24-Jan-2025 | 16:08 EST

Romania 'BBB-/A-3' Ratings Affirmed; Outlook Revised To Negative From Stable On Higher Fiscal And External Risks

Overview

- Romania's fragmented and uncertain political environment will likely delay the new government's fiscal consolidation agenda.
- High pre-election spending pushed fiscal deficits to close to 8.7% of GDP in 2024--well above our expectations, which also signals challenges to cost containment amid a slowing economy.
- Loose fiscal policies will keep the current account deficits (CADs) wide and increasingly financed by debt-creating flows, potentially exposing Romania to foreign investor confidence shocks.
- We therefore revised our outlook to negative from stable and affirmed our 'BBB-/A-3' sovereign credit ratings on Romania.

Rating Action

On Jan. 24, 2025, S&P Global Ratings revised its outlook on Romania to negative from stable. At the same time, we affirmed our 'BBB-/A-3' long- and short-term foreign and local currency sovereign credit ratings.

Outlook

The negative outlook reflects our view of rising risks to Romania's public finances over the next several years. This follows average deficits of 7.6% of GDP since 2020, while the debt-to-GDP ratio has increased by more than 15%.

Downside scenario

We could lower the ratings if government policies alongside subdued economic growth led to higher-than-expected fiscal deficits over the medium term. In our view, this would result in a steeper increase of public debt and the interest burden, while also weighing on Romania's substantial CADs.

Upside scenario

We could revert the outlook to stable if Romania's external and fiscal deficits narrowed substantially.

Rationale

We revised the outlook to negative to reflect risks to Romania's public finances. In our view, delivering on the government fiscal consolidation plan could be challenging, not least because of the increased political fragmentation evidenced by the outcomes of last year's elections as well as slower economic growth prospects. In the absence of additional measures, we expect deficits will not dip below 6% of GDP before 2028. Public debt, net of liquid government assets, will exceed 60% of GDP by 2027 and the government's interest bill will likely settle around a high 8% of revenue over the medium term. Romania's fiscal deficits over the past few years--especially the deficit in 2024 of almost 8.7% of GDP--have substantially and consistently exceeded our expectations.

Persistent budget overruns have resulted in nominal public debt increasing by a factor of 2.5x since 2020 and interest costs increasing by over 3.0x, increasing the government's debt rollover needs. Loose fiscal policies have also aggravated existing economic imbalances, such as one of the highest CADs of emerging markets globally, averaging close to 7% of GDP over the next few years.

The consolidation efforts of the new administration take place in a polarized political environment--following the annulment of the presidential election in December 2024--and a weaker growth outlook aggravated by stagnating economic activity in Romania's main trading partners, namely Germany. Delayed consolidation will likely keep existing macroeconomic imbalances elevated for longer. It could also result in a further delay of EU funds available to Romania if consolidation efforts fall short of the minimum fiscal correction required by the EU fiscal rules. The country has been under the European Commission (EC)'S Excessive Deficit Procedure (EDP) since 2020.

Institutional and economic profile: Romania's new government faces a polarized political environment and limited policy space

- Following the 2024 election, the coalition government comprises three parties, supported by a parliamentary group, which, combined, hold a narrow majority in a fragmented parliament.
- The annulment of the first round of presidential elections has exacerbated a highly polarized political environment.
- Economic growth in 2024 fell short of our expectations as strong domestic demand mainly translated into import growth; we think that Romania's growth outlook will remain challenging in 2025.

Romania's super election year--which comprised local, EU, presidential, and parliamentary elections--concluded with the parliamentary elections, which indicated a substantial degree of political fragmentation. Three parties were able to agree on a government coalition, although they depend on the support of an additional parliamentary group to achieve a majority. Shortly after the parliamentary elections, the Constitutional Court of Romania annulled the results of the first round of presidential elections on perceived interference from foreign sources. The decision added to a contentious political environment, with several protests taking place after the court's decision.

The current government is largely aligned on most policy items, including its pro-EU stance, but must operate within limited policy space. Its parliamentary majority is narrow and depends on the support of an additional parliamentary group. Fiscal policy space is limited, given the need to consolidate within the limits under the EC's EDP. Romania also faces other challenges in the form of relatively low growth, high external deficits, and persistently high inflation.

