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Minutes of Executive Board Meeting 19/73-5

2:30 p.m., August 28, 2019

5. Romania—2019 Article IV Consultation

Documents: SM/19/198 and Supplement 1; and Supplement 2

Staff: Lee, EUR; Kaufman, SPR

Length: 42 minutes

Executive Board Attendance

T. Zhang, Acting Chair

Executive Directors	Alternate Executive Directors
	M. Maidi (AE), Temporary
	S. Bah (AF), Temporary
	D. Vogel (AG), Temporary
	L. Johnson (AP), Temporary
	M. Coronel (BR), Temporary
	P. Sun (CC)
	J. Montero (CE), Temporary
L. Levonian (CO)	
	S. Benk (EC)
	P. Rozan (FF), Temporary
	K. Merk (GR)
	B.Singh (IN), Temporary
	M. Psalidopoulos (IT)
	K. Chikada (JA)
	C. Sassanpour (MD), Temporary
	W. Abdelati (MI), Temporary
A. De Lannoy (NE)	
T. Ostros (NO)	
A. Mozhin (RU)	
	B. Alhomaly (SA), Temporary
A. Mahasandana (ST)	
	P. Trabinski (SZ)
S. Riach (UK)	
	P. Pollard (US), Temporary

G. Bauche, Acting Secretary
V. Sola, Summing Up Officer
B. Zhao, Board Operations Officer
M. McKenzie, Verbatim Reporting Officer

Also Present
European Central Bank: D. Rakitzis, R. Rueffer. European Department: R. Bems, P. Gerson, A. Hajdenberg, J. Lee, O. Luca, S. Toh. Legal Department: H. Pham. Strategy, Policy, and Review Department: R. Cartaxo Mano, M. Kaufman, D. Ostojic. World Bank Group: V. Tsoungui Belinga. Senior Advisors to Executive Directors: M.Gilliot (FF), P. Harvan (EC), G. Vasishtha (CO). Advisors to Executive Directors: D. Andreicut (UK), S. Belhaj

(MD), J. Damgaard (NO), J. Garang (AE), J. Hanson (NE), Z. Huang (CC), T. Manchev (NE), B. Parkanyi (NE), M. Shimada (JA), A. Srisongkram (ST), A. Urbanowska (SZ).

5. ROMANIA—2019 ARTICLE IV CONSULTATION

Mr. De Lannoy and Mr. Tolici submitted the following statement:

On behalf of the Romanian authorities, we would like to thank staff, led by Mr. Lee, for their productive engagement during the Article IV mission and express our appreciation for the constructive policy findings and recommendations reflected in their report. While the authorities argued that the Government's program and reform agenda warrant a more optimistic macroeconomic outlook than staff's baseline scenario, there is broad agreement between the authorities and staff on a wide range of issues. Going forward, the authorities will carefully consider the staff's recommendations.

Romania continued to register one of the highest economic growth among the EU countries, while unemployment dropped to record low levels. However, the strong economic performance has been accompanied by mounting tensions surrounding macroeconomic equilibria. After peaking up in the first half of 2018 inflation has returned within the central bank's target at the end of 2018. While the fiscal deficit remained within the EU rules, maintaining the deficit on target appears somewhat challenging, but the authorities reaffirmed their commitments to the EU fiscal framework and ensured consistency between policy objectives and sound public finances. Public and external debt levels remained low, while current account deficit widened on the back of strong import growth.

The resilience of the financial sector improved consistent with 2018 FSAP recommendations. The banking system is sound, NPL ratios continued to decrease and advance toward the EU average, adequate buffers were kept in place and the authorities aim at addressing the remaining vulnerabilities as raised in the FSAP. The medium-term challenges will be to foster a sustainable and more inclusive growth by strengthening public investment and structural reforms while complementing fiscal stimulus with improved EU funds absorption. The authorities are aware of existing vulnerabilities and remain fully committed to address these challenges adequately and consistently.

Growth remained solid and will maintain at a strong pace over the medium term. In 2018 economic growth remained strong reaching 4.1 percent, and per capita GDP recorded one of the fastest growth amongst new EU member states since 2016. Simultaneously the unemployment rate dropped to the 4.2, the lowest level in recent years. The expansion was primarily driven by private consumption, underpinned by higher purchasing power as a result of income policies focusing on achieving more inclusive growth. The private investment underwent a setback in 2018, when the contribution of gross fixed capital formation to GDP growth turned negative (-3.2 percent). Nevertheless, investment growth has resumed in Q1 2019 due to the rise in construction works and contributed to a stronger-than-anticipated acceleration of economic growth, to 5.0 percent from 4.1 percent in Q4 2018. Consistent with their higher estimates of potential growth, the accruing effects of growth-friendly tax-cuts and steady improvement in the EU funds absorption, the authorities project faster growth than staff's baseline: 5.5 percent in 2019 and 5 percent over the medium term.

During the first three quarters of 2018 the inflation rate ran above the upper bound of the ±1 percentage point variation band of the 2.5 percent flat target given the persistence of significant excess aggregate demand, swift dynamic of unit wage costs and supply shocks. At the end of 2018, the annual CPI inflation stood at 3.3 percent, within the target band.

The external position remained sustainable in 2018, although the risk of external imbalances increased. The current account widened in 2018 by 1.3 percent of GDP (to 4.5 percent of GDP) on the back of strong import growth, boosted by buoyant consumption and slower growth of exports of goods and services, resulting in the lowest net export contribution to GDP growth in five years (-1.7 percent). The deficit is anticipated to remain at sustainable levels over the medium term, continuing to be financed mainly from non-debt-generating flows (FDI and EU funds), to allow for a downward trend of the external debt-to-GDP ratio. While staff's analysis suggests that Romania's external position in 2018 was weaker than fundamentals, the authorities have a more positive view and consider the EBA-lite CA model to underestimate the contribution of cyclical and structural factors to the current account deficit in 2018. Gross external debt continued the downward trend in 2018, reaching 48 percent of GDP from a peak of 75.7 percent of GDP in 2012. The share of short-term debt in total external debt remained low (28 percent of GDP) and the international reserves are adequate, exceeding thresholds for most metrics.

Romania continued and improved its presence in international capital markets in line with the Government Public Debt Management Strategy 2018 – 2020 therefore generating significant buffers. In the first 7 months of 2019 the Ministry of Public Finance issued Eurobonds amounting to EUR 5 bill, exceeding the planned external financing needs for the whole year, and ensuring the partial pre-financing of the estimated financing needs for 2020.

However, the authorities are fully aware of the risks associated with a sharper-than-expected external slowdown and adverse developments in global financial conditions, and continue to carefully monitor these risks.

While the output gap remained positive, budget deficits will be kept within the limits allowed by EU fiscal rules. The fiscal relaxation initiated in 2016 has continued, in line with the government’s strategy of directly supporting economic growth through measures aimed at increasing the real disposable income of households. The budget deficit reached 3 percent of GDP in 2018, while the structural deficit rose to 3.0 percent (compared with the 1 percent-of-GDP target in the Stability and Growth Pact). The Convergence Program 2019-2022 foresees the ESA budget gradually decreasing to 2 percent of GDP in 2022, while the structural deficit is estimated to enter on an adjustment trajectory towards the MTO as of 2021, reaching a level of 2.4 percent of GDP in 2022. The authorities are fully aware of the challenges to meet 2019-2020 targets and will take the necessary steps to comply with the EU fiscal rules. To mitigate the risks posed to public finances by the recently adopted Pension Law, the implementation of the law will be matched by strong fiscal-structural reforms and the benefit increase will be subject to existing available fiscal space.

Like staff, the authorities concur on the urgency of improving revenue collection by reforming the tax administration, upgrading the IT infrastructure and adopting a modern compliance risk management system with technical assistance from FAD. On the expenditure side, the authorities are committed to increase expenditure efficiency and transparency by strengthening expenditure reviews and the procurement process. The draft amendments to the Public Procurement Law envisage increasing transparency in public procurement, enhancing the absorption of the EU funds and a better use of public funds.

Risks to debt sustainability are low, with the level of public debt-to-GDP ratio at only 35.0 percent at the end of 2018, and the DSA projecting the ratio to remain below the 60 percent threshold (under Stability and Growth pact) under all stress test scenarios.

Monetary policy is focused on bringing inflation in line with the target over the medium- term. Throughout 2018, the NBR continued the adjustment in its monetary policy stance that started in the last quarter of 2017. Following the noticeable increase in inflation in the first quarter of 2018, the central bank raised the policy rate three times by 0.25 percentage points, up to 2.5 percent, while tightening the liquidity in the banking system to help monetary management and mitigate FX pressures. With large swings in money market liquidity, amplified by a strong impact of main autonomous factors, the central bank pursued an adequate management of money market liquidity while underpinning the good functioning of money markets.

In the first quarter of 2019, higher domestic demand, currency depreciation and price disruptions associated with GEO 114/2018 have pushed the inflation above the target band. The NBR stressed its commitment to continue strict liquidity management while considering a greater flexibility of the exchange rate. The monetary stance will remain geared towards bringing the annual inflation (and maintaining over the medium term) in line with the flat target of 2.5 percent ±1percentage point variation band, in a manner further supportive of economic growth, while safeguarding financial stability. However, the NBR Board underlines that a coherent macroeconomic policy mix and progress in structural reforms designed to foster the growth potential over the long term are crucial for safeguarding a stable macroeconomic framework and enhancing the economy's resilience to potential adverse developments.

The financial sector continues to be solid and resilient, and good progress has been made with implementing the 2018 FSAP recommendations. In 2018 the banking sector soundness indicators continued to comply with the required thresholds. The NPL further followed the downward trend started in 2014, reaching less than 5 percent at end 2018 (from 21.5 percent in 2013) while non-performing loans provisioning, at 58.5 percent, remained well above the EU-wide average. To support the improvement in asset quality, the systemic risk buffers came into effect starting in June 2018. The capitalization of the banking sector remained around 18 percent. The NBR will continue to closely monitor and supervise the banking system and take any necessary measures to ensure that banks maintain sufficient capital and liquidity.

The profitability of the banking sector consolidated its uptrend against the background of ongoing reduction in net impairment loss and a fast-paced leu-denominated lending. At the end of 2018, the ROA and ROE stand above the EU average at 1.6 percent and 14.6 percent respectively, while the average values over the past ten years ranked the Romanian banking sector 12th and 8th among the EU's 28 Member States.

At the same time, the unpredictability that followed the adoption of GEO 114/2018 heightened the risks associated with the legislative framework in the financial and banking sector. Following consultations between authorities and banking industry, the deficiencies were significantly reduced by the adoption of GEO 19, in March 2019.

The authorities broadly agreed with the conclusions of the 2018 FSAP mission and most of its recommendations have already been fully or partially implemented. To prevent excessive indebtedness and a worsening of the loan portfolio, a 40 percent ceiling on households' total level of indebtedness has been introduced on January 1, 2019. The authorities share staff's concerns over the sovereign bank nexus and are considering the introduction of a systemic risk buffer while conducting further impact analyses to avoid potential financial stability implications. The new legislation adopted in July 2019 has strengthened the AML/CFT framework and ongoing efforts will be done to fully comply with FATF standards.

Advancing structural reforms and improving EU absorption will enhance Romania's competitiveness and facilitate investment. The authorities are aware of the key challenges to improve the corporate governance of SOEs, to restructure those that have sustained long-standing problems and to pose a drain on the budget and raise EU-funds absorption. Steps have been taken to restructure major energy producers and to prepare IPOs for some of them. The selection of private management for SOEs in energy and transportation sectors is in different stages of execution and, upon completion, will contribute to improving the governance of the state-owned companies. The establishment of the Sovereign Fund for Development and Investments is no longer on the Government's agenda, eliminating a source of uncertainty on the governance of SOEs.

The authorities and staff agreed that efforts are needed to improve investments in infrastructure, including by more effective EU funds absorption. Some of the measures implemented under GEO 114/2018 aimed to stimulate the construction sector while PPPs, for which a new framework was adopted, could provide additional funding for bridging the infrastructure gap. The EU funds remain the critical source of financing investment and a significantly improved absorption is top priority. Progress has been made to expedite the assessment process, improve the implementation of large infrastructure projects and reduce the administrative burden. The authorities will continuously focus on accelerating program implementations and maximizing the impact of EU funds while increasing transparency and accountability. The authorities are confident that further building on this base will allow for a significant acceleration of the absorption in the coming years.

The authorities agree on the need to continue fighting against corruption and indicate that no further initiatives related to judicial system will follow.

The authorities would like to thank staff for the thorough and constructive discussions during the Article IV mission, and for their valuable advice on macroeconomic policies. They remain committed to focusing their strategy on promoting sustainable and inclusive growth, improving competitiveness and reducing vulnerabilities.

Mr. Obiora, Ms. Maidi and Mr. Garang submitted the following statement:

We thank staff for detailed reports and Mr. De Lannoy and Mr. Tolici for their informative buff Statement.

We broadly agree with the analysis and assessment of staff. Romania's economic growth has remained strong on account of the procyclical stimulus and expansionary fiscal policy set in 2016. However, growth is expected to decelerate in 2019 mainly due to risks that are tilted on the downside, including political uncertainties and deepening external vulnerabilities. Specifically, inflationary pressures, increasing wage growth unaligned with productivity gains, and the deepening twin deficits remain causes for concern over the sustainability of long-term growth. Going forward, the authorities are encouraged to prioritize macroeconomic policies and address underlying risks to raise growth prospects and tackle widening imbalances.

An ambitious fiscal consolidation is required to ensure sustainability and EU convergence. With a rise in the fiscal deficit that breaches the EU threshold, we urge the authorities to consider employing a prudent fiscal strategy that gives primacy to revenue-enhancing measures, including reconsideration of the longstanding IT modernization project that was cancelled. To this end, we are comforted with the enlightening information in the buff Statement by Mr. De Lannoy and Mr. Tolici on the authorities' plans to boost revenue and streamline expenditures. With an eye on managing the debt levels, we commend authorities for allowing the implementation of the new pension law to reflect on the fiscal space and medium-term priorities. We also think the authorities' efforts to bolster spending efficiency is a welcome development. Going forward, we urge the authorities to strengthen the credibility of medium-term budgets and build buffers.

The monetary policy stance should remain supportive of price stability. We are encouraged by the authorities' commitment to ensure greater exchange rate flexibility and to tighten the monetary policy stance to further manage potential inflationary pressures and external vulnerabilities. We agree with staff on the importance of promoting an independent and credible central bank and urge the authorities to better sequence the newly introduced Consumer Credit Reference Index (IRCC). To this end, we urge the authorities to address the shortcomings on the pricing of household loans to complement the tightening liquidity conditions. However, we remain concerned about the uncertainties created by the implementation of the tax on bank assets, especially as it relates to the costs of bank credit. We think that the potential implications of this tax on developments and stability of the financial sector needs to be carefully considered. Nevertheless, we welcome progress made on the implementation of the FSAP recommendations. Specifically, we think that ongoing work to introduce a carefully calibrated Systemic Risk buffer to increase resilience against risks from large exposure to the sovereign is important. We also commend the authorities' commitment to strengthening the AML/CFT framework through the new legislation and urge the authorities to push ahead with the implementation of the framework to ensure a robust financial sector and inclusive intermediation.

Key structural reforms are fundamental to boosting medium-term growth. We are encouraged by the authorities' commitment to address backlogs of infrastructural bottlenecks and create an enabling environment for a thriving and competitive private sector. Like staff, we underline the importance of strengthening public investment institutions and the effective absorption of EU funds to improve infrastructure. We urge the authorities to be mindful of competitiveness and productivity issues in setting minimum wages. In this connection, we agree with staff that minimum wages should be set in a transparent and objective manner to avoid a rigid labor market. We also welcome the amendments to the procurement framework, which aims to enhance transparency and better absorption of EU funds.

Ms. Riach submitted the following statement:

We thank staff for their insightful report in the context of Romania's Article IV consultation. We also thank Mr. De Lannoy and Mr. Tolici for their informative buff statement.

As an emerging economy, Romania has potential for rapid growth to converge to the rest of Europe and, indeed, in the past couple of years it has outperformed its EU partners. However, this buoyant growth was led by consumption growth boosted by expansionary policies and hence may not be sustainable in the longer run. While the catching-up process should provide room for income convergence, the authorities should also focus on productivity growth and investments. We therefore agree with staff that consolidating public finances and shifting them towards capital spending should become a priority.

