International Monetary Fund

Romania – 2008 Article IV Consultation

Concluding Statement of the Mission

1. **Romania's per capita income, while still at the tail end of the EU's income league, has been catching up fast.** In 2007, real GDP grew by a robust 6 percent, despite a drought-induced slump in agriculture. While per capita GDP, based on purchasing power parities, is still only about 37 percent of the euro area's level, Romania has caught up at an impressive speed over recent years, narrowing its income gap by about 10 percentage points since 2003.

2. **However, Romania's fast real convergence has gone hand-in-hand with growing macroeconomic imbalances, and global financial market tensions have added to stability concerns.** Capital inflows have fuelled a persistent domestic spending boom, mirrored by an unsustainably high current account deficit. And the boom is increasingly spilling over into underlying inflation pressures. While global financial market turbulence so far has been mainly reflected in higher external funding costs and exchange rate volatility, there can be little doubt that Romania's dependence on continued large external financing presents a significant vulnerability.

3. **Against this backdrop, the main challenge for Romania is to adopt economic policies that are much more coordinated and forward looking.** Fiscal and incomes policies have responded procyclically to the domestic spending boom, undermining the National Bank of Romania's (NBR) inflation targeting efforts. But Romania's policy making challenge seems to go well beyond fairly obvious coordination problems in stabilization policies. The sustainable speed of real convergence will ultimately depend on the ability of economic policies to address growth bottlenecks in a forward-looking manner. In particular, policies to address shortages in public infrastructure or labor skills take time to implement and bear fruit, and therefore need to be formulated and anchored in a medium-term framework.

Macroeconomic Developments

4. **The already large external deficit has continued to widen.** Massive capital inflows have allowed Romania's domestic spending on investment and consumption to exceed available incomes by increasingly larger margins. The widening spending-income gap has its counterpart in a ballooning external deficit, which reached 14 percent of GDP in 2007, an unsustainably high level, notwithstanding a still moderate external debt level.

5. **External competitiveness seems, however, to remain adequate.** Over the last year or so, the leu/euro exchange rate has exhibited pronounced volatility: it appreciated relentlessly until mid-2007, but, with the onset of global financial tensions, abruptly reversed course, and depreciated sharply. At the same time, exporters have continued to gain market

share, and the mission's analysis suggests that external price and cost competitiveness at present exchange rate levels remains intact.

6. **High CPI inflation has emerged as a new concern.** At this point, however, high headline inflation seems largely driven by supply-side shocks to food and energy prices, which are likely to prove one-off. Of more concern is that booming domestic demand is increasingly running up against capacity bottlenecks, particularly a tight labor market and an underdeveloped public infrastructure. Private-sector wage growth is outpacing productivity growth, with public-sector wage and employment policies adding to private-sector wage-push inflation. Price setters, faced with higher unit labor and other costs of doing business, are trying to maintain their price markups, as also indicated by the recent surge in PPI inflation. Available survey data suggest that inflation expectations may also be creeping upward.

7. **Credit exposures are rising, increasing the banking system's vulnerability to large adverse shocks.** Real private credit expanded by some 50 percent in 2007, and has increasingly been funded by foreign borrowing. Particularly strong growth in domestic foreign-currency credit – including a surge in Swiss-franc denominated credits from a low base – and direct foreign borrowing have further increased currency mismatches in corporate and household balance sheets. While financial soundness indicators for the banking sector as a whole still look relatively solid, capital buffers have declined and non-performing loans have increased.

Policy Developments

8. **Fiscal policy in 2007 was highly procyclical.** The cash fiscal deficit increased to 2¼ percent of GDP, up from ½ percent of GDP in 2006. Adjusted for the automatic effects of the booming economy on the fiscal position, the mission estimates that the 2007 structural deficit surged to 3½ percent of GDP. As a result, the fiscal stance was highly expansionary, adding an estimated net fiscal stimulus of 2¼ percent of GDP to an already overheating economy.

9. **Fiscal policy making also remained very short-term oriented.** The originally approved 2007 budget was rectified four times, a process that left little time or resources for forward-looking budget planning. The Ministry of Finance's efforts to contain the traditional end-year spending surge did not succeed. Moreover, in its first accession year, Romania also had limited success in tapping EU grants, indicating weak budget planning. Finally, in mid-2007, a proposal to hike pensions in two steps during 2008-09 passed unanimously on a fast-track basis, although there was little clarity on the financing of the second-stage hike or the implications for the medium-term financial integrity of the public pension system.

