Romania

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	Local currency	Foreign currency	Outlook
Moody's	Baa3	Baa3	Stable
S&P	BBB-	BBB-	Stable
Fitch	BBB-	BBB-	Stable

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

Executive Summary

- Due to weaker external demand, high inflation and tighter financial conditions, GDP growth slowed in 1Q23 to just 0.2% qoq and 2.9% yoy, well down from the vigorous rates seen during the post-pandemic rebound of 2021-22. Domestic demand has remained strong, however, with consumption benefiting from relatively low unemployment and firm wage growth, and investment benefiting from inflows of EU funds including disbursements under the Recovery and Resilience Plan (RRP).

- With energy price pressures having eased somewhat, CPI inflation has fallen from November's peak. But at 10.6% yoy in May, it remains well above the central bank's 2.5% target, and core rates are high and sticky. The NBR's Monetary Policy Rate has been held at 7.00% since January, having been hiked by 575bps since September 2021. High interest rates have helped to maintain the leu in a managed peg against the euro ahead of targeted adoption of the single currency in 2026.

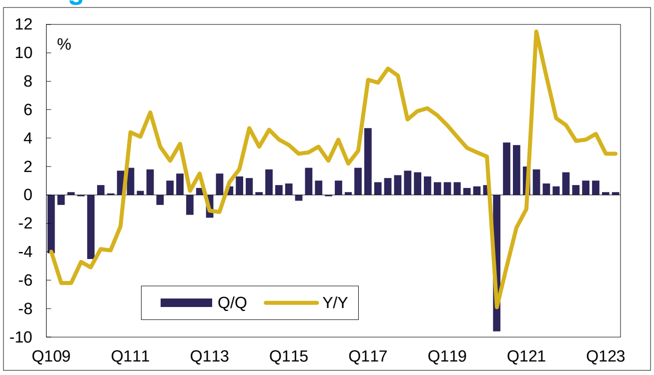
- With ongoing economic growth, the government deficit narrowed last year and is expected to fall below 5% of GDP in 2023. Further reforms will be required to reduce it below the 3% Stability and Growth Pact limit and meet conditions for euro adoption. The sizeable current account deficit remains financed in part by inflows of FDI and EU funds, with scope to increase the absorption rate of the latter to support medium-term economic growth.

Economic performance and prospects

Throughout 2022, Romania's economy was resilient in the face of various shocks, ranging from the war in neighbouring Ukraine, extremely rapid rises in energy prices and pressures from increasing inflation. Full-year GDP growth in 2022 moderated 1.1ppt to 4.7%, still comfortably outpacing growth of 3.5% in the euro area. However, as external demand weakened sharply, GDP slowed from 1.0% qoq in 4Q22 to just 0.2% qoq in 1Q23, representing the softest rate since the first wave of pandemic in 2020. That, nevertheless, left GDP up a still-respectable 2.9% yoy, representing a less abrupt slowdown than most of Romania's peers (e.g. Hungary, Czech Republic, and Poland). And it took Romania's GDP 6.9% above its pre-pandemic peak in 1Q20. Private consumption was one of the main drivers of growth in 2022 and also provided support in 1Q23. Despite downward pressure from high inflation and tight financing conditions, it is expected to remain a key driver going forward.

