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COMMISSION OF THE EUROPEAN COMMUNITIES

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# COMMISSION RECOMMENDATION

## Providing a policy advice on the economic and budgetary policy in Romania

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THE COMMISSION OF THE EUROPEAN COMMUNITIES,

Having regard to the Treaty establishing the European Community, and in particular Article 211 thereof,

Whereas:

(1) Member States of the European Union are encouraged to adopt structural reforms to strengthen their growth potential following the Lisbon Agenda while respecting the requirements of the Stability and Growth Pact.

(2) According to Article 99 of the Treaty, Member States shall regard their economic policies as a matter of common concern and shall coordinate them within the Council.

(3) The Stability and Growth Pact is based on the objective of sound government finances -through the avoidance of excessive government deficits and the achievement of a medium-term budgetary objective of close to balance or in surplus- as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation, an essential part of the macroeconomic framework of the Economic and Monetary Union.

(4) The ECOFIN report of 20 March 2005 to the European Council on 'Improving the implementation of the Stability and Growth Pact', endorsed by the European Council in its conclusions of 22 March 2005, provides that "the Commission will issue policy advice to encourage Member States to stick to their adjustment path [towards the medium term budgetary objective (MTO)]". The so-called Code of Conduct[1] further specifies that the Commission policy advice shall be given in accordance with Article 211, second indent, of the Treaty and that it shall be made public.

(5) Romania has experienced strong economic growth averaging 6½% annually between 2003 and 2007, but its GDP per capita (expressed in PPS) is still low at just below 40% of the EU average in 2007. Recently, the strongly performing economy is showing signs of overheating with a high and growing net external borrowing (from 10.4% of GDP in 2006 to 13.4% of GDP in 2007) while the FDI coverage of external borrowing dropped from 89% in 2006 to 44% in 2007. Growing labour shortages, strong wage growth hampering competitiveness and rapid increases in household borrowing are other signs of overheating. A sudden increase in inflation, after a long period of successful disinflation, was triggered primarily by supply-side shocks due to

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1 "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.

the weather-related poor performance of the agricultural sector in 2007. This was underpinned by the effects on aggregate demand of income and credit growth, non-restrictive fiscal and public wage policies and the depreciation of the Leu since August 2007 (following the appreciation in recent years).

(6) The Commission services' 2008 spring forecast projects real GDP growth at 6¼ % in 2008, easing towards just above 5% in 2009. Initially, domestic demand dynamics are expected to keep their momentum on the back of buoyant credit and wage growth. However, in the second half of 2008, rising commodity prices and tighter credit conditions, including the cumulative impact of recent interest rate hikes by the central bank, are likely to start dampening consumption and investment growth. This effect is expected to persist well into 2009. Net borrowing from the rest of the world is forecast to reach about 15½% of GDP in both 2008 and 2009. Annual inflation is projected to edge-up to an average of around 7½% in 2008, easing to slightly below 5% in 2009. In contrast to the projected gradual growth slowdown in the forecast scenario, the risk of a sustained strong boom and a further build-up of domestic and external imbalances leading ultimately to a sharper and more sudden adjustment cannot be fully excluded especially if the fiscal policy stance is not sufficiently geared to the need to contain domestic demand pressure. The general uncertainty related to the unfolding of the international financial turmoil could also bring negative surprises. For Romania to maintain its fast convergence track towards the average EU27 per capita GDP, it will be crucial to address the growing external imbalances. In this context, fiscal policy has an important role by cooling down internal demand, while also improving the quality of public finance, in particular through a shift towards growth-enhancing investment.

(7) Against the background of this scenario, fiscal policy has been expansionary and lacks a credible and predictable medium-term framework. Budgetary execution has been hampered by frequent in-year rectifications, shifting expenditure towards current spending, in particular to wages and social transfers, following revenue windfalls and under-executed capital expenditure. Furthermore, the concentration of large expenditure outlays at the end of the year significantly limits the predictability of the budgetary outcome. Partly as a result of weak budgetary planning and execution, fiscal policy has progressively loosened over the past years. Following the notification of a deficit outcome of 2.5% of GDP in 2007, the Commission services' 2008 spring forecast expects the general government deficit to increase to 2.9% of GDP in 2008 (taking into account the recent budgetary measures of March 2008) and to 3.7% of GDP in 2009 (under the conventional assumption of unchanged policies). As regards the structural balance (cyclically adjusted and net of one-off and other temporary measures), after a deterioration from a deficit of 2.7% to 3.4% of GDP between 2006 and 2007, the Commission services' spring 2008 forecast projects a further deterioration of the structural deficit to 3.7% of GDP in 2008 and 4.1% of GDP in 2009. This includes pension reforms costs estimated at 0.2% of GDP in 2008 and 0.3% of GDP in 2009. The forecast implies a further back-loading of any progress towards the MTO of 0.9% of GDP compared to the convergence programme. A comparison of the key macroeconomic and budgetary projections is presented in the table in the annex.

