Romania: a major fiscal deficit correction has started (talking points)

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The Hungarian Fiscal Council and The National Bank of Hungary Conference, Budapest, 27 October 2025

Overview

1. A worsening international and institutional context
2. Strains in the EU
3. Romania: a major budget deficit correction has started

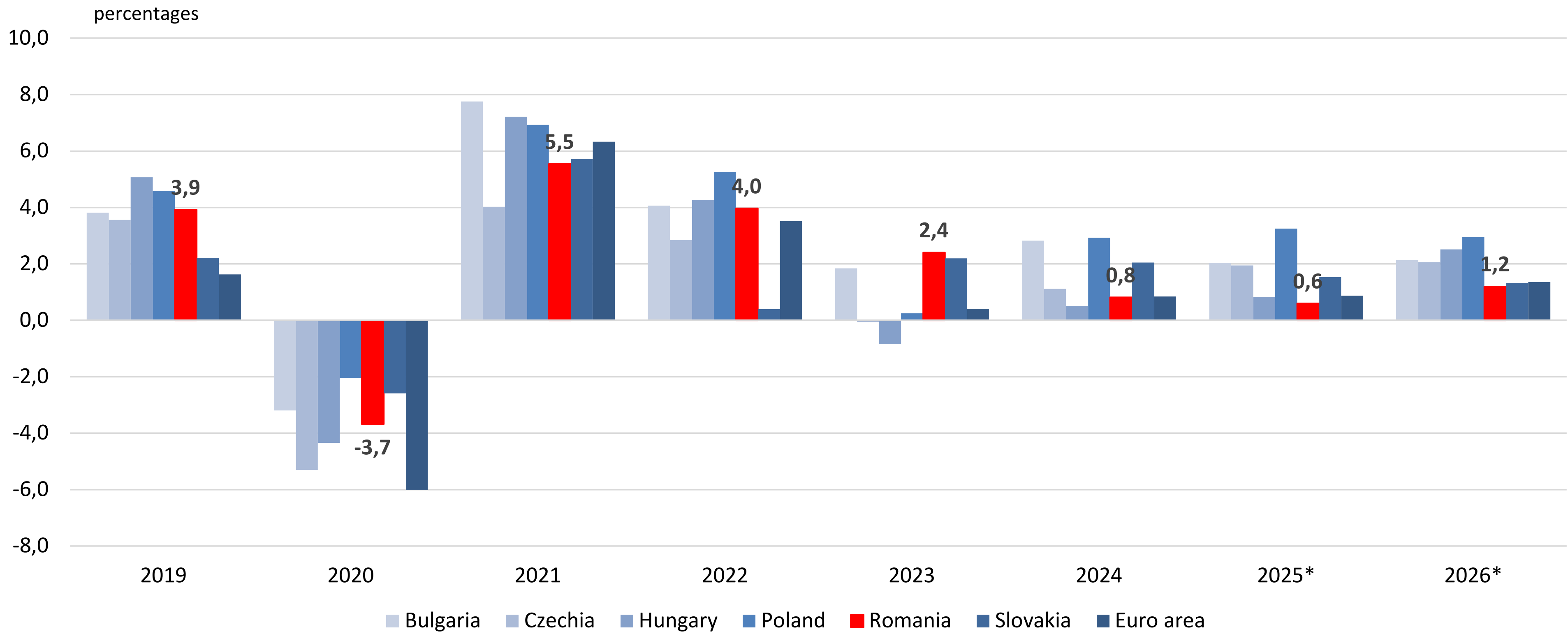
1. A worsening international context

- Fragmentation goes on, rules and institutions are questioned
- Security concerns, geopolitical tensions, military conflicts, trade warfare
- **A new wave of finance deregulation on its way?**
- Private finance/financial engineering should worry us…collapse of highly leveraged firms and reverberations; *high leverage, opacity, complexity* are coming back…**seeds of a new financial crisis** (BoE, IMF warnings)?
- Crypto assets (stable coins) – a new threat to financial stability
- Pressures on central banks –will their independence be dented?
- Budget deficits and public debts…***fiscal dominance***
- AI can enhance productivity, but poses risks to financial stability
- An unruly, chaotic world? The return of *Real politik*

