ROMANIA

Highlights

- **Economic growth moderated to 2.8 per cent in 2014.** Private consumption was the main driver of growth, boosted by improving confidence, a rise in minimum wages and interest rate cuts, on the back of falling inflation; while the contribution of net exports and investments remained subdued. In the second quarter of 2015, GDP grew by 3.4 per cent year-on-year, driven mainly by consumption and partly by investments.
- **Privatisation efforts are proceeding slowly.** Following mixed results in 2014, the privatisation of 11 state-owned enterprises is still pending. The cargo railway company CFR Marfa is being restructured to increase its efficiency, while efforts to privatise the state-owned energy and transport companies have been postponed to 2016.
- **The non-performing loans (NPLs) ratio has declined**. The ratio stood at 12.8 per cent in June 2015, declining from a peak of 23 per cent at the end of 2013, as the National Bank of Romania (NBR) stimulated NPL resolution, partly through higher provisioning and sales, and partly by allowing banks to write-off provisioned NPLs while still retaining legal claims against borrowers.

Key priorities for 2016

- **Efforts to improve infrastructure quality should be intensified.** The quality of transport infrastructure remains poor by EU standards. Although private sector participation in road sector projects is encouraged and some public-private partnership contracts have been awarded, the country has not yet structured a successful concession in line with best industry practices.
- **Further improvements are needed to enhance the business environment.** Romania scores relatively poorly compared with its European peers on business climate indicators. Despite tangible progress in many areas of judicial reform and the fight against high-level corruption, according to the European Commission, the fight against lower-level corruption remains a key challenge.
- **Efforts on corporate restructuring are needed to resolve remaining NPLs sustainably.** Since most of the NPLs are in the corporate sector, sustainable resolution of remaining NPLs may require a focused effort on corporate restructuring. In addition, lenders and their parent banks should be further encouraged to offload NPLs to the market, given the increased interest from specialised distressed asset investors.

Main macroeconomic indicators %

	2011	2012	2013	2014	2015 proj.
GDP growth	1.1	0.6	3.4	2.8	3.5
Inflation (average)	5.8	3.3	4.0	1.1	-0.5
Government balance/GDP	-5.4	-3.2	-2.2	-1.4	-1.8
Current account balance/GDP	-4.6	-4.5	-0.8	-0.4	-0.7
Net FDI/GDP (neg. sign = inflows)	-1.3	-1.8	-2.0	-1.7	-1.8
External debt/GDP	69.9	76.0	70.1	58.4	n.a.
Gross reserves/GDP	26.4	27.0	25.3	22.0	n.a.
Credit to private sector/GDP	44.5	45.0	41.4	37.9	n.a.

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Macroeconomic performance

Romania's economic growth moderated to 2.8 per cent in 2014. Private consumption emerged as the main driver of growth in 2014, boosted by a rise in the minimum wage and interest rate cuts, while the contribution of net exports and investments remained subdued. In the second quarter of 2015, private consumption remained the major contributor to GDP growth of 3.4 per cent year-on-year, with investments also picking up, boosted by rising industrial confidence. Meanwhile, inflation remained below the central bank's target range of 1.5 to 3.5 per cent for most of 2014 and early 2015, on the back of a fall in food and energy prices, a reduction in VAT on bakery products, and lower inflation expectations.

External vulnerabilities eased and fiscal performance remained steady. The current account was almost fully rebalanced in 2014, recording a deficit of just 0.4 per cent of GDP. General government debt is low by regional standards, standing at 39.9 per cent of GDP in 2014, while considerable fiscal adjustment since the 2008 crisis has brought the budget deficit down in recent years, reaching 1.4 per cent of GDP in 2014. However, the budget deficit target for 2016 is set to rise to 2 to 3 per cent of GDP, and may be further jeopardised by the reduction in VAT from 24 per cent to 9 per cent for food products, effective June 2015, as well as to 20 per cent for other goods and services, effective from January 2016, and then to 19 per cent as of January 2017.

Growth is expected to increase to 3.5 per cent in 2015 and 3.7 per cent in 2016, on the back of an improvement in domestic demand and an export boost. While the historically low level of interest rates will continue to bolster domestic demand in 2015 and 2016, better growth prospects in the eurozone, albeit still moderate, may push up Romania's net exports, keeping growth at around 3.5 per cent in 2015 and 3.7 per cent in 2016. Downside risks, including prolonged weakness in the eurozone, further worsening of geopolitical tensions in Ukraine and a larger slow-down in Russia, may hamper growth prospects in the near term. Nevertheless, medium-term growth prospects in Romania remain favourable, reflecting the diversified economy, large market size and the significant scope for convergence within the European Union (EU), as the GDP per capita (adjusted for purchasing power standards) is around 54 per cent of the EU average. Provided that structural reforms are implemented and investments continue to revive, potential annual growth rates of 4.0 to 4.5 per cent are feasible. The country is envisaged as entering the euro area in 2019. Although this timeline is tight, and may be reconsidered, the country meets all the Maastricht criteria for entry into the Exchange Rate Mechanism (ERM-II), although further convergence and structural reforms are needed.

