

We are paying for misguided fiscal policies

The political crisis could have been avoided had there been wisdom to place the very serious macroeconomic situation at the forefront of policy-making. Some are already speaking about the 2028 elections, when what is essential now is to focus on the state of public finances, the National Recovery and Resilience Plan (NRRP), and reforms. The formation of a new government should not be delayed, as it must continue fiscal consolidation.

The burden of deficits and fiscal dominance

Fiscal dominance is a concept and phenomenon widely discussed among economists due to a pressing reality: the shocks of the last two decades have led to increased budget deficits and public debt, influencing economic policies and impacting the conduct of central banks. These shocks have highlighted imprudence in fiscal policies and inadequate regulatory arrangements.

The global financial crisis that erupted in 2008 and threatened financial systems and economies was a dramatic episode concerning the relationship between fiscal and monetary policies. Governments and central banks intervened massively to prevent the collapse of financial systems and economies. Major central banks spent hundreds of billions (cumulatively, trillions of dollars/euros) by purchasing government and commercial bank bonds; bonds issued by large corporations were also bought. It became clear that, in extremely difficult moments, unconventional means are used. This situation arose because prudential rules, including fiscal rules, were underestimated or even ignored, while the financial industry was not regulated wisely. But what powerful economies can afford in terms of public interventions (they also have reserve currencies of their own) cannot be afforded by small or emerging economies, which are perceived as vulnerable.

Fiscal rules were revised within the European Union to make them more effective and to take national specificities into account. However, it is the responsibility of each EU member state to pursue macroeconomic and fiscal policies that respect prudential principles and self-protection by considering various risks. Responsible policies would also protect citizens by avoiding painful macroeconomic corrections. Even membership in the Eurozone does not spare countries from severe difficulties. After all, the sovereign debt crisis involved euro area countries (Spain, Portugal, Ireland, Greece), even though those states did not face currency risk.

In small and medium-sized economies with large fiscal and external deficits, a central bank conducting its own monetary policy has a much narrower room for manoeuvre.

Fiscal correction cannot occur without society paying a price

At the end of the previous decade, Romania was the only EU member state under the excessive deficit procedure, after years of imprudent fiscal policies. Governments also ignored that the country had very low fiscal revenues (including contributions) – 27-28% of GDP, compared to the EU average of 40% of GDP and the average of 34-35% of GDP in the peer countries. There was no serious concern regarding increasing these revenues.

During this decade, deficits increased significantly, but not only because of the succession of shocks (the pandemic, energy crisis amplified by the invasion of Ukraine, military conflicts, climate change, the trade war, and disorder in international relations). In 2023 and the following year, measures were adopted that led to an ESA fiscal deficit that exceeded 9% of GDP in 2024, a level recorded only during the pandemic year; it was the highest deficit in the EU. The deficit increased in 2024 largely due to new permanent expenditures with wages and pensions. This further demonstrates how damaging it is to neglect the need to increase fiscal revenues, namely.

Fiscal correction began through wage and pension freezes and increases of taxes and duties, but the ESA deficit of 7.8% of GDP in 2025 remained the highest in the EU (the cash deficit was 7.65% of GDP). In 2026, the fiscal deficit should move toward 6.2% of GDP, according to the draft budget, which would be a remarkable adjustment. However, there is still a long way to go before achieving primary surpluses (the deficit before servicing public debt) that would facilitate the stabilization of public debt.

A large-scale fiscal correction, cannot be carried out without society suffering its effects; someone has to pay, even though the burden of adjustment is unfortunately not distributed fairly. This correction is being implemented gradually, but it is painful nonetheless.

Poland and Hungary are expected to have higher budget deficits than Romania this year. However, both countries have relatively balanced external accounts and considerably higher fiscal revenues, and their economies are more competitive. Poland also spends more than twice as much, as a percentage of GDP, on defence compared to Romania.

Four major issues related to *fiscal dominance* can be identified when assessing our economy: the monetary issue, the fiscal issue itself, the role of European funds, and the political issue.

