INTERNATIONAL MONETARY FUND

IMF Country Report No. 17/133

ROMANIA

May 2017

2017 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ROMANIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2017 Article IV consultation with Romania, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its May 22, 2017 consideration of the staff report that concluded the Article IV consultation with Romania.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on May 22, 2017, following discussions that ended on March 17, 2017, 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 May 4, 2017.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Romania.

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INTERNATIONAL MONETARY FUND

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Press Release No. 17/191
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May 25, 2017

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Washington, D. C. 20431 USA

IMF Executive Board Concludes Article IV Consultation with Romania and Ex-Post Evaluation of Exceptional Access Under the 2013 Stand-By Arrangement

On May 22, 2017 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Romania.

Romania saw strong economic growth in 2016, resulting in a closed output gap. Private consumption was boosted by an expansionary and pro-cyclical fiscal policy and wage increases. The cyclically adjusted budget deficit grew by 1½ percent of GDP in 2016, reflecting large tax rate cuts and wage increases. Headline inflation remained subdued due to indirect tax cuts, administrative price adjustments, and low euro area inflation and oil prices. There has been welcome progress in reducing banking sector non-performing loans.

Growth is expected to reach 4.2 percent in 2017—supported by continued stimulus to private consumption from a new round of fiscal relaxation and wage increases—and to moderate to 3½ percent in the medium term. A reorientation of policies—from stimulating consumption to supporting investment—is required to reduce poverty, raise medium term growth, and accelerate the pace of convergence towards the EU's income level.

The main risks to the economic outlook include a perception of weakening fiscal prudence or institutions, which could adversely affect market confidence. This, together with heightened political tensions, could erode consumption and investment, increase the cost of government borrowing and put pressure on the exchange rate which would affect banks' balance sheets through their FX exposures. Maintaining adequate reserve levels, a flexible exchange rate, and fiscal buffers will help against such risks. Prudent economic policies and visible steps to accelerate the pace of structural reforms and improve governance would send a powerful signal about Romania as a good place for doing business.

The Executive Board also discussed an ex post evaluation of the precautionary SBA with Romania approved in September 2013. The ex post evaluation finds that while policy

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[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.

objectives under the program were broadly appropriate, and some progress was achieved, setbacks on key structural reforms and concerns about the quality of fiscal measures prevented program completion. The report also includes recommendations for the design of future Fund programs.

Executive Board Assessment

Executive Directors welcomed Romania's progress in reducing economic imbalances after the global financial crisis. Growth has been robust in recent years and unemployment has declined. Directors noted, however, that the recent deterioration in fiscal policies and a weakened pace of structural reforms could threaten these gains. Against this background, they underscored the need for a reorientation of policies from stimulating consumption towards supporting investment to protect buffers and sustainably raise living standards.

While observing that Romania's public debt is relatively low, Directors highlighted that the recent and projected fiscal expansion is not warranted by the economy's cyclical position. Successive tax cuts have reduced revenues while the share of wages and pensions has grown at the cost of investment. Directors underscored that additional measures would be needed to keep the fiscal deficit below the authorities' target of 3 percent of GDP in 2017.

Directors noted that the unified wage bill and further tax cuts pose risks to the fiscal balance. They called for targeting a medium-term deficit of 1.5 percent of GDP to protect buffers and gradually reduce public debt. Directors emphasized the need to avoid further tax cuts, moderate pension increases, and carefully assess and modify the planned unified wage law in line with available fiscal space and the medium-term fiscal objectives. They encouraged efforts to enhance the effectiveness of the public sector. These include strengthening revenue administration, enhancing expenditure efficiency, and strengthening transparency and commitment controls for local investment programs.

Directors noted that there has been some progress with structural reforms. They emphasized the need to reenergize the reform momentum to secure faster convergence with the EU. Priority should be given to improving the performance of state-owned enterprises, including by restarting the privatization and restructuring program, and fully implementing the corporate governance law. Directors also called for stronger efforts to strengthen public investment management institutions to fully utilize EU funds and improve the quality of domestically-financed public investment. Recognizing progress made in the fight against corruption, Directors encouraged the authorities to maintain the momentum.

Directors encouraged the central bank to remain vigilant to rising inflationary pressures and to consider tightening monetary conditions. They recommended supporting higher market rates by narrowing the interest rate corridor and absorbing excess liquidity. This would lay the groundwork for a subsequent policy rate hike.

Directors commended the significant reduction in nonperforming loans and underscored the need for continued efforts to reduce them further, especially for corporate loans. They welcomed the decisions of the Constitutional Court which have lessened threats to financial stability. Directors called for close monitoring of the growing exposure of banks to households and government debt and taking steps to mitigate emerging risks.

Directors broadly agreed with the conclusions of the ex post evaluation of the precautionary SBA approved in September 2013. They noted that while policy objectives under the program were broadly appropriate and some progress was achieved, setbacks on key structural reforms and concerns about the quality of fiscal measures prevented program completion. Directors considered that the EPE on Romania held some potentially useful lessons for the design of future Fund programs, including the need to pay close attention to political economy and capacity constraints, prioritization and sequencing of reforms, and private sector balance sheets and their role in the financing of the economy.

Romania: Selected Economic Indicators

Population: 19.8 million (2015)
Quota: 1,811 million SDRs (0.4% of total)
Key export markets: European Union (Germany, Italy, France)
Main products and exports: Machinery and transport equipment, manufactured goods

Per capita GDP: US$8,956 (2015)
Literacy rate: 99.3%
People at risk of poverty: 37.3% (2015)

	2015	2016	2017	2018
		Prel.	Proj.	
Output				
Real GDP growth (%)	3.9	4.8	4.2	3.4
Output gap	-1.2	0.3	1.1	0.9
Employment				
Unemployment (%)	6.8	5.9	5.4	5.2
Prices				
CPI inflation (%, period average)	-0.6	-1.6	1.3	3.1
General government finances				
Revenue	32.8	29.0	29.1	29.3
Expenditure	34.3	31.4	32.7	33.1
Fiscal balance	-1.5	-2.4	-3.7	-3.9
Primary balance	-0.2	-1.1	-2.3	-2.5
Structural fiscal balance 1/	-0.5	-2.3	-3.8	-3.9
Public debt (including guarantees)	39.4	39.1	40.5	41.7
Money and credit				
Broad money (% change)	9.7	9.7	8.7	7.9
Credit to the private sector (% change)	3.0	1.2	4.0	4.4
Policy rate (percent) 2/	1.75	1.75	-	-
Balance of payments				
Current account (% GDP)	-1.2	-2.3	-2.7	-2.5
FDI (% GDP)	-1.8	-2.3	-2.2	-2.1
Reserves (months imports)	5.9	5.3	5.1	5.1
External debt (% GDP)	56.5	54.6	52.9	49.8
Exchange rate				
REER (% change)	-0.8	1.4	…	…

Sources: Romanian authorities, World Bank, Eurostat and IMF staff calculations.

1/ Fiscal balance (cash basis) adjusted for the automatic effects of the business cycle and one-off effects.

2/ For 2016, latest available data.

INTERNATIONAL MONETARY FUND

ROMANIA

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION

May 4, 2017

KEY ISSUES

Background. Romania strengthened its economy considerably after the global financial crisis. Growth has been solid and unemployment low. Public debt and fiscal and current account imbalances are moderate compared to many emerging markets. Notwithstanding this progress, significant challenges remain and the momentum of progress in policies has waned. Income convergence with the EU has slowed and poverty is among the highest in the EU. Successive tax cuts and wage increases in excess of productivity gains have supported consumption, but investment remains weak. A reorientation of policies to prioritize investment will more sustainably achieve the authorities' objective of bringing more Romanians into the middle class.

Outlook and risks. The projected procyclical fiscal stance will provide a temporary boost to consumption and growth. However, absent structural reforms to support higher investment, growth is expected to moderate in the medium term. Underlying inflation is expected to gradually rise. Risks to the outlook are tilted to the downside due to expected pressures on the budget and challenges in accelerating structural reforms.

Policy recommendations.

- **Fiscal policy.** Maintain a broadly neutral stance for this year. Avoid expansionary policies—for example, excessive wage and pension increases and further tax cuts. Build stronger policy buffers by lowering the deficit to 1½ percent of GDP by 2020. Support this adjustment through fiscal structural reforms to reprioritize investment over consumption and improve the efficiency of public administration.

- **Monetary policy.** Maintain the policy rate for now but remain vigilant against rising inflationary pressures. Bring short-term market rates closer to the policy rate by absorbing excess liquidity and narrowing the interest rate corridor.

- **Financial sector.** Sustain the progress in cleaning up banks' balance sheets and closely monitor credit market developments to help foster prudent credit expansion.

- **Structural reforms.** Improve the quality of public investment (through better absorption of EU funds and improved governance of state-owned enterprises) and support private investment (through improving public administration and the functioning of labor markets). Sustain recent progress in the fight against corruption.

Approved By
Thanos Arvanitis and Andrea Richter Hume

Discussions were held in Bucharest during March 8-17, 2017. The staff team was led by R. Baqir and comprised E. Crivelli, L. Lin (EUR); S. Hannan (SPR), M. Marinkov (FAD), A. Rosha (LEG), A. Hajdenberg (Resident Representative), G. Babici and V. Barnaure (Bucharest office). The mission met with President Iohannis, Prime Minister Grindeanu, Vice-Prime Minister Shhaideh, Minister of Finance Ștefan, Governor Isărescu, Minister of Economy Tudose, members of Parliament, other senior officials, representatives of political parties, labor and business organizations, and financial institutions.

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BACKGROUND

1. **Romania made considerable progress in recent years, manifested in relatively strong fundamentals compared to its peers**. Growth has been brisk in the last two years, debt is relatively low compared to other emerging markets, and external imbalances are moderate. Important reforms were undertaken after the global financial crisis, assisted by Fund-supported programs, that helped build policy buffers. Markets have recognized this progress and sovereign spreads have been low even when political tensions rose.

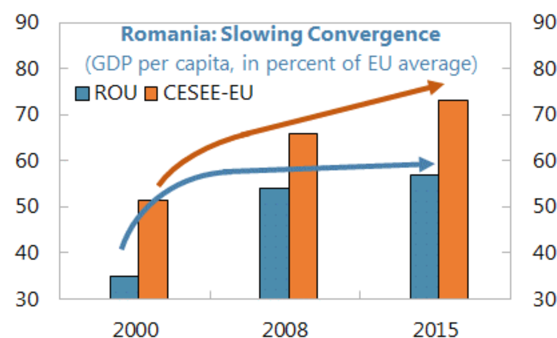
2. **Notwithstanding this progress, significant challenges remain and policies are at risk of deteriorating.** Romania's income is well below the EU average and its poverty rate is one of the highest in the EU. Private investment remains below pre-crisis levels, hampered by a still difficult business environment. Public investment execution (supported by EU funds) has slowed down and the quality of infrastructure ranks low among Romania's peers. State-owned enterprises (SOEs) continue to dominate some key sectors (power, transport), but are generally inefficient, and plans to improve SOE governance and advance privatization have stalled. Finally, steps to improve public administration need to continue, to increase efficiency and reduce corruption. Despite rapid economic growth, fiscal policy turned pro-cyclical in 2016, reversing the consolidation trend of previous years. Further fiscal loosening and reduced budget flexibility are envisaged in 2017, making it challenging to reach the government's target. The mix of expansionary fiscal policy and slow structural reforms risks eroding policy buffers and lowering Romania's growth potential.

3. **The key focus of the discussions was on re-orienting policies from favoring consumption to improving investment to more sustainably achieve faster convergence with the EU.** This will require action in several areas, as also highlighted in past Fund advice (Annex III):

- improving the structure of the fiscal budget while gradually reducing the deficit;

- macro-critical structural reforms to improve the quality of public investment (through better absorption of EU funds and improved SOE governance) and support private investment (through improving public administration and the functioning of labor markets); and

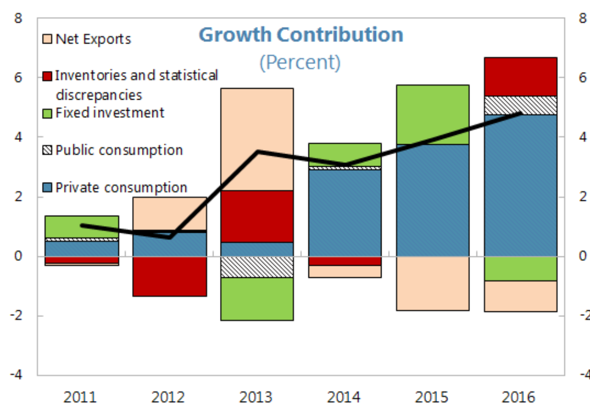
- a continued emphasis on the fight against corruption, an area where Romania has earned international recognition.



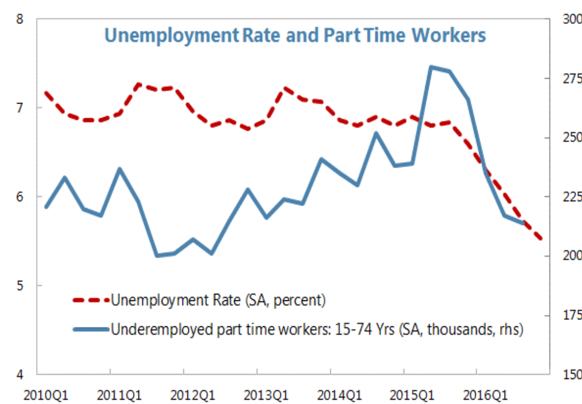
Source: World Bank's World Economic Indicators.
Note: In PPP, constant 2011 dollars.

RECENT ECONOMIC DEVELOPMENTS

4. **Growth has accelerated, resulting in a closed output gap, boosted by pro-cyclical policies.** Output grew 4.8 percent in 2016—among the fastest pace in the EU—driven mostly by a sharp increase in private consumption on the back of large tax cuts and wage and pension increases and a pickup of residential investment. In contrast, public investment contracted sharply, due to a slow start of EU fund absorption in the new programming period.



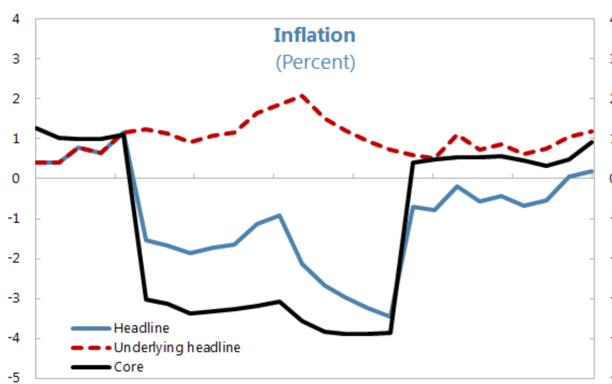
Sources: Haver and IMF staff estimation.



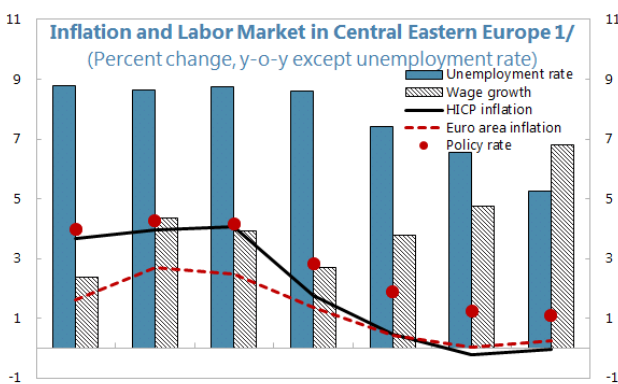
Source: Haver Analytics.

5. **Gross wages rose nearly 13 percent in 2016 and the labor market has tightened.** Recent wage increases have outpaced labor productivity, leading to rising unit labor costs, and public sector wages grew more sharply than the private sector in 2016 (Figure 3). The unemployment rate declined to 5½ percent at end-2016 (near all-time lows), and part time employment diminished. However, youth unemployment remains above 20 percent, emigration is high, adding to the challenges of a shrinking working-age population, and active labor market policies are not yet sufficiently developed.

6. **Despite rising wages, headline inflation remained subdued in 2016 due to indirect tax cuts, administrative prices adjustments, and low euro area and oil price inflation.** Adjusted for



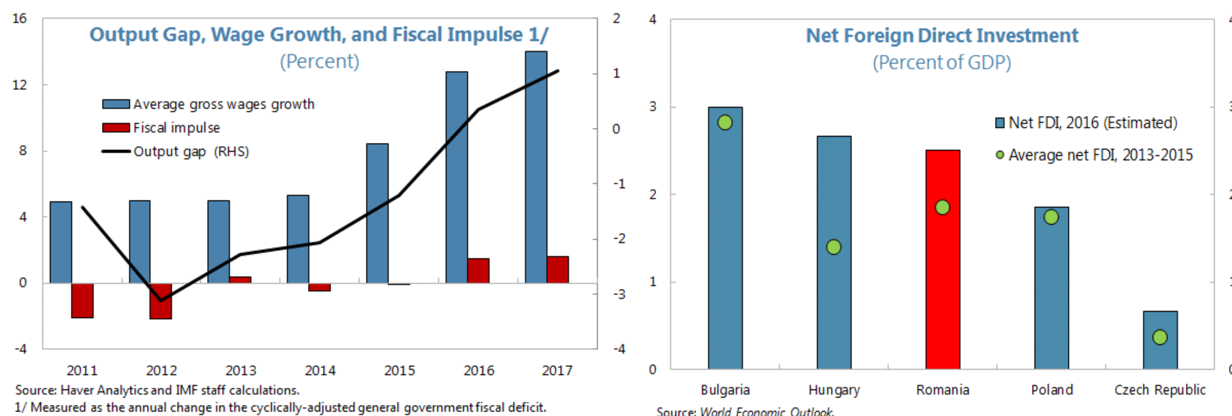
Sources: Haver Analytics and IMF staff estimation.



Sources: Haver Analytics and IMF staff calculations.
1/ The chart shows the average across four countries: Czech Republic, Hungary, Poland and Romania.

the effects of recent tax changes and other measures,[1] underlying inflation reached 1¼ percent in February 2017, below the floor of the central bank's target range of 1.5 to 3.5 percent. Romania's recent experience with inflation is similar to many other countries in the region.[2]

7. The cyclically adjusted budget deficit grew by 1½ percent of GDP in 2016. This reflected various tax rate cuts (including the large standard VAT rate reduction from 24 to 20 percent) and wage increases. The headline general government deficit (cash basis) rose by 0.9 percent to 2.4 percent of GDP. The outturn was below the authorities' target of 2.75 percent mostly due to under-execution of the EU-funded capital budget and the associated co-financing. The ESA deficit for 2016 is estimated at 3 percent of GDP, with the difference relative to the cash deficit mainly explained by court-ordered wage payments and accrued revenues.



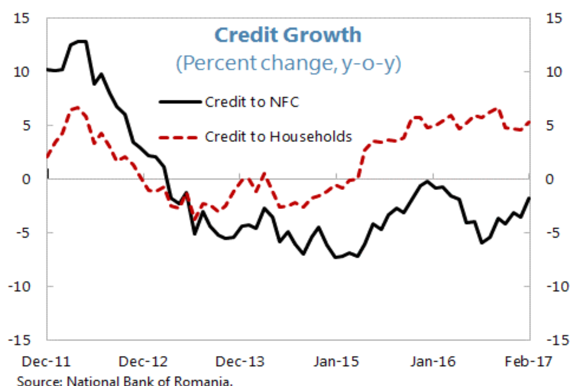
8. The current account deficit widened by more than 1 percent of GDP in 2016. Strong consumption growth boosted the goods trade deficit to 5.5 percent of GDP in 2016. The capital account balance registered a positive inflow of €4.2 billion in 2016, compared to €3.9 billion in 2015. Net FDI flows increased, predominantly due to reinvested earnings and intra-company loans. The net financial account posted positive inflows as the positive net FDI and portfolio inflows offset the net outflows of other investment, predominantly from domestic banks.

9. Banks remain generally sound and the immediate risks to financial stability from recent initiatives have abated for now. Parliament passed two laws last year to allow debtors to walk away from mortgages and convert Swiss Franc denominated loans at historical exchange rates. Recent rulings by the Constitutional Court, stating that the giving in payment law should be applied in court on a case-by-case basis and within the provisions dealing with distressed borrowers in the civil code, have greatly limited the potential negative impact of this law on the banking sector. The court also declared the CHF conversion law unconstitutional. The ratio of non-performing loans (NPLs) has fallen significantly, though the level of NPLs for non-financial corporations is still high. Banks' profitability remains robust, capital positions are strong, and liquidity abundant on average.

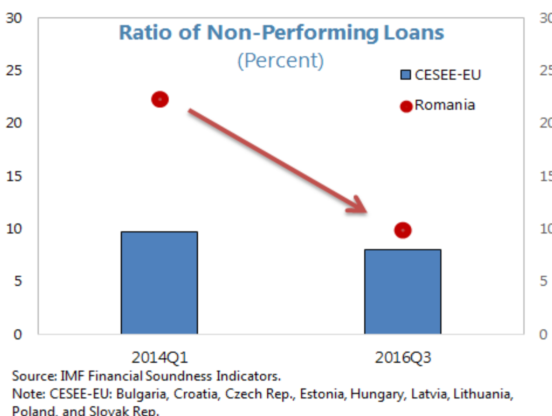
[1] The VAT rate cut, excise reduction for fuels, and elimination of some fees and charges implemented in early 2017 had an estimated negative impact of 1 ppt. on headline inflation.

[2] IMF working paper WP/14/191 and Romania Article IV selected issues paper (2016).

Credit growth to non-financial corporations (NFCs) remained subdued in 2016, even though some recovery has been observed recently. Even after considering write-offs and sales of NPLs, NFC credit grew by 1.8 percent in 2016. A still high level of NPLs, the ongoing deleveraging process of foreign parent banks, and a constrained investment sentiment have hindered credit growth.



Source: National Bank of Romania.



Source: IMF Financial Soundness Indicators.
Note: CESEE-EU: Bulgaria, Croatia, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Poland, and Slovak Rep.

OUTLOOK AND RISKS

10. Growth is projected to remain above potential in 2017 and slow to around 3¼ percent in the medium-term. On current policies, real GDP growth could reach 4.2 percent this year. However, the outturn will depend, inter alia, on whether the authorities take measures to bring the deficit under the EU's excessive deficit procedure (EDP) threshold of 3 percent of GDP. Growth is expected to decline in the medium term as the transitory effects of the fiscal impulse wear out and progress on structural reforms remains slow. Growth could rise to about 4½ percent over the medium-term if macro-critical reforms to boost EU funds absorption are implemented.

Romania: Macroeconomic Outlook
(Percent)

	2015	2016	2017	2018	2019
Real GDP (yoy)	3.9	4.8	4.2	3.4	3.3
Output gap	-1.2	0.3	1.1	0.9	0.7
CPI inflation (yoy, eop)	-0.9	-0.5	2.2	3.1	2.7
Unemployment rate (average)	6.8	5.9	5.4	5.2	5.8
(In Percent of GDP)					
Current account balance	-1.2	-2.3	-2.7	-2.5	-2.4
Fiscal balance (cash)	-1.5	-2.4	-3.7	-3.9	-3.8
Gross general government debt (direct debt only)	37.1	37.4	38.9	40.2	41.5
Gross external debt	56.5	54.6	52.9	49.8	47.3

Sources: Eurostat; Romanian authorities; and IMF staff projections.

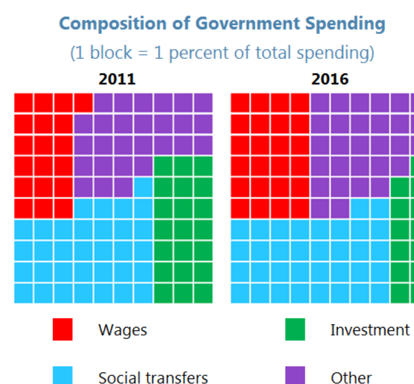
11. Risks to the medium-term baseline are tilted to the downside (Annex II). A perception that fiscal prudence has been abandoned—for example, due to fiscal measures currently under consideration—or institutions are weakening could adversely affect market confidence. Such concerns have recently led Moody's to downgrade Romania's outlook to stable from positive. There are also risks to competitiveness if large public sector wage increases lead to similar wage increases in the private sector. Such developments, together with potential heightened political tensions, could erode consumption and investment, increase the cost of government borrowing and put pressure on the exchange rate which would affect banks' balance sheets through their FX exposures. While adequate reserve levels, a flexible exchange rate, and fiscal buffers will help against such risks, it is important that policies remain prudent, particularly during a period when external conditions are unsettled, and uncertainty about policy and financial market developments remains elevated.

12. Authorities' views. The government forecast assumes a higher impact of the fiscal and structural measures introduced in their program on near- and medium-term growth prospects. It projects growth at 5.2 percent for 2017 and above 5.5 percent during 2018–2020. The central bank's growth forecast is broadly in line with staff's.

POLICY DISCUSSIONS

A. Fiscal Policy

13. Against the backdrop of possible significant fiscal worsening, staff advised fiscal discipline to rebuild buffers. Successive tax cuts have structurally shrunk the revenue envelope while the share of wages and pensions has grown at the cost of investment. The current expansionary stance is not warranted by the cyclical position of the economy and puts at risk Romania's favorable macroeconomic indicators relative to peers (see text panel). Recent experience when Romania's public debt tripled in only a few years, highlights the importance of fiscal prudence. Staff recommended the revenue envelope be protected—including by avoiding any further tax cuts—and wage and pension growth be moderated. In line with past Fund advice, the authorities should aim for a medium-term deficit of 1.5 percent of GDP to rebuild buffers. This can be achieved by reducing the 2017 deficit to around 2.3 percent of GDP—a broadly neutral stance—and to 2 percent in 2018.



Source: IMF staff calculations.
Note: Investment refers to total capital spending (including EU funds). Social transfers category includes pensions.

14. Without additional effort, the budget deficit is set to exceed the target of 3 percent of GDP in 2017. Staff projects a deficit of 3.7 percent of GDP on account of new wage and pension increases and tax cuts in the 2017 budget that will add to the effects of the previously legislated tax cuts entering into effect this year. Staff advised near-term measures to reduce the deficit focusing on expenditure reprioritization[3] and the postponement of a planned pension increase, while safeguarding social spending. The authorities prefer to wait to monitor budget execution in the first part of the year. However, without timely action, reducing the deficit to 3 percent may require withholding the

Measures to Reduce the 2017 Fiscal Deficit and Yields
(Percent of GDP; cash basis)

Measure	Yield
Reprioritize expenditures; failing that, enforce the 10 percent buffer on spending	0.6
Reconsider implementation of pension point increase	0.3
Enforce the cap on personnel spending	0.2
Revenues from higher SOE dividends	0.1
Other measures (including efficiency gains from revenue administration)	0.1

Sources: Romanian authorities and IMF staff calculations.
Note: The numbers may not add up due to rounding off.

[3] Including by generating savings through centralized procurement and substituting domestically funded with EU funded investment.

automatic 10 percent spending buffer and delaying capital spending, both of which are less desirable ways to achieve the target.

Fiscal Outlook and Staff Recommendation

The new government adopted a number of fiscal relaxation measures in the 2017 budget…

Fiscal Cost of New Measures Introduced in the 2017 Budget

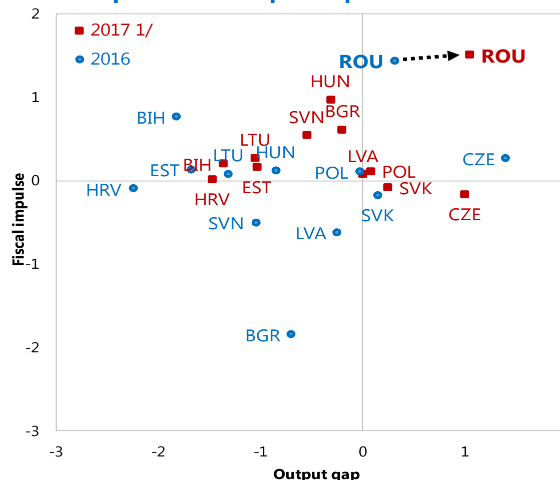
(Percent of GDP)

	2017	2018
Revenue	**-0.5**	**0.0**
Personal income tax	-0.2	0.0
Social security contributions	-0.1	0.0
Non-tax revenue	-0.1	0.0
Expenditure	**1.0**	**0.3**
Wages	0.4	0.0
Pensions	0.5	0.3
Other	0.1	0.0
Total effect on the budget	**1.4**	**0.4**

Sources: Romanian authorities and IMF staff calculations.
Note: Totals may not add up due to rounding off.

…making the procyclical stance the most pronounced in the region.

Fiscal Impulse and Output Gap

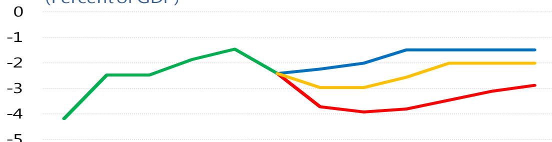


Sources: WEO and IMF staff calculations.
Note: Fiscal impulse is calculated as the change in the cyclically-adjusted budget balance. Hence, positive values for the fiscal impulse show expansionary fiscal policy. Output gap expressed as percentage of potential output.
1/ 2017 data are based on IMF staff projections.

On current policy, staff projects that the deficit will reach 3.7 percent of GDP in 2017 (exceeding the 3 percent EDP ceiling) and that public debt will keep rising gradually ("baseline" below).

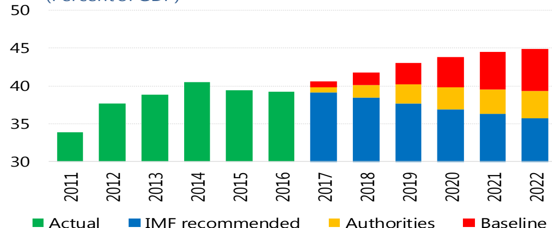
Fiscal Balance

(Percent of GDP)



Public Debt

(Percent of GDP)



Source: Ministry of Public Finance, and IMF staff estimates and projections.

Staff recommends a more ambitious fiscal adjustment path to put public debt on a gradual downward trajectory.

