Document of

The World Bank

FOR OFFICIAL USE ONLY

Report No. 56012-RO

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

PROGRAM DOCUMENT

FOR A PROPOSED SECOND DEVELOPMENT POLICY LOAN

IN THE AMOUNT OF € 300 MILLION
(US$ 380.5 MILLION EQUIVALENT)

TO

ROMANIA

FOR THE PUBLIC FINANCIAL MANAGEMENT, SOCIAL PROTECTION AND FINANCIAL SECTOR STRENGTHENING PROGRAM

December 21, 2010

Poverty Reduction and Economic Policy Department
Central Europe and the Baltic Countries Department
Europe and Central Asia Region

ROMANIA - GOVERNMENT FISCAL YEAR

Jan 1 –Dec 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of December 1, 2010)

Currency Unit	RON
US$1.00	3.28

Weights and Measures

Metric System

ABBREVIATION AND ACRONYMS

AMA	Advanced Measurement Approaches (Basel II)
CAS	Country Assistance Strategy
CFAA	Country Financial Accountability Assessment
CCA	Complementary Child Allowance
CFB	Complementary Family Benefit
CNAS	National Health Insurance Fund
CNVM	National Securities Commission
COA	Court of Accounts
CPAR	Country Procurement Assessment Report
CPS	Country Partnership Strategy
CSA	Insurance Supervisory Commission
CSSPP	Private Pension Supervision Commission
DPL	Development Policy Loan
DRG	Diagnosis Related Group
DSG	Domestic Standing Group
EBCI	European Bank Coordination Initiative
EBRD	European Bank for Reconstruction and Development
EC	European Commission
EIB	European Investment Bank
ESFS	European System of Financial Supervision
EU	European Union
FDI	Foreign Direct Investment
ILO	International Labor Office
IMF	International Monetary Fund
IPSAS	Institute for International Public Sector Accounting Standards
LDP	Letter of Development Policy
LOI	Letter of Intent
LPA	Lone Parent Allowance
MDGs	Millennium Development Goals
MoPF	Ministry of Public Finance
MOU	Memorandum of Understanding
MOH	Ministry of Health
MTEF	Medium-Term Expenditure Framework
NACS	National Agency of Civil Servants
NASB	National Agency for Social Benefits
NBR	National Bank of Romania
NGOs	Non-Governmental Organizations
OECD	Organization for Economic Cooperation and Development
PAL	Programmatic Adjustment Loan
PCF	Per Capita Financing
PEIR	Public Expenditure and Institutional Review
PETS	Public Expenditure Tracking System
PFM	Public Financial Management
PHRD	Japan Policy and Human Resources Development Trust Fund
PPIBL	Public and Private Institution Building Loan
QAG	Quality Assurance Group

FRL	Fiscal Responsibility Law
FSAP	Financial Sector Assessment Program
FX	Foreign Exchange
GDP	Gross Domestic Product
GMI	Guaranteed Minimum Income
GNFS	Goods and Non Factor Services
GNP	Gross National Product
HICP	Harmonized Index of Consumer Prices
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IFIs	International Financial Institutions
IFRS	International Financial Reporting Standards
SA	Social Assistance
SBA	IMF Stand-by Arrangement
SDP	Strategic Development Plan
SDR	Special Drawing Rights
SMOU	Supplementary Memorandum of Understanding
UCA	Universal Child Allowance
UNDP	United Nations Development Programme
UNICEF	United Nations Children's Fund
VAT	Value Added Tax

Vice President:	Philippe Le Houerou
Country Director:	Peter Harrold
Sector Director:	Luca Barbone
Sector Manager:	Satu Kahkonen
Task Team Leader:	R. Sudharshan Canagarajah
Co-Task Team Leader	Catalin Pauna

ROMANIA

SECOND DEVELOPMENT POLICY LOAN

TABLE OF CONTENTS

TABLES

FIGURES

ANNEXES

LOAN AND PROGRAM SUMMARY

ROMANIA

SECOND DEVELOPMENT POLICY LOAN

Borrower	Romania
Implementing Agency	Ministry of Public Finance
Financing Data	IBRD Loan of Euro 300,000,000 (US$ 380,500,000 equivalent).
Operation Type	Second Development Policy Loan (DPL2)
Main Policy Areas	Public finance, social sectors, and financial sector.
Program Development Objective(s) and Contribution to CPS	The objective of the proposed operation is to support the government's reforms in fiscal management, social protection and the financial sector, and position Romania to emerge from the economic and financial crisis on a stronger footing, so as to be able to resume and sustain convergence to the living standards of more advanced EU economies. These reforms aim to: (i) strengthen public expenditure management, a key weakness and root cause of Romania's vulnerability to the financial crisis; (ii) cushion the impact of the crisis on the poor and vulnerable by enhancing the efficiency and targeting of social assistance, and improving the fiscal sustainability of pensions; and (iii) minimize risks of a domestic financial sector crisis by addressing current and potential vulnerabilities as well as strengthening regulation and supervision for a more resilient and well-functioning financial sector in the longer-term. The Country Partnership Strategy (CPS) that was presented to the Board with DPL1 (the first operation in this DPL series) focuses on three pillars: i) economic growth and competitiveness; ii) public sector reform; iii) social cohesiveness. The focus of this DPL series on public finances, the social sectors and the financial sector is fully aligned with these pillars.
Key Outcome Indicators by end of DPL series	<u>Reforms in public finance:</u> a) *Medium Term Expenditure Framework (MTEF) implementation* More strategic allocation of budget resources and stronger budget execution controls. Measured by a reduction in variance between approved budget and actual expenditures for major ministries/functions. b) *Public Sector Pay* More transparent and performance-based system of public pay. Measured by base salary comprising at least 70 percent of average total compensation among public servants in all occupational categories. c) *Health* Better fiscal management and increased efficiency in public expenditures to provide better services and greater equity in access. Measured by lower public expenditure on drugs, a lower share of public expenditures on ambulatory care and a lower rate of admission to acute care facilities.

	d) Education Better fiscal management and increased efficiency in public expenditures to provide better services and greater equity in access. Measured by an increase in the average class size. <u>Reforms in social protection</u> *e) Social Assistance* Strengthened social assistance through the best targeted program (Guaranteed Minimum Income—GMI). Measured by a 30 percent increase in the number of paid GMI beneficiaries. *f) Pensions* Greater sustainability of pillar 1 pension scheme. Measured by reduction in fiscal deficit by 0.5 percent of GDP relative to baseline in 2012. <u>Reforms in financial sector</u> a) Strengthened contingency planning to reduce potential vulnerabilities and improve resilience and functioning of the financial sector over the longer-term. Measured by systematic increase in the percentage of corporate insolvency cases handled through reorganization proceedings. b) Improved resilience and functioning of the financial sector through regulatory and supervisory changes. Measured by the completion of joint supervision of financial conglomerate groups by the relevant regulators.
Risks and Risk Mitigation	Romania was hard hit by the global economic crisis. The large fiscal deficit at the onset of the crisis increased the magnitude of adjustment at a time when the severe economic downturn heightened the difficulties of adjustment. The Government's program, supported by International Financial Institutions (IFIs), rests heavily on strong macroeconomic policy adjustments supported by a large package of external official financial resources to stabilize the economy and support external debt rollover/debt service without excessive pressures on the exchange rate that could weaken the banking sector further. Economic risks that could affect the proposed operation include regional financial market turbulence which could result in lower debt rollover rates or larger capital outflows. Destabilizing exchange rate depreciations could also harm the financial sector. Further RON depreciation could increase bankruptcies and hamper growth. A protracted downturn in the Romanian economy could have a serious impact on the domestic banking sector through increased corporate and household distress. Delays in reform would have a negative impact on market confidence. Political risks stem from an embattled coalition government and coming elections in 2012. Fiscal austerity measures have increased social tensions. These risks are mitigated partially by the size of the multilateral support package, which provides some cushion by allowing reserves accumulation. Higher reserves help counter a worse-than-expected case scenario of capital outflows and prolonged financial sector distress. The content of the program also mitigates risks. In the banking sector, the program supported by the Fund includes in-depth examinations and recapitalization requirements in the event of capital shortfalls, as well as the strengthening of regulatory and supervisory powers. Under the

	proposed DPL program, these measures are reinforced through contingency planning reforms. These include the preparation of a strategic action plan to govern potential interventions from NBR and MoPF to sustain financial sector stability and the establishment of a framework to facilitate debt restructuring, implemented under DPL1, and encouraging adequate restructuring of viable impaired loans, supported under DPL2. Finally, the fiscal reforms envisaged under the overall program will reduce fiscal pressures both in the short run and over the medium term and contribute to lowering external financing needs.
Operation ID	P117667
Map	IBRD 33469

The Second Development Policy Loan is being prepared by a Bank team consisting of Swati Ghosh, R. Sudharshan Canagarajah (Task Team Leaders), Catalin Pauna (co-TTL), Bernard Myers, Ufuk Guven, Emil Tesliuc, Aylin Isik-Dikmelik, Agnes Couffinhal, Richard Florescu, Lars Sondergaard, Mariana Moarcas, Sophie Sirtaine, Bogdan Constantinescu, Ruxandra Costache, Nicholay Chistyakov. The document was processed by Raluca Banioti and Nancy Davies-Cole.

I. INTRODUCTION

1. **This program document describes the proposed second loan in a program of three possible Development Policy Loans (DPL) to Romania for a total amount of € 1 billion**. The first DPL (DPL1) disbursed €300 million in September 2009. This second DPL (DPL2) is also for €300 million. A third DPL (DPL3) for €400 million is tentatively targeted for CY2011. As outlined in the program document for DPL1[1], this DPL program supports the Government's structural reforms in three key areas: a) improving fiscal sustainability and management of public finances, including at sectoral level in health and education; b) enhancing social protection systems to address the immediate needs of the poor and vulnerable while ensuring more sustainable social protection over the longer-term; and c) strengthening contingency planning in, and the resilience of, the financial sector. The proposed Bank operation reinforces and complements existing programs by the International Monetary Fund (IMF) and the European Commission (EC). This document does not discuss the general features of the program to be supported by the DPL series, which were covered in the DPL1 document mentioned above, but focuses on developments under the DPL2.

2. **The DPL series is central to the Bank's engagement in Romania as described in the Country Partnership Strategy (CPS) that was presented to the Board on July 16, 2009, together with DPL1.** While financing a relatively small share of the €20 billion package agreed by the Government with the IMF and the EC, the DPL targets structural reforms which will considerably improve Romania's medium to long term outlook for sustainable development.

3. **Short term economic and political risks are significant, but the staff considers them to be manageable.** The Government recognizes and addresses these risks. Despite a slower-than-expected economic recovery, an ambitious fiscal adjustment equivalent to 4.6 percent of GDP implemented by the Government in July 2010 has put Romania on track to reach the fiscal targets for the remainder of the 2010-2011. The structural reform agenda is also progressing satisfactorily, with notable steps on pensions, public wages and labor market reforms. Commercial banks remain well-capitalized in spite of the increase in non-performing loans (NPLs), and impact from the turmoil in other EU member countries has been limited. The IMF Board approved the fifth review of the SBA with Romania on September 24, 2010 and released the respective tranche. The next review has been tentatively scheduled for January 2011. The EC has also declared that the program it supports is on track, released its third tranche in September 2010, and will review progress in January 2011.

4. **Since the beginning of the program, the Government has shown strong commitment to the reform agenda.** The Government has pledged publicly and in meetings with the IMF, EC and the World Bank (hereafter referred to as IFIs) its firm intention to continue to implement its program of macroeconomic management and structural reforms. The President has issued numerous public statements in support of the Government's reform program and endorsed publicly the programs with the IFIs.

[1] Program Document for a Proposed First Development Policy Loan to Romania, June 17, 2009 (Report No. 48606-RO).

II. COUNTRY CONTEXT

A. RECENT ECONOMIC DEVELOPMENTS

5. **Romania entered the global crisis of 2008 with high growth rates, but also large macroeconomic imbalances.** Real GDP grew at over 6.5 percent per year on average during 2003 to 2008. At the same time, the 2008 external current account deficit reached almost 12 percent of GDP, the trade balance almost 14 percent, and the fiscal deficit almost 5 percent of GDP. The 2008 inflation stood at almost 8 percent (Table 1).

6. **In 2008 Romania faced major economic and social challenges.** From a 9 percent growth in the third quarter of 2008, the economy had contracted by almost 13 percent in the fourth quarter of 2008. As a result of the global financial crisis, financial markets faced potential disruptions arising from liquidity problems in commercial banks. Fiscal revenues plummeted and Romania faced the prospects of a fiscal deficit in the double digits for 2009.

2009 Developments

7. **In 2009 the economy went into a recession.** Growth and demand contracted sharply. Entering the crisis with the largest structural deficit in the EU of almost 9 percent of GDP in 2008, Romania was forced to impose strict fiscal targets. Economic activity contracted by 7.1 percent. Both consumption and investment declined. Gross domestic investment declined in real terms by 29.1 percent. Household consumption shrank in real terms by 10.8 percent reflecting the drop in consumer and mortgage credit and the reduction of households' disposable incomes.

8. **The rapid decline in domestic demand helped ease inflationary pressures in 2009.** Core inflation[2] fell from a peak of 8.1 percent in mid-2008 to 2 percent in December 2009. The decline in headline inflation lagged mostly because of significant hikes in tobacco excises during 2009, and second round pass-through effects of the 15 percent RON depreciation in early 2009. Still, for 2009 as a whole average headline inflation eased to 5.6 percent, from 7.8 percent in 2008.

[2] Core inflation figures refer to a measure of CPI which excludes administered prices, volatile prices (especially energy and food), and prices of main excisable products (i.e., alcohol and tobacco).

Table 1: Selected Macroeconomic Indicators, 2008-2014

	Actual		Projected					
	2008	**2009**	**2010** Orig.	**2010** Rev.	**2011**	**2012**	**2013**	**2014**
	Annual percentage change							
Output and prices								
Real GDP	7.3	-7.1	-1.9	-1.9	1.5	4.4	4.2	4.2
Domestic demand	7.2	-12.8	-3.8	-3.9	1.0	5.0	4.7	4.7
Consumer price index (HICP av)	7.8	5.6	5.9	6.1	6.1	3.4	3.0	3.0
Registered unemployment rate	4.0	6.3	7.8	7.8	7.7	7.1	6.3	5.5
Nominal wages	23.6	8.4	2.0	2.0	1.4	5.0	6.0	7.0
	In percent of GDP							
Savings and investment								
Gross domestic investment	31.3	25.1	24.8	27.8	27.9	28.2	29.4	30.4
Gross national savings	19.7	20.8	19.6	21.8	21.8	22.0	23.5	25.1
General government								
Revenue	32.2	31.8	32.3	32.3	32.5	32.9	32.5	31.6
Expenditure	37.0	39.2	39.1	39.3	36.9	36.0	34.6	33.4
Fiscal balance	-4.8	-7.4	-6.8	-6.8	-4.4	-3.0	-2.1	-1.8
Privatization proceeds	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
External financing	0.4	2.9	4.6	4.6	2.8	0.7	0.6	0.6
Domestic financing	4.3	4.5	2.2	2.2	1.6	2.3	1.5	1.2
Structural balance [1/]	-8.7	-6.7	-4.4	-4.4	-1.9	-1.3	-1.0	-1.2
Gross public debt (direct debt only)	19.5	28.2	33.9	33.9	36.2	35.9	34.7	33.3
	Annual percentage change							
Money and credit								
Broad money (M3)	17.5	9.0	10.6	10.6	5.2	8.9	8.9	10.2
Credit to the private sector	33.7	0.9	8.9	7.4	2.3	9.2	7.4	7.8
Domestic credit to private sector at constant exchange rate (eop)2/	26.5	-2.6	-	7.3	9.5	-	-	-
	Percent per annum							
Interest rates								
Euribor six months	3.52	4.52	-	-	-	-	-	-
NBR policy rate	10.25	8.00	-	-	-	-	-	-
NBR lending rate (Lombard)	14.25	12.00	-	-	-	-	-	-
Interbank offer rate (1 week)	12.72	10.69	-	-	-	-	-	-
	In percent of GDP							
Balance of payments								
Current account balance	-11.6	-4.2	-5.2	-6.0	-6.1	-6.2	-5.9	-5.3
Merchandise trade balance	-13.7	-5.9	-5.4	-5.8	-6.6	-6.3	-6.1	-5.6
Capital and financial account	12.7	-2.0	3.2	2.1	6.4	9.7	10.1	9.8
FDI	6.7	3.1	3.0	2.6	3.7	3.7	3.7	3.7
International investment position	-51.8	-68.3	-61.3	-61.3	-62.6	-61.1	-61.8	-62.0
Gross official reserves	20.2	26.6	32.1	27.6	30.1	29.0	26.7	24.9
In months of imports	6.4	10.3	8.6	9.7	10.3	10.1	-	-
Gross external debt	51.4	69.2	72.3	78.8	81.3	74.3	66.2	58.4
	Annual Average							
Exchange rates								
RON per euro (end of period)	4.0	4.2	-	-	-	-	-	-
Real effective exchange rate CPI based (depreciation -)	110.5	102.2	-	-	-	-	-	-
Nominal GDP (billion RON)	514.7	491.3	511.6	511.6	544.4	599.1	659.4	726.7

[1/] Actual fiscal balance adjusted for automatic effects of internal imbalance (output gap) and external imbalance (absorption gap). 2/ Real, as of December of each year.
Source: IMF December, 2010 and staff calculations.

9. **The Government adopted strong measures to contain the 2009 fiscal deficit**. As discussed in the DPL1 Program Document[3], the 2009 budget included revenue increases and expenditure cuts totaling 3 percent of GDP. Inter alia, it: (i) increased social contributions by 3.3 percent; (ii) increased property taxes; (iii) eliminated VAT reduction for the purchase of a first dwelling; (iv) eliminated 137,000 public sector vacancies; (v) reduced non-wage benefits for public sector employees; and (vi) reduced expenditure on goods and services.

