03 November 2017

Public Finance

Romania
Rating Report

SCOPE

BBB

NEGATIVE OUTLOOK

Credit strengths

- EU membership
- High growth potential
- Reduction of imbalances

Credit weaknesses

- Deterioration in public finances
- Institutional shortcomings
- Vulnerabilities to short-term shocks

Rating rationale and Outlook:

Scope's affirmation of Romania's BBB rating reflects the country's EU membership and the resulting wealth- and institutional convergence underpinned by high actual and potential growth rates as well as the sustained reduction in fiscal and external imbalances since the 2009-2011 EU/IMF balance of payments financial assistance. However, the rating remains constrained by the country's still relatively weak institutions, evidenced by the low adherence to fiscal rules, short-comings in judicial reform and the fight against corruption. The Negative Outlook indicates the rising risk from Romania's pro-cyclical/expansionary budgetary policy, specifically, the considerable tax cuts and wage increases in a high-growth environment, which could lead to a re-emergence of significant fiscal and current account imbalances.

Figure 1: Sovereign scorecard results

Scope's sovereign risk categories	Romania	Peer comparison		
		Average	Bulgaria	Hungary
Domestic economic risk				
Public finance risk				
External economic risk				
Financial risk				
Political and institutional risk				
Qualitative adjustment (notches)	-		-	-
Final rating	BBB		BBB	BBB

AAA AA A BBB BB B CCC CC C

NB. The comparison is based on Scope's Core Variable Scorecard (CVS), which is determined by relative rankings of key sovereign credit fundamentals. The CVS peer group average is shown together with two selected countries chosen from the entire CVS peer group. The CVS rating can be adjusted by up to three notches depending on the size of relative credit strengths or weaknesses.

Positive rating-change drivers

- Reversal of recent fiscal slippage
- Sustained growth outlook
- Institutional improvements

Negative rating-change drivers

- Deterioration in public finances
- Sudden capital outflows
- Reversal of institutional reforms

Ratings and outlook

Foreign currency

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

Local currency

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

Lead analyst

Rudolf Alvise Lennkh, CFA
+49 69 6677389-85
a.lennkh@scoperatings.com

Team leader

Dr Giacomo Barisone
+49 69 6677389-22
g.barisone@scoperatings.com

Scope Ratings AG

Neue Mainzer Straße 66-68
60311 Frankfurt am Main

Phone + 49 69 6677389 0

Headquarters

Lennéstraße 5
10785 Berlin

Phone +49 30 27891 0
Fax +49 30 27891 100

info@scoperatings.com
www.scoperatings.com

Bloomberg: SCOP

Domestic economic risk

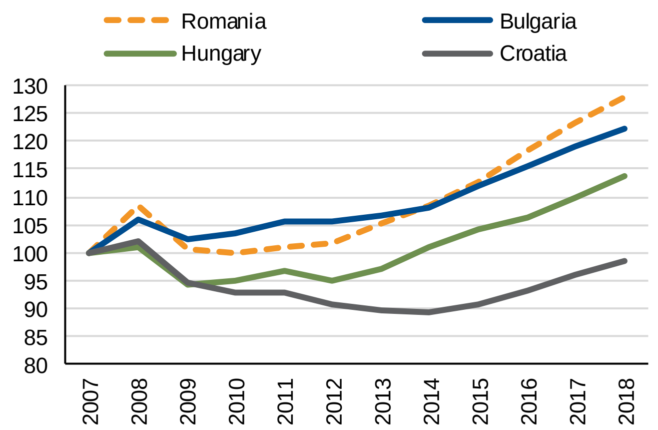
Growth potential of the economy

Robust economic growth prospects

Romania's GDP per capita is estimated at around 60% of the EU28 average, below Hungary's (70%) but in line with Croatia's (60%) and above Bulgaria's (48%). The growth outlook is robust and expected to support the ongoing process to catch up with the rest of the EU over the coming years. In fact, Romania has been one of the fastest-growing economies in the EU, with real GDP growth averaging 3.8% over the last four years and even accelerating to 4.8% in 2016. This has been driven mostly by a sharp increase in private consumption, on the back of a fiscal expansion, including large tax cuts, wage and pension increases, as well as a rise in residential investment.

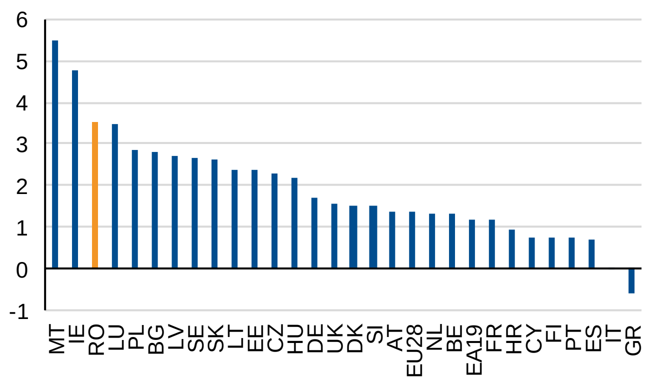
Public investment slowed in 2016 (also the case for other CEE peers), driven by the lower absorption of EU structural funds related to the transition to the new 2014-2020 EU multiannual framework. It is, however, now set to rebound as the disbursement of structural funds and the associated co-financing from Romanian authorities accelerates. Scope notes that between 2014 and 2020, Romania is expected to receive EUR 23bn in EU structural and cohesion funds, making it one of largest recipient of EU funds in terms of percentage of GDP.

Figure 2: Real GDP growth (2007=100)



Source: Haver, Ameco

Figure 3: Potential GDP growth (avg. 2016-2028, %)



Source: Haver, Ameco

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Over the medium term, growth is expected to slow to around 3.5% unless the authorities implement reforms to boost EU fund absorption. While this growth outlook is still one of the highest in the EU, IMF research shows that an increase in EU fund absorption of close to 95% of the new programming period would increase potential growth to about 4.5%[1].

In addition, Scope notes that productivity concerns, as well as labour-market and demographic challenges, further constrain the growth outlook. The minimum wage increased by about 19% in 2016 and about 16% in 2017, which, together with the low unemployment rate, a shrinking labour force and persistent skills-shortages, has led to a tighter labour market and economy-wide wage increases. The wage increases, particularly in the public sector, have outpaced labour productivity gains and risk undermining Romania's cost competitiveness. In fact, since 2010, public-sector wages have increased around 87%, while wages in the business economy have risen by around 72%, both significantly above the 52% increase in GDP per person employed.

[1] IMF Article IV Romania, May 2017.

In addition, although the jobless rate is expected to continue declining to around 5.3% by 2018, total employment still decreased by approximately 1% in 2016, and labour force participation remains relatively low at 65%, below Bulgaria's (75%) and Hungary's (68%) but still above Croatia's level of around 60%. Compounding these challenges is the high net emigration, adding to challenges caused by the shrinking working-age population, which has already fallen by about 1m over the last six years.

Economic policy framework

Weak economic policy framework

In spring 2009, following a 30% currency depreciation and a loss of market access, the Romanian authorities requested the first balance-of-payments financial assistance programme with a total financial envelope of EUR 20bn, co-financed by the EU and the IMF and agreed to last from 2009 to 2011. The two subsequent programmes in 2011-2013 and 2013-2015 were precautionary – no disbursements were made – and aimed at supporting the economic recovery and fiscal discipline to close the internal and external imbalances[2]. Despite these efforts, and a relatively effective monetary policy, Scope notes that several factors continue to constrain the effectiveness of Romania's economic policy framework, including the weak enforcement of fiscal rules, a low share of EU-funded investments, inefficient state-owned enterprises, and the weak business environment.

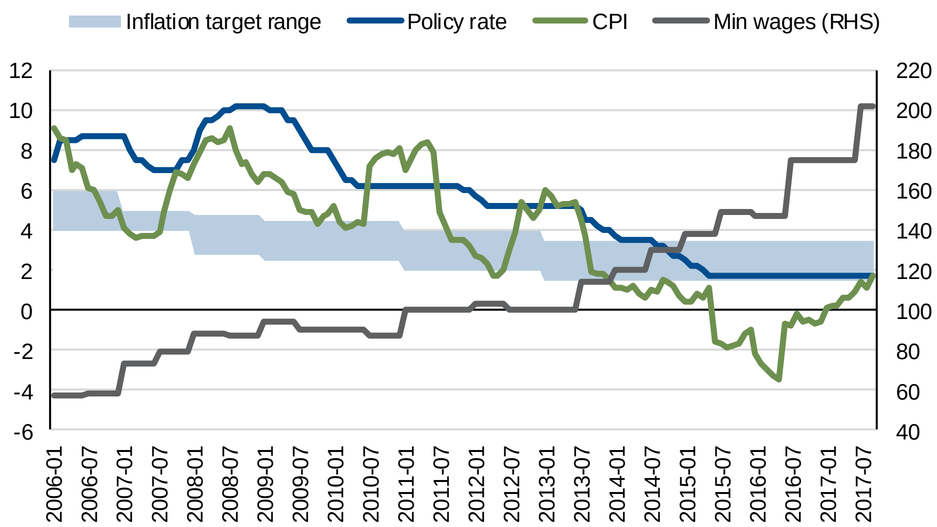
Relatively effective monetary policy

The National Bank of Romania (NBR) has kept the accommodative monetary policy rate at the historical low of 1.75%, and the amplitude of the symmetrical corridor of interest rates around the policy rate at +/- 1.5 percentage points, unchanged since May 2015. In Scope's view, this policy stance can adequately balance the downside pressures – indirect tax cuts, administrative price adjustments, and low euro-area and oil-price inflation – with the upside pressures from rising wages. However, the latest inflation developments point to a steady increase in the CPI, with year-on-year inflation rising to 1.8% in September 2017. In fact, the IMF currently expects inflation to exceed the upper end of the NBR's inflation target band of 2.5% (+/- 1pp) by mid-2018, on account of rising inflation in trading partners, high wage growth amid tight labour market conditions, and the additional fiscal impulse. These developments could require an adjustment in the monetary policy stance going forward.

