May 2006
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# Romania: 2006 Article IV Consultation—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; 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 2006 Article IV consultation with Romania, the following documents have been released and are included in this package:

- the staff report for the 2006 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on February 7, 2006, 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 March 30, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of April 24, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its April 26, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for Romania.

The document listed below has been or will be separately released.

Selected Issues Paper and Statistical Appendix

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

**To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.**

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INTERNATIONAL MONETARY FUND

ROMANIA

**Staff Report for the 2006 Article IV Consultation**

Prepared by the Staff Representatives for the 2006 Consultation with Romania

Approved by Susan Schadler and Martin Fetherston

March 30, 2006

- Article IV discussions were held in Bucharest during January 25-February 7, 2006. The mission comprised Messrs. van der Mensbrugghe (head), Christou, Tiffin, and Adler (all EUR), Roger (MFD), and Ms. Vera Martin (PDR). Ms. Schadler (EUR) joined the mission for a few days. The resident representative, Mr. Justice, assisted the mission.

- The mission met with the President, Prime Minister, Deputy Prime Minister, the Ministers of Public Finance, Economy, Labor, and Transportation, the Governor of the National Bank of Romania (NBR), other senior officials, and members of parliament, including opposition parties. It also met with the EC, EBRD, IBRD, academics, bankers, labor unions, employers' associations, and the foreign investors council. Mr. Croitoru (OED) participated in policy discussions.

- On July 7, 2004, the Executive Board concluded the 2004 Article IV consultation and approved a 24-month precautionary Stand-By Arrangement (SDR 250 million (24.27 percent of quota)). The first review was completed September 22, 2004 (Appendix I). No other reviews have been concluded.

- In May 2005, Romania subscribed to the Special Data Dissemination Standard. Romania's statistical base is adequate for surveillance, but the quality of the national accounts, price, fiscal, and balance-of-payments data needs improvement (Appendix III).

- The mission held a press conference. The authorities published the mission's concluding statement.

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## Executive Summary

**Background.** Real GDP growth slowed to 4.1 percent in 2005, with agricultural output falling as a result of floods and industrial output growth slowing due in part to the abolition of global textile quotas. Domestic demand grew strongly, however, reflecting a sharp increase in private consumption, which in turn was supported by a direct tax cut, higher wages, and rapid credit growth. Consequently, the disinflation process has slowed (CPI inflation was 8.6 percent y-o-y in December 2005 and 8.5 percent y-o-y in February 2006), and the current account deficit widened to 8.7 percent of GDP in 2005.

**Outlook.** Growth is expected to pick up to 5.2 percent in 2006, driven by a recovery in agriculture and industry. Domestic demand growth will slow due to fiscal consolidation, more moderate wage growth, and monetary tightening. Staff's scenario projects inflation of 6.5 percent at end-2006 and a current account deficit of 8.5 percent of GDP. The authorities broadly agreed with the scenario, but thought that growth could be higher.

**Policy Issues and Discussions**

**Fiscal policy should be the centerpiece for the macroeconomic strategy, especially given the likelihood of continued large capital inflows**. Further fiscal consolidation should aim at stemming excess demand and keeping public finances on a sustainable medium-term path. Staff advocated a balanced budget in 2006 and small surpluses over the medium term, but the authorities considered that a milder adjustment would be sufficient and appropriate to achieve their macro objectives. Given the tight expenditure envelope, Romania's substantial infrastructure requirements, and the need for additional resources for the country's contribution to the EU budget and co-financing of EU projects, the revenue base should be strengthened.

**A prudent wage policy is critical for successful disinflation.** To this end, the government's wage policy needs to be recalibrated to the needs of a low inflation country, featuring wage increases only once a year. The authorities noted their recent decision to freeze non-EU-related vacant positions, and their intent to exercise prudence in their SOE- and minimum-wage policies, but acknowledged that vigilance will be necessary to avoid wage overruns.

**In light of the 2005 inflation outturn, the authorities need to establish firmly the credibility of their new inflation-targeting regime.** Staff urged a tightening of monetary policy, through an increase in interest rates. In early-February, the NBR increased its policy rate by 100 basis points and has since stepped up sterilization operations, bringing the effective interest rate in line with the policy rate. The authorities agreed with the staff's assessment that the exchange rate remains competitive. Staff recommended that intervention in the foreign exchange market be fully sterilized and focused on reducing excess volatility, rather than controlling the longer-term trend. Financial soundness indicators point to a relatively healthy and resilient banking system, and the mission suggested further implementation of FSAP recommendations.

**Sustained growth and rapid convergence to EU living standards are contingent on progress in structural reforms.** There was agreement on the need to maintain momentum on privatization, continue energy price adjustments, make the labor market more flexible, strengthen governance, and improve the business climate.

## I. Introduction

1. **Discussions were held against a backdrop of widening macroeconomic imbalances and approaching EU accession.** While convergence to the EU continues and confidence remains high, developments during the past year have raised concerns. Growth and disinflation have slowed, and the external deficit has widened. The European Commission's latest report noted Romania's progress in implementing EU legislation, but also cautioned that accession could be delayed until January 2008 unless decisive actions are undertaken, mainly in developing sufficient administrative and judicial capacity, and fighting corruption. The next monitoring report will be presented in May 2006, and the accession date may be decided in June 2006.

2. **The political events of late-2004 had significant economic implications.** Opposition leader Basescu won the presidential elections in December 2004, and his party formed a coalition government. The new government cut the personal income and profit taxes to a single rate of 16 percent effective January 1, 2005 and initiated a process for increasing pensions. These policies, in tandem with significant public-sector wage increases, exacerbated already-strong demand pressures. Political turmoil in mid-2005, in which an initial announcement to hold early parliamentary elections was reversed, led to the reconsideration of some critical policies.

## II. Background

3. **Romania has registered substantial accomplishments since 2000.** Stop-go policies during the 1990s left Romania behind many other transition economies with mediocre growth, high inflation, and low FDI. Following the 1999 currency crisis, macroeconomic conditions improved as a result of fiscal adjustment, enhanced financial performance of state-owned companies (SOEs), and privatization. The NBR achieved substantial disinflation while slowing the rate of depreciation. This stabilization, and improved prospects for EU accession, prompted a positive supply response.

Key Macroeconomic Indicators, 2000-05

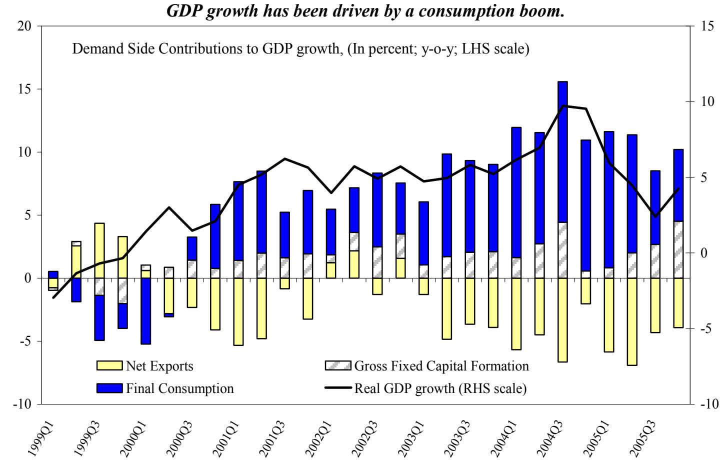
| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 Prel. Estimates |
|---|---|---|---|---|---|---|
| (In percent of GDP, unless otherwise indicated) | | | | | | |
| Real GDP growth (percent) | 2.1 | 5.7 | 5.1 | 5.2 | 8.4 | 4.1 |
| CPI (change in percent; end of period) | 40.7 | 30.3 | 17.8 | 14.1 | 9.3 | 8.6 |
| Current account deficit | -3.7 | -5.5 | -3.3 | -5.8 | -8.5 | -8.7 |
| General government deficit | -4.0 | -3.2 | -2.6 | -2.2 | -1.0 | -0.8 |
| Reserve cover (months of imports) | 2.3 | 3.5 | 3.6 | 2.8 | 4.1 | 5.6 |
| Gross External Debt | 29.8 | 32.8 | 32.8 | 32.9 | 35.1 | 32.4 |
| (In percent) | | | | | | |
| Contribution to real GDP growth | | | | | | |
| Domestic demand | 4.5 | 8.9 | 4.2 | 8.8 | 13.0 | 9.1 |
| Consumption | 1.3 | 5.4 | 4.1 | 6.9 | 10.2 | 7.4 |
| Households | -0.6 | 4.8 | 3.7 | 5.7 | 9.2 | 6.5 |
| Government | 1.9 | 0.6 | 0.5 | 1.2 | 1.0 | 0.9 |
| Fixed Capital Formation | 1.0 | 1.9 | 1.7 | 1.8 | 2.3 | 2.8 |
| Non-government | 1.2 | 1.8 | 1.5 | 1.6 | 2.5 | 2.8 |
| Government | -0.2 | 0.1 | 0.2 | 0.3 | -0.2 | 0.0 |
| External demand | -2.3 | -3.1 | 0.9 | -3.6 | -4.5 | -5.0 |

Sources: Romanian authorities; and Fund staff estimates.

4. **Macroeconomic conditions have deteriorated recently.** Specifically,

- **Economic growth has slowed.** Following an 8.4 percent outturn in 2004, which was aided by an exceptional harvest, real GDP growth slowed to 4.1 percent in 2005. While agriculture declined owing to severe floods, industrial output growth slowed, partly resulting from the drop in external demand associated with the abolition of global textile quotas. Demand, on the other hand, grew strongly, reflecting a sharp increase in private consumption—supported by significantly lower taxes, higher wages, and faster credit growth.

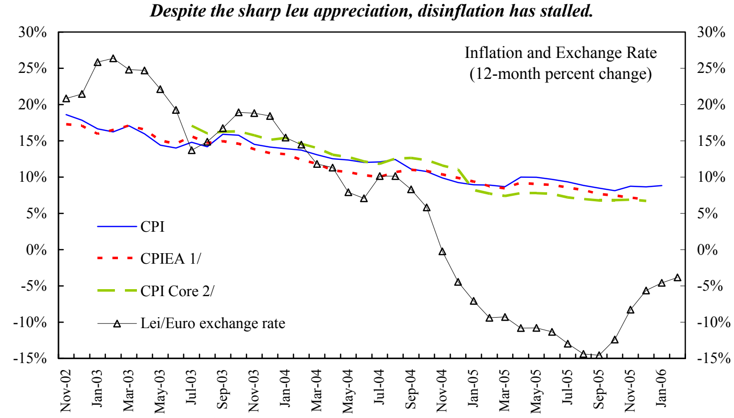
***GDP growth has been driven by a consumption boom.***




*Source: National Institute of Statistics of Romania.*

- **Despite the significant appreciation of the leu, disinflation slowed considerably.** Given the strength of domestic demand, and higher oil and administered prices, CPI inflation stood at 8.6 percent y/y in December, against the NBR's target of 7.5 percent (with a ±1 percent band). This outturn would have been even worse without the mitigating impact of an appreciating currency—the NBR has allowed greater exchange rate flexibility since end-October 2004, responding to increased capital inflows. The currency has appreciated by about 11 percent against the euro from September 2004 to December 2005 and by a further 5 percent in the first two months of 2006, while inflation slowed to 8.5 percent y/y in February.

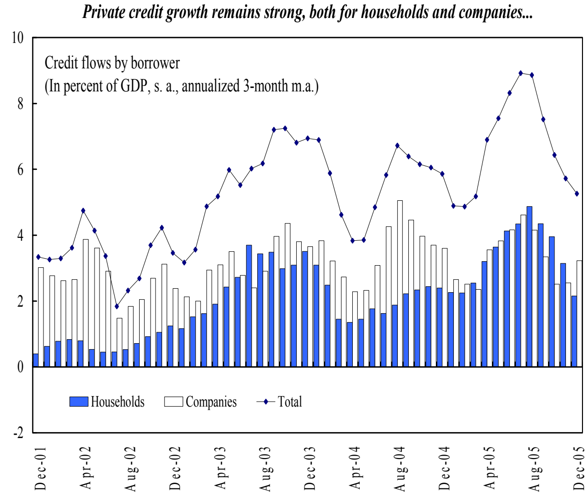
*Despite the sharp leu appreciation, disinflation has stalled.*



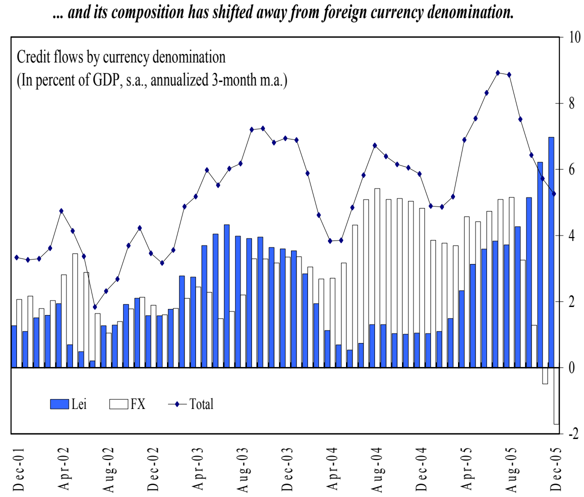

Sources: Romanian authorities and Fund staff estimates.
1/ CPIEA excludes administered prices.
2/ CPI Core excludes administered prices, fuels, vegetables, fruits and eggs.

- **Strong credit growth has been associated with expanding domestic demand and inflationary pressures.** Real domestic credit grew by 45 percent in 2005, and while foreign-currency denominated credit growth has slowed more recently, leu credit growth has picked up substantially. The shift away from foreign currency-denominated lending partly reflects a number of measures introduced to contain foreign currency-denominated credit (Box 1), as well as a monetary easing in the fall of 2005.

*Private credit growth remains strong, both for households and companies...*




*... and its composition has shifted away from foreign currency denomination.*




Source: Romanian authorities; and Fund staff estimates.

**Box 1. Credit-Related Measures**

- (July 2005). The reserve requirement of 30 percent is extended to all foreign currency-denominated liabilities, regardless of their maturity or contract date.

- (August 2005). The reserve requirement on RON-denominated liabilities, with maturities less than 2 years, is lowered from 18 to 16 percent.

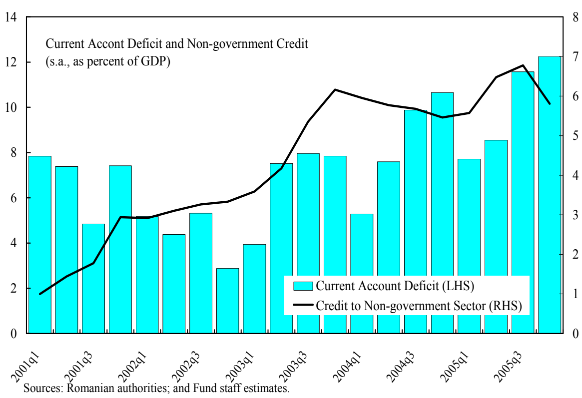
- (August 2005). Regulations on limits to household-lending risk are tightened. The new regulations set a monthly debt-service ceiling of 40 percent of the net monthly income of the borrower, and cover the sum of all commitments (e.g., mortgage, real-estate and consumer loans). Moreover, the monthly debt service ceilings for consumer and real-estate credits are limited to 30 and 35 percent of monthly net income, respectively.

- (September 2005). For credit institutions granting foreign exchange-denominated loans, exposure to unhedged borrowers is limited to 300 percent of the creditor's own funds. In this context, only borrowers with foreign currency income are considered to be hedged.

- (December 2005 and February 2006). The reserve requirement on foreign currency-denominated liabilities was increased from 30 percent to 35 percent, and again to 40 percent.

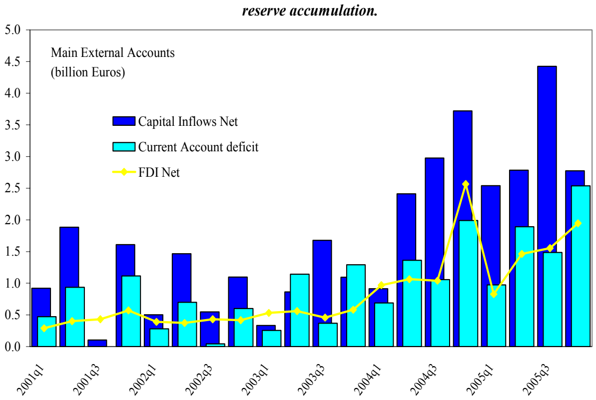
- **The credit expansion has also paralleled sizeable external imbalances.** The current account deficit widened to 8.7 percent of GDP in 2005 from 8.5 percent of GDP in 2004.[1] Import growth continues to outpace export growth, but rising FDI and EU transfers covered about 90 percent of the current account, with private capital inflows financing the rest and supporting substantial reserve accumulation. An updated debt sustainability analysis points to a sustainable deficit of 8 percent of GDP (Box 2 and Appendix IV).

***The credit expansion has paralleled a widening of the current account deficit...***




Sources: Romanian authorities; and Fund staff estimates.

***... but capital inflows have fully financed the current account and allowed for a large reserve accumulation.***




[1] Revised FDI data have implied higher current account deficits since 2003, as previously-underreported reinvested earnings are now included in the incomes account. At end-2005, the 2004 deficit was revised from 7.5 to 8.5 percent of GDP.

## Box 2. Current Account Sustainability

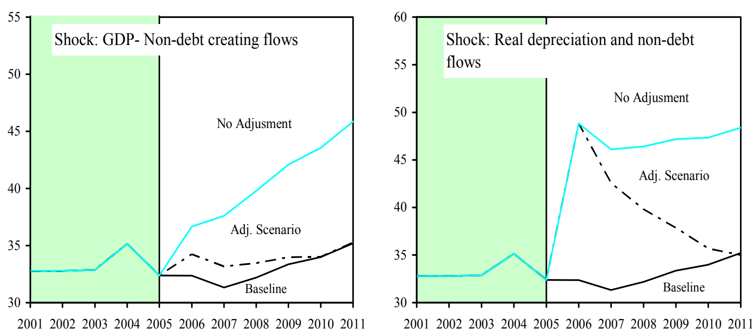
***A current account deficit of 8 percent of GDP on average would stabilize the gross external debt-to-GDP ratio at 35 percent over the medium-term*,** a level deemed appropriate according to the methodologies used in recent research. The analysis estimates non-debt-creating inflows at 5 percent of GDP on average over 2006–11, reflecting large-scale privatization deals, rising greenfield FDI, and an optimistic estimate about the use of EU funds. The current account deficit is projected at 8.5 percent of GDP in 2006; and, under the described scenario, the debt-to-GDP ratio would stabilize at around 35 percent by 2010-11.

**Current Account Sustainability**

| Assumptions | 2005 | Average 2006-2011 | |
|---|---|---|---|
| (annual percentage changes, unless otherwise noted) | | | |
| Non-debt creating flows (in percent of GDP) | 6.6 | 5.1 | |
| Nominal GDP growth (in US Dollar terms) | 30.6 | 14.2 | |
| Real GDP growth | 4.1 | 5.6 | |
| Implied real exchange rate appreciation (based on GDP deflator) | 12.0 | 5.4 | |
| Nominal exchange rate appreciation (period average) | 12.0 | 2.6 | |
| (in percent of GDP) | | | |
| **Current account Balance consistent with stable external debt ratio at 35 percent.** | | -8.0 | |
| **Alternative scenarios: CA stabilizing debt at 35 percent of GDP:** | | | |
| (a) with non-debt flows = 3.5 percent of GDP and real GDP growth of 3.5 percent. | | -5.9 | 1/ |
| (b) A 10 percent real depreciation and a sudden-stop of non-debt flows in 2006-07. | | -6.7 | 2/ |
| **Memorandum items:** | | | |
| Actual/projected current account balance | -8.7 | -8.1 | |
| Actual/projected gross debt ratio | 32.4 | 33.1 | |

1/ Current account that the stabilizes debt-to-GDP ratio at 35 percent by 2011.
2/ Required current account deficit during 2007-11 to bring the debt-to-GDP ratio back to 35 percent.

External Debt in relation to GDP

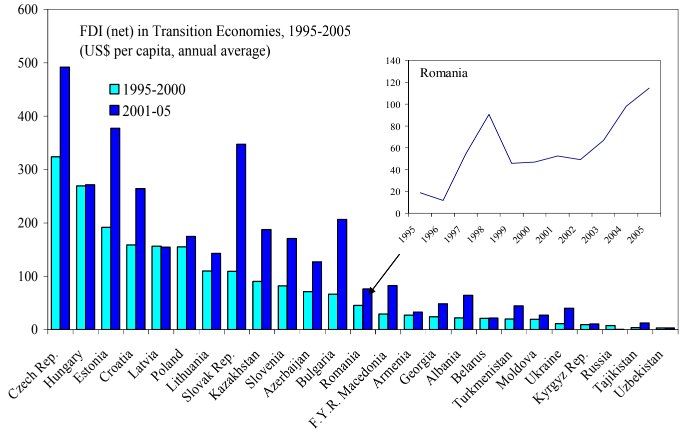



***However, the analysis is sensitive to the FDI and economic growth assumptions.*** Under a pessimistic scenario with lower inflows and GDP growth, the debt-to-GDP ratio would rise to 45 percent over the medium term. A current account adjustment of 2 percentage points per year would be required to keep the debt-to-GDP ratio at about 35 percent over the medium term. Part of the necessary adjustment would be automatic as domestic demand would moderate and FDI-related imports would decline, while policies would need to address the remainder.

***The analysis is also sensitive to exchange rate developments*.** A 10 percent real depreciation, accompanied by a sudden stop of non-debt-creating flows in 2006, would raise external debt by 17 percentage points of GDP on impact, before any current account response. Returning to a debt-to-GDP ratio of 35 percent by 2011, would require a current account deficit of 6¾ percent of GDP on average over 2007-10, against a baseline of 8 percent of GDP.

- **The widening of the current account deficit reflects a number of factors.** On one hand, Romania's high rate of return on capital is attracting the foreign savings necessary for complete integration with the EU. In fact, although per capita FDI remains relatively low, it has picked up recently, reflecting increased confidence in Romania's prospects. On the other hand, consumption is booming, the composition of imports has not changed substantially, and the share of machinery in total imports—an indicator of investment activity—has remained constant and is well below shares in recent EU entrants.

***FDI inflows to Romania have picked up recently, although they remain low compared to EU new member states.***




Imports of Machinery 1/
(Percent of total imports)

| | 1995 | 2000 | 2004 |
|---|---|---|---|
| Hungary | 23.6 | 43.4 | 44.5 |
| Czech Republic | 30.4 | 31.7 | 32.9 |
| Poland | 25.6 | 26.8 | 25.2 |
| Romania 2/ | 22.1 | 25.0 | 23.4 |
| Bulgaria | 12.6 | 16.9 | 18.5 |
| Lithuania | 16.1 | 15.8 | 19.3 |

*Source: COMTRADE*

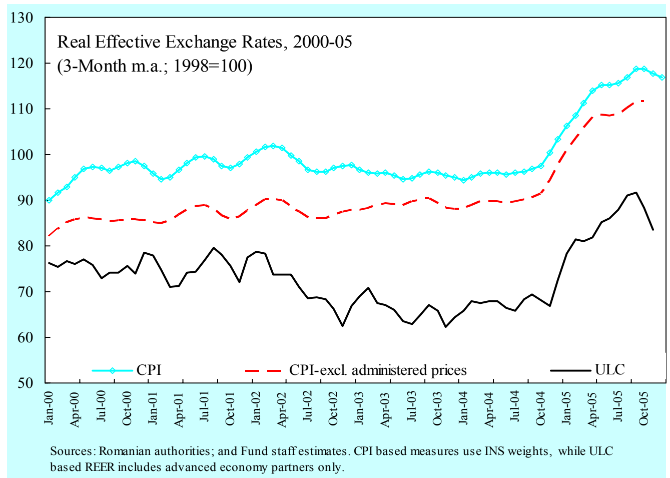
1/ Excluding cars.

2/ Romania's share was about 25 percent in 2005.

- **Romania's competitive advantage has narrowed.** The gains achieved by the 1999 exchange-rate correction were preserved until end-2004 in an environment of low capital inflows. However, the recent appreciation, in tandem with strong wage growth and declining productivity gains, is eroding profitability and competitiveness (Box 3).

## Box 3. Competitiveness

**Responding to changes in the macroeconomic environment and policies, competitiveness has shifted.** Following the adoption of greater exchange rate flexibility and the liberalization of the capital account, an appreciating currency combined with strong wage growth has impacted competitiveness. All effective exchange rate indicators have appreciated significantly, e.g. the ULC-based and CPI-based REER appreciated by 17 percent and 21 percent respectively during September 2004-December 2005. Enterprise profitability in the manufacturing sector appears to have deteriorated on account of wage growth and a slowdown in productivity, although increasing labor costs have been largely offset by strong growth in the price of exported goods. Nonetheless, Romania has historically enjoyed a significant competitive edge; staff analysis suggests there still exists a margin for further appreciation, at a measured pace, without causing a significant deterioration in the external balance.

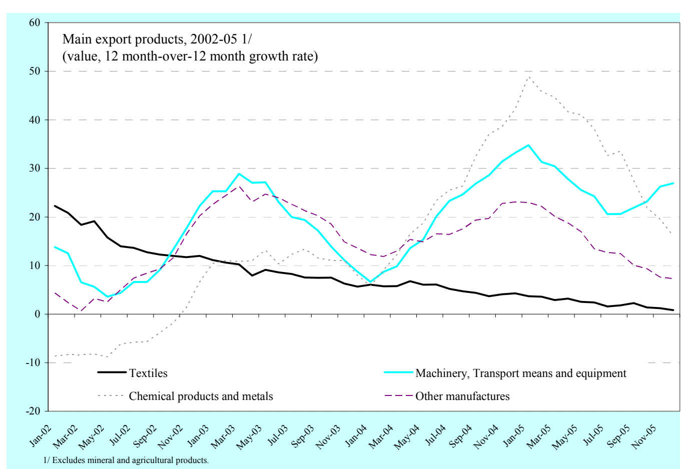



**Export performance has been robust, although evidence across sectors has been mixed, reflecting the transition to higher valued-added goods.** Despite a slowdown from 2004, also visible in other transition economies, Romania's total and non-oil export performance has remained strong, with 20 percent growth during 2005. Manufacturing exports— representing ⅔ of total exports— continued to grow over the same period, driven mainly by strong growth of exports of machinery and equipment (26 percent), and food and plastic products (20 percent). On the other hand, textiles growth (representing 20 percent of exports) has continued to decelerate, partly in response to the recent abolition of global textile quotas, while exports of wood products were also flat (reflecting strong domestic construction demand). The shift toward higher value-added goods (e.g. vehicles, and other machinery and equipment) was confirmed by the mission's discussions with the authorities.

