September 2010
IMF Country Report No. 10/301

Romania— Fifth Review Under the Stand-By Arrangement, and Requests for Waiver of Nonobservance of Performance Criterion, and Request for Modification and Establishment of Performance Criteria—Staff Report; Supplementary Information; Press Release on the Executive Board Discussion; Statement by the Executive Director for Romania

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

- The staff report, prepared by a staff team of the IMF, following discussions that ended on August 4, 2010, with the officials of Romania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on September 10, 2010. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- Supplementary information of September 22, 2010.
- Press Release summarizing the views of the Executive board as expressed during its September 24, 2010, discussion of the staff report that completed the review.
- A statement by the Executive Director and Advisor to the Executive Director for Romania

The documents listed below will be separately released.

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

*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

ROMANIA

Fifth Review Under the Stand-By Arrangement, Request for Waiver of Nonobservance of Performance Criterion, and Request for Modification and Establishment of Performance Criteria

Prepared by the European Department
(In Consultation with Other Departments)

Approved by Poul M. Thomsen and Aasim Husain

September 10, 2010

Discussions: Discussions were held in Bucharest during July 24–August 5, 2010. The mission met with Prime Minister Boc, Finance Minister Vladescu, Central Bank Governor Isarescu and other senior officials, and representatives of labor and business organizations, and financial institutions. The staff team comprised J. Franks (head), A. Cebotari and M. Stierle (all EUR); F. Salman (SPR); F. Hasanov (FAD); L. Zanforlin and M. Dobler (MCM). T. Lybek (Resident Representative) assisted the mission. Discussions were held jointly with staff from the European Commission, the ECB and the World Bank.

Stand-By Arrangement: A 24 month, SDR 11.443 billion (€12.95 billion, US$17.07 billion, 1,110.77 percent of quota) Stand-By Arrangement was approved by the Executive Board on May 4, 2009 (Country Report No.09/183), and four purchases totaling SDR 9.031 billion have been made so far. The European Commission and the World Bank are also providing funds under the program. The sixth tranche amounting to SDR 769 million will be made available subject to the completion of this review.

Program status: The performance criteria and indicative targets for end-June 2010 have been met, with the exception of the criterion on general government arrears. Inflation remained within the inner band of the inflation consultation mechanism throughout the period. The end-September structural benchmark on reforming local government finances was completed ahead of schedule.

Key issues: The review focused on three issues: (i) the fiscal outlook for 2010–11 in light of the weaker economic prospects; (ii) implications of the recent VAT increase for the inflation outlook and monetary policy; and (iii) progress towards implementing agreed structural fiscal reforms.

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I. INTRODUCTION AND SUMMARY

1. **The economic outlook has weakened since the last review**. Growth turned positive in the second quarter, but the recovery is likely to be hampered in the remainder of the year by the effects of needed fiscal consolidation and of damage to agriculture from recent flooding. The mission has thus revised the 2010 GDP forecast down to about -2 percent, with modest growth expected to return in 2011. Inflation is projected to peak at 7 to 8 percent late this year due to the VAT increase, before returning to the central bank's target range by end-2011.

2. **The program remains broadly on-track despite worse macroeconomic prospects**. The performance criteria and indicative targets for end-June 2010 have been met except for the criterion on government payments arrears. To address the arrear problem, the authorities have agreed to make a major repayment in the health sector (the largest source of arrears in the central government) as a prior action for concluding the review. The end-September structural benchmark on reforming local government finances was completed ahead of schedule.

3. **The significant fiscal package enacted in June should deliver the structural adjustment required to correct fiscal imbalances.** The package—with an annual yield of about 5 percent of GDP and a balanced mix of revenue and expenditure measures—has set the country on track to meet the fiscal targets in the remainder of the program, without a need for further major policy shifts. The main challenges are to assure the continuation of the adjustment measures and follow through with the downsizing of the public sector.

4. **The structural reform agenda is advancing.** The authorities expect parliamentary approval of the pension reform by mid-September (a prior action for the review). The second round of public sector wage reform is on track for approval in September-October, and it will be critical to securing a lower public wage bill that is consistent with the recent cuts. The authorities have also initiated important reforms of the labor market and of the social benefits system, which will improve its targeting and help mitigate the impact of the austerity package. Public enterprise reforms are progressing slowly, and additional action may be required in the future to prevent a deterioration of their financial position. Improving the absorption of European Union structural funds, which is trailing other EU countries, is critical to securing needed investments under tight budget constraints.

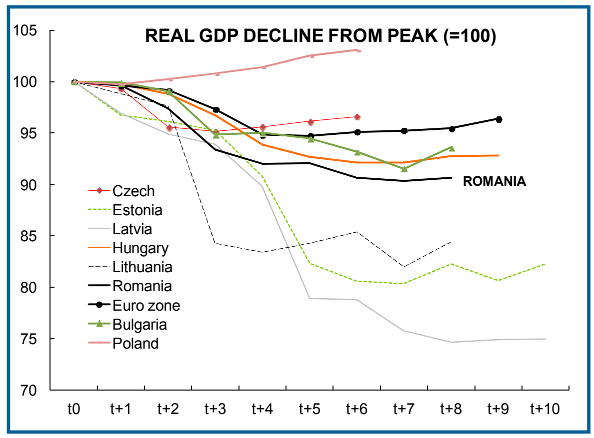
5. **The banking system had been affected by the downturn, but remains well-capitalized and liquid.** Nonperforming loans (NPLs) are likely to continue to grow through the end of the year, due to weak economic activity and the pay cuts in the public sector. Aggregate capital buffers remain large, however, with all banks above 10 percent capital adequacy, and the national bank maintains its proactive approach towards securing adequate capital reserves.

II. Macroeconomic Developments and Outlook

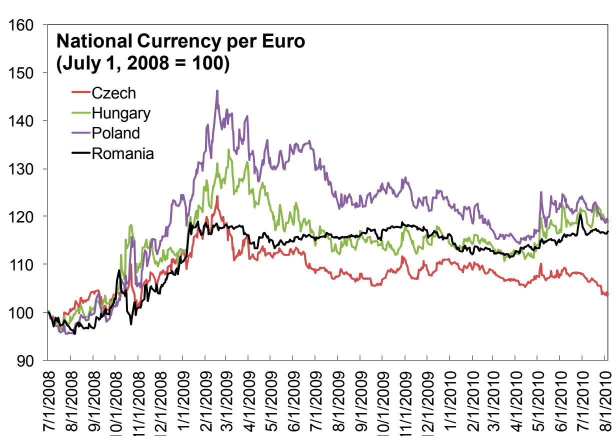
Economic growth finally turned positive, but further recovery will be delayed, as fiscal austerity measures and recent floods will weigh on domestic demand. Growth is projected to turn the corner only in late 2010, prompting a downgrade in the outlook for 2010-11.

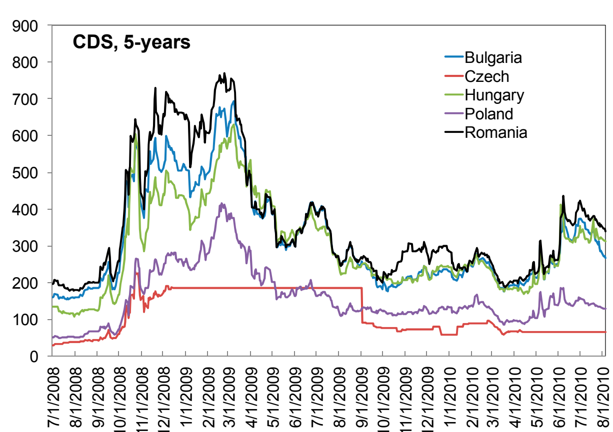
A. Recent Developments

6. **The economic decline halted, but possibly temporarily**. Growth turned modestly positive in the second quarter (0.3 percent q-o-q), putting the peak-to-trough decline of the real GDP at 9.7 percent, among the largest in Europe (after the Baltics; chart). The recovery coincided with a turnaround in private domestic demand, supported by stabilization in the labor market, and with a pickup in inventory investment. External demand, a positive contributor to growth over the past two years, weighed on growth in the second quarter as a result of rapidly growing imports and may be losing steam as its main driver (Figure 1). The recovery may be delayed in the second half of the year by the recently enacted fiscal austerity measures, the impact of the severe floods on agricultural production, and the recent plunge in consumer confidence and economic sentiment.

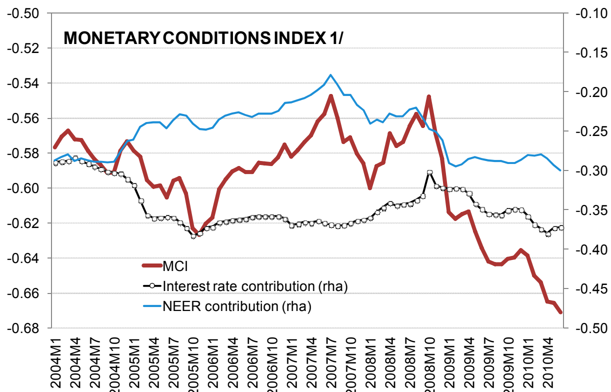


7. **Financial stress has subsided in recent months, in line with regional markets** (charts and Figure 2). Romanian equity markets have recovered somewhat since their June trough and credit default spreads have narrowed, although remain the highest in the EU after Greece. The leu has generally followed the trends of regional emerging market currencies—depreciating during the second quarter and recovering some of the lost grounds since—albeit with a smaller volatility due to central bank interventions to smooth currency fluctuations.

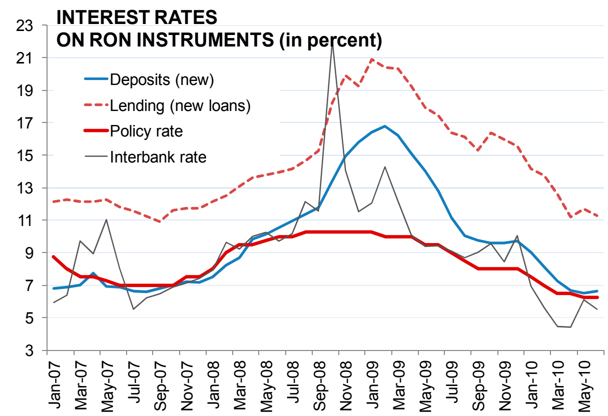




8. **Monetary conditions continue to ease, supporting a fall in economy-wide interest rates** (charts). Ample liquidity in the market left interbank rates below the monetary policy rate during most of the year, which in turn helped bring down deposit and lending rates in the banking system. Lending rates did not fall by as much, however, as banks raised lending margins to cover increased provisioning due to the still rising NPLs. The 5 percent depreciation of the nominal effective exchange rate since March also contributed to easing monetary conditions.



1/ Weighted average of annual change in the 3-month interbank offer rate and the nominal effective exchange rate (at a ratio of 1.5 to 1)



9. **The recent increase in the VAT rate led to a significant jump in inflation in July, interrupting the disinflation trend**. Headline CPI inflation jumped from 4.4 percent in May to 7.1 percent in July following the 5 percentage point increase in the main VAT rate. The initial passthrough of the VAT hike to prices is likely to increase in the next few months as stocks are gradually renewed at higher prices. Prior to the VAT increase, prices were on a firm disinflation trend towards the center of the National Bank' target band of 3½ percent ± 1 percentage point. Excluding tobacco prices—which were significantly affected by the excise hikes—inflation in Romania had reached the EU average of 1.7 percent by March, although administrative increases in pharmaceutical prices led to a subsequent pick-up (Figure 1).

10. **While weak economic activity continued to take a toll, the banking sector remains adequately capitalized**. At end-June, non-performing loans rose to 17.8 percent of total loans for the system as a whole, with a notable dispersion around this average among individual banks, and are expected to rise through the remainder of the year as the recent fiscal austerity measures dampen disposable incomes.[1] As a result of rising provisions, the sector posted losses during the second quarter of the year. The banking system remains adequately capitalized, however, as the authorities proactively secured capital injections at a number of banks to protect buffers. The average capital adequacy ratio of the system was

[1] Data on non-performing loans in Romania do not net out the value of collateral held against the loans, hence the numbers may appear high in cross-country comparisons.

14.3 percent at end-June 2010, with all individual banks registering a ratio above 11 percent (significantly higher than the 8 percent regulatory minimum). Lending to the private sector has been flat since early 2009, with declining local currency lending offset by an increase in foreign currency lending that mostly reflects the repatriation of offshore loans.[2] Lending to the government, on the other hand, now accounts for 20 percent of total bank loans compared to 8 percent at the end of 2008, although crowding out effects appear limited so far due to flagging private demand.

Romanian Banking System - Core Indicators					
	Dec-08	Jun-09	Dec-09	Mar-10	Jun-10
Capital adequacy					
Capital adequacy ratio	13.8%	13.5%	14.7%	15.0%	14.3%
Leverage ratio[1]	8.1%	6.9%	7.6%	8.1%	7.9%
Asset quality					
Non-performing loans ratio[2]	6.5%	11.8%	15.3%	17.2%	17.8%
Loan loss ratio[3]	2.8%	4.7%	7.9%	9.1%	10.2%
Profitability					
Return on assets	1.6%	0.1%	0.3%	0.6%	-0.2%
Return on equity	17.0%	0.6%	2.9%	6.0%	-1.6%
Liquidity					
Loans to deposit ratio	122.0%	119.0%	112.8%	113.2%	117.5%
Immediate liquidity ratio[4]	34.4%	33.6%	35.3%	37.1%	35.9%

Source: NBR.

1/ Tier 1 capital/ total average net assets.

2/ Unadjusted exposure from loans and interest falling under "doubtful" and "loss" / total classified loans and interest, excluding off-balance sheet items.

3/ Unadjusted exposure from loans classified as "loss" defined as past 90 days and/or initiation of legal preceeding/ total loans and interest, excluding off-balance sheet items.

4/ Cash, sight and term deposits with banks plus government securities free of pledge/ total liabilities.

11. **Romania's external position continues to strengthen.** The external current account deficit adjusted from 13½ percent of GDP in 2007 to 5 percent of GDP (on a 12-month basis) by mid-2010, due mainly to shrinking imports. The adjustment now appears to have played out, as imports are recovering at a rapid pace, in part driven by imported inputs for manufacturing exports. Foreign direct investment was weak, financing only half of the current account deficit, while other capital account inflows remained strong. The parents of the largest foreign-owned banks have broadly complied with their commitment to maintain their exposure to Romania, and overall private external debts have been almost fully rolled over during the first half of the year. As a result, the end-June net foreign asset target has been met with a margin of some €3.5 billion. In light of the strengthened external position, it was agreed at a recent meeting of the European Bank Coordination Initiative (EBCI) to allow a reduction in the commitment of the banks to 95 percent of their end-March 2009 exposure. This relaxation allows banks greater flexibility in their global portfolio management and reflects subsiding external financing pressures for Romania, in part due to the success of the previous EBCI commitments. The resulting outflows are anticipated at less than €700 million, as most banks are expected to maintain or expand their operations in Romania.

12. **Political pressures remain strong.** The prime minister announced a cabinet reshuffle on September 2, which included the resignation of six ministers, including of finance,

[2] High reserve requirements before the crisis encouraged subsidiaries of foreign banks to book loans to residents offshore. As reserve requirements were reduced, loans were moved back to the subsidiaries' balance sheets.

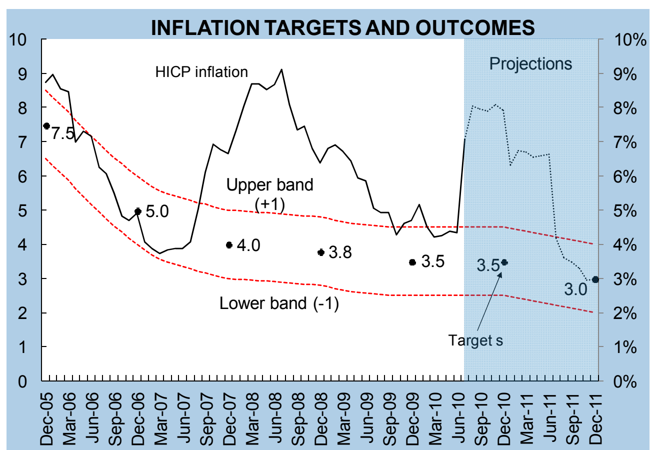
economy and labor. The prime minister has reiterated his government's strong commitment to the reform agenda and to the Fund program.

B. Revised Macroeconomic Framework

13. **The macroeconomic outlook has weakened since the last review, and continues to be subject to exceptional uncertainties**:

- *Growth.* The recovery is expected to take hold only late in 2010, as fiscal austerity measures and higher food prices due to the recent severe floods take their toll on real disposable incomes until then. Together with a weaker underlying recovery in domestic demand so far and waning net exports, these prompted a downward revision in the growth forecast for 2010 to -1.9 percent. Net external demand will gradually cede its place as the main driver of growth to domestic demand as incomes recover in 2011. Meanwhile, both will remain weak contributors to growth in 2011, which is projected to reach only 1½ percent. Notwithstanding the expected effect of the crisis in lowering potential output growth to around 3-3½ percent over the medium-term, growth should accelerate in 2012, as the balance sheet adjustments in both public and private sectors wind up and the economy starts to catch up to potential levels.