The monetary issue: constant pressure on the central bank

Large fiscal deficits and expansionary policies may stimulate economic growth, but not on sustainable foundations; they can fuel inflation and deepen external deficits. When deficits are no longer tolerated by markets, a correction occurs, which may be very painful. This is what has been happening in Romania since 2025.

The very high inflation in the second half of 2025 and the first semester of 2026 is the result of tax increases and the liberalization of electricity tariffs. Fiscal revenues increased and expenditures on wages and pensions decreased in real terms (the inflation tax). The war in the Middle East was not the main factor that increased inflation from approximately 5% (had fiscal

correction not begun) to over 10% in April 2026. Even before the outbreak of this war inflation was already above 9%.

Significantly higher inflation and economic slowdown, or recession, represent the price we pay for imprudent fiscal policies. It is a cost of *fiscal dominance* on the economy.

A rapid and massive increase in fiscal revenues through combating tax evasion and tax avoidance – as many voices demanded – was not possible in 2025, just as drastic expenditure cuts were not possible either. Therefore, taxes and duties were increased; something had to be done rapidly and visibly to reduce the fiscal deficit given the spectre of sovereign risk downgrade to junk status (subinvestment grade). These measures, together with the liberalization of electricity tariffs, triggered an inflationary surge.

It is worth to remind that in 2010, during another fiscal adjustment episode, nominal public sector wages were cut by 25% and the VAT was increased from 19% to 24%. In 2025, it is difficult to imagine that drastic cuts to nominal incomes/wages could have been implemented; socially and politically, this was practically impossible (although certain bonuses were reduced or eliminated). The budget imbalance of 2024 created a considerably more complicated situation than in 2009-2010. Let us compare the indicators for those two moments: an ESA fiscal deficit above 9% of GDP in 2009 (with the impact of the global financial crisis on GDP dynamics) vs. a deficit of 9.3% of GDP in 2024; public debt around 23% of GDP in 2009 vs. approximately 55% of GDP in 2024; a current account deficit of 4.3% of GDP in 2009 vs around 8% of GDP in 2024.

For the second half of this year, the National Bank of Romania (NBR) forecasts considerable disinflation due to base effects, and it is likely that the year will end with inflation around 5%, provided no other strong shocks occur; inflationary expectations remain nonetheless a concern.

Strong *fiscal dominance* and distortions in the domestic energy market have made Romania an outlier in the EU regarding inflation dynamics. The central bank been forced to maintain the nominal monetary policy rate at a much higher level than policy rates in most EU countries (only Hungary had a similar rate). This situation has also been reflected in domestic monetary conditions.

In almost all communications following the NBR's monetary policy meetings, as well as in other documents, references are made to the conduct of fiscal policy and uncertainties related to it; this is a way of speaking about *fiscal dominance* and a defective policy mix. Romania's fiscal policy has been a major constraint for the NBR's monetary policy, a straitjacket.

The fiscal issue: deficits are a major problem, public debt may become one

Large fiscal deficits accumulated over the years shape market perceptions and explain Romania's sovereign risk – only one notch above junk. Romania had the largest fiscal deficit in the EU in 2025 too. Public debt has risen rapidly in recent years – from approximately 35% of GDP in 2019 to over 60% of GDP in the first months of 2026.

If the fiscal deficit is not reduced, public debt will become increasingly burdensome because of rising debt servicing costs (see the section on public debt sustainability in the Fiscal Council's report on the draft budget, March 2026). Public debt sustainability would become a major issue.

Romania suffers from the twin deficits syndrome, with a current account deficit slightly below 8% of GDP in 2024 and only a small decline in 2025. Moreover, approximately 50% of these deficits are financed through external borrowing. Reducing the fiscal deficit must be assessed from the perspective of the external balance as well. If Romania did not have such large external deficits (as is the case in other countries in the region), foreign markets might tolerate fiscal deficits of above 4% of GDP, though certainly not indefinitely.

