



GOVERNMENT OF ROMANIA

CONVERGENCE PROGRAMME

2016-2019

- April 2016 -

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INTRODUCTION

The updated 2016 version of the 2016 - 2019 Convergence Programme was based on the EC Council Regulation 1466/1997 on strengthening the supervision of budgetary positions and the supervision and coordination of economic policies, as amended in EC Council Regulation 1055/2005 and EU Regulation 1175/2011 of the European Parliament and the Council.

The Convergence Programme is in accordance with the Code of Conduct regarding the specifications for the implementation of the Stability and Growth Pact and the Indicative Guidelines for the format and contents of the Stability and Convergence Programmes of September 3, 2012.

The submission of the Convergence Programme by the Member States, and the assessment thereof by the European Commission, is a component of the “European Semester” that relates to strengthening the economic, structural and budgetary policies. The European Semester is the Europe 2020 Strategy’s main instrument, the preventative instrument of the Stability and Growth Pact (amended by the 6-regulation pack which came into effect on December 13, 2011), and of the *Macroeconomic Imbalance Procedure* and *Euro Plus Pact*.

In 2015, the structural deficit of the Romanian general government was 0.3% of GDP, which is in line with the provisions of the Stability, Coordination and Governance Pact of the Economic and Monetary Union requiring the observance of the medium term objective (MTO). Romania achieved the MTO 1% of GDP target in 2014, earlier than expected.

The European Commission in the thorough review included in the country report stated as a fact that Romania is not facing macroeconomic imbalances. However, a number of risks associated with the net investment position was identified, initiatives of the Parliament which may impact the banking system and pro-cyclical fiscal policies.

The 2016 Convergence Programme has been based on the provisions included in the Fiscal and Budgetary Strategy and the macroeconomic framework as updated for 2016-2018. The current country-wide budget planning estimates a budget deficit according to ESA of 2.9% of GDP for the years 2016 and 2017. In addition, a deviation from MTO is expected in 2016 and 2017, mainly as a result of the tax and duty cuts approved in the new Fiscal Code and the wage increases or social assistance entitlements approved back in 2015.

The Government of Romania sticks to its commitment to join the Euro currency area. An exact date is to be set after a timetable for joining the Euro is prepared; the timetable will be completed before the release of the next updated convergence programme, taking into account the achievement of nominal and real convergence criteria. The commitment to adopt the Euro is still an important anchor to promoting the budget and structural reforms required to boost the Romanian economy's resilience.

In terms of real convergence, which is assessed based on the gap from the European gross domestic product (GDP) average per capita expressed as the purchasing power standards (PPS), Romania has made a significant progress in the past couple of years, and reached at about 55% as against the EU-28, compared to 52% in 2010. In line with the economic developments described herein, the real convergence in Romania will reach close to 65% in 2018, with prospects showing that in 2020 the gross domestic product per capita in terms of PPS could account for 70% of the European average.

Table 1 - Annual average GDP growth rate in 2010 – 2015 (%)

	UE28	Romania
Real growth	1.1	1.8
Deflator	1.8	3.7
Nominal growth	3.0	5.7
GDP per capita growth of PPS (2010-2014) (Purchasing Power Standard)	2.4	5.0

Source: Eurostat and the National Prognosis Commission

1. ECONOMIC POLICY FRAMEWORK

1.1. ECONOMIC POLICY BACKGROUND

In accordance with the Ruling Strategy, the medium term economic strategy of the Government is directed towards promoting competitiveness and employment, continuing structural reforms, improving EU funds absorption, consolidating the public finance starting with 2018 and the financial stability.

Over the recent years, Romania has made significant steps towards reducing macroeconomic imbalances, which in conjunction with the monetary policies and the structural reforms, either implemented or in progress, helped preserving the macroeconomic and financial stability. In the aftermath of the financial crisis, Romania saw a slight economic improvement, with annual hikes of below 1%, but after that, in 2013-15, GDP growth went back to its annual rate of 3.4%. The unemployment remained flat in the recent years, below 7%, with investments picking up to an annual growth rate of 17.6% in the last quarter of the previous year. Despite all this, Romania has one of the highest poverty or social exclusion rates in EU (40.2%, compared to 24.4% in EU-28 in 2014).

While actually trending down, the poverty rate among employed people remains the highest in the EU.¹ In addition, high discrepancies still exist between rural and urban areas, Romania facing extremely high poverty risks, social exclusion risks, and uneven income. In the rural areas, the poverty and social exclusion rate is twice as high as in the cities, i.e. 55% compared to 27.9%². In this context, the Government has committed in February 2016 to an “Integrated Poverty Fighting Package”, that is the intervention priorities consolidated into a plan of 47 measures as a move to make a significant progress in fighting poverty. All these factors slow down the economy's growth potential.

The Government's fiscal policy is focused on providing an encouraging and non-biased environment, at the same time considering the measures to improve transparency, stability and predictability of the fiscal policy. Moreover, the sustainable evolution of the public finance is of the most importance, considering the adverse demographic outlook.

Starting with the second half of 2014, Romania implemented a number of fiscal policy measures to cut taxes as a move to give an impulse to the economic growth. A first relaxation measure was to reduce the tax wedge by cutting social insurance contributions by 5 percentage points; the measure became effective in October 2014. Lower VAT rates were gradually introduced for several categories of goods: bread and bakery (9% as of September 2013); food products (9% as of June 2015) and books and cultural services (5% as of January 2016). In addition, in January 2016 the standard VAT rate dropped from 24% to 20% with the implementation of the new Fiscal Code. The lower VAT rates encouraged consumption and investments with an impact on the short term economic growth.

¹ As regards the employed, the poverty and social exclusion rate was 31.3% in 2014.

² Overall, the gap in EU is only 3 percentage points between rural and urban areas.

Another measure with a positive impact on the disposable income of the population, included in the Fiscal Code, is the increase of personal allowances for the personal income tax purposes, based on the number of the dependents. In addition to all these measures, the revised Fiscal Code provides for a substantial change when it comes to the dividend tax, that dropped from 16% to 5% effective as of January 2016. Moreover, starting this year the micro-businesses with more than 2 employees are allowed a significant turnover tax cut, i.e. from 3% to 1%.

1.2. MONETARY AND EXCHANGE RATE POLICIES

Monetary and exchange rate policies

In compliance with its Statute³, the primary objective of the National Bank of Romania (NBR) is to ensure and maintain price stability, which is the best contribution monetary policy can make to sustainable economic growth. The NBR monetary policy is designed and implemented in the context of inflation targeting⁴, which coexists with a managed floating regime. This exchange rate regime allows for a flexible response to the shocks that may hit the economy, while being compatible with using inflation targets as nominal policy anchors for monetary policy.

According to its current institutional characteristics, the NBR's monetary policy is consistently geared towards attaining the flat inflation target of 2.5 percent ± 1 percentage point⁵, compatible with the definition of medium-term price stability for the Romanian economy, as well as towards bringing down the annual inflation rate in the longer run to levels compatible with the European Central Bank's quantitative definition of price stability.

In 2015, tailoring the monetary policy stance from such a perspective called for two distinct manners of reaction of the central bank. In particular, during the first months of the year the NBR continued to cut the policy rate in prudent steps and to change the parameters of some of its instruments, before halting their adjustment at mid-year and maintaining a status-quo thereafter.

Behind the central bank's approach in the first part of 2015 stood the annual inflation rate falling steadily below the lower bound of the variation band of the flat target in 2014 Q4⁶ and the early months of 2015 (to a new historical low⁷ of 0.4 percent in February) and especially the further downward revision of its projected path, which implied its remaining below the mid-point of the target even on the medium term. In the near run, the change in

³ Law 312 of 2004.

⁴ The NBR adopted inflation targeting in August 2005.

⁵ The NBR adopted the multi-annual flat inflation target of 2.5 percent ± 1 percentage point since December 2013. Previously, the inflation targeting strategy had been characterized by gradually decreasing annual (Dec./Dec.) inflation targets set for two-year horizons. These targets had been lowered from 7.5 percent ± 1 percentage point in 2005 to 3.0 percent ± 1 percentage point in 2011, while for 2010 and 2012 they had been left unchanged from a year earlier, i.e. 3.5 percent ± 1 percentage point and 3 percent ± 1 percentage point respectively.

⁶ Annual inflation rate fell to 0.83 percent in December 2014.

⁷ In 25 years.

the inflation outlook was driven primarily by the relative decline in current and projected levels of fuel price and volatile food price dynamics, to which added subsequently the strong transitory impact expected to come from broadening, as of 1 June 2015, the scope of the reduced VAT rate to all food items, non-alcoholic beverages and food service activities^{8,9}.

Over the longer term, the decline in projected inflation¹⁰ stemmed, however, from the downward adjustment of inflation expectations and of euro area/EU inflation forecast, and hence of the projected dynamics of import prices. Their effects were seen more than offsetting those induced by the faster narrowing and the relatively earlier closing of the forecasted negative output gap (towards the end of 2016), amid (i) maintenance of stimulative real monetary conditions, coupled with a relatively improved monetary policy transmission, (ii) a rise in households' real disposable income, also as a result of introducing the reduced VAT rate for all food items, (iii) the return to a slightly countercyclical fiscal policy stance, and (iv) a strengthened recovery of the euro area/EU economy.

Against this backdrop, the NBR extended the prudent rate-cutting cycle¹¹ January through May 2015 - lowering the policy rate in four successive steps of 25 basis points each, down to 1.75 percent¹² - with a view to ensuring price stability over the medium term consistent with the flat inflation target of 2.5 percent ± 1 percentage point in a manner supportive of economic growth, also via the recovery of lending. In complement, the central bank continued to progressively narrow (in steps of ± 25 basis points) the symmetrical corridor of interest rates on the standing facilities around the policy rate to ± 1.5 percentage points. In the context of preserving adequate liquidity management in the banking system, the measure was aimed at reducing interbank money market rate volatility and consolidating the transmission of the policy rate signal, also considering a possible increase in banks' structural liquidity surplus, chiefly on the back of Treasury's operations associated with the use of EU funds. Also, the NBR lowered in May 2015 the minimum reserve requirement ratio on leu-denominated liabilities of credit institutions by another 2 percentage points¹³ to 8 percent, so as to support the sustainable recovery of lending and to continue the harmonisation of the reserve requirement mechanism with the standards and practices of the European Central Bank.

The rise in volatility on international financial markets and in the uncertainty surrounding Romania's agreements with international institutions, posing risks to the leu exchange rate,

⁸ This measure, adopted on 7 April, provided for the reduction in the VAT rate to 9 percent, from 24 percent, for goods and services whose prices account for 81 percent of the prices under "food items, non-alcoholic beverages and food service activities" in the consumer basket.

⁹ In this context, the annual inflation rate appeared set to fall into negative territory at the end of 2015 Q2 and remain there for about 12 months.

¹⁰ In the May forecasting round, the annual inflation rate projected for December 2016 dropped to 1.9 percent, from 2.4 percent envisaged in the February 2015 round.

¹¹ The NBR had resumed this cycle in August 2014, with the policy rate being cut in three successive steps of 25 basis points each, down to 2.5 percent (November 2014).

¹² The cumulated cuts over the past 10 months equalled 1.75 percentage points.

¹³ Starting with the 24 May-23 June 2015 maintenance period.

in conjunction with the relatively faster narrowing of the negative output gap¹⁴ and increase in unit wage costs in the first half of the year, called however for reconsidering the monetary policy cycle at mid-2015. This was later on further substantiated by the nature and size of the fiscal easing measures set to be implemented starting in 2016 (according to the new Tax Code¹⁵) and by the wage hikes for certain budgetary employees in 2015 H2, likely to widen considerably the divergence between short-term and longer-term inflation outlook.

Specifically, in view of the ample transitory disinflationary effects expected to be exerted by the new indirect tax reductions, especially the standard VAT rate cut, the annual inflation rate was seen moving deeper¹⁶ into negative territory in the first months of 2016 and remaining below the lower bound of the variation band of the flat target until year-end. However, after the fading out of the one-off impact of the main fiscal measures, stronger inflationary pressures were becoming conspicuous. They were expected to arise from further fast growth of unit wage costs and particularly from the earlier reversal of the economy's cyclical position (mid-2016) and the subsequent relatively swifter increase in excess demand, amid fiscal and income policies easing, as well as the consolidation of lending¹⁷; under the circumstances, the forecasted annual inflation rate was moving into the upper half of the variation band of the flat target in early 2017.

The divergent nature of the forecasted inflation pattern became more pronounced at the beginning of 2016¹⁸, on account of the relative intensification of underlying inflationary pressures anticipated to emerge over the medium term, with the projected trajectory of annual inflation rate staying, however, in the upper half of the variation band of the flat target over the remainder of the projection horizon¹⁹. Concurrently, the uncertainties and mixed risks to the medium-term inflation outlook grew, with the most significant ones stemming from (i) the content and implementation of the future unified wage law for

¹⁴ Amid the significant pick-up in growth in 2015 Q1, fuelled by stronger final consumption and investment, and the emerging signs of a further uptrend of the economy, except the agricultural sector, in Q2.

¹⁵ The revised version of the new Tax Code, adopted by the Parliament of Romania on 3 September 2015, set forth: (i) the cut in the standard VAT rate from 24 percent to 20 percent as of 1 January 2016 and to 19 percent as of 1 January 2017; (ii) the removal of the special excise duty on fuels as of 1 January 2017; (iii) the lifting of the tax on special constructions and the cut in the dividend tax from 16 percent to 5 percent as of 1 January 2017; (iv) other adjustments in the excise duties on tobacco products. The Code was, however, subsequently amended via Government Emergency Ordinance No. 50 of 27 October 2015, which approved the implementation, as of 1 January 2016, of the following measures: the cut in the dividend tax, the broadening of the scope of the reduced 9 percent VAT rate to potable water delivery services, and the reduction of the income tax for micro-enterprises with hired workers.

¹⁶ In line with the previous forecasts, the annual inflation rate went into negative territory in June 2015 and remained there subsequently, coming in at -0.93 percent at year-end.

¹⁷ The annual growth rate of credit to the private sector returned to positive territory in August, solely on account of a faster increase in the leu-denominated component, whose share in total credit exceeded that of foreign currency-denominated loans starting September.

¹⁸ February 2016 Inflation Report.

¹⁹ The annual inflation rate was anticipated to come in at 3.4 percent in December 2017; when recalculated by excluding the one-off impact of the cut by another percentage point in the standard VAT rate (at the beginning of 2017), it stood at 3.7 percent at the end of the projection horizon.

budgetary employees that would considerably augment the fiscal policy easing and generate demonstration effects on private sector wages, through the potential size of wage hikes in the budgetary sector, and from (ii) the heightened uncertainties about global economic growth and international trade generated by the economic slowdown of China and of other major emerging markets.

