INTERNATIONAL MONETARY FUND

IMF Country Report No. 23/395

ROMANIA

2023 ARTICLE IV CONSULTATION—PRESS RELEASE; AND STAFF REPORT

December 2023

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2023 Article IV consultation with Romania, the following documents have been released and are included in this package:

- A **Press Release**
- The **Staff Report** prepared by a staff team of the IMF for the Executive Board's consideration on lapse-of-time basis following discussions that ended on October 4, 2023, with the officials of Romania on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 17, 2023.
- An **Informational Annex** prepared by the IMF staff.

The documents listed below have been or will be separately released.

Selected Issues

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International Monetary Fund
Washington, D.C.

PRESS RELEASE

PR23/427

IMF Executive Board Concludes 2023 Article IV Consultation with Romania

FOR IMMEDIATE RELEASE

Washington, DC – **December 8, 2023:** The Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Romania, and considered and endorsed the staff appraisal without a meeting.[2]

Romania has weathered the economic shocks from the pandemic, Russia's war in Ukraine, and the resulting surges in energy and food prices relatively well. Growth, at 4.7 percent, surprised on the upside in 2022 but slowed in the first half of 2023 to around 1.9 percent y/y as consumption weakened due to real incomes being eroded by inflation, and external demand remained subdued. Public and private investment, on the other hand, has accelerated further. CPI inflation peaked at 16.8 percent y/y in November 2022, and has since been falling steadily to 8.8 percent y/y in September, aided by base effects, price caps on energy and, more recently, receding energy and food prices, an easing of supply bottlenecks, and monetary tightening. The financial sector remains robust. Fiscal deficits remain high. While spending pressures from the pandemic and support measures to cushion increases in energy and food prices have abated, structural spending has increased since 2019 without offsetting increases in revenue, and fiscal consolidation has stalled in 2023. The current account deficit also remains large but is declining, and is largely driven by direct investment flows and rising inflows of EU funds. International reserves have increased significantly.

Despite the slowdown, growth is expected to remain robust. In 2023, growth is projected at 2¼ percent, before recovering modestly to around 2¾ percent in 2024 as stronger consumption—driven by rising real wages—and external demand are partially countered by the necessary fiscal consolidation. In the medium term, Romania's growth trajectory is expected to return to its potential rate of around 3¾ percent as consumption and exports recover further, and investment, underpinned by RRF funds, remains strong. CPI inflation is projected to return inside the NBR's target band in early 2025 on the back of weaker economic growth and falling prices for food and energy, which comprise almost half of the consumption basket. A fiscal package adopted by the authorities in September is a first step towards fiscal consolidation, although the deficit in 2023 is projected by staff at 6 percent of GDP. In 2024, without further fiscal measures, the deficit is forecast to fall to slightly above 5 percent of GDP. Over the medium term, owing to fiscal adjustment and—near the end of the projection horizon—declining EU capital grants, the current account deficit is projected to narrow moderately to around 6 percent of GDP.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report.

[2] The Executive Board takes decisions under its lapse-of-time procedure when the Board agrees that a proposal can be considered without convening formal discussions.

Executive Board Assessment[3]

In concluding the 2023 Article IV consultation with Romania, Executive Directors endorsed staff's appraisal, as follows:

Romania's economy has performed relatively well in difficult times. Growth, while slowing, remains fairly robust, and higher than in most peers. Inflation, after peaking at lower levels than in CESEE peers, remains too high but is receding gradually. The impressive convergence to Western European income levels is continuing. At the same time, Romania's external position in 2022 was substantially weaker than the level implied by fundamentals and desirable policies, although the assessment is subject to considerable uncertainty.

Growth is expected to recover modestly in 2024, and to return to its potential rate in the medium term, but there are substantial risks. Escalation of the war in Ukraine, a possible further weakening of activity across Europe, or an abrupt global slowdown could undermine growth and capital flows to emerging markets. Prolonged strong wage growth in Romania could delay the projected fall in core inflation. Finally, the electoral calendar could make fiscal consolidation and structural reforms in 2024 difficult to achieve.

A weak fiscal position renders Romania vulnerable. The scope to respond to adverse developments is circumscribed by a structural budget deficit well in excess of sustainable levels. Addressing this is a key priority Continued efforts to improve expenditure efficiency and tax collection are needed and welcome, but high spending pressures to address relative poverty and raise productivity imply that revenues must be increased.

The recently adopted fiscal package offers a welcome improvements in tax policy and should help reduce the fiscal deficit somewhat in 2024; but more will be needed. In particular, the reduction of some tax exemptions it is a step forward. However, some measures—notably the new turnover taxes—are not in line with good practice and should be reconsidered. Moreover, further tax reforms to raise at least 2 percent of GDP in additional revenue beyond the gains from the recent tax package are needed to put the fiscal deficit on a sustainable medium-term trajectory, while ensuring that all taxpayers pay their fair share. Streamlining VAT and personal income taxes (including the closing of loopholes and the removal of tax privileges) should be key elements of such a reform. Once this is achieved, consideration should be given to re-introduce progressive income taxation.

Tax and expenditure policies will need to become more predictable. Announcing further tax reforms well in advance will help companies and households adjust to these changes. Spending on pensions and public sector wages should be set on a sustainable formula-based trajectory, as envisaged in the NRRP. These steps should help improve medium-term budgeting, and underpin a credible path for the necessary fiscal consolidation. The new draft pension law would help reduce spending over the longer run, but generate upfront fiscal costs that could jeopardize efforts to reduce the deficit in the next few years. A gradual phase-in of these costs and prudent implementation are needed to avoid this risk.

Monetary policy should not be relaxed until core inflation is on a firm downward path as needed for returning headline inflation within the tolerance band by early 2025.

[3] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.IMF.org/external/np/sec/misc/qualifiers.htm.

Inflation is declining broadly in line with projections, but risks arise from strong wage growth. Moreover, the monetary authorities should also stand ready to tighten monetary policy if upside risks to core inflation materialize.

The recent episode of higher exchange rate volatility offers an opportunity to gradually increase two-way exchange rate flexibility over the medium term. This would reduce opportunities for destabilizing capital flows, raise monetary policy effectiveness, and enhance resilience to economic shocks. In this context, it is important to move gradually to preserve confidence gains made over the past decade. Enhanced data on inflation expectations would support the calibration of monetary policy.

While financial sector vulnerabilities are limited, emerging risks need to be monitored. Strong fundamentals of the financial sector underpin its resilience, but the recent increase in corporate FX borrowing warrants close scrutiny. The turnover tax on banks could, if maintained for an extended period, weaken banks' financial buffers and already-low financial intermediation.

Improvements to the AML/CFT system should be swiftly implemented. Building on ongoing progress, the authorities should compile an overarching AML/CFT strategy to ensure the effective functioning of the AML/CFT system.

There is significant room to underpin real income growth and further convergence with Western Europe. This requires investment in physical infrastructure as well as people, and strengthening the efficiency of the state.

- Making the most of available EU support is critical—both to help finance much-needed investment, and to support implementation of the agreed reform agenda.
- Governance reforms are critical, including to enhance administrative capacity and transparency, fight corruption, and make SOEs more efficient. Such reforms would reinforce Romania's attractiveness for investment and also counteract continued (though declining) net outmigration.
- Raising labor force participation is key to mitigating the effects of a falling population. Increasing opportunities for women to join the formal labor force, and improving education outcomes to enhance opportunities for all are especially important.

Advancing the green transition of Romania's economy is vital. Reducing GHG emissions in line with EU and updated NECP targets is challenging, even though Romania's electricity production is already dominated by low-carbon sources. In particular, the emissions by transport and housing sectors are difficult to address. This not only requires large and well-coordinated investments, but also a complementary set of policies to mitigate the social impact of the transition. Such policies should disincentivize carbon emissions (including through taxation) while shielding compensating low-income households. The scheduled closure of coal mines will require special efforts to provide compensation and new opportunities for affected households. Romania's large potential for renewable energy offers it important opportunities to benefit from decarbonization and become more competitive in green value chains.

Romania: Selected Economic Indicators

Population (million):	19.0	Per capita GDP ($):	15,791
Quota (m SDRs/% of total):	1,811 (0.4%)	Literacy rate (%):	98.9
		Poverty rate (%) 1/:	21.2

Key export markets: EU (Germany, France, Italy)

Main products and exports: Machinery and transport equipment, manufactured goods

	2021	2022	2023	2024
			Projections	
Output				
Real GDP (% change)	5.7	4.6	2.2	2.7
Employment				
Unemployment (% labor force)	5.6	5.6	5.6	5.6
				Prices
Consumer prices (avg)	5.0	13.8	10.5	5.8
Consumer prices (eop)	8.2	16.4	7.4	4.4
General government finances (% GDP)				
Revenue	30.4	31.0	31.9	31.9
Expenditure	37.1	36.8	37.9	37.0
Net lending/borrowing	-6.7	-5.8	-6.0	-5.1
Structural balance	-7.4	-5.7	-5.6	-4.8
Structural primary balance	-5.9	-3.7	-3.2	-2.6
Gross debt	51.7	50.5	51.6	52.2
Money and credit				
Broad money (% change)	15.8	6.9	13.6	10.0
Credit to the private sector (% change)	14.8	12.1	4.6	6.3
Policy rate (eop, %)	1.75	6.75	…	…
Balance of payments				
Current account (% GDP)	-7.2	-9.3	-6.9	-6.7
Direct investment, net (% GDP)	-3.7	-3.4	-3.0	-3.3
International reserves (months of prospective imports)	3.9	4.3	4.7	4.7
External debt (% GDP)	56.5	50.6	50.5	51.2
Exchange rate				
REER (% change)	1.0	3.7	…	…

Sources: Eurostat, World Development Indicators, and IMF staff estimates and projections.

1/ At risk of poverty rate (cut-off point: 60% of median equivalized income after social transfers).

ROMANIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION

November 15, 2023

KEY ISSUES

Context: Romania has weathered the economic shocks from the pandemic, Russia's war in Ukraine, and the resulting surges in energy and food prices relatively well. Growth has slowed down but is expected to remain fairly robust in 2023 and 2024, supported by investment. Inflation remains notably above target but has been declining steadily through 2023. Fiscal deficits remain too large, although the authorities adopted a fiscal package to limit spending and raise additional revenues.

Outlook and Risks: Growth is expected to gradually recover to its medium-term potential of around 3¾ percent. Inflation is projected to continue its downward path but remain outside the NBR's target band into early 2025. Key risks stem from the war in Ukraine, and a possible further slowdown of activity in Europe or globally. Domestically, multiple elections in 2024 may render continued fiscal consolidation and structural reforms difficult.

Key Policy Recommendations:

- *Fiscal consolidation:* Fiscal deficits will need to fall below 3 percent of GDP to stabilize public debt, help secure necessary market financing at lower interest rates, and support ongoing disbursement of EU funds. To this end, additional substantive tax reforms need to be designed to yield at least 2 percent of GDP in additional revenue beyond the tax package already adopted.
- *Monetary policy:* A gradual relaxation of monetary policy should wait until core inflation is on a firm downward path such that the target range is clearly within reach. In case of a meaningful upward revision of projected core inflation, the National Bank of Romania should stand ready to tighten monetary policy as needed.
- *Medium term growth:* Raising Romania's growth potential requires making the most of EU support; pursuing structural reforms to strengthen transparency and governance; and pursuing policies to raise the labor force participation rate, especially of women, which is one of the lowest in Europe.
- *Green transition:* Achieving carbon neutrality will require large and well-coordinated investments. Tax instruments should be used to incentivize switching to green energy. However, it is vital to mitigate the social impact of the transition, by supporting vulnerable workers and lower-income households.

Approved By
Helge Berger and Bergljot Barkbu

Discussions for the 2023 Article IV consultation were held in Cluj-Napoca and Bucharest during September 22–October 4, 2023. The mission team comprised J.K. Martijn (head), F. Misch, A. Pitt (all EUR) and A. Panton (RES), G. Babici (local economist), and G. Gottlieb (Senior Regional Resident Representative). T. Kang and S. Mohona assisted from headquarters. M. Copaciu (OED) joined part of the discussions.

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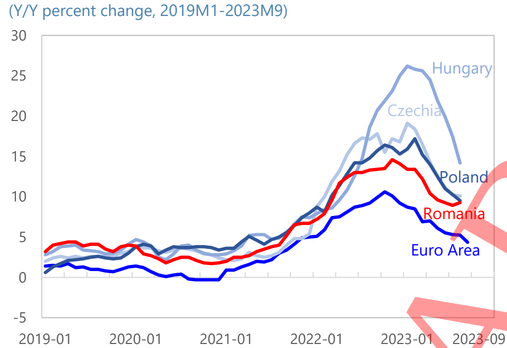
ANNEXES

CONTEXT AND RECENT DEVELOPMENTS

1. **Romania has weathered the economic shocks from the pandemic, Russia's war in Ukraine, and the resulting surges in energy and food prices relatively well.** Growth has been fairly robust, in part enabled by Romania's high degree of self-sufficiency in energy and limited trade and financial linkages with Russia and Ukraine, and HICP inflation peaked at lower levels than in regional EU peers. While the intake of refugees from Ukraine has been limited, Romania is playing an increasingly important role in the shipment of Ukrainian grain exports.

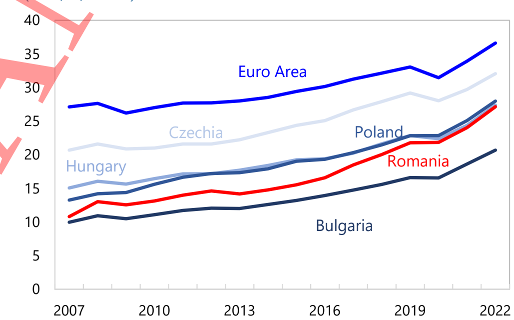
2. **Convergence to higher income levels of Central, Eastern, and South-Eastern European (CESEE) peers and the Euro Area has continued.** GDP per capita (in purchasing power standard terms) reached 74 percent of the Euro Area average, up from 40 percent when Romania joined the EU in 2007.

EU: HICP Inflation
(Y/Y percent change, 2019M1-2023M9)



Source: Eurostat.

EU: GDP per Capita
(PPS; 1,000 €)



Source: Eurostat.

3. **Growth surprised on the upside in 2022 but slowed in 2023.** At 4.7 percent, growth in 2022 was supported by consumption as well as private and public investment. However, in 2023H1, growth slowed to around 1.9 percent y/y as consumption weakened due to real incomes being eroded by inflation, and external demand remained subdued. Public and private investment, on the other hand, has accelerated further. The output gap is estimated to turn slightly negative in 2023.

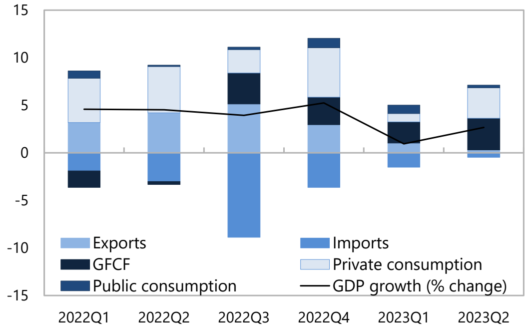
4. **Inflation is declining but remains significantly above target.**[1] CPI inflation peaked at 16.8 percent y/y in November 2022, and has since been falling steadily to 8.8 percent y/y in September, driven by base effects, price caps on energy and, more recently, receding energy and food prices, an easing of supply bottlenecks, and monetary tightening.[2] Core inflation peaked later, at 15.1 percent y/y in February 2023, as energy and food price increases permeated through the economy. Two-year ahead inflation expectations have also declined from their peak but remain

[1] The difference between Romania's CPI and the standardized EU-wide measure (Harmonized Index of Consumer Prices—HICP) is generally larger than in other EU member states due to different weights.

[2] The electricity and gas price caps will expire in March 2025, and currently are only partially binding, given the decline in international energy prices.

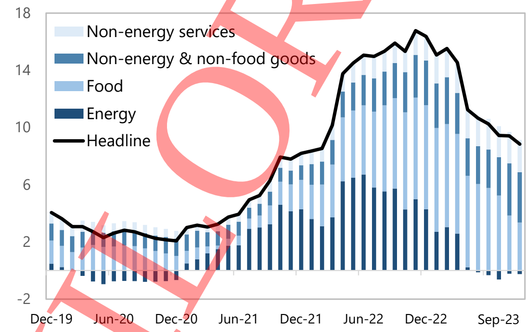
slightly above the National Bank of Romania's (NBR) tolerance band of ±1 percent around the target of 2.5 percent.

Romania: Growth Contribution
(y/y, percentage points)



Sources: Haver Analytics; and IMF staff calculations.

Romania: Inflation Decomposition
(Y/Y percent change, 2019M12-2023M9)

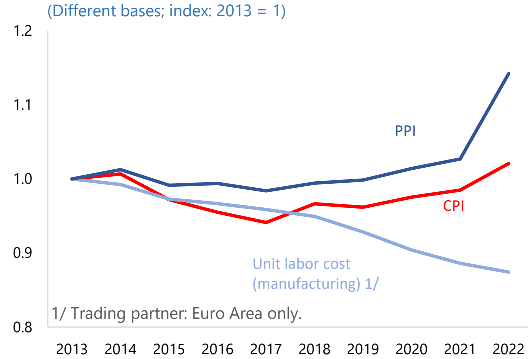


Sources: Haver Analytics; Romania National Institute of Statistics, and IMF staff calculations.

5. **Fiscal deficits remain large.** While spending pressures from the pandemic and support measures to cushion increases in energy and food prices have abated, large structural spending increases since 2019—mainly on wages and pensions—without offsetting increases in revenue have led to persistently higher fiscal deficits. In 2022, the fiscal deficit fell to 5.8 percent of GDP (cash based; after 6.7 percent in 2021, the second year of the pandemic), aided by modest tax reforms and the dampening impact of an unanticipated sharp increase in inflation on spending in real terms[3,4]. But consolidation has stalled in 2023, with the deficit reaching 3.6 percent of GDP in the first nine months, compared with 3.0 percent last year. Pandemic support has been phased out, and fiscal measures to contain energy prices, largely financed by windfall taxes, are winding down.

6. **The current account deficit is declining but remains also large.** Past analysis suggests that the fiscal deficit is the main structural driver of the current account imbalance.[5] Nonetheless, while the fiscal deficit fell in 2022, the current account deficit widened to 9.3 percent of GDP on account of strong domestic demand and surging import prices. In the first two quarters of 2023, the current account deficit declined to 6.8 percent of GDP as real imports fell. Current EBA estimates—based solely on the size of the current account

Romania: Real Effective Exchange Rate
(Different bases; index: 2013 = 1)



Sources: IMF databases, Haver database, and staff calculations.

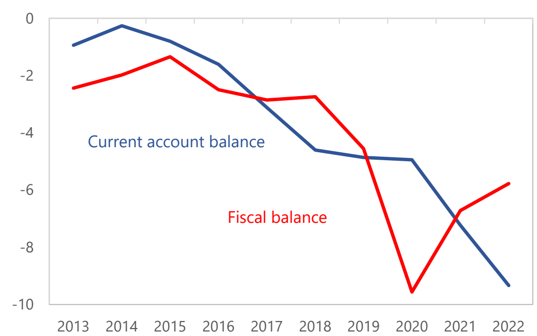
[3] The tax reforms included increasing the tax on dividends, reducing the threshold for CIT registration to €500,000 (still well above European norms), and closing some PIT loopholes (while introducing new ones).

[4] In ESA terms, the deficit in 2022 reached 6.1 percent of GDP, in line with the authorities' commitment to the European Commission.

[5] See Country Report No. 2022/311.

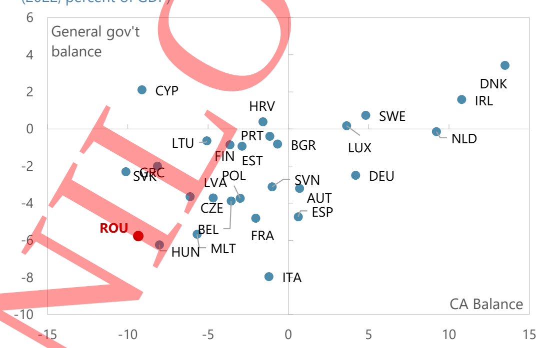
deficit—indicate an overvaluation of 17 percent in 2022, compared to 10 percent a year earlier.[6] However, the ULC-based REER estimate has depreciated, suggesting that competitiveness has not deteriorated. A large share of the current account deficit is driven by direct investment flows and rising inflows of EU resources (structural funds and the Recovery and Resilience Facility—RRF), which have also fueled a significant increase in international reserves.

Romania: Fiscal and Current Account Balances
(Percent of GDP)



Sources: Authorities, and IMF staff calculations.

EU: Current Account and General Gov't Balances
(2022, percent of GDP)



Source: World Economic Outlook.

7. **The financial sector remains robust.** The banking system has maintained its overall strong capital, liquidity, and profitability positions. With the monetary tightening, nominal credit growth has decelerated sharply since mid-2022, and real credit growth turned negative. Household and corporate debt is very low relative to peers.

8. **A grand coalition government of the social democratic (PSD) and liberal (PNL) parties has been in place since November 2021.** The position of Prime Minister switched from the PNL to the PSD in June 2023, as agreed at the formation of the coalition. In 2024, elections will be held at all levels (local, general, presidential, and European).

OUTLOOK AND RISKS

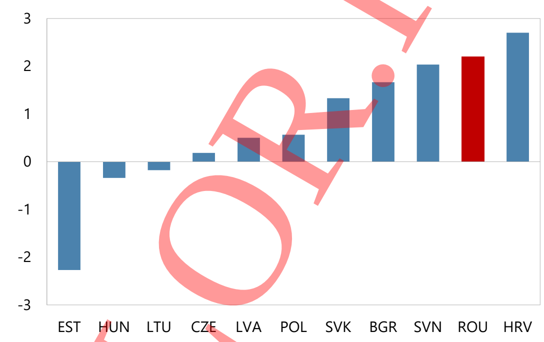
A. Outlook

9. **Despite the slowdown, growth is expected to remain robust.** In 2023, growth is projected to weaken to 2¼ percent. In 2024, the economy is forecast to recover modestly to growth of around 2¾ percent as stronger consumption—driven by rising real wages—and external demand are partially countered by the necessary fiscal consolidation. In the medium term, the economy is expected to return to its potential growth rate of 3¾ percent as consumption and exports recover further, and investment, underpinned by RRF funds, remains strong.

[6] The EBA current account model suggests that Romania's external position in 2022 was substantially weaker than implied by underlying fundamentals and desirable policies, implying overvaluation (Annex IV). However, the large unexplained residuals point to significant uncertainty.

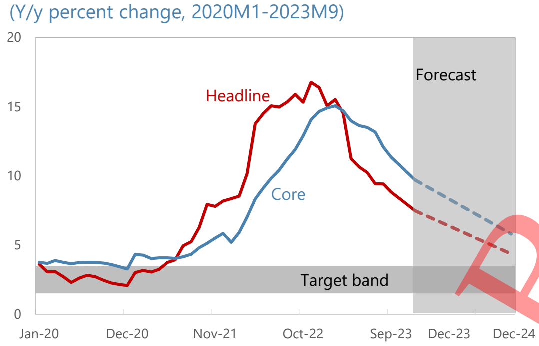
10. CPI inflation is projected to remain outside the NBR's target band into 2025Q1. Headline inflation declined to single digits in July 2023 and is expected to return gradually to the target band by 2025Q1 on the back of weaker economic growth and falling prices for food and energy, which represent almost half of the consumption basket. However, with double-digit wage increases in 2023, outpacing headline inflation, and a tight labor market, core inflation is expected to fall more slowly, reaching single digits only in 2023Q4.[7]

CESEE-EU: Projected Real GDP
(2023, percent change)



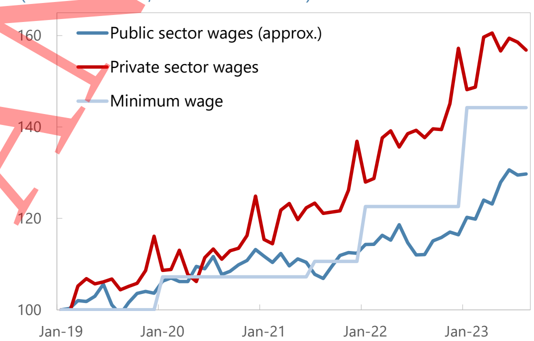
Source: IMF World Economic Outlook Database.

Romania: Inflation
(Y/y percent change, 2020M1-2023M9)



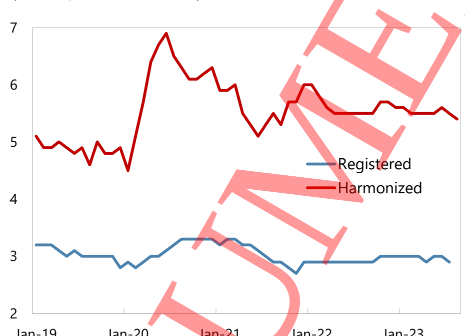
Sources: Haver Analytics and IMF staff calculations.

Romania: Average Gross Monthly Wage
(Jan-2019=100, 2019M1-2023M8)



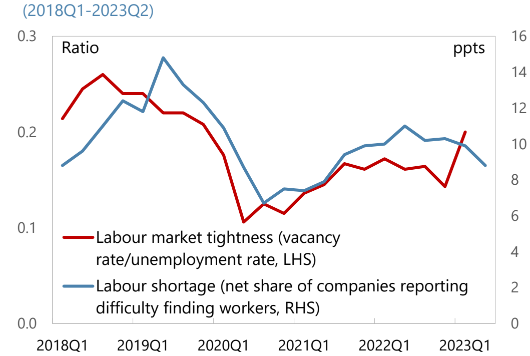
Sources: Eurostat, Haver Analytics; and IMF staff calculations.

