GOVERNMENT OF ROMANIA

CONVERGENCE PROGRAMME

2011-2014

April 29, 2011

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Acronyms

NBR – Romanian National Bank

ILO – International Labour Office

WB – World Bank

RD&I – Research, Development and Innovation

EC – European Commission

NFHEQ – National Framework for High Education Qualifications

NCP – National Commission of Prognosis

IFI – International Financial Institutions

IMF – International Monetary Fund

SME – Small and Medium-Sized Enterprises

MPF – Ministry of Public Finance

GDP - Gross Domestic Product

CP – Convergence Programme

NRP – National Reform Programme

ESA 95 – European System of Accounts, 1995

PEO – Public Employment Office

EU - European Union

INTRODUCTION

The current 2011-2014 Convergence Programme (CP) is an updated edition that was prepared in compliance with EC Regulation 1055/2005 amending EC Regulation 1466/1997 on strengthening of the surveillance and economic policy coordination. In line with European Commission's requirements, the fifth edition of the Convergence Programme observes the content and format methodology of Convergence and Stability Programmes (CSP) as adopted by the Ecofin Council on September 7, 2010.

In 2010, the European Council decided to strengthen the coordination of reform and fiscal - budgetary policies in the Member States, in order for the future EU economic policy decisions to be coherent and integrated. To this purpose, starting with the first half of 2011, the European Semester[1] was launched, a period during which the policies that a Member State wishes to implement as of the following year are subjected to the European fora[2] for review and specific recommendations to be taken into account when preparing the national budgets. The fact that the two documents – CP and NRP - are submitted simultaneously is something new compared to previous editions, but it is at the same time a challenge when it comes to ensuring that the two programmes are complementary and consistent. Practically, these two documents reflect the medium term and long term adjustments to achieve the national targets included in the Europe 2020 Strategy and the sustainability of public finances in the long run.

CP shows how the objectives built into the Government Programme will be put into practice between 2011-2014, as well as a vision with regard to long term sustainable development.

One of the challenges of the fiscal policy in this interval is how to reconcile the objective regarding the achievement of the nominal budgetary convergence criterion in a sustainable manner, with the measures needed to limit the effects of the global economic and financial crisis, on the Romanian economy. To this purpose, the budgetary objectives aim to smooth down the cyclical nature of the economy, reduce inflationary pressures and keep foreign deficits under control.

The current Convergence Programme confirms Romania's intention to bring down the structural deficit to less than 2% of GDP until 2014, ensuring a sufficient buffer to avoid budgetary deficit going over 3% of GDP.

Romania maintains its commitment of adopting the euro currency in 2015, which is an important anchor in promoting the budget and structural reforms in order to boost economic flexibility. To help preparations for adopting the euro currency, an **Inter-ministerial Committee** has been established under the Prime Minister's coordination, formed of NBR, MPF and other responsible entities.

[1] Starts with the Annual Growth Survey, an indicative guide at the disposal of the MS authorities
[2] European Commission, European Council, EU Council.

1. ECONOMIC POLICY FRAMEWORK

1.1 Economic Policy Background

In 2007, the world's economy was hit, by the deepest economic crisis after the 1930's Recession, affecting both developed and emerging countries Starting with Q4 2008, the crisis rapidly spilled over into Romania due to Romania's high level of economic integration within the EU, that facilitate the rapid spread of negative shocks into and within the country.

In the short run, re-launching the economy remains a priority for the government, alongside with job creation and securing the sustainability of public finance.

With a limited fiscal space due to previous years expansionary policy the Government acted promptly in 2009 and 2010 by launching a consistent package of anti-crisis measure that aimed at stabilizing the economy and resuming the process of economic growth.

This year, the Government of Romania successfully concluded the 24-month financial assistance programme with the EC, IMF, WB and other international financial institutions, amounting to 19.95 billion Euro. This programme has helped Romania adjust its foreign deficit, secure appropriate foreign financing and improve confidence in the outlook of the Romanian economy. Given the likelihood of unforeseen deterioration of the economic and/or financial situation due to factors potentially outside of the authorities' control, a new precautionary medium term financial assistance has been concluded with the EU and the IMF for 2012-2014,   aiming at ensuring stability and anchoring the medium-term reform programme,

1.2 Objectives and Priorities of the Government

In line with the Government Programme and considering the Europe 2020 Strategy, the Euro Plus Pact[3] and the precautionary financial assistance with EC and IMF, the medium-term strategy includes the following objectives:

I. Promote competitiveness:

1. Frame a lifelong learning strategy;
2. Setting up a plan to eliminate administered prices for electricity and natural gas in parallel with protection provided to vulnerable groups;
3. Strengthen the capacity and improve performance of RD&I by implementing a new institutional financing system;
4. Remove legal and administrative barriers to electricity and gas trade;
5. Prioritize public sector investments to achieve competitiveness objectives ;
6. Reduce public wage bill's share to GDP by one percentage point in 2012, compared to 2011,and gradual removal, by the end of 2012, of the nominal cuts of 25% enforced in 2010. Hence, the evolution of the unit labour cost will be below the labour productivity level;
7. Attract private investors by selling out stakes on the stock exchange market;
8. Develop European cooperation in the RD&I sector by promoting R&D strategic projects;

[3] In line with the Memorandum adopted in the government meeting of March 23, 2011 on approving Romania's participation to the Pact, during the European Council of March 24 and 25, this year Romania announced its participation to the Euro Plus Pact.

9. Prepare and submit to the European Commission a Plan on closing down non-viable mines currently operating under the National Company “Huila SA”, in line with the Council Decision 787/2010;
10. Encourage growth of private sector investments.

II. Promote employment

1. Implement a single pay framework in the public sector, through adoption of the Law 284/2010on the unitary pay system for public sector employees;
2. Promote flexicurity and employment, implement the new Labour Code;
3. Consolidate social dialogue and improve flexibility of negotiations;
4. Amend and supplement the legal framework for unemployment and employment;
5. Introduce the reform of the adult professional training legal framework;
6. Tailor education system on labour market needs;
7. Amend and supplement the Law *279/2005 concerning apprenticeship at the workplace;*
8. Implement the *2010-2012 National Strategy on reducing frequency of undeclared labour;*
9. Implement the law on casual work for journeymen;
10. Elaborate a simplified framework of mutual recognition of the European area diplomas;
11. Reform the social assistance system by introducing a new framework aimed at a better distribution of financial and human resources already in the system, including at the level of local decentralized administration structures.

III. Consolidate sustainability of public finance

1. Continue fiscal consolidation while targeting a 2011 budget deficit of 4.4 per cent of GDP in terms of actual payments (below 5 per cent in terms of commitments) and below 3 per cent of GDP in terms of commitments, in 2012;
2. Introduce numerical rules for the general government deficit, in line with the provisions of the Maastricht Treaty;
3. Implement the new Unitary Pension System Law 263/2010;
4. Speed up cutting down on general government arrears by restructuring the health sector and strengthening budget discipline at the local authorities’ level through the recently introduced amendments to the Local Public Finance Law 273/2006;
5. Implement the program of child care allowances;
6. Ensure predictability of the pre-university education system;
7. Finalize the legal framework in the social assistance sector.

IV. Consolidate financial stability

1. Continue to carefully monitor the foreign currency borrowing in the non-government sector;
2. Continue banking system consolidation and the reforms initiated by the introduction of the measures included in the financial assistance programme concluded with EU and IMF for the period 2009-2011;

3. Introduce measures relating to the unforeseen situations plan, in order to avoid the systemic risks in the banking sector;
4. Adopt the new prudential rules applicable to loan institutions – amend GEO 99/2006 on loan institutions and capital adequacy;
5. Modify the legislation regarding the insurance of companies' bankruptcy (Law 503/2004).

Romanian authorities' commitment is to fulfil the objectives set out in the Government Programme. **The agreements with the international financing institutions**, on one hand, provide the macroeconomic stability framework necessary for stimulating economic growth and, on the other hand, encourage structural reforms thus ensuring long term fiscal sustainability and public policies efficiency. At the same time, the macroeconomic recovery strategy is seen as having a three-fold purpose: reducing government debt and budget deficit (as share of GDP), increasing employment rates and reforming social protection sector. These policies are included in the most EU member states' economic recovery programs. In the medium term, the Government commitment is to focus on *continuing the European integration, paying a special attention to preparations for adopting the Euro currency.* The Maastricht criteria, a prerequisite for the Euro currency adoption have already imposed a very thorough framework for the forthcoming macroeconomic policies. This needs to be **supplemented by structural measures,** to ensure a good functioning and competitiveness of the Romanian economy after the adoption of the Euro currency.

In terms of fiscal policy, the Government's vision focus on an encouraging and non-biased environment and on measures aimed at consolidating its transparency, stability and predictability. Sustainable development of public finance is essential, taking into account the adverse demographic trends. The consolidation of both the taxable base and of the way taxes and contributions are organized continues to be a crucial factor when it comes to ensuring the resources necessary to economic development and the achievement of the Government's obligations and Romania's commitments as a Member State of the European Union.

With regard to the medium term specific objective, the starting point was the assumption that the structural deficit will be below 2% of GDP in 2014, allowing automatic stabilizers to work in a symmetrical way to keep the economic volatility under control. This level allows a sufficient buffer to avoid going over the 3 per cent threshold for the budget deficit in case of adverse shocks on the economic growth pace.

Euro Plus Pact

In the context of the objectives set out in the Pact and assumed by Romania, the objectives included in the Convergence Programme primarily refer to:

► Consolidation of public finance sustainability

Measures that have been implemented:

1) Implementation of the unitary pension system law 263/2010 introducing:
    - A gradual increase of the standard retirement ages to 65 for men and 63 for women until 2030, as well as the gradual increase of the full contribution period to 35 years for men and women until 2030;
    - More restrictive criteria for accessing partial early retirement by enforcing a penalty of 0.75% per month before the standard retirement age. Thus, the active professional life will be encouraged.

Measures to be implemented in the upcoming 12 months:

1) Introduce numerical rules for the general government deficit, in line with the provisions of the Maastricht Treaty;
2) Continue fiscal consolidation while targeting a 2011 budget deficit of 4.4 per cent of GDP in terms of actual payments (below 5 per cent in terms of commitments) and below 3 per cent of GDP in terms of commitments, in 2012;
3) Speed up cutting down on general government arrears by restructuring the health sector and strengthening budget discipline at the local authorities' level through the recently introduced amendments to the Local Public Finance Law 273/2006;
4) Implement the program of child care allowances;
5) Improve flexibility of the pre-university education system by:
    - Enforcement of the "money follows the student" principle;
    - Improving the per capita funding formula in the pre-university education system, in line with the Education Law 1/2011;
6) Finalize the legal framework on social assistance including social benefits and services.

► **Consolidate financial stability**

Measures that have been implemented:

Starting with 2004, Romania took measures to slowdown the pace of foreign currency borrowing; most instruments used to for this purpose are still in force, including after the adjustments made in conjunction with the EU accession: (i) higher differentiated mandatory reserve rates for the liabilities in foreign currencies (currently 20%) as compared to those in domestic currency (15%); (ii) loan-to-value ratio limits of maximum 75%; (iii) debt service to net monthly income ratios different for the consumption loans (30%) and mortgage loans (35%); the total amount of such loans was capped to 40% not only for the credit institutions but for the non-bank financial institutions as well (including leasing companies); (iv) limited aggregated exposures of credit institutions (in connection with own funds) against the debtors not covered for the currency risk; (v) more restrictive stress test coefficients for foreign currency loans (significantly higher coefficients for loans in USD or CHF); (vi) mandatory capital increase for credit institutions with a very high exposure to foreign currency loans and loan-to-value or loan-to-deposits ratio limits higher than the banking system average; (vii) moral persuasion.

Romania commits to continuously and carefully monitor the non-government loan sector and in addition to previous measures is considering the adoption of new measures to limit the risks caused by the debtors who are not covered for the currency risk, especially individual households.

Measures to be implemented in the upcoming 12 months:

1) Continue with the necessary steps towards the full implementation of IFRS by the banking sector starting with 2012, based on the below strategies aiming at a smooth transition to the new accounting standards and consolidation of actual capitalization and liquidity levels from before the implementation of the new accounting system:
    a) IFRS will be actually implemented after a transition period of 3 years (2009, 2010, 2011); in these three years, the credit institutions will have to prepare 2 sets of financial situations, one according to the European Directives (official) and the other one in compliance with IFRS;

b) In 2011, the reporting framework (accounting, prudential and statistic) will be adjusted to take into account the new accounting standards that are to be implemented; to this purpose, under the new preventive agreement, NBR will issue, by the end of June 2011, proposals of prudential filters aimed at maintaining the current prudential policy regarding the banks' solvency, provisions and reserves and helping the timely implementation of IFRS, that is, at the beginning of 2012.

2) Continue the consolidation of the banking system and in-depth reforms initiated by the measures stipulated in the financial assistance agreements concluded with EU and IMF for the interval 2009-2011:

   a) Amend the legislation to allow the use of the resources available in the Bank Deposit Guarantee Fund to finance (including through guarantees) the restructuring measures authorized by NBR regarding the transfer of deposits, including for assets and liabilities transfers, provided that this measure be less expensive than paying out damages;

   b) Setting up procedures to introduce the new responsibilities of the central bank and of the guarantee fund in the credit institutions restructuring, as well as ensure immediate access of the guarantee fund institution to government funds, whenever necessary;

   c) Revisit the pieces of legislation on liquidation of credit institutions in order to make them consistent, if necessary;

   d) Expand the range of instruments accepted as collateral in refinancing to include T-Bonds issued in domestic currency by the international financing institutions listed on the Bucharest Stock Exchange and T-Bills issued in Euro on the foreign markets;

   e) Introduce a prudential treatment of temporary participations (debt-to-equity swaps) resulted from loan restructuring, to avoid hurting the financial position of the banks; such prudential treatment should guarantee that: (i) credit institutions get involved in this kind of operations only after a prudential decision-making; (ii) the value of shares is fully deducted from the credit institutions' own funds in order to avoid any artificial improvement of the prudential indicators; and (iii) the revenues from releasing credit risk provisions, generated by these operations, will not be subject to taxation;

   f) Monitor foreign currency loans and take the necessary measures so that the cost of such loans can accurately reflect the currency risk exposure of the borrowers;

   g) The legal initiatives on the bankruptcy of natural persons or recovery of liabilities should not be adopted, as they may undermine the debtors' discipline.

3) Introduce measures relating to the unforeseen situations plan, in order to avoid the systemic risks in the banking sector, by:

   a) Developing a bank identification mechanism, for the systemically important banks that match the requirements of the public interest test in terms of financial stability;

   b) Update the set of corrective policies, by joining the future European standards approximation process aiming at the resolution of problem banks in the case of cross-border bank groups; to this purpose, the target is to introduce the principle allowing a regulated removal from the market of all non-viable institutions, regardless of their type or size, without resorting to public funds, in order to preserve financial stability;

   c) Develop a foreign communication framework in high risk situations that may affect financial stability, in a move to improve the capacity to prevent or mitigate panic among bank creditors.

1.3 Monetary and exchange rates policies

In compliance with its statute[4], the primary objective of the National Bank of Romania (NBR) is to ensure and maintain price stability. Starting August 2005, monetary policy has been implemented in the context of inflation targeting, against the background of a managed floating regime. This exchange rate regime is in line with using inflation targets as nominal policy anchors and allows monetary policy to provide a flexible response to unexpected shocks that may hit the economy.

Monetary policy will remain firmly oriented towards meeting the inflation targets set by the NBR together with the government and implicitly ensuring a long-lasting reduction in medium-term inflation rate to levels in line with the ECB's quantitative definition of price stability. In this respect, an underpinning is expected to be provided by the adoption of a flat multi-annual inflation target of 2.5 percent ±1 percentage point as from 2013. This decision was taken by the NBR Board at end-2010, along with that of maintaining the 2012 inflation target at the previous year's level, i.e. 3 percent ±1 percentage point.

The shift to a flat inflation target is not only a beneficial, but also an ambitious change to the inflation targeting framework, thus ending the stage of gradually declining annual inflation targets[5] set and announced over 2-year horizons, which was a typical feature of this strategy since its implementation.

The major reason behind the decision to preserve the 2012 inflation target at 3 percent ±1 percentage point was the imperative of attaining this objective given that, under the impact of multiple supply/cost side shocks occurring successively or concurrently since 2007 H2, the annual inflation rate has repeatedly overshot the end-of-year targets over the past few years. This approach reflected the NBR's concern for setting credible and feasible objectives whose achievement is essential for strengthening central bank credibility and thus enhancing the efficacy of anchoring inflation expectations.

Fulfilling the 2012 inflation target, which implies the consolidation of disinflation and the anchoring of inflation expectations at lower inflation levels, is essential also from the standpoint of ensuring a successful shift to the stage of adopting a flat multi-annual inflation target of 2.5 percent ±1 percentage point in 2013. This implies a longer-term monetary policy commitment to an objective consistent with the medium-term price stability definition in the Romanian economy; it is meant to ensure that the inflation rate be brought down to a level compliant with the inflation criterion in the Maastricht Treaty and the ultimate shift to the continuous long-term inflation target, in line with the ECB's quantitative definition of price stability. This process is expected to be supported by the recognised benefits of adopting a flat inflation target, primarily manifest through the strong nominal anchor that such a target provides for the inflation targeting strategy.

The flat inflation target of 2.5 percent ±1 percentage point is regarded as an optimum level of medium-term inflation rate in the Romanian economy starting with 2013 due to: (i) expectations of additional increases in tradables prices and particularly in non-tradables prices at a faster pace than that deemed optimal in full-fledged economies, mainly as a result of the anticipated resumption of economic convergence, including price level convergence, after exiting the deep economic contraction phase, (ii) the protracted action of some inflation-generating supply/cost side factors outside the central bank's sphere of influence (administered price adjustments, indirect tax harmonisation), (iii) the persistence of some asymmetric nominal rigidities and (iv) the relative price

[4] Law No. 312/2004.

[5] Annual inflation targets were lowered from 7.5 percent ±1 percentage point in 2005 to 3 percent ±1 percentage point in 2011. The annual inflation targets for 2010 and 2012 were left unchanged at 3.5 percent ±1 percentage point and 3 percent ±1 percentage point respectively.

changes accompanying the notable structural adjustments to be further implemented in the Romanian economy.