In response to this context, in July 2015, the NBR put an end to the prudent policy rate-cutting cycle, and in the following months and into early 2016 it kept the policy rate unchanged at 1.75 percent. At the same time, the central bank maintained the existing level of the minimum reserve requirement ratio on leu-denominated liabilities, while further pursuing adequate liquidity management in the banking system. Nevertheless, given the lasting moderation of foreign currency lending, the NBR reduced the minimum reserve requirement ratio on foreign currency-denominated liabilities of credit institutions from 14 percent to 12 percent with a view to further harmonising the minimum reserve requirement mechanism with the standards and practices of the European Central Bank²⁰.

Over the coming period, the main challenge facing monetary policy will be the solid anchoring of inflation expectations in order to ensure and maintain medium-term price stability in a manner that would contribute to sustainable economic growth, in the context of relative compatibility with the monetary policy cycles of central banks in the region and in the euro area. This challenge stems mainly from the recent/expected significant easing of fiscal and income policies, alongside the possible persistence of delays in public investment, structural reforms and EU funds absorption, which could lastingly affect the growth potential and competitiveness of the Romanian economy, especially amid a weaker pace of recovery of the euro area economy and of global economic growth.

Both in the short run and over the longer term, the calibration of the parameters of monetary policy instruments, including the NBR's key interest rate, in the context of ensuring an adequate monetary policy stance, will be correlated mainly with the nature/intensity of pressures on future inflation coming from the cyclical position of the economy – anticipated to see a reversal in mid-2016 –, as well as with the behaviour of medium-term inflation expectations and the risks thereto. An essential part in substantiating the decisions will further play the uncertainties and configuration of the balance of risks associated to the medium-term inflation forecast, including the likelihood of their materialising – with the risk of an additional easing of fiscal and income policies being especially relevant in the present context –, as well as the characteristics of the monetary policy transmission mechanism, implicitly of lending to the private sector and of economic agents' saving/investing behaviour. Particularly important remain the characteristics of the structural reforms and the EU funds absorption, given that preserving the consistency of the macroeconomic policy mix and heightening the economic growth potential are pivotal to

²⁰ The measure was implemented starting with the 24 January - 23 February 2016 maintenance period.

meeting the medium-term price stability objective, as a premise of sustainable and lasting economic growth.

2. ECONOMIC OUTLOOK

2.1. THE ECONOMY AT GLOBAL LEVEL / TECHNICAL ASSUMPTIONS

The EC winter forecast expects 2016 to be the fourth year of economic growth, but the growth will continue at a moderate pace, mainly on the back of consumption. Hence, after an increase of the real GDP of 1.9% in the EU and 1.7% in the Eurozone in 2016, the activity is expected to slightly intensify in 2017 and reach 2% in EU and 1.9% in the Eurozone. Each of these numbers is a downward revision of 0.1 percentage points for EU and the forecast maintained at the same level for the Eurozone compared to the estimates released in the fall of 2015.

The world's economic growth (excluding EU) was expected to go down to 3.2% in 2015, compared to 3.7% in 2014. However, global developments show an improved economic outlook so that the EC forecast counts in 2016 and 2017 on real GDP annual growth rates of 3.6% and 3.8%, respectively.

IMF estimates in the April 2016 World Economic Outlook foresee an increase of the global economy by 3.1% in 2015 and by 3.2% in 2016, to reach 3.5% in 2017. Thus, the growth rate of GDP provided for in this report is lower compared to the January 2016 forecast, against the background of significant uncertainties concerning the asset volatility on the international markets and a slowdown in the growth pace of the countries with more advanced economies. The same developments are forecast for the emerging countries, with, in addition, a pressure generated by non-economic factors that may be a threat to the economic activity. However, despite this less positive picture, the financial markets of the advanced economies showed a real improvement, as early as the first weeks of 2016.

Under the circumstances, an increase of GDP in the advanced economies is expected, by 1.9% in 2016 and 2.0% in 2017. The Eurozone growth is expected to reach 1.5% in 2016 and further to increase in 2017 by 0.1 percentage points.

In Germany, Romania's main commercial partner and the EU economy driver, the economy is positive in 2015 and the following years. Hence, the growth rate of 1.5% in 2015, which accounts for a decrease of 0.1 percentage points compared to 2014, will remain flat in 2016, but it will reach 1.6% in 2017.

In Italy, the second commercial partner of Romania, the economic context shows that, after a GDP drop by 0.3% in 2014, a slight growth of 0.8% is expected in 2015, to be followed by an acceleration of the growth rate to 1% in 2016 and 1.1% in 2017.

France's economy is expected to pick up in 2015, with a 1.1% growth compared to only 0.2% in 2014. The same level as in 2015 is expected in 2016, and it will go up to 1.3% in 2017.

The projection of the Brent oil price was revised downwards, from 50.8\$/barrel in 2015 to 35\$/barrel in 2016. In 2017 a slight increase is expected compared to 2016, with the Brent oil price expected to go up to 41\$/barrel.

Considering the evolution of the global economy in the upcoming period of time, in Romania in the interval 2016-2017 exports of goods are expected to grow annually by 6.4% and imports of goods by 7.9%, in average. After a share to GDP of 5.2% of the FOB-CIF trade deficit in 2015, it is expected to trend up and reach 6.0% in 2016 and 6.3% in 2017.

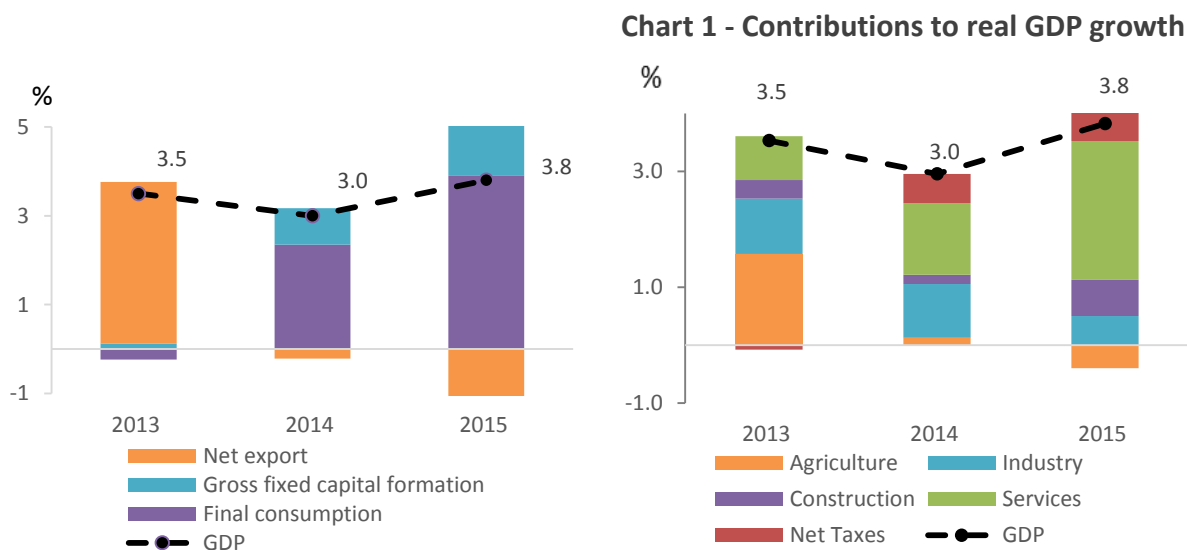
2.2. CYCLICAL DEVELOPMENTS AND CURRENT PERSPECTIVES

2.2.1. CURRENT PERSPECTIVES

In 2015, the fifth year in a row of economic growth (after 1.1% in 2011; 0.6% in 2012; 3.5% in 2013; and 3% in 2014) Romania's economic growth was 3.8%. This increase in 2015 came from the positive contribution of the domestic demand. The main growth factor was the final consumption, with the increase of private consumption by 6.1%, on the backdrop of a low inflation rate, interest rates at historic minimum levels and a significant increase of the real wage. The government consumption went up by 1.8%.

The gross fixed capital formation was, in its turn, an important contribution to the economic growth, showing a hike of 8.8% compared to 2014. Here, the gross fixed capital formation increased by 27.1% in the government sector and by 4.9% in the private sector.

The export of goods and services went up by 5.5%, with imports raising by 9.1%, and the net foreign demand having a negative contribution (1.5 per cent), in particular because of the domestic demand increase that wasn't entirely covered from the domestic output.



Source: National Prognosis Commission

Domestic supply showed an increase of the gross value added in constructions (8.8%), services (4.7 %) and industry (2.0%), with the gross value-added in agriculture going down by 9.4% compared to 2014.

In 2015 Romania had the lowest inflation rate after 1990, with consumer prices dropping as annual average by 0.59%, and at end-December the decrease was 0.93% compared to the end of 2014.

The annual inflation rates were negative starting June last year, under the impact of the extended lower VAT rate of 9% for all food products, non-alcoholic beverages and catering services.

In addition to the above fiscal measures, other negative influences accentuated the decrease in consumer prices, such as the oil quotations on the international markets strongly reflected by the fuel prices, and the good harvest of vegetables and fruits that was not affected by the bad weather.

The annual inflation dropped to 2.98% in March as a result of the lowered VAT rate for the remaining products and services by 4 percentage points, as of January 2016 and the quotation of oil on the international markets.

Compared to December, the consumer prices go down too, by 0,92%, based on the 2.26% cut in the service tariffs and the decrease by 1.60% of non-foods.

In 2015, according to the National Accounts data, employment went down by 0.9% as a result of a substantial decrease in agriculture by 9.2%, industry by 3,5% and constructions by 1.4%, and an increase by 6.3% in the services sector. The number of employees in the economy increased by 2.9%, with 7.2% in services sector and 0.3% in construction sector, while the number of employees in agriculture and industry went down by 3.9% and 3.5%, respectively.

The LFS unemployment rate remained flat in 2015 compared to 2014, i.e. 6.8%.

2.2.2. CYCLICAL DEVELOPMENTS

The potential GDP²¹ will go up in 2016 - 2019 with an annual average rate of 3.9%, against the background of the resumed investments (the dynamics of the gross fixed capital formation - GFCF) in 2014.

At the same time, the accelerated domestic demand - final household consumption, government consumption, public and private investments - will allow the output-gap to close in 2017 and become significantly positive in 2019²².

The contributions of the capital and total factor productivity (TFP) are the main drivers of the potential growth. Since 2013, TFP has been the main growth factor, specific to the development period until 2006 in Romania, which indicates on one hand the improved efficiency in using the production factors and, on the other hand, the structural changes implemented in Romania.

²¹ Calculated based on the DG ECFIN method adopted in the legislation of all MS.

²² If the forecast period is limited to 2017 instead of 2019, the potential growth slows down slightly to 3.2% in 2016 and 3.7% in 2017, which leads to an output-gap of -0.2% in 2016 and 0.4% in 2017.

The capital contribution is positive and trending up too, as a result of some investments (GFCF) expected to grow on the companies and household side once with the increase of the purchase power. The forecast includes the new net investment numbers in 2014, which booked an annual nominal growth of investments in machinery and transport means by 14.1% (while the provisional data indicate a decrease by 6.4%). Provisional data for 2015 show an increase of 11.6%.

The labor contribution (potential number of hours worked) is to see slightly positive values as of 2017, on one hand influenced by the decrease of the population at working age (with a negative and persisting impact on a long term) and on the other hand by the increase of employment due to improvements in activity and employment rates. In addition to all the above there is also the lowered natural rate of unemployment - the non-accelerating wage rate of unemployment - NAWRU. Moreover, the average number of hours worked is trending up, consistently with the economic growth path, but it is linked to the increase of employment, thus preserving the labor productivity terms. Another aspect worth mentioning is that the unemployment gap (the difference between the unemployment rate and NAWRU) closes starting with 2016. Both the unemployment rate and NAWRU go down from 6.7% in 2016 to 6.5% in 2019. This aspect represents a limitation of the medium term growth potential, with the decrease of the natural unemployment rate putting inflation pressures through the non-sustainable growth of the labor cost.

Table 2 – Factor contribution to potential GDP growth

	Potential GDP	Contributions - % -			
		Capital	Labor	TFP	Output Gap
2015	2.9	1.2	-0.3	2.0	-1.2
2016	3.4	1.3	0.0	2.1	-0.4
2017	3.9	1.4	0.2	2.2	0.0
2018	4.1	1.6	0.3	2.2	0.4
2019	4.2	1.7	0.2	2.2	0.9

Source: National Prognosis Commission.

The differences between the potential growth and the sum of contributions, where the case, are the result of rounded-up figures.

2.3. MEDIUM-TERM SCENARIO

The macroeconomic framework of the Converge Programme took into account the following: (i) the provisions of the new Fiscal Code, which are a stimulus to households as well as to investments and business environment; (ii) the wage increases of 2015 with a substantial impact on consumption and investments equally; (iii) the European and global context as defined by the European Commission in its winter forecast, a context featuring many uncertainties and less favorable to speeding up development; (iv) the positive impact

of the lower oil price on the Romanian economy; (v) the economic and social achievements in 2015.

An economic growth of 4.2% was estimated for 2016, which is based exclusively on the domestic demand. In this context, it was estimated that the investments (the gross fixed capital formation) would increase by 6.6% from the 2015 level, with the private consumption to go up by 6.3%. For 2017, the economic growth was projected at approximately the same level as in 2016, namely 4.3% with a positive impact from cutting the dividend tax rate and comparable international circumstances. In 2018 and 2019, the economic growth will continue at a pace of 4.5% and 4.7%, respectively, on the back of the same domestic demand.

Table 3 – GDP Components

- annual percentage changes -

	2016	2017	2018	2019
Real GDP	4.2	4.3	4.5	4.7
Private consumption expenditure	6.3	5.3	5.1	4.9
Public consumption expenditure	3.2	1.8	1.6	2.0
Gross fixed capital formation	6.6	6.9	7.3	7.5
Exports of goods and services	4.5	5.6	6.3	6.6
Imports of goods and services	8.7	7.8	7.9	7.8

Source: National Prognosis Commission

The medium term economic growth will create the conditions for an improved employment, in particular in respect of the number of employees. Hence, the employment is estimated to raise gradually until 2019, and to vary in structure to the advantage of the employees, the share of which is expected to go close to 77% in 2019, compared to 72% in 2015.

The LFS rate of unemployment, will go down from 6.7% in 2016 to 6.4% in 2019.

For 2016, the expectation is that consumer prices will increase by 0.9% compared to December 2015, while as annual average they will go down by 0.7%.

As of 2017, the inflation will remain relatively flat, with an annual average between 2.3% and 2.5%. The continued process of keeping the inflation at low levels will be sustained by preserving a firm monetary policy conduct, to ensure stability of price on a medium term. The forecast took into account normal agricultural years and a moderate increase of the international oil price.

2.4. SECTORAL BALANCES

In 2015, the growth of exports of goods, compared to 2014, was of 4.1%, with imports having increased by 7.6%. Under the circumstances, the FOB-CIF trade deficit went up by 38% compared to the one in 2014.