Macroeconomic developments

The rapid real income growth is helping with the nominal catching-up process, but it also contributes to growing vulnerabilities. Expansionary policies have boosted growth to 7 percent in 2017 and are expected to sustain it at around 3.5-4 percent in the near term. However, with the unemployment rate at record lows and higher inflation, Romania's economic cycle has likely passed its peak. Wages have been growing double digit and the government is upward-adjusting pensions through its new pension law. While such income policies can facilitate both the catching up to the rest of the EU in nominal terms as well as the fair distribution of gains from incoming FDI and EU membership, the rapidly growing twin deficits are a sign of growing vulnerabilities. These policies resulted in pressure on both unit labor costs and the trade balance, leading to a deterioration of the current account deficit and to risks for cost competitiveness. Currently, government and private debt levels are not excessive, but a false sense of safety must be avoided as financing needs in both sectors are persistently rising. Annex II of the report is particularly instructive in this regard.

Fiscal policies

A sizable adjustment is needed to meet the government's 2019 deficit target. Public debt is low, at around 37 percent of GDP, while the headline fiscal deficit is now close to 3 percent of GDP. However, with a positive and widening output gap, the underlying structural balance has been deteriorating rapidly since 2016. Moreover, as staff note in the report, current spending has been favored over capital spending, suggesting growing fiscal pressure going forward. Already this year it could prove difficult for the government to meet its own deficit target of 2.8 percent of GDP, while the structural improvement required under EU fiscal rules appears out of reach. In its latest recommendation adopted in June 2019, the Council of the EU asked Romania to take the necessary measures to achieve a structural adjustment of 1 percent of GDP in 2019 and an additional 0.75 percent in 2020. Both staff and the European authorities estimate that a substantial adjustment would be needed to meet this year's target; while the new pension law, without compensatory measures, would put the fiscal trajectory further off track. We therefore share staff's recommendation for the authorities to come up with quality countervailing measures in the 2019 budget and beyond, and to revisit the pension law in order to prevent engraining public spending that cannot be supported by the economy in the long run.

Monetary and financial market policies

We agree with staff that increasing inflation levels give rise to concerns, and that monetary policy alone does not suffice to ensure economic stability. Inflation pressures have increased on the back of wage developments, the positive output gap and international dynamics in commodity prices. While the central bank's strict liquidity management could help inflation to return inside the target band by mid-2020, we share staff's view that monetary policy alone cannot fully stabilize the economy and appropriate structural reforms might be needed to prevent the build-up of excessive price pressures and macroeconomic imbalances.

Follow-up to the 2018 FSAP has further strengthened Romania's banking sector; however, certain government policies could hinder much needed lending to the corporate sector. Banks' performance has been strong, which has in turn led to strengthening capital and liquidity positions. However, the bank tax still constitutes a matter of concern, particularly for banks with low profitability. In this context, we welcome the changes to the calibration of the tax which alleviated the most significant concerns regarding the impact on monetary policy and financial stability. Like staff and the central bank however, we worry that the newly introduced consumer credit reference index (IRCC) could possibly weaken the transmission mechanism of monetary policy and may distort the allocation of credit in the economy.

Structural policies

Overall, we share staff's assessment that progress with the structural reform agenda has stalled or been reversed and needs a new impetus in order to support long term growth and convergence with the EU average. Low infrastructure quality is constraining growth. Therefore, improving its quality, by strengthening public investment management institutions and the absorption of EU funds, is a priority. Public investment would also benefit from a more stable and predictable decision-making process, as well as from more efficient public procurement and from the full and sustainable implementation of the national public procurement strategy. Investment and economic activity would also benefit, including from the use of impact assessments and stakeholder consultations. Moreover, we fully concur with staff on the importance of re-igniting the fight against corruption and on the vital importance of a stable legal framework for business confidence in Romania. Finally, reinforcing institutions will be key to stemming migration and addressing labor market shortages.

Mr. Mozhin and Mr. Palei submitted the following statement:

We thank staff for a set of well-focused papers on Romania and Mr. De Lannoy and Mr. Tolici for highlighting the authorities' views in their BUFF statement. Our general impression was that the staff report was unnecessarily gloomy and alarming.

The Romanian economy continues to perform well. After a very large GDP increase in 2017, growth has moderated and remains high, close to 4 percent in 2018 and about 5 percent this year. High growth rates, even if they eventually decline to about 3 percent projected by staff, bode well for continuing rapid convergence with average EU income level with very high probability. The level of GDP per capita in Romania is already very close to several advanced economies in the EU, including Greece, Latvia, Poland, and Portugal. Staff may want to qualify their statements in the report or reconsider the need to refer at all to a gap between the level of income in Romania and the so-called "Western Europe". The latter is neither uniform nor particularly dynamic in terms of growth, in contrast to Romania. Romania's growth rates over the past several years are even more impressive, given the demographic headwinds recently analyzed in the European Department's regional paper[1]. We note, for example, that since 2011-2012 remittances to Romania have increased significantly to about 2 percent of GDP, mostly due to labor emigration. Growing remittances are likely to assure more stable financing of the Romanian economy.

We note from the report that the Romanian authorities are more optimistic in their projections of potential growth, as they estimate it at 5 percent, well above the 3 percent in staff's baseline scenario. Accordingly, the differences between the authorities and staff in their views on output gap, the cyclical position of the economy, and the estimates of the structural fiscal balance are sizeable. In their report, staff could have highlighted the existing uncertainties more explicitly.

Staff are concerned about the fiscal consequences of the new Pension Law (Box 2), and we welcome close attention to fiscal risks and public debt sustainability in Romania. At the same time, it would be useful to put the

[1] Demographic Headwinds in Central and Eastern Europe, by Anna Ilyina et all, No. 19/12, 2019.

adoption of the law into a broader context. How does the 42 percent replacement ratio compare with those in Romania's peers? Is the 62 percent replacement ratio targeted by the authorities for 2022 close to the levels broadly considered to be adequate in the region? If the increase in the replacement ratio is advisable from the social security point of view, we would welcome the pension reform and, at the same time, emphasize more the need to ensure fiscal health in Romania through other measures, with a focus on improvements in tax administration and collection. From this point of view, we recall the analysis and policy advice in the SIP last year. We also agree with staff that public spending should be under the authorities' scrutiny, as it was suggested in the menu of possible measures for fiscal consolidation. We would invite staff to elaborate on the specific reasons for low EU fund absorption in Romania. We also note the Romanian authorities' good track record in the fiscal area and their public commitment to maintaining fiscal balance under control.

While the headline inflation has somewhat increased, the core inflation remains within the targeted range. The well-behaved inflation may point to the lack of overheating pressures in the economy and may be an argument in favor of the authorities' more optimistic view on the growth prospects. At the same time, we agree with staff and the Romanian monetary authorities on the need for close monitoring of inflation expectations and of the risks to the current outlook, including the ones stemming from the fiscal developments. We welcome growing credibility of inflation targeting framework in Romania, which is supported by the improving health of the financial sector, largely due to the authorities' structural reforms. The declining euroization of the economy and the growing trust in the national currency should be attributed to the consistent implementation of monetary policy and strengthening of the banking sector.

From the external sector perspective, the Romanian economy remains resilient. The NIIP is stable and within the range considered to be safe. The shares of Romania's exports in the key foreign markets are also stable or even improving. There are no clear signs of currency overvaluation. Foreign exchange reserves are at the upper end of the ARA range. The latter fact and other indicators of reserves adequacy make us wonder why staff in the draft press release claim that the reserves "can prove insufficient under an adverse event". Staff's clarification would be useful.

We agree that the increase in current account deficit from about 3.2 percent in 2017 to the projected level of 5.5 percent provides good reasons for an additional analysis. It could be a temporary deterioration due to the slowdown of exports from Romania to its main trading partners. Good growth prospects in Romania may lead to somewhat higher imports. Overall, we would welcome additional analysis of the key drivers of current account balance and encourage the authorities to continue monitoring the developments in international trade.

We share staff's concerns about the decline in public investments and agree with the need to address this issue. Having said that, we would like to better understand the impediments to higher public and private investments in Romania. Staff's comments would be appreciated. Romania is ranked rather high in the Doing Business database, above many EU and OECD economies. At the same time, more progress could be achieved in some specific areas, including starting a business, dealing with construction permits, and getting electricity. Are there any specific plans in Romania to improve the situation in these three areas?

Mr. Ostros and Mr. Damgaard submitted the following statement:

We thank staff for the interesting report and Mr. De Lannoy and Mr. Tolici for their informative buff statement. Growth in Romania has been strong in recent years, leading to faster convergence toward the EU income average compared to other new member states. However, pro-cyclical fiscal policy, which has amplified the consumption-led boom, and twin deficits are causes for concern. The current upswing provides a window of opportunity to recalibrate policies to build fiscal space and reduce vulnerabilities. We associate ourselves with Ms. Riach's gray and generally concur with staff's appraisal, while adding the following for emphasis.

Whereas public debt remains moderate, fiscal adjustments are needed to reduce the budget deficit. The cash fiscal balance was close to the 3 percent EU limit in 2017 and 2018 and is on course to breach the threshold this year according to staff's estimates. The new pension law, which was passed in June 2019, will put additional pressure on the public finances over the medium term. Given the positive output gap and the increasing deficit, we encourage the authorities to implement quality measures to tighten the fiscal stance. We also see a need to redirect some public spending from current expenditures to investments to boost potential future growth. We agree with staff's recommendation to increase tax collection efficiency by upgrading IT systems and improving compliance risk management. Could staff provide an estimate of the expected budget impact of such reforms?

Monetary policy should be tightened. Inflationary pressures have been growing in 2019, and we agree with staff that monetary tightening is warranted. Like staff, we are also concerned that the new Consumer Credit Reference Index (IRCC) may have adverse effects on the monetary policy transmission given the backward-looking calculations and high volatility.

We commend the authorities for implementing the majority of the 2018 FSAP recommendations. These measures will improve the resilience of the financial sector, and we encourage the authorities to carefully consider the remaining recommendations, including the systemic risk buffer to address the sovereign-bank nexus. Moreover, we encourage the authorities to keep strengthening the AML/CFT framework in compliance with the FATF standards. The effects of the new tax on bank assets should also be carefully monitored, e.g., analyzing the effects on credit allocation.

We encourage the authorities to focus on wide-ranging structural reforms to boost investment and growth potential. Special focus should be given to strengthening public investment management institutions, effective absorption of EU funds, and promoting private-public partnerships for infrastructure projects. The unfinished restructuring of the large state-owned enterprise sector needs to be completed to raise productivity as well as the quality of public goods and services. Finally, we fully agree with staff on the importance of renewing the fight against corruption.

Mr. de Villeroché, Ms. Gilliot and Mr. Rozan submitted the following statement:

We thank staff for their insightful set of documents and Mr. De Lannoy and Mr. Tolici for their useful buff statement. Romania continues to enjoy strong growth momentum, fueled by a strong domestic demand. The labor market appears very dynamic, and Romania is converging with the EU average in terms of real income. Nevertheless, imbalances appear to have widened. Procyclical policies and heightened vulnerabilities arising from the twin deficits invite for caution, to sustain convergence and avoid the materialization of risks to the outlook. A rebalancing of the policy mix and improving the composition of public spending appears warranted. To bolster investment and sustain income convergence, additional emphasis on structural and governance policies would be useful. We associate ourselves with Ms. Riach’s statement and wish to provide the following comments for consideration.

Outlook and risks

The country's economic growth remains among the highest in Europe albeit decelerating from 2019 onwards. Unemployment rate is at record lows and wage are increasing at a significant pace. Nonetheless, the economy is facing rising external risks and, as underscored in the Risk Assessment Matrix, excessive fiscal relaxation and wage increases, as well as backtracking on structural reforms could result in a worsening of market sentiment and slump in both productivity and competitiveness. The results of the Growth-at-Risk model customized to Romania are insightful and valuable and we encourage staff to expand its use across other countries. Compared to previous cases, we would be interested in staff's comments on the inclusion in the modelling of additional external and domestic risk factors such as respectively trade policy uncertainty and monetary and fiscal policies as regressors given their potential procyclical and disruptive effects. Likewise, given the enforcement in May 2019 of a new benchmark reference rate for loans to consumers in national currency (the Consumer Credit Reference Index, IRCC) aimed at replacing the ROBOR index, does staff contemplate an updated version of the GaR analysis based on modified regressor for domestic financial conditions?

With a significant increase in unit labor cost and related appreciation of the REER in 2018, Romania's competitiveness is eroding. The current account deficit has mainly been driven by consumer goods imports reflecting a dynamic domestic demand supported by continued wage growth, which has not translated into higher investment, and the subdued growth prospects of its trading partners and the procyclical fiscal stance raise concerns about a further deterioration. Though we fully concur with staff that wage growth should not outpace productivity, we found that the more accurate recommendations would have been helpful on this aspect. Could staff precise its view on the optimal levels for both wage and minimum wage growth that preserves private consumption, employment without being harmful to external competitiveness?

Fiscal policy

Fiscal policy tightening is needed while efforts are warranted to enhance composition and the efficiency of fiscal policy. The public debt ratio remains low, but the upward trend highlighted by staff is somewhat worrying. The large share of foreign currency denominated debt (about a half of total public debt), the significant increase in pension spending linked to the new pension law and the decline in reserve coverage are likely to put more pressure on public financing needs and exposing the country to a sharp reversal in market conditions and exchange rate. Beyond, spending efficiency and composition are key, and we encourage authorities to put additional emphasis on capital expenditures; the steps highlighted in the buff statement go in the right direction in this regard. This is key to sustain real income convergence and higher productivity growth over the medium term. Accordingly, we agree that quality measures for both revenues and expenditures including a reassessment of the pension law would help achieve the authorities' 2019 deficit target while preserving social transfers to the poorest and more vulnerable groups of the population.

Monetary policy

While recognizing that monetary policy alone does not suffice, inflationary pressures give rise to concerns. Inflation projections along with the deterioration of the current account would warrant not only policy rate hikes but also tighter liquidity management and greater exchange rate flexibility to mitigate FX pressures and limit interventions. Inflation targeting has contributed to reduce the annual inflation rate and mitigate the risk of inflation shocks. However, this regime is still undermined by disanchored inflation expectations, fast-growing wage costs, excess aggregate demand, insufficient flexibility of the exchange rate and lack of coordination between fiscal and monetary policies. Finally, the policy adjustment efforts should not rest only on monetary policy and be completer with other appropriate policies such as the needed structural reforms to prevent excessive pressures and macroeconomic imbalances.

Structural reforms

A renewed impetus on structural reform would help restore the balance between consumption and investment and sustainably accelerate Romania's income convergence towards its European peers. In line with staff's recommendations, efforts should be stepped up to pursue macro-critical reforms, enhance the absorption capacity of EU funds, and bridge the structural gaps in the quality of infrastructure, regulatory framework and governance issues including the strengthening of the anti-corruption framework, building on recent good progress, in particular the transposition of the fourth directive. As pointed out by staff, strengthening of institutions can also have a positive effect on reducing emigration. Finally, we saw few references to the impact of aging in the report barring the one brought up through a budgetary perspective. We acknowledge the existing IMF paper on Demographic headwinds in Central and Eastern Europe, but we feel that explicit recommendations would have helped getting a better grasp of the issues at stake. In the present case, we would interested in staff's priority recommendations to tackle labor market shortages.

Mr. Moreno and Mr. Montero submitted the following statement:

We thank staff for their report and Mr. De Lannoy and Mr. Tolici for their informative buff statement. We support staff's appraisal and associate ourselves with Ms. Riach's statement. We would like to make the following brief remarks for emphasis.

Romania continued to grow strongly supported by consumption boosted by expansionary policies, while investment lagged and structural reforms stalled ─or even reversed─. In this setting, rising inflation and widening fiscal and external imbalances are gradually eroding competitiveness and policy buffers, which may weigh on longer-term challenges, such as adverse demographics, a weak business climate or large infrastructure gaps.

Apart from stressing the need for a more balanced macroeconomic policy mix, with a much tighter fiscal stance to relieve the pressure on monetary policy to avoid overheating, we would like to underscore the importance of the structural reform agenda to support sustainable long-term growth and convergence with the EU levels. The improvement of the public investment management framework and the increase in the quality and efficiency of infrastructure should be high in the agenda in order to expand the absorption of EU funds and to address Romania's large infrastructure gaps. Public (and private) investment would also benefit from a more stable and predictable decision-making process, as well as from more efficient public procurement mechanisms. Finally, we strongly support staff's call to reignite the fight against corruption and to ensure a stable legal framework, both of which are crucial to enhance the institutional quality and business confidence.

