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# **Romania:** Letter of Intent, and Technical Memorandum of Understanding

December 22, 2010

The following item is a Letter of Intent of the government of Romania, which describes the policies that Romania intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Romania, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

**ROMANIA: LETTER OF INTENT (LOI)**

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, DC, 20431
U.S.A.

Bucharest, December 22, 2010

Dear Mr. Strauss-Kahn:

1. The anti-crisis program supported by the International Monetary Fund (IMF), the European Union (EU), and the World Bank (WB) has continued to play a crucial role in stabilizing the Romanian economy, reversing imbalances, rebuilding confidence of international financial markets, and setting the stage for future sustainable economic growth. Economic activity is now stabilizing and we expect growth to resume in the coming months, leading to an increase of around 1½ percent in 2011 (compared to around -2 percent in 2010). Inflation has jumped sharply in recent months due to the effects of the July VAT increase and food price pressures. We expect inflation to peak at slightly above 8 percent at end 2010 before beginning to return to within the National Bank of Romania's target band in the course of 2011. We continue to project a current account deficit of about 5–6 percent of GDP for 2010.

2. Our performance on the quantitative targets and the structural reform agenda has been strong (Tables 1 and 2).

- *Quantitative performance criteria and indicative targets.* All end-September 2010 quantitative performance criteria were observed, with the exception of that on general government arrears (¶8). However, we have taken action to assure that central government arrears are near zero and will remain so for the remainder of the program. The indicative target on the operating balance of loss-making state-owned enterprises was also missed. Inflation remained within the inner band of the inflation consultation mechanism throughout the period.
- *Structural benchmarks*. All structural benchmarks to end-December will be met, albeit with delays in some cases. We have reformed the Deposit Guarantee Fund's (DGF's) funding regime and have reviewed its governance structure by end-September, as programmed. The Unified Wage legislation will be approved by parliament in December (prior action), with only a small delay from the end-October target. There has been a delay in the parliamentary ratification of some of the June austerity measures and we now expect that this will take place in the context of the approval of the 2011 budget. While the earlier structural benchmark on approval of the pension reform law was met, there was a delay in enactment which we now expect in December (¶16; prior action). We are making significant progress on other structural benchmarks under the program.

3. In view of this performance—and of the supplementary and corrective actions outlined in this Letter—we request completion of the sixth review under the Stand-By Arrangement. We request a waiver of applicability for the targets on the general government balance, on the ceiling on government guarantees, and for the inflation consultation band. We also request a waiver of non-observance for the end-December performance criterion on general government arrears as that target is unlikely to have been met.

4. We believe that the policies set forth in the letters of April 24, 2009, September 8, 2009, February 5, 2010, June 16, 2010, June 29, 2010, September 9, 2010 and in this Letter are adequate to achieve the objectives of our economic program, but the government stands ready to take additional measures as appropriate to ensure achievement of its objectives. As is standard under all IMF arrangements, we will consult with the IMF before modifying measures contained in this Letter or adopting new measures that would deviate from the goals of the program, and will provide the IMF and the European Commission (EC) with the necessary information for program monitoring.

**Fiscal sector**

5. We are on track to meeting this year's fiscal targets, following the difficult fiscal adjustment measures applied in July. The overall deficit target for the end-September has been met with a significant margin due to strict expenditure control and better-than-anticipated tax revenues. We also expect to meet the full year deficit target of 6.8 percent of GDP for 2010. The recent payment of health sector arrears and overdue bills produced a sharp drop in domestic payments arrears, but the end-September ceiling has been breached again given limited progress in the repayment of local government arrears. We will take action to maintain central government and social security arrears near zero for the remainder of the program (¶8).

6. For 2011, we remain fully committed to reducing the deficit to 4.4 percent of GDP. On the revenue side, we intend to leave the main components of the tax system unchanged. On the spending side, we are committed to keeping the wage bill within the agreed limit of RON 39 billion, excluding contributions from the military (RON 1.6 billion under the new pension law), while calibrating wages, bonus payments, and public employment policies to ensure some recovery of real public sector wages. To secure the 2011 deficit target and compensate for the elimination of the minimum tax, we will take the following measures: (i) undertake further health sector reforms (¶17) to improve revenues and control expenditures; (ii) reduce the total subsidies for livestock welfare for 2011, after confirming the introduction of funding for these programs in the European National Program for Rural Development and further streamline state aid; (iii) continue public employment reductions by *inter alia* maintaining the policy of replacing only 1 of 7 departing workers; and (iv) broaden the base of health contributions to cover pensioners earning between RON 740 and RON 1000. We are continuing the comprehensive reform of the education system, which should improve the quality of instruction while generating additional savings as a result of rationalization of the school network and of the teacher workload. Within the budget envelope, we will allocate additional resources to investment in the first half of the year so as to improve absorption of

EU funds. If absorption improves sufficiently, we will work on solutions to create greater fiscal space for investment from mid-2011. The European Union will provide expert assistance for utilizing the resources available from the EU, European Investment Bank, and the World Bank, including through innovative financing solutions. We stand ready to take compensatory actions if any judicial impediments arise to the execution of this fiscal strategy. Parliamentary approval of the agreed 2011 budget (including ratification of the 24 percent VAT rate) will be a prior action for the review. The remaining policies in the fiscal area remain as outlined in our letter of intent of September 9, 2010 (¶6).

