GOVERNMENT OF ROMANIA

CONVERGENCE PROGRAMME

2008-2011

- May 2009-

Tabels

Charts

List of Acronyms

NBR – National Bank of Romania
ILO – International Labour Office
EC– European Commission
HEQNF – Higher Education Qualification National Framework
SMEs– Small and Medium-Sized Enterprises
GDP - Gross Domestic Product
LPS – Labour Public Service
EU - European Union

1. INTRODUCTION

The current edition update of the 2008-2011 Convergence Programme is based on the provisions laid down in the EC Regulation 1055/2005 - amending EC Regulation 1466/1997 on strengthening budget supervision and economic policy coordination. Responding to EC requirements, the Convergence Programme third edition observes the methodology adopted by the Ecofin Board on October 10, 2005 with regard to the contents and the structure of the Convergence and Stability Programmes. Moreover, the current edition takes into account the “European Council’s Opinion” issued on the second edition of Romania’s Convergence Programme, which recommended tighter budget targets for the following years and a revised public expenditure composition.

In updating the Convergence Programme, the Ministry of Public Finance took into consideration the latest developments and projections of the domestic and foreign economic environment, as well as the legal framework in force – including the provisions laid down in the 2009 budget approved by the Parliament and the recent budgetary rectification.

One important challenge to the fiscal policy during the forecasting interval is the reconciliation between the objective of meeting in a sustainable manner the budget convergence nominal criterion and a set of measures aiming at controlling the effects of the global economic and financial crisis on the Romanian economy. To this purpose, the budget policy aims at smoothing the economy over the cycle, reducing inflation pressure generated by the excess demand and reducing the external imbalances.

The third edition of the Convergence Programme describes Romania’s ability to bring the **structural deficit** down to around 1% of GDP by 2012 and create a safety margin to avoid exceeding the 3% budget deficit ceiling.

Romania maintains its commitment of adopting the euro currency in 2014, which is an important anchor in promoting the budget and structural reforms as a pre-condition to boost economic flexibility.

2. OVERALL ECONOMIC POLICY FRAMEWORK

2.1 Government Objectives and Priorities

The Government's budget strategy seeks to restore the public finances' reliability and stability on a short and medium term, focusing on promoting an appropriate mix of coherent measures aimed at containing the budget deficits and reducing the net financing needs of the government sector, in parallel with channeling substantial resources to public investments.

In order to address the macroeconomic imbalances and minimize the worsening prospects during the forecasting period, the coordination of macroeconomic policies - especially fiscal and revenue policies – is a must.

In line with the EU objectives as laid down in the renewed Lisbon Strategy, the Economic Policy General Guidelines and the European Union's Stability & Growth Pact, the medium-term strategy includes the following objectives:

(a) Maintain macroeconomic stability, continue the disinflation process, adjust the budget and current account deficits to levels sustainable from the financing side;

(b) Protect the population categories most affected by the economic crisis;

(c) Improve the medium-term predictability and performance of the fiscal policy, maximize and improve efficiency of the use of the European Union funds;

(d) Prioritize public investments in infrastructure in terms of funds allocation process, as a mean to create new jobs;

(e) Ensure the long term sustainability of the public finances;

(f) Improve efficiency of public administration.

The Government's vision in the **fiscal** policy area focuses on ensuring a motivating and unbiased environment, at the same time centered on measures aimed at consolidating transparency, stability and predictability of the fiscal policies. In addition, improving the sustainability of public finances is a crucial objective amid the adverse demographic trends. The consolidation of the tax base continues to be essential in ensuring the necessary resources for the economic development and the fulfillment of Romania's commitments as an EU Member State.

As regards the specific medium term objective, the underlying assumption is that the structural deficit will reach 0.9% of GDP in 2012, ensuring the symmetrical operation of the automatic stabilizers with a view to limit the volatility of the economy. This level will allow a safety margin to avoid exceeding the 3% budget deficit ceiling, in the event of potential shocks with negative impact on the rate of economic growth.

The Government formulated the priorities in accordance with the international environment trends, by elaborating a set of measures aimed at sustaining the recovery process and stimulating economic growth. Such adjustment measures at a national level are coordinated with the provisions laid down in the European Economic Recovery Plan.

Table 2.1. Measures aimed at limiting the crisis effects

	Impact on the budget

	Impact on the budget
TOTAL	**43.5 billion lei** (8.2% of GDP)
A. Measures to re-launch and stimulate economic growth	**38.4 billion lei** (7.2% of GDP)
Allocate 8.9 billion Euro to investments, accounting for 20% of the 2009 total budget expenditures and 7,1% of GDP. Improve the EU funds absorption mechanism. Establish the inter-ministerial group for EU funds absorption, under the direct coordination of the Prime-Minister and the Vice Prime-Minister. Remove tax on reinvested profits. The SMEs Credit Guarantee Fund to become operational and the SMEs Credit Counter-Guarantee Scheme to be established.	37.9 billion lei
Allocate from the State Budget at least the same funds as in 2008 to promote exports.	0.26 billion lei
Continue and extend the car park renewal "Rabla" program: - Cars older than 10 years to be included in the program; so far the program only included cars older than 12 years. - The cassation bonus was increased from 3,000 lei to 3,800 lei, with owners of 60,000 vehicles estimated to benefit from it, as compared to only 40,000 in 2008. Institutions and government agencies with own revenues are to be included in the general consolidated budget. The modification of the public railway tariffs based on indicators such as tone/kilometer.	0.23 billion lei
B. Measures to finance the economy and increase liquidity	**4.07 billion lei** (0.8% of GDP)
Central administration to pay the debt to economic agents, more specifically unpaid invoices and works completed and accepted for which no invoices have been issued. Recoverable VAT to be offset against VAT obligations, or other taxes due to the state budget in the months following the registration of the reimbursement request, as well as after the expiration of the legal deadline of 45-days.	3 billion lei
Capitalization of CEC Bank.	0.9 billion lei
Capitalization of Eximbank, by using the dividends due to the state to increase share capital and by allocating public funds to instruments aimed at insuring and guaranteeing export operations, such as currency risk and payment failure risk. Speed up the procedure for attracting European funds, with the public procurement law to be amended in order to improve the procedural flexibility. The adoption of new legislation pieces on PPPs in order to increase the dynamics of the private investments in infrastructure.	0.17 billion lei
C. Social measures	**1.04 billion lei** (0.2% of GDP)
Social pensions to be granted to low-income retired people to cover the difference	

	Impact on the budget
between the current pension level and the 350 lei minimum ceiling, in two tranches, as follows: up to 300 lei as of April 1, 2009 while the remaining amounts starting with October 1, 2009.	0.75 billion lei
The granting of compensation up to 90% of the value of the medical drugs List B, benefiting the pensioners with pensions up to 600 lei.	
The treatment of the revenues in the technical unemployment period (up to three months) as follows: - From the employee perspective – revenues of a non-salary nature will be taxed by applying the corresponding taxation arrangements; - From the employer perspective- exemption from taxes to the state budget and the social security contributions.	0.10 billion lei
The allocation of a subsidy for 50% of the value invested in continuous professional training of both employed and unemployed.	0.013 billion lei
Holding of regular consultations with social partners regarding the developments in the public wages, based on the economic performance in the first quarter and taking into consideration the short term forecasts	
Holding of discussions between the Government and the social partners with a view to draw up a single law on salaries for the employees in the budgetary system.	
The extension of the unemployment period by 3 months beginning with 2009.	0.18 billion lei
Granting of public utility status to the sectoral professional training committees.	
The freezing of the salaries of government officials placed in positions assimilated to dignitary offices for 2009.	

2.2 Monetary and Exchange Rate Policy

According to its statue[1], the primary objective of the National Bank of Romania is to ensure and maintain price stability. Starting August 2005, monetary policy has been implemented within the

[1] Law No. 312/2004

direct inflation targeting strategy, which coexists with the managed floating regime. Such an exchange rate regime is in line using inflation targets as a nominal anchor for monetary policy and allows for a flexible response of the policy to the unforeseen shocks that may hit the economy.

Given the prerequisite of implementing additional structural reform aimed to increase the flexibility of the Romanian economy and its capacity to withstand asymmetric shocks, the domestic currency to join the Exchange rate Mechanism II (ERM II) no sooner than 2012. This assertion also takes into account the necessary fulfillment of the criteria that would warrant the minimum two-year participation in ERM II. Both the ERM II pre-entry period and the duration of actual stay in this mechanism are seen as landmarks of the convergence process the Romanian economy has embarked upon.

The dampening of the effects of the global economic and financial crisis, on the one hand, and sounder national economy fundamentals alongside increasingly more stable long run exchange rate expectations led by the advancement of the convergence process, on the other hand, will support the gradual decrease in the volatility of the exchange rate of the leu and the subsequent increase in its stability. In addition, the likely persistence of a significant productivity differential and the prospective medium-term rebound in foreign direct investment will pave the way for the domestic currency to resume its sustainable appreciation, in real terms, trend against the euro, which would be a beneficial adjustment in terms of real and nominal convergence of the Romanian economy.

Given that the Romanian economy is still witnessing a disinflation process, although a sustainable inflation rate in the medium run has not been recorded yet, inflation targets are set an annual basis (December/December) as mid-points within a variation band of ± 1 percentage point, being agreed upon jointly by the National Bank of Romania and the Government for a two-year horizon.

Thus, annual inflation targets set in the context of the direct inflation targeting strategy followed a downward trend, which went from 7.5 percent ± 1 percentage point in 2005 down to 3.5 percent ± 1 percentage point in 2009. For 2010, the inflation target is maintained at the previsions year's level, i.e 3.5 percent ± 1 percentage point. The major rational behind this decision is the pressing need for attaining the 2010 inflation target, a key prerequisite for preserving central bank credibility given the overshooting of the 2007 and 2008 inflation targets under the impact of numerous, strong inflationary shocks that occurred successively or simultaneously.

An additional reason is the difficulty of achieving a more ambitious target in 2010 due to the prospects of persistently adverse effects from the necessary adjustment to sustainable levels of external imbalances, on the one hand, and the increase – against the background of the intensification and broadening of the global economic and financial crisis – in the authorities' concern for the sustainable consolidation of the disinflation taking into account the reduction in the existing macroeconomic imbalances and the maintenance of the financial stability, on the other hand.

Other reasons for taking a prudent approach to setting the 2010 inflation target were the anticipated persistence in the years ahead of direct inflationary effects exerted by the factors beyond the central bank's sphere of influence, the most significant being: (i) the adjustment of administered prices and indirect taxes, (ii) the continuing nominal and real convergence of the Romanian economy, and (iii) the lingering of some asymmetric nominal rigidities.

At the same time, this inflation target meets the requirement for consolidated disinflation in a sustainable manner and for attaining, in line with the euro adoption calendar, an inflation rate level compatible with both the inflation criterion laid down in the Maastricht Treaty and the ECB' s quantitative definition of price stability.

Achieving the medium-term inflation target and calibrating monetary policy accordingly will further stand out as a concern for the central bank, given that short-term priorities include the orderly unwinding of macroeconomic imbalances (soft landing) – witch has already been initiated in 2008, and preserving financial system stability.

Against this backdrop, maintaining monetary policy efficacy and ability to anchor inflation expectations can only be achieved by rebalancing and enhancing the consistency and credibility of the macroeconomic policy mix as well as by speeding up structural reforms.

From this perspective, the significant tightening of fiscal and income policies is a must, which needs to materialize in the considerable narrowing of the budget deficit and hence the reduction of the savings/investment imbalance. Tight policies are essential for minimizing social and economic costs associated with the necessary adjustment of macroeconomic imbalances in an environment marred by the deep economic and financial crisis worldwide. Furthermore, the sustainability of disinflation and the resumption of sound economic growth over the medium and long run are conditional upon a tight policy stance – also through the potentially positive impact on foreign investors' confidence in relation to the outlook for the domestic economy.

The effective implementation of a such macroeconomic policy mix will allow the gradual adjustment which has the purpose of reducing the overload of the monetary policy stance, whose restrictiveness increased significantly during 2008, amid successive policy rate hikes up to 10.25 percent in July and the resumption of disinflation in the second half of 2008, with annual inflation rate dropping from 9.04 percent in July to 6.30 percent in December. Subsequently, the central bank maintained a very prudent monetary policy stance and embarked upon a rate-cutting cycle no sooner than February through a marginal reduction of 0.25 of a percentage point amid the shaping of an improved inflation, mainly due to an elimination of excess aggregate demand. In a more comprehensive context of the monetary conditions adjustment in broad, the decrease of the monetary policy rate cuts are envisaged to be further gradual, in correlation with the dissipation of aggregate demand-pull inflationary pressures resulting from the opening and short-term widening of a negative output gap, the less pronounced depreciation trend of the domestic currency, and lower exchange rate volatility.

The significant increase in the financial depth of the economy manifest over the recent years and especially the possibly faster drop in credit (and in particular the currency component), in the context of diminishing external financing sources for banks, are expected to have a major contribution to the speeding-up of the strengthening of the role of the interest rate within the monetary policy transmission mechanism. This process will also be enhanced by NBR's more flexible approach to the management of liquidity in the banking system via money market operations amid the central bank's recent shift towards the creditor position in relation to credit institutions, context in which the provision of liquidity through a variety of tools, to ensure proper functioning of the financial system, is associated with the concern to avoid excessive volatility of the exchange rate.

2.3. Structural reforms

In December 2008, the European Economic Recovery Plan was adopted by the European Council, focusing on multiple areas. Since the adoption of this plan, the macroeconomic environment has worsened, as presented in the EC interim forecast issued in January 2009. Structural reforms are a central element of this recovery plan, since they could support the employment, the population income and the aggregate demand in the short run, and strengthen and facilitate the flexibility and the rapid recovery of growth, including the support of the credibility of the efforts made towards fiscal stimulus by increasing the rate of growth of the potential GDP.

In its National Reform Programme, Romania set up similar targets to those assumed at European level, although adjusted to the performance of the labour market and of other connected areas, in a move to ensure economic stability and public finance sustainability, increase competitiveness and productivity while improving the functioning of the labour market. In this section we will present some of the measures proposed by the new Government, as follows:

The policy objectives for improving the business environment and developing liberal professions in Romania are:

- Secure a predictable legal environment to allow activity planning by economic operators;
- Enhance the legislation by adding up new state aid schemes;
- Cut substantially the red tape, reduce administrative barriers and streamline the fragmented nature of the non-fiscal tax system;
- Encourage a new quality culture by coherently organizing the market supervision, quality infrastructure and consumer protection;
- The support by the state of the "competitiveness poles";
- Develop the competitive capacity of SMEs and encourage the domestic capital;
- Improve SMEs access to financing through foreign and/or state budget financial schemes.

Objectives of the regional development policy have in view to:

- Reduce existing regional imbalances by encouraging competitiveness and revigorating the disadvantaged areas.
- Ensure a balanced regional development by correlating national public policies for sectoral development with local development public policies: infrastructure and transport, employment, rural development, education and health, environment.

The main lines of actions for reaching such objectives include:

- A creation of a legal procedure framework to define the components of different strategic decision-making levels and evaluation of the local human, economic, financial resources etc.;
- The correlated development of urban and rural areas through cooperation between local and county authorities, regional councils and the regional development agencies to integrate the local development plans and the regional development plans and monitor the implementation thereof;
- Promote the public private partnership in a move to reduce regional disparities;
- Establish a set of criteria to assess the local public administration authorities in order to identify and reduce any existing inconsistencies, by supporting structural funds absorption, implementing state aid schemes etc.
- Develop human resources and capitalize on the cooperation potential with the private sector and the local education system.

The Romanian labour market has a relatively low employment rate as compared to the EU average, with high unemployment rates in the age categories 15-19 and 20-24, a high percentage of early retirement from the formal labour market and a significant employment rate in the agriculture sector – which is a mainly non-taxed working environment.

The Government objectives aiming at improving the labour market include:

- Develop and implement the Higher Education Qualification National Programme (HEQNF) to match higher education with labour market requirements, thus improving the relevance of the higher education as a response to labour market demand;

- Develop a set of tools and methods to analyze and anticipate the changes on the labour market, as a move to adjust the professional formation supply to the labour market demand;

- Improve the Employment Public Service (EPS) capacity to supply employment, formation and professional advisory services in order to respond to the needs of people in search of a job (including persons from vulnerable social groups) and the employers' requirements;

- Improve the participation rate of young unemployed to the employment stimulation measures by increasing the employability rates in the first four months of unemployment;

- Cut red-tape in recruiting by establishing local one-stop-shops (in the counties) and render them more operational by implementing one single recruitment procedure.

The objectives of the public administration reforms are as follows:

- Continue the public administration reform focused on an increased autonomy of local administrations given by the autonomy in decision-making as well as in financial and patrimony aspects against the background of a continuous decentralization process simultaneously with observing the subsidiarity principle. The main lines of action are: administrative and financial decentralization, improve human resources management and public procurement efficiency, increase transparency and efficiency of the administrative measures, property and land registration.

- The deep restructuring of the central and local public administrations, including by reducing the number of staff, with a view to establish an efficient organizational model of the administrative powers, in parallel with a substantial reduction of the public overhead expenditures.

- Cut red-tape and improve the efficiency of public services.

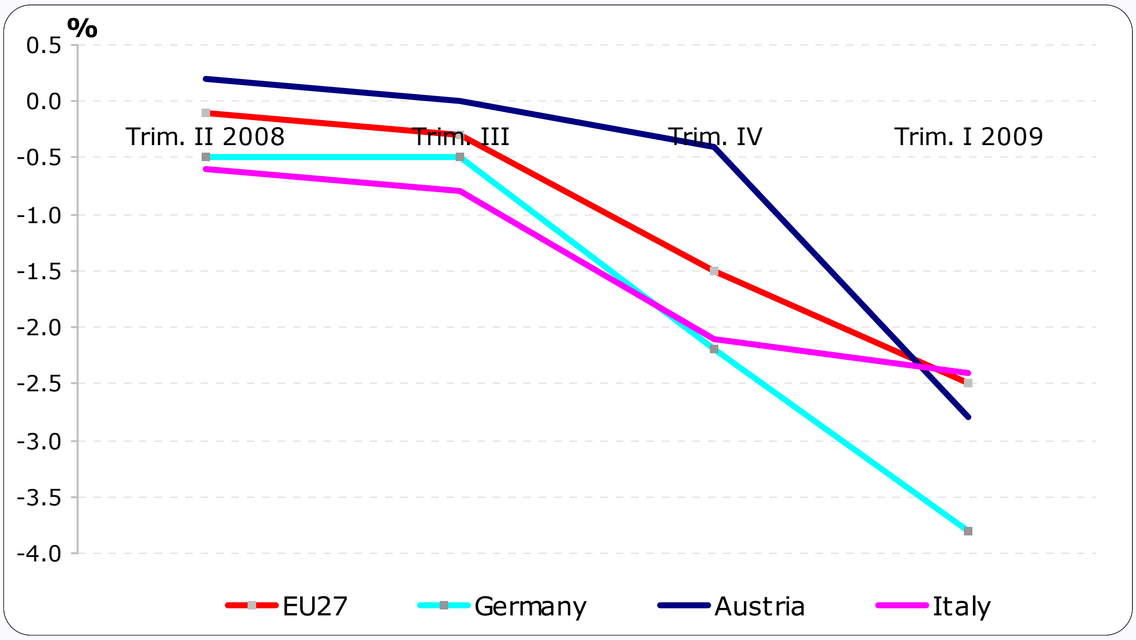
3. MACROECONOMIC SCENARIO

3.1. Assumptions on the International Economic Environment

At the beginning of the year, namely in January, due to the materialization of the risks announced in the autumn forecast, both the European Commission (EC) and the International Monetary Fund (IMF) have revised previous forecasts.

The economic developments in the first quarter of 2009 are reflecting the amplification tendency of the crisis in the EU member states. Thus, the EU GDP contracted by 2.5% (qoq, seasonal adjusted data), higher than the contraction of 1.5% in the third quarter. Germany, Austria and Holland were the member states with the deepest contractions from the Euro area.

Chart 3.1 Quarterly Gross Domestic Product*)



*) seasonally adjusted data

Source: Eurostat

According to the EU Commission spring forecast, the world GDP is expected to contract by 1.5% in 2009, with more pronounced negative growth rates in the advanced economies. The GDP is expected to contract by 3% in USA and 5.25% in Japan.

The recession will lead to a decrease of the EU GDP by 4% in 2009. In the case of the five largest EU economies, the real GDP is expected to contract by 5.5% in Germany, 4-4.5% in Italy and United Kingdom and by around 3% in France and Spain.

Although China is in a better position to combat the global recession, its economic growth is expected to slowdown at 6%.