Regarding the effectiveness of Romania's monetary policy, the EC notes that the monetary transmission has improved in recent years, supported by the NBR's substantial narrowing of the interest rate corridor, the growing share of leu-denominated loans in total credit, and the cleaning-up of banks' balance sheets[3]. In addition, the IMF assessment confirmed that overall governance at the NBR remains robust, although the legal framework needs to be updated to strengthen the NBR's financial autonomy. Accountability and transparency practices are strong; annual financial statements are independently audited and made public. Robust controls are maintained over foreign reserves management, government banking, and vault operations[4].

[2] Romania has fully repaid the IMF loan and about 50% of the EC loan. EUR 2.35 bn remain outstanding to the European Commission.
[3] EC, Post-programme surveillance report Romania, spring 2017.
[4] IMF Article IV Romania, May 2017.

Figure 4: Policy rate, inflation (YoY, %), minimum wages (RHS, 2013=100)



Source: Romanian central bank, Eurostat

Ineffective fiscal policy

Romania has a comprehensive fiscal framework which is not fully enforced. The EC notes that the country's significant departure in 2016 from its medium-term-objective (a structural deficit of 1% of GDP or on the adjustment path towards it) had breached the Fiscal Responsibility Law as well as Romania's obligations under the Stability and Growth Pact and the Fiscal Compact[5]. In addition, the country did not adopt its medium-term fiscal strategy in time, by mid-August, and instead sent this to the Parliament along with the draft budget law in December[6]. Scope notes that this weak enforcement of fiscal rules and the ongoing loose fiscal stance could at some point affect market confidence.

In addition, despite recent measures, tax evasion is high and a low level of tax compliance remains a challenge, with weak revenue collection as demonstrated by the largest value-added tax gap in the EU (see Figure 5)[7]. In this context, the IMF has indicated the need for Romania to modernise compliance risk management. On the other hand, the anti-fraud system of split VAT payments enacted on 1 July 2017, which requires public institutions and enterprises to pay VAT for goods or services directly to the state budget account rather than to the supplier, could result in improved revenue collection in Scope's view[8].

Low EU fund absorption

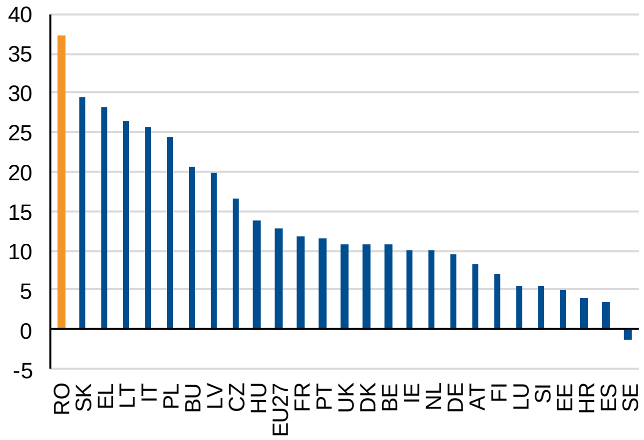
Scope notes that the absorption of structural funds remains significantly below the EU28 average. Based on 2016 figures, with 90% of the total amount available to Romania in the 2007-2013 programming period, the country had the second-lowest rate, just ahead of Croatia's figure. The EC points to ongoing weaknesses in public investment management and the absence of long-term planning as reasons for the insufficient project pipeline in 2014-2020[9]. Similarly, the IMF notes that investment could benefit from a determined effort to improve the quality of public investment management institutions, and that, compared to other EU countries, Romania should improve particularly the areas of project selection, project appraisal, coordination with local government, and budget unity.

[5] Romania reached its MTO in every year between 2013 and 2015, being among the few EU Member States that achieved this objective.
[6] EC, Post-programme surveillance report Romania, spring 2017.
[7] The VAT gap measures the difference between actual VAT collections and those that could be obtained if the existing VAT laws were perfectly enforced.
[8] IMF Article IV Romania, May 2017
[9] EC, Country Report Romania 2016.

Weak business environment

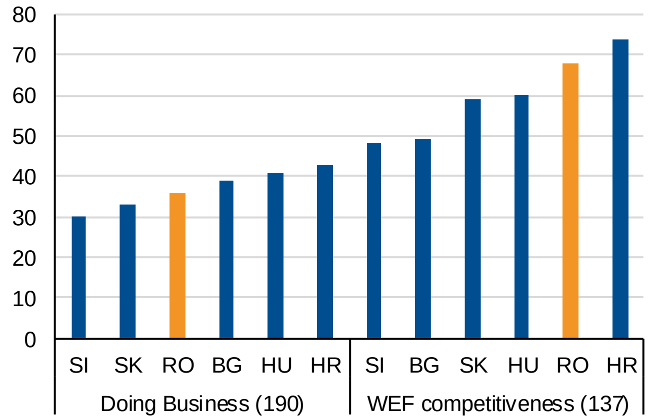
Cumbersome administrative procedures and fast-changing legislation and policies have harmed the business environment in Romania. According to the EC, the complexity of administrative procedures, the volatility of fiscal and tax policies and the extensive use of government emergency ordinances are creating uncertainty and weighing on investment decisions[10]. In fact, the World Bank's 2017 Doing Business report ranked Romania 36th out of 190 countries (21st among the EU28), with the country scoring particularly poorly on the availability of electricity (134th), dealing with construction permits (95th) and starting a business (62nd). The World Economic Forum's competitiveness indicator ranks Romania 68th out of 137 countries (26th among the EU28, ahead of only Croatia and Greece), highlighting institutional shortcomings, especially the legal framework's efficiency in challenging regulations, the burden of government regulation and the country's ability to attract and retain talent.

Figure 5: VAT gap (%)



Source: Source: European Commission

Figure 6: Doing Business and Competitiveness scores 2016-17



Source: World Bank, World Economic Forum

Macroeconomic stability and imbalances

Possible emergence of imbalances and structural impediments to sustainable growth

Romania is expected to remain under the EC's post-programme surveillance until spring 2018, when the country repays 70% of its loan from the EU's balance-of-payments financial assistance programme. However, Scope cautions that instability and imbalances could re-emerge, given the expansionary fiscal policies in the current strong-growth environment. These policies increase the risks of unsustainable growth and could lead to a re-emergence of fiscal and current-account imbalances.

The sustainability of Romania's growth is further compromised by the country's inefficient and insufficient infrastructure investment: infrastructure quality is among the lowest in the EU. In addition, the country's poverty rate is one of the highest in the EU with people at risk of poverty or social exclusion estimated at around 37% of the population, which reduces the resilience of households and undermines future productivity growth. Scope also notes that agriculture, while accounting for 29% of total employment, makes up just 5% of GDP[11].

[10] EC, Country Report Romania 2016.
[11] Ibid.

Public finance risk

Fiscal performance

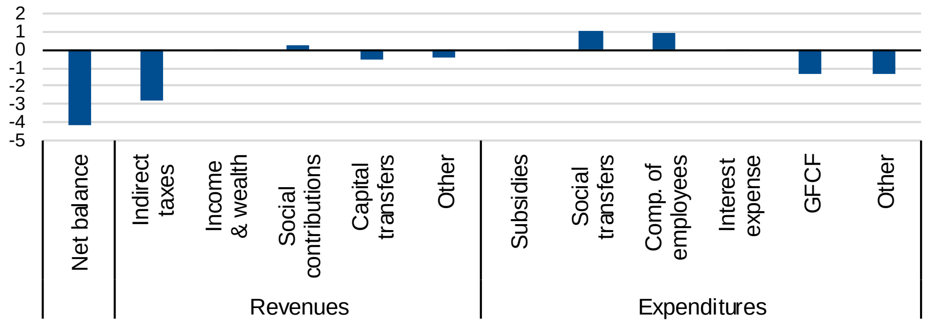
Weakening fiscal performance

Following the EU/IMF balance-of-payments programme of 2009-2011, Romania successively reduced its government deficit from almost 10% of GDP in 2009 to about 1% in 2015, recording primary surpluses in 2014 and 2015. However, in 2016 the government's fiscal policy turned pro-cyclical, reversing the consolidation trend of previous years via various tax rate cuts (including a large standard VAT rate reduction from 24% to now 19%) and wage increases, increasing the deficit to 3.0%, based on EC data. Scope notes that the successive tax cuts have structurally shrunk the revenue envelope while the share of wages and pensions has grown at the cost of investment.

