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ROMANIA

June 2018

2018 ARTICLE IV CONSULTATION—PRESS RELEASE; STAFF REPORT; AND STATEMENT BY THE EXECUTIVE DIRECTOR FOR ROMANIA

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2018 Article IV consultation with Romania, the following documents have been released and are included in this package:

- A **Press Release** summarizing the views of the Executive Board as expressed during its June 4, 2018 consideration of the staff report that concluded the Article IV consultation with Romania.
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on June 4, 2018, following discussions that ended on March 16, 2018, 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 May 3, 2018.
- An **Informational Annex** prepared by the IMF staff.
- A **Staff Supplement** updating information on recent developments.
- A **Statement by the Executive Director** for Romania.

The IMF's transparency policy allows for the deletion of market-sensitive information and premature disclosure of the authorities' policy intentions in published staff reports and other documents.

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June 6, 2018

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IMF Executive Board Concludes Article IV Consultation with Romania

On June 4, 2018 the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Romania.

Romania recorded strong economic growth in 2017, with record low unemployment and an improving financial sector. Private consumption boosted by fiscal stimulus and wage increases led the strong growth, while investment lagged and structural reforms slowed. Public investment fell to a multi-year low in percent of GDP with a low absorption of EU funds. Both the government deficit and current account deficit widened, respectively to 2.8 and 3.4 percent of GDP in 2017. Reflation is quickly gathering pace. While the National Bank of Romania's inflation target was met in 2017, headline inflation has risen since January above the upper end of the band, reaching 5.2 percent (y/y) in April 2018.

Growth is expected to reach 5 percent in 2018—led again by continuing stimulus to private consumption from fiscal relaxation—and accompanied by a current account deficit and elevated inflation, even as monetary policy is tightened. Growth is expected to moderate to 3 percent in the medium term as the transitory effects of the fiscal stimulus fade, and lagging investment and lack of sustained progress on structural reforms would constrain potential growth over the medium term.

With signs of overheating, there is a risk that the current policy trajectory increases macroeconomic volatility, undermines the capacity to withstand adverse shocks, and eventually slows down convergence toward the advanced EU countries. The main external risks to the economic outlook include an abrupt shift in global risk appetite against the backdrop of continued monetary policy normalization. Domestically, further deterioration in

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

fiscal and external balances or a weakening of institutions could disrupt investor confidence. External and domestic shocks could coincide and weaken confidence and capital flows. Maintaining Romania's adequate reserve levels, fiscal buffers and a flexible exchange rate would help against these risks.

Executive Board Assessment[2]

Executive Directors welcomed the robust growth, reduced unemployment and improved financial sector conditions. Directors raised, however, concerns about emerging signs of overheating, including higher inflation and twin deficits, as well as lagging investment and slower structural reforms. Against this background, they called for a tighter macro-economic policy stance, while strengthening the medium-term orientation and predictability of policies to sustain Romania's convergence to higher living standards within the EU.

Directors noted that a more cautious fiscal policy stance would help economic rebalancing and reduce the burden on monetary policy. In the context of strong economic growth, they recommended a fiscal target below the 2018 Budget target of 3 percent of GDP, and noted that additional fiscal measures would likely be needed to reach this target.

Directors encouraged fiscal reforms to ensure achievement of Romania's medium-term budgetary objective. They emphasized the need to avoid further tax cuts, moderate wage and pension increases, and review the implementation of the unified wage law and pension changes in line with available fiscal space and medium-term fiscal objectives. Directors stressed the importance of reforms to enhance the efficiency of the public sector by strengthening tax administration to improve tax collection efficiency, raising expenditure efficiency through expenditure reviews and centralizing procurement, and improve EU Funds absorption.

Directors supported the monetary tightening that had been undertaken to curb inflation. They encouraged the central bank to remain vigilant and pursue further policy tightening as necessary to anchor inflation expectations to the targeted level. The central bank should continue to manage liquidity conditions to enhance monetary transmission.

Directors emphasized the need to accelerate the structural reform momentum. They called for improving public investment management institutions to fully utilize EU funds and address large infrastructure needs. Directors emphasized the need for strong corporate governance in the state-owned enterprises. They also noted that the minimum wage mechanism should balance social and competitiveness concerns. Recognizing past progress made in the fight

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

against corruption, Directors encouraged the authorities to maintain the reform momentum.

Directors noted the improvements in the financial sector in recent years and the findings of the FSAP. They called for strengthened macroprudential policies to address emerging vulnerabilities from the exposure of banks to the government and the real estate sector. They supported enhancing supervisory practices and the crisis management framework.

Romania: Selected Economic Indicators

Population: 19.6 million (2017)
Quota: 1,811 million SDRs (0.4% of total)

Per capita GDP: US$10,782 (2017)
Literacy rate: 99%
People at risk of poverty: 38.8% (2016)

Key export markets: European Union (Germany, Italy, France)
Main products and exports: Machinery and transport equipment, manufactured goods

	2016	2017	2018	2019
		Prel.	Proj.	
Output				
Real GDP growth (%)	4.8	6.9	5.1	3.5
Output gap	-1.5	1.5	2.8	2.6
Employment				
Unemployment (%)	5.9	4.9	4.6	4.6
Prices				
CPI inflation (%, period average)	-1.6	1.3	4.7	3.1
General government finances				
Revenue	29.0	27.9	28.0	28.6
Expenditure	31.4	30.8	31.6	32.0
Fiscal balance	-2.4	-2.8	-3.6	-3.4
Primary balance	-1.1	-1.7	-2.3	-2.1
Structural fiscal balance 1/	-1.7	-3.4	-4.2	-3.9
Public debt (including guarantees)	39.0	36.8	37.3	38.4
Money and credit				
Broad money (% change)	9.7	11.6	9.5	9.1
Credit to the private sector (% change)	1.2	5.6	5.1	4.3
Policy rate (percent)	1.75	1.75	-	-
Balance of payments				
Current account (% GDP)	-2.1	-3.4	-3.7	-3.7
FDI (% GDP)	-2.7	-2.4	-2.4	-2.4
Reserves (months imports)	5.6	5.0	4.6	4.4
External debt (% GDP)	54.7	49.7	48.8	47.1
Exchange rate				
REER (% change, GDP-deflator based)	1.8	1.9	…	…

Sources: Romanian authorities, World Bank, Eurostat and IMF staff calculations.
1/ Fiscal balance (cash basis) adjusted for the automatic effects of the business cycle and one-off effects.

ROMANIA

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION

May 3, 2018

KEY ISSUES

Background and Risks

Romania posted one of the highest growth rates in the EU in 2017, with record-low unemployment and an improving financial sector. Domestic consumption supported by fiscal stimulus led the strong growth, while investment lagged and structural reforms slowed. Economic growth is expected to again exceed potential in 2018 with elevated inflation, but slow down over the medium term assuming the fiscal stimulus wanes. With signs of overheating, however, there is a risk that the current policy trajectory increases macroeconomic volatility, wears down buffers, and ultimately slows down convergence toward the advanced EU countries. Investor confidence in Romania could be disrupted by further deterioration in fiscal and external balances, weakening of institutions, or global financial volatility.

Policy Recommendations

- *Fiscal policy*. Pursue a tighter fiscal stance than envisaged in the authorities' current plans in order to stabilize the economy, rebuild room for fiscal policy maneuver, and preserve competitiveness. Implement fiscal structural reforms to strengthen tax collections and improve the efficiency of public spending and administration.

- *Monetary policy*. Frontload interest rate increases to curb inflationary pressures and anchor expectations, while absorbing excess liquidity to strengthen monetary policy transmission. Calibrate monetary tightening to the degree of fiscal adjustment.

- *Structural reforms*. Strengthen public investment management institutions and governance of state-owned enterprises (SOEs), including to use EU funds more effectively and raise the quality of infrastructure. Sustain the fight against corruption.

- *Financial sector*. Further strengthen macroprudential tools to limit banks' mortgage exposure and ensure adequate capital buffers against large sovereign exposures, maintain a focus on non-performing loans reduction, and further improve supervisory practices.

Approved By
Jörg Decressin and Kevin Fletcher

Discussions were held in Bucharest during March 6-16, 2018. The staff team was led by J. Lee and comprised E. Crivelli, S. G. Toh (EUR); M. Marinkov (FAD), D. Ostojic (SPR), E. Nier (MCM), A. Hajdenberg (Resident Representative), and G. Babici (Bucharest office). The mission met with Prime Minister Dăncilă, Deputy Prime Minister Ştefan, Deputy Prime Minister Stănescu, Minister of Public Finance Teodorovici, Governor Isărescu, Minister of Labor and Social Justice Vasilescu, Minister of Economy Andruşcă, members of Parliament, other senior officials, representatives of political parties, labor and business organizations, civil society, and financial institutions.

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CONTEXT

1. **The Romanian economy is growing strongly.** The fiscal relaxation since 2016, rapid wage increases, and a favorable external environment have fueled domestic consumption and contributed to Romania having one of the highest growth rates in the EU in 2017. The financial sector has strengthened, with banks well-capitalized and non-performing loans having declined significantly.

2. **Signs of overheating have emerged in parallel, and without policy changes, growth will turn increasingly fragile and buffers will get thinner.** Strong growth has been accompanied by rising inflation—also one of the highest in the EU—and an expanding current account deficit. On the structural front, public investment has slowed with its share in the budget falling, while the quality of infrastructure ranks low among the EU countries. SOE reforms have stalled in the absence of a clear policy commitment. The widening of twin deficits risks eroding policy buffers, while the weak public investment and slow structural reforms would lower growth potential over the medium term. Continuation of procyclical fiscal and wage policies could thus heighten macroeconomic volatility, as cautioned in the past (Annex III). Monetary policy has started to respond, but monetary tightening alone would be a suboptimal policy mix for macroeconomic stabilization.

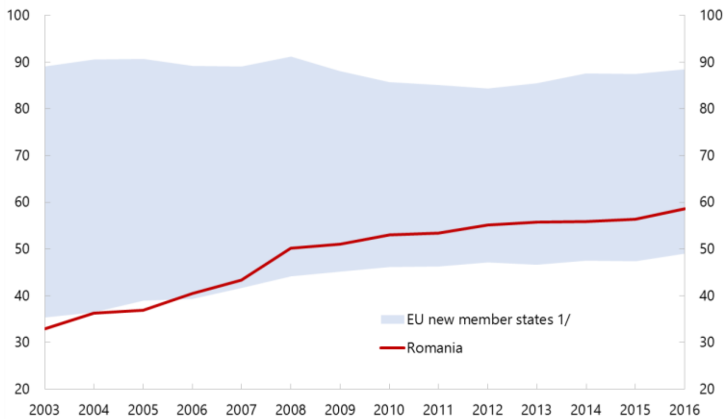
3. **The fiscal relaxation has continued against the backdrop of frequent changes in government**. Following the fall of government in 2015, the succeeding technocratic government implemented the fiscal stimulus previously adopted by parliament. This marked a change from the fiscal conservatism during the preceding years. The current ruling coalition came to power in 2017 with a governing program based on further fiscal expansion and has since replaced its own government twice due to internal disagreements. The budget deficit rose close to 3 percent of GDP in 2017 amid tax cuts and raises in pensions and public-sector wages, despite compression in public investment.

4. **Discussions focused on improving the policy mix via fiscal moderation, and strengthening the medium-term orientation and predictability of policies.** These policy changes would need to be supported by an efficient government and strong governance, to more sustainably achieve inclusive convergence with the living standards in the advanced EU countries. Having joined the EU in 2007, Romania made considerable progress towards a more rules-based governance, including reforming the economy and institutions ranging from the judiciary to the fiscal responsibility framework. It now needs to entrench these gains and continue the convergence in institutional qualities as well as income levels.

Figure 1. Romania: Towards a Medium-term Orientation of Policies

Convergence to average EU income levels would require sustained, strong growth over the long term…

Income Convergence
(GDP per capita in PPP, in percent of EU average)

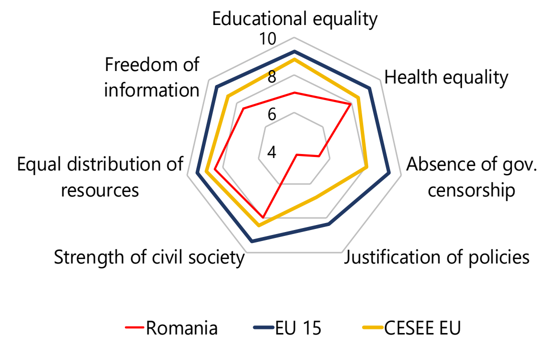


Sources: World Development Indicators; and IMF staff calculations.
1/ EU new member states excluding Romania are: Croatia, Czech Republic, Hungary, Poland, Bulgaria, Slovak Republic, Slovenia, Estonia, Latvia, and Lithuania.

… while perceptions-based indicators on quality of institutions relative to the EU and the region show that further catch-up is in order.

Quality of Institutions

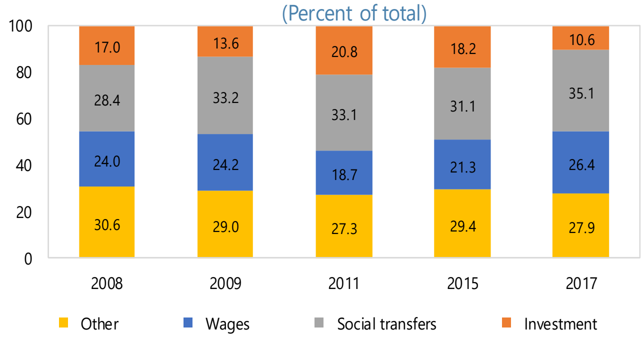
(index: 0=worst, 10=best)



Sources: Europe REO, Nov. 2017, Annex 2.2, Varieties of Democracy Institute (V-Dem) database https://www.imf.org/en/Publications/REO/EU/Issues/2017/11/06/Eurreo1117; staff calculations.
Note: Equal distribution of resources measures poverty and distribution of goods and services as well as levels of inequality in these distributions and proportion of population ineligible for social services.

Public spending composition has deteriorated recently, with the lowest investment share in a decade…

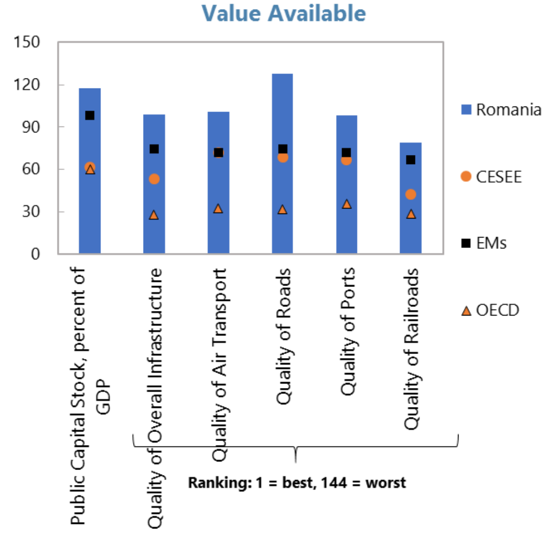
Composition of government spending
(Percent of total)



Source: Romanian authorities and IMF staff calculations

…and the quality of infrastructure investment remains a pressing area for improvement.

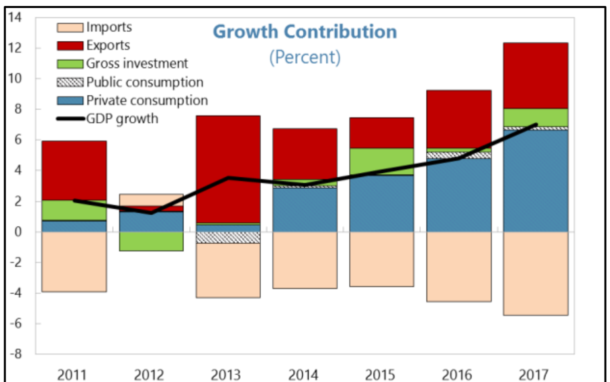
Capital Stock and Infrastructure Quality, Latest Value Available



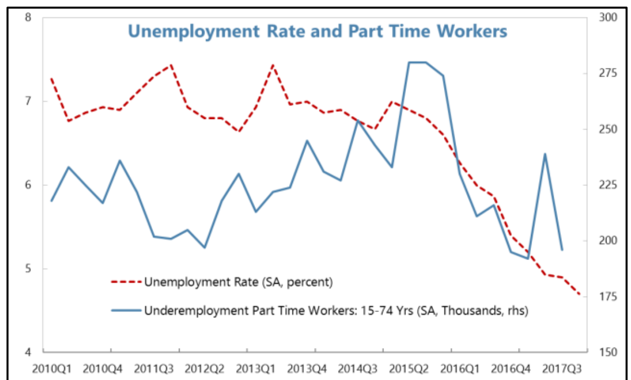
Sources: IMF FAD Expenditure Assessment Tool (EAT), World Economic Outlook, World Development Indicators, IMF Investment and Capital Stock Dataset, and World Economic Forum.

RECENT ECONOMIC DEVELOPMENTS

5. Growth surged to 6.9 percent in 2017, driven by private consumption, and the labor market has tightened. This primarily reflected the cumulative effects of tax cuts, public and minimum wage hikes, and pension increases in recent years. Improving external demand, notably from the euro area, further bolstered activity and has started to spill over into private investment, while monetary policy has been accommodative. Public investment has lagged, reflecting weakness in domestically and EU-funded capital spending. The unemployment rate has fallen to a 25-year low and employment exceeded pre-crisis levels, with double-digit private sector wage growth arising from a tight labor market. Consistent with various indicators, the output gap is estimated to be positive, albeit subject to usual statistical uncertainty.

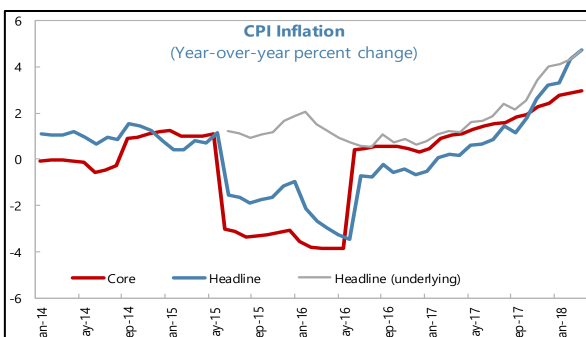


Sources: Haver and IMF staff estimation.

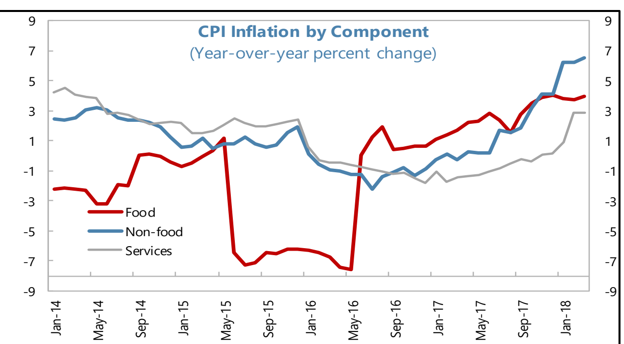


Source: Haver Analytics.

6. Reflation is quickly gathering pace. Following disinflation from mid-2015 to early 2017 accentuated by indirect tax cuts and fee reductions, inflation has accelerated since mid-2017, as food and energy price increases added to rising core inflation. While the National Bank of Romania's (NBR) inflation target (2.5 ± 1 percent) was met in 2017, headline inflation has stayed above the upper end of the band since January, reaching 5 percent (y/y) in March 2018. The NBR tightened the corridor around the policy rate in October-November 2017, and raised the policy rate for the first time since 2008, by 25 basis points each in January and February.

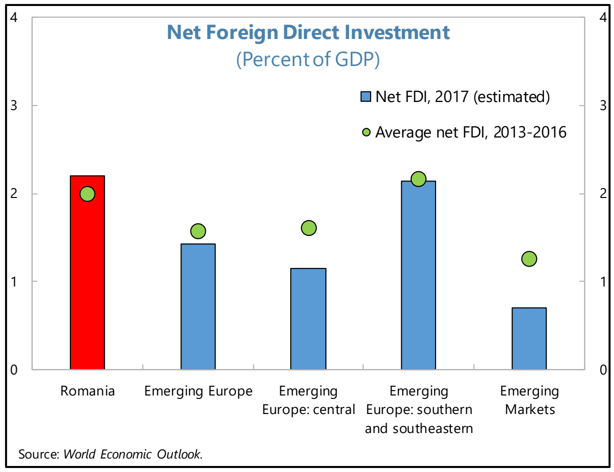


Note: Underlying headline inflation was adjusted for impacts from changes in VAT rate, fuel excise, and administered prices; core inflation is defined as inflation for the CPI basket that excludes VFE (vegetable, fruit and egg), fuel, administered prices, alcohol and tobacco. But core inflation is still influenced by changes in VAT rate.

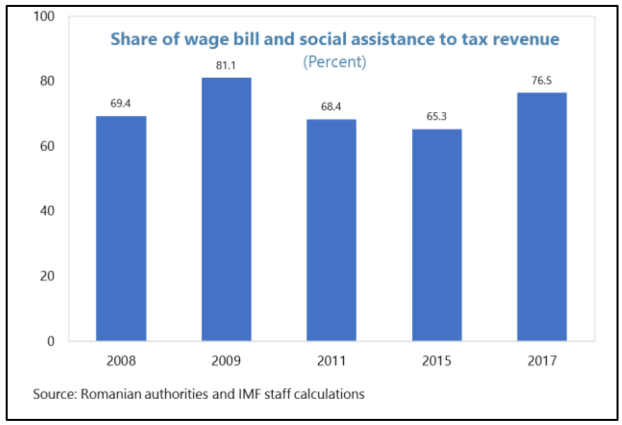


Note: Non-food and services inflation were earlier kept down by changes in VAT rate, fuel excises, and administered prices.

7. The current account deficit rose to 3.4 percent of GDP in 2017 (2016: 2.1 percent of GDP). Strong consumption-related imports deepened the goods trade deficit to 6.3 percent of GDP in 2017, while the capital account inflows declined primarily due to lower EU funds-related grants. Net FDI flows remained a key funding source, staying above 2 percent of GDP largely due to reinvested earnings. Reserve coverage remains broadly adequate according to most reserve adequacy metrics (Annex IV).

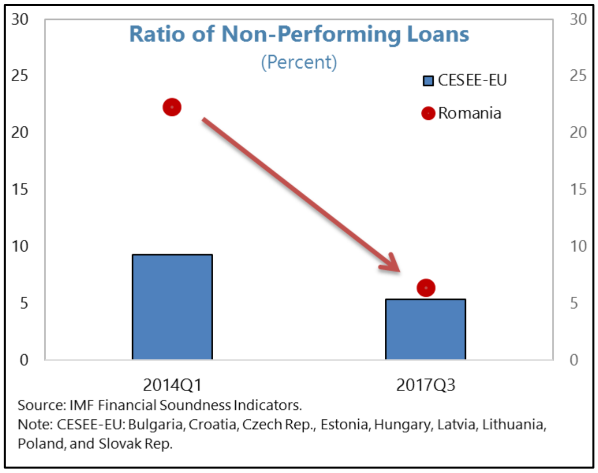


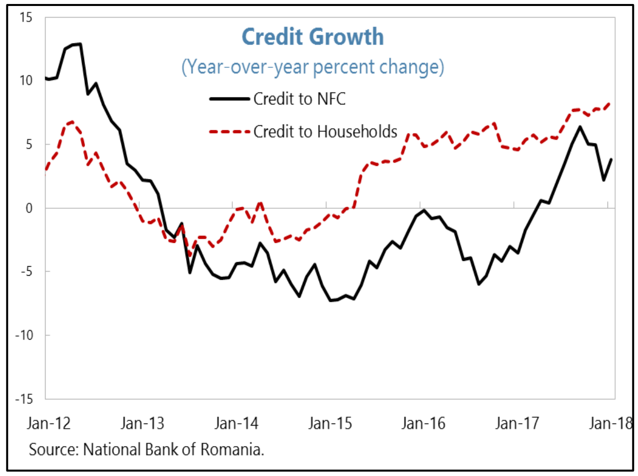
8. The 2017 headline general government deficit (cash basis) widened to 2.8 percent of GDP. The corresponding ESA deficit was about 2.9 percent of GDP, slightly below the EU's excessive deficit procedure (EDP) threshold of 3 percent of GDP. However, the expenditure composition continued to deteriorate in 2017. The capital budget was under-executed, bringing the share of total public capital spending to the lowest in a decade. Spending on goods and services also declined sharply. The wage bill increased by 0.6 percentage points of GDP, rapidly raising the share of rigid spending—on wages and social assistance—in tax revenue. Tax revenues declined by 1.1 percentage points of GDP relative to 2016, reflecting contractions in VAT, excise, and corporate income tax revenue.[1] While these contractions are partially explained by tax policy changes that were implemented in 2017, they also reflect efficiency losses in VAT and excise collections.



9. Credit growth to households accelerated while non-performing loans (NPLs) declined. Low interest rates, the robust labor market recovery, and the government's Prima Casa guarantee program have helped sustain a double-digit growth in mortgage lending during 2017. Nevertheless, the stock of private credit, at 27 percent of GDP, remained one of the lowest in the EU. Bank credit growth to nonfinancial corporates remained subdued in 2017 in part due to write-offs and sales of NPLs, which helped lower the NPL ratio for the whole banking sector to 6.4 percent at end-2017 (from its peak of 22 percent in 2014). Corporate sector leverage has nevertheless increased due to sizable external funding and reliance on domestic trade credit.

[1] These exceeded modest revenue gains from the mid-year tax amendments which helped contain the 2017 deficit: introduction of social security contributions for part-time workers and reintroduction of the fuel surcharge. Higher dividend transfers from SOEs (including extraordinary dividends) also helped contain the 2017 government deficit.





OUTLOOK AND RISKS

10. Growth is projected to remain above potential in 2018 and slow to around 3 percent in the medium term. On current fiscal policies, real GDP growth could reach about 5 percent this year, led by consumption and accompanied by elevated inflation and a current account deficit, even as monetary policy is further tightened. Growth is expected to decline below potential in the medium term, assuming that sizable positive fiscal impulses in recent years will turn into small negative impulses from 2019 and the cumulative effects of recent wage increases will wane. Substantial monetary tightening is projected for 2018-19, also cooling growth and keeping inflation below the upper end of the target band. Lagging investment and lack of sustained progress on structural reforms would constrain the potential growth rate below 4 percent.

11. Current baseline policies are on a trajectory to undermine the capacity to withstand adverse shocks over the medium term. Romania's reserves and moderate government debt could provide some cushion against risks, and so could allowing for greater flexibility in the exchange rate. However, under the current policies, the existing buffers would wear thin gradually over the medium term. Government debt will keep rising steadily, bearing the risk of surging above 50 percent of GDP in the event of a shock to growth (Annex I). Monetary policy alone would not be able to fully stabilize the economy and leave inflation in the upper half of the target band, narrowing room for smooth policy responses. Under further shocks, a sharper-than-desired monetary tightening could be needed, triggering excessively volatile movements in capital flows and the exchange rate.

12. Risks to the baseline are tilted to the downside (Annex II). The key external downside risk is a sharper-than-expected tightening in global financial conditions from an abrupt shift in global risk appetite against the backdrop of continued monetary policy normalization, which would lead to capital outflows and higher borrowing costs. Domestically, further deterioration in fiscal and external balances or a weakening of institutions could disrupt investor confidence, while a delayed policy response to higher-than-expected inflation could intensify demand pressures. External and domestic shocks could coincide and escalate into collapses in confidence and capital flows.