Mr. Saraiva and Mr. Coronel submitted the following statement:

We thank staff for the report and Mr. de Lannoy and Mr. Tolici for their useful statement. While we welcome Romania's continued robust growth, reduced unemployment, and stronger financial sector conditions, we lament that some of the risks forewarned by staff and the board during the two previous article IV discussions have materialized. Most notably, augmented inflation pressures and a widening of the twin deficits can be attributed to an excessively easy policy stance adopted in 2016. All the while, structural reforms nearly stalled, and investment as a proportion of GDP has decreased.

Reversing course back to the pre-2016 policy shift, even if political conditions evolve favorably, could prove challenging. The adopted GEO 114 ordinance measures did not sit well with the markets and introduced economic uncertainty, as well as distortions. Some of the emergency ordinance measures have indeed been revised, which bodes well for further adjustments. While acknowledging the authorities' legitimate concerns to address obstacles to investment, we note an important divergence between staff's assessment of the adoption of GEO 114 and the authorities' more benign view. Could staff provide a more thorough assessment of the impact of GEO 114 on construction activity and elaborate on alternative, more efficient ways in which the authorities could pursue their policy objectives in this area?

The recently passed pension reform has brought to the fore doubts regarding the macroeconomic outlook. It should be recognized that the previous system's replacement rate of 42 percent was low and probably socially unsustainable. However, as per staff's estimate, if not adjusted or countervailed, the pension reform could increase debt by 20 p.p. of GDP and double the country's gross financing needs within the next five years. Yet, the report mentions a clause in the new legislation that requires fiscal space to be opened for such a hike in expenditures. In addition, staff suggests that re-pacing the pension reform implementation and being more audacious on fiscal reform efforts could mitigate negative macroeconomic impacts over the medium term. That notwithstanding, staff rightly calls for a "comprehensive review of the pension system" in order to avoid macroeconomic imbalances, as well as crowding out public investment and needed social spending.

We welcome the authorities' commitment to achieve the 2.8 percent of GDP fiscal deficit target this year. We believe that the economy has retained a strong enough position to gradually resume the path towards rebalancing by tightening the macroeconomic policy stance, particularly on the fiscal front, while strengthening the medium-term orientation and predictability of policies. Staff, however, estimates that revenue and spending measures of around 1 percent of GDP are still needed to successfully reach the fiscal target in 2019. Could staff explain in more detail how the authorities envisage meeting the deficit target this year and how the required measures would affect growth performance in the short run?

On the monetary policy front, we agree with staff that, considering the still large positive output gap and mounting inflation pressures, an even tighter stance would be warranted. The National Bank of Romania (NBR) has committed to tighten liquidity management, rein in headline inflation, and allow greater exchange rate flexibility to further enhance the economy's shock-absorption capacity. A clear stance by the NBR to bring inflation to the target would bolster its credibility and independence.

Besides the pressing need for fiscal consolidation, the authorities should focus on removing structural hurdles to further expanding Romania's growth potential. Much work is still pending regarding strengthening the SOEs' corporate governance, reversing the decline of investment in government spending, aligning wage growth with productivity, and fostering a business friendlier environment to attract much needed FDI. That said, the more recent loss of momentum on the pace of reform is not particularly auspicious and could keep potential growth stagnated.

We commend Romania's progress on the implementation of the 2018 FSAP recommendations. The banking sector remains solid, with continuously improving indicators and balance sheets repairs proceeding. NPLs have converged towards EU levels, but lackluster credit growth remains a drag to the economy. Banks have faced temporary challenges concerning a newly introduced benchmark reference rate, as well as the implementation of an overly complicated tax scheme from the GEO 114 ordinance. Some of these measures have been already adjusted, however, we see potential for further revision and simplification.

Mr. Psalidopoulos and Mr. Di Lorenzo submitted the following statement:

We thank staff for the comprehensive set of papers, and Messrs. De Lannoy and Tolici for their informative buff statement. We associate ourselves with Ms. Riach's gray and would like to provide the following comments.

Absent major policy corrections, emerging macroeconomic and fiscal imbalances expose the country to substantial risks. After a period marked by very strong output and income expansion, the growth rate of the economy is projected to converge to its potential of below 4 percent. However, the economy remains vulnerable to external shocks that could trigger a sharp growth deceleration, leading to a deterioration of the twin deficits and in financing conditions. This would put a strain on the buffers currently available, that are already decreasing. Therefore, action is urgently needed to tame the fiscal deficit, reduce inflation, improve competitiveness and institutional quality, and sustain income convergence.

A reversal of the procyclical fiscal expansion that has marked the last years is needed to prevent a further rise in public debt and associated financing needs. Additional fiscal measures are needed to put the structural budget on a sustainable path towards the medium-term objective. We thus welcome the authorities' commitment to take the necessary steps to comply with the EU fiscal rules. Fiscal policy should also aim to rebalance budget composition toward capital spending. Upgrading infrastructure quality requires improving the framework for public investment management, while the absorption of EU funds should be prioritized with respect to the creation of new PPPs. The recently approved pension law is expected to have significant fiscal costs; consequently, we encourage the authorities to pace its implementation according to the available fiscal space. Efficiency of tax collection would enormously benefit from a modernization of the tax administration and from a review aimed to increase transparency, simplicity and neutrality of the tax code. In staff's analysis additional fiscal measures of the order of 0.9 percent are needed in the fiscal year 2019 to secure the deficit target set by the authorities. Given the limited time left available to implement such correction, some additional clarifications from staff on the measures more likely to generate an immediate effect on the budget are welcome.

We welcome that staff and authorities are in broad agreement on the direction of monetary policy. Recently emerged inflation pressures need to be reined-in through a tighter monetary stance matched by narrow liquidity management while fiscal and structural policies need to play their part in abating some of those pressures. With inflation currently above target, any measures that risk to weaken the effectiveness of monetary policy transmission, including by reducing independence and thus the credibility of the central bank, should be absolutely avoided. We agree that allowing greater exchange rate flexibility can reduce pressures in case of capital outflows. At the same time, we note that the exchange rate regime is already classified as floating. Further elaboration by staff would be welcome.

The financial sector is largely resilient and profitable, underpinned by strong capital and liquidity position. Nonetheless the credit to the economy, and notably to the corporate sector, continues to stall despite the robust banks' balance sheets and a strong growth momentum. What are in staff's opinion the main factors determining this sluggish performance?

Higher-quality and self-sustainable growth requires significant reform efforts. We attach the highest importance to the need to avoid any backtrack on the progress achieved in the fight against corruption. In this regard, we encourage the authorities to implement the recommendations put forward by the European Council in order to finally close the Cooperation and Verification Mechanism initiated in 2007. Moreover, a more predictable policy making process will reduce a source of uncertainty, making less difficult to investors to take long-term business decisions and avoiding possible negative consequences on economic activity.

Mr. Beblawi and Ms. Abdelati submitted the following statement:

We thank staff for a comprehensive set of reports and Mr. de Lannoy and Mr. Tolici for their informative buff statement. Romania continues to register one of the highest growth rates among EU countries, with declining employment and generally strong performance that has supported convergence toward EU income levels. However, fiscal and external imbalances are widening, and staff calls for a correction in the course of policies to reduce the likelihood of a setback. We note the broad agreement between the authorities and the staff on a wide range of issues, but the authorities have a more optimistic outlook compared to staff's baseline scenario.

In line with the objective of supporting growth and convergence, the structural fiscal deficit widened in 2018 and staff expects a larger deficit in 2019 than the authorities' projected 2.8 percent of GDP. Staff therefore calls for additional measures of nearly 1 percent of GDP. We note however, that the authorities aim to keep budget deficits within the limits allowed by EU fiscal rules and to begin to move toward Romania's medium-term objective target starting from 2021.The buff confirms that the authorities concur on the urgency of improving revenue collection by reforming tax administration with FAD assistance and upgrading the IT infrastructure. The buff also refers to fiscal structural reforms to limit the negative impact on public finances of the newly adopted Pension Law. All of these would have longer term impact. We note the authorities' expectation of improved revenue performance in the rest of 2019 and the existence of available buffers that can be used according to the public finance law to meet the 2019 budget target. We would be interested to hear from staff on the authorities' record of meeting budget targets?

We agree with staff that a stronger fiscal position would reduce the need for further tightening to offset inflation pressures and narrow the external imbalance. We encourage the NBR to remain watchful of the growing external imbalance and need for somewhat greater exchange rate flexibility, while balancing financial stability concerns. Nevertheless, we take note of the NBR's analysis that the leu is broadly in line with fundamentals. We also consider that risks remain limited so far given Romania's overall public debt is modest at 35 percent of GDP, and Romania's raised financing in international capital markets in excess of planned targets so far for 2019. External debt is on a declining trend at 48 percent of GDP, with a low share of short-term external debt. Nevertheless, policies will be needed to address and reverse the deterioration of the current account in recent years, which reached a deficit of 4.5 percent of GDP in 2018. In this regard, more information on the temporary/permanent nature of the widening deficit would be appreciated.

While the resilience of the financial sector has improved in several dimensions, and the financial sector continues to be solid, the authorities recognize existing vulnerabilities. It is therefore important to remain committed to address these challenges adequately. We are encouraged by the progress in implementing the recommendations of the 2018 FSAP. Staff draws attention to the banks' exposure to the Romanian state, which approached 20 percent of assets in 2018. How does this compare to historical numbers? We welcome the authorities' internal discussions of a systemic risk buffer for banks.

We agree with staff and the authorities on the need to advance structural reforms and improve EU funds' absorption to enhance Romania's competitiveness and facilitate investment. It is necessary to improve public investment in infrastructure from its multi-decade low levels.

Mr. Chikada and Mr. Shimada submitted the following statement:

We thank staff for their comprehensive report and Mr. De Lannoy and Mr. Tolici for their insightful statement. It is encouraging that Romanian economy has remained strong, raising its income level towards those of advanced EU countries, notwithstanding weakened momentum and increased uncertainty regarding the European economy. However, the main driver of the economy is consumption supported by fiscal stimulus, and public investment has declined. As a result, macroeconomic imbalance has expanded, and risks are tailed to the downside and sizable. As we broadly concur with the staff's opinion, we will limit our comments on following points.

We take note of somewhat divergent views towards further monetary policy tightening between staff and the authorities. That is, while staff recommends further monetary policy tightening, the authorities seem to be more inclined to assess the effects of already-implemented rate-hikes as well as the price disrupting effects of GEO. It is also worth noting that vulnerabilities of the financial sector seem to be well contained thus far, despite widening fiscal and capital deficits and strong economic growth. We would appreciate staff's view on why the financial sector seems to be relatively detached from possibly over-heating economy and on need for further monetary policy tightening from the financial stability angle.

Furthermore, despite its consumption driven economic growth, the Romanian economy is broadly synchronized with Euro Area, particularly Germany. In this regard, we would be interested in hearing staff's view to what extent the ongoing slow-down of German economy could affect the Romanian economy and how resilient its consumption could be against the external shocks.

We concur with staff's assessment that fiscal consolidation is essential for Romania. In this regard, we strongly urge the authorities to reconsider the implementation of the new pension law, which could nearly double gross financing needs to 14.4 percent of GDP by 2024 under the debt sustainability analysis. While we understand that the increase of pension benefits could help narrow the poverty risk gap for elderly people, it will have no effect on the poverty risk gap for population aged 18 to 64, as shown in Box 2. Moreover, we would like to caution the authorities that once implemented, relaxation of pension benefits tends to be politically irreversible. The authorities should aim for measures to address the poverty risk in all ages, while keeping fiscal space. In this regard, we welcome the staff's comments on the potential policy the authorities could take to balance social needs and fiscal sustainability.

The authorities need to re-energize structural reform to boost potential growth. We take note with staff's concern that progress with the structural reform agenda has stalled or been reversed in some cases. The decline in public investment and the lack of infrastructure progress negatively affects Romania's competitiveness, FDI and growth potentials. We encourage the authorities to promote structural reform, in public investment management institution, the governance of SOEs, anti-corruption and labor market.

Ms. Mahasandana and Mr. Srisongkram submitted the following statement:

We thank staff for the well written report and Mr. De Lannoy and Mr. Tolici for their helpful buff statement. Romania continues to enjoy strong economic growth and the overall outlook remains largely positive despite risks being tilted to the downside. Nonetheless, adjusting macroeconomic policies to rein in the twin deficits will be critical to secure policy space and medium-term sustainability. Given the strong growth momentum and sizeable positive output gap as well as elevated inflation pressure, there is room for the authorities to adopt tighter fiscal and monetary policies, while continuing to pursue the structural reform agenda to raise potential growth. We agree with the broad thrust of staff appraisal and offer the following comments.

Durable fiscal consolidation should be the lead policy tool in reining in the twin deficits. We welcome the authorities' firm commitment to the budget deficit target and the EU fiscal rules. Meanwhile, we share staff's view that in the current economic context there may be room for additional measures on both revenue and expenditure sides to further contain the budget deficit, including to reduce wages and pension expenditure in favor of investment spending. Implementation of reforms to strengthen revenue collection and improve expenditure efficiency will be critical for medium-term fiscal sustainability, especially in light of the new pension law. To what extent would these fiscal-structural reforms help to accommodate additional burden from the new pension law?

Maintaining a tight monetary policy stance is appropriate. As inflationary pressure is likely to remain elevated given the positive output gap and wage developments, we agree with staff that the NBR should stand ready to tighten monetary policy as necessary. Could staff elaborate more on the "trade-off between greater exchange rate flexibility and financial sector stability" expressed in the authorities' view? Staff's view on implication of exchange rate volatilities on financial stability in Romania' context is welcome. We recognize concerns regarding the IRCC and its implications on NBR's monetary operations, as well as its suitability for housing loan given that interbank loans, from which the IRCC is calculated, are very different from housing loans. Could staff share their views on what the NBR could do to address the IRCC's shortcomings?

On the external balance assessment, we note the authorities 'consider the EBA lite CA model to underestimate the contribution of cyclical and structural factors to the current account deficit in 2018'. Could staff share their thoughts whether, and how those factors might affect the gap assessment?

Further efforts are needed to address the banking sector's high exposure to sovereign debt and the real estate sector. We note that the Romanian banking sector remain sound and commend the authorities' efforts to further bolster its resilience, including the good progress made so far in implementing the 2018 FSAP recommendations and the new legislation to improve the AML/CFT framework. On the FSAP, we encourage the authorities to remain steadfast in addressing bank exposure to the housing market and sovereign debt where progress have been slow, especially given that they are important source of vulnerability identified by the stress tests.

Following through on the structural reform agenda is essential to pave way for higher growth. We support staff's call to re-invigorate the reform efforts to reduce constraint on infrastructure and long-term investment, and improve SOE governance to ensure more effective EU fund absorption. We positively note the authorities' commitment to fight corruption. On minimum wages, we also reiterate that the pace of minimum wage increases should be aligned to labor productivity growth and account for competitiveness and employment prospects.

Mr. Raghani and Mr. Bah submitted the following statement:

We thank staff for their well-balanced report and Mr. De Lannoy and Mr. Tolici for their informative buff Statement.

The Romanian authorities should be commended for the fastest GDP growth achieved in the European Union over the recent years which led the country to make good progress in rising the population's income level towards the average of European Union member states. While the authorities' policies have also resulted in strong employment, we note that inflation is on the rise and the current account deficit expanded in 2018 due to strong import growth. The fiscal deficit remained below 3 percent of GDP although expenditure composition shifted more towards social assistance and current spending such as wages.

Bolstering Romania's growth potential and addressing the emerging fiscal and external imbalances are needed. To this end, further efforts are required to pursue fiscal consolidation, tighten monetary policy, foster greater exchange rate flexibility and speed up structural reforms. In this context, the authorities' commitment to the EU fiscal framework is reassuring as it will help them achieve their objectives while implementing sound public policies. We agree with the staff's analysis and policy recommendations and would like to provide the following comments for emphasis.

In the fiscal area, we encourage the authorities to purse fiscal consolidation to achieve their 2019 deficit objective of 2.8 percent of GDP. In this regard, fiscal reforms should be geared at increasing revenue and enhancing expenditure efficiency. This will help avoid the use of one-off measures to meet budgetary targets. On the revenue side, required steps should include the implementation of modern compliance risk management systems and improvement in the efficiency of the large tax payer office. We also encourage a comprehensive review of the tax system to address distortions and take advantage of potential revenue niches. The review of the GEO 114 issued in December 2018 is welcome given the economic distortions resulting from its implementation. Moreover, it is important to finalize this review to foster the development of a domestic financial market and spur private investment. On the pension law, the authorities' efforts should balance social and equity needs with fiscal costs.