In the first two months of 2016, the Romanian exports went up by 4.1% while imports increased by 8.5%, compared to the same interval of the year 2015. Therefore, the trade balance (FOB-CIF) in the first 2 months of 2016 closed on a deficit in amount of EUR 993.5 million, trending up by 75.8% compared to the corresponding interval of the previous year.

Export is expected to remain in 2016 a component of the demand, which will support the economic growth in Romania. Hence, for 2016 we estimate a 5.5% increase of the exports of goods, while the imports of goods will go up by 7.8%. Overall, the forecast shows that the trade deficit share to GDP is to be 6% in 2016.

For the interval 2017-2019 the exported goods are expected to see an annual average increase of 7.5%, with imports of goods expected to raise by 8.2%. The GDP share of the FOB-CIF trade deficit in 2019 will go up to 6.9%. Trade operations with EU Member States are expected to intensify, so that the export of goods to EU would increase from 73.7% in 2015 to about 78% in 2019, with the share of imports of goods going up from 77.2% in 2015 to about 80% in 2019.

In 2015, the balance of payments current account run a deficit 2,7 times higher compared to 2014, reaching a share to GDP of 1.1%. The current account deficit was covered entirely from foreign direct investments, that amounted to EUR 3 billion and were higher by around 25% compared to 2014.

Table 4 - Sectoral Balances

- % of GDP	2015	2016	2017	2018	2019
1. Net balance, compared to the rest of the world	1.2	0.7	0.5	0.5	0.5
Of which:					
- balance of goods and services	-0.5	-1.0	-1.2	-1.4	-1.4
- balance of primary and secondary income	-0.6	-0.6	-0.6	-0.4	-0.4
- capital account	2.3	2.3	2.3	2.3	2.3

Source: National Prognosis Commission

In the first 2 months of 2016, the balance of payments current account run a deficit of EUR 337 million, 8 times higher compared to the similar period of 2015, on the backdrop of the lower positive balance of goods and services and the increased deficit of primary revenue balance.

In 2016, the current account deficit of the foreign balance of payments is expected to amount to EUR 2.6 billion, which accounts for 1.6% of GDP. Foreign Direct Investments will fully cover the current account deficit.

In the medium run, the current account deficit will remain within the range of EUR 3.2 – 3.6 billion, with a share to GDP of 1.7% in 2017 and 1.8% in 2019. In 2017-2019, the share to GDP of the net balance with the rest of the world, considering the capital account as well, will remain positive and trending slightly down, with a high positive contribution of the capital account. It is worth mentioning that the capital account share to GDP will remain at the level of 2.3% for the whole period.

3. GENERAL GOVERNMENT AND DEBT BALANCE

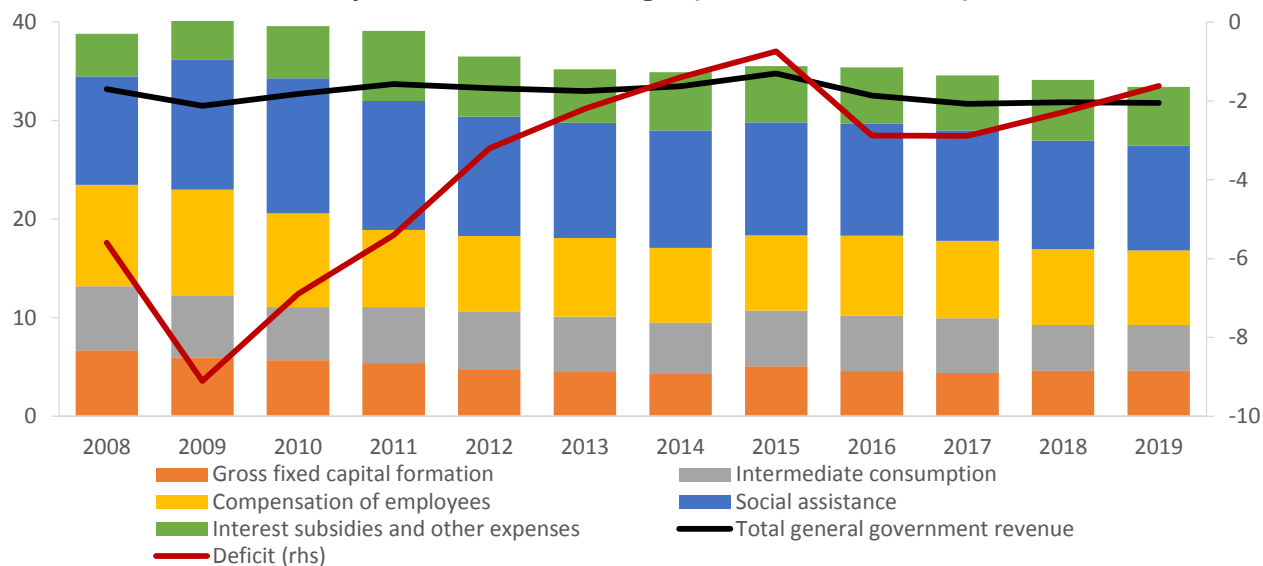
3.1. EVOLUTION OF PUBLIC FINANCE IN 2015 - 2016

In 2015, the GDP share of revenues, according to ESA, was 34.8%, which is 1.3 percentage points higher than in the previous year, with the total revenues increased by 11% in 2015 compared to 2014. In structure, the improvement of revenues comes in principal from the higher VAT collections by 12.3% in nominal terms (8% of GDP), with the last year's strong increase of the private consumption, despite of the lowered 9% VAT rate for foods and non-alcoholic drinks effective since mid-2015. Collections from the personal income tax, the corporate income tax and the capital gains increased annually by 12.6% (5.9% of GDP) and from excise duties and the fees for the use of goods raised by 8% (3.6% of GDP), and 20.7% (0.5% of GDP), respectively. Social contributions went slightly up compared to the previous year (8.1% of GDP), with the SSC rate going down by 5 pp in October 2014, a decrease that was balanced at the other end by the increase of the wage bill in the economy in 2015.

In addition, the share of expenditures in GDP calculated according to ESA 2010 was 35.5%, higher by 1.2 pp compared to the previous year. In the expenditure structure one can notice the decrease of staff expenditures, expenditures with the intermediate consumption and the interest on the public debt by 0.1 pp compared to the previous year, with subsidies and social security expenditures remaining flat as percentage of GDP in 2014, at 0.5% and 11.5%, respectively. The major increase in 2015 compared to 2014 is reflected by the gross fixed capital formation by 0.8 percentage points, from 4.3% of GDP to 5.1% of GDP, as 2015 was the closing year for the 2007-2013 financial framework in terms of eligibility for reimbursement of payments incurred under the projects. The funds needed for these projects were provided, so that the expenditures related to investments from European Funds went up, while the investments from own resources and from reimbursable funding followed the annual trend.

The ESA budget deficit was adjusted by 4.9 percentage points in 2008-2015, from 5.7% of GDP in 2008 to 0.7% in 2015. If the budget revenues increased in this interval by 0.9 percentage points, with the EU transfers for European projects going up, the budget deficit adjustment was caused in principal by the decrease of expenditures in the public sector by 4 percentage points. During this interval, the wage expenditures went down by 2.9% of GDP, the investment expenditures and the intermediate consumption expenditures went down by 2.6% of GDP, and the social assistance expenditures raised by 0.2% of GDP, while interest expenditures, subsidies and other expenditures raising by 1.2% of GDP.

Chart 2 - Revenues and Expenditures of the Budget (ESA 2010, % of GDP)



Source: Ministry of Public Finance

The budget projection for 2016 is based on the provisions of the Fiscal and Budgetary Strategy for 2016-2018, updated with macroeconomic indicators from the spring forecast and taking into account the following measures in the fiscal and budgetary sector:

- measures introduced by the Fiscal Code Law 227/2015 effective as of January 1 2016, with a Lei 9-billion impact (mainly the cut of the standard VAT rate from 24% to 20%, of dividend tax rate from 16% to 5%, the change in the micro-business turnover tax rate depending on the number of employees, the increase of the personal allowances for personal income tax purposes);
- the measures approved in 2015 with an impact of around 13 billion lei on the general government budget expenditures in 2016 include: the doubled children allowance (1.8 billion lei); the increased benefits to war veterans and persons persecuted on ethnic and political grounds (0.6 billion lei); 25% increase to hospital staff (1.8 billion lei); 15% increase to staff of the teaching system (1.7 billion lei); 12% increase for public institutions subordinated at local level (1.3 billion lei); 25% increase to social assistance staff (0.6 billion lei), including people with disabilities (0.2 billion lei); 10% wage increase to the rest of the public sector employees (3.0 billion lei); food and equipment for the police and the military (1 billion lei); service pensions to clerks, navigating staff, the staff of the diplomatic and consular missions, civil servant working for the Parliament (0.3 billion lei), increase of the minimum gross average wage from 1,050 lei to 1,250 lei as of May 1, 2016;
- we took in consideration the deferred measures adopted in the previous years, such as: vacation tickets/vouchers, bonuses and extra-hours, gift tickets and compensations when people retire or are put in reserve status (the legislation to postpone these measures in 2017 has not been approved yet; it must be approved before 2016 ends).

For the year 2016 the provisions of Law 411/2004 on the privately managed pension funds, republished, as amended, were revised to provide for a maximum level of 6% of the share of privately managed pensions. Since 2009 was excepted from the increase by 0.5 percentage points of the share transferred to Pillar 2, the completion deadline for this reform measure was extended by one year. This change in the law took into account the need to avoid putting additional pressure on the 2016 consolidated budget so as to meet the deficit target of 3% of GDP. The measure requires the increase by 0.1 pp of the contribution to Pillar 2, instead of 1 pp, as a move to increase the social insurance budget revenues in 2016.

The wage policy measures in 2016 are promoted consistently with the legislation in force, along with the fiscal and budgetary measures that are to be introduced during the time interval under review. The implementation of the pay law provisions for the staff of the public sector will observe the wage bill size established for 2016 amounting to 57.7 billion lei in the general consolidated budget, accounting for 7.6% of GDP.

In 2016, the policy for filling the vacated positions in the public sector is to be implemented in accordance with the provisions of article 31 of GEO 83/2014 on the wages of staff paid from public funds in 2015, and other measures related to public expenditures, passed with revisions and supplements in Law 71/2015. According to the above-mentioned provisions, the budget holders have the authority to decide the maximum number of positions for which funds are to be provided, to allow the payment in full of wage entitlements granted by law, in observance of the staff expenditures limits approved in the budget.

The preliminary data regarding the performance of budget revenues in the first quarter of 2016 compared to the same interval of the previous years is positive (in nominal terms) for the main categories of budget revenues collected from direct taxes. Collections from the corporate income tax went up by 26%, mainly due to the increase in the tax paid by the companies, and the collections from the personal income tax went up by 3.3% against the background of a hike in collections from wage taxes by 5.8%, whereas the collected dividend tax and interests went down because of the cut in the dividend tax rate from 16% to 5% in 2016.

The revenues from social security contributions collected in the first quarter of 2016 went up by 4.2% compared to the previous year, with the increased transfers to the Pension Pillar 2 and the removal of employer and employee contributions for the military and police staff. As regards the direct taxes, the VAT collections dropped by 1.7% under the impact of the lowered standard VAT rate from 24% to 20% as of January 1 2016 and the special VAT rate for foods of 9% effective since June 1, 2015. These measures caused the VAT average rate to drop from 22.9% in the first half of 2015 to 16.8% in 2016, accounting for a 26% cut, whereas the robust increase of consumption (retail) made up to some extent for the significant VAT cut. Collections from excise duties in the first quarter of 2016 went up by 8.3% compared to the same interval of the previous year. In structure, a positive performance was seen for the collections from sale of energy products (3.5%), tobacco products (18%) due to the increase of total excise rate for

cigarettes, whereas the performance was negative for the alcohol products sales (-9%) as the excise rate was cut for this category.

Table 5 - Impact of legislative measures on the government balance

Measures introduced in 2016	Expected impact (in million lei)
Impact of the extension of GD 5,6,7/2013,of which:	1,094
The tax on the monopoly in the electricity and natural gas sector GD 5/2013	151
The tax on natural resource exploitation income, other than from natural gas. GD 6/2013	71
The tax on additional income from natural gas price deregulation. GD 7/2013	872
Change of the contribution rate for the military, police and special penitentiaries staff	-1150
Introduction of the individual social contribution for the military, police and special penitentiaries staff	746
The employer and employee pension contributions will be removed for the military, police and special penitentiaries staff	-1,896
Change in the contribution rate to pension pillar 2, i.e. an increase by 0.1 percentage points (5.1% in 2016)	-107
Implementation of GEO on tax amnesty	414
The main measures of the Fiscal Code:	
VAT rate reduced from 24% to 20% (11 months from collection), and 9% for water and 5% for books	-7,560
Reduce the tax on dividends from 16% to 5%;	-850
Income from wages, assimilated to wages - Provide the personal tax allowance based on the number of dependents,, that will range between 300 lei per month and 800 lei per month, for a gross monthly income of no more than 1,500 lei. Personal allowances granted for the taxable amount calculation purposes to the taxpayers with under-aged children as dependents.	-539
Measures which will be introduced in 2017	Expected impact (in million lei)
Impact of the extension of GD 5/2013 on the tax on the monopoly in the electricity and natural gas sector	149
Tax introduced in the petroleum sector	565
Change in the contribution rate to pension pillar 2, i.e. an increase by 0.4 percentage points (5.5% in 2017)	-609
Impact of the unified pay law	756
The main measures of the Fiscal Code:	
Cut the standard VAT rate from 20% to 19% as of January 1, 2017, including VAT for excise duties	-2,541
Remove the 7 cents excise duty and increase the excise duty from 430.71 lei/1000 cigarettes in 2016 to 435.58 lei/1000 cigarettes in 2017	-2,886
Remove the constructions tax as of January 1, 2017	-1,062
Introduce the obligation to pay the health social insurance on both the income from investments and wages of individuals.	448
Introduce a maximum ceiling for the monthly calculation base of the social health insurance contribution (SHC). The maximum ceiling is 5 gross average wages.	-659

Source: Ministry of Public Finance

3.2. PUBLIC FINANCE PERFORMANCE ON THE MEDIUM TERM

Budget estimates for 2017-2019 were built in accordance with the provisions of the 2016-2018 Fiscal and Budgetary Strategy, the macroeconomic indicators of the 2016 spring forecast and the legislative changes listed below:

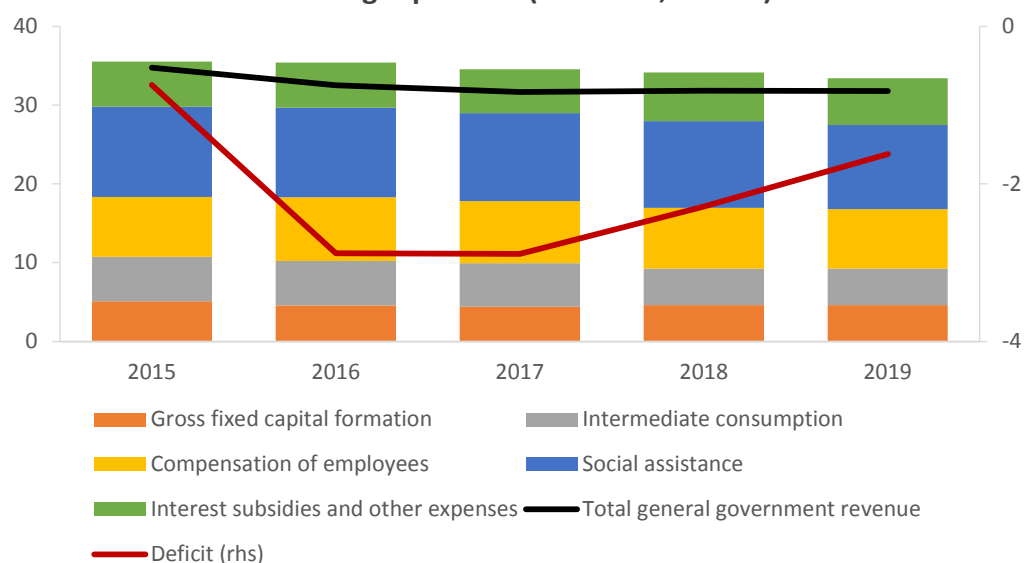
- implement the measures adopted in the Fiscal Code Law 227/2015 to become effective as of January 1, 2017, expected to have a negative impact of 6.7 billion lei on the budget in 2017 (standard VAT rate to be reduced from 20% to 19%; excise duties for energy products to decrease; the building tax to be canceled; the ceiling of 5 gross average wages to be introduced for the social health insurance contribution purposes);
- amend the provisions of GEO 57/2015 regarding the increase of transfers to Pension Pillar 2 by 0.9 percentage points in 2017 in the sense of gradually increasing transfers to Pension Pillar 2 by 0.4 percentage points in 2017 and 0.5 percentage points in 2018. This measure will lead to a positive impact of 590 million lei in 2017;
- pass the taxation law in the petroleum and mining sector by end-2016, which generates a positive impact of 560 million lei in 2017 and similar in 2018-19;
- continue to apply the provisions of GD 5/2013 on the monopoly tax in the electricity and natural gas sector, expected to generate a positive impact of around 150 million lei in 2017 and similar in 2018-19;
- pass the minimum insertion income law in the form promoted by the Government, to become effective as of April 1, 2018;
- remove the monthly child raise allowance ceiling, with an impact on the expenditures side of 600 million lei in 2017;
- apply the draft unified pay law proposed by the Government to get a net impact of 1.5 billion lei in 2017;
- apply the pension law to generate, according to the macroeconomic indicators, an escalation by 4.46% of the pension point in 2017.

For 2017, consideration is being given to new taxation arrangements for the petroleum sector, to apply to all agreement holders through a separate onshore and offshore taxation (horizontally, in the upstream segment). With IMF technical assistance and in line with the best international practices, the Government planned to revisit the taxation of the oil and natural gas production sector by enforcing a tax on the additional corporate income tax in the upstream segment, at the same time with an uplift for to encourage investments both onshore and offshore. This taxation system will be implemented so that the actual tax rate for the companies in this sector does not exceed the international average rate of 60%. The draft will be promoted as the GD 6/2013 on special taxation measures in the exploitation sector of natural resources, other than natural gas and the GD 7/2013 on the tax on additional income from natural gas price deregulation are to expire after December 31 2016, and the application period of GD

5/2013 on special taxation measures of natural monopoly in the electricity and natural gas sector is to be extended.

After the expected decrease of budget revenues in 2016 to 31.7% of GDP, coming in principal as a result of the Fiscal Code measures and from decreased EU reimbursements on projects, the collections are expected to remain flat until 2019. At the same time, total budget expenditures are expected to adjust by 2 pp in 2016-2019, from 35.4% of GDP to 33.4%, with the staff expenditures restored to 7.7% of GDP in 2019 (which is close to the 7.6% of GDP in 2015), social assistance expenditures going down as share to GDP (0.7 pp until 2019). In addition, the intermediate consumption is expected to reach 5.4% of GDP (after the expenditures with goods and services are escalated to reflect the annual inflation) and the investment expenditures will remain at 4.5% of GDP with a decrease of the component that is fully funded from own resources.

Chart 3 - Consolidated budget position (ESA 2010, % GDP)



Source: Ministry of Public Finance and Eurostat

We estimate that the budget deficit will go significantly up in 2016, while still below the 3% of GDP limit, but it will go back on an adjustment path in terms of GDP share, as of 2018. In fact, the prospects regarding the budget deficit performance remain prudential and may be influenced, in a positive way, by the budget execution bias, over the recent years, towards a lower than expected budget deficit and by the second-round effects generated by the cuts of taxes and duties with a more positive impact on the budget revenues than it is expected now. In structural terms, the budget deficit will go again on a convergence track with MTO in 2018.

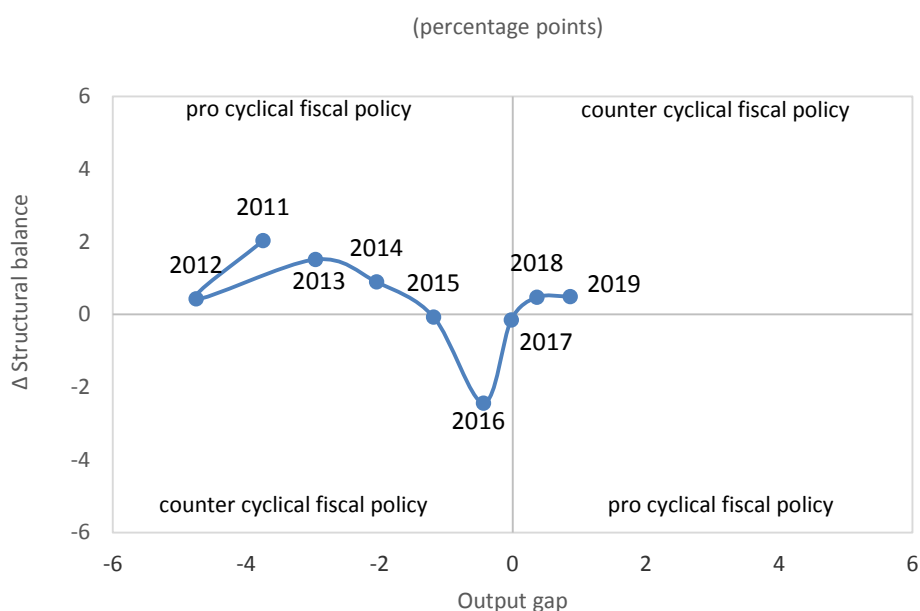
Table 6 - General Government Balance (% GDP)

	2016	2017	2018	2019
	Estimates	Estimates	Estimates	Estimates
BALANCE according to ESA	-2.9	-2.9	-2.3	-1.6
Structural Balance	-2.7	-2.9	-2.4	-1.9

Source: Ministry of Public Finance

The structural budget balance and output-gap data indicate a pro-cyclical tax policy, in crisis times as well as after the economy starts picking up. The structural deficit was reduced until 2015 by 5.3 percentage points from -5.6 of GDP in 2010, but the estimates are only -2.7% in 2016 and -2.9% in 2017, as a consequence of the fiscal relaxation measures.

Chart 4 - Fiscal Position (+ consolidation, - relaxation)



Source: National Prognosis Commission and the Ministry of Public Finance

Improved collection of taxes and duties

To improve voluntary compliance, the county-based public finance directorates will be connected with the specialized taxpayer assistance call-center. In addition, quality standards will be introduced for the services provided and the automated systems to manage crowding by automatically releasing the order numbers to taxpayers; this is expected to modernize the internal business of structures dedicated to taxpayer assistance and guidance. Other measures aim at introducing bank card payments of taxes, contributions and duties, simplifying tax returns and developing electronic filing. The soft notices campaign will be continued for the taxpayers covered by the high net wealth individuals compliance program. To decrease the stock of arrears, the arrear management capacity is developed under the Revenue Administration Modernization Project. The new customs code of the Union, the national technical regulations

for enforcing the new legislation and the start of IT system development projects provided for by the Community legislation are expected to lead to an improved efficiency of collection.

The fight against tax evasion considers the development of a generalized risk assessment for the whole tax administration activity, on the basis of the tax information about taxpayers, as well as developing IT applications to conduct analyses of the fiscal inspection missions, to confirm the risk criteria and supply the information for future risk assessments. Other measures reducing informal economy include a more dynamic freight traffic and early-warning systems monitoring, dismantling the fraud chains in areas with a high fiscal risk, continue encouraging the issuance of fiscal cash register receipts, increase the number of fiscal inspections conducted based on a risk assessment, improve efficiency of fiscal inspections on the medium-sized taxpayers segment and intensified auditing of taxpayers with a fiscal risk from transfer pricing. In the VAT segment, checks will continue to assess the intentions and capacity of taxable persons to run operations involving VAT transactions, apply the VAT registration criteria introduced by the NAFA President Order 3840/2015, monitor the taxable persons registered for VAT purposes and revise the deregistration procedure based on the assessment related to the intentions and capacity of taxable persons to run a business involving VAT transactions.

3.3. GOVERNMENT DEBT LEVEL AND PERFORMANCE²³

GOVERNMENT DEBT AND THE GOVERNMENT PUBLIC DEBT MANAGEMENT STRATEGY

The government debt according to EU methodology accounted at the end of 2015 for 38.4% of GDP, far below the 60% ceiling required by the Maastricht Treaty. In the government debt, at the end of 2015, the general government domestic debt accounted for 19.3% of GDP and the general government external debt amounted to 19.1% of GDP, as the consequence of a financing process in the previous years focused on a significant external funding component.

The objectives of the Government Public Debt Management Strategy in the medium run are as follows:

- Cover the central government's financing needs and the payment obligations, while minimizing the costs on medium and long term;
- Limit the financial risks associated to the government public debt portfolio;
- Develop the domestic market of government securities.

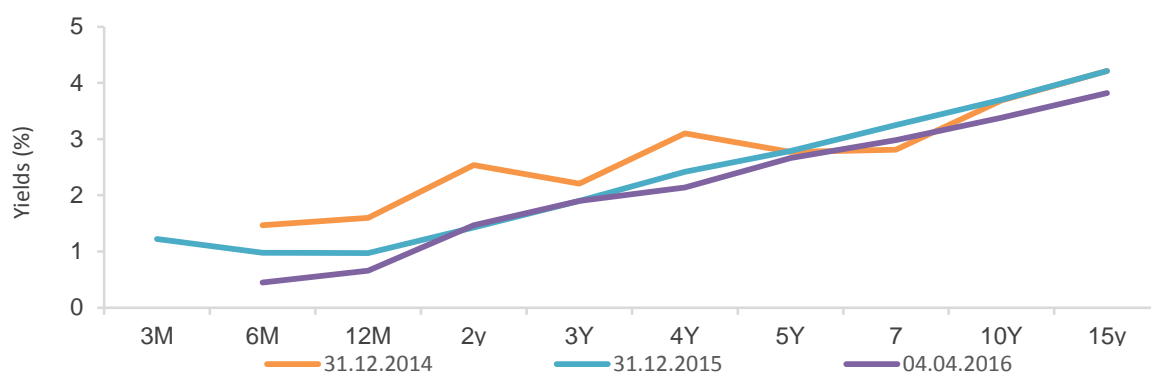
In 2016, the funds to finance the budget deficit and refinance the government public debt will come mainly from domestic sources and in completion from foreign sources, and on the medium term the net financing will be provided mostly from domestic sources to facilitate further development of the domestic market of government securities and help reducing the exposure to currency risks, at the same time taking into account the absorption capacity of the domestic market and in general the demand for the debt instruments denominated in domestic

²³ All indicators used in this chapter are consistent with the EU methodology.

currency²⁴.

The financing strategy from domestic sources provides in principal for the use of government securities denominated in lei, namely T-Bills, including short maturities (3, 6 and 12months) for cash and medium and long term benchmark bond management purposes, which will be issued depending on the market demand and the objective of consolidating the yield curve in domestic currency. The yields of government securities trended down over the past couple of years, against the background of the relaxed policy measures conducted by NBR, with the yields being influenced by the liquidity conditions of the money market as well, the reduced rates of the minimum reserve requirements in respect of the liabilities in RON of the lending institutions and the appetite of non-resident investors. As in the Chart below, the interest rates of short and medium term government securities went sharply down, given the high supply on these segments of maturity, below the level of the NBR monetary policy interest rate for maturities below 2 years, in the context of maintaining a surplus of liquidity on the domestic market. The yield curve became sharper on the medium and long term, with investment opportunities for non-resident investors.

Chart 5 – Yields of government securities on the primary market



Source: Ministry of Public Finance

Romanian government securities included in JPM Morgan and Barclays indexes continue to positively influence the local market and rising investor market. At the end of 2015, 9 Romanian government bonds with an approximate share of 3.49% were included in the GBI-EM Global Diversified Investment Grade index, and 12 government bonds, accounting for 1.26% were included in the Barclays EM Local Currency Government Index.

In order to reduce the costs of financing and for a better functioning of the secondary market, MoPF plans to continue the policy of building the liquid benchmark bonds along the whole length of the yield curve, simultaneously with a transparent policy of issuing the government securities, to reach an amount per issuance of EUR 2 billion in equivalent²⁵, and inform the

²⁴ In addition to the domestic demand for the government securities denominated in lei, non-resident investors may play an important part with respect to both the amounts that are to be placed on the domestic market and, in particular, to the structure of maturities in the financing process, considering the high appetite of those investors for the government securities with medium and long maturities.

²⁵ The refinancing risk attached to such issuances will be managed by continuing to keep the financial buffer in foreign currency available to the State Treasury.

market on the amounts, frequency of issuances/reopenings for some maturity categories. The government securities in EUR will be issued on the domestic market only in the context of similar instruments in significant amounts reaching maturity, or if the central bank (BNR) decided to relax the minimum reserve requirements for the foreign currency liabilities of the lending institutions. Under these specific circumstances, the issuance of EUR-denominated bonds on the domestic market will respond to a very high demand for such instruments from local investors, lacking alternatives, thus allowing to create the conditions for a good maturity/cost ratio.

In the first half of 2016 we expect the implementation of the minimum mandatory market-making requirements on the electronic E-Bond trading platform dedicated to primary dealers, which will help improving the transparency of bids and the market-making for government securities, allowing trading cost reductions for the participants to the secondary market.

In addition, specific secondary market operations, such as buyback and bond exchange operations could be used in 2016, depending on the procedure and operational framework to be finalized by the central bank, in order to facilitate refinancing of maturing high amount issuances which have accumulated and to speed up the process of creating new series of liquid benchmark bonds. Similarly, we intend to use reverse repos to an efficient cash management, after consultations with the central bank aimed at coordinating the financing and the cash management policies with the monetary policies.

