



COMMISSION OF THE EUROPEAN COMMUNITIES

Brussels, 7.3.2007
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Recommendation for a

COUNCIL OPINION

**in accordance with the first paragraph of Article 9 of
Council Regulation (EC) No 1466/97 of 7 July 1997**

on the convergence programme of Romania, 2006-2009

(presented by the Commission)

EXPLANATORY MEMORANDUM

1. GENERAL BACKGROUND

The Stability and Growth Pact, which entered into force on 1 July 1998, 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. The 2005 reform of the Pact acknowledged its usefulness in anchoring fiscal discipline but sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run.

Council Regulation (EC) No 1466/97 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies¹, which is part of the Stability and Growth Pact, stipulates that Member States have to submit, to the Council and the Commission, stability or convergence programmes and annual updates thereof (Member States that have already adopted the single currency submit (updated) stability programmes and Member States that have not yet adopted it submit (updated) convergence programmes).

Romania joined the European Union on 1 January 2007 and submitted its first convergence programme on 25 January 2007. In accordance with the Regulation, the Council is to deliver an opinion on it on the basis of a recommendation from the Commission and after having consulted the Economic and Financial Committee (see box for the main points covered by the assessment).

2. BACKGROUND FOR THE ASSESSMENT OF THE PROGRAMME

In order to set the scene against which the budgetary strategy in the convergence programme is assessed, this section summarises the economic and budgetary performance over the last ten years.

Romania enjoyed strong economic growth over the past five years, but its GDP per capita (expressed in PPS) is still low at 34% of the EU-25 average in 2005. Therefore, the scope for catching up remains ample and represents Romania's overriding challenge for the medium- and long-term. In 2001-2005 macroeconomic stability improved, as reflected by the sharp and sustained decline in inflation and the consolidation of public finances. Investment accelerated and was reinforced by a notable increase in net FDI which helped shift production into more technology-intensive sectors. The structure of industrial output and exports changed towards higher value-added products, preserving external competitiveness despite the increase in unit labour costs. The notable recovery of economic activity only resulted in a marginal increase in the employment rate, which is fairly low at around 58%. At the same time, Romania witnesses steady emigration and the ageing of its population. The introduction of the flat tax on personal income in January 2005 contributed to a reduction of the informal labour market, which however remains very large.

¹ OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). All the documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

Box: Main points covered by the assessment

As required by Article 5(1) (for stability programmes) Article 9(1) (for convergence programmes) of Council Regulation (EC) No 1466/97, the assessment covers the following points:

- whether the economic assumptions on which the programme is based are plausible;
- the medium-term budgetary objective (MTO) presented by the Member State and whether the adjustment path towards it is appropriate;
- whether measures being taken and/or proposed to respect that adjustment path are sufficient to achieve the MTO over the cycle;
- when assessing the adjustment path towards the MTO, whether a higher adjustment effort is made in economic good times, whereas the effort may be more limited in economic bad times, and, for euro-area and ERM II Member States, whether the Member State pursues an annual improvement of the cyclically-adjusted balance, net of one-off and other temporary measures, of 0.5% of GDP as a benchmark to meet its MTO;
- when defining the adjustment path to the MTO (for Member States that have not yet reached it) or allowing a temporary deviation from the MTO (for Member States that have), the implementation of major structural reforms which have direct long-term cost-saving effects (including by raising potential growth) and therefore a verifiable impact on the long-term sustainability of public finances (subject to the condition that an appropriate safety margin with respect to the 3% of GDP reference value is preserved and that the budgetary position is expected to return to the MTO within the programme period), with special attention for pension reforms introducing a multi-pillar system that includes a mandatory, fully-funded pillar;
- whether the economic policies of the Member State are consistent with the broad economic policy guidelines.

