ROMANIA

Highlights

- **The economy is being hit hard by the coronavirus crisis.** GDP grew by a robust 4.2 per cent in 2019, but the economy is experiencing a sharp recession in 2020 with the export-dependent manufacturing sector being severely affected.
- **The government has introduced a support package similar to those in other peer countries, although somewhat smaller.** Adopted measures include employment support schemes, as well as loan guarantees to small and medium-sized enterprises (SMEs), on top of fiscal relief measures.
- **Structural reforms have been hampered by parliamentary fragmentation and the Covid-19 crisis.** Not only has there been limited progress in reforms, but there have also been some reversals in the past year, including in the areas of privatisation and the banking sector.

Key priorities for 2021

- **Further actions to strengthen good governance should be undertaken.** Public administration and governance reform, and improvements in policymaking processes, including through digitisation, and in strengthening corporate governance of state-owned enterprises, should remain priorities.
- **Investments in infrastructure should be stepped up.** Given significant infrastructure gaps, the positive trend of public capital spending in the past year should continue. Ensuring administrative capacity, including for absorbing the allocated European Union (EU) funds, is critical.
- **Medium-term fiscal sustainability is important for the country's further transition.** The additional crisis-related fiscal stimulus in 2020 and curbed revenues, on top of an already unbalanced budget, will require the authorities to devise a medium-term fiscal strategy to reduce the deficit.

Main macroeconomic indicators %

	2016	2017	2018	2019	2020 proj.
GDP growth	4.7	7.3	4.5	4.2	-5.0
Inflation (average)	-1.1	1.1	4.1	3.9	2.5
Government balance/GDP	-2.6	-2.6	-2.9	-4.3	-9.2
Current account balance/GDP	-1.4	-2.8	-4.4	-4.6	-5.3
Net FDI/GDP [neg. sign = inflows]	-2.6	-2.6	-2.4	-2.4	-1.2
External debt/GDP	52.0	55.4	49.1	48.5	n.a.
Gross reserves/GDP	21.2	20.7	17.3	16.6	n.a.
Credit to private sector/GDP	28.1	26.3	25.6	24.7	n.a.

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Covid-19: macroeconomic implications

Romania is being severely affected by the coronavirus crisis. After robust growth of 4.2 per cent in 2019, on the back of expanding domestic demand, Romania is experiencing a recession in 2020. Key transmission channels are lower consumption and a drop in exports. A domestic lockdown and state of emergency were introduced in mid-March 2020, lasting until mid-May and severely affecting travel, economic activity and consumer and business sentiment. The lockdown heavily affected private consumption: retail sales dropped by almost one-fifth in April on a year-on-year basis, although some recovery has taken place in the following months. Industrial production collapsed in April by almost 40 per cent year-on-year, causing, among other things, exports of goods to drop. GDP fell in the first half of 2020 by 4.6 per cent year-on-year, with private consumption expenditure falling by 5 per cent and exports by 15 per cent. The unemployment rate has risen to 5.4 per cent in July 2020 (up from 3.7 per cent in January 2020), with further job losses likely in the coming months, as government support schemes are phased out. Inflation has picked up to 2.2 per cent year-on-year in June, which is within the central bank's target of 2.5 per cent +/- 1 percentage point.

The fiscal position has deteriorated further, requiring a budget revision. Romania entered the Covid-19 crisis with a significant fiscal deficit (4.3 per cent of GDP in 2019). The combination of a declining economy and revenues, a fiscal stimulus programme amounting to around 4 per cent of GDP, and another increase in pensions (on top of that in 2019) in September 2020, is expected to raise the fiscal deficit in 2020 to an estimated 8.6 per cent of GDP, as per the August 2020 revised budget. However, market access to funding on favourable terms remains strong. Romania still has a relatively moderate level of public debt of 35 per cent at the end of 2019, which is another mitigating factor, although this ratio is rapidly increasing. Because of the widening budget deficit, Fitch and Moody's downgraded their outlook on Romania's sovereign credit rating to negative in April 2020, but the country remains in investment-grade territory with all of the main credit ratings agencies.

The National Bank of Romania (NBR) has reacted promptly to loosen monetary policy. In a first reaction to the pandemic, the NBR reduced the monetary policy rate by a total of 1 percentage point to 1.5 per cent through three cuts (the latest in August 2020), and narrowed the related interest rates corridor to ±0.5 percentage points from ±1.0 percentage points, thus lowering further the lending facility rate. It also provided liquidity to credit institutions via repo transactions (repurchase of government securities). The NBR has also agreed with the European Central Bank to establish a repo (repurchase agreement) line for euro liquidity of up to €4.5 billion, to address possible euro liquidity needs in the event of market failures, in exchange for high-quality euro-denominated collateral. The repo line was first meant to be in place until the end of 2020, but in late August was renewed until 30 June 2021. The NBR also intervened in the foreign exchange markets to stabilise the Romanian leu-euro rate, given the high depreciation pressures.