  Risks to this outlook are large, but broadly balanced. On the downside, investor and consumer confidence remain low and could lead to weaker-than-expected domestic demand, particularly if uncertainty about the stability of the fiscal framework persists or if political tensions increase. On the upside, a stronger recovery in the region could generate higher demand for exports, and a faster return in confidence could boost domestic demand.



- *Inflation.* Inflation will remain above the targeted path until late-2011 due to the VAT hike and supply factors. Staff and the authorities estimate that the price-level effects of the recent VAT hike will add up to 3 percentage points to inflation before end-2010.[3] In addition, further adjustments in administered prices, the recent leu depreciation and increases in food prices due to flooding are estimated to add another 1 percentage point to

[3] This assumes a full and immediate passthrough of the VAT increase to administered prices (15 percent of the CPI basket) and a gradual passthrough of up to 75 percent for the remaining items, with an average final passthrough to inflation of close to 80 percent.

inflation. Altogether, these factors could bring inflation to 7-8 percent by end-2010, compared to the targeted 3½ ±1 percentage point. Barring second-round effects from the VAT hike, these effects should peter out around mid-2011, putting the central bank's 2011 target of 3 percent ±1 percentage point within reach.

Risks to the inflation outlook are large, but also balanced. On the upside, second-round increases in prices following the VAT hike, and risks from higher-than-projected food prices due to the floods and recent pressures in the world wheat markets could generate higher inflation. On the downside, the wide output gap could lead to a smaller-than-projected passthrough of the VAT increase.

- *External Position.* The balance of payments outlook remains broadly unchanged from the previous review. The current account is projected at around 5 percent of GDP, close to its long-term estimated norm. Weaker FDI inflows and potential outflows due to the revised EBCI agreement are broadly offset by stronger capital inflows in other areas, including for government financing.

Romania: Macroeconomic Outlook

	2007	2008	2009	2010	2011	2012
Real GDP growth	6.3	7.3	-7.1	-1.9	1.5	4.4
Domestic demand growth	14.2	7.2	-12.8	-3.8	1.3	5.1
Net exports (contribution)	-9.6	-0.8	7.3	2.1	0.2	-1.0
CPI inflation, average	4.8	7.8	5.6	5.9	5.2	3.0
CPI inflation, eop	6.6	6.3	4.7	7.9	3.0	3.0
Current account balance (% of GDP)	-13.4	-11.9	-4.5	-5.1	-5.4	-5.1
o/w: private	-10.3	-7.0	2.9	1.6	-1.0	-2.1
Trade Balance (% of GDP)	-14.3	-13.7	-5.9	-5.3	-7.7	-7.7
Gross international reserves (bn euros)	28.7	28.3	30.9	38.9	40.2	41.5

III. Policy Discussions

The discussions focused on the fiscal outlook for 2010-11 in light of the weaker economic prospects, on the implications of the recent VAT increase for the inflation outlook and monetary policy, and on progress towards implementing agreed structural fiscal reforms.

A. Fiscal Policies

With the enactment of the ambitious adjustment package, fiscal policies are on track to meeting the 2010-11 targets, and no significant policy change is envisaged at this time.

14. **Despite pressures from weak economic activity, fiscal performance in the first half of the year was broadly in line with the program**. The overall deficit and the current spending targets were each met by a small margin. Tax revenues were weaker than programmed, offset by higher dividends from state companies and expenditure restraint, but have recovered visibly in the past few months with improving economic conditions, stepped up tax administration efforts and an auspicious first-month yield of the VAT increase.

15. **The recent austerity package has been implemented, setting the government on track to meet the 2010-11 program targets**.

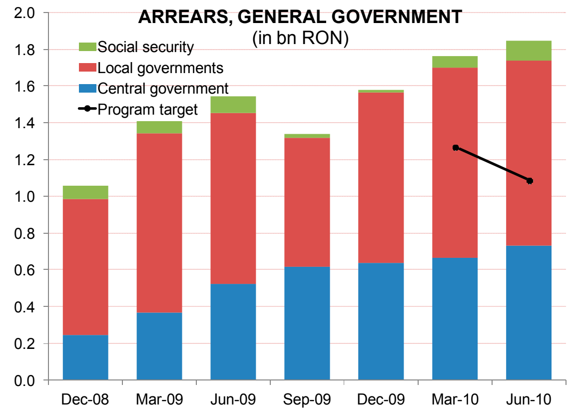
- *Fiscal outlook for 2010*. An ambitious adjustment package was implemented in July, yielding an annualized 4.6 percent of GDP due to a 25 percent cut in public wages, a 15 percent cut in most social transfers, and a 5 percentage point hike in the standard VAT rate, among other measures. Together with the personnel reductions of some 74,000 planned for this fall, the package will provide the necessary adjustment in the remainder of the year. However, weaker growth prospects are still expected to generate some revenue shortfall relative to the program. With the shortfall relatively small, the authorities considered that the confidence benefits of keeping the fiscal target unchanged significantly outweighed the additional adjustment costs and have taken steps to prevent the widening of the deficit, cutting spending on goods and services by 10 percent on an annualized basis and advancing some provisions of the pension reform legislation that could bring short-term relief. The government is thus in a good position to meet this year's fiscal deficit target of 6.8 percent of GDP, especially in light of the recent pickup in tax yields.

- *Fiscal outlook for 2011*. The full-year impact of the 2010 measures, together with continued expenditure restraint, should be sufficient to ensure the achievement of next year's deficit target of 4.4 percent of GDP. The main policy challenge will be to secure the extension of the wage and social transfer cuts (1.5 percent of GDP) into 2011 through legislation establishing a new public wage scale (structural benchmark) and overhauling the social assistance schemes; both laws are expected to be passed this fall. The government is also taking measures to ensure continued expenditure restraint: pensions will remain frozen, the heating subsidies will be eliminated, and the government will reduce personnel by another 15,000 and will eliminate the 13th salary and the holiday bonus for civil servants. Implementation risks remain, however, especially in light of weak government support in parliament and the approaching legislative elections in 2012.

- *Fiscal outlook for the medium-term*. Robust economic recovery and continued expenditure restraint could make the achievement of the Maastricht fiscal target feasible by 2012 without further major adjustment measures. Following the recent enactment of the fiscal responsibility legislation, the government has outlined its medium-term fiscal strategy for 2011-13 in a document soon to be sent to the Fiscal Council (now operational) and to parliament. The strategy commits to reaching the 3 percent deficit target by 2012, gives priority to investments co-financed by EU funds (see LOI¶ 11 on measures being taken to enhance absorption of these funds), and allows modest wage increases to recoup the current wage cuts.

16. **Bringing arrears under control continues to pose a challenge.** The domestic payment arrears target was missed again, as arrears continued to increase (chart). Over half are generated by local governments, with the remainder largely in central government's

health spending. To address the problem, the authorities committed to repaying, as a prior action for the review, the previously programmed repayment of about 2 billion lei (0.4 percent of GDP) in arrears and unpaid bills. To prevent a further buildup in arrears, the authorities: (i) have initiated a restructuring of the health sector (see below); (ii) have started to use budget and cash appropriations to control expenditure commitments while working on integrating the systems tracking expenditure payments and commitments (structural benchmark for end-March 2011); and (iii) have enacted amendments to the public finance law that will prevent local governments from assuming new commitments until previous obligations have been met, and will modify their balanced current budget rules to apply ex-post to expenditures inclusive of arrears (structural benchmark for end-September).



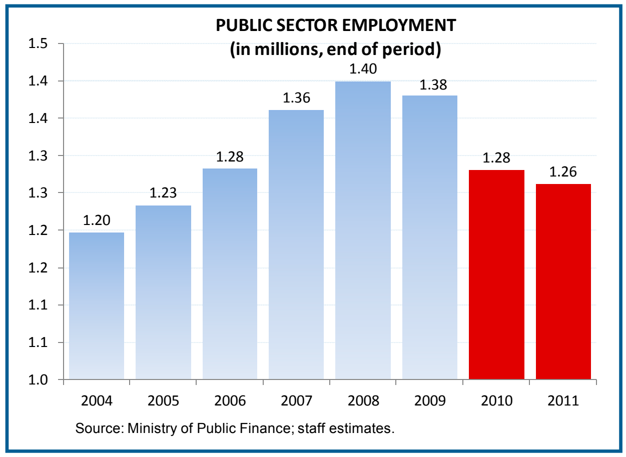
17. **Deficit financing has been challenging during the recent market turbulence**. Increased risk perception in the region and uncertainties surrounding the approval of the June austerity measures pushed local currency bond yields past the authorities' comfort level, leading them to reduce debt issuance and rely increasingly on liquidity buffers. With improved market conditions, the €1.2 billion local Euro-denominated bond issue in July[4], and expected EU disbursements, financing constraints are expected to ease and the authorities aim to rebuild their buffers to comfortable levels. In addition, they plan to launch a new "euro medium term notes" program this fall that will maintain Romania's presence in the external markets under more flexible issuance procedures, and plan to issue €7 billion in 5-year euro-denominated notes over the next three years. Nevertheless, sovereign risk spreads remain high and debt markets are on edge, so careful management will be needed to assure smooth financing.

B. Structural Reforms

Structural reforms continue to be geared towards supporting the fiscal consolidation agenda, and remain on track. The authorities have initiated a new reform of social assistance programs.

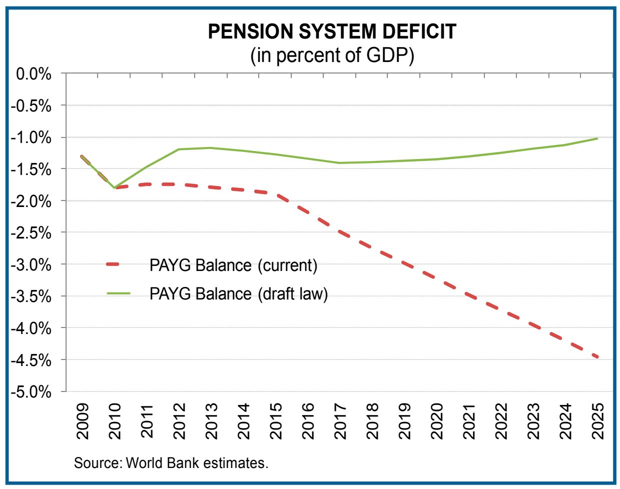
18. **The downsizing of the public sector is at an early stage, but is set to accelerate in the remainder of the year**. Public sector employment declined by only 2¾ percent from its end-2008 peak, but the restructuring is set to accelerate. The authorities approved legislation to cut another 5 percent this year and have committed to a further reduction of 1⅓ percent

[4] The bond was issued on the domestic market, with a 4.9 percent coupon and a one-year maturity.



in 2011. Together, these should offset about two thirds of the increase in public employment during the pre-crisis boom years and should yield about 0.4 percent of GDP in annual savings, allowing some recovery in the wages of the remaining public servants. The government intends to use EU-financed projects aimed at professional retraining of the laid-off staff to facilitate their reintegration into the labor market.

19. **Pension reform is on track to be approved by mid-September** (prior action). The reform will gradually move pension indexation from wages to consumer prices, further increase the retirement age, and tighten eligibility for early retirement and for disability-related pensions. It is expected to save ⅔ percent of GDP per year in the near term, rising to over 3 percent of GDP in the long-term (chart). Some elements of the reform have been implemented in advance to ensure earlier savings: namely, the costly and inequitable special pension regimes established for certain public employees are already being eliminated, with the exception of those for the magistrates (expected to yield at least 0.2 percent of GDP annually).[5] The authorities have also begun auditing disability pensioners to eliminate inappropriate claims, with about 4 percent of the claims audited so far found unjustified. Finally, after a hiatus during 2009 in the scheduled increase in contributions to the private second pillar, the government is committed to continuing the phased-in increase in contributions in 2011.



20. **The authorities have initiated the overhaul of the system of social benefits, to strengthen social safety nets and eliminate inefficiencies**. The reform, undertaken with assistance from the World Bank, aims at improving targeting—by eliminating the programs that are not means-tested, streamlining and consolidating benefits provided by different levels of government, increasing controls over benefit claims, and capping the benefits per person—thereby also helping alleviate the impact of the austerity package on the most

[5] The Supreme Court found the cut in magistrate pensions unconstitutional.

vulnerable. Legislation introducing these reforms is expected to be approved by the government by end-October 2010, and to save some 0.3 percent of GDP per year.

21. **The second pillar of the public wage reform is on track to be approved by end-September** (structural benchmark). The reform, prepared with assistance from the World Bank, will introduce a new salary grid that is simpler, link pay to job responsibility and qualification, and benchmark it to private sector wages. Annual supporting legislation will then set the reference wage values as a function of the proposed budgetary envelope for the coming year. The 2011 legislation will be fully costed to ensure that it is consistent with the lower wage envelope resulting from the 25 percent cut in 2010, set to expire at end of the year.

22. **Preparations for a labor market reform are also underway**. The authorities are drafting amendments to modernize Labor Code and other labor market legislation to increase the flexibility of the market, reduce informality and tax evasion, and improve the wage negotiation framework. The revised legislation is expected to enter into effect by end-2010.

23. **Initial steps to restructure the health sector should start bearing fruit**. The government has implemented the restructuring measures agreed during the fourth review (LOI of June 16, 2010, ¶18) and these should start generating savings in the second half of 2010. In particular, the recent introduction of a reference price scheme for drugs should cut the cost of subsidized medicine, while the decentralization of hospital administration to local governments should improve their efficiency and lead to the consolidation in the sector. A claw-back tax on medical suppliers was introduced in July, and the system of copayment for hospital visits—expected to be in place in early 2011—will not only provide extra funding but should help reduce excessive reliance on the state-funded emergency care system in favor of primary care.

24. **Efforts to improve the performance of state-owned enterprises (SOEs) have so far been timid**. The operating losses of the ten largest loss-making SOEs that are monitored under the program are declining, but their arrears continue to accumulate and further efforts will be needed to improve their performance. To this end, the authorities are planning tariff increases, personnel cuts and further expenditure restraint. At the same time, plans are on track to divest some firms under full state ownership and minority stakes in at least 150 firms, although the process is likely to come to a close only next year.

25. **Finally, the authorities have stepped up efforts to combat tax evasion.** They enacted legislation to deal with VAT and excise compliance, improve large taxpayer control, and introduce indirect audit methodologies for high net wealth individuals. Additional legislation on the taxation of high net wealth individuals and on broadening the definition of taxable income is expected to be finalized by end-September. In line with recent IMF technical assistance advice, the authorities are also contemplating changes to the VAT registration thresholds, streamlining tax administration offices and improving information

technology networks, and reforming the system of productivity bonuses to limit them only to those directly involved in tax collections.

C. Financial Sector Policies

26. **The authorities remain vigilant concerning potential regional spillovers and continue to strengthen the financial safety net.** Although some pressures remain, the liquidity position of Greek subsidiaries in Romania remains in line with the rest of the system. The NBR continues to strengthen its liquidity operations and plans to complete in the third quarter work on broadening the range of acceptable collateral for refinancing operations. Measures to improve funding of the deposit guarantee fund (DGF)—through an increase in bank contribution rates and the elimination of stand-by credit lines with banks—are on track to be approved by end-September (structural benchmark). The reforms of the DGF's governance structure to prevent bank employees from participating in its Board, which requires a change to legislation, have been rescheduled to end-December (reset structural benchmark). Legislation to strengthen the resolution framework for problem banks, aimed at boosting NBR's powers to deal with weak banks and already enacted by government ordinance in March, will be ratified by parliament by end-November.

27. **The authorities will continue to take steps to ensure that the regulatory and operating environment for financial institutions remains sound.** They have agreed to reverse recent legislative initiatives that infringed on the independence of the central bank and of non-bank financial regulators by end-December and to remove the provisions inconsistent with the monetary financing prohibitions under EU law by mid-September.[6] In addition, a recent government ordinance aimed at increasing the transparency of consumer loan pricing will be reviewed to ensure consistency with the EU legislation and to avoid retroactive changes to the contractual terms of loan contracts. The authorities have also taken steps towards the adoption of the International Financial Reporting Standards (IFRS) by 2012, a longstanding objective under the program, by issuing necessary notification to banks at end-July.

