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Assessment of the 2020 Convergence Programme for

Romania

(Note prepared by DG ECFIN staff)

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Executive Summary

- On 6 April 2020, the Commission provided guidelines to the Economic and Financial Committee on how the format and content of the 2020 Stability and Convergence Programmes can be streamlined in light of the exceptional circumstances related to the Covid-19 pandemic. This assessment takes into account the severe constraints that Member States faced in providing the information usually required in their Programmes. The assessment focuses on the near term in light of the high uncertainty attached to the projections.
- The Programme estimates a 1.9% contraction of real GDP in 2020 and a return to close to potential growth over the medium term, while not providing an estimate for 2021. The Commission 2020 spring forecast expects a more significant contraction of 6% in 2020, followed by a 4.2% increase in 2021. The difference stems from more optimistic assumptions regarding the negative impact of the lockdown in the Programme.
- The Programme projects the general government deficit to increase to 6.7% of GDP in 2020, from 4.3% of GDP in 2019. The Commission 2020 spring forecast projects a general government deficit of 9.2% of GDP in 2020. The difference stems, in particular, from the difference in underlying macroeconomic projections and from the fact that a relative moderation of some current spending items in the Programme is not fully supported by enacted measures.
- The Programme includes expenditure measures taken in response to the COVID-19 outbreak of a cumulative budgetary impact of 1.2% of GDP in 2020, notably for technical unemployment and related benefits, out of which 0.4% of GDP financed by additional EU transfers. Moreover, the authorities adopted measures to support the liquidity of companies and individuals: in the field of taxation, a loan guarantee for SMEs and a possibility of bank loan deferrals.
- The Programme also incorporates significant pension increases beyond the standard pension indexation mechanism, adopted in summer 2019. They are set to significantly increase public spending and thus fiscal deficits in 2020 and beyond.
- The macroeconomic and fiscal outlook are affected by high uncertainty due to the outbreak of the COVID-19 pandemic. Moreover, further downward risks to the budget targets stem from the underlying unrealistic macroeconomic projections and the possible overestimation of some revenues and underestimation of some current expenditure items.

1. INTRODUCTION

This document assesses the economic and budgetary projections contained in the 2020 Convergence Programme of Romania for 2020[1] (hereafter called the Programme), which was submitted on 14 May 2020, after the deadline of 30 April established by the Regulation. The government approved the Programme on 14 May 2020.

Romania is currently subject to the corrective arm of the SGP. The Council opened the Excessive Deficit Procedure for Romania on 3 April 2020. The country is recommended to correct the excessive deficit by 2022.

On 20 March 2020, the Commission adopted a Communication on the activation of the general escape clause of the Stability and Growth Pact. The clause, as set out in Articles 5(1), 6(3), 9(1) and 10(3) of Regulation (EC) 1466/97 and Articles 3(5) and 5(2) of Regulation (EC) 1467/97, facilitates the coordination of budgetary policies in times of severe economic downturn. In its Communication, the Commission shared with the Council its view that, given the expected severe economic downturn resulting from the COVID-19 outbreak, the current conditions permit the activation of the clause. On 23 March 2020, the Ministers of Finance of the Member States agreed with the assessment of the Commission. The activation of the general escape clause allows for a temporary departure from the adjustment path towards the medium-term budgetary objective, provided that this does not endanger fiscal sustainability in the medium term. For the corrective arm, the Council may also decide, on a recommendation from the Commission, to adopt a revised fiscal trajectory. The general escape clause does not suspend the procedures of the Stability and Growth Pact. It allows Member States to depart from the budgetary requirements that would normally apply while enabling the Commission and the Council to undertake the necessary policy coordination measures within the framework of the Pact.

Romania is among those Member States who have triggered national escape clauses to suspend budgetary constraints set by their national fiscal rules, as part of the effort to accommodate the budgetary implications of the outbreak.

2. MACROECONOMIC DEVELOPMENTS

In 2019, economic activity expanded by 4.1% supported by private consumption and a rebound in investment. For 2020, the Programme's macroeconomic scenario assumes a negative economic impact of the coronavirus crisis lasting 4 months (from March until June), followed by a partial recovery over July-September that builds up in the last quarter of 2020. This results in a projected 1.9% contraction of real GDP in 2020. This is a downward revision of projected GDP growth by 7.6 percentage points compared to the 2019 Convergence Programme. For 2021, the Programme does not give an estimate but projects growth to return close to potential, at around 3-4%, over the medium term.

[1] The Convergence Programme contains only short-term budgetary projections, in line with the guidelines for a streamlined format of the 2020 Stability and Convergence Programmes in light of the COVID-19 outbreak, provided by the Commission services on 6 April 2020.

