ROMANIA

Highlights

- **The economy grew by 3.7 per cent in 2015 on the back of private consumption.** Growth was supported by an increase in wages, better labour market conditions and subdued inflation, which has been negative since June 2015 on the back of lower food and energy prices, the reduction in VAT and lower inflation expectations.
- **Romania continued its progress under the Cooperation and Verification Mechanism, but challenges remain.** Romania made progress in the independence of its judiciary and the fight against high-level corruption, according to the European Commission. An anti-corruption strategy was launched for public debate in July 2016.
- **The decline in non-performing loans (NPLs) continued.** The NPL ratio decreased to 10.6 per cent in August 2016, from a peak of 22.0 per cent at the end of 2013, on the back of the central bank's initiative to stimulate NPL write-off, and an improvement in lending to the private sector. Meanwhile, banks continued to restructure their loan portfolios.

Key priorities for 2017

- **The fight against corruption should be further strengthened.** While Romania progressed in its fight against corruption, the country has yet to reach a full consensus on judiciary reforms and needs to consolidate existing reforms to maintain sustainable and irreversible progress.
- **Efforts should be made to improve infrastructure.** The quality of transport infrastructure remains poor by EU standards and the lack of coordination and strategic planning hampers public investments. The legal framework on public procurement should be improved by further pursuing the ongoing reorganisation of the procurement system.
- **Privatisation of state-owned enterprises should be re-energised.** The privatisation process stalled in 2015 and 2016. Romania should continue its efforts to restructure loss-making state-owned enterprises (SOEs) and privatise them in order to achieve higher overall productivity and efficiency.

Main macroeconomic indicators %

	2012	2013	2014	2015	2016 proj.
GDP growth	0.6	3.5	3.1	3.7	4.8
Inflation (average)	3.3	4.0	1.1	-0.6	-1.5
Government balance/GDP	-2.5	-2.5	-1.9	-1.5	-2.8
Current account balance/GDP	-4.8	-1.1	-0.5	-1.1	-2.0
Net FDI/GDP (neg. sign = inflows)	-1.9	-2.0	-1.8	-1.7	-1.8
External debt/GDP	76.2	70.2	58.5	55.6	n.a.
Gross reserves/GDP	27.1	25.3	21.9	21.7	n.a.
Credit to private sector/GDP	37.5	33.9	31.1	29.9	n.a.

CONTINUES

Macroeconomic performance

Romania's economic growth edged up to 3.7 per cent in 2015. Private consumption emerged as the main driver of growth, on the back of higher disposable income, boosted by a rise in wages, improved labour markets and low inflation. Investments rose on the back of a lower cost of funding, following the National Bank of Romania's (NBR's) policy rate cut in May 2015 to an historically low level of 1.75 per cent, and improved investor confidence. Economic growth accelerated to 5.2 per cent in the first half of 2016, on the back of domestic demand. Meanwhile, inflation has been in negative territory since June 2015, on the back of declining food and energy prices, a reduction in VAT and lower inflation expectations. Consumer Price Index (CPI) growth stood at -0.6 per cent in September 2016.

External vulnerabilities remain modest, while fiscal performance has been steady. Despite a recent uptick, the current account deficit remained low at 1.2 per cent of GDP in 2015. General government debt is low by regional standards, standing at 39.2 per cent of GDP at the end of 2015, while the general government budget deficit declined further to 1.5 per cent of GDP. However, the reduction in standard VAT, the recent hike in public and minimum wages and still not fully efficient budgetary process may jeopardise the budget deficit target in 2016, which is set at 2.95 per cent of GDP.

Growth is expected at around 4.8 per cent in 2016 and 3.7 per cent in 2017, driven by strong domestic demand. Various factors will drive this stronger growth rate, including: the historically low level of interest rates; the VAT rate cut (from 24 per cent to 20 per cent as of 2016 and 19 per cent as of 2017); the 19 per cent hike in the minimum wage as of May 2016; planned wage increases in the public sector; a cut in employees' social security contributions by 2017; better economic sentiment; and the low inflation environment. Key downside risks to the economy are prolonged weakness in the eurozone, rising domestic political and reform uncertainty and further worsening of global investor sentiment. Growth prospects in the medium term remain favourable, due to the diversified and large economy, and the likely convergence towards EU living standards. Lasting annual growth rates of 4 per cent are achievable if structural reforms are pursued and investments continue to grow.