10. **Monetary policy was confronted with a fluid macroeconomic environment.** During the first half of 2007, the NBR reacted to the sharply appreciating exchange rate and declining inflation with aggressive policy rate easing. While booming domestic demand and growing capacity pressures raised some questions about the wisdom of this easing course, the NBR also had countervailing concerns that the nominal exchange rate might have become

excessively overvalued. However, starting in July 2007, surging food and energy prices as well as the sharply depreciating exchange rate pushed inflation well above the target band, and the NBR responded by hiking its policy rate in several steps to 9.5 percent.

11. **The NBR took measures to contain banking system vulnerabilities.** Additional provisions on foreign-currency denominated loans to unhedged borrowers took effect in March 2008. Moreover, with structural excess liquidity in the banking system tightening, a new regulation has been issued requiring banks to strengthen their liquidity management.

12. **In part reflecting political gridlock, the pace of structural reforms has slowed down.** The future speed of sustainable real convergence will largely depend on advancing structural reforms. However, Romania continues to trail best-performing new EU member peers on most structural reform indicators, lagging particularly in the areas of business licensing, ease of employing workers, registering property, public infrastructure, and control of corruption.

Macroeconomic Outlook

13. **Uncertainty about Romania's macroeconomic outlook has increased.** The IMF's latest *World Economic Outlook* projects that negative spillovers from global financial market tensions will dampen growth in advanced economies well below potential, with negative knock-on effects for Eastern European growth and exports. At the same time, financial risk is being re-priced globally, and will likely be reflected in higher external funding costs for Romanian borrowers. However, how fast and to what extent adverse spillovers will impact the country's economic outlook remains uncertain.

14. **The mission has revised its baseline macroeconomic outlook.** GDP growth has been lowered to 5½ percent in 2008 and to 4¾ percent in 2009. But, assuming appropriate policy responses going forward, we maintain in our baseline scenario that the economy's imbalances will gradually normalize over the medium term. In particular, we project headline inflation to remain high in 2008 (6½ percent, end-year), but with a tight monetary stance maintained and supply-side price shocks subsiding, inflation should decline back into the NBR's inflation target corridor in 2009.

15. **Reflecting high levels of uncertainty, we see this baseline as bracketed by two starkly different alternative scenarios:**

- ***A continued boom:*** Large capital inflows would continue, trading partner growth would surprise on the upside, and business and consumer confidence would remain significantly above historical averages. Thus, growth could continue at high rates, the current account deficit would widen further, and controlling underlying inflation pressures could become even more challenging.
- ***A sharp slowdown:*** Confidence could slump abruptly below historical averages, and trading partner growth and capital inflows could contract sharply. While inflation and the current account deficit would correct to more sustainable levels much more quickly than under the baseline scenario, the risk of a sharp slowdown turning into an economic bust would also be significant.

Policy Recommendations

16. **Given the uncertain macroeconomic outlook, more coordinated and forward-looking policy responses will be essential under any scenario.** ***Fiscal and incomes policies*** under the baseline will need to be tightened relative to plans, and significantly more so under the continued-boom scenario. However, a sharp-slowdown scenario could put strong pressure on the fiscal position, as revenue collections fall short of plans, but the scope for allowing automatic fiscal stabilizers to operate would be limited by the lack of fiscal prudence during the boom. In any scenario, ***monetary policy*** will need to keep inflation expectations firmly anchored. Under the baseline or continued-boom scenarios, ***financial sector policies*** would need to continue to monitor and preempt financial stability risks, while a sharp-slowdown scenario could require reactive policy interventions.

Fiscal Policy

17. **The following features of a desirable stability- and growth-oriented fiscal framework for Romania would seem hardly controversial:**

- To ensure fiscal sustainability, a medium-term fiscal deficit target of about 1 percent of GDP seems appropriate. Thus, the fiscal deficit should be close to this target when the economy is at external and internal balance.
- To help stabilize the economy, in coordination with monetary policy, fiscal policy should avoid procyclicality as the economy moves through different growth phases.
- And to support fast real convergence, while also attending to the population’s social protection needs, fiscal policy should mobilize and spend scarce budget resources efficiently on programs that strengthen the economy’s supply side.

18. **In the mission’s view, the 2008 budget is not in line with this desirable fiscal framework.** The originally approved budget targeted a deficit of 2¾ percent of GDP. The recent budget rectification and measures to control spending reduced the deficit target to 2¼ percent of GDP, clearly steps in the right direction. However, the mission believes that a lower deficit target of about 1¾ percent of GDP, while falling short of first-best policy, would have been more appropriate. Moreover, the mission also views the revenue projections as overoptimistic, and spending plans will likely have to be curtailed in line with a more realistic resource envelope, even under the present relatively loose fiscal deficit target.

