A major fiscal correction has started during hard times (talking points)

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Talking points prepared for the workshop The Euro and Europe's next phase, The European Institute, LSE, 18 November, 2025.

Overview

1. A worsening international and institutional context

2. Strains in the EU

3. Romania: a major budget deficit correction has started

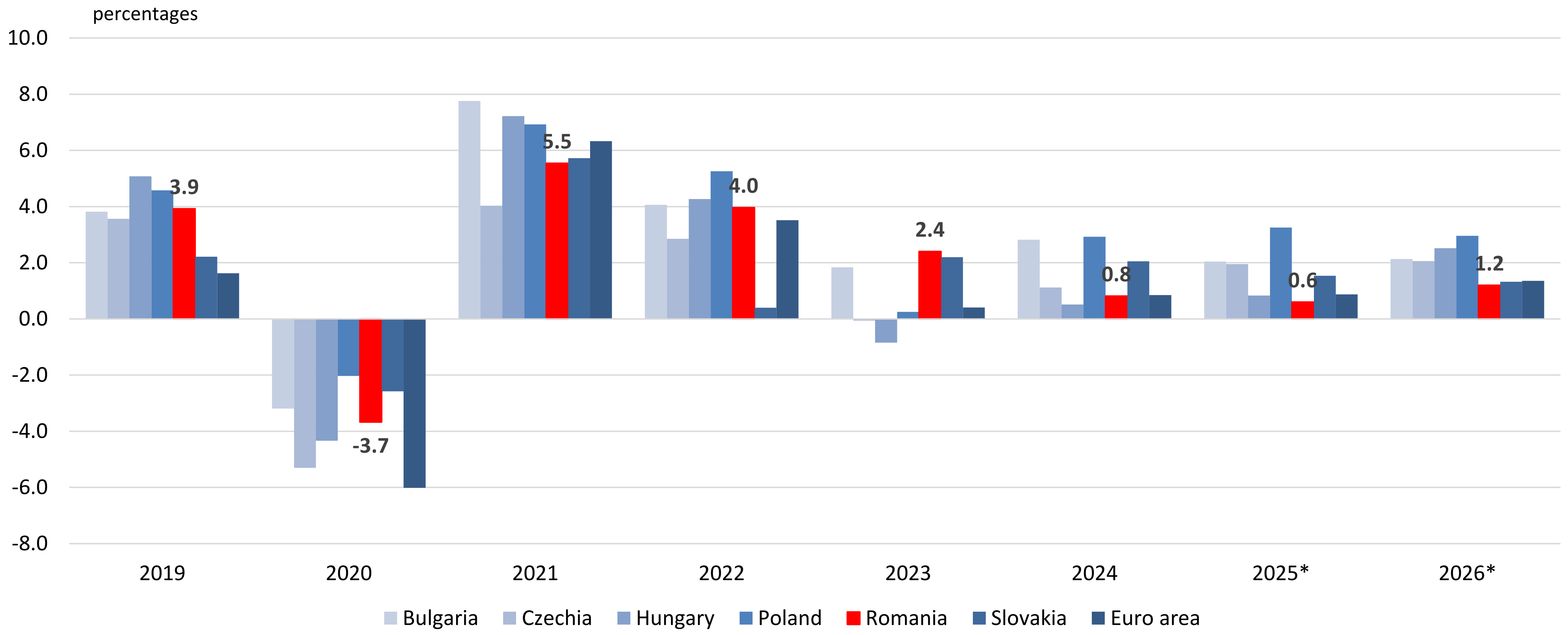
1. A worsening international context