2. Strains in the EU

- Lower economic growth and **social and political fatigue** due to shocks (pandemic, climate change, energy crisis, the war in Ukraine, cost of living crisis, trade wars, ubiquitous uncertainty, etc.)…high energy prices
- Inflation has declined in many countries and monetary policy rates have also come down, but it may creep upwards again…in a world battered by shocks
- **Worries about budget deficits and public debts, poorly regulated non-banking finance (shadow banking), other payments routes (crypto assets, block chain)…would ECB's policy effectiveness be endangered?**
- The EU's competitiveness gap may grow --Draghi's new sermons
- A capital markets and investment union…a long way still; it could hardly operate unless based on deep integration…and innovation demands more than such a union
- Defense expenditures on the rise, painful policy tradeoffs
- Divided societies and weakened polices; social resistance to reforms

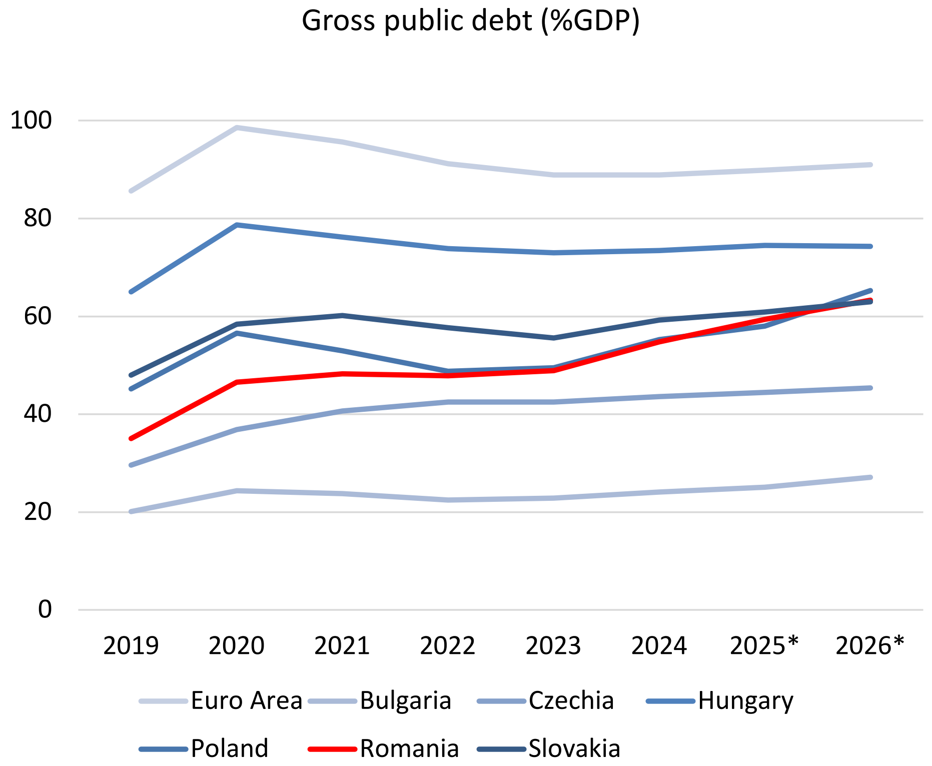
Subdued economic growth

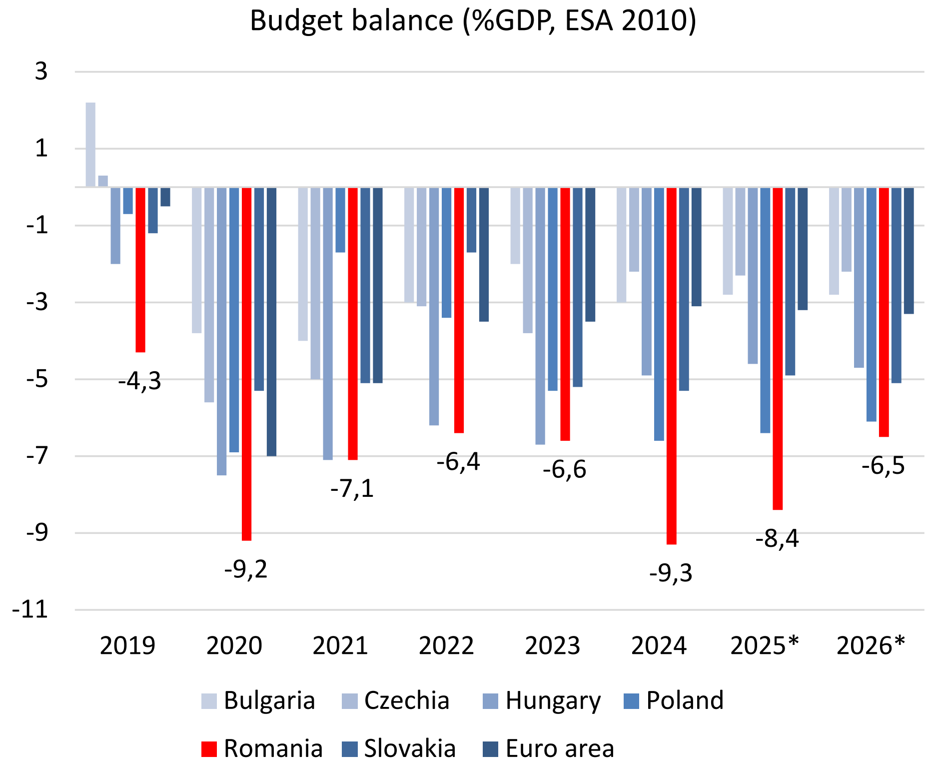


Source: AMECO

Note: values for 2025 and 2025 represent AMECO forecast, for Romania values are from NCSP summer forecast