On monetary and exchange rate policies, the authorities' commitment to keep inflation in check is welcome in a context of elevated inflation pressures owing notably to the fiscal stimulus, wage increases and the important positive output gap. Implementing in the near term a tight monetary policy will be appropriate to bring back inflation within the central bank's target band. To enhance Romania's external buffers and absorb exogenous shocks, measures to foster greater exchange rate flexibility and limit central bank's interventions will be needed. Enforcing the independence of the central bank should play a key role in strengthening the credibility of monetary policy. We would appreciate additional elaboration on the Consumer Credit Reference Index (IRCC) introduced last March about which staff has identified several shortcomings.

The authorities should preserve the stability of the banking sector which has strong capital and liquidity positions and which ratio of NPLs is close to the EU average. To better reinforce this stability while promoting intermediation, we encourage the authorities to continue implementing the recent FSAP recommendations and streamlining the new bank taxation to further increase credit to the private sector. A careful introduction of a well-calibrated systemic risk buffer will be helpful in bolstering the sector's resilience. The newly-adopted law to strengthen the AML/CFT framework is a welcome step in this direction.

Finally, we encourage the authorities to make further progress on structural reforms aimed at removing investment bottlenecks. In order to improve Romania's infrastructure, further efforts are required to enhance the management of public investment institutions and increase the absorption capacity of EU funds while reinforcing the framework for public-private partnerships. The authorities should also continue to address the governance of state-owned enterprises and fight corruption. Moreover, in a context in which wage growth exceeds productivity, it will be helpful to establish a transparent mechanism related to minimum wages.

With these remarks we wish the Romanian authorities every success in their future endeavors.

Ms. Pollard submitted the following statement:

We thank staff for the comprehensive Article IV report and Mr. De Lannoy and Mr. Tolici for the helpful buff statement. Over the last decade, Romania has made considerable progress toward EU economic convergence. The banking sector also appears well capitalized, liquid, and profitable. However, we are concerned that the recent economic and structural policy mix may undermine past progress toward achieving macroeconomic stability and reducing corruption. Unless Romania adjusts the direction of policies and the policy formulation process itself, the economy could face growing external and fiscal financing risks and declining investor confidence. We broadly agree with the staff appraisal in the Article IV.

Romania's economy appears to be overheating amid a large positive output gap, pro-cyclical fiscal stimulus, and rising inflation. Twin deficits have emerged quickly in recent years. Romania's projected 3.7 percent of GDP fiscal deficit for 2019 may be relatively modest compared to peers, but it is well above EU targets. Moreover, the estimated 4 percent of GDP deterioration in the structural balance since 2015 underlines the persistent reliance on fiscal stimulus across successive governments over that period. We agree with staff's call for fiscal consolidation to help reduce imbalances and anchor public debt sustainability.

In that context, the new pension law scheduled to go into effect next year is worrisome. Can staff please comment on why they did not include the 0.7–3.3 percent of GDP increase in annual pension spending under the law in its economic baseline projections?

We share staff's concern that the confusion surrounding the various provisions of last year's Emergency Ordinance (EO) 114, as much as the provisions themselves, will undermine public and investor confidence in Romania's policy process. The lack of consultation with the central bank on the bank asset tax and its monetary policy implications, and the subsequent reversal of the tax's link with short-term interest rates, suggested that the government had not fully considered the measures' implications. We encourage the authorities to improve the policy formulation process and avoid large unexpected, non-transparent policy shifts.

There is substantial merit in staff's recommendation to tighten monetary policy, both to contain inflation and to demonstrate its independence. We also don't believe that tighter monetary policy would necessarily attract hot-money flows and generate balance of payments risks in the coming years. Indeed, Romania's balance of payments risks have already increased, while tighter fiscal policy would remove pressure on the central bank to adjust rates.

Finally, we share staff's concerns over the potential weakening of governance and anti-corruption efforts in Romania. Indeed, Romania has previously been recognized for past progress in fighting corruption, which can help improve revenues, enhance spending efficiency, and strengthen competitiveness. We strongly urge the authorities to avoid back-tracking on Romania's strengthened governance and anti-corruption framework.

Mr. Merk and Ms. Kuhles submitted the following statement:

We thank staff for an informative and concise report and Mr. De Lannoy and Mr. Tolici for their helpful buff statement. We concur with the thrust of the staff appraisal and associate ourselves with Ms. Riach's statement. Romania has enjoyed a relatively strong growth momentum and progress is similarly palpable in the convergence of real incomes towards more advanced EU member states. However, this has to some degree been driven by prolonged fiscal expansion that has contributed to the build-up of mounting macroeconomic imbalances and renders the economy increasingly vulnerable. Against this backdrop, the authorities are invited to undertake dedicated actions that encompass fiscal consolidation and promoting sustained growth through comprehensive structural reforms. Given ongoing concerns related to the conduct of economic policies, particular attention should be devoted by the authorities to improving the predictability of the legal framework conditions and the policy environment more generally.

We call on the authorities to take corrective actions that put fiscal policy back on a prudent path. Although public debt still level remains comparatively low, the structural budgetary balances have deteriorated noticeably due to recent fiscal policy slippages. Moreover, imminent risks to the fiscal outlook might emerge from the uncertain impact of the pension reform. Thus, pursuing high-quality and durable fiscal consolidation is imperative to build buffers and to safeguard confidence and long-term sustainability. In addition, fiscal tightening would also contribute to balancing the short-term macroeconomic policy mix in an economy already operating above potential and to lessen some of the adjustment burden that otherwise would fall squarely on monetary policy. To this end, we strongly encourage the authorities to ensure a structural adjustment in full compliance with European and national fiscal rules and in line with their reaffirmed commitment to the EU fiscal framework.

The quality of the composition of public revenues and expenditures could be improved even beyond the most immediate consolidation needs. While stable and coherent tax policy decisions form the basis of increased revenue generation, these should be complemented by improvements in the operational efficiency of tax collection. On the expenditure side, we agree with staff that the authorities should aim to moderate rigid spending that potentially adds pressure on the double deficit. At the same time, and within the limits imposed by fiscal rules, a better prioritization of public spending towards closing infrastructure gaps and developing human capital is highly advisable, including the provision of education and health care services to underprivileged groups. Improving strategic planning and project implementation capacities could boost key public infrastructure investment while more efficient procurement practices help secure a targeted use of public resources and prevent corruption.

We agree with staff that further tightening of monetary policy and allowing for exchange rate flexibility is warranted. The exact calibration of monetary tightening should take the fiscal path into account and might be less pronounced depending on necessary fiscal consolidation efforts proceeding as recommended and its contribution to lower inflationary pressures. We note the potential flaws of the newly introduced IRCC benchmark and the possible repercussions on the monetary policy transmission mechanism. We would be interested in staff drawing a comparison between the IRCC and the "traditional" ROBOR benchmark, including their volatility features so far and the medium-term prospect for convergence of these benchmarks?

We strongly encourage the authorities to regain the momentum on structural reforms to revive the economy's long term growth prospects. Fully harnessing the potential of private sector development is dependent on addressing impediments such as cumbersome administrative procedures, inefficiencies in the SOE sector, corruption, infrastructure gaps and wage setting exceeding productivity while respecting the role of social partners. We deem staff's recommendations suitable in this regard, which are in essence aligned or complementary to economic policy recommendations recently adopted by the ECOFIN council of the EU. There would also be merits in enhancing quality control, impact assessment and stakeholder involvement in the design of public policies to avoid unnecessary uncertainties and uneven policy shifts and state interventions.

We appreciate the overall sound performance of the banking sector. We encourage the authorities to make further progress on financial sector regulation and on the AML/CFT framework, also taking into account the FSAP recommendations, to safeguard financial stability and to deepen the development of financial services. Concerns remain with regards to possible unintended economic consequences and distorted incentives stemming from the new tax on banks' assets. Could staff provide further details on and preferably an assessment of the amendments – implemented in March – to the most controversial aspects of the tax?

Mr. Sun and Mr. Huang submitted the following statement:

We thank staff for the informative report and Mr. De Lannoy and Mr. Tolici for their helpful buff statement. Romania has enjoyed a robust economic growth in 2018 with a historic low unemployment rate. Nevertheless, the economy is facing challenges, as inflation is rising and the twin deficits are deteriorating. Looking forward, the authorities are encouraged to start fiscal consolidation and resume the structural reform momentum. We agree with the thrust of staff's appraisal and would like to limit ourselves to the following comments for emphasis.

A durable fiscal consolidation, supported by a right policy mix, is necessary to sustain the robust growth. We take note of staff's projection that the 2019 fiscal deficit target would be missed without additional measures, leading to another fiscal impulse. In this regard, we echo staff's call for a fiscal consolidation with quality measures. The authorities are encouraged to follow staff's suggestions to close the tax efficiency gap to regional peers, such as reorganizing the revenue administration and modernizing the IT infrastructure. According to staff's assessment, the new pension law could result in substantial increase in fiscal expenditure and public debt. It is therefore important to strike a delicate balance between meeting social and public investment needs and ensuring long-term fiscal sustainability.

Tight monetary policy is appropriate given the elevated inflation pressure. We agree with staff that greater exchange rate flexibility would help to preserve buffers and absorb external shocks. We take note of the introduction of a new benchmark rate and encourage the authorities to have a comprehensive assessment of its impact on monetary policy transmission effectiveness. The banking sector is well capitalized and liquid. We commend the authorities' efforts to bring the non-performing loan ratio from 22 percent in 2013 to 5 percent at the end of 2018. Continuous efforts are needed to implement the remaining 2018 FSAP recommendations. We encourage the authorities to keep a vigilant watch on the sovereign-bank nexus and take measures if necessary.

Regaining structural reform momentum is essential to raise growth potential. We take note with concern that progress in some areas of the structural reforms has been slow. The authorities are encouraged to strengthen public investment management capacity and increase the share of public investment in fiscal spending to close the widening infrastructure gap. We join staff in encouraging stepped-up efforts in the fight against corruption. We welcome the authorities' recent efforts in SOE reforms, as indicated in the buff statement. The selection of private management for SOEs in the energy and transportation sectors should continue, as this is crucial to help improve corporate governance of the SOEs. The strong wage growth exceeding gains in productivity could erode competitiveness, and it is necessary to establish a minimum wage mechanism linked to a set of objective criteria that reflect productivity developments.

Finally, given the high ratio of people at risk of poverty, we encourage staff to have a closer look at social spending efficiency in the next Article VI consultation.

With these remarks, we wish the authorities every success in their policy endeavors.

Mr. Mouminah, Mr. Alkhareif and Mr. Keshava submitted the following statement:

We thank staff for the well-written report and Mr. De Lannoy and Mr. Tolici for their informative buff statement. We broadly share staff's analysis and policy recommendations and would limit our remarks to the following issues.

While we welcome the continued robust economic growth and strong employment, we underline the importance of improving the macroeconomic policy mix to reduce macroeconomic imbalances, strengthen buffers, and sustain convergence toward average EU income levels. Indeed, both fiscal and current account deficits have been widening and inflation pressures are building while investment has lagged. In this connection, we welcome the focus of discussions on the measures needed to address the imbalances while accelerating structural reforms to raise growth potential over the medium term. This is important as Romania’s income is still well below the EU average. In addition, the share of population at risk of poverty or social exclusion is extremely high.

We are reassured by the authorities’ commitment to keep budget deficits within the limits allowed by EU fiscal rules. Here, we take note of the passage of budget revision on August 12, as reported in the staff supplement, to keep the 2019 deficit target at about 2.8 percent of GDP. In this connection, we encourage gradual but sustained consolidation over the medium term through effective revenue mobilization and expenditure efficiency measures. To this end, we welcome the agreement between the authorities and staff on the importance of improving revenue collection by modernizing revenue administration and increasing expenditure efficiency and transparency by strengthening expenditure reviews and the procurement process. To mitigate the risks posed to public finances from the new pension law, the authorities have stated that its implementation will be matched by strong fiscal-structural reforms. Staff elaboration on the authorities’ plans will be welcome as the new law is estimated to add 3.2 percent of GDP to the total government expenditure in 2022.

We are encouraged that good progress has been made in implementing the 2018 FSAP recommendations, which will help in improving the financial sector’s resilience. However, we note that the recommendation to gradually scale back the Prima Casa program has not been implemented. In fact, an expansion of the program has been announced. In this context, we encourage the authorities to reconsider it as the FSAP had underscored that banks’ indirect exposures to government guarantees through the Prima Casa program further strengthen the sovereign-bank nexus. Therefore, scaling back of the program should be considered. On AML/CFT, we take positive note of the authorities’ recent efforts and encourage continued measures to strengthen the framework in line with the FATF standards.

Finally, the authorities should accelerate their efforts to advance structural reforms and improve absorption of EU funds. Indeed, as rightly noted by staff, stepping up of reform efforts would help in alleviating constraints on growth, enhancing competitiveness, and facilitating investment.

With these remarks, we wish the authorities further success.

Mr. Trabinski and Ms. Urbanowska submitted the following statement:

We thank staff for the informative report and Mr. De Lannoy and Mr. Tolici for their helpful buff statement. We would like to offer the following comments for emphasis.

While we broadly share staff's assessment of Romania's economic outlook, considering historical data, we tend to agree with the authorities' higher growth estimates. Romania remains one of the fastest growing countries in the EU, with growth driven by strong consumption and accompanied by solid employment. In view of Romania's current priorities, we see chances of a significant pick up in investment from its low base due to an increased absorption of EU funds, along with the authorities' efforts to boost investment spending. Nevertheless, we agree with staff that a relatively large share of consumption in GDP growth could compromise the sustainability of economic expansion. Therefore, a correction in the macroeconomic policy mix is needed to sustain income convergence with the EU and to reduce risks of a potential setback.

Pro-cyclical fiscal policy has led to a substantial deterioration of public finances. In recent years, government spending has focused on consumption-boosting rigid expenses (including the wage bill) at the expense of investment. High-quality fiscal consolidation is needed to restore the right balance between consumption and investment, as well as to reduce the burden on monetary policy. A reduction of the fiscal deficit would require decisive measures on both the revenue and expenditure sides. In particular, improving tax collection by upgrading IT systems and strengthening expenditure reviews would be of utmost importance. Furthermore, we concur with staff that the newly adopted pension law will have a negative effect on debt dynamics and debt sustainability. A careful reassessment of the pension law seems warranted to minimize the public finance exposure to downside risks.

Like staff, we believe that monetary policy alone may not suffice to ensure economic stability. A coherent and well-calibrated policy mix, with a greater role of prudent fiscal measures, is needed to prevent the build-up of excessive price pressures and macroeconomic imbalances. We believe that the recent rise in inflation also reflected transitory factors, such as the supply-side shock in the food market and tax hikes in the energy sector. At the current juncture, a more cautious approach to monetary policy adjustments seems adequate, considering the higher-than expected global slowdown, political uncertainty and more expansionary monetary policy stances around the world. However, too rapid policy rate increases may negatively affect private investment and competitiveness. In this context, we note the authorities' commitment to price stability and a continued strict liquidity management, while considering greater exchange rate flexibility.

A healthy financial sector is key for stability. We welcome the strong performance of the Romanian banks, which are well capitalized and liquid. We take note of the recently adopted bank tax. While we understand the reasons for its implementation, we would encourage the authorities to reassess the effectiveness of the tax in order to prevent potential adverse effects on monetary policy. Given the banks' significant exposure to the government, we take note of the staff's call to introduce a systemic risk buffer, as advised in the 2018 FSAP. We wonder whether staff have a particular size of this buffer in mind, and whether unintended costs of introducing such a buffer are possible? Staff's comments would be welcome. We commend the authorities for their commitment to strengthening the AML/CFT framework in accordance with the FATF standards.

The structural reform agenda needs a new impetus to boost potential growth. Strengthening public investment management institutions remains a priority. More effective absorption of EU funds, paired with a reduction of the administrative burden and a centralized procurement system, would facilitate investment and improve infrastructure quality. We also encourage the authorities to follow through on the SOEs reform agenda to strengthen governance and fight corruption.

Mr. Ray and Ms. Johnson submitted the following statement:

We thank staff for the comprehensive report and Mr. De Lannoy and Mr. Tolici for their informative buff statement. Romania has recently been outperforming its EU partners and so on a convergence path. But this outperformance has been driven by consumption supported by expansionary policies. In the longer run, this is not a sustainable path and there are signs that the Romanian economy is overheating. We agree with staff that macroeconomic policy settings need to be adjusted and renewed impetus given to structural reforms.