Both the IMF and the EC expect further fiscal loosening going forward, challenging the government's target of staying below the 3% Maastricht criterion. While the budget law foresees a deficit of 2.98%, the EC points to the optimistic assumptions underlying the budget. In fact, the EC projects a deficit of around 3.5% in 2017 and 3.7% in 2018 while the IMF's October World Economic Outlook expects a deficit of still 3.0% in 2017 but 4.4% in 2018. This expected fiscal deterioration is based on the government's 2017-2020 plan, which includes the implementation of the unified wage bill[12], the reduction of social security contribution rates, and further cuts to personal income and VAT. These adverse budgetary developments motivated the EC to give warning already in May 2017 on the existence of a significant observed deviation from the adjustment path toward the medium-term budgetary objective.[13]

In addition, Romania's Fiscal Council noted in September 2017 that with one exception (and that only partially), the draft budget revision does not comply with fiscal rules and that even the revised budget will not keep the deficit under 3% of GDP, unless investment expenditure is further revised downward and the discretionary request for extraordinary dividend distributions addressed to the state companies is implemented. The Fiscal Council concluded that while these 'measures probably create the premises to avoid exceeding the deficit target this year, the situation in 2017 is likely to greatly complicate the construction of the budget in the coming years.'[14]

Figure 7: Change in budget items 2015 vs 2018F, % of GDP

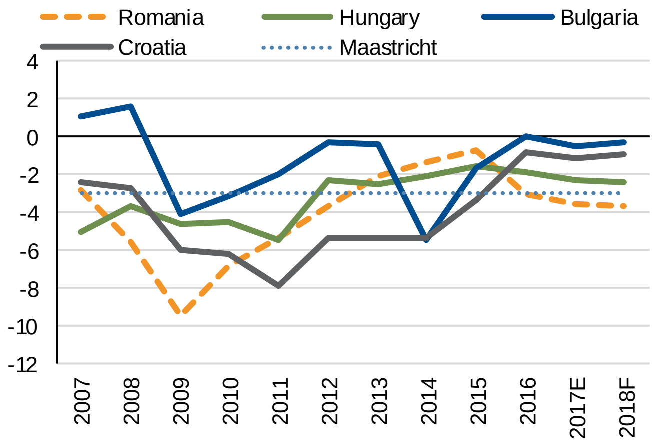


Source: European Commission

[12] Scope notes that while the unified wage bill aims to eliminate distortions in the public remuneration system, it implies a large increase in average public wages that poses considerable fiscal risks. In the draft law, average wages would more than double in nominal terms by 2022, which translates to a net impact on the budget of about 2.6% of GDP in addition to what is implied in the IMF's baseline scenario. However, changes to the social security contribution system which would require workers to pay the employer share of contributions would result in government savings as the state would not need to pay social security contributions for public employees. If implemented these measures would reduce the fiscal cost of the draft unified wage law to an estimated 1.5% of GDP, according to the IMF. However, the public wage bill would still rise from 7.7% of GDP in 2015 to around 9% of GDP in 2018. To mitigate fiscal slippage risks the authorities aim to adopt a gradual and flexible implementation of the law, phasing it in through 2022 and taking fiscal space constraints into consideration. See EC Post-programme surveillance report Romania, spring 2017 and IMF Article IV Romania 2017.
[13] https://ec.europa.eu/info/sites/info/files/c-2017-3518_ro_0.pdf
[14] http://fiscalcouncil.ro/OpinieR1_CF_2017englezafinal.pdf

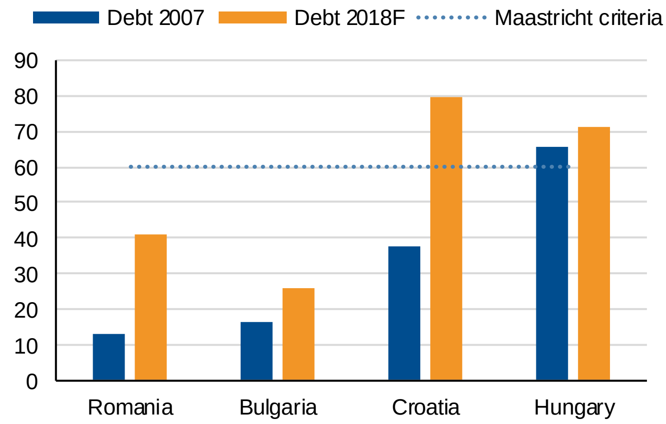
As a result of successive fiscal deficits, debt is expected to increase from around 13% in 2007 to around 38% in 2018, above Bulgaria's (25%), but still below that of Hungary (71%) and Croatia (79%), and in line with the 60% Maastricht criterion. However, the tripling of Romania's debt over the last 10 years highlights the credit-relevant importance of budgets staying within the 3% threshold.

Figure 8: Fiscal balances (% of GDP)



Source: European Commission

Figure 9: General government gross debt (% of GDP)



Source: European Commission

Low health and pension-related obligations

Scope considers Romania's contingent liabilities to be low, due to the relatively modest level of state guarantees which the EC estimates at around 2.2% of GDP, which is below the levels of Hungary (9.2%), and equal to Croatia (2.2%). In addition, according to the European Commission's 2015 Ageing Report, long-term health and pension-related expenditures amounted to around 12% of GDP in 2013, below those of peers and the EU28 average. The Commission's projections to 2060 envisage a minor increase in the share of ageing-related expenditure to around 13% of GDP, given de facto no change in the level of pensions and only a minimal increase in healthcare-related spending, reducing the risk of significant additional ageing-related expenditures.

Possible fiscal risks from state-owned enterprises

However, Scope notes that fiscal risks could emerge from Romania's state-owned enterprises (SOEs), which continue to dominate some key sectors such as energy and transport. According to the EC, while their operational results have improved recently, they remain generally inefficient, with poor service delivery, weak profitability and high arrears of about EUR 770m. In addition, the IMF notes that while Law 111 on SOE's corporate governance was passed in 2016 in line with international good practices, progress in restructuring SOEs was very limited, and attempts at privatisation and initial public offerings failed.

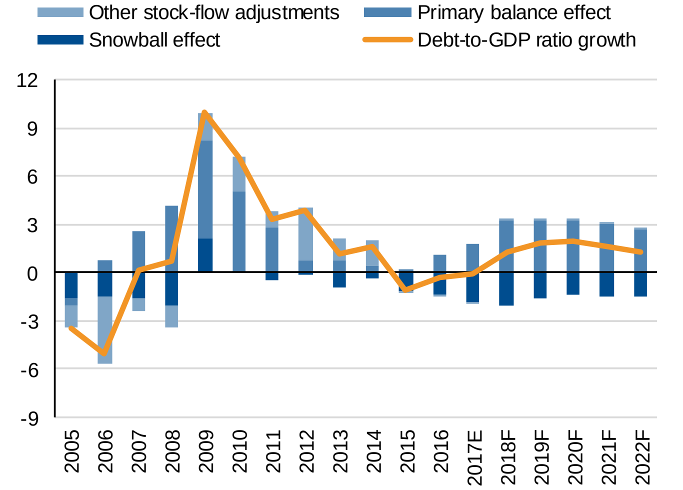
In addition, Scope notes that the establishment of the sovereign fund for development and investment (FSDI) from January 2018 could expose the government to additional fiscal risk. According to a draft legislation launched for public consultation by the Ministry of Public Finance, the fund will centralise SOE ownership of 27 state holdings in companies. According to the draft legislation, the FSDI will take the form of a joint stock financial intermediation company whose single shareholder will be the Romanian state. This entity is envisaged to be classified as a public financial institution outside the state budget, but this is still subject to Eurostat confirmation. Also, it remains unclear how the budget might be affected when dividends from profitable SOEs are diverted away from the state budget to the fund.

