral	0	Still-elevated but declining foreign-currency exposure in the banking system

NPLs, % of total loans



Source: IMF, Scope Ratings GmbH

Tier 1 ratio, % of risk-weighted assets



Source: IMF, Scope Ratings GmbH

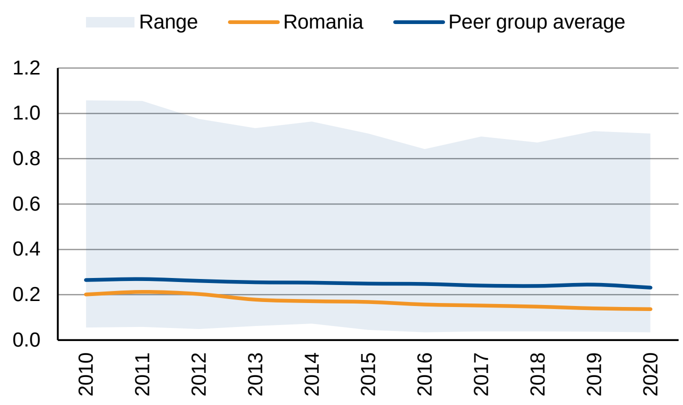
ESG Risks

- **Environment:** Environment-related credit risks of Romania remain material. The economy displays one of the highest carbon intensities in the EU. The comparative dependence of the Romanian economy upon higher energy-intensity production presents a challenge for policy makers under a context of tightening policies and needed economic transitions towards the green economy. Romania faces investment needs of around EUR 150bn (7% of GDP annually) to achieve climate objectives through 2030. Here, the current long-term EU budget presents a critical opportunity for Romania to increase production of renewable energies and make possible such transition to lower-carbon economic designs long term. Scope notes that Romania is less dependent on Russian energy sources compared to regional peers due to local production and is expected to increase investment in offshore gas production in the Black Sea.
- **Social:** Social-related credit factors are captured via unfavourable demographic trends reflecting an ageing population and significant emigration, high income inequality and poverty, that will constrain longer-term growth prospects of Romania and pose budgetary pressures. The old-age dependency ratio (those aged 65 years or over as a percentage of those aged 15-64) is projected to increase to around 35% by 2035, from 29% in 2021.
- **Governance:** The near-term political stability under the majority coalition government strengthens credibility of the government's fiscal policy with a higher likelihood that the budgetary programme could see a lengthier period of implementation. However, Romania's poor historical track record with respect to sustained fiscal consolidation, record of unstable government, which increases incentives for periods of expansionary fiscal policy around frequent electoral periods, plus governance bottlenecks in spending control and a substantial overshoot of fiscal deficit targets present challenges to its debt sustainability as well as upside risks to baseline debt projections. Acknowledging risks, any reversal in fiscal discipline being observed of current and future governments and/or renewed challenge to the outlook for debt sustainability could see risk for the ratings.

Overview of Scope's qualitative assessments for Romania's *ESG Risks*

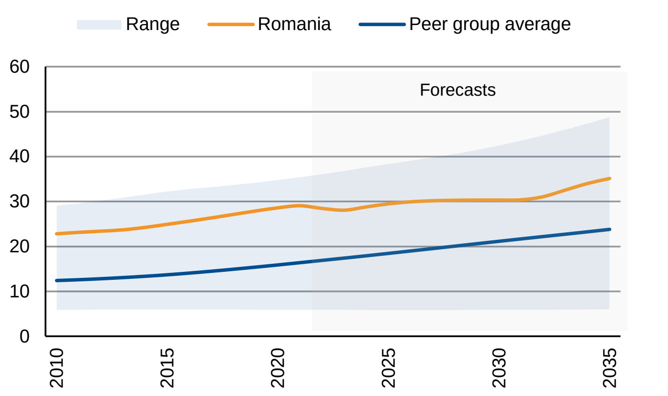
CVS indicative rating	Analytical component	Assessment	Notch adjustment	Rationale
bb+	Environmental risks	Neutral	0	High carbon and energy intensity of the economy; less dependence on Russian energy imports compared to peers
	Social risks	Weak	-1/3	Elevated poverty, elevated income inequality, adverse demographics
	Institutional and political risks	Neutral	0	Improved political stability

