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**The Romanian financial system:
from central bank-led to dependent financialization**

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The Financialization of the Romanian Economy: from central bank-led to dependent financialization

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Abstract: This study argues that financialization is not a phenomenon exclusively associated with complex innovation in highly developed financial markets. Financialization also affects countries with 'shallow' financial markets but with a significant presence of transnational financial actors that become a powerful economic and political force able to navigate and shape uneven regulatory and institutional terrains in order to sustain new modes of profit generation. The study distinguishes two stages in the financialization of the Romanian economy. The first, central-bank dominated stage saw the systemic transformation of firm-bank-state relations that resulted in the creation of impatient banking and the forestalling of industrial policy options. The second, dependent financialization, is in turn characterised by new modes of profit generation for transnational financial actors, interconnectedness and fragility as the main mechanism of incorporation in European financial structures.

Key words: impatient banking, financialization, carry-trades, sterilizations, macroeconomic policies, pension funds, dependency, financial globalization.

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Executive Summary

The purpose of this study is to shed light on the processes of financialization taking place in the Romanian economy, its financial institutions and financial markets since the collapse of the socialist planned system in 1989. In line with the FESSUD approach, it stresses that finance matters in order to conceptualize financialization as a quantitative and qualitative change in financial systems that involves de-regulation, interconnectedness and fragility, all tied together by practices of an increasingly impatient finance. The study shows that financialization is not a phenomenon exclusively associated with complex innovation in highly developed financial markets. Financialization also affects countries with 'shallow' financial markets but with a significant presence of transnational financial actors that become a powerful political and economic force, able to navigate uneven regulatory and institutional terrains in order to sustain new modes of profit generation.

The study argues that Romania's transformation from a planned to a financialized capitalist economy can be broadly divided in two distinct periods, separated by the 1998-99 twin banking/balance of payment crisis and the 1999 start of negotiations for EU membership that accelerated the liberalization of the capital account and the entry of foreign financial actors. Financialization proceeded in two stages echoing Peck and Tickell's (2002) stages of neoliberalism: a roll-back, central-bank dominated stage seeking the systemic transformation of firm-bank-state relations that resulted in the creation of impatient banking and the forestalling of industrial policy options; and a roll-out (productive) stage characterised by new modes of profit generation for transnational financial actors, interconnectedness and dependency as the main mechanism of incorporation in European financial structures.

The first period is a period of autonomous, policy induced, *central-bank led financialization*. The term refers to the set of practices and ideas focused on changing the socialist legacy of relational banking into arm's-length relations between (state-owned) finance and industry. Such material and ideational efforts, spearheaded by the central bank

and demanded by international financial institutions providing much-needed official lending, resulted in the financialization of banking activity. Both private and state-owned banks became increasingly impatient lenders as central bank' monetary policies effectively undermined relationship banking. Invoking poor management and the political capture of bank-firm relations, the Romanian central bank (BNR henceforth) implemented tight monetary policies and exchange rate flexibility that curtailed the possibilities for banks to generate profits from traditional lending to business even when governments proved willing to provide targeted subsidies.

In turn, the central bank used such instances of government support for state-owned companies as an institutional alibi to shift responsibility for failed macroeconomic stabilization to 'inept' and 'corrupt' governments that maintained distorted policies. It first framed the poor performance of state-owned banks as a consequence of poorly designed programs for preferential credit rather than its own tight monetary policy that inflicted liquidity shortages and high interest rates on banks, and prevented these from sustaining maturity mismatches characteristic to relational banking. The central bank simultaneously framed inflation as the outcome of politicized bank lending to uncompetitive state-owned companies (a monetarist explanation) rather than its failure to provide exchange rate stability. While state-owned banks managed to withstand such policy pressures by lending less and at shorter maturities, the 1998-99 crisis made apparent how the key to survival in a regime of central bank-led financialization was to rely increasingly on profits from transaction-oriented banking (trading cross-currency risk and government bonds) or to seek foreign-ownership.

The second period sees the consolidation of *dependent financialization*. While dependency in the first instance arises from the dominant presence of transnational banks that accelerate the changes introduced by central-bank led financialization, the term captures the emergence of new forms of organization of financial markets and actors, characterized by *(cross-border) interconnectedness*, *state agency* and *fragility*. It further highlights the importance of setting processes of financialization in the context of

globalized finance, with transnational banks shaping, and connecting, local and global financial architectures.

Transnational banks' complex business models and (cross-border) interconnectedness

Dependent financialization echoes what Nolke and Vlieghenart (2009) termed the dependent variety of capitalism to describe the post-socialist economies of Central and Eastern Europe (see also Ban, 2013). In their account, transnational companies rely on cheap skilled labour to set up subsidiaries, funded through foreign direct investment or by borrowing from the banks in their home countries. Similarly, in dependent financialized economies, transnational banks channel capital and liquidity across subsidiaries through internal capital markets. Group-based liquidity allocation enables various new modes of profit generation, across various markets. Transnational banks set up non-bank intermediaries to enter new markets for financial services (private pensions, insurance) or to overcome regulatory constraints (eg. foreign currency lending to households). Transnational banks can 'externalize' loan intermediation to circumvent policies aimed at containing rapid credit growth.

In turn, trading-based modes of profit generation connect local currency markets, local asset markets and international wholesale funding markets. These relationships are *transformative*, financializing market structures. Thus, currency markets no longer reflect international trade in goods and services but capital flows driven by cross-currency risk trading. Similarly, interbank money markets no longer reflect demand for, and supply of, reserves arising from traditional deposit taking and lending activity but instead the interplay of capital inflows and the central bank's capital account management strategy. Markets became financialized quantitatively (rapid growth, increasingly liquid) and qualitatively (structural changes in demand/supply conditions driven by trading-based banking).

Furthermore, dependent financialization also transforms households. The financial sector mediates spending and investment decisions as households accumulate financial

obligations through networks of mortgage and consumer credit. For example, in Romania, the share of household loans to GDP increased fifteen fold between 2002-2008, from less than 2% of GDP to about 22% of GDP, driven by rapid growth in foreign currency lending. Financialized households make (more or less informed) decisions about currency and liquidity risk by arbitraging interest rate differentials, decisions that 'plug' them into international financial networks and exposes them to international volatility through the exchange rate channel.

State agency

Crucially, the state plays an important role because it manages and maintains the mechanisms that produce financialized behaviour. Public policies ease the entry of impatient actors (through capital account liberalization), enable their exit (through the central bank's liquidity management strategies), provide supporting regulatory environments and in general, endorse new financial practices in the name of financial deepening and enhanced market liquidity. Three examples stand out for Romania.

First, the central bank influenced the financialization of Romanian banking. It produced assets for the market portfolios of financialized banks throughout the early 2000s. Given the under-developed state of most asset markets that would attract capital inflows (crucial for the central bank's deflationary efforts since these appreciate the currency and reduce inflation), the central bank generated such assets through its sterilization activities. Indeed, sterilization instruments amounted to around 30% of overall banking assets throughout most of the period. Similarly, policy interest rates exercise little influence over lending conditions, but instead matter for market-based modes of profit generation by influencing the yields that private financial institutions can obtain on Romanian assets. Second, regulatory constraints on household lending were eased considerably in early 2007. The central banks 'celebrated' EU membership (January 2007) by allowing transnational banks to rely on their own risk assessment models for household lending at a time of rapid growth in foreign currency credit supported by cross-border

funding. As a result, households' borrowing increased three times faster than in the previous year, and so did their exposure to currency risk. Third, following World Bank advice, the Romanian government agreed to the gradual privatization of the public pension system starting with 2007. Financialization, both in terms of increased market portfolios and interconnectedness is apparent here from the mechanisms of privatization. The Romanian state collects contributions and channels a share of these to private pension funds (most members of transnational banking groups); who in turn demand safe assets in the form of government bonds or bank deposits. This reduces the capacity of the Romanian Treasury to rely on captive sources of funding its budget deficit (a common practice before 2008), forcing it in turn to generate debt instruments that pension funds can hold by becoming actors on the sovereign bond market. The Romanian state fuels both the liabilities side of private pension funds (providing free funding) and the assets side (providing government bonds); it effectively creates profitability for private financial actors while demanding limited commitments in return. On a more fundamental level, the financialization of the welfare state establishes the liquidity of the market for government debt as a policy priority not only for funding government deficits but also for social welfare. This severely restricts the room for designing policy measures that would select 'non-financialized' or patient types of government debt holders, since such measures would be detrimental to market liquidity.

Financial fragility

Lastly, the study shows that dependent financialization exacerbates financial fragility. Transnational banks generate common and mutual exposures that concentrate and propagate systemic risk across markets, and across borders. Regulatory initiatives remain constrained by EU-wide principles of level playing field, disputed regulatory responsibilities between home and host country regulators and regulatory arbitrage through foreign banks' internal capital markets. This in turn generates high exposure to short-term foreign debt and to funding difficulties experienced by parent banks (or parent companies).

Furthermore, during periods of international financial volatility, transnational banks may lead or support speculative currency attacks. During two such episodes (early 1999 and October 2008), the Romanian central bank responded with measures that had significant negative externalities, tightening money market liquidity and effectively increasing the cost of borrowing during recessions. This approach entails significant economic costs if patient banks with 'legitimate' funding gaps cannot access interbank money markets. Policy makers refrained from the alternative, capital controls, fearing a political backlash in the name of the EU's freedom of capital provisions.

The materialization of financial fragility further renders visible the regulatory challenges underpinning dependent financialization: interconnected regulatory agencies (home and host to transnational banking groups) without mechanisms for managing cross-border systemic risk.

To sum up, this study argues that the story of Romania's dependent financialization is ultimately the story of financialized transnational banks. Whereas impatient non-resident actors can and do play important roles in the build-up of financial fragilities, the study argues that it is the interaction between transnational banks and state policies that underpins the mechanisms that produce financialized behaviour.

Transnational banks rely on fragile modes of profit generation that include proprietary currency trading, sterilization assets and off-balance sheet provision of counterparty liquidity to impatient non-residents; they dominate most financial market segments (stock market, pensions, insurance, corporate debt) directly or through affiliated non-bank intermediaries; and engage in regulatory arbitrage and destabilizing speculative attacks. Whereas the post-Lehman crisis energized a new willingness to constrain the power of transnational banks in the core economies where these are headquartered, in the 'periphery' countries - such as Romania - the crisis re-affirmed the considerable political power that transnational banks exercise due to their systemic role. Since Lehman, transnational banks successfully intervened in cross-border regulatory deliberations and eventually persuaded host regulators to support their narrative of the crisis (poorly

developed financial systems in host countries) and to accommodate their preferences for regulatory reform: that regulators do not view their reliance on internal capital markets as a source of systemic risk but instead push onwards with the project of financial deepening (read financialization) as a market solution to the vulnerabilities of impatient banking.

1. Introduction

This study traces the financialization of the Romanian economy by exploring the transformations in its economy, its financial institutions and financial markets since the collapse of the socialist planned system in 1989. In line with the FESSUD approach, it stresses that finance matters in order to conceptualize financialization as a quantitative and qualitative change in financial systems that involves de-regulation, innovation and fragility, all tied together by practices of an increasingly impatient finance. Thus, the study is guided by analytical concerns with both actors and practices specific to processes of financialization.

The study highlights several factors and actors that influenced the pace and nature of financialization:

- (i) The entry of transnational financial capital, initially through foreign-owned banks and then through other financial actors (including non-resident investors, pension funds, insurance companies etc.), with new modes of profit generation and increasing regulatory clout.
- (ii) International institutions, primarily the International Monetary Fund (IMF) along with the World Bank and European Union institutions, that encouraged or demanded regulatory regimes (the liberalization of the capital account; level-playing fields) and institutional innovations in support of (new) financial actors and markets.
- (iii) Deliberate state action through macroeconomic policies and regulatory frameworks that tacitly enable new modes of profit generation; in particular the central bank's liquidity management framework.

The study shows that financialization is not a phenomenon exclusively associated with complex innovation in highly developed financial markets. Financialization also affects

countries with 'shallow' financial markets but with a significant presence of transnational financial actors that become a powerful political and economic force, able to use uneven regulatory and institutional terrains to their advantage. The study conceptualizes this phenomenon as dependent financialization, and Romania as a dependent financialized economy.

In financialized economies, traditional indicators of financial development – such as credit to GDP or money supply to GDP ratios – have to be expanded in order to better capture macrofinancial linkages that reflect cross-border banking business models, cross-currency trading strategies and endogenous financial instability. Furthermore, this study makes the case that scholarly work and regulatory initiatives would benefit from firmly embedding financial actors within the political economy and from developing adequate metrics to capture distinctive modes of profit generation. Without this, research cannot answer crucial questions about the conditions under which finance can be changed to better serve broader socio-economic objectives.

1.1 Financialization: a theoretical framework

A large and growing body of literature has investigated the process of financialization, broadly defined as the growing importance of financial actors and financialized practices in capitalism (Epstein, 2005; Krippner, 2005; Stockhammer, 2004). French et al. (2011) identified three distinct analytical frames broadly concerned with the changing behaviour of *private actors*. The regulation school approaches financialization as a new regime of accumulation in which financial activities replace trade and manufacturing as the main channel of profitability. In turn, the critical social accountancy school associated with the CRESC centre at the University of Manchester takes a meso view to link shareholder pressures to the changing behaviour of non-financial corporations. A sociological

perspective examines the increasing inroads that financial relations carve into social spheres, including everyday life.

Scholarship informed by political economy concerns in turn examines the possibility that *governments and other state actors* – the central bank in particular – can be important drivers of financialization. D’Arista (2005) and Vernengo (2008) turn to the financialization of macroeconomic policy, conducted, as in the inflation targeting regimes, with clear distributional consequences in favour of financial capital (see Fontana, 2009). Gabor (2010a; 2012a) shows that financialization generates, and is in turn accelerated by, particular institutional configurations that consolidate epistemic authority and political power in the central bank. Financialized monetary policy contributes to the financialization of banking activity, defined by Hardie and Howarth (2009) as a move away from traditional credit portfolios to market-portfolios. The Liikanen report (2012) documents such a shift for European banks, increasingly dependent on market-based finance to meet their asset growth, a shift of importance for Romania’s dependent financialization since its banking sector is owned by European banks.

The financialization of distinctive *asset markets* has received increasing analytical attention. This literature combines temporality (short vs long-term) and motives (risk trading vs. relational lending) to characterize financial behaviour, echoing Crotty’s (2003) earlier discussion of the rise of impatient finance. Indeed, a growing body of research documents the financialization of commodity markets. UNCTAD (2007) drew attention to the key role that financial investors have come to play as commodities become a new asset class, with volumes traded on derivative segments vastly outpacing physical production and driving price volatility. Furthermore, Hardie (2011) developed a framework for understanding the financialization of government bond markets in developing countries. Hardie distinguishes between the financialization of the market structure – that is, the increasing liquidity of that market that allows trading large volumes without significant price volatility – and financialized investors, trading risk with short-time horizons, whose ability to exit the market and short the asset contribute to the increasing financialization of

the market structure. In contrast, loyal investors hold government bonds to maturity and may provide relief during a crisis by increasing demand if mechanisms underpinning loyalty are in place (such as protection from mark-to-market accounting). Gabor and Ban (2012) extended this framework to the sovereign bond markets of high-income countries, defining a collateral motive that reflects the shift in banks' business models away from traditional credit portfolios to market portfolios (Hardie and Howarth, 2009) that require wholesale funding in secured money markets (repo markets). Collateral-based finance is similarly impatient due to the nature of risk management frameworks. Counterparty risk is replaced by collateral liquidity risk, the risk that the collateral market loses liquidity or experiences price volatility, resulting in higher haircuts or additional margin calls. Common to these discussions is the recognition that the financialization of asset markets is accompanied by, and contingent on, the presence of transnational capital and international financial actors.

Yet the financialization literature pays limited attention to two markets crucial for transnational finance: currency markets and interbank money markets (see Gabor, 2010b for an account of Eastern Europe). Partly, this is a matter of re-interpreting the literature on capital account liberalization through a financialization lens. Indeed, research has now documented the increasing importance of carry-trade activities in currency markets of both developed and developing countries (see Galati et al., 2007; Gabor, 2012b). Under free capital mobility, financial actors 'chase' higher yields through leveraged borrowing at low interest rates in the funding currency to invest in high-yielding currencies (for example, the Japanese Yen funded demand for Australian assets before Lehman). A carry is a risk trading – or financialized – practice *par excellence*. Carry returns increase if the target currency appreciates, and often contributes to appreciation if carry inflows are substantial. In contrast, carry profits will disappear if the target currency depreciates suddenly or if funding conditions change suddenly (Brunnermeier et al, 2009). Carry-traders, typically highly leveraged, can prevent losses if they can exit rapidly, thus triggering exchange rate volatility and reducing the liquidity of markets where they held assets. Although thriving on

exchange rate stability (appreciation), carry-trades are inherently fragile (Curcuru et al, 2010).

Indeed, the ability to enter and exit is crucial to how the financialization of asset markets unfolds. Full capital account liberalization and favourable domestic liquidity conditions support the entry of non-resident investors and carry-induced demand from domestic actors (transnational banks). Liquid (financialized) asset markets allow impatient financial actors to exit rapidly when expectations deteriorate and uncertainty increases. Financialization increasingly depends on the presence of global banks in domestic banking systems and non-resident investors in domestic asset markets.

Furthermore, financialization strengthens the interconnectedness of markets and actors. For example, a carry-trade involves holding assets in countries with high interest rates, thus connecting the currency market with domestic asset markets (government debt, corporate debt) or bank deposits, and indirectly contributing to asset bubbles (Galati et al, 2007; Curcuru et al, 2010). Changing banking models are crucial to countries' exposure to carry-trade activity, as foreign-owned banks engage in proprietary trading or provide counterparty liquidity to non-resident investors' positions (see Fritz and Prates, 2013 for similar trends in Brazil and South Korea). Banks actively intermediate capital inflows (Gabor, 2012b), and to do so, they need liquid domestic money markets or a central bank that stands ready to provide reserves (as an inflation-targeting central bank would in order to control short-term money market rates). Demand on the interbank money market is no longer driven by banks' funding gaps from lending activity, but reflects complex liquidity management decisions underpinning diversified business lines that include counterparty liquidity to carries, consumer credit and market portfolios besides the traditional credit portfolio of relational banking.

Such changes in currency and money markets highlight the deliberate role that states can play in processes of (dependent) financialization. A growing body of research documents that central banks influence the growth and nature of financial innovation through interest rate decisions and liquidity management strategies. In highly developed

financial markets, Adrian and Shin (2008, p. 23) persuasively argue, 'short term interest rates are determinants of the cost of leverage and are found to be important in influencing the size of financial intermediary balance sheets', supporting banks' increasingly large market-portfolios, a process that this study describes as the financialization of banking. Equally, liquidity management decisions can generate constraints in funding markets that trigger a rapid unravelling of carry-trade positions and a currency crash (Brunnermeier et al. 2008). Hence, the dynamics of financialized currency markets depend on policy choices in high income countries that provide funding currencies (see IMF, 2010) and determine global liquidity conditions (Hattori and Shin, 2009).

Conversely, central banks also influence processes of financialization in developing countries, albeit through different mechanisms. Where traditional relational banks rely on interbank money markets to cover funding gaps, central banks can inflict liquidity shortages if guided by monetarist understandings of the policies necessary to fight inflation (Gabor, 2010a). Such funding uncertainties in turn curtail banks' willingness to extend long-term credit to non-financial corporations and financialize banking activity by prompting banks to replace relational lending with short-term trading portfolios. Furthermore, in the presence of transnational financial actors, strategies of exchange rate appreciation (reserve accumulation), motivated by inflation-targeting commitments, may encourage speculative activity and contribute to the increasing financialization of currency and money markets. This occurs as transnational financial institutions include sterilization instruments as an asset class in their carry-trade strategies (Christensen, 2004; Gabor, 2010a,b; 2012b). The central bank's interventions in currency markets act as a catalyst for the financialization of banking (see Paineira, 2012 for a similar argument for South Korea and Brazil).

In sum, financialization pervades economic spaces, policy decisions and the behaviour of economic agents. Although the presence of transnational financial capital plays an important role in its development, its manifestations are uneven across different institutional landscapes. While economic geographers have argued that the distinction

national/foreign may lose analytical relevance in highly globalized banking activity (Christophers, 2013), the national scale remains relevant as long as regulatory and macroeconomic policy decisions influence the pace and form that financialization takes in various asset markets in different countries. The Romanian economy offers a fertile terrain for exploring these processes because in the space of twenty years, it has changed from a closed, planned and state-owned economy to a European Union member with a foreign-owned banking sector and a fully liberalized capital account.

1.2 Stages of financialization in Romania: from central bank led to dependent financialization

This study argues that Romania's transformation from a planned to a capitalist economy can be broadly divided in two distinct periods, separated by the 1998-99 twin banking/balance of payment crisis together with the start of negotiations for EU membership. Financialization proceeded in two stages echoing Peck and Tickell's (2003) stages of neoliberalism: a roll-back, central-bank dominated form seeking the systemic transformation of firm-bank-state relations that results in the creation of impatient banking and the forestalling of industrial policy options; and a roll-out (productive) form that generate new forms of profit generation, interconnectedness and dependency as the main mechanism of incorporation in European financial structures (see Table 1).

Table 1 The financialization of markets and institutions: from central bank-led to dependent financialization

	Financialization of banking activity	Financialization of currency market	Financialization of interbank money market	Financialization of sovereign bond market
Drivers of financialization	<ul style="list-style-type: none"> *Monetary/macprudential policy *Structural change: market-based modes of profit generation 	<ul style="list-style-type: none"> * Cross-currency risk trading rather than trade flows *Ability to enter/exit (regulation/market liquidity) *Yield differentials 	<ul style="list-style-type: none"> *Bank business models *Capital account management (sterilizations) 	<ul style="list-style-type: none"> *Ability to exit *Collateral motive
Phase I: <i>Central-bank led financialization</i> (domestic banks, capital controls)	<ul style="list-style-type: none"> * Ideological preference for arms-lengths relationship between finance and industry *Policy-induced shift from relational banking (impatient banking) 	<ul style="list-style-type: none"> *Limited (capital controls) 	<ul style="list-style-type: none"> *Limited (liquidity shortages) 	<ul style="list-style-type: none"> *Limited (loyal investors; captive sources)
Phase II: <i>Dependent financialization</i> (Transnational banking, liberalized capital account)	<ul style="list-style-type: none"> *Market portfolios (sterilization instruments; derivatives; stock market) *Loan externalization *Internal capital markets (cross-border funding) 	<ul style="list-style-type: none"> *Cross-currency (OTC) trading , derivative segment *Non-resident dominance. *Speculative attacks 	<ul style="list-style-type: none"> *Structural excess of liquidity from capital account management. * Sterilizations *Enables carry-trades. 	<ul style="list-style-type: none"> *Contingent on sovereign debt management strategy (captive sources) *Privatization of pension provisions
	Banks' proprietary trading and counterparty liquidity to non-resident carry-traders			
	Sterilization instruments as target asset			

The first period is a period of policy induced, *central-bank led financialization*. The term refers to the set of practices and ideas focused on changing the socialist legacy of relational banking into arm's-length relations between finance and industry. The (contingent) result of such material and ideational efforts, spearheaded by the central bank

and demanded by the international institutions, was the financialization of banking activity as banks found it increasingly difficult to sustain relational banking. Invoking poor management and political capture, the central bank implemented tight monetary policies and exchange rate flexibility that curtailed the possibilities for banks to generate profits from traditional lending to business even when governments proved willing to provide targeted subsidies. In turn, the central bank used such instances of government support for state-owned companies as an *institutional alibi*.

The central bank first framed the poor performance of state-owned banks as a consequence of poorly designed programs for preferential credit rather than tight monetary policy through liquidity shortages and high interest rates that prevented banks from sustaining maturity mismatches. The central bank simultaneously framed inflation as the outcome of politicized bank lending to uncompetitive state-owned companies (a monetarist explanation) rather than its failure to provide exchange rate stability. While state-owned banks managed to withstand such policy pressures by lending less and on short-term, the 1998-99 crisis showed that the key to survival in a regime of central bank-led financialization was to rely increasingly on profits from cross-currency positions and government bond portfolios or be privatized.