D. Monetary and Exchange Rate Policies

28. **The central bank paused its easing cycle following the VAT increase, given increased uncertainty about the inflation outlook**. After a 4 percentage point cumulative reduction in interest rates since early 2009, the NBR left its key policy rate unchanged since July due to uncertainties associated with the VAT increase and food prices. The authorities believe that while monetary policy does not need to react to the one-off increase in prices

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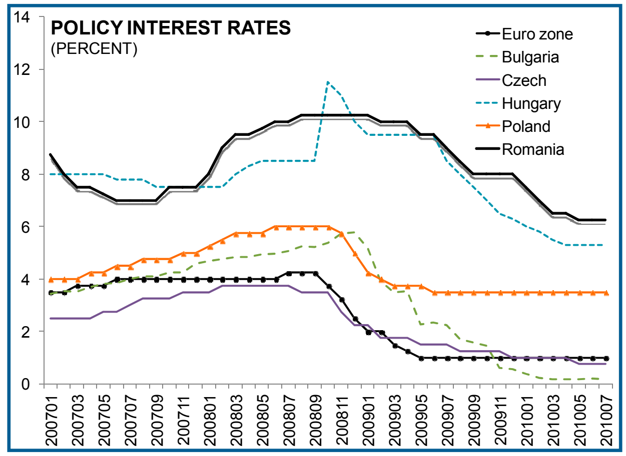
[6] The recently enacted package of fiscal adjustment measures included the central bank and the non-bank financial regulatory bodies among the institutions that are subject to the 25 percent wage cut, which undermines their financial independence and, in the case of the central bank, raises issues of consistency with EU law.



caused by the VAT hike, heightened vigilance will be needed to keep inflation expectations in check and stave off possible second-round inflationary effects. Reserve requirements have remained unchanged since November 2009 but at relatively high levels[7]. Interventions in the foreign exchange market have aimed to smooth excessive fluctuations, which served the authorities well during the crisis. Looking forward, monetary policy will be geared towards reaching the projected disinflation path net of the tax effect.

IV. Program Modalities

29. **The attached Letter of Intent (LOI) describes the authorities' progress in implementing their economic program and sets out their commitments through March 2011**.

- *Some modifications to the program's conditionality are proposed* (Tables 1–2): (i) the end-September fiscal deficit and current spending targets will be modified to make them consistent with the revised fiscal projection and the agreed timing of arrears repayment; (ii) passage of the second pillar of the public wage reform legislation is rescheduled from end-September to end-October, to allow sufficient time for its completion, while maintaining an unchanged deadline when the reform comes into effect; and (iii) the reforms of the governance structure of the DGF are rescheduled from end-September to end-December, to allow sufficient time for the legislative process.

- *New structural benchmarks are proposed* (Table 2): (i) parliamentary approval of legislation to strengthen the resolution framework for problem banks, already in effect through a government ordinance (December 1, 2010); and (ii) parliamentary approval of the agreed 2011 budget (December 15, 2010).

30. **Program modalities**. The Fund arrangement remains adequate to meet Romania's balance of payment needs through end-2010, alongside financing commitments from the European Union and the World Bank. No changes are therefore proposed to the level of access or the schedule of purchases (Table 8).

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[7] The reserve requirements are 25 percent for foreign currency liabilities and 15 percent for local currency liabilities, both short-term.

31. **Romania's capacity to repay the Fund is expected to remain strong.** Fund credit outstanding would peak in 2011 at 33.9 percent of gross reserves (Table 9). Peak payments would be in 2013–14 at a still manageable 12.8 and 14.1 percent of gross reserves, respectively. While this exposure remains large, the associated servicing risks are mitigated by the relatively low level of public debt (under 37 percent of GDP), with public external debt peaking at around 14 percent of GDP at end-2010 (Table 10). Total external debt is projected to increase to about 72 percent of GDP at end-2010 from 51 percent at end-2008, but a return to economic growth would gradually reduce it to manageable levels in the medium term (Table 11). Romania's strong political commitment to the SBA program and its excellent track record servicing external obligations also provide comfort that it will fulfill its financial obligations to the Fund in a timely manner.

32. **Fund staff has continued to cooperate closely with the staff of the European Commission (EC) and the World Bank (WB).** Staff from the three institutions consult regularly regarding developments in Romania, and EC and WB staff participated fully in the Fund mission. The EU has disbursed the first two tranches of its support (€2½ billion), and two additional tranches are expected by end-2010 (€2.4 billion). The WB has disbursed its first tranche (€0.3 billion) in September 2009, with the remaining tranches (€0.7 billion) expected in late 2010 and early 2011.

Disbursements by other IFIs and EU, EUR bn		
Past disbursements		**3.3**
July 2009	EU 1st tranche	1.5
March 2010	EU 2nd tranche	1.0
Since May 2009	WB/EIB/EBRD	0.8
Expected disbursements		**3.7**
September 2010	EU 3rd tranche	1.2
December 2010	EU 4th tranche	1.2
May 2011	EU 5th tranche	0.15
Sept 2010 to May 2011	WB/EIB/EBRD	1.1

Box 1. Romania: Stand-By Arrangement

Access: SDR 11.443 billion.

Length: 24 months.

Phasing. SDR 4.37 billion was made available upon Board approval of the arrangement on May 4, 2009, and the subsequent three tranches amounting to SDR 4.66 billion were disbursed during September 2009-July 2010 with the completion of the first to the fourth reviews (Table 8). The sixth tranche amounting to SDR 769 million will be made available subject to the completion of this review. Two subsequent disbursements, totaling SDR 1.643 billion, are contingent upon completion of the sixth review (December 2010) and seventh review (March 2011).

Conditionality

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

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

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

- ***Prior Actions***
  - Repayment of RON 1.95 billion in arrears, most in the health sector
  - Parliamentary approval of pension reform legislation

- ***Structural Benchmarks (Pending and Proposed)***
  - Parliamentary ratification of the fiscal adjustment measures *September 20, 2010*
  - Passage of pension legislation *September 30, 2010* (*reset as prior action)*
  - Reform of the DGF's funding and governance regimes *September 30, 2010*
  - Passage of implementing legislation for the unified wage law *October 31, 2010 (reset from September 30, 2010)*
  - Reform tax administration methodology for high net wealth individuals *November 30, 2010*
  - Parliamentary ratification of amendments to the bank resolution framework *December 1, 2010 (proposed)*
  - Parliamentary approval of agreed 2011 budget *December 15, 2010 (proposed)*
  - Integration of the accounting and Treasury payment systems *March 31, 2011*
  - Reforming DGF's governance regime *December 31, 2010 (reset from September 30, 2010)*

V. STAFF APPRAISAL

33. **The Romanian authorities have risen to the challenge posed by deteriorating fiscal finances and have implemented an impressive adjustment package**. With an annual yield of close to 5 percent of GDP and a good balance between revenue and expenditure measures, the package has set the authorities firmly towards meeting the fiscal targets in the

remainder of the program and reaching the Maastricht target of a 3 percent of GDP deficit by 2012, without a need for further major policy shifts.

34. **The main challenge for fiscal policies remains establishing a strong track record of policy implementation and ensuring stability of its policy framework.** This challenge can be met by securing the continuity of the adjustment measures—through parliamentary ratification of the VAT increase and approval of a wage reform that delivers a permanent adjustment in the wage bill after the expiration of the wage cuts—and by following through with plans to downsize the public sector. While no further measures should be needed, especially in light of the recently improved revenue performance, meeting the fiscal targets will still depend on continued expenditure restraint. Frequent public discussions about potential modifications to the adjustment package is proving detrimental to market sentiment, and may adversely affect recovery prospects and should be avoided. An important priority going forward should be to ensure certainty and stability of the tax regime, while reaping the gains from the already enacted package. Finally, while the reliance on very short-term deficit financing and cash reserves may have been justified by recent market unrest, going forward the authorities must move to normalize their debt issuance to ensure adequate financing buffers and avoid potentially damaging liquidity crunches.

35. **Coming to grips with the persistent problem of domestic payment arrears should become a policy priority**. While the size of the arrears is small (0.4 percent of GDP at end-June) and their repayment should not impose a heavy fiscal burden, it will provide major benefits in terms of improving payment discipline and unblocking financial payments in the economy. The settlement of a part of these arrears and unpaid bills as a prior action for completing this review is only a first step, which needs to be followed by concerted efforts at improving commitment controls at all levels of government so as to prevent their further accumulation.

36. **The success of the authorities' consolidation strategy hinges on their ability to carry out structural reforms**. The pension and public wage reforms are two major pillars supporting the adjustment effort, and their approval is therefore critical. Staff firmly supports the authorities' efforts to further streamline public employment, as it would allow some recovery in real incomes of the remaining, better-qualified, employees. It also strongly welcomes the authorities' initiatives to reform the labor markets and the burdensome system of social assistance benefits. Efforts to improve tax collections may also be bearing fruit, with some improvement in the revenue performance in recent months, and should be expanded along the lines of the recent technical assistance advice. Romania's yield from major taxes remains well below that of other EU countries, suggesting that there is significant scope for improvement. Staff urges the authorities to improve the absorption of the EU funds in order to meet the large infrastructure needs under tight budget constraints, and recommends further reforms of the capital budgeting process to ensure adequate prioritization and valuation of the investment projects. Reforms of the state enterprises, while proceeding along with the restructuring of the public sector, are too timid relative to the size

of the problem and may not be adequate to stem the deterioration in their finances; staff encourages the authorities to put in place more ambitious reform and aggressively pursue privatization measures.

37. **Staff supports the pause in monetary easing in the wake of the VAT increase**, as it will allow the monetary authorities to gauge the immediate impact of the tax hike and, in the event, of the recent floods. Looking forward, vigilance will be key to staving off second-round effects. They are likely to be muted given the cyclical position of the economy but risks from unsettled inflation expectations exist. Barring such effects, the authorities appear set to meet the end-2011 inflation target while having some room for eventual further easing. The authorities should gear their policy decisions towards reaching the projected disinflation path net of the tax effect.

38. **Financial system defenses against the crisis have proven resilient, but continued watchfulness will be needed given potential regional spillovers and further asset quality deterioration.** The authorities' proactive approach to monitoring and securing adequate capital buffers will need to continue as non-performing loans rise until economic recovery takes hold. Reforms of the bank resolution framework and of the deposit insurance fund have either been completed or are under way. Staff supports steps by the authorities to introduce international financial standards starting in 2012, and their commitment to reversing recent measures that inadvertently infringed on the independence of the central bank and of the non-bank financial supervisors.

39. **On the basis of Romania's performance under the SBA, staff supports the authorities' request for completing the fifth review.** Staff also supports the approval of a waiver of nonobservance of the end-June 2010 performance criterion on the accumulation of domestic arrears on the basis of the small nature of the deviation and the corrective actions undertaken by the government. Staff also recommends establishment of quantitative conditionality for end-December 2010, and approval of the modification of program conditionality, as proposed by the attached Letter of Intent.