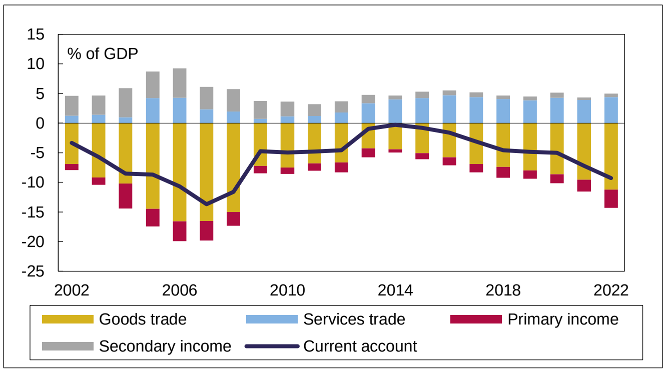
Not least given the slower start to the year, full-year GDP growth in 2023 is bound to be down on last year. The European Commission's spring forecast published in May expected Romania's economy to expand by 3.2% in 2023 followed by a slight acceleration to 3.5% in 2024. The OECD's updated forecast in June suggested that growth would remain subdued in the second quarter before picking up to 2.6% over 2023 as a whole and 3.2% in 2024. The recovery should get ongoing support from private consumption amid higher nominal wages (including the increased minimum wage) and pensions, as well as an extension of the government's energy price cap to end-2025. Other key drivers of growth include fixed investment projects related to the EUR27bn (9.5% of 2022 GDP) allocated to Romania under the EU's Recovery and Resilience Facility (RRF) as well as regular payments under the EU's Multiannual Financial Framework (MFF) for 2021-2027. Indeed, Romania is a major net beneficiary of funds aimed at supporting cohesion and agriculture in the EU.

GDP growth



Source: Eurostat; Bloomberg

Current account



Source: IMF; Refinitiv

Along with foreign direct investment (FDI), EU funds play an important role in financing Romania's elevated current account deficit, which amounted to 8.56% of GDP in 1Q23. That represented a slight narrowing from the 13-year highs above 9.3% of GDP in the prior two quarters, whose magnitude reflected the sharp increases in energy and commodity prices due to the war in Ukraine. By the same token, the narrowing of the deficit in the first quarter reflected the recent declines in energy prices. Indeed, thanks to the improvement in the terms of trade, the current account deficit is expected to narrow further in 2023, albeit remaining elevated by historical standards at more than 7% of GDP. Despite the large current account deficit, however, rising international forex reserves have kept external financing pressures low, and the leu exchange rate against the euro has also remained stable in line with the authorities' managed float regime.

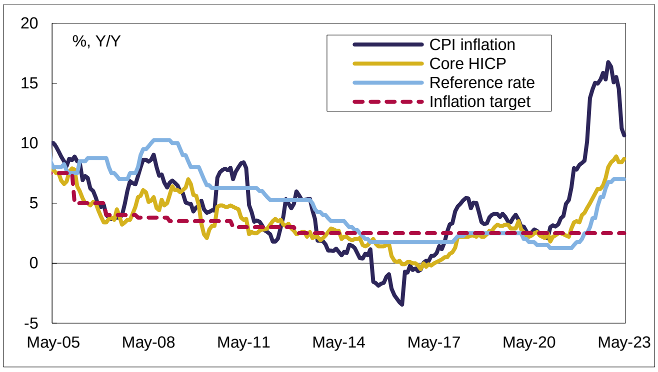
Inflation and monetary policy

Given the large price shocks related to the pandemic and Russian invasion of Ukraine, headline CPI inflation on the national measure surged throughout 2022, peaking at 16.8% yoy in November. The subsequent fall in energy prices helped it decline to 10.6% yoy in May 2023. However, underlying inflation remains high and sticky, with the core EU-harmonised HICP rate (excluding food and energy) still at 8.7% yoy in May, just 0.2ppt down from the more than eight-year high reached in February. The softening of global prices of core goods, food and energy should help inflation to moderate over the rest of the year and into 2024 although high wage growth suggests that the services component could remain elevated. The National Bank of Romania (NBR) forecasts CPI inflation to average 7.1% in 2023 and 4.2% in 2024, still well above the 2.5% inflation target. Nevertheless, it sees the risks to that outlook as skewed to the upside.

The NBR tightened monetary policy steadily as the inflation outlook worsened during 2021-2022. In January, the key policy rate was increased to 7%, taking the cumulative tightening since September 2021 to 575bps. Additional rate hikes in due course cannot be ruled out should the inflation outlook deteriorate. However, the impact of tighter monetary policy on credit supply is expected to be more than offset by the continued flow of EU funding for investment.

