COUNCIL OPINION

of 12 February 2008

on the updated convergence programme of Romania, 2007-2010

(2008/C 49/10)

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community,

Having regard to Council Regulation (EC) No 1466/97 of 7 July 1997 on the strengthening of the surveillance of budgetary positions and the surveillance and coordination of economic policies [1], and in particular Article 9(3) thereof,

Having regard to the recommendation of the Commission,

After consulting the Economic and Financial Committee,

HAS DELIVERED THIS OPINION:

(1) On 12 February 2008, the Council examined the updated convergence programme of Romania, which covers the period 2007 to 2010.

(2) Romania has experienced strong economic growth averaging 6,5 % annually between 2003 and 2006. However, the strongly performing economy is showing clear signs of overheating with a high and growing external account deficit (projected at close to 13 % of GDP in 2007) with a smaller coverage of FDI financing-despite sustained non-privatization related investment in 2007 — but still mitigated by a larger share of medium and long term capital inflows based on so far available 2007 data.

Growing labour shortages, strong wage growth hampering competitiveness and rapid increases in household borrowing are other signs of overheating. A sudden increase in inflation, after a long period of successful disinflation, was triggered primarily by supply-side shocks due to the weather-related poor performance of the agricultural sector in 2007. This was underpinned by the effects on aggregate demand of income and credit growth, non-restrictive fiscal and public wage policies and the depreciation of the Leu since August 2007 (following the appreciation in recent years). For Romania to maintain its fast convergence track towards the average EU-27 per capita GDP, it will be crucial to address the growing external imbalances. In this context, fiscal policy has an important role by cooling down internal demand, while also improving the quality of public finance, in particular through a shift towards growth-enhancing investment.

(3) The macroeconomic scenario underlying the programme envisages real GDP growth to accelerate from 6,1 % in 2007 to 6,5 % in 2008 and to ease towards 5,8 % in 2010. Assessed against currently available information [2], projected growth in 2008 and 2009 is on the high side. In particular, it is unclear how the reduction of the negative contribution of net exports to growth will be achieved in a context of rising unit labour costs and strong demand pressures, exacerbated by a non-restrictive fiscal policy. The size and the fast deterioration of the external imbalances is a reason for concern as witnessed by the depreciation trend of the Leu since mid-2007, against the background of a general risk-repricing in international financial markets. The programme's projections for inflation also appear to be on the very low side. The strong inflationary pressures from wage developments (including public wages), rapid increases in international food and commodity prices and the weaker exchange rate (after a long period of appreciation), suggest a more pronounced slow-down of the rapid disinflation process. The inflation (HICP) differential with the EU-27 is thus expected to stabilize or to narrow only slightly over the forecast period. Overall, the mix of policies in the programme might not lead to progress towards nominal convergence.

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

[2] The assessment takes notably into account the Commission services' autumn forecast and the Commission assessment of the July 2007 national reform programme.

(4) According to the updated programme, the projected 2007 general government deficit is 2,9 % of GDP, 0,2 percentage point higher than the Commission services' autumn forecast and the target of the previous programme. The positive base effect from the lower than expected deficit in 2006 was offset by the increase in expenditure outweighing the increase in revenue in 2007. Budgetary implementation in 2007 is therefore not in line with the invitation in the Council opinion of 27 March 2007 on the previous convergence programme to 'exploit the good times to significantly strengthen the pace of adjustment towards the MTO by aiming for more demanding budgetary targets in 2007' ([1]).

(5) The update confirms the previous programme's main objective to achieve the medium-term objective (MTO) for the budgetary position, a structural deficit (i.e. a deficit in cyclically-adjusted terms net of one-off and other temporary measures) of 0,9 % of GDP, by 2011 (i.e. beyond the programme period). The programme targets a stabilisation of the headline deficit at 2,9 % of GDP over the period 2007-2009 and a reduction to 2,4 % of GDP in 2010. The primary balance follows a similar path. No fiscal policy effort is made between 2007 and 2009 when the structural deficit is estimated to remain constant at around 3,5 % of GDP and only in 2010 a 0,75 % adjustment towards the MTO is envisaged. Compared with the previous convergence programme, which targeted a relatively gradual rather than fully back-loaded adjustment to the MTO, the budgetary targets are less ambitious despite the programme's more favourable growth assumptions in 2008-2009. The adjustment in the update is driven by a significant increase in the revenue-to-GDP *ratio* (by 3,5 percentage points, mostly relying on optimistic revenue-base projections) outpacing a marked increase in the expenditure-to-GDP *ratio* (by close to 3 percentage points).

