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Romania—Staff Report for the 2010 Article IV Consultation, Fourth Review Under the Stand-By Arrangement, and Requests for Modification and Waiver of Nonobservance of Performance Criteria—Staff Report; Staff Supplement; Public Information Notice and Press Release on the Executive Board Discussion; Statement by the Executive Director for Romania.

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on May 10, 2010, with the officials of Romania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 17, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff supplement of June 30, 2010.
- A Public Information Notice (PIN) and a Press Release summarizing the views of the Executive board as expressed during its July 2, 2010, discussion of the staff report that completed the review.
- A statement by the Executive Director for Romania

The documents listed below will be separately released.

- Letter of Intent and supplementary Letter of Intent sent to the IMF by the authorities of Romania*.
- Technical memorandum of Understanding*.

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ROMANIA

Staff Report for the 2010 Article IV Consultation, Fourth Review Under the Stand-By Arrangement, and Requests for Modification and Waiver of Applicability of Performance Criteria

Prepared by the Staff Representative for Romania

Approved by Poul M. Thomsen and Aasim Husain

June 16, 2010

Discussions: Discussions were held in Bucharest during April 27-May 10, 2010. The mission met with President Basescu, Prime Minister Boc, Finance Minister Vladescu, Central Bank Governor Isarescu and other senior officials, and representatives of labor and business organizations, and financial institutions. The staff team comprised J. Franks (head), A. Cebotari, C. Fernandez Valdovinos, M. Stierle, B. Yontcheva (all EUR); N. Hobdari (SPR); F. Hasanov (FAD); L. Zanforlin (MCM). T. Lybek (Resident Representative) assisted the mission. Discussions were held jointly with staff from the European Commission, the ECB and the World Bank.

Stand-By Arrangement: A 24 month, SDR 11.443 billion (€12.95 billion, US$17.07 billion, 1,110.77 percent of quota) Stand-By Arrangement was approved by the Executive Board on May 4, 2009 (Country Report No.09/183), and three purchases totaling SDR 8.263 billion have been made so far. The European Commission and the World Bank are also providing funds to cover the financing gap under the program. The fifth tranche amounting to SDR 768 million will be made available subject to the completion of this review.

Previous Article IV consultation: The previous consultation was concluded on June 25, 2008, and the reports were posted at www.imf.org on July 2, 2008.

Data: Romania subscribes to the SDDS; data provision is adequate for surveillance (Informational Annex).

Political developments: President Basescu was reelected December 7, 2009. Prime Minister Boc received the support of the Romanian parliament on December 23, 2009. In addition to votes from the Democratic Liberal Party (PD-L) and the Democratic Union of Hungarians (UDMR), he received support from independent parliamentarians.

Exchange Rate Regime: Romania has accepted the obligations of Article VIII and maintains a floating exchange rate system free of restrictions on current international payments and transfers.

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I. Executive Summary

1. **The growth outlook remains weak and uncertain.** The economic situation worsened since the January review and staff revised the 2010 GDP growth forecast from +0.8 percent to -0.5 percent. However, high-frequency indicators suggest that the recession is bottoming out and staff expects growth to turn positive in the remainder of the year.

2. **Disappointing fiscal performance in Q1 2010 required adopting additional adjustment measures.** The fiscal deficit target was missed by a small margin, as was the ceiling on government payments arrears. Without further adjustment, staff estimated the deficit would climb to 9.1 percent of GDP by year-end, compared to the 5.9 percent target. To take account of the cyclical deterioration of the economy, staff and the authorities agreed to revise the SBA's deficit target to 6.8 percent of GDP and the authorities chose a package of measures involving expenditure cuts of roughly 2 percent of GDP to achieve the new deficit target.

3. **While the banking sector has so far withstood the crisis well, banks face deteriorating asset quality and rising provisioning costs that are squeezing profits.** The authorities are carefully monitoring the liquidity and solvency ratios of the system and proactively asked banks to add 2009 profits to capital. The system remains liquid and adequately capitalized and foreign banks as a group have broadly maintained their exposure to Romania.

4. **Progress on fiscal reforms has resumed.** The Fiscal Responsibility Law was approved. The government is also preparing amendments to the Local Public Finance Law to improve financial controls on local governments as well as further reforms to combat tax evasion. Pension reform legislation was approved by the government and sent to Parliament for debate and approval on an urgent basis. However, further fiscal consolidation is required in coming years to sustainably reverse the imbalances which left Romania vulnerable to crisis.

5. **Pressing ahead with structural reforms is key for boosting growth and achieving sustainable real convergence.** Future growth depends not only upon reestablishing macroeconomic stability, but also on improving capital investment, and increasing labor productivity. To boost investment, steps should be taken to improve the business climate, improve infrastructure and EU funds absorption, and strengthen competition. Higher labor productivity should be fostered by reforming the labor market to address significant rigidities and low labor participation rate and by education reforms.

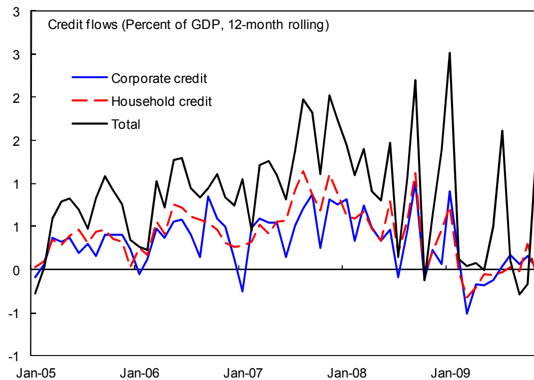
II. Context: Boom, Bust, and Weak Outlook

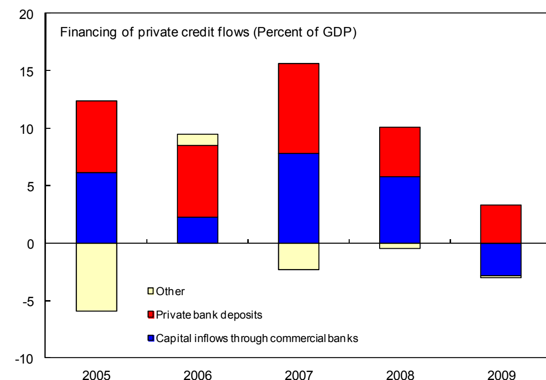
A. Rapid Growth and Growing Imbalances

6. **As in many other CEE countries, Romania's economy boomed in conjunction with its EU accession in 2007, but high growth rates were associated with the build-up of both external and internal imbalances**. Large capital inflows stimulated domestic

demand while labor constraints and fast rising public sector wages exacerbated wage inflation resulting in pressures on prices. The National Bank of Romania (NBR) adopted sharply tightened monetary policy to counteract price pressures, but inflation expectations remained high. Procyclical fiscal policy helped drive domestic demand to unsustainable levels (Figure 6).

7. **The rapid development of the banking system came with increasing vulnerabilities to outside liquidity shocks and foreign exchange risks**. Dominated by foreign banks, banking activity grew quickly. From 2003 until the crisis, private sector credit grew at an average annual rate of 50 percent. As credit expansion outpaced the growth rate of local deposits,[1] bank lending became increasingly dependent on external financing, much of which came from the parents of foreign-owned banks. The share of foreign currency lending also reached almost two-thirds of total credit. Hence, the banking sector became vulnerable to two major sources of risks: (i) liquidity risks if inflows from aboard dried up and (ii) foreign exchange risks through the banks' exposure to the unhedged businesses and households. To contain credit growth rates, the National Bank of Romania (NBR) sharply increased reserve requirements on both RON and FX liabilities and tightened prudential regulations. However, direct lending from abroad also increased as firms sought to circumvent local market restrictions.



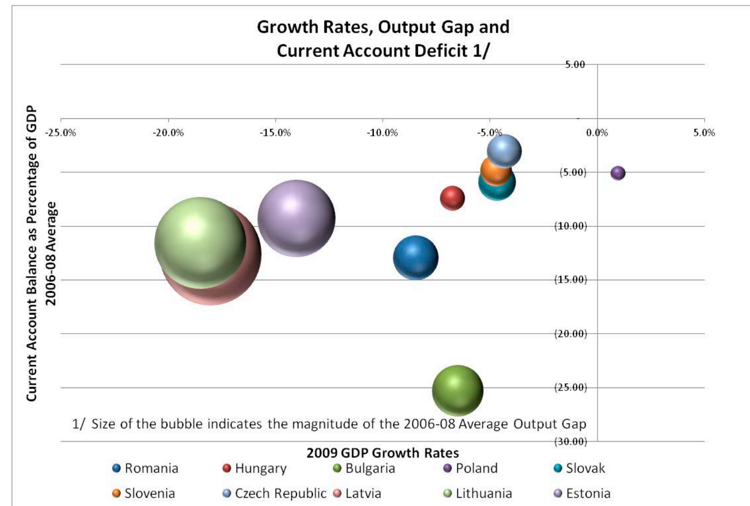


Source: Romanian National Bank; Haver; Datastream.

[1] As illustrated by the increase in the loan-to-deposit ratio that rose from 80 to 112 percent in 5 years.

B. Recent Crisis and Policy Response

8. **The global economic and financial crisis severely hit Romania in late 2008 and 2009**. Capital inflows suddenly dried up amid the global financial crisis, Romanian exports began to plummet, and country risk indicators skyrocketed as markets perceived the country to be among the more vulnerable to the downturn. Real GDP plummeted[2] as domestic demand also contracted sharply, while balance of payments pressures drove a 15 percent depreciation of the leu against the Euro from October 2008 to early 2009, putting pressures on household, corporate and bank balance sheets (Figure 7). Although banks generally entered the crisis well capitalized, they faced rising non-performing loans (NPLs), a dried up interbank market liquidity and limited access to external sources of funds. The country's large pre-crisis fiscal imbalance left it in a weak position to respond to these developments.



9. **Faced with deteriorating conditions, in early 2009 the authorities put together a comprehensive policy package supported by an IMF Stand-By Agreement (SBA) along with funds from the EU and other multilateral institutions.** The program aimed at correcting fiscal and current account imbalances that built up before the crisis while avoiding excessive contraction. The policy instruments included (i) gradual fiscal consolidation accompanied by structural reforms to restore fiscal sustainability and boost market confidence, (ii) steps to further strengthen the resilience of the financial sector and to obtain commitments from foreign parent banks to maintain their Romanian subsidiaries capitalized and liquid[3], and (iii) prudent monetary policy management to reduce inflation.

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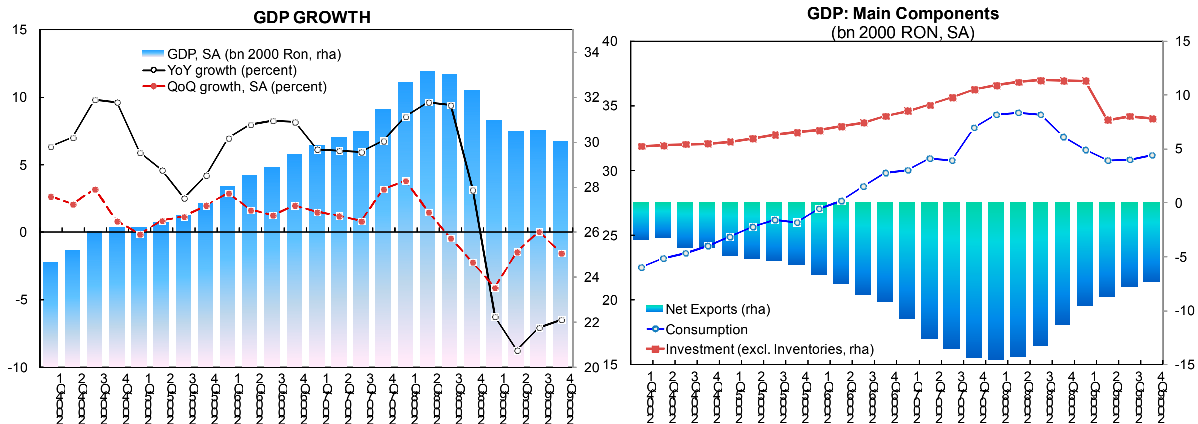
[2] Real GDP dropped by 13 percent (quarter-on-quarter, annualized) in the fourth quarter of 2008, compared with the pre-crisis average growth of 9 percent.

[3] Banks have provided additional capital as a cushion against future losses, and the nine largest foreign banks with subsidiaries in Romania joined the European Bank Coordination Initiative under which they agreed to maintain their overall exposure to the country and to provide capital as needed. The deposit insurance system is

(continued…)

10. **The program contributed to stabilizing the economy and alleviating financing pressures.** Economic activity remained weak throughout 2009 (declining by 7.1 percent y-o-y), but exchange rate pressure eased, the country risk premium narrowed significantly, and financial sector stress eased. The sharp decline in domestic demand helped adjust the current account, while the multilateral support package and the commitment of international banks to maintain their exposures in Romania eased capital account pressures. Financial market stabilization (Figure 4) allowed the central bank to prudently ease monetary policy. The government was able to finance its fiscal deficit through disbursements from the EU and the Fund, together with improved access to the local and international bond markets as sovereign CDS spreads for Romania gradually returned to near pre-crisis levels.



11. **Romania's external trade and current account deficit contracted sharply in 2009.** The collapse in global trade and capital flows hit Romania's economy hard. As a result of the sharp contraction in domestic demand that followed, imports fell by nearly 35 percent (y-o-y) during the first nine months of 2009, almost double the rate of decline of exports during the same period. Hence, the crisis contributed to a sharp external adjustment, with the current account deficit falling to 4½ percent of GDP in 2009 from a peak of 13½ percent in 2007. Such adjustment was one of the largest among new EU member states. Reflecting global trade patterns, Romania's trade staged a recovery towards end-2009, with export growth again outpacing import growth.

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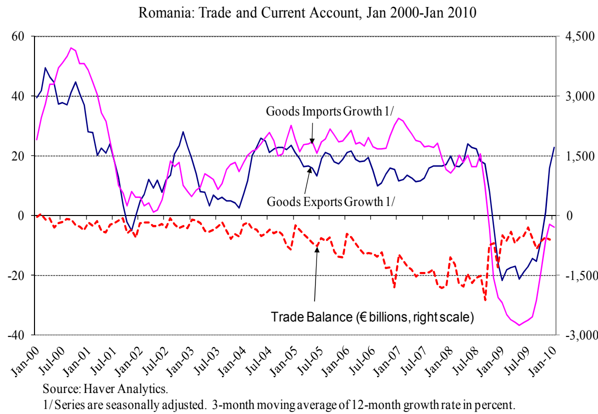
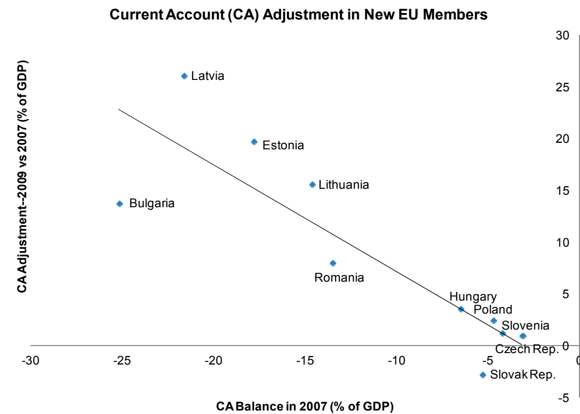
being strengthened and bank resolution laws are being improved so that the government can better respond if banks were to get into trouble.

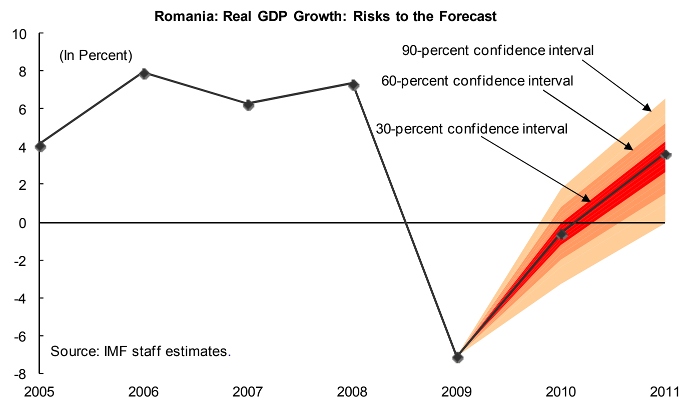




C. Outlook and Risks

12. **The outlook for 2010 is challenging.** Economic activity continued to decline in the first quarter of 2010 and, while staff projects a moderate recovery in the remainder of the year, growth is likely to be slightly negative for the year as a whole. Domestic demand will remain subdued for some time, as unemployment continues to rise and real wages adjust to the recession with a lag, while investment will pick up slowly given tight credit conditions and a low capacity utilization rate. The contribution of net exports is expected to remain positive in 2010, although less so than last year given the tepid recovery in Romania's main trade partners and some revival in imports. While the banking sector has so far withstood the crisis well, banks face deteriorating asset quality and rising provisioning costs that are squeezing profits. NPLs increased sharply from 6.5 in December 2008 to 15.3 in December 2009 and are projected to reach about 20 percent at the end of the year.

13. **Risks to the outlook are tilted towards the downside and uncertainty is particularly high.** With domestic demand still weak, the expected recovery rests on hope of an upturn in demand in Western Europe. Financing constraints, banking sector vulnerabilities, skittish investors, as well as potential spillovers from regional developments and volatile international markets may slow down the incipient recovery. In particular, recent regional developments have generated renewed downward pressure on the exchange rate and have stalled the fall in CDS spreads experienced in Romania since the program was agreed in March 2009. Persistent uncertainties of this nature would adversely affect credit supply and the health of the banking system and could produce a double dip recession. On the upside, a potential reversal of the inventory cycle



may prop up growth and the easing of monetary policy may begin to stimulate credit growth to fuel a rebound in consumption and investment.

14. **Beyond 2010, GDP should recover, with growth forecast to rise by around 3½ percent in 2011 and rising to the range of 4–4½ percent per year in 2012–15.** Staff envisages some lasting effects of the crisis on potential output growth in the medium-term due to the lower capital stock and lasting effects on financial intermediation. Potential output growth is expected to average 3–3½ percent in the medium-term, well below the average growth rates experienced in 2003–2008 (Box 1).

15. **The current account deficit is expected to stabilize at a sustainable level in the medium run, financed mainly by FDI inflows.** Staff baseline projections are for the current account deficit to increase to about 5 percent of GDP in 2010, and stabilize at around that level over the medium term. This stabilization is projected on the basis of the expected economic recovery in Romania's trading partners, sluggish recovery in domestic demand reflecting the real exchange rate depreciation that has taken place since mid-2008, as well as limited scope for private credit growth as banks continue to deleverage. FDI inflows are projected to amount to about 4½ percent of GDP over the medium term, and thus expected to finance most of the projected current account deficit. As a result, external debt is projected to decline gradually to about 45 percent of GDP in 2014, from 65 percent in 2009.

Box 1: The Crisis Impact on Potential Growth

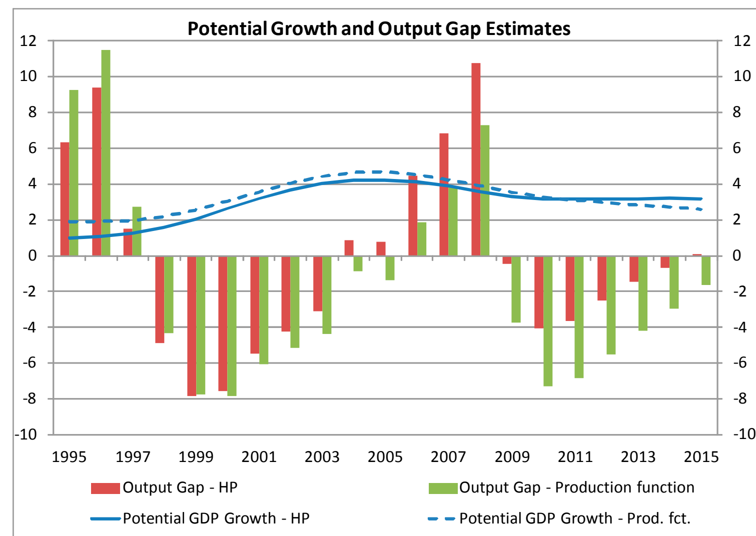
Historically, economic growth has been largely driven by investment. The accumulation of capital explains most of output increases up to the crisis year. During the latest strong-growth period, labor input also provided additional growth stimulus but the contribution of Total Factor Productivity (TFP) was slightly negative. In 2009, the contribution of capital fell substantially but remained positive. The strikingly negative contribution of total factor productivity appears to reflect the crisis situation, implying a severe reorganization of the economy. Near-term economic growth is expected to follow the same historical pattern with capital accumulation being the main source of growth.

Contribution to GDP Growth

	Real GDP	Growth contributions (pps.)		
	growth (%)	Capital stock	Labor	TFP
Average 1993 – 99	0.6	2.3	-1.2	-0.5
Average 2000 – 04	5.5	2.5	-0.2	3.2
Average 2005 – 08	6.4	6.1	0.4	-0.3
2009	-7.1	2.9	-0.9	-9.5
Average 2010 – 15	*2.9*	*3.4*	*-0.1*	*-0.4*

Source: IMF staff estimates. Figures in italics refer to potential growth.

The global crisis and the economic recession will take their toll on Romania's growth capacity. The global economic crisis and the sudden stop in capital flow triggered not only the steep recession in 2009 but also a more permanent slowdown in potential output growth as the financial crisis affected investment and productivity.[1] In addition, a large part of the recent increase in unemployment could be transferred into higher structural unemployment, as a result of hysteresis effects. All these factors are likely to have a lasting negative long-term impact on potential output. Potential growth is estimated at around 3% until 2015, down compared with 4 to 5% in recent years.[2] Projections also indicate that the output gap could close around 2015.



[1] Reduced financing will affect capital accumulation through lower investment rates, and total factor productivity through the credit crunch and lower investment in research and development (R&D).

[2] Results are quite similar using a Hodrick-Prescott filter or a production function approach.

III. Short-Term Issues and Program Implementation

The program remained broadly on track in Q1, but weak revenue and a build-up of spending pressures pointed to significant deviations for the remainder of the year. Even after adjusting for weaker GDP growth, additional consolidation measures were necessary to reach the end-year targets. As domestic demand plummeted, core inflation fell allowing the NBR to pursue prudent monetary easing. The financial sector reacted well to the international support package, but banks face the challenge of rising NPLs and potential liquidity pressures.

A. Performance Under the Program

16. **Most first quarter program targets were met, but mounting expenditure pressures and weaker-than-expected revenue collection caused fiscal targets to be missed and jeopardize compliance with end-of year 2010 targets.** The government missed the end-March fiscal deficit target by a small margin, and once again missed the target on domestic payments arrears (for which they request waivers). Revenues fell far short of programmed levels, forcing the authorities to slash discretionary outlays in March in an attempt to reach the target. All other quantitative performance criteria were met by ample margins, as were the indicative targets on general government current expenditure and operating losses of SOEs (LOI ¶2).

17. **All structural benchmarks for the review have been met** (Table 2)**.** On the financial side, banking legislation was modified to increase the authority of the special administrator to implement promptly a broad range of measures in bank resolution, including purchase and assumption, sales of assets, and transfer of deposits while taking into account the provisions of EU company law. The NBR's decision-making power with respect to the proceedings to deal with an insolvent credit institution was strengthened and the Deposit Guarantee Fund claims were provided with the same seniority as claims of depositors. On the fiscal side, the Fiscal Responsibility Law was approved by Parliament, legislation on SOEs to improve their accountability has been enacted, and the first stage of the tax administration reforms has also been approved.

Box 2. Romania: Stand-By Arrangement

Access: SDR 11.443 billion.

Length: 24 months.

Phasing. SDR 4.37 billion was made available upon the Board's approval of the arrangement on May 4, 2009, and the second tranche of SDR 1.718 billion was made available upon completion of the first review under the SBA on September 21, 2009. The third and fourth tranches amounting to SDR 2.175 billion were disbursed after the combined second and third reviews on February 19, 2010. The fifth tranche amounting to SDR 768 million will be made available subject to the completion of this review. The three subsequent disbursements, totaling SDR 2.412 billion, are contingent upon completion of further quarterly reviews, starting from mid-September, 2010, mid-December 2010, and mid-March 2011.

Conditionality

- ***Quantitative Performance Criteria***
  - A floor on the change in net foreign assets
  - A ceiling on general government domestic arrears
  - A floor on the overall general government cash balance
  - A ceiling on general government guarantees
  - Non-accumulation of external debt arrears

- ***Quantitative Indicative Target***
  - General government current primary spending
  - Operating balance of the 10 largest loss-making SOEs

- ***A consultation band around the 12-month rate of inflation of consumer prices***

- ***Prior Actions***
  - Enactment of agreed fiscal measures for 2010 (¶7 in the Letter of Intent). *Prior action for Board consideration of fourth review.*

- ***Structural Benchmarks***
  - Passage of fiscal responsibility law. *By March 31, 2010*
  - Passage of amendments to the banking and winding up laws. *By March 31, 2010*
  - Approval of tax administration reforms. *By April 30, 2010*
  - Legislative changes to improve monitoring and control of SOEs. *By June 30, 2010*
  - Approval of local government finance reforms. *By June 30, 2010, proposed to be moved to September 30, 2010.*
  - Passage of revised pension legislation. *By June 30, 2010.*
  - Passage of implementing public wage legislation. *By September 30, 2010.*
  - Reforming DGF's funding and governance regime. *Proposed for September 30, 2010.*
  - Reform of tax administration methodology for high net wealth individuals. *Proposed for November 30, 2010*
  - Integration of accounting reporting system with the Treasury payment system. *Proposed for March 31, 2011*

B. Fiscal Consolidation

18. **The first quarter fiscal performance was disappointing.** Cumulative tax receipts in the first quarter of 2010 were not only lower than anticipated (by 0.4 percent of GDP), but also lower compared to the same period in 2009. The revenue shortfall, stemming mainly from lower VAT revenues and social security contributions, was partly due to weaker-than-expected economic activity and still rising unemployment, but also to lower yields as tax evasion, especially in excises, appears to have increased substantially. While cash expenditures were held to well below program in an attempt to meet the Q1 target, underlying expenditure pressures accumulated. Pension and other social outlays were significantly higher than anticipated, and promised cuts in goods and services spending did not materialize, due in part to significant overruns in the health care system. The increase in arrears also reflected accumulated expenditure pressure, despite the authorities' commitment to remedial measures.

19. **Reaching the original end-year targets proved unrealistic**. The downward revision in economic conditions, falling revenue yields, and the sharply higher projected expenditures in goods and services, pensions and social transfer payments, combined to move the program's deficit target of 5.9 percent of GDP well out of reach. In the absence of compensatory measures, staff estimated the deficit would have climbed to 9.1 percent of GDP. Of this deterioration, roughly 0.8 percent of GDP is due to lower economic growth and a statistical revision in the size of GDP, 1.3 percent of GDP is due to expected expenditure overruns (including paying down arrears), and 1 percent of GDP due to falling revenue yields. Staff and the authorities agreed to adjust the target to 6.8 percent of GDP to accommodate for the cyclical deterioration of the economy and the statistical revision of GDP without endangering the medium term credibility of the consolidation path.

20. **Attaining even the adjusted deficit target required measures totaling 2.3 percent of GDP in 2010.** Staff and the authorities discussed a number of different possible revenue and expenditure packages to close the gap, with staff advocating a greater reliance on revenue measures. However, the authorities opted for a package focused almost entirely on radical expenditure cuts to meet the revised program target. Their adjustment measures consist of expenditure cuts of roughly 2 percent of GDP, including a 25 percent cut in public sector wages and 15 percent reduction in pensions and transfer payments (LOI ¶7).[4] Public staffing will continue to be streamlined. Moreover, structural reforms in the health system, pensions, education, and local government finance will generate further savings and assist in consolidation efforts going forward (LOI ¶12, 17–20). In addition, revenue-boosting measures of 0.3 percent of GDP will include widening the tax base, improving tax enforcement and introducing a turnover tax on medical suppliers (see text table). The authorities recognized that

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[4] Due to legal concerns about the cuts in wages and social transfer payments, the authorities have specified in the law (now pending in the parliament) that the specific reductions will be in effect until end-2010. However, the law also specifies that the 2011 budget limits for wages and social transfers will be set on the basis of the new, lower outlays, assuring continuation of the reductions.

the heavy emphasis on expenditure cuts posed political and implementation risks. Political opposition could scuttle the measures in parliament, and likely court challenges could delay or derail implementation. For this reason, they agreed that enactment of the measures would be a prior action for conclusion of the review and committed to implementing revenue measures if their expenditure cuts are not applied or fall short (LOI ¶7).

Fiscal program (in percent of GDP)

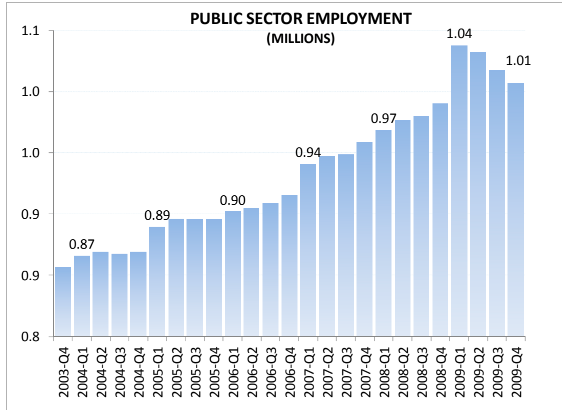
	2010
Overall deficit - revised macroframework, no new measures	9.1
Overall deficit - revised program	6.8
Required adjustment effort, *of which:*	**2.3**
Reduction in personnel spending (25% compensation cut)	1.0
Reduction in social assistance (15% cut)	1.0
Other cuts in spending (transfers, subsidies)	0.4
Lost taxes due to wage and social transfers cuts	-0.3
Broadening of the tax base	0.1
Net lending repayment	0.2
Turnover tax on medical distributors	0.0

21. **The authorities took some steps to mitigate the impact on the most vulnerable.** The minimum pension will remain unchanged and no pensions will be cut below that level. There will also be no reduction in the minimum wage and workers near that threshold will be protected from falling below it. To mitigate the social consequences of cutting social transfers, less efficient social assistance programs will be cut by more so as to allow for lesser reductions in better targeted programs. Social assistance programs will also be reformed to better target the poor and most vulnerable as agreed with the World Bank.

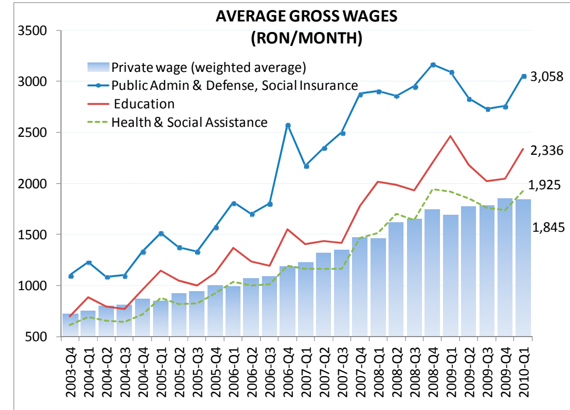
22. **While substantial, the cuts in personnel compensation and social transfers mostly reverse recent increases.** In 2005–2008, spending on public wages and pensions nearly doubled and public wage growth has outpaced growth in private wages (see figure below). A cut of 25 percent in personnel compensation would result in compensation falling to between 2007 and 2008 levels in nominal terms and the 2006 level in percent of GDP. A 15 percent cut in pensions would put pensions back at the 2008 level. In addition, many social assistance programs are poorly targeted and have witnessed large increases as well (about 10–40 percent growth in 2008–2009 for some large programs). The authorities argued that their expenditure-based consolidation program was superior to one including tax increases because it directly addressed the expenditure boom that generated the fiscal gap, notwithstanding distributional concerns about the adjustment falling mainly on public employees and recipients of social transfer payments. Staff broadly supported public wage cuts, but expressed the view that increases in broad-based taxes would spread out the adjustment burden on a wider group than the cuts in social spending. In addition, the mission suggested that reductions in public employment and a more targeted restructuring of the social benefits and health system would yield better results. The authorities agreed in principle, but noted that such reforms take time; meanwhile, they preferred spending cuts to tax increases. In the mission's discussions with trade unions, union leaders generally recognized the need for significant fiscal adjustment, but stressed their preference for greater reliance on revenue measures (particularly progressive taxation) with more gradual expenditure reductions.

Romania: Pension and Public Wage Developments, 2004-10

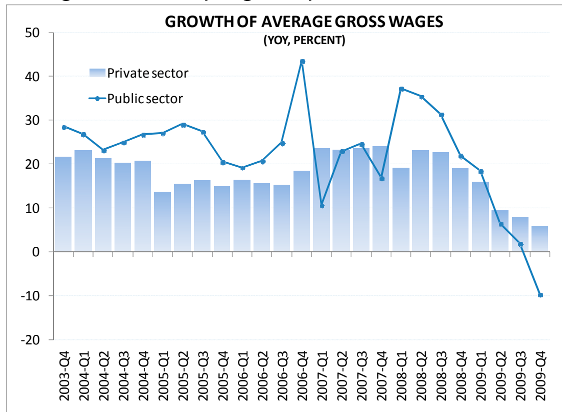
Public employment increased significantly in 2004-08, with some correction since the start of the program in 2009



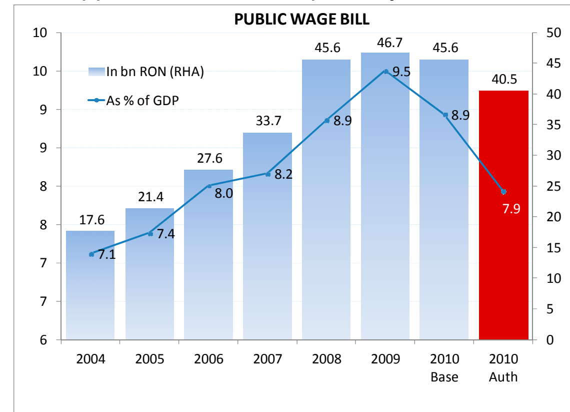
Wages in the public sector are higher than in the private sector, especially for public administration & defense



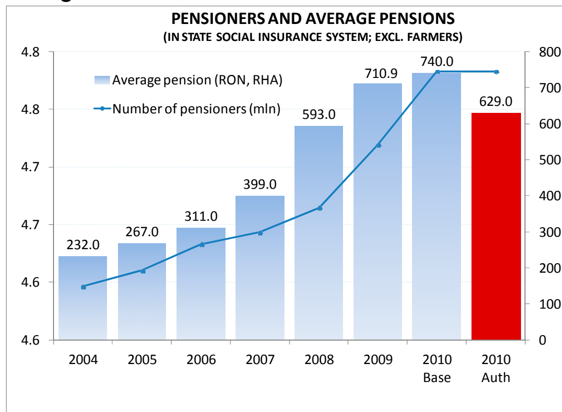
…and historically they grew much faster, except during the recent program period



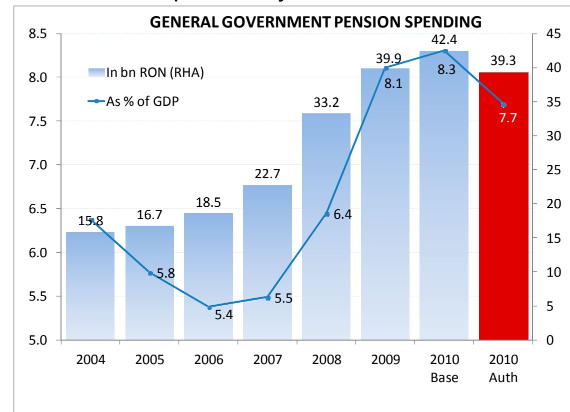
As a result, the public wage bill increased by over 2pp of GDP over the past 5 years



Public pensions increased significantly during 2008-09, as did the number of retirees



This pushed the public pension bill up by 3pp of GDP over the past two years



Source: Haver, National Forecasting Commission, and staff estimates.

23. **The authorities are struggling with the chronic problem of domestic arrears.** The stock of arrears has increased since the beginning of the year mostly due to increases in the health sector and central government, which caused them to miss the program target yet again in March, 2010.[5] Efforts to control arrears in late 2009 and early 2010 were swamped by falling revenues at all levels of government, leaving little cash to clear arrears while covering ongoing expenditures. The authorities indicated that they will take further steps to address the arrears issues both at the central and local government levels. First, at the general government level, more spending will be allocated in the budget this year to clear health arrears and a restructuring plan is underway to contain arrears growth in the future. Line ministries will monitor their subordinated units to observe commitment ceilings and sanctions for breaching limits will be enforced. Second, at the local government level, the government plans to use swap agreements to clear mutual debts between local authorities and public enterprises.[6] Going forward, the amendments to the local public finance law (structural benchmark end-September 2010) will preclude the accumulation of overdue payments. In addition, the authorities plan to integrate the accounting reporting system with the Treasury payment system (structural benchmark for end-March 2011) to improve monitoring commitments and assist in budget management and control (LOI ¶10). The authorities have made progress in recent months in reducing arrears in VAT refund payments to exporters.

24. **The authorities made progress on fiscal structural reforms.** The Fiscal Responsibility Law was approved by parliament (end-March structural benchmark). Legislation to improve the accountability of SOEs has been approved in early 2010, significantly ahead of the end-June structural benchmark. The authorities are committed to refining the Unified Wage Law (UWL) approved in 2009. They indicated that work on the implementing legislation on the UWL is progressing and that they expect to be able to meet the September program target. To further reduce pressures on the wage bill, the government has committed to reducing personnel by another 70,000 by January 2011 on top of a reduction of roughly 30,000 since late 2009; has already restructured about 100 state agencies; and a functional review of major ministries is being carried out by the World Bank. Sustained efforts to improve revenue collection and streamline tax administration operations are being continued with support of the IMF technical assistance missions in 2009-10, and the first stage of these reforms, focused on noncompliance and increasing control of largest taxpayers, has been approved as part of the end-April structural benchmark (LOI ¶13). Further reforms in tax administration will focus improving methodologies to identify and audit unreported income, especially of high-income individual taxpayers (proposed structural benchmark for end-November 2010; LOI ¶13), and on combating other forms of tax evasion. Supported by IMF

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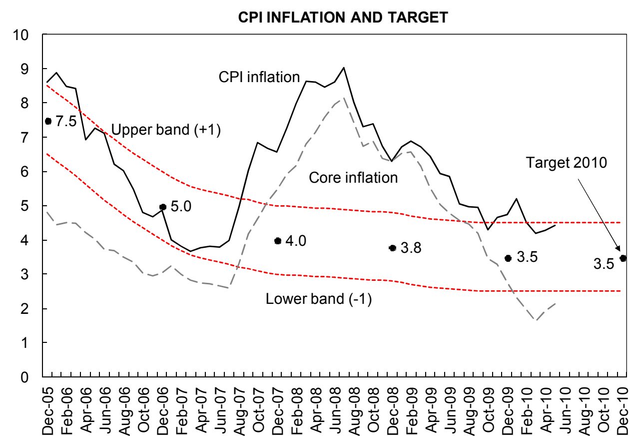
[5] In particular, arrears rose in the health sector as the health authorities had negotiated agreements in 2009 to allow for deferred payments on medicines and supplies. These deferred payments are coming due in 2010, adding to pressure on arrears.

[6] The swap arrangement would involve mutually cancelling overdue tax obligations of public enterprises with arrears owed to those enterprises by the general government.

technical assistance in April 2010, the government is also preparing amendments to the Local Public Finance Law to mitigate potential fiscal risks from local governments; to allow additional time for improving the draft legislation, the associate structural benchmark is proposed to be moved from end-June to end-September, 2010 (LOI ¶11–17).

C. Price Developments and Monetary Policy

25. **The widening output gap helped reduce core inflation but supply factors sustained headline inflation.** Core inflation fell from a peak of 8.1 percent in mid-2008 to 2.1 percent in May 2010 due to weak demand and receding exchange rate pressures. The decline in headline inflation lagged, however, preventing the central bank from meeting its inflation target in 2009 for a third consecutive year. Factors boosting the headline rate included significant hikes in tobacco excises (which contributed about 2 percentage points out of 4.7 percent at end-2009), direct and indirect pass-through of the 15 percent leu depreciation early in 2009, as well as administrative price adjustments. These supply shocks accounted for the observed persistence in headline inflation over the past few years, and their second-round effect on core prices prevented a faster disinflation in response to weakening demand (see Figure 5 and Analytical Note 1).

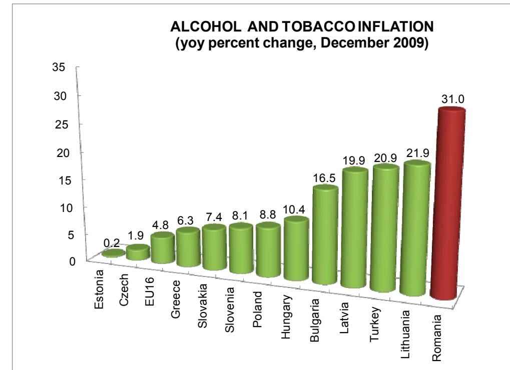


26. **As inflationary and exchange rate pressures abated, the NBR was able to ease monetary policy in response to the crisis.** Interest rates were cut by 400 basis points since February 2009 to 6.25 percent, reserve requirements were reduced significantly (in particular on foreign currency liabilities), and the NBR provided ample liquidity to the banking system, especially through repo operations. A more aggressive relaxation was hindered by the need to maintain inflation expectations in check given the persisting high headline inflation and by exchange rate concerns in early 2009.

27. **There is room for further prudent monetary easing in the near future, provided subdued inflationary pressures and weak demand conditions persist** (Figure 5). Inflation is projected to fall to about 3¾ percent by end-2010, close to the middle of the authorities' range of 3½ percent ±1 percentage points, as the impact of the supply shocks largely dissipates. Risks to the inflation outlook are broadly balanced: cyclical factors should continue to put downward pressure on inflation, while domestic food prices will reverse their negative contribution to inflation, with further upward risks from continued increases in world energy prices and adjustments in regulated prices. Potential pressures from regional economic uncertainties and unsettled financial markets also argue for a measured approach to further easing.

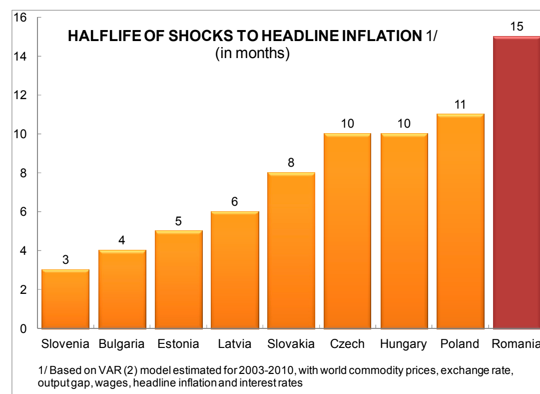
Box 3. Inflation in Romania: How Persistent?

Headline inflation in Romania has remained high relative to its EU peers over the past two years, despite the collapse in demand during 2008-09, raising the question of why it has been so persistent. In part, the high inflation can be attributed to supply shocks. During 2009, Romania's adjustment in tobacco excise duties to EU requirements has been among the largest in the region and added some 2 percentage points (of the 4.7 percent) to the headline inflation at end-2009. The exchange rate depreciation (~15 percent), has also been among the largest in the region, further fuelling inflation. However, core inflation has also remained high relative to the peers and started to decline only in late 2009. Has inflation in Romania been intrinsically persistent, or do supply factors account fully for the high inflation in recent years?



Standard measures of inflation persistence—such as the sum of autocorrelation coefficients in univariate autoregressive models—show that headline and core inflation in Romania are not more persistent in the long run than their regional peers and that inflation inertia has decreased significantly after the introduction of inflation targeting regime (see Analytical Note 1).

However, it does appear that headline inflation is relatively sticky. For example, the half-life of a shock to headline inflation in Romania—i.e. the number of periods it takes for a shock to dissipate to below half of its original magnitude—is 15 months in Romania, compared to 10⅓ months in other inflation targeters and 5.2 months in countries with fixed exchange rate regimes (chart). This suggests that the main source of the persistence in headline inflation lies in the sluggishness of "noncore" items such as tobacco and food. Indeed, inflation in these subindices of the CPI has been among the most persistent. It also suggests that while monetary policy focus on core inflation is appropriate, it should not fully accommodate supply shocks (such as food or tobacco inflation) because of their second round effects on underlying inflation. The findings imply a favorable outlook for meeting the inflation targets going forward, as the direct and second-round effects of the 2009–10 supply shocks have largely dissipated. The main upward risks are continued increases in world oil prices and administrative adjustments in domestic gas and drug prices, which will also have strong second round effects on core inflation.



1/ Based on VAR (2) model estimated for 2003-2010, with world commodity prices, exchange rate, output gap, wages, headline inflation and interest rates

D. Financial Sector Challenges

28. **The deep contraction in economic activity during 2009 is taking a toll on the banking sector**. Non-performing loans continued to increase and rising provisions compressed banks' profits while lending to the private sector continued to contract. The rate of increase in impairments for consumer loans slowed, suggesting NPLs in this category may have peaked. However the system is still experiencing a rapid deterioration of loan portfolio quality in the small and medium enterprise and corporate sectors as bankruptcies are rising.

29. **Banks' capital levels continue to remain adequate as the NBR has proactively requested capital increases in a number of banks and shareholders have applied a conservative earning retention policy.** At the aggregate system level, the average capital adequacy ratio in the system rose to 14.03 percent at end-2009, against 13.77 percent at the end of 2008. At the level of individual banks, all banks have a capital ratio above 10 percent[7]. Moreover, while the capital ratios of some small banks did come under pressures, recent stress tests by the NBR showed that the current ratios are sufficient to withstand the expected deterioration in loan portfolios throughout 2010. In addition, for banks experiencing rapidly deteriorating asset quality, owners are expected to provide further resources in the course of the year.

30. **The parents of the largest foreign owned banks have largely complied with their commitment of maintaining their exposure to Romania.** While there are fluctuations, as a group the nine banks have broadly maintained their exposures to Romania in the 12 months to March 2010. However, as market conditions have stabilized, representatives from some banks favor a gradual easing in the exposure limits that would be consistent with internal risk-management models and credit developments while continuing to provide capital buffers to ensure strong solvency and support confidence.

31. **The authorities have been preparing for the possibility of spillovers from market volatility.** Existing regulations require banks to have in place contingency plans as well as plans for alternative financing. The supervision department of the NBR has been reviewing such plans and ensuring they encompass credible assumptions. NBR has also been strengthening its liquidity operations framework. It has enhanced its liquidity monitoring including through the reporting of assets and liability's maturity breakdown by currency and has reviewed emergency lending arrangements, which are available to all banks, foreign- and domestic-owned. In addition, the NBR has taken steps to broaden the range of acceptable

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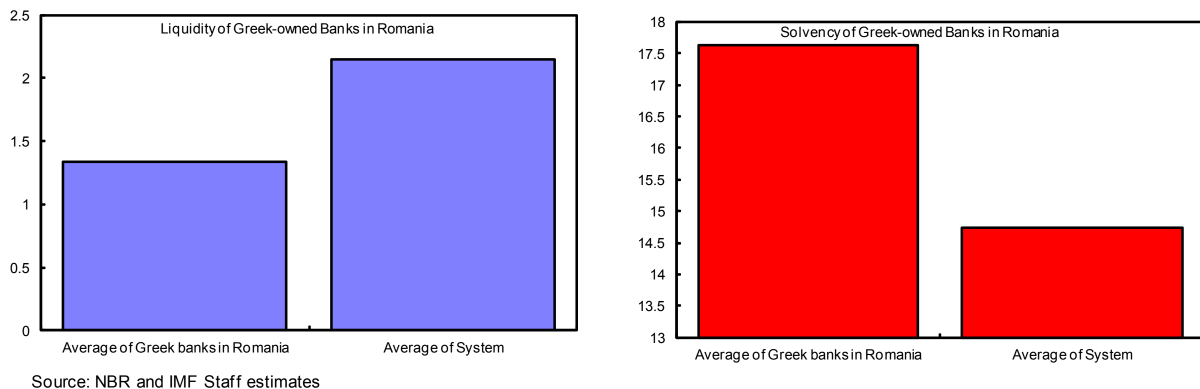
[7] The regulatory minimum for the capital adequacy ratio is 8 percent.

collateral for refinancing operations at the central bank. As other European central banks, the NBR has made contingency plans to address episodes of financial distress.