Debt sustainability

Debt sustainability concerns

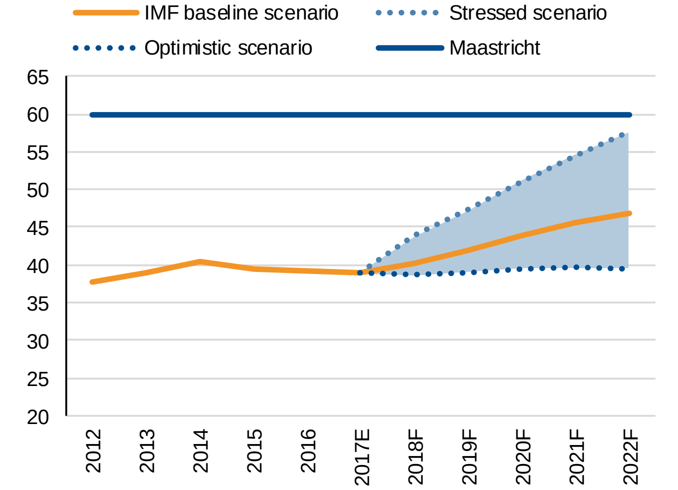
Against this background, Scope's public debt sustainability analysis, based on IMF forecasts under a combination of growth, interest-rate, primary-balance and foreign-currency shocks, confirms that slower growth and especially higher primary deficits remain the key risks to Romania's debt sustainability. The results reflect Romania's expected fiscal deficits going forward, as well as a moderate exchange rate sensitivity given the relatively high share of foreign-currency-denominated debt. Scope's baseline scenario is for the debt-to-GDP ratio to increase to just below 50% by 2022, while a more adverse scenario (assuming a combined one percentage point shock for each year over the forecast horizon to real GDP growth, interest rates, the primary balance as well as a 10% depreciation in the leu) would lead to a debt-to-GDP level of slightly below 60% 2022. While this would still be in line with Maastricht criteria and below some of Scope's other BBB rated sovereigns such as Hungary, Scope notes that Romania lost market access in 2009 with a debt-to-GDP ratio of around 23%, in the context of the international financial crisis. Romania's ability to service its debt thus relies primarily on the government's debt structure and market access.

Figure 10: Contribution to government debt changes (% of GDP)



Source: IMF, Calculations Scope Ratings AG

Figure 11: General government debt (% of GDP)



Source: IMF, Calculations Scope Ratings AG

2017-2026 average	Real GDP growth (% change)	Primary balance (% of GDP)	Real eff. interest rate (%)	Debt end period (% of GDP)
Historic values (2012-2016)	3.2	-0.7	1.0	39.1
IMF baseline	3.9	-2.9	-0.3	46.9
Optimistic scenario	4.8	-2.0	-0.3	39.4
Stressed scenario*	3.1	-3.7	0.5	57.7

Source: IMF, Calculations Scope Ratings AG
*Includes 10% depreciation of leu

Market access and funding sources

Sustained market access

Following the loss of market access in 2009, Romania has been financing its deficit and debt on the markets since 2011 at stable and favourable conditions, with the average 10-year government bond yield dropping from above 7% in 2011 to around 3% in October 2016. Despite 10-year yields increasing by one percentage point to around 4%, Romania successfully tapped in October the 10-year Eurobond issued in April 2017 at 2.1%.

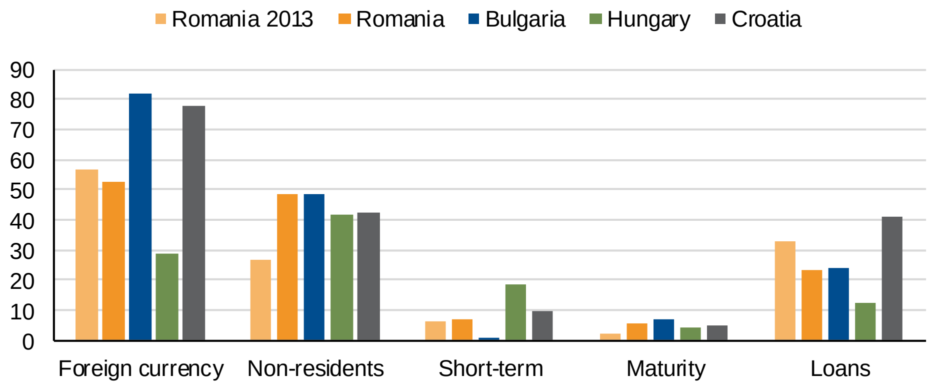
Improved debt structure but high foreign-currency exposure

Scope notes that the structure of Romania's debt has improved over the past few years, though risks remain. Public debt continues to be vulnerable to exchange rate risk, with the share of foreign-currency-denominated debt decreasing only slightly from around 57% in 2013 to around 52% in 2016. However, Scope notes positively that in line with the Romanian debt management strategy, foreign-currency-denominated debt is mostly in euro[15].

In addition, based on Eurostat data, debt held by non-residents decreased markedly from around 55% in 2013 to around 48% in 2016. This reflects also the continuous shift of public government debt away from non-marketable debt, in the form of loans contracted from International Financial Institutions to marketable debt securities. While this shift is positive, Scope notes that loans, albeit falling over the last few years from around 33% of total debt in 2013 to around 23% in 2016, remains high but in line with peers.

Conversely, Romania's share of short-term debt hovers around 7% in 2016, with an average maturity for issued securities now of around five years, up from about three years in 2013, reflecting the debt management strategy to issue longer-term securities and lengthen the yield curve. Lastly, to reduce re-financing risks, the Romanian authorities raised the cash buffer from approx. 1.6% of GDP in 2010 to around 3.6% in 2016, which is above that of Bulgaria (3.6%) and Croatia (2.7%). The EC notes that, given the relatively high share of foreign-currency-denominated debt, the authorities' foreign-exchange cash buffer stands at about five months of gross financing needs, above the four-month threshold defined under the balance-of-payments assistance programme.

Figure 12: Share of total debt (% of total, 2016)



Source: European Commission

External economic risk

Current-account vulnerabilities

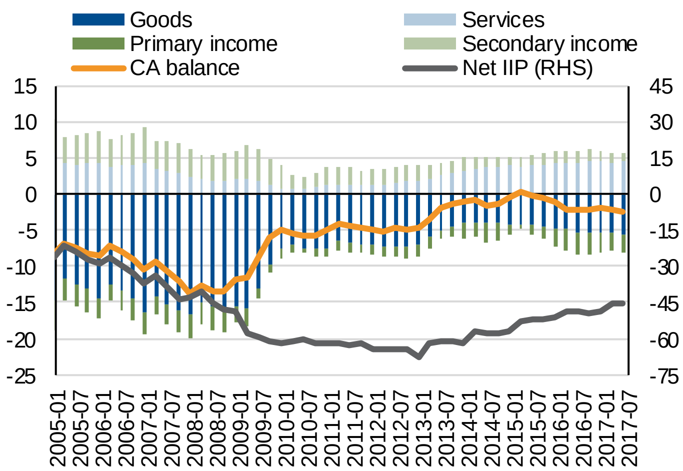
Widening current-account deficits and negative international investment position

Romania's external vulnerabilities are moderate. Over the past few years the current-account deficit narrowed significantly from about 13% of GDP in 2008 to around 2% in 2016, driven mostly by a decrease in the balance-of-goods deficit and a rising surplus in the services balance. Scope notes that the adjustment was also aided by Romania's cost competitiveness, which led to one of the highest growth rates in export market shares, reduced dependence on imports of gas and petroleum products, and lower global energy prices[16].

[15] http://discutii.mfinante.ro/static/10/Mfp/buletin/executii/Strategiaadmindatpubguv2017_2019_09iunie_21062017engl.pdf
[16] EC, Post-programme surveillance report Romania, spring 2017.

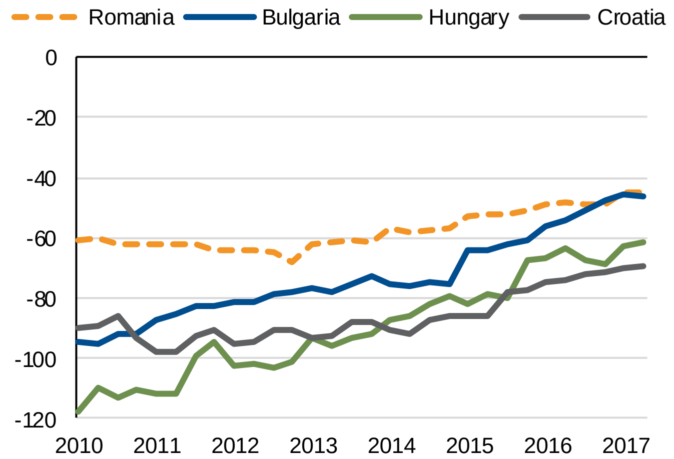
More recently, the slight widening of the current-account deficit of around 1% of GDP during 2016 was driven by a pick-up in imports on the back of strong domestic consumption, which boosted the goods trade deficit. Going forward, Scope expects the current-account deficit to widen somewhat, given the increase in domestic demand but also the relative loss in cost competitiveness induced by the recent wage increases, which is expected to outpace productivity gains. In this context, Scope highlights that insufficient investment in R&D, the unfavourable business environment and the limited number of highly qualified workers are some of the factors constraining the economy's productivity as well as the country's export capacity[17].

Figure 13: Current-account balance (% of GDP)



Source: European Commission

Figure 14: Net international investment position (% of GDP)



Source: European Commission

External debt sustainability

Improved external debt sustainability given increased flows of foreign direct investment

Over the past four years strong nominal GDP growth and lower current-account deficits have improved Romania's negative net international investment position (NIIP) from its peak of around -68% of GDP in Q1 2013 to around -45% of GDP at the beginning of 2017, in line with CEE peer levels. Scope notes that while a negative NIIP is normal for a developing economy like Romania, the financing sources, and particularly an ability to attract foreign investment, determine external debt sustainability.