- 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

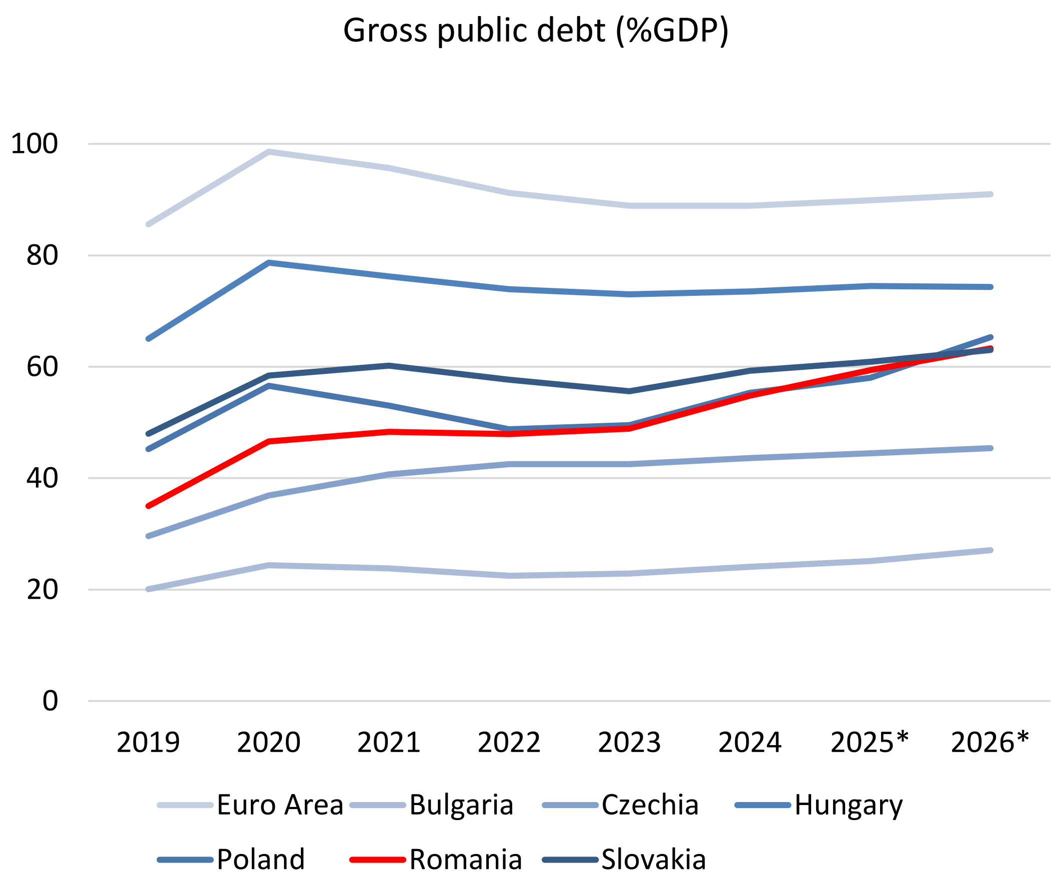
- Lower economic growth and **social and political fatigue** due to shocks (pandemic, climate change, energy crisis, the war in Ukraine, cost of living crisis, trade wars, ubiquitous uncertainty, etc.)…high energy prices
- Inflation has declined in many countries and monetary policy rates have also come 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