Figure 1. Romania: Recent Economic Trends

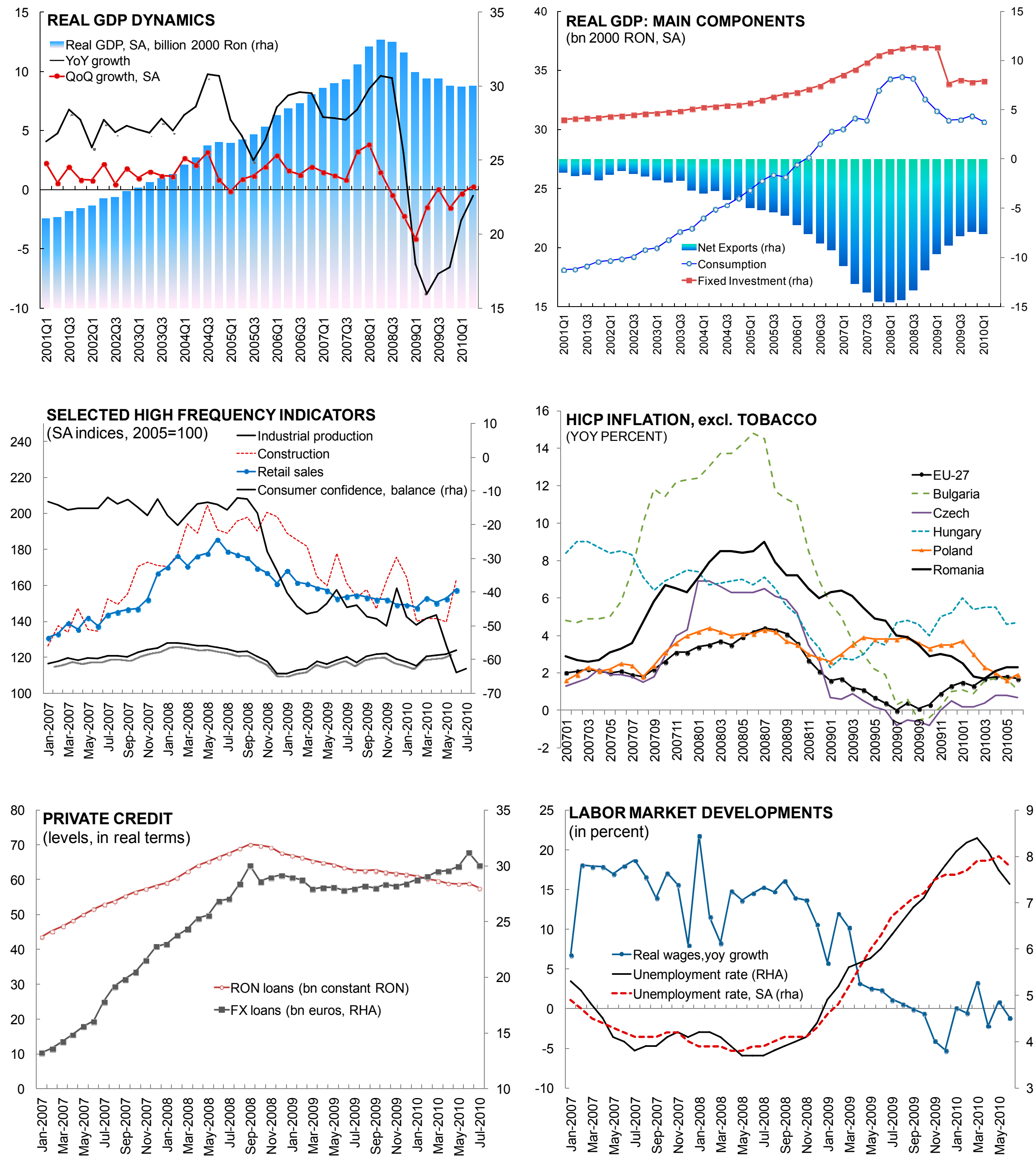


Figure 2. Romania: Financial Market Developments

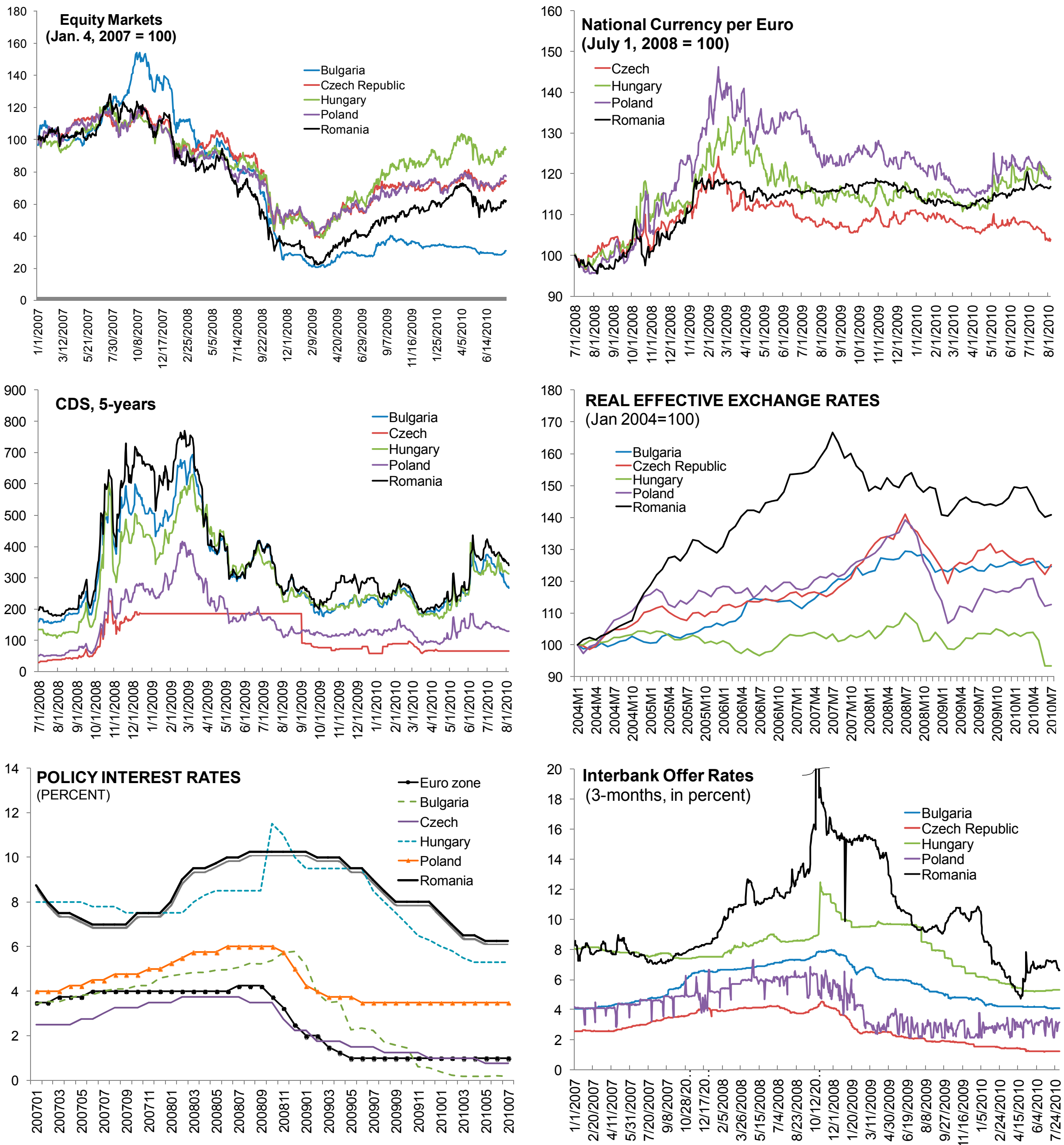
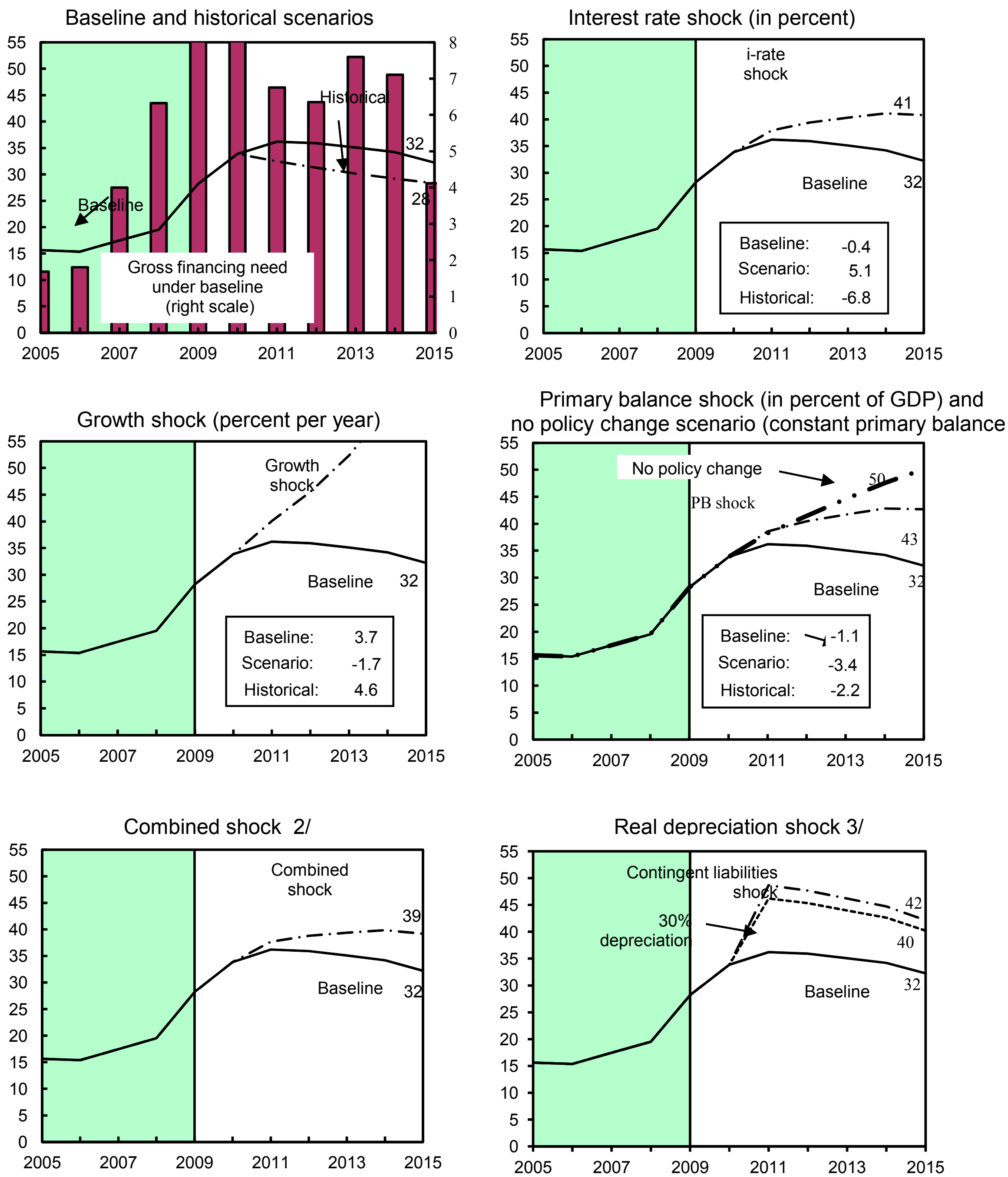
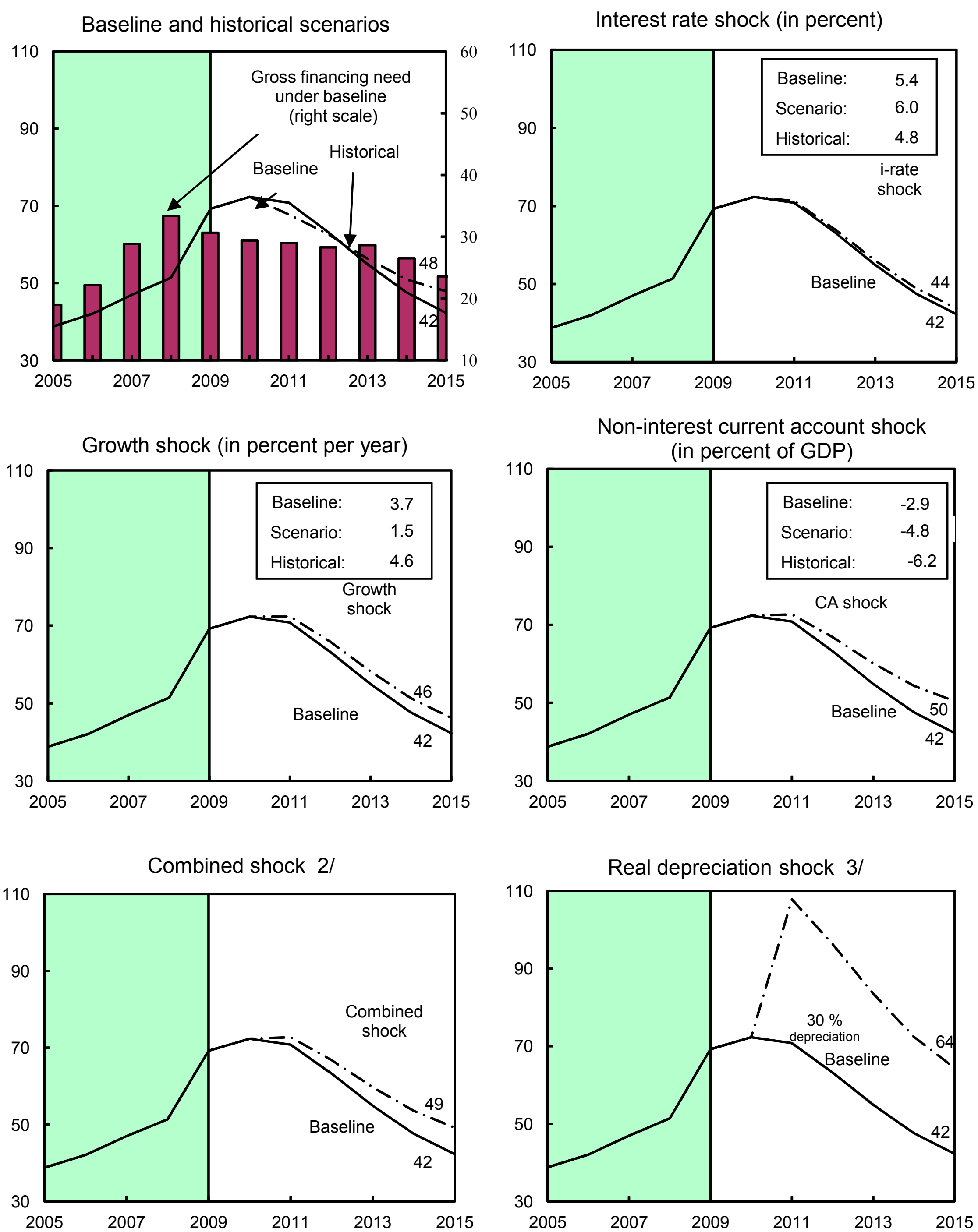


Figure 3. Romania: Public Debt Sustainability: Bound Tests 1/
(Public debt in percent of GDP)



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

Figure 4. Romania: External Debt Sustainability: Bound Tests 1/
(External debt in percent of GDP)



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

Table 1. Romania: Quantitative Program Targets

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March	June		Sept	Dec
	Actual	Actual	Actual	Actual	Actual	Actual	Prog.	Prelim.	Prog.	Prog.
I. Quantitative Performance Criteria										
1. Cumulative change in net foreign assets (mln euros) 1/3/	25,532	-3,500	-5,119	-4,566	-4,874	779	-4,040	-509	-2,000	-2,000
2. Cumulative floor on general government overall balance (mln lei) 2/	-24,655	-8,300	-14,456	-25,563	-36,101	-8,422	-18,200	-18,015	-28,200	-34,650
3. Stock in general government arrears from the end of previous year (bn lei)	1.06	1.41	1.55	1.4	1.50	1.76	1.09	1.8	0.81	0.48
4. Ceiling on general government guarantees issued during the year (face value, bn lei)	0.0	…	0.02	0.7	2.2	4.6	12.0	5.6	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	0	0	0	0	0	0	…	0	0
III. Inflation Consultation										
6. 12-month rate of inflation in consumer prices										
Outer band (upper limit)	…	…	8.4	7.7	6.5	6.5	6.0	…	10.0	10.0
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.0	…	9.0	9.0
Actual/*Center point*	6.3	6.7	5.9	4.8	4.7	4.2	*4.0*	4.4	*8.0*	*8.0*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.0	…	7.0	7.0
Outer band (lower limit)	…	…	4.4	3.7	2.5	2.5	2.0	…	6.0	6.0
IV. Indicative Target										
7. General government current primary spending (excl. EU funds and social assistance, mln lei) 2/	92,327	22,149	43,238	63,878	85,637	32,749	66,200	66,124	100,000	131,000
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-495	-2,000	-1,947	-3,000	-4,000
Memorandum Item:										
Cumulative projected revenue of general government, net of EU funds (mln. lei)	…	…	…	…	151,508	36,355	74,950	74,669	114,700	157,950

1/ The December 2008 figure is a stock.
2/ The December 2008 figure is for the whole year.
3/ NFA targets for end-June 2010 have been adjusted as actual disbursements fell short of projected levels by EUR 1.5 bn.

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

Measure	Target Date	Comment
Prior actions		
1. Repayment of RON 1.95 billion in arrears and unpaid bills, most in the health sector		
2. Parliamentary approval of pension reform legislation		
Quantitative performance criteria		
1. Floor on net foreign assets	June, 2010	Met
2. Floor on general government overall balance	June, 2010	Met
3. Ceiling on general government guarantees	June, 2010	Met
4. Ceiling on general government domestic arrears	June, 2010	Not met
5. Non-accumulation of external debt arrears	June, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	June, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	June, 2010	Met
Inflation consultation band		
Inner band	June, 2010	Met
Outer band	June, 2010	Met
Structural benchmarks		
1. Approval of reforms to mitigate fiscal risks from local governments	September 30, 2010	Met in June 2010
2. Passage of implementing legislation for the unified wage law	October 31, 2010	Reset from September 30, 2010
3. Passage of pension legislation	September 30, 2010	Reset as prior action
4. Parliamentary ratification of the fiscal measures approved by the government	September 30, 2010	VAT ratification pending
5. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement	September 30, 2010	Pending
6. Reform tax administration methodology for high net wealth individuals	November 30, 2010	
7. Integrate the accounting reporting system with the Treasury payment system	March 31, 2011	
New Conditionality (Structural Benchmarks)		
1. Parliamentary ratification of amendments to the bank resolution framework	December 1, 2010	
2. Parliamentary approval of agreed 2011 budget	December 15, 2010	
3. Amend deposit insurance legislation to ensure that neither members of the board nor employees of credit institutions participate in the DGF Board	December 31, 2010	modified from September 30, 2010

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

	2007	2008	2009	2010		2011	2012	2013	2014	2015
				Prog.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
Output and prices				(Annual percentage change)						
Real GDP	6.3	7.3	-7.1	-0.5	-1.9	1.5	4.4	4.2	4.2	4.2
Domestic demand	14.2	7.2	-12.8	-1.5	-3.8	1.3	5.1	5.0	4.9	5.0
Net exports (contribution)	-9.6	-0.8	7.3	1.4	2.1	0.2	-1.0	-1.1	-1.0	-1.1
Consumer price index (CPI, average)	4.8	7.8	5.6	6.6	5.9	5.2	3.0	3.0	3.0	3.0
Consumer price index (CPI, end of period)	6.6	6.3	4.7	7.9	7.9	3.0	3.0	3.0	3.0	3.0
Unemployment rate (average)	4.3	4.0	6.3	8.9	7.2	7.1	6.5	5.8	5.1	4.4
Nominal wages	22.6	23.6	8.4	4.3	2.0	1.4	5.0	6.0	7.0	8.0
Saving and Investment				(In percent of GDP)						
Gross domestic investment	31.0	31.3	25.1	24.8	24.7	24.5	25.2	26.8	28.3	30.2
Gross national savings	17.5	19.4	20.6	19.8	19.6	19.0	20.0	21.8	23.4	25.3
General government finances										
Revenue	32.3	32.2	31.8	32.6	32.3	32.5	32.7	32.4	31.4	30.7
Expenditure	35.4	37.0	39.2	39.4	39.1	36.9	35.7	34.8	33.7	32.1
Fiscal balance	-3.1	-4.8	-7.4	-6.8	-6.8	-4.4	-3.0	-2.5	-2.4	-1.4
Privatization proceeds	0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External financing	0.1	0.4	2.9	4.6	4.6	0.8	0.0	0.0	0.0	0.0
Domestic financing	2.9	4.3	4.5	2.2	2.2	3.6	3.0	2.5	2.4	1.4
Structural fiscal balance 1/	-6.2	-8.9	-6.7	-3.3	-4.4	-1.9	-1.3	-1.4	-1.8	-1.2
Gross public debt (direct debt only)	17.5	19.5	28.2	33.9	33.9	36.2	35.9	35.1	34.2	32.2
Money and credit				(Annual percentage change)						
Broad money (M3)	33.7	17.5	9.0	10.4	10.6	5.2	8.9	8.9	10.2	10.9
Credit to private sector	60.4	33.7	0.9	7.3	9.0	7.0	11.3	12.6	11.7	14.8
Interest rates, eop				(In percent)						
Euribor, six-months	4.79	3.52	4.52	-	-	-	-	-	-	-
NBR policy rate	7.50	10.25	8.00	-	-	-	-	-	-	-
NBR lending rate (Lombard)	12.00	14.25	12.00	-	-	-	-	-	-	-
Interbank offer rate (1 week)	7.10	12.70	10.70	-	-	-	-	-	-	-
Balance of payments				(In percent of GDP)						
Current account balance	-13.4	-11.9	-4.5	-5.0	-5.1	-5.4	-5.1	-5.0	-4.9	-4.9
Merchandise trade balance	-14.3	-13.7	-5.9	-7.0	-5.3	-7.7	-7.7	-7.8	-8.0	-8.1
Capital and financial account balance	17.3	12.7	-1.1	4.0	3.2	6.1	7.0	7.0	6.9	6.9
Foreign direct investment balance	5.7	6.7	3.8	4.1	3.0	4.2	4.5	4.5	4.5	4.5
International investment position	-40.1	-51.8	-68.3	-62.5	-61.3	-62.6	-61.1	-61.9	-62.2	-60.2
Gross official reserves	23.0	20.2	26.6	31.7	32.1	31.4	28.4	24.1	20.4	19.0
Gross external debt	47.0	51.4	69.2	69.0	72.3	70.8	63.2	54.9	47.6	42.3
Exchange rates										
Lei per euro (end of period)	3.5	4.0	4.2	-	-	-	-	-	-	-
Lei per euro (average)	3.3	3.7	4.2	-	-	-	-	-	-	-
Real effective exchange rate										
CPI based (depreciation -)	8.3	-4.9	-7.5	-	-	-	-	-	-	-
Memorandum Items:										
Nominal GDP (in bn RON)	416.0	514.7	491.3	510.4	511.6	544.4	599.1	659.4	726.7	805.6

Social and Other Indicators

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

Unemployment rate: 7.4% (July 2010)

Poverty rate: 5.7% (2008)

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

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

Table 4. Romania: Balance of Payments, 2007–11
(In billions of euros, unless otherwise indicated)