Fiscal dominance heightens uncertainty and harms policies

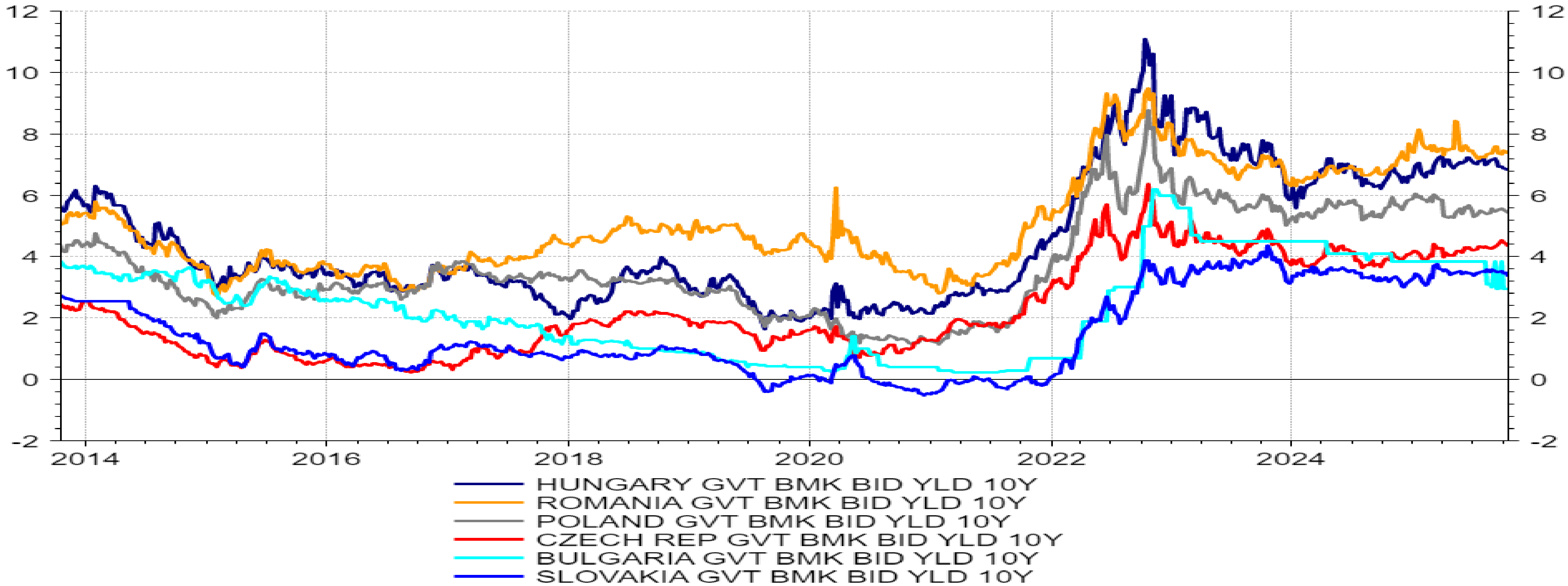




Source: AMECO

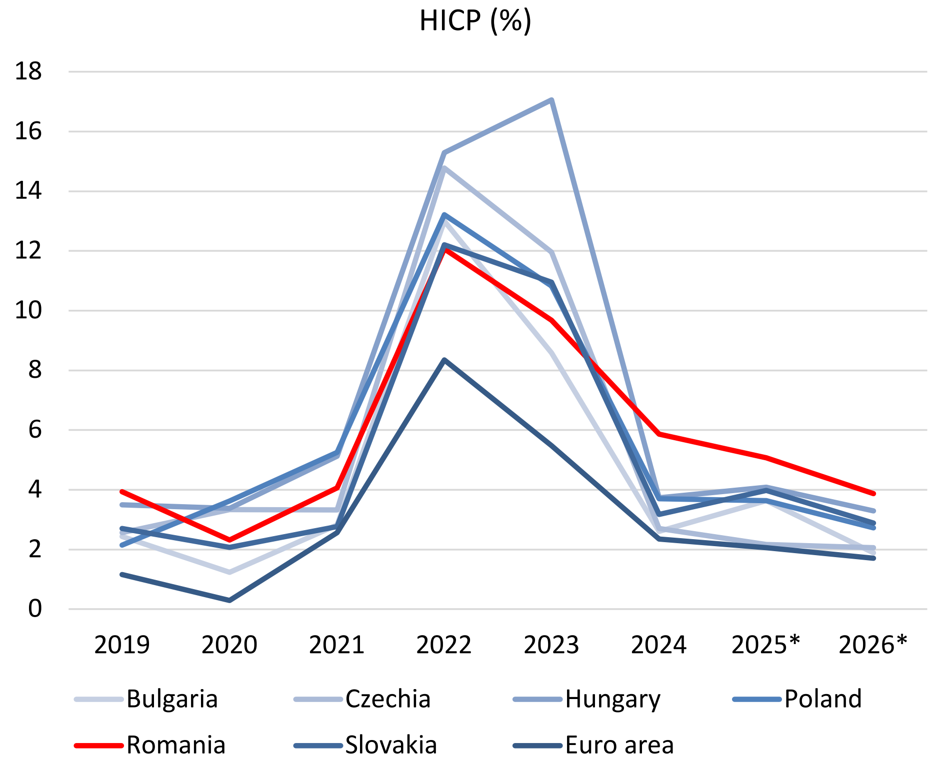
Note: Budget balance values for Romania for 2025 and 2026 represent FC forecasts in cash terms

Shocks influence financing costs – 10-year government bond yields (percentages)

