



**GOVERNMENT OF ROMANIA**

**CONVERGENCE PROGRAMME  
2009-2012**

- March 2010-

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**List of Acronyms**

NBR – National Bank of Romania

ILO – International Labour Office

EC– European Commission

HEQNF – Higher Education Qualification National Framework

SMEs– Small and Medium-Sized Enterprises

GDP - Gross Domestic Product

LPS – Labour Public Service

EU - European Union

## Introduction

The current updated edition of the 2009-2012 Convergence Programme is based on the provisions laid down in the EC Regulation No. 1055/2005, which amends EC Regulation 1466/1997 regarding the strengthening of the budgetary and economic policies surveillance and coordination.

Responding to EC requirements, the fourth edition of the Convergence Programme, observes the methodology adopted by Ecofin Council on October 10, 2005. Moreover, the current edition takes into account the "European Council's Opinion" regarding the third edition of Romania's Convergence Programme, which recommends a more restrictive budgetary policy for the following years and a revised content of the public expenditure structure.

For updating the Convergence Programme, the Ministry of Public Finance took into account the latest developments and projections of the domestic and international economic environment, as well as the existing legal framework, including the approved 2010 budget.

One of the objectives assumed by the fiscal policy during the forecasting period is the reconciliation between the reduction of the budget deficit and meeting on a sustainable basis of the convergence nominal criterion while at the same time elaborating the necessary set of measures aiming to contain the effects of the global economic and financial crisis on the Romanian economy. To this purpose, the budget policy aims at smoothing functioning of the economy through the cycle, reducing the inflationary pressures and containing the external imbalances.

The fourth edition of the Convergence Programme describes the Romania's ability of diminishing the structural deficit to less than 1% of the GDP up to 2014, and creating a safety margin to avoid exceeding the 3% level.

Romania maintains its commitment of adopting the euro currency by the 1st of January 2015, being an important anchor in promoting the necessary budgetary and structural reforms aiming at increasing the flexibility of the Romanian economy.

## 2. OVERALL ECONOMIC POLICY FRAMEWORK

### 2.1 Overall economic policy context

Starting with 2008 the global economy has been confronting the deepest economic downturn since the Great Recession in 1930. The crisis had a high level of synchronization, both the developed and the emerging economies being affected, showing a significant increase of the inter-dependence between the world economies. In the context of a more and more globalized world and our strong trade linkages, the financial crisis started to impact the Romanian economy by the fourth quarter of 2008.

In this context, the short term Government's priority has been to sustain the economic recovery process, to create new jobs and to improve the sustainability of the public finance.

Despite the limited budgetary space, due to the expansionary macroeconomic policies promoted in the previous period, the Government had a timely reaction in 2009 and implemented a set of measures to contain the spread of the crisis and to create the needed recovery conditions aiming:

- ✓ to stimulate the demand by increasing the purchasing power for dwellings (First House Programme), for cars (Rabla Programme), sustaining the export activity (capitalization of Eximbank);
- ✓ to stimulate the investments (removal of the reinvested profits tax, allocation of resources for investments in the dwellings thermic rehabilitation);
- ✓ to stimulate the agriculture (First Silo Programme);
- ✓ social measures (the two steps increase of the social pensions to the lower income segments of retired people);
- ✓ to protect labour market (technical unemployment, allocation for „Funds for more competitive and healthy employees programme”, the extension by three months of the unemployment benefit period).

Moreover, the Romanian Government has signed a multilateral financial agreement with the International Monetary Fund, the European Commission, the World Bank, and with other international financing institutions, amounting to EUR 19,95 billion, for a 24 months period.

The Programme created the right conditions for an orderly adjustment of the external deficit, ensured an adequate financing level and represented a solid anchor for the perspective of the Romanian economy.

The implemented measures were well-targeted, timely and coordinated with the provisions of the European Economic Recovery Plan. Their impact is rather difficult to be quantified given the uncertainty regarding the relationships between the various instruments of economic policy and the macroeconomic indicators in the context of a more pronounced macroeconomic volatility environment. If the programme would not have been implemented, the contraction rate of the real GDP and the secondary effects on the labour market, specifically on the employment and unemployment, would have been higher, involving a greater opportunity cost for the overall economy and society.

Despite the unavoidable short term costs, the crisis has to be seen as a major opportunity for implementing structural and budgetary reforms which will lead to the long term increase of the capacity of Romanian economy to face global competitive pressures, to attract foreign direct investments and create new jobs.

## **2.2. Government objectives and priorities**

According to the Governing Programme and the EU objectives provided by the re-launched Lisbon Strategy, the Broad Economic Policy Guidelines and the European Union's Stability and Growth Pact, the medium term Government Economic Strategy is focused on the following objectives:

- (a) promote the economic recovery and create new jobs;
- (b) adjust the current account and public deficits, continue the disinflation process;
- (c) protect the population categories most affected by the economic crisis;
- (d) improve the medium-term predictability and performance of the fiscal policy, maximize and improve efficiency of the use of the European Union funds;
- (e) ensure the long term public finance sustainability;
- (f) restructure and improve the efficiency of the public administration
- (g) firmly implementation of the commitments assumed by the multilateral financial agreement with the International Monetary Fund, the European Commission, the World Bank, and the other international financing institutions.



The Government's vision on the fiscal policy area focuses on ensuring a motivating and unbiased environment, being at the same time centered on measures aiming at consolidating the transparency, stability and predictability of the fiscal policies. In addition, improving the sustainability of the public finances is a crucial objective taking into account the adverse demographic trends. The consolidation of the tax base continues to be the key to ensuring the necessary resources for the economic development and the fulfillment of Romania's commitments as an EU Member State. As far as regarding the specific medium term objective, the underlying assumption is that the structural deficit will reach 0.7% of GDP in 2014, ensuring the symmetrical functioning of the automatic stabilizers with a view to limit the volatility of the economy. This level will allow a safety margin to avoid exceeding the budget deficit ceiling of 3% of GDP, in the event of potential negative shocks associated to the economic growth rate.

### 2.3 Monetary and exchange rate policies

In compliance with its statute<sup>1</sup>, the primary objective of the National Bank of Romania 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 this policy to provide a flexible response to potential shocks that may hit the economy.

Considering the need to implement additional structural reforms leading to an increase in the Romanian economy's resilience and its capacity to withstand asymmetric shocks, the national currency is expected to enter the exchange rate mechanism II (ERM II) no sooner than 2012. This assertion also takes into account the need to fulfil other requirements, among which is the progress in fiscal consolidation, which would allow for the minimum two-year stay in ERM II. It is estimated that both the period prior to entering ERM II and the actual participation in this mechanism should be seen as major stages in the Romanian economy's convergence that is seen resuming after the economy's return to growth.

The gradual decline in the leu exchange rate volatility and its subsequent increased stability will be underpinned by the lowering/fading of the fallout from the global

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<sup>1</sup> Law No. 312/2004.

financial and economic crisis, on the one hand, and the country's sounder economic fundamentals – including the effect of implementing the economic policy mix agreed with the EU, the IMF and other financial institutions – and the further convergence process that may stabilise anticipations on exchange rate developments in the medium term, on the other hand. In addition, the likely maintenance of a significant productivity differential and the potential recovery of foreign direct investment in the medium run would pave the way for the leu to resume the appreciation trend versus the euro, which would entail benefits in terms of the Romanian economy's nominal and real convergence.

Given that the Romanian economy is still characterised by disinflation – without attaining, for the time being, a sustainable inflation rate in the medium term –, the inflation targets, expressed as a mid-point within a  $\pm 1$  percentage point variation band, are annual figures (December/December), and are set up by the National Bank of Romania in agreement with the government, for a two-year period of time.

Over the past few years, the annual inflation targets followed a downward path, their levels falling from 7.5 percent  $\pm 1$  percentage point in 2005 to 3.5 percent  $\pm 1$  percentage point in 2009 and 2010. The end-2011 inflation target was lowered to 3.0 percent  $\pm 1.0$  percentage point. The option for a more pronounced downtrend in annual inflation targets relied mainly on the prospects of a sustained deceleration of inflation in the years ahead, driven by the severe economic contraction in 2009, under the impact of the global financial and economic crisis, as well as the slow pace of recovery expected for the world economy, including the Romanian economy, in the post-crisis period. Another major reason behind the above-mentioned option was the target's capacity to fulfil the requirement of consolidating disinflation and ensuring achievement of the inflation criterion laid down in the Maastricht Treaty, in a manner consistent with the timetable for euro adoption, as well as the subsequent compliance with the European Central Bank's quantitative definition of price stability.

At the same time, the option for a 3.0 percent inflation target in 2011 reflects the National Bank of Romania's concern to set up realistic goals, this achievement being essential for enhancing the central bank credibility and, implicitly, for effectively anchoring medium-term inflation expectations. In this context, maintaining a prudent approach regarding the reduction pace for the 2011 target is substantiated by the

risks and uncertainties surrounding the magnitude of direct inflationary effects, further exerted by factors outside the central bank's area of influence, the most significant being: (i) adjustment of administered prices; (ii) resumption of convergence of the Romanian economy, including price convergence after the synchronised economic downturn is over; and (iii) the persistence of some asymmetric nominal rigidities.

Consolidation of disinflation at a pace required by the objective of achieving the annual inflation targets is still a challenge for the monetary policy. In 2009, one of the challenges arose from the need to ensure an orderly adjustment of the notable macroeconomic imbalances that had built up previously, as well as from the goal of preserving the financial stability in a context fraught with adverse effects from the global financial and economic crisis. At this juncture, ensuring sustainable disinflation, without jeopardising the economic growth potential in the medium term, was conditional on rebalancing and increasing the coherence and credibility of the macroeconomic policy mix and on accelerating structural reform measures. This implied strengthening income and fiscal policies so as to allow a gradual accommodation of the monetary policy stance to the developments in the real and financial sectors of the domestic economy that were increasingly hit by the global crisis.

The multilateral external financing arrangement signed by the Romanian authorities with the EU, the IMF and other international financial institutions, having a robust economic programme attached, supported such a calibration of the economic policy, likely to have a favourable impact on foreign investors' confidence in the domestic economy. The objective was to safeguard the economy against the adverse shocks of declining capital inflows during the period required for implementing the measures aimed at adjusting fiscal and external imbalances as well as strengthening the banking system. The previously strong depreciation pressures on the domestic currency have faded in the wake of signing the arrangement, leading to an improvement in investor sentiment towards the Romanian economy, but also as a result of a slight upturn in global risk appetite.

Upon initiating the tightening process of the fiscal and income policies and after the leu exchange rate had stabilised somewhat, also underpinned by the larger-than-expected adjustment of the current account deficit, monetary policy faced the challenge of relatively persistent core inflation over the short term, as revealed by its lagged response to the speed and magnitude of aggregate demand shortage

widening<sup>2</sup>. Adding to this challenge was the outlook for annual GDP dynamics remaining in negative territory over the upcoming quarters and a slower subsequent recovery in economic activity – based on the ongoing decline in confidence and financial deleveraging globally and hence domestically – as well as expectations of a faster disinflation over the medium term.

Against this background, the National Bank of Romania opted for a gradual adjustment of real broad monetary conditions, meant to preserve the prudent monetary policy stance. Thus, the central bank cut the policy rate from 10.25 percent to 8 percent during 2009 (February through September) in five steps. In addition, the central bank lowered in three stages, the minimum reserve ratio on credit institutions' foreign currency-denominated liabilities to 25 percent from 40 percent previously, while the minimum reserve ratio on foreign currency-denominated liabilities with residual maturities of more than two years from the end of the observation period and without contractual clauses, was cut in a single move to zero from 40 percent. Requires reserves on credit institutions' leu-denominated liabilities were lowered 5 percentage points to 15 percent. The National Bank of Romania's decisions aimed at consolidating the convergence of inflation rate towards medium-term objectives and ensuring the conditions for a sustainable revival of lending in the domestic economy. Reducing the minimum reserve ratio was also part of the process of gradual alignment to ECB standards in the field.

Given the anticipated *ex-ante* inflationary impact of the hike in excise duties on tobacco products starting 1 January 2010 and particularly the unfavourable effects on expectations coming from heightened risks related to fiscal and income policies amid rising tensions in domestic politics, the National Bank of Romania stopped the downward trend in the policy rate in 2009 Q4. In fact, due to higher prices of cigarettes and fuels, the disinflation process which had resumed in 2008 H2 broke off temporarily towards the end of 2009, with the annual inflation rate reaching 4.7 percent in December, slightly above the upper limit of the variation band around the central target set for year-end (3.5 percent  $\pm$ 1 percentage point), but 1.6 percentage points below the year-earlier level of 6.3 percent. On the other hand, disinflation related to the adjusted CORE2 measure picked up, its annual pace of growth falling to 2.8 percent in December 2009 from 6.3 percent in December 2008.

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<sup>2</sup> The 7.6 percent economic downturn seen in 2009 Q1 fed through only partly to the decline of annual core inflation January through September 2009 (from 6.3 percent in December 2008 to 4.2 percent in September 2009).

The subsequent stabilisation of the domestic political climate and the reactivation of the multilateral external financing arrangement with the EU, the IMF and other IFIs, likely to mitigate the risks related to the economic policy mix implemented by the authorities and hence to boost foreign investor sentiment towards the domestic economy, allowed the National Bank of Romania to resume the rate cutting cycle. The approach was also prompted by the moderation in the persistent nature of core inflation manifest at end-2009 and the outlook for consolidated disinflation over the medium term, in correlation with the anticipated width and length of negative output gap. Thus, January through February 2010, the central bank lowered the policy rate twice (each time by 0.50 percentage points) to 7.0 percent.

Monetary policy will remain prudent in the period ahead. The speed and size of future adjustments in the policy rate and in broad monetary conditions will mainly hinge on the magnitude of disinflationary effects of the wider and protracted aggregate demand shortage as well as on the pace at which inflation expectations will alleviate. Another major driver behind the central bank's decisions to adjust its policy toolkit relates to the likelihood of risks to inflation forecast materializing over the policy-relevant horizon. Particularly relevant is the risk of second-round effects triggered by adjustments in administered prices and costlier fuels. Thus, the National Bank of Romania will pro-actively seek to firmly anchor inflation expectations and ensure sustainable disinflation in line with achieving the medium-term inflation targets, while also laying the groundwork for a sustainable revival of lending and hence for lasting economic recovery. However, the fulfilment of these objectives is strictly conditional upon the macroeconomic policy mix and structural reforms further complying with the updated coordinates of the multilateral external financing arrangement signed by Romania with the EU, the IMF and other international financial institutions.

#### **2.4. Structural Reforms**

In its National Reform Programme, Romania sets up similar targets to those assumed at European level, adjusted to the performance level of the labor market and of the other connected areas, in a move to ensure macroeconomic stability and public finance sustainability, to increase the competitiveness and productivity as well as to improve the functioning of the labor market.

For this reason, the Government will take the following measures:

- ✓ implement the unitary payment system in public sector;
- ✓ elaborate the pension law and implement the pension system reform;
- ✓ elaborate and implement the fiscal responsibility law;
- ✓ implement the standard costs in the local public expenditure area;
- ✓ develop the continuous professional training system and increase participation to the training programs;
- ✓ increase the participation of the young unemployed to the measures aiming to improve the occupational chances;
- ✓ reduce the employees recruitment bureaucracy by setting up one stop shops at the local level and making them operational in view of achieving a single recruitment procedure;
- ✓ improving the decision process and public policies, the quality of the administrative activity, and the horizontal coordination and management;
- ✓ motivating the companies to create, add and retain value in the national productive chain based on processes, products and services;
- ✓ taking important reform decisions in National Tax Administration Agency (reduction of bureaucracy, improving the procedures and costs reduction; continue the efforts aiming to improve the voluntary tax compliance, support the business environment, increase the efficiency of the tax collection and improve the control capacity to combat tax evasion.

## **2.5 Romania under the excessive deficit Procedure**

The excessive deficit procedure is governed by the Article 126 of the Treaty and the Council Regulation regarding the acceleration and clarification of the excessive deficit procedure implementation. The excessive deficit procedure sets down the criteria and the deadlines for the European Council (ECOFIN) to adopt a decision regarding the existence of an excessive deficit.

The excessive deficit Procedure is initiated when the actual or forecasted deficit exceeds the 3% of GDP ceiling, except the situation when the deviation is of an exceptional and temporary nature outside of the control area of the respective member state and has a major impact on the fiscal position, or due to a major contraction of the economic activity.

According to the Council Decision dated July 7, 2009 Romania is facing the excessive deficit procedure. According to this decision, the Romanian authorities implemented in a strict manner the provisions in the previous Council Decision. However, considering the higher than expected negative impact of the international context on the Romanian economy, the Council has issued a revised recommendation whose main provisions are as follows:

- the Romanian authorities have to implement the budgetary measures agreed for 2010 and diminish within a medium term framework and in a sustainable manner the budget deficit to less than 3% of the GDP until 2012;
- the Council sets down the deadline of 16 August 2010 by which Romania has to implement the agreed measures for attaining the consolidation objective in 2010. The progress report will be based on the outcome assessment compared to the European Commission's autumn forecast;
- adopt and implement the Pension Law and improve the long-term sustainability of the pension system;
- make efforts for an average annual consolidation of 1,75 percentage points for the 2010-2012 interval and elaborate the necessary measures for reaching the deficit objective of below 3% of GDP and, if cyclical conditions allowing, to accelerate the reduction of the budgetary deficit only if the overall economic conditions are more favorable compared to the initial forecasts.

The initial budget and rectifications realized in 2009 foreseen budgetary measures in order to reach the assumed objectives, some of the most important being: (i) an increase of 3,3 percentage points of the social security contributions; (ii) increasing the excise for tobacco and spirits; (iii) creating a minimum income tax for contributors who declare a lower income tax compared to the legal threshold; (iv) expenditure rationalization by freezing public sector wages, reducing the bonuses and benefits, freezing the public sector employment and elimination of the vacancy jobs; (v) reducing the subsidies and goods and services expenditures; (vi) implementing a VAT non-deductibility regime with some exemptions for vehicles and fuels expenditures for certain transportation means.

The proposed measures for 2010 are mainly focused on containing the current expenditures by: (i) diminishing the wages expenditures by freezing the salaries (with the exception of the wages situated below the minimum monthly ceiling of Ron 705), freezing the public sector employment and continue the replacement policy of 1 for 7 (leaving the public sector) and cutting down the expenditures related to the bonuses and supplementary hours; (ii) making savings by freezing the pensions (except the social ones) and by a better rationalization of the disability and anticipated pensions taking into account a more restrictive implementation of the existing legal framework; (iii) diminishing the goods and services and transfers expenditures; (iv) reassessment of property taxes, increase of the excises for tobacco and fuels and implementation of the turnover tax on medical products distributors. A detailed presentation of the quantitative impact of the adopted measures is available in chapter 5.3 Medium term and 2010 Public Finance evolution.



### 3. MACROECONOMIC SCENARIO

#### 3.1 Assumptions on the International Economic Environment

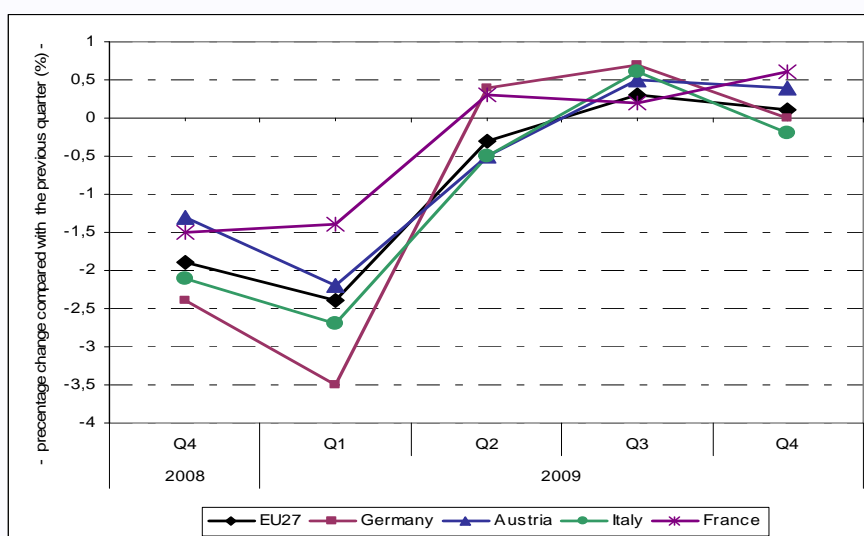
The global economy encountered in 2008 the deepest economic crisis after the Great Recession of 1930. The crisis had a high degree of synchronization across the developed and emerging economies, showing a significant increase in the interdependence degree of world economies.