7. For 2012, we aim to bring the deficit down to the 3 percent of GDP Maastricht target (in accrual terms). This will require continued expenditure restraint, including on wages and bonuses, and may require additional measures. We will strictly limit further *ad hoc* changes to the tax system to ensure predictability and stability. Once we are firmly on track to meeting our deficit target, we will undertake—with technical assistance from the IMF and in consultation with the EC and World Bank—a comprehensive review of the tax system with a view to its revenue-neutral optimization and simplification. Should the economic recovery create sufficient fiscal space, we will consider a gradual reduction in labor taxation, the high incidence of which weighs heavily on competitiveness, employment creation and labor market practices. The Medium-Term Fiscal Strategy for 2011–13 is an important step in implementing the Fiscal Responsibility legislation and in solidifying our commitment to the Maastricht targets. We also intend to begin discussions in the coming months on a new arrangement, which will help anchor our fiscal performance in 2011 and 2012. We will strengthen the recently established Fiscal Council by providing it with adequate funding so as to ensure that its secretariat is fully staffed with appropriately skilled people.

8. We continue our efforts in clearing outstanding payment arrears. At the central level, we paid off RON 1.9 billion in health arrears and overdue bills in September. We will allocate necessary funds in 2010–11 to prevent accumulation of further arrears and will assure that central government and social security sector arrears will remain near zero at end-November 2010 (prior action). In line with a new EU directive, we will reduce over time the period for paying bills after submission to no more than 30 days. New legislation on local government finance will also allow for greater control of local government arrears beginning in January 2011. To improve commitment control, the recent IMF technical assistance mission helped us with efforts to integrate the accounting reporting system with the Treasury payment system. However, the reforms will take longer than anticipated and we will focus our initial efforts on completing the tender for consultants to implement the project and having a full project plan should be in place by March 2011 (modified structural benchmark reset for March 15, 2011). EU and World Bank experts will review the local government arrears issue with a view toward improving financial management in the local administrations. We will continue using budget appropriations as commitment ceilings and will enforce sanctions against institutions and individuals who breach the ceilings.

9. Our financing strategy will focus on extending the maturity of our domestic debt and consolidating the financial buffers. We will, thus, aim to transition from use of short-term

cash management facilities to increased issuance of longer-term instruments under market-determined conditions, with a view to building a yield curve. We also plan to launch a "euro medium term notes" program in late 2010 or early 2011 that will maintain our presence in the external markets under more flexible issuance procedures and will help us balance the financing between the domestic and external markets. We are firmly committed to stabilizing our financial buffers over the coming months and to gradually increasing them to around 4 months of financing needs. To enhance our capabilities, in 2011 we will conduct a formal review of our debt management strategy with the assistance of IMF, EC, and World Bank experts.

**Fiscal and structural reforms**

10. We continue efforts to improve our tax collection and administration and to fight tax evasion. Work is progressing on a draft ordinance on high net wealth individuals to be approved by end-December (structural benchmark, reset from end-November) and an IMF expert will assist in its subsequent implementation. The definition of income will be broadened and the right to audit unreported income will be strengthened. As agreed with the IMF and the EC, we will request a shift in the VAT mandatory threshold from the EU Council of Ministers to EUR 50,000, while studying options for simplified taxation for smaller taxpayers under the threshold. Starting next year, we plan to implement new criteria to allocate taxpayers into small, medium, and large segments. The requirement of electronic filing for medium and large taxpayers has come into effect in November. We will continue our efforts to introduce information technology (IT) systems and consolidate the IT department in ANAF to improve tax administration. We will also provide customs and tax administration with the necessary technical equipment to fight tax evasion. We will continue our efforts to implement measures described in our previous letters.

11. The accelerated absorption of EU funds remains a focal objective of the government. Over the coming year, we will focus on strengthening the administrative capacity of units managing the funds; modernizing and consolidating the legislative and regulatory framework for public investment and other fields relevant for EU fund absorption; and prioritizing investment to assure sufficient financing for key projects as per recommendations in the recent functional reviews. Specifically, we are committed to: (i) giving priority to investment projects co-financed with EU funds when initiating new investments; (ii) prioritizing the existing portfolio of capital projects to focus on projects where funding can be fully secured, with low priority projects discontinued; (iii) strengthening the project appraisal process by requiring private sector review of the bankability of projects; (iv) encouraging private sector participation in projects via outsourcing or public-private partnership arrangements; and (v) ensuring full staffing of program management bodies and the adequate remuneration of the specialized staff, financed with support from technical assistance funds. The government will move the EU project management unit from the Ministry of Public Finance to the Prime Minister's office and strengthen its authority and staffing with full authority to take necessary actions across ministries to speed up EU funds absorption for investment projects to ensure

economic growth. We will create facilities for reallocating the capital budget during the year to those ministries with the best absorption performance.

12. We are undertaking a social benefits reform to improve the efficiency of protection of the poorest and most vulnerable, while providing support for the fiscal adjustment strategy. Efficiency will be increased by allowing for more focused income and means tested eligibility criteria. The reform, which has already been submitted to parliament, will consolidate the guaranteed minimum income scheme, heating benefits and family allowance into one new means-tested scheme. Disability allowances will also be subject to an income-test. We will also streamline the current maternity policy to bring it more in line with the EU average. The draft is currently being discussed in the government. To reduce the significant rate of benefits fraud detected in recent inspections and increase spending efficiency, we have also doubled the personnel working on social benefit inspection.