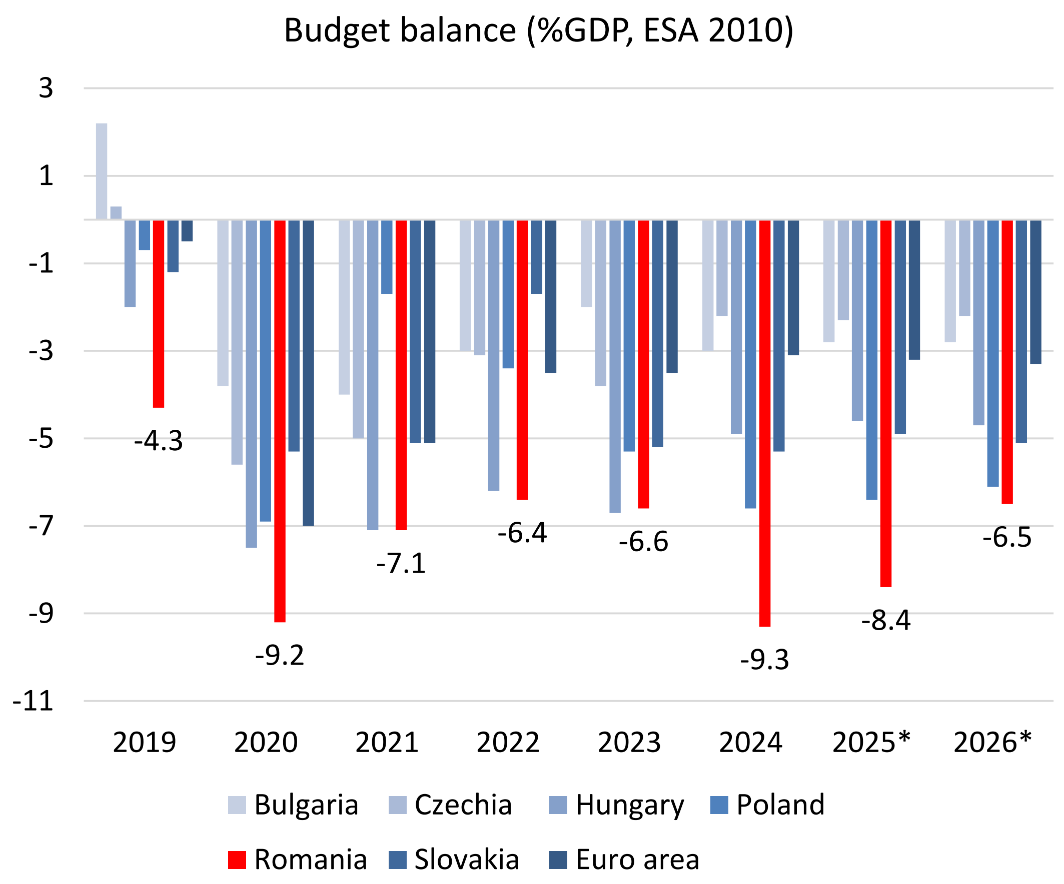
Subdued economic growth



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

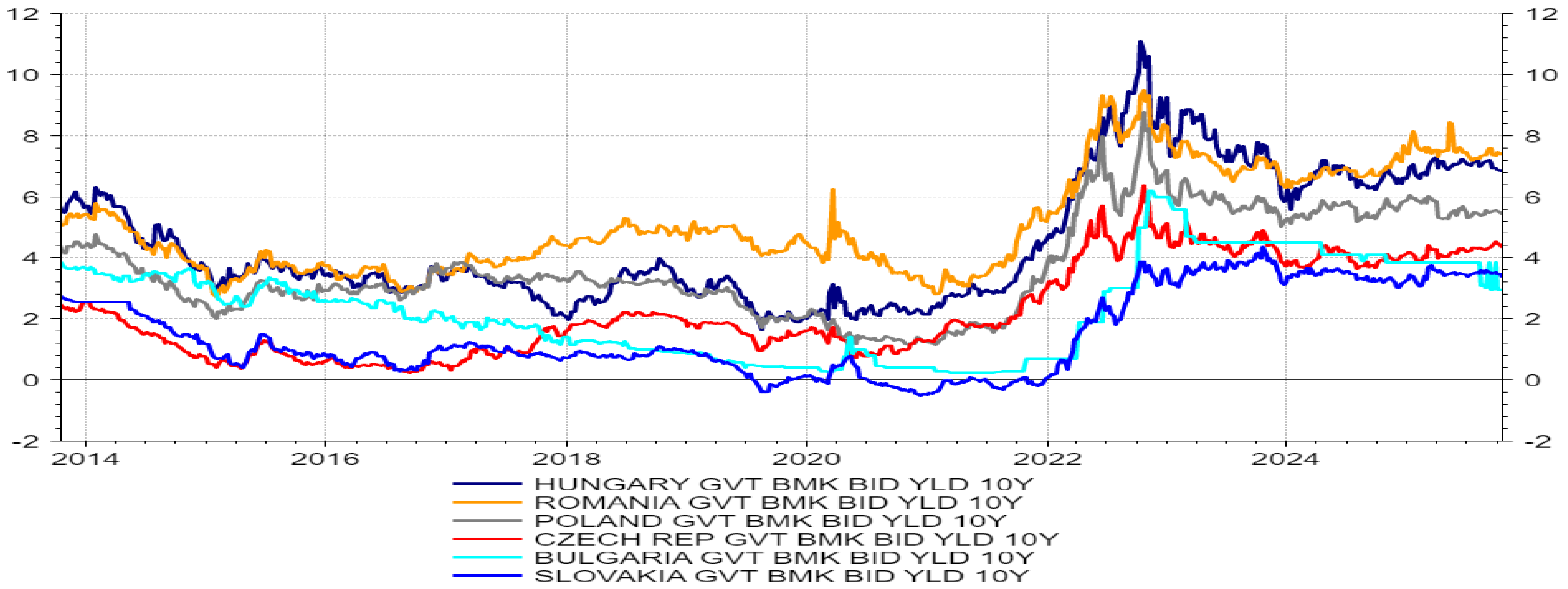