19. **The mission also takes note of several significant risks to the 2008 fiscal deficit.** Reflecting fragmented politics and a series of key elections approaching, fiscal policy making seems to have shifted to a particularly short-term mode. Three risks stand out:

- Among proposals to cut taxes, the upper house has already approved a cut in the VAT rate on food items from 19 to 5 percent. The full-year fiscal cost of the proposal could amount to up to ½ percent of GDP, depending on implementation details.

- Suggestions by key political parties to bring forward the already approved pension increase from January 2009 to an earlier date. The full-year fiscal cost of the pension increase would amount to about 1½ percent of GDP.
- And there could be potentially significant overruns in the public sector wage bill, which the 2008 budget seeks to broadly stabilize (as a percent of GDP) at the 2007 level.

The mission urges the authorities to strongly oppose these and other initiatives that would put at risk the fiscal targets for 2008 and undermine macroeconomic stability.

20. **Against this backdrop, what could be done to improve Romania's present "fiscal policy culture"?** In the absence of a realistic and binding medium-term fiscal framework, a high degree of day-to-day fiscal discretion will likely continue to drive the budget process. In the mission's view, a three-pronged approach, with all three prongs to be implemented in parallel, should be considered:

- ***Upgrading fiscal expertise and capacity at the executive and legislative levels:*** This includes adding resources that strengthen budget formulation, transparency, analysis, audit, accounting, and shifting to performance-based budgeting.
- ***Modifying rules and procedures to change the present short-term policy orientation:*** The scope for multiple budget rectifications should be reduced; the modalities of emergency ordinances should be reconsidered; and all revenue and spending items included in the approved budget should be supported by already approved legislation.
- ***Setting up an independent fiscal agency:*** In the short term, the establishment of an independent expert panel to provide macroeconomic and revenue forecasts should be considered to help insulate the budget process from politically motivated biases. Over time, consideration could be given to expanding the role of such an agency to also provide assessments of specific budgetary proposals.

Monetary Policy

21. **Although inflation now exceeds the target range by an uncomfortable margin, the inflation-targeting (IT) framework has proven its mettle in a difficult external and domestic environment.** In particular, the mission sees little merit in raising the inflation target or widening the band; such accommodating steps could only add to the difficulty of anchoring inflation expectations. However, with inflation likely to remain significantly above the target range before re-entering it in 2009, implementation and communication of the IT framework will remain a difficult challenge. The NBR should continue to upgrade its IT implementation capacity. Following the lead of selected best-practice IT central banks, an independent expert review of the framework might also be useful to take stock of the NBR's accumulated experience.

22. **The monetary stance going forward will need to remain clearly focused on lowering inflation in line with the announced target path.** While the macroeconomic outlook is likely to remain fluid, absent a sharp-slowdown scenario, additional policy

tightening may well be needed to keep inflation expectations anchored, while bringing inflation back into the end-2009 target range. Without prejudice to its primary objective, the NBR also needs to give continued consideration to the impact of further policy rate increases on financial vulnerabilities. However, the NBR should try to avoid fostering any impressions in the markets that it will be strongly averse to allowing either the policy rate or the leu/euro exchange rate to cross certain unconditional threshold values.

Financial Sector Policies

23. **Building on its already strong financial stability analysis, the NBR should further intensify surveillance of the financial sector.** Recent issues of the *Financial Stability Report* testify to its greatly enhanced capacity to monitor and assess financial sector trends and risks. At the same time, stress testing methodologies could be refined further, including by allowing stronger feedback effects between the real economy and banking soundness indicators. The recent initiative to remedy the lack of reliable statistics for real estate prices, while overdue, is also welcome. The planned update of the Financial Sector Assessment Program later in the year will provide a good opportunity for a comprehensive review of the strengths and vulnerabilities of Romania's financial system.

24. **Additional preemptive measures to reduce risks to financial stability seem also warranted.** It is admittedly difficult to identify, motivate, and implement such measures in a setting where financial fragilities are rising but not yet acute. Nevertheless, as regards credit risk, higher capital requirements for riskier exposures, including real estate ones, should be considered. The new regulation for liquidity risks may need to be complemented by on-site inspections of selected banks, and the NBR should consider broadening the range of eligible collateral for its overdraft facility. With many banks seemingly still focused on aggressively gaining market share, including by promoting exotic credit products, it is important that the NBR continues to encourage monitoring and containing operational risks. The most recent memorandum of understanding on cross-border financial crisis preparedness, which was signed by all EU countries, has again highlighted the need to coordinate regulatory and prudential actions with pertinent foreign regulators.

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We would like to thank the authorities as well as our counterparts outside the government for excellent cooperation, constructive discussions, and the usual warm hospitality.

Bucharest, April 21, 2008