Although the government plans to consolidate public finances and to advance required reforms to unlock EU transfers--including from the Recovery and Resilience Facility (RRF)--implementation will remain challenging. We consider the RRF an important policy anchor that incentivizes the government to reform the country's institutional framework. Romania has some of the lowest governance indicators within the EU and corruption and government effectiveness specifically remain weak points. While many political reforms under the Recovery and Resilience Strategy will be largely uncontentious, we think that those concerning the pension system, state-owned enterprises, and anti-corruption measures will be harder to implement. In addition, Romania has been under the EDP since 2020. We think that a perceived lack of improvement in Romania's fiscal position, along the lines of the EU fiscal rules, could continue to delay some RRF funds.

Unlocking EU funds for investments will be important to boost economic growth, which has amounted to less than 1% in 2024. We expect that economic sluggishness could spill over into 2025, which is why we forecast the real economy to only modestly expand by 2.1%. Real GDP growth in 2024 was impeded by weak external demand, particularly from Germany, the country's main trading partner. In addition, much of Romania's domestic demand growth has been channeled toward imports rather than domestic production. Admittedly, Romania reported one of the largest increases in real disposable income growth dynamics globally over the past 18 months on the back of a 20% wage increase in the public sector over the past year, several raises of the minimum wage, and a substantial pension hike. Despite this, the labor market has been robust, with stable employment levels and unemployment only rising marginally from all-time lows.

EU funds of slightly below €60 billion, about 17% of estimated 2024 GDP, are still available to Romania under the current 2021-2027 Multiannual Financial Framework and under the RRF. These funds will enable more investment in energy transition, transportation, and health care.

At the same time, Romania's economy continues to face several structural challenges, including adverse demographic trends, which will persist in the longer run. The declining working-age population could increasingly drag on growth, absent reform efforts to address skill mismatches or improve the business environment, and ultimately to slow net emigration. Over the past decade, Romania's working-age population has decreased by about 1.1% per year, and we expect that this could moderate only marginally over the next few years.

Flexibility and performance profile: Fiscal consolidation will be challenging for several years, following last year's sizable overspend

- Pre-election spending pushed the general government deficit to almost 8.7% of GDP in 2024, and we do not expect deficits to dip below 6% of GDP before 2028.
- The pro-cyclical fiscal policy has widened the CAD, which will remain elevated at over 7% of GDP on average between 2025-2028. However, we still think that EU fund inflows will moderate the increase in external debt over the same period.
- Fiscal policy has partly pushed inflation to the highest level in Central and Eastern Europe (CEE). In our view, price increases will likely remain above the National Bank of Romania (NBR)'s target range (at least over the next two years).

Romania's general government deficits have substantially exceeded our previous expectation, with overall deficits in 2024 likely amounting to close to 8.7% of GDP in cash terms, compared to our previous estimate of 7.3% of GDP. This will make fiscal consolidation over the next years more challenging than we expected. Although revenue rose by over 10% year on year, headline expenditure growth likely amounted to a substantial 19% year on year. Expenditure overruns were largely due to a wage increase in the public sector of 20%, costing about Romanian leu (RON) 18 billion (about 1% of GDP); rising social transfers, including a pension hike, costing a combined RON14 billion, or 0.8% of GDP; military spending rising to close to 2.5% of GDP this year; and additional public investment of about RON24 billion, 1.4% of GDP.

The authorities have announced a series of consolidation measures, including revenue side measures, such as the removal of personal income tax exemptions, potentially amounting to RON4 billion; delaying public investment programs, which are not cofinanced by the EU; and freezing public sector wages and social assistance programs, including the indexation of pensions. While the authorities are trying to consolidate public finances faster, we expect deficits will stay above 7.5% of GDP in 2025 and only slightly dip below 6% of GDP by 2028 in the absence of further fiscal adjustments.

The fiscal deficits significantly exceed the thresholds stipulated by the EU's Stability and Growth Pact rules. Therefore, Romania remains under the EDP, which it entered 2020. EU countries under the EDP are required to reduce public deficits to 3% of GDP over an adjustment period of, at most, seven years. In Romania's case, this would imply a fiscal adjustment of about 0.8%-0.9% of GDP each year over this maximum adjustment period. Although Romania's government aims to increase the effectiveness of its tax administration, we think that such consolidation efforts will only come to fruition over the medium term. The EDP and the RRP also require Romania to make further progress on structural fiscal reforms on strengthening its tax administration, specific changes in the tax regime, and legislative changes to the overall budgetary process and spending reviews.

Romania's high fiscal deficits imply that government debt, net of liquid government assets, will continually rise over the next three years, exceeding 60% of GDP by 2027. We think that the country will have to increase its reliance on international markets. Romania has built a strong track record in issuing foreign currency bonds in recent years. Furthermore, external financing sources are available in the form of the loan component in the RRF and from pan-European financial institutions. Over 50% of Romania's government debt is denominated in foreign currency, predominantly in euros. Romania will also continue to tap its domestic market, including by selling retail bonds and notwithstanding the domestic banking sector's already-substantial exposure to the government, at over 20% of its assets. Against the higher financing requirements, we forecast interest expenditure will average approximately 7.6% of government revenue between 2025 and 2028.