Keeping the inflation rate on a trajectory consistent with meeting the annual inflation targets and subsequently with the flat target continues to pose a challenge to monetary policy. In 2010, the main obstacle to fulfilling this objective was the inflation flare-up generated in July by the 5 percentage point hike in the standard VAT rate[6] (from 19 percent to 24 percent). This put an end to the tendency shown by the 12-month inflation rate to come back within the variation band of the target after the peak reached in July 2008[7], with a strongly negative impact on the evolution and short-term outlook for inflation, to which added subsequently other adverse supply-side shocks as well. Consequently, in spite of the aggregate demand shortage widening further amid the ongoing economic contraction, in H2 the annual inflation rate followed a trajectory significantly above the upper limit of the variation band around the central target, to reach 7.96 percent at end-2010.

Although the quarterly forecast drafted in July emphasised the high likelihood of the annual inflation rate to deviate significantly from the end-2010 target, the NBR Board decided not to resort to its upward revision. Behind this decision stood the temporary nature of the inflation rate deviation from the target stemming from an adverse supply-side shock outside the sphere of influence of monetary policy; in fact, this temporary deviation was confirmed by the updated forecast of medium-term macroeconomic developments, which outlined the prospects for the annual inflation rate to resume its convergence towards the medium-term central target, after the dissipation of the first-round effect of the VAT rate hike (2011 Q3). Another rationale of the NBR Board's decision was the need to prevent a disanchoring of inflation expectations in the longer run by maintaining the NBR's commitment to the inflation targets, including with a view to averting the second-round effects of the VAT rate increase from becoming manifest, as well as by reasserting the central bank's focusing on the medium-term target – whose fulfilment can be envisaged through monetary policy instruments, by taking into account the time needed in order for this policy to have an effective impact on the prices' growth rate.

In face of this challenge, the NBR reacted also by putting an end to the consecutive cuts in the monetary policy rate it had implemented during the first five months[8] of 2010 against the background of a clearer prospect for disinflation to consolidate amid further economic contraction and widening aggregate demand shortage. The central bank's response in June was aimed at ensuring a solid anchoring of inflation expectations and at countering the risk of side-effects of the VAT rate hike to become manifest, implicitly laying the groundwork for the inflation rate to resume its convergence towards the central target after the fading out of the direct impact of this shock.

Subsequently, the NBR continued to pursue a cautious monetary policy owing to the persistent risk of inflation expectations to worsen, given the new adverse supply-side shocks in H2, arising mainly from the pick-up in the prices of foodstuffs and fuels and the adjustment of some administered prices. Thus, in August 2010-February 2011, the NBR Board adopted other five successive decisions to keep the monetary policy rate at 6.25 percent and decided to maintain the minimum reserve

6 This measure was adopted by the authorities on 26 June 2010 and implemented on 1 July 2010. It was aimed at ensuring fiscal consolidation in line with the commitments undertaken by the arrangements concluded with the EU, the IMF and other international financial institutions.

7 In July 2008-June 2010, the annual inflation rate went down from 9.04 percent to 4.38 percent; during this period, its downward trend reversed markedly twice, as a result of the steep depreciation of the leu at end-2008 and the increase in excise duties on tobacco products at end-2009 and in early 2010.

8 In January-May 2010, the monetary policy rate was gradually cut – in four consecutive steps – by 1.75 percentage points, to 6.25 percent, thus extending the downward trend initiated in early 2009.

requirement ratios[9] on both leu- and foreign currency-denominated liabilities of credit institutions at the same levels.

Behind this decision stood also the risk of the leu exchange rate volatility to grow excessively entailed by the persistent uncertainties surrounding the implementation/efficacy of fiscal consolidation measures and structural reforms agreed upon with the IMF and the EU, as well as by the persistence of fluctuations in the global risk appetite reflecting mainly the evolution of fears relative to the sovereign debt crisis in the euro area. However, this risk lost much of its relevance towards the end of 2010, given the improvement in international market sentiment and the anticipation of fulfilling most of the structural and macroeconomic objectives for 2010, agreed upon with the EU and the IMF, developments that may lead to the drop in the risk premium attached to the domestic market investment. Against this background, as well as a result of the consolidation following the ample adjustment of the current account balance during 2009, the exchange rate of the leu remained in 2010 relatively stable, except for a few short-lived episodes when its volatility was higher.

In the medium run, the major challenge of monetary policy is the solid anchoring of inflation expectations by resuming and consolidating disinflation at the forecasted pace, concurrently with creating the conditions for a sustainable resumption of lending, and implicitly sustainable economic growth. However, from this standpoint, the monetary policy stance is strictly conditional upon the firm and consistent implementation of the programme of structural reforms and macroeconomic policies, as well as on the higher absorption of European funds, according to the commitments under the – ongoing and upcoming – arrangements signed with the EU, the IMF and other international financial institutions. The first component of the economic programme requires chiefly further sustained fiscal consolidation, primarily via continuing restructuring and maintaining the restrictiveness of public sector wages, as well as via deepening reforms in the key areas of this sector, such as the taxation system, health system, pension system, education, local public finances.

Given that the major objective of the monetary authority is an as solid as possible anchoring of inflation expectations, and that the risks to the reconsolidation of disinflation according to the projected trajectory continue to be significant, monetary policy will maintain its prudent stance in the coming period. Both in the short run and over a longer time horizon, the calibration of the pace and magnitude of the potential adjustments in the policy rate in the context of adequate broad monetary conditions will be correlated mainly with the intensity of disinflationary pressures generated by the negative output gap – that is expected to gradually close in the following years – and with the behaviour of medium-term inflationary expectations. The assessments underlying such decisions will take into account, on the one hand, the likelihood of major risks to inflation forecast materializing over the policy-relevant horizon[10] and, on the other hand, the developments and features of lending. In terms of the potential adjustment of monetary policy coordinates, a key precondition is the consistent continuation of fiscal consolidation and structural reforms – essential for minimising the risk of second-round effects of supply-side shocks to emerge and for improving investor perception on the Romanian economy prospects, which implies a long-lasting drop in the local market risk premium.

[9] The minimum reserve requirement ratios on both leu- and foreign currency-denominated liabilities of credit institutions were kept at 15 percent and 25 percent respectively.

[10] In the context of the most recent medium-term forecast, the major risks include potential first- and second-round effects of possible additional supply-side shocks (faster rise in commodity prices on the world market, particularly prices of foodstuffs and energy and the higher-than-expected adjustment in administered prices).

The commitment to adopting the euro in 2015 is maintained and is seen as a major anchor to promote the adjustments needed for increasing the resilience and flexibility of the Romanian economy.

In order to prepare the changeover to the euro, an Inter-Ministry Committee was set up. It is coordinated by the Prime Minister and encompasses the National Bank of Romania, the Ministry of Public Finance and other relevant institutions.

In February 2010, a Committee for the Changeover to the Euro was established within the National Bank of Romania. Its objective is to provide the technical, organisational and legislative support to the central bank in order to fulfil its tasks relative to the introduction of the euro. Starting with October, the representatives of the Ministry of Public Finance enjoy permanent observer status within the Committee. From among the activities performed by this body, worth mentioning are the following: to draft bills on euro adoption, to review the institutional structure in place in other Central and East European countries in preparing the euro adoption, to assess Romania's compliance with nominal and real convergence criteria, etc.

1.4. Structural Reforms

In its National Reform Programme, targets similar to those assumed at European level, adjusted to the Romanian labour market were established. The scope is to ensure macroeconomic stability and public finance sustainability, increase competitiveness and economic productivity and improve labour market operation.

To this purpose, the Government will take the following actions:

- ✓ **Implementation of the unitary pay system in the public sector** according to which all categories in the public sector will be paid in compliance with their salary rights established in special acts; the wage and salary rights will be established only through judicial norms having the power of laws; the same compensations will be provided for the same amount of work and the fiscal sustainability will be improved;
- ✓ **Pension System Reform implementation** aiming at a gradual increase of the retirement age for women and certain categories with a special status, gradual adoption of an inflation-index-based system, integration to the unitary public pension system of individuals concerned by special laws or special retirement provisions, and increase of the taxable base to include new categories of taxpayers (liberal professions, managers, family associations);
- ✓ **Implementation of the Fiscal - Budgetary Responsibility Law** introducing improved procedures for preparing annual budgets, restrictions as to budget revisions during the year and more strict fiscal rules with regard to total expenditures, staff expenditures and the budget deficit, as well as the Fiscal Council responsible for conducting independent reviews of the macroeconomic and budget forecasts, implementation of cost standards in the expenditures of local authorities;
- ✓ Develop the continuous professional training system and increase participation to training programmes;
- ✓ Introduce a set of measures to encourage the job creation and reduce unemployment primarily among young persons;
- ✓ Reform social assistance programs on family allowance, heating allowance, and guaranteed minimum income, in a move to improve efficiency and cut down on costs;
- ✓ Cut recruiting red tape by setting up one-stop-shop offices at local and county levels, that will be based on a single recruitment procedure to speed up recruiting;
- ✓ Improve the quality of management, decision-making and horizontal coordination of public policies;

- ✓ Encourage companies to develop the capacity to create, add, capture and retain the value in the domestic production chain, based on processes, products and services;
- ✓ Continue to implement the reforms adopted in 2010 by ANAF (fight against tax evasion, support to the business environment, improved revenue management) alongside other reforms such as implementation of simplified and modern procedures to access public online services.

Implementation of 2011 ANAF measures:

1. The fight against tax evasion

- Improve methods to fight intra-Community frauds (especially for VAT – the "carousel" fraud) and multi-national frauds as well;
- Strengthen control of large taxpayers;
- Implement e-commerce and verification of very wealthy individuals.

2. Simplify and modern procedures

- Develop the methodology for assessing default taxes, duties and contributions;
- Simplify the online filing procedure for individuals.

3. Support to the business environment

- Re-introduce rescheduling in paying arrears;
- Introduce legal, administrative and operational measures to simplify customs clearance formalities.

4. Improved revenue administration

- Simplify the way of paying fiscal obligations by introducing e-payment and electronic payment for legal persons as well;
- Implement an electronic environment for auctioning goods seized from debtors;
- IT-supported management of enforcement;
- Electronic transmission of letters on imposing/removing attachment of debtors' bank accounts.

The medium term objectives (2012-2013) include:

- ✓ Encourage electronic filing and payment;
- ✓ Improve arrear management; reduce arrears;
- ✓ Fight cross-border fraud;
- ✓ Improve ANAF organization in a move to boost efficiency: continuously reduce the cost of collection;
- ✓ Increase the extent of IT-supported ANAF operations;
- ✓ Introduce the unified receivable management system for individuals and businesses;
- ✓ Implement the fiscal help-desk function.

2. ECONOMIC OUTLOOK

2.1 The Global Economy / Assumptions

The economic perspectives on which the evolution scenario of the Romanian economy is based, are correlated with the foreign assumptions within 2010 Autumn Forecast and February 2011 Interim Forecast of the European Commission, with the IMF assumptions published in the *World Economic Outlook Update,* in January 2011, as well as the most recent developments.

The world economy invigorated in the last quarter of 2010, with the baseline indicators showing an increase in the economic recovery pace. The global economy left the critical point of the crisis behind with 2010 seeing an increase in the demand in many advanced economies, but also in some emerging and developing economies. Hence, the world GDP went up by 4.5%, the EU27 GDP and the Eurozone GDP went up by 1.8% and 1.7 %, respectively. In 2011, the economic outlook of the European Union seems more encouraging than it looked in the autumn forecast. The more favorable foreign environment will encourage exports in the EU, mainly in the export-driven economic sectors. In addition to exports, expected to continue to support the economic recovery, a more balanced domestic demand is expected. The 2011 economic outlook was revised upwards in the EC Interim Forecast at both international and EU levels, due to the support of more favorable international developments and by the confidence with regard to a sustainable recovery of the European economies.

Table 2.1 Baseline Assumptions

	2010	2011	2012	2013	2014
Short Term Interest Rate (annual average)	6.8	--	--	--	--
Long Term Interest Rate (annual average)	7.4	--	--	--	--
Exchange rate USD/EUR (annual average)	1.33	1.36*	1.36	1.36	1.36
Annual change of nominal effective exchange rate	-1.5	-1.9	0.0	--	--
Exchange rate Lei/EUR (annual average)	4.21	4.18	4.18	4.16	4.13
World GDP growth (EU not-included)	5.8	4.8*	5.0	5.1	5.2
EU GDP growth	1.8	1.8*	2.0	2.0	2.0
Foreign market growth	19.2	9.0	10.1	10.3	10.4
Volume of world imports	14.0	7.5	7.3	--	--
Crude Oil Price (Brent USD/barrel)	79.9	101.6*	104.5	--	--

** EC Interim Forecast*

The EU27 GDP and the Eurozone GDP will increase by 1.8% and 1.6%, respectively, by 0.1 pp more than in the autumn 2010, but the recovery pace varies among MS with the imbalance adjustment pressures. Domestic demand will continue to grow in Germany, an important Romanian trade partner. .

The global economies will continue to grow unequally, with a growth gap between the more advanced economies and the emerging economies, which will benefit the latter.

A forward-looking scenario not only takes into account a GDP growth at both, the global as well as the EU 27 level, but also an increase in global imports and an expansion of Romanian exports.

The risk of seeing the price of crude oil escalate in in 2011 is real, with the EC Interim Forecast assuming an increase of the brent oil price by 12.7 $/barrel compared to the autumn forecast, thus going up to 101.6 $/barrel. Considering the political turmoil in the Middle East and North Africa, many relevant institutions, including the *US Energy Information Administration*, revised upward the oil price increase forecast expected in 2012 upward. The technical assumptions regarding the USD/EUR Fx rate are in line with the European Commission, i.e. 1.36 USD/EUR.

In the first half of the 2011-2014 period of time, concerns about the increasing inflation still remain due to both the pressures on the farming products market and the energy products market, as well as surpluses of capital inflows that could overheat the emergent markets. In the EU, the basic inflation is expected to go up slightly, against the background of economic activity recovery and a high inflation imported from emergent economies.

2.2 Cyclical Developments and Current Outlook

Current Outlook

The effects of the global economic and financial crisis were severe in 2009, when GPD has decreased by 7.1% in terms of a significant adjustment of the current account deficit (4.2% of GDP from 11.6% in 2008) and of an increasing budget deficit.

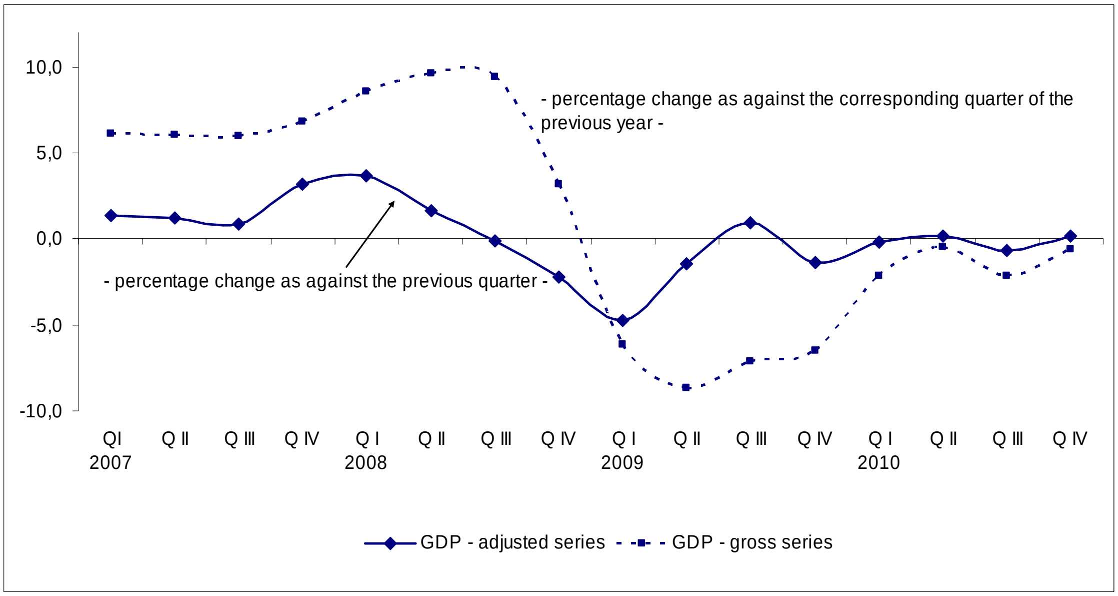
Domestic demand kept its downward trend and the economic decline continued in 2010 with the gross domestic product going down by 1.3%, meaning a better evolution than anticipated in the autumn forecast. A positive aspect was the simultaneous adjustment of the budget deficit from 8.5% of GDP in 2009 to 6.4% (under ESA 95) and the preservation of a sustainable current account deficit, i.e 4.1% of GDP. 2010 may be seen as the recovery year in industry, as the industrial output went up by 5.5%, fully recovered from the reduction of 2009, in parallel with a better adjusted structure to the requirements of foreign and domestic market; it was also the year with the highest exports of goods exceeding even the pre-crisis levels.

The domestic demand components decreased compared to 2009, especially the gross fixed capital formation that has been impaired by the scarce financing sources and the lack of confidence of the private sector in the economic evolution. Most of the demand was covered by imported goods and services, which went up by 11.6%, whereas exports of goods and services increased by 13.1%.

The domestic demand was supported by the gross value added in industry, which increased by 5.1%. The other sectors decreased, with the most significant decline of 10.7% in the construction sector.

If we look at the quarterly gross domestic product and compare it to the previous quarter, the dynamic changes between -0.7% and +0.2%, showing a certain stability of the economy that could resume continuous growth if circumstances remain favorable.

Graphic 2.1 Quarterly GDP



Source: National Institute of Statistics

The 2011 macroeconomic framework assumed an economic and financial improvement and the resumption of the sustainable economic growth, making an increase of 1.5 per cent of the gross domestic product for the whole year possible.

Domestic demand will be the driver of economic growth, with the gross fixed capital formation increasing more than the final consumption. After the significant contractions in 2009 and 2010, the gross fixed capital formation is expected to go up by 3.4%. The public investment expenditures will play an important role within the budgetary policies, with efforts concentrated on reducing the budget deficit.

After the severe contraction of the previous years and with an increase in the disposable income, private consumption will start growing again, by 1.9%. Government consumption expenditures will keep on going down, under continuous budgetary restrictions.

Exports of goods and services will continue to be a driver in the economy, as they are expected to grow up by 8.1% in real terms. Imports of goods and services will increase by 7.1%.

On the domestic supply side, 2011 is expected to bring an increase, mainly in the industrial sectors with the largest exports. In general, the gross value added is expected to increase in all activity sectors. Keeping the growing trend started in 2010, the industry will go up by 2.7% and will be the main pillar of the GDP growth. The construction sector will go up by a slight 1.6 per cent, after the severe decline in 2009 and 2010. The gross value added in agriculture will be higher by 1% compared to 2010, mainly as a consequence of the previous strong enough years' basic effect. Likewise, services are expected to have a positive contribution to GDP growth, although their contribution will be modest, due to an expected increase of the gross value added in this sector of 0.9%.

