Romania and the IMF

Press Release:
IMF Completes Fourth Review Under Stand-By Arrangement with Romania and Approves US$1.146 Billion Disbursement
July 2, 2010

Country's Policy Intentions Documents

Romania: Letter of Intent, Supplementary Letter of Intent of June 29, 2010, and Technical Memorandum of Understanding

June 16, 2010

ROMANIA: LETTER OF INTENT (LOI)

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

Bucharest, June 16, 2010

Dear Mr. Strauss-Kahn:

1. The comprehensive anti-crisis program supported by the Fund, the EU, and the World Bank has continued to play a crucial role in normalizing financial conditions reversing economic imbalances, and setting the stage for economic recovery. These improvements notwithstanding, conditions turned out to be more difficult than we had anticipated. Economic activity remained depressed in recent months, due both to subdued domestic demand and the slow recovery among Romania's trading partners. Uncertainties related to the crisis in Greece have also increased market risks. Accordingly, we now expect economic recovery to become apparent later in the year, and project economic growth around zero or slightly negative in 2010.

2. The weaker economic growth and difficulties in revenue collections and pressures in certain public spending categories have created challenges in meeting our fiscal targets. However, our performance on other quantitative targets and the structural reform agenda has been strong (Tables 1 and 2):

- *Quantitative performance criteria and inflation consultation mechanism*. The quantitative performance criteria on net foreign assets and general government guarantees, as well as the continuous performance criterion on non-accumulation of external arrears were met. The indicative targets on general government current primary spending for end-March 2010 and on the financial balance of the largest loss-making state-owned enterprises (SOEs) were also met. In addition, inflation remained within the inner band of the inflation consultation mechanism throughout the period. The performance criterion on the general government deficit for end-March was missed by a very small margin, as was the quantitative performance criterion on the target on general government arrears (see paragraph 3 below).

- *Structural benchmarks*. The fiscal responsibility law was approved by parliament in March, and implementation is underway. Amendments to the banking and winding-up laws to enhance the bank resolution framework were also adopted in March 2010. In addition, the legislation and internal regulations needed for the implementation of tax administration reforms were adopted by government ordinance in April. The discussion of pension reform legislation in Parliament is at an advanced stage, and we expect Parliamentary approval by end-June. Finally, we are making significant progress in preparing implementing legislation for the unified wage law as well as on other structural benchmarks under the program.

3. In view of this performance—and on the supplementary and corrective actions outlined in this Letter—we request completion of the fourth review under the Stand-By Arrangement. We request a waiver of nonobservance of the end-March 2010 performance criteria on general government arrears and on the general government overall balance, and that these performance criteria be modified for end-June 2010 as proposed in the attached Table 1.

4. We believe that the policies set forth in the letters of April 24, 2009, September 8, 2009, February 5, 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 with the necessary information for program monitoring.

Macroeconomic Framework for 2010

5. Economic activity remains weak and, contrary to earlier expectations, growth continued to be negative during the first quarter of 2010. This mainly reflects weak domestic demand, as well as adverse weather conditions in early 2010. We now expect economic growth to improve later in the year, although uncertainties in external markets remain considerable. However, for 2010 as a whole we forecast growth to remain around zero or slightly negative. Inflation fell from 4.7 percent at end-2009 to 4.4 percent at end-May, remaining well within the inner inflation band under the target with the Fund. At end-2010, inflation is expected to ease further to around 3¾ percent on the back of weak domestic demand and prudent monetary policy implementation. The weaker recovery in domestic demand has restrained imports, and we now project a current account deficit of about 5 percent of GDP for 2010, compared to 5½ percent expected earlier. With capital flows for 2010 largely unchanged from our earlier projections, we expect NFA to be higher by about €1 billion relative to the end-2010 target. However, the NFA target will not be revised upward, to provide the National Bank of Romania (NBR) greater flexibility to respond to unexpected market disturbances.

Fiscal Sector

6. A core objective of the program is to buttress our commitment to sustainable public finances by containing the fiscal deficit and credibly reducing it over the medium term. To this end, the 2010 budget was designed to achieve a fiscal deficit of around 6 percent of GDP, about 1½ percentage points of GDP lower than in the previous year. Unfortunately, several factors have placed that target in danger. First, downward revisions to the estimated GDP mean that the original targets will yield a somewhat higher deficit ratio to GDP.