Meeting the government's own short-term fiscal target looks challenging. More broadly, rebalancing spending away from recurrent towards capital would be beneficial. We support the staff view that a comprehensive review of the tax system is warranted, and policies to strengthen revenue administration should be prioritized to enhance efficiency. The new pension law poses a significant medium-term challenge that either needs active fiscal adjustments to accommodate it or to be reassessed.

Can staff elaborate further on the demographic challenges facing Romania, including the impact on fiscal policy over the medium-term? Do staff have a view on the investment required in youth and future generations of workers to drive productivity?

Structural and governance reforms are needed to improve Romania’s competitiveness and support medium-term growth. In addition to boosting spending on infrastructure, there is scope to lift the quality of infrastructure by strengthening public investment management. We note the authorities’ commentary on the minimum wage. While the level of the minimum wage is a choice for the authorities, we support staff’s assessment that it should be set through a transparent mechanism.

Mr. Di Tata and Mr. Vogel submitted the following statement:

We thank staff for the comprehensive report and Mr. De Lannoy and Mr. Tolici for their insightful buff statement.

Romania’s economic growth remains strong but macroeconomic imbalances associated with expansionary policies are increasing. Real GDP growth reached 4.1 percent in 2018, led largely by private consumption, while wage growth has been strong. The unemployment rate dropped to 4.2 percent in 2018, the lowest level in recent years. Headline inflation was within the target band by end-2018 but has increased since February 2019 owing to demand pressures, currency depreciation, and sectoral price disruptions. The current account deficit has widened due to strong import growth, while the reserve coverage remains appropriate. Going forward, the big question and most important challenge faced by the country relates to the sustainability of the recent growth path. Based on the staff’s baseline projections, which are more pessimistic than those of the authorities, real GDP growth would remain at about 4 percent in 2019 before slowing to 3 percent over the medium term, inflation is likely to pick up, and the current account deficit would increase to above 5 percent of GDP in 2019-20. Main downside risks include a stronger-than-expected external slowdown, a sharp tightening of global financial conditions, and possible further fiscal stimulus or backtracking of structural policies owing to the electoral cycle. Could staff elaborate on the differences of opinion with the authorities regarding the possible impact of GEO 114 on growth, as well as on the authorities’ reservations about the staff's assessment that Romania's external position is weaker than implied by underlying fundamentals and desirable policies?

The report clearly underscores the need for Romania to follow a durable, high-quality, fiscal consolidation process to reduce the burden on monetary policy and contain the current account deterioration. Even though public debt remains low, as highlighted by Mr. De Lannoy and Mr. Tolici, the country's cyclical position and vulnerabilities call for the initiation of a process aimed at moderating fiscal imbalances. In the absence of corrective measures, staff projects the fiscal deficit to widen from 2.8 percent of GDP in 2018 to 3.7 percent in 2019, owing mainly to significant increases in public wages and pensions. We agree with staff on the need for additional quality measures to keep the deficit at about 2.8 percent of GDP in 2019 and further reduce it over the medium term. In this regard, we encourage the authorities to strengthen tax administration and carry out a comprehensive review of the tax system to identify distortions, rebalance the budget by reducing the share of the wage bill and pensions to make room for investment, and increase expenditure efficiency and transparency. The authorities have indicated that they are committed to keeping the fiscal deficit within the limits allowed by the EU fiscal rules and reducing it over the medium term. Could staff elaborate on the actions being envisaged by the authorities to achieve those objectives? Moreover, could it provide an estimate of total tax expenditures in Romania?

We encourage the authorities to review the new pension law. Based on the staff's projections, the new law would increase the public debt by 20 percentage points of GDP over the medium term. The authorities have indicated that the implementation of the law would be matched by strong fiscal-structural reforms and that the increase in benefits would be subject to available fiscal space. However, we agree with staff that it is necessary to conduct a comprehensive review of the pension system to reassess the balance among social needs, equitable distribution, and competing budget priorities.

We welcome the NBR's commitment to continue with strict liquidity management while allowing for greater exchange rate flexibility to preserve buffers and absorb shocks. Monetary policy may need to be tightened further to counteract inflation pressures, which are expected to remain elevated due to the cyclical strength of the economy and fiscal stimulus. In this context, we would like to emphasize the trade-off among policies and the importance of fiscal consolidation to reduce the burden on monetary policy. We also encourage the authorities to reconsider the use of the Consumer Credit

Reference Index (IRCC) as the new benchmark reference rate owing to its shortcomings.

The financial sector remains solid and resilient, profitability has improved, and good progress has been made in implementing the 2018 FSAP recommendations. Banks have strong capital and liquidity positions and NPLs have been reduced further to less than 5 percent at end-2018. Looking ahead, additional progress is needed in some areas, in line with FSAP recommendations, to further strengthen financial stability. In this regard, could staff comment on the prospects for introducing a calibrated systemic risk buffer to increase the banking sector's resilience under a high sovereign exposure? We encourage the authorities to vigorously implement the new AML/CFT legislation and strengthen the asset declaration framework for senior officials.

We concur with the view that structural reforms should be re-energized to improve Romania's medium-term growth prospects. In this regard, we agree on the need to strengthen investment in infrastructure by improving public investment management institutions and the absorption of EU funds; move ahead with SOE reforms; moderate minimum wage growth; and press ahead with the plans to renew the fight against corruption, particularly in view of recent initiatives that could potentially weaken the country's capacity in this area. As noted in the report, strong governance can also help reduce emigration, which could adversely affect the country's long-term growth prospects.

With these comments, we wish the Romanian authorities every success in their future endeavors.

Mr. Benk and Mr. Harvan submitted the following statement:

We thank staff for the good set of papers, and Messrs. De Lannoy and Tolici for their helpful buff statement. While Romania continues to experience strong economic growth and progress on its convergence to the EU, risks and imbalances have widened. Loose fiscal policy boosts growth further above potential, while the twin deficits and inflationary pressures increase. At the same time, the structural reform agenda remains stalled or backtracked in key reform areas. Procyclical policies and policy missteps amid a fragile political environment remind us of the 2005-2008 era, which eventually led to a hard landing and a series of Fund programs. We strongly encourage the authorities to take steps to ensure long-term macroeconomic stability and fiscal sustainability. We broadly agree with staff's appraisal and policy advice. We also associate ourselves with Ms. Riach's statement and add the following comments.

We concur with staff on the need for a durable fiscal consolidation in line with European and domestic fiscal rules, as well as steps to improve the quality and long-term sustainability of public finances. A substantial deviation from the adjustment path toward the medium-term budgetary objective under EU fiscal rules was observed in 2017 and 2018, and the same is projected going forward. We encourage the authorities to implement staff's recommended measures to revert the current procyclical stance. However, we note the disagreement between the authorities and staff on the macro outlook, as well as on the fiscal adjustment need, which questions the credibility and commitment of the authorities to implement the required adjustment measures. Staff's views on the authorities' commitment would be appreciated.

Recent changes in the pension system have rolled back 2008 reforms and endanger the medium-term fiscal sustainability. Furthermore, noting the significant poverty risk gap and inequality (with a Gini coefficient being one of the highest in the EU, and rising), we would see merit in a highly progressive tax on pensions (with a primary focus on special pensions) as a countermeasure. Staff's comments on the ongoing political discussions on a pension tax would be welcome.

Furthermore, steps are needed to improve the quality of public finances. Tax efficiency falls well behind its peers in the context of a sizeable value-added tax gap. Public investment is at the lowest level in a decade and is crowded out by the surging wage bill, while the soaring expenditures are not translated into improvements in the quality of public services. A reprioritization of public expenditure is needed to address the significant gaps in infrastructure.

Given large inflationary pressures, the central bank should further tighten monetary policy. We commend the National Bank of Romania for its sound policies and established credibility; nevertheless, we underscore that monetary policy alone might not be able to fully stabilize the economy, nor to counterbalance potential policy missteps from the government side. Appropriate structural policies and monetary-fiscal policy mix are needed to prevent the buildup of excessive price pressures and macroeconomic imbalances.

The financial sector remains on sound footing, with progress in implementing the FSAP recommendations. Banks have strong capital and liquidity positions, and non-performing loans have fallen close to the EU average. Good progress has been made to improve resilience and the macroprudential toolkit, consistent with the 2018 FSAP recommendations. However, the exposure of banks to the Romanian state remains high, while the recent bank tax could increase the cost of credit and restrain the expansion of bank credit to the private sector.

Structural reforms have stalled or backtracked in key reform areas, including the fight against corruption and efforts are needed to boost Romania’s growth potential. Recent developments and government measures have raised concerns with regard to the rule of law, judicial and magistrate independence, and the fight against corruption, as Romania is currently subject to the EU’s Cooperation and Verification Mechanism. The unpredictability of the policymaking and the instability of the legal framework have negative long-term effects on the economy as a whole. Renewing efforts in the fight against corruption would support FDI, enhance spending efficiency, and reduce emigration. The quality of infrastructure, including in the transport, energy, waste and wastewater sectors, needs significant improvement in order to support Romania’s growth prospects. State-owned enterprises (SOEs) have a key role in critical infrastructure sectors, but little progress has been made on corporate governance, and the existing rules are not sufficiently enforced. In light of the continuous and often missed conditionality on SOE governance reform in the 2009, 2011, and 2013 Fund programs, can staff comment on the progress since then?

Ms. Levonian, Ms. McKiernan and Mr. Mooney submitted the following statement:

We thank staff for their comprehensive report and Messrs. De Lannoy and Tolici for their informative buff statement. The Romanian economy is among the fastest growing in the EU, with private consumption the main driver for growth. However, the balance of risks is tilted to the downside due to the current account and fiscal deficits, in addition to inflationary pressures, combining to erode room for macroeconomic policy maneuver. As we broadly agree with the thrust of the staff appraisal, we offer only the following remarks for emphasis.

We note staff’s view that Romania will breach the 3 percent of GDP budget deficit threshold in 2019 and agree that durable fiscal consolidation supported by quality measures is necessary. It is crucial that fiscal policy be tightened and anchored on the basis of Stability and Growth Pact (SGP) requirements. We agree with staff that the strengthening of revenue and expenditure efficiency would assist in the sustainability of fiscal consolidation over the medium term. In this regard, modernization of the revenue administration by updating the IT infrastructure and adopting current compliance risk management systems is urgently required. We note the impact of the new pension law on total government expenditure and concur with staff's call for a reassessment, particularly given the law's constraining impact on public investment and other social spending.

We welcome the strong performance of the banking sector and note the progress made in terms of NPL reduction. We agree with staff that a carefully crafted systemic risk buffer would increase the banking sector's resilience under a high sovereign exposure and note that authorities have been discussing this issue internally. The tax on bank assets may create uncertainty and we encourage authorities to monitor this closely to ensure that the cost of bank credit to the private sector is not negatively impacted. We positively note the progress made to date on the implementation of the 2018 FSAP recommendations, in particular the recently introduced legislation strengthening the AML/CFT framework.

We note staff's assessment that the structural reform agenda has stalled and agree that these reforms require a new impetus. Stronger absorption of EU funding would lead to improved infrastructure spending and ultimately higher growth. In addition, the full and sustainable implementation of the national procurement strategy is required to benefit public investment, while further strengthening of the governance of SOEs would improve competitiveness. We note that recent justice laws to amend the criminal codes have been criticized as weakening Romania's capacity to fight corruption, and therefore encourage authorities to resume the positive efforts made to date in the anti-corruption field. Can staff expand on the reasons why the recent amendments to justice laws have been criticized as weakening the fight against corruption? We agree with staff that the relatively high minimum wage may negatively impact competitiveness and that future increases should be facilitated through a transparent mechanism agreed with social partners. Did staff carry out any analysis around female workforce participation or gender pay gaps?

Mr. Mojarrad and Mr. Belhaj submitted the following statement:

We thank staff for the informative report and Mr. de Lannoy and Mr. Tolici for their insightful statement. We broadly agree with staff's assessment and would like to make the following comments for emphasis.

Romania continues to perform well. In recent years, high growth has positively impacted the labor market dynamics, contributing to reducing unemployment and mobilizing the country's human potential. Improving employment conditions has also supported income convergence towards EU standards and will undoubtably reduce poverty, weaken the pull factor for migration, and contain brain drain.

However, rising macroeconomic imbalances are a source of concern. Such imbalances could compromise the long-term prospects of a sustainable growth, given a dampened global economic outlook and surging risks of external growth slowdown. A reinvigorated reform agenda will therefore have positive effects on Romanian's macroeconomic outlook and improve growth quality.

Fiscal consolidation is needed given the increased risks to the baseline scenario. The authorities' underlying budget assumptions are currently challenged by the global economic slowdown that would result in lower demand from EU countries, rendering the authorities' growth outlook to be too optimistic. Recent developments support staff's arguments for a tighter fiscal stance and we therefore agree that corrective actions should be taken to moderate the expansionary policies which fueled consumption and inventory accumulation, and which resulted in higher fiscal deficit and increased inflationary pressures. Fiscal adjustment would also mitigate the need for additional monetary tightening that would further drag private investments. In this regard, we would appreciate staff clarification on the reasons behind the delayed 2019 budget.

Corrective actions should include better quality expenditures. Improving the quality of expenditures by increasing the share of capital spending will contribute to restore the balance in favor of productive investments and reduce budget rigidities which could result in higher financing needs and debt accumulation.

Corrective actions should also target higher mobilization of revenues. We agree with staff that more efforts should be made to mobilize resources and strengthen tax collection efficiency especially in view of the potential negative impact of the new pension law on fiscal sustainability. Could staff elaborate on the limited progress on tax collection efficiency and on the reasons behind the cancellation of the IT modernization project mentioned in Annex 4? We noted that the last technical assistance support to Romania goes back to 2016. Could staff offer more explanations, including on the planned Fund's TA for tax administration?

Significant achievements have been made to strengthen the financial sector. The authorities' efforts to enhance the resilience and performance of the financial sector have delivered remarkable results so far. We recommend, however, continued vigilance in monitoring the identified areas of vulnerability. This being said, the low level of bank credit to an economy experiencing such strong growth performance is particularly striking. Staff comments are welcome. We take positive note of the progress in implementing the 2018 FSAP recommendations and commend the authorities for their commitment to reconsider the contested judicial reforms. The preservation of Romanian's widely recognized advances in terms of transparency and fight against corruption are keys for strengthening confidence and improving business climate.

We join staff in underlying the importance of a renewed focus on structural reforms to revitalize the process of convergence with the EU. Better SOEs performance will increase Romania's long-term economic growth potential, improve employment, and enhance budget revenues. A special focus should also be put on reinforcing SOE's corporate governance, as well as on building the capacities of the relevant Ministries.

We note the persistent low absorption capacity of EU funds targeting investment and we appreciate an update from staff on the hindrance to investments and on concrete measures to address bottlenecks and administrative burdens.

With these remarks, we wish Romania every success.

The representative from the European Central Bank submitted the following statement:

We would like to thank Messrs. De Lannoy and Tolici for their informative buff statement, and Staff for their report. We broadly agree with Staff and would like to highlight a few items.

On the assessment of the macroeconomic outlook for Romania, we broadly share Staff's views and agree that risks remain on the downside. Growth is expected to remain above potential in 2019, supported mainly by strong domestic demand and private consumption. However, it is expected to slow down to around 3 percent in the medium-term, while private and public investment developments remain contingent on EU fund absorption and progress on structural reforms. We, like Staff, view the risks to economic activity to be sizeable and tilted to the downside, as external and domestic shocks could materialise in tandem and lead to disruptions in confidence and capital flows.

We share Staff's view that elevated inflation levels give rise to concerns. Annual HICP inflation exceeds the National Bank of Romania's (NBR) inflation target band since early 2018. Based on the latest projections by the NBR, we expect inflation to ease next year and generally to stay in the upper part of the target band in the medium term. The recent deviation episodes are, however, indicative of the potential vulnerability to external and policy factors that Romania faces.

Monetary policy alone does not suffice to ensure economic stability. While there might be some scope for monetary policy tightening to help contain undesired inflation developments, like IMF Staff, we believe that monetary policy alone might not be able to fully stabilise the economy. Appropriate structural policies might be needed to prevent the build-up of excessive price pressures and macroeconomic imbalances.

On the external sector assessment, we broadly concur with Staff, and would like to emphasise our concerns that a further deterioration in fiscal and external balances in the presence of some institutional weaknesses and amid increased global financial volatility could prove disruptive for investor confidence in Romania.

