FitchRatings

RATING ACTION COMMENTARY

Fitch Affirms Romania at 'BBB-'; Outlook Negative

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Fitch Ratings - Frankfurt am Main - 07 Oct 2022: Fitch Ratings has affirmed Romania's Long-Term Foreign-Currency Issuer Default Rating (IDR) at 'BBB-' with a Negative Outlook.

A full list of rating actions is at the end of this rating action commentary.

KEY RATING DRIVERS

Credit Strength and Weaknesses: Romania's 'BBB-' rating is underpinned by EU membership and EU capital flows that support external and macro-stability, and GDP per capita, governance and human development indicators that are above 'BBB' category peers. These are balanced against larger twin budget and current account deficits than peers, a weak record of fiscal consolidation and high budget rigidities, and a fairly high net external debtor position.

Negative Outlook: The Negative Outlook reflects the downside risks posed by the Ukraine war and European energy crisis on Romania's economic, fiscal and external performance, aggravated by a much weaker eurozone growth outlook and more challenging external financing conditions than at the time of our last review in April. These risks are aggravated by competing policy objectives that underlie persistent macroeconomic imbalances. It also reflects continued uncertainty regarding the implementation of policies to address structural fiscal imbalances over the medium term despite progress this year.

Fiscal Risks to Increase: Fitch forecasts a narrowing of the fiscal deficit in 2022 to 6.4% of GDP, broadly in line with budget targets, driven to a large extent by solid revenue performance (which is likely to exceed 20% yoy). Expenditure growth has been more muted due to moderate pension and wage increases but has started to accelerate, given price-spill overs on goods and services and additional support measures.

We expect a more challenging fiscal picture in 2023 in light of slower growth and higher expenditure demands. This will entail difficult policy trade-offs and could reduce fiscal transparency if the authorities rely on one-offs, reducing capex or implementing ad-hoc windfall taxes. So far the energy support schemes, which include caps on electricity and gas to households and to a lesser extent firms, are planned to be financed by windfall taxes with a limited impact on the budget, but more direct support cannot be excluded.

Medium-term Fiscal Outlook Reliant on Reforms: We expect the headline deficit to fall to 5.5% in 2023 and 4.7% in 2024, mostly driven by a gradual improvement in revenue collection in line with a tax reform approved in 2Q22 that aims to reduce loopholes and raise some taxes. Reforms on the pension and wage schemes (due in the next year according to commitments on the Recovery and Resilience Plan) are essential to assure medium-term fiscal sustainability, as well as continued EU fund support.

There is continued commitment by the authorities to implement these reforms but they will prove politically costly, with Romania having a weak track record of approving structural fiscal reforms. Overall, we see continued risks of fiscal slippage, including the potential for additional spending ahead of 2024 super-electoral cycle.

Financing Challenges: Very high nominal growth will largely offset the rise in interest costs and still large primary fiscal deficits, with the ratio of public debt/GDP remaining at an average 49.5% in 2022-2024 (compared with the current 'BBB' median of 55.5%). Romania's challenges are around financing given global risk aversion and the large financing needs. Although the latter are set to moderate somewhat in 2023-24 (from close to 11% of GDP in 2022), this will still require extensive external issuances (of around EUR8 billion-EUR10 billion) and relying on a heavily tapped domestic market. Loans from the Recovery and Resilience Facility (RRF) and other multilateral support will help reduce some pressures but this will be towards the end of our forecast period.

External Imbalances Persist: A stronger-than-expected widening of the trade and income balances mean we now forecast the current account deficit to reach 9.9% in 2022 (the largest in the 'BBB' category and in the EU). This highlights the deterioration in terms of trade and ongoing structural challenges both on fiscal and sectoral side. As long as Romania

continues to receive EU funds and moderate levels of FDI, we expect the need of debt-financing flows at around 1/3rd of the current account deficit (CAD). Over the medium term, the CAD should narrow gradually, thanks to fiscal consolidation and a recovery of exports, but external imbalances will remain a constraint. We expect the net external debt position to average around 23% of GDP over the forecast period, compared with the 'BBB' median of 1.5%.

Strong Performance but Prospects Deteriorates: Fitch now expects the economy to expand by 6.2% in 2022, one of the strongest rates in the EU, thanks to a very solid performance in the first two quarters of the year. Growth has been driven by inventory build-up (which might reverse in coming quarters) but also strong private consumption, despite the war in Ukraine. Nevertheless, we expect high inflation, rising interest rates and a weaker external environment to lead to a rapid slowdown in GDP growth in the coming quarters, with the economy likely to enter a technical recession in 1Q23. The weak statistical carry-over and substantial energy cost pressures means we forecast growth of only 1.6% in 2023, recovering to 3.7% in 2024 as public investment tied to EU funds is ramped up.