However, as a result of the unprecedented monetary and fiscal stimulus measures taken by governments, there are signs of stabilization and recovery in economic activity throughout Europe and worldwide. Stock exchange activity returned to a normal pace, the access to financing improved while the consumer confidence indices ameliorated as well.

Thus, in the third quarter of 2009 the economic activity throughout the EU 27 recorded an increase after four quarters of contraction, as the growth of gross domestic product compared to the previous quarter was 0.3%. Positive trends continued in the fourth quarter, but of lower amplitude, respectively 0.1%.

Furthermore, Romania's main trade partner countries are recovering, with their GDP registering growth rates compared with the previous quarter, except Italy, which continued the declining trend. These developments create the conditions for the recovery of Romanian exports and therefore for the resumption of the economic growth in 2010.

Chart 3.1 Quarterly evolution of gross domestic product<sup>1)</sup>



<sup>1)</sup> Seasonally adjusted data  
Source: Eurostat

According to the European Commission's Autumn Forecast, world gross domestic product is expected to contract by 1.2% in 2009 with a more pronounced feature in the advanced economies. The gross domestic product is expected to decrease by around 2.5% in the U.S., 5.9% in Japan and 4.1% for the European Union in 2009. Regarding the five largest EU economies, the gross domestic product is expected to contract by around 5.0% in Germany, 4.7-4.6% in Italy and the United Kingdom, by 3.7% in Spain and 2.2% in France. The economic growth is forecasted to reach 8.7% in China in 2009.

Following the impact of worldwide stimulus policies and the gradual resumption of the trade flows, the global growth is expected to recover to an estimated 3.1% in 2010. The activity will stabilize in all major economies, except for Spain which is expected to shrink further by 1%.

- percentage change compared with the previous year -

<b>Table 3.1 Assumption on foreign environment</b>	2006	2007	2008	2009	2010
GDP – World economy	5.1	5.1	3.1	-1.2	3.1
GDP EU27, of which:	3.2	2.9	0.8	-4.1	0.7
• Consumption	2.2	2.1	0.8	-1.7	0.2
• Investment	6.2	5.9	-0.3	-11.4	-2.0
GDP Euro area	3.	2.8	0.6	-4.0	0.7
GDP USA	2.7	2.1	0.4	-2.5	2.2
GDP Japan	2.0	2.3	-0.7	-5.9	1.1
GDP Germany	3.2	2.5	1.3	-5.0	1.2
GDP Italy	2.0	1.6	-1.0	-4.7	0.7
GDP France	2.2	2.3	0.4	-2.2	1.2
HCPI EU -27	2.3	2.4	3.7	1.0	1.3

Source: European Commission Autumn forecast

IMF's revised forecast published in January estimated a 0.8% decline of world economy in 2009. The IMF forecasts a deep recession of the developed countries (-3.2%), as a result of the more prolonged and deeper impact of the financial crisis on the real activity compared to the previous forecast.

There is estimated a sharp contraction of the exports and imports of goods and services of the developed countries by 12.1% and 12.2%, with a slight recovery in 2010 (5.9% and 5.5%, respectively).

According to the IMF's revised forecast, the economic growth in 2010 will reach 2.1% in the advanced economies and 1.0% in the Euro area. Germany and Italy are estimated to register growth rates of 1.5% and 1.0% respectively, while there is expected a 1.4% growth rate for France.

In emerging and developing countries, the economic growth is estimated to accelerate to around 6% in 2010, compared with a forecasted increase of 2% in 2009.

The projection of the price for Brent crude oil was revised in the January forecast, from 61.5 \$/barrel in 2009 and 76.5 \$/ barrel in 2010 in the October edition of the World Economic Outlook, to a level of 62 \$/barrel and 76 \$/barrel, respectively.

According to the IMF's report published in January 2010, the world economy recovery process is supported by special measures implemented by governments aiming to facilitate a rebalancing of global demand, measures which have to be maintained in the countries where the recovery is not expected to have lasting effects.

Nevertheless, the return to confidence and the reduction of the uncertainty would support the strengthening of financial markets, higher than expected growth of the capital flows, trade and demand. The new initiatives aiming at reducing the unemployment in the U.S. would also help the world economic activity.

### **3. 2 Recent macroeconomic evolutions in Romania**

The financial and economic crisis had a strong impact on the developments of the real economy during the first 9 months of 2009, as the Romanian economy is a relatively small and open economy. Thus, after registering a 2.9% y-o-y GDP growth in the fourth quarter of 2008, in the first quarter of 2009 the gross domestic product – in real terms, gross series – diminished by 6.2% y-o-y, the trend worsening during second and third quarters, when the economy contracted by 8.7% and 7.1% respectively.

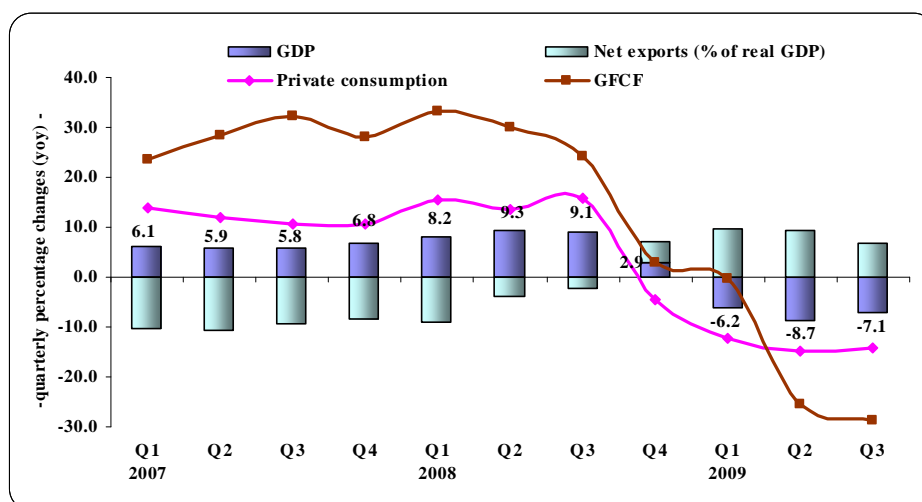
In seasonally adjusted terms, the GDP contracted in the third quarter of 2008 by 0.1% q-o-q followed by a reduction of 2.8% and 4.6% q-o-q in the fourth quarter of the

same year and in the first quarter of 2010 respectively. However, starting with the second quarter of 2010, the decline subsided to 1.1% q-o-q and continued the trend in the third quarter when the economy contracted by 0.6%.

Cumulated, during the first 9 months of 2009, the negative impact of the crisis reflected in the contraction of the gross domestic product by 7.1%, as a result of the contraction of the domestic and external demand by 13.7% and 10.1% respectively. Within the domestic demand, the final consumption contracted by 11.1%, as a result of the credit market deterioration and the negative evolutions and uncertainties associated to labor market. Meanwhile, the gross fixed capital formation diminished by 22.6%, as a result of the reduction of the foreign direct investment inflows and the uncertainties associated to the prospects for goods and services demand.

The only major component which registered a positive contribution to GDP's real growth were the net exports, respectively by 8.3%, as a result of the reduction of the exports and imports of goods and services by 10.1% and 24.3% respectively during the first 9 months.

Chart 3.2 Evolution of GDP and of its main components



The gross value added diminished by 11.9% in construction, by 7.1% in industry, by 6.2% in services and by 1.2% in agriculture in the first 9 months of 2009.

The overall estimates regarding the economic evolution in 2009 foresee a 7.0% reduction of the gross domestic product compared to 2008. The domestic demand is estimated to contract by 13% due to the reduction of both final consumption (-10.1%) and gross fixed capital formation (-20%). The restructuring of budgetary

expenditures and the reduction of wages will lead to diminish of the government's consumption by 2.7% compared to 2008. The import and export of goods and services will be lower by 10.5% and 24.8% respectively, leading to a positive contribution of 7.6 percents to the gross domestic product's real growth.

- percentage changes against previous year -

<b>Table 3.2 Evolution of GDP</b>	2007	2008	2009 (Estimation NCEF)
Domestic demand, of which:	14.2	7.2	-13.0
- Private consumption	11.9	9.5	-10.6
- Government's consumption	-0.1	7.1	-2.7
- Gross fixed capital formation	30.3	16.2	-20.0
Export of goods and services	7.8	8.7	-10.5
Import of goods and services	27.3	7.8	-24.8
<b>GDP</b>	<b>6.3</b>	<b>7.3</b>	<b>-7.0</b>
Industry	5.4	1.9	-4.3
Agriculture	-15.3	21.9	-2.0
Construction	33.9	26.1	-18.9
Services	7.0	5.4	-5.6

Source: National Institute of Statistics

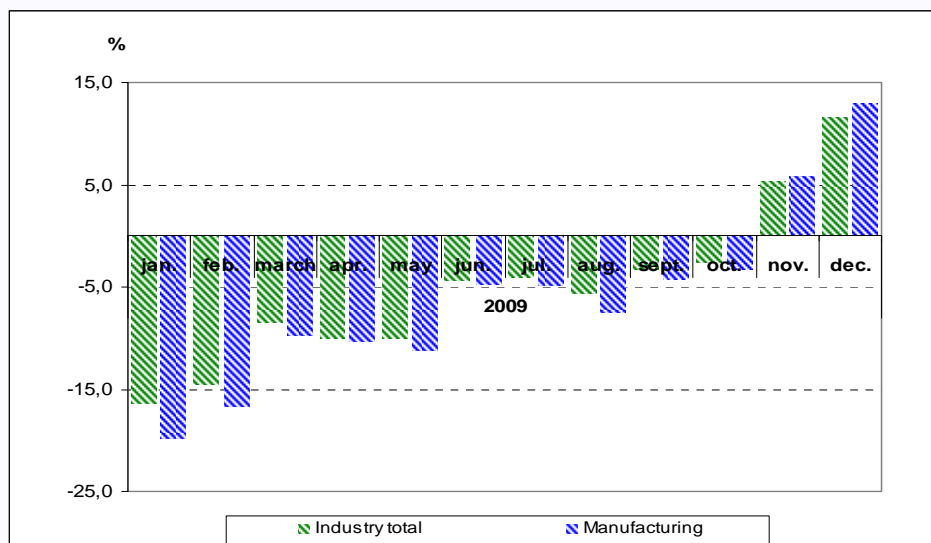
There is a broad based contraction expected in all the economic sectors, reflected in the decrease of the gross value added. The most significant reduction in terms of gross value added will be registered by the construction sector (-18.9%), followed by the services (-5.6%) while the industry and agricultural sectors will contract by 4.3% and 2.0% respectively.

The industrial production decreased by 5.5% (gross series) in 2009, due to the contraction of the extractive industry and the manufacturing sector by 12.0% and 6.5%, respectively. However, the developments in the monthly data show a slight recovery, as of December 2009 the industrial production was higher by 11.6% y-o-y, being the second month in 2009 when there was recorded a growth of the industrial production volume (in November, the increase was 5.3% y-o-y).

In the fourth quarter of 2009, the industrial production grew by 4.0% y-o-y, adding a positive contribution to last quarter GDP's evolution.

Chart 3.3 Monthly evolution of industrial production

- percentage change against the same month of previous year (%) -



Source: National Institute of Statistics

Some distinctive evolutions of the industrial activities are noticeable:

- activities highly influenced by the effects of the financial crisis (metallurgy, manufacture of construction materials);
- activities which recovered some of the output contraction, during the second part of the year (manufacturing of motor vehicles, food);
- activities which were not influenced by the crisis (wood and related products, electric equipment).

Activities ensuring more than 50% of the output of the manufacturing industry achieved superior output in December y-o-y, as follows: road transport motor vehicles (+190.9%); electric equipment (+75.3%); wood and related products (+42.1); rubber and plastic products (+35.5%); metallurgic industry (+28.1%); chemicals (+15.8%); paper and paper related products (+8.0%), food (+2.7%).

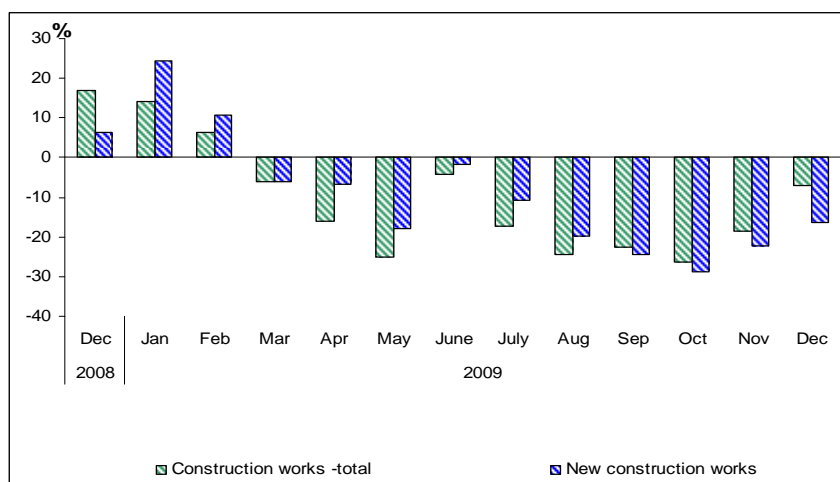
The smaller contraction of the industrial production (by 5.5%), compared to the contraction of the imports of goods and services (by 32.3%), shows a better use of the domestic resources.

The construction works (gross series) diminished by 15.1% y-o-y in 2009, due to the reductions recorded in a broad based manner: maintenance and current repairs (-13.2%), new construction works (-13.8%) and capital repair works (-24.1%). There were evident reductions in respect of all the major components, as follows: civil

engineering (-12.2%), non residential buildings (-15.7%) and residential buildings (-20.2%).

**Chart 3.4 Monthly evolution of construction works**

- percentage change against the same month of previous year (%) -

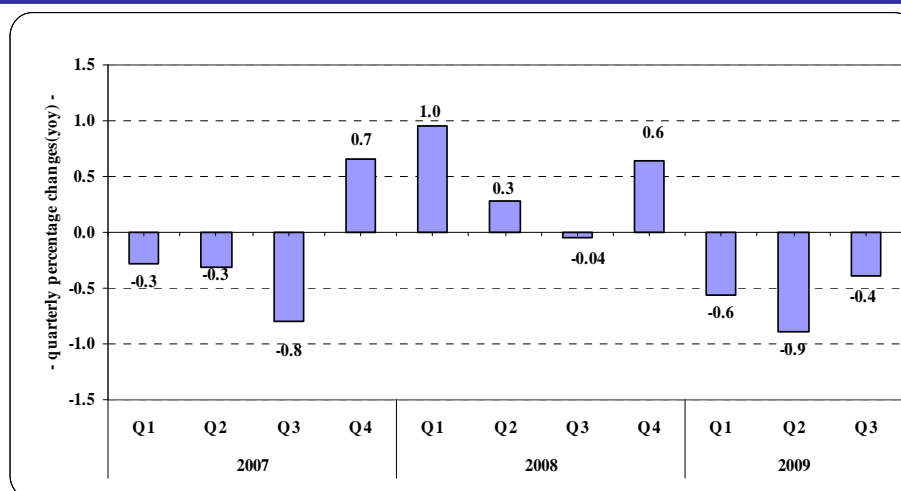


Source: National Institute of Statistics

The working age active population grew by 0.3% during the first 9 months of 2009 compared to the same period of 2008, while the rate of activity increased to 63.4% from 63.1%. The working age employed population and the average employees number (according to ILO methodology) decreased by 0.6% and 0.9% respectively, leading to a reduction of the working age population employment rate, from 59.3% to 59%.

The rate of employment of the working age population was higher for men (65.6%, compared to 52.4 % for women) and in rural area (61.4%, compared to 57.3% in urban area). The rate of employment within youngsters (age 15 – 24) reached 24.9%, lower by 0.3 percentage points compared to the same period in 2008. The ILO unemployment grew by 578,000 persons in the first 9 months of 2009 to 664,000 persons in the same period of 2008 while the ILO unemployment rate increased from 5.8% to 6.7%.

Chart 3.5 Evolution of employment



Source: National Institute of Statistics

The number of the unemployed persons registered at the employment agencies increased from 403,400 persons at the end of 2008 to 709,400 persons at the end of 2009 while the unemployment rate reached 7.8% compared to 4.4% in December 2008, mainly as the result of the reduction of the employees number.

The economic crisis contributed substantially to the correction of the external imbalances during 2009. The exports of goods continued their descending trend registered in the last quarter of the previous year, due to the contraction of the external demand, diminishing by 13.9% as against 2008, albeit at a lower level compared to the first semester and the first 9 months of 2009 (-20.1% and, respectively, -18.2%), while the import of goods decreased significantly by 32.3%, explaining the decrease of the trade deficit by 58.6%.

The exports composition is registering a structural improvement evident in an increased share of higher value added exports of machinery and transport equipment, from 36.2% to 42.8%.

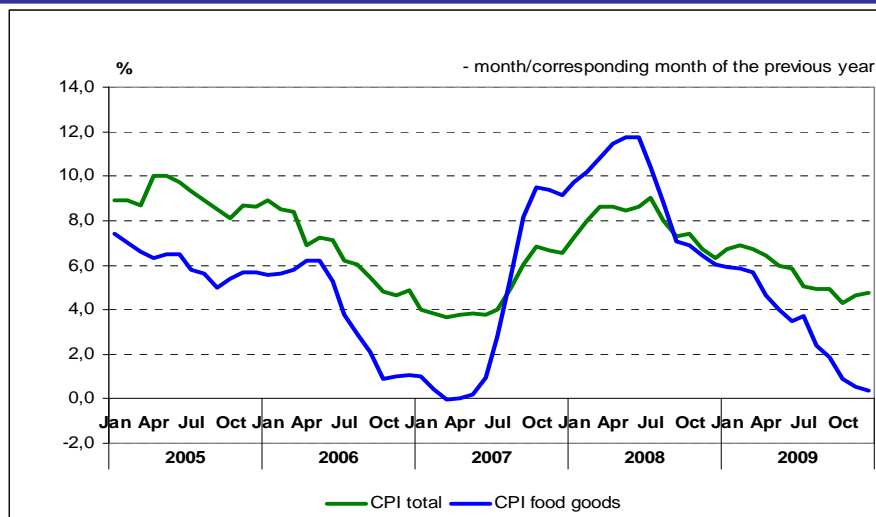
The current account deficit of the external balance of payment was 5,054 mill. euro in 2009, registering a decrease by 68.7% as a result of the contraction of the trade deficit (FOB-FOB) by 64.7%. Moreover, the deficit of the income balance diminished by 42.1% while the current transfers balance decreased by 31.4%, still registering a positive balance. Moreover, the current account deficit was financed 96.9% from



foreign direct investment inflows. The end of period inflation rate was 4.74% in 2009, with a corresponding annual average of 5.59%.

A particular contribution to the tempering of the annual inflation came from the evolution of the food prices, 4.36 percentage points lower in December than the annual inflation rate, respectively 0.38%.

**Chart 3.6 Evolution of CPI and food products CPI – annual growths**



Source: National Institute of Statistics

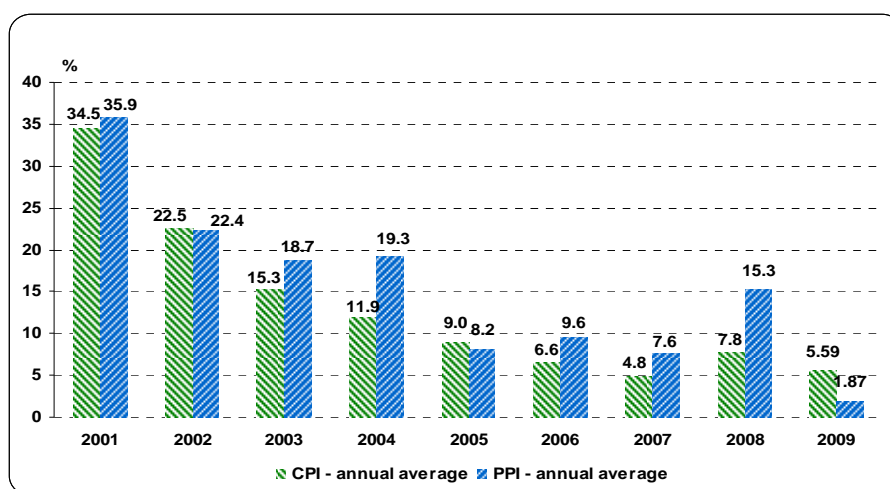
The end of the year growth rate of the non-food product prices (7,72%) exceeded by 1.76 percentage points the level recorded in the previous year, as a result of the two stages hike of the excises duties for tobacco products, which had a contribution around 1.8 percentage points to the inflation rate.