Second, the weaker-than-expected economic recovery has depressed revenue collections and has boosted spending on unemployment benefits, particularly in the first quarter. Third, there appear to be problems with increasing tax evasion, with revenue yields falling in many key taxes (particularly excise taxes and VAT). Cumulative tax revenues are considerably lower than initially projected (by 0.8 percent of GDP at end-April). The 2010 budget planned for RON 2.4 billion non-tax revenue from a loan repayment from Rompetrol. However, actual payment is uncertain. Negotiations will be concluded by the next review date on the exact payment schedule. Finally, while overall expenditures were held to well below targeted levels in an effort to reach the Q1 fiscal targets agreed with the IMF and EU, underlying current spending pressures continue to accumulate, particularly in pensions, social transfers, and in goods and services. These pressures have produced the overshooting of the arrears target and have forced the undesirably low availability of resources for capital investment. Together, these factors endanger compliance with the 2010 fiscal deficit targets. Under a no-policy-change scenario the fiscal deficit would reach 9.1 percent of GDP at end-2010, some 3 percentage points of GDP higher than initially programmed.

7. Given renewed uncertainties in international markets and the need to demonstrate our clear commitment to a sustainable fiscal path, the government is committed to taking additional difficult—but necessary—measures to bring the fiscal deficit to 6.8 percent of GDP 2009 (which corresponds to 6.5 percent of GDP before the GDP revisions).

- On the spending side, we will implement by June 1: (i) a 25 percent cut in total wages, bonuses, and other compensation paid to all public sector employees (1 percent of GDP this year); (ii) a 15 percent cut in pensions and other social transfers (1 percent of GDP); (iii) cuts in transfers to local governments (0.3 percent of GDP); and (iv) further reductions in heating subsidies (0.03 percent of GDP. Further savings will be achieved through a temporary freeze on early retirement, strict controls on new disability pensions, and by approving a new scheme to regulate the payment of "stimulentes" (nonwage incentive payments for certain ministries). Action has already been taken to reduce public employment by some 20,000 workers in 2010, and we intend to further streamline staffing in the coming months. Structural changes to the health system, pensions, education, and local government finance will also generate savings (see ¶12 and ¶17-20);

- To increase revenues, we will introduce the following measures: (i) a broadening in the personal income and social security tax bases (as specified in the Technical Memorandum of Understanding (TMU)); (ii) the introduction of a turnover tax (clawback) on medical distributors.

- Enactment of items (i-iii) on the spending side and of the measures to broaden tax bases will be a prior action for the conclusion of the review. We will also take measures to further streamline public employment in the coming months. If these actions prove insufficient to achieve the end-year targeted deficit, we will take additional action, including increases in tax rates as needed.

8. To protect the more vulnerable members of society, we will keep the minimum wages and pensions unchanged, and no wage or pension will be cut below that level. We will also reform our social support programs with a view toward improving their effectiveness and targeting them better on the poor and needy. In this context, the Guaranteed Minimum Income (GMI) scheme, which is one of the better targeted programs, will be exempted from the 15 percent cut in social spending, with other—less efficient—programs reduced by more to attain the overall spending reduction. Specifically, we will reduce or improve the targeting of the Lone (Single) Parent Allowance (LPA) and the Complementary Child Allowance (CCA) as agreed with the World Bank. In parallel, we will be working to further reduce the leakages from the GMI and others social programs to enhance their anti-poverty impact.

9. The confidence generated by adherence to the program, together with improved market conditions, has allowed us to improve the maturity profile of our public debt and significantly lower the yields on new borrowing in recent months. To strengthen our ability to respond flexibly to possible future market disturbances, we plan to continue increasing gradually financial buffers at the Treasury to about 4 months of fiscal deficit financing and public debt redemptions.

10. The stock of domestic payment arrears has increased since the last review. We fully realize the importance of not incurring further arrears and clearing the existing stock. At the local government level, the amendments to the local public finance law (see ¶12) will preclude the accumulation of future arrears. Most local arrears are to suppliers and we plan to utilize swap agreements with local authorities to offset mutual debts. At the central level, with most arrears in the health sector, we will implement a health sector restructuring plan (see ¶ 18). To further improve monitoring and control mechanisms to eliminate arrears at both central and local government levels, we will integrate the accounting reporting system with the Treasury payment system (structural benchmark for end-March 2011). This link will allow us to monitor commitments and assist in budget management and control. Lastly, we will require line ministries to monitor their subordinated units in observing commitment ceilings and enforce sanctions against institutions and individuals who breach the ceilings.