Major structural reform developments

Romania has continued its progress under the Cooperation and Verification Mechanism (CVM) but challenges remain. In its January 2016 report under the CVM, the European Commission (EC) concluded that Romania had made further progress in the fight against high-level corruption and independence and professionalism of the judiciary. However, a full consensus on judiciary reforms is needed to maintain sustainable progress, and reforms should be consolidated for irreversible progress. In July 2016, the government presented an anti-corruption strategy for public debate, in order to support the anti-corruption body's efforts and to implement further preventive measures.

The investment environment has improved, but with remaining weaknesses in certain areas. Romania ranked 36th out of 190 countries in the World Bank *Doing Business 2017* report, performing better than the regional average (Europe and Central Asia), but lagging behind some of its peers in the European Union. The main areas requiring improvement emerged as: getting electricity, dealing with construction permits and starting a business. 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.

New public procurement laws have been approved. The new laws, approved in May 2016, are designed to transpose EU directives into national legislation, and to simplify the public investment process. Meanwhile, secondary legislation on public-private partnerships (PPPs) is still to be implemented. While lack of coordination and strategic planning hampers public investments in infrastructure, the EC's Staff Country Report 2016 cites survey data that show that perceptions of corruption and fraud in procurement are limiting private investments.

CONTINUES

The corporate segment of the energy market is fully liberalised, but liberalisation in the household segment is proceeding slowly. 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 remains slow, with liberalisation set to be completed in 2018 for the electricity market and 2021 for the gas market. The Romanian energy sector requires significant investments to diversify its energy sources and enhance cross-border interconnections. The sector also suffers from a dominance of SOEs and delays in aligning national energy efficiency legislation with EU legislation.

State-owned enterprises still dominate some key sectors. The dominance of SOEs, especially in the energy and transportation sectors, weighs on public finances. The privatisation of Romanian Post failed in September 2015, although it may resume through an initial public offering (IPO) in the near future if a strategic plan is set up. There are plans for the privatisation of Bucharest Airport and air carrier Tarom, but as of mid-2016 the procedures were not yet under way. Following the failure of the privatisation of CFR Marfa, the national freight railway transporter, the government decided to restructure the company to prepare it for privatisation through an IPO in the second half of 2017. The authorities plan to privatise Hidroelectrica, the country's biggest electricity producer, through an IPO in November 2016, but it is likely that the procedure will be postponed to 2017 as the company's exit from insolvency was delayed from May to June 2016.

NPLs continued to decline, with efforts made to restructure banks' loan portfolios. Following the National Bank of Romania's (NBR) initiative in recent years to stimulate NPL write-off, the NPL ratio declined to 12.4 per cent in May 2016 (European Banking Authority definition), from a peak of 22.0 per cent at the end of 2013. While the write-off process contributed to the decline, it was also supported by an improvement in lending to the private sector. Meanwhile, banks have made efforts to restructure their loan portfolios, targeting both corporates and households. Although most of the restructuring operations were conducted to change the terms and conditions of loan agreements, some of the operations were carried out for loan refinancing. A sustainable resolution would require a combination of banks' loan portfolio restructuring and corporate restructuring.

Efforts have been made to revive confidence in the financial sector, but challenges remain. Despite the NBR's efforts to reinstate confidence in the banking sector, a new law has raised concerns about the stability of the financial system. The debt discharge law for mortgage backed loans (walk-away option) was enacted in April 2016 after several amendments, and it allows debtors to discharge their debt obligations by transferring the immovable collateral to creditors, instead of making payments. A draft law on conversion of foreign currency-denominated loans to lei, if implemented, may result in retroactive changes in banks' balance sheets, leading to a decline in lending. Meanwhile, an asset quality review (AQR) and stress tests for the banking sector started in 2015, with results expected in late 2016. Earlier stress tests for the insurance sector revealed significant deficiencies in the sector, including non-compliance with solvency requirements.