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COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 24.6.2009
SEC(2009) 862 final

Recommendation for a

COUNCIL DECISION

on the existence of an excessive deficit in Romania

EXPLANATORY MEMORANDUM

1. THE APPLICATION OF THE STABILITY AND GROWTH PACT IN THE CURRENT CRISIS SITUATION

Many EU countries are presently facing general government deficits above the 3% of GDP reference value set in the Treaty. The often strong deterioration in the deficit as well as the debt positions must be seen in the context of the unprecedented global financial crisis and economic downturn. Several factors are at play. First, the economic downturn brings about declining tax revenue and rising social benefit expenditure (e.g. unemployment benefits). Second, recognising that budgetary policies have an important role to play in the current extraordinary economic situation, the Commission called for a fiscal stimulus in its November 2008 European Economic Recovery Plan (EERP), endorsed by the European Council in December. The Plan explicated that the stimulus should be timely, targeted and temporary and differentiated across Member States, with more room for manoeuvre for those Member States that have achieved sustainable public finance positions and improved their competitive positions. It also called for structural reforms that support demand and promote resilience in the short term, while paying special attention to actions in the four priority areas of the Lisbon strategy. Finally, several countries have taken measures to stabilise the financial sector, some of which impact on the debt position or constitute a risk of higher deficits and debt in the future, although some of the costs of the government support could be recouped in the future.

The Stability and Growth Pact requires the Commission to initiate the excessive deficit procedure (EDP) whenever the deficit of a Member State exceeds the 3% of GDP reference value. The amendments to the Stability and Growth Pact in 2005 aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation, and thereby ensuring long-term sustainability of public finances.

2. PREVIOUS STEPS IN THE EXCESSIVE DEFICIT PROCEDURE

Article 104 of the Treaty lays down an excessive deficit procedure (EDP). This procedure is further specified in Council Regulation (EC) No 1467/97 “on speeding up and clarifying the implementation of the excessive deficit procedure”[1], which is part of the Stability and Growth Pact.

According to Article 104(2) of the Treaty, the Commission has to monitor compliance with budgetary discipline on the basis of two criteria, namely: (a) whether the ratio of the planned or actual government deficit to gross domestic product (GDP) exceeds the reference value of 3% (unless either the ratio has declined substantially and continuously and reached a level that comes close to the reference value; or, alternatively, the excess over the reference value is only exceptional and temporary and the ratio remains close to the reference value); and (b)

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[1] OJ L 209, 2.8.1997, p. 6. Account is also taken of the Opinion of the Economic and Financial Committee on the “Specifications on the implementation of the Stability and Growth Pact and guidelines on the format and content of stability and convergence programmes”, endorsed by the ECOFIN Council of 11 October 2005, available at: http://ec.europa.eu/economy_finance/other_pages/other_pages12638_en.htm.

whether the ratio of government debt to GDP exceeds the reference value of 60% (unless the ratio is sufficiently diminishing and approaching the reference value at a satisfactory pace).

Article 104(3) stipulates that, if a Member State does not fulfil the requirements under one or both of these criteria, the Commission has to prepare a report. This report also has to “take into account whether the government deficit exceeds government investment expenditure and take into account all other relevant factors, including the medium-term economic and budgetary position of the Member State”.

On the basis of the data notified by the Romania authorities in April 2009[2], subsequently validated by Eurostat,[3] and taking into account the Commission services’ spring 2009 forecast, the Commission adopted a report under Article 104(3) for Romania on 13 May 2009[4].

Subsequently, and in accordance with Article 104(4), the Economic and Financial Committee formulated an opinion on the Commission report on 28 May 2009.