The service tariffs grew by 6.86%, 0.85 percentage points lower compared to their previous year growth rate, mainly due to the depreciation of the national currency, some of the sectors being very sensitive to the developments of the exchange market e.g. the air transportation (8.41%) or the phone services (7.83%).

The exchange rate represented an important explanatory factor for the inflation. The exchange rate recorded a nominal depreciation at the beginning of the year, followed by a period of relative stability, while in the last month of the year there was evident an appreciation trend. Hence, the prices of the imported products have been negatively influenced, particularly during the first part of the year as well as the prices of some administrated products, correlated to the European currency or to the American dollar.

A favorable effect which sustained the descending trend of the inflation rate was represented by the reduction of the excess aggregate demand, as a result of the global financial and economic crisis. Moreover, the restrictive measures implemented by the Romanian National Bank correlated with the cautious income and budgetary policies promoted by the government contributed to the support of the disinflation process.

Chart 3.7 Consumption prices and Industrial production prices - annual average



Source: National Institute of Statistics

The industrial production prices increased by 4.21% y-o-y in December 2009 with the both components: the domestic and external ones rising by 3.55% and 5.96% respectively. The average industrial production inflation diminished to 1.87% in 2009 from 15.3% in 2008.

### 3.3 Medium-term development scenario and cyclical evolutions

#### 3.3.1 Cyclical evolutions

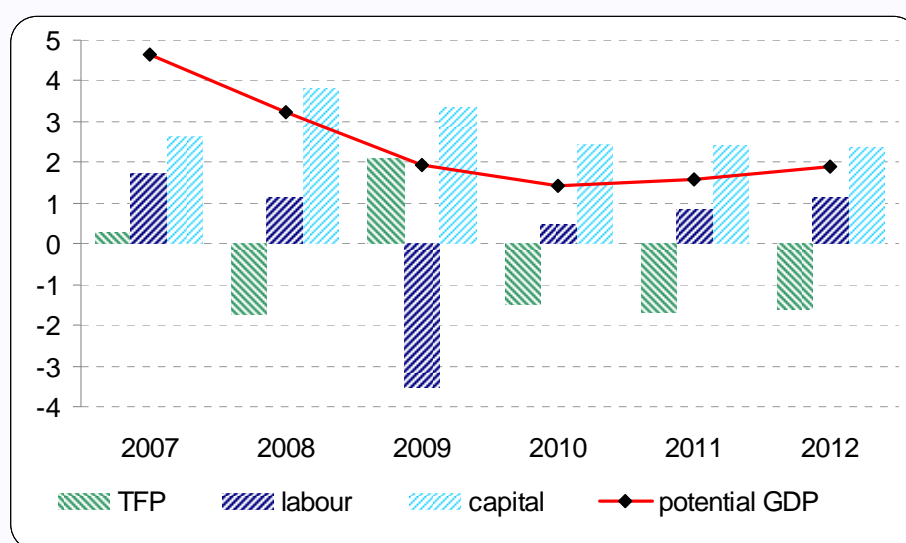
According to the estimates based on the Cobb-Douglas production function, the average potential GDP growth rate calculated for the period between 2008 and 2012 is 2.08%. During the mentioned period, the capital stock will decrease slightly, so that the capital's average contribution to the growth of the potential GDP is 2.87% per year.

The potentially employed working-age population (15 - 64 years) will record moderate increases. It is significant the fact that the evolution of the employed

population is expected to have a positive, but still moderate contribution to the growth of the potential GDP during the next period (2010-2012).

The total productivity factor (TPF) will have a negative contribution to the growth of the potential GDP during the mentioned period (chart 3.8), being mostly the outcome of a more difficult financing environment and of a lower expected foreign direct investment inflow, due to the difficult international financial and economic context.

Chart 3.8 Factor contributions towards potential GDP growth

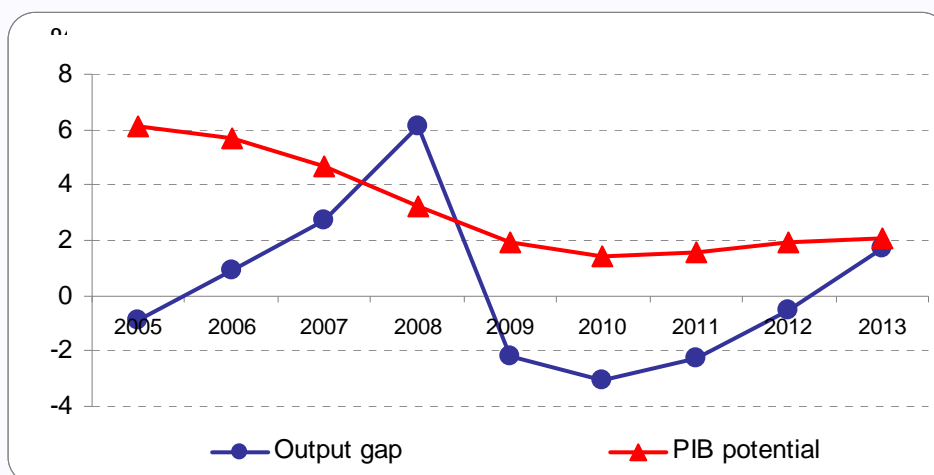


Source: Ministry of Public Finance, National Prognosis Commission, RQM, DOFIN

We expect a significant improvement of the factors' quality on a medium term as a result of the implementation of structural reforms, leading to the decrease of the negative contribution of the total productivity factor.

The output gap become negative starting with 2009 (8.26% decrease in 2009, compared to 2008) registering a tendency toward balance on medium term, according to the proposed macroeconomic policies mix.

Chart 3.9 Output – gap



Source: Ministry of Public Finance, National Prognosis Commission, RQM, DOFIN

The economic growth forecast for the 2009-2012 period is below the potential GDP, taking into consideration the envisaged macroeconomic policy mix, being forecasted to tend toward potential on the medium term together with the resumption of the global growth and the reduction of the domestic imbalances.

### 3.3.2 Medium-term development scenario

The macroeconomic forecast for 2010 and the subsequent 2 years took into consideration the parameters agreed within the loan agreement with the EC, IMF and World Bank. The active measures aiming at the improvement of the business environment, the reduction of the macroeconomic imbalances and the resumption of the bank lending are expected to secure the proper conditions for the economy to recover and create job opportunities.

The economic activity's contraction trend will continue during the first part of 2010. Thus, it is possible to register negative real growths rates during the first 2 quarters of 2010, but we forecast an overcoming of the negative growth interval and the start of a moderate recovery process with an expected real GDP gain of 1.3% y-o-y. The growth of the unemployment in the first part of the year will diminish the available household's income, but for the overall year we forecast an increase of the number of employees and the maintenance of the purchasing power of the population,

having an associated impact on the households' consumption growth rate. Government's expenditures will be restructured with the aim of containing the current expenditures and increasing the public investment space while on the same time promoting the adjustment of the budget deficit.

The domestic demand (consumption and investment) will increase by 1.4%. The main component expected to grow will be the private consumption, where the expenditures are envisaged to increase by 3.8%, due to the growing confidence in the governmental measures promoted for the economic recovery and the resumption of the consumption growth trend as a result of the improvement of the credit process. The gross fixed capital formation is expected to register certain delays and possibly contract by 1% due to related financial difficulties and excess capacity. The government's consumption will be reduced further by 3.5% as a result of the measures implemented for the restructuring and adjustment of the public wage expenditures.

<b>Table 3.3 Economic growth</b>	2008	2009	2010	2011	2012
	<i>Annual percentage changes</i>				
Real GDP	7.3	-7.0	1.3	2.4	3.7
Nominal GDP	23.7	-1.8	6.6	7.4	8.4
	<i>Components of real GDP</i>				
Private consumption expenditures	9.5	-10.6	3.8	2.8	3.8
Government consumption expenditures	7.1	-2.7	-3.5	-1.3	1.9
Gross fixed capital formation	16.2	-20.0	-1.0	5.0	6.7
Export of goods and services	8.7	-10.5	3.3	2.4	3.4
Import of goods and services	7.8	-24.8	3.6	3.3	5.5
	<i>Contributions to GDP's growth (percents)</i>				
Final domestic demand	12.3	-14.1	1.5	2.8	4.6
Changes in stocks and net purchases	-4.2	-0.5	0.0	0.0	0.0
Net export	-0.8	7.6	-0.2	-0.4	-0.9

Source: National Commission for Economic Forecasting

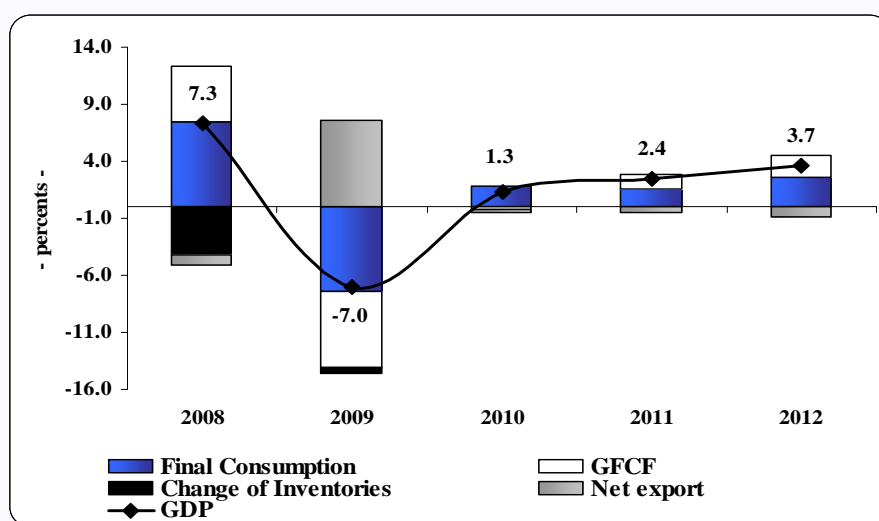
The increasing domestic and external demand will have a positive influence over the external trade's evolution. The exports and imports of goods and services will rise

moderately, leading to a slightly negative contribution (0.2 percents) to the GDP's real growth.

In the next two years (2011 and 2012), GDP's growth is expected to accelerate, once trade will intensify and the activity will recover across the economic sectors. The gross domestic product is expected to increase by 2.4% in 2011 and by 3.7% in 2012. The growth will be driven by the domestic demand, with the gross fixed capital formation registering an increasing trend from 2011, respectively by 5.0% and 6.7% in 2012. This forecast is based on the assumption of securing the financing supplies of the undergoing projects, the improvement of the European grants' absorption, while ensuring the financing from the State's budget of the eligible investment projects.

The external trade of goods and services will recover due to expansion of the domestic and external demand and the recovery of global trade with both the exports and imports increasing in real terms, while the net export's contribution to GDP's growth will be negative.

Chart 3.10 GDP's real growth – contributions on components of use



Source: National Commission for Economic Forecasting

The gross capital formation will maintain a share of around 25% in GDP in 2010, due to the contraction of the investment of the private sector, compensated by a slight increase for the governmental sector. The share of the gross capital formation will increase, to almost 27% of GDP in 2012 as a result of the investment's acceleration. The following table shows the improvement of the savings, particularly within the

governmental sector, leading to a smaller external financing need with the foreign direct investment inflows being expected to amount to 3.8% of GDP.

	-% of GDP				
<b>Table 3.4 Savings - Investments Balance</b>	2008	2009	2010	2011	2012
Domestic saving	18.2	19.6	19.7	20.6	21.3
National saving	19.9	21.2	20.2	20.9	22.1
- private sector	18.4	21.4	18.5	17.4	17.2
- governmental sector	1.5	-0.2	1.7	3.5	4.9
Gross capital formation	31.3	25.3	25.2	25.9	26.9
- private sector	24.3	17.5	17.2	18.0	19.0
- governmental sector	7.0	7.8	8.0	7.9	7.9
Saving-Investment balance	-11.4	-4.1	-5.0	-5.1	-4.8
- private sector	-5.9	3.9	1.3	-0.7	-1.8
- governmental sector	-5.5	-8.0	-6.3	-4.4	-3.0

*Source: National Commission for Economic Forecasting*

The downside trend of the current account deficit between 2009 and 2012 is sustained by the contribution of the governmental sector, reflected in the commitment to reduce the budgetary deficit to 3% of GDP. The difficult state of the credit market and the adjustment of the external deficit led to increased level of savings in the private sector which compensated partially the high budgetary deficit in 2009 and 2010.

The domestic saving will cover to a greater extent the foreseen investment (gross capital formation), with the ratio being forecasted to increase from 77% in 2009 to 79% in 2012. The financing of investment from external capital transfers and EU grants will increase, resulting in a corresponding decrease of the external financing needs by 1,2% of GDP each year.

Despite having recovered lately a certain share of the gap with the EU average, Romania is still lagging most of the European countries. GDP per capita, expressed in standard purchasing power parity (PPS) represented 47% of EU 27 average in 2008 and is expected to exceed 50% by 2012.

Assuming that the recession will be ending in 2010, the exports and imports of goods are estimated to increase by 3.5% and 4.2% respectively. Under these circumstances, the share of trade deficit in GDP will remain at the same level as the one recorded in 2009, respectively 5.7%, as a result of a recovery registered in the both segments, the intra-community and extra-community. Thus, intra-community and extra-community exports are forecasted to increase by 3.3% and 4.1% respectively, while intra-community and extra-community imports will increase by 4.1% and 4.4% respectively. The recovery of the industrial activity will be reflected in a growing trend of the extra-community imports of raw materials (for metallurgy, petrochemical industry, fertilizers industry).

The current account deficit of the external balance of payment is expected to remain within sustainable limits, representing around 5.1% of GDP and will be covered from foreign direct investment inflows in a share of 76%.

Exports of goods and services will increase, by 4.6% in 2011 and by 6.7% in 2012, as a result of the resumption of global economic growth in the forthcoming period and the overcoming of the financial and economic crisis. Domestic economic activity is expected to accelerate, leading to additional imports, which are forecasted to increase by 4.9% in 2011 and 8.3% in 2012. As a result, the share of trade deficit in GDP will slightly increase, reaching 5.9% in 2012. The intra-community exports are expected to increase by 4.2% in 2011 and 6.2% in 2012, while intra-community imports will increase by 4.8% and 8.0%, respectively.

The current account deficit will not deteriorate, representing 5.2% of GDP in 2011 and 5.0% in 2012 with the surplus of the current transfer's balance being expected to continue to partially compensate the negative impact of trade and revenue balance deficits.

We expect a 0.9% decrease in the working age employed population, as a result of the economic slowdown, foreseen especially in the industry in 2010 leading to the reduction of the employment rate from an estimated level of 58.5% in 2009 to 58.0% in 2010. Once the economic recovery is taking hold, we expect a raise of 0.1% in the employed population both in 2011 and 2012, leading to an improvement of the employment rate expected to overshoot by 2012 its 2008 level.

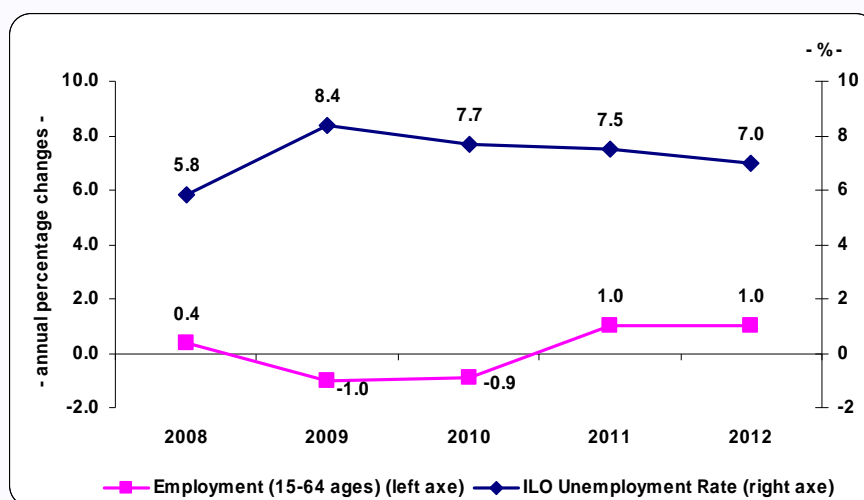


Table 3.5 Labor force evolution <sup>3</sup>	2008	2009	2010	2011	2012
	- percentage change -				
Total population	0.0	0.0	-0.1	-0.1	-0.1
Active population	-0.3	0.1	0.1	0.7	0.5
Employment	0.4	-1.0	-0.9	1.0	1.0
ILO unemployment	-10.3	45.7	-7.1	-3.2	-5.4
	- % -				
Activity rate	62.9	63.0	63.1	63.6	64.0
Employment rate	59.0	58.5	58.0	58.6	59.3
ILO unemployment rate	5.8	8.4	7.7	7.5	7.0

Source: National Commission for Economic Forecasting

The ILO unemployment rate, estimated at 8.4% for 2009, will improve starting with 2010 and is expected to reach 7.5% in 2011 and 7.0% in 2012. After the increase in 2009, the unemployment is expected to decrease to 6.2% in 2012 as a result of the economic growth and associated job creation.

Chart 3. 11 Unemployment Rate Evolution



Source: National Commission for Economic Forecasting

The disinflation process will be maintained as a result of a more coherent mix of economic policies promoted within the financing agreement, implying the implementation of prudent wage and income policies, the continuation of structural reforms and a tight monetary policy. The reduction of the inflation rate will be sustained by a demand deficit, especially in the first half of the year, followed by a recovery toward the end of the year, when it is expected to reach positive values.

<sup>3</sup> This refers to the working age population (15-64 age)

The rate of inflation will decrease to 3.5% in 2010 while the annual average will reach 3.7%.

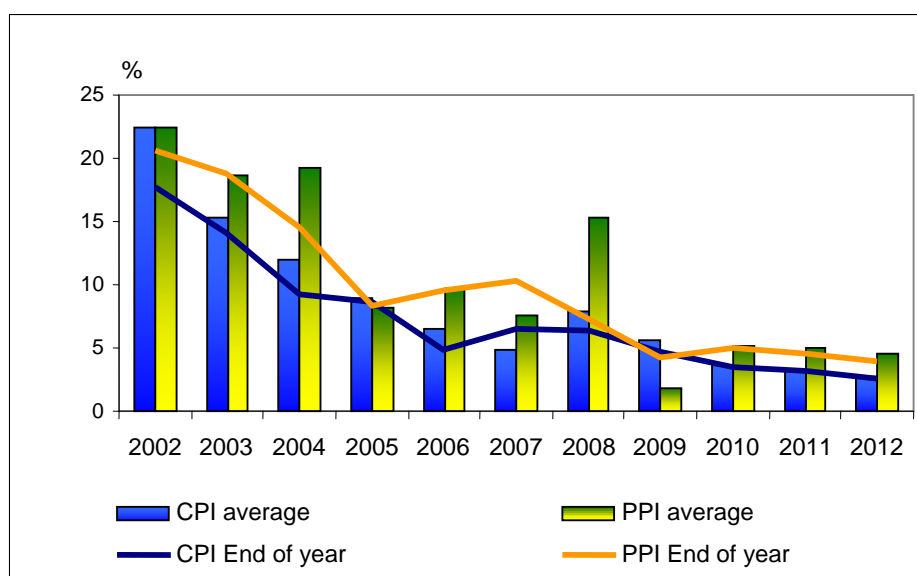
A significant contribution to this development is explained by the expected appreciation trend of the exchange rate, already evident at the beginning of 2010. The major corrections of the macroeconomic imbalances, achieved in 2009, especially for the balance of payments' current account deficit, create the background for a relative stabilization of the exchange rate, leading to the tempering of the domestic (related to the Euro) and imported prices for goods and services. Moreover, some unfavorable factors resulting from the increase of the excise duties for tobacco products and cigarettes were taken into account for the estimation of the inflation rate.

However, the gradual diminishing of the impact caused by the upward adjustment of the excises, the implementation of a cautious wage policy and the continuation of structural reforms will help to maintain the disinflation process on a sustainable path up to 2012, leading to a gradual decrease of the inflation rate to 2.6% in 2012.

The continuation of the disinflation process will contribute to the additional decrease of the inflationary expectations, sustained also by the real appreciation of the domestic currency in real terms against the euro, made possible by the productivity growth differential between Romania and its main foreign partners.

A gradual reduction of the industrial prices, to an average level of 4.5% in 2012, is also forecasted.