	2007 Act	2008 Act	2009 Act	2010 Prog	2010 Proj	2011 Proj.
Current account balance	-16.7	-16.6	-5.2	-6.1	-6.2	-6.9
Merchandise trade balance	-17.8	-19.1	-6.8	-8.6	-6.5	-9.9
Exports (f.o.b.)	29.5	33.7	29.1	31.5	35.4	37.4
Imports (f.o.b.)	-47.4	-52.8	-35.9	-40.1	-41.9	-47.3
Services balance	0.4	0.7	-0.4	-0.2	-0.1	0.1
Exports of non-factor services	6.9	8.8	7.0	7.7	7.3	8.0
Imports of non-factor services	-6.5	-8.1	-7.4	-7.9	-7.4	-7.9
Income balance	-4.1	-3.7	-2.1	-2.5	-2.5	-2.9
Receipts	2.4	2.3	1.2	1.5	1.5	1.8
Payments	-6.6	-6.0	-3.3	-4.0	-3.9	-4.7
Current transfer balance	4.8	5.6	4.1	5.2	2.8	5.7
Capital and financial account balance	22.0	17.7	-1.2	4.9	3.9	7.9
Capital transfer balance	0.8	0.6	0.5	0.4	0.4	0.4
Foreign direct investment balance	7.0	9.3	4.4	5.0	3.6	5.4
Portfolio investment balance	0.4	-0.8	0.4	-0.2	2.2	0.4
Other investment balance	13.8	8.7	-6.5	-0.3	-2.3	1.6
General government 1/	-0.6	0.2	0.2	1.4	2.1	0.0
Domestic banks	6.0	3.0	-5.3	0.0	-0.6	0.0
Other private sector	8.5	5.5	-1.4	-1.7	-3.9	1.6
Errors and omissions	-0.7	-0.5	-0.2	0.0	0.0	0.0
Prospective financing	...	...	2.1	4.8	4.4	0.5
European Commission	...	...	1.5	3.4	3.4	0.2
World Bank	...	...	0.3	0.7	0.4	0.3
EIB/EBRD	...	...	0.3	0.7	0.7	0.0
Overall balance	4.6	0.6	-4.5	3.5	2.1	1.4
Financing	-4.6	-1.0	4.3	-3.5	-2.1	-1.4
Gross international reserves (increase: -)	-4.5	-1.0	-2.6	-7.4	-5.6	-2.4
Use of Fund credit, net	-0.1	0.0	5.9	3.9	3.9	1.0
Purchases 2/	0.0	0.0	5.9	3.9	3.9	1.0
Repurchases	0.1	0.0	0.0	0.0	0.0	0.0
Other liabilities, net 3/	0.0	0.0	1.0	0.0	0.0	0.0
Memorandum items:			(In percent of GDP)			
Current account balance	-13.4	-11.9	-4.5	-5.0	-5.1	-5.4
Foreign direct investment balance	5.7	6.7	3.8	4.1	3.0	4.2
Merchandise trade balance	-14.3	-13.7	-5.9	-7.0	-5.3	-7.7
Exports	23.7	24.1	25.1	25.7	29.2	29.1
Imports	-38.0	-37.8	-31.0	-32.7	-34.6	-36.9
Gross external financing requirement	26.7	32.9	30.3	29.7	28.2	27.4
			(Annual percentage change)			
Terms of trade (merchandise)	5.3	-4.7	9.2	-7.4	-2.8	-4.8
Merchandise export volume	8.7	10.6	-12.7	8.4	7.9	3.9
Merchandise import volume	26.1	3.6	-24.2	4.3	2.6	6.2
Merchandise export prices	5.2	3.2	-1.1	-0.4	12.8	1.6
Merchandise import prices	-0.1	7.6	-10.3	7.1	13.8	6.3
			(In billions of euros)			
Gross international reserves 3/	28.7	28.3	30.9	38.3	38.9	40.2
GDP	124.6	139.7	116.0	122.5	121.1	128.3

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

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

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

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

Table 5. Romania: Gross Financing Requirements, 2009-11
(In billions of euros, unless otherwise indicated)

	2009					2010					2011	Total
	Q1	Q2	Q3	Q4	Year	Q1	Q2	Q3	Q4	Year		2009-11
	Act	Act	Act	Act	Act	Act	Proj	Proj	Proj	Proj.	Proj.	
I. Total financing requirements	**13.1**	**15.3**	**11.1**	**8.7**	**48.2**	**10.2**	**8.3**	**9.1**	**9.8**	**37.3**	**38.0**	**123.5**
I.A. Current account deficit	0.9	1.4	1.2	1.6	5.2	1.6	2.1	1.3	1.3	6.2	6.9	18.3
I.B. Short-term debt	9.2	10.4	6.4	4.7	30.7	5.0	4.4	4.2	3.7	17.3	18.6	66.6
Public sector	2.8	4.1	0.9	1.0	8.8	1.4	0.8	0.2	0.1	2.5	3.9	15.2
Banks	3.6	4.6	4.0	2.2	14.4	2.6	2.9	2.6	2.4	10.5	9.6	34.5
Corporates	2.8	1.7	1.5	1.5	7.5	1.0	0.7	1.4	1.2	4.3	5.1	16.9
I.C. Maturing medium- and long-term debt	1.8	3.0	1.6	3.5	9.9	2.8	1.9	2.6	2.6	9.9	10.8	30.6
Public sector	0.2	0.3	0.2	0.3	1.0	0.2	0.3	0.9	0.2	1.6	0.9	3.5
Banks	0.8	1.6	0.4	1.9	4.7	1.0	0.6	0.8	0.7	3.1	4.7	12.5
Corporates	0.8	1.1	1.0	1.3	4.2	1.6	1.0	0.9	1.7	5.2	5.2	14.6
I.D. Other net capital outflows 1/	1.1	0.5	1.9	-1.1	2.4	0.8	-0.1	1.0	2.2	3.9	1.6	7.9
II. Total financing sources	**10.9**	**12.2**	**9.9**	**8.6**	**41.6**	**9.3**	**7.5**	**8.0**	**8.9**	**33.6**	**36.8**	**112.0**
II.A. Foreign direct investment, net	1.5	1.1	0.9	0.9	4.4	0.8	1.0	0.9	0.9	3.6	5.4	13.4
II.B. Capital account inflows (EU)	0.0	0.0	0.3	0.2	0.5	0.0	0.1	0.2	0.2	0.4	0.4	1.3
II.C. Short-term debt	7.2	7.4	5.1	4.9	24.6	5.9	4.5	4.2	4.0	18.6	18.6	61.8
Public sector	3.7	3.1	1.1	1.3	9.2	1.9	0.7	1.2	0.1	3.9	3.9	17.0
Banks	2.4	3.4	2.6	2.4	10.8	3.0	2.6	1.6	2.4	9.6	9.6	30.0
Corporates	1.1	0.9	1.4	1.2	4.6	1.0	1.2	1.4	1.5	5.1	5.1	14.8
II.D. Medium- and long-term debt	2.2	3.7	3.6	2.6	12.1	2.6	1.9	2.7	3.8	11.1	12.4	35.6
Public sector 2/	0.0	0.2	0.1	0.5	0.8	1.1	0.2	0.9	1.2	3.4	0.9	5.2
Banks	0.8	2.0	1.8	0.8	5.4	0.4	1.1	0.9	0.7	3.1	4.7	13.2
Corporates	1.4	1.5	1.7	1.3	5.9	1.1	0.6	1.0	1.9	4.6	6.8	17.3
III. Increase in gross reserves	**-2.0**	**1.8**	**1.9**	**0.3**	**2.0**	3.1	-1.3	2.0	1.8	5.7	**0.4**	**8.0**
IV. Errors and omissions	**0.2**	**-0.1**	**-1.3**	**-0.1**	**-1.3**	**0.4**	**-0.7**	**0.0**	**0.0**	**-0.3**	**0.0**	**-1.6**
V. Program financing	**0.0**	**4.9**	**3.5**	**0.5**	**8.9**	**3.6**	**0.1**	**3.1**	**2.8**	**9.5**	**1.5**	**20.0**
IMF	0.0	4.9	1.9	0.0	6.8	2.4	0.0	1.8	0.9	5.1	1.0	12.9
Others	0.0	0.0	1.6	0.5	2.1	1.2	0.1	1.4	1.9	4.5	0.5	7.1
European Commission	0.0	0.0	1.5	0.0	1.5	1.0	0.0	1.2	1.2	3.4	0.2	5.1
World Bank	0.0	0.0	0.0	0.3	0.3	0.0	0.0	0.0	0.4	0.4	0.3	1.0
EIB/EBRD	0.0	0.0	0.1	0.2	0.3	0.2	0.1	0.2	0.3	0.7	0.0	1.0
VI. Other Financing 3/	**0.0**	**0.0**	**1.0**	**0.0**	**1.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**	**1.0**
Memorandum items:												
Rollover rates for amortizing debt (in percent)												
Banks	72	87	100	77	84	94	106	73	101	93	100	…
Corporates	69	86	124	89	90	81	106	103	117	102	116	…
Gross international reserves 3/	27.4	28.7	30.6	30.9	30.9	34.8	35.0	37.0	38.9	38.9	40.2	…
Coverage of gross international reserves												
- Months of imports of GFNS (next year)	…	…	…	…	7.5	…	…	…	…	8.4	8.0	…
- Short-term external debt (in percent)	92	103	109	121	121	129	122	129	125	125	133	…

Source: IMF staff estimates.
1/ Includes includes portfolio equity, financial derivatives and other investments, assets position.
2/ Excludes the disbursements by the IMF directly to the Treasury, amounting to €0.9 billion in 2009Q3 and €0.8 billion in 2009Q4.
3/ Reflects two SDR allocations in August and September 2009.

Table 6. Romania: General Government Operations, 2007–11
(In percent of GDP)

	2007	2008	2009	2010		2011
				Prog.	Proj.	Proj.
Revenue	32.3	32.2	31.8	32.6	32.3	32.5
Taxes	27.9	28.0	27.8	27.7	26.7	27.2
Taxes on profits	2.9	2.8	2.7	2.6	2.3	2.3
Taxes on income	3.5	3.6	3.8	3.5	3.5	3.5
Value-added taxes	7.5	7.9	7.0	7.4	7.2	7.9
Excises	3.0	2.7	3.2	3.4	3.2	3.2
Customs duties	0.2	0.2	0.1	0.1	0.1	0.1
Social security contributions	9.5	9.5	9.7	9.2	9.0	8.9
Other taxes	1.4	1.2	1.2	1.3	1.4	1.4
Nontax revenue	3.4	3.1	2.9	3.5	4.0	3.7
Capital revenue	0.2	0.2	0.1	0.1	0.1	0.1
Grants, including EU disbursements	0.8	0.9	1.0	1.4	1.5	1.5
Expenditure	35.4	37.0	39.2	39.4	39.1	36.9
Current expenditure	30.7	32.5	35.3	35.5	35.3	33.2
Compensation of employees	8.1	8.9	9.5	8.3	8.2	7.4
Maintenance and operations	6.1	6.2	5.7	5.8	5.7	5.1
Interest	0.7	0.7	1.2	1.8	1.7	1.8
Subsidies	1.7	1.5	1.5	1.2	1.3	1.1
Transfers 1/	14.1	15.1	17.0	18.0	17.8	17.5
Pensions	5.4	6.4	8.1	8.3	8.3	8.7
Other social transfers	3.9	4.1	4.9	5.1	5.0	4.1
Other transfers 2/	4.0	3.4	3.4	4.1	4.0	4.2
o\w contribution to EU budget	0.9	0.9	1.2	1.1	1.0	1.1
o\w pre-accession EU funds	…	…	0.6	0.7	0.7	0.3
Other spending	0.7	1.2	0.5	0.5	0.5	0.5
Proj. with ext. credits	0.0	0.0	0.4	0.5	0.5	0.3
Capital expenditure 3/	4.7	4.6	4.4	3.9	3.8	3.7
Reserve fund	0.0	0.0	0.0	0.0	0.0	0.1
Net lending	0.0	-0.1	-0.5	0.0	0.0	0.0
Fiscal balance	-3.1	-4.8	-7.4	-6.8	-6.8	-4.4
Primary balance	-2.4	-4.1	-6.2	-5.0	-5.1	-2.6
Financing	3.1	4.8	7.4	6.8	6.8	4.4
Privatization proceeds	0.1	0.1	0.0	0.0	0.0	0.0
External	0.1	0.4	2.9	4.6	4.6	0.8
Domestic	2.9	4.3	4.5	2.2	2.2	3.6
Financial liabilities						
Gross public debt 4/	19.8	21.3	29.9	35.6	35.5	37.7
Gross public debt excl. guarantees	17.5	19.5	28.2	33.9	33.9	36.2
External	7.1	6.9	10.2	14.4	14.4	14.3
Domestic	10.4	12.6	18.0	19.5	19.5	21.9
Memorandum items:						
Total capital spending	…	6.3	6.6	6.9	6.8	6.5
Fiscal balance (ESA95 basis)	-2.5	-5.3	...	...	...	...
Output gap 5/	8.6	11.0	-1.8	-8.9	-6.1	-6.7
Conventional structural fiscal balance	-6.2	-8.9	-6.7	-3.3	-4.4	-1.9
Nominal GDP (in billions of RON)	416.0	514.7	491.3	510.4	511.6	544.4

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

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

2/ Includes co-financing of EU projects.

3/ Does not include all capital spending.

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

5/ Percentage deviation of actual from potential GDP.

Table 6. Romania: General Government Operations, 2007–11 (concluded)
(In millions of RON)

	2007	2008	2009	2010		2011
				Prog.	Proj.	Proj.
Revenue	134,173	165,549	156,373	166,617	165,425	177,007
Taxes	116,066	143,855	136,350	141,194	136,780	148,154
Taxes on profits	11,917	14,426	13,466	13,434	11,663	12,266
Taxes on income	14,402	18,523	18,551	17,916	18,102	18,823
Value-added taxes	31,243	40,874	34,322	37,911	36,879	43,147
Excises	12,552	13,646	15,646	17,516	16,390	17,442
Customs duties	856	962	656	648	591	629
Social security contributions	39,443	49,008	47,829	47,088	46,143	48,467
Other taxes	5,653	6,416	5,879	6,681	7,012	7,379
Nontax revenue	13,991	15,892	14,487	17,842	20,616	20,251
Capital revenue	963	1,076	546	541	525	552
Grants	3,154	4,702	5,057	7,040	7,503	8,050
o/w EU pre-accession funds	...	...	2,959	3,415	3,415	1,365
Financial operations and other	...	25	-67	...	...	...
Expenditure	147,141	190,407	192,782	201,243	200,066	200,919
Current expenditure	127,513	167,095	173,445	181,221	180,363	180,511
Compensation of employees	33,696	45,608	46,676	42,144	42,156	40,200
Maintenance and operations	25,187	32,012	28,028	29,522	28,921	27,918
Interest	3,096	3,776	6,063	9,116	8,710	9,605
Subsidies	6,875	7,899	7,215	6,092	6,696	6,071
Transfers 1/	58,660	77,800	83,407	91,722	91,229	95,258
Pensions	22,664	33,187	39,851	42,351	42,329	47,622
Other social transfers	16,186	20,973	24,101	25,841	25,834	22,207
Other transfers 2/	16,769	17,646	16,931	21,039	20,643	22,948
o\w contribution to EU budget	3,799	4,506	5,650	5,626	5,171	6,061
o\w pre-accession EU funds			2,959	3,415	3,415	1,365
Other spending	3,041	5,993	2,523	2,491	2,423	2,481
Proj. with ext. credits	0	0	2,056	2,625	2,652	1,458
Capital expenditure 3/	19,629	23,794	21,837	19,821	19,473	20,132
Reserve fund	0	0	0	201	230	276
Net lending	0	-481	-2,500	0	0	0
Fiscal balance	-12,968	-24,858	-36,409	-34,626	-34,641	-23,911
Primary balance	-9,872	-21,082	-30,346	-25,510	-25,931	-14,306
Financing	12,968	24,858	36,409	34,626	34,641	23,911
Privatization proceeds	600	371	0	0	0	0
External	324	2,284	14,233	23,474	23,474	4,244
Domestic	12,044	22,203	22,177	11,151	11,167	19,667
Financial liabilities						
Gross public debt 4/	82,324	109,752	146,938	181,564	181,579	205,490
Gross public debt excl. guarantees	72,747	100,435	138,598	173,224	173,239	197,150
External	29,672	35,733	49,966	73,440	73,440	77,684
Domestic	43,075	64,702	88,632	99,784	99,799	119,466
Other liabilities						

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

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

2/ Includes co-financing of EU projects.