3. THE EXISTENCE OF AN EXCESSIVE DEFICIT

According to the April 2009 EDP notification by the Romanian authorities, subsequently validated by Eurostat, the general government deficit in Romania reached 5.4% of GDP in 2008, thus exceeding the 3% of GDP reference value. The Commission report under Article 104(3) considered that the deficit was not close to the 3% of GDP reference value and that the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it does not result from an unusual event or from a severe economic downturn in 2008 in the sense of the Treaty and the Stability and Growth Pact. Despite growth slowing down in the final quarter of the year, overall GDP growth in 2008 accelerated to a rate of 7.1%, from 6% in 2007 and significantly above the rate of potential growth. Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services’ spring 2009 forecast the general government deficit is expected to reach 5.1% of GDP in 2009 and 5.6% in 2010. This projection is based on GDP growth of -4.0% in 2009 and 0% in 2010. The Commission services' forecast takes into account measures for the current year in the budget for 2009 approved in February 2009 and the additional measures adopted by the government in April 2009. The deficit criterion in the Treaty is not fulfilled.

General government gross debt remains well below the 60% of GDP reference value and stood at 13.6% of GDP in 2008. Nevertheless, according to the Commission services’ spring 2009 forecast, the debt-to-GDP ratio is anticipated to increase significantly to 18¼% in 2009 and 22¾% in 2010.

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2 According to Council Regulation (EC) No 3605/93, Member States have to report to the Commission, twice a year, their planned and actual government deficit and debt levels. The most recent notification of Romania can be found at: http://epp.eurostat.ec.europa.eu/portal/page/portal/government_finance_statistics/procedure/edp_notification_tables

3 Eurostat news release No 56/2009 of 22 April 2009.

4 All EDP-related documents for Romania can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

In line with the provisions in the Stability and Growth Pact, the Commission in its report gave due consideration to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on the estimates of the Romanian authorities, the net costs of this reform amount to 0.2% of GDP in 2008, 0.3% in 2009, 0.4% in 2010 and 0.4% in 2011. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value, which is not the case of Romania. In any event, the government deficit adjusted for the pension reform cost in 2008 would be well above 3% of GDP.

In line with the provisions in the Treaty and the Stability and Growth Pact, the Commission also analysed in its report "relevant factors". According to the Stability and Growth Pact, these can only be taken into account in the steps leading to the decision on the existence of an excessive deficit if the deficit satisfies the double condition of closeness and temporariness. In the case of Romania, the double condition is not met. Considered on their own merit, the relevant factors in the current case on balance present a mixed picture.

The opinion of the Economic and Financial Committee in accordance with Article 104(4) of the Treaty is consistent with the assessment in the Commission report under Article 104(3).

The Commission, having taken into account its report under Article 104(3) and the opinion of the Economic and Financial Committee under Article 104(4), is of the opinion that an excessive deficit exists in Romania. This opinion, adopted by the Commission on [24 June] 2009, is herewith addressed to the Council according to Article 104(5). The Commission recommends that the Council shall decide accordingly, in conformity with Article 104(6). In addition, the Commission is submitting to the Council a recommendation for a Council recommendation to be addressed to Romania with a view to bringing the situation of an excessive deficit to an end according to Article 104(7).

4. RECOMMENDATIONS TO END THE EXCESSIVE DEFICIT SITUATION

According to Article 3(4) of Council Regulation (EC) No 1467/97, the Council recommendation under Article 104(7) has to establish a deadline of six months at most for effective action to be taken by the Member State concerned as well as a deadline for the correction of the excessive deficit, which "should be completed in the year following its identification unless there are special circumstances". Article 2(6) of the Regulation implies that the "relevant factors" considered in the Commission report under Article 104(3) of the Treaty have to be taken into account in deciding whether special circumstances exist. Article 3(4) of the Regulation specifies that the Council has to recommend that the Member State achieves a "minimum annual improvement of at least 0.5% of GDP as a benchmark, in its cyclically adjusted balance net of one-off and temporary measures, in order to ensure the correction of the excessive deficit within the deadline set in the recommendation".