Returning to the present situation, it is essential to avoid significant deviations from the fiscal consolidation trajectory this year; the government that will be formed must continue the correction process. Rating agencies and international markets await the installation of the new government and, above all, the signals and actions it will undertake. This is why it is more than appropriate not to delay the 2027 budget project this year (as it did happen last year).

Large fiscal deficits sustain high interest rates on the domestic market, illustrating a crowding-out effect. This statement may sound paradoxical given that bank deposits exceed considerably the volume of loans granted by commercial banks. However, the crowding-out effect is visible through the high level of interest rates.

Some voices advocate tax reductions. If the new government were to implement such measures, it would simultaneously need to reduce public expenditure in order not to jeopardize fiscal consolidation. In any case, such an operation would be highly risky, counterproductive.

Consolidation will not end in 2026; it must continue in order to reduce the deficit to 3% of GDP within a few years, and even below this threshold to create fiscal space. It is vital to significantly improve tax revenues collection to support fiscal consolidation, cover increased defence expenditures, and alleviate the underfunding of essential public sectors such as education and healthcare.

Tax evasion and tax avoidance constitute a national security problem and must be combated through ANAF reform and legislative changes, through a change in mentality, and by eliminating the feeling of impunity.

The wage reform must be implemented without negatively affecting the correction of the fiscal deficit.

European funds

European resources (the EU budget) are meant to reduce development gaps – especially through structural and cohesion funds. The volume of Romania's public investments has been strongly supported by European resources. This function has been all the more valuable in a country confronted with large fiscal deficits and low tax revenues; European funds have also

supported Romania's balance of payments, which matters in the assessments made by rating agencies and those financing fiscal deficits.

European resources mitigate the contractionary impact of fiscal correction. The reduction of European funds (the PNRR ends this year) becomes a major challenge from this perspective.

Romania must attract foreign investments, including from non-EU countries, to help increase the competitiveness of its economy.

The political issue – “where are the adults in the room”

The political crisis (because it is more than a simple governmental crisis, as some analysts prefer to call it) changes the parameters for assessing fiscal consolidation, even though Romania has a budget in 2026 (let us imagine what the situation would have been had this crisis occurred before the budget was finalized). This crisis could have been avoided if there had been responsibility and wisdom in prioritizing the grave macroeconomic situation. Some are speaking already about the 2028 elections, while what is essential now is to focus on the fiscal situation.

There is an expression – “where are the adults in the room?” (not strictly referring to age) – which applies to the political crisis that has emerged. There must be lucidity and responsibility, at least at this late hour; a government should be formed as quickly as possible, with a programme capable of continuing fiscal consolidation and reforms, as well as the absorption of European funds.

The political crisis puts pressure on monetary policy (for example, turbulence on the foreign exchange market). But the National Bank of Romania cannot be a factotum, and solving the political equation depends on forming a new government. Yet the type of government matters greatly, because perceptions and market and social sentiments are shaped by its strength, as well as by the signals it sends regarding fiscal consolidation and reforms.

It is inappropriate to compare Romania's political crisis and the replacement of one government with another to, for example, political instability in Bulgaria or in the United Kingdom in recent years. Those countries do not face the burden of very large fiscal and external deficits.

Final thoughts

Fiscal dominance complicates the mission of the National Bank of Romania; the central bank will face more difficult circumstances because of the political context, institutional fragility, and ongoing tensions. Confidence in the Romanian leu is linked to fiscal consolidation and the financing of deficits.

Fiscal dominance is more visible in Romania than in other countries due to the size of the economy, the level of deficits and fiscal revenues, sovereign risk, and the ending of the PNRR.

We live in turbulent times, with a very complicated geopolitical situation and much disorder in the world, circumstances in which we must rely more on our own resources.

Romania needs a government that does not question the fiscal consolidation, that manages as effectively as possible the absorption of EU funds and the implementation of necessary reforms.