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CORRIGENDUM

This document corrects document SWD(2022) 638 final of 23.05.2022.
Correction of figures in table 2.1.

The text shall read as follows:

COMMISSION STAFF WORKING DOCUMENT

In-depth review for Romania

in accordance with Article 5 of Regulation (EU) No. 2011/1176 on the prevention and correction of macroeconomic imbalances

Accompanying the document

COMMUNICATION FROM THE COMMISSION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE, THE COMMITTEE OF THE REGIONS AND THE EUROPEAN INVESTMENT BANK

2022 European Semester – Spring Package

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On the basis of this in-depth review for Romania undertaken under Regulation (EU) No 1176/2011 on the prevention and correction of macroeconomic imbalances, the Commission has considered in its Communication "European Semester – 2022 Spring Package" (COM(2022)600 final) that:

Romania is experiencing imbalances. Vulnerabilities relate to external accounts, linked to large fiscal deficits, and to competitiveness issues that are re-emerging. The high current account deficit further worsened in 2021 and is not forecast to improve this year or next. Large fiscal deficits pre-date the COVID-19 crisis and have driven up the current account deficit which poses risks to external debt sustainability. Sovereign borrowing costs have increased since early 2021. The expected acceleration in wages could weigh further on cost competitiveness. Nominal depreciation could mitigate competitiveness losses but add to inflationary pressures and increase the burden of serving debts in foreign currencies, which are significant for the government and the private sector. The negative net international investment position is expected to remain below its pre-pandemic levels. The external position is expected to benefit from significant RRF funds but external financing can otherwise become more challenging amid tighter global financial conditions. Recent policy initiatives, including the successful implementation of Romania's RRP, can address some vulnerabilities, still further action is needed to improve competitiveness and potential growth.

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1. INTRODUCTION

In 2021, over the previous annual cycle of surveillance under the Macroeconomic Imbalances Procedure (MIP), the Commission identified "macroeconomic imbalances" in Romania. ([1]) These imbalances were related to a persistent sizeable current account deficit in a context of large government deficits, while previous overheating pressures were receding. The 2022 Alert Mechanism Report published in November 2021 concluded that a new in-depth review (IDR) should be undertaken for Romania with a view to assess the persistence of imbalances or their unwinding. ([2])

In 2021, GDP rebounded strongly, after the COVID-19 related shock. ([3]) GDP grew by 5.9% in real terms in 2021, largely driven by private consumption and gross fixed capital formation. Despite headwinds caused by external demand shocks and supply chain disruptions, exports continued growing, not as fast as imports though. The trade deficit contributed to a further increase in the current account deficit. The real GDP growth outlook remains positive, albeit more muted than previously anticipated. Given the slowdown in late 2021 and early 2022, the economy is set to expand by 2.6% in 2022 and 3.6% in 2023, supported by major investments and reforms included in the recovery and resilience plan (RRP) and other EU funded projects, notably under Cohesion Policy Funds. Russia's invasion of Ukraine has placed a further drag on the economy, due to the continuous disruption in supply chains and the surge in energy prices. Nominal GDP in 2023 is forecast to exceed its 2019 level by 36.3%. HICP increased at 4.1% annually in 2021 and is forecast to increase to8.9% in 2022 mainly due to rising energy, commodities and food prices. By the end of 2021, the labour market had not fully recovered from the pandemic-induced recession, with the unemployment rate at 5.6%. The unemployment rate is projected to stay roughly the same, but wage growth is set to slightly rebound, pushed by inflation, amid more muted productivity gains. The general government deficit remained high at 7.1% of GDP in 2021, adding significantly to the large net external borrowing needs of the Romanian economy. The 2022 budget and the accompanying medium-term fiscal strategy confirm the headline EDP target, but apart from a freeze on the majority of public sector wages in 2022, do not spell out the underlying measures to achieve the target. Current projections remain highly uncertain, in particular due to the war in Ukraine and rising inflation.

This in-depth review presents the main findings of the assessment of imbalances. The assessment is backed by a thematic section on the external position. Spill-overs and systemic cross-border implications of imbalances are also taken into account. In addition, assessments of structural issues made in previous IDRs and in the context of fiscal assessments are also considered if relevant. The MIP assessment matrix is published in the 2022 Country Report for Romania. ([4])

([1]) European Commission (2021), European Semester Spring Package 2021, COM(2021) 500 final.
([2]) European Commission (2021), Alert Mechanism Report 2022, COM (2021) 741 final.
([3]) Forecast data are from European Commission (2022), European Economic Forecast: Spring 2022, Institutional Paper 172.
([4]) European Commission (2022), Country Report Romania 2022, SWD(2022)624 final.

2. ASSESSMENT OF MACROECONOMIC IMBALANCES

Assessment of gravity, evolution and prospects of macroeconomic imbalances

Despite the positive export dynamics, the current account deficit widened to 7.0% of GDP in 2021, marking its sixth year of deterioration, largely reflecting the still high government deficit. Since its position of being close to balance in 2015, the Romanian current account deficit has expanded each year, also pushed by the general government net borrowing that added significantly to the external borrowing needs of the economy. The increase in energy prices, also associated to the Russian military aggression against Ukraine, may adversely affect the current account balance, although dependence on imported energy remains below the EU average (see box 2.1). The current account balance is set to stay at around the same level in 2022 and 2023, which is well beyond what fundamentals would suggest. Against this backdrop, the net international investment position (NIIP) of Romania remains negative. Moreover, the steady and continuous improvements of the NIIP-to-GDP ratio over the past decade, which were mostly due to denominator effects rather than improvements in the savings-investment balance, stopped in 2020, and the prospects are for some deterioration this year and next (see Graph 3.1(f)). A more detailed analysis of the external sector dynamics is presented in the thematic section.

Until 2019, the current account deficit was financed mainly through net direct investments. The economic downturn in 2020 triggered a shift in the financing of the current account deficit away from more stable direct investments towards portfolio investments, in particular debt securities. Nevertheless, with the improvement in the economic situation in 2021 there was a reduction of financing by debt securities by half and a marked expansion of direct investments net inflows.

