ROMANIA

Highlights

- **Growth remains strong.** The economy grew by 4 per cent in 2018 but fiscal and current account deficits have increased as a result of the government's pro-cyclical stimulus measures.
- **Progress under the Cooperation and Verification Mechanism (CVM) continues to be uneven.** The latest CVM report noted reversals on Romania's progress in the areas of the rule of law and the fight against corruption.
- **Investor sentiment was hurt by a package of measures taken in late December 2018 (Emergency Ordinance 114/2018).** The proposals would have had a potentially significant negative impact on specific sectors, including banking, pension funds, energy, and telecommunications, but following pressure from various stakeholders, the government has softened the measures.

Key priorities for 2020

- **Further reforms to strengthen good governance 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. Initial public offerings (IPOs) and secondary public offerings (SPOs) of SOEs already listed would attract investors and increase market capitalisation.
- **Business environment reforms should be prioritised.** Efforts to address the difficulties in accessing skilled labour, inadequate transport infrastructure and inefficient government bureaucracy constitute the highest reform priorities.

Main macroeconomic indicators %

	2015	2016	2017	2018	2019 proj.
GDP growth	3.9	4.8	7.1	4.0	4.0
Inflation (average)	-0.4	-1.1	1.1	4.1	3.6
Government balance/GDP	-0.6	-2.6	-2.6	-3.0	-3.5
Current account balance/GDP	-1.2	-2.1	-3.4	-3.5	-3.4
Net FDI/GDP [neg. sign = inflows]	-1.8	-2.6	-2.6	-2.5	-2.5
External debt/GDP	56.3	52.0	52.3	46.4	n.a.
Gross reserves/GDP	21.7	21.2	20.8	17.5	n.a.
Credit to private sector/GDP	29.9	28.0	26.3	25.9	n.a.

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Macroeconomic performance

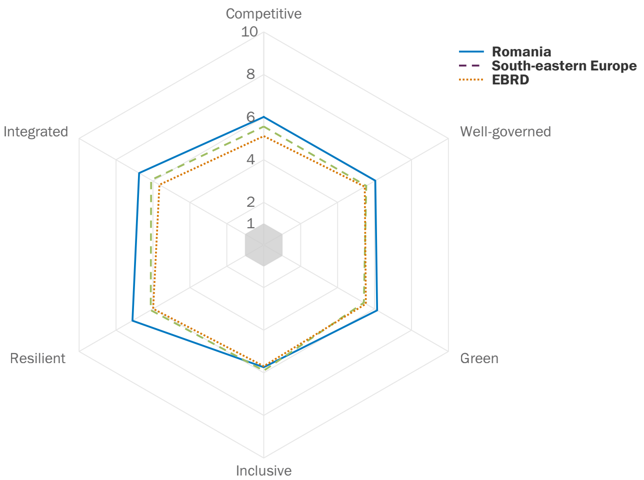
Growth has moderated but remains strong. Following a growth peak of 7.1 per cent in 2017, the economy slowed to an estimated 4.0 per cent growth in 2018. Private consumption has been the main driver of the economy over the past two years (although at a slower pace in 2018), supported by a pro-cyclical fiscal policy, including public-sector salary hikes. Fuelled by increased absorption of EU funds, the contribution of investment to growth was also positive. Despite growing exports, the trade deficit has been widening since 2015, as rising domestic demand has driven up imports even more, thus negatively contributing to growth. The unemployment rate, at about 4.0 per cent as of the end of 2018, is the lowest in a decade, making recruitment difficult and driving wage growth. The average net monthly wage in December 2018 was €635, an increase of about 10.0 per cent year-on-year in real terms. The economy grew by 4.6 per cent year-on-year in the first half of 2019, which was better than expected by most analysts.

Inflation has accelerated. Driven by the tightening labour market and rising household consumption, inflation peaked at a five-year high of 5.4 per cent in June 2018, well above the central bank's upper target of 2.5 per cent +/-1pp. Consequently, the central bank tightened its monetary policy, raising its main policy rate three times in 2018 from 1.75 to 2.50 per cent. Although inflation gradually receded to 3.3 per cent in December 2018, it has risen to an average of 3.9 per cent in the first half of 2019, again above the central bank's upper target.

Twin deficits have increased in the wake of government pro-cyclical stimulus measures. The current account deficit is estimated to have widened to 3.5 per cent of gross domestic product (GDP) in 2018 (from about 1.0 per cent in 2015), driven by rising imports and dividends outflows from the accumulated foreign direct investment stock. Meanwhile, the budget deficit is estimated to have reached 3.0 per cent of GDP in 2018 (second highest in the European Union (EU)) on the back of continued loose fiscal policies as well as weak revenues. The International Monetary Fund and the European Commission (EC) have expressed concerns about plans for pension and public-sector wage increases. In June 2019, the lower house of the parliament passed the new pension law, which provides for an accelerated increase in public pensions over the next two years until they reach a level 70.0 per cent higher than the current one by September 2021. On the positive side, general government debt is low by regional standards, at around 35.0 per cent of GDP, and has been stable for some time thanks to high nominal growth.

GDP growth is likely to moderate further in the short term. Growth is expected at 4.0 per cent in 2019, moderating to 3.2 per cent in 2020, reflecting weakness in major trading partners, not least the euro area, and higher perceived investment risks. In the longer term, the diversified economy, large market size and scope for convergence within the EU (GDP per capita in power purchasing standards is 64.0 per cent of the EU average) should allow growth rates of around 4.0 per cent to be sustained, provided structural reforms remain on track.