32. **The authorities have been keeping close watch on the developments in Greece.** They are aware of the possibility of liquidity pressures and have intensified liquidity monitoring of all banks in the system. Although some pressures have appeared, evidenced in particular by increased deposit rates, the liquidity position of the subsidiaries of Greek banks remains in line with that of the rest of the system. As for capitalization, the average capital ratio for the subsidiaries of the Greek banks' is higher than the average of the banking system. In effect, Greek parent banks have proactively increased capital resources, while the ratio of NPLs to total loans is also lower than average. Subsidiaries of Greek banks in Romania constitute roughly 20 percent of system assets.



Source: NBR and IMF Staff estimates

33. **To further support confidence, authorities are strengthening the Deposit Guarantee Fund**. The NBR will draft amendments to the legal framework of the Deposit Guarantee Fund that will: (i) improve its governance to assure that no official of a credit institution sits on its board; and (ii) improve the funding regime with a view to enhancing confidence in the system by increasing both the actual and targeted coverage ratio and by eliminating contingent credit lines by banks (structural benchmark for end-September 2010; LOI ¶24). The process will begin with an increase in banks' *ex ante* contribution rates.

34. **The NBR is striving to enhance the banking supervisory framework**. Technical support from the Monetary and Capital Markets Department of the IMF has been requested to further strengthen the stress test methodology in different risk areas (LOI ¶22). The prudential framework is considered adequate to address the current challenges and no amendments are currently envisaged. Under the SBA arrangement, the authorities agreed to consult Fund and European Commission staff prior to the introduction of new or revised key prudential regulations. Formally raising the minimum level of the capital adequacy ratio from 8 percent to 10 percent remains a medium-term objective (LOI ¶25) while the authorities remain committed to adopting the International Financial Reporting Standards (IFRS).

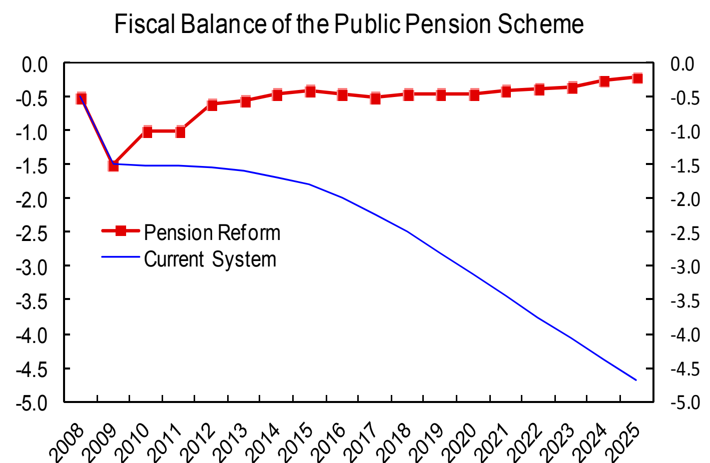
IV. Medium-Term Perspectives: The Challenge of Achieving Sustainable Growth

Romania faces three main challenges over the medium- and long-term to assure sustainable economic growth: First, policies must be put in place to assure the resolution of the macroeconomic imbalances generated in the run-up to the crisis. While the forced adjustment of the crisis has brought an abrupt correction to external imbalances, additional policy action is needed in coming years to eliminate the internal fiscal imbalance and forestall a reemergence of competiveness problems and an unsustainable current account. Second, as with other new member states of the EU, Romania has the medium-term objective of accession to the euro area which requires nominal convergence to the Maastricht criteria. Third, nominal convergence should be coupled with real convergence—that is to say sustainable growth to bring Romanian living standards more into line with EU averages. For both nominal and real convergence, Romania must improve the flexibility of the economy and increase its potential growth rate through structural reforms in labor, product, and investment markets, and increase investment—particularly in infrastructure.

A. Medium-Term Fiscal Consolidation

35. **Optimizing fiscal policy in the medium term should aim at creating conditions for stability and growth via low deficits and controls on current spending that free up resources for investment.** Although Romania's public debt level has risen only to about 30 percent of GDP at the end of 2009, high levels of deficit in future would preclude euro area accession and risk incurring higher interest costs and adversely affecting the private sector. While considerable effort has been expended in 2009–2010 to reverse the unsustainable pre-crisis fiscal policies, additional medium-term fiscal consolidation is required to avoid a return to pre-crisis overheating and external imbalances and to deal with the future spending pressures of an aging population. In addition, creating fiscal space through consolidation and reorganizing expenditures towards capital spending will help boost growth through better infrastructure and less waste of public resources. Structural reforms will help realign the public sectors' spending obligations with its resources while improving its efficiency. Key elements in the medium-term fiscal adjustment strategy should include:

Fiscal Balance of the Public Pension Scheme



- *Pension reform.* The authorities should follow-through with planned reforms in pensions, including the pension reform law currently in parliament and the move to

build up the pillar two private pension system. The proposed reform will in the long run save several percent of GDP per year, bringing the public system nearer to break-even status.

- *Reforms to permanently rein in the wage bill.* While the authorities' 25 percent cut in wages in 2010 will generate a major improvement in the fiscal balance, it is not a substitute for a comprehensive restructuring of public employment and pay. The already adopted unified wage law aims not only at reversing the exponential growth of the wage bill, but also to improve the simplicity, transparency, and fairness of public compensation. Approval of follow-up legislation to implement a new system will be crucial for medium-term fiscal sustainability. The increase in public employment of some 250,000 during the pre-crisis period should also be reversed over time.

- *Reforms of social spending.* Much of the spending pressure affecting the fiscal accounts in 2010 stems from poorly targeted and inefficient social spending, including poverty assistance, the health care system, and education. The authorities need to press ahead with their plans on reforming social assistance programs, streamlining the number of programs and improving the targeting and incentives in the remaining ones. Efforts already beginning to improve the efficiency and outcomes of the health and education systems should continue.

Box 4: Fiscal Responsibility Law: A Major Reform of the Budget Process

Romania's current budget process limits the government's ability to run prudent fiscal policy. The budget process is largely an unconstrained expenditure driven process and has an annual focus. The controls on fiscal outcomes are weak with poor forecast of revenues and expenditures, absence of credible and binding expenditure ceilings, and numerous budget revisions during the year. The government uses notional medium-term expenditure framework as the budget process starts afresh every year without giving due consideration to the previous year's expenditure estimates as a guide for setting ceilings and preparing budget submissions. In addition, supplementary budgets are enacted several times a year (five in 2008), usually reallocating resources from capital to current spending and even resulting in higher deficits.

The Fiscal Responsibility Law (FRL) approved by Parliament at end-March is designed to strengthen fiscal discipline, provided political commitment exists. The FRL should help improving medium term fiscal planning, budget formulation and execution, transparency of the budget process and accountability through the following key elements:

- **Implementing fiscal rules.** Fiscal rules such as expenditure ceilings and fiscal balance limits will guide the government in setting expenditure envelopes. As a result, the government has to engage in the process of prioritizing expenditures, especially if any extra spending is desired. In addition, over the economic cycle, the fiscal balance has to be in surplus or in balance, thus requiring the government to run a prudent fiscal policy in good times to compensate for any deficit in recessionary times.
- **Requiring supplementary budgets.** With two supplementary budgets per year, the budget planning and execution should improve. The first budget revision can be submitted no earlier than July of each year, and the total budget envelope cannot be increased.
- **Upgrading reporting requirements and raising accountability**. Reporting requirements will allow the government to analyze fiscal policy implementation, adjust policy accordingly, and provide accountability and transparency. In its current form, various data are gathered and presented but analysis is lacking. Half-yearly and annual reports on economic and budget outlook should provide a platform to analyze the developments and suggest changes, if any. The establishment of an independent Fiscal Council should help raise accountability.

B. Better Infrastructure

36. **Poor quality of infrastructure is one of the impediments to Romania's competitiveness and long-run growth.** Poor infrastructure is in part a result of limited fiscal space for undertaking large scale capital projects; lack of an adequate framework for capital budgeting to evaluate, prioritize and monitor public infrastructure projects, which leads to inefficiency and waste in public investment spending; significant state involvement in the energy and transportation sector; and an underdeveloped market for long-term financing which precludes private sector involvement in capital projects.

37. **Improvements in infrastructure will be key to boosting Romania's long-term growth**, both through its direct impact on the capital stock and through its competitiveness-enhancing effects. This could be achieved in a number of ways:

- *Creating fiscal space.* Fiscal consolidation is already underway, and its focus on reductions in current spending will have to be sustained over the medium-term in order to create additional fiscal space for infrastructure investment. At the same time, large EU grants for capital projects are already available to Romania and priority should be given to increasing their absorption by: (i) enhancing technical capacity to develop qualifying proposals; (ii) strengthening submission requirements for domestically funded capital projects; and (iii) improving procurement procedures to prevent challenges in courts that stall projects.

Romania needs to boost the absorption of EU funds

in € million	EU commitments (2007-2009)	Automatic payments by the Commission	Payments based on claims subject to Commission approval	Interim payments in % of commitments
Regional development Fund	2,616.01	807.88	93.10	3.56
Social Fund	1,084.86	331.57	0.34	0.03
Cohesion Fund (energy and transport)	1,941.87	668.00	0.73	0.04
Agriculture and rural developement Fund	2,589.56	561.58	315.22	12.17
Fishery Fund	67.44	37.29	0.00	0.00
All structural Funds	8,299.73	2,406.32	409.38	4.93

- *Using existing fiscal space efficiently through improved capital budgeting.* The recently approved Fiscal Responsibility Legislation should help improve the capital budget process through focus on multiyear budgeting, but additional reforms will be needed to: (i) improve the prioritization of projects; (ii) review the existing portfolio of projects and rationalize it to focus on priority projects, with others deferred or discontinued; (iii) ensure adequate funding for priority projects; (iv) setting a database of proposed and approved capital projects ranked by economic and financial

return; (v) strengthen the project appraisal and review process through the establishment of independent review teams; and (vi) improve the transparency of capital budget project selection and performance by publishing regular updates on MOF website.

- *Reducing state presence in electricity and transportation sectors*. Divesting state holdings in these sectors will not only reduce support to loss-making state enterprises, but will also improve efficiency by attracting private capital. The authorities have indicated their intention to reactivate the privatization program, especially in industry, energy, and transport. The government intends to wind-up the energy firm Termoelectrica, privatize the cargo rail firm, complete the privatization of additional firms via the privatization agency AVAS. The Ministry of Economy will also initiate the sale of minority stakes in several firms under its control. It envisages phasing out subsidies for coal mining by the end of this year and developing an exit strategy to be achieved within the next 5 years.

C. Competitiveness Issues

38. **Boosting competitiveness requires bringing inflation down and ensuring that wages are set consistently with productivity growth.** Staff analysis shows a recent improvement in REER indicators. The results of three standard quantitative methods show a sharp reduction in REER overvaluation from the 2007 peak and, on balance, suggest only a modest, but manageable, overvaluation of the currency. Both the equilibrium real exchange (ERER) and macroeconomic balance (MB) methods show a sharp reduction in REER overvaluation from the 2007 peak. And while these methods indicate medium-term overvaluation between 5½ and 13½ percent, such overvaluation is not statistically significant at standard levels of confidence. The external sustainability (ES) method also suggests a moderate overvaluation if Romania were to target an NFA level of -53 percent of GDP, determined on the basis of its openness level. Romania has made rapid gains in both EU and global export markets shares, mainly due to a rapid increase in non-textile manufacturing exports, and has also increased the share of medium-and high tech exports. However, Romania's economy-wide unit labor costs (ULCs) have increased at a much faster pace than in other new EU member states and while wages in the manufacturing sector remain among the lowest in the region, so does hourly productivity (see Analytical Note 3).

Romania: Quantitative REER Assessment

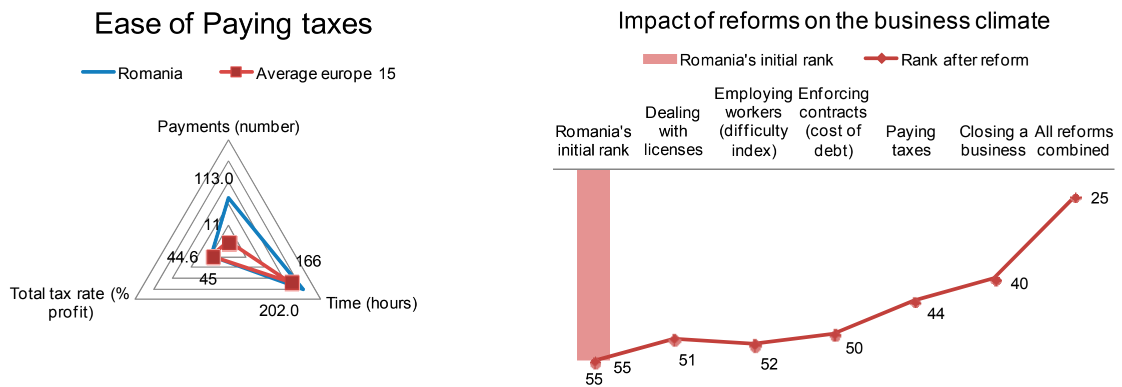
Approach	Magnitude of Misalignment
Equilibrium Real Exchange Rate	Overvalued: 13½ percent 1/
Macroeconomic Balance	Overvalued: 5½ percent 1/
External Sustainability	Overvalued: 5¼ percent 2/
Overall assessment	**Overvaluation: 5-15 percent**

1/ Not statistically significant at 10 percent level.
2/ Level of misalignment for bringing the NFA level to -53 percent of GDP.

D. Structural Reforms

Business climate-essential for boosting investment

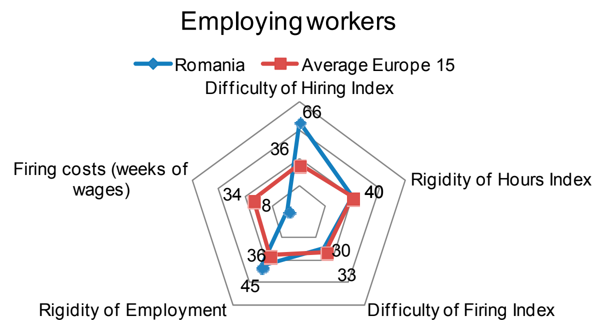
39. **Improving Romania's business climate would boost Romania's growth potential.** Romania lags behind other EU member States in terms of quality of business environment according to indicators on perceived corruption (Transparency International), ease of doing business (World Bank) or competitiveness (World Economic Forum). The EU's latest report on Romania's state of business climate notes mixed results while Romania slid down by ten positions on the World Bank's ease of doing business ranking in the past year. In particular, Romania has room for improvement in tax simplification, contract enforcement and hiring. The chart below shows the impact in terms of business-friendliness of reforms that would bring Romania to the average level of the Euro area countries in areas such as labor market, tax administration, and contract enforcement.



Source: World Bank; IMF Staff estimates

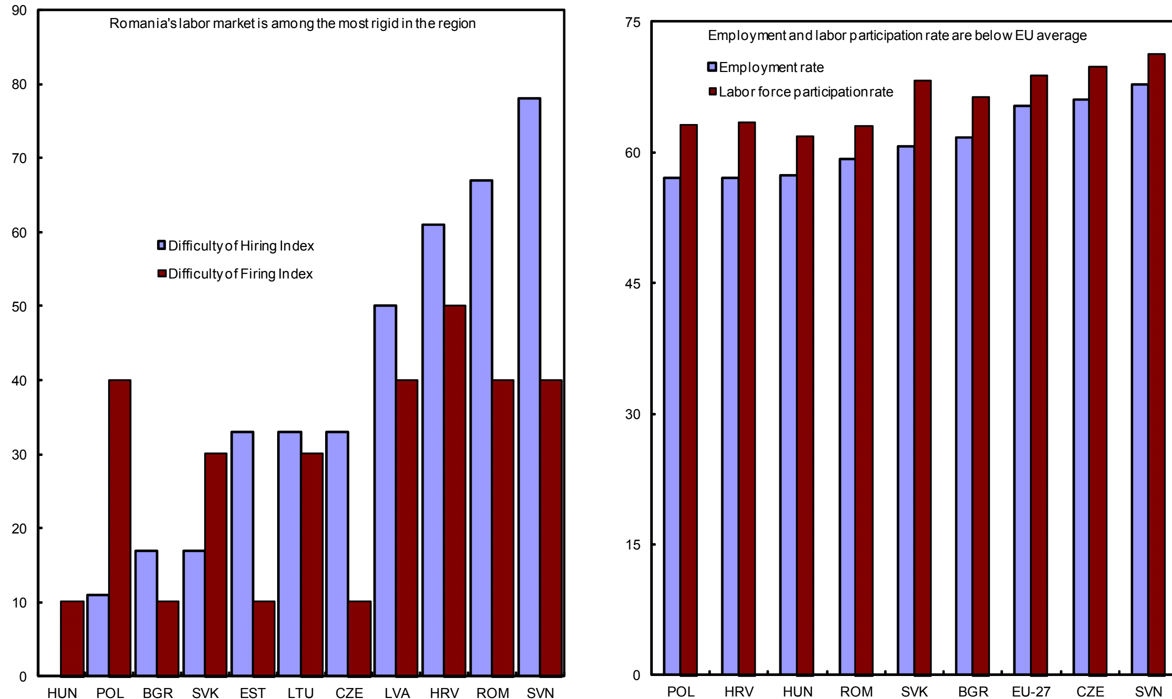
Labor market reform—improving hiring conditions and raising participation

40. **Raising Romania low labor force participation and employment rate would boost both current welfare and longer-term growth.** Romania has one of the lowest employment rates among EU countries. Lifting the Romanian employment rate (58.6 percent of the labor force) gradually to the average level in the EU (65.9 percent) while reforming the early retirement schemes would boost potential growth by about 0.6 percentage points, help with fiscal sustainability, and pension costs. Moreover, Romania's labor market is rigid compared to other countries in the region (see chart). Labor reforms should include helping low-skilled workers enter the job market and promoting senior labor. The authorities highlighted that Romania's draft pension reform includes changes in the incentives structure for early retirement. They also envisage modifying the



Source: World Bank; IMF Staff estimates

labor code in order to increase working time flexibility and to reduce hiring and firing costs. Effective vocational training could also help senior and low skilled workers rejoin the labor market.



Source: Eurostat and World Bank

41. **The authorities envisage a comprehensive education reform.** After four years of negotiations, a commission including all parties, unions and NGOs has signed the national education pact. The corresponding new education law (vote in parliament expected for end June) addresses several key challenges including a nationwide standard wage for teachers, an increase in teaching hours per teacher, a nationwide system to allocate means according to the number of pupils while at the same time all other decisions will be decentralized, including the implementation of after school activities and establishing competence centers. Education reform should contribute to fiscal consolidation while improving the productivity of the future workforce through better training.

E. The Road to Euro: The Need for Reforms to Improve Flexibility

42. **While Romania is officially committed to seeking entry into the Euro area in 2014–15, there is increasing recognition within the country that this timetable may be overly ambitious.** Entry into the Euro area in 2014 would require (i) joining ERM2 in 2011–12, which in turn would require the ability to sustain reasonable exchange rate stability, and (ii) adherence to the other Maastricht criteria. An overly ambitious timetable for adopting the

euro could be costly as entry into the euro area takes away important adjustment tools. While adopting the euro eliminates exchange rate risks for foreign-currency denominated loans and can help anchor inflation, it also comes at the expense of limited flexibility in response to future shocks and the danger of loss of competitiveness if domestic adjustment capacity is insufficient.

43. **Successful economic performance within the Euro area will depend upon the flexibility and productivity of the Romanian economy.** After adopting the Euro, Romania will need to rely on internal adjustment mechanisms rather than on monetary and exchange rate policy to deal with asymmetric shocks. Romania's trade is Euro-oriented but the structure of the economy is different and shocks are not fully synchronized with the EU (see Analytical Note 5). If business cycles are not synchronized, the higher potential costs of joining the monetary union need to be mitigated by other adjustment mechanisms which are as yet underdeveloped. Specifically, the loss of the monetary policy tool needs to be mitigated by flexible wages and prices, financial integration and a counter-cyclical fiscal policy which is effective in stabilizing the economy. The newly adopted fiscal responsibility law is a step forward as it will help anchor the deficit target in a medium-term framework incorporating expenditure ceilings but more needs to be done to boost productivity and flexibility.

V. PROGRAM MODALITIES AND OTHER ISSUES

44. **The attached Letter of Intent (LOI) describes the authorities' progress in implementing their economic program and sets out their commitments through end-December 2010**.

- *Some modifications to the program's conditionality are proposed* (Tables 1–2): (i) the end-June fiscal deficit targets will be modified to make them consistent with the new annual deficit target and the timing of the authorities' measures; (ii) the indicative target for current primary spending will be modified to make it consistent with the revised fiscal projections; (iii) the indicative target on the operating balance of certain state-owned enterprises will be tightened to make the target more binding; (iv) the reference baseline of multilateral disbursements for the adjustor on the NFA target will be modified to account for a revised schedule of disbursements; and (v) the structural benchmark on approval of reform measures to mitigate fiscal risks from local governments is moved from end-June 2010 to end-September 2010.

- *New structural benchmarks are proposed* (Table 2): (i) integration of the public accounting reporting system with the Treasury payment system (end-March 2011); (ii) measures to improve the tax administration methodology for high net wealth individuals (end-November 2010); and (iii) reform of the Deposit Guarantee Fund's governance arrangements and of the funding regime, including through an increase in bank contribution rates (end-September 2010).

45. **Program modalities**. The Fund arrangement remains adequate to meet Romania's balance of payment needs through end-2010, alongside financing commitments from the European Union and the World Bank. The estimated external financing needs for the year have declined somewhat against the backdrop of a faster-than-envisaged adjustment in the current account. However, staff has not proposed changes to the initially programmed phasing of disbursements given the fragility of the stabilization process and unsettled regional markets (Table 8).

46. **Use of Fund resources**. The authorities intend to draw the amount available at the completion of the review, and have agreed that the full amount will be used by the NBR for balance of payment support.

47. **Romania's capacity to repay the Fund is expected to remain strong.** Fund credit outstanding would peak in 2011 at 32.7 percent of gross reserves (Table 9). Peak payments would be in 2013–14 at a still manageable 12.4 and 13.3 percent of gross reserves, respectively. While this exposure remains large, the associated servicing risks are mitigated by the relatively low level of public debt. Direct public indebtedness is expected to remain relatively low (under 37 percent of GDP), with public external debt peaking at around 14 percent of GDP at end-2010 (Table 10). Total external debt is projected to increase to about 69 percent of GDP at end-2010 from 53 percent at end-2008, but the declining current account deficit and a return to economic growth would gradually reduce it to manageable levels in the medium term (Table 11). Romania's strong political commitment to the SBA program and its excellent track record servicing external obligations, also provide comfort that it will fulfill its financial obligations to the Fund in a timely manner.

48. **Fund staff has continued to cooperate closely with the staff of the European Commission (EC) and the World Bank (WB).** Fund, EC and the WB staff have consulted each other regularly regarding economic and policy developments in Romania, and they participated jointly in meetings with the authorities. The EC disbursed its second tranche of its support in March 2010 (€1 billion) and a third tranche is expected to be disbursed in September 2010 (€1.2 billion). The WB disbursed its first tranche (€0.3 billion) in October 2009, with the remaining tranches (€0.7 billion in total) expected in late 2010.

VI. Staff Appraisal

49. **The government decision to rely primarily on expenditure cuts to close the 2010 fiscal gap is ambitious, but entails implementation risks and generates distributional concerns.** While it is clear that an unsustainable rise in current spending was behind the pre-crisis increase in the fiscal deficit, legal and political challenges have made it very difficult to reverse spending increases in the past, particularly in wages and social entitlements. Attempts at expenditure cuts during the program in 2009 were hampered by these difficulties. Staff would have preferred a greater reliance on short-term revenue measures, together with a medium-term strategy to reduce current spending through wage

and pension reforms, which would have avoided some of these risks while achieving the same objectives. In addition, increases in broad-based taxes (such as VAT and income taxes) would likely have had less impact on the disadvantaged than the social spending cuts chosen by the authorities. That said, the sharp short-term cuts may facilitate an earlier return to fiscal sustainability and will help contain the share of public spending in GDP, which had risen sharply in recent years. Having decided on these difficult measures, the authorities should make every effort to ensure that these emergency cuts are translated into permanent adjustment.

50. **In the medium term, fiscal policy should aim at a more permanent reduction in fiscal deficit via reforms in current spending, while making room for growth-enhancing investment.** It is crucial that the expenditure reductions undertaken in 2010 become the base for future budgets—avoiding a rebound in spending in 2011. Pension and public wage reforms are essential if these ad hoc cuts are to be translated into lasting savings. However, with continued reductions in public employment and the enactment of pension, health and education reforms, the deficit would remain on a downward path to fall below the 3 percent Maastricht threshold in the medium-term without the need for major tax increases. The fiscal responsibility law is a welcome step towards avoiding ad-hoc intra-year adjustments that have happened in the past. In addition, streamlining and making the public administration more efficient while increasing it capacity to absorb EU funds, will be essential for sustained higher economic growth.

51. **The NBR has skillfully negotiated a path between the need for monetary easing to stimulate the economy and the need to contain exchange rate and capital flight pressures.** While they missed their end-2009 inflation target, inflation is on a declining trend. Inflation is now within the NBR's target band of 3.5 percent ±1 percentage point, and should remain there by end-2010. In staff's view, there is room for further prudent monetary easing in the near future, provided subdued inflationary pressures and weak demand conditions persist. However, the authorities will have to remain alert to renewed pressures on the exchange rate due to regional uncertainties. While there may be room for some additional depreciation, which would boost exports and help the economic recovery, large movements could have negative inflationary and balance sheet effects.

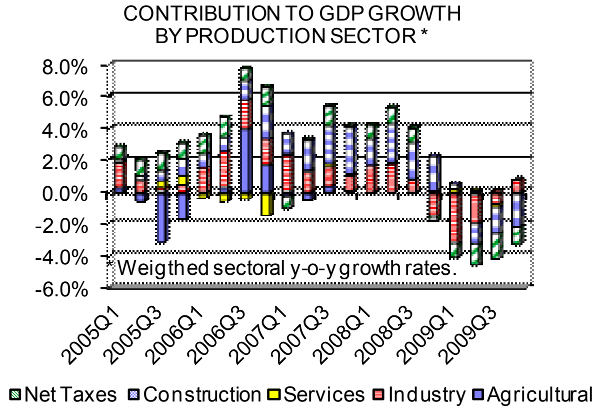
52. **The authorities' proactive banking supervision and regulation has helped maintain the stability of the financial system, but vigilance remains essential given potential risk from regional uncertainties and pressures from the economic downturn**. Funding levels in the banking system have remained stable and average capital levels are well above regulatory requirements, but pressures on capital will continue due to the impact of the economic downturn on credit quality. Staff recommends that the authorities continue to implement measures to preserve financial stability and carefully monitor risks that may arise from liquidity pressures.

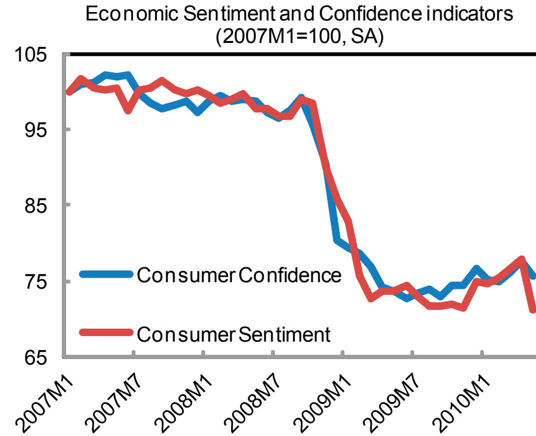
53. **Pressing ahead with structural reforms is required to prepare for eventual euro adoption.** Romania should not rush into ERM2, as its current economic structure is not well-adapted to the rigors of monetary union with countries whose structure and response to shocks is much different. Too-early entry into the Euro area could result in a loss of competitiveness and an inability to bounce back from future downturns. However, Romania should not postpone efforts to boost the economic flexibility and productivity. In particular, labor market reforms should help unblock the economy's rigidity and ensure that wages remain in line with productivity, while improvements in the business climate, privatizations, and better absorption of EU funds could boost investment.

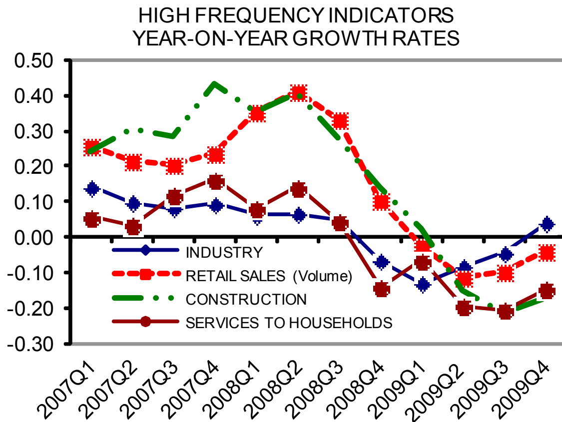
54. **On the basis of Romania's performance under the SBA, staff supports the authorities' request for completing the fourth review.** Staff also supports the approval of a waiver of nonobservance of the end-March 2010 performance criterion on the government's overall balance given the small nature of the deviations and the corrective actions undertaken by the government and of the performance criterion on the accumulation of domestic arrears on the basis of the corrective actions to be taken. Staff also recommends establishment of quantitative conditionality for end- September and December 2010, and approval of the modification of program conditionality, as proposed by the attached Letter of Intent.

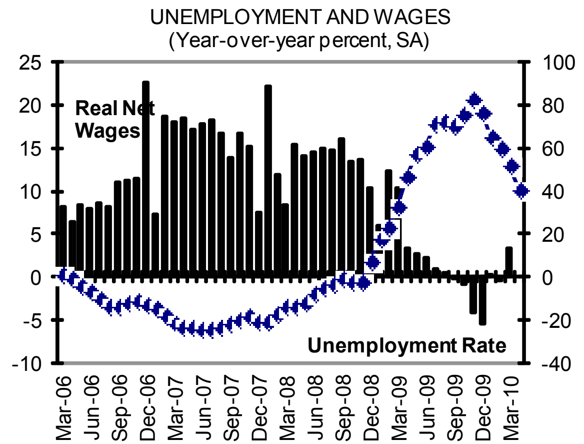
55. **It is proposed that the next Article IV consultation be held on a 24-month cycle, subject to the decision on consultation cycles in program countries.**

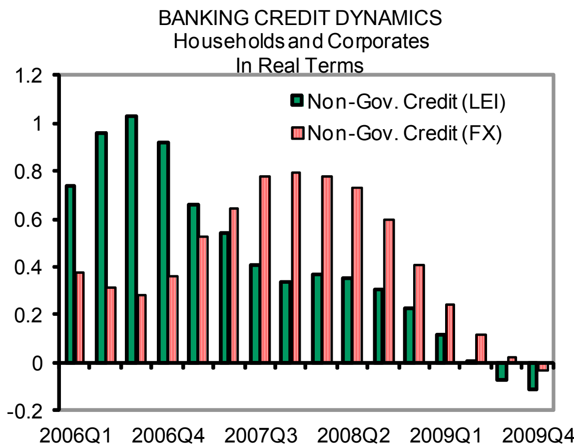
Figure 1. Romania: Selected Economic Indicators

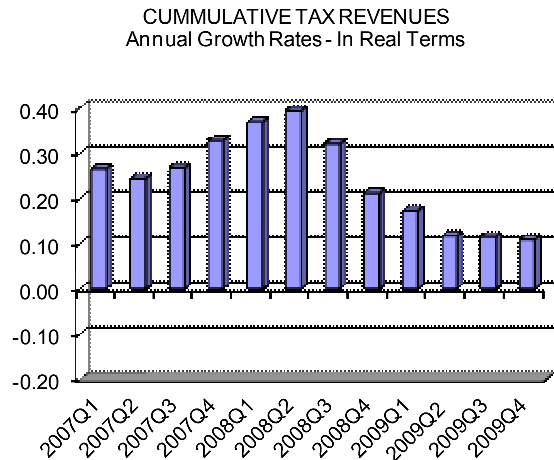






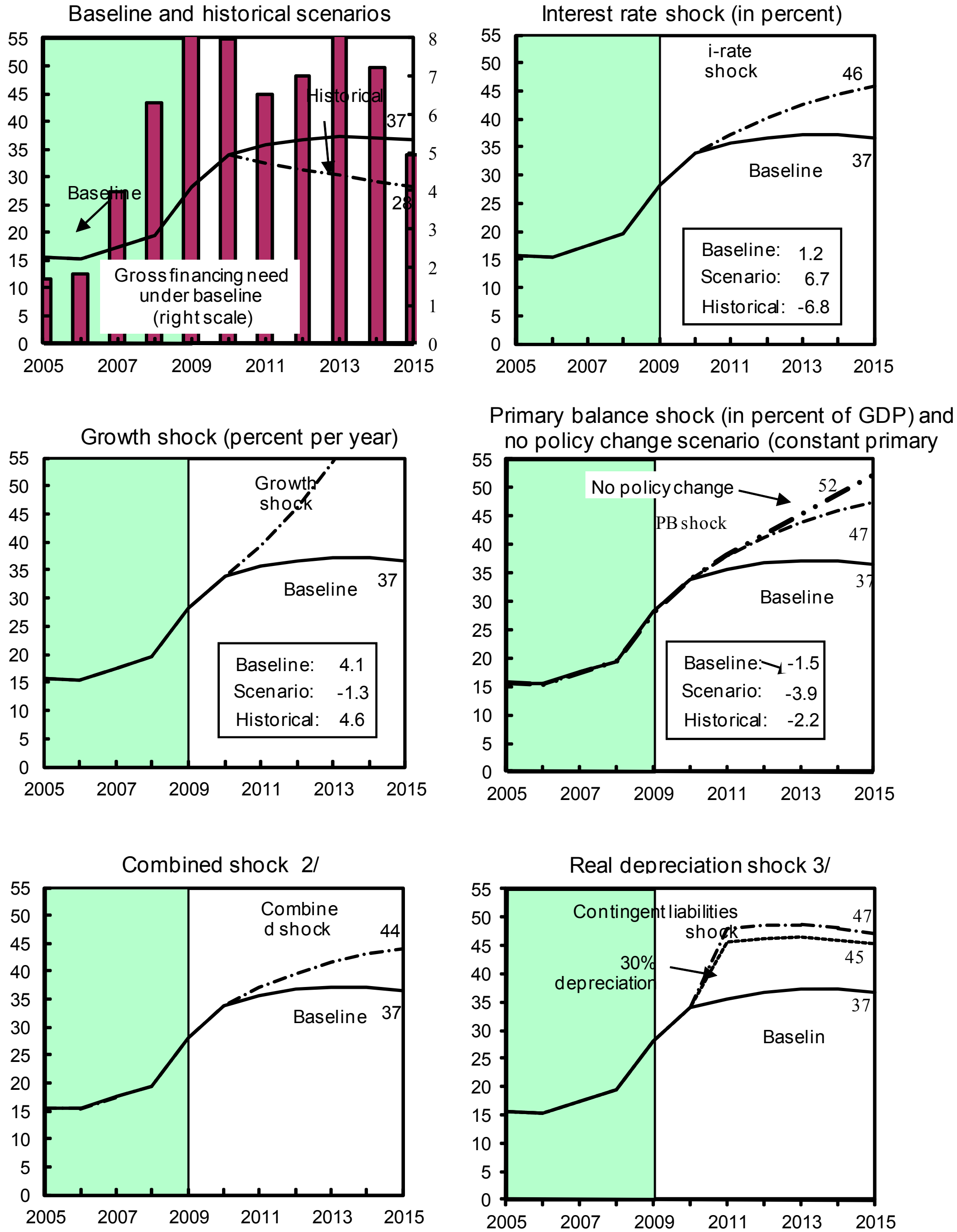






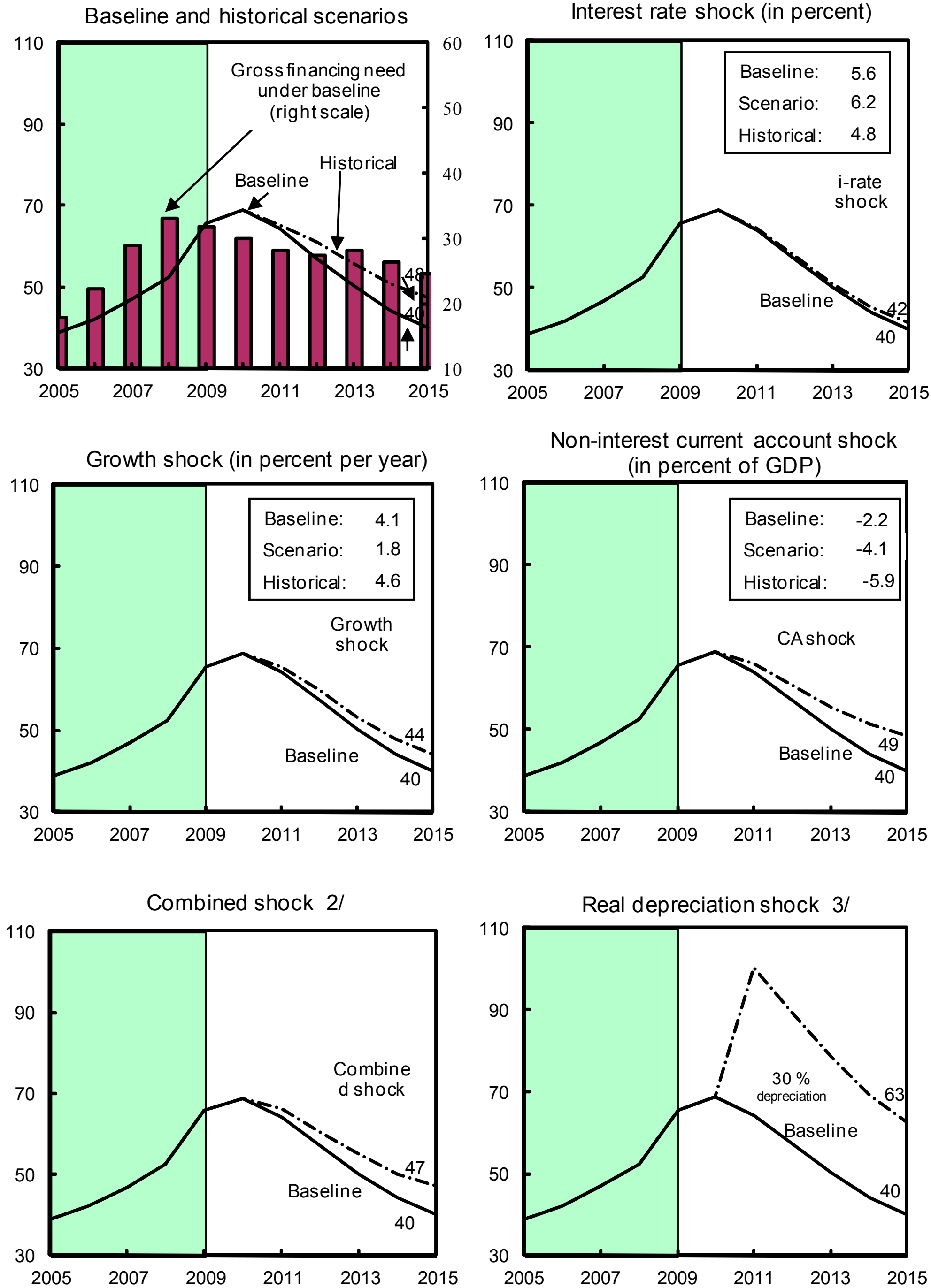
Source: Haver; IMF Staff estimates.

Figure 2. Romania: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



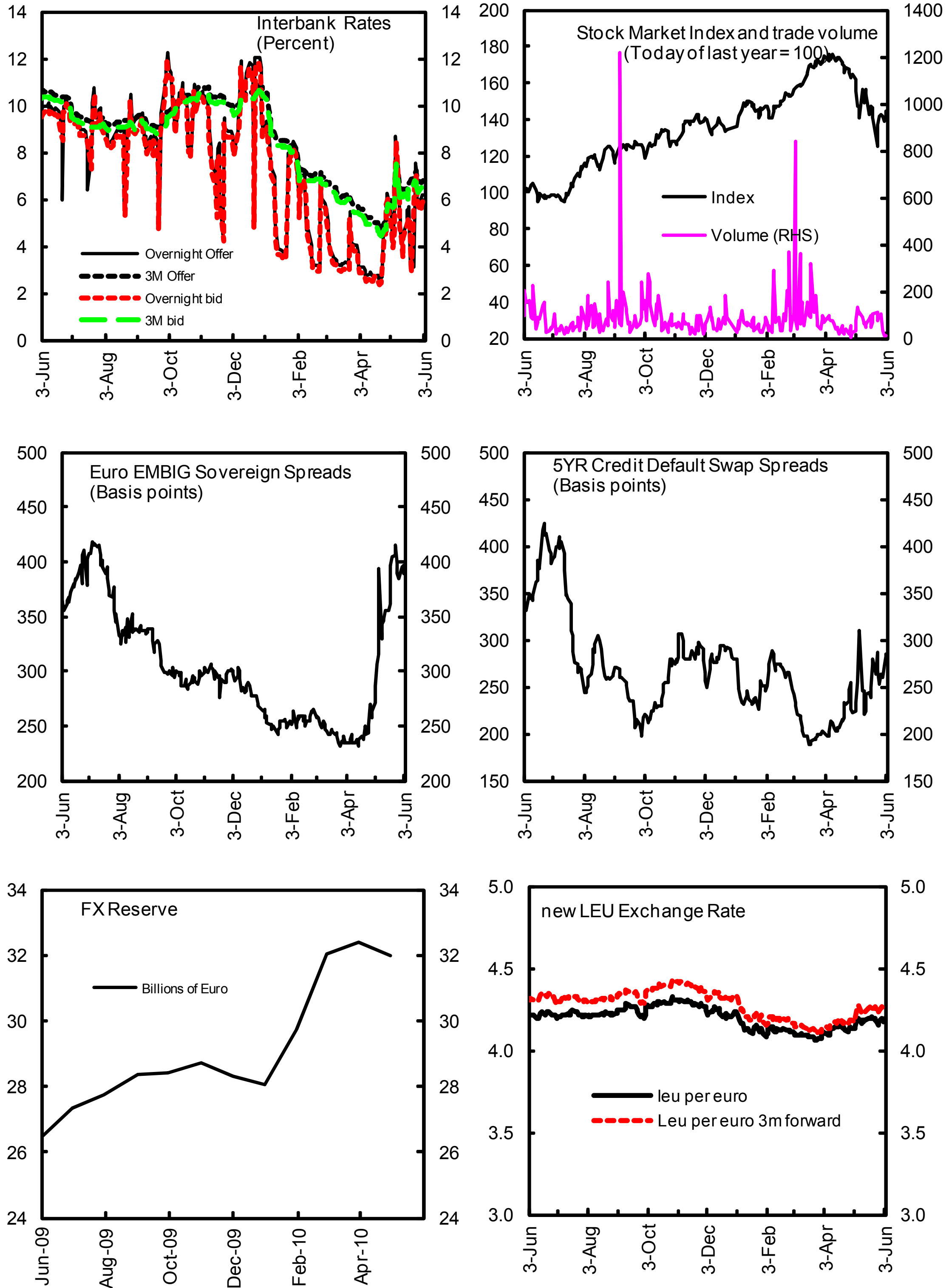
Sources: International Monetary Fund, country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Seven-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent and 10 percent of GDP shock to contingent liabilities occur in 2009, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Figure 3. Romania: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



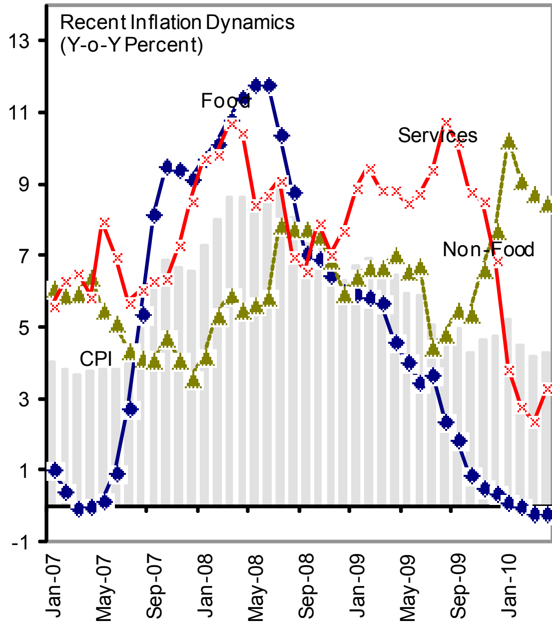
Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2010.

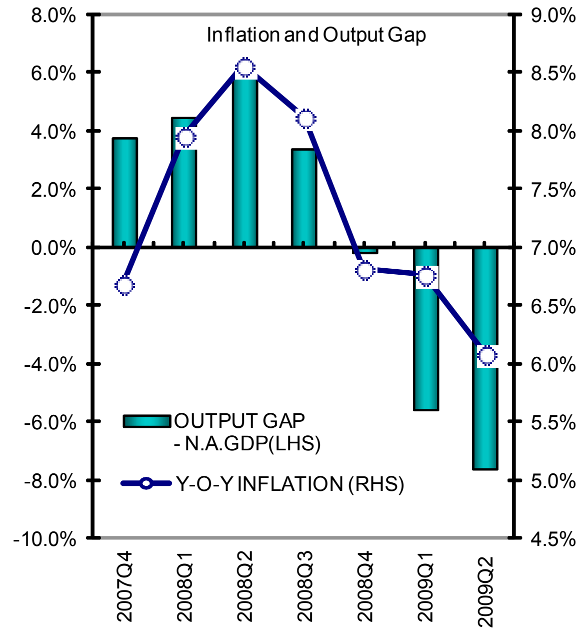
Figure 4. Romania: Financial Markets

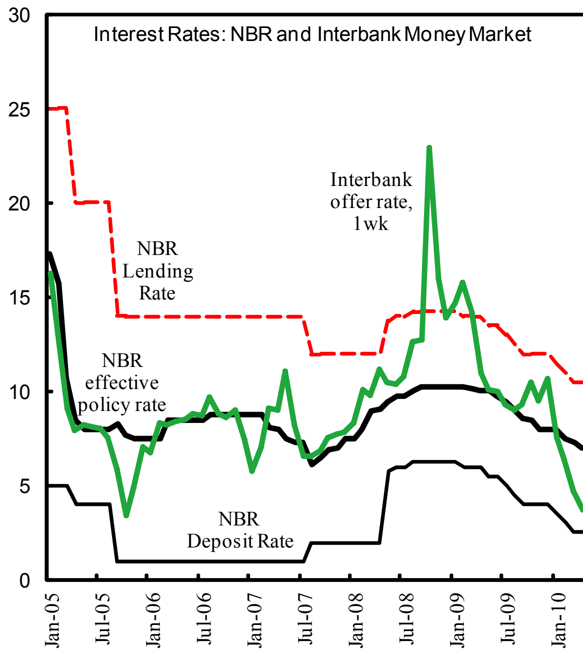


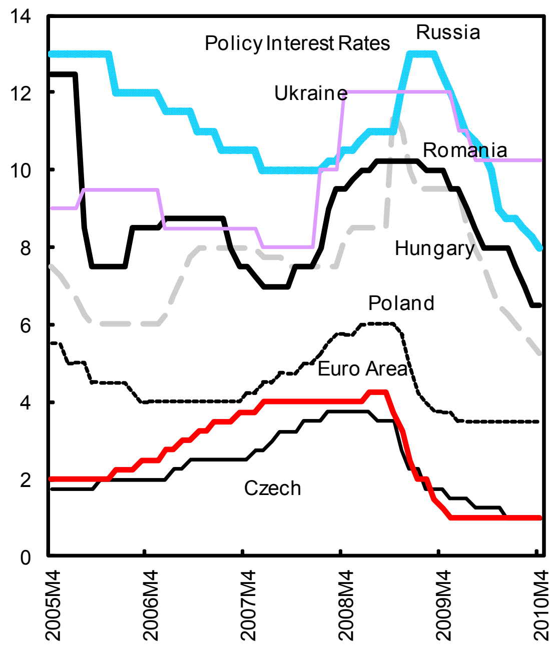
Source: Bloomberg, DataStream, IFS.

