MOODY'S
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Rating Action: Moody's changes Romania's outlook to negative from stable; affirms Baa3 rating

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Frankfurt am Main, April 24, 2020 -- Moody's Investors Service ("Moody's") has today changed the outlook on the Government of Romania's ratings to negative from stable and affirmed the Baa3 foreign and domestic long-term issuer and senior unsecured ratings. The senior unsecured MTN programme (P)Baa3 ratings as well as the Prime-3 (P-3) short-term issuer ratings in foreign and domestic currency have also been affirmed.

The two key drivers for the change of the outlook to negative are:

1. A structural deterioration in public finances compounded by an increase in long-term liabilities that relate to the 2019 pension reform;

2. A worsening of Romania's external position with an increase in short-term foreign-currency debt that heightens the country's susceptibility to event risk.

The affirmation of Romania's Baa3 ratings balances the country's strong medium-term growth potential and stronger economic metrics than the median of Baa3-rated sovereigns against the deteriorating trend in public finances and the worsening of Romania's external position. The affirmation of Romania's Baa3 ratings also takes into account the country's moderate institutions and governance strength.

The long-term country ceilings of Romania for local and foreign currency bonds and for local currency bank deposits remain unchanged at A3. Its long-term country ceiling for foreign currency bank deposits remains unchanged at Baa3. Its short-term country ceilings for foreign-currency bonds and foreign-currency bank deposits remain unchanged at Prime-2 (P-2) and at Prime-3 (P-3), respectively.

RATINGS RATIONALE

RATIONALE FOR CHANGING THE OUTLOOK TO NEGATIVE FROM STABLE

FIRST DRIVER: A STRUCTURAL DETERIORATION IN PUBLIC FINANCES COMPOUNDED BY AN INCREASE IN LONG-TERM LIABILITIES THAT RELATE TO THE 2019 PENSION REFORM

The first driver of the action is the ongoing trend of a structural deterioration in Romania's public finances which is compounded by an increase in long-term liabilities that relate to the 2019 pension reform. In addition, this year's economic recession in the context of the coronavirus outbreak weighs on Romania's fiscal outlook, as Moody's forecasts Romania's GDP to contract by 5.0% in 2020. Moody's expects Romania's general-government fiscal deficit to reach 7.7% of GDP in 2020, followed by a deficit of 6.2% of GDP in 2021. The government's response to the economic consequences of the coronavirus crisis is targeted to support households and corporates. In particular, the country's technical unemployment scheme aims to provide workers with up to 75% of the gross average wage. Revenues will also be affected by the recession as automatic stabilizers kick in.

Moody's forecast includes the fiscal impact of the pension reform that was adopted in June 2019. In the short term, the 40% increase in the pension point scheduled for 1 September 2020 will -- if implemented -- push current expenditures upwards, with the full effect on public accounts taking place in 2021. In the medium-term, public pension spending is projected to reach 11.6% of GDP by 2030 absent a policy change, almost double compare to the previous projections from the national authorities, which foresaw 6.6% of GDP in 2030. On top of the cumulative effects of ad-hoc increases, a more generous indexation formula and shorter contribution periods -- if not reversed -- will drive public pension spending over the next decade.

The pension reform increases the budgetary pressures stemming from the combined negative impact of an ageing population and net migration outflows that results in an expected absolute decline in the number of inhabitants. According to the European Commission's 2018 Ageing Report projections, Romania's population aged 65 or above will represent 34.7% relative to the 15-64 years population in 2030, sharply up from 26.3% in 2016. Over the same period, the population is expected to shrink from 19.7 million to 18 million.

As a result of the deterioration of the fiscal balance and the economic recession, Moody's expects Romania's debt-to-GDP ratio will increase to 43.7% by the end of this year from 35.2% of GDP in 2019. Looking ahead, Moody's forecasts Romania's deficit to narrow gradually to 6.2% of GDP in 2021 and 4.4% of GDP in 2022. Under this scenario, public debt would reach 46.8% of GDP in 2021 and 47.8% of GDP in 2022.