Export performance in selected transition economies, 1995-2005
(annual average growth rates)

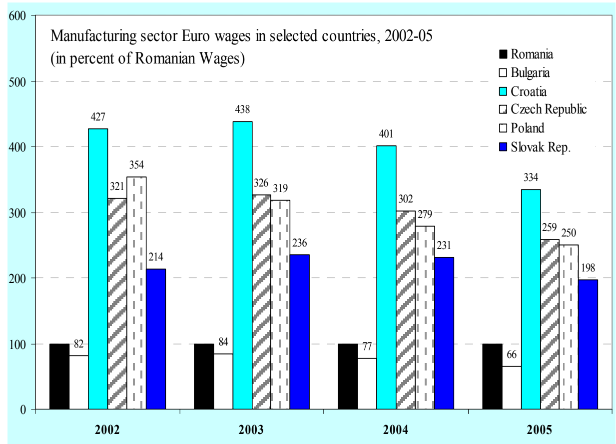
| | Total Exports of goods | | | Non-oil exports | | |
|---|---|---|---|---|---|---|
| | 1995-2003 | 2004 | 2005 | 1995-2003 | 2004 | 2005 |
| Bulgaria | 5.4 | 31.7 | 18.6 | 5.2 | 27.2 | 14.5 |
| Czech Republic | 10.8 | 37.2 | 21.4 | 10.8 | 37.2 | 21.4 |
| Hungary | 14.6 | 28.9 | 13.4 | 14.6 | 28.7 | 13.1 |
| Latvia | 11.1 | 33.3 | 26.9 | 11.1 | 33.3 | 26.9 |
| Poland | 11.8 | 34.2 | 16.6 | 11.8 | 34.2 | 16.6 |
| ***Romania*** | ***10.6*** | ***31.7*** | ***19.8*** | ***11.4*** | ***32.8*** | ***20.3*** |
| Slovak Republic | 12.4 | 27.1 | 15.0 | 12.3 | 25.1 | 12.3 |
| Slovenia | 5.5 | 24.8 | 6.4 | 5.5 | 24.8 | 6.4 |
| Ukraine | 6.6 | 40.8 | 4.5 | 6.6 | 40.8 | 4.5 |

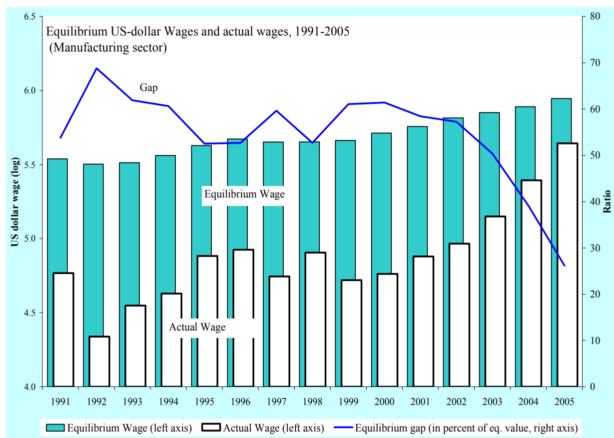
Source: World Economic Outlook

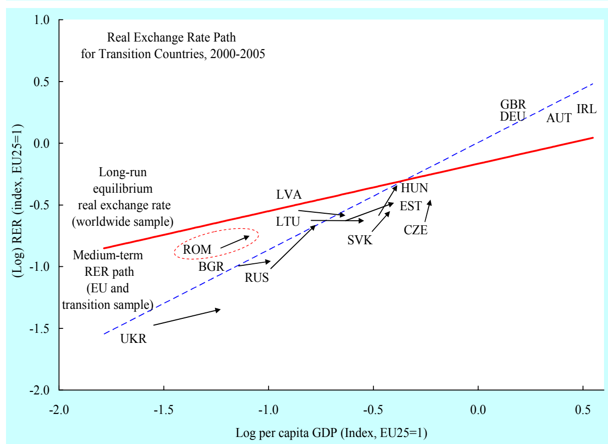


## Box 3. Competitiveness (continued)

**A number of equilibrium-based indicators suggest that, although Romania's competitive edge has narrowed, there is still room for appreciation, albeit at a measured pace**. Romania has historically benefited from low manufacturing sector wages vis-à-vis other transition economies. And while this wage differential has recently narrowed, Romania's wages remain relatively low. By employing a cross-country panel framework, which includes 85 countries, and using manufacturing wages denominated in U.S. dollars as a proxy for the real exchange rate, the staff has modeled the equilibrium wage as a function of different measures of productivity and income (e.g., per capita GDP, human capital, share of agriculture, and institutional indicators). Such an approach indicates that Romania's real exchange rate had been significantly undervalued throughout the 1990s (see: Selected Issues Paper, *Competitiveness)*. And although the implied extent of undervaluation has narrowed sharply since 2000, especially in 2005, a gap of some 20-30 percent between the actual and the equilibrium wage remains.




**Similar results are obtained when looking at a PPP-based measure of the real exchange rate.** When compared to a world-wide benchmark, Romania and other transition economies show undervalued exchange rates for most of the transition period— although Romania's currency is arguably overvalued when compared to the EU-transition group. This pattern is not too surprising, given that most transition economies started the 1990s with extremely competitive costs and significantly undervalued real exchange rates. In this context, most of these countries have experienced a trend real appreciation over the past decade, as they moved from one equilibrium toward another. Looking forward, Romania will most likely continue along a similar path as it converges with the EU. So, while the authorities should guard against complacency and monitor future productivity developments closely, staff analysis suggests that the exchange-rate developments of 2005 form part of a larger, ongoing structural process, and should not yet be viewed with undue alarm.

5. **Further fiscal consolidation occurred last year.** The general government deficit was kept to 0.8 percent of GDP—against a revised target of 1 percent of GDP and a deficit of 1 percent of GDP in 2004.

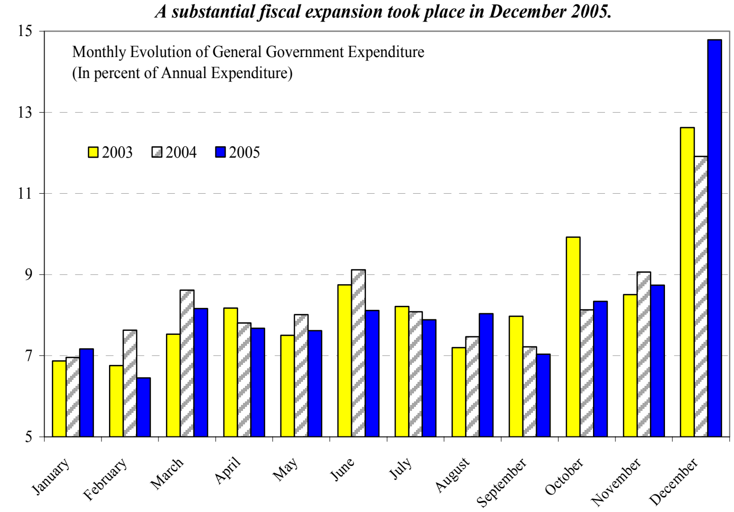
General Government Balances, 2004-06
(In percent of GDP)

| | 2004 | 2005 | | | 2006 | |
|---|---|---|---|---|---|---|
| | Outturn | Original Budget | 4th Suppl. Budget 1/ | Prel. Estimates | Approved Budget | Staff Proj. 2/ |
| Total revenue | 30.1 | 32.1 | 31.5 | 30.3 | 31.5 | 30.6 |
| *of which:* Tax revenue | 27.1 | 28.0 | 27.6 | 27.3 | 27.9 | 27.2 |
| personal income tax | 2.9 | 3.0 | 2.3 | 2.4 | 2.6 | 2.6 |
| profit tax | 2.6 | 2.6 | 2.4 | 2.3 | 2.3 | 2.3 |
| VAT | 6.7 | 7.1 | 7.9 | 7.8 | 8.1 | 7.9 |
| Total expenditure | 31.1 | 33.6 | 32.6 | 31.1 | 32.0 | 31.5 |
| *of which:* current expenditure | 28.3 | 29.2 | 29.6 | 28.4 | 28.8 | 28.4 |
| wages | 4.8 | 5.0 | 5.7 | 5.4 | 5.5 | 5.2 |
| goods and services | 7.3 | 7.2 | 7.3 | 7.5 | 6.4 | 6.8 |
| capital expenditure | 2.8 | 4.3 | 2.9 | 2.6 | 3.2 | 3.1 |
| *Measures to reach target* | ... | ... | ... | ... | ... | *1.0* |
| Overall balance | -1.0 | -1.5 | -1.0 | -0.8 | -0.5 | 0.0 |

Sources: Romanian authorities; and Fund staff estimates and projections.
1/ Revised budget in December 2005.
2/ On the basis of a balanced budget; and measures equivalent to 1 percent of GDP.

The introduction of the flat tax, however, led to a loss in personal income and profit tax collections of about 1 percent of GDP (Box 4). This loss was offset by higher-than-budgeted indirect tax collections, due to strong demand for goods and services. Overall revenue, therefore, was broadly constant in terms of GDP. On the expenditure side, there were large overruns in the wage bill and significant cuts in capital expenditure (compared to budget). In addition, the low absorption of external grants led to significant shortfalls on co-financing. Moreover, fiscal policy was relaxed significantly in December 2005 (the budget recorded a surplus of 1 percent of annual GDP during January-November) as the government cleared arrears, paid for flood-related repairs and other goods and services, and injected capital into Exim Bank.

***A substantial fiscal expansion took place in December 2005.***



## Box 4. Tax Policy

Effective January 1, 2005, the profit tax was cut from 25 percent to 16 percent; a single personal income tax rate of 16 percent replaced a progressive five-bracket scale with rates of 18-40 percent; while the tax on micro-enterprises was increased and an already-approved cut in the social contributions rate was cancelled. Effective May/June 2005, the increase in excises envisaged for July was brought forward and excises increased further; the tax on interest and short-term capital gains (for securities and commercial real estate) was increased from 1 to 10 percent, the tax on gambling to 16 percent, and the profit tax, VAT, and excise-tax bases were broadened.

The revenue loss from the cut in the personal income and profit tax (compared with 2004) amounts to about 1 percent of GDP. Compared with the baseline of no tax cuts, the loss is about 1½ percent of GDP. This loss was compensated by better-than-budgeted VAT collections mainly on account of strong consumption.

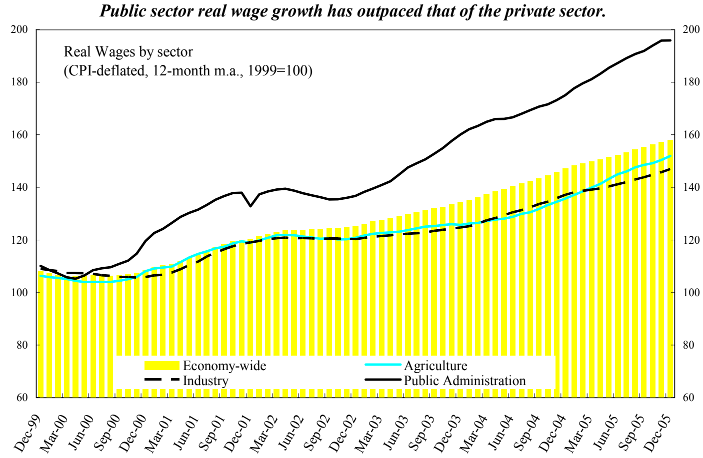
| | 2004 | 2005 | | |
|---|---|---|---|---|
| | | Original | Baseline | |
| | Actual | Budget | No Tax Changes | Outturn |
| | (In percent of GDP) | | | |
| Tax Revenue | 27.1 | 28.0 | 28.4 | 27.3 |
| Corporate income tax | 3.0 | 2.8 | 3.3 | 2.7 |
| Personal income tax | 2.9 | 3.0 | 3.2 | 2.4 |
| VAT | 6.7 | 7.1 | 7.7 | 7.8 |
| Excises | 3.2 | 3.8 | 3.0 | 3.2 |
| Social contributions | 9.2 | 9.3 | 9.4 | 9.4 |

Sources: Ministry of Finance and Fund staff estimates.

The 2006 budget includes: a reduction in the social contributions rate to 47½ percent; an increase in the agricultural land tax; an increase in the tax on interest, dividends, and short-term capital gains to 16 percent, and increases in excises (effective July 2006).

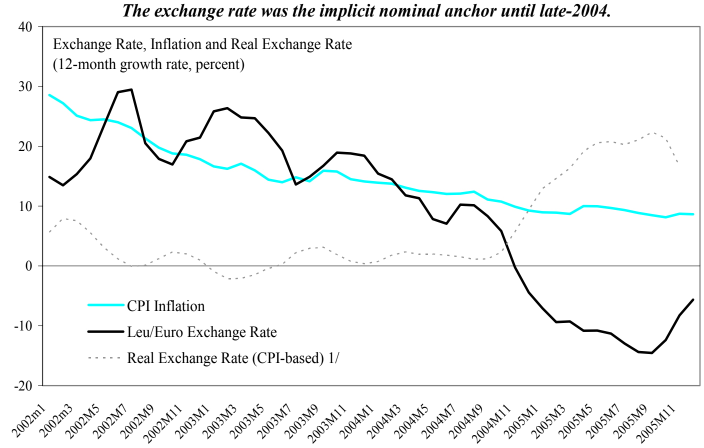
6. **In addition to the tax cut, procyclical wage and pension policies exacerbated domestic demand pressures.** Following substantial increases in late-2004, public-sector wages increased in two rounds during 2005, rising by up to 50 percent between October 2004 and October 2005. This policy led to average public-sector wage increases of 16-34 percent in 2005, helping to increase the wage bill by 0.6 percentage points of GDP. Finally, the recalculation of pensions for those retired before 2001 also increased government spending.

*Public sector real wage growth has outpaced that of the private sector.*



7. **The authorities' previous monetary policy framework gradually brought inflation down to low double-digits.** Up until end-2004, the NBR used the exchange rate as an implicit nominal anchor; guiding the rate to broadly match its disinflation goals, while allowing some real appreciation to reflect Romania's strong productivity growth. That policy was aided by restrictions on short-term capital inflows, affording the NBR a degree of autonomy in setting its policy interest rate. However, as part of the authorities' EU commitments, the capital account has been liberalized—as of April 2005 non-residents have been allowed to hold local-currency deposits, and as of February 2006 they are also allowed to hold treasury bills. The NBR reduced its policy interest rate from 21¼ percent in June 2004 to 7½ percent at end-2005; reflecting its success in reducing inflation, but also in an effort to lower capital inflows and to encourage more borrowing in local currency.

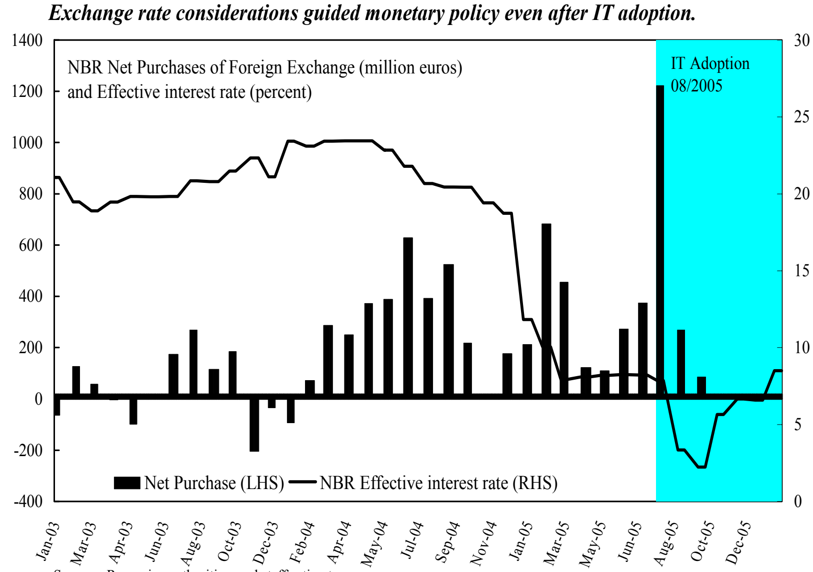
***The exchange rate was the implicit nominal anchor until late-2004.***




*Source: Staff estimates.*
*1/ 3-month moving average.*

8. **Despite the recent adoption of inflation-targeting (IT), the NBR is still influenced strongly by other macroeconomic objectives.** In a major regime change, the NBR announced its shift to IT in August 2005. However, facing sustained upward pressure on the exchange rate, it reduced its sterilization efforts in September 2005—refusing to absorb the full amount of excess liquidity in the banking system, and so driving its effective interest rate (the average rate at which it accepts bank deposits) significantly below its headline policy rate. The drop in the effective interest rate was largely successful in arresting short-term pressure on the exchange rate, but represented a significant procyclical easing of policy—throughout the final quarter of 2005, the effective interest rate was

***Exchange rate considerations guided monetary policy even after IT adoption.***

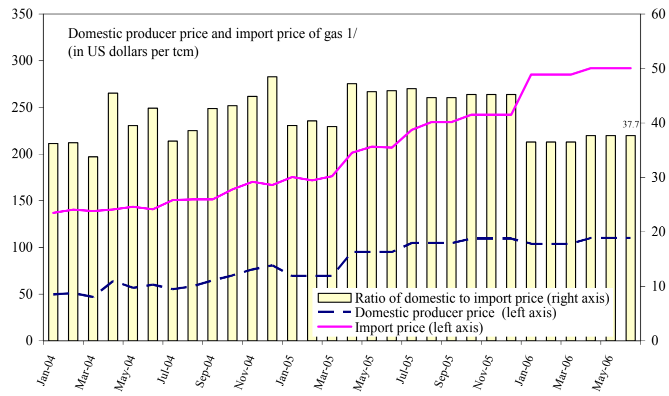



Sources: Romanian authorities; and staff estimates.

deeply negative in real terms. With less pressure on the exchange rate, the NBR has been able to refrain from intervention since November 2005, and has taken steps to gradually increase the volume of sterilization and raise the effective interest rate.

9. **Progress on structural reforms has been mixed.** Large-scale privatization has continued (including with the sale of Romania's largest bank (BCR), expected to be completed shortly), but the government is reconsidering its strategy for privatizing the last remaining publicly-owned bank (CEC). The privatization and deregulation of the electricity and gas markets has continued, the national reference price for heating has increased, and a new two-part heating tariff has been introduced. Still, gas prices (both producer and retail) have not adjusted in line with opportunity costs, and the domestic producer price is now only 38 percent of the international import price. Significant progress has been made in the implementation of the mining sector strategy. And parliament has approved amendments to the Labor Code: including on the use of short-term contracts, the extension of the probation period, more flexible working hours, and the introduction of an employer's right to retrench labor for economic reasons. However, these amendments fall short of eliminating some of the main sources of labor-market rigidity. Finally, judicial reform has progressed, including the recent establishment of a National Anticorruption Prosecutor's Office that will be able to investigate and prosecute members of parliament. Little progress has been made on the liquidation of Rafo, a large oil refinery and one of the biggest debtors to the budget.

***The domestic wellhead gas price remains well below the international price.***




Source: ANRGN
1/ Tariffs for the second quearter of 2006 are based on a Leu/$ exchange rate of 3.0, used by the authorities.

## III. Report on the Discussions

10. **Discussions focused on policies for reducing imbalances and setting the stage for sustainable high growth.** With slowing growth and disinflation, and a widening current account deficit, there was broad recognition that, unless decisive action is taken, the situation could deteriorate further. Accordingly, discussions covered the following questions:

- What is the most appropriate policy mix to reduce imbalances and best support the authorities' growth and inflation objectives in a new era of no capital controls?

- Can Romania bring inflation down to low single digits without relying as much on exchange rate appreciation and thus losing competitiveness and threatening growth?

- How can fiscal policy respond to substantial expenditure needs and raise resources to cover EU accession-related expenditures, while lowering the burden on monetary policy to lower inflation?

- What are the main elements of the structural reform agenda that will help Romania's convergence to EU living standards?

11. **The authorities have concurred with the thrust of the Fund's overall economic assessment and policy advice** (Box 5).

**Box 5. Fund Policy Recommendations and Implementation**

The authorities have broadly followed the Fund's policy advice 1/, although some recent policy decisions have exacerbated excess demand pressures.

**Fiscal policy:** While fiscal consolidation has continued, last year's tax cuts led to a significant revenue loss and were not accompanied by sufficient broadening of the tax base. Progress on tax administration and the articulation of a medium-term fiscal framework has been slow.

**Monetary policy:** Over the past two years, monetary policy has been broadly in line with Fund advice and has been successful in bringing inflation down to single digits, albeit slower than expected.

**Wage policy:** Substantial wage increases in the general government sector during 2004-06 have not been in line with the Fund's long-standing recommendation for prudent wage policy, and have threatened macroeconomic stability. By contrast, wage policy in the SOEs and minimum wage increases during 2005-06 were more prudent.

**Structural policies:** Significant progress has been made on privatization, and energy pricing has been broadly in line with Fund recommendations. However, domestic gas prices have fallen behind international prices and labor market flexibility has improved only marginally. Recent efforts to increase the independence and effectiveness of the judiciary should help improve the business climate.

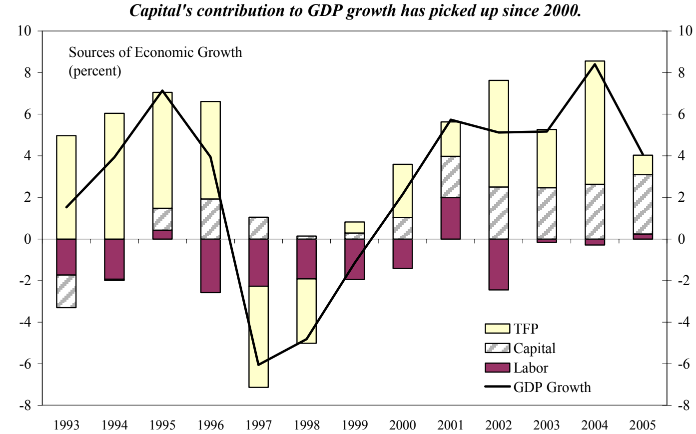
1/ http://www.imf.org/external/pubs/ft/scr/2004/cr04221.pdf

## A. Macroeconomic Outlook, Vulnerability, and Risks

12. **The authorities recognized that sustaining strong growth requires macroeconomic stabilization and renewed reform.** A tightening of macroeconomic policies is needed to resume disinflation and contain external imbalances. Tighter fiscal and incomes policies will allow monetary policy to fight inflation without excessive upward pressure on the exchange rate. In this connection, staff supported the authorities' commitment to further establish the credibility of the inflation-targeting regime. Moreover, the authorities agreed with the staff's analysis that, while the recent sharp leu appreciation has narrowed the margin, the exchange rate remained competitive.

13. **With suitable policies, staff sees sustainable economic growth at 5-6 percent.** Convergence to EU living standards[2] will require increased investment and employment creation. Increased investment, aided by EU transfers and the use of foreign savings, will raise capital's contribution to output growth, while privatization and enterprise restructuring will help sustain strong productivity gains. And as with recent EU accession countries (see: *Growth in the Central and Eastern European Countries of the European Union—A Regional Review*, (IMF Occasional Paper (to be published)), Romania's growth prospects will likely be enhanced through closer institutional, trade and financial integration with Western Europe. The authorities shared staff's optimism about Romania's prospects and noted that the sustainable growth rate could be boosted even further. Staff added that higher growth rates could only be supported by more ambitious reforms (Box 6).

***Capital's contribution to GDP growth has picked up since 2000.***




*Source: National Institute of Statistics of Romania and Fund staff estimates.*

Romania: Growth Accounting
(In percent)

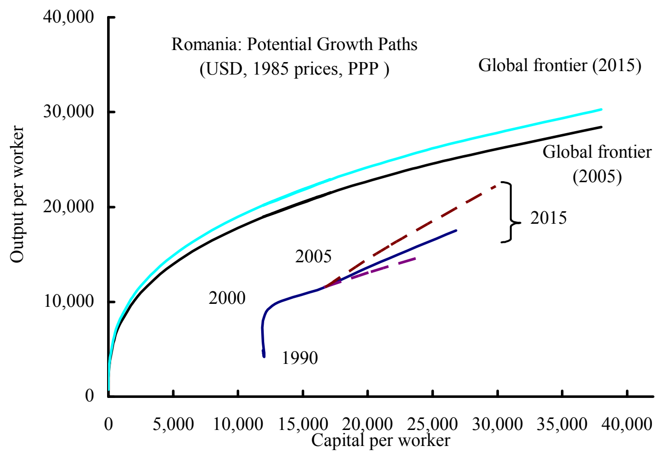
| | GDP Growth | Contributions: Capital | Labor | TFP |
|---|---|---|---|---|
| 1992-99 | 0.5 | 0.4 | -1.7 | 1.9 |
| 1999-2005 | 5.1 | 2.2 | -0.4 | 3.2 |
| 2005-11 | 5.6 | 3.0 | -0.2 | 2.7 |

Source: Fund staff estimates and projections.

[2] Selected Issues Paper, *Real Convergence Prospects*.

## Box 6. Accession, Efficiency, and Long-Term Growth

**As outlined by the staff's analysis in *Growth in the Central and Eastern European Countries of the European Union—A Regional Review*, (IMF Occasional Paper (to be published)), integration with the EU will likely play a profound role in supporting growth in Romania.** As with other countries, catch-up growth will be dominated initially by increases in TFP, and recent staff research has provided a quantitative model of how Romania's productivity may evolve over the next decade (see IMF Country Report No. 05/416). The model uses a stochastic-frontier framework that relates each country's productivity to its overall efficiency—i.e., how effectively the country employs its available resources. The model then provides a measure of this efficiency, gauged against a hypothetical benchmark in which all resources are used optimally using international best-practice techniques. In the context of Romania's accession, the model allows us to draw from the experience of other countries, focusing in particular on that of the EU.




**With convergence, we can expect a sizeable improvement in overall efficiency and income.** Part of this will reflect an EU-supported increase in public investment and infrastructure. A further—perhaps larger—part will reflect the authorities' success in bringing Romania's institutional framework into greater harmony with EU standards. Within this framework, staff have outlined three quantitative scenarios.

In the **high-case scenario**, it is assumed that the authorities are able to absorb all EU grants, and that they are able to implement in full a successful program of institutional and structural reform. It is estimated that, over the next ten years, this would bring Romania's efficiency level from the current level of 50 percent to about 70 percent—the estimated efficiency level for both Greece and Portugal in 2000 was about 75 percent. The net result is a significant boost in TFP, and a sustainable GDP growth rate of 7½ percent. The staff's **medium-case scenario** is deliberately conservative. It allows for some slippage in the authorities' structural reform program, and assumes a more subdued pace of public investment—the latter resulting from project-management bottlenecks or other binding constraints. Overall, this scenario envisages a modest improvement of efficiency from 50 to 60 percent; corresponding to a TFP growth rate similar to 2000-05, and a sustainable GDP growth rate of about 5 percent. **The low-case scenario**, on the other hand, assumes no improvement in Romania's efficiency level, corresponding to an incomplete reform effort and a persistently unfriendly investment climate. Productivity in this case is disappointing, with GDP growth averaging only 3 percent.

Romania: Contributions to Long-Run Growth, 2000-2015

| | 2000-2005 | 2006-2015 | | |
|---|---|---|---|---|
| | Avg. | Low case | Baseline | High case |
| *Efficiency* | 48 | 50 to 50 | 50 to 60 | 50 to 70 |
| Capital per worker 1/ | 2.2 | 1.3 | 1.7 | 2.1 |
| Human capital | 0.6 | 0.6 | 0.6 | 0.6 |
| Total Factor Productivity | 2.5 | 1.0 | 2.6 | 4.6 |
| Output per worker | 5.3 | 2.9 | 4.9 | 7.3 |
| *Memo Item:* | | | | |
| Avg. real investment growth | 8.5 | 4.0 | 6.0 | 8.0 |
| Avg. real output growth | 5.8 | 3.0 | 5.0 | 7.5 |

1/ Projections based on an average labor force growth rate of 0.7 percent p.a. Capital/GDP is estimated at 1.5 in 2005.

Source: Fund staff calculations

14. **With an appropriate policy mix, staff forecast a modest pick-up in 2006 growth, alongside further disinflation and a lower current account deficit.** Growth, projected at 5.2 percent, will be driven by a recovery in agriculture and industry, while domestic demand growth will slow due to fiscal consolidation (as outlined in the staff's scenario), more moderate wage growth, and monetary tightening. Staff's scenario projects an inflation outcome of 6.5 percent and a current account deficit of 8.5 percent of GDP, mainly on account of a slowdown in consumption-related import growth. The authorities broadly agreed with this scenario, but thought that growth could be higher.

Savings-Investment Balances, 2004-06
(In percent of GDP)

| | 2004 | 2005 | 2006 | |
|---|---|---|---|---|
| | | Prel. Estimates | Staff Proj. 1/ | |
| Savings Rate | 13.9 | 14.0 | 15.7 | |
| Non-government | 12.1 | 12.1 | 12.9 | |
| Government | 1.7 | 1.8 | 2.8 | |
| Investment rate | 22.3 | 22.7 | 24.2 | |
| of which: fixed investment | 21.6 | 23.1 | 24.1 | |
| Non-government | 18.9 | 20.5 | 21.3 | |
| Government | 2.8 | 2.6 | 2.8 | 2/ |
| Savings-Investment Balance | -8.5 | -8.7 | -8.5 | |
| Non-government | -7.4 | -7.9 | -8.5 | |
| Government | -1.0 | -0.8 | 0.0 | |

Sources: Romanian Authorities, Fund staff estimates and projections.

1/ On the basis of a balanced budget, and measures equivalent to 1 percent of GDP.

2/ Staff's scenario assumes lower-than-budgeted capital spending (0.3 percent of GDP) in line with recent budget implementation trends.

15. **Although vulnerability indicators point to low short-term risks, medium-term risks would be more substantial without a shift to more stability-oriented policies and structural reforms.** External and public debt levels are low, and reserve coverage is comfortable. However, uneven policy implementation remains a key source of risk. In the absence of a change in the policy mix, inflationary pressures will continue, the deterioration in external competitiveness could deepen, and the widening in the current account deficit could continue, potentially fueling a boom-bust cycle (baseline scenario in text table).