The manufacturing and services sectors are expected to make sizeable negative contributions to growth. Private consumption, which expanded by 5.9% in 2019 in real terms, is expected to moderately decline, by 0.7% in 2020. After very strong growth in 2019, investment is projected to decrease by 2.6% in 2020 amid heightened uncertainty. Exports are forecast to contract somewhat more than imports. The slight reduction in the deficit of the trade balance is expected to result in a small correction of the current account deficit. The measures adopted by the government to support household income as well as businesses' liquidity, notably through loans guarantees for SMEs, are expected to limit the economic downturn and support the recovery. On the other hand, any delays in the exit from the lockdown beyond June are expected to have a more pronounced impact on economic activity.

The state of emergency was declared in Romania on 16 March for a period of 30 days and was subsequently extended by another month. The movement of the population was substantially restricted, border and travel restrictions were introduced, non-essential shops, bars, restaurants were closed. Teleworking arrangements were made operational for private companies and part of the public sector.

The real GDP decline projected in the Programme for 2020 is significantly lower than the contraction of 6% projected in the Commission 2020 spring forecast. This is mostly due to more optimistic assumptions regarding the negative impact of the lockdown in the Programme. The inflation projections for 2020 in the Programme are somewhat higher than in the Commission's spring 2020 forecast.

The economic growth assumptions in the Programme are subject to a high degree of uncertainty. Downward risks to the macroeconomic outlook stem from a possible second wave of infections towards the end of 2020, a delayed restart of economic activity as well as the small fiscal buffers available to support economic activity over a longer period of time.

In its opinion on the 2020 budget amendment of 17 April 2020, the Romanian Fiscal Council concluded that the 1.9% decline in real GDP expected for 2020 was very optimistic. According to the Fiscal Council, two additional macroeconomic scenarios should be considered for 2020: one assuming a contraction of real GDP of 4% to 6% and a more pessimistic scenario assuming a GDP contraction of 8% to 9%.

Table 1: Comparison of macroeconomic developments and forecasts

	2019		2020		2021	
	COM	CP	COM	CP	COM	CP
Real GDP (% change)	4.1	4.1	-6.0	-1.9	4.2	n.a.
Private consumption (% change)	5.9	5.9	-6.2	-0.7	4.9	n.a.
Gross fixed capital formation (% change)	18.2	18.2	-15.0	-2.6	5.0	n.a.
Exports of goods and services (% change)	4.6	4.6	-12.8	-6.7	9.9	n.a.
Imports of goods and services (% change)	8.0	8.0	-14.4	-5.6	9.8	n.a.
Contributions to real GDP growth:						
- Final domestic demand	8.7	8.6	-6.9	-0.6	4.4	n.a.
- Change in inventories	-2.9	-2.9	-0.3	-1.0	0.0	n.a.
- Net exports	-1.7	-1.7	1.2	-0.3	-0.3	n.a.
Output gap[1]	0.5	0.6	-8.0	-4.4	-6.6	n.a.
Employment (% change)	-0.1	n.a.	-2.5	n.a.	0.6	n.a.
Unemployment rate (%)	3.9	n.a.	6.5	n.a.	5.4	n.a.
Labour productivity (% change)	4.1	n.a.	-3.6	n.a.	3.5	n.a.
HICP inflation (%)	3.9	3.9	2.5	2.9	3.1	n.a.
GDP deflator (% change)	6.9	6.9	2.3	4.1	2.5	n.a.
Comp. of employees (per head, % change)	8.9	n.a.	2.6	n.a.	4.8	n.a.
Net lending/borrowing vis-à-vis the rest of the world (% of GDP)	-3.1	n.a	-1.7	n.a	-1.7	n.a.

Note:

[1]In % of potential GDP, with potential GDP growth recalculated by Commission services on the basis of the programme scenario using the commonly agreed methodology.

Source :

Commission 2020 spring forecast (COM); Convergence Programme (CP).

3. RECENT AND PLANNED BUDGETARY DEVELOPMENTS

3.1. DEFICIT AND DEBT DEVELOPMENTS AND TARGETS

In 2019, the general government deficit rose to 4.3% of GDP from 2.9% in 2018. The increase was driven by higher current expenditure, in particular on public wages, intermediate consumption and social benefits. Additionally, public investment rebounded from the very low levels of previous years. The 2019 deficit outcome was much higher than the 2.8% of GDP targeted for 2019 in the 2019 Convergence Programme. The difference is driven by the revenue side, in particular by lower revenue from social contributions than originally planned.

For 2020, Romania targets a general government deficit of 6.7% of GDP. Revenues are projected to decrease by 1.0 percentage point of GDP compared to 2019, while expenditures are projected to increase by 3.5 percentage points of GDP including due to the cost of automatic stabilisers. The Programme includes expenditure measures taken in response to the COVID-19 outbreak of a cumulative budgetary impact of 1.2% of GDP, notably for subsidies (technical unemployment), out of which 0.4% of GDP are to be financed by additional EU transfers (according to the information in the 2020 budget amendment of 17 April 2020). Moreover, social transfers are set to increase considerably (by 1.4 percentage points of GDP), due to the significant increases to old-age pensions enacted before the COVID-19 crisis. The measures are described in detail in section 3.2 below.