13. The government continues efforts to improve the performance of public enterprises. The 10 largest loss-making public enterprises failed to meet the indicative target for operating losses in the third quarter. Moreover, arrears have continued to increase, violating EC conditionality on a quarterly reduction of arrears. Measures have been taken to improve the revenue side of these companies (via higher tariffs) as well as cost reductions via personnel cuts and restructuring, but progress continues to be slow. The government will continue the process of winding-up or privatizing state owned enterprises (including Termoelectrica and the cargo rail company) with the goal of securing an optimum price. The privatization agency AVAS continues work on preparing the sale of small firms under its majority ownership and the minority stakes it holds in at least 150 additional firms, but completion of most sales will be expected in 2011.

14. The government will continue to reform the transportation sector to reduce losses and clear arrears of the major SOEs in the railway and road transport sectors. This will be done through widening the revenue base, strengthening controls, reforming legislation to increase transparency of the procurement and contracting frameworks, and increasing reliance on value-for-money analysis of our investment projects. We also aim to gradually increase the system’s use of railway transportation, away from roads, in order to reduce road maintenance costs. To boost absorption of EU funds, we will give priority to investment projects for cross-country road and rail connections from Nadlac to Constanta (European Corridor IV), finalize the EU project portfolio for 2014–20, and contract independent experts to monitor project execution. Finally, we will restructure the Ministry of Transport and Infrastructure to strengthen administrative capacity through independent human resource evaluation and introduction of a performance-based remuneration system.

15. Preparation of framework and implementing legislation for the unified wage law is nearing completion. It is expected to be approved by parliament in December 2010 (prior action). The parameters will ensure that: (i) the public wage bill remains within the agreed envelope for 2011; (ii) all remaining bonuses are set as ceilings rather than mandatory levels, both at an individual and aggregate level, allowing for flexibility according to performance and budgetary conditions; (iii) the productivity bonus system (*stimulente)* will be eliminated

by incorporating it into the basic wage and annulling the legislative provisions that create its financing fund, while allowing some flexibility for rewarding strong tax collections within the overall bonus ceiling. The government remains committed to further reductions in public employment in the remainder of 2010 and in 2011.

16. Enactment of the pension reform was delayed because the president sent it back to parliament to reconsider of the pension age of women. The parliament has reapproved the legislation early December and it will be signed by the president and enacted by mid-December (prior action). As noted in our September letter, we have suspended early retirements until the new law enters into force, and the new pension indexation provisions will enter into effect in 2012, after the 2011 pension freeze expires.

17. The government will continue restructuring the health sector to ensure the functioning of health care system within budgetary allocations going forward. While we continue to implement measures to reduce healthcare costs (see LOIs of June 16, June 29, and September 9, 2010), these have proven insufficient to balance the much reduced budget for the health system without accumulating arrears. To achieve an appropriate balance between the need to preserve adequate healthcare services and to control costs, we will undertake the following measures in 2010 that will be continued in 2011:

- Ensure that the revised 2010 and the 2011 budget for the health system are consistent with the projected spending after restructuring measures.

- To increase the revenues of the system, we will: (i) approve urgent legislation to establish a beneficiary copayment for all healthcare services (excluding emergency), with exemptions based solely on means-testing to protect the most vulnerable; and (ii) clarify the legislative framework for the clawback tax on drug suppliers.

- To further reduce spending, we will: (i) restructure the hospital system; (ii) limit the number of contracted hospital in-patients by 10 percent relative to the 2010 levels, through annual contracts with the hospitals; (iii) eliminate mandatory contracting with all hospitals, allowing competitive contracting with selected hospitals while ensuring transparency and oversight; (iv) reduce the price markup paid by the government for drugs in the national programs (list C2) at both retail and wholesale levels to 1.5 and 4 percent, respectively; (v) in the primary healthcare system, reduce the share of per-capita reimbursement of doctors from 70 to 50 percent, in favor of per-service reimbursement; and (vi) reform, with assistance from the World Bank, the package of benefits insured by the government to exclude coverage of costly nonessential health services.

- To improve controls over the financial performance of the sector, we will cap the nominal amount of quarterly services contracted with hospitals, primary care doctors and pharmacies to budgeted amounts; and develop a transparent and integrated IT system in the Ministry of Health and Health House to monitor and increase efficiency of health spending and to use the system as a basis for health policymaking.

18. We are continuing work on labor market reforms to increase flexibility, increase representativity in the negotiations between social partners, and encourage greater labor force participation, particularly for young people. We have submitted to parliament a revised law on day laborers to parliament, and a draft enhanced apprenticeship law is ready for submission. Before end-December (after consultation social partners and with the IMF, the World Bank and the European Commission), we will send a revised social dialog code and an improved labor code to parliament. We are also making efforts to improve the provision of training programs to low-skilled workers. After freezing the minimum wage since 2008, we will raise it to broadly compensate for recent inflation, while delinking the unemployment benefits from the minimum wage.

**Financial sector**

19. The protracted recession and uncertainty caused by recent government ordinance on credit contracts is weighing on asset quality and on the profitability of the banking sector. Loans classified as doubtful and loss rose to 20.2 percent, while those calculated on the 90 day loss classification reached 11.7 percent at end-September, and they are expected to continue to rise into next year. Capitalization ratios stayed high due to timely injections of capital by banks, but pressures remain due to losses from increased provisioning in a number of banks. The average capitalization ratio for the banking sector was 14.6 percent at end-September, and all institutions remained above 11 percent. Nearly all parents of the nine largest foreign banks have complied with their commitment to maintain exposures under the European Bank Coordination Initiative (EBCI) and in aggregate ended October at 98 percent.