Moreover, in order to improve affordability of government securities among small investors and improve their financial education, after a first 2-year issuance in 2015 the FIDELIS project of government securities for individuals will continue, depending on the potential attention of those investors for this type of securities.

External financing sources in the medium run will come in principal from Eurobonds issued on the external capital markets under the MTN Programme and in addition loans contracted with official creditors (international financial institutions).

The Ministry of Public Finance plans to remain present on the foreign capital markets, taking into account the interest for bonds denominated in EUR, to consolidate and extend the price references for the government securities, in particular for longer maturities, depending on the market. However, the issuances denominated in USD on the foreign markets or in other currency, may provide advantages due to longer maturities, increased market absorption capacity for the new issuances and a diversified investor base. This financing source is particularly important to Romania, as alternative financing in the case of foreign events which could limit the access to financing on the European market.

MoPF will preserve its flexibility in respect of the time to access the foreign markets and the amount of foreign issuances, taking into account the associated costs, the risk factors and potential implications on the objectives and policies of the central bank, as well as the evolution of the local market.

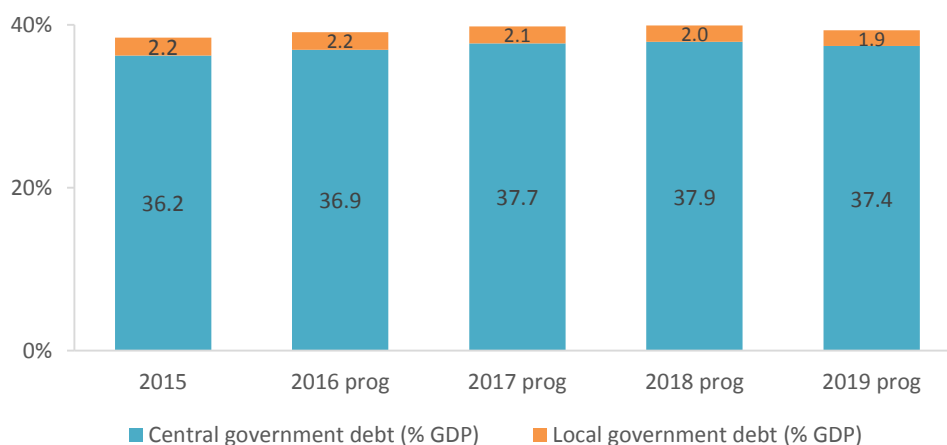
In addition, the implementation of structural reforms in key sectors of the economy, as well as the implementation of priority projects/programs for the Romanian economy will continue to be funded from the loans contracted with the international financial institutions (World Bank, EIB, EBRD, the Council of Europe Development Bank), which will play an important role in limiting the costs and extending maturities of the debt portfolio by the terms they offer in respect of costs and maturities.

Hence, in the medium run, the Ministry of Public Finance intends to continue to work together with the international financial institutions to benefit of the financial advantage attached to their products, such as IBRD DPLs and the loans contracted to finance the budget deficit and refinance the government public debt, with the money to become available based on the implementation of some measures and/or actions needed in the sector reforms.

The sources needed to refinance the government public debt will come from the markets on which the debt was issued, as well as from the State Treasury foreign currency financial reserve. To improve debt management and avoid seasonal pressures in securing the budget deficit financing and public government debt refinancing sources, the financial foreign currency buffer of the State Treasury will be preserved, at a comfortable level, to reduce the risks in times of high financial market volatility. For 2016, the buffer will be consolidated so as to cover 4 months of gross financing needs.

With an average annual economic growth of 4.4% of GDP and deficits calculated according to EU methodology up to 3% of GDP, in 2016 – 2019 the share of the gross government debt is not expected to exceed 40% of GDP, as in the Chart below.

Chart 6 – Gross Government Debt according to EU Methodology

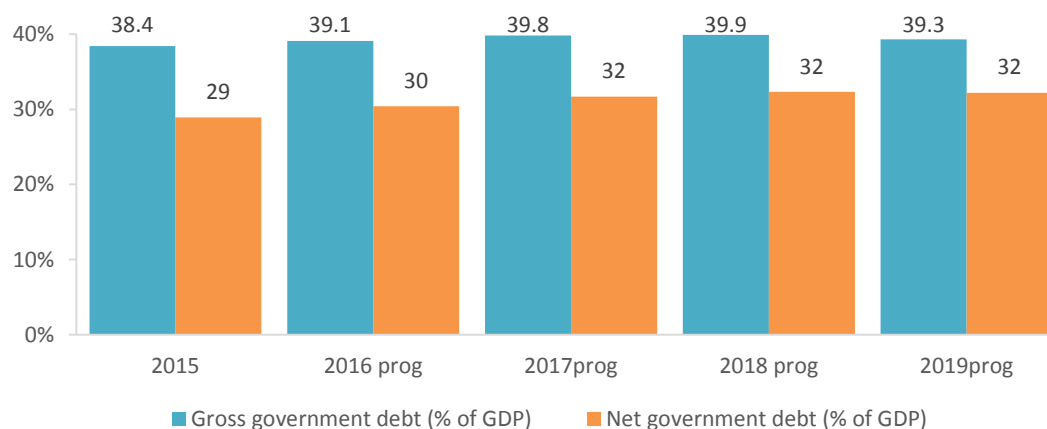


Source: Ministry of Public Finance

If the liquid financial assets are considered²⁶, the net general government debt (gross debt minus liquid financial assets) in the interval under review will not exceed 32.5% of GDP.

²⁶ AF1 (gold and SDR), AF2 (deposits and cash), AF3 (securities, other than shares consolidated at market value), AF5 (shares and other equity contributions, if listed; including mutual fund shares).

Chart 7 – Government Debt according to EU Methodology



Source: Ministry of Public Finance

The factors which influence the change of debt share to GDP during 2016-2019, including stocks—flows adjustments, are included in annex 4.

3.4. STRUCTURAL REFORMS

Structural reforms in the state-owned companies sector

The Ministry of Energy will continue to prepare for privatization the Oltenia Energy Complex (CEO)²⁷ and the electricity producer Hidroelectrica²⁸, and to restructure and improve efficiency of companies in which the government owns a stake. The initial public offering for Hidroelectrica is to be resumed after the court grants the exit from the insolvency procedure.

A restructuring plan is being prepared for Oltenia Energy Complex to be implemented in 2016-2020, which includes measures to cut costs, as well as reducing by 10% the mining and energy production capacity until 2020, reducing the number of staff and prioritizing the investment program. Also, the government is taking into consideration to start an initial public offering to sell a 15% stake of new shares in the Oltenia Energy Complex, through a capital increase.

In addition, other programs are to be implemented in 2016 to restructure the companies under the authority of the Ministry of Economy. In this context, we mention the completion of the merger through absorption of Electrocentrale Titan by Societatea Electrocentrale Grup SA. A program is being developed to reorganize the National Uranium Company to help the company recover and implement a program to develop its production capacities, including for investing in modernization and re-engineering.

²⁷ Oltenia Energy Complex (CEO) is the largest coal-based energy producer in Romania, set up by merging Turceni Energy Complex, Rovinari Energy Complex, Craiova Energy Complex with Oltenia National Lignite Company.

²⁸ Hidroelectrica is the main power producer and the main system service supplier in Romania.

With respect to the corporate governance improvement, the final report on the implementation of the GEO 109/2011 on the SOEs corporate governance²⁹, prepared by independent evaluators was published in February 2015. This report included a number of recommendations regarding the continuation of the disinvestment process (or reducing the participation of the state) through privatization, restructuring and sale of assets, the improvement of the framework aimed at increasing the accountability and encouraging the public companies, as well as the increase of the capacity to monitor the corporate governance.

The amendments formulated for GEO 109/2011 were discussed with the international financial institutions and observations were received after the consultations with the business environment in October 2015. The aggregate amendment document was approved by the Government in January 2016, endorsed by the dedicated commissions and will be discussed in plenary for a final vote. The main amendments referred to the following:

- introduce the letter of expectations as an informal working instrument in the selection of managers and directors; in this letter, the authority sets out the outcomes expected from the management and the leaders of a public company, for a period of minimum 4 years;
- introduce the letter of intention as an informal working document developed based on the elements described in the letter of expectations and the public information on the activity of a public company; in this letter, the candidates for the director position, as selected and included on the shortlist, describe their development vision/program for the respective public company. The statement of intentions is a component of the final evaluation of the candidates included on the shortlist for classification and appointment;
- merge the management and administration plans and have the managers and directors develop a single management plan;
- cancel the regulation regarding the possibility of the supervisory authority to reject the management plan and introduce the concept of negotiation;
- introduce the obligation regarding the selection of managers in the standalone companies (*regii autonome*) with over 500 employees, by a human resources independent expert;
- reduce the number of terms in office for the managers from 5 to maximum 3;
- the lump sum compensation for the non-executive members will be twice as much the average of the monthly gross average wage over the previous 12 months, for the performance of the main activity of the company, and the variable component of the compensation will be maximum 12 monthly average wages of the executive members;

²⁹ The legal framework that guarantees the objectiveness and transparency of the management and board selection process is the Government Emergency Ordinance 109/2011 on the corporate governance of public companies, as revised and supplemented. It was adopted to create the legal and administrative environment for an improved efficiency of operators, taking into account that public companies (standalone companies - *regii autonome* - or the companies in which the government owns a majority or full stake) are an important segment of the national economy and therefore the liquidity, solvency and operability of these companies have a decisive influence on the entire economy.

- the professional liability insurance of the administrators will be covered by the public company and shall not be part of the compensation;
- in deciding the wages of administrators and directors, the objectives and outcome indicators set out based on the letter of expectations shall be taken into account;
- the statutory auditors shall be appointed before the end of the financial year, by the general shareholders meeting of the board, as applicable, for a minimum term of three years;
- the data and information, as well as the reports that must be published, shall be displayed on the website of the respective public company, through the diligence of the head of the managing board or the supervisory board;
- introduce penalties for the failure to observe the calendar of the selection procedure and the deadline for developing the management plan;
- introduce penalties for any head of the supervisory public authority who delays the start of the procedure;
- strengthen the capacity of the Ministry of Public Finance as the institution monitoring the implementation of GEO 109/2011 and the performance of the public companies management, as well as the regulatory function for a consistent application by the supervisory public authorities, through the development of guidelines and instructions.

In addition, the Ministry of Public Finance contracted a World Bank grant for technical assistance to help achieve the financial management strengthening objective through a higher quality of public expenditures and financial outcomes of the state-owned companies. The activities to be implemented under the above-mentioned project include: (i) consolidate the capacity to improve corporate governance of SOEs and to provide assistance to the shareholders (supervisory authorities) for management outcome indicator evaluation in the state-owned companies; (ii) develop strategic and technical guidelines (such as instructions, regulations, guides, forms etc.) aimed at improving the quality of corporate governance and financial reporting of state-owned companies and the implementation thereof, in the form of pilot projects, in maximum 3 state-owned companies; (iii) assess the current financial reporting standards by comparing them to international standards.

Minimum insertion income

One of the government's key initiatives to improve the efficiency of the social transfers system and reduce poverty is to revise the legislation on the means-tested social assistance programs. The government's intention is to consolidate the current programs based on means-testing (the minimum guaranteed income, the allocations to support families and heating aids) into a larger program, representative for fighting against poverty. The three social aid categories currently dedicated to poor people will be replaced by the minimum insertion income (MIN) going to a bigger share³⁰ of poor citizens.

³⁰ In accordance with the national social inclusion and poverty reduction strategy in place for 2015-2020, MIN will cover a bigger part of the poorest population, 20%-22% compared to 10% included in the current programs.

It will be possible to include more poor citizens in the MIN program (and increase the benefits allocated by the program) given that the MIN budget will be higher than the total budget of the three current programs and the methodology improved. Thus, the program provides for a new formula of social assistance benefits by excluding part of the income (from work) of the families in the means-testing process, encouraging the beneficiaries able to work and thus benefit of social assistance measures. This new program will cut the system's administrative costs and reduce fraud. The eligibility criteria will be in line with the European methodology for measuring poverty.

Other social assistance improvements based on means-testing in the MIN program include the allocations for children of the beneficiary families who go to school, as a move to increase the level of education, and dwelling benefits (in addition to heating aids) for the purpose of reducing dwelling costs. The consolidation of the three social assistance programs into one single program is estimated to be operational as of April 1, 2018. The draft legislation on the minimum insertion income has been approved by the Government and submitted to the Parliament for debates and approval.

4. SENSITIVITY ANALYSIS AND COMPARISON WITH THE PREVIOUS VERSION OF THE CONVERGENCE PROGRAMME

4.1. RISKS

The risks which may affect the real economy and, by this, the economic growth objective are mainly foreign risks. The Romanian economy, as part of the European economy, depends on the international economic context and, in particular, the economic growth of the main partners in trading.

The European and international economic framework remains very uncertain with respect to the Eurozone. From the autumn forecast, some of the upside risks (for example the low oil prices and weak European currency) and downside risks (further slowdown of the global growth) materialized, but other risks appeared. Risks became higher with respect to the growth outlook in the Eurozone.

The growth is world-wide below the expectations of the international financial organizations in the first half of 2016, as a reaction to the economic contraction in the US due to the fall in the oil prices. IMF estimates in its April 2016 Report an increase of the global economy by 3.2% in 2016 and further by 3.5% in 2017. Thus, the growth rate of GDP provided for in this report is lower compared to the January 2016 forecast, against the background of significant uncertainties concerning the asset volatility on the international markets and a slowdown in the growth pace of the countries with more advanced economies.

The medium term risks include, as far the more advanced economies are concerned, a stagnation or a slowing down growth, whereas in the emerging economies, including China, the growth potential will become weaker.

EU economic growth might be affected by delays in, or partial implementation of, structural, fiscal and institutional reforms needed by the Member States, which could deepen the discrepancies among them. Unless the labor market continues to improve, or if the unemployment goes up, the private consumption - the most important GDP component in the EU - could stop increasing and slow down the economic growth.

A more rapid than expected restoration of energy prices would have an impact on the household and corporate expenditures and impair the economic activity. On the other hand, a sharper decline of staples prices would have a negative impact on the growth outlook, given the threats for the financial stability of oil exporting countries, which could bring trouble not only on the low European exports, but also on the financial markets.

Geopolitical tensions keeps uncertainty at high levels and might become an obstacle to investments, against expectations.

Moreover, unless major political changes are implemented at EU level, (for instance with respect to migrants management), the developments could hinder the economic growth. The public perception about the increasing number of refugees may badly impact confidence in the economy, less encouraging the private consumption. An enlarged suspension of the Schengen

and the measures threatening the results of the domestic market may have a potentially negative impact on the growth. Any unexpected relapse of the Greek crisis may weight more in the investment decisions and thus in the economic growth.

On the domestic side, risks are generally balanced when it comes to the impact on the domestic demand and supply.

