Statement by Mr. Hilbers and Mr. Voinea on Romania
September 21, 2022

On behalf of the Romanian authorities, we would like to thank staff, led by Mr. Martijn, for their productive engagement during the Article IV mission and express our appreciation for the constructive discussions and valuable policy recommendations reflected in their report. The authorities broadly agree with the thrust of staff's appraisal and would like to make the following additional comments.

Growth outlook

Following a 5.9% growth in 2021, Romania's growth exceeded expectations this year. In Q2 2022, Romania recorded the second largest quarterly growth in Europe (2.1%), which contributed to a 5.8% annual growth in the first half of the year. This growth dynamic demonstrates the resilience of the economy against external shocks, in particular the negative spillovers from the war against Ukraine. The main drivers of growth in 2022 have been household final consumption, on the expenditure side, and IT services (which grew by 24%), on the income side. The full elimination of pandemic-related restrictions since the beginning of the year released the pent-up demand and contributed to favorable consumer sentiment.

We welcome the second upward revision of the IMF growth projection, from 4% to 4.8% for end-2022. The authorities also consider that the growth potential remains elevated in the coming years, based on gross fixed capital formation, mainly through an increased absorption of European funds, which would help develop local infrastructure and create job opportunities.

European funds

The expected inflows of EU funds come from three channels: the 2014-2020 structural funds (which can be spent by end-2023), the 2021-2027 structural funds, and the RRF. As the report clearly indicates, Romania has made significant progress along the learning curve of EU funds accession: after a slower start, the absorption rate for the 2007-2013 structural funds exceeded 90%, and we expect a similar trajectory also for the previous and current financial exercises. Moreover, to emphasize the importance of the high absorption rate of EU funds, the milestones of the National Recovery and Resilience Plan (NRRP) are monitored by a cabinet-level task force under the direct coordination of the Prime Minister. These milestones include important structural reforms and large investment projects; as of September 2022, Romania has met its commitments to date, and continues to work to fulfill this ambitious plan.

Fiscal policy

On fiscal policy, the authorities are confident that that they will meet their deficit target, which is 5.8% of GDP, lower than the revised IMF forecast of 6.4%. This would represent an adjustment of 1pp of GDP relative to 2021 which will positively influence the public debt to GDP ratio (Maastricht definition), estimated to reach around 48% at the end of 2022. In the first six months of 2022, the budget deficit was only 1.7% of GDP, more than 1 pp of GDP lower than compared to the same period of last year, which contributed to a public debt to GDP ratio of 48.3% as of end-June 2022. Revenues increased by 22.9%, mainly based on VAT revenues, while expenditures increased by only 14.3%, less than inflation. Part of that expenditure increase is related to the support provided to more than 1 million war refugees from Ukraine, including shelter, food, and integration in the education systems.

The authorities agree that fiscal consolidation is necessary, and point out that this process has already begun, as the budget deficit has been on a pronounced downward slope since 2020. By the end of 2022, the adjustment would be close to 4% of GDP and it is projected to continue, aiming to bring the deficit below 3% of GDP in 2024. Together with improved tax collection (especially VAT receipts), tax reform would be an important part of fiscal consolidation. The authorities are grateful for two recent Technical Assistance missions on property and income taxation, which recommended a series of measures to increase revenues by moving towards market-based property taxation, a tax system with fair burden-sharing, eliminating income tax exemptions, and limiting the space for fiscal optimization through various juridical entities subject to lower taxation (such as micro-enterprises). A significant part of these recommendations, which were issued in June this year, were adopted by a government ordinance passed in July; the authorities have requested further technical assistance to prepare their implementation.

External sector

Since 2013-2015, when the current account deficit plateaued at around 1% of GDP (following a sharp adjustment from the 2007 levels above 13% of GDP), the current account deficit widened, reaching around 7% of GDP in 2022. Nevertheless, a large part of this deterioration is attributable to the supply shocks during the pandemic, further escalated by the surge in imported commodity prices, as the war in Ukraine unfolded. Moreover, Romania's exports increased seven times in nominal terms in the last two decades and almost three times since the GFC; they also shifted qualitatively from textiles to autos and IT services, entailing more value added. Therefore, the decrease of the exports to GDP share, as depicted by the paper on the current account imbalance, is not necessarily a reflection of lower external competitiveness; one could argue that a structural shift took place, based on the higher domestic purchasing power.

The market-based exchange rate stability points to the same direction. This is supported by the large inflows of EU funds, seasonal remittances, and a renewed interest of non-residents in local debt securities, as well as swiftly rising deposit rates in local currency. Hence, we agree with staff's view that external sector vulnerabilities are not a major source of risk, since they are mitigated by significant FDI financing, a stable net international investment position, and adequate international reserves.