Persistent high fiscal deficits weigh on the government's debt level as well as on the external financing needs of the country as a whole. Even before the outbreak of the COVID-19 crisis, the fiscal stance was expansionary despite robust economic growth, leading to large government deficits. These increased further during the pandemic to finance measures to support the economy. The budget deficit is projected to gradually narrow from 7.1% in 2021 to 6.3% of GDP in 2023, after increasing to 7.5% of GDP in 2022, while the Romanian government aims to reduce it below 3% of GDP by 2024, in line with the EDP recommendations. Romania's fiscal deficits have been increasingly financed from abroad and raised the total government debt ratio from 35.3% of GDP in 2019 to 48.8% of GDP in 2021. The share of general government external debt reached 50.9% in 2020, up from 46.3% a year before and the share of debt denominated in foreign currency remained somewhat over 51% in 2020 and 2021. However, the share of short-term debt (i.e. maturity of less than one year) stayed low and the gross financing needs of the government are moderated. Romanian sovereign debt has been rated with the lowest investment grade by the main rating agencies. Long-term yields on government debt kept on rising since February 2021, reaching more than 6% in the first quarter of 2022 and are among the highest in the region. The Commission's fiscal sustainability assessment ([9]) shows that Romania faces high fiscal sustainability risks over the medium–term, and medium risks over the long-term.

Cost competitiveness pressures eased during the pandemic but are expected to increase again. Before the COVID-19 crisis, over the years 2016-2019, nominal unit labour costs (ULCs) grew on average by over 8% per year, mainly due to wages (nominal compensation per employee) growing on average by 13.5% per year over that period. The pandemic led to a moderation in wage growth, but already in 2021 wage growth rebounded strongly to 5.7%, from 2.6% in 2020. As public wages were frozen in 2021, private and industry wages grew more than those of the public sector for the first time in five years. Still, public wages grew on average 50% more than private services (33% more than industry) ([10]). Possible wage-growth spillovers from the public to the private sector risk denting the

([9]) See European Commission Country Report on Romania for the latest results and the 'Fiscal Sustainability Report 2021', Institutional Paper 171, 25 April 2022 for methodological details

([10]) Calculations based on data on net wages by sector published by the Romanian National Institute of Statistics (INSS TEMPO database).

competitiveness of exports ([11]). The deceleration of ULCs growth between 2019 and 2021 enabled more moderate appreciations of the real effective exchange rate than in past years. Nominal unit labour costs are forecast to increase by 6.4% in 2022 and 4.1% in 2023, which, while well below pre-crisis rates, is higher than for several trading partners. This will be on the back of stronger nominal wage growth of 8.3% and 7% in 2022 and 2023 respectively, and as productivity growth moderates to an average of 2.3%. The effects on future export and investment performance remains to be seen, as the economy recovers from the pandemic.

Non-cost factors limit Romania's competitiveness. An insufficient transport infrastructure hinders businesses' ability to ship merchandise both within and outside the country, and jeopardises spatial cohesion. A shrinking labour force, skills shortages, limited capacity of the public employment services, a weak training and education system and low innovative capacity negatively affect the business environment. Significant red tape coupled with an inefficient public administration, and a rather unpredictable legislative framework ([12]), further undermine competitiveness and investment inflows and overall country attractiveness as an investment destination.

The financial sector weathered the COVID-19 shock well, but the sovereign-bank nexus remains significant. The banking sector remained well capitalised and liquid, with the aggregate Common Equity Tier 1 ratio slightly increasing from 19.6% in 2020Q3 to 20.4% in 2021Q3. Bank profitability as measured by the return-on-equity increased from 8.2% in 2020Q3 to 10.3% in 2021Q3. The gross non-performing loans (NPLs) ratio declined to 3.7% in 2021Q3. Consolidated private sector debt is low at around 50% of GDP, but part of it is denominated in foreign currency 16.7% of the domestic loans for households and 37.2% of the domestic loans for non-financial corporations), which exposes debt service to exchange rate risk. The sovereign-bank nexus, however, has remained significant. With government debt holdings by the local banks at around 24% of their total assets in August 2021, the own-sovereign exposure of banks in Romania is among the highest in the EU. Risks related to the phase-out of state-support measures and to potential second-round effects on economic growth from Russia's unprovoked invasion of Ukraine could lead to further vulnerabilities associated to private sector debt.

Assessment of MIP relevant policies

In November 2021, the Council approved Romania's Recovery and Resilience Plan (RRP), which contains several measures that contribute to addressing Romania's macroeconomic imbalances. The successful implementation of the RRP should improve fiscal sustainability and the business environment in the long run, compensating short-run effects such as the boost of imports due to the high import content of investments. In particular, the tax and pension reform component covers measures aimed at modernising the fiscal administration, revenue collection, improving the budgetary programming by making it more transparent and predictable, as well as adopting a new law on public pensions system to cap its total gross expenditure at 9.4% of GDP, thus safeguarding its sustainability. The RRP foresees a number of measures that aim at making the legislative process more predictable, transparent and less burdensome for business. For example, legislative initiatives with a significant impact on the business environment will go through regulatory screening and any newly introduced burdens will be offset by removing equivalent burdens. A Single Industrial Licence should moreover minimise excessive red tape for companies.

The RRP is set to address several of the factors limiting competitiveness. Investments are foreseen in road and rail infrastructure, benefitting trade and distribution chains. On education, around 12% of the plan will focus on improving the quality and access to education and its digital and overall infrastructures. Further measures will provide aid schemes for the digitalisation of SMEs and support businesses in general through the operationalisation of the National Development Bank. On innovation, reforms of the

([11]) See European Commission, DG ECFIN, 2019. Wage Dynamics in Romania. Luxembourg: Publications Office. https://data.europa.eu/doi/10.2765/287819 and National Bank of Romania. 2016. "Inflation Report, February 2016," February. https://www.bnr.ro/PublicationDocuments.aspx?icid=6876.

([12]) Unpredictability stems from the use of Government Emergency Ordinances (GEOs), which is a widespread method of enacting laws in Romania. For instance, the number of GEOs went up from 91 in 2019, to 226 in 2020 and then decreased to 145 for 2021. The high number of GEOs issued in the period 2020-2021, should also be considered in the context of the extraordinary circumstances occasioned by the pandemic. See the 2021 In-depth Review for Romania and the Romanian 2020 Country report: (https://ec.europa.eu/info/sites/default/files/12_en_autre_document_travail_service_part1_v3.pdf) (https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52020SC0522&from=EN)

R&D&I system also aim at attracting more talent and resources to broaden the innovative capacity of research institutes and strengthen science-industry linkages. The capacity, transparency and effectiveness of the judiciary system and public administration is also set to be improved.