The second period sees the consolidation of *dependent financialization*. While dependency in the first instance arises from the dominant presence of transnational banks that accelerate the changes introduced by central-bank led financialization, the term captures the emergence of new forms of organization of financial markets and actors characterized by interconnectedness, state agency and fragility. Thus, new modes of profit generation are embedded in new relationships. For example, transnational banks set up non-bank intermediaries to enter new markets for financial services (private pensions, insurance) or to overcome regulatory constraints. In another example, cross-currency search for yield, be it by domestic banks or non-resident players, connects local currency markets, local asset markets and international wholesale funding markets. Such relationships are *transformative*, financializing market structures. State action both

sanctions and supports the mechanisms that produce financialized behaviour: easing the entry of impatient actors (capital account liberalization), allowing or constraining exit (through the central bank's liquidity management strategies) and in general, accepting new financial practices in the name of financial deepening and enhanced market liquidity. Yet interconnectedness exacerbates financial fragility, as the new consensus on macroprudential policies highlights (Galati and Moessner, 2011; Yellen, 2013). Common and mutual exposures worsen pro-cyclicality, concentrating and propagating systemic risk across markets, and across borders. The materialization of financial fragility further renders visible the regulatory challenges underpinning dependent financialization: interconnected regulatory agencies (home and host to transnational banking groups) without mechanisms for managing cross-border systemic risk. Romania's crisis after the fall of Lehman Brothers demonstrates well such dynamics.

In further detail, successive governments encountered serious difficulties with securing access to international financial markets to fund structural current account deficits before 2000. The sustained balance of payment difficulties translated into a long and complex dependence on the IMF's conditional support (with smaller contributions from the World Bank, the European Bank for Reconstruction and Development), and an extended power struggle between the central bank, the IMF's closest political ally, and successive governments of leftist (neo-communist for some) orientation over the fundamental principles for economic reform. Throughout this period, Romania signed five IMF agreements, all terminated before term for non-compliance with either macroeconomic targets (credit growth) or structural conditionality (mainly privatization of public utilities and state banks).

The 1998-1999 banking crisis ended a period of extended financial disintermediation and saw renewed public commitment to a rapid privatization of state-owned banks and financial deregulation. It accelerated a double movement from state to private and from domestic to foreign ownership for financial institutions and manufacturing companies. Influential policy actors, including the Romanian central bank and international financial

institutions, played an important role in redefining the relationship between (state-owned) banks and the non-financial corporations along what Crotty (2003) described as ‘impatient’ finance. Tight liquidity policies, often conceived through the IMF’s monetarist conditionality and legitimized through the language of soft budget constraints, sought to curtail banks’ long-term lending to non-financial corporations. In response, state-owned corporations could only mobilize temporary support from sympathetic governments, as programs for industrial regeneration could not be sustained for long without support from the IMF and the central bank.

The central bank eventually won the power struggle between the domestic institutions of economic governance, and cemented its epistemic authority during the 1998-99 twin-crisis. Without IMF support, at the time testing insisting on private sector support, the central bank designed a program of internal devaluation that successfully averted default on Romania’s external debt in early 1999. That same year, the European Union recommended the start of negotiations for EU membership. Testimony to his political power as much as his credibility, the central bank governor, Mugur Isarescu, was designated prime minister in order to oversee the design of the economic strategy for EU accession¹.

After 2000, the Romanian economy, through its increasingly diverse financial actors, became integrated in international financial markets. Plans for European Union (EU) membership accelerated the liberalization of the capital account, initiated in 1999 and finalized in 2006, when restrictions on non-resident trading in fixed income and stock markets were lifted, one year before Romanian became a EU member (January 2007). Large capital inflows introduced new modes of profit generation reliant on impatient search for yield (Rajan, 2005) and dependent on exchange rate appreciation (or at least stability), generating vulnerabilities well documented for developing countries (see Gala, 2008).

¹ Mugur Isarescu was prime-minister between December 1999 and December 2000. He then ran as an independent candidate for presidency in the 2000 elections, with support from a coalition of right-wing parties, but lost the elections. He returned to the central bank, and remains governor to date (April 2013).

Romania became an Eastern European 'tiger', its rapid economic growth accompanied by overvalued exchange rates, large current account imbalances and rapidly growing foreign-currency (henceforth forex) lending feeding consumption and real estate booms, with cross-border borrowing mainly intermediated by the foreign-owned banking sector. This is the period of transnational financial capital, its financialization dynamics involving households alongside currency and fixed income markets.

Through a financialization lens, Romania became a 'financially-dependent' political economy. Its foreign-owned corporate sector relies more on borrowing abroad from parent companies or foreign financial institutions than from the domestic financial system. In turn, foreign-owned banks perform cross-border credit intermediation and maturity transformation while profit-generating activities in the domestic financial system involve several impatient strategies funded from cross-border sources and new types of relationships across increasingly financialized currency and interbank money markets. Indeed, impatient capital inflows, intermediated by both domestic banks and non-resident investors, had an important bearing on market structures. The currency market no longer reflects international trade in goods and services but capital flows driven by cross-currency risk trading (Plantin and Shin, 2011). The interbank money market no longer reflects demand for, and supply of, reserves arising from traditional deposit taking and lending activity alone but increasing resident banks' trading/market-making activities and central bank's capital-account/exchange-rate management strategy. Markets became financialized both quantitatively (rapid growth, increasingly liquid) and qualitatively (structural changes in demand/supply conditions as well as in the behaviour of private financial actors).

In a financialized economy, the regimes of macroeconomic governance support new modes of profit generation. Capital account management, and exchange rates, become policy priorities, albeit not overtly. In turn, inflation targeting regimes are ineffective because interest rate decisions have, as the Romanian central bank openly admits (BNR, 2012), limited effects on consumption and investment decisions since companies rely little

on the domestic financial system to raise funding whereas households borrow primarily in foreign currency. Policy interest rates matter instead for new modes of profit generation by influencing the yields that private financial institutions can obtain on Romanian assets, including the currency.

Thus, a financialized economy strengthens the interconnectedness between the macroeconomy and financial markets, or macrofinancial linkages. It entails *strategic interactions* between the central bank and private financial institutions that connect, and financialize, currency markets and money markets. Since the central bank cannot predictably influence aggregate demand with its policy rate, it has to engineer exchange rate appreciations consistent with its inflation target. For this purpose, the central bank uses both its policy rate and its liquidity management framework to make domestic assets attractive to capital inflows (see Paineira, 2012). Indeed, foreign investors can only take positions in domestic asset markets if domestic counterparties are willing to provide domestic liquidity, and if the central bank remains tacitly committed to exchange rate appreciation (Galati et al, 2007). This is crucial since adverse developments in liquidity conditions or exchange rate depreciation generate substantial losses for cross-currency trading strategies (Brunnermeier and Pedersen, 2009). In other words, the profitability of impatient finance depends on how the central bank manages money market liquidity as part of its capital account management strategy (Buiter and Silber, 2008; Gabor, 2012a).

The 2008- crisis demonstrated that dependent financialization entails distinctive vulnerabilities and regulatory challenges. Regulators have limited control over credit cycles since foreign-owned banks and foreign-owned companies rely heavily on intra-group finance and can thus 'externalize' loan intermediation, by-passing regulatory measures. Regulatory initiatives to stem foreign currency credit remained constrained by both EU-wide principles of level playing field, disputed regulatory responsibilities between home and host country regulators and regulatory arbitrage through foreign banks' internal capital markets (see Pistor, 2010). This in turn generates high exposure to short-term foreign debt and to funding difficulties experienced by parent banks (or parent companies).

During periods of international financial volatility, the central bank is confronted with speculative attacks that can only be counteracted with measures that have significant negative externalities. It may seek to curtail the willingness of domestic counterparties to provide the domestic liquidity necessary for launching a speculative attack either by starving money markets of liquidity, as Romania did throughout 2009 (Gabor, 2012b) or by informal measures to suspend capital account convertibility, as Latvia did in 2008-2009 (Buiter and Silbert², 2008; Fitch, 2009³). The first approach entails significant economic costs if banks with legitimate funding needs cannot access interbank money markets, while the second may trigger a political backlash since it challenges EU's freedom of capital.

The policy options available to financialized economies in crisis are limited. The traditional adjustment strategy in non-financialized economies - devalue exchange rates to stimulate export activity - cannot be implemented because banks, companies and households depend on exchange rate stability. The adjustment then requires an internal deflation through wage cuts and fiscal contractions while monetary policy cannot be eased without accelerating capital flight.

Indeed, although Romania has the lowest relative levels of financial depth in the European Union, it proved to be highly vulnerable to the post-Lehman deleveraging. With deteriorating funding conditions in international financial markets, parent banks threatened to curtail the credit lines that had enabled their subsidiaries to grow rapidly their activities in various market segments. To avoid a currency and banking crisis, Romania turned to IMF support in April 2009 (the third country in Eastern Europe to do so, after Hungary in November 2008 and Latvia in February 2009; see Myant et al, 2013). The agreement further set the basis for an ad-hoc institutional setting to involve parent banks

² According to Buiter and Sibert (2008, p.16), the Latvian central bank 'discouraged speculation against their currencies by not authorising large transactions involving domestic currency borrowing, if these large amounts were not justified....by the needs of trade and normal financial transactions, but were instead part of an attempt to short the lat and cause the currency peg with the Euro to collapse'.

³ http://www.kase.gov.lv/texts_files/20091015_Fitch_affirms.pdf

in what became known as the Vienna Initiative (or the European Bank Coordination Initiative), an EBRD/IMF led initiative to secure the roll-over of short-term credit to subsidiaries. The initiative allowed transnational banks to intervene in the regulatory initiatives that have sought to resolve the complex challenges of designing effective regulatory regimes for transnational banks in the absence of a European regulatory framework. In turn, monetary policy and regulatory reform remained guided by concerns to protect banks' balance sheets. Even so, Romania experienced two years of economic contraction before returning to 2.2 % of GDP growth in 2011 and then 0.7% of GDP in 2012.

The study offers first a short overview of the socialist planning system to then document the dynamics of financialization of the Romanian economy.

2. Before 1990: the planned production system

This section explores briefly the legacy of the Romanian socialist planning relevant for post-socialist reforms of the relationship between finance and industrial activity.

Romania's trajectory under the planned system can be broadly divided into two different periods delineated by foreign policy shifts (Gabor, 2010a). After the Romanian Communist Party took power in 1945, Romania moved into the Soviet sphere of influence and underwent the standard industrialization strategy characteristic to centrally planned economies. Across the Soviet block, the strategy of 'simultaneous transition' to socialism involved building capacity to manufacture capital goods.

The Romanian strategy changed in the late 1960s in response to Soviet attempts to establish a new division of labour in the socialist block that would establish the Soviet Union as the key producer of heavy industry. Romania objected to its newly assigned role as producer of primary goods or light industry and to plans that would move planning authority to a supra-national level. Wishing to preserve policy autonomy, President Nicolae Ceausescu embarked on an ambitious industrialization strategy that stressed the interdependency between industrial development and national sovereignty (Linder, 1986).

2.1 Finance and production in the first period (simultaneous socialist transition)

Central planners designed the financial sector of a planned economy to be strictly subordinated to the requirements of the industrialization strategy (Ellman, 1989). The organization of socialist production shared some of the principles underpinning capitalist production. Socialist theoreticians subscribed to Galbraith's (1967) crucial observation: technological change, the driving force in capitalism, typically occurred in monopolistic or oligopolistic companies because innovation requires commitments of time and capital unavailable to small companies operating in perfectly competitive markets (Persky, 1991).

State monopolies, carefully guided by central planners, could successfully replace the large-scale production characteristic to capitalist monopolies and avoid its inherent instability. The basic socialist model of production envisaged large, vertically integrated firms, each operating under monopoly or oligopoly conditions. Except for a few resource-intensive countries, domestically produced raw inputs were reserved for internal use. Furthermore, international trade within the communist block was based on well-defined requirements for intermediary inputs (Winiecki, 1988). Prices played no role in the allocation of resources. Central planners calculated prices as mark-ups on labour and input costs, occasionally adjusted to reflect changes in costs.

Following this institutional blueprint, finance was organized as follows. In the industrial monetary circuit, several banks channeled credit to different economic sectors according to output target plans, as planners adjusted flows to settle transactions between companies but not for payment of wages. In this circuit, money functioned as a unit of account (Dow et al, 2008). In the household circuit, central planners limited domestic financial assets to two forms: bank deposits and domestic currency (Demekas and Khan, 1991). A savings bank attracted household deposits without performing maturity transformation or credit intermediation (Amsden et al, 1994).

The shift to a nationally-determined industrialization strategy entailed efforts to redefine this model of organizing the relationship between finance and production.

2.2 The autonomous period (1970s – 1989): the IMF-led and domestic restructuring programs

Romania redefined itself as a 'socialist developing country' in 1972. It extended its foreign relationships beyond the socialist block. It was the first socialist country to join the GATT in 1971, the IMF and World Bank in 1972, to receive generalized trade preferences from the European Economic Area and to allow Western companies to operate joint ventures within its borders. By 1974, the country was trading more with capitalist states than with the

Soviet block. Investment grew at a rapid pace, concentrated in industry (steel, chemicals and petrochemical refining), transport and communication. The rapid expansion was mainly financed from domestic resources, by heavily drawing labour from the agricultural sector⁴ and restricting consumption. Oil and gas exports financed imports of capital goods from capitalist countries.

The apparent success in self-sufficient industrialization had important consequences. While both capitalist and Soviet countries struggled against recessionary pressures during the late 1970s, Romania continued unabated with its rapid investment strategy in energy-intensive industries. However, the quest for heavy industrialization proved ill-timed (Gabor, 2010a). The rapid increase in oil refining capacity coincided with the peak in domestic oil production. Central planners turned to oil imports financed by foreign loans, leaving the country exposed to the international debt pressures of the 1980s. By 1981, Romania recognized that it was facing a balance of payments crisis. This marked the beginning of various experiments with 'structural adjustment', first designed under IMF conditionality (1981-1984) and then of a domestic pedigree until the fall of the Ceausescu regime in 1989 (Ban, 2012).

The IMF-sponsored program focused on structural measures that would increase the autonomy, and economic efficiency, of state-owned companies. Value added targets replaced quantitative targets for production. Central planners further introduced forward contracting between companies to improve coordination and avoid excessive accumulation of stocks. The IMF also stipulated that companies finance capital investment from either profits or bank credit, rather than rely on the state budget. For this, interest rates on credit for investment were raised progressively to improve the efficiency of capital allocation.

The program further sought to introduce some market mechanisms in the exports sector. The system of subsidies for exports and imports - known as the price equalization fund - was changed to ensure greater sensitivity to world prices, taxing exporters out of

⁴ The sectoral shifts in employment show more than 20 percent of the labour force moving from agriculture to industry and services, thus closing the gap with CMEA members.

profits if the export prices received were not competitive (Demekas and Khan, 1991). The IMF program further unified the various exchange rates applied to different trade transactions and depreciated the exchange rate against the US dollar. Although the IMF later changed its evaluation of the program's effectiveness⁵, it is important to stress that the program complied with its own targets. Romania successfully completed the three-year agreement with the IMF in 1984.

Ceausescu however decided against continuing the relationship with the IMF. The Polish experience suggested that the IMF's presence might weaken his grip on power. Instead, he initiated a new structural adjustment phase, explicitly seeking to curtail the country's dependency on external loans (Ban, 2012). All possible sources of foreign currency were mobilized into the early repayment of foreign debt, with apparent success. Within five years, Romania reduced its outstanding foreign debt from around US\$ 7000 million to US\$ 170 million in 1989. But this success had important consequences for economic performance (and social stability). In order to accumulate external surpluses, Romania implemented measures similar to what the IMF would have recommended: a reduction in effective demand. State-owned enterprises bore the brunt of the adjustment. Policy makers reduced imports of intermediary inputs in order to redirect foreign currency reserves to debt payments. While the IMF-induced hikes in interest rates were reversed, capital investment suffered from changes in taxation. Unrealistic plan targets, on which the tax liabilities were derived, resulted in heavy taxation. The domestic adjustment program further sought to tighten monetary conditions, just as the previous IMF agreement did. Paradoxically, while the taxation policy relied on, and effectively demanded, higher output targets, the credit policy sought to curtail companies' access to credit.

⁵ According to the IMF evaluation of that plan: "Although enterprises were required to finance a larger part of their investment, they possessed limited resources owing to the overstatement of their profits and excessive tax burden on enterprises during the 1980s. Moreover, they were not able to invest their own funds as they wished, because their investment projects had to be approved by the SPC. Consequently it is doubtful whether their funds were more efficiently allocated. Similarly, as increased interest costs were taken into account in the plan and were reflected in lower planned profits and remittances from profits to the budget, the use of investment funds probably did not lead to greater efficiency." (Demekhas and Khan, 1991).

State-owned companies responded to such conflicting pressures by relying on the mechanisms for coordination prevailing in the socialist economy. Indeed Burawoy (1985) described the production politics that characterized planned economies as a set of social relations between and within state-owned enterprises. Indeed, socialist production was organized into highly concentrated, vertically integrated industrial sectors, guided by explicit concerns with economies of scale⁶. This organization enabled companies to overcome liquidity shortages through endogenous credit relations within their production chain, replicating the experience of other industrial sectors in more 'market driven' socialist countries.

The IMF (1991) estimated that such inter-company credits rose to 40 percent of GDP by 1989, a level close to more 'market-based' socialist economies, such as Poland (48% of GDP), Yugoslavia (43%) and China (40%) (Calvo and Corricelli, 1992). However, it is important to stress that companies suffered despite the availability of such endogenous credit creation mechanisms. Indeed, official statistics suggest industrial production decreased by an average of 1.5 percent between 1985-1989, a figure probably higher given the tendencies to overestimate production (Daianu, 1994). The structural adjustment programs eroded the viability of the industrial sector and the credibility of its management. Post-socialist reformers faced several difficult questions: how to proceed with industrial reform? Could state-owned companies become viable in a market-based, competitive system, particularly given the damage inflicted by the policies of the 1980s? If so, what would be the role of the financial sector in this process? What institutional innovations should be applied to a concentrated, state-owned banking sector to best serve the reform process?

⁶ For Romania, a small number of enterprises with over 3000 employees provided more than 50% of total industrial output by 1989. In contrast firms with less than 500 workers employed only 4% of the labour force and generated less than 6% of output.

3. The post-socialist dynamics of the Romanian financial system

Romania's transformation into a capitalist economy, and the underlying changes in its financial system, has been particularly uneven in comparison to its neighbouring countries that became members of the European Union. Indeed, Cernat (2002) described it as a unique form of 'cocktail capitalism', defying classification. This chapter introduces the key trends in the evolution of the Romanian financial system. It first provides an overview of the macroeconomic trends in the 1990-2011 period, to then focus on various indicators of financial development in the Romanian economy.

3.1 Macroeconomic trends

Throughout the 1990s, the Romanian economy experienced a protracted period of macroeconomic instability. The first four years after the fall of the planned system saw a rapid contraction in economic activity, and particularly in industrial output, that lost 10% on average each year between 1990 and 1993. The contraction was accompanied by rampant inflation (a 239% annual average) and very rapid exchange rate depreciation: by the end of 1993, the exchange rate between the domestic currency and the US dollar had jumped to ROL/USD 1276 from a rate of ROL/USD 34 in 1990, almost *40 times higher* and a 255% annual average depreciation. Conditions stabilized throughout 1994-1996, when economic growth and industrial output returned to positive territory, while inflation and exchange rate depreciation slowed down (see Table 2). A new period of contraction followed, with GDP and industrial output falling throughout 1997-1999, while inflation and exchange rate depreciation accelerated. The 1990s ended with a banking crisis, and a narrowly avoided currency crisis.

Table 2 Macroeconomic indicators, % annual average change, Romania, 1990-2011

	1990-1993	1994- 1996	1997- 1999	2000- 2008	2009- 2011
GDP	-6.4	4.9	-4	5.6	-1.9
Industrial output	-10.5	5.3	-7.7	5.4	1.9
CPI inflation (period average)	239.1	48.8	82.2	15.4	5.8
Exchange rate depreciation ⁷	255	46.9	67.3	7.6	2.7
Current account deficit (%GDP)	-5.22	-4.5	-5.6	-7.9	-4.4
Balance of payments (% of GDP, positive for net inflows)	-3.45	-0.43	-1.1	4.5	2.3

Source: data from the National Institute of Statistics and World Bank

Note: period averages for GDP growth, industrial output and CPI inflation; end of period for nominal exchange rates. A balance of payment surplus equals an increase in reserve assets (see IMF Balance of Payments Manual⁸)

These dynamics have to be understood in the context of the Romanian dependency on foreign loans to fund structural current account deficits. Although at the fall of communism Romania had no foreign debt, this did not ease its access to international financial markets. Its agreements with the IMF, usually interpreted as a guarantee of credible policies in international financial markets, did little to improve access (Gabor, 2010a).

The IMF advised devaluations to solve balance of payments problems and restore external competitiveness, but such advice is only effective in countries with limited dependency on imports for consumption and production. Romania, on the contrary, with a state-owned industrial sector heavily dependent on imports of intermediary goods, demonstrated the importance of the structuralist observation that exchange rate volatility would affect production costs and reduce profitability without resolving current account

⁷ Calculated against USD/ROL for 1990-2005, then EUR/RON.

⁸ <http://www.imf.org/external/pubs/ft/bopman/bopman.pdf>

deficits (Taylor, 1983; Katseli, 1983). Indeed, it experienced large current account deficits throughout the 1990s (fluctuating around 5% of GDP on average), despite rapid exchange rate depreciation. With limited access to private international finance, it had to rely on the IMF and the foreign reserves of the central bank to cover balance of payments deficits.

After 2000, the economic outlook improved markedly. Rapid GDP growth was accompanied by improved industrial performance (10.5% average growth throughout 2004-08), exchange rate appreciation in nominal and real terms; all in the context of rapid disinflation. However, external imbalances worsened, with the current account deficit increasing to almost 14% of GDP by 2008. The liberalization of the capital account, completed by 2007, saw increasingly large capital inflows that funded the deficits on the current account, with balance of payment surpluses rising to an annual average of 4.5% of GDP throughout the period, driven largely by cross-border bank borrowing. Debt-generating capital inflows, intermediated by the banking sector, resulted in a foreign-currency lending boom that contributed to the overheating of the economy.

The post-Lehman deleveraging in international financial markets had serious negative consequences, particularly for short-term foreign debt. Net short-term outflows, particularly on the non-resident segment (unwinding carry-trades), reached EUR 8.8 bn in 2009. Capital outflows threatened a currency crisis and prompted the central bank to advise the Romanian government to ask for IMF support. The global financial crisis set a severe setback for the Romanian economy: two years of economic contraction (2009 and 2010), a slowdown in industrial output and a hard landing (a correction of current account deficits through lower domestic demand).

3.2 The evolution of the financial system

Twenty years after the fall of the socialist regime, the Romanian financial sector presents one of the lowest levels of financial intermediation in the European Union. It underwent a

period of rapid disintermediation before 2000 as a consequence of the volatile macroeconomic climate arising from the persistent failure of macroeconomic policies to deliver economic stability, the restructuring of state-owned companies and state-owned banks and the IMF conditionality that imposed constraints on credit growth. Indeed, by 1997, lending to companies and households had fallen to less than 10% of GDP from around 80% of GDP registered in 1990, and around a third of overall assets (see Table 3). This trend is a first signal of the shift away from the relational banking characteristic to bank-based financial systems.

Table 3 Structure of the financial system (net asset as % of GDP)

	1990	1996	2002	2007	2008	2009	2010
Credit institutions (assets)	125	28.7	31.2	61.0	61.1	66.3	66.6
<i>Domestic credit (non-government)</i>	<i>79</i>	<i>9.3</i>	<i>11.7</i>	<i>35.6</i>	<i>38.5</i>	<i>40.7</i>	<i>40.7</i>
Non-bank financial institutions	n/a	n/a	2.9	7.2	8.3	7.4	5.6
Insurance companies	n/a	n/a	1.5	3.0	2.9	3.3	3.3
Private pension funds	n/a	n/a	0.0	0.0	0.2	0.5	0.9
Financial investment companies	n/a	n/a	1.5	2.8	1.1	1.5	1.4
Open-end investment funds	n/a	n/a	0.1	0.3	0.2	0.3	0.5
Stock market capitalization	n/a	0.3	10.1	25.7	11.3	10.9	10.2
Total	125	29	47	100	85.1	90.2	88.5

Source: data from National Bank of Romania and IMF (2010).