Authorities' Views

13. The government forecast assumes a higher impact of the fiscal and structural measures introduced in its program on growth prospects. It anticipates a stronger investment growth in the near term and a stronger medium-term total factor productivity growth comparable to the pre-crisis values. It projects growth at 6.1 percent for 2018, 5.7 percent during 2019-2020, and 5 percent in 2021. The fiscal authorities were not as concerned on the erosion of policy buffers over the medium term.

POLICY DISCUSSIONS

Fiscal moderation would reduce the amount of monetary tightening required to help temper overheating. This would help avert crowding out private investment and enhance macro-financial stability. It will also smooth the medium-term fiscal consolidation and should be based on strengthening the quality and predictability of the budget framework. Structural and governance reforms should resume and improve the business environment. The Financial Sector Assessment Program (FSAP) has provided recommendations to strengthen the financial sector.

A. Fiscal Moderation and Efficiency

14. The authorities' budget deficit target of 3 percent of GDP in 2018 requires implementing additional measures in staff's assessment. The 2018 budget includes both wage and pension increases, with an estimated impact of 2 percent of GDP. It also introduced a convoluted shift of the employer's social security contribution to the employee, as well as reductions in the personal income tax and social security rates that were aimed at keeping the private sector labor costs and net wages unchanged (Box 1). Staff assesses that the revenue gains from the recently-implemented split-VAT system and more efficient collection will likely be less than budgeted and that social spending in 2018 will likely be higher than budgeted. To meet the 2018 budget target, staff encouraged the authorities to implement high-quality measures (amounting to 0.6 percent of GDP) that avoid a further deterioration in the budget structure and protect capital spending (see table on possible measures in Figure 2).

15. Given the current cyclical position of the economy, a tighter fiscal stance than the authorities' target is warranted in 2018 and over the medium term. Consumption-oriented fiscal relaxation when the economy is growing strongly could exacerbate overheating without raising potential growth. The authorities target a fiscal deficit of 3 percent for 2018, which would impart about ¼ percentage point of GDP fiscal impulse to an economy that already exhibits signs of overheating. In staff's view, a more appropriate target from a cyclical perspective would be a deficit of 2 percent of GDP, implying a withdrawal of fiscal stimulus to the tune of ¾ percentage point of GDP. Going all the way to the 2 percent target would require measures equivalent to about 1½ percentage points of GDP because the authorities' 3 percent deficit target is not sufficiently supported with measures (¶14). While staff appreciates that government debt is relatively low, fiscal consolidation beyond the 2018 budget—to 2 percent of GDP—would help safeguard fiscal buffers and moderate macroeconomic volatility by improving the fiscal-monetary policy mix (¶19). Lowering the deficit further to 1.5 percent of GDP by 2020 would help Romania transition to its medium-term objective (MTO) of 1 percent of GDP.

16. Fiscal policy should be centered on improving efficiency, to support consolidation and improve the budget's composition. Romania's declining and comparatively low tax revenue as a share of GDP underscores the importance of effective revenue mobilization and expenditure management. These would help with large unmet needs in priority areas including infrastructure, education, and health, as well as long-term challenges linked to adverse demographic dynamics.

- ***Improving revenue collection.*** There is significant scope to strengthen revenue collection in Romania (Box 2). Tax changes need to be more predictable and less frequent, and further tax rate cuts should be avoided. Staff advised conducting a comprehensive review of the tax system, given multiple changes to the tax system in recent years. Tax collection efficiency could be improved, including by rationalizing exemptions and reforming tax administration, especially for the value-added tax (VAT). Implementing and operationalizing new IT infrastructure in revenue administration is a key priority, given Romania's outdated and fragile systems.

- ***Bolstering expenditure efficiency.*** Prioritization of large investment projects should be enforced and reflected in annual budgets. Expenditure reviews for key sectors could identify efficiency gains, and adopting a centralized procurement system could generate savings on goods and services spending. Staff welcomed the plans by the Ministry of Public Finance (MoPF) to make progress in these areas.

- ***More efficient absorption of EU funds.*** The absorption rate of EU funds for programming period 2014-20 has been only 13 percent through March 2018. More effective absorption of EU funds, especially for large infrastructure projects, would help increase the budget share of total capital spending, while supporting fiscal consolidation.

17. The fiscal responsibility law (FRL) could enhance policy predictability. Romania enacted in 2010 a sound FRL to strengthen fiscal discipline and budget formulation (CR/16/113), with a Fiscal Council being put in place. However, the fiscal rules in the FRL have not been observed. Staff reiterated that implementing all aspects of the FRL would install a more coherent and medium-term oriented fiscal framework with greater credibility. The Fiscal Council's advice should be better integrated into the budget process. Stronger revenue mobilization and expenditure management through the above-mentioned recommendations would also make it easier to plan ahead and abide by the FRL. Staff also advised clarifying the potential changes to Pillar II pension system to remove associated uncertainty, and recommended a sustainability assessment for the pension system while continuing to ensure that its social protection objectives are met.

Authorities' Views

18. The authorities expressed a commitment to a stronger fiscal management and the EU deficit limit of 3 percent of GDP, but not to a further reduction in the 2018 deficit proposed by the mission. They agreed on prioritizing higher capital expenditure, more effective EU funds absorption, more efficient spending, and stronger revenue collection. On the latter, the MoPF is requesting FAD TA on tax administration. The authorities are also in the process of setting up the National Center for Financial Information (CNIF), which will be an IT structure within the MoPF that will unify all the fiscal information databases, including that of the revenue administration (ANAF).

Figure 2. Romania: Fiscal Outlook and Staff Recommendations

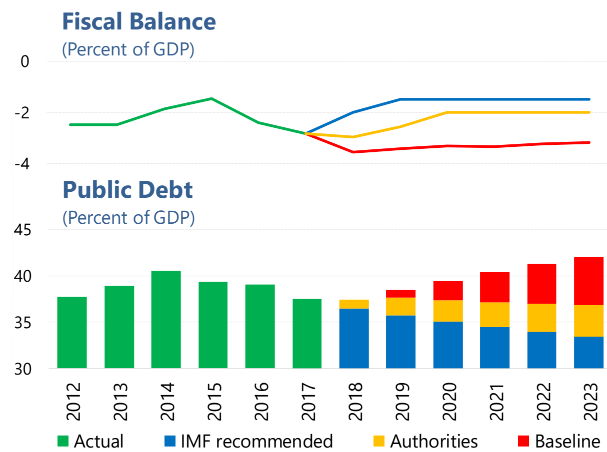
Given the current cyclical position of the economy, staff assesses that a tighter fiscal stance will help improve the policy mix and rebuild fiscal buffers.

Fiscal Balance Targets
(Percent of GDP; cash basis)

Measure	2018	2019	2020
Budget deficit under current policies (IMF estimate)	-3.6	-3.4	-3.3
Authorities' budget target	-3.0	-2.6	-1.9
IMF-recommended budget	-2.0	-1.5	-1.5
Measures needed (cumulative)	1.6	2.1	2.1
Implied structural adjustment relative to previous year (IMF-recommended)	0.8	0.5	0.2

Sources: Romanian authorities and IMF staff calculations.
Note: The 2018 target of 2.96 percent of GDP in cash terms corresponds to around 3 percent in ESA terms. The line "Measures needed (cumulative)" indicates in cumulative terms the additional measures needed, starting from 2018, to bring the deficit from the "Budget deficit under current policies" to the "IMF-recommended budget."

Under the baseline scenario with current policies, the deficit will reach 3.6 percent of GDP in 2018 and public debt will gradually rise over the medium term.



The wage and pension increases implemented in 2018 are costly and place pressure on government finances.

Fiscal Cost of New Measures Introduced in the 2018 Budget
(Staff estimates, percent of GDP)

	2018
Revenue	**-0.1**
Personal income tax	-1.5
Lowering PIT on wages to 10 percent	*-1.0*
Other changes to PIT	*-0.5*
Social security contributions	1.1
Other	0.3
Expenditure	**2.0**
Wages	1.3
Pensions	0.6
Total effect on the budget	**2.1**

High-quality near-term measures should be implemented to meet the government's 3 percent of GDP deficit target for 2018 and the staff-recommended 2 percent target.

Menu of possible measures for fiscal consolidation
(Percent of GDP; cash basis)

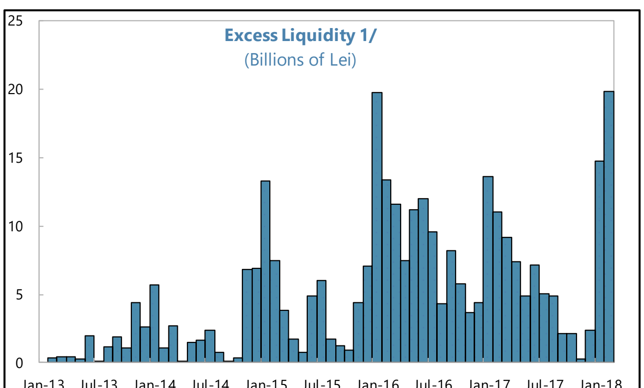
Measure	Estimated yield
Postpone (or gradually implement) the pension point increase	0.3
Enforce the 10 percent buffer on current spending items	0.2
Reprioritize current expenditures (e.g. centralized procurement)	0.1
Revenue efficiency gains, broadening of the tax base	0.5
Other measures (e.g. faster absorption of EU-funds)	0.5

Sources: Romanian authorities and IMF staff calculations.

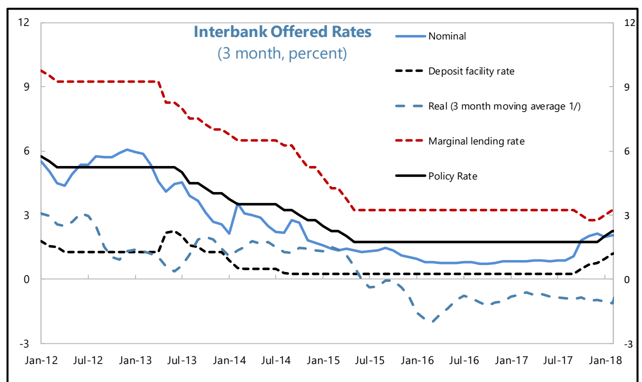
B. Monetary Tightening

19. Staff advocated a better fiscal-monetary policy mix, arguing that fiscal moderation would reduce the burden on monetary policy and help improve the balance between consumption and investment. Given the signs of overheating including rising inflation and tight labor markets, prompt macroeconomic stabilization is needed to reduce risks for a hard landing. If the task of stabilization is left to monetary policy alone, interest rates would have to be raised to such a level that will increasingly weigh on investment and competitiveness. Box 3 presents the benefits of a policy mix that includes a fiscal moderation, using policy simulations based on a model developed by the IMF's Research Department.

20. Monetary policy anyway needs further tightening to rein in inflation and anchor expectations. Inflationary pressure is arising from global energy prices, strong domestic demand, wage increases, and recent currency dynamics, reflecting the anticipated fiscal impulse and positive output gap in 2018. Compounded by adverse base effects and administered price increases, headline inflation is projected to persist above the target band until the end of 2018, which risks destabilizing inflation expectations, a major inflation driver in Romania (CR/16/114). Policy responses are in order, with the fiscal path influencing the degree of necessary tightening. At the same time, the central bank and monetary policy should continue to stay independent, refraining from stimulating activity at the cost of higher inflation. Central bank independence has been found to strengthen the credibility and effectiveness of monetary policy. The recent monetary tightening was a welcome start, and the mission encouraged the NBR to continue raising the policy rate in a frontloaded manner, while also managing liquidity to align the market and policy rates to strengthen monetary transmission.[2] Sharper adjustments at a later stage could trigger destabilizing capital flows and exchange rate changes.



Source: NBR monthly bulletin.
1/ Stock of deposit in the NBR deposit facility (monthly average).



Sources: Haver; Eurostat; National Bank of Romania; and IMF staff calculations.
1/ Computed using the underlying headline inflation rate, adjusted for VAT changes.

[2] Due to excess liquidity in the system, the money market rate tended to be close to the lower bound of the interest rate corridor (the rate on the NBR's deposit facility) which in real terms (adjusted for underlying inflation) is negative.

21. Staff's overall assessment is that Romania's external position in 2017 was broadly in line with the underlying fundamentals (Annex IV). The three EBA-lite models suggest a moderate REER undervaluation of around 1–7 percent. Going forward, however, this assessment could change if the current account deficit deteriorates further. Reserve coverage is broadly adequate according to all reserve adequacy metrics. At times in 2017, the NBR increased FX sales due to seasonal trends and when the currency came under pressure in a still somewhat shallow market. Staff reiterated advice to limit interventions only to smoothing excess volatility of the lei.

Authorities' Views

22. The authorities concurred with the need to further tighten monetary policy. The NBR emphasized that it has begun to adjust the monetary policy stance, while noting that inflation would remain temporarily elevated in 2018 due to administered price adjustments and base effects. While a policy mix that combined fiscal moderation with monetary tightening would be ideal, the NBR was prepared to raise interest rates further as necessary, while remaining watchful for adverse effects in the event of a significant interest rate differential vis-a-vis the rest of the EU. They noted that monetary transmission had improved since Q4 2017, with the longer-term money market rates now closer to the policy rate. The authorities shared staff's view that the Romanian currency is broadly in line with its equilibrium level.

C. Structural Reforms

23. Re-energizing structural reforms is essential to strengthen convergence with the EU and alleviate constraints on growth. Romania had made considerable progress in strengthening the judiciary and the fight against corruption[3] and floated minority stakes in key SOEs. Law 111 on corporate governance, legislated in 2016, strengthened the professional and transparency requirements for management of SOEs. Earlier reform momentum, however, has waned. Given that rules-based governance and more efficient government are key to sustain inclusive convergence, a renewed reform momentum is called for.

24. Effective absorption of EU funds can help address Romania's large infrastructure gap. Strengthening public investment management institutions remains a priority to improve Romania's infrastructure quality, which is the lowest in the EU (especially for road and rail transport). The quality of public investment can also be improved by increasing the share of EU-funded investment, which is better targeted and subject to stronger feasibility studies and ex-ante conditionality. Raising the EU funds absorption rate to 95 percent for programming period 2014–20 on quality projects could bring about a 10-percent increase in the 2022 GDP beyond the baseline (CR/17/134). Efforts by the Ministry of EU Funds and the MoPF to fulfill ex-ante conditionality, designate project managers for large projects, and reduce administrative burden are positive steps. Staff encouraged the authorities to further improve administrative capacity, especially at line ministries to ensure a higher absorption rate, with funds applied to priority areas. Staff also emphasized the need for

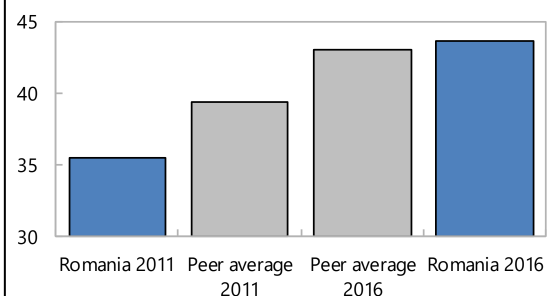
[3] EUR Regional Economic Outlook, Nov 2017: Reforming the Judiciary.

timely preparation of new projects—based on strong feasibility assessments—to ensure a smooth transition into the next EU funds programming period.

25. Improving service and financial performance of many SOEs requires a renewed commitment to strong corporate governance. SOEs play a notable role in transport and energy sectors—key network industries to accelerate growth. Staff encouraged the authorities to resume the stalled process of restructuring and privatization—including through initial public offerings—to improve the quality of service and financial performance of many SOEs. Staff advised against any weakening of the current legal framework for SOE corporate governance—Law 111—and recommended strengthening the implementation of its legal provisions and monitoring of results, including by building the capacity of the MoPF unit and line ministries overseeing the SOE reform agenda. The government plans to establish a sovereign investment fund with shares of SOEs and a development bank to support investment. Staff pointed to international experience on the risks associated with such entities and advised to follow international best practices, including on governance, reporting, and management of fiscal risks (CR/17/134).

26. Staff recommended improving the mechanism for adjusting minimum wages. The minimum wage in Romania has more than doubled since 2011, and the ratio of minimum-to-average wage surpassed the regional average in 2016. Staff recommended that the pace of future minimum wage increases should consider competitiveness, productivity growth, and employment prospects. Negative employment effects of minimum wage hikes tend to get much stronger around a minimum-to-average wage ratio in the mid-40s (CR/16/151). It would help to establish a transparent minimum wage mechanism, based on a set of objective criteria (as proposed in SM/16/94) and endorsed by social partners, to avoid undermining competitiveness and hampering job creation, particularly for low-skilled employees.

Minimum to Average Wage Ratio 1/
(Percent)



Sources: Eurostat; national authorities, and IMF staff calculations.
1/ Peer average refers to the average for Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Czech Rep., Estonia, Hungary, Latvia, Lithuania, Montenegro, Poland, Serbia, Slovak Rep., Slovenia, Turkey.

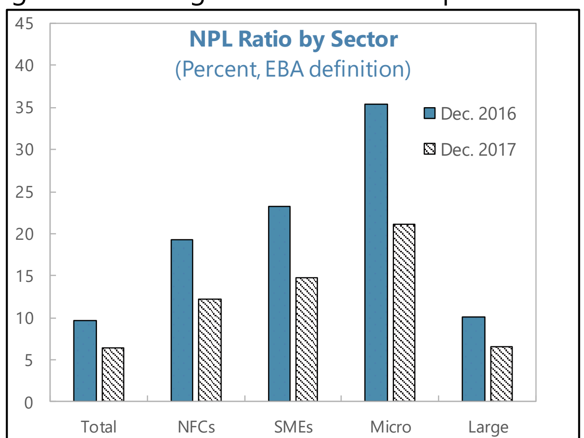
27. Romania's progress in the fight against corruption has been recognized internationally and needs to continue. Reducing corruption would help improve government revenue, enhance spending efficiency, and strengthen competitiveness. Recent initiatives to amend the justice law, the criminal codes, and laws on conflict of interest and corruption, however, have been reportedly seen as threatening the independence of Romania's judicial system and its capacity to fight corruption effectively. In line with the FSAP recommendations, the authorities are encouraged to continue strengthening the AML/CFT framework in compliance with the FATF standards (e.g., comprehensive assessment of ML/TF risks, customer due diligence requirements for politically exposed persons, enhancing entity transparency, and strengthening the asset declaration framework for senior officials).

Authorities' Views

28. **The authorities and staff agreed on some areas.** Government officials emphasized the progress made so far in terms of completing the appointment of management authorities, lifting ex-ante conditionality, and reducing bureaucracy to accelerate absorption of EU funds. On SOE reform, the authorities pointed to the improved financial performance of selected enterprises—particularly in the energy sector—and committed to the implementation of Law 111 on corporate governance. The authorities intend to incrementally increase the minimum wage until 2020 as guided by their governing program, and regarded it to be an acceptable mechanism. They agreed on the need to continue the fight against corruption, while acknowledging the ongoing political debate on the functioning of the judiciary.

D. Financial Sector Resilience

29. **The resilience and profitability of the banking sector has improved in recent years.** Banks' profitability and liquidity positions have strengthened. Foreign-owned banks' dependence on parent funding declined to about a third of the level in 2011, while deposits from the domestic private sector increased from about 48 percent of total bank liabilities in 2011 to about 64 percent in 2017. Banks' NPLs declined significantly, reflecting the NBR's proactive efforts to encourage NPL sales and write-offs. The level of NPLs for corporates (at around 12 percent, on average) remains high, especially among small and medium enterprises, and staff encouraged continued efforts to reduce them.



Source: National Bank of Romania.

30. **Notwithstanding these improvements, vulnerabilities arise from the high exposure of banks to the real estate sector and sovereign debt**. Real estate exposure rose with housing loans increasing from 21 to 54 percent of household loans between 2008 and 2017. These mortgage contracts (mostly at variable rates) expose banks to credit risks in the event of sharp increases in interest rates. The effectiveness of existing macroprudential tools on mortgages is undermined by the Prima Casa program, which allows loan-to-value ratios up to 95 percent. The Romanian banking system has also a large exposure to their own sovereign debt (one of the highest in the EU at around 20 percent of assets in 2017), that could lead to valuation losses in the event of interest rate increases. Finally, despite declining considerably since 2011, about 35 percent of banks' liabilities and assets remain denominated in foreign exchange (FX), and FX liquidity risks can exist within an environment of ample overall liquidity.

31. **Drawing on the conclusions of the ongoing Financial Sector Assessment Program (FSAP), staff recommended macroprudential policies to address these vulnerabilities** (Annex V):

- *A Debt-Service-to-Income (DSTI) limit on mortgage lending would mitigate risks from the exposure of banks to the real estate sector*. An appropriately set DSTI limit can boost borrowers' resilience and should be imposed on all mortgages, including those made under the Prima Casa program. In this context, staff welcomed the government's strategy to gradually scale back the program.

- *Carefully calibrated capital surcharges could address vulnerabilities from sovereign exposures*. Capital surcharges—preferably the Systemic Risk Buffer—should be calibrated carefully to increase the resilience of the banking system while avoiding unintended market impacts.

- *FX liquidity risks need a more proactive management.* Monitoring a currency-differenciated Net Stable Funding Ratio and imposing a currency differenciated Liquidity Coverage Ratio can help mitigate these risks.

- *The National Committee for Macroprudential Oversight (NCMO) should strengthen its accountability framework.* Staff welcomed recent steps in this direction, including developing a common assessment of systemic risk at each NCMO meeting and publicly disclosing proposed policy actions and voting distribution.

32. Supervisory practices and the crisis management framework need bolstering. The processes supporting banks' supervisory review should be further developed, and the framework for Emergency Liquidity Assistance should be finalized and implemented. The central bank should establish liquidity facilities for the Bank Deposit Guarantee Fund. Given the increasing market share of non-bank financial lenders (NBFLs) (10 percent of total loans in 2017), staff recommended aligning the provisioning regime across banks and NBFLs to mitigate credit risks and avoid reputational risk to the financial system more broadly. Recent regulation adopted by the NBR to strengthen oversight of the larger NBFLs is encouraging.

33. Staff warned against legislative initiatives that could harm the financial system. Several recent initiatives would, if enacted, reduce the amount of credit provided to the real economy and slow the resolution of NPLs, thereby adversely affecting financial stability. This includes the proposed caps on interest rates for household lending, as well as several measures that adversely affect the functioning of the market for NPLs, such as allowing individuals to repurchase debt from debt collectors at a legislated maximum amount. The mission encouraged the authorities to carefully assess legislative initiatives affecting the financial system and examine their implications on the provision of credit.

Authorities' Views

34. The NBR agreed with the main vulnerabilities identified by the ongoing FSAP and welcomed its recommendations. Initial steps have been taken to implement most of the FSAP recommendations. The NCMO will likely take more time to adopt capital surcharges for banks' sovereign debt holdings that would require a careful assessment of their impact on the debt market.

The NBR has responded proactively to legislative initiatives that could harm the financial system by providing impact assessments.

STAFF APPRAISAL

35. Economic growth in Romania has been strong in recent years, but policy changes will be required to protect policy buffers. Record low unemployment and improved financial sector conditions have accompanied one of the highest growth rates in the EU in 2017. However, signs of overheating have emerged, with higher inflation and twin deficits chipping away the resilience to shocks, even if Romania's external position is still broadly in line with underlying fundamentals. Moreover, investment has lagged consumption and structural reforms have slowed, hampering broader and more inclusive convergence with the advanced EU countries over the medium term.

36. A smaller-than-budgeted fiscal deficit would improve the fiscal-monetary policy mix and increase medium-term resilience. Bringing the 2018 deficit below a cyclically neutral level would reduce the burden on monetary policy and improve the balance between consumption and investment. If the task of macroeconomic stabilization is left to monetary policy alone, interest rates would have to be raised to a level that will increasingly weigh on investment and competitiveness. A lower deficit in 2018 would also be a first step towards reaching Romania's medium-term budgetary objective under EU rules.

37. Relative to current policies, additional measures will likely be needed to meet the authorities' budget deficit target of 3 percent of GDP in 2018, let alone a more desirable and lower deficit target recommended by staff. These measures should avoid a further deterioration of the budget structure and protect capital spending, to break away from the squeezing of capital spending and the increase in the share of rigid spending in recent years. It is also important to stop the decline in tax revenues over the past several years, which was largely due to tax rate cuts and weakening tax compliance.

38. Improving the efficiency of fiscal policy would help support future consolidation and improve the budget's composition. Romania's declining and comparatively low tax revenue highlights the importance of effective revenue mobilization and expenditure management. Tax changes need to be made more predictable and less frequent and further tax rate cuts should be avoided. Tax collection efficiency could be improved, including by reforming tax administration for the VAT and operationalizing new IT infrastructure in revenue administration. Expenditure efficiency should be bolstered, including by undertaking expenditure reviews for key sectors and adopting a centralized procurement system. Continuing efforts to improve EU funds absorption, especially at line ministries, would help increase total capital spending while supporting fiscal consolidation.

39. The central bank should continue tightening monetary policy to curb inflation and anchor expectations, given that inflation is expected to remain elevated through most of 2018. The recent monetary tightening was a welcome start, and the NBR should continue raising the policy rate in a frontloaded manner, while also managing liquidity to align the market and policy rates. Central bank independence should continue to be upheld, buttressing monetary policy credibility. Interventions in the foreign exchange market should be limited to smoothing excessive volatility.

40. Structural reforms should be re-energized to strengthen growth potential and accelerate convergence. Strengthening public investment management institutions is a priority for absorbing EU funds more effectively and addressing Romania's large infrastructure gap. Improving SOE performance requires a renewed commitment to strong corporate governance—including the governance standards codified in Law 111—and ongoing restructuring. Plans to establish a sovereign investment fund and a development bank should reflect international experiences on the risks associated with such entities and base their design on best practices. Establishing a transparent minimum wage mechanism, based on a set of objective criteria, would help balance social and competitiveness implications. Romania's progress in the fight against corruption has been recognized internationally and needs to continue.

41. Implementing the FSAP recommendations will help to further improve the resilience of the banking sector. While banks are well capitalized and liquid with NPLs now close to EU averages, vulnerabilities arise from the exposure of banks to the government and the real estate sector. These vulnerabilities could be addressed with macroprudential policies, including a debt-service-to-income limit on mortgage lending, a carefully calibrated capital surcharge for sovereign exposures, and more proactive management of FX liquidity risks. Bolstering supervisory practices and the crisis management framework are also recommended, including finalizing the framework for Emergency Liquidity Assistance and aligning provisioning regimes across banks and NBFLs. Meanwhile, legislative initiatives that harm the financial system should be avoided.

42. It is recommended to hold the next Article IV consultation on the standard 12-month cycle.

Box 1. The Unified Wage Law and Change to Social Security Contributions

In June 2017, the Romanian parliament adopted the Unified Wage Law (UWL) to significantly raise public wages. The implementation began in January 2018, with the full effects expected to materialize in 2022. The law, which seeks to eliminate distortions in the public remuneration system, implies a large increase in average public wages and carries significant fiscal costs (CR/17/133).

To mitigate the fiscal costs associated with the UWL, the authorities have adopted a change in the labor taxation system. This change requires employees to pay the largest part of the employer share of social security contributions, which reduced the gross impact of the UWL over 2018-2022. To help ensure the employer's cost and net wages in the private sector are not negatively affected, the social security contributions and PIT rates were reduced (by 2 and 6 percentage points, respectively). If these changes are matched by about 20 percent increase in the gross (before-tax) wages, the tax wedge and net wage would not change. Although these changes can thus be broadly neutral for the private sector, they create uncertainty on ultimate outcomes, increase administrative costs, and undermine the predictability of tax policy.