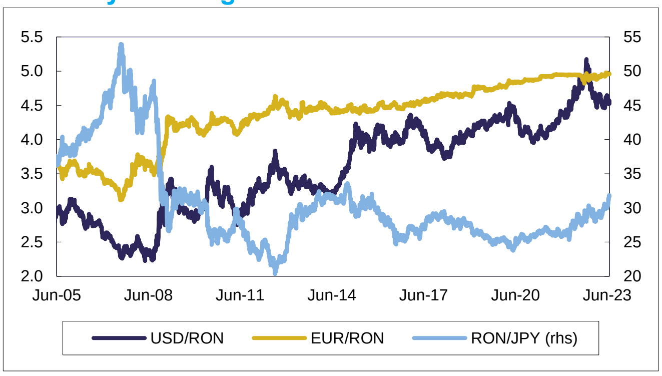
Since joining the EU in 2007, Romania has committed to adopt the euro once it fulfils the necessary conditions. In March, the country announced its intention to bring forward its target year for joining the single currency to 2026 from 2029. But Romania will first need to demonstrate a track record of sustainable economic convergence and stability, including reducing significantly inflation as well as the fiscal and external deficits. However, for several years, while it used its inflation target as the key anchor for monetary policy, the NBR has successfully limited exchange rate fluctuations against the euro, against which the leu depreciated less than 2.5% in the three years to end-June 2023. International reserves (including gold) have doubled since 2009 and amounted to EUR59.2bn (of which EUR53.6bn forex reserves) at end-June, providing cover for more than four months of imports.

Inflation and interest rates



Source: National Bank of Romania; Bloomberg

Currency exchange rate



Source: Bloomberg

Fiscal policy

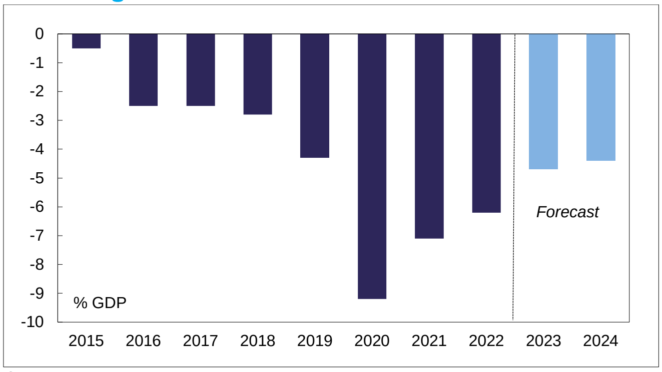
In 2022, the fiscal deficit was reduced to 6.2% of GDP, down from the previous year's outturn of 7.1% and the pandemic peak of 9.2% in 2020. The reduction reflected firm economic growth as well as fiscal consolidation measures introduced in the 2021 budget. The European Commission expects the government deficit to decrease further to 4.7% in 2023, only a touch above the government's target. That should help stabilise the outstanding stock of gross general government debt at around 47% of GDP, well below the EU average (84%) and 60% convergence criterion ceiling, and close to its regional peers. Tax revenues, as a proportion of GDP, are likely to remain stable at about 27% in 2023, remaining the second lowest in the EU. The expansion of the tax base is not only important for the country's fiscal outlook but also a crucial element in obtaining continued EU-funding under the RRF.

Indeed, EU fund transfers are contingent upon Romania successfully implementing a range of political and fiscal reforms under its Recovery and Resilience Plan (RRP) that was endorsed by the European Commission in September 2021. The plan consists of 107 investment measures and 64 reforms supported by an estimated EUR14.2bn in grants and

EUR14.9bn in loans. 41% of the plan's funds aim to support the country's green transition while 20.5% aim to support the digital transition. The plan represents an important policy anchor, incentivising the government to improve its fiscal position consistent with the EU's excessive deficit procedure (EDP) target of 3% in 2024.