A minimum wage setting mechanism will prevent future ad-hoc increases as in the past, easing cost-competitiveness pressures. In early 2021, the government raised the minimum gross salary to Lei 2300 (EUR 466) and approved a subsequent increase to Lei 2550 (EUR 515) for January 2022. These increases were already taking into account several economic indicators such as inflation and productivity, as opposed to past ad-hoc increases, but an objective mechanism is still not in place. The RRP foresees for 2024, a reform establishing a new mechanism for setting the minimum wage, based on objective criteria and consistent with competitiveness and job creation in the country. Furthermore, public wages were frozen in 2021, except in the health sector, after a cumulative increase of 37.5% over the past four years, contributing to an easing of cost-competitiveness pressures.

There is scope for further action to address labour shortages and skills mismatches, overly regulated markets, weak business innovation and poor public administrative capacity. The 2022 Romania Country Report ([13]) identifies four priorities ahead, which could build up and complement ambitious reforms and investments contained in Romania's RRP. Firstly, the supply of skills does not meet its demand, and active labour market policies have failed to narrow this gap – especially among the most vulnerable segments of the labour force. Secondly, because of overly regulated markets, certain business services can weigh significantly on companies' books, thus undermining their competitiveness. Thirdly, knowledge transfer between science and industry is still limited: the supply of ideas is scant, companies (especially those that do not benefit from foreign direct investments) lack the capacity to absorb them, and the governance of the R&D&I system is fragmented. Finally, weak administrative capacity – with insufficient own resources and over-reliance on transfers from the central government – is one of the causes for low-quality local public services.

Conclusions

Romania is facing vulnerabilities relating to its competitiveness and particularly to its external balance developments. The large fiscal and current account deficits, which pre-dated the COVID-19 crisis, have increased further with the pandemic-induced recession. Government debt increased significantly, albeit from moderate levels, and sovereign borrowing costs kept growing. Currency exposures are significant for government and private sector debt. Cost competitiveness losses have eased somewhat in recent years due to more moderate pay rises. A volatile policy environment contributes to uncertainty and high risk premia, with detrimental effects on investment activity and the business environment. Concerns around the external position are not expected to unwind soon, amid a sizeable government deficit**.** The current account deficit further deteriorated in 2021 and is expected to remain elevated in the medium term, with sizeable fiscal deficits also forecast to continue. The financing of the significant external borrowing needs could become more challenging as global monetary policies normalise. The expected acceleration in wages could weigh on cost competitiveness. Nominal depreciation gave some relief to the competitiveness losses over past years but it could create further inflationary pressures and weigh on the service of government and private debts in foreign currencies. Romanian trade and financial links with both Ukraine and Russia are fairly small and are likely to affect economic vulnerabilities more via its impact on energy markets and prices (see box 2.1).

Recent policy initiatives, including the successful implementation of Romania's recovery and resilience plan, could address some vulnerabilities, still further action is needed. After several years of expansionary fiscal policy, some fiscal consolidation albeit limited has started in 2021. The freezing of public sector wages in 2021 had a positive impact on cost competitiveness. Increases in the minimum wage appear to be contained and should, within the RRP commitments, be based on an objective mechanism. The RRP also includes measures that are conducive to improving non-cost competitiveness, such as improving infrastructure, education, the business environment and the efficiency of the public administration, the legislative process, financial management as well as the judiciary. The activation measures provided by the public employment service, including up- and re-skilling, are not sufficient and effective in view of the rapidly shrinking workforce and increasing labour shortages. The number of

([13]) European Commission (2022), Country Report Romania 2022, SWD(2022)624 final.

beneficiaries profiting from these services is increasing only slowly, with participation in activation measures still one of lowest in the EU. The quality of local public services suffers from a fragmented decentralisation framework and inadequate own fiscal capacity. Finally, research institutions' scant supply of ideas and the poor ability of the private sector to absorb them jeopardises Romania's innovativeness and competitiveness.

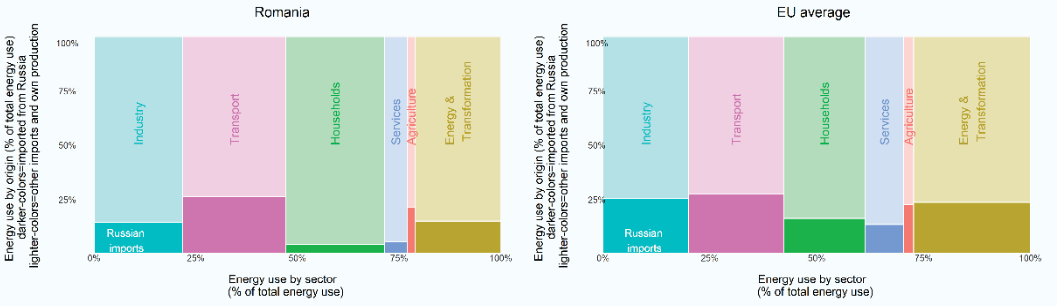
Based on the findings in this in-depth review, the Communication "European Semester – 2022 Spring Package" ([14]) sets out the Commission's assessment as to the existence of imbalances or excessive imbalances in Romania, in line with Regulation 1176/2011.

([14]) European Commission (2022), European Semester Spring Package 2022, COM(2022)600 final.

Box 2.1: Exposures to the commodity price surge, and to Russia

This box summarizes risks and exposures regarding the commodity price surge, and the importance of direct links with the Russian economy. The surge of commodity prices since 2021 had been aggravated by the Russian military aggression against Ukraine. This box reviews the risks for the macroeconomic vulnerabilities of Romania. Romania shares an important border with Ukraine and is subject to some direct repercussions from the war, most notably refugee inflows, although the majority leave to other countries. In contrast, most Romanian trade and financial links with both Ukraine and Russia are fairly small. Gas and oil imports from Russia are the only notable exceptions, with some implications for the domestic economy.

Graph b.1.1: Sectoral distribution of energy use and of energy imported from Russia



Notes: The left panel displays the distribution of primary energy usage in Romania according to Eurostat energy balances. The horizontal axis displays the relative importance of energy-consuming sectors. The vertical axis displays the importance of energy importance from Russia in satisfying that need. Note that this dependence on Russia differs according to sector's use of natural gas vs oil and coal. For comparison, the right hand panels displays the same concept for the EU aggregate. Russian imports include oil and petroleum products, natural gas and solid fossil fuels.
Sources: Eurostat and European Commission services calculations

The Romanian energy mix is similar to the EU average, with a focus on oil and gas. Romania depends on crude oil imports, in particular from Russia, as the input for its large refining industry, which then re-exports its products (see Table b.1.1). Imports from Russia account for a significant share of energy consumption in industry, transport, and electricity production (See Graph b.1.1). Domestic residential heating features suggest that Russian gas is of smaller importance for the household sector. On aggregate, the dependence on imported gas remains low and below the EU average. Overall, the commodity price surge since 2021 is likely to affect the Romanian trade balance. At constant prices, Romanian net fossil fuel imports normally amount to ca. 1.5% of GDP. The wholesale prices expected for 2022 are likely to widen that amount to ca. 3% of GDP for 2022, with a narrowing expected for 2023.

