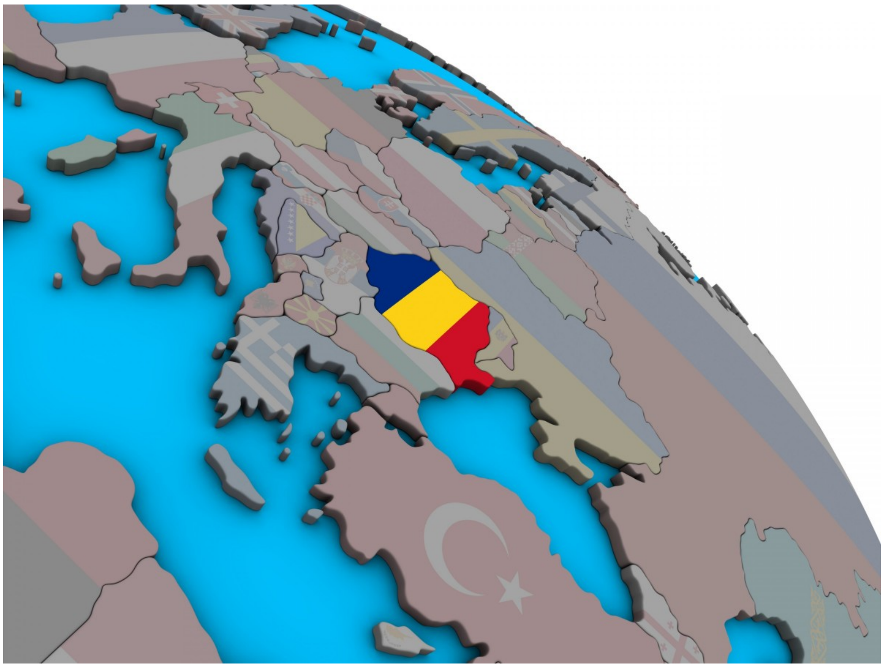
Romania: Investment grade hanging by a thread

Romania's long standing fiscal fragilities have moved to the forefront as all three main rating agencies now have Romania on the lowest investment grade and negative outlook. Risks for a more imminent downgrade have risen but we believe that rating agencies will still have patience, with some conditions



In recent years, concerns about Romania have revolved around public finances amid elevated deficits and planned pension increases which could derail fiscal balances more permanently. In this context, the Covid-19 outbreak will almost certainly cause damage to the fiscal balance beyond the boundaries of what investors and rating agencies previously considered to be tolerable. For 2020, we forecast government debt/GDP to surge to c.43% (above the psychological threshold of 40%) driven by a 7.9% of GDP budget deficit which already assumes that the pension hikes will be cancelled.

More recently, Fitch and Moody's have acted by revising their outlooks on the Baa3/BBB- ratings to negative and changing forecasts accordingly. S&P had already placed Romania on negative outlook in December, and with many things having changed – and not for the better – it will be difficult for the rating agency to stay put. Among the rating agencies, we acknowledge the risk of a more imminent negative rating action by S&P (due to Covid-19). That said, we believe that rating agencies will hold off on downgrades until year-end when we could get some more clarity on a post-election fiscal strategy. As things appear now however, we can't say with confidence that the sovereign rating will remain intact into 2021.

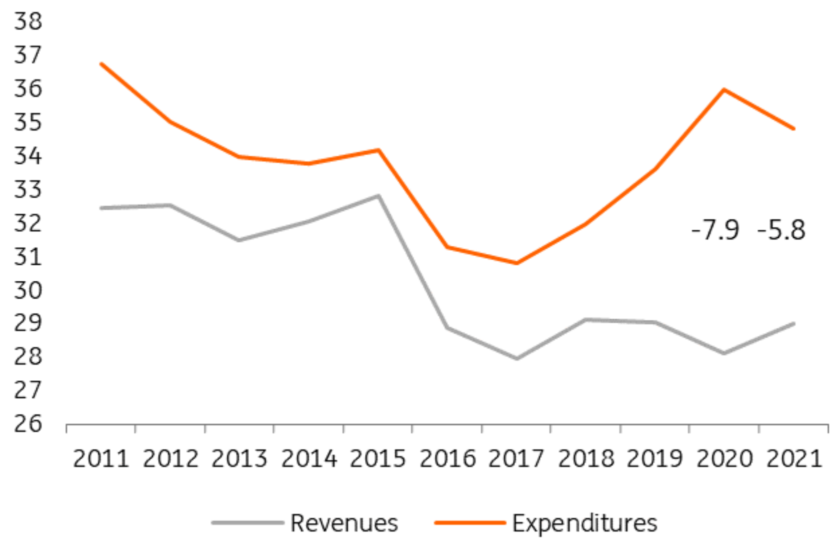
Budget gap could reach historical wides

With Romania having burned its fiscal buffers during good economic times, the economy is left exposed to a downturn. A combination of lower GDP, lower revenues and higher expenses will put to the test most factors that the soaring deficit relates to: including financing options, ratings, political will to contain the problems, institutional cooperation, and monetary policy response.