Fiscal Balance Targets

(Percent of GDP; cash basis)

Measure	2017	2018	2019
Budget deficit under current policies (IMF estimate)	-3.7	-3.9	-3.8
Authorities' budget target	-3.0	-3.0	-2.6
Measures needed (cumulative)	0.8	1.0	1.2
IMF-recommended budget	-2.3	-2.0	-1.5
Additional measures needed (cumulative)	0.7	1.0	1.1

Sources: Romanian authorities and IMF staff calculations.
Note: The line "Measures needed (cumulative)" indicates the annual measures starting from 2017 in cumulative terms needed, in the IMF staff's view, to reach the authorities' budget target. The 2017 target of 2.96 percent of GDP in cash terms corresponds to around 3 percent in ESA terms. The line "Additional measures needed (cumulative)" indicates in cumulative terms the additional measures needed to bring the deficit from the "Authorities' budget target" to the "IMF-recommended budget."

15. Moreover, there are risks of further deterioration of the fiscal balance going forward. Under current policies, the deficit is projected to deteriorate to 3.9 percent of GDP in 2018, accounting for the full-year effect of the pension increase scheduled to enter into effect in July 2017. This does not reflect measures included in the government's 2017–2020 plan (such as the implementation of the unified wage bill, reduction of social security contribution rates, and further tax cuts) which have not been finalized but if adopted could raise the deficit by 6 percent of GDP by 2022. This calculation does not factor in any potential second-round effects that may reduce the cost by expanding the economy (see table).

Fiscal Cost of Potential Additional Measures, 2017-2022 1/
(Percent of GDP)

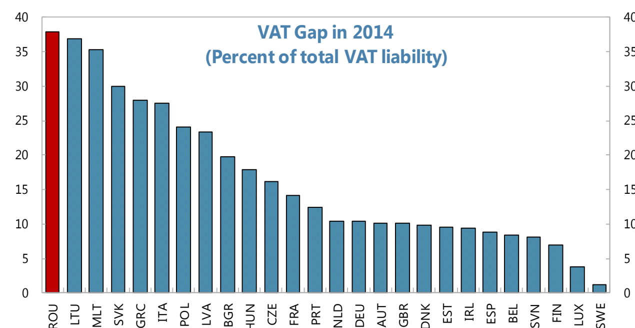
Measure	2017-2022	Staff view
Revenue	**3.4**	**Revenue envelope should be protected, including by avoiding any further tax cuts.**
Cut in social security contributions	1.0	Authorities should avoid implementing this measure in the absence of a more comprehensive pension system review.
Differential reduced PIT	1.4	Authorities should avoid further tax cuts, including PIT; changes to tax rates should be part of a broader tax review.
Reduction in VAT to 18 percent	0.4	Authorities should avoid further tax cuts, including VAT; changes to tax rates should be part of a broader tax review.
Loss of dividends from SOEs	0.3	Since these dividends are earmarked for the Sovereign Investment Fund, authorities should ensure that these funds are transparently directed towards investment (with a corresponding decrease in investment spending financed directly out of the budget, to compensate for the revenue loss).
Zero-rated VAT for real estate	0.3	Authorities should avoid introducing exemptions to their tax code.
Expenditure	**2.6**	**Wage and pension growth should be moderated.**
Unified wage law 2/	2.6	The unified wage law should be implemented in line with fiscal space, and should be supported by efforts to reform public administration (see also Box 1).
Total effect on the budget	**6.0**	

1/ Staff estimates based on preliminary information as of April 2017. Figures may not add up due to rounding off.
2/ Figures reported in this table represent the net effect on the budget (that is, net of contributions to taxes and social security).

16. To prevent growing deficits from threatening fiscal sustainability, medium term consolidation should be considered, supported by reforms to enhance the effectiveness of the public sector.

- ***Reforming public remuneration***. The authorities are planning to introduce a unified wage law to eliminate distortions in the public remuneration system. The current draft, however, would imply a large increase in average public wages that would pose considerable fiscal risks. It could also undermine competitiveness if the rise in public wages lead to private sector wage increases. The draft law should be carefully revisited to reduce its cost in line with the medium-term fiscal objectives and be part of a broader public administration reform that seeks to create a more transparent and equitable pay system (Box 1). In this context, the authorities should strengthen the implementation of reforms included in the 2014 Public Administration Strategy, aimed at streamlining the public sector, while improving services and reducing red tape.

- ***Improving revenue collection***. Romania has the largest Value-Added Tax



Source: European Commission (2016)
Note: Estimates for 2014. The VAT gap is the difference between actual VAT collections and those that could be obtained if the existing VAT laws were perfectly enforced (i.e. the VTTL, or the VAT Total Tax Liability). The VAT gap is then represented as percentage of VTTL.

compliance gap in the EU. Reform of the tax administration (ANAF) needs to be accelerated. Key priorities are to implement a modern compliance risk management approach, strengthening the large taxpayers' unit, and reforming the IT system (Box 2).[4] Staff also recommended adopting legislation on natural resource taxation (in line with IMF technical assistance recommendations) to provide greater certainty to the tax framework.

- ***Enhancing expenditure efficiency and commitment controls***. The authorities should implement recommendations from recently conducted expenditure reviews at the Ministry of Transport and expand such reviews to other key sectors. Considering the significant expenditure commitment in the 2017 budget for local investment programs, it would be important to strengthen transparency and the commitment controls system. Given recent pension increases, staff also advised the authorities to assess the sustainability of the pension system.

- ***Improving compliance with fiscal rules.*** Romania has a comprehensive fiscal responsibility law in line with international best practices. However, it is not fully enforced. Past fiscal performance against the fiscal rule is not assessed in the budget and there is no discussion on the alignment between government's plans and fiscal rules. There is also considerable scope to further integrate the work of the fiscal council in the budget process.

Authorities' views

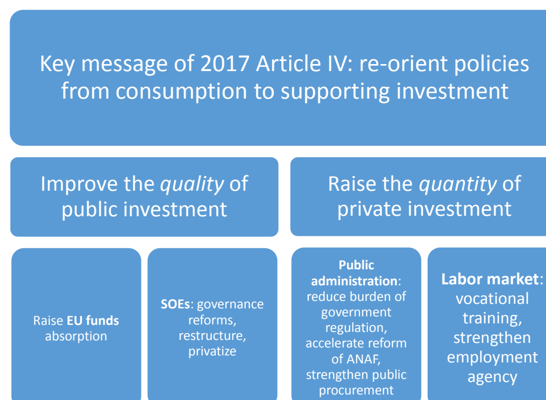
17. The authorities emphasized their strong commitment to adhere to the European fiscal rules. They recognized that meeting the 2017 deficit target will be challenging but assured the mission that they would monitor budget execution closely and take compensatory measures if needed. On the unified wage law, the authorities agreed with staff on the need for a gradual implementation but noted that the fiscal impact of the law may be lower than anticipated since it would cancel entitlements related to future wages granted by the Constitutional Court. In the area of revenue administration, they reiterated that this is one of the government's priority areas and expressed confidence that the implementation of key identified actions for ANAF would result in improved revenue collection. The authorities requested follow-up technical assistance on improving compliance in the segment of high net worth individuals.

[4] The World Bank is currently supporting an overhaul of ANAF's IT system through its Revenue Administration Modernization Program (RAMP). However, progress has been slow.

B. Structural Reforms

18. Staff stressed the importance of improving public and private investment for achieving higher sustainable growth (Annex IV)**.** On public investment, the key challenge is quality: while capital spending has outpaced that of peers, the quality of Romania's infrastructure is amongst the lowest in the EU.[5] Staff advised that the quality of public investment can be improved by increasing the share of EU-funded investment over domestically-funded investment—an area of particular focus during this consultation—and through reforms to state-owned enterprises, many of which play a critical role in infrastructure sectors. To raise private investment staff advised reforms in the labor market and continued progress in the fight against corruption, factors that have been highlighted in surveys on the investment climate.

Romania: Recommended Structural Reforms



19. The quality of public investment can be improved by raising EU funds absorption. EU-funded investment is better targeted, requires stronger feasibility studies, and is subject to ex-ante conditionality, resulting in higher quality of public investment.[6] However, currently only one third of total capital spending is EU-funded. Staff analysis (Annex VIII) suggests that raising the EU funds absorption rate to 95 percent for the programming period 2014–2022—a rate achieved by several countries in the region—could raise potential growth to about 4½ percent—1 percentage point above staff's baseline—by increasing the efficiency-adjusted public capital stock.[7] Total public investment would increase by close to 2 percent of GDP over the medium term in such a scenario. In addition, higher EU-funded infrastructure investment would also boost domestic demand through its positive (crowding-in) impact on private investment. Finally, EU-funded investment can be targeted to increase the share of investment going to less-developed regions such that the benefits of higher sustainable growth can also help them achieve faster convergence.

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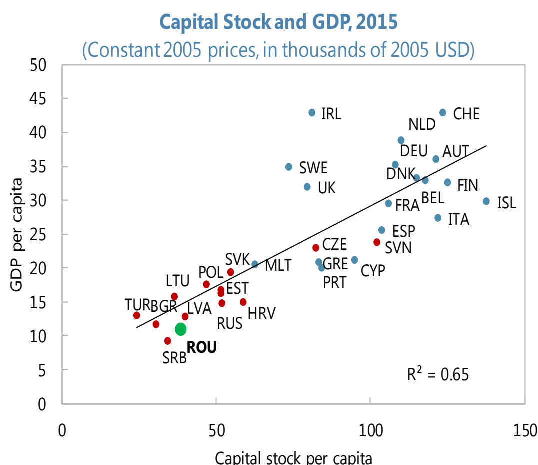
[5] For a discussion on the quality of public infrastructure in Romania see also Country Report Romania 2016, European Commission.

[6] See, for example, European Commission, 2017, The Value Added of Ex ante Conditionalities in the European Structural and Investment Funds, Staff Working Document 127, March.

[7] A Selected Issues Paper looks at the role of EU funds in quantifying the impact of efficiency-adjusted public capital on growth.

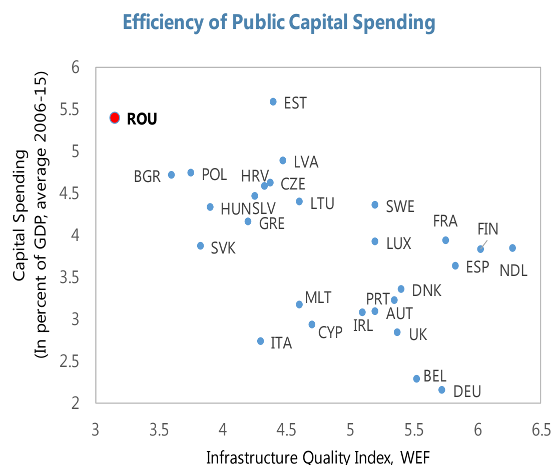
Efficient Public Investment, EU Funds, and Potential Growth

Investment is key to support sustainable growth and re-accelerate the pace of income convergence.



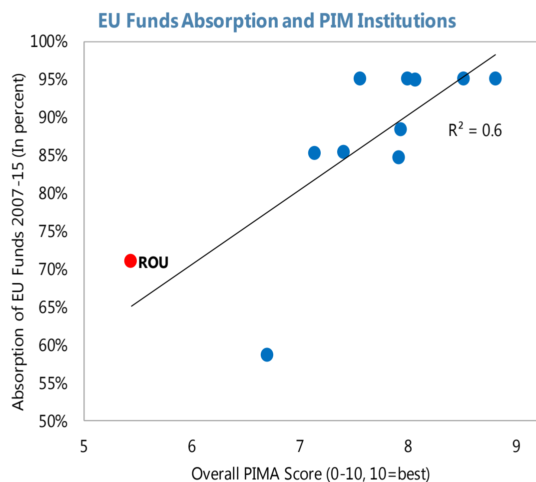
Source: Penn World Tables, Version 8.1.
Note: Red dots = central, eastern, and south-eastern countries; blue dots = other advanced European economies.

Public investment in Romania has outpaced that of peers, but the quality of infrastructure is low.



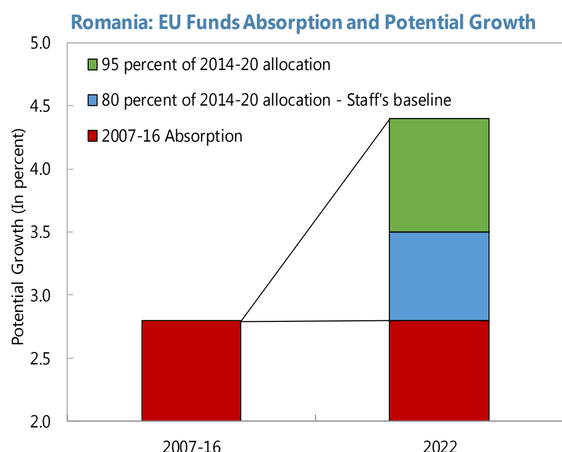
Sources: Eurostat; and World Economic Forum quality of infrastructure index (2015) on roads, railroads, seaports and air transport (average).

There is a critical need to strengthen public investment institutions to fully utilize European funds and improve the quality of public investment.



Sources: Eurostat; and IMF staff calculations.

The impact of higher EU funds absorption on potential growth can be substantial.



Source: IMF staff calculations.

20. Raising EU funds absorption can be achieved by improving the quality of public investment management institutions. According to staff estimates, strengthening the quality of public investment management (PIM) institutions in Romania to the average of the EU countries, would raise the efficiency-adjusted public capital stock by about 15 percent.[8] Recent efforts to

[8] Raising EU funds absorption could also contribute to better PIM institutions more generally, contributing to higher quality domestically-financed public investment.

complete the designation of managing authorities, comply with ex-ante conditionality, and advance non-eligibility checks on EU-financed projects are important to improve PIM institutions. Staff emphasized the need to focus on better feasibility studies, prioritization of projects, and strengthening the legal framework for procurement.

Measures to raise EU funds absorption

Preparation	Conducting strong feasibility assessments on identified large infrastructure projects, strictly following the standards required for EU financing; simplifying administrative burden
Prioritization	Better prioritizing large infrastructure projects, by integrating project prioritization in the budget process and publishing the list with budgeted amounts allocated to each project
Procurement	Strengthening the legal framework for public procurement, by streamlining the fragmented system, eliminating overlapping competences, and improving competition
Funding source	Systematic effort to limit domestic financing of projects that qualify for EU funds, including by making eligibility checks compulsory; ensuring a stable source of funding for strategic projects over the medium-term

21. The quality of public infrastructure would also be improved by re-energizing reforms of state-owned enterprises (SOEs). SOEs play a notable role in transport and energy sectors—key network industries to accelerate growth—but service delivery has been poor, profitability is weak, and arrears are still significant.[9] Staff encouraged the authorities to restart the stalled process of restructuring and privatization of SOEs to address these problems. Announcing a timeframe for initial public offerings (IPOs) of selected large SOEs, such as Hidroelectrica, would also help raise Romania's international profile as an investment destination. In addition, SOE reform can also reduce exposure to contingent liabilities. Staff also encouraged the authorities to strengthen the capacity of the Ministry of Public Finances unit in charge of monitoring SOEs and overseeing implementation of the corporate governance law. Staff advised to exclude banks from the SOE corporate governance law since they are already subject to a specialized corporate governance law. Staff also recommended strengthening reporting and accountability of SOE investment projects in budget documents and budget execution reports. The government envisages creating an investment fund with shares of SOEs to support investment. The mission recommended that this fund be based on best international practices related to the appointment of management, transparency, auditing, selection of investment projects, and use of state guarantees to minimize potential fiscal risks (Box 3).

22. The fiscal cost of these structural reforms is expected to be limited and the economy's cyclical position augurs well for renewing the emphasis on structural reforms. Substitution of EU-funded investment for domestically financed public investment would largely be budget-neutral over the medium-term. There is widespread political support to raise EU funds absorption and the constraints are largely administrative. Regarding SOE reform, restructuring is estimated to have a limited impact on employment, of less than 1 percent of the labor force. Moreover, it would be easier for the affected workers to re-enter the job market during the current period of buoyant labor market conditions and rising wages than during times of slack. Fiscal costs of SOE reforms would relate to severance payments from the SOEs (usually around 6 to 12 months of wages) and a

[9] For a detailed analysis of SOE challenges and reform priorities in Romania see IMF Country Report 15/80, Romania: Selected Issues, 2015.

complementary payment from the state budget for layoffs; the total cost is expected to be about ½ percent of GDP.[10]

23. Efforts are also needed to facilitate private investment. These include improving the functioning of the labor market, and strengthening the drive against corruption:

- ***Labor market***. While unemployment is low in Romania, structural reforms are needed to address low labor force participation, high youth unemployment, a rapidly aging society, and high emigration. While increasing the formal labor force participation, labor market reforms can also help expand the tax revenue base. Staff encouraged the authorities to focus on reducing mismatches in the labor market by improving vocational education and training and strengthening the capacity of the National Employment Agency. Moreover, recent increases in the minimum wage risk undermining competitiveness and hampering job creation, particularly for low-skilled employees. Staff urged the authorities to establish a transparent minimum wage setting mechanism based on clear and objective criteria, especially labor productivity.

- ***Fight against corruption.*** The mission stressed the importance of continuing with the fight against corruption, an area where Romania has made considerable gains. This would bring multiple economic benefits: raising tax collections, improving the allocation of scarce public resources, and attracting both domestic and foreign investment. Staff emphasized the need to focus on the effective implementation of the national anti-corruption strategy, preventing conflict of interest in public procurement, strengthening the management of seized assets, enhancing the monitoring of asset declarations, and effectively implementing AML/CFT measures in line with international standards.

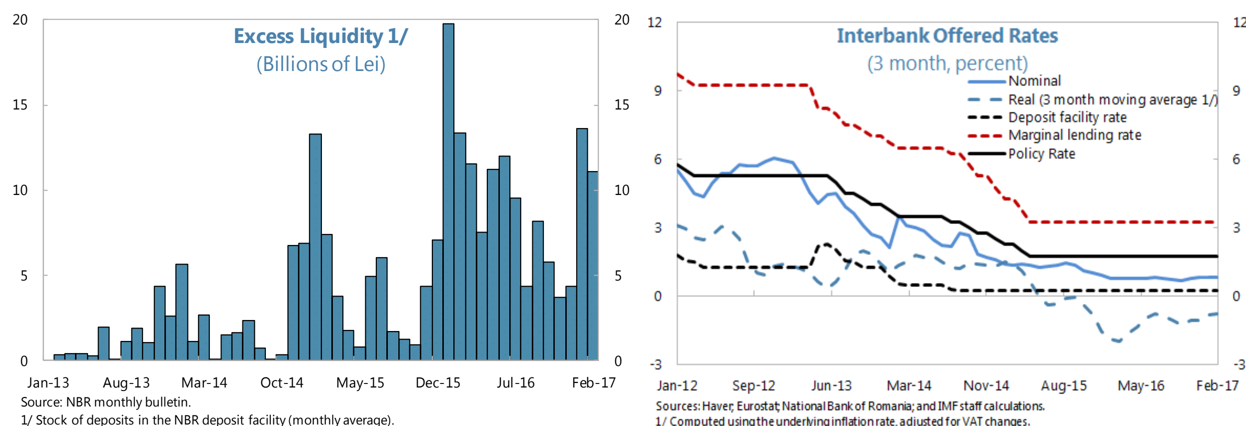
Authorities' Views

24. The authorities broadly agreed with staff's recommendations to improve the efficiency of public investment. Government officials agreed with staff on the potential benefits of accelerating EU funds absorption. While they recognize that absorption during the first years of the new programing period has been slow, they also emphasized that the progress made so far in terms of appointing managing authorities, and lifting ex-ante conditionality would help them accelerate absorption in the coming years. On SOE reform, the authorities noted that privatization and IPOs will depend on progress with establishing the sovereign fund. Finally, they agreed that the fight against corruption should continue.

[10] The monthly allowance equals the difference between the previous wage (but not more than the economy average) and the unemployment benefit, for a period between 12 and 24 months depending on seniority.

C. Monetary Policy

25. Monetary conditions have remained accommodative. The policy rate has remained at 1.75 percent since May 2015. Due to excess liquidity in the system, the money market rate is close to the lower bound of the interest rate corridor (the rate on the NBR's deposit facility) which in real terms (adjusted for underlying inflation) is negative. The continued gap between the interbank market and the policy rate continues to undermine the effectiveness of the monetary policy framework.[11]

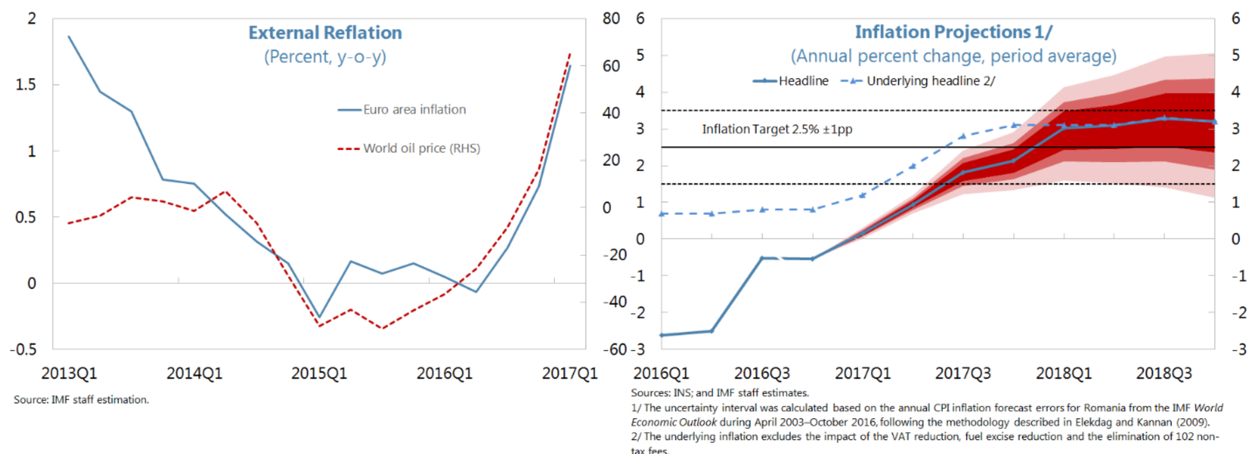


26. The central bank should remain vigilant against rising inflationary pressures and consider tightening monetary conditions. While underlying inflation and credit growth have been subdued, inflationary pressure is building as a result of rising oil prices and inflation in trading partners, tight labor market conditions, and the additional fiscal stimulus. Staff projects that without monetary tightening, inflation will exceed the upper end of the target band by mid-2018, although uncertainty is still sizable at this point following a protracted period of low inflation. Given lags in the monetary transmission mechanism, and in line with strengthening the monetary policy framework, the authorities should reduce the gap between the short-term market and the policy rate by narrowing the interest rate corridor and absorbing excess liquidity.[12] This would prepare the ground for an eventual policy rate hike later, when there is greater clarity regarding inflation

[11] A Selected Issues Paper on the monetary transmission mechanism (Annex VI) shows that monetary policy is less effective in an environment with higher excess liquidity.

[12] In line with previous staff recommendation, the liquidity absorption could be implemented primarily through issuance of certificates of deposit and using deposit-taking operations.

pressures.[13] In the absence of corrective fiscal measures, monetary policy will need to shoulder a bigger burden in managing domestic demand—a suboptimal policy mix.



27. Staff's overall assessment is that Romania's external position in 2016 was broadly in line with the underlying fundamentals (Annex V)**.** The three EBA-lite models suggest a moderate REER undervaluation of around 4–7 percent. However, the decline in the REER (CPI based) in 2016 is likely predominantly due to the strong appreciation of the dollar after the US elections. More broadly, staff assesses that recent wage growth has exceeded productivity gains, suggesting that external competitiveness may have weakened.[14] Reserve coverage is broadly adequate according to all reserve adequacy metrics. Excess liquidity in the domestic market and the worsening of global sentiment had prompted NBR to increase FX sales in the latter part of 2015 and in early 2016. In line with staff recommendations, the NBR limited interventions since then.

Authorities' views

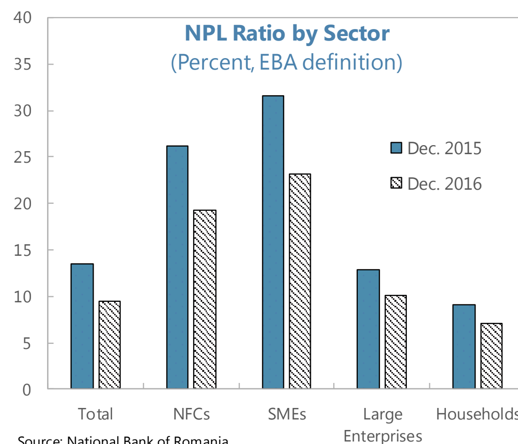
28. The authorities noted staff's recommendations to tighten monetary conditions but would prefer to be on hold until inflation becomes more visible. The NBR forecasted that inflation would tend to approach the upper bound of the inflation target variation band towards the end of the projection horizon but pointed to high uncertainties surrounding the inflation forecast, arising from domestic and external factors. It also noted that the still-low headline inflation makes it challenging to communicate a potential need for tightening. The central bank also expressed the concern that higher domestic rates could lead to short-term capital inflows, given the current regional low interest rate environment.

[13] Staff's inflation projection in the text chart assumes policy rate hikes starting in 2017Q3.

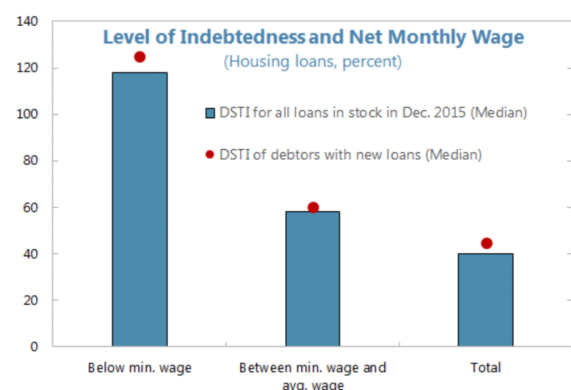
[14] A Selected Issues Paper explores the relationship between exchange rate changes and growth (see Annex VII).

D. Financial Sector

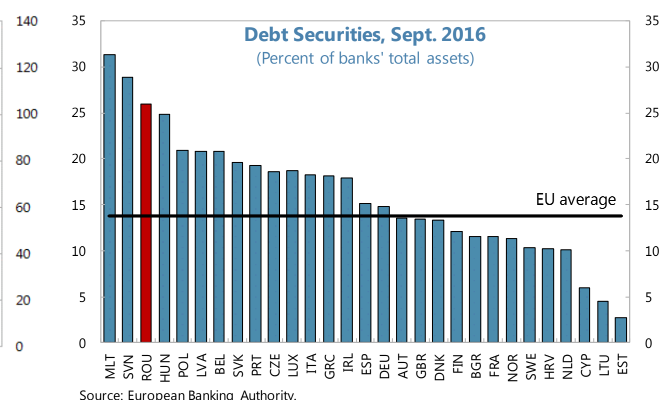
29. The mission welcomed the significant reduction in banks' NPLs and encouraged the NBR to continue to work to reduce NPLs—especially for corporates—and to closely monitor banks' growing exposure to households and the government. NPLs have fallen significantly due to the NBR's proactive efforts to encourage NPL sales and write-offs. The level of NPLs for corporates (at around 19 percent) remains high and staff encouraged continued efforts to reduce them. While overall credit growth has been sluggish, mortgage lending has grown primarily due to the government's *Prima Casa* guarantee program.[15] Rising interest rates could burden household balance sheets: an increase in the average interest rate by 200 basis points could raise the debt service-to-income (DSTI) ratio by 6–10 percentage points. Another potential area of concern could be market risk due to Romanian banks' large holdings of government debt. The growing exposure of banks to households and the government should be carefully monitored and the central bank should address any emerging risks. To prevent and manage risks to financial stability, the authorities have set up a formal macroprudential authority (with representatives from the NBR, the financial supervisory authority and the government).



Source: National Bank of Romania.



Source: NBR, Financial Stability Report, December 2016.

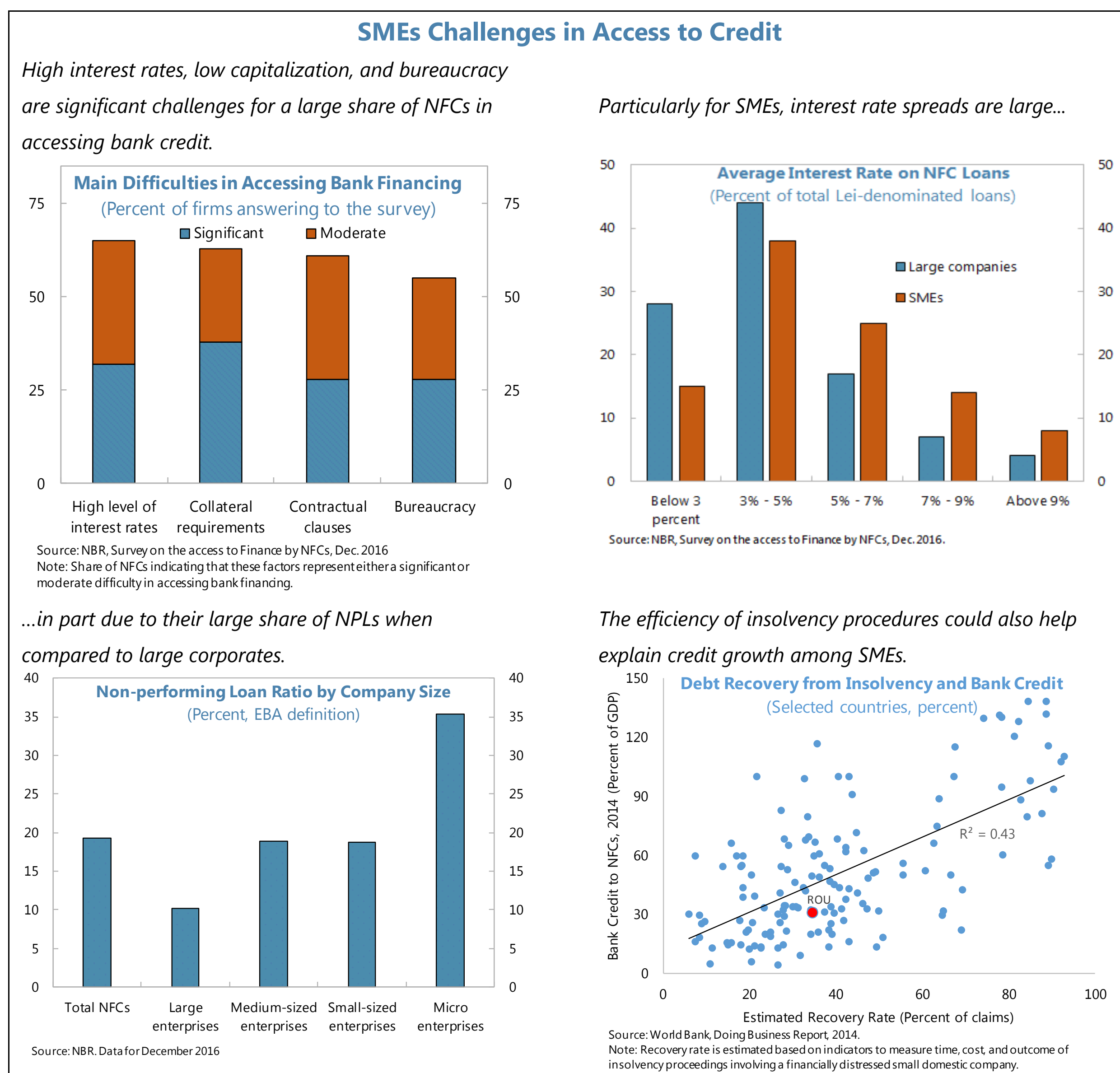


Source: European Banking Authority.