In this context, Scope views positively that Romania's foreign direct investment (FDI) is again, since 2014, the main source of external funding for the economy, as opposed to portfolio and other investments which are more volatile and have provided the main funding of external debt from 2007 until the end of 2013. This fundamental change in external financing notwithstanding, Romania still lags CEE peers in terms of attracting FDI. The inward FDI stock of Romania is relatively low at around 40% of GDP, below Bulgaria's and Hungary's levels, both around 87%, and even that of Croatia (57%)[18].

The external debt as a share of GDP has been on a downward trend since 2012 due to the decline in private external liabilities, driven by a deleveraging in the banking sector. As of Q2 2017, total external debt was around 50% of GDP, which compares favourably to the levels of Bulgaria (68%), Croatia (86%) or Hungary (91%). In addition, Scope notes that the composition of Romania's external debt is similar to that of peers: about one-third

[17] Ibid.
[18] FDI stock was channeled primarily to manufacturing (32.0% of total FDI), construction and real estate transactions (14.0% of FDI stock), trade (12.8%), financial intermediation and insurance (12.6%), and professional, scientific, technical and administrative activities and support services (5.6%). The top five countries by share of FDI stock as at 31 December 2016 were: the Netherlands (24.3%), Germany (13.2%), Austria (11.9%), France (6.9%) and Cyprus (6.5%). National Bank of Romania, Foreign Direct Investment in Romania in 2016, September 2017

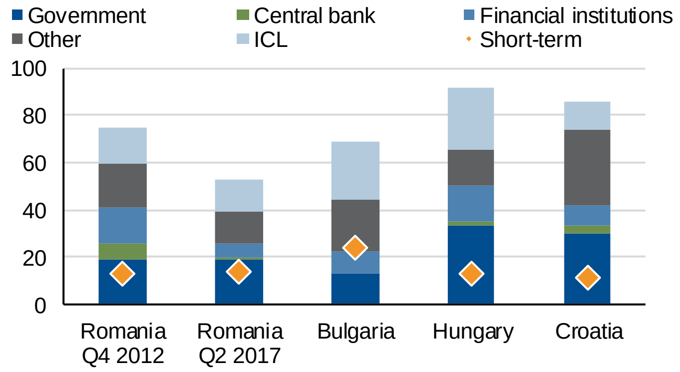
of the exposure relates to the public sector; whereas a quarter of the exposure relates to intra-company loans, which reduces rollover risks for the private sector. Lastly, Scope notes that the share of Romania's short-term external debt is relatively low at around 12%, in line with CEE peer levels.

Vulnerability to short-term shocks

Vulnerability to short-term shocks

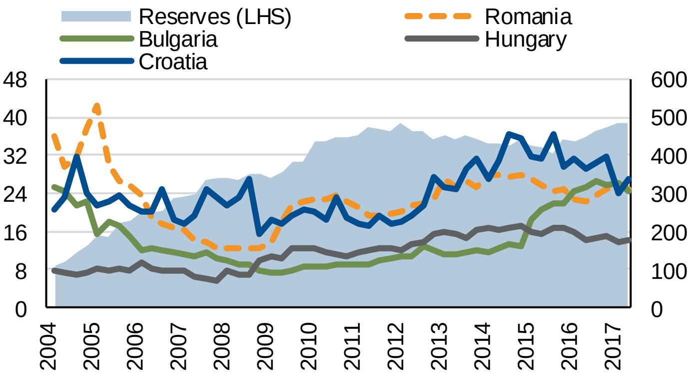
Romania's exchange rate arrangement is managed floating[19], and since 2009, has had a relatively stable evolution, with the RON/EUR rate fluctuating between 4.2 and 4.5. Scope notes that while pressure on the exchange rate would likely support economic growth via expenditure switching, as foreign goods become more expensive and exports cheaper (trade channel), the depreciation would adversely affect borrowers' balance sheets by raising the value of foreign-currency debt. This would affect banks' balance sheets through their foreign-exchange exposures, which comprise around 40% of total non-government domestic credit, or about 11% of GDP. It is this financial channel which exposes Romania to short-term shocks: A sharp currency depreciation, possibly caused by heightened domestic political risks or a change in global market sentiment, could adversely affect economic growth in Romania. However, Scope notes that Romania's foreign-currency reserve coverage is broadly adequate, with gross international reserves relatively stable at around EUR 40bn and the short-term external debt coverage comfortably above 300% in line with that of Bulgaria and Croatia and markedly above Hungary's level.

Figure 15: External debt (% of GDP, Q2 2017)



Source: Haver, European Commission, Central Banks; Short-term as % of total

Figure 16: Reserves (EUR bn, LHS); short-term external debt coverage (%)



Source: Haver, Central Banks

Financial stability risk

Banking sector performance

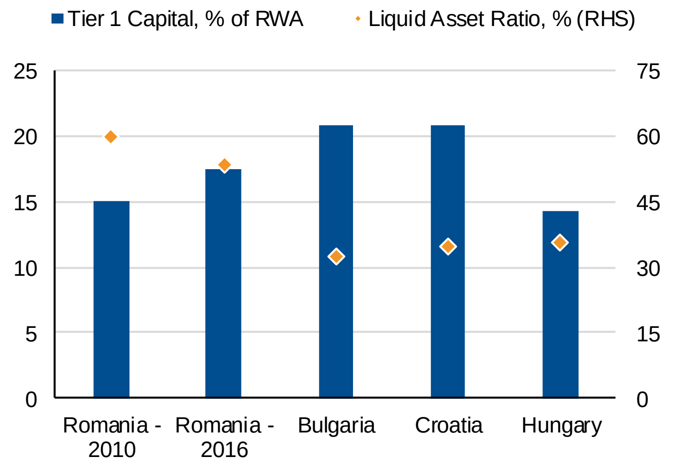
Adequate capitalisation and liquidity levels, improving asset quality and profitability

In Scope's assessment, Romania's banking sector is well capitalised and remains highly liquid, also when compared to CEE peers' levels, with a common equity tier 1 ratio of 18%, and a liquid asset ratio of 35%. Asset quality has been improving: the NPL ratio fell from around 21% in 2014 to around 8% in Q2 2017 (according to the European Banking Authority definition), driven in part by the NBR's proactive efforts to encourage NPL sales and write-offs. However, the EC notes that bank balance sheets continue to be burdened by the quality of corporate exposures and a high level of delinquency related to consumer loans[20].

[19] The Romanian leu is not participating in ERM II.
[20] EC, Post-programme surveillance report Romania, spring 2017.

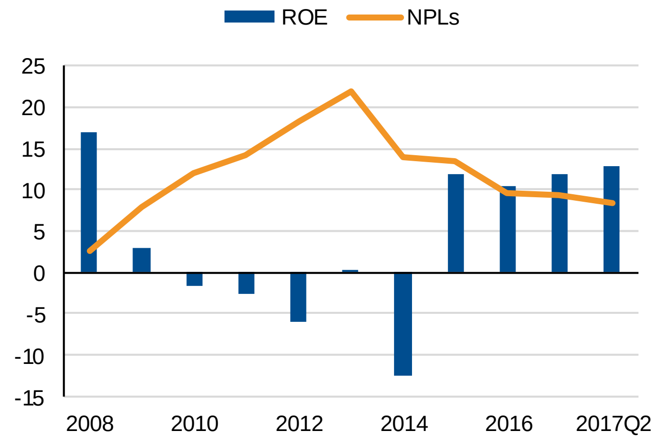
Following consecutive losses during 2010-2014, profitability has returned with banks posting a return on equity of 13% (June 2017). In addition, Scope notes that contagion risks continue to decline as banks increasingly substitute domestic deposits for foreign sources of funding. wIn fact, the share of foreign deposits to total liabilities has fallen successively from around 30% in 2012 to around 10% presently.

Figure 17: Capitalisation and liquidity (2016)



Source: IMF FSI

Figure 18: Asset quality and profitability



Source: IMF FSI

Banking sector oversight and governance

Macro-prudential authority in line with European Systemic Risk Board recommendations

Scope views positively that Romania is one of five EU members which have not used public funds to support their financial sectors since the onset of the crisis. In addition, the recent enactment of the law on the National Committee for Macro-Prudential Supervision, in line with the European Systemic Risk Board's recommendation for a formal macro-prudential authority, points to active and constructive engagement to prevent and manage financial stability risks. At the same time, the IMF notes that the framework for private-debt resolution, particularly for SMEs, could strengthen further via pre-insolvency procedures and the harmonisation of tax laws to fully support the insolvency law's aims[21].

Risks from legislative initiatives largely avoided by constitutional court rulings

Despite these positive initiatives, Scope notes that the Romanian parliament passed two laws in 2016 that could have adversely impacted the banking sector. The first law allowed debtors to walk away from mortgages (debt discharge) while the second aimed at converting Swiss-franc-denominated loans at historical exchange rates. The adverse impact on the banking sector from the first legislation was limited by the constitutional court, which ruled that the law should be applied on a case-by-case basis only and within provisions dealing with distressed borrowers in the civil code, significantly reducing moral hazard. The court also ruled the Swiss-franc conversion law as unconstitutional and held that conversion should be done in line with conditions at the conversion date.