We also see merit in staff's assessment that the correlation between the twin deficits is stronger in Romania than the general model provides for, leading to the recommendation that fiscal consolidation should be the main policy priority to contain the widening current account deficit. The distributional structure of the fiscal consolidation would also matter for reducing the demand for imported goods.
Fiscal consolidation is even more relevant in the context of rising financing costs; since the war in Ukraine started, Romania's spreads increased by more than 200 basis points, in line with its peers. Monetary tightening at home and abroad, to anchor inflationary expectations, adds further pressure. Nevertheless, the yields on local currency bonds have eased in the last two months, signaling investors' confidence in Romania's economic capacity to withstand external shocks.

Political stability is also a strongpoint, with a large majority coalition government that has proven its capacity to take appropriate measures to mitigate the spillovers from the war in Ukraine, and especially to protect vulnerable households from skyrocketing energy prices.

Monetary policy

The annual inflation rate in August was 15.3%; most of the increase came from exogenous CPI components, primarily from hefty increases in natural gas and electricity prices (+70%, respectively +16%), alongside a bump in fuel prices (+36.3%), amid the global supply-side shocks exacerbated by the war

against Ukraine but also due to the US dollar strengthening against the euro. The increase in energy prices would have been even higher in the absence of a support scheme approved by the government that capped energy prices until August 2023. Food prices (+18.2%), which account for one third of the CPI basket, also played a major role, especially for essential products such as flour, potatoes, oil, and sugar. The food prices' component contributed mostly to the increase in CORE2 inflation (just shy of 10% in June 2022, compared to 3% a year ago).

To anchor the inflationary expectations, The National Bank of Romania started its tightening cycle in September 2021 and has hiked the rate multiple times since then, from 1.25% to 5.5% (of which by 300 bp after the invasion of Ukraine began). Prompted by the policy rate hikes and the central bank's firm control over market liquidity, the main interbank money market rates had risen even faster. The annual CPI inflation rate is projected to level off during Q3 and to embark on a downward path as of Q4, which should continue over the next two years, as the positive output gap closes, due to the ongoing monetary policy normalization and medium-term fiscal consolidation, in addition to the base effect, under the assumption of a gradual fading of global supply-chain disruptions. Therefore, the NBR forecasts that inflation will return within the target interval (a 1pp variation band around the 2.5pp target) in the second half of 2024. The inflation outlook is marked by uncertainty stemming from the evolution of energy and food prices, a protracted war against Ukraine, a sharper contraction of external demand, monetary policy stances of the main central banks, possible labor market tightening and labor cost pressures.

Financial sector

The monetary policy tightening led to a steep increase in the interest rates for local currency deposits. Despite a 17% annual increase in private credit (as of June), the loan to deposit ratio remains well below unit (66%).

The banking sector's profitability remains strong (ROE above 11%), consistently above EU average. The solvency ratio is above 21% in March 2022 (19% for tier 1), slightly down from the previous year, due to mark-to-market adjustments reflecting the upward trajectory of domestic bonds, but comfortably above the Basel III thresholds. The Liquidity Coverage Ratio is well above the 100% regulatory limit (212%). The NPL ratio stays around 3%, while provisioning is at 67%. There is a systemic risk buffer (up to 2%) applied to a few banks with higher NPL and lower provisioning ratios. A 0.5% countercyclical capital buffer will take full effect as of October 2022. Another macroprudential measure introduced in 2019, following an FSAP recommendation — limiting the debt-service-to-income at 40% for households—performed well during the pandemic-induced shock, and contains risks during the current episode of interest rate hikes.

Green transition

Romania is one of the EU countries least dependent on Russian gas imports. However, to further increase energy independence and accelerate green transition, Romania plans a large expansion of its power generating capacity (by almost one third compared to 2020), largely with renewables and nuclear. The most important tranche of NRRP (12 bn. Euro) is allocated to support green transition goals, including the commitments to reach a 34 percent share of renewables by 2030, accelerate the decarbonization of the transport sectors, increase energy efficiency and promote re- and afforestation.

Real convergence

Romania has been a success story of European integration. Since 2000, when accession negotiations started, the euro-denominated nominal GDP increased eight times; and since 2007, when EU accession took place, Romania's income per capita increased from around 30% to over 70% of the EU average.

Romania's EU membership has been pivotal for its fast growth, although, as the paper on regional disparities rightfully shows, the convergence has been uneven among regions and social groups. More needs to be done to achieve growth that is inclusive and more equally distributed between regions, sectors, and different parts of society. A return of some of Romania's large contingent of emigrants would further enhance its growth potential.

Finally, the authorities reiterate that they remain committed to focusing their policy priorities on promoting sustainable and inclusive growth while achieving fiscal consolidation, enhancing the absorption of European funds, anchoring inflation expectations, and advancing the green transition.