Source: AMECO

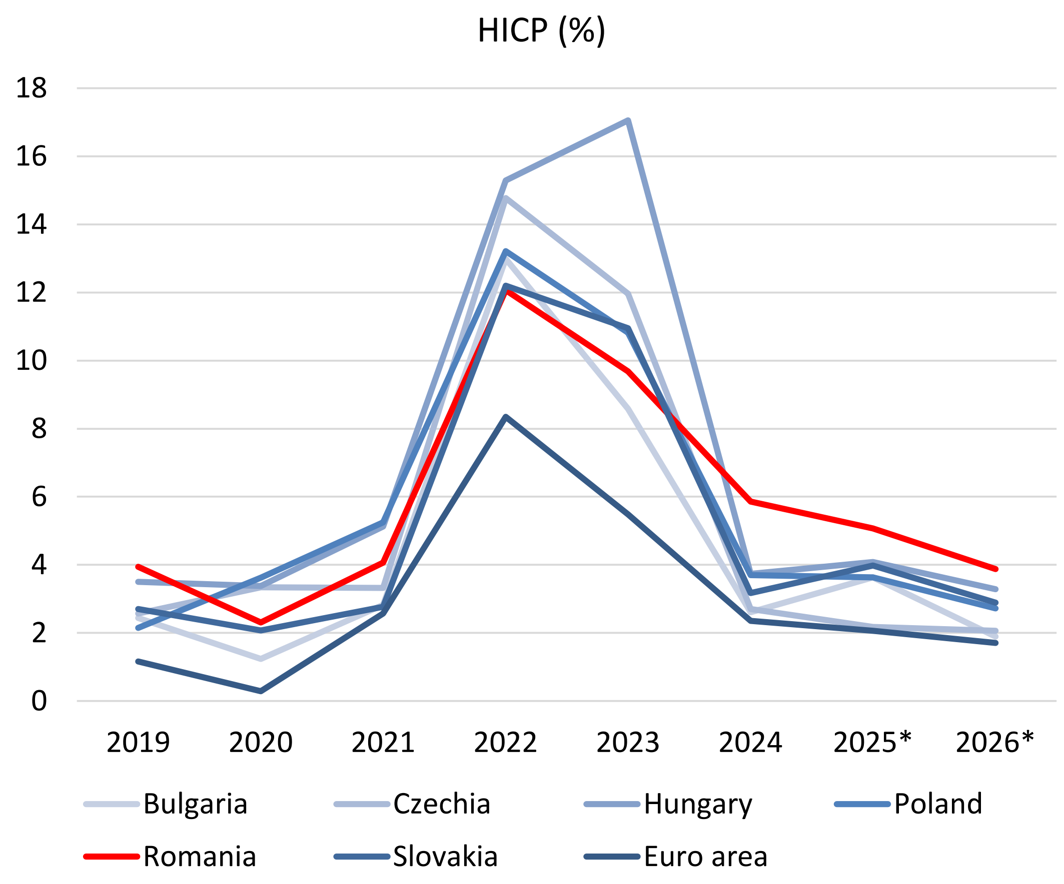
Note: Budget balance values for Romania for 2025 and 2026 represent FC forecasts in cash terms