The long-awaited budget revision didn't bring what markets and agencies have been hoping for, such as measures to contain expenditure, especially on wages and social assistance. The government estimates a 1.9% GDP contraction in 2020, which looks unrealistic in our view. The budget deficit would reach 6.7% of GDP but it is worth mentioning that this projection does not contain any significant cost-control measures.

Our current 7.9% of GDP forecast for the budget deficit already assumes that the 40% pension hike will not be implemented, that the doubling of the child benefits will be delayed until next year, and even some modest measures on public sector wages and/or pensions (including wage cuts for higher paid workers, taxing special pensions). None of these measures have been adopted yet. Even if adopted, we believe that risks are skewed towards a higher deficit than our current forecast, at least judging by the very weak January-March budget execution.

Revenues and expenses (% of GDP)



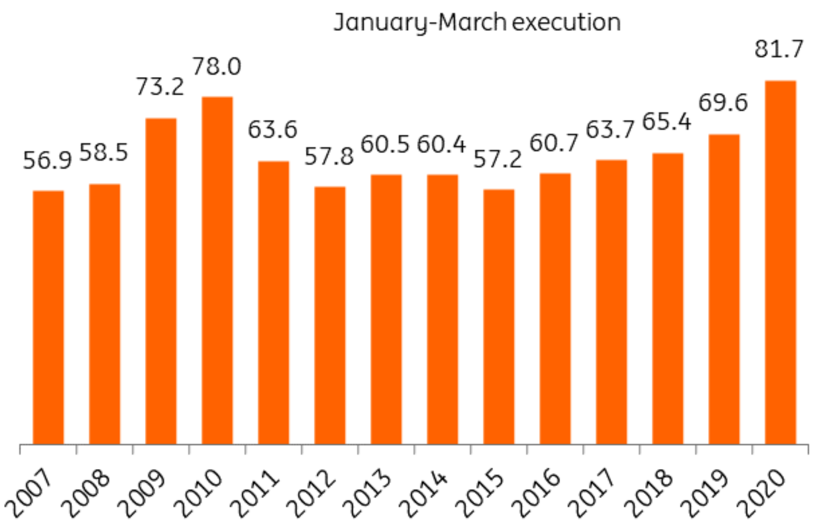
Source: MinFin, ING estimations

For the first three months of 2020, revenues are already 3.3% lower than in the same period of 2019. Revenues in March alone dropped by 25% versus a year ago (and 31% versus the plan) but it is worth mentioning that execution was already looking weak in February, before the lockdown.

The share of rigid spending in total spending has long passed the comfort zone and reached alarming levels in the first three months of 2020. Public sector wages plus social assistance (pensions mainly) made up almost 82% of total revenues in 1Q20 (and 93% in March alone), a new historical high. The electoral year makes the sticky character of this spending even stickier. Hence, since it is unlikely that we will see any wage cuts in the public sector nor meaningful measures on the pensions side (apart from our already assumed cancellation of the 40% hike), its share in total revenues could settle more permanently around 90%.

Among the few budget execution positives we see at this point is the apparent commitment from the government to keep investment spending up and running - capital spending grew by 20% YoY in 1Q20. The continuation of this trend is nevertheless very much dependent on deficit spending and, subsequently, on smooth deficit financing.

Wages and social assistance (% of revenues)



Source: MinFin, ING

Looking to NBR, EU/IFI funding and Eurobonds to match substantial financing needs

As for the financing needs for the remainder of 2020 (May-December), things don't look rosy: The government foresees a deficit of RON72.5bn in its latest budget revision for 2020 although we estimate the number to be at least RON10bn higher.

In the first four months of the year, the budget deficit has likely reached around RON30bn (RON18bn over January to March, thereof RON9.8bn for March alone) while redemptions amounted to roughly RON20bn. This stands against RON38bn in issuance, meaning that issuance is already some RON12bn behind as of end-April if we consider other things (including cash buffer utilisation, borrowings from the Treasury's general account, no pre-financing in the previous year) to be constant.