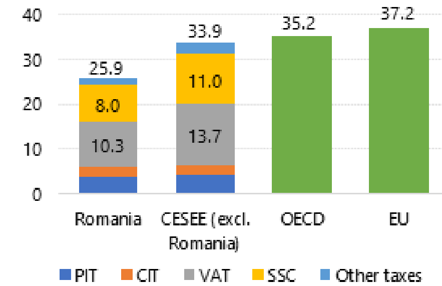
Illustration:

Shift of Social Security Contributions

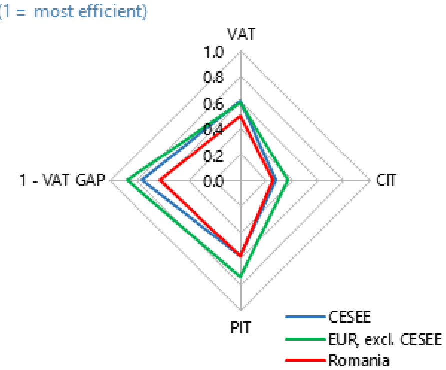
	Baseline	Proposed SSC shift
Gross wage (before taxes)	**3,000**	**3,601**
Social Security Contributions Rates	39.3%	37.3%
Employer	22.8%	2.3%
Employee	16.5%	35.0%
Personal Income Tax	16%	10%
Net wage (take home)	**2,104**	**2,106**
Labor cost to employer	**3,683**	**3,682**
Total taxes to state	**1,578**	**1,575**
Social Security Contributions	1,178	1,341
Personal Income Tax	401	234
Tax wedge	42.9%	42.8%

Box 2. Options for Tax Revenue Mobilization

Tax collection in Romania is low compared to peers, mostly due to lower collection of value added tax (VAT) and social security contributions. In addition, tax revenue in Romania dropped by about 2 percentage points of GDP since 2007. This box summarizes the findings of a Selected Issues Paper.



While the tax rates are broadly aligned with peers in CESEE, tax efficiency lags behind, especially for VAT. The VAT C-efficiency indicator in Romania (0.5) is lower than in other CESEE or advanced EU countries (0.6). This efficiency gap reflects Romania's VAT compliance gap (which measures the effectiveness of the tax administration), which is the largest in the EU (37 percent). Closing this gap with respect to other CESEE countries could raise VAT collection in Romania by 2 percentage points of GDP. For other main taxes, such as the personal income tax (PIT) and corporate income tax (CIT), efficiency indicators in Romania are close to other CESEE countries but still below advanced EU countries.



Sources: OECD; and IMF staff calculations.

Strengthening tax administration is crucial to improving tax collection efficiency in Romania. Revenue administrations in countries with the highest tax collection efficiency have developed into full service-oriented revenue bodies, simplifying the fulfilment of tax liabilities through extended use of information technology. Implementing and operationalizing new IT infrastructure in Romania is a key priority, given its outdated and fragile systems. In addition, legislative, procedural, and structural constraints keep limiting the effectiveness of the administration of large taxpayers. There are yet also no strategies or processes in place to direct operational efforts towards mitigating the key compliance risks that make up the bulk of the tax gap.

Romania improved the growth-friendliness of its revenue structure since the global financial crisis, but the recent changes to the tax system seem harmful to growth. The tax burden shifted away from growth-harmful taxes—revenue from income taxes and social security contributions dropped by 2 percentage points of GDP over 2008-16. Up until 2011, this revenue loss was compensated with broadly neutral forms of taxation—especially VAT. However, the more recent changes to the system of social security contributions (Box 1) together with the continuous reduction in VAT collection since 2011 could be growth-harmful. Furthermore, the reduction in overall tax revenue has undermined public investment, which has negative implications for growth.

Box 3. Illustrating an Alternative Macroeconomic Policy Mix 1/

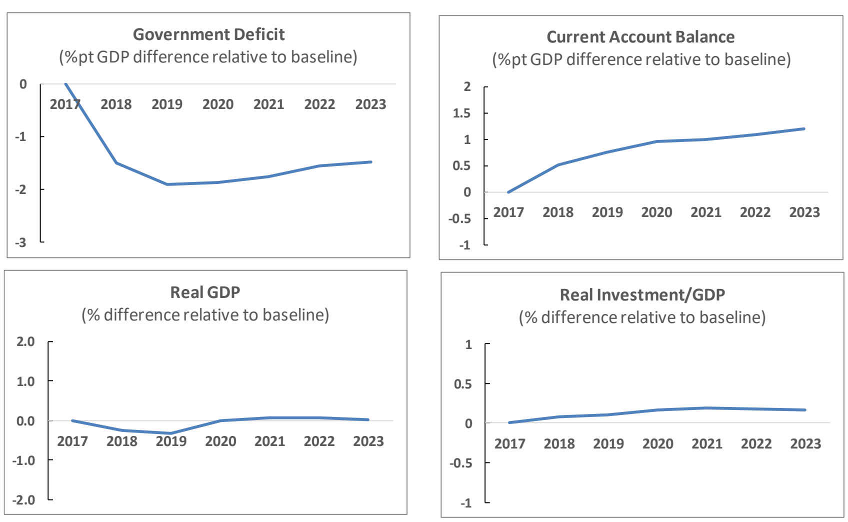
Baseline shows continued imbalances in the policy mix. The Flexible System of Global Models (FSGM) provides a useful analytical tool to simulate the impact from the mix of fiscal and monetary policies on the Romanian economy, which is growing above potential.[2] In staff's baseline with fiscal deficits around 3 percent of GDP into the medium term and even substantial monetary tightening, inflation remains around the top-end of the target band and fiscal buffers are further eroded, thus increasing vulnerability.

Combining fiscal moderation into the policy mix. An alternative scenario illustrates fiscal consolidation that targets the fiscal deficit below the cyclically neutral level – close to two percent of GDP in 2018, and 1½ percent of GDP into the medium term. The fiscal package of measures is designed to be growth friendly, centered on tax reforms to raise collections (e.g. reduce the VAT compliance gap) and streamlining of expenditures for efficiency, while protecting public investment. Monetary policy tightening is calibrated to the fiscal trajectory to keep inflation within the target band.

Results. The improved policy mix helps strengthen fiscal and external balances, while supporting lower inflation. The fiscal tightening would temporarily have a negative impact on growth, but allow monetary policy to be more accommodative compared to the baseline scenario, which would partially offset fiscal tightening and result in a small combined aggregate effect on growth. This mix would also avoid interest rates having to be raised to levels that weigh on private investment and competitiveness, thus supporting improved potential growth in the medium term. The public debt-to-GDP ratio would be reduced by about 9 percentage points over the medium term. Furthermore, this simulation is conservative and does not reflect that part of the recommended fiscal adjustment is embedded in measures to improve the tax system and public administration, which would help enhance economic efficiency, better the business environment, and ease shortages in the labor market.

Medium term impact of the Macroeconomic Policy Mix, 2017-23

Fiscal package and endogenous monetary policy

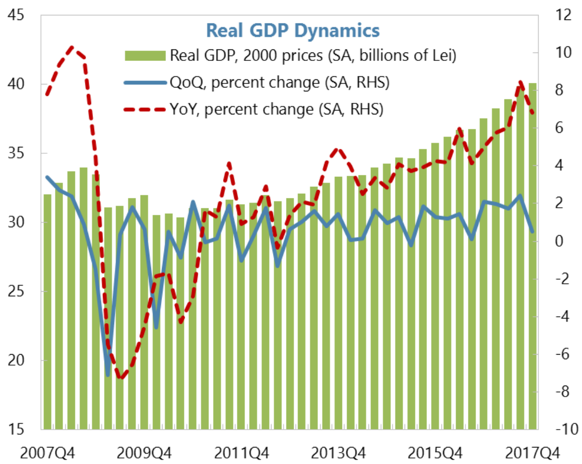


1/ Prepared by Zoltan Jakab (RES) and Seng Guan Toh (EUR)

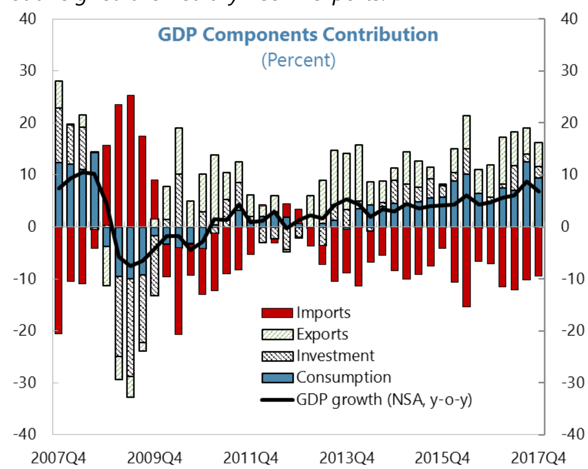
2/ The FSGM is a system of models developed by staff in the IMF Research Department. See "The Flexible System of Global Models—FSGM," IMF Working Paper 15/64 at https://www.imf.org/~/media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/wp/2015/ wp1564.ashx

Figure 3. Romania: Real Sector, 2007–18

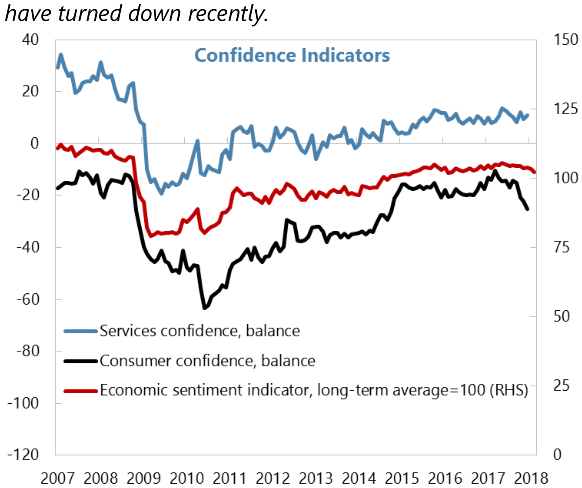
The economy is on a cyclical upswing...



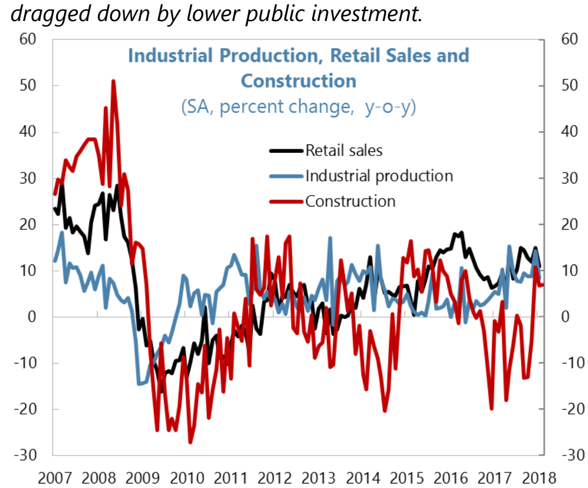
... mainly driven by consumption growth. Imports growth outweighed the healthy rise in exports.



Services confidence indicators remain near post-crisis highs, but economic sentiment and consumer confidence have turned down recently.



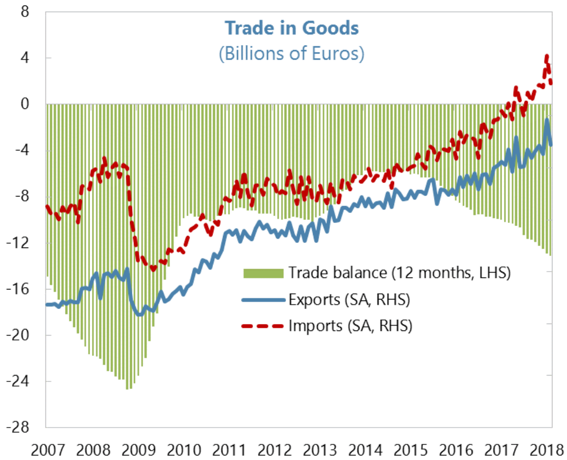
In 2017, retail sales and industrial production reflected stronger economic activity, while construction works were dragged down by lower public investment.



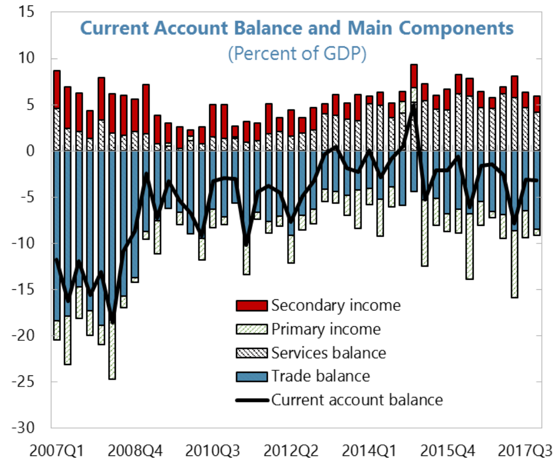
Sources: Haver Analytics; and IMF staff calculations.

Figure 4. Romania: External Sector, 2007–18

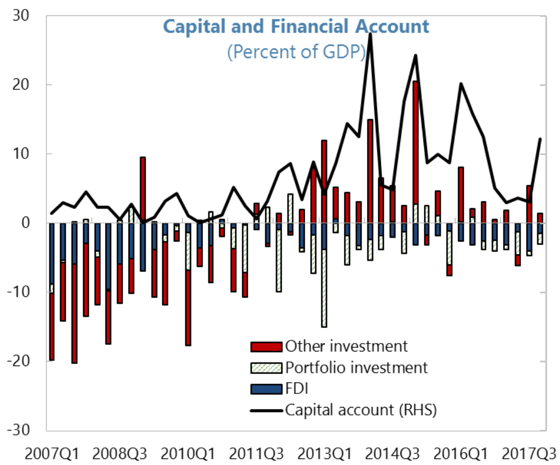
The trade balance in goods deteriorated further in 2017 due to a pickup in imports…



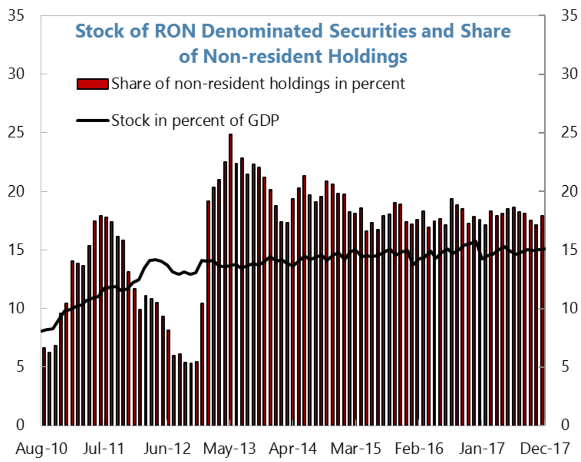
…and contributed to a widening current account deficit.



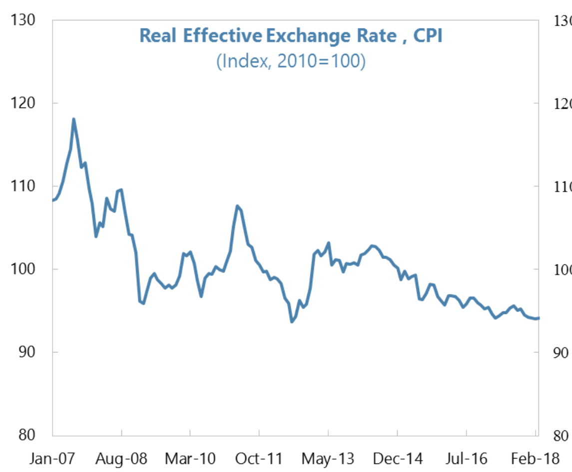
Net FDI flows were sustained due to reinvestment of earnings.



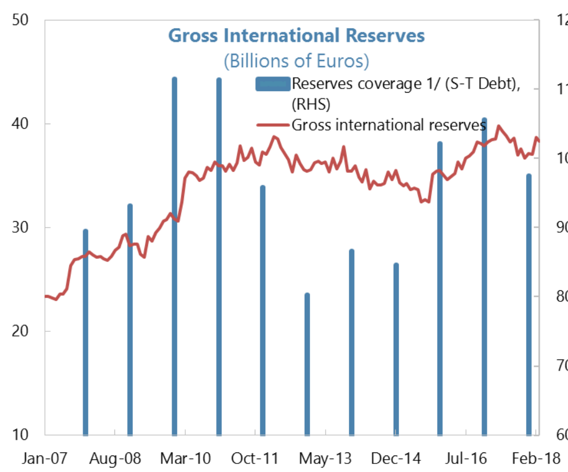
Non-resident holdings of government debt have remained substantial.



The real exchange rate depreciated in 2017.



Foreign reserve coverage remains broadly adequate.

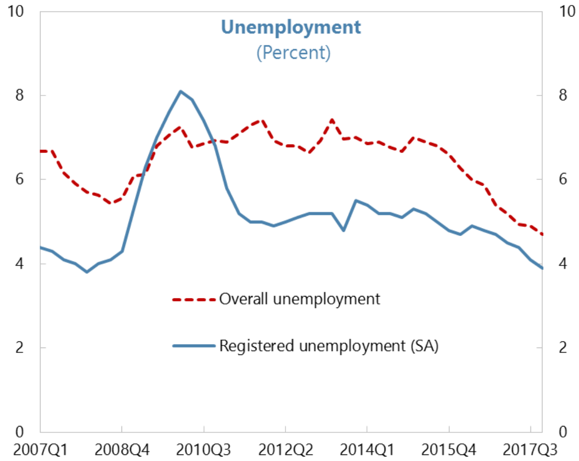


Sources: Haver Analytics; National Bank of Romania, IMF Information Notice System (INS); and IMF staff calculations.

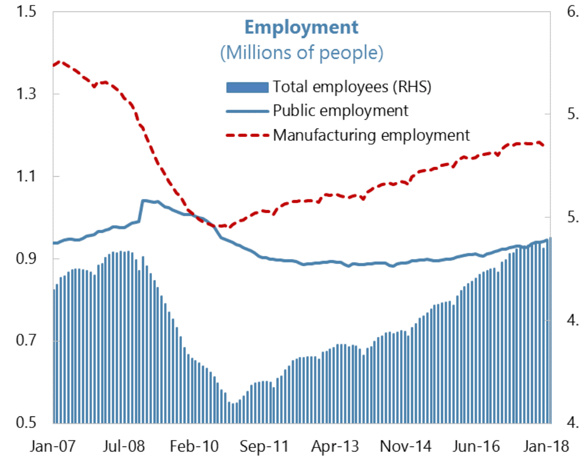
1/ Reserves coverage is based on end-of-year data.

Figure 5. Romania: Labor Market, 2007–18

The unemployment rate has continued to fall.

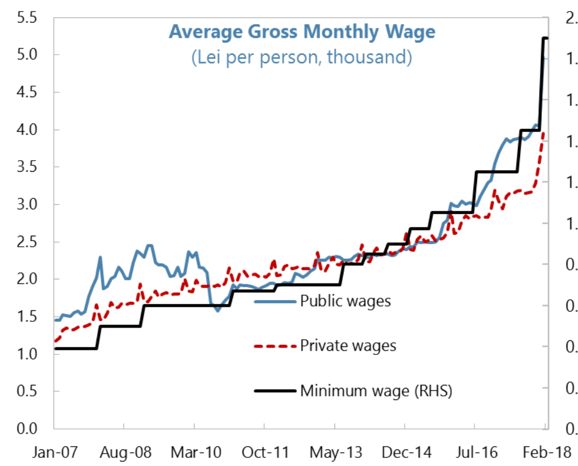


The number of employees has exceeded pre-crisis levels.

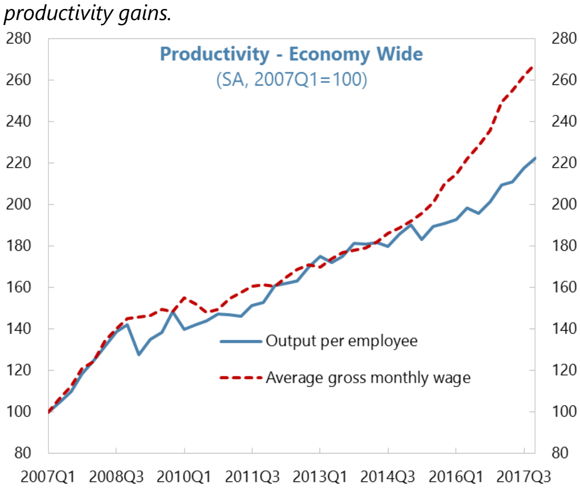


Real wage growth has been elevated …

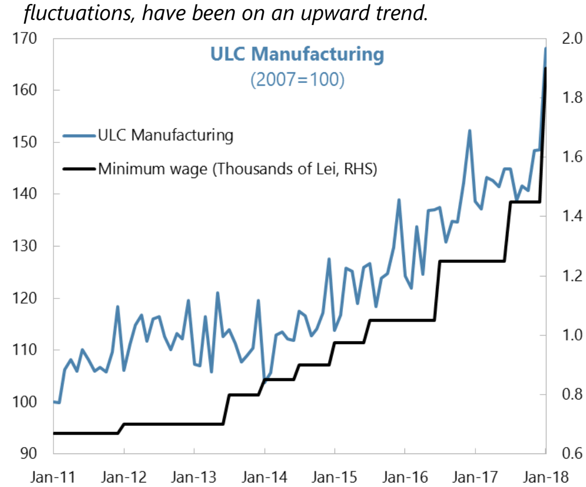
… owing to large public sector and minimum wages hikes.



Recent wage increases have exceeded the economy-wide productivity gains.



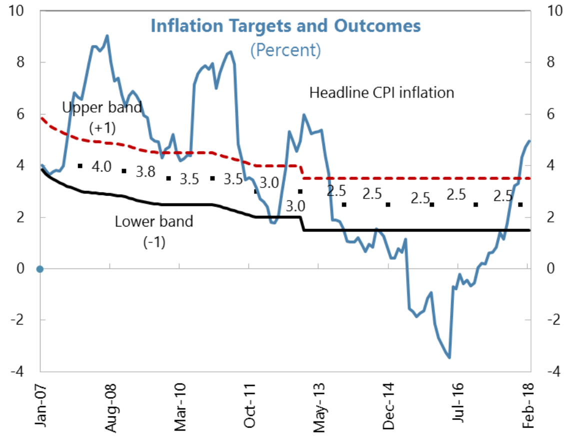
Unit labor costs in the manufacturing sector, despite large fluctuations, have been on an upward trend.



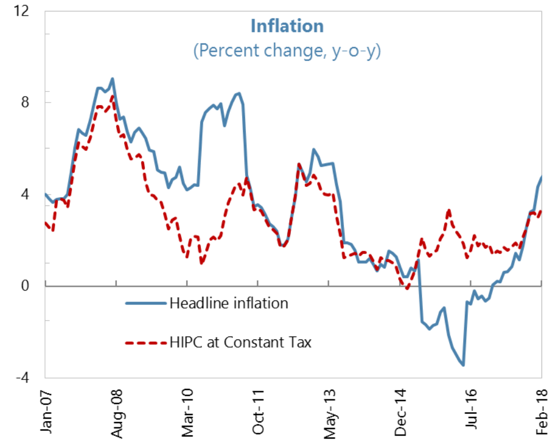
Sources: Eurostat, Haver Analytics; and IMF staff calculations.

Figure 6. Romania: Monetary Sector, 2007–18

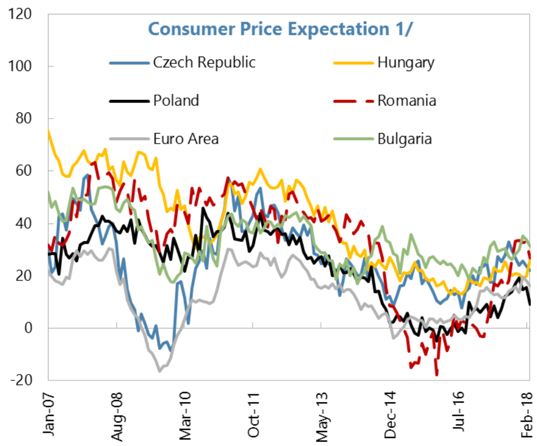
Headline inflation has risen back to the target band, and exceeded the band since January partly on base effects...



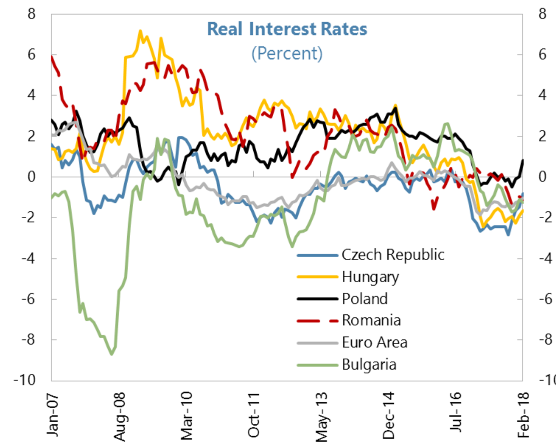
... while underlying inflation, adjusted for recent indirect tax changes, has also risen.



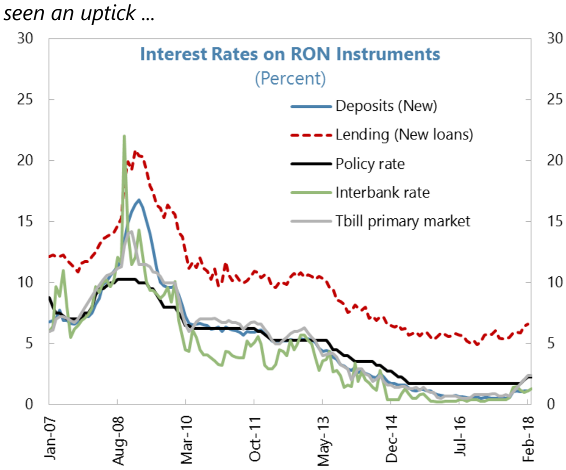
Inflation expectations across the region have risen.



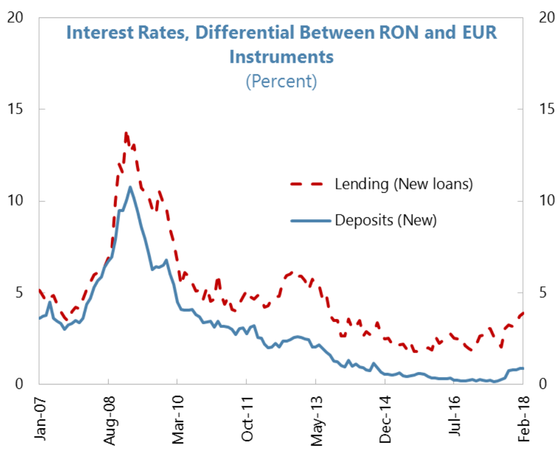
The policy rate was raised in January and February 2018, with rates also raised in the Czech Republic recently, but real rates remain low.



... and interest rates for domestic currency instruments have seen an uptick ...



... widening the differential with the rates on Euro-denominated instruments.

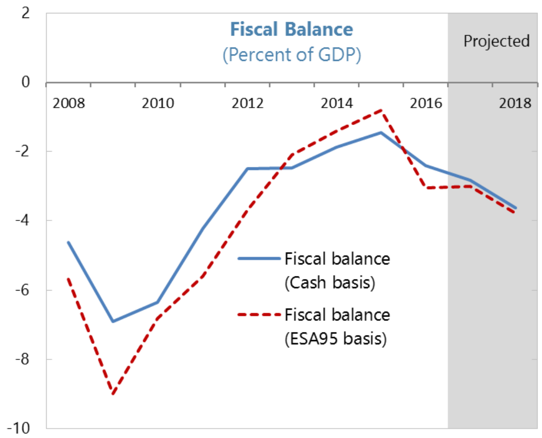


Sources: Haver Analytics; National Bank of Romania; Eurostat; Consensus Forecast; and IMF staff estimate.