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

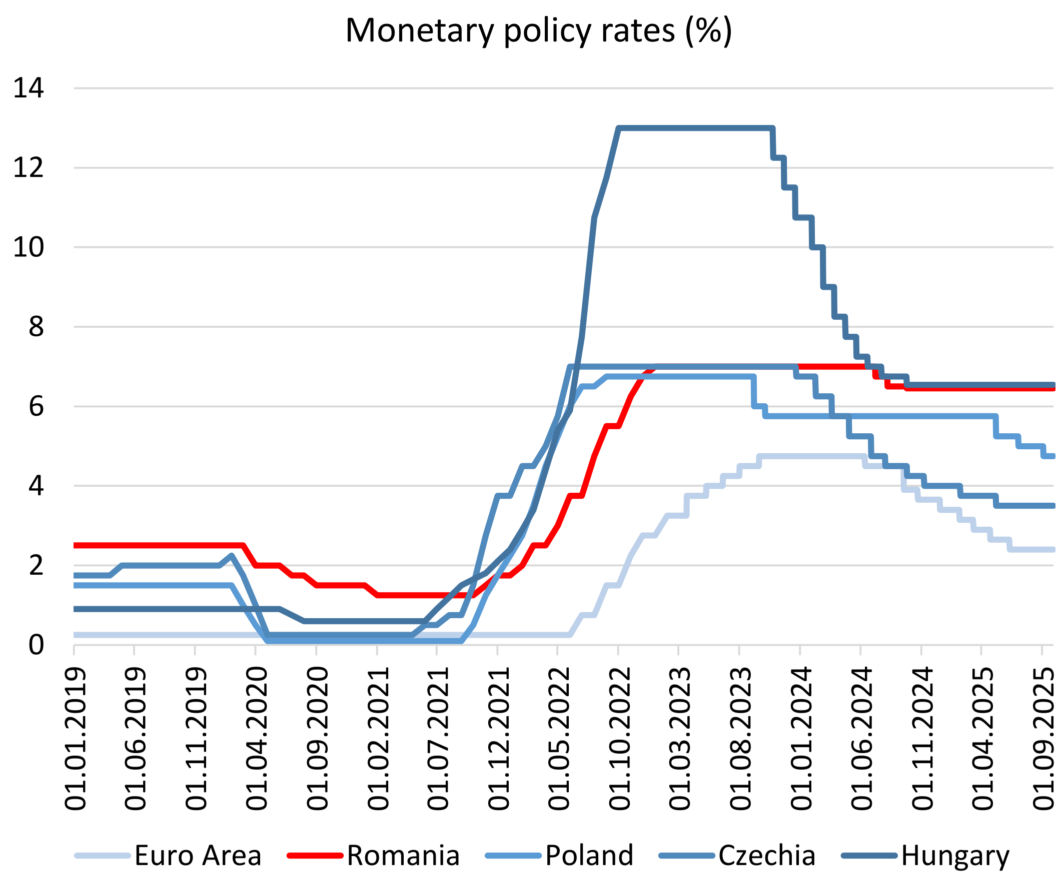


Source: Refinitiv Datastream

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

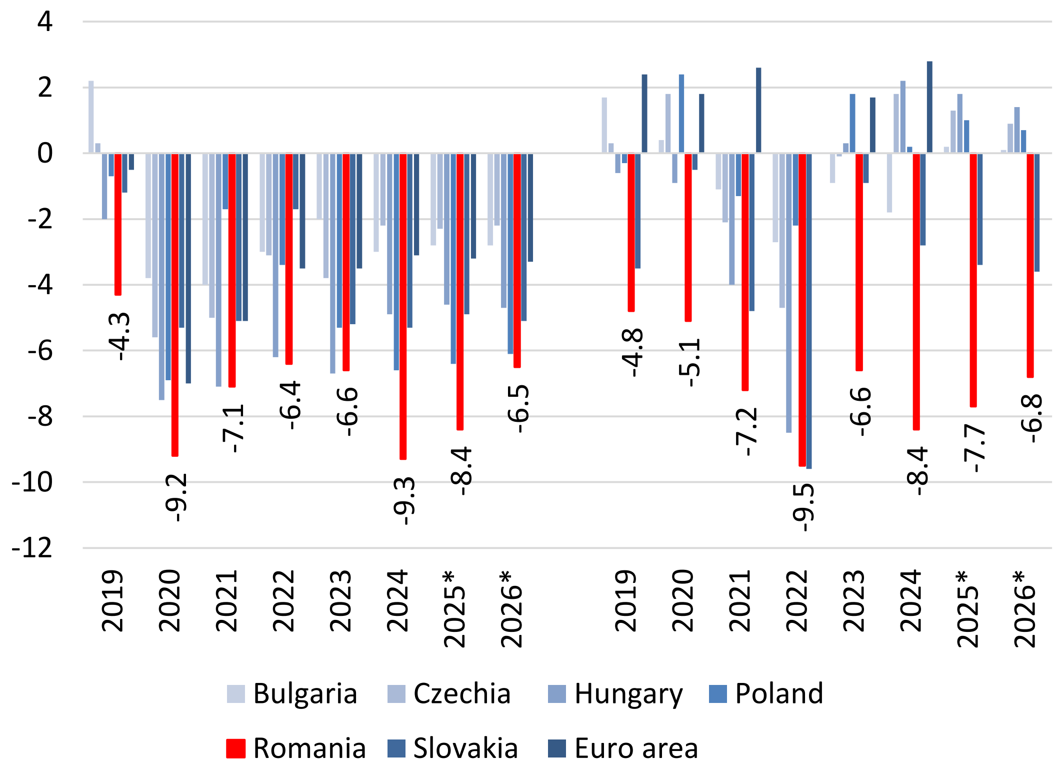