Romania: Unemployment
(Percent, 2019M1-2023M8)



Source: Haver Analytics.

Romania: Labor Market Tightness
(2018Q1-2023Q2)



Sources: NBR calculations and estimates.

[7] Annex II discusses the effects of rising wages in greater detail.

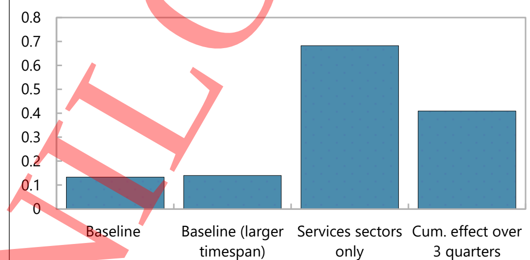
Box 1. Romania: Pass-Through from Wages to Inflation[1]

Wage growth in Romania—both in real and nominal terms—has been high. The transmission of wages to inflation is shaped by (i) the impact of wages on the cost of production, (ii) the pass-through from producer prices to consumer prices, and (iii) the relative weight of different goods and services in the overall consumption basket of households. This box focuses on (i) and (iii).

Regression results suggest that a 1 percent wage increase is associated with an increase in PPI inflation by 0.13 percentage points, on average and across all sectors. The effects are larger in certain sectors and accumulate over several quarters. For instance, pass-through in the service sector is about 6 times higher than for the average sector, and the cumulative pass-through over 3 quarters is about 4 times larger than the contemporaneous effect. Estimates are based on regressing sectoral PPI inflation on sectoral gross wages using fixed effects to control for a range of unobserved and potentially confounding factors including sector-specific seasonality and annual changes in sector-specific productivity.

Romania: Estimated Effects of Wage Growth in PPI Inflation

(Increase in PPI inflation a result of a 1 percent increase in wages, percentage points)



Sources: National Institute of Statistics; IMF staff estimation.

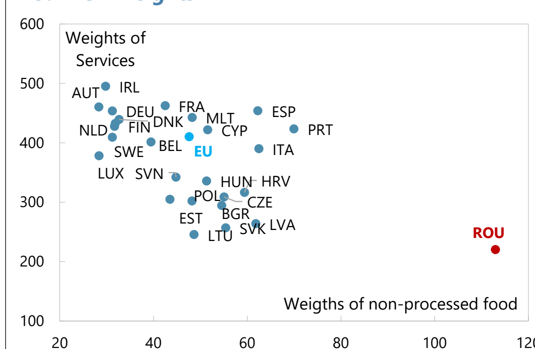
Notes: Effects refer to the same quarter, unless otherwise noted. Baseline sample covers 2016-2023 period.

While the effects of wage increases on PPI inflation can be substantial, its effects on overall CPI inflation is likely somewhat cushioned by the composition of the consumption basket (relative to other EU countries).

- First, consumption of services is low. The regression results reflect that domestic wages matter more for services than for most goods because services are less tradeable and have a higher labor component.

- Second, Romania has by far the highest consumption share of non-processed food (which is arguably the consumption category least affected by market wages), also suggesting that home production is more important than in other countries.

EU: HICP Weights



Source: Eurostat.

[1] See Annex II.

11. **Staff project the 2023 deficit at 6 percent of GDP, well above the target of 4.4 percent agreed with the European Commission.** Revenues are falling short of optimistic budget projections, and expenditures have risen well above planned levels, including due to large wage increases for teachers, health workers, and military personnel, and spending overruns in goods and services and interest payments. In response, the authorities in September 2023 adopted a fiscal package to limit spending and raise additional revenues. Its impact this year is likely marginal, but it will be fully into effect at the start of 2024 and improve public finances in that year and beyond by about 1 percent of GDP, resulting in a deficit forecast just above 5 percent of GDP in 2024.

2023: Budget and Projections
(% GDP)

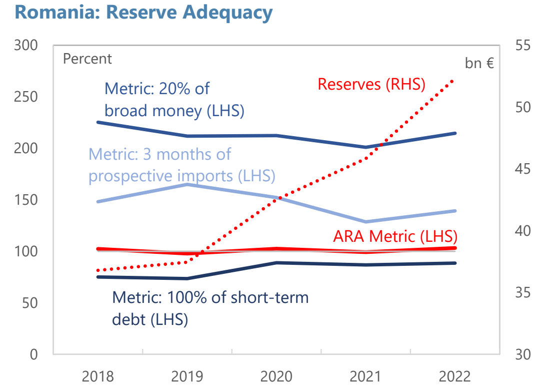
	Budget	Staff Proj.
Revenue	33.1	31.3
Tax revenue	27.1	25.7
Direct taxes	15.9	15.2
Indirect taxes	11.2	10.5
Nontax revenue	3.1	2.9
Grants	3.0	2.7
Expenditure	37.5	37.3
Expense	34.0	34.6
Personnel	8.2	8.4
Goods and services	4.8	5.1
Interest	1.9	2.4
Transfers	18.3	17.8
Other	0.8	0.8
Capital	3.5	2.7
Net lending/borrowing	-4.4	-6.0

12. **The current account deficit, while narrowing, is set to remain wide.** In 2023, the deficit is projected to fall to just under 7 percent of GDP in 2023 as domestic demand has slowed, import prices of energy have fallen, and services exports continue their strong upward trend. Over the medium term, owing to fiscal adjustment and—near the end of the projection horizon—declining EU capital grants, the current account deficit is projected to narrow somewhat further, but remain around 6 percent of GDP.

B. Risks

13. **There are several risks surrounding this outlook** (Annex III). The main risks stem from regional conflict (the war in Ukraine, re-emergence of tensions in Moldova), a possible further weakening of activity across Europe, and an abrupt global slowdown which could undermine growth and capital flows to emerging markets. A miscalibration of monetary policy by major central banks and continued strong wage growth could complicate monetary policy and delay the projected fall in core inflation. Finally, in 2024—given the multiple elections—it could be challenging to implement fiscal consolidation and the next steps under the National Recovery and Resilience Plan (NRRP), posing risks to the associated inflows of EU grants and to longer-term growth.

Romania: Reserve Adequacy



Sources: Authorities and IMF staff calculations.

14. **The large twin deficits create financial vulnerabilities, but substantial buffers contain immediate threats.** Importantly, the large current account deficit is mostly financed without reliance on debt. Large EU inflows bolster investor confidence, and Eurobond spreads over German bunds have fallen below levels seen in 2019 as the regional external financing environment has

improved for Romania. Central bank reserves—reinforced by the ECB's repo line—have increased significantly since 2019, and a substantial fiscal liquidity buffer also remains in place.[8] Even though budget deficits and gross financing needs are projected to remain elevated and debt to rise, there is some fiscal space.

Authorities' Views

15. The authorities broadly agreed with the staff's assessment of the outlook. Government officials stressed that public and private investments had been the key drivers sustaining growth, and the importance of continuing this performance. NBR officials concurred that growth in 2024 will likely be weaker than projected before. They noted that headline and core inflation were on a downward path and expected inflation to return within the tolerance band in 2025. They also highlighted this year's decline in the current account deficit, in part owing to rising services exports and they shared staff's view on the key risks.

POLICY DISCUSSIONS

The main policy challenge is to address the excessive structural fiscal deficit. Additional revenues need to be mobilized to meet pressing spending needs while resuming fiscal consolidation to stabilize public debt and reduce external vulnerabilities. Monetary policy should remain tight until inflation is fully under control. Reinvigorating structural reforms and boosting low labor force participation, especially among women, would support green and inclusive long-term growth.

A. Fiscal Policy

16. The authorities' fiscal package adopted in September is a step in the right direction, but significant further consolidation is needed. Fiscal deficits will need to fall below 3 percent of GDP, as agreed with the European Commission, to stabilize public debt over the medium term, help secure necessary market financing at lower interest rates, and support disbursement of EU funds. Additional adjustment by at least 2 percent of GDP in the next two years will be needed to reduce the fiscal deficit to 4½ percent of GDP in 2024, and below 3 percent by 2025. In this regard, the authorities' ongoing consideration of additional consolidation measures is welcome.

17. The scope to achieve further fiscal adjustment via reductions in spending or increasing revenue collection efficiency is limited. Ongoing spending reviews are welcome and could help streamline government expenditures over time but are unlikely to offer large savings. Furthermore, supporting an ageing population, addressing social needs, improving public services—especially education and healthcare—towards EU standards, and increasing defense expenditure, present legitimate upward spending pressures. Similarly, improvements in revenue administration (ongoing with IMF support), while needed, also do not offer quick or predictable results, and cannot be relied on to achieve the necessary near-term fiscal adjustment.

[8] Reserves have risen due to EU transfers and are broadly adequate.

Box 2. Romania: The New Fiscal Package

The new tax package improves policy design in some areas. It broadens the tax base and improves revenues by limiting exemptions to paying personal income tax (PIT) and health insurance contributions for workers in the agricultural, construction, food processing and IT sectors. It also reduces the number of goods subject to preferential VAT rates. These measures improve fairness and support fiscal adjustment in a growth-friendly way.

Impact of Revenue Measures, 2024
(% GDP)

PIT and SSC	0.4
CIT	0.3
VAT	0.2
Excises	0.1
Total	**1.0**

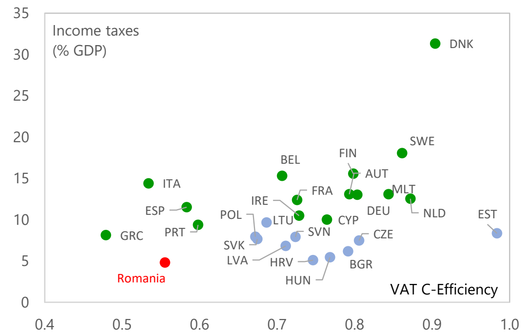
Other measures do not address design deficiencies in the tax code. The increase in the micro-enterprise tax from 1 to 3 percent of sales in some sectors will raise tax revenue; but to really close this loophole, the threshold for registering as a microenterprise should be reduced further, from €500,000 to about €100,000, more in line with EU norms. In addition, the new turnover taxes on banks and large enterprises are inefficient and imply higher taxes on companies with low margins, and may reduce financial intermediation. They should be reconsidered as early as possible.

The fiscal package also contains measures to limit spending and combat tax evasion. Staff do not foresee large or rapid savings from these steps, which include the reduction of vacancies and elimination of management positions in the public administration, and increased penalties, electronic tracking of goods, and reducing the threshold for cash payments for large transactions.

18. Further tax reforms are required to increase revenue, efficiency, and fairness (see Country Report No. 22/310). Romania's tax revenue is one of the lowest in the EU as a share of GDP. Key measures to consider are (i) elimination of remaining exemptions, privileges and loopholes, including in the PIT and the micro-enterprise regime; (ii) further VAT streamlining to raise efficiency towards the EU average; (iii) implementing the reformed property tax; and (iv) using tax policy to promote the efficient use of energy and, more broadly, foster the transition to a carbon-neutral economy (see below). Moreover, once the PIT has been streamlined, consideration should be given to introducing progressive income taxation, which would help mitigate Romania's high income inequality. Overall, the distributional impact of any tax package would need to be taken into account, and part of the additional revenue could be needed to alleviate the burden on lower-income households, e.g., by introducing a zero income tax bracket and/or increasing means-tested social transfers.

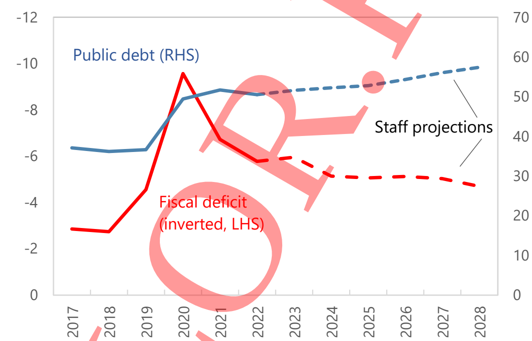
19. Staff projections do not incorporate a draft pension law that was presented in November 2023. This law could increase public spending by around 0.5 percent of GDP in 2024 and more in 2025 compared with the current baseline projections. The higher upfront costs stem from a pension recalculation as part of a broader reform of the pension law included under the NRRP. Measures envisaged to more than offset this upfront cost, however, are set to take effect only in the medium to longer run, and their impact is uncertain. It would be prudent to phase in the recalculation gradually to align it with the realization of expected savings or offset the short-term impact through additional fiscal measures. Otherwise, the feasibility and credibility of the envisaged fiscal consolidation could be undercut.

EU: VAT C-Efficiency and Income Taxes
(2021) 1/



Sources: Eurostat, and staff calculations. 1/ Excludes Luxembourg.

Romania: Fiscal Projections
(Percent of GDP)



Sources: Authorities, and IMF staff estimates and projections.

20. Fiscal policy also needs to be well planned and clearly communicated. Establishing a credible path for medium-term fiscal consolidation will help secure market financing at lower borrowing costs. Early communication and consultation on tax policy changes are also critical. Ad-hoc changes create uncertainty and undermine the ability to plan for households and firms. In this regard, the establishment of a tax policy unit in the Ministry of Finance is welcome as it may facilitate developing a medium-term revenue strategy, and design and analyze tax policies well in advance of their implementation. Spending on public sector wages and pensions also needs to be become more predictable, and the planned reforms in these areas in the context of the NRRP are vital. These steps would help improve medium-term budgeting.

21. It will be critical to make full use of the available EU support. EU funds available through 2026 from the RRF and RePowerEU total 1½ percent of GDP per annum, in addition to the 1¼ percent of GDP in cohesion funds in the EU's 2021–27 budget period. With regard to the RRF, the second payment was disbursed in October 2023.

Authorities' Views

22. The government foresaw that the fiscal deficit could be contained below 6 percent of GDP in 2023 and reaffirmed its commitment to reduce it further to no more than 3 percent of GDP over the medium term. With regard to the deficit in 2023, they stressed that supporting Ukrainian refugees, and investments to improve infrastructure close to the border with Ukraine, imposed significant costs, while defense spending was being raised to 2.5 percent of GDP on a structural basis. They also pointed to expenditure measures already taken before the adoption of the fiscal package in September, and stepped-up efforts to improve revenue administration, that were expected to help contain the deficit going forward. They highlighted the importance of the recent fiscal package for underpinning fiscal consolidation in 2024 and beyond, including the additional measures to enhance expenditure efficiency and fight tax evasion, in part by speeding up digitalization. At the same time, the authorities acknowledged that further tax reforms would still be needed.

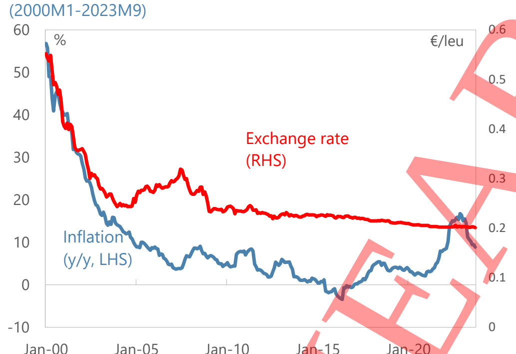
23. The authorities stressed their determination to continue meeting the policy milestones under the RRP. They explained that they had submitted a proposal for a revising parts of the RRP (which became necessary as Romania's allocation of funds had been reduced by €2 bn). They pointed out that Romania would be the sixth EU member state whose second payment request was disbursed, and anticipated submitting the third payment request before the end of 2023.[9] They noted that the preparations for critical forthcoming RRP milestones were on track, including for reforming the special pensions, the broader pension system, and the public wage system.

B. Monetary and Financial Sector Policies

Monetary Policy

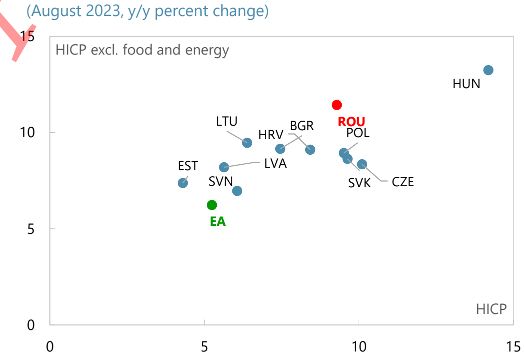
24. **Romania's monetary policy framework, with a relatively stable exchange rate to the euro, supported price stability in the decade prior to the pandemic** (Annex I). Romania enjoyed a high degree of price stability from the mid-2000s until 2022, similar to peers, with a gradual and stable path of depreciation of the leu against the euro. Nonetheless, monetary policy challenges arise from partial euroization and a small financial sector—which limit policy transmission—and a high share of food and energy in the CPI, with prices that are largely exogenous. Furthermore, volatile capital flows can upset monetary conditions and create uncertainty.

Romania: Exchange Rate and Inflation
(2000M1-2023M9)



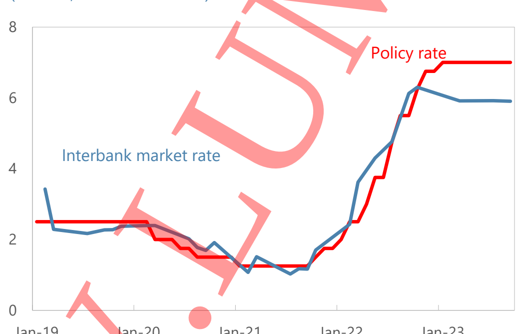
Sources: Haver Analytics and IMF staff calculations.

CESEE: Inflation
(August 2023, y/y percent change)



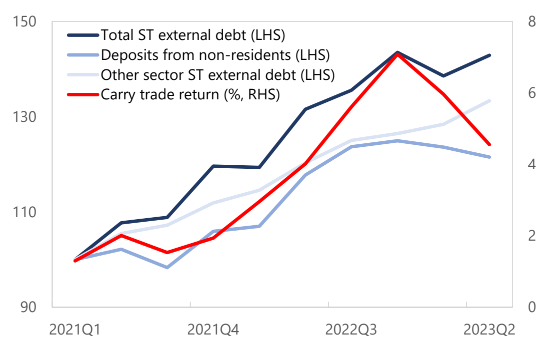
Sources: Haver Analytics and IMF staff calculations

Romania: Interest Rates
(Percent, 2019M1-2023M9)



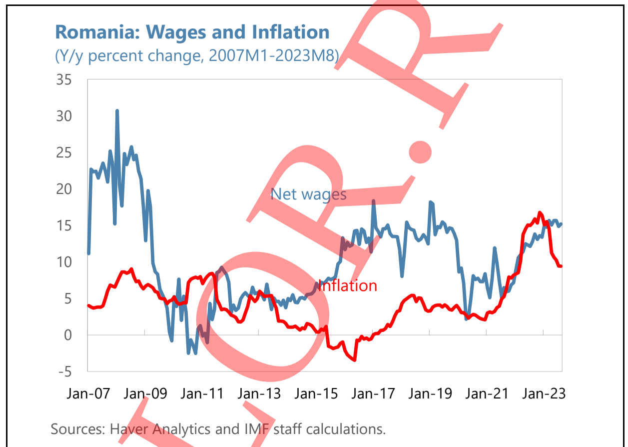
Sources: Haver Analytics and IMF staff calculations.

Romania: External Debt and Carry Trade Returns
(2021Q1=100, 2021Q1-2023Q2)



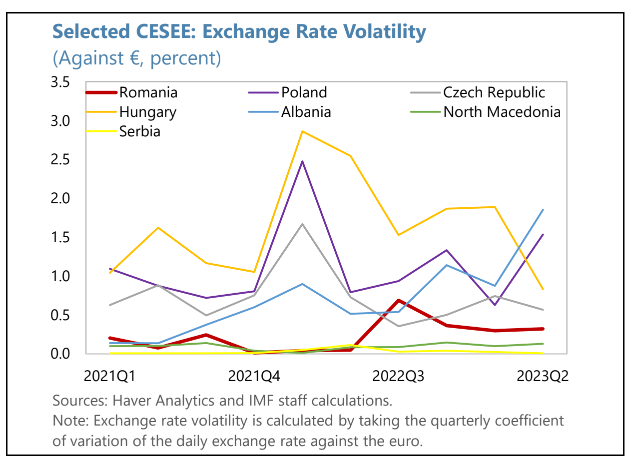
Sources: Haver Analytics and IMF staff calculations.

[9] The second payment has since indeed been disbursed.



25. The recent inflationary episode has put this framework to the test (see Annex I on the Integrated Policy Framework)**.** The NBR responded strongly to the inflation surge by raising its policy interest rate in 2022 broadly in line with CESEE peers to 7 percent by January 2023 and has appropriately not ruled out further increases. This contractionary monetary policy stance has helped curb inflation and anchor inflation expectations. However, in the context of large injections of liquidity due to financial inflows for the government budget, and with rising appreciation pressures associated with carry trade, the NBR allowed liquidity to rise in early 2023, causing market rates to fall below the policy rate, thereby weakening the cumulative tightening and potentially sending conflicting messages.

26. While price pressures are moderating, the NBR should maintain a cautious approach to ensure inflation returns within the tolerance band around the target by early 2025. Monetary policy tightening has helped reduce inflation and keep inflation expectations anchored. Looking forward, the NBR's public commitment to keep rates on hold until 2024 is appropriate in light of still-elevated core inflation and upside risks from strong wage growth, fueled in part by recent public sector wage increases (Annex II). A relaxation of monetary policy should therefore wait until core inflation is on a firm downward path such that the target range is clearly within reach. A cautious approach is also appropriate in light of still moderately elevated inflation expectations. The staff's baseline assumes a gradual reduction in the policy rate from mid-2024 through 2025, consistent with the projected disinflation towards the NBR target, and with the real rate remaining at or above the current level. Moreover, there is a strong case for implementing any reduction in interest rates in a gradual manner, given the high uncertainty about the inflation process, monetary transmission, and fiscal policies. In case of a meaningful upward revision of projected core inflation, the NBR should stand ready to tighten monetary policy, including liquidity management, as needed. The government's price controls for food items, on the other hand, are not a suitable instrument for lowering inflation as they can compress supply and raise prices of other goods. Staff also suggested developing more comprehensive and detailed surveys on inflation expectations.



27. The recent increase in exchange rate volatility could set the stage for permanently allowing greater exchange rate flexibility. The NBR has let exchange rate volatility increase somewhat since mid-2022, which usefully reminded borrowers and carry traders of the risks associated with balance sheet mismatches. A gradual increase in two-way exchange rate flexibility over the medium term would limit opportunities for destabilizing capital flows, increase monetary policy effectiveness, and enhance resilience to economic shocks. In conjunction with fiscal consolidation, it would also help strengthen Romania's weak external position.

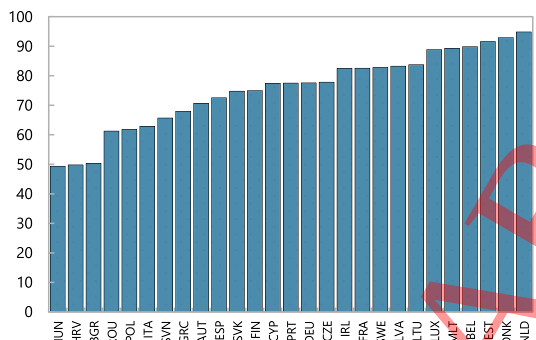
Box 3. Romania: Weak Monetary Pass-Through to Mortgages

Potentially, mortgages are an important channel through which monetary policy affects household demand. Mortgages are the largest part of household debt in Europe, varying from about half of household debt in Hungary to more than 90 percent in the Netherlands.

In Romania, the transmission of monetary policy via outstanding mortgages is still very low:

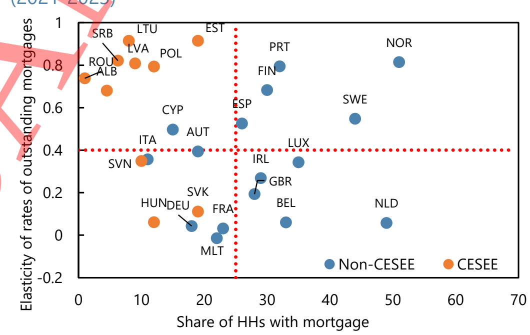
- Debt service of existing mortgages is responsive to changes in policy rates as in many other CESEE countries, given the relatively high share of flexible rate mortgages in new mortgages.
- However, Romania's has a relatively low share of households with mortgages, and mortgage debt represents less than 8 percent of GDP, compared with above 30 percent on average in the EU.

EU: Housing Loans
(Percent of total household debt, 2023M6)



Sources: ECB and IMF staff calculations.

Selected Countries: Transmission via Outstanding Mortgages
(2021-2023)



Sources: ECB, Haver Analytics, National Authorities and Beyer et al. (2023)

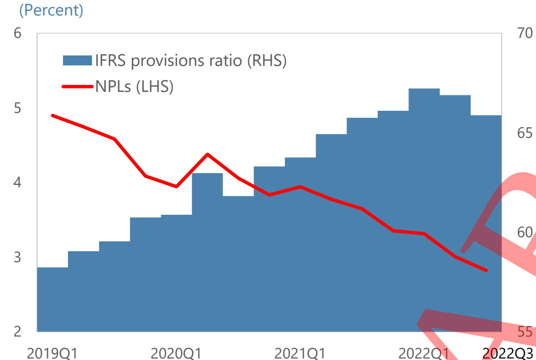
Authorities' Views

28. The NBR concurred with the thrust of staff's monetary policy advice, in particular that a cautious approach was warranted in light of upside risks to inflation. The NBR saw wage pressures, the fiscal path, and international commodity prices as the main sources of these risks. The authorities pointed to the recent rise in bank savings and the decline in bank lending, in particular in domestic currency, as evidence on the effectiveness of monetary transmission. They agreed that greater exchange rate flexibility could be desirable in principle, but also noted that, at the current stage, its stability offered a key anchor for broader economic stability. The authorities maintained formal euro adoption as a long-term objective but considered that the various conditions that would need to be fulfilled implied a high bar for joining the euro area.