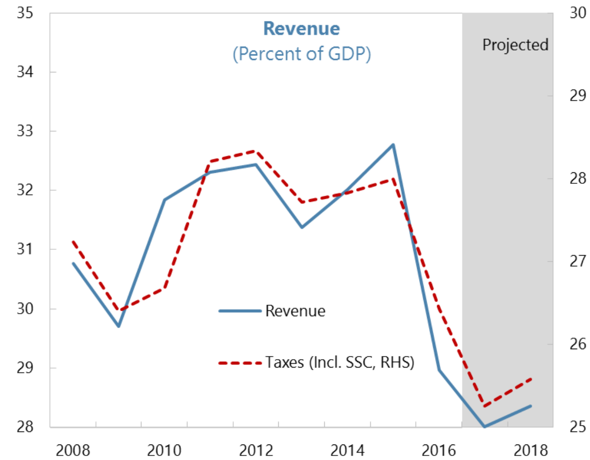
1/ Equals to the percentage of favourable answers minus the percentage of unfavourable answers in the survey on price trends over next 12-months.

Figure 7. Romania: Fiscal Operations, 2008–18

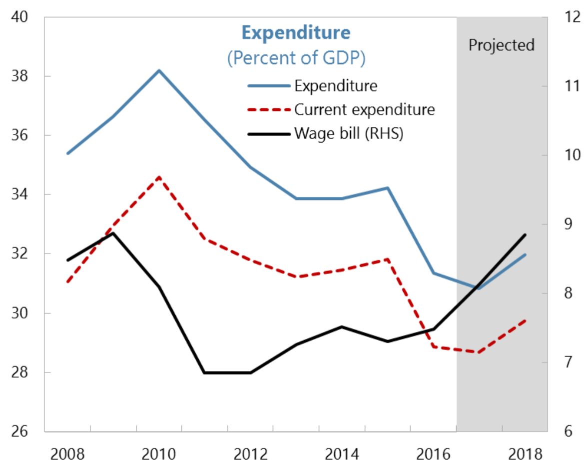
The fiscal deficit deteriorated further in 2017…



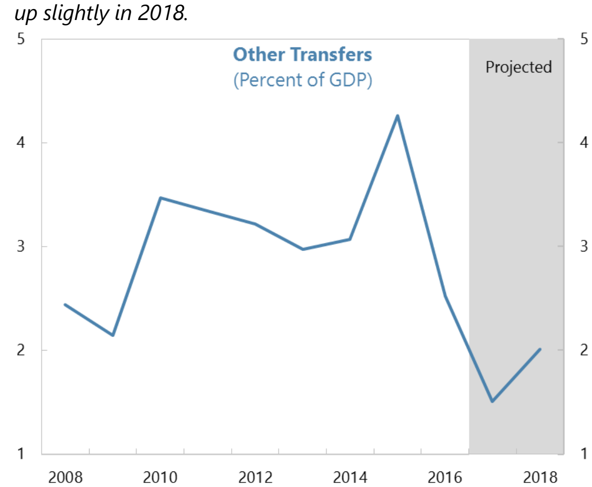
…due to further tax cuts…



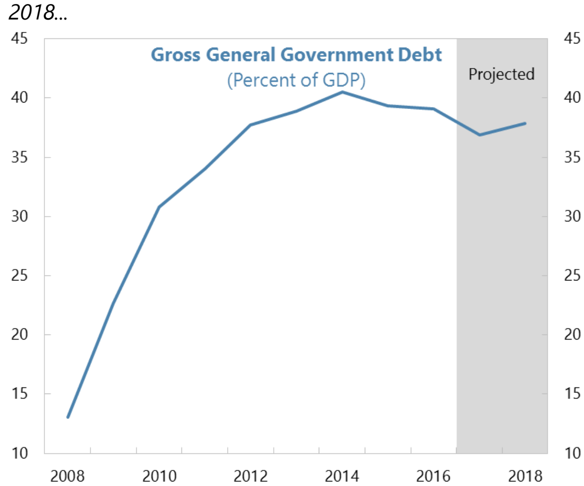
…and increases in public wages, pensions, and social transfers.



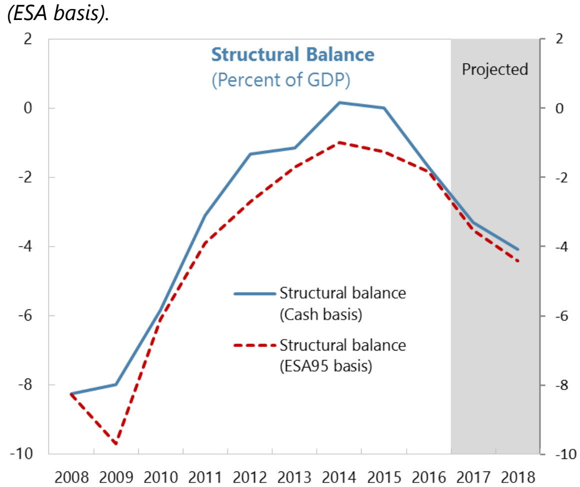
Absorption of EU funds dropped further in 2017, but is to pick up slightly in 2018.



After declining in 2017, debt is expected to tick up slightly in 2018…



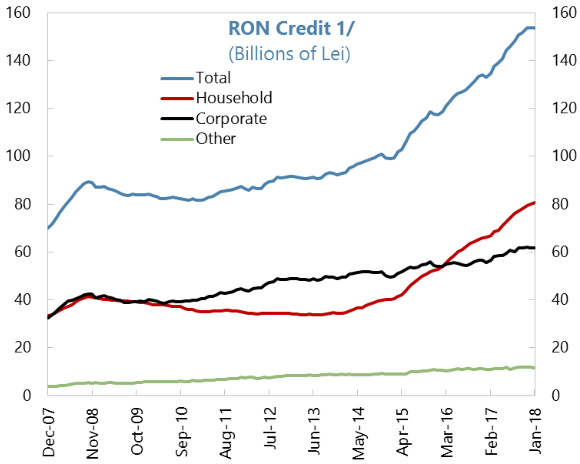
…while the structural deficit widens beyond 4 percent of GDP (ESA basis).



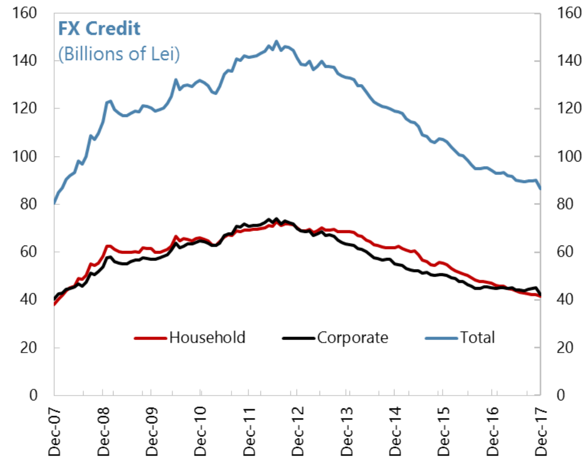
Sources: Romanian authorities; and IMF staff estimates and projections.

Figure 8. Romania: Financial Sector, 2007–18

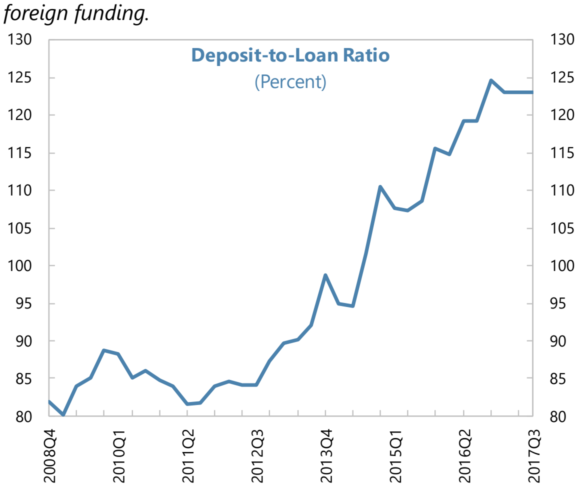
Local currency lending has been picking up...



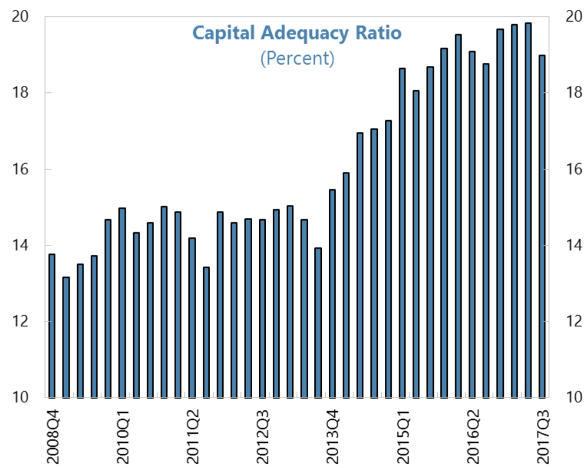
...as the share of FX loans in total credit declines.



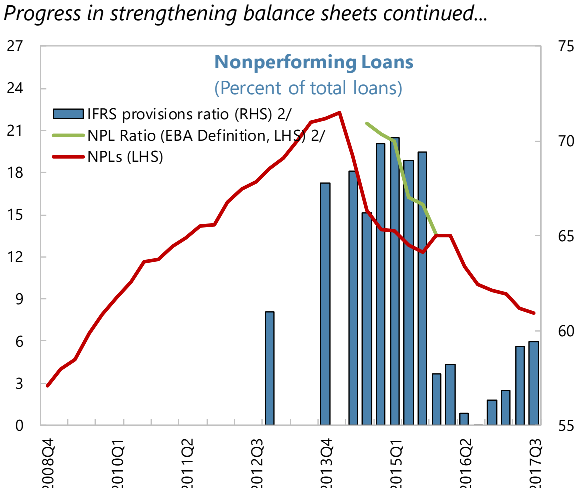
The increase in domestic deposits allows banks to rely less on foreign funding.



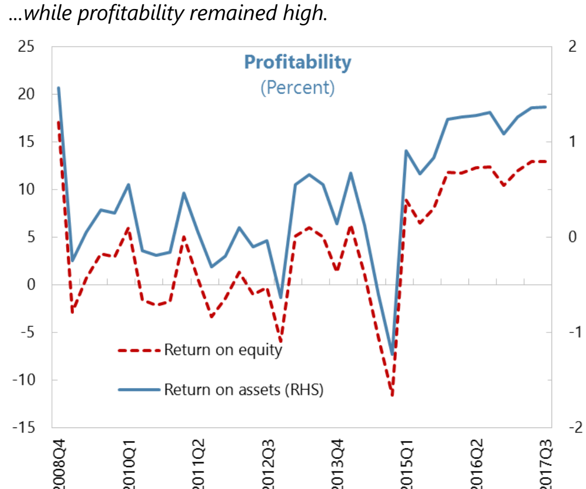
Capital buffers are substantial.



Progress in strengthening balance sheets continued...



...while profitability remained high.



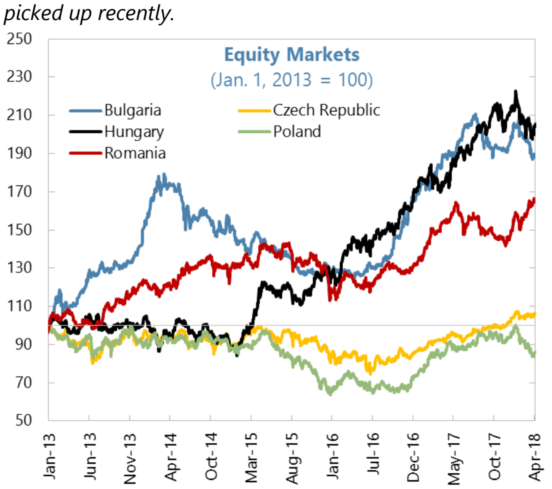
Sources: Dxtime; and National Bank of Romania.

1/ Excludes credit to central government.

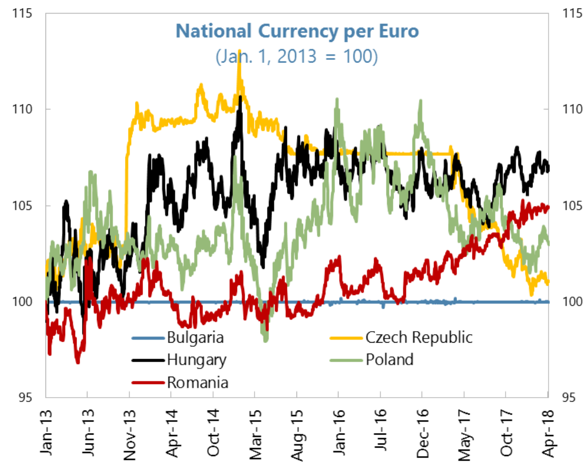
2/ In December 2015, the NBR moved from a national definition to an EBA methodology-based definition of NPL's.

Figure 9. Romania: Financial Developments, 2013–18

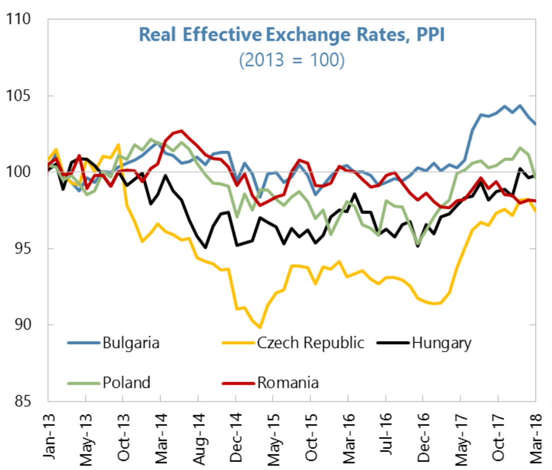
Romania's stock market index has been tepid in 2017, but picked up recently.



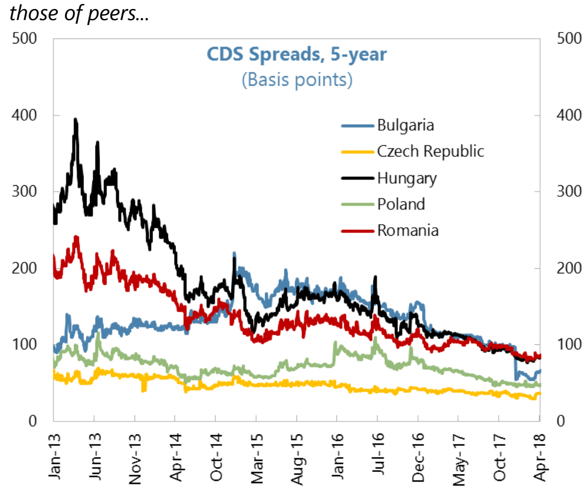
The leu has depreciated vis-a-vis Euro since September 2016...



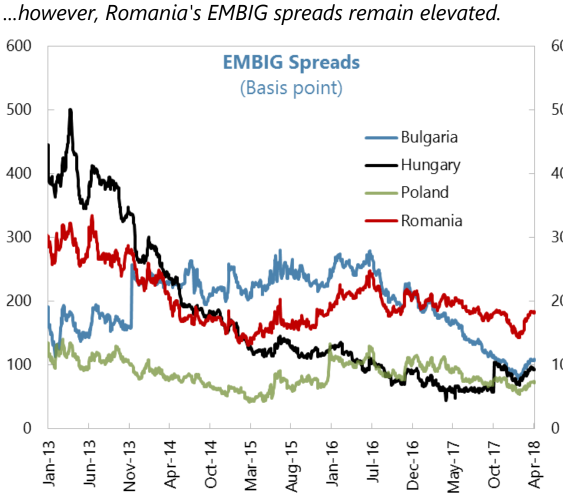
...albeit relatively stable in real terms.



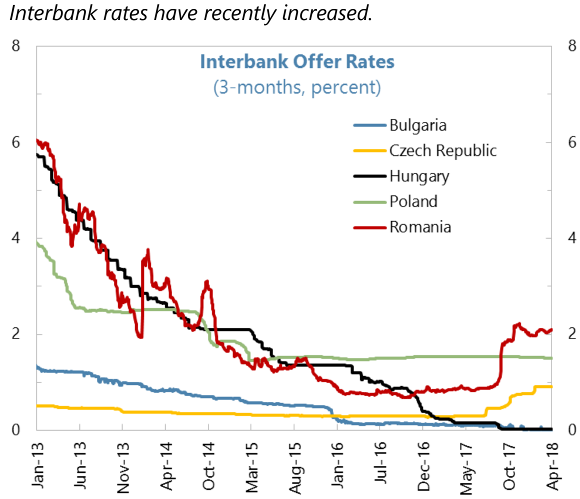
Romania's CDS spread has remained broadly in line with those of peers...



...however, Romania's EMBIG spreads remain elevated.



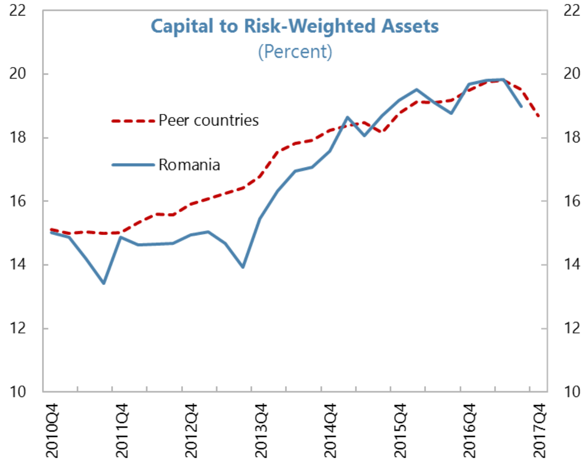
Interbank rates have recently increased.



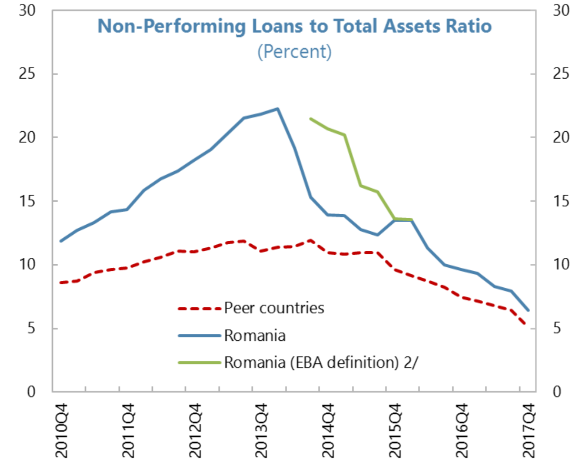
Sources: Bloomberg; and Haver Analytics.

Figure 10. Romania and Peer Countries: Financial Soundness Indicators, 2010-18 1/

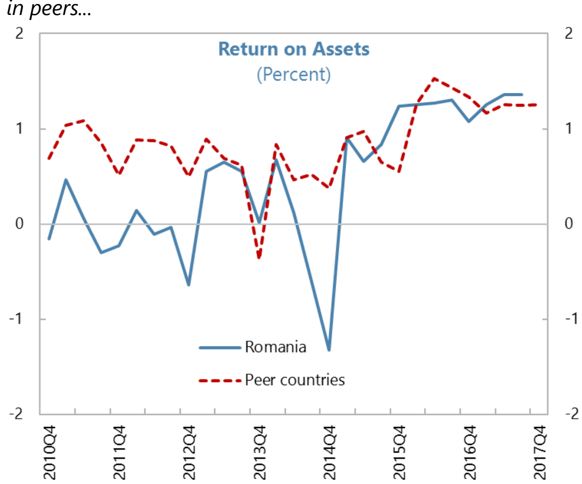
Romanian banks remain well capitalized on average.



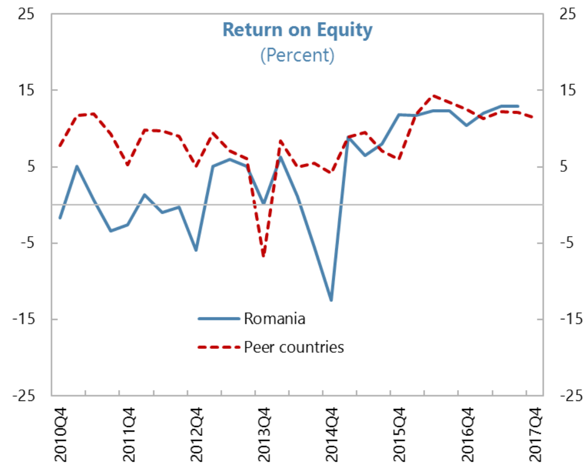
Asset quality has been weaker than in peers, but a balance sheet clean-up is well advanced.



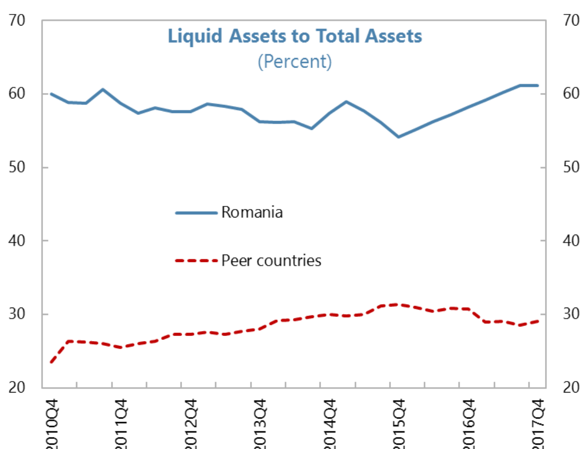
This has weighed on bank profitability more in Romania than in peers…

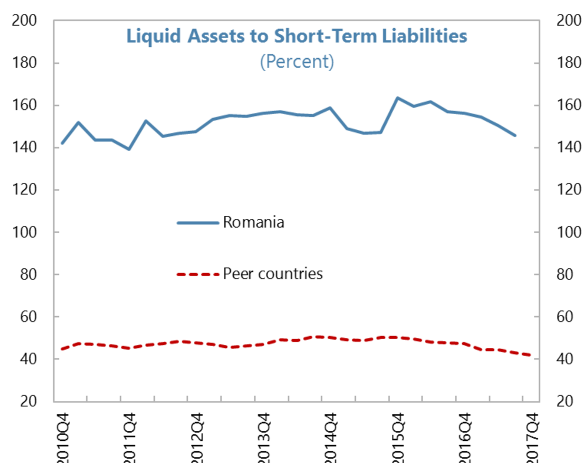


…but profitability has recovered recently.



Romanian banks are generally very liquid.





Sources: Haver Analytics; and National Bank of Romania.

1/ Unweighted average of Bulgaria, Croatia, Czech Republic, Hungary, Poland, Slovakia and Slovenia.

2/ In December 2015, the NBR moved from a national definition to an EBA methodology-based definition of NPL's.

Table 1. Romania: Selected Economic and Social Indicators, 2012–19

	2012	2013	2014	2015	2016	2017	2018	2019
						Prel.	Proj.	Proj.
Output and prices 1/			(Annual percentage change)					
Real GDP	1.2	3.5	3.1	4.0	4.8	6.9	5.1	3.5
Contributions to GDP growth								
Domestic demand	0.1	-0.1	3.4	5.4	5.3	7.7	6.3	3.6
Net exports	1.1	3.6	-0.3	-1.4	-0.5	-0.7	-1.3	-0.1
Consumer price index (CPI, average)	3.3	4.0	1.1	-0.6	-1.6	1.3	4.7	3.1
Consumer price index (CPI, end of period)	5.0	1.6	0.8	-0.9	-0.5	3.3	3.5	3.2
Core price index (CPI, end of period)	3.3	-0.1	1.1	-3.1	0.3	2.4	3.2	3.2
Producer price index (average)	5.4	2.1	-0.1	-2.2	-1.8	3.5	...	...
Unemployment rate (average)	6.8	7.1	6.8	6.8	5.9	4.9	4.6	4.6
Nominal wages	5.0	5.0	5.3	8.5	12.8	14.8	11.0	9.6
Saving and Investment			(In percent of GDP)					
Gross domestic investment	26.8	25.6	24.7	25.2	24.0	24.4	23.1	22.8
Gross national savings	22.1	24.5	24.0	23.9	21.9	21.1	19.4	19.1
General government finances 2/								
Revenue	32.4	31.4	32.1	32.8	29.0	27.9	28.0	28.6
Expenditure	34.9	33.9	33.8	34.2	31.4	30.8	31.6	32.0
Fiscal balance	-2.5	-2.5	-1.7	-1.5	-2.4	-2.8	-3.6	-3.4
External financing (net)	3.2	2.1	1.9	-0.5	0.7	0.8	0.9	0.8
Domestic financing (net)	0.9	1.4	1.2	0.8	1.3	1.2	2.7	2.6
Primary balance	-0.7	-0.8	-0.2	-0.2	-1.1	-1.7	-2.3	-2.1
Structural fiscal balance 3/	-1.3	-1.1	0.2	0.0	-1.7	-3.4	-4.2	-3.9
Gross public debt (including guarantees)	37.7	38.9	40.5	39.3	39.0	36.8	37.3	38.4
Money and credit			(Annual percentage change)					
Broad money (M3)	2.7	8.8	8.4	9.3	9.7	11.6	9.5	9.1
Credit to private sector	1.3	-3.3	-3.4	3.0	1.2	5.6	5.1	4.3
Interest rates, eop			(In percent)					
NBR policy rate	5.25	4.0	2.50	1.75	1.75	1.75	...	...
NBR lending rate (Lombard)	9.25	7.0	4.75	4.25	3.25	2.75	...	...
Interbank offer rate (1 week)	5.9	1.8	0.7	0.6	0.6	1.5	...	...
Balance of payments			(In percent of GDP)					
Current account balance	-4.8	-1.1	-0.7	-1.2	-2.1	-3.4	-3.7	-3.7
Merchandise trade balance	-6.9	-4.0	-4.3	-4.9	-5.5	-6.3	-6.8	-6.7
Exports (goods)	29.9	30.4	31.1	30.6	30.7	30.4	30.8	30.9
Imports (goods)	-36.8	-34.4	-35.5	-35.5	-36.2	-36.8	-37.6	-37.7
Capital account balance	1.4	2.1	2.6	2.4	2.5	1.2	1.3	1.4
Financial account balance	-2.6	-3.0	0.1	0.4	-0.7	-2.0	-2.9	-2.4
Foreign direct investment balance	-1.9	-2.0	-1.8	-1.8	-2.7	-2.4	-2.4	-2.4
International investment position	-67.8	-61.7	-56.9	-53.6	-49.3	-45.7	-45.9	-45.4
Gross official reserves	26.5	24.6	23.6	22.1	22.3	19.7	18.4	17.2
Gross external debt	75.5	68.0	63.0	57.4	54.7	49.7	48.8	47.1
Exchange rates								
Lei per euro (end of period)	4.4	4.5	4.5	4.5	4.5	4.7	...	...
Lei per euro (average)	4.5	4.4	4.4	4.4	4.5	4.6	...	...
Real effective exchange rate								
CPI based (percentage change)	-6.0	4.7	0.3	-3.6	-1.8	-1.6	...	...
GDP deflator based (percentage change)	-4.8	4.1	0.9	-0.5	1.8	1.9	...	...
Memorandum Items:								
Nominal GDP (in bn RON)	595.4	637.5	668.1	712.7	762.3	858.3	934.4	996.6
Potential output growth	2.8	2.8	3.2	3.3	3.5	3.7	3.7	3.7

Social and Other Indicators

GDP per capita: US$10,782 (2017); **GDP per capita, PPP:** current international $23,027 (2016)

People at risk of poverty or social exclusion: 38.8% (2016)

Sources: Romanian authorities; IMF staff estimates and projections; World Development Indicators database, Eurostat.

1/ Staff's inflation projections assume monetary tightening.

2/ General government finances refer to cash data.

3/ Fiscal balance (cash basis) adjusted for the automatic effects of the business cycle and one-off effects.