Economic performance is expected to recover in 2021. Currently we forecast GDP to drop in 2020 by 5 per cent but rebound in 2021 by 3 per cent. The recovery is contingent on a gradual normalisation of economic activity in both Romania and its main economic partners, and a resumption of structural reforms. However, this would be hard to achieve should other major Covid-19 outbreaks emerge later in 2020 or early 2021.

Policy response to Covid-19

The government intervened to support liquidity and preserve jobs. The announced fiscal package in March 2020 of about 3 to 4 per cent of GDP includes: (i) additional funds for the healthcare system; (ii) partial coverage of wages for individuals who are technically unemployed (up to 75 per cent of the average gross wage), as well as for parents staying at home; and (iii) guarantees for supporting lending to SMEs, and a separate mechanism for large companies. Other measures include a deferral of loan payments for both firms and citizens of up to nine months (until the end of 2020), faster reimbursement of value-added tax, suspending foreclosures on overdue debtors, and postponement of property tax by three months. In June 2020 the government introduced a temporary measure to cover up to 45 per cent of the average gross wages for employees who return to work from technical unemployment, while firms employing people over 50 or under 30 years of age will receive subsidies of up to RON 2,500 (€515) per month for a year. In addition, a *Kurzarbeit*

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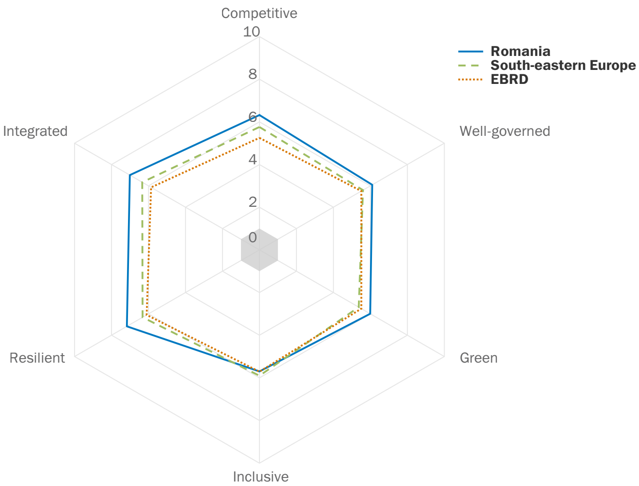
scheme, where the employer pays part of the wage proportional to the work hours, and the state tops up the payments to employees up to 75 per cent, was approved by the government. The government has also further relaxed procedures to smooth state-guaranteed loans to SMEs, under the IMM Invest programme, with the aim of accelerating the processing of loan requests. On top of the state-guaranteed lending from banks, the government decided also to directly finance SMEs from unused EU funds.

Assessment of transition qualities (1-10)



Structural reform developments

The government has unveiled an Economic Relaunch Plan focused primarily on public investments. In July 2020 the government unveiled the National Investment and Economic Relaunch Plan, which includes €100 billion worth of public investments and improved social protection over the next 10 years. The government envisions setting up a sovereign investment fund and a national promotional bank as the institutions in charge of implementing the plan. Investments in transport infrastructure remain a priority, but the plan also includes financial support to companies and sizeable state aid to greenfield investments that will contribute to regional development. The overall aim of the plan is to raise the country's GDP per capita, at purchasing power parity, to 87 per cent of the EU average by 2025, from the current 69 per cent.

Progress under the EU'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 European Commission welcomed the fact that the new government expressed a wish to reset the approach.

FTSE Russell has upgraded Romania's equity market to (Secondary) Emerging market status. The upgrade is effective from September 2020. This is a significant change and should have a positive impact on market development, investor sentiment and overall investment inflows. This move could give a boost to the privatisation process for state-owned enterprises, which has stalled and even reversed in the past year (see below). More recently, Nuclearelectrica and Banca Transilvania met the FTSE Global All Cap Index eligibility requirements as of the end of June 2020.

A new law temporarily freezing the sale of state assets has been adopted. Initiated by the opposition, the "Bill on certain measures to protect national interests in the economic sector" (or "anti-privatisation law") was passed by parliament in June 2020. It bans any sale of state-owned assets for two years, as well as stalling current privatisation procedures. The intention of the law was to postpone the privatisation for the period after the Covid-19 crisis, as those backing the law claimed that sales carried out now (or in the near future) would be at low prices because of the effects of the crisis. The government appealed the bill and the Constitutional Court is expected to review it.

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Several bills targeting consumer credit, with a potential negative impact on the banking sector, have been adopted. One bill, approved by parliament in May 2020, sets interest rate caps on mortgage and consumer loans. The law states that in the case of mortgage loans, the effective interest rate cannot exceed the policy rate by more than 2 percentage points, and in the case of consumer loans by more than 15 percentage points. The Giving in Payment Law, also adopted in May 2020, allows a debtor to be discharged of any obligations towards their creditor by handing over the property subject to the mortgage loan. Another new law is aimed at limiting the value of claims that can be recovered in the case of banks selling a claim to a distressed credit manager. On a more positive note, the bank tax on total assets introduced in December 2018 by Government Emergency Ordinance 114/2018, was removed, effective from the beginning of 2020.