Starting with 2000, the financial system grew rapidly, doubling as a share of GDP between 2001 and 2007, to almost 100%, driven by a rapid growth in lending to companies and households combined with a stock market boom. That share declined after Lehman, driven by a rapid contraction in stock market capitalization. The financial system remains dominated by banking institutions, increasingly foreign owned. Whereas state-owned banks

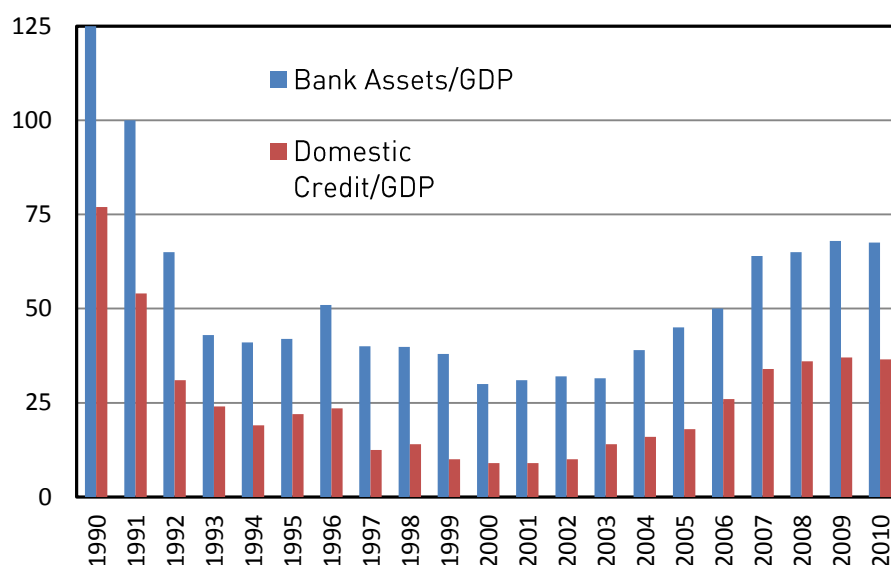
controlled 75% of the overall assets of the banking sector in 1997, that share had declined to less than 10% by 2005, as Western European banks entered through privatizations.

Credit institutions intermediate over 80% of total financial transactions (excluding trading on stock markets). The second largest type of financial institution, the non-banking financial intermediaries (henceforth NBFIs), similarly recorded a rapid growth before the financial crisis to around 8% of GDP, a fourfold increase on 2002. According to central bank data, this sector is dominated by financial leasing activities targeting non-financial corporations in the service sector. The introduction of the private pension pillar in 2007 generated growth in private pension funds, yet growth remained moderate due to on-going controversies about the shift of funds from the public to the private sector. The Bucharest Stock Exchange similarly saw a rapid expansion prior to the crisis, from 10% of GDP in 2002 to 26.7% of GDP in 2007, to then contract during the first year of the crisis by half of trading value - to 11.3% of GDP - where it remained throughout 2010. These dynamics point to the build up of a stock market bubble prior to 2008.

A more detailed picture reveals that both banks assets and domestic lending decreased rapidly as a share of GDP during the 1990s, the era of central-bank led financialization. The recovery during 1994-1996 was reversed after 1997, when a new agreement with the IMF imposed tight lending restrictions on banks and accelerated bank privatization and/or bankruptcy of state-owned companies. The central bank maintained tight lending conditions throughout 1998 and 1999 to mitigate the consequences of capital outflows in the aftermath of the East Asian and Russian crisis.

Furthermore, it is important to note that domestic credit contracted faster than overall bank assets, as banks changed their business models to target the existing areas of profitability, including currency markets, government bond markets and the central bank's sterilization instruments (Erurk and Solari, 2007); see also the chapter on bank assets). Indeed, by the end of the 1990s, lending to companies amounted to only a third of overall bank assets. Households in turn held no bank debt.

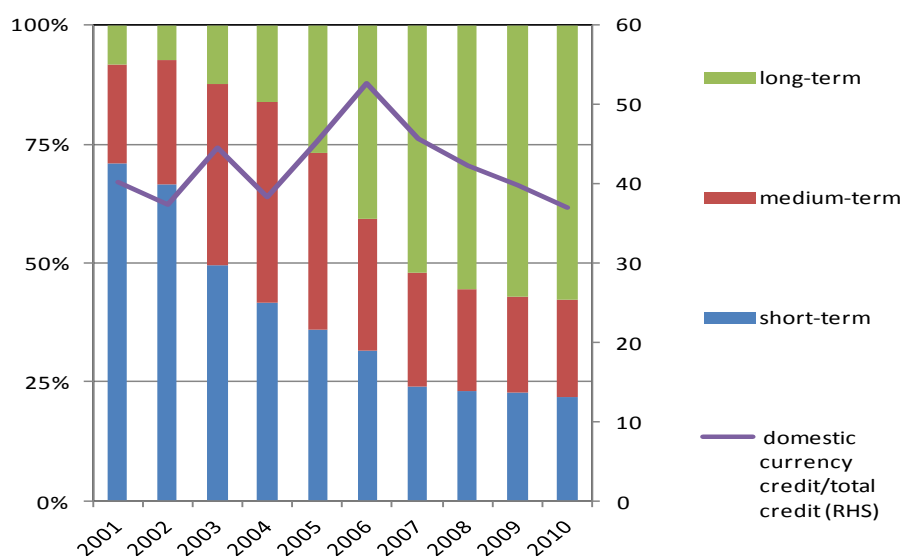
Figure 1 Trends in financial intermediation, Romania



Source: compiled from data from National Bank of Romania and IMF (2006).

Given the central bank's tight liquidity policies, banks could not sustain significant maturity mismatches throughout the 1990s. By 2000, over 70% of domestic credit – largely to companies, both state-owned and private – was extended at short-maturities, compared to less than 10% long-term credit. The maturity distribution improved after 2000, with short-term credit falling to less than 25% of overall credit, whereas long-term credit increased to over 50%. On the contrary, the currency distribution remained broadly similar. The 1990s saw a rapid increase in foreign currency credit in response to a volatile macroeconomic environment accompanied by rapid exchange rate depreciation. Both bank assets and liabilities became increasingly dollarized and then 'euroized', a common response to macroeconomic instability in developing countries. Thus the share of foreign currency credit reduced gradually throughout the early 2000s to around 50% of total credit, to then increase to over 60% by 2010, in response to regulatory pressures, interest rate differentials and the slowdown in the demand for credit induced by the crisis.

Figure 2 Maturity and currency composition, loans to non-government

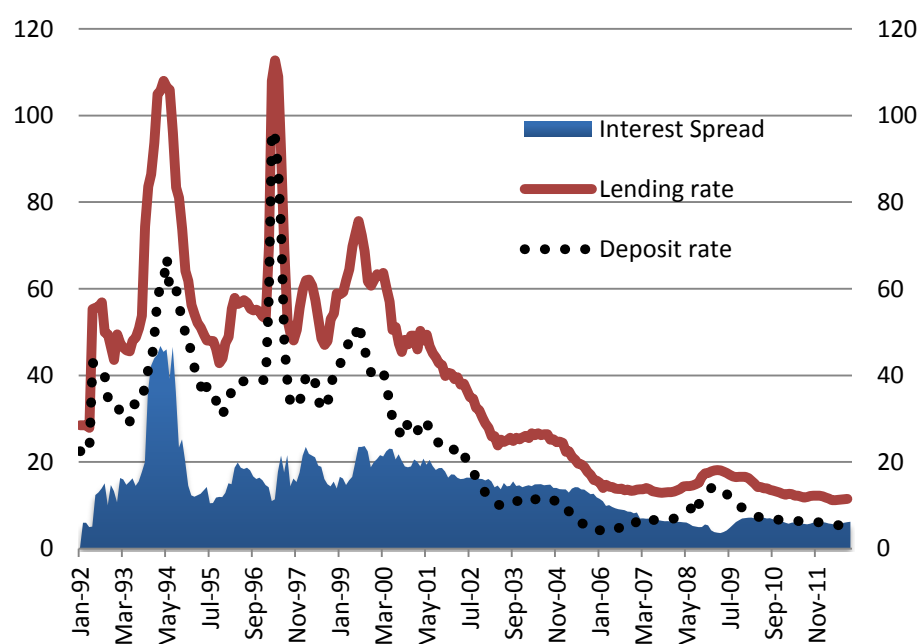


Source: data from National Bank of Romania.

Interest rate spreads remained volatile throughout the 1990s, and decreased rapidly after 2000. Three periods of high nominal interest rates are notable before 2000: late 1993/early 1994, early 1997 and late 1998/early 1999. On these occasions, banks increased both lending and deposit rates substantially, with an asymmetric increase in spreads in 1994, when the lending rates reached levels 40% higher above deposit rates. The first two episodes coincide with the initiation of a new IMF program, and reflect the central bank's efforts to tighten lending conditions (see chapter on Macroeconomic Policies). The third moment relates to the 1998-1999 banking crisis against the background of an internal devaluation program given the country's difficulties to access international financial markets in the aftermath of the Russian crisis. The increase in deposit rates suggests that banks sought to replace central bank lending, available at very high interest rates, with customer deposits. Banks preferred to perform limited maturity transformation, lending mostly on short-term while households and companies increasingly turned to foreign currency deposits to avoid exchange rate volatility. From 2000, interest spreads narrow, as lending rates and deposits interest rates fall under 10% by early 2008. With the crisis, both

lending rates and deposits rates increased, although the spread narrowed as banks initiated a strong competition on the deposit segment, similar to other European countries.

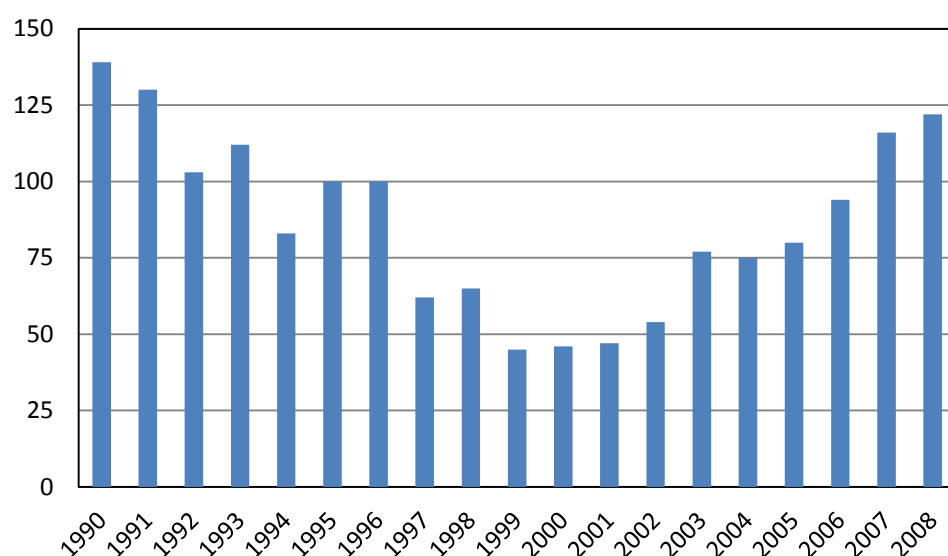
Figure 3 Interest rate dynamics, domestic currency credit, Romania, 1992-2012



Source: data from National Bank of Romania.

Conversely, the loan-to-deposit ratio followed broadly the trend of disintermediation described above (see Figure 4). The banking sector experienced substantial funding gaps (in domestic currency) even though domestic credit contracted rapidly throughout the early years of post-socialism (1990-1993).

Figure 4 Loan-to-deposit ratio, Romania, 1990-2008



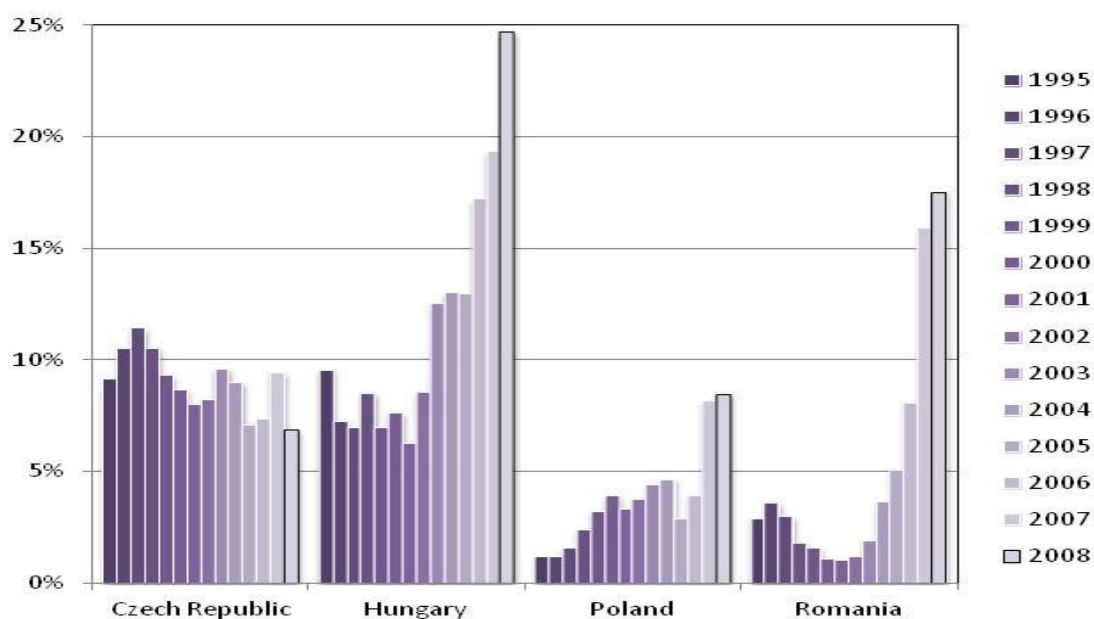
Source: data from National Bank of Romania and IMF (2006).

Note: Loan-to-deposit ratio of domestic credit to resident deposits, including government.

On the liabilities side, the volatile macroeconomic climate had a negative impact on households' and companies' willingness to hold deposits in domestic currency, whose portfolio choices increasingly turned to foreign currency savings. In the absence of a functioning interbank market, commercial banks could only cover funding gaps by borrowing from the central bank, so that the central bank's lending policies (including both the availability of reserves and the interest rates on those reserves) had a crucial impact on lending conditions in the economy. From 1994, funding gaps remained negative (banks lending less than available deposits) until 2005, as lending to households picked up. The fall of the ratio to less than 50% in 1999-2001 indicated the severity of the contraction in bank lending as well as restricted access to credit for non-financial corporations. In that period, banks performed increasingly less credit intermediation, lending out less than half of the resources collected, in response to high share of non-performing loans throughout the 1990s and tight monetary policy.

Since 2000, rapid bank asset growth and a household credit boom were funded through volatile sources including borrowing from parent banks and wholesale cross-border markets, a trend similar to other developing countries (Shin, 2010). Indeed, cross-border lending to Romanian banks accelerated after 2002 to reach almost 18% of GDP by 2008, outpacing similar growth in Poland (see Figure 5). Particularly high rates of growth were registered between 2006 and 2008, as the central bank suspended the macroprudential measures that had imposed tight conditions on lending to households, allowing instead banks to rely on internal risk assessments. The lax regulatory regime saw a rapid asset expansion funded through internal capital markets. When the distinct possibility of intra-group contagion threatened Hungary and Romania in early 2009, both countries resorted to ad-hoc negotiations with parent banks in order to secure their commitments to roll-over short-term credit lines to subsidiaries, and to the IMF's crisis support.

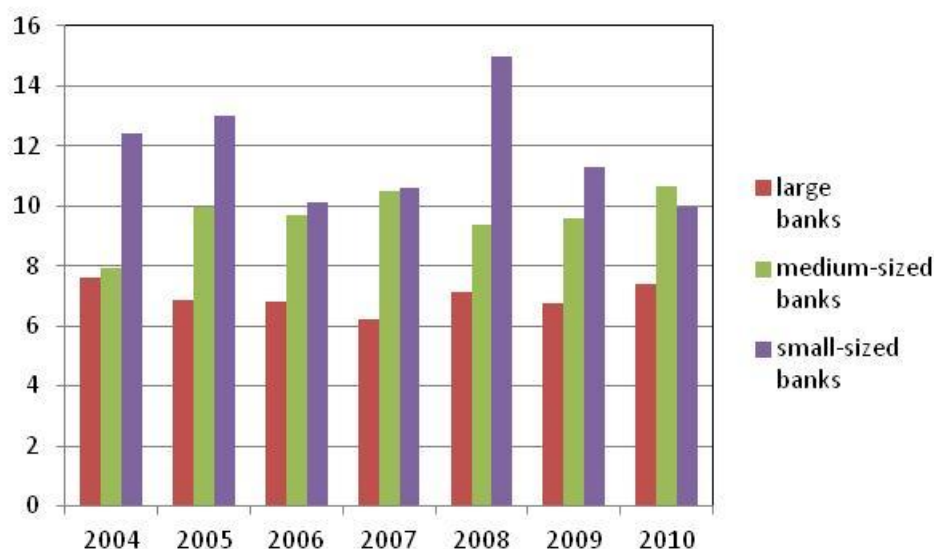
Figure 5 Cross-border bank lending, share of GDP, new member states, 1995-2008.



Source: BIS data.

Leverage ratios registered different trends across distinctive types of banks. Similar to other countries in the European Union, small banks have higher leverage ratios than medium sized or large banks (see Figure 6). The leverage ratio for large banks decreased up to 2008 from around 8% to around 6%. It recovered afterwards, whereas small-banks have returned to values registered during 2006 and 2007, of around 10%. In turn, medium-sized banks have seen their leverage ratios on an upward trend since 2004, only interrupted in 2008.

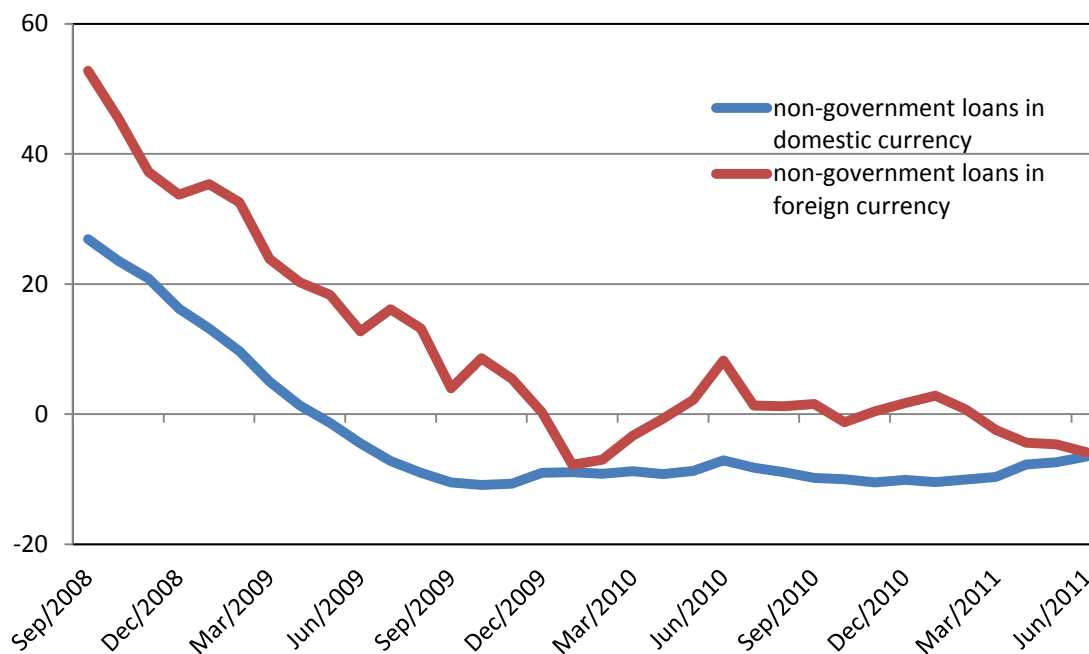
Figure 6 Leverage ratios, by bank size.



Source: data from the Romanian National Bank

The increase in leverage is typically associated with a rapid expansion of banks' assets. Conversely, a financial crisis will pressure banks to deleverage. Indeed, the Romanian banking sector experienced these trends immediately after the collapse of Lehman Brothers (see Figure 7), as foreign-owned banks responded to changing funding conditions in international financial markets. Credit to household and non-financial companies, growing at a real rate of 50% year on year for foreign currency credit and around 30% for domestic currency credit in September 2008, slowed down considerably after September 2008. It first reached negative territory for domestic currency loans in April 2009, and then for forex loans in January 2010. Afterwards, forex credit experienced a subdued recovery, supported by the central bank's decision to reduce rapidly the reserve requirements on long-term foreign currency liabilities.

Figure 7 Credit to households and companies, year-on-year growth (percentage points), 2008-2011



Source: data from the Romanian National Bank

In sum, Romania's evolution since the early 2000s can be described as a classic route to a financial crisis. Transnational banks contributed to increased financial fragility, compounded by an ill-devised financial liberalization set to the pace of European membership ambitions. Large capital inflows, mostly intermediated by the foreign owned banking sector, supported a credit boom with increasingly poorer quality of loans extended by both banks and non-bank financial institutions. The central bank tacitly endorsed such dynamics because of credibility gains. Exchange rate appreciation reduced inflationary pressures, validating the central bank's decision to adopt inflation targeting in 2005. As is often the case for developing countries, the apparent gains in domestic stability came at the expense of growing external imbalances. The banking sector became vulnerable to cross-border funding tensions and to the distinct possibility that parent banks would refuse to rollover short-term credit lines. The post-Lehman deleveraging translated into a hard

lending for the Romanian economy, with credit contracting rapidly as the central bank kept interest rates at the highest levels in the EU in order to contain the capital flight.

4. Macroeconomic policies and financialization

The questions about the role that macroeconomic policy regimes play in shaping financialization are particularly pertinent given the challenges of introducing capitalist relations in a formerly planned economy. Post-socialist reformers had to address a crucial question: what type of capitalist political economy should Romania aim for? The decisions about the objectives and instruments of macroeconomic governance depended on the answer to that question.

At first glance, the answer was straightforward. Romania, more than other planned economy, functioned as an extreme version of the coordinated model described by the varieties of capitalism literature (see Hall and Soskice, 2001). With virtually no private economic activity, planners, state-owned companies and the financial sector had developed entrenched institutional complementarities. State-owned firms relied on strategic modes of coordination to plan and finance production, similar to how capitalist firms relied on long-term relationships with banks and other institutions in distinctive spheres in the political economy.

Post-socialist Romania was confronted with pervasive market imperfections and absent markets. It lacked an interbank money market, currency markets, public and private debt markets. Yet if reforms wanted to go down the coordinated economy route, they faced the challenge of developing institutional mechanisms for credible commitment, effective information-sharing and discipline (Hall and Gingerich, 2009) of the type that coordinated capitalist economies have to rely on precisely because of market imperfections. The institutions of macroeconomic governance, including the central bank, the IMF and successive governments, had often conflicting views about the necessary mechanisms, or

indeed the possibility that such mechanisms could be set in place and what their role should be in the process.

This section discusses how monetary and exchange rate regimes, fiscal policy and sovereign debt management revealed conflicting views about the path of economic reform throughout the early years of 'transition', to then move to an increasingly normalized regime of financialized accumulation.