Macro-financial vulnerabilities and fragility

Slowly resuming credit growth to NFCs

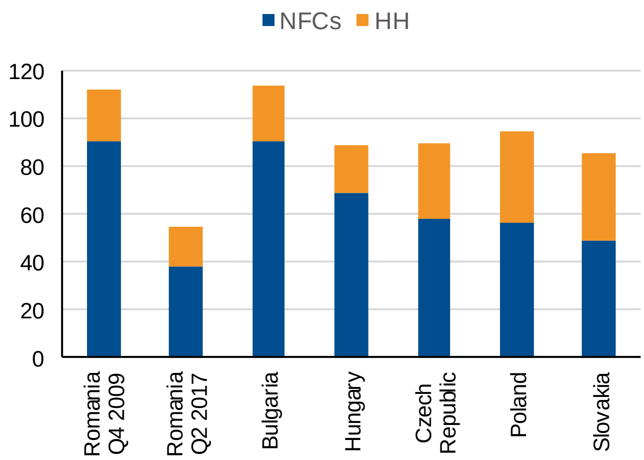
Scope notes that following the rebalancing and deleveraging of the economy, limited access to and demand for credit reduce the risks for the emergence of financial vulnerabilities. Specifically, the ongoing deleveraging process of foreign parent banks (including the subsidiaries of Greek banks, which still hold a combined market share of roughly 10%) and a constrained investment sentiment have hindered credit growth.

[21] IMF Article IV, Romania May 2017.

At the same time, low capitalisation, and bureaucracy remain significant challenges for a large share of non-financial corporates (NFCs) in accessing bank credit[22]. Despite these structural impediments, credit growth to NFCs is slowly picking up, growing 6.4% year on year in Q3 2017, up from 1.9% in Q2 2017.

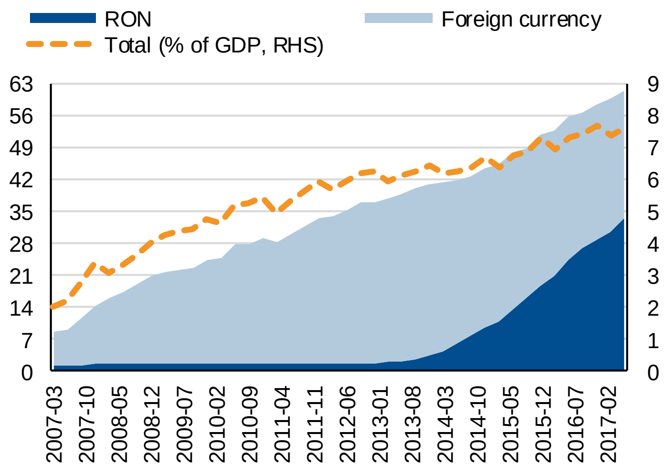
Scope also views positively that local-currency lending has increased as the share of foreign-currency loans in total credit declines. Specifically, outstanding euro-denominated loans to NFCs fell from about RON 70bn in 2012 to about RON 44bn in 2017, while outstanding loans denominated in leu have increased steadily from about RON 45bn to around RON 60bn over the same period. This structural shift, in part facilitated by the NBR[23], reduces re-financing risks of corporates and thus the vulnerability of the banking sector.

Figure 19: Outstanding private-sector debt (% of GDP)



Source: Eurostat, ECB

Figure 20: Mortgages, RON bn, % of GDP



Source: Romanian Central Bank

At the same time, Scope notes the significant increase in household mortgages encouraged via the government's Prima Casa guarantee programme. Mortgages denominated in leu have tripled over the last two years from about RON 10bn to above RON 30bn in Q2 2017. While house prices have increased by 14% over the past two years, they are still about 17% below 2009 levels. In addition, total household debt is still relatively low, also compared to that of peers. However, the rapid rise in mortgages exposes households to interest rate shocks. In fact, the IMF estimates that an increase in the average interest rate by 200bp could raise the debt service-to-income ratio by 6-10 percentage points.

In addition, Scope notes that local banks' government security holdings and their loans to the government sector as a share in total assets place Romania among the top EU Member States, with 22.6% in December 2016, in line with Hungary and Croatia, but significantly above the EU average was 9.2%[24]. This exposure could adversely affect banking stability in case of a sovereign interest rate shock. However, as highlighted in the NBR's May 2017 financial stability report, the propensity to finance the household and the government, while lending to the real economy remains weak, may also suggest that a certain development ceiling has been reached and that structural changes in both the banking sector and the financial soundness of real sector entities may be required.

[22] IMF Article IV Romania, May 2017.
[23] The NBR cut the Minimum Reserve Requirements ratio on leu-denominated liabilities of credit institutions from 15% to 8%.
[24] National Bank of Romania, Financial Stability Report May 2017

Institutional and political risk

Willingness to pay

Romania joined the EU in 2007, fully adopting its regulatory framework (acquis communautaire). This has provided an anchor for institutional stability and predictability. In Scope's assessment Romania is as likely as any EU peer to be willing to honour debt obligations in full and on time.

Recent events and policy decisions

Remaining shortcomings identified in EC's Cooperation and Verification Mechanism

At the accession of Romania to the EU in 2007, the EC set up the Cooperation and Verification Mechanism (CVM) to address shortcomings in judicial reform and the fight against corruption. The EC has since been assisting Romania in this area, regularly verifying progress against four benchmarks set for this purpose which aim to i) ensure a more transparent and efficient judicial process; ii) establish an integrity agency with responsibilities for verifying assets, incompatibilities and potential conflicts of interest; iii) conduct professional, non-partisan investigations into allegations of high-level corruption; and iv) take further measures to prevent and fight against corruption, in particular within local government[25].

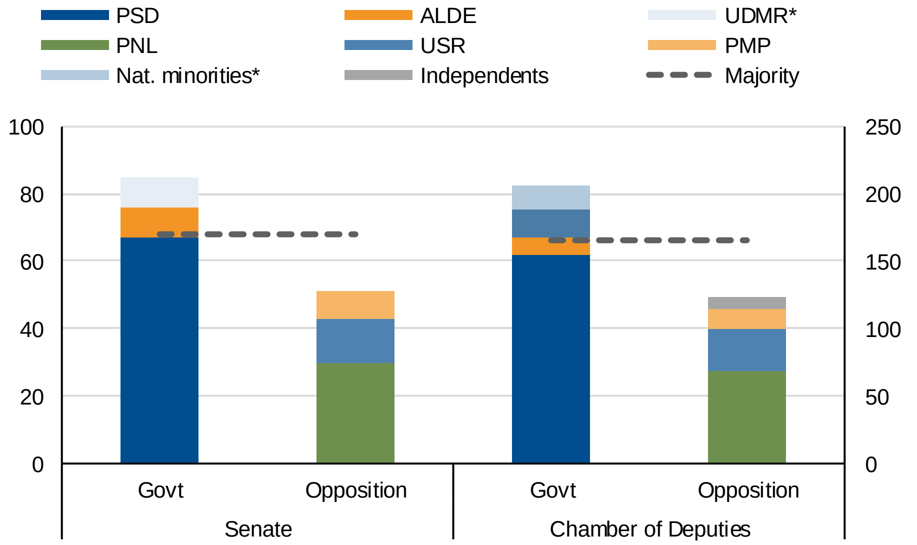
The 2017 CVM report points out that over the past 10 years Romania has made major progress towards the CVM benchmarks. Several key institutions and important legislation are in place, and an established track record can be seen in many areas. Romania has also demonstrated to the Commission that internal safeguards against an abrupt reversal of progress have been implemented. However, the existence of significant shortcomings still prevents the EC from concluding that benchmarks have been met. The next progress review is scheduled for the end of 2017[26].

Political uncertainty given divisions with government

In this context, Scope notes that following the December 2016 parliamentary election, the government led by Sorin Grindeanu of the Social Democratic Party (PSD) sought to weaken anticorruption laws by barring corruption-related prosecutions involving sums less than RON 200,000 (about EUR 50,000). Following public protests, however, the law was dropped. Nevertheless, after a vote of no confidence on 21 June, the PSD's leader, Liviu Dragnea, who is barred from holding high office because of an electoral-fraud conviction, replaced Mr Grindeanu as prime minister of the PSD with his ally Mihai Tudose. In Scope's assessment, corruption allegations and infighting within the PSD could result in ongoing political uncertainty despite the coalition government's comfortable majorities in both the chamber of deputies and the senate[27].

[25] https://ec.europa.eu/info/sites/info/files/swd-2017-25_en.pdf
[26] https://ec.europa.eu/info/sites/info/files/com-2017-44_en_1.pdf
[27] EIU, September 2017.