Key Macroeconomic Indicators, 2005-07

| | 2005 | 2006 | | 2007 | |
|---|---|---|---|---|---|
| | Prel. Estimates | Baseline 1/ | Staff Proj. 2/ | Baseline 1/ | Staff Proj. 2/ |
| (In percent of GDP, unless otherwise indicated) | | | | | |
| Real GDP growth (percent) | 4.1 | 5.4 | 5.2 | 5.1 | 5.6 |
| CPI (change in percent; end of period) | 8.6 | 7.5 | 6.5 | 6.1 | 4.0 |
| Current account deficit | -8.7 | -8.8 | -8.5 | -8.6 | -8.3 |
| General government deficit | -0.8 | -0.5 | 0.0 | -1.0 | 0.2 |
| Reserve cover (months of imports) | 5.6 | 5.6 | 6.6 | 5.5 | 6.5 |
| Gross External Debt | 32.4 | 33.7 | 32.4 | 33.4 | 31.3 |
| Public Debt | 18.9 | 17.8 | 16.7 | 16.6 | 15.3 |
| (In percent) | | | | | |
| Contribution to Growth | | | | | |
| Domestic demand | 9.1 | 9.2 | 7.9 | 7.8 | 7.8 |
| Consumption | 7.4 | 5.6 | 4.9 | 5.5 | 5.2 |
| Households | 6.5 | 5.7 | 5.0 | 5.1 | 4.4 |
| Government | 0.9 | -0.1 | -0.1 | 0.4 | 0.8 |
| Fixed Capital Formation | 2.8 | 2.3 | 2.6 | 2.3 | 2.5 |
| Households | 2.8 | 2.3 | 2.4 | 1.8 | 2.0 |
| Government | 0.0 | 0.1 | 0.2 | 0.5 | 0.5 |
| External demand | -5.0 | -3.8 | -2.7 | -2.8 | -2.1 |

Sources: Romanian authorities; and Fund staff estimates and projections.
1/ Baseline is based on the approved budget and unchanged policies.
2/ Incorporates a change in the policy mix as recommended by Fund staff, including measures equivalent to 1 percent of GDP.

All these factors would adversely affect the debt-service capacity of households and enterprises, placing the banking system under strain.

## B. Macroeconomic Policies

### Fiscal policy

16. **The authorities and staff agreed that fiscal policy should be the centerpiece of the authorities' strategy, although differences of view arose regarding the size of fiscal adjustment.** Fiscal policy should aim at stemming excess demand and keeping public finances on a sustainable medium-term path. To this end, staff urged the authorities to target a balanced budget in 2006 and small surpluses over the medium term. With the expenditure envelope already tight, staff suggested that the proposed fiscal adjustment be implemented through revenue-raising measures. Staff also noted that although fiscal sustainability is not an immediate concern, in light of the country's low public debt (Appendix IV) a tight fiscal and incomes policy is needed to quell excess demand pressures from continued large capital inflows. The authorities saw merit in further fiscal consolidation this year, but considered the 0.3 percent of GDP adjustment envisaged for 2006 (from last year's outturn of 0.8 percent of GDP) as sufficient. They also noted that the factors that led to the excess demand pressures last year, namely the tax cut and wage hikes, would not be repeated this year. They felt that small deficits could be accommodated in the medium term, without endangering fiscal sustainability and noted the need to boost infrastructure spending.

17. **Given the tight expenditure envelope, both sides saw the need for permanently strengthening revenue.** First, the recent compression of expenditure, manifested in growing arrears, is unsustainable. Second, to enhance employment and growth, the social contributions tax needs to fall, and the associated revenue loss has to be offset by other taxes. Third, the government-revenue ratio is considerably below levels in all EU-25 countries, Bulgaria, and Croatia. Moreover, additional revenue will be needed to provide resources for Romania's contribution to the EU budget and co-financing of EU projects.[3]

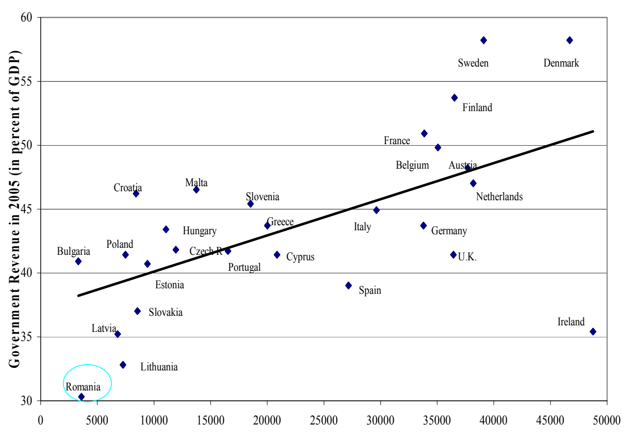
**Social Security Contributions Rates, 2004**

(In percent of gross earnings)

| | Employer | Employee | Total |
|---|---|---|---|
| Romania 1/ | 32.5 | 17.0 | 49.5 |
| Czech Republic | 35.0 | 13.0 | 48.0 |
| Slovak Republic | 35.0 | 13.0 | 48.0 |
| Hungary | 32.0 | 14.0 | 46.0 |
| Poland | 21.0 | 25.0 | 46.0 |
| Bulgaria | 32.0 | 10.7 | 42.7 |
| Slovenia | 16.0 | 22.0 | 38.0 |
| Croatia | 16.6 | 20.6 | 37.2 |
| Estonia | 34.0 | 1.0 | 35.0 |
| Lithuania | 31.0 | 3.0 | 34.0 |
| Latvia | 24.0 | 9.0 | 33.0 |

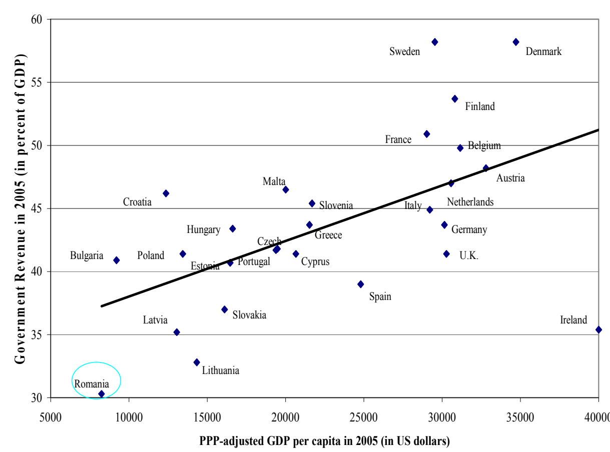
Sources: World Bank EU-8, Quarterly Economic Report, April 2005; and IMF staff.
1/ Reduced to 47.5 percent as of January 1, 2006.

*Romania's general government revenue is the lowest compared with EU countries,*




Sources: Eurostat, WEO, and staff estimates.

*... even if GDP is measured on PPP-adjusted terms.*



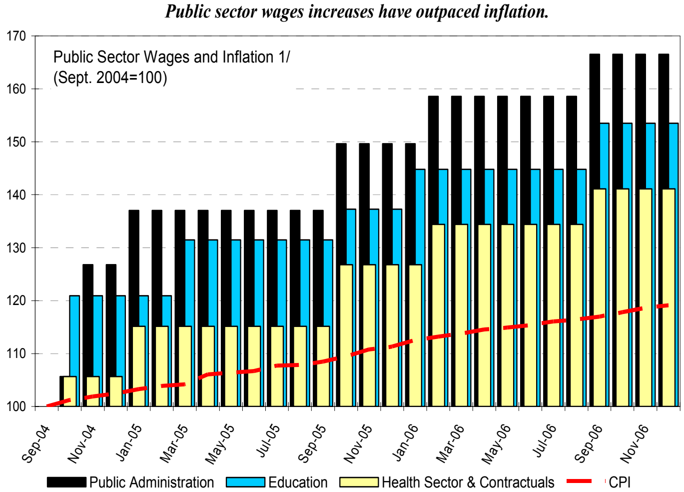

Finally, Romania faces substantial infrastructure needs. Staff suggested the following menu of options for strengthening revenue: an increase in the VAT, revisiting the rate of the flat tax, broadening the tax base, increasing property taxes, increasing administrative fees, and improving revenue administration. Staff also noted the importance of stability in the fiscal code and recommended that significant revenue-raising measures be approved in the first half of this year, to take effect no later than January 2007. The authorities indicated their plans for a comprehensive revision of the fiscal code later in 2006, but did not elaborate on specific measures. They noted, though, that planned improvements in revenue administration should strengthen revenue collections.

[3] Selected Issues Paper, *Fiscal Impact of EU Accession*.

18. **The authorities' efforts to strengthen revenue administration are a step in the right direction, but must be buttressed with legislative changes.** With FAD and World Bank assistance, the authorities have embarked on a comprehensive reform of revenue administration. Staff urged the authorities to draw on the plan proposed by the June 2004 FAD mission to modernize tax administration and broaden the tax base. This plan aims at: establishing full control of field offices; limiting the role of the unified revenue agency to revenue administration; eliminating restrictions on audits and arrears enforcement; and harmonizing tax and social requirements for income definitions and bases, eligibility determination, and payment. Staff also noted the need to adopt a comprehensive plan to eliminate illegal trade in petroleum products and cigarettes, and fight corruption in customs administration. Finally, staff cautioned that although administration improvements are always welcome, it would take time for such benefits to materialize.

19. **The authorities recognized the importance of a strict public-sector wage policy for successful disinflation.** To anchor inflation expectations in low single digits, public sector wages should increase only once a year. Moreover, wage levels need to reflect skill needs, otherwise a ballooning wage bill will only undermine the creation of a modern civil service and the ability to absorb EU funds. Staff also noted that following recent substantial wage increases, the government's wage policy should be recalibrated to the needs of a low inflation economy. To this end, the announced average public sector wage increases for 2006 of 12-15 percent are incompatible with the NBR's 5-percent inflation objective. The authorities broadly shared the mission's assessment and agreed that, given recent wage increases, a tightening of wage policy is required. Moreover, starting in 2007, they committed to one wage increase per year. Finally, they noted that the increase in the minimum wage was contained to 6.5 percent in 2006 and considered the 3.5 percent increase in the wage bill of the SOEs that are monitored under the Stand-By Arrangement prudent.

***Public sector wages increases have outpaced inflation.***




1/ On the basis of projected inflation of 6.5 percent for end-2006.

20. **Staff noted that additional measures will be needed to achieve the fiscal objective.** The envisaged reduction in the allocation for goods and services is not sustainable and could lead to new arrears. This consideration, combined with pressures stemming from recent wage increases, points to an underlying deficit of over 1 percent of GDP, compared with the approved deficit of 0.5 percent of GDP. Staff welcomed the government's decision to freeze all vacant positions in the general government (with the exception of EU accession-related hiring), which is expected to offset wage overruns. Staff also urged the authorities to cancel bonuses and monitor wage developments closely. In the absence of further measures, meeting the deficit target may again result in a squeeze in capital expenditure. The authorities

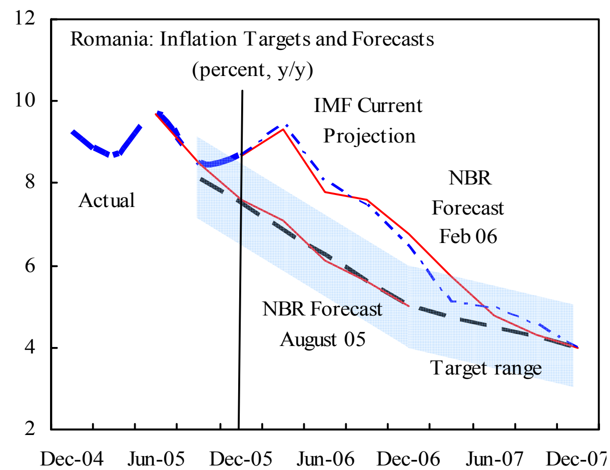
felt confident that the budgeted allocation for goods and services was sufficient, and thus additional measures would not be needed to meet their deficit target. Staff also highlighted the risk to the fiscal target of using the proceeds from the sale of BCR for non-budgeted projects. Finally, staff noted that, to balance the budget and provide for a permanent increase in revenue, strong revenue action is needed.

21. **The authorities acknowledged the fiscal-management challenges associated with the expected sizeable privatization proceeds and EU transfers.** As a first step, it is important to assess the macroeconomic impact of privatization proceeds (projected at about 3 percent of GDP in 2006) and EU transfers (over 2 percent of GDP in 2007). Staff noted that, while privatization inflows will help reduce public debt and support the pension reform in the coming years, they may also risk generating pressures for higher spending, thus resulting in higher deficits, and weakening the resolve for fiscal reform. In addition, staff stressed the importance of developing a medium-term framework that will set a realistic fiscal trajectory, fully incorporating revenue from privatization, post-accession EU receipts and expenditures, and the impact of ongoing reforms. Moreover, it is important to put in place mechanisms to ensure the efficient allocation of resources and absorption of EU inflows. Transparency and candid communication will help avoid surprises, while simultaneously improving budgetary controls. With EU accession approaching, structural fiscal reforms will be important in improving the quality of public expenditure. The World Bank has been assisting the authorities with, among other, reforms of the civil service, health, and pension systems, with the objectives of overhauling pay and employment practices, improving the quality of health services while containing costs, and introducing a second pension pillar, respectively. Finally, public spending management needs to be improved to ensure a uniform spending pattern over the year.

### Monetary policy

22. **Discussions focused on the need to strengthen confidence in the NBR's commitment to inflation targeting.** In the staff's view, the introduction of inflation targeting had been somewhat inauspicious—the announcement of the new regime had coincided with strong capital inflows, prompting the NBR to intervene heavily in the foreign exchange market and to cut interest rates, rather than allow further appreciation. While acknowledging that the authorities faced a difficult environment, staff noted that the inflation target had been missed just four months after its announcement and remarked that the policy compromise had sent mixed signals to the market, complicating the NBR's efforts to successfully anchor inflationary expectations.

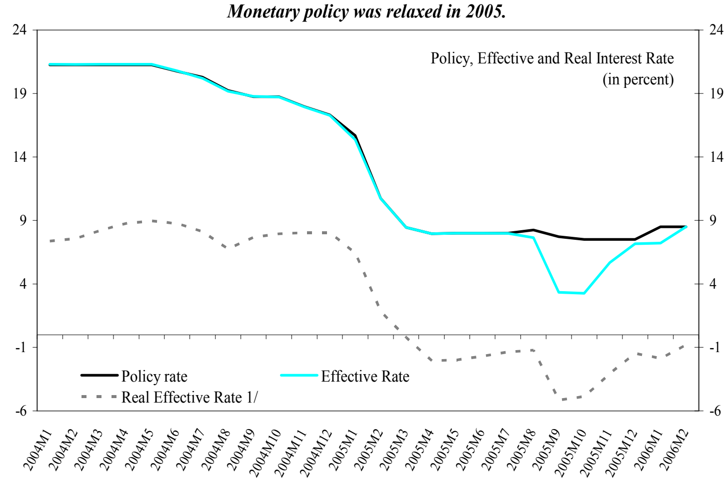
23. **Staff projections for inflation, broadly in line with those of the authorities, imply that the NBR was unlikely to meet its target for 2006.** Missing this year's target would reflect the impact on inflationary expectations of the 2005 miss, together with the delayed impact of monetary easing and higher wages. In addition, planned increases in administered prices would likely add 2½-3 percentage points to the headline inflation rate. Market forecasts for end-2006 were generally consistent with this view, falling within the 7-8 percent range.




24. **Nonetheless, it was agreed that, on balance, there was little benefit in adjusting upward the inflation targets for 2006-07.** While noting that it is generally desirable to set targets that are ambitious yet feasible, staff concurred that a large revision of the 2006 target would be more costly in terms of the NBR's credibility. The authorities pointed to their own simulations, which suggested that such a revision would significantly dampen the pace of disinflation over the forecast horizon. The mission stressed that the key to regaining credibility was to provide a frank public discussion of the reasons for missing the 2005 target—including a discussion of policy errors. Also, while candidly acknowledging that the 2006 target range might now be out of reach, the discussion should focus instead on the inflation forecast for end-2007 and include a credible action plan to achieve the 4-percent target by the end of this period. The authorities agreed on the need for supporting fiscal and incomes policy to achieve the inflation objective.

25. **In this context, staff urged an immediate tightening of monetary policy—both to bring the 2006 target closer within reach and to ensure that inflation can feasibly arrive at the center of the target range for 2007.** To signal clearly the primacy of inflation over other considerations, staff suggested that this should be effected principally through higher interest rates, requiring an immediate increase of both the policy and the effective rates of at least 100 basis points. Further increases might prove necessary depending on the evolution of exchange rates,

*Monetary policy was relaxed in 2005.*




1/ Based on 12-month backward-looking inflation rate.

wages, and the persistence of inflationary expectations.

26. **The authorities shared the staff's view that, while Romania's margin of competitiveness has been eroded, the exchange rate remains competitive (Box 3).**[4] Exports were still performing well due to a welcome shift away from low value-added goods, as well as an improvement in the quality of goods. Moreover, trend real appreciation was a phenomenon shared by most transition countries as they converged with Western Europe, although the recent real appreciation was sharper and faster than that experienced in other transition economies. Staff's analysis showed that Romania's real exchange rate was still undervalued, and would continue to rise with further market-friendly institutional reform and associated capital inflows. The authorities agreed with this assessment. In this context, the mission suggested that an appreciation resulting from monetary tightening should be accommodated, unless it leads to a possible undershooting of the inflation target. Staff stressed that intervention in the foreign exchange market should be sterilized fully at the policy rate, and should be focused primarily on reducing excess volatility, rather than attempting to control a longer-term trend. In addition, staff emphasized that NBR balance sheet concerns should not determine the conduct of monetary policy.

27. **Following the conclusion of the mission, the NBR announced a 100 basis-point increase in the policy rate to 8.5 percent.** Sterilization operations have also been stepped up, bringing the effective rate in line with the policy rate. And as expected, this has generated added pressure on the local currency, which has appreciated by about 5 percent against the euro since the beginning of the year. In the staff's view, these movements will impact demand and inflation in the conventional manner—although, taking into account the effect of high euroization and low household debt on Romania's monetary transmission mechanism, the exchange rate channel is likely to be stronger, and the interest-rate channel weaker, compared to other more financially-developed economies.

28. **Prudential restrictions on credit flows (Box 1) had a significant short-run impact on the mix between foreign-currency and local-currency lending.**[5] From a peak of 5 percent of GDP in August 2005, the annualized flow of foreign-currency credit turned negative by end-December, while local-currency flows have almost doubled to 7 percent of GDP over the same period. The mission observed, however, that the shifting composition of lending had been assisted in large part by monetary loosening over the course of 2005, which had resulted in a narrowing gap between local– and foreign-currency interest rates. Nonetheless, despite expanding lei credit, the pace of overall lending has decelerated—with a drop in the total (annualized) credit flow from about 9 percent of GDP in August to just above 5 percent of GDP in December.

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[4] The mission presented a seminar to discuss its findings on competitiveness. The staff's analysis and conclusions are included in a Selected Issues Paper.

[5] Selected Issues Paper, *Credit Growth: Developments and Prospects*; and WP/05/128.

29. **Staff cautioned, however, that the effectiveness of administrative measures would likely diminish over time.** Demand for credit remains strong, so borrowers and lenders have a continued incentive to find alternate channels for funding. Indeed, some foreign-owned banks have started to adjust to the new lending limits; e.g., by selling their loan portfolios abroad, or by raising additional capital. Moreover, restrictions on bank lending may have encouraged direct foreign borrowing by large corporate clients, and may have also favored the less-regulated non-bank financial sector. On the latter point, the authorities have taken steps to bring non-bank institutions (NBFI) within the scope of their authority, and the mission welcomed efforts to speed up the implementation of supporting legislation—pending passage of this legislation, an emergency ordinance bringing NBFIs under NBR regulation and supervision was passed, and it is anticipated that the new NBFI requirements will be fully effective by mid-2006.

30. **To ensure the development of a sound and efficient financial system, staff advised the authorities to be wary of viewing prudential-style measures as a substitute for more traditional stabilization instruments.** Prudential measures should aim to ensure that the risks associated with credit growth are adequately managed by lenders. Moreover, staff warned that, if used in the place of interest rates to dampen demand. such measures are often associated with undesirable or unintended consequences, and might fuel doubts regarding the priority given to controlling inflation.

## C. Financial Sector Stability and Development

31. **The mission observed that, while the banking sector seemed well-positioned to absorb adverse shocks, the authorities needed to be alert to medium-term vulnerabilities.** Financial soundness indicators suggest a relatively healthy and robust financial system, and discussions increased staff's confidence in this assessment. Rates of return on equity and capital-adequacy ratios are high, while non-performing loan (NPL) ratios remain at moderate levels. NBR stress tests also suggested that the banking system was resilient to the direct impact of interest rate and exchange rate movements. Still, indirect exposures through loan portfolios are more difficult to assess, and need to be reflected in high capital ratios and conservative provisioning. In addition, strong income and credit growth in recent years have helped hold down NPL ratios. As growth slows to more sustainable rates and loan portfolios mature, NPL ratios could increase significantly.

32. **Substantial progress has been made in strengthening the regulatory and supervisory framework.** Many recommendations made in the 2003 Financial Sector Assessment Program (FSAP) have been implemented, including the introduction of consolidated supervision; payment and settlements systems; the recent extension of supervision to cover non-bank credit institutions; improved information exchanges with foreign-banking supervisors; tighter regulation of lending exposures; and establishment of a credit bureau. The mission observed that progress in developing capacity for assessing financial-system stability had been impressive. Staff looked forward to the publication of the first Financial Stability Report in April/May 2006.

33. **Implementation of FSAP recommendations should continue**, including improving accounting and audit practices in the corporate and financial sectors; strengthening investor and creditor rights and judicial-system effectiveness; promoting increased information sharing through the credit bureau, including through closer monitoring of banks' efforts to assess borrower indebtedness. The mission supported efforts to further upgrade the NBR's risk-assessment capacity, especially in preparation for introduction of Basel II. Staff suggested that the authorities should also consider issuing financial instruments to establish benchmark yields, thus promoting domestic capital-market activity.

## D. Structural Policies

34. **The authorities saw structural reforms as crucial for convergence to EU living standards.** Discussions focused on a range of issues, many of which are covered by the World Bank in the context of their PAL 2 discussions.

### Privatization

35. **The authorities acknowledged the need to maintain momentum for privatization.** They noted that the recent sale of BCR was an important success for the government and should help improve the business climate and attract FDI. Staff urged them to continue with the privatization of CEC, the restructuring and privatization of the power generation sector (including Romgaz), and the privatization of other smaller companies.

### Energy Sector and Mining

36. **Although the authorities recognized the need to continue energy price adjustments, they were hesitant in announcing their intentions.** Staff regretted that gas prices had not been adjusted in line with opportunity costs. They also urged the authorities to announce publicly a schedule for increased domestic producer prices, in line with their EU commitment to achieve import parity over the medium term. Accelerating the speed of price convergence, while allowing adequate time for agents to adjust, would help expedite enterprise restructuring. Staff also noted the importance of implementing the heating sector strategy. Finally, staff commended progress in implementing the mining sector strategy and argued for the accelerated restructuring of the hard coal sector.

## Labor market

37. **There was consensus that a more flexible labor market is needed.** Staff noted that labor market rigidities are impediments to a business-friendly environment and Romania stands out compared with other countries, particularly on costs of hiring and firing workers. The authorities recognized that labor market flexibility was low as of end-2005, but noted that the recent amendments to the Labor Code (not incorporated in the calculation of World Bank indicators) were expected to increase flexibility and participation, including by reducing the costs of hiring and firing. Staff expressed reservations about the adequacy of these measures and urged the authorities to further amend labor market legislation to increase employers' representation in the Economic and Social Council, and eliminate the obligatory nature of collective wage contracts for non-signatory parties.

**Indicators of Labor Market Flexibility and Business environment**

| | **Romania** | Bulgaria | Czech Republic | Hungary | Poland | Region 1/ | OECD |
|---|---|---|---|---|---|---|---|
| **Starting a Business (2005)** | | | | | | | |
| Procedures (number) | **5.0** | 11.0 | 10.0 | 6.0 | 10.0 | 9.7 | 6.5 |
| Time (days) | **11.0** | 32.0 | 40.0 | 38.0 | 31.0 | 36.5 | 19.5 |
| Cost (% of income per capita) | **5.3** | 9.6 | 9.5 | 22.4 | 22.2 | 13.5 | 6.8 |
| **Hiring & Firing Workers (2005)** | | | | | | | |
| Difficulty of Hiring Index 2/ | **67.0** | 61.0 | 33.0 | 11.0 | 11.0 | 34.5 | 30.1 |
| Difficulty of Firing Index 3/ | **50.0** | 10.0 | 20.0 | 20.0 | 40.0 | 41.5 | 27.4 |
| Hiring cost (% of salary) | **34.0** | 32.2 | 37.0 | 33.5 | 25.8 | 29.6 | 20.7 |
| Firing costs (weeks of wages) | **98.0** | 29.8 | 21.6 | 33.5 | 24.9 | 32.8 | 35.1 |
| **Closing a Business (2005)** | | | | | | | |
| Time (years) | **4.6** | 3.3 | 9.2 | 2.0 | 1.4 | 3.5 | 1.5 |
| Cost (% of estate) | **9.0** | 9.0 | 14.0 | 14.0 | 22.0 | 14.0 | 7.4 |
| Recovery rate (cents per dollar) | **17.5** | 33.5 | 17.9 | 35.8 | 64.0 | 29.8 | 73.8 |

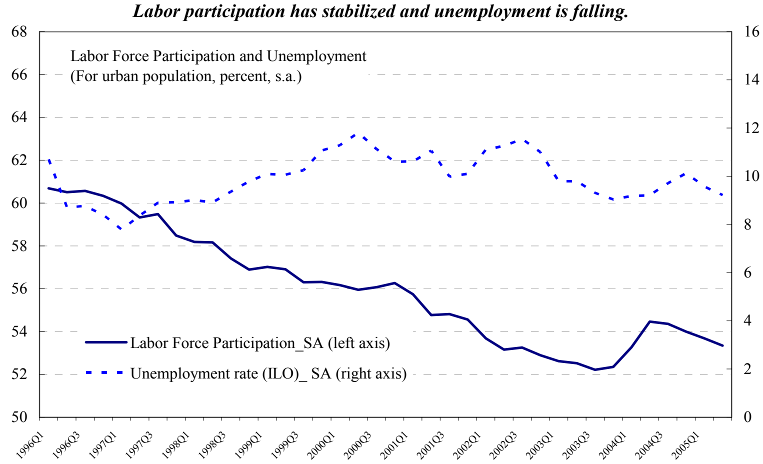
*Source: World Bank- Doing Business.*

1/ Includes Europe and Central Asia.

2/ The index takes a value between 0 and 100, with higher values indicating more rigid regulation. The index measures (i) whether term contracts can be used only for temporary tasks; (ii) the maximum duration of term contracts; and (iii) the ratio of the mandated minimum wage to the average value added per worker

3/ The index has several components, including (i) whether redundancy is not considered fair grounds for dismissal; (ii) whether notification to and approval from the labor union or the labor ministry is needed for firing 1 redundant worker or for group dismissals; etc.

***Labor participation has stabilized and unemployment is falling.***




Sources: National Institute of Statistics of Romania and Fund staff estimates.

## Governance

38. **The authorities are determined to strengthen governance and improve the business climate.** During various discussions, the business community noted the difficulties of using the judicial system. The authorities, however, felt that rapid progress is being made on forcefully implementing the judicial reform agenda. They also noted their determination to pursue the liquidation of Rafo, and to implement effectively the improved bankruptcy proceedings approved last year.

Finally, the authorities established a National Anticorruption Prosecutor's Office that will be able to investigate and prosecute members of parliament.

### E. Program Issues

39. **Staff noted its preparedness to engage in program discussions, should the authorities request a resumption of the SBA review discussions**. In June 2005, staff had reached understandings on the completion of the next SBA reviews, but political turmoil in July derailed implementation of key policies agreed with staff. The authorities expressed their interest in resuming discussions to complete reviews of the SBA prior to its expiration in July 2006, and noted that over the coming months they would engage staff on the key conditionality for a Fund-supported program.

## IV. Staff Appraisal

40. **Romania stands at an important crossroad.** Although convergence to the EU continues and confidence in the country's medium-term prospects remains high, the economic outlook is clouded by widening imbalances. Economic growth and disinflation have slowed, and external imbalances have widened. Despite continued fiscal consolidation, domestic demand has been exacerbated by rapid credit growth and procyclical policies— i.e., substantial tax cuts and public-sector wage increases.

41. **A tightening of policies is needed to resume Romania's disinflation path to reduce external imbalances and vulnerabilities and to set the stage for sustainable growth.** Consumption smoothing is understandable, but it is important to pay due regard to enhancing the economy's productive capacity and to design macroeconomic policies more prudently until real income growth is secured. Higher foreign savings will ultimately boost investment and help the country's integration into the EU. But care must be taken to invest these funds wisely, and to ensure that the urge to increase current consumption does not generate excess private or government spending that could jeopardize the authorities' stabilization goals. Tighter fiscal and incomes policies will relieve some of the burden on monetary policy and will minimize upward pressure on the exchange rate. While most vulnerability indicators are satisfactory, failure to address the economy's widening imbalances may eventually lead to an adverse change in market sentiment.

42. **A strong fiscal stance should be the centerpiece of the authorities' strategy, especially given the likelihood of continued large capital inflows.** To this end, and although fiscal sustainability is not of immediate concern, the authorities should target a balanced budget for 2006 and small surpluses thereafter. Without further measures, meeting the government's 2006 deficit target of 0.5 percent of GDP may again result in an unfortunate squeeze in capital expenditure. Moreover, staff cautioned the authorities on the utilization of privatization proceeds for higher spending, thus resulting in a larger deficit, which would then compromise their macroeconomic objectives.