2010 was characterized by a very good evolution of the Romanian foreign trade. The achievements are even bigger than before the crisis, with the exports largely contributing to easing the economic decline. In 2010 goods were exported in amount of 37.3 billion euros, compared to 29 billion in 2009 and 33.7 billion euros in 2008.

Significantly, the 2010 increase in exports was accompanied by a lower increase of imports of goods, of 20.1% compared to 28.2% in exports. It results a trade deficit of only 9.5 billion euros, by 361 million euros lower as compared to 2009 and by more than 14 billion euros below 2008.

The increasing pace of exports throughout the year allowed for the full recovery of the exports decrease by 4.6 billion euros, in 2009. Moreover, the amount of 2010 exports was by 10.6% (i.e. 3.6 billion euros) higher, as compared to 2008. Under these circumstances, exports continue to be a supporting factor of the Romanian economy. In 2010, monthly exports were by around 300 million euros higher than in 2008, with a monthly average of 3.1 billion euros compared to 2.8 billion euros in 2008.

The data show an improvement of Romanian's position in comparison with other MS a fact that has been appreciated by international bodies. While ranking 22nd in terms of trade deficit in absolute terms in 2008, Romania climbed to position 20 in 2010. In equivalent terms, considering the commercial deficit per inhabitant, Romania is ranking the 14th among the 27 EU Member States.

In the first two months of 2011, exports increased by 41.9% compared to the same period of 2010, the monthly average of 3459 million euros being one of the highest monthly exports of the recent years. Imports went up by 25.0%, therefore the FOB-FOB trade deficit was only 5 million euros.

The pace of exports is expected to slow down in 2011 since the pace of economic growth itself will be slower in a number of beneficiary countries of Romanian exports, as Germany. Hence, the forecast scenario estimates an increase in exported goods of 15.1% and one of 11.8% in imported goods .Under these circumstances, the GDP share of the FOB-FOB trade deficit will decrease by 0.7 percentage points compared to the year 2010, and reach 4.1%.

Intra-Community and extra-Community exports of goods will increase by 14.6% and 16.2% respectively, with the intra-Community and extra-Community imports picking up by 11.2% and 13.3%, respectively.

The annual inflation rate reached 7.96% in December 2010, by 3.22 percentage points over the end-2009 level. After a relative stability of the annual inflation rate in the first six months of 2010, starting with July 2010 there was an increase due to the raise in the standard VAT rate by 5 percentage points from 19% to 24%.

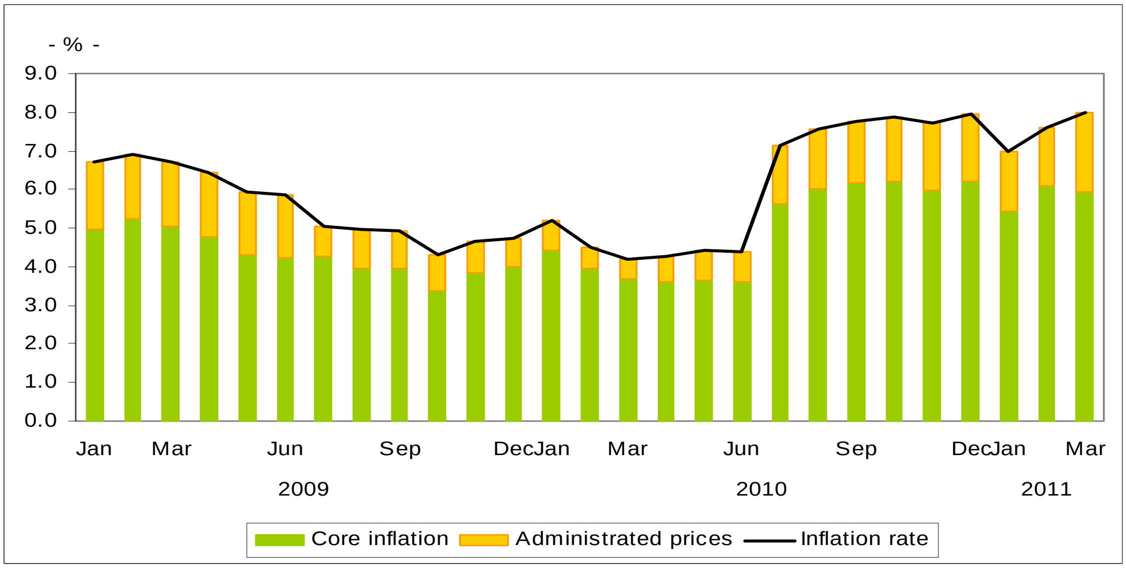
In term of annual average, the 2010 inflation exceeded the 2009 average by 0.5 percentage points, reaching 6.09%.

With regard to food prices, these were by 1.51 percentage points under the annual inflation rate; however, during the second half of the year, food prices went up as a result of lack of domestic farming products supply.

As for the non-food prices, their increase at the end of the year (9.76%) was by 1.8 percentage points over the consumer price index.

The 6.43% increase in service tariffs was lower by 1.53 percentage points than the annual inflation rate.

Graphic 2.2 Contribution Of Regulated Prices To Annual Inflation



Source: National Commission for Prognosis computations based on the data published by the National Institute for Statistics

The core inflation[11] increased by 7.77% in December compared to end-2009. The administrated prices of goods increased more than general consumer prices. Of the administrated prices, the water, sewerage and salubrity prices increased most significantly (15.85%), followed by railway transport (13.97%), thermal power (11.94%) and electricity (8.58%).

In addition to the effect of the increased VAT rate the higher inflation rate in the second half of the year, was generated by the depreciation of the European currency compared to the first half of the year. This triggered a higher price increase for the imported goods and the domestic products and goods linked to the European currency, since the two influencing factors worked together. However, the decreased consumption in the fourth quarter temperate the mid-year inflationist trends.

In March 2011, compared to December 2010, the consumer prices went up by 2.16% due to a 4.12 per cent increase in the food prices.

The annual inflation in March 2011 went up to 8.01%, thus showing a slight increase of 0.05 percentage points compared to December 2010.

In 2011, disinflation is expected to pick up, with the year-end inflation rate estimated to go down by more than 3 percentage points, to reach 4.8%, while the annual average will go slightly over the 2010 figure to reach 6.5%.

The factors that put pressure on the supply in 2010 will stop, allowing a consistent inflation rate decrease at year-end; these factors include the ended effect of the VAT rate hike in July 2010, the end of the excise increases for most excisable goods, the decrease of the lei/euro exchange rate used in calculating excise duties down to a level that is by 0.08% below the previous year number.

The aggregated demand is also expected to have a favorable impact on inflation throughout 2011, although it is estimated to be less important compared to the previous year.

11 Computed as the difference between CPI and administrated prices.

Farming products are expected to have a negative influence on the disinflation process, as the tensions on these markets will carry on in the first half of 2011. During this interval an attenuation of the disinflation is expected due to developments of the oil prices on the foreign markets, but this is expected to smooth out towards the end of the year.

As well, import prices are expected to put some pressure on inflation, with a more important negative contribution once the upward revision of inflation takes place (+0.4 percentage points) as estimated by the European Commission in its interim forecast.

In 2010, the annual inflation has not been under any pressure by the annual average fx rate. Therefore, the domestic currency went up by 0.65% in nominal terms in 2010, compared to the 2009 average, with an actual appreciation of 6.8%.

The exchange rate is not expected to be highly volatile in 2011, and it may appreciate to reach an annual average under the 2010 level, i.e. 4.18 lei/euro.

The GDP deflator in 2010 was below the average CPI (4.5% compared to 6.1%), with the deflator of the gross fixed capital formation at 2.9% and in a negative zone for the government consumption expenditures (-3.8%). The gap between these two indicators is expected to remain in 2011, as the price index will be increasing for most GDP components, still with a lower increase for imports.

Employment, as defined in the national accounts[12], decreased in 2010 by 1.8% compared to 2009, with the number of employees up by 0.9%, and the number of self-employed down by 8.6%. The number of employees increased in the constructions and other services sectors, but it went down in agriculture and industry. In 2011 the economic growth is expected to pick up and allow creation of new jobs. Hence, the employment is expected to go up by 0.4% and the number of employees by 0.6%.

The AMIGO unemployment rate increased from 6.9% in 2009 to 7.3% in 2010 and it is estimated to go down till 6.4 per cent in 2011, when economic activities will be resumed in most sectors.

Cyclical developments

Considering the mechanism presented by the Commission in DGECFIN's *"The impact of the economic and financial crisis on potential growth[13]"* one can draw the conclusion that the effects of the economic and financial crisis on the potential GDP growth depend on the specific situations of each Member State.

In terms of budget situation, labor market and the composition of GDP on the supply side, there is a compounded effect of the crisis on Romanian GDP that can be seen in the level (in 2009), and in the medium-term growth rates. For the comparison of potential GDP before and after the crisis, the potential GDP values estimated by the National Commission for Prognosis's 2007 autumn forecast were used.

Methodologically, we need to mention that the National Commission for Prognosis estimates the potential employment by using the population at working age and its employment rate (the trend of which is calculated using the Hodrick-Prescott filter), as well as the unemployment rate trend calculated by using the above-mentioned filter.

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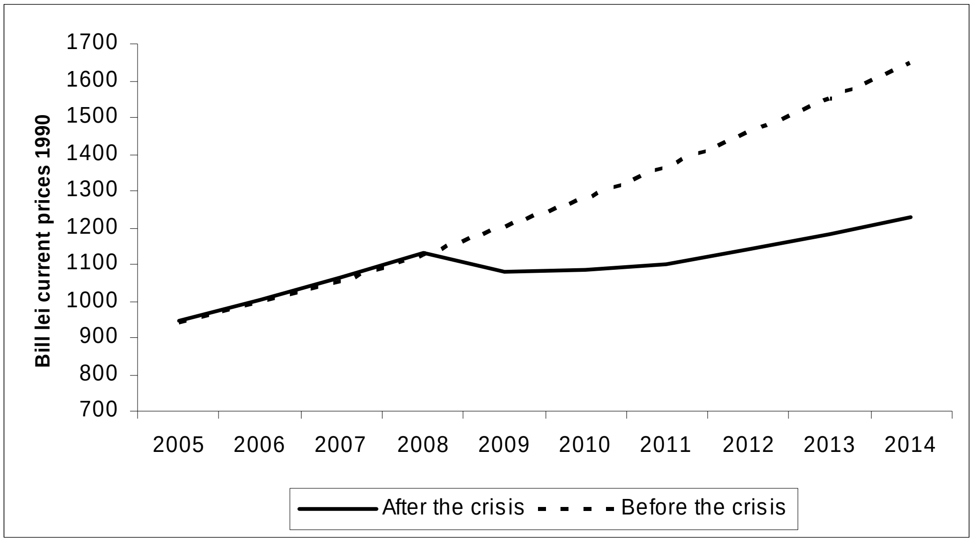
12 Persons (employees and self-employed) who perform any type of production activity according to the European System of Accounts (ESA), both residents and non-residents working for resident firms.

13 Quarterly Report on the Euro Area, Volume 8, No 2 (2009)

Graphic 2.3 – Potential GDP - Levels



Source: NCP

The decrease of potential GDP by 4.7% in 2009 was a consequence of the following factors:

- A negative contribution (-1.2 percentage points) of the labor factor, due to an increase of the natural unemployment rate to 8.3%; this was the result on one hand of the actual unemployment rate increase, and on the other hand of the significant decline primarily in intensive labor sector (constructions and services) in 2009;
- A negative contribution of total factor productivity (-5.0 percentage points), caused by the decrease of investments in the domestic economy and the cut in the private sector's R&D expenditures or the availability of bank financing; these factors were identified by the European Commission in the above-mentioned paper, as well;
- A positive contribution of the capital stock of 1.5 percentage points. The amplitude of this positive contribution (due to the size calculation model) goes down to less than half compared to the baseline version (+3.2 percentage points).

Potential growth will pick up in 2011-2014, but slowly compared to the baseline scenario, as presented in the table below:

Tabel 2.2 Potential GDP Growth

- % -

	2009	**2010**	**2011**	**2012**	**2013**	**2014**
Baseline Scenario	6.6	6.5	6.5	6.5	6.5	6.0
Current Scenario	-4.7	0.6	1.2	3.5	4.2	4.6

Source: NCP

The contribution of potential GDP factors will pick up in 2011 – 2014, but the levels are below the pre-crisis ones.

Table 2.3 Contribution to Potential Growth

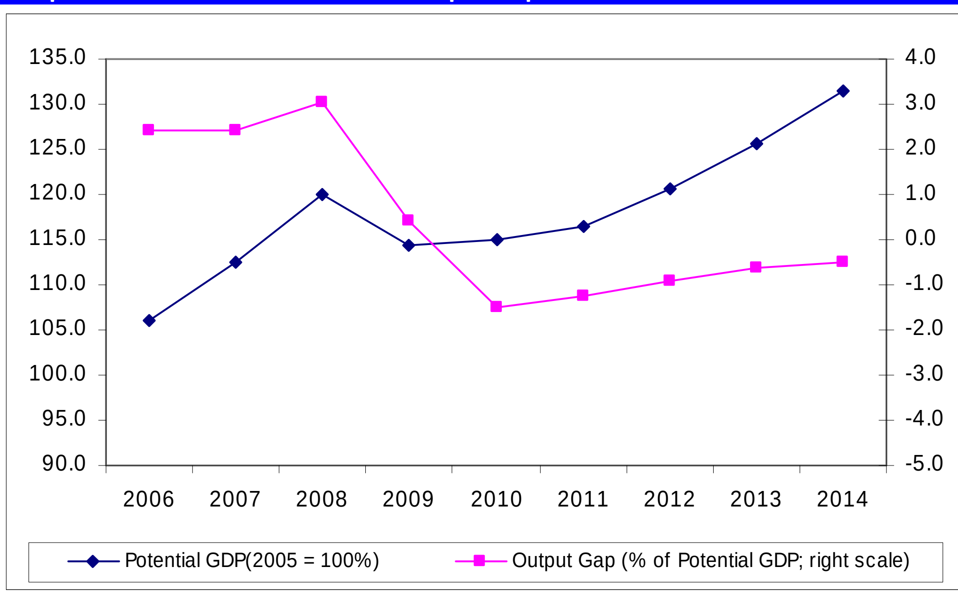
- % -

	Capital	Labor	TFP	GDP
2009	1.5	-1.2	-5.0	**-4.7**
2010	0.8	0.0	-0.2	**0.6**
2011	0.9	0.0	0.3	**1.2**
2012	1.0	0.0	2.5	**3.5**
2013	1.5	0.0	2.7	**4.2**
2014	1.8	0.0	2.8	**4.6**

Source: NCP

The zero contribution of the labor factor is visible, contradicting the pre-crisis estimation. This is partially explained on one hand, by certain inertia of the labor market, and on the other hand by the estimated developments in terms of working age population and the activity rate of the working age population. A slow improvement in the *Non-Accelerating Inflation Rate of Unemployment* (NAIRU) is expected, i.e. from 7.9% in 2010 to 7.5% in 2014. With regard to the capital factor and the total factor productivity the structural change will be significant, as their ratio will be reversed. For instance, according to the baseline estimation for 2014, for a potential growth of 6% the capital contribution was 3.2 percentage points, while the total factor productivity contribution was 2.5 percentage points, with the labor factor at 0.3 percentage points. Currently, for a potential growth of 4.6% in 2014 the capital factor contribution is 1.8 percentage points, the total factor productivity contribution is 2.8 percentage points, and the labor factor has a neutral contribution. The small capital contribution to the potential growth, while on the rise from 0.8 percentage points in 2010 to 1.8 percentage points in 2014 is closely linked to the gross fixed capital formation forecast.

Graphic 2.4 Potential GDP and the Output Gap



Source: NCP

The output gap turned negative as of 2010, and will reach a minimum of -1.5% of potential GDP in 2011 aiming for an equilibrium in the medium run, in line with the proposed macroeconomic policy mix. A slightly negative value of the output gap is expected in 2014 (i.e. -0.5% of potential GDP).

The differences in the current Program compared to the previous one, comes from the revision of estimated potential GDP based on the achievements of 2009 and 2010 on one hand, and from a higher certitude as to the effects of the economic and financial crisis on the medium-term growth, on the other hand.

2.3 Medium-term scenario

On medium term, 2012-2014 period, the forecasting scenario includes an accelerated economic growth pace ranging between 4.0 and 4.7%, that will allow recovering the decline of 2009 and 2010 generated by the economic and financial crisis and reducing the gap with the more developed Member States (catching up). This scenario is based on an improvement in all economic sectors, mainly the highly potential exporting sectors of industry, as well as in the constructions sector that may take advantage of the need of infrastructure in all sectors.

Table 2.4 Macroeconomic Projections

	2010	2011	2012	2013	2014
	Percentage change				
Real GDP	-1.3	1.5	4.0	4.5	4.7
Private Consumption Expenditures	-1.7	1.9	3.9	4.2	4.4
Public Consumption Expenditures	-3.6	-1.1	1.5	1.8	1.9
Gross Fixed Capital Formation	-13.1	3.4	5.8	7.8	8.5
Exports of goods and services	13.1	8.1	9.7	9.5	9.6
Imports of goods and services	11.6	7.1	8.3	8.7	9.5
	Percentage contributions to GDP Growth				
Final Domestic Demand	-5.2	1.8	4.1	4.8	5.1
Change in Stocks	4.1	-0.2	-0.2	-0.2	-0.2
Net Exports	-0.2	0.0	0.1	0.0	-0.2

Source: NCP

The domestic demand will be the driver for growth, with a pace of the gross fixed capital formation of over 5.8%, and up to 8.5% in 2014. The private consumption expenditures will increase by around 4%, against a background of increased available revenues and a higher confidence in the economic environment, the public sector consumption will start picking up, after two years of continous decrease, but the increase will have to secure a reduction of these expenditures' share of GDP and the improvement of the budget sector expenditures. Exports and imports of goods and services will increase in real terms by broadly over 7%.

Exports increased more than imports in 2010 and afterwards in the first two months of 2011, allowing for a significant decrease of the trade deficit and implicitly the current account deficit. Under these circumstances, the current Convergence Programme as compared to the previous edition presents revised estimates for 2011 and the interval 2012-2014.