Figure 5. Romania: Monetary Policy developments



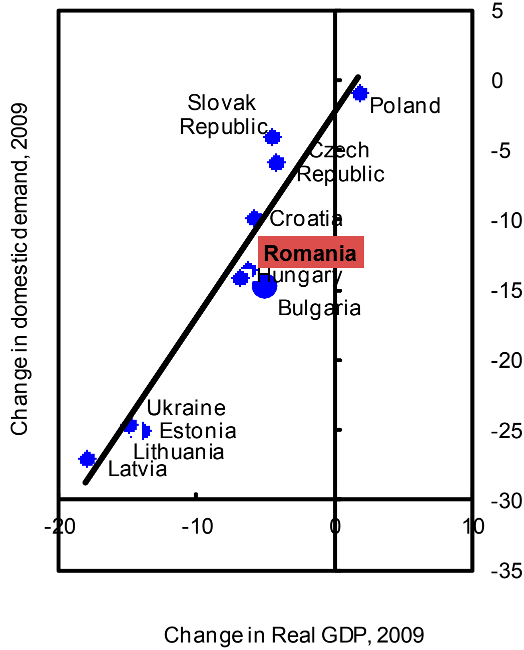


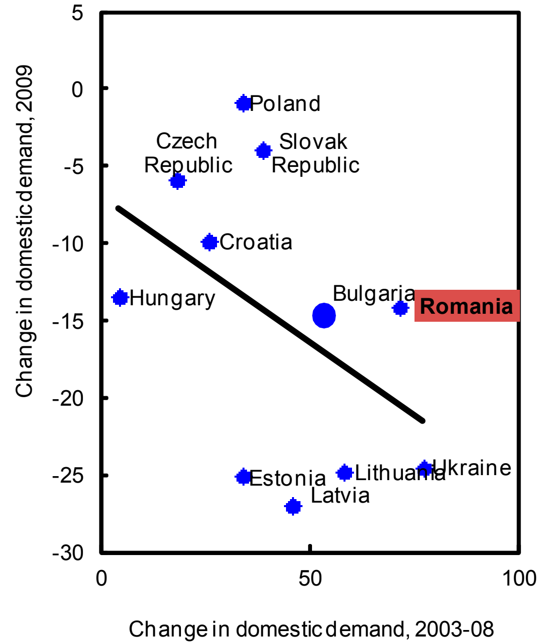


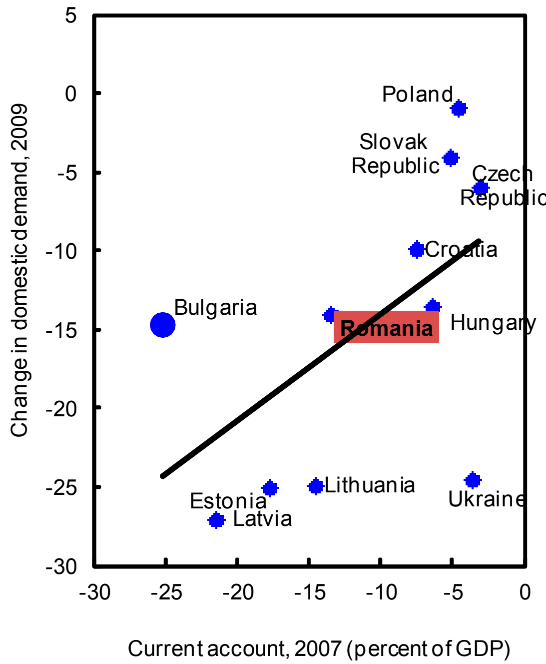


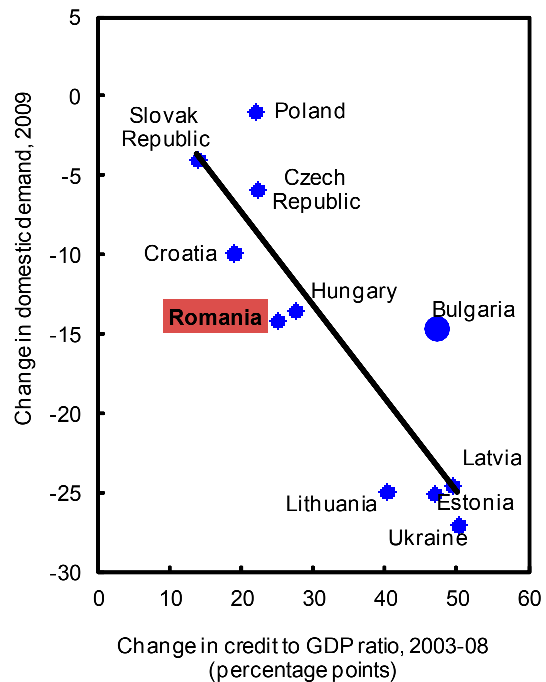
Source: Haver; EMEA; IMF staff esitmates.

Figure 6. Romania: Boom and Bust
(Percent, unless otherwise indicated)



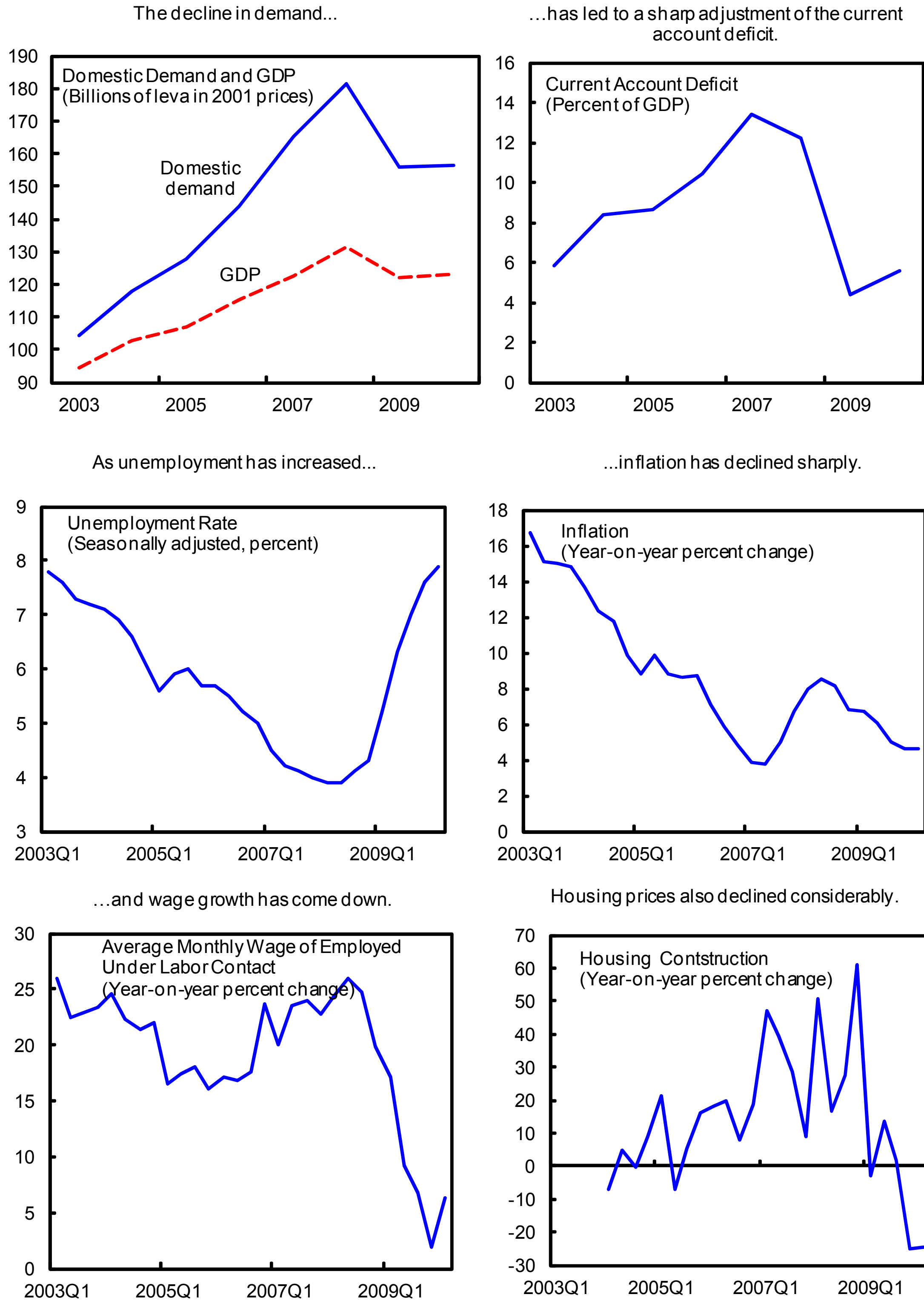






Source: World Economic Outlook; International Financial Statistics.

Figure 7. Romania: Adjustment of Imbalances



Source: Haver; World Economic Oultook.

Table 1. Romania: Quantitative Program Targets

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March		June	Sept	Dec
	Actual	Actual	Actual	Actual	Actual	Prog.	Est.	Prog.	Prog.	Prog.
I. Quantitative Performance Criteria										
1. Cumulative change in net foreign assets (mln euros) 1/3/	25,532	-3,500	-5,119	-4,566	-4,874	-2,000	779	-2,500	-2,000	-2,000
2. Cumulative floor on general government overall balance (mln lei) 2/	-24,655	-8,300	-14,456	-25,563	-36,101	-8,250	-8,422	-18,200	-25,700	-34,650
3. Stock in general government arrears from the end of previous year (bn lei)	1.06	1.41	1.55	1.4	1.50	1.27	1.76	1.09	0.81	0.48
4. Ceiling on general government guarantees issued during the year (face value, bn lei)	0.0	…	0.02	0.7	2.2	12.0	4.6	12.0	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	0	0	0	0	0	0	0	0	0
III. Inflation Consultation										
6. 12-month rate of inflation in consumer prices										
Outer band (upper limit)	…	…	8.4	7.7	6.5	6.5	6.5	6.0	5.75	5.5
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.5	5.0	4.75	4.5
Center point	*6.3*	*6.7*	*5.9*	*4.8*	*4.7*	*4.5*	*4.2*	*4.0*	*3.75*	*3.5*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.5	3.0	2.75	2.5
Outer band (lower limit)	…	…	4.4	3.7	2.5	2.5	2.5	2.0	1.75	1.5
IV. Indicative Target										
7. General government current primary spending (excl. EU funds and social assistance, mln lei) 2/	92,327	22,149	43,238	63,878	85,637	32,900	32,749	66,200	95,600	126,700
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-1,381	-495	-2,000	-3,000	-4,000

1/ The December 2008 figure is a stock.

2/ The December 2008 figure is for the whole year.

3/ NFA targets for end December have been adjusted as actual disbursements fell short of projected levels by EUR 1 bn.

Table 2. Romania: Performance for Fourth Review and Proposed New Conditionality

Measure	Target Date	Comment
Prior Action		
1. Enactment of agreed fiscal measures (LOI ¶ 7)	Prior action	
Quantitative performance criteria		
1. Floor on net foreign assets	March, 2010	Met
2. Floor on general government overall balance	March, 2010	Not met
3. Ceiling on general government guarantees	March, 2010	Met
4. Ceiling on general government domestic arrears	March, 2010	Not met
5. Non-accumulation of external debt arrears	March, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	March, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	March, 2010	Met
Inflation consultation band		
Inner band	March, 2010	Met
Outer band	March, 2010	Met
Structural benchmarks		
1. Passage of Fiscal Responsibility Law	March 31, 2010	Met
2. Passage of amendments to the banking and winding-up laws to enhance the bank resolution framework	March 31, 2010	Met
3. Approval of legislation and internal regulations by ordinance necessary to implement tax administration reforms	April 30, 2010	Met
4. Legislative changes to improve monitoring and control of SOEs	June 30, 2010	Met in January 2010
5. Approval of institutional reform measures to mitigate fiscal risks from local governments	June 30, 2010	Revised to end-September 2010
6. Passage of pension legislation	June 30, 2010	
7. Passage of implementing legislation for the unified wage law	September 30, 2010	
Proposed New Conditionality		
1. Approval of institutional reform measures to mitigate fiscal risks from local governments	September 30, 2010	Revised from end-June, 2010
2. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement (LOI ¶24)	September 2010	
3. Reform tax administration methodology for high net wealth individuals (LOI ¶13)	November 30, 2010	
4. Integrate the accounting reporting system with the Treasury payment system (LOI ¶10)	March 31, 2011	

Table 3. Romania: Selected Economic and Social Indicators, 2007–15

	2007	2008	2009	2010		2011	2012	2013	2014	2015
				Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Output and prices				(Annual percentage change)						
Real GDP	6.3	7.3	-7.1	1.3	-0.5	3.6	4.4	4.3	4.0	4.0
Domestic demand	14.6	9.9	-14.0	0.1	-1.5	2.6	5.6	5.8	5.7	4.3
Net exports (contribution)	-16.7	-2.6	16.1	1.1	1.4	0.4	-2.6	-3.0	-3.3	0.0
Consumer price index (CPI, average)	4.8	7.8	5.6	3.9	4.2	3.3	3.0	3.0	3.0	3.0
Consumer price index (CPI, end of period)	6.6	6.3	4.7	3.2	3.7	3.0	3.0	3.0	3.0	3.0
Unemployment rate (average)	4.3	4.0	6.3	7.9	8.9	8.4	7.3	6.2	5.1	4.1
Nominal wages	22.6	23.6	8.4	4.4	4.3	6.2	6.0	5.9	5.7	5.7
Saving and Investment				(In percent of GDP)						
Gross domestic investment	31.0	31.3	25.1	30.7	24.8	25.2	25.2	25.2	25.2	25.2
Gross national savings	17.6	19.7	20.6	25.2	19.8	20.2	20.2	20.2	20.2	20.2
General government finances										
Revenue	32.3	32.2	31.8	31.3	31.7	30.9	30.8	30.5	30.1	29.7
Expenditure	35.4	37.0	39.2	37.3	38.5	35.3	34.8	33.9	32.9	32.0
Fiscal balance	-3.1	-4.8	-7.4	-5.9	-6.8	-4.4	-4.0	-3.4	-2.8	-2.3
Privatization proceeds	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External financing	0.1	0.4	2.9	3.7	4.6	0.7	0.0	0.0	0.0	0.0
Domestic financing	2.9	4.3	4.5	2.2	2.2	3.7	4.0	3.4	2.8	2.3
Structural fiscal balance 1/	-4.3	-6.9	-5.4	-2.4	-3.4	-1.3	-1.2	-1.0	-0.6	-2.3
Gross public debt (direct debt only)	17.5	19.5	28.2	31.5	33.9	35.7	36.8	37.3	37.2	36.6
Money and credit				(Annual percentage change)						
Broad money (M3)	33.7	17.5	9.0	6.6	7.2	7.3	7.7	7.6	8.4	8.4
Credit to private sector	60.4	33.7	0.9	5.8	5.2	10.2	6.4	8.7	9.0	10.0
Interest rates, eop				(In percent)						
Euribor, six-months	4.79	3.52	4.52	-	-	-	-	-	-	-
NBR policy rate	7.50	10.25	8.00	-	-	-	-	-	-	-
NBR lending rate (Lombard)	12.00	14.25	12.00	-	-	-	-	-	-	-
Interbank offer rate (1 week)	7.10	12.70	10.70	-	-	-	-	-	-	-
Balance of payments				(In percent of GDP)						
Current account balance	-13.4	-11.6	-4.5	-5.5	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Merchandise trade balance	-14.3	-13.7	-5.8	-7.1	-7.0	-7.2	-7.5	-7.6	-7.8	-7.4
Capital and financial account balance	17.3	12.7	-0.9	4.2	4.0	6.1	6.9	6.9	6.8	6.8
Foreign direct investment balance	5.7	6.7	3.8	4.1	4.1	4.2	4.5	4.5	4.5	4.5
International investment position	-40.1	-51.8	-68.3	-53.6	-62.5	-60.2	-58.5	-60.0	-61.3	-60.6
Gross official reserves	23.0	20.2	26.6	30.5	31.2	30.0	27.2	23.4	20.1	19.0
Gross external debt	47.0	52.6	65.7	68.3	69.0	64.3	57.2	50.2	44.3	40.2
Exchange rates										
Lei per euro (end of period)	3.5	4.0	4.2	-	-	-	-	-	-	-
Lei per euro (average)	3.3	3.7	4.2	-	-	-	-	-	-	-
Real effective exchange rate										
CPI based (depreciation -)	9.0	-4.1	-7.8	-	-	-	-	-	-	-
Memorandum Items:										
Nominal GDP (in bn RON)	416.0	514.7	491.3	538.9	510.4	553.9	602.8	655.4	710.6	770.4

Social and Other Indicators

GDP per capita (current US$, 2008): $9,300; **GDP per capita, PPP** (current international $, 2008): $14,065

Unemployment rate: 8.3% (February 2010)

Poverty rate: 5.7% (2008)

Sources: Romanian authorities; Fund staff estimates and projections; and World Development Indicators database.

1/ Actual fiscal balance adjusted for the automatic effects of the business cycle.

Table 4. Romania: Balance of Payments, 2007–15
(In billions of euros, unless otherwise indicated)

	2007	2008	2009	2010		2011	2012	2013	2014	2015
	Act	Act	Act	Prog	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account balance	-16.7	-16.2	-5.2	-6.8	-6.1	-6.9	-7.8	-8.7	-9.7	-10.7
Merchandise trade balance	-17.8	-19.1	-6.8	-8.7	-8.6	-9.7	-11.6	-13.3	-15.1	-16.0
Exports (f.o.b.)	29.5	33.7	29.1	29.9	31.5	33.9	36.6	39.5	42.8	46.1
Imports (f.o.b.)	-47.4	-52.8	-35.9	-38.6	-40.1	-43.6	-48.2	-52.8	-57.9	-62.1
Services balance	0.5	0.7	-0.4	0.3	-0.2	-0.1	0.1	0.3	0.6	0.8
Exports of non-factor services	6.9	8.8	7.0	7.0	7.7	8.3	9.1	9.9	10.8	11.6
Imports of non-factor services	-6.5	-8.1	-7.4	-6.8	-7.9	-8.4	-9.0	-9.6	-10.3	-10.8
Income balance	-4.2	-3.7	-2.1	-2.7	-2.5	-3.1	-3.0	-3.1	-3.2	-4.3
Receipts	2.4	2.3	1.2	1.5	1.5	1.9	2.6	3.0	3.3	3.7
Payments	-6.6	-6.0	-3.3	-4.2	-4.0	-5.0	-5.7	-6.1	-6.5	-7.9
Current transfer balance	4.8	6.0	4.1	4.4	5.2	6.0	6.7	7.3	8.1	8.8
Capital and financial account balance	21.9	17.8	-1.0	5.2	4.9	8.2	10.8	12.0	13.2	14.7
Capital transfer balance	0.8	0.6	0.5	0.7	0.4	0.4	0.4	0.3	0.2	0.1
Foreign direct investment balance	7.0	9.3	4.4	5.0	5.0	5.7	7.0	7.8	8.7	9.7
Portfolio investment balance	0.4	-0.8	0.6	-0.2	-0.2	0.5	0.5	0.6	0.7	0.8
Other investment balance	13.8	8.7	-6.5	-0.3	-0.3	1.7	2.9	3.2	3.6	4.0
General government 1/	-0.6	0.2	0.2	1.4	1.4	0.0	0.1	0.1	0.1	0.2
Domestic banks	6.0	3.0	-5.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other private sector	8.5	5.5	-1.4	-1.7	-1.7	1.6	2.8	3.1	3.5	3.9
Errors and omissions	-0.7	-0.7	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Prospective financing	...	...	2.1	4.8	4.8	0.2				
European Commission	...	...	1.5	3.4	3.4	0.2				
World Bank	...	...	0.3	0.7	0.7	0.0				
EIB/EBRD	...	...	0.3	0.7	0.7	0.0				
Overall balance	4.6	1.0	-4.3	3.2	3.5	1.5	3.0	3.3	3.6	4.0
Financing	-4.6	-1.0	4.3	-3.2	-3.5	-1.5	-3.0	-3.3	-3.6	-4.0
Gross international reserves (increase: -)	-4.5	-1.0	-2.6	-6.9	-7.4	-2.6	-1.5	1.7	1.6	-2.1
Use of Fund credit, net	-0.1	0.0	5.9	3.7	3.9	1.0	-1.5	-4.9	-5.2	-1.9
Purchases 2/	0.0	0.0	5.9	3.7	3.9	1.0	0.0	0.0	0.0	0.0
Repurchases	0.1	0.0	0.0	0.0	0.0	0.0	1.5	4.9	5.2	1.9
Other liabilities, net 3/	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:	(In percent of GDP)									
Current account balance	-13.4	-11.6	-4.5	-5.5	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Foreign direct investment balance	5.7	6.7	3.8	4.1	4.1	4.2	4.5	4.5	4.5	4.5
Merchandise trade balance	-14.3	-13.7	-5.8	-7.1	-7.0	-7.2	-7.5	-7.6	-7.8	-7.4
Exports	23.7	24.1	25.1	24.2	25.7	24.9	23.5	22.8	22.1	21.3
Imports	-38.0	-37.8	-31.0	-31.3	-32.7	-32.1	-31.0	-30.4	-29.9	-28.7
Gross external financing requirement	26.7	32.6	31.7	29.9	29.7	28.0	26.2	25.0	23.5	23.4
	(Annual percentage change)									
Terms of trade (merchandise)	5.3	-4.0	8.8	-5.0	-7.4	-3.3	-0.5	0.6	0.8	0.4
Merchandise export volume	8.7	10.3	-12.6	1.4	8.4	6.4	6.6	6.7	6.7	5.8
Merchandise import volume	26.1	4.0	-24.4	0.5	4.3	4.2	8.6	8.9	9.0	5.9
Merchandise export prices	5.2	3.5	-1.2	2.0	-0.4	1.3	1.2	1.3	1.5	1.7
Merchandise import prices	-0.1	7.2	-10.1	6.9	7.1	4.5	1.6	0.7	0.7	1.2
	(In billions of euros)									
Gross international reserves 3/	28.7	28.3	30.9	37.7	38.3	40.9	42.3	40.6	39.1	41.2
GDP	124.6	139.7	116.0	123.6	122.5	136.0	155.4	173.7	193.8	216.4

Sources: Romanian authorities; and Fund staff estimates and projections.

1/ Includes IMF disbursement to the Treasury of €0.9 billion in 2009 and €1.2 billion in 2010, and issuance of an Euro bond of €1 billion in 2010.

2/ IMF disbursements amounted to €6.8 billion in 2009 and are projected to amount to €5 billion in 2010. Of these €0.9 billion in 2009, and €1.2 billion in 2010 have been disbursed directly to the Treasury, and included in the capital and financial account as noted in footnote 1.

3/ Reflects the allocation of SDR 908.8 million that was made avaialable in two tranches in August and September 2009.

Table 5. Romania: Gross Financing Requirements, 2009-11

(In billions of euros, unless otherwise indicated)

	2009					2010					2011	Total
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year		2009-11
	Act	Act	Act	Act	Act	Act	Proj	Proj	Proj	Proj.	Proj.	
I. Total financing requirements	**13.0**	**15.5**	**11.0**	**8.7**	**48.2**	**9.9**	**7.7**	**8.1**	**9.0**	**33.3**	**39.2**	**163.6**
I.A. Current account deficit	0.9	1.6	1.1	1.6	5.2	1.5	1.7	1.0	2.3	6.1	6.9	25.5
I.B. Short-term debt	9.2	10.4	6.4	4.7	30.7	5.0	3.4	4.2	3.7	16.2	16.2	84.3
Public sector	2.8	4.1	0.9	1.0	8.8	1.4	0.1	0.2	0.1	1.6	1.6	15.0
Banks	3.6	4.6	4.0	2.2	14.4	2.6	2.4	2.6	2.4	10.0	10.0	47.0
Corporates	2.8	1.7	1.5	1.5	7.5	1.0	0.9	1.4	1.2	4.6	4.6	22.3
I.C. Maturing medium- and long-term debt	1.8	3.0	1.6	3.5	9.9	2.7	2.1	2.2	2.3	9.1	16.1	47.0
Public sector	0.2	0.3	0.2	0.3	1.0	0.2	0.3	0.9	0.3	1.6	3.4	7.8
Banks	0.8	1.6	0.4	1.9	4.7	1.1	0.3	0.5	0.4	2.2	3.7	14.0
Corporates	0.8	1.1	1.0	1.3	4.2	1.4	1.5	0.8	1.6	5.3	9.0	25.2
I.D. Other net capital outflows 1/	1.1	0.5	1.9	-1.1	2.4	0.7	0.6	0.7	0.8	1.9	0.0	6.9
II. Total financing sources	**10.9**	**12.2**	**9.9**	**8.6**	**41.6**	**9.4**	**6.6**	**7.4**	**8.1**	**30.9**	**40.1**	**153.1**
II.A. Foreign direct investment, net	1.5	1.1	0.9	0.9	4.4	0.7	1.3	1.4	1.5	5.0	5.7	21.0
II.B. Capital account inflows (EU)	0.0	0.0	0.3	0.2	0.5	0.0	0.1	0.1	0.1	0.5	0.4	1.9
II.C. Short-term debt	7.2	7.4	5.1	4.9	24.6	6.0	3.3	4.3	4.0	16.2	16.2	79.2
Public sector	3.7	3.1	1.1	1.3	9.2	1.9	0.1	0.2	0.1	1.6	1.6	15.9
Banks	2.4	3.4	2.6	2.4	10.8	3.0	2.4	2.7	2.5	10.0	10.0	43.8
Corporates	1.1	0.9	1.4	1.2	4.6	1.1	0.9	1.5	1.3	4.6	4.6	19.5
II.D. Medium- and long-term debt	2.2	3.7	3.6	2.6	12.1	2.7	1.9	1.5	2.5	9.2	17.8	50.9
Public sector 2/	0.0	0.2	0.1	0.5	0.8	1.1	0.2	0.2	0.2	1.7	3.4	8.7
Banks	0.8	2.0	1.8	0.8	5.4	0.4	0.3	0.5	0.4	2.2	3.7	13.9
Corporates	1.4	1.5	1.7	1.3	5.9	1.2	1.4	0.8	1.8	5.3	10.6	28.3
III. Increase in gross reserves	**-2.0**	**1.6**	**1.9**	**0.3**	**1.8**	**3.1**	**1.1**	**0.7**	**1.6**	**7.3**	**2.1**	**22.1**
IV. Errors and omissions	**0.2**	**-0.1**	**-1.4**	**-0.1**	**-1.5**	**0.2**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**-1.3**
V. Program financing	**0.0**	**4.9**	**3.5**	**0.5**	**8.9**	**3.4**	**2.2**	**1.4**	**2.6**	**9.8**	**1.2**	**19.8**
IMF	0.0	4.9	1.9	0.0	6.8	2.4	0.9	0.9	0.9	5.1	1.0	12.9
Others	0.0	0.0	1.6	0.5	2.1	1.0	1.3	0.5	1.7	4.7	0.2	6.9
European Commission	0.0	0.0	1.5	0.0	1.5	1.0	1.2	0.0	1.2	3.4	0.2	5.0
World Bank	0.0	0.0	0.0	0.3	0.3	0.0	0.0	0.4	0.3	0.7	0.0	1.0
EIB/EBRD	0.0	0.0	0.1	0.2	0.3	0.0	0.2	0.2	0.2	0.6	0.0	0.9
VI. Other Financing 3/	**0.0**	**0.0**	**1.0**	**0.0**	**1.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.0**
Memorandum items:												
Rollover rates for amortizing debt (in percent)												
Banks	72	87	100	77	84	92	98	102	106	100	100	…
Corporates	69	86	124	89	90	96	95	105	114	100	100	…
Gross international reserves 3/	27.4	28.7	30.6	30.9	30.9	34.9	34.7	36.2	38.3	38.3	40.9	…
Coverage of gross international reserves												
- Months of imports of GFNS (next year)	8.5	8.6	…	…	7.7		…	…	…	8.8	8.6	…
- Short-term external debt (in percent)	98	112	126	126	126	136	135	141	149	149	159	…

Source: IMF staff estimates.

1/ Includes includes portfolio equity, financial derivatives and other investments, assets position.

2/ Excludes the disbursements by the IMF directly to the Treasury, amounting to €0.9 billion in 2009Q3 and €0.8 billion in 2009Q4.

3/ Reflects two SDR allocations in August and September 2009.

Table 6. Romania: General Government Operations, 2007–15
(In percent of GDP)

	2007	2008	2009	2010		2011	2012	2013	2014	2015
			Prel.	Prog.	Proj.	Proj.	Proj.	Proj	Proj	Proj
Revenue	32.5	32.2	31.8	31.3	31.7	30.9	30.8	30.5	30.1	29.7
Taxes	28.1	28.0	27.8	26.7	26.9	26.2	26.1	26.0	25.8	25.7
Taxes on profits	2.9	2.8	2.7	2.4	2.6	2.6	2.6	2.6	2.6	2.6
Taxes on income	3.5	3.6	3.8	3.5	3.5	3.4	3.3	3.3	3.2	3.2
Value-added taxes	7.6	7.9	7.0	6.6	6.7	6.6	6.6	6.6	6.7	6.7
Excises	3.0	2.7	3.2	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Customs duties	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	9.6	9.5	9.7	9.2	9.2	8.9	8.8	8.7	8.6	8.4
Other taxes	1.4	1.2	1.2	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Nontax revenue	3.4	3.1	2.9	3.2	3.3	3.0	3.0	3.0	3.0	3.0
Capital revenue	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants, including EU disbursements	0.8	0.9	1.0	1.3	1.4	1.6	1.6	1.5	1.2	0.9
Financial operations and other	…	0.0	0.0	…	…	…	…	…	…	…
Expenditure	35.6	37.0	39.2	37.3	38.5	35.3	34.8	33.9	32.9	32.0
Current expenditure	30.9	32.5	35.3	33.4	34.5	31.2	30.9	30.1	29.0	28.2
Compensation of employees	8.2	8.9	9.5	8.5	7.9	7.0	6.9	6.6	6.3	6.1
Maintenance and operations	6.1	6.2	5.7	5.1	5.8	5.1	5.1	5.1	5.1	5.1
Interest	0.7	0.7	1.2	1.7	1.8	1.8	1.9	1.9	1.8	1.8
Subsidies	1.7	1.5	1.5	1.2	1.2	1.0	0.9	0.8	0.7	0.7
Transfers 1/	14.2	15.1	17.0	16.5	17.3	16.2	16.1	15.7	15.0	14.4
Pensions	5.5	6.4	8.1	7.5	7.7	6.9	6.9	6.6	6.5	6.6
Other social transfers	3.9	4.1	4.9	4.5	4.9	4.3	4.1	3.8	3.7	3.5
Other transfers 2/	4.1	3.4	3.4	4.0	4.2	4.4	4.7	4.8	4.3	3.9
o\w contribution to EU budget	0.9	0.9	1.2	1.1	1.2	1.1	1.0	0.9	0.9	0.8
o\w pre-accession EU funds	…	…	0.6	0.6	0.7	0.2	0.0	0.0	0.0	0.0
Other spending	0.7	1.2	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Proj. with ext. credits	0.0	0.0	0.4	0.5	0.5	0.0	0.0	0.0	0.0	0.0
Capital expenditure 3/	4.8	4.6	4.4	3.8	3.9	4.0	3.8	3.8	3.8	3.8
Reserve fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	0.0	-0.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal balance	-3.1	-4.8	-7.4	-5.9	-6.8	-4.4	-4.0	-3.4	-2.8	-2.3
Primary balance	-2.4	-4.1	-6.2	-4.2	-5.0	-2.6	-2.0	-1.6	-1.0	-0.6
Financing	3.1	4.8	7.4	5.9	6.8	4.4	4.0	3.4	2.8	2.3
Privatization proceeds	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External	0.1	0.4	2.9	3.7	4.6	0.7	0.0	0.0	0.0	0.0
Domestic	2.9	4.3	4.5	2.2	2.2	3.7	4.0	3.4	2.8	2.3
Financial liabilities										
Gross public debt 4/	19.9	21.3	29.9	33.1	35.6	37.2	38.1	38.5	38.3	37.7
Gross public debt excl. guarantees	17.6	19.5	28.2	31.5	33.9	35.7	36.8	37.3	37.2	36.6
External	7.2	6.9	10.2	12.7	14.4	14.0	12.9	11.8	10.9	10.1
Domestic	10.4	12.6	18.0	18.8	19.6	21.7	23.9	25.4	26.3	26.6
Memorandum items:										
Total capital spending	…	6.0	5.9	5.6	5.8	5.6				
Fiscal balance (ESA95 basis)	-2.5	-5.3	…	…	…	…	…	…	…	…
Output gap 5/	3.2	5.7	-5.2	-9.5	-8.9	-8.7	-7.9	-7.1	-6.7	0.0
Conventional structural fiscal balance	-4.3	-6.9	-5.4	-2.4	-3.4	-1.3	-1.2	-1.0	-0.6	-2.3
Nominal GDP (in billions of RON)	412.8	514.7	491.3	538.9	510.4	553.9	602.8	655.4	710.6	770.4

Sources: Ministry of Finance; Eurostat; and Fund staff projections.

1/ Increase in 2009 mostly reflects higher EU-financed capital spending and budgeted rise in pensions.

2/ Includes co-financing of EU projects.

3/ Does not include all capital spending. Total investment increased from 6.0 percent of GDP in 2008 to 7.0 percent of GDP in the authorities' 2009 budget.

4/ Total public debt, including government debt, local government debt, and guarantees.

5/ Percentage deviation of actual from potential GDP.

Table 6. Romania: General Government Operations, 2007–15 (concluded)
(In millions of RON)

	2007	2008	2009	2010		2011	2012	2013	2014	2015
				Prog.	Proj.	Proj.	Proj	Proj	Proj	Proj
Revenue	134,173	165,549	156,373	168,847	161,659	171,099	185,677	199,919	213,703	228,657
Taxes	116,066	143,855	136,350	143,870	137,344	145,330	157,324	170,150	183,499	197,709
Taxes on profits	11,917	14,426	13,466	12,964	13,434	14,291	15,551	16,909	18,334	19,876
Taxes on income	14,402	18,523	18,551	19,076	17,796	18,756	20,123	21,575	23,067	24,661
Value-added taxes	31,243	40,874	34,322	35,549	34,361	36,552	39,947	43,584	47,402	51,391
Excises	12,552	13,646	15,646	18,369	17,516	18,633	20,276	22,047	23,904	25,916
Customs duties	856	962	656	711	648	689	761	834	915	981
Social security contributions	39,443	49,008	47,829	49,773	46,909	49,363	53,000	56,865	60,839	65,085
Other taxes	5,653	6,416	5,879	7,429	6,681	7,045	7,666	8,336	9,038	9,799
Nontax revenue	13,991	15,892	14,487	17,439	16,734	16,525	17,981	19,552	21,199	22,983
Capital revenue	963	1,076	546	497	541	558	608	661	716	777
Grants	3,154	4,702	5,057	7,040	7,040	8,686	9,764	9,555	8,288	7,189
o/w EU pre-accession funds	...	...	2,959	3,415	3,415	1,338	1,228	...	...	...
Financial operations and other	...	25	-67	...	...	...	...	...	...	...
Expenditure	147,141	190,407	192,782	200,754	196,299	195,466	209,642	222,507	233,661	246,727
Current expenditure	127,513	167,095	173,445	180,082	176,277	172,916	186,412	197,248	206,274	217,035
Compensation of employees	33,696	45,608	46,676	45,657	40,556	38,997	41,485	43,267	45,114	47,040
Maintenance and operations	25,187	32,012	28,028	27,565	29,522	28,425	30,931	33,633	36,466	39,535
Interest	3,096	3,776	6,063	9,200	9,200	10,200	11,652	12,342	12,780	13,751
Subsidies	6,875	7,899	7,215	6,252	6,092	5,800	5,365	5,250	5,123	5,554
Transfers 1/	58,660	77,800	83,407	88,782	88,282	89,494	96,980	102,756	106,791	111,154
Pensions	22,664	33,187	39,851	40,406	39,204	38,446	41,325	43,053	46,545	50,735
Other social transfers	16,186	20,973	24,101	24,459	25,160	23,803	24,507	25,232	25,979	26,748
Other transfers 2/	16,769	17,646	16,931	21,383	21,383	24,527	28,190	31,255	30,780	29,892
o\w contribution to EU budget	3,799	4,506	5,650	5,970	5,920	6,095	6,163	6,094	6,215	6,333
o\w pre-accession EU funds			2,959	3,415	3,415	1,338				
Other spending	3,041	5,993	2,523	2,535	2,535	2,718	2,958	3,216	3,487	3,781
Proj. with ext. credits	0	0	2,056	2,625	2,625	0	0	0	0	0
Capital expenditure 3/	19,629	23,794	21,837	20,471	19,821	22,343	23,004	25,014	27,121	29,403
Reserve fund	0	0	0	201	201	207	226	245	266	288
Net lending	0	-481	-2,500	0	0	0	0	0	0	0
Fiscal balance	-12,968	-24,858	-36,409	-31,907	-34,640	-24,368	-23,965	-22,588	-19,958	-18,069
Primary balance	-9,872	-21,082	-30,346	-22,707	-25,441	-14,168	-12,313	-10,247	-7,178	-4,318
Financing	12,968	24,858	36,409	31,907	34,640	24,368	23,965	22,588	19,958	18,069
Privatization proceeds	600	371	0	0	0	0	0	0	0	0
External	324	2,284	14,233		23,474	4,074	0	0	0	0
Domestic	12,044	22,203	22,177		11,166	20,294	23,965	22,588	19,958	18,069
Financial liabilities										
Gross public debt 4/	82,324	109,752	146,938	178,148	181,579	205,946	229,911	252,499	272,457	290,526
Gross public debt excl. guarantees	72,747	100,435	138,598	169,566	173,238	197,606	221,571	244,159	264,117	282,186
External	29,672	35,733	49,966	68,507	73,440	77,513	77,513	77,513	77,513	77,513
Domestic	43,075	64,702	88,632	101,059	99,799	120,093	144,057	166,646	186,604	204,673
Other liabilities										

Sources: Ministry of Finance; Eurostat; and Fund staff projections.

1/ Increase in 2009 mostly reflects higher EU-financed capital spending and budgeted rise in pensions.

2/ Includes co-financing of EU projects.

3/ Does not include all capital spending. Total investment increased from 6.0 percent of GDP in 2008 to 7.0 percent of GDP in the authorities' 2009 budget.

4/ Total public debt, including government debt, local government debt, and guarantees.

Table 7. Romania: Monetary Survey, 2007–11

(In millions of lei (RON), unless otherwise indicated; end of period)

	Dec-07	Dec-08	Dec-09	Dec-10 Proj. 2/	Dec-11 Proj.
		I. Banking System			
Net foreign assets	**29,070**	**13,138**	**17,684**	**32,673**	**37,145**
In million euros	8,052	3,297	4,182	7,704	9,439
o/w commercial banks	-18,666	-24,388	-19,708	-19,708	-19,708
Net domestic assets	**119,046**	**160,890**	**171,946**	**170,554**	**180,997**
Public sector credit	9,571	17,268	46,816	57,982	78,276
Private sector credit	148,181	198,086	199,882	210,324	231,799
Other	-38,706	-54,464	-74,751	-97,751	-129,078
Broad Money (M3)	**148,116**	**174,028**	**189,630**	**203,227**	**218,142**
Intermediate money (M2)	148,044	173,629	188,013	200,389	215,095
Money market instruments	72	399	1,617	2,838	3,047
Narrow money (M1)	79,914	92,549	79,361	84,585	101,105
Currency in circulation	21,442	25,287	23,968	24,862	30,059
Overnight deposits	58,472	67,262	55,394	59,723	71,046
		II. National Bank of Romania			
Net foreign assets	**96,466**	**110,323**	**101,015**	**116,255**	**114,705**
In million euros	26,720	27,683	23,891	27,413	29,147
Net domestic assets	**-47,593**	**-59,855**	**-49,354**	**-62,665**	**-57,853**
Public sector credit, net	-8,499	-1,428	-13,626	-13,626	-13,626
Credit to banks, net	-41,168	-51,126	-23,848	-37,159	-32,347
Other	2,074	-7,301	-11,879	-11,879	-11,879
Reserve money	**48,873**	**50,468**	**51,662**	**53,590**	**56,852**
		(Annual percentage change)			
Broad money (M3)	33.7	17.5	9.0	7.2	7.3
NFA contribution	-8.7	-10.8	2.6	7.9	2.2
NDA contribution	42.4	28.3	6.4	-0.7	5.1
Reserve money	41.3	3.3	2.4	3.7	6.1
NFA contribution	58.5	28.4	-18.4	29.5	-2.9
NDA contribution	-17.1	-25.1	20.8	-25.8	9.0
Domestic credit, real	54.3	28.4	9.4	4.9	12.2
Private sector, at constant e/r	56.3	26.5	-2.6	5.0	15.2
Public sector, real	153.3	69.7	158.9	19.5	31.1
Broad money (M3), at constant e/r	25.4	10.5	4.1	3.4	4.3
Private deposits, at constant e/r	30.9	13.5	8.4	6.2	9.3
Memorandum items:					
CPI inflation, eop	6.6	6.3	4.7	3.7	3.0
Inflation target	3 - 5	2.8 - 4.8	2.5 - 4.5	2.5 - 4.5	2.0 - 4.0
Interest rates (percent):					
Policy interest rate	7.50	10.25	8.00	6.25	…
Interbank offer rate, 1 week	7.1	12.7	10.7	6.2	
Corporate loans 1/	11.6	19.5	15.4	10.9	…
Household time deposits 1/	6.94	15.27	9.9	7.8	…
Share of foreign currency private deposits	32.1	34.8	38.8	37.0	…
Share of foreign currency private loans	54.3	57.8	60.1	60.4	…
M2 velocity	2.81	2.96	2.61	2.54	2.57
Money multiplier (M3/reserve money)	3.03	3.45	3.67	3.79	3.84

Sources: National Bank of Romania; and Fund staff estimates.

1/ Rates for new local currency denominated transactions.

2/ For interest rates and shares of foreign currency loans and deposits, latest available data.

Table 8. Romania: Schedule of Reviews and Purchases

Date	Amount of Purchase		Conditions
	Millions of SDRs	Percent of Quota	
May 4, 2009	4,370	424.19	Approval of arrangement
September 21, 2009	1,718	166.76	First review and end-June 2009 performance criteria
December 15, 2009 1/	1,409	136.77	Second review and end-September 2009 performance criteria
February 19, 2010	766	74.35	Third review and end-December 2009 performance criteria
June 30, 2010	768	74.55	Fourth review and end-March 2010 performance criteria
September 15, 2010	769	74.65	Fifth review and end-June 2010 performance criteria
December 15, 2010	769	74.65	Sixth review and end-September 2010 performance criteria
March 15, 2011	874	84.84	Seventh and end-December 2010 performance criteria
Total	11,443	1110.76	

Source: IMF staff estimates.

1/ The amount of purchase for the second review was available from December 15, 2009, but was made together with the amount for the third review on February 19, 2010 given the delay in completing the second review.

Table 9. Romania: Indicators of Fund Credit, 2010–16 1/

(In millions of SDR)

	2010	2011	2012	2013	2014	2015	2016
Existing Fund Credit							
Stock 2/	8,263	8,263	6,956	3,096	272	0	0
Obligations 3/	52	104	1,409	3,932	2,848	274	0
Repurchase	0	0	1,307	3,860	2,824	272	0
Charges	52	104	102	73	24	2	0
Prospective Fund Credit under Stand-By Arrangement							
Disbursement	2,306	874	0	0	0	0	0
Stock 2/	2,306	3,180	3,180	2,892	1,411	109	0
Obligations 3/	16	39	40	328	1,513	1,315	110
Repurchase	0	0	0	288	1,481	1,302	109
Charges	16	39	40	40	32	13	1
Stock of existing and prospective Fund credit							
In millions of SDR	10,569	11,443	10,136	5,988	1,683	109	0
In percent of quota	1,026	1,111	984	581	163	11	0
In percent of GDP	9.9	9.9	7.7	4.1	1.0	0.1	0.0
In percent of exports of goods and services	30.2	30.9	25.5	14.0	3.6	0.2	0.0
In percent of gross reserves	31.7	32.7	28.1	17.4	5.1	0.3	0.0
Obligations to the Fund from existing and prospective Fund arrangements							
In millions of SDR	68	143	1,449	4,260	4,361	1,588	111
In percent of quota	6.6	13.8	140.7	413.5	423.3	154.2	10.7
In percent of GDP	0.1	0.1	1.1	2.9	2.7	0.9	0.1
In percent of exports of goods and services	0.2	0.4	3.6	10.0	9.4	3.2	0.2
In percent of gross reserves	0.2	0.4	4.0	12.4	13.3	5.1	0.4

Source: IMF staff estimates.

1/ Using IMF actual disbursements, SDR interest rate as well as exchange rate of SDR/US$ and US$/€ of June 3, 2010.

2/ End of period.

3/ Repayment schedule based on repurchase obligations.