30. Credit growth to non-financial corporations has remained sluggish, in particular to small and medium-sized enterprises (SMEs). Profitability of non-financial corporates (NFCs) has improved, but credit growth has been subdued and the ratio of private credit to GDP in Romania is among the lowest in the region. While large corporates do not seem credit constrained, availability of bank financing for SMEs is costlier, in part due to higher NPLs for the SME sector. Several actions

[15] Since the launch of the Prima Casa program in 2009 until end-November 2016, 203,783 government guarantees were provided, for a total of approximately RON 17.5 billion (2.2 percent of GDP).

could be taken to improve access to credit (panel chart), including raising the capitalization of SMEs, accelerating property registration following recent adoption of a new cadaster framework, strengthening the insolvency framework, and improving specialized expertise at banks.



31. The framework for private debt resolution, particularly for SMEs, could be further strengthened. The provisions of the business insolvency law are broadly in line with international best practice.[16] However, there remains room for improvement, in particular through (i) encouraging the use of pre-insolvency procedures; (ii) streamlining procedures and enhancing the speed of the insolvency process, particularly for SME debt restructuring; and (iii) ensuring that other laws (for example, tax laws) are harmonized so as to fully support the objectives of the insolvency law. The

[16] A Selected Issues Paper analyzes the impact of the recent reforms to the insolvency laws and identifies areas for future work.

recently enacted personal insolvency law (which is not yet in effect) could serve as a means to provide good faith debtors with a fresh start while maintaining credit discipline. Staff advised that the secondary legislation for implementing the law should be informed by a detailed impact assessment including for banks and should safeguard against eroding secured creditor rights and moral hazard.

Authorities' views

32. The authorities broadly agreed with staff's views. In their assessment, while immediate threats to financial stability have abated, medium-term risks from banks' exposure to households and government debt are rising and require careful monitoring. They mentioned additional capital requirements and lower DSTI ratio ceilings as possible remedial measures. They also agreed that the drop in the volume of loans to NFCs, and in particular to SMEs, is worrisome from the perspective of economic growth potential and credit institutions' capacity to generate operating profits. The authorities agreed that the potential impact of the personal insolvency law on banks could usefully be assessed as part of the forthcoming FSAP planned for 2017-18.

STAFF APPRAISAL

33. Romania's macroeconomic indicators compare favorably with peers but there is a risk that policy buffers may be eroded. Romania made important progress with reforms after the global financial crisis. However, successive tax cuts, wage increases in excess of productivity, and limited high-quality public investment are beginning to threaten these gains. It is imperative to reorient polices from focusing on fueling consumption to supporting investment.

34. Fiscal policy needs to focus on gradually reducing deficits under a clear medium-term anchor. Successive tax cuts have structurally shrunk the revenue envelope while the share of wages and pensions has grown at the cost of investment. The envisioned fiscal expansion for this year is not warranted by the economy's cyclical position. Without further measures, the fiscal deficit will likely breach the EU's EDP threshold of 3 percent of GDP. There are risks of further considerable deterioration of the fiscal balance in the near-future, such as from the unified wage law and further tax cuts. Fiscal policy should instead focus on protecting revenues by refraining from further tax cuts, as well as moderating the increase of the wage bill and pensions, while targeting a medium-term deficit of 1.5 percent of GDP to rebuild buffers. The planned unified wage law should be carefully assessed and modified so that it is implemented in line with the medium-term fiscal objectives and creates a transparent and equitable pay system that does not distort the labor market and helps make public administration more efficient.

35. Medium term consolidation should be supported by reforms to enhance the effectiveness of the public sector. There is an urgent need to strengthen ANAF to tackle pervasive tax evasion, and support revenue collections. Further progress in enhancing expenditure efficiency is needed, including by implementing recommendations from recently conducted expenditure reviews,

and strengthening transparency and the commitment controls for local investment programs. The authorities should assess the sustainability of the pension system.

36. While there has been some progress, there is a critical need to reenergize structural reforms. A strong push is needed to accelerate macro-critical structural reforms aimed at supporting efficient investment and faster income convergence with the EU. Stronger efforts are required to strengthen public investment management institutions to fully utilize EU funds and improve the quality of domestically financed public investment. Improving the performance of SOEs, including by restarting the privatization and restructuring program and implementing the corporate governance law, will also raise economic efficiency and enhance the quality of public investment.

37. The fight against corruption should continue. Romania has made considerable gains in this area, but corruption is still present in many areas of economic activity. Maintaining the momentum will require effective implementation of the national anti-corruption strategy, preventing conflict of interest in public procurement, enhancing the detection of proceeds of corruption, and strengthening the management of seized assets.

38. The central bank should consider tightening monetary conditions. Under current projections, inflation is expected to exceed the upper end of the NBR's target band by mid-2018 on account of rising inflation in trading partners, high wage growth amidst tight labor market conditions, and the additional fiscal impulse. Given lags in the monetary transmission mechanism, the NBR should start supporting higher market rates by narrowing the interest rate corridor and absorbing excess liquidity. This will lay the ground work for a subsequent rate hike. Interventions in the foreign exchange market should be limited to smoothing excessive volatility. Staff's assessment is that Romania's external position in 2016 was broadly in line with the underlying fundamentals.

39. Romania stands out for significant progress in reducing NPLs and the central bank should remain on guard for emerging risks in the financial sector. Previous threats to financial stability from potentially damaging laws have lessened after recent decisions of the Constitutional Court. The NBR should closely monitor the growing exposure of banks to households and government debt and address any emerging risks.

40. It is recommended to hold the next Article IV consultation on the standard 12-month cycle.

Box 1. The Unified Wage Law[1,2]

The objective of the proposed law is to enhance the efficiency of the public remuneration system and reduce inequities in compensation of government employees. Implementation of this law will result in rising public sector wages, reflecting the authorities' belief that wage levels are relatively low, particularly in critical areas such as health care. The law is envisaged to be phased in through 2022.

The law establishes a nominal pay level for each function. It sets up a wage grid and envisages an increase in wages for those currently below the grid level. Salaries currently above the grid level will be frozen. The wage grid includes all job functions in the public sector and classifies them into seven occupational categories, with a proposed coefficient of 12 between the highest and lowest pay. Wages increase automatically for each job function, reflecting tenure and resulting in an estimated 1.8 percent average annual increase during the first 10 years. The law also provides for a variable component (bonuses) of up to 30 percent of the total remuneration at the institutional level. In addition, it raises the premium fund to be distributed based on performance from 2 to 5 percent of the total wage bill.

The draft law moves in the direction of organizing the public remuneration system, but it carries high fiscal risks and certain aspects are vague. Although certain features of the draft law seem aligned with best practices, others warrant reservation. The rationale for varying increases for different groups in the early years of implementation are unclear and have significant fiscal implications. Beyond 2022, the wages are mapped to a grid based on coefficients which facilitates wage adjustments. However, these coefficients are multiplied by the minimum wage to determine the pay levels, making the basis for adjustment highly volatile and less flexible. It is also not clear that the coefficients reflect a comprehensive job evaluation that ensures pay equity, or that the equivalence scales were calibrated to the private sector. Furthermore, while the law tried to address fiscal sustainability concerns (through, for example, explicitly defining this principle in the law and limiting maximum pay), the mechanisms to ensure fiscal sustainability are not defined in the law. Finally, it is unclear whether the local government will be covered by the law.

The estimated fiscal impact of the law is significant. While some increases in public sector wages might be warranted, the law would raise the wage bill well above emerging economy peers by 2022.[3] In the draft law, average wages would more than double in nominal terms by 2022. Staff estimates that the full cost of the law is RON 61.2 billion or 6.6 percent of GDP, which translates to a net impact on the budget (after contributions to taxes and social security) of about 2.6 percent of GDP in addition to what is implied in the baseline scenario.

Staff advised that the law should be guided by the broad principles of affordability, equity, transparency and relative simplicity. More specifically, it should: (i) be affordable and implemented gradually, in line with available fiscal space; (ii) introduce a simplified salary grid structure; (iii) be based on job responsibility, complexity, and qualification; (iii) benchmark private sector wages to ensure that public pay is broadly aligned with labor market conditions; and (iv) set ceilings for bonuses and performance pay, rather than mandatory levels.

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[1] Contributor: Mauricio Soto (FAD).

[2] The analysis in this box is based on information available as of April 27, 2017.

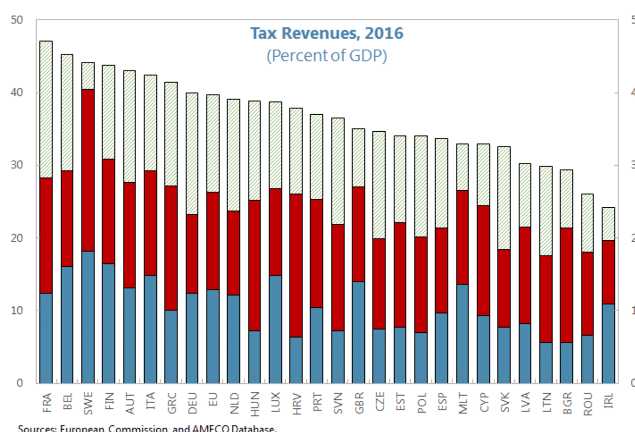
[3] Currently, Romania's public sector wage bill is lower than the median for emerging economies (i.e. 7.5 versus 9 percent of GDP). Staff estimates indicate that, under this wage law, it would be 2.5-3 percentage points above the emerging economy peers by 2022.

Box 2. Domestic Revenue Mobilization in Romania

Romania's tax system is broadly in line with general taxation principles but compliance remains weak. The VAT is EU-compatible, a CIT unencumbered by too many incentives, and the PIT is flat. There remains, however, considerable room for further improvements in the efficiency and fairness of the tax structure. There is also significant scope for reducing the tax gap by improving taxpayer compliance.

The authorities have pursued a tax reduction plan since 2015 and this trend is set to continue in 2018. Some of the measures had positive effects on the revenue base, such as those aimed at simplification of tax legislation and at broadening the base of social security contributions. Other measures, however, focused on tax cuts (including VAT, fuel excises and health contributions), with revenue losses of nearly 2½ percent of GDP over 2016 and 2017. In addition, the government has proposed a number of measures for 2017 and 2018, including further cuts in VAT, increases in VAT exemptions and reduced differential PIT rates, which will put considerable pressure on the budget deficit.

Ongoing revenue administration reforms have the potential to raise revenue yield but progress has been slow. With the support of the World Bank, ANAF is implementing a modernization (RAMP) specifically focused on enhancing collection efficiency and tax compliance. One of the key objectives of the RAMP is for ANAF to implement and operationalize a new IT infrastructure. However, progress has been slow. Earlier this year, ANAF also announced a 14-point action plan to raise revenue collection, which will be implemented in 2017. Although these measures were based on good practice principles, they were quite general, thus making it difficult to gauge their quality and feasibility. Finally, the authorities are still working on revising the taxation law in the petroleum and mining sectors. While the draft law incorporates some of the recommendations from past IMF technical assistance, many elements are still unclear, including those related to additional profit tax, royalties and the application of the law to existing and new projects.



Sources: European Commission, and AMECO Database.

Considerable challenges remain and future progress will depend on commitment and ownership at the highest levels. In addition to specific challenges mentioned above, the effectiveness of the administration of large taxpayers continues to be limited by legislative, procedural and structural constraints. While some elements of compliance management have been introduced for large taxpayers and high wealth individuals, following FAD technical assistance in these specific areas, ANAF has not generally adopted modern compliance risk management approaches. There are also no strategies or processes in place to direct operational efforts towards mitigating the key compliance risks that make up the bulk of the tax gap. Going forward, revenue reforms will need to be more strategic and backed by strong political commitment and high-level management. More generally, the authorities should focus on broadening the tax base and reducing the collection gap to help cover medium-term spending pressures.

Box 3. The Sovereign Fund for Development and Investment

The Romanian government is in the process of designing a sovereign fund to support investment, with the aim of launching it in July 2017. The intention is to exclude this vehicle's investments from the state budget, while still conforming to the sector classification rules of the EU. The exact modalities of this fund are not yet known, but it is likely to include elements of the original proposal in the newly-elected government's economic plan.

The Romanian government announced its intention to create a Sovereign Fund for Development and Investment (*Fondul Suveran de Dezvoltare si Investiţii*, FSDI). According to the original proposal, the FSDI will be set up as a joint stock company, will hold the state's shares in SOEs, and will not be part of the general government (while adhering to the accounting rules of the EU). Financing for the FSDI would derive from the dividends of those companies and debt issuance. The Fund would partner with IFIs and the private sector (in the form of PPPs, for example) to invest in infrastructure projects (e.g., highways, hospitals), recapitalize large Romanian companies (including the state-owned banks, CEC and Eximbank) and set up new manufacturing companies in disadvantaged regions.

The exact modalities of the Fund are yet to be determined. The authorities are considering the Polish Development Fund (PFR), which is an off-budget vehicle that complies with the EU's accounting rules, as a possible model.[2] While a public entity could play a role in accelerating investment in Romania,[1] a vehicle like the FSDI could also generate significant fiscal risks. Key aspects still to be defined include: (i) whether all SOEs included in the FSDI are part of general government; (ii) how the loss of dividends form the general budget will be compensated; (iii) how projects will be selected and what role the public investment program and national investment agency will play; and (iv) the process for selection and appointment of supervisory and managing boards.

The FSDI should be based on best international practices. These apply to the appointment of management, transparency, auditing, selection of investment projects, and use of state guarantees to minimize potential fiscal risks. The emphasis should be placed on prudent management of assets and coordination with other government institutions. The rules and operations of FSDI should also be transparent with stringent mechanisms to ensure accountability and prevent misuse.

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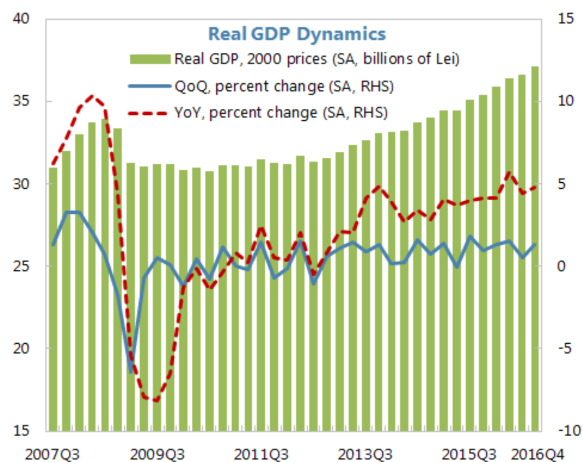
[1] For example, independent expertise implicit in the FSDI could accelerate the administrative, procurement and oversight aspects of investment spending. Also, the FSDI could even be considered as a possible mechanism to enhance the effectiveness and efficiency of EU-funded spending.

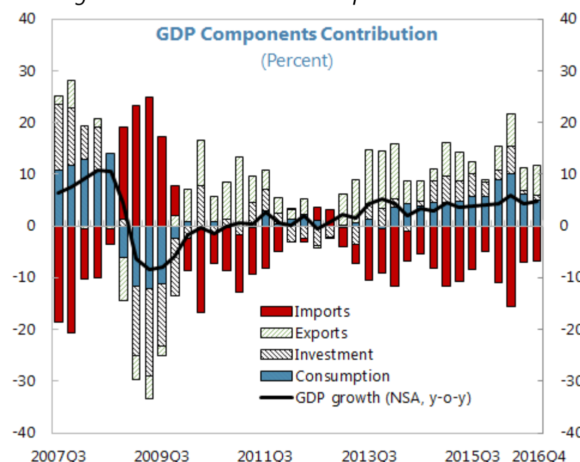
[2] The PFR was announced in February 2016 and integrates the Polish state-owned development bank (BGK) and the state-owned investment fund (PIR), aiming to raise their efficiency. The fund plans, inter alia, to finance small and large domestic companies, finance infrastructure, and support exports.

Figure 1. Romania: Real Sector, 2007–17

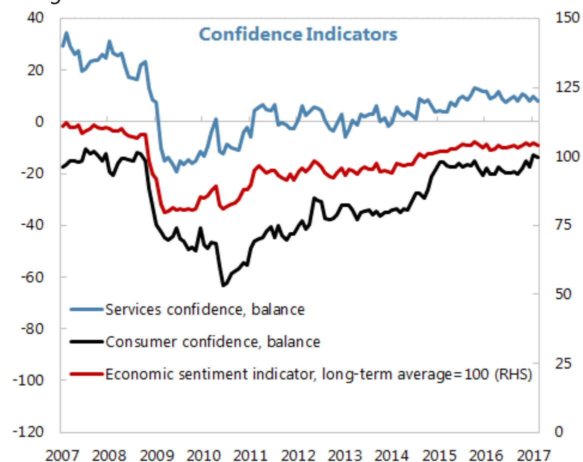
The economy is on a cyclical upswing…



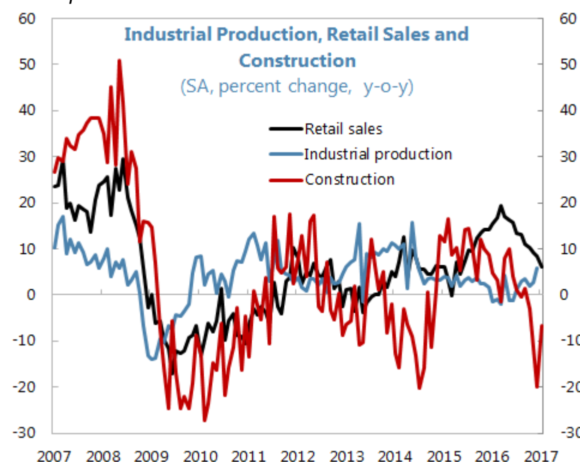
… mainly driven by consumption growth. Imports growth outweighed the moderate rise in exports.



Consumer and economic confidence indicators have been rising…



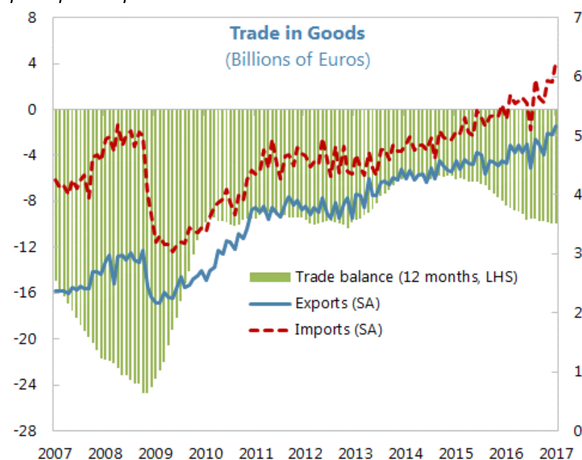
…supporting retail sales, while construction weakened on lower public investment.



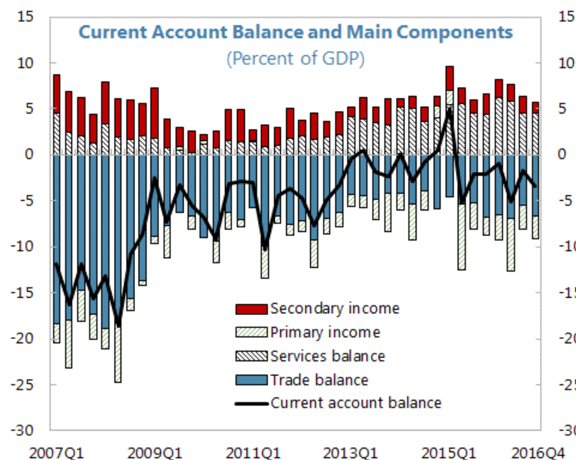
Sources: Haver Analytics; and IMF staff calculations.

Figure 2. Romania: External Sector, 2007–17

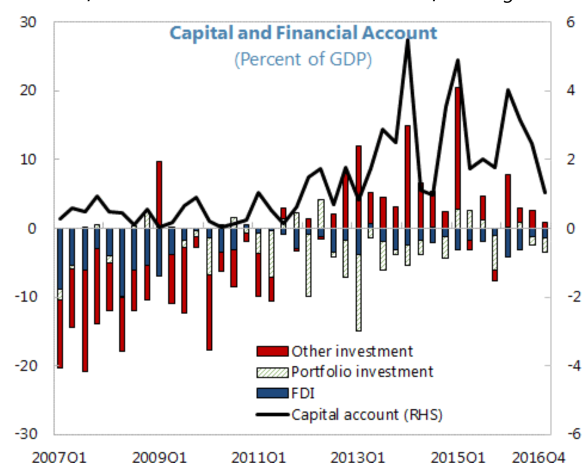
The trade balance in goods deteriorated in 2016 due to a pickup in imports…



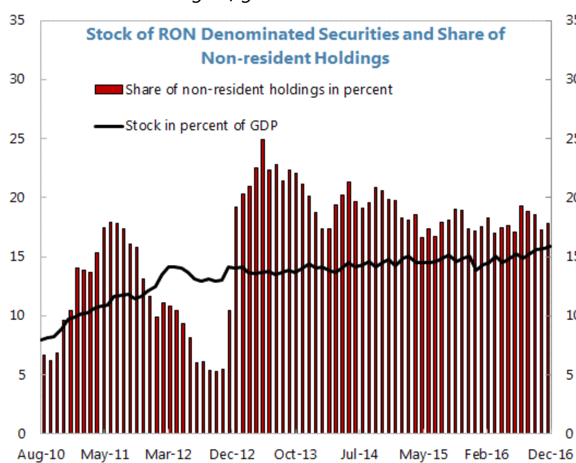
…and contributed to a widening current account deficit.



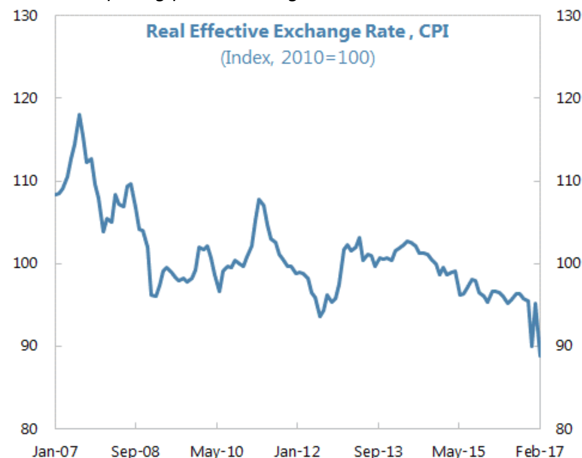
Net FDI flows increased due to reinvestment of earnings.



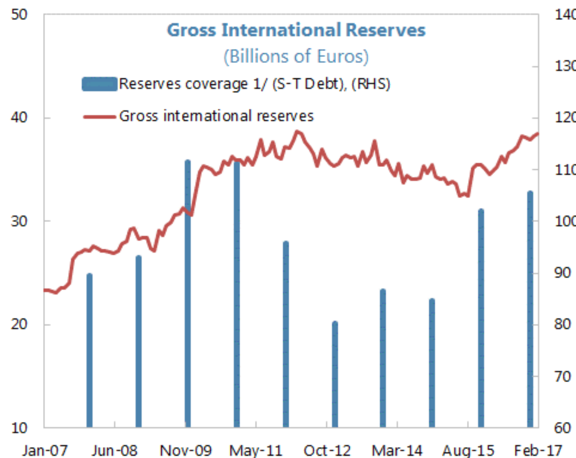
Non-resident holdings of government debt remained stable.



The real exchange rate depreciated around 2.3 percent in 2016 (comparing period averages).



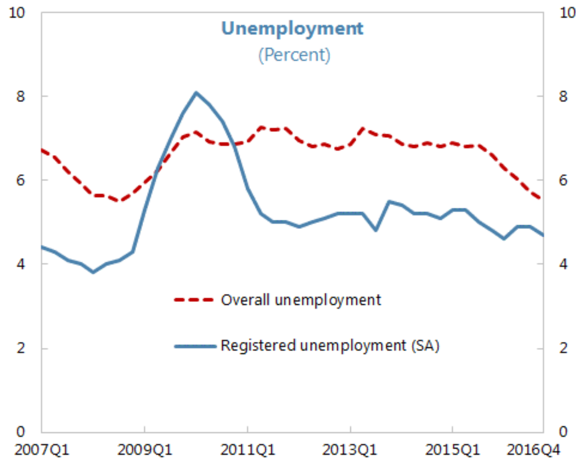
Foreign reserve coverage remains broadly adequate.



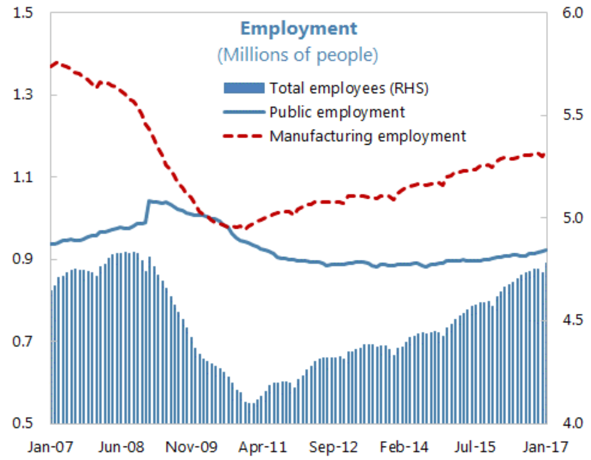
Sources: Haver Analytics; National Bank of Romania, IMF Information Notice System (INS); and IMF staff calculations.
1/ Reserves coverage is based on end-of-year data.

Figure 3. Romania: Labor Market, 2007–17

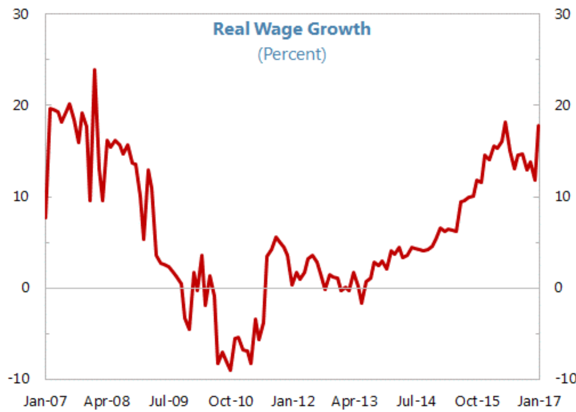
The unemployment rate has recently fallen.



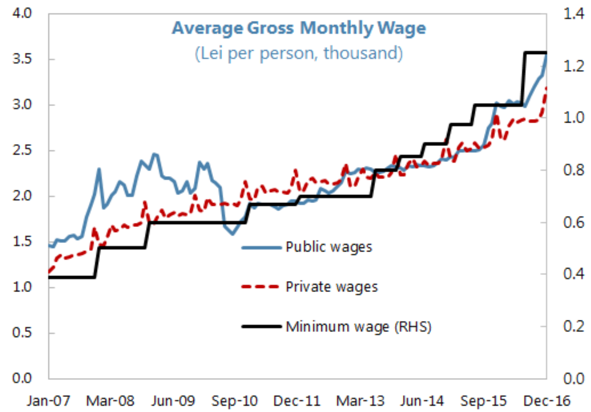
The number of employees in the official sector has been recovering at a solid pace.



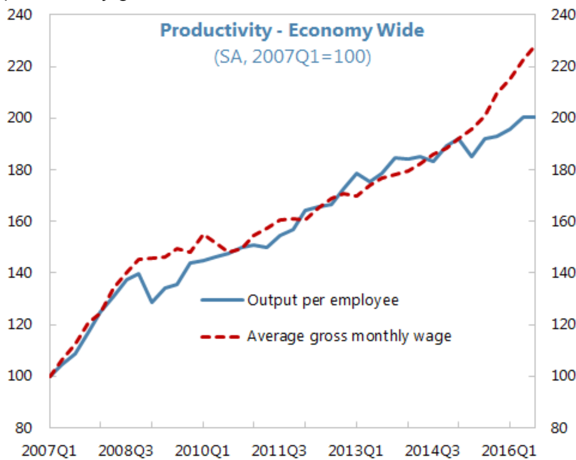
Real wage growth has been elevated …



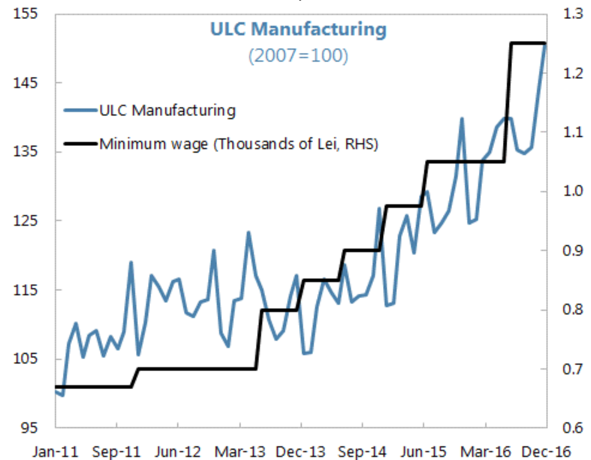
… owing to large public sector and minimum wages hikes.



Recent wage increases have exceeded the economy-wide productivity gains.



Unit labor costs in the manufacturing sector, despite large fluctuations, have been on an upward trend.

