ROMANIA

Highlights

- **Following rapid growth in 2017, the economy is slowing down.** Romania recorded one of the fastest growth rates in the European Union (EU) in 2017 at 7.3 per cent, driven by strong private consumption and investment. However, growing fiscal and external imbalances have been accompanied by tighter monetary policy and a slow-down of growth so far in 2018.
- **The resilience of the banking system improved as the decline in non-performing loans (NPLs) continued.** Successive sales of NPLs and fast loan growth have brought the ratio of NPLs down to 5.7 per cent, from a high of 22.0 per cent in 2013.
- **Progress in structural reforms has been uneven.** Some modest progress occurred in implementing the Cooperation and Verification Mechanism (CVM) recommendations, but other measures adopted by the government have prompted concerns about judicial independence and the government's commitment to fighting corruption.

Key priorities for 2019

- **Further reforms to strengthen judicial independence and transparency should be undertaken.** Progress in this area would help to alleviate concerns surrounding the independence of the judiciary and the government's anti-corruption commitment.
- **Privatisation of state-owned enterprises (SOEs) needs to be prioritised. SOEs remain dominant in some sectors such as energy and transport.** Privatisation of these enterprises through initial public offerings (IPOs) would attract investors and increase market capitalisation, thereby helping to upgrade Romania from frontier market to emerging market status.
- **Business environment reforms should be prioritised.** Difficulty in accessing skilled labour, inadequate transport infrastructure and inefficient government bureaucracy constitute the highest reform priorities. In particular, growing labour shortages need to be addressed by retaining and attracting qualified workers.

Main macroeconomic indicators %

	2014	2015	2016	2017	2018 proj.
GDP growth	3.1	4.0	4.8	7.3	4.2
Inflation (average)	1.4	-0.4	-1.1	1.1	4.7
Government balance/GDP	-1.9	-1.5	-2.4	-2.9	-3.0
Current account balance/GDP	-0.7	-1.2	-2.1	-3.4	-3.5
Net FDI/GDP [neg. sign = inflows]	-1.9	-2.4	-3.3	-2.3	-2.9
External debt/GDP	56.8	55.6	52.9	45.3	n.a.
Gross reserves/GDP	21.6	21.8	21.4	20.1	n.a.
Credit to private sector/GDP	31.1	29.9	28.2	26.4	n.a.

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Macroeconomic performance

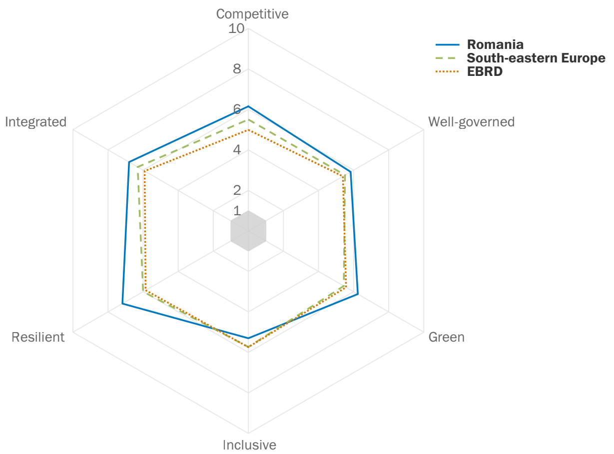
Romania's growth rate of 7.3 per cent was one of the highest in the EU in 2017. Private consumption was the main driver of growth in 2017, supported by a pro-cyclical fiscal policy including cuts in VAT and other consumer taxes. Strong wage growth and low unemployment, at 4.1 per cent in September 2018, also boosted consumption growth. After declining during the previous year, investment also picked up in 2017, fuelled by increased absorption of EU funds. There are signs in the first half of 2018 that the economy is slowing down, with the growth rate for this period reaching 4.0 per cent year-on-year.

To address growing overheating concerns, the central bank has started to tighten monetary policy. The tightening labour market and rising household consumption drove inflation to 5.4 per cent in June, the highest figure since 2013 and well above the central bank's upper target of 3.5 per cent. Consequently, the central bank has started to tighten its monetary policy, raising its main policy rate three times so far in 2018 from 1.75 to 2.50 per cent. Further increases are likely given the continued inflationary pressure and monetary tightening in the USA.

Fiscal and external imbalances have increased. The current account deficit rose to 3.4 per cent of GDP in 2017, driven by rising imports, and continued to grow in the first half of 2018. Meanwhile, the budget deficit reached 2.9 per cent of GDP in 2017 and may exceed 3.0 per cent of GDP in 2018 on the back of continued loose fiscal policies. On the positive side, general government debt is low by regional standards, at 35 per cent of GDP as of the end of 2017, and has been declining.

GDP growth is likely to moderate in 2018-19. Growth is projected to moderate to 4.2 per cent in 2018 and 3.6 per cent in 2019, due to weakening policy stimulus and tighter monetary policy, although growth will continue to be supported by investment linked to EU funds. Downside risks, including the exacerbation of the current labour shortages, changes in global investor sentiment and domestic political and reform uncertainty, may hamper growth 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 60 per cent of the EU average) should allow growth rates of around 4 per cent to be sustained, provided further structural reforms are undertaken.

Assessment of transition qualities (1-10)



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Major structural reform developments

Romania's investment environment is better than regional peers, although challenges remain. In the World Bank's *Doing Business 2019* report, Romania ranked 52nd out of 190 countries, a deterioration of seven places over the previous year. The slide in performance is in part due to the introduction of new value added tax regulations making starting a business more difficult. Other areas that are particularly challenging include obtaining construction permits and getting electricity, but Romania performs best among the countries surveyed in trading across borders.

Progress under the Cooperation and Verification Mechanism (CVM) continues to be uneven. The coalition's ongoing attempts to pass amendments to several justice laws are a cause for concern – as was the dismissal in July 2018 of the head of the National Anti-Corruption Directorate (DNA) – as they could weaken the fight against corruption.

Plans to privatise state-owned enterprises remain stalled. SOEs remain dominant players in the energy and transportation sectors, weighing on public finances. However, uncertainty surrounding the legitimacy of the Sovereign Wealth Fund for Development and Investment (FSDI), established to hold the state's participation in profitable SOEs, means that prospects for privatisation of these entities remain unclear.

Romania is close to reaching emerging market status, which would have a positive effect on investment. Romania meets most of the criteria required for being upgraded from frontier to emerging market status by the market index maker MSCI. Low liquidity is the main limiting factor, which highlights one of the potential benefits to be gained from privatising SOEs through IPOs. An upgrade to emerging market status could result in a significant increase in inflows to Romanian capital markets.

There was considerable progress in reducing the share of NPLs. Banks continue to clean up their balance sheets and restructure their loan portfolios. The combination of NPL sales and strong credit growth has pushed the NPL ratio down to 5.7 per cent in June 2018, from a peak of 22.0 per cent at the end of 2013. While still above the EU average of around 4.0 per cent, NPLs are expected to further decline over the coming year on the back of further sales.