The largest contribution to the revenue increases (1,4 percentage points of GDP) is made by taxes due to an assumed buoyancy of direct taxes (income taxes are expected to increase due to a favourable evolution of average earning and the number of employees and corporate taxes would benefit from a positive effect of the employers' social contribution cuts), but also due to VAT measures (concerning the timing of some VAT receipts), though not sufficiently spelled out in the programme. 'Other revenues' rise by a similar amount which also reflects an assumed increase in EU funds. Social contributions are subject to several reform measures in 2008 with an assumed net positive effect (6 percentage points rate cuts, introduction of the second pension pillar and broadening of the pension contribution base by removing the ceiling of five times the average wage and by including bonuses in the tax base). On the expenditure side, the change stems to a large extent from a substantial increase in public investment due to an assumed significant increase in the absorption of EU funds, which seems ambitious. Also, social payments (especially pensions) are expected to substantially increase. This increase will only be partly offset by a sharp decline in compensation of employees and subsidies (both not substantiated in the programme).

(6) The budgetary outcomes could be worse than projected in the programme. In particular, given the favourable tax elasticity assumed by the programme and the most recent information regarding budgetary execution, the planned level of revenue in 2007 is unlikely to be achieved. This would imply a negative base effect for revenue over the programme period, implying worse budgetary outcomes than projected for the period 2008-2010. This could be amplified by favourable growth assumptions retained for the years 2008-2009. The buoyancy of especially social contributions and indirect taxes may also be overestimated. On the expenditure side, the programme seems to continue the pattern of over-budgeting of investment spending. Consequently, there are risks that resources allocated to investments will be, at least partly, shifted to current spending as seen in the past, in particular to those items which seem under-budgeted in the programme, namely the compensation of employees, social transfers and subsidies.

Although the programme expects a more prudent public wage policy over 2008-2010, this is not substantiated in the programme and does not seem realistic in the light of past public wage overruns: in 2006 and 2007, wage bill increases were more than twice as high as originally planned. Taking this expenditure shift into account, the expenditure-to-GDP *ratio* may be higher than planned in particular for the years 2009-2010. Additional risk factors are weaknesses in budgetary planning and execution, expenditure pressures in the election years 2008 and 2009 and uncertainty regarding the

([1]) OJ C 89, 24.4.2007, p. 19.

amount of compensations by the general government to owners of properties nationalised during the communist regime under the so-called 'property fund'. Moreover, the fiscal tightening foreseen in 2010 is not sufficiently substantiated with measures.

(7) In view of this risk assessment, the budgetary stance in the programme is insufficient to ensure that the MTO is achieved by 2011, as envisaged by the programme. A safety margin against breaching the 3 % of GDP deficit reference value (estimated at 1,75 % of GDP) would not be provided by the end of the programme period and thus there is a serious risk that the reference value will be breached in the near term. After a sharp deterioration in the deficit in 2007, no adjustment towards the MTO can be expected before 2010 despite the fact that the economy is showing signs of overheating. This is not in line with the Stability and Growth Pact. The budgetary stance does not help addressing the macroeconomic imbalances identified above, in particular the high and growing external deficit and domestic demand pressures, which put at risk macroeconomic and financial stability.

(8) In the absence of long-term projections of age-related expenditures, based on the common macroeconomic assumptions as carried out by the EPC/Commission, it is not possible to assess the impact of population ageing in Romania on a comparable and robust basis as it currently done for the other Member States. While a significant impact of ageing on expenditure cannot be excluded given the current demographic structure, the 2007 budgetary position in the programme, with a large structural deficit, is not sufficient to stabilise debt even before considering the long-term budgetary impact of ageing. Improving the structural budgetary position over the medium-term would thus contribute to containing risks to the sustainability of public finances.

(9) The convergence programme seems to be consistent to some extent with the July 2007 national reform programme (NRP). In particular, it confirms the main government policy priorities such as improving the quality and management of government expenditure, the business environment and the public administration and the main reforms directly affecting public finances in particular in the areas of labour market, pension, health care and education. It also confirms the expenditure priorities in the fields of education, research, health, infrastructure, environment and agriculture. On the other hand, the convergence programme does not provide systematic information on the direct budgetary costs associated with the main reforms envisaged in the NRP.

(10) As regards the data requirements specified in the code of conduct for stability and convergence programmes, although there is some progress, the programme has some gaps in the required and optional data ([1]).

The overall conclusion is that the budgetary strategy outlined in the programme is not in line with a prudent fiscal policy, necessary to contain the growing external deficit and inflationary pressures which put at risk macroeconomic and financial stability and the convergence process. The programme does not envisage a reduction of the deficits, entailing a risk of an excessive deficit. Progress towards the MTO is insufficient and fully back-loaded despite strong growth prospects. In view of the risks to the budgetary targets and the significant adjustment that would be necessary after the programme period, the MTO is unlikely to be achieved by 2011 as planned.