**Chart 3.12 Evolution of the consumption prices and of the industrial production prices**



Source: National Commission for Economic Forecasting

	<i>percentage changes</i>				
<b>Table 3.6 Deflator evolution</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>2011</b>	<b>2012</b>
GDP deflator	15.2	5.6	5.3	4.8	4.6
Consumer price index – average	7.85	5.59	3.7	3.2	2.8
Private consumption deflator	9.5	5.5	4.1	3.8	3.5
Public consumption deflator	22.2	6.6	4.6	6.1	5.6
Investments deflator (GFCF)	12.6	5.0	4.8	4.5	4.2

*Source: National Commission for Economic Forecasting*

#### 4. COMPARISON WITH THE PREVIOUS CONVERGENCE PROGRAMME EDITION.

##### 4.1. Comparison of macroeconomic framework

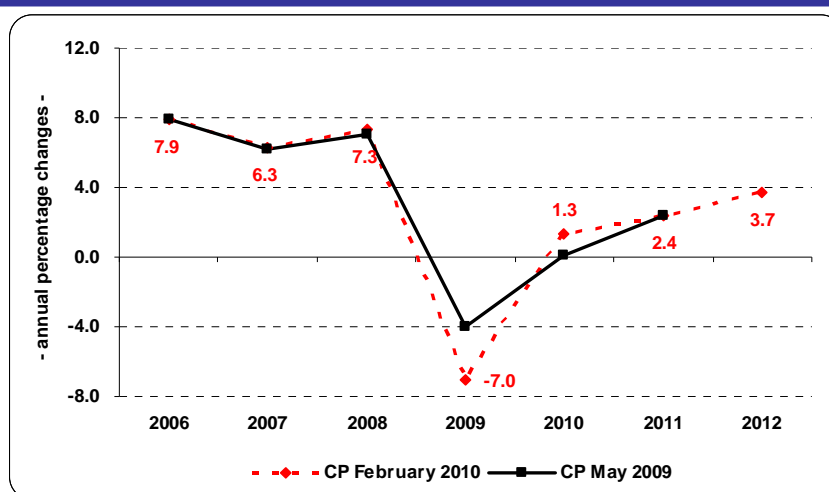
The medium term development scenario differs substantially from a comparative perspective with the latest edition of the convergence program published in May 2009.

The differences between the two programs are related mainly to the following items:

- The update of the statistical data for 2007-2008
- The stronger than expected negative impact of the economic and financial crisis in 2009.

Thus, the contraction of the real GDP estimated for 2009, was 3 percentage points lower than the previous estimate, respectively 7.0% against 4.0%, with significant differences on the expenditure structure. There are also risks associated to the projection in 2010 but of a more balanced nature. The consistency of the recovery process is depending on the outcome of the policy measures in contributing to a more efficient and sound financial system and the improvement of the confidence, including a more rapid increase of the global demand compared to the expectations. Thus, a 1.3% increase of GDP is expected for 2010, comparatively with a 0.1% increase in the previous version. For the year 2011 the same trend is forecasted, so that the economic activity will be more accelerated than in the previous year, but the magnitude of the economic growth is maintained as in the previous edition, namely 2.4%.4.1 C

Chart 4.1 Comparison between GDP growth forecasts



Source: National Commission for Economic Forecasting

CP May 2009 = Convergence Program, May 2009 version

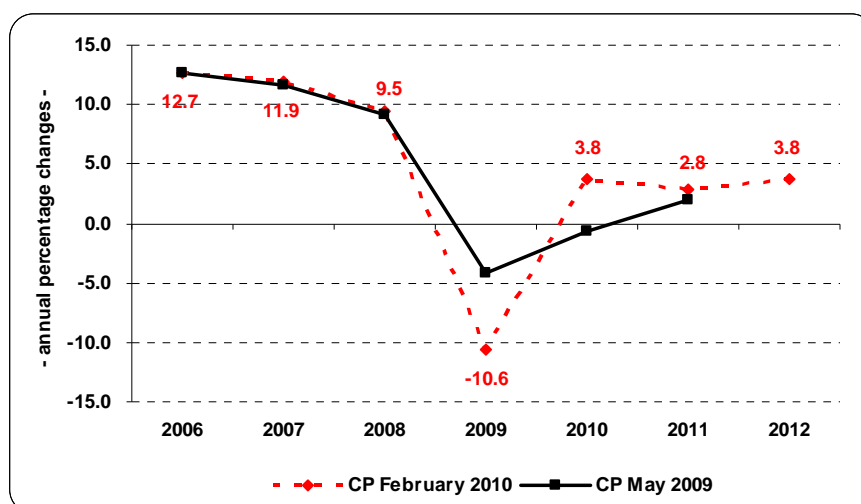
CP February 2010= Convergence Program, February 2010 version

The economic growth is expected to accelerate to 3.7% in 2012 as a result of an improved state of the global environment and the overcome of the consequences of the economic and financial crisis

Additional differences compared to the previous edition of the convergence program are observed in the structure of the domestic demand and the response of the domestic supply. These differences are explained by the trends highlighted in the recent statistical updates and by the changes in the economic and budgetary policy.

The private consumption is estimated to show a larger reduction in 2009 than predicted in the previous edition (-10.6% compared with -4.1%), due to the significant decline in the financial resources of the population, amidst the growing unemployment and the constraints of the credit system. Given this revision in 2009, we realized an upside adjustment of the private consumption for the interval 2010-2012, compared to the previous version of the convergence program.

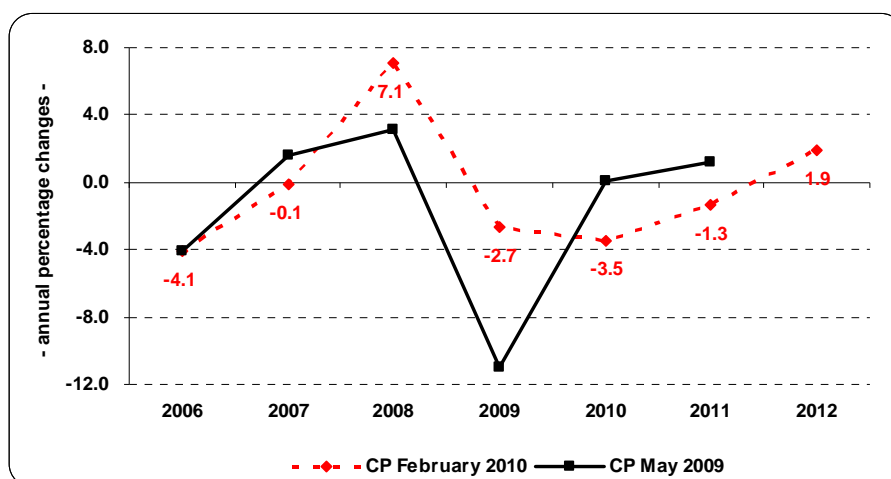
Chart 4.2 Comparison between private consumption expenditures growth forecasts



Source: National Commission for Economic Forecasting

The changes of budgetary policy are reflected in a different structure of budget expenditure, highlighting the efforts to reduce the personal and goods and services expenditures, correlated with the targets established in the loan agreement concluded with EC, IMF and WB. Thus, the projection of the public consumption expenditure for 2009-2012 foresees a decrease in the first two years followed by a moderate increase in 2012.

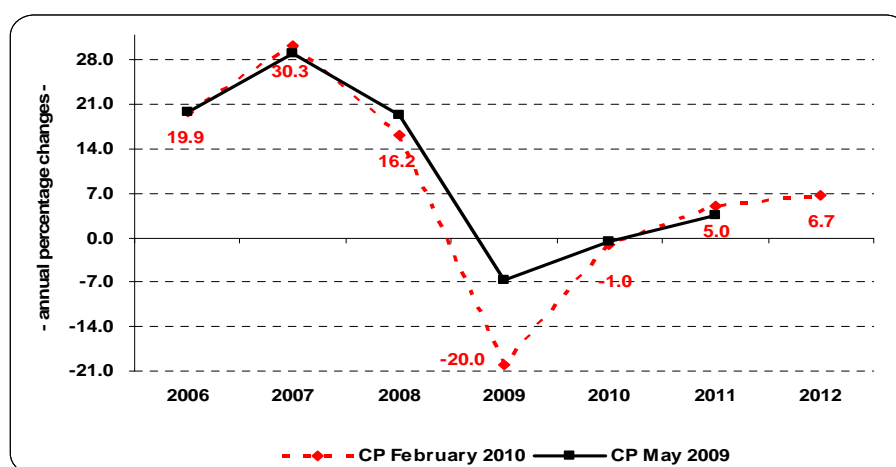
Chart 4.3 Comparison of the public consumption expenditure growth forecasts



Source: National Commission for Economic Forecasting

The gross fixed capital formation will contract to a larger extent in 2009 than anticipated in the previous version of the convergence program, however on the medium term there are not expected major differences between the two editions.

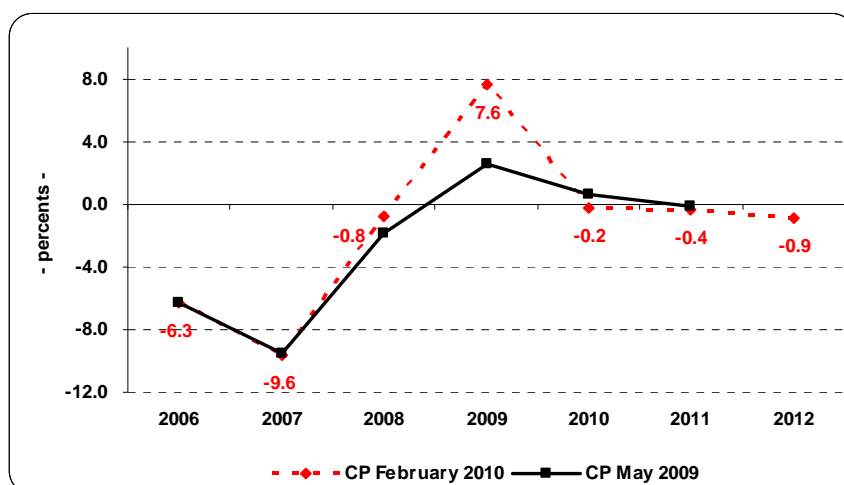
Chart 4.4 Comparison between GFCF growth rates forecasts



Source: National Commission for Economic Forecasting

Data related to the net export of goods and services in 2009 highlights a stronger than expected reduction of the external deficits being reflected in a more positive contribution of the net exports to the GDP's growth, compared to the one in the previous edition. The economic activity will recover, leading to additional imports of raw materials, which will imply a return to a slightly negative contribution of the net exports to the real GDP growth during the following years.

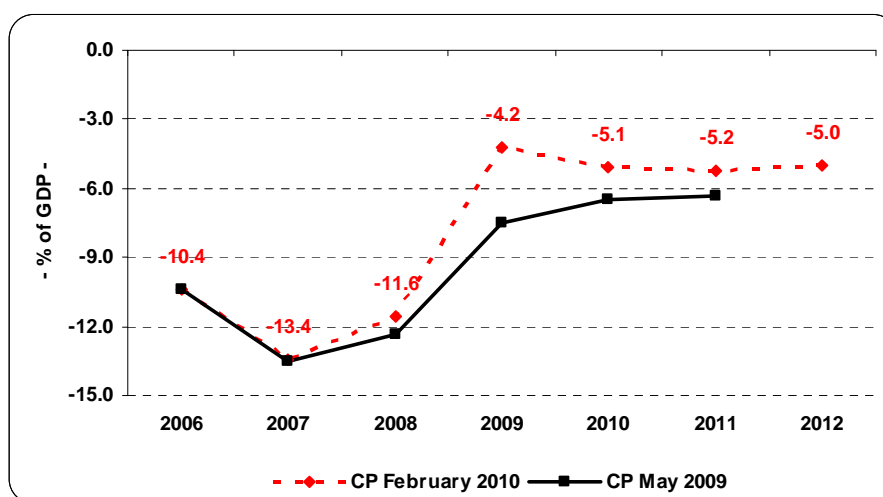
Chart 4.5 Comparison between the net export contribution to the real GDP growth



Source: National Commission for Economic Forecasting

The strong adjustment of the current account deficit from 11.6% of GDP in 2008 to 4.2% in 2009 will be reflected accordingly in the medium term developments. The current account deficit will be relatively stable between 2010 and 2012, registering a lower level compared to the previous edition of the Convergence Program.

Chart 4.6 Comparison between the current account deficit shares in GDP



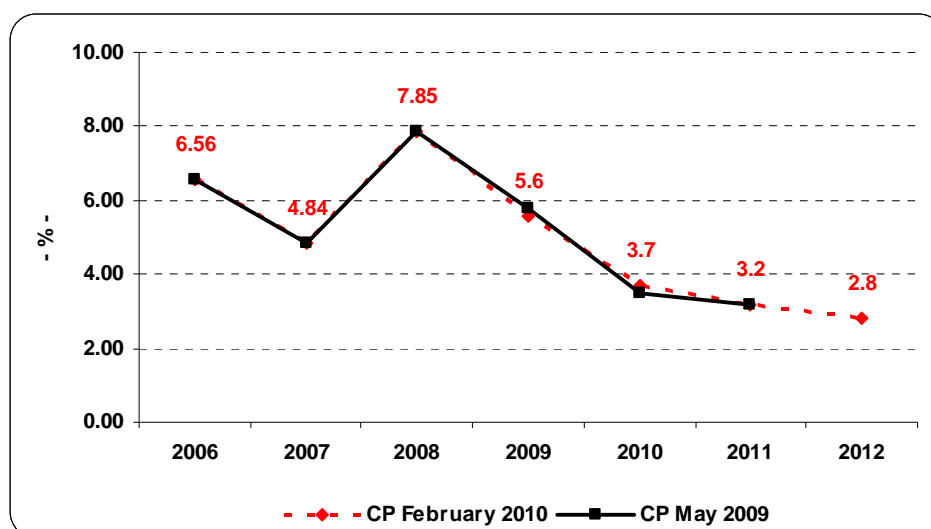
Source: National Commission for Economic Forecasting

The evolution of consumer prices in 2009, as annual average, registered a downward trend, expected in our previous convergence program edition, with an outcome 0.21 percentage points below the estimates. Thus, the annual average growth of consumer prices reached 5.59%, as against 5.8% (the forecasted average). The

reduction of the consumer prices was due to a more favorable evolution of the food commodity prices, which increased by only 3.25 %.

The disinflation trend is expected to continue in 2010, the estimated annual average being of 3.7 %, higher by 0.2 percentage points compared with our previous evaluation. This increase comes from a faster price growth in the first month of the year, due to excise increases but also to the exchange rate used in the calculation.

Chart 4.7 Comparison between annual average inflation rates



Source: National Commission for Economic Forecasting

#### 4.2 Budget Deficit Comparison

The previous edition of the Convergence Program forecasted a budget deficit of 5.1% of GDP in 2009, calculated on the basis of the budget approved by the Parliament. Due to the difficult economic conditions, the budget deficit has been rectified upward in September 2009, at 7.3% of GDP on a cash basis. In 2009, the cash deficit outcome was 7.2% of GDP according to the provisional data and 8.0% of GDP according to ESA 95. As a result of these deviations, the medium term deadline for the correction of the budget deficit below 3% of GDP was prolonged to 2012.

	-% of GDP			
Table 4.1 comparison of budget deficit	2008	2009	2010	2011
1. CP May 2009	5.4	5.1	4.1	2.9
2. CP February 2010	5.5	8.0	6.3	4.4
3. Differences (2-1)	0.1	2.9	2.2	1.5

Source: Ministry of Public Finance



## 5. GOVERNMENT FINANCES - DEFICIT AND DEBT

### 5.1 Fiscal and Budgetary Policy

The government budgetary strategy aims to restore the credibility and stability of public finance on short and medium term, by promoting a coherent mix of measures able to diminish the budget deficit, to reduce the financing needs while allocating a high level of resources to the public investments. An important component of the fiscal consolidation is maximizing the structural funds absorption in order to finance public investments, sustain the economic recovery and partially compensate the lower activity in the private sector. The level of the public investments will be maintained due to the positive impact on the potential economic growth but their financing will be to a large share from European funds.

The fiscal objectives have been adjusted as a reaction to the actual economic crisis but the fundamental priorities will continue to be ensuring the medium and long term public finance sustainability and the fair division of the expenditures and the tax burden between the generations and, on short term, sustaining the monetary policy, in particular the symmetric functioning of the automatic stabilizers in order to contain the volatility of the economy and to sustain the additional reduction of the inflation and interest rates. Coordinating the macroeconomic policies, mainly the monetary and budgetary policies is compulsory in order to adjust in a sustainable manner the macroeconomic imbalances and to prevent their amplification along the projection horizon.

1. sustainable adjustment of the budget deficit with a view to reach the level of 3% of the GDP until 2012;
2. develop a binding medium term budgetary and fiscal framework;
3. improve the tax administration by continuing the reform process and reduce the compliance costs;
4. improve the efficiency level of the way the public funds are used by setting up clear formulated priorities, mainly for the investment projects by the horizontal coordination of the economic policies;
5. improve the sustainability of the social protection system;

The Government vision in the fiscal policy area is continuing to be focused on ensuring a motivating and level playing field for a better transparency, stability and predictability. Additionally, the improvement of the public finance sustainability represents a major priority given the unfavorable demographic perspectives.

The complex character in which fiscal policy will be implemented derives, on one hand, from the necessity to promote an orderly adjustment process of the macroeconomic imbalances in order to prevent a long period of economic contraction and, on the other hand, to support the low income population segments and increase the volume of the public investments.

The estimated adjustment of the current account deficit to 4,7% of GDP in 2009, as a result of the lower aggregate demand, has been mainly due to the improvement of the private sector saving-investment balance. The public budget deficit increased compared to the outcome in 2008 due to the contraction of the consolidated budget revenues and the functioning of the automatic stabilizers, allowing the mitigation at the macroeconomic level of the contraction of the corporate and households consumption and investments demand.

The economic recovery process expected in 2010 creates the needed conditions for accelerating the fiscal consolidation. The actual edition of the convergence programme presents a strategy for ending the excessive deficit procedure and to reduce the government deficit below the level of 3% of GDP by 2012. On long term, the Government will continue its efforts for the fiscal consolidation in order to reach a balanced budget along the economic cycle, creating at the same time a safety margin in order to avoid exceeding the ceiling of 3% of GDP given possible future adverse economic conditions which a negative impact on the economic growth rate. Implementation of the fiscal responsibility law is an important anchor from the perspective of changing the institutional incentive framework and increasing the probability of benefitting from sound fiscal policy decisions, able to allow the attainment of these objective.

### **5.2 Public Finance Development in 2009**

By the end of 2008, the economic activity has been gradually decelerating, from an average quarterly increase of 9% yoy up to a decline of 13% in the last quarter and continued the decreasing trend in 2009. The decline was determined by the

contraction of the domestic demand, particularly the consumption, as a result of the lower credit availability, diminishing population incomes and deteriorating consumer sentiment. The budget deficit has been revised by two budget rectifications at a level of 4,6% and 7,2% of GDP respectively, calculated according to the cash methodology, as a result of the deterioration of the macroeconomic framework, providing a balance between the short term answer of the fiscal policies to the cyclical developments and to the medium term consolidation objectives.

Therefore, a more pronounced short term adjustment would exacerbate the recession by an additional negative pressure on the domestic demand, and at the same time, giving up the medium term consolidation plans to reduce the budget deficit below the ceiling of 3% of GDP would have negative consequences on the trust of the financial markets and on the perspectives of joining the euro area.

#### **The Government's answer to the severe deterioration of the economic activity**

The 2009 initial budget has foreseen budgetary measures for limiting the deterioration of the fiscal position, the most important being: (i) an increasing by 3,3 percentage points of the social contributions; (ii) increasing the excise for tobacco and spirits; (iii) expenditures rationalization of the public sector salaries by freezing them, cutting down the bonuses and benefits, freezing the public sector employment and elimination of the vacancy jobs; (iv) reducing the goods and services and subsidies expenditures.

The first budget rectification in April 2009 diminished additionally the budget expenditures by 0,85% of GDP and increased the revenues with 0,25% of GDP, the main measures being: (i) freezing the public sector salaries; (ii) freezing the acquisition of vehicles, furniture and office supply; (iii) supervision of the main economic operators, having state owned capital and partially or totally state owned patrimony, in order to reduce the arrears, outstanding debts and losses; (iv) creating a minimum income tax for contributors who declare a lower income tax compared to the legal threshold; (v) lack of deductibility of the expenditures for fuels and certain transportation means; (vi) non-deductibility of the value added tax related to the procurement of vehicles and fuel, excepting vehicles designated exclusively for the mass transportation.