Taking into account the consolidating trend of growth in the world economy in the upcoming period, reflecting the end of the financial and economic crisis, in 2012-2014 we expect an increase of the annual average of export goods by 13.6% and an 11.6% increase in imports. Therefore, the GDP share of the FOB-FOB trade deficit is expected to go up, reaching 2.5% in 2014. The annual average growth of intra-Community exports is estimated at 13.1% while intra-Community imports are expected to grow by 11.1%. Extra-Community exports will show a higher increase of around 14.8%, over the average by 1.2 percentage points.

The inflation's downward trend will continue in 2012-2014, for both annual inflation and annual average. The recovery of the disinflation process will be made possible by firmly continued monetary policies, together with the other components of the economic policy mix (fiscal and revenues). The estimates were based on normal agricultural years and a low volatility of the international oil price. In addition, a gradual reduction in the excise increase, prudential wage policies and continued structural reforms will help keeping the disinflation process on a sustainable path. Hence, the inflation rate will drop to 2.5% in 2014, with an annual average of 2.8%. Moreover, the disinflation will contribute to a supplementary drop in the inflation expectations. One other way to anchor the inflationary expectations will be domestic currency appreciation trend, in real terms, compared to the euro. This will be possible if we give consideration to a more accelerated productivity growth in the Romanian economy, compared to its foreign partners. The exchange rate will have a modest impact, sustaining the disinflation process. Hence, a slight appreciation of the domestic currency against the European currency was taken into account.

Table 2.5 Prices evolution

	2010	2011	2012	2013	2014
	percentage changes				
GDP Deflator	4.5	3.9	4.8	4.4	4.5
Private Consumption Deflator	4.9	4.9	5.0	4.4	4.2
Harmonised CPI	6.1	6.5	3.5	3.2	2.8
Investment Deflator	2.9	4.4	5.5	3.5	3.2

Source: NCP

The private consumption deflator will be higher compared to the consumer price index in 2012-2014, due to higher prices expected for services, such as utilities, transport and rent. Investment deflator is expected to go up in 2012, reflecting an increase of the capital goods demand due to a higher pace of investments, but in the next period the growth pace will smooth down due to a higher confidence in the economic stability. *Terms of trade*, will be in favour of exports.

According to the national accounts the **employment,** will increase in 2012-2014, mainly due to a higher number of employees. Labour productivity will improve due to a higher growth rate of the gross domestic product compared to the increase in the employment. The compensation of employees will go up, but its share (D1) in the gross value added will go down from around 46% in 2010 to 42% in 2014. The unemployment rate, according to AMIGO, will drop simultaneously with the employment rate increase, mainly for the population aged 20 to 64.

Table 2.6 Labour Force

	2010	2011	2012	2013	2014
	percentage change				
Total employment [1)]	-1.8	0.4	0.6	0.5	0.4
Number of employees [1)]	0.9	0.6	0.7	0.6	0.5
Labour Productivity [2)]	0.5	1.1	3.3	3.9	4.2
Compensation per employee (D1)	1.3	3.9	6.5	6.7	6.4
Unemployment rate [3)] - % -	7.3	6.4	6.2	6.0	5.8

Source: NCP

[1)] Employment, the domestic concept definition in the national accounts

[2)] Real GDP per employed

[3)] The definition in line with Eurostat (Labour Force Survey – AMIGO)

2.4 Sectoral Balances

In 2010, the balance of payments current account recorded an increase in deficit by only 1.1% compared to 2009, with a GDP share of 4.1%. The current account deficit was financed from foreign direct investments (54.3%) which were 29.5% lower than in 2009.

In the first two months of 2011, the balance of payments current account showed a deficit of only 44 million euro, essentially due to the very low deficit of the trade balance (5 million euro), and the surplus of current transfers which increased by 60.4% compared to two months 2010. The current account deficit was fully financed from FDI, 2.1 times higher than two months 2010.

The current account deficit is expected to stay within sustainable limits in 2011, at 4.3% of GDP, and is to be 63.9% covered by foreign direct investments.

In the medium run, the current account deficit will maintain at around 6-7 billion euro, with its share in GDP going up to 4.8% in 2012, to go down to 4.1% in 2014.

Considering the capital account, the GDP share of foreign deficit, , will go down from 3.9% to 3.2% in 2011-2014, with an increase in the capital account contribution.

Table 2.7 Sectoral Balances

% of GDP	2010	2011	2012	2013	2014
Net balance, compared to the rest of the world	-3.9	-3.9	-4.0	-3.4	-3.2
of which:					
- goods and services balance	-5.4	-4.8	-4.0	-2.8	-2.4
- revenues and transfers balance	1.3	0.5	-0.8	-1.4	-1.7
- capital account	0.2	0.4	0.8	0.8	0.9

Source: NCP

In 2011 - 2014 the foreign investments are expected to go up from 3.6 billion euro to 5.8 billion euro, namely from 2.8% to 3.4% as GDP share.

3. GENERAL GOVERNMENT AND DEBT BALANCE[14]

3.1 Strategic Policies

The 2011-2014 budget frame incorporates the consolidated economic governance concept introduced at European level, which includes an extensive legislative package expected to bring a higher discipline and thoroughness at EU MS macroeconomic level and to prevent future crises.

In answer to the deep international crisis that affected the Romanian economy as well, the Government of Romania established a consolidation strategy focusing n an important reform process to adjust expenditures in the public sector and implement tax measures that will help reduce the budget deficit, and anticipated pressures coming from population ageing as well as help preserving a sound growth pace in the long run.

Fiscal consolidation is a mandatory requirement for an efficient and competitive economy I which takes into account a budget deficit (in cash) of 4.4% of GDP in 2011 and below 3% of GDP both cash and ESA in 2012-2014.

Fiscal and budgetary consolidation is one of the basic objectives of the Romanian Government; consolidation efforts placed Romania on a secure pathway towards reaching fiscal targets on both medium and short term, but additional measures such as continuing expenditure restrictions and structural tax reforms are still necessary in order to implement the adjustments.

In 2011-2012, as well as in the medium run, consolidation will not show the same amplitude as in 2009-2010, but it will be continued in order to ensure a stable economic growth, as well as a more efficient and competitive economy.

3.2 Medium-Term Objectives

The fiscal consolidation actions envisaged by the Government in the medium run are:

- Continue reform measures in the public sector expenditures;
- Improve investment policies;
- Continue the reduction and prevention of current and new arrears;
- Improve corporatist governance.

The rationalization of public expenditures is focused on reforms and measures started in 2010, whose effects are expected in 2011, as well as in the medium term.

The main measures include:

✓ **Reduce salary expenditures** in the public sector as a share of GDP through a substantial cut in 2010 (followed by an average recovery of around 15% in 2011) and in conjunction with removing vacation bonuses and the 13th salary. At the same time, the 1 to 7 staff-replacement rate will be kept. The baseline effect of this measure will secure a decreasing trend of salary expenditures-to-GDP ratio in the medium run.

✓ Substantiate and improve the efficiency of material expenditures in line with the implementation of cost standards introduced in the public administration;

✓ Generate savings by **restructuring the Government agencies;**

[14]) The budget indicators contained in this section are calculated using the cash methodology. The budget indicators according to ESA are contained in the annexes to the current paper.

✓ **Restructure the health sector** in order to realize an appropriate balance between the need of having good medical care services and the need to keep costs under control and avoid accumulation of arrears:

- Introduce co-payment for medical services;
- Reduce the number of hospitalized patients by 10% compared to 2010;
- Reduce the subsidies on drugs covered by the Government and provided by national health programs (C2 List);
- Cut down the share of settlements for the services provided by physicians depending on the number of patients, from 70% to 50%;
- Clarify the legal framework regarding 'claw back' taxes applicable to drug retailers;
- Remove the obligation of concluding contracts with all hospitals, thus allowing a competitive contracting with selected hospitals and ensuring transparency and surveillance;
- Reform (with WB assistance) the medical service package secured by the Government, in order to avoid coverage for highly expensive and unnecessary medical services;
- Implement the hospital restructuring strategy, to reduce the number of beds currently financed.

✓ **Reform the Public Pension System** and freeze the pension point in 2011.

✓ **Reform the Education System in line with the National Education Law no. 1/2011.**

✓ **Improve social assistance program efficiency** through a better targeting and the consolidation of the approximately 200 social payments;

- A better targeting, by immediate or gradual removal of the programs that are not subject to financial means testing;
- Restructure and consolidate social payments at different administrations levels;
- Improve controls on social payments applications;
- Cap the maximum social payment per individual.

Channeling the public sector funds to investments and speeding up the absorption of EU funds in order to complement the national budget funds and help the economy improve its growth potential constitutes the highest priority of the Government.

Prioritize investments:

- Improve the capital investment planning and monitoring capacity by establishing a project database;
- Enforce the National Infrastructure Development Program aimed at:
  - building, modernizing and rehabilitating county and local roads;
  - building sewerage systems, waste water plants and local water supply networks to improve the quality of living in rural areas;
- Re-orient capital expenditures in the public sector to gradually move from investments that are fully covered by domestic sources to EU co-financed investments.

The measures already taken aimed at cutting down arrears and the future lines of actions in this sensitive area include:

- Revision of the legal framework for adopting new pieces of legislation, namely:

- The Government Emergency Ordinance nr. 51/2010 on the regulation of various measures aimed at reducing arrears in the economy and other financial measures; the purpose is to unblock the activity of economic operators in need to recover money from the local public administration authorities;
- The Government Emergency Ordinance nr. 63/2010 on amending and supplementing the provisions of the Local Public Finance Law nr. 273/2006, and as on adopting a number of financial measures; this piece of legislation introduces a number of measures to ensure that outstanding payments are made;
  - The annual budget will include separate budget allocations that will be used to pay the outstanding debts of the previous year
  - No new budget commitments are allowed unless outstanding debts are paid for the respective expenditure title.

- Improve budgetary procedures and expenditure management to avoid the recurrence of arrears by preparing an action plan which includes an improved budget commitments control mechanism and enforcement measures, in order to avoid building up new arrears.
- The legislation referring to the payments associated in commercial operations will be prepared in line with *European Parliament and Council Directive 7/2011on fighting delayed payments in commercial transactions.*
- Over the next two years the period for paying bills submitted (to the central government and social security system) will be gradually reduced.In order to improve control, the accounting reporting system will be integrated with the Treasury payment system;
- The Government will carry on reforms in the public health sector by enforcing measures expected to reach an appropriate balance between the need for good medical care services and the need to keep costs under control, and by implementing a transparent IT system integrated into the health system to monitor and improve efficiency of health sector spending;
- A political objective assumed by Romania in line with international bodies' requirements (IMF, European Commission, World Bank) is the **SOEs reform,** primarily in key sectors such as energy and public transport.

  Under these circumstances, the state must be prudential in its actions and observe the rights of other shareholders while refraining from abusing its dominant position as majority shareholder and of its regulation power.

  The line ministries will play the major role by preparing medium and long term development strategies for the companies under their coordination, as well as restructuring and development measures to improve efficiency by cutting subsidies and maximize profits.

  These comprehensive strategies are aimed at improving SOEs' viability and reorganizing their governance. Strategic action plans will be elaborated for the main companies (by the end of April 2011) and for all other companies (by the end of July 2011) that will:

  - supply updated information on the financial viability of each state-owned enterprise in which the state is the majority shareholder, as well as of each autonomous entity ;
  - classify the SOEs into groups of companies that are to be liquidated, sold out or preserved (the latter may be restructured if necessary);
  - present the lines of action to be taken for closing down, improving viability of, or privatizing, these companies;

- present specific plans to substantially cut arrears (through redemptions, swaps or securitization etc.)
- implement a system for SOEs and AE to submit to MoPF monthly reports on the main financial and economic indicators.
- amend Ordinance 79/2008 to introduce the obligation for AEs and for the subordinated companies to local authorities to send to MPF operational and financial indicators, on a quarterly basis.
- The necessary legislation to solve SOEs governance issues will be prepared (with WB assistance) and approved, mandatory and independent external audits on a regular basis will be introduced and the financial control of SOEs will be transferred from the line ministries to MoPF until the end of September 2011

Other corporatist governance measures:

- A Corporatist Governance Regulation will be prepared for the SOEs that will establish the functions of the Board Members and of the executive management, as well as their competencies and responsibilities;
- The accountability of the Board and management will be increased by concluding contracts of management and mandate with specific and measurable tasks based on economic indicators;
- The Board will establish a management control, will monitor the conflict of interests and will protect the shareholders' rights;
- The Board composition will be improved by increasing independence and developing new efficient forms for performing most important functions;
- The main Board functions will be built into a working plan or other benchmark paper that will describe the implementation procedures;
- The Ministry of Public Finance will monitor the compliance with the legal provisions regarding the efficient use of financial resources of economic operators;
- At regular intervals, the economic operators will report their financial results to their respective line ministries in order to allow recovery measures and corrections of any deviations from the initial parameters set in the mandate contracts and the revenues and expenditures budgets.

3.3 2010 and 2011[15] Budget Policy

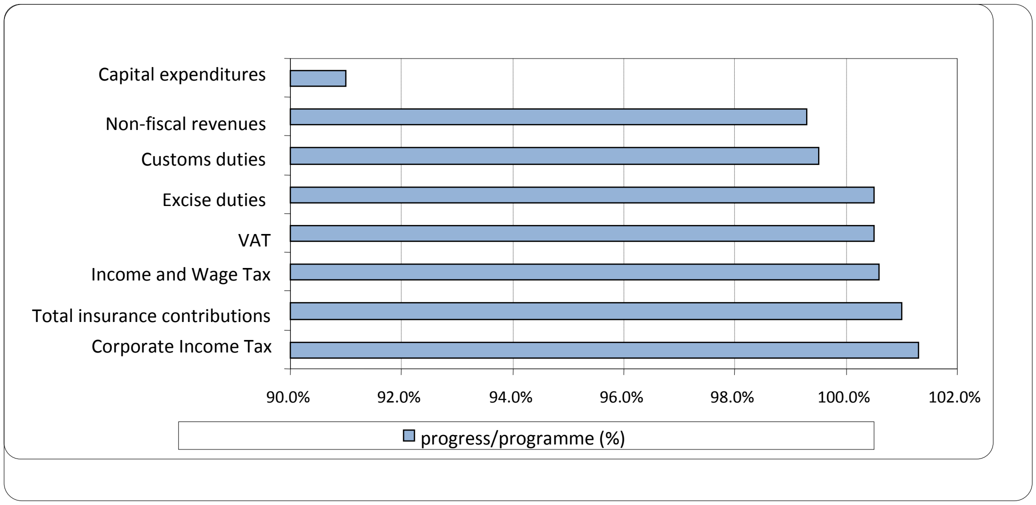
2010 Budget Policy

The General Government revenues went up to a total amount of 168.8 billion lei (32.8% of GDP), showing a nominal increase of 7.3% (1.1% in real terms) compared to 2009.

The General Government revenues degree of realization were achieved 100,8% compared to the previous program.

[15] Cash Data

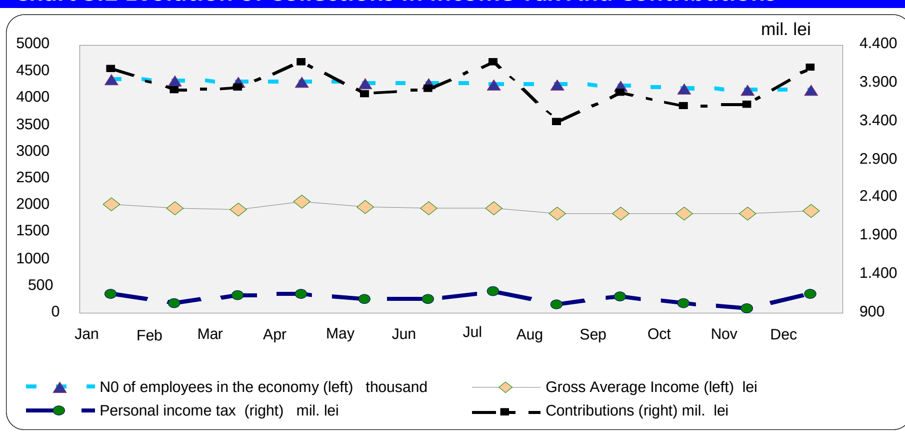
Chart 3.1 General Government Revenues



Source: MPF

- The corporate income tax **collections** decreased by 4.9%. No problems were encountered in relation with any credit institution in the system due to a solid banking system and to prudential and administrative measures implemented by NBR, while the lack of toxic assets in the balance sheets of banks operating in Romania allowed avoiding capitalization using public funds;
- **Income tax collections** amounted to 18.5 billion lei (a drop of 3.2%), reflecting the 6.7% decrease in the number of employees and the 1.9% decrease in the gross average salary (Oct. 2010/ Oct. 2009).

Chart 3.2 Evolution of Collections In Income Tax And Contributions



Source: NSI, MPF

- **VAT collections** increased by 14.3% as a result of the increase of the standard rate from 19% to 24% starting with the second half of 2010.
- **Excise** collections increase was trigerred by the increase of the benchmark rate of the excises' payment to 14.2% and the increase of the excise duty rate itself for some goods.
- **Non-fiscal revenues** went up to 19.3% following a number of measures for recovering the budget deficit, such as:

- The amounts generated by the salary cuts among public authorities and entities that are fully financed from own revenues were included in the general government;
- Certain amounts from the own financing sources of the SOEs were transferred to the general government.

➢ **Social contributions** collected by the general government dropped by 4.5%, compared to the same interval of the previous year. These were influenced, on one hand, by the same factors that influence the income tax and on the other hand by specific measures, (such as the 6-month contribution exemption granted to companies that hire unemployed people), as well as incentives resulting from the technical unemployment regulations.

➢ Collections of local budget **revenues** increased by 14.3%, following the legal changes that increased the taxable bases and the penalties in the local taxes system.

The development of the 2010 budgetary revenues compared to the previous year was influenced by:

- ***macroeconomic indicators***[16]that generated a 0.4-billion lei impact (of which -0.2 billion in corporate income tax due to GDP evolution; 2.2 billion in the case of VAT and corporate income tax due to CPI evolution)
- ***legal changes,*** *the majority of which was adopted in the second half of 2010* had a positive impact of 4.9 billion lei (of which 3.7 billion due to VAT rate change and 1.8 billion following the increase in excise duties' rates)
- ***revenues collection*** negatively influenced the budget by -1.5 billion lei.

The General Government Expenditures amounted to 202.2 billion lei, showing an increase in nominal terms by 4.4% compared to the previous year (1.9% decrease in real terms). In terms of GDP share, the level is close to the previous year (39.4%).