The expansionary fiscal policy contributed to a widening CAD in 2024, likely exceeding 8% of GDP, which we expect will only gradually reduce to 6.9% of GDP on average between 2025-2028. We expect the goods' trade deficit to remain at about 9% of GDP over the next few years, reflecting high domestic demand and some underlying competitiveness issues. As a result, gross external financing needs will remain above 100% of current account receipts and usable reserves over 2025-2028. That said, we expect the external financing mix will benefit from rising EU fund inflows over the next years, following a temporary dip in 2024. Overall, nondebt creating inflows of EU investment grants and foreign direct investment could cover about 50% of CADs on average, supporting the NBR's strong reserve position. We estimate reserves will remain at slightly above four months of current account payments over the next three years. Even so, we expect Romania's narrow net external debt will increase to about 46% of current account receipts by 2028, over 10 percentage points above its 2024 level.

Pro-cyclical fiscal policy and high wage growth have added to inflation, which remained at 5.5% year on year in December 2024 (Harmonized Index of Consumer Prices, HICP). Although this represents a reduction from the peak of 14.6% reported in November 2022, it is still the highest level across CEE countries and has only gradually reduced over the past few months. Core inflation remains above headline inflation, which raises the risk of inflation remaining persistent over the next several months, in our view. Upside risks stem from energy prices, food prices, and changes to taxes and excises. Therefore, we expect inflation to remain above the NBR's target of 2.5% (plus or minus 1 percentage point) at least over the next two years, especially in the case of protracted fiscal consolidation and elevated wage growth. This inflation outlook poses a challenge for the central bank, which cut its main policy rates by 25 basis points in July 2024 and again in August 2024, from its peak of 7.0% to currently 6.5%.

Romania's banking sector is predominantly foreign owned and largely deposit funded--we consider it as a limited contingency risk for the government. Nonperforming loans remain in the European Banking Authority-defined low-risk bucket, despite a marginal increase. Profitability in 2024 slightly decreased from its peak in 2023, and capital and liquidity ratios remain healthy and slightly above the average for CEE countries. Loans to the private sector remain at about 23% of GDP, reflecting low financial intermediation. The banking sector's elevated exposure to construction and real estate lending, alongside firms' rising level of indebtedness and a considerable share of foreign currency loans, could challenge financial stability if the related risks were to materialize.

Environmental, social, and governance (ESG) credit factors for this change in credit rating/outlook and/or CreditWatch status:

- Other governance factors

Key Statistics

Table 1

Romania--Selected indicators

	--Year ended Dec. 31--

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
Economic indicators (%)										
Nominal GDP (bil. LC)	1,067	1,070	1,192	1,389	1,605	1,762	1,895	2,025	2,153	2,283
Nominal GDP (bil. $)	252	252	287	296	351	379	408	453	483	507
GDP per capita (000s $)	13.0	13.0	14.9	15.6	18.4	20.0	21.6	24.0	25.7	27.1
Real GDP growth	3.9	(3.7)	5.5	4.0	2.4	1.0	2.1	2.7	2.5	2.3
Real GDP per capita growth	4.6	(3.2)	6.2	4.8	2.3	1.3	2.4	3.0	2.8	2.7
Real investment growth	14.9	(0.5)	4.0	5.4	14.5	2.1	2.0	2.8	2.7	2.7
Investment/GDP	24.3	24.2	26.3	27.0	25.8	24.5	24.3	24.3	24.3	24.4
Savings/GDP	19.4	19.1	19.1	17.4	19.1	16.2	17.0	17.3	17.6	17.6
Exports/GDP	40.1	36.8	40.5	43.4	39.2	35.8	34.8	34.3	33.8	33.5
Real exports growth	5.4	(9.5)	12.6	9.3	(0.8)	(2.4)	2.3	2.5	2.5	2.5
Unemployment rate	4.9	6.1	5.6	5.6	5.6	5.6	5.5	5.4	5.4	5.4
External indicators (%)										
Current account balance/GDP	(4.9)	(5.1)	(7.2)	(9.5)	(6.6)	(8.2)	(7.3)	(7.0)	(6.8)	(6.8)
Current account balance/CARs	(10.7)	(12.1)	(15.8)	(19.6)	(15.0)	(20.4)	(18.6)	(18.1)	(17.8)	(18.1)
CARs/GDP	45.4	42.1	45.6	48.6	44.3	40.5	39.3	38.4	37.9	37.4
Trade balance/GDP	(7.9)	(8.6)	(9.5)	(11.4)	(8.9)	(9.4)	(9.1)	(9.0)	(9.0)	(9.0)
Net FDI/GDP	2.2	1.3	3.7	3.3	2.0	1.9	2.1	2.2	2.1	2.1
Net portfolio equity inflow/GDP	(0.3)	(0.5)	(0.1)	(0.4)	(0.1)	(0.5)	(0.2)	(0.2)	(0.2)	(0.2)