As a result of the stimulus packages undertook by different governments and the resumption of trade flows, the global growth is expected to reach 2% in 2010. In 2010, the economies will stabilize for the majority of the states, except Spain which is forecasted to contract by around 1%.

-Percentage change previous year -

Tabel 3.1 Estimates for external environment	2006	2007	2008	2009	2010
GDP – worlds economy	5.0	5.0	3.1	-1.4	1.9
GDP EU – 27, out of which	3.1	2.9	3.1	-4.0	-0.1
• Consumption	2.3	2.2	0.9	-1.5	-0.4
• Investment	6.1	5.4	0.1	-10.5	-2.9
GDP euro zone	2.9	2.7	0.8	-4.0	-0.1
GDP USA	2.8	2.0	1.1	-2.9	0.9
GDP Japan	2.0	2.4	-0.7	-5.3	-0.1
GDP Germany	3.0	2.5	1.3	-5.4	0.3
GDP Italy	1.8	1.5	-1.0	-4.4	0.1
GDP France	2.2	2.2	0.7	-3.0	-0.2
HCPI(Harmonized Consumer Price Index)UE -27	2.3	2.4	3.7	0.9	1.3

Source: Spring Forecast, European Commission

The International Monetary Fund estimates a decline of 1.3% of the world economy in 2009, representing the first major contraction in the last 60 years. The IMF forecast reveals a deep recession of the developed countries (-3.8%), under the circumstances of prolonging and deepening of the financial crisis compared to the previous estimates, with clear effects on the pace of the real activity.

For 2009, in the IMF opinion, Japan is forecasted to decline the most, by 6.2%, while the Euro Area will contract by 4.2% and the USA by 2.8%. Our main trade partners will record the following developments: Germany - 5.6%, Italy -4.4%, France -3.0%.

Regarding the developed countries, there is estimated for 2009 a decrease of the exports and imports of goods and services by 13.5% and 12.1% respectively, followed by a slight recovery in 2010 (0.5% and 0.4% respectively).

According to the IMF forecasts, the world economic growth in 2010 will reach 1.9%, and -0.4% in the Euro Area. Germany and Italy economic growth will reach -1.0% and -0.4% respectively, while France will reach 0.4%.

Projections for Brent crude oil was revised from 68$/barrel for 2009 and 78$/barrel in 2010 to a level of 52$/barrel and 62.5$/barrel respectively, due to a slower recovery of the world demand compared to the previous estimates.

The current Euro-Area slowdown is having broad cross-border consequences in Eastern Europe, EU area representing one of the most important trade partners of East European countries. Thus the synchronization of the business cycles between the two regions is quite significant. Romania, in particular, presents a higher level of correlation with Euro-Area regarding the business cycle.

The IMF warns that the economic conditions would deteriorate further if the banking crisis will not be resolved by governments around the world through sustainable solutions allowing the resumption of the real sector lending process. Nevertheless, the space for budgetary manoeuvre is limited for the majority of developed countries due to record budget deficit levels. For instance, the IMF forecasts that the UK is heading for the biggest deficit amongst all the G20 countries, which will amount to11% of GDP by 2010.

In the same time the IMF also warns of a serious risk that emerging economies will be unable to secure external finance, as banks and investors in developed countries will withdraw their investments. The risks are larger for emerging countries that rely on cross-border flows to finance high current account deficits, placing the Central and Eastern European countries as most vulnerable and likely to be the most adversely affected in the next period of time. Among these, the Baltic States, Hungary, Romania and Bulgaria will face the largest economic contractions.

On the other hand, the CONSENSUS forecast for 2009, shows the changes due to the evolving nature and dynamics of the economic crisis. Thus, if the October 2008 forecast for US economic growth was zero, in April 2009 the economic growth was revised downwards to -2.7%. The same situation is in the case of the Euro Area (from +0.5% to -3.4%), Japan (from +0.5% to -6.3%) and UK (from -0.2% to -2.7%).

For Germany is expected a contraction of the industrial production by 14.4% this year, leading to a negative economic growth of 4.5% while the estimations for 2010 are pointing to a slightly positive economic growth of 0.5%.

In Italy, the contraction was caused by the developments in the capital expenditures area with the companies reducing their investment programs due to the tight lending conditions and thereby increasing uncertainty over demand. As a consequence, according to the CONSENSUS forecast in April, industrial production is expected to contract by 12.4% this year and gross domestic product by 3.6%. For 2010 is forecasted an economic stagnation.

France encounters a negative economic growth in 2009 (-2.5%) and a slight recovery will be noticed in 2010 (0.3%). However, France's economy has not yet fallen officially into a recession, although this could occur after the first quarter of 2009.

In this unfavourable climate, consumer and investors confidence has both suffered a major decline. The Romania's economic conditions will deteriorate further, as a consequence of a deep recession in Euro area.

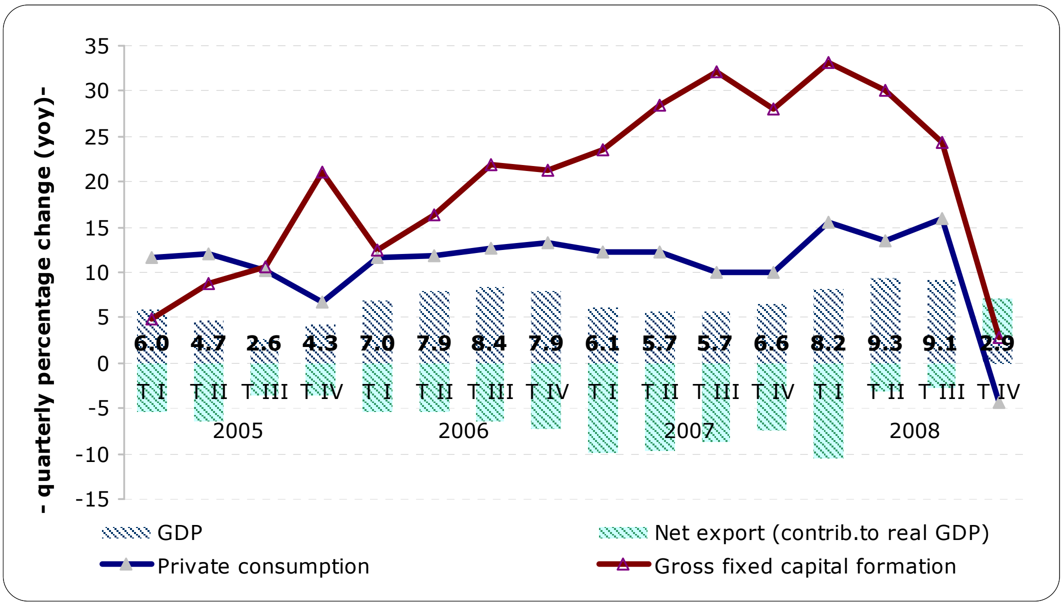
3.2 Recent macroeconomic evolutions

The economic evolution was favourable during the first 9 months of 2008, when the growth rates of the majority of the economic sectors accelerated; afterwards, the negative effects of the global economic and financial crisis have begun to manifest. Thus, GDP's real growth in 2008 was 7.1%, with a different pattern within the year, a 8.9% increase during the first 9 months as compared to the same period of 2007, while in the fourth quarter the economic growth decelerated to 2.9%. According to the estimates based on seasonal adjusted data, the GDP contracted in the fourth quarter by 3.4% qoq of 2008.

In the first three quarters of the year, the domestic demand, for consumption and investment, expanded with growth rates over 10%, sustained by rapid increases in wages and nongovernmental loans. Thus, the gross fixed capital formation registered quarterly growth rates exceeding 30% in the first two quarters and exceeding 24% in the third quarter. The private consumption also registered high growth rates, between 13.4% in the second quarter and 15.9% in the third quarter. The evolution of the foreign trade of goods and services is significant, recording an important change in the second quarter, when the dynamic – in real terms – of the export of goods and services exceeded the import of goods and services' one, continuing also in the subsequent quarters as well. However, the net exports continued to register a negative contribution to the GDP growth.

In the fourth quarter the effects of the global economic crisis have begun to manifest in Romania as well, the economic slowdown becoming a reality. The statistical data showed a significant deceleration of the industrial activity, along with a reduction in the growth rate of the activity in services and constructions. The domestic demand contracted, as the private consumption decreased by 4.4% as against the fourth quarter of 2007 and the growth of the gross fixed capital formation decelerated to 2.8%. The export of goods and services increased by only 1.6%, in real terms, while the import of goods and services contracted by 9.8%, leading to a positive contribution of net exports to GDP growth of 4.3%

Chart 3.2 GDP and its main components



Source: National Institute of Statistics

The domestic demand has grown by 7.9% in 2008, mainly due to the increase of the gross fixed capital formation by 19.3% and of the final consumption by 8%, correlated with a 3.5% negative contribution of stocks to GDP's real growth.

The evolution of the foreign trade has been influenced, on the one side, by the evolution of the terms of trade and, on the other side, by the depreciation of the national currency, both favoring the exports of goods. Nevertheless, the negative contribution of the net export of goods and services to GDP's real growth maintained in 2008, as the growth rate registered by the exports of goods and services exceeded the growth rate of the imports by almost 2 pp.

Table 3.2 Evolution of GDP - percentage changes as against previous year -

	2005	2006	2007	2008
Domestic demand, of which:	7.9	12.9	14.0	7.9
- Private consumption	10.1	12.7	11.6	9.1
- Government's consumption	3.8	-4.1	1.6	3.2
- Gross fixed capital formation	15.3	19.9	29.0	19.3
Export of goods and services	7.6	10.4	7.9	19.4
Import of goods and services	16.0	22.6	27.2	17.5

	2005	2006	2007	2008
GDP	**4.2**	**7.9**	**6.2**	**7.1**
Industry	2.6	7.2	5.3	1.3
Agriculture	-17.2	3.4	-16.5	21.4
Construction	11.2	23.4	33.6	26.1
Services	8.8	6.8	7.3	5.1

Source: National Institute of Statistics

Regarding the sectoral developments, the results were as follows:

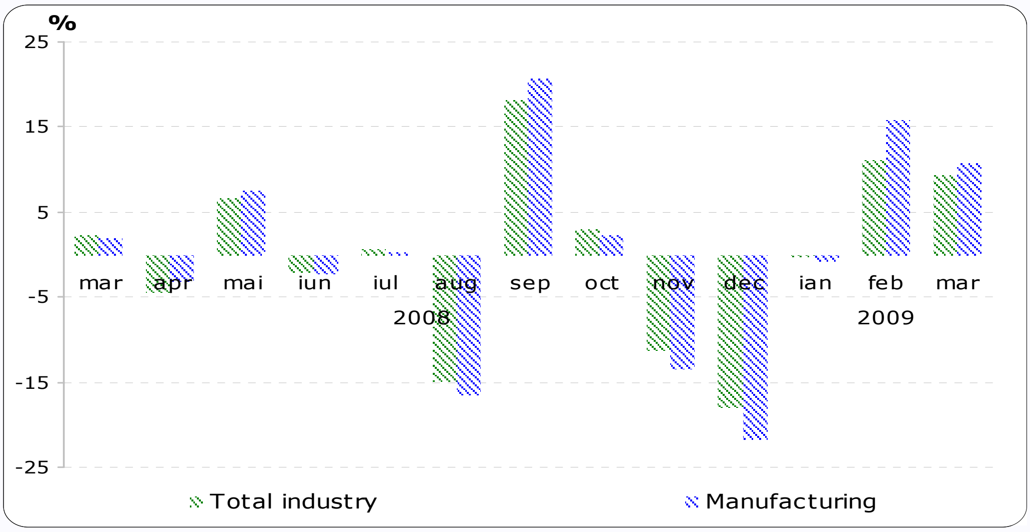
- gross industrial value added grew by 1.3% in 2008, as compared to 4.8% during the first 9 months, due to the decline of certain industries in the fourth quarter (clothing articles, auto industry, metallurgy, furniture, electrical machinery and device) and to the diminishing of the amplitude of growth recorded in the first part of the year for other branches with significant weights in the industrial production (food and beverages, electricity and thermal energy, other extractive activities);
- the agriculture registered a 21.7% growth rate in 2008, as compared to the previous year (mainly due to the vegetal sector, which increased by 39.6%, the animal and the services' sectors decreasing by 5.2% and by 8.1% respectively) while the gross value added increased by 21.4%;
- the gross value added in the construction sector recorded an increase of 26.1% in 2008, compared to 31.1% in the first 9 months;
- the consequences of the crisis influenced the activity of the services sector especially the retail trade and services rendered to the population, following a tightening of the lending conditions which led to a diminish of the activity of the banking system and of the industrial sector. The gross value added in the tertiary sector increased by 5.1% in 2008.

In the first quarter of 2009, the GDP contracted by 6.4% yoy for the first time since 2000. The seasonal adjusted data shows a contraction of 2.6% compared to the previous quarter, after a more pronounced diminish of 3.4% yoy in the fourth quarter. The activity reduction registered in the first quarter is evident in the industrial and agricultural sectors while the construction sector maintained a positive evolution

In the first quarter of 2009, the industrial production decreased in real terms by 13% (gross series), due to the manufacturing contraction by 15.2%. Nevertheless, the monthly evolutions show a certain recovery, as the industrial production on March exceeded by 21.5% its level from January 2009 and by 21% its level in December 2008. As a result, the industrial production was 8.5% lower in March yoy, compared to 16.4% in January.

Chart 3.3 Monthly evolution of industrial production

- percentage change against previous month (%) -



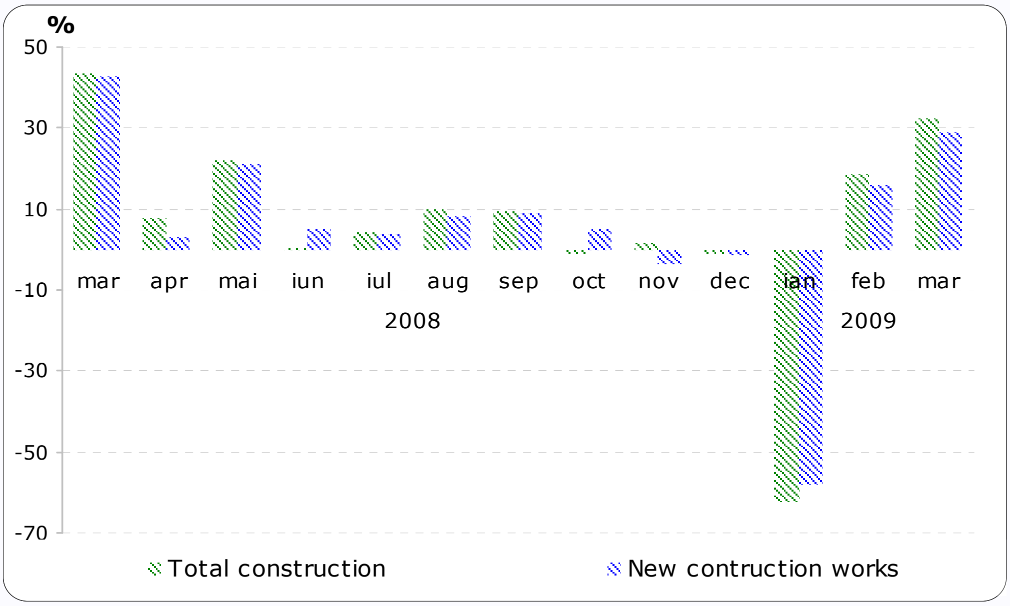
Source: National Institute of Statistics

In March, activities which ensure 36% of the manufacturing output realized a superior production compared to the level registered in March 2008, as: tabocco (+23.3%), other transport equipment (+20,1%), transportation vehicles (+7,4%), wood (+6,2%), printing and reproduction of recordings (+1,1%), food (+0,5%).

The volume of the construction works increased by 4.4%, this development being sustained by the new construction works (9.2%). The most significant growth was registered by the residential buildings (21.4%), followed by the non-residential buildings (5.1%).

Chart 3.4 Monthly evolution of construction works

- percentage change against previous month (%) -

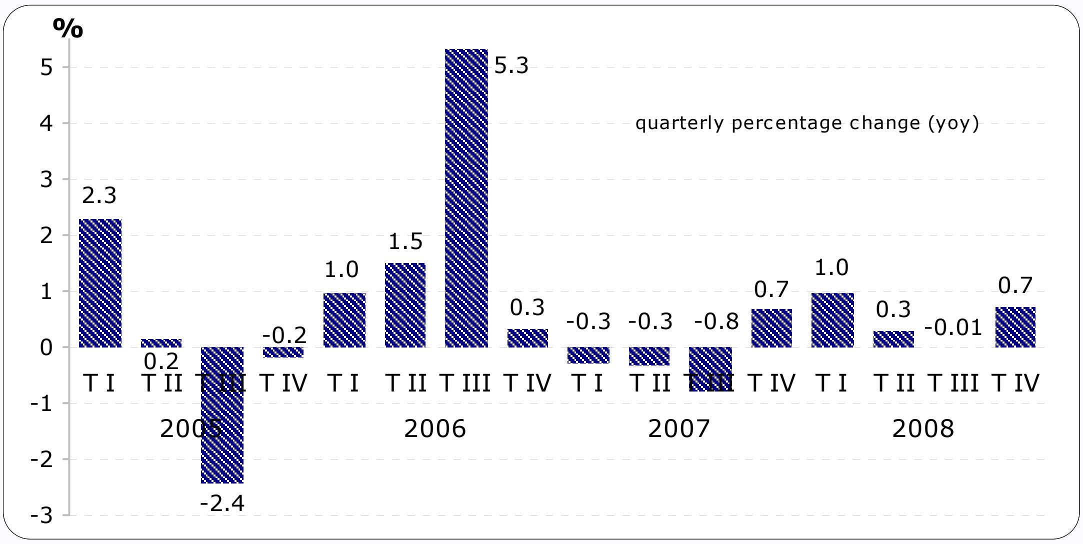


Source: National Institute of Statistics

The working age active population decreased by 0.3% in 2008 as compared to 2007, while the activity rate diminished from 63.0% to 62.9%. The employment increased by 0.5%, leading to an employment rate of 59.1%, an increase of 0.3 percentage points as compared to 2007.

The pattern of the previous periods was maintained, the employment rate of the working age population had significantly higher values for men (65.7% as compared to 52.5% for women), as well as for the rural area population (61.3% as compared to 57.6% in the urban area). The employment rate for young people (15-24 years) was 24.8%, namely 0.4 percentage points higher as compared to the previous year.

Chart 3.5 The evolution of employment



Source: National Institute of Statistics

In structure, in 2008, the gains in occupation were the result of the increase of the average employee number (measured according to the ILO methodology) with 1.6% compared to 2007 and the reduction of other occupational categories (especially the agricultural one) by 2.7%.

The unemployment number diminished from 641 thousand in 2007 to 575 thousand in 2008. Correspondingly, the unemployment rate diminished from 6.4% in 2007 to 5.8% in 2008.

The difficulties from the labor market as a result of the activity reduction in the fourth quarter of 2008, had an impact on the unemployment rate. A greater and greater number of people were not able to find a job on their own and recoursed to the services provided by the employment agencies. As a result, the unemployment rate increased to 4.4% in December 2008, compared to 3.9% in September 2007 and 4% in December 2007.

In the first quarter of 2009, the employment number continued a diminishing trend, with an immediate effect in increasing the unemployment rate. The average employees number (in the civil sector) diminished by 1.8% compared to the first quarter of 2008. The number of unemployed persons registered to the employment agencies increased from 403,4 thousand persons at the end of 2008 to 513,6 thousand persons at the end of the first quarter in 2009, while the unemployment rate reached 5.6%. In April, the number of unemployed increased by 1%, reaching 517,7 thousand persons.

The **external trade** of goods registered a lower growth in 2008 compared to 2007, as a result of significant gains registered in the first 10 months, after which both exports and imports decelerated compared to the corresponding period of 2007. Export of goods increased by 13.8% as compared to 14.3% in 2007, while import of goods increased by 9.8% as compared to 26.0% in 2007. The trade deficit (FOB-FOB) was only 3.1% higher than in 2007, respectively by 0.55 billion Euro.

Intra-community exports amounted to 23.7 billion Euro, representing 70.4% of total exports, while extra-community exports amounted to 10.0 billion Euro. Intra-community exports increased by 11.3% while extra-community exports increased by 20.3%.

Intra-community imports amounted to 38.9 billion Euro, representing 69.1% from total imports while the extra-community imports amounted to 17.4 billion Euro. The increase registered by intra-community imports was 6.4%, while the extra-community imports increased by 18.1%, a reorientation of Romanian trade towards extra-community area being easily noticed.