Table b.1.1: Selected exposures

Trade & financial exposures	unit	RO	EU
Domestic value added embodied in exports to Russia	% of GDP	0.3%	0.4%
Non-energy Russian import content in final demand	% of GDP	0.6%	0.4%
Russian tourist nights spent	% of total 2019	1.3%	2.7%
FDI assets held in Russia	% of 2020 GDP	0.0%	2.5%
Portfolio & other inv. assets held in Russia	% of 2020 GDP	0.0%	0.9%
FDI liabilities towards Russia	% of 2020 GDP	0.1%	1.2%
Portfolio & other inv. liabilities towards Russia	% of 2020 GDP	0.1%	1.1%
Consolidated banking exposures towards Russia	% of 2021 GDP		0.5%

Energy mix	unit	RO	EU
Solids fossil fuels (incl. peat)	% of Gross inland consumption 2020	10.9%	10.8%
Oil and petroleum products	% of Gross inland consumption 2020	30.1%	32.7%
Natural gas	% of Gross inland consumption 2020	30.3%	24.4%
Renewables and waste	% of Gross inland consumption 2020	19.6%	19.0%
Nuclear	% of Gross inland consumption 2020	9.0%	13.1%
Commodity exposures	**unit**	**RO**	**EU**
Net petroleum imports from all countries	% of GDP 2021	1.3%	1.2%
Crude oil imports from Russia '20	% of oil imports	32.3%	25.7%
Net gas imports from all countries	% of GDP 2021	0.2%	0.6%
Gas imports from Russia '20	% of gas imports	44.8%	43.6%

Notes: data source Eurostat for commodity exposures, European Commission Figaro for value-added exposures, BIS for consolidated banking exposures, European Commission FinFlows for other financial exposures. Energy gross inland consumption excludes net imports of electricity and derived heat.

Table 2.1: Selected economic and financial indicators (Part 1), Romania

all variables y-o-y % change, unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	forecast 2023
Real GDP	6.5	0.6	4.5	4.5	4.2	-3.7	5.9	2.6	3.6
Potential growth (1)	5.7	2.5	3.4	3.9	4.1	3.1	3.4	3.1	3.3
Contribution to GDP growth:									
Domestic demand	13.3	-1.2	4.1	5.1	6.5	-2.0	5.5	3.0	4.3
Inventories	-1.2	0.0	0.3	1.0	-0.6	-0.3	1.8	0.1	-0.3
Net exports	-5.8	1.4	0.0	-1.6	-1.6	-1.5	-1.4	-0.5	-0.4
Contribution to potential GDP growth (1):									
Total Labour (hours)	-0.9	-1.1	-0.3	-0.1	-0.5	-0.8	-0.9	-0.5	-0.4
Capital accumulation	1.7	2.3	1.0	0.7	1.7	1.7	1.6	1.6	1.7
Total factor productivity	4.9	1.3	2.7	3.3	2.8	2.3	2.7	2.0	2.0
Output gap (2)	4.0	-0.8	-1.0	1.9	2.0	-4.8	-2.5	-3.0	-2.7
Unemployment rate	8.8	8.5	7.9	5.3	4.9	6.1	5.6	5.5	5.3
Harmonised index of consumer prices (HICP)	9.5	5.7	0.8	4.1	3.9	2.3	4.1	8.9	5.1
GDP deflator	13.4	6.1	3.1	6.2	6.8	3.9	5.4	9.5	4.9
External position									
Current account balance (% of GDP), balance of payments	-9.5	-6.3	-1.3	-4.6	-4.9	-5.0	-7.0	-7.4	-7.3
Trade balance (% of GDP), balance of payments	-10.7	-7.5	-1.1	-3.4	-4.1	-4.3	-5.7	.	.
Primary income balance (% of GDP)	-3.2	-1.5	-1.1	-1.8	-1.4	-1.5	-1.7	.	.
Secondary income balance (% of GDP)	4.4	2.7	0.9	0.6	0.7	0.9	0.4	.	.
Current account explained by fundamentals (CA norm, % of GDP) (3)	-1.8	-0.8	-0.4	0.1	0.2	0.3	0.2	0.4	0.5
Required current account to stabilise NIIP above -35% of GDP over 20Y (% of GDP) (4)	-3.3	-3.6	-4.8	-4.3	-4.0	-3.7	-3.9	-3.5	-3.1
Capital account balance (% of GDP)	0.5	0.6	2.2	1.2	1.3	1.9	2.2	.	.
Net international investment position (% of GDP)	-37.4	-61.7	-54.3	-43.8	-43.6	-47.9	-45.7	.	.
NENDI - NIIP excluding non-defaultable instruments (% of GDP) (5)	-5.0	-22.2	-12.0	-3.9	-4.1	-7.1	-6.7	.	.
Net FDI flows (% of GDP)	-6.4	-2.8	-2.3	-2.4	-2.2	-1.4	-3.0	.	.
Competitiveness									
Unit labour costs (ULC, whole economy)	7.4	5.2	3.8	8.2	6.6	4.7	-9.0	6.4	4.1
Nominal compensation per employee	18.0	7.9	8.5	12.9	10.9	2.6	5.7	8.3	7.0
Labour productivity (real, hours worked)	7.0	2.8	4.8	4.3	3.1	-2.2	14.2	1.5	2.5
Real effective exchange rate (ULC)	9.1	-3.0	2.6	5.2	1.5	.	.	.	.
Real effective exchange rate (HICP)	8.5	-2.9	-0.1	2.3	-0.2	1.3	0.1	.	.
Export performance vs. advanced countries (% change over 5 years)	84.1	69.1	25.5	20.7	15.6	21.2	.	.	.
Private sector debt									
Private sector debt, consolidated (% of GDP)	41.8	70.7	58.3	47.5	46.7	48.4	50.3e	.	.
Household debt, consolidated (% of GDP)	10.6	21.4	17.5	15.8	15.5	16.2	16.9e	.	.
Household debt, fundamental benchmark (% of GDP) (6)	5.7	12.8	19.5	19.6	19.2	20.9	20.4	.	.
Household debt, prudential threshold (% of GDP) (6)	92.7	65.6	56.2	62.2	64.1	60.3	59.8	.	.
Non-financial corporate debt, consolidated (% of GDP)	31.1	49.3	40.8	31.6	31.3	32.2	33.4e	.	.
Corporate debt, fundamental benchmark (% of GDP) (6)	16.3	23.1	32.9	35.6	36.2	40.0	39.9	.	.
Corporate debt, prudential threshold (% of GDP) (6)	107.1	79.4	85.6	95.0	98.7	98.3	97.9	.	.
Private credit flow, consolidated (% of GDP)	12.8	3.0	-0.3	1.9	2.0	1.3	3.7e	.	.
Corporations, net lending (+) or net borrowing (-) (% of GDP)	-2.8	8.0	11.6	12.1	8.9	8.9	8.3	10.5	10.7
Households, net lending (+) or net borrowing (-) (% of GDP)	.	.	.	:	:	-5.6	-8.3	-10.7	-11.7
Net savings rate of households (% of net disposable income)	.	.	.	.	.	.	.	.	.