(8) In its opinion of 12 February 2008 on the updated convergence programme of Romania, the Council concluded that "the budgetary strategy outlined in the programme is not in line with a prudent fiscal policy, necessary to contain the growing external deficit and inflationary pressures which put at risk macroeconomic and

financial stability and the convergence process" and that "the programme does not envisage a reduction of the deficits, entailing a risk of an excessive deficit. In addition, it remarked that "progress towards the MTO is insufficient and fully back-loaded despite strong growth prospects. In view of the risks to the budgetary targets and the significant adjustment that would be necessary after the programme period, the MTO is unlikely to be achieved by 2011 as planned". The Council therefore invited Romania to: (i) significantly strengthen the pace of adjustment towards the MTO by aiming for substantially more demanding budgetary targets in 2008 and subsequent years […]; (ii) restrain the envisaged high increase in public spending, improve its expenditure composition so as to enhance the economy’s growth potential and improve the planning and execution of expenditure within a binding medium-term framework; and (iii) pursue policies to contain inflationary pressures, complementing the recommended tighter fiscal stance with appropriate public wage policy and further structural reforms.

(9) In its country-specific recommendations in the context of the 2008 update of the broad economic policies of the Member States and the Community and on the implementation of Member States' employment policies[2], the Council, on 14 May 2008, recommended that Romania avoids pro-cyclical fiscal policy to contain the growing current account deficit and inflationary pressures, keep wage developments in line with productivity growth and improve budget planning and execution as well as the quality of public finances by reviewing the composition of public spending and by reducing and redirecting state aid to horizontal objectives. It also recommended to: urgently strengthen administrative capacity at both central and local levels of government; improve the business environment, increase employment, activity rates and productivity levels, especially by accelerating reforms of the education system and by transforming subsistence/semi-subsistence farming into sustainable employment. As points to watch, the Council mentioned: long-term sustainability of public finances; R&D and innovation; infrastructure development and roll-out of ICT; undeclared work and public employment services.

(10) Over the recent years, Romania has undertaken a number of structural reforms. In the area of pensions, measures have been taken to increase the long-term financial sustainability of the pension system. These include setting up a voluntary third pension pillar as of 2007 as well as a second pension pillar as of 2008, the gradual increase of the statutory retirement age (to 60 for women and 65 for men by 2014) and of the minimum contribution period (from 10 to 15 years also by 2014). On the other hand, pension expenditure will come under increased pressure, notably given the impact of ageing on expenditure. Firstly, the government has decided in June 2007 measures resulting in an almost doubling of pensions over 2008-2009. Secondly, the pension budget will have to absorb the loss of revenues associated with a cut by 1.5 pps in pension contributions in 2008 as well as the costs related to the introduction of the second pension pillar. In the area of health, reforms aiming notably at improving the quality and efficiency of the health services are underway. With respect to labour markets, measures to boost employment and combat undeclared work included *inter alia* a comprehensive tax reform introduced in 2005 and successive cuts in social contributions in 2006 and 2007. A further reduction by 6 pps will be gradually implemented in the course of 2008. Plans for additional structural reform measures

2 OJ L 139, 14.5.2008, p. 57.

have recently been put forward by the Romanian government following the country-specific recommendations made by the Council on 14 May 2008 in the framework of the Lisbon strategy, but still need to be specified and implemented.