The new EU fiscal rules

- **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

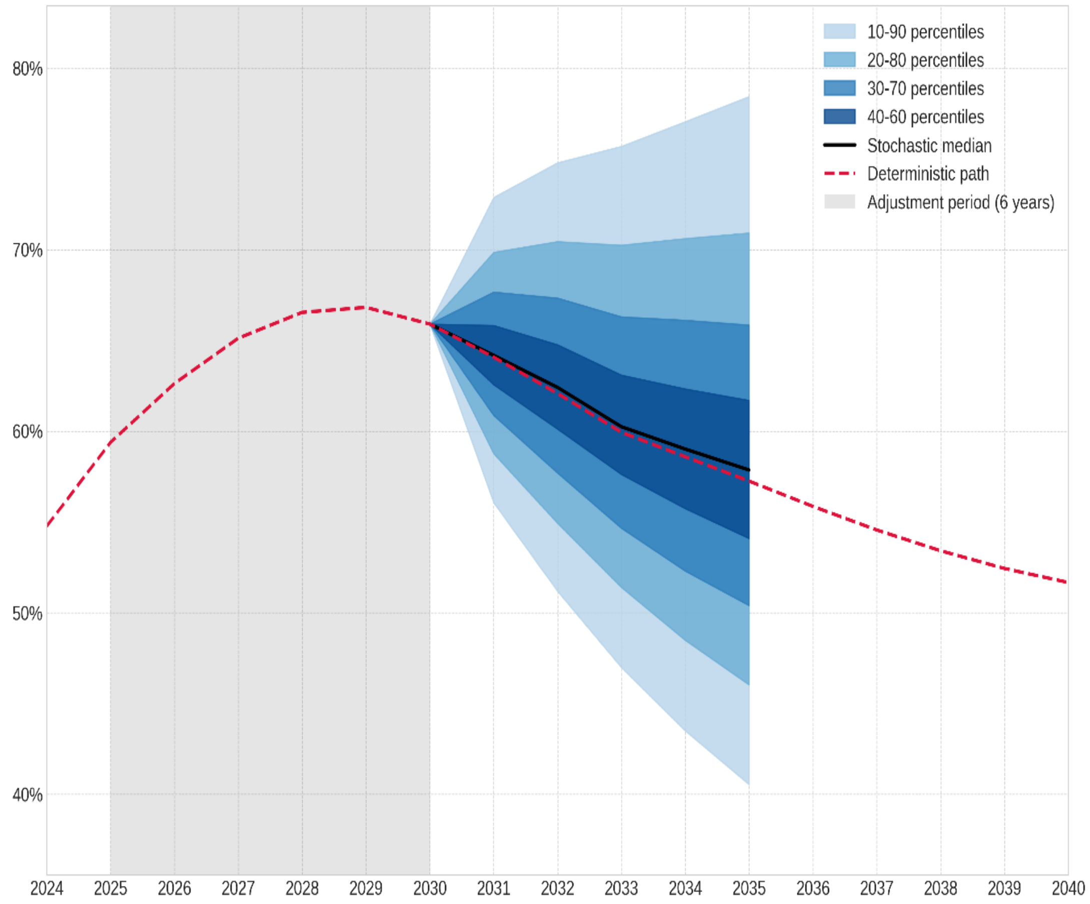
Note: Budget balance values for Romania for 2025 and 2026 represent FC forecasts in cash terms