As a result of the higher than expected economic contraction, the second budget rectification focused on the additional reduction of the budgetary revenues

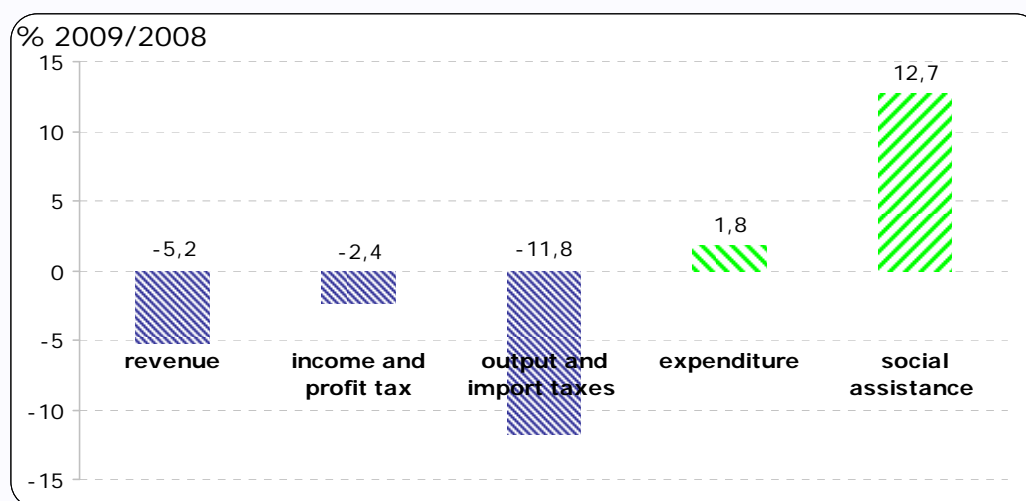
projections by 17,4 billion lei (3,5% of GDP) and the upward revision of the deficit to 7,2% of GDP (according to the cash methodology), equivalent of adjustment measures amounting to 0,8% of GDP for the rest of 2009. The net adjustment was provided by a supplementary reduction of expenditures as follows: canceling the payments related to bonuses and supplementary working hours in the public system (estimated savings of 0,1% of GDP); compulsory free of pay vacation for 10 days for all the government layers (estimated savings of 0,3% of GDP); freezing the expenditures of goods, services and certain transfers (estimated savings of 0,2% of GDP), including restructuring of some state agencies which are going to be dissolved, merged or integrated in the respective ministries.

The budget deficit has increased from 5,5 % of GDP in 2008 to 8% by the end of 2009 (7,2% according to cash methodology), mainly as a result of the impact of the economic contraction on the budgetary revenues and expenditures (automatic stabilizers), but also due to related measures to sustain the economic recovery and stability process.

The budgetary revenues recorded a negative nominal dynamic (5,2%) compared to the previous years growth rates of over 10%, mainly due to the reduction of fiscal and non fiscal revenues by 8%, as a result of the negative developments of the foreign trade and the private consumption on the import and production tax revenues (-11,8% yoy). The reduction of VAT revenues (-16%) and custom taxes (-32%), has been partially compensated by the excises revenues(14,2%), as a result of the increase of the excise level for cigarettes and of the developments of the exchange rate.

The dynamic of the income and profit tax collections (-2,4%) has been affected by the reduction of the turnover across the economy sectors and by the labor market deterioration tendency so that the revenues out of the profit tax recorded a contraction by 8,9% while the collections out of the income tax maintained relatively constant. The collections out of social contributions contracted by 2%.

Chart 5.1 Factors explaining the budget deficit development over 2009/2008



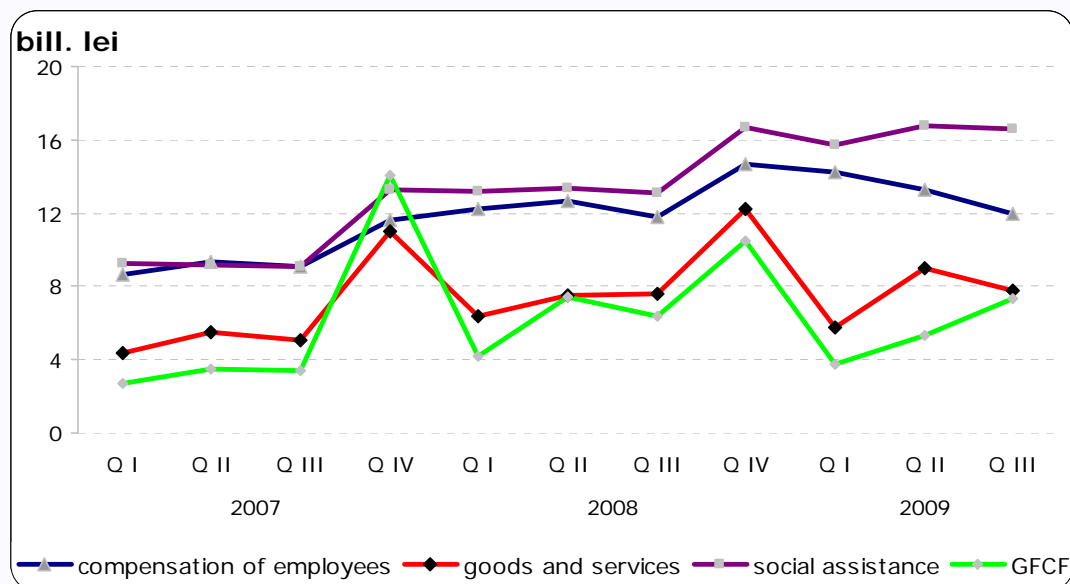
Source: Ministry of Public Finance, european methodology

The lower revenues were compensated by a strict control of the budgetary expenditures. The advance of 1.8% of the general consolidated budget expenditures was mainly due to the social assistance and interests expenditures which increased by 12.7% and 92% respectively, as a result of the functioning of the automatic stabilizers, but at the same time due to the developments of the interests rates and the higher public debt stock. In order to mitigate the economic and financial crisis impact on the most vulnerable social categories, the Government introduced a minimum social pension for the retired people, starting with the 1<sup>st</sup> of April 2009 amounting to 300 lei with a later increase to 350 lei starting with the 1<sup>st</sup> of October 2009. Moreover, the pensions were increased by 3% starting with the 1<sup>st</sup> of April 2009 and by 2% starting with the 1<sup>st</sup> of October 2009 while the guaranteed minimum income was increased by 15% financed entirely from the state budget.

The salary expenditures diminished by 4.0% yoy as a result of tight control measures and the reduction of the bonuses and supplementary payments despite the base effect of the salary increasing measures granted in the second part of 2008 (otherwise the reduction of salary expenditures would have been even higher). The goods and services expenditures were lower by 11.5% yoy, as a result of reducing measures approved by the Emergency Government Ordinance no.34/2009 regarding the budget rectification for 2009. Moreover, the restructuring of the state agencies of the government sector, by dissolving, merging or incorporating them in the respective ministries, facilitated the reduction and the control of these

expenditures. The public investments represented a priority for the Government in 2009, and as a result the gross fixed capital formation increased yoy by 0.8 percentage points of GDP, having a countercyclical impact on the aggregate demand.

Chart 5.2 Quarterly evolution of budget spending, composition



Source: Ministry of Public Finance, european methodology

### Fiscal measures developed in 2009

#### VAT

- implementing the provisions of the European directives especially the Directive 2008/8/CE, Directive 2008/9/CE, Directive 2006/112/CE and Directive 2008/117/CE in the national legislation;
- setting up the obligation of submitting monthly VAT tax deduction forms by the all tax payers categories realizing income from intra-community acquisitions;
- extension up to December 31, 2012 of the obligation to pay VAT in the customs for the goods imports;
- eliminating the reverse charge/taxation for the delivered goods or/and services provided by the persons for which the insolvency procedure was opened;
- increase in advance compared to initial calendar the excises for cigarettes and tobacco products in two stages (1<sup>st</sup> of April and 1<sup>st</sup> of September);
- increase the excises for certain alcohol products;
- implementing in the national legislation the provisions of the new European

community directive which regulates the excises (Directive 2008/118/CE for the general regime of excises);

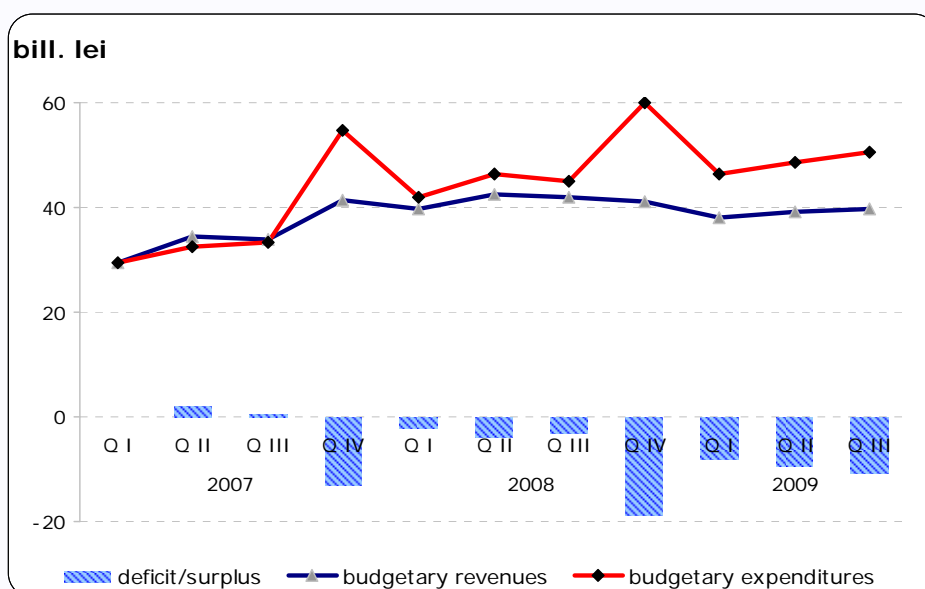
**Profit tax**

-introducing a minimum profit tax;

-approving profit tax exemption for the reinvested profit by Law no.329/November, 2009;

-taxation of the reserves resulted out of the re-evaluation of the fixed assets including the land, made after the 1<sup>st</sup> of January 2004, along with the fiscal amortization or at the moment of deducting them from the records.

**Chart 5.3 Quarterly evolution of budget revenue and spending**



Source: Ministry of Public Finance, european methodology

**5.3 2010 and Medium Term Public Finance Development**

The budgetary policy was formulated to support the reduction of the budgetary deficit and the diminishing of the net financing needs of the public sector while at the same time sustaining the economic recovery process and creating of new jobs. Therefore, the Government intends to:

- Maintain unchanged the general taxation level;
- Rationalize the current budget expenditures and increase the fiscal investment space;
- Ensure the proper conditions for the absorption of the structural, cohesion and Common Agricultural Policy funds;

- Create a binding medium term expensenditure framework;
- Combat the tax evasion and improve the collection;
- Finalize the standard costs and the personnel and quality norms for the public services.

The budgetary programme of 2010 focuses on reducing the budget deficit to 5,9% of GDP (6,3% according the European methodology), involving an equivalent of 2 percentage points of GDP adjustment compared to 2009 in structural terms. The adopted measures are focused on reducing the current expenditures which registered a rapid dynamic in the last years, mainly: (i) diminishing the personnel expenditure by freezing the salaries (except the salaries below the monthly ceiling of Ron 705), freezing the public sector employment and continue the replacing policy of 1 person out of 7 leaving the system and cutting down the bonuses and supplementary hours payment; (ii) freezing the pensions (except the social pensions) and promoting a better rationalization of the disability and anticipated pensions taking into account a more restrictive implementation of the current legislation; (iii) diminishing the goods and services and certain transfers expenditures; (iv) a better administration of the social assistance and consolidation of the existing number of 200 social assistance programmes while at the same time ensuring the improvement of the social protection system by a better expenditure targeting and securing additional resources; (v) re-evaluation of the taxation of the property and land, the increase of the tobacco and fuels excises and establishment and collection of a turnover tax for the medical products distributors.

**Table 5.1 Adjustment measures on revenue and expenditure in 2010**

	2010 (% din PIB)
Budget deficit, baseline	9.0
Budget deficit, programme	5.9
Adjustment effort, out of which:	3.07
Expenditure	2.08
Adjustment in personnel spending (wage freeze, cut in bonuses)	0.8
Savings in pension fund	0.77
Cuts in goods and services	0.5
Revenue	0.99
Increase in excises	0.37
Reimbursement of Rompetrol bond	0.47
Turnover tax on medical distributors	0.1
Other measures	0.06

*Source: Ministry of Public Finance, cash methodology*



The difficult and volatile European and international context increases the uncertainty related to the medium term public finance evolution, the economic forecasts being especially influenced by the economic recovery perspective of the EU economies.

Some reform measures expected to lead to long-term savings and improve the quality of the public finances, are relevant for the fiscal strategy, including: (i) restructuring the public sector at the same time with the implementation of the unitary salary system; (ii) the pension reform; (iii) implementing a binding medium term budgetary framework and the Fiscal Responsibility Law; (iv) restructuring of the state owned enterprises; (v) restructuring the financial relationships of the local authorities and self financed institutions in order to ensure a higher financial responsibility; (vi) improving the tax administration; (vii) increased efficiency of the social assistance programmes. These measures are detailed in the chapters regarding the quality of public finance and sustainability of the public finance.

**Table 5.2 The main fiscal-budgetary developments in 2010-2012**

Legislation	Forecast 2010-2012
<b>Income tax</b>	
Maintaining the flat rate for income tax at 16%.	A decline by 0.2 percentage points as share in GDP in 2010.
Temporary elimination of the income tax for interest earnings, including those of non-residents, with a view to stimulate saving (2010).	On medium-term we estimate the same prudent evolution of wages in line with productivity gains; income tax proceeds are expected to remain at 3.5% of GDP in 2011-2012.
<b>Profit tax</b>	
Maintaining the flat corporate tax rate at 16%.	A decline of 0.2 percentage points as a share in GDP compared with the previous year, reaching a level of 2.6% of GDP until 2012.
Elimination of the minimum tax and introducing a forfeit tax system, applied only to specific areas of activity.	
Maintaining the exemption of the taxation of the reinvested profit in equipment and technologies in 2010.	
<b>VAT</b>	
Maintaining the actual statutory rates	Modest nominal increase in 2010 as

Legislation	Forecast 2010-2012
<p>for VAT. Implementing the Directive 2009/162/EU of the Council from December, 2009 and some provisions from Directive 2008/8/EC of the Council from February, 2008.</p>	<p>compared with receipts in 2009, VAT revenue as a share of GDP will remain on a medium term at a lower level than 2008 outcome in line with a balanced development in consumption and external trade.</p>
<b>Excises</b>	
<p>The increase of excises beginning with the 1<sup>st</sup> of January 2010 for certain category of products according to the agreed schedule (cigarettes, some energy products, electricity). Eliminate of the unharmonized excise area the products for which the excise is set up in percentage quotas beginning with the 1<sup>st</sup> of January 2010. Medium term increase of the excise for certain excisable products according to the schedule set up in the Romania's transition periods foreseen in the Accession Agreement.</p>	<p>Increase by 0.3 percentage point as a share of GDP compared with 2009, following the positive impact of exchange rate and excise level increase. The revenues from excises are estimated to reach 2.8% of GDP in 2011 in line with the economic assumptions and legal provisions.</p>
<b>Social Security Contributions</b>	
<p>Maintaining the level of social security contributions on medium term. Maintaining the fiscal facility regarding the technical unemployment in 2010. Create certain facilities regarding the exemption from the payment of social security contributions by the employers which hire unemployed persons in certain conditions in 2010.</p>	<p>A moderate increase of the gross wages on medium term and the gradual implementation of the second pension pillar will lead to the diminishing of the share of the social contributions in GDP until 2014.</p>
<b>Local taxes</b>	
<p>Increasing the financial autonomy of</p>	<p>The local revenues register a 16.8%</p>

Legislation

Forecast 2010-2012

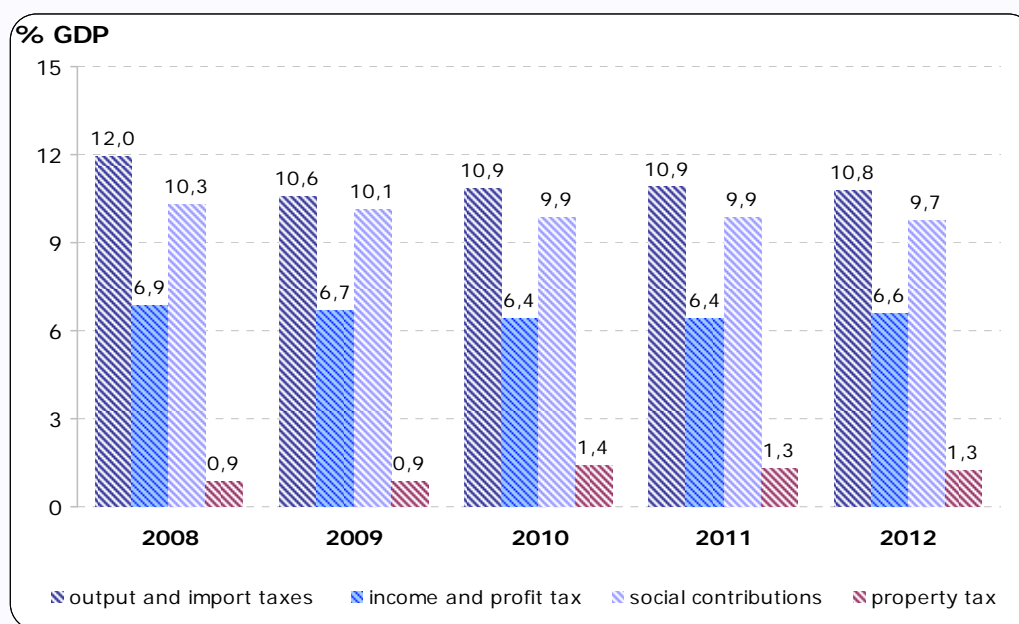
the local authorities and the consolidation of the local budget revenues by:

- (i) granting the authorization to adjust the level of the local taxes according to the local needs and local population preferences;
- (ii) calculate at market level the income tax value for the buildings and inner land if their market value is higher than the value determined by the actual formula;

the nominal increase compared to 2009, taking into account the reevaluation of the property taxes starting with the 1<sup>st</sup> of January 2010.

Medium term budget framework will be designed within the fiscal strategy formulation process provided under the Fiscal responsibility law.

Chart 5.4 Evolution of budget revenue in 2008-2012



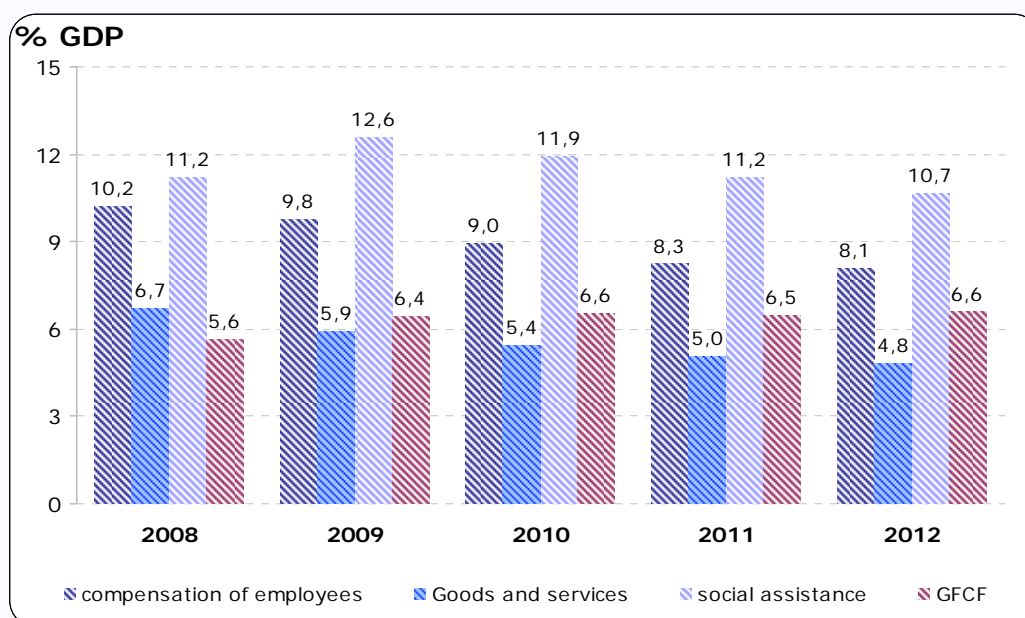
Source: Ministry of Public Finance, european methodology

The Government is committed to continue between 2010-2012 the consolidation measures taken in 2009, ensuring at the same time the social protection of the lower income population categories, The budget deficit level is expected to diminish by 1.7 percentage points of GDP in 2010, 1,9 percentage points of GDP in 2011 and 1.4 percentage points of GDP in 2012 equivalent of a cumulated reduction of 5

percentage points of GDP between 2009-2012. The diminishing of the personnel expenditures by 1.7 percentage points of GDP is based on the restructuring of the public salary system and the savings made by the implementation of the unitary salary law, resulting in an expected share of 7% of GDP of the personal expenditures in 2015 (cash methodology). The Government estimates that the rationalization of the material expenditures correlated with the implementation of the public administration standard costs will generate additional savings of 1.1 percentage points of GDP. Making the social assistance programmes more efficient by an improvement of their targeting correlated with the impact of the economic recovery and the functioning of automatic stabilizers, will ensure a reduction of their share by 1.9 percentage points of GDP up to 2012.

