ROMANIA

Highlights

- **The economy is growing strongly.** Output grew by 4.8 per cent in 2016 and 5.8 per cent in the first half of 2017, driven by private consumption and supported by a pro-cyclical fiscal policy. However, the fiscal deficit has risen and there is a risk that the 3.0 per cent of GDP budget deficit limit will be breached in 2017.
- **Structural reforms have been hindered by the unstable political environment.** However, progress continues to be made under the European Union's Cooperation and Verification Mechanism, particularly in the fight against corruption, and a new anti-corruption strategy for 2016-20 was adopted.
- **Non-performing loans (NPLs) continue to decline, but remain above the EU average.** NPL sales of around €4 billion have been achieved since the adoption of loan resolution measures in late 2014, and the NPL ratio has declined to 8.2 per cent from a peak of 22.0 per cent at the end of 2013.

Key priorities for 2018

- **Efforts need to be made to address business environment impediments.** These include the low efficiency of public administration, and the complexity of procedures and corruption, which are holding back infrastructure development. Urgent action needs to be taken to improve transport infrastructure, which constitutes one of the weakest areas of the business environment, and is vital for the country's development. Similarly, the government needs to address the "red tape", legal uncertainty and judicial inefficiency, which inhibit corporate investment.
- **Reforms to fight corruption should continue.** Romania has made major strides in judicial reform and the fight against corruption, following the adoption of a new anti-corruption strategy for 2016-20. However more action is needed in order to sustain the momentum and consolidate previous successes.
- **Privatisation plans should be re-invigorated.** Proposals for partial privatisations and initial public offerings of state-owned enterprise (SOEs) including Bucharest Airport, Hidroelectrica power company and Oltchim chemical company have seen some progress but are currently stalled, and the future of such privatisations is unclear in the context of the planned establishment of the Sovereign Wealth Fund for Development and Investment (FSDI).

Main macroeconomic indicators %

	2013	2014	2015	2016	2017 proj.
GDP growth	3.5	3.1	3.9	4.8	5.3
Inflation (average)	4.0	1.1	-0.6	-1.6	1.1
Government balance/GDP	-2.5	-1.9	-1.5	-2.4	-3.3
Current account balance/GDP	-1.1	-0.7	-1.2	-2.3	-3.0
Net FDI/GDP (neg. sign = inflows)	-2.0	-1.9	-2.4	-2.9	-2.9
External debt/GDP	64.7	56.1	54.1	49.7	n.a.
Gross reserves/GDP	25.5	21.6	21.8	21.4	n.a.
Credit to private sector/GDP	33.9	31.1	30.0	28.2	n.a.

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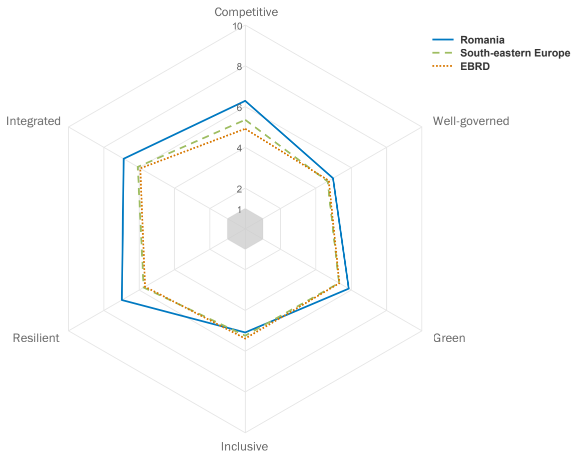
Macroeconomic performance

Romania was one of the best-performing economies in the EU in 2016, growing by 4.8 per cent. This strong performance has continued in 2017, with first-half growth of 5.8 per cent. Private consumption has been the main driver of growth, supported by a pro-cyclical fiscal policy including cuts in VAT and other consumer taxes. Alongside fiscal policies, strong wage growth and low unemployment at a seasonally adjusted rate of 5.3 per cent in June 2017, also influenced consumption growth. However, despite a historically low central bank policy rate of 1.75 per cent supporting private investment, overall investment growth was negative in 2016 as a result of the government's difficulties in absorbing the 2014-20 EU funds. Net exports also constituted a drag on growth in 2016 as rising domestic demand drove up imports. After 19 consecutive months of deflation, consumer prices started to rise in January 2017 and have subsequently continued their upward trajectory, as the base effect of VAT cuts the previous year dropped out and private consumption increased.

External vulnerabilities are increasing and the fiscal position is deteriorating. Rising imports, profit repatriation and falling remittances have resulted in an increased current account deficit of 2.3 per cent of GDP in 2016. Recent declines in foreign direct investment (FDI) mean that the deficit is no longer covered by FDI inflows, as had typically been the case previously. On the fiscal side, falling revenues and hikes in public wages and pensions caused the budget deficit to increase to 2.4 per cent of GDP in 2016, and it may exceed 3.0 per cent of GDP in 2017 on the back of continued loose fiscal policies, potentially giving rise to the European Commission (EC) introducing an Excess Deficit Procedure (EDP). On the positive side, general government debt is low by regional standards, at 37.6 per cent of GDP.