We agree with Staff's views on fiscal policy, especially regarding the strong concerns about the current pro-cyclical fiscal policy pursued and the relevant recommendations. The current pro-cyclical fiscal policy stance has led to a substantial deterioration of public finances. Even though the current level of public debt is not particularly high, the already adverse deficit dynamics have worsened since the adoption of the pension law, further increasing the risk of a breach of EU fiscal rules. Any further deterioration in public finances may ultimately undermine the sustainability of public debt, notwithstanding current low levels, and a false sense of safety should therefore be avoided, also in view of the persistently rising public and private sector financing needs.

It is vital that fiscal policy be tightened and anchored on SGP requirements. Consolidation efforts recommended by the Council in June 2019 should be fully pursued. In this context, the Romanian government should take the necessary measures to ensure a combined structural adjustment of 1.75 percent of potential GDP until end-2020 in ESA terms, as well as to return to its medium-term budgetary objective (MTO) of a structural deficit at 1.0 percent of GDP.

Finally, on fiscal-structural reforms, we agree with the recommendations Staff put forward. Improving the quality of Romanian infrastructure by strengthening the public investment management institutions and the absorption of EU funds is a priority. Moreover, we fully concur with Staff on the importance of re-igniting the fight against corruption and would like to highlight the vital importance that a stable legal framework has for business confidence in Romania.

The Acting Chair (Mr. Zhang) made the following statement:

Directors' gray statements indicated that Romania has recorded another year of solid growth, coupled with record low unemployment. This presents the case of a fast-growing emerging market economy within the European Union (EU). On the other hand, Directors also pointed out that this expansion was accompanied by mounting twin deficits and inflation pressures. In order to address these vulnerabilities, Directors pointed out that it will be necessary to start a durable fiscal consolidation, tighten monetary policy, and implement a wide range of structural reforms.

Mr. De Lannoy made the following statement:

I issued an extensive buff statement, so I would like to focus on two concerns that have been recurrent in most gray statements and are prominent in the staff report, mainly, the risk of missing the fiscal targets and the need to tighten monetary policy.

The first issue is straightforward. The staff forecast for the budget deficit this year is significantly higher than that of the government's and is higher than the 3 percent threshold, according to EU rules. Let me put this in a broader perspective. Under Romania's Fund programs between 2009 and 2015, Romania recorded a remarkable adjustment of its budget deficit, from 9 percent of GDP in 2009 to 0.8 percent of GDP in 2015. In 2013, Romania exited the excessive deficit procedure. It has never reentered it since and met the medium-term budgetary objective of 1 percent of GDP structural deficit. While the structural deficit has increased since 2016, it should be noted that since 2012, Romania has always stayed below the budget deficit limits of 3 percent of GDP. The 3 percent limit has been and continues to be a clear commitment of the authorities, and this commitment has been met every year by each government.

The second issue is more sensitive, and it needs to be put in an international context. As mentioned in the staff report, monetary policy alone cannot solve all problems in the economy. In addition, the monetary policy of an open economy, whose currency is not a reserve currency, cannot be undertaken in isolation from the monetary policy of its peers and that of the major central banks in the world, nor can it ignore the reality of free movement of capital flows. The staff report mentions a misalignment of the exchange rate from its fundamentals. The policy recommendation is greater exchange rate flexibility and a tightening of the monetary policy to reduce inflation. The inflation target is 2.5 percent plus/minus 1 percent and was met both in 2017 and 2018, despite the exogenous shocks and a procyclical fiscal policy, which started in 2016. In the first half of 2019, headline inflation exceeded 4 percent, mainly due to exogenous factors. However, core inflation is forecasted to remain below the upper margin of the target band, and headline inflation is forecasted to return within the band next year.

Since the Article IV consultation took place, the exchange rate did not depreciate. In fact, it appreciated. It would have appreciated even further had the national bank not intervened to buy foreign currency. The reason for these developments is that the market perceived a high interest rate differential between Romania and its peers in the region, resulting in volatile capital inflows entering the country. The recommendations regarding greater exchange rate flexibility and tighter monetary policy should be discussed against this background.

An even higher interest rate differential would attract additional volatile capital flows, which would put more pressure on the appreciation of the exchange rate and, therefore, result in a further deterioration of the current account.

We all agree that the current account poses vulnerabilities, so the authorities see no case for widening it further. We would also note that, as other European economies are slowing down, the major central banks are contemplating the possibility of further monetary easing.

It is normal for an emerging economy to post relatively higher inflation rates, yet inflation is under control. The national bank is using an array of policy tools, including tighter liquidity managements, to contain it.

Finally, we agree on the need for an adequate policy mix that allows the authorities to preserve macroeconomic stability while stimulating sustainable and inclusive growth. Macroprudential policy is an important part of this policy mix. As of January 1, 2019, the national bank has adopted a debt-service-to-income limit of 40 percent overall, of which no more than 20 percent is for consumer loans. This measure, which was one of the recommendations of the recent Financial Sector Assessment Program (FSAP) and is the subject of a recent Fund working paper, represents a de facto tightening of the monetary policy, without the negative spillovers of a policy rate hike.

Consumer loans dropped year on year in the first half of 2019, compared to 18 percent growth in the first half of last year; therefore, putting an efficient brake on the risk of overheating.

The staff representative from the European Department (Mr. Lee), in response to questions and comments from Executive Directors, made the following statement:[2]

I thank Directors for the interesting questions raised, which we tried to answer through the written responses. We would be happy to respond to any further questions, but for now, I would like to provide a short update on the still unfolding political developments since a few days ago.

The current government of Romania no longer has a parliamentary majority, as the junior party of the ruling coalition left the coalition, announcing two days ago that it was moving to the opposition. As a result, also given Romania's electoral rules and the fact that the presidential election is scheduled this November, there is a very high likelihood that the country will be governed by a minority or apolitical government that lacks a strong political mandate until the next parliamentary election. It seems that the earliest the next parliamentary election can occur will be sometime early next year, probably March. If such a situation results, it will probably end up increasing the policy uncertainty further, especially when there are many fiscal challenges that we discussed in our report.

Ms. Riach made the following statement:

We thank staff for the comprehensive report and Mr. De Lannoy and Mr. Tolici for their informative buff statement. We support staff's recommendations and would like to stress the following points.

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[2] Prior to the Board meeting, SEC circulated the staff's additional responses by email. For information, these are included in an annex to these minutes.

Romania has experienced a strong growth performance over recent years, with the economy outperforming its EU partners. At the same time, however, growth has been driven mainly by consumption and boosted by expansionary policies. This may not be sustainable in the long run.

The rapidly growing fiscal and current account deficits point to growing vulnerabilities. In this context, we welcome staff's call for durable fiscal consolidation and agree that these efforts should be accompanied by targeted structural reforms.

On the fiscal front, a sizable adjustment will be needed to meet the government's 2019 deficit target. While public debt remains low and the fiscal deficit close to 3 percent, the underlying structural balance has been deteriorating rapidly since 2016. Moreover, the new pensions law is likely to put the fiscal trajectory further off track. We, therefore, share staff's view and support the recommendation for the authorities to come up with quality measures in the 2019 budget and beyond.

Turning to monetary policy, we share staff's concerns about the increasing inflation levels. We also agree that monetary policy has limited room for maneuver and safeguarding economic stability and needs to be complemented by structural reforms. We note the loss of reform momentum over recent years and stress the need to provide a new impetus for such reforms in order to support long-term growth and EU convergence.

Considering the financial sector, we welcome the progress made to implement the 2019 FSAP recommendations. Nonetheless, like staff, we are concerned that certain government policies could hinder much-needed bank lending to the corporate sector. This includes the new bank tax.

We also have some concerns about the recently introduced reference index for consumer credit (IRCC), which could impact the transmission of monetary policy.

Finally, we agree with staff that a key domestic risk is a further increase in vulnerability caused by policy shocks. These risks may be further exacerbated by the upcoming electoral cycle. We encourage the authorities to ensure a more predictable policy environment.

With this, we wish the authorities success in their endeavors.

Mr. Benk made the following statement:

We thank staff for their answers to our questions. We issued a gray statement, wherein we have pointed out the mounting risks and the longstanding structural weaknesses of the Romanian economy.

I believe that the staff's answers to Directors' specific questions rightly revealed many of the specific issues that had not been discussed in detail in the staff report. I do not want to reiterate the concerns expressed in our gray statement. Instead, let me just point to two issues that have more general implications beyond the Romanian case, and I hope that the Strategy, Policy, and Review Department (SPR) can provide some clarification.

The first is the baseline projection. It was surprising that the fiscal and the other impacts of the new pension law were not included in the baseline projection. I was even more surprised to read staff's explanation, that they are just waiting for next year's budget and are hoping for some countermeasures, which may come no later than in half a year's time, if at all, especially in light of the recent political developments that staff has just mentioned.

Could SPR clarify if this is the best practice for preparing a baseline projection? On what basis does staff differentiate between or among legislative measures, and whether or not to include them in the baseline which, according to my understanding, should be a no-policy-change scenario, which is how such baselines are typically interpreted by the markets.

My second point concerns the governance reform of the state-owned enterprises (SOEs), which was considered one of the key macro-critical issues in the last Fund program with Romania and was a cornerstone of the structural conditionality in that program, which eventually went off track, mostly because these benchmarks were missed. The staff report touches on it only marginally, even though staff admitted that their reform agenda has stalled on this front. My general suggestion to staff would be, as a best practice, to follow up more closely during Article IV consultations on the previous program recommendations, on issues considered earlier to be macro-critical.

Mr. Psalidopoulos made the following statement:

I would like to associate myself with Ms. Riach and provide the following points for emphasis.

The Romanian economy continues to perform well, mainly driven by a solid private consumption growth and with a very low unemployment rate. Nevertheless, as staff explained, vulnerabilities in the economy could act as shock amplifiers, especially from tighter external financing conditions amid rising uncertainty in the EU and globally.

Although public debt is still relatively low, public finance could benefit from actions that, by firmly putting it on a downward path, could lower financial risks, reduce risk premia, and create room for taking action in case of shocks.

Given that achieving the goal of a deficit below 3 percent of GDP for 2019 appears increasingly difficult due to the political developments that staff mentioned, we urge the authorities to modernize tax administration and to improve expenditure efficiency and transparency, including an application of the pension law that limits its impact on the budget. An immediate adoption of these reforms will improve the credibility and the predictability of policy action, and it would also be consistent and supportive of a tight monetary policy stance.

Finally a renewed impetus needs to be given to the structural reform agenda, notably starting by implementing the EU recommendations to ensure that the fight against corruption remains strong.

Ms. Mahasandana made the following statement:

We have issued a gray statement, and I would like to keep my intervention short, to only a few points.

First, we echo Mr. Saraiva that the Romanian economic position is strong enough to afford tighter macroeconomic policy, especially on the fiscal front. As many Directors have stated in their gray statements, achieving a durable fiscal consolidation path through quality measures and fiscal structural reform remains a key priority, especially now with the additional fiscal burden from the new pension law. The authorities' commitment to meet the fiscal deficit target is well noted, but we also agree with the staff that additional measures in the budget should be considered, so as not to rely only on ad hoc measures to achieve the set target, like last year.

Second, although we agree with the Director that the central bank should tighten monetary policy, as needed, given the complex situation, especially in dealing with capital flows, as stated by Mr. De Lannoy, we would like to hear more about this from staff, especially regarding the appropriate policy mix for Romania to achieve its price and financial stability mandates.

Lastly, the issue related to Romania's new benchmark rates is also faced by other emerging markets that are looking to develop more transparent market-based benchmark interest rates. We feel that this is also important because they have implications for monetary policy transmissions and credit markets, and we believe staff should keep a close eye on this issue. There may be value in drawing from experience and lessons from other emerging markets to craft policy advice for the authorities on this front.

Mr. Mozhin made the following statement:

We have issued a rather lengthy written statement. The first thing I want to say is simply to thank staff for responding to the long list of questions that we posed in our gray statement. This is very much appreciated.

I would like to reiterate that the vulnerabilities in the Romanian economy have been increasing in the latest years. In the short run, there is not much reason to worry because the debt is low and international reserves are broadly sufficient and adequate. It is more about the medium to long term, where the concern is that, in the case of the continuation of these trends, the country may face significant vulnerabilities down the road. This may not happen immediately, but over the medium term.

The staff representative from the European Department (Mr. Lee), in response to further questions and comments from Executive Directors, made the following additional statement:

I thank Directors for the follow-up questions and also the encouragement and endorsements.

Although Mr. Mozhin did not necessarily put it in the form of a question, we would like to say that our view is very similar—that there is no outright short-term risk on the horizon and everyone agrees, which is why we see no conspicuous market developments, even after the political unraveling over the last few days.

The only point we are trying to emphasize is that this will be coming down the road in the case of a continuation of this trend, exactly as Mr. Mozhin pointed out. But we want to emphasize that when such an event occurs, there is a large element of unpredictability in the timing. For that reason, we thought it would be part of our contribution to alert all the stakeholders that there is this concern which needs to be taken seriously, and in combination with the fact that policy has been moving in that direction for several years now. I want to reiterate that we come to a very similar assessment.

About the questions on SOEs, yes, it was a critical element of the most recent program and a key reason why the program was concluded a little prematurely. We will follow up on it in our discussions. The fact that it has not been addressed in depth in the report reflects mainly two elements. One is that we made a bit of a conscious choice this year to make the cyclical or vulnerability concern a key focus of this year's conversation. Again, we may have emphasized it a bit too much, in the judgment of some Directors or other readers, but we thought it was important to fully develop all kinds of risks that could result from the current course of policies.

The other reason is that there has been no noticeable change in the state of the SOE law. There is a marginally positive development that the discussion of the sovereign investment fund that has been going on for some time has been dropped. That is a bit of a positive development because the continuing discussion and uncertainty around that has been creating some agony among market participants and other observers about what will end up being the actual guideline for SOE governance. But we will continue to follow these critical issues that were discussed in past consultations or programs.

On the monetary policy for a small open economy subject to international financial markets with no reserve currency under its disposal, this is a continuing challenge for many in the profession, including most of the staff here as well. There is an ongoing discussion in the Fund among staff on developing the right nuance for small open economies in such a difficult context.

In the case of Romania, we also have been struggling with this question—in our discussions with the authorities, amongst ourselves, within the team, or among other colleagues in the Fund. The thinking behind our recommendation was an attempt to seek a balance. As was observed by several Directors, Mr. De Lannoy, and also by us, there is no sign of an immediate concern, an immediate instability in the financial market of Romania. But at the same time, there is an obvious risk from inflation. At the end of last year, the inflation target was met. However, since then, inflation pressure has remained strong. The way the inflationary target is formulated for

Romania has been around headline inflation rather than core inflation. It is fair to say that inflation has been above target and it looks likely to remain so for quite some time going forward.

Given the fairly obvious pressure and the risk to inflation and the relatively stable financial market at the moment, our view was that a bit tighter monetary policy would not carry much risk of generating financial instability. If the financial market were different, we would have had to make a different calculation.

If the question is, what is the general principle to apply in these situations, in the Romania team, we are not in a position to offer such a general framework but will keep struggling to strike what we believe to be the best balance as the situation evolves. For that, we will try to learn from the experience of other countries as well.

The staff representative from the Strategy, Policy, and Review Department (Mr. Kaufman), in response to questions and comments from Executive Directors, made the following statement:

There was a question about what should be included in the baseline projection. Let me quote from the guidance note, which basically says that the baseline should focus on established policies. What it means is those policies that are in place, as well as policies announced that are likely to be implemented, in the best judgment of the team.

In the written answers, the team mentioned that the earliest opportunity to see the full fiscal package that will accompany the new pension law will be in next year's budget. In the best judgment of the team, that is the appropriate time to understand and incorporate that into the baseline.

The staff representative from the European Department (Mr. Lee), in response to further questions and comments from Executive Directors, made the following additional statement:

Let me offer a little bit of a follow-up on how we interpret and applied that guideline.