In the first quarter, as a result of the reduction of the external demand, the exports continued their descending trend, decreasing by 19.4% yoy, a lower rate of decrease compared to the outcome in the first two months (-26%), due to the developments in the exports which diminished in March by only 6.9% yoy. The exports increased by 23% in March compared to the previous month while the imports contracted in a significant way in the first quarter (-35.4%).

There is evident a continuation of the improvement trend in the quality of the exports, the machinery and transportation equipment share in total exports increasing by 6.7 pp (from 33.9% to 40.6%). The trade deficit contracted overall by 61%.

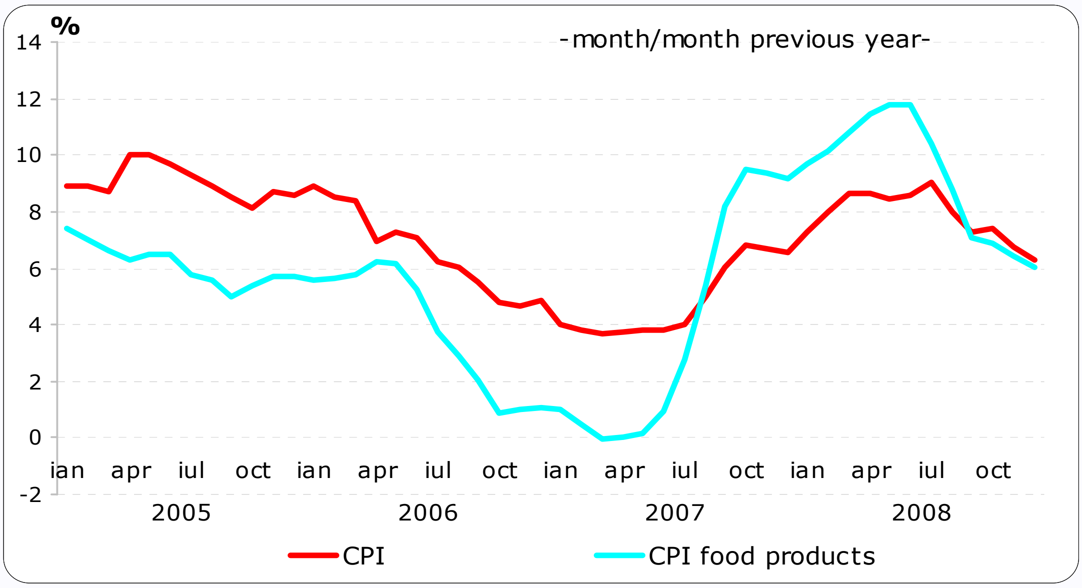
The current account deficit increased by 1.3% in 2008, reaching 16.9 billion Euro (12.3% of GDP), being covered in a share of 53.8% by foreign direct investment inflows, which amounted to 9.1 billion Euro as compared to 7.3 billion Euro in 2007.

In the first quarter, the current account of the balance of payments improved, its deficit decreasing by 82.1%, reaching 709 million Euro. The current account deficit was financed integrally from foreign direct investment inflows, which reached 1456 million Euro compared to 1691 million Euro in the first quarter of 2008. The trade deficit amounted to 1337 million Euro, decreasing by 67.2% compared to the first quarter of 2008. Moreover, the income balance deficit reduced compared to the same period of the previous year while the surplus of the transfers balance maintained almost the same.

In the first half of 2008, the **annualized rate of inflation** continued the upward trend observed since the second half of 2007, reaching a level of 9.04% in July. However, a trend reversal has been observed since August; therefore the annualized rate of inflation reached 6.3% in December.

The evolution of food-goods prices mainly contributed to tempering the annual rate of inflation, with an increase 0.28 percentage points below the total annual rate of prices, 6.02% respectively. A more favourable evolution of the food prices was registered in September for the first time, in the previous months the food inflation remaining at levels superior to the total inflation, due to the unfavourable weather conditions in the previous year, affecting both the domestic production of vegetables and fruits, as well as to a base effect characterized by lower level of prices in the first half of the year 2007.

Chart 3.6 CPI and food products CPI



Source: National Institute of Statistics

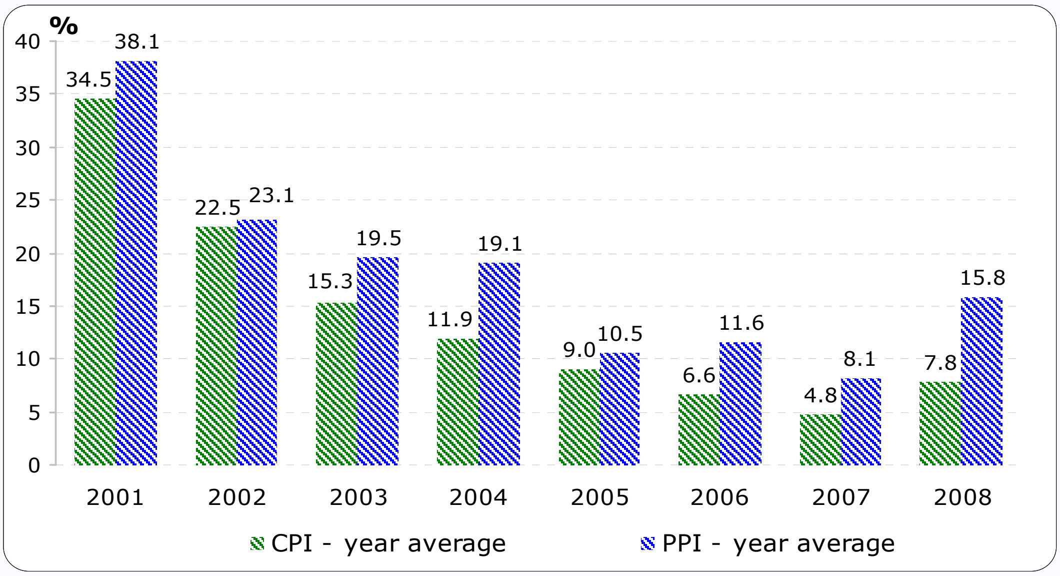
The evolution of food-goods prices must be correlated with the evolution of agricultural products prices. The available statistical data indicate a decrease of 4.1% in December 2008 / December 2007, due to a decline in crop products prices where a deflation was registered (-19.6%) on the background of a good year for agriculture, while prices of animal products grew by 20.04%.

As regards the non-food product prices, the annualized increase (5.96%) was by 2.36 percentage points over the level reached in the same period of the previous year. The increase in the service tariffs (7.71%) was by 0.84 percentage points lower than the figure for the same interval of the previous year.

The exchange rate was another factor which exerted pressure on the inflation; the exchange rate followed a trend of nominal depreciation as from the second half of 2007. Under these circumstances, the prices of imported goods are influenced in a negative way, as well as the prices of a number of administered products depending on either the European currency or the US dollar, in the case of natural gas. As a consequence, the macroeconomic policy mix aimed at restoring the inflation back on a declining trend. At the end of 2008, the inflation rate reached 6.3%, with an annual rate of 7.85%, a relatively high level if we take into account the European and international prices developments.

The industrial prices increased by 7.92% in 2008 as a result of the increase of the industrial prices for the domestic market with 7.21% and the increase of the industrial prices for the external market by 10.74%.

Chart 3.7 Evolution of inflation at the end of the year- end year



Source: National Institute of Statistics

During the first quarter of 2009, the annual rate of inflation reached 6.71%, especially due to the developments of the services tariffs which increased by 8.84 % as compared to the previous year. The increases of the tariffs resulted primarily from a depreciation of the national currency, which had an impact upon the correlated services with the European currency, such as the air transport (15.01%) and the telecommunications services (10.83%). During the same period, the prices for the non-food and food-goods registered increases below the general level of the prices, 5.69% and 6.69% respectively.

The industrial prices increased by 5.67% in the first quarter as a result of the increase by 6.59% of the industrial prices for the external market and the increase by 5.32% of the industrial prices for the domestic market.

In the first four month of the year, the domestic currency depreciated compared to the Euro by 13.4% in nominal terms and by 7.7% in real terms.

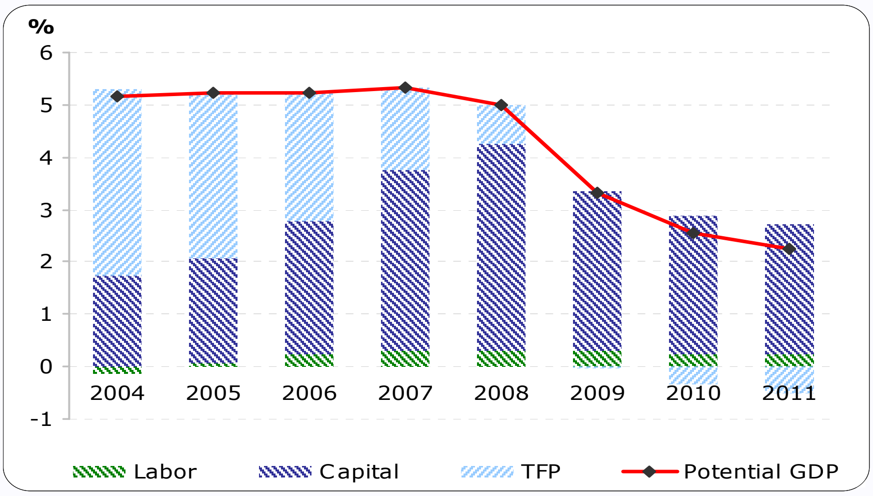
3.3 Medium Term Development Scenario and Cyclical Developments

3.3.1 Cyclical Developments

According to the estimates based on the Cobb-Douglas production function, the average increase rate of the potential gross domestic product calculated for the interval 2008-2011 is 3.28%. During this interval the capital stock is expected to go up entailing a higher capital contribution to the increase of the potential gross domestic product, which is expected to average 3.03% annually.

The potentially employed population at working age (15 - 64 years) is expected to see a moderate growth, in average by 0.3% annually. Noteworthy, the potentially employed population will have a positive contribution to the growth of the potential gross domestic product in the next period of time. In turn, the total factor productivity (TFP) is expected to have a less significant contribution to potential gross domestic product growth.

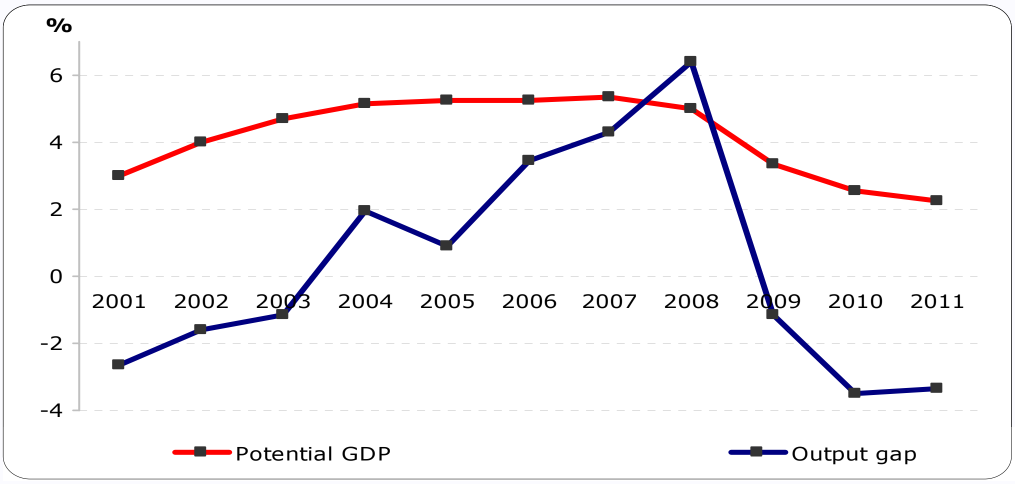
Chart 3.8 Factor contributions towards potential GDP growth



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

We foresee the output gap to become negative in 2009 (a decline in 2009 of 7.5 percentage points as compared to 2008) and to remain close to a balanced position on a medium term, in accordance with the proposed macroeconomic policy mix.

Chart 3.9 Output – gap



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

The economic growth forecasted for 2009-2011 is below the one forecasted for the potential gross domestic product taking into account the stance of the overall mix of macroeconomic policies and various risks that may occur both domestically and externally. Its trend represents the outlook base regarding the acceleration of the real convergence process towards the economic level of the European Union Member States.

3.3.2 Medium term development scenario

The macroeconomic forecast for 2009 takes into account the fact that the contraction trend manifested within the economic activity, compared to the previous year, will continue all along the year. It is possible that the Romanian economy will begin an economic recession, for the first time after 9 years of growth. Therefore, the macroeconomic framework forecasts a contraction in GDP, in real terms, by 4% as against 2008, as a result of the lower household consumption due to the reduction of incomes and credit constraints and lower governmental consumption as a result of the fiscal adjustment.

The domestic demand will diminish significantly, as its main components – the private consumption and the gross fixed capital formation – will also register decreases, by 4.1% and respectively 6.5%. The public investment in infrastructure is a top priority of the Government, being expected to accelerate along with the process for the absorption of European funds. The Governmental consumption will decrease by 11%, as a result of the consolidation of the budget deficit.

Table 3.3 Economic growth

	2007	2008	2009	2010	2011
Annual percentage changes					
Real GDP	6.2	7.1	-4.0	0.1	2.4
Nominal GDP	19.8	22.1	5.4	7.0	7.7
Components of real GDP					
Private consumption expenditures	11.6	9.1	-4.1	-0.6	2.0
Governmental consumption expenditures	1.6	3.2	-11.0	0.1	1.2
Gross fixed capital formation	29.0	19.3	-6.5	-0.5	3.5
Export of goods and services	7.9	19.4	-13.7	1.7	2.8
Import of goods and services	27.2	17.5	-15.6	-0.4	2.6
Contributions to GDP's growth (percents)					
Final domestic demand	15.6	12.5	-6.6	-0.5	2.5
Changes in stocks and net purchases	0.1	-3.5	0.0	0.0	0.0
Net export	-9.5	-1.9	2.6	0.6	-0.1

Source: National Commission for Economic Forecasting

The lower external demand correlated with the contraction of the domestic economic activity, will influence the evolution of the foreign trade, by reducing significantly both the exports and the imports of goods and services. A positive contribution of the net export (2.6 percents) to GDP's real growth is foreseen, as the contraction of the imports might exceed the export's one.

As the measures provided by the economic and financial recovery plan will become effective, both in Romania and in the other EU member states, it is expected that the economic deterioration will slowdown and the confidence degree will increase.

Within the forthcoming two years (2010 and 2011), GDP's growth will progressively attain positive values, due to the developments in trade and the manufacturing output.

After the stabilization of the economies and the overcome of the recession in 2010, when the economic growth is forecasted to be around zero (0.1%), we expect the resumption of the economic activity in 2011 and, on this basis, a 2.4% GDP growth. This forecast is based on the assumption of the improvement of the domestic and the international economic environments, the stabilization of the financial markets and the encouragement of additional investment and private consumption by the stimulus measures.

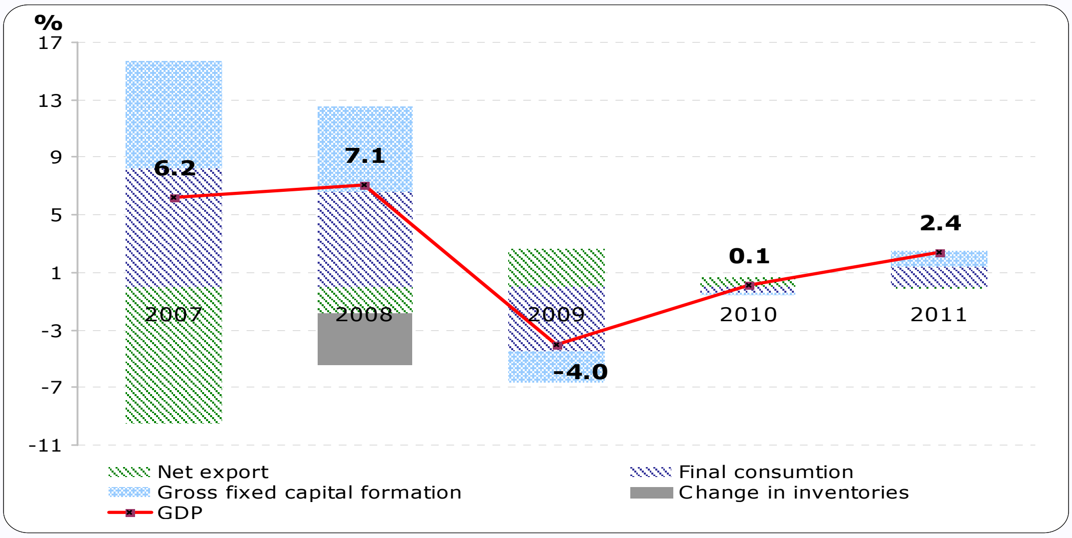
The domestic demand will manifest a recovery trend, sustained by the investment process. Thus, the forecast for 2010 shows a slight reduction of 0.5%, while for 2011 we expect a 2.3% growth.

After ending the declining trend in 2010, there are also assumptions for the recovery of the investment process in the private sector, on the background of the beginning of projects financed from structural funds. Thus, the gross fixed capital formation is expected to maintain at the same level as in 2009, with a slight reduction of 0.5%. For 2011, there is estimated a change of trend, on the basis of a growing propensity toward investment and unlocking of the lending process; as a result, the gross fixed capital formation will increase by 3.5%

As the labor market will stabilize and the population incomes will increase, compared to the labor productivity, a recovery of the private consumption expenditures is expected in 2011, after a contraction of 0.6% in 2010. In addition, the governmental consumption will follow an ascending trend, increasing by 0.1% in 2010 and 1.2% in 2011.

The foreign trade of goods and services will recover due to an increase of both the domestic and external demand and by intensifying the global trade. It is foreseen a higher value added and competitiveness of the exported products. Considering these hypothesis, the positive contribution of the net export to GDP's growth will maintain in 2010, but at a lower level (0.6 percent, compared to 2.6 percent in 2009), while in 2011 its contribution will become slightly negative (-0.1 percent).

Chart 3.10 Contribution of the components of use to GDP's real growth



Source: National Commission for Economic Forecasting

Despite the increase in the investments of the governmental sector, the share of gross fixed capital formation in GDP will decrease in 2009, due to the contraction of the investments in the private sector. In 2010, following the stop of the decline and afterwards the acceleration of the investment process, the share of the gross capital formation in GDP will increase, reaching 31.4% in 2011. The table below shows the improvement of savings especially in the governmental sector, which will reduce the foreign financing needs. It is important that, part of such needs are expected to be covered from foreign direct investments, accounting in average for 3.8% of GDP.

Table 3.4 Savings - Investments Balance - % of GDP-

	2007	2008	2009	2010	2011
Domestic saving	17.1	18.8	22.3	24.5	25.8
National saving	17.6	19.3	22.2	24.3	25.2
- private sector	14.7	19.3	20.8	21.0	20.8
- governmental sector	2.9	0.0	1.3	3.3	4.4
Gross capital formation	31.1	31.4	29.5	30.6	31.4
- private sector	25.7	26.0	23.1	23.2	24.1
- governmental sector	5.4	5.4	6.4	7.4	7.3
Saving-Investment balance	-13.5	-12.2	-7.4	-6.4	-6.2

-private sector	-11.0	-6.8	-2.3	-2.3	-3.3
- governmental sector	-2.5	-5.4	-5.1	-4.1	-2.9

Source: National Commission for Economic Forecasting

The domestic savings will cover the planned investments (gross capital formation) to a larger extent, namely 60% in 2008 and will reach 82% in 2011. At the same time, there will be an increase of the level of investment financing through foreign capital transfers, including European funds, which will cause a reduction of the financing needs from external sources by 1.1% of GDP in each year.

From the economic development point of view, Romania still lags far behind most European countries, although it managed to catch up, in the recent past, reducing the difference from the EU average. The gross domestic product per capita, expressed in purchasing power standard (PPS), was around 42% of the EU 27 average in 2007 and it is expected to go up to 50% in 2011.

It is estimated that the **exports of goods** in 2009 will decrease by 15.5% and **imports of goods** by 25.4%, due to the reduction of industrial production by 10%. In this context, compared to 2008, the share of trade deficit in GDP will decrease by 5.1 pp, reaching 8.3%. Exports and imports of intra-community goods will reduce by 12.9% and 22,5% respectively while the exports and imports of extra-community goods will decrease by 21.9% and 31.9% respectively.