Financial Sector Policies

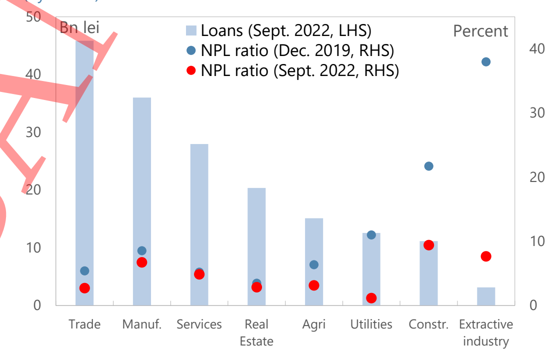
29. The banking sector remains sound, and systemic financial sector risks are limited. The banking system maintains its overall strong capital, liquidity, and profitability positions. The ongoing consolidation in the banking sector through the acquisition of smaller, less profitable banks with weaker capital positions by larger banks has strengthened the sector. The recent two-step increase of the countercyclical capital buffer to 1 percent by 2023M10 and the lowering of loan-to-value ratios for second homes appropriately bolsters banks' resilience, supports monetary policy, and helps bring down credit growth. Bank funding is solid with strong reliance on deposits (of which a relatively high share is insured). Profitability remains strong and NPL ratios are falling. While banks' exposure to real estate is relatively high, residential real estate prices have increased over recent years at a pace below peers, and by some measures remain undervalued. Rents in prime commercial real estate (CRE) have been broadly remained stable, and NPLs in sectors linked to CRE (real estate, construction) are much below pre-pandemic levels. Initially high unrealized losses of the large government bond portfolio held by banks have subsided in line with a decrease in yields and thanks to the maturing of some of the bonds. The banking turmoil in the U.S. and Switzerland had only limited effects on the banking sector, given its low reliance on wholesale funding. However, the planned turnover tax on banks could undermine already-weak financial intermediation and gradually weaken financial buffers of banks.

Romania: Non-Performing Loans
(Percent)



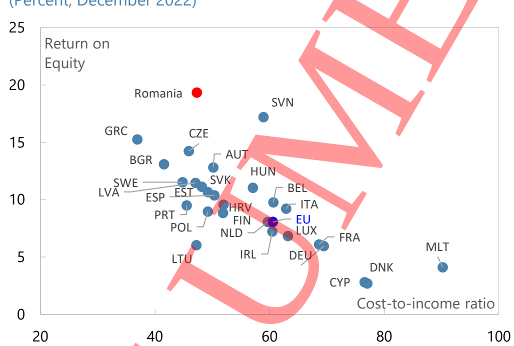
Source: IMF Financial Soundness Indicators.

Romania: Loans and NPL Ratios
(By sector)



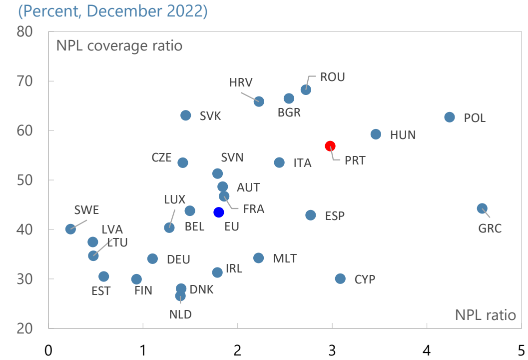
Source: National Bank of Romania.

EU: Return on Equity and Cost-to-Income Ratio
(Percent, December 2022)



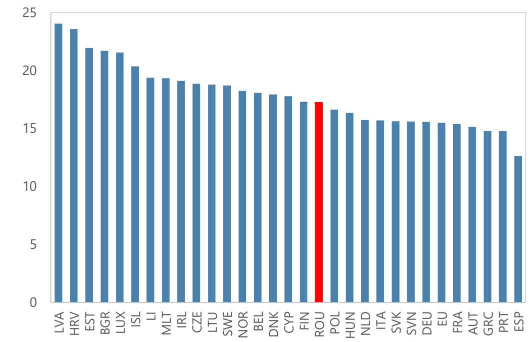
Source: European Banking Authority.

EU: NPL Ratio and NPL Coverage Ratio
(Percent, December 2022)



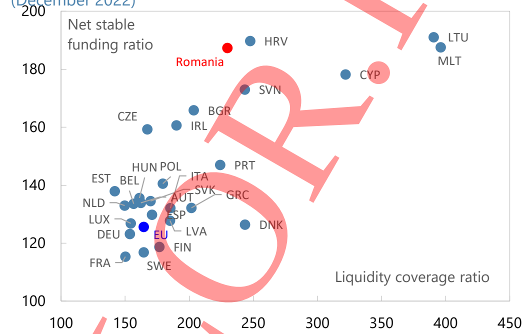
Source: European Banking Authority.

EU: CET1 Ratio
(December 2022)



Source: European Banking Authority.

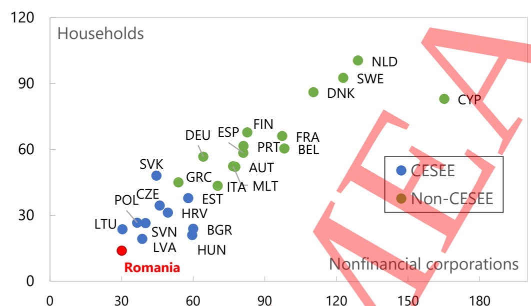
EU: Net Stable Funding Ratio and Liquidity Coverage Ratio
(December 2022)



Source: European Banking Authority.

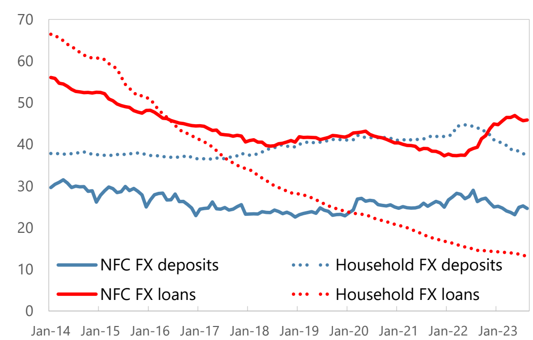
30. While real credit growth remains negative, emerging risks from the recent increase in corporate FX borrowing should be monitored. Real credit growth remains negative, and household and corporate debt is very low relative to peers, limiting the potential fallout from interest rate increases. Strict borrower-based macroprudential measures have discouraged a switch to FX loans by households. However, corporate FX debt has increased sharply since 2021 in response to the larger interest rate differential to the euro. Banks and supervisors monitor FX borrowing by non-financial corporations and should scrutinize that it is appropriately hedged, including through reliable sources of income from abroad.

EU: Private Sector Debt
(Percent of GDP, 2021)



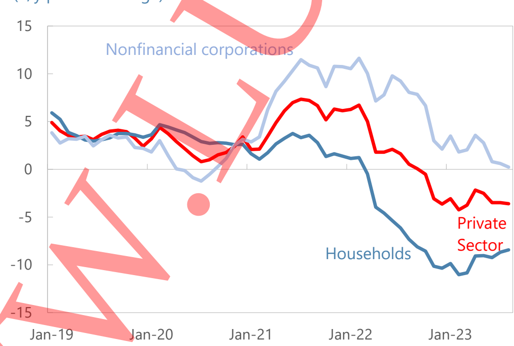
Sources: Eurostat and European Central Bank.
Notes: Data for BEL, HRV, FRA, GRC, POL, PRT, ROU and SVK are from 2022.
Excludes LUX.

Romania: Euroization
(Percent of respective total, 2014M1-2023M8)



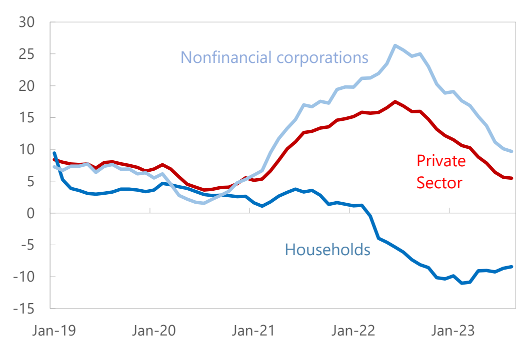
Sources: Haver Analytics and IMF staff calculations.

Romania: Real Credit Growth
(Y/y percent change)



Sources: National Bank of Romania; and IMF staff calculations.

Romania: Nominal Credit Growth
(Y/y percent change)



Sources: National Bank of Romania; and IMF staff calculations.

31. Improvements to the AML/CFT framework and its implementation are important. The MONEYVAL Mutual Evaluation Report of May 2023 found that, in most respects, the elements of an effective AML/CFT system are in place, but that its effectiveness is insufficient in 10 out of 11 pre-defined areas, and Romania currently falls under MONEYVAL's enhanced follow-up process. The key risks identified include tax evasion, corruption, and human trafficking The report identified a number of priority actions, in particular, increasing resources and capacity of the financial intelligence function, improving parallel financial investigations, strengthening asset tracing, establishing a risk-based supervisory function, improving reporting by financial intermediaries, improving beneficial ownership information, developing a national CFT strategy, and enhancing solutions for data collection.

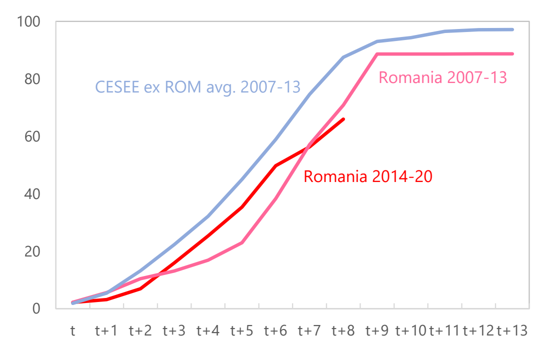
Authorities' Views

32. The authorities broadly concurred with staff's analysis, did not see major immediate financial sector risks, and agreed that the increase in FX borrowing merited close monitoring. They welcomed the ongoing consolidation in the banking sector. They broadly agreed with the recommendations of the recent MONEYVAL report, had prepared a draft action plan for its implementation, and reported progress in upgrading IT systems, notwithstanding practical difficulties in resolving IT and staffing bottlenecks.

C. Structural Reforms

33. Despite significant progress, Romania still lags peers in absorbing EU funds. The authorities have stepped up efforts to use cohesion and NRRP funds more fully. Going forward, strengthening the medium-term budget framework, and developing a centralized coordination mechanism and a pipeline of appraised investment projects across sectors, as recommended in last years' PIMA, would be helpful.

EU: Absorption of EU Structural Funds
(Cumulative EU payments as percent of total planned amounts)



Sources: European Commission, and IMF staff calculations.

34. The NRRP provides an important opportunity for advancing structural reforms. In addition to fiscal structural reforms, it envisages reforms to increase transparency, strengthen public sector efficiency and governance, and improve the monitoring of state-owned enterprises (SOEs).

- *Improving the management and monitoring of SOEs would enhance efficiency.* A new independent agency to monitor SOEs (216 under the central government, and around 1,300 under local governments) is being established, and new legislation strengthening the criteria and processes of appointing their board members is under preparation.

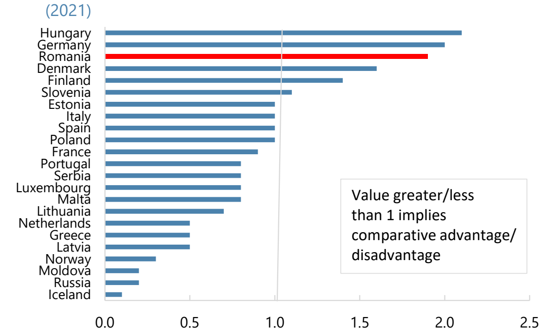
- *The effective implementation of digitization remains a bottleneck*. In the tax administration—a priority area—taxpayer services are being digitalized, and cash registers connected. Furthermore, a legal framework for digitalization of government cloud services is being created.

- *Improving governance would help reduce informality and inequality*. Key areas for reform include strengthening anti-corruption institutions; enhancing regulation with respect to conflicts of interest (consideration non-financial interests; disclosure requirement for members of parliament; rules on dealings with lobbyists); strengthening whistleblower protection by transposing EU Directive 2019/1937; and strengthening recovery of assets lost to corruption.

35. **Raising labor force participation (LFP) is important in light of Romania's ageing and declining population.**[10] Romania's LFP is among the lowest in the EU. Closing the LFP rate gap of 9½ percentage points to the EU average would increase the labor force by about 14½ percent, ease labor shortages, and raise potential GDP by about 6½ percent, helping to sustain growth and reduce inequality. It would also raise tax revenue. Policies should focus on helping women work in the formal economy through better availability of childcare and part-time jobs. Investing in the quality of education—where Romania lags EU peers—would also help raise labor supply and productivity. These measures should be prioritized as they take time to implement and yield returns.

36. **Climate change is macro-critical for Romania.**[11] In particular, climate change entails an increased risk of drought. This would have an adverse impact on agriculture which accounts for 4½ percent of the economy and 21 percent of employment. Moreover, electricity generation using hydropower (which provides 30 percent of Romania's electricity) and nuclear power could also be affected. Lastly, Romania's old and less-resilient infrastructure stock is vulnerable to climate-related disasters (e.g., flooding) and costly to maintain. At the same time, decarbonization will entail significant costs. In total, climate mitigation investment needs in crucial sectors like electricity, buildings, and transport could amount to nearly 3.2 percent of cumulative GDP by 2050.[12] However, the transition to a low-carbon economy also offers opportunities for Romania. With its large potential for renewables (and hence also for green hydrogen), and a comparative advantage in low-carbon tech products, Romania is well-positioned to benefit from accelerated decarbonization and become more competitive in green value chains.

Selected Countries: Comparative Advantage in Low-Carbon Tech Products
(2021)



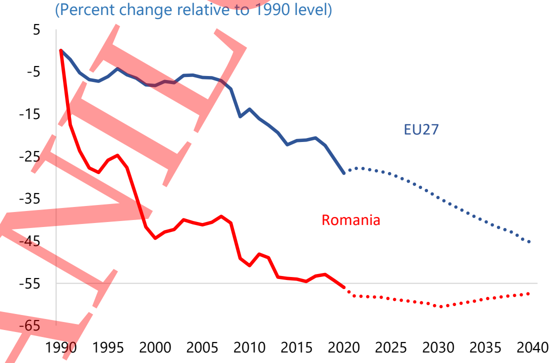
Sources: IMF climatee change dashboard, and staff calculations.

[10] See Selected Issues Paper "Labor Force Participation in Romania".

[11] See Selected Issues Paper "Making Romania Fit and Resilient for the Net-Zero Transition".

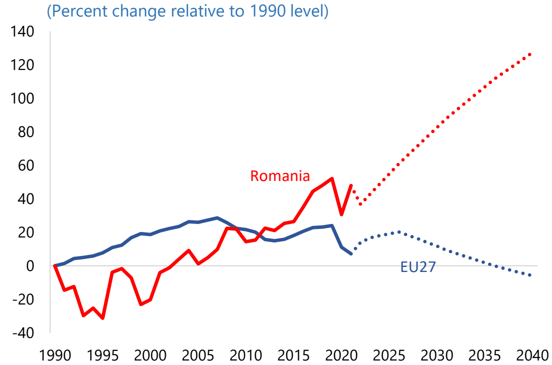
[12] A large share of the estimated green investment needs are expected from the private sector, underscoring the urgency for structural reforms that promote private sector development (World Bank 2023: Romania Country Climate and Development Report, available at: www.worldbank.org/en/country/romania/publication/country-climate-and-development-report-for-romania).

37. Romania seems well on the way to reaching the EU's interim target of a 55 percent reduction of greenhouse gas (GHG) emissions by 2030 (relative to 1990), but achieving net zero by 2050 will be challenging. By 2019, Romania's GHG emissions had already declined by about 54 percent, and are projected to remain below the threshold through 2030. However, while emissions from electricity production are set to decline further, in hard-to-abate sectors especially, transportation and buildings, they are rising. The pathway to carbon-neutrality by 2050 is therefore uncertain and depends on the effectiveness of further measures.



Sources: European Environment Agency.

38. The Integrated National Energy and Climate Plan (INECP) is currently being updated to achieve the EU-wide targets. It envisages the phase-out of electricity generation from coal, while investments in natural gas (acting as a transition fuel), renewables, storage and transmission are being accelerated to ensure energy security. Several sectoral green schemes are in place, targeting increased renewable energy generation (e.g., the National Hydrogen Strategy; contract-for-difference for renewables), and strict energy efficiency standards for buildings. The NRRP offers significant resources (41 percent of total support) to this end, including for climate adaptation. However, there are also gaps in the regulatory framework, e.g., with regard to green finance, and incentivizing energy efficiency in the building and transport sectors.



Sources: European Environment Agency.

39. In addition to investments, subsidies, and regulatory tools, the authorities should make greater use of tax instruments to support the green transition. A complementary carbon tax in the transport and building sectors, which are not yet covered under the EU ETS regime, could help reverse the ongoing rise in emissions in these sectors while generating substantial fiscal revenues. Revenue from such taxes would need to be used efficiently to boost growth, e.g., by lowering labor income taxes, or investing in infrastructure (World Economic Outlook, October 2022). Indeed, with strong domestic policies, such taxes could support growth, in part because the output and employment multipliers of carbon taxes are lower than of income taxes. Additional excise taxes on fossil fuels could achieve similar goals, and reduce the existing implicit subsidies on diesel fuel, while promoting electric mobility. In implementing these policies, vulnerable households should receive targeted support—recycling part of the tax revenues—but not be exempt from green pricing policies.

Authorities' Views

40. **The authorities were confident of their ability to raise absorption of EU funds.** With regard to cohesion funds, they pointed to already-improved performance in the EU's 2013–20 budget cycle and expected to achieve an absorption rate of close to 95 percent. Moreover, contracting for projects envisaged in the 2021–27 budget cycle had already started. In addition, they were planning to further decentralize decision-making, with incentives and performance indicators for subnational governments.

41. **Government officials concurred that raising LFP was an important policy objective.** They noted ongoing programs to identify and support specific groups with low LFP. While they acknowledged that resources to this end were insufficient, they also suggested that the large seasonal migration of Romanian workers posed, aside from measurement problems, idiosyncratic challenges to incentivizing higher LFP. They agreed that raising women's LFP, and improving education outcomes were essential.

42. **The authorities broadly agreed with priority areas for governance reform.** They mentioned that important work is under way, including to enhance recovery of assets financed or lost through bribery.

43. **The authorities concurred with staff on the importance of reaching the EU's emissions targets.** They explained that current policies would be upgraded to reach these targets. They also indicated that the update of the NECP was imminent, and they pointed to the significant investments to strengthen energy infrastructure under the NRRP. However, they also indicated that accessing EU funds by the private sector had involved delays. With regard to carbon taxes, they noted that the expansion of the ETS was planned at the EU level for 2027–28.

STAFF APPRAISAL

44. **Romania's economy has performed relatively well in difficult times.** Growth, while slowing, remains fairly robust, and higher than in most peers. Inflation, after peaking at lower levels than in CESEE peers, remains too high but is receding gradually. The impressive convergence to Western European income levels is continuing. At the same time, Romania's external position in 2022 was substantially weaker than the level implied by fundamentals and desirable policies, although the assessment is subject to considerable uncertainty.

45. **Growth is expected to recover modestly in 2024, and to return to its potential rate in the medium term, but there are substantial risks.** Escalation of the war in Ukraine, a possible further weakening of activity across Europe, or an abrupt global slowdown could undermine growth and capital flows to emerging markets. Prolonged strong wage growth in Romania could delay the projected fall in core inflation. Finally, the electoral calendar could make fiscal consolidation and structural reforms in 2024 difficult to achieve.

46. **A weak fiscal position renders Romania vulnerable.** The scope to respond to adverse developments is circumscribed by a structural budget deficit well in excess of sustainable levels.

Addressing this is a key priority Continued efforts to improve expenditure efficiency and tax collection are needed and welcome, but high spending pressures to address relative poverty and raise productivity imply that revenues must be increased.

47. The recently adopted fiscal package offers a welcome improvements in tax policy and should help reduce the fiscal deficit somewhat in 2024; but more will be needed. In particular, the reduction of some tax exemptions it is a step forward. However, some measures—notably the new turnover taxes—are not in line with good practice and should be reconsidered. Moreover, further tax reforms to raise at least 2 percent of GDP in additional revenue beyond the gains from the recent tax package are needed to put the fiscal deficit on a sustainable medium-term trajectory, while ensuring that all taxpayers pay their fair share. Streamlining VAT and personal income taxes (including the closing of loopholes and the removal of tax privileges) should be key elements of such a reform. Once this is achieved, consideration should be given to re-introduce progressive income taxation.

48. Tax and expenditure policies will need to become more predictable. Announcing further tax reforms well in advance will help companies and households adjust to these changes. Spending on pensions and public sector wages should be set on a sustainable formula-based trajectory, as envisaged in the NRRP. These steps should help improve medium-term budgeting, and underpin a credible path for the necessary fiscal consolidation. The new draft pension law would help reduce spending over the longer run, but generate upfront fiscal costs that could jeopardize efforts to reduce the deficit in the next few years. A gradual phase-in of these costs and prudent implementation are needed to avoid this risk.

49. Monetary policy should not be relaxed until core inflation is on a firm downward path as needed for returning headline inflation within the tolerance band by early 2025. Inflation is declining broadly in line with projections, but risks arise from strong wage growth. Moreover, the monetary authorities should also stand ready to tighten monetary policy if upside risks to core inflation materialize.

50. The recent episode of higher exchange rate volatility offers an opportunity to gradually increase two-way exchange rate flexibility over the medium term. This would reduce opportunities for destabilizing capital flows, raise monetary policy effectiveness, and enhance resilience to economic shocks. In this context, it is important to move gradually to preserve confidence gains made over the past decade. Enhanced data on inflation expectations would support the calibration of monetary policy.

51. While financial sector vulnerabilities are limited, emerging risks need to be monitored. Strong fundamentals of the financial sector underpin its resilience, but the recent increase in corporate FX borrowing warrants close scrutiny. The turnover tax on banks could, if maintained for an extended period, weaken banks' financial buffers and already-low financial intermediation.

52. Improvements to the AML/CFT system should be swiftly implemented. Building on ongoing progress, the authorities should compile an overarching AML/CFT strategy to ensure the effective functioning of the AML/CFT system.

53. There is significant room to underpin real income growth and further convergence with Western Europe. This requires investment in physical infrastructure as well as people, and strengthening the efficiency of the state.

- *Making the most of available EU support is critical—both to* help finance much-needed investment, and to support implementation of the agreed reform agenda.
- *Governance reforms are critical,* including to enhance administrative capacity and transparency, fight corruption, and make SOEs more efficient. Such reforms would reinforce Romania's attractiveness for investment and also counteract continued (though declining) net outmigration.
- *Raising labor force participation is key to mitigating the effects of a falling population.* Increasing opportunities for women to join the formal labor force, and improving education outcomes to enhance opportunities for all are especially important.

54. Advancing the green transition of Romania's economy is vital. Reducing GHG emissions in line with EU and updated NECP targets is challenging, even though Romania's electricity production is already dominated by low-carbon sources. In particular, the emissions by transport and housing sectors are difficult to address. This not only requires large and well-coordinated investments, but also a complementary set of policies to mitigate the social impact of the transition. Such policies should disincentivize carbon emissions (including through taxation) while shielding compensating low-income households. The scheduled closure of coal mines will require special efforts to provide compensation and new opportunities for affected households. Romania's large potential for renewable energy offers it important opportunities to benefit from decarbonization and become more competitive in green value chains.

55. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

Proposed Decision

The following decision, which may be adopted by a majority of votes cast, is proposed for adoption by the Executive Board.

The Executive Board endorses the thrust of the staff appraisal in the report for the 2023 Article IV consultation with Romania (SM/23/238, 11/17/2023).

It is expected that the next Article IV consultation with Romania will take place on the standard 12-month cycle.