For the remainder of the year (May to December), this leaves us with a RON52bn deficit estimate (based on our view of a full-year deficit of at least RON82.5bn) and RON21bn of redemptions. All in all, financing needs therefore total around RON73bn (€15bn) in the next eight months. In theory, we should also add to this number the residual RON12bn to account for the underfunding in the first four months of the year, to come to a grand total of RON85bn (€17.5bn) in financing needs.

Relying exclusively on the market to issue anywhere close to this amount is not realistic in our view. We therefore expect the NBR to step up its bond buying programme, with additional EU funding (RON4bn so far with more likely to come) also providing a helping hand. In external bond markets, we had anticipated €6bn in ROMANI issuance for 2020 (with €3bn already raised). Current market conditions pose a challenge for now, so the stronger uptake in local bond auctions allows the government to be somewhat more opportunistic, but eventually we will see supply. The financing pressure will, in our opinion, also push Romania towards a multilateral financing agreement with IFIs (analogous to 2009), more likely by early next year.

Although there are many unknowns for 2020 as it is, looking towards 2021 we believe that it will be very difficult for any government to avoid tax increases. VAT is the main candidate here, but additional taxes on higher pensions and wages could be considered.

Rating trajectory continues to hinge on fiscal policy decisions

In our note of 25 February, we highlighted the negative rating implications on the risk of fiscal slippage, with heightened risks of a negative outlook or review for downgrade by Fitch and Moody's (link). Both rating agencies have since followed through and placed Romania's BBB- and Baa3 ratings on negative outlook in April. We kick off with a quick summary of recent rating actions and provide our updated views. Figure 6 shows a comparison between INGF and rating agencies' forecasts.

Comparison of INGF and rating agency forecasts

		2019	2020F	2021F	2022F
GDP growth (% YoY)	ING	4.1	-7.7	7.1	4.2
	Moody's (Apr 20)	4.1	-5.0	4.0	
	S&P (Dec 19)	3.9	3.5	2.9	2.8
	Fitch (Apr 20)	4.1	-5.9	5.3	4.0
CPI (% YoY)	ING	3.8	2.5	3.0	3.0
	Moody's (Apr 20)	4.0	2.8	3.0	
	S&P (Dec 19)	4.0	3.5	3.2	3.2
	Fitch (Apr 20)	3.9	2.5	3.2	
General government balance (% of GDP)	ING	-4.6	-7.9	-5.8	-4.0
	Moody's (Apr 20)	-4.3	-7.7	-6.2	
	S&P (Dec 19)	-4.3	-4.0	-3.2	-3.0
	Fitch (Apr 20)	-4.6	-7.9	-4.2	
General government primary balance (% of GDP)	ING	-3.5	-6.8	-5.0	-3.1
	Moody's (Apr 20)	-3.1	-6.3	-4.8	
	S&P (Dec 19)	-2.9	-2.5	-1.7	-1.4
	Fitch (Apr 20)	-3.4	-6.5	-2.8	-2.5
General government debt (% of GDP)	ING	35.4	42.9	45.8	48.4
	Moody's (Apr 20)	35.2	43.7	46.8	
	S&P (Dec 19)	36.5	38.0	38.9	39.6
	Fitch (Apr 20)	35.4	44.8	45.1	46.4
Current account balance (% of GDP)	ING	-4.6	-3.0	-3.0	-3.5
	Moody's (Apr 20)	-4.6	-3.4	-2.4	
	S&P (Dec 19)	-5.6	-5.6	-5.0	-4.6
	Fitch (Apr 20)	-5.0	-3.0	-3.8	

Source: Moody's, S&P, Fitch, ING

- **Fitch** revised the outlook on the BBB- rating to negative on 17 April, in line with our view. This was mainly driven by worsening public finances, exacerbated by poor fiscal management in recent years, which will see debt/GDP increase to 45% this year (based on a 6% GDP contraction and 8% of GDP fiscal deficit). Uncertainties come from Covid-19 (scope and length) and government expenditure, with Fitch's base case resting on the reduction or cancellation of the 40% pension increase and the limitation of further wage increases.

- Despite the increased risks, the timing of the **Moody's** decision took us by surprise as the rating agency's credit opinion from 6 April indicated an improvement in the rating scorecard outcome for Romania, placing it in the Baa1-Baa3 range (from Baa2-Ba1 previously), implying rating resilience. In its rating decision, Moody's specifically referred to the pension reforms, with forecasts incorporating the fiscal impact and pointing to a structural deterioration in public finances. As a second driver, the rating agency noted the increase in short-term foreign currency debt. Moody's has indicated a 12 to 18-month horizon to resolve the negative outlook (absent of further severe shocks).
- **S&P** placed Romania's BBB- rating on negative outlook on 10 December 2019 on fiscal slippage and risks to the government's fiscal outlook driven by the pension hike law, the upcoming election cycle and an economic slowdown (link). Since then, the coronavirus spread has put additional pressure on the ratings. The December forecasts are now outdated and we are likely to see substantial negative revisions in growth and fiscal metrics against some improvement in the current account, particularly if we take our and other rating agencies' projections as guidance.