The current account deficit of the external balance of payments is expected to reach 9.4 billion euro, representing 7.5% of GDP, mainly due to the decline by 43.4% of the trade deficit. For 2009, in the context of the global financial crisis, is expected a lower level of foreign direct investments inflow compared to the previous year, namely 4.5 billion euro, meaning a decrease of about 50%.

Starting from the assumption regarding the end of the recession in 2010 and the resumption of growth of the world economy in 2011, the exports of goods will increase by 5.5% and imports by 2.8% in 2010, followed by an increase of 6.2% and 4.8% respectively, in 2011. In 2010 the trade deficit will decrease by 4.3%, with a slight increase in 2011.

Intra-community exports are expected to increase below average by 3.5% in 2010 and 3.7% in 2011, while intra-community imports will increase by 0.4% and 2.5% respectively.

The current account deficit will maintain at 9-10 billion euro, with its share in GDP estimated at 6.5% in 2010 and 6.3% in 2011.

The balance of current transfers will be stable in 2010 and 2011 at about 5.5 billion euro, however, contributing to the attenuation of the negative impact on the current account of the deficits registered by the trade and revenue balances.

There are estimated inflows of foreign direct investments of 5.4 billion euro and 5.6 billion euro in 2010 and 2011 respectively. The current account deficit will be significantly financed by autonomous sources, which are not creating debt, estimated to reach a share of 80% at the end of 2011.

The FDI coverage share of the current account deficit will diminish once the foreign direct investment inflow will stabilize, along with a substantial increase of the contribution of the capital transfers, mostly as a result of the absorption of EU funds.

As regards the **labour market**, taking into account the economic slowdown, especially in industry, the employment is expected to decrease by 2.2% in 2009. As a result the occupation rate will decrease from 59.1% in 2008 to 57.8% in 2009. As the economic growth will start to recover, in 2010 and 2011 the employment is expected to go up by 0.6% and 1% respectively, leading to an improvement of the occupation rate. The unemployment rate will register a downward trend, reaching 7.7% in 2010 and respectively 7.4%, in 2011. Though, there is a low probability that the occupation rate will not reach in 2011 the level attained in 2008.

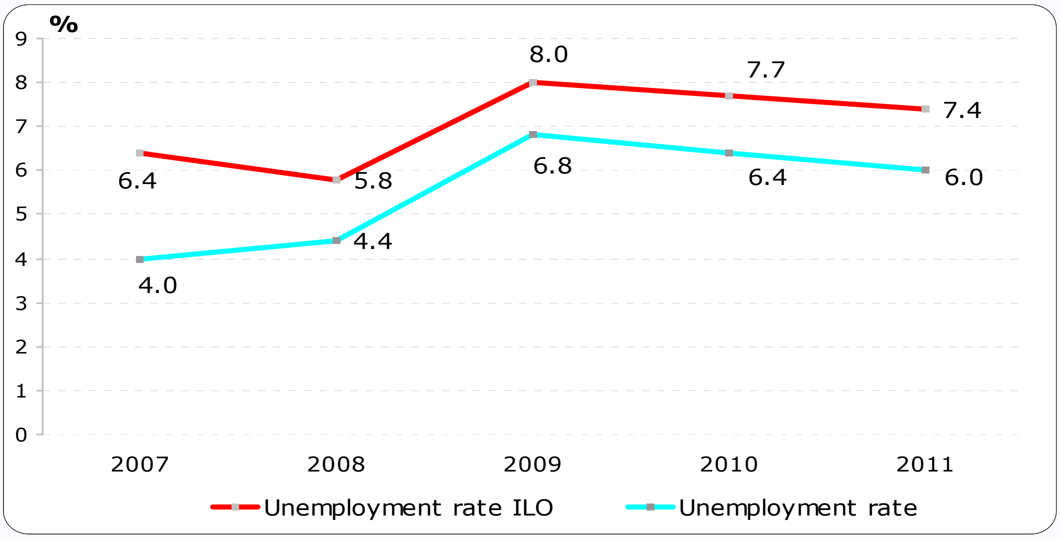
Table 3.5 Labour force evolution*

	2007	2008	2009	2010	2011
			- percentage changes -		
Total population	-0.1	0.0	-0.1	-0.1	-0.1
Active population	-1.1	-0.3	0.3	0.3	0.7
Employment	-0.2	0.5	-2.2	0.6	1.0
ILO unemployment	-12.0	-10.3	38.3	-3.1	-3.2
			- % -		
Activity rate	63.0	62.9	63.1	63.3	63.8
Employment rate	58.8	59.1	57.8	58.2	58.9
ILO unemployment rate	6.4	5.8	8.0	7.7	7.4

Source: National Commission for Economic Forecasting

The number of the unemployed will increase by 220 thousand persons, reaching a rate of 8% in 2009. The number of the registered unemployed will increase by 217 thousand persons until the end of 2009, corresponding to an unemployment rate of 6.8%. Starting with 2010, there is expected an improvement of the occupation and the reduction of the unemployment rate.

Chart 3. 11 Unemployment rate



Source: National Commission for Economic Forecasting

The **inflation** is expected to decrease gradually. Therefore, the inflation rate in 2009 will go down at the end of the year to 4.5%, corresponding to an average of 5.8%.

The forecast for consumer prices is based on the decline of the excess demand during 2009, triggered by the recently worsening global financial and economic conditions. Simultaneously, the

* It refers to the working age population (15-64 years old)

disinflation process will be helped by the prudential measures taken by the NBR, aimed at tempering credit growth as well as a cautious wage and budgetary policies promoted by the government. On the other hand, the international economic context, along with persistent macroeconomic imbalances in the second half of the previous year, caused higher exchange rate volatility, with the domestic currency depreciating as against the main foreign currencies, a trend which may continue this year as well. This will determine an increase of the imported goods prices, but also of the prices for domestic products or services, which depend on the European currency. At the same time, the consequence of such depreciation can be reflected in a reduction of private consumption, especially for those individuals who, over the past years, resorted to loans in foreign currencies. Under these circumstances, the reduction of the demand will go significantly down, to the benefit of the estimated disinflation process.

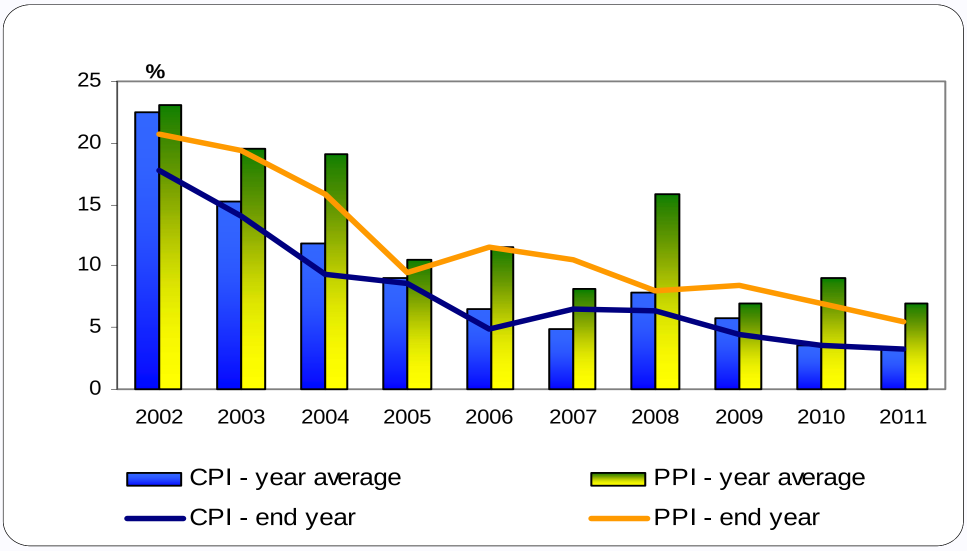
The administered prices will contribute to the decrease of the inflation rate below the 2008 rate, by 1.8 percentage points at the end of year.

Moreover, in the forecasting period 2010-2011, the gradual reduction of administered prices' growth, a prudential wage policy and the continuation of structural reforms will help to maintain the disinflation process on a sustainable path. Hence, the inflation rate will decrease gradually to 3.2% in 2011.

In addition, the continuation of the disinflation process will contribute to additional decrease of inflationary expectations. Another efficient mean to anchor the inflationary expectations will be the resumption of the domestic currency appreciation trend, in real terms, against the euro, beginning with 2010. This is possible if we take into account a more accelerated productivity growth in Romania as compared to its main foreign partners.

For the industrial prices, there is forecasted a gradual reduction to an average level of 7% in 2011.

Chart 3.12 Evolution of CPI and PPI



Source: National Commission for Economic Forecasting

Table 3.6 Deflator evolution

percentage changes	2007	2008	2009	2010	2011
GDP deflator	12.7	14.0	9.9	6.9	5.1

Consumer price index – average	4.84	7.85	5.8	3.5	3.2
Private consumption deflator	4.9	9.0	6.1	3.8	3.3
Public consumption deflator	10.3	18.8	9.2	8.2	6.1
Investments deflator (GFCF)	10.4	12.1	7.0	6.0	4.8

Source: National Commission for Economic Forecasting

3.3.3 Prognosis Risks

The premises of the medium term macroeconomic framework for the current edition of the Convergence Programme were built on a number of assumptions that took into account, the latest forecasts of different specialised institutions, revealing a contraction of the world and EU economies in 2009, higher than the expectations at the beginning of the year, followed by a gradual recovery during 2010. It is important to note that 2009 is an year of uncertainties and major risks, taking into account the fact that the world economy is facing a serious crisis, which affects in different manners every state, including Romania.

A higher adjustement of the world economy real sector to the problems of the financial sector might have a negative impact on the Romanian economy as well, by the reduction of the export market for Romanian products.

In addition, Romania faces the risks of bad weather conditions for the agriculture (draught or floods), which would reduce the supply of farming products triggering a decline in self-consumption and the farming market, and an increase of imports in order to cover the domestic demand.

If these risks will materialize correlated with other risks related to the international price of oil and gas or the price of food products, than it is possible that the recession of the Romanian economy will deepen. This evolution is, as well, a consequence of the impact on the domestic supply of a lower demand, as a result of the employment difficulties on the labour market and the decline in revenues.

Along with the decline in the domestic supply, the external imbalances are likely to widen, the trade deficit is expected to grow, with the current account deficit share in GDP, remaining at the level of 2008, instead of decreasing. The declining activity will lead to a lower economic competitiveness and a higher unemployment rate than anticipated in the baseline scenario.

4. COMPARISON WITH THE PREVIOUS CONVERGENCE PROGRAMME EDITION

4.1 Macroeconomic Framework

The medium term macroeconomic development scenario presented in this programme is substantially different from the latest edition of the Convergence Programme, issued in November 2007.

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

- the statistical data regarding the economic outcome in 2008;
- the update of 2002-2007 statistical data;
- the global financial and economic crisis.

Thus, the real GDP growth in 2008 was higher by 0.6pp than the estimation in the previous edition, namely 7.1% as compared to 6.5%, but the expenditures' structure registered substantial deviations. Firstly, we have to stress that the data used in November 2007 version for 2007 were estimates based on the then-available statistical information. Meanwhile, the National Statistics Institute published the provisional and the semi-final data for 2007.

For the period 2008-2010 the differences appear as a result of the premises of the January 2009 interim forecast, as follows:

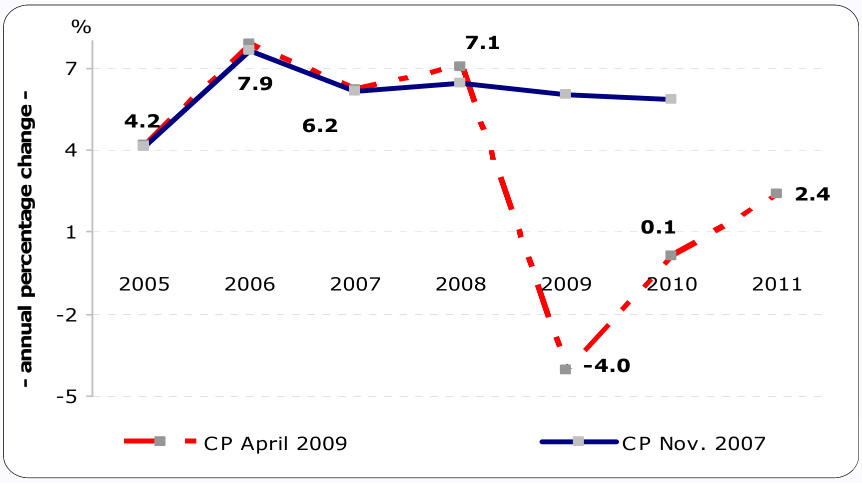
- 2008 was a favorable year from the economic point of view in the first 9 months, when GDP went up by 8.9%, followed by a decline in growth to 2.9% in the fourth quarter, on the background of worsening economic conditions with impact on all GDP expenditure components. These developments led to an estimated economic growth in 2008 of 7.1%, as against 6.5% in the previous edition;

- 2009 is a year with increased uncertainties, for both the domestic and international environment, with a negative impact on all European states and the European Union as a whole. As a consequence, in 2009 we expect a 4% GDP contraction as compared to the 6.1% growth in the previous programme edition;

- the forecast for 2010 shows a continous restraint of the economic activity in the first part and afterwards a slight recovery, which might materialize in a GDP real growth of 0.1% for the overall year.

If there will be a consolidation of the global situation and the critical moment of the economic and financial crisis will be overpassed, the economic growth might accelerate in 2011 to 2.4%.

Chart 4.1 Comparison between GDP growth forecasts

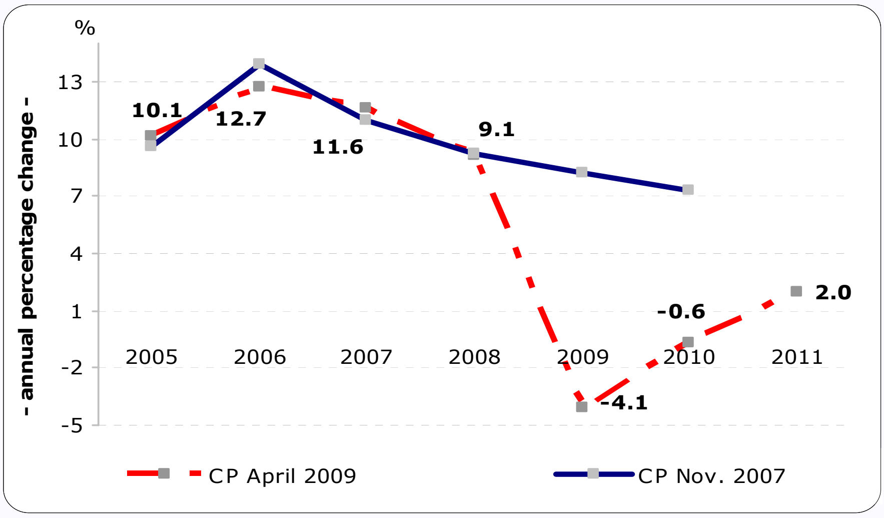


Source: National Prognosis Commission
CP Nov 2007 = Convergence Programme, November 2007 Edition
CP Jan 2009 = Convergence Programme, January 2009 Edition

Other differences compared to the previous programme forecast are related to the composition of the domestic demand and the associated response of the domestic supply. These differences are due, on one hand, to the trends reflected by the recently published data and the statistical updates and, on the other hand, to the changes in the economic and budgetary policies.

Thus, the private consumption evolution in 2008 recorded a similar increase as compared to the previous edition (9.1% as against 9.2%). However, there were adjustements made for the following years to the forecasts of different GDP components, including the reduction of the pace of growth in the private consumption.

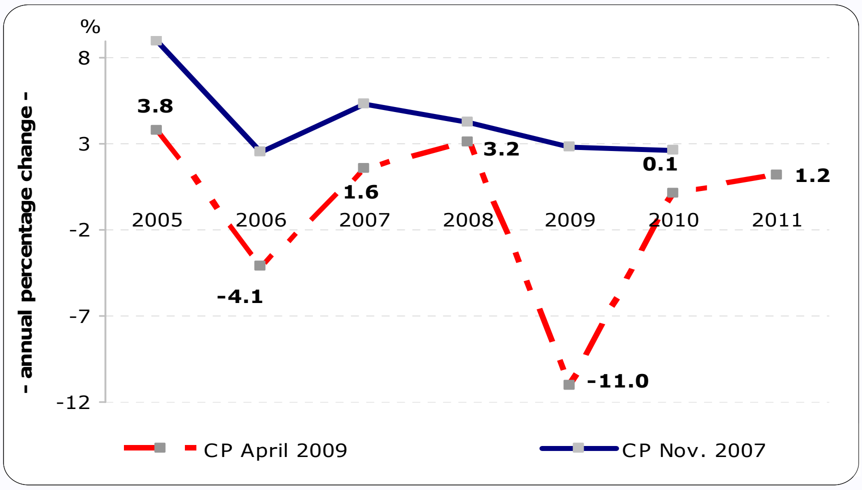
Chart 4.2 Comparison between private consumption expenditures growth forecasts



Source: National Prognosis Commission

As regards the public consumption expenditures, the differences between the two editions of the Convergence Programme occured primarily following the update of the data for the period 2002-2007, with an adjustement to lower growth rate. Policy changes were reflected also by a new structure of the budget expenditures, showing an important share of the funds allocated to public investments along with the reduction and rationalization of the material and personnel expenditures. Given these circumstances, the projection of public consumption expenditures for the period 2009 - 2011 shows an increase rate below the forecast presented in the previous edition of the Convergence Programme.

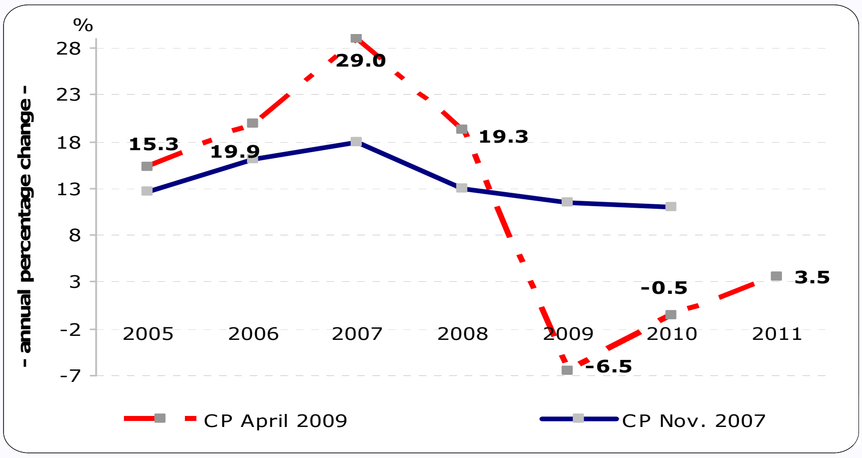
Chart 4.3 Comparison of the public consumption expenditure growth forecasts



Source: National Prognosis Commission

The data revision for the previous years regarding the gross fixed capital formation implied an upward trend of the growth rates for the gross fixed capital formation. A major divergence can be observed in 2007, when based on the then-available statistical data a 18% increase of the gross fixed capital formation was estimated, but the developments in the investment porcess led to a 29% increase towards the end of the year. Further differences resulted from the major changes occurred in the Romanian economy, reflected in a substantial investment growth in 2008 compared to the previous edition forecast, while for 2009-2011 is envisaged a slowdown of the growth rates. Significantly is that such increases are supported by the anti-crisis measures adopted by the Government, with a special attention given to the infrastructure projects.

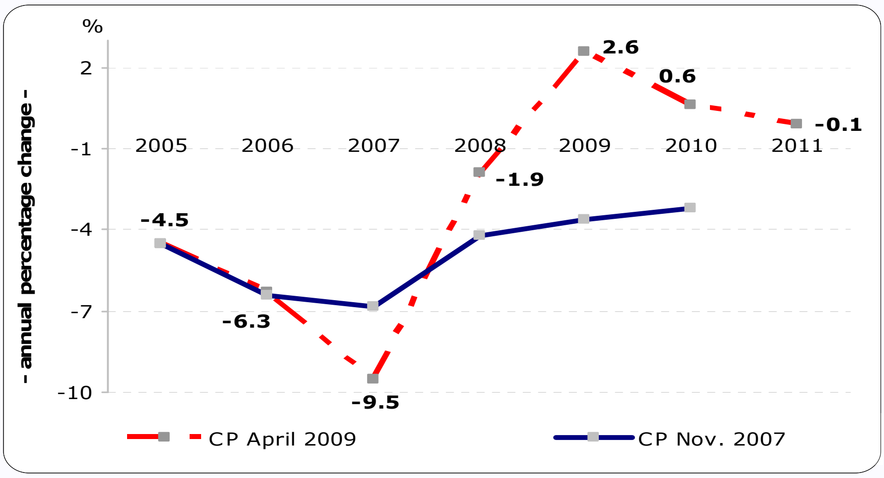
Chart 4.4 Comparison between GFCF growth rates forecasts



Source: National Prognosis Commission

The data regarding the net exports of goods and services in 2007 shows a widening of external imbalances, reflected in a higher negative contribution of net exports to GDP growth; however, the developments in 2008 determined a lower contribution than initially forecasted in the previous edition of the Convergence Programm, due to a higher dynamic of the exports of goods and services compared to the imports. An improvement of net exports is forecasted for the next period, with a positive contribution to real GDP growth, as compared to the previous edition.