Fiscal reforms

11. We are fully committed to implementing the Fiscal Responsibility Law (FRL) passed by Parliament at end-March 2010. The set-up of the Fiscal Council is under way, and we will ensure that the Council members and the secretariat are fully staffed with appropriately skilled people as soon as possible. We are developing the Fiscal Strategy (FS) for 2011-2013 and will submit it to Parliament by end-June. This Strategy will incorporate a fiscal deficit target objective of no more than 4.4 percent of GDP in 2011 and will eliminate the 13th salary paid to the public sector employees. We will also limit the 2011 wage bill to 39 billion RON and set a limit of 1,290,000 total public employees at the beginning of 2011. To encourage budgetary discipline, prioritize projects, and increase efficiency, the Ministry of Public Finance will submit indicative expenditure ceilings to major spending institutions in preparing the FS. We will link the FS to the annual budget process and will set up a Review Team supported by the Cabinet to review line ministries' budget proposals, press them to

improve their submissions so as to improve productivity, service delivery, and the quality of regulations in line with the FRL requirements, and produce a report on efficiency-making expenditure cuts to be incorporated into the 2011 budget.

12. To strengthen fiscal discipline of local governments and preserve macro-fiscal stability, we are in the process of amending the local public finance law. The amendments will include: (i) changes to the legal definition of a balanced budget from one based on the *budgeted* revenues and expenditures towards one based on *actual* revenues and accrual expenditures; (ii) reflection in one law of all rules on local borrowing and introduction of additional prudential limits, such as a ceiling on the stock of debt and requirement of operating surplus in years prior to borrowing; (iii) approval of multi-annual borrowing ceilings and investment transfers from the state budget to improve multiyear capital budgeting; and (iv) incorporation of relevant sanctions from the FRL (structural benchmark for end-September 2010). To comply with the Unified Wage Law, we will apply wage bill limits according to staffing standards across local governments.

13. Reinforced tax administration efforts are required to tackle the decline in revenue yields during the recession. In the first stage, our efforts focused on addressing VAT non-compliance and fraud, improving management of growing tax arrears, and increasing control of the largest taxpayers; the regulatory framework needed to support these efforts has been approved by the government in April 2010. In the second stage, we will focus on high-income individual taxpayers and develop indirect audit methodologies to augment current audit techniques to identify unreported income. In particular, we will amend the Fiscal Code and the Fiscal Procedures Code to: (i) establish ANAF's right to access bank records and third-party records, upon proper notification and through a due process, to enable proper determination of income; (ii) review the definitions of income to enable taxation of income from any source not legally exempted; (iii) strengthen the requirement to report income; as well as (iv) strengthen the right to audit for unreported income (structural benchmark for end-November, 2010). We will also establish a special office to coordinate high-income individual taxation issues and the development of initiatives or projects to identify, quantify, or improve compliance in the high-income area.

14. To combat tax evasion and smuggling and improve tax collection we will take the following measures by end-June:

- On VAT we will (i) establish common minimum standards for registration and removal from records of the taxpayers who carry out intra-Community trade, in particular acquisitions of goods, and (ii) set up a registry of the intra-Community operators;
- Establish collateral for intra-Community acquisitions of products with increased risk of tax fraud;
- Review the authorization regime for operators performing activities with goods under suspension of excise duty by introducing more stringent requirements, including

setting mandatory collateral for the production, processing and holding of such goods;

- Review conditions for transferring shares/equity in companies, as well as those governing the liability of administrators, shareholders and third parties in order to combat the risk of fraud;

- Amend the legal framework governing the trading of duty-free goods, including by imposing a cap on the quantities of certain excisable goods traded in duty-free regime, increasing surveillance on duty-free shops, introducing the mandatory stamping of the excisable goods traded in duty free shops, tightening conditions for licensing the duty free shops and for maintaining the already granted licenses, reviewing the facts constituting contraventions and of those triggering the revocation of the license and increasing the operating fee;

- Improve legislation on the use of electronic cash registers;

- Improve legislation on the organization and undertaking of gambling activities; and,

- Strengthen legislative provision for enhanced legal protection of public sector employees in carrying out their duties in good faith.