Table 10. Romania: Public Sector Debt Sustainability Framework, 2005–15
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	15.6	15.4	17.5	19.5	28.2	**33.9**	**35.7**	**36.8**	**37.3**	**37.2**	**36.6**	**-1.2**
o/w foreign-currency denominated	8.7	6.9	7.2	7.2	14.7	22.0	19.4	16.2	11.5	7.5	5.6	
Change in public sector debt	-1.7	-0.3	2.1	2.0	8.7	5.7	1.7	1.1	0.5	-0.1	-0.5	
Identified debt-creating flows (4+7+12)	-2.5	-2.9	0.0	2.6	8.3	5.7	1.7	1.1	0.5	-0.1	-0.5	
Primary deficit	-0.4	0.6	2.4	4.1	6.2	5.0	2.6	2.0	1.6	1.0	0.6	
Revenue and grants	31.4	32.3	32.3	32.2	31.8	31.7	30.9	30.8	30.5	30.1	29.7	
Primary (noninterest) expenditure	31.0	32.9	34.6	36.3	38.0	36.7	33.4	32.8	32.1	31.1	30.2	
Automatic debt dynamics 2/	-0.9	-3.0	-2.3	-1.4	2.1	0.7	-0.8	-1.0	-1.1	-1.1	-1.1	
Contribution from interest rate/growth differential 3/	-1.5	-1.7	-1.9	-2.6	2.2	0.7	-0.8	-1.0	-1.1	-1.1	-1.1	
Of which contribution from real interest rate	-0.8	-0.7	-1.1	-1.6	0.7	0.6	0.3	0.5	0.4	0.3	0.3	
Of which contribution from real GDP growth	-0.6	-1.0	-0.8	-1.0	1.5	0.1	-1.1	-1.4	-1.5	-1.4	-1.4	
Contribution from exchange rate depreciation 4/	0.6	-1.3	-0.4	1.2	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	-1.3	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-1.3	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	0.7	2.6	2.1	-0.6	0.4	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	49.8	47.6	54.2	60.7	88.6	107.2	115.5	119.3	122.1	123.6	123.4	
Gross financing need 6/	1.7	1.8	4.0	6.3	8.7	8.0	6.5	7.0	8.2	7.2	5.0	
in billions of U.S. dollars	1.7	2.2	6.8	12.9	14.1	12.8	11.3	13.8	17.9	17.6	13.4	
Scenario with key variables at their historical averages 7/						**33.9**	**32.6**	**31.3**	**30.2**	**29.2**	**28.3**	**-3.1**
Scenario with no policy change (constant primary balance) in 2010-2015						**33.9**	**38.1**	**41.6**	**45.3**	**48.9**	**52.4**	**-1.7**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.1	7.9	6.3	7.3	-7.1	-0.5	3.6	4.4	4.3	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	7.0	6.0	5.8	5.2	6.0	6.6	5.9	5.9	5.6	5.2	5.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.2	-4.5	-7.7	-10.1	3.2	2.2	1.2	1.6	1.3	1.0	0.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.2	19.4	6.5	-16.5	0.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	12.2	10.5	13.6	15.2	2.8	4.5	4.7	4.3	4.3	4.3	4.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.8	14.4	11.9	12.4	-2.7	-4.1	-5.4	2.5	1.8	0.8	1.2	
Primary deficit	-0.4	0.6	2.4	4.1	6.2	5.0	2.6	2.0	1.6	1.0	0.6	

1/ Coverage: general government. Gross public debt excluding guarantees is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 11. Romania: External Debt Sustainability Framework, 2005-2015
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	38.8	42.1	47.0	52.6	65.7	**69.0**	**64.3**	**57.2**	**50.2**	**44.3**	**40.2**	**-6.9**
Change in external debt	3.6	3.3	4.9	5.6	13.1	3.3	-4.7	-7.1	-6.9	-6.0	-4.1	
Identified external debt-creating flows (4+8+9)	-6.6	-5.3	-1.6	0.5	10.9	1.5	-1.8	-2.3	-2.0	-1.7	-1.5	
Current account deficit, excluding interest payments	7.4	9.2	12.2	10.1	1.1	1.4	1.6	1.9	2.2	2.4	2.6	
Deficit in balance of goods and services	10.2	12.0	13.9	13.2	6.2	7.2	7.2	7.4	7.4	7.5	7.0	
Exports	33.0	32.2	29.3	30.4	31.2	32.0	31.1	29.4	28.5	27.7	26.7	
Imports	43.2	44.2	43.2	43.6	37.3	39.2	38.3	36.8	35.9	35.2	33.7	
Net non-debt creating capital inflows (negative)	-6.9	-8.5	-6.0	-6.1	-4.3	-3.9	-4.5	-4.8	-4.8	-4.8	-4.8	
Automatic debt dynamics 1/	-7.0	-6.0	-7.8	-3.6	14.1	4.0	1.2	0.6	0.6	0.8	0.8	
Contribution from nominal interest rate	1.2	1.2	1.2	1.5	3.4	3.6	3.4	3.1	2.8	2.6	2.3	
Contribution from real GDP growth	-1.1	-2.5	-2.1	-3.1	4.5	0.3	-2.3	-2.5	-2.2	-1.8	-1.6	
Contribution from price and exchange rate changes 2/	-7.1	-4.7	-7.0	-2.0	6.2	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	10.1	8.6	6.5	5.1	2.2	1.8	-2.9	-4.8	-4.9	-4.3	-2.6	
External debt-to-exports ratio (in percent)	117.4	130.9	160.5	172.7	210.7	215.7	206.9	194.4	176.3	159.9	150.7	
Gross external financing need (in billions of Euros) 4/	14.2	21.7	35.9	46.2	36.8	36.8	38.4	42.7	48.8	51.1	52.9	
in percent of GDP	17.9	22.2	28.8	33.1	31.7	30.0	28.3	27.5	28.1	26.4	24.4	
Scenario with key variables at their historical averages 5/						**69.0**	**65.4**	**61.3**	**55.7**	**50.8**	**47.5**	**-9.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.1	7.9	6.3	7.3	-7.1	-0.5	3.6	4.4	4.3	4.0	4.0	
GDP deflator in Euros (change in percent)	25.4	13.7	19.9	4.4	-10.6	6.2	7.1	9.5	7.2	7.3	7.4	
Nominal external interest rate (in percent)	4.5	3.8	3.7	3.5	5.3	5.8	5.5	5.5	5.5	5.7	5.9	
Growth of exports (Euro terms, in percent)	20.6	19.5	15.9	16.5	-15.0	8.4	7.8	8.1	8.3	8.5	7.5	
Growth of imports (Euro terms, in percent)	25.9	25.4	24.5	13.2	-29.0	11.0	8.4	9.8	9.2	9.3	6.9	
Current account balance, excluding interest payments	-7.4	-9.2	-12.2	-10.1	-1.1	-1.4	-1.6	-1.9	-2.2	-2.4	-2.6	
Net non-debt creating capital inflows	6.9	8.5	6.0	6.1	4.3	3.9	4.5	4.8	4.8	4.8	4.8	

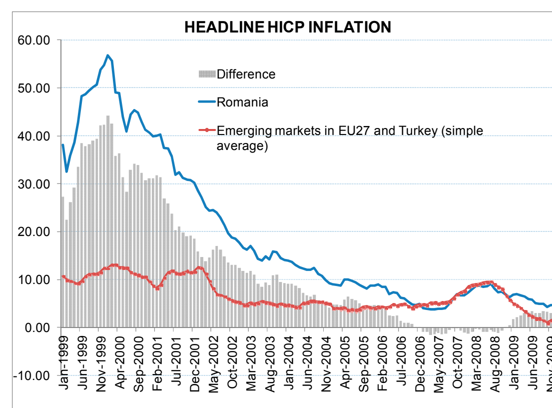
1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in Euro terms, g = real GDP growth rate,
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

ANALYTICAL NOTE 1. ROMANIAN INFLATION: HOW PERSISTENT?[8]

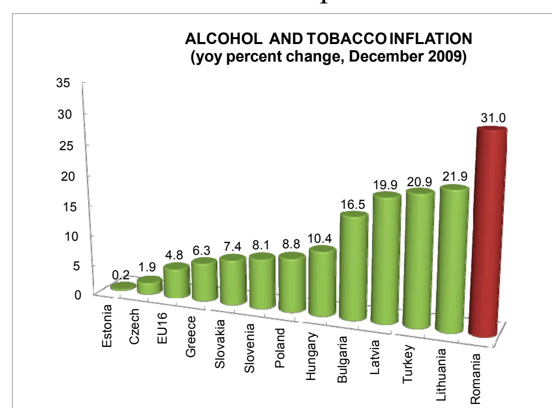
Unlike most countries, headline inflation in Romania has remained relatively high despite the collapse in demand during 2008-09, and the central bank has missed its inflation target for the past three years. This has brought forward question about why inflation in Romania has remained persistent and what are the prospects for meeting the inflation target going forward. This note addresses these issues.

Some Stylized Facts

The past ten years have been a period of dramatic disinflation in Romania, with inflation brought down from close to 60 percent in the early 2000's to levels similar to other emerging markets in the EU. The subsequent surge in inflation during 2008 mimicked developments elsewhere in the region, as it was driven by commodity and food prices, but inflation did not come down as fast as elsewhere and remained about 3 percentage points above the average for the regional emerging countries (chart). At end-2009, inflation stood at 4.7 percent, slightly above the central bank inflation target band. The decline in inflation during 2008–09 was also slow in light of the large collapse in demand during this period.



In part, the recent persistence in headline inflation can be clearly attributed to supply shocks. During 2009, Romania saw a significant increase in tobacco and alcohol prices as a result of having to adjust its specific excise duties to the minimum required by the EU. These adjustments were higher in Romania relative to other countries, because of (i) the higher gap relative to the EU requirement; (ii) the large depreciation of the currency in 2009, which further increased the local currency value of the excise (set in euros); and (iii) the authorities' decision to speed up the adjustment and carry the bulk of it out during 2009–10 (chart). Thus, tobacco/alcohol inflation accounted for about 2 percentage points of the 4.7 percent inflation at end-2009.



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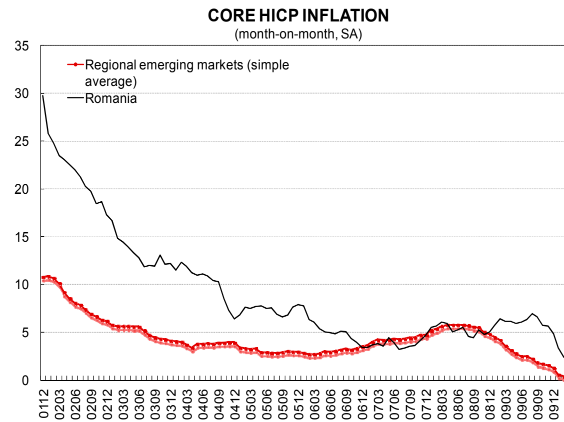
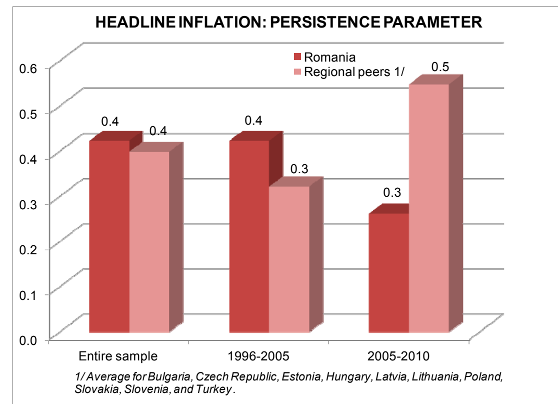
[8] Prepared by Aliona Cebotari.



Even if supply factors contributed significantly to headline inflation, core inflation has also remained higher relative to the regional peers.[9] Despite the significant widening of the output gap throughout 2009, core inflation started to decline only in late 2009, dropping precipitously to about 2 percent by February 2010.

Has inflation in Romania been intrinsically persistent, or do other factors account for the high inflation in recent years? A common way of describing intrinsic persistence is by looking at the autocorrelation properties of inflation, which we measure as the sum of autoregressive coefficients in a univariate autoregressive model $\pi_t = c + \sum_{i=1}^{4} bi\, \pi_{t-i}$ of monthly inflation with four lags. To avoid spuriously high estimates of persistence because of the long span of the sample, we test for breaks in the time series properties of inflation in our model and allow for discrete breaks in the intercept (mean inflation), but also look at a shorter sample that covers broadly the inflation-targeting period in the case of Romania (2005–10).

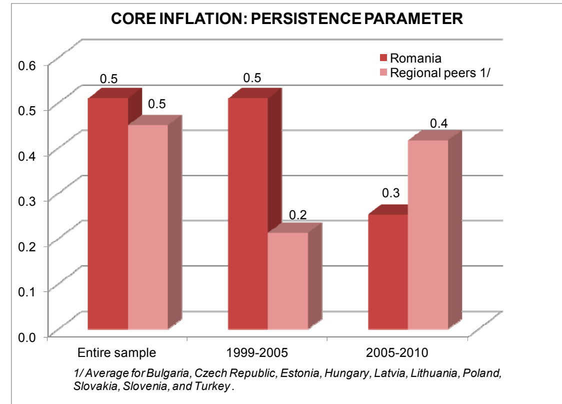
- Estimated over the past fourteen years, the sum of AR coefficients for Romania is about 0.4 (and significant), which is in line with the average for its regional peers (chart). The inflation inertia declined following the introduction of inflation targeting in 2005, with the persistence coefficient dropping from about 0.4 during the pre-IT period to 0.26 during the inflation-targeting regime and appears among the lowest in the region during this period. The low persistence relative to other countries in the region reflects in part comparison with several countries with pegged exchange rate regimes, whose inflation inertia appears to have increased significantly during 2005–10 because in the absence of a nominal exchange rate instrument inflation has been the main adjustment mechanism for the real effective exchange rate. Nevertheless, even excluding countries with pegged exchange rate regimes, Romania compares favorably



[9] In this note we use Eurostat's monthly Harmonized Index of Consumer Prices (HICP) excluding food, energy, alcohol and tobacco as a measure of core inflation.

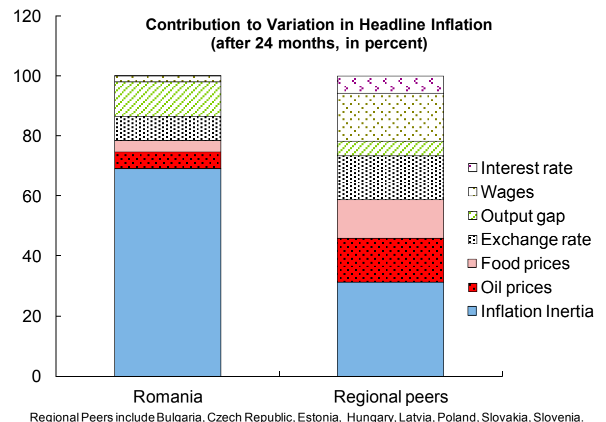
with the neighbors, with a 0.26 persistence coefficient compared to a 0.4 on average for the Czech Republic, Hungary, Poland, and Turkey.

- The results for core inflation do not reveal significant persistent either. The intrinsic persistence of core inflation, once we allow for a time-varying mean, has been about 0.5 over the past ten year, which is broadly in line with the average for emerging markets in the region. Inflation inertia fell after the introduction of inflation targeting and, at 0.3 during 2005–10, is similar to the regional peers with a flexible exchange rate regime but lower when compared to all emerging markets in the EU, including countries with pegged regimes.



Do the persistence properties of inflation change if we account for extrinsic influences of inflation? To answer this question, we estimate a vector autoregressive (VAR) model that captures the interaction of annual inflation with domestic demand conditions (output gap); monetary conditions (short-term money market rates); world food and oil prices; marginal costs (average wage in industry); and the nominal exchange rate (measured by the NEER)[10]. We estimate the model for a shorter sample 2003–2010 to avoid likely structural breaks in the dynamic properties of inflation, but also look at the outcomes for a longer sample.

Stripping away various extrinsic determinants of inflation appears to suggest that intrinsic inertia of the headline inflation in Romania is significantly higher than in its regional peers (chart). Inflation inertia accounts for 41 percent of the total variance in Romania, compared to about 20 percent on average for its regional peers, at a two-year horizon. This large difference is again driven in part by comparison



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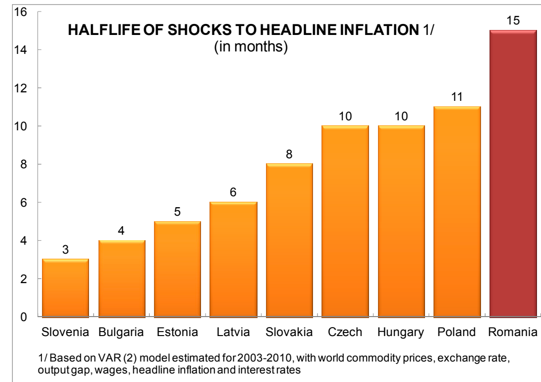
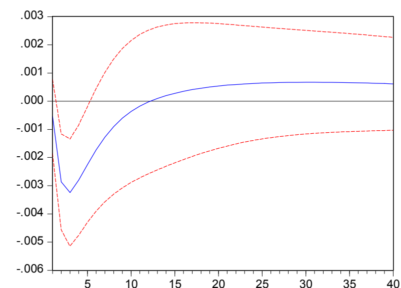
[10] We use a 2-lag model with monthly data in logs, which performs well for most countries on the basis of the lag-length selection criteria. The model's responses to shocks are assumed to follow the following causal ordering of innovations: commodity prices -> exchange rate -> output gap -> wages->inflation -> interest rate. This ordering implies that monetary policy shocks have no contemporaneous effects on any other variable as has been commonly assumed in the literature. The output gap is proxied by (the inverse) deviations of the unemployment rate from trend.

with currency board countries: this time, taking into account the impact of wages on inflation has revealed that inflation persistence in pegged-regime countries is very small, which drives down the average for Romania's peers. Compared to other inflation-targeters, Romania's inflation persistence does appear higher nevertheless, accounting for 41 percent of the total variance compared with about 37 on average for the Czech Republic, Hungary, and Poland. Another measure of inflation persistence—the half-life of a shock to headline inflation, or the number of periods it takes for a shock to dissipate to below half of its original magnitude—confirms this finding: the half life on an inflation shock is 15 months in Romania, compared to 10⅓ months in other inflation targeters and 5.2 months in countries with fixed exchange rate regimes.

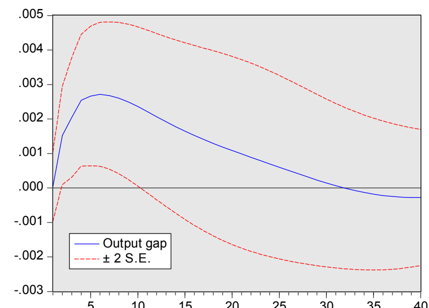


The results also suggest that extrinsic factors have a significant impact on inflation:

- The estimated impact of the exchange rate varies depending on the specification, but exchange rate shocks invariably have a very quick impact on prices, which peaks within three months and unfolds after about a year. We also find that the impact of exchange rate shocks is asymmetric during episodes of appreciations and depreciations: while exchange rate depreciations tend to increase prices, appreciations do not necessarily lead to price decreases, suggesting inflation is unlikely to benefit from the early-2010 currency appreciation, while it might still be facing the headwinds of the 2009 depreciation.



- Demand conditions have a somewhat delayed impact on headline inflation. The impact of shocks to the output gap, which are significant drivers of headline inflation, peaks at 7–8 months, explaining in part why it has remained high in the face of a widening gap. Shocks to marginal costs also have a more persistent effect, peaking after two years.

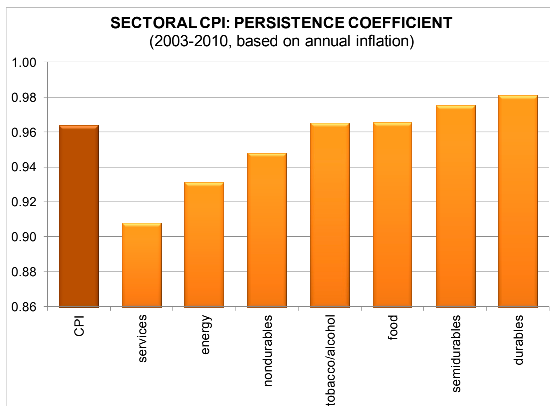


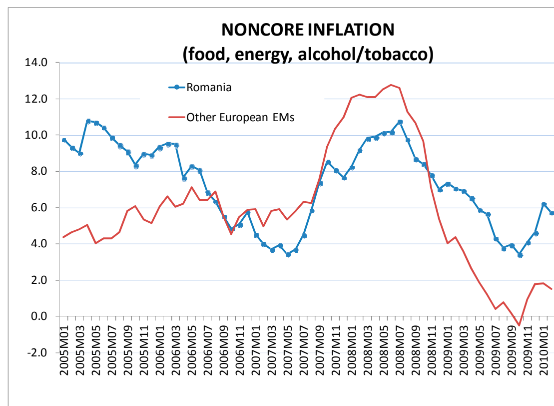
- Commodity prices account for a relatively low share of the variability in inflation, because of a low passthrough of world food prices to domestic inflation. While the contribution of oil prices to inflation variance is about 16 percent, broadly in line with Romania's peers, world food prices explain a small portion of the inflation variation, consistent with the small pass-through we find

of the world commodity prices to domestic food prices in Romania, as these appear driven significantly by local weather conditions.

A similar VAR analysis of the determinants of core inflation, on the other hand, suggests that its apparent persistence to date is not due to inherent stickiness but to extrinsic factors.[11]

- Accounting for the extrinsic influences on core inflation still preserves the finding that the inherent persistence of core inflation—measured as either the share of variance due to inflation inertia or as the half life to shocks to core inflation— is not out of line compared to other countries. In particular, shocks to core inflation have a half life of about 7 months, compared to an average of 10 months among the peers. This suggests that somewhat higher inflation inertia in Romania's headline inflation could be traced back to development in noncore prices. A look at the persistence properties of various CPI subindices for Romania suggests that alcohol/tobacco inflation and domestic food inflation—the two key subindices outside core inflation — have been very sticky over the past seven years (chart). As a result, overall noncore inflation, which also includes energy products, has remained significantly above that of Romania's peers (chart). While evidence traditionally points to notable persistence in services inflation because of the high share of labor in the sector, this does not appear to be the case in Romania, at least over the most recent period.





- The exchange rate and second-round effects from noncore inflation are the key extrinsic drivers of core inflation, together accounting for about 40 percent of its variance. Impulse responses imply, for example, that the 16 percent depreciation of

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[11] As previously, we estimate a two-lag VAR model, with the following ordering of innovations: exchange rate -> noncore inflation (food, energy, tobacco and alcohol) -> output gap -> wage inflation-> core inflation -> interest rate. The model is generally estimated over 1999–2010, although for shorter periods when data are not available.

the NEER during 2007–09 may have contributed up to 0.5 percentage points to core inflation in the short-term. Similarly, the 3 percentage point increase in noncore inflation in early 2010 in part reflecting the hikes in tobacco excises would add some 0.1 percentage points to the underlying inflation within the subsequent 6 months. This second-round passthrough explains in part the relatively higher core inflation in Romania compared to its peers, given the magnitude of the underlying supply shocks and the higher share of noncore items in the consumer basket. For example, the nominal effective exchange rate depreciated by some 16 percent during 2007–09, among the sharpest in the region, and, as we have seen earlier, noncore inflation remained above regional averages. In addition, while in most countries noncore items account for 30-45 percent of the consumer basket, their share is significantly higher in Romania (60 percent). Moreover, tests suggest that, at the 5 percent significance level, exchange rate and noncore inflation Granger cause core inflation.

Table 2. Contribution to Variation in Core Inflation

(after 24 months, in percent)

	Exchange rate	Supply factors 1/	Output gap	Wages	Inflation inertia	Interest rate
Romania	**18.8**	**11.6**	**18.5**	**10.4**	**34.0**	**6.8**
Bulgaria	6.2	38.8	12.5	19.6	21.9	1.0
Czech	13.4	37.2	6.0	4.6	29.6	9.2
Estonia	23.3	10.3	2.0	36.1	16.7	11.6
Hungary	29.2	16.7	8.0	0.6	43.4	2.1
Latvia	13.1	7.8	7.3	42.9	22.7	6.2
Poland	32.5	19.1	3.3	34.5	8.2	2.3
Slovakia	5.9	22.0	5.1	3.7	44.2	19.1
Slovenia	2.5	33.6	2.4	11.3	39.3	10.8

1/ Food, energy and alcohol/tobacco.

- Demand conditions and wage inflation have a delayed impact on core inflation as well, peaking at about 20–21 months, which again may explain the delayed drop in core inflation despite the significant widening of the output gap during 2009. For example, the impact of shocks to output gap on core inflation in Romania peaks at around 21 months, compared to an average of 9 months among the regional peers (although similar to Poland). In addition, the slow response to demand shocks suggests that that the costs of disinflation in terms of output could be relatively high, since for a targeted reduction in core inflation, the output will need to be reduced by more.

Conclusions and Outlook for Inflation

While standard measures of inflation persistence—such as the sum of autocorrelation coefficients—suggest that inflation in Romania is not more persistent than its regional peers, accounting for its extrinsic influences reveals that headline inflation is indeed relatively sticky. We do not find this to be the case for core inflation, which remained high until recently due to the effects of the sharp currency depreciation and the second-round passthrough of hikes in tobacco excises.

This suggests that the main source of the persistence in headline inflation lies in the sluggishness of "noncore" items such as tobacco and food, in the case of the former due

to staggered adjustments in excises. It also suggests that while monetary policy focus on core inflation is appropriate, it should not fully accommodate supply shocks (such as food or tobacco inflation) because of their second round effects on underlying inflation.

The findings suggest a favorable outlook for meeting the inflation target in 2010. Barring further increases in commodity prices or administered price adjustments, most cyclical factors at work should provide tailwinds to the disinflation effort. The output gap and declining wage inflation, while appearing to have bottomed out, should put downward pressures on inflation over the next year or so, given the response lags. The effects of the 2008-09 currency depreciation have largely dissipated and—while the recent leu appreciation may not contribute much to the disinflation process given the asymmetric impact of appreciation and depreciation episodes on inflation—it will also not add to the pressures. The second-round effects of the hikes in tobacco excises in early 2010 could, on the other hand, reverse the recent decline in core inflation, but only temporarily. Staff forecasts suggest that headline inflation is likely to decline to about 3½–3¾ percent by end-2010, in line with the authorities' mid-band target. The main upward risks are continued increases in world oil prices and administrative adjustments in domestic gas and drug prices, which will also have strong second round effects on core inflation.

ANALYTICAL NOTE 2. ROMANIA'S EXTERNAL COMPETITIVENESS AND STABILITY[12]

I. MOTIVATION AND MAIN FINDINGS

In the run-up to EU accession, Romania became an increasingly attractive destination for private capital inflows. This contributed to a sharp increase in the current account deficit (from about 3 percent of GDP in 2003 to a peak of 13½ percent in 2007), and a rapid appreciation of the real exchange rate (amounting to about 50 percent between mid-2004 and mid-2007). The external situation has changed drastically since 2007—the current account deficit has fallen by 2/3, the real exchange rate has depreciated sharply, and previously large non-FDI capital inflows fell to a trickle in 2009.

Against this background, this analytical note reviews Romania's external competitiveness and stability, focusing mainly on price competitiveness indicators. On balance, the analysis below suggests that while Romania's external competitiveness has improved considerably since 2007, but needs to be enhanced further. The real exchange rate remains moderately overvalued, and to ensure strong competitiveness the focus of policies should be to bring inflation down and press ahead with structural reforms. In the product markets, such reforms should aim to increase productivity and, in the labor market, to ensure that wages are set consistently with productivity growth.

II. RECENT EXTERNAL DEVELOPMENTS AND STYLIZED FACTS

Romania's real effective exchange rate (REER) has been on a depreciating trend since mid-2007, following a sharp appreciation in earlier years, although it appreciated slightly in early 2010 (Figure 1). At end-March 2010, the CPI-based REER had depreciated by about 13 percent relative to its peak in July 2007, reversing part of the appreciation since mid-2004. The depreciation of the CPI-based REER 2008–09 was due to nominal depreciation, which more than offset continued higher inflation in Romania relative to its trading partners (Figure 2). The trend in ULC-based REER is similar, but the magnitude of appreciation during 2004–07 is much larger compared to the CPI-based REER.

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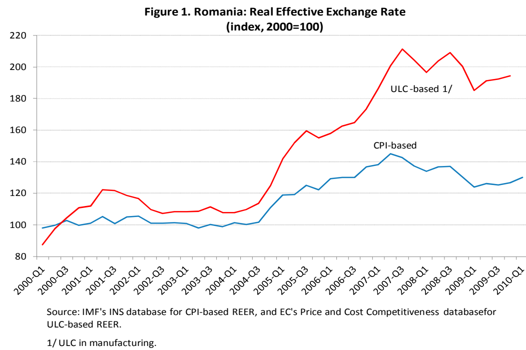
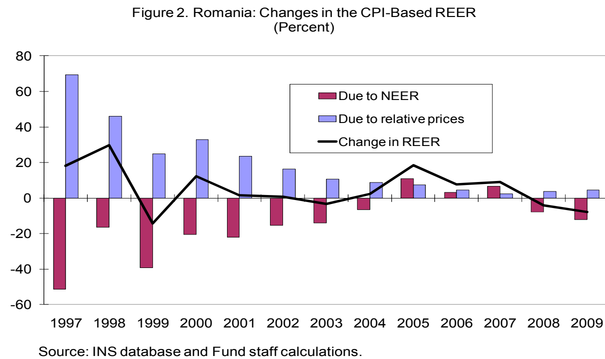
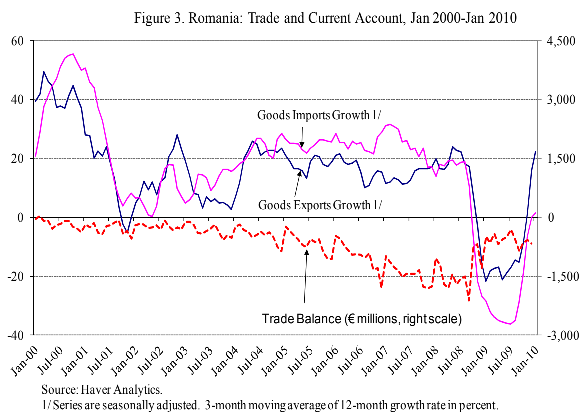
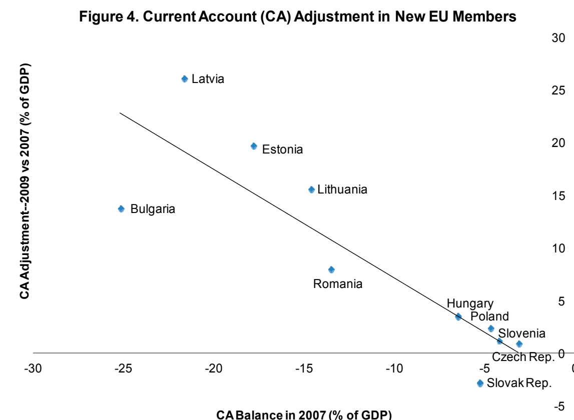
[12] Prepared by Niko Hobdari.





Romania's external trade and current account deficit contracted sharply in 2009. Following a strong absorption boom in the run up to the EU membership fueled by private capital inflows, the global financial crisis hit Romania hard, contributing to a sharp contraction in domestic demand. As a result, after years of double-digit growth, imports fell by nearly 35 percent (y-o-y) during the first nine months of 2009, almost double the rate of decline of exports during the same period. Reflecting global trade patterns, Romania's exports and imports staged a recovery towards end-2009 (Figure 3). The crisis also contributed to a sharp external adjustment, with the current account deficit falling to 4½ percent of GDP in 2009 from a peak of 13½ percent in 2007. Such adjustment was one of the highest among new EU member states, reflecting Romania's large current account deficit at the outset of the crisis (Figure 4).





Compared to BOP crises of the last decade, on average Romania has had a more moderate real exchange rate depreciation, a lower current account adjustment, but sharper collapse in external trade (Table 1). The depreciation of Romania's real exchange rate in the aftermath of the crisis was about 1/3 of the average depreciation in the BOP crises in emerging market economies of the last decade, and about 1/2 of depreciation in Hungary and Poland during this crisis. The subsequent appreciation has been much more moderate as well. The collapse in global trade impacted severely Romania's exports, and the sharp retrenchment in domestic demand contributed to a decline in imports that exceeded that in previous crisis, despite the more muted exchange rate adjustment.

Table 1. REER and Current Account Adjustments Following BOP Crisis in Selected EMCs

	REER Depreciation		Subsequent REER Appreciation (in percent)		Current Account Balance Prior to Crisis (percent of GDP) 1/	Current Account Adjustment (percentage points of GDP) 2/		Change (in percent)			
								Exports of GNFS		Imports of GNFS	
	Period	Magnitude (%)	1Y	3Y		1Y	3Y	+Y3/-Y3	+1Y/-Y	+Y3/-Y3	+1Y/-Y
Argentina	Oct '01-Jun '02	-65.1	31.4	24.6	-2.9	11.8	8.7	14.1	-6.6	-35.7	-51.3
Brazil	Jan '98-Feb '99	-42.0	17.5	8.9	-3.4	-0.9	-0.7	9.1	-6.5	-5.3	-16.3
Hungary	Aug '08-Feb '09	-20.5	13.8	…	-7.2	7.6	…	…	-21.0	…	-27.0
Indonesia	Apr '97-Jan '98	-68.1	74.3	79.2	-2.5	6.3	6.6	5.6	-11.7	-19.6	-21.9
Korea	May '96-Jan '98	-43.7	37.1	35.2	-2.5	14.0	9.0	15.1	-4.4	-9.9	-32.9
Malaysia	Mar '97-Jan '98	-35.2	11.7	17.5	-6.6	19.6	19.2	8.5	-10.6	-11.9	-26.8
Mexico	Dec '93-Mar '95	-48.2	25.7	58.2	-6.1	5.6	5.2	68.9	25.3	25.0	-11.1
Philippines	Apr '97-Jan '98	-27.4	12.6	-9.1	-4.1	6.4	2.6	14.7	-8.4	6.8	-21.4
Poland	Aug '08-Feb '09	-27.2	17.2	…	-4.2	2.5	…	…	-21.1	…	-28.3
Thailand	Apr '97-Jan '98	-41.5	37.1	22.7	-5.9	18.7	16.1	2.1	-8.8	-25.9	-33.1
Average		**-41.9**	**27.8**	**29.6**	**-4.5**	**9.2**	**8.3**	**17.3**	**-7.4**	**-9.5**	**-27.0**
Romania	**Aug '08-Feb '09**	**-13.2**	**6.4**	**…**	**-12.0**	**7.6**	**…**	**…**	**-13.3**	**…**	**-28.9**

Source: WEO and INS databases.

1/ Average of 3 years prior to the crisis.

2/ Relative to the 3 years prior to the crisis.

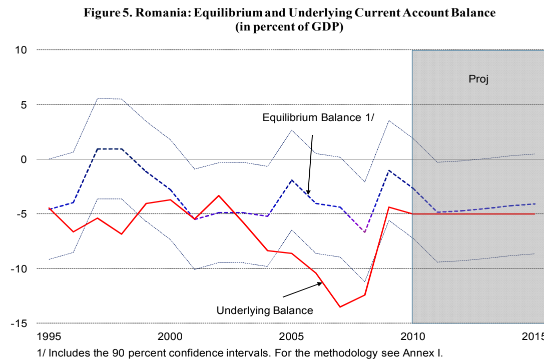
III. QUANTITATIVE METHODS FOR ASSESSING THE REER LEVEL

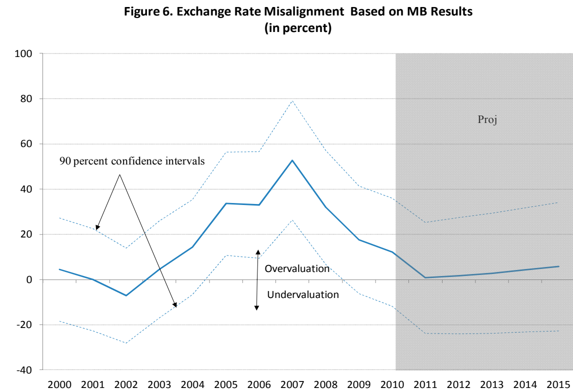
This section assesses Romania's REER level on the basis of the exchange rate prevailing at end-2009 using three standard methods: (i) equilibrium real exchange rate (ERER); (ii) macroeconomic balance (MB); and (iii) external sustainability (ES). The discussion on the first two methods below is based on Vitek (2010) results, which uses a panel data set of annual macroeconomic variables for 182 economies, whereas the discussion on the third method is based on standard trade elasticities and baseline projections of Romania's growth, inflation, and openness of its economy.[13]

A. Macroeconomic Balance

The MB method suggests a more moderate overvaluation of Romania's REER compared to the ERER method, and the estimated overvaluation is not statistically significant (Figure 5). The MB results suggest that the medium-term REER is overvalued by about 5½ percent (Figure 6). However, unlike the period 2005-08 when the REER was clearly overvalued (i.e., was outside the 90-percent confidence interval by a large margin), the REER overvaluation is no longer statistically significant (i.e., is well within the 90-percent confidence interval).

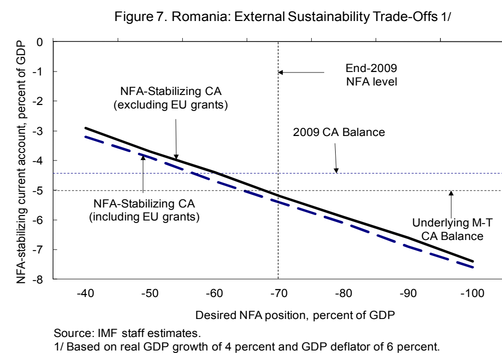
[13] See Lee et al. (2008) for a description and Annex 2.I for the main steps under the three methodologies.





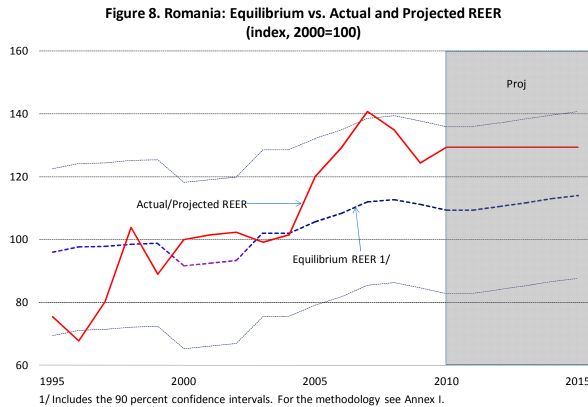
B. External Sustainability

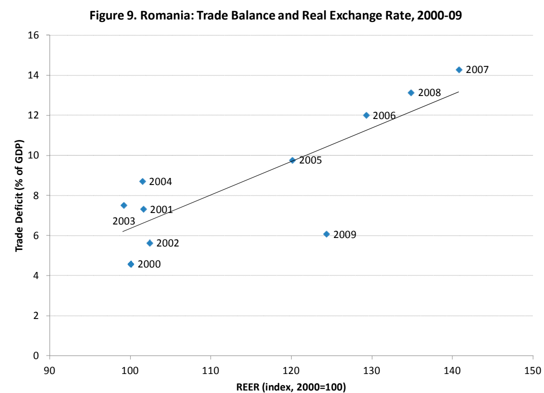
The ES method also suggests a moderate overvaluation of Romania's REER. Romania's NFA declined from -53 percent of GDP at end-2008 to -70 percent at end-2009. This deterioration was due mainly to the sharp GDP decline in 2009, but also official borrowing from IFIs that more than offset the reduction in external private debt during 2009. The projected medium-term current account deficit under the baseline scenario—about 5 percent of GDP—will lead to a gradual improvement in Romania's NFA position, and will stabilize it at around -64 percent of GDP (Figure 7). Based on IMF (2002), an appropriate NFA target for Romania would be around -53 percent of GDP, given its openness level. To stabilize Romania's NFA at such a level, a current account deficit of about 4.1 percent of GDP is needed, implying an REER overvaluation of about 5¼ percent.



C. Equilibrium Real Exchange Rate

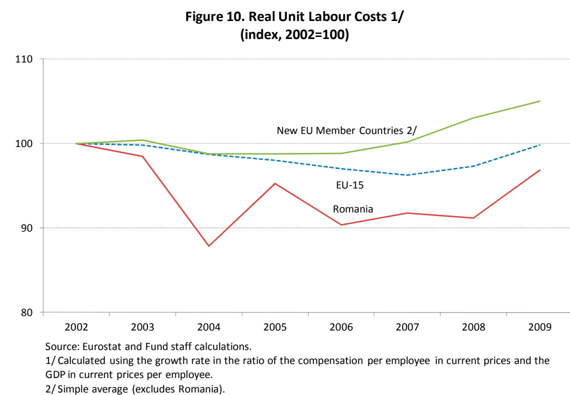
The ERER method suggests a higher overvaluation of Romania's REER than the MB and ES methods, although not statistically significant at standard levels of confidence (Figure 8). Results indicate that Romania's REER was broadly in line with its estimated equilibrium during 1995–2004, but started to become increasingly overvalued from 2005. The overvaluation increased to about 25 percent in 2007 (statistically significant at the 10 percent level), but started to moderate in 2008. The ERER results suggest that Romania's medium-term REER is about 13½ percent overvalued, although not statistically significant at the 10 percent level. This assessment seems to be supported by the fact that the adjustment in the trade balance in 2009, seems excessive in light of the REER appreciation that has taken place so far (Figure 9). It is thus unclear at this stage to what extent the current account adjustment in 2009 is sustainable at the current REER level.

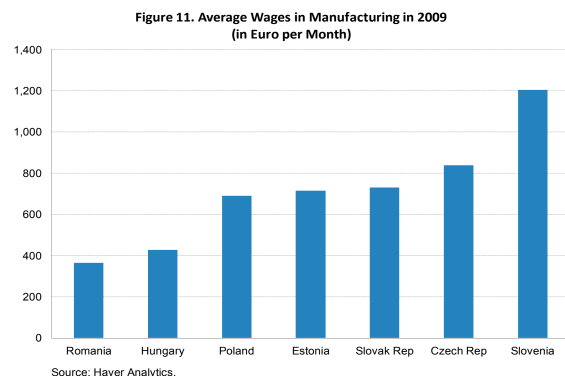




IV. Romania's Competitive Indicators

The assessment obtained from the three quantitative REER methods above is subject to large margins of uncertainty, given that structural relationships in transition economies such as Romania tend to have frequent structural breaks. In particular, it is not yet known to what extent the global financial crisis will affect international trade and capital flows. Given these uncertainties, this section reviews recent developments in a number of indicators—such as Romania's unit labor costs, manufacturing wages, trade market shares, and export composition. The objective is to combine the information from these indicators with the results from the quantitative REER methods above, to help reach an informed judgment on Romania's competitiveness and the appropriateness of its exchange rate level.



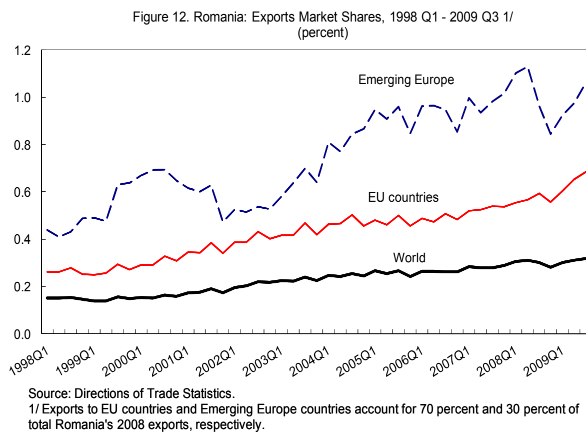


Romania's productivity strengthened during the last decade, and despite a rapid increase in manufacturing wages they remain among the lowest in the EU. Romania's overall unit labor costs (ULCs) declined by about 12 percent between 2002 and 2004, but drifted higher in recent years, offsetting part of the earlier decline (Figure 10). This increase in ULCs since 2004 reflected the sharp real appreciation that started in 2005, and also the impact of the crisis in 2009 as the decline in economic activity exceeded that of employment. The developments in Romania's ULCs were more favorable than the average in the EU-15 and the other new EU member states. At the same time, Romania's manufacturing wages also remain among the lowest relative to other new EU member states (Figure 11). More specifically, manufacturing wages in Romania

averaged about 365 €/month in 2009. The country with the closest level of manufacturing wages to Romania in 2009 was Hungary (almost 20 percent higher), whereas in the other countries manufacturing wages were significantly higher than in Romania (ranging from 90 percent in Poland to 230 percent in Slovenia). While reflecting productivity differentials, Romania's lower manufacturing wages also make Romania an attractive location for foreign investors. Indeed, FDI to Romania (as a share to GDP) have been among the highest in the new EU member states in recent years.

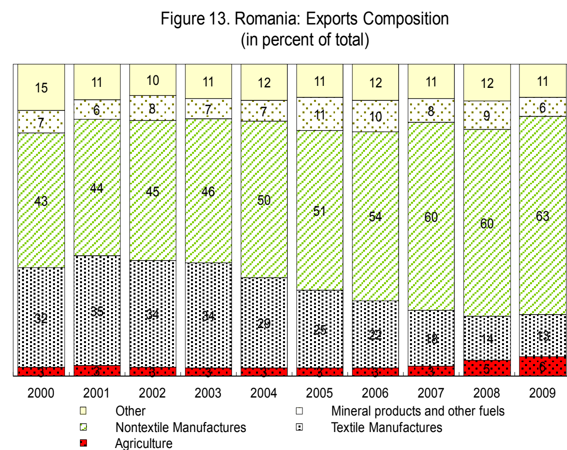
Romania has gained export market share at a rapid pace and the composition of its exports has shifted towards non-textile manufactures. Since late-1990s, Romania has basically doubled its export shares in the regional and world markets, and continued to gain market share in 2009 despite the sharp contraction in its external trade (Figure 12). The gain in market share by Romania to the EU market during the 2000s is similar to that of Poland and Bulgaria, and significantly faster than the Czech Republic and Hungary. In addition, the composition of its exports has shifted towards non-textile manufactures, which has more than offset the secular decline in textile manufactures (Figure 13).

Figure 12. Romania: Exports Market Shares, 1998 Q1 - 2009 Q3 1/
(percent)



Source: Directions of Trade Statistics.
1/ Exports to EU countries and Emerging Europe countries account for 70 percent and 30 percent of total Romania's 2008 exports, respectively.

Figure 13. Romania: Exports Composition
(in percent of total)



V. Conclusions

The analysis in this note suggests moderate but manageable external competitiveness concerns for Romania. To ensure strong competitiveness, the focus of policies should be to bring inflation down and press ahead with structural reforms. In the products markets, such reforms should aim to increase productivity and, in the labor market, to ensure that wages are set consistently with productivity growth.

The results of the three standard quantitative methods suggest, on balance, modest overvaluation of Romania's REER that is not statistically significant at standard levels

of confidence.[14] Both the ERER and MB methods show that the significant overvaluation accumulated during the overheating phase of the Romanian business cycle (through 2008Q3) has largely been corrected. And while these methods indicate a medium-term overvaluation between 5½ and 13½ percent, such overvaluation is not statistically significant at standard levels of confidence. The ES method also suggests a moderate undervaluation if Romania were to target an NFA level of -53 percent of GDP, determined on the basis of its openness level. The above results of quantitative methods, however, are subject to significant margins of uncertainty, given the unknown impact of global financial crisis on global trade and capital flows.

Table 2. Romania: Estimated REER Misalignment

Approach	Magnitude of Misalignment
Equilibrium Real Exchange Rate	Overvalued: 13½ percent 1/
Macroeconomic Balance	Overvalued: 5½ percent 1/
External Sustainability	Overvalued: 5¼ percent 2/
Overall assessment	**Overvaluation: 5-15 percent**

1/ Not statistically significant at 10 percent level.
2/ Level of misalignment for bringing the NFA level to -53 percent of GDP.

Various wage and labor productivity indicators show a moderate reduction in Romania's ULCs during the 2000s, and Romania has also continued to gain export market share. While labor productivity has increased rapidly since early 2000s, Romania's wages in the manufacturing sector remain among the lowest in the region, reflecting differences in productivity. At the same time, Romania has made rapid gains in both EU and global export markets shares, mainly due to a rapid increase in non-textile manufacturing exports, and has also increases the share of medium-and high tech exports.

[14] This assessment is based on the level of the exchange rate prevailing at end-2009. In early 2010 Romania's REER appreciated by some 2-3 percent relative to end-2009 level reflecting mainly the appreciation of €/RON exchange rate. If sustained, such appreciation would have posed increasing sustainability problems. As of end-May 2010, however, Romania's REER had returned back to its end-2009 level.

Annex 2.I: Methodology and Data for Exchange Rate Assessment

This annex summarizes the steps for three methodologies used in this analytical note to assess where Romania's REER stands with respect to its fundamental determinants. The ERER and MB methods are based on results of Vitek (2010), which uses a panel data set of macroeconomic variables for 182 economies.

ERER Method

- Estimating a reduced-form equilibrium relationship between the actual REER and a set of fundamentals, consisting of terms of trade, relative productivity, relative government consumption, net foreign assets, aid inflows, and remittance inflows.
- Calculating the REER adjustment needed to restore equilibrium as a difference between the actual REER and the "equilibrium REER" estimated on the basis of the above set of REER medium-term fundamentals.

MB Method

- Estimating an equilibrium relationship between the current account (CA) balance and a set of fundamentals, including relative income, relative income growth, relative old age dependency, relative population growth, relative fiscal balance, oil balance, initial net foreign assets, aid inflows, and remittance inflows.
- Calculating the needed REER adjustment to close the gap between the underlying CA and the "CA norm" derived from previous step, using the medium-term semi-elasticity of the current account balance to the REER. The latter is estimated as $\eta = -0.71 * \eta_x - 0.92 * (\eta_m - 1)$, where -0.71 and 0.92 denote, respectively, the medium run elasticity of the volume of exports or imports with respect to REER, and η_x and η_m denote, respectively, the medium-term projection of the ratio of exports and imports to output. The projected medium-term η for Romania is -0.14.

ES Method

- Calculating the size of the CA balance that will stabilize the NFA at a given "benchmark" position. A range of NFA levels is used in this note.
- Comparing the "stabilizing" CA balance obtained from the above step with that expected to prevail in the medium term at unchanged policies.
- Calculating the needed REER adjustment to close the gap between the "stabilizing" CA balance and the projected CA at unchanged policies, using the semi-elasticity of the current account balance to the REER (-0.14).