20. We are committed to continuing the consolidation of the safety net to deal with financial distress. The parliament has ratified the amendments to the banking law, which enable the special administrator to promptly implement a broad range of restructuring measures, and amendments to the winding up law are expected to be ratified shortly. We have taken steps to strengthen the funding and governance of the Deposit Guarantee Fund (DGF) and will amend the deposit insurance legislation accordingly by end-December (structural benchmark). We will also amend by ordinance the DGF law by mid-March, 2011, to allow for the use of resources administered by the DGF (including through guarantees) to facilitate restructuring measures authorized by the National Bank of Romania (NBR) regarding the transfer of deposits, including purchase and assumption transactions, if such use would be less costly than the direct payment of deposit guarantees (structural benchmark). The current provisioning framework is sound and the NBR does not consider that any new prudential regulation in this area is necessary at present. The NBR will continue to consult with the IMF and EC staff before introducing or amending other aspects of the regulatory framework and we will refrain from promoting legislative initiatives (such as the current draft of the personal insolvency law) that would undermine credit discipline.

21. As a prior action, we will work with parliament to ensure that the emergency ordinance 50 of 2010 improves transparency and protects consumer rights, while safeguarding the stability of the financial system. At the same time, we will ensure that the National Bank is the only agency authorized to regulate banks' lending activity.

22. We remain committed to reversing recent legislative initiatives that inadvertently infringed on the independence of the central bank and of non-bank financial regulators. An ordinance was issued removing monetary financing provisions of the wage cuts imposed on the NBR, and we will reverse provisions violating the autonomy of wage-setting by end-December.

**Monetary and exchange rate policy**

23. So far, the effects of the recent increase in VAT on inflation have been somewhat less than expected. However, food price pressures from higher world prices and the effects of recent flooding on domestic agricultural production have pushed the headline CPI somewhat above previous expectations. We now expect inflation to peak in the coming months at slightly above 8 percent before receding in 2011. Barring significant second-round increases, the price-level effects should peter out after mid-2011, allowing the attainment of the end-2011 target of 3 percent ±1 percentage point. There are risks, however, if second round effects materialize or if significant adjustments in administered prices take place. While the one-off nature of the VAT-induced price increase does not warrant a monetary policy response, increased vigilance is required to keep inflation expectations in check and stave off possible second-round inflationary effects. The NBR board has paused its easing cycle until the effects of the VAT increase become clearer and headline inflation begins to ease. Looking forward, monetary policy will be geared towards reaching the projected disinflation path net of the first-round tax effect.

**Program modifications and monitoring**

24. The program will continue to be monitored through regular reviews, prior actions, quantitative performance criteria and indicative targets, and structural benchmarks. The quantitative targets for end-December and continuous PCs have been set at the fifth review and are subject to clarifications as set out in the attached updated Technical Memorandum of Understanding. An end-January 2011 NFA performance criterion and indicative targets for end-March 2011 are proposed as set out in Table 1 and the structural benchmarks are set out in Table 2. The understandings between the Romanian authorities and IMF staff regarding the quantitative performance criteria and the structural measures described in this letter are further specified in the attached Technical Memorandum of Understanding.

| | |
|---|---|
| /s/ | /s/ |
| Gheorghe Ialomiţianu | Mugur Isarescu |
| Minister of Public Finance | Governor of the National Bank of Romania |

Attachments

## Table 1. Romania: Quantitative Program Targets

| | 2008 | 2009 | | | | 2010 | | | | | 2011 | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Dec | March | June | Sept | Dec | March | June | Sept | | Dec | January | March |
| | Actual | Actual | Actual | Actual | Actual | Actual | Actual | Prog. | Actual | Prog. | Perf. crit. | Indicative |
| **I. Quantitative Performance Criteria** | | | | | | | | | | | | |
| 1. Change in net foreign assets (mln euros) 1/ 2/ | 25,532 | -3,500 | -5,119 | -4,566 | -4,874 | 779 | -509 | -2,000 | -318 | -2,000 | 0 | 350 |
| 2. Floor on general government overall balance (mln lei) 3/ 4/ 5/ | -24,655 | -8,300 | -14,456 | -25,563 | -36,101 | -8,422 | -18,015 | 27,505 | 23,732 | -34,650 | | -6,300 |
| 3. Stock in general government arrears (bn lei) | 1.06 | 1.41 | 1.55 | 1.4 | 1.50 | 1.76 | 1.8 | 0.81 | 1.57 | 0.48 | | 0 |
| 4. Ceiling on general government guarantees issued since start of program (face value, bn | … | … | 0.02 | 0.8 | 2.2 | 4.6 | 5.5 | 12.0 | 6.5 | 12.0 | | 12.0 |
| **II. Continuous Performance Criterion** | | | | | | | | | | | | |
| 5. Nonaccumulation of external debt arrears | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | | 0 |
| **III. Inflation Consultation** | | | | | | | | | | | | |
| 6. 12-month rate of inflation in consumer prices | | | | | | | | | | | | |
| Outer band (upper limit) | … | … | 8.4 | 7.7 | 6.5 | 6.5 | 6.0 | 10.0 | … | 10.0 | | 9.0 |
| Inner band (upper limit) | … | … | 7.4 | 6.7 | 5.5 | 5.5 | 5.0 | 9.0 | … | 9.0 | | 8.0 |
| Actual/*Center point* | 6.3 | 6.7 | 5.9 | 4.8 | 4.7 | 4.2 | 4.4 | *8.0* | 7.8 | *8.0* | | *7.0* |
| Inner band (lower limit) | … | … | 5.4 | 4.7 | 3.5 | 3.5 | 3.0 | 7.0 | … | 7.0 | | 6.0 |
| Outer band (lower limit) | … | … | 4.4 | 3.7 | 2.5 | 2.5 | 2.0 | 6.0 | … | 6.0 | | 5.0 |
| **IV. Indicative Target** | | | | | | | | | | | | |
| 7. General government current primary spending (excl. EU funds and social assistance, mln | 92,327 | 22,149 | 43,238 | 63,878 | 85,637 | 32,749 | 66,124 | 100,000 | 98,721 | 131,500 | | 32,200 |
| 8. Operating balance (earnings before interest and tax) net of subsidies of 10 SOEs, defined in TMU (mln. lei) 3/ | | | | | | -1,081 | -2,333 | -3,000 | -3,801 | -4,000 | | -750 |
| Memorandum Item: | | | | | | | | | | | | |
| Revenue of general government, net of EU funds (mln. lei) 3/ | … | … | … | … | 151,508 | 36,355 | 74,669 | 114,700 | 116,091 | 157,950 | | 40,100 |