15. Some progress has been made in the monitoring and control of the largest loss-making public enterprises. However, more comprehensive effort is needed to deal with their budgetary cost and payments arrears. Therefore, the government will aggressively reactivate its privatization program, especially in the industry, energy, transport, tourism and agriculture areas. We will take the following additional actions: (i) wind-up the energy firm Termoelectrica by splitting out the viable assets and closing the remaining company by end-June 2011; (ii) privatize the cargo rail firm by end-March 2011. The privatization agency AVAS will complete the sale of 18 small firms under its full ownership during 2010, and will sell the minority stakes it holds in at least 150 additional firms. The Ministry of Economy will also initiate the sale of minority stakes in several firms under its control. Finally, in accordance with EU competition rules, we will phase out subsidies for coal mining by end-2010 and we will develop an exit strategy to be achieved within the next 5 years.

16. The unified wage law has been approved and is in force; it has already resulted in a noticeable easing of upward pressure on the wage bill by eliminating some bonuses and placing a ceiling on others. The preparation of the implementation legislation for the unified wage law to fully implement new, unified wage scales throughout the public sector is on track. We will agree on the text with the International Financial Institutions before submission to parliament, with the aim of having it approved by law by end-September 2010 (structural benchmark).

17. The pension reform now in parliament will generate significant savings in the coming years, helping to bring the retirement system into a more sustainable financial condition. However, in recent months there has been a spike in pension costs, due to a sharp increase in

individuals taking early retirement and new disability pension claims. Disability pensioners now constitute nearly 4½ percent of the labor force, and have grown rapidly in recent years. The increase in new pension claims is expected to increase this year's pension deficit by over ½ percent of GDP to more than 2¼ percent of GDP. To bring the system's short-term finances under better control, we will approve legislation to allow new disability pension claims only if they have been previously vetted by the Ministry of Labor's medical evaluation teams. On an immediate basis, we will also prohibit any new early retirement claims until after the new pension reform legislation is in effect in 2011.

Health Care System

18. Reforms in the public healthcare system are essential to improve the efficiency of service and to better control public spending. To help improve the revenue stream of the healthcare sector and tackle the stock of arrears, we remain committed to (i) introducing patient service fees by next year, (ii) sharply narrowing the exemptions for such fees compared to original plans, (iii) implementing the planned clawback tax on medical suppliers; and (iv) cutting the number of hospital beds by 9,200. The Ministry of Health and the National Health House will also take all necessary measures to ensure the functioning of health care system within the budgetary allocations established in the 2010 budget. We will also begin deeper structural reforms of the health care sector, in consultation with the World Bank. The first prong of these reforms involves reducing the cost of pharmaceuticals by promoting a consumption shift towards generic drugs and recentralizing drug procurement especially in national programs. The second prong involves improvements in the efficiency of hospital services and management and includes: (i) decentralizing the management of most hospitals to local governments; (ii) introducing a new financing mechanism for hospitals, based on standardized costs by type of hospital, cofinancing by local governments, and ceilings on wage spending to limit overruns; and (iv) reforming the system of emergency care to reduce excessive reliance on the system for primary care. These reforms will be approved by government emergency ordinance by end-July 2010.

Labor Market and Education

19. To improve the long term competitiveness of the Romanian economy, we are undertaking reforms in education and the labor market aimed at improving efficiency and productivity. We will introduce by end-2010 a revised labor code and collective contract legislation, to increase flexibility of working time, and to reduce hiring and firing costs through more flexible contracts. We also aim at allowing greater wage flexibility. The Romanian government will also identify and enforce measures to fight tax evasion on the labor market in order to improve the collection of social contributions.

20. The Romanian government aims at improving the quality of education, enhancing the productivity of the education system, and reducing public expenditures. The introduction effective January 1, 2010, of the per capita financing provides long term predictability and sustainability of the wages in the education sector. At the same time, based on the politically agreed National Education Pact, the Government has submitted to parliament the new

Education Law that establishes a sound financial management of resources, both for wages and for school expenditures. This law will also lead to a further optimization of the school network.