Major structural reform developments

Romania made further progress under the Cooperation and Verification Mechanism (CVM), but some challenges remain. In its January 2015 report under the CVM, the European Commission (EC) concluded that Romania had made progress in many areas of judicial reform, and the fight against high-level corruption, but efforts to fight lower-level corruption should be intensified. Some concerns over inconsistency of court decisions and outstanding legislative issues remain.

Romania scores relatively poorly compared with its European peers on business climate indicators. Despite some improvements to the business environment and performing better than the regional average (Europe and Central Asia), Romania ranks lower than most of the EU comparator economies in ease of doing business. In the World Bank *Doing Business 2016* report, Romania ranks 37th out of 189 countries. Challenges remain with regard to getting electricity, dealing with construction permits and registering property. The implementation of the Corporate Insolvency Law, adopted in 2014, still remains limited.

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Some of the biggest challenges lie in the infrastructure sector. The quality of transport infrastructure remains poor by EU standards, as the country ranks last in the EU for perceived quality of infrastructure, according to the World Economic Forum's *Global Competitiveness Report 2015-2016*. The small network of motorways, underdeveloped road infrastructure, poor maintenance of railways and insufficient freight transport on inland waterways hamper businesses and the economy. Although private sector participation in road sector projects is encouraged and some public-private partnership contracts have been awarded, the country has failed to structure a concession in line with good industry practice. The government approved the General Transport Master Plan in February 2015, to meet its *ex ante* conditionality in order to access EU Structural Funds, but insufficient political consensus and ownership may delay further infrastructure development.

Liberalisation and deregulation of the energy sector have progressed but significant challenges remain. There is a functioning, competitive electricity market for corporations, and a gradually liberalising electricity market for households. Gas price liberalisation for corporations started with hikes in regulated prices in late 2013 and early 2014, and was finalised for small and medium-sized enterprises (SMEs) as of January 2015. Yet the pace of liberalisation for households is slow, which was a major reason for a delay in completion of the third review of the IMF programme. However, in June 2015 the Romanian government and the EC agreed on a timetable for household gas price deregulation, which envisages a gradual gas price hike over the coming years, starting from July 2015 to 2021, when full liberalisation should be in place.

Privatisation of several state-owned enterprises is pending. The privatisation and restructuring of loss-making state-owned enterprises (SOEs) have stalled, despite this being an important pillar of the balance-of-payments programmes of the IMF and EU. SOEs remain dominant in the energy and transportation sectors; however, their suboptimal performance has an adverse effect on public finances. The privatisation process continues to yield mixed results. After the privatisation of CFR Marfa, the state-owned cargo railway company, failed in 2013, the government changed the privatisation strategy in June 2015 and decided to restructure the company to increase its efficiency before taking any further action towards privatisation. The government now envisages listing a minority stake on the local stock market, instead of selling a majority stake to a strategic investor. On a potentially optimistic note, in June 2015, talks with investors to sell a majority stake in the Tarom air carrier were launched and preparations to sell a minority stake in Bucharest Airports Company, through an initial public offering, commenced.

NPLs have been significantly reduced but further restructuring needs to be carried out. In mid-2014, the National Bank of Romania (NBR) launched a programme to stimulate NPL write-off, by increased provisioning and requiring the write-off of fully provisioned NPLs, while allowing banks to retain legal claims against borrowers even if the loans were written off. The programme led to a decline in the NPL ratio to 12.8 per cent in June 2015, from a peak of 23.0 per cent at the end of 2013. Although the write-off process is mostly completed and provisioning policies in the banking sector are improved, a sustainable resolution may also require corporate restructuring, given that most NPLs originate in the corporate sector.

Financial markets remained stable, but financial intermediation is still to be reinvigorated. Despite a fall in recent years, the share of foreign currency-denominated loans was still high at 56 per cent in 2014, leaving the banking sector exposed to exchange rate risk. Credit growth remained subdued on the back of foreign banks' deleveraging, high corporate leverage, and a lack of lending opportunities amid still-low growth. In August 2014, the Financial Supervision Authority (FSA) approved the STEAM (Set of Actions Towards Establishing and Acknowledgement of the Emerging Market Status) project to support the further development of capital markets. The STEAM includes a set of measures to increase the attractiveness of capital markets, streamline lending operations, develop local bond markets, and increase implementation of corporate governance principles by market players. Results from its implementation remain to be seen.