Table 2. Romania: Medium-Term Macroeconomic Framework, Current Policies, 2014–23

	2014	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Prel.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
GDP and prices (annual percent change)										
Real GDP	3.1	4.0	4.8	6.9	5.1	3.5	3.1	3.1	3.1	3.1
Agriculture 1/	4.0	-10.6	2.1	15.3	…	…	…	…	…	…
Non-Agriculture 1/	3.1	5.2	5.3	6.3	…	…	…	…	…	…
Real domestic demand	3.4	5.4	5.3	7.6	6.7	3.4	3.0	2.8	3.1	3.2
Consumption	4.0	4.9	6.8	8.4	5.6	3.6	3.0	2.8	2.9	3.2
Investment	3.2	7.4	-2.0	4.7	4.6	2.9	2.9	3.0	3.7	3.1
Exports	8.0	4.6	8.7	9.7	7.1	6.8	6.3	6.4	6.4	6.3
Imports	8.7	8.0	9.8	11.3	9.0	6.3	5.7	5.5	6.1	6.1
Consumer price index (CPI, average) 2/	1.1	-0.6	-1.6	1.3	4.7	3.1	3.1	3.1	3.1	3.1
Consumer price index (CPI, end of period) 2/	0.8	-0.9	-0.5	3.3	3.5	3.2	3.1	3.1	3.1	3.1
Saving and investment (in percent of GDP)										
Gross national saving	24.0	23.9	21.9	21.1	19.4	19.1	19.3	19.3	19.4	19.3
Gross domestic investment	24.7	25.2	24.0	24.4	23.1	22.8	22.9	22.9	22.9	22.8
Government	5.3	6.2	3.8	3.1	3.8	3.9	4.0	4.4	4.6	4.5
Private	19.4	18.9	20.2	21.3	19.3	18.9	18.9	18.5	18.3	18.3
General government (in percent of GDP)										
Revenue	32.1	32.8	29.0	27.9	28.0	28.6	28.7	28.9	28.9	28.7
Expenditure	33.8	34.2	31.4	30.8	31.6	32.0	32.0	32.2	32.2	31.9
Fiscal balance	-1.7	-1.5	-2.4	-2.8	-3.6	-3.4	-3.3	-3.3	-3.2	-3.2
Structural fiscal balance 3/	0.2	0.0	-1.7	-3.4	-4.2	-3.9	-3.7	-3.5	-3.2	-3.0
Gross general government debt (direct debt only)	38.1	37.1	36.8	34.8	35.5	36.7	37.8	38.9	39.8	40.7
Gross general government debt (including guarantees)	40.5	39.3	39.0	36.8	37.3	38.4	39.4	40.4	41.3	42.0
Monetary aggregates (annual percent change)										
Broad money (M3)	8.4	9.3	9.7	11.6	9.5	9.1	9.1	8.2	7.5	7.5
Credit to private sector	-3.4	3.0	1.2	5.6	5.1	4.3	4.2	4.5	4.7	4.8
Balance of payments (in percent of GDP)										
Current account	-0.7	-1.2	-2.1	-3.4	-3.7	-3.7	-3.6	-3.6	-3.5	-3.5
Trade balance	-4.3	-4.9	-5.5	-6.3	-6.8	-6.7	-6.6	-6.4	-6.4	-6.4
Services balance	3.9	4.2	4.6	4.2	4.2	4.2	4.3	4.4	4.4	4.5
Income balance	-1.3	-2.4	-2.6	-2.6	-2.7	-2.7	-2.8	-3.0	-3.1	-3.1
Transfers balance	1.1	1.7	1.5	1.4	1.6	1.6	1.5	1.5	1.6	1.6
Capital account balance	2.6	2.4	2.5	1.2	1.3	1.4	1.6	2.0	2.2	2.2
Financial account balance	0.1	0.4	-0.7	-2.0	-2.9	-2.4	-2.5	-2.8	-3.1	-3.4
Foreign direct investment, balance	-1.8	-1.8	-2.7	-2.4	-2.4	-2.4	-2.4	-2.6	-2.7	-2.8
Memorandum items:										
Gross international reserves (in billions of euros)	35.5	35.5	37.9	37.1	36.9	36.9	38.0	39.6	41.8	44.1
Gross international reserves (in months of next year's imports)	6.4	5.9	5.6	5.0	4.6	4.4	4.2	4.1	4.0	4.0
International investment position (in percent of GDP)	-56.9	-53.6	-49.3	-45.7	-45.9	-45.4	-44.5	-43.6	-42.7	-42.0
External debt (in percent of GDP)	63.0	57.4	54.7	49.7	48.8	47.1	45.9	44.8	42.9	41.0
Short-term external debt (in percent of GDP)	12.6	12.9	13.7	13.2	13.0	12.2	11.4	10.7	10.1	9.5
Terms of trade (merchandise, percent change)	0.9	2.6	0.6	-1.3	-0.3	-0.2	-0.1	-0.1	-0.1	-0.1
Nominal GDP (in billions of lei)	668.1	712.7	762.3	858.3	934.4	996.6	1,061.1	1,127.9	1,198.3	1,272.9
Output gap (percent of potential GDP)	-3.4	-2.8	-1.5	1.5	2.8	2.6	1.9	1.3	0.7	0.0
Potential GDP (percent change)	3.2	3.3	3.5	3.7	3.7	3.7	3.7	3.7	3.7	3.7

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

1/ Based on gross value added data from the National Institute of Statistics (NIS) in Romania. Note that there is a small discrepancy between the supply side GDP data from the NIS and the demand side data from Eurostat.

2/ Staff's inflation projections assume monetary tightening.

3/ Actual fiscal balance adjusted for the automatic effects related to the business cycle and one-off effects.

Table 3. Romania: Balance of Payments, 2014–19
(In billions of euros, unless otherwise indicated)

	2014	2015	2016	2017	2018	2019
				Prel.	Proj.	Proj.
Current account balance	-1.0	-2.0	-3.6	-6.3	-7.4	-7.8
Merchandise trade balance	-6.5	-7.8	-9.3	-11.9	-13.6	-14.4
Exports (f.o.b.)	46.8	49.1	52.2	57.2	61.7	66.3
Imports (f.o.b.)	53.4	56.9	61.5	69.1	75.4	80.7
Services balance	5.9	6.8	7.7	7.9	8.4	9.1
Exports of non-factor services	15.1	16.6	18.0	20.7	22.3	24.0
Imports of non-factor services	9.2	9.8	10.3	12.8	13.9	14.9
Primary income, net	-2.0	-3.8	-4.5	-5.0	-5.4	-5.8
Receipts	2.3	2.3	2.8	3.2	3.4	3.5
Payments	4.3	6.1	7.3	8.2	8.7	9.3
Secondary income, net	1.7	2.8	2.5	2.6	3.2	3.4
Capital account balance	4.0	3.9	4.3	2.2	2.7	3.1
Financial account balance	0.2	0.6	-1.2	-3.8	-5.9	-5.2
Foreign direct investment balance	-2.7	-3.0	-4.5	-4.6	-4.9	-5.2
Portfolio investment balance	-2.9	0.0	-0.9	-2.9	-3.0	-2.2
Other investment balance	5.8	3.6	4.3	3.7	2.0	2.2
General government	0.4	0.4	0.8	2.1	0.1	0.1
Domestic banks	4.1	2.4	4.1	2.3	2.7	2.5
Other private sector	1.3	0.8	-0.7	-0.4	-0.8	-0.5
Errors and omissions	0.1	0.4	0.8	0.7	0.0	0.0
Multilateral financing	0.3	-0.8	0.0	-0.7	-1.4	-0.5 .
European Commission	0.0	-1.5	0.0	-1.2	-1.4	-1.0 .
World Bank	0.3	0.8	0.0	0.5	0.0	0.5 .
Overall balance	3.2	0.9	2.7	0.4	1.2	0.5
Financing	-3.2	-0.9	-2.7	-0.4	-1.2	-0.5
Gross international reserves ("-": increase)	1.2	0.6	-2.3	-0.4	0.2	0.0
Use of IMF credit, net	-4.4	-1.5	-0.1	0.0	0.0	0.0
Purchases 1/	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-4.4	-1.5	-0.1	0.0	0.0	0.0
Other liabilities, net	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:	(In percent of GDP)					
Current account balance	-0.7	-1.2	-2.1	-3.4	-3.7	-3.7
Foreign direct investment balance	-1.8	-1.8	-2.7	-2.4	-2.4	-2.4
Merchandise trade balance	-4.3	-4.9	-5.5	-6.3	-6.8	-6.7
Exports	31.1	30.6	30.7	30.4	30.8	30.9
Imports	35.5	35.5	36.2	36.8	37.6	37.7
Gross external financing requirement	27.9	27.4	25.5	23.0	24.0	22.9
	(Annual percent change)					
Terms of trade (merchandise)	0.9	2.6	0.6	-1.3	-0.3	-0.2
Export volume	7.5	3.9	7.0	7.4	7.1	6.8
Import volume	8.4	10.1	9.6	9.0	9.0	6.3
Export prices	-1.5	0.2	-1.8	1.6	-0.3	0.5
Import prices	-2.4	-2.3	-2.4	2.9	0.0	0.7
	(In billions of euros)					
Gross international reserves 2/	35.5	35.5	37.9	37.1	36.9	36.9
Excluding IMF credit	35.5	35.4	37.9	37.1	36.9	36.9
of which: Excluding banks' required reserves						
GDP	150.3	160.3	169.8	187.9	200.6	214.2

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

1/ Includes IMF disbursement to the Treasury of €0.9 billion in 2009 and €1.2 billion in 2010.

2/ Operational definition, reflecting valuation effects and the allocation of SDR 908.8 million that was made available in two tranches in August and September 2009.

Table 4. Romania: Gross External Financing Requirements, 2014–19

(In billions of euros, unless otherwise indicated)

	2014	2015	2016	2017 Prel.	2018 Proj.	2019 Proj.
Total financing requirements 1/	**32.0**	**35.1**	**44.1**	**43.7**	**45.4**	**46.3**
Current account deficit	1.0	2.0	3.6	6.3	7.4	7.8
Short-term debt	21.0	19.9	30.3	26.2	26.3	27.2
Public sector	9.1	8.5	9.0	6.8	6.8	6.8
Banks	7.8	7.7	8.8	6.3	6.8	7.2
Corporates	4.0	3.7	12.5	13.1	12.8	13.3
Maturing medium- and long-term debt	9.2	12.3	8.2	8.2	9.6	9.3
Public sector	1.1	2.4	1.3	0.8	2.1	2.1
Banks	3.9	6.1	2.5	3.4	3.2	2.8
Corporates	4.2	3.8	4.4	4.0	4.3	4.3
Other net capital outflows 2/	0.8	0.9	2.1	2.9	2.0	2.0
Total financing sources	**34.7**	**36.4**	**45.7**	**44.1**	**46.5**	**46.8**
Foreign direct investment, net	2.7	3.0	4.5	4.6	4.9	5.2
Capital account inflows	4.0	3.9	4.3	2.2	2.7	3.1
Short-term debt	19.6	21.6	29.9	27.2	27.2	27.2
Public sector	9.3	8.3	9.1	6.8	6.8	6.8
Banks	6.4	9.0	7.5	6.8	7.2	7.2
Corporates	3.9	4.3	13.3	13.6	13.3	13.3
Medium- and long-term debt	8.5	8.0	7.0	10.1	11.7	11.3
Public sector	3.0	2.2	2.2	3.7	5.0	4.2
Banks	2.4	3.0	0.7	1.9	2.1	2.3
Corporates	3.1	2.9	4.1	4.6	4.6	4.8
Errors and omissions	0.1	0.4	0.8	0.7	0.0	0.0
Increase in gross international reserves	-1.2	-0.6	2.3	0.4	-0.2	0.0
Financing gap	**-4.1**	**-2.3**	**-0.1**	**-0.7**	**-1.4**	**-0.5**
Program financing	**-4.1**	**-2.3**	**-0.1**	**-0.7**	**-1.4**	**-0.5**
IMF 3/	-4.4	-1.5	-0.1	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	-4.4	-1.5	-0.1	0.0	0.0	0.0
European Commission	0.0	-1.5	0.0	-1.2	-1.4	-1.0
Disbursements	0.0	0.0	0.0	0.0	0.0	0.0
Principal repayments	0.0	-1.5	0.0	-1.2	-1.4	-1.0
Others	0.3	0.8	0.0	0.5	0.0	0.5
World Bank	0.3	0.8	0.0	0.5	0.0	0.5
EIB/EBRD/IFC	...	...	...	...	...	...
Memorandum items:						
Gross external financing needs (in percent of GDP)	21.3	21.9	26.0	23.2	22.6	21.6
Rollover rates for amortizing debt ST (in percent)						
Public sector	102	99	101	100	100	100
Banks	82	117	85	107	106	100
Corporates	96	114	106	104	104	100
Rollover rates for amortizing debt MLT (in percent)						
Public sector	268	90	169	457	243	199
Banks	60	48	29	54	65	81
Corporates	74	75	93	114	106	111
Rollover rates for total amortizing debt (in percent)						
Public sector	120	97	110	138	133	123
Banks	75	87	72	89	93	95
Corporates	85	94	103	106	104	103
Gross international reserves 4/	35.5	35.5	37.9	37.1	36.9	36.9
Coverage of gross international reserves						
Months of imports of GFNS (next year)	6.4	5.9	5.6	5.0	4.6	4.4
Short-term external debt (in percent)	84.6	89.2	102.4	91.1	89.5	90.5

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

1/ The sharp increase in financing requirements in 2016 is partly due to the changes in the methodology of collecting data for short term debt for corporates.

2/ Includes portfolio equity, financial derivatives and other investments.

3/ SDR interest rate as well as exchange rate of SDR/US$ and US$/€ of January 15, 2015.

4/ Operational definition.

Table 5a. Romania: General Government Operations, 2014–2019 1/

(In percent of GDP)

	2014	2015	2016	2017 Prel.	2018 Proj.	2019 Proj.
Revenue	32.1	32.8	29.0	27.9	28.0	28.6
Taxes	27.3	27.5	25.9	24.7	24.8	25.2
Corporate income tax	2.0	2.1	2.2	1.9	1.9	1.9
Personal income tax	3.5	3.8	3.7	3.6	2.2	2.3
VAT	7.6	8.0	6.8	6.2	6.2	6.3
Excises	3.6	3.7	3.5	3.1	3.2	3.1
Customs duties	0.1	0.1	0.1	0.1	0.1	0.1
Social security contributions	8.6	8.1	8.0	8.4	9.8	10.2
Other taxes	1.8	1.7	1.6	1.4	1.3	1.4
Nontax revenue	2.6	2.7	2.4	2.5	2.1	2.1
Capital revenue	0.2	0.1	0.1	0.1	0.1	0.1
Grants, including EU disbursements	1.7	2.4	0.5	0.6	1.0	1.2
Expenditure	33.8	34.2	31.4	30.8	31.6	32.0
Current expenditure	31.4	31.8	28.9	28.6	29.4	29.8
Compensation of employees	7.5	7.3	7.5	8.1	8.7	9.1
Goods and services	5.9	5.7	5.4	4.7	4.3	4.2
Interest	1.5	1.3	1.3	1.2	1.3	1.4
Subsidies	0.9	0.9	0.9	0.7	0.7	0.7
Transfers	15.4	16.5	13.8	13.8	14.3	14.5
Pensions	7.7	7.2	6.8	6.7	6.7	6.8
Other social transfers	2.9	3.4	4.0	4.1	4.0	3.9
Other transfers 2/	4.1	5.3	2.5	2.5	3.0	3.1
Other spending	0.6	0.6	0.5	0.6	0.7	0.6
Projects with external credits	0.1	0.1	0.1	0.0	0.0	0.0
Capital expenditure 3/	2.6	2.6	2.5	2.3	2.2	2.2
Reserve fund	0.0	0.0	0.0	0.0	0.0	0.0
Net lending and expense refunds	-0.1	-0.1	0.0	-0.1	0.0	0.0
Fiscal balance	-1.7	-1.5	-2.4	-2.8	-3.6	-3.4
Primary balance	-0.2	-0.2	-1.1	-1.7	-2.3	-2.1
Financing	1.7	1.5	2.4	2.8	3.6	3.4
External borrowing (net)	1.9	-0.5	0.7	0.8	0.9	0.8
Domestic borrowing (net)	1.2	0.8	1.3	1.2	2.7	2.6
Use of deposits	-1.3	0.9	-0.6	1.1	0.0	0.0
Privatization proceeds	0.0	0.0	0.0	0.0	0.0	0.0
Financial liabilities						
Gross general-government debt 4/	40.5	39.3	39.0	36.8	37.3	38.4
Gross general-government debt excl. guarantees	38.1	37.1	36.8	34.8	35.5	36.7
External	19.9	18.6	18.2	17.0	16.5	16.2
Domestic	18.2	18.5	18.6	17.8	19.0	20.4
Memorandum items:						
Total capital spending	5.3	6.2	3.8	3.3	3.8	3.9
Fiscal balance (ESA2010 basis)	-1.3	-0.8	-3.0	-2.9	…	…
Output gap 5/	-3.4	-2.8	-1.5	1.5	2.8	2.6
Cyclically adjusted balance 6/	-0.6	-0.5	-1.9	-3.3	-4.4	-4.2
CAPB 6/	0.9	0.7	-0.7	-2.1	-3.1	-2.9
Structural fiscal balance 6/	0.3	0.0	-1.7	-3.4	-4.3	-4.0
Gross general government debt (authorities definition) 7/	44.3	44.3	44.5	42.9	…	…
Nominal GDP (in billions of lei)	668.1	712.7	762.3	858.3	934.4	996.6

1/ Unless otherwise noted, the table is on a cash basis following GFSM 86. The general government is composed of the central government, local governments, social security funds, and the road fund company.
2/ Includes EU-financed capital projects.
3/ Does not include all capital spending.
4/ Total consolidated general-government debt, including state government debt, local government debt, and guarantees.
5/ Percentage deviation of actual from potential GDP.
6/ Expressed in percentage of potential GDP.
7/ Includes guarantees and intra-governmental debt.

Table 5b. Romania: General Government Operations, 2014–2019
(In millions of lei)

	2014	2015	2016	2017 Prel.	2018 Proj.	2019 Proj.
Revenue	214,315	233,554	220,783	239,822	262,004	285,355
Taxes	182,550	195,906	197,676	211,957	231,510	251,588
Corporate income tax	13,675	14,803	16,394	16,149	17,385	18,542
Personal income tax	23,702	27,288	28,384	30,751	20,958	23,054
VAT	50,878	57,132	51,675	53,544	58,257	62,508
Excises	24,095	26,018	26,957	26,604	29,566	30,601
Customs duties	643	816	883	933	1,027	1,098
Social security contributions	57,585	57,604	61,274	71,711	91,818	101,602
Other taxes	11,972	12,245	12,110	12,264	12,498	14,183
Nontax revenue	17,412	19,495	18,411	21,843	19,983	21,313
Interest Revenue	157	743	353	392	438	468
Capital revenue	1,072	918	769	830	872	902
Grants	11,483	16,984	3,927	5,163	9,639	11,552
Financial operations and other	1,798	250	0	29	0	0
Expenditure	225,808	243,915.5	239,082	264,064	295,179	319,369
Current expenditure	209,512	226,688	220,067	245,596	274,524	297,339
Compensation of employees	50,400	52,026	57,040	69,597	81,671	90,785
Goods and services	39,538	40,808	40,950	40,585	39,927	41,941
Interest	10,202	9,572	10,008	10,122	12,097	13,508
Subsidies	6,108	6,275	6,605	6,201	6,490	6,689
Transfers	102,672	117,552	105,019	118,840	134,067	144,125
Pensions	51,532	51,532	51,707	57,081	62,304	68,061
Other social transfers	19,661	24,413	30,130	35,490	37,727	38,886
Other transfers 1/	27,189	37,618	19,210	21,037	27,909	30,908
Other spending	4,291	3,988	3,972	5,232	6,128	6,270
Projects with external credits	592	456	444	250	273	291
Capital expenditure 2/	17,246	18,263	19,015	19,679	20,656	22,030
Reserve fund	0	0	0	0	0	0
Net lending and expense refunds	-950	-1,036	0	-1,211	0	0
Fiscal balance	-11,493	-10,361	-18,299	-24,242	-33,176	-34,015
Primary balance	-1,448	-1,532	-8,643	-14,511	-21,518	-20,974
Financing	11,493	10,361	18,299	24,242	33,176	34,015
External borrowing (net)	12,591	-3,809	4,983	6,843	8,413	7,613
Domestic borrowing (net)	8,194	5,468	10,013	10,537	24,763	26,402
Use of deposits	-8,745	6,435	-4,428	9,346	0	0
Privatization proceeds	0	0	0	0	0	0
Financial liabilities						
Gross general-government debt 3/	270,736	280,415	297,449	315,801	348,977	382,992
Gross general-government debt excl. guarantees	254,870	264,274	280,407	298,334	331,510	365,525
External	133,284	132,701	138,579	145,884	154,297	161,910
Domestic	121,586	131,573	141,828	152,450	177,213	203,615
Memorandum item:						
Total capital spending	35,548	44,330	30,831	28,110	35,750	39,192
Gross general government debt (authorities definition) 4/	295,656	315,934	339,080	368,236	…	…

1/ Includes EU-financed capital projects.

2/ Does not include all capital spending.

3/ Total consolidated general-government debt, including state government debt, local government debt, and guarantees.

4/ Includes guarantees and intra-governmental debt.

Table 5c. Romania: Consolidated General Government Balance Sheet, 2012–2016
(In millions of lei, unless otherwise indicated)

	2012	2013	2014	2015	2016
Net worth and its changes:	**491,452**	**512,173**	**525,107**	**561,499**	**592,356**
Nonfinancial assets	**597,894**	**643,361**	**665,701**	**706,420**	**757,194**
Fixed assets	583,573	628,600	648,789	687,028	737,410
Buildings and structures	....	....	....	....	....
Machinery and equipment	....	....	....	....	....
Other fixed assets	....	....	....	....	....
Inventories	14,321	14,761	16,912	19,392	19,784
Valuables	....	....	....	....	
Nonproduced assets	....	....	....	....	
Financial assets	**171,254**	**170,679**	**187,851**	**191,358**	**203,117**
by instrument					
Monetary gold and SDRs	-	-	-	-	
Currency and deposits	31,956	38,464	49,406	46,024	61,173
Securities other than shares	187	187	197	100	104
Loans	6,666	6,603	6,610	6,718	7,050
Shares and other equity	82,983	74,215	78,411	76,542	76,168
Insurance technical reserves	-	18	23	123	52
Financial derivatives	-	-	-	-	
Other accounts receivable	49,463	51,192	53,204	61,851	58,570
by debtor					
Domestic	154,013	152,498	167,534	165,341	175,501
Foreign	17,241	18,181	19,854	25,462	23,363
Liabilities	**277,696**	**301,867**	**328,444**	**336,279**	**367,955**
by instrument					
Special Drawing Rights (SDRs)	-	-	-	-	
Currency and deposits	4,987	4,222	6,755	8,754	8,409
Securities other than shares	143,517	165,716	199,583	210,816	229,075
Loans	80,374	79,601	74,462	68,839	65,678
Shares and other equity	2	-	-	-	
Insurance technical reserves	128	164	202	259	303
Financial derivatives	-	-	-	-	
Other accounts payable	48,687	52,163	47,443	47,611	64,490
by debtor					
Domestic	151,746	157,658	171,774	181,093	195,429
Foreign	125,950	144,209	156,670	155,186	172,526
Memorandum items					
Net financial worth	(106,441)	(131,188)	(140,593)	(144,921)	(164,838)
Maastricht debt	219,762	238,882	261,401	268,595	284,958
Memorandum:					
Nominal GDP (Lei - billions)	595.4	637.5	668.1	712.7	762.3

Sources: Romanian authorities; Eurostat; and IMF staff calculations.

Table 6. Romania: Monetary Survey, 2014–2019
(In millions of lei, unless otherwise indicated; end of period)

	2014	2015	2016	2017 Prel.	2018 Proj.	2019 Proj.
			I. Banking System			
Net foreign assets	**94,282**	**108,650**	**139,669**	**150,640**	**162,027**	**173,455**
In millions of euros	21,035	24,014	30,756	32,325	34,807	37,302
o/w commercial banks	-11,778	-9,799	-5,781	-3,486	-789	1,748
Net domestic assets	**167,549**	**177,605**	**174,466**	**199,941**	**221,860**	**245,283**
General government credit, net	29,639	36,542	26,329	36,854	57,411	67,083
Private sector credit	211,164	217,532	220,100	232,641	244,186	254,686
Other	-73,254	-76,200	-71,965	-69,554	-79,737	-76,486
Broad Money (M3)	**261,831**	**286,256**	**314,135**	**350,581**	**383,886**	**418,737**
Money market instruments	258	129	109	107	117	128
Intermediate money (M2)	261,573	286,126	314,026	350,474	383,769	418,609
Narrow money (M1)	118,582	149,550	179,980	210,742	230,762	251,712
Currency in circulation	39,890	46,482	54,672	63,476	69,506	75,816
Overnight deposits	78,691	103,069	125,308	147,266	161,256	175,896
			II. National Bank of Romania			
Net foreign assets	**147,071**	**152,988**	**165,921**	**166,868**	**165,701**	**165,325**
In millions of euros	32,813	33,813	36,538	35,811	35,596	35,554
Net domestic assets	**-78,694**	**-78,998**	**-80,455**	**-69,018**	**-58,556**	**-48,452**
General government credit, net	-41,757	-37,675	-47,449	-41,079	-39,079	-35,079
Credit to banks, net	-24,064	-27,465	-17,583	-13,396	-12,396	-11,896
Other	-12,873	-13,857	-15,423	-14,543	-7,080	-1,477
Reserve money	**68,377**	**73,990**	**85,466**	**97,850**	**107,146**	**116,873**
			(Annual percent change)			
Broad money (M3)	8.4	9.3	9.7	11.6	9.5	9.1
NFA contribution	13.9	5.5	10.8	3.5	3.2	3.0
NDA contribution	-5.5	3.8	-1.1	8.1	6.3	6.1
Reserve money	-0.4	8.2	15.5	14.5	9.5	9.1
NFA contribution	21.7	8.7	17.5	1.1	-1.2	-0.4
NDA contribution	-22.1	-0.4	-2.0	13.4	10.7	9.4
Domestic credit, real	-5.8	6.6	-2.3	5.3	4.4	3.3
Private sector, real	-4.2	4.0	1.8	2.2	1.6	1.0
Public sector, real	-13.4	20.5	-21.5	24.5	18.4	13.2
Broad money (M3), in real terms	7.2	10.7	10.3	8.0	5.8	5.7
Private credit, nominal	-3.4	3.0	1.2	5.6	5.1	4.3
Memorandum items:						
CPI inflation, eop	0.8	-0.9	-0.5	3.3	3.5	3.2
NBR inflation target band	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5	1.5 - 3.5
Interest rates (percent)						
Policy interest rate	2.75	1.75	1.75	1.75	…	…
Interbank offer rate, 1 week	0.7	0.6	0.6	1.5		
Corporate loans 1/	5.9	4.4	3.7	4.9	…	…
Household time deposits 1/	2.8	1.5	0.9	0.8	…	…
Share of foreign currency private deposits	33.9	33.3	32.3	33.0	…	…
Share of foreign currency private loans	56.3	49.3	42.8	37.2	…	…

Sources: National Bank of Romania; and IMF staff estimates and projections.
1/ Rates for new local currency denominated transactions.

