FitchRatings

RATING ACTION COMMENTARY

# Fitch Revises Romania's Outlook to Negative; Affirms at 'BBB-'

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**Link to Fitch Ratings' Report(s):**
Romania - Rating Action Report

Fitch Ratings - Frankfurt am Main - 17 Apr 2020: Fitch Ratings has revised Romania's Outlook to Negative from Stable, while affirming the Long-Term Foreign-Currency (LTFC) Issuer Default Rating (IDR) at 'BBB-'.

A full list of rating actions is detailed below.

Under EU credit rating agency (CRA) regulation, the publication of sovereign reviews is subject to restrictions and must take place according to a published schedule, except where it is necessary for CRAs to deviate from this in order to comply with their legal obligations. Fitch interprets this provision as allowing us to publish a rating review in situations where there is a material change in the creditworthiness of the issuer that we believe makes it inappropriate for us to wait until the next scheduled review date to update the rating or Outlook/Watch status. The next scheduled review date for Fitch's sovereign rating on Romania will be 1 May 2020, but Fitch believes that developments in the country warrant such a deviation from the calendar and our rationale for this is laid out below.

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public finances expected in the short-term as the outbreak and spread of the COVID-19 pandemic aggravates an already weak fiscal position. The combination of a sharp economic contraction and a rise in spending will cause a material widening of the public deficit and a sharp rise in debt in 2020. Although Fitch expects the economy to recover in 2021, uncertainty regarding the scope and length of the pandemic, combined with poor fiscal management in recent years, creates significant challenges in consolidating public finances over the medium term.

We forecast the general government deficit to widen to 8% of GDP in 2020, reflecting a projected sharp fall in revenue as most economic sectors suffer and an increase in expenditure, driven in part by automatic stabilisers. It also reflects a weak starting position, as Romania failed to take advantage of favourable macroeconomic conditions in recent years to improve its headline and structural deficit, with the general government deficit reaching 4.6% of GDP in 2019 (the highest in the EU and versus the BBB median deficit of 1.6%). The government has revised its 2020 budget target deficit to 6.7% of GDP (from 3.6% originally), following the introduction of various support measures, which include higher healthcare spending, various income- and tax-measures for affected companies and workers, and increase in loan guarantees. These measures amount to 3% of GDP (below aid packages pledged by other countries in the region) and are partly financed by drawing down European funds more rapidly.

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Fitch expects the deficit to narrow in 2021, to 4.2% of GDP, driven in part by a recovery in economic activity. Our forecast rests on the assumption that the government contains the rise in expenditure on non-discretionary items, in particular by reducing or cancelling the 40% increase in public pensions due in September this year approved by the previous government and limits future wage increases. Nevertheless, a complicated political backdrop could hinder such plans and lead to more prolonged deterioration in fiscal metrics. Overall, despite efforts by the current administration (in power since November 2019) to improve fiscal management, Romania´s poor record in fiscal consolidation heightens downside risks to the rating.

Our public-finance projections see the debt ratio rising sharply to almost 45% of GDP in 2020, from 35.2% in 2019. Although this would still be below the projected 'BBB' median of 50%, it would constitute the highest ratio since 1995. Under our baseline assumption, public debt/GDP should rise only moderately in 2021 but this is subject to significant upside risks.

MEDIUM

Fitch forecasts the economy to contract 5.9% in 2020, from a growth of 4.1% in 2019 and a downward revision of 9.2pp since our last rating action in November 2019. Although Romania is less dependent than other countries in the region on services sectors that have been highly affected by COVID-19 (i.e. tourism, transport), we expect a sharp contraction in consumption, investment and exports as global demand collapses and domestic economic activity suffers from lockdown measures and a drop in confidence. We expect the unemployment rate to jump to 8% in 2020 (the highest one year increase on record) from a record low of 3.9% in 2019, reflecting in part the limited scale of government measures to offset the economic shock. According to data by the Labour Ministry, companies have submitted requests for temporary unemployment for around 560,000 workers by mid-April. .

In our central scenario, we expect the disruptions from the COVID-19 pandemic to unwind over the course of this year, with most sectors recovering by end-2020 and job losses moderating. We forecast the economy to expand by over 5% in 2021, driven by strong growth in manufacturing and services exports, a pick-up in investment (both public and private) and a recovery in consumption. Shifting investment priorities by global companies could even benefit some Romanian industries (such as information and communications technology, agriculture) over the medium term. However, we see material downside risk to our short- and medium- term growth forecasts, given uncertainty surrounding the extent and duration of economic and social restrictions.