In the case of Romania, special circumstances are considered to exist. In view of the large domestic and external imbalances and the adverse effect of the global financial turmoil on the economic and financial situation in Romania, the authorities requested multilateral financial assistance in March 2009[5]. According to the Commission services' spring 2009 forecast growth is projected to contract by 4% compared to a significant positive growth of 7.1% in 2008. While the economic adjustment programme agreed to by the Romanian authorities in the framework of the multilateral financial assistance could limit the fall and a recovery is expected for 2010 (with growth expected at around zero), risks are mostly on the downside, reflecting uncertainty about the speed with which financial markets will stabilise and the depth of the global economic downturn.

Against this background, it is appropriate to consider the correction of the excessive deficit in a medium-term framework. Bearing in mind the need to act promptly to address the fiscal situation in Romania, and in accordance with the path for deficit reduction as specified in the June 2009 convergence programme – [on which the Council gave its opinion on 7 July 2009] – the correction of the excessive deficit by 2011 is appropriate. The June 2009 convergence programme envisages a reduction of the government deficit to below 3% of GDP by 2011, in line with the fiscal targets agreed in the framework of the medium-term financial assistance.

The reduction would start in 2009, as the deficit is targeted to decrease from 5.4% of GDP in 2008 to 5.1% of GDP in 2009 due to consolidation measures undertaken in the 2009 budget adopted in February 2009 and additional measures taken in a rectified budget approved by the government in April 2009. According to the convergence programme the deficit will be reduced to 4.1% of GDP in 2010 and to below 3% in 2011.

In its opinion of [7 July 2009] on the Romanian convergence programme, the Council concluded that the budgetary targets are subject to downside risks throughout the programme period. Risks stem mainly from the macroeconomic outlook which could be worse than anticipated. In addition, there are risks concerning the effective implementation of the planned expenditure measures in 2009. Moreover, in 2010 and 2011, the achievement of the budgetary targets needs to be underpinned by concrete measures.

In 2009, the deficit target should be achieved by implementing the fiscal measures foreseen in the 2009 budget and the April 2009 amended budget. In the following years, a structural effort of at least 1½% percentage points of GDP annually is required to achieve a deficit below 3% of GDP by 2011.[6] In line with the policy conditions under the medium-term financial assistance, the fiscal consolidation should be expenditure driven. In particular, measures should concentrate on containing current expenditure, notably with respect to the public sector wage bill. The detailed measures that are necessary to achieve this consolidation path beyond 2009 should be spelled out and any opportunity should be seized to accelerate the reduction of the deficit. Additional annual fiscal efforts might be necessary if downside risks were to materialise so as to achieve the government deficit targets up to 2011 with a view to bringing the government deficit below 3% of GDP in that year in a credible and sustainable manner.

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5 The total multilateral financial assistance amounts to up to EUR 20 billion over the period to the first quarter of 2011. The EU provides a medium-term loan of up to EUR 5 billion in conjunction with EUR 12.95 billion from the International Monetary Fund. Additional multilateral support of EUR 2 billion will be provided by the World Bank (1 billion), the European Investment Bank and the European Bank of Reconstruction and Development (1 billion together) on top of their general lending activities. The multilateral financial assistance is conditional on the implementation by the Romanian authorities of a comprehensive economic policy programme.

6 It should be noted that there are uncertainties linked to the calculations of cyclically-adjusted and structural balances, notably due to the difficulty of contemporaneous output gap estimates and budgetary elasticity volatility, and especially during turbulent economic times. Thus, any interpretation should be made with caution.

In order to further enhance the credibility of the medium-term consolidation strategy, Romania should implement the measures agreed in the medium-term financial assistance in the area of fiscal governance and long-term sustainability of public finances. In particular, in order to improve the budgetary strategy and process, the Romanian authorities committed in the context of the financial assistance programme to adopt decisions aiming at setting up a binding medium-term budgetary framework, ensuring more realistic revenue forecasts, establishing limits on budget revisions during the year, laying-out fiscal rules and creating a fiscal council to provide independent and expert scrutiny. In order to improve budgetary predictability and transparency, the public compensation system should be restructured, including by unifying and simplifying the pay scales and reforming the bonus system. To improve the long-term sustainability of public finances, key parameters of the pension system should be reformed, in particular the indexing of public pensions and the retirement age.