(e) estimate based on ECB quarterly data

(1) Potential output is the highest level of production that an economy can reach without generating inflationary pressures. The methodology to compute the potential output is based on K. Havik, K. Mc Morrow, F. Orlandi, C. Planas, R. Raciborski, W. Roeger, A. Rossi, A. Thum-Thysen, V. Vandermeulen, The Production Function Methodology for Calculating Potential Growth Rates & Output Gaps, COM, European Economy, Economic Papers 535, November 2014.

(2) Deviation of actual output from potential output as % of potential GDP.

(3) Current accounts in line with fundamentals ("current account norms") are derived from reduced-form regressions capturing the main determinants of the saving-investment balance, including fundamental determinants, policy factors and global financial conditions. See L. Coutinho et al. (2018), "Methodologies for the assessment of current account benchmarks", European Economy, Discussion Paper 86/2018, for details.

(4) This benchmark is defined as the average current account required to reach and stabilise the NIIP at -35% of GDP over the next 20 years. Calculations make use of Commission's T+10 projections.

(5) NENDI is a subset of the NIIP that abstracts from its pure equity-related components, i.e. foreign direct investment (FDI) equity and equity shares, and from intracompany cross-border FDI debt, and represents the NIIP excluding instruments that cannot be subject to default.

(6) Fundamentals-based benchmarks are derived from regressions capturing the main determinants of credit growth and taking into account a given initial stock of debt. Prudential thresholds represent the debt threshold beyond which the probability of a banking crisis is relatively high, minimising the probability of missed crisis and that of false alerts. Methodology to compute the fundamentals-based and the prudential benchmarks based on Bricongne, J. C., Coutinho, L., Turrini, A., Zeugner, S. (2019), "Is Private Debt Excessive?", Open Economies Review, 1- 42.

Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

Table 2.2: **Selected economic and financial indicators (Part 2), Romania**

all variables y-o-y % change unless otherwise stated	2003-07	2008-12	2013-17	2018	2019	2020	2021	forecast 2022	forecast 2023
Housing market									
House price index, nominal	.	-12.5	2.5	5.6	3.4	4.7	4.4	.	.
House price index, deflated	.	-16.2	0.7	1.7	-1.9	2.2	-1.1	.	.
Overvaluation gap (%) (7)	.	24.0	-13.4	-15.4	-18.6	-13.7	-15.2	.	.
Price-to-income overvaluation gap (%) (8)	.	36.4	-13.9	-27.7	-31.8	-25.5	-27.5	.	.
Residential investment (% of GDP)	1.9	2.9	2.5	2.0	2.2	2.4	2.6	.	.
Government debt									
General government balance (% of GDP)	-1.6	-6.1	-1.8	-2.8	-4.3	-9.3	-7.1	-7.5	-6.3
General government gross debt (% of GDP)	16.3	27.0	37.4	34.7	35.3	47.2	48.8	50.9	52.6
Banking sector									
Return on equity (%)	23.0	6.0	0.7	14.3	15.2	12.5	.	.	.
Common Equity Tier 1 ratio	10.9	17.1	19.2	16.4	18.4	20.1	.	.	.
Gross non-performing debt (% of total debt instruments and total loans and advances)	1.4	6.8	11.4	3.9	3.3	3.0	.	.	.
Gross non-performing loans (% of gross loans) (9)	.	.	12.6	5.0	4.3	3.9	3.7	.	.
Cost of borrowing for corporations (%)	.	.	4.9	5.8	.	.	4.6	.	.
Cost of borrowing for households for house purchase (%)	.	.	4.4	5.8	5.5	4.8	3.7	.	.

(7) Unweighted average of price-to-income, price-to-rent and model valuation gaps. The model valuation gap is estimated in a cointegration framework using a system of five fundamental variables; total population, real housing stock, real disposable income per capita, real long-term interest rate and price deflator of final consumption expenditure, based on Philiponnet, N., Turrini, A. (2017), "Assessing House Price Developments in the EU," European Economy - Discussion Papers 2015 - 048, Directorate General Economic and Financial Affairs (DG ECFIN), European Commission. Price-to-income and price-to-rent gaps are measured as the deviation to the long term average (from 1995 to the latest available year).
(8) Price-to-income overvaluation gap measured as the deviation to the long term average (from 1995 to the latest available year).
(9) Domestic banking groups and stand-alone banks, EU and non-EU foreign-controlled subsidiaries and EU and non-EU foreign-controlled branches.

Source: Eurostat and ECB as of 2022-05-02, where available; European Commission for forecast figures (Spring forecast 2022)

3. THEMATIC CHAPTER: EXTERNAL IMBALANCES

Demand, trade and current account balance

The fiscal deficit has contributed markedly to the net external borrowing of the Romanian economy, even before the COVID-19 crisis. The government's net borrowing position in 2021 amounted to 7.1% of GDP, down from 9.3% in 2020, after increasing fiscal deficits between 2015 and 2019. At the same time, the net borrowing position of households is estimated to have worsened somewhat, remaining negative, while the estimated net lending of corporations is set to slightly increase for both 2021 and 2022. Overall, the net lending/borrowing position of the total economy worsened from -4.2% in 2020 to -5.4% in 2021 of GDP. Only very gradual improvements are forecast for the next two years, in line with current account projections.