Assessment of transition qualities (1-10)



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Major structural reform developments

Controversial economic policy measures have been softened. A set of measures announced in December 2018 (Emergency Ordinance 114/2018) and affecting the banking, pension, telecommunications (telecoms) and energy sectors caused significant concern among investors because of their potentially damaging impact on investment and business confidence. Steps have been taken since to soften some of the measures. The bank asset tax was eventually set at 0.4 per cent (which may be further adjusted downwards depending on the credit growth and the loan-deposit (net) interest margin), with the taxable amount excluding government loans and securities. Capital requirements for private pension funds have been raised (although lowered relative to the original ordinance), while a cap was introduced on administration fees charged by private fund managers. In the telecoms sector, the 3 per cent turnover tax levied on all telecoms operators as of January 2019 remains in place, as originally proposed. Similarly, the gas price caps, at RON 68 (around €14) per MWh for the next three years, will be maintained for household consumers and producers supplying household heating centres, but will be removed for industrial consumers. The latter measures are still at odds with EU legal requirements, and the EC has already launched an infringement procedure against Romania, claiming that the provision breaches the EU Gas Directive. Nevertheless, the measures left significant doubts about the predictability of the business environment and the quality of the legislative process.

Some business environment reforms have advanced. Over the past year, Romania made starting a business easier by allowing voluntary value added tax registration and making paying taxes less costly by eliminating a number of employer-paid taxes and contributions. However, the country's ranking fell three places to 55th (out of 190 economies) in the World Bank's *Doing Business 2020* report. In a positive development, in September 2019 FTSE Russell announced that Romania will be assigned Secondary Emerging market status, effective in September 2020.

Progress under the European Commission's Cooperation and Verification Mechanism (CVM) continues to be uneven. The latest CVM report, published in October 2019, noted reversals on Romania's progress in the areas of the rule of law and the fight against corruption. However, the authorities have recently confirmed their commitment to close the relevant benchmarks.
The government has endorsed a plan for euro adoption. A memorandum with this aim was published in February 2019, including the plan for the adoption of the euro by 2024. Romania meets only one of the nominal criteria for joining the eurozone, namely, the criterion that the government deficit should be below 3 per cent of GDP (although with a negative trend). The country does not fulfil the criteria on price stability and on the convergence of long-term interest rates.

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The government has revived plans for establishing an investment and development sovereign fund. According to a revised draft bill from March 2019, the fund's portfolio would include controlling or minority stakes in 28 companies in the transport, pharmaceutical and energy sectors and cash of €2 billion to be disbursed in stages, which is supposed to come from privatisation revenues held in a reserve account of the government. Also, according to the legislation, the fund will be able to privatise the companies it holds at discretion and without complying with a high degree of transparency. The most valuable companies that will be part of the fund, besides the state-owned minority stakes in OMV Petrom, Telekom Romania, and Engie, Eon subsidiaries, are Hidroelectrica, Romgaz, Nuclearelectrica, Constanta Port, Conpet, Romanian Lottery, Cuprumin, Unifarm and Antibiotice Iasi.

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Offshore gas development in the Black Sea is progressing slowly. The Black Sea Oil & Gas company has launched its investment in developing the offshore gas reserves in the Black Sea, following government approval in April 2019. This is the first new offshore gas development project in Romania's Black Sea to be built after 1989. At the same time, in late 2018 OMV Petrom deferred a decision to go ahead with investments in its offshore gas fields, due to changes in both the offshore law (including the mandatory sale of 50 per cent of the output on the local market at regulated price) and the introduction of a supplementary 2 per cent turnover tax on energy companies, enacted by the government suddenly in late 2018. OMV Petrom runs the project in a 50-50 joint-venture with American group ExxonMobil. Meanwhile, in December 2018 Romania's gas transport grid operator Transgaz launched the tender for a major pipeline, aimed at bringing the natural gas produced by OMV Petrom and ExxonMobil at the Black Sea to the Bulgaria-Romania-Hungary-Austria gas pipeline. The new connection is the latest of a long series of pipelines Transgaz is currently developing or planning to build quickly. Under another project, Transgaz will make its gas route from Moldova reversible in order to allow exports to Moldova (and Ukraine, in principle) as well.

Romanian banks continue to clean up their balance sheets amid increasing profits. The non-performing loan (NPL) ratio in the country's banking system, calculated under European Banking Association methodology, dropped to less than 5 per cent as of the end of 2018, from a peak of more than 20 per cent in 2014. Romania's banks reported aggregated net profits of €1.5 billion in 2018, the highest annual profit for the past decade (2009-18). However, the introduction of the tax on bank assets may put pressure on the banks' profitability. Meanwhile, in June 2019 Romania's state-owned Eximbank, which specialises in corporate banking, reached an agreement to take over Banca Romaneasca, the local subsidiary of the Greek bank NBG. Also, in March 2019 Romania's Constitutional Court invalidated three controversial banking laws (which had been passed in December 2018) following objections raised by the opposition parties. The first law capped interest rates on retail loans (mortgage and consumer); a second law regulated the regime for NPLs, allowing the buyers of such loans to recover from debtors at almost twice the price they paid to buy them from the original creditors; and the third law reduced the power of creditors, obliging them to ask for court orders to enforce their claims.