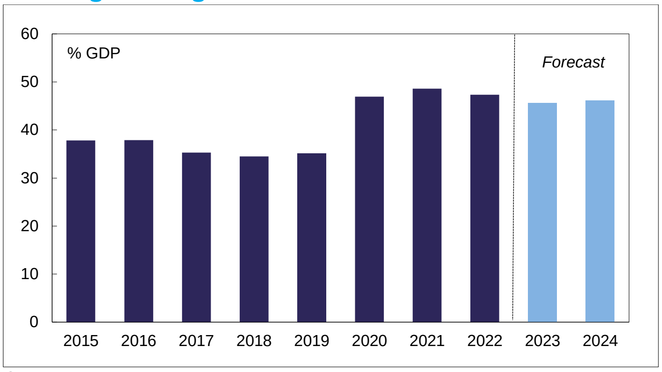
Indeed, the uncertain macroeconomic outlook should encourage the government to advance reforms to unlock the low-cost EU financing. Given Romania's historically weak absorption of EU funds, reforms to boost institutional quality and to tackle corruption will be particularly important. In June, the European Commission (EC) endorsed a partially positive preliminary assessment of progress under the RRP, noting improvements related to public policy delivery, enhanced tax administration, sustainability of the pensions system, the independence of the judiciary and the fight against corruption. However, some milestones were not met, resulting in the activation of a 'payment suspension' procedure, meaning some funds remain frozen. In late June, Romania passed a watered-down version of the special pension reform requested by the EC, which is an essential milestone for further payment requests.

General government balance



Source: Eurostat; Bloomberg

Gross general government debt



Source: Eurostat; Bloomberg

Political background

Since November 2021, Romania has been governed by a grand coalition between the National Liberal Party (PNL), the Social Democratic Party (PSD), and the smaller Democratic Alliance of Hungarians in Romania (UDMR). The current coalition provides Romania with greater political stability than it enjoyed in previous years. Frequent changes of government in the past caused instability and hindered policymaking. Significant competition between the major parties often resulted in increased periods of expansionary fiscal policy close to electoral periods with negative consequences for the public finances. Rotation of key government positions between the coalition partners, including that of the Prime Minister, are hoped to strengthen the credibility and sustainability of the government's fiscal reform programme and help to unlock funds under the EU's Recovery and Resilience Facility (RRF).

The war in Ukraine exposed Romania to geopolitical risks due to its shared land border with Ukraine and Moldova as well as its coastline on the Black Sea. NATO membership is seen as an ultimate guarantee to the country's national security. Proximity to the conflict has seen significantly more than 100k Ukrainian refugees make Romania their home since the invasion. The coalition government has taken several measures to mitigate the economic and social spill-over effects from the war in Ukraine, e.g. by capping energy prices for households and some small companies.

Despite solid medium-term GDP growth prospects, Romania has unfavourable demographic developments that reflect an aging population as well as high and continuous levels of emigration. Indeed, Romania's population has fallen from 21.8 million in 2002 to 19 million in 2022. According to the World Bank, the proportion of Romania's population above the age of 65 increased to 19% at end-2021 from 15% in 2009. Net emigration has been elevated since joining the European Union and averaged 55k per annum during that period. Although the net number of people leaving slowed throughout the pandemic, it could rise again once Romania joins the Schengen Area, allowing visa free movement of its citizens in the European Union. In December, Romania failed to receive a unanimous vote by EU member states on Schengen accession and the topic now needs to be revisited by the Council of Ministers. Emigration contributes to the tightness of the labour market and the unemployment rate remains somewhat above its pre-pandemic level, albeit relatively low at 5.6% in May. With the economic recovery, it is expected to fall to 5.1% in 2024.