Figure 21: Senate (LHS) and chamber of deputies (RHS), seats



Source: Romanian Parliament *Government-supporting

Geopolitical risk

Romania has been a NATO member since 2004, supporting the country's Western allegiances as well as increasing its geostrategic importance to Western partners. In Scope's assessment Romania is exposed to potential geopolitical risk to the same extent as its CEE peers.

Methodology

The methodology applicable for this rating and/or rating outlook, 'Public Finance Sovereign Ratings', is available on www.scoperatings.com.

Historical default rates of Scope Ratings can be viewed in the rating performance report on https://www.scoperatings.com/#governance-and-policies/regulatory-ESMA. Please also refer to the central platform (CEREP) of the European Securities and Markets Authority (ESMA): http://cerep.esma.europa.eu/cerep-web/statistics/defaults.xhtml.

A comprehensive clarification of Scope's definition of default, definitions of rating notations can be found in Scope's public credit rating methodologies at www.scoperatings.com.

The rating outlook indicates the most likely direction of the rating if the rating were to change within the next 12 to 18 months. A rating change is, however, not automatically ensured.

I. Appendix: CVS and QS results

Sovereign rating scorecards

Scope's Core Variable Scorecard (CVS), which is based on relative rankings of key sovereign credit fundamentals, signals an indicative 'BBB' ('bbb') rating range for Romania. This indicative rating range can be adjusted by up to three notches on the Qualitative Scorecard (QS) depending on the size of relative credit strengths or weaknesses versus peers based on the analysts' qualitative findings.

The following relative credit strengths have been identified for Romania: i) growth potential of the economy. Relative credit weaknesses include: i) economic policy framework; ii) vulnerability to short-term shocks; and iii) recent events and policy decisions. The combined relative credit strengths and weaknesses generate no adjustment and signal a sovereign rating of BBB for Romania. A final rating of BBB was assigned to Romania.

Rating overview

CVS category rating range	bbb
QS adjustment	BBB
Final rating	BBB

To calculate the rating score within the CVS, Scope uses a minimum-maximum algorithm to determine a rating score for each of the 22 indicators. Scope calculates the minimum and maximum of each rating indicator and places each sovereign within this range. Sovereigns with the strongest results for each rating indicator receive the highest rating score; sovereigns with the weakest results receive the lowest rating score. The score result translates to an indicative rating range that is always presented in lower case.

Within the QS assessment, analysts conduct a comprehensive review of the qualitative factors. This includes but is not limited to economic scenario analysis, a review of debt sustainability, fiscal and financial performance, and policy implementation assessments.

There are three assessments per category for a total of 15. For each assessment, the analyst examines the relative position of a given sovereign within its peer group. For this purpose, additional comparative analysis beyond the variables included in the CVS is conducted. These assessments are then aggregated using the same weighting system as in the CVS.

The result is the implied QS notch adjustment, which is the basis for the analysts' recommendation to the rating committee.

Foreign- versus local-currency ratings

Romania has about half of its outstanding debt denominated in foreign currency. The country's recent experience of losing market access, and the subsequent EU/IMF balance-of-payments financial assistance confirmed that debt obligations are treated equally between currency denominations. This is further corroborated by the recent history of sovereign defaults, which does not provide a strong justification for a rating bias in favour of either local- or foreign-currency debt.

II. Appendix: CVS and QS results

CVS

Rating indicator	Category weight
Domestic economic risk	**35%**
Economic growth	
Real GDP growth	
Real GDP volatility	
GDP per capita	
Inflation rate	
Labour & population	
Unemployment rate	
Population growth	
Public finance risk	**30%**
Fiscal balance	
GG public balance	
GG primary balance	
GG gross financing needs	
Public debt	
GG net debt	
Interest payments	
External economic risk	**15%**
International position	
International investment position	
Importance of currency	
Current-account financing	
Current-account balance	
T-W effective exchange rate	
Total external debt	
Institutional and political risk	**10%**
Control of corruption	
Voice & accountability	
Rule of law	
Financial risk	**10%**
Non-performing loans	
Liquid assets	
Credit-to-GDP gap	
Indicative rating range	**bbb**
QS adjustment	**BBB**
Final rating	**BBB**

QS

Maximum adjustment = 3 notches

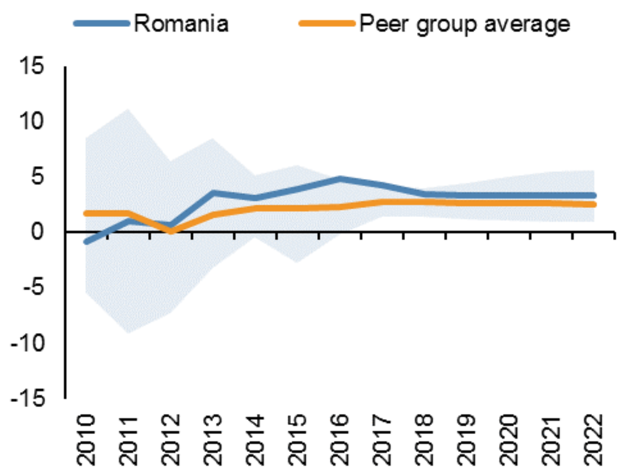
	+2 notch	+1 notch	0 notch	-1 notch	-2 notch
Growth potential of the economy	○ Excellent outlook, strong growth potential	◉ Strong outlook, good growth potential	○ Neutral	○ Weak outlook, growth potential under trend	○ Very weak outlook, growth potential well under trend or negative
Economic policy framework	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Macroeconomic stability and imbalances	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Fiscal performance	○ Exceptionally strong performance	○ Strong performance	◉ Neutral	○ Weak performance	○ Problematic performance
Debt sustainability	○ Exceptionally strong sustainability	○ Strong sustainability	◉ Neutral	○ Weak sustainability	○ Not sustainable
Market access and funding sources	○ Excellent access	○ Very good access	◉ Neutral	○ Poor access	○ Very weak access
Current-account vulnerabilities	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
External debt sustainability	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Vulnerability to short-term shocks	○ Excellent resilience	○ Good resilience	○ Neutral	◉ Vulnerable to shock	○ Strongly vulnerable to shocks
Perceived willingness to pay	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Recent events and policy decisions	○ Excellent	○ Good	○ Neutral	◉ Poor	○ Inadequate
Geo-political risk	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector performance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Financial sector oversight and governance	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate
Macro-financial vulnerabilities and fragility	○ Excellent	○ Good	◉ Neutral	○ Poor	○ Inadequate

*** Implied QS notch adjustment = (QS notch adjustment for domestic economic risk)*0.35 + (QS notch adjustment for public finance risk)*0.30 + (QS notch adjustment for external economic risk)*0.15 + (QS notch adjustment for institutional and political risk)*0.10 + (QS notch adjustment for financial stability risk)*0.10**

Source: Scope Ratings AG

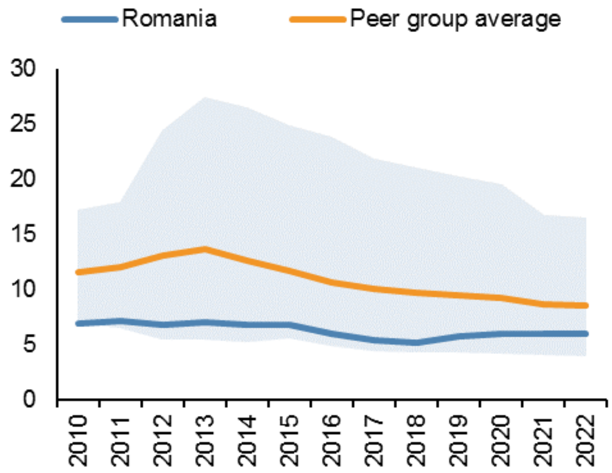
III. Appendix: Peer comparison

Figure 22: Real GDP growth



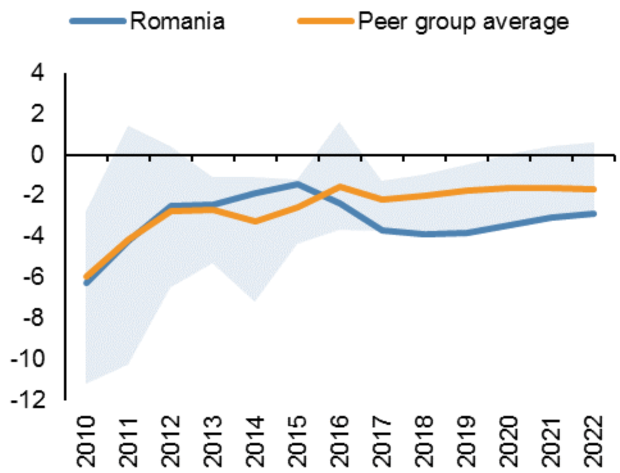
Source: IMF, Calculations Scope Ratings AG