Table 1. Romania: Main Economic Indicators, 2019–28
(Annual percent change, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
NATIONAL ACCOUNTS										
Real GDP (expenditure)	3.9	-3.7	5.7	4.6	2.2	2.7	3.6	3.8	3.8	3.7
Final domestic demand	5.8	-2.1	5.5	6.1	4.2	2.7	3.2	3.8	3.9	3.7
Consumption	4.0	-3.0	6.3	6.3	2.5	2.6	2.8	3.9	4.0	3.7
Private	3.4	-3.9	7.2	6.9	2.6	3.0	3.1	3.9	4.0	3.6
Public	7.2	1.1	1.8	3.1	1.6	0.3	1.5	4.3	3.9	3.9
Gross fixed capital formation	12.6	1.1	2.9	5.6	10.2	3.0	4.6	3.6	3.6	3.6
Private	9.3	-2.7	5.7	5.0	8.3	4.3	4.5	4.0	4.2	5.6
Public	29.7	17.7	-7.3	7.7	17.8	-1.9	5.1	2.1	1.0	-4.9
GNFS exports	5.0	-9.3	12.5	9.3	2.7	5.6	6.3	6.1	5.3	4.8
GNFS imports	8.6	-5.2	14.7	9.9	1.7	6.3	5.4	5.9	5.1	4.4
Contribution to GDP (percentage points)										
Final domestic demand	6.0	-2.2	5.8	6.5	4.5	2.9	3.5	4.2	4.3	4.0
Net exports	-2.0	-1.6	-2.1	-1.3	0.3	-1.0	-0.1	-0.5	-0.4	-0.3
Inventories and statistical discrepancy	-0.1	0.1	2.1	-0.6	-2.6	0.7	0.2	0.2	0.0	0.0
Investment (% GDP)	24.3	24.5	26.3	26.8	23.8	24.6	24.8	24.9	24.6	24.3
Public	4.2	5.1	4.7	4.9	5.6	5.1	5.1	5.4	4.8	4.4
Private	20.0	19.5	21.6	21.8	18.2	19.5	19.8	19.6	19.8	19.9
Gross national savings (% GDP)	19.4	19.6	19.1	17.4	16.9	17.9	18.5	18.8	18.7	18.5
Public	-0.3	-4.5	-2.0	-0.9	-0.4	0.0	0.0	0.2	-0.2	-0.3
Private	19.7	24.1	21.1	18.3	17.3	18.0	18.5	18.6	18.9	18.8
Potential output	3.5	2.9	3.0	3.0	3.0	3.0	2.9	4.2	3.8	3.7
Output gap (% potential GDP)	3.2	-1.2	-0.8	0.7	-0.1	-0.3	0.3	0.0	0.0	0.0
LABOR MARKET										
Labor force (15-64)	0.0	-0.4	-6.7	0.9	0.4	1.3	0.7	0.7	0.8	0.9
Employment	-0.1	-1.8	-9.0	0.7	0.8	1.4	0.9	1.0	0.9	1.0
Wages (monthly)	13.0	6.4	7.1	11.3	13.8	10.0	7.5	7.0	7.0	7.0
Unemployment rate (% labor force)	4.9	6.1	5.6	5.6	5.6	5.6	5.4	5.2	5.1	5.0
PRICES										
Consumer prices (avg)	3.8	2.6	5.0	13.8	10.5	5.8	3.1	2.8	2.6	2.5
Consumer prices (eop)	4.0	2.1	8.2	16.4	7.4	4.4	3.0	2.7	2.5	2.5
Core CPI (eop)	3.7	3.3	5.8	14.7	9.7	5.8	3.3	3.2	2.6	2.6
GDP deflator (eop)	6.8	4.1	5.4	13.4	8.2	6.7	5.6	3.3	2.6	2.5
MACRO-FINANCIAL										
Broad money (nominal)	10.9	15.3	15.8	6.9	13.6	10.0	...	...	...	...
Credit to the private sector (real)	2.4	3.4	6.1	-3.6	-2.6	1.9	...	...	...	...
Corporations	2.2	3.1	10.7	2.1	0.5	2.3	...	...	...	...
Households	3.4	2.6	1.4	-10.4	-6.3	2.0	...	...	...	...
GENERAL GOVERNMENT FINANCES (% GDP)										
Revenue	28.8	28.6	30.4	31.0	31.9	31.9	31.6	31.7	31.2	31.0
Expenditure	33.3	38.2	37.1	36.8	37.9	37.0	36.7	36.8	36.2	35.7
Net lending/borrowing	-4.6	-9.6	-6.7	-5.8	-6.0	-5.1	-5.1	-5.1	-5.0	-4.7
Structural balance	-5.0	-4.9	-7.4	-5.7	-5.6	-4.8	-5.2	-5.1	-5.0	-4.7
Structural primary balance	-3.9	-3.6	-5.9	-3.7	-3.2	-2.6	-3.1	-3.2	-3.1	-2.8
Gross debt	36.6	49.4	51.7	50.5	51.6	52.2	52.8	54.3	56.0	57.4
BALANCE OF PAYMENTS										
Current account (% GDP)	-4.9	-4.9	-7.2	-9.3	-6.9	-6.7	-6.3	-6.1	-5.9	-5.8
Export volume (goods and services)	5.0	-9.3	12.5	9.3	2.7	5.6	6.3	6.1	5.3	4.8
Import volume (goods and services)	8.6	-5.2	14.7	9.9	1.7	6.3	5.4	5.9	5.1	4.4
Capital account (% GDP)	1.3	1.9	2.2	2.5	2.7	2.0	1.7	1.7	1.2	1.0
Direct investment, net (% GDP)	-2.2	-1.3	-3.7	-3.4	-3.0	-3.3	-3.2	-3.3	-3.3	-3.3
International reseves (stock, bn €)	37.5	42.5	45.8	52.3	61.8	66.9	69.7	74.4	78.0	80.2
% of short-term external debt	105.6	127.8	119.9	119.6	154.1	148.6	141.9	144.6	140.2	133.6
Int'l investment position, net (% GDP)	-43.1	-47.3	-46.7	-40.9	-40.2	-41.7	-42.9	-44.6	-46.9	-49.1
External debt (% GDP)	49.0	57.5	56.5	50.6	50.5	51.2	51.1	52.0	53.2	54.2
MEMORANDUM ITEMS										
Nominal GDP (bn lei)	1,064	1,067	1,189	1,410	1,559	1,708	1,870	2,007	2,137	2,271
Nominal GDP (bn €)	224	221	242	286	315	342	372	397	420	444
Population (million)	19.4	19.3	19.2	19.0	19.0	18.9	18.8	18.7	18.6	18.5
GDP per capita ($)	12,929	13,005	14,885	15,791	17,975	19,742	21,677	23,308	24,742	26,210
Lei/€ (annual avg)	4.75	4.84	4.92	4.93	...	...	...	...	...	...
Real effective exchange rate	-0.5	1.4	1.0	3.7	...	...	...	...	...	...

Sources: Authorities' data and IMF staff estimates and projections.

Table 2. Romania: Fiscal Accounts, 2019–28[1]
(In percent of GDP, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
GENERAL GOVERNMENT OPERATIONS										
Revenue	**28.8**	**28.6**	**30.4**	**31.0**	**31.9**	**31.9**	**31.6**	**31.7**	**31.2**	**31.0**
Revenue excl. grants	27.8	27.1	28.7	29.2	29.3	29.9	30.0	30.0	30.0	30.0
Tax revenue	25.2	24.7	26.4	26.3	26.4	27.0	27.1	27.1	27.2	27.2
Direct taxes	15.3	15.2	15.7	15.1	15.2	16.1	16.2	16.3	16.4	16.4
Of which: Corporate income taxes	1.9	1.7	1.9	2.1	2.2	2.5	2.5	2.5	2.5	2.5
Personal income taxes	2.3	2.3	2.5	2.5	2.5	2.7	2.8	2.8	2.8	2.8
Social security contributions	10.5	10.5	10.7	10.0	10.0	10.3	10.4	10.4	10.4	10.4
Indirect taxes	9.9	9.5	10.7	11.2	11.1	10.9	10.9	10.9	10.8	10.8
Of which: VAT	6.1	5.7	6.7	6.7	6.7	6.8	6.9	6.9	6.9	6.9
Excises	3.0	2.9	2.9	2.5	2.4	2.6	2.6	2.6	2.6	2.6
Nontax revenue	2.5	2.3	2.3	2.8	2.8	2.9	2.8	2.8	2.8	2.7
Grants 2/	1.0	1.5	1.7	1.8	2.7	2.0	1.6	1.7	1.1	1.0
Expenditure	**33.3**	**38.2**	**37.1**	**36.8**	**37.9**	**37.0**	**36.7**	**36.8**	**36.2**	**35.7**
Expense	30.5	35.1	34.3	33.9	35.2	34.3	34.0	34.2	33.3	32.7
Personnel	9.6	10.3	9.4	8.3	8.4	8.9	8.9	9.0	9.0	9.0
Goods and services	5.0	5.4	5.4	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Interest	1.1	1.4	1.5	2.1	2.4	2.3	2.1	2.0	2.0	2.0
Subsidies	0.7	0.8	0.7	1.3	1.1	0.8	0.7	0.7	0.7	0.7
Transfers	14.4	17.4	17.3	17.2	18.1	17.3	17.2	17.4	16.5	15.8
EU-related 2/	1.2	1.7	2.0	2.1	3.2	2.6	2.7	3.0	2.1	1.4
Social assistance	10.8	13.0	12.4	12.4	12.5	12.2	12.1	11.9	11.9	11.9
Pensions	6.6	7.6	7.5	7.0	7.1	7.3	7.5	7.6	7.6	7.6
Other	4.2	5.4	4.8	5.4	5.4	4.9	4.6	4.3	4.4	4.4
Other transfers	2.4	2.7	3.0	2.8	2.5	2.5	2.5	2.5	2.5	2.5
Other expenses	-0.3	-0.1	-0.1	-0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital	2.8	3.1	2.8	2.9	2.7	2.7	2.7	2.7	2.8	2.9
Operating balance	-1.7	-6.5	-3.9	-2.9	-3.2	-2.4	-2.4	-2.5	-2.2	-1.8
Primary balance	-3.4	-8.3	-5.3	-3.8	-3.6	-2.9	-3.0	-3.2	-3.1	-2.8
Net lending/borrowing	**-4.6**	**-9.6**	**-6.7**	**-5.8**	**-6.0**	**-5.1**	**-5.1**	**-5.1**	**-5.0**	**-4.7**
Financing	**4.6**	**9.6**	**6.7**	**5.8**	**6.0**	**5.1**	**5.1**	**5.1**	**5.0**	**4.7**
Domestic	3.2	5.3	2.2	2.3	2.4	2.4	2.6	2.6	2.6	2.6
External	0.9	4.5	4.5	3.5	3.6	2.7	2.5	2.5	2.4	2.1
Of which: EU loans, net 3/	...	...	...	0.0	0.4	0.5	0.9	1.3	0.6	0.0
Other (use of deposits and privatization proceeds)	0.5	-0.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
GENERAL GOVERNMENT GROSS DEBT										
Gross debt (authorities' definition) 4/	36.6	49.4	51.7	50.5	51.6	52.2	52.8	54.3	56.0	57.4
In percent of total										
Medium- and long-term	99.3	98.4	96.9	96.1	98.6	99.2	99.2	99.3	99.3	99.3
Short term	0.7	1.6	3.1	3.9	1.4	0.8	0.8	0.7	0.7	0.7
Foreign exchange-denominated or -linked	48.8	51.0	51.3	50.8	53.4	53.5	53.5	53.6	53.5	53.2
At variable interest rates	24.4	22.6	26.2	27.9	14.5	13.4	12.3	11.3	10.3	8.3
Gross debt (Maastricht definition)	35.1	46.9	48.6	47.3	48.5	49.1	49.6	51.0	52.7	54.0
MEMORANDUM ITEMS										
Fiscal balance (ESA 2010)	-4.3	-9.2	-7.1	6.2	...	...	...	...	...	...
Cyclically adjusted balance (percent of potential GDP)	-5.6	-8.3	-6.4	-6.0	-5.9	-5.0	-5.2	-5.1	-5.0	-4.7
Structural balance (percent of potential GDP)	-5.2	-4.7	-7.3	-5.7	-5.6	-4.8	-5.2	-5.1	-5.0	-4.7
Fiscal impulse	-2.2	-5.6	1.5	-0.5	-1.8	0.8	-0.2	-0.5	0.2	0.1
Output gap (percent of potential GDP)	3.2	-1.2	-0.8	0.7	-0.1	-0.3	0.3	0.0	0.0	0.0
Total capital spending	4.2	5.1	4.7	4.9	5.6	5.1	5.1	5.4	4.8	4.4
Real revenue excl. grants (percent change)	6.0	-4.9	12.5	6.1	0.3	5.9	6.4	4.5	3.7	3.5
Real expenditure excl. EU-related transfers (percent change)	11.0	11.0	2.3	2.9	0.2	2.7	4.9	3.7	4.6	4.2
Nominal GDP (bn lei)	1,064	1,067	1,189	1,410	1,559	1,708	1,870	2,007	2,137	2,271
% change	10.9	0.3	11.5	18.6	10.6	9.6	9.5	7.3	6.5	6.3

Sources: Authorities' data and IMF staff estimates and projections.

1/ Cash basis. The general government is composed of the central and local governments, the Social Security Fund, and the Road Fund Company.
2/ Excludes direct EU agricultural payments.
3/ From Resilience and Recovery Fund.
4/ Includes guarantees.

Table 3. Romania: Balance of Payments, 2019–28
(Annual percent change, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024	2025	2026	2027	2028
					Projections					
BALANCE OF PAYMENTS										
Current account	**-4.9**	**-4.9**	**-7.2**	**-9.3**	**-6.9**	**-6.7**	**-6.3**	**-6.1**	**-5.9**	**-5.8**
Merchandise trade balance	-8.0	-8.6	-9.6	-11.3	-10.0	-10.2	-9.9	-9.9	-9.8	-9.7
Exports (f.o.b)	28.1	26.1	29.1	30.0	28.7	28.1	28.0	28.2	28.5	28.7
Imports (f.o.b)	36.1	34.7	38.6	41.3	38.7	38.3	37.8	38.1	38.3	38.5
Services balance	3.9	4.3	3.9	4.4	4.9	5.3	5.4	5.7	5.8	5.9
Exports of nonfactor services	12.1	10.8	11.5	12.9	13.0	13.3	13.2	13.5	13.7	14.0
Imports of nonfactor services	8.2	6.5	7.6	8.5	8.1	8.0	7.8	7.8	8.0	8.1
Primary income, net	-1.4	-1.5	-2.0	-3.1	-2.3	-2.2	-2.3	-2.3	-2.2	-2.2
Compensation of employees, net	1.6	1.4	1.5	1.2	1.2	1.2	1.2	1.1	1.1	1.1
Direct investment income, net	-3.7	-3.7	-4.2	-4.9	-4.2	-4.0	-4.1	-4.0	-4.0	-4.0
Other	0.7	0.8	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6
Secondary income, net	0.7	0.9	0.4	0.6	0.5	0.4	0.4	0.4	0.4	0.3
General government	-0.3	0.0	-0.5	-0.4	-0.3	-0.3	-0.3	-0.4	-0.4	-0.4
Other sectors 1/	1.0	0.9	0.9	1.0	0.8	0.8	0.8	0.7	0.8	0.7
Capital account	**1.3**	**1.9**	**2.2**	**2.5**	**2.7**	**2.0**	**1.7**	**1.7**	**1.2**	**1.0**
Of which: Capital transfers, net 2/	1.0	1.5	2.1	2.4	2.7	2.0	1.6	1.7	1.1	1.0
Financial account	**-2.3**	**-3.5**	**-6.1**	**-5.6**	**-3.5**	**-4.7**	**-4.6**	**-4.4**	**-4.7**	**-4.7**
Direct investment, net	-2.2	-1.3	-3.7	-3.4	-3.0	-3.3	-3.2	-3.3	-3.3	-3.3
Abroad	0.8	0.1	0.5	0.6	0.4	0.5	0.5	0.4	0.5	0.5
In Romania	2.9	1.4	4.1	3.9	3.4	3.8	3.7	3.7	3.8	3.7
Portfolio investment and financial derivatives, net	-1.1	-6.1	-1.4	-1.6	-2.7	-1.8	-1.1	-1.4	-1.5	-1.3
Other investment, net	1.1	1.4	-2.0	-2.9	-1.0	-1.0	-1.0	-0.8	-0.8	-0.6
Reserve assets	-0.1	2.5	0.9	2.3	3.1	1.5	0.7	1.2	0.9	0.5
Errors and omissions, net	**1.3**	**-0.5**	**-1.0**	**1.3**	**0.7**	**0.0**	**0.0**	**0.0**	**0.0**	**0.0**
BALANCE SHEET										
Int'l investment position, net	**-43.1**	**-47.3**	**-46.8**	**-40.9**	**-40.2**	**-41.7**	**-42.9**	**-44.6**	**-46.9**	**-49.1**
Assets	34.9	40.4	40.1	36.8	38.4	38.5	37.7	38.1	38.4	38.4
Liabilities	78.0	87.7	86.9	77.6	78.6	80.2	80.7	82.7	85.3	87.6
Direct investment	-38.4	-40.1	-40.4	-36.7	-36.1	-36.6	-36.9	-37.8	-39.0	-40.2
Assets	5.3	5.5	5.7	5.5	5.6	5.6	5.6	5.7	5.8	6.0
Liabilities	43.8	45.6	46.1	42.1	41.7	42.2	42.5	43.5	44.9	46.2
Portfolio investment and financial derivatives	-13.4	-20.1	-18.0	-13.9	-15.3	-15.9	-15.7	-16.2	-16.8	-17.3
Other investment	-8.0	-6.4	-7.3	-8.5	-8.4	-8.8	-9.1	-9.4	-9.6	-9.7
Reserve assets	16.7	19.3	19.0	18.3	19.6	19.6	18.7	18.7	18.6	18.1
Gross external debt	**49.0**	**57.5**	**56.6**	**50.5**	**50.5**	**51.2**	**51.1**	**52.0**	**53.2**	**54.2**
Central bank	0.5	0.5	1.4	1.2	1.1	1.0	0.9	0.8	0.8	0.8
General government	17.7	26.2	24.4	20.2	23.9	23.4	23.6	24.8	25.5	25.6
Banks	3.5	3.3	3.2	3.8	2.8	3.7	3.1	2.6	2.3	2.3
Other sectors	27.2	27.5	27.6	25.4	22.8	23.2	23.5	23.8	24.7	25.5
Short term	15.8	15.1	15.8	15.3	12.7	13.2	13.2	13.0	13.2	13.5
Of which: Trade credit and intercompany loans	13.2	12.5	13.2	12.8	10.4	10.6	10.7	10.4	10.7	10.9
Medium and long term	33.2	42.4	40.7	35.3	37.8	38.0	37.9	39.0	40.0	40.7
MEMORANDUM ITEMS										
CA + capital transfers + direct investment in Romania	-1.0	-2.1	-1.0	-3.0	-0.9	-0.9	-1.0	-0.7	-1.0	-1.0
International reserves (in bn €)	**37.5**	**42.5**	**45.8**	**52.3**	**61.8**	**66.9**	**69.7**	**74.4**	**78.0**	**80.2**
% short-term debt (orig. maturity)	105.6	127.8	119.9	119.6	154.1	148.6	141.9	144.6	140.2	133.6
Months of prospective imports	4.9	4.6	3.9	4.3	4.7	4.7	4.6	4.6	4.5	4.4
Gross external financing requirement	26.7	28.0	27.0	27.8	25.6	23.3	23.1	23.5	23.2	23.5
GNFS export volume (percent change)	5.0	-9.3	12.5	9.3	2.7	5.6	6.3	6.1	5.3	4.8
GNFS import volume (percent change)	8.6	-5.2	14.7	9.9	1.7	6.3	5.4	5.9	5.1	4.4
Terms of trade (percent change)	1.5	3.1	0.0	-1.1	2.4	0.9	0.2	0.5	0.3	0.2
REER (CPI-based, percent change)	-0.5	1.4	1.0	3.7	…	…	…	…	…	…
Exchange rate (lei/€, average)	4.8	4.9	4.9	4.9	…	…	…	…	…	…
Nominal GDP (in billion euro)	224	220	241	286	315	342	372	397	420	444

Sources: Authorities' data and IMF staff estimates and projections.

1/ Includes CAP payments.

2/ Largely EU structural funds and CAP payments.

Table 4. Romania: Monetary Survey, 2019–24
(In billion lei, unless otherwise indicated)

	2019	2020	2021	2022	2023	2024
					Projections	
			(In billion lei)			
NATIONAL BANK OF ROMANIA						
Net foreign assets	176	198	217	246	291	317
Net domestic assets	-68	-98	-74	-86	-115	-123
Credit to general government, net	-23	-89	-32	-39	-72	-72
Credit to banks, net	-21	-40	-16	-23	-25	-25
Other	-23	30	-26	-24	-18	-26
Reserve money	108	100	143	160	176	194
BANKING SYSTEM						
Net foreign assets	182	237	241	251	300	330
Of which: Commercial banks	6	39	23	5	9	13
Net domestic assets	241	251	324	353	385	424
Domestic credit	349	372	445	464	518	583
Credit to general government, net	82	89	121	101	138	179
Credit to the private sector, net	268	282	324	364	380	404
Other items, net	-108	-121	-121	-112	-134	-159
Broad money (M3)	423	487	564	603	685	754
Money market instruments	0	0	0	0	0	0
Quasi money	146	150	158	205	261	287
Narrow money (M1)	277	338	407	398	425	467
Currency outside banks	74	88	96	101	112	123
Overnight deposits	203	249	311	297	313	344
			(Annual percent change, unless otherwise indicated)			
MONETARY INDICATORS						
Broad money	10.9	15.3	15.8	6.9	13.6	10.0
NFA contribution	4.0	12.9	0.8	1.8	8.3	4.3
NDA contribution	6.9	2.4	15.0	5.1	5.3	5.7
Real	6.6	13.0	7.0	-8.2	5.8	5.4
Reserve money	7.9	-7.8	43.6	11.7	10.1	10.0
NFA contribution	3.5	20.4	19.5	19.7	28.6	14.6
NDA contribution	4.4	-28.2	24.1	-8.1	-18.4	-4.6
Real	3.7	-9.7	32.8	-4.0	2.5	5.4
Domestic credit (real)	9.1	4.2	10.7	-10.3	4.0	7.8
Public sector	38.4	6.9	25.3	-28.4	27.7	24.3
% of GDP	7.7	8.4	10.2	7.1	8.9	10.5
Private sector	2.4	3.4	6.1	-3.6	-2.6	1.9
% of GDP	25.2	26.5	27.3	25.8	24.4	23.7
To nonfinancial corporations	2.2	3.1	10.7	2.1	0.5	2.3
% of GDP	11.1	11.6	12.5	12.5	12.2	11.9
To households	3.4	2.6	1.4	-10.4	-6.3	2.0
% of GDP	13.4	14.0	13.8	12.1	11.1	10.7
MEMORANDUM ITEMS						
Net foreign assets of the NRB (in billion euro)	37	41	44	50	58	63
Share of foreign currency private deposits (commercial bank	35.4	36.1	35.3	34.3	32.3	32.6
Share of foreign currency private loans (commercial banks, %	32.4	30.5	27.6	31.2	31.8	31.5
Loans/deposits ratio (commercial banks)	0.8	0.7	0.7	0.7	0.7	0.6
Lei-denominated	0.8	0.8	0.8	0.8	0.7	0.7
Foreign-exchange denominated	0.7	0.6	0.5	0.7	0.7	0.6
Velocity	2.5	2.2	2.1	2.3	2.3	2.3
Interest rates (%, eop)						
Policy interest rate	2.50	1.50	1.75	6.75	…	…
Interbank offered rate, 1 week	2.92	1.81	2.40	4.90	…	…
Corporate loans 1/	5.79	4.65	4.58	9.96	…	…
Household time deposits (evg)	1.98	1.54	1.41	3.70	…	…
CPI inflation (%, eop)	4.0	2.1	8.2	16.4	7.4	4.4
Exchange rate (lei/€, eop)	4.78	4.87	4.95	4.95	…	…
Nominal GDP (in billion lei)	1,064	1,067	1,189	1,410	1,559	1,708

Sources: National Bank of Romania and IMF staff estimates and projections.

1/ Rates for new local currency denominated transactions.

Table 5. Romania: Financial Soundness Indicators, 2018–23

(In percent, unless otherwise indicated)

	2018 Dec	2019 Dec	2020 Dec	2021 Dec	2022 Dec	2023 Jun
Capital						
Regulatory capital/risk-weighted assets	20.7	22.0	25.1	23.3	23.4	22.8
Regulatory tier 1 capital/risk-weighted assets	18.6	20.0	23.2	20.9	20.5	19.7
Tier 1 capital/total assets	9.3	10.2	10.3	8.6	8.5	8.1
Asset quality						
Nonperforming loans (NPLs)/total loans	5.0	4.1	3.8	3.4	2.7	2.6
NPLs net of provisions/total loans	13.5	9.7	8.4	7.8	6.5	6.9
NPL provisions/NPLs	58.5	60.7	63.3	66.1	65.5	64.1
Earnings and profitability						
Return on assets	1.6	1.3	1.0	1.4	1.5	1.9
Return on equity	14.6	12.2	8.7	13.3	16.4	21.1
Net interest income/gross income	65.4	66.4	67.2	65.9	70.6	70.4
Noninterest expense/gross income	53.2	54.3	53.8	53.9	52.1	49.3
Personnel expense/noninterest expense	48.2	45.2	48.0	48.4	48.4	50.0
Personnel expense/gross income	25.6	24.6	25.8	26.1	25.2	24.6
Liquidity						
Liquid/total assets	52.6	53.2	55.5	15.2	14.2	29.2
Liquid assets/short-term liabilities	170.6	165.3	162.7	19.9	18.4	38.5
Foreign exchange risk						
Net open foreign exchange position position/regulatory capital	0.7	0.9	-2.5	4.5	0.9	0.7
Foreign exchange liabilities/total liabilities	30.9	30.3	29.8	29.3	29.8	...
Foreign exchange loans/total loans	34.0	32.4	30.5	27.6	31.1	...
Market risk						
Net derivatives position/capital	-0.2	-0.4	-0.3	-0.2	-0.7	-0.3
Derivatives (assets)/capital	0.7	0.5	0.6	0.5	1.5	1.3
Derivatives (liabilities)/capital	0.9	0.9	0.9	0.7	2.2	1.6
Commercial real estate loans/total loans	20.2	20.0	18.2	16.8	16.9	15.5
Residential real estate loans/total loans	26.2	26.0	25.0	24.0	22.2	21.3
Corporates: earnings/interest + principal expenses	124.4	122.5	146.8	...	...	...
Other indicators (of deposit taking institutions)						
Customer deposits/total loans	131.3	137.4	149.0	147.8	141.1	130.2
Loan-to-deposit ratio	76.2	72.8	67.1	67.7	70.9	76.8
Lending-deposit rates spread (bps)	628	602	526	494	610	581

Sources: National Bank of Romania and IMF staff estimates.