10. **Notwithstanding these measures, the 2009 fiscal deficit reached 7.4 percent of GDP**. Revenue declined by over 8 percent in real terms compared to 2008 to under 32 percent of GDP. There were significant shortfalls in collection of the VAT, social security contributions and non-tax revenues. Above all, expenditure increased by 1.5 percent in real terms compared to 2008 to more than 39 percent of GDP. The rise in expenditure was partly due to social protection spending to mitigate the impact of the economic crisis, which represented around 10 percent of GDP in 2009 compared with 8.4 percent in 2008, and which financed mainly general increases in pensions in 2008 and 2009, a generous inflation indexation of pension benefits, and additional increases to certain groups of retirees. Revenue shortfalls and expenditure overruns led to accumulation of arrears by both the central and local governments, primarily to private suppliers and in particular health sector suppliers.

11. **The current account deficit narrowed to 4.2 percent of GDP, as the fall in domestic demand reduced the trade deficit from 14 percent of GDP in 2007-2008 to less than 6 percent in 2009.** At the same time, the capital account went from a surplus of 15 percent in 2007-2008 to a deficit of 2 percent in 2009. Private sector flows went from a surplus of almost 9 percent of GDP in 2007-2008 to a deficit of almost 6 percent in 2009. There was less than a full rollover of maturing debt: rollover of external debt was about 82 percent in the first half of 2009. However, following agreement on the international program of support, rollover rates stabilized in the second semester of 2009.

12. **Both external and public debt increased markedly**. IFIs, mainly the IMF, provided over 18 percent of the €48 billion in gross financing requirements for 2009. Almost two-thirds of the financing requirements were for short-term debt service, and half of financing came from new short-term borrowing (Table 2). Financing requirements boosted external debt to 219 percent of exports (over 69 percent of GDP, up from 51 percent in 2008). Public debt increased by almost 9 percent to over 28 percent of GDP, and the public sector debt to revenue ratio increased by almost 50 percent to about 89 percent (Table 3).

13. **Financial markets weathered well the stress in 2009**. The three-year Credit Default Spread (CDS), which stood at an average of 624 basis points in January 2009 declined to 210 basis points by early October 2009. The private sector took the brunt of financial sector difficulties: domestic credit to the private sector contracted by 2.6 percent in 2009 (year-end at constant exchange rate) compared with an average growth of over 41 percent in 2007-2008, largely due to lower demand by enterprises and households, stricter lending standards due to worsening asset quality and rising provisioning requirements, and crowding out by the rapid increase in credit to the public sector – almost 160 percent higher than in 2008.

14. **The National Bank of Romania (NBR) and the Government took strong measures to safeguard the stability of financial markets, which helped reassure markets**. These measures included: (i) capital increases in a number of banks; (ii) a broader range of acceptable collateral for refinancing operations at the central bank; (iii) strengthening of the Deposit Guarantee Fund including improving the funding regime to increase the actual and targeted coverage ratio; (iv)

[3] Report No. 48606-RO, June 17, 2009.

adoption of a Strategic Action Plan for strengthening the financial sector, which includes contingency plans under NBR supervision; (v) NBR reporting of asset and liability maturity breakdowns by currency; and (vi) NBR review of emergency lending arrangements available to all banks. The largest nine foreign banks broadly complied with the terms of the European Bank Coordination Initiative (EBCI), and as a group they retained their March 2009 committed exposure to Romania.

Table 2: Gross Financing Requirements
(Billion Euro)

	2009	2010	2011	Total 09-11
Total financing requirements	**47.9**	**35.1**	**32.9**	**116.0**
1.A Current account deficit	4.9	6.8	7.2	19.0
1.B Short term debt	30.7	18.1	17.4	66.2
Public sector	8.8	3.3	2.8	14.9
Banks	14.4	10.6	9.8	34.8
Corporates	7.5	4.2	4.8	16.5
1.C Maturing medium and long term debt	9.9	10.8	8.8	29.5
Public sector	1.0	1.6	0.9	3.5
Banks	4.7	3.2	2.6	10.5
Corporates	4.2	6.0	5.3	15.5
1.D Other capital outflows	2.4	-0.6	-0.5	1.3
Increase in gross reserves	**2.0**	**3.0**	**5.3**	**10.3**
Total financing sources	**40.9**	**31.0**	**33.7**	**105.6**
II. A Foreign direct investment	3.6	2.9	4.4	10.9
II. B Capital account inflows (EU)	0.6	0.6	0.6	1.8
II. C Short term debt	24.6	18.9	18.1	61.6
Public debt	9.2	2.8	2.8	14.9
Banks	10.8	11.3	9.8	31.9
Corporates	4.6	4.8	5.5	14.9
II. D Maturing medium and long term debt	12.1	8.5	10.6	31.2
Public debt	0.8	2.3	2.6	5.7
Banks	5.4	2.2	2.6	10.2
Corporates	5.9	4.0	5.4	15.3
Financing gap (program financing)	**8.9**	**7.2**	**4.5**	**20.6**
IMF	6.8	4.3	1.9	13.1
EC	1.5	2.2	1.4	5.0
WB	0.3	0.0	0.7	1.0
EIB/EBRD	0.3	0.8	0.5	1.5
Other financing (SDR allocations)	1.0	0.0	0.0	1.0

Source: IMF and staff estimates as of December 6, 2010.

15. **The Government took discretionary measures to contain the increase in unemployment in 2009**. The rise in unemployment was partly contained due to a strong labor hoarding effect aided by the Government through a generous "technical unemployment" subsidy to companies. The overwhelming majority of the unemployed came from the private sector, as the public sector was slow to implement personnel attrition. As a result, registered unemployment[4] increased only from an average of 4 percent of the labor force in 2008 to 6.3 percent in 2009.

16. **Romania has one of the highest poverty rates in the EU in spite of impressive strides in poverty reduction.** The poverty rate[5] has declined dramatically since 2000, from 36 percent in 2000 to 5.7 percent in 2008 and 4.4 percent in 2009. Poverty declined in 2009 due to increased social protection and insurance spending. The 2009 Household Budget Survey (HBS) reported

[4] Share of unemployment benefit claimants in the labor force.
[5] The poverty rate (headcount) shows the number of persons below the poverty line of Ron 258.9 (US$ 86) per adult equivalent per month, expressed in January 2009 prices.

that 81 percent of households were receiving at least one social protection benefit, while 51 percent were having benefits from social insurance. The share of social protection beneficiaries is higher in rural than in urban areas (87 percent versus 77 percent), mainly due to the farmers' pensions. The 2009 pension increases reduced the rate of poverty among pensioners to 2.9 percent (from 4.2 percent a year before), compared with 5.6 percent for non-pensioners (6.9 percent in 2008).[6]

2010 Developments

17. **The economic and financial crisis continued throughout 2010, and the Government was required to take more aggressive steps to address these challenges**. The GDP and domestic demand continued to contract, inflation picked up, and the fiscal deficit remained unsustainably high in spite of strong adjustment measures taken by the Government. The stress in financial markets abated and solvency levels improved, but the financial sector remains vulnerable to the turmoil in international markets and the risk of contagion from Euro zone member countries. The Government and the National Bank of Romania (NBR) are implementing strong measures to prevent financial sector problems.

18. **Growth and demand contracted further in 2010, albeit at a slower rate, while inflation accelerated**. GDP decreased by about 2 percent (of which about 0.5 percent due to flooding), gross domestic investment is estimated to have contracted by 12-15 percent for the year (after declining by 18.7 percent in the first half), and household consumption declined by 3.5 percent. Inflation will exceed 8 percent in 2010 in spite of declining demand, due to higher food prices because of flooding and higher world market prices, the 5 percent increase in the VAT rate to 24 percent, and increases in administered prices. At the same time, there are some indications that the recession may be coming to an end; the industrial sector, in particular, has grown by 5.2 percent during January – September 2010.

19. **The 2010 fiscal deficit remained almost as high as in 2009 at about 7 percent of GDP, in spite of strict austerity measures taken by the Government**. The fiscal deficit could have exceeded 9 percent of GDP, had the Government not implemented an unprecedented austerity package on July 1st, 2010, consisting of tax increases and expenditure cuts estimated to yield savings of 4.6 percent of GDP on an annual basis. *Revenue boosting measures,* in addition to the mentioned increase in the VAT rate, included the introduction of a turnover tax on medical suppliers, significant increases in property taxes, and the reintroduction of taxes on bank deposit interest and capital gains. In addition, measures to improve tax enforcement included, in particular, the introduction of indirect control methods and of electronic filing for large and medium-sized tax contributors. *Expenditure cuts* included a 25 percent nominal reduction in public sector wages, the elimination of most public sector wage supplements, a further reduction in public sector staffing, a reduction in untargeted transfer payments, and cuts in outlays for goods and services. The cuts in personnel compensation have wiped out in good part the 2005-2008 pay increases, and public employment is 5 percent lower than at end-2008. These measures notwithstanding, revenue continued to decline in real terms by 0.5 percent (32.5 percent of GDP). Expenditure was reduced by 2.4 percent in real terms, but remained above 39 percent of GDP. Moreover, the Government could not meet its targets for reducing arrears, although it reduced them sharply in September 2010 when arrears to health sector suppliers were reduced by RON1.9 billion (€440 million, or 0.4 percent of GDP). The weak performance is due not only to the prolonged recession, but also to the inability of State-owned enterprises (SOEs) to meet obligations to the budget (including contributions to health and social insurance), as well as to the lax fiscal management by local administrations.

[6] Household Budget Surveys (HBS) 2008 and 2009.

20. **The current account deficit has widened to 6 percent of GDP in 2010, driven by a further decline in workers' remittances.** The trade balance is about the same as in 2009, but with a positive trend: both exports and imports are higher (21 and 16 percent, respectively) than in 2009, pointing to an incipient recovery of economic activity. The increase in exports is particularly encouraging, and may indicate increased competitiveness due to lower costs of inputs and labor. At the same time, workers' remittances declined further from 2009: current transfers balance is estimated at around 2.8 percent of GDP, down from 4.2 percent in 2009. The FDI balance in 2010 is lower than in 2009 at under €3 billion (2.6 percent of GDP).

21. **Balance of payments financing requirements have remained considerable in 2010, though lower than in 2009**. Gross requirements are estimated at about €35 billion, of which 52 percent is for financing short-term debt. Over 60 percent of financing is coming from short-term borrowing and 20 percent from IFIs. External debt is about the same as in 2009 at 218 percent of exports, while public debt increased markedly from 28 percent to 34 percent of GDP, and the ratio of public debt to revenue reached almost 105 percent.

22. **The stress on financial markets has eased in 2010**. The turmoil in the financial markets due to the Greek crisis has resulted in an increase in Romanian CDS again but, at an average of 285 basis points for November 2010, the CDS remains well below its peak in late 2008-early 2009 (780 basis points on February 24, 2009) and has declined by around 80 basis points since September 2010. Funding costs of Banks have also eased in domestic and external markets. Since the agreement on the international support package the exchange rate has remained broadly stable. The stock market has also improved, up over 150 percent in November 2010 from February 25, 2009. In light of the strengthening of Romania's external position, EBCI lowered the floor for the exposure commitment of the banks to 95 percent.

23. **Capital adequacy ratios[7] remain relatively high, but credit to the private sector remains low.** The capital adequacy rate was 14.6 percent in September 2010, about the same as in 2009. All banks have a capital adequacy rate of over 11 percent, compared to a statutory minimum of 8 percent. After declining (at constant exchange rate) in 2009, credit to the private sector has increased in 2010 by more than 7 percent, although the increase is more modest than that of credit to the public sector, which increased by a further 15 percent after the 160 percent increase of the previous year, and represents now 20 percent of total bank loans, compared with 8 percent at end-2008. Non-performing loans (NPLs, representing loans and interests classified as doubtful and loss) rose to 20.2 percent at end-September 2010, up from 4.7 percent in June 2008 and 11.7 percent in 2009.

24. **Prudential regulations have been strengthened to address the risks of contagion from the turmoil in European financial markets.** The contingency plans mandated by the Strategic Action Plan for strengthening the financial sector are being reviewed by the NBR supervision department to verify the credibility of the assumptions and the robustness of the banks' emergency funding arrangements. The reporting framework that the NBR has put in place monitors exposures that do not appear in the local banks' balance sheets (such as parent group direct exposure to Romanian entities).

25. **While an estimate of the poverty impact of the crisis and of the measures supported by the DPL is not yet available, it is likely that overall impact will be modest**. In 2009, poverty scored a decade-long minimum, with 4.4% of the population living in absolute poverty, compared to 35.9% a decade earlier. Strong redistributive policies during 2009 have pushed poverty down despite the economic crisis. The prospects for maintaining progress in poverty

[7] The ratio between the risk-weighted assets and own funds of banks.

reduction in 2010 are comparatively more favorable than in 2009, since the rate of economic decline slowed. There are a number of factors that could contribute to decrease in living standards in 2010, such as: (i) high unemployment levels, though declining from over 8.3 percent in early 2010 to around 7 percent currently; (ii) unfavorable climatic conditions which have affected rural population; (iii) higher inflation, reducing real incomes across the board; (iv) massive cuts in the compensation of public sector employees, who lost not only 25 percent in basic salaries, but also numerous other benefits; and (v) cuts in untargeted social transfers. But this decline in living standards is distributed primarily among middle- to upper-income households.

26. **The impact of the cuts in public sector wages and untargeted social transfers on the poor is mitigated by several factors**: *First*, the incidence of poverty among public servants is very low. There is a minimum wage floor of 600 RON per month that is high enough to maintain the living standards of civil-servant households above the poverty line. *Second*, the social assistance programs that have been reduced are programs with low targeting performance that affect mostly middle and upper income households. The main measures include the reduction in the "child raising" allowance by 15 percent, the elimination of the new family allowance and the package ("trusou") and allowance for new born babies. *Third*, the policy to top-off low-pensions to a minimum of RON350 continued during 2010; this measure had the largest poverty reduction impact in 2009. *And fourth*, the budget of the GMI was protected, and the family allowances program was redesigned to have a greater poverty alleviation impact.

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

27. **The overall macroeconomic framework is deemed satisfactory to proceed with the proposed DPL, although the medium term outlook continues to be subject to uncertainties and risks.** The resumption of growth in 2011 hinges on the pace of recovery in Western Europe and successful implementation of the reform program. Risks include a more protracted than expected downturn in the Romanian economy with consequences for government's fiscal position and a negative impact on bank balance sheets, and exchange rate volatility. Political and social risks are also significant. These risks are discussed in detail in Chapter V.

28. **Growth is expected to resume in 2011 though at low rates, and to pick-up further in 2012.** Economic growth is projected to resume in 2011 at 1.5 percent, accelerate in 2012 to 4.4 percent of GDP, and continue at 4.0-4.5 percent per annum over the medium term, driven by the recovery of the global economic environment, renewed investor confidence, and steady increase in domestic demand at 4-5 percent per annum as of 2012. The output gap due to the crisis would close by 2015. Year-end inflation would gradually decline to 3.7 percent in 2011 and 3 percent in 2012.

29. **Bringing the fiscal deficit down in a sustainable way while ensuring a resumption of growth remain the principal medium term challenges for the Government.** While the policies currently in place should enable Romania to meet both the 2011 and 2012 fiscal deficit targets, there are significant implementation challenges to key elements of the reform program. The containment of current spending in the medium term depends on the ability of the government to retain the bulk of the wage cuts throughout 2011[8], a continued reduction in public employment and the implementation of the new pension and unitary pay laws as planned. Healthcare reforms will have to address the formidable pressures for expenditure overruns as in the past. The government will also need to resist the temptation, especially in the run up of the

[8] The wage bill cuts were approved by the Constitutional Court conditionally upon being applied for a limited time.

2012 elections, to reduce taxes or social contributions or to delay the rationalization of the social assistance programs. Also, successful implementation of the revenue-enhancing measures requires addressing the capacity constraints of tax administration.

30. **The Government is committed to enhancing revenue performance through tax policy reform, measures to improve tax collection, and faster absorption of EU funds**:

- *Ad hoc* changes to the tax system will be strictly limited, with a view to ensuring predictability and stability, and promoting growth and competitiveness. Once firmly on track to meeting deficit targets, the Government will undertake a comprehensive review of the tax system with a view to its revenue-neutral optimization and simplification – in consultation with, and with the assistance of, the IMF and the World Bank. Contingent on fiscal space, they will consider a gradual reduction in labor taxation with a view to enhancing competitiveness.
- Efforts to enhance tax collection will focus on the 25,000 largest taxpayers (who provide 80 percent of revenue), increased taxation of high net wealth individuals, strengthened auditing of unreported income, introduction of compulsory electronic filing for medium and large taxpayers, and measures in customs administration to reduce tax evasion.
- To improve mobilization of EU funds, the Government intends to strengthen the administrative capacity of units managing them, modernize the legislative and regulatory framework for public investment and other expenditure eligible for EU financing, encourage public-private partnerships, and give priority to public investments co-financed with the EU.