Table 7. Romania: Financial Soundness Indicators, 2010–17

(In percent)

	2010 Dec.	2011 Dec.	2012 Dec.	2013 Dec.	2014 Dec.	2015 Dec.	2016 Dec.	2017 Dec. Prel.
Core indicators								
Capital adequacy								
Capital to risk-weighted assets	15.0	14.9	14.9	15.5	17.6	19.2	19.7	18.9
Tier 1 capital to risk-weighted assets 1/	14.2	13.9	13.8	14.1	14.6	16.7	17.5	16.8
Asset quality								
Nonperforming loans to total gross loans 2/	11.9	14.3	18.2	21.9	20.7	13.5	9.6	6.4
IFRS Provisions for NPLs / NPLs	...	...	76.7	67.8	56.6	57.7	56.3	57.8
Earnings and profitability								
Return on assets	-0.2	-0.2	-0.6	0.0	-1.3	1.2	1.1	1.3
Return on equity 3/	-1.7	-2.6	-5.9	0.1	-12.5	11.8	10.4	12.7
Net interest income to operating income	60.6	62.0	62.3	58.8	58.6	58.5	56.3	58.8
Noninterest expense to operating income (cost to income)	64.9	67.8	58.7	56.5	55.5	58.4	53.0	54.9
Personnel expense to operating income	21.0	21.9	26.0	25.5	24.9	26.6	24.7	26.1
Liquidity								
Liquid assets 4/ to total assets	60.0	58.7	57.6	56.2	57.4	54.1	53.4	53.4
Liquid assets 4/ to short-term liabilities 5/	142.2	139.0	147.7	156.3	158.9	163.4	156.3	145.5
Liquid assets 4/ to total attracted and borrowed sources	80.9	75.8	76.4	73.5	74.1	57.0	55.6	55.1
Foreign exchange risk								
Net open position in foreign exchange, in percent of capital	-1.4	-4.7	1.3	2.5	-2.0	0.7	0.5	-0.5
Lending in foreign exchange, in percent of non-gov. credit	63.0	63.4	62.5	60.9	56.2	49.3	42.8	38.6
Foreign currency liabilities, in percent of total attracted and borrowed sources	43.5	44.8	46.3	45.2	42.9	41.5	37.1	36.5
Deposits in foreign exchange, in percent of non-gov. dom. deposits	36.0	33.5	36.4	34.1	33.2	32.4	31.3	31.9
Encouraged indicators								
Deposit-taking institutions								
Leverage ratio 6/	8.9	8.1	8.0	7.9	7.4	8.2	8.9	8.3
Personnel expenses to noninterest expenses	32.3	32.2	44.3	44.9	45.0	46.1	46.6	47.4
Customer deposits to total (non-interbank) loans	84.8	84.0	87.3	98.7	109.5	115.6	130.8	123.1
Loan-to-Deposit (LTD) Ratio	117.9	119.1	117.4	104.6	91.3	85.4	79.1	74.7
Structural indicators (September 2017)								
Number of banks: 35; Number of foreign-owned subsidiaries/branches: 22/7; Share of deposits/loans of 5 largest banks: 61 percent/58 percent								

Source: National Bank of Romania.

1/ For 2010, market and operational risk are not used in compiling risk weighted assets.

2/ In December 2015, the NBR moved from a national definition to an EBA methodology-based definition of NPL's.

3/ Return on equity is calculated as net profit/loss to average own capital.

4/ Liquid assets = balance sheet assets and off balance sheets items with residual maturity of up to 3 months.

5/ Short term liabilities = balance sheet liabilities and off balance sheet items with residual maturity of up to 3 months.

6/ Tier 1 capital to average assets.

Annex I. Debt Sustainability Analysis

Public debt in Romania is expected to remain relatively low but rise gradually over the medium term. Under the baseline scenario, the public debt-to-GDP ratio is projected to reach 42 percent by 2023 from the current level of 36.8 percent. Gross public financing needs (7.7 percent of GDP in 2017) are expected to remain contained below 10 percent over the projection horizon. While the DSA suggests that public debt is sustainable under various shocks, the combined macro-fiscal shock shifts the debt trajectory most significantly, pushing debt to about 57 percent by 2023. In the recession scenario debt reaches around 54 percent by 2023[1]. Exchange rate volatility and exposure to international capital outflows continue to present notable risks, with their associated debt profile vulnerability indicators exceeding the upper early warning benchmarks.

A. Comparison with the Previous Assessment

1. **The baseline debt trajectory is lower relative to last year's DSA[2].** The debt outturn for 2017 was lower-than expected, because the fiscal balance remained contained below 3 percent (outturn of 2.8 compared to 3.7 percent of GDP in 2017 DSA with mid-year measures) and because of better real growth (outturn of 6.9 compared to 4.2 percent in 2017 DSA). The medium-term trajectory for debt is lower due to: (i) the lower base in 2017, (ii) lower projected deficits for 2018 and 2019 compared to 2017 DSA, and (iii) higher projected growth for 2018 and 2019 compared to 2017 DSA. Under the baseline scenario, which incorporates all legislated fiscal loosening measures, the budget deficit is expected to exceed 3 percent over the period 2018-2023—without additional measures—thus violating the 3 percent rule under the Stability and Growth Pact. The budget deficit does however gradually decline after 2019, reaching 3.2 percent of GDP by 2023 as absorption of EU-funds improves and replaces capital spending financed directly out of the budget.

B. Baseline and Realism of Projections

2. **Debt level.** Under the baseline scenario, gross debt level (including guarantees) is projected to rise gradually over the medium term, reaching 42 percent in 2023. Gross financing needs over the same period are projected to remain well-below 10 percent of GDP, averaging around 7 percent of GDP.

3. **Fiscal balance and adjustment.** In the baseline projection, the budget deficit worsens in 2018, before gradually improving over the remainder of the projection horizon and reaching 3.2 percent of GDP in 2023. The deterioration in the budget deficit in 2018 is mainly driven by the wage increases, which became effective January 1st, 2018, and pension increases expected to become effective on July 1st, 2018. Over the medium term, revenue and expenditure projections are driven by

[1] This scenario assumes a drop in real GDP growth to 0.5 percent in 2019, with a gradual recovery thereafter.

[2] 2017 Romania Article IV Staff Report (IMF Country Report No. 17/113).

the macroeconomic projections for key variables[3] and the assumption that absorption of EU funds will gradually improve over the medium term[4]. Taking into account the distribution of fiscal adjustment episodes provided in the DSA template (Figure 2), the projected 3-year adjustment in the cyclically-adjusted primary balance (CAPB) of 0.5 percent of GDP indicates that there may be more room for adjustment in Romania. Similarly, the 3-year average level of the CAPB places Romania in lower end of the distribution for comparator countries.

4. Growth. Compared to outcomes, past projections of growth suggest moderate forecast errors, with the median forecast error in line with comparator countries. Considering the high sensitivity of Romania's debt dynamics to surprises in GDP growth, there seems to be no systematic projection bias in the baseline assumption for growth that could undermine the DSA assessment (Figure 2). The current real GDP growth projection of 5.1 percent for 2018 is lower than the authorities' forecast of 6.1 percent. Reflecting the temporary nature of the fiscal impulse in 2017 and 2018, as well as the slow progress in structural reforms, medium-term growth is expected to stabilize at 3.1 percent of GDP. The boom-bust analysis is not triggered because the three-year cumulative change in the credit-to-GDP ratio does not exceed 15 percent in Romania.

5. Maturity, rollover and other risks. To manage financing risk, the authorities maintain a foreign currency financing buffer (excluding privatization proceeds). Most of longer-term debt consists of official financing, while the average maturity of government securities issued on the domestic market is 3.3 years. The authorities have been addressing rollover risks under a debt management strategy which aims to issue longer-term securities as well as lengthen the yield curve. However, public debt continues to be vulnerable to exchange rate risk, with foreign currency denominated debt accounting for about half of total public debt and non-residents' share in domestic-currency debt securities holdings at 17.9 percent. Reliance on temporary financing[5] has also increased quite sharply in 2017, and could have a negative impact on liquidity and refinancing risks.

C. Stochastic Simulations

6. The fan charts illustrate the possible evolution of the debt ratio over the medium term and are based on both the symmetric and asymmetric distributions of risk. Under the symmetric distribution of risk, there is a high level of certainty that debt will remain below 60 percent of GDP (threshold under the Stability and Growth Pact) over the medium term. However, if restrictions are

[3] Including GDP, private consumption growth, inflation, imports, the exchange rate, employment growth, and wage growth.

[4] Higher absorption of EU funds leads to higher grants and lower capital spending directly funded out of the budget. Both of these in turn result in a slight increase in total capital spending over the medium term.

[5] Public debt according to Romania's national legislation includes temporary financing of past deficits from the State Treasury General Current Account. This is considered to be intra-governmental debt and is excluded from the gross debt figures reported in this DSA.

imposed on the primary balance[6], there is a 75 percent certainty that debt will not exceed 60 percent of GDP in the medium term.

D. Stress Tests

7. Real GDP growth. The debt ratio remains under 60 percent of GDP under all scenarios[7] (Figure 5) – however, it is most sensitive to the real GDP growth shock, under which debt reaches about 51 percent of GDP. This scenario also results in a marked increase in public gross financing needs in 2019 and 2020, reaching the 10 percent threshold. The sensitivity of Romania's public debt is further evident in the illustrative recession scenario which assumes a growth of 0.5 percent in 2019 and a slow recovery thereafter (Figure 4). Under this scenario, public debt reaches 55 percent in 2023 and public gross financing needs average around 10 percent of GDP over the medium term.

8. Combined shock. A combined shock incorporates the largest effect of individual shocks on all relevant variables (real GDP growth, inflation, primary balance, exchange rate and interest rate). Under this scenario, debt would reach 57 percent of GDP in 2023 without showing signals of a declining trajectory. Gross financing needs peak at around 11 percent of GDP in 2020, averaging about 10 percent in the remaining years of the projection horizon.

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[6] This is the asymmetric scenario, where it is assumed that there are no positive shocks to the primary balance.

[7] Including a contingent liability shock (Figure 5). Barring unexpected events, the effect on public debt of potential contingent liabilities of the government would be limited. SOE debt is estimated at around 7 percent of GDP (including SOEs under insolvency procedures).

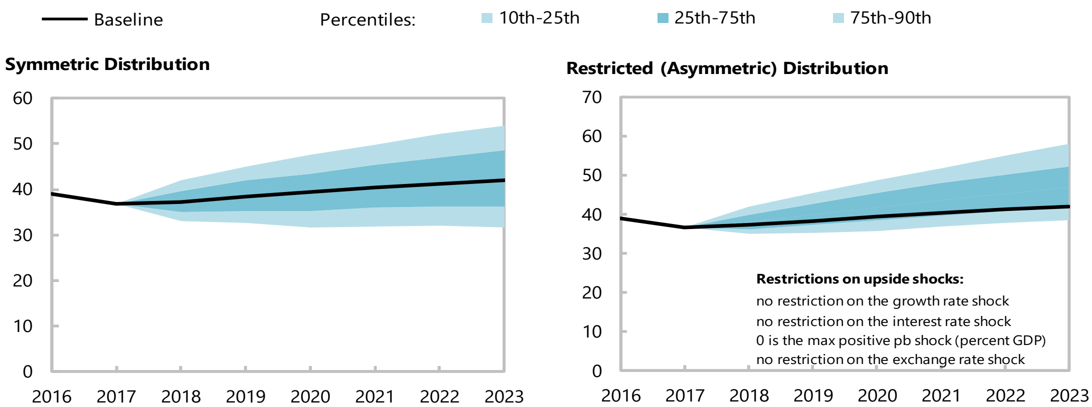
Figure 1. Romania: Public DSA Risk Assessment

Heat Map

Debt level [1/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability shock
Gross financing needs [2/]	Real GDP Growth Shock	Primary Balance Shock	Real Interest Rate Shock	Exchange Rate Shock	Contingent Liability Shock
Debt profile [3/]	Market Perception	External Financing Requirements	Change in the Share of Short-Term Debt	Public Debt Held by Non-Residents	Foreign Currency Debt

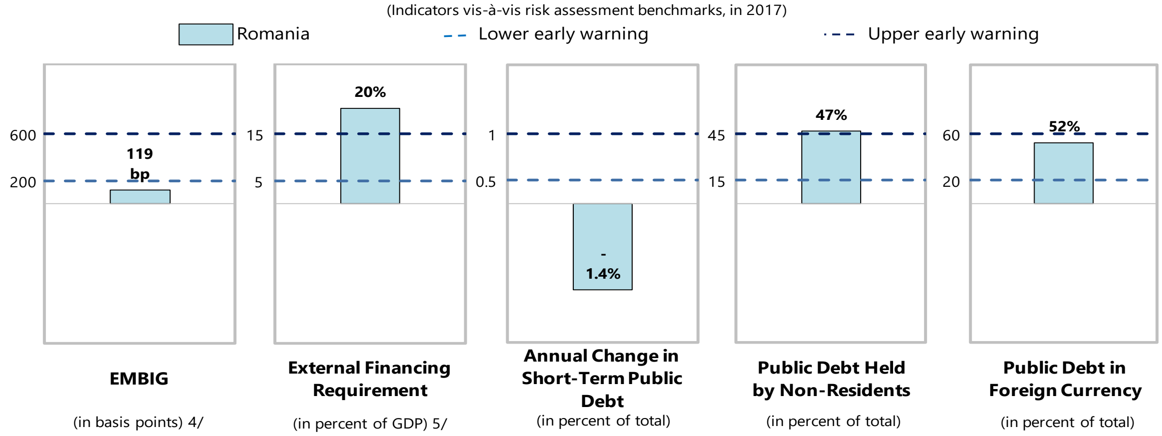
Evolution of Predictive Densities of Gross Nominal Public Debt

(in percent of GDP)



Debt Profile Vulnerabilities

(Indicators vis-à-vis risk assessment benchmarks, in 2017)



Source: IMF staff.

1/ The cell is highlighted in green if debt burden benchmark of 70% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

2/ The cell is highlighted in green if gross financing needs benchmark of 15% is not exceeded under the specific shock or baseline, yellow if exceeded under specific shock but not baseline, red if benchmark is exceeded under baseline, white if stress test is not relevant.

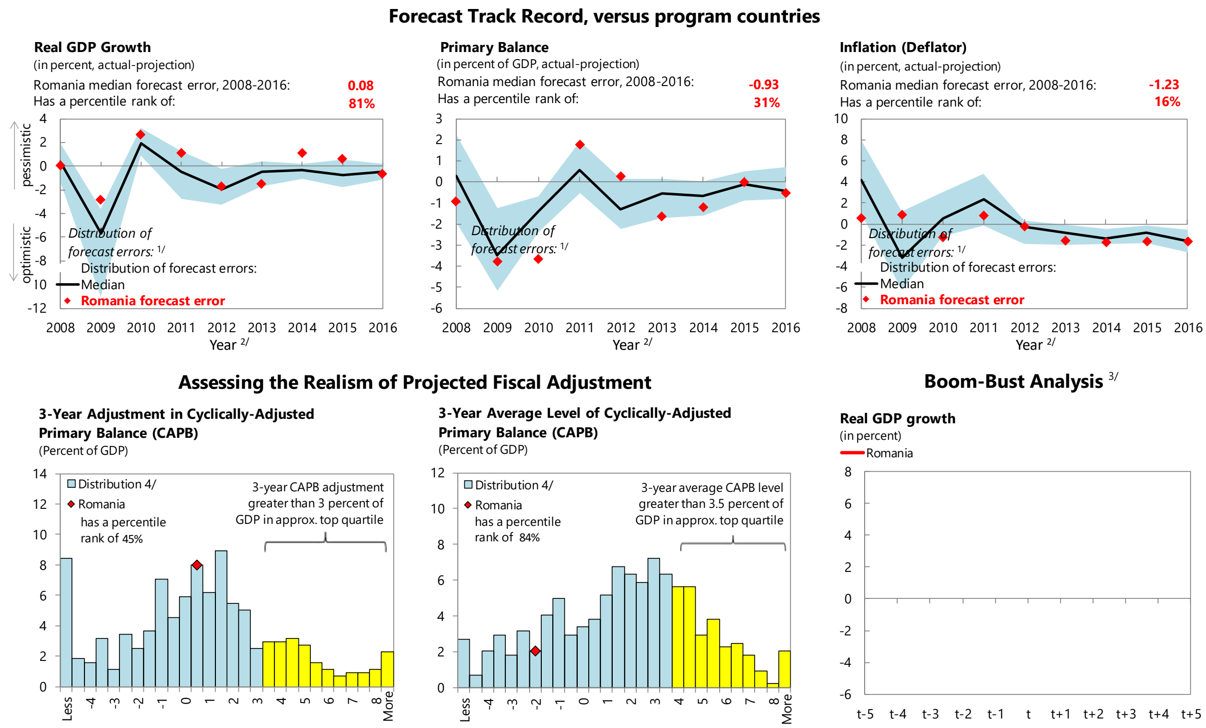
3/ The cell is highlighted in green if country value is less than the lower risk-assessment benchmark, red if country value exceeds the upper risk-assessment benchmark, yellow if country value is between the lower and upper risk-assessment benchmarks. If data are unavailable or indicator is not relevant, cell is white.
Lower and upper risk-assessment benchmarks are:

200 and 600 basis points for bond spreads; 5 and 15 percent of GDP for external financing requirement; 0.5 and 1 percent for change in the share of short-term debt; 15 and 45 percent for the public debt held by non-residents; and 20 and 60 percent for the share of foreign-currency denominated debt.

4/ EMBIG, an average over the last 3 months, 22-Dec-17 through 22-Mar-18.

5/ External financing requirement is defined as the sum of current account deficit, amortization of medium and long-term total external debt, and short-term total external debt at the end of previous period.

Figure 2. Romania: Public DSA – Realism of Baseline Assumptions



Source : IMF Staff.

1/ Plotted distribution includes program countries, percentile rank refers to all countries.

2/ Projections made in the spring WEO vintage of the preceding year.

3/ Not applicable for Romania.

4/ Data cover annual obervations from 1990 to 2011 for advanced and emerging economies with debt greater than 60 percent of GDP. Percent of sample on vertical axis.

Figure 3. Romania: Public Sector Debt Sustainability Analysis (DSA) – Baseline Scenario

(in percent of GDP unless otherwise indicated)

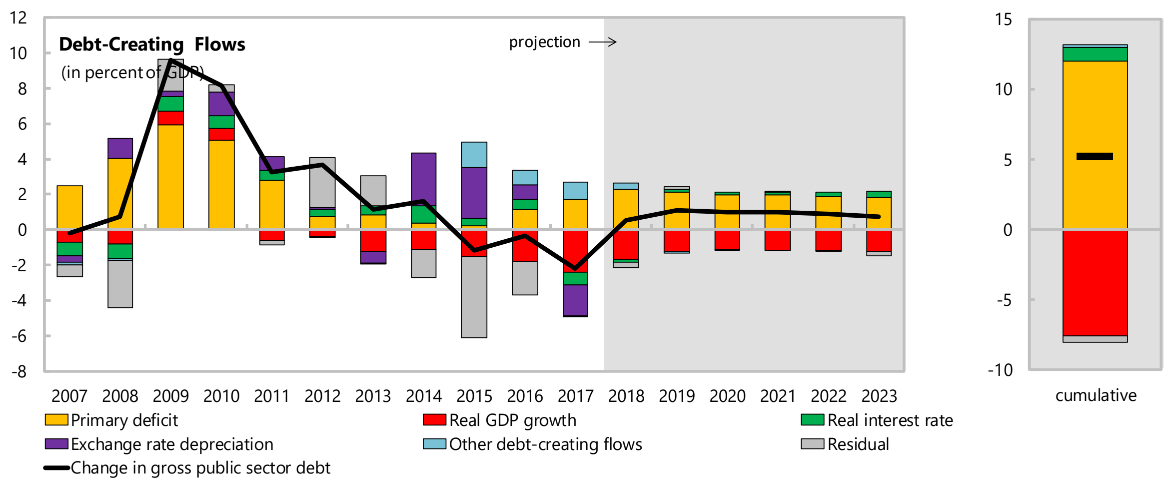
Debt, Economic and Market Indicators [1]

	Actual			Projections					
	2007-2015 [2]	2016	2017	2018	2019	2020	2021	2022	2023
Nominal gross public debt	29.9	39.0	36.8	37.3	38.4	39.4	40.4	41.3	42.0
Public gross financing needs	10.6	9.1	7.5	8.2	7.6	5.7	6.5	6.3	7.3
Real GDP growth (in percent)	2.3	4.8	6.9	5.1	3.5	3.1	3.1	3.1	3.1
Inflation (GDP deflator, in percent)	6.2	2.1	5.3	3.6	3.0	3.3	3.1	3.0	3.0
Nominal GDP growth (in percent)	8.7	7.0	12.6	8.9	6.7	6.5	6.3	6.2	6.2
Effective interest rate (in percent) [4]	6.6	3.8	3.6	3.4	3.6	3.8	3.6	3.8	4.1

As of March 22, 2018		
Sovereign Spreads		
EMBIG (bp) 3/		131
5Y CDS (bp)		85
Ratings	Foreign	Local
Moody's	Baa3	Baa3
S&Ps	BBB-	BBB-
Fitch	BBB-	BBB-

Contribution to Changes in Public Debt

	Actual			Projections							
	2007-2015	2016	2017	2018	2019	2020	2021	2022	2023	cumulative	debt-stabilizing primary balance [9]
Change in gross public sector debt	3.0	-0.3	-2.2	0.5	1.1	1.0	1.0	0.9	0.7	5.2	
Identified debt-creating flows	3.3	1.6	-2.2	0.8	0.9	1.0	1.0	0.9	1.0	5.6	
Primary deficit	2.5	1.1	1.7	2.3	2.1	2.0	2.0	1.9	1.8	12.0	-0.8
Primary (noninterest) revenue and grants	31.5	28.9	27.9	28.0	28.6	28.7	28.8	28.9	28.7	171.6	
Primary (noninterest) expenditure	34.0	30.0	29.6	30.3	30.7	30.6	30.8	30.7	30.5	183.7	
Automatic debt dynamics [5]	0.7	-0.4	-4.9	-1.8	-1.1	-1.0	-1.0	-0.9	-0.8	-6.6	
Interest rate/growth differential [6]	-0.2	-1.2	-3.1	-1.8	-1.1	-1.0	-1.0	-0.9	-0.8	-6.6	
Of which: real interest rate	0.3	0.6	-0.7	-0.1	0.2	0.1	0.2	0.3	0.4	1.0	
Of which: real GDP growth	-0.6	-1.8	-2.4	-1.7	-1.2	-1.1	-1.1	-1.2	-1.2	-7.6	
Exchange rate depreciation [7]	1.0	0.8	-1.8	...	...	...	...	...	...	...	
Other identified debt-creating flows	0.1	0.9	1.0	0.3	-0.1	0.0	0.0	0.0	0.0	0.2	
Privatization receipts (negative)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Increase in deposits	0.2	0.9	1.0	0.3	-0.1	0.0	0.0	0.0	0.0	0.2	
Residual, including asset changes [8]	-0.4	-1.9	0.0	-0.3	0.2	0.0	0.0	0.0	-0.3	-0.4	



Source: IMF staff.

1/ Public sector is defined as general government and includes public guarantees.

2/ Based on available data.

3/ EMBIG.

4/ Defined as interest payments divided by debt stock (excluding guarantees) at the end of previous year.

5/ Derived as $[(r - \pi(1+g) - g + ae(1+r)]/(1+g+\pi+g\pi))$ times previous period debt ratio, with r = interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; a = share of foreign-currency denominated debt; and e = nominal exchange rate depreciation (measured by increase in local currency value of U.S. dollar).

6/ The real interest rate contribution is derived from the numerator in footnote 5 as $r - \pi(1+g)$ and the real growth contribution as $-g$.

7/ The exchange rate contribution is derived from the numerator in footnote 5 as $ae(1+r)$.

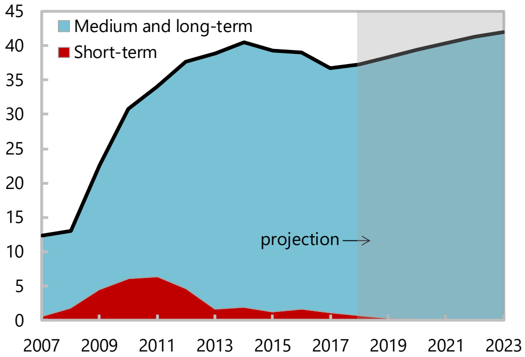
8/ Includes changes in the stock of guarantees, asset changes, and interest revenues (if any). For projections, includes exchange rate changes during the projection period.

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.