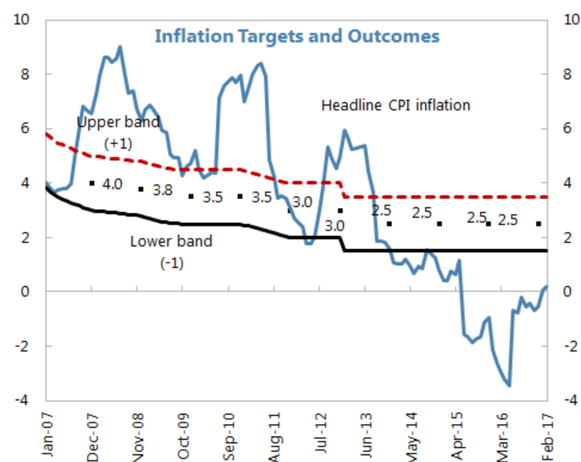


Sources: Eurostat, Haver Analytics; and IMF staff calculations.

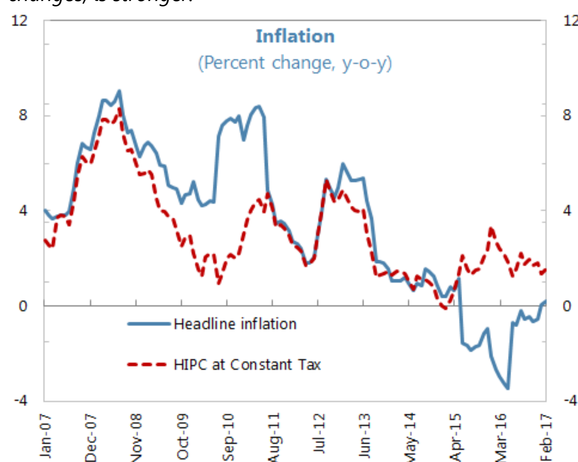
Figure 4. Romania: Monetary Sector, 2007–17

(Percent)

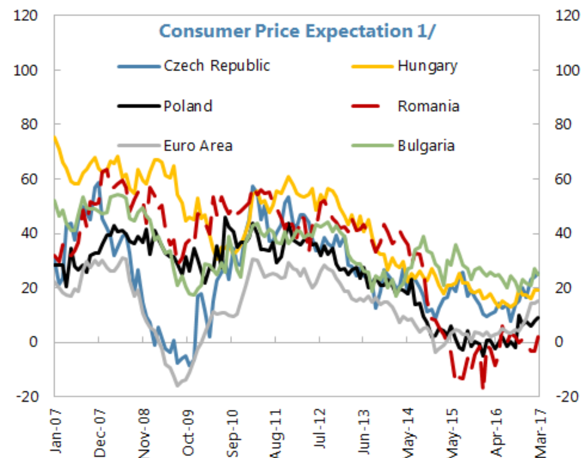
Headline inflation has returned to positive territory...



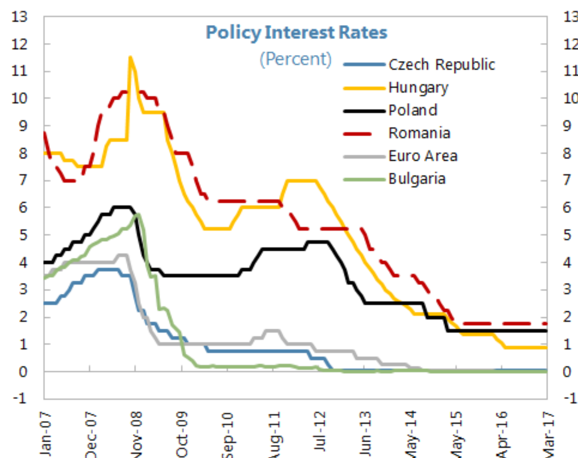
... but underlying inflation, adjusted for recent indirect tax changes, is stronger.



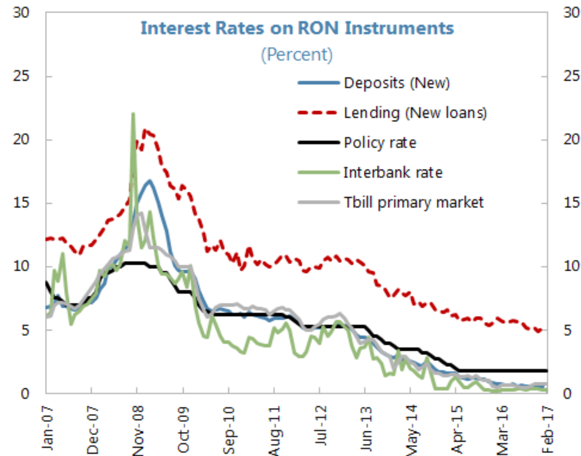
Inflation expectations have recently risen.



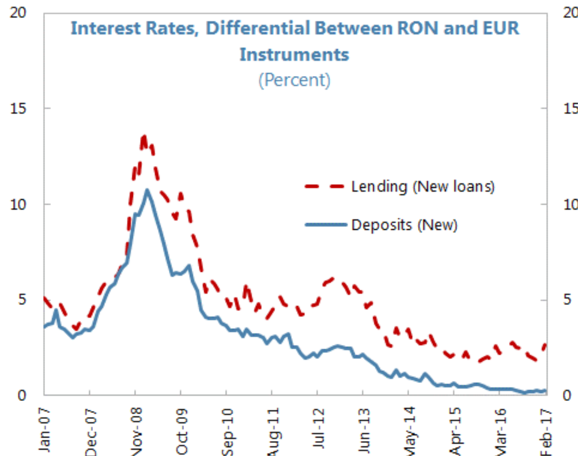
The policy rate has been on hold since May 2015...



... and interest rates for domestic currency instruments remained at low levels ...



... bringing them closer to the rates on Euro-denominated instruments.

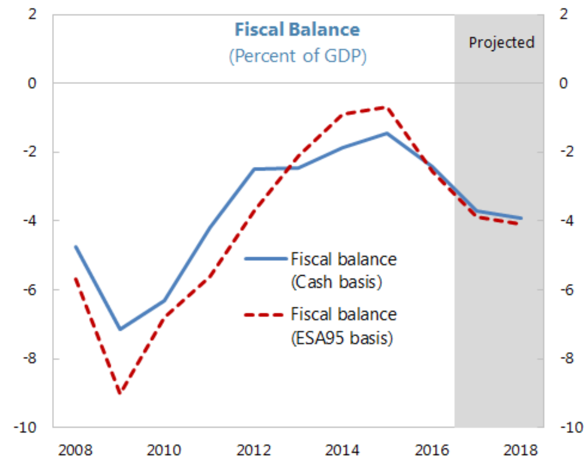


Sources: Haver Analytics; National Bank of Romania; Eurostat; Consensus Forecast; and IMF staff estimates.

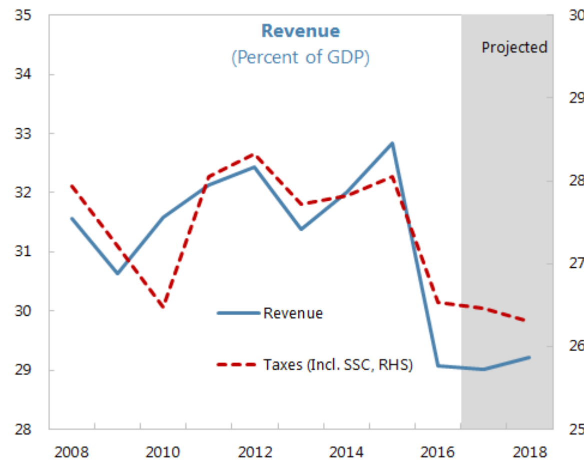
1/ Equals to the percentage of favourable answers minus the percentage of unfavourable answers in the survey on price trends over the next 12-month.

Figure 5. Romania: Fiscal Operations, 2008–18

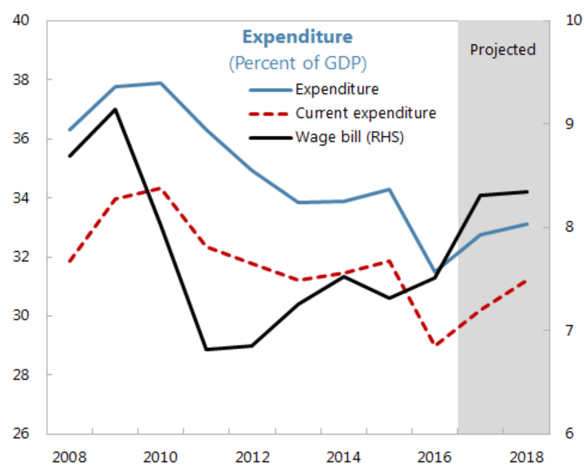
The fiscal deficit is projected to deteriorate further in 2017…



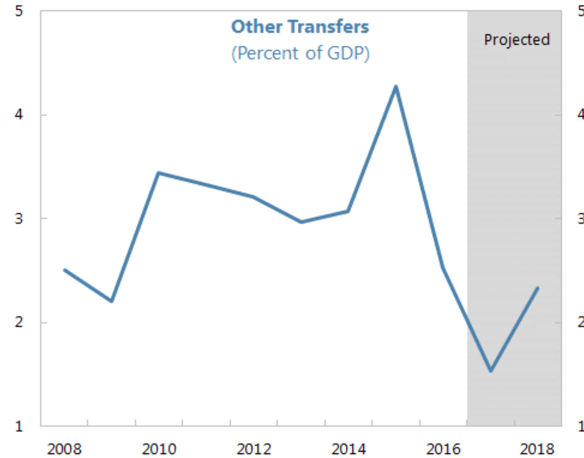
…due to further tax cuts…



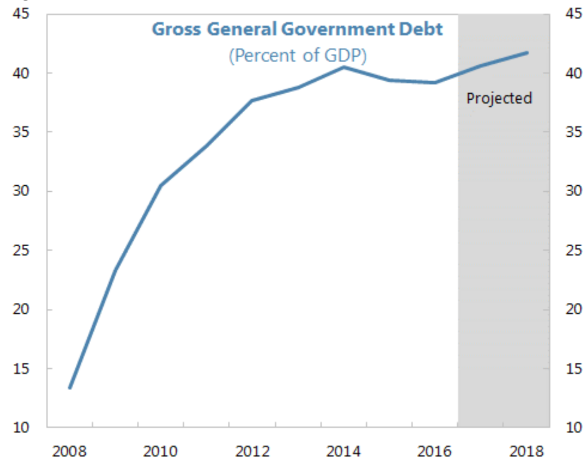
…and increases in public wages, pensions, and social transfers.



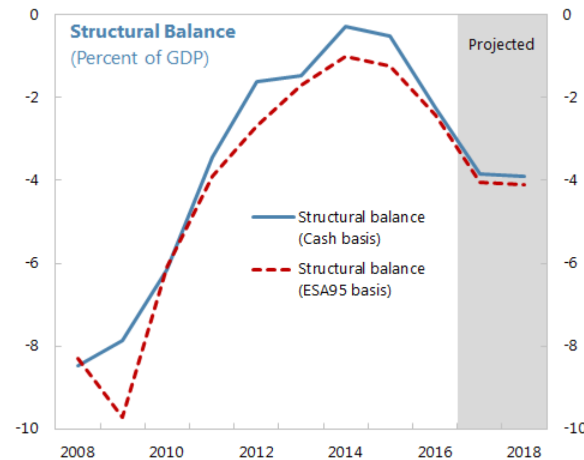
Absorption of EU funds is projected to drop further in 2017, but pick up slightly in 2018.



After remaining fairly constant in 2016, debt will start to grow again…



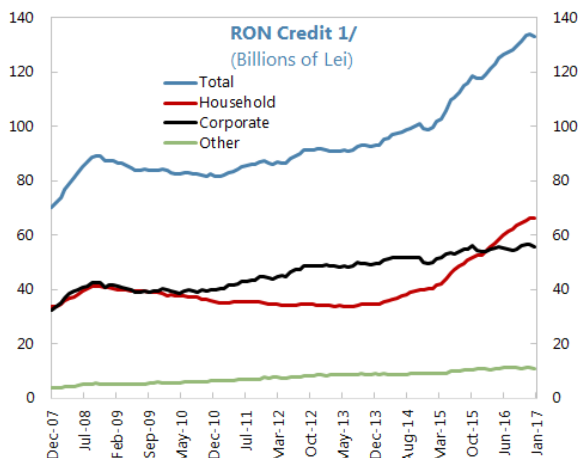
…as the structural deficit widens to about 4 percent of GDP (ESA basis).



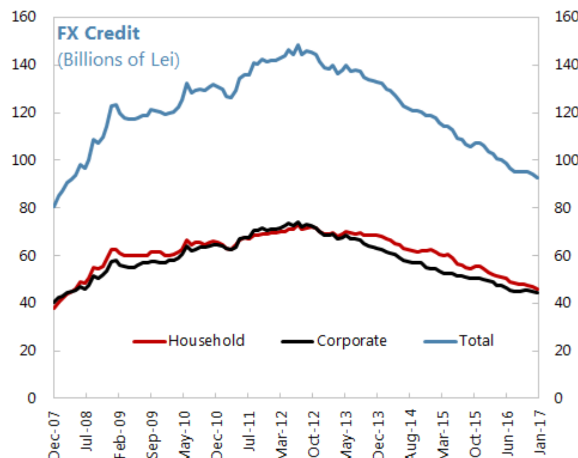
Sources: Romanian authorities; and IMF staff estimates and projections.

Figure 6. Romania: Financial Sector, 2007–17

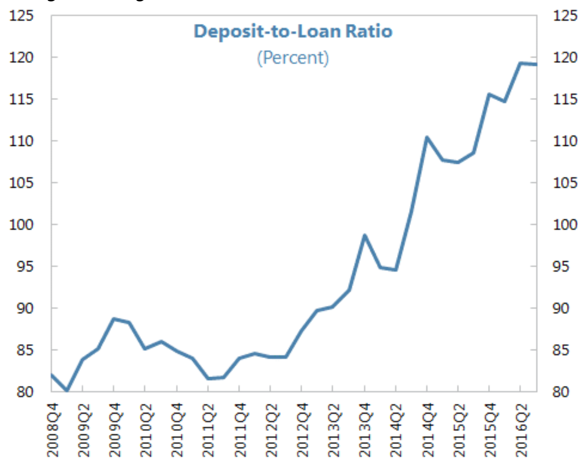
Local currency lending has been picking up...



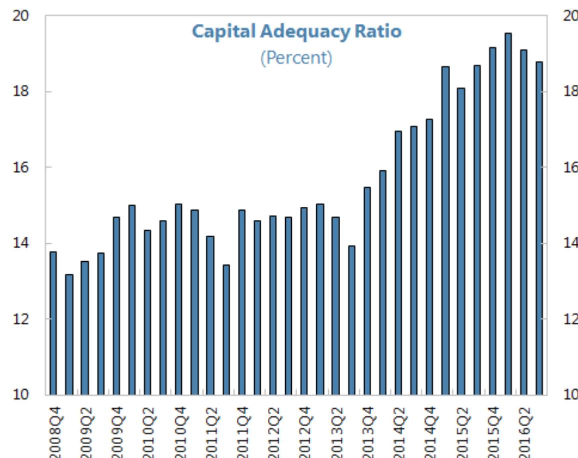
...as the share of FX loans in total credit declines.



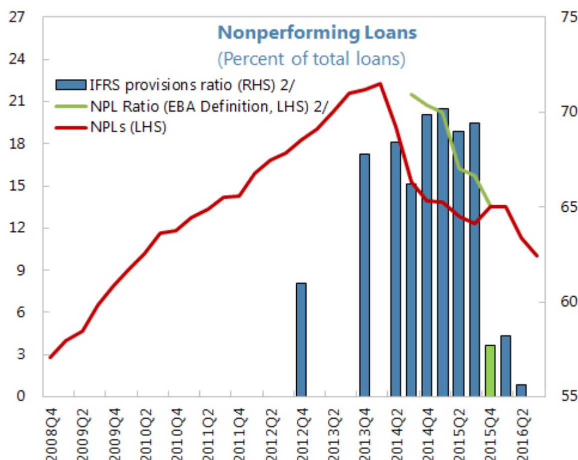
The increase in domestic deposits allows banks to rely less on foreign funding.



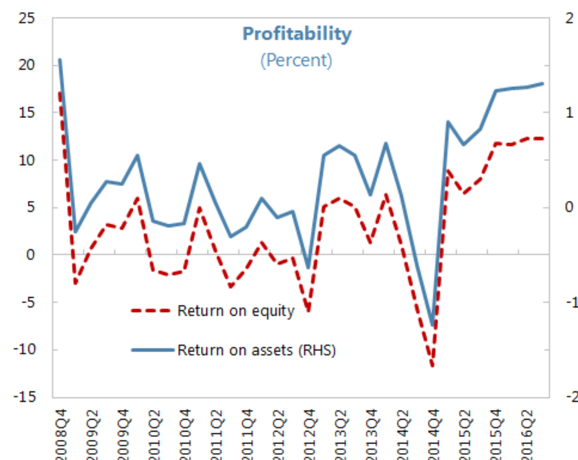
Capital buffers are sufficient to absorb even severe shocks.



Progress in strengthening balance sheets continued...



...while profitability remained high.



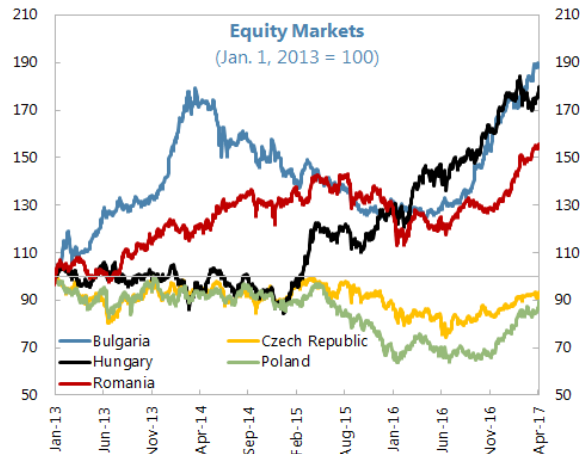
Sources: Dxtime; and National Bank of Romania.

1/ Excludes credit to central government.

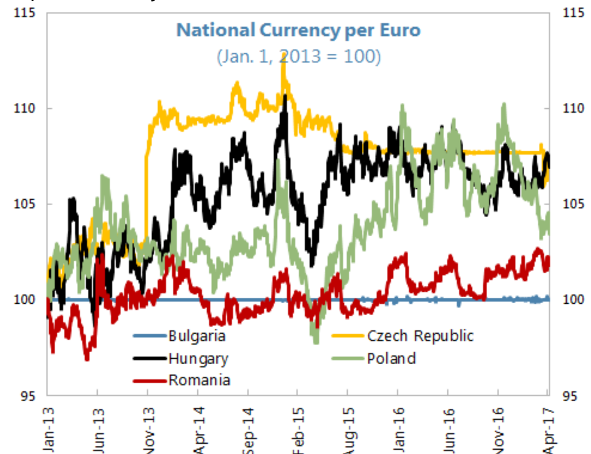
2/ In December, 2015, the NBR moved from a national definition to an EBA methodology-based definition of NPL's.

Figure 7. Romania: Financial Developments, 2013–17

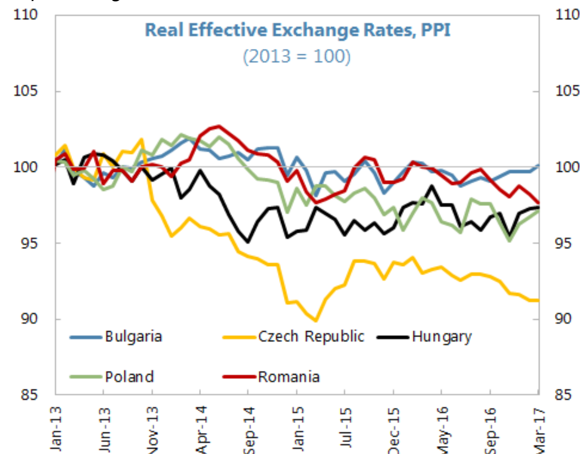
Romania's stock market index has been on an upward trend since late 2016.



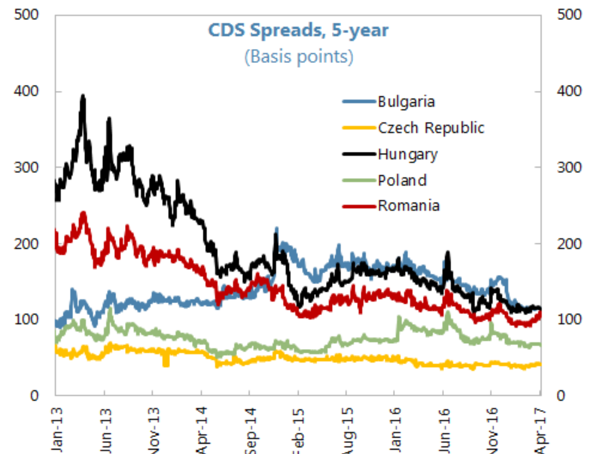
The leu has depreciated by around 2 percent since late September last year.



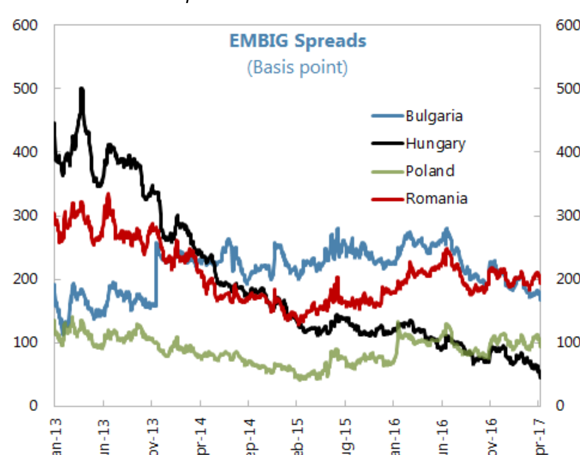
The real effective exchange rate (deflated by PPI) has been depreciating.



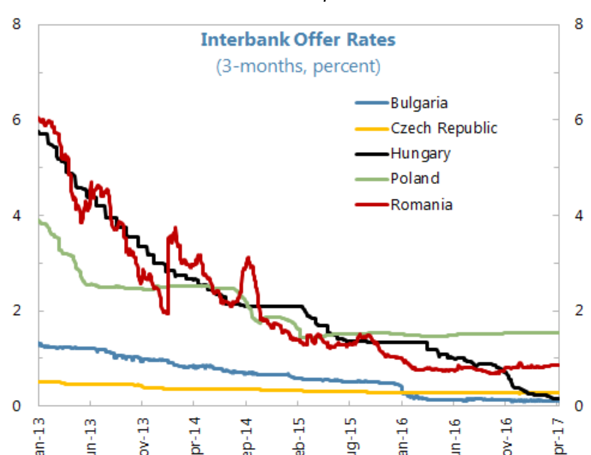
Romania's CDS spread has increased recently.



Romania's EMBIG spreads remain elevated.



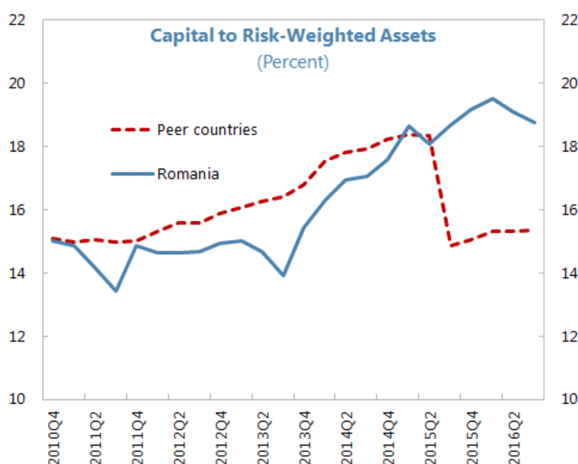
Interbank rates have been almost flat.



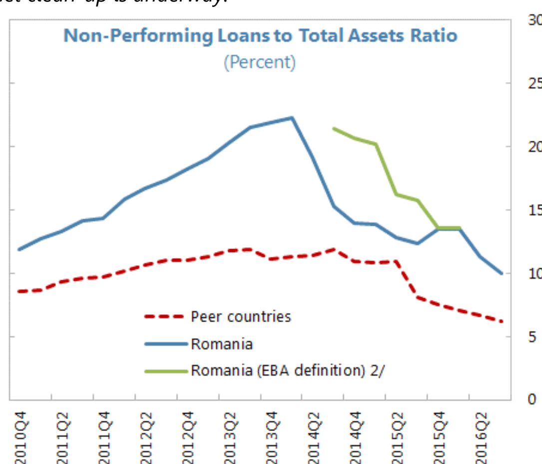
Sources: Bloomberg; and Haver Analytics.

Figure 8. Romania and Peer Countries: Financial Soundness Indicators, 2010-16 1/

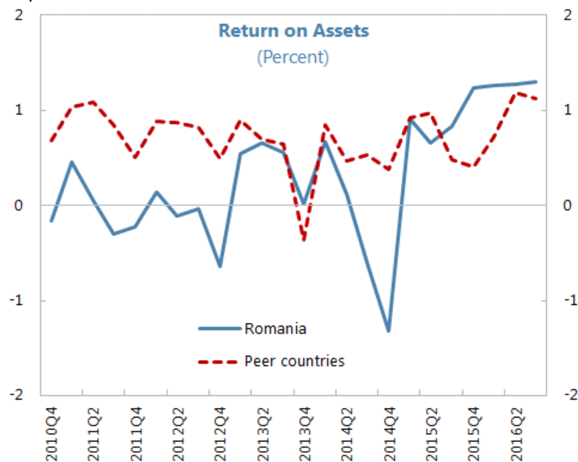
Romanian banks remain well capitalized on average.



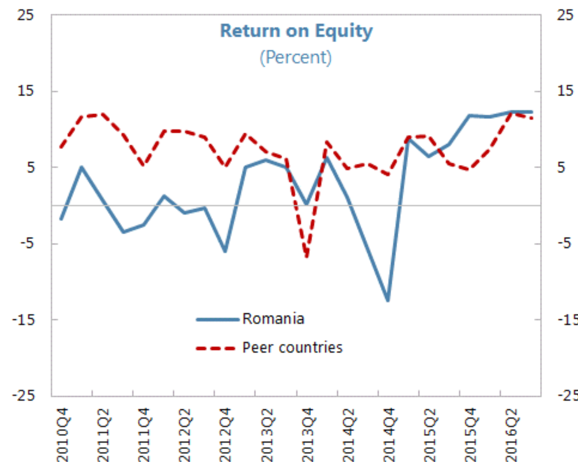
Asset quality has been weaker than in peers, but a balance sheet clean-up is underway.



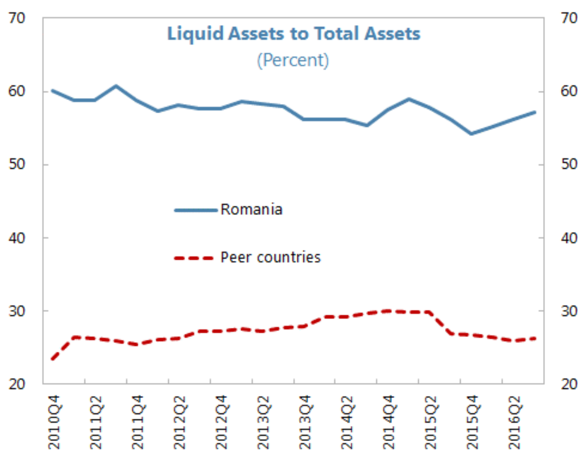
This has weighed on bank profitability more in Romania than in peers...

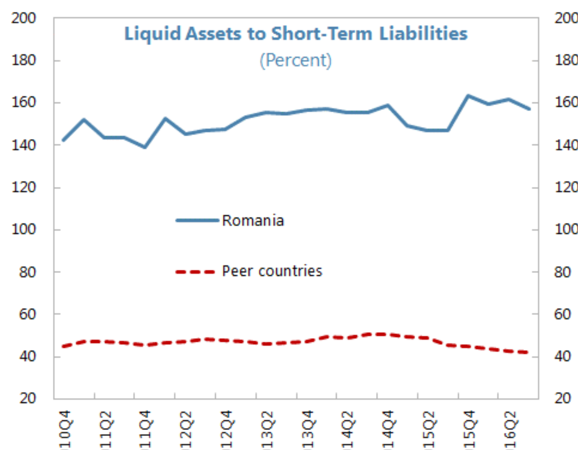


...but profitability has recovered recently.



Romanian banks are generally very liquid.





Sources: Haver Analytics; and National Bank of Romania.
1/ Unweighted average of Bulgaria, Croatia, Czech Republic, Hungary, Poland, Slovakia and Slovenia.
2/ In December, 2015, the NBR moved from a national definition to an EBA methodology-based definition of NPL's.