43. **Given the tight expenditure envelope, there is a need to strengthen revenues.** It is therefore regrettable that the introduction of the flat tax resulted in a sizeable revenue loss. Additional resources will be required for Romania's contribution to the EU budget and co-financing of EU projects, and to allow for a much-needed boost in infrastructure spending. High social contribution taxes remain an impediment to employment, and needed cuts in labor taxation will have to be offset by other taxes. Finally, given the importance of stability in the tax code, well-designed revenue-raising measures should be approved now and take effect no later than January 2007. This would forgo the need of tinkering with the tax regime thereafter. It is also important to broaden the tax base and modernize fiscal administration.

44. **The authorities should prepare an ambitious and transparent medium-term framework—setting a realistic fiscal trajectory, and fully incorporating the impact of ongoing reforms and post-accession flows.** Such a framework would avoid surprises, while simultaneously improving budgetary controls. In this context, public spending management needs to be improved to ensure a uniform pattern over the entire year and thus prevent sudden inflationary pressures. Moreover, the authorities need to assess the macroeconomic impact of large privatization proceeds and EU funds. It is essential to put in place mechanisms to ensure the efficient allocation of resources and a high absorption rate for EU inflows.

45. **Prudent public sector wage policy is critical for macroeconomic stability**. With large wage increases, inflation in Romania has been considerably higher than in all other European countries over the past 15 years. The government's wage policy needs to be recalibrated to the needs of a low inflation economy, featuring wage increases only once a year. While the government's recent decision to freeze all vacant positions in the general government (with the exception of EU accession-related hiring) is welcome, vigilance will be necessary to avoid wage overruns. In the staff's view, the 2006 wage increases in the general government are not compatible with the NBR's announced inflation target. Nonetheless, the authorities should be commended for their prudent decisions regarding the minimum wage and the wage bill of public enterprises.

46. **The central bank should continue strengthening its inflation-targeting credentials.** The recent tightening of monetary policy is most welcome, but further tightening might be necessary. The February increase in the policy interest rate by 100 basis points is an important first step, as it not only underscores the primacy of inflation over other considerations, but will also play a vital role in bringing inflation down to the center of the target range by end-2007. Although the exchange rate remains competitive, Romania's margin of competitiveness has been eroded, so productivity gains and prudent wage policies will be needed to offset the impact of a strong currency. The staff recommends that interventions in the foreign exchange market be fully sterilized and focused on reducing excess volatility in the foreign exchange market, rather than on controlling the longer-term trend. With real appreciation likely as part of the income convergence process with the EU, it is preferable that this is achieved via the exchange rate rather than higher inflation.

47. **The banking sector seems well-positioned to absorb adverse shocks, but the authorities still need to be alert to medium-term vulnerabilities.** Financial soundness indicators suggest a relatively healthy and robust financial system, and stress tests suggest that the banking system would be resilient to the direct impact of interest rate and exchange rate movements. Still, indirect exposures through loan portfolios are more difficult to assess, and need to be reflected in capital ratios and conservative provisioning.

48. **The authorities have made substantial progress in strengthening the regulatory and supervisory framework.** Most of the recommendations contained in the 2003 FSAP have been implemented, and the NBR has made impressive progress in developing its capacity for assessing overall stability. Staff commends the authorities for the recent step to regulate nonbank financial institutions and encourages them to implement the remaining FSAP recommendations.

49. **An ambitious program of structural reform is needed to accelerate convergence to EU living standards while enhancing competitiveness.** The recent progress on **privatization** is welcome and the authorities are encouraged to maintain momentum with the privatization of CEC bank, Romgaz, and other smaller companies. The **labor market** is more flexible following the recent amendments to the Labor Code, but further amendments are needed to eliminate the imposition of collective wage contracts for non-signatory parties and to increase employers' representation in the Economic and Social Council. The **legal framework** has improved significantly, but implementation challenges remain, including the need to reduce corruption, improve financial discipline, strengthen exit mechanisms for bankrupt enterprises, and enforce creditor rights. To provide sufficient time for economic agents to adjust, the authorities are encouraged to publish the schedule for raising **gas prices** to import parity, and adjusting other energy prices in line with opportuniry costs; delaying such adjustments will entail higher costs later on. Finally, it is important to continue progress on the government's **mining strategy**.

50. It is proposed that Romania's Article IV consultation cycle remains subject to provisions of the decision on consultation cycles approved by the Board on July 15, 2002 (No. 12794-(02/76)).

Table 1. Romania: Selected Economic and Financial Indicators, 2000-06

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 Prel. Estimates | 2006 Staff Proj. 1/ |
|---|---|---|---|---|---|---|---|
| Real economy (change in percent) 2/ | | | | | | | |
| Real GDP | 2.1 | 5.7 | 5.1 | 5.2 | 8.4 | 4.1 | 5.2 |
| Final domestic demand | 2.1 | 7.0 | 5.5 | 8.3 | 11.7 | 9.4 | 6.8 |
| CPI (end of period) | 40.7 | 30.3 | 17.8 | 14.1 | 9.3 | 8.6 | 6.5 |
| CPI (period average) | 45.7 | 34.5 | 22.5 | 15.3 | 11.9 | 9.0 | 7.9 |
| Unemployment rate (end of period; percent) | 10.5 | 8.6 | 8.4 | 7.2 | 6.2 | 5.8 | 5.7 |
| Gross national saving (percent of GDP) | 15.8 | 17.0 | 18.3 | 16.0 | 13.9 | 14.0 | 15.7 |
| Gross domestic investment (percent of GDP) | 19.5 | 22.6 | 21.7 | 21.8 | 22.3 | 22.7 | 24.2 |
| Public finance (general government, percent of GDP) 3/ | | | | | | | |
| Revenue | 31.2 | 30.1 | 29.6 | 28.7 | 30.1 | 30.3 | 31.3 |
| Expenditure | 35.3 | 33.3 | 32.3 | 30.9 | 31.1 | 31.1 | 31.3 |
| Overall balance | -4.0 | -3.2 | -2.6 | -2.2 | -1.0 | -0.8 | 0.0 |
| Primary balance | 0.9 | 0.6 | 0.4 | -0.2 | 0.2 | 0.3 | 1.0 |
| Total public debt 4/ | 27.8 | 27.5 | 25.9 | 23.5 | 22.4 | 18.9 | 16.7 |
| Money and credit (end of year, percent change) | | | | | | | |
| Real domestic credit 5/ | 7.9 | 28.0 | 32.3 | 56.9 | 40.4 | 44.7 | 33.8 |
| Broad money | 38.0 | 46.2 | 38.2 | 23.3 | 40.1 | 33.8 | 24.3 |
| Interest rates (percent) 6/ | | | | | | | |
| NBR interest rate (end of period) | 60.1 | 39.9 | 21.5 | 23.4 | 18.8 | 7.2 | 8.5 7/ |
| Treasury bill rate (end of period) | 59.4 | 38.4 | 17.4 | 18.4 | 11.5 | 5.5 | … |
| Balance of payments (percent of GDP) | | | | | | | |
| Trade balance | -4.5 | -7.4 | -5.7 | -7.5 | -8.8 | -9.9 | -10.3 |
| Current account balance | -3.7 | -5.5 | -3.3 | -5.8 | -8.5 | -8.7 | -8.5 |
| External debt | 29.8 | 32.8 | 32.8 | 32.9 | 35.1 | 32.4 | 32.4 |
| Official reserves (end-year, US$ million) | 3,466 | 5,168 | 6,260 | 7,143 | 14,873 | 22,866 | 28,643 |
| Reserve cover (months of prospective imports, in € terms)) | 2.3 | 3.5 | 3.6 | 2.8 | 4.1 | 5.6 | 6.6 |
| Exchange rate | | | | | | | |
| Lei per Euro (end of period) | 2.41 | 2.78 | 3.51 | 4.17 | 3.96 | 3.68 | 3.48 8/ |
| Lei per US$ (end of period) | 2.59 | 3.16 | 3.35 | 3.30 | 2.91 | 3.11 | 2.94 8/ |
| NEER appreciation (+) (percent) | -22.8 | -22.3 | -14.4 | -11.1 | -5.1 | 9.7 | … |
| REER appreciation (+) (CPI-based, in percent, period average) | 9.3 | 1.5 | 2.6 | 0.4 | 4.0 | 17.0 | … |
| REER appreciation (+) (ULC-based, in percent, period average) | -0.3 | -0.9 | -6.5 | -5.5 | 5.0 | 23.4 | … |

**Social indicators** (reference year):
**Per capita GDP** (2005): $4445; **income distribution** (GINI coefficient, 2000): 30.3;
**Poverty rate** (2002)**:** 18 percent; **primary education completion rate** (2002): 94 percent; **gender pay gap** (2003): 18 percent;
**Life expectancy at birth** (2003): 74.9; **infant mortality per 1000 live births** (2002) : 19.

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

1/ Incorporates a change in the policy mix, including a balanced budget, as recommended by Fund staff.
2/ National accounts data are based on ESA95 guidelines.
3/ Beginning 2004, fiscal data are based on a new classification and thus they are not comparable to series before 2004.
4/ Including domestic public debt and external public debt (public and publicly guaranteed).
5/ Credit to the nongovernment sector; weighted average of real lei credit growth and U.S. dollar-measured foreign currency credit growth.
6/ NBR effective policy interest rate (combined sterilization operations and use of deposit facility), compounded. Treasury bill rate for the last auction, as of September 22, 2005.
7/ The last observation is for February 2006.
8/ In RON, actual as of February 28, 2006.

Table 2. Romania: Balance of Payments, 2002-06
(In millions of euros, unless otherwise indicated)

| | 2002 | 2003 | 2004 | 2005 | 2006 |
|---|---|---|---|---|---|
| | | | | Prel. Estimates | Staff Proj. |
| Current account | -1,623 | -3,060 | -5,099 | -6,891 | -8,098 |
| Ratio to annual GDP | -3.3 | -5.8 | -8.5 | -8.7 | -8.5 |
| Current account balance plus FDI | -0.2 | -2.1 | 0.0 | -2.1 | -1.0 |
| Less estimated reinvested profits from FDI | -2.3 | -4.7 | -7.1 | -7.3 | -7.0 |
| | | | | | |
| Trade balance | -2,752 | -3,955 | -5,323 | -7,806 | -9,805 |
| Exports | 14,675 | 15,614 | 18,935 | 22,255 | 24,484 |
| Imports | -17,427 | -19,569 | -24,258 | -30,061 | -34,288 |
| Services and income, net | -483 | -1,133 | -2,748 | -2,743 | -3,175 |
| Receipts | 2,903 | 2,998 | 3,232 | 5,244 | 6,565 |
| *Of which* : Interest | 277 | 219 | 230 | 522 | 613 |
| Payments 1/ | -3,386 | -4,131 | -5,980 | -7,987 | -9,710 |
| *Of which* : Interest | -705 | -720 | -773 | -1,152 | -1,251 |
| Unrequited transfers (net) | 1,612 | 2,028 | 2,972 | 3,658 | 4,881 |
| *Of which* : official | 290 | 199 | 126 | 69 | 290 |
| | | | | | |
| Capital account | 4,799 | 4,439 | 9,111 | 11,004 | 13,756 |
| Capital transfers | 95 | 188 | 512 | 584 | 650 |
| Direct investment 1/ | 1,515 | 1,946 | 5,127 | 5,208 | 7,149 |
| Portfolio investment | 24 | -23 | 6 | 372 | 550 |
| Borrowing by public sector 2/ | 1,273 | 1,213 | 901 | 1,050 | 774 |
| Loans (net) | 890 | 662 | 901 | 856 | 474 |
| Disbursements | 2,034 | 1,625 | 2,012 | 1,552 | 2,096 |
| *Of which* : Direct debt | 773 | 480 | 546 | 492 | 646 |
| *Of which* : Government guaranteed | 1,261 | 1,145 | 1,466 | 1,060 | 1,450 |
| Amortization | -1,144 | -963 | -1,111 | -696 | -1,622 |
| Bonds (net) | 383 | 551 | 0 | 194 | 300 |
| Disbursements | 680 | 700 | 0 | 494 | 300 |
| Amortization | -297 | -149 | 0 | -300 | 0 |
| Borrowing by private sector (net) | 638 | -53 | 373 | 756 | 1,584 |
| Medium- and long-term loans (net) | 638 | -53 | 373 | 756 | 1,584 |
| Disbursements | 1,639 | 975 | 1,699 | 2,465 | 3,060 |
| Amortization | -1,001 | -1,028 | -1,326 | -1,709 | -1,476 |
| Trade credit (net) and Other Long Term | 501 | 128 | 1,002 | 711 | 790 |
| *Of which* : short-term (net) | 443 | 195 | 817 | 388 | 546 |
| Commercial banks' net foreign assets | 745 | 1,031 | 1,190 | 2,322 | 2,258 |
| Assets (increase, -) | 550 | 211 | -467 | 373 | 300 |
| Liabilities | 195 | 820 | 1,657 | 1,949 | 1,958 |
| Net errors and omissions | -1,190 | -469 | 884 | 1,522 | 0 |
| | | | | | |
| Overall balance | 1,986 | 910 | 4,896 | 5,635 | 5,658 |
| | | | | | |
| Financing | -1,986 | -910 | -4,896 | -5,635 | -5,658 |
| | | | | | |
| Net foreign assets NBR (increase, -) | -1,986 | -910 | -4,896 | -5,635 | -5,658 |
| Assets (increase, -) | -1,894 | -1,020 | -4,839 | -5,431 | -5,616 |
| Liabilities | -92 | 110 | -57 | -204 | -42 |
| IMF, net | 8 | 110 | -138 | -121 | -42 |
| Others, net | -100 | 0 | 81 | -83 | 0 |
| | | | | | |
| Memorandum items: | | | | | |
| Current account balance plus FDI | -108 | -1,114 | 28 | -1,683 | -949 |
| Ratio to GDP | -0.2 | -2.1 | 0.0 | -2.1 | -1.0 |
| Export growth (percent) | 15.4 | 6.4 | 21.3 | 17.5 | 10.0 |
| Volume growth (percent) | 10.6 | 7.8 | 10.2 | 4.4 | 6.5 |
| Unit value growth (percent) | 4.3 | -1.3 | 10.0 | 12.6 | 3.3 |
| Import growth (percent) | 8.6 | 12.3 | 24.0 | 23.9 | 14.1 |
| Volume growth (percent) | 11.6 | 19.6 | 18.0 | 16.7 | 11.0 |
| Unit value growth (percent) | -2.7 | -6.1 | 5.1 | 6.2 | 2.8 |
| GDP growth | 5.1 | 5.2 | 8.4 | 4.1 | 5.2 |
| GDP (in billions of €) | 48.7 | 52.7 | 60.2 | 79.1 | 94.9 |
| Terms of trade (percentage change) | 7.2 | 5.1 | 4.8 | 6.0 | 0.5 |
| External debt (in millions of €) | 15,967 | 17,338 | 21,156 | 25,623 | 30,730 |
| *Of which* : Public and publicly guaranteed | 9,127 | 9,557 | 10,372 | 11,329 | 12,156 |
| External debt/GDP (percent) | 32.8 | 32.9 | 35.1 | 32.4 | 32.4 |
| Debt service (in millions of €) | 3,251 | 2,955 | 3,348 | 3,978 | 4,390 |
| Debt service ratio | 19.0 | 16.2 | 15.3 | 15.2 | 14.8 |
| Gross official reserves of the NBR (in millions of US$) 3/ | 6,260 | 7,143 | 14,873 | 22,866 | 28,643 |
| (in months of imports of goods and services) | 3.6 | 2.8 | 4.1 | 5.6 | 6.6 |
| (as percent of short-term debt) | 187.7 | 144.5 | 200.0 | 259.5 | 286.9 |

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

1/ Includes extrapolated staff estimates of reinvested earnings on foreign direct investment based on 2004 survey data.
2/ Includes public enterprises.
3/ Includes gold.

Table 3. Romania: Summary of Consolidated General Government According to the New Classification, 2004-06

| | 2004 | 2005 | | | 2006 | | | | 2004 | 2005 | | | 2006 | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Staff Scenario | | | | | | | | Staff Scenario | | |
| | Actual | Original Budget Nov-2004 | 4th Suppl. Budget Dec-2005 | Preliminary Outturn | Approved Budget | Underlying Budget | Meeting the gov. target | Balanced Budget | Actual | Original Budget Nov-2004 | 4th Suppl. Budget Dec-2005 | Preliminary Outturn | Approved Budget | Underlying Budget | Meeting the gov. target | Balanced Budget |
| | (In millions of New Lei) | | | | | | | | (In percent of GDP) | | | | | | | |
| Total revenue | 74,045.4 | 83,919.1 | 88,692.9 | 86,964.4 | 101,481.6 | 102,033.7 | 102,033.7 | 101,893.1 | 30.1 | 32.1 | 31.5 | 30.3 | 31.5 | 30.4 | 30.4 | 30.6 |
| Current revenue | 71,944.5 | 78,683.4 | 83,753.1 | 84,835.4 | 96,429.4 | 96,981.5 | 96,981.5 | 96,840.9 | 29.2 | 30.1 | 29.8 | 29.5 | 29.9 | 28.9 | 28.9 | 29.1 |
| Tax revenue | 66,834.1 | 73,101.5 | 77,630.9 | 78,379.8 | 90,116.8 | 90,668.9 | 90,668.9 | 90,528.3 | 27.1 | 28.0 | 27.6 | 27.3 | 27.9 | 27.0 | 27.0 | 27.2 |
| Corporate income tax | 7,443.6 | 7,330.1 | 7,786.0 | 7,793.0 | 8,909.9 | 8,909.9 | 8,909.9 | 8,909.9 | 3.0 | 2.8 | 2.8 | 2.7 | 2.8 | 2.7 | 2.7 | 2.7 |
| Profit | 6,483.9 | 6,676.7 | 6,660.0 | 6,533.9 | 7,502.3 | 7,502.3 | 7,502.3 | 7,502.3 | 2.6 | 2.6 | 2.4 | 2.3 | 2.3 | 2.2 | 2.2 | 2.3 |
| Capital gains and other | 959.7 | 653.4 | 1,126.0 | 1,259.1 | 1,407.6 | 1,407.6 | 1,407.6 | 1,407.6 | 0.4 | 0.2 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 |
| Personal income tax | 7,182.7 | 7,753.3 | 6,467.2 | 6,881.9 | 8,512.4 | 8,730.4 | 8,730.4 | 8,730.4 | 2.9 | 3.0 | 2.3 | 2.4 | 2.6 | 2.6 | 2.6 | 2.6 |
| Salaries, dividends, etc | 7,122.7 | 7,688.7 | 6,403.0 | 6,748.3 | 8,444.2 | 8,662.2 | 8,662.2 | 8,662.2 | 2.9 | 2.9 | 2.3 | 2.3 | 2.6 | 2.6 | 2.6 | 2.6 |
| Other (local) taxes | 60.0 | 64.6 | 64.2 | 133.6 | 68.2 | 68.2 | 68.2 | 68.2 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Property tax | 1,757.8 | 1,946.4 | 1,916.7 | 1,880.2 | 2,761.4 | 2,761.4 | 2,761.4 | 2,761.4 | 0.7 | 0.7 | 0.7 | 0.7 | 0.9 | 0.8 | 0.8 | 0.8 |
| VAT | 16,547.2 | 18,609.4 | 22,232.2 | 22,537.8 | 26,047.0 | 26,381.1 | 26,381.1 | 26,240.5 | 6.7 | 7.1 | 7.9 | 7.8 | 8.1 | 7.9 | 7.9 | 7.9 |
| Excises | 7,996.3 | 9,858.3 | 9,023.8 | 9,079.4 | 10,702.4 | 10,702.4 | 10,702.4 | 10,702.4 | 3.2 | 3.8 | 3.2 | 3.2 | 3.3 | 3.2 | 3.2 | 3.2 |
| Other indirect taxes | 1,489.5 | 1,636.3 | 1,111.2 | 1,052.3 | 1,065.8 | 1,065.8 | 1,065.8 | 1,065.8 | 0.6 | 0.6 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 |
| Customs | 1,751.1 | 1,675.2 | 2,121.3 | 2,186.9 | 1,877.0 | 1,877.0 | 1,877.0 | 1,877.0 | 0.7 | 0.6 | 0.8 | 0.8 | 0.6 | 0.6 | 0.6 | 0.6 |
| Other tax revenue | 78.2 | 1.7 | 50.0 | 11.5 | 30.0 | 30.0 | 30.0 | 30.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Social contributions | 22,587.7 | 24,290.8 | 26,922.5 | 26,956.8 | 30,210.9 | 30,210.9 | 30,210.9 | 30,210.9 | 9.2 | 9.3 | 9.6 | 9.4 | 9.4 | 9.0 | 9.0 | 9.1 |
| Nontax revenue | 5,110.4 | 5,581.9 | 6,122.2 | 6,455.6 | 6,312.6 | 6,312.6 | 6,312.6 | 6,312.6 | 2.1 | 2.1 | 2.2 | 2.2 | 2.0 | 1.9 | 1.9 | 1.9 |
| Capital revenue | 457.9 | 499.2 | 412.0 | 449.8 | 600.3 | 600.3 | 600.3 | 600.3 | 0.2 | 0.2 | 0.1 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Grants | 1,643.0 | 4,736.5 | 4,527.8 | 1,679.2 | 4,451.9 | 4,451.9 | 4,451.9 | 4,451.9 | 0.7 | 1.8 | 1.6 | 0.6 | 1.4 | 1.3 | 1.3 | 1.3 |
| Total expenditure | 76,628.7 | 87,869.8 | 91,587.7 | 89,218.3 | 103,093.6 | 106,238.1 | 105,353.6 | 105,095.2 | 31.1 | 33.6 | 32.6 | 31.1 | 32.0 | 31.6 | 31.4 | 31.5 |
| Current | 69,758.8 | 76,371.4 | 83,360.2 | 81,630.8 | 92,790.0 | 95,934.5 | 95,050.0 | 94,791.6 | 28.3 | 29.2 | 29.6 | 28.4 | 28.8 | 28.6 | 28.3 | 28.4 |
| Personnel | 11,806.1 | 13,013.4 | 15,996.7 | 15,470.4 | 17,650.5 | 18,535.0 | 17,650.5 | 17,392.1 | 4.8 | 5.0 | 5.7 | 5.4 | 5.5 | 5.5 | 5.3 | 5.2 |
| Goods and services | 18,066.7 | 18,838.2 | 20,519.8 | 21,484.5 | 20,480.9 | 22,740.9 | 22,740.9 | 22,740.9 | 7.3 | 7.2 | 7.3 | 7.5 | 6.4 | 6.8 | 6.8 | 6.8 |
| Interest 1/ | 3,133.8 | 4,314.4 | 3,296.3 | 3,007.6 | 3,488.8 | 3,488.8 | 3,488.8 | 3,488.8 | 1.3 | 1.6 | 1.2 | 1.0 | 1.1 | 1.0 | 1.0 | 1.0 |
| Subsidies | 5,515.9 | 5,505.6 | 5,923.7 | 6,462.6 | 6,393.4 | 6,393.4 | 6,393.4 | 6,393.4 | 2.2 | 2.1 | 2.1 | 2.3 | 2.0 | 1.9 | 1.9 | 1.9 |
| Transfers 2/ | 30,495.5 | 33,417.6 | 36,280.4 | 34,283.3 | 43,433.6 | 43,433.6 | 43,433.6 | 43,433.6 | 12.4 | 12.8 | 12.9 | 11.9 | 13.5 | 12.9 | 12.9 | 13.0 |
| Other expenditure | 740.8 | 1,205.2 | 951.3 | 922.5 | 947.7 | 947.7 | 947.7 | 947.7 | 0.3 | 0.5 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Reserve fund | 0.0 | 77.0 | 392.0 | 0.0 | 395.1 | 395.1 | 395.1 | 395.1 | 0.0 | 0.0 | 0.1 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capital | 6,784.0 | 11,321.5 | 8,155.8 | 7,551.3 | 10,229.0 | 10,229.0 | 10,229.0 | 10,229.0 | 2.8 | 4.3 | 2.9 | 2.6 | 3.2 | 3.0 | 3.0 | 3.1 |
| Net lending | 85.9 | 176.9 | 71.7 | 36.2 | 74.6 | 74.6 | 74.6 | 74.6 | 0.0 | 0.1 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| *Measures to meet the deficit target* | | | | | | | 1,707.9 | 3,202.1 | | | | | | | 0.5 | 1.0 |
| Overall Balance | -2,583.2 | -3,950.7 | -2,894.8 | -2,253.9 | -1,612.0 | -4,204.4 | -1,612.0 | 0.0 | -1.0 | -1.5 | -1.0 | -0.8 | -0.5 | -1.3 | -0.5 | 0.0 |
| Memorandum items: | | | | | | | | | | | | | | | | |
| Primary expenditure | 73,494.9 | 83,555.4 | 88,291.4 | 86,210.7 | 99,604.8 | 102,749.3 | 100,156.9 | 100,804.3 | 29.8 | 32.0 | 31.4 | 30.0 | 30.9 | 30.6 | 29.8 | 30.3 |
| Primary current expenditure | 66,625.0 | 72,057.0 | 80,063.9 | 78,623.2 | 89,301.2 | 92,445.7 | 91,561.2 | 91,302.8 | 27.0 | 27.6 | 28.5 | 27.4 | 27.7 | 27.5 | 27.3 | 27.4 |
| Primary balance | 550.6 | 363.7 | 401.5 | 753.7 | 1,876.8 | -715.6 | 1,876.8 | 3,488.8 | 0.2 | 0.1 | 0.1 | 0.3 | 0.6 | -0.2 | 0.6 | 1.0 |
| Nominal GDP (millions of New Lei) | 246,372 | 261,500 | 281,200 | 287,186 | 322,500 | 335,812 | 335,812 | 333,236 | 246,372 | 261,500 | 281,200 | 287,186 | 322,500 | 335,812 | 335,812 | 333,236 |

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

1/ Including called-up guarantees.

2/ Includes cofinancing of projects and the contribution to the EU budget beginning 2007.

Table 4. Romania: Summary of Consolidated General Government According to the New Classification, 2004-11

| | 2004 | 2005 | 2006 | | | | 2007 | | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | Staff Scenario | | | Staff Scenario | | | | | |
| | Actual | Preliminary Outturn | Approved Budget | Underlying Budget | Meeting the gov. target | Balanced Budget | Meeting the gov. target | Staff Projection | Staff Projections | | | |
| | (In percent of GDP) | | | | | | | | | | | |
| Total revenue | 30.1 | 30.3 | 31.5 | 30.4 | 30.4 | 30.6 | 29.0 | 30.2 | 29.9 | 29.8 | 29.9 | 30.0 |
| Current revenue | 29.2 | 29.5 | 29.9 | 28.9 | 28.9 | 29.1 | 27.8 | 28.5 | 28.2 | 28.0 | 28.0 | 28.0 |
| Tax revenue | 27.1 | 27.3 | 27.9 | 27.0 | 27.0 | 27.2 | 26.3 | 26.9 | 26.6 | 26.6 | 26.6 | 26.6 |
| Corporate income tax | 3.0 | 2.7 | 2.8 | 2.7 | 2.7 | 2.7 | 2.6 | 2.7 | 2.6 | 2.6 | 2.6 | 2.6 |
| Profit | 2.6 | 2.3 | 2.3 | 2.2 | 2.2 | 2.3 | 2.3 | 2.3 | 2.3 | 2.4 | 2.4 | 2.4 |
| Capital gains and other | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Personal income tax | 2.9 | 2.4 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.7 | 2.7 | 2.7 |
| Salaries, dividends, etc | 2.9 | 2.3 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.6 | 2.7 | 2.7 | 2.7 |
| Other (local) taxes | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Property tax | 0.7 | 0.7 | 0.9 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 | 0.8 |
| VAT | 6.7 | 7.8 | 8.1 | 7.9 | 7.9 | 7.9 | 7.7 | 7.9 | 7.9 | 7.9 | 7.9 | 7.9 |
| Excises | 3.2 | 3.2 | 3.3 | 3.2 | 3.2 | 3.2 | 3.4 | 3.5 | 3.6 | 3.8 | 3.8 | 3.8 |
| Other indirect taxes | 0.6 | 0.4 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Customs | 0.7 | 0.8 | 0.6 | 0.6 | 0.6 | 0.6 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 | 0.5 |
| Other tax revenue | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 |
| Social contributions | 9.2 | 9.4 | 9.4 | 9.0 | 9.0 | 9.1 | 8.4 | 8.6 | 8.2 | 7.9 | 7.9 | 7.9 |
| Nontax revenue | 2.1 | 2.2 | 2.0 | 1.9 | 1.9 | 1.9 | 1.6 | 1.6 | 1.6 | 1.5 | 1.5 | 1.5 |
| Capital revenue | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 | 0.1 | 0.1 | 0.1 |
| Grants | 0.7 | 0.6 | 1.4 | 1.3 | 1.3 | 1.3 | 1.0 | 1.5 | 1.6 | 1.6 | 1.8 | 1.8 |
| Total expenditure | 31.1 | 31.1 | 32.0 | 31.6 | 31.4 | 31.5 | 30.1 | 31.4 | 31.4 | 31.5 | 31.7 | 31.8 |
| Current | 28.3 | 28.4 | 28.8 | 28.6 | 28.3 | 28.4 | 26.7 | 28.0 | 28.0 | 27.9 | 27.9 | 28.0 |
| Personnel | 4.8 | 5.4 | 5.5 | 5.5 | 5.3 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 | 5.2 |
| Goods and services | 7.3 | 7.5 | 6.4 | 6.8 | 6.8 | 6.8 | 6.5 | 6.7 | 6.6 | 6.5 | 6.5 | 6.5 |
| Interest 1/ | 1.3 | 1.0 | 1.1 | 1.0 | 1.0 | 1.0 | 1.0 | 1.0 | 0.9 | 0.8 | 0.8 | 0.8 |
| Subsidies | 2.2 | 2.3 | 2.0 | 1.9 | 1.9 | 1.9 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 | 1.2 |
| Transfers 2/ | 12.4 | 11.9 | 13.5 | 12.9 | 12.9 | 13.0 | 12.6 | 13.7 | 13.8 | 13.9 | 14.0 | 14.0 |
| Other expenditure | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 | 0.3 |
| Reserve fund | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 |
| Capital | 2.8 | 2.6 | 3.2 | 3.0 | 3.0 | 3.1 | 3.3 | 3.3 | 3.4 | 3.6 | 3.7 | 3.7 |
| Net lending | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | 0.1 | 0.0 | 0.1 | 0.1 | 0.1 |
| *Measures to meet the deficit target* | | | | | 0.5 | 1.0 | 0.1 | 1.4 | 1.7 | 1.9 | 1.9 | 1.9 |
| Overall Balance | -1.0 | -0.8 | -0.5 | -1.3 | -0.5 | 0.0 | -1.0 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| Memorandum items: | | | | | | | | | | | | |
| Primary expenditure | 29.8 | 30.0 | 30.9 | 30.6 | 29.8 | 30.3 | 29.1 | 30.4 | 30.5 | 30.7 | 30.9 | 31.0 |
| Primary current expenditure | 27.0 | 27.4 | 27.7 | 27.5 | 27.3 | 27.4 | 25.8 | 27.0 | 27.0 | 27.1 | 27.1 | 27.2 |
| Primary balance | 0.2 | 0.3 | 0.6 | -0.2 | 0.6 | 1.0 | -0.2 | 1.2 | 1.1 | 1.0 | 1.0 | 1.0 |
| Nominal GDP (millions of New Lei) | 246,372 | 287,186 | 322,500 | 335,812 | 335,812 | 333,236 | 385,034 | 376,542 | 415,108 | 455,977 | 499,234 | 544,794 |

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

1/ Including called-up guarantees.

