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**Statement by Mr. Raczko and Mr. Gasiorowski on Romania
(Preliminary)
Executive Board Meeting 08/55
June 25, 2008**

We would like to thank staff for the set of well written papers and Mr. Bakker and Mr. Tanasescu for their insightful Buff statement.

The European Union membership has accelerated inflows of foreign capital, which in turn fueled private investments. However, a surge of capital inflows has been absorbed not only by a rapid growth of domestic demand but also by foreign exchange reserves accumulation. Hence, the widening current account deficit, although confirming growing macroeconomic imbalances, may not lead to a deterioration of economic prospects if only the authorities implemented proper macroeconomic policies. “A soft landing” scenario is still possible and depends on a successful stability-oriented policy mix aimed at a gradual cooling down of the economy and allowing to achieve an optimal level of the current account deficit.

We agree with the staff’s opinion that the growing asset prices, tightening labor market and increasing production capacity utilization confirms overheating of the economy. The current high interest rates and exchange rate appreciation are fueling additional inflows of foreign capital. In such a case, growing foreign reserves should be sterilized to avoid inflation pressure. Additionally, the authorities have implemented new regulations defining provisions for foreign currency lending, which should mitigate the credit boom. We will appreciate the staff’s opinion on the effectiveness of these two measures on controlling the inflow of capital.

In the staff’s opinion, the fiscal policy stance was significantly deteriorated in 2007. We would like to remind that the fiscal deficit increased due to additional expenditures, which were related to the EU membership. The contribution to the EU budget, extra expenditures for administration and co-financing of EU projects significantly increased the fiscal burden. On the revenue side, the adjustment of tax system, for instance the adoption of the Sixth Directive, might have changed the tax collection system, which has an impact on budgetary incomes. We would welcome if staff could provide more detailed information about the size and distribution of fiscal costs of EU membership.

The EU membership significantly determines the budgetary framework. For example, the staff's advice to curtail the large budgeted hikes in spending on capital may contradict the additionality rule,¹ which defines a minimal level on infrastructure expenditures from the budgetary resources. It is not the only information delivered in the staff report that is difficult to interpret from the EU rules' perspective. For instance, there is no information if the cut in the VAT rate on food products is in compliance with the EU tax policy. Moreover, the rapid increase of grants in 2007 is not explained and we do not know if the grants are linked to pre-accession funds or EU structural programs. Additionally, we would appreciate information if the EU resources are included in the fiscal balance sheet or not. The rapid increase of the revenue and expenditure side suggests that the financing of EU projects is included in the fiscal balance. If that is so, staff should be very cautious in evaluating the fiscal stance as in the case of EU financed projects the revenues obtained from the EU and the size of EU expenditures on the projects are not equal if the calculation is made on a cash basis. However, the project related EU revenues would equal the expenditures if the calculations were made on the accrual based ESA95 standard. In the future, we suggest to attach comprehensive information, in the form of e.g. a special box, explaining the impact of the EU membership on the fiscal side. We thus strongly support Mr. Stein and Mr. von Stenglin's call on staff to apply the ESA95 data classification standard and compile the fiscal data on an accrual basis rather than a cash basis.

Nonetheless, a tighter fiscal and income policy, as well as an ambitious structural reform program would be highly recommended to reduce the risk of a hard landing and to ensure further sustainable real convergence. Hence, we agree with staff that a more ambitious tightening in 2008 would be recommended to counteract the current overheating pressures and to have more room to widen the budget deficit in case of a slowdown.

We thank staff for its thorough analysis of external stability. It concludes that there is no strong evidence for a significant exchange rate overvaluation. However, the assessments of equilibrium exchange rates can only give a very broad impression since the uncertainty of the results is large. We would like to underline that these uncertainties are even higher in an environment of a rapid catch up.

In light of the fact that growth is upholding strongly, additional tightening of monetary policy is most likely needed to improve the credibility of inflation targeting and to keep inflation expectations at bay. On the other hand, we agree with staff that bringing inflation down toward its target of 3.5 +/- 1 percent for the end of 2009 remains a challenge. Further, in light of the uncertainties ahead, it is important to preserve the value of the exchange rate flexibility and make clear to the markets that the exchange rate could fluctuate significantly.

The risks to the financial sector are increasing. We note that the capital adequacy ratio and return on assets are on a slide down, probably reflecting a threatening tempo of the increase of credit. Moreover, even the decrease of the capital adequacy requirement did not prevent the return on equity from decreasing. We also note that even the rapid growth of credit did not prevent the non performing loans to increase by 23 percent in 2007. On the

¹ The "additionality rule" requires that money from the European programs is meant to be used to supplement and not to substitute the core government spending on economic development.

other hand, the worsening ratio of liquid assets to short term liabilities show a worsening structure of the balance sheets. Therefore we welcome the steps taken recently and we fully subscribe to the advice regarding the financial sector given by staff and we welcome the intention to convey an FSAP study at the end of this year. However, we do not share the staff's opinion that "it is difficult to identify, motivate and implement preemptive measures" for the financial sector now. In our opinion if there would be a slowdown of capital inflow, it will be the financial sector to bear the consequences first, as the reliance on foreign funding is increasing.

The significant role played by foreign banks in Romania also calls for the need for a proper cooperation and coordination of possible remedy actions between the Romanian financial supervisors and the supervisors in the banks' home countries. A key issue would be to avoid possible supervisory arbitrage when regulations in the home country would enhance loosening of the credit standards in the Romanian subsidiaries, while the costs of last lending and guaranteeing of deposits would be borne locally.