Domestic risks are counteracted by the fiscal relief measures. The exemption of reinvested profits, the lower rates of SSC and VAT for food, measures which shall produce effects as early as 2015, are powerful encouragement for investments and growth. All these will be doubled by the effects of the measures provided for by the new Fiscal Code.

At the same time, there is a risk that the additional domestic demand generated by the new Fiscal Code would be covered more from imports, which has an impact on the foreign imbalances.

We expect the bank lending to continue to pick up, but in order to achieve the economic growth objectives in 2016 the lending process to companies needs to be significantly increased. In this context, it is to point out the need to improve the competitiveness of the Romanian companies. From this viewpoint, the relaxation measures taken by the Government will be stimulating for investments and modernization of production capacities, so that the private sector may increase its contribution to the economic growth.

Inflation risks relate to the possible gap between the increase of the wages in the economy and the output progress which may bring additional inflation-related pressures. Another source of risk is the packaging and waste management, with an impact on the consumer basket prices.

4.2. BUDGET PROJECTION SENSITIVITY IN DIFFERENT SCENARIOS AND ASSUMPTIONS

Since tax and duty collections are closely linked to the employment rate, the average wage and the economic growth, the table below shows the impact of the change in economic variables considered separately on the budget revenues, with 2016 as baseline year.

Compared to the baseline scenario, taking into account the share in total budget revenues, the highest risk is associated with the collections of social security contributions. Hence, the decline of the economic growth by one percentage point (which involves the simultaneous decrease in employment and wages) is reflected by a lower collections from the social security contributions with -0.081% of GDP.

Table 7 Budget projection sensitivity in different scenarios and for different assumptions

Taxes and Duties (share to GDP)	Macroeconomic Base	Change in the macroeconomic base (percentage points)	Change in revenues (% of GDP) in 2015
1. Personal Income Tax (3.5%)	Gross Average Wage	Reduced by 1	-0.031
	Level of employment	Reduced by 1	-0.027
	GDP	Reduced by 1	
2. Social insurance contributions (8.2%)	Gross Average Wage	Reduced by 1	-0.081
	Level of employment	Reduced by 1	-0.081
	GDP	Reduced by 1	
3. Corporate income tax	Gross Average Wage	Reduced by 1	
	Level of employment	Reduced by 1	
	GDP	Reduced by 1	-0.015
4. Value-Added Tax	Gross Average Wage	Reduced by 1	-0.102
	Level of employment	Reduced by 1	
	GDP	Reduced by 1	

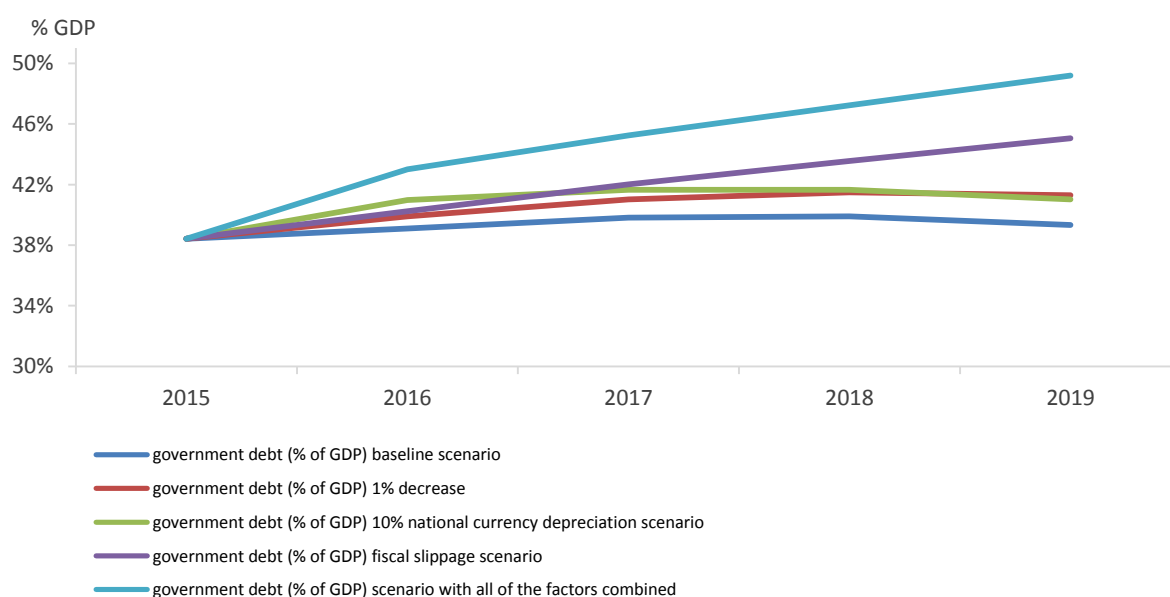
Source: Ministry of Public Finance

4.3. PUBLIC DEBT SENSITIVITY

Sensitivity analysis of public debt³¹ is having regard to:

- 1) the influence of economic growth, the domestic currency depreciation and fiscal slippages on the government debt; and
- 2) the impact of domestic currency depreciation and interest rates changes on interest payments.

Chart 8 – Factors which impact the government debt

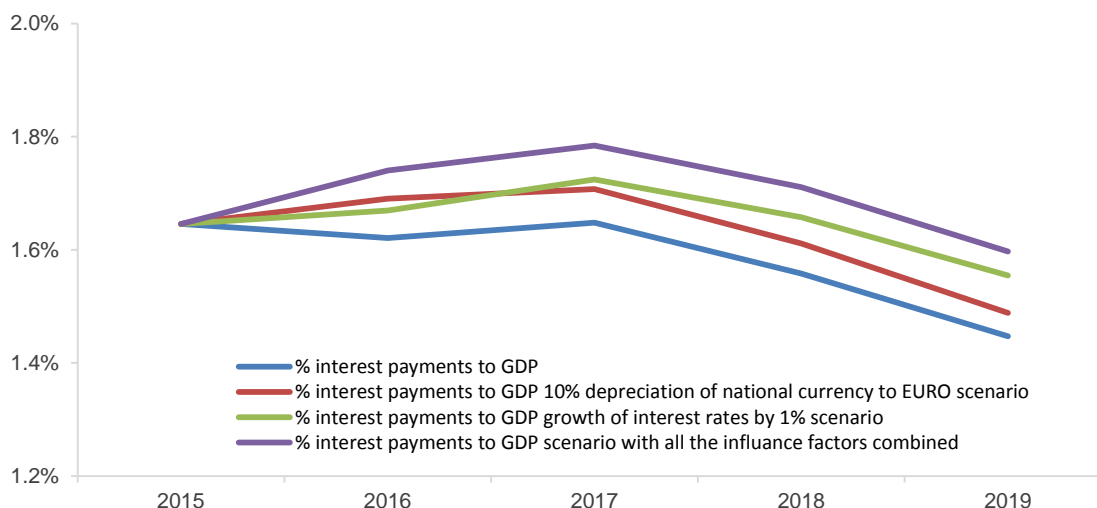


Source: Ministry of Public Finance

³¹ All indicators used in this sub-chapter are consistent with the EU methodology.

In the Chart above one can see that the influence of an economic decline by 1% of GDP would have a negative impact on the indebtedness level, which will go up by 2% of GDP in the year 2019, and the depreciation of the domestic currency against the Euro by 10%, as Euro is the main currency of the foreign currency debt denomination, would trigger, in 2019, an increase of the debt share to GDP up to 1.7% of GDP. A fiscal slippage translated into a cash deficit to be financed of 3.9%³² of GDP in 2016 – 2019, would lead to a higher indebtedness by up to 5.8% of GDP in 2019, while the combined influence of all these factors on the government debt share to GDP would trigger an increase of the indicator by 9.9% of GDP in 2019.

Chart 9 – Factors which influence the interest payments



Source: Ministry of Public Finance

The Chart above shows that the depreciation of the domestic currency against the Euro³³ would have a low negative impact on the interest payments, which will go up by up to 0.04% of GDP in 2019, while the interest rates raising by 1% would result in a higher increase of interest payments share by up to 0.1% in 2019. The combined impact of these factors on the payments would trigger a raise of interest payments by 0.15% of GDP in 2019.

4.4. COMPARISON WITH THE PREVIOUS VERSION OF THE CONVERGENCE PROGRAMME

The macroeconomic scenario of medium term development described herein is substantially different, in terms of GDP performance, from the baseline scenario of previous programme edition of April 2015. The differences between the two programme versions come, in principal, from the revised statistical data in 2013-2014 and the provisional data published for 2015, as well as the implications of the measures of the new Fiscal code and the increase of wages in 2015.

³² In order to determine this indicator, the European Commission's winter forecast was taken into account, which foresees for 2017 an ESA deficit of 3.8 of GDP.

³³ The other foreign currencies of debt denomination are also trending up.

Hence, in the previous version of the Convergence Programme, the GDP was projected to grow by 3.2% in 2015. The economic results obtained in the economic sectors, namely constructions and services, showed an increase of the GDP by 3.8%.

For the year 2016 and the upcoming years, the forecast took into account the impact of the Fiscal Code. As a consequence, it is provided for that in 2016 GDP will go up by 4.2% compared to the 3.4% forecast in the previous edition, mainly on the back of the domestic demand. The forecast for 2017-2019 provides for an accelerated economic activity, with a growth rate higher than the one foreseen by the previous programme, namely 4.3% in 2017, 4.5% in 2018 and 4.7% in 2019. GFCF will speed up backed by an improved EU absorption, with the private consumption to trend down as the fiscal measures' impact fades away.

Chart 10 - A comparative review of GDP growth forecasts

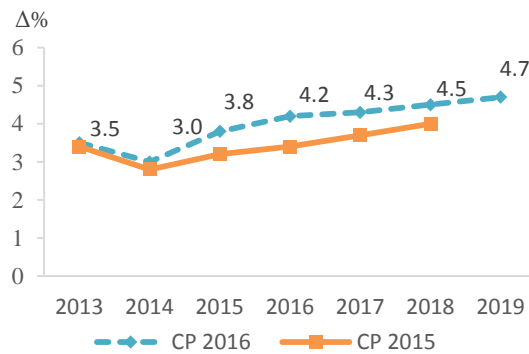


Chart 11 - A comparative review of GFCF growth forecasts

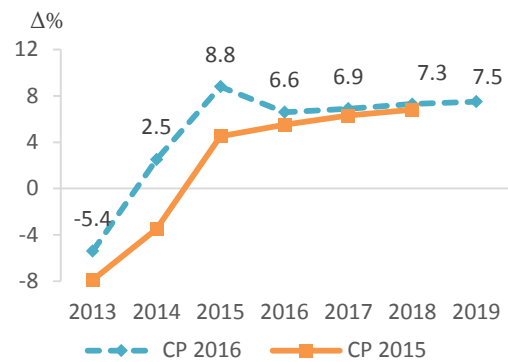


Chart 12 - A comparative review of private consumption growth forecasts

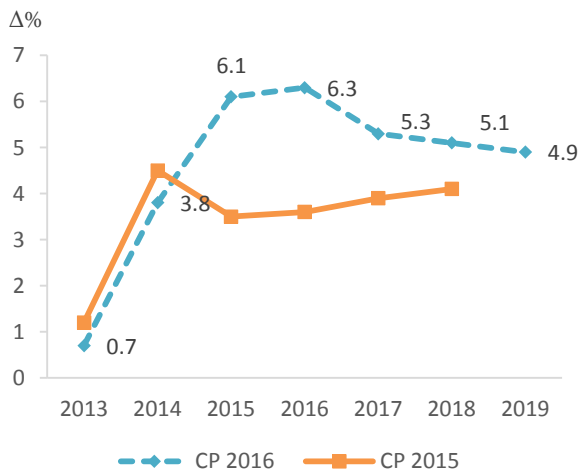
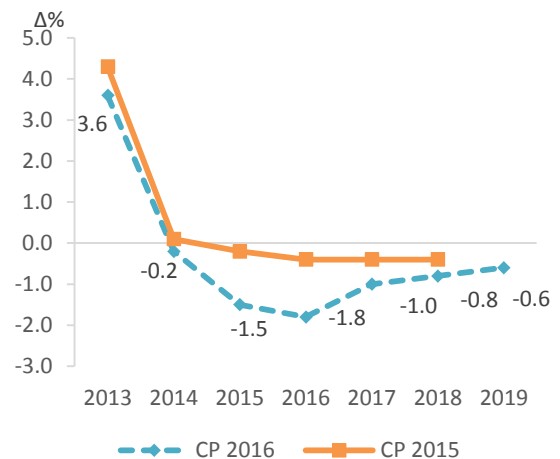


Chart 13 - A comparative review of net export contributions to GDP growth



5. LONG TERM SUSTAINABILITY OF PUBLIC FINANCE

The public finance viability for the EU Member States is reviewed once in three years. According to the updated projections for the purpose of the new exercise, the share of pensions expenditures is expected to remain, until the end of the forecast interval, below the EU average. Risks would increase if the primary structural balance went back to the levels of 1998-2012. The public debt level is expected to remain substantially below the 60% of GDP baseline value and certain consolidation measures may be considered to cap the increase of costs associated to ageing population (mainly pensions).

One should note the positive assessment of the sustainability, compared to the 2009 Report, when sustainability-related risks for Romania was high on a long term, following the budgetary impact of expenditures generated by the population ageing process, which were far above the EU average. In this sense, the improvement of projections according to the 2012 Report is also confirmed by the 2015 exercise.

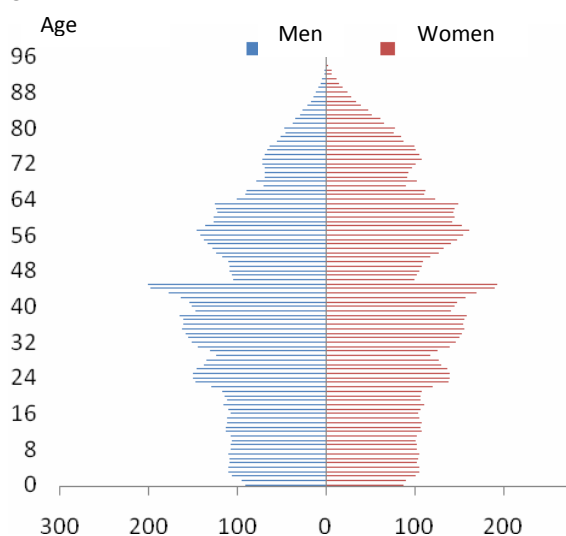
The updated projection of population ageing-related expenditure increase indicates, for Romania, a raise of 2.2 percentage points of GDP in 2013-2060 (the European average is 1.8 percentage points). The breakdown on the main expenditure components is as follows:

- 0.1 percentage points of GDP is the increase in pension expenditures (European average is 0.2 percentage points)
- 1.9 percentage points of GDP is the increase of healthcare and long term care expenditures (European average is 2 percentage points);
- 0.4 percentage points of GDP is the increase in education expenditures (European average is 0 percentage points)

If we compare with other European states, the growth rate of ageing-related expenditures in Romania reflects the sharply reversed age pyramid. It is worth mentioning that the forecast did not include the EC recommendation to even out at 65 the retirement ages for men and women.