Enhanced surveillance under the EDP, which seems necessary also in view of the Community medium-term financial assistance made available to Romania, will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy to ensure the correction of the excessive deficit. In this context, a separate chapter in the updates of the Romania convergence programme which will be prepared between 2009 and 2012 could usefully be devoted to this issue.

Comparison of key macroeconomic and budgetary projections

		2007	2008	2009	2010	2011	2012	2013
Real GDP (% change)	COM Spring 2009	**6.2**	**7.1**	**-4.0**	**0.0**	n.a.	n.a.	n.a.
	CP June 2009	**6.2**	**7.1**	**-4.0**	**0.1**	**2.4**	n.a.	n.a.
Output gap[1] (% of potential GDP)	COM Spring 2009[2]	**6.6**	**8.5**	**0.2**	**-3.0**	n.a.	n.a.	n.a.
	CP June 2009 [3]	**4.3**	**8.7**	**-0.5**	**-2.5**	**-2.9**	n.a.	n.a.
General government balance (% of GDP)	COM Spring 2009	**-2.5**	**-5.4**	**-5.1**	**-5.6**	n.a.	n.a.	n.a.
	CP June 2009	**-2.5**	**-5.4**	**-5.1**	**-4.1**	**-2.9**	n.a.	n.a.
Primary balance (% of GDP)	COM Spring 2009	**-1.8**	**-4.7**	**-3.6**	**-4.0**	n.a.	n.a.	n.a.
	CP June 2009	**-1.8**	**-4.7**	**-3.6**	**-2.4**	**-1.4**	n.a.	n.a.
Cyclically-adjusted balance[1] (% of GDP)	COM Spring 2009	**-4.5**	**-7.9**	**-5.2**	**-4.7**	n.a.	n.a.	n.a.
	CP June 2009	**-3.9**	**-8.2**	**-5.3**	**-3.3**	**-2.0**	n.a.	n.a.
Structural balance[4] (% of GDP)	COM Spring 2009	**-4.4**	**-7.9**	**-5.2**	**-4.7**	n.a.	n.a.	n.a.
	CP June 2009	**-3.7**	**-8.2**	**-5.3**	**-3.3**	**-2.0**	n.a.	n.a.
Government gross debt (% of GDP)	COM Spring 2009	**12.7**	**13.6**	**18.2**	**22.7**	n.a.	n.a.	n.a.
	CP June 2009	**12.7**	**13.6**	**18.0**	**20.8**	**22.0**	n.a.	n.a.

Notes:

[1] Output gaps and cyclically-adjusted balances from the programmes as recalculated by Commission services on the basis of the information in the programmes.

[2] Based on estimated potential growth of 5.1%, 5.2%, 3.9% and 3.2% respectively in the period 2007-2010.

[3] Based on estimated potential growth of 5.3%, 5%, 3.3% and 2.5% and 2.2% respectively in the period 2007-2011.

[4] Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.2% of GDP in 2007 deficit-reducing and 0% over the period 2008-2010 according to the Commission services' spring 2009 forecast and 0.2% of GDP in 2007 deficit-reducing and 0% over the period 2008-2011 according to the most recent convergence programme.

Source:
Convergence programme (CP); Commission services' spring 2009 forecasts (COM); Commission services' calculations.

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THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(6) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) According to Article 104 of the Treaty Member States shall avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The excessive deficit procedure (EDP) under Article 104, as clarified by Council Regulation (EC) No 1467/97 on speeding up and clarifying the implementation of the excessive deficit procedure[7] (which is part of the Stability and Growth Pact), provides for a decision on the existence of an excessive deficit. The Protocol on the excessive deficit procedure annexed to the Treaty sets out further provisions relating to the implementation of the EDP. Council Regulation (EC) No 3605/93[8] lays down detailed rules and definitions for the application of the provision of the said Protocol.