Table 1. Romania: Selected Economic and Social Indicators, 2011–18

	2011	2012	2013	2014	2015	2016	2017	2018
						Prel.	Proj.	Proj.
Output and prices			(Annual percentage change)					
Real GDP	1.1	0.6	3.5	3.1	3.9	4.8	4.2	3.4
Contributions to GDP growth								
Domestic demand	1.1	-0.5	0.1	3.5	5.8	5.8	4.8	4.0
Net exports	-0.1	1.1	3.5	-0.4	-1.8	-1.0	-0.6	-0.6
Consumer price index (CPI, average)	5.8	3.3	4.0	1.1	-0.6	-1.6	1.3	3.1
Consumer price index (CPI, end of period)	3.1	5.0	1.6	0.8	-0.9	-0.5	2.2	3.1
Core price index (CPI, end of period)	2.4	3.3	-0.1	1.2	-3.1	0.3	2.2	3.0
Producer price index (average)	7.1	5.4	2.1	-0.1	-2.2	-1.8	...	...
Unemployment rate (average)	7.2	6.9	7.1	6.8	6.8	5.9	5.4	5.2
Nominal wages	4.9	5.0	5.0	5.3	8.5	12.8	14.0	5.8
Saving and Investment			(In percent of GDP)					
Gross domestic investment	27.9	26.8	25.6	24.7	25.0	25.0	24.2	24.3
Gross national savings	22.9	22.1	24.5	24.0	23.7	22.7	21.5	21.8
General government finances 1/								
Revenue	32.1	32.4	31.4	32.0	32.8	29.0	29.1	29.3
Expenditure	36.3	34.9	33.9	33.9	34.3	31.4	32.7	33.1
Fiscal balance	-4.2	-2.5	-2.5	-1.9	-1.5	-2.4	-3.7	-3.9
External financing (net)	2.7	3.2	2.1	1.9	-0.5	0.6	1.3	1.3
Domestic financing (net)	2.2	0.9	1.4	1.2	1.1	1.1	2.4	2.6
Primary balance	-2.8	-0.7	-0.8	-0.4	-0.2	-1.1	-2.3	-2.5
Structural fiscal balance 2/	-3.4	-1.6	-1.5	-0.3	-0.5	-2.3	-3.8	-3.9
Gross public debt (including guarantees)	33.9	37.6	38.8	40.5	39.4	39.1	40.5	41.7
Money and credit			(Annual percentage change)					
Broad money (M3)	6.6	2.7	8.8	8.1	9.7	9.7	8.7	7.9
Credit to private sector	6.6	1.3	-3.3	-3.4	3.0	1.2	4.0	4.4
Interest rates, eop 3/			(In percent)					
NBR policy rate	6.0	5.25	4.0	2.50	1.75	1.75	1.75	...
NBR lending rate (Lombard)	10.0	9.25	7.0	4.75	4.25	3.25	3.25	...
Interbank offer rate (1 week)	6.0	5.9	1.8	0.7	0.6	0.6	0.5	...
Balance of payments			(In percent of GDP)					
Current account balance	-4.9	-4.8	-1.1	-0.7	-1.2	-2.3	-2.7	-2.5
Merchandise trade balance	-7.0	-6.9	-4.0	-4.3	-4.9	-5.5	-6.3	-6.1
Exports (goods)	30.1	29.9	30.4	31.1	30.7	30.8	34.8	35.2
Imports (goods)	-37.1	-36.8	-34.4	-35.5	-35.6	-36.2	-41.1	-41.3
Capital account balance	0.5	1.4	2.1	2.6	2.4	2.5	1.1	1.3
Financial account balance	-2.0	-2.6	-3.0	0.1	0.4	-0.5	-2.6	-1.9
Foreign direct investment balance	-1.3	-1.9	-2.0	-1.8	-1.8	-2.3	-2.2	-2.1
International investment position	-64.2	-67.8	-61.7	-56.9	-51.1	-48.6	-48.2	-46.4
Gross official reserves	27.9	26.5	24.6	23.6	22.2	22.4	21.9	20.7
Gross external debt	74.0	74.6	68.0	63.0	56.5	54.6	52.9	49.8
Exchange rates 3/								
Lei per euro (end of period)	4.3	4.4	4.5	4.5	4.5	4.5	4.6	...
Lei per euro (average)	4.2	4.5	4.4	4.4	4.4	4.5	4.5	...
Real effective exchange rate								
CPI based (percentage change)	2.9	-6.0	4.7	0.2	-3.7	-2.3	...	...
GDP deflator based (percentage change)	1.8	-4.8	4.1	0.8	-0.8	1.4	...	...
Memorandum Items:								
Nominal GDP (in bn RON)	565.1	595.4	637.5	668.1	711.1	761.5	806.9	865.2
Potential output growth	2.1	2.4	2.6	2.8	3.0	3.2	3.5	3.5

Social and Other Indicators

GDP per capita: US$ 8,956 (2015); **GDP per capita, PPP:** current international $21,403 (2015)

People at risk of poverty or social exclusion: 37.3% (2015)

Sources: Romanian authorities; IMF staff estimates and projections; World Development Indicators database, Eurostat.

1/ General government finances refer to cash data.

2/ Fiscal balance (cash basis) adjusted for the automatic effects of the business cycle and one-off effects.

3/ For 2017: data as of April 7.

Table 2. Romania: Medium-Term Macroeconomic Framework, Current Policies, 2013–22

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
GDP and prices (annual percent change)										
Real GDP	3.5	3.1	3.9	4.8	4.2	3.4	3.3	3.3	3.3	3.3
Agriculture 1/	33.0	4.1	-11.3	-2.6	...	...	...	...	...	...
Non-Agriculture 1/	1.6	3.2	5.3	5.6	...	...	...	...	...	...
Real domestic demand	-0.1	3.4	5.5	5.5	5.1	3.8	3.6	3.6	3.7	3.4
Consumption	-0.3	4.0	4.9	6.9	5.7	3.5	3.3	3.3	3.3	3.3
Investment	-5.4	3.2	8.3	-3.3	3.7	5.3	4.4	3.9	4.8	4.4
Exports	19.7	8.0	5.4	8.3	7.2	6.5	6.2	6.2	6.2	6.2
Imports	8.8	8.7	9.2	9.8	7.8	7.1	6.5	6.4	6.7	6.0
Consumer price index (CPI, average) 2/	4.0	1.1	-0.6	-1.6	1.3	3.1	2.9	2.6	2.5	2.5
Consumer price index (CPI, end of period) 2/	1.6	0.8	-0.9	-0.5	2.2	3.1	2.7	2.5	2.5	2.5
Saving and investment (in percent of GDP)										
Gross national saving	24.5	24.0	23.7	22.7	21.5	21.8	22.1	22.3	22.4	22.5
Gross domestic investment	25.6	24.7	25.0	25.0	24.2	24.3	24.5	24.6	25.0	25.2
Government	5.6	5.3	6.2	3.8	3.5	3.7	3.8	3.8	4.0	4.1
Private	20.0	19.4	18.7	21.3	20.7	20.7	20.7	20.8	21.0	21.1
General government (in percent of GDP)										
Revenue	31.4	32.0	32.8	29.0	29.1	29.3	29.3	29.4	29.6	29.8
Expenditure	33.9	33.9	34.3	31.4	32.7	33.1	33.1	32.8	32.7	32.6
Fiscal balance	-2.5	-1.9	-1.5	-2.4	-3.7	-3.9	-3.8	-3.4	-3.1	-2.9
Structural fiscal balance 3/	-1.5	-0.3	-0.5	-2.3	-3.8	-3.9	-3.8	-3.4	-2.9	-2.7
Gross general government debt (direct debt only)	36.5	38.1	37.1	37.4	38.9	40.2	41.5	42.5	43.2	43.6
Gross general government debt (including guarantees)	38.8	40.5	39.4	39.1	40.5	41.7	42.9	43.8	44.4	44.8
Monetary aggregates (annual percent change)										
Broad money (M3)	8.8	8.1	9.7	9.7	8.7	7.9	7.3	7.4	6.1	5.2
Credit to private sector	-3.3	-3.4	3.0	1.2	4.0	4.4	3.9	3.9	3.9	3.9
Balance of payments (in percent of GDP)										
Current account	-1.1	-0.7	-1.2	-2.3	-2.7	-2.5	-2.4	-2.3	-2.5	-2.7
Trade balance	-4.0	-4.3	-4.9	-5.5	-6.3	-6.1	-6.1	-6.0	-6.3	-6.5
Services balance	3.3	3.9	4.2	4.5	5.1	5.2	5.2	5.4	5.4	5.5
Income balance	-2.2	-1.3	-2.3	-2.8	-2.9	-2.9	-3.0	-3.1	-3.1	-3.1
Transfers balance	1.9	1.1	1.7	1.5	1.5	1.4	1.4	1.4	1.5	1.5
Capital account balance	2.1	2.6	2.4	2.5	1.1	1.3	1.2	1.2	1.3	1.3
Financial account balance	-3.0	0.1	0.4	-0.5	-2.6	-1.9	-2.3	-2.4	-2.6	-2.7
Foreign direct investment, balance	-2.0	-1.8	-1.8	-2.3	-2.2	-2.1	-2.0	-1.9	-1.8	-1.7
Memorandum items:										
Gross international reserves (in billions of euros)	35.4	35.5	35.5	37.9	39.1	39.7	41.4	44.4	46.6	48.3
Gross international reserves (in months of next year's imports)	6.8	6.4	5.9	5.3	5.1	5.1	5.1	5.1	5.1	5.1
International investment position (in percent of GDP)	-61.7	-56.9	-51.1	-48.6	-48.2	-46.4	-45.1	-43.2	-42.1	-41.3
External debt (in percent of GDP)	68.0	63.0	56.5	54.6	52.9	49.8	47.3	44.9	43.6	41.2
Short-term external debt (in percent of GDP)	13.3	12.6	12.4	13.8	13.4	12.2	11.4	10.7	10.1	9.6
Terms of trade (merchandise, percent change)	0.8	0.8	3.2	0.5	-1.0	1.2	0.5	0.7	-0.1	-0.3
Nominal GDP (in billions of lei)	637.5	668.1	711.1	761.5	806.9	865.2	920.6	979.2	1,037.2	1,099.1
Output gap (percent of potential GDP)	-2.3	-2.1	-1.2	0.3	1.1	0.9	0.7	0.5	0.3	0.0
Potential GDP (percent change)	2.6	2.8	3.0	3.2	3.5	3.5	3.5	3.5	3.5	3.5

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

1/ Based on gross value added data from the National Institute of Statistics (NIS) in Romania. Note that there is a small discrepancy between the supply side GDP data from the NIS and the demand side data from Eurostat.

2/ Staff's inflation projections assume monetary tightening.

3/ Actual fiscal balance adjusted for the automatic effects related to the business cycle and one-off effects.

Table 3. Romania: Balance of Payments, 2012–18

(In billions of euros, unless otherwise indicated)

	2012	2013	2014	2015	2016	2017	2018
					Prel.	Proj.	Proj.
Current account balance	-6.4	-1.5	-1.0	-1.9	-4.0	-4.7	-4.7
Merchandise trade balance	-9.3	-5.8	-6.5	-7.8	-9.3	-11.3	-11.8
Exports (f.o.b.)	39.9	43.9	46.8	49.1	52.2	61.9	67.4
Imports (f.o.b.)	49.2	49.7	53.4	56.9	61.4	73.2	79.1
Services balance	2.5	4.7	5.9	6.8	7.7	9.0	9.9
Exports of non-factor services	9.9	13.4	15.1	16.6	18.0	21.4	23.3
Imports of non-factor services	7.4	8.7	9.2	9.8	10.4	12.3	13.3
Primary income, net	-2.3	-3.1	-2.0	-3.7	-4.8	-5.1	-5.6
Receipts	2.2	2.5	2.3	2.4	2.8	2.8	2.9
Payments	4.5	5.6	4.3	6.1	7.6	8.0	8.6
Secondary income, net	2.7	2.7	1.7	2.8	2.5	2.6	2.8
Capital account balance	1.9	3.0	4.0	3.9	4.2	2.0	2.5
Financial account balance	-3.4	-4.4	0.2	0.6	-0.8	-4.5	-3.7
Foreign direct investment balance	-2.6	-2.9	-2.7	-3.0	-3.9	-3.9	-4.0
Portfolio investment balance	-3.4	-5.5	-2.9	0.0	-1.2	-2.3	-2.4
Other investment balance	2.5	4.0	5.8	3.6	4.3	1.7	2.8
General government	0.4	0.9	0.4	0.4	0.8	0.9	1.5
Domestic banks	2.2	2.5	4.1	2.4	4.1	1.9	1.7
Other private sector	-0.1	0.7	1.3	0.8	-0.7	-1.1	-0.4
Errors and omissions	1.2	0.2	0.1	0.3	1.3	0.0	0.0
Multilateral financing	1.0	0.7	0.3	-0.8	0.0	-0.7	-0.9
European Commission	0.0	0.0	0.0	-1.5	0.0	-1.2	-1.4
World Bank	0.0	0.7	0.3	0.8	0.0	0.5	0.5
Overall balance	1.1	6.8	3.2	0.9	2.4	1.8	1.5
Financing	-1.1	-6.8	-3.2	-0.9	-2.4	-1.8	-1.5
Gross international reserves ("-": increase)	1.5	-2.1	1.2	0.6	-2.3	-1.1	-0.6
Use of IMF credit, net	-1.6	-4.6	-4.4	-1.5	-0.1	0.0	0.0
Purchases 1/	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-1.6	-4.6	-4.4	-1.5	-0.1	0.0	0.0
Other liabilities, net	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:			(In percent of GDP)				
Current account balance	-4.8	-1.1	-0.7	-1.2	-2.3	-2.7	-2.5
Foreign direct investment balance	-1.9	-2.0	-1.8	-1.8	-2.3	-2.2	-2.1
Merchandise trade balance	-6.9	-4.0	-4.3	-4.9	-5.5	-6.3	-6.1
Exports	29.9	30.4	31.1	30.7	30.8	34.8	35.2
Imports	36.8	34.4	35.5	35.6	36.2	41.1	41.3
Gross external financing requirement	33.9	31.6	27.9	27.4	22.8	22.8	22.3
			(Annual percent change)				
Terms of trade (merchandise)	-3.4	0.8	0.8	3.2	0.5	-1.0	1.2
Export volume	1.0	19.7	8.0	5.4	8.3	7.2	6.5
Import volume	-1.8	8.8	8.7	9.2	9.8	7.8	7.1
Export prices	-5.2	-1.1	-1.7	0.3	-1.9	9.8	2.1
Import prices	1.1	-5.5	-2.5	-2.8	-2.4	10.8	1.0
			(In billions of euros)				
Gross international reserves 2/	35.4	35.4	35.5	35.5	37.9	39.1	39.7
Excluding IMF credit	24.4	29.5	35.5	35.4	37.9	39.1	39.7
of which: Excluding banks' required reserves							
GDP	133.6	144.3	150.3	160.0	169.6	178.1	191.5

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

Table 4. Romania: Gross External Financing Requirements, 2012–18

(In billions of euros, unless otherwise indicated)

	2012	2013	2014	2015	2016 Prel.	2017 Proj.	2018 Proj.
Total financing requirements 1/	**44.0**	**49.8**	**48.5**	**49.3**	**57.3**	**36.4**	**38.5**
Current account deficit	5.8	1.3	1.0	1.9	4.0	4.7	4.7
Short-term debt	25.8	22.2	21.0	19.9	24.1	22.4	23.4
Public sector	7.5	8.6	9.1	8.5	9.0	9.0	9.0
Banks	14.1	9.0	7.8	7.7	8.8	6.2	5.6
Corporates	4.2	4.6	4.0	3.7	6.3	7.3	8.9
Maturing medium- and long-term debt	12.1	26.5	25.7	26.5	27.5	9.2	10.3
Public sector	2.8	15.2	17.6	16.6	20.7	1.3	2.4
Banks	4.9	6.5	3.9	6.1	2.5	3.7	3.7
Corporates	4.4	4.8	4.2	3.8	4.3	4.2	4.2
Other net capital outflows 2/	0.3	-0.2	0.8	0.9	1.6	0.0	0.0
Total financing sources	**42.3**	**56.3**	**51.2**	**50.6**	**58.3**	**38.2**	**39.9**
Foreign direct investment, net	2.2	3.1	2.7	3.0	3.9	3.9	4.0
Capital account inflows	1.9	3.2	4.0	3.9	4.2	2.0	2.5
Short-term debt	23.3	22.4	19.6	21.6	23.9	22.9	22.9
Public sector	6.7	8.1	9.3	8.3	9.1	9.0	9.0
Banks	12.1	9.0	6.4	9.0	7.5	5.6	5.0
Corporates	4.5	5.2	3.9	4.3	7.3	8.4	8.9
Medium- and long-term debt	14.9	27.5	25.0	22.2	26.3	9.3	10.5
Public sector	6.7	20.5	19.5	16.4	21.6	2.7	3.3
Banks	5.1	3.8	2.4	3.0	0.7	2.4	2.6
Corporates	3.1	3.2	3.1	2.9	4.0	4.2	4.6
Errors and omissions	0.9	-0.4	0.1	0.3	1.3	0.0	0.0
Increase in gross international reserves	-1.4	2.1	-1.2	-0.6	2.3	1.1	0.6
Financing gap	**-0.6**	**-3.9**	**-4.1**	**-2.3**	**-0.1**	**-0.7**	**-0.9**
Program financing	**-0.6**	**-3.9**	**-4.1**	**-2.3**	**-0.1**	**-0.7**	**-0.9**
IMF 3/	-1.6	-4.6	-4.4	-1.5	-0.1	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-1.6	-4.6	-4.4	-1.5	-0.1	0.0	0.0
European Commission	0.0	0.0	0.0	-1.5	0.0	-1.2	-1.4
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Principal repayments	0.0	0.0	0.0	-1.5	0.0	-1.2	-1.4
Others	1.0	0.7	0.3	0.8	0.0	0.5	0.5
World Bank	0.0	0.7	0.3	0.8	0.0	0.5	0.5
EIB/EBRD/IFC	1.0	…	…	…	…	…	…
Memorandum items:							
Rollover rates for amortizing debt ST (in percent)							
Public sector	90	95	102	99	101	100	100
Banks	85	100	82	117	85	90	90
Corporates	107	113	96	114	115	115	100
Rollover rates for amortizing debt MLT (in percent)							
Public sector	240	134	111	99	104	216	140
Banks	104	59	60	48	29	65	70
Corporates	71	67	74	75	93	100	110
Rollover rates for total amortizing debt (in percent)							
Public sector	131	120	108	99	103	114	108
Banks	90	83	75	87	72	81	82
Corporates	89	90	85	94	106	110	103
Gross international reserves 4/	35.4	35.4	35.5	35.5	37.9	39.1	39.7
Coverage of gross international reserves							
Months of imports of GFNS (next year)	7.3	6.8	6.4	5.9	5.3	5.1	4.8
Short-term external debt (in percent)	80.3	86.6	84.6	102.1	105.6	102.6	116.1

Sources: Romanian authorities; and IMF staff estimates and projections.
1/ The sharp increase in financing requirements in 2016 is partly due to the changes in the methodology of collecting data for short term debt for corporates.
2/ Includes portfolio equity, financial derivatives and other investments.
3/ SDR interest rate as well as exchange rate of SDR/US$ and US$/€ of January 15, 2015.
4/ Operational definition.

Table 5a. Romania: General Government Operations, 2012–2018 1/

(In percent of GDP)

	2012	2013	2014	2015	2016 Prel.	2017 Proj.	2018 Proj.
Revenue	32.4	31.4	32.0	32.8	29.0	29.1	29.3
Taxes	27.8	27.2	27.3	27.5	26.0	26.0	25.9
Corporate income tax	2.0	1.9	2.0	2.1	2.2	2.2	2.2
Personal income tax	3.5	3.6	3.5	3.8	3.7	3.8	3.8
VAT	8.5	8.1	7.6	8.0	6.8	6.5	6.5
Excises	3.4	3.3	3.6	3.7	3.5	3.2	3.1
Customs duties	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	8.7	8.5	8.6	8.1	8.0	8.7	8.7
Other taxes	1.6	1.7	1.8	1.7	1.6	1.5	1.5
Nontax revenue	3.1	2.7	2.6	2.7	2.4	2.3	2.2
Capital revenue	0.1	0.1	0.2	0.1	0.1	0.1	0.1
Grants, including EU disbursements	1.4	1.4	1.7	2.4	0.5	0.6	1.1
Expenditure	34.9	33.9	33.9	34.3	31.4	32.7	33.1
Current expenditure	31.8	31.2	31.5	31.9	28.9	30.2	31.2
Compensation of employees	6.9	7.3	7.5	7.3	7.5	8.3	8.3
Goods and services	5.8	6.1	5.9	5.7	5.4	5.2	5.1
Interest	1.8	1.7	1.5	1.3	1.3	1.4	1.4
Subsidies	1.0	0.8	0.9	0.9	0.9	0.8	0.8
Transfers	16.1	15.3	15.5	16.5	13.8	14.3	15.5
Pensions	8.1	7.7	7.7	7.2	6.8	7.0	7.4
Other social transfers	3.2	3.0	2.9	3.4	4.0	4.2	4.0
Other transfers 2/	4.3	4.0	4.2	5.3	2.5	2.5	3.3
Other spending	0.5	0.5	0.6	0.6	0.5	0.6	0.6
Projects with external credits	0.3	0.1	0.1	0.1	0.1	0.1	0.1
Capital expenditure 3/	3.2	2.8	2.6	2.6	2.5	2.5	1.9
Reserve fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Net lending and expense refunds	-0.1	-0.2	-0.1	-0.1	0.0	0.0	0.0
Fiscal balance	-2.5	-2.5	-1.9	-1.5	-2.4	-3.7	-3.9
Primary balance	-0.7	-0.8	-0.4	-0.2	-1.1	-2.3	-2.5
Financing	2.5	2.5	1.9	1.5	2.4	3.7	3.9
External borrowing (net)	3.2	2.1	1.9	-0.5	0.6	1.3	1.3
Domestic borrowing (net)	0.9	1.4	1.2	1.1	1.3	2.4	2.6
Use of deposits	-1.7	-1.0	-1.3	1.3	0.5	0.0	0.0
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities							
Gross general-government debt 4/	37.6	38.8	40.5	39.4	39.1	40.5	41.7
Gross general-government debt excl. guarantees	35.3	36.5	38.1	37.1	37.4	38.9	40.2
External	17.0	18.0	19.9	18.6	18.3	18.6	18.6
Domestic	18.3	18.5	18.1	18.5	19.0	20.3	21.5
Memorandum items:	0.4	0.0	0.3	0.2	-1.2	-2.6	-2.8
Total capital spending	6.4	5.6	5.3	6.2	3.8	3.5	3.7
Fiscal balance (ESA2010 basis)	-3.7	-2.1	-1.4	-0.8	-3.0	-3.8	-4.0
Output gap 5/	-3.1	-2.3	-2.1	-1.2	0.3	1.1	0.9
Cyclically adjusted balance 6/	-1.4	-1.7	-1.2	-1.0	-2.5	-4.0	-4.2
CAPB 6/	0.3	-0.1	0.3	0.2	-1.2	-2.6	-2.8
Structural fiscal balance 6/	-1.6	-1.5	-0.3	-0.5	-2.3	-3.8	-3.9
Gross general government debt (authorities definition) 7/	40.5	41.9	44.3	44.4	44.5	…	…
Nominal GDP (in billions of lei)	595.4	637.5	668.1	711.1	761.5	806.9	865.2

Sources: Ministry of Public Finance; Eurostat; and IMF staff estimates and projections.

1/ Unless otherwise noted, the table is on a cash basis following GFSM 86. The general government is composed of the central government, local governments, social security funds, and the road fund company.

2/ Includes EU-financed capital projects.

3/ Does not include all capital spending.

4/ Total consolidated general-government debt, including state government debt, local government debt, and guarantees.

5/ Percentage deviation of actual from potential GDP.

6/ Expressed in percentage of potential GDP.

7/ Includes guarantees and intra-governmental debt.

Table 5b. Romania: General Government Operations, 2012–2018
(In millions of lei)

	2012	2013	2014	2015	2016 Prel	2017 Proj.	2018 Proj.
Revenue	193,148	200,038	213,834	233,554	220,783	234,525	253,297
Taxes	165,702	173,489	182,586	195,906	197,676	209,897	223,794
Corporate income tax	11,826	12,191	13,684	14,803	16,394	17,814	19,101
Personal income tax	20,956	22,736	23,692	27,288	28,384	30,843	33,144
VAT	50,516	51,827	50,879	57,132	51,675	52,671	55,877
Excises	20,260	21,106	24,095	26,018	26,957	25,816	26,694
Customs duties	707	620	643	816	883	1,061	1,144
Social security contributions	51,658	54,379	57,612	57,604	61,274	69,979	75,275
Other taxes	9,778	10,630	11,982	12,245	12,110	11,713	12,560
Nontax revenue	18,328	17,153	17,188	19,495	18,411	18,684	19,261
Interest Revenue	279	182	157	743	353	379	406
Capital revenue	653	650	1,073	918	769	802	829
Grants	8,422	9,112	11,189	16,984	3,927	5,143	9,412
Financial operations and other	43	-365	1,798	250	0	0	0
Expenditure	207,921	215,810	226,327	243,915.5	239,082	264,049	286,731
Current expenditure	189,274	198,957	210,136	226,688	220,067	243,616	270,123
Compensation of employees	40,799	46,299	50,247	52,026	57,040	67,040	72,169
Goods and services	34,444	38,580	39,582	40,808	40,950	42,120	44,305
Interest	10,710	10,749	10,199	9,572	10,008	11,686	12,531
Subsidies	6,122	5,150	6,094	6,275	6,605	6,688	6,899
Transfers	95,585	97,310	103,422	117,552	105,019	115,602	133,705
Pensions	48,051	49,374	51,539	51,539	51,707	56,630	64,448
Other social transfers	18,997	19,005	19,663	24,407	30,130	33,926	34,995
Other transfers 1/	25,569	25,712	27,942	37,618	19,210	20,484	28,892
Other spending	2,968	3,219	4,278	3,988	3,972	4,562	5,370
Projects with external credits	1,614	869	592	456	444	480	514
Capital expenditure 2/	19,305	17,855	17,140	18,263	19,015	20,330	16,608
Reserve fund	0	0	0	0	0	104	0
Net lending and expense refunds	-657	-1,002	-949	-1,036	0	0	0
Fiscal balance	-14,774	-15,772	-12,493	-10,361	-18,299	-29,524	-33,434
Primary balance	-4,343	-5,206	-2,451	-1,532	-8,643	-18,217	-21,309
Financing	14,774	15,772	12,493	10,361	18,299	29,524	33,434
External borrowing (net)	19,271	13,351	12,591	-3,809	4,889	10,463	11,035
Domestic borrowing (net)	5,305	8,972	8,194	7,693	9,814	19,012	22,349
Use of deposits	-9,916	-6,630	-8,745	9,004	3,545	0	0
Privatization proceeds	5	25	0	0	50	50	50
Financial liabilities							
Gross general-government debt 3/	224,040	247,499	270,338	280,173	297,588	327,062	360,446
Gross general-government debt excl. guarantees	210,254	232,766	254,472	264,032	284,587	314,061	347,445
External	101,476	114,997	133,248	132,597	139,718	150,180	161,216
Domestic	108,778	117,769	121,224	131,435	144,869	163,881	186,229
Memorandum item:							
Total capital spending	37,954	35,730	35,294	44,330	30,831	28,000	31,642
Gross general government debt (authorities definition) 4/	240,843	267,151	295,656	315,692	339,220	…	…

Sources: Ministry of Public Finance; Eurostat; and IMF staff estimates and projections.

1/ Includes EU-financed capital projects.

2/ Does not include all capital spending.

3/ Total consolidated general-government debt, including state government debt, local government debt, and guarantees.

4/ Includes guarantees and intra-governmental debt.

Table 5c. Romania: Consolidated General Government Balance Sheet, 2011–2015
(In millions of lei, unless otherwise indicated)

	2011	2012	2013	2014	2015
Net worth and its changes:	**495,615**	**489,343**	**510,588**	**524,783**	**561,369**
Nonfinancial assets	**582,568**	**597,894**	**643,361**	**665,701**	**706,420**
Fixed assets	568,669	583,573	628,600	648,789	687,028
Buildings and structures	....	....	....	....	....
Machinery and equipment	....	....	....	....	....
Other fixed assets	....	....	....	....	....
Inventories	13,899	14,321	14,761	16,912	19,392
Valuables	....	....	....	....	....
Nonproduced assets	....	....	....	....	....
Financial assets	**153,768**	**171,254**	**170,764**	**187,473**	**190,889**
by instrument					
Monetary gold and SDRs	-	-	-	-	-
Currency and deposits	19,658	31,956	38,464	49,353	46,012
Securities other than shares	-	187	187	197	100
Loans	6,633	6,666	6,603	6,610	6,718
Shares and other equity	81,654	82,983	74,215	78,397	76,308
Insurance technical reserves	-	-	18	23	123
Financial derivatives	-	-	-	-	-
Other accounts receivable	45,824	49,463	51,277	52,894	61,627
by debtor					
Domestic	139,375	154,013	152,498	167,534	165,341
Foreign	14,394	17,241	18,266	19,939	25,547
Liabilities	**240,722**	**279,805**	**303,537**	**328,391**	**335,939**
by instrument					
Special Drawing Rights (SDRs)	-	-	-	-	-
Currency and deposits	6,398	4,987	4,222	6,755	8,754
Securities other than shares	110,589	143,517	165,716	199,583	210,816
Loans	81,530	82,485	81,495	76,214	70,365
Shares and other equity	5,583	2	-	-	-
Insurance technical reserves	89	128	164	202	259
Financial derivatives	69	-	-	-	-
Other accounts payable	36,463	48,685	51,939	45,638	45,746
by debtor					
Domestic	131,876	151,745	157,658	170,175	179,712
Foreign	108,845	128,059	145,879	158,216	156,227
Memorandum items					
Net financial worth	(86,953)	(108,550)	(132,773)	(140,917)	(145,051)
Maastricht debt	193,217	221,873	240,777	263,153	270,121
Memorandum:					
Nominal GDP (Lei - billions)	565.1	595.4	637.5	668.1	711.1

Sources: Romanian authorities; Eurostat; and IMF staff calculations.