1/ The December 2008 figure is a stock.
2/ Performance criterion for January 2011 and indicative target for March 2011 are relative to December 2010 target.
3/ Cumulative figure during calendar year (e.g. March 2011 figure is cumulative from January 1, 2011).
4/ In accordance with TMU, the end-September program target was adjusted from the original target of -28,200 by one-half of the revenue over-performance.
5/ The target for March 2011 can be adjusted with higher or lower capital spending as defined in TMU.

Table 2. Romania: Performance for Sixth Review and Proposed New Conditionality

| Measure | Target Date | Comment |
|---|---|---|
| **Prior actions** | | |
| 1. Parliamentary approval of the agreed 2011 budget, including ratification of the 24 percent VAT rate | | |
| 2. Ensuring central government and social security arrears at near zero at end-November 2010 | | |
| 3. Approval of the unified public wage legislation | | |
| 4. Enactment of the pension reform | | |
| 5. Amending ordinance on credit contracts so that it improves transparency and protects consumer rights while safeguarding the stability of the financial system. | | |
| **Quantitative performance criteria** | | |
| 1. Floor on net foreign assets | September, 2010 | Met |
| 2. Floor on general government overall balance | September, 2010 | Met |
| 3. Ceiling on general government guarantees | September, 2010 | Met |
| 4. Ceiling on general government domestic arrears | September, 2010 | Missed |
| 5. Non-accumulation of external debt arrears | September, 2010 | Met |
| **Quantitative Indicative Target** | | |
| 1. Ceiling on general government current primary spending | September, 2010 | Met |
| 2. An indicative target on the operating balance of ten largest loss-making SOEs | September, 2010 | Missed |
| **Inflation consultation band** | | |
| Inner band | September, 2010 | Met |
| Outer band | September, 2010 | Met |
| **Structural benchmarks** | | |
| 1. Approval of reforms to mitigate fiscal risks from local governments | September 30, 2010 | Met in June 2010 |
| 2. Reform of the DGF's funding regime through increase in bank's contribution rates and elimination of stand-by credit lines, and review of DGF governance arrangement | September 30, 2010 | Met; the reform of the governance arrangement modified to end-December 2010 |
| 3 Parliamentary ratification of the fiscal measures approved by the government | September 30, 2010 | Partially met, VAT ratification reset as prior |
| 4 Passage of framework and implementing legislation for the unified wage law | October 31, 2010 | Not met, reset as prior action |
| 5 Reform tax administration methodology for high net wealth individuals | November 30, 2010 | Reset to December 31, 2010 |
| 6 Parliamentary ratification of amendments to the bank resolution framework | December 1, 2010 | Partially met |
| 7. Parliamentary approval of agreed 2011 budget | December 15, 2010 | Reset as prior action |
| 8. Amend deposit insurance legislation to ensure that neither members of the board nor employees of credit institutions participate in the DGF Board | December 31, 2010 | |
| 9. First phase to integrate the accounting reporting system with the Treasury payment system | March 31, 2011 | Modified and reset for March 15, 2011 |
| **Proposed structural benchmarks** | | |
| 10. Amend legislation to allow the use of the deposit guarantee fund resources to facilitate bank restructuring, including purchase and assumption transactions | March 15, 2011 | |

## ROMANIA: TECHNICAL MEMORANDUM OF UNDERSTANDING (TMU)

December 22, 2010

1. **This Technical Memorandum of Understanding (TMU) updates and replaces the TMU dated September 9, 2010**. It: (i) defines the variables subject to the quantitative targets specified in the Letter of Intent (LOI); (ii) describes the methods to be used in assessing the program performance and the information requirements to ensure adequate monitoring of the targets (Section I); and (iii) provides clarifications for some of the structural conditionality under the program (Section II). As is standard under all Fund arrangements, we will consult with the Fund before modifying measures contained in this letter, or adopting new measures that would deviate from the goals of the program, and provide the Fund with the necessary information for program monitoring.

2. **For the purposes of the program**, *the exchange rates* of the Romanian Leu (RON) to the euro is set at RON 3.9852 = €1, to the U.S. dollar at RON 2.8342 = $1, to the Japanese yen at RON 3.1419 = ¥100, and to the pound sterling at RON 4.1169 = £1, the rates as shown on the National Bank of Romania's (NBR's) website as of December 31, 2008. The exchange rates to other currencies, where applicable, will also be the ones shown on the NBR's website as of December 31, 2008.