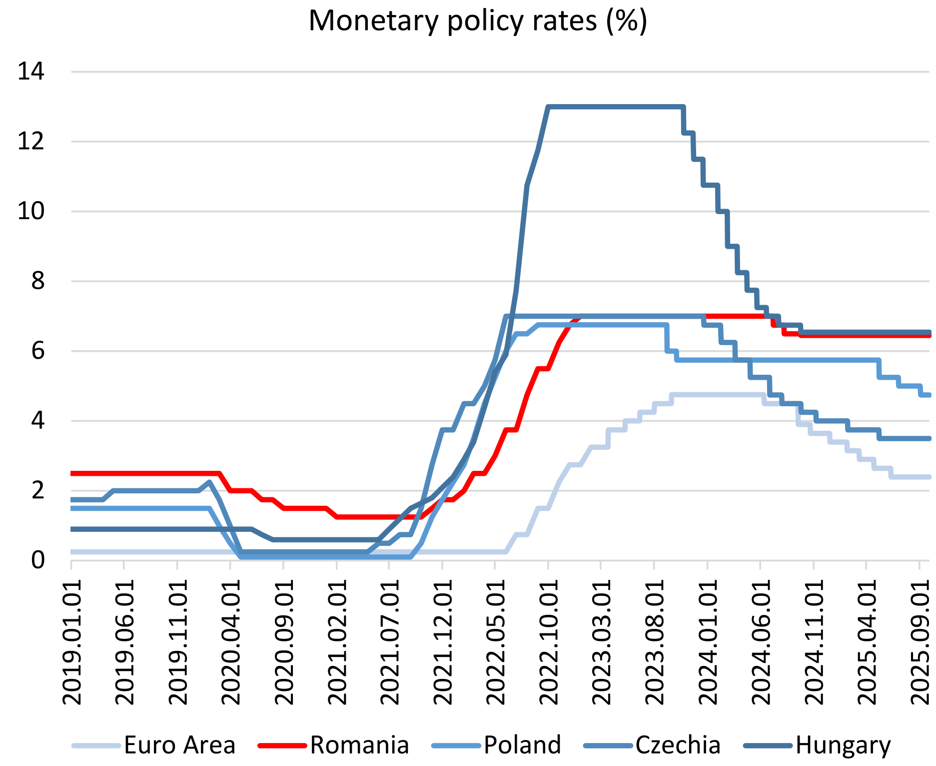


Source: Refinitiv Datastream

HICP and monetary policy rates



Source: AMECO (for Romania it does not reflect the VAT and excises hikes and electricity price liberalization)



Source: ECB, NBR, NBP, CNB, MNB

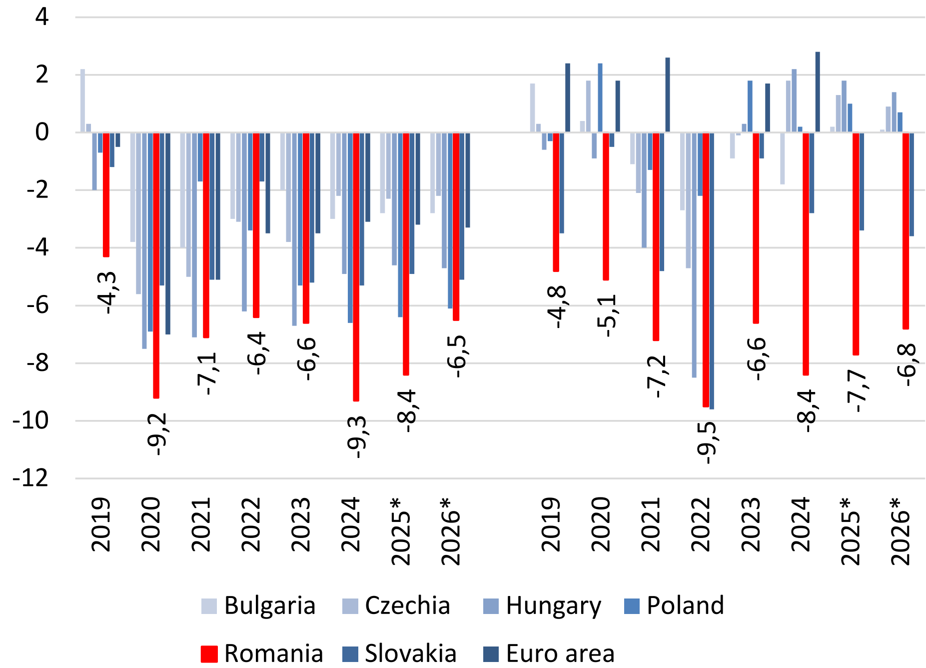
The new EU fiscal rules

- **So many shocks (climate change, energy prices, trade conflicts, more defense expenditure, etc) complicate the implementation of fiscal rules**
- The new rules provide more flexibility for macro corrections, but…
- Do not address the basic design flaws of the euro area: no joint fiscal capacity, no EDIS, no *safe asset, a* capital markets and investment union cannot be a *deus ex machina* by itself…
- Cuts in social expenditure and higher tax revenues are needed in not a few countries…but massive social and political resistance
- **National IFIs need a macro-prudential approach in their activity as shocks have fiscal implications sooner or later**