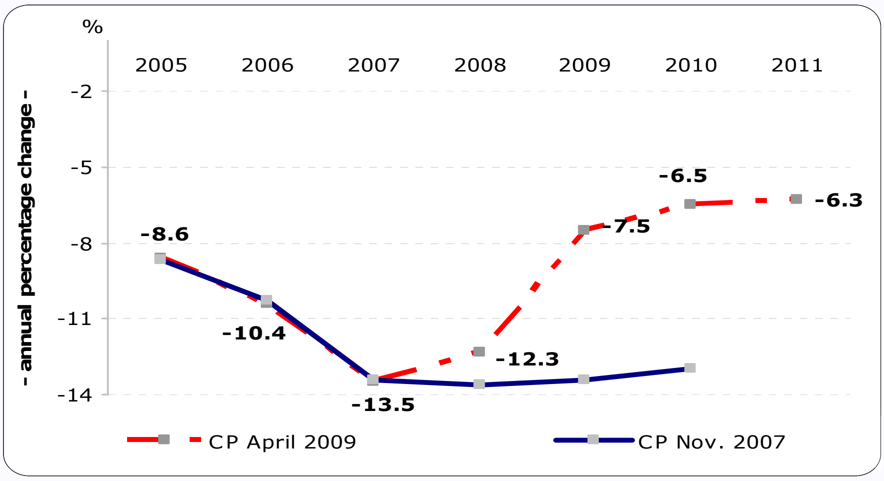
Chart 4.5 Comparison between the net export contribution to the real GDP growth



Source: National Prognosis Commission

Given the global financial crisis, there will be a substantial slump in the Romanian foreign trade. Thus, both exports and imports of goods are expected to show significant decreases in 2009 and slight increases in the following period as compared to the previous programme edition. In addition, revenues and transfers balance, as share in GDP, will go down as compared to the previous edition of the Convergence Programme. In this context, the current account deficit is expected to decrease, as a share of GDP, from the peak of 13.5% in 2007, followed by 12.3% in 2008, to 6.3 % in 2011.

Chart 4.6 Comparison between the current account deficit shares in GDP

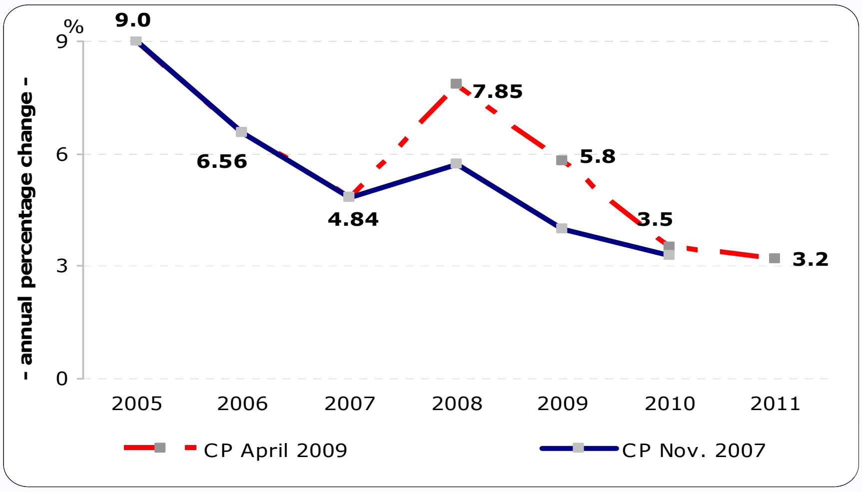


Source: National Prognosis Commission

Consumer prices evolution in 2008, measured as annual average, had an ascending trend, as expected since the previous programme edition, but its amplitude was higher. The consumer price increased higher than expected due to the increase in food goods prices in the first part of the year, but also to the depreciation by 9% of the domestic currency against the euro.

The disinflation trend evident from the second half of 2008 is expected to continue in 2009, supported by a slump in demand slump with an offsetting effect vis-à-vis the impact of the currency depreciation.

Chart 4.7 Comparison between annual average inflation rates



Source: National Prognosis Commission

4.2 Budget Deficit Comparison

The previous Convergence Programme Edition forecasted a budget deficit of 2.9% of GDP in 2008, based on the approved budget. In the light of the budget execution data, the actual budget deficit amounted to 5.4% of GDP. On a medium term, the forecasted deficit is expected to adjust to 2.9% of GDP.

Table 4.1 Budget deficit comparison % of GDP -

	2007	2008	2009	2010	2011

1. CP November 2007	2.9	2.9	2.9	2.4	
2. CP April 2009	2.5	5.4	5.1	4.1	2.9
3. difference (2-1)	0.4	2.5	2.2	1.7	

Source: Ministry of Public Finance

5. GOVERNMENT FINANCES - DEFICIT AND DEBT

5.1 Fiscal and Budgetary Policy Objectives and Strategy

The government budgetary strategy is intended to restore the credibility and stability of public finance on short and medium term, by promoting a combination of concrete and coherent measures able to limit the budgetary deficit and reduce the need for financing the governmental sector while allocating a high level of resources to public investments.

The allocation of important amounts to investment expenditures represents the path towards limiting the effects of the international crisis upon the rate of economic growth and towards partially offsetting for the reduction in the activity in the private sector. The gross formation of fixed capital from budgetary sources will increase to over to 6.4% of GDP in 2009, while the gross formation of fixed capital in the private sector is expected to decline by 11% in real terms.

In order to correct the macroeconomic imbalances and to prevent their amplification during the projected horizon, it is necessary to coordinate the macroeconomic policies, especially the fiscal and the revenue one with the monetary policy. Hence, the central objectives in projecting the fiscal policy are to ensure sound public finances over the medium term and that spending and taxation impact fairly between generations, and on the short term to support the monetary policy, in particular the symmetric operation of the automatic stabilizers with a view to limit the economic volatility, prevent the return of inflation and keep the interest rate at a low level.

Romanian Government pursues the fundamental objective of ensuring macroeconomic stability and supporting the process of sustainable economic growth by:

1. promoting a combination of consistent macroeconomic policies, by maintaining prudential budgetary and salary policies;
2. creating a binding fiscal and budgetary framework on medium term;
3. improving the revenue administration through the tax administration reform and the reduction of the collection costs;
4. broadening the tax base in sectors such as the environment, the state enterprises and the agriculture;
5. substantial improving the efficiency of public funds spending, by formulating clear priorities, especially for the investment projects, through the horizontal coordination of the economic policies.

A less restrictive behavior of the fiscal policy compared with the coordinates of the baseline scenario would translate into difficulties in the budget deficit financing and an enhancement of competition between the public and private sectors in order to attract the available financing resources. In the context of an estimated reduction in the total financing resources amid the financial crisis, such behavior would result in an increased difficulty of the private sector to access credit markets and, *ceteris paribus*, a slower rate of economic growth with negative effects on the budget revenues.

The structural deficit of the budget is projected to reach 0.9% of GDP in 2012, observing the provisions of the revised Stability and Growth Pact, allowing a sufficient safety margin as compared to the level of 3% of GDP against the background of a potential slowdown in the GDP growth rate.

The complex character of the implementation of the fiscal budgetary policy derives from the necessity of a systematic development of the process of adjusting the macroeconomic imbalances, with a view to preventing a massive, lasting contraction of economic activity.

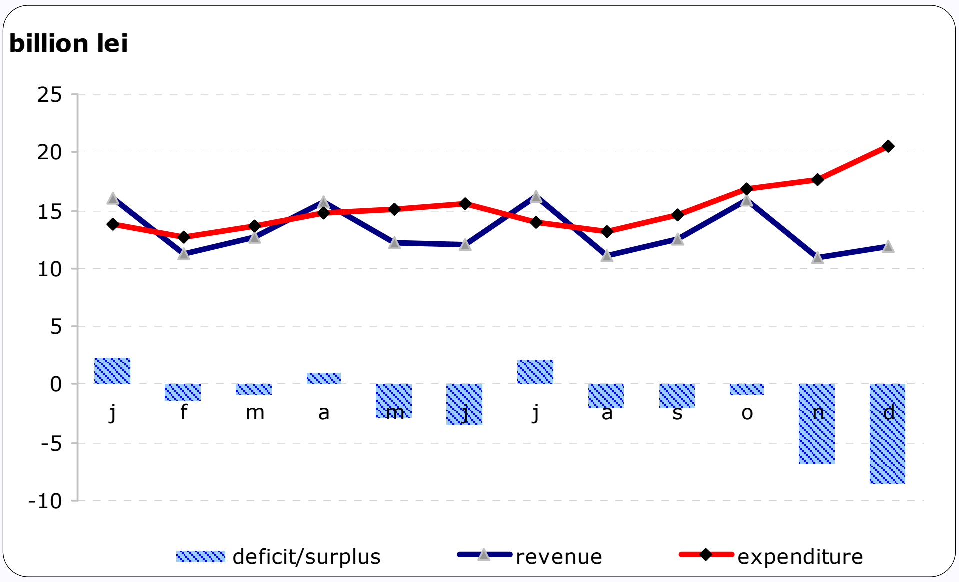
The Government vision in the field of **fiscal policy** is focused on ensuring a motivated and non-discriminatory environment while concentrating on measures meant to consolidate its transparency, stability and predictability. Moreover, the improvement of the public finance sustainability has a crucial importance in the light of the adverse demographic perspectives.

5.2 Public Finance Development in 2008

In 2008, the budgetary policy was expansionary, pro-cyclical and led to an accumulation of significant macroeconomic imbalances reflected by the budgetary and current account deficits and a high inflation rate. The lack of predictability of the fiscal-budgetary policy and the budgetary deviation recorded last year facilitated a rapid downgrade of perception, confirmed by the lower ratings granted to Romania by the rating agencies, increased pressures in terms of the national currency depreciation and increased financing costs.

The public finance position at the end of 2008 considerably deteriorated, the budget deficit spiked to 4.9% of GDP, according to the cash methodology and about 5.4% of GDP according to the European methodology, i.e. a twofold level as compared to the budget target. In the fourth quarter, the monthly deficit of the general government budget recorded the largest level in the past years, although the economic growth to 7.1% in 2008 was the highest in the European Union.

Chart 5.1 Monthly Development of Budgetary Revenues and Expenditures in 2008



Source: Ministry of Public Finance

Although the economic activity decelerated in the second half of 2008 and the effects of the banking liquidity crisis on the economic operators in the context of the recent international evolutions, had a negative impact on the revenue collection to the general consolidated budget; the numerous budgetary rectifications highlighted the inflationary and pro-cyclical nature of the budget policy by increasing the revenue and expenditure in an unsustainable way.

The total revenue collected in 2008 represented only 32.8% of GDP[2] (Lei 165.5 billion), in comparison with scheduled revenue of 37.2% of GDP (Lei 191 billion). The main overestimated revenues include the European funds (underperformance of 1.6% of GDP), VAT (underperformance of 1.2% of GDP),

[2] That includes the self-financing institutions, according to the European methodology. Without such institutions, the revenues accomplished in 2008 are 30.9% of GDP.

excises (underperformance of 0.5% of GDP), profit tax (underperformance of 0.5% of GDP), non-tax revenues (underperformance of 1.3% of GDP).

Public expenditures recorded higher dynamics in 2008 though the amounts were not directed towards the productive activities. Personnel expenditures show a nominal increase of 35,4% compared with 2007, reaching 9.1% of GDP, and 24% of the total public expenditures.

The number of positions occupied in the budget sector over 2005-2008 period cumulatively increased by about 162,500 (13%), reaching to 1,394,200 employees; the highest dynamic was recorded in the central administration which expanded by 50.000 jobs (17%), the number of positions filled increased by 28% in the institutions financed from their own revenues and from subsidies. Also, during this period, the number of approved positions increased by 214,900 reaching 1,531,900 in 2008. The personnel outlay in the budgetary sector doubled in nominal terms over 2005-2008, and the highest share in the total personnel expenditures is detained by the local administration.

Table 5.1 Dynamics of Personnel Expenditures, by Main Budgets

	2005		2006		2007		2008	
	Million lei	% of total	Million lei	% of total	million lei	% of total	million lei	% of total
Central administration	7,654	35.8%	10,587	38.4%	13,709	40.7%	16,484.3	36.1%
Local administration	8,035	37.6%	10,628	38.5%	12,052	35.8%	16,541.2	36.3%
Institutions fully/partially financed from own revenues	5,668	26.6%	6,379	23.1%	7,935	23.5%	12,582.8	27.6%
Total	21,356	100%	27,594	100.0	33,696	100%	45,608.3	100.0

Source: Ministry of Public Finance

Moreover, a declining trend is observed for the share of the base wages in the total salary expenses, corroborated with an increase in the premium, bonuses and in-kind wage outlays. Thus, the share of the base salaries in total salary expenses decreased from 55% in 2005 to 48% in 2008, while the other components of the salary gain increased their share in the total personnel expenditures from 27% in 2005 (45% of salary expenditures) to 36% in 2008 (52% of the salary expenses). As a trend, the aggregated base salaries increased by 79% while the bonuses expended by 136%, and the outlays related to premiums and extra-work hours by 272%. In fact, the bonuses and the extra-work hours doubled their share in the total personnel expenses in the reference period, from 5% in 2005 to 10% in 2008.

The goods and services expenditures increased by 27% compared with those in the previous year, reaching 6.4% of GDP, while the capital expenditures reached 4.7% of GDP compared to the programmed level of 5.2% of GDP. The excessive deficit led to an increase by 16.4 billion lei of the public governmental debt on November 30, 2008 as compared with the reading as of end 2007.

5.3 Medium Term Public Finance Development

The medium term public finance development is driven by the deteriorated budget position in 2008 and by the difficult international and European context. The economic growth forecast continues to be under the burden of a wide spectrum of uncertainties, the most significant of which are connected with the economic activity prospects and the EU markets' sentiment.

Recognizing the need of a significant adjustment with a view to restore the balance of public finance in the context of an economic growth lower than expected for 2009, the Government has decided to promote a mix of economic and budget policies which are meant to:

- lead to scaling down of the budget deficits and the financing requirements for the public sector;
- confine the effects of the global financial crisis on the Romanian economy;
- consolidate the level of budgetary revenues by promoting some measures to expand the tax basis, improve tax collection and increase certain categories of taxes;
- keep under control and rationalize the dynamics of the current expenditures of the public administration (wage-related expenditures , materials etc.).
- create and maintain sufficient space for public investments.

Consequently, the budget represents a commitment to obtain a significant and constant progress in the fiscal consolidation in the following three years. The fiscal policy will be characterized by coherence, predictability and stability, by elaborating and re-writing some projects of the Fiscal Code and the Fiscal Procedure Code, unitary integrated and harmonized with EU directives and economic realities. The consolidation of the budget revenue base is still essential for ensuring the resources required for the economic development and for Romania to meet its commitments assumed as an EU member state.

Reassessment of the main macroeconomic indicators, enactment of regulations and implementation of reform measures imposed by the recent developments, as well as the stipulations of the loan agreement between Romanian government and the International Monetary Fund, European Commission, World Bank and other international financial institutions led to the revision of 2009 budget. The total of the available resources was diminished by 6.2 billion RON as net result of the reduction of budgetary revenues and the drawing of the EU grants and the increase of the budget deficit.

Tabel 5.2 The structure of the resources available in 2009

	Initial budget (bln.lei)	Initial budget % PIB	Revised budget (bln.lei)	Revised budget % PIB
Total, of which:	205.6	35.5%	199.4	37.5%
Revenues from economy	183.5	31.7%	166.7	31.4%
Grants	10.27	1.8%	8.5	1.5%
-Preaccession	5.13	0.9%	4.6%	0.9%
-Postaccession	5.14	0.9%	3.9%	0.7%
Public deficit	11.78	2.0%	24.4	4.6%

In the context of the review of the projection for economic growth in 2009 from 2.5% to -4%, consolidated budget revenues are estimated at 175 billion lei (32.9% of GDP), increasing with 0.3 pp from 2008. The overall revenue figure included also additional resources generated by the return of the social contributions to their January 2008 level (4.34 billion lei) and the moving forward of the increase of the excise duties of cigarettes and other tobacco products from 2010 in 2009 (0.59 billion lei). Compared with the initial budget, revenues were revised downward with 18.8 billion lei (among which VAT-5 billion lei, excises-2.6 billion lei, corporate income-1.7 billion lei, income tax-1.8 billion lei, social insurance contributions-2.3 billion lei, nontax revenues 3.2 billion lei), and the budgetary expenditures have been adjusted by 6.2 billion lei.

In the first quarter of 2009, the consolidated budget deficit registered 1.5% of GDP compared to a balanced position registered in the same period of the previous year. This development was influenced by the reduction of the consolidated budget revenues with 0.8 pp from 8% of GDP in March 2008 to 7.2 % of GDP in March 2009 (a nominal reduction of 5.5% compared to the reference period). Moreover, the consolidated budget expenditures increased as a share of GDP, from 8% in March 2008 to 8.5% in March 2009, corresponding to a 8.7% nominal increase. In the consolidated budget structure, the state budget registered a deficit of 1.9% of GDP at the end of the first quarter while the local budgets registered surpluses of 0.4% of GDP.

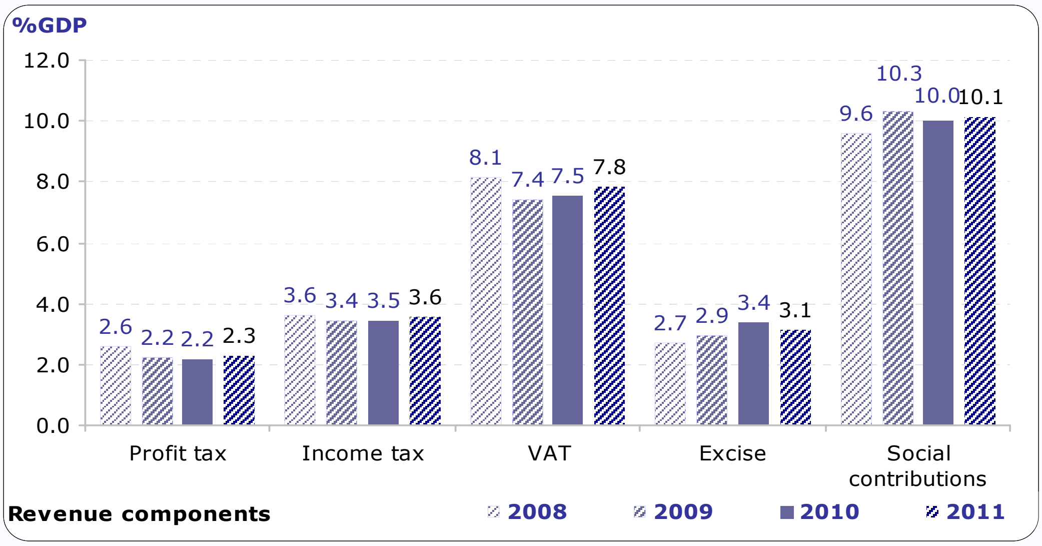
Table 5.3 The Main Fiscal-Budgetary Developments in 2009-2012

Legislation	Forecast 2009-2012
Revenue tax	
Maintaining the flat rate for income taxation of 16% and ensuring equity in the distribution of the fiscal burden for the low income taxpayers. Temporary elimination of the income tax for interest earnings, including those of non-residents, in order to stimulate saving (2009).	A 1% nominal reduction as compared with 2008, i.e. a decline by 0.2pp as share in GDP. This development is mainly determined by the moderate increases of the gross average salary and the average number of employees in 2009 compared with 2008. On medium-term we estimate the same prudent evolution of wages in line with productivity gains and the income tax proceeds are expected to stabilize at 3.6% of GDP in 2011.
Profit tax	
Maintaining the flat corporate tax rate of 16%. Introduction of a minimum tax owned by the tax payers, including the micro enterprises which declare a profit less than the minimum proposed level. The taxation of the reserves from the reevaluation of the fixed assets including	A 10% nominal reduction compared with 2008, declining by 0.4 pp as share in GDP compared with the previous year. This evolution is influenced by the reduced economic activity in certain sectors as well as by the high costs of financing of the economic operators in 2009. We estimate that the revenues from the profit tax will come back to the level of 2.3% of GDP in 2011 in the context of resuming economic growth.