GDP growth is likely to remain robust in the short term. A growth rate of 5.3 per cent is expected in 2017 as continued strong domestic demand is supported by the increases in minimum and public sector wages, and investment is boosted as absorption of EU funds increases. In 2018 growth is expected to slow to around 4.2 per cent as policy stimulus weakens. Downside risks, including prolonged weakness in the eurozone, changes in global investor sentiment and domestic political and reform uncertainty, may hamper growth prospects in the near term. In the longer term, the diversified economy, large market size and scope for convergence within the EU (GDP per capita, purchasing power parity-adjusted, is only 59 per cent of the EU average) should allow growth rates of around 4 per cent to be sustained, provided structural reforms are undertaken in the areas of privatisation, infrastructure and local capital market deepening.

Assessment of transition qualities (1-10)



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Major structural reform developments

Romania continues to make progress under the Cooperation and Verification Mechanism (CVM). The government adopted a new anti-corruption strategy for 2016-20 in August 2016, and approved a Code of Conduct for government members. Some progress was made in amending the Criminal Code to align with Constitutional Court rulings. The 2016 Report of the European Commission on progress under the CVM noted that the positive trend of the previous three years has continued. At the same time, the report reiterated that a number of key issues remain outstanding and urged the authorities to focus on the “irreversibility” of the results on anti-corruption.

The investment environment has improved, although challenges remain. Romania ranks better than the regional average (Europe and Central Asia), but lower than most of the EU comparator economies as regards ease of doing business. In the World Bank *Doing Business 2018* report, Romania ranks 45th out of 190 countries. According to the EC, public service delivery is hampered by low efficiency of public administration, complexity of procedures and corruption, while red tape, legal uncertainty and judicial inefficiency remain challenging for companies.

Privatisation of key enterprises remains stalled. State-owned enterprises (SOEs) remain dominant players in the energy and transportation sectors. Plans for the partial privatisations and initial public offerings (IPOs) of major SOEs such as Bucharest Airport and Hidroelectrica, the country’s biggest electricity producer, have been under discussion for some time but are currently stalled. The prospective establishment of the Sovereign Wealth Fund for Development and Investment (FSDI) in late 2017, into which it is proposed that the state’s participation in profitable SOEs will be transferred, and which would invest in projects in various priority areas, may have further adverse impact on privatisation plans. As of the third quarter of 2017, the structure and objectives of the FSDI – aside from funding public investment – have not yet been clearly determined.

Challenges in infrastructure remain. According to the Global Competitiveness Report 2017-2018, Romania ranks 102nd (out of 137) in the quality of transport infrastructure, which constitutes one of the weakest areas of its business environment. Similarly, the country has the second lowest ranking in the European Union in the World Bank’s Logistics Performance Index. During 2016, secondary regulations regarding the newly updated public procurement laws were introduced, with a goal to transpose EU directives into national legislation. The new public-private partnership (PPP) law, approved in November 2016, is currently under revision and a new draft law (including secondary legislation) is expected to be adopted later in 2017. However, a lack of coordination and strategic planning hampers public investments in infrastructure, while perceptions of corruption and fraud in procurement limit private investments.

The corporate segment of the energy market is fully liberalised, but liberalisation in the household segment is slow. The electricity and gas market for corporates is competitive, as liberalisation for this segment was completed in 2014 and 2015. However, liberalisation for the household segment is not set for completion until 2018 for the electricity market and 2021 for the gas market. The sector requires significant investment to diversify its energy sources and enhance cross-border interconnections. The sector also suffers from the dominance of SOEs and delays in aligning national energy efficiency legislation with EU legislation.

NPLs continue to decline, but remain above the EU average. Banks are continuing to clean their balance sheets, with NPL sales reaching around €4 billion by the end of 2016 since the adoption of loans resolution measures in late 2014. The NPL ratio declined to 8.2 per cent in July 2017 (European Banking Authority definition), from a peak of 22.0 per cent at the end of 2013. NPLs are expected to further decline over the coming year, although remaining above the EU average of 5 per cent. Meanwhile, banks continue to make efforts to restructure their loan portfolios.

Confidence in the banking sector has been enhanced. Following the recommendation of the European Systemic Risk Board, Romania set up a National Committee for Macro-Prudential Supervision in March 2017, which will work to ensure financial stability. The risks posed by the newly adopted debt discharge law for mortgage-backed loans, which allows debtors to discharge their debt obligations by transferring the collateral to creditors, were limited by a Constitutional Court decision to restrict its applicability. Meanwhile, the authorities have pledged to perform an asset quality review and stress test for the banking sector in 2018.