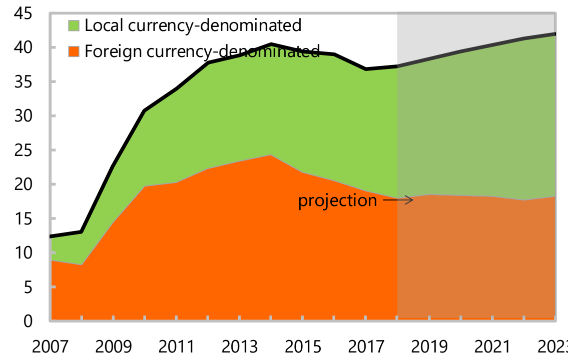
Figure 4. Romania: Public DSA – Composition of Public Debt and Alternative Scenarios

Composition of Public Debt

By Maturity
(in percent of GDP)



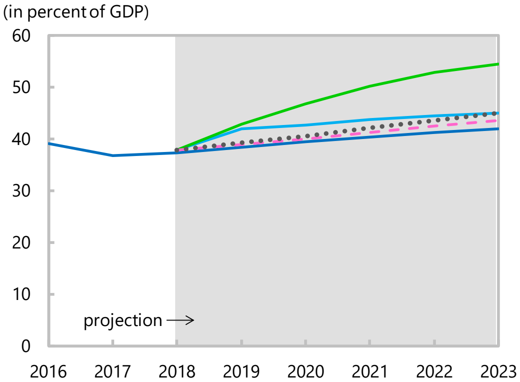
By Currency
(in percent of GDP)



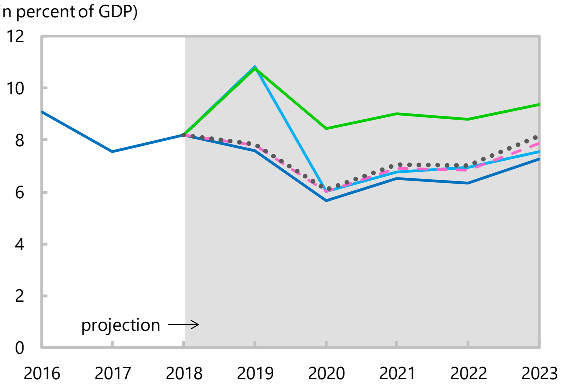
Alternative Scenarios

Baseline
Contingent Liability Shock
Historical
Recession scenario
Constant Primary Balance

Gross Nominal Public Debt
(in percent of GDP)



Public Gross Financing Needs
(in percent of GDP)



Underlying Assumptions
(in percent)

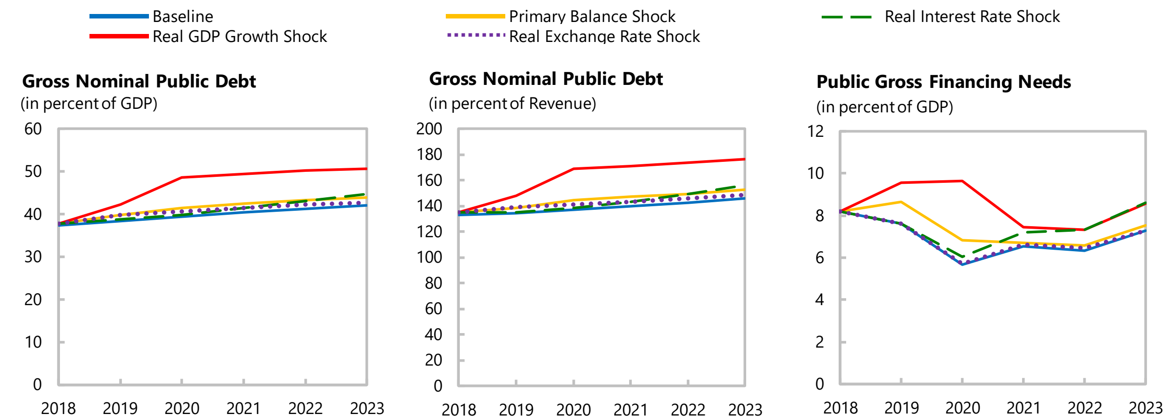
Baseline Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	5.1	3.5	3.1	3.1	3.1	3.1
Inflation	3.6	3.0	3.3	3.1	3.0	3.0
Primary Balance	-2.3	-2.1	-2.0	-2.0	-1.9	-1.8
Effective interest rate	3.4	3.6	3.8	3.6	3.8	4.1
Constant Primary Balance Scenario						
Real GDP growth	5.1	3.5	3.1	3.1	3.1	3.1
Inflation	3.6	3.0	3.3	3.1	3.0	3.0
Primary Balance	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate	3.4	3.6	3.7	3.6	3.8	4.1
Recession scenario						
Real GDP growth	5.1	0.5	0.8	1.3	1.8	2.3
Inflation	3.6	3.0	3.3	3.1	3.0	3.0
Primary Balance	-2.3	-5.1	-4.3	-3.8	-3.2	-2.6
Effective interest rate	3.4	3.6	3.9	3.8	4.1	4.4

Historical Scenario	2018	2019	2020	2021	2022	2023
Real GDP growth	5.1	2.5	2.5	2.5	2.5	2.5
Inflation	3.6	3.0	3.3	3.1	3.0	3.0
Primary Balance	-2.3	-2.3	-2.3	-2.3	-2.3	-2.3
Effective interest rate 1/	3.4	3.6	3.9	3.8	4.1	4.5
Contingent Liability Shock						
Real GDP growth	5.1	3.5	3.1	3.1	3.1	3.1
Inflation	3.6	3.0	3.3	3.1	3.0	3.0
Primary Balance	-2.3	-5.2	-2.0	-2.0	-1.9	-1.8
Effective interest rate 1/	3.4	4.1	4.0	3.9	4.1	4.3

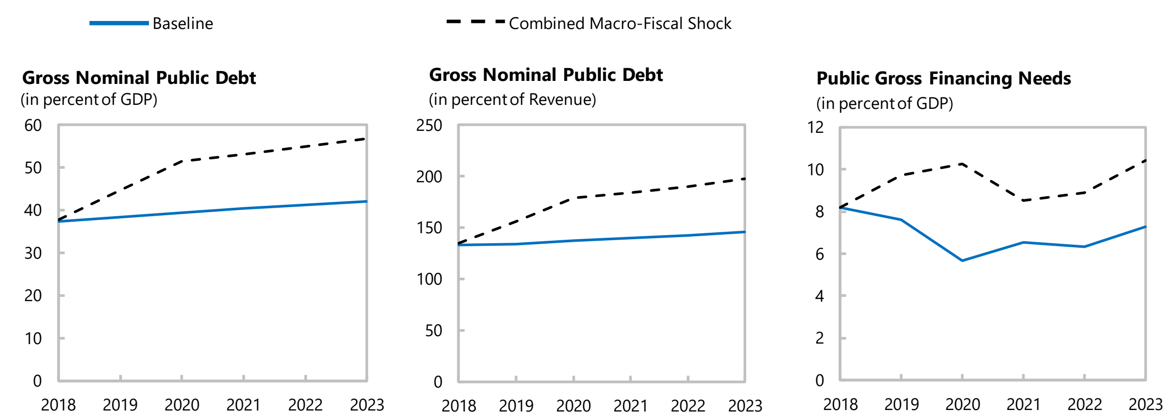
1/ Declining effective interest rate reflects negative historical real interest rates in Romania during the reference period.
Source: IMF staff.

Figure 5. Romania: Public DSA – Stress Tests

Macro-Fiscal Stress Tests



Additional Stress Tests



Underlying Assumptions
(in percent)

Primary Balance Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	5.1	3.5	3.1	3.1	3.1	3.1
Inflation	3.6	3.0	3.3	3.1	3.0	3.0
Primary balance	-2.3	-3.1	-3.0	-2.0	-1.9	-1.8
Effective interest rate	3.4	3.6	3.8	3.8	3.9	4.2
Real Interest Rate Shock						
Real GDP growth	5.1	3.5	3.1	3.1	3.1	3.1
Inflation	3.6	3.0	3.3	3.1	3.0	3.0
Primary balance	-2.3	-2.1	-2.0	-2.0	-1.9	-1.8
Effective interest rate	3.4	3.6	4.8	5.4	6.3	7.1
Combined Shock						
Real GDP growth	5.1	-0.8	-1.2	3.1	3.1	3.1
Inflation	3.6	2.0	2.2	3.1	3.0	3.0
Primary balance	-2.3	-3.8	-5.3	-2.0	-1.9	-1.8
Effective interest rate	3.4	3.8	4.9	5.7	6.6	7.3

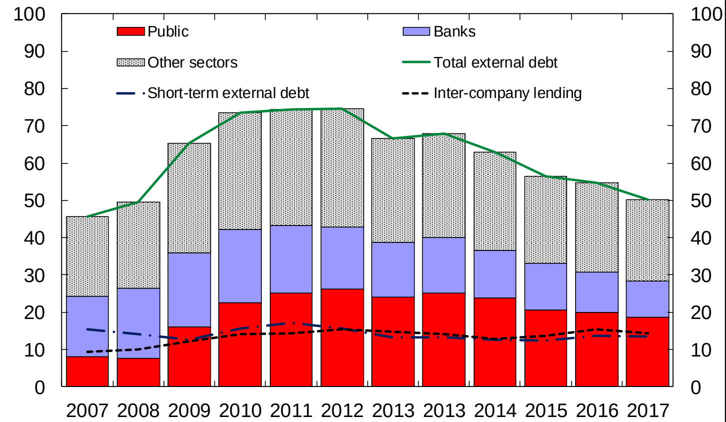
Real GDP Growth Shock	2018	2019	2020	2021	2022	2023
Real GDP growth	5.1	-0.8	-1.2	3.1	3.1	3.1
Inflation	3.6	2.0	2.2	3.1	3.0	3.0
Primary balance	-2.3	-3.8	-5.3	-2.0	-1.9	-1.8
Effective interest rate	3.4	3.6	3.9	4.0	4.1	4.4
Real Exchange Rate Shock						
Real GDP growth	5.1	3.5	3.1	3.1	3.1	3.1
Inflation	3.6	6.2	3.3	3.1	3.0	3.0
Primary balance	-2.3	-2.1	-2.0	-2.0	-1.9	-1.8
Effective interest rate	3.4	3.8	3.7	3.6	3.8	4.1

Source: IMF staff.

External Debt

9. The external debt continues the downward trend. After peaking in 2012 at 74.6 percent of GDP, the gross external has been gradually declining to 49.7 percent of GDP in 2017. Private sector deleveraging, both in banking and non-banking sector, has been the main driver of the declining debt. The short-term debt accounted for 27 percent of total external debt in 2017, and is largely covered by the inter-company lending which stands at 29 percent of total external debt. Public external debt at 17.2 percent of GDP, remains low by international standards.

External Debt Path
(In percent of GDP)



Sources: Authorities data, IMF staff calculations.

10. The external debt is expected to further decline over the medium term. The external debt is expected to decline to around 41 percent of GDP in 2023, largely driven by nominal GDP growth and modest borrowing plans. The projected current account path remains sustainable, and debt dynamics in the scenario with key variables at their historic level is very similar to the baseline. The roll-over risk of the non-banking sector is limited, as almost all short-term exposure stems from inter-company lending.

11. Staff analysis indicates that Romania's debt dynamics is resilient to most of the shocks, except sharp currency depreciation. The debt continues to decline under the interest rate, the growth rate, current account or combined shock scenarios, although at a slower pace. However, a stress scenario with 30 percent depreciation indicates that the external debt would increase sharply to over 70 percent of GDP in 2019, and thereafter gradually decline to around 60 percent of GDP in 2023.

Table 1. Romania: External Debt Sustainability Framework, 2013-2023

(In percent of GDP, unless otherwise indicated)

	Actual				Est.			Projections						
	2013	2014	2015	2016	2017			2018	2019	2020	2021	2022	2023	**Debt-stabilizing non-interest current account 6/**
Baseline: External debt	68.0	63.0	57.4	54.7	49.7			**48.8**	**47.1**	**45.9**	**44.8**	**42.9**	**41.0**	**-3.8**
Change in external debt	-6.6	-5.0	-5.6	-2.7	-5.0			-1.0	-1.6	-1.3	-1.1	-1.9	-1.9	
Identified external debt-creating flows (4+8+9)	-6.4	-3.8	-4.5	-3.7	-4.3			-1.1	-0.4	-0.3	-0.3	-0.6	-0.6	
Current account deficit, excluding interest payments	-1.4	-1.6	-0.6	0.6	2.0			1.8	1.8	1.8	1.9	1.8	2.0	
Deficit in balance of goods and services	0.8	0.4	0.6	0.9	2.1			2.6	2.5	2.3	2.0	1.9	1.9	
Exports	39.7	41.2	41.0	41.3	41.4			41.9	42.1	42.3	42.9	43.3	43.5	
Imports	40.5	41.6	41.6	42.3	43.6			44.5	44.6	44.5	44.9	45.2	45.4	
Net non-debt creating capital inflows (negative)	-1.9	-1.7	-1.8	-2.6	-2.4			-2.4	-2.4	-2.4	-2.5	-2.7	-2.8	
Automatic debt dynamics 1/	-3.1	-0.5	-2.1	-1.7	-4.0			-0.5	0.2	0.3	0.3	0.3	0.2	
Contribution from nominal interest rate	2.4	2.2	1.8	1.5	1.3			1.9	1.8	1.7	1.6	1.6	1.5	
Contribution from real GDP growth	-2.4	-2.0	-2.3	-2.6	-3.4			-2.4	-1.6	-1.4	-1.3	-1.3	-1.2	
Contribution from price and exchange rate changes 2/	-3.1	-0.7	-1.6	-0.6	-1.9			...	...	...	...	...	...	
Residual, incl. change in gross foreign assets (2-3) 3/	-0.2	-1.2	-1.1	1.0	-0.7			0.1	-1.2	-1.0	-0.8	-1.4	-1.3	
External debt-to-exports ratio (in percent)	171.1	153.0	140.0	132.4	120.0			116.4	111.9	108.5	104.4	99.1	94.2	
Gross external financing need (in billions of Euros) 4/	45.6	41.9	43.9	43.3	43.3			48.0	48.9	48.7	47.3	47.5	48.1	
in percent of GDP	31.6	27.9	27.4	25.5	23.0			23.9	22.8	21.3	19.5	18.4	17.5	
Scenario with key variables at their historical averages 5/								**48.8**	**48.2**	**47.9**	**47.8**	**46.9**	**46.1**	**-2.7**
Key Macroeconomic Assumptions Underlying Baseline						10-Year Historical Average	10-Year Standard Deviation							
Real GDP growth (in percent)	3.5	3.1	4.0	4.8	6.9	2.5	4.3	5.1	3.5	3.1	3.1	3.1	3.1	
GDP deflator in Euros (change in percent)	4.3	1.1	2.6	1.0	3.5	1.5	4.3	1.6	3.2	3.4	3.2	3.2	3.1	
Nominal external interest rate (in percent)	3.5	3.4	3.1	2.8	2.7	3.5	0.8	4.0	3.9	3.9	3.8	3.7	3.6	
Growth of exports (Euro terms, in percent)	15.1	8.0	6.2	6.7	11.0	10.1	11.5	7.9	7.3	7.0	8.0	7.3	7.0	
Growth of imports (Euro terms, in percent)	3.3	7.1	6.7	7.5	14.1	6.1	13.9	9.0	7.0	6.5	7.3	7.1	6.9	
Current account balance, excluding interest payments	1.4	1.6	0.6	-0.6	-2.0	-1.9	3.1	-1.8	-1.8	-1.8	-1.9	-1.8	-2.0	
Net non-debt creating capital inflows	1.9	1.7	1.8	2.6	2.4	2.5	1.4	2.4	2.4	2.4	2.5	2.7	2.8	

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, e = nominal appreciation (increase in Euro value of domestic currency), and a = share of domestic-currency denominated debt in total external debt.

2/ The contribution from price and exchange rate changes is defined as [-r(1+g) + ea(1+r)]/(1+g+r+gr) times previous period debt stock. r increases with an appreciating domestic currency (e > 0) and rising inflation (based on GDP deflator).

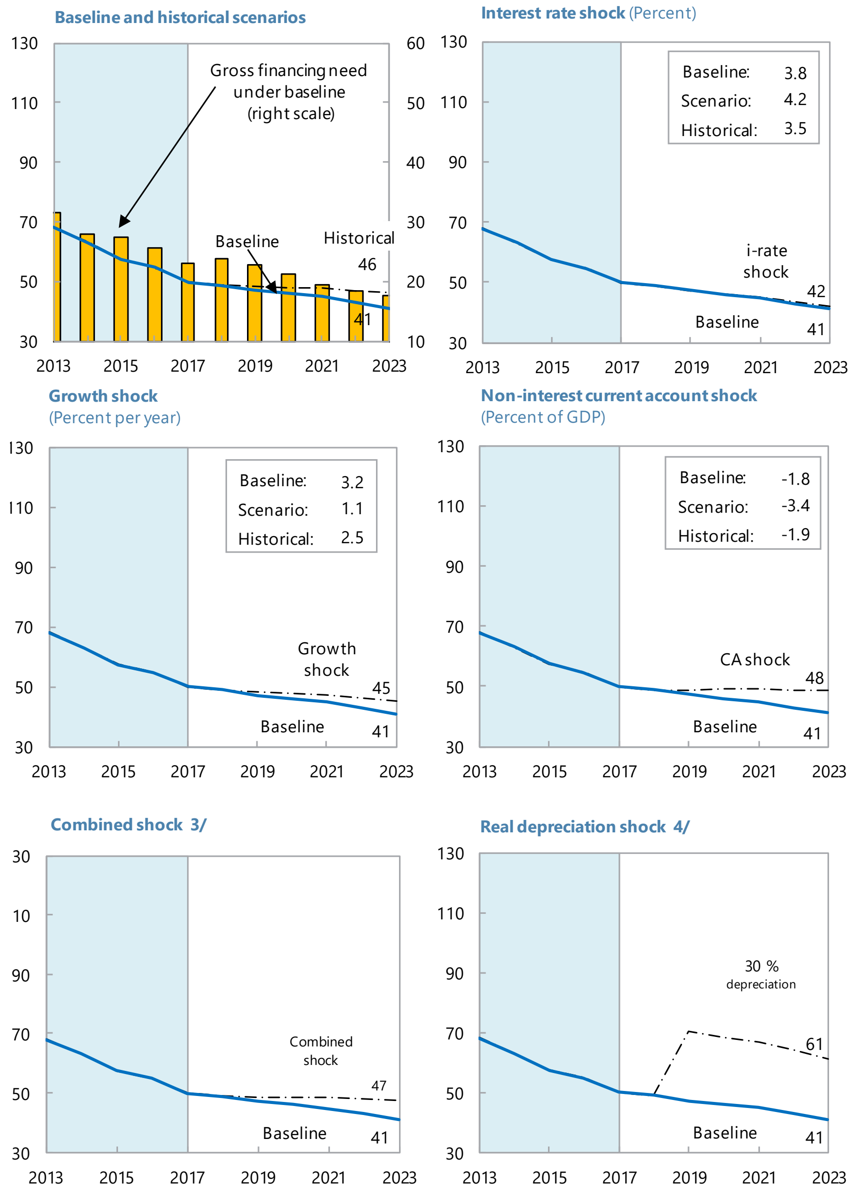
3/ For projection, line includes the impact of price and exchange rate changes.

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; Euro 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, Euro deflator growth, and non-debt inflows in percent of GDP) remain at their levels of the last projection year.

Figure 6. Romania: External Debt Sustainability: Bound Tests 1/, 2/
(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/ For historical scenarios, the historical averages are calculated over the ten-year period, and the information is used to project debt dynamics five years ahead.
3/ Permanent 1/4 standard deviation shocks applied to real interest rate, growth rate, and current account balance.
4/ One-time real depreciation of 30 percent occurs in 2018.

Annex II. Risk Assessment Matrix (RAM) 1/

Risk	Relative Likelihood and Transmission Channels	Expected Impact if Risk is Realized	Policy Response
1. Tighter global financial conditions arising from abrupt change in global risk appetite, against backdrop of continued monetary policy normalization, increase global rates and term premia (short term)	High • Investors may sell Romanian financial assets after reassessment of risks. • Outflows could arise from foreign holdings of government bonds and short-term debt financing requirements. • Financial market volatility could lead to a rapid and significant rise in interest rates, a steepening of the yield curve, and currency depreciation.	Medium • Increase in borrowing costs • Risk of exchange rate overshooting and financial instability. • NPLs rise due to weakened repayment capacity of borrowers of lei and FX loans.	• Utilize some of fiscal financing buffer until markets settle down. • Allow for exchange rate flexibility while offsetting excessive market volatility
2. Weakening of confidence in the Romanian economy due to policy uncertainty and divergence (short/medium term)	High • Procyclical fiscal stance and growing macroeconomic imbalances may lead to a sharp slowdown when the cycle turns, economic disruption, and adverse market sentiment, reflected in consumption and investment decisions.	Medium • Increase in borrowing costs • Sudden capital outflows • Slower growth and rise in unemployment	• Utilize some of fiscal financing buffer until markets settle down. • Allow for exchange rate flexibility while offsetting excessive market volatility • Communicate commitment to prudent medium term oriented policies
3. Excessive fiscal relaxation (short term)	High/Medium • Loss of fiscal credibility and associated worsening of market sentiment, and public debt rises • Romania enters EU's Excessive Deficit Procedure.	Medium • Borrowing costs increase and private investment is crowded out, weighing on growth prospects • Further widening of the current account deficit	• Restrain future public wage increases, cut lower priority expenditure • Improve tax administration to raise more revenues
4. Overheating pressures intensify (short term)	High/Medium • Inflation sustains a protracted rise above the target, destabilizing inflation expectations. • An adverse wage-price spiral develops.	Medium • Purchasing power of households diminish, while external competitiveness of Romania deteriorates. • Widening of current account deficit intensifies depreciation pressures.	• Tighten monetary and fiscal policies to reduce aggregate demand, within a prudent policy mix. • Restrain wage increases • Accelerate supply-side boosting structural reforms to raise potential output
5. Slippages in structural reforms (short/medium term)	High/Medium • Bottlenecks in public administration continue to hamper public investment and EU funds absorption.	Medium • Delay in much-needed infrastructure upgrade would constrain growth prospects.	• Improve EU projects implementation capacity • Improve investment prioritization, strengthen public investment review process, improve procurement framework • Strengthen anti-corruption efforts
6. Structurally weak growth in the Euro area (medium term)	High • Exports could fall, particularly if the Euro area enters into a protracted period of slower growth. • FDI could drop as investors reassess future euro area demand for Romanian exports.	Medium • Lower growth, higher unemployment • Potential widening of the current account deficit	• Allow limited use of automatic stabilizers to work as a sharp fiscal deterioration could worsen market sentiment • Improve competitiveness through strengthening structural reforms to raise exports beyond Euro area

1/ The RAM shows events that could materially alter the baseline path. (The scenario most likely to materialize in the view of IMF staff.) The relative likelihood of risks is staff's subjective assessment of risks surrounding the baseline. Non-mutually exclusive risks may interact and materialize jointly.

Annex III. Implementation of the 2017 Article IV Key Recommendations

Key Recommendations	Policy Actions
	Fiscal
Maintain a broadly neutral fiscal stance for 2017, while avoiding expansionary policies such as excessive wage and pension increases and further tax cuts.	The cyclically adjusted fiscal deficit widened further in 2017, reflecting expenditure increases (mostly wages) and tax cuts.
Build stronger policy buffers by lowering the deficit to 1.5 percent of GDP by 2020.	The 2018 budget targets a deficit just below 3 percent of GDP, continuing the procyclical pattern of fiscal policy.
Reprioritize investment over consumption and improve the efficiency of public administration.	The composition of public spending deteriorated further in 2017. The wage bill increased at the expense of a sharp under-execution of the capital budget (domestic and EU-funded), resulting in a decline in total public capital spending.
	Monetary and financial
Maintain the policy rate for now but remain vigilant against rising inflationary pressures.	The policy rate was kept unchanged in 2017 (raised from January 2018), but the central bank published updated quarterly inflation forecasts to show inflation rising in the forecast period to warrant a response, and narrowed the interest rate corridor (including raising deposit facility rate) in October and November 2017 to prepare for rate hikes.
Bring short-term market rates closer to the policy rate by absorbing excess liquidity and narrowing the interest rate corridor.	Short-term market rates were closer to the policy rate in Q4 2017 as excess liquidity was reduced, also helped by the narrowing of the interest rate corridor by 50 basis points on either side of the policy rate (to a width of +/- 100 basis points).
Sustain progress in cleaning up banks' balance sheets (reduce NPLs)	The central bank has continued efforts towards further NPL reduction and a sharp recent reduction in the NPL ratio to 6.4 percent at end-2017 from 22 percent in 2014.
	Structural reforms
Improve the quality of public investment through better absorption of EU funds and improved governance of state-owned enterprises.	EU funds absorption remained very low in 2017 for the programming period 2014-2020. Law 111 on SOE corporate governance was amended in parliament to exempt a large number of SOEs from its application, albeit subsequently the amendments were rejected by the Constitutional Court.

Annex IV. External Sector Assessment

Staff's overall assessment was that Romania's external position in 2017 was broadly in line with fundamentals and desirable policies.

1. Current Account (CA). Higher domestic demand due to booming economy, coupled with a slight worsening in the terms of trade, resulted in a deterioration of the current account relative to 2016. The deterioration was in line with staff's earlier forecasts that imports will pick up following their sharp contraction in the post crisis period. The EBA-lite tool suggests a cyclically-adjusted CA norm of -3.9 percent of GDP, implying a CA gap of 0.9 percent of GDP, which partly stems from fiscal policy gaps.

Romania: Estimated Policy Contributions to Current Account Gap, 2017
(percent of GDP)

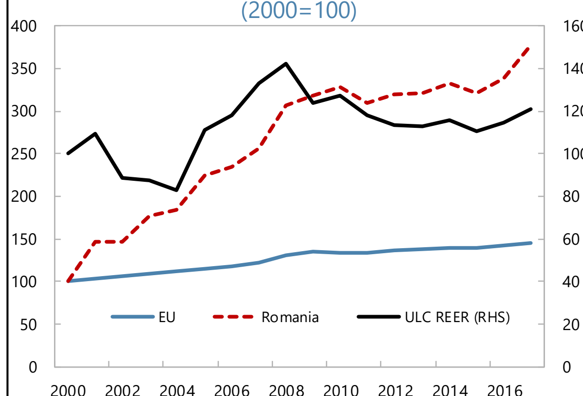
EBA-Lite CA Method	
Cyclically-adjusted CA	-3.0
Cyclically-adjusted CA norm	-3.9
Model estimated CA gap	0.9
Of which:	
Fiscal policy (difference between domestic and world fiscal deficits)	0.3
World fiscal deficit	-1.1
Domestic fiscal deficit	-0.8
Policy gaps, other	0.4
Residuals	0.2
Model Implied REER Gap 1/	-1.3
EBA-Lite REER Index Model	
EBA REER Gap 1/	-6.9
EBA-Lite External Sustainability Model	
CA Gap	1.0
EBA REER Gap 1/	-1.4

1/Negative value implies REER is below levels consistent with fundamentals and desirable policies.

2. Capital and Financial Flows. As in the previous years, the FDI inflows were the main contributor to financing the CA deficit, covering about two-thirds of it. The majority of the FDI inflows are reinvested earnings, and they are expected to continue to play the important role in financing the CA deficits over the medium term. Portfolio flows picked up in 2017 on account of sovereign bond issuance.

3. International Investment Position. Romania's net international investment position (NIIP), at -45.7 percent of GDP at end-2017, has continued to improve over the last five years. While the NIIP improved as a share of GDP compared to the same period of the last years, it deteriorated in nominal terms as accumulation of liabilities was higher than accumulation of assets.

Unit Labor Cost 1/
(2000=100)



Sources: Eurpean Commision and Haver.
1/Annual growth based on quarterly data (Q42017).

4. Real Exchange Rate. The real exchange rate (CPI-based) depreciated by 1.6 percent during the 2017. However, the unit labor cost increased about 11.3 percent, as wage growth outpaced productivity growth, and the ULC-based REER appreciated about 5 percent. Based on the EBA-lite External Sustainability Model, an appreciation of 1.4 percent would close the CA gap and stabilize NIIP at 45.9 percent of GDP. EBA-lite CA and REER models imply undervaluation of 1.3 and 6.9 percent respectively. Staff overall assessment is that the real exchange rate is broadly in line with the fundamentals.

5. Competitiveness. Romania has been recording steady gains in export market shares, particularly in exports of machinery and transport equipment. The overall market share in imports of key trading partners in the EU rose by 45 percent during 2008-2016, while market share for machinery and transport equipment rose by almost 80 percent over the same period. Export of food items has been also performing well, largely due to export of cereal. Safeguarding competitiveness gains achieved over the last several years will be crucial, as will continuing to diversify the economy to further foster competitiveness.

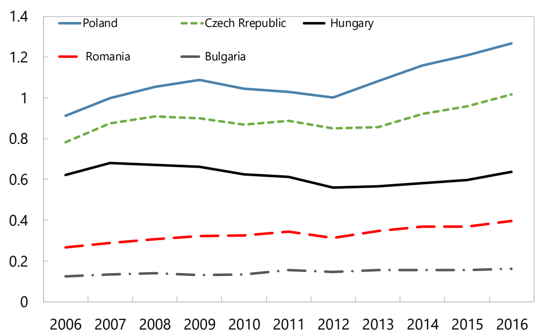
Export Diversification

	2006	2016
Concentration Index	0.11	0.11
Diversification Index*	0.47	0.42
Number of products	242	244

Source: UNCTAD Stat.

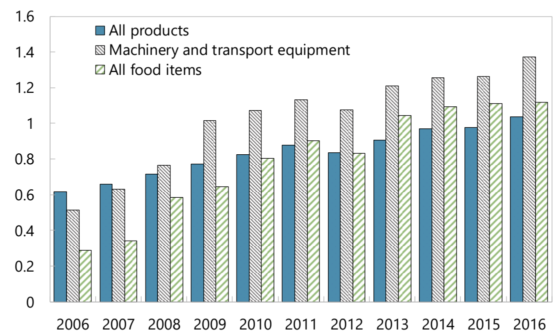
* Higher index values indicate less diversification

Export Share
(Percentage of total world)



Sources: UNCTAD Stat.

Exports Share in the EU
(In percent)



Sources: UNCTAD Stat; and IMF staff calculation.

6. Reserve Adequacy. Romania's gross international reserves stood at €37.1 billion at the end of 2017, comfortably above most reserves metrics thresholds. Reserves were above 150 percent of the reserves adequacy metric developed by the Fund for emerging markets. At the same time, reserves are covering about 5.0 months of next year's imports and over 50 percent of broad money, and account for about 91 percent of short-term debt (at the remaining maturity). The financing risk for the corporate sector remains limited, as the majority of the short-term debt stems from intra-company loans with low rollover risks. Given the further projected decline of reserves in 2018 and high share of FX lending, staff advises limiting interventions to only smoothing the excess volatility of the lei.