Table 6. Romania: Monetary Survey, 2012–18
(In millions of lei, unless otherwise indicated; end of period)

	2012	2013	2014	2015	2016	2017	2018
					Prel.	Proj.	Proj.
				I. Banking System			
Net foreign assets	**30,203**	**60,659**	**94,282**	**108,650**	**139,667**	**152,919**	**163,045**
In millions of euros	6,820	13,525	21,035	24,014	30,756	33,832	36,112
o/w commercial banks	-18,594	-15,953	-11,778	-9,799	-5,781	-3,854	-2,176
Net domestic assets	**191,815**	**180,937**	**167,549**	**177,605**	**174,495**	**188,473**	**205,444**
General government credit, net	49,599	44,985	39,194	46,676	36,429	44,604	53,503
Private sector credit	225,836	218,462	211,164	217,399	220,091	228,895	238,966
Other	-83,620	-82,510	-82,809	-86,470	-82,026	-85,026	-87,026
Broad Money (M3)	**222,018**	**241,547**	**261,831**	**286,256**	**314,162**	**341,392**	**368,488**
Money market instruments	188	296	258	129	109	118	127
Intermediate money (M2)	221,830	241,251	261,573	286,126	314,053	341,274	368,361
Narrow money (M1)	89,020	100,311	118,582	149,550	180,014	194,273	209,692
Currency in circulation	31,477	34,785	39,890	46,482	54,750	59,087	63,776
Overnight deposits	57,543	65,526	78,691	103,069	125,264	135,186	145,916
				II. National Bank of Romania			
Net foreign assets	**112,552**	**132,202**	**147,071**	**152,988**	**165,921**	**170,341**	**172,870**
In millions of euros	25,414	29,479	32,813	33,813	36,538	37,686	38,288
Net domestic assets	**-55,244**	**-63,537**	**-78,694**	**-78,998**	**-80,455**	**-78,105**	**-73,314**
General government credit, net	-24,973	-31,204	-41,757	-37,675	-47,449	-43,449	-41,449
Credit to banks, net	-14,443	-23,266	-24,064	-27,465	-17,583	-24,107	-23,107
Other	-15,828	-9,067	-12,873	-13,857	-15,423	-10,549	-8,757
Reserve money	**57,308**	**68,666**	**68,377**	**73,990**	**85,466**	**92,236**	**99,557**
				(Annual percent change)			
Broad money (M3)	2.7	8.8	8.4	9.3	9.7	8.7	7.9
NFA contribution	6.7	13.7	13.9	5.5	10.8	4.2	3.0
NDA contribution	-4.0	-4.9	-5.5	3.8	-1.1	4.4	5.0
Reserve money	-6.9	19.8	-0.4	8.2	15.5	7.9	7.9
NFA contribution	4.0	34.3	21.7	8.7	17.5	5.2	2.7
NDA contribution	-10.9	-14.5	-22.1	-0.4	-2.0	2.7	5.2
Domestic credit, real	-4.8	-5.9	-5.8	6.6	-2.3	4.3	3.7
Private sector, real	-3.5	-4.8	-4.2	4.0	1.8	1.7	1.2
Public sector, real	-10.2	-11.1	-13.4	20.5	-21.5	19.8	16.3
Broad money (M3), in real terms	-2.2	7.1	7.2	10.7	10.3	6.3	4.7
Private credit, nominal	1.3	-3.3	-3.4	3.0	1.2	4.0	4.4
Memorandum items:							
CPI inflation, eop	5.0	1.6	0.8	-0.9	-0.5	2.2	3.1
NBR inflation target band	2.0 - 4.0	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5
Interest rates (percent)							
Policy interest rate	5.25	4.00	2.75	1.75	1.75	1.75	…
Interbank offer rate, 1 week	5.9	1.8	0.7	0.6	0.6	0.5	
Corporate loans 1/	9.8	6.8	5.9	4.4	3.7	3.9	…
Household time deposits 1/	5.6	3.9	2.8	1.5	0.9	0.9	…
Share of foreign currency private deposits	36.7	34.5	33.9	33.3	32.3	…	…
Share of foreign currency private loans	62.5	60.9	56.3	49.3	42.8	…	…

Sources: National Bank of Romania; and IMF staff estimates and projections.

1/ Rates for new local currency denominated transactions.

Table 7. Romania: Financial Soundness Indicators, 2010–16

(In percent)

	2010 Dec.	2011 Dec.	2012 Dec.	2013 Dec.	2014 Dec.	2015 Dec.	2016 Dec. Prel.
Core indicators							
Capital adequacy							
Capital to risk-weighted assets	15.0	14.9	14.9	15.5	17.6	19.2	18.3
Tier 1 capital to risk-weighted assets (1/)	14.2	13.9	13.8	14.1	14.6	16.7	16.2
Asset quality							
Nonperforming loans (2/) to total gross loans	11.9	14.3	18.2	21.9	20.7	13.5	9.5
IFRS Provisions for NPLs / NPLs	...	...	76.7	67.8	69.8	57.7	56.2
Earnings and profitability							
Return on assets	-0.2	-0.2	-0.6	0.0	-1.3	1.2	1.1
Return on equity (3/)	-1.7	-2.6	-5.9	0.1	-12.5	11.8	10.7
Net interest income to operating income	60.6	62.0	62.3	58.8	58.6	58.5	56.3
Noninterest expense to operating income (cost to income)	64.9	67.8	58.7	56.7	55.4	57.6	53.0
Personnel expense to operating income	21.0	21.9	26.0	25.5	24.9	26.6	24.7
Liquidity							
Liquid assets (4/) to total assets	60.0	58.7	57.6	56.3	57.4	54.2	53.4
Liquid assets (4/) to short-term liabilities (5/)	142.2	151.8	147.7	156.3	158.9	163.4	156.3
Liquid assets (4/) to total attracted and borrowed sources	80.9	75.8	76.4	73.5	74.1	57.0	55.6
Foreign exchange risk							
Net open position in foreign exchange, in percent of capital	-1.4	-4.7	-1.8	2.5	-2.0	0.8	0.5
Lending in foreign exchange, in percent of non-gov. credit	63.0	63.4	62.5	60.9	56.2	49.3	42.8
Foreign currency liabilities, in percent of total attracted and borrowed sources	43.5	44.8	46.3	45.2	42.9	41.5	34.5
Deposits in foreign exchange, in percent of non-gov. dom. deposits	36.0	33.5	36.4	34.1	33.2	32.4	31.3
Encouraged indicators							
Deposit-taking institutions							
Leverage ratio (6/)	8.1	8.1	8.0	7.9	7.4	8.2	8.3
Personnel expenses to noninterest expenses	32.3	32.3	44.3	44.9	45.0	46.2	46.6
Customer deposits to total (non-interbank) loans	84.8	84.0	87.3	98.7	109.5	116.5	130.8
Loan-to-Deposit (LTD) Ratio	117.9	119.1	114.5	101.3	91.3	85.8	80.3
Structural indicators (November 2016)							
Number of banks: 37; Number of foreign-owned subsidiaries/branches: 23/8; Share of deposits/loans of 5 largest banks: 60.4 percent/56.9 percent							

Source: National Bank of Romania.

1/ For 2010, market and operational risk are not used in compiling risk weighted assets.

2/ In December 2015, the NBR moved from a national definition to an EBA methodology-based definition of NPL's.

3/ Return on equity is calculated as net profit/loss to average own capital.

4/ Liquid assets = balance sheet assets and off balance sheets items with residual maturity of up to 3 months.

5/ Short term liabilities = balance sheet liabilities and off balance sheet items with residual maturity of up to 3 months.

6/ Tier 1 capital to average assets.

Annex I. Debt Sustainability Analysis

Public debt in Romania is expected to remain relatively low but rise gradually over the medium term. Under the baseline scenario, the public debt-to-GDP ratio is projected to reach 44.8 percent by 2022 from the current level of 39.1 percent. Gross financing needs (around 9 percent of GDP in 2016) are expected to remain contained below 10 percent over the projection horizon. While the DSA suggests that public debt is sustainable under various shocks (including the contingent liabilities' shock), shocks to real GDP growth shift the debt trajectory up significantly: debt reaches 55 percent by 2022 in the standard real GDP growth shock scenario and 60 percent by 2022 in the recession scenario.[1] Furthermore, exchange rate volatility and exposure to international capital outflows continue to present notable risks, with their associated debt profile vulnerability indicators exceeding the upper early warning benchmarks.

Public Debt

A. Comparison with the Previous Assessment

1. The baseline debt trajectory is higher relative to last year's DSA.[2] Despite a slightly lower-than-expected debt outturn in 2016 and a higher projection for GDP growth in 2017, gross public debt (including guarantees) is 0.2 percentage points higher in 2017 relative to the previous forecast (40.3 versus 40.5 percent to GDP) and 0.7 percentage points higher by the end of the projection period (44.2 versus 44.8 percent of GDP). This outcome is mainly driven by the higher expected budget deficits relative to last year's DSA. Under the baseline, which incorporates the most recent procyclical fiscal measures, the budget deficit is expected to exceed 3 percent every year until 2021, thus violating the 3 percent rule under the Stability and Growth Pact. The budget deficit does however gradually decline after 2018, reaching 2.9 percent of GDP by 2022 as absorption of EU-funds improves and replaces capital spending financed directly out of the budget.

B. Baseline and Realism of Projections

2. Debt level. Under the baseline scenario, gross debt level (including guarantees) is projected to rise gradually over the medium term, reaching 44.8 percent in 2022. Gross financing needs over the same period are projected to remain below 10 percent of GDP, averaging around 8 percent of GDP.

3. Fiscal balance and adjustment. In the baseline projection, the budget deficit worsens in 2017 and 2018, before gradually improving over the remainder of the projection horizon and reaching 2.9 percent of GDP in 2022. On the revenue side, the deterioration in the budget in 2017 and 2018 is driven by the revenue cuts that will be implemented in 2017 as well as the 2015 tax

[1] This scenario assumes a drop in real GDP growth to 0.5 percent in 2018, with a gradual recovery thereafter.

[2] 2016 Romania Article IV Staff Report (IMF Country Report No. 16/113).

code measures that entered into effect in 2017. As some of the 2017 revenue cuts will be implemented in the later months of 2017, the full effect of these measures is taken into account in 2018. On the spending side, the projections incorporate the effects of the wage and pension increases that will be implemented in 2017. As with the revenue projections, the full effect of these measures is taken into account in 2018. Over the medium term, revenue and expenditure projections are driven by the macroeconomic projections for key variables[3] and the assumption that absorption of EU funds will gradually improve over the medium term.[4] Considering the distribution of fiscal adjustment episodes provided in the DSA template (Figure 2), the projected 3-year adjustment in the cyclically-adjusted primary balance (CAPB) of 1.0 percent of GDP indicates that there may be more room for adjustment in Romania. Similarly, the 3-year average level of the CAPB places Romania in the lower end of the distribution for comparator countries.

4. Growth. Compared to outcomes, past projections of growth suggest moderate forecast errors, with the median forecast error in line with comparator countries. Considering the high sensitivity of Romania's debt dynamics to surprises in GDP growth, there seems to be no systematic projection bias in the baseline assumption for growth that could undermine the DSA assessment (Figure 2). The current real GDP growth projection of 4.2 percent for 2017 is lower than the authorities' estimate of 5.2 percent. Reflecting the temporary nature of the fiscal impulse in 2017 and the slow progress in structural reforms, medium-term growth is expected to stabilize at 3.3 percent of GDP. The boom-bust analysis is not triggered because the three-year cumulative change in the credit-to-GDP ratio does not exceed 15 percent in Romania.

5. Maturity and rollover risks. To manage financing risk, the authorities maintain a foreign currency financing buffer (excluding privatization proceeds). Most of longer-term debt consists of official financing, while the average maturity of government securities issued on the domestic market is 3.5 years. The authorities have been addressing rollover risks under a debt management strategy which aims to issue longer-term securities as well as lengthen the yield curve. However, public debt continues to be vulnerable to exchange rate risk, with foreign currency denominated debt accounting for about half of total public debt and non-residents' share in domestic debt securities holdings at 17.6 percent.

C. Stochastic Simulations

6. The fan charts illustrate the possible evolution of the debt ratio over the medium term and are based on both the symmetric and asymmetric distributions of risk. Under the symmetric distribution of risk, there is a high level of certainty that debt will remain below 60 percent of GDP (threshold under the Stability and Growth Pact) over the medium term. However, if restrictions are

[3] Including GDP, inflation, imports, the exchange rate, employment growth, and wage growth.

[4] Higher absorption of EU funds leads to higher grants and lower capital spending directly funded out of the budget. Both of these in turn result in a slight increase in total capital spending over the medium term.

imposed on the primary balance,[5] there is a 75 percent certainty that debt will not exceed 60 percent of GDP in the medium term.

D. Stress Tests

7. Real GDP growth. The debt ratio remains under 60 percent of GDP under all scenarios[6] (Figure 5) – however, it is most sensitive to the real GDP growth shock, under which debt reaches about 55 percent of GDP. This scenario also results in a marked increase in public gross financing needs in the period 2017-2019, in excess of the 10 percent threshold. The sensitivity of Romania's public debt is further evident in the illustrative recession scenario which assumes a growth of 0.5 percent in 2018 and a slow recovery thereafter (Figure 4). Under this scenario, public debt reaches 60 percent in 2022 and public gross financing needs average around 11 percent of GDP over the medium term.

8. Combined shock. A combined shock incorporates the largest effect of individual shocks on all relevant variables (real GDP growth, inflation, primary balance, exchange rate and interest rate). Under this scenario, debt would reach 60 percent of GDP in 2022 without showing signals of a declining trajectory. Gross financing needs peak at around 13 percent of GDP in 2019, averaging 12 percent in the remaining years of the projection horizon.

[5] This is the asymmetric scenario, where it is assumed that there are no positive shocks to the primary balance.

[6] Including a contingent liability shock (Figure 5). Barring unexpected events, the effect on public debt of potential contingent liabilities of the government would be limited. SOE debt is estimated at around 7 percent of GDP (including SOEs under insolvency procedures).

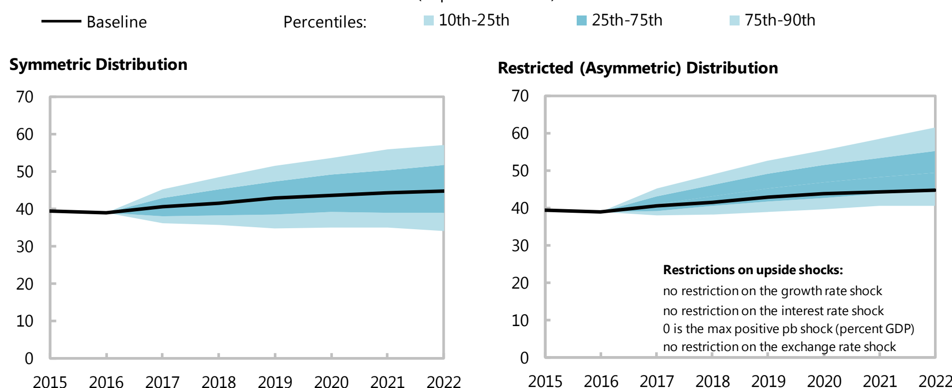
Annex I. Figure 1. Romania Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

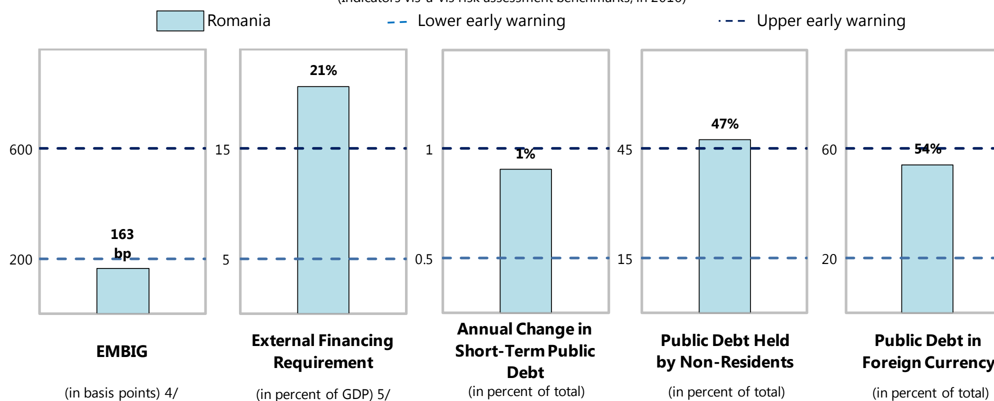
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2016)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

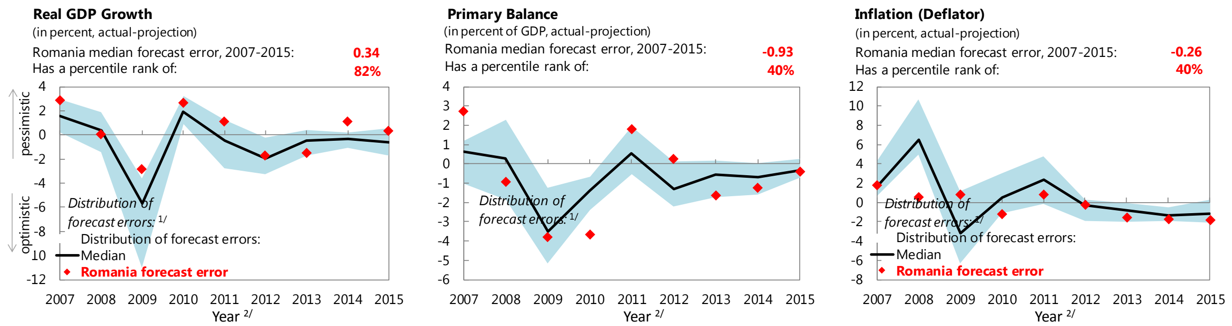
200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 27-Dec-16 through 27-Mar-17.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

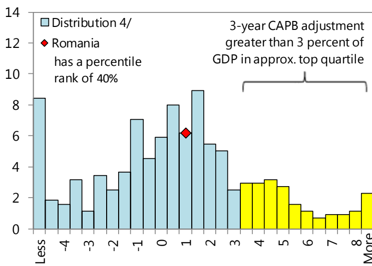
Annex I. Figure 2. Romania Public DSA – Realism of Baseline Assumptions

Forecast Track Record, versus program countries

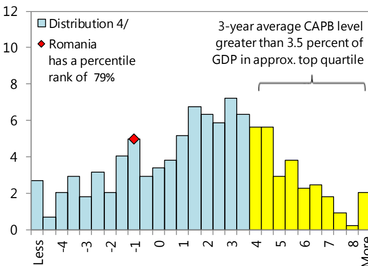


Assessing the Realism of Projected Fiscal Adjustment

3-Year Adjustment in Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)

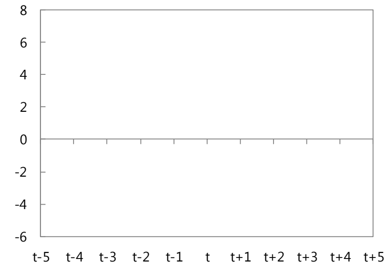


3-Year Average Level of Cyclically-Adjusted Primary Balance (CAPB)
(Percent of GDP)



Boom-Bust Analysis 3/

Real GDP growth
(in percent)
Romania



Source : IMF Staff.
1/ Plotted distribution includes program countries, percentile rank refers to all countries.
2/ Projections made in the spring WEO vintage of the preceding year.
3/ Not applicable for Romania.
4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Annex I. Figure 3. Romania Public Sector DSA – Baseline Scenario

(In percent of GDP, unless otherwise indicated)

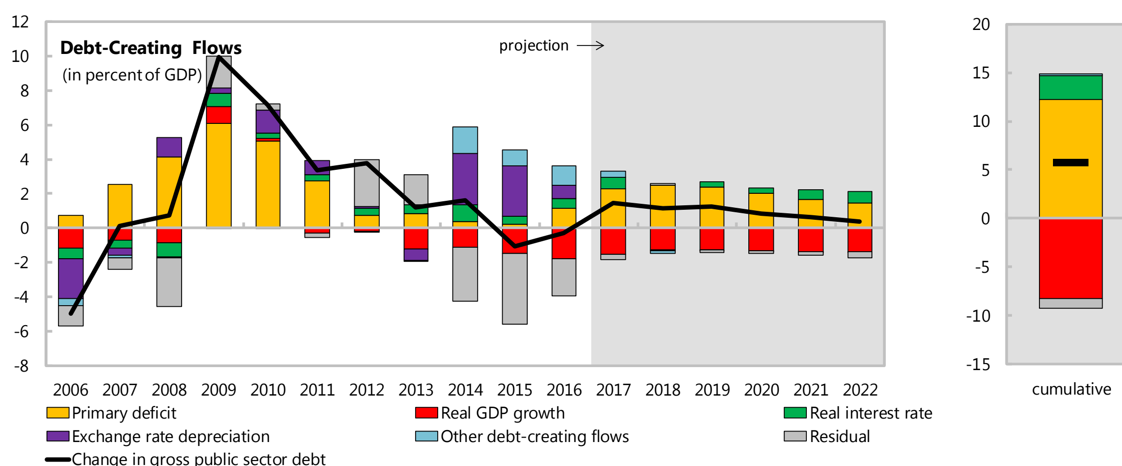
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2006-2014 [2]	2015	2016	2017	2018	2019	2020	2021	2022
Nominal gross public debt	27.0	39.4	39.1	40.5	41.7	42.9	43.8	44.4	44.8
Public gross financing needs	10.2	8.6	9.1	9.1	9.4	7.6	7.9	7.6	8.0
Real GDP growth (in percent)	2.6	3.9	4.8	4.2	3.4	3.3	3.3	3.3	3.3
Inflation (GDP deflator, in percent)	7.1	2.4	2.2	1.7	3.7	3.0	3.0	2.5	2.6
Nominal GDP growth (in percent)	10.0	6.4	7.1	6.0	7.2	6.4	6.4	5.9	6.0
Effective interest rate (in percent) [4]	7.0	3.8	3.8	3.6	3.7	3.9	3.8	3.9	4.2

As of March 27, 2017		
Sovereign Spreads		
5Y CDS (bp)		100
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2006-2014	2015	2016	2017	2018	2019	2020	2021	2022	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	2.5	-1.1	-0.3	1.4	1.1	1.3	0.8	0.6	0.4	5.7	
Identified debt-creating flows	2.7	3.0	1.8	1.8	1.0	1.4	1.0	0.9	0.7	6.7	
Primary deficit	2.6	0.2	1.1	2.3	2.5	2.4	2.0	1.7	1.5	12.3	-0.7
Primary (noninterest) revenue and grants	31.7	32.7	28.9	29.0	29.2	29.3	29.3	29.6	29.7	176.1	
Primary (noninterest) expenditure	34.2	33.0	30.1	31.3	31.7	31.7	31.3	31.3	31.2	188.4	
Automatic debt dynamics [5]	0.0	1.9	-0.4	-0.9	-1.3	-1.0	-1.1	-0.8	-0.7	-5.8	
Interest rate/growth differential [6]	-0.3	-1.0	-1.2	-0.9	-1.3	-1.0	-1.1	-0.8	-0.7	-5.8	
Of which: real interest rate	0.2	0.5	0.6	0.7	0.0	0.3	0.3	0.5	0.6	2.4	
Of which: real GDP growth	-0.5	-1.5	-1.8	-1.5	-1.3	-1.3	-1.3	-1.4	-1.4	-8.2	
Exchange rate depreciation [7]	0.4	2.9	0.8	…	…	…	…	…	…	…	
Other identified debt-creating flows	0.1	0.9	1.1	0.4	-0.1	0.0	0.0	0.0	0.0	0.2	
Privatization receipts (negative)	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits	0.2	0.9	1.1	0.4	-0.1	0.0	0.0	0.0	0.0	0.3	
Residual, including asset changes [8]	-0.2	-4.1	-2.2	-0.3	0.1	-0.1	-0.1	-0.2	-0.4	-1.0	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees, defined as .

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as [(r - π(1+g) - g + ae(1+r)]/(1+g+π+gπ)) times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as r - π (1+g) and the real growth contribution as -g.

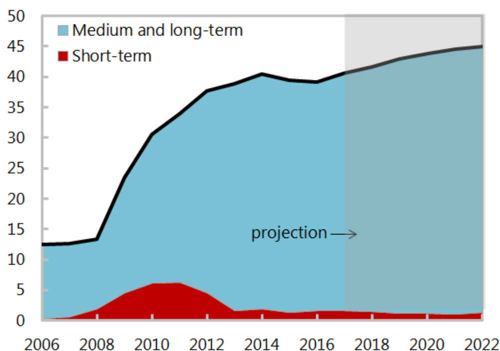
7/ The exchange rate contribution is derived from the numerator in footnote 5 as ae(1+r).

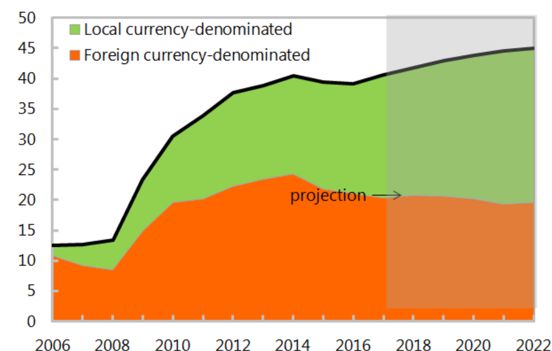
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

Annex I. Figure 4. Romania Public DSA – Composition of Public Debt and Alternative Scenarios

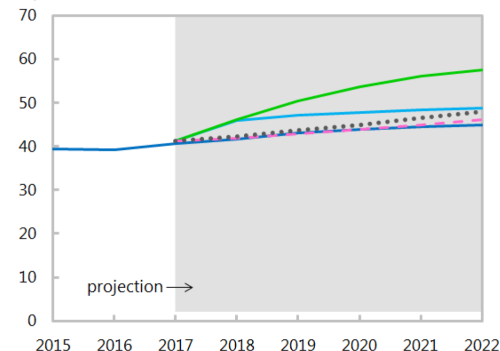
Composition of Public Debt

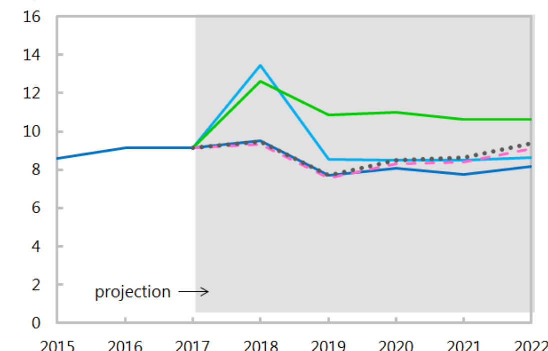




Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Recession scenario
Constant Primary Balance





Underlying Assumptions
(in percent)

Baseline Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	3.4	3.3	3.3	3.3	3.3
Inflation	2.0	3.8	3.0	3.0	2.6	2.6
Primary Balance	-2.3	-2.5	-2.4	-2.1	-1.7	-1.5
Effective interest rate	3.6	3.7	3.9	3.8	3.9	4.2
Constant Primary Balance Scenario						
Real GDP growth	4.2	3.4	3.3	3.3	3.3	3.3
Inflation	2.0	3.8	3.0	3.0	2.6	2.6
Primary Balance	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	3.6	3.7	3.8	3.7	3.9	4.2
Recession scenario						
Real GDP growth	4.2	0.5	1.0	1.5	2.0	2.5
Inflation	2.0	3.8	3.0	3.0	2.6	2.6
Primary Balance	-2.3	-5.4	-4.7	-3.9	-3.0	-2.3
Effective interest rate	3.6	3.7	4.0	3.9	4.2	4.5

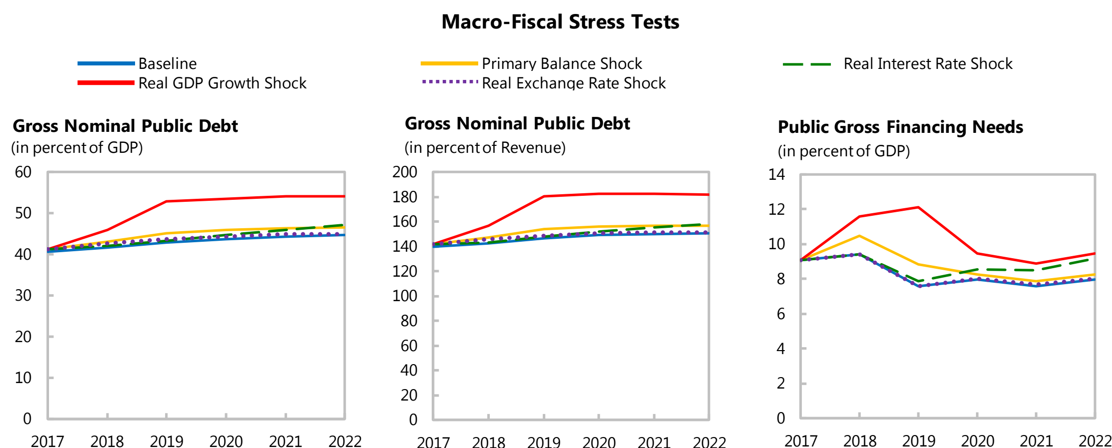
Historical Scenario	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	2.4	2.4	2.4	2.4	2.4
Inflation	2.0	3.8	3.0	3.0	2.6	2.6
Primary Balance	-2.3	-2.4	-2.4	-2.4	-2.4	-2.4
Effective interest rate 1/	3.6	3.7	3.8	3.6	3.8	4.1
Contingent Liability Shock						
Real GDP growth	4.2	3.4	3.3	3.3	3.3	3.3
Inflation	2.0	3.8	3.0	3.0	2.6	2.6
Primary Balance	-2.3	-6.2	-2.4	-2.1	-1.7	-1.5
Effective interest rate 1/	3.6	4.2	4.2	4.0	4.2	4.4

1/ Declining effective interest rate reflects negative historical real interest rates in Romania during the reference period.

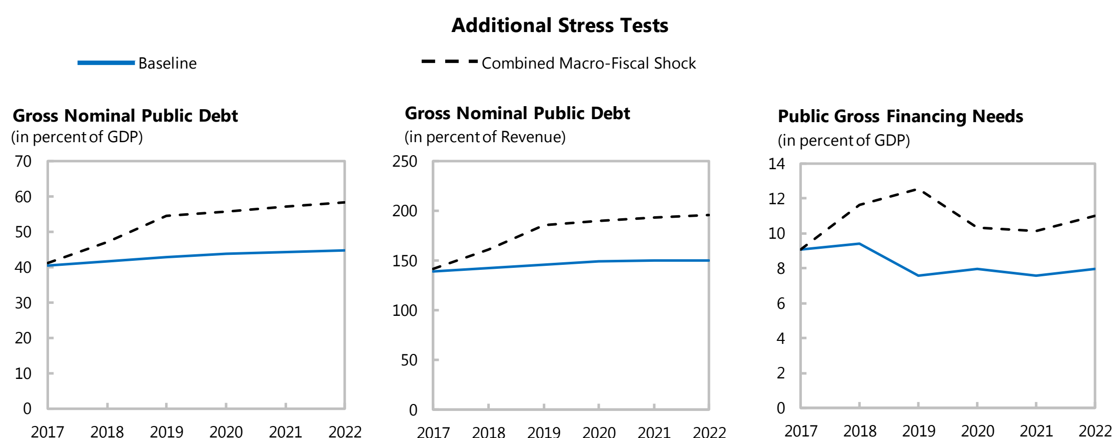
Source: IMF staff.