3. Romania's budget conundrum – a major budget deficit correction has started

- A very large budget deficit (9.3% of GDP in 2024), though public debt still manageable
- A twin deficits syndrome; much of the current account deficit funding through borrowing
- Half of the budget deficit funding is on the domestic market
- Very low tax revenues (27% vs 40% of GDP EU average and 34-35% of GDP in peer countries…there is much scope to raise tax revenues

Budget balance and current account balance (% GDP, ESA 2010)



Source: AMECO

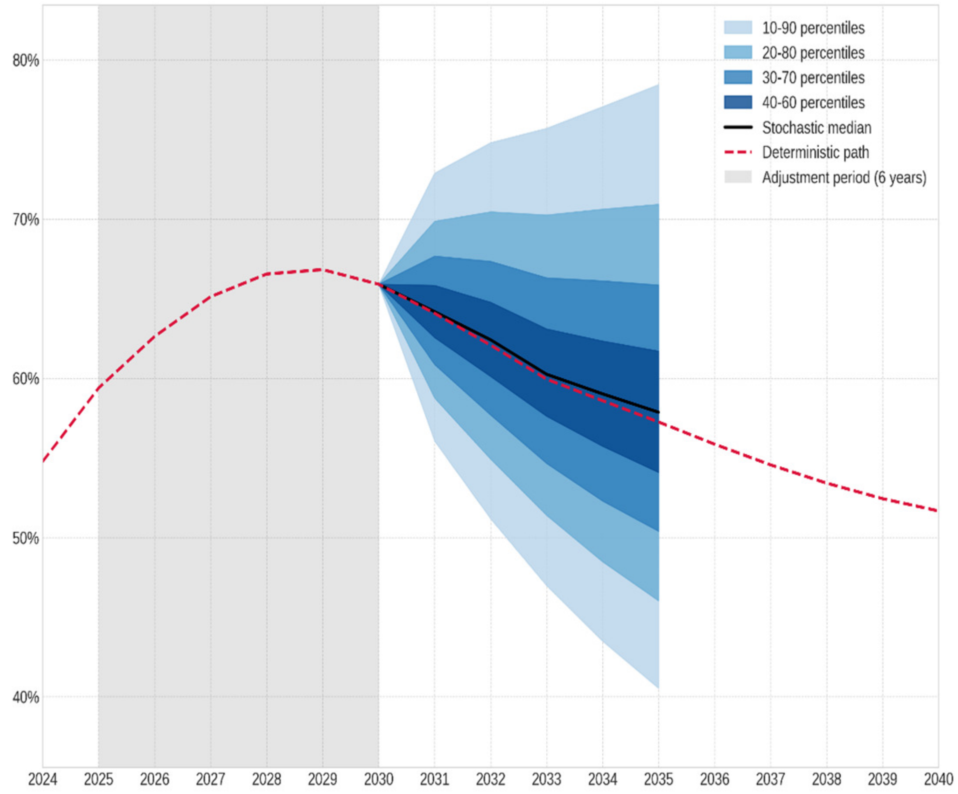
Note: Budget balance values for Romania for 2025 and 2026 represent FC forecasts in cash terms

A major budget deficit correction has started

- Bringing the budget deficit to 3% of GDP, be it over several years, is a huge challenge; both the revenue and expenditure sides are dealt with to cut the deficit
- Stabilize public debt (it is 57% of GDP currently, from 35% in 2019)
- Shift the current account deficit toward 4% of GDP over several years by cutting the budget deficit
- Key role of EU funds for economic stability (large share of public investment)…**but these funds will be downsized in the future (NRRPs come to an end)…will this curtailment cause a shock?**
- **CEE has developed a sort of *EU funds dependency…a middle income trap?***

Projected trajectory of Romania's public debt in a 6-year linear adjustment scenario, 2025-2030 (%GDP)

- 2024 ended with an ESA budget deficit 1.4 pp of GDP higher than anticipated in the MTP – thence the starting point of the projection is significantly higher
- Considering the 6-year adjustment period , efforts to adjust structural primary balance to stabilize debt trajectory would be 8.15 pp of GDP.