(4) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the EDP. In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(5) Article 104(5) of the Treaty requires the Commission to address an opinion to the Council if the Commission considers that an excessive deficit in a Member State exists or may occur. Having taken into account its report in accordance with Article 104(3) and having regard to the opinion of the Economic and Financial Committee in accordance with Article 104(4), the Commission concluded that an excessive deficit

[7] OJ L 209, 2.8.1997, p. 6.
[8] OJ L 332, 31.12.1993, p. 7.

exists in Romania. The Commission therefore addressed such an opinion to the Council in respect of Romania on 13 May 2009[9].

(6) Article 104(6) of the Treaty states that the Council should consider any observations which the Member State concerned may wish to make before deciding, after an overall assessment, whether an excessive deficit exists. In the case of Romania, this overall assessment leads to the following conclusions.

(7) According to the April 2009 EDP notification by the Romanian authorities, subsequently validated by Eurostat, the general government deficit in Romania reached 5.4% of GDP in 2008, thus exceeding the 3% of GDP reference value. The deficit was not close to the 3% of GDP reference value and that the excess over the reference value cannot be qualified as exceptional within the meaning of the Treaty and the Stability and Growth Pact. In particular, it does not result from an unusual event or from a severe economic downturn in 2008 in the sense of the Treaty and the Stability and Growth Pact. Despite growth slowing down in the final quarter of the year, overall GDP growth in 2008 accelerated to a rate of 7.1%, from 6% in 2007 and significantly above the rate of potential growth. Furthermore, the excess over the reference value cannot be considered temporary. According to the Commission services' spring 2009 forecast the general government deficit is expected to reach 5.1% of GDP in 2009 and, on a no-policy-change assumption, 5.6% in 2010. This projection is based on GDP growth of -4.0% in 2009 and 0% in 2010. The Commission services' forecast takes into account measures for the current year in the budget for 2009 approved in February 2009 and the additional measures adopted by the government in April 2009. The deficit criterion in the Treaty is not fulfilled.

(8) General government gross debt remains well below the 60% of GDP reference value and stood at 13.6% of GDP in 2008. Nevertheless, according to the Commission services' spring 2009 forecast, the debt-to-GDP ratio is anticipated to increase to 18¼% in 2009 and 22¾% in 2010.

(9) In line with the provisions in the Stability and Growth Pact, due consideration was given to systemic pension reforms introducing a multi-pillar system that includes a mandatory, fully funded pillar. While the implementation of these reforms leads to a temporary deterioration of the budgetary position, the long-term sustainability of public finances clearly improves. Based on the estimates of the Romanian authorities, the net costs of this reform amount to 0.2% of GDP in 2008, 0.3% in 2009, 0.4% in 2010 and 0.4% in 2011. According to the Stability and Growth Pact, these can be taken into account on a linear degressive basis for a transitory period and only in case where the deficit remains close to the reference value, which is not the case of Romania. In any event, the government deficit adjusted for the pension reform cost in 2008 would be well above 3% of GDP.

(10) According to Article 2(4) of Council Regulation (EC) No 1467/97, "relevant factors" can only be taken into account in the steps leading to the Council decision on the existence of an excessive deficit in accordance with Article 104(6) if the double condition - that the deficit remains close to the reference value and that its excess over the reference value is temporary - is fully met. In the case of Romania, this double

[9] All EDP-related documents for Romania can be found at the following website: http://ec.europa.eu/economy_finance/netstartsearch/pdfsearch/pdf.cfm?mode=_m2.

condition is not met. Therefore, relevant factors are not taken into account in the steps leading to this decision.

HAS ADOPTED THIS DECISION:

Article 1

From an overall assessment it follows that an excessive deficit exists in Romania.

Article 2

This decision is addressed to Romania.

Done at Brussels,

For the Council
The President