In view of the above assessment and the need to ensure sustainable convergence, Romania is invited to:

(i) significantly strengthen the pace of adjustment towards the MTO by aiming for substantially more demanding budgetary targets in 2008 and subsequent years in order to contain the risk of an excessive deficit, foster macroeconomic stability and rein in widening external imbalances and address the risks to the long-term sustainability of public finances;

([1]) In particular, data on short-term and long-term interest rates, general government expenditure by function and details on long-term sustainability projections are missing.

(ii) restrain the envisaged high increase in public spending, improve its expenditure composition so as to enhance the economy's growth potential and improve the planning and execution of expenditure within a binding medium-term framework;

(iii) pursue policies to contain inflationary pressures, complementing the recommended tighter fiscal stance, with appropriate public wage policy and further structural reforms.

Comparison of key macro economic and budgetary projections

		2006	2007	2008	2009	2010
Real GDP (% change)	**CP Dec 2007**	**7,7**	**6,1**	**6,5**	**6,1**	**5,8**
	COM Nov 2007	7,7	6,0	5,9	5,8	n.a.
	CP Jan 2007	*8,0*	*6,5*	*6,3*	*5,9*	*n.a.*
HICP inflation (%)	**CP Dec 2007**	**6,6**	**4,8**	**5,7**	**4,0**	**3,3**
	COM Nov 2007	6,6	4,7	5,6	4,6	n.a.
	CP Jan 2007	*6,6*	*4,5*	*4,3*	*3,2*	*n.a.*
Output gap (1) (% of potential GDP)	**CP Dec 2007**	**2,2**	**2,1**	**2,1**	**1,8**	**1,1**
	COM Nov 2007 (2)	2,4	2,1	1,3	0,3	n.a.
	CP Jan 2007	*2,1*	*2,2*	*1,9*	*1,1*	*n.a.*
Net lending/borrowing *vis-à-vis* the rest of the world (% of GDP)	**CP Dec 2007**	**– 10,3**	**– 12,6**	**– 10,5**	**– 10,1**	**– 10,2**
	COM Nov 2007	– 10,3	– 12,8	– 14,5	– 15,3	n.a.
	CP Jan 2007	*– 10,2*	*– 8,9*	*– 8,3*	*– 7,8*	*n.a.*
General government balance (% of GDP)	**CP Dec 2007**	**– 1,9**	**– 2,9**	**– 2,9**	**– 2,9**	**– 2,4**
	COM Nov 2007	– 1,9	– 2,7	– 3,2	– 3,9	n.a.
	CP Jan 2007	*– 2,3*	*– 2,7*	*– 2,6*	*– 2,0*	*n.a.*
Primary balance (% of GDP)	**CP Dec 2007**	**– 1,0**	**– 2,0**	**– 2,1**	**– 2,1**	**– 1,6**
	COM Nov 2007	– 1,0	– 1,8	– 2,3	– 3,0	n.a.
	CP Jan 2007	*– 1,2*	*– 1,6*	*– 1,5*	*– 1,0*	*n.a.*
Cyclically-adjusted balance (1) (% of GDP)	**CP Dec 2007**	**– 2,6**	**– 3,6**	**– 3,6**	**– 3,5**	**– 2,8**
	COM Nov 2007	– 2,6	– 3,3	– 3,6	– 4,0	n.a.
	CP Jan 2007	*– 3,0*	*– 3,4*	*– 3,2*	*– 2,3*	*n.a.*

		2006	2007	2008	2009	2010
Structural balance (3) (% of GDP)	**CP Dec 2007**	**– 2,2**	**– 3,4**	**– 3,4**	**– 3,4**	**– 2,7**
	COM Nov 2007	– 2,6	– 3,3	– 3,6	– 4,0	n.a.
	CP Jan 2007	*– 3,0*	*– 3,4*	*– 3,2*	*– 2,3*	*n.a.*
Government gross debt (% of GDP)	**CP Dec 2007**	**12,4**	**11,9**	**13,6**	**14,2**	**14,9**
	COM Nov 2007	12,4	12,5	12,8	13,5	n.a.
	CP Jan 2007	*12,8*	*13,5*	*12,6*	*11,7*	*n.a.*

Notes:

(1) Output gaps and cyclically-adjusted balances according to the programmes as recalculated by Commission services on the basis of the information in the programmes.

(2) Based on estimated potential growth of 5,7 %, 6,4 %, 6,7 % and 6,9 % respectively in the period 2006-2009.

(3) Cyclically-adjusted balance excluding one-off and other temporary measures. According to the most recent programme, one-off and other temporary measures are 0,4 % of GDP in 2006, 0,2 % in 2007, 0,2 % in 2008, 0,1 % in 2009 and 0,1 % in 2010 (all deficit-increasing). There are no one-offs in the Commission services' autumn forecast as the Commission services do not consider the compensations under the so-called property fund as one-offs.

Sources:

Convergence programme (CP); Commission services' autumn 2007 economic forecasts (COM); Commission services' calculations.