31. **The Government is also planning to continue in 2011 expenditure restraint, reduce the drain of SOEs on the budget, and prevent further accumulation of arrears**:

- To contain expenditure, the 2011 wage bill is projected to decrease by 4 percent in nominal terms (0.7 percent of GDP), the reduction of public employment will continue, there will be better control of expenditures, and health and education sector reforms will seek to improve service delivery while achieving financial savings. A health sector restructuring plan is being implemented, limiting wage spending on physician service and drug costs escalation, and reducing hospital costs through better hospital management.
- To reduce the drain of SOEs on the budget, the Government intends to take steps to reduce the losses of the ten largest loss-making SOEs, continue SOEs privatization program and divestiture of State minority share in firms, and reform the transportation sector to reduce losses and clear arrears of major railway and road transports SOEs.
- To reverse the accumulation of payment arrears by the central government, the Government is planning to integrate the accounting reporting system with the Treasury payment system by end-March 2011, use budget appropriations as commitment ceilings, require line ministries to monitor their subordinated units in observing ceilings, and enforce sanctions against institutions and individuals who breach the ceilings. Performance criteria for the stock of the general government arrears have been introduced in the ongoing SBA for December 2010, as well as an indicative target for April 2011.To prevent further build-up of arrears by local governments, as of 2011 they will be required to include arrears repayment in budget execution and will not be able to commit to new expenditures or contract loans until previous obligations are repaid.[9]

[9] The relevant amendments to the Local Public Finance Law were enacted in June 2010. A Government ordinance has also been issued allowing local governments the use of swap agreements to offset mutual debts and partially clear arrears.

32. **The Government aims to meet by 2012 the Growth and Stability Pact fiscal deficit target of 3 percent of GDP**. This requires a vigorous pursuit of the adjustment and structural reform agenda. The 2011 fiscal deficit is projected at 4.4 percent of GDP. The economic recovery and continued expenditure restraint will make the achievement of the Maastricht fiscal target of 3 percent of GDP feasible by 2012. Following the recent enactment of the Fiscal Responsibility Legislation, the Government approved a medium-term Fiscal Strategy for 2011-13. The strategy commits to observing the 3 percent fiscal deficit target by 2012, giving priority to investments co-financed by EU funds, and allowing wage increases in accordance with the unitary pay law to recoup the recent wage cuts. The fiscal deficit is projected to continue to decline to 1.4 percent of GDP by 2015.

33. **The external balance is projected to stabilize over the medium-term, subject to addressing bottlenecks affecting competitiveness and recovery in EU-15 countries**. Structural reforms pursued in the public and financial sectors, as well as the measures to enhance labor market flexibility such as the ongoing revision of the Labor Code and the removal of barriers to doing business will help ensure a stable external balance in the medium term, with a current account deficit in the 6 percent range in 2011-2013 and declining to 5 percent by 2015, well below pre-crisis levels. This stabilization would benefit from the anticipated economic rebound of the EU-15 member countries, dynamic exports growing at historical highs, moderate import growth contained by the real exchange rate depreciation that has taken place since mid-2008, and the pick-up in workers' remittances. FDI flows are expected to reach 3.7 percent of GDP over the medium-term, providing the bulk of the financing of the current account deficit, although they will remain well below their pre-crisis levels of almost 7 percent of GDP.

34. **Romania's financing needs in 2011 will be lower than the previous two years**. Gross external financing needs in 2011 are estimated at €33 billion, €2.2 billion less than in 2009, due to smaller claims on the build-up of reserves and increasing FDI (Table 2). The projections assume rollover rates for amortizing debt of 100 percent for banks and 116 percent for corporates.

35. **External debt will continue to rise in 2011 but by 2015 will gradually return to the pre-crisis levels of under 50 percent of GDP, while the ratio of public debt to revenue will stabilize at slightly over 30 percent of GDP.** (Table 3). External debt is projected at almost 75 percent of GDP and over 217 percent of exports in 2011. Public debt will also be higher though manageable at over 36 percent of GDP, and its ratio to revenue will exceed 111 percent in 2011. The Government will seek to extend the maturity of public debt and consolidate the financial buffers.

Table 3: Public and External Debt Sustainability

(percent of GDP unless otherwise mentioned)

	2007	2008	2009	2010	2011	2012	2013	2014
Public sector debt								
Baseline public sector debt	**17.5**	**19.5**	**28.2**	**33.9**	**36.2**	**35.9**	**34.7**	**33.3**
o/w foreign currency denominated	7.2	7.2	15.9	22.6	21.4	17.6	12.4	8.0
Change in public sector debt	2.1	2.0	8.7	5.7	2.3	-0.3	-1.2	-1.4
Identified debt creating flows	0.0	2.6	8.3	5.7	2.3	-0.3	-0.8	-0.9
Primary deficit	2.4	4.1	6.2	5.1	2.6	1.3	0.8	0.7
Revenue and grants	32.3	32.2	31.8	32.3	32.5	32.7	32.4	31.4
Primary (non interest) expenditure	34.6	36.3	38.0	37.4	35.1	34.1	33.2	32.1
Automatic debt dynamics1/	-2.3	-1.4	2.1	0.6	-0.3	-1.6	-1.7	-1.6
Contribution from interest rate/growth differential2/	-1.9	-2.6	2.2	0.6	-0.3	-1.6	-1.7	-1.6
Other identified debt creating flows	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Residual including asset changes	2.1	-0.6	0.4	0.0	0.0	0.0	0.0	0.0
Public sector debt to revenue ratio	**54.2**	**60.7**	**88.6**	**104.7**	**111.4**	**109.8**	**107.3**	**106.1**
External debt								
Baseline external debt	**47.0**	**51.4**	**69.2**	**74.1**	**74.9**	**68.0**	**60.3**	**53.2**
Change in external debt	4.9	4.4	17.8	4.9	0.8	-6.9	-7.7	-7.2
Identified debt creating flows	-4.3	-2.3	14.5	2.5	-0.9	-2.5	-3.3	-3.3
Current account deficit excluding interest payments	12.2	10.1	2.4	2.8	2.8	3.1	3.1	2.9
Net non-debt creating capital inflows	-5.8	-6.1	-3.5	-3.4	-5.7	-5.3	-5.9	-5.6
Automatic debt dynamics	-10.7	-6.3	15.5	3.0	2.0	-0.3	-0.5	-0.5
Contribution from nominal interest rate	1.1	1.4	1.9	3.0	3.2	2.9	2.6	2.3
Contribution from real GDP growth	-1.9	-2.9	4.6	0.0	-1.2	-3.2	-3.1	-2.8
Contribution price and exchange rate changes	-9.9	-4.9	9.0	-	-	-	-	-
Residual, including changes in gross foreign assets	9.2	6.8	3.4	7.6	3.4	-4.6	-5.3	-4.8
External debt to exports ratio	**160.7**	**169.0**	**219.0**	**217.7**	**217.5**	**201.3**	**181.4**	**162.1**

1/Derived as $[(r-\pi(1+g) - g + \alpha\, \varepsilon\, (1+r)]/(1+g+\pi+ g\pi)$ times previous period debt ratio, with r =interest rate; π = growth rate of GDP deflator; g = real GDP growth rate; α = share of foreign currency denominated debt; and ε= nominal exchange rate depreciation (measured by the increase in local currency value of US dollar).

2/The real interest rate contribution is derived from the denominator in footnote 1/ as $r - \pi\,(1+g)$ and the real growth contribution as $-g$.

Note: Debt sustainability analysis includes proposed DPL and EC support. IMF lending to the central bank is included only in the external debt sustainability analysis.

Source: IMF, December, 2010.

III. THE GOVERNMENT'S PROGRAM

36. **Romania's overarching objective to achieve convergence with the EU in terms of income and living standards is articulated in the National Reform Program (NRP).** With a GDP per capita of 45 percent of the EU 27 average, Romania must close a large gap. The pursuit of the convergence agenda has been articulated in the NRP which is promoting sustainable and equitable economic growth in the context of the European Lisbon Strategy. The NRP, updated annually and reviewed by the European Commission, complements the four themes of the Lisbon Agenda – investing in people and modernizing labor markets, unlocking the business potential, especially of SMEs, investing in knowledge and innovation, and energy and climate change – with the need to improve the quality and management of administrative capacity and government expenditure in the context of prudent macroeconomic policies. As of 2011 the NRP will be aligned with the objectives and targets of Europe 2020 Agenda, the successor of the Lisbon Agenda.

37. **The agenda of the governing coalition is formulated in a Government program for the period 2009-2012**.[10] The objectives of the program are twofold: first, dealing with the effects of the crisis by stimulating confidence in the economy and mitigating its adverse impact in general, and on the poor and vulnerable in particular; and second, anchoring short-term measures in a medium-term structural reform agenda that would support economic growth and resume progress towards convergence with EU living standards, social cohesion and eventual entry into the Euro-zone. The Government recognizes the need to re-focus the policy attention on the large unfinished structural reform agenda.

38. **The DPL is aligned with the measures proposed by the Government for the 2009-2012 Program and which cover three broad categories**: (i) improving fiscal sustainability and management of public finances; (ii) strengthening social assistance and social protection; and (iii) enhancing the resilience of the financial sector. These measures are detailed below and to the extent possible linked to each phase of the DPL program.

A. IMPROVING PUBLIC FINANCES

Strengthening the medium-term expenditure framework

39. **The non-functional medium-term expenditure framework (MTEF) hampers sound fiscal management.** Medium term expenditure projections have had so far little impact on planning and budgeting. Annual budgets are revised frequently during the year to accommodate ad-hoc measures – resulting in low predictability of the budget and poor fiscal discipline, and impeding the ability of ministries to plan and manage effectively. In particular, staffing decisions and agreements to increase wages often exceed approved budgets, leading to reallocations and large discrepancies between budgets and actual spending. Multiannual capital investment projects suffer from weak programming, delaying implementation and increasing costs.

40. **Under the 2009-2012 Program the Government is committed to gradually consolidate the MTEF implementation over the medium-term**. The MTEF will enhance aggregate fiscal discipline and improve the allocation of resources. A more disciplined budget process is critical in the current environment of severe fiscal constraints:

- In phase 1 the MTEF was approved by Parliament and submitted in the 2009 annual report on the EC Convergence Program. It included actual spending for 2008, detailed

[10] www.gov.ro/programul-guvernare-2009-2012.

estimates of expenditures for 2009 and broad fiscal aggregates for 2010-11. Within expenditures, it included a breakout by type of budget (e.g., state, local, etc.), and expenditures by main economic classification, i.e., personnel, operations and maintenance, transfers and subsidies, capital (fixed and non-fixed), and debt service.

- In the current phase 2 the Parliament approved the MTEF for 2010-2012 and the Government submitted it to the EC. As of 2011 the MTEF includes fiscal risks analysis and binding aggregate expenditure ceilings under the Fiscal Responsibility Law (FRL), with strict rules enforcing the ceilings, rigorous monitoring, and severe penalties for failure to comply with the approved ceilings. The FRL requires approval of the MTEF by the Parliament prior to voting on the annual budget, and prohibits new measures during the budget year that increase aggregate expenditures beyond the limits agreed under the MTEF. Collective bargaining agreements on public sector wages will be subject to MTEF ceilings for personnel costs and will be valid only within that framework. An annex to the MTEF will allocate capital expenditures across existing projects to ensure their timely completion, articulate the policy rationale for the allocations, and propose fiscal scenarios for years 2 and 3. Projects that could not be completed within the period due to funding limitations will be prioritized for redesign, cancellation, or new funding authorization. The Government also drafted a Fiscal Strategy for the period 2011-13 with technical assistance from the Bank.
- In the next phase the Government will enact the MTEF for 2011-2013, with ceilings for major ministries that use at least 70 percent of the budget subject to consultations with the newly created Fiscal Council. The 2011-2013 MTEF has been submitted to the Parliament after the Fiscal Council declared it to be in line with the fiscal strategy, and is consistent with the FRL guidelines. The Parliament has scheduled the debate on the MTEF for end-December 2010.

Reforming public pay and employment

41. **Personnel costs consume a large component of the consolidated budget and are not anchored in performance objectives.** Aggregate personnel spending expanded by 66 percent in real terms from 2005 to 2008. The growth of expenditure stems from both increased staffing and higher salaries. The number of approved employment positions increased at all levels of government, including the central level (20 percent), local governments (17 percent), and other public institutions (35 percent). Salary adjustments were granted across the board following negotiations with public sector unions, rather than being performance-based.

42. **Romania's public pay system has changed little over the years and falls short of modern systems**: i) non-wage compensation represents a disproportionate share of total compensation and undermines transparency and equity; ii) large pay disparities among positions with similar responsibilities distort rational deployment of skills; iii) compressed salary scales and over reliance on seniority undercut incentives to acquire new skills and assume new responsibilities; and iv) compensation decisions are not linked to private sector compensation and are based on the bargaining power of trade unions, and/or arbitrary assessments made by decision-makers. Staff opinion surveys highlight a widespread belief that hiring, compensation and promotion policies and practices undermine the integrity, and hence effectiveness of the civil service, and do not respect the principles of merit-based recruitment and advancement of staff.

43. **The public pay reform agenda under the Government's 2009-2012 Program fosters fundamental changes to enhance the capacity of public administration to attract and retain critical skills, and reward performance.** The new pay and grading system for the public sector is based on well-established principles: (i) a grade structure that promotes equal pay for equal

work using a modern job evaluation methodology based on occupation and job responsibilities; (ii) assignment of all positions within a grade to a job family based on the content of the actual work responsibilities; (iii) a single, unified pay-scale for all public institutions, defining base rates for all jobs in all grades; (iv) incentives for staff willing and able to assume greater responsibilities in any grade or job family; and (v) unified control of the public service.

44. **The 2009-2012 Program will gradually implement the new pay and grading system**:

- In phase 1 the Government eliminated or reduced as of April 2009 some non-wage bonuses and allowances, enacted a Unitary Pay Law (UPL) in October 2009, and established a Pay Commission to ensure that the design and implementation of the reformed pay system respect the structure and principles laid out in the UPL.
    - ➢ The April 2009 Ordinance began reducing the share of the non-wage component in total compensation in order to enhance the transparency of the pay system.
    - ➢ The UPL sets out the structure and principles behind a new pay system and a strict timetable for introduction of subsidiary legislation on specific implementation procedures and schedules: i) it limits non-wage personnel expenditures and bonuses for non-military personnel to 30 percent; ii) sets a salary grading structure based on job responsibility and qualification; iii) sets salary grades that align pay in the public sector for selected benchmark positions to actual labor market conditions (through a salary survey); iv) reduces disparities in pay between similar performing positions; v) enhances career advancement for high-performing public servants; and vi) articulates an implementation plan for the introduction of the new pay system fully costed and consistent with the medium term budget projections. An implementing law was submitted to the Parliament in October 2010. Implementation will take place over several years and its pace is contingent on the mobilization of the necessary fiscal resources. The proposed procedures mandate quarterly reports on the effectiveness of the new human resource management policies (e.g., turnover by position, qualified applicants for positions, etc.).
    - ➢ The Pay Commission issued a Pay System Reform report in June 2010, to aid in drafting the implementing legislation of the UPL.
- In current phase 2 the Framework UPL will be implemented as of 2011, together with measures to monitor the application of civil service policies on merit-based recruitment.
- In the next phase the Government will introduce subsidiary legislation and procedures to enhance compliance with new personnel policies.

45. **The reform of public pay and employment is complemented by Functional Reviews (FRs) of the Ministries**. The FRs will help the Government identify needed reforms in the area of strategic management, organizational structures, budget and human resources management, performance management, and client orientation. The EC has taken the lead role in the FRs, financed them, and assessed their implementation. The Bank is the executing agency: it submitted in October 2010 to the Government FRs for transport, agriculture, public finance center of Government, and competition; by March 2011 it will analyze six more sectors, including health, economy, environment, regional development, labor and social policy, and higher education, research and development. The Government is preparing action plans for reforms based on these reviews which will become part of their core program in the coming period (and see paragraph 65).

Improving public finances in health services

46. **Increased expenditure on health has not translated into better health standards and improved patient satisfaction.** Health financing comes from contributions to the National Health Insurance Fund (CNAS) and taxes. Expenditure increased from 2.9 percent of GDP in 1990 to 3.7 percent of GDP in 2007. However, and in spite of a significant improvement in health indicators since the 1970s, Romania's health status remains poor compared to other European countries. Moreover, as discussed below, there are major inequities in access to, and quality of medical care.

47. **CNAS cannot meet adequately the demand for health services due to important deficiencies:** i) co-payment mechanisms do not fully cover the cost of the benefits package, forcing providers, especially hospitals, to shift the costs of drugs, medical supplies and food to patients and denying poor patients critical care; ii) escalating drug costs consume an increasing proportion of resources. iii) purchasing and payment methods favor expensive hospital care.; iv) the performance of primary care providers and their role as gatekeepers are not well monitored; and v) Diagnosis Related Group (DRG) rates are generally too low to recover the hospitals' costs.

48. **The hospital infrastructure is fairly large, poorly managed, and financially unsound.** Progress with hospital reform has been limited to the introduction of new payment mechanisms. The number of hospitals has increased since the 1980s (416 hospitals in 1980 and 447 in 2007, of which 425 public) while population declined. Romania had 6.4 beds per 1,000 people in 2007, compared with the EU average of 5.7. Many cases are treated in hospitals even if they could be handled on an outpatient basis, due to dysfunctional referral links between primary care, ambulatory services and hospitals. Many Romanian hospitals have incurred financial debts in recent years despite a substantial increase in health insurance collections and an expansion of the health service budget, due to poor management systems, weak fiscal discipline, and perverse incentives. Fiscal constraints in 2009-2010 have led to a further increase in hospital arrears.

49. **The Government's 2009-2012 program supports health sector reforms aimed at mobilizing resources and improving the efficiency and equity of service provision**. On the demand side, the reforms include measures to move away from expensive hospital based services towards less costly outpatient and primary care services, as well as the introduction of co-payments differentiated according to the amount and level of health services required, to replace informal payments with transparent fees.[11] On the supply side, the program would support the Government's efforts to rationalize hospital infrastructure, improve the mechanisms governing the use of new drugs and technologies, and review the package of benefits insured by the Government, to exclude coverage of costly non-essential health services:

- In phase 1 the Government implemented ahead of schedule legislation to increase the excise duty on tobacco with a view to mobilizing additional resources for the health sector, and new cost-saving regulations governing drug pricing and promotion of generic drugs in the framework contracts concluded by CNAS with service suppliers.
- In phase 3 the Government will enact legislation to introduce co-payments (including exemptions for the poor), and revise provider payment mechanisms.