3. **For the purposes of the program, the *general government* includes the entities as defined in the 2010 budget**. These are: the central government (state budget, treasury, self-financed state entities included in the budget, etc.), local governments, social security funds (pension, health, and unemployment), road fund company, and administration of the property fund. This definition of general government also includes any new funds, or other special budgetary and extra budgetary programs that may be created during the program period to carry out operations of a fiscal nature as defined in the IMF's *Manual on Government Finance Statistics 2001*. The authorities will inform IMF staff of the creation of any such new funds or programs immediately.

## I. QUANTITATIVE PERFORMANCE CRITERIA, INDICATIVE CEILING, AND CONTINUOUS PERFORMANCE CRITERIA

### A. Floor on the Net Foreign Assets

4. **For program purposes, Net Foreign Assets (NFA) are defined as the NFA of the NBR minus Treasury liabilities to the International Monetary Fund.**

5. **NFA** of the National Bank of Romania (NBR) are defined as the euro value of gross foreign assets of the NBR (including reserve requirements of the commercial banking system held at the NBR) minus gross foreign liabilities of the NBR; and will be measured on the basis of the NBR's operational rather than accounting definitions. Non-euro denominated foreign assets and liabilities will be converted into euro at the program exchange rates.

6. **Gross foreign assets of the NBR** are defined to include the NBR's holdings of SDRs, the country's reserve position at the Fund, holdings of cash, securities and deposits abroad in convertible foreign currencies. Excluded from reserve assets are: (i) gold and other precious metals; (ii) assets in nonconvertible currencies; (iii) illiquid assets; (iv) any assets that are pledged, collateralized, or otherwise encumbered, unless there is also a gross foreign liability associated with it; (v) claims on residents; and (vi) claims in foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

7. **Gross foreign liabilities of the NBR** are defined as all foreign exchange liabilities to residents and nonresidents, including commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options), and all credit outstanding from the Fund, but excluding (i) banks' foreign currency deposits against reserve requirements; and (ii) government foreign currency deposits at the NBR. This definition is meant to bring the concept of foreign liabilities closer to the balance of payment definition, on which the targets are based.

**Floor on cumulative change in NFA from the beginning of the year (in mln. euros) 1/**

| | 2009 | 2010 2/ | | | | 2011 2/ | |
|---|---|---|---|---|---|---|---|
| | December | March | June | Septembe | December | January | March |
| | (Stock) | Actual | Actual | Actual | PC | PC | Indicative |
| Cumulative change in NFA | 20,658 | 779 | -509 | -318 | -2,000 | 0 | 350 |
| *Memorandum Item:* Gross Foreign Assets | 28,418 | 3,145 | 1,838 | 3,724 | 3,000 | | 2,100 |

1/ PC=performance criterion; data for end-month. Performance criterion for January 2011 and indicative target for March 2011 are relative to the December 2010 target (€18,658 million).
2/ Flows in 2010 and 2011 are relative to previous year's end-period stock.

8. **NFA targets will be adjusted upward (downward) by the surplus (shortfall) in program disbursements relative to the baseline projection**. Program disbursements are defined as external disbursements from official creditors (World Bank and the EC) that are sable for the financing of the overall central government budget. The NFA targets will also be adjusted upward by the increase in commercial bank reserve requirements held with the NBR relative to end-December, 2009 (€7,874 million), measured at program exchange rates.

External Program Disbursements – Baseline Projections (in mln. euros)

| | 2010 | | | | 2011 |
|---|---|---|---|---|---|
| | March | June | September | December | March |
| Cumulative flows from end of previous year | 1,000 | 2,200 | 2,500 | 4,100 | 1,500 |

### B. Consultation Mechanism on the 12-month Rate of Inflation

9. **The quarterly consultation bands for the 12-month rate of inflation in consumer prices (as measured by the headline consumer price index (CPI) published by the Romanian Statistical Institute), are specified below**. Should the observed year-on-year rate of CPI inflation fall outside the outer bands specified below, the authorities will complete a consultation with the Fund on their proposed policy response before requesting further purchases under the program. In addition, the NBR will conduct discussions with the Fund staff should the observed year-on-year rate of CPI inflation fall outside the inner bands specified for the end of each quarter in the table above.

| | 2009 | 2010 | | | | 2011 |
|---|---|---|---|---|---|---|
| | December (actual) | March (actual) | June (actual) | September (actual) | December (target) | March (indicative) |
| Outer band (upper limit) | | | | | 10.0 | 9.0 |
| Inner band (upper limit) | | | | | 9.0 | 8.0 |
| *Actual* / Center point | *4.7* | *4.2* | *4.4* | *7.8* | 8.0 | 7.0 |
| Inner band (lower limit) | | | | | 7.0 | 6.0 |
| Outer band (lower limit) | | | | | 6.0 | 5.0 |

### C. Performance Criterion on General Government Balance

10. **The budget deficit will be monitored quarterly through the cash balance of the general government**. The authorities will consult with IMF staff on corrective measures in the event of shortfalls in government revenue and financing.