Energy Risks: The short-term macroeconomic outlook is subject to significant downside risks, in particular around the impact of higher energy costs in Europe. Romania is one of the least exposed countries in CEE to Russia energy trade, having one of the largest domestic gas production capacities in Europe. The latter, combined with storage capacity almost filled, means that the risk of gas supply disruptions over the coming winter is low. However, the price and availability of electricity remains a significant challenge, potentially having a major disruptive effect on certain industries and spill-over to households, despite the government's support schemes. Moreover, risks of a stronger slowdown in the eurozone would translate to much weaker Romanian exports.

High Inflation and Pressure on Policy Framework: We have revised our annual harmonised inflation forecasts to 12.2% in 2022 (from 10% previously), and now expect inflation to fall more gradually to only 11% in 2023 and 5.7% to 2024. The impact of high energy and food prices has translated to higher inflation across all categories, but there are some signs of month-on month moderation thanks in part to price-cap measures. However, core inflation has continued to accelerate, highlighting the risks around structural challenges in some sectors (food processing) and underlying price pressures from a relatively tight labour market. There is a high degree of uncertainty around the inflation trajectory, in particular given the extent of pass through of energy costs over the coming years.

The National Bank of Romania (NBR) accelerated its tightening cycle in recent months but the pace of monetary tightening will slow significantly and could even reverse in 2023 if growth momentum decelerates more rapidly. The NBR's efforts to tackle inflation, maintain a stable exchange rate and support the macro environment is stretched by ongoing widening of the CAD and the country's high risk premia. Further bouts of volatility could make it more challenging to balance these policies, necessitating a sharper adjustment on the external or fiscal side.

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. 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 59.1 percentile, reflecting a recent 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.

RATING SENSITIVITIES

Factors that could, individually or collectively, lead to negative rating action/downgrade:

-**Macro:** A large adverse macroeconomic shock, for example due to energy rationing in Europe, which would materially lower medium-term growth prospects compared with Fitch's current expectation

-**Fiscal:** Reduced confidence in the capacity to implement fiscal consolidation, which leads to faster than projected increase in public debt and/or financing stress.

-**External:** Failure to reduce the CAD and/or reduced capital inflows that leads to a rapid deterioration in external liquidity buffers.

Factors that could, individually or collectively, lead to positive rating action/upgrade:

-**Fiscal:** Improved confidence that the government's fiscal strategy will lead to a narrowing fiscal deficit and broad stabilisation of general government debt/GDP over the medium term.

-**External:** Evidence of increased economic and external resilience to tighter financing conditions and geopolitical/energy risks

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 Foreign-Currency (LT FC) IDR scale.

Fitch's sovereign rating committee adjusted the output from the SRM to arrive at the final LT FC IDR by applying its QO, relative to SRM data and output, as follows:

- External Finances: -1 notch, to reflect higher external vulnerability than implied by the SRM model, given the large current account deficit and adverse policy developments in recent years that have impacted external competitiveness and aggravated its exposure to shocks. It also reflects Romania's higher net external debtor and net investment liabilities positions than the 'BBB' median.

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 LT FC 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.

BEST/WORST CASE RATING SCENARIO

International scale credit ratings of Sovereigns, Public Finance and Infrastructure 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.

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 therefore highly relevant to the rating and a key rating driver with a high weight. As Romania has a percentile rank above 50 for the respective governance Indicator, this has a positive impact on the credit profile.

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. As Romania has a percentile rank above 50 for the respective governance indicators, this has a positive impact on the credit profile.

Romania has an ESG Relevance Score of '4[+]' for Human Rights and Political Freedoms as the Voice and Accountability pillar of the WBGI is relevant to the rating and a rating driver. As Romania has a percentile rank above 50 for the respective governance indicator, this has a positive impact on the credit profile.

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. As Romania has a record of 20+ years without a restructuring of public debt, which is captured in our SRM variable, this has a positive impact on the credit profile.

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		PRIOR
Romania	LT IDR Affirmed	BBB- Rating Outlook Negative	BBB- Rating Outlook Negative

	ST IDR	F3	Affirmed	F3
	LC LT IDR	BBB- Rating Outlook Negative	Affirmed	BBB- Rating Outlook Negative
	LC ST IDR	F3	Affirmed	F3
	Country Ceiling	BBB+	Affirmed	BBB+
senior unsecured	LT	BBB-	Affirmed	BBB-
senior unsecured	ST	F3	Affirmed	F3

VIEW ADDITIONAL RATING DETAILS

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APPLICABLE CRITERIA

Country Ceilings Criteria (pub. 01 Jul 2020)

Sovereign Rating Criteria (pub. 12 Jul 2022) (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, v1.7.2 (1)

Debt Dynamics Model, v1.3.1 (1)

Macro-Prudential Indicator Model, v1.5.0 (1)

Sovereign Rating Model, v3.13.1 (1)

ADDITIONAL DISCLOSURES

Dodd-Frank Rating Information Disclosure Form

Solicitation Status

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Sovereigns Europe Romania