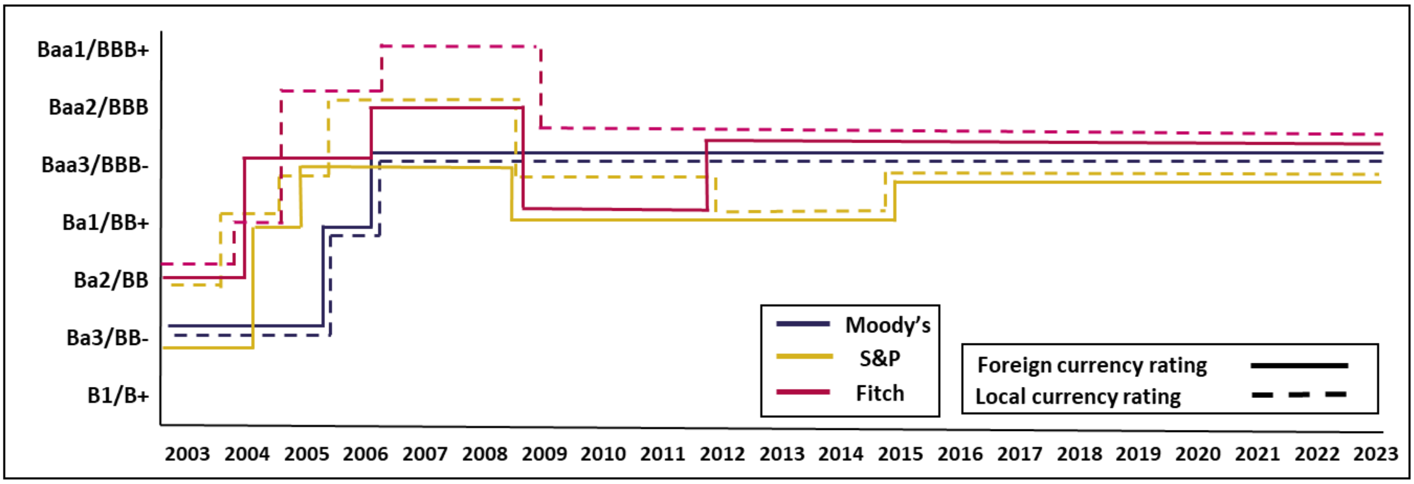
Rating agencies' views

Moody's: The credit opinion from May 2023 states that Romania's credit profile balances the strong growth potential of the country's economy against relatively weak institutions and governance strength and an increase in geopolitical risk following the Russian invasion of Ukraine, with which Romania shares a border. Romania's very large and partly structural current account deficit is also a weakness of the credit profile, although large inflows of foreign direct investment (FDI) and European Union investment funds provide stable sources of funding. Although Romania's government debt burden is moderate, the relatively high level of debt denominated in foreign currency adds to fiscal risks. As credit strengths, Moody's lists strong medium-term economic growth potential; a moderate government debt burden and favourable debt affordability metrics; and an important policy and institutional anchor provided by EU membership. Credit challenges emerge from institutional drawbacks, particularly related to control of corruption; large external imbalances heightening external vulnerability risks; and an increase in geopolitical risks following the Russian invasion of Ukraine.

S&P: In April 2023 S&P ratings affirmed Romania's sovereign credit rating at 'BBB-/Stable/A-3'. S&P expect Romania to report one of the strongest real growth rates in CEE in 2023, notwithstanding several near-term economic challenges including persistently high inflation, low growth of key trading partners in the eurozone, and remaining risks from the Russia-Ukraine conflict. Key growth factors are EU-funded investments under the RRF and MFF. High external deficits reflect continuously strong domestic demand, rising import prices, and primary income outflows. S&P expect some of these effects to moderate over the near term, which will decrease the deficit over the next several years, to slightly above 6.5% of GDP by the end of 2026. EU funds and FDI continue to fund Romania's external deficit (about 50% of the current account deficit in 2022) while foreign currency interventions by the NBR remain moderate and have helped keep the Leu broadly stable vis-a-vis the Euro over the past 12 months. Fiscal consolidation is progressing and the budget deficit is expected to fall to 4.6% of GDP in 2023 (5.7% in 2022). The government deficit is expected to fall to ~3% by 2025.