The plausibility of the programme's macroeconomic assumptions is assessed by reference to the Commission services' autumn 2006 forecast, using also the commonly agreed methodology for the estimation of potential output and cyclically-adjusted balances. The assessment of consistency with the broad economic policy guidelines is made against the broad economic policy guidelines in the area of public finances as included in the integrated guidelines for the period 2005-2008.

The assessment also examines:

- the evolution of the debt ratio and the outlook for the long-term sustainability of the public finances, which should be given "sufficient attention in the surveillance of budgetary positions" according to the Council report of 20 March 2005 on "Improving the implementation of the Stability and Growth Pact". A Commission Communication of 12 October 2006 sets out the approach to the assessment of long-term sustainability²;
- compliance with the code of conduct³, which inter alia prescribes a common structure and set of data tables for the stability and convergence programmes.

² Communication from the Commission to the Council and the European Parliament, "The long-term sustainability of public finances in the EU" - COM(2006) 574, 12.10.2006 - and European Commission, Directorate-General for Economic and Financial Affairs (2006), "The long-term sustainability of public finances in the European Union", European Economy No 4/2006.

³ "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.

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on the convergence programme of Romania, 2006-2009

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies⁴, and in particular Article 9(1) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

- (1) On [27 March 2007] the Council examined the convergence programme of Romania, which covers the period 2006 to 2009.
- (2) Romania enjoyed strong economic growth over the past five years, but its GDP per capita (expressed in PPS) is still low at 34% of the EU-25 average in 2005. Therefore, the scope for catching up remains ample and represents Romania's overriding challenge for the medium- and long-term. In 2001-2005 macroeconomic stability improved, as reflected by the sharp and sustained decline in inflation and the consolidation of public finances. The average inflation rate stood at 6.6% in 2006.
- (3) The macroeconomic scenario underlying the programme envisages that real GDP growth will decelerate progressively from a well-above potential rate of 8% in 2006 to a still sustained 5.9% in 2009. Assessed against currently available information, this scenario appears to be based on plausible growth assumptions. The programme's projections for inflation appear to be on the low side since they assume a sustained deceleration of credit and private consumption growth which may not materialise. Unlike the programme, the Commission's services 2006 autumn forecast projects a

⁴ OJ L 209, 2.8.1997, p. 1. Regulation as amended by Regulation (EC) No 1055/2005 (OJ L 174, 7.7.2005, p. 1). The documents referred to in this text can be found at the following website: http://europa.eu.int/comm/economy_finance/about/activities/sgp/main_en.htm

further widening of the external deficit in 2007 and 2008 on the basis of imports that continue to outpace exports as a result of strong private consumption and investment.