(11) Romania has also undertaken a number of measures to strengthen the budgetary planning and execution and to improve tax administration. In 2006, the country has started the implementation of a medium-term fiscal framework and the principle of budgetary allocation based on programmes. On the revenue side, measures aimed at a simplification and improvement of fiscal procedures, increased compliance and modernisation of fiscal administration. More recently, in March 2008, the Romanian authorities revised downwards the official deficit target to 2.4% of GDP (compared to the 2.9% target set in the convergence programme) by planned expenditure cuts. To underpin these cuts, they have also taken measures to improve expenditure management (e.g. monthly expenditure ceilings for both central and local authorities and an overall annual ceiling for the amount of loans that local authorities can contract). However, despite these measures, a considerable risk of a higher deficit for 2008 remains due to several factors such as: lower revenues, including a more negative impact of the envisaged cut in the social contribution rate; public wage slippages as seen in the past; a continuation of the dismal track record in terms of budgetary planning and execution (in particular if the recent measures are not effective); and expenditure pressures due to the political cycle (elections in 2008 and 2009). Furthermore, despite the measures taken to improve expenditure management, the urgency to develop an overall binding medium-term fiscal framework, leading to a multi-annual budget, is not addressed in the March 2008 reforms. Recently announced intentions to plan capital expenditure two years ahead seem to be a step in this direction, but still need to be specified and implemented. Finally, efforts to enhance the quality of statistical reporting in the area of government finance statistics are being undertaken in coordination with Eurostat.

(12) In order to further boost potential growth in the medium term structural reforms need to be stepped up and further measures need to be adopted in the budgetary area. With respect to structural reforms, in order to ease supply constraints and enhance external competitiveness, reform measures need to be accelerated predominantly in the labour market and education (in particular to implement an integrated approach to increasing employment, activity rates and productivity levels, especially by accelerating reforms of the education system to respond better to labour market needs, by reducing early school leaving, by significantly increasing adult participation in education and training; and by transforming subsistence/semi-subsistence farming into sustainable employment) as well as with respect to the business environment. In addition, the over-arching challenge of strengthening administrative capacity needs to be tackled forcefully. To foster long-term sustainability of public finances, further reforms of the pension and health care systems are necessary. Moreover, notwithstanding the recent measures adopted by the government in March 2008, the projected deterioration of public finances implies a significant divergence from the adjustment path towards the MTO as formulated in the most recent update of the convergence programme which was already assessed as insufficient in the Council Opinion. Moreover, it poses a risk in terms of possibly breaching the 3% of GDP reference threshold. This divergence would occur against continued signs of overheating in the Romanian economy. Therefore, it will be important to strengthen the pace of budgetary consolidation, including by implementing additional measures to enhance control and efficiency of expenditure, including effective ex-post evaluation mechanisms. In particular, the

implementation of a binding multi-annual fiscal framework, based on long-term strategic objectives needs to be stepped up. This would significantly enhance the budgetary credibility and predictability and would allow a better budgetary reflection of long-term growth strategies, as set-out in the Lisbon agenda. Furthermore, it would contribute to strengthening fiscal discipline and using windfall revenues for deficit reduction. A comprehensive effort to accelerate structural reforms and fiscal consolidation would not only ensure compliance with the Stability and Growth Pact, but would also be consistent with avoiding a further build-up of domestic and external imbalances and would, ultimately, contribute to a smooth convergence process.

HEREBY RECOMMENDS ROMANIA:

(1) to take urgent action to implement a binding medium-term fiscal framework with a view to improve at the same time the quality of public finances;

(2) to implement rigorously the policy invitations of the Council issued on 12 February 2008 on the updated convergence programme of Romania for the period 2007 to 2010 so as to ensure that the general government deficit does not breach the 3% of GDP reference value and to help containing external imbalances;

(3) to accelerate structural reforms in particular to implement an integrated approach to increasing employment, activity rates and productivity levels, especially by accelerating reforms of the education system to respond better to labour market needs, by reducing early school leaving, by significantly increasing adult participation in education and training; and by transforming subsistence/semi-subsistence farming into sustainable employment; to improve the business environment and to strengthen administrative capacity. This would aim at increasing Romania's growth potential and strengthening its external competitiveness.

This Recommendation is addressed to Romania.