Fitch expects GDP per capita to fall sharply in 2020 before rising modestly in 2021, to USD12.800 at market exchange rates. This would be broadly the same level as in 2019 and only 90% of the level of our previous forecast. Nonetheless, it will remain slightly above the `BBB´ median, supporting the rating.

Romania´s IDRs also reflect the following key rating drivers:

Fitch forecasts Romania´s current account deficit (CAD) to narrow to 3% of GDP in 2020 (after reaching an estimated deficit of 5% in 2019, according to Fitch´s estimates based on IMF data), as a projected sharp fall in goods and services exports due to COVID-19 will be offset by a more pronounced contraction in goods and services imports. This adjustment - evident in previous cycles of economic contraction - reflects in part a large import component of investment. Although foreign direct investment (FDI) inflows will slow, capital transfers should remain substantial (reflecting a ramp-up of the EU funding cycle), with non-debt creating inflows covering around 75% of the CAD. A rise in external public borrowing will lead to modest deterioration in net external debt to 17.5% of GDP, almost double the current 'BBB' median.

Inflation started to moderate in 1Q20 (to 3.1% in March) from a recent high of 4% in December 2019, due in part to a high base rate. This trend is likely to accelerate in coming months given the sharp fall in demand and lower oil prices. We now see inflation averaging 2.5% in 2020 before accelerating slightly in 2021 as the economy recovers. A more benign inflation outlook will provide the National Bank of Romania (NBR) some scope to support the economy by reducing interest rates further, following a 50bp cut to its key rate in March to 2%, the first cut in almost five years. However, given the potential build-up of exchange rate pressures if interest rate cuts are too aggressive, we expect the NBR to primarily focus on maintaining liquidity in the financial system and supporting the money and government bond markets. The NBR has adequate international reserves (EUR39 billion, 17.5% of 2019 GDP) to contain shocks.

We expect Romania to continue to rely heavily on the domestic market to meet its public-financing requirements (which we estimate at 10% of GDP in 2020), helped by the purchase of government securities on the secondary market by the NBR. The government is also relying on external financing from international financial institutions and could tap international capital markets.

Fitch believes the financial sector is in a better position to weather a crisis than in 2008-2009, with a liquid and highly capitalised banking sector that is less reliant on cross-border funding. The capital adequacy ratio was a preliminary 20% at end-2019 (with the final figure likely to be higher given profit inclusions) versus 13.8% at end-2008, while liquid assets-to-short-term liabilities were close to a historical high in 3Q19 (165%). However, economic contraction will lead to deterioration in asset quality (non-performing exposures as per EBA definition stood at a low of 4.1% in end-2019), a rise in impairment charges and will reduce demand for credit. This, combined with pressures on interest margins, will affect profitability and put pressure on banks' capital positions.

Romania's human development indicators are above the 'BBB' range median, while its percentile rankings in the World Bank's composite governance indicator are broadly in line with peers'. Governance indicators have fallen in recent years, in particular in terms of government effectiveness, reflecting in part erratic policymaking that has limited investment and halted structural and fiscal reforms. The PNL government does not have a majority in parliament and relies on either ad-hoc alliances or emergency ordinances to approve legislation. This has left it very vulnerable—it already lost a vote of confidence in February, only to be re-instated in March given the COVID-19 pandemic. Local and parliamentary elections are now likely to take place simultaneously at end-2020, which could provide some scope for the PNL government to approve difficult reforms in the coming months. However, it also raises the risks of political bickering and could delay approval of fiscal measures.

ESG - Governance: Romania has an ESG Relevance Score (RS) of 5 for both Political Stability and Rights and for the Rule of Law, Institutional and Regulatory Quality and Control of Corruption, as is the case for all sovereigns. Theses scores reflect the high weight that the World Bank Governance Indicators (WBGI) have in our proprietary Sovereign Rating Model (SRM). Romania has a moderate WBGI ranking at 56.1 percentile, reflecting a recent track record of peaceful political transitions, a moderate level of rights for participation in the political process, moderate institutional capacity, established rule of law and a moderate level of corruption.

## SOVEREIGN RATING MODEL (SRM) AND QUALITATIVE OVERLAY (QO)

Fitch's proprietary SRM assigns Romania a score equivalent to a rating of 'BBB' on the Long-Term LTFC IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LTFC IDR by applying its QO, relative to rated peers, as follows:

- External Finances:-1 notch, to reflect Romania's higher net external debtor and net investment liabilities positions than the 'BBB' range median, as well as greater external vulnerability than implied by the model.