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.



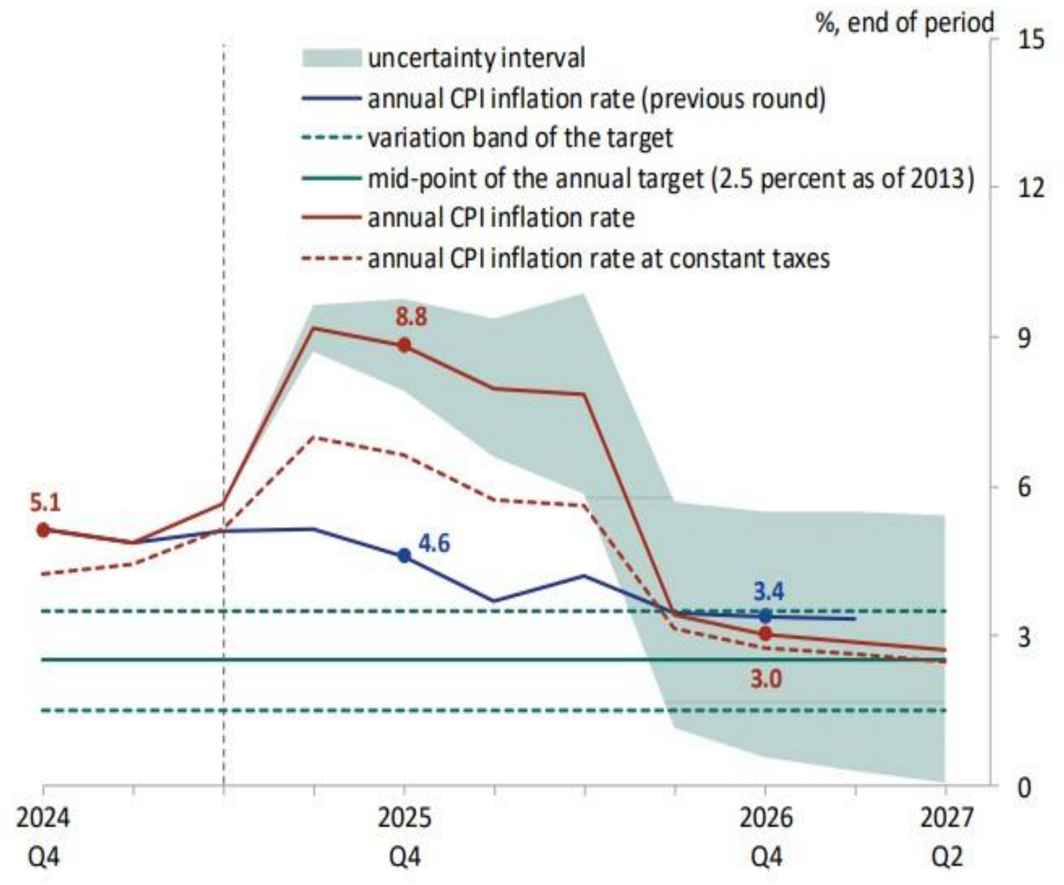
Source: FC's calculations, based on DSA replication code