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Analytical Note 3: Assessment of Reserve Adequacy for Romania[15]

The financial situation in Romania has stabilized since it was granted exceptional financial assistance from IFIs in May 2009 to cushion the adverse impact of the global financial crisis. The sharp reversal in capital flows that started in late-2008 and continued into early 2009 has moderated, and the disbursements of official financial assistance helped build international reserves above the pre-crisis level.

Against this background, this analytical note assesses Romania's reserve adequacy. In summary, Romania's reserves coverage compares well with other emerging market countries (EMCs) and the level of reserves seems adequate. Romania's reserves coverage is well above the two main rules of thumb, and broadly consistent with the optimal level of reserves suggested by a model-based approach that takes into account both the benefits of consumption smoothing and the opportunity cost of holding reserves.

The note proceeds as follows. Section I discusses the principles determining the size of reserves holdings in EMCs. Section II reviews recent developments in Romania's reserves. Section III uses a model-based framework to determine reserve adequacy for Romania.

I. Principles Determining Size of Reserves Holding in EMCs

Holding of reserves is one of the main self-insurance mechanisms for countries to cushion the impact of adverse economic shocks. An adequate level of reserves allows countries to smooth consumption during a crisis, and may also help reduce the probability of crises through confidence effects and giving authorities room for maneuver. However, holding of reserves involves financial costs, as they yield a return that is generally well below the interest rate that the authorities pay on their debt. Thus in determining the level of reserves, countries have to balance the consumption-smoothing and potential confidence benefits of a ready stock of reserves, against the financial costs of holding such reserves.[16]

As a general principle, it is not optimal to self-insure through reserves for any potential shock. In the case of tail events, it seems superior to make temporary use, if needed, of bilateral or multilateral resources (e.g., IMF). As regards insurance from "reasonable risks," given the EMCs increasing integration with international financial markets and thus higher exposure to sudden stops in financial flows, their focus on reserve adequacy has shifted away from trade considerations, and toward the financial account and balance-sheet fragilities. In

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[15] Prepared by Niko Hobdari.

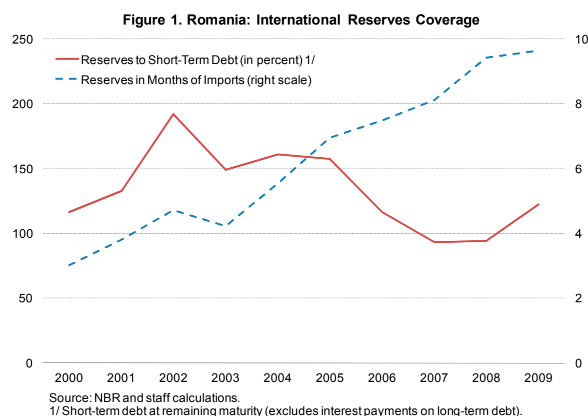
[16] See IMF (2007) for an in-depth discussion of benefits and costs of reserves holding.

practice, this has meant placing increasingly less weight on the traditional three-month-of-import rule, and more to the Greenspan-Guidotti rule, according to which reserves should fully cover short-term debt.

II. How Does Romania's Reserve Coverage Compare with Other EMCs?

Romania's international reserves increased rapidly in the run up to the EU. Driven by a sharp acceleration in capital inflows, particularly debt-creating bank inflows, Romania's reserves increased from just under €8 billion at end-2003 to nearly €29 billion at end-2007, an average annual increase of about 40 percent.

Reserves coverage to imports of goods and services (GNFS) increased sharply since 2003 despite a rapid trade expansion. Although GNFS imports increased by about 17 percent per year during 2003-07, the increase in reserves was even faster. As a result, the coverage of reserves doubled from about 4 months of GFNS imports at end-2003 to 8 months at end-2007 (Figure 1). The reserve coverage increased further to about 9½ months at end-2009, but this was mainly due to the collapse in trade from the global financial crisis.



In contrast, reserves coverage to short-term external debt declined rapidly since 2003. With an increasing share of capital inflows as short-term debt, reserves coverage to short-term debt declined from nearly 200 percent at end-2003 to below 100 percent at end-2008. The improvement in 2009 reflected mainly the increase in gross reserves and an improvement in the maturity structure of private external debt during 2009.

Romania's reserves coverage compares favorably with other EMCs. Coverage to GNFS imports was 9½ months at end-2009, well above the median of 6 months for the EMCs included in Figure 2. In addition, coverage to short-term external debt at end-2009 was about 122 percent, right at the median level for the EMCs included in Figure 3. Compared to other countries in the region, Romania has one the highest reserves coverage to short-term debt.

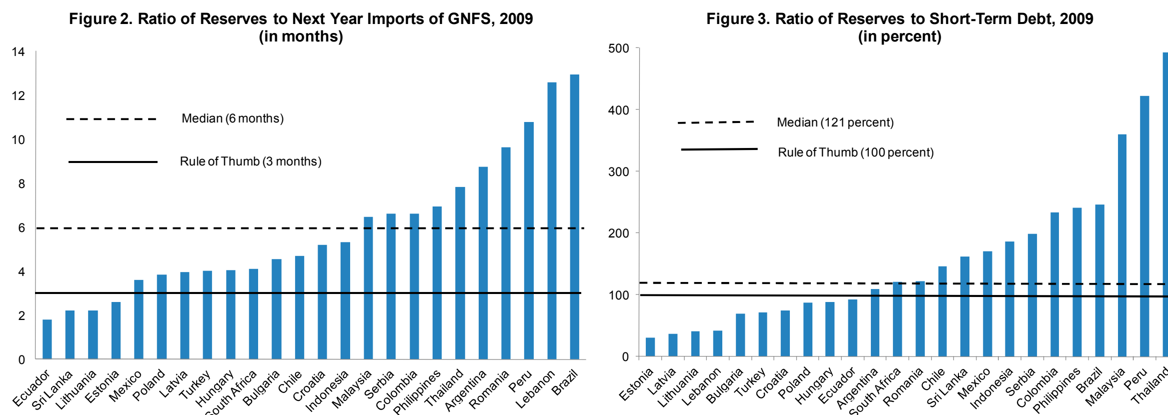


Figure 2. Ratio of Reserves to Next Year Imports of GNFS, 2009 (in months)

Figure 3. Ratio of Reserves to Short-Term Debt, 2009 (in percent)

III. Model-Based Approach to Reserve Adequacy in Romania

While Romania's reserves coverage is well above both rules of thumb—i.e., the 3-months-of-imports and 100 percent short-term debt—such rules lack analytical foundations. This section calibrates the optimal level of reserves for Romania using the framework of Jeanne and Ranciere (2006).

That paper develops a model that optimizes the reserves holdings, taking into account both the benefits of consumption smoothing in a small open economy that is hit by a sudden stop in capital inflows, as well as the opportunity cost of holding reserves. The model generates a formula that calibrates the optimal reserves as follows:

$$\rho = \lambda + \gamma - (1 - p^{\frac{-1}{\sigma}}) \qquad (1)$$

where:

$$p = 1 + \frac{\delta}{\pi(1 - \delta - \pi)} \qquad (2)$$

and:

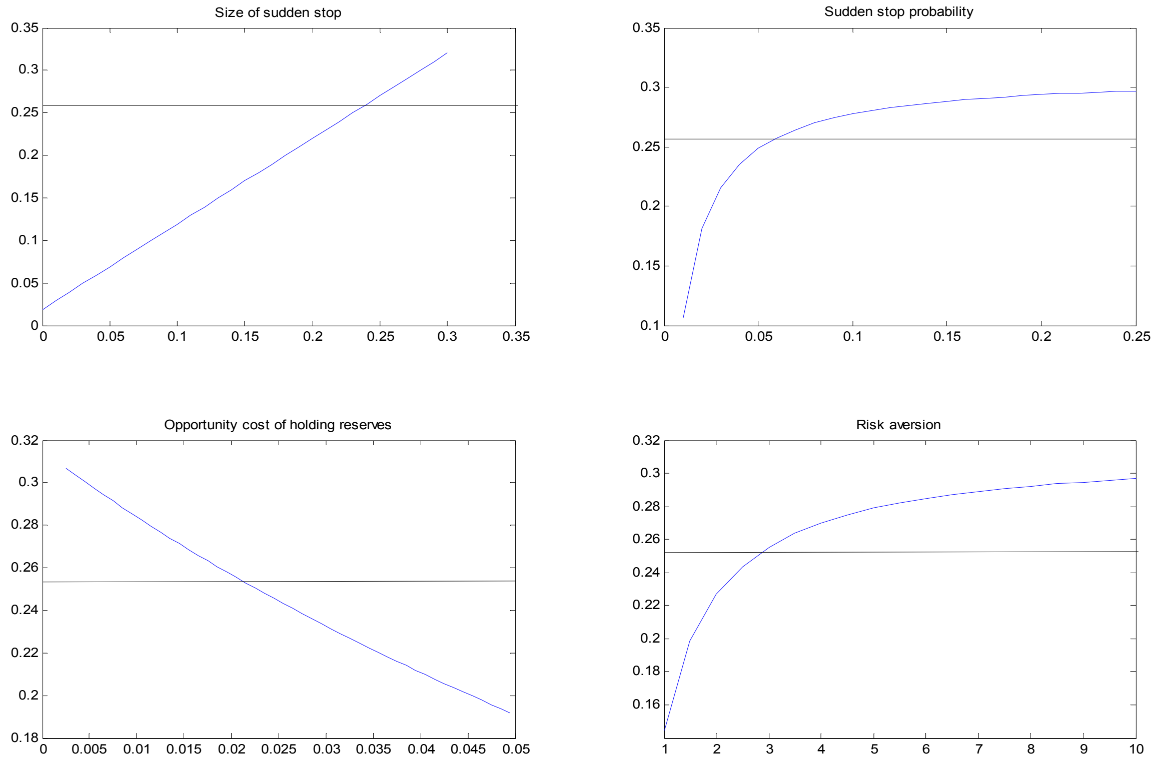
ρ – is the level of reserves as a share of GDP
λ – is short-term debt as a share of GDP
γ – is the output cost of a sudden stop
σ – is the risk aversion parameter
δ – is the opportunity costs of reserves holding, and
π – is the probability of a sudden stop

To calibrate the level of reserves for Romania, the following baseline values were used: λ=25 percent of GDP (20 percent for short-term debt at remaining maturity at end-2009, and 5 percent for the current account deficit projected in 2010); λ=6.5 percent of GDP, and π=8 percent (both from Jeanne and Ranciere); δ=200 basis points (current difference between charges on liabilities to IMF and interest from reserves); and σ=3 (Salman, 2005).

These parameters generate a baseline level of reserves for Romania of 25½ percent of GDP, or about €31 billion on the basis of projected GDP for 2010. This is equivalent to the level of Romania's reserves at end-2009 (€30.9 billion), and lower than that projected for end-2010 (€37½ billion). Clearly, except for the level of short-term debt (actual data) and current account deficit (baseline projection), the choice of the other parameters above is somewhat arbitrary. In addition, authorities may want to insure against a smaller amount of sudden stop (the calibration assumes insurance for 100 percent of short-term debt at remaining maturity, plus the full amount of the current account deficit).

The sensitivity of the optimal level of reserves holdings for Romania is greatest regarding the size of sudden stop and the opportunity costs of reserves holding. Figure 4 below shows the sensitivity of the optimal level of reserves for Romania for four main parameters: (i) size of sudden stop, (ii) sudden stop probability, (iii) opportunity cost of holding reserves, and (iv) magnitude of risk aversion. For reasonable parameter values on sudden stop probability and risk aversion, the sensitivity of results is relatively moderate. However, sensitivity of results is significant for the size of sudden stop and the opportunity cost of reserves. More specifically, if the sudden stop would affect only short-term debt (i.e., will have no impact on financing needed to cover the projected current account deficit), the desired level of reserves would fall from 25½ percent of GDP (€31 billion) in the baseline, to about 22 percent of GDP (€27 billion). Results are also highly sensitive to the opportunity costs of holding reserves. For example, if the opportunity costs of holding reserves would increase from 200 to 300 basis points, the optimal level of reserves would fall to 24 percent of GDP (€29 billion).

Figure 4: Romania: Sensitivity of Size of Optimal Reserves
(as share of GDP)



Source: IMF staff calculations based on Jeanne and Ranciere (2006).

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ANALYTICAL NOTE 4: UNDERSTANDING OUTPUT COLLAPSE IN ROMANIA[17]

I. INTRODUCTION

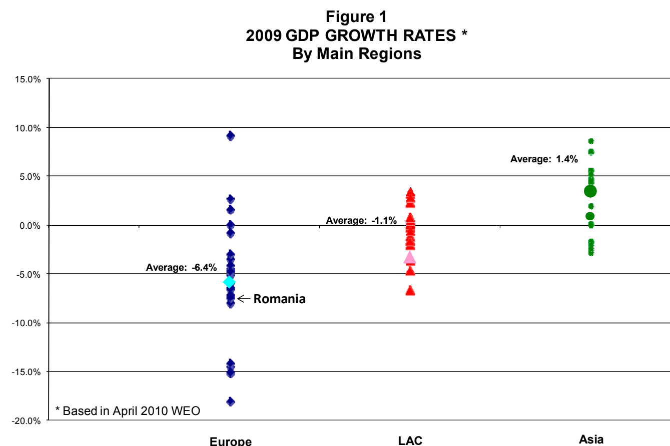
While any economic crisis is always painful, the current global crisis is expected to be particularly harsh and its economic and social consequences will be quite large. First, by any measure, the economic meltdown is the deepest of the postwar period. Second, the degree of synchronicity of the downturn is the highest over the past half century.[18] This global crisis, which started in the U.S. housing market, spread rapidly across markets and borders after the Lehman Brother's collapse in September 2008. Emerging markets and developing countries were then confronted with two sizeable shocks. First, a "sudden stop" of capital inflows was prompted by the global deleveraging process. Second, a decline in exports followed the recession in advanced economies. However, despite the intensity of the shocks and its synchronized propagation, the impact on economic activity varied widely across nations.

Why growth performance was relatively weaker in Emerging Europe than in Latin American or Asia? Even though Emerging Europe has been hard hit on average, there is also an extraordinary variation on how much economies in this region were affected. The 7.1 percent GDP contraction in Romania in 2009 was one of the largest in the region. Why this heterogeneity even within countries in the same region? Were all countries just innocent bystanders of a crisis that originated in financial sectors of the US and other advanced economies? Or did weak policy frameworks impair countries resilience to external shocks? Based on cross-country regressions, this note seeks to answer these questions.

II. PRELIMINARY LOOK AT THE DATA

Cross-Regional Analysis

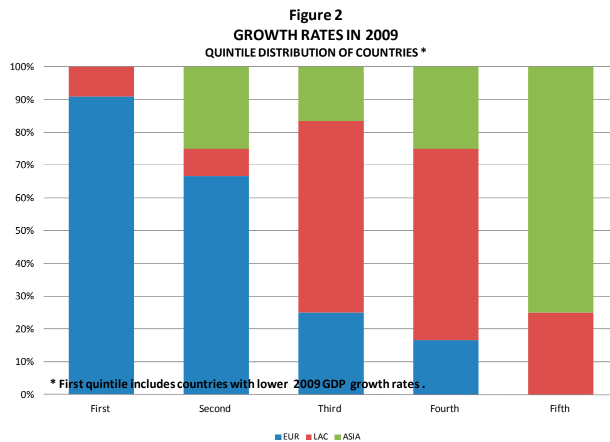
While the current crisis had serious output repercussions worldwide, i.e. in both developed and developing economies, the severity of the impact was far from homogenous across regions or countries. Figure 1 presents the 2009 growth rates for a sample of 58 emerging markets and



[17] Prepared by Carlos G. Fernández Valdovinos.

[18] In 2009, all advanced economies plus roughly half emerging markets and developing countries were in recession.

developing countries.[19] In this sample growth rates varies from a low -18.5 percent for Lithuania to a high 8.5 percent in China. Among regions, Emerging Europe was hit the hardest as GDP contracted by 6.4 percent on average. In Latin America GDP also declined, but only by 1.3 percent on average. In contrast, output in Emerging Asia grew by 1.1 percent on average.



An analysis by quintiles also highlights that countries in Emerging Europe were badly hit by the global crisis.[20] Figure 2 shows that European economies account almost entirely for the first quintile.[21] Moreover, 75 percent of countries in this region are in either the first or second quintile. Countries in Emerging Asia and Latin America fared much better. Why was the impact so different across regions and countries? Why countries in Emerging Europe suffered larger output declines than other economies in the world? In particular, what could explain the larger-than-average GDP drop in Romania?

Previous studies have employed a wide range of variables to capture alternative transmission mechanisms for the ongoing global crisis. Similarly, this paper explores five likely channels of transmission: (i) macroeconomic imbalances; (ii) financial vulnerabilities; (iii) trade linkages; (iv) overall policy framework; and (v) other variables. Economic developments during the run-up to the global crisis had several common characteristics in countries most affected by the meltdown. In particular, it seems that most potential channels have played a central role for the cross-border transmission (and amplification) of the recent shocks.

Table 1 shows, for each quintile, the average value of some variables employed in the econometric exercises. Within the sample, it is clear that hardest hit countries exhibited large internal and external imbalances in the run-up to the crisis. The financial linkage channel was also important: the degree of leverage, the growth in bank credit and the amount of capital inflows are positively correlated with the severity of the growth impact. Countries with higher business cycle correlations with developed economies and more open to external trade have also registered a worse growth performance. Finally, there is some indication that economies

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[19] Data is from the April 2010 IMF *World Economic Outlook*. The sample includes countries from Europe (23), Latin America (18) and Asia (17) (Appendix 4.I).
[20] For this exercise countries are divided into quintiles according to their 2009 growth rates, with the first quintile comprising economies with the largest GDP drop.
[21] Mexico, with close economic links with the US, is the exception.

with stronger macroeconomic policies have seen smaller fallouts in output. It is also clear from the table that countries in Emerging Europe suffered sharper output contractions on the back of mounting macroeconomic vulnerabilities and relatively weak domestic policies. Romania was not an exception.

TABLE 1: OUTPUT PERFORMANCE AND MACROECONOMIC FUNDAMENTALS

Countries classsified by quintiles and regions

		Macroeconomic Imbalances		Financial Sector Vulnerabilties		Trade Linkages		Policy Framework		
	2009 GDP Growth Rate	Output Gap 1/	CA Balance 2/	Private Sector Credit 3/	Capital Inflows 4/	Openess 5/	BC Correlation 6/	Fiscal Balance 7/	Exchange Rate Regime 8/	Inflation 9/
By Quintiles										
First	-10.5%	11.5%	-10.6%	16.8%	28.5%	117.5%	0.64	-1.7%	0.45	6.9%
Second	-4.3%	5.8%	-5.3%	9.4%	13.5%	112.5%	0.57	-1.5%	0.25	10.6%
Third	-1.7%	5.1%	-4.4%	9.8%	6.9%	63.8%	0.54	0.0%	0.58	5.4%
Fourth	1.0%	2.7%	-2.8%	5.6%	3.5%	65.5%	0.37	-1.5%	0.17	7.1%
Fifth	5.4%	1.7%	1.7%	4.6%	3.2%	66.7%	0.23	-0.6%	0.42	15.7%
By Region										
Emerging Europe	-5.8%	8.6%	-9.4%	20.3%	26.4%	92.0%	0.58	1.0%	0.46	7.5%
Baltics	-15.7%	16.7%	-14.6%	26.0%	57.4%	104.9%	0.75	3.0%	1.00	8.2%
CEE	-4.7%	6.3%	-9.3%	20.6%	24.8%	116.3%	0.61	1.8%	0.29	5.1%
SEE	-2.8%	4.8%	-15.0%	22.9%	18.7%	65.2%	0.64	2.4%	0.67	5.3%
Others	-5.6%	10.7%	-1.0%	15.4%	21.6%	89.7%	0.42	0.6%	0.29	11.4%
LAC	-0.5%	3.9%	-2.8%	6.1%	2.7%	62.7%	0.36	0.5%	0.33	8.0%
Emerging Asia	2.3%	2.0%	1.9%	5.1%	16.9%	115.2%	0.42	1.7%	0.35	8.7%

1/ Output gap is calculated using the Hodrick-Prescott filter to the 1991-2014 real GDP data. The figure is the 2006-08 average as percentage of potential GDP.
2/ Percentage of GDP. The figure is the 2006-08 average.
3/ Percentage of GDP. The figure is the increase in the ratio during the 2005 and 2008 period.
4/ Percentage of GDP. Capital inflows is defined as the sum of the lines Other Investment (liabilities) and Portfolio Investment (liabilities) in the BOP. Sum for the 2006-08 period.
5/ Percentage of GDP. Sum of exports and imports of goods and services for the year 2008.
6/ Average business cycle correlation with Euro zone, United States and Japan for the 1991-2014 period. Business cycle component calculated using Hodrick and Prescott filter.
7/ General Government Balance as percentage of GDP in 2008.
8/ Based on IMF de facto classification of exchange rate regimes. Dummy variable equals to 1 for countries having a fixed exchange rate regime (i.e. exchange arrangement with no separate legal tender, currency board arragenment and other coventional fixed peg arragement).
9/ Calculated using average CPI during the year. The figure is the 2006-08 average.

III. Regression Results

This section uses cross-country regression analysis to assess more formally how recent output dynamics were affected by different factors. The dependent variable in baseline regressions is the 2009 GDP growth rate. For the econometric exercises, potential explanatory variables are divided into two groups (see Appendix 4.II). The first group includes the control variables, which portray each country trade linkages and main structural characteristics: correlation of business cycles with developed economies, degree of openness, population size, per-capita GDP, share of industry in GDP, institutional indexes, etc. The second group contains a set of important pre-crisis fundamentals: current account balance, inflation rate, general government balance, exchange rate regime, growth in credit to the private sector, amount of capital inflows, international reserves ratios, etc. The empirical results are presented in Table 2.

There is strong evidence that output contracted more in countries highly integrated to the world economy. After controlling for GDP, the variable measuring the degree of synchronization of economic cycles with developed economies (i.e. the average correlation coefficient of business cycles with US, Euro area and Japan) enters significantly and with the correct sign in all models. The empirical work also confirms that countries having important financial sector vulnerabilities in years prior to the crisis suffered the steepest output contraction. In particular, results suggest that domestic credit booms and sizeable capital

inflows[22] are robust pre-crisis predictors of output declines. However, and in contrast to previous findings in the literature, the degree of leverage did not enter significantly in any model once one control for other factors.

Table 2: Baseline Regressions Results

Extended Models

Specificatio Dependent variable: 2009 GDP growth rate	(1	(2	(3	(4	(5	(6	(7
Constan	0.20	0.129	0.21	0.289	0.21	0.303	0.24
	(0.040 ***	(0.052 **	(0.042 ***	(0.067 ***	(0.059 ***	(0.058 ***	(0.059 ***
Control variables							
Business Cycle Correlation	-0.107	-0.100	-	-	-	-	-
	(0.019 ***	(0.020 ***	(0.021 ***	(0.021 ***	(0.022 ***	(0.021 ***	(0.022 ***
Share of Industry in GDP	0.00	0.000	0.00				
	(0.000	(0.001	(0.000				
Log. PPP GDP	-0.036	-0.037	-	-	-	-	-
	(0.006 ***	(0.006 ***	(0.006 ***	(0.009 ***	(0.009 ***	(0.006 ***	(0.006 ***
Global Competitiveness Index	0.04	0.063	0.04	0.017	0.02		
	(0.012 ***	(0.016 ***	(0.011 ***	(0.020	(0.020		
Financial Sector Vulnerabilties							
Cummulative Credit Growth	-0.001			-		-	
	(0.001 **			(0.000 *		(0.000 **	
Capital		-0.074			-		-
		(0.039 *			(0.033 **		(0.035 **
Leverag			-				
			-				
Monetary and Fiscal Policies							
Gen. Gov.				-	-	-	-
				(0.002	(0.002	(0.002	(0.002
Gen. Gov. Balance* Europe Dummy				0.006	0.00	0.006	0.00
				(0.003 **	(0.003 **	(0.002 **	(0.003 ***
Inflation Rate				-	-	-	-
				(0.182 *	(0.172 *	(0.133 **	(0.133 **
Exchange Rate Regime				-	-	-	-
				(0.012	(0.012	(0.010	(0.010 *
International Reserves/GDP				0.020	0.09	0.022	0.09
				(0.034	(0.042 **	(0.033	(0.044 **
Observation	5	5	5	5	5	5	5
R-squared	0.5	0.5	0.59	0.6	0.64	0.6	0.60

Standard errors in parenthesis

****, ** and * indicate statistically significance at 1, 5 and 10 percent levels.*

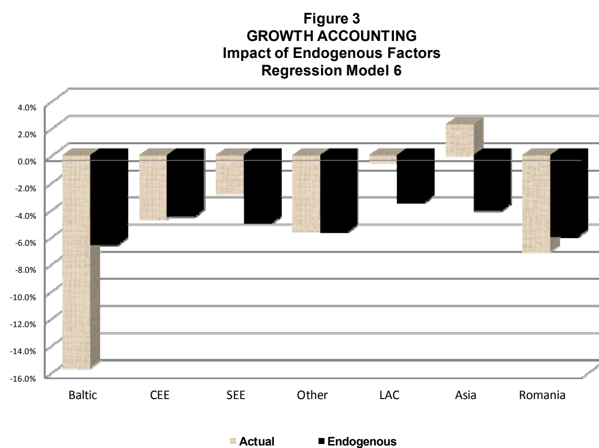
Improved macroeconomic frameworks have also helped countries to reduce the degree of output contraction, but there is stronger evidence for the importance of monetary and fiscal policies than for exchange rate policy in dampening the impact of the crisis. For instance, a better monetary framework (i.e. lower inflation rate) was instrumental across all countries to avert systemic damages of the current meltdown. The effect of sound fiscal policies is, however, not homogenous across all regions: the general government deficit was statistically significant only for countries in Emerging Europe. In this region, countries that

[22] Capital flows are defined as the sum of portfolios investment (liabilities) and other investment (liabilities).

pursued loose fiscal policies before the crisis (reflected in large budget deficits) have experienced a greater fall in GDP, other things equal.[23] The significance of other macro-policy (like exchange rate regime or international reserve coverage) is not robust across all specifications.

A growth accounting exercise could be performed using these econometric results. To this aim, the explanatory variables employed in the regressions are divided into two categories: exogenous and endogenous. The exogenous variables are those considered to be outside the authorities' control, at least in the short run, and include all the control variables. The endogenous ones comprise the variables reflecting financial sector vulnerabilities and the policy framework. These variables can be clearly influenced by government's decisions. The estimated parameters from regression model 6 and 7 in Table 2 and the variables mean values (for each group of countries) are used to construct the predicted output drop arising from endogenous and exogenous variables.

Figure 3
GROWTH ACCOUNTING
Impact of Endogenous Factors
Regression Model 6



While deteriorating external conditions were important factors, unsustainable domestic policies explain a large part of the recent output collapse in Emerging Europe. Some countries in the region entered the global recession with deep-rooted vulnerabilities, running large current account deficits due to loose fiscal policy and excessive credit growth. Thus, external shocks during the crisis were exacerbated by poor macroeconomic policies. The growth accounting exercise indicates that weak domestic policies could explain a large part of the recent output collapse in European countries. In fact, the output contraction due to endogenous factors is estimated to be larger for European countries than for the average country in Latin America or Asia.

The negative effects of weak domestic policies in Romania were far more important than in almost any other sub-regional group. Financial sector vulnerabilities and weak macroeconomic policies account roughly for a 6.1 percent GDP contraction in 2009, almost the entirely actual contraction.[24] If Romania had had the same macroeconomic policies as the average country in the CEE sub-region, its growth rate would have been around 1.5 percent higher.

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[23] This finding is in line with the notion that countries with more pre-crisis fiscal space were able to adopt more effective countercyclical fiscal policies during the meltdown.
[24] Using model 7 for the exercise delivers a similar result: weak domestic policies could account for a 4 percent 2009 GDP contraction in Romania.

IV. Conclusions and Policy Implications

Results in this paper highlighted that sound policy frameworks were crucial buffers to cushion external shocks. These shocks were wide-raging and severe, but some economies fared better than others during the global meltdown. Cross-country regressions showed that a relatively small set of variables could explain much of the difference in countries' growth performance after the financial crisis intensified in September 2008. In particular, empirical results showed that trade linkages have played a key role in the transmission of the crisis to emerging markets and developing countries. However, there is also robust evidence that financial vulnerabilities and poor macroeconomic policies have intensified the impact of external shocks. Countries with more rapid growth in lending to the private sector (usually associated with massive capital inflows), weaker fiscal positions and higher inflation rates prior to the crisis tended to suffer larger output losses.

While deteriorating external conditions triggered the inmediate crisis, unsustainable domestic policies contributed to the large output collapses in Emerging Europe. Several countries in the region were ill suited to face the global meltdown, including Romania. They entered the global recession with deep-rooted vulnerabilities, running large current account deficits due to loose fiscal policy and excessive credit growth. The pre-crisis capital inflow-fueled-boom left the region highly exposed to a reversal in market sentiment and a "sudden-stop" of capital inflows. In addition, expansionary macroeconomic policies further exacerbated private sector demand pressures, built even larger imbalances and left no room for counter-cyclical stimuli once the crisis unfolded.

This empirical attempt to explain the heterogeneous experiences of countries suggest some preliminary policy lessons. In years prior to the crisis some economies have made strides in strengthening fiscal positions, solidifying financial systems and their regulation, and anchoring inflation expectations. For this reason they were able to respond to the external crisis with active (fiscal and monetary) policies to boost output and employment, suffering considerably smaller declines in output. The message is clear: policy preparation could pay important dividends when external conditions deteriorate. Importantly, as the crisis draws to a close and economies start to move forward, the benefits of improved frameworks need to be safeguard by a continuation of prudent policies. After all, the next financial crisis may be around the corner.

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APPENDIX 4.I: LIST OF COUNTRIES

Emerging Europe	**Latin America**	**Emerging Asia**
Albania	Argentina	Bangladesh
Azerbaijan, Rep. of	Bolivia	Cambodia
Belarus	Brazil	China,P.R.: Mainland
Bosnia & Herzegovina	Chile	China,P.R.:Hong Ko
Bulgaria	Colombia	India
Croatia	Costa Rica	Indonesia
Czech Republic	Dominican Republic	Korea, Republic of
Estonia	Ecuador	Lao People's Dem.R
Georgia	El Salvador	Malaysia
Hungary	Guatemala	Mongolia
Latvia	Honduras	Myanmar
Lithuania	Mexico	Nepal
Macedonia, FYR	Nicaragua	Philippines
Moldova	Panama	Singapore
Montenegro, Rep. of	Paraguay	Sri Lanka
Poland	Peru	Thailand
Romania	Uruguay	Vietnam
Russian Federation	Venezuela, Rep. Bol.	
Serbia, Republic of		
Slovak Republic		
Slovenia		
Turkey		
Ukraine		

APPENDIX 4.II: LIST OF EXPLANATORY VARIABLES

Trade linkages

Business cycle correlation, average with US, Euro area and Japan- Author's calculation
Share of total exports and imports in GDP - IMF World Economic Outlook
Share of trade to US, Euro area and Japan - IMF Direction of Trade and World Economic Outlook
Trade openness - IMF Direction of Trade and World Economic Outlook

Financial Sector Vulnerabilties

Capital Inflows I: sum of porfolio investment and other investments - IMF World Economic Outlook
Capital Inflows II: sum of direct investment, porfolio investment and other investments - IMF World Economic Outlook
Cumulative credit growth 2005–2008 - International Financial Statistics- Monetary Survey
Domestic credit/domestic deposits (leverage) - International Financial Statistics- Monetary Survey

Policy Framework

Current account balance as a share of GDP - IMF World Economic Outlook
Exchange rate regime - Author's calculation based on IMF's classification system
External Debt: ratio to GDP - IMF World Economic Outlook
Financial development: credit to private sector to GDP ratio - IMF World Economic Outlook
General government overall balance as percent of GDP - IMF World Economic Outlook
Inflation. End of Period - IMF World Economic Outlook
Inflation. Average - IMF World Economic Outlook
Money Supply Growth - International Financial Statistics - Monetary Survey
Stock of international reserve assets as share of external debt - IMF World Economic Outlook
Stock of international reserve assets as share of GDP - IMF World Economic Outlook
Stock of international reserve assets as share of imports of goods and services - IMF World Economic Outlook

Other variables

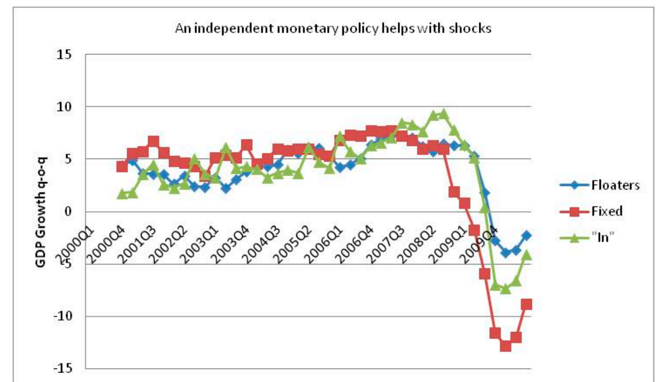
Doing Business Index - The World Bank
Global Competitiveness Index - The World Economic Forum
Index of Economic Freedom - The Heritage Foundation
Per-capita GDP - IMF World Economic Outlook
Population - IMF World Economic Outlook
PPP GDP - IMF World Economic Outlook
Share of Industry in GDP - The World Bank database
Share of Agriculture in GDP - The World Bank database

ANALYTICAL NOTE 5. THE TRADE-OFFS OF EURO ADOPTION

I. NOT IF, BUT WHEN

For all new EU member states (NMS), participation in the eurozone is mandatory but the candidate countries can set the target date. As part of the entry requirements to joining the European Union, Romania has the obligation to join the Economic and Monetary Union (EMU), as soon as it meets the Maastricht economic convergence criteria. However, the treaty doesn't set the pace of economic convergence with the EMU[25]. De facto, countries can choose the timetable for euro adoption. The need to fulfill the Maastricht criteria prior to entry is both a constraint and an opportunity to benefit from an independent monetary policy until the economy is ready to join the currency area.

A premature adoption of the single currency—before achieving a sufficient degree of convergence and economic flexibility—could be detrimental for a candidate country. Adopting the euro implies foregoing the exchange rate buffer and the monetary policy tool and relying only on nominal adjustments to compensate for economic shocks. The loss of monetary policy will have to be compensated by other adjustment mechanisms. In addition, countries with relatively higher inflation risks eroding competitiveness when entering a monetary union and abandoning the possibility of foreign exchange adjustment.



II. TRADE-OFFS OF ADOPTING THE EURO

A. Pros and Cons of Joining a Monetary Union

The main benefits expected from joining the euro area include macroeconomic stability and growth as well as economic convergence toward the best performers of the area through lower transaction costs, trade creation, and lower interest rates. The reduction in transaction

[25] The economic convergence criteria include (i) the candidate country's inflation shall not be above 1.5 percentage point the average inflation in the 3 EMU countries with lowest inflation, (ii) its deficit should be below 3 percent of GDP, (iii) its public debt lower than 60 percent of GDP, (iv) the country needs to demonstrate the capacity of maintaining a stable exchange rate through participation in ERM II, and (v) the long-term nominal interest rate cannot be more than 2 percentage point above the rate for the 3 EMU countries with the best performance in term of price stability.

cost is expected to fuel cross-country trade as the single currency eliminates the uncertainty related to exchange rate movements and thus diminishes the risks related to foreign trade while larger foreign investment are likely to raise potential output and improve welfare Moreover, Romania would benefit from eliminating the exchange rate risks associated with its substantial foreign exchange denominated debt.

However, adopting the euro implies losing the monetary and exchange rate policy instruments. Once it has joined the EMU, if Romania is affected by a country specific shocks, it won't be able to use monetary policy for obtaining some counter-cyclical effects or benefit from the exchange rate buffer. The ECB's monetary policy might be less appropriate for smoothing Romania's output and price volatility. While emerging market are expected to grow faster to catch up with core European countries, Romania will be subject to a monetary policy that fits mature economies and might generate macro and microeconomic imbalances. In addition, higher inflation might erode Romania's competitiveness and lead to sluggish growth and unemployment.

B. How Synchronized Is Romania with the Euro Area?

The degree of similarity in the economic structure of Romania and the Euro area matters as it determines the degree of synchronization in their economic activity and therefore similarity in the transmission of shocks.[26] Among MNS, Romania's value added structure is the least similar to the euro area one. Romania is less open than some other NMS but trade relatively intensively with the EU. A higher share of intra-industry trade implies that Romania would be increasingly affected by common industry specific shocks. While Romania's GDP is highly correlated with the euro area, inflation's co-movement with the euro area has been low, reflecting the inflationary pressure associated with to the catching up process.

Among candidate countries, Romania's economy is the least structurally similar to the euro area. In terms of output similarity measured by the Bray-Curtis value added similarity index[27], the structure of Romania's economy is the least similar to the euro area among candidate countries, which already have economic structures that are more dissimilar to the

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[26] A condition for the benefits of joining a currency area to outweigh the costs is for the business cycle of the candidate country to be synchronized with the core of the union so that the one-size-fits-all monetary policy doesn't hurt the candidate country.

[27] The Bray-Curtis similarity index is computed as the ratio between absolute differences and sums of the shares of sectoral contribution to total value added in the given country and the euro area.

euro area than the historical member countries (Figure 1). The structural differences are due to the relatively high share of agriculture in value added and much lower share in services (Figure 2). Unsurprisingly, value added structural characteristics are persistent: as can be seen from figure 3 showing the evolution of the index for historical members, the index remains relatively stable over time even after entry in the EMU. The relative dissimilarity in value added will contribute to amplify differences in transmission of shocks.

Figure 1: Structural similarity of selected European countries with the euro area.

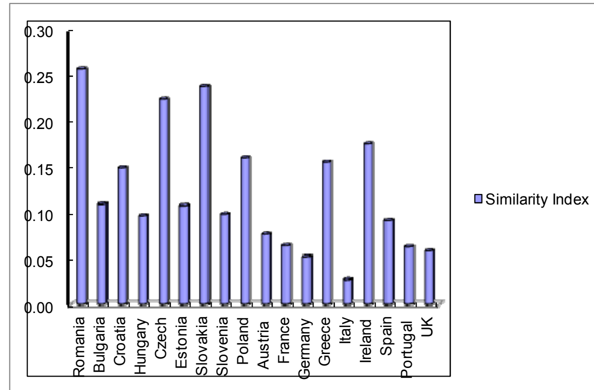
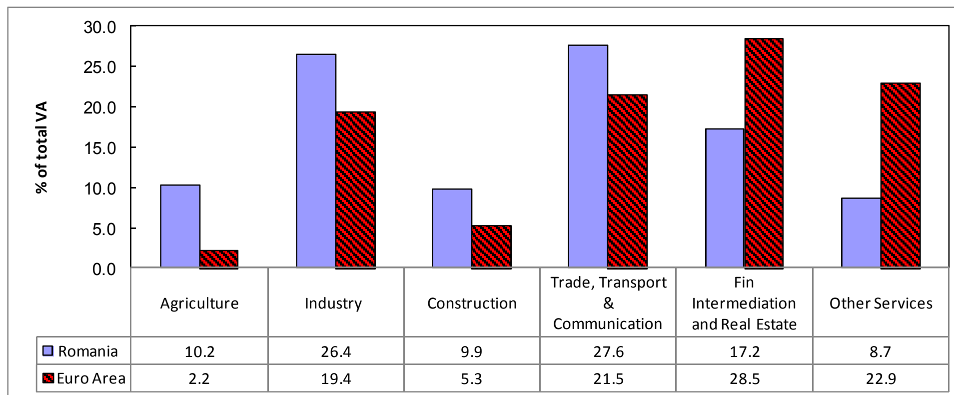
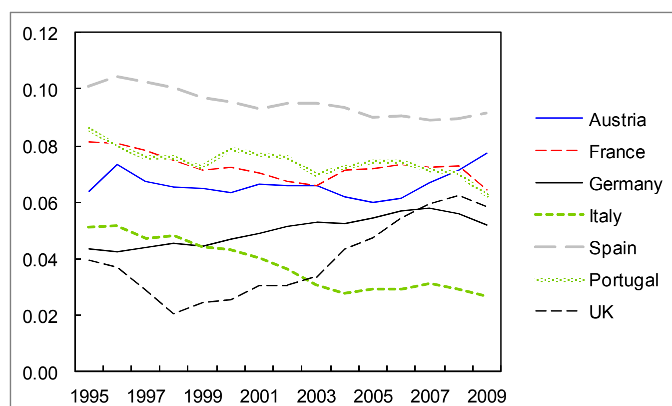


Figure 2: Value Added Structure in Romania and in the Euro Area



	Agriculture	Industry	Construction	Trade, Transport & Communication	Fin Intermediation and Real Estate	Other Services
Romania	10.2	26.4	9.9	27.6	17.2	8.7
Euro Area	2.2	19.4	5.3	21.5	28.5	22.9

Figure 3: Evolution of Structural Similarity with Euro Area



While the economy is relatively less open than other NMS, Romania's trade is geared toward the euro area and the rising share of intra-industry trade suggest that is likely to getting closer to the euro area's industrial structure. Another indicator of structural similarity is the Grubel-Lloyd Index of intra-industry trade[28], combined with the indicators of the country's share of trade in GDP and intensity of trade with the euro area. Shocks are more likely to be more symmetric as the NMS' trade with the currency area is more intensive or intra-sectoral. As can be seen from Table 1 and Figure 4, while Romania's main trading partners are within the euro area, it remains less open than other candidate countries, suggesting vulnerability to country-specific shocks. However, while remaining relatively low, the share of intra-industry trade has increased over the past decade indicating that Romania is progressively reducing its exposure to risks of external asymmetric shocks.

Table 1: direction of exports and trade openness of NMS

	Romania		Slovenia		Bulgaria		Poland		Hungary		Slovakia		Czech Republic	
	95-99	00-08	95-99	00-08	95-99	00-08	95-99	00-08	95-99	00-08	95-99	00-08	95-99	00-08
	(in % of total exports)													
Euro area	55.5	58.0	62.2	58.0	43.1	50.8	59.4	57.8	66.6	64.7	46.2	54.9	69.3	69.1
New member states	4.6	8.9	5.8	8.9	3.7	6.6	7.5	11.4	7.2	10.1	37.0	28.1	8.8	10.0

[28] For an industry i with exports Xi and imports Mi the Grubel-Lloyd intra-industry trade (IIT) index is computed as IITI = 100*(1-((Xi-Mi)/|Xi+ Mi|)). This is the fraction of total trade in the industry, Xi+Mi that is accounted for by IIT.

Figure 4: trade openness of selected NMS

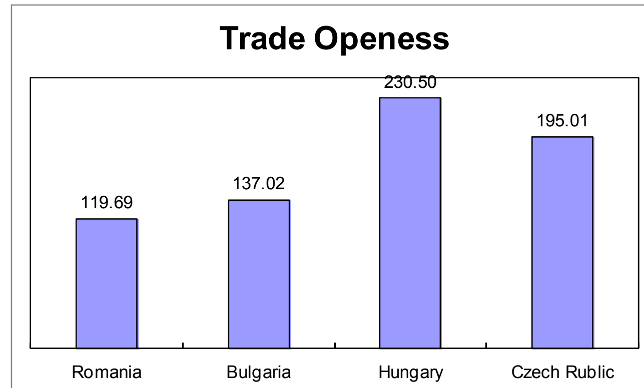
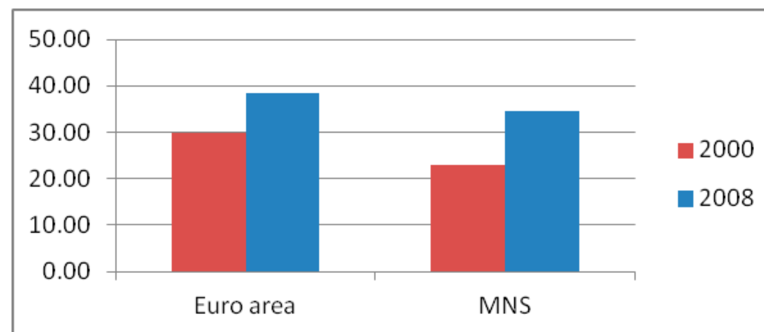
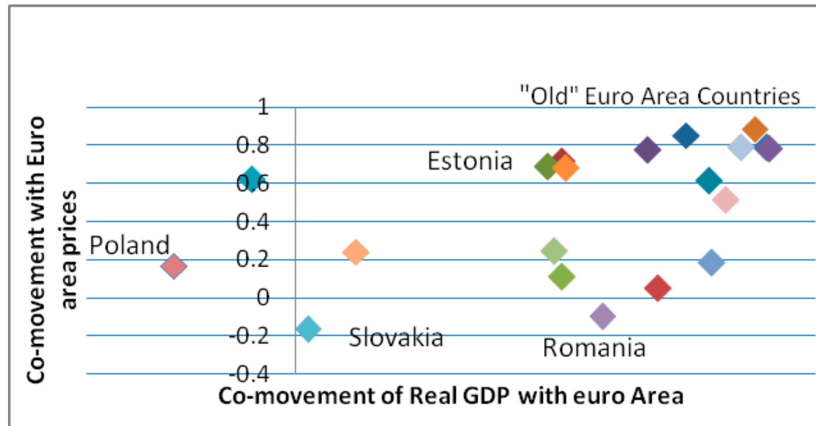


Figure 5: Romania's share of intra-industry trade in total trade with EMU and other NMS



Finally, Romania's co-movements of real GDP and inflation with the Euro area show that output is relatively correlated but the price evolution reflects Romania's inflationary pressures. As Romania has entered the union with relatively low levels of income, it has since experienced fast growth and convergence of income levels toward the EU average. The income convergence is accompanied by price level convergence so it generates upward pressure on the inflation rate of new members.

Figure 6: Correlation of GDP growth and HICP inflation with the Euro Area 2000-2009



C. Risks of Rising Imbalances and Loss of Competitiveness

An inadequate monetary policy could lead to rising imbalances and bring Romania back to an unsustainable growth path. Joining the euro area is likely to lower Romania's nominal interest rates while inflationary pressures might remain present as income level will continue to raise and catch up with the average euro area level. The drop in real interest rates could fuel a lending boom, generate a widening positive output gap and lead to unsustainable growth of domestic demand, a current account deficit –imbalances that have characterized the pre-crisis situation.

Inflationary pressures in the absence of the exchange rate adjustment can lead to loss of competitiveness and subsequent high unemployment and slow growth as shown in prior examples such as East Germany, Greece and Portugal that have all experienced competitiveness loss after joining a currency union.

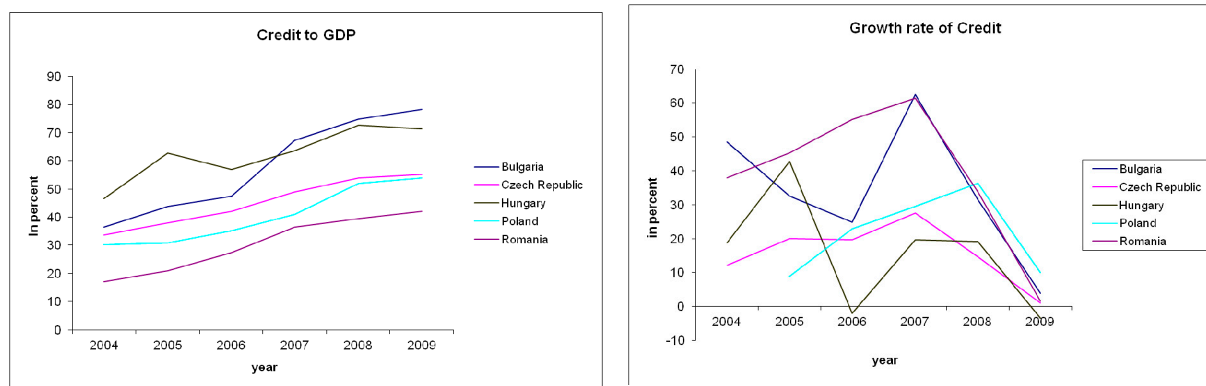
Mitigating policies need to rely on flexible labor and product markets. What used to come as a change in the real exchange rate from a nominal exchange rate with sticky domestic costs and prices will need to come from domestic nominal variables. However, downward wage flexibility is painful and is unlikely to be implemented over the long run.