**Cumulative floor on general government balance**

| | (In millions of lei) |
|---|---|
| End-December 2009 (actual) | -36,101 |
| End-March 2010 (actual) | -8,422 |
| End-June 2010 (actual) | -18,015 |
| End-September 2010 (actual) | -23,325 |
| End-December 2010 (performance criterion) | -34,650 |
| End-March 2011 (indicative) | -6,300 |

11. **The budget deficit will be measured from above the line using the budget execution data**. The Ministry of Public Finance (MoPF) will also provide monthly data to measure the deficit from below the line. The balance of the general government measured from below the line will include:

+ (i) net external financing, excluding valuation gains and losses;
+ (ii) change in net domestic credit from the financial system, excluding valuation gains and losses from deposits denominated in foreign currency and including adjustments for;
  + (a) received EU funds not yet spent (advance payments);
  + (b) claims of the government on EU funds;
  + (c) property fund obligations not yet paid;
+ (iii) change in the stock of issued government securities, net of valuation changes;
+ (iv) net changes in other financing.

12. **If the difference between the general government deficit measured from above the line and from below the line is larger than lei 200 million each quarter during 2010**, the MoPF will consult with IMF staff.

13. **In the event that non-grant revenues exceed those projected under the program, the deficit target will be adjusted downward by one half of the surplus to allow for additional capital spending while reducing the deficit further**. The following table shows the accumulated projected non-grant revenue for 2010, to which the actual non-grant revenue will be compared.

| **Cumulative projected revenue of general government, net of EU funds** | (In millions of lei) |
|---|---|
| End-December 2009 (actual) | 151,508 |
| End-March 2010 (actual) | 36,355 |
| End-June 2010 (actual) | 74, 669 |
| End-September 2010 (actual) | 115,966 |
| End-December 2010 (projection) | 157,950 |
| End-March 2011 (projection) | 40,100 |

14. **In the event that current spending in the previous quarter exceeds the indicative target (defined below),** deficit target for the next quarter will be adjusted downward by a corresponding amount.

15. **The indicative target for the general government balance for the first quarter of 2011 will be adjusted downward from -6,300 by the amount that capital spending (including EU funds-related spending) exceeds 5,740 million lei, up to a limit of -8,000**

**million.** Likewise, the target will be adjusted upward by the amount of that capital spending undershoots 5,740 million lei in the first quarter of 2011.

### D. Performance Criterion Limiting the Issuance of Government Guarantees to the Non-Financial Private Sector and Public Enterprises

16. **The issuance of general government guarantees to the non-financial private sector and public enterprises will be limited during the program period**. This ceiling may be adjusted upward by up to RON 4.3 billion relative to the original ceiling of RON 7.7 billion for guarantees for financing the counterpart payments of investment projects financed by the EU or for guarantees on projects cofinanced by the EBRD, IBRD/IFC, EIB, AfDB, IADB, ADB, Council of Europe Development Bank, Black Sea Trade and Development Bank, Nordic Investment Bank, KfW, JICA and Export Import Bank of the U.S.

| **Ceiling on new general government guarantees issued from end-2008 until:** | (In billions of lei) |
|---|---|
| End-December 2009 (actual) | 2.2 |
| End-March 2010 (actual) | 4.6 |
| End-June 2010 (actual) | 5.5 |
| End-September 2010 (actual) | 6.5 |
| End-December 2010 (performance criterion) | 12 |
| End-March 2011 (indicative) | 12 |

### E. Performance Criterion on Non-Accumulation of Domestic Arrears by the General Government

17. **The performance criterion established on the stock in domestic payments arrears of the general government contemplates no accumulation of new arrears and their elimination during the program period**. The stock will be measured net of intergovernmental arrears, but both gross and net arrears will be reported by the government. In case of need, the government will take corrective measures to prevent the accumulation of new spending arrears. For the purpose of the program, arrears mean accounts payable past due date by 90 days (in line with ESA95 definitions for expenditures). Separate from the performance criterion defined above, we will make necessary payments to ensure that the stock of arrears in the central government and social funds (as defined in ¶3 above) is under 250 million lei as of November 30, 2010.

| **Stock in general government arrears from the end of previous year** | (In billions of lei) |
|---|---|
| End-November 2009 (stock, actual) | 1.40 |
| End-March 2010 (actual) | 1.76 |
| End-June 2010 (actual) | 1.8 |

| | |
|---|---|
| End-September 2010 (actual) | 1.5 |
| End-December 2010 (performance criterion) | 0.48 |
| End-April 2011 (indicative target) | 0.00 |

## F. Continuous Performance Criteria on Non-Accumulation of External Debt Payments Arrears by the General Government

18. **The general government will not accumulate external debt arrears during the program period**. For the purposes of this performance criterion, an external debt payment arrear will be defined as a payment by the general government, which has not been made within seven days after falling due. The performance criterion will apply on a continuous basis.

## G. Indicative Target on General Government Current Primary Spending

19. **The indicative target on current primary expenditure of the general government is defined as** spending on personnel, goods and services excluding EU funds (specified under external grant category), subsidies, transfers to public entities, pensions (social security budget in social assistance category and one-third of the state budget in the same category), state aid and other spending in other transfers category, Reserve Fund, and other expenditure as classified in the monthly reporting tables. The current spending target will be adjusted for the extra spending due to swap arrangement between local governments and public enterprises by an amount spent in the respective quarter.[1]

| **Cumulative change in general government current primary expenditures** | (In millions of lei) |
|---|---|
| End-December 2009 (actual) | 85,637 |
| End-March 2010 (actual) | 32,749 |
| End-June 2010 (actual) | 66,124 |
| End-September 2010 (actual) | 98,277 |
| End-December 2010 (indicative target) | 131,500 |
| End-March 2011 (indicative target) | 32,200 |

## H. Monitoring of Public Enterprises

20. **As of 2009, the Ministry of Public Finance, the Ministry of Labor and Social Protection, and other pertinent institutions have implemented a monitoring system of public enterprises**. During the program period, information will be provided to document that sanctions—decline in remuneration and dismissal of management according to

[1] The swap arrangement would involve mutually cancelling overdue tax obligations of public enterprises with arrears owed to those enterprises by the general government (local administration).