Fitch: In March 2023 Fitch revised Romania's Outlook to 'Stable' from 'Negative' and affirmed the issuer's default rating (IDR) at 'BBB-'. The rating reflects Romania's public debt stability at debt/GDP at 49% in 2021-2022 below the 'BBB' median of 56%. Fitch see gradual fiscal consolidation and expect narrowing of the budget deficit stemming from higher revenues supported by tax reforms, while the expenditure/ GDP ratio will remain broadly stable. Downside risks have been reduced with credit fundamentals relatively resilient to shocks from the war in Ukraine and the subsequent energy crisis in Europe. External finances were also solid, with international reserves rising, reflecting stable FDI, high EU fund flows and ample market access. Romania also benefits from greater political stability from the current grand coalition, which was formed in November 2021, contrasting previous years of short-lived governments and significant competition between the major parties, often with negative consequences for public finances.

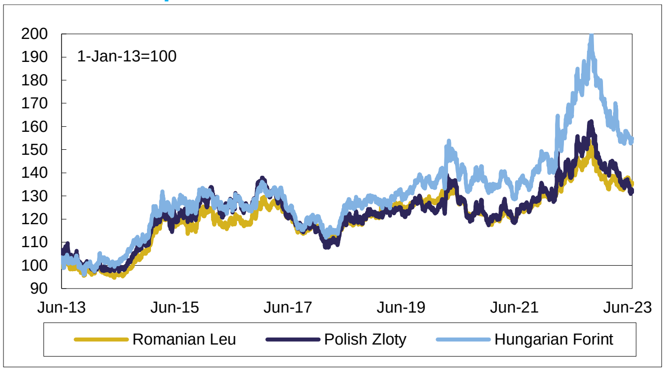
ROMANIA RATING HISTORY



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

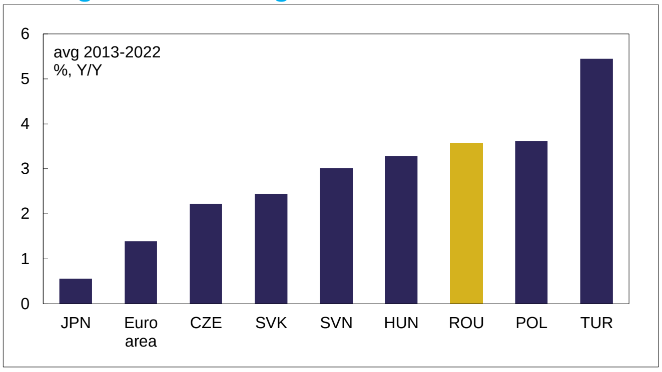
Appendix:

Central European currencies



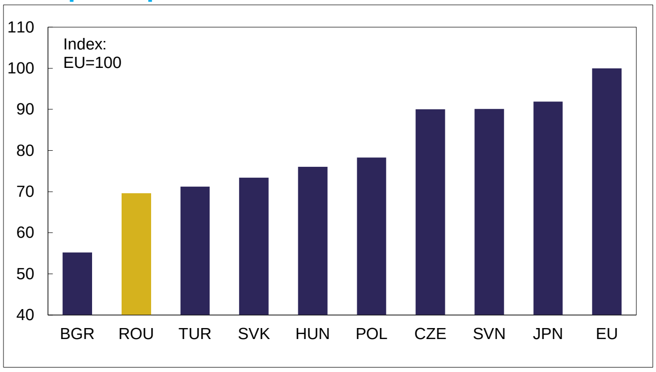
Source: Bloomberg

Average annual GDP growth: 2013-2023



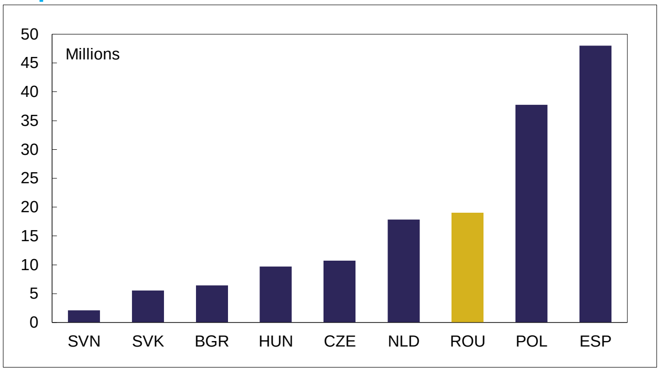
Source: Bloomberg

GDP per capita*



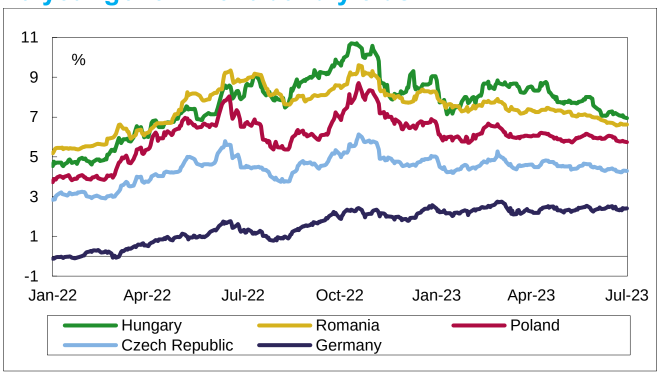
*Source: IMF; *At current prices (PPP; international $ per capita); Latest comparable data as of FY21*

Population at 1Q23



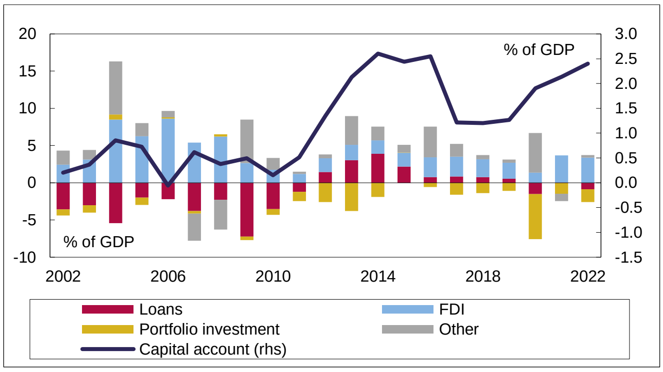
Source: Eurostat

10-year government bond yields



Source: Bloomberg

Financial account



Source: IMF; Refinitiv

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3) Samty Residential Investment became a consolidated subsidiary of Daiwa Securities Group Inc. effective 10 September 2019.

4) On 30 May 2019, Daiwa Securities Group Inc. formalized an equity/business alliance with Samty, and as of 14 June 2019 it owned 16.95% of shares outstanding in Samty along with convertible bonds with a par value of Y10bn. Conversion of all of said convertible bonds into common shares would bring the stake of Daiwa Securities Group Inc. in Samty to 27.28%.

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- For derivative and margin transactions etc., our company may require collateral or margin requirements in accordance with an agreement made beforehand with you. Ordinarily in such cases, the amount of the transaction will be in excess of the required collateral or margin requirements**.
- There is a risk that you will incur losses on your transactions due to changes in the market price of financial instruments based on fluctuations in interest rates, exchange rates, stock prices, real estate prices, commodity prices, and others. In addition, depending on the content of the transaction, the loss could exceed the amount of the collateral or margin requirements.
- There may be a difference between bid price etc. and ask price etc. of OTC derivatives handled by our company.
- Before engaging in any trading, please thoroughly confirm accounting and tax treatments regarding your trading in financial instruments with such experts as certified public accountants.

* The amount of the trading commission cannot be stated here in advance because it will be determined between our company and you based on current market conditions and the content of each transaction etc.
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