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

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

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

	Dec-07	Dec-08	Dec-09	Dec-10 Proj. 2/	Dec-11 Proj.
		I. Banking System			
Net foreign assets	**29,070**	**13,138**	**17,684**	**26,774**	**31,988**
In million euros	8,052	3,297	4,182	6,177	7,673
o/w commercial banks	-18,666	-24,388	-19,708	-19,708	-19,708
Net domestic assets	**119,046**	**160,890**	**171,946**	**183,002**	**188,781**
Public sector credit	9,571	17,268	46,816	57,982	77,649
Private sector credit	148,181	198,086	199,882	217,771	232,838
Other	-38,706	-54,464	-74,751	-92,751	-121,706
Broad Money (M3)	**148,116**	**174,028**	**189,630**	**209,776**	**220,769**
Intermediate money (M2)	148,044	173,629	188,013	206,846	217,686
Money market instruments	72	399	1,617	2,930	3,083
Narrow money (M1)	79,914	92,549	79,361	87,311	102,323
Currency in circulation	21,442	25,287	23,968	25,663	30,421
Overnight deposits	58,472	67,262	55,394	61,648	71,902
		II. National Bank of Romania			
Net foreign assets	**96,466**	**110,323**	**101,015**	**112,195**	**114,147**
In million euros	26,720	27,683	23,891	25,885	27,381
Net domestic assets	**-47,593**	**-59,855**	**-49,354**	**-56,878**	**-56,610**
Public sector credit, net	-8,499	-1,428	-13,626	-13,626	-13,626
Credit to banks, net	-41,168	-51,126	-23,848	-31,372	-31,104
Other	2,074	-7,301	-11,879	-11,879	-11,879
Reserve money	**48,873**	**50,468**	**51,662**	**55,317**	**57,537**
		(Annual percentage change)			
Broad money (M3)	33.7	17.5	9.0	10.6	5.2
NFA contribution	-8.7	-10.8	2.6	4.8	2.5
NDA contribution	42.4	28.3	6.4	5.8	2.8
Reserve money	41.3	3.3	2.4	7.1	4.0
NFA contribution	58.5	28.4	-18.4	21.6	3.5
NDA contribution	-17.1	-25.1	20.8	-14.6	0.5
Domestic credit, real	54.3	28.4	9.4	3.6	9.4
Private sector, at constant e/r	56.3	26.5	-2.6	7.3	9.5
Public sector, real	153.3	69.7	158.9	14.8	30.1
Broad money (M3), in real terms	25.4	10.5	4.1	2.6	2.2
Private deposits, at constant e/r	30.9	13.5	8.4	8.8	6.3
Memorandum items:					
CPI inflation, eop	6.6	6.3	4.7	7.9	3.0
Inflation target	3 - 5	2.8 - 4.8	2.5 - 4.5	2.5 - 4.5	2.0 - 4.0
Interest rates (percent):					
Policy interest rate	7.50	10.25	8.00	6.25	…
Interbank offer rate, 1 week	7.1	12.7	10.7	5.0	
Corporate loans 1/	11.6	19.5	15.4	12.0	…
Household time deposits 1/	6.94	15.27	9.9	7.4	…
Share of foreign currency private deposits	32.1	34.8	38.8	37.0	…
Share of foreign currency private loans	54.3	57.8	60.1	60.4	…
M2 velocity	2.81	2.96	2.61	2.54	2.57
Money multiplier (M3/reserve money)	3.03	3.45	3.67	3.79	3.84

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

Table 8. Romania: Schedule of Reviews and Purchases

Date	Amount of Purchase: Millions of SDRs	Amount of Purchase: Percent of Quota	Conditions
May 4, 2009	4,370	424.19	Approval of arrangement
September 21, 2009	1,718	166.76	First review and end-June 2009 performance criteria
December 15, 2009 1/	1,409	136.77	Second review and end-September 2009 performance criteria
February 19, 2010	766	74.35	Third review and end-December 2009 performance criteria
July 2, 2010	768	74.55	Fourth review and end-March 2010 performance criteria
September 24, 2010	769	74.65	Fifth review and end-June 2010 performance criteria
December 15, 2010	769	74.65	Sixth review and end-September 2010 performance criteria
March 15, 2011	874	84.84	Seventh and end-December 2010 performance criteria
Total	11,443	1110.76	

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

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

(In millions of SDR)

	2010	2011	2012	2013	2014	2015	2016
Existing Fund Credit							
Stock 2/	9,031	9,031	7,724	3,768	560	0	0
Obligations 3/	57	117	1,423	4,041	3,240	563	1
Repurchase	0	0	1,307	3,956	3,208	560	0
Charges	57	117	115	85	31	3	1
Prospective Fund Credit under Stand-By Arrangement							
Disbursement	1,538	874	0	0	0	0	0
Stock 2/	1,538	2,412	2,412	2,316	1,219	109	0
Obligations 3/	9	30	31	127	1,123	1,122	110
Repurchase	0	0	0	96	1,097	1,110	109
Charges	9	30	31	31	26	12	1
Stock of existing and prospective Fund credit							
In millions of SDR	10,569	11,443	10,136	6,084	1,779	109	0
In percent of quota	1,026	1,111	984	591	173	11	0
In percent of GDP	10.2	10.7	8.4	4.5	1.2	0.1	0.0
In percent of exports of goods and services	28.8	30.1	24.7	13.8	3.7	0.2	0.0
In percent of gross reserves	33.4	34.8	30.1	19.1	5.8	0.3	0.0
Obligations to the Fund from existing and prospective Fund arrangements							
In millions of SDR	66	147	1,454	4,168	4,363	1,685	111
In percent of quota	6.4	14.3	141.1	404.6	423.5	163.6	10.7
In percent of GDP	0.1	0.1	1.2	3.1	2.8	1.0	0.1
In percent of exports of goods and services	0.2	0.4	3.5	9.4	9.1	3.3	0.2
In percent of gross reserves	0.2	0.4	4.3	13.1	14.3	5.2	0.3

Source: IMF staff estimates.

1/ Using IMF actual disbursements, SDR interest rate as well as exchange rate of SDR/US$ and US$/€ of July 8, 2010.
2/ End of period.
3/ Repayment schedule based on repurchase obligations.

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

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	Debt-stabilizing primary balance 9/
Baseline: Public sector debt 1/	15.6	15.4	17.5	19.5	28.2	**33.9**	**36.2**	**35.9**	**35.1**	**34.2**	**32.2**	**-1.8**
o/w foreign-currency denominated	8.7	6.9	7.2	7.2	15.9	22.6	21.4	17.6	12.4	7.9	5.9	
Change in public sector debt	-1.7	-0.3	2.1	2.0	8.7	5.7	2.3	-0.3	-0.8	-0.9	-2.0	
Identified debt-creating flows (4+7+12)	-2.5	-2.9	0.0	2.6	8.3	5.7	2.3	-0.3	-0.8	-0.9	-2.0	
Primary deficit	-0.4	0.6	2.4	4.1	6.2	5.1	2.6	1.3	0.8	0.7	-0.2	
Revenue and grants	31.4	32.3	32.3	32.2	31.8	32.3	32.5	32.7	32.4	31.4	30.7	
Primary (noninterest) expenditure	31.0	32.9	34.6	36.3	38.0	37.4	35.1	34.1	33.2	32.1	30.5	
Automatic debt dynamics 2/	-0.9	-3.0	-2.3	-1.4	2.1	0.6	-0.3	-1.6	-1.7	-1.6	-1.7	
Contribution from interest rate/growth differential 3/	-1.5	-1.7	-1.9	-2.6	2.2	0.6	-0.3	-1.6	-1.7	-1.6	-1.7	
Of which contribution from real interest rate	-0.8	-0.7	-1.1	-1.6	0.7	0.1	0.2	-0.1	-0.3	-0.3	-0.4	
Of which contribution from real GDP growth	-0.6	-1.0	-0.8	-1.0	1.5	0.5	-0.5	-1.5	-1.4	-1.3	-1.3	
Contribution from exchange rate depreciation 4/	0.6	-1.3	-0.4	1.2	0.0	...	...	...	...	...	...	
Other identified debt-creating flows	-1.3	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Privatization receipts (negative)	-1.3	-0.4	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Residual, including asset changes (2-3) 5/	0.7	2.6	2.1	-0.6	0.4	0.0	0.0	0.0	0.0	0.0	0.0	
Public sector debt-to-revenue ratio 1/	49.8	47.6	54.2	60.7	88.6	104.7	111.4	109.6	108.4	109.1	105.0	
Gross financing need 6/	1.7	1.8	4.0	6.3	8.7	8.6	6.8	6.4	7.6	7.1	4.1	
in billions of U.S. dollars	1.7	2.2	6.8	12.9	14.1	13.6	11.1	11.8	15.9	16.8	11.1	
Scenario with key variables at their historical averages 7/						**33.9**	**32.5**	**31.3**	**30.2**	**29.2**	**28.3**	**-3.1**
Scenario with no policy change (constant primary balance) in 2010-2015						**33.9**	**38.2**	**41.5**	**44.6**	**47.5**	**50.1**	**-2.8**
Key Macroeconomic and Fiscal Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.2	7.9	6.3	7.3	-7.1	-1.9	1.5	4.4	4.2	4.2	4.2	
Average nominal interest rate on public debt (in percent) 8/	7.0	6.0	5.8	5.2	6.0	6.3	5.5	5.1	5.0	5.2	5.2	
Average real interest rate (nominal rate minus change in GDP deflator, in percent)	-5.2	-4.6	-7.7	-10.1	3.2	0.1	0.7	-0.2	-0.6	-0.6	-1.2	
Nominal appreciation (increase in US dollar value of local currency, in percent)	-6.2	19.4	6.5	-16.5	0.3	...	...	...	...	...	...	
Inflation rate (GDP deflator, in percent)	12.2	10.6	13.5	15.2	2.8	6.2	4.8	5.4	5.6	5.8	6.3	
Growth of real primary spending (deflated by GDP deflator, in percent)	0.8	14.3	12.0	12.4	-2.7	-3.5	-4.6	1.2	1.6	0.6	-0.9	
Primary deficit	-0.4	0.6	2.4	4.1	6.2	5.1	2.6	1.3	0.8	0.7	-0.2	

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

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

	Actual					Projections						
	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	38.8	42.1	47.0	51.4	69.2	**72.3**	**70.8**	**63.2**	**54.9**	**47.6**	**42.3**	**-8.0**
Change in external debt	3.6	3.3	4.9	4.4	17.8	3.1	-1.5	-7.6	-8.4	-7.3	-5.3	
Identified external debt-creating flows (4+8+9)	-5.4	-5.3	-1.6	0.7	11.0	5.1	0.9	-1.5	-1.3	-1.1	-1.6	
Current account deficit, excluding interest payments	8.5	9.2	12.2	10.4	1.4	2.6	2.8	2.8	3.0	3.1	2.6	
Deficit in balance of goods and services	10.2	12.0	13.9	13.2	6.4	6.5	8.7	8.5	8.4	8.4	7.7	
Exports	33.0	32.2	29.3	30.4	31.1	32.1	32.2	30.8	29.5	28.3	26.8	
Imports	43.2	44.2	43.2	43.6	37.6	38.6	40.9	39.3	37.9	36.6	34.4	
Net non-debt creating capital inflows (negative)	-6.9	-8.5	-6.0	-6.1	-4.3	-2.4	-4.5	-4.8	-4.8	-4.8	-4.8	
Automatic debt dynamics 1/	-7.0	-6.0	-7.8	-3.6	13.8	4.9	2.6	0.5	0.6	0.6	0.6	
Contribution from nominal interest rate	1.2	1.2	1.2	1.5	3.3	3.7	3.6	3.3	3.0	2.6	2.4	
Contribution from real GDP growth	-1.1	-2.5	-2.1	-3.1	4.4	1.3	-1.0	-2.8	-2.4	-2.0	-1.8	
Contribution from price and exchange rate changes 2/	-7.1	-4.7	-7.0	-2.0	6.1	...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	9.0	8.6	6.5	3.7	6.9	-2.1	-2.4	-6.1	-7.1	-6.1	-3.7	
External debt-to-exports ratio (in percent)	117.4	130.9	160.5	168.9	222.6	225.4	219.8	205.4	186.2	168.4	158.1	
Gross external financing need (in billions of Euros) 4/	15.2	21.7	35.9	46.6	35.5	35.6	37.2	41.2	47.2	49.5	50.3	
in percent of GDP	19.0	22.2	28.8	33.4	30.6	29.4	29.0	28.3	28.7	26.5	23.6	
Scenario with key variables at their historical averages 5/						**72.3**	**67.8**	**62.7**	**56.4**	**50.9**	**47.9**	**-9.4**
Key Macroeconomic Assumptions Underlying Baseline												
Real GDP growth (in percent)	4.2	7.9	6.3	7.3	-7.1	-1.9	1.5	4.4	4.2	4.2	4.2	
GDP deflator in Euros (change in percent)	25.4	13.8	19.8	4.4	-10.6	6.5	4.3	8.8	8.5	8.8	9.5	
Nominal external interest rate (in percent)	4.5	3.8	3.7	3.5	5.3	5.5	5.3	5.3	5.3	5.5	5.7	
Growth of exports (Euro terms, in percent)	20.6	19.5	15.9	16.5	-15.1	7.8	6.3	8.6	8.2	8.7	8.1	
Growth of imports (Euro terms, in percent)	25.9	25.4	24.5	13.2	-28.5	7.4	12.1	9.1	9.1	9.7	7.3	
Current account balance, excluding interest payments	-8.5	-9.2	-12.2	-10.4	-1.4	-2.6	-2.8	-2.8	-3.0	-3.1	-2.6	
Net non-debt creating capital inflows	6.9	8.5	6.0	6.1	4.3	2.4	4.5	4.8	4.8	4.8	4.8	

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

APPENDIX I. ROMANIA: LETTER OF INTENT (LOI)

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

Bucharest, September 9, 2010

Dear Mr. Strauss-Kahn:

1. The anti-crisis program supported by the International Monetary Fund (IMF), the European Union (EU), and the World Bank (WB) has continued to play a crucial role in stabilizing the Romanian economy, reversing imbalances, and setting the stage for future sustainable economic growth. Despite these improvements, the recovery will be delayed due to continued weakness in domestic demand, adverse developments in the region, and recent serious flooding. Accordingly, we now project economic growth of around -2 percent in 2010, rebounding to 1½-2 percent in 2011. Inflation is expected to temporarily jump sharply in the third and fourth quarters due to the one-off effects of the recent VAT increase, reaching 7-8 percent at end 2010 before beginning to return to within the National Bank of Romania's target band in the course of 2011. We continue to project a current account deficit of about 5 percent of GDP for 2010.

2. Our performance on the quantitative targets and the structural reform agenda has been strong (Tables 1 and 2).

- *Quantitative performance criteria and indicative targets.* All end-June 2010 quantitative performance criteria and indicative targets were observed, with the exception of that on general government arrears (¶7). As a prior action, we intend to pay down RON 1.9 billion in arrears in the health sector (the largest source of arrears). In addition, inflation remained within the inner band of the inflation consultation mechanism throughout the period.

- *Structural benchmarks*. The reform of local government finances was completed ahead of schedule. The discussion of pension reform legislation in Parliament is at an advanced stage, and we expect parliamentary approval by mid-September (prior action). We are making significant progress in preparing implementing legislation for the unified wage law as well as on other structural benchmarks under the program. We also expect to complete the reform of Deposit Guarantee Fund's (DGF's) funding regime by end-September, as programmed.

3. In view of this performance—and of the supplementary and corrective actions outlined in this Letter—we request completion of the fifth review under the Stand-By

Arrangement. We also request a waiver of non-observance for the end-June performance criterion on general government arrears.

4. We believe that the policies set forth in the letters of April 24, 2009, September 8, 2009, February 5, 2010, June 16, 2010, June 29, 2010, and in this Letter are adequate to achieve the objectives of our economic program, but the government stands ready to take additional measures as appropriate to ensure achievement of its objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this Letter or adopting new measures that would deviate from the goals of the program, and will provide the IMF and the European Commission (EC) with the necessary information for program monitoring.

Fiscal sector

5. Despite weak economic conditions, we have met the overall deficit target for the first half of the year, largely due to strict expenditure controls and personnel reductions of some 27,000. Our fiscal adjustment effort for the remainder of 2010 will be supported by the recently enacted adjustment package (yielding 4.6 percent of GDP on an annual basis) — which included a 5 ppt. VAT increase, a 25 percent cut in public wages, and a 15 percent cut in most social benefits — along with further reductions in personnel (74,000). Weaker growth prospects are expected to generate some revenue shortfall relative to the program, and we have taken additional measures to prevent the widening of the deficit. In particular, we have cut spending on goods and services by 10 percent on an annualized basis and have advanced some of the provisions of the pension reform legislation that could bring short-term relief. Thus, we are on track to meeting this year's deficit target of 6.8 percent of GDP.

6. For 2011, we remain fully committed to reducing the deficit to 4.4 percent of GDP as targeted under the program. The full year impact of the 2010 measures, as well as continued expenditure restraint, will be sufficient to ensure the achievement of this target. Provided that there are further personnel reductions of at least15,000 by end- 2011, these will also give us room to grant a modest public wage increase during 2011 while meeting the commitment to restrict next year's wage bill to under 39 billion lei (including all forms of compensation, but excluding social security contributions for the military). The implementing legislation for the unified wage law will ensure that the new public wage scale that will be introduced in January 2011 will be consistent with the lower wage envelope. Further savings will be secured through expenditure restraint, the elimination of the 13th salary and of the holiday bonus, a continued freeze in pensions, the elimination of heating subsidies (originally planned for 2010), and the overhaul of the social assistance system expected to yield at least 0.2 percent of GDP (see ¶12). Parliamentary approval of the 2011 budget in line with these commitments and including the 24 percent VAT will be a structural benchmark for mid-December 2010.