4.1 Monetary policy and exchange rate policy

The Romanian central bank relied on three monetary policy regimes between 1990 and 2012, closely aligned with the formal exchange rate regimes (see Table 4). Since 1990, the objective of monetary policy has been price stability, rather than employment or growth. Between 1990 and 1996, the central bank set money supply targets, often decided through the IMF's financial programming approach. The IMF also insisted on, and obtained, formal commitment to a flexible exchange rate, although in practice the central bank took a more active role in currency management, reflecting a 'fear of floating' pervasive in developing countries with significant pass-through from exchange rates into prices (Calvo and Reinhart, 2000). In 1997, the central bank adopted reserve money targeting, recognizing the instability of the demand for money (BNR, 1998). More importantly, with the IMF's blessing, it switched to a managed exchange rate, viewing real exchange rate appreciation as the critical instrument for achieving price stability (IMF, 1997; Gabor, 2010a). Later, the IMF recognized that its early insistence on exchange rate flexibility had been inconsistent with a large pass-through from exchange rates into prices, and that price stability could not be achieved without exchange rate manipulation (IMF, 2000). In 2005, the central bank adopted an inflation targeting framework and renounced direct interventions in currency markets. IT explained this move as a response to the rapid capital account liberalization that required new policy tools and frameworks to address future speculative pressures (BNR, 2006). When confronted with rapid capital outflows after the collapse of Lehman Brothers, the central bank (informally) renewed its active exchange rate management strategy,

fearing that a rapid depreciation in the context of “Euroized” balance sheets in the banking sector would trigger a banking crisis.

Table 4 Macroeconomic policy regimes, Romania, 1990-2012

Monetary policy regimes	Formal regime	Instruments	Liquidity conditions
1990-1997	<i>Monetary targeting</i> (broad money targets)	Credit ceilings Standing facilities (discount window)	* Liquidity shortages (1990-1993). contractionary broad money targets established under IMF agreements. * Preferential credit at ex-ante positive real interest rates (1995-1996)
1997-2005 Partly liberalized capital account	<i>Reserve money targeting</i>	Sterilizations of currency market interventions	* Asymmetric distribution of liquidity (1998-9 banking crisis) * Structural excess of liquidity on interbank market.
2006-2012 Fully liberalized capital account	<i>Inflation targeting</i>	*Sterilizations (2005-08) *Repos (2009-12) *Sterilizations (2011-12)	* Structural excess of liquidity on interbank market (2005-2008) *Tight money market liquidity (2009-2011)
Exchange rate regime	Formal regime	Instruments	Liquidity conditions on currency markets
1990-1997	<i>Exchange rate flexibility</i> (IMF conditionality)	*Devaluations *Direct market interventions - high pass through to prices (inflation)	<i>Demand pressures</i> : structural current account deficit, little access to international financial markets. BoP crisis: 1991, 1992, 1994, 1995, 1997
1997-2005 Partly liberalized capital account	<i>Nominal anchor</i> (real appreciation to ensure disinflation)	*Sterilizations as carry-trade vehicle; *Transnational banks intermediate capital inflows	Substantial capital inflows during 1997 and after the early 1999 banking crisis. Speculative pressures in the aftermath of the 1998 Russian crisis
2006-2012 Fully liberalized capital account	<i>Exchange rate flexibility</i>	*Sterilizations (2005-2008) *Direct market interventions (2009-2012)	*Entry of non-resident players (carry-trades) *Speculative attack Oct. 2008 + unwinding carry-trades

Note: BoP = balance of payment

4.1.1 Central bank-led financialization: 1990-1997 (the silent war)

The fall of the socialist regime had immediate consequences for the organization of the financial sector. A two-tier system was quickly established to separate the central bank from other banking institutions. The Commission for Reform, set up in early 1990 to design a post-socialist economic future for Romania, viewed the role of the financial sector through a coordinated capitalist economy lens and focused on strengthening relational banking. Yet once Romania turned to the IMF, macroeconomic stabilization plans drew on a pessimistic view of the relationship between banks and (state-owned) industrial firms, and in doing so, generated pervasive liquidity shortages and credit crunches, a typical outcome of IMF stabilization plans (Gabor, 2012a).

Indeed, the first economic strategy envisaged an activist industrial policy to reform the state-owned industrial sector, heavily affected by Ceausescu's external debt repayment push, in parallel with the development of a dynamic private sector. Activist industrial policies would rely on existing institutional complementarities between state-owned banks and state-owned industrial conglomerates, including the provision of long-term finance by the banking sector, complemented with subsidies and incentives for export performance (Government Commission, 1990). It conceptualized monetary policy through endogenous money theories, arguing that the central bank should support commercial banks in their task of financing the technological upgrading of the industrial sector. The report also detailed plans to encourage the entry of private commercial banks that would bring much needed technology and capital. The Government Commission acknowledged that it had to design its industrial strategy carefully in order to ensure that state-owned companies became profit maximizers and that financial discipline prevailed (Gabor, 2010a).

This approach changed with the entry of the IMF in 1991. Romania's foreign currency reserves were contracting rapidly by end of 1990, due to an avalanche of negative

developments. Among these, the most important were the hesitant implementation of the industrial reform plans, the disintegration of the former export networks rooted in international socialist relations; large imports of consumer goods and the Middle East crisis (the largest source of energy imports). Romanian policy makers had little choice but to heed the IMF's advice.

The IMF paid little consideration to the original industrialist vision of the Romanian government. Instead, it advocated the rapid establishment of arms-length relations and competitive markets typical of liberal economies (Demekas and Khan, 1991; Williamson, 1991). IMF held a pessimistic view of the state-owned industrial sector, and of the possibility that state-owned banks could impose discipline through relational banking. Instead, the IMF advocated a radical and rapid shift to a system governed by relative prices and market signals as the only viable approach to disciplining an obsolete, monopolistic and energy intensive industrial sector.

The first Stand-By agreement with the IMF, signed in April 1991, proposed a package of radical reforms opposite to the 'gradualism' of the original industrial strategy approach. It established liberalization of most prices in the economy, particularly of key intermediate and final products that the initial strategy sought to maintain under administrative control⁹ in order to support industrial production. Indeed, price liberalization proceeded rapidly, transforming a system of complex price controls established through the central plan into one that retained controls on 14 categories of consumer goods while controls on strategic intermediate imports were quietly abandoned. The IMF described the price reform as follows: 'in only eight months Romania went from a system of complete price controls to one that compares favourably with many market economies' (Demekas and Khan, 1991: 21).

⁹ Products of the mining, fuel and energy sectors; metallurgy; the chemical industry; forestry; basic branches of the machine building industry; the main products of the food industry; transportation, postal and telecommunication services.

For the IMF, the communist legacy contained the seeds of an extended period of high inflation. First, like other formerly planned economies, chronic shortages and rationing lead to accumulation of forced savings (a monetary overhang) that would increase inflationary pressures (Wolf, 1991). Second, and more important, the strategic interactions between state-owned companies and the state-owned banks meant that soft-budget constraints –firm behaviour that is not profit-maximising (see Kornai, 1991) – would be reproduced as state-owned banks would continue to extend soft-credits (Lane, 1991; Fischer and Gelb, 1991). Monetary and fiscal restraint had to accompany price liberalization and ensure that state-owned companies became profit-maximizers (Wolf, 1990; IMF et al, 1991; Bruno, 1992). In other words, the IMF held, a tight credit policy would not affect output, but merely redistribute excess money (the monetary overhang) while disciplining state-owned banks into disciplining state-owned companies.

Competing ideas about money and its role in capitalist production were at the core of the competing views of reform held by the IMF and the Government Commission. For the former, money was neutral, could only affect prices but without changing real economic activity. The Commission in turn operated with a PostKeynesian understanding of money as a social phenomenon, crucial for economic activity in both the short and the long-run, with money supply dynamics endogenously reflecting prices set through mark-up (Dow, 2004). IMF economists put it as follows:

‘There were few monetarists in transitional economies, at least in the beginning [...] The idea that prices were related to money was often not intuitive. Rather, the price formation process was viewed as a complex process that involved many technical elements and many factors outside the authorities’ control, especially external factors. In fact, tight monetary policy was precisely designed to make the traditional cost-plus-mark up pricing policy impossible. This meant that the same situation IMF economists would see as inflationary would often be viewed as too tight a monetary policy setting by the local authorities. (Allen and de Haas, 2001, quoted in Gabor, 2010a, p.34).

Thus, macroeconomic policies focused on changing the relationship between (state-owned) production and finance, marking a period of central bank-led financialization. Monetary policy, underpinned by the IMF's conditionality, sought to eliminate the strategic interactions between state banks and state-owned companies. The central bank feared that relational banking would interfere with its price stability objective (Gabor, 2010a) as banks had limited capacity to mitigate the moral hazard and informational asymmetries prevailing in bank-based capitalist financial intermediation (Boot, 2000), whereas state-owned companies lacked the effective mechanisms for discipline and credible commitment characteristic to coordinated economies with similar relational banking (Hall and Gingerich, 2004).

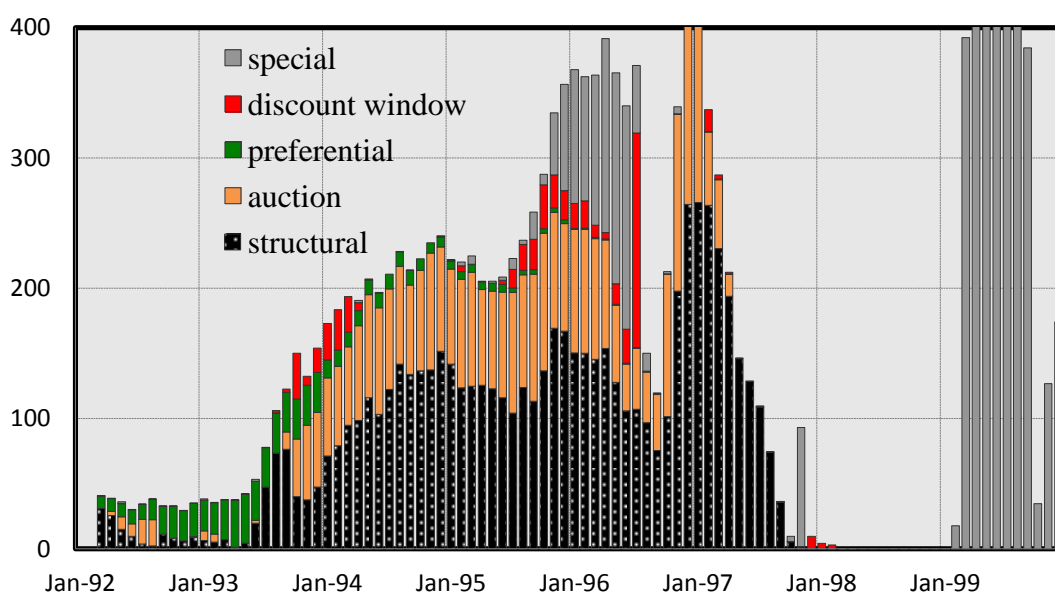
The central bank position was supported by widespread agreement in the literature that state-owned companies would not abandon the socialist practice of soft-budget constraints (Kornai, 1986; IMF, 1991; Wolf, 1991), refusing to follow price signals in order to organize production and determine competitiveness (see also the chapter on industrial restructuring in this study). In order to ensure that state-owned banks would contribute to tightening the budget constraints, the IMF agreements signed in 1991, 1992 and 1994 established contractionary targets for central bank lending and credit growth (see Gabor, 2010a for a detailed account).

Successive governments initially committed to respect such targets and then abandoned their commitments when confronted with an extensive contraction of the economy, higher unemployment and the rapid deterioration in standards of living (Pop, 2006). On such occasions or in the run-up to elections, as for example in 1993 and 1996, governments would instruct the central bank to extend preferential credit to state-owned banks that would in turn target strategic sectors (agriculture for example in 1996). The National Bank of Romania implemented industrial policies reluctantly, and sought to mitigate possible inflationary consequences by restricting other types of lending or by

imposing high interest rates on its liquidity support. Its policies created repeated episodes of acute liquidity shortages.

Data on central bank lending to commercial banks indicates to the extent of liquidity shortages throughout this period. Thus policy documents describe the 1991-1993 years as a period of rampant inflation and excess liquidity driven by preferential central bank lending, followed by a period of improved monetary control and disinflation throughout the 1994 and early 1995 (see BNR, 1993; 1995 and Gabor, 2010a). Populist politics throughout 1996 brought a new phase of easy central bank liquidity, followed by tighter policies after the 1997 agreement. However, Figure 8 suggests the opposite.

Figure 8 Central bank lending to commercial banks, ROL million, 1992-2000



Source: data from the Romanian National Bank.

Central bank lending remained relatively stable until August 1993, albeit with a change in composition to preferential credit. In other words, the central bank did follow governments' instruction to lend on preferential terms, but it did so by reducing other types of lending, so that overall liquidity injected in the economy did not change throughout a period of rampant

inflation and funding gaps above 120%. That the central bank refused to accommodate banks' demand for reserves in a highly inflationary environment, caused by exchange rate volatility rather than excess money, indicates the extent of liquidity shortages confronting banks in that period. It also explains why banks refused to allow state-owned companies access to their deposits and the repeated payment blockages in the economy throughout this period (Gabor, 2010).

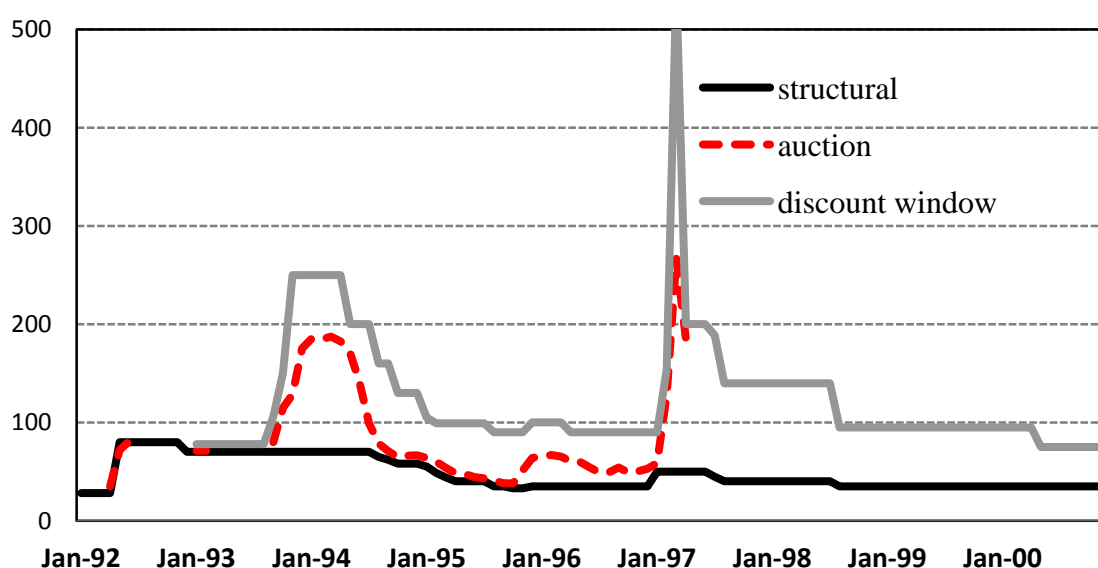
Indeed, liquidity shortages occurred often in IMF programs in crisis countries, resulting from the institution's overly contractionary monetary targets or underestimates of inflation (Schadler, 2005, Calvo and Corriceli, 1992 or Bofinger, 1996). In sum, the central bank's liquidity policies rendered a crucial bank activity, maturity transformation, difficult to perform since banks had funding gaps while the interbank was yet to be established. Domestic credit contracted by a staggering 60% within three years, from around 75% of GDP in 1990 to 25% of GDP in 1993.

The central bank stepped up liquidity injections after June 1993, easing liquidity shortages. Total refinancing doubled in volume between July 1993 and April 1994, while inflation was falling and funding gaps reduced rapidly as lending contracted. Refinancing credit was offered through two facilities, the structural credit lines and the auction facilities, as governments complied with IMF requests and wound down the preferential credit lines. When the government, attempting to shore up political support in an electoral year (1996), instructed the BNR to provide concessional credit to agriculture and the energy sector (Pop, 2006), overall lending did not increase much in volume, as the central bank reduced access to other liquidity facilities while simultaneously raising the rate on its auction facility. Indeed, most of the growth in central bank lending in early 1996 was driven by the special credit lines, extended to two failing *private* banks, Dacia Felix and Credit Bank, to contain systemic risk since Romania had no deposit guarantee scheme at the time while the two banks held together around 14% of household deposits. Refinancing fell rapidly after 1997, as the central bank shifted its policy strategy to exchange rate management, injecting liquidity through interventions on the currency market. By 1999,

central bank lending narrowed to special credit extended to banks in the process of bankruptcy.

While the central bank became more willing to accommodate banks' demand for reserves after 1993, it did so at increasingly high interest rates (see Figure 9). Indeed, the IMF demanded positive real interest rates in the 1993 agreement (Gabor, 2010a). The central bank had previously failed to deliver positive real interest rates not because it sought to stimulate the economy, but simply because it failed to predict, as did the IMF, the rapid increase in prices. *Ex post* real interest rates remained negative. After 1993, the central bank responded to this problem by imposing high interest rates on most of its credit lines – for example interest rates on auction refinancing, at that time the second largest type of central bank credit in late 1993, was raised to almost 200%. Similarly, interest rates on discount window remained at high levels throughout the period, seeking to discourage banks from accessing central bank liquidity. The 1997 IMF program produced a new liquidity squeeze, with interest rates on most lending facilities increasing rapidly.

Figure 9 Interest rates on central bank lending facilities, Romania, 1992-2001



Source: data from the Romanian National Bank

In sum, prior to 1997, the central bank fought inflation with the wrong (monetarist) instruments. Periods of acute liquidity shortages were accompanied by rampant inflation (1991-1993), whereas periods with an accommodative liquidity stance saw rapid disinflation (1994-1995).

The explanation, both the central bank and the IMF (2001) later recognized, rested on the fundamental role that exchange rates played for price stability. Prior to 1997, the IMF agreements established that freely floating exchange rates were imperative to correct the substantial misalignment inherited from socialism (Demekas and Khan, 1991; BNR, 1992a). Initially, Romania operated with parallel exchange rates (to the dollar) until November 1991. The official rate was deployed for imports of raw materials and energy (financed through a requirement for export companies to surrender 50% of export revenues). Following conditions in the first IMF agreement, the interbank currency market began operations in February 1991, with small volumes that rendered the parallel rate, set 'freely' (although hardly under competitive conditions) quite volatile. Supply shortages on the interbank market meant that the market exchange rate devalued faster than the official one, and functioned as a benchmark for policy makers to set the pace of devaluation for the official rate.

Whereas the central bank typically agreed with the IMF's interpretation of liquidity conditions in the economy, it faced far more difficulties in implementing its requests for flexible exchange rates. Policy documents highlight that the central bank was well aware of the exchange rate pass-through and that several interventions had been successful in arresting the speed of devaluation and thus price inflation. But such success had to be weighed against political economy considerations that led the central bank to support exchange rate flexibility.

First, foreign reserves are necessary to establish a credible managed exchange rate, or the support from the IMF to replicate Poland's Zloty Stabilisation Fund of the early 1990s (Sachs, 1996). The Romanian central bank had none of the two. Furthermore, the central bank identified an *ideological* constraint to a managed exchange rate, arising from its view

of the state-owned industrial sector (BNR, 1993). A strategy to over-value the currency would provide protectionism to state-owned enterprises, an implicit subsidy for imports of raw materials and intermediary imports that would delay industrial reform. Inflation could not be tackled through exchange rate policies because the *real* cause of inflation was the gradualism delaying micro-restructuring. However, this position posed real dilemmas for the central bank, since exchange rate volatility generated price volatility and damaged its credibility as an institution of macroeconomic management. By 1995, it had recognized that much and asked the IMF to allow the exchange rate as nominal anchor (IMF, 1995). The IMF refused, citing low foreign reserves and low central bank credibility.

Central bank-led financialization: the silent war between state banking and state companies

Central bank-led financialization, manifested in attempts to tighten monetary policy while tolerating high exchange rate volatility (and thus price volatility) in order to change relational banking, confronted commercial banks, both state-owned and private, with unprecedented challenges.

In order to continue to perform traditional activities of maturity transformation and credit intermediation, commercial banks require central bank support during moments of profound crisis, be it triggered by the collapse of the planned system or by capitalist crises. Central bank support was crucial given that Romania did not have a functioning interbank money market until 1994. However, the central bank of Romania, under IMF pressure and defending its organizational interests, often refused to perform lender of last resort activities, or when it did, it charged high interest rates, blurring the already difficult distinction between liquidity and solvency problems in a crisis.

Pressured by the macroeconomic policy stance into the task of 'disciplining' state-owned companies, (state-owned) commercial banks rapidly shifted towards impatient practices. When confronted with liquidity shortages throughout the early 1990s, state-owned banks often refused to release the deposits of state-owned companies, delaying

their payments to suppliers by weeks and even months. For instance throughout 1993, during the second IMF program, the central bank recognized that banks were deliberately delaying payment settlements (BNR, 1993). The central bank responded by introducing new financial instruments – fixed value cheques – to allow large state-owned companies to settle payments and prevent the build up of inter-company arrears. The manager of a large state-owned company put it as follows:

'[We are] a state-owned enterprise that succeeded in both increasing production and mobilizing demand. Whatever we have achieved through restructuring production, banks are destroying, through extremely high interest rates and a very slow payment mechanism. We have ROL 200 mil with CEC¹⁰, which requires thirty days for access [...]. While the essence of restructuring, money, is at banks' discretion, there is a silent war going on' (in Gabor, 2010a: 46).

The quote testifies to the success that central bank-led financialization had in undermining relational banking. In turn, state-owned companies responded to payment blockages by resorting to inter-enterprise arrears, taking advantage of the existing relationships in supply chains and political connections. Although the scholarship attributes these arrears to soft-budget behaviour (Radulescu, 1999; IMF, 2001), the increasingly difficult relationship with the banking sector played an important, if rarely acknowledged role.

Thus Gabor (2010a) argues that state-owned companies could hardly have been expected to become immediately viable in such difficult circumstances: the loss of export markets, high and volatile import prices given rapid exchange rate depreciation combined in some cases with administrative controls over the prices they could charge on final goods, and finally, limited access to bank financing and at prohibitive costs. The imports of consumer goods in order to overcome supply bottlenecks, part of the IMF advice in Eastern Europe (Amsden *et*

¹⁰ The largest savings bank at that time.

al, 1994), left industrial producers competing for scarce foreign resources with retail importers.

A different approach to reforming the relationship between state-owned banks and state-owned industry would have been entirely possible. Amsden et al. (1994) for example drew attention to the East Asian solution to create a state development bank and thus mediate the profound uncertainties of the post-plan period. Instead, policy narratives interpreted state ownership in the banking sector combined with extensive information asymmetries as evidence that banks could not implement a market-driven process of credit allocation, nor that they should be allowed to continue their strategic interactions with state-owned companies. Tight monetary policy would restrict relational banking with state-owned industries (McKinnon, 1991).

The central bank, through its tight liquidity policies and tolerance of exchange rate volatility, became fundamental to the financialization of banking activity. When not instructed to extend preferential credit for which they received access to central bank liquidity, commercial banks behaved increasingly impatient in response to the highly uncertain macroeconomic climate and the central bank's non-accommodative stance. The share of short-term credit in total lending to (state-owned) companies rose to above 80% by the end of 1991, where it remained for the rest of the period. From a financialization standpoint, the central bank was highly successful in undermining relational banking prevailing in coordinated capitalist economies: state-owned enterprises could only access credit at very short maturities and high interest rates. The difficulty, of course, remained that the financing opportunities characteristic to liberal economies – stock markets or private debt markets – were not available either.

4.1.2 Towards dependent financialization: reserve money targeting and managed exchange rates (1997-2005)

The election of a government with ostensive neoliberal preferences brought radical changes in the conduct of macroeconomic policies after 1997. The central bank shifted to reserve money targeting, but more importantly, the new IMF program sanctioned the use of exchange rate as a nominal anchor to deliver price stability (IMF, 1997). Monetary policy became tightly intertwined with capital account management strategies even if Romania had, at the time, very limited capital account liberalization. In effect, the central bank relied on commercial banks, increasingly foreign owned, to intermediate capital inflows, generate exchange rate appreciation and disinflation.