D. Additional Post-Crisis Challenges and Credible Timetable

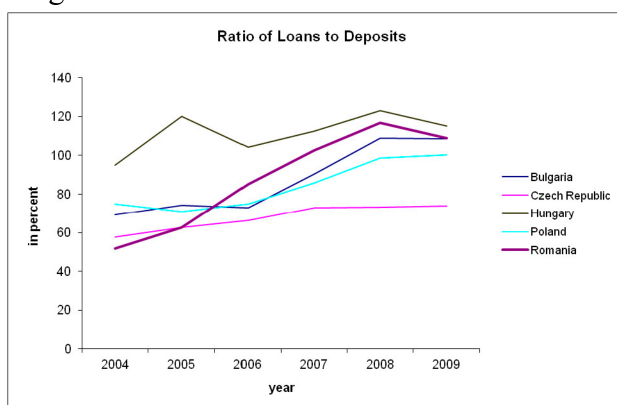
The financial crisis has worsened the fiscal situation of most EU countries but not modified the entry requirements for the euro adoption. In particular, joining the euro requires a fiscal deficit below 3 percent of GDP. Early euro adoption would require a very ambitious fiscal consolidation path given the post-crisis weak outlook.

ANALYTICAL NOTE 6. THE ROMANIAN BANKING SYSTEM DURING THE DOWNTURN

The financial crisis sparked by the default of Lehman Brothers in generated a deep contraction in financial flows to Central and Eastern Europe and was followed by a sharp economic downturn. The reduction in exports and production and increases in unemployment caused a significant deterioration of corporate and household sector balance sheets across Europe. After several years of strong acceleration, credit growth in Romania suffered a significant turnaround as external capital inflows halted.



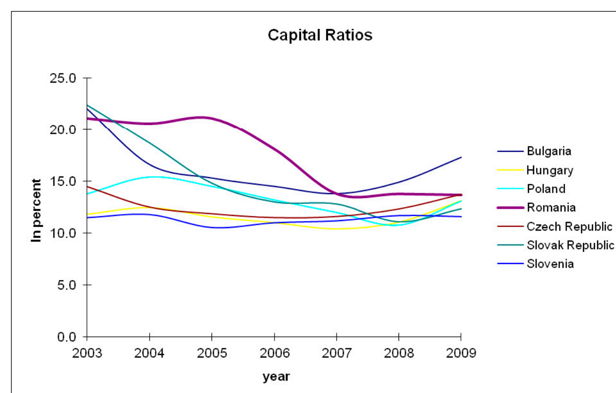
In the whole of the CESEE region, private sector financing was curtailed as banks reduced reliance on foreign funding and intensified efforts to increase their local deposit base. Developments in Romania remained mostly in line with its neighboring countries, although it become one of the countries where the effort to reduce reliance on parent funding was more prominent, as evidenced by a significant reduction of the loan to deposit ratio. Banks actively sought to increase their deposit base to reduce reliance on parent funding. This was also reflected in a significant turnaround in the current account balance experienced in the course of 2009. In the banking sector, this represented increased competition for domestic deposits which translated into an increase in local deposit rates in the early months of 2009, both in domestic currency and in foreign currency. Such pressures did ease during the course of the year, although the market segmented, with banks competing on different deposit products.

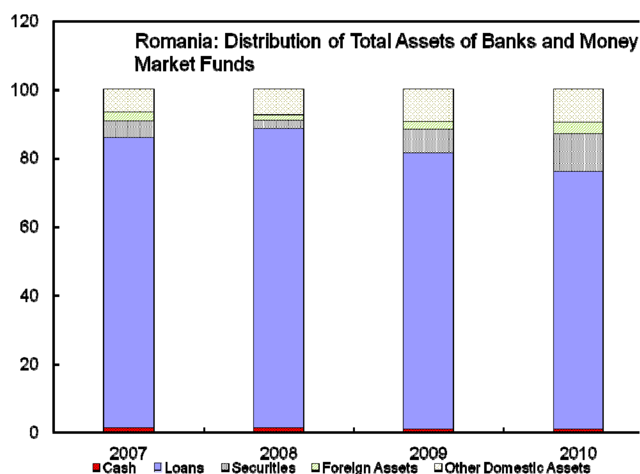


In Romania, as in other countries, the banking sector business strategy during 2009 was directed to strengthening the capital base. As in other CESEE countries, banks operating in Romania faced a significant deterioration of on balance sheet asset quality as unemployment and bankruptcies increased. Thus, it became necessary to rebuild capital buffers to absorb losses. In line with their commitments in the framework of the European Banking Coordination Initiative, parent banks have proactively increased capital resources

for their Romanian subsidiaries during the course of 2009, and applied a conservative earnings retention policy. As a result, the capitalization ratio was strengthened in the course of the year.

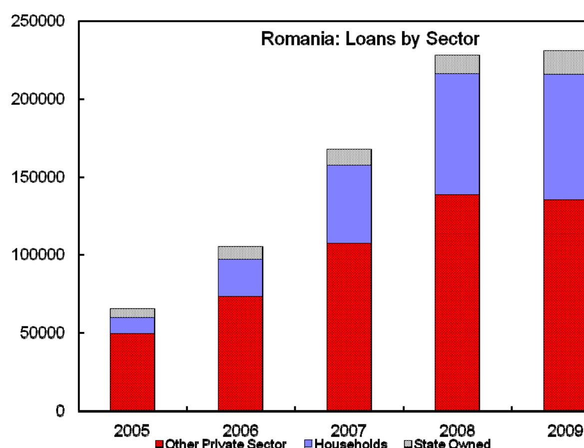
On-balance sheet risk was reduced while banks' portfolios were shifted towards lower-risk investments, with loans to the corporate sector falling slightly as a share of total loans, while the share of loans to state owned entities increased. In addition, the portfolio of government securities held by the banking sector more than tripled between November 2008 and November 2009.

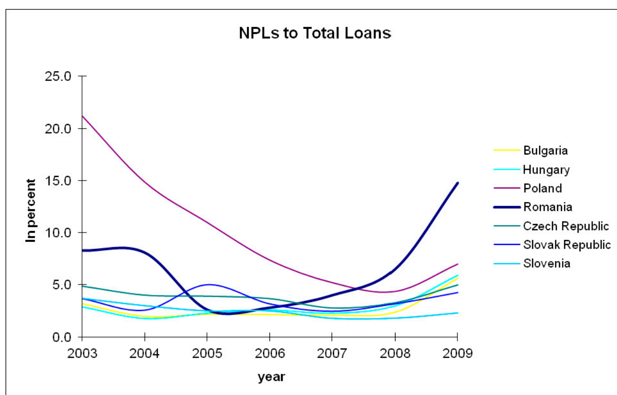




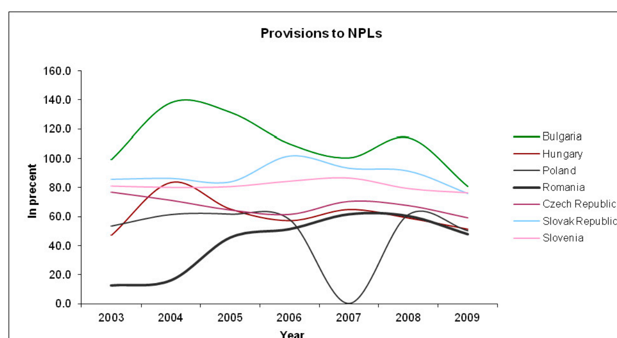
The increase in banks' holdings of government-issued securities mirrored reductions in minimum reserve requirements decided by the NBR during the course of 2009. Such trend was indicative of a commitment of banks of maintaining the size of their operations in Romania, which was also formalized under the IMF and EC-sponsored program. This implied a reduction of the risk-weighted assets without shrinking their total balance sheet.

Both demand and supply factors determined the sharp decline in private sector credit growth, as total credit to non-financial sector declined by 0.2 percent against a growth of 37 percent in 2008. There was only a nominal increase in EUR-denominated loans and the share of EUR loans in total loans increased. This was due primarily to a number of loan portfolios banks repatriated in August which had been previously held offshore. This had the effect of boosting their FX-denominated loan portfolios reported in Romania, although no new lending took place.

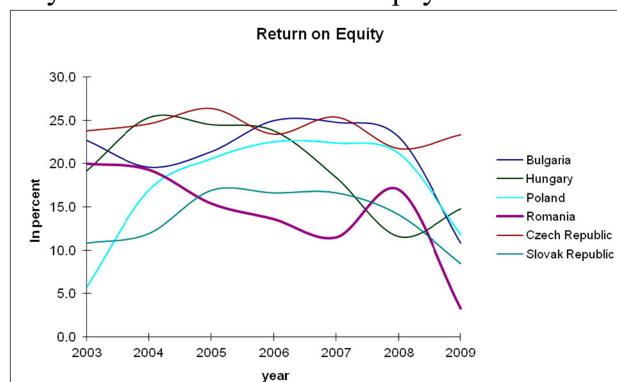




The significant deterioration in economic activity caused NPLs to triple but banks provisioned accordingly. Trends in NPLs have been similar to those in neighboring countries; however, absolute levels appear higher in Romania as exposures are not netted of collateral values, as is the case in many other countries. Non-performing assets on balance sheet increased significantly across all categories of the loan portfolio, but in particular in the retail uncollateralized segment. Most of the loans in the retail category are credit card loans which were extended in RON with a floating interest rate. The loans with the lowest delinquency rates were the mortgage real estate loans. In the corporate sector, construction and real estate loans were those with the highest level of impairments, as the financial crisis brought a collapse in the domestic real estate sector activity. Provisions for impairments have maintained a relatively stable trend and did not diverge from those of other countries, as the banks increased provisions in line with impairments.

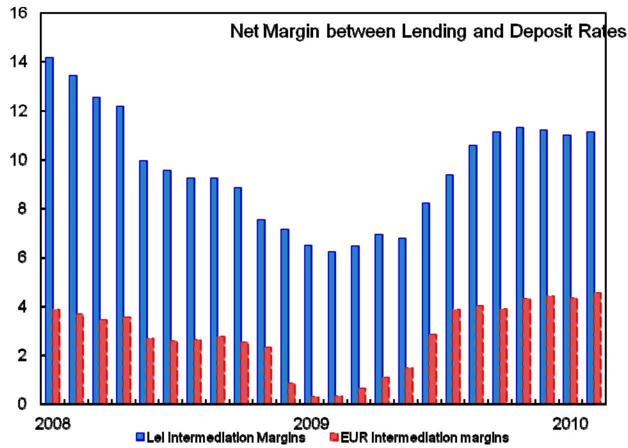


FX-denominated portfolios performed relatively well during 2009, with NPL rates averaging 35 percent of the past due portfolio against their 65 percent share in of the total loan portfolio and a NPL rate of 65 percent for the domestic currency portfolio. The performance of the FX-denominated portfolios has been surprising and contrary to expectations following the sharp depreciation of the lei in the latter part of 2008. However, FX loans are extended mostly on a collateralized basis and generally for housing and for longer maturities, which typically increases incentives to repay.



Interest rates remained elevated evidencing liquidity pressures and heightened deposit competition. In the early part of 2009, deposit rates in local and foreign currency jumped evidencing the significant liquidity strains in the system. Bank net intermediation margins suffered and profitability was affected. Although the pressures eased through the course of the year, pressure remained. NBR monetary policy actions were successful in reducing interbank rates, but the market appears to have remained segmented with only certain banks being able to finance through the interbank market, while others having to rely exclusively on parent resources. The high levels of NPLs are causing lending rates to remain

high. The cost of risk increased significantly during the economic downturn and banks have



not reduced lending rates in accordance with the reduction in policy rates, rather directing credit to the public sector.

Going forward the system will still have to generate significant provisions to face the deteriorating portfolios and competition for deposits will compress lending margins. It is likely that the profitability of the sector will remain subdued as banks seek to manage the challenges brought by the weak economy, including the rise in bankruptcies and the impact of increasing unemployment.

APPENDIX I. ROMANIA: LETTER OF INTENT (LOI)

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC, 20431
U.S.A.

Bucharest, June 16, 2010

Dear Mr. Strauss-Kahn:

1. The comprehensive anti-crisis program supported by the Fund, the EU, and the World Bank has continued to play a crucial role in normalizing financial conditions reversing economic imbalances, and setting the stage for economic recovery. These improvements notwithstanding, conditions turned out to be more difficult than we had anticipated. Economic activity remained depressed in recent months, due both to subdued domestic demand and the slow recovery among Romania's trading partners. Uncertainties related to the crisis in Greece have also increased market risks. Accordingly, we now expect economic recovery to become apparent later in the year, and project economic growth around zero or slightly negative in 2010.

2. The weaker economic growth and difficulties in revenue collections and pressures in certain public spending categories have created challenges in meeting our fiscal targets. However, our performance on other quantitative targets and the structural reform agenda has been strong (Tables 1 and 2):

- *Quantitative performance criteria and inflation consultation mechanism*. The quantitative performance criteria on net foreign assets and general government guarantees, as well as the continuous performance criterion on non-accumulation of external arrears were met. The indicative targets on general government current primary spending for end-March 2010 and on the financial balance of the largest loss-making state-owned enterprises (SOEs) were also met. In addition, inflation remained within the inner band of the inflation consultation mechanism throughout the period. The performance criterion on the general government deficit for end-March was missed by a very small margin, as was the quantitative performance criterion on the target on general government arrears (see paragraph 3 below).

- *Structural benchmarks*. The fiscal responsibility law was approved by parliament in March, and implementation is underway. Amendments to the banking and winding-up laws to enhance the bank resolution framework were also adopted in March 2010. In addition, the legislation and internal regulations needed for the implementation of tax administration reforms were adopted by government ordinance in April. The discussion of pension reform legislation in Parliament is at an advanced stage, and we expect Parliamentary approval by end-June. Finally, we are making significant

progress in preparing implementing legislation for the unified wage law as well as on other structural benchmarks under the program.

3. In view of this performance—and on the supplementary and corrective actions outlined in this Letter—we request completion of the fourth review under the Stand-By Arrangement. We request a waiver of nonobservance of the end-March 2010 performance criteria on general government arrears and on the general government overall balance, and that these performance criteria be modified for end-June 2010 as proposed in the attached Table 1.

4. We believe that the policies set forth in the letters of April 24, 2009, September 8, 2009, February 5, 2010, and in this Letter are adequate to achieve the objectives of our economic program, but the government stands ready to take additional measures as appropriate to ensure achievement of its objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this Letter or adopting new measures that would deviate from the goals of the program, and will provide the IMF and the European Commission with the necessary information for program monitoring.

Macroeconomic Framework for 2010

5. Economic activity remains weak and, contrary to earlier expectations, growth continued to be negative during the first quarter of 2010. This mainly reflects weak domestic demand, as well as adverse weather conditions in early 2010. We now expect economic growth to improve later in the year, although uncertainties in external markets remain considerable. However, for 2010 as a whole we forecast growth to remain around zero or slightly negative. Inflation fell from 4.7 percent at end-2009 to 4.4 percent at end-May, remaining well within the inner inflation band under the target with the Fund. At end-2010, inflation is expected to ease further to around 3¾ percent on the back of weak domestic demand and prudent monetary policy implementation. The weaker recovery in domestic demand has restrained imports, and we now project a current account deficit of about 5 percent of GDP for 2010, compared to 5½ percent expected earlier. With capital flows for 2010 largely unchanged from our earlier projections, we expect NFA to be higher by about €1 billion relative to the end-2010 target. However, the NFA target will not be revised upward, to provide the National Bank of Romania (NBR) greater flexibility to respond to unexpected market disturbances.

Fiscal Sector

6. A core objective of the program is to buttress our commitment to sustainable public finances by containing the fiscal deficit and credibly reducing it over the medium term. To this end, the 2010 budget was designed to achieve a fiscal deficit of around 6 percent of GDP, about 1½ percentage points of GDP lower than in the previous year. Unfortunately, several factors have placed that target in danger. First, downward revisions to the estimated GDP mean that the original targets will yield a somewhat higher deficit ratio to GDP.

Second, the weaker-than-expected economic recovery has depressed revenue collections and has boosted spending on unemployment benefits, particularly in the first quarter. Third, there appear to be problems with increasing tax evasion, with revenue yields falling in many key taxes (particularly excise taxes and VAT). Cumulative tax revenues are considerably lower than initially projected (by 0.8 percent of GDP at end-April). The 2010 budget planned for RON 2.4 billion non-tax revenue from a loan repayment from Rompetrol. However, actual payment is uncertain. Negotiations will be concluded by the next review date on the exact payment schedule. Finally, while overall expenditures were held to well below targeted levels in an effort to reach the Q1 fiscal targets agreed with the IMF and EU, underlying current spending pressures continue to accumulate, particularly in pensions, social transfers, and in goods and services. These pressures have produced the overshooting of the arrears target and have forced the undesirably low availability of resources for capital investment. Together, these factors endanger compliance with the 2010 fiscal deficit targets. Under a no-policy-change scenario the fiscal deficit would reach 9.1 percent of GDP at end-2010, some 3 percentage points of GDP higher than initially programmed.

7. Given renewed uncertainties in international markets and the need to demonstrate our clear commitment to a sustainable fiscal path, the government is committed to taking additional difficult—but necessary—measures to bring the fiscal deficit to 6.8 percent of GDP 2009 (which corresponds to 6.5 percent of GDP before the GDP revisions).

- On the spending side, we will implement by June 1: (i) a 25 percent cut in total wages, bonuses, and other compensation paid to all public sector employees (1 percent of GDP this year); (ii) a 15 percent cut in pensions and other social transfers (1 percent of GDP); (iii) cuts in transfers to local governments (0.3 percent of GDP); and (iv) further reductions in heating subsidies (0.03 percent of GDP. Further savings will be achieved through a temporary freeze on early retirement, strict controls on new disability pensions, and by approving a new scheme to regulate the payment of "stimulentes" (nonwage incentive payments for certain ministries). Action has already been taken to reduce public employment by some 20,000 workers in 2010, and we intend to further streamline staffing in the coming months. Structural changes to the health system, pensions, education, and local government finance will also generate savings (see ¶12 and ¶17-20);

- To increase revenues, we will introduce the following measures: (i) a broadening in the personal income and social security tax bases (as specified in the Technical Memorandum of Understanding (TMU)); (ii) the introduction of a turnover tax (clawback) on medical distributors.

- Enactment of items (i-iii) on the spending side and of the measures to broaden tax bases will be a prior action for the conclusion of the review. We will also take measures to further streamline public employment in the coming months. If these actions prove insufficient to achieve the end-year targeted deficit, we will take additional action, including increases in tax rates as needed.

8. To protect the more vulnerable members of society, we will keep the minimum wages and pensions unchanged, and no wage or pension will be cut below that level. We will also reform our social support programs with a view toward improving their effectiveness and targeting them better on the poor and needy. In this context, the Guaranteed Minimum Income (GMI) scheme, which is one of the better targeted programs, will be exempted from the 15 percent cut in social spending, with other—less efficient—programs reduced by more to attain the overall spending reduction. Specifically, we will reduce or improve the targeting of the Lone (Single) Parent Allowance (LPA) and the Complementary Child Allowance (CCA) as agreed with the World Bank. In parallel, we will be working to further reduce the leakages from the GMI and others social programs to enhance their anti-poverty impact.

9. The confidence generated by adherence to the program, together with improved market conditions, has allowed us to improve the maturity profile of our public debt and significantly lower the yields on new borrowing in recent months. To strengthen our ability to respond flexibly to possible future market disturbances, we plan to continue increasing gradually financial buffers at the Treasury to about 4 months of fiscal deficit financing and public debt redemptions.

10. The stock of domestic payment arrears has increased since the last review. We fully realize the importance of not incurring further arrears and clearing the existing stock. At the local government level, the amendments to the local public finance law (see ¶12) will preclude the accumulation of future arrears. Most local arrears are to suppliers and we plan to utilize swap agreements with local authorities to offset mutual debts. At the central level, with most arrears in the health sector, we will implement a health sector restructuring plan (see ¶ 18). To further improve monitoring and control mechanisms to eliminate arrears at both central and local government levels, we will integrate the accounting reporting system with the Treasury payment system (structural benchmark for end-March 2011). This link will allow us to monitor commitments and assist in budget management and control. Lastly, we will require line ministries to monitor their subordinated units in observing commitment ceilings and enforce sanctions against institutions and individuals who breach the ceilings.

Fiscal reforms

11. We are fully committed to implementing the Fiscal Responsibility Law (FRL) passed by Parliament at end-March 2010. The set-up of the Fiscal Council is under way, and we will ensure that the Council members and the secretariat are fully staffed with appropriately skilled people as soon as possible. We are developing the Fiscal Strategy (FS) for 2011-2013 and will submit it to Parliament by end-June. This Strategy will incorporate a fiscal deficit target objective of no more than 4.4 percent of GDP in 2011 and will eliminate the 13th salary paid to the public sector employees. We will also limit the 2011 wage bill to 39 billion RON and set a limit of 1,290,000 total public employees at the beginning of 2011. To encourage budgetary discipline, prioritize projects, and increase efficiency, the Ministry of Public Finance will submit indicative expenditure ceilings to major spending institutions in preparing the FS. We will link the FS to the annual budget process and will set up a Review Team supported by the Cabinet to review line ministries' budget proposals, press them to

improve their submissions so as to improve productivity, service delivery, and the quality of regulations in line with the FRL requirements, and produce a report on efficiency-making expenditure cuts to be incorporated into the 2011 budget.

12. To strengthen fiscal discipline of local governments and preserve macro-fiscal stability, we are in the process of amending the local public finance law. The amendments will include: (i) changes to the legal definition of a balanced budget from one based on the *budgeted* revenues and expenditures towards one based on *actual* revenues and accrual expenditures; (ii) reflection in one law of all rules on local borrowing and introduction of additional prudential limits, such as a ceiling on the stock of debt and requirement of operating surplus in years prior to borrowing; (iii) approval of multi-annual borrowing ceilings and investment transfers from the state budget to improve multiyear capital budgeting; and (iv) incorporation of relevant sanctions from the FRL (structural benchmark for end-September 2010). To comply with the Unified Wage Law, we will apply wage bill limits according to staffing standards across local governments.

13. Reinforced tax administration efforts are required to tackle the decline in revenue yields during the recession. In the first stage, our efforts focused on addressing VAT non-compliance and fraud, improving management of growing tax arrears, and increasing control of the largest taxpayers; the regulatory framework needed to support these efforts has been approved by the government in April 2010. In the second stage, we will focus on high-income individual taxpayers and develop indirect audit methodologies to augment current audit techniques to identify unreported income. In particular, we will amend the Fiscal Code and the Fiscal Procedures Code to: (i) establish ANAF's right to access bank records and third-party records, upon proper notification and through a due process, to enable proper determination of income; (ii) review the definitions of income to enable taxation of income from any source not legally exempted; (iii) strengthen the requirement to report income; as well as (iv) strengthen the right to audit for unreported income (structural benchmark for end-November, 2010). We will also establish a special office to coordinate high-income individual taxation issues and the development of initiatives or projects to identify, quantify, or improve compliance in the high-income area.

14. To combat tax evasion and smuggling and improve tax collection we will take the following measures by end-June:

- On VAT we will (i) establish common minimum standards for registration and removal from records of the taxpayers who carry out intra-Community trade, in particular acquisitions of goods, and (ii) set up a registry of the intra-Community operators;
- Establish collateral for intra-Community acquisitions of products with increased risk of tax fraud;
- Review the authorization regime for operators performing activities with goods under suspension of excise duty by introducing more stringent requirements, including

setting mandatory collateral for the production, processing and holding of such goods;

- Review conditions for transferring shares/equity in companies, as well as those governing the liability of administrators, shareholders and third parties in order to combat the risk of fraud;

- Amend the legal framework governing the trading of duty-free goods, including by imposing a cap on the quantities of certain excisable goods traded in duty-free regime, increasing surveillance on duty-free shops, introducing the mandatory stamping of the excisable goods traded in duty free shops, tightening conditions for licensing the duty free shops and for maintaining the already granted licenses, reviewing the facts constituting contraventions and of those triggering the revocation of the license and increasing the operating fee;

- Improve legislation on the use of electronic cash registers;

- Improve legislation on the organization and undertaking of gambling activities; and,

- Strengthen legislative provision for enhanced legal protection of public sector employees in carrying out their duties in good faith.

15. Some progress has been made in the monitoring and control of the largest loss-making public enterprises. However, more comprehensive effort is needed to deal with their budgetary cost and payments arrears. Therefore, the government will aggressively reactivate its privatization program, especially in the industry, energy, transport, tourism and agriculture areas. We will take the following additional actions: (i) wind-up the energy firm Termoelectrica by splitting out the viable assets and closing the remaining company by end-June 2011; (ii) privatize the cargo rail firm by end-March 2011. The privatization agency AVAS will complete the sale of 18 small firms under its full ownership during 2010, and will sell the minority stakes it holds in at least 150 additional firms. The Ministry of Economy will also initiate the sale of minority stakes in several firms under its control. Finally, in accordance with EU competition rules, we will phase out subsidies for coal mining by end-2010 and we will develop an exit strategy to be achieved within the next 5 years.

16. The unified wage law has been approved and is in force; it has already resulted in a noticeable easing of upward pressure on the wage bill by eliminating some bonuses and placing a ceiling on others. The preparation of the implementation legislation for the unified wage law to fully implement new, unified wage scales throughout the public sector is on track. We will agree on the text with the International Financial Institutions before submission to parliament, with the aim of having it approved by law by end-September 2010 (structural benchmark).

17. The pension reform now in parliament will generate significant savings in the coming years, helping to bring the retirement system into a more sustainable financial condition. However, in recent months there has been a spike in pension costs, due to a sharp increase in

individuals taking early retirement and new disability pension claims. Disability pensioners now constitute nearly 4½ percent of the labor force, and have grown rapidly in recent years. The increase in new pension claims is expected to increase this year's pension deficit by over ½ percent of GDP to more than 2¼ percent of GDP. To bring the system's short-term finances under better control, we will approve legislation to allow new disability pension claims only if they have been previously vetted by the Ministry of Labor's medical evaluation teams. On an immediate basis, we will also prohibit any new early retirement claims until after the new pension reform legislation is in effect in 2011.

Health Care System

18. Reforms in the public healthcare system are essential to improve the efficiency of service and to better control public spending. To help improve the revenue stream of the healthcare sector and tackle the stock of arrears, we remain committed to (i) introducing patient service fees by next year, (ii) sharply narrowing the exemptions for such fees compared to original plans, (iii) implementing the planned clawback tax on medical suppliers; and (iv) cutting the number of hospital beds by 9,200. The Ministry of Health and the National Health House will also take all necessary measures to ensure the functioning of health care system within the budgetary allocations established in the 2010 budget. We will also begin deeper structural reforms of the health care sector, in consultation with the World Bank. The first prong of these reforms involves reducing the cost of pharmaceuticals by promoting a consumption shift towards generic drugs and recentralizing drug procurement especially in national programs. The second prong involves improvements in the efficiency of hospital services and management and includes: (i) decentralizing the management of most hospitals to local governments; (ii) introducing a new financing mechanism for hospitals, based on standardized costs by type of hospital, cofinancing by local governments, and ceilings on wage spending to limit overruns; and (iv) reforming the system of emergency care to reduce excessive reliance on the system for primary care. These reforms will be approved by government emergency ordinance by end-July 2010.

Labor Market and Education

19. To improve the long term competitiveness of the Romanian economy, we are undertaking reforms in education and the labor market aimed at improving efficiency and productivity. We will introduce by end-2010 a revised labor code and collective contract legislation, to increase flexibility of working time, and to reduce hiring and firing costs through more flexible contracts. We also aim at allowing greater wage flexibility. The Romanian government will also identify and enforce measures to fight tax evasion on the labor market in order to improve the collection of social contributions.

20. The Romanian government aims at improving the quality of education, enhancing the productivity of the education system, and reducing public expenditures. The introduction effective January 1, 2010, of the per capita financing provides long term predictability and sustainability of the wages in the education sector. At the same time, based on the politically agreed National Education Pact, the Government has submitted to parliament the new

Education Law that establishes a sound financial management of resources, both for wages and for school expenditures. This law will also lead to a further optimization of the school network.

Financial Sector

21. The recession is taking a toll on the Romanian banking system but solvency levels remain high. Banks face pressures on asset quality and rising provisioning costs that are squeezing profits. Non-performing loans (NPLs) rose to 17.2 percent (representing loans and interests classified as doubtful and loss) in March 2010 and lending to private sector continued to contract. However, the rate of deterioration of asset quality is slowing suggesting impairments may have peaked. The banking system remains well-capitalized after paid-in committed increases in capital in a number of banks, which brought the average capital adequacy ratio to 14.7 percent for the system with all banks having a ratio above 10 percent. The largest foreign banks have broadly complied with the terms of the European Bank Coordination Initiative (EBCI). While individual bank exposures have fluctuated, as a group by end-March 2010 the nine banks had retained their March 2009 committed exposure to Romania.

22. As in other European central banks, we have been preparing for the possibility of spillovers from market volatility and made contingency plans to address episodes of possible financial distress. We have enhanced the liquidity monitoring including through the reporting of assets and liabilities' maturity breakdown by currency. We have reviewed existing emergency lending arrangements, and the collateral eligible for all refinancing operations has been broadened to include euro denominated government securities issued in the domestic market and will be broadened further to include bonds issued by IFIs listed on the Bucharest Stock Exchange and Eurobonds issued by the Romanian government as soon as some remaining technical issues have been clarified. With a view to further strengthening our already comprehensive stress testing approach, we have asked for technical support from the Monetary and Capital Markets Department of the IMF on further enhancing our stress test methodology in different areas.

23. We remain committed to improving the resolution process of distressed financial institutions. We have upgraded our domestic legal norms in line with EU requirements to strengthen the resolution framework for problem banks. We have also strengthened the existing authority of the special administrator to implement promptly a broad range of measures, including purchase and assumption, sales of assets, and transfer of deposits. The March 2010 structural benchmark regarding amendments to the bank insolvency regime was met.

24. We continue to be committed to further promote financial stability by increasing resources for the Deposit Guarantee Fund (DGF). The target coverage ratio for ex-ante financing will be increased to 2 percent. To achieve this target, over time the banks' contribution rates will be set to 0.3 percent beginning in 2011 and the stand-by credit lines will be eliminated (structural benchmark September 2010). We will also review the

governance arrangements of the DGF to ensure that neither members of the board nor employees of credit institutions participate in the DGF Board (end-September 2010). We have also provided the same seniority to the DGF's claims as those of depositors (March 2010 structural benchmark). We remain committed to support financial stability by refraining from promoting legislative initiatives (such as the current draft of the personal insolvency law) that would undermine credit discipline.

25. The current provisioning framework is sound and the NBR does not consider that any new prudential regulation in this area is necessary at present. The NBR will continue to consult with the Fund and EC staff before introducing or amending other aspects of the regulatory framework. Formally and permanently raising the minimum level of the capital adequacy ratio from 8 percent to 10 percent remains a medium-term objective. The NBR and the MoPF remain committed to adopting the necessary legal framework by the end of the program period for implementing comprehensive International Financial Reporting Standards (IFRS), with a view toward applying IFRS as of the beginning of 2012.

Monetary and Exchange Rate Policy

26. Monetary policy will remain focused on keeping inflation within the target band. Disinflation remains on track, helped by the large negative output gap, restrained wage developments, and recent food price deflation. Headline inflation fell from 4.7 percent at end-2009 to 4.4 percent in May 2010, despite a significant adjustment in tobacco excises early in the year. Together with reduced exchange rate pressures, this has allowed a measured adjustment of monetary policy, with interest rates reduced from 8 percent in late 2009 to 6.25 percent recently, for a cumulative reduction of 400 basis points since February 2009.

27. Further adjustment in monetary policy in the near future will be conditional upon subdued inflationary pressures and evolving recovery prospects. Inflation is projected to fall to around 3¾ percent by end-2010, close to the middle of our target range of 3½ percent ±1 percentage point. The benign inflation outlook is consistent with the downward revision of our inflation target to 3 percent ±1 percentage point for end-2011. At the same time, a prudent approach will be maintained in light of risks from further adjustments in regulated prices, increases in energy prices, and the unsettled financial markets in the region. These risks also imply that the timing and pace of future reductions in reserve requirements will have to be carefully calibrated to avoid disturbances in money and exchange rate markets. In line with our inflation targeting framework, we will maintain the existing managed float exchange rate regime.

Program Modifications and Monitoring

28. The program will continue to be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural benchmarks. The quantitative targets for end-September and end-December 2010 as well as the continuous

performance criteria are set out in Table 1; and the structural benchmarks are set out in Table 2. The understandings between the Romanian authorities and IMF staff regarding the quantitative performance criteria and the structural measures described in this memorandum are further specified in the TMU attached to this memorandum.

/s/	/s/
Sebastian Vladescu	Mugur Isarescu
Minister of Public Finance	Governor of the NBR

Attachments

Table 1. Romania: Quantitative Program Targets

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March		June	Sept	Dec
	Actual	Actual	Actual	Actual	Actual	Prog.	Est.	Prog.	Prog.	Prog.
I. Quantitative Performance Criteria										
1. Cumulative change in net foreign assets (mln euros) 1/3/	25,532	-3,500	-5,119	-4,566	-4,874	-2,000	779	-2,500	-2,000	-2,000
2. Cumulative floor on general government overall balance (mln lei) 2/	-24,655	-8,300	-14,456	-25,563	-36,101	-8,250	-8,422	-18,200	-25,700	-34,650
3. Stock in general government arrears from the end of previous year (bn lei)	1.06	1.41	1.55	1.4	1.50	1.27	1.76	1.09	0.81	0.48
4. Ceiling on general government guarantees issued during the year (face value, bn lei)	0.0	…	0.02	0.7	2.2	12.0	4.6	12.0	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	0	0	0	0	0	0	0	0	0
III. Inflation Consultation										
6. 12-month rate of inflation in consumer prices										
Outer band (upper limit)	…	…	8.4	7.7	6.5	6.5	6.5	6.0	5.75	5.5
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.5	5.0	4.75	4.5
Center point	*6.3*	*6.7*	*5.9*	*4.8*	*4.7*	*4.5*	*4.2*	*4.0*	*3.75*	*3.5*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.5	3.0	2.75	2.5
Outer band (lower limit)	…	…	4.4	3.7	2.5	2.5	2.5	2.0	1.75	1.5
IV. Indicative Target										
7. General government current primary spending (excl. EU funds and social assistance, mln lei) 2/	92,327	22,149	43,238	63,878	85,637	32,900	32,749	66,200	95,600	126,700
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-1,381	-495	-2,000	-3,000	-4,000

1/ The December 2008 figure is a stock.
2/ The December 2008 figure is for the whole year.
3/ NFA targets for end December have been adjusted as actual disbursements fell short of projected levels by EUR 1 bn.

Table 2. Romania: Performance for Fourth Review and Proposed New Conditionality

Measure	Target Date	Comment
Prior Action		
1. Enactment of agreed fiscal measures (LOI ¶ 7)	Prior action	
Quantitative performance criteria		
1. Floor on net foreign assets	March, 2010	Met
2. Floor on general government overall balance	March, 2010	Not met
3. Ceiling on general government guarantees	March, 2010	Met
4. Ceiling on general government domestic arrears	March, 2010	Not met
5. Non-accumulation of external debt arrears	March, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	March, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	March, 2010	Met
Inflation consultation band		
Inner band	March, 2010	Met
Outer band	March, 2010	Met
Structural benchmarks		
1. Passage of Fiscal Responsibility Law	March 31, 2010	Met
2. Passage of amendments to the banking and winding-up laws to enhance the bank resolution framework	March 31, 2010	Met
3. Approval of legislation and internal regulations by ordinance necessary to implement tax administration reforms	April 30, 2010	Met
4. Legislative changes to improve monitoring and control of SOEs	June 30, 2010	Met in January 2010
5. Approval of institutional reform measures to mitigate fiscal risks from local governments	June 30, 2010	Revised to end-September 2010
6. Passage of pension legislation	June 30, 2010	
7. Passage of implementing legislation for the unified wage law	September 30, 2010	
Proposed New Conditionality		
1. Approval of institutional reform measures to mitigate fiscal risks from local governments	September 30, 2010	Revised from end-June, 2010
2. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement (LOI ¶24)	September 2010	
3. Reform tax administration methodology for high net wealth individuals (LOI ¶13)	November 30, 2010	
4. Integrate the accounting reporting system with the Treasury payment system (LOI ¶10)	March 31, 2011	

APPENDIX II. ROMANIA: TECHNICAL MEMORANDUM OF UNDERSTANDING

June 16, 2010

1. This Technical Memorandum of Understanding (TMU) updates and replaces the TMU dated February 5, 2010. It: (i) defines the variables subject to the quantitative targets specified in the Letter of Intent (LOI); (ii) describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets (Section I); and (iii) provides clarifications for some of the structural conditionality under the program (Section II). As is standard under all Fund arrangements, we will consult with the Fund before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the Fund with the necessary information for program monitoring.

2. For the purposes of the program, *the exchange rates* of the Romanian Leu (RON) to the euro is set at RON 3.9852 = €1, to the U.S. dollar at RON 2.8342 = $1, to the Japanese yen at RON 3.1419 = ¥100, and to the pound sterling at RON 4.1169 = £1, the rates as shown on the National Bank of Romania's (NBR's) website as of December 31, 2008. The exchange rates to other currencies, where applicable, will also be the ones shown on the NBR's website as of December 31, 2008.

3. For the purposes of the program, the *general government* includes the entities as defined in the 2010 budget. These are: the central government (state budget, treasury, self-financed state entities included in the budget, etc.), local governments, social security funds (pension, health, and unemployment), road fund company, and administration of the property fund. This definition of general government also includes any new funds, or other special budgetary and extra budgetary programs that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's *Manual on Government Finance Statistics 2001*. The authorities will inform IMF staff of the creation of any such new funds or programs immediately.

I. QUANTITATIVE PERFORMANCE CRITERIA, INDICATIVE CEILING, AND CONTINUOUS PERFORMANCE CRITERIA

A. Floor on the Net Foreign Assets

4. **For program purposes, Net Foreign Assets (NFA) are defined as the NFA of the NBR minus Treasury liabilities to the International Monetary Fund.**

5. **NFA** of the National Bank of Romania (NBR) are defined as the euro value of gross foreign assets of the NBR (including reserve requirements of the commercial banking system held at the NBR) minus gross foreign liabilities of the NBR; and will be measured on the basis of the NBR's operational rather than accounting definitions. Non-euro denominated foreign assets and liabilities will be converted into euro at the program exchange rates.

6. **Gross foreign assets of the NBR** are defined to include the NBR's holdings of SDRs, the country's reserve position at the Fund, holdings of cash, securities and deposits abroad in convertible foreign currencies. Excluded from reserve assets are: (i) gold and other precious metals; (ii) assets in nonconvertible currencies; (iii) illiquid assets; (iv) any assets that are pledged, collateralized, or otherwise encumbered, unless there is also a gross foreign liability associated with it; (v) claims on residents; and (vi) claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

7. **Gross foreign liabilities of the NBR** are defined as all foreign exchange liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options), and all credit outstanding from the Fund, but excluding (i) banks' foreign currency deposits against reserve requirements; and (ii) government foreign currency deposits at the NBR. This definition is meant to bring the concept of foreign liabilities closer to the balance of payment definition, on which the targets are based.

Floor on cumulative change in NFA from the beginning of the year (in mln. euros) 1/

	2009	2010 2/			
	December	March	June	September	December
	(Stock)	Actual	PC	PC	PC
Cumulative change in NFA	20,658	779	-2,500	-2,000	-2,000
Memorandum Item:					
Gross Foreign Assets	28,418	3,145	700	2,100	3000

1/ PC=performance criterion; data for end-month.
2/ Flows in 2010 are relative to end-2009 stock.

8. NFA targets will be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the baseline projection. Program disbursements are defined as external disbursements from official creditors (World Bank and the EC) that are usable for the financing of the overall central government budget. The NFA targets will also be adjusted upward by the increase in commercial bank reserve requirements held with the NBR relative to end-December, 2009 (€7,874 million), measured at program exchange rates.

9. External Program Disbursements – Baseline Projections (in mln. euros)

	2010			
	March	June	September	December
Cumulative flows from end-December 2009	1,000	2,200	2,500	4,100

B. Consultation Mechanism on the 12-month Rate of Inflation

9. The quarterly consultation bands for the 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the Romanian Statistical Institute), are specified below. Should the observed year-on-year rate of CPI inflation fall outside the outer bands specified below, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program. In addition, the NBR will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner bands specified for the end of each quarter in the table above.

	2008	2009	2010			
	December (actual)	December (actual)	March (actual)	June	September	December
Outer band (upper limit)				6.0	5.75	5.5
Inner band (upper limit)				5.0	4.75	4.5
Center point	*6.3*	*4.7*	*4.2*	*4.0*	*3.75*	*3.5*
Inner band (lower limit)				3.0	2.75	2.5
Outer band (lower limit)				2.0	1.75	1.5

C. Performance Criterion on General Government Balance

10. The budget deficit will be monitored quarterly through the cash balance of the general government. The authorities will consult with IMF staff on corrective measures in the event of shortfalls in government revenue and financing.

Cumulative floor on general government balance

	(In millions of lei)
End-December 2009 (actual)	-36,101
End-March 2010 (actual)	-8,422
End-June 2010 (performance criterion)	-18,200
End-September 2010 (performance criterion)	-25,700

End-December 2010 (performance criterion)	-34,650

11. The budget deficit will be measured from above the line using the budget execution data. The Ministry of Public Finance (MoPF) will also provide monthly data to measure the deficit from below the line. The balance of the general government measured from below the line will include:

+ (i) net external financing, excluding valuation gains and losses;
+ (ii) change in net domestic credit from the financial system, excluding valuation gains and losses from deposits denominated in foreign currency and including adjustments for;
  + (a) received EU funds not yet spent (advance payments);
  + (b) claims of the government on EU funds;
  + (c) property fund obligations not yet paid;
+ (iii) change in the stock of issued government securities, net of valuation changes;
+ (iv) net changes in other financing.

12. If the difference between the general government deficit measured from above the line and from below the line is larger than lei 200 million each quarter during 2010, the MoPF will consult with IMF staff.

13. In the event that non-grant revenues exceed those projected under the program, the deficit target will be adjusted downward by one half of the surplus to allow for additional capital spending while reducing the deficit further. The following table shows the accumulated projected non-grant revenue for 2010, to which the actual non-grant revenue will be compared.

Cumulative projected revenue of general government, net of EU funds	(In millions of lei)
End-December 2009 (actual)	151,508
End-March 2010 (actual)	36,355
End-June 2010 (projection)	74,950
End-September 2010 (projection)	114,100
End-December 2010 (projection)	154,650

14. In the event that current spending in the previous quarter exceeds the indicative target (defined below), deficit target for the next quarter will be adjusted downward by a corresponding amount.

D. Performance Criterion Limiting the Issuance of Government Guarantees to the Non-Financial Private Sector and Public Enterprises

15. The issuance of general government guarantees to the non-financial private sector and public enterprises will be limited during the program period. This ceiling may be adjusted upward by up to RON 4.3 billion relative to the original ceiling of RON 7.7 billion for guarantees for financing the counterpart payments of investment projects financed by the EU or for guarantees on projects cofinanced by the EBRD, IFC, or EIB.

Ceiling on new general government guarantees issued from end-2008 until:	(In billions of lei)
End-December 2009 (actual)	2.2
End-March 2010 (actual)	4.6
End-June 2010 (performance criterion)	12
End-September 2010 (performance criterion)	12
End-December 2010 (performance criterion)	12

E. Performance Criterion on Non-Accumulation of Domestic Arrears by the General Government

16. The performance criterion established on the stock in domestic payments arrears of the general government contemplates no accumulation of new arrears and their elimination during the program period. In case of need, the government will take corrective measures to prevent the accumulation of new spending arrears. For the purpose of the program, arrears mean accounts payable past due date by 90 days (in line with ESA95 definitions for expenditures).

Stock in general government arrears from the end of previous year	(In billions of lei)
End-November 2009 (stock, actual)	1.40
End-March 2010 (actual)	1.76
End-June 2010 (performance criterion)	1.09
End-September 2010 (performance criterion)	0.81
End-December 2010 (performance criterion)	0.48
End-April 2011 (indicative target)	0.00

F. Continuous Performance Criteria on Non-Accumulation of External Debt Payments Arrears by the General Government

17. The general government will not accumulate external debt arrears during the program period. For the purposes of this performance criterion, an external debt payment arrear will be defined as a payment by the general government, which has not been made within seven days after falling due. The performance criterion will apply on a continuous basis.

G. Indicative Target on General Government Current Primary Spending

18. The indicative target on current primary expenditure of the general government is defined as spending on personnel, goods and services excluding EU funds (specified under external grant category), subsidies, transfers to public entities, pensions (social security budget in social assistance category and one-third of the state budget in the same category), state aid and other spending in other transfers category, Reserve Fund, and other expenditure as classified in the monthly reporting tables:

Cumulative change in general government current primary expenditures	(In millions of lei)
End-December 2009 (actual)	85,637
End-March 2010 (actual)	32,749
End-June 2010 (indicative target)	66,200
End-September 2010 (indicative target)	95,600
End-December 2010 (indicative target)	126,700

H. Monitoring of Public Enterprises

19. As of 2009, the Ministry of Public Finance, the Ministry of Labor and Social Protection, and other pertinent institutions have implemented a monitoring system of public enterprises. During the program period, information will be provided to document that sanctions—decline in remuneration and dismissal of management according to Ordinances 37/2008 and 79/2008—are imposed if the budgets and company targets for restructuring are not observed.

20. The quarterly indicative target for 2010 will be set on the aggregate operating balance (earnings before interest and tax), net of subsidies, of the following public enterprises: (1) C.N. Cai Ferate CFR; (2) S.N. Transport CFR Calatori; (3) CN a Huilei; (4) SC Termoelectrica; (5) C.N. de Autostrazi si Drumuri Nationale; (6) S.C. Metrorex; (7) S.N.

de Transport Feroviar CFR Marfa S.A.; (8) SC Electrocentrale Bucuresti; (9) Societatea Comerciala Electrificare CFR S.A.; and (10) S.C. Administratia Nationala a Imbunatatirilor Funciare. The data shall be reported with operating results by firm. The targets for June 2010, September 2010 and December 2010 will be -2000, -3000 and -4000, respectively.

I. Reporting Requirements

21. Performance under the program will be monitored from data supplied to the IMF by the NBR and the MoPF as outlined in Table 1. The authorities will transmit promptly to the IMF staff any data revisions as well as other information necessary to monitor the arrangement with the IMF.