Legislation	Forecast 2009-2012
land, realized until January 1, 2004. Elimination of the taxation on the reinvested profit in equipment and technologies.	
VAT	
Maintaining the actual statutory rates for VAT. The elimination until December 2010, of the deduction right for the VAT levied on the cars acquisition including the fuel used for the transportation. The introduction of compulsory monthly filling of the VAT declaration for the imposable persons which are realizing intra-community acquisitions disregarding the level of the turnover.	A 3% nominal reduction as compared with 2008, in decline by 0.7 pp as share in GDP compared with 2008. The revenues from VAT are influenced in 2009 by the contraction of the economic activity in certain sectors, which determines a decrease in the value added of such sectors. On medium-term, the revenues from VAT will record an upward trend in the context of collection improvement and are expected to reach 7.8% of GDP in 2011.
Excises	
Frontload excise increase for cigarettes in 2009 (April 1 and September 1 respectively). Increasing the excises for certain alcohol products, with associated budgetary impact in 2010.	An increase of 14% compared with 2008, i.e. an increase by 0.2 pp as share in GDP compared with 2008, under the assumptions of arrears recoveries and collection improvement. The revenues from excises are estimated to reach 3.1% of GDP in 2011.
Social Security Contributions	
Returning to the level of social security contributions in the first semester of 2008. Regulating the social security contributions by the Fiscal Code.	An accelerated dynamics of 13% (increasing by 0.7 pp of GDP) compared to proceeds in 2008, in the context of increasing the pension fund contribution rate by 2.3 pp for the employer and by 1 pp for the employee. The moderate evolution of the gross average salary on medium term will diminish the share of the contributions up to 10.1 % of GDP in 2011.

The budget framework on medium term is indicative and it does not include the fiscal and administrative measures to be taken in order to increase the share of revenues in the GDP on medium term. This framework is adjusted as the fiscal outline on medium term will be completed in a Book of Public Finance over the next period.

Chart 5.2 Evolution of Budget Revenues in 2008-2011



Source: Ministry of Public Finance, calculated according to the cash methodology

The adjustment of the budget deficit from 5.4% of GDP in 2008 to 5.1% of GDP (ESA95 methodology) in 2009 represents a realistic target of the Government taking into account the difficult national and international economic context.

In the budget draft for 2009 the Government proposed the adjustment of the goods and services expenditures by 1.6% of GDP (nominal reduction by 15%), of subsidies by 0.4% of GDP and of the personnel expenditures by 0.9% of GDP, up to the level of 7.5% of GDP. Supplementary, the budget was revised by reducing the expenditures with 6.2 billion RON, out of which 1.9 billion RON for the personnel expenditures, 1.5 billion RON for the material expenditures, 3.3 billion RON for transfers and 1.7 billion RON for capital goods. The interest expenditures were increased by 1.8 billion RON to cover the costs associated with the financing of the budget deficit.

The envisaged measures are aiming at containing the budgetary effort by

-the elimination/reduction of the granting of bonuses

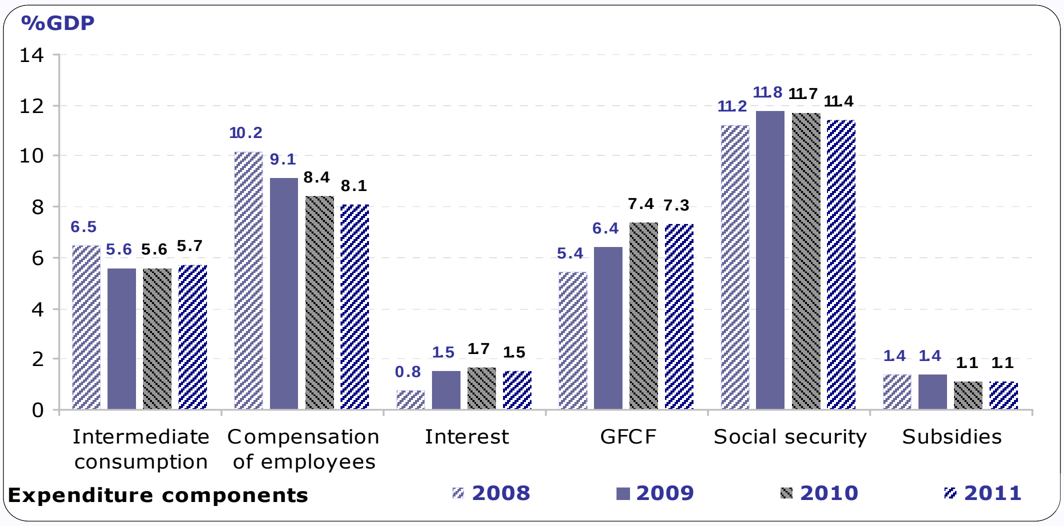
-the employment freezing with the exception of a maximum ceiling of 15% of the positions remained vacant after the enactment of the legislative stipulation

-the freezing of car and furniture acquisition including the inventory equipment

-monitoring of the state-owned enterprises from the point of view of losses, arrears and wage expenditures according to the budgets approved by the government.

For the 2010-2011 period, the Government is decided to continue the rationalization of the current expenditures by reducing the subsidies and granting prudent salary increases at a level correlated with consumer price development and freezing of hiring in the public sector, as well as analyzing the organizational structures and functions of the institutions financed from own revenues, on the basis of which suggestions for rationalizing their expenditures will be prepared. In this regard, the government decided the implementation of a coherent wage system starting respecting the equity and proportionality systems by making a clear commitment for the adoption of unitary pay legislation for the employees in the public sector.

Chart 5.3 Development of Budgetary Expenditures in 2008-2011



Source: Ministry of Public Finance

The interest expenditures are expected to remain on medium term at the level of 1.5% registered in 2008. The functioning of automatic stabilizers will sustain the economy through the increase of social assistance expenditures to 11.8% of GDP in 2009. Once the expected economic growth is resumed, the expenditures will diminish to 11.4% from GDP in 2011.

The gross fixed capital formation will increase from 5.4% from GDP in 2008 to 6.4% from GDP in 2009 up to 7.4% from GDP in 2010. The financing sources for investments are the domestic resources and the European funds.

Table 5.4 Public Investment Financing Sources

	2009	
	billion euro	% of GDP
Total, of which :	**8.9**	**7.1**
Domestic resources	5.2	4.1
Pre-accession funds	0.9	0.7
Post-accession funds [3]	1.9	1.5
Projects under reimbursable financing	1.0	0.8

Source: Ministry of Public Finance calculated according to cash methodology

The main sectors that have a high share in the total public investments are the transport sector (20.2%), the public works and housings (8.2%), rural infrastructure (13.0%), education (5.8%), environment protection (3.7%) and local budgets (32.7%).

[3] Including national cofinancing of lei 2.4 billion.

Table 5.5 Allocation of investments by line ordinators-2009

	Million ROL	% of total
Total	**37,931**	**100%**
Transportation	7,659	20.19%
Agricultural, forestry and rural development	4,920	12.97%
Regional development and Housing	3,100	8.17%
Education	2,195	5.79%
Environment	1,390	3.66%
Local budgets	12,422	32.75%
Others	6,245	16.46%

Source: Ministry of Public Finance

The budget projection of the Government also includes the effects of the package meant to limit the crisis impact on Romania, which consists of measures for resuming and stimulating economic growth, measures for financing the economy and increasing the liquidity, as well as social measures.

5.4 EU Accession Impact on the Public Finance

Achievement of a high level of absorption of European funds over the 2007-2013 represents one of the strategic objectives of Romania and at the same time, a major benefit of the accession to the European Union. This desideratum requires substantial efforts to ensure a flexible accession system and to eliminate/limit any barriers that may affect the absorption process.

Table 5.6 Distribution of Amounts Allocated to Romania in 2007-2015

million Euro

Instrument	Public	Private	Total
Structural Funds and Cohesion Fund	11,641.2	7,571.0	19,213.0
The European Agricultural Fund for Rural Development	1,968.1	6,054.4	8,022.5
The European Fund for Fishery	57.7	173	230.7
The European Fund for Agricultural Guarantee		6,884.0	6,884.0
Total	**13,667.8**	**19,682.4**	**34,350.2**

Source: Ministry of Public Finance

The period 2009-2010 is decisive in terms of the absorption of pre-accession community funds, considering the fact that the receipt of PHARE, ISPA and SAPARD funds will stop after the full accomplishment of the programmes financed under these funds, depending on the commitment and the payments agreed upon with the European Commission.

There are estimated 11.8 billion Euro to be reimbursed by the EU for the period 2009-2011.

Table 5.7 Distribution of the post-accession funds estimated to be reimbursed by EU

million Euro

Instruments/Year	2009	2010	2011	Total 2009-2011

				million Euro
Instruments/Year	2009	2010	2011	Total 2009-2011
Structural and Cohesion Funds	1,031.7	3,678.8	3,496.9	8,207.4
The European Agricultural Fund for Rural Development	617.3	315.0	449.6	1,381.9
The European Fund for Fishery	17.0	7.9	9.5	34.4
The European Fund for Agricultural Guarantee	666.3	775.6	749.2	2,191.1
Total	**2,332.3**	**4,777.3**	**4,705.2**	**11,814.8**

Source: Ministry of Public Finance

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

On the same time, the reimbursed amounts from the EU accomplished in the account of the expenditures of the beneficiaries from the private sector (which are not reflected in the budget) are added to the amounts included in the budgetary revenues.

In 2009 the expenditures related to the projects with post-accession financing, of the central and local administrations, and to the programmes co-financed from community funds are estimated to 7.6 billion Lei (1.43% of GDP). The post-accession funds estimated for 2009 are 4.8 billion lei, representing 0.9% of GDP[4].

Achievement of the forecast level of revenues from post-accession funds is directly proportional to the accelerated rate of funds absorption. In this way, an important role will have the inter-ministerial group monitoring the implementation of the European funds, coordinated by the prime minister, which is expected to weekly analyze the absorption of such funds.

The Ministry of Public Finance will have a major contribution to this body, as an institution that coordinates the budgetary process and as national coordinator of the management of the PHARE, ISPA funds and of structural instruments.

The following table shows the total expenditures estimated to be incurred from the state budget to implement the projects financed from post-accession external non-reimbursable funds (mainly structural and cohesion funds for agriculture, rural development and fishery), as well as the estimation of the amounts to be reimbursed by the EU in the account of such expenditures.

Table 5.8 Budget financing of EU projects - million lei-

	2009	2010	2011
Pre-accession			
Expenditure of funds from the EU	3,516	740	6
Co-financing from the budget (FNP)	1,421	1,362	296

4 The estimation was based on the rates of Community intervention established for the various financing instruments.

Post-accession			
Revenues*)	4,755	10,134	10,905
Expenditures**)	7,583	16,551	18,986

**) Represents amounts reimbursed by the EU in the payments already realized from the budget on account of grants*

***) includes the total value of projects under Title VIII 'Projects funded FEN post of 'plus-financing grants of financial assistance after the EC under Title VII' Further transfers'*

Source: Ministry of Public Finance

These estimations are indicative, as the level of absorption of the European funds is continuously monitored by the Government that will identify and promote the solutions necessary for increasing the medium-term absorption and for remedying the identified problems in order to make full use of such funding in the process of national development.

5.5 Calculation of Cyclic and Structural Deficit

To estimate the elasticity of taxes and duties as well as the elasticity of expenditures, the OECD and EC methodology described by Van der Noord (2000) and Girouard (2005) has been applied. This methodology is based on the decomposing of each elasticity into a number of components that can be estimated by using the existing data specific econometric techniques. The elasticity of revenues (income tax, profit tax, social insurance contributions, and indirect taxes) and of expenditures is shown in the table below.

Table 5.9 Elasticity of Budgetary Revenues and Expenditures compared with GDP

	Revenues				Expenditures
	Elasticity of revenue tax	Elasticity of social security contributions	Elasticity of profit tax	Elasticity of indirect taxes	Elasticity of primary expenditures
Van der Noord method(2000)	1.04	0.76	1.20	0.97	-0.10

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

The structural components of the budget are obtained by subtracting the cyclic component from the current budget components by using the following formula:

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

The cyclic component of each category of revenues and expenditures ($B_{t\ j}^C$) is calculated by using the output gap and estimated elasticity by GDP (α_j^{PIB}). The formula used to calculate the cyclic component is the following:

$$B_{t\ j}^C = B_{t\,j} \times \alpha_j^{PIB} \times output\_gap_t$$

Table 5.10 Cyclic and Structural Deficit (% of GDP)

% of GDP	2007	2008	2009	2010	2011
1. Real GDP growth	6,2	7,1	-4,0	0,1	2,4
2. Current balance	-2,5	-5,4	-5,1	-4,1	-2,9
3. Payments net of interest	0,8	0,8	1,5	1,7	1,5
4. Output gap	4,30	6,40	-1,14	-3,50	-3,35

5. Cyclic component of the budget	1,22	1,82	-0,34	-1,00	-0,97
6. Cyclically adjusted balance	-3,72	-7,22	-4,76	-3,10	-1,93
7. Primary adjusted balance	-2,92	-6,42	-3,26	-1,40	-0,43

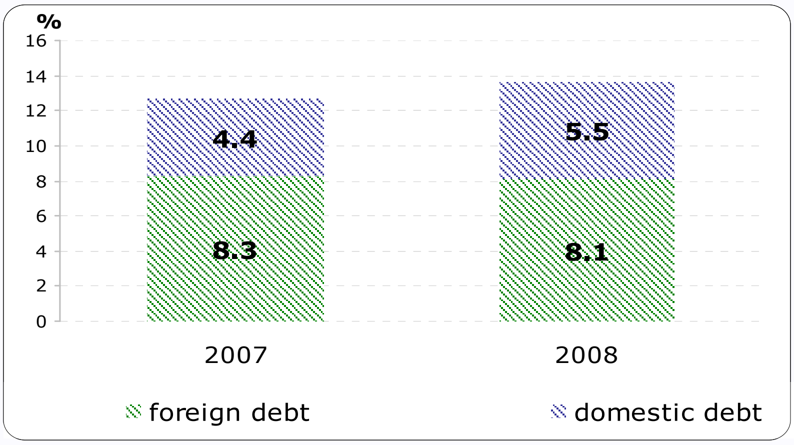
Source: Ministry of Public Finance, National Prognosis Commission, RQM

The calculation for the 2007-2011 is based on the assumptions of a real GDP and the output gap presented in the table above. Therefore, under these assumptions, it is noticed that the primary adjusted deficit increased to 6.42% of GDP in 2008 and is estimated to go down to 0.43% of GDP in 2011.

5.6 Public Debt and Debt Strategy

The level of public indebtedness of Romania was below 15 % of GDP, clearly below the 60% ceiling established through the Maastricht Treaty. Thus, on the background of sustained economic growth, at the end of 2007 the government debt calculated according to EU methodology (ESA 95) represented 12.7% of GDP, while, at the end of 2008 this indicator was 13.6 % of GDP, out of which the domestic debt was 5.5% and the external debt was 8.1%.

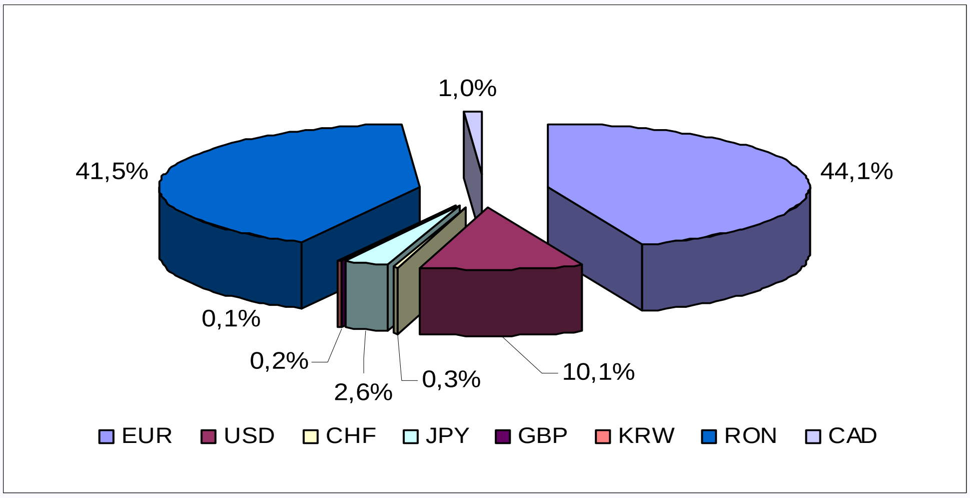
Chart 5.4 Government Debt Structure



Source: Ministry of Public Finance

The breakdown of the Government debt at December 31, 2008 by debt instruments, shows that the issuance of government securities represented 41.7% of the total debt, and the difference was covered by loans. As regards the initial maturity of the government debt, 18.5% of the total represented short-term debt, while 81.5% being medium and long term debt. In the same time, regarding the structure of the government debt by interest rate, 55.2% of the total was variable interest rate debt. The government debt in domestic currency at the end of 2008 represented 41.5 % of the total debt, while the largest share of the government debt contracted in foreign currency was denominated in Euro, i.e. 44.1 % of the total government debt.

Chart 5.5 Structure of Government Debt by Currency



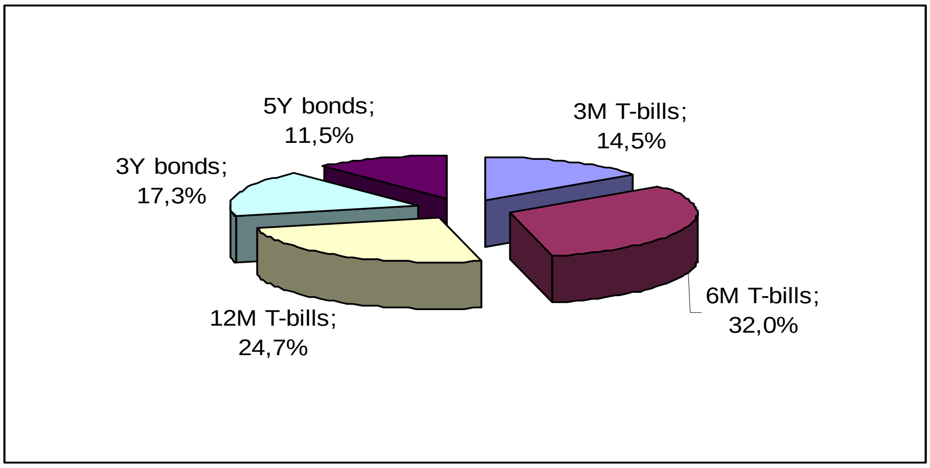
Source: Ministry of Public Finance

The financing of the budgetary deficit in 2008 and the refinancing of the government public debt was accomplished through:

- Issuances of T-Bills and benchmark bonds on the domestic market, amounting to 12.5 billion lei and an Eurobond issuance on the foreign capital markets amounting to EUR 750 million;
- Loan disbursements for projects financed under the outstanding debt facilities concluded with the international financing institutions and commercial banks in amount of 2.2 billion lei, along with the first tranche of EUR 250 million out of 1 billion new loan facility concluded with EIB to cofinance the projects under the transport, environment and competitivity operational programs and other eligible EU projects in these fields;
- Temporary loans from the funds available in the state treasury general current account, in amount of 12.3 billion lei;
- Loans contracted by the local public administration authorities, in amount of 3 billion lei ;
- Amounts recovered by the Authority for State Assets Recovery from the non-performing banking assets and receipts from privatization, in amount of 0.4 billion lei.

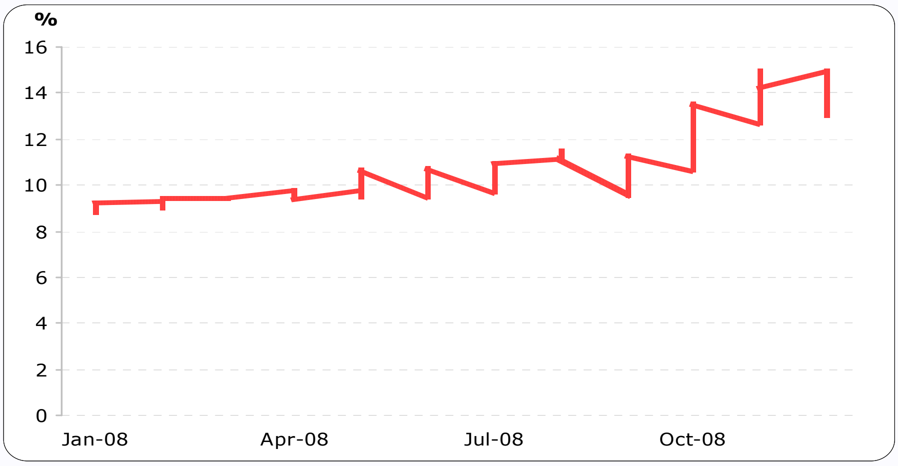
Consequently, in 2008 government securities were regularly issued on the domestic market according to the announced issuance calendar, in order to meet the objective of developing the state security market and building the yield curve of government securities on the domestic market.