During the mission, the pension law was being discussed, and we could see that it is coming. We had a series of meetings. In a way, it was a little mischaracterization in our reply when we said that we are waiting for the next year's budget. It is true, but we should have elaborated better. Next year's budget will be the first time the authorities will put out the medium-term budget framework which incorporates the new pension law. All we have now is that one piece of the expenditure that will be influencing government finances over the next several years, which is the new pension law. But that law comes with a clause, saying that the actual implementation of a benefits increase will reflect the fiscal space available, but exactly how that will happen has not been mapped out. The first possible opportunity to receive a detailed description is in the medium-term budget that will be released with next year's budget

During the mission, we tried to get some more information on what the authorities currently have in mind, which will ultimately be reflected in the medium-term budget. We received consistent replies from the Finance Minister and the Prime Minister, that to make sufficient space for implementing this new pension law, the authorities will recognize the importance of pushing ahead with fiscal structural reforms for the same reasons that we have been discussing them and the Directors have been endorsing them in this consultation. In addition, depending on the progress of such structural reforms, the actual increase of the benefits will be influenced by the available fiscal space. That was the best information that we could get.

We thought that adding the new benefit increase to the information that we had would not reflect the authorities' intention or plan either. One might rather crudely or harshly say that the authorities currently have no concrete plan. That is a fair statement. But that is different from going ahead and presenting the baseline scenario, as if that is the authorities' actual plan, which is not quite the case either.

The best we could do, was to fully flag the risk of a worst-case scenario, which would be that the pension increases are implemented in full but with no offsetting policy measures. In other words, increasing the pension while every other element of the government budget stays the same as before. That is why we included the full risk scenario in Box 2. We thought that was probably the most constructive way to have this discussion in the public domain.

Mr. De Lannoy, in a brief concluding statement, thanked Directors for their views and thanked staff for the constructive dialogue with his authorities.

The Acting Chair (Mr. Zhang) noted that Romania is an Article VIII member and no decision was proposed under Article VIII.

The following summing up was issued:

Executive Directors agreed with the thrust of the staff appraisal. They welcomed the strong economic growth and low unemployment, but raised concerns about widening current account and fiscal deficits and renewed inflation, as well as lagging structural reforms and investment. To address the growing imbalances, Directors called for shifting from procyclical to countercyclical fiscal policy, complemented by a tighter monetary policy stance and greater exchange rate flexibility. They further supported strengthening policy predictability and renewing structural reform initiatives to sustain convergence to average EU income levels.

Directors called for a durable fiscal consolidation to help curb the twin deficits and reduce the burden on monetary policy. They encouraged sustained fiscal reforms to achieve consolidation over the medium term and improve budget composition. Directors supported meeting this year's budget target with quality measures, including shifting expenditures away from rigid spending–such as wages and pensions–towards investment, reversing the trend of declining public investment in recent years. They cautioned that the new pension law could undermine fiscal sustainability and should be subjected to a comprehensive review, balancing social, equity and investment needs in line with available fiscal space. Directors also encouraged modernizing revenue administration by upgrading IT systems and improving compliance risk management, and improving expenditure efficiency and transparency through stronger expenditure reviews and the procurement process.

Directors supported further monetary policy tightening, given continuing inflation pressures. They encouraged further action beyond tight liquidity management to rein in inflation, which would support the credibility and independence of the central bank.

While welcoming the strong banking sector performance, Directors noted that efforts to strengthen financial stability should continue, including sustaining the good progress on implementing the 2018 FSAP recommendations. They called for measures to increase resilience to risks stemming from high bank exposure to the Romanian state and encouraged close monitoring of the new tax on bank assets due to its potential impact on monetary policy transmission and credit allocation. Directors also noted that the new AML/CFT legislation should be followed by a robust implementation.

Directors emphasized the need to re-energize the structural reform agenda to improve Romania’s medium-term growth prospects. They noted that public investment should be increased by focusing on public infrastructure and achieving a more efficient absorption of EU funds. Directors called for moving ahead with the state-owned enterprise reform agenda to improve the quality of public goods and services. They recommended moderating minimum wage hikes and linking changes to a set of objective criteria that reflect productivity. Directors further highlighted that Romania’s fight against corruption should be renewed, noting that these reforms could alleviate constraints on growth, enhance competitiveness and facilitate investment.

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

APPROVAL: May 19, 2020

JIANHAI LIN
Secretary

Annex

The staff circulated the following written answers, in response to technical and factual questions from Executive Directors, prior to the Executive Board meeting:

Recent developments, outlook and risks

1. ***In this regard, we would be interested in hearing staff's view to what extent the ongoing slow-down of German economy could affect the Romanian economy and how resilient its consumption could be against the external shocks.***

- Thus far, domestic consumption has been cushioned by the ongoing fiscal stimulus and strong wage increases, and this can withstand a relatively moderate slowdown in external demand but not a large external financing shock or sharp slowdown in global trade or growth. Merchandise export growth began to slow since late 2018, notably to Germany, from about +10 percent y/y in October 2018, but remained positive on the whole (about +4 percent y/y average in March–May 2019) before turning negative in June (-5 percent y/y). The largely moderate slowdown so far was likely supported by Romania's niche in value-segments and the diversification afforded by external demand related to the Renault and Dacia supply chains. If the Euro Area slowdown led by Germany broadens and becomes prolonged, the dampening of economic activity is expected to intensify in the rest of 2019 and 2020.

2. ***Compared to previous cases, we would be interested in staff's comments on the inclusion in the modelling of additional external and domestic risk factors such as respectively trade policy uncertainty and monetary and fiscal policies as regressors given their potential procyclical and disruptive effects. Likewise, given the enforcement in May 2019 of a new benchmark reference rate for loans to consumers in national currency (the Consumer Credit Reference Index, IRCC) aimed at replacing the ROBOR index, does staff contemplate an updated version of the GaR analysis based on modified regressor for domestic financial conditions?***

- Staff would consider these suggestions in future exercises. As the GaR is a statistical model, available data including for Romania for most of the period since 2000 offers limited episodes of changes in terms of significant shifts in trade policy uncertainty (albeit more recent shifts could be useful to consider ahead). Since 2000, Romania experienced a relatively steady and positive rise in trade integration with European supply chains, driven by FDI and the process of its EU accession. Given the model's focus on exploring the effects of macro-financial variables, the effects of monetary and fiscal policies are captured indirectly through their effects on domestic financial conditions, expressed mainly in market rates and volatility. Building in the effects of the newly introduced IRCC would likely require more quarterly data for a period of time before it could be usefully incorporated as a regressor in the model.

3. ***While acknowledging the authorities' legitimate concerns to address obstacles to investment, we note an important divergence between staff's assessment of the adoption of GEO 114 and the authorities' more benign view. Could staff provide a more thorough assessment of the impact of GEO 114 on construction activity and elaborate on alternative, more efficient ways in which the authorities could pursue their policy objectives in this area?***

Could staff elaborate on the differences of opinion with the authorities regarding the possible impact of GEO 114 on growth, …

- In staff's view, the introduction of GEO 114 particularly in its initial form contained measures that were relatively unprecedented in Romania's recent history in terms of adversely targeting several sectors that had been important for FDI and critical for the well-functioning of the economy (e.g. banking, telecoms, energy and capital markets-pension managers). Staff viewed the damage to foreign investment and the business climate as considerable and potentially long-lasting. Following adverse market reactions, the authorities subsequently undertook a series of revisions to the original GEO 114 measures from March 2019 onwards, with the effect of diluting or mitigating the economic impact, which may underpin their more benign view.
- The one measure in GEO 114 which introduced a stimulus was for the construction sector, where the minimum wage was raised significantly, and several generous tax exemptions for employees were granted. Staff preliminary assessment is that the fiscal incentives for the sector alone could cost about ½ percent of GDP, but the effects based on available indicators in H1 2019 appear even larger than that, perhaps as more companies reportedly stepped forward to declare activities within the formal construction sector and benefit from the fiscal incentives. In staff's views, stimulating the construction sector could have balanced the mix of incentives from foregone revenues with some actions on the expenditure side, notably on strengthening public investment institutions and accelerating public investment processes to close the critical infrastructure gap in Romania.

Fiscal policy

4. ***The authorities have indicated that they are committed to keeping the fiscal deficit within the limits allowed by the EU fiscal rules and reducing it over the medium term. Could staff elaborate on the actions being envisaged by the authorities to achieve those objectives? Moreover, could it provide an estimate of total tax expenditures in Romania?***

Staff, however, estimates that revenue and spending measures of around 1 percent of GDP are still needed to successfully reach the fiscal target in 2019. Could staff explain in more detail how the authorities envisage meeting the deficit target this year and how the required measures would affect growth performance in the short run?

- The recently passed budget revision envisages three main additional measures for meeting the 2019 budget targets: (i) higher dividend collections from SOEs, (ii) anticipated yield from a tax amnesty and tax debt restructuring program, and (iii) further use of EU retrospective financing. No significant growth impact in 2019 for these measures is expected. For the medium term, the authorities' fiscal strategy provides a gradual reduction in the budget deficit to 2 percent of GDP by 2021 but without yet providing the full array of specific measures behind it except for better revenue collection.
- Tax expenditures are estimated at 4.3 percent of GDP in 2018 and projected to rise to 4.5 percent of GDP in 2019 due to the recently introduced tax exemptions for the construction sector. The main tax expenditures are related to the low VAT rates for food and beverages, PIT exemption for pensions below certain threshold and SSC exemptions for non-monetary compensation, pensions and the construction sector employees.

5. ***In staff's analysis additional fiscal measures of the order of 0.9 percent are needed in the fiscal year 2019 to secure the deficit target set by the authorities. Given the limited time left available to implement such correction, some additional clarifications from staff on the measures more likely to generate an immediate effect on the budget are welcome.***

- Given the short timeframe, it is increasingly difficult to achieve 0.9 percent adjustment in the current fiscal year. Nevertheless, staff estimates that select expenditure measures, including elimination of some bonuses for public employees and enforcement of the 10 percent buffer on current spending bonuses, could still have a limited impact of around 0.2 percent on the fiscal balance. Additional budget measures would have to contribute the remaining 0.7 percent. Staff has only limited information about the additional measures to be deployed by the government to meet this year's fiscal deficit target.

6. ***Recent developments support staff's arguments for a tighter fiscal stance and we therefore agree that corrective actions should be taken to moderate the expansionary policies which fueled consumption and inventory accumulation, and which resulted in higher fiscal deficit and increased inflationary pressures. Fiscal adjustment would also mitigate the need for additional monetary tightening that would further drag private investments. In this regard, we would appreciate staff clarification on the reasons behind the delayed 2019 budget.***

- The budget bill was sent to parliament only in February 2019, because of lack of political consensus on the measures initially proposed. Subsequently the president challenged it to the Constitutional Court, which led to further delay.

7. ***We note the authorities' expectation of improved revenue performance in the rest of 2019 and the existence of available buffers that can be used according to the public finance law to meet the 2019 budget target. We would be interested to hear from staff on the authorities' record of meeting budget targets?***

However, we note the disagreement between the authorities and staff on the macro outlook, as well as on the fiscal adjustment need, which questions the credibility and commitment of the authorities to implement the required adjustment measures. Staff's views on the authorities' commitment would be appreciated.

- In recent years, the fiscal deficit target has been met by deploying ad-hoc measures that undermined the predictability of fiscal policy. Given fiscal outturns so far, staff expects a similar approach this year. However, while the authorities remain committed to the end-year target, reaching it will be increasingly difficult, as there are fewer one-off measures available. In addition, the gap between the budget and fiscal outturns this year is larger than in previous years.

8. ***We agree with staff's recommendation to increase tax collection efficiency by upgrading IT systems and improving compliance risk management. Could staff provide an estimate of the expected budget impact of such reforms?***

Implementation of reforms to strengthen revenue collection and improve expenditure efficiency will be critical for medium-term fiscal sustainability, especially in light of the new pension law. To what extent would these fiscal-structural reforms help to accommodate additional burden from the new pension law?

- Potential gains are sizable. The 2018 selected issues paper estimates potential gains from improved tax collection efficiency at 2.5 percent of GDP, if Romania raised efficiency to the average level of CESEE countries. The paper found that IT services and risk management are two areas where Romania lags regional benchmarks most. A sizable budget impact of any improvements, however, can only be expected in the longer term. Staff estimates the 2020-22 impact from updating IT systems at 0.3 percent of GDP. In terms of improved expenditure efficiency, short term impact is estimated at 0.6 percent of GDP. Overall, when combined, revenue and expenditure measures can only have a limited impact to accommodate expenditures stemming from the new pension law, given the rapid increase in benefits under the new pension law.

9. ***To mitigate the risks posed to public finances from the new pension law, the authorities have stated that its implementation will be matched by strong fiscal structural reforms. Staff elaboration on the authorities' plans will be welcome as the new law is estimated to add 3.2 percent of GDP to the total government expenditure in 2022.***

- So far, the authorities have not provided details regarding structural reforms that would ensure fiscal space for the estimated expenditures from the new pension law. For staff estimates on the impact of fiscal structural reforms see answers to point 8 above.

10. ***Could staff elaborate on the limited progress on tax collection efficiency and on the reasons behind the cancellation of the IT modernization project mentioned in Annex 4? We noted that the last technical assistance support to Romania goes back to 2016. Could staff offer more explanations, including on the planned Fund's TA for tax administration?***

- There has been no progress on the TA request for tax administration, following the initial mention during a meeting with tax authorities.

11. ***The authorities should aim for measures to address the poverty risk in all ages, while keeping fiscal space. In this regard, we welcome the staff's comments on the potential policy the authorities could take to balance social needs and fiscal sustainability.***

- Staff's recommended fiscal reforms, both on the revenue and expenditure sides, would help with fiscal sustainability, providing additional resources for social needs. Increasing public investment and improving SoE performance would help by improving the capacity and quality of public institutions that provide social services. Increasing some of the taxes that are currently at relatively low levels can contribute to fiscal sustainability.

12. ***Staff are concerned about the fiscal consequences of the new Pension Law (Box 2), and we welcome close attention to fiscal risks and public debt sustainability in Romania. At the same time, it would be useful to put the adoption of the law into a broader context. How does the 42 percent replacement ratio compare with those in Romania's peers? (2018) Is the 62 percent replacement ratio targeted by the authorities for 2022 close to the levels broadly considered to be adequate in the region?***

- The current replacement ratio of 42 is close to the EU average. An increase to 62 would move Romania into the top quartile in the EU. Similar comparison with CEE peers.

13. ***Can staff please comment on why they did not include the 0.7–3.3 percent of GDP increase in annual pension spending under the law in its economic baseline projections?***

- The new pension law, promulgated in July, lays out the plan for the additional fiscal expenditures on pensions, but note the measures that would ensure fiscal space. Staff wanted to wait for the next year's budget, which will be the earliest opportunity to see the full fiscal package that will accompany the new pension law, before it is included in the baseline. However, Box 2 was included to stress the severity of the risks implied by implementation of the law without offsetting policy measures.

14. ***Furthermore, noting the significant poverty risk gap and inequality (with a Gini coefficient being one of the highest in the EU, and rising), we would see merit in a highly progressive tax on pensions (with a primary focus on special pensions) as a countermeasure. Staff's comments on the ongoing political discussions on a pension tax would be welcome.***

- Such a measure was considered by the authorities for the revised budget this year, but it was dropped from the final version. The revenue impact from progressive pension tax is likely not to exceed 0.3 percent of GDP.

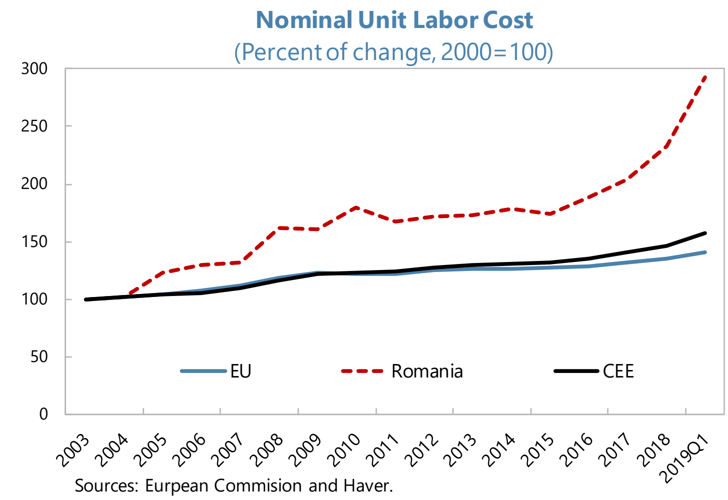
External Sector

15. ***From the external sector perspective, the Romanian economy remains resilient. The NIIP is stable and within the range considered to be safe. The shares of Romania's exports in the key foreign markets are also stable or even improving. There are no clear signs of currency overvaluation. Foreign exchange reserves are at the upper end of the ARA range. The latter fact and other indicators of reserves adequacy make us wonder why staff in the draft press release claim that the reserves "can prove insufficient under an adverse event". Staff's clarification would be useful.***

- Staff underscores that Romania reserves are adequate and together with moderate external debt, provide a temporary cushion. However, given eroding buffers and widening macroeconomic balances, staff is cautioning that buffers could be depleted in the case of an adverse external shock and recommends a correction in the course of macroeconomic policies to sustain convergence and reduce the likelihood of a setback.