Ordinances 37/2008 and 79/2008—are imposed if the budgets and company targets for restructuring are not observed.

21. **The quarterly indicative target for 2010 is set on the aggregate operating balance (earnings before interest and tax), net of subsidies, of the following public enterprises**: (1) C.N. Cai Ferate CFR; (2) S.N. Transport CFR Calatori; (3) CN a Huilei; (4) SC Termoelectrica; (5) C.N. de Autostrazi si Drumuri Nationale; (6) S.C. Metrorex; (7) S.N. de Transport Feroviar CFR Marfa S.A.; (8) SC Electrocentrale Bucuresti; (9) Societatea Comerciala Electrificare CFR S.A.; and (10) S.C. Administratia Nationala a Imbunatatirilor Funciare. The data shall be reported with operating results by firm. The targets for December 2010 and March 2011 will be -4000 and -750 million lei, respectively.

## I. Reporting Requirements

22. **Performance under the program will be monitored from data supplied to the IMF by the NBR and the MoPF as outlined in Table 1**. The authorities will transmit promptly to the IMF staff any data revisions as well as other information necessary to monitor the arrangement with the IMF.

**Table 1. Romania: Data Provision to the IMF**

| Item | Periodicity |
|---|---|
| To be provided by the Ministry of Finance | |
| Preliminary monthly data on general government accounts | Monthly, on the 25th day of the following month |
| Quarterly final data on general government accounts | Quarterly cash data, on the 35th day past the test date<br>Quarterly accrual data, on the 55th day past test date |
| The budget deficit of the general government using ESA95 definition | Quarterly, with a lag of three months |
| Preliminary data on below-the-line financing for the general government | Monthly, with a lag of no more than 35 days past the test date |
| Final quarterly data on below-the-line financing for the general government | Quarterly, no later than 45 days past the test date |
| Total accounts payable and arrears of the general government | Preliminary monthly, within the next month.<br>Quarterly, within 55 days |
| Stock of the central government external arrears | Daily, with a lag of not more than seven days |
| Public debt and new guarantees issued by the general government | Monthly, within one month |
| Preliminary monthly data on general government primary spending, net of EU disbursements | Preliminary monthly data will be reported to the IMF staff within 25 days |
| Final quarterly data on general government primary spending, net of EU disbursements | Quarterly, within 35 days from the test date |
| From 2010, the operating balance, profits, arrears, and personnel expenditures of 10 largest public enterprises by total expenditures | Quarterly, within 55 days |
| Data on EU project grants (reimbursements and | Monthly, within three weeks of the end of each month |

| | |
|---|---|
| advances), capital expenditures and subsidies covered by EU advances or eligible for EU reimbursement on EU supported projects specifically agreed with the EU | |
| **To be provided by the National Bank of Romania** | |
| NFA data, by components, in both program and actual exchange rates | Weekly, each Monday succeeding the reporting week and with a 3 working day lag in the case of end-quarter data |
| Monetary survey data in the format agreed with IMF staff | Monthly, within 30 days of the end of the month |
| The schedule of contractual external payments of the *banking sector* falling due in the next four quarters, interest and amortization (for medium and long-term loans) | Monthly, 45 days after the end of each month |
| The schedule of contractual external payments of the *corporate sector* falling due in the next four quarters interest and amortization (for medium and long-term loans) | Monthly, 45 days after the end of each month |
| The stock of short-term external debt of banks and corporate | Monthly, 45 days after the end of each month |
| Balance of payments in the IMF format currently used to report | Monthly, 45 days after the end of each month |
| Exposure (deposits, loans, subordinated loans) of (i) foreign parent banks to their subsidiaries in Romania; (ii) IFI and (iii) other creditors to banks in Romania (by national and foreign currency). | Monthly, 20 days after the end of each month |

## II. Structural Conditionality: Specifications

### A. Public Wage Legislation

23. **Following the unified public wage law approved in October 2009, a new framework law and implementing legislation for 2011 will be approved before the sixth review IMF Board meeting that will abide by the following principles**:

a. It will ensure the respect of the quantitative targets for the public wage bill included in the unified public wage law and the proposed changes will be fully costed.

b. It will ensure that new salary grading structure is simplified and that pay will be linked based on job responsibility and qualification. The established new pay system will be benchmarked on private sector wages (through a salary survey) to ensure that public pay is broadly aligned with actual labor market conditions, within affordability constraints.

c. The regulation would introduce a limit of 30 percent on non-wage personnel expenditures and caps on individual bonuses for non-military personnel. All remaining bonuses will be set as ceilings rather than mandatory levels, both at an individual and aggregate level. For the purpose of this law, "stimulus" payments will be treated as bonuses and the legislative provisions that created corresponding financing funds will be annulled.

### B. Financial Sector: Emergency Ordinance 50/2010

24. **The ordinance will be amended before being adopted by parliament to either remove the retroactive component, or alternatively to allow banks full flexibility to adjust contractual terms on loan contracts entered into prior to the ordinance coming into effect so as to safeguard financial sector stability.** In addition, we will ensure that the National Bank is the only agency authorized to regulate banks' lending activity.