2/ Includes cofinancing of projects and the contribution to the EU budget beginning 2007.

## Table 5. Romania: Monetary Survey, 2003-06

(In millions of redenominated lei, unless otherwise indicated; actual/projected exchange rates)

| | 2003 | 2004 | 2005 | | | | 2006 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | December | December | March | June | September | December | March | June | September | December |
| | | | | | | | Staff Projections | | | |
| **Monetary Survey** | | | | | | | | | | |
| Net foreign assets (including valuation changes) | 24,673 | 33,406 | 35,677 | 40,931 | 44,926 | 46,847 | 49,576 | 58,026 | 59,790 | 60,183 |
| In millions of U.S. dollars | 7,570 | 11,493 | 12,550 | 13,693 | 15,185 | 15,074 | 16,228 | 19,886 | 20,886 | 21,680 |
| *Of which* : Commercial banks | -1,251 | -3,255 | -4,138 | -4,223 | -6,384 | -6,632 | -7,061 | -7,326 | -7,790 | -8,412 |
| NBR 1/ | 8,821 | 14,748 | 16,688 | 17,916 | 21,569 | 21,706 | 23,289 | 27,212 | 28,676 | 30,092 |
| Net domestic assets | 21,402 | 31,127 | 32,280 | 33,269 | 35,226 | 39,485 | 41,329 | 39,873 | 43,795 | 47,156 |
| Domestic credit | 30,094 | 36,560 | 39,000 | 41,460 | 46,214 | 54,664 | 53,738 | 54,849 | 59,731 | 62,532 |
| Government | -194 | -5,243 | -4,296 | -7,496 | -8,799 | -3,943 | -8,529 | -12,231 | -13,631 | -15,742 |
| Non-government | 30,288 | 41,803 | 43,297 | 48,956 | 55,012 | 60,673 | 62,266 | 67,080 | 73,362 | 78,273 |
| In foreign currency | 16,784 | 25,400 | 26,175 | 29,413 | 32,476 | 32,762 | 31,075 | 32,948 | 35,703 | 36,120 |
| (in millions of U.S. dollars) | 5,149 | 8,739 | 9,207 | 9,840 | 10,977 | 10,542 | 10,172 | 11,292 | 12,472 | 13,012 |
| In lei | 13,504 | 16,403 | 17,121 | 19,543 | 22,536 | 27,911 | 31,191 | 34,132 | 37,659 | 42,153 |
| Other items net | -8,693 | -5,433 | -6,720 | -8,191 | -10,987 | -15,179 | -12,408 | -14,977 | -15,936 | -15,376 |
| Broad money | 46,075 | 64,534 | 67,957 | 74,200 | 80,152 | 86,332 | 90,905 | 97,898 | 103,585 | 107,338 |
| *Of which* : Lei denominated (M2) | 28,958 | 41,070 | 44,934 | 48,835 | 54,563 | 60,449 | 64,851 | 72,430 | 77,739 | 81,165 |
| Currency in circulation | 5,798 | 7,537 | 7,786 | 9,582 | 10,341 | 11,386 | 11,894 | 13,548 | 14,221 | 15,288 |
| Lei deposits | 23,160 | 33,533 | 37,148 | 39,254 | 44,222 | 49,063 | 52,957 | 58,882 | 63,518 | 65,878 |
| Foreign currency deposits | 17,117 | 23,464 | 23,023 | 25,365 | 25,589 | 25,883 | 26,055 | 25,469 | 25,846 | 26,173 |
| In millions of U.S. dollars | 5,251 | 8,072 | 8,098 | 8,486 | 8,649 | 8,329 | 8,529 | 8,729 | 9,029 | 9,429 |
| Memorandum items: 2/ | | | | | | | | | | |
| Broad money (M2X) growth | 23.3 | 40.1 | 41.1 | 46.5 | 41.3 | 33.8 | 33.8 | 31.9 | 29.9 | 24.3 |
| NFA contribution 2/ | 6.5 | 19.0 | 18.3 | 25.7 | 19.8 | 20.8 | 20.5 | 23.0 | 19.6 | 15.4 |
| NDA contribution 2/ | 16.7 | 21.1 | 22.8 | 20.8 | 21.5 | 13.0 | 13.3 | 8.9 | 10.3 | 8.9 |
| Lei-denominated money growth (M2) | 27.6 | 41.8 | 53.2 | 50.0 | 47.8 | 47.2 | 44.3 | 48.3 | 42.5 | 34.3 |
| Growth of currency in circulation | 27.2 | 30.0 | 34.8 | 39.1 | 34.8 | 51.1 | 52.8 | 41.4 | 37.5 | 34.3 |
| Real broad money growth | 8.1 | 28.2 | 29.9 | 33.6 | 30.2 | 23.1 | 22.2 | 22.2 | 20.9 | 16.8 |
| Real lei-denominated money growth (M2) | 11.9 | 29.8 | 41.0 | 36.8 | 36.2 | 35.5 | 31.8 | 37.3 | 32.6 | 26.1 |
| Real growth of currency in circulation | 11.5 | 19.0 | 24.0 | 26.8 | 24.3 | 39.0 | 39.5 | 30.9 | 28.0 | 26.1 |
| Growth of lei credit to nongovernment, adjusted 3/ | 102.4 | 21.5 | 19.3 | 33.7 | 46.4 | 70.3 | 82.2 | 77.5 | 67.1 | 51.0 |
| Growth of lei credit to nongovernment, adjusted, real 3/ | 77.4 | 11.2 | 9.7 | 22.0 | 34.9 | 56.8 | 66.4 | 64.3 | 55.5 | 41.9 |
| Growth of foreign currency credit, adjusted, in US$ 3/ | 38.1 | 60.5 | 63.4 | 62.0 | 56.4 | 34.8 | 22.1 | 21.2 | 18.8 | 26.5 |
| Growth of credit to nongovernment, composite 3/ 4/ | 56.8 | 40.5 | 41.9 | 46.4 | 47.8 | 44.7 | 44.0 | 41.2 | 36.5 | 33.8 |
| M2X (Broad Money) velocity | 4.6 | 4.0 | 4.1 | 3.9 | 3.6 | 3.5 | 3.6 | 3.4 | 3.2 | 3.2 |
| M2 (Domestic Broad Money) velocity | 7.3 | 6.3 | 6.2 | 5.9 | 5.3 | 4.9 | 5.1 | 4.6 | 4.3 | 4.2 |
| M2X+Tbill velocity | 4.2 | 3.6 | 3.8 | 3.6 | 3.6 | 3.3 | 3.6 | 3.4 | 3.2 | 3.2 |
| M2X+Tbill growth | 21.6 | 40.4 | 35.8 | 38.1 | 35.4 | 26.2 | 29.7 | 29.0 | 28.6 | 23.4 |

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

1/ Figures before and after December 2003 are not strictly comparable, owing to an update in the US$/EUR exchange rate used to convert EUR stocks in US$-equivalent.

2/ All changes are 12-month rates of change, unless indicated otherwise. The NFA/NDA contribution rates are adjusted for the change in the EUR/US$ exchange rate from December 2003.

3/ Adjusted for write-offs in the last 12 months and changes in the US$/EUR exchange rate.

4/ Real lei credit growth and foreign currency credit growth, weighted by their respective shares.

## Table 6. Romania: Balance Sheet of the National Bank, 2003-06 1/

(In millions of redenominated lei, unless otherwise indicated; actual/projected exchange rates, monthly averages)

| | 2003 | 2004 | 2005 | | | | 2006 | | | |
|---|---|---|---|---|---|---|---|---|---|---|
| | December | December | March | June | September | December | March | June | September | December |
| | | | | | | | Staff Projections | | | |
| Net foreign assets (including valuation) 2/ | 23,577 | 31,084 | 36,286 | 41,398 | 47,115 | 50,134 | 54,296 | 62,495 | 64,788 | 65,636 |
| In millions of U.S. dollars | 7,142 | 10,752 | 13,161 | 13,940 | 16,446 | 16,258 | 17,621 | 21,358 | 22,517 | 23,524 |
| Net domestic assets | -11,015 | -16,505 | -21,209 | -24,069 | -28,482 | -28,775 | -32,753 | -38,443 | -39,014 | -38,988 |
| Total credit | -5,523 | -17,862 | -24,106 | -24,397 | -19,788 | -27,086 | -31,021 | -35,194 | -35,745 | -35,689 |
| Credit to banks | -4,101 | -14,525 | -20,944 | -20,075 | -13,636 | -21,423 | -25,559 | -27,330 | -28,181 | -28,325 |
| NBR refinancing (including to DGF and Law 101 | 209 | 111 | 109 | 75 | 75 | 45 | 45 | 45 | 45 | 45 |
| Deposit taking operations, CDs and Overnight Fac | -4,311 | -14,636 | -21,053 | -20,150 | -13,711 | -21,469 | -25,604 | -27,375 | -28,226 | -28,370 |
| Reverse repo | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Credit to government | -1,421 | -3,337 | -3,162 | -4,322 | -6,152 | -5,662 | -5,462 | -7,864 | -7,564 | -7,364 |
| Treasury balance (+deficit, -surplus) | -1,422 | -3,337 | -3,162 | -4,323 | -6,153 | -5,662 | -5,462 | -7,864 | -7,564 | -7,364 |
| Treasury overdraft | -431 | -2,861 | -868 | -1,722 | -2,885 | -3,431 | -3,431 | -3,431 | -3,431 | -3,431 |
| Treasury deposits | 991 | 477 | 2,294 | 2,600 | 3,268 | 2,231 | 2,031 | 4,433 | 4,133 | 3,933 |
| Treasury bills | 1 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Other items net | -5,492 | 1,357 | 2,897 | 329 | -8,694 | -1,690 | -1,732 | -3,249 | -3,270 | -3,299 |
| Lei reserve money | 12,562 | 14,579 | 15,077 | 17,329 | 18,633 | 21,358 | 21,543 | 24,051 | 25,774 | 26,648 |
| Currency | 6,675 | 8,514 | 8,611 | 9,952 | 11,188 | 12,425 | 12,911 | 14,163 | 14,884 | 15,910 |
| Bank deposits | 5,887 | 6,065 | 6,466 | 7,377 | 7,444 | 8,933 | 8,632 | 9,888 | 10,890 | 10,738 |
| Memorandum items: 3/ | | | | | | | | | | |
| Real reserve money growth (adjusted) 4/ | 14.8 | 30.1 | 24.1 | 29.2 | 24.6 | 34.8 | 36.0 | 32.3 | 26.3 | 17.8 |
| Nominal reserve money growth (adjusted) 4/ 5/ | 31.0 | 42.2 | 34.9 | 41.6 | 35.2 | 51.9 | 48.9 | 42.9 | 35.8 | 25.4 |
| NDA contribution | 16.1 | -17.6 | -80.4 | -69.8 | -59.6 | -78.8 | -70.6 | -78.8 | -58.6 | -44.6 |
| NFA contribution | 14.5 | 59.8 | 115.3 | 111.4 | 94.8 | 130.7 | 119.5 | 121.7 | 94.4 | 70.0 |

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

1/ For program purposes, all values are defined on a monthly average basis.
2/ Program definition excludes deposits of commercial banks to meet required reserves against foreign currency deposits. This, and the fact that the figures are monthly averages, explains the differences from the monetary survey.
3/ All changes are 12-month rates of change, unless indicated otherwise.
4/ Adjusted for changes in minimum reserve requirements.
5/ The minimum reserve requirement for lei deposits was decreased from 25 percent to 22 percent in April 2002, to 18 percent in December 2002, and to 16 percent in September 2005.

Table 7. Romania: Financial Soundness Indicators, 2003-05

| | 2003 | 2004 | 2005 |
|---|---|---|---|
| Number of banks (absolute numbers) | 38 | 39 | 39 |
| Capital Adequacy | | | |
| CAR | 20.0 | 18.8 | 20.2 |
| Capital/Total Assets | 10.1 | 8.5 | 8.8 |
| Asset Quality 1/ | | | |
| NPLs/Gross Loans | 8.3 | 8.1 | 8.3 |
| NPLs/Capital | 35.6 | 36.6 | 35.3 |
| Loan provisions and loan risk reserve/NPLs | 33.5 | 34.3 | 31.4 |
| Loan provisions and loan risk reserve/Capital | 11.9 | 12.5 | 11.1 |
| Earnings and Profitability | | | |
| Return on Average Assets | 2.7 | 2.5 | 1.9 |
| Return on Average Equity | 20.0 | 19.3 | 15.4 |
| Net interest income less provisions/assets | 4.1 | 4.1 | 3.0 |
| Net interest income less provisions/gross income | 11.6 | 15.3 | 6.3 |
| Liquidity | | | |
| Liquid assets/Total assets | 62.7 | 63.6 | 61.8 |
| Liquid assets/Short term liabilities | 210.8 | 193.9 | 245.7 |
| Other Indicators | | | |
| Foreign currency denominated loans/total loans | 56.4 | 61.5 | 54.4 |
| Foreign currency denominated liabilities/total liabilities | 45.0 | 46.8 | 44.3 |
| Total net foreign exchange position/capital | 1.6 | -2.0 | -0.6 |
| Off-balance sheet credit equivalents/Total loans | 35.3 | 33.8 | 33.9 |

Source: National Bank of Romania.

1/ NPL are non-performing loans including the categories: loss, doubtful and substandard. The NPL ratio for loss and doubtful loans was 2.6 percent at end-2005, down from 2.9 percent end-2004. Provisioning requirements are 100% for loss, 50% for doubtful.

Table 8. Romania: Medium-Term Balance of Payments Outlook, 2004-11
(In millions of euros, unless otherwise indicated)

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|
| | | Prel. Estimates | Staff Projections | | | | | |
| Current account | -5,099 | -6,891 | -8,098 | -9,542 | -10,522 | -11,635 | -12,847 | -14,119 |
| Ratio to GDP | -8.5 | -8.7 | -8.5 | -8.3 | -8.1 | -8.0 | -7.9 | -7.8 |
| Less reinvested earnings on FDI | -7.1 | -7.3 | -7.0 | -6.8 | -6.6 | -6.5 | -6.4 | -6.3 |
| Current account plus FDI | 0.0 | -2.1 | -1.0 | -3.5 | -3.6 | -3.7 | -3.8 | -3.6 |
| Trade balance | -5,323 | -7,806 | -9,805 | -11,006 | -13,175 | -15,252 | -17,431 | -19,765 |
| Ratio to GDP | -8.8 | -9.9 | -10.3 | -9.6 | -10.2 | -10.5 | -10.3 | -9.6 |
| Exports | 18,935 | 22,255 | 24,484 | 26,017 | 27,553 | 29,304 | 31,179 | 33,473 |
| Imports | -24,258 | -30,061 | -34,288 | -37,023 | -40,728 | -44,556 | -48,610 | -53,238 |
| Services account, net | -2,748 | -2,743 | -3,175 | -4,252 | -4,276 | -4,290 | -4,404 | -4,613 |
| Of which: interest, net | -543 | -630 | -637 | -647 | -702 | -675 | -874 | -1,601 |
| Unrequited transfers | 2,972 | 3,658 | 4,881 | 5,716 | 6,930 | 7,906 | 8,989 | 10,259 |
| Capital account | 9,111 | 11,004 | 13,756 | 11,918 | 12,601 | 15,036 | 15,970 | 18,533 |
| Direct investment 1/ | 5,127 | 5,208 | 7,149 | 5,499 | 5,824 | 6,266 | 6,750 | 7,565 |
| Capital transfers | 512 | 584 | 650 | 681 | 876 | 1,813 | 2,161 | 2,161 |
| Portfolio Investment | 6 | 372 | 550 | 250 | 250 | 250 | 250 | 250 |
| Borrowing by public sector 2/ | 901 | 1,050 | 774 | 1,588 | 1,361 | 2,090 | 1,510 | 2,277 |
| Loans (net) | 901 | 856 | 474 | 1,088 | 1,361 | 1,490 | 1,610 | 1,677 |
| Disbursements | 2,012 | 1,552 | 2,096 | 2,961 | 3,502 | 3,891 | 4,393 | 4,845 |
| Of which: direct debt | 546 | 492 | 646 | 800 | 915 | 992 | 1,146 | 1,223 |
| Of which: government guaranteed | 1,466 | 1,060 | 1,450 | 2,161 | 2,587 | 2,899 | 3,247 | 3,622 |
| Amortization | -1,111 | -696 | -1,622 | -1,873 | -2,141 | -2,401 | -2,784 | -3,168 |
| Bonds (net) | 0 | 194 | 300 | 500 | 0 | 600 | -100 | 600 |
| Disbursements | 0 | 494 | 300 | 500 | 600 | 600 | 600 | 600 |
| Amortization | 0 | -300 | 0 | 0 | -600 | 0 | -700 | 0 |
| Borrowing by private sector | 373 | 756 | 1,584 | 1,872 | 2,311 | 2,847 | 3,500 | 4,299 |
| Medium- and long-term loans (net) | 373 | 756 | 1,584 | 1,872 | 2,311 | 2,847 | 3,500 | 4,299 |
| Disbursements | 1,699 | 2,465 | 3,060 | 3,679 | 4,511 | 5,530 | 6,780 | 8,312 |
| Amortization | -1,326 | -1,709 | -1,476 | -1,808 | -2,200 | -2,684 | -3,280 | -4,013 |
| Short-term (net) | 817 | 388 | 546 | 750 | 565 | 309 | 148 | 125 |
| Other medium and long-term credit | 185 | 323 | 244 | -90 | -88 | -90 | -100 | -96 |
| Net foreign assets DMBs (increase, -) | 1,190 | 2,322 | 2,258 | 1,368 | 1,501 | 1,551 | 1,751 | 1,951 |
| Assets (increase, -) | -467 | 373 | 300 | 250 | -17 | -17 | -17 | -17 |
| Liabilities | 1,657 | 1,949 | 1,958 | 1,118 | 1,518 | 1,568 | 1,768 | 1,968 |
| Short-term | 567 | 909 | 913 | 521 | 708 | 731 | 824 | 918 |
| Medium- and long-term, net | 1,090 | 1,271 | 1,045 | 597 | 810 | 837 | 944 | 1,050 |
| Net errors and ommisions | 884 | 1,522 | 0 | 0 | 0 | 0 | 0 | 0 |
| Overall balance | 4,896 | 5,635 | 5,658 | 2,376 | 2,079 | 3,401 | 3,124 | 4,413 |
| Financing | -4,896 | -5,635 | -5,658 | -2,376 | -2,079 | -3,401 | -3,124 | -4,413 |
| Net foreign assets NBR (increase, -) | -4,896 | -5,635 | -5,658 | -2,376 | -2,079 | -3,401 | -3,124 | -4,413 |
| Assets (increase, -) | -4,839 | -5,431 | -5,616 | -2,248 | -2,002 | -3,401 | -3,124 | -4,413 |
| Liabilities | -57 | -204 | -42 | -128 | -77 | 0 | 0 | 0 |
| IMF, net | -138 | -121 | -42 | -128 | -77 | 0 | 0 | 0 |
| Purchases | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Repurchases | -138 | -121 | -42 | -128 | -77 | 0 | 0 | 0 |
| Other, net | 81 | -83 | 0 | 0 | 0 | 0 | 0 | 0 |
| Financing gap | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Memorandum items: | | | | | | | | |
| Export growth (percent) | 21.3 | 17.5 | 10.0 | 6.3 | 5.9 | 6.4 | 6.4 | 7.4 |
| Import growth (percent) | 24.0 | 23.9 | 14.1 | 8.0 | 10.0 | 9.4 | 9.1 | 9.5 |
| Net Resource Balance/GDP (percent) | -4.3 | -5.8 | -5.4 | -5.2 | -5.4 | -5.5 | -5.6 | -5.6 |
| FDI and Capital Transfers / Current Account Deficit (%) | 110.6 | 84.1 | 96.3 | 64.8 | 63.7 | 69.4 | 69.4 | 68.9 |
| External debt/GDP (percent) | 35.1 | 32.4 | 32.4 | 31.3 | 32.2 | 33.4 | 34.0 | 35.2 |
| External Public and publicly guaranteed debt/GDP (percent) | 17.2 | 14.3 | 12.8 | 12.1 | 12.3 | 12.4 | 12.4 | 12.4 |
| Net External Indebtedness/GDP (%) | 13.7 | 9.9 | 7.1 | 8.5 | 10.4 | 11.5 | 12.6 | 13.6 |
| Debt service ratio | 15.3 | 15.2 | 14.8 | 16.1 | 18.8 | 17.7 | 21.4 | 22.6 |
| Gross reserves of NBR (in millions of US$) 3/ | 14,873 | 22,866 | 28,643 | 31,332 | 33,831 | 37,980 | 41,783 | 47,177 |
| (over short-term debt by remaining maturity) | 200.0 | 259.5 | 286.9 | 261.0 | 258.6 | 239.5 | 236.7 | 262.9 |
| (in months of imports of following year) | 4.1 | 5.6 | 6.6 | 6.5 | 6.4 | 6.6 | 6.6 | 6.8 |

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

1/ Includes extrapolated staff estimates of reinvested earnings on foreign direct investment based on 2004 survey data.
2/ Including public enterprises.
3/ Includes gold.

Table 9. Romania: Medium-Term Projections, 2000-11
(In percent of GDP unless otherwise indicated)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | | | | Prel. Estimates | Staff Projections | | | | | |
| **Income and prices** | | | | | | | | | | | | |
| Nominal GDP (in millions of re-denominated lei) | 803.8 | 1,167.7 | 151,475 | 197,565 | 246,372 | 287,186 | 333,236 | 376,542 | 415,108 | 455,978 | 499,234 | 544,793 |
| Nominal GDP (in billions of US dollars) | 37.1 | 40.2 | 45.8 | 59.5 | 75.5 | 98.6 | 113.5 | 137.2 | 155.1 | 174.1 | 195.3 | 218.2 |
| (growth rates) | | | | | | | | | | | | |
| Real GDP | 2.1 | 5.7 | 5.1 | 5.2 | 8.4 | 4.1 | 5.2 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 |
| Domestic Demand | 4.3 | 8.4 | 3.9 | 8.4 | 12.1 | 8.3 | 7.9 | 7.8 | 7.3 | 6.9 | 6.7 | 6.8 |
| Household consumption | -0.8 | 6.9 | 5.3 | 8.5 | 14.1 | 9.8 | 7.5 | 6.6 | 6.2 | 5.8 | 5.6 | 5.6 |
| Government consumption | 12.3 | 3.6 | 3.0 | 7.5 | 5.0 | 4.4 | -0.6 | 4.0 | 4.2 | 4.5 | 5.2 | 6.2 |
| Gross fixed investment | 5.5 | 10.1 | 8.2 | 8.6 | 10.8 | 13.0 | 11.3 | 10.3 | 8.9 | 8.7 | 8.6 | 8.4 |
| of which: non government | 7.7 | 10.9 | 8.3 | 8.1 | 11.6 | 14.1 | 11.1 | 9.1 | 8.9 | 8.6 | 8.6 | 8.5 |
| of which: government | -11.2 | 3.6 | 8.1 | 13.2 | 2.7 | 1.0 | 14.6 | 26.8 | 9.0 | 10.9 | 9.5 | 8.4 |
| Increase in stocks (contribution) 1/ | 2.2 | 1.6 | -1.6 | 0.1 | 0.5 | -1.1 | 0.5 | 0.1 | 0.2 | 0.1 | -0.1 | -0.2 |
| External Demand (contribution) | -2.3 | -3.1 | 0.9 | -3.6 | -4.5 | -5.0 | -2.7 | -2.1 | -1.6 | -1.3 | -1.2 | -1.2 |
| Exports of goods and services | 23.4 | 12.1 | 17.5 | 8.4 | 13.9 | 7.6 | 7.8 | 7.9 | 8.0 | 8.0 | 8.0 | 7.9 |
| Imports of goods and services | 27.1 | 18.4 | 12.0 | 16.0 | 22.1 | 17.2 | 12.2 | 11.1 | 10.1 | 9.3 | 9.0 | 8.9 |
| GDP deflator, p.a. | 44.2 | 37.4 | 23.4 | 24.0 | 15.0 | 12.0 | 10.2 | 7.0 | 4.3 | 4.0 | 3.6 | 3.3 |
| CPI, e.o.p. | 40.7 | 30.3 | 17.8 | 14.1 | 9.3 | 8.6 | 6.5 | 4.0 | 3.5 | 3.2 | 3.0 | 2.8 |
| CPI, p.a. | 45.7 | 34.5 | 22.5 | 15.3 | 11.9 | 9.0 | 7.9 | 4.8 | 3.8 | 3.3 | 3.1 | 2.9 |
| **Saving and investment balances 2/** | | | | | | | | | | | | |
| Total domestic saving | 14.2 | 14.9 | 16.0 | 14.5 | 13.1 | 12.3 | 13.7 | 14.8 | 15.0 | 15.5 | 15.8 | 16.1 |
| Net factor receipts and transfers from abroad | 1.6 | 2.1 | 2.3 | 1.6 | 0.7 | 1.7 | 2.0 | 1.9 | 2.6 | 2.9 | 3.2 | 3.4 |
| Total national saving | 15.8 | 17.0 | 18.3 | 16.0 | 13.9 | 14.0 | 15.7 | 16.7 | 17.6 | 18.4 | 19.0 | 19.5 |
| Non-government | 16.7 | 17.1 | 17.7 | 14.9 | 12.1 | 12.1 | 12.9 | 13.1 | 14.0 | 14.6 | 15.1 | 15.6 |
| Government | -1.0 | -0.1 | 0.6 | 1.2 | 1.7 | 1.8 | 2.8 | 3.6 | 3.6 | 3.8 | 3.9 | 3.9 |
| Total investment | 19.5 | 22.6 | 21.7 | 21.8 | 22.3 | 22.7 | 24.2 | 25.0 | 25.8 | 26.4 | 26.9 | 27.3 |
| Non-government investment | 16.4 | 19.4 | 18.5 | 18.5 | 19.6 | 20.1 | 21.4 | 21.7 | 22.3 | 22.8 | 23.2 | 23.6 |
| Government investment | 3.0 | 3.1 | 3.2 | 3.4 | 2.8 | 2.6 | 2.8 | 3.3 | 3.4 | 3.6 | 3.7 | 3.8 |
| Gross fixed capital formation | 18.9 | 20.7 | 21.3 | 21.4 | 21.6 | 23.1 | 24.1 | 24.8 | 25.4 | 26.0 | 26.6 | 27.1 |
| Increase in stocks | 0.6 | 1.9 | 0.4 | 0.4 | 0.7 | -0.4 | 0.1 | 0.2 | 0.4 | 0.4 | 0.3 | 0.2 |
| Savings - investment balance | -3.7 | -5.5 | -3.3 | -5.8 | -8.5 | -8.7 | -8.5 | -8.3 | -8.1 | -8.0 | -7.9 | -7.8 |
| Non-government | 0.3 | -2.3 | -0.7 | -3.6 | -7.4 | -7.9 | -8.5 | -8.5 | -8.3 | -8.2 | -8.1 | -8.0 |
| Government | -4.0 | -3.2 | -2.6 | -2.2 | -1.0 | -0.8 | 0.0 | 0.2 | 0.2 | 0.2 | 0.2 | 0.2 |
| External debt | 29.8 | 32.8 | 32.8 | 32.9 | 35.1 | 32.4 | 32.4 | 31.3 | 32.2 | 33.4 | 34.0 | 35.2 |
| Public Debt 3/ | 27.8 | 27.5 | 25.9 | 23.5 | 22.4 | 18.9 | 16.7 | 15.3 | 15.1 | 15.0 | 14.7 | 14.4 |

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

1/ Includes statistical discrepancy.
2/ Beginning 2004, fiscal data are based on a new classification and thus ratios are not comparable to series before 2004.
3/ Includes domestic and external public debt, public and publicly guaranteed.