Figure 23: Unemployment rate, % of total labour force



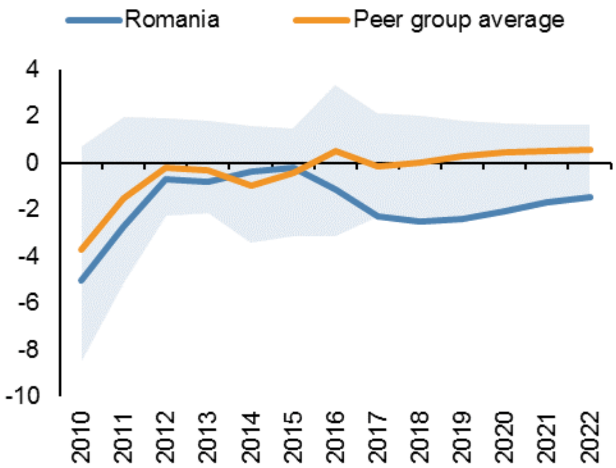
Source: IMF, Calculations Scope Ratings AG

Figure 24: General government balance, % of GDP



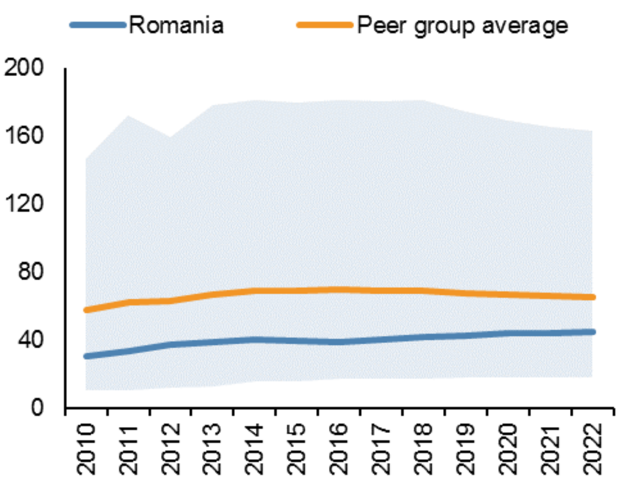
Source: IMF, Calculations Scope Ratings AG

Figure 25: General government primary balance, % of GDP



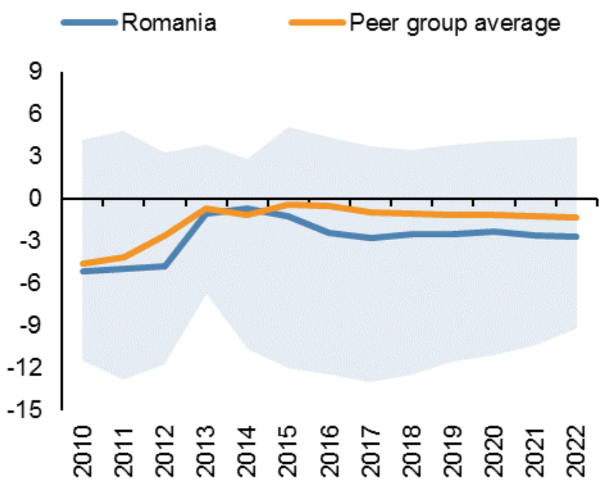
Source: IMF, Calculations Scope Ratings AG

Figure 26: General government gross debt, % of GDP



Source: IMF, Calculations Scope Ratings AG

Figure 27: Current-account balance, % of GDP



Source: IMF, Calculations Scope Ratings AG

IV. Appendix: Statistical tables

	2012	2013	2014	2015	2016	2017E	2018F
Economic performance							
Nominal GDP (Bil.RON)	595.4	637.5	668.1	711.1	761.5	827.8	902.6
Population ('000s)	20,096	20,020	19,953	19,871	19,760	19,759	19,758
GDP-per-capita PPP (Int'l USD)	18,983	19,877	20,797	22,071	23,626	-	-
GDP per capita (RON)	29,626	31,841	33,486	35,787	38,536	41,896	45,682
Real GDP growth, % change	0.6	3.5	3.1	3.9	4.8	5.5	4.4
GDP growth volatility (10-year rolling SD)	5.0	5.0	4.7	4.7	4.4	4.2	3.7
CPI, % change	3.3	4.0	1.1	-0.6	-1.6	1.1	3.3
Unemployment rate (%)	6.8	7.1	6.8	6.8	5.9	5.3	5.2
Investment (% of GDP)	26.8	25.6	24.7	25.0	25.0	24.4	24.5
Gross national savings (% of GDP)	22.1	24.5	24.0	23.7	22.7	21.4	21.6
Public finances							
Net lending/borrowing (% of GDP)	-2.5	-2.5	-1.9	-1.5	-2.4	-3.0	-4.4
Primary net lending/borrowing (% of GDP)	-0.7	-0.8	-0.4	-0.2	-1.1	-1.8	-3.2
Revenue (% of GDP)	32.4	31.4	32.0	32.8	29.0	28.9	30.0
Expenditure (% of GDP)	34.9	33.9	33.9	34.3	31.4	31.9	34.4
Net interest payments (% of GDP)	1.8	1.7	1.5	1.2	1.3	1.2	1.2
Net interest payments (% of revenue)	5.4	5.3	4.7	3.8	4.4	4.3	4.1
Gross debt (% of GDP)	37.7	38.9	40.5	39.4	39.1	38.9	40.2
Net debt (% of GDP)	28.9	29.5	29.7	29.7	31.2	31.2	32.6
Gross debt (% of revenue)	116.3	124.0	126.6	120.1	134.8	134.8	133.9
External vulnerability							
Gross external debt (% of GDP)	75.3	68.2	63.0	57.6	54.8	-	-
Net external debt (% of GDP)	38.4	35.8	29.8	27.2	22.5	-	-
Current-account balance (% of GDP)	-4.8	-1.1	-0.7	-1.2	-2.3	-3.0	-2.9
Trade balance [FOB] (% of GDP)	-	-4.0	-4.3	-4.9	-5.5	-6.7	-7.3
Net direct investment (% of GDP)	-1.9	-2.0	-1.8	-1.8	-2.7	-	-
Official forex reserves (EOP, Bil. USD)	35,413.0	35,434.5	35,505.7	35,485.1	37,905.4	-	-
REER, % change	-6.1	3.9	1.3	-2.5	-1.3	-	-
Nominal exchange rate (EOP, RON/USD)	3.4	3.3	3.7	4.1	4.3	-	-
Financial stability							
Non-performing loans (% of total loans)	-	17.9	15.8	10.7	7.7	-	-
Tier 1 ratio (%)	14.8	15.8	14.5	16.4	17.1	-	-
Private debt (% of GDP)	71.9	66.6	62.1	59.1	55.8	-	-
Domestic Credit-to-GDP gap (%)	-12.5	-17.0	-11.3	-10.6	-6.1	-	-

Sources: IMF, European Commission, European Central Bank, World Bank, United Nations, Scope Ratings AG

V. Regulatory disclosures

This credit rating and/or rating outlook is issued by Scope Ratings AG.

Rating prepared by Rudolf Alvise Lennkh, Lead Analyst

Person responsible for approval of the rating: Dr Giacomo Barisone, Managing Director

The ratings/outlook were first assigned by Scope as a subscription rating in January 2003. The subscription ratings/outlooks were last updated on 05.05.2017. The senior unsecured debt ratings as well as the short-term issuer ratings were assigned by Scope for the first time. As a "sovereign rating" (as defined in EU CRA Regulation 1060/2009 "EU CRA Regulation"), the ratings on Romania are subject to certain publication restrictions set out in Art 8a of the EU CRA Regulation, including publication in accordance with a pre-established calendar (see "Sovereign Ratings Calendar of 2017" published on 21.07.2017 on www.scoperatings.com). Under the EU CRA Regulation, deviations from the announced calendar are allowed only in limited circumstances and must be accompanied by a detailed explanation of the reasons for the deviation. In this case, the deviation was due to the recent revision of Scope's Sovereign Rating Methodology and the subsequent placement of ratings under review, in order to conclude the review and disclose ratings in a timely manner, as required by Article 10(1) of the CRA Regulation.

Rating Committee: the main points discussed were: i) Romania's economic growth potential, ii) macroeconomic stability and imbalances, iii) EU membership and institutional framework, iv) fiscal framework, performance and budget, v) market access and funding sources, vi) public debt sustainability, vii) external debt structure and reserve adequacy and viii) peers.

Solicitation, key sources and quality of information

The rating was initiated by Scope and was not requested by the rated entity or its agents. The rated entity and/or its agents did not participate in the ratings process. Scope had no access to accounts, management and/or other relevant internal documents for the rated entity or related third party.

The following material sources of information were used to prepare the credit rating: public domain and third parties. Key sources of information for the rating include: Ministry of Finance of Romania, National Bank of Romania, BIS, European Commission, European Central Bank, OECD, IMF, WB, and Haver Analytics.

Scope considers the quality of information available to Scope on the rated entity or instrument to be satisfactory. The information and data supporting Scope's ratings originate from sources Scope considers to be reliable and accurate. Scope does not, however, independently verify the reliability and accuracy of the information and data. Prior to publication, the rated entity was given the opportunity to review the rating and/or outlook and the principal grounds upon which the credit rating and/or outlook is based. Following that review, the rating was not amended before being issued.

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