CO2 emissions per GDP, mtCO2e



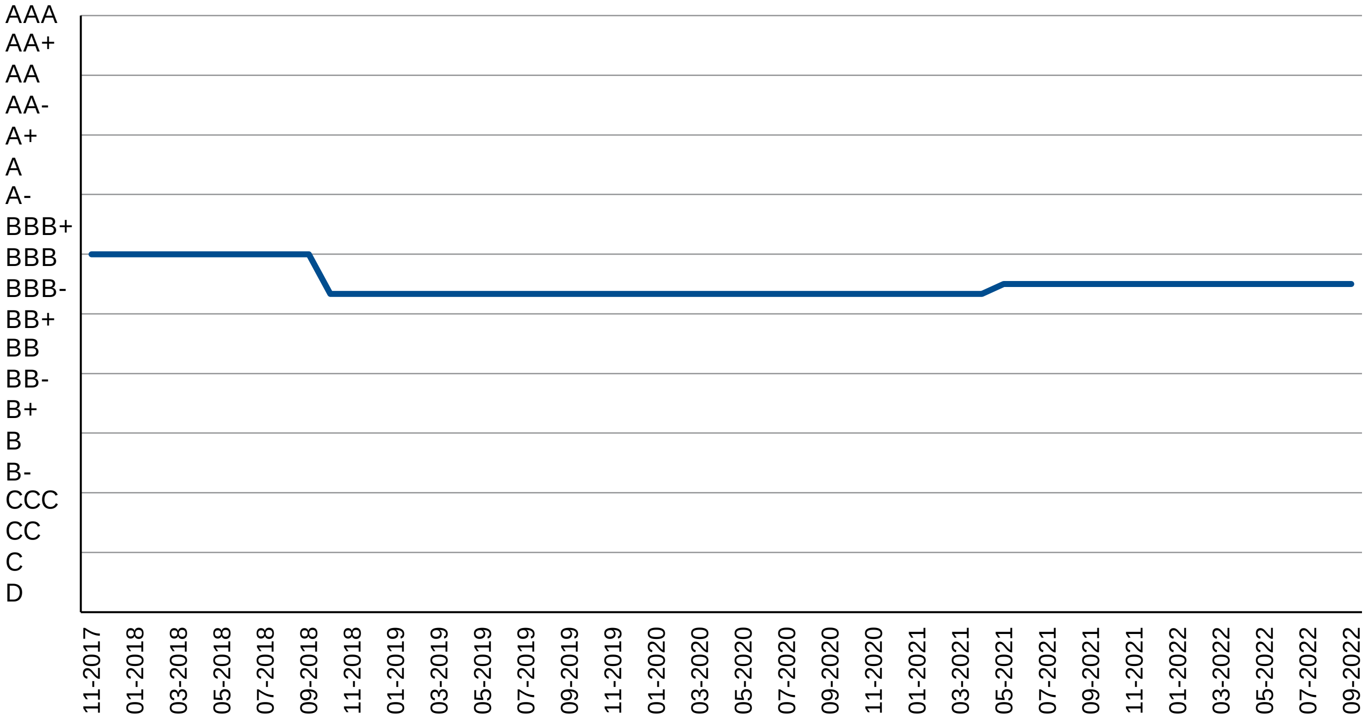
Source: European Commission, Scope Ratings GmbH

Old age dependency ratio, %



Source: United Nations, Scope Ratings GmbH

Appendix I. Rating history



Appendix II. Rating peers

Rating peers are related to sovereigns with an indicative rating in the same rating category or in adjacent categories per Scope's Core Variable Scorecard.

Peer group*
Greece
Serbia

Publicly rated sovereigns only; the full sample may be larger.

Appendix III. Statistical table for selected CVS indicators

This table presents a selection of the indicators (24 out of 29) used in Scope's quantitative model, the Core Variable Scorecard.

	2016	2017	2018	2019	2020	2021E	2022F	2023F
Domestic Economic Risk								
GDP per capita, USD 000s'	9.5	10.8	12.4	12.9	12.9	14.7	14.8	16.2
Nominal GDP, USD bn	188	212	241	250	250	283	287	313
Real growth, %	4.7	7.2	4.5	4.3	-3.6	5.9	6.7	3.7
HICP inflation, %	-1.1	1.1	4.1	3.9	2.4	4.1	11.1	7.1
Unemployment rate, %	7.2	6.1	5.2	4.9	6.0	5.6	5.6	5.5
Public Finance Risk								
Public debt, % of GDP	37.4	35.1	34.7	35.3	47.2	48.8	50.0	52.5
Net interest payment, % of government revenue	4.2	3.9	4.6	3.9	4.6	4.8	5.2	5.9
Primary balance, % of GDP	-1.2	-1.9	-1.6	-3.8	-8.5	-5.4	-5.4	-3.9
External Economic Risk								
Current account balance, % of GDP	-1.6	-3.1	-4.7	-4.9	-5.0	-7.0	-9.2	-7.0
Total reserves, months of imports	6.2	5.3	4.8	4.5	5.6	4.9	-	-
NIIP, % of GDP	-48.8	-46.7	-43.8	-43.4	-47.7	-45.6	-	-
Financial Stability Risk								
NPL ratio, % of total loans (IMF)	9.6	6.4	5.0	4.1	3.8	3.4	-	-
Tier 1 ratio, % of risk weighted assets (IMF)	17.5	18.0	18.6	20.0	23.2	20.9	-	-
Credit to private sector, % of GDP	28.1	26.5	25.7	24.7	26.0	26.6	-	-
ESG Risk								
CO^2 per 1,000 units of GDP, $mtCO^2e$	156.7	152.2	147.3	139.6	136.3	-	-	-
Income quintile share ratio (S80/S20), x	7.1	7.7	7.6	7.1	-	-	-	-
Labour force participation rate, %	65.6	67.3	67.8	68.6	69.2	65.6	-	-
Old age dependency ratio, %	25.6	26.4	27.2	27.9	28.6	29.1	28.5	28.1
Composite governance indicator[1]	0.3	0.2	0.2	0.3	0.3	-	-	-

[1]Average of the six World Bank Governance Indicators
Source: Eurostat, IMF, World Bank, UN, National Statistics Institute and National Bank of Romania, Scope Ratings GmbH

Appendix IV. Economic development and default indicators

IMF Development Classification	Emerging market and Developing economy
5y USD CDS spread (bps) as of 23 September 2022	373

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