Even prior to the impact of the economic slowdown, Romania's general government deficit had been on an adverse trend, rising from 0.6% of GDP in 2015 to 4.3% of GDP in 2019. Romania's widening deficit is of structural nature and has emerged against the backdrop of buoyant economic growth (4.9% real GDP growth on average between 2015 and 2019). The increase in public spending resulted from strong growth in the public sector wage bill, driven by net hires and substantial wage increases. The fall in revenues followed significant cuts in personal income tax (rate reduction from 16% to 10%, with a RON 13.5 billion impact in 2018, or 1.4% of GDP in 2018) and value-added tax (two-stage reduction in the standard VAT rate, from 24% in 2015 to 20% in 2016 and 19% in 2017, with an estimated RON 11.0 billion impact, or 1.3% of GDP in 2017).

SECOND DRIVER: A WORSENING OF ROMANIA'S EXTERNAL POSITION WITH AN INCREASE IN SHORT-TERM FOREIGN-CURRENCY DEBT THAT HEIGHTENS SUSCEPTIBILITY TO EVENT RISK

The second driver of the action is the worsening of Romania's external position, with an increase in short-term foreign currency debt that heightens the country's susceptibility to event risk. Romania's sizeable external debt (47.5% of GDP at the end of 2019) has gradually shifted towards a higher share of short-term debt against the backdrop of increased borrowing from non-financial companies and deposit-taking companies except the central bank. At the end of 2019, the share of short-term on total external debt stood at 30.4% against 26.1% at the end of 2016. As a result, the external vulnerability indicator (EVI) has been rising since 2014 and is expected to reach 164% in 2020.

Romania's exposure to the rest of the world is significant, with non-residents holding 46.3% of the country's total public debt, and the share of foreign-currency denominated debt standing at 48.7% in 2019. A depreciation of the leu would lead to a further deterioration of Romania's public finances. However, Moody's notes that the Romanian treasury's debt management strategy to develop the domestic market for government securities is a mitigant to Romania's susceptibility to external-vulnerability risk. The strategy has supported a gradual rise in the share of local-currency denominated general government debt securities over the past five years, reaching 51.3% in 2019 against 46.2% in 2015.

The build-up of short-term external debt and the worsening of the EVI have been accompanied by an adverse trend with respect to Romania's current-account deficit. From an almost balanced position in 2014, the current-account deficit has risen markedly to 4.6% of GDP in 2019. A deteriorating goods balance drove the overall current account, as import-intensive growth outpaced solid export performance. Imports of consumer goods have grown faster than other imports, against the backdrop of an expansionary and pro-cyclical fiscal policy which has led to a twin-deficit situation.

The pace of increase of the current-account deficit has been accompanied by a decline of its coverage by foreign direct investments (FDI). While the coverage of the current-account deficit by non-debt generating flows (FDI, equity, capital account balance) was well above 100% between 2013 and 2016, the ratio dropped to 111% in 2017, followed by 84% in 2018 and 79% in 2019. Looking ahead, FDI's are likely to remain subdued in the near term due to the economic recession and the general contraction in international flows. Although the anticipated reduction in the current account deficit due to suppressed demand will reduce financing needs, Moody's expects non-debt generating flows to remain insufficient to fully cover the deficit.

RATIONALE FOR AFFIRMING THE RATINGS AT Baa3

The affirmation of Romania's Baa3 rating balances the country's strong growth potential with a deteriorating trend in public finances as well as the worsening of Romania's external position. The rating is supported by our expectation that Romania's post-coronavirus growth potential will remain underpinned by a dynamic private sector and the commitment of foreign-owned companies operating in Romania. The affirmation of Romania's Baa3 rating reflects also the country's moderate institutions and governance strength.

Compared to Baa3-rated sovereign peers, Romania's economy is both larger (USD 241.6 billion against a median of USD 210.2 billion in 2018) and faster-growing than the Baa3 median (3.6% against 1.5% on average between 2014 and 2023). With respect to fiscal metrics, Romania's debt affordability compares favourably to the Baa3 median, with both interest payments-to-GDP (1.2% in 2018) and interest payments-to-revenues (3.7% in 2018) below the median (2.8% and 4.9%, respectively, in 2018). This is also the case for debt burden indicators, with both the debt-to-GDP and the debt-to-revenues ratios below that of Baa3 median

(34.7% and 108.5% against 46.8% and 161.1%, respectively, in 2018).