The 2020 deficit target of 6.7% of GDP is lower than the 9.2% of GDP projected in the Commission forecast. The difference stems, in particular, from a difference in underlying macroeconomic projections and the fact that a relative moderation of some current spending items is not fully supported by enacted measures.

The general government debt is planned in the Programme to increase from 35.2% of GDP in 2019 to 40.9% of GDP in 2020, driven by government deficit and nominal GDP developments. [2]

[2] In light of the activation of the general escape clause, the measures taken in response to the coronavirus outbreak in 2020 are not treated as one-off and are thus not excluded from the estimation of the structural budget balance.

Table 2: General government budgetary position

(% of GDP)	2019	2020		2021	
	COM	COM	CP	COM	CP
Revenue	**31.7**	**32.3**	**32.7**	**32.2**	**n.a.**
of which:					
- Taxes on production and imports	10.6	10.2	10.5	10.3	n.a.
- Current taxes on income, wealth, etc.	4.8	4.6	4.8	4.7	n.a.
- Social contributions	11.3	11.7	11.5	11.6	n.a.
- Other (residual)	5.0	5.8	5.9	5.6	n.a.
Expenditure	**36.0**	**41.5**	**39.5**	**43.5**	**n.a.**
of which:					
- Primary expenditure	34.8	40.0	38.1	41.8	n.a.
of which:					
Compensation of employees+Intermediate consumption	16.6	18.3	17.2	18.0	n.a.
Compensation of employees	11.2	12.5	11.6	12.2	n.a.
Intermediate consumption	5.4	5.9	5.6	5.8	n.a.
Social payments	11.8	14.4	13.2	16.8	n.a.
Subsidies	0.4	1.2	1.2	0.4	n.a.
Gross fixed capital formation	3.4	3.3	3.7	4.0	n.a.
Other (residual)	2.5	2.9	2.7	2.5	n.a.
- Interest expenditure	1.2	1.5	1.4	1.7	n.a.
General government balance (GGB)	**-4.3**	**-9.2**	**-6.7**	**-11.4**	**n.a.**
Primary balance	**-3.1**	**-7.8**	**-5.4**	**-9.6**	**n.a.**
One-off and other temporary measures	-0.1	0.0	0.0	0.0	n.a.
GGB excl. one-offs	**-4.2**	**-9.2**	**-6.7**	**-11.4**	**n.a.**
Output gap[1]	0.5	-8.0	-4.4	-6.6	n.a.
Cyclically-adjusted balance[1]	-4.4	-6.7	-5.2	-9.2	n.a.
Structural balance[2]	**-4.3**	**-6.7**	**-5.2**	**-9.2**	**n.a.**
Structural primary balance[2]	-3.1	-5.2	-3.8	-7.5	n.a.
Gross debt ratio	**35.2**	**46.2**	**40.9**	**54.7**	**n.a.**

Notes:

[1]Output gap (in % of potential GDP) and cyclically-adjusted balance according to the programme as recalculated by Commission on the basis of the programme scenario using the commonly agreed methodology.

[2]Structural (primary) balance = cyclically-adjusted (primary) balance excluding one-off and other temporary measures.

Source :

Convergence Programme (CP); Commission 2020 spring forecasts (COM); Commission calculations.

3.2. MEASURES UNDERPINNING THE PROGRAMME

In order to support employment, the government introduced a technical unemployment benefit scheme for companies that send their employees home and suspend activity due to the COVID-19 crisis. The authorities introduced similar benefits for those who cannot claim technical unemployment, such as the self-employed. Finally, the government introduced a benefit for parents who cannot work remotely and have to stay home with children.

In order to support the liquidity of companies, the government sped up VAT reimbursements, deferred payment of local taxes and temporarily suspended forced execution of tax obligations due to the state budget. These measures should have no significant budgetary impact on the whole 2020 but can help address temporary liquidity problems. The government also introduced a rebate for taxpayers who nevertheless paid their corporate income tax by the statutory April 25 deadline

The authorities also established guarantees of up to RON 15 billion to SMEs for contracting loans for financing investment and working capital. The government also approved laws allowing loan payment deferral by up to 9 months for debtors affected by the coronavirus crisis and a deferral of rent and utility bills for SMEs.