From the balance of payments perspective, the current account deficit widened further in 2021, primarily due to a larger deficit in trade in goods. Romania's current account has deteriorated from an almost balanced position in the middle of the 2010s to a deficit of around 5% of GDP at the end of 2020, with the fast growing imports fuelled by the brisk increase in domestic consumption. Due to the swift rebound from the COVID-19 recession in 2021, net exports registered a further deterioration**.** The increase in the trade deficit in goods was partly driven by a widening negative energy balance. In 2021 and early 2022, external demand for Romanian exports was affected by the slow economic recovery of some major trade partners as well as by supply-side bottlenecks. Smaller contributions to the widening current account deficit, which moved from 5% of GDP in 2020 to 7.0% in 2021, came from a slight increase in the primary income deficit (which moved from 1.5% to 1.8%) but also from lower surpluses in international trade in services and in the secondary income account (See Graph 3.1(b)).

Romania continues gaining export market share despite a recent slowdown. Romania's export market shares increased by 1.6% in 2019 and by a further 2.4% in 2020. Over 2015-2020 they increased by 20.6%, among the top three Central and Eastern European Member States and the fifth across the EU. According to the Standard International Trade Classification, in 2020 main export products included machinery and transport equipment (with almost half of the total share), other manufactured goods (accounting for about a third of the total) and food, drinks and tobacco. On the import side, the structure is broadly similar, with machinery and transport equipment taking a lower share of around 37%, and followed by other manufactured goods (30%) and by chemicals and related products (15%).

The current account balance remains well below the levels explained by economic fundamentals. The current account balance also worsened in cyclically-adjusted terms, to -8.1% of GDP in 2021, leading to a higher current account gap, i.e. distance to current account norm, which itself amounts to a small surplus of 0.2% of GDP (Table 3.1). It is estimated that domestic currency exhibits an overvaluation of about 10% with respect to the real effective exchange rate that would be consistent with the current account equal to the norm, i.e. consistent with closing the current account gap ([22]).

The current account balance is forecast to marginally deteriorate. The projected increase in international energy prices is expected to push even further into negative territory the trade balance for the next year (Graph 3.1(a)), reflecting the fact that Romania is a net importer of energy. This places the current account deficit on a slightly more negative trend of 7.4% and 7.3% of GDP for 2022 and 2023, respectively (see Graph 3.1(b)).

External financial flows dynamics

On the financing side of the external accounts, the composition of flows reverted to direct investments. In 2020, the net external financing needs were mostly met by increases in the government's

([22]) See Salto, M. and Turrini, A. (2010), "Comparing alternative methodologies for real exchange rate assessment", (European Economy, Economic Papers 427) external debt liabilities amid the high government financing needs, after years of reliance on foreign direct investment (Graph 3.1(c)). Net foreign direct investment inflows, as a share of GDP, dropped from 2.2% in 2019 to just 1.4% in 2020 (sum of the last four quarters). The drop in this external financing instrument was compensated by an increase in the net debt portfolio investments, from 1.4% of GDP in 2019, to 6.7% in 2020, mainly driven by the government sector, which recorded an increase from 1.7% to 6% of GDP over the same period. However, the trend in financing gradually reversed over 2021, with net foreign direct investments amounting to 3% of GDP and debt portfolio investments to 1.5%. The large decline in net debt portfolio inflows in 2021 is mainly due to government raising less debt abroad, with net flows of government portfolio debt declining from 6% of GDP in 2020 to 1.9% in 2021. The central bank's external liabilities in the form of other investment increased by 0.9 of GDP. The net acquisition of other investment assets of Romanian residents went slightly below zero, after reaching 2.8% of GDP in 2020.

Government financing needs remained well serviced during the COVID-19 crisis but financing conditions have tightened more recently. Increased global uncertainty and financial markets tensions in the months following the COVID-19 outbreak did not affect the government's ability to meet its external financing needs. In 2021, the share of government debt denominated in foreign currency maintained roughly the same level as in 2020, reaching 51.3%, but the share of general government external debt increased to 50.9% in 2020, up from 46.3% a year before. This trend will likely continue in the short term, with the Ministry of Finance estimating that about 70% of the 2022 budget deficit is expected to be financed from external sources. Financial markets' perception regarding the sustainability of the Romanian public debt remained broadly unchanged for 2021, with the reading of the three agencies ratings indicating that the Romanian sovereign debt is staying at the lowest investment grade. Government bond yields benefited from an Assets Purchase Programme launched by the National Bank of Romania in the spring of 2020, which reduced markedly the borrowing costs. However, since the beginning of 2021, the yields have increased again to more than 6% for the 10-year bond in early 2022, against the background of higher inflation and a change in the monetary policy stance with policy rate rises since late 2021.

Developments in external stock positions

The negative net international investment position of Romania improved slightly in 2021, mainly due to strong nominal GDP growth. In 2020, the net international investment position (NIIP) worsened to -47.9% of GDP, from -43.6% a year before. However, by 2021 the NIIP-to-GDP ratio improved to about -45.7% of GDP (Graph 3.1(d)). While the contribution from net financial flows to the change in the NIIP-to-GDP ratio in 2021 was negative, amid negative net lending/borrowing over the period, the positive impact of GDP growth, augmented by some positive valuation effects, prevailed.

While the NIIP remains close to prudential levels, it is considerably worse than what fundamentals would suggest. The NIIP norm, i.e. the level suggested by fundamentals, currently stands at -6% of GDP (Table 3.1). ([23]) The recently recorded and forecast current account balances are considerably below those required to halve the gap to the NIIP norm in ten years (Table 3.1), but also somewhat below levels needed to stay around the prudential NIIP benchmark over the same period (equalling almost -4%-5.4% of GDP). Similar to positions of other Central and Eastern Europe Member States, the Romanian NIIP contains a significant share of FDI stocks on the liabilities side, rendering the debt component of their NIIP much more limited. This is captured by the NIIP excluding the non-defaultable instruments (NENDI): in 2021 it amounted to -6.7% of GDP, thus remaining broadly stable. The sectoral breakdown of the NIIP (Graph 3.1(e)) indicates that the worsening of the government external net stocks halted in 2021 and remained generally contained at around -22% of GDP. Private sector, including the monetary and financial institutions positions, recorded a small improvement, while the central bank (including reserves) remains the sole net positive contributor, accounting for 18.4% of GDP in 2021.