The subsidies will continue to be cut down according to the commitments assumed toward EU, generating cumulated savings of 0.4 percentage points of GDP until 2012. The resulting additional fiscal space will enable the maintenance of the investments on medium term to around 6.5 % of GDP.

Chart 5.5 Development of budgetary expenditures in 2008-2012



Source: Ministry of Public Finance, european methodology

#### 5.4 EU Accession Impact on the Public Finance

Achievement of a high level of EU funds absorption within 2010-2012 periods represents one of the Romania's main objective and at the same time, a major benefit of the accession to the European Union, requiring efforts to ensure a flexible accession system and to eliminate certain barriers that may constraint the absorption process.

**Table 5.3 Distribution of Amounts Allocated to Romania in 2007-2012**

	mil. euro
Tool	Total
Structural and Cohesion Funds	19.668
European Agricultural Fund for Rural Development	8.022
European Fisheries Fund	231
European Agricultural Guarantee Fund	6.884,0
<b>Total</b>	<b>34.805</b>

*Source: Ministry of Public Finance*

The following two years are decisive for completing the preaccession funds absorption process given the fact that PHARE, ISPA and SAPARD programs will cease after the integral finance of the projects. EU is going to reimburse 18.267,03 mil EUR out of the pre-accession funds in the 2010-2012 period.

**Table 5.4 Distribution of the post-accession funds estimated to be reimbursed by EU in 2010-2012 period**

	mil. euro			
Tool/Year	2010	2011	2012	Total 2010-2012
Structural and Cohesion Funds	2.497,88	3.514,27	4.132,19	10.144,34
European Agricultural Fund for Rural Development	1.665,53	1.694,68	1.590,58	4.950,79
European Fisheries Fund	36,40	39,30	42,30	118
European Agricultural Guarantee Fund	873,10	1.023,40	1.157,40	3.053,9
<b>Total</b>	<b>5.072,91</b>	<b>6.271,65</b>	<b>6.922,47</b>	<b>18.267,03</b>

*Source: Ministry of Public Finance*

In the context of the new approach regarding the reflection in the state budget of the amounts earmarked to finance the draft projects that are going to be implemented by the beneficiaries from the public administration, under the programmes related to the EU Cohesion Policy, the Joint Agricultural and Fishery Policies as well as other post-accession facilities and instruments that operate on the principle of expenditures reimbursement by the beneficiaries, the budgetary revenues will reflect a part of the expenditures corresponding to the amounts to be reimbursed by the EU. These amounts will be registered as revenues to the budget which sustained the financing of the respective projects.

The amounts reimbursed by the EU in the account of the expenditures made by the post-accession programmes, are both related to the projects whose beneficiaries are from the Government and private sector, the later one not being reflected as revenues in the budget.

In 2009, the central and local administrations expenditures related to the projects having post-accession financing and to the programmes co-financed from community funds, are estimated to 7.6 billion Lei (1.43% of GDP). The post-accession revenues estimated for 2009 are 4.8 billion lei, representing 0.9% of GDP<sup>4</sup>. Achievement of the forecasted level of revenues out of post-accession funds is made conditional by the acceleration of the absorption process. An important role from this perspective will have the inter-ministerial group established for the monitoring of the implementation projects financed with EU funds, coordinated by the prime minister, expected to analyze weekly the absorption process.

Moreover, the Ministry of Public Finance will have a major contribution as a national coordinator of the administration of the PHARE, ISPA and structural instruments. In the following table we present the budget projections related to the projects financed by EU funds and the estimated amounts which are forecasted to be reimbursed by the EU.

**Table 5.5 Budget financing of EU projects**

	-bill. lei-		
	2010	2011	2012
Revenues	7,04	8,69	9,76
Expenditures *	11,52	12,25	12,59

*\*) including national contribution*

These estimates are only indicative, the level of the absorption of the European funds being continuously monitored by the Government aiming to identify and promote the necessary measures in order to increase the medium term absorption capacity.

### 5.5 Calculation of the Cyclical and Structural Deficit

Calculation of the Cyclical and Structural Deficit as well as of the potential Gross Domestic Product (using the Cobb Douglas production equation), have been achieved using the OECD and EC methodology, as described by Van der Noord (2000) and Girouard (2005). The data used have been based on the Eurostat data, average 2000 prices base (TRAMO-SEATS was used to deseasonalize).

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

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

The cyclical component of every income and expenditures category,  $B_{tj}^C$ , is calculated by using the output gap and the estimated GDP elasticity ( $\alpha_j^{PIB}$ ). The formula used in order to calculate the cyclical component is the following:

$$B_{tj}^C = B_{tj} \times \alpha_j^{PIB} \times output\_gap_t$$

The results are presented in the following table:

**Table 5.6 The cyclical and structural deficit (% of the GDP)**

% of the GDP	2007	2008	2009	2010	2011	2012
1. Real GDP growth (%)	6.2	7.1	-7.0	1.3	2.4	3.7
2. Current balance	-2.5	-5.5	-8	-6.3	-4.4	-3
3. Net payments of interest	0.8	0.8	1.5	1.8	1.8	1.5

% of the GDP	2007	2008	2009	2010	2011	2012
4. Output gap	2.7	6.09	-2.16	-3.06	-2.27	-0.55
5. Cyclical component of the budget	0.76	1.75	-0.60	-0.83	-0.61	-0.15
6. Adjusted cyclical balance	-3.26	-7.25	-7.40	-5.47	-3.79	-2.85
7. Adjusted primary balance	-2.46	-6.45	-5.90	-3.67	-1.99	-1.35

The output gap was negative in 2009 as a result of a higher GDP contraction compared to the potential level. The structural deficit increased from 3.26% of GDP in 2007 to 7.25% of GDP in 2008, demonstrating once again that the budgetary policy was pro-cyclical exacerbating the macroeconomic imbalances while for 2009 the structural deficit was rather stable compared to the previous year.

Leaving the automatic stabilizers to function, the Government allowed the increasing of the budgetary deficit in 2009 in order to reduce the impact of the lower aggregate demand in the private sector.

There is a medium term tendency of diminishing the negative cyclical component which is expected to reach a positive level between 2012-2013, due to economic recovery and a more rapid growth of the GDP compared to the potential. From a theoretical point of view, a zero value of the output gap, would lead to the equalization of the budget deficit and the structural one (the output gap and the cyclical components are approximately equal to zero). Practically, this may happen in 2012 when the value of the output gap tends toward zero (-0.5% of GDP) and the structural deficit (2,8 of GDP) is very close to the effective one (3% of GDP).

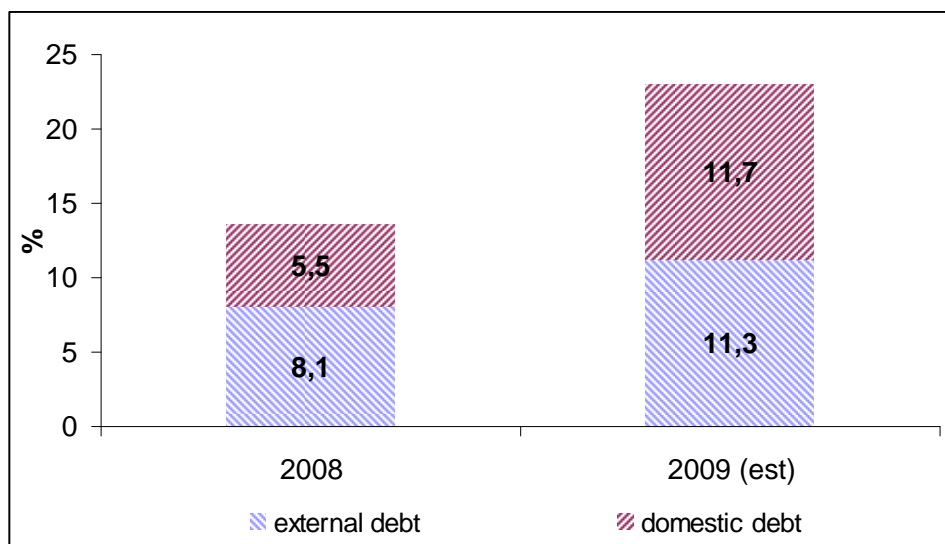
## 5.6 Public Debt and Debt Strategy

The level of public indebtedness of Romania is around 25% of GDP, clearly below the 60% ceiling established by the Maastricht Treaty. Thus, at the end of 2008 the government debt calculated according to EU methodology (ESA 95) represented



13.6% of GDP, increasing to 23% of GDP at the end of 2009 as a result of the international financial crisis and deepening recession in Romania, out of which the domestic debt was 11.7% and the external debt was 11.3%.

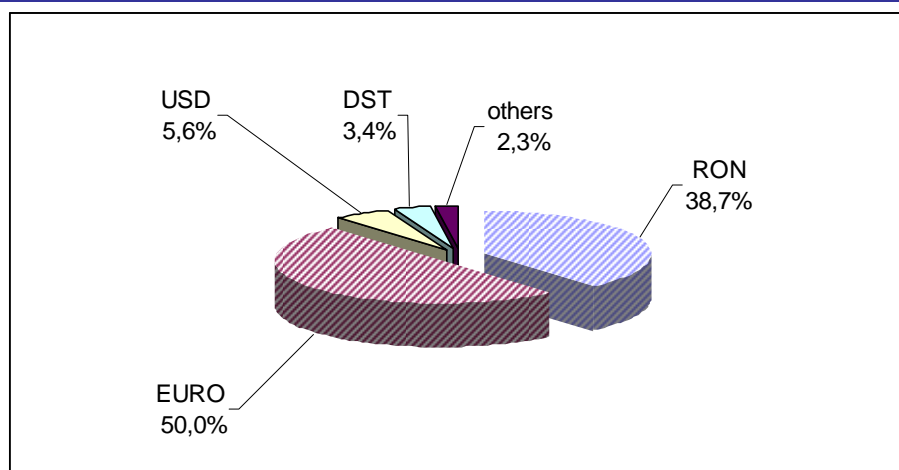
Chart 5.6 Government debt structure



Source: Ministry of Public Finance

The breakdown of the public debt at December 31, 2009 by debt instruments shows that the issuance of government securities represented 51.0% of the total debt, the difference being covered by loans. As regards the initial maturity of the public debt, 20.9% of the total represented short-term debt, while 79.1% being represented by medium and long term debt. At the same time, regarding the structure of the public debt by interest rate, 52.2% of the total was variable interest rate debt. The public debt issued in domestic currency at the end of 2009 represented 38.7 % of the total debt, while the largest share of the public debt contracted in foreign currency was denominated in Euro, respectively 50.0% of the total government debt.

Chart 5.7 Structure of Securities Issued by the State, by Maturity



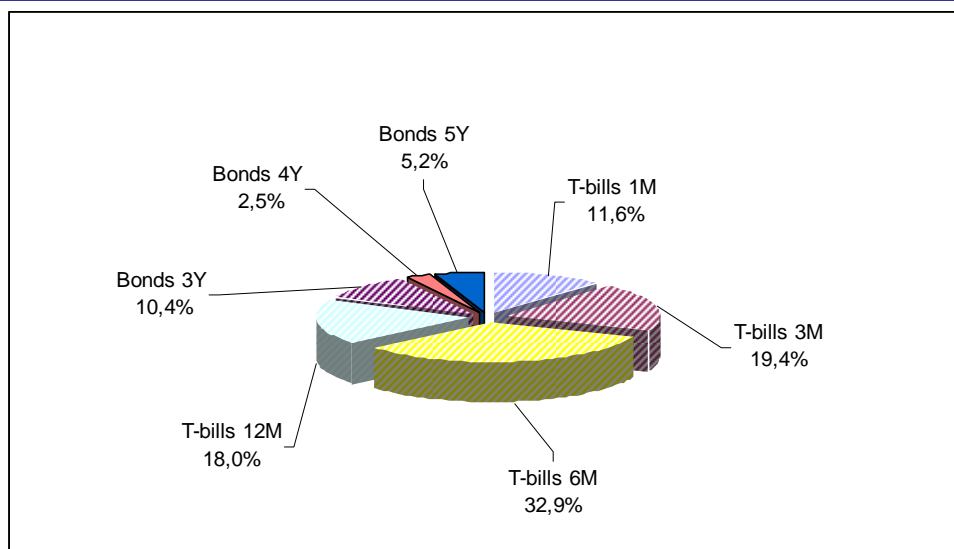
Source: Ministry of Public Finance

The financing of the budgetary deficit in 2009 and the refinancing of the public debt was accomplished mainly from domestic sources and additionally from external sources through:

- Issuance of government securities in local currency on the domestic market, respectively T-Bills and benchmark bonds with medium-term maturity (3 and 5 years),
- Contracting domestic market loans, as well external loans used for projects finance,
- Contracting loans within the financial package concluded with the IMF, EC and World Bank,
- Loans contracted by the local public administration authorities,
- Amounts recovered by the Authority for State Assets Recovery from the non-performing banking assets and amounts recovered by the Ministry of Economy under GEO no. 249/2000.

Government securities were regularly issued in 2009 on the domestic market according to the announced issuance calendar, in order to sustain the objective of developing the domestic security market and building the domestic yield curve for government securities.

Chart 5.8 Structure of government securities issued in 2009, by maturity



Source: Ministry of Public Finance

Based on the consultation with market players, there were issued government securities of 5.7 billion lei until the end of January 2010, out of which 6 and 12-month treasury bills amounted to 4.7 billion lei while the difference was represented by 3 and 5-year benchmark bonds. The government securities yields went down by 2 percentage points yoy in January. Depending on their maturity and taking into account the NBR decision to cut further the key interest rate at 7% and the average inflation target established at 3.5%, we expect a continuing declining trend of the yields.

Given the accumulation of increased refinancing risk by issuing large short term volumes of government securities and taking into account the comparative costs advantage, Romanian authorities agreed in March 2009, a 2 years financial package with the IMF, the EU Commission and other international financial institutions (World Bank, EIB, EBRD) amounting to 19.95 billion euros, with the aim to avoid a further deterioration of the economic situation.

The first tranche from the European Commission loan amounting to 1.5 billion euros disbursed in July and half of the second tranche from the IMF credit (SDR 1.7 billion) disbursed in September were used for budget deficit financing. Moreover on October 21, 2009 was disbursed the first development policy loan (DPL 1) from the World Bank amounting to 300 million Euros.

Our main objective was represented by the minimization of the medium and long term costs and reducing the refinancing risk by balancing the maturity of the contracted debt, while building the domestic market securities issuance, in order to reduce the currency risk and sustain the development of this market.

The Ministry of Public Finance provided state guarantees in order to attract financial resources and sustain high economic multiplier projects for companies influenced in a negative way restrained in their access to financial resources by the global financial crisis. Thus, starting July, 2009 became operational the government programme "First Home" (issued for banks to sustain the residential mortgage market).

The ceiling of guarantees agreed with the IMF in 2009 amounting to 7.7 billion lei was increased to 12.0 billion lei and extended to the 2009-2012 period with the additional amounts secured to ensure the co-financing of the projects financed by the European Union and other multilateral financial institutions (EBRD, IFC and EIB).

**Table 5.7. State Guarantees**

- mil. EUR -

	2006	2007	2008	2009
The amount of state guarantees issued for domestic and external loans, out of which:	58.6	118.9	0.0	486.4
- contracted by the local public administration authorities	7.2	0.0	0.0	0
- First House Program	-	-	-	486.4
- contracted by economic operators	51.4	118.9	0.0	0

Source: Ministry of Public Finance

During 2010-2012, the budget deficit will be financed from both domestic and external sources, having in view the attainment of progress in terms of the implementation of the medium term Government Public Debt Management Strategy, as follows:

1. controlled increase of the public debt;
2. lowering the medium and long term public debt costs;
3. limiting the risks associated with the public debt portfolio;
4. developing government securities market.

The external loans, contracted from the IMF, the European Commission and the World Bank will be used for the financing of the budget deficit in 2010 and 2011.

It is estimated that in 2010, approx. EUR 3.35 bln. will be drawn within the medium term financial assistance from the EC and EUR 0.7 bln. within DPLs loans contracted from the World Bank, as well as half of the 3<sup>rd</sup> and 4<sup>th</sup> tranches from the IMF loan, amounting to SDR 1.1 bln. (respectively EUR 1.2 bln.)

Half of the 2<sup>nd</sup>, 3<sup>rd</sup> and 4<sup>th</sup> tranches, as well as the other tranches from the IMF credit, which will be used by the NBR to consolidate its foreign exchange reserves and support the balance of payments, were not included in the *public debt* presented in Table 3 according to EU methodology (ESA95).

We underline the fact that the governmental debt figures are dated December 2009 while the state bonds market related data is up to January 2010.

We also mention the fact that the 3<sup>rd</sup> and the 4<sup>th</sup> tranches have been withdrawn out of the IMF loan in February 2010, in equal percentages, by the Ministry of Public Finance and the National Bank of Romania. Supplementary, the EC launched the common currency issue for Romania in March, related to the 2<sup>nd</sup> tranche amounting to 1 billion EUR scheduled to be withdrawn until the middle of March, 2010.

## 5.7 Sensitivity Analyses

The main hypothesis of the baseline scenario presented in the Convergence Programme is provided by the gradual recovery of the global economy growth. A positive external demand shock (a faster recovery of the euro area), has a direct positive impact on the domestic economic growth and the corporate profitability by the increase of the net exports, and subsequently, on the private sector wages, disposable income and consumption.

Despite the lowering risks regarding the economic activity trend, we should be prepared for a more conservatory evolution of the public finance, if the baseline scenario does not materialize.

The amplitude of the economic recession and recoveries is usually underestimated. Regarding the budgetary revenues, the underestimation is relevant for the volatile base revenues, as profit tax, while the taxes associated to the labor market are overestimated on the recovery side of the business cycles.

### The elasticity of the budgetary variables

The budgetary revenues are obviously influenced by the employment level in the economy, by the average earnings and the economic growth. The following table presents the impact on the budgetary revenues, of the variation of the economic variables, considered as exogeneous, taking 2009 as a starting year. Taking into account the share in the total budgetary revenues, the greatest risk compared to the baseline scenario is represented by the social security contributions and indirect taxes (VAT). Referring to the social contributions, a lower real GDP growth by 1 percentage point will lead to an estimated negative impact on social security contributions collections of 0,2% of GDP, due to a reduction of the average earnings and employment level.

In this context it is important to mention the Government decision for stimulating the labor market by granting facilities to the companies related to technical unemployment and for hiring unemployed persons.

**Tabelul 5.8 Sensitivity of the general consolidated budget revenues to the variations of the macroeconomic variables**

Category of taxes (share in GDP)	Macroeconomic base	Variations of the macroeconomic base (pp)	Variations of the revenues (% of GDP) 2009
1. Personal income tax (3.5%)	Gross average salary	Reduced by 1	-0,027
	Employment level	Reduced by 1	-0,029
	Gross domestic product	Reduced by 1	-0,075
2. Social security contributions (9.9%)	Gross average salary	Reduced by 1	-0,077
	Employment level	Reduced by 1	-0,125
	Gross domestic product	Reduced by 1	-0,204
3. Profit tax (2.3%)	Gross average salary	Reduced by 1	0,005
	Employment level	Reduced by 1	0,040
	Gross domestic product	Reduced by 1	-0,010
4. Value added tax (7.3%)	Gross average salary	Reduced by 1	-
	Employment level	Reduced by 1	-
	Gross domestic product	Reduced by 1	-0,062
Total	Gross average salary	Reduced by 1	-0,100
	Employment level	Reduced by 1	-0,114
	Gross domestic product	Reduced by 1	-0,340

Source: Ministry of Public Finance

### Public Debt Sensitivity

Two scenarios were used for analyzing the impact of the economic growth on the budgetary stance. The baseline scenario is represented by the medium term projections presented in the macroeconomic framework; the alternative scenario is based on an economic growth hypothesis lower by 1 percentage point compared to the baseline scenario. In the baseline scenario, the share of the public debt in GDP is expected to increase by 6,7 percentage points in 2012 compared to 2009 (from 23,0 to 29,7%), while in the alternative scenario the public debt is expected to increase by 7 percentage points (from 23,0 in 2009 to 30,0% in 2012).