Chart 5.6 Structure of Securities Issued by the State in 2008, by maturity



Source: Ministry of Public Finance

Chart 5.7 Evolution of Annualized Yield[5] of Government Securities on December 31, 2008



Source: Ministry of Public Finance

As regards the state guarantees, the national legislation in force[6] foresees that such guarantees should be granted by the Ministry of Public Finance on the basis of a law specially issued for this purpose, for projects of major importance and only with the endorsement of the Competition Office in order to meet Romania's commitments in the field of state aide. No state guarantee was issued in 2008.

Table 5.11 State Guarantees - mil. EUR -

[5] The yield (nominal rate of interest) is annualized depending on the due term of the state securities. For instance, if the state securities were issued for 3 months, the following forumla is used : Y=[(1+y/400)^4-1]*100, where y = the yield.

[6] Government Emergency Ordinance no.64/ 2007

	2005	2006	2007	2008
The amount of state guarantees issued for internal and external loans, out of which:	403.3	58.6	118.9	0.0
- contracted by the local public administration authorities	12.8	7.2	0.0	0.0
- contracted by economic operators	390.5	51.4	118.9	0.0

Source: Ministry of Public Finance

During 2009-2011 we will seek to accomplish the main objective of maintaining the level of public debt within sustainable limits and ensuring the sources needed to finance the budgetary deficits and refinance the maturing public debt at a minimum medium and long run possible cost within an acceptable risk level. One main objective remains the development of the government securities market.

Subject to the domestic and international financial markets developments the budgetary deficit will be mainly financed from domestic sources and to some extent from external sources, trying to meet, the main objectives included in the Government Public Debt Management Strategy for 2008-2010, as follows:

1. controlled increase of government public debt;

2. cutting the costs associated with the government public debt on medium and long term;

3. limiting the risks associated with the government public debt portfolio;

4. developing the market of government securities.

Up to March 31,2009 there were issued government securities of 20.3 billion lei, mostly 1, 3 6 and 12-month treasury bills amounting to 20.0 billion lei; the difference is represented by 3 and 5-year benchmark bonds. This aggressive policy of issuing government securities to cover the financing requirements from the very first part of 2009 aims to create a buffer in the State Treasury, so that to reduce the intervention of the State Treasury via cash management instruments (deposits form credit institutions) to covering the temporary gaps in the state treasury account. In March 2009, the government securities yields went down by 2.75% (against December levels) depending on their maturity due to the confidence of the investors in a downward trend of the inflation (established at 5.8% for 2009) as well as a lack of appetite in crediting thus increasing the demand in the primary market auctions. After NBR decision taken on May 6, 2009, to cut the key interest rate to 9.5% it is expected that the level of such yields will continue to decline easily. For the moment, the maximum yields accepted at the auctions for government securities are established at 11.5%.

MPF has in view to use in the financing process, the external loans, received from the external financial package which will be contracted from IMF, World Bank and European Commission and other international financial institutions, in amount of EUR 19.95 bln.

It is estimated that in 2009, approx. EUR 2.0 bln will be drawn within the medium term financial assistance from EC and EUR 500 mil. within DPL loans contracted from the World Bank, these amounts being estimated to finance the budget deficit and to refinance the maturing public debt. The IMF loan which it will be used by the BNR to consolidate its foreign exchange reserves and support the balance of payments, in amount of EUR 12.95 bln, was not included in the indicator *government debt* presented in Table 3 according to EU methodology (ESA95). If you are considering also this loan, then the debt level will reach 30.8% of GDP at the end of 2011.

5.7 Sensitivity Analyses

5.7.1 Budget Analysis

On the revenue side, the collections from taxes and duties are obviously influenced by the nominal consumption and the wage fund. Compared with the basic macroeconomic scenario we estimated for 2009 the influence of the lower average increase of the gross salary per economy from 5.8% to 4.8%, a negative dynamics of the number of employees from 0,4% to -0,6% and a slowdown of the nominal increase rate of GDP by one percentage point, from 12.83% to 11.83%.

The table presented below shows the impact of the modifications of the above mentioned macroeconomic variables on the general budget revenues. As we expected, the impact is negative and especially in the case of the social contributions, a reduction of the level of hiring in the economy determines a reduction of the budgetary revenues of 0.11% of GDP, while a lower increase of the gross average salary per economy determines a reduction of 0.07% of GDP.

Table 5.12 Sensitivity of the General Consolidated Budget Revenues to the Modifications of the Macroeconomic Variables

Category of taxes and duties (share in GDP)	Macroeconomic base	Modifications to the macroeconomic base (pp)	Modifications to revenues (% of GDP) 2009
1. Tax on the personal income (3.5%)	Gross average salary	Reduced by 1	-0,024
	Level of hiring	Reduced by 1	-0,029
2. Social security contributions (9.9%)	Gross average salary	Reduced by 1	-0,074
	Level of hiring	Reduced by 1	-0,125
3. Tax on profit (2.3%)	Gross average salary	Reduced by 1	0,032
	Level of hiring	Reduced by 1	0,043
	Gross domestic product	Reduced by 1	-0,01
4. Tax on value added (7.3%)	Gross average salary	Reduced by 1	
	Level of hiring	Reduced by 1	
	Gross domestic product	Reduced by 1	-0,018
Total	**Gross average salary**	**Reduced by 1**	**-0,066**
	Level of hiring	**Reduced by 1**	**-0,111**
	Gross domestic product	**Reduced by 1**	**-0,028**

Source: Ministry of Public Finance

5.7.2 Public Debt Sensitivity Analysis

This subchapter analyses the influence of the economic growth on government debt share in the GDP, the influence of the depreciation/appreciation of the local currency compared against EURO and the market interest rates increase on the interest payments related to the government debt.

Analysis of the economic growth downturn - To analyze the economic growth rate decrease on the stock of public debt, two scenarios were used. The first scenario is based on the 2009 budgetary macroeconomic framework and the alternative scenario is based on the assumption of an annual economic growth lower by 1% than in the base scenario. In the base scenario, the government debt share in the GDP will increase by 8.4% in 2011 compared with 2008 (from 13.6% in 2008 to 22.0% in 2011), and in the alternative scenario the share of the government debt in the GDP will increase by 8.6 % (from 13.6% in 2008 to 22.2% in 2011).

Analysis of the depreciation of the domestic currency related to Euro and USA - For this analysis there have been used the base scenario and an alternative scenario built on the assumption of a 5 % depreciation of the domestic currency compared with EURO and USD on medium term. While in the base scenario the share of the interest payments in the GDP will increase from 0.77% in 2008 to 1.50% in 2011, in the alternative scenario the interest payments share in GDP will increase up to 1.52% in 2011.

Analysis of the influence of the interest rate increase - For this analysis, the alternative scenario was built on the assumption of a 1% increase of the market interest rates (EURIBOR and LIBOR) compared with the base scenario. In the base scenario, the share of interest payments in GDP will increase from 0.77% in 2008 to 1.5% in 2011, while in the alternative scenario the share of interest payments in the GDP will increase up to 1.53% in 2011.

Concluding, the sensitivity of the current government debt portfolio is reduced because of economic growth fluctuations, interest rate and exchange rate, mainly due to the small size of the government debt portfolio.

5.8 Budgetary Consequences of the Structural Reforms in the Pension Sector

In the context of an ageing population and the costs associated with it, is necessary the continuation of the reform efforts of the public pension system while deepening the coverage area of the private pillars in order to supplement the retired population incomes.

In this sense legislative measures were taken to expand the taxation base and to attract new categories of tax-payers. Starting with January 2008, the taxation base is represented by the gross monthly income achieved (instead of the gross monthly salary). Moreover, new categories were introduced in the taxation base: the censorships, the boards of directors, the incentives, the hourly payment and the clinic indemnities for medical doctors. The ceiling of 5 gross average salaries in establishing the contribution to the social security contribution paid by the employees was removed.

The implementation of the **mandatory private pension system** (pillar II) represented an important stage in the reform of the pension system. While on short term this measure will have a negative impact on the budgetary deficit, on long term it is estimated to reduce the volume of public expenditures and improve the sustainability of the pension system.

For assessing the budgetary impact of contributions to Pillar II the following assumptions were used:

- the first year of evaluation is 2008, the collection rate is 95%,
- the individual contribution is 2% in 2008 and 2009, 2.5% in 2010 and 3% in 2011
- the number of contributors with an age up to 35 years old account for 70% of the total number of employees;
- out of the number of persons with an age from 35 to 45 years old that contribute to the public system of pensions, 75% will exert the option of contributing to Pillar II,

- the gross average income, average number of employees and their distribution by age were forecast according to the statistical data for 2008 and the demographic forecasts according to EUROPOP 2008.

Table 5.13 Diminished Contribution to the Public Pension System (Million, 2007 prices)

	2008	2009	2010	2011
Contributions directed to Pillar 2	832	1499	1928	2387
Share in GDP, %	0.20	0.29	0.36	0.42

Source: Ministry of Public Finance

The analysis shows that the budgetary impact of the implementation of Pillar II is relatively low: the amount of the individual contributions directed to Pillar II is below 0.2% of GDP in 2008, and will progressively increase to 0.42% of GDP in 2011, reaching 1% of GDP in 2017 when the amount of the quota directed from the pay-as-you-go system will reach the maximum level of 6%.

Pillar III **–** the scheme of **optional pensions under private administration** was implemented in September 2007. While by the end of September 2007 only 14.5 thousand participants were reported, in December 2008 there were about 151 thousand persons and the net assets totaled 84 million lei. The funds operating in the two systems invested the majority of assets in government securities, state bonds, bank deposits etc.

6. THE QUALITY OF PUBLIC FINANCE

6.1 Budget Expenditures

The quality of public finance is all the more important, since the macroeconomic context and the future projections are substantially worsening. For this reason, one of the Romanian Government's priorities for the next time period is to consolidate the quality of public finances by improving the efficiency, transparency and accountability in using the public resources.

In order to ensure the budget resources necessary to support investments and the economic sectors with a high value added, the Government plans to substantially consolidate the budget policy and to implement, starting with the next budget cycle, a compulsory medium term fiscal framework introducing the ex-ante connection of prioritized public policies, the objectives of such public policies and the budget resources. The fiscal code to be elaborated will ensure the stability and simplification of the legislation and will improve the predictability of the fiscal system. The principle of the flat tax will be maintained, with the fiscal code aiming to regulate the social security contributions and to introduce a lump-sum tax system for the economic activities which have not been sufficiently taxed in order to create a level playing field. In the non-fiscal field, from the total of 489 current taxes, 179 taxes will be reduced (out of which 99 are licensing taxes) - 36 taxes will be canceled and 143 taxes will be reduced by merging a number of 264 taxes.

As regards the fiscal administration, the reforms aim to increase the budget revenues administration, in a move to improve the services provided to taxpayers, to increase transparency and simplify the administration procedures to reduce the costs of voluntary compliance.

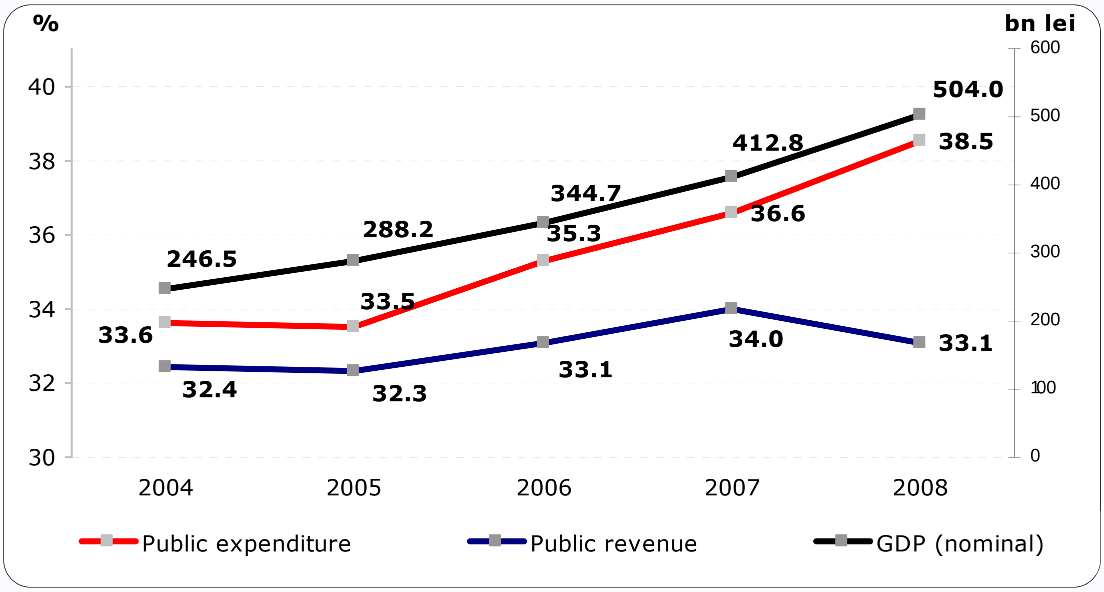
The budget policy key objective is the prioritization of budget resources that are to be allocated to those infrastructure investment projects having a high capacity to fuel potential growth. The substantial increase of public investment expenditures, including by increasing the European funds absorption, will support the positive dynamics of investments in the economy, under pressure by the credit evolution. In addition, the investment multiplication effect could alleviate the adverse impact on the domestic demand by the expected slowdown of the wage revenues dynamics in the private sector and the tightening budget expenditure policy in terms of salaries and acquisitions of goods and services, as well as by the increasing private sector unemployment rate.

Having in mind the fiscal constraints in the current economic conditions and the investment priorities presented above, the budget strategy takes into consideration tightened austerity and efficiency of adjustable current public expenditures. The budget policy austerity, reflecting in the substantial reduction of the budget deficit and implicitly of the saving-investments gap, is an essential requirement for minimizing economic and social costs related to the necessary process of adjusting the macroeconomic imbalances in an adverse global context due to the extended economic and financial crisis.

6.2 Budget revenues

Despite the recent years' economic growth, the budget revenues share in GDP stays around 32%, with a substantial increase of the public expenditures share in GDP.

Chart 6.1 Budget Revenues and Expenditures (ESA 95) as compared to GDP Growth



Source: 2004-2007 Eurostat 2008 Ministry of Public Finance forecasting

There is a reduced taxation of the economy and there are still activities carried out outside the markets, in the grey zone of the economy or in family production premises. The substantial economic growth in 2005-2008 was accompanied by an increase of grey economy and the expansion of the tax evasion. The share of grey economy in GDP went up from 14.5% in 2004 to over 21% in 2008, with the black labour market being the most important share of the grey economy (in the first 9 months the black labour market accounted for 50.8% of the unobserved economy).

Table 6.1 Potential revenues from economy – 2008 estimates

Indicators	Amount (mil. lei)	Share in total	% of GDP
Total revenues, out of which:	**58.116**	**100,0%**	**11,3**
Black labour market	29.556	50,9%	5,8
VAT Tax Evasion	23.815	41,0%	4,6
Informal Sector	4.745	8,1%	0,9

Source: NPC calculations based on NSI data

The entire grey economy is currently not taxed, and the taxation is a long term process. The potential budget revenues from the unobserved economy are estimated at 11% of GDP, out of which evasion on VAT accounted in 2008 for 5% of GDP.

Improved collection capacity takes into consideration simplified and modern procedures, the use – on a larger scale- of the on line submission of declarations for payment of taxes and the establishment of specialized units to capitalize on debtors' complex assets. The following measures will be taken to help reducing the hidden economy by cutting tax evasion:

- Improve control efficiency by intensifying controls in high fiscal risk areas;
- Create a unitary control cell and harmonize the methodology and control plans of the different structures within the National Agency for Fiscal Administration;

- Develop the fiscal intelligence service by improving and expanding the information sources;
- Intensify the activity of the audit bodies in the area of fiscal inspection on individuals.

  The arrears will be reduced by introducing the following measures:

- Monthly monitoring of arrears and the companies' solvency;
- gradual implementation of enforcement measures, starting with the assets not affecting the main activity carried out by the taxpayers;
- The implementation of the results of the twining project *Facility in Transition RO/2007 – IB/FI/08* aimed at building a standard arrear monitoring and management IT system.

7. LONG TERM SUSTAINABILITY OF PUBLIC FINANCE

In terms of demography, in the long term, Romania will face major challenges related to ageing population: despite a life expectancy on the up - to a relatively close level to the EU average - the fertility rate is amongst the lowest in the European Union.

The main factors in assessing the sustainability of the public finance are the demographic evolution, labor market and macroeconomic outlook.

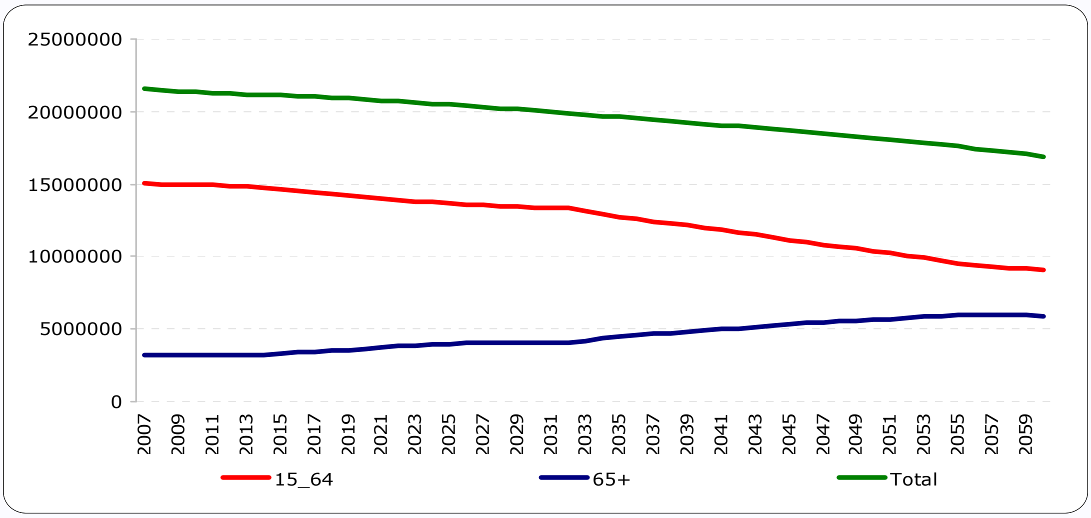
For this Convergence Programme Edition we used the EUROPOP 2008 demographic assumptions by Eurostat and the EC forecast on labour market and macroeconomic indicators, with the results obtained by using an in-house model developed by the Ministry of Public Finance[7].

7.1 Demographic Evolution

The Eurostat demographic forecast for Romania shows a significant decrease of the population number by 4.6 million persons in 2060 as compared to 2008.

In addition, the accelerated ageing process is obviously the consequence of the low fertility rate; in 2008 the fertility rate was 1.32 children per woman, highly under the optimal reproduction level. According to the Eurostat forecast, the fertility rate will go slightly up, to reach 1.52 children per woman in 2060, but this figure is below the reproduction level necessary for the entire forecasting interval.

Chart 7.1 Evolution of population



Data source: 2008 Eurostat-EUROPOP

The age composition of the population will be deeply affected: the share of the population at working age (15-64 years) will go significantly down (by 15 percentage points during the forecasting interval). The number of young population is on the down, due to the fact the number of female population at fertility age will counter-balance the fertility rate increase; in exchange, the share of population over 65 years old will double at the end of the interval.