Annex I. Romania's Macroeconomic Policy Mix Through the Lenses of the Integrated Policy Framework

A. Introduction

1. This Annex presents Romania's response to the recent commodity shock through the lenses of the IMF's integrated policy framework. The Integrated Policy Framework (IPF) aims to provide guidance for the appropriate macroeconomic policy mix to achieve macroeconomic and financial stability based on a systematic and comprehensive approach. It jointly considers monetary, exchange rate, macroprudential and capital flow management policies including their interactions; see IMF (2020) for details. While the focus is not on fiscal and structural policies, as these policies tend to be less agile, for Romania, credible and durable fiscal consolidation remains a critical element of an appropriate policy mix.

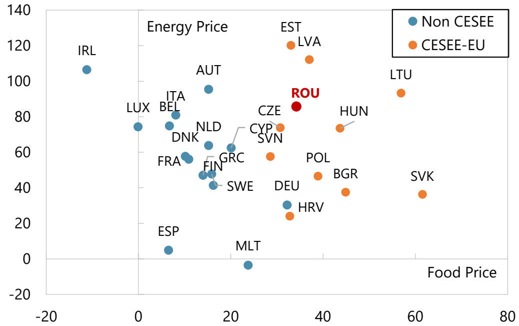
2. Romania is different from most other IPF pilot country cases so far. Romania's exchange rate volatility is comparatively limited. The current de-facto exchange rate regime has been classified by the Fund as stabilized since September 2021. The use of effective capital flow management measures (CFM) is generally ruled out through EU membership. Romania further shows a relatively high degree of euroization and a small financial sector compared to EU peers, limiting monetary policy transmission.

3. Considering Romania's macroeconomic policy framework and Romania's response to the recent commodity shock through the lenses of the IPF is nevertheless useful. Romania has recently faced complicated policy choices for ensuring price stability and managing short-term, potentially destabilizing capital inflows. In addition, given Romania's small financial sector and relatively high degree of euroization compared to EU peers, the exchange rate is a relatively important monetary transmission channel, further warranting a comprehensive view on Romania's policy mix.

B. Commodity Shock and Deployment of the Macroeconomic Toolkit

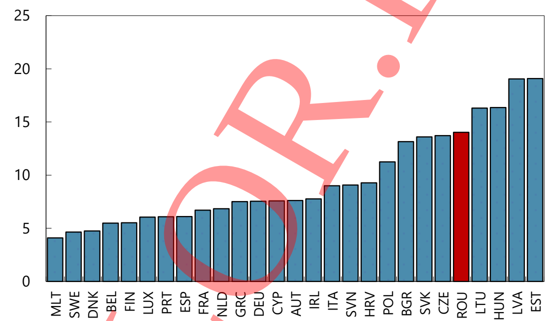
4. Over the last two years, Romania faced a severe commodity shock. While commodity prices increased throughout Europe, country-specific factors, such as the sourcing of energy and food products and domestic energy cost pass through, implied that there was significant heterogeneity in price changes across countries. Such differences in price increases can be magnified once weights for CPI / HICP compilation are considered. In Romania, given that the weights of energy and food items in private consumption are large, the effects of the commodity price increases on inflation was larger than in many EU peers including the euro area, implying that the shock was partly asymmetric.

Food vs. Energy Prices
(Percent, 2021M7-2023M9)



Sources: Eurostat and IMF staff calculations.

Energy and Food Inflation
(Cumulative 2021M7-2023M9 price changes in percent, weighted using HICP weights)

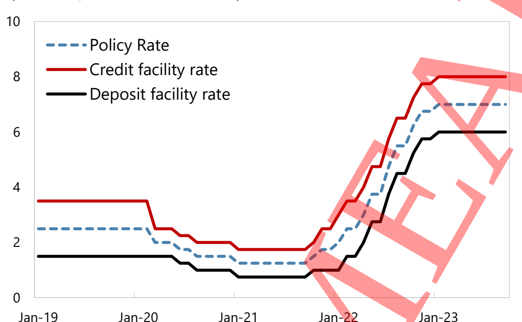


Sources: Eurostat and IMF staff calculations.

5. The NBR took several measures in response.

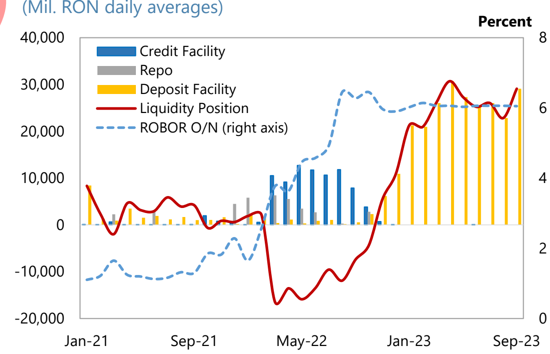
- **Monetary policy:** The NBR tightened liquidity management from mid-2021, before hiking the policy rate. Exchange-rate stability was broadly maintained through the episode (see below). Apart from the possibility that FX is bought through active spot interventions, the build-up of reserves at the central bank can also be passive, namely through the NBR's handling of FX receipts on behalf of the treasury. These transactions are not necessarily sterilized.

Romania Policy Rate
(Percent, 2019M1-2023M9)



Source: National Bank of Romania.

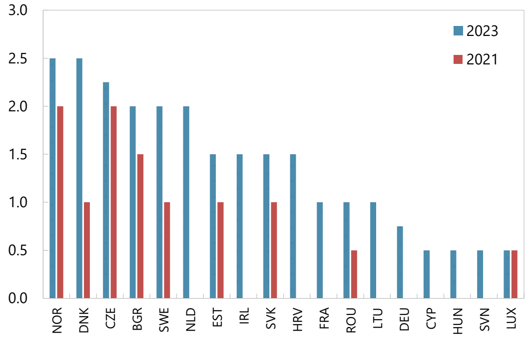
Market Liquidity
(Mil. RON daily averages)



Sources: National Bank of Romania and IMF staff calculations.

- **Macroprudential policy:** The authorities curbed credit growth beyond the impact of monetary tightening through increasing the CCyB in two steps to 1%, effective by 2023M10, and through lowering the loan-to-value limits by 10 percentage points for loans granted to individuals for the purchase of investment properties in early 2022.

CCyB Rate
(Percent)



Sources: European Systemic Risk Board.

Exchange Rate Volatility
(Percent)

Sources: Haver Analytics and IMF staff calculations.
Note: Exchange rate volatility is calculated by taking the coefficient of variation of the exchange rate against EUR for the time period 2021m7-2023m9.

6. **While EU membership generally rules out capital flow measures, Romania has in place several instruments that aim at limiting vulnerabilities from foreign-currency debt.** Borrower-based measures help mitigating risks associated with household lending in FX. The debt service to income (DSTI), as measured by the ratio between total monthly payment obligations arising from credits and borrower's net income is capped at 20% for FX exposures, some 20pp lower than for Lei exposures. Loan-to-value (LTV) limits for housing loans are between 5 and 25pp lower for FX loans, depending on the currency and whether the borrower is hedged. While reserve requirements based on foreign currency-denominated liabilities from credit institutions' balance sheets could also help contain the expansion of foreign exchange liabilities, in Romania, they are used as a tool of monetary policy. Currently, reserve requirements are 8% for domestic currency and 5% for foreign currency liabilities).

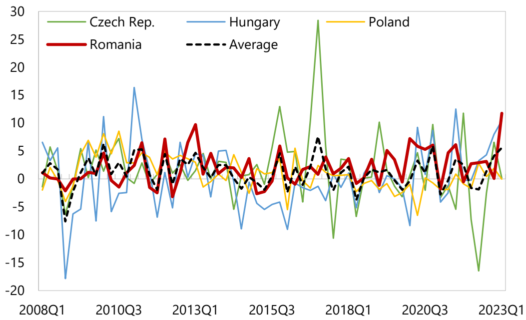
C. Trade-offs During the Recent Shock

7. **The NBR tightened monetary policy largely in line with regional peers, and much earlier and more than the ECB, in part reflecting the asymmetry of the commodity price shock.** The NBR increased the policy rate from 1.25 percent in 2021M9 to 7 percent in 2023M1, increasing policy and market rate differentials with the euro area.

8. **Short-term external capital inflows accelerated as a result, possibly pointing to the presence of destabilizing carry trade.** Ex-post returns to carry trade increased across Romania and regional peers, but Romania's relatively stable exchange rate reduces the risk for carry traders. Carry trade can be hard to detect as it can come in many forms - for instance, carry traders may be resident or non-resident entities, but the observed increase in non-resident capital inflows would be consistent with increased carry trade activity.

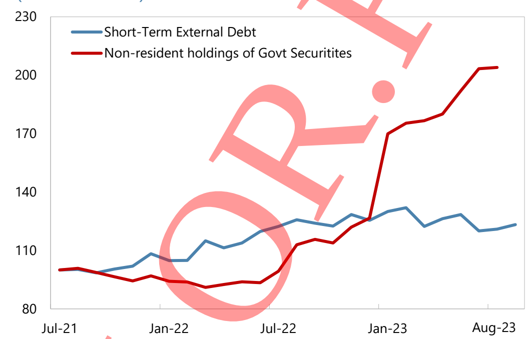
9. **Short-term capital inflows increase the likelihood of and susceptibility to future potential shocks that trigger sudden exchange rate depreciations.** Carry trade fuels capital inflows that in turn induce appreciation, and their sudden reversals that could be triggered by a variety of shocks could lead to sharp exchange rate depreciations, especially when FX markets are shallow (see below). Furthermore, Romania's relatively high degree of euroization compared to EU peers makes it more vulnerable to depreciations.

Non-resident Portfolio Inflows
(Percent of GDP)



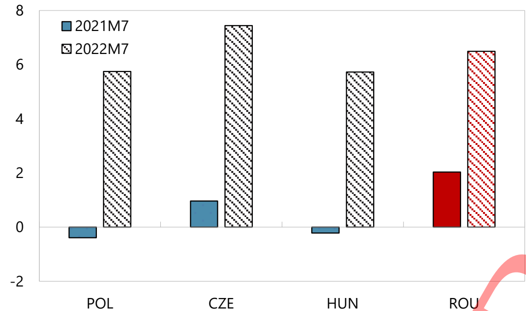
Sources: International Financial Statistics, Haver Analytics, and staff calculations.

Romania Debt Holdings
(Jul-2021=100)



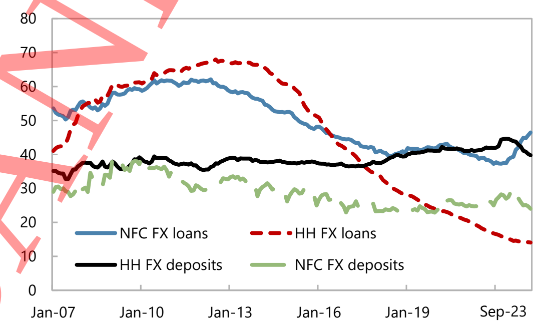
Sources: Haver Analytics, and IMF staff calculations.

Carry Trade Return
(Percent)



Sources: Haver Analytics, Eurostat and IMF staff calculations.

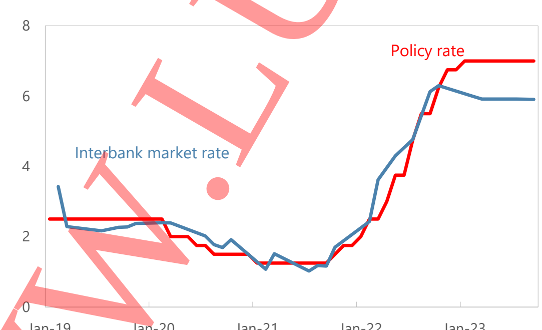
Romania Foreign Currency Exposure and Financial Euroization
(Percent of total loans and deposits, 2007M1-2023M9)



Sources: Haver and IMF staff calculation.

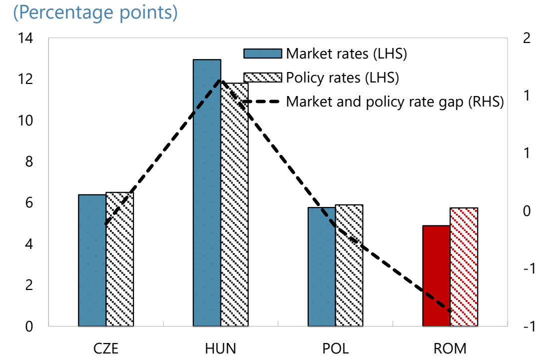
10. Fighting inflation while at the same time limiting destabilizing short-term capital inflows can involve trade-offs. The conversion by the Treasury of large FX receipts into domestic currency through the NBR, which was only partly sterilized, generating a rapid expansion of excess liquidity during 2022Q4 and 2023Q1. As a result, market rates fell by around 150bps, reducing returns on carry trades, while still hiking the policy rate through January 2023. Prior to that, in January 2022, the NBR had fully restored the wider symmetric corridor of the deposit and lending rate around the policy rate that had existed before the COVID pandemic, enabling greater deviation of market from policy rates.

Romania: Interest Rates
(Percent, 2019M1-2023M9)



Sources: Haver Analytics and IMF staff calculations.

Change in Interest Rates, 2021M7-2023M9
(Percentage points)



Sources: Haver; IMF staff calculations

D. Diagnosis on FX Interventions

11. **The de-jure exchange rate arrangement is managed floating.** The National Bank of Romania (NBR) may intervene in the foreign exchange market including to smooth excessive exchange rate fluctuations. The de-facto exchange rate arrangement is classified by the Fund as stabilized. The de-facto methodology for classification of exchange rate regimes is based on a backward-looking statistical approach that relies on past exchange rate movement and historical data. Therefore, this reclassification does not imply statements or views on future or intended policies nor does it imply a policy commitment on the part of the country authorities. [IMF AREAER Database]

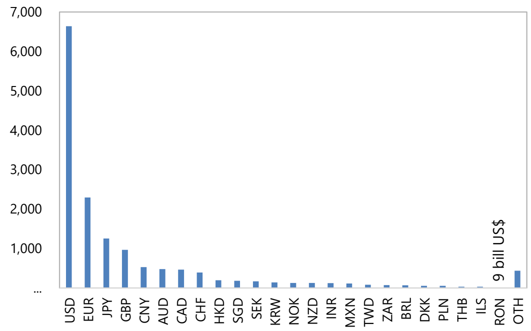
12. **There is no public information on the occurrence, scale or magnitude of FXI.** The NBR's arrangement with the MoF—namely that the NBR receives all FX inflows on behalf of the MoF and handles all outflows including interest and principal payments of public debt in foreign currency—means that even sophisticated methods to proxy FXIs as in Adler et al. (2020) cannot be applied to approximate the NBR's transactions in the FX market. Furthermore, NBR communication on matters regarding exchange rate management is also limited.

13. **Available data suggests that FX reserves have increased significantly, on the back of inflows from EU funding, underpinning the credibility of the current practice of limiting exchange rate variability.** The NBR publishes monthly data on the level of reserves but does not decompose aggregate month-to-month changes which reflect inflows and outflows on behalf of the Ministry of Finance, changes in minimum reserve requirements on credit institutions' FX liabilities and FXI, among other sources. Large EU inflows, amounting to €9.8bn in 2022 (3.1 percent of GDP), have contributed to the increase in reserves, by €6.2bn to 103 percent of the ARA metric, which implies that the NBR has the firepower for FXI and could credibly manage the exchange rate.[1]

14. **Romania's FX market is relatively shallow, providing some justification framework for FX interventions to prevent excessive volatility.** FX markets are considered deep when they can absorb changes in positions. By contrast, they are considered shallow if in the face of surges of inflows or outflows driven by some external investors, the remaining market participants cannot fully absorb the change in positions. There is no perfect metric for FX market depth. One possibility is to equate FX market shallowness to larger deviations from UIP after a risk-off shock. However, interest rate parity is based on the assumption of capital mobility (which is mostly fulfilled) and perfect substitutability of domestic and foreign assets (which is unlikely, as Romanian assets are perceived as riskier than most other European assets based on bond yield spreads for instance), and associated measures are volatile.

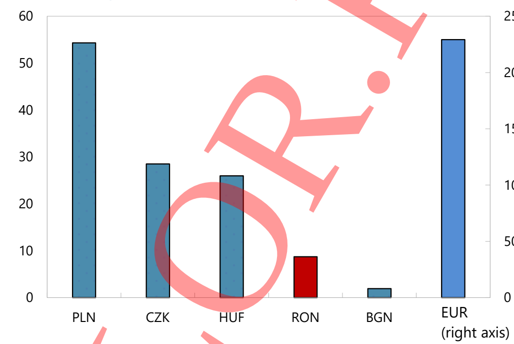
[1] In end-2022, reserves have been slightly above the Fund's research adequacy threshold; see IMF (2016a) for methodological details.

OTC Foreign Exchange Turnover
(Bill US$, April 2022)



Source: Bank of International Settlements.

OTC Foreign Exchange Turnover: CESEE Countries
(Bill US$, April 2022)

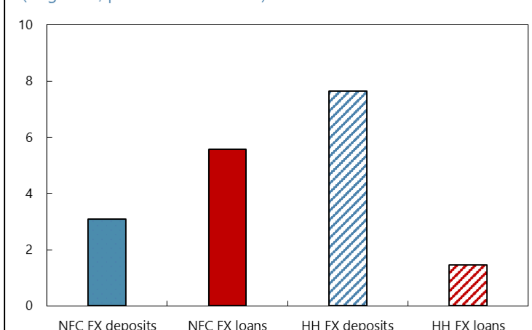


Source: Bank of International Settlements.

15. **Financial euroization represents another consideration for FXI.** Asset euroization reflects, to a large degree, distrust in the domestic currency as a saving vehicle, as depositors have been burned by high inflation associated with large depreciations in the past—in the case of Romania, during the 1990s. The combination of relatively high euroization compared to EU peers and a managed exchange rate (without a formal peg) make Romania stand out in the EU, but not among emerging market economies more broadly. Overcoming the lack of confidence in the domestic currency is a steep challenge that has not been achieved in the past 25 years, despite persistent disciplined monetary policy implementation and typically low inflation. Importantly, pronounced depreciation can reinforce euroization and possibly lead to disintermediation (EUR, 2016b).

16. **In this context, the IPF framework recognizes balance sheet mismatches as a possible justification for FX interventions.** At the aggregate level, NFC FX loans from the domestic banking system by far exceed NFC FX deposits. However, mismatches should be evaluated at the individual level. In this context, FX lending to NFCs has increased significantly since early 2022, raising concern about the degree of hedging. In addition, more than half of public debt is denominated in foreign currency. The authorities are well aware of the currency risk that FX borrowing entails and routinely remind banks and borrowers that in the event of a depreciation of the domestic currency, the capacity of unhedged borrowers to service FX debt can quickly deteriorate.

Romania: Euroization
(Aug-2023, percent of 2023 GDP)

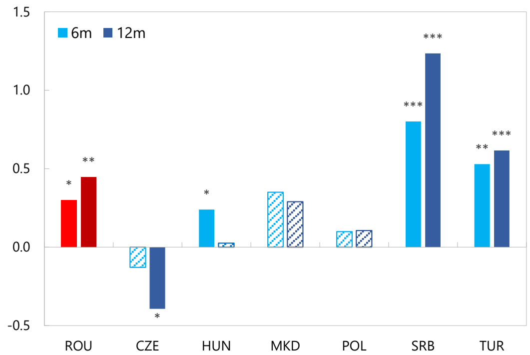


Sources: Haver Analytics and IMF staff calculations.

17. **Exchange rate stability appears to be relatively important for controlling inflation and the anchoring of inflation expectations in Romania.** Keeping the exchange rate stable against the euro could anchor inflation expectations to those in the euro area and underpin confidence in the domestic currency, not least because sudden depreciations can fuel expectations of high inflation (again, especially given experiences in the 1990s). The regression specifications are detailed in Section F. The results suggest that there are robust, significant and relatively large effects of

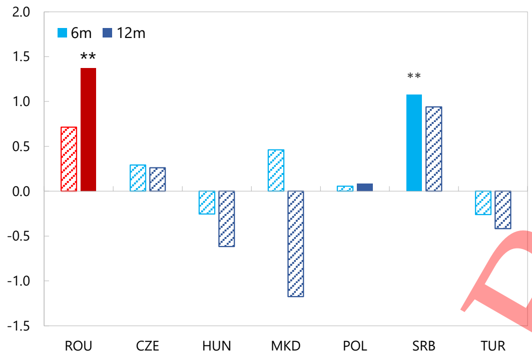
contemporaneous depreciation to the EUR on 12-month ahead inflation and inflation expectations for both specifications. By contrast, the effects in EU peers are either not consistently significant or smaller. Interestingly, depreciation against the USD does not have significant effects on inflation levels and expectations.

Impact of Depreciation against EUR on CPI Inflation
(Regression coeffcients, linear)

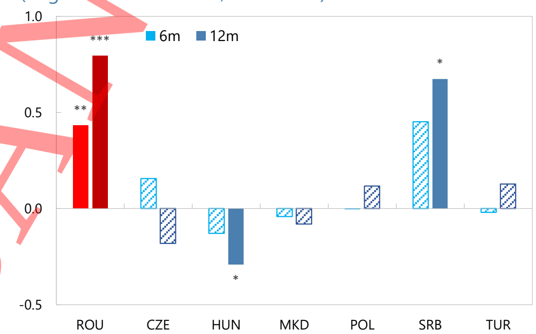


Impact of Depreciation against EUR on Inflation Expectations
(Regression coeffcients, linear)

Impact of Depreciation against EUR on CPI Inflation
(Regression coeffcients, non-linear)

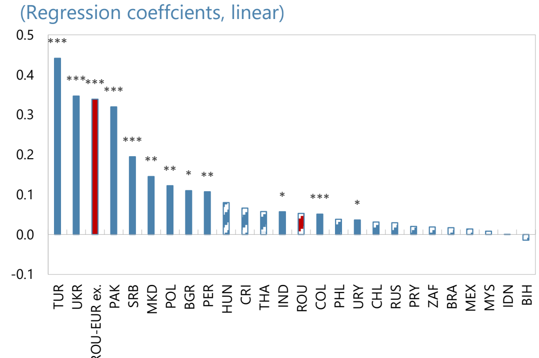


Impact of Depreciation against EUR on Inflation Expectations
(Regression coeffcients, non-linear)



Impact of Depreciation against USD on CPI Inflation
(Regression coeffcients, linear)

Impact of Depreciation against USD on CPI Expectations
(Regression coeffcients, linear)



Note: Coefficients represent percentage increases in the CPI / CPI expectations in response to a 1 pp decrease in the m/m change of the exchange rate. Impact of Depreciation against USD is presented for 12month horizon.
** denotes significance Significant at 10%, ** denotes significance at 5% and *** denotes significance at 1% levels*

18. An increase in exchange rate flexibility would support a move to full-fledged inflation targeting. Allowing greater exchange rate flexibility on a sustained basis would accommodate interest rate differentials as needed to address asymmetric shocks to inflation, help limit opportunities for carry trade and balance sheet mismatches, and increase resilience to external shocks. Furthermore, in conjunction with fiscal consolidation, it would help strengthen Romania's weak external position. At the same time, it is understood that moving to more exchange rate flexibility would pose serious challenges and could require a comprehensive strategy to gradually overcome euroization. In this regard, capital flow measures used by some dollarized countries to limit vulnerabilities may not be allowed for Romania under EU regulation.[2] It should be noted that, within a flexible exchange rate and inflation targeting framework, occasional FXI to smooth large and sudden swings in the exchange rate could still be justified based on IPF guidance.

19. Another option would be to join the euro area over the medium term. As part of the entry requirements to joining the European Union, Romania has accepted the obligation to join the eurozone when it meets the relevant economic convergence criteria (IMF, 2010). The authorities can set the target date for this. However, joining the euro area would be subject to strict requirements, and currently, Romania does not meet the entry criteria. Furthermore, a premature adoption of the single currency—before achieving a sufficient degree of convergence and economic flexibility—could be detrimental, as the ECB's monetary policy might be less appropriate for smoothing Romania's output and price volatility.

20. In the meantime, the existing policy practices that dampen exchange rate flexibility elevate the importance of the capacity to employ fiscal policies in response to changing macroeconomic and financial conditions (EUR, 2016b). Fiscal consolidation would support monetary policy in reducing inflation and is key to lowering the excessive current account deficit.