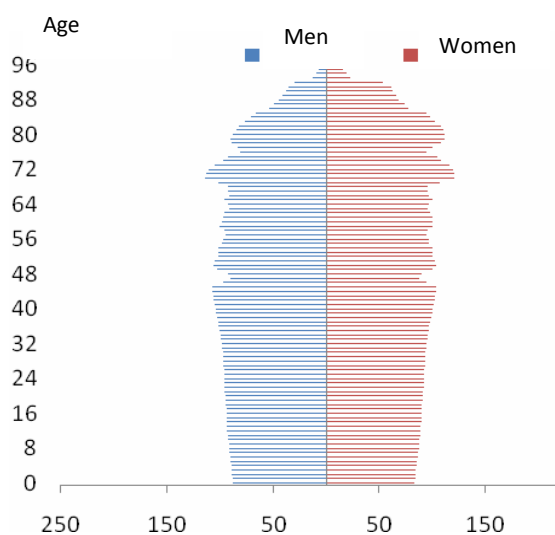
Chart 14 – Structure of the population: 2013–2060

Structure of Romania’s population in 2013



Source: Eurostat-EUROPOP2013

Structure of Romania’s population in 2060



Source: Eurostat-EUROPOP 2013

Demographic changes will affect the composition of population in Romania. The magnitude and speed of the ageing process are related to the life expectancy, fertility and migration trends. The rapid ageing will change the ratio between the population at retirement age and the active population, triggering major changes in the age structure and negative consequences on the labor market.

In the medium and long run, the performance of the pension sector is strongly influenced by the demographic outlook, which is given by the birth rate and the life expectancy, alongside the inevitable ageing of the population.

Table 8 – Long term forecast of pension expenditures

	2013	2014	2020	2030	2040	2050	2060
Pension Pillar 1	8.2	8.2	8.1	8.1	8.4	8.4	8.1
Pension Pillar 2	-	-	-	0.1	0.4	0.7	0.8

Source: National Prognosis Commission

The estimates of the pension model indicate an increase of pension expenditures share under Pillar 1, from 8.2% of GDP in 2013 to around 8.4% of GDP at the beginning of the 2040-50 decade, followed by a gradual decrease towards the end of the forecasting interval, until below the share of the baseline year.

The Pension Pillar 2 will have an increasingly substantial share in the total pension expenditures, and is expected to amount to around 0.8% of GDP at the end of the forecasting interval.

The review from the perspective of the EC 2015 Report on Fiscal Sustainability confirms the absence of significant short term risks, despite sensitivities related to the net foreign investment position, public debt and non-performing loans. However, on a medium term, considerable risks may appear.

The debt sustainability analysis reveals an increase of the debt to over 60% of GDP until 2026, combined with the risks pointed out by the sensitivity tests, in particular the negative shocks that may threaten the primary balance. The simulation of simultaneous shocks on the growth, the interest rate and the primary balance leads to a share higher than 70% of the public debt to GDP, in 2020. However, we believe that by the convergence to MTO in accordance with the preventive instrument of the SGP and if we follow the fiscal adjustment path indicated by the Commission Communication on the flexibility within the Stability and Growth Pact, Romania's public debt could go down to 35% of GDP in 2026. On the other hand, the gap indicator showing the medium term sustainability draws attention on the risks coming from the non-favorable initial budget position and, in part, from the projected public expenditures linked to the population ageing. To conclude, the European Commission sees high sustainability risks for Romania on medium term. On a long term, these risks are seen as average and come in particular from the non-favorable initial budget position, and increased by the public expenditures related to the population ageing process, mainly healthcare and long term care expenditures.

It is important to notice that the fiscal relaxation included in the new fiscal code led to a noticeable improvement of the voluntary compliance of companies, by the fact of unveiling some economic activities that were not taxed before.

6. QUALITY OF PUBLIC FINANCE

Structural measures aimed at an increased transparency of the public expenditures, review and improvement of the efficiency of public spending, modernization of public procurements, investment prioritization, consolidation of the corporate governance in the SOEs, will lead, in the medium run, to an improvement of the quality of public finances.

Prioritization of public investments

Given the budget constraints in 2016-2019, investment expenditures must be redirected to gradually replace the investments fully funded by the public budget by investments co-funded in a joint effort with the European Union and to prioritize significant public investment projects. In 2013-2014, a methodology was adopted that must be used to prioritize significant projects; this methodology relies on 4 principles: how opportune is a project in the context of the sector or national strategies; how justified a project is in economic and social terms; the project's financial affordability and sustainability; implementation arrangements ensuring the success of a project. This methodology sets out and describes in detail the main action lines for the Ministry of Public Finance in the assessing the significance of public investment projects, namely the sustainability and affordability review for the projects in the stage of drafting the pre-feasibility study and the assessment of the project readiness, at the time that the decision to approve/re-approve the technical and economic indicators is promoted for Government approval.

The objectives of this reform are as follows: (i) orienting the public investment projects with a major economic and social impact, as a priority, towards non-reimbursable funding, all the more since they support the national strategies lined up to the EU strategic objectives; (ii) reduce delays in implementation and make sure that projects are completed according to their approved deadlines; (iii) strengthen the government's decision-making process with respect to the public investments, along the lines of the annual budget law formulation process. To improve the capacity of public authorities to prepare, select and prioritize in a strategic way the public investment projects, the Ministry of Public Finance signed a technical assistance contract with the World Bank for the Project called *Improvement of Public Investment Management*, ended in December 2015.

GEO 88/2013 was amended in May 2015 to line up the prioritization of public projects with the budget calendar. At the end of the public investment management improvement project, a number of recommendations were made by the World Bank to improve the selection process of public investments. In 2016, to continue strengthening the role of the Ministry of Public Finance/*Public Investment Unit* in coordinating the new investment project preparation and to improve their capacity in the crucial stages of the public investment cycles - strategic prioritization, selection, assessment and monitoring of projects - the Public Investment Unit is to draft and promote for endorsement/approval 2 pieces of legislation aimed at revising the *GEO 88/2013* and *GD 225/2014*. The revision of

this legislation will rely on the recommendations made by the World Bank in the context of the public investment management project.

Improved budget transparency

At the beginning of March 2015, the Ministry of public Finance launched an online platform³⁴ to improve the budget transparency, which hosts the budget implementation reports of public entities. This platform provides information to the public on the way that public funds are distributed and spent by central and local public administrations. Currently, 13700 public entities can be monitored in this way.

The program is to be extended during the year to include the state-owned companies and the standalone companies (*regiile autonome*), and to include new information on the structure of public institutions, aggregate reports, financial and accounting reports and other aggregate data. The efficiency of public spending is expected to improve together with the improved budget transparency, at the same time reducing the fraud and corruption risks.

Public Expenditure Review

The Ministry of Public Finance will institutionalize the expenditure review as a move to improve the efficiency of the public spending process on the medium term. As a first step, a directorate dedicated to conducting these reviews and issuing pertinent recommendations for an optimal allocation of funds was established within the ministry.

This is a phased-in approach, which starts from a few key areas that will be pilot the public spending review process. Initially, the transport, education and regional development will be included in the project. After the completion of pilots, a roll-out model will be used to include all the expenditure areas on the medium term, aiming at improving the efficiency in the economy. This will be integrated with the budget process, taking into account the recommendations made by the Public Expenditure Directorate for the next year's budget formulation.

Public Procurements

Romania is required to pass into the national legislation the provisions of the Directive 2014/24/EU of the European Parliament and the Council of February 26 2014 on the public procurements and repealing the Directive 2004/18/EC.

The problems faced by the procurements area, which were underlined as such in the National Public Procurement Strategy, include: (i) the lack of expertise in preparing the tender documents by the contracting authorities, including the part related to the technical requirements of procurements and (ii) the lack of expertise within the contracting authorities when it comes to the assessment of the technical and financial

³⁴www.transparenta-bugetara.gov.ro

proposals submitted by the participants to the tender process. In addition, it has been found that the public procurements are under-valued by the contracting authorities, with bidders offering abnormally low prices that prove impossible to observe along the way and the excessive use of the "lowest price" criterion in awarding public procurement contracts, even in cases when this criterion is not appropriate, as it is much safer in the event of future audits.

Tender procedures are lengthy, including because of many appeals, and the legislation is difficult to use and interpret in a consistent manner, due to frequent changes in the law.

The new draft law on public and sector procurements aim at providing mechanisms to do away with the above-mentioned problems through:

- the possibility to initiate and organize in a transparent, useful way, consultations with independent experts, participants to the market and the industry, so that the contracting authorities could have direct access to expert opinions, allowing a full and educated drafting of the tender documents, including elements of the optimal technical solution;
- the minimum duration of the tendering procedures will be shorter than those regulated by the current legislation;
- according to the rules, the contracting authority awards the public procurement contracts to the bidder which submits the most economically advantageous bid;
- the most economically advantageous bid is identified based on the "lowest price" criterion or the "lowest cost" criterion based on the costs over the lifetime of the procurement object, or the "best quality/price ratio" criterion based on qualitative aspects, environment and/or social aspects, so that the contracting authorities are encouraged to take into consideration other factors, in addition to the price;
- encourage contracting authorities to use as frequently as possible the competitive negotiation procedure, in observance of the specifically regulated cases;
- encourage the use of partnerships for innovation in the implementation of the objective related to research-innovation, in the case of innovating procurements, encourage green public procurements;
- centralized procurement is encouraged, as a move to simplify the tender procedures, reduce the trading costs, have a professional public procurement process, for a more efficient use of public funds.

The public procurement process will be re-defined also by implementing the assessment process of bids in the way that was determined and mentioned in the national public procurement strategy; here it is worth mentioning the opening of bids in several steps, intermediate communications of the tender procedure results and attracting experts to assist the contracting authority during the tender procedure.

7. INSTITUTIONAL FEATURES OF PUBLIC FINANCE

The budget framework is regulated by the *Law 60/2010 on the fiscal and budgetary accountability*, republished, the *Public Finance Law 500/2002* and the *Local Public Finance Law 273/2006*. The fiscal and budgetary accountability law introduced the provisions of *Directive 85/2011* and of the *Stability, Coordination and Governance Pact of the Economic and Monetary Union*.

The Fiscal Council was created pursuant to the same fiscal and budgetary accountability law, as a standalone authority which helps with the consolidation of the fiscal and budgetary accountability in Romania, the improvement of the fiscal and budgetary transparency and the promotion of the public finance sustainability. The Fiscal Council has a large range of attributions, such as: evaluate macroeconomic projections used in supporting the forecast of general government revenues; estimate the impact of packages of measures which could influence the budget balance; analyze the budget execution and the extent to which this corresponds to proposed targets; issue recommendations on the current and future fiscal policy.

In its annual reports, the Fiscal Council conducts an evaluation of the main fiscal and budgetary policy aspects, the fiscal transparency and the sustainability of public finances, the way that taxes are collected and the efficiency of expenditures, as well as of the fiscal and budgetary outlook on the short and medium term. During the year, the Fiscal Council issued opinions concerning the most important changes in the legislation and gave a negative vote to the measures having a substantial impact of the increase of the budget deficit.

ANNEXES

Table 1 a - Macroeconomic projections

	Code	2015	2015	2016	2017	2018	2019
	ESA						
		Level1	Rate of Change				
		Bn Lei					
1. Real GDP	B1*g	692.6	3.8	4.2	4.3	4.5	4.7
2. Nominal GDP	B1*g	712.8	6.8	6.2	6.5	6.7	6.7
Real GDP Components							
3. Private Consumption Expenditures	P3	433.0	6.1	6.3	5.3	5.1	4.9
4. Public Consumption Expenditures	P3	94.4	1.6	3.2	1.8	1.6	2.0
5. Gross fixed capital formation	P51	175.6	8.8	6.6	6.9	7.3	7.5
6. Changes in inventories and net acquisition of valuables (% of GDP)	P52+ P53	1.8	-0.8	0.0	0.0	0.0	0.0
7. Exports of goods and services	P6	290.4	5.5	4.5	5.6	6.3	6.6
8. Imports of goods and services	P7	302.6	9.1	8.7	7.8	7.9	7.8
Contributions to GDP growth							
9. Final domestic demand			6.1	6.0	5.3	5.3	5.3
10. Changes in inventories and net acquisition of valuables	P52+ P53		-0.8	0.0	0.0	0.0	0.0
11. Net Export	B11		-1.5	-1.8	-1.0	-0.8	-0.6

1) The actual level of GDP and its components is in the previous year's prices.

Table 1 b - Price developments

	2015	2016	2017	2018	2019
	Rate of Change				
1. GDP Deflator	2.9	2.0	2.1	2.2	2.0
2. Private Consumption Deflator	1.2	0.6	1.5	1.8	1.5
3. Harmonized Consumer Price Index	-0.4	-0.5	2.3	2.5	2.3
4. Public Consumption Deflator	2.0	2.2	1.7	2.1	2.1
5. Investment Deflator	0.3	0.5	1.2	1.0	0.8
6. Export Deflator (goods and services)	0.9	1.5	0.3	-0.1	0.6
7. Import Deflator (goods and services)	-2.0	-1.3	-1.2	-1.1	-0.5

Table 1 c - Labor market developments

	CODE ESA	2015	2015	2016	2017	2018	2019
		LEVEL THOU. PERS.	Rate of Change				
1. Total employment ¹⁾		8561.6	-0.9	0.2	0.6	0.9	1.0
2. Employment, thousand hours worked ²⁾		15559234	-0.4	0.4	0.8	1.0	1.0
3. Unemployment rate -% ³⁾			6.8	6.7	6.6	6.5	6.4
4. Labor productivity ⁴⁾			4.7	4.0	3.7	3.5	3.6
5. Labor productivity ⁵⁾			4.2	3.8	3.5	3.4	3.6
6. Compensation of employees - million lei	D1	230199	6.2	8.4	7.8	7.4	7.3
7. Compensation per employee - lei		37302	3.2	5.6	5.2	5.1	5.1

¹⁾ Employment, the definition for the domestic concept of the national accounts

²⁾ Definition from national accounts

³⁾ Definition harmonized with Eurostat (Labor Force Survey – AMIGO)

⁴⁾ Real GDP per employed person

⁵⁾ Real GDP per hour worked

Table 1 d - Sectoral Balances

- % of GDP	CODE ESA	2015	2016	2017	2018	2019
1. Net balance, compared to the rest of the world	B9	1.2	0.7	0.5	0.5	0.5
Of which:						
- balance of goods and services		-0.5	-1.0	-1.2	-1.4	-1.4
- balance of primary and secondary income		-0.6	-0.6	-0.6	-0.4	-0.4
- capital account		2.3	2.3	2.3	2.3	2.3
2. Net Balance of the Private Sector	B.9	1.9	3.6	3.4	2.8	2.1
3. Net Balance of the Government Sector	EDP B.9	-0.7	-2.9	-2.9	-2.3	-1.6
4. Statistical Discrepancy						