ENVIRONMENTAL, SOCIAL, GOVERNANCE CONSIDERATIONS

Moody's takes account of the impact of environmental (E), social (S) and governance (G) factors when assessing sovereign issuers' economic, institutional and fiscal strength and their susceptibility to event risk. In the case of Romania, the materiality of ESG to the credit profile is as follows.

Environmental considerations are not material to Romania's credit profile, and the country has not been identified as being one of the sovereigns materially exposed to physical climate change risks. Romania has among the lowest greenhouse gas emission per person in the European Union (EU), although carbon intensity (tonnes per EUR 10 000 GDP) is among the highest. The share of renewable energy sources has increased over the last decade, standing at 23.9% in overall energy consumption in 2018, above the EU average of 18.9%. However, Romania is amongst the EU countries most subject to large flooding events, and about 13% of the country lies in floodplains.

We regard the coronavirus outbreak as a social risk under our ESG framework, given substantial implications for public health and safety. The spread of the coronavirus, deteriorating global economic outlook, falling oil prices, and asset price declines are creating a severe and extensive credit shock across many sectors, regions and markets. We believe that the combined negative effect of these developments will put further pressure on Romania's credit metrics. On a structural basis, a combination of a negative natural rate of population growth and net migration outflows weigh on the country's labour supply, partially impairing the labour market and dragging down potential growth. Adverse demographics are also likely to weigh on fiscal sustainability in the medium-term.

Romania's governance considerations are reflected in our assessment of institutions and governance strength. Moderate performances in terms of rule of law and control of corruption, as exhibited by the Worldwide Governance Indicators (WGI) are combined with uneven macroeconomic policy effectiveness.

FACTORS THAT COULD LEAD TO AN UPGRADE OR DOWNGRADE OF THE RATINGS

WHAT WOULD CHANGE THE RATING UP

Given the negative outlook, a rating upgrade is unlikely in the near future. Moody's would likely change the rating outlook to stable if it were to conclude that the government is successful in halting and -- over the medium-term -- reversing the structural deterioration in public finances. In the medium-term, structural fiscal consolidation supported by higher tax collection and a lower share in current expenditure would improve fiscal sustainability. Together with a rebalancing towards higher investment expenditure, a steady reduction in the structural current-account deficit and increased coverage by non-debt generating flows would also be credit positive.

WHAT WOULD CHANGE THE RATING DOWN

Romania's ratings would likely be downgraded were Moody's to conclude that Romania's fiscal strength will continue to structurally deteriorate while external imbalances remain at an elevated level. Ultimately, this conclusion would likely reflect the medium-term absence of a determined and effective policy response to the country's structural challenges, weakening our assessment of institutional and governance strength. Absent further severe shocks to the economy and/or intensification of financial risks, Moody's expects to resolve the negative outlook over the next 12 to 18 months. Under this scenario, Moody's assessment would take into consideration the policy agenda of the government to be elected at the end of this year or early in 2021.

GDP per capita (PPP basis, US$): 26,448 (2018 Actual) (also known as Per Capita Income)

Real GDP growth (% change): 4.4% (2018 Actual) (also known as GDP Growth)

Inflation Rate (HICP, % change): 3.0% (2018 Actual)

Gen. Gov. Financial Balance/GDP: -2.9% (2018 Actual) (also known as Fiscal Balance)

Current Account Balance/GDP: -4.4% (2018 Actual) (also known as External Balance)

External debt/GDP: 48.8% (2018 Actual)

Economic resiliency: baa3

Default history: No default events (on bonds or loans) have been recorded since 1983.

On 21 April 2020, a rating committee was called to discuss the rating of the Romania, Government of. The main points raised during the discussion were: The issuer's economic fundamentals, including its economic strength, have not materially changed. The issuer's fiscal or financial strength, including its debt profile, has materially decreased. The issuer has become increasingly susceptible to event risks.

The principal methodology used in these ratings was Sovereign Ratings Methodology published in November 2019 and available at https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_1158631 . Alternatively, please see the Rating Methodologies page on www.moodys.com for a copy of this methodology.

The weighting of all rating factors is described in the methodology used in this credit rating action, if applicable.

REGULATORY DISCLOSURES

For further specification of Moody's key rating assumptions and sensitivity analysis, see the sections Methodology Assumptions and Sensitivity to Assumptions in the disclosure form. Moody's Rating Symbols and Definitions can be found at: https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_79004.

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