Source: FC's calculations, based on DSA replication code

Budget correction measures taken in Romania with impact in 2025 and 2026

Revenues	
Measures	**Applicable from**
VAT standard rate increase from 19% to 21%	1st August 2025
VAT reduced rate increase from 9% to 11% for food, medicines, pesticides, irrigation water, chemical fertilizers, water	1st August 2025
VAT reduced rate increase from 5% to 11% for books, culture, energy and fire woods	1st August 2025
Other VAT reduced rates increased to the standards level	1st August 2025
Divident tax increase from 10% to 16%	1st January 2026
Property tax, double level for households	1st January 2026
Ecological tax	1st January 2026
Double level for Ro-vinieta	1st January 2026

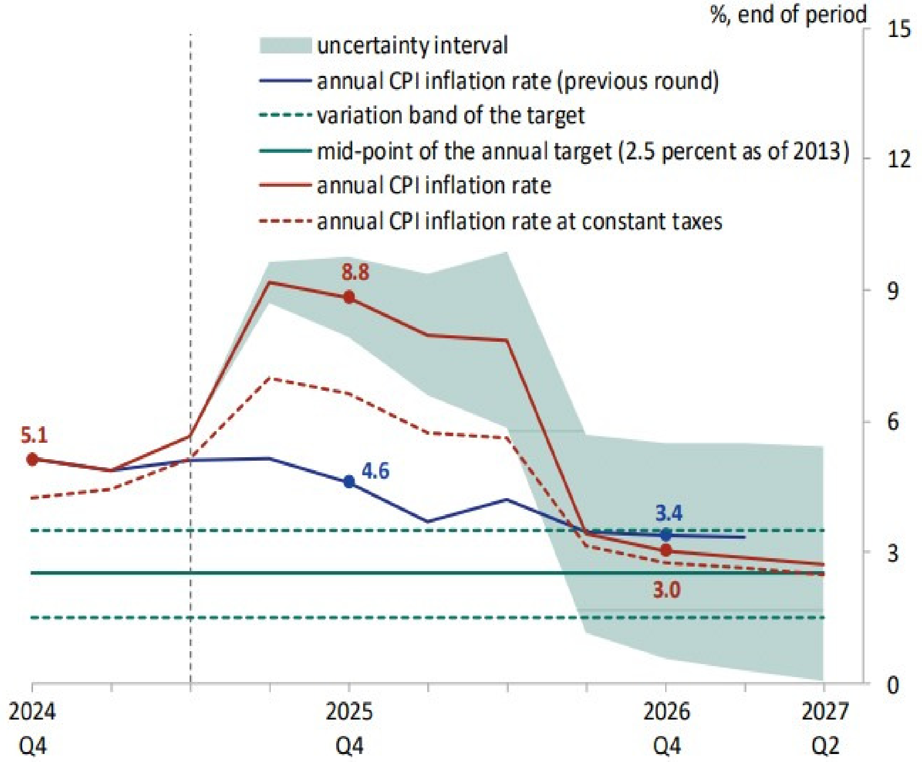
Expenditures	
Measures	**Applicable from**
Eliminating public sector bonuses	1st August 2025
Reduction of scholarships funds	1st August 2025
Measures of the Single National Health Fund (contribution of co-insured persons, modification of the method of calculating sick leave allowance)	1st August 2025
Investment expenditure reduction - NRRP loans, grant transfers, cancellation and reprioritization of national programs	1st August 2025
Frozen personnel and social assistance expenditure	1st January 2026
Public sector reforms	1st January 2026
Reducing the threshold for granting holiday vouchers from 8,000 lei to 6,000 lei gross with redemption in the off-season	1st January 2026

Expected fiscal correction during 2025-2026

- **The targeted budget deficit in 2025: cca. 8.4% of GDP (a correction of cca.0.6% of GDP via tax hikes and expenditure cuts…an *inflation tax***
- Correction measures introduced on August 1st
- Without the set of measures, the budget deficit in 2025 would be close to the level of 2024
- The VAT and excises hikes, the electricity tariff rise, have pushed inflation to cca.10% in September this year
- Wages in the public sector and pensions will quite likely stay at current nominal levels in 2026
- **The budget deficit in 2026 could be below 6.5% of GDP**
- Reducing tax evasion and tax avoidance massively could shift the budget deficit below 5% after 2026; *progressive taxation* is an option
- Defense expenditure makes the budget deficit reduction harder