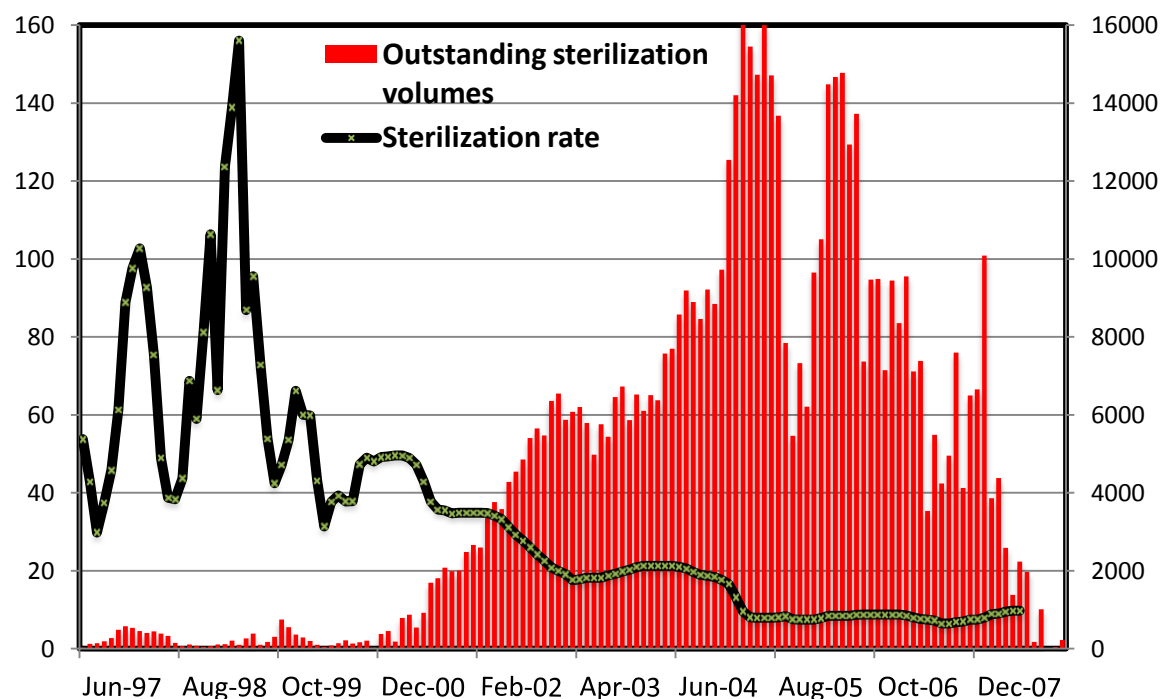
After 1997, the importance of state action in supporting new modes of profit generation, and increased interconnectedness, becomes apparent through the sterilization strategies of the Romanian central bank. In response to the large capital inflows, the central bank took buying positions on the currency market, creating new liquidity to purchase foreign reserves. To sterilize this liquidity, in line with its reserve-targeting framework, the central bank could take a passive or active approach. In the passive approach, it simply accepts that banks deposit excess reserves at its deposit facility, usually remunerated at interest rates below the interbank market rate. A more active approach, involves sales of government bonds (open market operations), own debt issuance if the portfolio of government debt is smaller than sterilization volumes, currency swaps or direct borrowing on money markets (Mohanty and Turner, 2005). Usually, commercial banks act as counterparty in sterilization operations, although the central bank may allow non-residents access to its sterilization operations, as it does for example in Hungary (Balogh, 2009). It is important to stress that sterilization are not only costly for the central bank, but that they become an attractive asset for carry-trade strategies.

Banks with access to international financial markets (or with forex liabilities from supporting international trade) take simultaneous positions on the currency market (selling

foreign currency to the central bank) and on the interbank market, depositing the domestic currency reserves obtained from forex transactions into sterilization operations in what Christensen (2004) and Gabor (2011, 2012a) described as “sterilization games” to describe carry-trade activity. Such sterilization games were pervasive in Romania prior to Lehman.

Initiated in small volumes in 1997, sterilizations become the key monetary policy instrument after 2000. Sterilization volumes grew at a rapid pace (to around 38% of GDP by 2003), to decrease afterwards on the account of deliberate central bank action and increased lending (see Figure 10 and section on bank assets). The short-term character of such operations means that banks take decisions on positions depending on expected nominal, rather than real, return on investments (UNCTAD, 2004). In sum, financialized banks treat sterilization instruments as a new asset class, part of market portfolios.

Figure 10 Sterilization volumes (RON mil, right hand scale) and sterilization interest rates (%), 1997-2008



Source: data from National Bank of Romania.

Before 2008, the Romanian central bank usually sterilized by taking short-term deposits from commercial banks and issued lower volumes of debt certificates because of the relatively small portfolio of sovereign debt available. The sterilization strategy partly reflected the limited financialization of private debt markets. Without liquid instruments to attract capital inflows, the central used short-term sterilizations to create carry-trade vehicles that foreign owned would access by borrowing abroad. Larger capital inflows would appreciate the exchange rate and assist the central bank in its disinflation strategy.

Thus, the sterilization interest rate became increasingly less relevant in a traditional transmission mechanism¹¹. The central bank's monetary policy department admitted that the interbank market had 'an insignificant role' in propagating monetary policy impulses (Antohe et al., 2003: 8), contradicting IMF research that suggested an improved pass-through from the sterilization rate to longer-term interest rates (Tienman, 2004). Rather than a cost of funding, the policy (sterilization) rate influenced yield differentials for carry-trade strategies, moving in line with developments on the currency markets and the sovereign debt market rather than the central bank's forecasts of aggregate demand¹².

Financialization simultaneously permeated bank behaviour (banks treated sterilization instruments as a high-yielding asset), the currency market, where trading became increasingly driven by cross-currency strategies, and the interbank money market, where demand and supply of liquidity reflected currency positions rather than funding gaps.

11 The central bank made active use of reserve requirements in an attempt to strengthen its influence on interbank money market liquidity. By triggering immediate credit and monetary adjustments via the money multiplier, changes in reserve requirements are advocated as a powerful, albeit rudimentary, instrument for controlling high-powered money. Lower required reserves create additional reserves for banks, enabling the banking system to expand loans, which in turn changes the money stock without modifying the monetary base. Required reserves on both domestic and foreign currency liabilities were changed in line with the central bank's monetary policy stance, although without resolving the structural surplus of liquidity.

12 After the extended volatility registered during 1997-99, sterilization rates decreased rapidly as sterilisation volumes increased. However, interest rate cuts did not respond to developments in aggregate demand or the central bank's projections of monetary targets. The central bank recognized that it reduced interest rates in response to lower yield on new issues of government debt (throughout 2002 for instance) 12 and the pace of capital account liberalization that opened up Romanian asset markets to non-resident investors in 2005.

Financialized banking behaviour threatened commercial banks following traditional intermediation approaches because of the asymmetric distribution of liquidity on the interbank money market (see section on the interbank market). Financialized banks with cross-currency trading strategies held excessive reserves from exchanging foreign loans on the currency market, whereas ‘relational’ banks with funding gaps from lending activity had to cover the deficit of reserves on the interbank market.

During times of crisis, banks with excess liquidity would take speculative positions on the currency market rather than lend on the interbank money market, pushing the central bank to tighten liquidity conditions and further increase costs of funding for banks with funding gaps from lending to the real economy. The anatomy of the 1998-1999 banking crisis (see Section 6.5 on the financialization of the interbank market), and the 2008 speculative attack (see Croitoru, 2011) highlights the pressures that such speculative behaviour exerts on non-financialized banks.

4.1.3 Inflation targeting regime (August 2005-)

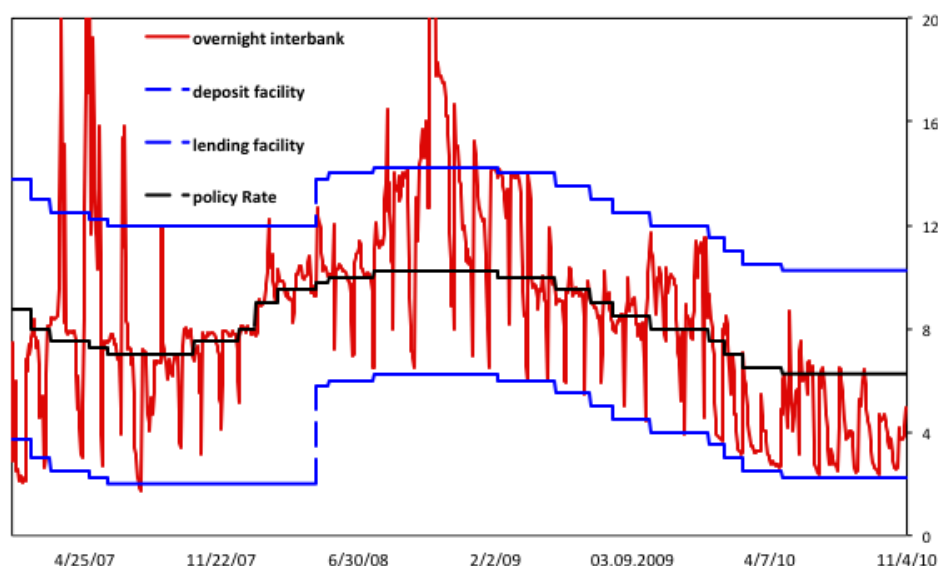
The Romanian central bank timed the switch to inflation targeting to coincide with the full liberalization of the capital account. It recognized that its framework of monetary targeting had little influence on liquidity management decisions, tailored to the exchange rate strategy, and inconsistent with a permanent excess supply of liquidity on the interbank money market.

Furthermore, it argued that full capital account liberalization required a flexible exchange rate regime combined with an active use of interest rate policy. To tackle the increased vulnerability to speculative capital movements once non-residents were allowed to purchase Treasury bills and hold bank deposits (April 2005) the central bank had to move to interest rate manipulation (BNR, 2005). Indeed, the central bank lowered interest rates rapidly before September 2005, explicitly in order to reduce the attractiveness of Romanian assets to non-resident investors.

The central bank argued that the macroeconomic climate supported its regime change. Fiscal dominance no longer threatened disinflation efforts, and most importantly, it had improved its credibility by bringing inflation to single-digit territory. The central bank instituted a CPI-based inflation target (7% for 2005 and 5% for 2006), set together with the government as a midpoint within a target band of ± 1 percentage point and a forward-looking policy rule. It abandoned currency interventions, although it made it clear that occasional interventions remained possible to contain excessive volatility.

The new regime did not change aggregate liquidity conditions immediately. Indeed, overnight money market rates usually fell to the level of the deposit facility at the end of the reserve maintenance period as commercial banks deposited the liquidity they could not place in sterilization operations (see Figure 11). Liquidity conditions changed after Lehman's collapse, as banks became increasingly reluctant to lend to each other, while the central bank refused to stabilize the interbank interest rates because it worried its liquidity injections would allow commercial banks to renew speculative pressures on the currency market, as they tried shortly in October 2008 (see Croitoru, 2011).

Figure 11 Policy and market interest rates, 2007-2011



Source: data from National Bank of Romania and IMF (2006).

The inflation targeting regime met with serious difficulties. The central bank only hit the target in 2006, despite repeated interest rates changes. Policy rates were raised in successive steps after July 2007 until August 2008, seeking to contain the rapidly inflating credit boom, particularly on the household segment, where year-on-year growth averaged around 50% in that period.

The limited effectiveness of interest rate decisions reflected the structural conditions of the dependent type of capitalism. The trade-offs involved in inflation targeting regimes in developing countries are well-known: if the central bank seeks to cool an economy overheated by capital inflows through interest rate increases, it will perversely stimulate greater capital inflows attracted by interest rate differentials, leading to further exchange rate appreciation and looser domestic financial conditions (Shin, 2010). In banking systems dominated by transnational banks, interest rate increases have further perverse effects, prompting banks to switch to foreign currency lending that can be funded cheaply from intra-group loans, as foreign-owned banks in Romania did prior to 2008.

Furthermore, domestic currency interest rates played a limited role in influencing investment or pricing decisions because companies had limited reliance on bank credit. Indeed, central bank statistics suggested that bank loans (both in domestic and foreign currency) remained below 15% of overall debt for companies during the inflation-targeting regime. Instead, transnational banks offered foreign companies the possibility of loan externalization, through which lending was directly extended by the parent bank (see chapter on the financing of the economy). By the time Lehman Brothers collapsed, Romania offered a perfect example of the difficulties that the globalization of financial markets and banking activity poses for the central bank's control of domestic monetary conditions, and of price stability (see Woodford, 2007 for a reflection on the impact of globalization on inflation-targeting type of policies).

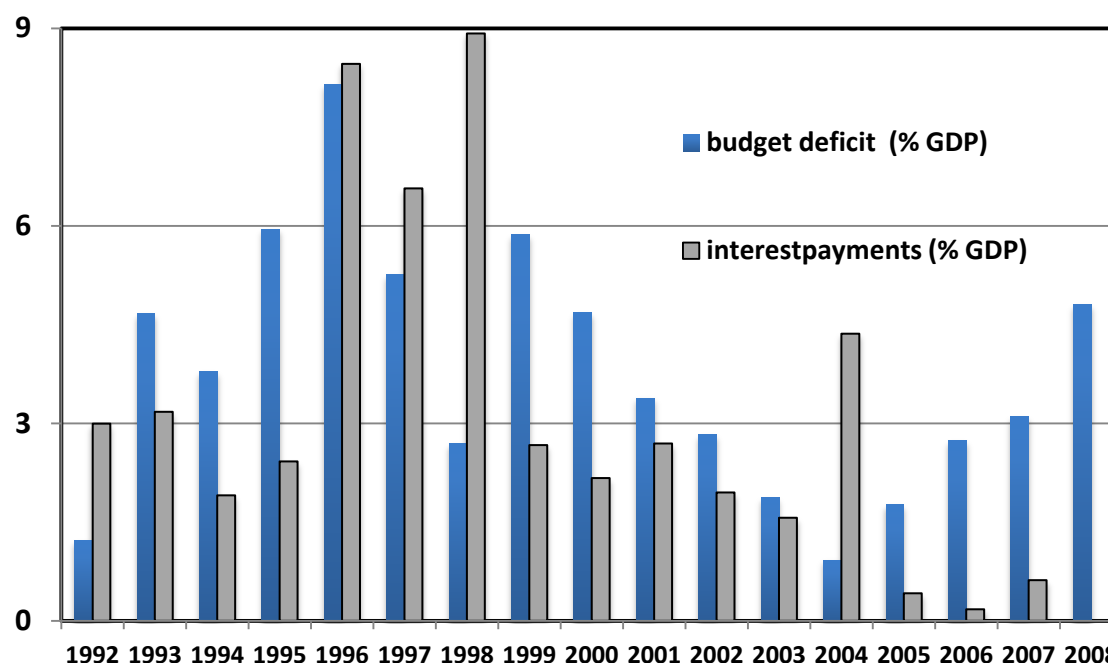
4.2 Fiscal policy and sovereign debt management

4.2.1 The common wisdom

Scholarly and policy research agree that the various Romanian governments in place before 1997 failed to conduct an appropriate fiscal policy (see IMF, 1997; BNR, 1999). Despite commitments to fiscal rectitude inscribed in the IMF agreements, budget deficits rose as a share of GDP, from around 1% in 1992, to above 7% in 1996, an electoral year when the party in government sought to retain power by populist spending that worsened the budget deficit (see Figure 12).

Furthermore, governments also deployed additional channels for fiscal activism, effectively forcing quasi-fiscal objectives onto both monetary and exchange rate policy. The central bank was instructed to provide subsidized credit to state-owned companies (Radulescu, 2003). Rapid inflation further eroded the real value of government debt. Governments pressured the central bank to intervene in currency markets in order to protect the same state-owned companies from the rigours of international competition (IMF, 1997). Daianu et al (2001) calculated that quasi-fiscal deficits reached as high as 11% of GDP before 1997.

Figure 12 Budget deficits and interest rate payments on public debt, 1992-2008, Romania



Source: data from Romanian Ministry of Finance reports; no data for 2008 interest payments on public debt.

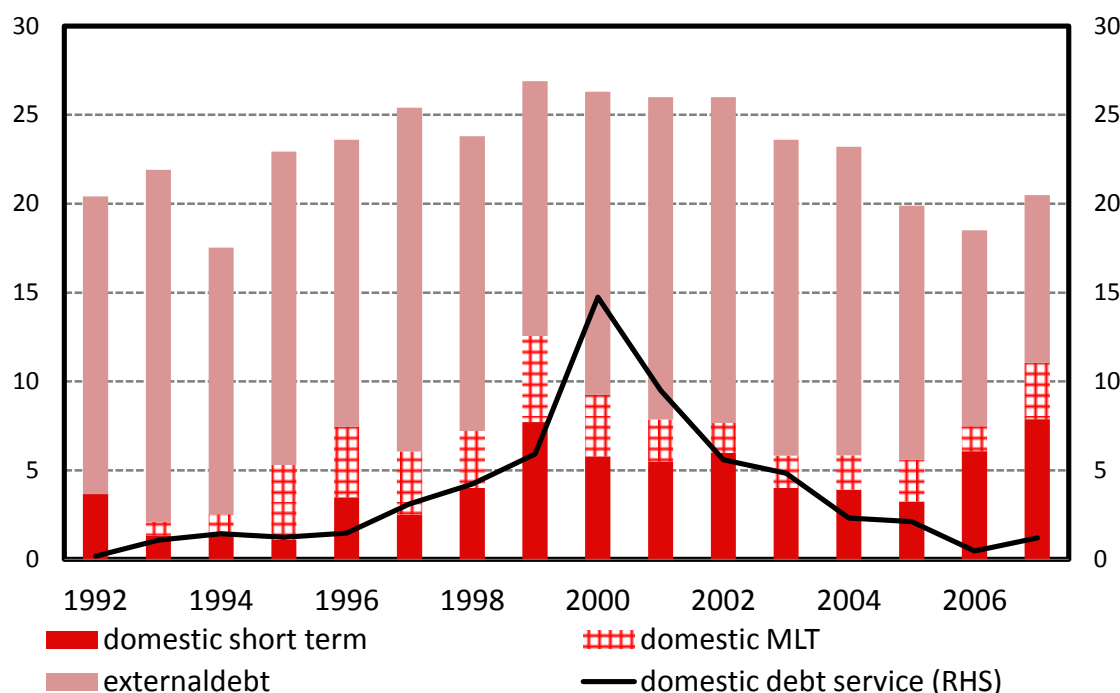
After 1997, the mainstream account holds, governments took a more conservative fiscal stance. Fiscal domination of monetary and exchange rate policy disappeared, and governments shifted to market financing of their debt. The government assumed the costs of the 1999 banking crisis - translated into a deficit of 5.9% of GDP - and after 2000, proved the benefits of market discipline, with budget deficits under 3% for most of the period. Fiscal policy remained countercyclical until 2007. In 2006, the IMF stressed that the Romanian fiscal position was fundamentally sustainable but recommended that the government should use fiscal policy as an instrument for managing the capital account, alongside tight income policies, in order to contain the expansionary effects of large capital inflows:

“In the authorities’ strategy to preserve macroeconomic stability, fiscal policy will continue to play a central role. In view of Romania’s low public debt, fiscal sustainability is not a concern. However, prudent fiscal policy and a tight incomes policy are needed to address excess demand pressure stemming from continued large capital inflows.” (IMF, 2006:69)

For this reason, the IMF, with support from the Romanian central bank, strongly opposed decisions to increase public sector wages (IMF, 2007:34). Indeed, by 2007, two of the three Maastricht criteria that Romania fulfilled referred to government finances (budget deficits and public debt).

Public debt, domestic and external, remained at relatively low levels since the early 1990s (see Figure 13). Thus public debt to GDP ratios fluctuated around 20% throughout the period, falling as a share of GDP from 26% in 1999 to around 20% in 2007, well below average at similar levels of development. Indeed, between 1994 and 2004, average public debt to GDP ratios for developing countries fell from 75% of GDP to 64% of GDP, with the similar figure for Eastern Europe and Central Asia countries falling from 46% of GDP to 36% of GDP (see Panizza, 2008). Similar to other developing countries, the Romanian governments met their financing needs mostly through foreign borrowing. The share of external debt in total public debt ranged from 70% to 80% up to 2005, with the exception of 1999, when Romania was effectively locked out of international financial markets for most of the year.

Figure 13 Public debt dynamics, Romania, 1992-2007, as share of GDP.



Source: data from Romanian Ministry of Finance reports

Furthermore, before 1996, foreign funding came largely from official sources. According to Ministry of Finance (2004) data, multilateral loans - from the IMF and the European Commission - amounted to over 80% of total foreign debt between 1990 and 1996, highlighting the leverage that the IMF had on the Romanian policy arena. Furthermore, the composition of external debt points to an important distinction in sovereign debt management between levels and availability of financing. Indeed, although Romania had relatively low levels of external public debt, it faced extraordinary difficulties in funding it without IMF support. It first accessed syndicated loans in 1995, and first issued debt in international markets in 1996 (Daianu et al, 2001). The peak in foreign debt service in 1999, in the context of tight international funding markets, was widely expected to trigger a default, nearly avoided through an internal contraction (Gabor, 2010a). After 2000, the relative importance of multilateral lending declines markedly to less than 50% of total

external debt. Simultaneously, Romanian governments turn increasingly to domestic financial markets, with domestic public debt increasing to over 11% of GDP by 2007, nearly half of total public debt.

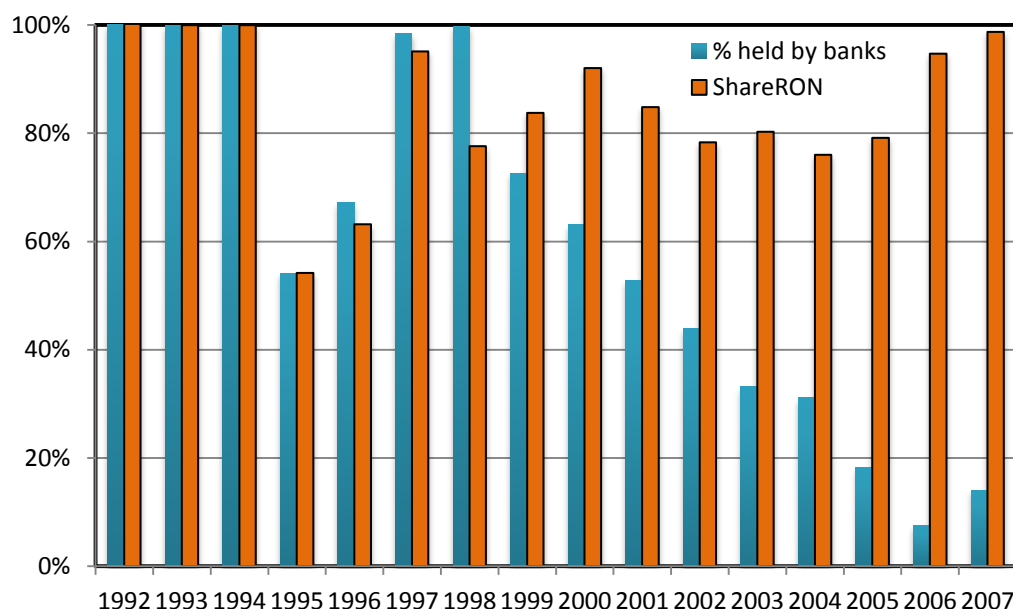
Nevertheless, the dynamics in domestic borrowing point to a different interpretation of the Romanian fiscal trajectory since 1990, one that highlights the actors and strategies of financing government deficits.

4.2.2 An alternative account: resisting the financialization of sovereign bond markets

First, it is important to note that interest payments on public debt contributed substantially, and often surpassed, the overall budget deficit (see Figure 12). For example, the primary budget registered surpluses in 1992, 1996-1998 and again in 2004. The high interest costs of financing government debt point to the unprecedented extent of adjustment in social spending required to accumulate primary surpluses during periods of crisis and high unemployment, social costs typically associated with IMF Stand-By agreements (Cordero, 2009).

These figures alone contest the dominant narrative that governments exercised relentless fiscal domination before 1997; had they done so, interest costs would have been kept to a minimum by making recourse to captive sources, including the state-owned banking sector, to fund deficits at low interest rates. Indeed, the introduction of fixed income instruments in 1993 saw debt service increase in line with domestic debt, albeit at longer maturities (see Figure 13). A break-down by currency and holders shows that in the early period, state-owned banks held all domestic public debt, denominated in domestic currency. That trend reverses in 1995 and 1996, when the state turned to foreign currency borrowing from non-bank (retail) and other investors (see Figure 14).