Table 1. Romania: Data Provision to the IMF

Item	Periodicity
To be provided by the Ministry of Finance	
Preliminary monthly data on general government accounts	Monthly, on the 25th day of the following month
Quarterly final data on general government accounts	Quarterly cash data, on the 35th day past the test date Quarterly accrual data, on the 55th day past test date
The budget deficit of the general government using ESA95 definition	Quarterly, with a lag of three months
Preliminary data on below-the-line financing for the general government	Monthly, with a lag of no more than 35 days past the test date
Final quarterly data on below-the-line financing for the general government	Quarterly, no later than 45 days past the test date
Total accounts payable and arrears of the general government	Preliminary monthly, within the next month. Quarterly, within 55 days
Stock of the central government external arrears	Daily, with a lag of not more than seven days
Public debt and new guarantees issued by the general government	Monthly, within one month
Preliminary monthly data on general government primary spending, net of EU disbursements	Preliminary monthly data will be reported to the IMF staff within 25 days
Final quarterly data on general government primary spending, net of EU disbursements	Quarterly, within 35 days from the test date
From 2010, the operating balance, profits, arrears, and personnel expenditures of 10 largest public enterprises by total expenditures	Quarterly, within 55 days
Data on EU project grants (reimbursements and advances), capital expenditures and subsidies covered by EU advances or eligible for EU reimbursement on EU supported projects specifically agreed with the EU	Monthly, within three weeks of the end of each month

To be provided by the National Bank of Romania	
NFA data, by components, in both program and actual exchange rates	Weekly, each Monday succeeding the reporting week and with a 3 working day lag in the case of end-quarter data
Monetary survey data in the format agreed with IMF staff	Monthly, within 30 days of the end of the month
The schedule of contractual external payments of the *banking sector* falling due in the next four quarters, interest and amortization (for medium and long-term loans)	Monthly, 45 days after the end of each month
The schedule of contractual external payments of the *corporate sector* falling due in the next four quarters interest and amortization (for medium and long-term loans)	Monthly, 45 days after the end of each month
The stock of short-term external debt of banks and corporate	Monthly, 45 days after the end of each month
Balance of payments in the IMF format currently used to report	Monthly, 45 days after the end of each month
Exposure (deposits, loans, subordinated loans) of (i) foreign parent banks to their subsidiaries in Romania; (ii) IFI and (iii) other creditors to banks in Romania (by national and foreign currency).	Monthly, 20 days after the end of each month

II. Structural Conditionality: Specifications

A. Public Wage Legislation

22. Following the unified public wage law approved in October 2009, an implementing legislation will be approved before end September 2010 that will abide by the following principles:

a. It will ensure the respect of the quantitative targets for the public wage bill included in the unified public wage law and the proposed changes will be fully costed.

b. It will ensure that new salary grading structure is simplified and that pay will be linked based on job responsibility and qualification. The established new pay system will be benchmarked on private sector wages (through a salary survey) to ensure that public pay is broadly aligned with actual labor market conditions, within affordability constraints.

c. The regulation would phase in a limit of 30% on non-wage personnel expenditures and caps on individual bonuses for non-military personnel. For the purpose of this law, “stimulus” payments will be treated as bonuses.

B. Broadening of the Tax Base

23. The personal income tax base will be broadened to incorporate, at the least, meal vouchers, interest income, capital gains, and severance payments. Social security contribution exemptions will be eliminated for most “intellectual property” claimants.

INTERNATIONAL MONETARY FUND

ROMANIA

Romania—Staff Report for the 2010 Article IV Consultation, Fourth Review Under the Stand-By Arrangement, and Requests for Modification and Waiver of Applicability of Performance Criteria—Informational Annex

Prepared by the European Department

June 16, 2010

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ANNEX I. ROMANIA: FUND RELATIONS

As of May 31, 2010

I.	**Membership Status:**	Joined 12/15/72	Article VIII
II.	**General Resources Account:**	SDR million	% Quota
	Quota	1,030.20	100.00
	Fund holdings of currency	9,293.21	902.08
	Reserve Tranche Position	0.00	0.00
III.	**SDR Department:**	SDR million	% Allocation
	Net cumulative allocation	984.77	100.00
	Holdings	809.56	82.21
IV.	**Outstanding Purchases and Loans:**	SDR Million	% Quota
	Stand-by Arrangements	8,263.00	802.08

V. Financial Arrangements:

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	05/04/09	05/01/11	11,443.00	8,263.00
Stand-By	07/07/04	07/06/06	250.00	0.00
Stand-By	10/31/01	10/15/03	300.00	300.00
Stand-By	08/05/99	02/28/01	400.00	139.75
Stand-By	04/22/97	05/21/98	301.50	120.60
Stand-By	05/11/94	04/22/97	320.50	94.27
Stand-By	05/29/92	03/28/93	314.04	261.70
Stand-By	04/11/91	04/10/92	380.50	318.10

VI. Projected Payments to Fund (Expectations Basis)[1]

(SDR million; based on existing use of resources and present holdings of SDRs):

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[1] This schedule presents all currently scheduled payments to the IMF, including repayment expectations where applicable and repayment obligations otherwise. The IMF Executive Board can extend repayment expectations (within predetermined limits) upon request by the debtor country if its external payments position is not strong enough to meet the expectations without undue hardship or risk.

	Forthcoming				
	2010	2011	2012	2013	2014
Principal			1,307.25	3,859.63	2,824.25
Charges/interest	104.48	207.18	214.76	153.61	25.28
Total	104.48	207.18	1,522.01	4,013.23	2,849.93

VII. Implementation of HIPC Initiative: Not Applicable

VIII. Implementation of Multilateral Debt Relief Initiative (MDRI): Not Applicable

IX. Technical Assistance

The transition in Romania has been supported by substantial technical assistance from multilateral agencies and bilateral donors. The Fund has provided support in a number of areas with more than 40 technical assistance missions since 1990, although the authorities have had a mixed record with regard to implementation. Expert Fund assistance has focused on a number of key areas, including: fiscal reforms; modernization of the central bank and the banking system; creating a market-oriented legal structure; training; improving the collection and reporting of statistics, and AML/CFT. The implementation of a comprehensive tax administration reform designed in line with the recommendations of several technical assistance missions of the Fund's Fiscal Affairs Department started in January 2003. A report on the observance of standards and codes (ROSC) on fiscal transparency was completed on November 6, 2002 (IMF Country Report No. 02/254). A public debt management technical assistance (TA) was fielded in April 2006. In July 2009, there were two FAD TA missions. The first assisted the authorities with the preparation of a fiscal responsibility law (FRL). The other provided advice on revenue administration issues, focusing on recommendations to improve service and compliance and strengthen the tax administration's organizational structure. There were follow-up missions in April 2010 on the implementation of the FRL and the budget execution on central and local levels, and on setting up a high net worth individuals unit in the tax administration.

In 2003 an FSAP was completed, and an FSAP Update was completed in May 2009. Furthermore, technical assistance by the Fund's Monetary and Capital Markets Department on stress testing is scheduled to take place in September 2010.

X. Anti-Money Laundering and Combating the Financing of Terrorism Framework

The legislative framework for anti-money laundering and combating the financing of terrorism (AML/CFT) has been recently updated to bring Romania in line with international standards and to fulfill the requirements set forth by the third EU directive on AML/CFT. Obligations have been introduced for reporting entities to ascertain beneficial ownership of client accounts and to carry out enhanced due diligence for high-risk customers, such as in the case of politically exposed persons. The supervisory framework has been extended to

cover certain non-financial businesses and professions. The level of AML supervision of the banking sector has improved, and the NBR appears to be taking this issue seriously. The authorities have also started to undertake more inspections of the financial sector at large and on the non financial sector (including casinos, a sector that had been pointed out in the past as particularly vulnerable to money laundering risks). Romania recently underwent an AML/CFT mutual evaluation conducted by MONEYVAL, and the report was approved at the MONEYVAL Plenary (July 2008). The authorities should ensure the effective implementation of the new AML/CFT provisions and continue to focus on supervision of the financial sector at large as well as of casinos and bureaus de change.

XI. Safeguards Assessment

Under the Fund's safeguards assessment policy, the National Bank of Romania (NBR) was subject to full safeguards assessment with respect to the Stand-By Arrangement approved on May 4, 2009. The assessment was completed on May 29, 2009 and concuded that the NBR continues to have a relatively strong safeguards framework in place.

XII. Resident Representative

The Fund has had a resident representative in Bucharest since 1991. Mr. Tonny Lybek assumed the post of regional resident representative in March 2009.

ANNEX II. ROMANIA: IMF-WORLD BANK RELATIONS

A. Partnership in Romania's Development Strategy

Romania's objectives ahead remain two-fold: to deal with the crisis and mitigate its adverse impact, while anchoring these measures in a medium-term structural reform agenda that would support economic growth and resume progress towards convergence with EU living standards, social cohesion and eventual entry into the Euro-zone. EU assistance to Romania remains core for supporting the economic recovery in 2010-11, and the relations with the EU will retain their priority.

The Bank's Development Policy Loan (DPL) series, part of the Euro 19.9 billion international support package to Romania involving the IMF, the European Commission and the World Bank, supports the *structural reforms* needed to improve fiscal sustainability, enhance the social protection systems and strengthen the functioning of the financial sector. The World Bank also has several sector investment operations, economic and sector work, and commitments through the International Finance Company.

The Bank's analysis is shared with the IMF and is used as an input to the fiscal framework, including structural reform measures that have important fiscal implications, such as pension reform and enhancing the fiscal efficiency of social assistance programs.

Overall, the IMF and World Bank staffs maintain a close collaborative relationship in supporting the Government's reform program and are coordinating their policy advice to the Romanian authorities.

B. IMF-World Bank Collaboration in Specific Areas

Public sector reform. The Bank and the Fund are supporting measures to address the weaknesses in public expenditure management that have been at the core of fiscal deficits. The Bank's DPL program supports the strengthening of the Medium Term Expenditure Framework to improve the financial management and predictability of public spending as well as the quality of public services. The DPL also supports public sector pay reform. The public sector pay system is at variance with the rest of Europe: (i) non-wage compensation is disproportionately large; (ii) there are wide disparities in pay between positions with similar skills and responsibility; (iii) seniority is more important than performance; (iv) pay decisions are not based on reliable information on private sector comparators; and (v) political interference undermines competitive recruitment and pay. The government intends to use analytical work provided by the Bank as a basis for reforming the pay system.

Financial sector reform. Following a jointly conducted FSAP in June 2003, the Bank and the IMF completed an FSAP update for Romania in 2009. The FSAP and FSAP update have provided a shared perspective on the potential risks in the financial sector, the development agenda and the prioritization of reforms in that sector. Under the DPL series, the Bank is supporting measures to strengthen the functioning and resilience of the financial sector. TA was also provided to the Financial Sector authorities, and the Ministry of Justice of Romania, in relation with the DPL series. The TA focused in particular on: a) assistance to the Ministry of Justice in the preparation of Guidelines for Corporate Debt Restructuring and in amending the Insolvency Law so as to remove obstacles to out-of-court corporate debt restructuring; b) assistance to the National Bank of Romania (NBR) on the preparation of Guidelines for Mortgage Debt Restructuring.

C. Areas Where the World Bank Leads and Its Analyses Serve as Inputs Into the IMF Policy Formulation and Advice

Social Protection. Under the IMF-Bank partnership, the IMF has paid close attention to the social dimension of the programs**.** For example, the fiscal deficit target allows for protecting the poor and low-income earners from the impact of the global crisis, through higher social spending and measures to increase the coverage of the best targeted program (Guaranteed Minimum Income) and other Social Assistance programs targeting the elderly poor.

Pensions. The Bank supports the measures intended to secure the pension system sustainability, including but not limited to the gradual linkage of benefit adjustments to inflation and an increase in retirement ages for women to equalize women's retirement ages with that of men at 65. Pension reform is also a structural benchmark for the Fund's SBA.

Education. The Bank has supported measures to increase the fiscal savings and improve the quality and access to education services, namely the capita financing starting with school year 2010/2011 (the measure is piloted in eight counties, accounting for 20 percent of total student enrollment). In addition the Bank has supported the government program in education through an investment operation targeting the rehabilitation of schools in rural areas.

Health. The Bank supports the Government program in health through an investment operation and the DPL program. The DPL focuses on strengthening the financial sustainability of the national health insurance system through the introduction of co-payments (referred to as "health moderating tickets"), complemented by an exemption mechanisms for the poor. This measure will be complemented by a hospitalization strategy as well as a technical position paper and roadmap for evidence-based transparent mechanisms for inclusion of new technology and drugs in the benefit package.

D. IFC Program

IFC's current committed portfolio is $607 million, the second highest in the Southern Europe and Central Asia region after Turkey. IFC has played an active crisis response role in Romania, investing over $260 million of its own funds and mobilizing an additional $150 million in eight projects in various sectors of the economy. In addition, Romania will also benefit from two recently committed crisis responses regional funds, which aim to raise a total of €500 million to address bad debts and to assist local companies facing financing difficulties.

Notwithstanding the crisis, IFC is investing in Romania on selective basis. IFC has withdrawn from sectors and lines of business where the private sector is ready to take over. IFC envisages a phased reduction of involvement over a period of three to five years – depending on the market conditions and crisis impact. In the banking sector, as it is largely dominated by foreign banks (approx 90% of banking assets), the strategy of IFC in financial markets is to work with local banks and strengthen their capacity to provide loans to underserved sectors and products such micro, small and medium enterprises, local currency, housing finance, agribusiness, and energy efficiency. In the real sector, IFC will assist local companies to become more competitive in domestic market and to expand in other countries in the region, as well as promote South-South investments to/from Romania. IFC will also continue to support high development impact projects such as in infrastructure, in frontier regions and in climate change related projects.

E. World Bank Group Strategy and Lending Operations

The current IBRD and IFC Country Partnership Strategy (CPS) for Romania, covering the period 2009-2013, was presented to the Board on July 16 2009. anchors the World Bank Group's program around two pillars: i) helping the Government to implement structural reforms to help mitigate the crisis by reducing social and economic vulnerabilities; and ii) putting in place the basis for sustainable economic growth in the medium term. The DPL series will constitute the bulk of new lending in the early years of the CPS. Given the severity of the crisis and the exceptional need for large-scale budget support, almost all new lending in the first year or two of the CPS will be concentrated on this DPL series. A large existing portfolio of investment loans is being restructured to provide a better fit with the Government's priorities and absorption capacity. Selective, new investment lending could be considered in the outer years. The CPS outlines a substantial Analytical and Advisory Services program that supports the design of the DPL program.

The DPL has been the primary vehicle for discussions around mitigation of the crisis. The FSAP was also critical in providing background analysis, while a program of Analytical and Advisory work – including Technical Assistance on Health and Pensions– has complemented this effort. In relation to laying the foundations for sustainable economic growth, the Bank has a wide program of work in the structural reform area, including: in the

social sectors, agriculture, energy, and public administration reform (see Table 1 below). In the area of public administration, the Bank is undertaking a functional review of several key Ministries and agencies with the aim of helping them identify efficiencies and opportunities for reform.

Project ID	Project Name	Fiscal Year	IBRD	GRANT	Undisb ursed.
P100470	AVIAN FLU - RO	2007	37.7		23.6
P100638	CESAR	2008	65		62.0
P086694	ECSEE APL #1	2005	84.3		9.2
P075163	HAZ MITIG	2004	150		56.0
P081950	HAZARD MITIGATION (GEF)	2004		7	2.97
P078971	HEALTH SEC REF 2 (APL #2)	2005	80		41.3
P099528	INT. NUTRIENT POLL CONTROL (GEF)	2008		5.5	3.8
P093775	INTEG NUTRIENT POLLUTION CONTROL	2008	68.1		65.5
P043881	IRRIG REHAB	2004	80		34.5
P090309	JUDICIAL REFORM	2006	130		138.6
P088165	KNOW ECON	2006	60		31.9
P087807	MINE CL, ENV & SOCIO-EC REG (CRL)	2005	120		69.7
P086949	MOD AGR KNOW & INF SYST (MAKIS)	2005	50		34.5
P088252	MUNICIPAL SERVICES PROJECT	2007	131.7		52.5
P093096	SOC INCL PROG (CRL)	2006	58.5		56.6
Overall Result			**1115.3**	**12.5**	**682.9**

ANNEX III. ROMANIA: STATISTICAL ISSUES

Romania—STATISTICAL ISSUES As of May 19, 2010
I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance. The quality of the national accounts, price, fiscal, and balance of payments data is adequate. The authorities have improved economic and financial statistics with technical assistance, including from the Fund, over the past several years. Romania began participating in the GDDS in February 2001 and graduated to subscription to the SDDS in May 2005.
National accounts: Quarterly and annual national accounts statistics are produced by the National Institute for Statistics (INS) using the *European System of Accounts 1995 (ESA95)*. Estimates are methodologically sound and are reported to the Fund on a timely basis for publication in the *International Financial Statistics (IFS)*. Provisional and semi-final versions are disseminated in the Statistical Yearbook and other publications, as well as on the web (www.insse.ro).
Inflation: The Consumer Price Index is subject to standard annual re-weighting, and is considered reliable. In January 2004, the INS changed the coverage of the Producer Price Index to include the domestic and export sectors.
Labor market: Labor market statistics are broadly adequate. The definition used for employment is consistent with ESA 95.
Public finances: Annual GFS data are reported on an accrual basis derived from cash data using various adjustment methods. Tax revenues are adjusted using the time-adjusted cash method; expense data are adjusted using due-for-payments data; and, interest payments are calculated on an accrual basis. Beginning in 2002, the Special Fund for Development of the Energy System, the Special Fund for Public Roads, the Special Fund "Romanian Agriculture Development," and the Special Fund "Romania" were included in the state budget, while the Special Fund for Insured Protection was eliminated from general government accounts. The reported data excluded data on the Agency for Recovery Bank Assets.[2] EUR receives monthly cash budget execution data. Accrual data are available on a quarterly basis and with a 55 day lag after the end of each quarter. Consolidated data on central government operations are reported for inclusion in the *GFS*

[2] Formerly, the Agency for Bank Asset Recovery and the Authority for Privatization and Management of State Ownership.

Yearbook. Consolidated general government data were reported for the first time for inclusion in the *2005 GFS Yearbook.*	
Monetary and financial data: The National Bank of Romania (NBR) reports monetary and financial statistics on a regular and timely basis for publication in the *IFS*. Since December 2004, the NBR reports monetary data to STA using the Standardized Report Forms (SRFs). The data are being published in the *IFS Supplement*, beginning September 2006. Romania's data and metadata for financial soundness indicators are posted on the IMF's website (http://www.imf.org/external/np/sta/fsi/eng/cce/index.htm).	
Balance of payments: The NBR routinely reports balance of payments statistics to the Fund in a timely fashion. A 2003 STA mission undertook a detailed review of the NBR's compilation methodology for balance of payments and international investment position statistics, developed in consultation with Eurostat, and concluded that the proposed system is broadly appropriate. The STA mission supported implementation of this compilation system in 2004, along with a new FDI survey.	
II. Data Standards and Quality	
Romania is subscriber to the Fund's Special Data Dissemination Standard (SDDS) since May 4, 2005.	IMF Reports on the Observance of Standards and Codes (ROSC) have been published as Country Report No. 01/206, 02/254 and 03/389.

ROMANIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(AS OF MAY 19, 2010)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	Apr.2010	May.2010	D and M	D and M	D and M
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr.2010	May.2010	D and M	W and M	M
Reserve/Base Money	Apr.2010	May.2010	D and M	W and M	M
Broad Money	Apr.2010	May.2010	M	M	M
Central Bank Balance Sheet	Apr.2010	May.2010	M	M	M
Consolidated Balance Sheet of the Banking System	Apr.2010	May.2010	M	M	M
Interest Rates[2]	Apr.2010	May.2010	M	M	M
Consumer Price Index	Apr.2010	May.2010	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar. 2010	May 2010	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	Mar. 2010	May 2010	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Mar. 2010	May 2010	M	M	M
External Current Account Balance	Mar.2010	May.2010	M	M	Q
Exports and Imports of Goods and Services	Mar.2010	May.2010	M	M	M
GDP/GNP	Q1 2010	May.2010	Q	Q	Q
Gross External Debt	Q1 2010	May.2010	M	M	Q
International Investment Position [7]	Q1 2010	May.2010	Q	Q	Q

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic non-bank financing.
[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds), and state and local governments.
[5] Including currency and maturity composition.
[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).
[7] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND

ROMANIA

Romania—Staff Report for the 2010 Article IV Consultation, Fourth Review Under the Stand-By Arrangement, and Requests for Modification and Waivers of Nonobservance of Performance Criteria – Supplementary Information, and Supplementary Letter of Intent

Prepared by the Staff Representative for Romania

Approved by Poul M. Thomsen and David Marston

June 29, 2010

1. This statement provides an update on policy developments and implications for the program since the issuance of the staff report. The additional information changes the staff appraisal.

Fiscal developments

2. **On June 25, the Constitutional Court ruled on the package of expenditure cuts agreed with staff and approved by the parliament**. The Court accepted the legality of the 25 percent cut in public sector wages and the cuts of 15 percent in most social transfers, but rejected the constitutionality of the 15 percent reduction in pensions. This decision created a gap of 0.7 percent of GDP to achieve the agreed 6.8 percent of GDP deficit target. The authorities responded quickly to implement compensatory measures. On June 26, the Cabinet approved an emergency decree to increase in the standard VAT rate from 19 percent to 24 percent, effective immediately (revised prior action), and on June 29 parliament re-approved legislation to implement the wage cuts accepted by the Court.[1] The VAT increase is expected to yield RON 3.6 billion (0.7 percent of GDP) for the remainder of 2010 at current revenue yields, effectively closing the gap created by the rejection of the pension cuts (text table and revised Table 6).

3. **The government has taken other actions to fully implement the agreed fiscal consolidation**. The cabinet approved the revenue measures that formed part of the agreed

[1] Under Romanian law, when the Constitutional Court rules part of a law unconstitutional, it returns the whole law to parliament for action. Thus, the wage cuts (which were accepted) do not go into effect automatically. For this reason, the parliament had to re-approve them as new legislation. Staff reached an understanding with the authorities to require parliamentary approval of the wage cuts and of the decree increasing the VAT as an end-September 2010 structural benchmark. Parliamentary approval of the wage cuts on June 29 partially met the benchmark.

adjustment package (0.3 percent of GDP), although these were not part of the prior action. These measures included broadening the tax base for the income tax and social security contributions, and introducing a tax surcharge on owners of multiple properties. Separately, a Ministerial order has been issued to implement the agreed cuts in transfer payments to local governments. This action will be followed up next month by a budget revision law to make the cuts permanent.

Fiscal program (in percent of GDP)

	2010
Overall deficit - revised macroframework, no new measures	9.1
Overall deficit - revised program	6.8
Required adjustment effort, *of which:*	**2.3**
Reduction in personnel spending (25% compensation cut)	0.8
Reduction in social assistance except for pensions (15% cut)	0.3
Other cuts in spending (transfers, subsidies)	0.5
Lost taxes due to wage and social transfers cuts	-0.3
VAT increase to 24% from 19%	0.7
Broadening of the tax base	0.1
Net lending repayment	0.2
Turnover tax on medical distributors	0.0

Macroeconomic developments

4. **Economic indicators available since the issuance of the staff report suggest a weak economic recovery, but downside risks have risen.** Industrial production and export growth have remained positive, but demand-related indicators are weak and confidence and economic sentiment indicators are sharply negative. Credit indicators also remain weak, with interest rates affected by increased risk perception for Romania in international markets and credit growth still negative.

5. **The VAT increase will have a significant one-off effect on inflation.** While pass-through may initially be more subdued due to weak domestic demand, preliminary staff estimates suggest the consumer prices will rise by 3½-4½ percentage points above staff's previous estimate of 3.7 percent at year-end (revised Table 3). Thus, the NBR will likely miss its 2010 inflation target by a significant margin, but inflation should return to its downward path in 2011.

Pension reform

6. **The lengthy debate in parliament on the confidence motion to approve the fiscal package has contributed to a delay in approval of pension reform legislation.** While parliamentary committees have approved the draft law, last week the parliament postponed the discussion of the bill to September, which will not allow the structural benchmark to be met by end-June, as agreed (revised Table 2). Staff expects that the legislation will be approved by Parliament by end-September 2010 (reset structural benchmark) and implemented in 2011, as agreed. Therefore, the delay will not have a tangible impact on the program. Moreover, many of the provisions of the legislation that have a short-term impact –

such as the elimination of the special noncontributory pensions and tightening disability pension procedures – have been included in recently approved fiscal package, and will actually be in force earlier than anticipated.

Revised proposed decision

7. **Staff supports the approval of the requested waivers of applicability** of all end-June 2010 performance criteria (other than on the NFA target), as well as of the condition to consult with the Fund based on inflation at end-June. These waivers are needed as data on the end-June 2010 performance criteria and on inflation as of end-June 2010 are not available.

8. **A revised proposed decision, granting the requested waivers of applicability, is attached.** The net foreign asset targets adjustor for end-June 2010 is no longer proposed to be modified, as data on this target has become available and the target has been met.

Modifications to the staff appraisal

9. **Staff continues to support Board approval of the review.** The mix between expenditure cuts and revenue measures is now more balanced than in the package originally proposed by the government, and the protection of pensioners will further mitigate negative social effects. Indeed, the proposal is closer to the measures that had been advocated by staff, as discussed in paragraphs 20 and 49, of Country Report No.???. While implementation risks remain notable (including the possibility that the VAT increases will not be ratified by the parliament), the government's legal authority to raise taxes makes such risks lower than under the original package. Furthermore, the government's willingness to implement compensatory measures within hours of the adverse court decision demonstrates considerable political resolve to achieve the objectives of the Fund supported program. Staff and the authorities agreed that parliamentary ratification of the VAT decree will be an end-September 2010 structural benchmark.[2]

10. Monetary policy will face additional challenges in bringing inflation under control. The sharp short-term inflationary effect of the VAT increase will temporarily push prices outside of the NBR's desired disinflation path. In staff's view, there is no immediate need for a change in the monetary policy stance as a result of the direct effects of higher taxation on prices. However, the authorities will have to be vigilant in not accommodating possible second-round inflationary effects. The key will be to gear policy decisions to the projected inflationary path 12–18 months ahead, once the immediate impact of the tax hikes has dissipated.

[2] In the unlikely event that the parliament rejected the measure, staff would negotiate a new mix of expenditure and revenue measures to achieve the targeted adjustment.

Table 1. Romania: Quantitative Program Targets (Revised)

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March		June	Sept	Dec
	Actual	Actual	Actual	Actual	Actual	Prog.	Est.	Prog.	Prog.	Prog.
I. Quantitative Performance Criteria										
1. Cumulative change in net foreign assets (mln euros) 1/3/	25,532	-3,500	-5,119	-4,566	-4,874	-2,000	779	-2,500	-2,000	-2,000
2. Cumulative floor on general government overall balance (mln lei) 2/	-24,655	-8,300	-14,456	-25,563	-36,101	-8,250	-8,422	-18,200	-25,700	-34,650
3. Stock in general government arrears from the end of previous year (bn lei)	1.06	1.41	1.55	1.4	1.50	1.27	1.76	1.09	0.81	0.48
4. Ceiling on general government guarantees issued during the year (face value, bn lei)	0.0	…	0.02	0.7	2.2	12.0	4.6	12.0	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	0	0	0	0	0	0	0	0	0
III. Inflation Consultation										
6. 12-month rate of inflation in consumer prices										
Outer band (upper limit)	…	…	8.4	7.7	6.5	6.5	6.5	6.0	10.0	10.0
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.5	5.0	9.0	9.0
Center point	*6.3*	*6.7*	*5.9*	*4.8*	*4.7*	*4.5*	*4.2*	*4.0*	*8.0*	*8.0*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.5	3.0	7.0	7.0
Outer band (lower limit)	…	…	4.4	3.7	2.5	2.5	2.5	2.0	6.0	6.0
IV. Indicative Target										
7. General government current primary spending (excl. EU funds and social assistance, mln lei) 2/	92,327	22,149	43,238	63,878	85,637	32,900	32,749	66,200	98,000	130,900
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-1,381	-495	-2,000	-3,000	-4,000
Memorandum Item:										
Cumulative projected revenue of general government, net of EU funds (mln. lei)	…	…	…	…	151,508	…	36,355	74,950	117,100	159,600

1/ The December 2008 figure is a stock.
2/ The December 2008 figure is for the whole year.
3/ NFA targets for end December 2009 have been adjusted as actual disbursements fell short of projected levels by EUR 1 bn. Note that the NFA adjustor for June 2010 will remain as described in the Letter of Intent of February 5, 2010, while the adjustors for September and December 2010 are set as described in the Letter of Intent of June 16, 2010.

Table 2. Romania: Performance for Fourth Review and Proposed New Conditionality (Revised)

Measure	Target Date	Comment
Prior Action		
1. Enactment of agreed fiscal measures (LOI ¶7, as modified by supplementary LOI ¶1)	Prior action	Met
Quantitative performance criteria		
1. Floor on net foreign assets	March, 2010	Met
2. Floor on general government overall balance	March, 2010	Not met
3. Ceiling on general government guarantees	March, 2010	Met
4. Ceiling on general government domestic arrears	March, 2010	Not met
5. Non-accumulation of external debt arrears	March, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	March, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	March, 2010	Met
Inflation consultation band		
Inner band	March, 2010	Met
Outer band	March, 2010	Met
Structural benchmarks		
1. Passage of Fiscal Responsibility Law	March 31, 2010	Met
2. Passage of amendments to the banking and winding-up laws to enhance the bank resolution framework	March 31, 2010	Met
3. Approval of legislation and internal regulations by ordinance necessary to implement tax administration reforms	April 30, 2010	Met
4. Legislative changes to improve monitoring and control of SOEs	June 30, 2010	Met in January 2010
5. Approval of institutional reform measures to mitigate fiscal risks from local governments	June 30, 2010	Revised to end-September 2010
6. Passage of pension legislation	June 30, 2010	Not met; reset to end-September 2010
7. Passage of implementing legislation for the unified wage law	September 30, 2010	
Proposed New Conditionality (Structural Benchmarks)		
1. Approval of institutional reform measures to mitigate fiscal risks from local governments	September 30, 2010	Revised from end-June, 2010
2. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement (LOI ¶24)	September 30, 2010	
3. Reform tax administration methodology for high net wealth individuals (LOI ¶13)	November 30, 2010	
4. Integrate the accounting reporting system with the Treasury payment system (LOI ¶10)	March 31, 2011	
5. Parliamentary ratification of the fiscal measures approved by the government (supplementary LOI ¶1)	September 30, 2010	Measure on wage cuts already met
6. Passage of pension legislation	September 30, 2010	Reset from end-June, 2010

Table 3. Romania: Selected Economic and Social Indicators, 2007–15 (Revised)

	2007	2008	2009	2010		2011	2012	2013	2014	2015
				Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Output and prices				(Annual percentage change)						
Real GDP	6.3	7.3	-7.1	1.3	-0.5	3.6	4.4	4.3	4.0	4.0
Domestic demand	14.6	9.9	-14.0	0.1	-1.5	2.6	5.6	5.8	5.7	4.3
Net exports (contribution)	-16.7	-2.6	16.1	1.1	1.4	0.4	-2.6	-3.0	-3.3	0.0
Consumer price index (CPI, average)	4.8	7.8	5.6	3.9	6.6	5.2	3.0	3.0	3.0	3.0
Consumer price index (CPI, end of period)	6.6	6.3	4.7	3.2	7.9	3.0	3.0	3.0	3.0	3.0
Unemployment rate (average)	4.3	4.0	6.3	7.9	8.9	8.4	7.3	6.2	5.1	4.1
Nominal wages	22.6	23.6	8.4	4.4	4.3	6.2	6.0	5.9	5.7	5.7
Saving and Investment				(In percent of GDP)						
Gross domestic investment	31.0	31.3	25.1	30.7	24.8	25.2	25.2	25.2	25.2	25.2
Gross national savings	17.6	19.7	20.6	25.2	19.8	20.2	20.2	20.2	20.2	20.2
General government finances										
Revenue	32.3	32.2	31.8	31.3	32.6	32.6	32.6	32.2	31.8	31.4
Expenditure	35.4	37.0	39.2	37.3	39.4	37.0	36.6	35.7	34.6	33.8
Fiscal balance	-3.1	-4.8	-7.4	-5.9	-6.8	-4.4	-4.1	-3.5	-2.8	-2.3
Privatization proceeds	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External financing	0.1	0.4	2.9	3.7	4.6	0.8	0.0	0.0	0.0	0.0
Domestic financing	2.9	4.3	4.5	2.2	2.2	3.6	4.1	3.5	2.8	2.3
Structural fiscal balance 1/	-4.3	-6.9	-5.4	-2.4	-3.3	-1.2	-1.2	-0.9	-0.5	-2.3
Gross public debt (direct debt only)	17.5	19.5	28.2	31.5	33.9	35.7	36.8	37.3	37.2	36.7
Money and credit				(Annual percentage change)						
Broad money (M3)	33.7	17.5	9.0	6.6	10.4	7.3	7.7	7.6	8.5	8.5
Credit to private sector	60.4	33.7	0.9	5.8	7.3	10.2	6.0	8.5	9.0	10.0
Interest rates, eop				(In percent)						
Euribor, six-months	4.79	3.52	4.52	-	-	-	-	-	-	-
NBR policy rate	7.50	10.25	8.00	-	-	-	-	-	-	-
NBR lending rate (Lombard)	12.00	14.25	12.00	-	-	-	-	-	-	-
Interbank offer rate (1 week)	7.10	12.70	10.70	-	-	-	-	-	-	-
Balance of payments				(In percent of GDP)						
Current account balance	-13.4	-11.6	-4.5	-5.5	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Merchandise trade balance	-14.3	-13.7	-5.8	-7.1	-7.0	-7.2	-7.5	-7.6	-7.8	-7.4
Capital and financial account balance	17.3	12.7	-0.9	4.2	4.0	6.1	6.9	6.9	6.8	6.8
Foreign direct investment balance	5.7	6.7	3.8	4.1	4.1	4.2	4.5	4.5	4.5	4.5
International investment position	-40.1	-51.8	-68.3	-53.6	-62.5	-60.2	-58.5	-60.0	-61.3	-60.6
Gross official reserves	23.0	20.2	26.6	30.5	31.7	31.3	28.4	24.4	21.0	19.8
Gross external debt	47.0	52.6	65.7	68.3	69.0	64.3	57.2	50.2	44.3	40.2
Exchange rates										
Lei per euro (end of period)	3.5	4.0	4.2	-	-	-	-	-	-	-
Lei per euro (average)	3.3	3.7	4.2	-	-	-	-	-	-	-
Real effective exchange rate										
CPI based (depreciation -)	9.0	-4.1	-7.8	-	-	-	-	-	-	-
Memorandum Items:										
Nominal GDP (in bn RON)	416.0	514.7	491.3	538.9	510.4	553.9	603.1	656.2	711.9	772.2

Social and Other Indicators
GDP per capita (current US$, 2008): $9,300; **GDP per capita, PPP** (current international $, 2008): $14,065
Unemployment rate: 8.3% (February 2010)
Poverty rate: 5.7% (2008)

Sources: Romanian authorities; Fund staff estimates and projections; and World Development Indicators database.

1/ Actual fiscal balance adjusted for the automatic effects of the business cycle.

Table 4. Romania: Balance of Payments, 2007–15 (Revised)
(In billions of euros, unless otherwise indicated)

	2007	2008	2009	2010		2011	2012	2013	2014	2015
	Act	Act	Act	Prog	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Current account balance	-16.7	-16.2	-5.2	-6.8	-6.1	-6.9	-7.8	-8.7	-9.7	-10.7
Merchandise trade balance	-17.8	-19.1	-6.8	-8.7	-8.6	-9.7	-11.6	-13.3	-15.1	-16.0
Exports (f.o.b.)	29.5	33.7	29.1	29.9	31.5	33.9	36.6	39.5	42.8	46.1
Imports (f.o.b.)	-47.4	-52.8	-35.9	-38.6	-40.1	-43.6	-48.2	-52.8	-57.9	-62.1
Services balance	0.5	0.7	-0.4	0.3	-0.2	-0.1	0.1	0.3	0.6	0.8
Exports of non-factor services	6.9	8.8	7.0	7.0	7.7	8.3	9.1	9.9	10.8	11.6
Imports of non-factor services	-6.5	-8.1	-7.4	-6.8	-7.9	-8.4	-9.0	-9.6	-10.3	-10.8
Income balance	-4.2	-3.7	-2.1	-2.7	-2.5	-3.1	-3.0	-3.1	-3.2	-4.3
Receipts	2.4	2.3	1.2	1.5	1.5	1.9	2.6	3.0	3.3	3.7
Payments	-6.6	-6.0	-3.3	-4.2	-4.0	-5.0	-5.7	-6.1	-6.5	-7.9
Current transfer balance	4.8	6.0	4.1	4.4	5.2	6.0	6.7	7.3	8.1	8.8
Capital and financial account balance	21.9	17.8	-1.0	5.2	4.9	8.2	10.8	12.0	13.2	14.7
Capital transfer balance	0.8	0.6	0.5	0.7	0.4	0.4	0.4	0.3	0.2	0.1
Foreign direct investment balance	7.0	9.3	4.4	5.0	5.0	5.7	7.0	7.8	8.7	9.7
Portfolio investment balance	0.4	-0.8	0.6	-0.2	-0.2	0.5	0.5	0.6	0.7	0.8
Other investment balance	13.8	8.7	-6.5	-0.3	-0.3	1.7	2.9	3.2	3.6	4.0
General government 1/	-0.6	0.2	0.2	1.4	1.4	0.0	0.1	0.1	0.1	0.2
Domestic banks	6.0	3.0	-5.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other private sector	8.5	5.5	-1.4	-1.7	-1.7	1.6	2.8	3.1	3.5	3.9
Errors and omissions	-0.7	-0.7	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Prospective financing	...	...	2.1	4.8	4.8	0.2	...	...	...	...
European Commission	...	...	1.5	3.4	3.4	0.2	...	...	...	...
World Bank	...	...	0.3	0.7	0.7	0.0	...	...	...	...
EIB/EBRD	...	...	0.3	0.7	0.7	0.0	...	...	...	...
Overall balance	4.6	1.0	-4.3	3.2	3.5	1.5	3.0	3.3	3.6	4.0
Financing	-4.6	-1.0	4.3	-3.2	-3.5	-1.5	-3.0	-3.3	-3.6	-4.0
Gross international reserves (increase: -)	-4.5	-1.0	-2.6	-6.9	-7.4	-2.6	-1.5	1.7	1.6	-2.1
Use of Fund credit, net	-0.1	0.0	5.9	3.7	3.9	1.0	-1.5	-4.9	-5.2	-1.9
Purchases 2/	0.0	0.0	5.9	3.7	3.9	1.0	0.0	0.0	0.0	0.0
Repurchases	0.1	0.0	0.0	0.0	0.0	0.0	1.5	4.9	5.2	1.9
Other liabilities, net 3/	0.0	0.0	1.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:			(In percent of GDP)							
Current account balance	-13.4	-11.6	-4.5	-5.5	-5.0	-5.0	-5.0	-5.0	-5.0	-5.0
Foreign direct investment balance	5.7	6.7	3.8	4.1	4.1	4.2	4.5	4.5	4.5	4.5
Merchandise trade balance	-14.3	-13.7	-5.8	-7.1	-7.0	-7.2	-7.5	-7.6	-7.8	-7.4
Exports	23.7	24.1	25.1	24.2	25.7	24.9	23.5	22.8	22.1	21.3
Imports	-38.0	-37.8	-31.0	-31.3	-32.7	-32.1	-31.0	-30.4	-29.9	-28.7
Gross external financing requirement	26.7	32.6	31.7	29.9	29.7	28.0	26.2	25.0	23.5	23.4
			(Annual percentage change)							
Terms of trade (merchandise)	5.3	-4.0	8.8	-5.0	-7.4	-3.3	-0.5	0.6	0.8	0.4
Merchandise export volume	8.7	10.3	-12.6	1.4	8.4	6.4	6.6	6.7	6.7	5.8
Merchandise import volume	26.1	4.0	-24.4	0.5	4.3	4.2	8.6	8.9	9.0	5.9
Merchandise export prices	5.2	3.5	-1.2	2.0	-0.4	1.3	1.2	1.3	1.5	1.7
Merchandise import prices	-0.1	7.2	-10.1	6.9	7.1	4.5	1.6	0.7	0.7	1.2
			(In billions of euros)							
Gross international reserves 3/	28.7	28.3	30.9	37.7	38.3	40.9	42.3	40.6	39.1	41.2
GDP	124.6	139.7	116.0	123.6	122.5	136.0	155.4	173.7	193.8	216.4

Sources: Romanian authorities; and Fund staff estimates and projections.
1/ Includes IMF disbursement to the Treasury of €0.9 billion in 2009 and €1.2 billion in 2010, and issuance of an Euro bond of €1 billion in 2010.
2/ IMF disbursements amounted to €6.8 billion in 2009 and are projected to amount to €5 billion in 2010. Of these €0.9 billion in 2009, and €1.2 billion in 2010 have been disbursed directly to the Treasury, and included in the capital and financial account as noted in footnote 1.
3/ Reflects the allocation of SDR 908.8 million that was made avaialable in two tranches in August and September 2009.

Table 5. Romania: Gross Financing Requirements, 2009-11 (Revised)

(In billions of euros, unless otherwise indicated)

	2009					2010					2011	Total
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year		2009-11
	Act	Act	Act	Act	Act	Act	Proj	Proj	Proj	Proj.	Proj.	
I. Total financing requirements	**13.0**	**15.5**	**11.0**	**8.7**	**48.2**	**9.9**	**7.6**	**8.0**	**7.8**	**33.3**	**39.3**	**120.7**
I.A. Current account deficit	0.9	1.6	1.1	1.6	5.2	1.5	1.7	0.9	2.0	6.1	6.9	18.2
I.B. Short-term debt	9.2	10.4	6.4	4.7	30.7	5.0	3.4	4.2	3.7	16.3	16.3	63.3
Public sector	2.8	4.1	0.9	1.0	8.8	1.4	0.1	0.2	0.1	1.8	1.8	12.4
Banks	3.6	4.6	4.0	2.2	14.4	2.6	2.4	2.6	2.4	10.0	10.0	34.4
Corporates	2.8	1.7	1.5	1.5	7.5	1.0	0.9	1.4	1.2	4.5	4.5	16.5
I.C. Maturing medium- and long-term debt	1.8	3.0	1.6	3.5	9.9	2.7	2.0	2.2	2.2	9.1	16.1	35.1
Public sector	0.2	0.3	0.2	0.3	1.0	0.2	0.3	0.9	0.3	1.7	3.4	6.0
Banks	0.8	1.6	0.4	1.9	4.7	1.1	0.3	0.5	0.4	2.3	4.0	11.0
Corporates	0.8	1.1	1.0	1.3	4.2	1.4	1.4	0.8	1.5	5.1	8.8	18.1
I.D. Other net capital outflows 1/	1.1	0.5	1.9	-1.1	2.4	0.7	0.6	0.7	0.0	1.9	0.0	4.3
II. Total financing sources	**10.9**	**12.2**	**9.9**	**8.6**	**41.6**	**9.4**	**6.6**	**7.4**	**7.8**	**30.9**	**40.2**	**112.6**
II.A. Foreign direct investment, net	1.5	1.1	0.9	0.9	4.4	0.7	1.3	1.4	1.5	5.0	5.7	15.1
II.B. Capital account inflows (EU)	0.0	0.0	0.3	0.2	0.5	0.0	0.1	0.1	0.1	0.5	0.4	1.4
II.C. Short-term debt	7.2	7.4	5.1	4.9	24.6	6.0	3.3	4.3	3.1	16.3	16.3	57.2
Public sector	3.7	3.1	1.1	1.3	9.2	1.9	0.1	0.2	0.0	1.8	1.8	12.8
Banks	2.4	3.4	2.6	2.4	10.8	3.0	2.4	2.7	2.0	10.0	10.0	30.8
Corporates	1.1	0.9	1.4	1.2	4.6	1.1	0.9	1.5	1.1	4.5	4.5	13.6
II.D. Medium- and long-term debt	2.2	3.7	3.6	2.6	12.1	2.7	1.8	1.5	3.1	9.1	17.8	38.9
Public sector 2/	0.0	0.2	0.1	0.5	0.8	1.1	0.2	0.2	0.2	1.7	3.4	5.9
Banks	0.8	2.0	1.8	0.8	5.4	0.4	0.3	0.5	1.1	2.3	4.0	11.6
Corporates	1.4	1.5	1.7	1.3	5.9	1.2	1.3	0.8	1.7	5.1	10.4	21.4
III. Increase in gross reserves	**-2.0**	**1.6**	**1.9**	**0.3**	**1.8**	**3.1**	**-0.9**	**2.8**	**2.5**	**7.4**	**2.1**	**11.3**
IV. Errors and omissions	**0.2**	**-0.1**	**-1.4**	**-0.1**	**-1.5**	**0.2**	**0.0**	**0.0**	**0.0**	**0.1**	**0.0**	**-1.4**
V. Program financing	**0.0**	**4.9**	**3.5**	**0.5**	**8.9**	**3.4**	**0.2**	**3.4**	**2.6**	**9.8**	**1.2**	**19.9**
IMF	0.0	4.9	1.9	0.0	6.8	2.4	0.0	1.8	0.9	5.1	1.0	12.9
Others	0.0	0.0	1.6	0.5	2.1	1.0	0.2	1.7	1.7	4.7	0.2	6.9
European Commission	0.0	0.0	1.5	0.0	1.5	1.0	0.0	1.2	1.2	3.4	0.2	5.0
World Bank	0.0	0.0	0.0	0.3	0.3	0.0	0.0	0.4	0.3	0.7	0.0	1.0
EIB/EBRD	0.0	0.0	0.1	0.2	0.3	0.0	0.2	0.2	0.2	0.6	0.0	0.9
VI. Other Financing 3/	**0.0**	**0.0**	**1.0**	**0.0**	**1.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.0**
Memorandum items:												
Rollover rates for amortizing debt (in percent)												
Banks	72	87	100	77	84	92	98	102	110	100	100	…
Corporates	69	86	124	89	90	96	95	105	104	100	100	…
Gross international reserves 3/	27.4	28.7	30.6	30.9	30.9	34.9	32.6	36.2	38.3	38.3	40.9	…
Coverage of gross international reserves												
- Months of imports of GFNS (next year)	…	…	…	…	7.7	…	…	…	…	8.8	8.6	…
- Short-term external debt (in percent)	98	112	126	126	126	136	127	141	149	149	159	…

Source: IMF staff estimates.

1/ Includes includes portfolio equity, financial derivatives and other investments, assets position.

2/ Excludes the disbursements by the IMF directly to the Treasury, amounting to €0.9 billion in 2009Q3 and €0.8 billion in 2009Q4.

3/ Reflects two SDR allocations in August and September 2009.