Annex I. Figure 5. Romania Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions

(in percent)

Primary Balance Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	3.4	3.3	3.3	3.3	3.3
Inflation	1.7	3.7	3.0	3.0	2.5	2.6
Primary balance	-2.3	-3.5	-3.4	-2.0	-1.7	-1.5
Effective interest rate	3.6	3.7	3.9	3.9	4.1	4.3
Real Interest Rate Shock						
Real GDP growth	4.2	3.4	3.3	3.3	3.3	3.3
Inflation	1.7	3.7	3.0	3.0	2.5	2.6
Primary balance	-2.3	-2.5	-2.4	-2.0	-1.7	-1.5
Effective interest rate	3.6	3.7	4.7	5.2	5.9	6.6
Combined Shock						
Real GDP growth	4.2	-1.0	-1.1	3.3	3.3	3.3
Inflation	1.7	2.6	1.9	3.0	2.5	2.6
Primary balance	-2.3	-4.2	-6.0	-2.0	-1.7	-1.5
Effective interest rate	3.6	3.8	4.8	5.4	6.1	6.8

Real GDP Growth Shock	2017	2018	2019	2020	2021	2022
Real GDP growth	4.2	-1.0	-1.1	3.3	3.3	3.3
Inflation	1.7	2.6	1.9	3.0	2.5	2.6
Primary balance	-2.3	-4.2	-6.0	-2.0	-1.7	-1.5
Effective interest rate	3.6	3.7	4.0	4.1	4.3	4.5
Real Exchange Rate Shock						
Real GDP growth	4.2	3.4	3.3	3.3	3.3	3.3
Inflation	1.7	5.1	3.0	3.0	2.5	2.6
Primary balance	-2.3	-2.5	-2.4	-2.0	-1.7	-1.5
Effective interest rate	3.6	3.8	3.8	3.7	3.9	4.2

Source: IMF staff.

External Debt

9. The projected medium term (in 2022) current account deficit of -2.7 percent of GDP is in line with a declining external debt-to-GDP ratio. The current account deficit adjusted remarkably since the global financial crisis, from above 10 percent of GDP in 2008 to below 2 percent of GDP by 2013, due to strong exports and import compression. The deficit has steadily widened since then, particularly last year, on the back of strong imports owing to improved consumption. The current account deficit in the last two years was financed by a combination of private and public inflows. In particular, the strong increase in FDI inflows helped to finance the widening current account deficit in 2016. Going forward, FDI net flows is projected to continue contributing partly towards financing the current account deficit. The external debt, as a share of GDP, has been on a downtrend since 2012 due to the decline in private external liabilities, partly reflecting deleveraging in the banking sector. Going forward, the external debt as a share of GDP is expected to continue to fall gradually.

10. The external debt sustainability analysis indicates that the projected current account deficits remain sustainable. Gross external debt, at 54.6 percent of GDP in 2016, was 2.0 percentage points lower than 2015. In absolute euro terms, the gross external debt was around EUR 2 billion higher in 2016 compared to the previous year. Around one-third of the external debt stock was public debt. Around 25 percent of the external debt was at short-term maturities, mainly on the non-bank sector. Short-term financing risk for non-bank private sector is expected to be limited as a substantial portion of the short-term debt is intra-company loans with relatively low rollover risks.

11. Romania could be vulnerable if negative global market sentiment or domestic risks (e.g. recent political developments) lead to sharp currency depreciation. Bound tests reveal that a 30 percent currency depreciation shock would markedly increase the external-debt-to-GDP ratio over the medium team. A current account shock (excluding interest rate payments, average of 3.3 percent of GDP in the period 2018-2022) would maintain the external-debt-to-GDP ratio around current levels. However, other standard shocks would only lead to a slower decline in the external-debt-to-GDP ratio.

Annex I. Table 1. Romania: External Debt Sustainability Framework, 2012-2022

(In percent of GDP, unless otherwise indicated)

	Actual				Est.			Projections						
	2012	2013	2014	2015	2016			2017	2018	2019	2020	2021	2022	Debt-stabilizing non-interest current account 6/
Baseline: External debt	74.6	68.0	63.0	56.5	54.6			**52.9**	**49.8**	**47.3**	**44.9**	**43.6**	**41.2**	**-2.7**
Change in external debt	1.7	-6.6	-5.0	-6.5	-2.0			-1.6	-3.2	-2.4	-2.5	-1.3	-2.4	
Identified external debt-creating flows (4+8+9)	-1.0	-6.4	-3.8	-4.3	-3.1			-1.6	-1.2	-1.0	-1.0	-0.6	-0.4	
Current account deficit, excluding interest payments	2.3	-1.6	-1.6	-0.6	0.9			0.9	0.7	0.8	0.7	1.0	1.3	
Deficit in balance of goods and services	5.1	0.8	0.4	0.6	0.9			1.2	1.0	0.9	0.6	0.9	1.0	
Exports	37.3	39.7	41.2	41.1	41.4			46.8	47.3	47.7	48.5	49.3	50.0	
Imports	42.3	40.5	41.6	41.7	42.3			48.0	48.3	48.6	49.1	50.2	51.1	
Net non-debt creating capital inflows (negative)	-2.1	-1.9	-1.7	-1.8	-2.2			-2.1	-2.0	-1.9	-1.8	-1.8	-1.7	
Automatic debt dynamics 1/	-1.2	-2.9	-0.5	-2.0	-1.8			-0.4	0.1	0.1	0.1	0.1	0.0	
Contribution from nominal interest rate	2.5	2.6	2.3	1.8	1.4			1.8	1.7	1.7	1.6	1.5	1.4	
Contribution from real GDP growth	-1.2	-2.4	-2.0	-2.3	-2.6			-2.2	-1.7	-1.5	-1.5	-1.4	-1.4	
Contribution from price and exchange rate changes 2/	-2.5	-3.1	-0.7	-1.5	-0.6			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	2.7	-0.2	-1.2	-2.1	1.1			0.0	-1.9	-1.4	-1.4	-0.7	-2.0	
External debt-to-exports ratio (in percent)	200.2	171.1	153.0	137.6	131.8			113.1	105.2	99.2	92.6	88.5	82.3	
Gross external financing need (in billions of Euros) 4/	42.0	45.6	41.9	43.9	38.7			40.7	42.8	39.1	39.7	40.5	41.1	
in percent of GDP	31.4	31.6	27.9	27.4	22.8			22.8	22.3	19.2	18.3	17.6	16.8	
Scenario with key variables at their historical averages 5/								**52.9**	**51.0**	**49.1**	**47.2**	**45.8**	**43.2**	**-5.2**
Key Macroeconomic Assumptions Underlying Baseline						10-Year Historical Average	10-Year Standard Deviation							
Real GDP growth (in percent)	1.7	3.5	3.1	3.9	4.8	3.3	4.6	4.2	3.4	3.3	3.3	3.3	3.3	
GDP deflator in Euros (change in percent)	3.6	4.3	1.1	2.4	1.1	4.7	7.7	0.8	4.0	3.1	3.1	2.7	2.7	
Nominal external interest rate (in percent)	3.6	3.8	3.5	3.1	2.6	4.0	1.0	3.4	3.5	3.6	3.6	3.5	3.4	
Growth of exports (Euro terms, in percent)	22.7	15.1	8.0	6.2	6.8	14.5	13.4	18.7	8.8	7.5	8.1	7.8	7.8	
Growth of imports (Euro terms, in percent)	16.2	3.3	7.1	6.6	7.5	11.5	18.1	19.2	8.1	7.2	7.5	8.5	7.9	
Current account balance, excluding interest payments	-2.3	1.6	1.6	0.6	-0.9	-3.5	4.9	-0.9	-0.7	-0.8	-0.7	-1.0	-1.3	
Net non-debt creating capital inflows	2.1	1.9	1.7	1.8	2.2	3.5	2.5	2.1	2.0	1.9	1.8	1.8	1.7	

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, e = nominal appreciation (increase in Euro value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

3/ For projection, line includes the impact of price and exchange rate changes.

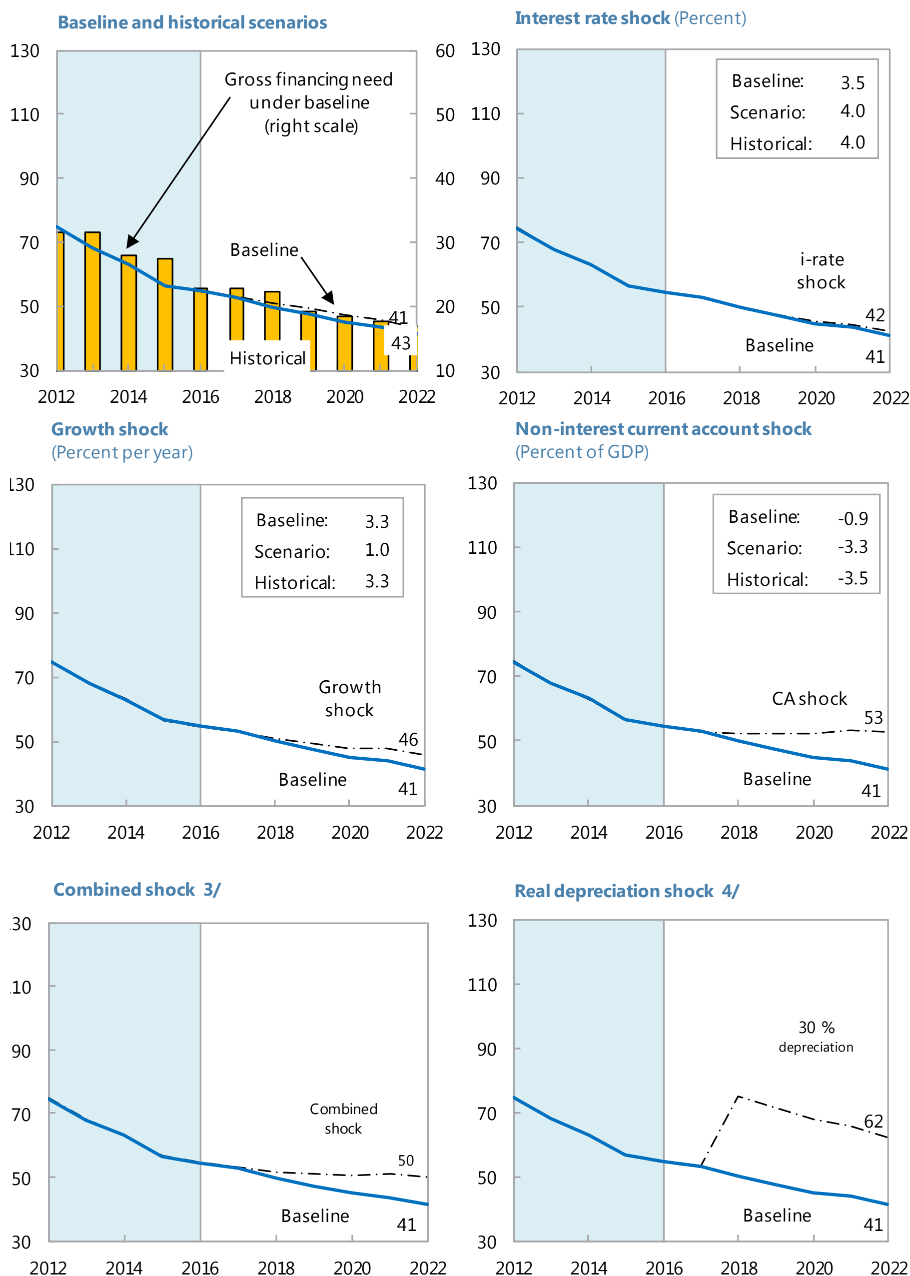
4/ Defined as current account deficit, plus amortization on medium- and long-term debt, plus short-term debt at end of previous period.

5/ The key variables include real GDP growth; nominal interest rate; Euro 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, Euro deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Romania: External Debt Sustainability: Bound Tests 1/ 2/

(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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2018.

Annex II. Risk Assessment Matrix (RAM) [1/]

Risk	Relative Likelihood and Transmission Channels	Expected Impact if Risk is Realized	Policy Response
1. Significant further strengthening of the US dollar and/or higher rates	Medium • Investors may sell Romanian financial assets after reassessment of risks and increases in U.S. term premia.	Medium • Increase in borrowing costs • Risk of exchange rate overshooting and financial instability	• Utilize some of fiscal financing buffer until markets settle down. • Allow for exchange rate flexibility while offsetting excessive market volatility
2. Policy uncertainty and divergence	High • Heightened political tensions may lead to economic disruption, and adverse market sentiment, reflected in consumption and investment decisions.	Medium • Increase in borrowing costs • Sudden capital outflows • Slower growth	• Preemptively increase FX reserves • Maintain adequate fiscal buffers
3. Weaker-than-expected global growth	Medium • Exports could fall, particularly if the euro area enters into a protracted period of slower growth. • FDI could drop as investors reassess future euro area demand for Romanian exports.	Medium • Lower growth, higher unemployment • Potential widening of the current account deficit	• Allow limited use of automatic stabilizers to work as a sharp fiscal deterioration could worsen market sentiment • Improve competitiveness through strengthening structural reforms
4. Continued fiscal relaxation	High/Medium • Loss of recently built fiscal credibility and associated worsening of market sentiment • Romania enters EU's Excessive Deficit Procedure and public debt rises.	Medium • Borrowing costs increase and private investment is crowded out weighing on growth prospects • Further widening of the current account deficit	• Restrain future wage increases, cut lower priority expenditure • Improve tax administration to raise more revenues
5. Slippages in structural reforms	High/Medium • Bottlenecks in public administration continue to hamper public investment and EU funds absorption.	Medium • Delay in much-needed infrastructure upgrade would constrain growth prospects.	• Improve EU projects implementation capacity • Improve investment prioritization, strengthen public investment review process, improve procurement framework • Strengthen anti-corruption efforts

1/ The RAM shows events that could materially alter the baseline path. (The scenario most likely to materialize in the view of IMF staff.) The relative likelihood of risks is staff's subjective assessment of risks surrounding the baseline. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. Implementation of the 2016 Article IV Key Recommendations

Key Recommendations	Policy Actions
	Fiscal
Anchor fiscal policy on a debt reduction path including by repealing / postponing the planned tax reductions and gradually reduce deficits	The 2016 deficit outturn was in line with IMF-recommended target mostly due to under-execution of the EU-funded capital budget and public debt as a share of GDP declined. However, the 2017 budget envisages a substantially higher deficit raising the public debt ratio.
Improve revenue administration	The authorities undertook a TADAT assessment and requested follow up TA on the large tax payers' unit. The tax compliance gap (particularly for VAT) remains substantial.
Strengthen fiscal institutions and the efficiency of public administration	An expenditure review at the Ministry of Transport (with support from FAD technical assistance) was completed, the government plans to proceed with a pilot review at the Ministry of Health.
	Monetary and financial
Maintain policy stance but signal a tightening bias.	Policy rate was kept unchanged in 2016. Interventions in the foreign exchange market became limited.
Safeguard financial stability in the face of legislative initiatives.	Rulings by the constitutional court have significantly limited the adverse impact from legislation that would have allowed debtors to walk away from mortgages and convert Swiss Franc denominated loans at historical exchange rates. The Swiss Franc conversion law was declared unconstitutional.
Continue reducing non-performing loans (NPL)	The central bank has continued efforts towards further NPL reduction and a sharp recent reduction in the NPL ratio to below 10 percent from 22 percent in 2014.
	Structural reforms
Raise quality of public investment and increase EU funds absorption.	EU funds absorption accelerated towards the end of the commitment program but there was a very slow start into the new programming period, suggesting limited progress in improving the quality of public investment management institutions, mainly in the areas of planning and execution.
Improve financial performance of state-owned enterprise (SOE) sector through better governance and restructuring	Law 111 on SOE corporate governance was passed by parliament. There was very limited progress in SOE restructuring, and privatization and initial public offerings attempts were unsuccessful.
Avoid minimum wage increases beyond productivity gains.	The minimum wage was increased by about 19 percent in 2016, and further increased in 2017 by about 16 percent, surpassing productivity gains.

Annex IV. Selected Structural Reform Areas

Priority reform areas	Selected recommendations
1. Public administration	
Human resource management. The public administration currently lacks a uniform approach to human resources management. Frequent institutional reorganizations impact negatively on the independence of the civil service, the predictability of decision-making, and on career-building for civil servants. Ad hoc salary increases take place outside an overall plan to address recruitment, evaluation and promotion.	Adopt a general and transparent approach on public service human resource management, including a civil service strategy closely interlinked with the revision of the unified wage law.
Public procurement system. Deficiencies in the current system are an obstacle to providing value added to public investment and may be responsible for low absorption of EU funds.	A new Public Procurement Authority (ANAP) was created in 2015 and public procurement laws (transposing EU directives), including secondary legislation were enacted in 2016. Further effort is needed to reinforce ex-ante and internal controls of ANAP and the contracting authorities, to strengthen anticorruption measures, to adopt web-based guidelines for contracting authorities, and to provide further training to public procurement officers.
State-owned enterprises. Law 111 on SOE's corporate governance was passed in 2016 in line with international good practices. Romania has resumed hiring professional managers in several SOEs but progress has been slow. SOEs listing and privatization has stalled and financial performance of main SOEs remains weak.	Speed up Hidroelectrica's Board appointment and listing. Prepare timeline for listings of Constanta Port, Bucharest Airports and Posta Romania. Strengthen the capacity of the MoFP unit to monitor financial performance indicators of SOEs and oversight a smooth implementation of Law 111.
Tax administration. Despite recent measures adopted by ANAF and ongoing reorganization, tax evasion is high and a low level of tax compliance (particularly for the VAT) remain a challenge.	Policy priorities could address: (1) Operational planning and performance monitoring; (2) Management of compliance and institutional risk; (3) Constraints in updating the taxpayer database; (4) Weaknesses in the audit program; (5) Inadequate risk screening of VAT refunds. There is an urgent need to upgrade the IT system.
Burden of government regulation. Together with legal uncertainty continue to weigh on competitiveness. Cumbersome administrative procedures and fast-changing legislation and policies are detrimental factors to doing business in Romania.	Proceed with the implementation of the Public Administration Strategy of 2014 related to improving public policies and regulation, reducing red tape, strengthening human resources management, and improving the provision of public services and local public administration.
2. Labor market	
Active labor market measures. Comprehensive measures were adopted in 2016 to improve active labor market participation but youth unemployment remains elevated. Initiatives such as the Youth Guarantee have only partially reached young people not in employment, education or training.	Develop a national apprenticeship plan for the priority sectors identified in the national competitiveness strategy. Support the development of a more integrated approach, offering pathways to unemployed youth that are also not in training.
National Employment Agency. In 2016, the agency implemented reforms to improve service delivery and developed a profiling procedure for jobseekers. The agency needs to further strengthen its capacity to attract vacancies or to offer attractive services to employers.	Support the implementation of a plan to facilitate coordinated actions with social assistance and education counsellors. Strengthen the capacity of the agency by providing further training to its counsellors in case management and by hiring professionals oriented towards youth and long-term unemployed.
Minimum-wage setting. A study on the impact of minimum wage increases was undertaken, but a minimum wage setting mechanism, based on clear and objective criteria related to economic and labor market conditions, is not yet in place.	Prepare a proposal to establish a transparent mechanism for minimum wage setting.

Source: Staff analysis based on European Commission country reports and specific recommendations 2016/17 and Tax Administration Diagnostic Assessment (TADAT) to Romania (2016).

Annex V. External Sector Assessment

Staff's overall assessment is that Romania's external position in 2016 was broadly in line with fundamentals.

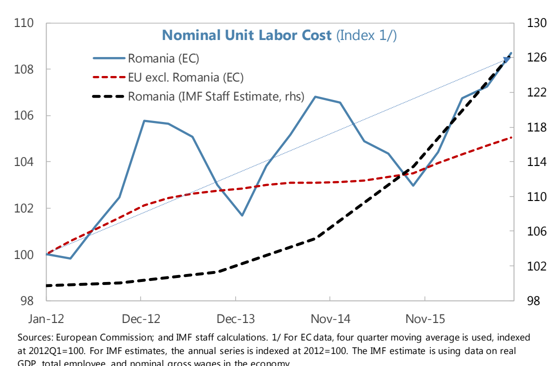
1. Foreign Assets and Liabilities. At -48.6 percent of GDP in 2016, Romania's net international investment position (IIP) has continued to improve in the last four years. Compared to the previous year, the net position improved in 2016 as a share of GDP but deteriorated in absolute euro terms as the rise in foreign liabilities outpaced the rise in foreign assets.

Romania: Estimated Policy Contributions to Current Account Gap, 2016 (percent of GDP)	
EBA-Lite CA Method	
Cyclically-adjusted CA	-2.1
Cyclically-adjusted CA norm	-3.3
Model estimated CA gap	1.2
Of which:	
World fiscal deficit	1.0
Domestic fiscal deficit	-0.4
Policy gaps, other	0.4
Residuals	0.2
Model Implied REER Gap 1/	-4.7
EBA-Lite REER Index Model	
EBA REER Gap 1/	-6.0
EBA-Lite External Sustainability Model	
CA Gap	1.7
EBA REER Gap 1/	-6.8

1/Negative value implies REER is below levels consistent with fundamentals and desirable policies.

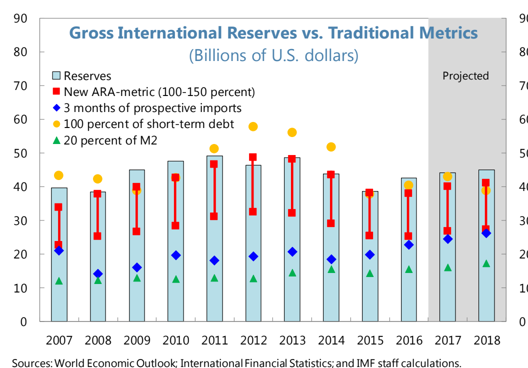
2. Current Account. Romania's current account (CA) deficit has narrowed remarkably since the global financial crisis, from above 10 percent of GDP in 2008 to below 2 in 2013, primarily on the back of strong exports and import compression. More recently, the CA deficit deteriorated due to increased imports owing to higher domestic demand as the economy continues to grow. The IMF EBA-lite tool, used for Romania's external sector assessment since last Article IV report, estimates that a cyclically-adjusted CA norm of -3.3 percent of GDP is consistent with medium-term fundamentals. With the cyclically-adjusted CA at -2.1 percent of GDP in 2016, this implies a CA gap of 1.2 percent. The estimated CA gap includes a policy gap of 1.0 percent, mainly due to the fiscal gap in the rest of the world.

3. Real Exchange Rate. The real effective exchange rate, based on CPI, depreciated by around 2.3 percent in 2016 (using period averages). However, most of the depreciation was towards the end of the year and mostly due to the US dollar appreciation, with EUR/RON remaining almost flat around that time. The three methodologies used in EBA-lite yield similar REER gaps for Romania. Assuming that exchange rate changes would be the primary driver of adjustment, the EBA-Lite CA model estimates that an appreciation of around 4.7 percent would be needed to close the gap between the underlying cyclically-adjusted CA and the norm. The EBA-Lite REER index model suggests an undervaluation of 6.0 percent, while the EBA-Lite External Sustainability Approach (using the benchmark of net IIP stabilizing at 2016 level of -48.6 percent of GDP) suggests an undervaluation of around 6.8 percent. More broadly, recent wage growth has exceeded productivity gains, resulting in rising unit labor costs. In light of these considerations, staff assesses that the real exchange rate is broadly in line with its equilibrium level.



Sources: European Commission; and IMF staff calculations. 1/ For EC data, four quarter moving average is used, indexed at 2012Q1=100. For IMF estimates, the annual series is indexed at 2012=100. The IMF estimate is using data on real GDP, total employee, and nominal gross wages in the economy.

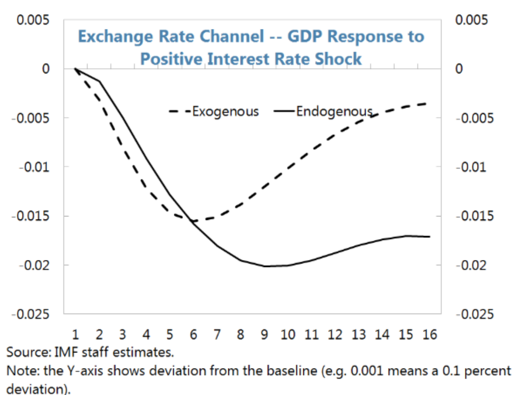
4. Reserve Adequacy. Reserve coverage in Romania is broadly adequate according to most reserve adequacy metrics. The reserve level of €37.9 billion at end-December 2016 is above the standard rules of thumb for three months coverage of prospective imports and 20 percent of broad money. It is also in line with the reserve adequacy metric for emerging markets developed by Fund staff. Comparing with the 100 percent short-term debt (at remaining maturity) benchmark, reserves are slightly above full coverage in 2016. Short-term financing risk for non-bank private sector is expected to be limited as a substantial portion of the short-term debt is intra-company loans with relatively low rollover risks. Nevertheless, in light of the downside external and domestic risks, a prudent stance with moderate reserve accumulation remains appropriate.



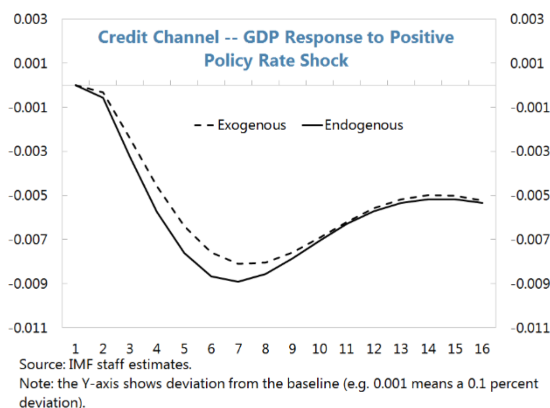
Annex VI. Monetary Policy Transmission Mechanism in Romania

1. **An empirical approach is used to analyze the monetary policy transmission mechanism in Romania, focusing on the real effects of monetary policy changes.** Past research mainly focused on the interest rate pass-through (Enache and Radu 2015, Saborwski 2012). Antohi et al. (2003) used theoretical intuitions to analyze the connection between the financial sector and the real economy. This annex summarizes the findings of a Selected Issues paper.

2. **The interest rate and exchange rate channels have the strongest impact on output.** A vector autoregressive (VAR) model with three variables is estimated: the real output, HICP at constant tax and the policy rate. The baseline model is then augmented with the variables of interest (i.e. the exchange rate and the real new credit). To gauge the strength of each channel, following Baqir (2002) and Disyatat and Vongsinsirikul (2003), the impacts of interest rate shocks are compared when the variable of interest is treated as exogenous and endogenous variables in the VAR model, respectively. The inclusion of the exchange rate channel amplifies the output impact of the policy rate hike and also makes it more persistent. The model with the endogenous exchange rate channel suggests that an interest rate shock of about 0.8 percentage point could lead to a 2 percent decline in output in about 8 quarters. However, the exercise suggests that the credit channel is not as strong, which could be related to the relatively low credit-to-GDP ratio and the relatively high obstacles in access to finance in Romania.

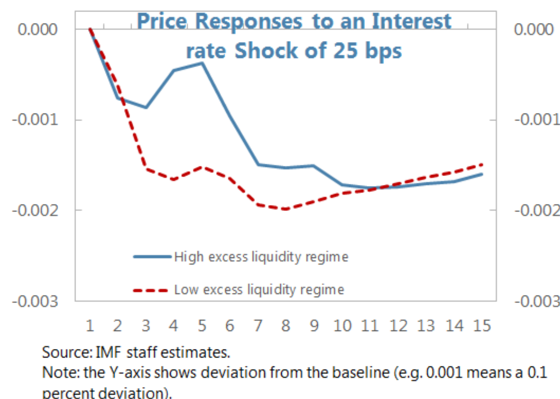


Source: IMF staff estimates.
Note: the Y-axis shows deviation from the baseline (e.g. 0.001 means a 0.1 percent deviation).



Source: IMF staff estimates.
Note: the Y-axis shows deviation from the baseline (e.g. 0.001 means a 0.1 percent deviation).

3. **Monetary transmission is less effective in an environment with higher excess liquidity.** Policy discussions as well as the literature (Agénor, Aizenman and Hoffmaister (2004), Saxegaard (2006)) generally found that excess liquidity in the banking system may weaken the transmission of monetary policy. To study this formally, a threshold VAR model is estimated allowing for two regimes with different levels of excess liquidity, which could capture the non-linear effects of shocks. The results show that a policy rate shock is more potent in periods with lower excess liquidity, as compared to periods with higher excess liquidity.

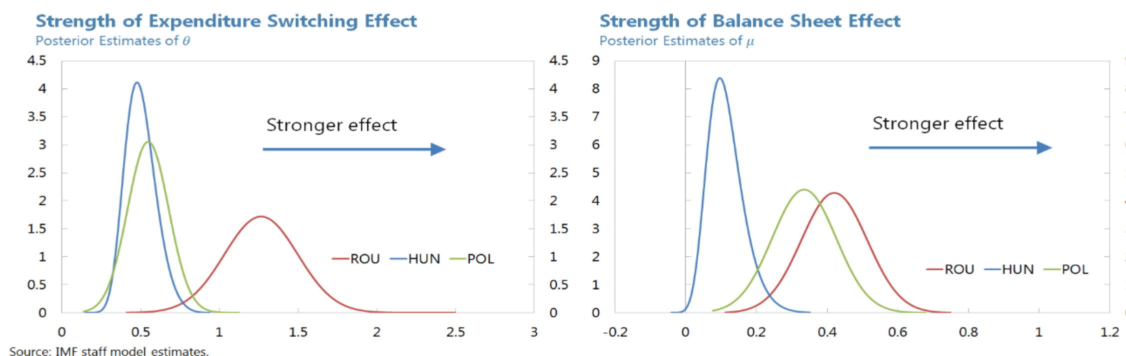


Source: IMF staff estimates.
Note: the Y-axis shows deviation from the baseline (e.g. 0.001 means a 0.1 percent deviation).

Annex VII. Exchange Rate and Economic Growth Nexus – A Structural Model to Assess the Trade and Financial Channels

1. **The expected tightening of domestic and foreign monetary conditions is likely to be transmitted to Romania's exchange rate.** Reflecting the mechanics of partially dollarized emerging market economies, a currency depreciation can affect economic growth via two key channels. On the one hand, it supports growth via expenditure switching, as foreign goods become more expensive and exports cheaper (*the trade channel*). On the other hand, a currency depreciation adversely affects borrowers' balance sheets and by raising the value of foreign currency debt leads to lower growth (*the financial channel*). The relationship between exchange rate and economic growth ultimately depends on the relative strength of these two key channels. This Annex summarizes the findings of a Selected Issues Paper looking at how monetary policy shocks—both foreign and domestic—can influence the empirical relationship. The question is analyzed within a consistent small-scale DSGE model that is estimated for Romania, Hungary and Poland.

2. **The trade and financial channels are stronger for Romania compared to Hungary and Poland (Figures 1 and 2).** Recent research shows that the rise of global value chains has weakened the relationship between exchange rates and trade in global-value-chain-related products (IMF, 2015). This could explain why Hungary and Poland, that are more a part of the German supply chain, have weaker trade channels compared to Romania. Similarly, the strongest financial channel in Romania can be explained by the largest deterioration in net international investment position (as a share of GDP) in the last decade compared to Hungary and Poland.