The following developments were seen in the structure of the general government expenditures:

- **Wage bill** dropped by 8.6%, following the austerity measures implemented by the Government: 25% wage cuts in the public sector, while simultaneously freezing all salaries (except for the minimum wage), as well as job vacancies in the public sector, reduction of overtime pay and further implementation of the restructuring programs focusing on public sector staff;
- **Goods and services expenditures** increased by 4.0% in 2010 compared to 2009, also as a result of the increase in the health fund budget expenditures for the payment of arrears;
- **Interest payments** increased by 20 due to the increased budget deficits accumulated over the previous years and the loans committed to cover such deficits, creating an increased effort for making the principal and interest payments;
- **Subsidies expenditures** dropped by 6.7%, principally as a result of the rationalization measures aimed at restructuring the public companies, reduced subsidies in agriculture, old technologies, household heating etc. ;
- **Social assistance expenditures** raised by +7.3% as a result of an increase in unemployment expenditures;
- **Investments expenditures** that include capital expenditures and the development programs funded from domestic and foreign sources were 33.7 billion lei in 2010, accounting for 6.6% of GDP.

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16 National Prognosis Commission (NPC); the 2010 autumn forecast prognosis; November 5, 2010

The measures envisaged in 2010 were principally focused on current expenditure cuts that had increased the most in the last couple of years; these measures included:

- in the first six months of the year, salary freezing (except for salaries below 705 lei per month) at the level of December 31, 2009;
- as of July 2010, the public sector wages were cut by 25%. Where this cut resulted in an amount lower than the minimum gross salary at country level, the amount of 600 lei was paid;
- the '1 in 7 staff replacement'-policy continued;
- bonuses were cut and the overtime was paid-off in terms of paid days-off ;
- all public sector wages that were due as of December 31, 2010 according to court rulings were rescheduled for payment in 2012 – 2014.

2010 Legal Measures:

- increase of excise duties
- VAT still not deductible for company cars used for personal purposes
- No salary indexation;
- The measure regarding limited occupation of vacancies (15%) still in force;
- Capital expenditures and goods & services expenditures cut down due to interdiction of purchasing cars, furniture and office equipment;
- VAT rate raised from 19% to 24%;
- Public sector salaries reduced by 25%;
- Most social benefits reduced by 15%;
- Increase of the tax on vehicles and on buildings for individuals with more than one building in property in addition to their home

Budgetary Policy in 2011

The Budget Policy promoted in 2011 is prudential, restrictive and focused on continuing the fiscal consolidation efforts in order to reach the targeted budget deficit (in cash) of 4.4% of GDP.

Revenues:

Budget revenues estimation was based on:

- the same taxation rates for corporate income tax, income tax and VAT;
- extending health contributions by including pensions over 740 lei per month higher budget revenues expected as a result of combating tax evasion;
- improved tax collection and administration.

Expenditures:

The main challenge of the 2011 spending policy is to continue the adjustment measures by keeping budgetary restrictions and continuing structural reforms.

The wage bill was limited to 39 billion lei (excluding military social insurance contributions (1.6 billion lei) in conformity with the new pension law), reflecting the downsizing policy of this envelope compared to previous years. The specific measures include removal of vacation bonuses and the 13th salary, as well as the ongoing limitation of public sector employment to 15% of the total vacancies during the year.

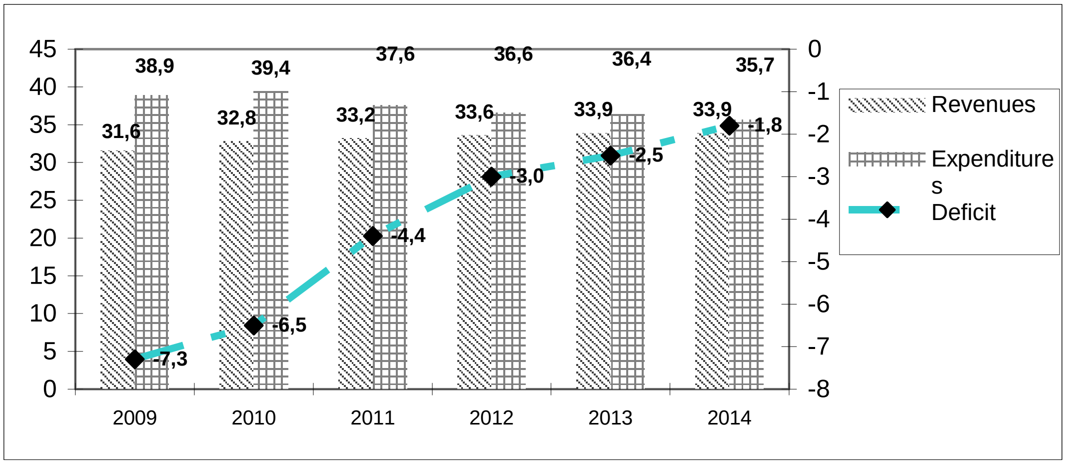
The measures on capping the goods and services expenditures are to be preserved in 2011, in conjunction with reducing subsidies.

Investments are scheduled at 6.5% of GDP and around 17% of total budget expenditures to help stimulating economic growth.

3.4. Medium-Term Budget Outlook

In the medium run, the specific objective of the budgetary policy will be to continue adjusting the budget deficit, targeting 3% of GDP in 2012, 2.5% of GDP in 2013 and 1.8% of GDP in 2014 (cash method).

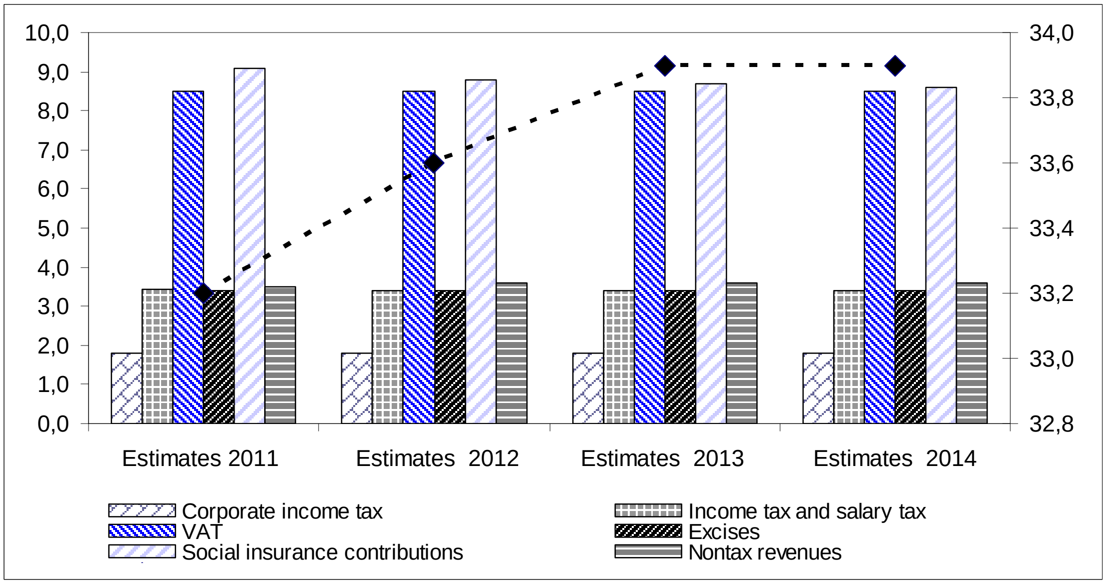
Chart 3.3 Consolidated Budget Position (% of GDP)



Source: MPF

Similarly, most budget revenues will continue to rise (in absolute value and as GDP share) by 1.1% of GDP in 2014 compared to 2010, based on economic recovery and the measures considered by ANAF for reducing tax evasion and grey economy..

Chart 3.4 Budget Revenues As GDP Share (%)

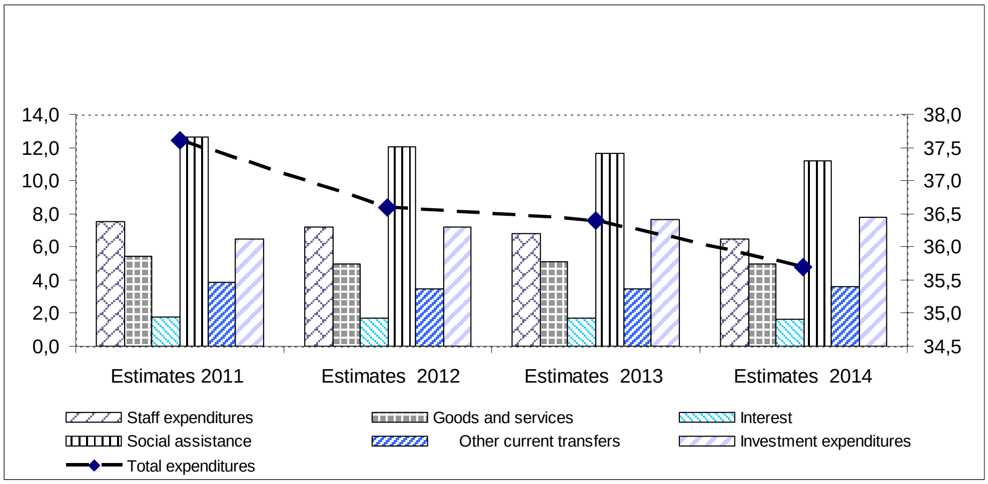


Source: MPF

Additionally, the effect of reducing wage bills, subsidies and goods and services expenditures in conjunction with the reforms undertaken in the public pension system, will increase the total amount of expenditures by only 24.2% in 2011-2014.

This, in turn, accounts for a 3.7 percentage points cut of their GDP share in 2014 compared to 2010. This effort to adjust current budget expenditures will continue to accommodate an upward trend of investment expenditures (an increase of 1.2 percentage points to GDP compared to 2010), alongside a large reduction of the budget deficit (by up to 20.7 billion lei) compared to 2010.

Chart 3.5 Evolution of Budget Expenditures Share to GDP (%)



Source: MPF

On the expenditure side, consideration was given to restructuring public sector expenditures in the sense of adjusting current spending to sustainable levels, with the purpose of reducing the budget deficit and channel unrestricted expenditures to investment projects.

Another priority of the budget policy is accelerated EU funds absorption. Shifting the burden of public investment financing from domestic sources to European funds will help adjustment and contribute to reaching the medium term specific objective.

A special attention was given to staff expenditures, with the prudential measures started in 2009-2010 being continued; according to current plans, the GDP share of staff expenditures is expected to go down to around 6.5% of GDP in 2014 (from 9.4% of GDP in 2009).

Structural reforms are focused on continuation and consolidation of the measures initiated in 2011 aiming at improving corporatist governance of SOEs, eliminating the arrear problem at both central and local level, continue health system reforms and the measures taken in the energy and transport sectors.

3.5 The Impact Of EU Accession On Public Finance

A high EU funds absorption in 2011-2013 is one of the strategic objectives of Romania and, at the same time, the possibility to capitalize on a major benefit of the EU accession. This will require high efforts to ensure an efficient system for accessing and implementing European funds and eliminate/reduce any barriers that could impair the absorption process.

million Euros

Table 3.1 Amounts Allocated To Romania In 2007-2013	
Instrument	**Total**
Structural and Cohesion Funds	19,668
European Agricultural Fund for Rural Development	8,022
European Fishery Fund	231
European Agricultural Guarantee Fund	6,580
Total	34,501

Source: MPF

In 2011-2013 a total amount of 18,113.80 million Euros is expected to be reimbursed from the EU post-accession funds.

In 2009-2010, a number of specific measures were taken to simplify the implementation mechanism and remove stalemates and delays in Community instruments absorption, aiming: (i) facilitation of beneficiary's access to funds (ii) simplification of project financing mechanisms and facilitation of access to financing sources for both private and public beneficiaries (iii) public procurement legislation was amended to speed up tender procedures by reducing tender times, in a move to have a more flexible procurement process, as well as to introduce more efficient mechanism to settle appeals.

million Euros

Table 3.2 Distribution Of Amounts On The Main Post-Accession Funds Estimated To Be Reimbursed By The European Union In 2011-2013

Instrument/Year	2011	2012	2013	Total 2011-2013
Structural and Cohesion Funds	2464.19	3693.68	3730.18	9888.05
European Agricultural Fund for Rural Development	1055.64	1482.82	1455.02	3993.48
European Fishery Fund	63.90	52.92	42.19	159.01
European Agricultural Guarantee Fund	1007.47	1186.61	1364.47	3558.55
Total	4591.20	6416.03	6591.86	17599.09

Source: MPF

3.6 Structural Balance And Fiscal Position

The budget deficit and the cyclical deficit, as well as the potential gross domestic products were calculated (using the Cobb Douglas type production function) based on OECD and CE methodology, as described by van den Noord (2000) and Girouard (2005). The used data were sourced from Eurostat database, in basic prices 2000 (seasonally adjusted by data treated using the TRAMO – SEATS method).

According to the above-mentioned methodology, the structural components of the budget are obtained by extracting the cyclical component from the current budget component, using the formula below:

$$CAB_t = B_t - B_t^C = B_t - \sum_j B_{t\ j}^C$$

The cyclical component of each category of revenues and expenditures ($B_{t\ j}^C$) is calculated by using the output gap and the estimated elasticity against GDP (α_j^{PIB}). The formula used to calculate the cyclical component is as follows:

$$B_{t\ j}^C = B_{t\,j} \times \alpha_j^{PIB} \times output\_gap_t$$

The results are presented in the table below:

Table 3.3 Cyclical and structural deficit (% of GDP)

	2010	2011	2012	2013	2014
1. Real GDP increase (%)	-1,3	1,5	4,0	4,5	4,7
2. Current balance	-6,4	-4,9	-3,0	-2,6	-2,1
3. Net interest of payments	1,6	1,8	1,8	1,8	1,7
4. Output gap	-1,5	-1,3	-0,9	-0,6	-0,5
5. Cyclic component of the budget	-0,4	-0,4	-0,3	-0,2	-0,2
6. Cyclically adjusted balance	-6,0	-4,5	-2,7	-2,4	-1,9
7. Primary adjusted balance	-4,4	-2,7	-0,9	-0,6	-0,2

Source: NPC, MPF

After the 2008 pro-cyclical and expansionist budgetary policy when the structural deficit increased to 7.25% of GDP from 3.26% of GDP in 2007, since 2009 the structural deficit has started to reduce.

On a medium term, there is a diminishing trend in the cyclical component, given that the effectively forecast GDP grows faster than the potential GDP. In 2014, for an output gap of -0.5% of GDP, the structural deficit is 1.9% of GDP, while the actual deficit is 2.1% of GDP.

3.7 Developments and the level lf debt

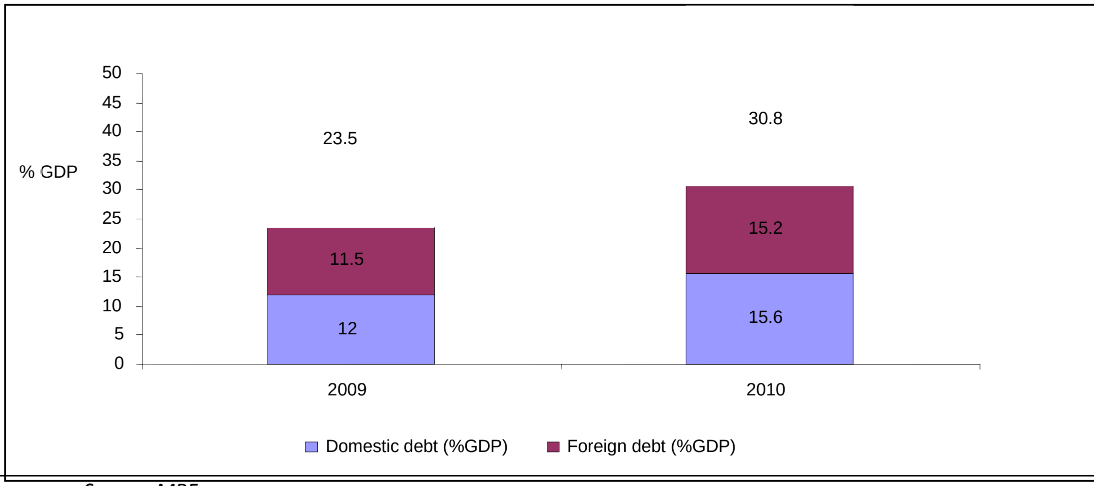
General government debt [17] and Debt Management Strategy

Romania's public debt according to the EU methodology (ESA95) was below 31% of GDP at the end of 2010, far below the 60% of GDP ceiling established by the Treaty of Maastricht. Hence, while at end-2009 the general government debt represented 23.5% of GDP[18], at the end of 2010, with the growing effects of the international financial crisis and the deep recession in Romania, this indicator

[17] All indicators used in this section are in compliance with the EU methodology.
18 2009 GDP: 498,008 billion lei.

went up to 30.8% of GDP, of which domestic debt accounts for 15.6%, and the foreign debt is 15.2%.

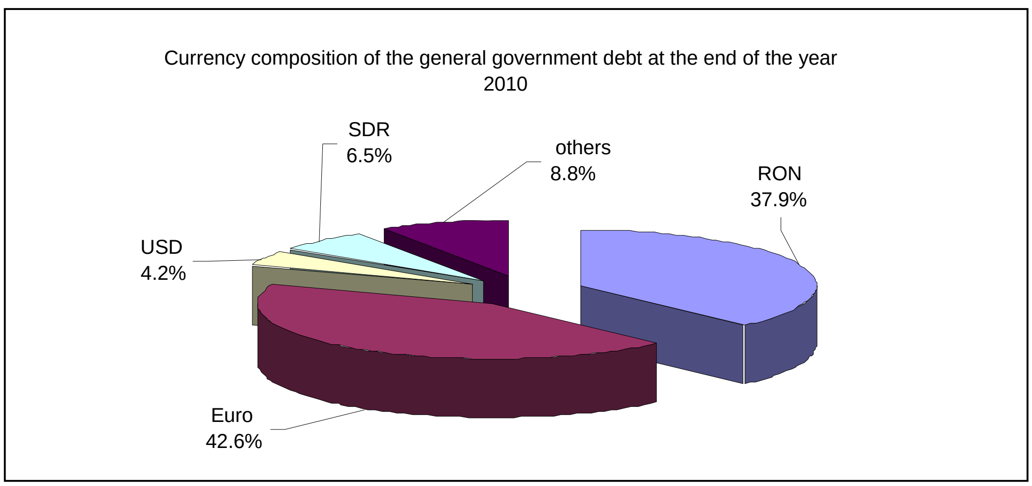
Chart 3.6 General Government Debt Composition



Source: MPF

The general government debt composition at December 31, 2010 on debt instruments shows that the government securities represented 55% of total debt, the difference being covered by loans. Regarding the initial maturity of general government debt, 25.8% of the debt was contracted on short term maturities, and the structure of general government debt by type of interest rate, shows that 40.5% of the total debt was floating interest rate debt. The general government debt denominated in national currency at the end of 2010 accounted for 37.9 % of total debt, while from the general government debt contracted in foreign currencies, the largest share was represented of the debt denominated in Euro, respectively 42.6% of total general government debt.