F. Regressions

To assess the pass-through of the EUR/RON exchange rate on inflation (and analogously on inflation expectations), we estimate linear and non-linear local projections:

$$
\begin{aligned}
Price_{t+f} - Price_t &= \alpha + \sum_{i=0}^{2}\left(\beta_i^f \,\mathrm{d\_EUR}_{t-i}\right) \\
&+ \sum_{i=0}^{2}\left(\theta_i^f \,\mathrm{infl}_{t-i}\right) + \sum_{i=0}^{2}\left(\gamma_i^f \,\mathrm{IP}_{t-i}\right) + \sum_{i=0}^{2}\left(\delta_i^f \,\mathrm{d\_oil}_{t-i}\right) + \sum_{i=0}^{2}\left(\varphi_i^f \,\mathrm{d\_food}_{t-i}\right) + \mu
\end{aligned}
$$

[2] For international experiences, see Kokenyne et al. (2010), and IMF (2016b and 2018).

$$Price_{t+f} - Price_t$$
$$= \alpha + \sum_{i=0}^{2}\left(\beta_i^f \text{d\_EUR}_{t-i}\right) + \sum_{i=0}^{2}\left(\rho_i^f \text{d\_EUR}_{t-i}^2\right)$$
$$+ + \sum_{i=0}^{2}\left(\theta_i^f \text{infl}_{t-i}\right) + \sum_{i=0}^{2}\left(\gamma_i^f \text{IP}_{t-i}\right) + \sum_{i=0}^{2}\left(\delta_i^f \text{d\_oil}_{t-i}\right) + \sum_{i=0}^{2}\left(\varphi_i^f \text{d\_food}_{t-i}\right) + \mu$$

Where $Price = \{CPI\ Inflation, Expected\ Inflation\}$

$and\ f = \{6{,}12\}$

Variable	Definition
Expected Inflation	12-month-ahead Consensus inflation forecasts
d_EUR	monthly change in the EUR exchange rate
Infl	y-o-y inflation
IP	cyclical component of the industrial production index
d_oil	monthly percentage change in the global oil price index
d_food	monthly percentage change in global food prices

Variable	Definition
CPI	Headline consumer price index
Expected Inflation	12-month-ahead Consensus inflation forecasts
d_EUR	Monthly change in the EUR exchange rate
Infl	Y-o-y inflation
IP	Cyclical component of the industrial production index
d_oil	Monthly percentage change in the global oil price index
d_food	Monthly percentage change in global food prices

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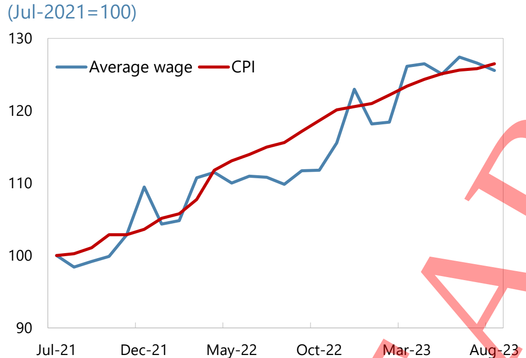
Annex II. Wage Growth and Inflation in Romania

Strong wage growth can complicate bringing down inflation to the NBR's target band. This annex examines various dimensions that matter for the pass-through of wage growth to headline inflation. Despite some mitigating factors, the findings suggest that the risks of continued high wage growth for inflation are substantial.

A. Introduction

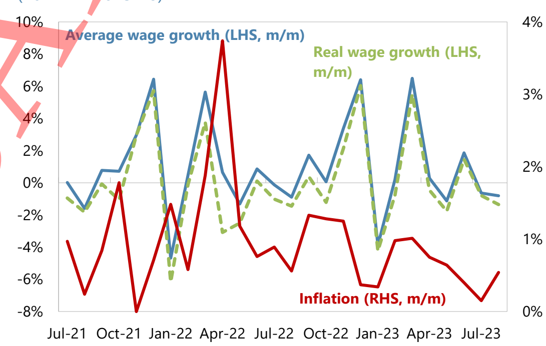
1. **Continued strong wage growth triggers the question whether this will feed into inflation going forward.** Cumulative wage growth since mid-2021 now slightly exceeds cumulative inflation, suggesting growth in real wages and a more-than-full compensation of the fall in purchasing power due to inflation. Real wages currently grow at roughly 4% y/y and 2% m/m, suggesting that real wage growth is accelerating. Since 2013, manufacturing wages have outgrown labor productivity.[1] The mission will look into this large and persistent deviation.

Wage and Inflation
(Jul-2021=100)



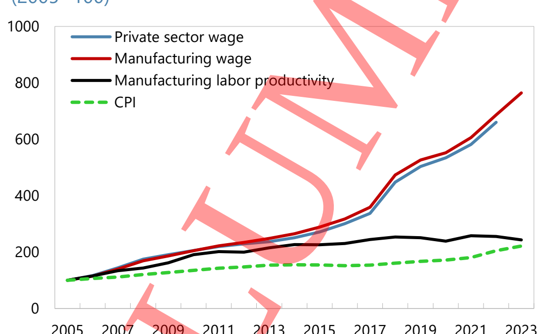
Source: Haver Analytics and IMF staff calculations.

Wage and Inflation Growth
(2021m7-2023m8)



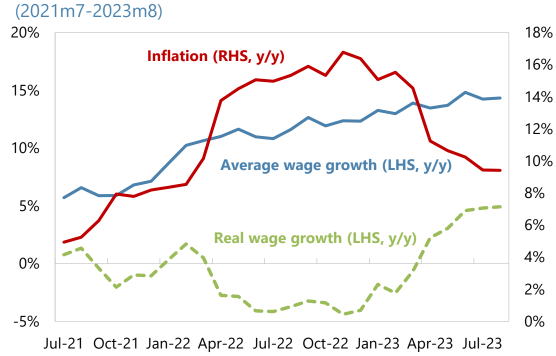
Sources: Haver Analytics and IMF staff calculations.

Wage, Inflation and Labor Productivity
(2005=100)



Sources: Romania Authorities, Haver Analytics, and IMF staff calculations.

Wage and Inflation Growth
(2021m7-2023m8)

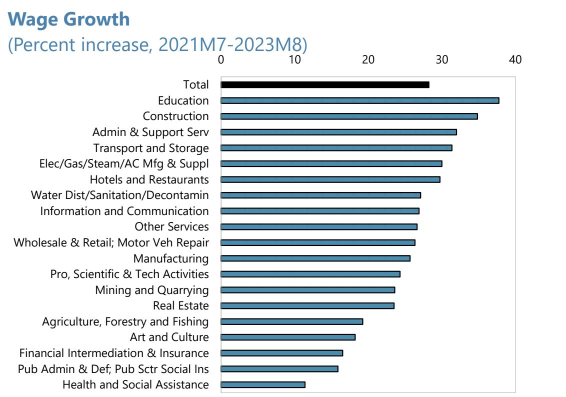


Sources: Haver Analytics and IMF staff calculations.

2. **Headline wage growth hides significant heterogeneity across sectors.** Private sector wage growth fueled overall wage growth over the last year or so, with most sectors showing

[1] The level shift in the wages in 2018 was due to a change in payroll taxation whereby the tax burden was shifted to the employees.

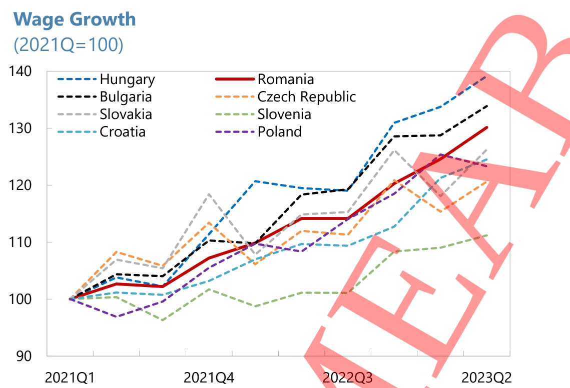
cumulative wage increases above 20 percent. Going forward, the public sector is likely to contribute to continued strong wage growth going forward, with wage increases of 17 percent already agreed for some public sector workers.



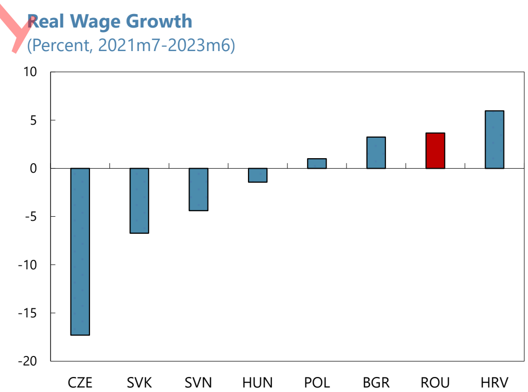
Sources: Haver Analytics and IMF staff calculations.

Sources: Haver Analytics and IMF staff calculations.

3. There is strong wage growth in many CESEE countries. Romania's wage growth is not exceptional. However, real wages have not increased in all countries.



Sources: Haver Analytics and IMF staff calculations.



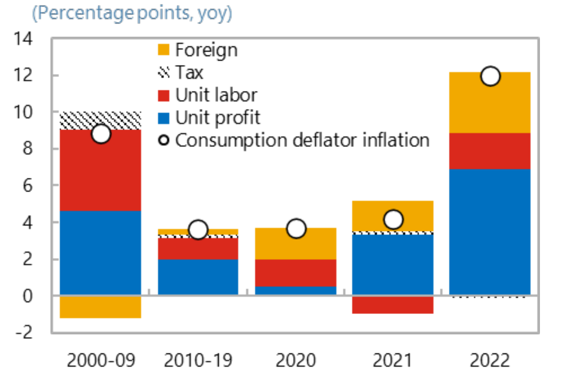
Sources: Haver Analytics and IMF staff calculations.

4. Previous Fund work examined the effects of wages on inflation. Alvarez et al. (2022) examine wage-price spirals using cross-country data from advanced economies dating back to the 1960s. They find that an acceleration of nominal wages should not necessarily be seen as a sign that a wage-price spiral is taking hold. Using data from EU countries, Boranova et al. (2019) find that the pass-through from wage growth to inflation is significantly lower in periods of subdued inflation and inflation expectations, greater competitive pressures, and robust corporate profitability. Their starting point is the apparent disconnect between wage growth and inflation before the pandemic. Based on a panel VAR analysis, IMF (2023) shows that wage pass-through to core inflation is smaller when inflation expectations are better anchored and when corporate profitability is higher.

5. Hansen et al. (2023) decompose past inflation into contributions from changes in labor costs, import costs, profits and taxes for the euro area. Employing their methodology to

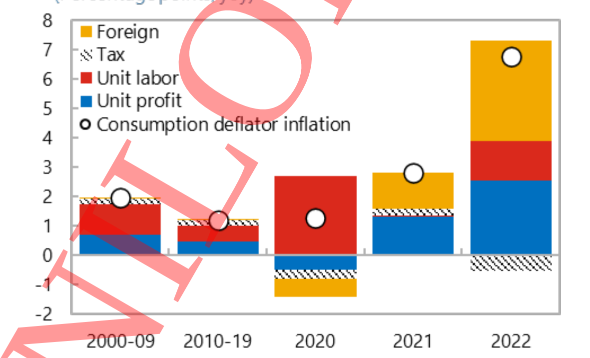
Romania suggests that in 2022, inflation as measured by the change in the consumption deflator was primarily driven by increases in profits followed by increases in import prices. The contribution of labor costs is smaller but growing. The picture is similar for the euro area, although the role of import prices is relatively more important.

Consumption Deflator Inflation Decomposition
(Percentage points, yoy)



Sources: Eurostat, OECD, IMF staff calculations.

Euro Area: Consumption Deflator Inflation Decomposition
(Percentage points, yoy)



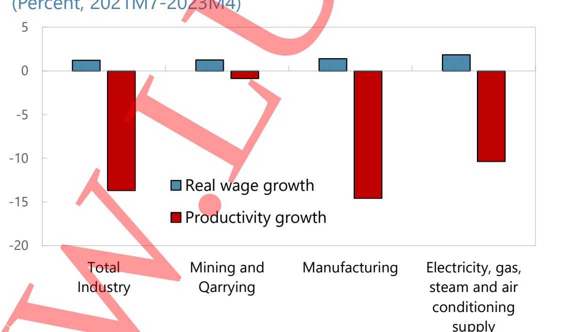
Sources: Eurostat, OECD, IMF staff calculations.

B. Private Sector Wage Growth and Inflation

6. **The extent to which wage increases affects headline inflation depends on several factors and is difficult to predict ex-ante.** One approach is to consider (i) the pass-through of wages to producer prices; (ii) the effects of producer prices on consumer prices; and (iii) consumption patterns, i.e., the extent to which domestic wages matter for the consumption basket of households. We use a mix of stylized facts and econometric evidence to examine each dimension.

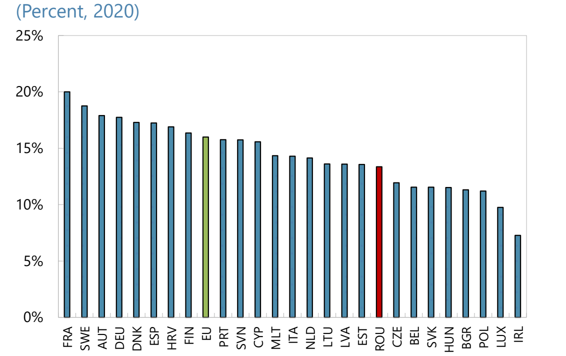
- **The effects on wages on producer prices may increase from moderate levels.** First, wage growth (in real terms) may not have effects on producer prices if matched by equal increases of labor productivity, but recent wage growth exceeded by far productivity growth (at least in those sectors where data are available). Second, while the labor share, i.e., the share of wage costs in turnover, at 14 percent, is slightly below the EU average, it is higher than in many CESEE peers.

Romania: Real Wage and Productivity Growth
(Percent, 2021M7-2023M4)



Sources: Eurostat and IMF staff calculations.

Labor Share
(Percent, 2020)



Sources: Eurostat and IMF staff calculations.

- **Regression analysis based on sectoral data can be used to examine the effects of wage levels on PPI changes in greater detail in the past.** We use rich, unweighted, sectoral wage data that is matched with producer prices for production of domestic products and of services at quarterly frequency.[2] In the baseline, we limit the span of the data to the 2015Q1–2023Q1 period to avoid having many more time periods than sectors and to ensure relevance for the current context (data from the more distant past may not reflect structural changes in the economy that have been taken place). We regress the sectoral, gross wage on sectoral PPI inflation, using fixed effects to control for a range of unobserved factors at the industry-year, quarter-year and industry-quarter level that absorb a variety of confounding factors including sector-specific seasonality and annual changes in sector-specific productivity:

$$PPIinf_{syq} = \beta_1 Log\left(wage_{syq}\right) + \gamma_{sy} + \gamma_{sq} + \gamma_{yq} + \varepsilon_{st} \qquad (1)$$

- **The results suggest the cumulative effects over several quarters can be substantial.** The results suggest that a 1 percent increase wages are on average associated with an increase in PPI inflation of around 0.13 percentage points in the same quarter. This is somewhat smaller what Romania's current labor share would suggest, potentially because we use unweighted data, and because it ignores any lags in the effects. In specifications (2), we increase the time span of the data; the coefficient remains robust. In specification (3), we remove all non-service sectors; the coefficient increases significantly, in line with our expectations. In the remaining specifications, we show that over time, the effect of wage increases is magnified. In specifications (4), (5) and (6), we include the moving two-quarter average, the moving three-quarter average and lagged values of the wage levels. The results suggests that over three quarters, the effects of wages on PPI inflation more than triple relative to the baseline specification, and that a substantial part of wage increases is passed on to PPI inflation.

[2] While our variables are available at monthly frequency for some sectors, we use quarterly averages for consistency purposes and to remove noise.

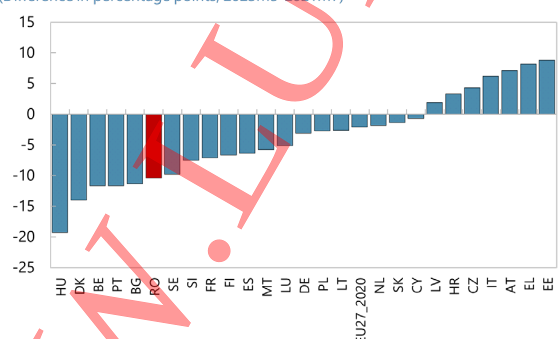
Table 1. Romania: Regression Results

VARIABLES	(1) PPI_change	(2) PPI_change	(3) PPI_change	(4) PPI_change	(5) PPI_change	(6) PPI_change
Log(wage)	13.31*	14.04***	68.22***			14.21*
	(7.340)	(3.303)	(13.73)			(7.286)
Log(wage), 2q MA				22.87**		
				(9.926)		
Log(wage), 3q MA					40.91***	
					(12.00)	
Log(wage), 1st lag						11.29*
						(6.551)
Log(wage), 2nd lag						19.61***
						(6.783)
Observations	952	2,318	140	952	952	952
R-squared	0.506	0.480	0.654	0.507	0.512	0.515
Industry-year FE	Yes	Yes	Yes	Yes	Yes	Yes
Industry-quarter FE	Yes	Yes	Yes	Yes	Yes	Yes
Year-quarter	Yes	Yes	No	Yes	Yes	Yes
No of sectors	34	34	5	34	34	34
No. of periods	28	71	28	28	28	28

Standard errors in parentheses
*** p<0.01, ** p<0.05, * p<0.1

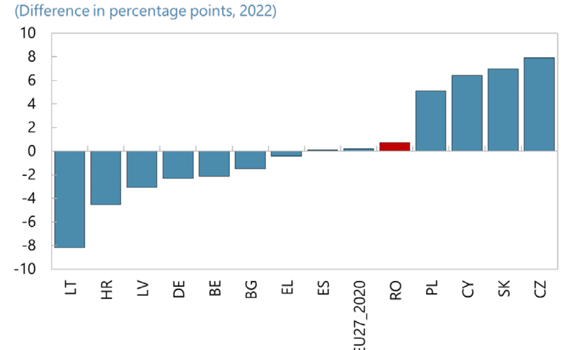
- **The transmission of producer increases on consumer prices could likewise increase.** The PPI for (domestic) consumer goods has increased by 10 percentage points more than the HICP-based index for goods which is a crude way of suggesting that profit margins shrank among some businesses over the 2021M7–2023M5 period (even though overall profits may have increased, as suggested by the decomposition analysis). However, profit margins cannot shrink endlessly. The services PPI and the HICP-based index for services have increased by roughly the same amounts in 2022, but services are less important in the consumption basket of Romanians.

HICP and PPI Goods Inflation
(Difference in percentage points, 2023M5-2021M7)



Sources: Eurostat, IMF staff calculation

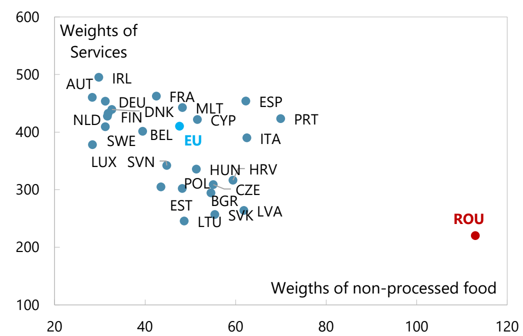
HICP and PPI Services Inflation
(Difference in percentage points, 2022)



Sources: Eurostat, IMF staff calculation

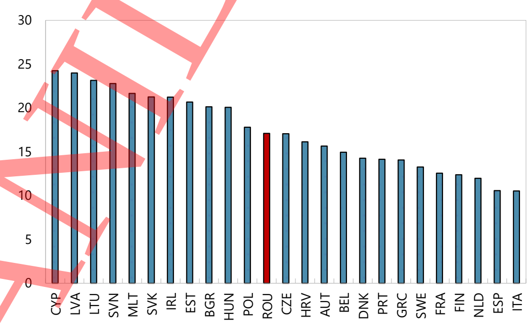
- **The consumption patterns of Romanian households is likely to somewhat cushion the effects of wage growth on headline inflation relative to other EU countries.** First, consumption of services is low. Presumably, domestic wages matter for services than for most goods because services are less tradeable and have a higher wage component. Second, Romania has by far the highest consumption share of unprocessed food (which is arguably the consumption category least affected by market wages), suggesting that home production is more important than in other countries. Finally, the import share of private consumption is broadly in line with the EU average but below those of CESEE peers where data are available.

HICP Weights



Source: Eurostat.

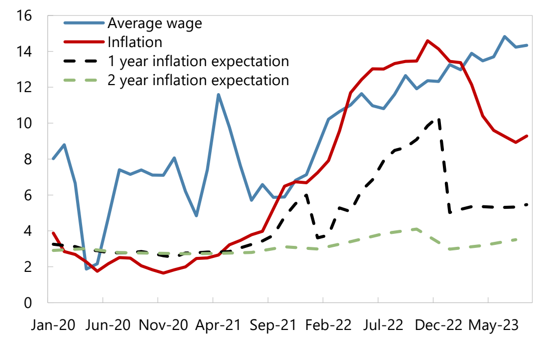
Import Share of Total Private Consumption
(Percent)



Source: OECD.

7. **Inflation expectations are subsiding.** While nominal wages are accelerating, headline inflation and 1-year and 2-year ahead inflation expectations are slowly declining. This suggests that high wage growth does not necessarily undermine the anchoring of inflation expectations.

Romania: Wage, Inflation and Inflation Expectations
(Percent, Y/Y, 2020M1-2023M8)

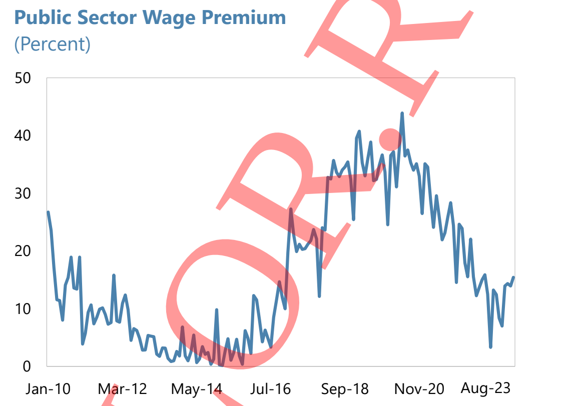


Sources: Haver Analytics, Consensus Forecasts and IMF staff calculations.

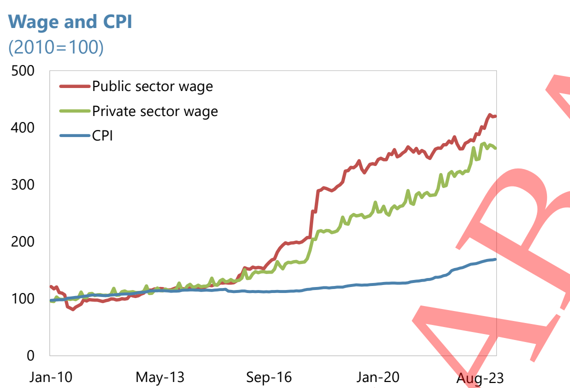
C. Public Sector Wage Growth and Inflation

8. **Whether the anticipated public sector wage growth will feed into inflation depends on several factors.** Given strong anticipated public sector wage growth, this question is especially topical in Romania. Public sector wages do not affect consumer prices directly as many public services are provided for free or below market costs. However, public sector wages could increase inflation expectations; and push up private sector wages if the public and private sector compete at least in part for the same workers or if public sector wage increases provide at least implicit guidance for private sector wage negotiations.

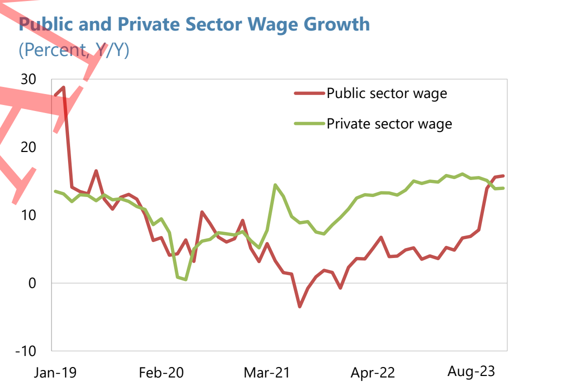
9. Previous Fund work examined the effects of public sector wage increases on private sector wages and inflation. Abdallah et al. (2023) compile a novel cross-country database on average public and private sector wages and public-private wage differentials. On average, public-sector workers earn around 10 percent more relative to comparable private sector workers, with the premium being higher for non-advanced economies and increasing during economic downturns and prior to elections. Using local projections, they show that both private sector wages and inflation respond positively to increases in public wages, albeit with heterogeneity across countries.



Sources: Haver Analytics and IMF staff calculations.



Sources: Haver Analytics and IMF staff calculations.



Sources: Haver Analytics and IMF staff calculations.