Financial Sector

21. The recession is taking a toll on the Romanian banking system but solvency levels remain high. Banks face pressures on asset quality and rising provisioning costs that are squeezing profits. Non-performing loans (NPLs) rose to 17.2 percent (representing loans and interests classified as doubtful and loss) in March 2010 and lending to private sector continued to contract. However, the rate of deterioration of asset quality is slowing suggesting impairments may have peaked. The banking system remains well-capitalized after paid-in committed increases in capital in a number of banks, which brought the average capital adequacy ratio to 14.7 percent for the system with all banks having a ratio above 10 percent. The largest foreign banks have broadly complied with the terms of the European Bank Coordination Initiative (EBCI). While individual bank exposures have fluctuated, as a group by end-March 2010 the nine banks had retained their March 2009 committed exposure to Romania.

22. As in other European central banks, we have been preparing for the possibility of spillovers from market volatility and made contingency plans to address episodes of possible financial distress. We have enhanced the liquidity monitoring including through the reporting of assets and liabilities' maturity breakdown by currency. We have reviewed existing emergency lending arrangements, and the collateral eligible for all refinancing operations has been broadened to include euro denominated government securities issued in the domestic market and will be broadened further to include bonds issued by IFIs listed on the Bucharest Stock Exchange and Eurobonds issued by the Romanian government as soon as some remaining technical issues have been clarified. With a view to further strengthening our already comprehensive stress testing approach, we have asked for technical support from the Monetary and Capital Markets Department of the IMF on further enhancing our stress test methodology in different areas.

23. We remain committed to improving the resolution process of distressed financial institutions. We have upgraded our domestic legal norms in line with EU requirements to strengthen the resolution framework for problem banks. We have also strengthened the existing authority of the special administrator to implement promptly a broad range of measures, including purchase and assumption, sales of assets, and transfer of deposits. The March 2010 structural benchmark regarding amendments to the bank insolvency regime was met.

24. We continue to be committed to further promote financial stability by increasing resources for the Deposit Guarantee Fund (DGF). The target coverage ratio for ex-ante financing will be increased to 2 percent. To achieve this target, over time the banks' contribution rates will be set to 0.3 percent beginning in 2011 and the stand-by credit lines will be eliminated (structural benchmark September 2010). We will also review the

governance arrangements of the DGF to ensure that neither members of the board nor employees of credit institutions participate in the DGF Board (end-September 2010). We have also provided the same seniority to the DGF's claims as those of depositors (March 2010 structural benchmark). We remain committed to support financial stability by refraining from promoting legislative initiatives (such as the current draft of the personal insolvency law) that would undermine credit discipline.

25. 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. Formally and permanently raising the minimum level of the capital adequacy ratio from 8 percent to 10 percent remains a medium-term objective. The NBR and the MoPF remain committed to adopting the necessary legal framework by the end of the program period for implementing comprehensive International Financial Reporting Standards (IFRS), with a view toward applying IFRS as of the beginning of 2012.

Monetary and Exchange Rate Policy

26. Monetary policy will remain focused on keeping inflation within the target band. Disinflation remains on track, helped by the large negative output gap, restrained wage developments, and recent food price deflation. Headline inflation fell from 4.7 percent at end-2009 to 4.4 percent in May 2010, despite a significant adjustment in tobacco excises early in the year. Together with reduced exchange rate pressures, this has allowed a measured adjustment of monetary policy, with interest rates reduced from 8 percent in late 2009 to 6.25 percent recently, for a cumulative reduction of 400 basis points since February 2009.

27. Further adjustment in monetary policy in the near future will be conditional upon subdued inflationary pressures and evolving recovery prospects. Inflation is projected to fall to around 3¾ percent by end-2010, close to the middle of our target range of 3½ percent ±1 percentage point. The benign inflation outlook is consistent with the downward revision of our inflation target to 3 percent ±1 percentage point for end-2011. At the same time, a prudent approach will be maintained in light of risks from further adjustments in regulated prices, increases in energy prices, and the unsettled financial markets in the region. These risks also imply that the timing and pace of future reductions in reserve requirements will have to be carefully calibrated to avoid disturbances in money and exchange rate markets. In line with our inflation targeting framework, we will maintain the existing managed float exchange rate regime.

Program Modifications and Monitoring

28. 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 as well as the 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 memorandum are further specified in the TMU attached to this memorandum.