Chart 3.7 GeneralGeneral Government Debt at end-2010



Source: MoPF

From 2010, in order to improve public debt management and avoid seasonal pressures to ensure funding sources of the budget deficit and refinancing of the public debt, the Ministry of Public Finance decided to constitute a foreign currency financial reserves (buffer) following to be enhanced by an equivalent amount of funding requirements to cover the budget deficit and refinance public debt for about four months.

In 2010, deficit financing and public debt refinancing were covered principally from domestic sources (around 60%) with the rest covered from external sources, the following instruments being used:

- *issuances of government securities in lei, respectively treasury bills and benchmark bonds issued on the domestic market with maturity of 3 and 5 years, as well as reopenings of benchmark bonds with 10 years maturity(remaining maturity 7 years);*

Hence, in 2010 government securities were periodically issued on the domestic market, in line with the announced calendar of government securities issuances, in order to achieve the objective of developing the government securities market as well as to build and consolidate the yield curve of government securities on the domestic market. In 2010, government securities were issued in amount of 51.9 billion lei, of which 75% treasury bills with maturity at 6, 9 and 12 months, the difference being represented by the benchmark bonds with 3 and 5 years maturity, as well as the re-opening of the benchmark bond with 10 years maturity (remaining maturity of 7 years). Compared to the yield of government securities issued in December 2009, the yield of securities issued in December 2010 went down in average by 3.0% to around 7%,.

- *Borrowings on the domestic and foreign markets*

At the end of July 2010, with the existing liquidities in foreign currency on the inter-banking market, in order to cover its financing needs the Ministry of Public Finance issued a Euro 1.2 billion tbills on the domestic market (the amount borrowed was roughly three times higher than the amount announced), and in November the same year MPF issued an bond in amount of Euro 1.3 billion with a maturity of 3 years. This issuance extended the maturities of government securities and helped consolidating of the foreign currency buffer of MPF. In March 2010, MPF, along with other sovereign issuers, took advantage of the opportunities windows that appeared in a favorable moment (enough liquidity in financial market and reasonable margins) and issued an Eurobond on the foreign capital markets in amount of 1 billion Euros, with a 5% coupon, an yield of 5.18% and 5 years maturity. The Eurobond was issued to finance the budget deficit and refinance the government debt. This issuance was around 5 times oversubscribed, reflecting the high interest of the foreign capital markets for the Romanian bonds denominated in Euros.

- *new foreign borrowings under the external financial package contracted with the IMF, the EC and the IBRD[19], as well as external loans for project financing*

From the external financial package contracted with the IMF, the EU and the IBRD in 2009, for financing of the budget deficit there were drawn third and fourth tranches of the IMF loan (1.1 billion SDR, respectively 1.2 billion Euros equivalent) and second and third tranches from the EU loan (2.15 billion Euros). In addition to the external loans presented for budget deficit financing purpose in 2010 there were used drawings in amount of about 0.5 billion Euros from the ongoing external loans for project financing.

- *loans contracted by the local government authorities*
- *amounts recovered by the Authority for State Assets Recovery (AVAS) from non-performing bank assets and amounts recovered by the Ministry of Economy in accordance with the provisions of GEO 249/2000.*

Financing Strategy in 2011-2014

The budget deficit financing in 2011-2014 will be covered from both domestic and foreign sources, in a balanced manner, in line with the objectives of Strategy of the Public Government Debt on 2011-2013 Medium Term ; these objectives are:

[19] Part of the WB Group.

i. controlled increase of the public government debt and keeping it within sustainable limits,

ii. reduce the costs of public government debt in the long run, with an acceptable risks level in the public government debt portfolio,

iii. develop the domestic government securities market.

The strategy focusing on domestic resources for financing of budget deficit and refinancing of public government debt will use government securities issuances on the domestic market, essentially T-Bills with maturities of up to one year and new benchmarks with maturities of 3, 5, 7 and 10 years, in both domestic and foreign currency depending on the market opportunities, and even with longer maturity if there is sufficient demand on the market, under reasonable cost and liquidity terms. Depending on the market appetite, and as a measure to optimize the government securities portfolio, benchmark bonds issued in previous years will be re-opened up to a volume that would allow increasing liquidity on the secondary market.

To top up the needs related to the budget deficit financing and refinancing of public debt, government securities will be issued on the foreign capital markets under the EMTN (Euro Medium Term Notes) Program established for 2011-2013, in total amount of 7 billion Euros. This programme allows a high flexibility in accessing the foreign financial market, when opportunity windows are identified and the price expectations are favorable.

In 2011, in order to finance the budget deficit and refinancing the debt, the remaining tranches of the external financial package will be drawn, according to the table below:

Table 3.4 External financial package – disbursements

	Amounts
EC- Balance of Payments Facility - tranche 4*)	1,200 million Euros
EC- Balance of Payments Facility - tranche 5	150 million Euros
World Bank – Development Policy Loans	700 million Euros

**)disbursed on March 24, 2011*

As of 2012, the budget deficit financing from foreign sources will be mainly assured from Eurobonds issued on external capital markets.

General government debt projection on medium term

Under the current circumstances, the estimated general government debt ratio in GDP for 2012 - 2014 will not exceed 33.2% of GDP, as presented in the table below:

Table 3.5 General government debt projection on medium term

% of GDP

	2010	2011	2012	2013	2014
General government debt*, of which:	30.8	33.3	33.2	32.8	31.9
- central government debt	28.4	30.8	30.6	30.2	29.4
- local government debt	2.4	2.5	2.6	2.6	2.5
- social security funds debt	0	0	0	0	0

Source: MPF

**) gross debt outstanding consolidated between and within the sectors of general government.*

An alternative financing source during the analysis period could be represented by the privatization receipts to be obtained from the privatization of some state assets, which could assure the low cost resources to finance the budgetary deficit and redemption of government debt, especially the domestic debt, thus reducing indebtedness level and extending debt portfolio duration.

On a medium and long term, the risks of high expenditures in conjunction with the ageing population, within an accentuated ageing process in parallel with the decrease of active population number, may be substantially controlled by the implementation of Law no 263/2010 on the unitary pension system in the public sector, expected to improve the viability of the pension system and largely contribute to ensure the public finance sustainability.

The factors expected to have an impact on the general government debt ration in GDP in 2011-2014, including stock-flows adjustments (difference between the interest paid and accrued interest, appreciation/depreciation of foreign currency debt; discount/premium for government securities issuances/redemption etc.) are presented in Table 3 General Government Debt.

The Budgetary Risk from Government Guarantees

In the context of financial and economic crisis, a number of support programmes were promoted by the Romanian authorities, using the issuance of government guarantees for:

a) easy access to mortgage loans for persons who did not own a home (First Home Programme – 1.7 billion Euros total ceiling in 2009-2011);

b) providing the co-financing for the project financed from EU funds (support programme under GEO no. 9/2010, total 2011 ceiling is 300 million Euros);

c) thermal rehabilitation under GEO no. 69/2010, 2011 ceiling being in amount of 200 million lei.

In addition, considering the effects of the global financial crisis on the loan access, terms and conditions for the companies that implement strategic projects, which have a multiplication effect in the economy, the government guarantee instrument was used for this type of projects as well.

Table 3.6 Government Guarantees

- million Euros -

	2009	2010
Total government guarantees, of which	525.4	1282.5
- First Home Governmental Programme	486.4	927.6
- loans contracted by companies	-	320.0
- support programme for projects financed from EU funds (GEO no. 9/2010)	-	4.9
- thermal rehabilitation (GEO no. 69/2010)	-	0.007
- loans contracted by local governments authorities	39.0	30.0

Source: MPF

Having regard to the national economic recovery and growth prospects in 2012-2014, in order to reduce the budgetary risk resulted from the payments that should be made by MPF and administrative-territorial units (ATU) in the account of government guarantees issued, the ceilings for government guarantees issuance were set as follows:

Table 3.7 Government Guarantees Ceilings

-million lei-

	2011	2012	2013	2014
Annual ceiling for the guarantees issued by MoPF and ATU	10,000.0 *)	10,000.0	6,000.0	6,000.0

Source: MoPF

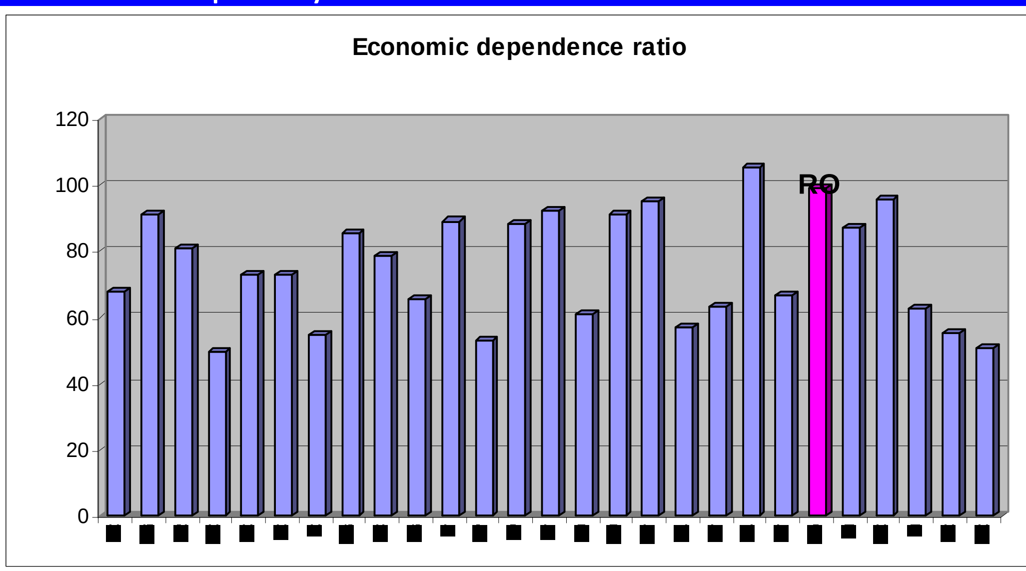
**) the ceiling for 2011 shall be adjusted with the guarantees to be issued for the Nabucco Project funding.*

Since the guarantees stock in decreasing and taking into account the fact that this instrument was rarely used during the economic growth period (no government guarantees were issued in 2008), the payments estimated to be made from state budget in the account of state guarantees follow a downward trend, from 0.1 %of GDP in 2011 to 0.06 % in 2014. The assumptions for this scenario are based on the government guarantees issued for the loans contracted by companies, the guarantees issued under the "First Home" government programme, the guarantees issued in accordance with GEO no. 9/2010 on the approval of the support programme for the beneficiaries of the projects for priority areas of economy, financed from EU funds allocated to Romania,, as well as the guarantees for the thermal rehabilitation programme in accordance with GEO no. 69/2010.

3.8 Budgetary Consequences of Structural Reforms in the Pension System

During 2009-2010, due to the hike in social protection expenditures (pensions, unemployment benefits, minimum pensions, social assistance services), the government started the substantial reform of the public pension system, in order to improve its sustainability. The development of the contributors/beneficiaries dependence ratio shows a continuing decrease over the recent years (placing Romania on an unfavorable position in the European Union).As long term demographic projections outline an additional deterioration of this position, measures were taken in order to enlarge tax base by attracting new taxpayers categories and integrating special pensions, increasing retirement age for women, limiting early retirements and disability pensions, as well as limiting the benefits by implementing a gradual system of moving towards the indexation pensions based on inflation rate and establishing of a pension benefit system, exclusively according to actual contributions paid.

Chart 3.8 Economic Dependency Ratio



Source: Ageing Report, 2009

Measures introduced by the Law no. 263/2010 on the unitary public pension system in the public sector:

1. Gradual moving to an indexation system linked to inflation rate
    - until 2020, the pension point will increase annually by 100% of inflation rate plus 50% of the real increase of the gross average wage of the previous year
    - as of 2021, it will be increased annually by 100% inflation rate plus 45% of the real increase of the gross average wage of the previous year, a percentage that is to be gradually reduced by 5% every year
    - as of 2030, the pension point will be increased annually by 100% inflation rate
2. Starting with January 1, 2012, only at the initial registration in the pension system, a correction index is to be applied that is calculated as a ratio between 43.3% of the gross average wage of the previous year and the pension point in force at the respective date for an established average annual score.
3. Integration within the public pension system of persons in sectors regulated by special laws or provisions in parallel with the gradual increase of the retirement age for both men and women, from 55 years in January 2011 to 60 years in January 2030.
4. The minimum contribution period within the public pension unitary system will gradually increase from 13 years in January 2011, to 15 years in January 2015, for both men and women.
5. As of 2015, only the retirement age for women will go up gradually to reach 63 years in 2030. The full contribution period for women will be gradually increased from 30 years in 2015 to 35 years in 2030.

By implementing the above measures an 1% of GDP reduction of pension expenditures in the public sector is expected by 2020.

Table 3.8 Estimated Effects of the Reform Measures

	2011	2020	2030	2060
Total, % of GDP	0.1	1.0	2.3	3.4
of which:				
1. the increase of contributor number	0.1	0.3	0.5	0.6
2. the increase of retirement age	0	0.1	0.5	0.7
3. indexation with the inflation rate	0	0.5	1.3	2.0
4. reduced early/disability retirement	0	0.1	0.1	0.1

Source: MoPF

Private pension systems

Although the private pensions system was recently implemented (Pillar II in May 2008 and Pillar III in the second half of 2007), the development of number of participants, net assets and yields for the two private pension pillars during 2009-2010 shows a good performance of the private system .

In 2011 the employee contribution channeled from Pillar I to Pillar II is of 3% and it will gradually increase by 0.5% every year, until 6%. Under the current circumstances (pension law implemented from January 1, 2011) the contribution to Pillar 2 will increase as in the table below:

Table 3.9 Public pension system development

	2011	2012	2013	2014
Contributions channeled to Pillar II, in million lei	2078	2679	3394	4169
Contribution rate in %	3	3.5	4.0	4.5
GDP share of Pillar II contributions, in %	0.38%	0.45%	0.51%	0.58%

Source: MPF

4. SENSITIVITY ANALYSIS AND COMPARISON TO THE PREVIOUS CONVERGENCE PROGRAMME

4.1 Risks

The tensions that generate the fragility of the financial markets are still seen as risks. The difficulties related to foreign debts that some Member States of the Eurozone may face will have a spillover effect in other EU MS. Fiscal consolidation in the states having high budget deficits may induce a decrease of domestic demand.

Moreover, there are concerns related to prices growth on the foreign oil markets, due to the enhancement of current geo-political conflicts in the Middle East and North Africa, as well as on the food markets, taking into account the background of bad weather conditions at a global level. These may have a negative impact on the purchasing power and, consequently, on private consumption.

On the domestic side, there is a long term risk of adverse weather conditions for the agriculture sector, that would reduce agro-food products supply, with a diminishing efect on the autonomous consumption and on the individual farmers' market and, at the same time of increasing the imports of such farming products in order to cover the demand.

The low EU funds absorption rate which involves a low investment level and a limited credit represents also a risk for the domestic demand.

4.2 Budget projection sensitivity in various scenarios and based on various assumptions

Elasticity of budgetary variables

Given the fact that tax collections from taxes and fees are closely linked to the evolution of the employment rate within the economy, of the average earnings and the economic growth, the table below shows the impact on the economic variables of the budgetary revenues, considered independent, based of figures of 2010.

Compared to the baseline scenario, taking into consideration of the share in total revenues, the highest risk is associated to collections from social contributions and indirect taxes (mainly VAT).

Hence, the highest negative impact given to the reduced economic growth by 1pp (involving the simultaneous decrease of employment and salaries) is reflected in the social contributions evolution (-0.18% of GDP).

Under the circumstances, it is important to emphasize the determination of the Romanian government to improve the flexibility of the labor market and encourage employment through the recently approved measures.

Table 4.1 Sensitivity of general government revenues to macroeconomic variable changes

Taxes and fees (share in GDP)	Macroeconomic Base	Macroeconomic Base Change (pp)	Revenues Elasticity (% of GDP) 2010
1. Personal Income Tax (3.5%)	Gross Average Salary	Reduced by 1	-0.035
	Employment Level	Reduced by 1	-0.026
	Gross Domestic Product	Reduced by 1	
2. Social Insurance Contributions (8.9%)	Gross Average Salary	Reduced by 1	-0.087
	Employment Level	Reduced by 1	-0.076
	Gross Domestic Product	Reduced by 1	
3. Corporate Income Tax (2%)	Gross Average Salary	Reduced by 1	0.025
	Employment Level	Reduced by 1	0.025
	Gross Domestic Product	Reduced by 1	-0.019
4. VAT (7.6%)	Gross Average Salary	Reduced by 1	-
	Employment Level	Reduced by 1	-
	Gross Domestic Product	Reduced by 1	-0.072
Total	Gross Average Salary	Reduced by 1	-0.202
	Employment Level	Reduced by 1	-0.076
	Gross Domestic Product	Reduced by 1	

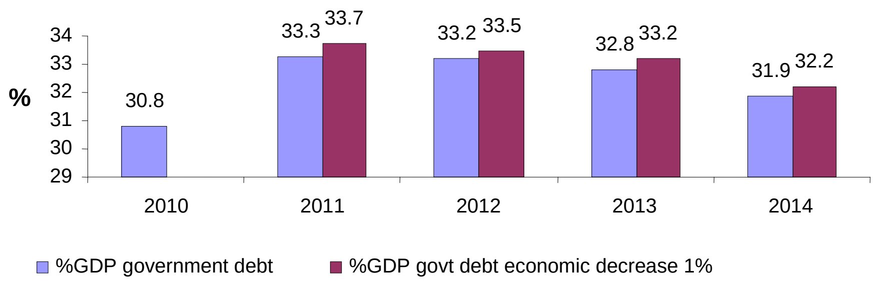
Source : MoPF

Public Debt Sensitivity Analysis

This chapter treats the influence of economic growth on the government debt share to GDP, the influence of the domestic currency appreciation/depreciation against the euro and the increase of interest rates on the interest payments made in conjunction with the government debt.