Table nr. 2 a– Projection of the consolidated budget

	CODE ESA	2015	2015	2016	2017	2018	2019
		LEVEL MLN. LEI	- % of GDP				
Net Balance (EDP B9), by sub-sectors							
1. Consolidated Budget	S.13	-5,287.9	-0.7	-2.9	-2.9	-2.3	-1.6
2. Central Government	S.1311	-12,001.3	-1.7	-3.1	-3.1	-2.4	-1.8
3. State Government	S.1321	M	M	M	M	M	M
4. Local Government	S.1313	5,117.8	0.7	0.1	0.0	0.0	0.1
5. Social Insurance Fund	S.1314	1,595.7	0.2	0.1	0.1	0.1	0.1
Consolidated Budget (S13)							
6. Total collected	TR	247,941.0	34.8	32.5	31.7	31.9	31.8
7. Total expenditures	TE ¹⁾	253,228.9	35.5	35.4	34.6	34.1	33.4
8. Net Balance	EDP B.9	-5,287.9	-0.7	-2.9	-2.9	-2.3	-1.6
9. Interest	EDP D.41	11,731.5	1.6	1.6	1.6	1.6	1.4
10. Primary Balance ²⁾		6,443.6	0.9	-1.3	-1.2	-0.7	-0.2
11. One-off and other temporary measures ³⁾		0.0	0.0	0.0	0.0	0.0	0.0
Selected components of Revenues							
12. Total taxes (12=12a+12b+12c)		141,920.1	19.9	18.6	17.8	17.9	17.8
12a. Tax on production and imports	D.2	94,377.5	13.2	12.0	11.2	11.2	11.1
12b. Current taxes on income, wealth etc.	D.5	47,542.6	6.7	6.5	6.6	6.7	6.7
12c. Capital Taxes	D.91						
13. Social contributions	D.61	58,073.5	8.1	8.1	8.1	8.1	8.2
14. Property Income	D.4	5,751.7	0.8	0.7	0.7	0.7	0.7
15. Other ⁴⁾		42,195.7	5.9	5.1	5.0	5.1	5.1
16=6. Total Revenue	TR	247,941.0	34.8	32.5	31.7	31.9	31.8
p.m.: tax burden (D.2+D.5+D.61+D.91-D.995) ⁵⁾							
Selected components of Expenditures							
17. Compensation of employees + intermediate consumption	D.1+ P.2	94,525.7	13.3	13.7	13.4	13.2	13.0
17a. Compensation for employees	D.1	54,323.0	7.6	8.1	7.9	7.8	7.7
17b. Intermediate Consumption	P.2	40,202.7	5.6	5.6	5.5	5.5	5.4
18. Social Contributions (18=18a+18b) of which unemployment benefits ⁶⁾		81,781.5	11.5	11.4	11.2	11.0	10.7
		769.5	0.1	0.1	0.1	0.1	0.1
18a. Social contributions in kind	D.6311, D.6312, D.63131	6,479.5	0.9	0.9	0.9	0.9	0.9
18b. Social contributions, other	D62	75,302.0	10.6	10.4	10.3	10.1	9.8
19=9. Interest	EDP D.41	11,731.5	1.6	1.6	1.6	1.6	1.4
20. Subsidies	D.3	3,476.9	0.5	0.5	0.5	0.5	0.5
21. Gross fixed capital formation	P.51	36,285.9	5.1	4.6	4.5	4.5	4.5
22. Capital transfers	D.9	7,974.7	1.1	1.2	1.2	1.2	1.2
23. Other ⁷⁾		17,452.7	2.4	2.4	2.2	2.2	2.1
24=7. Total expenditures	TE1	253,228.9	35.5	35.4	34.6	34.1	33.4

¹⁾ Adjusted for the net flow of swap-related flows, i.e. TR-TE=EDP B9

²⁾ The primary balance is calculated as (EDP B9, point 8) plus (EDP D.41, point 9)

³⁾ A plus sign means deficit-reducing one-off measures

⁴⁾ P.11+P.12+P.131+D.39+D.7+D.9 (different from D.91)

⁵⁾ Including those collected by EU and including an adjustment for uncollected taxes and social contributions (D.995)

⁶⁾ Includes the benefits in cash (D.621 and D.624) and benefits in kind (D.631) related to unemployment

aid

⁷⁾ D.29+D4 (different from D.41)+D.5+D.7+D.9+P.52+P.53+K.2+D.8

Table nr. 2b - No-policy change projections ¹

	2015	2015	2016	2017	2018	2019
	Level	% of GDP	% of GDP	% of GDP	% of GDP	% of GDP
1. Total revenue at unchanged policies	247,941.0	34.8	32.5	31.7	31.9	31.8
2. Total expenditures at unchanged policies	253,228.9	35.5	35.4	34.6	34.1	33.4

¹⁾ The projections shall start at the time when the Stability or Convergence Programme is drafted and show revenue and expenditure trends under a 'no-policy change' assumption, as defined on p.15. Therefore, figures for X-1 should correspond to actual data for revenue and expenditure.

Table no.2c – Amounts to be excluded from the expenditure benchmark

	2015	2015	2016	2017	2018	2019
	Level	% of GDP	% of GDP	% of GDP	- % of GDP	% of GDP
1. Expenditure on EU programmes fully matched by EU funds revenue	17,396.7	2.4	1.8	1.8	2.0	2.0
2. 2. Cyclical unemployment benefit expenditure ¹	5.7	0.0008	-0.0005	0.0001	0.0001	0.0011
3. 3. Effect of discretionary revenue measures ²	0	0.48	0	0	0	0
4. 4. Revenue increase mandated by law	0	0	0.04	0	0	0

¹⁾ The methodology used to arrive to the cyclical component of the unemployment expenditures as defined by COFOG under code 10.5

$$E_t^{UC} = E_t^U \cdot \frac{u_t - NAWRU_t}{u_t}$$

The following formula was used: where:

E_t^U represents the unemployment expenditures and E_t^U reprezintă cheltuielile cu șomajul și E_t^{UC} the cyclical component of unemployment expenditures.

²⁾ Revenue increase required by law should not be included in the impact of discretionary measures: the data in rows 3 and 4 must be mutually excluded.

Table nr. 3– Central administration expenditures by functions

		- % of GDP	
	CODE COFOG	2015*)	2018
1. General Public Services	1	4.1	n.a.
2. Defense	2	0.9	n.a.
3. Public Order and Safety	3	2.3	n.a.
4. Economic Affairs	4	6.1	n.a.
5. Environment Protection	5	0.9	n.a.
6. Housing and Community Amenities	6	1.2	n.a.
7. Health	7	4.1	n.a.
8. Recreation, culture, religion	8	1.0	n.a.
9. Education	9	3.2	n.a.
10. Social Protection	10	11.7	n.a.
11. Total expenditures (=point 7=24 in Table 2a)	TE	35.5	34.1

*) 2015 data are semi - final

Table nr. 4 – Government Debt Evolution

- % of GDP	ESA CODE	2015	2016	2017	2018	2019
1. Gross Government Debt ¹⁾		38.4	39.1	39.8	39.9	39.3
2. Change in the government debt		-1.4	0.7	0.7	0.1	-0.6
Contribution to the change of the gross debt						
3. Primary Balance ²⁾		0.9	-1.3	-1.2	-0.7	-0.2
4. Interest ³⁾	EDP D.41	1.6	1.6	1.6	1.6	1.4
5. Stocks—flows adjustments		-2.1	-2.2	-2.1	-2.2	-2.2
<i>Of which:</i>						
- Differences between interest paid and accrual ⁴⁾		-0.3	-0.2	-0.1	-0.1	-0.1
- Net accumulation of financial assets ⁵⁾		-0.5	-0.3	0	0	0
<i>of which:</i>						
- from privatization		0	0	0	0	0
- Valuation effects and others ⁶⁾		-1.3	-1.7	-2.0	-2.1	-2.1
p.m. Implicit interest rate on debt ⁷⁾		4.4	4.5	4.5	4.2	3.9
Other relevant variables						
6. Liquid financial assets ⁸⁾	% of GDP	9.5	8.7	8.1	7.6	7.1
7. Net financial debt (7=1-6)	% of GDP	28.9	30.4	31.7	32.3	32.2
8. Debt amortization (existing obligations) since the end of the previous year ⁹⁾	% of GDP	7.6	6.6	3.2	3.9	3.3
9. Percentage debt denominated in foreign currency	% in debt	53.8	50.9	49.3	46.9	44.2
10. Average maturity ¹⁰⁾	years	5.4	5.6			

¹⁾ As defined in Regulation 3605/93 (not an ESA concept)

²⁾ According to position 10 in Table 2a

³⁾ According to position 9 in Table 2a

⁴⁾ The differences in respect of interest expenditures, other expenditures and revenues may be distinguished when relevant or when the debt-to-GDP ratio is above the benchmark

⁵⁾ Liquid assets (foreign currency), government bonds, active in third countries, enterprises controlled by the state and the difference between listed and non-listed assets may be distinguished when relevant or when the debt-to-GDP ratio is above the benchmark

⁶⁾ The changes resulting from exchange rate variations and the operations on the secondary market may be distinguished when relevant or when the debt-to-GDP ratio is above the benchmark

⁷⁾ The associated proxy version is the ration between annual interest payments and the average debt stock from the previous year

⁸⁾ AF1, AF2, AF3 (consolidated at market value), AF5 (if listed on stock exchange; including mutual fund shares).

⁹⁾ Indicator calculated based on the debt at 12/31/2015

¹⁰⁾ Average remaining maturity

Table nr. 5 - CYCLICAL DEVELOPMENTS

- % of GDP	ESA CODE	2015	2016	2017	2018	2019
1. Real GDP Growth (%)		3.8	4.2	4.3	4.5	4.7
2. Net Consolidated Balance	EDP B.9	-0.7	-2.9	-2.9	-2.3	-1.6
3. Interest expenditures	EDP D.41	1.6	1.6	1.6	1.6	1.4
4. Temporary and <i>one-off</i> ¹⁾ measures						
5. Potential GDP Growth (%)		2.9	3.4	3.9	4.1	4.2
Contributions:						
- labor		-0.3	0.0	0.2	0.3	0.2
- capital		1.2	1.3	1.4	1.6	1.7
- total factor productivity		2.0	2.1	2.2	2.2	2.2
6. Output Gap		-1.2	-0.4	0.0	0.4	0.9
7. Cyclical Component		-0.4	-0.15	-0.01	0.12	0.29
8. Cyclically adjusted balance (2-7)		-0.3	-2.7	-2.9	-2.4	-1.9
9. Cyclically adjusted primary balance (8+3)		1.3	-1.1	-1.3	-0.8	-0.5
10. Structural Balance (8-4)		-0.3	-2.7	-2.9	-2.4	-1.9

¹⁾ A plus sign means deficit-reducing one-off measures

*) It does not include the adjustor of 0.25pp for co-financing the EU-funds supported programs.

Table nr. 6– Divergence from previous update

	ESA CODE	2015	2016	2017	2018	2019
GDP Growth (%)						
Previous edition		3.2	3.4	3.7	4.0	
Current Edition		3.8	4.2	4.3	4.5	4.7
Difference		0.6	0.8	0.6	0.5	
Budget Balance (% of GDP)						
Previous edition	EDP B.9	-1.5	-1.2	-1.0	-0.8	x
Current Edition	EDP B.9	-0.7	-2.9	-2.9	-2.3	-1.6
Difference		0.7	-1.7	-1.9	-1.5	-1.6
Gross Government debt (% of GDP)						
Previous edition		40.1	39.4	38.4	37.1	
Current Edition		38.4	39.1	39.8	39.9	39.3
Difference		-1.7	-0.3	1.4	2.8	

*) Includes an adjustor of 0.25pp for co-financing the EU-funds supported programs.

Table nr. 7 - LONG TERM SUSTAINABILITY OF PUBLIC FINANCE

- % of GDP	2013	2014	2020	2030	2040	2050	2060
Total expenditures							
Of which: Age-related expenditures	15.3	15.3	15.6	16.1	17.0	17.4	17.5
- Pension expenditures	8.2	8.2	8.1	8.1	8.4	8.4	8.1
- Social insurance expenditures							
Full service and early pensions	7.0	7.0	7.0	6.9	7.2	7.2	7.0
Other pensions (disability, successor)	1.2	1.2	1.1	1.3	1.2	1.2	1.1
Occupational pensions (if connected to the central administration)							
- Health care	3.8	3.8	4.1	4.3	4.6	4.7	4.8
- Long term care (it used to be part of health care)	0.7	0.7	0.8	1.0	1.2	1.4	1.6
- Education expenditures	2.6	2.6	2.6	2.7	2.8	2.9	3.0
Other age-related expenditures							
Interest expenditures							
Total Revenue							
of which: property income							
of which: from pension contributions (or social contributions, as appropriate)	5.5	6.1	6.1	6.1	6.1	6.3	6.5
Pension reserve fund assets							
Of which: consolidated public pension fund assets (assets other than the central administration's liabilities)							
Systemic pension reforms¹⁾							
Social Contributions diverted to mandatory private scheme ²⁾	0.7	1.0	1.5	2.1	2.4	2.5	2.7
Pension expenditures paid by mandatory private scheme ³⁾	0	0	0	0.1	0.4	0.7	0.8
Assumptions							
	- average rates -						
Labor productivity growth (hourly rates)	1.5	1.7	2.5	2.7	2.3	2.2	1.8
Real GDP Growth	3.4	2.8	3.3	1.8	1.4	1.5	1.3
Participation rate male (aged 20 to 64)	77.7	77.6	78.6	78.5	76.7	76.5	77.0
Participation rate female (aged 20 to 64)	60.2	59.8	60.1	59.5	57.5	57.4	58.0
Total participation rate (aged 20 to 64)	68.9	68.7	69.4	69.1	67.2	67.1	67.7
ILO Rate of unemployment	7.1	6.8	6.7	6.7	6.5	6.5	6.5
Share of population at 65 and over 65 in total population	16.4	16.7	18.0	20.4	23.1	26.9	28.8

Average rates refer to the above-mentioned interval. For the forecast interval the rates are calculated based on potential GDP estimated in the 2015 public finance sustainability assessment year.

¹⁾ Systemic Pension Reforms refer to pension reforms introducing a multi-pillar system, including a mandatory pillar with a total own fund; in 2014, 1 percent of GDP was directed to the Pension Pillar 2.

²⁾ Social contributions or other revenues to the mandatory pillar with a total own fund, for covering the pension obligations attracted in accordance with the systemic reform

³⁾ Expenditures with pensions or other social benefits paid by the mandatory pillar with total own fund, in respect of pension obligations attracted in accordance with the systemic reform

Table nr. 7 a – Contingent Liabilities

	2015	2016
Public Guarantees*)	2.2%	2.6%
<i>Of which: linked to the financial sector</i>	0.02%	0.02%

*) of the general government sector, excluding guarantees granted between units of the general government sector.