[7] The data was used to assess the expenditures related to the population ageing, within the working group for ageing populations and sustainability (AWG)

Table 7.1 Demographic Indicators

	2008	2020	2030	2040	2050	2060
Fertility rate	1.32	1.37	1.41	1.44	1.48	1.52
Life expectancy at birth (years)						
Male	69.8	73.0	75.5	77.8	79.9	81.9
Female	76.6	79.3	81.3	83.2	85.0	86.6
Life expectancy at age 65						
Male	13.6	15.2	16.6	17.9	19.2	20.4
Female	16.3	18.0	19.4	20.7	22.0	23.2
Net migration (thousands)	-5.6	6.3	-0.8	12.9	12.7	3.9
Population (million)	21.4	20.8	20.0	19.2	18.1	16.9
- at working age (15-64) % of the total	69.9%	67.9%	66.8%	62.6%	57.3%	53.6%
- over age 65, % of the total	14.9%	17.4%	20.3%	25.5%	30.9%	35.0%
Over age 55, % of population at working age	37.2%	43.3%	52.6%	66.0%	80.3%	87.7%

Data source: Eurostat-EUROPOP 2008, DG ECFIN

The rapid ageing will change the ratio between the population at retirement age and the active population, which will bring major changes in the age structure and negative implications on the labour market.

In 2050, the share of the active population over age 55 in the total population at working age will reach its peak.

7.2 Labour Market Evolution

The dependency rate forecast shows a significant deterioration: the share of population over 65 in total population at working age (age 15-64) will grow from 21% in 2008 to 65% in 2060 and the total dependency rate (population under 15 and over 64) as share in working age population is likely to double at the end of the forecasting interval.

Table 7.2 Labour Force and Dependency Rates

	2008	2020	2030	2040	2050	2060
Labour Force, thousand persons	9875	9650	8811	7918	6868	6051
Participation rate (age 15-64)	63.0%	64.8%	62.4%	60.8%	60.5%	61.3%
- age 25-54	78.9%	77.1%	75.3%	74.7%	75.2%	75.1%

	2008	2020	2030	2040	2050	2060
- age 55-64	42.4%	47.1%	48.2%	45.6%	44.2%	45.4%
Employment rate (age 15-64)	58.7%	61.0%	58.6%	57.2%	56.9%	57.6%
Old population share	15.1%	17.7%	22.3%	25.3%	26.3%	22.5%
Dependency rate of people over 65	21%	26%	30%	41%	54%	65%
Total dependency rate	43%	47%	50%	60%	75%	87%

Source: Eurostat-EUROPOP 2008

In the short run, for the next 3 years, the dependency rate in expected to decline taking into account an increase of the retirement age, on one hand, and the measures aimed at limiting the eligibility for early retirement.

The long-term forecast for pension expenditures took into account EUROPOP 2008 demographic assumptions by Eurostat. Initial projections [8] for the evolution of the labor market and macroeconomic indicators were adjusted in line with recent developments and forecast growth for 2009-2011 developed by the National Commission, keeping the diminishing trend of the initial technological gap (TFP) with the EU average. The results were obtained by using the following hypothesis, including legislation recently approved:

a) increasing social security contribution rates in 2009 by 2.4 pp compared with the average of 2008

b) calculation of the average pension in year 2009 was done according to the new value of the point of pension established in January (43.2% of the gross average salary in the economy) while from 2010-2060 it was considered at 45% of the gross average salary

c) introducing of a minimum pension ceiling in 2009

d) harshest conditions for granting anticipated and disability pension

e) the gradual introduction of a certain categories of taxpayers exempt from payment of social insurance.

In addition to the baseline that includes the above-mentioned amendments, it was built an alternative scenario which takes into account the reform proposals agreed with the IMF: indexing pensions according to inflation, increased retirement ages for women and increased expenditures for vulnerable groups of pensioners.

Baseline scenario

Table 7.3 Long Term Forecast for Pension Expenditures % in GDP

	2008	2010	2030	2040	2050	2060
Social Security Pensions[9]	7.1	8.5	9.8	11.7	13.3	14.0
Pillar 1	6.1	6.5	7.9	9.6	11.4	12.1
Pillar 2			0.1	0.4	1.3	1.8

Source: Ministry of Public Finance

[8] Data used to assess the expenditures related to population aging within the working group on aging populatin and sustainability (AWG)

[9] Includes the pensions paid by the State Budget to farmers, military, MIRA etc. (not included in PAYG)

The estimated results from the pension model for the baseline scenario, indicates an increase of total pension expenditures in GDP to 14% respective 12.1% for the state social insurance (Pillar 1) at the end of the forecast.

Pillar 2 will have a share of the increasingly significant in the overall pension expenditure since 2050, reaching 1.8% of GDP in 2060.

Alternative scenario

Table 7.3 Long Term Forecast for Pension Expenditures % in GDP

	2008	2020	2030	2040	2050	2060
Social Security Pensions	7.1	8.3	5.7	5.5	5.4	5.0
Of wich, - Pillar 1	6.1	6.5	5.0	4.5	4.5	4.2
Pillar 2			0.1	0.4	1.3	1.9

Source: Ministry of Public Finance

Alternative scenarios which involve the decoupling of pensions growth from the wages by indexing according to inflation determines the reducing of pension expenditures and the stabilization at a level close to retirement income starting from 2040. In the year 2060 results an estimated positive balance of the system, with a lower rate of replacement compared to the baseline scenario at the end of the forecast period.

7.3 Fertility Improvement Measures

Taking into account the long term demographic assumptions, the increase of the fertility rate is crucial in order to improve the current scenario which shows, under the existing circumstances, a rapid ageing rate of the population. To this purpose, the Government passed the Law 396/2006, on granting a marriage financial aid of 200 Euro per family, provided both spouses be at their first marriage. In addition, in a move to boost the birth rate, the Government Emergency Ordinance 148/2005 – on support to families for child raising – was amended, by introducing starting 1st January 2009 the option for the monthly allocation for child raising to represent either 85% of the monthly average of professional incomes over the previous 12 months (not more than 4000 lei) or 600 lei and an additional monthly incentive of 100 lei. At the same time, mothers will benefit of a child raising leave up to two years, or 3 years in the case of children with disabilities.

As of January 1, 2007, the state allowance for children will be of 200 RON per month, for children under 2 and children with disabilities under the age of 3.

The adoption of Law 263/2007 on the establishment and rules of functioning of day care centers created the appropriate legal framework for the raise, care and early education of children up to 3-year old. This law also allows the implementation of the tickets program for the day care centers.

7.4 Health Sector

The recent years showed a progress of health indicators, but these are still low as compared to the EU average. In order to determine the population health status and the risk factors, a National Health Assessment Program was run between July 2007 and 2008.

Despite of the sector spending having gone up to 3-4% of GDP in the recent years, their level is still low as compared to EU average, with the medical services far from meeting people's expectations. In order to improve the quality and efficiency of the health care services, and in a move to improve access to medical care, the structural reform of the health and sanitary system was started.

The reform's main objectives are:

- Ensure appropriate financing to the sanitary system, to best serve the needs of the population;
- Reduce hospital care costs, by an improved management of the financially autonomous hospitals;
- Increase the ambulatory medical care capacity to respond to health problems of the population, including by equipping the family doctor offices with computers, IT programs and communication means;
- Establish and consolidate the national emergency and first-aid medical assistance.

The following measures were adopted in a move to ensure the financial resources:

- Augmenting the level of the resources by increasing the number of contributors to the system;
- Regulating the private health insurance system (complementary system) for diversifying the resource base and raising the level of the competition in the system;
- Introducing and finalizing the concept of co-payment and of minimal health services package.

An additional involvement of the private sector in the provision of medical services is essential to reduce the pressure put on the public resources and improve the medical care quality.

An additional source of funds for investments was made available by the introduction, in 2006, of the vice tax, aimed at fighting the excessive tobacco and alcohol consumption, improving the public health system's infrastructure and financing the health programs, improving the vehicle park and the purchase of new ambulances.

In order to efficiently use the Single National Health Insurance Fund, a number of agreements were implemented to serve as settlement basis and the activities endorsed by the National Health Insurance House were decided.

8. PUBLIC FINANCE INSTITUTIONAL FEATURES

The government is committed to promulgate a Fiscal Responsibility Law until the end of 2009 with the aim of bringing substantial changes of the institutional framework for the implementation of the budgetary policy. In this regard, there will be created a Fiscal Council and there will be implemented fiscal rules in order to contain and diminish the discretionary component. Moreover, the government will draft a medium term budgetary strategy and will commit to the implementation of a binding medium term expenditure framework. The above mentioned measures will lead to a better functioning of the automatic stabilizers and will minimize the probability of registering budgetary slippages from the established objectives as it happened in 2008.

With a view to improve the analytical capacity, Ministry of Public Finance implemented in 2008 the **RQM (Romanian Quarterly Model).** The main objective of the model is to facilitate the assessing of the current economic conditions in the economy and to quantifying the impact of 'economic shocks' and of various policy changes on the public finances.

The developed model is a quarterly model with a current forecast period extending up to 3-4 years. The model consists of **six interconnected blocks**: supply-side, demand, wages and prices, external sector, monetary and financial sector government sector.

RQM structure is that of an **error correction model**, which distinguishes between long-run economic relations and short-run dynamics. This is still the mainstream approach to macroeconomic model building and combines the statistical rigor of **Vector Autoregressive Models** (VARs) and the theoretical foundations of Computable General Equilibrium Models (CGEMs). The adopted approach allows the application of statistically significant short-run dynamics that are underpinned by sound theoretical foundations that drive, in particular, longer run developments. In this way, the model's variables converge towards the steady state while the short term dynamics captures the empirical evidence.

Although, in the current version, the model is fully functional, its development must continue. There are several improvements which can be added to the model:

- The integration in the model of the modules for the calculation of potential GDP and output gap. The methodology provided for estimating the output gap can be fully automated by including it into the model. At present the estimation of potential GDP and output gap is done outside the model.
- The integration in the model of the modules for the calculation the cyclically adjusted balance (CAB). The methodology provided in the previous report for estimating the elasticities of the government revenues and expenditures, and for estimating CAB can be fully automated by including it into the model. At present the estimation of CAB is done outside the model.
- Explicitly including the expectations in the model.
- Specification of the reaction function of the fiscal authority, using CAB.
- Transforming the interest rate from exogenous in endogenous, by calibrating the reaction function of the National Bank.

ANNEXES

Table 1a. Macroeconomic projections

	ESA Code	2007 Level [1)] Billion lei	2007	2008	2009	2010	2011
			Percentage change				
1. Real GDP	B1*g	366.2	6.2	7.1	-4.0	0.1	2.4
2. Nominal GDP	B1*g	412.8	19.8	22.1	5.4	7.0	7.7
Real GDP components							
3. Private consumption expenditures	P3	265.0	11.6	9.1	-4.1	-0.6	2.0
4. Public consumption expenditures	P3	58.3	1.6	3.2	-11.0	0.1	1.2
5. Gross fixed capital formation	P51	113.8	29.0	19.3	-6.5	-0.5	3.5
6. Change in stocks (% of GDP)	P52		0.1	-3.5	0.0	0.0	0.0
7. Export of goods and services	P6	120.1	7.9	19.4	-13.7	1.7	2.8
8. Import of goods and services	P7	194.2	27.2	17.5	-15.6	-0.4	2.6
Contributions to GDP growth							
14. Final domestic demand		-	15.6	12.5	-6.6	-0.5	2.5
15. Change in stocks	P52	-	0.1	-3.5	0.0	0.0	0.0
16. Net exports	B11	-	-9.5	-1.9	2.6	0.6	-0.1

[1)] *The real level of GDP and the components thereof is in the previous year's prices*

Table 1b. Prices evolution

	2007	2008	2009	2010	2011
			Percentage change		
1. GDP Deflator	12.7	14.0	9.9	6.9	5.1
2. Private consumption deflator	4.9	9.0	6.1	3.8	3.3
3. Harmonised consumer prices index	4.48	7.85	5.8	3.5	3.2
4. Public consumption deflator	10.3	18.8	9.2	8.2	6.1
5. Investment deflator	10.4	12.1	7.0	6.0	4.8
6. Exports deflator (goods and services)	1.5	7.0	11.9	2.5	2.6
7. Imports deflator (goods and services)	-7.5	3.9	2.0	2.0	1.8

Table 1c. Evolution of the labor market

	ESA Code	2007 Level thousand persons	2007	2008	2009	2010	2011
			Percentage change				
1. Total employment - thousand persons		9353	0.4	0.2	-2.1	0.5	0.7
2. Employed population, hours worked			-	-	-	-	-
3. Unemployment rate - (according to ILO definition) -%			6.4	5.8	8.0	7.7	7.4
4. Labor productivity per person (real GDP/ employed person)			5.8	6.9	-1.9	-0.4	1.7
5. Labor productivity per hour			-	-	-	-	-
6. Compensation of employees – million lei	D1	157970	19.5	22.0	2.6	-	-
7. Compensation per employee		25490	18.9	20.5	6.0	-	-

Table 1d. Sectoral balances

% of GDP	ESA Code	2007	2008	2009	2010	2011
Net balance as against the rest of the world	B9	-12.9	-11.9	-6.3	-5.4	-5.2
out of which:						
- balance of goods and services		-14.0	-12.8	-7.4	-6.3	-5.8
- balance of revenues and transfers		0.5	0.5	-0.2	-0.2	-0.5
- capital account		0.6	0.4	1.2	1.1	1.1

Table 2. Consolidated budget - Projections

	ESA Code	2007 Level (mil. lei)	2007	2008	2009	2010	2011
			% of GDP				
Net borrowing (EDP B9) by sub-sectors							
1. Consolidated budget	S.13	-10,465.7	-2.5	-5.4	-5.1	-4.1	-2.9
2. Central Budget	S.1311	-13,837.4	-3.4	-4.4	-4.9	-3.7	-2.9
3. State Budget	S.1312						
4. Local Budgets	S.1313	-926.4	-0.2	-0.9	-0.2	-0.4	-0.3
5. Social Security Budget	S.1314	4298.1	1.0	-0.1	0.0	0.1	0.3
Consolidated Budget (S13)							
6. Total collections	TR	140499.4	34.0	33.1	33.2	33.7	34.2
7. Total expenditures	TE	150965.1	36.6	38.5	38.3	37.8	37.0
8. Net Balance	EDP B.9	-10465.7	-2.5	-5.4	-5.1	-4.1	-2.9
9. Interest	EDP D.41	3142.1	0.8	0.8	1.5	1.7	1.5
10. Primary Balance		-7323.6	-1.8	-4.7	-3.6	-2.4	-1.4
11. One-off and other provisional measures		-759.8	-0.2				
Revenue Components							
12. Total Taxes (12=12a+12b+12c)		80562.8	19.5	19.1	17.4	18.0	18.5
12a. Output and Import Taxes	D.2	52675.7	12.8	12.3	11.0	11.6	11.7
12b. Current Income Taxes. Taxes on Assets. etc.	D.5	27887.1	6.8	6.9	6.4	6.4	6.8
12c. Capital Taxes	D.91						
13. Social security contributions	D.61	43639.1	10.6	10.3	11.0	10.7	10.8
14. Revenues from ownership	D.4	3918.6	0.9	0.8	0.8	0.8	0.9
15. Other		12378.9	3.0	2.8	4.1	4.3	4.0
16=6. Total revenues	TR	140499.4	34.0	33.1	33.2	33.7	34.2
p.m.: fiscal burden (D.2+D.5+D.61+D.91-D.995)							
Expenditure Components							
17. Remuneration of employees + intermediary consumption	D.1+P.2	**64379.4**	**15.6**	**16.7**	**14.6**	**14.0**	**13.8**
17a. Remuneration of employees	D.1	38637.6	9.4	10.2	9.1	8.4	8.1
17b. Intermediary consumption	P.2	25741.8	6.2	6.5	5.6	5.6	5.7
18. Social security contributions (18=18a+18b)		40716.0	9.9	11.2	11.8	11.7	11.4
18a. Social contributions in kind	D.6311. D.63121. D.63131	2370.0	0.6	0.6	0.3	0.3	0.3
18b. Social contributions, other	D.62	38346.0	9.3	10.6	11.5	11.4	11.2
19=9. Interest	EDP D.41	3142.1	0.8	0.8	1.5	1.7	1.5
20. Subsidies	D.3	6220.2	1.5	1.4	1.4	1.1	1.1
21. Gross Fixed Capital Formation	P.51	23231.1	5.6	5.4	6.4	7.4	7.3
22. Other		13276.3	3.2	3.1	2.5	2.0	1.9
23=7. Total Expenditures	TE[10]	150965.1	36.6	38.5	38.3	37.8	37.0
p.m.: government consumption (nominal)	P.3	66690.8	16.2	L	L	L	L

[10] Dacia Compensation Titles

Table 3. Evolution of the general budget debt

% of GDP	2007	2008	2009	2010	2011
1. Gross government debt (according to ESA)[11]	12.7%	13.6%	18.0%	20.8%	22.0%
2. Change in govt. debt. %	-3.1%	0.9%	4.4%	2.8%	1.2%
Contribution to The Gross Debt Change					
3. Primary Balance	-1.8%	-4.7%	-3.6%	-2.4%	-1.4%
4. Interest (Incl. SIFM)	0.8%	0.8%	1.5%	1.7%	1.5%
5. Stock-Flow Adjustments	-2.1%	4.8%	6.5%	3.5%	1.1%
Out of Which: - Difference between Paid Interest and Accrual	-0.01%	-0.01%	-0.02%	-0.01%	-0.01%
- Net Accrual of Financial Assets	0.06%	0.12%	0.07%	0.06%	0.06%
Out of Which : from privatization	0.04%	0.06%	0.00%	0.00%	0.00%
- Assessment Effects and Other	-2.2%	4.7%	6.5%	3.5%	1.1%
P.M. Implicit Interest Rate on Debt	7.3%	6.4%	9.6%	8.9%	7.3%
Other Relevant Variables					
6. Liquid Financial Assets[12]	1.7%	0.0%	0.0%	0.0%	0.0%
7. Net Financial Debt (7=1-6)	11.0%	13.6%	18.0%	20.8%	22.0%

Table 4. Cyclical Evolutions

% of GDP	ESA Code	2007	2008	2009	2010	2011
1. Real GDP Growth (%)		6.2	7.1	-4.0	0.1	2.4
2. Net Consolidated Balance	EDP B9	-2.5	-5.4	-5.1	-4.1	-2.9
3. Interest Expenditures (including SIFIM in consumption)	EDP D41+SIFIM	0.8	0.8	1.5	1.7	1.5
4. Potential GDP Growth (%)		5.34	4.98	3.33	2.55	2.25
Factor Contribution:						
- Labour		0.30	0.31	0.32	0.24	0.24
- Capital		3.45	3.94	3.04	2.65	2.49
- Total Factor Productivity		1.58	0.74	-0.03	-0.34	-0.48
5. Output Gap		4.30	6.40	-1.14	-3.50	-3.35
6. Cyclical Component		1.22	1.82	-0.34	-1.00	-0.97
7. Adjusted Cyclical Balance (2-6)		-3.72	-7.22	-4.76	-3.10	-1.93
8. Adjusted Cyclical Primary Balance (7+3)		-2.92	-6.42	-3.26	-1.40	-0.43

Table 5. Deviations from the previous edition

[11] the IMF loan which will be used by the BNR in order to consolidate the foreign currency reserve and support the balance of payment is not included
[12] funds available in MFP foreign currency account representing collections from privatization.

	ESA Code	2007	2008	2009	2010	2011
GDP Growth (%)						
Previous Edition		6.1	6.5	6.1	5.8	
Updated Edition		6.2	7.1	-4.0	0.1	2.4
Difference		0.1	0.6	-10.1	-5.7	
Budget deficit (% of GDP)						
Previous Edition		-2.9	-2.9	-2.9	-2.4	
Updated Edition		-2.5	-5.4	-5.1	-4.1	-2.9
Difference		0.4	-2.5	-2.2	-1.7	
Gross public debt (% of GDP)						
Previous Edition		11.9	13.6	14.2	14.9	
Updated Edition		12.7	13.6	18.0	20.8	22.0
Difference		0.8	0.0	3.8	5.9	

Table 6. Long Term Public Finance Sustainability

% of GDP	2000	2005	2010	2020	2030	2050
Total Expenditures	33.6	35	35.4	41	39	37
Pensions	6.7	6.8	8.3	6.6	5.7	5.4
Health Care	3.5	3.3	3.6	3.7	4.0	4.7
Education	3.4	4.3				
Total Revenues	32.1	33.2	33.4	40.5	38.5	37
				- average pace -		
Labour Productivity Increase	2.2	8.6	3.1	3.9	4.2	3.6
GDP Real Growth	2.1	5.7	3.3	4.7	4.4	3.7
			- % -			
Participation rate - male	75.4	69.5	69.0	73.2	75.8	78.3
Participation rate – female	61.8	55.3	57.7	61.3	63.1	69.0
Total participation rate	68.7	62.4	63.3	67.2	69.5	73.6
Unemployment rate – ILO	6.9	7.2	7.7	4.4	4.2	3.9
Population at and over 65 / total population	13.6	14.7	15.3	16.9	18.6	22.3