- Macroeconomics: Fitch has removed the -1 notch in macroeconomics due to lower near-term risks to macroeconomic stability from economic policy and reduced distortion to the SRM output from previous pro-cyclical expansionary policies.

Fitch's SRM is the agency's proprietary multiple regression rating model that employs 18 variables based on three-year centred averages, including one year of forecasts, to produce a score equivalent to a LTFC IDR. Fitch's QO is a forward-looking qualitative framework designed to allow for adjustment to the SRM output to assign the final rating, reflecting factors within our criteria that are not fully quantifiable and/or not fully reflected in the SRM.

## RATING SENSITIVITIES

The main factors that may, individually or collectively, lead to negative rating action/downgrade are:

-Sharp deterioration in medium-term debt sustainability, for example due to failure to offset or delay increases in recurrent expenditure and/or implement a credible medium-term consolidation strategy post-pandemic shock.

- Weaker medium-term growth prospects, for example reflecting a more pronounced or longer period of economic contraction that leads to permanent sectoral damage.

The main factors that could, individually or collectively, lead to positive rating action/upgrade:

- Confidence that general government debt/GDP will stabilise over the medium-term, for example due to a post-pandemic fiscal consolidation.

- A sustained improvement in external debt ratios.

## BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Public Finance issuers have a best-case rating upgrade scenario (defined as the 99th percentile of rating transitions, measured in a positive direction) of three notches over a three-year rating horizon; and a worst-case rating downgrade scenario (defined as the 99th percentile of rating transitions, measured in a negative direction) of three notches over three years. The complete span of best- and worst-case scenario credit ratings for all rating categories ranges from 'AAA' to 'D'. Best- and worst-case scenario credit ratings are based on historical performance. For more information about the methodology used to determine sector-specific best- and worst-case scenario credit ratings, visit https://www.fitchratings.com/site/re/10111579.

## KEY ASSUMPTIONS

We assume that the global economy evolves in line with our Global Economic Outlook published on 2 April 2020. Eurozone GDP is forecast to decline 4.2% in 2020, before recovering 2.9% in 2021.

## REFERENCES FOR SUBSTANTIALLY MATERIAL SOURCE CITED AS KEY DRIVER OF RATING

The principal sources of information used in the analysis are described in the Applicable Criteria.

## ESG CONSIDERATIONS

Romania has an ESG Relevance Score of 5 for Political Stability and Rights as

WBGI have the highest weight in Fitch's SRM and are highly relevant to the rating and a key rating driver with a high weight.

Romania has an ESG Relevance Score of 5 for Rule of Law, Institutional & Regulatory Quality and Control of Corruption as WBGI have the highest weight in Fitch's SRM and are therefore highly relevant to the rating and are a key rating driver with a high weight.

Romania has an ESG Relevance Score of 4 for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI are relevant to the rating and a rating driver.

Romania has an ESG Relevance Score of 4 for Creditor Rights as willingness to service and repay debt is relevant to the rating and is a rating driver for Romania, as for all sovereigns.

Except for the matters discussed above, the highest level of ESG credit relevance, if present, is a score of 3. This means ESG issues are credit-neutral or have only a minimal credit impact on the entity, either due to their nature or to the way in which they are being managed by the entity. For more information on Fitch's ESG Relevance Scores, visit www.fitchratings.com/esg.

## RATING ACTIONS

| ENTITY/DEBT | RATING | | |
|---|---|---|---|
| Romania | LT IDR | BBB- | Affirmed |
| • | ST IDR | F3 | Affirmed |
| • | LC LT IDR | BBB- | Affirmed |
| • | LC ST IDR | F3 | Affirmed |
| • | Country Ceiling | BBB+ | Affirmed |
| • senior unsecured | LT | BBB- | Affirmed |

**VIEW ADDITIONAL RATING DETAILS**

Additional information is available on www.fitchratings.com

## APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 05 Jul 2019)

Sovereign Rating Criteria (pub. 28 Mar 2020) (including rating assumption sensitivity)

## APPLICABLE MODELS

Numbers in parentheses accompanying applicable model(s) contain hyperlinks to criteria providing description of model(s).

Country Ceiling Model, v1.7.1 (1)

Debt Dynamics Model, v1.2.0 (1)

Macro-Prudential Indicator Model, v1.4.0 (1)

Sovereign Rating Model, v3.11.0 (1)

## ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

Endorsement Policy

## ENDORSEMENT STATUS

| | |
|---|---|
| Romania | EU Issued |

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Sovereigns Europe Romania