Source: IMF staff model estimates.

3. **The increase in output and exchange rate appreciation from 2004 until pre-crisis can be attributed to (positive) demand shocks and capital inflows.** The positive demand shock reflects a temporary shift in households' discount factor leading to a rise in consumption. Since the GFC and until late 2009, the reduction in output as well as real exchange rate depreciation is predominantly driven by the negative demand shock.

4. **The results suggest that monetary policy shocks, both domestic and external, will moderate output growth; an increase in foreign interest rate will depreciate the real exchange rate while an increase in domestic interest rate will slightly appreciate the real exchange rate.** The magnitude of the impacts on output and real exchange rate, due to domestic rate hike, is smaller than in Hungary and Poland. The impacts on output and real exchange rate due to a foreign rate hike is comparable to that of Hungary.

Annex VIII. Efficient Public Capital, EU Funds, and Potential Growth in Romania

1. **Efficient public capital has a larger impact on growth, especially among emerging economies.** Following Gupta and others (2014), a Selected Issues Paper considers a production function approach to estimate the contribution of public capital to growth, using panel data for 60 advanced and emerging economies over 1991-2015. Public capital stocks are constructed using a modified perpetual inventory equation that reflects the public investment efficiency by considering the quality of public investment management (PIM) institutions and the extent of government effectiveness in each country. The estimated marginal product of efficiency-adjusted public capital is about 40 percent higher than that of unadjusted public capital, and up to 70 percent higher when estimated on potential growth.

Estimated Marginal Productivities

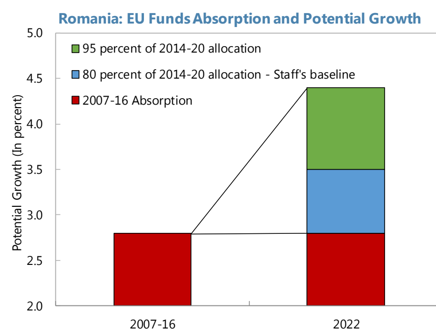
(Based on potential GDP)

	No adjustment	PIM-Institutions	Gov. Effectiveness
	(1)	(2)	(3)
Private Capital	0.12	0.23	0.42
Public Capital	0.40	...	...
Efficiency-adjusted Public Capital	...	0.47	0.69

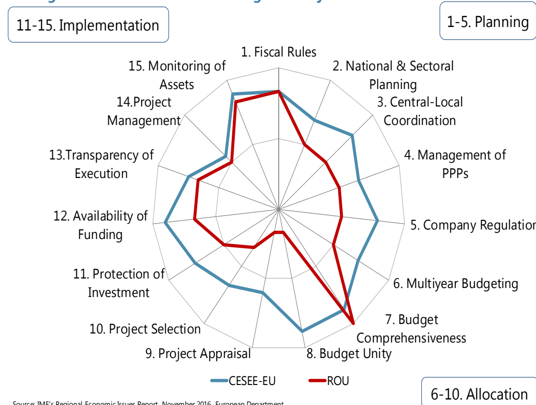
Source: Staff estimates

2. **EU funds contribute to efficient public capital stock accumulation.** Following Sturm (2001), the structural and economic determinants of efficiency-adjusted public capital accumulation are empirically analyzed for the same group of countries, with especial focus on the impact of EU funds. The estimated coefficient suggests that a 10 percent increase in EU funds, raises efficient public capital by about 4 percent.

3. **Altogether, the impact of EU funds on potential growth in Romania can be substantial.** Taking both, the estimated impact of EU funds on efficiency-adjusted public capital, and the impact of the latter on potential growth, it is possible to compute the impact on potential growth for different levels of EU funds absorption in Romania. Assuming that the average potential growth in 2007-16 is consistent with the average rate of EU funds absorption during that period, an increase in the latter to close to 95 percent of the new programming period would increase potential growth to about 4½ percent.



4. **Raising EU funds absorption in Romania requires a determined effort to improve the quality of public investment management institutions.** Staff analysis based on IMF's Public Investment Management Assessment (PIMA) tool indicate a strong positive association between EU funds absorption and the quality of PIM institutions among Central, Eastern, and Southeastern EU countries. When compared to other EU countries, Romania should improve particularly the areas of project selection, project appraisal, coordination with local governments, and budget unity.



INTERNATIONAL MONETARY FUND

ROMANIA

May 5, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By European Department

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FUND RELATIONS

As of February 28, 2017

Membership Status	Joined 12/15/72	Article VIII
General Resources Account	**SDR million**	**% Quota**
Quota	1,811.40	100.00
Fund holdings of currency	1,811.40	100.00
Reserve Tranche Position	0.00	0.00
SDR Department	**SDR million**	**% Allocation**
Net cumulative allocation	984.77	100.00
Holdings	988.04	100.33
Outstanding Purchases and Loans	**SDR Million**	**% Quota**
Stand-By Arrangements	0.00	0.00

Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	09/27/13	09/26/15	1,751.34	0.00
Stand-By	03/31/11	06/30/13	3,090.6	0.00
Stand-By	05/04/09	03/30/11	11,443.00	10,569.00
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

Overdue Obligations and Projected Payments to Fund[1]

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

	Forthcoming				
	2017	2018	2019	2020	2021
Principal					
Charges/interest	0.03	0.03	0.03	0.03	0.03
Total	0.03	0.03	0.03	0.03	0.03

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

Romania has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on the making of payments and transfers on current international transactions except for those maintained solely for the preservation of national or international security in accordance with UNSC resolutions and that have been notified to the Fund under the procedure set forth in Executive Board Decision No. 144-(52/51). The de jure exchange rate arrangement is managed floating.

Technical Assistance

Capacity building in Romania has been supported by substantial technical assistance from multilateral agencies and bilateral donors. The Fund has provided support in several areas with almost 30 technical assistance missions and expert visits since 2012.

Date	Purpose	Department
	Tax Administration	
March–April 2012	Strengthening the capacity of the National Agency for Fiscal Administration (ANAF).	FAD
July–August 2012	Organizational reforms, strategic direction, plan for restructuring of ANAF and implementation of a compliance strategy.	FAD
August–September 2012	Follow-up on the reorganization of ANAF.	FAD
November–December 2012	Follow-up with ANAF, particularly on the antifraud unit.	FAD
March–April 2013	Training to improve high net wealth individual compliance.	FAD
April, September, November 2013, January 2014	Follow-up with ANAF.	FAD
April 2014	Assistance to ANAF on pilot structural compliance project targeted at undocumented labor. Training on payroll audit.	FAD
April 2014	Stock taking on assistance and identification of future TA focus: compliance risk management, reorganization of ANAF, pilot projects.	FAD
January–February 2015	Follow-up and training to improve high net wealth individual compliance.	FAD
July-August 2015	Review of the performance of the large taxpayer office and tax compliance management concerning high wealth individuals.	FAD
April 2016	Tax compliance risk analysis related to large businesses.	FAD
November 2016	ANAF performance outcomes compare to international best practice.	FAD
	Tax Policy	
September 2013	Strengthening the property tax and natural resource tax regime.	FAD
September 2014	Follow-up assistance with creating a new natural resource tax regime.	FAD
June 2015	Workshop on petroleum tax regime design.	FAD
	Public Financial Management	
March 2012	Setting up commitment control and fiscal reporting systems.	FAD
October 2012	Follow-up assistance in setting up commitment control and fiscal reporting systems, especially methodologies and functionalities.	FAD
April 2013	Follow-up assistance in setting up commitment control and fiscal reporting systems, including methodology to verify arrears of local government.	FAD
December 2013	Follow-up assistance in setting up commitment control and fiscal reporting systems, including requirements from decentralization plans.	FAD
February 2014	Fiscal Transparency Evaluation.	FAD
January 2015	Follow-up assistance in setting up commitment control and fiscal reporting systems, review of public investment practices and program budgeting.	FAD
June 2015	Follow-up assistance on strengthening public investment management and implementing public expenditure reviews.	FAD

Date	Purpose	Department
June 2016	Assistance on institutionalizing spending reviews and preparing spending review reports.	FAD
October 2016	Follow-up assistance to advise on piloting spending reviews.	FAD

Date	Purpose	Department
	Financial Sector Issues and Monetary Policy	
November 2012	Follow-up on program-related financial sector issues, including progress with contingency planning.	MCM
October 2014	Assessment of the monetary policy framework.	MCM
	Accounting and NPL	
October 2013	Achieving timely NPL write-off within the IFRS framework.	MCM

Expert Fund assistance has focused in recent years mostly on structural fiscal reforms, in particular modernizing tax administration, strengthening public financial management, and reviewing tax policy options. Technical assistance to the National Bank of Romania focused on upgrading contingency planning, dealing with non-performing loans, and reviewing monetary and exchange rate policy tools.

Article IV Consultations

Romania is on a 12-month consultation cycle. The previous Article IV consultation was concluded by the Executive Board on May 9, 2016.

Safeguards Assessment

An update of the 2011 safeguards assessment, completed on January 10, 2014, found that overall governance at the NBR remains robust, although the legal framework is in need of update to strengthen the NBR's financial autonomy. Accountability and transparency practices are strong; annual financial statements are independently audited and published. Robust controls are maintained over foreign reserves management, government banking, and vault operations. Romania fully repaid the Fund on January 11, 2016 and therefore will no longer be subject to monitoring under the safeguards policy.

FSAP and ROSC

A joint IMF-World Bank mission conducted an update assessment of Romania's financial sector as part of the Financial Sector Assessment Program (FSAP) during November 3–14, 2008. The Financial Sector Assessment Report (FSSA) was discussed at the Board in April 2009.

A pilot of the IMF's new Fiscal Transparency Evaluation took place in February 2014 and the findings were published in March 2015. It assessed the government's fiscal reporting, forecasting, and risks management practices against the IMF's revised Fiscal Transparency Code.

Resident Representative

The Fund has had a resident representative in Bucharest since 1991. Mr. Alejandro Hajdenberg assumed the post of regional resident representative in April 2016.

RELATIONS WITH THE WORLD BANK

The current World Bank Group Country Partnership Strategy (CPS) for Romania, covering the period 2014–18, was presented to the Board on May 22, 2014. The strategy aims at reducing poverty and promoting shared prosperity. The CPS is built on three pillars: (i) *Creating a 21st Century Government*, with focus on a well-functioning public administration, effective in its service delivery and with an improved quality of public expenditure; (ii) *Growth and Private Sector Job Creation*, seeking sustainable poverty mitigation and shared prosperity through improvements in the business environment and SOE governance (especially in energy and transport), promoting innovation, and furthering the digital agenda and competitiveness; and (iii) *Social Inclusion*, a key to the EU's Europe 2020 Agenda, with a special focus on the Roma community.

i. International Bank for Reconstruction and Development (IBRD)

Romania's portfolio consists of seven active investment projects that amount to US$1.7 billion and one Development Policy Loan (DPL), which are complemented by three country-executed trust funds over US$10 million and 10 (Bank-funded) analytical pieces. The ongoing ten Reimbursable Advisory Services (RAS) are worth US$19 million and support the Roma Education Fund, the General Secretariat of the Government, the Ministry of Education, National Authority for the Protection of Children Rights and Adoption, Ministry of European Funds, Ministry of Public Finance and the National Agency of Public Procurement. Since 2010, 52 RAS agreements totaling US$73.41 million have been signed (data as of March 31, 2017).

- The seven active investment projects include the recently approved Justice Services Improvement Project ($67), Integrated Nutrient Pollution Control (US$120.5 million), the Romania Secondary Education Project (US$243 million), the Health Sector Reform Project (US$339 million), the Results-Based Project for Social Assistance System Modernization (US$710 million), the Revenue Administration Modernization Project (US$92 million) and the Judicial Reform Project (US$130 million) which is closing end of March, 2017.

- The Second Fiscal Effectiveness and Growth DPL is the 2nd DPL in a programmatic series of two, which supports structural reforms in the areas of: cash and debt management; centralized procurement for health; public investment prioritization; SOE corporate governance; social assistance; energy; cadaster; and capital markets.

- The country-executed trust funds focus on (i) afforestation; (ii) nutrients pollution control; and (iii) policymaking for people with disabilities.

- The Bank advisory services program covers key areas of engagement. Under the programming period 2007–13, the Bank has been providing guidance on policy formulation and strategy development in agriculture, competition, climate change, early school leaving, tertiary education, life-long learning, active ageing, social inclusion, Roma integration and transport. Among the 52 RAS that have been signed since 2010, a few provided support to the government in improving the public sector management for efficient and effective service delivery by: (i) shifting towards a

results-driven culture, improved policy prioritization, implementation, and coordination, (ii) strengthening public investment management, (iii) introducing performance management systems for EU funds, and (iv) supporting the strategic activities to meet the EU funding conditions for education, social inclusion, active aging (EU 2014–20 program budget).

- Analytical work (Bank-funded ASA) provides diagnostics and policy recommendations in key areas and stimulate cross sector synergy. Typical examples are the Public Expenditure Reviews and Financial Sector Assessments. Other ASAs delivered in the past include Rural Land Registration, Irrigation Prioritization, Roads Safety, Partnerships for Marginalized Roma, and Decentralization.

ii. International Finance Corporation (IFC)

Since the start of operations in Romania in 1990 through FY2017, IFC has invested approximately US$2.5 billion in long-term finance in 85 projects, including over US$600 million in mobilization from other investors. IFC has played an active crisis response role in Romania. From FY2009 to FY2017, IFC invested approximately US$1041 million of its own funds and it is currently the IFC's fourth-largest country exposure in the Central and Eastern Europe region with an outstanding investment portfolio of $372 million (as of March 27, 2017).

In FY17, IFC is targeting commitments of around $100 million. While vulnerabilities from the Euro zone crisis and global economic downturn persist, IFC will continue to play a countercyclical role through selective private sector investments. This includes supporting projects which create jobs, increase investment in underserved frontier regions, contribute to the growth and competitiveness of local firms in underserved sectors such as health, infrastructure, financial markets and improve resource efficiency. IFC will continue to play a countercyclical role through selective private sector investments and support of capital market development. In the financial sector IFC would continue to engage in distressed assets projects and support on-lending to SMEs through leasing companies and banks as financial intermediaries

STATISTICAL ISSUES

As of April 18, 2017
I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance.
National accounts: Quarterly and annual national accounts statistics are produced by the National Institute for Statistics (INS) using the *European System of Accounts 2010 (ESA 2010)*. 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).	
Prices: The Consumer Price Index is subject to standard annual reweighting, and is considered reliable. In January 2004, the INS changed the coverage of the Producer Price Index (PPI) to include the domestic and export sectors. PPI weights are revised every five years with revisions finalized three years after the new base year.	
Labor market: Labor market statistics are broadly adequate. The definition used for employment is consistent with *ESA 2010*.	
Public finances: Annual GFS data for the general government sector, including public corporations operating on a non-market basis, 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. Accrual data are also available on a quarterly basis three months after the end of each quarter. EUR receives monthly cash budget execution data. Consolidated data on general government operations are reported for inclusion in the *GFS Yearbook*.	
Monetary and financial statistics: The National Bank of Romania (NBR) reports monetary and financial statistics on a monthly basis for publication in the *IFS*. using the Standardized Report Forms (SRFs) including Other Financial Corporations (OFCs). The data are published beginning September 2006. **Financial Soundness Indicators (FSIs)**: The NBR reports all core and most encouraged FSIs for Deposit Takers on a quarterly basis, beginning in 2010 Quarter 1. In addition, the NBR reports FSIs for the nonfinancial corporations (NFCs) and households (HHs) sectors, as well as those concerning real estate markets.	
Balance of payments: The NBR routinely reports quarterly and annual external sector statistics to the Fund in a timely fashion. Since September 2014 the authorities implemented the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*), in line with other European countries. Romania also participates in the IMF's Coordinated Portfolio Investment Survey (CPIS) and Coordinated Direct Investment Survey (CDIS).	
II. Data Standards and Quality	
Romania is a subscriber to the Fund's Special Data Dissemination Standard (SDDS) since August 4, 2005.	A Data ROSC was published in November 2001.

Romania: Table of Common Indicators Required for Surveillance
(as of April 12, 2017)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 2017	Apr 2017	D and M	D and M	M
Reserve/Base Money	Jan 2017	Feb 2017	D and M	W and M	M
Broad Money	Jan 2017	Feb 2017	M	M	M
Central Bank Balance Sheet	Jan 2017	Feb 2017	M	M	M
Consolidated Balance Sheet of the Banking System	Jan 2017	Feb 2017	M	M	M
Interest Rates[2]	Jan 2017	Feb 2017	M	M	M
Consumer Price Index	Jan 2017	Mar 2017	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Jan 2017	Feb 2017	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 2016	Mar 2017	Q	Q	Q
External Current Account Balance	Jan 2017	Mar 2017	M	M	M
Exports and Imports of Goods and Services	Jan 2017	Mar 2017	M	M	M
Gross External Debt	Jan 2017	Mar 2017	M	M	M
International Investment Position[7]	Q4 2016	Feb 2017	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[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

May 18, 2017

STAFF REPORT FOR THE 2017 ARTICLE IV CONSULTATION— SUPPLEMENTARY INFORMATION

Prepared By European Department

This supplement provides information on key fiscal and other economic developments that became available after the staff report was issued. This information does not change the thrust of the staff appraisal.

1. **The authorities are considering a change in the social security contribution system that will mitigate the fiscal costs associated with the draft unified wage law**. As discussed in the staff report (¶s15, 16, and 34 and Box 1), the net cost of the draft unified wage law that was submitted to parliament is estimated at 2.6 percent of GDP. The authorities plan to change the social security contribution system to require workers to pay the employer share of contributions. The planned change would result in government savings as the state would not need to pay social security contributions for public employees.[1] If implemented, it will reduce the fiscal cost of the draft unified wage law to an estimated 1.5 percent of GDP.

2. **The fiscal impact of the draft law would still be significant.** In staff's estimate and taking into account other recent wage increases, the public wage bill would rise from 7.5 percent of GDP in 2016 to 10 percent of GDP in 2018, placing it in the upper quartile of the wage bill for emerging economies.[2] The Ministry of Finance plans to support further amendments to the draft law to keep the wage bill around 8 percent of GDP in 2018 and beyond, but details regarding these measures are not yet available.

3. **The authorities' updated Convergence Program for 2017-2020 presents some additional measures to contain the budget deficit**. On the revenue side, the major elements include plans to introduce employer social security contributions for part-time workers, change the VAT payment modality for public institutions, and

[1] The government envisions a similar change for private sector employees. In the government's view this change will strengthen compliance with social security contributions.

[2] The median wage bill for emerging economies is estimated at around 9 percent of GDP in 2015.

maintain the higher dividend distribution rates from state-owned enterprises (SOEs) as in the 2017 budget (at 90 percent). On the expenditure side, plans aim to reprioritize spending, reduce maintenance costs, generate savings on goods and services through centralized procurement, and restrict some pensions and allowances. The authorities estimate these measures will yield around 0.2 percent of GDP in 2017 and 0.6 percent of GDP in 2018.

4. **In staff's view, additional high-quality measures will be needed to reduce the deficit to well under the EDP threshold of 3 percent of GDP over the medium-term**. While staff has not had a chance to discuss the measures included in the Convergence Program with the authorities, staff's preliminary assessment of their yield—for those measures for which specific information was available—is lower than that estimated by the authorities. In addition, while some of the measures (such as those intended at broadening the tax base or extending centralized procurement) are welcome, some others may be less desirable ways to achieve the deficit target (see ¶14 of staff report).

5. **Recent data releases for growth, inflation, and budget execution are broadly in line with staff projections for 2017**.

- ***Growth***. Based on flash estimates GDP growth accelerated to 5.6 percent (y/y) in the first quarter of 2017 from 4.8 percent in the previous quarter. High frequency indicators show continued strong retail sales and industrial production and a widening of the trade deficit based on rising imports.

- ***Inflation***. Headline inflation jumped from 0.2 percent (y/y) in March 2017 to 0.6 percent (y/y) in April. Core inflation has averaged around 1 percent (y/y) in March and April 2017.

- ***Budget execution***. Preliminary data through April show a small budget surplus (below 0.1 percent of GDP), broadly similar to the surplus recorded over the same period in 2016. Investment spending has remained weak while personnel and social assistance spending continue to grow strongly. While overall revenue has been broadly in line with targets through April, there has been a decrease in VAT refunds.

Statement by Anthony De Lannoy, Executive Director for Romania and Cezar Botel, Advisor to the Executive Director
May 22, 2017

The macroeconomic fundamentals of Romania grew significantly stronger after the global crisis. Economic growth consolidated and has lately accelerated while unemployment dropped significantly. Inflation has eventually returned to positive values and is slowly but steadily advancing towards the central bank's target. Fiscal and current account deficits bottomed out in 2014-2015 and remain at relatively moderate levels after the ongoing fiscal relaxation which started in 2015. The current account deficit and external debt remain sustainable. The banking system is sound, NPL ratios decreased significantly, adequate buffers are in place and no public funds have been used to support the banking sector during or after the global financial crisis. While some vulnerabilities persist, high risks to financial stability from legal initiatives have abated. Maintaining the fiscal deficit on target appears to be somewhat challenging, but authorities are fully committed to act proactively and take the necessary steps to contain the risks. Fiscal stimulus complemented by improved EU funds absorption and deep structural reforms could unlock more sustainable and inclusive growth.

The Ex-Post Evaluation of Exceptional Access Under the precautionary 2013 SBA provides a useful assessment of the program including valuable lessons that can be used to improve the Fund's products. The Romanian authorities appreciate the support received from the Fund in partnership with the European Commission and the World Bank. They broadly agree with the conclusions of the report.

Growth accelerates under stimulus measures while external position remains sustainable.

After three years of growth rates above 3 percent, the economic activity in Romania continued to gain momentum in 2016. The annual growth accelerated to 4.8 percent, the country's highest after the crisis and one of the fastest in EU, while the average annual unemployment rate dropped to 5.9 percent, the lowest level in eight years. The expansion was primarily driven by private consumption, pushed to a nine-year high of 7.3 percent by stimulus from fiscal and income policies. Additional envisaged stimulus measures, the manifest recovery of the consumer confidence to the pre-crisis level, and the upward trend in consumer credit are expected to support further expansion of consumption, albeit at a slowing pace over the medium term. The dynamics of investment underwent a temporary setback in 2016, when the contribution of gross fixed capital formation to GDP growth turned negative. Nevertheless, investment growth is expected to resume in 2017 and gradually accelerate over the medium term, driven by credit expansion gaining momentum, accruing effects of growth-friendly tax cuts, and steady improvement of the EU funds absorption. Factoring in significant second-round effects of multiple fiscal stimuli on both domestic demand and potential output, the government projects faster growth than staff's baseline: one percentage point higher in 2017 and a moderately accelerating (rather than Fund's decelerating) path over the medium term.

At the beginning of 2017 the annual CPI inflation rate raised above zero after successive VAT cuts and other disinflationary supply shocks held it at negative values since June 2015.

Dwindling influence of these factors along with a positive output gap will drive inflation upwards, allowing it to reenter the ±1 percentage point variation band of the 2.5 percent flat target by end-2017. Thereafter, in the absence of unanticipated shocks, the inflation rate is expected to remain within the target band.

The current account deficit widened in 2016 by 1.1 percent of GDP on the back of imports boosted by buoyant consumption and a higher deficit in the primary income balance. However, the current account deficit was fully matched by the net FDI inflows which recorded a significant increase in 2016, driven mainly by reinvested earnings and intra-company loans. The deficit is anticipated to remain at sustainable levels over the medium term, with exports growth fueled by the gradual recovery of the external demand from EU main trading partners. Since the external deficit financing is expected to come mainly from non-debt-generating flows - FDI and EU funds -, the downward trend of the external debt-to-GDP ratio is projected to continue in the medium term. Both staff and the authorities agree that the external position in 2016 has been broadly in line with the fundamentals; recent developments continue to warrant this assessment. The share of short-term debt in total external debt is relatively low (around 25 percent), and the international reserves coverage is adequate according to all reserve adequacy metrics. Notwithstanding good fundamentals, the external position may be vulnerable to a sharp depreciation of the domestic currency triggered by a sudden worsening of the market sentiment. The authorities carefully monitor these risks.

While fiscal relaxation will be maintained in the short run, budget deficits will be kept within the limits allowed by EU fiscal rules.
In line with the government strategy of promoting economic growth, the fiscal relaxation initiated in previous years has continued at the beginning of 2017, through measures aimed at both increasing the real disposable income of households and improving business environment and supply incentives. The medium term strategy foresees the ESA budget deficit being held constant at slightly below the limit of 3 percent of GDP in 2017-2018, followed by a fiscal consolidation to 2 percent by 2020. While acknowledging the challenge of meeting the 2017-2018 targets, the authorities are strongly committed to comply with the EU fiscal rules, by closely monitoring the budget execution and taking compensatory measures if necessary. To mitigate the risks associated with the fiscal impact of the unified wage law, the authorities will adopt a gradual and flexible implementation which will take fiscal space constraints into consideration.

Concrete measures and reforms to increase budget revenues and reduce public spending, already taken or planned for 2017-2018, are identified in the April 2017 Convergence Report of Romania to the European Commission. An important measure designed to increase the VAT collection is the implementation as of July 1, 2017 of an anti-fraud system of split VAT payments which requires public institutions and enterprises to pay any VAT due for goods or services directly to the State budget account rather than to the supplier. Among the programmed reforms aimed at enhancing expenditure efficiency are included: reducing the number of agencies and institutions subordinated to the government, rationalizing public spending based on principles of auditing, digitization, prioritization and performance

assessment, improving corporate governance of SOEs, centralizing public procurement, creating a national database for records of public administration employment.

Monetary policy is focused on bringing inflation to target in the medium term. Throughout 2016 and the beginning of 2017 the central bank kept unchanged both the monetary policy rate, at the historical low of 1.75 percent, and the amplitude of the symmetrical corridor of interest rates on standing facilities around the policy rate, at ±1.50 percentage points. The status-quo approach was warranted by the persistent divergence between short-term developments in inflation and its longer-term outlook, as reflected by the central bank's successive forecast updates over a period marked by high uncertainty and risks generated by both external and internal factors.

With persistent excess liquidity in the banking system, the central bank pursued an adequate management of money market liquidity and maintained the required reserve ratio on leu-denominated liabilities of credit institutions at 8 percent. However, given the ongoing contraction in foreign currency credit and consolidation of forex reserves, the NBR cut the required reserve ratio on forex-denominated liabilities twice (most recently on May 5, 2017) down to 8 percent, thus continuing the harmonisation of the reserve requirements mechanism with ECB standards and practices.

To increase transparency and the effectiveness of conveying to the markets the rationale behind the adopted decisions, the central bank started in September 2016 to publish the minutes of the NBR Board monetary policy meetings.

The central bank will continue to gear monetary policy towards bringing, and maintaining in the medium run, the annual inflation rate into line with the flat target, in a manner supportive of sustainable economic growth. However, the NBR Board emphasizes that a balanced macroeconomic policy mix and progress in structural reforms are crucial for macroeconomic stability and for the resilience of the Romanian economy to adverse global developments.

Financial stability continues to be robust and immediate risks from legal initiatives have been alleviated.
Romania is among the 5 EU members which haven't used public funds to support the financial sector since the onset of the global crisis. The capital ratio of the Romanian banking sector is adequate and provides, together with the IFRS provisions, a consistent buffer to absorb potential losses and to support the lending activity. The average total capital ratio (18.3% as at December 2016) situates the Romanian banking sector in the lowest European Banking Authority's risk bucket. Contagion risks continue to decline with banks increasingly substituting domestic deposits for foreign sources of funding and the total share of domestic currency loans on the rise for five years.

NPLs have fallen significantly due to the NBR's efforts to encourage banks to clean-up their balance sheets. The overall NPL ratio dropped from 21.5 percent in September 2014 to less than 10 percent presently. Further efforts are needed, since NPL ratios for corporates and SMEs are still high. However, the NPLs are well provisioned, the EBA Risk Dashboard lists Romania's coverage ratio the highest in EU as of Q4 2016.

Liquidity is abundant and banks' profitability improved in 2016, ROA (1.1 percent) and ROE (10.7 percent) standing at year end above EU averages. Credit to households advanced rapidly in 2016. Credit to non-financial corporations (NFCs) remained subdued throughout 2016, but has recently shown signs of recovery, amid stronger economic growth, improved confidence, and historically low interest rates.

The high risks for financial stability generated by two laws passed last year by the Parliament have abated following recent rulings by the Constitutional Court. One of the laws allows debtors to walk away from mortgages ("give-in-payment"); the Court's ruling that the law should be applied on a case-by-case basis and within the provisions dealing with distressed borrowers in the civil code, has greatly limited the potential negative impact of this law on the banking sector. The second law, allowing debtors to convert Swiss Franc denominated loans into domestic currency loans at historical exchange rates, has been declared unconstitutional. However, authorities recognize that important risks to financial stability remain and need to be closely monitored. Highly significant is the risk of abrupt worsening of investor sentiment towards emerging economies, generated by uncertainties surrounding global economic growth, geopolitical tensions and Brexit implications for the future of the EU. Medium-term risks from rising banks' exposure to households and government debt are also relevant. To help prevent and manage risks to financial stability, the authorities have set up a formal macroprudential authority, the National Committee for Macroprudential Supervision (NCMS). NCMS brings together representatives from the NBR, the financial supervisory authority and the government to formulate and coordinate macroprudential policies, issue warnings and recommendations ("soft laws") for NBR and the financial supervisory authority. The authorities also welcome the forthcoming FSAP programmed for 2017-2018.

Improved EU absorption will support structural reforms critical for sustainable growth.

Significantly improving the EU funds absorption as a critical source of financing investment is a top priority for the authorities. While the absorption during the first years of the 2014-2020 financial framework has been weak, progress has been made with respect to designating the managing authorities, compliance with ex-ante conditionality, and limiting domestic financing of projects eligible for EU funding. The authorities are confident that further building on this base will allow a significant acceleration of the absorption in the coming years.

Steps have been taken to restructure major energy producers and prepare IPOs for some of them. SOEs reform is expected to gain momentum after the establishment of the Sovereign Fund for Development and Investment, envisaged to be launched in July 2017.

To stimulate labor mobility across the country and thus increase employment, the government instituted a system of grants for hiring, settlement and relocation. Measures have been taken to increase the quality of education -including through significant salary increases for educators- and to promote vocational training.

The authorities thank staff for the thorough and constructive discussions during and after the Article IV mission, and for their valuable advice on macroeconomic policies.