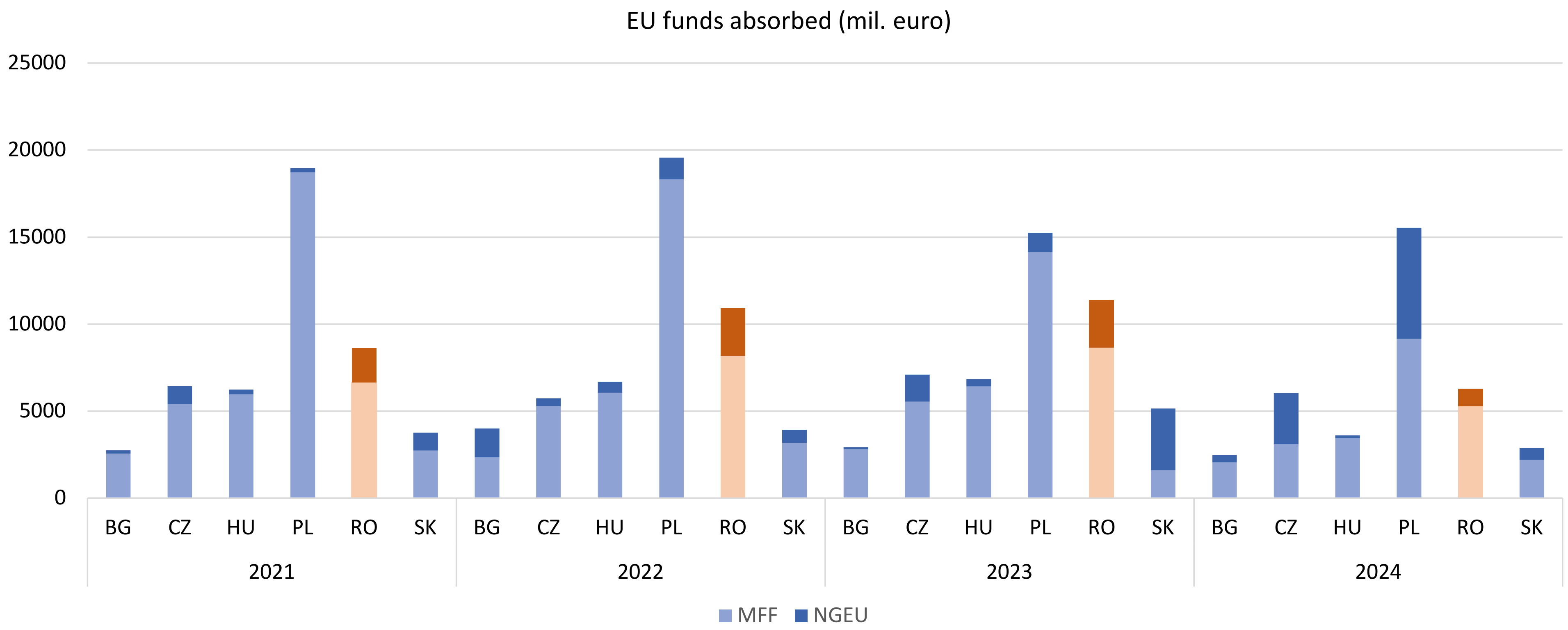
Latest forecast of CPI in Romania

- Revised significantly upwards in the first half of the projection interval, amid supply-side shocks in 2025 Q3.
- The CPI path is almost entirely shaped over the short and medium term by domestic developments…
- But the direct effect of the fiscal measures on the CPI fades out four quarters after their implementation.
- The main reassessments were driven by higher than anticipated electricity price, as well as VAT and excise duties hikes



Source: NBR

EU funds are essential in times of huge turbulences: they support growth and facilitate adjustment….but they create a heavy dependency



Source: European Union spending and revenue 2021-2027

Thank you for attention and let’s hope for better times!