Overall, the measures taken by the government of Romania are in line with the guidelines set out in the Commission Communication on a coordinated economic response to the COVID-19 outbreak.[3] They are timely, temporary and targeted. The full implementation of those measures, followed by a refocusing of fiscal policies towards achieving prudent medium term fiscal positions when economic conditions allow, will contribute to preserving fiscal sustainability in the medium term. They are included in the Commission 2020 spring forecast with a broadly similar fiscal impact. However, their potential scope is constrained by limited budgetary space, given that the general government deficit was already high before the COVID-19 outbreak. Moreover, there are concerns regarding the predictability and regulatory clarity of the measures. For example, the government and the parliament passed competing measure packages. The parliament package, initiated by the opposition, has been challenged at the Constitutional Court on procedural grounds. There are also concerns related to the administrative capacity of implementing the measures.

The Programme also incorporates significant pension increases beyond the standard pension indexation mechanism, adopted in summer 2019. Pensions are due to increase by 40 % in September 2020 and be additionally recalculated upward in September 2021, to match a new formula of calculation of new pensions. Due to this implementation schedule, the pension law is set to significantly increase public spending and thus fiscal deficits. Based on the long-term projections in the Programme, spending on public pensions is set to increase from 8.0% of GDP in 2016 to 8.9% of GDP in 2020 and 11.8% in 2025.

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[3] https://ec.europa.eu/info/sites/info/files/communication-coordinated-economic-response-covid19-march-2020_en.pdf

Table 3: Discretionary measures adopted or announced in response to COVID-19 outbreak

List of measures	Description	ESA Code (Expenditure / Revenue component)	Adoption Status	Budgetary impact in 2020 (% of GDP)	
	Risk incentive for employees in the health sector working with patients infected with COVID-19	D.1: compensation of employees	adopted		0.05
	Unemployment benefits for parents that stay at home with their children because the schools are closed due to government decision	D.3: Subsidies	adopted		0.1
	Technical unemployment benefit	D.3: Subsidies	adopted		0.6
	Benefits for those who cannot claim technical unemployment, such as the self-employed.	D.3: Subsidies	adopted		0.2
	Medical equipment and other expenditures to help fight COVID-19	P.51: Gross fixed capital formation	adopted		0.1
	Medical equipment and other expenditures to help fight COVID-19	P.2: Intermediate consumption	adopted		0.2
				Total	**1.2**

Source: 2020 Convergence Programme. The budgetary impact reported in RON in the Programme converted into % of GDP based on the nominal GDP projections in the Programme.

Table 4: Guarantees adopted or announced in response to COVID-19 outbreak

List of measures	Description	Adoption Status	Maximum amount of contingent liability* (% of GDP)	
	IMM invest – loan guarantees to SMEs	adopted		1.4

Source: 2020 Convergence Programme. The maximum amount of contingent liability reported in RON in the Programme converted into % of GDP based on the nominal GDP projections in the Programme.

3.3. Risk assessment

The macroeconomic and fiscal outlook are affected by high uncertainty due to the outbreak of the COVID-19 pandemic. The pandemic could become more severe and last longer than assumed, requiring more stringent and longer lasting containment measures. This would result in worse economic and fiscal outcomes. It could also require further fiscal policy measures. That would result in worse fiscal outcomes but help to mitigate the economic impact. An additional risk stems from the considerable size of public guarantees issued in response to the crisis.

Moreover, further downward risks to the achievement of the Programme targets stem from the underlying favourable macroeconomic projections and the possible overestimation of some revenues and underestimation of some current expenditure items. The Romanian Fiscal Council, in its opinion on the 2020 budget amendment of 17 April, considers that the underlying macroeconomic scenario, based on -1.9% real GDP growth, is very optimistic (see Section 2 above). Even so, based on this scenario, the Fiscal Council evaluates the 2020 budget deficit at about 7.3%-7.45% of GDP (as opposed to the 6.7% deficit estimated by the government), due to overestimated revenues and underestimated expenditures in the budget amendment.

4. Compliance with the provisions of the Stability and Growth Pact

4.1. Compliance with the deficit criterion

On 3 April 2020, the Council decided that an excessive deficit existed in Romania due to non-compliance with the deficit criterion in 2019. The decision was based on the updated fiscal targets by the government, which reflected the budget execution data for the year to–date. The 2019 general government deficit outturn of 4.3% of GDP confirmed the breach. The breach was the result of an expansionary fiscal policy since 2016, in the period of strong economic growth. The Council issued a recommendation with a view to bringing an end to the situation of an excessive deficit by 2022 at the latest. The recommendation set a deadline of 15 September 2020 to take effective action. To date, the authorities have taken fiscal policy measures to contain the negative socio-economic effects of the COVID-19 outbreak but have not yet started to address the unfavourable structural trends in Romania’s public finances that preceded the COVID crisis. In particular, the 2020 budget amendment adopted in April has retained the allocation for the 40% permanent pension increase scheduled to enter into force in September 2020.