Figure 14 Domestic public debt, held by banks and in domestic currency (RON), Romania, 1992-2007



Source: data from Romanian Ministry of Finance reports

The 1997-1999 period highlights the perils of financialized actors and practices on the sovereign debt market. The 1997 IMF program forced governments to turn to market-based funding of government deficits. Indeed, by June 1997 a primary dealer system was set in place. The first auction took place in April 1997, rendering Romanian assets for the first time attractive to foreign capital inflows. Indeed, capital inflows rose to USD 1.8bn through early 1997, attractive by exceptional yields: 400 percent return on three-month government paper. Once inflows dried up in the aftermath of the Russian crisis, the government bond market became captive to banks' speculative behaviour. The largest Romanian financial newspaper described banks' behaviour throughout the early 1999 as an 'ambush' on the state treasury, extracting higher yields in return for currency stability (Capital, 1999¹³).

¹³ <http://www.capital.ro/detalii-articole/stiri/bancile-duc-lupte-de-gherila-cu-autoritatea-monetara-3971.html>

Indeed, domestic debt service increased rapidly by 2000, reaching a staggering 14 % of GDP.

Was this a consequence of financialized (impatient) bank behaviour? The central bank recognized that much by narrating yields as a consequence of speculative activity:

The extremely high real positive margins illustrated the banks' propensity towards maximizing the gains from arbitrage activities through which banks speculated the disruptions in various segments of the financial market (BNR, 1999: 351).

Indeed, the quote hints to how the increasing interconnectedness of financial market segments plays out during crisis for countries dependent on international financial markets. Financialized banks with excess domestic reserves - in this episode created through the 1997-1998 central bank interventions in currency markets - have three possibilities for placing these: the currency market, sterilization operations or the sovereign bond market. For the Romanian central bank, the first option was the most threatening: banks' bets on the depreciation of the domestic currency threatened a return to rapid inflation, further eroding the fragile credibility of its anti-inflation strategy. With limited foreign reserves to defend the currency, the central bank chose to compete with the government for banks' domestic liquidity. However, both the central bank and government stand to lose and commercial banks to gain, from this competition, since they have to bid up the returns they are willing to offer in return for banks' domestic liquidity. Indeed, the central bank offered returns of up to 160% on its sterilization instruments in early 1999. Similarly, yields on short-term government debt averaged 120% in that period, and the Treasury abandoned various auctions as banks demanded yields of up to 200%.

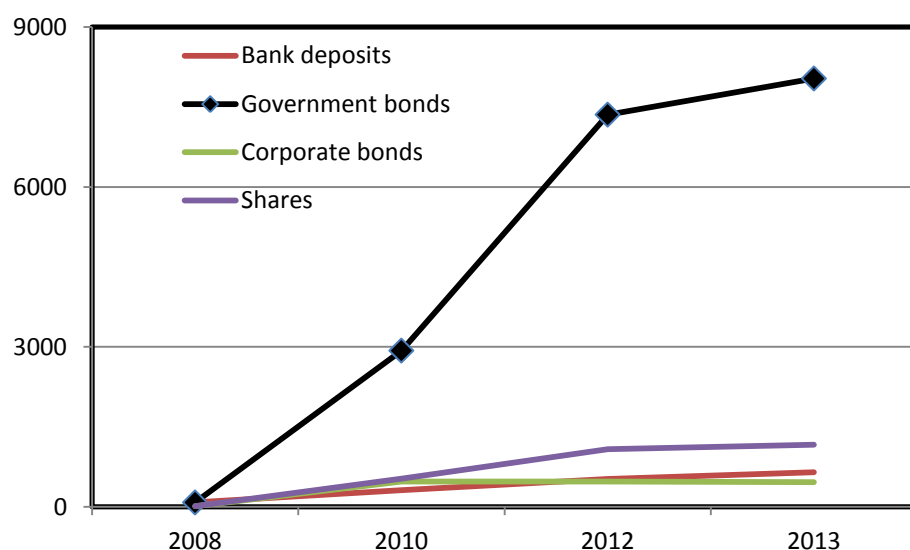
In response, sovereign debt managers returned to captive financing sources after 2000. The share of government debt held by banks fell to 63% in 2001 and to 6% by 2007, as governments met short-term needs from the Treasury Account (including the health

contributions, the unemployment fund and privatization revenues). Indeed, by 2007, the Treasury account held around 65% of overall domestic debt, from 35% in 2003. As governments recovered access to foreign markets, the terms at which it borrowed improved markedly, with debt service remaining under 3% of GDP before 2008. Having experienced the consequences of financialized bank behaviour on the Treasury market, Romanian governments reduced substantially the issue of domestic debt instruments. Compared to neighbouring countries, Romanian banks' exposure to sovereign debt only amounted to 5% of overall balance sheet in 2008. The sovereign debt managers resisted financialization by reducing market liquidity and selecting patient investors (individuals and captive sources).

However, the share of sovereign debt in total bank assets tripled within three years after September 2008, as government debt increased rapidly in the crisis; with yields pushed higher by the central bank's response to a speculative attack with the same tactic of absorbing private bank liquidity and crowding out sovereign debt managers (Gabor, 2012b).

Furthermore, other regulatory initiatives have contributed to the increasing financialization of the sovereign bond market since the crisis. Following World Bank advice, the Romanian government agreed to the gradual privatization of the public pension system starting with 2007. The Romanian state collects contributions and channels a share of these to private pension funds (in the mandatory private Pillar II scheme); who in turn demand safe assets in the form of government bonds or bank deposits. Indeed, the Pillar 2 assets managed by private pension funds increased rapidly between 2008 and 2013 (from RON 187 million to RON 10 billion by April 2013, see Figure 15), an increase largely driven by increased holdings of Romanian government debt (over 70% of total assets by 2013).

Figure 15 Portfolio composition, private pension funds (Pillar 2), 2008-2013.



Source: data from the Romanian Supervisory Commission for Private Pension Funds.

Note: data for July 2008 and April 2013.

At first sight, the rapid growth in demand for pension funds benefits the Romanian government, since it reduces its future pension commitments while simultaneously improving the liquidity of its sovereign bond market. Furthermore, pension funds tend to be more patient holders of government debt than banks or non-resident investors.

Two issues should be considered to qualify these apparent benefits. The privatization of pension funds gradually reduces the capacity of the Romanian Treasury to rely on captive sources of funding its budget deficit (a common practice before 2008), forcing it in turn to generate debt instruments that pension funds can hold by becoming actors on the sovereign bond market. The Romanian state fuels both the liabilities side of private pension funds (providing free funding) and the assets side (providing government bonds); it effectively creates profitability for private financial actors while demanding limited commitments in return. Second, the practice of securities lending implicitly transforms pension funds into impatient actors. Indeed, pension funds in high income countries often lend out their portfolio of government debt to other financial players with short-term

trading positions. Securities (collateral) mining is widespread (Singh and Stella, 2012), enabled by pension funds who make additional returns on their portfolios and tolerated by governments because of the gains for market liquidity during boom times.

Thus, on a more fundamental level, the financialization of the welfare state establishes the market liquidity for government debt as a policy priority not only for funding government deficits but also for social welfare. This severely restricts the room for designing policy measures that would select 'non-financialized' or patient types of government debt holders, since such measures would be detrimental to market liquidity.

To sum up, fiscal policy and sovereign debt management underwent different stages throughout the post-socialist period. Once interest rate costs and public debt dynamics are taken into account, the dominant account supported by both Romanian economists and official policy documents becomes problematic.

Thus, the pre-1997 period is described as the period of irresponsible fiscal management, both directly through expenditure and taxation decisions, and indirectly through fiscal domination of monetary and exchange rate policies. If anything however, Romanian governments struggled to access non-official foreign sources of funding, and instead had to (reluctantly) draw on IMF support, and the conditionality attached to such support. The IMF's insistence on fiscal adjustment has since become highly contested. Its view that real spending cuts could restore growth received little empirical validation (Easterly, 2004). The institution itself now recognizes that austerity has contractionary effects in the short-run (IMF, 2012).

In turn, the Romanian experience suggests that when governments have to rely on domestic market financing, financialized banks will take advantage of stress in international financial markets to engage in speculative games that pit the central bank against the Treasury, pushing yields on sovereign debt higher.

In fact, the period for which the IMF commanded fiscal authorities for low deficits and public debt managers for achieving public debt sustainability has been the period when governments reduced dramatically their reliance on market financing, instead using

Treasury resources (revenues from privatization and social security funds). Public debt sustainability, as Hardy (2011) observed for developing countries, fundamentally relies on governments' ability to avoid short-term investors and highly liquid government bond markets. With the growing importance of private pension funds, partly reflecting the privatization of the pension system, such resistance to financialization becomes less possible.

5. The structure of the financial sector

This section examines in detail the changes that various segments of financial markets in Romania have experienced since 1990. It starts with the banking sector that has dominated the financial system since the fall of socialism, to then consider in detail the emergence of non-bank financial intermediaries, the second most important type of financial institutions in the Romanian economy, and then dynamics on distinctive asset markets.

5.1 The evolution of the banking sector

The Romanian banking sector has undergone significant change since the fall of communism in 1989. The number of private banks increased rapidly until 1999, and then remained stable. By 1998, state-owned banks continued to control 75% of the overall assets of the banking sector, compared with 15% of the foreign-owned banks and private domestic banks with 9% (see Table 5). In turn, the dominance of state-owned banks was significantly eroded after 1999, when a banking crisis and renewed international pressure (from the IMF and the World Bank) saw the Romanian government accelerate the pace of privatization. Only two banks, CEC Bank and Eximbank, had remained in state-ownership by 2005, together amounting to less than 6% of overall banking assets. Privatization efforts since have failed as governments found it difficult to attract investor interest. Conversely, the low share of private domestic capital points to an important characteristic of the dependent economies: the absence of private domestic capital that could have been involved in the process of privatization.

Thus, the Romanian banking sector became largely foreign-owned by 2008, as the share of state-owned banks and private domestic banks¹⁴ fell under 15% of total banking assets. Banks generally follow the universal model, with several exceptions. Eximbank offers financial services for export and import activities. Procredit grants loans to small

¹⁴ Banca Transilvania, Banca Comercială CARPATICA, Libra Internet Bank and Banca Comercială Feroviara.

and medium companies, particularly in the agricultural sector. Furthermore, two banks have distinctive housing arms: BCR Housing Bank and Raiffeisen Housing Bank. These banks offer saving-cum-lending services, committing to lend at preferential rates and for longer maturities to borrowers that have saved a certain threshold of the nominal loan. The foreign-owned banks dominate the Romanian banking system, with the following distribution of market shares in 2011: Austria (38.8%), Greece (15.5%), France (14.4%), Netherlands (9%), Hungary (1.5%).

Table 5 Changes in ownership structure, Romanian banking sector, 1990-2011

	Number					Share in total assets			
	1990	1998	1999	2005	2011	1998	1999	2005	2011
State-Owned	5	7	4	2	2	75%	50%	6%	7.4%
Domestic private capital	2	13	11	7	4	9%	6%	31%	7.3%
Foreign private capital	0	16	19	30	36	15%	43%	62%	85%
TOTAL	7	36	34	39	41	100	100	100	100

Source: computed from *National Bank of Romania Annual Reports* 1992 (p.37), 1999 (p.45) and the *Financial Stability Report 2006* (p.8).

5.1.1 Banking reform: the mainstream account

The literature on bank reform in Romania distinguishes two periods broadly mirroring the stage of financialization identified by the report. The first period, 1990 to 1999, is typically described as the period of state-owned banking (OECD, 2002; IMF, 2004, Berglof and Bolton, 2001). Neo-communist governments resisted reform, thus perpetuating a banking system plagued by poor management, political capture, non-performing loans resulting from preferential credit extended to state-owned companies and pressures for monetization. Before 1999, state-owned banks continued to dominate the banking sector despite the rapid growth in the number of private (domestic and foreign) banks. The seven state-owned banks together held 75% of total banking assets at the end of 1998. According to this account, poor banking practices saw a protracted accumulation of overdue credit, increasing from 6% of non-government credit in domestic currency in 1992 to an estimated 18% in 1996, reflecting the perverse interactions between delayed bank restructuring and delayed restructuring of the real sector.

Willingness to reform the banking became manifest after 1997, and gained momentum with the banking crisis in 1998-1999. Indeed, a new government with applauded neoliberal credentials first introduced the legal support for rapid bank privatization (1997). The 1999 banking crisis, where one state-owned bank and several private banks became bankrupt, finally reversed the ongoing problems of Romanian banking: vested interests, asymmetric information and non-performing loans extended under political pressure (Caviglia et al, 2002; De Haas and van Lelyveld, 2006). Banking reform picked up speed after the crisis, initiating a double move, from state to private, and from domestic to foreign. The age of foreign banking, underpinned by successful privatization and greenfield entries, sealed the increased credibility of the Romanian reform process.

This narrative of the politicized state-owned banks ignores both the political pressures shaping the processes of privatization and the distinctive institutions with competing or aligned interests in that process (Pop, 2006). Indeed the central bank, private

and state banks, international financial institutions and successive governments shaped, through their interactions, the complex socioeconomic terrain in which bank privatization took place.

5.1.2 Bank privatizations as contingent processes

Pop (2006) or Gabor (2010a, 2012a) challenged the widespread notion that the problems of the Romanian banking system rested entirely with the failure of successive governments to restructure and privatize. This is an appealing narrative, constructed and re-affirmed in policy documents, because it provides a simple (neoliberal) account of a complex process where both public and private actors have played important roles.

To start with, it cannot be denied that state-owned companies and state-owned banks often developed relationships based on corrupt practices, and that such relationships would translate into deteriorated loan portfolios for banks (see IMF, 1997; BNR, 2000). This is a well-known and well-documented account. But relational banking is neither always 'corrupt' nor exclusive to state-owned entities. Indeed, strategic interactions between corporations and private banks prevail in coordinated types of capitalism (see Hall and Soskice, 2001) and are often a key ingredient in the competitiveness of those economies. Such interactions have been transposed to the Romanian context in direct form after 2006, when foreign-owned banks introduced loan externalization. This practice allowed foreign companies with activity in Romania to benefit from a loan extended by a parent bank based on existing relationships in other jurisdictions and to take advantage of lower costs of funding for the originating bank (and hence for the borrower). Transnational banks in turn could bypass regulatory constraints in the host country. Yet there is virtually no analysis that deems such practices of private (foreign) banks as corrupt.

Crucially, the focus on the relationship between state banks and state companies narrates the Romanian bank restructuring as an asset side story, and in doing so, it ignores the constraints on the liabilities side. With few exceptions (see Gabor 2010), the literature

pays virtually no attention to the cost and availability of funding for banks, including the impact that monetary policy had on banks' costs. Indeed, the early chapter on macroeconomic policies documented in detail the numerous occasions throughout the early 1990s (i.e. when implementing IMF conditionality) on which the central bank restricted access to its lending facilities or increased the interest rates on lender of last resort lending to extremely high levels.

A focus on the liabilities side changes the narrative of bank restructuring. Consider the first wave of privatizations, taking place against the background of a twin threat of banking and currency crisis in late 1998, early 1999. Three distinct factors influenced the process of bank privatization:

- *The pressures exercised by powerful international actors (the IMF position on extending extraordinary balance of payment support).*
- *The central bank's management of liquidity conditions on the interbank market in response to capital outflows after the August 1998 Russian crisis.*
- *Speculative bank activity (financialized practices) across the currency market, the money market and the sovereign bond market.*

In 1998, the IMF launched a burden-sharing program that made official balance of payments assistance conditional on countries' ability to raise funding in private financial markets. This proved particularly challenging for Romania. Tighter liquidity conditions in international financial markets coincided with a peak in foreign debt service, with foreign currency financing needs estimated to USD 5bn for 1999, over 45% of export earnings and more than double the volume of central bank's foreign currency reserves. Furthermore, Romanian exporters suffered from the embargo on Yugoslavia. The central bank worried that such funding requirements would be impossible to meet, concerns cemented by an

international consensus that Romania would default on its foreign debt service (EIU, 2000; BNR, 2001).

When Romania turned to the IMF for support, the international institution decided to include it in the pilot burden-sharing program. But precarious funding conditions in international markets implied that market access came with high risk and liquidity premiums. Romanian policy makers declined the expensive private funding, and instead embarked on a draconian internal adjustment that would curtail the current account deficit (Gabor, 2010a).

Against this context, macroeconomic crisis management played an important role *via* liquidity conditions in the interbank money market. By late 1998, the central bank worried that the speculative behaviour of domestic banks would worsen exchange rate volatility and capital flight (BNR, 2008; also Gabor, 2010a). As documented in the section of fiscal policy and sovereign debt market, banks with market portfolios (from currency trading) were forcing the central bank to pre-empt their currency positions by running down foreign reserves and by offering alternative high-yielding instruments¹⁵ (sterilization instruments) that also crowded out sovereign debt managers.

These measures generated very high interest rates on the interbank market, reaching up to 180% on the overnight segment throughout September 1998-March 1999. Indeed, the central bank recognized that the spike in interbank market rates reflected to a significant extent the speculative behaviour of domestic banks¹⁶. However, when the central bank tightened interbank liquidity to prevent a speculative attack, it failed to consider the impact of its policies on patient banks that depended on interbank funding. Indeed, several large state-owned banks with limited access to international financial markets and/or high

¹⁵ According to the central bank (2008: 234) “foreign exchange flows, which are conditional on money market, exhibited various levels across banks, thereby prompting speculative behaviour of some banks holding large amounts of foreign currency. [...] The interbank forex market became increasingly transparent, robust and steady, on the back of higher amount of transactions, though the key negative effect was a more speculative behaviour of banks, which made the intervention of the central bank even more costly.”

¹⁶ “The extremely high real positive margins illustrated the banks’ propensity towards maximizing the gains from arbitrage activities through which banks speculated the disruptions in various segments of the financial market” (BNR, 1999: 351).

portfolios of non-performing loans relied heavily on the interbank market to satisfy liquidity needs, partly because the central bank had stopped offering refinancing credit after the 1997 reforms¹⁷ (Gabor, 2010a; BNR, 2008). For patient banks, the anti-speculative strategy of the central bank translated into prohibitive funding conditions. Thus, central bank-led financialization made way for dependent financialization.

Indeed, this crisis episode accelerated bank privatization and the entry of foreign financial capital in two ways. First, the Romanian government introduced an emergency anti-crisis program in December 1998, including measures for the immediate privatization of two state-owned banks (measures demanded by the IMF and the World Bank). Within a few months, Societe Generale had purchased the controlling stake in the second largest state-owned bank. Second, tighter money market liquidity, underpinned by the central bank's defence of the currency and banks' speculative behaviour, forced several state-owned and privately owned banks to pay increasingly higher interest rates. The central bank used the opportunity to push for banking reform. This, in its view, required the bankruptcy of state-owned banks with significant portfolios of non-performing loans. It declared that for these banks, liquidity problems had become solvency problems and refused to extend lender of last resort support until the government initiated the bankruptcy process for one bank (Bancorex) and privatization for the second (Bancpost). The state budget absorbed the costs of bank restructuring, estimated at 10% of GDP. Romania avoided default, but at the expense of a banking crisis that opened up the banking sector to foreign (private) ownership.

Furthermore, ideological commitment also played an important part in the transformation of the Romanian banking sector. Take for instance the 2003 privatization of

17 BNR (1999: 347) "Refinancing credit and other credits declined by 10.5 percent to lei 613.4 billion. [...]. Directed credit was no longer granted and banks' resort to lombard credit lessened. Starting 1 July 1998, following the enforcement of the new BNR Act, overdraft credit was under a ban. As of 31 December 1998, refinancing credits totalled lei 555.5 billion, of which loan to Banca Agricolă in virtue of Art. 4 of Law No. 20/1996 amounted to lei 503.1 billion; loan granted to Banca Dacia Felix in virtue of Law No. 135/1996 in an amount of lei 52.0 billion, and preferential loans totalling lei 0.4 billion falling due on 31 March 1999 under Government Decision No. 61/1993 to support farmers to purchase tractors and agricultural machines.

the Banca Comerciala Romana (BCR), the largest commercial bank, with a 35% market share of total bank assets. Unlike previous cases of privatization, BCR was a successful state-owned bank: it had total assets of EUR 4.5 billion and made a net profit of €99.5 million in 2002 (Gabor, 2010a). To accelerate the privatization process, two international financial institutions present in Romania (EBRD and IFC¹⁸) first bought a 25% stake in the bank for USD 222 millions, roughly twice the profit that the bank had made the previous year. The IMF conditioned the disbursement of a loan tranche on the transaction (EIU, 2004).

The EBRD (2002) insisted that Romania would benefit from this transaction, not only directly through access to IMF funding but also because it demonstrated its commitment to bank privatization. In contrast, the Romanian government viewed privatization as a depoliticization of banking activity, necessary to curtail governments' interventions in market processes. Government officials warned that state ownership invited governments to use banks as captive sources to support sovereign debt dynamics, or to forcefully imposed bank loyalty in the sovereign debt markets¹⁹. The Romanian government suggested that market forces would be more effective to impose discipline on spending decisions, ignoring the well-documented speculative bank behaviour on the sovereign debt market which had pushed its own debt managers to avoid banks as counterparties.

In this case, the Romanian government and international financial institutions had closely aligned ideological positions that airbrushed any conflicts of interests in the name of private ownership. The privatization was concluded in 2005 when the Austrian Erste Bank

¹⁸ The umbrella organization of the IMF and the World Bank.

¹⁹ The Romanian Minister of Finance put it as follows (quoted in Gabor, 2010a: 76): 'You were asking at some point whether I would not like to make a phone call to a bank and impose a certain yield on Treasury bills. No, I would not like it. That is exactly why we sold BCR. It is wrong to have this option, because it opens up the possibility of abuse. One might say, I am very competent, I know exactly how much the bank should charge me and I am correct about it. Let us instead allow the markets to work, I am very happy that markets work. We have a functioning currency market. That the exchange rate is 4 (RON to the Euro), or 4.1 or 4.25 or 3.9, that is up to the market, not the Ministry of Finance. We have to adapt to the market. The interest rate (on government debt) is 4% or 8% because of market mechanisms. I would like it to be 1% or 0%'.

purchased the controlling shares for EUR 3.75 bn. The EBRD and the IFC together received EUR. 1.5 bn for their share, *eight* times higher than the initial purchase price (BNR 2006, p55). As an aside, it remains unclear why international organizations should obtain high profits from the privatization of a successful state-owned bank, undertaken in the name of improved competition in the banking sector. For example, the profits could have been used to improve the public health system, heavily affected by repeated efforts, typically designed through IMF programs, to tighten fiscal policy.

Subsequent efforts to privatize the largest savings bank failed. The Romanian government declared the offer of the only interested foreign bank, National Bank of Greece, unacceptable in 2006. The same savings bank became an object of dispute between the Romanian government and the European Commission in 2009 because of plans to use it as a development bank and thus mitigate the effects of the crisis. The state-owned bank had not followed the aggressive lending practices of private banks and its balance sheet was less exposed to exchange rate volatility or deleveraging. The Romanian state argued that an infusion of capital would allow the bank to increase lending to SMEs and the agriculture, sectors in which foreign-owned banks had limited interest. The European Commission rejected the proposal because it viewed such plans as anti-competitive state subsidy, arguing that recapitalization was only warranted for banks with severe funding difficulties (in Western Europe). By late 2011, the IMF renewed pressures for privatization, advising the government to follow the model of attracting institutional investors (EBRD and IFC) that it had used for the earlier privatization of large state-owned banks.