Done at Brussels, 12 June 2008

*For the Commission*
*Joaquin ALMUNIA*
*Member of the Commission*

*Annex: Comparison of key macroeconomic and budgetary projections*

| | | 2006 | 2007 | 2008 | 2009 |
|---|---|---|---|---|---|
| Real GDP (% change) | **NCEF** | **7.9** | **6.0** | **6.5** | **6.1** |
| | COM Apr 2008 | 7.9 | 6.0 | 6.2 | 5.1 |
| | *CP Dec 2007* | *7.7* | *6.1* | *6.5* | *6.1* |
| HICP inflation (%) | **NCEF**[1] | **6.6** | **4.9** | **7.5** | **4.5** |
| | COM Apr 2008 | 6.6 | 4.9 | 7.6 | 4.8 |
| | *CP Dec 2007* | *6.6* | *4.8* | *5.7* | *4.0* |
| Output gap (% of potential GDP) | **NCEF** | **NA** | **NA** | **NA** | **NA** |
| | COM Apr 2008[2] | 3.4 | 3.0 | 2.6 | 1.2 |
| | *CP Dec 2007*[3] | *2.2* | *2.1* | *2.1* | *1.8* |
| Net lending/borrowing vis-à-vis the rest of the world (% of GDP) | **NCEF** | **-10.4** | **-13.4** | **-11.7** | **-10.6** |
| | COM Apr 2008 | -10.4 | -13.2 | -15.4 | -15.5 |
| | *CP Dec 2007* | *-10.3* | *-12.6* | *-10.5* | *-10.1* |
| Employment[4] (y-on-y % change) | **NCEF** | **2.0** | **-0.2** | **1.5** | **1.2** |
| | COM Apr 2008 | *2.8* | *1.3* | *0.9* | *0.8* |
| | *CP Dec 2007* | *1.8* | *1.5* | *1.4* | *1.1* |
| Unemployment[4] (as % of civilian labour force) | **NCEF** | **7.3** | **6.4** | **6.3** | **6.1** |
| | COM Apr 2008 | *7.3* | *6.4* | *6.1* | *5.9* |
| | *CP Dec 2007* | *7.3* | *7.1* | *6.9* | *6.8* |
| Total expenditure, general government (as % of GDP) | **NCEF** | **NA** | **NA** | **NA** | **NA** |
| | COM Apr 2008 | 35.3 | 36.9 | 38.5 | 39.9 |
| | *CP Dec 2007* | *35.0* | *40.3* | *42.7* | *42.8* |
| General government balance (% of GDP) | **NCEF** | **NA** | **NA** | **NA** | **NA** |
| | COM Apr 2008 | -2.2 | -2.5 | -2.9 | -3.7 |
| | *CP Dec 2007* | *-1.9* | *-2.9* | *-2.9* | *-2.9* |
| Primary balance (% of GDP) | **NCEF** | **NA** | **NA** | **NA** | **NA** |
| | COM Apr 2008 | -1.4 | -1.8 | -2.1 | -2.9 |
| | *CP Dec 2007* | *-1.0* | *-2.0* | *-2.1* | *-2.1* |
| Cyclically-adjusted balance (% of GDP) | **NCEF** | **NA** | **NA** | **NA** | **NA** |
| | COM Apr 2008 | -3.3 | -3.4 | -3.7 | -4.1 |
| | *CP Dec 2007*[3] | *-2.6* | *-3.6* | *-3.6* | *-3.5* |
| Structural balance[5] (% of GDP) | **NCEF** | **NA** | **NA** | **NA** | **NA** |
| | COM Apr 2008 | -2.7 | -3.4 | -3.7 | -4.1 |
| | *CP Dec 2007* | *-2.2* | *-3.4* | *-3.4* | *-3.4* |
| Government gross debt (% of GDP) | **NCEF** | **NA** | **NA** | **NA** | **NA** |
| | COM Apr 2008 | 12.4 | 13.0 | 13.6 | *14.9* |
| | *CP Dec 2007* | *12.4* | *11.9* | *13.6* | *14.2* |

Notes:

[1]Figures for National Consumer Price Index (CPI)

[2]Based on estimated potential growth of 5.5%, 6.4%, 6.6% and 6.6%, respectively, in the period 2006-2009.

[3]Output gaps and cyclically-adjusted balances according to the programme as recalculated by Commission services on the basis of the information in the programme.

[4]Figures from the NCEF and the CP are based on a household survey (the so-called "AMIGO" data) and hence are not fully comparable with the National Accounts-based figures used in the Commission forecast.

[5]Cyclically-adjusted balance excluding one-off and other temporary measures. One-off and other temporary measures are 0.4% of GDP in 2006 and 0.2% of GDP in 2007 and 2008 and 0.1% of GDP in 2009 and 2010 (all deficit-increasing) according to the convergence programme and zero according to the Commission services' spring forecast.

*Source:*

*National Commission for Economic Forecasting (NCEF) Spring 2008 forecast; Commission services' spring 2008 economic forecasts (COM); December 2007 Convergence programme (CP).*