[11] In 2008, 60 percent of patients hospitalized declared having paid some amount without receipt.

Improving public finances in education

50. **The quality of general education can benefit from more efficient use of resources**.[12] Coherent and sustained policies and programs for curriculum upgrading, teacher training, and learning tools would make possible better learning outcomes. The resources needed to finance such programs are drained by the priority allocation to financing salaries and school investment and maintenance. The evolution of the number of classes and teachers has not reflected the steady decline in school-age population[13]. Local authorities and school principals have had little financial incentive to rationalize the class size and teachers' load by merging classes and closing down under-utilized schools, because until now public financing of general education has been tied to inputs – primarily the number of teachers – rather than to outputs – the number of students enrolled or graduating. The end result has been low efficiency of spending and lack of resources for improving the quality of education.

51. **The Government's program supports the rationalization of the school system and better use of resources through the use of per student financing.** The reform will provide local authorities and schools with financial incentives to use resources more efficiently and take the reallocation decisions needed to address quality enhancement objectives. The introduction of per student financing will also mark progress towards performance-based budgeting and enhance the transparency of the allocation process, and the accountability of budget management:

- In phase 1 a Government decision in December 2009 (subsequently modified in April 2010)[14] set the standards for per student financing formula and per county budget allocations for 2010 based on these standards. The number of classes was reduced in 2009-2010, increasing the average class size from 20.6 to 21.7.
- In the current phase 2 the law of education establishes the principle of per student financing and the next steps for implementation, and per student financing mechanisms will be implemented nationally. The Law has been adopted by the Parliament in December 2010.

52. **The Government needs to build strong consensus towards the education sector reform, and manage potential risks**. School closures are usually met with negative reactions from parents, representatives of the community, and local authorities. Providing incentives to use resources more efficiently also carries risks. For instance, to lower costs, principals may opt for less-experienced teachers who command lower salaries, at the expense of the quality of teaching. The Government must encourage beneficiaries and suppliers of education to work together. It would also need to take urgent steps to enhance the capacity of local administrations and school officials to manage these new responsibilities. Once the per student formula is in place, the Government will implement measures to ensure the effectiveness of per student financing, in particular greater autonomy granted to local actors, including school principals and municipal and district education officers.

---

[12] The quality of education as measured by international tests such as PISA (2001 and 2006) and TIMSS (1999, 2003 and 2007) has worsened over the past ten years, in spite of a constant trend towards smaller classes and lower student/teacher ratios, and notwithstanding a tripling of per student expenditure (in constant price terms).

[13] At the primary level, where comparable data exists for a long time period, Romania's pupil teacher ratio has fallen to less than 15.9 in 2008, compared to 24.1 in 1990 (i.e. a 34 percent drop) (Source: World Bank Edstat).

[14] The initial program projected piloting this reform in eight counties, to enable per student financing in September of 2010 (i.e. at the beginning of the 2010/11 school year) (DPL2) and enact legislation to allow schools in these counties to receive their budget according to a per capita finance formula (DPL3). The Government decided to move ahead faster than initially envisioned in the program and introduced per student financing for the entire school system on January 1, 2010 (Government Decision no. 1618/2009, modified by Decision no. 369/2010).

B. Strengthening Social Protection

Targeting social assistance

53. **Increased social protection spending since late 2008 to mitigate the impact of the crisis helped reduced poverty, but has been costly**. The poverty rate decreased from 36 percent in 2000 to 5.7 percent in 2008 and 4.4 percent in 2009, although Romania still had 1.2 million poor in 2008 and over 900,000 in 2009. The 2009 decline in the poverty rate during a difficult economic crisis has been due in part to increases in the minimum pension that trickled down to many poor households, but which proved to be costly and not well-targeted. As mentioned before, social spending rose in 2009 to 10 percent of GDP, compared to 8.4 percent a year before.

54. **The targeting efficiency of family allowances-- the largest social assistance benefits in terms of coverage and spending-- is at the lower end of international comparators**. There are four main family allowances programs[15]: i) Universal Child Allowance (UCA), a non means-tested cash transfer for children up to 18; ii) Complementary Child Allowance (CCA)—an income-tested cash transfer for families whose children reside with both parents; iii) Lone Parent Allowance (LPA)— an income-tested transfer applicable to families whose children reside only with one parent ; and iv) Child Care Leave/Child Raising Benefit—a non-means tested cash transfer paid to mothers of children under two. The income-tested benefits (CCA and LPA) perform relatively well, although there is room for improvement. Their targeting accuracy (percentage of total benefits going to the poorest 20 percent of the population) stood in 2009 at 51 percent for CCA and 52 percent for LPA, compared with 82 percent for the Guaranteed Minimum Income (GMI), the main social assistance program.[16]

55. **The effectiveness of social assistance is undermined by several constraints:** (i) lack of coherence and overlapping objectives due to the numerous, fragmented social assistance programs; (ii) inadequate targeting to poor families with children, as 80 percent of the expenditure on child and family benefits goes to universal programs; (iii) insufficient coverage of the best targeted program, the GMI; and (iv) flawed financing and administrative arrangements of the GMI, causing partial and/or delayed payments to beneficiaries.

56. **The Government program supports the increase of the GMI eligibility threshold and improved GMI funding and administrative arrangements**:

- In phase 1 GMI funding increased and the LPA and CCA were spared budget cuts. The 2010 State budget earmarked GMI funding and assumed its integral financing, eliminating the 20 percent contribution of local governments, which sometimes resulted in partial payments if local governments were fiscally constrained. In the first semester of 2010 the resources allocated to the GMI increased by 19 percent relative to the first semester of 2009. During the same period, the number of families benefiting from the GMI went up by 15 percent in gross terms and 3 percent in net terms[17], to reach 222,176 families. Stricter enforcement of eligibility conditions led to discontinuing GMI payments for about 12 percent of recipients.

[15] The total expenditure on family allowances in 2009 was about 1.06 percent of GDP, with the UCA accounting for the highest share (0.59 percent of GDP), followed by child raising allowances (0.35 percent of GDP) and income tested benefits (about 0.12 percent of GDP).

[16] GMI has a targeting accuracy comparable to that of the food stamps program in the US.

[17] The gross number of beneficiaries increased by 15 percent but 12 percent of the initial recipients lost benefits following tighter eligibility controls.

- In current phase 2 the emergency ordinance protecting GMI funding was enacted into law. The Government has initiated legislation aimed at improving the targeting of the two income-tested child allowances—the Complementary Child Allowance (CCA) and the Lone Parent Allowance (LPA).[18] The flat family benefit is replaced with a per-child benefit and provides larger benefits for the poorest decile. The new benefit schedule: (i) reduces the eligibility threshold of the income tested family programs to RON 370 (limiting benefits to the first three income deciles); (ii) provides higher benefits to families with incomes below RON 200 (effectively families in the first decile); and (iii) uses a per child benefit formula up to the first four children.
- In the next phase the GMI budget will be transferred to the Ministry of Labor, Family and Social Protection (MoLFSP) and administered through the National Agency for Social Benefits (NASB). Payments to beneficiaries will be executed through banks and post offices. Local governments will maintain entitlement and recertification attributions. The administration of the GMI budget by MoLFSP and its payment through NASB is in the process of being legislated with a view of becoming effective on January 1, 2011. The transfer of the GMI budget will increase the predictability and transparency of the benefit payments and reduce the potential for errors and fraud. Local governments would no longer have the discretion to allocate among various expenditure categories, as was the case in 2009, when the GMI was financed from a conditional block grant.

Pursuing the financial sustainability of the pension system

57. **The Romanian public pension system (Pillar 1) is no longer self-financed**. Comprehensive reforms since 2001 combined with better revenue collection supported by steady economic growth helped achieve a fragile surplus of 0.3 percent of GDP in 2006 and 0.2 percent of GDP in 2007. These gains were reversed in 2008 and 2009, when the Government increased the general level of pensions relative to the average wage (the pension point value[19]) and granted pension increases to certain groups of beneficiaries. The system ran a fiscal deficit of 1.3 percent of GDP in 2009 and 1.8 percent in 2010, in spite of a pension freeze at the end of 2009.[20] Without strong measures the deficit will continue to increase.

58. **The fiscal pressure on the public pension system stems from a number of structural weaknesses**: i) generous indexation rules, linking pension benefits to wages; ii) a low retirement age, especially for women, in spite of the 2001 reforms which gradually increased the retirement age through 2014 from 55 to 60 for women and from 60 to 65 for men; iii) relatively weak disincentives for early retirement[21]; and iv) lax eligibility criteria for disability pensions.

59. **The Government program supports reforms addressing the fiscal sustainability of Pillar 1 over the medium- to long-term**:

- In phase 1 the Government tightened controls on pension expenditures. Based on the actual expenditures in the first few months of 2010 pension expenditures for the year as a

[18] The legislation reduces the eligibility threshold from 470 RON per month per capita to 370 RON, provides higher benefits to households earning below 200 RON and single parent families, and maintains the nominal value of the UCA benefit in 2010 at the same level as in 2009.

[19] Romania has a point-based public pension system. In a point system, a working individual accumulates points for every year of contributions based on the ratio between his wage and the average wage. At the time of retirement, accumulated points are divided by the total number of years of contributions. This gives an average number of points, which is then multiplied by the point value to calculate the pension to be offered to that particular person.

[20] Pensions expenditure was projected to increase marginally, by 0.04 percent.

21 The penalty for early retirement is 0.45 percent of the full-length pension for each month of early retirement. Once retirement age is achieved, the full pension is restored.

whole would have increased by 5 percent in the absence of adjustments. The main reason for this was the doubling of the number of new beneficiaries in 2009 compared with 2008, due to a sharp increase in disability and early pensioners. The Government is conducting a rigorous review of the eligibility of disability pension beneficiaries and recalculating higher-end pensions for certain categories of retirees.

- In current phase 2 a new pension law will change the indexation rule to link adjustments in pension benefits to inflation (while maintaining the existing wage valorization[22] and the link between contributions and benefits.[23], and gradually increase the retirement age for women. These reforms will generate significant fiscal savings in the longer term.
- In the next phase the Government will design and implement measures to improve social protection for the elderly poor.

60. **The Government program also supports the restoration of scheduled contributions to Pillar 2.** The second pension pillar was enacted in 2006 in order to address future fiscal constraints. Its contribution rate, starting at 2 percent, was projected to increase by 0.5 percentage points per year until it reached 6 percent. However, the increment planned for 2009 was suspended, potentially threatening the viability of the scheme and jeopardizing the government's long term objective of reducing the fiscal impact of public pensions. In the current phase 2 the Government is restoring the projected pace of contributions to Pillar 2, although not making up for the 2009 shortfall.

C. Enhancing the Resilience of the Financial Sector

61. **Contingency planning to maintain the stability of the financial sector and enhance the resilience and functioning of the financial sector over the medium term are central to the government's crisis management agenda**:

- In phase 1 the Government approved a Strategic Action Plan addressing potential stability risks in the financial sector. This plan includes a dynamic classification of banks by their importance and a methodology of potential interventions of the National Bank of Romania (NBR), the Ministry of Public Finance (MoPF) and other financial supervisors in the resolution of illiquid or insolvent banks according to their systemic importance and other relevant parameters (e.g., the quality of governance, the capacity of shareholders to raise capital, etc.).
- In current phase 2 the Government supports restructuring of viable impaired loans and corporate debt, regulatory and supervisory reforms enhancing the political independence and the autonomy of sector regulators, and Basel II implementation: (i) Consumer Debt Restructuring Guidelines facilitate debt restructuring to avoid judicial action and the foreclosures of residential properties whenever possible[24]; (ii) an amended insolvency

[22] Valorization is the process of adjustment of past contributions to account for the changes in the value of contributions between the time they are paid and the time pension is claimed or calculated. In a point system, valorization is analogous to the procedure used to update the pension point value.

[23] Indexation of existing pensions is based on the indexation of the point value which will be gradually linked to inflation. The point value is set at 43.3 percent of gross average wage and adjusted by inflation and 50 percent of real wage growth during 2012 and 2020 (following a continued pension freeze in 2011). Full inflation indexation will be reached by 2028.

[24] The guidelines establish principles for the restructuring of mortgage loans addressing, inter alia, rules of engagement for all parties and elements of proper restructuring. They are voluntary and do not alter the rights and obligations of the parties under the original contract, but aim to promote out-of-court negotiations and loan restructuring between debtors and creditors

law and Guidelines for Corporate Debt Restructuring allow pre-packaged reorganization plans and remove impediments to out-of-court corporate rehabilitation and restructuring; and (iii) a robust policy and decision making process is being introduced for the assessment and accreditation of Basel II advanced models.[25]

- In the next phase the Government will enhance the supervision of financial groups across sub-sectors. Supervision is now largely sub-sector-based, with little coordination between the various supervisors, despite the existence of financial groups whose activities span several sub-sectors. While there is an MOU among the supervisors on collaboration, in practice this collaboration has been limited. For instance, there are no joint inspections of financial groups by the various supervisors and little supervisory attention seems to be devoted to intra-group transactions and risk concentrations. The NBR will take steps to review and update as needed the definition of financial groups, and adapt supervision arrangements accordingly.[26] The Government is also updating the legislation on the political independence and financial autonomy of financial sector regulators.

D. CONSULTATION AND PARTICIPATION

62. **The Government is consulting stakeholders periodically and informing the public on proposed reforms and measures.** Public consultation is guaranteed by required posting of new legislative policy initiatives on the internet for 30 days of consultations and feedback, with a background note justifying them and discussing their expected social and economic impact. While policies introduced through emergency ordinances are exempt, such ordinances must be endorsed by the Parliament upon effectiveness, and must thus comply with public consultation requirements. The Government holds public consultation meetings for important projects.

63. **The Government has carried out extensive consultations with stakeholders on the specific reform measures under DPL2 which has resulted in greater understanding and ownership.** Draft legislation and strategic policy documents which are prior actions and benchmarks for the DPL have been posted on the websites of the initiating line ministries for public debate. For most, consultative sessions were organized with the concerned stakeholders. For example, consultations took place with trade unions on the draft Unitary Pay Law. The trade unions were invited and accepted to join the Bipartite Commission to oversee pay reform, and participated in the elaboration of the methodology for the new pay system with technical assistance from the Bank. The Ministry of Labor drafted the new pension law in consultation with trade unions, pensioner representatives and employer associations. In health, the Government met with professional associations such as the Association of Hospital Administrators, the College of Physicians, the Association of Mayors, and the Association of Primary Healthcare (PHC) Physicians to discuss the hospital rationalization strategy and identify exemptions for co-

[25] The NBR will establish an internal governance structure for Basel II policy and accreditation decisions. The implementation process of Basel II is a major prudential policy decision, which can have a significant effect on the resilience of the banking system. Hence, a robust assessment process for all advanced models (IRB/AMA), as well as a governance structure is needed as part of the NBR's Basel II implementation. Basel III implementation stretches through 2019, and Romania has yet to decide on an implementation schedule.

[26] The NBR will compare the existing financial groups operating in Romania with the definition of Ordinance 98/2006 to mitigate the risk that certain financial groups are exposed to material intra-group risks not covered by this definition. Following an assessment of intra-group risks (e.g., contagion risk across sectors), the NBR will consider whether the application of the existing definition of financial conglomerates is adequate, and will amend it as needed. If such groups are identified, the regulators will ensure that all material intra-group transactions and risk concentrations are monitored under joint supervision arrangements. Where this is currently not the case, the relevant regulators should establish appropriate regulation and supervision arrangements and, if necessary, amend the relevant MOU.

payments. In education, the Government together with the Bank consulted mayors, principals, school inspectors, and teachers during field trips in the counties of Ilfov, Prahova, Brasov and Covasna which led to the design and adoption of the student per capita formula adoption at national level.

IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

A. LINK TO THE COUNTRY PARTNERSHIP STRATEGY

64. **As discussed in the Country Partnership Strategy (CPS) presented to the Board with the DPL1 operation in July 2009, the proposed DPL program is central to the Bank's engagement in Romania.** The Bank's strategy during this CPS period (2009-13) is to help Romania mitigate the impact of the current financial and economic crisis, while implementing the fundamental structural reforms needed to put the country onto a sustainable economic growth path. The main pillars of the CPS are: i) economic growth and competitiveness; ii) public sector reform; iii) social and spatial cohesion. The focus of this DPL program on public financial management, the social sectors and the financial sector is fully aligned with these pillars.

65. **The DPL series constitutes so far the only new lending under the current CPS.** Given the severity of the crisis and the exceptional need for large-scale budget support, all new lending in the first two years of the CPS, 2009 and 2010, consisted of the DPL series. The existing portfolio of investment loans is being restructured to provide a better fit with the Government's current priorities and absorption capacity. The CPS Progress Report, scheduled for presentation to the Executive Directors in September 2011, will include proposals for the next phase of Bank support to Romania. The CPS had not specified activities beyond the current two year period. The proposal is likely to include continued Development Policy Lending and selective new project lending. Discussions with the Government are underway on two potential investment operations, designed to improve development outcomes in social assistance and in the health sector, building on the policy reforms support through the first two DPLs. As noted earlier, the Government is formulating action programs based on the results of the Functional Reviews which will be designed to change the role of the Romanian state as it moves forward, and it is likely that the Bank's financial and technical support for these reforms will be sought, including through some adjustment of the DPL3 content.