/s/	/s/
Sebastian Vladescu	Mugur Isarescu
Minister of Public Finance	Governor of the NBR

Attachments

Table 1. Romania: Quantitative Program Targets

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March		June	Sept	Dec
	Actual	Actual	Actual	Actual	Actual	Prog.	Est.	Prog.	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	-2,000	779	-2,500	-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	-8,250	-8,422	-18,200	-25,700	-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	1.27	1.76	1.09	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	12.0	4.6	12.0	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	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	6.5	6.0	5.75	5.5
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.5	5.0	4.75	4.5
Center point	*6.3*	*6.7*	*5.9*	*4.8*	*4.7*	*4.5*	*4.2*	*4.0*	*3.75*	*3.5*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.5	3.0	2.75	2.5
Outer band (lower limit)	…	…	4.4	3.7	2.5	2.5	2.5	2.0	1.75	1.5
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	32,900	32,749	66,200	95,600	126,700
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-1,381	-495	-2,000	-3,000	-4,000

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

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

Measure	Target Date	Comment
Prior Action		
1. Enactment of agreed fiscal measures (LOI ¶ 7)	Prior action	
Quantitative performance criteria		
1. Floor on net foreign assets	March, 2010	Met
2. Floor on general government overall balance	March, 2010	Not met
3. Ceiling on general government guarantees	March, 2010	Met
4. Ceiling on general government domestic arrears	March, 2010	Not met
5. Non-accumulation of external debt arrears	March, 2010	Met
Quantitative Indicative Target		
1. Ceiling on general government current primary spending	March, 2010	Met
2. An indicative target on the operating balance of ten largest loss-making SOEs	March, 2010	Met
Inflation consultation band		
Inner band	March, 2010	Met
Outer band	March, 2010	Met
Structural benchmarks		
1. Passage of Fiscal Responsibility Law	March 31, 2010	Met
2. Passage of amendments to the banking and winding-up laws to enhance the bank resolution framework	March 31, 2010	Met
3. Approval of legislation and internal regulations by ordinance necessary to implement tax administration reforms	April 30, 2010	Met
4. Legislative changes to improve monitoring and control of SOEs	June 30, 2010	Met in January 2010
5. Approval of institutional reform measures to mitigate fiscal risks from local governments	June 30, 2010	Revised to end-September 2010
6. Passage of pension legislation	June 30, 2010	
7. Passage of implementing legislation for the unified wage law	September 30, 2010	
Proposed New Conditionality		
1. Approval of institutional reform measures to mitigate fiscal risks from local governments	September 30, 2010	Revised from end-June, 2010
2. 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 (LOI ¶24)	September 2010	
3. Reform tax administration methodology for high net wealth individuals (LOI ¶13)	November 30, 2010	
4. Integrate the accounting reporting system with the Treasury payment system (LOI ¶10)	March 31, 2011	

Romania: Supplementary Letter of Intent

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

Bucharest, June 29, 2010

Dear Mr. Strauss-Kahn:

29. This letter updates our Letter of Intent (LOI) of June 16, 2010. On June 25, the Constitutional Court invalidated the 15 percent cut in pensions approved by parliament, which formed part of the prior action (the cuts in wage and social transfers were not affected). To close the financing gap opened by the Constitutional Court decision, we have approved by emergency ordinance an increase in the VAT rate from 19 to 24 percent, effective immediately. The publication of this ordinance in the official gazette, which enacts the VAT increase, is a prior action for Board consideration of the fourth review. Moreover, parliamentary ratification of the VAT increase and of the expenditure measures that had been found constitutional will be a structural benchmark for end-September for 2010 (Table 2).

30. The change in the composition of this year's fiscal adjustment affects several targets under the program. In particular: (i) the increase in the VAT will have a temporary but significant impact on inflation, which we estimate at 3½-4½ percent and which will push inflation outside of the NBR's targeted path; (ii) the indicative target on general government current primary spending will be affected by the invalidation of the pension cuts; and (iii) the projected revenues used for the deficit target adjustor will be affected by the VAT increase. We therefore propose that these targets and projections be modified as indicated in the attached Table 1.