  We acknowledge that the risks of an S&P downgrade have increased, with the next scheduled review on 5 June. However, our base case remains for S&P to wait until year-end as many domestic uncertainties persist when it comes to the pension law (and offsetting measures) and to the post-election policy agenda. S&P's December assessment incorporated a 1% of GDP fiscal impact in 2020 from the 40% hike (partly mitigated by offsetting measures) but looked for a new government to revise the pension increases after the elections.

Romania's ratings would benefit from a credible medium-term fiscal strategy

Covid-19 is taking a heavy toll on Romania's growth and fiscal dynamics. Rating agencies have attempted to incorporate this in revised forecasts, and it has contributed to recent negative outlooks. However, we still find some notable differences and conclude the following:

- Comparing Moody's and Fitch's recent outlook revisions, our take is that the coronavirus outbreak has contributed to Fitch's decision. In contrast, it plays a less prominent role for Moody's which has however incorporated the impact of the pension hikes. We are waiting for S&P which still has to incorporate the current pandemic into its assessments but, on balance, we don't expect an imminent downgrade.
- We believe that pension reform and future policy agenda remain key. Whether the pension hike is implemented or not (and how the fiscal impact will be addressed if implemented) will make a substantial difference to forecasts beyond 2020. Moody's and S&P appear to have included the fiscal impact of a 40% hike, but the latter expects a new government to rein it in after the elections. Fitch, in line with our view, expects a cancellation or substantial reduction of the pension increase. An adverse scenario therefore implies the largest rating downside risk at Fitch, followed by S&P and less so at Moody's. However, a credible medium-term fiscal strategy that stabilises public debt is the key requirement for moving the outlook

back to stable across the board.

> All in all, Romania's investment grade rating looks tenuous and, while our base case doesn't foresee a downgrade until end-2020, the uncertainties posed by politics (and Covid-19) mean that we can't be confident that Romania's ratings will not be cut before then. The sovereign has come under intense scrutiny by rating agencies and will remain so.

Rating drivers/Factors that could lead to an upgrade or downgrade

Agency (review date)	Upgrade Drivers	Downgrade Drivers
Moody's Baa3 neg (23 Oct)	For outlook back to stable: • Successful halt and – over the medium-term – reversal of the structural deterioration in **public finances** • Improved **fiscal sustainability** driven by structural fiscal consolidation in the medium-term (higher tax collection and lower share in current expenditure) • Steady reduction in the **structural current-account deficit** and increased coverage by non-debt generating flows, together with a rebalancing towards higher investment expenditure	Resolution of negative outlook expected over the next 12-18 months absent further severe shocks to the economy and/or intensification of financial risks: • Continued structural deterioration in **fiscal strength** while **external imbalances** remain at an elevated level • Weaker assessments of **institutional and governance strength**, driven by the absence of a determined and effective policy response to structural challenges in the medium-term (incorporates policy agenda after 2020/21 elections)
S&P BBB- neg (5 Jun/4 Dec)	For outlook back to stable: • Government makes headway in anchoring **fiscal consolidation**, leading to stabilisation of public finances and external position	• **Fiscal and external imbalances** continue to deteriorate and persist for longer than anticipated, with absence of fiscal consolidation resulting in higher public and external debt than forecasted • Overextension of real wages and increased exchange rate volatility from lack of **economic policy synchronisation**, with potential negative repercussions on public- and private-sector balance sheets
Fitch BBB- neg (1 May/30 Oct)	• Confidence that **general government debt/GDP** will stabilise over the medium-term (e.g. due to post-pandemic fiscal consolidation) • Sustained improvement in **external debt ratios**	• Sharp deterioration in **medium-term debt sustainability** (e.g. due to failure to offset or delay increases in recurrent expenditure and/or implement a credible medium-term consolidation strategy post-pandemic shock) • Weaker **medium-term growth prospects** (e.g. reflecting a more pronounced or longer period of economic contraction that leads to permanent sectoral damage)

Source: Moody's, S&P, Fitch Ratings, ING

Author

Valentin Tataru
Chief Economist, Romania
valentin.tataru@ing.com

Disclaimer