Annex V. FSAP 2018: Key Recommendations

Recommendations (from Financial System Stability Assessment)	Agency	Time 1/
System Risks and Macroprudential Policies		
1. Strengthen the NCMO´s accountability framework by i) requiring proposed policy actions and distribution of votes to be publicly disclosed in the summary of meetings; and ii) developing a common assessment of systemic risk at each NCMO meeting.	NBR, MoPF, ASF	NT
2. Apply a stressed DSTI limit to household loans and continue scaling back the Prima Casa program.	NBR, MoPF	NT
3. Enforce a currency-differentiated LCR and NSFR for significant currencies.	NBR	NT
4. Introduce a carefully calibrated Systemic Risk Buffer to increase resilience against risks from large exposures to the sovereign.	NBR, MoPF, ASF	NT
5. Ensure provisioning requirements for NBFLs tighten in line with the application of International Financial Reporting Standards (IFRS) 9 to banks.	NBR, MoPF	NT
Sectoral Oversight		
Bank Regulation and Supervision		
6. Ensure consistency and objectivity in Supervisory Review and Evaluation Process (SREP) scores, findings and supervisory measures.	NBR	NT
7. Enhance supervisory tools by incorporating more forward-looking views (e.g., bottom up stress testing tools) and conducting more thematic reviews.		MT
8. Strengthen bank corporate governance (number and profile of independent board members, content and periodicity of exchanges between the NBR and board members).		NT
9. Review and amend the regulation not governed by EU harmonization (e.g., transactions with related parties) in a more prudent manner.		NT
Financial Market Infrastructures		
10. Adopt the PFMI and formalize and strengthen cooperation between the NBR and the ASF for the supervision of the Bucharest Stock Exchange CSD.	NBR, ASF	NT
11. Invest in more and more qualified IT staff, in particular in the area of cyber resilience, and implement a formal project management methodology.	NBR	I
AML/CFT		
12. Address the remaining gaps in the AML/CFT preventive framework, including with respect to PEPs, and entity transparency; assess and mitigate the ML/TF risks.	MoJ / MoAI	I
Crisis Management and Bank Resolution		
13. Prepare a simulation exercise that includes all members of the macroprudential committee plus the FGDB.	all	I
14. Seek an exemption from the Procurement law for bank resolution purposes.	NBR, MoPF	MT
15. Include MoPF officers linked to bank resolution under personal legal protection provisions.	MoPF	MT
16. Ensure that Romania’s interests are addressed in recovery and resolution plans of Romanian subsidiaries of foreign banks.	NBR	NT
17. Diversify the investment policy of the FGDB, and establish operational procedures with the NBR that allows the FGDB to have accounts in the central bank and a repo line.	FGDB/NBR	NT
18. Finalize and implement an ELA scheme and provisions for FX liquidity support.	NBR	NT

Agencies: ASF = Financial Services Authority; FGDB = Bank Deposit Guarantee Fund; MoPF = Ministry of Public Finance; NBR = National Bank of Romania.

1/ Time Frame: I (immediate) = within one year; NT (near term) = 1-3 years; MT (medium term) = 3-5 years.

INTERNATIONAL MONETARY FUND

ROMANIA

May 2, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

Prepared By

European Department

CONTENTS

FUND RELATIONS

(as of March 31, 2018)

Membership Status	Joined 12/15/72	Article VIII
General Resources Account	**SDR million**	**% Quota**
Quota	1,811.40	100.00
Fund holdings of currency	1,811.40	100.00
Reserve Tranche Position	0.00	0.00
SDR Department	**SDR million**	**% Allocation**
Net cumulative allocation	984.77	100.00
Holdings	988.03	100.33
Outstanding Purchases and Loans	**SDR Million**	**% Quota**
Stand-By Arrangements	0.00	0.00

Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	09/27/13	09/26/15	1,751.34	0.00
Stand-By	03/31/11	06/30/13	3,090.6	0.00
Stand-By	05/04/09	03/30/11	11,443.00	10,569.00
Stand-By	07/07/04	07/06/06	250.00	0.00
Stand-By	10/31/01	10/15/03	300.00	300.00
Stand-By	08/05/99	02/28/01	400.00	139.75
Stand-By	04/22/97	05/21/98	301.50	120.60
Stand-By	05/11/94	04/22/97	320.50	94.27
Stand-By	05/29/92	03/28/93	314.04	261.70
Stand-By	04/11/91	04/10/92	380.50	318.10

Overdue Obligations and Projected Payments to Fund[1]

(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2018	2019	2020	2021	2022
Principal					
Charges/interest	0.03	0.03	0.03	0.03	0.03
Total	0.03	0.03	0.03	0.03	0.03

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

Romania has accepted the obligations of Article VIII and maintains an exchange rate system free of restrictions on making of payments and transfers on current international transactions except for those maintained solely for preservation of national or international security in accordance with UNSC resolutions and that have been notified to the Fund under the procedure set forth in Executive Board Decision No. 144-(52/51). De jure exchange rate arrangement is managed floating and the de facto exchange rate arrangement is floating.

Technical Assistance

Capacity building in Romania has been supported by substantial technical assistance from multilateral agencies and bilateral donors. The Fund has provided support in several areas with almost 30 technical assistance missions and expert visits since 2012.

Date	Purpose	Department
	Tax Administration	
March–April 2012	Strengthening the capacity of the National Agency for Fiscal Administration (ANAF).	FAD
July–August 2012	Organizational reforms, strategic direction, plan for restructuring of ANAF and implementation of a compliance strategy.	FAD
August–September 2012	Follow-up on the reorganization of ANAF.	FAD
November–December 2012	Follow-up with ANAF, particularly on the antifraud unit.	FAD
March–April 2013	Training to improve high net wealth individual compliance.	FAD
Apr., Sep., Nov. 2013, Jan. 2014	Follow-up with ANAF.	FAD
April 2014	Assistance to ANAF on pilot structural compliance project targeted at undocumented labor. Training on payroll audit.	FAD
April 2014	Stock taking on assistance and identification of future TA focus: compliance risk management, reorganization of ANAF, pilot projects.	FAD
January–February 2015	Follow-up and training to improve high net wealth individual compliance.	FAD
July-August 2015	Review of the performance of the large taxpayer office and tax compliance management concerning high wealth individuals.	FAD
April 2016	Tax compliance risk analysis related to large businesses.	FAD
November 2016	ANAF performance outcomes compare to international best practice.	FAD
	Tax Policy	
September 2013	Strengthening the property tax and natural resource tax regime.	FAD
September 2014	Follow-up assistance with creating a new natural resource tax regime.	FAD
June 2015	Workshop on petroleum tax regime design.	FAD
	Public Financial Management	
March 2012	Setting up commitment control and fiscal reporting systems.	FAD
October 2012	Follow-up assistance in setting up commitment control and fiscal reporting systems, especially methodologies and functionalities.	FAD
April 2013	Follow-up assistance in setting up commitment control and fiscal reporting systems, including methodology to verify arrears of local government.	FAD
December 2013	Follow-up assistance in setting up commitment control and fiscal reporting systems, including requirements from decentralization plans.	FAD
February 2014	Fiscal Transparency Evaluation.	FAD
January 2015	Follow-up assistance in setting up commitment control and fiscal reporting systems, review of public investment practices and program budgeting.	FAD
June 2015	Follow-up assistance on strengthening public investment management and implementing public expenditure reviews.	FAD
June 2016	Assistance on institutionalizing spending reviews and preparing spending review reports.	FAD
October 2016	Follow-up assistance to advise on piloting spending reviews.	FAD

Date	Purpose	Department
	Financial Sector Issues and Monetary Policy	
November 2012	Follow-up on program-related financial sector issues, including progress with contingency planning.	MCM
October 2014	Assessment of the monetary policy framework.	MCM
	Accounting and NPL	
October 2013	Achieving timely NPL write-off within the IFRS framework.	MCM

Expert Fund assistance has focused in recent years mostly on structural fiscal reforms, in particular modernizing tax administration, strengthening public financial management, and reviewing tax policy options. Technical assistance to the National Bank of Romania focused on upgrading contingency planning, dealing with non-performing loans, and reviewing monetary and exchange rate policy tools.

Article IV Consultations

Romania is on a 12-month consultation cycle. The previous Article IV consultation was concluded by the Executive Board on May 22, 2017.

Safeguards Assessment

An update of the 2011 safeguards assessment, completed on January 10, 2014, found that overall governance at the NBR remains robust, although the legal framework is in need of update to strengthen the NBR's financial autonomy. Accountability and transparency practices are strong; annual financial statements are independently audited and published. Robust controls are maintained over foreign reserves management, government banking, and vault operations. Romania fully repaid the Fund on January 11, 2016 and therefore will no longer be subject to monitoring under the safeguards policy.

FSAP and ROSC

A joint IMF-World Bank mission conducted an update assessment of Romania's financial sector as part of the Financial Sector Assessment Program (FSAP) during October 21-November 31, 2017, and January 11-23, 2018. The Financial Sector Assessment Report (FSSA) was discussed at the Board in June 2018.

A pilot of the IMF's new Fiscal Transparency Evaluation took place in February 2014 and the findings were published in March 2015. It assessed the government's fiscal reporting, forecasting, and risks management practices against the IMF's revised Fiscal Transparency Code.

Resident Representative

The Fund has had a resident representative in Bucharest since 1991. Mr. Alejandro Hajdenberg assumed the post of regional resident representative in April 2016.

RELATIONS WITH THE WORLD BANK

(as of March 27, 2018)

The current World Bank Group Country Partnership Strategy (CPS) for Romania, covering the period 2014–18, was presented to the Board on May 22, 2014. The strategy aims at reducing poverty and promoting shared prosperity. The CPS is built on three pillars: (i) *Creating a 21st Century Government*, with focus on a well-functioning public administration, effective in its service delivery and with an improved quality of public expenditure; (ii) *Growth and Private Sector Job Creation*, seeking sustainable poverty mitigation and shared prosperity through improvements in the business environment and SOE governance (especially in energy and transport), promoting innovation, and furthering the digital agenda and competitiveness; and (iii) *Social Inclusion*, a key to the EU's Europe 2020 Agenda, with a special focus on the Roma community. A new World Bank Group Country Partnership Framework for the period of FY2019 –23, is under preparation and scheduled to be presented to the Board in June 2018.

i. International Bank for Reconstruction and Development (IBRD)

Romania's portfolio consists of five active investment projects amounting to US$859 million, which are complemented by one country-executed trust fund of US$3.07 million and 18 (Bank-funded) analytical pieces. The ongoing thirteen Reimbursable Advisory Services (RAS) are worth US$40 million and support the General Secretariat of the Government, the Ministry of National Education and Scientific Research, National Authority for the Protection of Children Rights and Adoption, Ministry of European Funds, Ministry of Public Finance, the National Agency of Public Procurement, Ministry of Regional Development, Public Administration and European Funds, Municipality of Constanta and Bucharest District 5 City Hall. Since 2010, 57 RAS agreements totaling US$94.63 million have been signed (data as of March 27, 2018).

- The five active investment projects include the Justice Services Improvement Project ($67 million), Integrated Nutrient Pollution Control (US$120.5 million), the Romania Secondary Education Project (US$243 million), the Health Sector Reform Project (US$339 million) and the Revenue Administration Modernization Project (US$92 million).

- The country-executed trust fund focuses on Afforestation of Degraded Agricultural Land Proto-Carbon;

- The Bank advisory services program covers key areas of engagement. Under the programming period 2007–13, the Bank provided guidance on policy formulation and strategy development in agriculture, competition, climate change, early school leaving, tertiary education, life-long learning, active ageing, social inclusion, Roma integration and transport. Among the 57 RAS that have been signed since 2010, a few provided support to the government in improving the public sector management for efficient and effective service delivery by: (i) shifting towards a results-driven culture, improved policy prioritization, implementation, and coordination, (ii) strengthening public investment management, (iii) introducing performance management systems for EU funds, and (iv) supporting the strategic activities to meet the EU funding conditions for education, social inclusion, active aging (EU 2014–20 program budget). Under the programming period 2014-20, the Bank has built upon the previous assignments in terms of strategic planning and regulatory impact assessment and has shifted its support largely towards strategy implementation and improving EU funds management. Out of the thirteen active RASs, two of them are funded from the local budget (Constanta Urban Development and Bucharest District 5 Urban Development).

- Analytical work (Bank-funded ASA) provides diagnostics and policy recommendations in key areas and stimulates cross-sector synergy. Typical examples are the Public Expenditure Reviews and Financial Sector Assessments. Other Bank-funded analytical work focuses on Partnerships for Marginalized Roma, Capital Market Supervision, Smallholder Inclusion in Agri-food Value and Supply Chains, Water Sector, Assessment of the District Heating System, Pensions, Regional Hospitals and Disaster Risk Management and Climate Resilience in Romania.

The World Bank has received financial requests for two new projects to be prepared and approved by the Bank's Board of Directors in CY2018: The Preparation of Bucharest-Brasov Corridor Project and the Justice Quarter and Esplanada District Development Project.

ii. International Finance Corporation (IFC)

Since the start of operations in Romania in 1990 through end-February FY2018, IFC has invested approximately US$2.8 billion in long-term finance in 89 projects, including over US$600 million in mobilization from other investors. For FY14-FY18 IFC, on own account and through mobilization, committed US$684 million in long-term finance. IFC's committed own account portfolio ranks third in IFC's Europe and Central Asia region. The portfolio amounts to US$573 million across 32 projects. By IFC industry cluster, 63 percent is in financial institutions, 29 percent in manufacturing/ agribusiness/ services, 5 percent in infrastructure, and 3 percent in ICT (as of March 27, 2018).

For FY18, IFC is targeting commitments of US$150 million. This includes supporting projects which create jobs, increase investment in underserved frontier regions, contribute to the growth and competitiveness of local firms in underserved sectors such as health, infrastructure, and improve resource efficiency. In the financial sector, IFC will support the development of capital markets, continue to engage in distressed assets projects and support on-lending to SMEs through leasing companies and banks.

STATISTICAL ISSUES

(as of April 13, 2018)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance.
National accounts: Quarterly and annual national accounts statistics are produced by the National Institute for Statistics (INS) using the *European System of Accounts 2010 (ESA 2010)*. Estimates are methodologically sound and are reported to the Fund on a timely basis for publication in the *International Financial Statistics (IFS)*. Provisional and semi-final versions are disseminated in the *Statistical Yearbook* and other publications, as well as on the web (www.insse.ro).
Prices: The Consumer Price Index is subject to standard annual reweighting, and is considered reliable. In January 2004, the INS changed the coverage of the Producer Price Index (PPI) to include the domestic and export sectors. PPI weights are revised every five years with revisions finalized three years after the new base year.
Labor market: Labor market statistics are broadly adequate. The definition used for employment is consistent with *ESA 2010*.
Public finances: Annual GFS data for the general government sector, including public corporations operating on a non-market basis, are reported on an accrual basis derived from cash data using various adjustment methods. Tax revenues are adjusted using the time-adjusted cash method; expense data are adjusted using due-for-payments data; and interest payments are calculated on an accrual basis. Accrual data are also available on a quarterly basis three months after the end of each quarter. EUR receives monthly cash budget execution data. Consolidated data on general government operations are reported for inclusion in the *GFS Yearbook*.
Monetary and financial statistics: The National Bank of Romania (NBR) reports monetary and financial statistics for publication in the *IFS*, using the Standardized Report Forms (SRFs). The SRFs for the central bank and other depository corporations are reported on a monthly basis, while the SRF for Other Financial Corporations (OFCs) is reported on a quarterly basis. **Financial Soundness Indicators (FSIs)**: The NBR reports all core and most encouraged FSIs for Deposit Takers on a quarterly basis. In addition, the NBR reports FSIs for the nonfinancial corporations (NFCs) and households (HHs) sectors, as well as those for real estate markets.
External sector statistics: The NBR routinely reports quarterly and annual balance of payments and international investment position statistics to the Fund and external debt statistics to the World Bank's QEDS database in a timely fashion. Since September 2014 the authorities implemented the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*), in line with other European countries. Romania participates in the IMF's Coordinated Portfolio Investment Survey (CPIS), Coordinated Direct Investment Survey (CDIS) and reports International Reserves and Foreign Currency Liquidity (IRFCL) Data Template.

II. Data Standards and Quality	
Romania is a subscriber to the Fund's Special Data Dissemination Standard (SDDS) since August 4, 2005.	A Data ROSC was published in November 2001.

Romania: Table of Common Indicators Required for Surveillance
(as of April 13, 2018)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Apr 2018	Apr 2018	D and M	D and M	M
Reserve/Base Money	Feb 2018	Mar 2018	D and M	W and M	M
Broad Money	Feb 2018	Mar 2018	M	M	M
Central Bank Balance Sheet	Feb 2018	Mar 2018	M	M	M
Consolidated Balance Sheet of the Banking System	Feb 2018	Mar 2018	M	M	M
Interest Rates[2]	Mar 2018	Apr 2018	M	M	M
Consumer Price Index	Mar 2018	Apr 2018	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	Mar 2018	Apr 2018	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q4 2017	Mar 2018	Q	Q	Q
External Current Account Balance	Feb 2018	Apr 2018	M	M	M
Exports and Imports of Goods and Services	Feb 2018	Apr 2018	M	M	M
Gross External Debt	Feb 2018	Apr 2018	M	M	M
International Investment Position[7]	Q4 2017	Feb 2018	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic non-bank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds), and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

[7] Includes external gross financial asset and liability positions vis-à-vis nonresidents.

INTERNATIONAL MONETARY FUND

ROMANIA

May 24, 2018

STAFF REPORT FOR THE 2018 ARTICLE IV CONSULTATION— SUPPLEMENTARY INFORMATION

Prepared By	European Department

This supplement provides information on key economic developments that became available after the staff report was issued. This information does not change the thrust of the staff appraisal.

1. Recent data releases point to downside risks to growth, amidst rising inflation.

- **Growth.** According to flash estimates, GDP growth unexpectedly decelerated on a seasonally adjusted basis to 4.2 percent y/y and 0 percent q/q in the first quarter of 2018. Retail sales and industrial production weakened in March consistent with this slowing, but other indicators remained buoyant: the trade deficit remained high, net wage and consumer credit maintained robust growth, and the unemployment rate continued to fall. Although the GDP components are not yet available, private consumption during the quarter was likely affected by the uncertainty in employee incomes including due to the shift in social security contributions, and industrial activity was affected by the broader slowdown in the Euro Area, both of which are seen as temporary. While the downside risk to the growth outlook in 2018 has increased with these developments, the need for fiscal consolidation and monetary tightening remains, given the still strong inflation pressures and cyclical position of the economy. In the event of a further substantial slowing of growth, the desirable pace of policy adjustments could be recalibrated.

- **Inflation.** Headline inflation rose further to 5.2 percent (y/y) in April 2018 from 5 percent (y/y) in March, far above the upper limit of the target band (2.5 percent ± 1 percent). Core inflation was 3 percent (y/y) in both March and April 2018.

2. The National Bank of Romania (NBR) raised its policy rate on May 7 by 25 basis points to 2.5 percent, with corresponding increases in its deposit and lending facility rates to 1.5 percent and 3.5 percent, respectively. Since mid-April 2018, the NBR has undertaken liquidity absorption operations, which have led to higher money market rates.

3. Preliminary budget execution through April 2018 showed a deterioration in the fiscal position relative to the same period last year. The fiscal balance had a deficit of 0.7 percent of GDP compared to a surplus of 0.2 percent of GDP recorded in January–April 2017. Although revenue rose by some 0.2 percentage point of GDP (mostly due to higher social security contributions), spending rose more (by 1 percentage point of GDP) due to a one-off defense payment in February, wage hikes for health and education sectors in March, and slightly higher interest expenditure.

Statement by Anthony De Lannoy, Executive Director for Romania and Cezar Botel, Advisor to the Executive Director June 4, 2018

The Romanian authorities would like to thank the Article IV and FSAP mission teams for the open and constructive discussions in Bucharest. While the authorities argued that the Government's program and reform agenda warrant a more optimistic macroeconomic outlook than staff's baseline scenario, there is broad agreement between the authorities and staff on a wide range of issues. Going forward, the authorities will carefully consider the staff's recommendations.

Romania's economic growth has been among the highest in the EU in recent years, while unemployment dropped to record low levels. The resilience of the financial sector continued to improve. Fiscal deficits were kept within EU rules, and public and external debt levels have remained low. Looking ahead, the main medium-term challenges will be to reinvigorate public investment and structural reforms aimed at fostering sustainable and more inclusive growth, bringing inflation back within the target band after the recent adverse supply shocks, and addressing the remaining vulnerabilities in the financial sector. The authorities are fully committed to address these challenges adequately and consistently.

After strongly accelerating in 2017, growth will maintain at a robust pace over the medium term while the external position will remain sustainable. Accelerating for the third consecutive year, economic growth in Romania has climbed to 6.9 percent in 2017, while employment levels increased above the pre-crisis levels and the unemployment rate continued to fall, reaching 4.5 percent in March 2018. Private consumption, boosted by fiscal measures designed to increase household income and reduce indirect taxation, continued to be the main driver of growth. The propagated effects of stimulus measures and the upward trend in consumer credit are expected to support further expansion of consumption, albeit at a slower pace over the medium term. At the same time, a recovery in private investment led the contribution of gross fixed capital formation to GDP growth to turn from negative in 2016 to positive in 2017, and the beginning of 2018 saw a significant rebound in non-residential and civil engineering construction work. Investment growth is expected to accelerate over the medium term, driven by accruing effects of growth-friendly tax cuts, steady improvement of the EU funds absorption, and credit expansion. Factoring in significant second-round effects of multiple fiscal stimuli on both domestic demand and potential output, the government projects a significantly slower deceleration of growth over the medium term, compared with staff's baseline.

While exports growth accelerated further in 2017, supported by FDI and stronger demand from European economies, imports grew faster on the account of the rapid expansion of domestic absorption, pushing the current account deficit above 3 percent. Over the medium term, the deficit is anticipated to remain at sustainable levels, continuing to be financed primarily by non-debt-generating flows (FDI and EU funds) which will allow for a further decline in the external debt-to-GDP ratio. The external position continues to be broadly in line with the fundamentals. The share of short-term debt in total external debt has been relatively low (27 percent), and the international reserves coverage is adequate according to all reserve adequacy metrics. The authorities are fully aware of the significant risks associated with a sudden sharp exchange rate depreciation and continue to monitor those risks carefully.

In the short term, fiscal policy will prioritize capital spending while keeping the deficit within EU fiscal rules. In the medium term, fiscal policy will focus on fiscal consolidation. Most of the measures with the largest impact on the budget will already be in place by the end of 2018, allowing for a gradual fiscal consolidation starting in 2019. The medium-term strategy foresees the ESA budget deficit decreasing from 2.95 percent of GDP in 2018 to 1.45 percent in 2021. At the same time, the government decided to maintain the medium-term objective for the structural deficit at 1 percent. While acknowledging the challenges of meeting these targets, the authorities are strongly committed to comply with the EU fiscal rules by closely monitoring the budget execution and taking compensatory measures if necessary. This commitment has been illustrated by the decision to shift the payment of social security contributions from employers to employees, as a means to mitigate the fiscal costs related to implementing the Unified Wage Law. Risks to debt sustainability are low, with the level of public debt-to-GDP ratio[1] at only 36.8 percent in 2017 and the DSA showing that the ratio would remain below 60 percent under all stress test scenarios.

A top priority for the authorities is to create the fiscal space necessary to reinvigorate public investment by increasing the efficiency of fiscal management. On the revenue side, the focus will be on reforming the tax administration (inter alia with technical assistance from FAD) and on building up an effective IT infrastructure for fiscal databases and revenue administration. On the expenditure side, the authorities are progressing towards setting up a centralized procurement system and operationalizing a Spending Review Department within the Ministry of Public Finance. The authorities also intend to propose to all political parties a Fiscal Pact aimed at promoting fiscal stability and predictability.

Monetary policy is focused on bringing inflation to the target range in the medium term. After remaining below the National Bank of Romania (NBR)'s target band of 2.5 percent +/- 1 percentage point during the first eight months of 2017, in September the annual inflation rate climbed within the band reaching 3.3 percent at year-end. This was the result of a series of adverse shocks in energy and food prices as well as of aggregate demand and labor market pressures.

During 2017, while maintaining the policy interest rate at 1.75 percent, the NBR took steps to normalize some components of the inflation targeting framework in line with the good practices of the European Central Bank. These steps included bringing the required reserve ratio on forex-denominated liabilities down to the same level (8 percent) as the ratio for Leu-denominated liabilities, and narrowing, in two steps, the corridor of interest rates on standing facilities around the monetary policy rate from ±1.5 percentage points at the beginning of 2017 to ±1 percentage points in November 2017.

The inflation rate has seen a pronounced increase in Q1 2018, climbing above the target band, and has reached 5.2 percent in April. The increase is primarily attributed to supply-side factors

[1] Calculated according to national legislation, without temporary financing

but also reflects stronger demand-pull and cost-push inflationary pressures. Against the background of simultaneous adverse supply shocks, rising inflationary pressures from fundamental drivers, entailing also the risk of de-anchoring medium-term inflation expectations, the NBR raised the policy rate three times by 25 basis points in January, February, and May, up to 2.5 percent. As a result of changes in the corridor width and policy rate, the deposit facility rate increased from 0.25 percent in September 2017 to 1.5 percent in May 2018.

The central bank will continue to gear monetary policy towards bringing the annual inflation rate back in line with the target, in a manner supportive of sustainable economic growth. The NBR Board also emphasizes the importance of a balanced macroeconomic policy mix, including from the standpoint of avoiding the overburdening of monetary policy and preventing undesired effects on the economy.

The financial sector has been growing more resilient and progress was made with adjusting the policy framework to address emerging vulnerabilities. Bank soundness indicators substantially improved in recent years. NPLs have fallen significantly due to the NBR's efforts to encourage banks to clean-up their balance sheets. The overall NPL ratio dropped from 21.5 percent in 2013 to close to 6.4 at end 2017 and provisioning is close to 65 percent. Banks' resilience improved through reduced dependence on parent funding from abroad and strengthened capital ratios.

Over time, the central bank has developed a rich experience in macroprudential policies, which allowed for an excellent cooperation between the NBR and FSAP mission teams with some valuable results. One example is a common technical note employing econometric modeling to evaluate the maximum sustainable indebtedness level for an individual in Romania at 50 per cent. Another example is the similarity of results obtained in solvency tests run in parallel by the two teams using different models. This suggests that the NBR's models do not underestimate risks and are therefore adequate for monitoring financial stability.

The authorities broadly agreed with the conclusions of the FSAP mission and its recommendations. Moreover, many of the measures proposed by staff had already been under the central bank's consideration and have been either implemented or close to implementation by the end of the mission. An example is the analysis by the NBR of the possibility of extending the use of debt-service-to-income ratios to mortgages to prevent excessive indebtedness of households.

In the authorities' view, the recommendation regarding the introduction of the capital buffer to address the sovereign bank nexus requires further review and impact analysis to avoid potential financial stability implications.

Improved EU absorption will support those structural reforms that are critical for sustainable growth. Significantly improving the EU funds absorption as a critical source of financing investment is a top priority for the authorities. While the absorption during the first years of the 2014-2020 financial framework has been weak, progress has been made with respect to designating the managing authorities, compliance with ex-ante conditionality, and reducing the administrative burden. The authorities are confident that further building on this base will allow for a significant acceleration of the absorption in the coming years.

SOEs reform is expected to gain momentum after the establishment of the Sovereign Fund for Development and Investment. The authorities are committed to the firm implementation of Law 111 on corporate governance. They also agreed on the need to continue the fight against corruption.