31. The lengthy parliamentary debate on the fiscal adjustment package has contributed to some delays in the approval of the pension reform legislation. The discussion of the bill was postponed to September, which has not allowed the structural benchmark to be met by end-June. We expect the legislation to be approved by parliament by end-September 2010 (reset of structural benchmark, see Table 2), with the reform implemented from 2011, as agreed under the program. Moreover, some provisions of the legislation that have a short-term impact, such as the elimination of the special noncontributory pensions and tightening of the disability pension procedures, have been included in the fiscal package legislation and will be in force earlier than anticipated.

32. We request that a waiver of applicability be approved for all end-June 2010 performance criteria other than for the net foreign assets target, as information on these criteria is not available. The net foreign assets target for end-June 2010, which has been observed, remains as established at the completion of the second and third reviews. We also request a waiver with respect to the inflation consultation band for end-June 2010 since information on inflation as of end-June is also not yet available. Finally, we note that our LOI of June 16, 2010 referred to a fiscal target of 6.8 percent for 2009 (paragraph 7) and we wanted to clarify that this target is for 2010.

/ s /

Sebastian Vladescu
Minister of Public Finance

/ s /

Mugur Isarescu
Governor of the NBR

Table 1. Romania: Quantitative Program Targets (Revised)

	2008	2009				2010				
	Dec	March	June	Sept	Dec	March		June	Sept	Dec
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I. Quantitative Performance Criteria										
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4. Ceiling on general government guarantees issued during the year (face value, bn lei)	0.0	…	0.02	0.7	2.2	12.0	4.6	12.0	12.0	12.0
II. Continuous Performance Criterion										
5. Nonaccumulation of external debt arrears	0	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	6.5	6.0	10.0	10.0
Inner band (upper limit)	…	…	7.4	6.7	5.5	5.5	5.5	5.0	9.0	9.0
Center point	*6.3*	*6.7*	*5.9*	*4.8*	*4.7*	*4.5*	*4.2*	*4.0*	*8.0*	*8.0*
Inner band (lower limit)	…	…	5.4	4.7	3.5	3.5	3.5	3.0	7.0	7.0
Outer band (lower limit)	…	…	4.4	3.7	2.5	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	32,900	32,749	66,200	98,000	130,900
8. Operating balance (earnings before interest and tax), net of subsidies, of 10 SOEs as defined in TMU						-1,381	-495	-2,000	-3,000	-4,000
Memorandum Item:										
Cumulative projected revenue of general government, net of EU funds (mln. lei)	…	…	…	…	151,508	…	36,355	74,950	117,100	159,600

1/ The December 2008 figure is a stock.
2/ The December 2008 figure is for the whole year.
3/ NFA targets for end December 2009 have been adjusted as actual disbursements fell short of projected levels by EUR 1 bn. Note that the NFA adjustor for June 2010 will remain as described in the Letter of Intent of February 5, 2010, while the adjustors for September and December 2010 are set as described in the Letter of Intent of June 16, 2010.

ROMANIA: TECHNICAL MEMORANDUM OF UNDERSTANDING

June 16, 2010

1. This Technical Memorandum of Understanding (TMU) updates and replaces the TMU dated February 5, 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	PC	PC	PC
Cumulative change in NFA	20,658	779	-2,500	-2,000	-2,000
Memorandum Item:					
Gross Foreign Assets	28,418	3,145	700	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	September	December
Outer band (upper limit)				6.0	5.75	5.5
Inner band (upper limit)				5.0	4.75	4.5
Center point	*6.3*	*4.7*	*4.2*	*4.0*	*3.75*	*3.5*
Inner band (lower limit)				3.0	2.75	2.5
Outer band (lower limit)				2.0	1.75	1.5

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 (performance criterion)	-18,200
End-September 2010 (performance criterion)	-25,700

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 (projection)	74,950
End-September 2010 (projection)	114,100
End-December 2010 (projection)	154,650

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 (performance criterion)	12
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 (performance criterion)	1.09
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:

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 (indicative target)	66,200
End-September 2010 (indicative target)	95,600
End-December 2010 (indicative target)	126,700

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 June 2010, September 2010 and December 2010 will be -2000, -3000 and -4000, respectively.

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 September 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.

B. Broadening of the Tax Base

23. The personal income tax base will be broadened to incorporate, at the least, meal vouchers, interest income, capital gains, and severance payments. Social security contribution exemptions will be eliminated for most “intellectual property” claimants.