B. COLLABORATION WITH THE IMF AND THE EUROPEAN COMMISSION

66. **The Bank has collaborated closely with the IMF and the European Commission (EC) since the start of the program.** The DPL program supports and complements an overall multilateral financial package amounting to €19.95 billion, of which the IMF would contribute €12.95 billion, and the EC €5 billion. The Bank would contribute €1billion to the package, of which DPL1 and DPL2 account for €600 million. The measures under the proposed DPL program have been discussed and closely coordinated with both the IMF and the EC to ensure that the reform measures envisaged reinforce and are complementary to the measures under the IMF and EC operations (Table 4). Quarterly monitoring of the program is carried out in close collaboration with the Fund and the EC. It had originally been envisaged that the DPL series would be completed by the time that the current IMF and EC programs will conclude in early Spring 2011. However, structural reforms have taken longer than anticipated due to the severe fiscal crisis and the political challenge the government has faced.

67. **The Government expects to meet all IMF structural benchmarks through end-December 2010 and is making steady progress on the program as a whole**. All end-September 2010 quantitative performance criteria under the IMF program were observed, with the exception of that on general government arrears. The next IMF Board review of the Stand-by arrangement is tentatively scheduled for January 7, 2011. The EC also considers the program to be on track, released its third tranche in September 2010, and plans to review progress and disburse its next tranche in January 2011.

Table 4: Areas of Coverage of Reforms Supported by the IFIs

	World Bank	IMF	EC
Public finances	Medium term expenditure framework with analysis of fiscal risks submitted in the EC Convergence Program with the binding ceilings according to the provisions of the Fiscal Responsibility Law. Framework Law (UPL) that sets out the principles and timetable for the introduction of subsidiary legislation for a reformed public pay system Introduction of per capita financing in education Introduction of co-payments for health services	Fiscal Responsibility Law. Measures. to strengthen tax administration Reform measures to mitigate fiscal risks from local governments Framework Law (UPL) that sets out the principles and timetable for the introduction of subsidiary legislation for a reformed public pay system	Fiscal Responsibility Law Adoption of multi-year budgetary framework Amendment of Code of Tax Procedure to improve tax management efficiency Improved control over local government spending Begin functional reviews of public administration System to monitor payment arrears in publicly owned enterprises Multi annual performance agreements between Ministry of Transport and main transport implementing agencies Framework Law (UPL) that sets out the principles and timetable for the introduction of subsidiary legislation for a reformed public pay system Concrete measures to improve absorption of EU structural funds
Social assistance/ social insurance	Increases in threshold of best targeted social assistance program –GMI. Better targeting of two income-tested child allowances - CCA and LPA. Reform of pillar 1 pension to move to inflation indexed benefit adjustment while maintaining wage valorization and gradual increase in retirement ages for women in a manner acceptable to the Bank.	Reform of pillar 1 pension in accordance with WB DPL and some reform of special regimes	Reform of pillar 1 pension in accordance with WB DPL and some reform of special regimes
Financial sector	Mortgage and corporate debt restructuring guidelines issued and amendments to insolvency law Internal regulation governing the decision making process and methods for Basel II implementation issued and adopted by NBR Law on Independence of Regulators	Amendments to banking and winding up laws to enhance bank resolution framework Reform of deposit guarantee framework	Amendments to legislation to strengthen powers of administrators of banks placed under special administration in line with EU company law and credit institutions directives. Law on Independence of Regulators

Note: the table shows areas covered by triggers for DPL2, structural benchmarks for fourth review IMF and structural reforms for third installment under EC SMOU.

C. RELATIONSHIP TO OTHER BANK OPERATIONS

68. **The current economic and political context provides a window of opportunity for making progress on the structural reforms agenda.** The DPL continues reforms launched under the 2003-06 programmatic adjustment loan (PAL), a series of three loans designed to support Romania's EU accession and integration by accelerating economic growth and promoting social inclusion. The PAL supported a wide range of reforms in public finance management, education, health, social assistance, pensions, judiciary, and private sector development. Following the successful implementation of PAL1 (rated Highly Satisfactory by the Bank's Quality Assurance Group--QAG), the subsequent PALs were canceled, as reform fatigue set in after EU accession in 2007 and the Government sought to diversify its sources of financing.

69. **The DPL agenda is complemented by reforms and activities undertaken in a series of investment operations, as well as the substantial technical assistance** provided under the Public and Private Institution Building Loan (PPIBL) which closed in December 2008 (Table 5).

Table 5: Investment Operations in DPL Areas

Area of reform in the DPL	Ongoing investment projects	Recently closed projects
Public finances		Public/Private Institution Building Loan, PAL
Education	Rural Education	
Health	Health Sector Reform APL# 2 Avian Influenza Control and Human Pandemic Preparedness Response	Health Sector Reform APL #1
Pension		Social Sector Development
Social Assistance	Social Inclusion Project Mine Closure and Socio-Economic Regeneration	Mine Closure and Social Mitigation Social Sector Development Social Development Fund 2

D. LESSONS LEARNED

70. **The DPL1 Program Document (PD) highlighted several lessons which guided this programmatic series**: (i) the Bank's effective role in helping with transition challenges; (ii) the importance of the knowledge acquired by the Bank over the years through investment lending programs across sectors; (iii) the ability of political parties to collaborate when national interest prevails, such as was the case with EU accession; (iv) the weak Government capacity to design and implement coherent policies; (v) need for flexibility in program design and implementation given the fluid economic and political situation; and (vi) the importance of leadership from the center of Government. Support from the Prime Minister's office and Presidency is crucial for successful implementation of reforms, especially when politically sensitive.

71. **The design of DPL2 also reflects lessons from implementation of DPL1**:

- **Successful implementation of a complex policy reform agenda stretching over several years hinges on anticipating and managing political transitions.** The Bank underestimated the post-accession reform fatigue and the impact of potentially substantial EU grant funds under the Structural and Cohesion Funds. The Bank must enhance the dialogue with stakeholders across the political spectrum, the civil service and other relevant stakeholders.
- **The program must build on the Bank's comparative advantage.** Romania's unfinished reform agenda is large and the IFIs may be tempted to broaden the coverage of the programs beyond what can be realistically managed and delivered. The DPL focuses on areas where the Bank enjoys a comparative advantage and is able to leverage other IFIs' support.

E. Analytical Underpinnings

72. **The DPL is anchored in past and ongoing analytical and technical assistance work**. In addition to past analytical work (as reported in the DPL1 Program Document, table 6), recent activities include the following: (i) the 2009 Public Expenditure Review (PER), which examined opportunities for efficiency gains in the major expenditure areas of the public budget and analyzed aggregate and sector expenditure patterns, the effectiveness and efficiency of spending, and the policy and institutional challenges faced by the government, including in education and health; (ii) technical notes prepared since November 2009 to assist the Government plan reforms of public sector pay and medium-term budgeting; (iii) ongoing work on the impact of the crisis on poverty and social policy monitoring; (iv) training provided in October 2009 on pension modeling and technical assistance for projecting the impact of planned pension reforms; and (v) technical assistance to prepare corporate and mortgage restructuring guidelines and revise the insolvency law. The DPL also draws on the EC de Larosiere report on Financial Supervision in the EU. The Bank will continue to support implementation of reforms by providing upon Client demand analytical notes addressing punctual questions.

V. THE PROPOSED OPERATION

A. Operation Description

73. **The proposed operation is the second of a programmatic series of three DPLs that was originally envisaged to span the 24 months of the IMF Standby Arrangement and EC budget support.** DPL2 (as was the case for DPL1) focuses on structural reforms in three areas of critical importance for Romania’s medium- to long-term prospects: public sector finances, social assistance and social insurance, and the financial sector.

74. **The Government remains committed to the overall DPL program presented to the Board of Directors on July 18, 2009**.

75. **Notwithstanding some changes in the actions supported by the DPL (Table 6), partly in response to the crisis and to reflect changes in the IMF and EC programs, the most important reforms supported by the program have made significant progress**. Of the DPL2 triggers stipulated in the DPL1 program document, four remained unchanged, three of them were met in a modified form, one was postponed for later action and one action was dropped (Law on the Political Independence and Financial Autonomy of Financial Sector Regulators). As the IMF and EC programs will be closing soon, and new programs of support are likely to be requested by Romania, the Bank will also have to assess in what ways it can best support Romania's reform efforts. The Government remains committed to completing the reforms started under this DPL series and which had been envisaged for support under DPL3 as stated in the Letter of Development Policy attached to this loan and the triggers specified in Annex 2. The dialogue will continue in these areas and, indeed, a number of the previously envisaged reforms are expected to be completed in the first half of 2011.

Table 6: Original and revised prior actions and triggers for DPL 2

Area/objective	Original DPL2 Trigger	Revised DPL2 prior action	Comment
MTEF: Improve strategic planning processes of the line ministries and prioritization of expenditures within credible resource envelopes	MTEF (2010-12) presented to Parliament and provisions on MTEF are incorporated into draft fiscal responsibility law so that in the future the MTEF is approved by Parliament with binding aggregate expenditure limits prior to the review of the annual budget law	The Government has submitted MTEF 2010-2012 to the European Commission through the Convergence Program 2009 - 2010, including fiscal risks analysis and has incorporated provisions on MTEF into the Law no.69/2010 on Fiscal Responsibility including the binding aggregate expenditure limits	Government has met the conditions of the original DPL action. It was reworded because the provisions of the Fiscal Responsibility Law called for the MTEF (2010-12) to be presented to Parliament as part the Fiscal Strategy, which was not due to Parliament before end-May 2010. The original timing of DPL2 preceded this date. Submission of the MTEF as part of the Convergence Program was approved by the Government. Greater specificity was added on the content of the MTEF, i.e., fiscal risk analysis. The MTEF for 2011-13, including fiscal risks analysis, approved by Government and in line with the Fiscal Responsibility Law and the Fiscal Strategy will be approved by the Parliament by end December 2010.
Public sector pay and employment: Enhance transparency of the public sector pay and employment system with a greater link between pay and job responsibility	Implementing regulation issued for the Unitary Pay and Grading Law, establishing labor market benchmarks to guide future wage adjustments and phases in over 3 years a limit of 30% on non wage personnel expenditures, and caps on individual bonuses	Framework Unitary Pay Law no 3330/2009 that sets out the principles and timetable for the introduction of subsidiary legislation for a reformed pay system enacted	Changed as it was evident during the policy discussions with the Government, the IMF and the EC that a framework law was needed prior to implementing regulations for UPL. However, the reform is on track and the Framework Law was approved. The Government has incorporated UPL elements in the 2011 budget as expected. The implementing regulations (original condition) are in the Parliament and expected to be approved by end-December 2010.
Health: Increase the cost-effectiveness of health sector expenditures	Legislation of revised benefit package enacted which includes co-payment and exemption mechanisms as well as system for inclusion of new technology and drugs		Moved to a subsequent action in order to give more time for this far reaching reform to be fully understood and owned by all stakeholders. The law was drafted in the spring of 2010 by the initiator (MoHealth) and circulated in the government, parliamentary commissions and among stakeholders (medical associations, trade unions, etc.) for extensive consultations, given the far reaching implications of this reform. The law was approved by Government at end-November, the exempted categories were defined, the payment caps set and other outstanding issues were clarified. The government approved law has been submitted to the Parliament for debate and approval.
Social Assistance: Increase coverage of well targeted program	Amended legislation adopted on GMI to increase eligibility threshold level by 15% (as outlined under EO in DPL 1), finance 100% of GMI from State budget (as outlined in EO under DPL 1), index to inflation and move GMI under NASB depending on results of the PETS	(i) Legislation on GMI ratifying the provisions of EO 57/2009 enacted and (ii) amendments to Law 416/2001 on GMI in order to transfer the program budget to the Ministry of Labor, Family and Social Protection and transfer the benefits payments from local governments to the NASB while keeping the entitlement and recertification attributions with the local governments submitted to the Parliament.	Reworded to accommodate the sequential progress on the reform process. It was agreed with the Government that a sequential approach was needed. The first part of the reform has been completed – legislation on GMI was enacted. In addition, amendments to the law for transfer of budget to MoLabor were submitted to the Parliament and expected to be approved soon. The reform is on track.

Improve targeting of other programs	Maintain the current level of the Universal Child Allowance (UCA) for children up to 2 years of age and 3 years of age in the case of disabled children, for the period 2009-2011. For children above these age limits, unify the UCA with the income-tested Complementary Family Benefit (CFB). The threshold and/or benefit levels could be increased without exceeding the existing aggregate envelope of UCA and CFB	The Government has: (i) submitted to the Parliament the draft law regulating the income-tested family allowances that reduce the maximum eligibility threshold from 470 RON per month per person to 370 RON and offers higher benefits to households earning below 200 RON per month and to single-parent families; and (ii) maintained the nominal value of the universal child allowance benefit in 2010 at the same level as in 2009 as stipulated in the Governmental Decision no.1662/2008.	No change. Reworded for specificity. The reform is currently under debate in the Parliament and expected to be approved soon. The reform is on track.
Pensions: Improve fiscal sustainability of pillar 1 pensions	Legislation adopted to delink pension indexation from the point value; gradually index already awarded pensions to inflation and include a percentage of real wage growth in pension indexation in specific years when real wage growth is above a certain threshold and gradually equalize retirement ages between men and women at 65	Legislation enacted on public pensions unitary system which gradually links pension benefit adjustments to inflation (and maintains the existing wage valorization) and increases retirement ages for women in a manner satisfactory to the Bank.	Except for the age limit for women, revised up to 63, the other pillars of the reform are unchanged. This was agreed with the IMF and EC. Rewording reflects this change.
Financial sector: Strengthen contingency planning	Mortgage and Corporate Debt Restructuring guidelines published and necessary legal amendments to the Insolvency Law issued	(i) Necessary legal amendments to the Insolvency Law no 87/2006 enacted: (ii) Mortgage Debt Restructuring guidelines issued by MoPF and published by MoPF and NBR and (iii) Corporate Restructuring Guidelines issued and published by MoPF, MoJ and NBR .	No Change. Rewording reflects specificity.
Improve functioning of financial markets	Internal regulation governing decision making process and methods for Basel II implementation adopted	Internal regulation governing decision making process and methods for Basel II implementation adopted by NBR	No Change. Rewording reflects specificity.
	Law on the Political Independence and Financial Autonomy of the Financial Sector Regulators and Supervisors approved by Parliament		Dropped as a prior action. However, the reform is broadly on track with delays as the Parliament has asked for more time for debate thee law. The law was approved by the Budget Finance Committee of the Chamber of Deputies and sent for the plenary vote. It is expected to be approved after full debate by the Parliament when it reconvenes after the holiday break in February 2011. The Government remains committed to completing this measure as reflected in the Letter of Development Policy by the time of the EC program fifth review, tentatively scheduled for March 2011. The Bank will follow up progress through policy dialogue and EC program conditionality

76. The following discussion summarizes DPL-supported actions and results to date. Their content and underlying issues are detailed in the Government's Program (Chapter III).

B. IMPROVING PUBLIC FINANCES

77. **The proposed reforms will improve the management and predictability of public spending, and foster better quality of public services**. The cross-sector reforms concern the Medium Term Public Expenditure Framework (MTEF) and the public pay system. For the former, the objective is to strengthen the quality of the annual budgeting process progressively and anchor it in a credible medium-term framework. For the latter, the objective is to improve the transparency and fairness of the public pay system and enhance its capacity to attract and retain critical skills in public administration. The health sector measures seek to improve the mobilization of resources and the efficiency and equity of service provision. Likewise, the education sector measures aim to improve the efficiency of resource use while enhancing the quality of general education. The specific measures agreed under the DPL are:

MTEF

- DPL1 supported the approval by the Government of a budget framework (MTEF) with spending limits by major economic classes prior to budget instructions being sent to line ministries. The purpose of the measure was to guide the strategic planning processes in the line ministries and foster prioritization of expenditures within realistic resource envelopes.
- The Government submitted the MTEF 2010-2012 to the European Commission through the Convergence Program 2009 - 2010, including fiscal risk analysis and has incorporated provisions on MTEF into the Law no.69/2010 on Fiscal Responsibility including binding aggregate expenditure limits (DPL2 prior action).
- The MTEF (2011-13) to be enacted (prior to the annual budget law) with ceilings for major ministries that collectively comprise at least 70 percent of the spending (DPL3 trigger).

Public Sector Pay

- DPL1 supported the introduction of legislation to reduce non-wage personnel expenditures and achieve fiscal savings, by eliminating or redefining some allowances and bonuses. The goal was to contain the spiraling out of control of the wage bill in the public sector.
- Framework Unitary Pay Law no 3330/2009 that sets out the principles and timetable for the introduction of subsidiary legislation for a reformed pay system enacted (DPL2 prior action).
- Pay adjustments in 2011 to be made in accordance with targets specified in the Unitary Pay Law (UPL); subsidiary legislation introducing the reformed pay system to be presented to Parliament and new procedures will be introduced to enhance compliance with personnel policies (DPL3 trigger).

Health

- DPL1 supported two reforms. *First*, the adoption of legislation to increase the overall tobacco excise duty and thus help mobilize additional resources for the financing of health services; and *second*, the implementation of new regulations governing drug pricing and promotion of generic drugs in the framework contracts between CNAS and service providers, with a view to containing the escalation of public spending for drugs.
- Ministerial order issued on drug pricing and joint order issued to promote generic drugs in framework contracts with service providers (DPL 1 prior action).
- Enact the legislation regarding the introduction of co-payment (amending Law 95/2006) and exemption mechanisms for the poor (e.g. a targeted voucher system) (DPL3 trigger).
- Legislation to be enacted for revised provider payment mechanisms (DPL3 trigger).