Table 10. Romania: Indicators of External Vulnerability, 2000-05 1/

(In percent of GDP, unless otherwise indicated)

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 |
|---|---|---|---|---|---|---|
| **Financial Indicators** | | | | | | |
| Public sector debt | 27.8 | 27.5 | 25.9 | 23.5 | 22.4 | 18.9 |
| Broad money (percent change, 12-month basis) | 38.0 | 46.2 | 38.1 | 23.3 | 40.1 | 33.8 |
| Credit to non-government (percent change, 12-month basis) | 56.4 | 69.4 | 58.8 | 80.7 | 57.2 | 57.8 |
| Real credit to non-government (percent change, 12-month basis) 2/ | 7.4 | 26.0 | 29.6 | 56.8 | 40.5 | 44.7 |
| Monthly weighted average T-bill rate | 62.4 | 38.4 | 17.4 | 18.4 | 11.5 | 6.2 3/ |
| Monthly weighted average real T-bill rate 4/ | 15.4 | 6.3 | -0.3 | 3.7 | 2.0 | -2.2 3/ |
| **External Indicators** | | | | | | |
| Exports (percent change, 12-month basis in €) | 21.9 | 12.9 | 15.4 | 6.4 | 21.3 | 17.5 |
| Imports (percent change, 12-month basis in €) | 19.1 | 22.1 | 8.6 | 12.3 | 24.0 | 23.9 |
| Terms of Trade (percent change, 12-month basis) | 2.7 | 8.0 | 7.2 | 5.1 | 4.8 | 6.0 |
| Current account balance | -3.7 | -5.5 | -3.3 | -5.8 | -8.5 | -8.7 |
| Current account balance after FDI | -0.2 | -2.0 | -0.2 | -2.1 | 0.0 | -2.1 |
| Errors and omissions | -0.3 | 1.2 | -2.4 | -0.9 | 1.5 | 1.9 |
| Gross official reserves (in € millions) | 3,725 | 5,776 | 6,651 | 6,329 | 11,861 | 18,355 |
| (in months of imports GNFS of the following year) | 2.3 | 3.5 | 3.6 | 2.8 | 4.1 | 5.6 |
| Central Bank short-term foreign liabilities (in € millions) | 109 | 112 | 0 | 0 | 0 | -83 |
| Gross reserves of the banking system (in € millions) | 5,276 | 7,312 | 8,486 | 7,946 | 12,883 | 17,829 |
| (in months of imports GNFS of the following year) | 3.4 | 4.4 | 4.6 | 3.5 | 4.5 | 5.4 |
| Short term foreign liabilities of the commercial banks (in €) | 244 | 415 | 522 | 1,028 | 1,620 | 2,214 |
| Open foreign currency position of the commercial banks (in €) | 345 | 397 | 404 | 357 | 310 | 440 5/ |
| Official reserves/Broad money (M2) | 52.2 | 67.5 | 59.6 | 44.8 | 53.1 | 65.6 |
| Official reserves/ Money Supply (M1) 6/ | 208.4 | 283.8 | 252.3 | 182.2 | 224.4 | 230.5 |
| Total short term external debt by remaining maturity 7/ | 4.3 | 5.8 | 6.7 | 5.6 | 5.6 | 5.0 |
| In percent of reserves | 32.4 | 35.7 | 38.3 | 37.2 | 26.0 | 22.3 |
| In percent of total debt | 14.3 | 17.7 | 20.4 | 17.0 | 15.8 | 15.5 |
| Total external debt (in € millions) | 11,988 | 14,726 | 15,967 | 17,338 | 21,156 | 25,623 |
| *Of which* : Public and Publicly guaranteed debt | 7,477 | 8,778 | 9,127 | 9,557 | 10,372 | 11,329 |
| Total external debt (in percent of exports of G&S) | 90.9 | 98.2 | 93.1 | 94.8 | 96.9 | 97.9 |
| Total external debt/ GDP | 29.8 | 32.8 | 32.8 | 32.9 | 35.1 | 32.4 |
| External interest payments (in percent of exports of G&S) | 4.4 | 4.6 | 4.1 | 3.9 | 3.5 | 4.4 |
| External amortization payments (in percent of exports of G&S) | 8.6 | 12.8 | 14.8 | 12.2 | 11.8 | 10.8 |
| Exchange rate (per US$, period average) | 2.2 | 2.9 | 3.3 | 3.3 | 3.3 | 2.9 |
| Exchange rate (per €, period average) | 2.6 | 3.1 | 3.8 | 4.1 | 3.6 | 3.5 |
| REER appreciation (+) (12-month basis) | 9.3 | 1.5 | 2.6 | 0.4 | 4.0 | 17.0 |
| **Financial Market Indicators** | | | | | | |
| Foreign currency debt ratings | | | | | | |
| Moody's | B3 | B2 | B1 | Ba3 | Ba1 | Ba1 |
| Standard and Poor's | B- | B | B+ | BB | BB+ | BBB- |
| Spread of benchmark bonds (basis points, end of period) | 406 | 400 | 286 | 161 | 58 | 47 8/ |

Sources: Romanian authorities; and Fund staff estimates.

1/ All stocks are reported as of end of period.

2/ Real credit growth is weighted average of real lei credit growth, and U.S. dollar-measured foreign currency growth.

3/ Actual average rate for September, 2005.

4/ The real rate is based on the ex-post 12-month CPI inflation.

5/ On-balance-sheet only. The overall open currency position, including off-balance-sheet items and capital paid in foreign exchange, was US$40 million long at end-August 2005.

6/ Narrow money is defined as currency plus lei-denominated sight deposits.

7/ Defined as short-term debt by original maturity basis plus amortization falling due on medium-term loans and bonds.

8/ For 2000, the benchmark bond is the '02; in 2001-2005, the spread quoted is the J.P. Morgan's Global EMBI Global Government Spread Romania index.

## Table 11. Romania: Indicators of Fund Credit, 2004-11

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|---|---|---|---|---|---|---|---|---|
| Outstanding Fund Credit 1/ | | | | | | | | |
| (end of period) | | | | | | | | |
| In millions of SDRs | 285.4 | 182.6 | 411.9 | 318.9 | 250.0 | 159.7 | 34.7 | 0.0 |
| In millions of U.S. dollars | 387.8 | 247.4 | 556.5 | 429.3 | 335.1 | 213.2 | 46.1 | 0.0 |
| In percent of quota | 27.7 | 17.7 | 40.0 | 31.0 | 24.3 | 15.5 | 3.4 | 0.0 |
| In percent of GDP | 0.5 | 0.3 | 0.5 | 0.3 | 0.2 | 0.1 | 0.0 | 0.0 |
| In percent of exports of goods and services | 2.9 | 1.5 | 2.7 | 1.6 | 1.0 | 0.6 | 0.1 | 0.0 |
| In percent of official reserves | 2.4 | 1.1 | 1.9 | 1.4 | 1.0 | 0.6 | 0.1 | 0.0 |
| Debt service due to the Fund 1/ | | | | | | | | |
| In millions of SDRs | 124.6 | 111.6 | 18.1 | 112.8 | 84.4 | 103.4 | 133.2 | 37.9 |
| In millions of U.S. dollars | 169.3 | 151.3 | 24.5 | 151.9 | 113.1 | 138.0 | 177.1 | 50.2 |
| In percent of quota | 12.1 | 10.8 | 1.8 | 10.9 | 8.2 | 10.0 | 12.9 | 3.7 |
| In percent of GDP | 0.2 | 0.2 | 0.0 | 0.1 | 0.1 | 0.1 | 0.1 | 0.0 |
| In percent of exports of goods and services | 1.3 | 0.9 | 0.1 | 0.6 | 0.3 | 0.4 | 0.5 | 0.1 |
| In percent of official reserves | 1.0 | 0.7 | 0.1 | 0.5 | 0.3 | 0.4 | 0.4 | 0.1 |

Sources: IMF's Finance Department and Romanian authorities.

1/ Includes GRA charges, and prospective purchases under current Standby Arrangement, which the authorities intend to treat as precautionary.

## ROMANIA—RELATIONS WITH THE FUND
(As of February 28, 2006)

**I. Membership Status:** Joined 12/15/72; Article VIII

| II. General Resources Account: | SDR million | % Quota |
|---|---|---|
| Quota | 1,030.20 | 100.00 |
| Fund holdings of currency | 1,192.09 | 115.71 |

| III. SDR Department: | SDR million | % Allocation |
|---|---|---|
| Net cumulative allocation | 75.95 | 100.00 |
| Holdings | 0.32 | 0.43 |

| IV. Outstanding Purchases and Loans: | SDR million | % Quota |
|---|---|---|
| Stand-By Arrangements | 161.89 | 15.71 |

**V. Financial Arrangements:**

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

**VI. Projected Payments to Fund (Expectations Basis)**[1]
(SDR million; based on existing use of resources and present holdings of SDRs):

| | Forthcoming | | | | |
|---|---|---|---|---|---|
| | 2006 | 2007 | 2008 | 2009 | 2010 |
| Principal | 93.00 | 68.89 | | | |
| Charges/interest | 6.14 | 4.31 | 2.58 | 2.58 | 2.58 |
| Total | 99.14 | 73.20 | 2.58 | 2.58 | 2.58 |

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

## VII. Exchange Rate Arrangements

Romania has maintained a de jure inflation-targeting regime since August 2005, but has also characterized its exchange-rate approach as a managed float. In this context, the authorities have intervened, often heavily, in response to perceived excessive exchange rate movements, but have no formal predetermined path. The official reference rate published by the NBR is an average of rates reported for interbank and client transactions. Romania has accepted the obligations of Article VIII, Sections 2, 3, and 4, with effect from March 25, 1998. Romania's exchange system is free of restrictions on the making of payments and transfers for current international transactions.

## VIII. Article IV Consultation

Romania is on the 24-month consultation cycle subject to the provisions of the decision on consultation cycles approved by the Board on July 15, 2002. The last consultation was concluded on July 7, 2004.

## IX. Technical Assistance

The transition in Romania has been supported by substantial technical assistance from multilateral agencies and bilateral donors. The Fund has provided support in a number of areas with more than 40 technical assistance missions since 1990, although the authorities have had a mixed record with regard to implementation. Expert Fund assistance has focused on a number of key areas, including: fiscal reforms; modernization of the central bank and the banking system; creating a market-oriented legal structure; training; and improving the collection and reporting of statistics. The implementation of a comprehensive tax administration reform designed in line with the recommendations of several technical assistance missions of the Fund's Fiscal Affairs Department started in January 2003. A report on the observance of standards and codes (ROSC) on fiscal transparency was completed on November 6, 2002 (IMF Country Report No. 02/254). Furthermore, in 2003 an FSAP was completed, while technical assistance by the Fund's Monetary and Financial Systems Department on inflation targeting is ongoing.

## X. Safeguards Assessment

Under the Fund's safeguards assessment policy, the NBR is subject to an assessment with respect to the precautionary Stand-By Arrangement approved on July 7, 2004. The assessment was completed on June 17, 2004 and concluded that the safeguards in place at the NBR appear generally adequate. However, certain weaknesses were identified in the internal audit and control system, and the safeguards assessment recommended measures to address them. Recent information received from the authorities indicates that these measures have been implemented as envisaged.

## XI. Anti-Money Laundering and Combating the Financing of Terrorism framework

The legislative framework for anti-money laundering and combating the financing of terrorism (AML/CFT) has been updated recently to bring Romania in line with international standards, in the context of Romania's EU accession. The AML/CFT system continues, however, to suffer from severe shortcomings, including in the supervisory area. While the level of AML supervision is improving in the banking sector and the NBR appears to be taking this issue seriously, it remains extremely weak for the financial sector at large. In addition, there is very little, if any, oversight of the non-financial sector for AML/CFT purposes and the authorities have started only recently to inspect casinos, a sector which appears to be particularly vulnerable to money laundering risks. Finally, while AML requirements have been extended to cover financing of terrorism recently, additional training of reporting entities and competent authorities in this area remains necessary.

## XII. Resident Representative

The Fund has had a resident representative in Bucharest since 1991. Mr. Graeme Justice assumed the post in January 2003.

## ROMANIA: RELATIONS WITH THE WORLD BANK

**Partnership in Romania's Development Strategy**

1. The Romanian authorities are pursuing a strategy designed to achieve macroeconomic stability and establish sustainable economic growth and poverty reduction, moving towards the eventual goal of accession to the European Union. Key elements of this policy include tightening payments discipline throughout the economy, especially in the energy sector, hardening budget constraints for state-owned enterprises, actively pursuing enterprise and banking privatization and restructuring, and strengthening the social safety net. Over the medium term, continuation of the current economic recovery will depend critically on the maintenance of reform momentum and moving steadily ahead with governance and private sector development reforms. Such reforms would stress transparency and accountability in government, judicial reforms, improvements in the business environment, and actions to strengthen the regulation and oversight of financial and capital markets.

2. In broad terms, the IMF has taken the lead in assisting Romania in achieving macroeconomic stability. As such its program focus is on the fiscal framework, monetary policy and those elements of the structural reform program that have a direct bearing on the macroeconomic situation. The main vehicles for its dialogue with the authorities are the previous Stand-By Arrangement (SBA) covering the period October 31, 2001 to October 15, 2003 and the current precautionary SBA.

3. The World Bank has taken the lead in policy dialogue on structural issues, including poverty reduction measures, private sector development, institution building and governance. It has a range of instruments through which it conducts dialogue, including adjustment lending operations such as PSAL 1 and PSAL 2, a series of Programmatic Adjustment Loans, the first of which went to the Bank Board in September 2004, several sector investment operations and economic work such as the Public Expenditure and Institutions Review (PEIR), and the Country Economic Memorandum (CEM).

4. In some areas where the Bank takes the lead in the dialogue, its analysis is shared with the IMF and is used as input for the fiscal framework, but there are no directly corresponding structural benchmarks or policy conditions in the IMF SBA. In other areas where the Bank takes the lead, the SBA does reflect certain elements in its conditionality. These are generally structural reform measures which have important fiscal implications, such as energy sector reform and restructuring. There are further areas of formal joint responsibility such as the Financial Sector Assessment Program (FSAP).

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

## A. IMF-World Bank Collaboration in Specific Areas

**Areas in which the World Bank leads and there is no direct IMF involvement**

6. The policy areas in which the Bank leads and which are not directly incorporated into the IMF program or country dialogue include strengthening the social safety net, revitalizing the economy in rural areas, institution building and governance, and improving the business environment. Bank policy dialogue for strengthening the social safety net includes poverty monitoring, social assistance, pension reform, child welfare reform, health sector reforms, and labor retraining and redeployment. These have been supported by the Bank's Employment and Social Protection Loan, the Social Sector Development Loan, the Social Development Fund and the Mine Closure Loan. They are further supported by economic work such as the recently completed Poverty Profile and the Local Services Delivery Study, and by planned economic studies on poverty and vulnerability, pension reform and gender assessment.

7. The Bank has a range of programs to revitalize the economy in rural areas. These include the Rural Finance Loan which supports income generation activities and will be complemented by a Rural/Urban Linkage Growth Study to set the stage for a Rural Development Loan supporting infrastructure development and improved governance at the community level. The Irrigation Rehabilitation loan supports infrastructure rehabilitation and institutional reform. Other supporting economic work includes the Community Networks Study and the Jiu Valley Development Study.

8. The Bank has a strong institution building and governance program. This builds on recent reforms in local public finance and taxation and decentralization. Policy dialogue has been facilitated the Public Expenditure and Institutions Review (PEIR) which included analysis and recommendations relating to 1) improved resource allocation in the health sector; 2) delivery of social assistance at the local level; 3) pension reform; 4) institutions for budget management 5) fiscal decentralization; and 6) reforms to the budget process in the judiciary. The policy dialogue has also been supported by a Country Financial Accountability Assessment (CFAA). The Bank completed a Diagnostic Survey of Corruption in Romania prior to the Government's preparing of its National Program for Prevention of Corruption. The first in a series of Programmatic Adjustment Loans (PAL) was approved by the World Bank Board in September, 2004. These focus on institutional and governance reforms in the public service and the judiciary as well as public expenditure management as well as the remaining structural reform agenda. They are supported by a $18.6 million Private and Public Sector Institution Building Loan (PPIBL) which provides technical assistance for these activities and others relating to privatization. Other institution-building support includes financing of a cadastral and land titling project, a project on the environmental aspects of mine closures, a hazards mitigation project cofinanced by a GEF grant which focuses on damage from earthquakes, floods toxic wastes and other hazards in high risk areas, and by a regional project on Trade and Transportation Facilitation in South East Europe.

9. Policy advice and support for reforms in the business environment have been offered by the Bank in several areas. Through PSAL 1 and PSAL 2 the Bank has focused on reducing barriers to entry for firms and joint ventures, implementing internationally recognized accounting standards and introducing improved bankruptcy and liquidation procedures. The PALs will also address business environment issues, and all these initiatives will be supported by technical assistance provided under the PPIBL.

**Areas in which the World Bank leads and its analysis serves as input into the IMF program**

10. The Bank supports the GOR's privatization program through PAL program which includes targets and timelines for privatization of commercial SOEs and financial institutions. The program builds on the progress established under PSALs 1 and 2 which identified pools of SOEs from which set minimum numbers of enterprises are selected for case-by-case privatization and workout. Specific enterprises including Alro, Alprom, and Petrom, were also identified. The PAL program continues this process with further targets for privatization of commercial enterprises and enterprises in the energy and banking sectors. Key to the success of this program is agreement with the Bank on strategies for the privatization of theses entities and the subsequent adoption of a clear, open and transparent tender process using the services of qualified investment advisors in a manner consistent with Bank policies.

11. The Bank has led the dialogue on restructuring, reform and eventual privatization of enterprises in the electricity, district heating and gas industries and on the adoption of regulatory legislation in preparation for privatization to strategic investors. As part of this process the Bank is supporting, inter alia, energy tariff reforms and reforms in the electricity, district heat and gas sectors. These objectives are woven into the policy conditions of the PAL program, along with conditions related to the privatization of electricity distribution enterprises. These conditions have been closely coordinated with the IMF since the SBAs have also included provisions for structural reforms in the energy sector including tariff setting, arrears clearance and collection rates. The Bank is leading the IFI dialogue with the Government on such critical long-term issues as power generation sector restructuring and the integration of the Romanian power sector with the South East European Regional Electricity Market and with the EU's electricity market, and provides assistance on the associated regulatory and market operation issues. The Bank has also provided technical assistance to the Ministry of Industry to establish a system of pricing and taxation of gas consistent with attracting further investment into the industry. Policy dialogue in these and other areas, notably including the district heating sector, will be further facilitated by ongoing dialogue with the Government on the recently completed Energy and Infrastructure Strategy paper and its operational recommendations.

12. The Bank has taken the lead in dialogue and policy advice regarding regulation, restructuring, privatization and liquidation of banks. Under PSAL 1 the Law on Bank Privatization was modified and transparent privatization procedures established. Liquidity and solvency requirements of the NBR were tightened and provisions introduced for

improved compliance with prudential regulations and external audits conducted according to International Accounting Standards. Legal and institutional reforms were introduced for orderly disposition of non-performing assets. These policy changes underpinned liquidation of the most troubled bank (Bancorex ) while Bank Agricola was restructured and eventually privatized as were two smaller state owned banks. This policy agenda is continued under the PAL program with steps privatize the Savings Bank (CEC). The Bank is continuing the dialogue with the government on the need to move forward with further improvements of the legal and regulatory framework for the securities and insurance sectors. The PPIBL will provide funding for these activities.

**Areas of shared responsibility**

13. While the Bank has taken the lead in privatization and in structural reforms in the energy sector as described above, the IMF has a strong interest from a macroeconomic perspective since privatization revenues have been primarily used to retire public debt, and quasi-fiscal deficits of the SOEs present a threat to macroeconomic stability. Accordingly, there is high degree of consultation and coordination between the two institutions on these matters. While the terms of the respective programs are mutually consistent and supportive, the focus and motivation for the Bank's program are on the efficiency of the resulting market structures, improved enterprise operation, service delivery and financial performance, and the transparency of the process and improvement in overall sector governance, and that of the IMF is on immediate revenue generation and expenditure control, and containment of ongoing fiscal burdens.

14. The Bank and the IMF jointly conducted a Financial Sector Assessment Program which was completed in June 2003.

**Areas in which the IMF leads and its analysis serves as input into the World Bank program**

15. While the Bank has focused on improvements in revenue administration, the Fund leads the dialogue on fiscal matters. The IMF also leads the dialogue on policies to contain certain expenditures in the public sector. These include policies regarding wage-setting in both the public service and SOEs and the budgets of SOEs.

16. In these areas the Bank takes into account the policy recommendations of the IMF and ensures that its own policy advice is consistent.

**Areas in which the IMF leads and there is no direct World Bank involvement**

17. The IMF is fully responsible for the dialogue on monetary policy, interest rates, the exchange rate regime, the balance of payments and all the related statistical and measurement issues.

### B. World Bank Group Strategy and Lending Operations

18. The last Country Assistance Strategy (CAS) for Romania was presented to the World Bank's Board on June 19, 2001. The CAS defined the Bank's lending and advisory services based on the Government's priorities of poverty reduction and EU accession, and built on the work initiated under the Comprehensive Development Framework, for which Romania was one of the pilot countries. About one half of the FY02–04 lending program was adjustment lending. Two distinct lending scenarios were outlined. In the event of a hesitant pace of reforms, Romania would have been in the low case of the CAS, with significant reductions in Bank Group support to a level of $60 million during FY02–04 to support actions centered on a few poverty focused interventions. However, Romania successfully remained in the high-case lending scenario under which Bank commitments of up to $995 million during FY02–04 were envisaged, compared with $600 million in FY98–00. This reflected the sustained fulfillment of the high-case triggers, which included progress in establishing a macroeconomic environment conducive to lower inflation and sustainable growth as well as progress on structural issues including privatization as initiated under the PSAL program, initiation of the privatization and work-out process for a number of remaining large state-owned enterprises, agreement on a plan and schedule for reducing energy arrears, agreement on a method and timetable for privatization of Romanian Commercial Bank and the Savings Bank, improvements in the financial sector legal and supervisory framework, an agreement on an anti-corruption strategy, and approval of social assistance legislation.

19. The high-case scenario embodied a program of accelerated structural and sectoral reforms that will pave the way for Romania's eventual accession to the EU. The first stage of this program was launched with the approval of PSAL 2 by the Bank Board in September 2002 and the delivery of the Public Expenditure and Institutions Review (PEIR) in July 2002. In the second stage to follow PSAL 2, the Bank offered support through a series of Programmatic Adjustment Loans (PALs) focusing on institutional and governance reforms, completion of the privatization agenda, implementation of the recommendations of the Energy and Infrastructure Strategy Paper and improvements to the business environment, as well as a Country Financial and Accountability Assessment and a Country Economic Memorandum focusing on the reform agenda for Romania's accession to the EU. The first of these PALs was approved by the Board September 2004 and closed successfully March 31, 2005.

20. The PAL 1 Program Document included a CAS Update covering FY05. The FY05 program, designed to support EU accession through sustaining and accelerating the reform process, continued with two distinct lending scenarios. Remaining in the high case depended on: (i) maintenance of a macroeconomic framework agreeable to the Bank; (ii) sustained progress in PAL 1 actions; (iii) adherence to the agreed schedules of electricity and gas price increases; (iv) sustained progress, satisfactory to the Bank on the sale of Petrom and two electricity distribution companies as well as privatization of AVAS companies, including reasonable progress in the sale of the remaining electricity companies; (v) observance of agreed pension deficit ceiling; and (vi) timely initiation and completion of planned technical assistance activities under the PPIPL supporting judicial and public administration reforms.

The next full CAS is to be discussed at the Board in the spring of 2006, after Bank management has completed its assessment of Romania's macroeconomic framework.

21. The World Bank has been active in Romania since 1991 and has built up a portfolio of 51 Bank-financed operations with total commitments of US$4.9 billion. Romania's portfolio is the largest in ECA in terms of number of projects and third largest in commitments. The active portfolio as of January 3, 2006 consists of 23 projects with aggregate net commitments totaling $1.6 billion and a total undisbursed balance of $1 billion. Sector composition in terms of net commitments is dominated by environment and socially sustainable development (48 percent, eleven projects), and energy and infrastructure (22 percent, five projects), followed by the social sectors (17 percent, four projects).

22. The quality of the Bank's Romania portfolio has been improving over the past several years. While the overall performance indicators are positive, several cross-cutting implementation issues persist. These include: (i) project management capacity (specifically, issues relating to procedures, inter-agency coordination, and project implementation unit staffing and facilities), (ii) the imposition of ceilings to withdrawals from external borrowing, in order to restrain public expenditures and protect the budget deficit target and the timely availability of counterpart contributions as well as the quality and processing of disbursement applications, to yield maximum development impact from the Bank's portfolio, and (iii) integration of procurement planning into the financial budgeting process.

23. IFC has dedicated substantial resources to assist the development of capital markets and infrastructure (utilities and telecommunication), and provide support for small and medium enterprises (SMEs). To date, IFC has committed over US$712 million of its own funds in 37 projects and has arranged over $241 million in syndications to support projects in the financial markets, information technology, food and beverage, general manufacturing and infrastructure. As of December 2005, IFC portfolio in Romania stood at $525 million. In addition to investments, IFC has undertaken a number of advisory assignments aimed at supporting the privatization and restructuring of large state-owned enterprises, public utilities and the health sector.

Questions may be referred to Ron Hood (473-0115) or Myla Williams (473-6997)

## ROMANIA: STATISTICAL ISSUES

1. Data collection and reporting are adequate for surveillance and program monitoring, but the quality of the national accounts, price, fiscal, and balance-of-payments data needs improvement. The authorities have made progress in improving economic and financial statistics with technical assistance, including from the Fund, over the past several years. Romania began participating in the GDDS in February 2001 and graduated to subscription to the SDDS in May 2005.

**Real Sector**

2. Quarterly and annual national accounts statistics are produced by the National Institute for Statistics (INS) using the *European System of Accounts 1995 (ESA95)*. Estimates are methodologically sound and are reported to the Fund on a timely basis for publication in the *International Financial Statistics (IFS)*. However, quarterly and annual national accounts are not harmonized on a regular basis and late revisions can sometimes be significant. The latest dedicated national accounts publication was released in October 2005 and included the final accounts for the 1999-2002 series. Provisional and semi-final versions are disseminated in the Statistical Yearbook and other publications, and on the web at (www.insse.ro).

3. The Consumer Price Index (CPI) is subject to standard annual re-weighting, and it is considered reliable. In January 2004, the INS changed the coverage of the PPI to include the domestic and non-domestic markets.

**Public Finance**

4. Consolidated data on central government operations are reported annually for the *GFS Yearbook* and quarterly for *IFS*, while EUR receives monthly budget data. Consolidated general government data have been reported for inclusion in the *2005 GFS Yearbook*. These data are reported on an accrual basis, having been derived from cash data using various methods: tax revenues are adjusted using the time-adjusted cash method; expense data are adjusted using due-for-payments data; and interest payments are calculated on an accrual basis. Beginning in 2002, the Special Fund for Development of the Energy System, Special Fund for Public Roads, Special Fund "Romanian Agriculture Development," and Special Fund "Romania" were included in the state budget, while the Special Fund for Insured Protection was eliminated from general government accounts. The reported data excluded data on the Agency for Recovery Bank Assets.[1] The authorities introduced a new budget classification for the 2006 budget and have produced the 2004-05 outturns on the basis of the new classification. However, they have not produced fiscal accounts for years prior to 2004.