Currency appreciation/depreciation compared to EUR: the alternative scenario was based on a medium term depreciation hypothesis by 5% of the local currency compared to EUR. Thus, in the baseline scenario the interests expenditure as a share of GDP will increase from 1,2% in 2009 to 1,45% in 2012, while in the alternative scenario the interests expenditure will increase to 1,47% in 2012.

Sensitivity of the interest expenditures to real GDP growth rate. A baseline scenario was used at the same time with an alternative one based on higher interest rates (EURIBOR and LIBOR) by 1 percentage point compared to the baseline scenario. In the baseline scenario the share of the interest expenditures in GDP will increase from 1,2% in 2009 to 1,45% in 2012 while in the alternative scenario the interest expenditures as a percent of GDP is forecasted to increase to 1,57% in 2012.

As a conclusion, the sensitivity of the actual government debt portfolio to the variation of the economic growth, the interest rate and the exchange rate, is low mainly due to the still small public debt level.

Quarterly quantitative targets have been set up within the commitments stipulated in the multilateral external finance agreement signed with the IMF, EC and the WB with an associated regular monitoring mechanisms in order to reduce the medium term slippage risks and implement the necessary corrective measures.<sup>4</sup> Implementing the Fiscal Responsibility Law, the Unitary Pay System and the Pension Law, represent structural performance criterias which are going to help in the adjustment process of the macroeconomic imbalances taking into account a difficult global context. Implementing the Fiscal Responsibility Law will enable the Government to follow a more forward looking risk management process by strenghtening the procedures

<sup>4</sup> In 2009 wage spending was reduced due to unpaid leaves for public sector.

regarding the budgetary planning and execution and strengthening the commitments control in order to minimize the fiscal risks in the public sector including the decentralized entities.

At the same time implementing the Unitary Pay System Law and the secondary legislation will generate medium term considerable savings in line with the programmed fiscal adjustment, contributing to long term quality improvement of public services and training of the public administration employees.

The implementation of the Pension Law will lead to the improvement of the sustainability of the pension system given the lowering and ageing population trend. Given the deteriorating trend of the dependency rate (number of employees/number of retired people), the delay of the implementation of the pension reform measures will lead to increasing borrowing needs in order to cover the payment of the pensions and ensure the same replacement rate for the future generations.

### **5.8 Budgetary Consequences of the Structural Reforms in the Pension Sector**

During 2009 the Romanian government launched a program aiming at mitigating the effects of the global economic and financial crisis, including social measures to protect the vulnerable categories, as well as increasing the revenues for the Social Insurance Budget as follows:

- social pensions granted to low-income retired people to cover the difference between the current pension level and the 350 lei minimum ceiling, in two steps, (up to 300 lei as of April 1, 2009 while the remaining amounts starting with October 1, 2009);
- increasing the nominal value of the pension point in 2 steps (718,4 lei as of April 1, 2009 respectively, 732,8 lei starting with October 1, 2009);
- raising the minimum guaranteed income;
- increasing the social insurance contribution rate starting with February 1, 2009.

The social security costs (pensions, unemployment, minimum pension, social assistance), increased in 2009 up to 9% in GDP, as a result of the automatic stabilizers and of the consecutive hikes in pension values in the previous years, demonstrating the urgency of a consistent pension reform in order to ensure the sustainability of the pension system.



Starting from the second half of 2009, Romanian government initiated the project of the Unitary Pension System Law, strongly supported by the World Bank, IMF and European Commission representatives, which will be approved by June and enter into force in 2011.

The main reform measures stipulated are:

- a gradual approach of indexing pensions to inflation rate;
- pension benefits correlated to paid contributions ;
- reducing anticipated pensions;
- more restrictive criteria for granting disability pensions;
- integrating the special pension schemes in the social security system;
- increase and equalize the standard retirement age for women and men;
- enlarging the tax base by including certain categories of taxpayers exempted from the payment of social insurance (free lancers, military, police) .

#### Private pension systems

The economic downturn spotlighted the importance of the private pension systems. Despite the short history of the Romanian private pension systems (third pillar starting in second half of 2007 and second pillar starting in May 2008), its development was quite successful.

The mandatory private pension system funds reported 4.9 million participants (increasing by 8.4% compared to 2008) at the end of December 2009 with a tripling of the net assets compared to December 2008.

The employee's contribution quota directed to second pillar reached 2.5% in 2010 with the revenues collected being forecasted to increase as follows:

**Table 5.9 Diminished Contributions to the Public Pension System**

	2010	2011	2012
Contributions directed to Pillar 2 , million Lei	1761	2239	2809
Share in GDP, %	0.33%	0.39%	0.45%

Source: Ministry of Public Finance

Pillar III – the scheme of **optional pensions under private administration** reported over 187 thousand participants in December 2009 , by 25% more than in the previous year.

The exempted ceiling for contribution was raised to 400 euro per year both for the employer and the employee in order to stimulate the participation to the system.

The financial crisis strengthens the need for a multi-pillar pension system, which can be highly resilient in the face of even severe financial and economic turbulence. According to OECD and FIAP (Federacion Internacional de Administradoras de Fondos de Pensiones) survey, the yields obtained in private pension systems exceed inflation rate, even if there are not regulations in this respect. The study points out that the financial turmoil and the economic crisis affected to a larger extent the public pension systems compared to the private ones. In the developed countries the average contribution rate to the private pension systems represents 10-15 percentage points, the private savings being stimulated by important fiscal facilities. The analysis covered the accumulated yields from the launching of the pension funds until the end of 2009 (from 6 years for Dominican Republic to 28 years for Chile), computing an average yearly real yield.

The study shows that in the long run the performances of the private pension systems in the management of the investment portfolio, are positive even in critical periods of time, as in 2008, when due to the financial crises and capital market losses, the value of some private pension funds assets have dropped. Although, as an average, the yields surpassed the inflation rate, and following the 2008 decline, the pension funds are on a recovery trend in 2009 in countries such as: Poland, Hungary, Bulgaria, Croatia, Slovakia, Baltic countries etc.

Source: OECD, FIAP, APAPR, surveying authorities

The second and third pillars registered an annual average yield of 15% and 7.9% respectively from their initial phase to end 2009.

**Table 5.10 Private pension systems development in Romania**

	Total participants (thou persons)			Net assets value (mill. lei)			Annual average yield (%)	
	2009	2008	growth 2009/2008	2009	2008	growth 2009/2008	2009	2008
Pillar II	4913.2	4531.9	8.4%	2384.5	831.9	186.6%	17.7%	11.5%
Pillar III	187.3	150.7	24.3%	204	84.4	141.7%	15.8%	2.7%

Source: Private Pensions Supervision Commission

## 6. QUALITY OF PUBLIC FINANCES

The significant deterioration of the macroeconomic context requires the design of a flexible fiscal policy, oriented to efficiency and performance, built upon clear cut sectoral priorities correlated with the reforms objectives and consistent with the budgetary consolidation path. The improvement of the efficiency and effectiveness of the public expenditures sustains the fiscal discipline required by the Stability and Growth Pact and promotes the structural reforms according to the revised Lisbon Agenda. The level of the public expenditures quality has an important impact upon the economic environment, upon the rate of economic growth and the population welfare.

### 6.1 Budgetary expenditures

In this recession period of the Romanian economy, a major challenge is the urgent implementation of an austerity type of structural reforms aiming to adjust the structural imbalances<sup>5</sup>.

Medium term key objectives are:

- reduce the budget deficit;
- ensure the inter-generational equity;
- rationalize the current expenditures and increase the fiscal investment space;
- improve the medium and long term sustainability of the public finances;
- increase the absorption capacity of the European funds;
- improve the medium term predictability of the budgetary policy.

The main fiscal policy objective is represented by the reduction of the budget deficit from 6.3% of GDP in 2010 to 3% of GDP in 2012. Improving the quality of the public finances by rationalizing the current expenditures and promoting a prudent revenue policy, is essential for sustaining the consolidation of the public finances while increasing the level of the public investments as a share of GDP.

Creating a fiscal space for the public investment expenditures will partially compensate the more reduced dynamic of the activity in the private sector allowing

<sup>5</sup> Usually, in bad times, macroeconomic policies will stimulate the aggregated demand by increasing public expenditures. In Romania, due to the high share of this item in GDP (38% in 2009) and to the difficulties in financing, the policy used is a restrictive one.

the achievement of the budgetary revenue targets. The increase of the public investment expenditures, including the improvement of the absorption capacity of the EU funds, will sustain a positive dynamic of the investments in the economy, already influenced by the developments of the credit markets. The multiplying effect of these investments will attenuate the negative impact of the reduction of the salary level and the increasing of the unemployment rate on the consumption demand and, at the same time, will sustain the recovery process.

In order to improve the medium and long term sustainability of the public finances, key reforms will be implemented being focused on the issuing of a binding medium term budgetary strategy, on the restructuring of the public pay system and the reform of the pension system. The restructuring of the pension system aims at increasing and equalizing gradually the retirement age for women and men, moving to an inflation indexed pension system and enlarging the tax base to include the non-contributive categories. The law of the public unitary pay system defines the guidelines and the framework for paying the people working for the state sector, aiming at increasing the transparency, simplifying the pay system and improving its financial sustainability by establishing pay salary increases correlated with the objective of diminishing the share of personnel expenditures in GDP from 9.2% in 2009 to 7.9% in 2012, and 7% of GDP in 2015 (according to the cash methodology).

The main changes brought by the legislation:

- the increase of the salary base in the total salary earnings, by including bonuses and allowances with the total amount granted as allowances for specific labor conditions, not exceeding 30% of the salary base taking into account the overall budget of each credit ordinator;
- granting salary increases correlated with the developments of the macroeconomic and social indicators;
- harmonization of the pay system according to the importance, responsibility, activity complexity and the education level;
- implementation of a control and prevention system in order to avoid the lack of efficiency and equity;
- the maximum gap between the minimum and the maximum salary in the budgetary sector is 1 to 12.

Implementing the Fiscal Responsibility Law will represent an important step in reforming the institutional framework for the implementation of the budgetary policy

which aims to minimize the probability of registering short term budgetary slippages, increasing the medium term predictability of the budgetary policy and improving its transparency. The main provisions of this legislation are: improved procedures for issuing multi-year budgets; limit the number of budgetary rectifications during the year; implementation of fiscal rules regarding total expenditures, salary expenditures and budget deficit; setting up a fiscal council to ensure an independent analysis of the macroeconomic and budgetary forecasts; create the framework necessary for issuing and managing the state guarantees and other collateral commitments. The implementation of these measures will lead to medium and long term gains being represented by a better quality of the public finances and by an increased efficiency of the public expenditures.

## 6.2 Budgetary revenues

The Fiscal Code will be finalized in the following period, aiming at improving the stability, predictability and simplifying the tax legislation. The level of the taxes will be maintained, except for the excises which will register an increase according to the calendar agreed with the European Union for the attainment of the minimum level established by the EU directives.

Objectives established for the tax administration activity:

- o simplifying and modernizing the procedures for the management of the fiscal receivables by extending the information and technology systems;
- o improving the tax payers services and the reduction of the voluntary tax compliance costs;
- o the fight against evasion by intensifying audit actions especially for the high risk activity areas and tax payers segments (audit based risk);
- o the completion of the Tax payers rights and duties chart for a better transparency and communication.

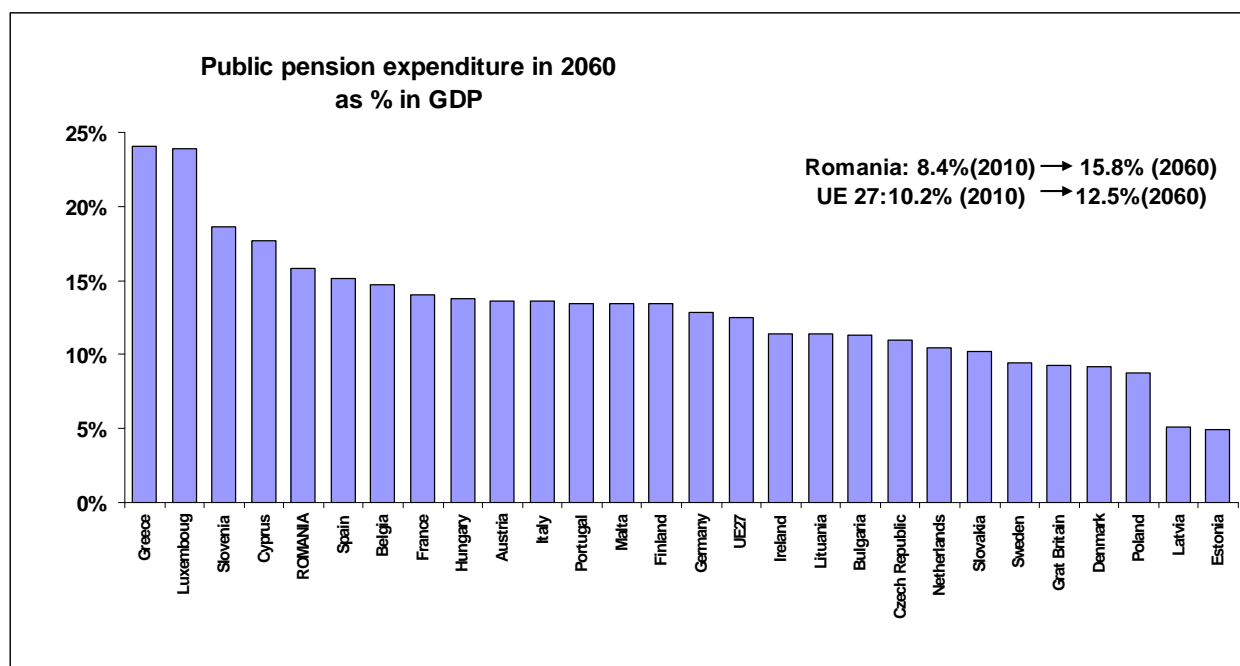
The arrears recovery policy will consist of:

- o reintroduction of the re-scheduling agreements with the tax payers;
- o change the penalty system by establishing separate interests and penalties for the payment delays;
- o improvement of the fiscal recordings by dematerializing the tax payers files.

## 7. LONG TERM SUSTAINABILITY OF PUBLIC FINANCE

The first overall assessment of Romanian pension system was made within the common projection exercise of age-related expenditure 2008-2060<sup>6</sup>, carried out by the European Commission, included in the 2009 Ageing Report. This represented the first participation for Romania in an exercise of long term projections ageing costs and the Sustainability Report, 2009.

Chart 7.1 Pension expenditure in 2060



Source: Sustainability Report, 2009

According to the Sustainability Report, the public pension systems across the member states are not sustainable over the time horizon (2008-2060) and the budgetary impact of aging is considerably higher than the costs of the financial and economic crisis.

On the basis of the current policies and the demographic projections, Romania public pension system is considered to be unsustainable. In 2060 Romania is ranked on 5th position regarding aging costs, after Greece, Luxemburg, Slovenia and Cyprus.

<sup>6</sup> The 2009 Ageing Report: economic and budgetary projections for the EU-27 Member States (2008-2060), published in May 2009 – European Commission (DG ECFIN) and the Economic Policy Committee - Ageing Working Group and Sustainability (AWG). Separate budgetary projections were run for five age-related expenditure items and Member States run the projections for pensions using their own national models

As the future costs related to aging population threatens fiscal sustainability there is an urgent need for pension and health reforms.

### 7.1 Pension System

The increases in pension values and the effect of automatic stabilizers on social costs overwhelmed the social security budget, leading to a high deficit which has to be financed by state budget transfers. Taking into account these developments and the European Commission's recommendations, Romania committed itself to reform the public pension system and to encourage to a large extent the private pension systems.

The medium and long term evolution of the pension system is strongly affected by the negative demographic trend, specifically the low birth rate, increase in life expectancy and consequently an accelerated ageing process.

The Eurostat demographic forecasts for Romania shows a significant decrease of the population (by 35%) in 2007-2060, as the consequence of the low fertility rate.

The speed of the ageing process will deeply affect the age composition of the population in the favor of population at retirement age with a negative impact on the labour market.

The ratio of the population over 65 years old to active population (15-64 years), will double, meaning that in 20-40 years the pension system resources will be substantially lower compared to expenditures.

**Table 7.1 Labour Force and Dependency Rates**

	2008	2020	2030	2040	2050	2060
Labour Force, thousand persons	9875	9650	8811	7918	6868	6051
Participation rate (age 15-64)	63.0%	64.8%	62.4%	60.8%	60.5%	61.3%
Employment rate (age 15-64)	58.7%	61.0%	58.6%	57.2%	56.9%	57.6%
Old population share	15.1%	17.7%	22.3%	25.3%	26.3%	22.5%
Dependency rate of people over 65	21%	26%	30%	41%	54%	65%
Total dependency rate	43%	47%	50%	60%	75%	87%

Source: Eurostat-EUROPOP 2008

In the second half of 2009 the project of the Unitary Pension Law was initiated with the assistance of the IMF and World Bank, being scheduled to be approved by June, 2010 and to enter into force in 2011. The most important reform measures are:

1. Point value indexation

- until 2020, pension point value will increase by 100% correlated with the inflation rate plus 50% of real gross wage increase in the previous year. If one of the above mentioned indicators is negative, only the positive value will be considered;
- starting 2021, the pension point value will increase by 100% with the inflation rate plus 45% of real gross wage increase in the previous year. The percent attached to the real wage increase will gradually reduce by 5% each year;
- starting 2030, pension point value will increase by 100% with inflation rate.

2. Starting 2011, January, 1<sup>st</sup>, only for the first pension a correction index will be applied to the number of points. The index is computed by dividing 43.3% of real gross wage in the previous year to the value of one pension point in the respective year;

3. Enlargement of the tax base to non-contributive tax segments (military, police). According to the current contribution rates, the employer will cover a quota of 20.8% of wage bill, and the employee 10.5% of the gross wage. For the personnel coming from army, the contribution of 5% paid to the state budget will be transferred to social security budget and the rest of 5.5%, will be financed by the equivalent increase of the gross wage;

4. Increase the retirement age up to 60 years for women and 65 years for men until 2014, followed by gradually upward adjustment and equalization of the retirement age to women and men to 65 years in 2030. Correspondingly, for women, the standard contribution length will rise from 30 years in 2015 up to 35 years in 2030, while, for men, the standard contribution length is expected to reach 35 years in 2015. The minimum contribution length will be reached in 15 years by the end of 2014, both for men and women;

5. Military and public officers with special status will be included in the public pension system:

- a gradual increase of the retirement age starting 2011, for both men and women from 55 years up to 60 years in 2030.



-until 2030, for both men and women the standard contribution length will expand gradually from 25 years 30 years, with an associated increase of the minimum contribution length from 15 years to 20 years;

6. Recalculation of the pension established under special laws for public officers with special status according to the PAYG system, using only the pension point indexation;

7. New categories will be compulsory integrated in the unitary public pension system, such as self employed, free lancers and family associations:

- free lancers for revenues (including copy rights) up to an equivalent of 4 average gross wages per year,
- social contribution will be paid on monthly basis, the minimum taxable revenue will be 35% of the average gross wage.

-maintaining an option for adhering to the public system for lawyers, clerical personnel that are not included in the public pension system;

8. Maximum taxable revenue is an equivalent of 5 average gross wages per month;

9. Recalculation of the pension established for military and police using the pension point indexation and all the service period considered within the public pension system. The pension benefit will be computed as pension point value multiplied to the number of points and will be paid from the Social Security Budget.

The medium term economic impact of the reform measures shows a relative reduction of the public pension deficit in the range of 0.6% to 1.5% in GDP, with expected higher long term savings (i.e. in 2060, the pension system deficit could be reduced by 4 percentage points in the reform scenario).

**Table 7.2 Assessment of the reform measures**

	2010	2020	2030	2060
Total, % in GDP	0	0.9	2.5	3.4
Out of which:				
1. enlarge number of contributors	0	0.4	0.5	0.7
2. retirement age increase	0	0.2	0.8	0.9
3. new indexation formula	0	0.3	1.1	1.5
4. reduction in early /disability pensions	0	0.1	0.1	0.2

Source: Ministry of Public Finance

The long-term forecast for pension expenditures took into account EUROPOP 2008 demographic assumptions by Eurostat. Initial DG ECFIN projections<sup>7</sup> for the evolution of the labor market and macroeconomic indicators were adjusted in line with recent developments and forecasts for 2009-2012 developed by the National Forecasting Commission, including current legislation at 2010, January 1<sup>st</sup> as basis for constant policy assumption baseline.