Education

- Legislation enacted to allow all schools in eight counties to receive their budget according to a per capita finance formula (DPL3 trigger – but already completed).[27]

C. STRENGTHENING SOCIAL PROTECTION

78. **Social assistance reforms seek to increase the coverage of the most efficient and well-targeted programs to provide greater support to poor families. Pension reform aims to enhance the fiscal sustainability of the public pension system and protect the elderly poor.** The specific measures agreed under the DPL program are:

Social Assistance

- DPL1 supported the introduction of legislation to improve the coverage and financial stability of the well-targeted GMI poverty mitigation program, by increasing the eligibility threshold of GMI by 15% and financing it entirely from the central State budget.
- Legislation has been enacted on GMI ratifying the provisions of EO 57/2009 (DPL2 prior action).[28]
- Submit to the Parliament the amendments to Law no 416/2001 on GMI (DPL2 prior action).
- Enact amendments to the legislation (Law 416/2001) to transfer the program budget to the Ministry of Labor, Family and Social Protection and transfer the benefits payments attributions from local governments to the NASB while keeping the entitlement and recertification attributions with the local governments (DPL3 trigger).

[27] As discussed in section III, legislation introducing per capita financing at national level in 2010-11 has been enacted.

[28] In addition to a 15 percent increase in the number of beneficiaries (see section III), legislation indexes the eligibility threshold with inflation annually, and finances the entire GMI budget from the State budget, in order to avoid potential shortfalls due to the local governments' financial difficulties.

- Legislation has been submitted to the Parliament on income-tested family allowances (DPL2 prior action).
- The nominal value of the universal child allowance benefit in 2010 has been maintained at the same level as in 2009 as stipulated in the Governmental Decision no 1662/2008 (DPL2 prior action).
- Enact Legislation on income-tested child allowances (CCA and LPA) that reduces the maximum eligibility threshold from 470 RON per month per capita to 370 RON, and offers higher benefits to households earning less at or below 200 RON and to Single Parent families (DPL3 trigger)**.**

Pensions

- Legislation has been enacted on the public pensions unitary system which gradually links pension benefit adjustments in pillar 1 to inflation (and maintains the existing wage valorization) and increases retirement ages for women in a manner satisfactory to the Bank (DPL2 prior action).[29]
- Measures to be designed and implemented to deal more effectively with the social protection of the elderly poor (DPL3 trigger).[30]

D. Enhancing the Resilience of the Financial Sector

79. **Financial sector reforms seek to bolster contingency planning and improve the resilience of the sector over the longer term through strengthened regulation and supervision**. The specific measures agreed under the DPL program are:

- DPL1 supported the approval by NBR and MoPF of the Strategic Action Plan for financial sector strengthening, to address potential challenges under adverse plausible scenarios impacting sector stability.
- Necessary amendments to the Insolvency Law no 169/2010 have been enacted; (ii) Mortgage Debt Restructuring Guidelines have been issued by MoPF and published by MoPF and NBR; and (iii) Corporate Debt Restructuring Guidelines have been issued and published by MoPF, MoJ and NBR (DPL 2 prior action).
- An internal regulation governing the decision making process and methods for Basel II implementation has been issued and adopted by NBR (DPL2 prior action).
- Assessment and amendments to be made as necessary on a) the adequacy of the definition of "Financial Conglomerate" in Ordinance 98/2006 in capturing all financial groups operating in Romania with material operations across more than one financial sub-sector and b) the adequacy of supervisory arrangements in the Memorandum of Understanding between the financial regulators for financial groups in Romania (DPL3 trigger).

E. Poverty and Social Impact

80. **Poverty is monitored by the Government and the Bank**. The Ministry of Labor, Family and Social Protection (MoLFSP) jointly with the National Institute for Statistics,

[29] As discussed in section III, the Law passed in the Parliament has been sent back by the President with the recommendation to increase the retirement age for women only to 63 by 2030, instead of 65.

[30] This would be a "zero" or non-contributory pension pillar or an additional component to GMI, depending on the results of AAA work currently being undertaken and further consultations with the Government.

calculates and monitors poverty figures based on a methodology developed together with the World Bank. In 2008 and 2009 the Bank validated the poverty figures produced by the two institutions on the basis of Household Budget Surveys (HBS). The distributional impact of the reform measures will be monitored annually based on the HBS data and administrative data provided by MoLFSP.

81. **The DPL-supported reforms will have in general a positive impact on the poor. Any adverse impact will be transitory and mitigated by support measures** (including those mentioned under DPL 1):

- The cross-sector reforms in public expenditure management and introduction of the Unitary Pay Law (UPL) will not affect the poorest segment of the population. They will benefit the entire population by enhancing fiscal and macro stability, and the predictability and transparency of public expenditure. The UPL implementation will also help contain inflationary pressures.
- In health, the poverty impact of the introduction of co-payments will be marginal. When health expenditures are netted out of household consumption[31] the proportion of poor households was 4.9 percent in 2009, half a percent higher than the overall poverty rate of 4.4 percent. This is the appropriate baseline for assessing the impact of co-payments. About half of the insured (9.4 million individuals) will be exempt from co-payments.[32] Introducing the co-payment system *without exemptions* would increase the poverty headcount by 0.5 percent, to 5.4 percent. *With exemptions*, the increase in poverty headcount would be 0.2 percent, to 5.1 percent.
- The expanded coverage and adequacy of the GMI program supported by DPL is expected to have a significant poverty reducing impact (see section III-B for more details).
- The DPL-supported reform of Complementary Child Allowance (CCA) and Single Parent Allowance (LPA) will increase benefits for the poorest decile and improve targeting. Simulations suggest that the reform measures discussed in section III-B will improve the targeting accuracy of these programs to the lowest quintile from around 51 percent to 60 percent. The generosity (benefits received as a percentage of post benefit household consumption) also increases for the poorest quintile (Figures 1 and 2).
- DPL2-supported reforms aim to protect future generation of retirees, by enhancing the fiscal sustainability of the Pillar 1 pensions and the financial viability of Pillar 2.

[31] Current out-of-pocket expenditures on health.

[32] Exempt categories include children under 18, some youth 18 - 26 years of age out of the labor force, patients with diseases included in the national health programs, and retirees with pensions below 700 RON/month.

Figure 1: Improved Targeting Accuracy

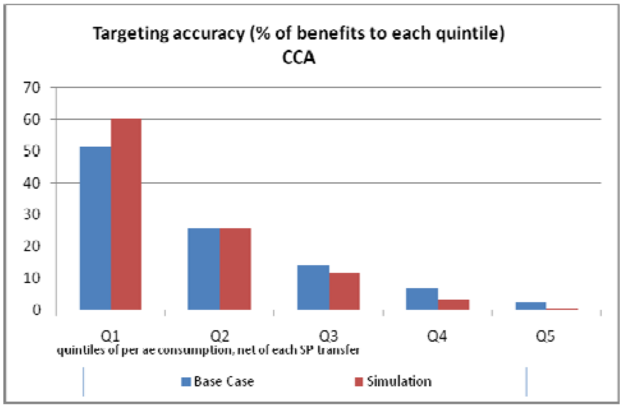
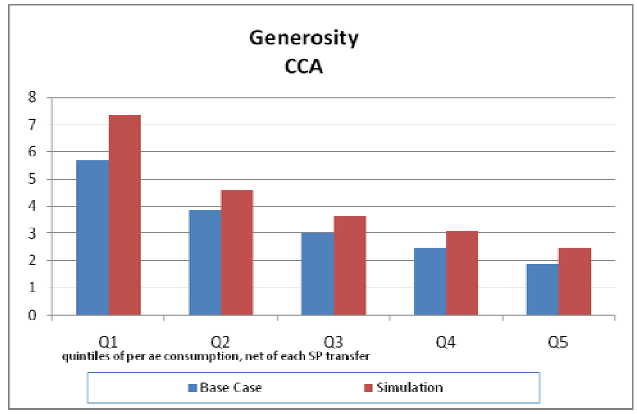


Figure 2: Improved Generosity for Poorest Quintile



F. ENVIRONMENTAL ASPECTS

82. **As noted in the DPL1 PD the specific policies supported by the DPL program are not likely to have significant positive or negative effects on Romania's environment, forests and other natural resources.** The measures contemplated under the loan are geared primarily toward ensuring stability and future financial system solvency as well as to allow a resumption of economic growth, and do not have significant links to the environment. Moreover, Romania has adequate environmental safeguards. Environmental legislation and regulation is reinforced by EU environmental directives, including the EU guidelines on the adoption of environmental assessments at the planning and programming level (June 2001) and the EU's Environmental Liabilities Directive setting out liability for damage to properties and natural resources (April 2007).

G. IMPLEMENTATION, MONITORING AND EVALUATION

83. **The implementation of the loan requires close coordination between the Bank and the national institutions responsible for implementation, as well as the leadership of the Prime Minister's Office and the Presidency.** The Ministry of Public Finance (MoPF), the National Bank of Romania (NBR), and the Ministries of Labor, Family and Social Protection (MoLFSP), Health, Education, and Justice will provide the requisite baseline data from which to measure outcomes by the end of the program. MoPF will coordinate reporting on the program's monitoring indicators. These indicators will be tracked, discussed and assessed among the Bank team and implementing agencies both by staff based in the field and by HQ staff during field visits. As discussed in section IV-D, leadership provided by the Cabinet of the Prime Minister and the Presidency is essential for the implementation, monitoring and evaluation of the program.

H. FIDUCIARY ASPECTS

84. **The Bank deems fiduciary risks to be moderate overall.** A Country Financial Accountability Assessment (CFAA) was completed at the end of 2003, a Country Procurement Assessment Report (CPAR) was done in 2005 and a Public Expenditure and Institutional Review (PEIR) was issued in 2006. Regular updates of Public Financial Management (PFM) reform were

carried out and the overall fiduciary risk associated with the PFM system is deemed to be moderate. The risk is considered: i) significant in the areas of accounting, reporting and internal control; ii) moderate in the fields of budgeting, treasury, cash management and external audit, and parliamentary oversight; and iii) low with regard to Bank investment operations. In addition to the measures highlighted in the DPL1 PD on PFM improvements, Romania adopted in 2010 an updated Local Public Finance Law, to become effective in January 2011.

85. **The Government is addressing the challenges highlighted by the DPL1 in 2009** : full development of the MTEF and of a well-integrated financial management information system; introduction of pre-budget statements, accrual-based budgets, formal mid-year budget reviews, in-year audit reports, and citizens' budgets; completion of computerized accounting and bookkeeping; decentralization of ex-ante internal control and audit functions; and further strengthening of external audit.

86. **NBR can be relied upon to hold proceeds from development policy operations.** The August 2009 IMF safeguards assessment concluded that safeguards in place at NBR generally appear adequate. The previously identified weaknesses (mentioned in the June 2005 safeguards assessment) were addressed. Based on the IMF's safeguards assessment, NBR can be relied upon to account for the Bank's loan proceeds from development policy operations, assuming that the arrangements are otherwise in accordance with the Bank's policies and with specific mutually agreed terms for the operation in question, and the Bank takes no further action in this area.

I. DISBURSEMENTS AND AUDITING

87. **The proposed loan will follow the World Bank's disbursement procedures for development policy loans.** Disbursements will not be linked to specific purchases, and evidence will therefore not be needed to support disbursements, nor will procurement requirements be necessary. The front end fee will be covered from the Borrower's own sources. At the request of the MoPF, the Bank will deposit the proceeds of the loan into a foreign exchange deposit account at the NBR as part of the general foreign exchange reserves. If loan proceeds are used for ineligible purposes as defined in the Loan Agreement, the Bank, upon notice, will require the Borrower to refund such amount promptly, and such amount shall be cancelled.

88. **MoPF will be responsible for the administration and accounting of loan proceeds.** The standard country rules will be followed by Treasury for administration and accounting. The proceeds of the Loan deposited at the NBR will be used to cover the budget deficit and/or public debt refinancing. MoPF will be responsible for preparing withdrawal applications along with maintaining the deposit account as required. With the assistance of NBR it will maintain records of all transactions under the deposit account in accordance with sound accounting practices. The Borrower will report to the Bank within 30 days after receiving the loan amounts by sending a confirmation letter on the loan amounts deposited in the foreign currency deposit account.

89. **The proceeds of the loan will be deposited in a single tranche by the Bank in an account chosen by the Borrower at the NBR and an audit of that account will not be required.** The currency of the NBR account will be the loan currency. Given the positive IMF assessments of the NBR, the unqualified NBR audit reports for 2005-2008, as well as the satisfactory audit compliance under the previous PAL and PSAL-2 development policy lending operations (disbursed in 2005), an audit of the NBR account for the proceeds of the loan is not considered necessary.

J. RISKS AND RISK MITIGATION

90. **The proposed DPL program entails political, social and economic risks**:

- Political risks concern in particular the inherent uncertainty which is characteristic of any coalition government facing a strong and vocal opposition, and the approaching 2012 local and parliamentary elections. The discussion and adoption of legislation underpinning reforms is often challenged by the opposition both on the floor of the Parliament and in the Constitutional Court, delaying action and sometimes modifying Government's intent. The 2012 elections may lead to the relaxation of public spending objectives, as the ruling coalition will try to shore up support for re-election by increasing financing for local projects, and may delay reforms which affect the electorate and require sacrifices in the short-run. Fiscal and policy slippages may undermine market confidence and increase balance of payments pressures.
- Social risks are associated primarily with parts of the multilateral support program covered by other IFIs, such as the fiscal austerity package agreed with the IMF. They could, however, impede the implementation of the DPL program since this program is part of the multilateral package.
- Economic risks are linked to the specific context of the crisis in Romania: (i) the large fiscal deficit of 2008 which forced fiscal austerity and increased the scope of adjustment at a time when the severity of the economic downturn made this difficult; (ii) the impact of regional financial market turbulence which could result in lower debt roll-over rates or larger capital outflows, destabilizing exchange rate depreciation, and negative feedback effects between the real and financial sectors; and (iii) balance-sheet effects arising from a further RON depreciation beyond the current program assumptions (and the resulting higher than expected inflation), which could compress Romania's growth prospects and affect the domestic banking sector due to increased corporate and household distress. Some reforms supported by DPL (e.g., implementation of the MTEF and the UPL) are contingent on budget resources or on technical inputs provided by the IMF.

91. **The above risks are partially mitigated by Government actions supported by the IFIs**:

- Political risks have been managed well so far by the Government, with the support of the President. Given the tensions between the ruling coalition and the opposition, the constant dialogue of the Bank with the parliamentary opposition to explain the necessity and the thrust of reforms and inform it on progress in implementation could help mitigate a potential change of direction or halt of reforms in case of significant changes in the governing coalition.
- Social risks are mitigated by the acceleration of social assistance reform and the provision of funding. Increases in pensions and unemployment and social assistance benefits prior to and, during the crisis have helped the vulnerable to better withstand the consequences of the economic decline, contributing to a reduction in poverty in 2009. The DPL has supported the increase in funding to the well-targeted GMI program. The Bank has also expanded communication efforts with the social partners, such as the main trade union confederations, emphasizing the costs of continuing with the economic status quo and the long-term benefits of reforms. Better dissemination of the findings of Bank-supported analytical work has been an important vehicle of the enhanced communication effort on the necessity of reforms.

- Economic risks are mitigated by the multilateral support package, proactive actions of State institutions, and the design of the program: (i) the IFIs leverage macroeconomic policy adjustments with a large package of external official financial resources. The external assistance package aims to help stabilize the economy and support external debt rollover/debt service without excessive pressures on the exchange rate that could further weaken the banking sector. The package provides considerable cushion in building up reserves that would help deal with a worse-than-expected case scenario of capital outflows and prolonged financial sector distress; (ii) NBR has so far managed well pressures on the national currency; and (iii) the design of the program supported by the Fund in the banking sector included in-depth examinations and recapitalization requirements and the strengthening of regulatory and supervisory powers. The DPL program added additional contingency planning reforms including the preparation of a strategic action plan for the banking sector to address potential interventions, and the establishment of a framework to facilitate private and corporate debt restructuring. Fiscal reforms will reduce the fiscal pressures both in the short run and over the medium term and contribute to lowering external financing needs.

Annex 1: Letter of Development Policy

Mr. Robert Zoellick

President

World Bank

Washington DC

Ref: Letter of Development Policy - Second Development Policy Loan

Dear Mr. Zoellick,

This letter summarizes aspects of our program to strengthen public sector finances, social protection and the financial sector.

In 2010, the Romanian economy is expected to contract by around 2 percent, after declining some 7 percent in 2009, in spite of firm measures taken by the government to promote stability, reverse imbalances and address structural causes of its underlying macroeconomic vulnerabilities. Romania's economy recovery will likely be delayed due to continued weakness in domestic demand, adverse global market conditions and from unforeseen external factors including large-scale flooding that has inundated swathes of the country. In spite of such challenges, we expect the economy to rebound in 2011.

While the magnitude of the decline in economic activity is higher than initially projected, we have revised our budget deficit target for 2010 to 6.8 percent of GDP. To achieve this target, we have decided to implement major cuts in public spending between July and December of this year, together with increases in VAT and other taxes. These measures form a package expected to yield a fiscal adjustment of around 4.6 percent of GDP on an annualized basis and include, as main components, a 5 percentage points VAT increase, a 25 percent reduction in the public sector wage bill, and a 15 percent cut in untargeted social assistance benefits, together with further reductions in public sector employment.

Fiscal performance in the first half of 2010 was somewhat weak relative to initial forecasts, owing primarily to lower-than-expected revenue collection- especially from VAT and social contributions and the relatively weak economic activity. Yet the revenue shortfall was largely offset by strict expenditure controls, including reductions in public sector employment and a 10 percent cut on an annualized basis in spending of goods and services. We have therefore succeeded in meeting the ceiling on general government spending and the fiscal deficit target for the first half of 2010, as agreed with the IMF. At the same time, significant expenditure pressures have continued to accumulate, owing primarily to large increases in public wages and pensions granted before 2009. In this context, in order to meet our fiscal target of 6.8 percent of GDP for 2010, the government has decided to introduce the fiscal austerity package presented above. In addition, measures have been promoted to widen tax bases, improve tax enforcement and reduce fraudulent access to public services, including to social benefits.