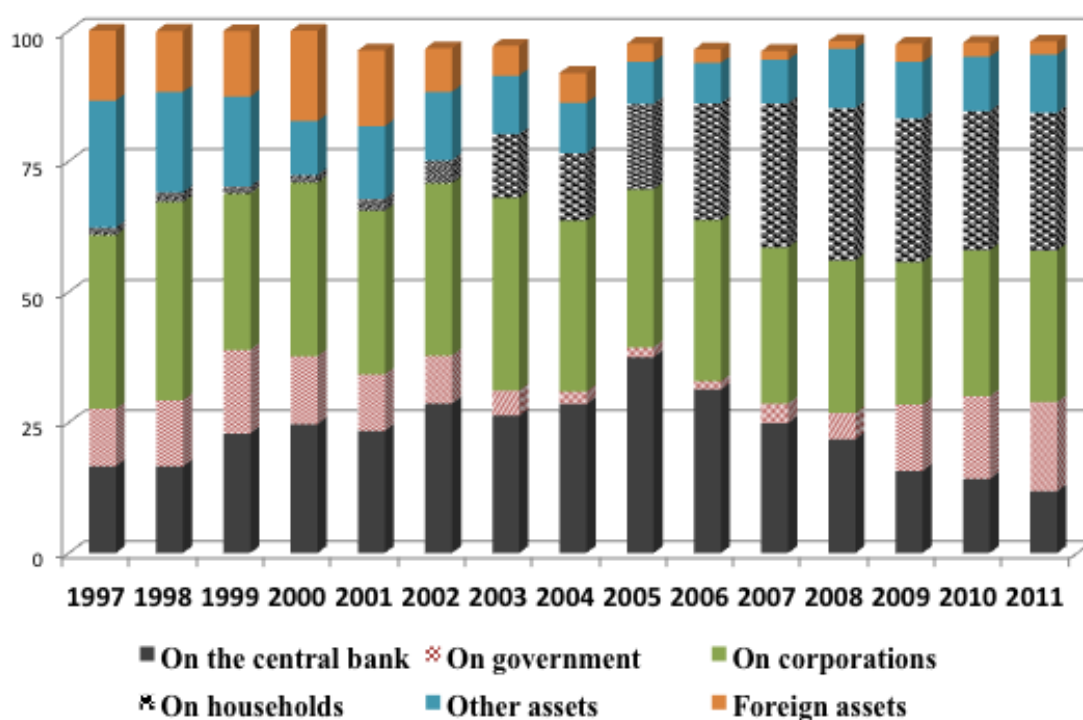
5.2 The structure of banks' balance sheets

The evolution of the Romanian financial system suggests that transnational banks integrate, and expose, national financial systems into international financial markets even at relatively lower levels of financial intermediation. Rather than balance sheet growth,

qualitative changes in the nature of financial intermediation mirror those in highly developed financial systems, both on the asset side – where market portfolios become increasingly important – and on the liabilities side – where market funding gains importance compared to traditional sources of funding (retail deposits).

On the asset side of the Romanian banking sector, the relative importance of customer loans has increased after 1997 (see Figure 16). Whereas credit to corporations has maintained a roughly constant share (around 30% of total assets), credit to households increased rapidly from less than 2% in 2000 to almost 30% in 2008. This reflected the rapid expansion in foreign currency credit to households, averaging annual growth of 50% between 2002 and 2008. The substantial share of assets denominated in foreign currency amplifies vulnerability to sudden stops of capital inflows and exchange rate depreciations.

Figure 16 Structure of bank assets, Romania, 1997-2011



Source: data from the Romanian central bank (www.bnro.ro)

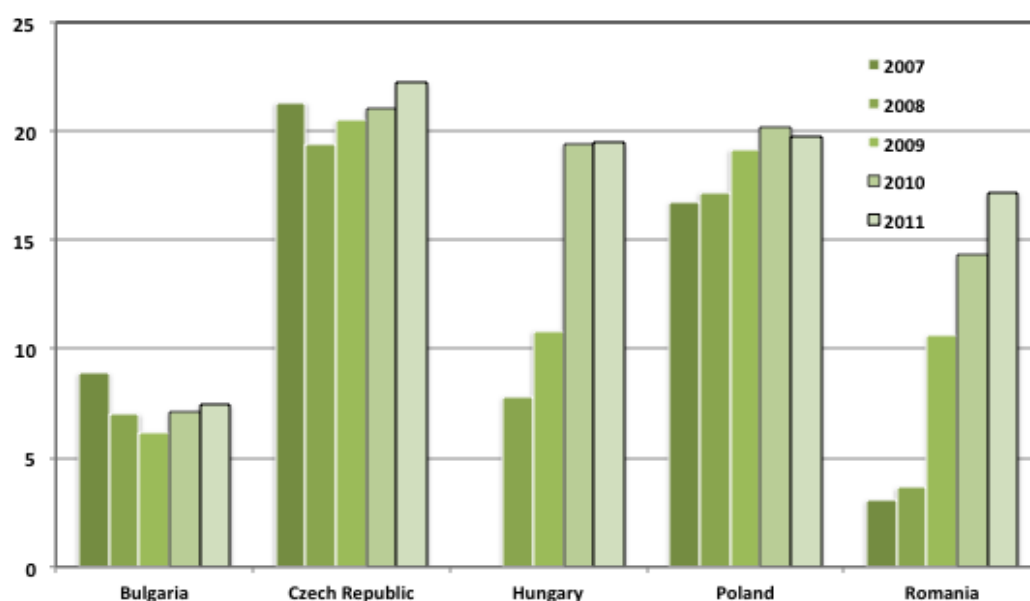
In turn, a significant share of banking activity - around 30% of overall assets - has been generated by market-based operations with the 'public' sector, the central bank and the government. Indeed, the share of these activities remained consistently above 25% of overall assets since 1997, reaching at its peak in 2005 almost 40%. This share confirms the growing importance of market portfolios for financialized banks.

The composition of market portfolios changed over time, reflecting the significance of deliberate state action for the pace and nature of financialization. The share of claims on the central bank increased rapidly to 37% of total assets in 2005, to decrease afterwards to 11% by 2011. In contrast, banks' lending to the government followed an opposite trend, decreasing rapidly before the 2008 crisis as debt managers sought to circumvent resident banks.

The claims on the central bank arise from sterilization operations. Indeed, a key feature of dependent financialization is the reliance on foreign capital inflows intermediated by resident banks. When local asset markets do not offer attractive placement opportunities (because of limited market liquidity, a consequence of deliberate government choices before 2008), the central bank may step in and create attractive instruments through sterilization operations (see chapter on macroeconomic policies). Indeed, Christensen (2004) or Gabor (2012b) described sterilization games through which banks with access to foreign currency funding - from either domestic deposits or parent banks - took advantage of the substantial yield differentials offered on Romanian assets (including central bank sterilization vehicles) by actively intermediating capital inflows. Sterilization games occur because they offer mutual gains. Moderate exchange rate appreciation from capital inflows allows the central bank to fulfil its commitments to price stability. In turn, resident banks benefit from a risk-free, profitable source of carry-trade returns (see Galati et al, 2007). The substantial share of claims on the central bank thus reflects resident banks' market activities on the interbank currency and money market.

Before 2008, the Romanian banking system had limited exposure to government debt. This partly reflected the strategy of sovereign debt managers to issue debt instruments for individuals or institutional investors other than banks (see fiscal policy and sovereign debt market section). In comparative terms, Romanian banks had one of the lowest ratios of debt instruments to total assets of all New Member States, reaching less than 5% before the crisis (see Figure 17). However, the crisis brought a rapid increase in bank holding of government debt, reflecting on the banks' side the search for profitable placement opportunities and on the government's side the limited access to foreign borrowing. This has cemented a sovereign-bank loop that, similar to Western European countries, ties banks to the sovereign and vice-versa. If the sovereign loses credibility, then banks' balance sheets may suffer, potentially triggering a twin sovereign-banking crisis.

Figure 17 Debt instruments, % of total bank assets



Source: ECB Statistical Warehouse.

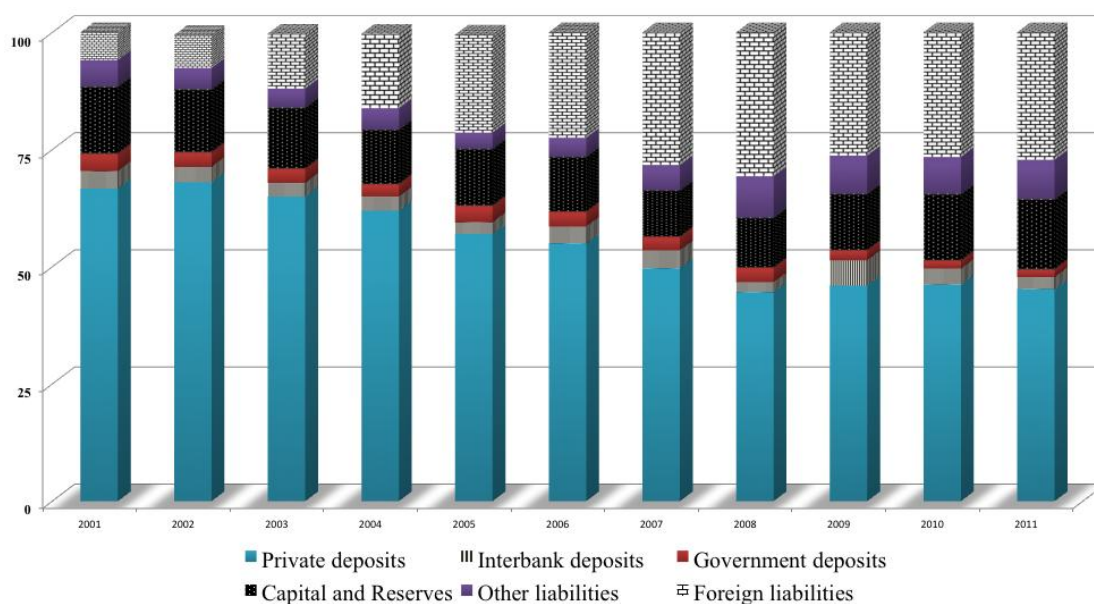
In sum, the substantial share of lending to the central bank and then the shift to sovereign assets reveals that banks in less developed financial systems have undergone shifts to

market-based portfolios similar to high-income countries (Liikanen Report, 2012; see also Hardie and Howarth, 2009). Romanian banks have become active intermediaries of capital inflows, either through proprietary trading on currency markets placed in sterilization vehicles or through acting as counterparties to non-resident investors targeting Romanian asset markets. While non-traditional banking activity can take a variety of forms, not all apparent on balance sheets (see Galati et al (2007) on various strategies for carry-trade activity), the asset side of the Romanian banking sector confirms the extent to which commercial banks in less developed financial systems can engage in financialized practices.

On the funding side, the increasing transnationalization of the Romanian banking sector has been accompanied by a change in funding strategies towards more precarious funding structures. Transnational banks typically choose between two funding models. Banks operating with centralized models rely on internal capital markets to allocate liquidity across subsidiaries. The parent bank raises wholesale funding in local or other large funding markets and channels it to subsidiaries, through intra-group loans, depending on the particular strategies for business lines. In contrast, decentralized funding models involve subsidiaries with autonomous lending and funding decisions. The subsidiaries depend on the local deposit base to fund their assets, whereas the parent bank provides coordination and monitoring. Often however, transnational banks with decentralized models will also use internal capital markets to support subsidiaries with funding gaps, particularly on the consumer finance lines (Liikanen Report 2012). In other words, intra-group flows play an important role in both centralized and decentralized models. Banks chose one or the other depending on geographical proximity – subsidiaries operating at distance would typically be more autonomous – and specific strategies for cross-border expansion. In Romania's case, the proximity of the parent banks –located in Austria, Greece, France or Holland – led to a centralized funding model where Romanian subsidiaries depended on funding from parent banks (Aydin, 2008).

The share of capital and reserves declined from around 14% to less than 10% by 2008 (see Figure 18), enabled by increased leverage that allowed banks to expand faster. Furthermore, banks relied relatively less on stable sources of funding – domestic deposits – whose share decreased from 66% in 2001 to 46% by 2008. In other words, banks covered increasing funding gaps by resorting to cross-border funding, as the share of foreign liabilities increased from 6% in 2001 to around 30% in 2008, the highest share in Eastern Europe. Such developments reflect the funding models of transnational banks and their underpinning vulnerabilities – indeed when Romania turned to IMF support in 2009, it did so because of concerns that parent banks would be reluctant to roll-over the short-term funding lines to their Romanian subsidiaries, then resolved through the Vienna Initiative.

Figure 18 Structure of banking liabilities, Romania, 2001-2011.



Source: National Bank of Romania Statistics.

Furthermore, the literature warns that reliance on short-term funding is pro-cyclical (Adrian and Shin, 2010) whereas banks with a strong deposit base tend to maintain lending

throughout the crisis (Cornett et al., 2010) and are less vulnerable to banking crisis (Bologna, 2011). Indeed, prior to the crisis, Romanian banks were heavily dependent on short-term cross-border funding from parent banks and international money markets. Because banks raised almost half of foreign funding on short-term (see table 6), they were confronted with roll-over risk once parent banks faced tighter liquidity conditions in their funding markets. For this reason, the Vienna Initiative brought together parent banks and regulatory authorities from both home and host markets in an effort to persuade parent banks to maintain commitment to Eastern European subsidiaries (Pistor, 2012). Regulators successfully avoided a disorderly deleveraging – as foreign liabilities only fell in 2009, and then remained stable at around 27% of total funding, at an improved maturity distribution – suggesting that foreign bank ownership can be a stabilizing factor during crisis.

Table 6 Share and maturity of non-resident deposits in banks' domestic liabilities

	Short-term foreign liabilities/foreign liabilities	Foreign liabilities/Total liabilities
2006	55%	22.5
2007	49%	28.3
2008	41%	30.4
2009	27%	26.1
2010	30%	26.7
2011	30%	27.0

Source: data from National Bank of Romania

Questions about the reform of transnational banks' business models in Romania remain un-answered, particularly in what concerns the reliance on cross-border funding to finance foreign currency lending. The Vienna Initiative established two working groups, the Local

Currency and Capital Market Development Group (focused on reorienting banks away from foreign currency lending) and the Absorption of EU Funds Group, that aim to coordinate public and private efforts in order to match stable sources of funding with more sustainable lending practices. Yet so far, there is little regulatory interest in breaking down the cross-border banking model into autonomous subsidiaries reliant on the domestic deposit base. The second round of the Vienna Initiative, in early 2012, emphasized the importance of allowing transnational banks autonomy to manage liquidity through internal capital markets (Kudrna and Gabor, 2013). If anything, the shift to market-based funding may accelerate in the future given that pension fund reforms will increasingly require households to shift saving from bank deposits to private pension funds.

5.3 The non-bank financial intermediaries (NBFIs)

The NBFI sector is one of the most pro-cyclical sectors in the Romanian financial system. Its share in GDP tripled between 2002 and 2008, when it reached 8.3% of GDP and 18% of the total loans extended to the non-government sector (households and businesses). The rapid growth was driven by regulatory arbitrage by resident banks and an increasing appetite for borrowing from households. Heavily affected by the crisis, the NBFI sector lost around 30% of its sectoral share by 2010, falling to 5.6% of GDP due to an increase in non-performing loans on its balance sheet and diminishing lending activity as both lending standards tightened and demand for credit contracted. By June 2012, its share in total lending activity fell to around 9%.

Large NBFIs have to register under the Special Register and have been subjected to central bank regulation since 2006. These together hold over 90% of the assets of the sector. On the asset side, NBFIs concentrate lending in two key areas: financial leasing and consumer loans. Thus, by 2008, financial leasing amounted to 82% of total loans, followed by consumer loans with 7.7%. By the end of 2011, leasing declined to 75% of total

loans, while consumer loans also fell to 6.5% respectively. It is important to notice that financial leasing is one of the few activities where Romania converged to European ratios before the crisis. Indeed, by 2008, the leasing market had reached 5.24% of GDP, higher than in Poland, Greece or France, driven by average 50% growth rates in NBFI financial leasing throughout 2005-2007 (see Table 7). Furthermore, by 2008, financial leasing was directed mainly to companies (75%) in the service sector (around 50%), reflecting demand for vehicles, equipment and real estate. Bank-affiliated leasing companies held over 60% of outstanding leasing contracts by 2008.

Table 7 Leasing as share of GDP, comparative European member states, 2008-2010.

	2008	2009	2010
Austria	8.87	8.97	8.61
Bulgaria	8.39	7.29	5.71
Czech Republic	6.88	6.23	5.70
France	4.29	4.33	4.29
United Kingdom	6.03	5.88	5.70
Greece	4.17	3.99	3.52
Hungary	11.03	10.25	9.07
Poland	3.60	3.95	3.91
Romania	5.24	4.51	3.65
Slovakia	5.69	5.52	5.13

Source: central bank of Romania (www.bnro.ro)

The currency composition reveals distinctive dynamics for the two dominant sectors (see Table 8). Whereas financial leasing is mostly denominated in foreign currency (over 70% throughout the period), consumer credit is extended in the national currency (over 90%). The NBFI sector is thus exposed to credit and currency risk in the case that the national currency devaluates rapidly.

Table 8 Activity and currency composition, leasing companies

	Share in total NBFi credit		Foreign currency loans (share)
	2005	2007	2007
Financial leasing	83.7	81.9	72%
Consumer Credit	11.9	7.73	10%
Mortgage companies	1.13	4	80%

Source: central bank data

NBFIs' funding strategies reflect regulatory constraints and the availability of cheap funding. Indeed, NBFIs can raise funding from shareholders and from other domestic or foreign sources. The largest companies in the sector were set by foreign owned banks to circumvent constraints posed on their lending activity, in foreign currency and on the household segment, by tighter regulatory conditions throughout 2005 and 2006 (see Regulation section). Banks moved lending to their NBFi arms.

For example, when the central bank increased restrictions on EUR denominated bank lending in 2005, banks designed complex strategies to circumvent restrictions. The central bank documents for example a mechanism to provide RON financing to the NBFi arm by, in turn, borrowing RON either in the domestic money market or through currency swaps with the NBFi itself (see BNR, 2007: 42). The NBFi would use the foreign currency thus obtained to import the leased goods, denominate the leasing contract in EUR but ask the lessee to pay the instalments in domestic currency, which it would use to service its funding from the parent bank. With this, the NBFi transferred currency risk to the lessee, while effectively extending a foreign currency loan and enabling the parent bank to circumvent macroprudential regulation on foreign currency credit. According to central bank data, financing in local currency from the domestic banking system increased from 46% in 2005 to 73% in 2006, as leasing contracts grew faster than credit growth in the

banking sector for that year. In response, the central bank extended the scope of prudential regulations to NBFIs in 2006.

Once the central bank relaxed regulatory constraints in January 2007, cross-border borrowing funded the rapid asset growth. By September 2008, when the crisis hit Romania, NBFIs had shifted to funding from external sources, amounting to over 80% of total NBFI debt. That share increased to 87% by June 2011. In turn, the share of funding from domestic credit institutions dropped from around 73% in 2006 to 10% by 2011. Similar to the banking sector, foreign ownership enabled access to external sources, typically from the parent bank, but also increased exposure to changing liquidity conditions in international financial markets. Against this context, NBFIs have to rely on the willingness of the parent bank to sustain funding and rollover maturing debt. As Table 9 suggests, NBFIs mostly borrow for the countries where the shareholders originate. Furthermore, foreign-owned NBFIs depend more on borrowing than on share capital, whereas Romanian-owned NBFIs funding sources are more evenly distributed.

Table 9 NBFI foreign funding, June 2011 (RON bn)

	Share capital	External funding
Austria	0.19	6.94
Romania	2.02	2.94
The Netherlands	0.65	1.70
United Kingdom	0.10	1.90
France	0.15	2.15
Italy	0.09	0.70
Luxembourg, Turkey and Switzerland	0.00	3.09
<i>Share of total NBFI debt</i>	-	87%

Source: data from Romanian central bank.

Furthermore, NBFIs also raised funding in wholesale markets of countries without direct participation in the Romanian NBFI sector: around 15% of total external borrowing for 2011 came from Luxembourg, Turkey and Switzerland.

To sum up, the dynamics of the NBFI demonstrate the vulnerabilities of both active regulatory arbitrage undertaken by banks and their NBFI subsidiaries before 2007, and a lax regulatory regime afterwards. NBFIs have been more willing to take on credit risk through lending practices orientated towards rapid growth, strengthening the procyclicality of credit activity in the Romanian financial system. For this reason, NBFIs saw the share of non-performing loans rise from less than 2% of their balance sheet at the end of 2007 to around 18% by middle of 2011. This had a negative impact on the profitability of the sector, as NBFIs registered losses for most of 2008 and 2009.

5.4 The interbank money market

The unsecured interbank market is important for the functioning of the financial system because that is traditionally the segment where banks trade liquidity with each other. Demand for liquidity (for reserves) comes from banks with funding gaps, whose lending activity cannot be entirely funded from available deposits. Conversely, banks' retail deposit activity may result in surplus liquidity: in a fractional reserve system, if lending (to businesses or households) does not use up the reserves available from deposits, banks have excess reserves to lend overnight or beyond and without collateral requirements on the interbank market (Goodhart, 1994). Transactions on the interbank money market are predominantly short-term, from overnight to one week.

The unsecured market plays a crucial role in the implementation of monetary policy orientated to price stability (rather than employment or growth). In monetary targeting regimes, the central bank varies the volume of high-powered money (bank reserves) in line with its money targets and estimates of the money multiplier. An excess of liquidity on the

interbank market, through strict monetarist logic, translated into rapid credit growth and inflation (Vine, 1997). Conversely, in inflation targeting regimes, policy control over the overnight interbank interest rates enables central banks to influence long-term interest rates and asset prices relevant to aggregate demand dynamics, and thus inflation (Woodford, 2003). Therefore, what matters for the central bank is the aggregate liquidity position in the interbank money market: an aggregate deficit of liquidity will translate into upward pressures on the interbank interest rate, and vice-versa. To ensure that the short-term market rate tracks closely policy rate decisions, central banks can use two distinct approaches (Bindseil, 2004).

The preferred mechanism involves active liquidity management through open market operations. Central banks manage liquidity on the unsecured segment of the interbank money market through repurchase operations (lending against collateral, with a promise to repurchase the underlying assets at a later date), to maintain unsecured market interest rates close to the policy interest rate. For example, in high-income countries, central banks are usually net creditors on the unsecured interbank market (or, in other words, there is an aggregate deficit of liquidity on that market). When the central bank increases the policy interest rate in response to inflationary pressures, it enforces that decision on the money market by altering the volume of liquidity injections.

Alternatively, liquidity management can be conducted through standing facilities. A less activist avenue is for the central bank to provide or absorb liquidity through its overnight standing facilities - the deposit facility, where commercial banks can deposit the reserves that could not be lent out on the interbank market, and the lending facility (the discount window), where commercial banks can borrow liquidity that could not be obtained on the interbank market. If the central bank establishes the interest rates on its standing facilities to form a close corridor around the policy rate (e.g. the deposit rate 25 basis points below, and the lending rate 25 basis points above the policy rate), liquidity management through standing facilities can offer an equally effective approach to enforcing interest rate decisions on the interbank money market. This approach however is

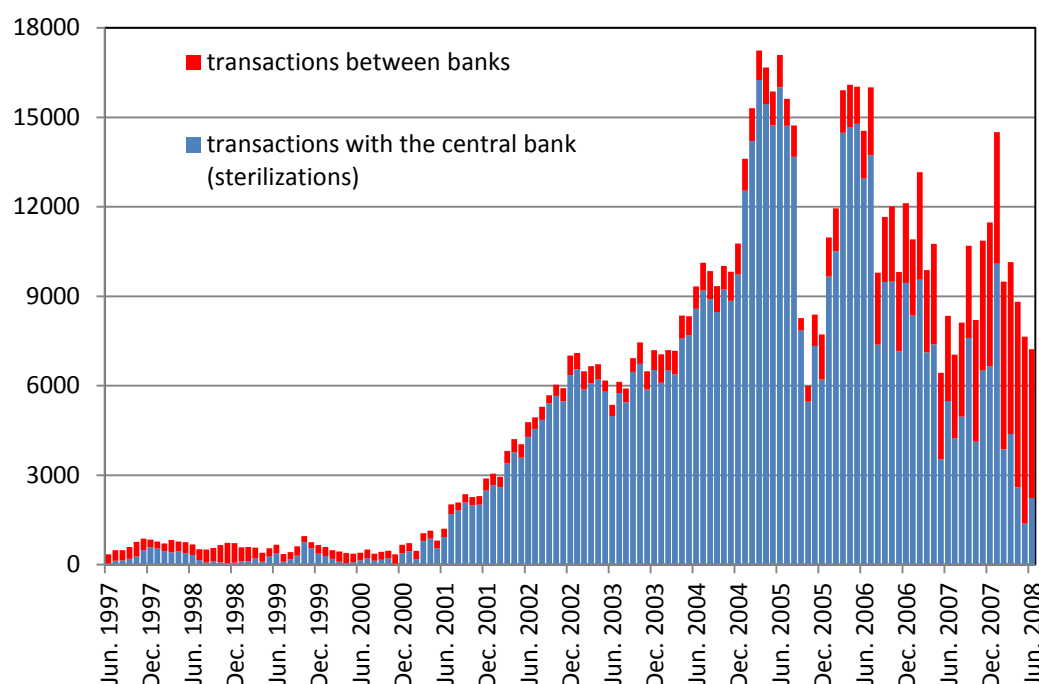
less deployed in practice because of the stigma associated with recourse to the lending facility, usually interpreted as evidence that a particular financial institution faces difficulties in meeting funding liabilities from market sources.