7. Our medium-term fiscal strategy remains focused on achieving the 3 percent Maastricht deficit objective by 2012, while ensuring the future stability and predictability of the tax system. Attainment of the 4.4 deficit target next year will facilitate this objective, but continued expenditure restraint will be needed to reduce the deficit while gradually recovering the real value of civil servants' compensation and allowing increased investment co-financed by EU funds to support growth. The soon-to-be released Medium-Term Fiscal Strategy for 2011-13 is an important step in implementing the Fiscal Responsibility legislation and in solidifying our commitment to the Maastricht targets. We will strengthen the recently established Fiscal Council by providing it with adequate funding so as to ensure that its secretariat is fully staffed with appropriately skilled people.

8. Measures to deal with the chronic problem of domestic payment arrears are being taken. At the local government level, the amendments to the local public finance law—that will preclude the accumulation of future arrears at the local level—were enacted by emergency ordinance at end-June, meeting the end-September structural benchmark ahead of schedule. From 2011, local governments will have to include arrears repayment in their budget execution, and will not be able to commit to new expenditures or contract loans until previous obligations are repaid. In the meantime, we have issued an ordinance that allows the local governments to utilize swap agreements to offset mutual debts and partially clear some arrears. At the central level, with most arrears in the health sector, we are implementing a health sector restructuring plan (see LOI of June 16, 2010 and ¶16) and we have allocated RON 1.9 billion in the revised 2010 budget to pay arrears (prior action for this review). To further improve arrear monitoring and control, we remain committed to integrating the accounting reporting system with the Treasury payment system (structural benchmark for end-March 2011); using budget appropriations as commitment ceilings; requiring line ministries to monitor their subordinated units in observing ceilings; and enforcing sanctions against institutions and individuals who breach the ceilings.

9. Recent market turbulence—brought on by uncertainties surrounding the approval of the June fiscal measures and by rising risk perception in the region—led us to temporarily reduce public debt issuance and to gradually make use of the existing financial buffers in the Treasury. With improved market conditions, we expect to return to an upward path in financial buffers to reach about 4 months of fiscal deficit financing and public debt redemptions.

Fiscal reforms

10. We continue our efforts to tackle tax evasion and improve revenue yields. Following a first round of reforms in April, we passed in June an ordinance tackling tax evasion. Among other things, the ordinance provides the authorization to access bank accounts, important for developing indirect audit methodologies on taxation of high net wealth individuals. In line with the IMF technical assistance advice, we plan a draft ordinance on further requirements of taxation of high net wealth individuals by end-September. We will

broaden the definition of income to enable taxation of income from any source not legally exempted and take other measures specified in the LOI of June 16, 2010 and in the IMF technical assistance reports. To further tackle tax evasion, we will engage in discussions with the EC regarding further amendments to domestic taxation. We intend to: (i) request a shift in the VAT mandatory threshold from the EU Council of Ministers to EUR 100,000; (ii) put a floor on VAT voluntary registrants to remove fraudulent claimants; and (iii) reduce threshold for medium taxpayer administration (currently RON 6.7 million). We will expand medium taxpayer administration so that it covers 20 percent of revenues, target the large taxpayer directorate's revenue share at 70 percent, and strengthen tax prosecutions. Our work in streamlining tax administration offices and improving information technology (IT) network will be based on the July 2010 IMF technical assistance mission's recommendations. We will also reform the system of productivity bonuses over the next year (consistent with the implementing legislation to the unified wage law) to limit them only to those directly involved in tax collections and to limit them to sustained improvements in revenues. We will continue to cooperate with the European Commission services to ensure that our legislation is consistent with EU taxation rules.

11. The accelerated absorption of EU Funds is a focal objective of the government. We have already taken measures that should generate a pick-up in absorption this year, by improving tendering and by facilitating access to project co-financing through special guarantee facilities. Looking forward, our efforts will focus on strengthening the administrative capacity of units managing the funds, especially in the transportation sector; modernizing and consolidating the legislative and regulatory framework for public investment; and prioritizing investment to assure sufficient financing for key projects. Specifically, we are committed to: (i) giving priority only to investment projects co-financed with EU funds when initiating new investments; (ii) trimming the existing portfolio of domestically-financed capital projects to focus on priority projects where funding can be fully secured, with other projects discontinued; (iii) strengthening the project appraisal process by requiring private sector review of the bankability of projects; (iv) encouraging private sector participation in projects via outsourcing or public-private partnership arrangements; and (v) ensuring full staffing of project management units and the adequate remuneration of the specialized staff, financed by technical assistance funds.

12. The overhaul of the social assistance benefits will provide an important support to the fiscal adjustment strategy while improving the efficiency of protections to the poorest and most vulnerable member of society. Social assistance spending accounts for close to 4 percent of GDP, but it is poorly targeted and wasteful, benefitting many well-off while often not reaching the needy. We have initiated sweeping reforms of the system (with assistance from the World Bank) that aim at: (i) improving targeting, through the immediate or gradual elimination of programs that are not mean-tested; (ii) streamlining and consolidating benefits provided by different levels of government; (iii) increasing controls over benefit claims; and (iv) capping the maximum benefits per person. Legislation

introducing these reforms is expected to be approved by the government by end-October 2010.

13. The government remains committed to improving the performance of public enterprises. The 10 largest loss-making public enterprises met the indicative target for operating losses in the second quarter. However, arrears have continued to increase, suggesting that further measures will be needed to comply with EU conditionality on a quarterly reduction of arrears. The government plans to implement measures to improve the revenue side of these companies (via higher tariffs) as well as cost reductions via personnel cuts and restructuring. The process of winding-up or privatizing state owned enterprises (including Termoelectrica and the cargo rail company) as laid down in the June 2010 LOI is on track. The privatization agency AVAS is preparing the sale of 13 small firms under its full ownership and the minority stakes it holds in at least 150 additional firms by end-2010, but completion of some of the sales will be delayed into 2011.

14. The preparation of implementing legislation for the unified wage law is on track. The legislation is to consist of two parts: an implementing framework law that will introduce the new pay system and specific annual legislation setting wage parameters. The legislation will be costed before submission to parliament to ensure that the 2011 wage bill falls within the agreed RON 39 billion envelope implied by the recent public wage cuts and that the system will observe the agreed limits on the wage bill over time. The legislation will also reform the productivity bonus system (*stimulente*) by folding them into the base wage. We are committed to having the legislation approved by end-October 2010 (structural benchmark), and will agree on the text of the legislation with the International Financial Institutions and the EC before submission to parliament.

15. Passage of the pension reform was somewhat delayed due to a heavy legislative agenda, but we now expect parliamentary approval by mid-September (prior action). The part of this reform cutting special pensions has already been implemented. We have begun auditing disability pensioners to eliminate fraudulent claims. We have suspended early retirements until the new pension law (which discourages early retirements via a larger discount factor) enters into force January 1, 2011. The new pension indexation provisions will enter into effect in 2012, after the 2011 pension freeze expires. We are committed to continuing to phase in the second pillar of the pension system, with the scheduled increase in contributions from 2.5 to 3 percent in 2011.

16. We remain committed to ensuring the functioning of health care system within the 2010 budgetary allocations and to achieving further savings in 2011. On the revenue side, the clawback tax on medical suppliers has been implemented, and the draft law regulating the co-payment system, including a sharp narrowing of exemptions compared with original plans, will soon be approved by parliament so as to enter into effect by January 2011. In order to improve the efficiency of hospital services, the management of many hospitals has been transferred to local authorities. In addition, a ceiling for wage spending equal to

70 percent of hospital costs has been introduced, and orders to cut 95 percent of the 9200 hospital beds originally envisaged have already been submitted, with other slated by mid August. A reference price scheme for selected pharmaceuticals has been established and will be extended in the coming months. Finally, benchmarking systems are being set up to control pharmaceutical costs and physician service costs.

17. We are preparing a reform of the labor market with the view to addressing existing rigidities and weaknesses. In particular, we are drafting amendments to modernize Labor Code and other labor market legislation to increase the flexibility of the market, reduce informality and tax evasion, and improve the wage negotiation framework. We expect the revised legislation to enter into effect by end-2010.

Financial sector

18. The Romanian banking system has been affected by the protracted recession and registered losses in the first half of the year. Loans classified as doubtful and loss reached 17.8 percent at end-June 2010, while loans more than 90 days overdue classified within loss category were 10.2 percent; further increases are expected in the second half of the year as economic activity remains depressed. Capitalization ratios have come under pressure but, following proactive capital increases by the shareholders, the average capitalization ratio for the banking sector was 14.3 percent at end-June 2010, with all institutions above 10 percent. In particular, the parents of the nine largest foreign banks have maintained a capital ratio above 10 percent and have broadly complied with their commitment to maintain exposures under the European Bank Coordination Initiative (EBCI). In light of the strengthening of Romania's external position, it was agreed to allow a reduction in the exposure commitments of the banks to 95 percent as of end-September 2010.

19. We are committed to continuing to consolidate the safety net to deal with financial distress. We have strengthened the resolution framework for problem banks by supplementing the existing authority of the special administrator to promptly implement a broad range of restructuring measures. We intend to secure parliamentary approval of these amendments by December 1, 2010 (structural benchmark). With technical assistance from the Fund, we will amend the DGF law to allow for the use of resources administered by the DGF (including through guarantees) to facilitate restructuring measures authorized by the National Bank of Romania (NBR) regarding the transfer of deposits, including purchase and assumption transactions, if such use would be less costly than the direct payment of the deposit guarantees. Preparations are on course to increase the coverage ratio for ex ante financing for the DGF to 2 percent. To achieve this, the banks' contribution rate will be increased to 0.3 percent beginning in 2011 and the stand-by credit lines will be eliminated (structural benchmark for end-September 2010). We will also amend the DGF law's governance arrangements to ensure that neither members of the board nor employees of credit institutions participate in the DGF Board (structural benchmark for end-December 2010).

20. For overly indebted households, efforts implemented by banks for a decentralized rescheduling and restructuring have been broadly adequate to address debt service pressures. We remain committed to supporting financial stability by refraining from promoting legislative initiatives, such as the current draft of the personal insolvency law that would undermine credit discipline. We will seek to maintain the current framework that allows banks to rely on their in-house expertise for the collection of their claims. We will encourage banks to continue their restructuring efforts and will monitor the results closely. We will review the recent ordinance (Ordinance 50/2010) to ensure transparency on interest rates for consumer credit contracts to ensure full compliance with EU law, particularly as regards non-retroactivity.

21. The current provisioning framework is sound and the NBR does not consider that any new prudential regulation in this area is necessary at present. The NBR will continue to consult with the Fund and EC staff before introducing or amending other aspects of the regulatory framework. The NBR and the Ministry of Public Finance remain committed to adopting the necessary legal framework by the end of the program period for implementing comprehensive International Financial Reporting Standards (IFRS), by the beginning of 2012. The NBR has issued the necessary notification to banks of the change, along with a timetable, on July 30.

22. We are committed to reversing recent legislative initiatives that inadvertently infringed on the independence of the central bank and of non-bank financial regulators. The recently enacted package of fiscal adjustment measures included the central bank and the non-bank financial regulatory bodies among the institutions that are subject to the 25 percent wage cut, which undermines their financial independence and breaches Article 130 of the EU Treaty. The ECB has also determined that the associated remittances to the budget of the wage savings constitute prohibited monetary financing of the deficit. We are committed to issuing an ordinance to remove the monetary financing provisions by mid-September, and to tackle the issue of the infringement of central bank independence by end-December.

Monetary and exchange rate policy

23. The recent increase in VAT will lead to a temporary but significant jump in inflation in the remainder of the current year, moving it well outside the NBR's target range. We estimate that the VAT hike, together with planned increases in administered prices and the effects of recent flooding on food prices, could push inflation some 3½-4½ percentage points above the projected path, bringing it to 7-8 percent by end-2010. Barring significant second-round increases, the price-level effects should peter out after mid-2011, allowing the attainment of the end-2011 target of 3 percent ±1 percentage point.

24. While the one-off nature of the VAT-induced price increase does not warrant a monetary policy response, increased vigilance is required to keep inflation expectations in check and stave off possible second-round inflationary effects. The NBR board has decided

to pause its easing cycle until the effects of the VAT increase become clearer. Looking forward, monetary policy will be geared towards reaching the projected disinflation path net of the tax effect.

Program modifications and monitoring

25. The program will continue to be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural benchmarks. The quantitative targets for end-September and end-December 2010 and continuous performance criteria are set out in Table 1; and the structural benchmarks are set out in Table 2. The understandings between the Romanian authorities and IMF staff regarding the quantitative performance criteria and the structural measures described in this letter are further specified in the attached Technical Memorandum of Understanding.

/s/	/s/
Gheorghe Ialomitianu	Mugur Isarescu
Minister of Public Finance	Governor of the National Bank of Romania

Attachments

Table 1. Romania: Quantitative Program Targets

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March	June		Sept	Dec
	Actual	Actual	Actual	Actual	Actual	Actual	Prog.	Prelim.	Prog.	Prog.
I. Quantitative Performance Criteria										
1. Cumulative change in net foreign assets (mln euros) 1/3/	25,532	-3,500	-5,119	-4,566	-4,874	779	-4,040	-509	-2,000	-2,000
2. Cumulative floor on general government overall balance (mln lei) 2/	-24,655	-8,300	-14,456	-25,563	-36,101	-8,422	-18,200	-18,015	-28,200	-34,650
3. Stock in general government arrears from the end of previous year (bn lei)	1.06	1.41	1.55	1.4	1.50	1.76	1.09	1.8	0.81	0.48
4. Ceiling on general government guarantees issued during the year (face value, bn lei)	0.0	…	0.02	0.7	2.2	4.6	12.0	5.6	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	0	0	0	0	0	0	…	0	0
III. Inflation Consultation										
6. 12-month rate of inflation in consumer prices										
Outer band (upper limit)	…	…	8.4	7.7	6.5	6.5	6.0	…	10.0	10.0
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.0	…	9.0	9.0
Actual/*Center point*	6.3	6.7	5.9	4.8	4.7	4.2	*4.0*	4.4	*8.0*	*8.0*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.0	…	7.0	7.0
Outer band (lower limit)	…	…	4.4	3.7	2.5	2.5	2.0	…	6.0	6.0
IV. Indicative Target										
7. General government current primary spending (excl. EU funds and social assistance, mln lei) 2/	92,327	22,149	43,238	63,878	85,637	32,749	66,200	66,124	100,000	131,000
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-495	-2,000	-1,947	-3,000	-4,000
Memorandum Item:										
Cumulative projected revenue of general government, net of EU funds (mln. lei)	…	…	…	…	151,508	36,355	74,950	74,669	114,700	157,950

1/ The December 2008 figure is a stock.
2/ The December 2008 figure is for the whole year.
3/ NFA targets for end-June 2010 have been adjusted as actual disbursements fell short of projected levels by EUR 1.5 bn.

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

Measure	Target Date	Comment
Prior actions		
1. Repayment of RON 1.95 billion in arrears and unpaid bills, most in the health sector		
2. Parliamentary approval of pension reform legislation		
Quantitative performance criteria		
1. Floor on net foreign assets	June, 2010	Met
2. Floor on general government overall balance	June, 2010	Met
3. Ceiling on general government guarantees	June, 2010	Met
4. Ceiling on general government domestic arrears	June, 2010	Not met
5. Non-accumulation of external debt arrears	June, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	June, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	June, 2010	Met
Inflation consultation band		
Inner band	June, 2010	Met
Outer band	June, 2010	Met
Structural benchmarks		
1. Approval of reforms to mitigate fiscal risks from local governments	September 30, 2010	Met in June 2010
2. Passage of implementing legislation for the unified wage law	October 31, 2010	Reset from September 30, 2010
3. Passage of pension legislation	September 30, 2010	Reset as prior action
4. Parliamentary ratification of the fiscal measures approved by the government	September 30, 2010	VAT ratification pending
5. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement	September 30, 2010	Pending
6. Reform tax administration methodology for high net wealth individuals	November 30, 2010	
7. Integrate the accounting reporting system with the Treasury payment system	March 31, 2011	
New Conditionality (Structural Benchmarks)		
1. Parliamentary ratification of amendments to the bank resolution framework	December 1, 2010	
2. Parliamentary approval of agreed 2011 budget	December 15, 2010	
3. Amend deposit insurance legislation to ensure that neither members of the board nor employees of credit institutions participate in the DGF Board	December 31, 2010	modified from September 30, 2010

Appendix II. Romania: Technical Memorandum of Understanding (TMU)

September 9, 2010

1. This Technical Memorandum of Understanding (TMU) updates and replaces the TMU dated June 16, 2010. It: (i) defines the variables subject to the quantitative targets specified in the Letter of Intent (LOI); (ii) describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets (Section I); and (iii) provides clarifications for some of the structural conditionality under the program (Section II). As is standard under all Fund arrangements, we will consult with the Fund before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the Fund with the necessary information for program monitoring.

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

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

I. Quantitative Performance Criteria, Indicative Ceiling, and Continuous Performance Criteria

A. Floor on the Net Foreign Assets

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

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

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

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

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

	2009	2010 2/			
	December	March	June	September	December
	(Stock)	Actual	Actual	PC	PC
Cumulative change in NFA	20,658	779	-509	-2,000	-2,000
Memorandum Item:					
Gross Foreign Assets	28,418	3,145	1,838	2,100	3000

1/ PC=performance criterion; data for end-month.