The implementation of the austerity package is not expected to have a significant impact on poverty for several reasons. First, the incidence of poverty among public servants is very low and unlikely to increase with the one-off cuts. Moreover, there is a minimum wage floor of 600 RON per month below which wages will not be reduced. Second, the social assistance programs that have been reduced are programs with low targeting performance- reducing these programs will not impact the poor in a significant way; rather, middle and upper income households will shoulder the burden. Third, the budget of the means tested programs (GMI, family allowances and heating allowances) has been protected.

Complementing the fiscal adjustment and macroeconomic stabilization program, the government has embarked upon an ambitious structural reform agenda to address the root causes of Romania's ongoing vulnerabilities and to enhance the efficiency and efficacy of public sector resource allocation. This reform agenda is supported by the DPL series, given its focus on improving the management of public finances, strengthening social protection and enhancing the resilience of the financial sector.

Reforms aimed at improving the management of public finances

Prior to the recent financial crisis, the annual budget changed frequently throughout the fiscal year to accommodate new measures. In particular, personnel expenditures escalated, and agreements to increase wages were often in excess of approved budget levels. Consequently, there were large differences between the original approved budget and budget execution.

Our reform agenda aims at improving the quality of the annual budgeting process and rooting it more firmly in a credible medium-term expenditure framework (MTEF) to ensure that the amounts budgeted reflect Romania's spending priorities and that these priorities are implemented effectively. Improvements in the MTEF have focused on enhancing macroeconomic assumptions, expenditure breakdown by major economic classification, aggregate revenues and the fiscal balance for a three-year forward looking period, as well as improving the macroeconomic and fiscal risks analysis. A Fiscal Responsibility Law (FRL) was adopted in April 2010 that incorporated aggregate expenditure ceilings, while the Fiscal Council is already in place. The FRL contains a series of fiscal principles and rules on revenue, expenditure, deficit, public debt and risk management with the aim of enhancing fiscal discipline and improving the efficiency of public finance management. In addition, a Fiscal Strategy highlighting the government's medium-term macroeconomic targets and fiscal priorities is at an advanced preparation stage.

Personnel costs consume a large component of the Romanian budget, having increased substantially in recent years. Moreover, the Romanian public pay system has been at variance with modern systems in several respects: i) non-wage compensation represented a disproportionate share of total compensation, undermining transparency and equity; ii) there are wide disparities in pay among positions with similar responsibilities; iii) incentives to take on new responsibilities are undermined by a compressed salary scale and over reliance on seniority and iv) compensation decisions are not based on reliable information on private sector comparators.

Our reform agenda in this area envisages changes to the public pay system that would enhance the capacity to attract and retain critical skills in public administration. To this end we have adopted a Unitary Pay Law which provides the structure and principles behind a new pay system as well as a strict timetable for the introduction of subsidiary legislation that will provide specific details including the implementation schedule of the reformed pay system.

We have also undertaken reforms in two key sectors with a view to mobilizing resources and improving the efficiency and equity of service provision. Within the health sector, we are introducing co-payments to help manage the demand side of health services and create incentives for people to use appropriate levels of health services. This is achieved through introducing variable co-payments that are based on the level of health services used. At present there is an over-reliance on the use of expensive hospital services even for ailments that could be addressed through simpler, cost-effective diagnostic treatments. We will make the necessary diligence in order to help the law enacted for regulating and introducing the co-payment for health services which should initiate a shift towards a system where patients pay for services in a more transparent way while allowing for exemptions based on objective and equitable criteria.

There is also scope for improving the efficiency of resource use while enhancing the quality and access to general education across the country. We are tackling this by directly addressing the weak incentives currently faced by local authorities in using resources more efficiently through the introduction of a per student financing formula.

Reforms to enhance social protection

We have undertaken measures in our social assistance programs that strengthen the poverty targeting of two of our important income-tested family allowance programs, by moving from a flat family benefit to a per-child benefit, and providing a larger benefit amount for the poorest deciles. At the same time, in order to contain the budgetary implications, we intend to ensure that the budget of the means tested child family allowance and state child allowance for children aged 2 and older, or of children aged 3 or older if disabled does not exceed in 2011 the level of the budget in 2009.

We have also undertaken an important reform of our pillar 1 pension system, to improve its fiscal sustainability. In 2009, the pension system ran a deficit amounting to 1.3% of GDP resulting from sharp increases in the point value (and hence in the indexation of benefits). In 2010 the pension system experienced a deficit, despite implementing a pension freeze. The reform agenda entails changing the indexation rule to improve the pensions system's overall fiscal sustainability while also maintaining adequate average replacement rates for both current and new retirees, and well as by increasing the retirement age for women. The new pension law links the indexation of retirement benefits gradually to inflation and allows for wage valorization, thus maintaining the link between contributions and benefits.

We also remain committed to strengthening the private pension pillar. We are committed to the scheduled increase in contribution rate directed to pillar 2 from 2.5 to 3 percentage points out of the contribution to the public pension system in 2011.

Reforms to strengthen the financial sector

Within the financial sector, we continue to strengthen our contingency planning, through the introduction of robust measures to encourage adequate restructuring of viable impaired loans—both corporate and mortgage. Given the high level and potential for further stresses in household and corporate debt, it is important to have mechanisms to prevent creditors from exercising their individual enforcement rights en mass and in which debtors try to place procedural obstacles to execution, thereby delaying credit recovery. As previous crises have shown, it is also important to develop under the insolvency system avenues for viable firms facing temporary payment difficulties to negotiate debt restructuring and corporate rehabilitation options with their creditors. Without this, many firms could be forced into bankruptcy, which could in turn jeopardize Romania's economic recovery.

We are also continuing to enhance the resilience and stability of the financial sector over the medium-term by addressing regulatory and supervisory issues. First, while the legal framework governing the political, financial and operational independence of the non-banking sector regulators—the CNVM, CSA and CSSPP—is generally well aligned with EU best practices and international standards, there were some remaining weaknesses that we have addressed to strengthen the capacity of these regulators to supervise the financial markets. Second, since the implementation process of Basel II is a major prudential policy decision that can have a significant effect on the resilience of the banking system, NBR has instituted a robust policy and decision making process for the assessment and accreditation of Basel II advanced models.

Finally, we will make the necessary diligence in order to help law for regulating the political independence and financial autonomy of the financial sector regulators and supervisors enacted in the first months of 2011 in line with international best practice.

Gheorghe Ialomițianu

Minister of Public Finance

Annex 2: Policy Matrix

	PUBLIC FINANCES				
OBJECTIVES	**DPL 1**	**DPL 2**	**DPL3 TRIGGER**	**INDICATIVE OUTCOMES**[33]	**LEAD AGENCY**
Cross sectoral **MTEF: Improve strategic planning processes of the line ministries and prioritization of expenditures within credible resource envelopes**	Budget framework (MTEF) approved by Government with spending limits by major economic classes prior to budget instructions being sent to line ministries	The Government has submitted MTEF 2010-2012 to the European Commission through the Convergence Program 2009 - 2010, including fiscal risks analysis and has incorporated provisions on MTEF into the Law no.69/2010 on Fiscal Responsibility including the binding aggregate expenditure limits	MTEF (2011-13) approved by Parliament with ceilings for the 3-year period for select ministries comprising at least 70% of spending and detailed annex of capital investment projects to be funded during the period.	10 percent reduction in variance between the original approved budget and the actual expenditures for *major ministries/functions* in 2011 budget relative to 2008. For 2008 average deviation between three largest economic classes (wages, G&S, capital) was 27%. Planned and actual spending for major capital projects are disclosed in budget documentation for the MTEF period. In 2008 no data were disclosed with the budget on planned vs. actual capital spending	MoPF
Public sector pay and employment: Enhance transparency of the public sector pay and employment system with a greater link between pay and job responsibility	Emergency Ordinance adopted to reduce non wage personnel expenditures	Framework Unitary Pay Law no 3330/2009 that sets out the principles and timetable for the introduction of subsidiary legislation for a reformed pay system enacted	Pay adjustments made in accordance with targets in UPL, subsidiary legislation presented to Parliament and new procedures introduced to enforce merit based principles of employment	Base salary comprises at least 70% of average total compensation among public servants in all occupational categories in 2011. Regulations implementing a unitary pay and grading system are enacted. For 2008 all occupation categories had base salaries that were below 70% of total compensation.	MLSFP in coordination with NACS

[33] Some of the original outcome indicators have been changed in order to better capture the specificities of the reform implemented.

	PUBLIC FINANCES				
OBJECTIVES	**DPL1**	**DPL 2**	**DPL3 TRIGGER**	**INDICATIVE OUTCOMES**	**LEAD AGENCY**
Sectoral **Health: Increase the cost-effectiveness of health sector expenditures**	Legislation adopted to increase the overall tobacco excise duty from €50 to €57 per 1,000 cigarettes		Enact the legislation regarding co-payment and exemption mechanisms (amending Law 95/2006)	Reduction in drug expenditures in ambulatory care by 5% in 2011 relative to 2008 (MOH and CNAS data) [Baseline 4277 million Ron in 2008]	MoH
	Ministerial order issued on drug pricing and joint order issued to promote generic drugs in framework contracts with service providers		Legislation for revised provider payment mechanisms enacted	5 percent lower rate of admission to acute care facilities per capita in 2011 relative to baseline 3 (CNAS data) [Baseline: 229 per 1,000 people] Coverage of co-payment exemption among eligible population below 50 percent in 2011.	
Education: Increase incentives for efficient spending within the education sector			Legislation enacted to allow all schools in eight counties to receive their budget according to a per capita finance formula	Increase in average class size to at least 21.5 in 2011 relative to the average class size observed in academic year 2008/9. [Baseline: 20.6] [34]	MoEd

[34] The average class size has been calculated as the total number of students enrolled (2,627,942) divided by the number of classes (127,398). The calculation of this indicator has been extended to national level data, as opposed to using data from only eight counties as initially introduced, to reflect the implementation of the per student financing formula nationally.

	SOCIAL PROTECTION				
OBJECTIVES	**DPL 1**	**DPL 2**	**DPL3 TRIGGER**	**INDICATIVE OUTCOMES**	**LEAD AGENCY**
Increase coverage of well targeted program	Emergency Ordinance adopted to increase eligibility threshold of GMI by 15%, starting in July and finance 100% of the GMI from Central State budget	(i) Legislation on GMI ratifying the provisions of EO 57/2009 enacted and (ii) amendments to Law 416/2001 on GMI in order to transfer the program budget to the Ministry of Labor, Family and Social Protection and transfer the benefits payments from local governments to the NASB while keeping the entitlement and recertification attributions with the local governments submitted to the Parliament.	Enact the legislation to transfer the program budget to the Ministry of Labor, Family and Social Protection and transfer the benefits payments from local governments to the NASB while keeping the entitlement and recertification attributions with the local governments e.	Number of GMI unpaid benefits and partial payments not exceeding 5 percent of due payments to entitled beneficiaries in 2010 and 2011. Baseline 20% in 2008. 15 percent increase in the number of paid GMI beneficiaries by June 2011. Baseline 236 thousand in June 2009.	MLSFP in coordination with MoPF
Improve targeting of other programs		The Government has: (i) submitted to the Parliament the draft law regulating the income-tested family allowances that reduce the maximum eligibility threshold from 470 RON per month per person to 370 RON and offers higher benefits to households earning below 200 RON per month and to single-parent families; and (ii) maintained the nominal value of the universal child allowance benefit in 2010 at the same level as in 2009 as stipulated in the Governmental Decision no.1662/2008.	Enact the legislation on income-tested child allowances (CCA and LPA) that reduces the maximum eligibility threshold from 470 RON per month per capita to 370 RON, and offers higher benefits to households earning less at or below 200 RON and to Lone Parent families .	Increase the share of complementary child allowance funds reaching the poorest quintile from 50% (2009) to at least 60% (2011).	MLSFP in coordination with MoPF

	SOCIAL PROTECTION				
OBJECTIVES	**DPL 1**	**DPL 2**	**DPL3 TRIGGER**	**INDICATIVE OUTCOMES**	**LEAD AGENCY**
Pensions: **Improve fiscal sustainability of pillar 1**		Legislation enacted on public pensions unitary system which gradually links pension benefit adjustments to inflation (and maintains the existing wage valorization[35]) and increases retirement ages for women in a manner satisfactory to the Bank.	Measures introduced to deal more effectively with the social protection of elderly poor e.g. through introduction of zero pillar or expanded GMI	The fiscal deficit of pillar 1 pension reduced by 0.5 percent of GDP from baseline by 2012 [Baseline deficit is 1.7 % of GDP in 2012 based on WB Prost model][36]	MLSFP in coordination with MoPF

[35]Valorization is the adjustment of past contributions to account for the changes in the value of contributions between the time they are paid and the time pension is claimed or calculated. In a point system, valorization is analogous to the procedure used to update the pension point value.
[36] Projections include impact of measures to reduce the number of disability beneficiaries and early retirees.

	FINANCIAL SECTOR				
OBJECTIVES	**DPL 1**	**DPL 2**	**DPL3 TRIGGER**	**INDICATIVE OUTCOMES**	**LEAD AGENCY**
Strengthen contingency planning	Strategic Action Plan for financial sector strengthening approved by NBR and MoPF	(i) Necessary legal amendments to the Insolvency Law no 87/2006 enacted: (ii) Mortgage Debt Restructuring guidelines issued by MoPF and published by MoPF and NBR and (iii) Corporate Restructuring Guidelines issued and published by MoPF, MoJ and NBR .		Increase in the percentage of corporate insolvency cases dealt with through reorganization proceedings in 2011 [Baseline 1.5% of total insolvency cases in March 2009, target 3%]	MoPF with support from NBR and the MoJ and in consultation with the private sector
Improve functioning of financial markets		Internal regulation governing decision making process and methods for Basel II implementation adopted by NBR	Adequacy of the definition of a Financial Conglomerate in ordinance 98/2006 assessed and any necessary amendments thereto issued; Adequacy of supervisory arrangement in the MOU between the financial sector regulators for Financial Groups in Romania assessed and amended as necessary	Joint supervision of financial groups by the relevant regulators	NBR NBR, in coordination with CSPP, CSA and CNVM

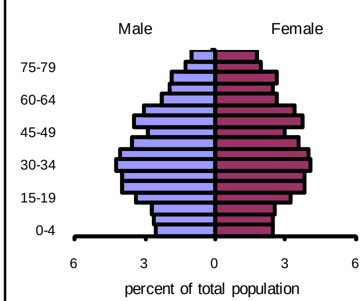
Annex 3: Romania At A Glance

Romania at a glance

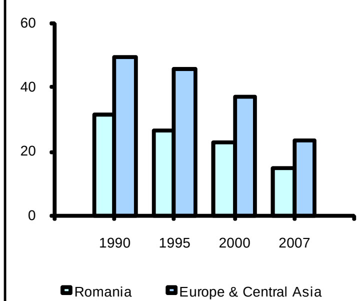
10/5/10

Key Development Indicators	Romania	Europe & Central Asia	Upper middle income
(2008)			
Population, mid-year (millions)	215	441	948
Surface area (thousand sq. km)	238	23,916	47,176
Population growth (%)	-0.2	0.3	0.8
Urban population (% of total population)	54	64	75
GNI (Atlas method, US$ billions)	178.1	3,274	7,472
GNI per capita (Atlas method, US$)	8,280	7,418	7,878
GNI per capita (PPP, international $)	13,500	12,220	12,297
GDP growth (%)	7.3	5.5	4.7
GDP per capita growth (%)	7.4	5.2	3.8
(most recent estimate, 2003–2008)			
Poverty headcount ratio at $1.25 a day (PPP, %)	<2	4	..
Poverty headcount ratio at $2.00 a day (PPP, %)	3	9	..
Life expectancy at birth (years)	73	70	71
Infant mortality (per 1,000 live births)	13	21	21
Child malnutrition (% of children under 5)	..	..	..
Adult literacy, male (% of ages 15 and older)	98	99	95
Adult literacy, female (% of ages 15 and older)	97	96	93
Gross primary enrollment, male (% of age group)	105	99	112
Gross primary enrollment, female (% of age group)	104	96	108
Access to an improved water source (% of population)	88	95	94
Access to improved sanitation facilities (% of population)	72	89	82

Age distribution, 2008

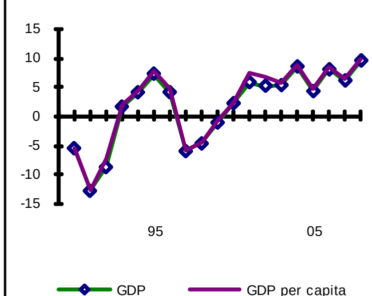


Under-5 mortality rate (per 1,000)



Net Aid Flows	**1980**	**1990**	**2000**	**2008** [a]
(US$ millions)				
Net ODA and official aid	..	243	432	*914*
Top 3 donors (in 2007):				
European Commission	..	62	264	*695*
Germany	..	68	25	*51*
France	..	0	17	*42*
Aid (% of GNI)	..	0.6	12	*12*
Aid per capita (US$)	..	10	19	*42*

Growth of GDP and GDP per capita (%)



Long-Term Economic Trends				
Consumer prices (annual % change)	..	..	..	*7.8*
GDP implicit deflator (annual % change)	*12.1*	13.6	44.3	116
Exchange rate (annual average, local per US$)	..	0.0	2.2	2.5
Terms of trade index (2000 = 100)	..	*83*	100	91

	1980	1990	2000	2008	**1980–90**	**1990–2000**	**2000–08**
					(average annual growth %)		
Population, mid-year (millions)	22.2	23.2	22.4	215	0.4	-0.3	-0.5
GDP (US$ millions)	..	38,299	37,053	200,071	13	-0.6	6.4
		(% of GDP)					
Agriculture	*16.4*	7.0	12.5	7.1	19	-19	7.5
Industry	*56.6*	25.0	36.4	25.2	-10	-12	6.2
Manufacturing	..	*210*	14.5	20.9	..	..	*5.7*
Services	*27.0*	68.0	511	67.6	..	0.9	5.0
Household final consumption expenditure	53.7	65.9	78.5	63.6	..	13	6.8
General gov't final consumption expenditure	12.3	13.3	7.2	15.5	..	0.8	5.0
Gross capital formation	36.3	30.2	19.5	314	..	-5.1	12.3
Exports of goods and services	..	30.0	32.7	29.9	..	8.1	10.8
Imports of goods and services	..	40.0	37.9	40.4	..	6.0	15.8
Gross savings	..	20.7	15.8	23.9			

Note: Figures in italics are for years other than those specified. 2008 data are preliminary. .. indicates data are not available.
a. Aid data are for 2007.