Table 6. Romania: General Government Operations, 2007–15 (Revised)
(In percent of GDP)

	2007	2008	2009	2010		2011	2012	2013	2014	2015
			Prel.	Prog.	Proj.	Proj.	Proj.	Proj	Proj	Proj
Revenue	32.3	32.2	31.8	31.3	32.6	32.6	32.6	32.2	31.8	31.4
Taxes	27.9	28.0	27.8	26.7	27.7	27.7	27.6	27.4	27.3	27.1
Taxes on profits	2.9	2.8	2.7	2.4	2.6	2.6	2.6	2.6	2.6	2.6
Taxes on income	3.5	3.6	3.8	3.5	3.5	3.3	3.3	3.2	3.2	3.1
Value-added taxes	7.5	7.9	7.0	6.6	7.4	8.0	8.0	8.1	8.1	8.1
Excises	3.0	2.7	3.2	3.4	3.4	3.4	3.4	3.4	3.4	3.4
Customs duties	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	9.5	9.5	9.7	9.2	9.2	8.9	8.8	8.7	8.5	8.4
Other taxes	1.4	1.2	1.2	1.4	1.3	1.3	1.3	1.3	1.3	1.3
Nontax revenue	3.4	3.1	2.9	3.2	3.5	3.3	3.3	3.3	3.3	3.3
Capital revenue	0.2	0.2	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Grants, including EU disbursements	0.8	0.9	1.0	1.3	1.4	1.6	1.6	1.5	1.2	0.9
Financial operations and other	...	0.0	0.0	…	...	...	...	...	...	...
Expenditure	35.4	37.0	39.2	37.3	39.4	37.0	36.6	35.7	34.6	33.8
Current expenditure	30.7	32.5	35.3	33.4	35.5	32.9	32.7	31.8	30.7	29.8
Compensation of employees	8.1	8.9	9.5	8.5	8.3	7.3	7.2	6.9	6.7	6.4
Maintenance and operations	6.1	6.2	5.7	5.1	5.8	5.2	5.2	5.2	5.2	5.2
Interest	0.7	0.7	1.2	1.7	1.8	1.8	1.9	1.9	1.8	1.8
Subsidies	1.7	1.5	1.5	1.2	1.2	1.0	0.9	0.8	0.7	0.7
Transfers 1/	14.1	15.1	17.0	16.5	18.0	17.5	17.4	17.0	16.3	15.7
Pensions	5.4	6.4	8.1	7.5	8.3	8.2	8.1	7.7	7.7	7.7
Other social transfers	3.9	4.1	4.9	4.5	5.1	4.5	4.2	4.0	3.8	3.6
Other transfers 2/	4.0	3.4	3.4	4.0	4.1	4.4	4.7	4.8	4.3	3.9
o\w contribution to EU budget	0.9	0.9	1.2	1.1	1.2	1.1	1.1	1.0	0.9	0.9
o\w pre-accession EU funds	…	…	0.6	0.6	0.7	0.2	0.0	0.0	0.0	0.0
Other spending	0.7	1.2	0.5	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Proj. with ext. credits	0.0	0.0	0.4	0.5	0.5	0.0	0.0	0.0	0.0	0.0
Capital expenditure 3/	4.7	4.6	4.4	3.8	3.9	4.1	3.9	3.9	3.9	3.9
Reserve fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending	0.0	-0.1	-0.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Fiscal balance	-3.1	-4.8	-7.4	-5.9	-6.8	-4.4	-4.1	-3.5	-2.8	-2.3
Primary balance	-2.4	-4.1	-6.2	-4.2	-5.0	-2.6	-2.1	-1.6	-1.0	-0.6
Financing	3.1	4.8	7.4	5.9	6.8	4.4	4.1	3.5	2.8	2.3
Privatization proceeds	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External	0.1	0.4	2.9	3.7	4.6	0.8	0.0	0.0	0.0	0.0
Domestic	2.9	4.3	4.5	2.2	2.2	3.6	4.1	3.5	2.8	2.3
Financial liabilities										
Gross public debt 4/	19.8	21.3	29.9	33.1	35.6	37.2	38.2	38.6	38.4	37.7
Gross public debt excl. guarantees	17.5	19.5	28.2	31.5	33.9	35.7	36.8	37.3	37.2	36.7
External	7.1	6.9	10.2	12.7	14.4	14.0	12.9	11.8	10.9	10.1
Domestic	10.4	12.6	18.0	18.8	19.5	21.6	24.0	25.5	26.3	26.6
Memorandum items:										
Total capital spending	…	6.0	5.9	5.6	5.8	5.7				
Fiscal balance (ESA95 basis)	-2.5	-5.3	...	...	...	...	...	...	...	...
Output gap 5/	3.3	5.7	-5.2	-9.5	-8.9	-8.7	-7.9	-7.1	-6.7	0.0
Conventional structural fiscal balance	-4.3	-6.9	-5.4	-2.4	-3.3	-1.2	-1.2	-0.9	-0.5	-2.3
Nominal GDP (in billions of RON)	416.0	514.7	491.3	538.9	510.4	553.9	603.1	656.2	711.9	772.2

Sources: Ministry of Finance; Eurostat; and Fund staff projections.

1/ Increase in 2009 mostly reflects higher EU-financed capital spending and budgeted rise in pensions.

2/ Includes co-financing of EU projects.

3/ Does not include all capital spending. Total investment increased from 6.0 percent of GDP in 2008 to 7.0 percent of GDP in the authorities' 2009 budget.

4/ Total public debt, including government debt, local government debt, and guarantees.

5/ Percentage deviation of actual from potential GDP.

Table 6. Romania: General Government Operations, 2007–15 (concluded) (Revised)
(In millions of RON)

	2007	2008	2009	2010		2011	2012	2013	2014	2015
				Prog.	Proj.	Proj.	Proj	Proj	Proj	Proj
Revenue	134,173	165,549	156,373	168,847	166,617	180,851	196,335	211,606	226,480	242,599
Taxes	116,066	143,855	136,350	143,870	141,194	153,561	166,314	180,007	194,274	209,463
Taxes on profits	11,917	14,426	13,466	12,964	13,434	14,559	15,851	17,246	18,709	20,295
Taxes on income	14,402	18,523	18,551	19,076	17,916	18,432	19,776	21,202	22,669	24,235
Value-added taxes	31,243	40,874	34,322	35,549	37,911	44,338	48,424	52,850	57,501	62,374
Excises	12,552	13,646	15,646	18,369	17,516	18,983	20,668	22,486	24,394	26,462
Customs duties	856	962	656	711	648	702	775	850	933	999
Social security contributions	39,443	49,008	47,829	49,773	47,088	49,374	53,012	56,877	60,852	65,099
Other taxes	5,653	6,416	5,879	7,429	6,681	7,172	7,809	8,496	9,217	9,998
Nontax revenue	13,991	15,892	14,487	17,439	17,842	18,036	19,637	21,365	23,178	25,142
Capital revenue	963	1,076	546	497	541	569	619	674	731	793
Grants	3,154	4,702	5,057	7,040	7,040	8,686	9,764	9,561	8,298	7,201
o/w EU pre-accession funds	...	...	2,959	3,415	3,415	1,338	1,279	...	...	...
Financial operations and other	...	25	-67	...	...	...	...	...	...	...
Expenditure	147,141	190,407	192,782	200,754	201,243	205,202	220,938	234,430	246,513	260,647
Current expenditure	127,513	167,095	173,445	180,082	181,221	182,265	197,300	208,711	218,612	230,382
Compensation of employees	33,696	45,608	46,676	45,657	42,144	40,374	43,578	45,467	47,427	49,472
Maintenance and operations	25,187	32,012	28,028	27,565	29,522	28,958	31,529	34,303	37,214	40,368
Interest	3,096	3,776	6,063	9,200	9,116	10,200	11,646	12,375	12,824	13,800
Subsidies	6,875	7,899	7,215	6,252	6,092	5,800	5,368	5,256	5,132	5,567
Transfers 1/	58,660	77,800	83,407	88,782	91,722	96,932	105,178	111,310	116,015	121,175
Pensions	22,664	33,187	39,851	40,406	42,351	45,231	48,628	50,673	54,798	59,746
Other social transfers	16,186	20,973	24,101	24,459	25,841	24,659	25,399	26,160	26,945	27,754
Other transfers 2/	16,769	17,646	16,931	21,383	21,039	24,321	28,189	31,252	30,775	29,882
o\w contribution to EU budget	3,799	4,506	5,650	5,970	5,920	6,345	6,418	6,352	6,480	6,606
o\w pre-accession EU funds			2,959	3,415	3,415	1,338				
Other spending	3,041	5,993	2,523	2,535	2,491	2,721	2,963	3,224	3,497	3,794
Proj. with ext. credits	0	0	2,056	2,625	2,625	0	0	0	0	0
Capital expenditure 3/	19,629	23,794	21,837	20,471	19,821	22,727	23,409	25,468	27,629	29,971
Reserve fund	0	0	0	201	201	211	230	250	272	295
Net lending	0	-481	-2,500	0	0	0	0	0	0	0
Fiscal balance	-12,968	-24,858	-36,409	-31,907	-34,626	-24,351	-24,603	-22,824	-20,033	-18,049
Primary balance	-9,872	-21,082	-30,346	-22,707	-25,510	-14,151	-12,957	-10,448	-7,208	-4,249
Financing	12,968	24,858	36,409	31,907	34,626	24,351	24,603	22,824	20,033	18,049
Privatization proceeds	600	371	0	0	0	0	0	0	0	0
External	324	2,284	14,233	23,474	23,474	4,242	0	0	0	0
Domestic	12,044	22,203	22,177	8,433	11,151	20,110	24,603	22,824	20,033	18,049
Financial liabilities										
Gross public debt 4/	82,324	109,752	146,938	178,148	181,564	205,915	230,518	253,342	273,374	291,423
Gross public debt excl. guarantees	72,747	100,435	138,598	169,566	173,224	197,575	222,178	245,002	265,034	283,083
External	29,672	35,733	49,966	68,507	73,440	77,681	77,681	77,681	77,681	77,681
Domestic	43,075	64,702	88,632	101,059	99,784	119,893	144,497	167,320	187,353	205,401
Other liabilities										

Sources: Ministry of Finance; Eurostat; and Fund staff projections.

1/ Increase in 2009 mostly reflects higher EU-financed capital spending and budgeted rise in pensions.

2/ Includes co-financing of EU projects.

3/ Does not include all capital spending. Total investment increased from 6.0 percent of GDP in 2008 to 7.0 percent of GDP in the authorities' 2009 budget.

4/ Total public debt, including government debt, local government debt, and guarantees.

Table 7. Romania: Monetary Survey, 2007–11 (Revised)
(In millions of lei (RON), unless otherwise indicated; end of period)

	Dec-07	Dec-08	Dec-09	Dec-10 Proj. 2/	Dec-11 Proj.
			I. Banking System		
Net foreign assets	**29,070**	**13,138**	**17,684**	**33,570**	**38,237**
In million euros	8,052	3,297	4,182	7,604	9,330
o/w commercial banks	-18,666	-24,388	-19,708	-19,708	-19,708
Net domestic assets	**119,046**	**160,890**	**171,946**	**175,753**	**186,449**
Public sector credit	9,571	17,268	46,816	57,967	78,076
Private sector credit	148,181	198,086	199,882	214,538	236,366
Other	-38,706	-54,464	-74,751	-96,751	-127,993
Broad Money (M3)	**148,116**	**174,028**	**189,630**	**209,324**	**224,686**
Intermediate money (M2)	148,044	173,629	188,013	206,400	221,548
Money market instruments	72	399	1,617	2,923	3,138
Narrow money (M1)	79,914	92,549	79,361	87,123	104,138
Currency in circulation	21,442	25,287	23,968	25,608	30,961
Overnight deposits	58,472	67,262	55,394	61,515	73,177
			II. National Bank of Romania		
Net foreign assets	**96,466**	**110,323**	**101,015**	**120,581**	**119,011**
In million euros	26,720	27,683	23,891	27,312	29,038
Net domestic assets	**-47,593**	**-59,855**	**-49,354**	**-65,384**	**-60,453**
Public sector credit, net	-8,499	-1,428	-13,626	-13,626	-13,626
Credit to banks, net	-41,168	-51,126	-23,848	-39,878	-34,947
Other	2,074	-7,301	-11,879	-11,879	-11,879
Reserve money	**48,873**	**50,468**	**51,662**	**55,198**	**58,558**
			(Annual percentage change)		
Broad money (M3)	33.7	17.5	9.0	10.4	7.3
NFA contribution	-8.7	-10.8	2.6	8.4	2.2
NDA contribution	42.4	28.3	6.4	2.0	5.1
Reserve money	41.3	3.3	2.4	6.8	6.1
NFA contribution	58.5	28.4	-18.4	37.9	-2.8
NDA contribution	-17.1	-25.1	20.8	-31.0	8.9
Domestic credit, real	54.3	28.4	9.4	2.4	12.0
Private sector, at constant e/r	56.3	26.5	-2.6	4.4	15.4
Public sector, real	153.3	69.7	158.9	14.7	30.8
Broad money (M3), in real terms	25.4	10.5	4.1	2.3	4.2
Private deposits, at constant e/r	30.9	13.5	8.4	7.9	9.4
Memorandum items:					
CPI inflation, eop	6.6	6.3	4.7	7.9	3.0
Inflation target	3 - 5	2.8 - 4.8	2.5 - 4.5	2.5 - 4.5	2.0 - 4.0
Interest rates (percent):					
Policy interest rate	7.50	10.25	8.00	6.25	…
Interbank offer rate, 1 week	7.1	12.7	10.7	6.2	
Corporate loans 1/	11.6	19.5	15.4	10.9	…
Household time deposits 1/	6.94	15.27	9.9	7.8	…
Share of foreign currency private deposits	32.1	34.8	38.8	37.0	…
Share of foreign currency private loans	54.3	57.8	60.1	60.4	…
M2 velocity	2.81	2.96	2.61	2.54	2.57
Money multiplier (M3/reserve money)	3.03	3.45	3.67	3.79	3.84

Sources: National Bank of Romania; and Fund staff estimates.
1/ Rates for new local currency denominated transactions.
2/ For interest rates and shares of foreign currency loans and deposits, latest available data.

Table 8. Romania: Schedule of Reviews and Purchases (Revised)

Date	Amount of Purchase		Conditions
	Millions of SDRs	Percent of Quota	
May 4, 2009	4,370	424.19	Approval of arrangement
September 21, 2009	1,718	166.76	First review and end-June 2009 performance criteria
December 15, 2009 1/	1,409	136.77	Second review and end-September 2009 performance criteria
February 19, 2010	766	74.35	Third review and end-December 2009 performance criteria
July 2, 2010	768	74.55	Fourth review and end-March 2010 performance criteria
September 15, 2010	769	74.65	Fifth review and end-June 2010 performance criteria
December 15, 2010	769	74.65	Sixth review and end-September 2010 performance criteria
March 15, 2011	874	84.84	Seventh and end-December 2010 performance criteria
Total	11,443	1110.76	

Source: IMF staff estimates.

1/ The amount of purchase for the second review was available from December 15, 2009, but was made together with the amount for the third review on February 19, 2010 given the delay in completing the second review.

Table 9. Romania: Indicators of Fund Credit, 2010–16 1/ (Revised)
(In millions of SDR)

	2010	2011	2012	2013	2014	2015	2016
Existing Fund Credit							
Stock 2/	8,263	8,263	6,956	3,096	272	0	0
Obligations 3/	52	104	1,409	3,932	2,848	274	0
Repurchase	0	0	1,307	3,860	2,824	272	0
Charges	52	104	102	73	24	2	0
Prospective Fund Credit under Stand-By Arrangement							
Disbursement	2,306	874	0	0	0	0	0
Stock 2/	2,306	3,180	3,180	2,892	1,411	109	0
Obligations 3/	16	39	40	328	1,513	1,315	110
Repurchase	0	0	0	288	1,481	1,302	109
Charges	16	39	40	40	32	13	1
Stock of existing and prospective Fund credit							
In millions of SDR	10,569	11,443	10,136	5,988	1,683	109	0
In percent of quota	1,026	1,111	984	581	163	11	0
In percent of GDP	9.9	9.9	7.7	4.1	1.0	0.1	0.0
In percent of exports of goods and services	31.0	31.7	26.2	14.4	3.7	0.2	0.0
In percent of gross reserves	31.7	32.8	28.2	17.5	5.1	0.3	0.0
Obligations to the Fund from existing and prospective Fund arrangements							
In millions of SDR	68	143	1,449	4,260	4,361	1,588	111
In percent of quota	6.6	13.8	140.7	413.5	423.3	154.2	10.7
In percent of GDP	0.1	0.1	1.1	2.9	2.7	0.9	0.1
In percent of exports of goods and services	0.2	0.4	3.7	10.2	9.7	3.3	0.2
In percent of gross reserves	0.2	0.4	4.0	12.4	13.3	5.1	0.4

Source: IMF staff estimates.

1/ Using IMF actual disbursements, SDR interest rate as well as exchange rate of SDR/US$ and US$/€ of June 3, 2010.
2/ End of period.
3/ Repayment schedule based on repurchase obligations.

Table 10. Romania: Public Sector Debt Sustainability Framework, 2005–15 (Revised)
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing primary balance 9/**
Baseline: Public sector debt 1/	15.6	15.4	17.5	19.5	28.2	**33.9**	**35.7**	**36.8**	**37.3**	**37.2**	**36.7**	**-1.2**
o/w foreign-currency denominated	8.7	6.9	7.2	7.2	14.7	22.0	19.4	16.2	11.4	7.4	5.6	
Change in public sector debt	-1.7	-0.3	2.1	2.0	8.7	5.7	1.7	1.2	0.5	-0.1	-0.6	
Identified debt-creating flows (4+7+12)	-2.5	-2.9	0.0	2.6	8.3	5.7	1.7	1.2	0.5	-0.1	-0.6	
Primary deficit	-0.4	0.6	2.4	4.1	6.2	5.0	2.6	2.1	1.6	1.0	0.6	
Revenue and grants	31.4	32.3	32.3	32.2	31.8	32.6	32.6	32.6	32.2	31.8	31.4	
Primary (noninterest) expenditure	31.0	32.9	34.6	36.3	38.0	37.6	35.2	34.7	33.8	32.8	32.0	
Automatic debt dynamics 2/	-0.9	-3.0	-2.3	-1.4	2.1	0.7	-0.8	-1.0	-1.1	-1.1	-1.1	
Contribution from interest rate/growth differential 3/	-1.5	-1.7	-1.9	-2.6	2.2	0.7	-0.8	-1.0	-1.1	-1.1	-1.1	
Of which contribution from real interest rate	-0.8	-0.7	-1.1	-1.6	0.7	0.6	0.3	0.5	0.4	0.3	0.2	
Of which contribution from real GDP growth	-0.6	-1.0	-0.8	-1.0	1.5	0.1	-1.1	-1.4	-1.5	-1.4	-1.4	
Contribution from exchange rate depreciation 4/	0.6	-1.3	-0.4	1.2	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	-1.3	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-1.3	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	0.7	2.6	2.1	-0.6	0.4	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	49.8	47.6	54.2	60.7	88.6	104.0	109.2	113.2	115.8	117.0	116.7	
Gross financing need 6/	1.7	1.8	4.0	6.3	8.7	8.0	6.5	7.1	8.2	7.2	4.9	
in billions of U.S. dollars	1.7	2.2	6.8	12.9	14.1	12.6	10.8	13.5	17.2	16.9	12.8	
Scenario with key variables at their historical averages 7/						**33.9**	**32.6**	**31.3**	**30.2**	**29.2**	**28.3**	**-3.1**
Scenario with no policy change (constant primary balance) in 2010-2015						**33.9**	**38.2**	**41.7**	**45.4**	**49.0**	**52.4**	**-1.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.1	7.9	6.3	7.3	-7.1	-0.5	3.6	4.4	4.3	4.0	4.0	
Average nominal interest rate on public debt (in percent) 8/	7.0	6.0	5.8	5.2	6.0	6.6	5.9	5.9	5.6	5.2	5.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.2	-4.5	-7.7	-10.1	3.2	2.1	1.2	1.6	1.2	0.9	0.9	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.2	19.4	6.5	-16.5	0.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	12.2	10.5	13.6	15.2	2.8	4.5	4.7	4.3	4.3	4.3	4.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.8	14.4	11.9	12.4	-2.7	-1.5	-3.1	2.9	1.7	0.9	1.3	
Primary deficit	-0.4	0.6	2.4	4.1	6.2	5.0	2.6	2.1	1.6	1.0	0.6	

1/ Coverage: general government. Gross public debt excluding guarantees is used.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign-currency denominated debt; and ε = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\varepsilon(1+r)$.
5/ For projections, this line includes exchange rate changes.
6/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
7/ The key variables include real GDP growth; real interest rate; and primary balance in percent of GDP.
8/ Derived as nominal interest expenditure divided by previous period debt stock.
9/ Assumes that key variables (real GDP growth, real interest rate, and other identified debt-creating flows) remain at the level of the last projection year.

Table 11. Romania: External Debt Sustainability Framework, 2005-2015 (Revised)
(In percent of GDP, unless otherwise indicated)

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	38.8	42.1	47.0	52.6	65.7	**69.0**	**64.3**	**57.2**	**50.2**	**44.3**	**40.2**	**-6.9**
Change in external debt	3.6	3.3	4.9	5.6	13.1	3.3	-4.7	-7.1	-6.9	-6.0	-4.1	
Identified external debt-creating flows (4+8+9)	-6.6	-5.3	-1.6	0.5	10.9	1.5	-1.8	-2.3	-2.0	-1.7	-1.5	
Current account deficit, excluding interest payments	7.4	9.2	12.2	10.1	1.1	1.4	1.6	1.9	2.2	2.4	2.6	
Deficit in balance of goods and services	10.2	12.0	13.9	13.2	6.2	7.2	7.2	7.4	7.4	7.5	7.0	
Exports	33.0	32.2	29.3	30.4	31.2	32.0	31.1	29.4	28.5	27.7	26.7	
Imports	43.2	44.2	43.2	43.6	37.3	39.2	38.3	36.8	35.9	35.2	33.7	
Net non-debt creating capital inflows (negative)	-6.9	-8.5	-6.0	-6.1	-4.3	-3.9	-4.5	-4.8	-4.8	-4.8	-4.8	
Automatic debt dynamics 1/	-7.0	-6.0	-7.8	-3.6	14.1	4.0	1.2	0.6	0.6	0.8	0.8	
Contribution from nominal interest rate	1.2	1.2	1.2	1.5	3.4	3.6	3.4	3.1	2.8	2.6	2.3	
Contribution from real GDP growth	-1.1	-2.5	-2.1	-3.1	4.5	0.3	-2.3	-2.5	-2.2	-1.8	-1.6	
Contribution from price and exchange rate changes 2/	-7.1	-4.7	-7.0	-2.0	6.2	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	10.1	8.6	6.5	5.1	2.2	1.8	-2.9	-4.8	-4.9	-4.3	-2.6	
External debt-to-exports ratio (in percent)	117.4	130.9	160.5	172.7	210.7	215.7	206.9	194.4	176.3	159.9	150.7	
Gross external financing need (in billions of Euros) 4/	14.2	21.7	35.9	46.2	36.8	36.8	38.4	42.7	48.8	51.1	52.9	
in percent of GDP	17.9	22.2	28.8	33.1	31.7	30.0	28.3	27.5	28.1	26.4	24.4	
Scenario with key variables at their historical averages 5/						**69.0**	**65.4**	**61.3**	**55.7**	**50.8**	**47.5**	**-9.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.1	7.9	6.3	7.3	-7.1	-0.5	3.6	4.4	4.3	4.0	4.0	
GDP deflator in Euros (change in percent)	25.4	13.7	19.9	4.4	-10.6	6.2	7.1	9.5	7.2	7.3	7.4	
Nominal external interest rate (in percent)	4.5	3.8	3.7	3.5	5.3	5.8	5.5	5.5	5.5	5.7	5.9	
Growth of exports (Euro terms, in percent)	20.6	19.5	15.9	16.5	-15.0	8.4	7.8	8.1	8.3	8.5	7.5	
Growth of imports (Euro terms, in percent)	25.9	25.4	24.5	13.2	-29.0	11.0	8.4	9.8	9.2	9.3	6.9	
Current account balance, excluding interest payments	-7.4	-9.2	-12.2	-10.1	-1.1	-1.4	-1.6	-1.9	-2.2	-2.4	-2.6	
Net non-debt creating capital inflows	6.9	8.5	6.0	6.1	4.3	3.9	4.5	4.8	4.8	4.8	4.8	

1/ Derived as [r - g - r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock, with r = nominal effective interest rate on external debt; r = change in domestic GDP deflator in Euro terms, g = real GDP growth rate,
ε = nominal appreciation (increase in dollar value of domestic currency), and α = share of domestic-currency denominated debt in total external debt.
2/ The contribution from price and exchange rate changes is defined as [-ρ(1+g) + εα(1+r)]/(1+g+ρ+gρ) times previous period debt stock. ρ increases with an appreciating domestic currency (ε > 0) and rising inflation (based on GDP deflator).
3/ For projection, line includes the impact of price and exchange rate changes.
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.
5/ The key variables include real GDP growth; nominal interest rate; dollar deflator growth; and both non-interest current account and non-debt inflows in percent of GDP.
6/ Long-run, constant balance that stabilizes the debt ratio assuming that key variables (real GDP growth, nominal interest rate, dollar deflator growth, and non-debt inflows in percent of GDP) remain at their levels
of the last projection year.

Annex I

Romania: Supplementary Letter of Intent

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC, 20431
U.S.A.

Bucharest, June 29, 2010

Dear Mr. Strauss-Kahn:

1. This letter updates our Letter of Intent (LOI) of June 16, 2010. On June 25, the Constitutional Court invalidated the 15 percent cut in pensions approved by parliament, which formed part of the prior action (the cuts in wage and social transfers were not affected). To close the financing gap opened by the Constitutional Court decision, we have approved by emergency ordinance an increase in the VAT rate from 19 to 24 percent, effective immediately. The publication of this ordinance in the official gazette, which enacts the VAT increase, is a prior action for Board consideration of the fourth review. Moreover, parliamentary ratification of the VAT increase and of the expenditure measures that had been found constitutional will be a structural benchmark for end-September for 2010 (Table 2).

2. The change in the composition of this year's fiscal adjustment affects several targets under the program. In particular: (i) the increase in the VAT will have a temporary but significant impact on inflation, which we estimate at 3½-4½ percent and which will push inflation outside of the NBR's targeted path; (ii) the indicative target on general government current primary spending will be affected by the invalidation of the pension cuts; and (iii) the projected revenues used for the deficit target adjustor will be affected by the VAT increase. We therefore propose that these targets and projections be modified as indicated in the attached Table 1.

3. The lengthy parliamentary debate on the fiscal adjustment package has contributed to some delays in the approval of the pension reform legislation. The discussion of the bill was postponed to September, which has not allowed the structural benchmark to be met by end-June. We expect the legislation to be approved by parliament by end-September 2010 (reset of structural benchmark, see Table 2), with the reform implemented from 2011, as agreed under the program. Moreover, some provisions of the legislation that have a short-term impact, such as the elimination of the special noncontributory pensions and tightening of the disability pension procedures, have been included in the fiscal package legislation and will be in force earlier than anticipated.

4. We request that a waiver of applicability be approved for all end-June 2010 performance criteria other than for the net foreign assets target, as information on these criteria is not available. The net foreign assets target for end-June 2010, which has been observed, remains as established at the completion of the second and third reviews. We also request a waiver with respect to the inflation consultation band for end-June 2010 since information on inflation as of end-June is also not yet available. Finally, we note that our LOI of June 16, 2010 referred to a fiscal target of 6.8 percent for 2009 (paragraph 7) and we wanted to clarify that this target is for 2010.

/ s /

Sebastian Vladescu
Minister of Public Finance

/ s /

Mugur Isarescu
Governor of the NBR

Table 1. Romania: Quantitative Program Targets (Revised)

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March		June	Sept	Dec
	Actual	Actual	Actual	Actual	Actual	Prog.	Est.	Prog.	Prog.	Prog.
I. Quantitative Performance Criteria										
1. Cumulative change in net foreign assets (mln euros) 1/3/	25,532	-3,500	-5,119	-4,566	-4,874	-2,000	779	-2,500	-2,000	-2,000
2. Cumulative floor on general government overall balance (mln lei) 2/	-24,655	-8,300	-14,456	-25,563	-36,101	-8,250	-8,422	-18,200	-25,700	-34,650
3. Stock in general government arrears from the end of previous year (bn lei)	1.06	1.41	1.55	1.4	1.50	1.27	1.76	1.09	0.81	0.48
4. Ceiling on general government guarantees issued during the year (face value, bn lei)	0.0	…	0.02	0.7	2.2	12.0	4.6	12.0	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	0	0	0	0	0	0	0	0	0
III. Inflation Consultation										
6. 12-month rate of inflation in consumer prices										
Outer band (upper limit)	…	…	8.4	7.7	6.5	6.5	6.5	6.0	10.0	10.0
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.5	5.0	9.0	9.0
Center point	*6.3*	*6.7*	*5.9*	*4.8*	*4.7*	*4.5*	*4.2*	*4.0*	*8.0*	*8.0*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.5	3.0	7.0	7.0
Outer band (lower limit)	…	…	4.4	3.7	2.5	2.5	2.5	2.0	6.0	6.0
IV. Indicative Target										
7. General government current primary spending (excl. EU funds and social assistance, mln lei) 2/	92,327	22,149	43,238	63,878	85,637	32,900	32,749	66,200	98,000	130,900
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-1,381	-495	-2,000	-3,000	-4,000
Memorandum Item:										
Cumulative projected revenue of general government, net of EU funds (mln. lei)	…	…	…	…	151,508	…	36,355	74,950	117,100	159,600

1/ The December 2008 figure is a stock.

2/ The December 2008 figure is for the whole year.

3/ NFA targets for end December 2009 have been adjusted as actual disbursements fell short of projected levels by EUR 1 bn. Note that the NFA adjustor for June 2010 will remain as described in the Letter of Intent of February 5, 2010, while the adjustors for September and December 2010 are set as described in the Letter of Intent of June 16, 2010.

Table 2. Romania: Performance for Fourth Review and Proposed New Conditionality (Revised)

Measure	Target Date	Comment
Prior Action		
1. Enactment of agreed fiscal measures (LOI ¶7, as modified by supplementary LOI ¶1)	Prior action	Met
Quantitative performance criteria		
1. Floor on net foreign assets	March, 2010	Met
2. Floor on general government overall balance	March, 2010	Not met
3. Ceiling on general government guarantees	March, 2010	Met
4. Ceiling on general government domestic arrears	March, 2010	Not met
5. Non-accumulation of external debt arrears	March, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	March, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	March, 2010	Met
Inflation consultation band		
Inner band	March, 2010	Met
Outer band	March, 2010	Met
Structural benchmarks		
1. Passage of Fiscal Responsibility Law	March 31, 2010	Met
2. Passage of amendments to the banking and winding-up laws to enhance the bank resolution framework	March 31, 2010	Met
3. Approval of legislation and internal regulations by ordinance necessary to implement tax administration reforms	April 30, 2010	Met
4. Legislative changes to improve monitoring and control of SOEs	June 30, 2010	Met in January 2010
5. Approval of institutional reform measures to mitigate fiscal risks from local governments	June 30, 2010	Revised to end-September 2010
6. Passage of pension legislation	June 30, 2010	Not met; reset to end-September 2010
7. Passage of implementing legislation for the unified wage law	September 30, 2010	
Proposed New Conditionality (Structural Benchmarks)		
1. Approval of institutional reform measures to mitigate fiscal risks from local governments	September 30, 2010	Revised from end-June, 2010
2. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement (LOI ¶24)	September 30, 2010	
3. Reform tax administration methodology for high net wealth individuals (LOI ¶13)	November 30, 2010	
4. Integrate the accounting reporting system with the Treasury payment system (LOI ¶10)	March 31, 2011	
5. Parliamentary ratification of the fiscal measures approved by the government (supplementary LOI ¶1)	September 30, 2010	Measure on wage cuts already met
6. Passage of pension legislation	September 30, 2010	Reset from end-June, 2010

INTERNATIONAL MONETARY FUND

Public Information Notice

EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 10/97
FOR IMMEDIATE RELEASE
July 23, 2010

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2010 Article IV Consultation and Fourth Review of the Stand-By Agreement with Romania

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Romania's economic performance under 24-month Stand-By Arrangement (SBA) approved on May 4, 2009 and concluded the 2010 Article IV consultation with Romania.[1] The completion of this program review enables the immediate disbursement of SDR 768 million, bringing total disbursements under the program to SDR 9.031 billion (about €9.32 billion or about US$12.60 billion.

Background

Before the current crisis, the Romanian economy was characterized by high growth rates, associated with the build-up of external and internal imbalances. Large capital inflows stimulated domestic demand, while labor constraints and rising public sector wages generated wage inflation. Fiscal policy was pro-cyclical, exacerbating the overheating of the economy despite tight monetary policy to counteract price pressures. The rapid development of the banking system came with vulnerabilities to outside liquidity shocks and foreign exchange risks. The global economic and financial crisis hit Romania hard in late 2008 and 2009. Capital inflows dried up, exports plunged, and country risk indicators skyrocketed. As a result of the sharp contraction in domestic demand, GDP plummeted and the current account deficit fell

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

markedly. Although banks generally entered the crisis well capitalized, they faced rising NPLs, a dried up interbank market and limited access to external sources of funds. The country's large fiscal deficit constrained the fiscal policy response to the crisis.

In early 2009 authorities put together a policy package supported by financing from the Fund, the EU, and the World Bank. The program included (i) fiscal consolidation accompanied by structural reforms to restore fiscal sustainability and boost market confidence, (ii) steps to further strengthen the resilience of the financial sector and to obtain commitments from foreign parent banks to maintain their Romanian subsidiaries capitalized and liquid, and (iii) prudent monetary policy management to reduce inflation. The program has contributed to stabilizing the economy and alleviating financing pressures. Economic activity remained weak throughout 2009 (declining by 7.1 percent), but exchange rate pressure eased, the country risk premium narrowed significantly, and financial sector stress eased. While for 2010 as a whole growth is forecast to be slightly negative, a gradually recovery is expected in the second half of the year. Domestic demand will remain subdued, as unemployment continues to rise and real wages adjust to the recession with a lag, while investment will pick up slowly. The contribution of net exports is forecast to remain positive but limited in 2010. Beyond 2010, GDP should recover, with growth forecast to rise to around 3½ percent in 2011 and to the range of 4-4½ percent per year in the medium-term.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They noted that despite one of the largest economic downturns in Europe, the Romanian authorities have made significant strides toward restoring macroeconomic stability and achieving an orderly adjustment of pre-crisis imbalances. They noted, however, that important challenges remain in ensuring that the economic and policy adjustments are sustainable. They encouraged the authorities to carry through with planned structural reforms to secure a sustainable fiscal position, boost potential growth, and reinforce the economy's resilience to shocks.

Directors commended the authorities' strong adjustment effort this year as an appropriate response to the near-term challenges posed by the sharp deterioration in the fiscal position. They agreed with the authorities' approach of balancing the adjustment between expenditure cuts and tax increases, by way of cushioning the social impact of the adjustment while decisively tackling the large public wage bill. . Directors also supported the proposed relaxation of the 2010 deficit target to accommodate the cyclical deterioration in the fiscal position since the last review.

Directors stressed that the sustainability of the targeted fiscal adjustment can only be secured if supported by structural reforms. They welcomed the recent approval of the fiscal responsibility legislation, and encouraged the authorities to complete the reforms of the pension and the public compensation systems. Other important reforms are the planned reductions in public employment, reforms of the healthcare system and of the local government finances, and efforts to boost tax collections. These reforms would ensure that the deficit remains on a downward path in the medium term.

Directors also emphasized that structural reforms in other areas, such as labor and product markets, are also crucial in building the economy's competitiveness and resilience. They would also help prepare Romania for an eventual euro adoption by ensuring that the economy can handle shocks without the support of monetary and exchange rate policies.

Directors commended the authorities for vigilant monetary and financial sector policies. They viewed the moderate pace of monetary easing as appropriate in striking a balance between the need to support the economy and to contain exchange rate pressures. They agreed that, while there may be room for further easing in the near future, a cautious approach remains warranted given inflation risks and regional uncertainties. Directors welcomed the authorities' proactive approach towards banking supervision and regulation, and called for continued vigilance in view of the unsettled regional situation and the deteriorating quality of the loan portfolio.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case. The staff report (use the free Adobe Acrobat Reader to view this pdf file) for the 2010 Article IV Consultation with Romania is also available.

Romania: Selected Economic and Social Indicators, 2007–11

	2007	2008	2009	2010 Prog.	2010 Proj.	2011 Proj.
Output and prices			(Annual percentage change)			
Real GDP	6.3	7.3	-7.1	1.3	-0.5	3.6
Domestic demand	14.6	9.9	-14.0	0.1	-1.5	2.6
Net exports (contribution)	-16.7	-2.6	16.1	1.1	1.4	0.4
Consumer price index (CPI, average)	4.8	7.8	5.6	3.9	6.6	5.2
Consumer price index (CPI, end of period)	6.6	6.3	4.7	3.2	7.9	3.0
Unemployment rate (average)	4.3	4.0	6.3	7.9	8.9	8.4
Nominal wages	22.6	23.6	8.4	4.4	4.3	6.2
Saving and Investment			(In percent of GDP)			
Gross domestic investment	31.0	31.3	25.1	30.7	24.8	25.2
Gross national savings	17.6	19.7	20.6	25.2	19.8	20.2
General government finances						
Revenue	32.3	32.2	31.8	31.3	32.6	32.6
Expenditure	35.4	37.0	39.2	37.3	39.4	37.0
Fiscal balance	-3.1	-4.8	-7.4	-5.9	-6.8	-4.4
Privatization proceeds	0.1	0.1	0.0	0.0	0.0	0.0
External financing	0.1	0.4	2.9	3.7	4.6	0.8
Domestic financing	2.9	4.3	4.5	2.2	2.2	3.6
Structural fiscal balance 1/	-4.3	-6.9	-5.4	-2.4	-3.3	-1.2
Gross public debt (direct debt only)	17.5	19.5	28.2	31.5	33.9	35.7
Money and credit			(Annual percentage change)			
Broad money (M3)	33.7	17.5	9.0	6.6	10.4	7.3
Credit to private sector	60.4	33.7	0.9	5.8	7.3	10.2
Interest rates, eop			(In percent)			
Euribor, six-months	4.79	3.52	4.52	-	-	-
NBR policy rate	7.50	10.25	8.00	-	-	-
NBR lending rate (Lombard)	12.00	14.25	12.00	-	-	-
Interbank offer rate (1 week)	7.10	12.70	10.70	-	-	-
Balance of payments			(In percent of GDP)			
Current account balance	-13.4	-11.6	-4.5	-5.5	-5.0	-5.0
Merchandise trade balance	-14.3	-13.7	-5.8	-7.1	-7.0	-7.2
Capital and financial account balance	17.3	12.7	-0.9	4.2	4.0	6.1
Foreign direct investment balance	5.7	6.7	3.8	4.1	4.1	4.2
International investment position	-40.1	-51.8	-68.3	-53.6	-62.5	-60.2
Gross official reserves	23.0	20.2	26.6	30.5	31.7	31.3
Gross external debt	47.0	52.6	65.7	68.3	69.0	64.3
Exchange rates						
Lei per euro (end of period)	3.5	4.0	4.2	-	-	-
Lei per euro (average)	3.3	3.7	4.2	-	-	-
Real effective exchange rate						
CPI based (depreciation -)	9.0	-4.1	-7.8	-	-	-
Memorandum Items:						
Nominal GDP (in bn RON)	416.0	514.7	491.3	538.9	510.4	553.9

Social and Other Indicators

Unemployment rate: 8.3% (February 2010)

Poverty rate: 5.7% (2008)

1/ Actual fiscal balance adjusted for the automatic effects of the business cycle.

INTERNATIONAL MONETARY FUND EXTERNAL RELATIONS DEPARTMENT

Press Release No. 10/280
FOR IMMEDIATE RELEASE
July 2, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fourth Review Under Stand-By Arrangement with Romania and Approves US$1.146 Billion Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Romania's economic performance under a program supported by a 24-month Stand-By Arrangement (SBA). The completion of the review enables the immediate disbursement of SDR 768 million (about €913.2 million or about US$1.1146 billion), bringing total disbursements under the program to SDR 9.031 billion (about €10,738.8 million or about US$13.475 billion). In completing the review the Executive Board also approved Romania's request for a waiver of applicability of end-June 2010 performance criteria.

The SBA was approved on May 4, 2009 (Press Release No 09/148) in the amount of SDR 11.443 billion (about €13.607 billion or about US$17.074 billion). The arrangement entails exceptional access to IMF resources, amounting to 1,111 percent of Romania's quota.

Following the Executive Board's discussion on Romania, Mr. John Lipsky, First Deputy Managing Director and Acting Chair, stated:

"Against the background of the large downturn, the Romanian authorities have made significant strides toward restoring macroeconomic stability and achieving an orderly adjustment of pre-crisis imbalances. They are taking ambitious adjustment measures to contain the weakening of the fiscal position and set the stage for a sustained improvement in public finances. Balancing the fiscal adjustment between expenditure cuts and tax increases will help cushion its social impact, while at the same time reversing excessive past increases in public wages.

"The authorities are committed to the sustainability of this adjustment over the medium term by buttressing it with comprehensive structural fiscal reforms. They plan to complement the recent approval of the fiscal responsibility legislation with reforms of the pension and public wage systems, reductions in public sector employment, reforms of the healthcare system and local government finances, and efforts to boost tax collection.

“The authorities’ monetary and financial sector policies are appropriately prudent and proactive, helping preserve financial stability in the face of the global financial crisis. While there is some room for further monetary easing going forward, the authorities are exercising caution, which is warranted by the uncertainties related to the inflationary impact of the VAT increase and regional developments. They will continue their proactive approach toward banking supervision and regulation, and will remain vigilant in view of the unsettled regional situation and the accompanied uncertainties regarding the quality of the loan portfolio. ”

Statement by Age Bakker, Executive Director for Romania and Mihai Nicolae Tanasescu, Senior Advisor to Executive Director July 2, 2010

My Romanian authorities would like to thank staff for the useful discussions held in Bucharest last month. The amount of work done is reflected in the staff report for both the 2010 Article IV Consultation and the Fourth Review under the Stand- By Arrangement, which provides a well-balanced assessment of the Romanian economy.

Like many countries in the region, Romania faces challenging times in the aftermath of the crisis, and my authorities value the continued close cooperation with the Fund in order to address these challenges.

The impact of the crisis

The global crisis has hit the Romanian economy through trade and financial channels, but also through a decline in confidence that led to a sharp contraction in domestic demand. Real GDP declined by 7.1 percent in 2009 and by a further 0.3 percent (qoq) in the first quarter of 2010. The sharp decline in domestic demand, together with the 15 percent depreciation of the *leu* against the Euro from late 2008 to early 2009, helped adjust the current account deficit from 13.5 percent of GDP in 2007 to 4.5 percent of GDP in 2009.

Weaker than expected economic performance has depressed revenue collections and boosted spending on unemployment benefits. The fiscal deficit widened and, without further adjustment, would climb to 9 percent of GDP in 2010. Monetary policy successfully focused on keeping inflation within the target band and core inflation fell from 8.1 percent in mid-2008 to 2.1 percent in May 2010 due to weak demand and receding exchange rate pressures. The banking system remains well capitalized, but non-performing loans continue to increase. Banks face pressures on asset quality and rising provisioning costs that are reducing profits.

To safeguard macroeconomic and financial stability, the authorities promptly put together a comprehensive policy package supported by an IMF Stand-By Arrangement along with funding from the EU and other multilateral institutions. The program greatly contributed to stabilizing the economy and alleviating financing pressures.

The program implementation

Since May 2009, when the current SBA was approved, the Romanian authorities made progress in implementing structural reforms to restore fiscal sustainability and have taken important steps to strengthen the resilience of the financial sector. However, weak revenues and a build-up of spending pressures caused the government to miss the end-March fiscal deficit target by a small margin, and to miss the target on domestic payments arrears. All other quantitative performance criteria, and all structural benchmarks were met, and the

program remained on track. The government is committed to accelerating fiscal consolidation. Even in the face of weaker GDP growth, they will continue to take additional measures to reach end-year targets, and to reach a 3 percent of GDP fiscal deficit by 2012.

Fiscal consolidation through strengthening structural reforms

Public finance has deteriorated over the last years, as all governments in place from 2005 to 2008 pursued pro-cyclical fiscal policies, approving large increases in public expenditures, especially in pensions and wages. Fiscal policy remained strongly expansionary even in 2008 when the crisis already distressed international markets. As a result, the share of total public expenditures increased from 33.5 percent of GDP in 2005 to 40 percent of GDP in 2009, while public revenues remained unchanged at around 32 percent of GDP.

In 2009 public revenues fell sharply, forcing the new government which came into power in December 2008 to deal with an increased expenditure level resulting from previous expansionary decisions. Under the SBA program strong fiscal adjustment measures were implemented, including a freeze of wages and pensions and an increase of taxation. The fiscal deficit reached 7.3 percent of GDP at end-2009. The continued deterioration in economic conditions in early 2010 made it necessary to adopt new additional measures in order to continue the fiscal consolidation process. It had become clear that without radical measures on the expenditure or revenue side, the fiscal deficit would not be reduced much further.

Staff has advocated a combination of lower public expenditures and increased taxation to close the gap, but the authorities considered this to be suboptimal as tax increases at a time of recession are not desirable. Moreover, increasing control over public spending and reducing its share of GDP will correct the excesses that occurred during the boom years rather than entrench them with higher taxes. It will also increase the likelihood that the fiscal adjustment will be durable. The authorities decided to implement radical measures consisting of expenditure cuts of roughly 2 percent of GDP, including a 25 percent cut in public sector wages and a 15 percent reduction in pensions and transfer payments. The latter implies that wages fall back to 2007/08 levels and pensions to the 2008 level. However, on June 25, 2010 the Constitutional Court accepted the legality of the 25 percent cut in public wages and the cuts of 15 percent in most social transfers, but rejected the constitutionality of the 15 percent reduction in pensions. The authorities responded quickly to implement compensatory measures and approve an emergency decree to increase the VAT rate from 19 percent to 24 percent. The VAT increase will close the fiscal gap of 0.7 percent of GDP, created by the rejection of the pension cuts. Further revenue-boosting measures of 0.3 percent of GDP include widening of the tax base, improving tax enforcement and the introduction of a turnover tax on medical suppliers. The measures add up to 2.3 percent of GDP and will lower the budget deficit to a sustainable level of 6.8 percent of GDP in 2010. This decisive action on the fiscal front is expected to raise the country's credibility on external markets, which can result in higher GDP growth rates in the long term.

The government considers the proposed cuts as only a first step, and they are determined to accelerate public administration reform by reducing the number of public institutions and increasing efficiency and accountability. In this context, they have already restructured 100 state agencies, and a functional review of major ministries is under way. They will implement further public compensation reform by adopting new legislation by end-September. This reform will be supported by a further reduction in personnel of another 70,000 by January 2011 on top of a reduction of roughly 30,000 since late 2009.

The government is strongly committed to fiscal consolidation in the long run. Crucial for its fiscal strategy is accelerating structural reforms to reduce unemployment, to restructure the wage system and to increase efficiency in the finances of local governments and state-owned enterprises. A major reform in the budget process was the approval of the Fiscal Responsibility Law. The law will strengthen fiscal discipline by improving medium-term fiscal planning, increasing transparency and accountability of the budget process.

To contain fiscal pressures over the medium term, the authorities will introduce several institutional reforms to increase the efficiency of local governments. Standard costing norms will be introduced and local governments seeking extra resources will need to sign adjustment programs with the central government, stipulating measures to tackle overruns. Another important step will be the approval of the new pension law by end-June. The new bill envisages a gradual move to inflation indexation, and to an increase and unification of the retirement age. At the same time contribution rates will be set annually in the budget legislation. Finally, the authorities will further improve tax administration; reforms focus on improved methodologies to identify and audit unreported income, especially of high individual taxpayers, and on combating other forms of tax evasion.

Monetary policy and financial sector challenges

Over the past years Romania has taken important measures to bring down inflation to levels similar to other emerging markets in the EU. End 2009 inflation stood at 4.7 percent, slightly above the target band, due mainly to significant hikes in tobacco excises (which contributed about 2 percentage points). For 2010 the inflation rate is projected to fall close to the central bank's target of 3.5 percent (with a tolerance band of plus/minus 1 percentage points). End-April inflation reached 4.3 percent. Nevertheless, upward inflationary risks remain (energy prices, regulated prices) and the central bank will remain prudent. Future reductions in interest rates and reserve requirements will have to be carefully calibrated to avoid disturbances in money and exchange rate markets.

Conservative prudential and regulatory policies, together with the maintenance of a stable exchange rate, have proved to be of great value in safeguarding financial stability during the crisis. The banking sector remains resilient, despite the fact that nonperforming loans are on the rise. Profitability is declining, but is still above 6 percent, and the system is still

experiencing a rapid deterioration of loan portfolio quality in small and medium enterprise sectors as bankruptcies are rising. Nevertheless, the aggregate capital adequacy ratio increased further to 14.03 percent at end-2009 against 13.77 percent at end of 2008, well above the required minimum level of 10 percent.

An important role has been played by the nine largest banks as a result of their full commitment to maintain overall exposure to the country during the program period, which has improved financial sector stability. However, the possibility of spillovers from market volatility, especially from Greece, led the authorities to ask banks to have contingency plans in place.

Romania has made further progress towards strengthening the financial sector through the Deposit Guarantee Fund. The central bank will amend the legal framework to improve the funding regime. This will enhance confidence in the system by increasing both the actual and targeted coverage ratio and by eliminating contingent credit lines by banks.

The central bank continued to improve banking supervision by strengthening liquidity requirements and governance rules applicable to banks. Banks are now required to report asset and liability maturity breakdown by currency. The stress test methodology in different risk areas was improved.

In conclusion, my authorities acknowledge that there are potential risks to program implementation. At the same time, they consider that the strength present policy response under the Stand-By Arrangement, even in the face of deterioration in economic activity, underlines their continued commitment. They are confident that further acceleration of structural reforms, including public administration reform, will address the current fiscal imbalances and will put Romania on a path to sustained economic growth.