16. ***Though we fully concur with staff that wage growth should not outpace productivity, we found that the more accurate recommendations would have been helpful on this aspect. Could staff precise its view on the optimal levels for both wage and minimum wage growth that preserves private consumption, employment without being harmful to external competitiveness?***

- Romania's ULC growth has been the highest among the EU-28 countries over the last several years (see chart). The question may not be answered in isolation, for it should reflect the pace of productivity developments and the shares of capital and labor income among other things. From this viewpoint, another conspicuous development in Romania has been that the labor share of income has been rising in recent years, while that has been falling in many other countries (WEO, April 2018). The choice of an optimal minimum wage will also need to reflect the social choice of a country, going beyond the logic of economic analysis. It is difficult to determine the optimal wage increase, but staff underscored the principles that should be followed in setting minimum wages, in particular with respect to being aligned with labor productivity growth.



Sources: Eurpean Commision and Haver.
1/ CEE peer countries include BGR, CZE, POL, HUN, SVN, SVK.

17. ***Nevertheless, policies will be needed to address and reverse the deterioration of the current account in recent years, which reached a deficit of 4.5 percent of GDP in 2018.In this regard, more information on the temporary/permanent nature of the widening deficit would be appreciated.***

- Romania's current account deficit has deteriorated significantly over the last several years. Specifically, import of consumer goods has increased in all subcategories, partly boosted by increasing income of consumers and partly reflecting the eroding competitiveness of domestic producers in the face of wage-driven cost pressures. The deterioration of the current account was caused by structural factors rather than temporary factors. Lack of structural reforms and weak investment bode ill for the prospects of the external sector.

18. ***On the external balance assessment, we note the authorities 'consider the EBA lite CA model to underestimate the contribution of cyclical and structural factors to the current account deficit in 2018'. Could staff share their thoughts whether, and how those factors might affect the gap assessment?***

Could staff elaborate … as well as on the authorities' reservations about the staff's assessment that Romania's external position is weaker than implied by underlying fundamentals and desirable policies?

- In the authorities view, the leu is broadly in line with fundamentals. They argue that structural and cyclical factors largely explain the current account deterioration in 2018. EBA lite CA model takes into account cyclical component. The cyclical contributions from the model are estimated at -0.6 percent of GDP (Annex VI), in principle reducing the CA gap. The authorities and staff concurred that EBA lite CA model does not capture structural factors. Structural factors are country specific and complex to model. Moreover, a successful modeling of structural factors could quantify the contribution of key structural factors on the CA gap, reducing the share of residuals while not necessarily reducing the size of the overall CA gap.

Structural Reforms

19. ***Finally, we saw few references to the impact of aging in the report barring the one brought up through a budgetary perspective. We acknowledge the existing IMF paper on Demographic headwinds in Central and Eastern Europe, but we feel that explicit recommendations would have helped getting a better grasp of the issues at stake. In the present case, we would interested in staff's priority recommendations to tackle labor market shortages.***

Can staff elaborate further on the demographic challenges facing Romania, including the impact on fiscal policy over the medium-term? Do staff have a view on the investment required in youth and future generations of workers to drive productivity?

- Tackling the ongoing labor force shortages requires long-term planning, coupled with consistent implementation. The recent EUR demographics paper identifies several policy options. One area with sizable potential gains is female labor force participation, which in Romania remains low relative to regional peers. Rising employment of older works could also contribute, albeit with smaller potential gains. Bringing in foreign workers, even on a temporary basis, could also alleviate labor market shortages, especially in sectors such as construction services. Finally, staff's advocated structural reform agenda can also help. For instance, shifting fiscal expenditures towards investment and improving the quality of public services, when persistently implemented, can limit the outward migration of Romania's labor force. Continued fight against corruption and consistent improvements in the quality of institutions can have a similar impact.

- Following the recent EUR-wide demographics study, staff plans to examine Romania-specific demographic challenges, including their fiscal impact. Staff has not estimated investment required in youth and future generations of workers to drive productivity.

20. ***Did staff carry out any analysis around female workforce participation or gender pay gaps?***

- Staff did not carry out analysis on the topic of gender pay gaps in Romania. The recent demographics study by EUR notes that female force labor participation in Romania is below the EU average, presenting a challenge and sizable potential gains in terms of labor force participation.

21. ***We note that recent justice laws to amend the criminal codes have been criticized as weakening Romania's capacity to fight corruption, and therefore encourage authorities to resume the positive efforts made to date in the anti-corruption field. Can staff expand on the reasons why the recent amendments to justice laws have been criticized as weakening the fight against corruption?***

- According to the Cooperation and Verification Mechanism report by the EC in November 2018, key problematic provisions of the new judicial laws included: the establishment of a special prosecution section for investigating offences committed by magistrates, new provisions on material liability of magistrates for their decisions, and a new early retirement scheme, restrictions on the freedom of expression for magistrates and extended grounds for revoking members of the Superior Council of Magistracy. The report also noted that proposed amendments of the criminal codes would entail profound changes in the procedural aspects of the criminal investigations and trial, and in the balance between the public interest in sanctioning crime, victims' rights and the rights of suspects. The amendments reduce the scope of corruption as an offense, reducing prosecution periods and punishment for certain offences in public position, such as abuse of office. The amendments introduce high threshold for direct intention of certain crimes and change rules for reporting bribery crimes. These provisions risk creating a situation of de facto impunity for corruption crimes.

22. ***In light of the continuous and often missed conditionality on SOE governance reform in the 2009, 2011, and 2013 Fund programs, can staff comment on the progress since then?***

- There has been no further progress on SOE governance reforms and staff is not aware of any plans for a reboot of the reform agenda on this front. We welcome the recent decision not to pursue the sovereign wealth fund, which was creating uncertainty about the future of SOE governance.

23. ***We would invite staff to elaborate on the specific reasons for low EU fund absorption in Romania.***

We note the persistent low absorption capacity of EU funds targeting investment and we appreciate an update from staff on the hindrance to investments and on concrete measures to address bottlenecks and administrative burdens.

- EU fund absorption capacity in Romania remains low, even though recently it has improved slightly. The latest available absorption rate (excluding down payments and agricultural subsidies) stands at 25 percent, compared to the average for regional peers of 29 percent. Several factors have contributed to the slow absorption, including lack of long-term planning, limited administrative capacity to develop and implement large projects and slow procurement procedures. Lack of progress on the structural reform front has limited the pace of improvement in the absorption rate. For example, the new procurement law has not been implemented as quickly as hoped. Staff has emphasized to the authorities the need to strengthen public investment management institution by further improving administrative capacity and the importance of timely preparation of new projects to ensure a smooth transition between EU fund programing periods.

24. ***We would like to better understand the impediments to higher public and private investments in Romania. Staff's comments would be appreciated. Romania is ranked rather high in the Doing Business database, above many EU and OECD economies. At the same time, more progress could be achieved in some specific areas, including starting a business, dealing with construction permits, and getting electricity. Are there any specific plans in Romania to improve the situation in these three areas?***

- A key impediment has been the high level of policy uncertainty and the lack of medium-term orientation of policies. For public investment, the low absorption rate for EU funds drives the recent decline. The staff has not discussed the three specific areas, however improvements in these areas (starting a business, dealing with construction permits, and getting electricity) would require a broad-based structural reform initiative that includes local governments (permits), line ministries (electricity) as well as the Trade Registry Office (business registration).

Monetary Policy

25. ***We agree that allowing greater exchange rate flexibility can reduce pressures in case of capital outflows. At the same time, we note that the exchange rate regime is already classified as floating. Further elaboration by staff would be welcome.***

- In the light of the environment of heightened external uncertainties and Romania's weakening external position, staff suggests embracing a greater exchange rate flexibility and limiting interventions to only smoothing the excessive volatility of leu to absorb shocks and preserve buffers. This is in line with classification of leu as "floating". The AREAER classification is conducted annually taking into account several indicators, but not limited to the exchange rate movements during the year.

26. ***We recognize concerns regarding the IRCC and its implications on NBR's monetary operations, as well as its suitability for housing loan given that interbank loans, from which the IRCC is calculated, are very different from housing loans. Could staff share their views on what the NBR could do to address the IRCC's shortcomings?***

- We would appreciate additional elaboration on the Consumer Credit Reference Index (IRCC) introduced last March about which staff has identified several shortcomings.
- We note the potential flaws of the newly introduced IRCC benchmark and the possible repercussions on the monetary policy transmission mechanism. We would be interested in staff drawing a comparison between the IRCC and the "traditional" ROBOR benchmark, including their volatility features so far and the medium-term prospect for convergence of these benchmarks?

- The introduction of the IRCC in May 2019 represented a revision to the initial proposal in GEO 114 to directly link the level of the interbank rates (ROBOR) to the size of the bank asset tax, which would have severely hampered monetary policy. Nonetheless, in staff's view there are three main shortcomings of the IRCC benchmark as it was formulated:

- First, it is backward-looking because it is calculated based on an average of actual transacted interbank rates up to two quarters earlier. This is unlike the traditional ROBOR (LIBOR-like) mechanism whereby the rate quotes that are used to compute the average factor in the forward-looking expectations of banks for interest rate movements based on current and future economic conditions. The IRCC's backward-looking feature potentially creates a mismatch for banks' pricing of loan rates and also complicates the setting of monetary policy, particularly when there is a substantive change in the economic environment and outlook over the recent period.

- Second, the transacted interbank rates underlying the calculation for the IRCC are subject to swings in bank liquidity conditions, which can introduce additional volatility into the benchmark index. Transmitting this volatility into pricing of loans is not ideal.
- Third, the new IRCC benchmark only applies to new loans, but the stock of existing loans remains tied to the old ROBOR benchmark. Having two interest rate pricing mechanisms simultaneously in operation potentially creates confusion among bank customers, and further complicates the setting and transmission of monetary policy. Convergence between these two benchmarks also cannot be assumed due to the differences in their formulation.
- The authorities are aware of these issues and are open to considering further revisions based on observing the performance of this newly introduced benchmark.

Financial Sector

27. ***The financial sector is largely resilient and profitable, underpinned by strong capital and liquidity position. Nonetheless the credit to the economy, and notably to the corporate sector, continues to stall despite the robust banks' balance sheets and a strong growth momentum. What are in staff's opinion the main factors determining this sluggish performance?***

The authorities' efforts to enhance the resilience and performance of the financial sector have delivered remarkable results so far. We recommend, however, continued vigilance in monitoring the identified areas of vulnerability. This being said, the low level of bank credit to an economy experiencing such strong growth performance is particularly striking. Staff comments are welcome.
We would appreciate staff's view on why the financial sector seems to be relatively detached from possibly over-heating economy and on need for further monetary policy tightening from the financial stability angle.

- The depth of the Romanian banking market as measured by bank credit and the size of banking sector assets is lagging relative to peers. As indicated in the 2018 FSAP, factors stemming from the structure of the economy, poverty, rurality and informality largely contribute to the low level of financial development. On a demand side, they include: (i) a high number of foreign own firms that are financed via mother companies (as indicated by a high level of intra company lending) or banks from abroad, and (ii) low number of bankable Romanian firms. On the supply side, access to credit continues being restricted for most companies, with gaps notable for MSMEs, start-ups, and in rural areas. In addition, high level of policy uncertainty could also negatively impact economic activity in the financial sector.
- The low level of financial development and the structure of economy with many foreign owned firms financed from abroad (see bullet above) together with an

appropriate supervisory and macro-prudential policies are contributing to the stability of the financial sector.

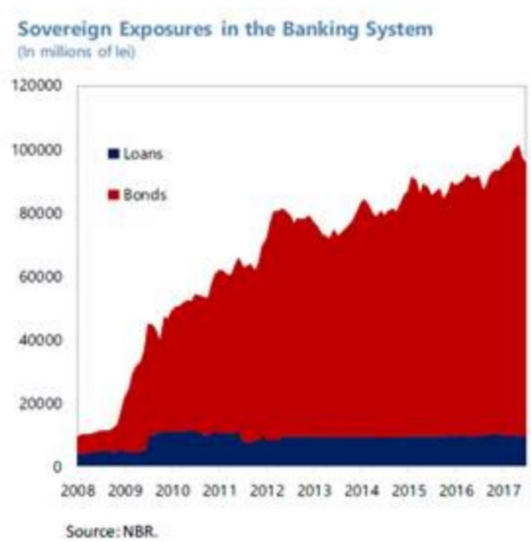
- At the current juncture and in line with the NBR's inflation targeting mandate, staff assesses that monetary policy should be focused on addressing inflation pressures. Risks from the financial cycle via excessive credit growth is broadly not yet a concern, and the NBR has been proactive on recent macroprudential measures notably introducing the debt service to income ratio for households this year.

28. ***Could staff elaborate more on the "trade-off between greater exchange rate flexibility and financial sector stability" expressed in the authorities' view? Staff's view on implication of exchange rate volatilities on financial stability in Romania' context is welcome.***

- While on one hand a greater exchange rate flexibility serves as a shock absorber, on the other hand exchange rate movements can create financial stability risks in a financial system with significant share of loans in foreign currency. The share of foreign currency loans in Romanian banking system has been declining over the last several years but remains above one third of loans are in foreign currency. The NBR regularly conducts stress testing and implements macro-prudential measures like, including currency-differentiated Liquidity Coverage Ratios, to manage FX risk in the financial sector.

29. ***Staff draws attention to the banks' exposure to the Romanian state, which approached 20 percent of assets in 2018. How does this compare to historical numbers?***

- Banks' own sovereign exposures have risen considerably in the past decade after the 2008 crisis (see chart), when it was only 5 percent share of assets, as also highlighted in the FSAP. The level of 20 percent of exposure is also among the highest compared to other EU countries.



30. ***Given the banks' significant exposure to the government, we take note of the staff's call to introduce a systemic risk buffer,***

as advised in the 2018 FSAP. We wonder whether staff have a particular size of this buffer in mind, and whether unintended costs of introducing such a buffer are possible? Staff's comments would be welcome.

Looking ahead, additional progress is needed in some areas, in line with FSAP recommendations, to further strengthen financial stability. In this regard, could staff comment on the prospects for introducing a calibrated systemic risk buffer to increase the banking sector's resilience under a high sovereign exposure?

- The 2018 FSAP had some preliminary discussion on calibrating such a systemic risk buffer (SRB), which is detailed in Appendix IV of the FSSA report. The policy response was intended to aim at ensuring resilience through increased loss absorbing capacity and provide disincentives against excessive concentration of risks, while at the same time avoiding unintended side-effects, such as an excessive reduction of liquidity, a bond market sell-off, or other unwarranted macro-financial dynamics. A gradual calibration was recommended to avoid unintended side-effects. Figure 1 in that Appendix provided an example of such a calibration, which applied a marginal scheme, with increasing SRB surcharges as sovereign exposures rise as a share of risk-weighted assets. The calibration applies a positive SRB only for exposure shares beyond a threshold, recognizing that banks hold some domestic government bonds to fulfill liquidity requirements. The authorities have since then been considering various options, and are continuing to discuss this topic at the National Committee for Macroprudential Oversight (NCMO).

31. ***Concerns remain with regards to possible unintended economic consequences and distorted incentives stemming from the new tax on banks' assets. Could staff provide further details on and preferably an assessment of the amendments – implemented in March – to the most controversial aspects of the tax?***

- The March 2019 amendments substantially reduced the level of the bank asset tax, in addition to de-linking the level of the tax from the ROBOR interbank rate benchmark. It also differentiated the level of taxes by size of banks, and exempted several types of bank assets including government securities from the tax, while introducing credit growth targets (see Annex I). Staff's preliminary assessment was that this new tax amounted to a 30 percent tax on profits at 2015-2018 average financial results, which remains sizable for a small financial sector. Staff views that the common justification for a bank tax—excessive size of banking activities—does not apply, as financial development in Romania is among the lowest in EU, and that this tax is likely to further slow its development, while also depressing investment in the sector. Targeting specific components of bank assets (e.g. favoring government securities) in the tax can also encourage resource misallocation, potentially increasing financial sector risks and complicating the conduct and communication of macroprudential policies.