- (4) For 2006, in the Commission services' autumn 2006 forecast estimated the general government deficit at 1.4% of GDP against a target of 0.7% of GDP set in the December 2005 pre-accession economic programme. The convergence programme estimates the deficit at 2.3% of GDP, but preliminary data point to an even worse outcome. The slippage compared to the original target reflects significant additional expenditure, notably current spending partly due to a reallocation of unspent investment expenditures, which more than offset stronger revenue growth than expected.
- (5) The main goal of the programme is to pursue fiscal consolidation so as to reach the medium-term objective of a structural deficit (in cyclically-adjusted terms net of one-off and other temporary measures) of 0.9% of GDP in 2011, i.e. beyond the programme period. The programme targets a small reduction of the general government deficit from 2.3% of GDP in 2006 to 2% of GDP in 2009, after a rise to 2.7% of GDP in 2007. The primary deficit is expected to follow a similar path and to stand at 1% of GDP at the end of the programme period.
- (6) The adjustment, which is marginal and back-loaded is done through an increase in the revenue-to-GDP ratio that is somewhat higher than the increase in the expenditure-to-GDP ratio (almost 4 percentage points compared to 3½ percentage points). On the revenue side, most of the increase comes from taxes (especially in 2007) and from "other revenues" (presumably associated with EU funds inflows). The rise in the expenditure ratio stems to a large extent from a very significant increase in public investment, which is planned to more than double as a percentage of GDP due to an assumed substantial increase in the absorption of EU funds. Compared with the December 2005 pre-accession economic programme, budgetary targets are far less ambitious although the underlying growth assumptions are similar.
- (7) The structural deficit (i.e. the cyclically-adjusted deficit net of one-off and other temporary measures) calculated according to the commonly agreed methodology is planned to deteriorate further from 3% of GDP in 2006 to around 3½% of GDP in 2007 before improving to 2¼% of GDP in 2009. As mentioned above, the medium-term objective (MTO) for the budgetary position presented in the programme is a structural deficit of 0.9% of GDP, which the programme aims to achieve by 2011, i.e. beyond the programme period. As the MTO is more demanding than the minimum benchmark (estimated at a deficit of 1¾% of GDP), achieving it should fulfil the aim of providing a safety margin against the occurrence of an excessive deficit. The MTO adequately reflects the debt ratio and average potential output growth in the long term.
- (8) The risks to the budgetary projections in the programme appear broadly balanced in 2007, but budgetary outcomes could be worse than projected in the programme thereafter. In 2007, both expenditure and revenues might be lower than planned: the former because public investment plans are unlikely to be achieved and the latter because the assumed tax intensity of economic activity appears to be very favourable. From 2008 onwards, the budgetary strategy is insufficiently specified, with a volatile path for several expenditure items and an unsubstantiated tightening in 2009. Expenditure slippage in recent years through frequent budgetary amendments, the uncertainty regarding the total amount of compensation to be paid by general

government to citizens for the non-return of properties nationalised during the communist regime and potential cancellations of public enterprises' unpaid liabilities towards general government point to a risk of expenditure overruns, even though the level of planned spending on investment will likely be undershot. In addition, over-budgeted resources allocated to investments might be shifted to consumption as seen in the past, with a negative impact on the quality of public spending.

- (9) In view of this risk assessment, the budgetary stance in the programme seems insufficient to ensure that the MTO is achieved within the programme period, as also envisaged in the programme. In addition, it does not seem to provide a sufficient safety margin against breaching the 3% of GDP deficit threshold with normal macroeconomic fluctuations throughout the programme period. The pace of the adjustment towards the MTO implied by the programme is clearly insufficient and should be strengthened significantly to be in line with the Stability and Growth Pact, which specifies that the adjustment should be higher in good economic times and could be lower in bad economic times. In particular, in a context of good times, the structural improvement is marginal and fully back-loaded, with a deterioration in 2007, while the planned adjustment, notably in 2009 is not supported by measures.
- (10) Government gross debt is estimated to have reached around 13% of GDP in 2006, well below the 60% of GDP Treaty reference value. The programme projects the debt ratio to decline by around 1 percentage point of GDP over the programme period.
- (11) In the absence of the long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Romania on a comparable and robust basis as it is currently done for the other Member States, for which the projections on this basis are available. However, a significant impact of ageing on expenditure cannot be excluded given the current demographic structure. The initial budgetary position, with a large structural deficit, is not sufficient to stabilise debt even before considering the long-term budgetary impact of ageing. Improving the structural budgetary position over the medium-term would contribute to containing risks to the sustainability of public finances.
- (12) The budgetary strategy in the programme is partly consistent with the broad economic policy guidelines included in the integrated guidelines for the period 2005-2008. In particular, the budgetary adjustment towards the MTO is clearly insufficient and should be strengthened significantly over the programme period. Moreover, the fiscal strategy put forward in the programme, notably the loosening of the fiscal stance until 2007, raises concern regarding the sustainability of high growth and of the external deficit, which is estimated to have reached 10.3% of GDP in 2006.
- (13) As regards the data requirements specified in the code of conduct for stability and convergence programmes, the programme has some gaps in the required and optional data⁵.

⁵ In particular the data on the subcomponents of the stock-flow adjustment and the contributions to potential GDP growth by labour, capital and TFP are missing.