1. The analysis of the Economic Growth Impact on Government Debt Balance in the baseline scenario is in line with the projections included in the medium term macroeconomic framework with the alternative scenario built on the assumption that the economic growth will be lower by around 1% compared to the baseline scenario:

Chart 4.1 Impact of a reduced economic growth on the government debt

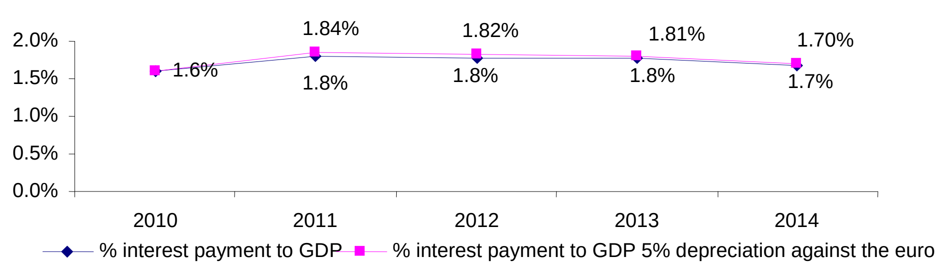


Source: MPF

As in the above diagram, the influence an economic growth under expectations will have a relatively continuous negative impact on the indebtedness, with the latter increasing by 0.3-0.4 % of GDP.

2.a) The analysis of the influence of appreciation/depreciation of the domestic currency against the euro on the interest payments in the baseline scenario and in the alternative scenario, where the domestic currency drops by 5% compared to the European currency, which is the main denomination of the foreign government debt:

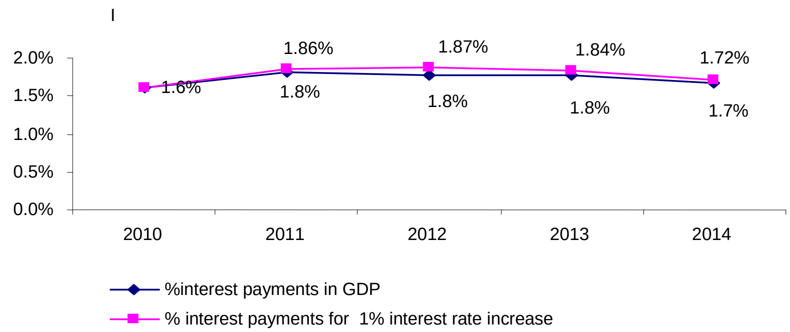
Chart 4.2 The influence of the domestic currency depreciation on interest payments



Source: MPF

b) Influence of the interest rate increase on the interest payments, in the baseline scenario and in the alternative scenario where the assumption is that interest rates for government securities as well as floating rates (Euribor and LIBOR) will go up by 1% compared to the baseline scenario.

Chart 4.3 Influence of the interest rates increase on interest payments



Source:

MPF

In both cases (2a and 2b) the negative impact of the factors on the interest payments is relatively low (below 0.1% of GDP).

4.3 Comparison with the previous edition of the Convergence Programme

Macroeconomic Framework

The medium term macroeconomic scenario presented in this edition is not substantially different from the one from the last edition of the Convergence Programme issued in February 2010, with regard to the macroeconomic developments in 2011-2012.

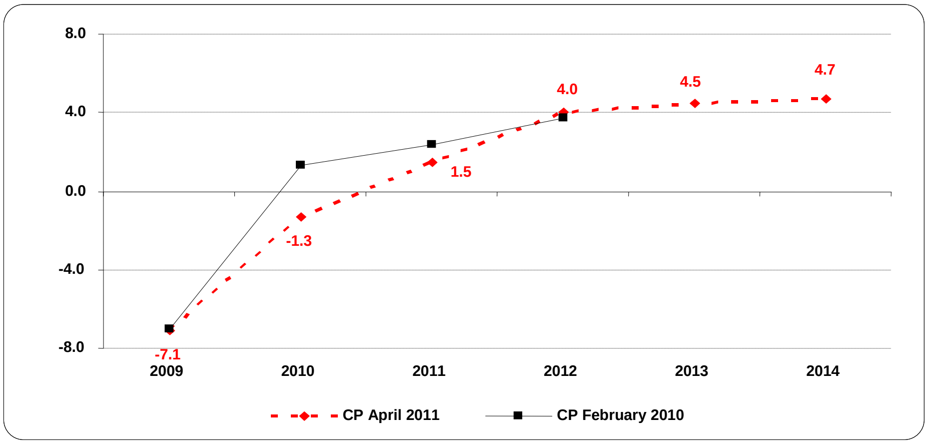
The source of differences between the two programmes is, in principal, related to the updated statistical information for 2009-2010, the base effect of these updates for the indicators that are substantially different compared to the previous forecast, as well as the short term effect of the fiscal consolidation and budget deficit reduction measures implemented in the second half of 2010.

Hence, in the previous Convergence Programme, the end of the recession was forecast for the year 2010, as the gross domestic product was expected to go up to 1.3%. According to statistical data, that took into account the effect of the budget expenditures cut and the increased VAT, the recession is continuing, at a slower pace than in 2009 (-7.1%) and the 2010 autumn forecast respectively ; the gross domestic product decreased by 1.3% compared to 1.9% in the autumn forecast.

As a result of the developments described above, the 2011 GDP is expected to go up by 1.5% and not by 2.4% as estimated in the previous edition, mainly due to exports of goods and services. The prognosis for 2012 forseen the acceleration of economic activity at a slightly increased pace compared to the previous edition, i.e. 4.0% compared to 3.7%, supported by both exports and the domestic demand.

Chart 4.4 Comparison of GDP increase estimates

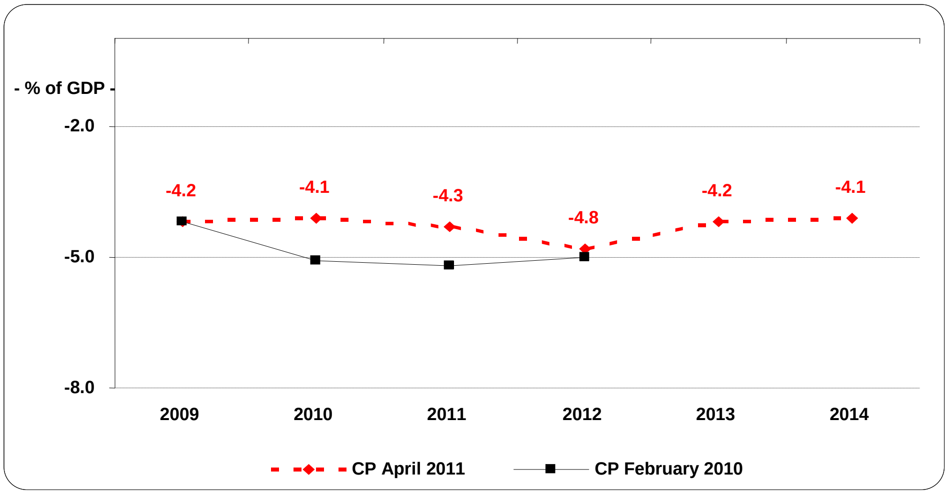
- annual percentage change -



Source: National Commission of Prognosis
CP February 2010 = February 2010 Convergence Programme
CP April 2011 = April 2011 Convergence Programme

The current edition of the Convergence Programme includes differences (compared to the previous programmes) in the projections regarding the composition of the domestic demand and the answer of the domestic supply to these demand. These differences come, on one hand, from the trend of recent achievements and, on the other hand, from the changes in the economic and budgetary policies.
The forecast for 2011 and 2012 were revised to reflect the 2010 data showing a trade deficit and a current account deficit as GDP share below the values presented in the previous convergence programme, and the recent achievements of 2011.
Hence, in 2011-2012 we expect higher annual average increases of exports and imports of goods than the previous edition, compatible with current account deficits below 5% of GDP, which is lower than in the previous edition when the forecast was above 5%.

Chart 4.5 Comparison of GDP shares of current account deficits

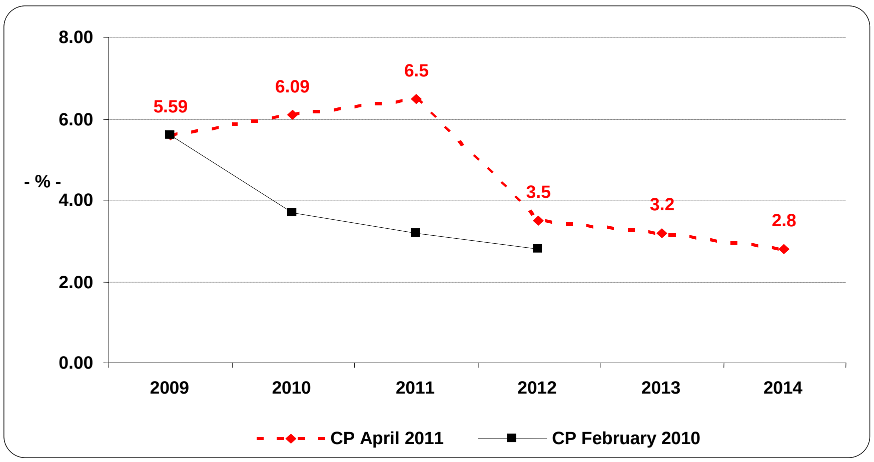


Source: National Commission of Prognosis

In 2010, the consumer prices in terms of annual average deviated from the disinflation trend projected in the previous Convergence Programme, and was above the 2009 annual average inflation by 0.5 percentage points. Hence, in 2010, the annual average inflation increase was 6.09%, higher by 2.39 percentage points compared to the 3.7% average estimated in the latest Programme edition. The deviation comes from fiscal adjustments (VAT, excise duties) and the increase, above expectations, of food and fuel prices.

The average inflation rate in 2011 is expected to go up to 6.5%, which is higher by 3.3 percentage points compared to previous estimates. This comes from the ongoing effect of the VAT rate increase in July 2010 and the substantial increase of food prices in the first months of the year.

Chart 4.6 Comparison of annual average inflation projections



Source: National Commission of Prognosis

Budget Deficit Comparison

In the previous Convergence Programme edition, the 2010 budgetary deficit was projected at 6.3% of GDP based on the budget approved by the Parliament. However, due to difficult economic developments, the budget was revised in August 2010[20], the deficit target based on actual payments as set in the *Stand-By Agreement* being at 6.8% of GDP. **The 2010 budget deficit** amounted to 33.5 billion lei, accounting for 6.5% of GDP, below the 6.8% target agreed with the IMF. This went down compared to 2009 from 7.3% to 6.5% of GDP due to a slight increase of budget revenues and **strict expenditure control**, under the conditions of some *additional* expenditures registered as interests, unemployment benefits, arrears or EU-funded projects.

Table 4.2 Budget deficit comparison

-% of GDP-

	2009	2010	2011	2012
1. Convergence Programme February 2010	8.0	6.3	4.4	3.0
2. Convergence Programme April 2011	8.5	6.4	4.9	3.0
3. Variations (1-2)	-0.5	-0.1	-0.5	0.0

Source: Ministry of Public Finance

20 Government Ordinance 18/2010

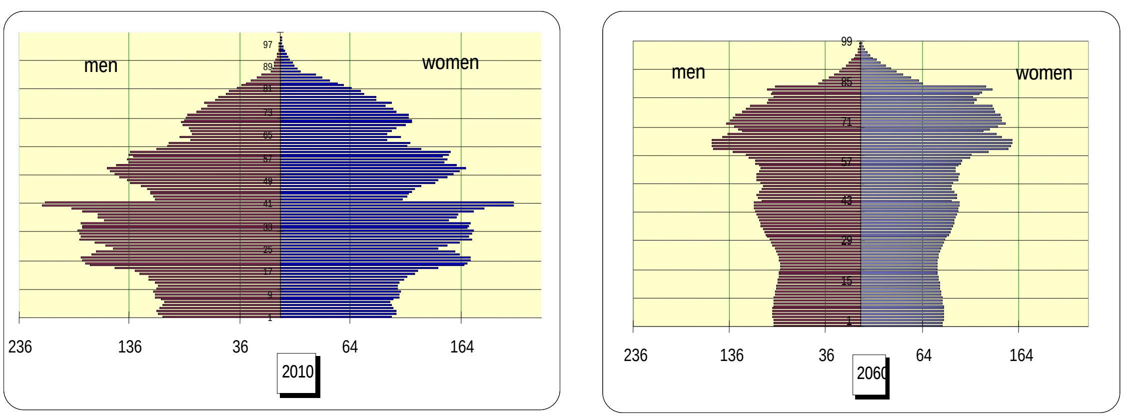
5. LONG TERM SUSTAINABILITY OF PUBLIC FINANCE

The Romanian pension system sustainability was assessed in the 2009 Sustainability Report which was based on estimates of population ageing-related expenditures in 2008-2060 as provided in the Ageing Report[21]. According to the conclusions of this report, the EU pension systems in the following decades are likely to become non-sustainable with a budgetary impact of the ageing population exceeding by far the costs of the financial and economic crisis.

Taking into account the fiscal sustainability, Romania was placed among the high risk countries along with Czech Republic, Ireland, Spain, Greece, Cyprus, Latvia, Lithuania, Malta, The Netherlands, Slovenia, Slovakia, and Great Britain. The sustainability gap indicators calculated at that time (under the circumstances of the year 2008) emphasized for Romania the need for a sustainable improvement of the primary budget balance, as a move to ensure fiscal sustainability. Basically, given the accelerated ageing process, the requirement for reducing the sustainability gap is to reduce the structural budget deficit simultaneously with creating fiscal space for public investments. In addition, a policy mix is necessary to increase revenues and cut budget expenditures in parallel with reforming social assistance and the health systems, in order to slow down the pace of ageing related expenditures. Taking into account the demographic trends in line with Eurostat estimates (EUROPOP 2008) the projections for Romania indicated a non-sustainable path of the public pension system, that was to place Romania, in 2060, on the fifth position among the EU Member States with a high GDP share of pension expenditures (after Greece, Luxembourg, Slovenia and Cyprus).

Under the circumstances, the measures taken in the recent years aimed at limiting the social assistance expenditures and the public pension system reform implemented this year include measures for enlarging pension contribution base in parallel with reducing additional costs generated by population ageing, representing important steps towards the improvement of long term sustainability of public finances.

Chart 5.1. Age Pyramid in 2010 and 2060



Source: Eurostat, Europop 2010

[21] Ageing Report, published in May 2009, the first Romanian contribution to this type of long term forecast.

5.1 The Pension Sector

In the medium and long run, developments in the pension sector are strongly under the influence of demographic factors such as the birth rate, life expectancy and the inevitable ageing process.

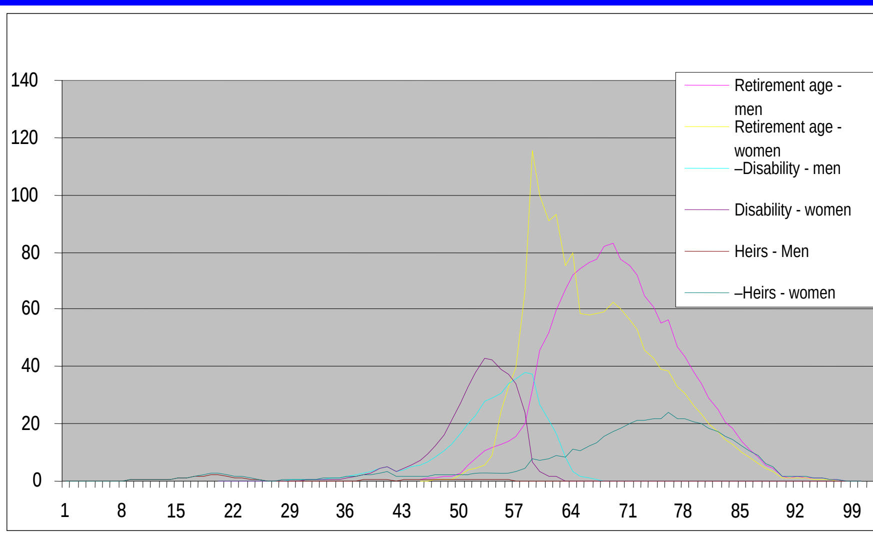
The demographic forecast for Romania, as recently assessed by Eurostat (EUROPOP 2010), maintains the 2008 data concerning regarding accelerated ageing. The forecast show a decrease by 37% of the population between 20 and 65 compared to a decrease of only 20% of the total population in 2010-2061, due to a low birth rate. Population over 65 will increase around 1.9 times, while population aged between 20 and 55 will actually halve.

The ageing process will have a negative impact on the labor market. The ratio between people over 65 and working age population (between 20 and 65) will grow substantially, which means that for the next 10 to 20 years the public pension system will have less resources than needed to cover expenditures.

In addition, the age composition of the retired persons shows a high share of relatively young pensioners (between 45 and 55) especially with disability pensions.

In the light of the above, the recent measures concerning the limited access to disability pensions, combined with increased retirement age for women may have a substantial contribution to limit the number of pensioners over the next years, especially considering that in 2025-2030 the number of people over 65 is expected to increase rapidly.

Chart 5.2 Number of retired by category, age and gender



Source: CNPAS

The long term forecast of pension expenditures took into account the EUROPOP 2010 demographic assumptions released by Eurostat and the forecasts of the National Commission for Prognosis regarding employment market developments and macroeconomic indicators, considering the legislation in force at January 1, 2011 as the constant policies background.

The forecast is based on the legal measures introduced by the pension law, as follows:

- A new indexation formula as of 2012;

- Until 2020, the pension point will be increased annually by 100% of the inflation rate, plus 50% of the real gross average earning increase of the previous year. If one of the indicators has a negative value, the one with a positive value will be used;
- From 2021, it will be increased annually by 100% of the inflation rate plus 45% of the actual increase of the gross average earning of the previous year, a percentage that is to be gradually reduced by 5% every year; as for 2030 only 100% of the inflation rate
- Retirement age gradually increased to 63 for women until 2030;
- Inclusion of the categories that have not contributed to the system before (military, police etc);
- Reduce early retirements and limit the number of disability pensions;
- Increase the contribution base by including new categories, such as liberal professions.

The measure of freezing the pension point at the 2010 level is still in force in 2011, to keep social assistance expenditures under control.

Table 5.1 Long Term Projection Of Pension Expenditures

% GDP

	2011	2030	2040	2050	2060
Social Insurance [22], of which,	9.0%	10.8%	11.3%	11.5%	10.8%
Pillar 1	8.8%	10%	11.3%	11.5%	10.8%
Pillar 2		0.1%	0.5%	1.5%	1.7%

Source: MPF

The results of the pension model show a slight increase of total pension expenditures to GDP ratio to around 11% at the end of the forecasted interval.