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

**Monetary and Financial**

5. The NBR reports monetary and financial statistics on a regular and timely basis for publication in the *IFS*. Since December 2004, the NBR reports monetary data to STA using the Standardized Report Forms, which are designed in accordance with the methodology in the *Monetary and Financial Statistics Manual*. Nevertheless, monetary statistics need to be reconciled with government finance statistics. In line with *1993 SNA* and *MFSM*, accrued interest on deposits and loans, and securities other than shares should be incorporated in the outstanding amount of financial assets or liquidity.

**Balance of Payments**

6. The NBR routinely reports balance of payments statistics to the Fund in a timely fashion. A 2003 STA mission undertook a detailed review of the NBR's compilation methodology for balance of payments and international investment position statistics, developed in consultation with Eurostat, and concluded that the proposed system is broadly appropriate. The STA mission supported implementation of this compilation system in 2004, along with a new FDI survey.

## ROMANIA: TABLE OF COMMON INDICATORS REQUIRED FOR SURVEILLANCE
(AS OF FEBRUARY 28, 2006)

| | Date of latest observation | Date received | Frequency of Data[6] | Frequency of Reporting[6] | Frequency of Publication[6] |
|---|---|---|---|---|---|
| Exchange Rates | Feb.2006 | Feb.2006 | D and M | D and M | D and M |
| International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1] | Feb. 2006 | Feb. 2006 | D and M | W and M | M |
| Reserve/Base Money | Jan.2005 | Feb 2006 | D and M | W and M | M |
| Broad Money | Jan. 2005 | Feb. 2006 | M | M | M |
| Central Bank Balance Sheet | Jan. 2005 | Feb. 2006 | M | M | M |
| Consolidated Balance Sheet of the Banking System | Jan. 2005 | Feb. 2006 | M | M | M |
| Interest Rates[2] | Dec. 2005 | Feb. 2006 | M | M | M |
| Consumer Price Index | Jan. 2006 | Feb. 2006 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4] | Jan. 2006 | Feb. 2006 | M | M | M |
| Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government | | | | | |
| Stocks of Central Government and Central Government-Guaranteed Debt[5] | Dec. 2006 | Feb. 2006 | M | M | M |
| External Current Account Balance | Dec. 2005 | Feb. 2006 | M | M | Q |
| Exports and Imports of Goods and Services | Jan. 2005 | Feb. 2006 | M | M | M |
| GDP/GNP | Q3 2005 | Dec. 2005 | Q | Q | Q |
| Gross External Debt | Dec. 2005 | Feb. 2006 | M | M | Q |

[1] Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
[3] Foreign, domestic bank, and domestic nonbank 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).

## ROMANIA—External and public debt Sustainability

### A. External Sustainability

1. **With appropriate policies in place, Romania's external sustainability will remain under control over the medium-term**. Under the baseline scenario, the external debt-to-GDP ratio is expected to increase slightly to about 35 percent over the medium-term, mainly on account of a slowdown of non-debt creating flows from the current level of 7-8 percent of GDP to about 4¼ percent of GDP by 2010-11. Romania's gross external financing needs are projected to remain stable at 14½ percent of GDP throughout the projection period, reflecting a slight increase in debt service that offsets the current account improvement.

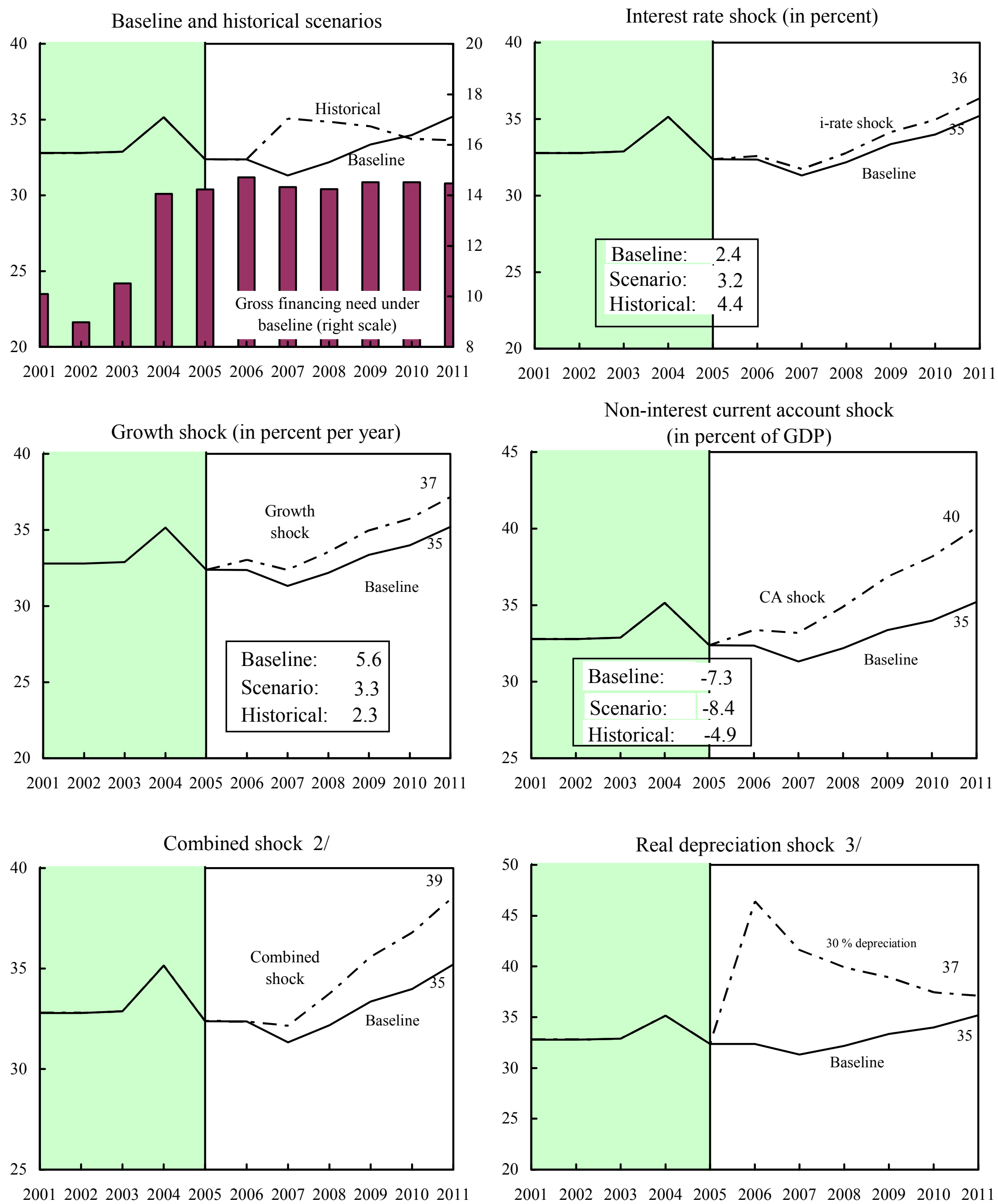
2. **Among the standard stress tests (B1-B4), Romania's external debt appears most vulnerable to a further widening of the current account deficit (B3).** An average 1 percent of GDP widening of the current account deficit would result in a debt-to-GDP ratio of 40 percent over the medium-term. Policies to contain domestic demand (through lower consumption and import growth) remain key to maintain Romania's external sustainability. Under other standard shocks, external debt dynamics would remain under control—a ratio of below 40 percent of GDP—although increasing over the medium term. A sharp real depreciation, however, could increase the debt-to-GDP ratio above 46 percent on impact, although the ratio would return to a 35-40 percent range by the end of the projection period.

### B. Fiscal Sustainability

3. **Public sector debt is expected to remain under control over the medium-term.** With appropriate policies in place, primary surpluses would remain stable at about 1 percent of GDP and overall fiscal balances would hinge at around ¼ percent of GDP over the medium-term. This path of fiscal accounts would lead to a fall in the public sector debt from the current level of 19 percent of GDP to about 14 percent of GDP by 2010-11. A primary deficit of ¾ percent of GDP would stabilize public debt at this level.

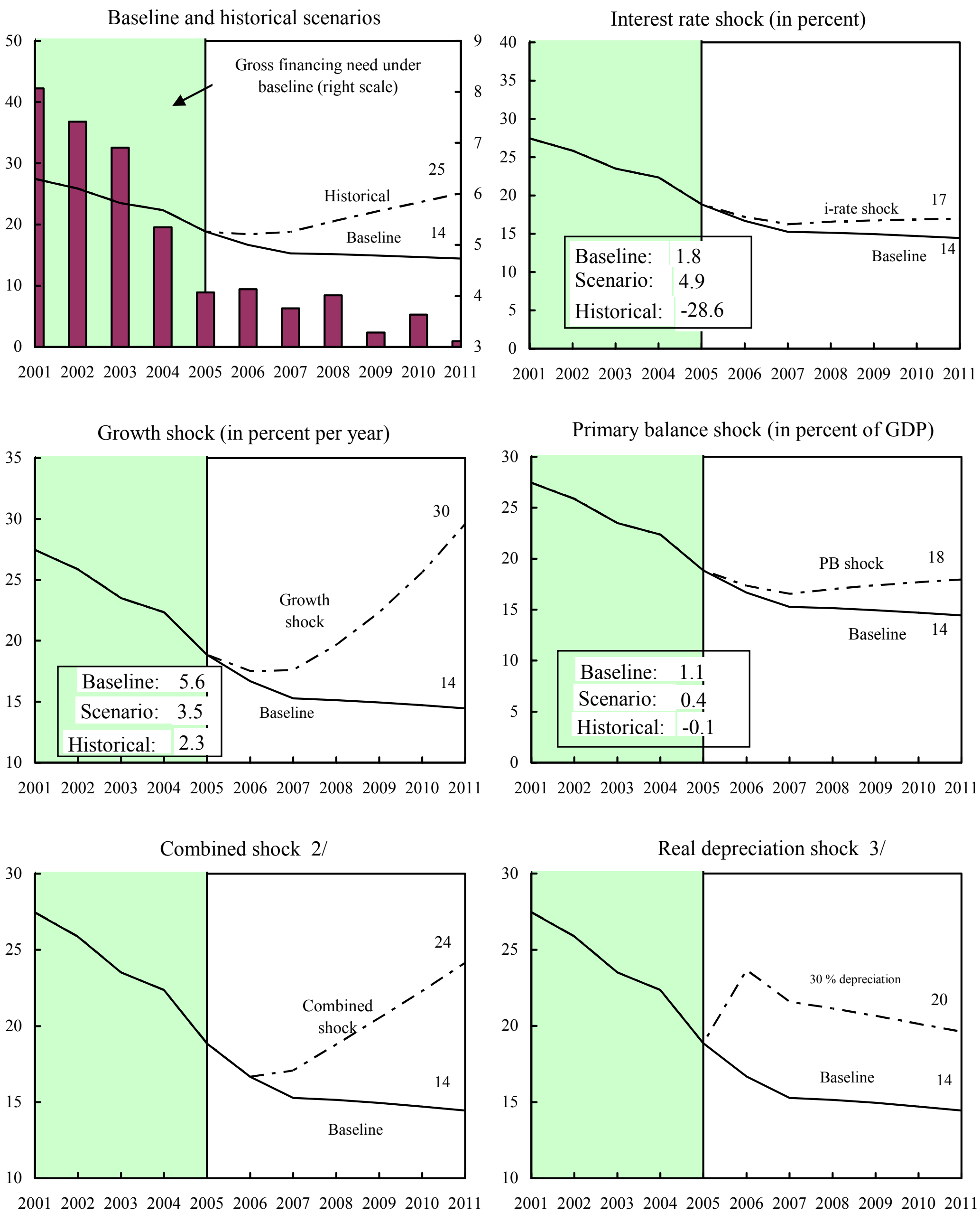
4. **However, stress tests on public debt dynamics suggest that fiscal sustainability remains vulnerable to real GDP growth shocks.** Should GDP growth slow down by about 2¼ percentage points to 3½ percent over the medium-term, public debt would climb to about 30 percent of GDP. Dynamics of public debt ratio are resilient to shocks to nominal interest rate, real exchange rate and primary balance, with the debt ratio remaining below 25 percent of GDP throughout the period.

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




Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
3/ One-time real depreciation of 30 percent occurs in 2006.

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




Sources: International Monetary Fund, Country desk data, and staff estimates.
1/ Shaded areas represent actual data. Individual shocks are permanent one-half standard deviation shocks. Figures in the boxes represent average projections for the respective variables in the baseline and scenario being presented. Ten-year historical average for the variable is also shown.
2/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and primary balance.
3/ One-time real depreciation of 30 percent occur in 2006, with real depreciation defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).

Table 12. External Debt Sustainability Framework, 1996-2011
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | | | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | |
| | | | | | | | | | | | | | I. Baseline Projections | | | | | | Debt-stabilizing non-interest current account 5/ |
| 1 **External debt** | 25.2 | 27.9 | 24.4 | 25.5 | 29.8 | 32.8 | 32.8 | 32.9 | 35.1 | 32.4 | | | **32.4** | **31.3** | **32.2** | **33.4** | **34.0** | **35.2** | **-7.0** |
| 2 Change in external debt | 1.6 | 2.7 | -3.5 | 1.1 | 4.3 | 3.0 | 0.0 | 0.1 | 2.3 | -2.8 | | | 0.0 | -1.0 | 0.9 | 1.2 | 0.6 | 1.2 | |
| 3 Identified external debt-creating flows (4+8+9) | 6.9 | 2.7 | -2.5 | 5.6 | -0.8 | -0.3 | -3.9 | -5.5 | -7.2 | -6.1 | | | -3.5 | -2.3 | -0.1 | 0.1 | 0.0 | -0.1 | |
| 4 Current account deficit, excluding interest payments | 6.4 | 4.8 | 5.8 | 2.8 | 2.5 | 4.3 | 2.3 | 4.9 | 7.6 | 7.8 | | | 7.7 | 7.6 | 7.5 | 7.5 | 7.3 | 6.8 | |
| 5 Deficit in balance of goods and services | 7.1 | 5.6 | 6.2 | 4.7 | 5.3 | 7.7 | 5.6 | 7.4 | 9.2 | 10.4 | | | 10.5 | 10.2 | 10.7 | 10.9 | 11.1 | 11.2 | |
| 6 Exports | 22.8 | 24.0 | 19.7 | 27.6 | 32.8 | 33.4 | 35.2 | 34.7 | 36.3 | 33.1 | | | 31.2 | 27.8 | 26.5 | 25.6 | 24.5 | 23.8 | |
| 7 Imports | 29.9 | 29.6 | 26.0 | 32.3 | 38.1 | 41.1 | 40.8 | 42.1 | 45.5 | 43.5 | | | 41.7 | 37.9 | 37.3 | 36.5 | 35.6 | 35.0 | |
| 8 Net non-debt creating capital inflows (negative) | -0.8 | -3.5 | -4.9 | -2.9 | -3.6 | -3.6 | -3.2 | -3.8 | -8.7 | -6.6 | | | -7.7 | -5.0 | -4.7 | -4.5 | -4.3 | -4.3 | |
| 9 Automatic debt dynamics 1/ | 1.3 | 1.5 | -3.4 | 5.7 | 0.3 | -1.0 | -3.0 | -6.6 | -6.1 | -7.4 | | | -3.5 | -4.9 | -3.0 | -3.0 | -3.0 | -2.6 | |
| # Contribution from nominal interest rate | 1.2 | 1.3 | 1.2 | 1.3 | 1.2 | 1.3 | 1.1 | 0.9 | 0.9 | 0.9 | | | 0.8 | 0.7 | 0.6 | 0.6 | 0.6 | 1.0 | |
| # Contribution from real GDP growth | -0.9 | 1.5 | 1.1 | 0.3 | -0.5 | -1.6 | -1.5 | -1.3 | -2.2 | -1.1 | | | -1.5 | -1.5 | -1.6 | -1.6 | -1.7 | -1.7 | |
| # Contribution from price and exchange rate changes 2/ | 1.0 | -1.4 | -5.7 | 4.0 | -0.4 | -0.7 | -2.6 | -6.2 | -4.8 | -7.1 | | | -2.8 | -4.1 | -2.0 | -1.9 | -1.9 | -1.9 | |
| # Residual, incl. change in gross foreign assets (2-3) | -5.3 | 0.0 | -1.1 | -4.5 | 5.2 | 3.3 | 3.9 | 5.6 | 9.4 | 3.3 | | | 3.5 | 1.2 | 1.0 | 1.1 | 0.6 | 1.3 | |
| External debt-to-exports ratio (in percent) | 110.6 | 116.5 | 123.7 | 92.3 | 90.9 | 98.2 | 93.1 | 94.8 | 96.9 | 97.9 | | | 103.8 | 112.8 | 121.3 | 130.4 | 138.6 | 147.8 | |
| **Gross external financing need (in billions of US dollars) 3/** | 4.8 | 5.6 | 6.2 | 4.7 | 2.7 | 4.1 | 4.1 | 6.3 | 10.6 | 14.0 | | | 16.7 | 19.7 | 22.1 | 25.3 | 28.3 | 31.6 | |
| in percent of GDP | 13.7 | 15.9 | 14.8 | 13.0 | 7.3 | 10.1 | 9.0 | 10.5 | 14.1 | 14.2 | | | 14.7 | 14.3 | 14.3 | 14.5 | 14.5 | 14.5 | |
| **Key Macroeconomic Assumptions** | | | | | | | | | | | 10-Year Historical Average | 10-Year Standard Deviation | | | | | | | Projected Average |
| Real GDP growth (in percent) | 3.9 | -6.1 | -4.8 | -1.1 | 2.1 | 5.7 | 5.1 | 5.2 | 8.4 | 4.1 | 2.3 | 4.8 | 5.2 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 |
| Exchange rate appreciation (US dollar value of local currency, in percent, period average) | -34.1 | -57.1 | -19.0 | -41.9 | -29.6 | -25.4 | -12.1 | -0.4 | 1.7 | 12.0 | -20.6 | 21.4 | -0.8 | 7.0 | 2.5 | 2.2 | 2.4 | 2.4 | 3.3 |
| Exchange rate appreciation (US dollar value of local currency, in percent, end-period) | -40.8 | -46.6 | -25.6 | -40.0 | -29.6 | -17.9 | -5.7 | 2.8 | 12.1 | -5.7 | -19.7 | 20.1 | 10.3 | 1.7 | 2.0 | 2.3 | 2.5 | 2.2 | |
| GDP deflator in US dollars (change in percent) | -4.2 | 6.0 | 25.8 | -14.1 | 1.5 | 2.5 | 8.5 | 23.4 | 17.0 | 25.5 | 9.2 | 13.5 | 9.4 | 14.5 | 7.0 | 6.3 | 6.2 | 5.8 | 7.9 |
| Nominal external interest rate (in percent) | 4.9 | 5.3 | 5.3 | 4.7 | 5.1 | 4.6 | 3.7 | 3.7 | 3.3 | 3.2 | 4.4 | 0.8 | 2.8 | 2.5 | 2.3 | 2.0 | 2.1 | 3.2 | 2.4 |
| Growth of exports (US dollar terms, in percent) | 2.3 | 4.6 | -1.5 | 18.7 | 23.3 | 10.5 | 20.2 | 27.9 | 32.7 | 19.1 | 15.8 | 11.4 | 8.4 | 7.8 | 7.9 | 8.3 | 7.5 | 8.6 | 8.0 |
| Growth of imports (US dollar terms, in percent) | 11.3 | -1.4 | 5.0 | 5.5 | 22.3 | 17.0 | 13.4 | 33.7 | 37.1 | 24.9 | 16.9 | 12.6 | 10.2 | 10.1 | 11.0 | 10.0 | 9.5 | 9.9 | 10.1 |
| Current account balance, excluding interest payments | -6.4 | -4.8 | -5.8 | -2.8 | -2.5 | -4.3 | -2.3 | -4.9 | -7.6 | -7.8 | -4.9 | 2.0 | -7.7 | -7.6 | -7.5 | -7.5 | -7.3 | -6.8 | -7.3 |
| Net non-debt creating capital inflows | 0.8 | 3.5 | 4.9 | 2.9 | 3.6 | 3.6 | 3.2 | 3.8 | 8.7 | 6.6 | 4.2 | 2.2 | 7.7 | 5.0 | 4.7 | 4.5 | 4.3 | 4.3 | 4.5 |
| | | | | | | | | | | | | | II. Stress Tests for External Debt Ratio | | | | | | Debt-stabilizing non-interest current account 5/ |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2006-11 4/ | | | | | | | | | | | | | **32.4** | **35.1** | **34.8** | **34.6** | **33.7** | **33.6** | **-6.3** |
| **B. Bound Tests** | | | | | | | | | | | | | | | | | | | |
| B1. Nominal interest rate is at baseline plus one standard deviation | | | | | | | | | | | | | **32.6** | **31.7** | **32.8** | **34.1** | **35.0** | **36.4** | **-6.8** |
| B2. Real GDP growth is at baseline minus one-half standard deviations | | | | | | | | | | | | | **33.0** | **32.4** | **33.5** | **35.0** | **35.7** | **37.2** | **-7.0** |
| B3. Non-interest current account is at baseline minus one-half standard deviations | | | | | | | | | | | | | **33.4** | **33.2** | **34.9** | **36.8** | **38.2** | **40.1** | **-7.3** |
| B4. One time 30 percent real depreciation in 2006 | | | | | | | | | | | | | **46.4** | **41.6** | **39.9** | **38.9** | **37.5** | **37.1** | **-9.0** |

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

Table 13. Public Sector Debt Sustainability Framework, 1996-2011
(In percent of GDP, unless otherwise indicated)

| | Actual | | | | | | | | | | | | Projections | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | 1996 | 1997 | 1998 | 1999 | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | | | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | |
| | | | | | | | | | | | | | I. Baseline Projections | | | | | | Debt-stabilizing primary balance 9/ |
| 1 **Public sector debt 1/** | 41.8 | 26.1 | 25.7 | 28.2 | 27.8 | 27.5 | 25.9 | 23.5 | 22.4 | 18.9 | | | **16.7** | **15.3** | **15.1** | **15.0** | **14.7** | **14.4** | **-0.7** |
| o/w foreign-currency denominated | 18.8 | 18.1 | 17.8 | 16.2 | 20.2 | 21.8 | 19.9 | 16.1 | 14.2 | 11.7 | | | 10.8 | 10.2 | 10.6 | 10.7 | 10.7 | 9.8 | |
| 2 Change in public sector debt | -4.9 | -15.6 | -0.4 | 2.5 | -0.4 | -0.4 | -1.6 | -2.4 | -1.2 | -3.5 | | | -2.2 | -1.4 | -0.1 | -0.2 | -0.2 | -0.3 | |
| 3 Identified debt-creating flows (4+7+12) | -6.5 | -7.5 | -1.2 | 3.6 | -1.0 | -1.2 | -1.7 | -4.0 | -4.1 | -4.2 | | | -6.1 | -3.7 | -2.0 | -1.8 | -1.7 | -1.7 | |
| 4 Primary deficit | 3.1 | 1.4 | 0.7 | -1.7 | -0.8 | -0.6 | -0.4 | 0.2 | -0.2 | -0.3 | | | -1.0 | -1.2 | -1.1 | -1.0 | -1.0 | -1.0 | |
| 5 Revenue and grants | 29.0 | 28.6 | 29.7 | 31.9 | 31.2 | 30.1 | 29.6 | 28.7 | 30.1 | 30.3 | | | 31.3 | 31.6 | 31.6 | 31.7 | 31.9 | 32.0 | |
| 6 Primary (noninterest) expenditure | 32.1 | 30.0 | 30.4 | 30.2 | 30.4 | 29.5 | 29.3 | 28.9 | 29.8 | 30.0 | | | 30.3 | 30.4 | 30.5 | 30.7 | 30.9 | 31.1 | |
| 7 Automatic debt dynamics 2/ | -9.3 | -8.5 | -0.7 | 6.5 | 0.7 | 0.1 | -0.9 | -3.9 | -3.6 | -3.5 | | | -1.5 | -1.6 | -0.7 | -0.8 | -0.7 | -0.7 | |
| 8 Contribution from interest rate/growth differential 3/ | -14.1 | -20.0 | -3.8 | -2.8 | -4.2 | -4.8 | -3.3 | -4.0 | -3.4 | -2.1 | | | -1.6 | -0.9 | -0.5 | -0.6 | -0.5 | -0.4 | |
| 9 Of which contribution from real interest rate | -12.8 | -21.1 | -4.6 | -3.0 | -3.8 | -3.7 | -2.2 | -3.0 | -1.8 | -1.3 | | | -0.7 | -0.1 | 0.3 | 0.2 | 0.3 | 0.3 | |
| 10 Of which contribution from real GDP growth | -1.2 | 1.1 | 0.9 | 0.2 | -0.4 | -1.1 | -1.1 | -1.0 | -1.6 | -0.8 | | | -0.9 | -0.8 | -0.8 | -0.8 | -0.8 | -0.8 | |
| 11 Contribution from exchange rate depreciation 4/ | 4.8 | 11.5 | 3.0 | 9.3 | 4.9 | 4.9 | 2.4 | 0.1 | -0.2 | -1.4 | | | 0.1 | -0.7 | -0.2 | -0.2 | -0.2 | -0.2 | |
| 12 Other identified debt-creating flows | -0.3 | -0.4 | -1.2 | -1.2 | -0.9 | -0.7 | -0.4 | -0.2 | -0.3 | -0.4 | | | -3.6 | -0.9 | -0.2 | -0.1 | 0.0 | 0.0 | |
| 13 Privatization receipts (negative) | -0.3 | -0.4 | -1.2 | -1.2 | -0.9 | -0.7 | -0.4 | -0.2 | -0.3 | -0.4 | | | -3.6 | -0.9 | -0.2 | -0.1 | 0.0 | 0.0 | |
| 14 Recognition of implicit or contingent liabilities | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 15 Other (specify, e.g. bank recapitalization) | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | | | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | |
| 16 Residual, including asset changes (2-3) | 1.6 | -8.2 | 0.8 | -1.1 | 0.6 | 0.8 | 0.1 | 1.6 | 2.9 | 0.7 | | | 3.9 | 2.3 | 1.9 | 1.7 | 1.5 | 1.4 | |
| Public sector debt-to-revenue ratio 1/ | 144.0 | 91.3 | 86.6 | 88.5 | 89.0 | 91.2 | 87.3 | 82.0 | 74.4 | 62.3 | | | 53.3 | 48.3 | 47.9 | 47.1 | 46.1 | 45.1 | |
| **Gross financing need 5/** | 12.4 | 11.0 | 10.2 | 10.1 | 7.4 | 8.1 | 7.4 | 6.9 | 5.3 | 4.1 | | | 4.1 | 3.8 | 4.0 | 3.3 | 3.6 | 3.1 | |
| in billions of U.S. dollars | 4.4 | 3.9 | 4.3 | 3.6 | 2.7 | 3.2 | 3.4 | 4.1 | 4.0 | 4.0 | | | 4.7 | 5.2 | 6.2 | 5.7 | 7.1 | 6.8 | |
| **Key Macroeconomic and Fiscal Assumptions** | | | | | | | | | | | 10-Year Historical Average | 10-Year Standard Deviation | | | | | | | Projected Average |
| Real GDP growth (in percent) | 3.9 | -6.1 | -4.8 | -1.2 | 2.1 | 5.7 | 5.1 | 5.2 | 8.4 | 4.1 | 2.3 | 4.8 | 5.2 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 | 5.6 |
| Average nominal interest rate on public debt (in percent) 6/ | 5.5 | 21.2 | 26.4 | 30.0 | 25.3 | 20.0 | 14.1 | 10.2 | 6.7 | 5.5 | 16.5 | 9.3 | 6.4 | 6.6 | 6.7 | 5.8 | 5.9 | 6.0 | 6.2 |
| Average real interest rate (nominal rate minus change in GDP deflator, in percent) | -39.8 | -125.9 | -28.9 | -17.7 | -18.9 | -17.4 | -9.3 | -13.7 | -8.2 | -6.5 | -28.6 | 35.6 | -3.8 | -0.4 | 2.4 | 1.9 | 2.3 | 2.7 | 1.8 |
| Nominal appreciation (increase in US dollar value of local currency, in percent) | -34.1 | -57.1 | -19.0 | -41.9 | -29.6 | -25.4 | -12.1 | -0.4 | 1.7 | 12.0 | -20.6 | 21.4 | -0.8 | 7.0 | 2.5 | 2.2 | 2.4 | 2.4 | 3.3 |
| Inflation rate (GDP deflator, in percent) | 45.3 | 147.2 | 55.3 | 47.7 | 44.2 | 37.4 | 23.4 | 24.0 | 15.0 | 12.0 | 45.1 | 38.7 | 10.2 | 7.0 | 4.3 | 4.0 | 3.6 | 3.3 | 4.4 |
| Growth of real primary spending (deflated by GDP deflator, in percent) | 0.0 | -12.1 | -3.6 | -1.9 | 2.9 | 2.7 | 4.2 | 3.8 | 12.1 | 4.7 | 1.3 | 6.3 | 6.1 | 6.3 | 5.9 | 6.3 | 6.4 | 6.1 | 6.2 |
| Primary deficit | 3.1 | 1.4 | 0.7 | -1.7 | -0.8 | -0.6 | -0.4 | 0.2 | -0.2 | -0.3 | 0.1 | 1.3 | -1.0 | -1.2 | -1.1 | -1.0 | -1.0 | -1.0 | -1.1 |
| | | | | | | | | | | | | | II. Stress Tests for Public Debt Ratio | | | | | | Debt-stabilizing primary balance 9/ |
| **A. Alternative Scenarios** | | | | | | | | | | | | | | | | | | | |
| A1. Key variables are at their historical averages in 2006-11 7/ | | | | | | | | | | | | | **18.4** | **18.8** | **20.5** | **22.1** | **23.6** | **25.1** | **-0.4** |
| **B. Bound Tests** | | | | | | | | | | | | | | | | | | | |
| B1. Real GDP growth is at baseline minus one-half standard deviation | | | | | | | | | | | | | **17.5** | **17.6** | **19.7** | **22.3** | **25.6** | **29.6** | **-0.8** |
| B2. Primary balance is at baseline minus one-half standard deviation | | | | | | | | | | | | | **17.3** | **16.5** | **17.0** | **17.4** | **17.7** | **18.0** | **-0.8** |
| B3. One time 30 percent real depreciation in 2006 8/ | | | | | | | | | | | | | **23.7** | **21.6** | **21.1** | **20.7** | **20.1** | **19.6** | **-0.9** |
| B4. 50 percent increase in nominal interest rate over the medium-term | | | | | | | | | | | | | **17.2** | **16.3** | **16.6** | **16.7** | **16.9** | **17.0** | **-0.3** |

1/ Gross central government debt.
2/ Derived as $[(r - \pi(1+g) - g + \alpha\varepsilon(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; $\pi$ = growth rate of GDP deflator; g = real GDP growth rate; $\alpha$ = share of foreign-currency denominated debt; and $\varepsilon$ = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).
3/ The real interest rate contribution is derived from the denominator in footnote 2/ as $r - \pi(1+g)$ and the real growth contribution as -g.
4/ The exchange rate contribution is derived from the numerator in footnote 2/ as $\alpha\ \varepsilon(1+r)$.
5/ Defined as public sector deficit, plus amortization of medium and long-term public sector debt, plus short-term debt at end of previous period.
6/ Derived as nominal interest expenditure divided by previous period debt stock.
7/ The key variables include real GDP growth and primary balance in percent of GDP.
8/ Real depreciation is defined as nominal depreciation (measured by percentage fall in dollar value of local currency) minus domestic inflation (based on GDP deflator).
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.