2/ Flows in 2010 are relative to end-2009 stock.

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

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

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

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

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

	2008	2009	2010			
	December (actual)	December (actual)	March (actual)	June (actual)	September	December
Outer band (upper limit)					10.0	10.0
Inner band (upper limit)					9.0	9.0
Center point	*6.3*	*4.7*	*4.2*	*4.4*	*8.0*	*8.0*
Inner band (lower limit)					7.0	7.0
Outer band (lower limit)					6.0	6.0

C. Performance Criterion on General Government Balance

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

Cumulative floor on general government balance

	(In millions of lei)
End-December 2009 (actual)	-36,101
End-March 2010 (actual)	-8,422
End-June 2010 (actual)	-18,015
End-September 2010 (performance criterion)	-28,200
End-December 2010 (performance criterion)	-34,650

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

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

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

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

Cumulative projected revenue of general government, net of EU funds	(In millions of lei)
End-December 2009 (actual)	151,508
End-March 2010 (actual)	36,355
End-June 2010 (actual)	74, 669
End-September 2010 (projection)	114,700
End-December 2010 (projection)	157,950

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

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

15. The issuance of general government guarantees to the non-financial private sector and public enterprises will be limited during the program period. This ceiling may be

adjusted upward by up to RON 4.3 billion relative to the original ceiling of RON 7.7 billion for guarantees for financing the counterpart payments of investment projects financed by the EU or for guarantees on projects cofinanced by the EBRD, IFC, or EIB.

Ceiling on new general government guarantees issued from end-2008 until:	(In billions of lei)
End-December 2009 (actual)	2.2
End-March 2010 (actual)	4.6
End-June 2010 (actual)	5.6
End-September 2010 (performance criterion)	12
End-December 2010 (performance criterion)	12

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

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

Stock in general government arrears from the end of previous year	(In billions of lei)
End-November 2009 (stock, actual)	1.40
End-March 2010 (actual)	1.76
End-June 2010 (actual)	1.8
End-September 2010 (performance criterion)	0.81
End-December 2010 (performance criterion)	0.48
End-April 2011 (indicative target)	0.00

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

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

G. Indicative Target on General Government Current Primary Spending

18. The indicative target on current primary expenditure of the general government is defined as spending on personnel, goods and services excluding EU funds (specified under external grant category), subsidies, transfers to public entities, pensions (social security budget in social assistance category and one-third of the state budget in the same category), state aid and other spending in other transfers category, Reserve Fund, and other expenditure as classified in the monthly reporting tables. The current spending target will be adjusted for the extra spending due to swap arrangement between local governments and public enterprises by an amount spent in the respective quarter.[8]

Cumulative change in general government current primary expenditures	(In millions of lei)
End-December 2009 (actual)	85,637
End-March 2010 (actual)	32,749
End-June 2010 (actual)	66,124
End-September 2010 (indicative target)	100,000
End-December 2010 (indicative target)	131,000

H. Monitoring of Public Enterprises

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

20. The quarterly indicative target for 2010 will be set on the aggregate operating balance (earnings before interest and tax), net of subsidies, of the following public enterprises: (1) C.N. Cai Ferate CFR; (2) S.N. Transport CFR Calatori; (3) CN a Huilei; (4) SC Termoelectrica; (5) C.N. de Autostrazi si Drumuri Nationale; (6) S.C. Metrorex; (7) S.N. de Transport Feroviar CFR Marfa S.A.; (8) SC Electrocentrale Bucuresti; (9) Societatea Comerciala Electrificare CFR S.A.; and (10) S.C. Administratia Nationala a Imbunatatirilor Funciare. The data shall be reported with operating results by firm. The targets for September 2010 and December 2010 will be -3000 and -4000, respectively.

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

I. Reporting Requirements

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

Table 1. Romania: Data Provision to the IMF

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

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

II. Structural Conditionality: Specifications

A. Public Wage Legislation

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

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

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

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

INTERNATIONAL MONETARY FUND

ROMANIA

Fifth Review Under the Stand-By Arrangement, Request For Waiver of Nonobservance of Performance Criterion, and Request For Modification and Establishment of Performance Criteria—Supplementary Information

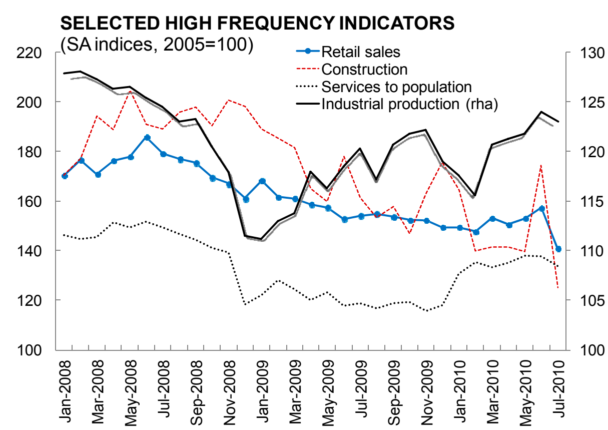
Prepared by the European Department
(In Consultation with Other Departments)

Approved by Poul M. Thomsen and Aasim Husain

September 22, 2010

1. **This supplement provides an update on economic and policy developments since the issuance of the staff report**. The additional information does not change the staff appraisal.

2. **Recent economic indicators confirm a weakening of the economic activity.** Economic data for July showed a decline across a broad range of activities, including sales, construction, services, and industrial production. On the demand side, this reflected a sharp drop in real wages following the 25 percent cut in public salaries and the jump in inflation with the VAT increase. Together with ebbing remittances, these are set to further dampen real disposable incomes and demand during the third quarter. Weaker demand, in turn, helped temper the passthrough of the VAT increase to inflation: the latter jumped from 4.4 percent in June to 7.1 and 7.6 percent in July and August, respectively, somewhat below market expectations.



3. **The prior actions for the review have been met.** The pension reform was passed in parliament in line with the program agreement, although opposition politicians have appealed the law to the Constitutional Court. The central government also repaid some 2 billion lei in arrears and unpaid bills in the health sector, thereby tackling the bulk of the current or impending arrears at the central government level. Efforts to repay local government arrears have been less successful due to a scarcity of tools to affect their financial management, which should be corrected early next year when the recent revisions to public finance legislation come into effect. In addition, the authorities have approved the reforms of the deposit guarantee (DGF) funding regime to increase the contribution rates, eliminate stand-by credit line with banks as a source of financing for the DGF, and increase the targeted coverage ratio (structural benchmark for end-September, see table). Also, as agreed in the letter of intent, the authorities have removed from the fiscal austerity package the provisions that required the central bank to transfer the savings from 25 percent wage cuts to the treasury, which were inconsistent with the monetary financing prohibitions under the EU law; the provisions affecting the central bank independence will be dealt with by end-year.

Table 2. Romania: Performance for Fifth Review and Proposed New Conditionality (revised)

Measure	Target Date	Comment
Prior actions		
1. Repayment of RON 1.95 billion in arrears and unpaid bills, most in the health sector		Met
2. Parliamentary approval of pension reform legislation		Met
Quantitative performance criteria		
1. Floor on net foreign assets	June, 2010	Met
2. Floor on general government overall balance	June, 2010	Met
3. Ceiling on general government guarantees	June, 2010	Met
4. Ceiling on general government domestic arrears	June, 2010	Not met
5. Non-accumulation of external debt arrears	June, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	June, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	June, 2010	Met
Inflation consultation band		
Inner band	June, 2010	Met
Outer band	June, 2010	Met
Structural benchmarks		
1. Approval of reforms to mitigate fiscal risks from local governments	September 30, 2010	Met in June 2010
2. Passage of implementing legislation for the unified wage law	October 31, 2010	Reset from September 30, 2010
3. Passage of pension legislation	September 30, 2010	Reset as prior action
4. Parliamentary ratification of the fiscal measures approved by the government	September 30, 2010	VAT ratification pending
5. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement	September 30, 2010	Met; the reform of the governance arrangement modified to end-December 2010
6. Reform tax administration methodology for high net wealth individuals	November 30, 2010	
7. Integrate the accounting reporting system with the Treasury payment system	March 31, 2011	
New Conditionality (Structural Benchmarks)		
1. Parliamentary ratification of amendments to the bank resolution framework	December 1, 2010	
2. Parliamentary approval of agreed 2011 budget	December 15, 2010	
3. Amend deposit insurance legislation to ensure that neither members of the board nor employees of credit institutions participate in the DGF Board	December 31, 2010	modified from September 30, 2010

Press Release No. 10/354
FOR IMMEDIATE RELEASE
September 24, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Completes Fifth Review Under Stand-By Arrangement with Romania and Approves €884.0 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fifth review of Romania's economic performance under a program supported by a 24-month Stand-By Arrangement (SBA). The completion of the review enables the immediate disbursement of SDR 769 million (about €884.0 million or about US$1.19 billion), bringing total disbursements under the program to SDR 9.8 billion (about €11.27 billion or about US$15.11 billion). In completing the review the Executive Board also approved Romania's request for a waiver of non-observance of the end-June 2010 performance criterion on general government domestic arrears.

The SBA was approved on May 4, 2009 (Press Release No 09/148) in the amount of SDR 11.443 billion (about €13.15 billion or about US$17.64 billion). The arrangement entails exceptional access to IMF resources, amounting to 1,111 percent of Romania's quota. Following the Executive Board's discussion on Romania, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, stated:

"Policy implementation under the Fund-supported program has remained strong despite ongoing economic weakness. After recently undertaking an ambitious fiscal adjustment, the authorities' efforts are focused on structural reforms that will secure fiscal sustainability and strengthen medium-term growth prospects.

"The recent fiscal consolidation effort has set Romania on a clear path to meeting its short and medium-term fiscal goals. The main challenge now is to ensure the continuity of the adjustment through continued spending restraint and fiscal structural reforms. Key measures include the recent pension reform, reforms of the public wage system, tax administration, and health sector, and restructuring public enterprises. The initiation of labor market and social safety net reforms will help boost productivity and target limited budgetary resources to the most vulnerable. Priority should be given to permanently resolving the issue of domestic arrears by way of improving payment discipline in the economy and increasing the credibility of the authorities' adjustment efforts.

"The authorities' monetary and financial sector policies have been appropriately prudent and proactive, helping preserve financial stability in the face of the global financial crisis. The temporary rise in inflation following the recent VAT rate increase calls for caution in gauging the room for further monetary easing. The banking system remains liquid and well-capitalized, but continued vigilance in financial sector supervision is crucial to assure financial sector resilience against the unsettled regional situation and increasing non-performing loans".

Statement by Age Bakker, Executive Director for Romania and Mihai Nicolae Tanasescu, Senior Advisor to the Executive Director September 24, 2010

My Romanian authorities would like to express thanks for the useful discussions held in Bucharest in July. The amount of work done is reflected in the staff report, which provides a well-balanced assessment of the program implementation.

Romania is on track with the implementation of its Fund-supported program, and all end-June performance criteria and indicative targets have been met, with the exception of the ceiling on general government domestic arrears, for which my authorities have requested a waiver. My authorities are committed to implementing further measures to reduce the arrears, and recently they made major repayments in the health sector, reducing considerably the stock of outstanding arrears.

Economic developments

Economic growth turned positive in the second quarter, due mainly to a turnaround in private domestic demand, exports, and a pickup in inventory investment. However, economic prospects changed after austerity measures were introduced and the government increased the VAT by 5 percentage points in July. In these circumstances, the recovery may be delayed in the second half of the year, and the growth forecast was accordingly revised downward to -1.9 percent. On the positive side, net external demand will gradually cede its place to domestic demand as the main driver of growth as incomes recover in 2011. Growth is projected to reach around 1.5 percent in 2011, and to continue a positive trend in the following years.

The inflation rate reached 7.1 percent at end-August. The recent VAT increase, further adjustments in administrated prices, and the recent depreciation of *leu*, will add around 3 percentage points to inflation in 2010, pushing annual inflation above the target. On the positive side, core inflation will remain within the target band, suggesting that inflationary pressures driven by demand remained low. At the same time, the wide output gap could lead to a smaller-than projected pass-through of the VAT increase.

External financing pressures have eased, and the balance of payments outlook remains unchanged from the previous review. The current account deficit has adjusted significantly from 12.5 percent in 2008 to around 5 percent this year, and is projected to remain at the same level in the years ahead.

The economic situation remains difficult, and risks to both growth and inflation are large, but balanced. My authorities are committed to continuing implementation of the needed measures to accelerate structural reforms, and to move to a secure the recovery in the years ahead by maintaining macroeconomic stability.

Fiscal policy and structural reforms

The fiscal package implemented in June has an annual yield of about 5 percent of GDP and a balanced mix of revenue and expenditure measures. This ambitious adjustment package put the fiscal policies on track to meeting the 2010 and 2011 targets. Weaker growth prospects are still expected to generate some revenue shortfall, but the authorities are committed to implementing additional adjustment measures, including cutting spending on goods and services by 10 percent on an annualized basis, to be able to meet this year's fiscal deficit target of 6.8 percent of GDP.

The main fiscal challenges for 2011 are related to securing an extension of the wage and social transfer cuts and overhauling the social assistance scheme. In this context, the government drafted new legislation to be passed this fall. At the same time, the authorities will continue to keep pensions frozen and to eliminate the heating subsidies. The administration will be downsized by another 15,000 public servants and bonuses will be eliminated. All these measures will consolidate the fiscal stance and create a path for stable economic growth. In the long term, the fiscal outlook remains positive, and the implementation of structural reforms will create space for further investments, co-financed by EU funds. Moreover, the Fiscal Council became operational, and the new 2011-2013 fiscal strategy has already been approved by the government with clear commitments to reaching a 3 percent deficit target by 2012.

Domestic payment arrears continue to pose a challenge, but the actions recently implemented, including the repayment of about 2 billion lei (0.4 percent of GDP), have demonstrated the government's commitment to addressing this structural problem. To prevent further buildup in arrears, the authorities have initiated a restructuring of the health sector and have enacted amendments to the public finance law that will prevent local governments from assuming new commitments until previous obligations are met.

To contain fiscal pressures over the medium term, the authorities will introduce several reforms to increase the efficiency of public institutions, including local governments. The authorities approved measures to reduce the number of public servants by 5 percent this year and have committed to a further reduction of 1.3 percent next year. Another important step is the pension reform law recently approved by Parliament. The law envisages a gradual move to inflation indexation, and an increase and unification of the retirement ages for both men and women at 65. To strengthen the private second pillar, the government will continue to increase its contribution in 2011.

With assistance from the World Bank, the authorities will implement a strong public expenditure review and will restructure the system of social benefits, to strengthen social safety nets and eliminate inefficiencies. In this context, the second pillar of the public wage reform will be approved by end-September. The legislation will link pay to job responsibility and qualification, and benchmark it to private sector wages.
Further structural reforms will include steps to restructure the health sector, improve the performance of state-owned enterprises, and improve the labor market. An important step

in increasing fiscal efficiency has been made by the tax authorities in combating tax evasion and, in line with recent IMF technical assistance advice, the authorities have improved the VAT registration thresholds, streamlining tax administration offices and improving information technology networks.

Monetary and financial sector policies

Monetary policy responded well to falling activity, and the Central Bank has taken crucial measures to bring down inflation levels. However, after July's government decision to increase the VAT, the Central Bank left its key policy rate unchanged. While the one-off nature of the VAT-induced price increase does not warrant a monetary policy response, the authorities believe that increased vigilance is required to keep inflation expectations in check and stave off possible second-round inflationary effects.

The Romanian banking system has so far weathered well the impact of the economic contraction. An important role has been played by the nine largest banks as the result of their commitment to maintaining overall exposure to the country, and to increasing capital when needed. However, the banking system registered losses in the first half of the year, but capitalization ratios remain strong and reached 14.3 percent at end-June, with all institutions above 10 percent. The banking system remains resilient, despite the fact that nonperforming loans are on the rise. A further increase is expected in the second part of the year, as economic activity remains depressed, but gradually NPLs will return to normal levels, as the economic recovery accelerates in the years ahead.

Romania has made further progress towards strengthening the financial sector. The Central Bank is preparing to amend Deposit Guarantee Fund's (DGF) law to allow for the use of resources administered by the DGF to facilitate restructuring measures regarding the transfer of deposits. At the same time the authorities will ratify legislation to strengthen the resolution framework for problem banks, aimed at boosting the Central Bank's powers to deal with weak banks, which was already enacted by government ordinance in March, 2010.

The Central Bank has continued to improve the banking supervisory and regulatory framework, including liquidity requirements, and is committed to take steps to ensure that the regulatory and operating environment for financial institutions remains sound. The authorities have also made progress towards the adoption of the International Reporting Standards by 2012, by issuing the necessary notification to banks.

In conclusion, my authorities acknowledge the potential risks to program implementation, but they consider that despite temporary deterioration in economic activity, the present policy response under the current SBA will address the fiscal imbalances and further acceleration of structural reforms will put Romania on a path to sustained economic growth in the years ahead.