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Annex III. Risk Assessment Matrix[1]

Risk	Transmission Channels	Expected Impact	Policy Response
Global risks			
Likelihood	**High**	**High**	
Intensification of regional conflict(s) (conjunctural)	Escalation of Russia's war in Ukraine or other regional conflicts and resulting economic sanctions disrupt trade (e.g., energy, food, tourism, and/or critical supply chain components), remittances, refugee flows, FDI and financial flows, and payment systems.	Negative global spillover through energy prices, trade, capital flows and confidence effects on financial markets and investment. Economic growth slows markedly, even considering that Romania is less directly exposed to Russia and Ukraine due to being to a singificant extent self-sufficient in energy and a large grain producer. However, geographical proximity to the conflict region could have confidence effects. Slowing activity resulting in weaker fiscal revenues and increase in borrowing costs from risk premia.	Temporarily loosen the fiscal stance to accommodate additional spending needs, financed where possible with EU support. Extend targeted support to the most vulnerable but avoid overly costly and broad-based price support schemes. At the same time, prepare and communicate/enact future consolidation measures. Focus monetary policy on reducing inflation. Advance structural reform agenda to facilitate reallocation of resources.
Likelihood	**High**	**Medium**	
Commodity price volatility (conjunctural)	A succession of supply disruptions (e.g., due to conflicts, uncertainty, and export restrictions) and demand fluctuations causes recurrent commodity price volatility, external and fiscal pressures in EMDEs, contagion effects, and social and economic instability.	Due to the conflict in Israel/Gaza, oil and/or gas supplies could be disrupted and/or prices spike again. However, Romania has own resources, which limits its exposure. The wholesale electricity price cap would mitigate these effects to some extent.	Consider gradually raising the wholesale electricity price cap (the price cap is scheduled to expire in March 2025); therafter any support should be well-targeted at poor households. Tighten monetary policy as needed to contain inflationary pressures.
Likelihood	**High**	**Medium**	
Abrupt global slowdown or recession (conjunctural)	Global and idiosyncratic risk factors combine to cause a synchronized sharp growth downturn, with recessions in some countries, adverse spillovers through trade and financial channels, and market fragmentation. In Europe, an intensifying fallout from the war in Ukraine, worsening energy crisis and supply disruptions, and monetary tightening exacerbate the economic slowdown.	Negative global spillover through trade, capital flows and confidence effects on financial markets and investment. Slowing activity results in weaker fiscal revenues.	Allow fiscal automatic stabilizers to operate. Advance structural reform agenda to facilitate reallocation of resources.
Likelihood	**Medium**	**Medium**	
Monetary policy miscalibration (conjunctural)	Amid high economic uncertainty and volatility, major central banks slow monetary policy tightening or pivot to loosen monetary policy stance prematurely, de-anchoring inflation expectations, triggering a wage-price spiral in tight labor markets, and spillovers to financial markets.	(i) Appreciation pressures. Risk of large capital inflows, exchange rate overshooting and financial instability, and loss of competitiveness. (ii) Increase in risk aversion and capital flight.	(i) Sterilize capital inflows while allowing some degree of exchange rate volatility to deter capital inflows. (ii) Raise interest rates.
Domestic risks			
	Medium	**Medium**	
4. **Political constraints within the new ruling coalition** hamper implementation of reform plans (conjunctural)	NRRP implementation, fiscal reforms and consolidation trajectory are disrupted, with reemergence of populist initiatives. Associated worsening of market sentiment, and increasingly challenging fiscal financing. Risk of credit rating downgrade on fiscal and debt trajectory.	Persistence of deficits lead to increased financing constraints. Possible feedback loops through banks, given debt exposures (sovereign-bank nexus). Over the medium ter, shortfalls in public investment reduce growth potetnial.	Design package of policies to limit political pushback against prudent reforms: Combine measures to address inequality (deepen education and health reforms, higher taxation of richer segments of the population) and provision of public investment with and structural reforms to raise growth. While restraining government spending (wages and pensions), provide compensation to more affected groups and sectors, as well as support programs to facilitate transition and smooth reallocation of resources.

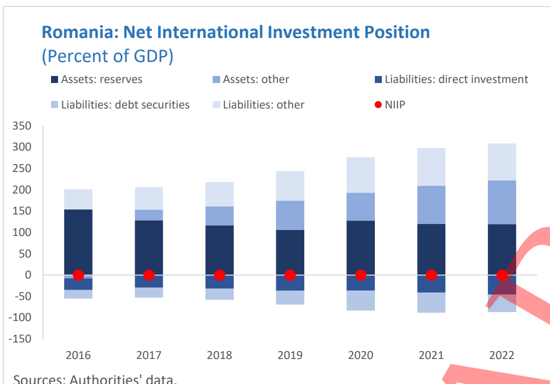
[1] The Risk Assessment Matrix shows events that could materially alter the baseline path. The relative likelihood is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability between 30 and 50 percent). The RAM reflects staff views on the source of risks and overall level of concern as of the time of discussions with the authorities. Non-mutually exclusive risks may interact and materialize jointly. The conjunctural shocks and scenario highlight risks that may materialize over a shorter horizon (between 12 to 18 months) given the current baseline. Structural risks are those that are likely to remain salient over a longer horizon.

Annex IV. External Sector Assessment

Overall Assessment: *The external position of Romania in 2022 was substantially weaker than the level implied by fundamentals and desirable policies. The current account deficit widened to 9.3 percent of GDP. Staff assesses the current account gap to be around -5.9 percent of GDP, implying a REER overvaluation of 17 percent, although the magnitude of this imbalance is subject to considerable uncertainty given the large residual. Reserves increased further in 2022 and are assessed to be adequate according to most metrics.*

Potential Policy Responses: *The authorities need to make a credible commitment to sustained fiscal consolidation and boost the country's capacity to absorb EU funds. Romania should also consider greater exchange rate flexibility as part of the policy mix, both to address a persistent currency overvaluation and to maintain reserve coverage. Structural reforms to boost productivity and competitiveness, as well as further investments in infrastructure and human capital, are also necessary.*

Foreign Assets and Liabilities: Position and Trajectory

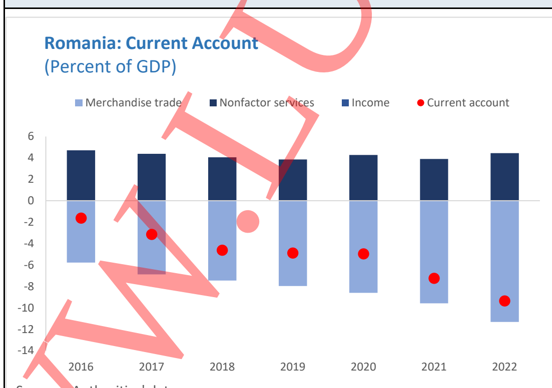


Background. Romania's net international investment position (NIIP) improved in 2022 to -40 percent of GDP due to strong real and nominal growth. An increase in nominal liabilities was driven mostly by strong inward direct and other investment, whereas portfolio liabilities declined. Nominal assets rose as well, largely in international reserves. FDI accounts for over half of Romania's external liabilities (54 percent), while trade credit and currency and deposits have risen to almost 12 percent. Debt securities account for 21 percent. Reserves comprise almost half of external assets. The NIIP is projected to remain broadly constant in 2023 as a share of GDP as nominal GDP growth is expected to remain robust, even though the current account deficit, while falling, is projected to remain large.

Assessment. The external balance sheet does not appear to be a major source of risk for Romania's external sustainability. External liabilities are concentrated in direct and other investment, and only a relatively small share in debt securities. Gross market borrowing needs as a percentage of GDP remain elevated but are declining, containing roll-over risks.

2022 (% GDP)	NIIP: -40	Gross Assets: 37	Debt Assets: 2	Gross Liab.: 77	Debt Liab.: 25

Current Account



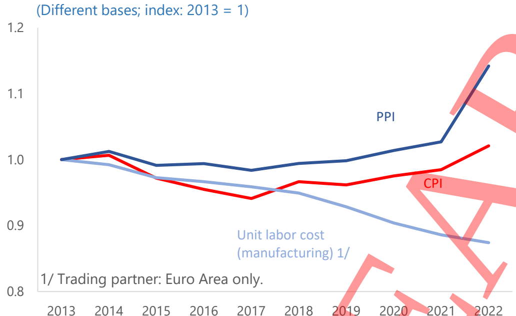
Background. Romania's current account (CA) deficit grew to 9.3 percent of GDP in 2022, notwithstanding a negative fiscal impulse. An increase in the goods deficit accounted for the entire deterioration, as a strengthening nonfactor services balance was offset by a declining income balance (largely due to higher profit remittances). The current account deficit is projected to narrow to below 7 percent of GDP in 2023, as slowing growth is expected to contain imports, and import prices are set to decline. Also, the services balance is projected to strengthen further in the medium term.

2022 EBA Model Estimate	
CA-Actual	**-9.3**
Cyclically adjusted	-8.5
Adjusted CA norm	-2.6
CA Gap	**-5.9**
Of which: Policy gaps	0.4
Residual	-6.3
Elasticity	0.35
REER Gap (%)	16.9

Assessment. The EBA CA model estimated norm is -2.6 percent of GDP after cyclical adjustments. The actual CA deficit in 2022 was 8.5 percent of GDP after cyclical adjustments, implying a CA gap of -5.9 percent of GDP. This suggests that Romania's external position at end-2022 was substantially weaker than implied by medium-term fundamentals and desirable policy settings. However, the residual is very large at -6.3 percent of GDP, implying a high degree of uncertainty about the drivers of Romania's current account and the extent of its misalignment with fundamentals. Recent one-off shocks and the range around the norm further increase the uncertainty around this assessment. Furthermore, the current account is financed to a large extent by capital transfers from the EU, limiting vulnerabilities. However, at EU grants, which augment the current account deficit without entailing new liabilities, are not incorporated in the CA norm. The External Sustainability (ES) approach of the EBA finds a similar CA gap of -5.8 percent of GDP.

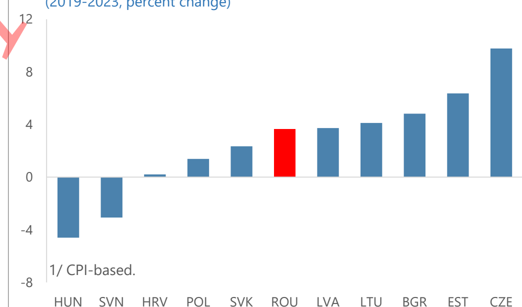
Real Exchange Rate

Romania: Real Effective Exchange Rate
(Different bases; index: 2013 = 1)



Sources: IMF databases, Haver database, and IMF staff calculations.

CESEE: Real Effective Exchange Rates 1/
(2019-2023, percent change)



Sources: Haver Analytics, and IMF staff calculations.

Background. The real exchange rate (CPI-based; IMF data) appreciated by 3.7 percent in 2022, the PPI-based measure by 11.2 percent, but the unit labor cost-based REER fell by 1.4 percent. The appreciation (based on Eurostat data) was similar to most CESEE peers.

Assessment. The EBA CA model based implies a REER overvaluation of about 17 percent in 2022 (applying an estimated elasticity of 0.35). This represents a further increase since 2021, when the overvaluation was estimated by the EBA model at 13 percent, and consistent with the REER appreciation (CPI-based). The EBA REER index (10.2 percent) and level (-18.2 percent) methodologies are subject to measurement uncertainty, are driven by large residuals, and do not appear to capture Romania-specific factors well. Accordingly, staff assesses the REER to be overvalued by 17 percent.

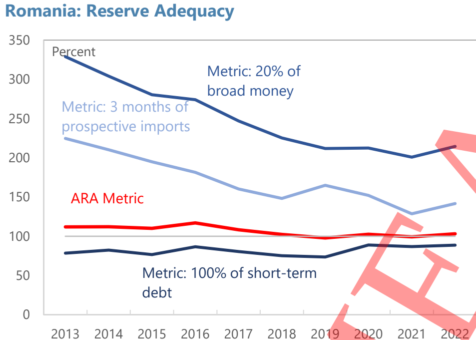
Capital and Financial Accounts: Flows and Policy Measures

Background. Capital account inflows in 2022 stood at 2.4 percent of GDP, up from 2.2 percent a year earlier, primarily reflecting an increase in EU grants. Net FDI inflows remained high, at 3.4 percent of GDP, only slightly lower than in 2021. Portfolio inflows remained at 1.7 percent of GDP, slightly higher than pre-pandemic levels. Other investment inflows rose to close to 3 percent of GDP, as the government received loans from under the EU's Recovery and Resilience Facility (RRF) and IFIs. Also, trade credits increased significantly. There are no restrictions on the capital and financial accounts.

Assessment. Capital account inflows are expected to continue to increase as EU funded projects ramp up, including through sizable resources under the Next Generation EU (NGEU) which has a total envelope of 9 percent of GDP over the next 6 years. There is also scope for higher absorption of large EU funds in the 2021–27 multi-annual EU budget for Romania. FDI inflows are expected to remain strong, underpinned by robust growth and attractiveness as a destination for reshoring investments, and notwithstanding large infrastructure investment needs, rising labor costs, and policy uncertainty. Portfolio investment flows into sovereign bonds may need continue to be sizeable, given only gradual fiscal consolidation, but FDI inflows and EU funds are projected to finance most of Romania's current account deficit.

FX Intervention and Reserves Level

Romania: Reserve Adequacy



Sources: Authorities and IMF staff calculations.

Background. Romania's de facto exchange rate arrangement has been classified as stabilized since August 2019. Reserves have risen substantially in euro terms since 2019, in part supported by inflows of EU funds. Overall, gross international reserves stood at 18.3 percent of GDP and could cover about 4.3 months of prospective imports or about 43 percent of M2 and 89 percent of short-term debt by residual maturity.

Assessment. Reserves are assessed to be adequate. Romania's reserve coverage is around 103 percent of the Fund's metric for assessing reserve adequacy (ARA) for emerging markets with a de-facto 'fixed' exchange rate regime.[1] Reserve adequacy would be above 145 percent of the ARA metric if a floating exchange rate regime were assumed and are adequate by most other standard metrics. However, in the medium term, reserves are projected to fall below 100 percent of the Fund's ARA metric, as current account deficits, albeit financed to a large extent by EU grants and FDI, are expected to remain elevated.

[1] Romania's exchange rate was re-classified retroactively as crawl-like from floating from July 2016, and subsequently reclassified retroactively as stabilized from crawl-like from September 2021. As a result, Romania's reserve adequacy metric in recent years is based off that for a 'fixed' exchange rate regime

Annex V. Sovereign Risk and Debt Sustainability Analysis

Romania: Risk of Sovereign Stress

Horizon	Mechanical signal	Final assessment	Comments
Overall	…	Moderate	The overall risk of sovereign stres is moderate, reflecting a relatively low level of vulnerability in the near-term and moderate levels of vulnerability in the medium-, and long-term horizons.
Near term 1/			
Medium term	High	Moderate	Medium-term risks are assessed as moderate against a mechanical 'high' signal on the basis of strong grow th prospects, significant scope for revenue mobilization, and Romania's EU membership and financial support through structural funds and RRP. Also, the government remains committed to medium-term fiscal consolidation.
Fanchart	High	…	
GFN	High	…	
Stress test	…	…	
Long term	…	Moderate	Long-term risks are moderate due to strong grow th prospects, significant scope for revenue mobilization, and Romania's EU membership.
Sustainability assessment 2/	Not required for surveillance countries	Not required for surveillance countries	
Debt stabilization in the baseline			No

DSA summary assessment

Commentary: While budget deficits and gross financing needs are projected to remain elevated and debt to rise, successful economic convergence to CESEE peers and continued favorable economic prospects, underpinned by EU membership, are the basis for high levels of investor confidence. In the medium to longer term, fiscal pressures arising from the need to build fiscal space for climate mitigation spending and demographic change pose risks.

Source: Fund staff.

Note: The risk of sovereign stress is a broader concept than debt sustainability. Unsustainable debt can only be resolved through exceptional measures (such as debt restructuring). In contrast, a sovereign can face stress w ithout its debt necessarily being unsustainable, and there can be various measures—that do not involve a debt restructuring—to remedy such a situation, such as fiscal adjustment and new financing.

1/ The near-term assessment is not applicable in cases w here there is a disbursing IMF arrangement. In surveillance-only cases or in cases w ith precautionary IMF arrangements, the near-term assessment is performed but not published.

2/ A debt sustainability assessment is optional for surveillance-only cases and mandatory in cases w here there is a Fund arrangement. The mechanical signal of the debt sustainability assessment is deleted before publication. In surveillance-only cases or cases w ith IMF arrangements w ith normal access, the qualifier indicating probability of sustainable debt ("w ith high probability" or "but not w ith high probability") is deleted before publication.

Figure 1. Romania: Debt Coverage and Disclosures

	CG	GG	NFPS	CPS	Other	Comments
1. Debt coverage in the DSA: 1/	CG	GG	NFPS	CPS	Other	
1a. If central government, are non-central government entities insignificant?					n.a.	

2. Subsectors included in the chosen coverage in (1) above:

CPS	NFPS	GG: expected	CG	#	Subsectors captured in the baseline	Inclusion	Comments
CPS	NFPS	GG: expected	CG	1	Budgetary central government	Yes	
				2	Extra budgetary funds (EBFs)	No	Limited amounts
				3	Social security funds (SSFs)	Yes	
				4	State governments	Yes	
				5	Local governments	Yes	
				6	Public nonfinancial corporations	No	
				7	Central bank	No	
				8	Other public financial corporations	No	

3. Instrument coverage:

Currency & deposits	Loans	Debt securities	Oth acct. payable 2/	IPSGSs 3/

4. Accounting principles:

Basis of recording		Valuation of debt stock		
Non-cash basis 4/	Cash basis	Nominal value 5/	Face value 6/	Market value 7/

5. Debt consolidation across sectors:

Consolidated	Non-consolidated

Color code: chosen coverage | Missing from recommended coverage | Not applicable

Reporting on intra-government debt holdings

Issuer \ Holder	Budget. central govt	Extra-budget. funds	Social security funds	State govt.	Local govt.	Nonfin. pub. corp.	Central bank	Oth. pub. fin corp	Total
1 Budget. central govt									0
2 Extra-budget. funds									0
3 Social security funds									0
4 State govt.									0
5 Local govt.									0
6 Nonfin pub. corp.									0
7 Central bank									0
8 Oth. pub. fin. corp									0
Total	0	0	0	0	0	0	0	0	0

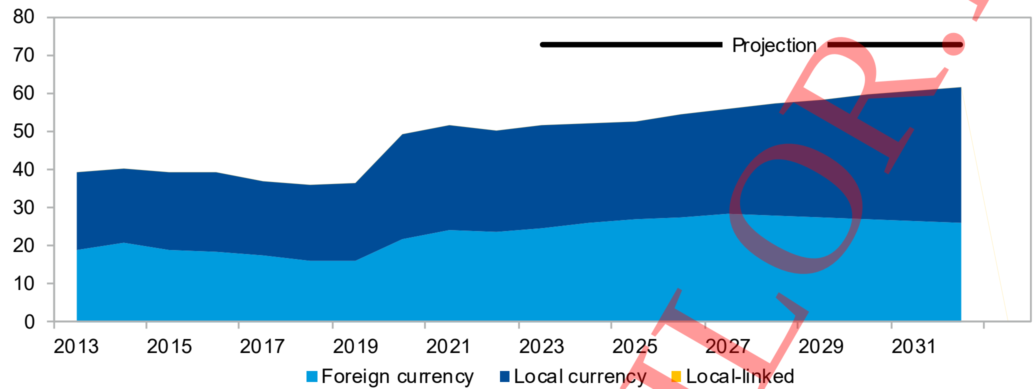
(Issuer rows 1–8 are grouped as CPS, NFPS, GG: expected, CG.)

1/ CG=Central government; GG=General government; NFPS=Nonfinancial public sector; PS=Public sector.
2/ Stock of arrears could be used as a proxy in the absence of accrual data on other accounts payable.
3/ Insurance, Pension, and Standardized Guarantee Schemes, typically including government employee pension liabilities.
4/ Includes accrual recording, commitment basis, due for payment, etc.
5/ Nominal value at any moment in time is the amount the debtor owes to the creditor. It reflects the value of the instrument at creation and subsequent economic flows (such as transactions, exchange rate, and other valuation changes other than market price changes, and other volume changes).
6/ The face value of a debt instrument is the undiscounted amount of principal to be paid at (or before) maturity.
7/ Market value of debt instruments is the value as if they were acquired in market transactions on the balance sheet reporting date (reference date). Only traded debt securities have observed market values.

Commentary: Budgetary reporting follows national legislation as well as EU standards.

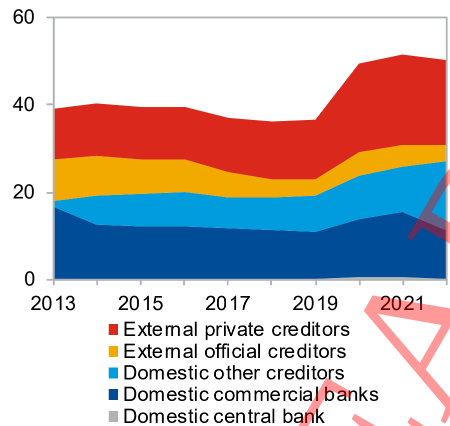
Figure 2. Romania: Public Debt Structure Indicators

Debt by currency (percent of GDP)



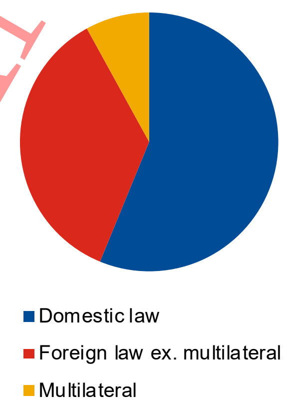
Note: The perimeter shown is general government.

Public debt by holder (percent of GDP)



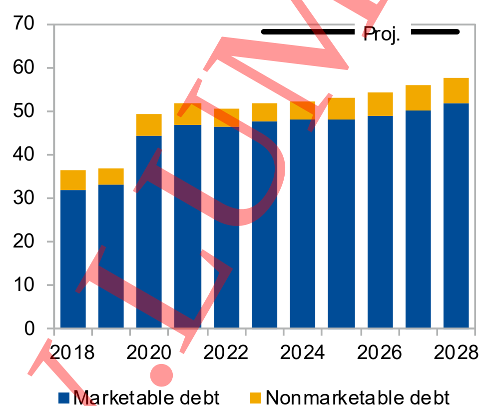
Note: The perimeter shown is general government.

Public debt by governing law, 2022 (percent)



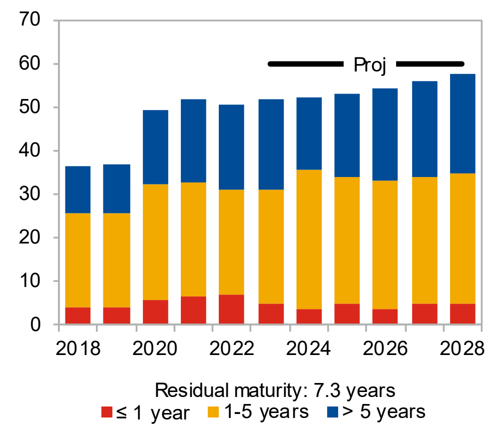
Note: The perimeter shown is general government.

Debt by instruments (percent of GDP)



Note: The perimeter shown is general government.

Public debt by maturity (percent of GDP)



Note: The perimeter shown is general government.

Commentary: With 36 percent of public debt denominated in or linked to foreign currencies (excluding debt to multilaterals), financing is vulnerable to changes in market perceptions.

Figure 3. Romania: Baseline Scenario

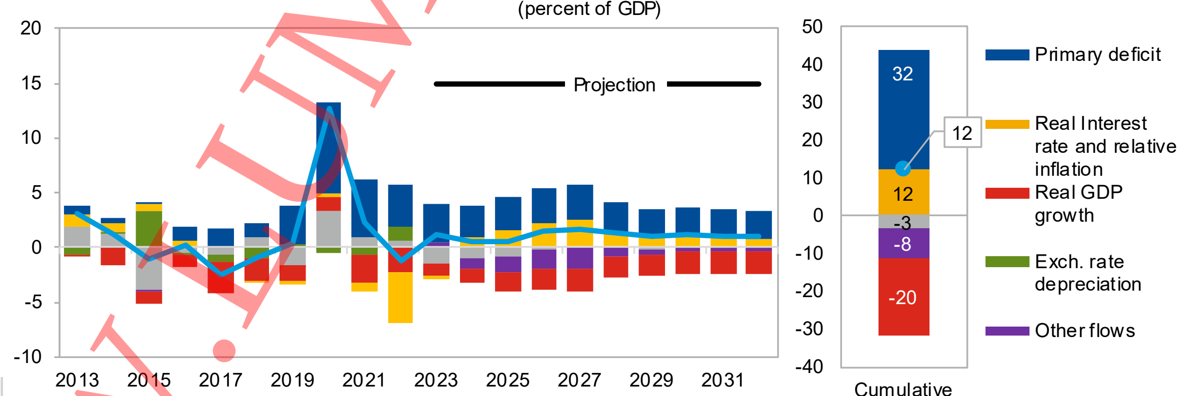
(In percent of GDP, unless indicated otherwise)

(percent of GDP unless indicated otherwise)

	Actual	Medium-term projection						Extended projection			
	2022	2023	2024	2025	2026	2027	2028	2029	2030	2031	2032
Public debt	50.5	51.6	52.2	52.8	54.3	56.0	57.4	58.4	59.6	60.7	61.7
Change in public debt	-1.2	1.1	0.6	0.6	1.5	1.7	1.4	1.0	1.2	1.0	1.1
Contribution of identified flows	-1.8	2.5	1.5	1.4	1.7	1.6	1.3	1.1	1.2	1.0	1.1
Primary deficit	3.8	3.6	2.9	3.0	3.2	3.1	2.8	2.6	2.7	2.5	2.6
Noninterest revenues	31.0	31.9	31.8	31.6	31.7	31.1	30.9	30.9	31.0	30.9	30.6
Noninterest expenditures	34.8	35.5	34.8	34.5	34.8	34.2	33.7	33.5	33.6	33.4	33.2
Automatic debt dynamics	-5.5	-1.5	-0.5	-0.2	0.3	0.5	-0.8	-1.0	-1.1	-1.2	-1.3
Real interest rate and relative inflation	-4.6	-0.4	0.9	1.6	2.2	2.5	1.2	1.0	1.0	0.9	0.8
Real interest rate	-5.8	-1.3	-0.1	0.8	1.9	2.3	1.1	0.7	0.8	0.7	0.6
Relative inflation	1.2	0.9	1.0	0.9	0.4	0.2	0.2	0.3	0.1	0.2	0.2
Real growth rate	-2.3	-1.1	-1.3	-1.8	-2.0	-2.0	-2.0	-2.0	-2.1	-2.1	-2.1
Real exchange rate	1.3	…	…	…	…	…	…	…	…	…	…
Other identified flows	0.0	0.5	-0.9	-1.4	-1.8	-2.0	-0.7	-0.5	-0.4	-0.3	-0.3
Contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
(minus) Interest Revenues	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other transactions	0.0	0.5	-0.9	-1.4	-1.7	-1.9	-0.7	-0.5	-0.3	-0.3	-0.2
Contribution of residual	0.6	-1.4	-0.9	-0.8	-0.2	0.1	0.1	-0.1	0.0	0.0	0.0
Gross financing needs	9.9	13.1	10.4	13.0	15.0	15.3	15.1	15.4	15.2	15.4	16.2
Of which: debt service	6.2	9.6	7.6	10.1	11.8	12.3	12.4	12.8	12.6	13.0	13.7
Local currency	4.9	7.9	4.9	7.1	7.8	7.4	7.3	7.7	7.4	7.9	8.4
Foreign currency	1.3	1.7	2.7	3.0	4.1	4.8	5.0	5.2	5.2	5.1	5.3
Memo:											
Real GDP growth (percent)	4.6	2.2	2.7	3.6	3.8	3.8	3.7	3.5	3.6	3.6	3.5
Inflation (GDP deflator; percent)	13.4	8.2	6.7	5.6	3.3	2.6	2.5	3.0	2.5	2.6	2.7
Nominal GDP growth (percent)	18.6	10.6	9.6	9.5	7.3	6.5	6.3	6.6	6.2	6.3	6.3
Effective interest rate (percent)	0.0	5.3	6.5	7.2	7.1	7.1	4.5	4.3	4.0	3.8	3.7