Pillar 2 will have an increasing share in total pension expenditures starting with 2050, and it will reach 1.7% of GDP in 2060.

5.2 The Health Sector

Health indicators showed a progress in the recent years, but they are still low compared to the EU average. Aiming to improve health care quality and efficiency and to increase population access to health care, the health sector reform has been started. With technical assistance provided by WB experts, the Ministry of Health elaborated the National Rationalization Strategy of the hospitals and health care system, whose activities started already and will be completed by 2012.

The main reform objectives include:

- prepare a legal and institutional framework allowing the development of the domestic health care system in conjunction with the European system;
- improve medical care quality and increase access to prevention and treatment;
- decentralize the organizational and decision making process, cut red tape in the health care system;
- introduce IT systems and make the health card operational;

22 Including the retired from the farming sector.

- redefine the basic medical service package;
- increase patients’ access to modern treatment, with reasonable prices, by introducing a new drug pricing policy;
- develop the private health insurance system;
- reduce in-patient by an improved management of self-financed hospitals;
- improve financing to develop the primary care and out-patient care system;
- develop and consolidate the emergency care and paramedics system;
- develop and plan human resources in health care sector.

To secure the funds needed to implement a health care system in line with the European standards, the following measures were adopted:

- the contribution base was expanded by increasing the number of contributors;
- the “claw back”[23] system was introduced to top up resources available in the health sector;
- medication cost efficiency was improved by introducing the reference prices and reducing the margins of the medication prices;
- decentralization of authority;
- hospital rationalization process was started to improve quality and efficiency of services;
- co-payment was introduced;
- the Single National Health Insurance Fund (FNUASS) was introduced at county health house level, and its efficiency was improved by introducing the custom of reimbursements based on practice protocols.

23 Drug manufacturers will gradually contribute to the drug prices purchased or compensated by the government.

6. THE QUALITY OF PUBLIC FINANCE

6.1 Policies strategy

For the economic growth to gradually pick up as of 2011 and consolidate over the medium term, the requirement is to preserve a prudential macroeconomic policy mix as a move to allow automatic stabilizers to operate. In addition, under a medium term budgetary framework, the predictable fiscal and budgetary policies have to continue; these have to be performance-oriented and focus on stable sectoral priorities, in line with the overall macroeconomic objectives. Improved efficiency, effectiveness and quality of public spending is a support to the fiscal discipline required under the Stability and Growth Pact as well as to structural reforms in line with the European Semester and the EU 2020 Strategy. As shown in the European Commission papers, public finance quality strongly impact on the economic environment, growth and standard of living.

6.2 Expenditure composition, efficiency and effectiveness

The main challenge in the short and medium run is to carry on with reforms started in the public finance sector and continue adjustments of macroeconomic and budgetary imbalances, against the background of the Romanian economic visibly on the path of stability, improvement and gradual resumption of economic growth. Measures for the increase of VAT rate and salary cuts implemented in 2010 have led to a substantial short term increase of the fiscal room for investments by consolidation of revenue base and decrease of salary operating expenditures. Wage and pension reforms adaptation and implementation will increase transparency and long term sustainability of public finance. It is important to keep the momentum and continue with these reforms at micro-economic level by improving our ability to prioritize, implement and follow up on public investments, increase efficiency in spending public money and improve EU funds absorption rate.

Key-objectives on the medium term:

- continue the process of reducing the budget deficit;
- increase budget policies predictability on a medium term;
- rationalization of operating expenditures and further increase the additional fiscal room for investments;
- improve EU funds absorption;
- improve medium and long term public finance sustainability;
- ensure intergenerational equity.

The main objective of the budgetary policy is to reduce the budget deficit to less than 3% of GDP in 2012 in line with the IMF and EU Stand-By commitments. Increase the quality of public finance by continuing the adjustment of operating expenditures and promoting sustainable policies to consolidate budget revenues through improved collection and reduced evasion is an essential move to continue public finance consolidation with a high public investment and EU funds absorption rate. These objectives will be facilitated by a more favorable domestic and European macroeconomic environment, reflected in a gradual recovery and sustainability of economic growth.

Reforms of the wage system and the pension and social insurance system were implemented to improve the medium and long term public finance sustainability. These reforms included the adoption of wage and pension laws, as well as of the fiscal - budgetary responsibility law expected to strengthen the budgetary policy implementation framework.

The main changes introduced by the pension system reforming law include the increase and gradual equalization of retirement ages for men and women, move to an inflation indexation system and expand the contribution base by including former non-contributors.

The single pay law introduced the guiding principles for a new unified payment system for the general government staff. The single pay law aims at increasing transparency, simplify the salary system and improve its financial sustainability by setting up correlated wage increases so that the personnel expenditures share to GDP could be cut down from 9.4% in 2009, to 7.5% of GDP in 2011 and 7.2% in 2012.

7. INSTITUTIONAL FEATURES OF THE PUBLIC FINANCE SYSTEM

The economic and budgetary policy in Romania over the years before crisis has brought domestic and foreign imbalances that must be corrected in the upcoming period. Sustainable lower budget deficits involve a budget process revision and important reforms of the revenues and expenditures policies. To this end, the Government has adopted the fiscal - budgetary responsibility Law, expected to introduce substantial changes of the institutional framework for the implementation of the budgetary policy. The provisions of the law:

- ✓ set up improved procedures to prepare multi-annual budgets;
- ✓ establish ceilings for the budget revisions during the year;
- ✓ foresees fiscal rules with regard to total expenditures, staff expenditures and the pension expenditures;
- ✓ set up a fiscal council in charge of performing an independent review of macroeconomic and budgetary forecasts;
- ✓ establishes a framework for issuing and managing the guarantees and other collateral obligations.

The fiscal-budgetary responsibility law provides for the preparation and implementation of a credible 3-year fiscal and budgetary Strategy, that includes a macroeconomic framework, a fiscal and budgetary framework, a medium term expenditure framework and a statement of responsibility.

The fiscal and budgetary responsibility principles include: (a) maintaining a prudential level of the government debt to allow fiscal sustainability; (b) ensuring a balanced general consolidated budget during the economic cycle; (c) a prudential management of liabilities, assets and fiscal risks in the public sector, to avoid burdening the next generations; (d) ensure the predictability of the taxation system; and (e) keeping an adequate fiscal reserve level to allow foreign debt servicing.

ANNEXES

Table 1a. Macroeconomic Prospects

	ESA Code	2010	2010	2011	2012	2013	2014
		Level [1)] Billion lei	Percentage change				
1. Real GDP	B1*g	491.7	-1.3	1.5	4.0	4.5	4.7
2. Nominal GDP	B1*g	513.6	3.1	5.5	8.9	9.1	9.3
Components of real GDP							
3. Private consumption expenditure	P3	306.3	-1.7	1.9	3.9	4.2	4.4
4. Public consumption expenditure	P3	87.5	-3.6	-1.1	1.5	1.8	1.9
5. Gross Fixed Capital Formation	P51	113.5	-13.1	3.4	5.8	7.8	8.5
6. Change in inventories and net acquisition of valuables (% of GDP)	P52	-	4.1	-0.2	-0.2	-0.2	-0.2
7. Exports of goods and services	P6	173.5	13.1	8.1	9.7	9.5	9.6
8. Imports of goods and services	P7	205.0	11.6	7.1	8.3	8.7	9.5
Contributions to real GDP Growth							
14. Final domestic demand		-	-5.2	1.8	4.1	4.8	5.1
15. Change in stocks	P52	-	4.1	-0.2	-0.2	-0.2	-0.2
16. Net exports	B11	-	-0.2	0.0	0.1	0.0	-0.2

[1)] The real GDP level and its components is in the previous year’s prices.

Table 1b. Price Developments

	2010	2011	2012	2013	2014
	Percentage change				
1. GDP deflator	4.5	3.9	4.8	4.4	4.5
2. Private consumption deflator	4.9	4.9	5.0	4.4	4.2
3. HICP	6.1	6.5	3.5	3.2	2.8
4. Public consumption deflator	-3.8	2.8	3.9	3.5	3.4
5. Investment deflator	2.9	4.4	5.5	3.5	3.2
6. Export price deflator (goods and services)	6.0	3.4	3.6	3.8	3.0
7. Import price deflator (goods and services)	3.2	2.3	2.5	1.5	2.0

Table 1c. Labor Market Developments

	ESA Code	2010	2010	2011	2012	2013	2014
		Level thousand persons	Percentage change				
1. Employment, persons[1)]		9035	-1.8	0.4	0.6	0.5	0.4
2. Employment, hours worked[2)]		17039837	-1.6	0.6	0.4	0.3	0.3
3. Unemployment rate (%)[3)]		-	7.3	6.4	6.2	6.0	5.8
4. Labour productivity[4)]		-	0.5	1.1	3.3	3.9	4.2
5. Labour productivity, hours worked [5)]		-	0.3	0.9	3.5	4.2	4.3
6. Compensations to employees – mil.lei	D1	208360	2.3	4.5	7.3	7.4	6.9
7. Compensation per employee		31411	1.3	3.9	6.5	6.7	6.4

[1)] *Occupied population, domestic concept national accounts definition*
[2)] *National accounts definition*
[3)] *Harmonised definition, Eurostat levels (Labor Force Survey – AMIGO)*
[4)] *Real GDP per employed person*
[5)] *Real GDP per hour worked*

Table 1d. Sectoral Balances

% of GDP	ESA Code	2010	2011	2012	2013	2014
1. Net lending/borrowing, vis-à-vis the rest of the world	B9	-3.9	-3.9	-4.0	-3.4	-3.2
of which:						
- Balance of goods and services		-5.4	-4.8	-4.0	-2.8	-2.4
- Balance of primary incomes and transfers		1.3	0.5	-0.8	-1.4	-1.7
- Capital account		0.2	0.4	0.8	0.8	0.9
2. Net lending/borrowing of the private sector	B.9	2.4	0.8	-1.6	-1.5	-1.9
3. Net lending/borrowing of general government	EDP B.9	-6.3	-4.7	-2.4	-1.9	-1.3
4. Statistical discrepancy		-	-	-	-	-

Table 2. General Government Budgetary Prospects

	ESA Code	2010	2010	2011	2012	2013	2014
		Level in mil. lei	% of GDP				
1. General Government	S.13	-33074.4	-6.4	-4.9	-3.0	-2.6	-2.1
6. Total revenue	TR	176383.9	34.3	34.3	34.5	34.6	34.7
7. Total expenditures	TE[1)]	209458.3	40.7	39.2	37.6	37.2	36.7
8. Net lending/borrowing	EDP B.9	-33074.4	-6.4	-4.9	-3.0	-2.6	-2.1
9. Interest expenditure	EDP D.41	7994.0	1.6	1.8	1.8	1.8	1.7
10. Primary balance[2)]		-25080.4	-4.8	-3.1	-1.2	-0.8	-0.4
11. One-off and other temporary measures[3)]							
12. Total taxes (12=12a+12b+12c)		93841.4	18.3	18.5	19.7	19.7	19.7
12a. Taxes on production and imports	D.2	62209.0	12.1	12.4	13.6	13.6	13.6
12b. Current taxes on income, wealth, etc.	D.5	31632.4	6.2	6.1	6.1	6.1	6.1
12c. Capital taxes	D.91						
13. Social contributions	D.61	49545.6	9.6	9.6	9.1	8.8	8.8
14. Property income	D.4	4438.5	0.9	1.0	1.1	1.2	1.2
15. Other[)]		28558.4	5.5	5.2	4.7	5.0	4.9
16=6. Total revenue	TR	176383.9	34.3	34.3	34.5	34.6	34.7
p.m.: Tax burden (D.2+D.5+D.61+D.91-D.995) [5)]							
17. Compensation of employees + intermediate consumption	D.1+P.2	85128.3	16.6	16.1	14.8	14.4	14.3
17a. Compensation of employees	D.1	49200.6	9.6	8.5	8.3	8.0	7.9
17b. Intermediate consumption	P.2	35927.7	7.0	7.5	6.6	6.4	6.4
18. Social payments (18=18a+18b)		70745.6	13.8	13.1	12.7	12.2	11.9
18a. Social transfers in kind supplied via market producers	D.6311, D.63121, D.63131	3049.4	0.6	0.6	0.6	0.5	0.5
18b. Social transfers, other than in kind	D.62	67696.2	13.2	12.5	12.2	11.7	11.4
19=9. Interest expenditure	EDP D.41	7994.0	1.6	1.8	1.8	1.8	1.7
20. Subsidies	D.3	3993.5	0.8	0.6	0.5	0.4	0.3
21. Gross fixed capital formation	P.51	28295.5	5.5	6.1	6.4	6.9	7.2
22. Other [6)]		13301.4	2.5	1.5	1.4	1.5	1.3

	ESA Code	2010	2010	2011	2012	2013	2014
		Level in mil. lei	% of GDP				
23=7. Total expenditures	TE1	209458.3	40.7	39.2	37.6	37.2	36.7

1) Adjusted for the net flow of swap-related, meaning TR-TE=EDP B9
2) The primary balance is calculated as (EDP B9, item 8) plus (EDP D.41, item 9)
3) A plus sign means deficit-reducing one-off measures
4) P.11+P.12+P.131+D.39+D.7+D.9 (other than D.91)
5) Including those collected by EU and including the adjustment for uncollected taxes and social contributions (D.995)
6) D.29+D4 (other than D.41)+D.5+D.7+D.9+P.52+P.53+K.2+D.8

Table 3. Government Debt

% of GDP	SEC Code	2010	2011	2012	2013	2014
1. Gross Debt [1]		30.8	33.3	33.2	32.8	31.9
2. Change in gross debt ratio		7.2	2.5	-0.1	-0.4	-0.9
Contribution to changes in gross debt						
3. Primary balance[2]		-4,8	-3,1	-1,2	-0,8	-0,4
4. Interest expenditure [3]	EDP D.41	1,6	1,8	1,8	1,8	1,7
5. Stock-flow adjustment		0.8	-2.4	-3.1	-3.0	-3.0
of which:						
- Differences between cash and accrual[4]		-0,06	-0,06	-0,08	-0,09	-0,01
- Net accumulation of financial assets		0,0	0,0	0,0	0,0	0,0
of which:						
- privatization proceeds		0,0	0,0	0,0	0,0	0,0
- valuation effects and other [5]		0.9	-2.3	-3.0	-2.9	-3.0
p.m. Implicit interest rate on debt[6]		5,8	5,8	5,6	5,6	5,4
Other relevant variables						
6. Liquid financial assets[7]		2,2	2,1	1,9	1,7	1,6
7. Net financial debt (7=1-6)		28,6	31,2	31,3	31,1	30,3

1) As defined in Regulation 3605/93
2) Cf. item 10 in Table 2
3) Cf. item. 9 in Table 2
4) Difference between cash interest and accrual interest
5) Changes from appreciation/depreciation of foreign currency debt, the discount/premium of T-Bills issuances/redemptions, on-lending and other.
6) Ratio between annual interest payments and average stock of debt
7) Funds from privatization available in MPF account.

Table 4. Cyclical Developments

% of GDP	ESA Code	2010	2011	2012	2013	2014
1. Real GDP growth (%)		-1,3	1,5	4,0	4,5	4,7
2. Net lending of general government	PDE B.9	-6,4	-4,9	-3,0	-2,6	-2,1
3. Interest expenditure (including SIFIM in consumption)	PDE D.41	1,6	1,8	1,8	1,8	1,7
4. One-off and temporary measures						
5. Potential GDP growth (%)		0,6	1,2	3,5	4,2	4,6
Contributions:						
- Labour		0,0	0,0	0,0	0,0	0,0
- Capital		0,8	0,9	1,0	1,5	1,8
- Total Factor Productivity		-0,2	0,3	2,5	2,7	2,8
6. Output Gap		-1,5	-1,3	-0,9	-0,6	-0,5
7. Cyclical budgetary component		-0,4	-0,4	-0,3	-0,2	-0,2
8. Cyclicaly adjusted balance (2-7)		-6,0	-4,5	-2,7	-2,4	-1,9
9. Cyclically adjusted primary balance (8+3)		-4,4	-2,7	-0,9	-0,6	-0,2
10. Structural Balance (8-4)		-6,0	-4,5	-2,7	-2,4	-1,9

Table 5. Divergence from previous update

	ESA Code	2010	2011	2012	2013	2014
Real GDP growth (%)						
Previous update		1.3	2.4	3.7	-	-
Current update		-1.3	1.5	4.0	4.5	4.7
Difference		-2.6	-0.9	0.3	-	-
General government net lending (% of GDP)						
Previous update	PDE B.9	-6.3	-4.4	-3.0	-	-
Current update	PDE B.9	-6.4	-4.9	-3.0	-2.6	-2.1
Difference 2-1		-0.1	-0.4	0.0	-	-
General government gross debt (% of GDP)						
Previous update		28.3	29.4	29.7		
Current update		30.8	33.3	33.2	32.8	31.9
Difference		2.5	3.9	3.5		

Table 6. Long Term Sustainability of Public Finance							
% of GDP	**2007**	**2010**	**2020**	**2030**	**2040**	**2050**	**2060**
Total expenditures	33.6	40.7	41.5	43.0	43.5	43.3	42.2
of which: age-related expenditures							
Pension expenditure	6.7	9.0	10.5	10.8	11.3	11.5	10.8
Health Care	3.3	3.4	3.8	4.2	4.4	4.7	4.9
Education expenditure	2.8	2.4	2.3	2.2	2.1	2.2	2.3
Total revenues	33.2	34.3	38.5	40.0	40.5	40.0	39
Assumptions							
		- Average rates -					
Labour productivity growth	5.9	0.7	4.4	3.8	3.4	3.1	2.8
Real GDP growth	6.3	-0.5	4.2	3.5	3.0	2.8	2.5
	- % -						
Participation rate – males (aged 20-64)	76.4	76.9	79.5	81.8	83.4	84.0	84.5
Participation rate - females	61.2	59.9	67.6	69.4	70.6	71.2	71.7
Total participation rates	68.7	68.3	73.5	75.6	76.9	77.6	78.0
Unemployment rate – ILO	6.4	7.3	5.2	5.0	4.8	4.6	4.4
Population aged 65 and over of the total population	14.9	14.9	15.8	18.0	20.0	21.5	24.0

Source NCP, MPF, 2009 Ageing Report

Participation rate refers to working age population (20-64).

Average rates refer to the mentioned interval.