**Statement by the IMF Staff Representative**
**April 26, 2006**

1. This statement provides information on recent developments since the issuance of the staff report. The new information does not change the thrust of the staff appraisal and reinforces the staff's concerns about the current policy mix which places a heavy burden on monetary policy to achieve the authorities' macroeconomic objectives.

2. As indicated in the statement by Messrs. Kremers and Croitoru, the authorities confirmed during discussions with staff on the occasion of the Spring Meetings their intention not to resume discussions for the completion of reviews under the SBA prior to its expiration in July 2006.

3. **On account of mounting expenditure pressures, on April 19 the government approved a revised 2006 budget, increasing the deficit from 0.5 to 0.9 percent of GDP.** It is the staff's understanding that the approved budget includes additional allocations equivalent to 1 percent of GDP for infrastructure, teachers' wages, social benefits, flood repairs, and other expenditure. This additional expenditure will be partially financed by higher-than-originally-budgeted revenue (estimated by the authorities at 0.6 percent of GDP) associated mainly with strong indirect tax collections due to the continued consumption boom, but also initially-conservative revenue projections. The government also approved (already-budgeted) hikes in excises effective July 1, 2006 in line with Romania's commitments to the EU; and additional excises on tobacco and alcohol, effective immediately. The increase in the budget deficit confirms the staff's view (¶20 of the staff report) that the underlying budget deficit for 2006 is about 1 percent of GDP.

4. **The Senate recently approved legislation (opposed by the government) that could increase the general government deficit relative to that in the revised budget.** In early April, the Senate approved a cut in the VAT rate on food to 9 percent (from the current 19 percent), with an estimated revenue loss of ¾ percent of GDP. If approved by the House, this will lead to a weakening of government revenue and a higher budget deficit. The government has indicated that it will not support such legislation and the authorities have informed staff that, in the event that it passes, offsetting revenue-raising measures will be adopted.

5. **The envisaged fiscal loosening will accentuate external imbalances.** Recent data releases confirm that macroeconomic imbalances are widening: the consumption boom continues, and strong import growth outpaces export growth, thus pointing to a widening current account deficit. The narrowing of the current account deficit projected in the staff report (incorporating a change in the policy mix as recommended by Fund staff) was driven by an improvement in the savings-investment balance of the government, thus allowing for a substantial increase in private sector investment. Staff now projects a widening in the current account deficit to about 9 percent of GDP in part on account of the envisaged fiscal loosening. This policy will increase the burden on monetary policy.

6. **The monetary authorities have affirmed their readiness to tighten policy further depending on the evolution of inflationary pressures.** Following the increase in the policy interest rate in February, the authorities have stepped up open-market operations and have brought the effective sterilization rate in line with the policy rate—this stance has been maintained through April. The envisaged fiscal loosening and the inflationary consequences of higher excise rates on tobacco and alcohol have however created a more challenging environment for the National Bank.

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# IMF Executive Board Concludes 2006 Article IV Consultation with Romania

On April 26, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Romania.[1]

## Background

Romania has registered substantial accomplishments since 2000. Macroeconomic conditions improved owing to fiscal adjustment, the enhanced financial performance of state-owned enterprises, and privatization. The National Bank of Romania (NBR) achieved substantial disinflation while slowing the rate of depreciation of the exchange rate. This stabilization, and improved prospects for EU accession, have created a positive supply response.

Macroeconomic results were not as strong in 2005 compared with 2004 on account of both internal and external factors. Growth slowed to 4.1 percent in 2005, with agricultural output falling as a result of floods and industrial output growth slowing due in part to the abolition of global textile quotas. Domestic demand, on the other hand, grew strongly reflecting a sharp increase in private consumption—supported by significantly lower direct taxes, higher wages, and faster credit growth. The credit expansion has contributed to a widening in the current account deficit to 8.7 percent of GDP in 2005, and also led to inflationary pressures. As a result, and despite the significant appreciation of the leu, disinflation slowed considerably: CPI inflation was 8.4 percent year-on-year in March 2006.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

Fiscal consolidation continued last year: the general government deficit declined to 0.8 percent of GDP in 2005 from 1 percent of GDP in 2004. However, some procyclical fiscal policies exacerbated domestic demand. The introduction of the 16–percent flat tax on personal income and profits led to a loss in collections of about 1 percent of GDP. This loss was offset by higher-than-budgeted indirect tax collections due to strong demand for goods and services, thus keeping the revenue-to-GDP ratio broadly constant. On the expenditure side, there were large overruns in the wage bill as a result of substantial increases in public sector wages (16–34 percent compared with the 2004 average), and significant cuts in capital expenditure (compared to the budget). Moreover, the recalculation of pensions for those retired before 2001 also increased government spending. Finally, there was a significant relaxation of fiscal policy in December 2005, as the government cleared arrears, paid for flood-related repairs and other goods and services, and injected capital into Exim Bank.

Having brought inflation down into single digits, the NBR succeeded in maintaining inflation on its downward trend in 2005 even though it slightly missed its inflation target for 2005. In a major regime change, the NBR announced its shift to inflation targeting in August 2005. However, facing sustained upward pressure on the exchange rate, it reduced its sterilization efforts in September 2005—by not absorbing the full amount of excess liquidity in the banking system, and so driving its effective interest rate (the average rate at which it accepts bank deposits) significantly below its policy rate. The drop in the effective rate was largely successful in arresting short-term pressure on the exchange rate, but represented a significant procyclical easing of policy. Since November 2005, the NBR has not intervened in the foreign exchange market, and has taken steps to gradually increase the volume of sterilization. In February 2006, the NBR redoubled its disinflation efforts by increasing its policy rate from 7.5 to 8.5 percent, and by stepping up sterilization operations to bring the effective rate in line with the policy rate. This has generated renewed pressure on the currency, which appreciated by about 4¼ percent against the euro from end-2005 to end-March 2006.

Mixed progress has been made on structural reforms. Large-scale privatization has been successful (including Romania's largest bank (BCR)), the liberalization of the electricity and gas markets has continued, the national reference price for heating has increased, and significant progress has been made in the implementation of the mining strategy. However, gas prices have not been adjusted in line with opportunity costs, and the domestic producer price is only 38 percent of the international import price. The Labor Code has been revised with the objective of increasing labor market flexibility, although a number of important rigidities remain. Finally, judicial reform has progressed, including the recent establishment of the National Anticorruption Prosecutor's Office.

**Executive Board Assessment**

Executive Directors commended the Romanian authorities on their economic policy achievements since 2000, including continued fiscal consolidation, disinflation, enhanced financial performance of state-owned enterprises, and privatization. These accomplishments, which resulted in a substantial improvement in macroeconomic conditions, pave the way for eventual accession into the EU.

Directors stressed that Romania faces important issues. Although convergence towards the EU continues and confidence in the country's medium-term prospects remains high, slowing disinflation and a widening current account deficit pose challenges. Directors urged the authorities to adopt policies to address these developments, and to ensure an environment that supports the growth-enhancing use of large capital inflows. While external and public debt levels are low, and reserve coverage is comfortable, reducing the external imbalance will be crucial for removing Romania's external vulnerability.

Directors, while acknowledging that fiscal sustainability is not of immediate import, expressed concern about the government's recent decision to increase the 2006 deficit target. They emphasized that fiscal consolidation will be essential to containing domestic demand, making room for capital inflows, and ensuring sustainability over the medium term. Directors also noted that Romania needs a coherent plan for absorbing prospective large inflows to the public accounts from EU funds and for saving privatization proceeds, so as not to generate excess demand pressures. They looked forward to the finalization of a medium-term budgetary framework, and urged the authorities to put in place mechanisms to ensure the efficient allocation of resources and a high absorption rate for EU inflows.

Directors observed that Romania's government revenue ratio is considerably below levels in the EU. In light of this, they regretted the sizeable revenue loss resulting from the introduction of the flat tax. Directors also noted the need for additional resources to cover Romania's contribution to the EU budget, to co-finance EU projects, and to accommodate a boost in infrastructure spending. High social contribution taxes remain an impediment to employment, and cuts in labor taxation will have to be offset by other taxes. In this connection, Directors urged the authorities to take revenue-raising measures that will strengthen revenue permanently, broaden the tax base, modernize fiscal administration, and make room for the needed higher expenditures.

Directors stressed the importance of a prudent public sector wage policy for macroeconomic stability. They urged the authorities to recalibrate their policy to the needs of a low inflation economy. They welcomed the authorities' intentions in this regard, including to restrict wage increases to only once a year. The government's recent decision to freeze all vacant positions in the general government (with the exception of EU accession-related hiring) is commendable. Vigilance will be necessary to avoid wage overruns. Directors welcomed the authorities' prudent decisions regarding the minimum wage and the wage bill of public enterprises.

Directors urged the authorities to continue strengthening the central bank's inflation-targeting credentials. They noted the difficult environment in which it is operating, given pronounced capital inflows, non-supportive wage policies, and administered price increases. In this context, Directors welcomed the recent tightening of monetary policy, and viewed that further tightening might be necessary, in light of the envisaged fiscal loosening and higher excise rates. They noted that, while the exchange rate remains competitive, Romania's margin of competitiveness has eroded, and viewed that productivity gains and prudent wage policies will be needed to offset the impact of a strong currency. Moreover, interventions in the foreign exchange market should be fully

sterilized and focused on reducing excess volatility in the foreign exchange market, rather than on controlling the longer-term trend.
Directors noted that financial soundness indicators suggest a relatively healthy and robust financial system, and that stress tests indicate that the banking system would be resilient to the direct impact of interest rate and exchange rate movements. Nevertheless, with bank credit to the private sector escalating, much of it in foreign currency and to unhedged households, Directors stressed that medium-term vulnerabilities will need to be monitored closely. They welcomed the implementation of recommendations contained in the 2003 FSAP and commended the authorities for the recent step to regulate nonbank financial institutions.

Directors noted that further ambitious structural reforms are needed to accelerate convergence to EU living standards while improving the business environment. They welcomed the recent progress on privatization and encouraged the authorities to maintain the momentum of the privatization of the Savings Bank, Romgaz, and other smaller companies. Directors also welcomed recent amendments to the Labor Code aimed at increasing labor market flexibility, but recommended further amendments to eliminate the imposition of collective wage contracts for non-signatory parties and to increase employers' representation. They urged improvements in the legal framework with a view to reduce corruption, improve financial discipline, strengthen exit mechanisms for bankrupt enterprises, and enforce creditor rights. Directors encouraged adjusting energy prices in line with opportunity costs.

***Public Information Notices (PINs)*** form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Romania: Selected Economic and Financial Indicators, 2000-06

| | 2000 | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | |
|---|---|---|---|---|---|---|---|---|
| | | | | | | Prel. Estimates | Staff Proj. 1/ | |
| Real economy (change in percent) 2/ | | | | | | | | |
| Real GDP | 2.1 | 5.7 | 5.1 | 5.2 | 8.4 | 4.1 | 5.2 | |
| Final domestic demand | 2.1 | 7.0 | 5.5 | 8.3 | 11.7 | 9.4 | 6.8 | |
| CPI (end of period) | 40.7 | 30.3 | 17.8 | 14.1 | 9.3 | 8.6 | 6.5 | |
| CPI (period average) | 45.7 | 34.5 | 22.5 | 15.3 | 11.9 | 9.0 | 7.9 | |
| Unemployment rate (end of period; percent) | 10.5 | 8.6 | 8.4 | 7.2 | 6.2 | 5.8 | 5.7 | |
| Gross national saving (percent of GDP) | 15.8 | 17.0 | 18.3 | 16.0 | 13.9 | 14.0 | 15.7 | |
| Gross domestic investment (percent of GDP) | 19.5 | 22.6 | 21.7 | 21.8 | 22.3 | 22.7 | 24.2 | |
| Public finance (general government, percent of GDP) 3/ | | | | | | | | |
| Revenue | 31.2 | 30.1 | 29.6 | 28.7 | 30.1 | 30.3 | 31.3 | |
| Expenditure | 35.3 | 33.3 | 32.3 | 30.9 | 31.1 | 31.1 | 31.3 | |
| Overall balance | -4.0 | -3.2 | -2.6 | -2.2 | -1.0 | -0.8 | 0.0 | |
| Primary balance | 0.9 | 0.6 | 0.4 | -0.2 | 0.2 | 0.3 | 1.0 | |
| Total public debt 4/ | 27.8 | 27.5 | 25.9 | 24.4 | 23.1 | 18.9 | 16.7 | |
| Money and credit (end of year, percent change) | | | | | | | | |
| Real domestic credit 5/ | 7.9 | 28.0 | 32.3 | 56.9 | 40.4 | 44.7 | 33.8 | |
| Broad money | 38.0 | 46.2 | 38.2 | 23.3 | 40.1 | 33.8 | 24.3 | |
| Interest rates (percent) 6/ | | | | | | | | |
| NBR interest rate (end of period) | 60.1 | 39.9 | 21.5 | 23.4 | 18.8 | 7.2 | 8.5 | 7/ |
| Treasury bill rate (end of period) | 59.4 | 38.4 | 17.4 | 18.4 | 11.5 | 5.5 | - | |
| Balance of payments (percent of GDP) | | | | | | | | |
| Trade balance | -4.5 | -7.4 | -5.7 | -7.5 | -8.8 | -9.9 | -10.3 | |
| Current account balance | -3.7 | -5.5 | -3.3 | -5.8 | -8.5 | -8.7 | -8.5 | |
| External debt | 29.8 | 32.8 | 32.8 | 34.1 | 36.3 | 32.4 | 32.4 | |
| Official reserves (end-year, US$ million) | 3,466 | 5,168 | 6,260 | 7,143 | 14,873 | 22,866 | 28,643 | |
| Reserve cover (months of prospective imports, in € terms) | 2.3 | 3.5 | 3.6 | 2.8 | 4.1 | 5.6 | 6.6 | |
| Exchange rate | | | | | | | | |
| Lei per Euro (end of period) | 2.41 | 2.78 | 3.51 | 4.17 | 3.96 | 3.68 | 3.48 | 8/ |
| Lei per US$ (end of period) | 2.59 | 3.16 | 3.35 | 3.30 | 2.91 | 3.11 | 2.94 | 8/ |
| NEER appreciation (+) (percent) | -22.8 | -22.3 | -14.4 | -11.1 | -5.1 | 9.7 | … | |
| REER appreciation (+) (CPI-based, in percent) | 9.3 | 1.5 | 2.6 | 0.4 | 4.0 | 17.0 | … | |
| REER appreciation (+) (ULC-based, 3-moth moving average, in percent) | -0.3 | -0.9 | -6.5 | -5.5 | 5.0 | 23.4 | … | |

**Social indicators** (reference year):

**Per capita GDP** (2005): $4445; **income distribution** (GINI coefficient, 2000): 30.3;

**Poverty rate** (2002)**:** 18 percent; **primary education completion rate** (2002): 94 percent; **gender pay gap** (2003): 18 percent;

**Life expectancy at birth** (2003): 74.9; **infant mortality per 1000 live births** (2002) : 19.

Sources: Romanian authorities; and Fund staff estimates and projections.
1/ Incorporates a change in the policy mix, including a balanced budget, as recommended by Fund staff.
2/ National accounts data are based on ESA95 guidelines.
3/ Beginning 2004, fiscal data are based on a new classification and thus they are not comparable to series before 2004.
4/ Including domestic public debt and external public debt (public and publicly guaranteed).
5/ Credit to the nongovernment sector; weighted average of real lei credit growth and U.S. dollar-measured foreign currency credit growth.
6/ NBR effective policy interest rate (combined sterilization operations and use of deposit facility), compounded. Treasury bill rate for the last auction, as of September 22, 2005.
7/ The last observation is for February, 2006.
8/ In RON, actual as of February 28, 2006.

**Statement by Jeroen Kremers, Executive Director for Romania**
**and Lucian Croitoru, Senior Advisor to Executive Director**
**April 26, 2006**

*The broad picture*

**The Romanian authorities appreciate the staff report and acknowledge that the report provides a realistic view of the policy challenges**. They broadly agree with staff recommendations. While the authorities and staff reached agreement on the need to address imbalances, as discussed earlier this year, they have different views on the magnitude of needed adjustments. Confident that the envisaged policy mix is adequate to preserve macrostability and sustain strong growth, the authorities do not intend to resume discussions for completing reviews of the SBA prior to its expiration in July 2006. The authorities thank staff for the sound and professional advice and look forward to continued cooperation.

**Macroeconomic conditions continue to be strong, although they were somewhat altered by recent developments.** After peaking at 8.4 percent in 2004, growth slowed down to 4.1 percent in 2005 due to a decline in agriculture output induced by severe floods and a drop in external demand, which was partly responsible for the slowing down in industrial output. Large capital inflows continued despite the fact that the National Bank of Romania (NBR) reduced its policy interest rate from 21¼ percent in June 2004 to 7½ percent by end-2005. These inflows increased after the capital account was liberalized in April 2005, as part of the authorities' EU commitments. This resulted in a significant leu appreciation. Facing sustained upward pressure on the exchange rate, the NBR reduced its effective interest rate for sterilization to below the headline policy interest rate soon after shifting to inflation targeting in August 2005. This monetary relaxation, which was partly reversed later in the year, added to the lower taxes adopted in January 2005, higher wages, and faster credit growth, all of which led to a sharp increase in private consumption. With strong domestic demand and higher oil and administered prices, CPI disinflation continued at a slower pace, reaching 8.6 percent y/y in December 2005[1] and 8.4 percent y/y in March this year[2]. The current account deficit has been roughly stable at 8.5 percent of GDP in 2004 and 8.7 percent of GDP in 2005. In part this reflects booming consumption. It also reflects the pick-up in FDI and Romania's high rate of return to capital. EU grants and FDI covered 90 percent of the current account, reflecting increased confidence in Romania's prospects. Private capital inflows financed the rest and supported a reserve accumulation of almost $ 8 billion in 2005. Fiscal consolidation continued for the fifth year in a row, with the general government deficit kept to 0.8 percent of GDP—below the target of 1 percent of GDP and a deficit of 1 percent of GDP in 2004. The financial system is healthy and robust, well positioned to absorb adverse shocks.

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[1] Against the NBR's target of 7.5 percent ±1 percent band at end-2005 and an outcome of 9.3 percent in December 2004.

[2] Against the NBR's target of 5 percent ±1 percent band at end-2006.

**Progress has been made in implementing structural reforms.** Privatization in the banking sector has continued with the sale of the largest Romanian bank (BCR). The privatization and deregulation of the gas and electricity market has also continued, and significant progress has been made in the implementation of the mining sector strategy. Gas prices remained at 38 percent of the international import prices, a gap that has to be eliminated by the end of 2008, as recently agreed with the EU.

**Looking forward, the authorities are committed to preserving macroeconomic stability and renewing reform efforts as prerequisites for sustained strong growth.** To contain external imbalances and make noticeable progress with disinflation, the authorities will further tighten macroeconomic policies. In 2006, tight budget deficit and tight incomes policy will help monetary policy to fight inflation and reduce pressure for currency appreciation. The fiscal deficit for this year is envisaged at 0.9 percent of GDP, roughly the same as last year's outcome. This represents a small increase compared with this year's original budget (which incorporated a 0.5 percent deficit) so as to accommodate some extra room for investment in infrastructure, education, and flood defense. As to the latter, Romania is currently experiencing yet another severe flooding of the Danube with many villages, citizens and businesses strongly affected. The authorities acknowledge that while the recent sharp leu appreciation has narrowed external competitiveness, the exchange rate remains competitive, so that a moderate further appreciation would not cause a significant deterioration in the external balance and could be accommodated.

**The authorities are aware that achieving growth consistent with the goal of convergence to EU living standards requires increased investment and employment creation.** They are improving their project-implementation capacity to absorb all EU funds and will increase the share of capital spending in the public budget to boost infrastructure. In addition, they are committed to further improving the investment climate, including by bringing the institutional framework to greater harmony with EU standards, and continuing privatization and enterprise restructuring to support productivity gains.

***Fiscal policy***

**In the authorities' strategy to preserve macroeconomic stability, fiscal policy will continue to play a central role**. In view of Romania's low public debt, fiscal sustainability is not a concern. However, prudent fiscal policy and a tight incomes policy are needed to address excess demand pressure stemming from continued large capital inflows. The authorities assess that a 0.9 percent defict is appropriate also in view of the fact that the tax cut and wage hikes that fueled consumption last year would not be repeated this year.

**Strengthening revenue will be a key element of the fiscal strategy**. Room left for expenditure compression approaches its limit since recent compression of expenditure resulted in arrears. Last year the government cleared arrears to the health sector (virtually eliminating all arrears) and it is its policy to avoid further arrears accumulation. Moreover, additional revenue will be needed to compensate further cuts in the social contribution tax aimed at enhancing employment and growth to provide resources for fulfilling Romania's contributions to the EU budget and co-financing of EU projects, and to meet modern infrastructure needs.

**A comprehensive revision of the fiscal code is ongoing and a draft will be submitted for Parliament's approval in June this year.** Among the measures envisaged to raise revenue are increases in some taxes, including taxes on buildings, land, and transportation means, and also the adoption of new taxes on tobacco and alcohol. The authorities feel that improved tax collection can still be a significant source of revenue and plan improvements in tax administration in line with FAD and World Bank recommendations. The micro-enterprises taxation system will be changed (in line with EU requirements) as of January 2007 to bring these enterprises under the regular corporate income tax, a change that is expected to bring additional revenue of about 0.6 percent of GDP. Royalty increases are also envisaged for water, oil, salt, and sand.

**The authorities are preparing to face challenges associated with the expected sizeable privatization proceeds and EU transfers**. Pressure for higher spending can be strong since privatization inflows in 2006 are expected to be about 3 percent of GDP and post-accession EU receipts will exceed 2 percent of GDP in the first year of accession. To deal with this pressure, the government is now finishing a medium-term budgetary framework, which fully incorporates these funds and also post-accession expenditure. The authorities plan to continue placing revenue from privatization with the NBR, who invests it abroad. The authorities are also working on creating mechanisms to ensure the efficient allocation of resources and absorption of the EU inflows. Drawing on the assistance received from the World Bank, the authorities started working on improving the quality of public expenditure, with the objective of overhauling pay and employment practices, improving the quality of health services, and introducing a second pension pillar.

***Wage-policy***

**Wage policy is aimed at managing demand pressures and protecting the competitiveness of the Romanian economy.** For 2006, the authorities agreed on a prudent annual increase of 6.5 percent in the statutory minimum wage. Also, the increase in the wage bill of the SOEs that were monitored under the SBA will be limited to 3.5 percent. The authorities acknowledge that, given the recent wage increases in the public sector, strict control of the wage bill is required. To this end, the authorities decided to freeze all vacant positions in the general government, which is expected to offset wage overruns, and to monitor wage developments closely. They also look forward to canceling bonuses if necessary. To anchor inflation expectations, the authorities committed to one wage increase per year starting in 2007, thus terminating the habit of interim ad hoc increases seen in the past.

***Monetary policy***

**The NBR is strongly committed to inflation targeting, although last year's target was missed by a slight 0.1 percentage points in a difficult environment.** Confronted with strong capital inflows at the time of the adoption of the inflation targeting regime, the NBR had to intervene heavily in the foreign exchange market and cut interest rates to alleviate the abrupt appreciation of the leu. The successful arrest of short-term pressures on the exchange rate came at the cost of a temporary easing of policy, which was reflected in slightly missing the inflation target last year and may also make meeting the target this year more difficult.

**The authorities decided to maintain the inflation targets for 2006 and 2007, while acknowledging that the 2006 target might be difficult to reach and a strong action plan is needed to achieve the 4-percent target by the end of 2007.** A significant revision of the 2006 target would have been costly in terms of the NBR's credibility, at least from the perspective that pressure for wage increases would have been linked to the revision's magnitude. In addition to inflationary expectations generated by the 2005 slight miss and to delayed effects of past monetary easing, this year's inflation would reflect higher wages and planned increases in administered prices, the latter contributing 2½-3 percentage point to headline inflation.

**To bring the 2006 target closer within reach and to secure the landing of inflation at the center of the target range in 2007, the NBR further tightened monetary policy this year.** After resuming full sterilization at the policy interest rate in November 2005, the NBR increased the policy interest rate by 100 basis points to 8.5 percent in February this year to signal clearly the primacy of inflation over other considerations. Monetary tightening added pressures on the local currency, which has appreciated by about 5 percent against the euro since the beginning of the year. Further tightening of monetary policy might follow, depending on the evolution of inflationary pressures.

**Credit growth has moderated but the authorities are still cautious since the effectiveness of administrative measures is likely to diminish over time.** Prudential restrictions have been adopted in July-August 2005 with the aim to tame foreign-currency lending. In addition, the monetary easing over the course of 2005 has led to a narrowing gap between local and foreign-currency interest rates. These policy actions have resulted in a shifting composition of lending and a deceleration of overall lending. The annualized flow of foreign-currency credit, which reached a peak of 5 percent of GDP in August 2005, turned negative in December, while local-currency flows have almost doubled to 7 percent of GDP over the same period. The total annualized credit flow dropped from about 9 percent of GDP in August to roughly 5 percent of GDP in December 2005. However, with still strong demand for credit, incentives for borrowers and lenders to find alternative channels for funding exist. Being aware that prudential measures cannot be used in place of interest rates without undesirable or unintended consequences, the authorities, consistent in their commitment to the inflation target, will rely more on the interest rate for stabilization purposes. Building on the substantial progress made in strengthening the regulatory and supervisory framework, the NBR will continue the implementation of FSAP recommendations, including by upgrading its own risk-assessment capacity, especially in preparation for the introduction of Basel II.

***Structural policies***

**The program for structural reform remains ambitious**. Privatization in the banking sector will continue with the savings bank CEC (the last state-owned bank), for which final bids are expected in May. Like in the case of BCR, price will weigh most heavily in selecting investors. The authorities acknowledge that, in addition to the recent amendments to the Labor Code, further reforms are needed to make the market fully flexible, including the elimination of the obligatory nature of collective wage contracts for non-signatory parties. Rapid progress is being made in implementing judicial reform, which helps strengthening governance and improving the business climate. The National Anticorruption Prosecutor Office, which has been established recently, will be able to investigate and prosecute members of Parliament.