Gross external financing needs/CARs plus usable reserves	101.4	101.9	102.1	106.8	103.5	100.6	101.3	102.4	102.5	103.2
Narrow net external debt/CARs	26.2	40.0	32.3	26.7	28.2	35.4	39.4	41.2	43.8	46.6
Narrow net external debt/CAPs	23.6	35.7	27.9	22.3	24.5	29.4	33.3	34.9	37.2	39.4
Net external liabilities/CARs	95.4	121.2	98.5	86.2	91.2	102.3	109.0	111.1	115.3	120.4
Net external liabilities/CAPs	86.2	108.1	85.1	72.1	79.3	85.0	92.0	94.0	97.8	102.0
Short-term external debt by remaining maturity/CARs	25.8	26.9	25.3	23.3	23.8	26.7	27.8	27.5	27.3	27.5
Usable reserves/CAPs (months)	3.8	3.9	4.0	3.4	3.6	4.6	4.5	4.3	4.2	4.2
Usable reserves (mil. $)	38,552	49,898	48,785	53,029	70,997	71,348	73,642	76,030	77,964	79,896
Fiscal indicators (general government; %)										
Balance/GDP	(4.3)	(9.2)	(7.1)	(6.4)	(6.5)	(8.2)	(7.5)	(6.7)	(6.1)	(5.8)
Change in net debt/GDP	5.4	9.7	6.9	5.2	5.6	9.0	8.0	7.3	6.8	6.0
Primary balance/GDP	(3.3)	(8.0)	(5.8)	(5.0)	(4.6)	(6.1)	(5.1)	(4.0)	(3.4)	(2.9)
Revenue/GDP	31.7	32.3	32.6	34.0	33.7	34.8	34.5	34.5	34.5	34.5
Expenditures/GDP	36.1	41.5	39.7	40.4	40.3	42.9	42.0	41.2	40.6	40.3
Interest/revenues	3.3	3.9	4.1	4.1	5.7	6.0	7.0	7.6	7.9	8.1
Debt/GDP	35.0	46.6	48.3	47.9	48.9	52.4	56.3	59.7	63.0	65.4
Debt/revenues	110.2	144.5	148.2	140.8	145.0	150.9	163.1	173.0	182.6	189.6
Net debt/GDP	31.7	41.3	44.0	42.9	42.8	47.9	52.6	56.5	60.0	62.6

Liquid assets/GDP	3.2	5.3	4.3	5.0	6.1	4.5	3.7	3.2	3.0	2.8
Monetary indicators (%)										
CPI growth	3.9	2.3	4.1	12.0	9.7	5.8	4.9	4.1	3.7	3.6
GDP deflator growth	6.9	4.1	5.6	12.1	12.8	8.8	5.3	4.1	3.7	3.6
Exchange rate, year-end (LC/$)	4.26	3.97	4.37	4.63	4.50	4.79	4.49	4.44	4.48	4.52
Banks' claims on resident non-gov't sector growth	7.0	5.0	14.2	11.2	5.9	7.2	7.0	6.8	7.0	7.1
Banks' claims on resident non-gov't sector/GDP	24.6	25.7	26.3	25.1	23.1	22.5	22.4	22.4	22.5	22.8
Foreign currency share of claims by banks on residents	33.1	31.3	28.5	32.4	33.0	32.0	31.5	31.5	31.5	31.5
Foreign currency share of residents' bank deposits	34.3	34.8	35.0	34.2	30.1	30.0	30.0	30.0	30.0	30.0
Real effective exchange rate growth	(0.5)	1.4	1.0	3.7	5.4	N/A	N/A	N/A	N/A	N/A

Sources: Eurostat (economic indicators), Bank of Romania and IMF (monetary indicators), Eurostat (fiscal and debt indicators), and National Bank of Romania (external indicators).

Adjustments: Usable reserves adjusted by subtracting required bank reserves on resident foreign-currency deposits from reported international reserves.