The overall conclusion is that, in a context of strong growth prospects and a widening external deficit, the programme envisages a pro-cyclical loosening in 2007 and clearly insufficient and back-loaded progress towards the MTO, which is targeted to be reached only beyond the programme period. Moreover, there are risks to the achievement of the budgetary targets from 2008 onwards. In view of the above assessment, Romania is invited to:

- (i) exploit the good times to significantly strengthen the pace of adjustment towards the MTO by aiming for more demanding budgetary targets in 2007 and subsequent years;
- (ii) control the envisaged high increase in public spending and review its composition so as to enhance the growth potential, as well as improve the planning and execution of public expenditures within a binding medium-term framework.

Comparison of key macroeconomic and budgetary projections¹

		2005	2006	2007	2008	2009
Real GDP (% change)	CP Jan 2007	4.1	8.0	6.5	6.3	5.9
	COM Nov 2006	4.1	7.2	5.8	5.6	n.a.
	PEP Dec 2005	5.7	6.0	6.3	6.5	n.a.
HICP inflation (%)	CP Jan 2007	9.1	6.6	4.5	4.3	3.2
	COM Nov 2006	9.1	6.8	5.1	4.6	n.a.
	PEP Dec 2005	9.0	7.0	5.0	3.6	n.a.
Output gap (% of potential GDP)	CP Jan 2007²	0.2	2.1	2.2	1.9	1.1
	COM Nov 2006 ⁶	0.4	1.9	1.5	1.0	n.a.
	PEP Dec 2005	n.a.	n.a.	n.a.	n.a.	n.a.
General government balance (% of GDP)	CP Jan 2007	-1.5	-2.3	-2.7	-2.6	-2.0
	COM Nov 2006	-1.5	-1.4	-2.6	-2.6	n.a.
	PEP Dec 2005	-0.4	-0.7	-1.0	-1.6	n.a.
Primary balance (% of GDP)	CP Jan 2007	-0.4	-1.2	-1.6	-1.5	-1.0
	COM Nov 2006	-0.3	-0.4	-1.7	-1.7	n.a.
	PEP Dec 2005	0.8	0.4	0.0	-0.6	n.a.
Cyclically-adjusted balance (% of GDP)	CP Jan 2007²	-1.5	-3.0	-3.4	-3.2	-2.3
	COM Nov 2006	-1.6	-2.0	-3.1	-2.9	n.a.
	PEP Dec 2005	n.a.	n.a.	n.a.	n.a.	n.a.
Structural balance ³ (% of GDP)	CP Jan 2007⁴	-1.5	-3.0	-3.4	-3.2	-2.3
	COM Nov 2006 ⁵	-1.6	-2.0	-3.1	-2.9	n.a.
	PEP Dec 2005	n.a.	n.a.	n.a.	n.a.	n.a.
Government gross debt (% of GDP)	CP Jan 2007	15.9	12.8	13.5	12.6	11.7
	COM Nov 2006	15.9	13.7	13.9	14.4	n.a.
	PEP Dec 2005	17.1	15.1	14.6	14.6	n.a.

Notes:

¹ The government accounts of Romania have not yet been officially subject to a complete quality assessment by Eurostat. Eurostat will publish and validate government balance and debt figures shortly after the data notification of 1 April 2007.

² Commission services calculations on the basis of the information in the programme.

³ Cyclically-adjusted balance (as in the previous rows) excluding one-off and other temporary measures.

⁴ There are no one-off and other temporary measures in the programme.

⁵ There are no one-off and other temporary measures in the Commission services' autumn 2006 forecast.

⁶ Based on estimated potential growth of 5.6%, 5.7%, 6.1% and 6.2% respectively in the period 2005-2008.

Source:

Convergence programme (CP); Pre-accession economic programme (PEP); Commission services' autumn 2006 economic forecasts (COM); Commission services' calculations