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

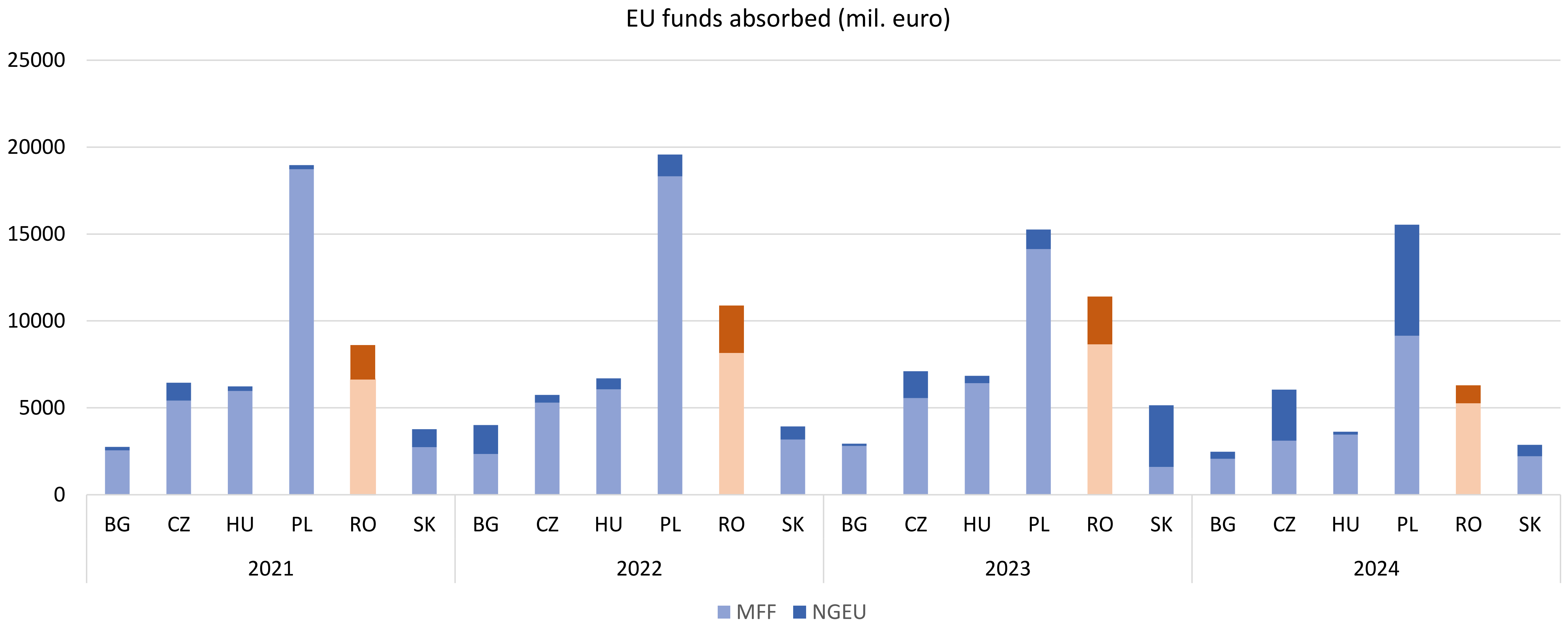
Latest forecast of CPI in Romania

- 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

- **No Euroa Area accession unless huge macroeconomic imbalance is corrected**

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