Foreign exchange reserves slightly decreased in absolute terms, but the share of debt denominated in foreign exchange stays relatively high. As a share of GDP, the foreign exchange reserves went down

([23]) The country-specific prudential benchmark denotes the NIIP level beyond which the probability of an international economic and financial crisis becomes higher. The NIIP level explained by fundamentals ('NIIP norm') represents the NIIP that would result if a country had run its current account in line with fundamentals since 1995. For details see Turrini and Zeugner (2019), "Benchmarks for Net International Investment Positions", European Economy, Discussion Paper 097/2019.

from 19.5% at the end of 2020 to close to 19.1% in at the end of 2021. The decrease came despite positive flows of reserve assets, which amounted to 0.9% of GDP over 2021. In terms of months of goods and services imports coverage they have also slightly diminished, currently registering 4.9 from 5.6 months at the end of 2020 due to the high increase in imports, but they still stay above the recommended levels. Moreover, in 2021, reserves remained at around 220% of (estimated) short-term external liabilities, with an ample margin over the 100% benchmark. In addition, short-term external assets (other than reserves) are roughly equal to the short-term external liabilities. A relatively high share of both private and public debt is denominated in foreign currencies and thus exposed to exchange rate valuation risk. The share of government debt denominated in foreign currency amounted to 49.9% at the end of 2021, roughly unchanged from the value registered a year ago. For households, the share of domestic loans in foreign exchange is lower, with a 20.8% in 2020 and followed a downward trend recently. However, the share of non-financial corporations' bank loans denominated in foreign exchange is higher than for households, at around 40.3% at the end of 2020 and at 37.2% in 2021, albeit also displaying a negative trend.

Risks for external positions and flows

While global financial flows normalised after the beginning of the pandemic, new risks are looming. There may still be some financing risks ahead given the likely tightening of global financing conditions and Russia's war in Ukraine. Risks are mitigated by central bank reserves that stand at levels higher than prudential benchmarks. The nominal effective exchange rate of the Romanian currency remained rather stable, with depreciation of slightly over 1% by December 2021, as compared to the same month in 2020. This is important as non-negligible shares of both domestic and external debt assets and liabilities are denominated in foreign currencies.

Given Russia's invasion of Ukraine many possible adverse shocks relevant for Romania's external positions could materialise. In principal, price effects, especially of energy and food, could negatively affect the trade balance and the current account balance. If price increases are large enough, such effects could negatively impact the external flows and stocks (at least in the short-run), even if existing vulnerabilities, namely fiscal deficits and booming consumption, recede. Furthermore, both consumers and investors could react to such events in their search for safety and the government sector could feel pressures to increase spending due to the extraordinary circumstances.

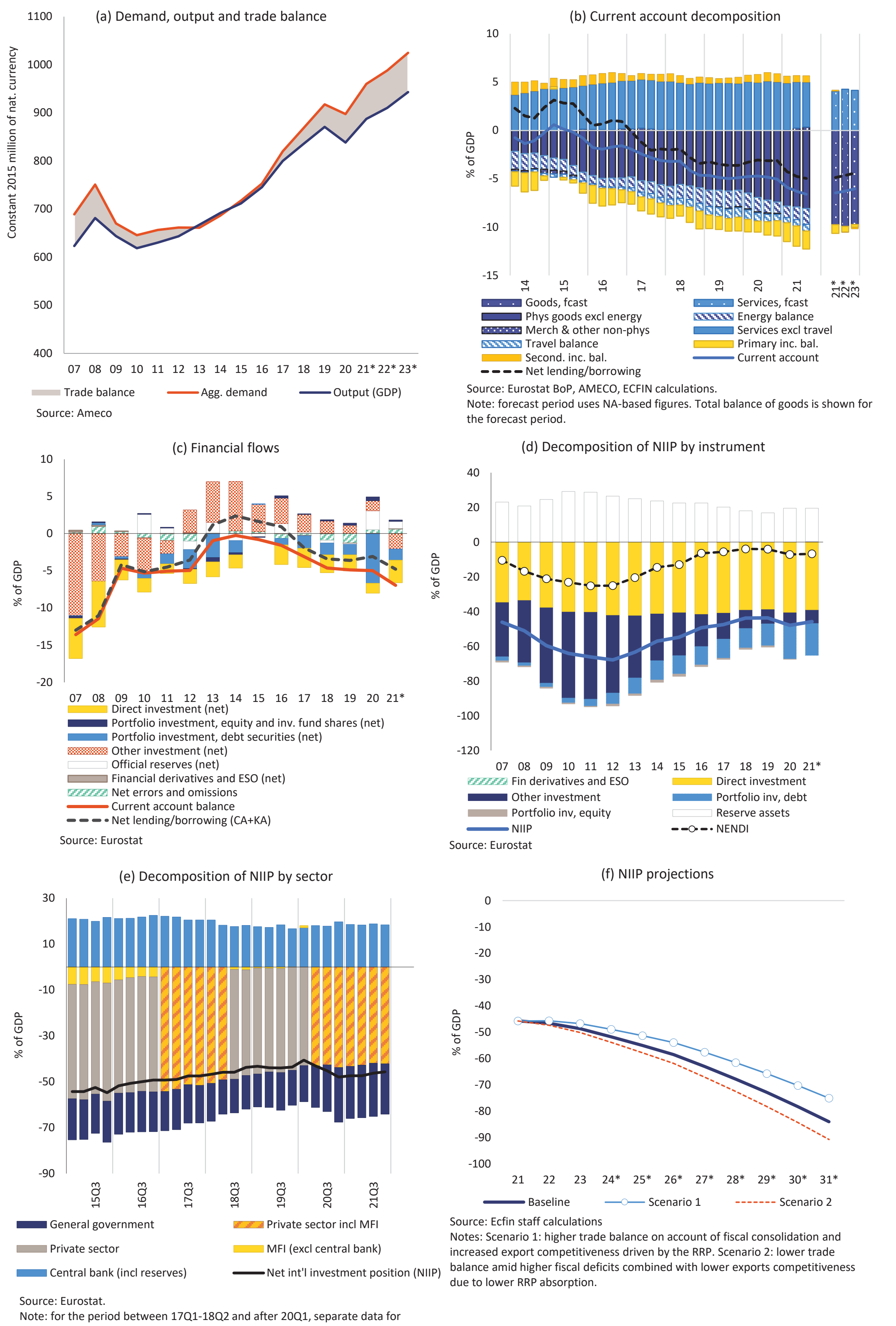
Long-term projections underline the importance of fiscal consolidation and steps towards successful implementation of the RRP. Baseline scenario (see Graph 3.1 (f)) assuming the same trend of trade deficits over the forecast horizon, suggests that Romania would reach a negative NIIP of around –84% of GDP by the end of 2031. Scenario 1 assumes Romania would undergo a fiscal consolidation in line with EDP recommendation and would be capable of absorbing the full amounts allocated under the RRP, thus becoming more competitive in international trade. The resulting projection still implies a worsening NIIP, although less negative than in the baseline by close to 9 pp. of GDP by the end of 2031. Contrary to Scenario 1, Scenario 2 assumes the incapacity to stay within the lines recommended by the EDP, (thus exercising a pull for imports due to a stimulated economy) and assumes a less successful absorption of RRF funds, thus making the economy less competitive than in the baseline scenario. The implied NIIP standing is worse-off by almost 16pp. of GDP compared with Scenario 1 and by around 7pp. of GDP compared with the baseline scenario. This is certainly a worsening compared to the current standings or the recommended benchmark and puts the economy on an unsustainable path with respect to the external sector.