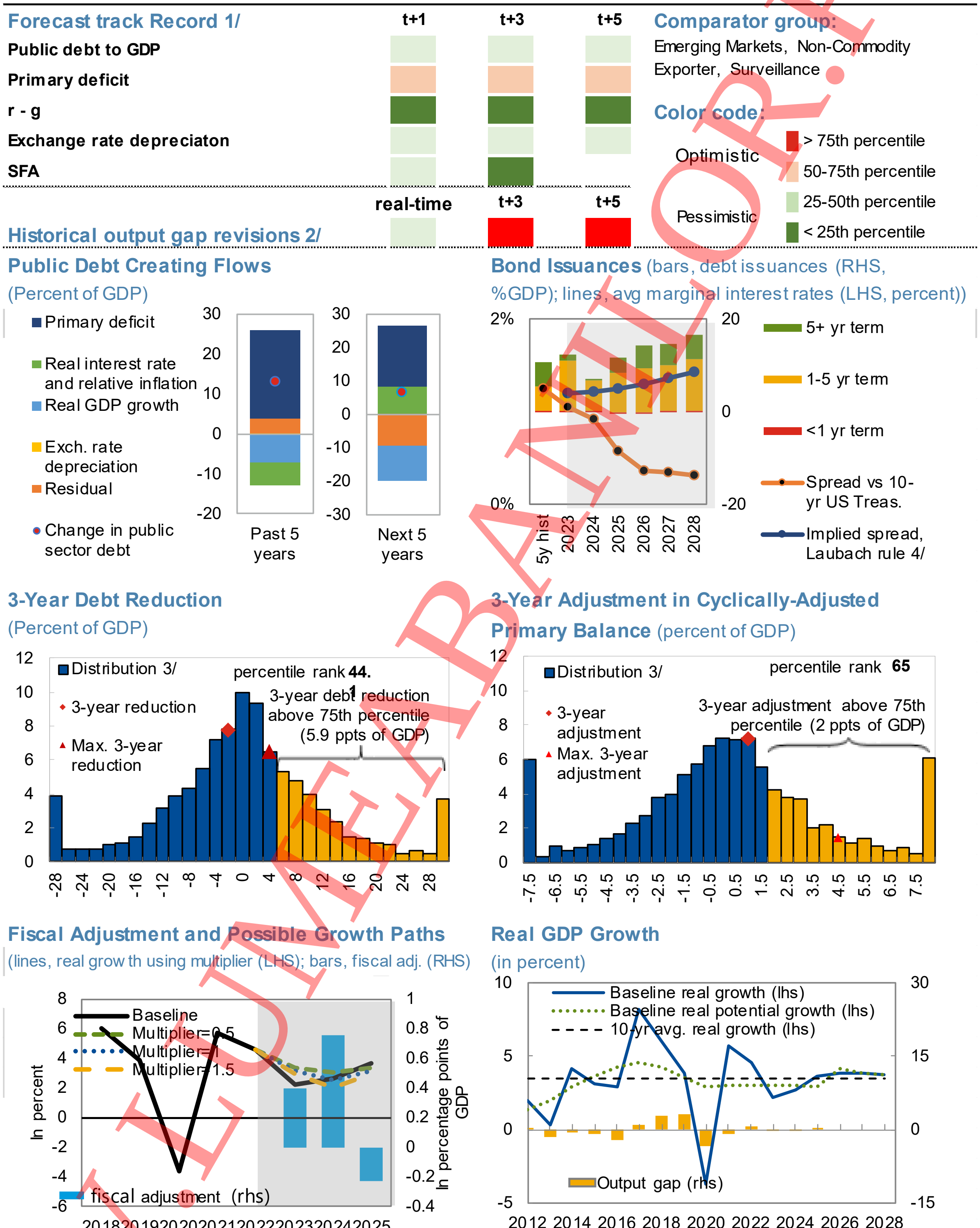
Contribution to change in public debt

(percent of GDP)



Commentary: Romania's public debt has increased significantly, albeit from a low level, and is projected to rise further throughout the projection horizon absent fiscal consolidation measures. However, the authorities remain committed to medium-term fiscal consolidation even though the 2023 fiscal target is highly unlikely to be reached.

Figure 4. Romania: Realism of Baseline Assumptions

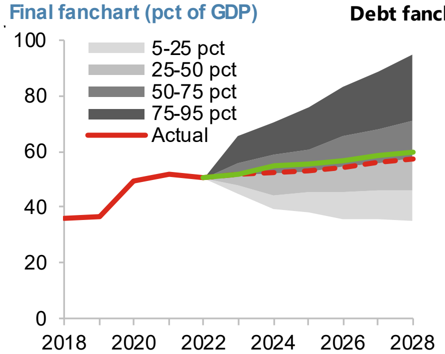


Commentary: Forecast errors do not point to major concerns. If anything, outcomes have frequently been better than forecasts, suggesting that debt dynamics may turn out more benign than currently projected.

Figure 5. Romania: Medium-Term Risk Assessment

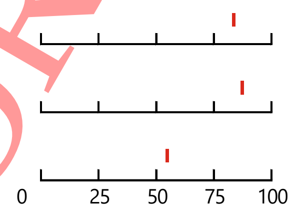
	Value	Contrib [1/]	Percentile in peer group [2/]

Final fanchart (pct of GDP)

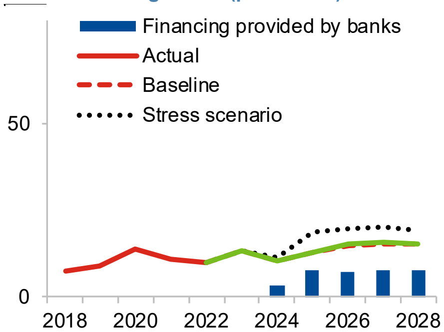


Debt fanchart module

	Value	Contrib [1/]
Fanchart width *(percent of GDP)*	59.9	0.9
Probability of debt non-stabilizaiton *(percent)*	97.9	0.8
Terminal debt-to-GDP x institutions index	32.8	0.7
Debt fanchart index (DFI)		2.4
Risk signal: [3/]		**High**

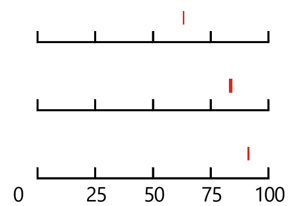


Gross financing needs (pct of GDP)



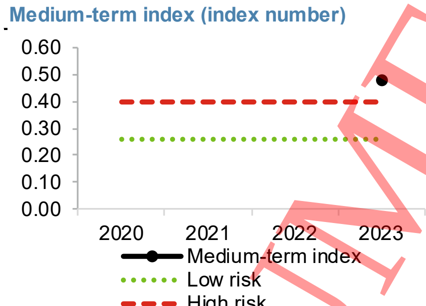
Gross financing needs (GFN) module

	Value	Contrib [1/]
Average baseline GFN *(percent of GDP)*	13.7	4.7
Banks' claims on the ge govt *(pct bank assets)*	22.4	7.3
Chg. In banks' claims in stress *(pct banks' assets)*	30.5	10.2
GFN financeability index (GFI)		22.1
Risk signal: [4/]		**High**



Banking crisis | Commodity prices | Exchange rate | Contingent liab. | Natural disaster

Medium-term index (index number)



Medium-term risk analysis

	Value	Norm. Value	Weight	Contribution
Debt fanchart index	2.40	0.53	0.50	0.27
GFN finaceability index	22.12	0.43	0.50	0.21
Medium-term index		0.5		
Risk signal: 5/		**High**		
Final assessment:		**Moderate**		

Prob. of missed crisis, 2023-2028, if stress not predicted: 54.5 pct.
Prob. of false alarms, 2023-2028, if stress predicted: 3.4 pct.

Commentary: In the medium to longer term, fiscal pressures arising from the need to build fiscal space for climate mitigation spending

Source: IMF staff estimates and projections.
1/ See Annex IV of IMF, 2022, Staff Guidance Note on the Sovereign Risk and Debt Sustainability Framework for details on index calculation.
2/ The comparison group is emerging markets, non-commodity exporter, surveillance.
3/ The signal is low risk if the DFI is below 1.13; high risk if the DFI is above 2.08; and otherwise, it is moderate risk.
4/ The signal is low risk if the GFI is below 7.6; high risk if the DFI is above 17.9; and otherwise, it is moderate risk.
5/ The signal is low risk if the GFI is below 0.26; high risk if the DFI is above 0.40; and otherwise, it is moderate risk.

Figure 6. Romania: Long-Term Projections and Risk Analysis

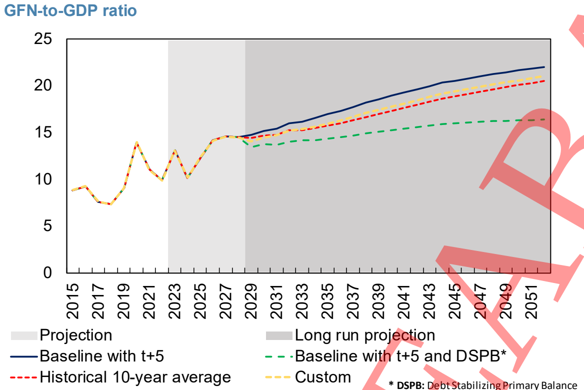
Large Amortization Trigger

Projection	Variable	Risk Indication
Medium-term extrapolation	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Medium-term extrapolation with debt stabilizing	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Historical average assumptions	GFN-to-GDP ratio Amortization-to-GDP ratio Amortization	
Overall Risk Indication		

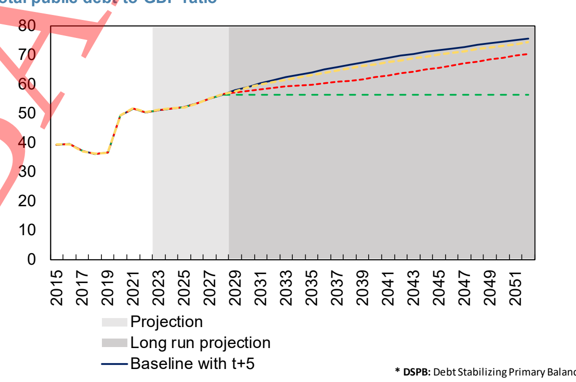
Alternative Baseline Long-term Projections (including Custom scenario)

	Baseline extension of fifth projection year	Custom baseline
Real GDP growth	3.7%	3.3%
Primary Balance-to-GDP	-2.8%	-2.0%
Real depreciation	-1.4%	0.0%
Inflation (GDP deflator)	2.5%	2.6%

GFN-to-GDP ratio



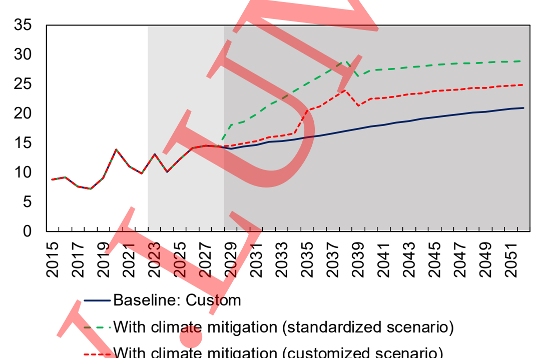
Total public debt-to-GDP ratio



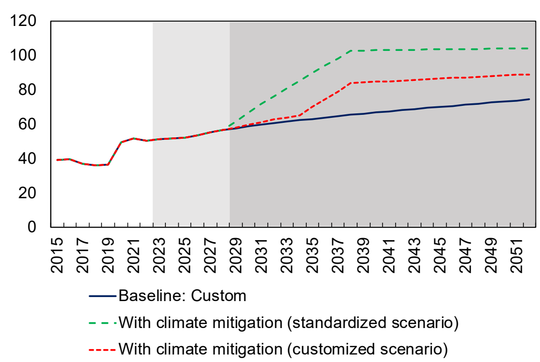
Commentary: Fiscal consolidation is needed to prevent public debt and gross financing needs (GFN) from rising steadily. Rising GFN would also increase vulnerabilities, notwithstanding mitigating factors such as EU membership.

Climate Change: Mitigation

GFN-to-GDP ratio



Total public debt-to-GDP ratio



Commentary: Climate mitigation costs, if debt-financed, would raise GFN and public debt even further.

Annex VI. Implementation of Past Article IV Recommendations

Key Recommendations (2022 Article IV)	**Policy Actions**
	Fiscal
Staff supported the authorities' deficit target for 2022 (5.8 percent of GDP), but cautioned against the authorities' optimistic revenue forecasts. Staff also advised against further support measures.	The deficit target was achieved (in cash terms; on an accrual basis, the outcome was 6.1 percent of GDP), aided by higher-than-anticipated inflation.
For 2023, staff also supported the authorities' deficit target of 4.4 percent of GDP. However, in the staff's view, the authorities' revenue and spedning projections were too optimitstic. Staff also advocated comprehensive tax reforms (personal income tax, value added tax, property tax, as well as taxation of carbon emissions in the meodium term) to support sustainable fiscal consolidation, with a deficit target of 3 percent of GDP in 2024, and lower thereafter.	The authorities remain committed to the fiscal consolidation path agreed with the European Commission, which envisages a fiscal defcit of 4.4 percent of GDP in 2023, and 3 percent thereafter. In the 2023 budget, they implemented some reforms to close tax loopholes, but they fell far short of what staff had recommended. They also introduced a property tax refrom, but implementation will be delayed due to technical reasons. On the expenditure side, they rely on restraint in pensions and public sector wages. However, pension and public sector wage reforms are being developed as part of Romania's NRRP commitments. The authorities modified the energy price cap in a budget-neutral way.
Staff emphasized the need to fully absorb available EU funds in a productive manner, and welcomed the authorities' efforts in this regard.	The authorities emphasized their focus on NRRP commitments. However, some benchmarks were missed, and disbursements have been delayed.
	Monetary and Financial
Staff recommended further monetary policy tightening at least through end-2022, but stressed that monetary policy would have to react nimbly to evolving conditions. In the event of rising longer-term inflation expectations, an acceleration of the pace of monetarty tightening would be warranted.	The authorities continued to raise the policy rate, while inflation--and inflation expectations--continued to rise. They halted further increases in the policy rate in January 2023. By then, while inflation expectations had risen, headline inflation appeared to have peaked.
Staff advocated a gradual increase in exchange rate flexibility to support external competeitiveness, and to help absorbing external shocks.	In the face of appreciation pressures on account of carry trades, the authorities allowed the market interest rate to fall below the policy interest rate in late-2022.
	Structural reforms
To help Romania absorb more EU funding and use investment funds more efficiently, staff encouraged the authorities to expeditiously strengthen medium-term planning and the medium-term budget framework, develop a centralized coordination mechanism and a pipeline of appraised investment projects across sectors.	The authorites have made efforts to strengthen absorption of EU funds. Public investment has increased significantly.
Staff also recommended reenergizing structural reforms and investments to raise productivity boost Romania's growth potential. Key areas were expanding digitalization, strengthening the anticorruption framework, improving the health and education systems, and reforming SOEs.	The government in early 2021 pledged to strengthen the governance of state-owned enterprises and introduced tighter monitoring criteria for SOEs. However, with the subsequent change in government reforms in this area have stalled. More broadly, the government is concentrating on meeting the benchmarks for disbursement of EU funds under the RRF.

ROMANIA

STAFF REPORT FOR THE 2023 ARTICLE IV CONSULTATION—INFORMATIONAL ANNEX

November 15, 2023

Prepared By	European Department

CONTENTS

FUND RELATIONS

(As of October 31, 2023)

Membership Status	Joined 12/15/72	Article VIII
General Resources Account	**SDR million**	**% Quota**
Quota	1,811.40	100.00
Fund holdings of currency	1,811.40	100.00
Reserve Tranche Position	0.00	0.00
SDR Department	**SDR million**	**% Allocation**
Net cumulative allocation	2,720.91	100.00
Holdings	2,737.40	100.62
Outstanding Purchases and Loans	**SDR Million**	**% Quota**
Stand-By Arrangements	0.00	0.00

Financial Arrangements

Type	Approval Date	Expiration Date	Amount Approved (SDR million)	Amount Drawn (SDR million)
Stand-By	09/27/13	09/26/15	1,751.34	0.00
Stand-By	03/31/11	06/30/13	3,090.6	0.00
Stand-By	05/04/09	03/30/11	11,443.00	10,569.00
Stand-By	07/07/04	07/06/06	250.00	0.00
Stand-By	10/31/01	10/15/03	300.00	300.00
Stand-By	08/05/99	02/28/01	400.00	139.75
Stand-By	04/22/97	05/21/98	301.50	120.60
Stand-By	05/11/94	04/22/97	320.50	94.27
Stand-By	05/29/92	03/28/93	314.04	261.70
Stand-By	04/11/91	04/10/92	380.50	318.10

Overdue Obligations and Projected Payments to Fund[1]

(SDR million; based on existing use of resources and present holdings of SDRs):

	Forthcoming				
	2024	2025	2026	2027	2028
Principal					
Charges/interest	0.03	0.03	0.03	0.03	0.03
Total	0.03	0.03	0.03	0.03	0.03

[1] When a member has overdue financial obligations outstanding for more than three months, the amount of such arrears will be shown in this section.

Exchange Rate Arrangement

The de jure exchange rate arrangement is managed floating and the de facto exchange rate arrangement is classified as stabilized. Romania has accepted the obligations of Article VIII, Section 2(a), 3, and 4 under the IMF's Articles of Agreement, and maintains an exchange rate system free of multiple currency practices and restrictions on making of payments and transfers on current international transactions except for those maintained solely for preservation of national or international security in accordance with UNSC resolutions and that have been notified to the Fund under the procedure set forth in Executive Board Decision No. 144-(52/51).

Technical Assistance

Capacity building in Romania has been supported by substantial technical assistance from multilateral agencies and bilateral donors. Expert Fund assistance has focused in recent years mostly on structural fiscal reforms, in particular modernizing tax administration, strengthening public financial management, and reviewing tax policy options.

Date	Purpose	Department
	Tax Administration	
February-March 2022	Addressing VAT non-compliance (virtual)	FAD
March-April 2022	Addressing tax noncompliance by multinational enterprises (virtual)	FAD
March-April 2022	Managing tax risks related to e-commerce/platform economy (virtual)	FAD
March-April 2022	Taxpayer services (virtual)	FAD
July-August 2022	Human Resource Development	FAD
September – October 2022	Large taxpayer compliance	FAD
November 2022	High wealth individuals	FAD
January-February 2023	Compliance risk management training program	FAD
July-August 2023	Compliance risk management analytical capability (virtual)	FAD
September-October 2023	Remote support preparation TADAT assessment	FAD
	Tax Policy	
March-April 2022	Strengthening property taxes (virtual)	FAD
May 2022	Improving progressivity of individual income tax	FAD
January 2023	Property taxes follow-up	FAD
January 2023	Tax gap integration with CRM (virtual)	FAD
June 2023	Evaluating fiscal regimes of hydrocarbons (royalties)	FAD
	Public Financial Management	
March 2022	Public Investment Management Assessment	FAD

Article IV Consultations

Romania is on a 12-month consultation cycle. The previous Article IV consultation was concluded by the Executive Board on September 21, 2022.

FSAP and ROSC

A joint IMF-World Bank mission conducted an update assessment of Romania's financial sector as part of the Financial Sector Assessment Program (FSAP) during October 21–November 31, 2017, and January 11–23, 2018. The Financial Sector Assessment Report (FSSA) was discussed at the Board in June 2018.

A pilot of the IMF's new Fiscal Transparency Evaluation took place in February 2014 and the findings were published in March 2015. It assessed the government's fiscal reporting, forecasting, and risks management practices against the IMF's revised Fiscal Transparency Code.

Resident Representative

Since September 2022, the local Fund office in Bucharest is overseen by the Senior Regional Resident Representative, Mr. Geoff Gottlieb.

COLLABORATIONS WITH OTHER INTERNATIONAL FINANCIAL INSTITUTIONS

- As of October 4, 2023, Romania has collaborations with the World Bank Group, the European Bank for Reconstruction and Development, and the European Investment Bank.

- Further information can be obtained from the following hyperlinks.

International Financial Institution	Hyperlink
The World Bank Group	https://www.worldbank.org/en/country/romania/overview#4
The European Bank for Reconstruction and Development (EBRD)	https://www.ebrd.com/country/romania.html
The European Investment Bank	https://www.eib.org/en/projects/regions/european-union/romania/index.htm

STATISTICAL ISSUES

(As of October 31, 2023)

I. Assessment of Data Adequacy for Surveillance
General: Data provision is adequate for surveillance.
National accounts: Quarterly and annual national accounts statistics are produced by the National Institute for Statistics (INS) using the *European System of Accounts 2010 (ESA 2010)*. Estimates are reported to the Fund on a timely basis for publication in the *International Financial Statistics (IFS)*. Provisional and semi-final versions are disseminated in the *Statistical Yearbook* and other publications, as well as on the web (www.insse.ro).
Prices: The Consumer Price Index is subject to standard annual reweighting, and is considered reliable. In January 2004, the INS changed the coverage of the Producer Price Index (PPI) to include the domestic and export sectors. PPI weights are revised every five years with revisions finalized three years after the new base year.
Labor market: Labor market statistics are broadly adequate. The definition used for employment is consistent with *ESA 2010*.
Public finances: Annual GFS data for the general government sector, including public corporations operating on a non-market basis, are reported on an accrual basis derived from cash data using various adjustment methods. Tax revenues are adjusted using the time-adjusted cash method; expense data are adjusted using due-for-payments data; and interest payments are calculated on an accrual basis. Accrual data are also available on a quarterly basis three months after the end of each quarter. EUR receives monthly cash budget execution data. Consolidated data on general government operations, financial assets and liabilities are reported for inclusion in the IMF *GFS annual database*.
Monetary and financial statistics: The National Bank of Romania (NBR) reports monetary and financial statistics for publication in the *IFS,* using the Standardized Report Forms (SRFs). The SRFs for the central bank and other depository corporations are reported on a monthly basis, while the SRF for Other Financial Corporations (OFCs) is reported on a quarterly basis. The NBR also reports data on some key series and indicators of IMF's Financial Access Survey including gender disaggregated data, mobile money and the two indicators adopted by the UN to monitor Target 8.10 of the Sustainable Development Goals (commercial bank branches 100,000 adults and ATMs per 100,000 adults). **Financial Soundness Indicators (FSIs):** The NBR reports all core and most encouraged FSIs for Deposit Takers on a quarterly basis. In addition, the NBR reports FSIs for the nonfinancial corporations (NFCs) and households (HHs) sectors, as well as those for real estate markets. However, FSIs for NFCs are reported with a long lag.

External sector statistics: The NBR routinely reports quarterly and annual balance of payments and international investment position statistics to the Fund and external debt statistics to the World Bank's QEDS database in a timely fashion. Since September 2014 the authorities implemented the sixth edition of the *Balance of Payments and International Investment Position Manual* (*BPM6*), in line with other European countries. Romania participates in the IMF's Coordinated Portfolio Investment Survey (CPIS), Coordinated Direct Investment Survey (CDIS) and reports International Reserves and Foreign Currency Liquidity (IRFCL) Data Template.	
II. Data Standards and Quality	
Romania is a subscriber to the Fund's Special Data Dissemination Standard Plus (SDDS Plus) since November 1, 2019.	A Data ROSC was published in November 2001.

Romania: Table of Common Indicators Required for Surveillance
(As of October 2023)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	Aug. 2023	Sept. 2023	D and M	D and M	M
Reserve/Base Money	Aug. 2023	Sept. 2023	D and M	W and M	M
Broad Money	Aug. 2023	Sept. 2023	M	M	M
Central Bank Balance Sheet	Aug. 2023	Sept. 2023	M	M	M
Consolidated Balance Sheet of the Banking System	Aug. 2023	Sept. 2023	M	M	M
Interest Rates[2]	Aug. 2023	Sept. 2023	M	M	M
Consumer Price Index	Sept. 2023	Oct. 2023	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	Sept. 2023	Oct. 2023	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	Q3 2023	Oct. 2023	Q	Q	Q
External Current Account Balance	Aug. 2023	Oct. 2023	M	M	M
Exports and Imports of Goods and Services	Aug. 2023	Oct. 2023	M	M	M
Gross External Debt	Aug. 2023	Oct. 2023	M	M	M
International Investment Position[7]	Q2 2023	Aug. 2023	Q	Q	Q

[1] Any reserve assets that are pledged or otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means.

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic non-bank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds), and state and local governments.

[5] Including currency and maturity composition.

[6] Daily (D), weekly (W), monthly (M), quarterly (Q), annually (A), irregular (I); and not available (NA).

[7] Includes external gross financial asset and liability positions vis-à-vis nonresidents.