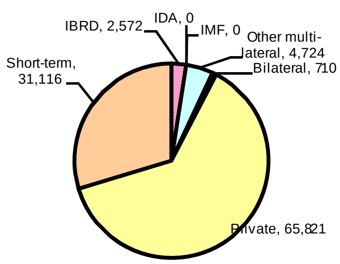
Development Economics, Development Data Group (DECDG).

Balance of Payments and Trade	**2000**	**2008**
(US$ millions)		
Total merchandise exports (fob)	10,366	47,480
Total merchandise imports (cif)	13,054	71,290
Net trade in goods and services	-1,930	-20,919
Current account balance	-1,355	-14,943
as a % of GDP	-3.7	-11.6
Workers' remittances and compensation of employees (receipts)	96	9,395
Reserves, including gold	3,396	30,300

Central Government Finance		
(% of GDP)		
Current revenue (including grants)	31.1	29.6
Tax revenue	29.2	27.5
Current expenditure	31.8	26.1
Overall surplus/deficit	-4.0	-4.8
Highest marginal tax rate (%)		
Individual	40	*16*
Corporate	25	*16*

External Debt and Resource Flows		
(US$ millions)		
Total debt outstanding and disbursed	11,160	104,943
Total debt service	2,500	18,537
Debt relief (HIPC, MDRI)	–	–
Total debt (% of GDP)	30.1	52.5
Total debt service (% of exports)	20.1	26.4
Foreign direct investment (net inflows)	1,037	13,328
Portfolio equity (net inflows)	58	23

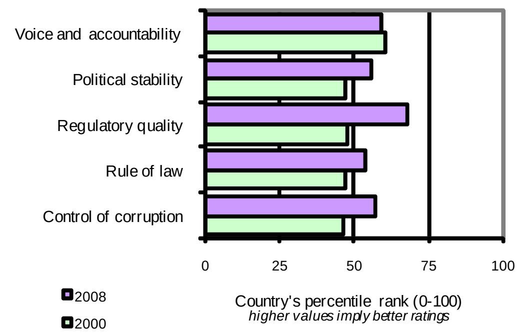
Composition of total external debt, 2008



US$ millions

Private Sector Development	**2000**	**2008**
Time required to start a business (days)	–	10
Cost to start a business (% of GNI per capita)	–	3.6
Time required to register property (days)	–	83
Ranked as a major constraint to business	**2000**	**2008**
(% of managers surveyed who agreed)		
Tax administration	..	*35.6*
Tax rates	..	*34.1*
Stock market capitalization (% of GDP)	2.9	10.0
Bank capital to asset ratio (%)	8.6	*7.3*

Governance indicators, 2000 and 2008



Source: Kaufmann-Kraay-Mastruzzi, World Bank

Technology and Infrastructure	**2000**	**2008**
Paved roads (% of total)	49.5	*30.2*
Fixed line and mobile phone subscribers (per 100 people)	29	137
High technology exports (% of manufactured exports)	5.6	*3.7*

Environment		
Agricultural land (% of land area)	65	*63*
Forest area (% of land area)	27.7	*27.7*
Nationally protected areas (% of land area)	..	*2.2*
Freshwater resources per capita (cu. meters)	*1,940*	*1,963*
Freshwater withdrawal (billion cubic meters)	23.2	..
CO2 emissions per capita (mt)	3.8	*4.1*
GDP per unit of energy use (2005 PPP $ per kg of oil equivalent)	4.2	*5.4*
Energy use per capita (kg of oil equivalent)	1,618	*1,860*

World Bank Group portfolio	**2000**	**2008**
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	1,898	2,572
Disbursements	384	239
Principal repayments	91	288
Interest payments	104	130
IDA		
Total debt outstanding and disbursed	0	0
Disbursements	0	0
Total debt service	0	0
IFC *(fiscal year)*		
Total disbursed and outstanding portfolio	284	583
of which IFC own account	112	508
Disbursements for IFC own account	17	99
Portfolio sales, prepayments and repayments for IFC own account	5	40
MIGA		
Gross exposure	20	123
New guarantees	0	*0*

Note: Figures in italics are for years other than those specified. 2008 data are preliminary.
.. indicates data are not available. – indicates observation is not applicable.

10/5/10

Development Economics, Development Data Group (DECDG).

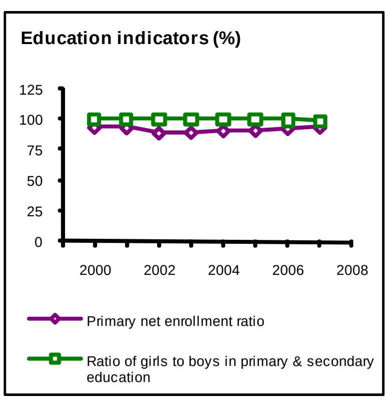
Millennium Development Goals

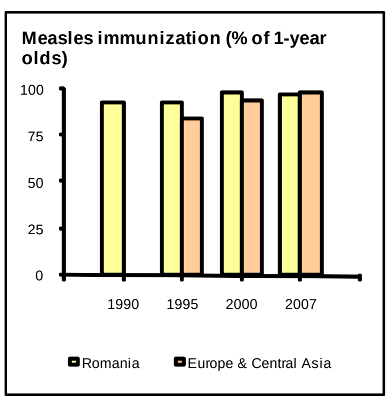
Romania

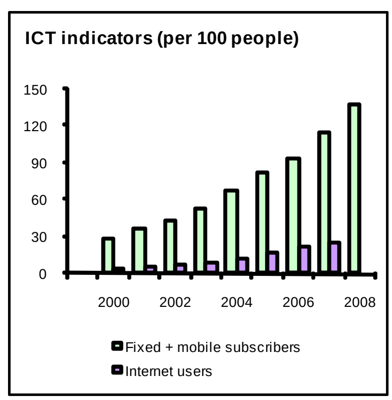
With selected targets to achieve between 1990 and 2015

(estimate closest to date shown, +/- 2 years)

	Romania			
Goal 1: halve the rates for extreme poverty and malnutrition	**1990**	**1995**	**2000**	**2008**
Poverty headcount ratio at $1.25 a day (PPP, % of population)	*<2*	*5.0*	3.7	*<2*
Poverty headcount ratio at national poverty line (% of population)	..	25.4	*28.9*	..
Share of income or consumption to the poorest qunitile (%)	*10.0*	*8.9*	8.2	*8.2*
Prevalence of malnutrition (% of children under 5)	..	..	3.7	..
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	*81*	..	94	*94*
Primary completion rate (% of relevant age group)	100	86	102	*120*
Secondary school enrollment (gross, %)	102	77	81	*87*
Youth literacy rate (% of people ages 15-24)	..	..	*98*	*97*
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	*99*	..	100	*99*
Women employed in the nonagricultural sector (% of nonagricultural employment)	42	42	46	*47*
Proportion of seats held by women in national parliament (%)	34	*7*	7	9
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	32	27	23	*15*
Infant mortality rate (per 1,000 live births)	27	21	19	*13*
Measles immunization (proportion of one-year olds immunized, %)	92	93	98	*97*
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	*24*
Births attended by skilled health staff (% of total)	..	*99*	*98*	*98*
Contraceptive prevalence (% of women ages 15-49)	..	*57*	*64*	*70*
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	0.1	0.1	*0.1*
Incidence of tuberculosis (per 100,000 people)	74	112	136	*115*
Tuberculosis cases detected under DOTS (%)	..	..	10	*85*
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	76	80	85	*88*
Access to improved sanitation facilities (% of population)	72	72	73	*72*
Forest area (% of total land area)	27.8	27.8	27.7	*27.7*
Nationally protected areas (% of total land area)	..	..	..	*2.2*
CO2 emissions (metric tons per capita)	6.7	5.5	3.8	*4.1*
GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)	2.9	3.5	4.2	*5.4*
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	10.2	13.1	17.4	23.4
Mobile phone subscribers (per 100 people)	0.0	0.0	11.1	113.7
Internet users (per 100 people)	0.0	0.1	3.6	*23.9*
Personal computers (per 100 people)	0.2	1.3	3.2	*19.2*







Note: Figures in italics are for years other than those specified. .. indicates data are not available. 10/5/10

Development Economics, Development Data Group (DECDG).

Annex 4: Funds Relation Note

IMF Executive Board Concludes 2010 Article IV Consultation and Fourth Review of the Stand-By Agreement with Romania

Public Information Notice (PIN) No. 10/97
July 23, 2010

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of Romania's economic performance under 24-month Stand-By Arrangement (SBA) approved on May 4, 2009 and concluded the 2010 Article IV consultation with Romania.[1] The completion of this program review enables the immediate disbursement of SDR 768 million, bringing total disbursements under the program to SDR 9.031 billion (about €9.32 billion or about US$12.60 billion.

Background

Before the current crisis, the Romanian economy was characterized by high growth rates, associated with the build-up of external and internal imbalances. Large capital inflows stimulated domestic demand, while labor constraints and rising public sector wages generated wage inflation. Fiscal policy was pro-cyclical, exacerbating the overheating of the economy despite tight monetary policy to counteract price pressures. The rapid development of the banking system came with vulnerabilities to outside liquidity shocks and foreign exchange risks. The global economic and financial crisis hit Romania hard in late 2008 and 2009. Capital inflows dried up, exports plunged, and country risk indicators skyrocketed. As a result of the sharp contraction in domestic demand, GDP plummeted and the current account deficit fell markedly. Although banks generally entered the crisis well capitalized, they faced rising NPLs, a dried up interbank market and limited access to external sources of funds. The country's large fiscal deficit constrained the fiscal policy response to the crisis.

In early 2009 authorities put together a policy package supported by financing from the Fund, the EU, and the World Bank. The program included (i) fiscal consolidation accompanied by structural reforms to restore fiscal sustainability and boost market confidence, (ii) steps to further strengthen the resilience of the financial sector and to obtain commitments from foreign parent banks to maintain their Romanian subsidiaries capitalized and liquid, and (iii) prudent monetary policy management to reduce inflation. The program has contributed to stabilizing the economy and alleviating financing pressures. Economic activity remained weak throughout 2009 (declining by 7.1 percent), but exchange rate pressure eased, the country risk premium narrowed significantly, and financial sector stress eased. While for 2010 as a whole growth is forecast to be slightly negative, a gradually recovery is expected in the second half of the year. Domestic demand will remain subdued, as unemployment continues to rise and real wages adjust to the recession with a lag, while investment will pick up slowly. The contribution of net exports is forecast to remain positive but limited in 2010. Beyond 2010, GDP should recover, with growth forecast to rise to around 3½ percent in 2011 and to the range of 4-4½ percent per year in the medium-term.

Executive Board Assessment

Executive Directors agreed with the thrust of the staff appraisal. They noted that despite one of the largest economic downturns in Europe, the Romanian authorities have made significant strides toward restoring macroeconomic stability and achieving an orderly adjustment of pre-crisis imbalances. They noted, however, that important challenges remain in ensuring that the economic and policy adjustments are sustainable. They encouraged the authorities to carry through with planned structural reforms to secure a sustainable fiscal position, boost potential growth, and reinforce the economy's resilience to shocks.

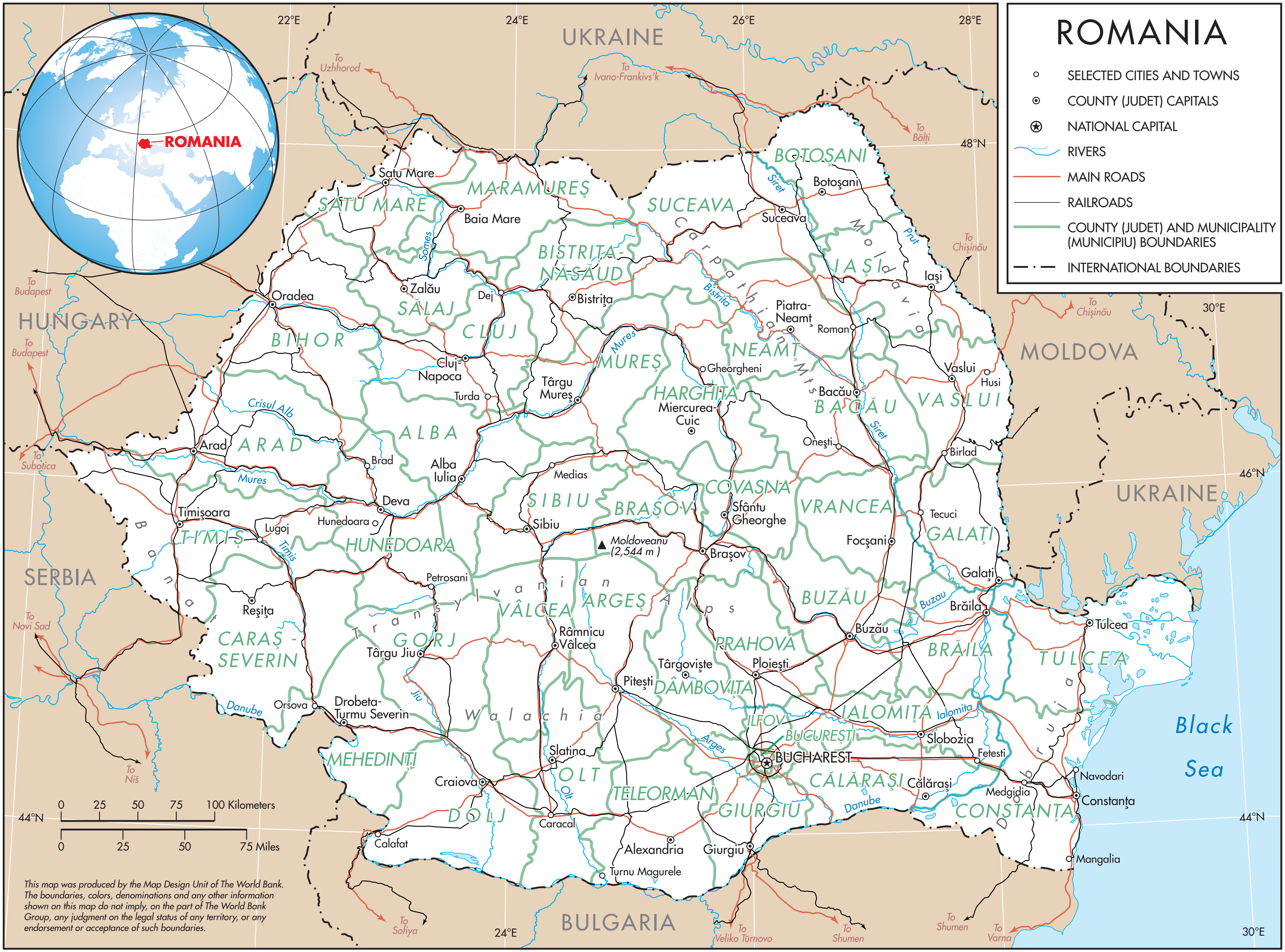
Directors commended the authorities' strong adjustment effort this year as an appropriate response to the near-term challenges posed by the sharp deterioration in the fiscal position. They agreed with the authorities' approach of balancing the adjustment between expenditure cuts and tax increases, by way of cushioning the social impact of the adjustment while decisively tackling the large public wage bill. . Directors also supported the proposed relaxation of the 2010 deficit target to accommodate the cyclical deterioration in the fiscal position since the last review.

Directors stressed that the sustainability of the targeted fiscal adjustment can only be secured if supported by structural reforms. They welcomed the recent approval of the fiscal responsibility legislation, and encouraged the authorities to complete the reforms of the pension and the public compensation systems. Other important reforms are the planned reductions in public employment, reforms of the healthcare system and of the local government finances, and efforts to boost tax collections. These reforms would ensure that the deficit remains on a downward path in the medium term.

Directors also emphasized that structural reforms in other areas, such as labor and product markets, are also crucial in building the economy's competitiveness and resilience. They would also help prepare Romania for an eventual euro adoption by ensuring that the economy can handle shocks without the support of monetary and exchange rate policies.

Directors commended the authorities for vigilant monetary and financial sector policies. They viewed the moderate pace of monetary easing as appropriate in striking a balance between the need to support the economy and to contain exchange rate pressures. They agreed that, while there may be room for further easing in the near future, a cautious approach remains warranted given inflation risks and regional uncertainties. Directors welcomed the authorities' proactive approach towards banking supervision and regulation, and called for continued vigilance in view of the unsettled regional situation and the deteriorating quality of the loan portfolio.

Contact: Mr. Jeffrey R. Franks, Mission Chief for Romania. Phone: 202 623 6347.



This map was produced by the Map Design Unit of The World Bank. The boundaries, colors, denominations and any other information shown on this map do not imply, on the part of The World Bank Group, any judgment on the legal status of any territory, or any endorsement or acceptance of such boundaries.

FEBRUARY 2008

IBRD 33469R2