Table 3.1: **Selected external indicators, Romania**

	Source:	2003-07	2008-12	2013-17	2018	2019	2020	2021	2022f	2023f
Flows [1]										
CA balance as % of GDP, NA	*(b)*	-9.6	-6.3	-1.1	-4.4	-5.3	-5.8	-7.0	-7.5	-7.3
CA balance as % of GDP, BoP	*(a)*	-9.5	-6.3	-1.3	-4.6	-4.9	-5.0	-7.0	-7.4	-7.3
Cyclically adj. CA balance as % of GDP [2]	*(c)*	-7.7	-6.3	-1.1	-3.8	-4.7	-6.1	-8.1	-9.2	-9.2
CA req. to stabilize NIIP above -35% [3]	*(c)*	-3.3	-3.6	-4.8	-4.3	-4.0	-3.7	-3.9	-3.5	-3.1
CA explained by fundamentals (CA norm) [4],[8]	*(c)*	-1.8	-0.8	-0.4	0.1	0.2	0.3	0.2	0.4	0.5
Required CA for specific NIIP target [5]	*(c)*	-2.1	-1.8	-2.6	-1.9	-1.6	-1.3	-1.2	-0.9	-0.5
Trade bal. G&S, % of GDP, NA	*(b)*	-10.7	-7.4	-1.1	-3.4	-4.1	-4.3	-5.7	-6.4	-6.7
Required TB for specific NIIP target [5]	*(c)*	-3.5	-1.8	-2.2	-1.1	-0.8	-0.3	0.0	0.5	1.0
Stocks										
NENDI as % of GDP	*(a)*	-6	-22	-12	-4	-4	-7	-7		
of which: net portfolio debt	*(a)*	-3	-3	-11	-11	-13	-20	-18		
of which: net mutual fund shares	*(a)*	0	0	0	0	0	0	0		
of which: net other investment	*(a)*	-25	-45	-24	-10	-8	-6	-8		
NIIP as % of GDP	*(a)*	-37	-62	-54	-44	-44	-48	-46	-47	-48
Prudential NIIP/NENDI benchmark [8]	*(c)*	-28	-34	-37	-44	-46	-46	-47	-47	-47
Fundamentally expl. NIIP benchmark (NIIP norm) [8]	*(c)*	-10	-10	-11	-9	-8	-8	-7	-6	-5
Gen. Government NIIP	*(a)*	-7	-12	-18	-15	-15	-24	-22		
Private Sector NIIP	*(a)*			-44	-41	-40				
of which: Net FDI [6]	*(a)*	-32	-39	-37	-35	-34	-36	-34		
MFI (excl CB) NIIP	*(a)*	-21	-22	-12	-5	-4				
Oth. financials NIIP	*(a)*			-2	-2	-2				
Central bank NIIP	*(a)*			22	18	17	20	18		
of which: Reserves	*(a)*			23	18	17	20	19		
of which: Target2	*(a)*									
Value-added trade and capital account										
VA imports % of agg. demand [7]	*(d)*	32	29	31						
Capital account bal. as % of GDP, NA	*(b)*	0.7	0.9	2.4	1.2	1.5	1.6	1.6	1.6	1.6
Indicators in % of potential GDP										
CA balance as % of potential GDP, NA	*(b,c)*	-10.0	-6.3	-1.1	-4.5	-5.4	-5.5	-6.9	-7.3	-7.1
CA balance as % of potential GDP, BoP	*(a,c)*	-9.9	-6.3	-1.3	-4.7	-5.0	-4.7	-6.8	-7.2	-7.1
Cyclically adj. CA balance as % of potential GDP	*(c)*	-8.1	-6.2	-1.1	-3.9	-4.8	-5.8	-7.9	-8.9	-9.0
Trade bal. G&S, as % of potential GDP, NA	*(b,c)*	-11.1	-7.5	-1.1	-3.5	-4.2	-4.1	-5.5	-6.2	-6.5
NENDI as % of potential GDP	*(a,c)*	-6.5	-21.9	-11.8	-4.0	-4.1	-6.7	-6.5		
NIIP as % of potential GDP	*(a,c)*	-39.4	-60.9	-53.7	-44.6	-44.5	-45.7	-44.6	-45.7	-46.9
Capital account bal. as % of potential GDP, NA	*(b,c)*	0.7	0.9	2.4	1.3	1.5	1.5	1.6	1.5	1.6

Abbreviations: NA=National Accounts, BoP=Balance of Payments, CA=Current Account, NENDI= NIIP excluding non-defaultable instruments, VA= Value Added, TB= Trade Balance.
(1) Flow data refer to national account concept, unless indicated otherwise.
(2) Cyclically adjusted CA is the CA adjusted for the domestic and foreign output gaps, taking into account trade openness.
(3) The average CA needed in order to stabilise the NIIP is based on European Commission "T+10" medium-term projections.
(4) The CA explained by fundamentals refers to the expected CA given the level of its fundamentals with respect to world average.
(5) The CA or TB needed either to halve the distance to fund. NIIP benchmark, or to reach the prud. NIIP benchmark in 10Y, whichever is higher. Based on European Commission "T+10" medium-term projections.
(6) In case private-sector FDI is not available, total economy FDI is displayed.
(7) VA imports as % of aggregate demand describes the % of aggregate demand that is sourced from foreign value added.
(8) More information on benchmark indicators methodology can be found on B1 intranet.
Source: (a) Eurostat, (b) AMECO, (c) European Commission calculations, (d) WIOD database

Graph 3.1: **Thematic Graphs: External position**



Source: European Commission services