In addition to the baseline scenario built on the recent legislative amendments, we project an alternative scenario taking into account the proposed reform measures included in the Unitary Pension Law agreed with the IMF: indexing pensions according to inflation, increased retirement age for women and increased expenditures for vulnerable groups of pensioners.

### Baseline scenario

Compared to the projection published in Ageing Report (using the legislation approved at 2008, July, 1<sup>st</sup>), some recent legislative measures (August 2008 – February 2010) were introduced:

1. computation of the average pension point in 2009 at 43.3% of the gross average economy salary;
2. increasing social security contribution rates starting with February 2009;
3. freezing the pension point value in 2010 at the level of the previous year;
4. establish a minimum pension ceiling in 2009 for PAYG and farmers pensions.

**Table 7.3 Long Term Pension Expenditures Forecast - baseline scenario**

	% in GDP				
	2010	2030	2040	2050	2060
Social Security Pensions <sup>8</sup>	8,5%	9,8%	11,7%	13,3%	14,0%
Pillar 1	6,5%	7,9%	9,6%	11,4%	12,1%
Pillar 2		0,1%	0,4%	1,3%	1,8%

Source: Ministry of Public Finance

The results for the baseline scenario indicates an increase of the total pension and state social insurance(Pillar 1) expenditures in GDP to 14% and 12.1% respectively at

<sup>7</sup> Data used to assess the expenditures related to population aging within the working group on aging populatin and sustainability (AWG)

<sup>8</sup> Includes the pensions paid by the State Budget to farmers, military, MIRA etc. (not included in PAYG)

the end of the forecasted period. The expenditures with the pensions paid from the second pillar will have an increasing share in the overall pension expenditure beginning with 2050, and are expected to reach 1.8% of GDP in 2060.

### Alternative scenario

The alternative scenario uses the following assumptions related to the project of the new Pension Law, scheduled to be implemented starting with 2011:

- a new indexation formula according to inflation, thus gradually decoupling of pensions growth from wages developments;
- increase and equalize the retirement age for men and women at 65 years;
- including in the tax base new taxpayers that are presently excluded (army force, police, etc);
- reducing early and disability retirement;
- increase tax base for self employed.

**Table 7.4 Long Term Pension Expenditures Forecast - alternative scenario**

	- % in GDP				
	2010	2030	2040	2050	2060
Social Security Pensions	8,5%	8,8%	9,5%	11,1%	10,6%
Pillar 1	6,5%	8,8%	9,5%	11,1%	10,6%
Pillar 2		0,1%	0,4%	1,1%	1,7%

Source: Ministry of Public Finance

Taking into account the negative prospects of the long term demography, is vital to increase the fertility rate in order to contain the impact of a rapid ageing rate of the population.

For this reason, the Government adopted some facilities aiming at boosting the birth rate by supporting the child raising families, such as:

- granting a marriage financial aid for the first marriage;
- granting of an option for the monthly maternity benefits to represent either 85% of the monthly average professional income registered in the previous 12 months (not more than 4000 lei) or 600 lei and an additional monthly incentive of 100 lei;
- one of the parents will benefit of a child raising holiday up to two years, or 3 years in the case of children with disabilities;

- set up the appropriate legal framework for the raise, care and early education of children up to 3-years old and granting tickets for the day care centers;
- drafting of the law providing services for children care and early education (legal framework for baby sitter and pedagogical training).

## 7.2 Health Sector

Despite the progress realized in the last years, the indicators of the health sector are still registering a lower level compared to the EU average. The National Health Evaluation Programme organized between 2007-2008 had the objective to identify the main risk factors associated to the health condition, aiming to improve the quality and efficiency of the health services, to increase the access to the medical care system and to launch the health structural reform. The Ministry of Health is in the final phase of the realization of the Hospitals Rationalization Strategy, achieved with the support of the technical expertise of the World Bank's specialists.

Main objectives of the reform are:

- Elaborating an institutional and legal framework which is able to allow the development of the Romanian sanitation system correlated with the European system;
- Improving the quality of the medical assistance and increasing the access to the curative and preventive medical services;
- Decisional and organizational decentralization and reduction of the beaurocracy;
- Cutting down the costs of the hospital medical assistance by improving the management of the hospitals, operating based on the financial independence principle;
- Increasing the capacity of the ambulatory medical assistance system by ensuring family medical consulting rooms with the necessary logistical equipments, soft and communication means;
- Increasing the access of the patient to the modern medical treatment and accessible prices by elaborating a new price policy for the medicines;

- Creating and consolidating the qualified first aid and the emergency national medical assistance system;

In view of ensuring the necessary funds to facilitate the access to an European health system level, the following measures have been taken:

- Increasing the taxation base by increasing the number of contributors;
- Supplementing the financial resources of the public health system by the "claw back" system;
- Adjusting the functioning of the private health insurance system (complementary) in order to diversify the resources base and increase the competition in the system;
- Introduce and finalize the co-payment concept and the minimal health package services;
- Additional involvement of the private sector in supplying the medical services;
- Ensuring an efficient use of the National Social Health Insurance Fund by elaborating and implementing protocols eligible for payments and setting up approved activities by the National Health Insurance House.

## 8. INSTITUTIONAL CHARACTERISTICS OF THE PUBLIC FINANCES

The economic and budgetary policy implemented in Romania during the last years led to domestic and external imbalances which should be corrected during the next period. The sustainable achievement of lower budget deficits supposes the considerable change of the budgetary process, and also reforms of the revenues and expenditure policies. For this purpose, the Government adopted the Fiscal Responsibility Law, a law which significantly changes the institutional framework for implementing the budgetary policy. The fiscal-budgetary responsibility law:

- ✓ settles improved procedures for the elaboration of the multi-annual budgets;
- ✓ settles restrictions for the budget rectifications made during the year;
- ✓ provides fiscal policy rules for the total expenditures, for the personnel compensation expenditures and budget deficit;
- ✓ creates a fiscal council which provides an independent and specialized analysis of the macroeconomic and budgetary forecasts;
- ✓ creates the framework for issuing and managing the guarantees and other collateral obligations.

The fiscal-budgetary responsibility law proposes the elaboration and implementation of a 3 years credible fiscal and budgetary strategy which includes a macroeconomic framework, a fiscal framework, and a medium term expenditures framework including a responsibility statement. The fiscal and budgetary strategy will be a key policy document providing information and objectives, allowing an improved decisionmaking process within the annual and medium term budgetary horizon, being elaborated by the Government and approved by the Parliament. The compliance with the Fiscal Strategy will be monitored by biannual and annual progress reports with the aim to inform the Government about needed adjustments necessary to observe the targets.

The main principles of the fiscal and budgetary responsibility law include the following: (a) maintaining a prudent level of the public debt in order to ensure its sustainability; (b) ensuring a general consolidated budget balance along the

economic cycle; (c) performing a cautious management of the assets, liabilities and fiscal risks related to the public sector in order to avoid the overburdening of the next generations; (d) providing predictability to the taxation regime; and (e) maintaining an adequate level of fiscal reserves for the external debt service.

The use of principles of fiscal and budgetary responsibility, of numerical rules for expenditures and budget balance, of some procedural rules for reporting and explaining the deviation from the targets, of medium term fiscal planning, will promote a cautious fiscal policy. Moreover, the draft of the law supposes the implementation of a number of fiscal rules, with reference to providing a budget balance in compliance with the Fiscal and Budgetary Strategy, maintaining ceilings for the total and personal compensation expenditures and maintaining the rate of growth for the expenditures below the nominal GDP increase.

The draft of the law also establishes a Fiscal Council consisting of 5 members appointed by the Parliament based on the suggestion of the National Bank of Romania, the Romanian Academy, and the Academy of Economic Studies, of the Romanian Banking Institute and of the Romanian Banking Association, which should provide the support for ensuring high quality standards in the macroeconomic and budgetary forecasts and the compliance of the budgetary policies with the fiscal responsibility principles.

The Fiscal and Budgetary Strategy for three years will be elaborated as a key policy document issued by the Government and approved by the Parliament containing:

- a macroeconomic framework;
- a fiscal and budgetary framework;
- a medium term expenditure framework;
- a settlement of responsibility.

1. The macroeconomic framework contains information about the current macroeconomic situation and forecasts for the next budgetary year and for two subsequent years.

2. The fiscal and budgetary framework includes compulsory ceilings for the next budgetary year, fiscal and budgetary policies (for revenues, expenditures, public debt and the financing of the budget deficit), the revenue policy, including the planned taxation measures, the debt sustainability and fiscal risks analysis.

3. The medium term expenditures framework is based on rules for multi-annual

expenditures, which provide expenditures ceilings and targets for a balanced budget, revenue and expenditure forecasts according to the economic classification including rules for restricting the local budget borrowing.

For the next budget year and for the two subsequent years, this framework contains the following:

- expenditure priorities and detailed arguments, including methods for improving the policies, the efficiency and the effectiveness of the provided services;

- a public investments program which includes the Government's priorities, the estimated results for the current year and the forecast of the costs for the next budget year and the two subsequent years, correlated with the investment ceilings;

4. The settlement of responsibility will be signed by the Prime Minister and the Minister of the Public Finance, which strengthen the accuracy and the integrity of the information contained in the fiscal and budgetary strategy and its compliance with the law, the targets or restrictions imposed by the fiscal rules and the conformity with the fiscal responsibility principles;

The compliance with the Fiscal Strategy will be monitored by biannual and annual progress reports with the aim to inform the Government about the need of possible adjustments necessary to observe the targets.



## ANNEXES

Table 1a. Macroeconomic projections

	ESA Code	2008	2008	2009	2010	2011	2012
		Level <sup>1)</sup> Bill.lei		Percentage change			
1. Real GDP	B1*g	446.6	7.3	-7.0	1.3	2.4	3.7
2. Nominal GDP	B1*g	514.7	23.7	-1.8	6.6	7.4	8.4
<b>Real GDP components</b>							
3. Private consumption expenditures	P3	304.9	9.5	-10.6	3.8	2.8	3.8
4. Public consumption expenditures	P3	71.3	7.1	-2.7	-3.5	-1.3	1.9
5. Gross fixed capital formation	P51	145.9	16.2	-20.0	-1.0	5.0	6.7
6. Change in stocks (% of GDP)	P52	-14.4	-4.2	-0.5	0.0	0.0	0.0
7. Export of goods and services	P6	132.5	8.7	-10.5	3.3	2.4	3.4
8. Import of goods and services	P7	193.7	7.8	-24.8	3.6	3.3	5.5
<b>Contributions to GDP growth</b>							
14. Final domestic demand		-	12.3	-14.1	1.5	2.8	4.6
15. Change in stocks	P52	-	-4.2	-0.5	0.0	0.0	0.0
16. Net exports	B11	-	-0.8	7.6	-0.2	-0.4	-0.9

<sup>1)</sup> The real level of GDP and the components thereof is in the previous year's prices

Table 1b. Prices evolution

	2008	2009	2010	2011	2012
	Percentage change				
1. GDP Deflator	15.2	5.6	5.3	4.8	4.6
2. Private consumption deflator	9.5	5.5	4.1	3.8	3.5
3. Harmonised consumer prices index	7.85	5.59	3.7	3.2	2.8
4. Public consumption deflator	22.2	6.6	4.6	6.1	5.6
5. Investment deflator	12.6	5.0	4.8	4.5	4.2
6. Exports deflator (goods and services)	18.2	5.0	1.2	0.8	1.3
7. Imports deflator (goods and services)	15.5	3.9	0.5	0.1	0.5

Table 1c. Evolution of the labor market

	ESA Code	2008	2008	2009	2010	2011	2012
		Level thousand persons	Percentage change				
1. Total employment		9369	0.2	-3.0	1.0	0.7	0.9
2. Employed population, hours worked			-	-	-	-	-
3. Unemployment rate - (according to ILO definition) -%			5.8	8.4	7.7	7.5	7.0
4. Labor productivity per person (real GDP/ employed person)			7.1	-4.1	0.3	1.7	2.8
5. Labor productivity per hour			-	-	-	-	-
6. Compensation of employees –million lei	D1	198290	25.0	-2.4	6.0	6.6	7.6
7. Compensation per employee - lei		30640	24.3	1.6	5.2	6.0	6.9

Table 1d. Sectoral balances

% of GDP	ESA Code	2008	2009	2010	2011	2012
Net balance as against the rest of the world	B9	-11.2	-3.9	-3.9	-3.9	-3.7
out of which:						
- balance of goods and services		-13.2	-5.9	-5.6	-5.4	-5.7
- balance of revenues and transfers		1.6	1.6	0.5	0.3	0.7
- capital account		0.4	0.4	1.2	1.2	1.3

Table 2. Consolidated budget - Projections

	ESA Code	2008 Level	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP	2012 % of GDP
Net lending (EDP B.9) by sub-sector							
1. Consolidated budget	S.13	-27.941,3	-5,5	-8,0	-6,3	-4,4	-3,0
2. Central Budget	S.1311	-22.784,9	-4,5	-6,2	-5,3	-3,9	-2,6
3. State Budget	S.1312						
4. Local Budgets	S.1313	-4.619,6	-0,9	-0,6	-0,5	-0,3	-0,3
5. Social Security Budget	S.1314	-536,8	-0,1	-1,2	-0,5	-0,2	-0,1
Consolidated Budget (S13)							
6. Total collections	TR	165.421,9	32,8	31,1	31,7	31,9	31,8
7. Total expenditures	TE	193.363,2	38,4	39,1	38,1	36,4	34,8
8. Net Balance	EDP B.9	-27.941,3	-5,5	-8,0	-6,3	-4,4	-3,0
9. Interest	EDP D.41	3.825,3	0,8	1,5	1,8	1,8	1,5
10. Primary Balance		-24.116,0	-4,8	-6,5	-4,5	-2,6	-1,6
11. One-off and other provisional measures							
Revenue Components							
12. Total Taxes (12=12a+12b+12c)		94.865,3	18,8	17,3	17,3	17,3	17,4
12a. Output and Import Taxes	D.2	60.291,8	12,0	10,6	10,9	10,9	10,8
12b. Current Income Taxes. Taxes on Assets. etc.	D.5	34.573,5	6,9	6,7	6,4	6,4	6,6
12c. Capital Taxes	D.91						
13. Social security contributions	D.61	51.988,1	10,3	10,1	9,9	9,9	9,7
14. Revenues from ownership	D.4	4.407,8	0,9	0,9	1,4	1,3	1,3
15. Other		14.160,7	2,8	2,8	3,2	3,4	3,4
16=6. Total revenues	TR	165.421,9	32,8	31,1	31,7	31,9	31,8
p.m.: fiscal burden (D.2+D.5+D.61+D.91-D.995)							
Expenditure Components							
17. Remuneration of employees + intermediary consumption	D.1+P.2	85.145,2	16,9	15,7	14,4	13,3	12,9
17a. Remuneration of employees	D.1	51.446,6	10,2	9,8	9,0	8,3	8,1
17b. Intermediary	P.2	33.698,6	6,7	5,9	5,4	5,0	4,8

	ESA Code	2008 Level	2008 % of GDP	2009 % of GDP	2010 % of GDP	2011 % of GDP	2012 % of GDP
consumption							
18. Social security contributions (18=18a+18b)		56.381,1	11,2	12,6	11,9	11,2	10,7
18a. Social contributions in kind	D.6311, D.63121, D.63131	3.058,1	0,6	0,6	0,5	0,5	0,5
18b. Social contributions, other	D62	53323,0	10,6	12	11,4	10,7	10,2
19=9. Interest	EDP D.41	3.825,3	0,8	1,5	1,8	1,8	1,5
20. Subsidies	D.3	5.764,8	1,1	1,0	0,8	0,7	0,6
21. Gross Fixed Capital Formation	P.51	28.452,3	5,6	6,4	6,6	6,5	6,6
22. Other		13.794,5	2,7	1,8	2,6	2,9	2,6
23=7. Total Expenditures	TE1	193.363,2	38,4	39,1	38,1	36,4	34,8
p.m.: government consumption (nominal)	P.3	87.123,9	17,3	L	L	L	L

Table 3. Evolution of the general budget debt

% of GDP	2008	2009	2010	2011	2012
1. Gross government debt (according to ESA) <sup>9</sup>	13.6%	23.0%	28.3%	29.4%	29.7%
2. Change in govt. debt. %	0.9%	9.4%	5.3%	6.4%	1.4%
<b>Contribution to The Gross Debt Change</b>					
3. Primary Balance	-4.8%	-6.5%	-4.5%	-2.6%	-1.6%
4. Interest ( Incl. SIFM )	0.8%	1.5%	1.8%	1.8%	1.5%
5. Stock-Flow Adjustments	4.9%	14.4%	8.0%	7.2%	1.5%
Out of Which:					
Difference between Paid Interest and Accrual	-0.01%	-0.21%	-0.09%	-0.06%	-0.02%
- Net Accrual of Financial Assets	0.12%	0.00%	0.00%	0.00%	0.00%
Out of Which : from privatization	0.06%	0.00%	0.00%	0.00%	0.00%
- Assessment Effects and Other	4.8%	14.6%	8.1%	7.3%	1.5%

<sup>9</sup> the IMF loan which will be used by the BNR in order to consolidate the foreign currency reserve and support the balance of payment is not included

% of GDP	2008	2009	2010	2011	2012
P.M. Implicit Interest Rate on Debt	6.4%	6.6%	6.9%	7.1%	5.4%
<b>Other Relevant Variables</b>					
6. Liquid Financial Assets	0.0%	0.0%	0.0%	0.0%	0.0%
7. Net Financial Debt ( 7=1-6 )	13.6%	23.0%	28.3%	29.4%	29.7%

**Table 4. Cyclical Evolutions**

% of GDP	ESA Code	2007	2008	2009	2010	2011	2012
1. Real GDP Growth (%)		6,2	7,1	-7,0	1,3	2,4	3,7
2. Net Consolidated Balance	EDP B9	-2,5	-5,5	-8	-6,3	-4,4	-3
3. Interest Expenditures (including SIFIM in consumption)	EDP D41+SIFIM	0,8	0,8	1,5	1,8	1,8	1,5
4. Potential GDP Growth (%)		4,64	3,23	1,94	1,43	1,58	1,91
Factor Contribution:							
- Labour		1,72	1,13	-3,53	0,5	0,85	1,14
- Capital		2,65	3,83	3,36	2,43	2,4	2,37
- Total Factor Productivity		0,28	-1,73	2,11	-1,5	-1,67	-1,61
5. Output Gap		2,7	6,09	-2,16	-3,06	-2,27	-0,55
6. Cyclical Component		0,76	1,75	-0,60	-0,83	-0,61	-0,15
7. Adjusted Cyclical Balance (2-6)		-3,26	-7,25	-7,40	-5,47	-3,79	-2,85
8. Adjusted Cyclical Primary Balance (7+3)		-2,46	-6,45	-5,90	-3,67	-1,99	-1,35

**Table 5. Deviations from the previous edition**

ESA Code	2008	2009	2010	2011	2012
GDP Growth (%)					
Previous Edition					
Updated Edition					
Difference					
Budget deficit (% of GDP)					
Previous Edition					
Updated Edition					
Difference					
Gross public debt (% of GDP)					
Previous Edition	13.6	18.0	20.8	22.0	
Updated Edition	13.6	23.0	28.3	29.4	29.7
Difference	0.0	-5.0	-7.5	-7.4	

Table 6. Long Term Public Finance Sustainability

% of GDP	2000	2007	2020	2030	2040	2060
Total Expenditures	33.6	35	39	43.5	42.5	42
Expenditures related to ageing population						
Pensions	6.7	6.6	8.5	9.8	11.7	14.1
Health Care	3.5	3.3	3.8	4.1	4.4	4.9
Education	3.4	2.8	2.3	2.2	2.1	2.3
Total Revenues	32.1	33.2	34.5	40.5	39.5	39
				- average pace -		
Labour Productivity Increase	2.5	5.9	3.4	2.7	2.7	1.7
GDP Real Growth	2.4	6.3	3.2	2.1	1.6	1.2
				- % -		
Participation rate – male	75.4	70.1	70.9	68	66.1	66.3
Participation rate – female	61.8	56	58.8	56.6	55.5	56.1
Total participation rate	68.7	63	64.8	62.4	60.8	61.3
Unemployment rate – ILO	6.9	6.4	6.0	6.0	6.0	6.0
Population at and over 65 / total population	13.6	14.9	17.4	20.3	25.5	35

The Participation rate refers to working age population (15-64 years old).