5.4.1 The financialization of the Romanian interbank money market

In a financial system dominated by banks that operate according to the traditional relational model, the interbank money market is crucial to banking activity. Indeed, where loan activity outpaces deposit taking, banks accumulate funding gaps that are typically covered by borrowing on the interbank market. Banks with excess reserves (from lower lending activity than deposits) will lend to banks with funding gaps. In turn, on financialized interbank money markets, liquidity flows reflect banks' complex trading strategies in various market segments, including the currency market, rather than relational banking alone. Liquidity is asymmetrically distributed: banks with excess liquidity from their activities on the currency market meet banks with reserve shortages from funding gaps.

A cursory look at the Romanian interbank market confirms this observation. Particularly from 2000 onwards, commercial banks trade more with the central bank, in sterilization operations, than between themselves (see Figure 19). Indeed, sterilization operations amounted to over 90% of all interbank transactions between 2000 and 2005. Transactions between banks increase in relative importance after 2006, reaching over 60% of total volumes traded by 2008, as lending to households picked up rapidly, creating funding gaps.

Figure 19 Interbank money market trading (outstanding RON mil volumes), 1997-2008



Source: data from National Bank of Romania

In other words, the central bank dominated the interbank money market through its sterilizations (deposit-taking) operations before Lehman. Few commercial banks turned to the interbank market to cover funding gaps. In fact, prior to 2007, most banks in the system had excess reserves arising from intermediating capital inflows, in line with a pervasive, and well-documented, structural excess of liquidity throughout Eastern European interbank money markets (see Balogh, 2009). Commercial banks treated sterilization instruments as an asset class in their carry-trade strategies (Gabor, 2010a; 2012b).

Thus the changes in the interbank money market highlight the deliberate role that states – and central banks in particular– can play in processes of financialization. The

central bank's liquidity management enabled resident banks to obtain profits from market activities, necessary to induce real appreciation of the exchange rate and disinflation.

The commercial banks that actively intermediate capital inflows (those with access to parent bank funding or international money markets) are thus able to obtain domestic liquidity by selling foreign currency to the central bank, and will tend to be net lenders of liquidity in the market or in sterilization operations, whereas (small) banks with domestic operations tend to be net borrowers in the market. Demand and supply on the interbank money market is no longer driven by banks' deposit and lending activity, but reflects business models ranging from traditional relational banking to consumer credit and market portfolios.

The central bank thus contributes to the financialization of the interbank money market by tying its dynamics to the currency market through exchange rate management. Financialized banks that have access to foreign currency funding – either from parent banks or from the increasing dollarization/euroization of bank liabilities – accumulate reserves from market portfolios (forex sales to central bank on the currency market). These reserves can be placed with the central bank (sterilizations), lent on the interbank money market or placed in government bonds. In turn, commercial banks with funding gaps from traditional lending activity – that is, without market-based activities – generate demand for reserves on the interbank market, often competing with the central bank's sterilization operations and with the government's debt management office.

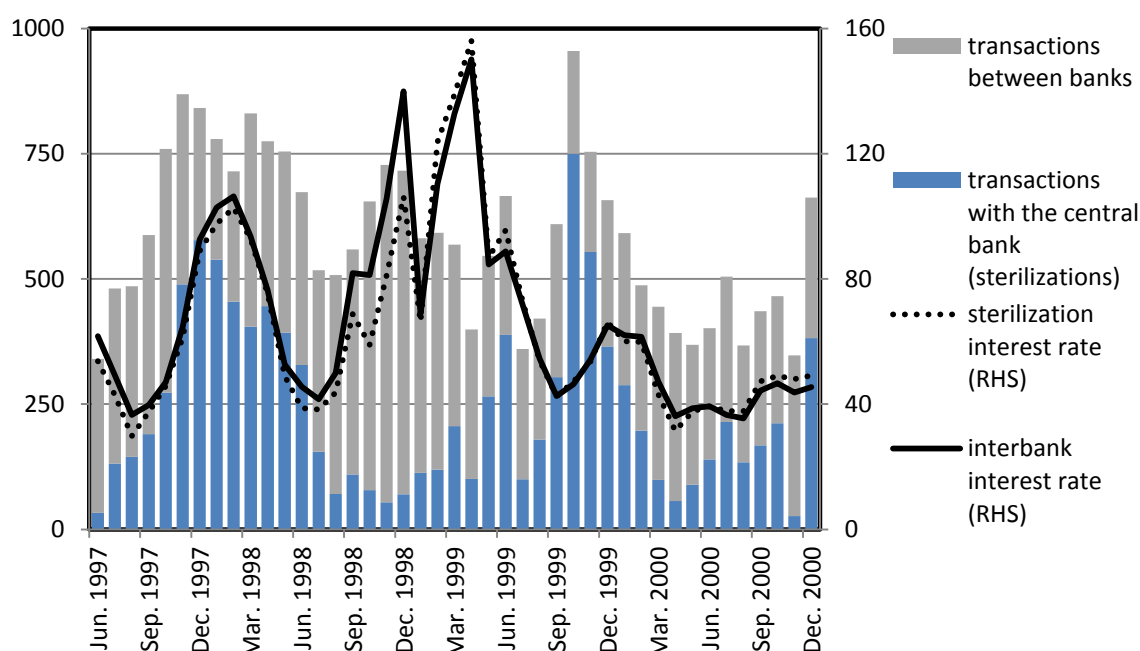
5.4.2 Speculative attacks: how financialization can damage patient banking

The financialization of the interbank money market can be damaging for 'patient' banks (see also section on bank restructuring) because speculative attacks on the currency play out in the interbank money market. Two episodes in the Romanian post-socialist history offer powerful examples: the 1998-99 Russian crisis and the Lehman's collapse in September 2008.

Throughout 1997, commercial banks active on the currency market made increasingly large deposits with the central bank (i.e. sterilizations), from around RON 32 million in June to over RON 500 million by December, a fifteen fold increase drive by large capital inflows and the central bank's currency market interventions (see Figure 20). Interbank interest rates fell as sterilization volumes went higher.

Capital flight during the 1998 Russian Crisis was accompanied by a rapid increase in interbank rates. Banks with excess liquidity previously places in sterilization instruments used some of that liquidity to take speculative currency positions (see BNR, 1999). This speculative active confronted the central bank with a trade-off between a currency crisis and financial instability. Injections of liquidity to stabilize the interbank money market – the usual lender of last resort response to periods of instability – would have allowed banks to further fund shorts on the currency market. The central bank preferred to tolerate higher interest rates on the interbank money market, and even increased upwards pressures, by continuing to offer sterilizations while simultaneously selling foreign reserves to prop up the domestic currency, sales that further absorbed domestic liquidity.

Figure 20 Interbank money market dynamics (outstanding daily averages and nominal interest rates), Romania, 1997-2000.



Source: data from National Bank of Romania (www.bnro.ro)

This defence strategy increased the costs of funding for state-owned and private banks with funding gaps that relied heavily on the interbank market to satisfy liquidity needs, partly because the central bank had stopped offering refinancing credit after the 1997 reforms (Gabor, 2010; BNR, 2008). Indeed, the share of transactions between banks reached 75% of total market volumes in that critical period, at interest rates as high as 160%. For patient banks, the anti-speculative strategy of the central bank and the asymmetric distribution of liquidity translated into prohibitive funding conditions. This further reinforced the dominant narrative of inefficient, poorly managed state-owned banks that had to be transferred into private, preferably foreign, ownership.

A similar process, albeit with different actors, unfolded after Lehman. The entry of non-resident investors on various asset markets since 2005 changes dynamics on the

interbank money market. Non-resident investors typically target high-yielding asset markets, funding their positions in cross-border wholesale money markets with low interest rates and abundant liquidity (Hattori and Shin, 2009). However, non-residents need to exchange the foreign currency funding for the target currency in order to hold assets. They can do so by entering swaps on the currency market, or directly borrowing in domestic currency. In both cases, domestic banks are typically the counterparty that provides non-residents with domestic currency (Galati et al, 2007).

Thus banks with excess reserves can choose to lend them on the interbank money market, to lend them to non-resident investors or to undertake their own carry-trade activities. Even banks without excess reserves may turn to the domestic interbank money market if providing domestic liquidity to non-resident carries becomes attractive. This diversification of market portfolios – underpinning the financialization of banking activity – partly accounts for the increasing importance of trading between banks in the interbank market once the capital account was liberalized. It also raises distinctive policy challenges when tensions in international financial markets translate into capital outflows or outright speculative pressures.

Should the central bank wish to curtail non-resident activity – or indeed to prevent a speculative attack – it can do so by tightening interbank money market liquidity to render it expensive for non-residents to borrow from domestic banks. The central bank must be prepared to accept high and volatile interbank interest rates in this case. Capital controls offer an alternative. For example, Latvia informally prohibited domestic banks to offer large domestic currency loans to counterparties intent on attacking the currency peg after September 2008 (Buiter and Sibert, 2008). Tee (2003) similarly attributes the successful attempts to prevent the internationalization of the Singaporean dollar to a range of capital controls that curtailed transactions between domestic banks and non-residents (either direct lending or derivative transactions).

Indeed, when non-resident investors began betting on the depreciation of the Romanian currency in October 2008, through large short positions funded by borrowing from domestic

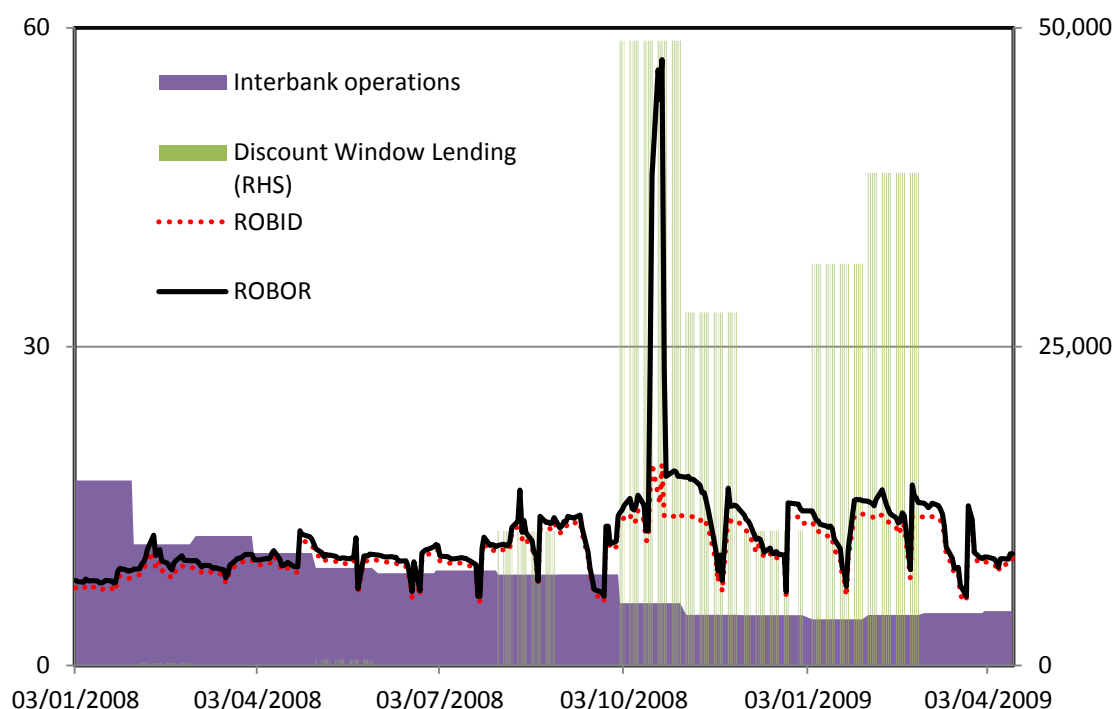
commercial banks (swaps), the central bank responded by inducing a liquidity shortage on the interbank money market. The intention was to reduce the access of speculators to domestic (RON) liquidity, as the governor explained:

We must wait and see if these quotes are genuine. If those who buy foreign currency can afford to pay high interest rates. We want the market to continue to determine the exchange rate, but it has to be a properly functioning market, not one where options are contracted overnight...If the market is to function properly, **whoever wants to speculate on the Romanian leu must have Romanian lei**. The governor Mugur Isarescu in *Ziarul Financiar*, 2012²⁰

To reduce the access of speculators to Romanian lei, the central bank sold foreign reserves (reportedly using EUR 1bn to defend the currency). It also shifted liquidity management to the standing facilities, lending lei to commercial banks through the discount window at interest rates high enough to wipe out carry gains (see Figure 21). Indeed, resident banks borrowed from the discount window as much as RON 50bn throughout October 2008, triple the average volume of interbank trading before the crisis. The shortage of domestic liquidity became so acute for several days in October 2008 that currency swap rates increased to 500% and interbank offered rates - the rate at which banks are willing to lend to each other - increased to 50%. The central bank reported that several private financial institutions failed to close their positions (see Croitoru, 2011).

²⁰ <http://www.zf.ro/opinii/opinie-de-cristian-hostiuc-zf-cum-a-parjolit-bnr-pamantul-ca-sa-opreasca-atacul-asupra-leului-in-octombrie-2008-8213552>. Author's translation from Romanian and author's emphasis. The same newspaper article reports the governor intimating that a vice-president of Merrill Lynch had been phoning his home in order to ask where the non-resident institution could borrow domestic currency, given the reluctance of resident banks to lend once the central bank threatened them publically if they supported the speculative attack.

Figure 21 Liquidity dynamics, October 2008 speculative attack (% LHS, mill. RON RHS)



Source: data from the Romanian central bank.

Paradoxically, there is very limited available data to explore the mechanics of the speculative attack, the parties involved and ultimately, the vulnerabilities of dependent financialization. First, most transactions between non-residents and resident banks take place off-balance sheet. Furthermore, the central bank can act as a gate-keeper. During the October 2008 speculative attack, against future transparency, the central bank issued new legislation that it would not publish interbank market rates when these increased above the interest rate at the discount window. This decision effectively hides from public scrutiny the damage that the central bank's responses to financialized banking can inflict on patient banks.

The central bank also issued strongly-worded public warnings against commercial banks that provided counterparty liquidity²¹. Shortly after, employees of the three resident

²¹ See <http://www.zf.ro/eveniment/isarescu-dealerii-au-jucat-poker-in-octombrie-2008-si-au-pierdut-pascariu-unicredit-bnr-sa-spuna-vinovatii-8177393>

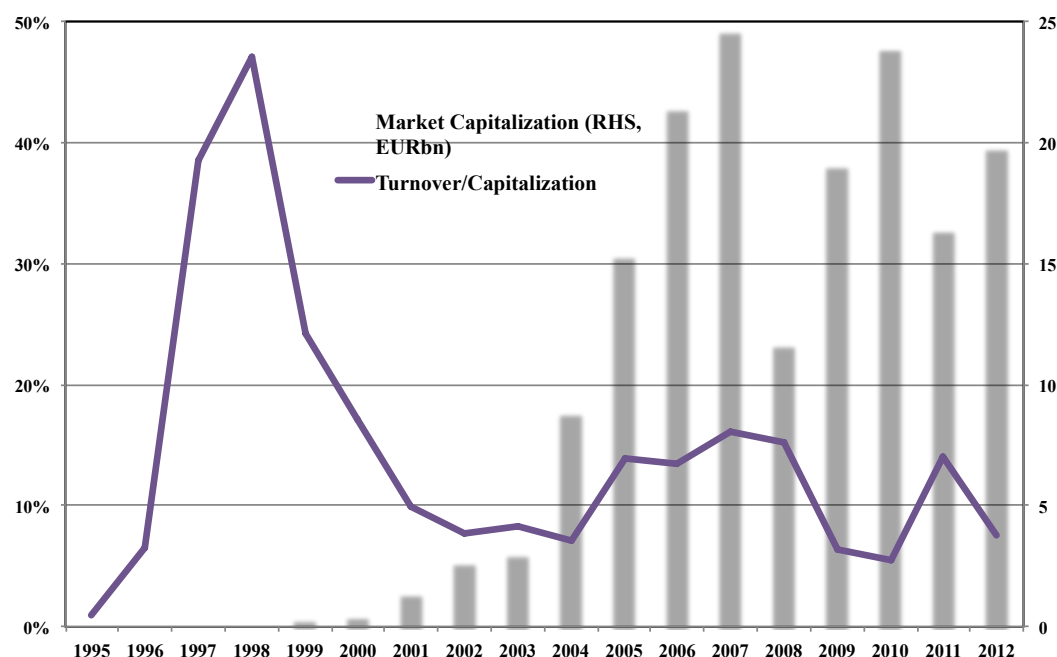
banks that the central bank had singled out left or were dismissed. Subsequently, the Romanian Competition Council launched an investigation into the potential anti-competitive, cartel behaviour of the banks involved in the attack, a Romanian equivalent of the British Libor investigations. After consultations with the central bank, the Council made its results public in April 2013 in a short press release. It decided that banks had not engaged in anti-competitive behaviour during the October 2008 episode, although it declined to offer an alternative narrative of an episode that the central bank clearly described at the time as a speculative attack. There are two possible explanations for this. Public authorities may have been persuaded that the information necessary to clarify what resident banks did in October 2008 was market-sensitive. Alternatively, this is another instance where the political power of large transnational banks is visibly exercised to shape the public narrative of their destabilizing practices. Both explanations point to a democratic deficit of dependent financialization that is less likely in the countries where the parent banks operate. The very public Libor scandal in the UK, the investigation and sanctions in its aftermath, clearly suggest that democratically elected institutions can rein in powerful financial interests.

5.5 The capital markets

The Romanian capital market is composed of two market operators, the Bucharest Stock Exchange (BVB) and the Sibiu Monetary and Commodities Exchange (Sibex) Market. The spot market is located at the BVB, whereas both BVB and Sibex trade derivatives. Set-up in 1995, the Bucharest stock market only gained pace after 2000, and increased rapidly since 2003. It registered an eightfold increase in market capitalization between 2003 and 2007, however coupled with a rapid relative decrease in liquidity (see Figure 22). Turnover, as share of market capitalization, decreased from the 50% peak in the early years to less than 20% after 2003. The financial crisis brought a rapid contraction in market capitalization in 2008, reversed after 2009. The central bank reports a similar regional pattern in the

volatility of stock market indexes, which it interpreted as evidence of common exposure to the pressures of the European sovereign debt crisis (BNR, 2012).

Figure 22 The dynamics of the Bucharest Stock Exchange, 1995-2012



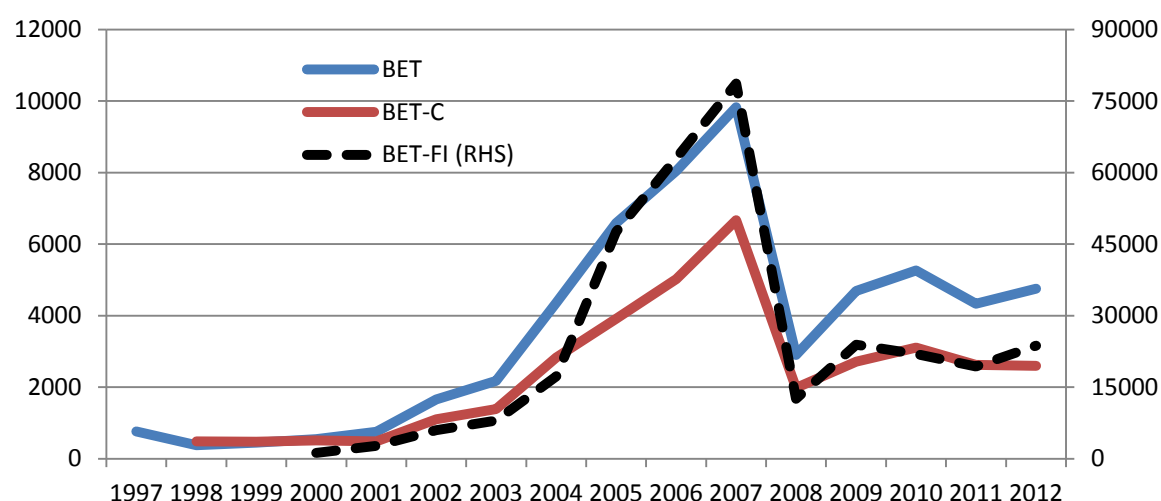
Source: data form the Bucharest Stock Exchange

The BVB reports three different indexes, grouping shares in terms of liquidity and structures of the issuing entity:

- a. BET: consists of the 10 most liquid stocks.
- b. BET-FI: refers to five, closed-end investment funds (SIF) constituted as part-owners of state-owned companies in 1996 to support the privatization process. According to the BVB, BET-FI represents an underlying trend for derivatives and structured products.
- c. BET-C: the most encompassing index, includes all shares except for the five SIFs.

The three indexes experienced a strong correlation since 1997, with higher values registered for the BET-FI (see Figure 23). The rapid contraction in 2008 was followed by a moderate recovery, with rates of growth far below the pre-2008 boom.

Figure 23 Stock market indexes, BVB Romania, 1997-2012



Source: data form the Bucharest Stock Exchange

The Romanian stock market trades the shares of financial groups (foreign-owned banks and a domestic bank), real estate companies, state-owned public utilities and private companies operating in the oil and gas markets. The only manufacturing company in the top ten by market capitalization is ALRO, a former state-owned aluminum producer privatized in 2002. The market structure is highly concentrated, with the top five stocks accounting for 80% of market capitalization. Conversely, the top 3 financial institutions, and the real estate developer, together account for 50% of market capitalization. Financial institutions dominate the stock market not only in terms of market capitalization, but also in terms of trading. According to IMF (2010) data, 23 of the 81 actors in 2008 were banks and their subsidiaries, dominant in the top ten by both trading value and volume.

Table 10 Companies traded on the Romanian Stock Exchange (Sept. 2012)

Company	Market share (%)
1 Erste Group Bank AG (<i>finance</i>)	39,99 %
2 OMV PETROM S.A. (<i>oil company</i>)	25,36 %
3 SC FONDUL PROPRIETATEA SA (<i>state-owned</i>)	8,28 %
4 BRD - GROUPE SOCIETE GENERALE S.A. (<i>finance</i>)	5,80 %
5 TRANSGAZ S.A. (<i>gas, state-owned</i>)	2,69 %
6 TRANSILVANIA Bank (<i>finance</i>)	2,49 %
7 NEW EUROPE PROPERTY INVESTMENTS PLC. ISLE OF MAN (<i>real estate</i>)	2,30 %
8 ROMPETROL RAFINARE S.A. (<i>oil refinery</i>)	1,58 %
9 ALRO S.A. (<i>aluminum, VIMETCO NL</i>)	1,41 %

Source: Bucharest Stock Exchange data

5.5.1 Derivatives market

The Sibiu derivative market registered a fivefold increase between 2003 and 2007, when it reached EUR 3.5 bn. It then contracted by almost half of market value in 2008, reaching EUR 1.8bn, a pace of contraction indicative of speculative positioning. The BVB derivative segment, introduced in 2007, registered a market value of turnover of EUR 3.8 million, much smaller in volume than the Sibex segment (IMF, 2010a).

5.5.2 The bond markets

Romania has a small bond segment on the Bucharest Stock Exchange. It launched with two small municipalities bonds in 2001; corporate bonds have been listed since 2003, and government bonds since July 2008 (see Table 11). Its relative importance is limited in

comparison with equities trading on the BVB: according to Pop and Georgescu (2011), turnover on the bond segment amounted to 8% of overall BVB turnover between 2001 and 2010. Public offerings reached less than 3% of overall turnover for the same period. On the corporate bond segment, IMF (2010) reports a small pool of issuers, dominated by banks (five out of six issuers).

Table 11 Government, municipal and corporate bonds trading, BSE, 2001-2012

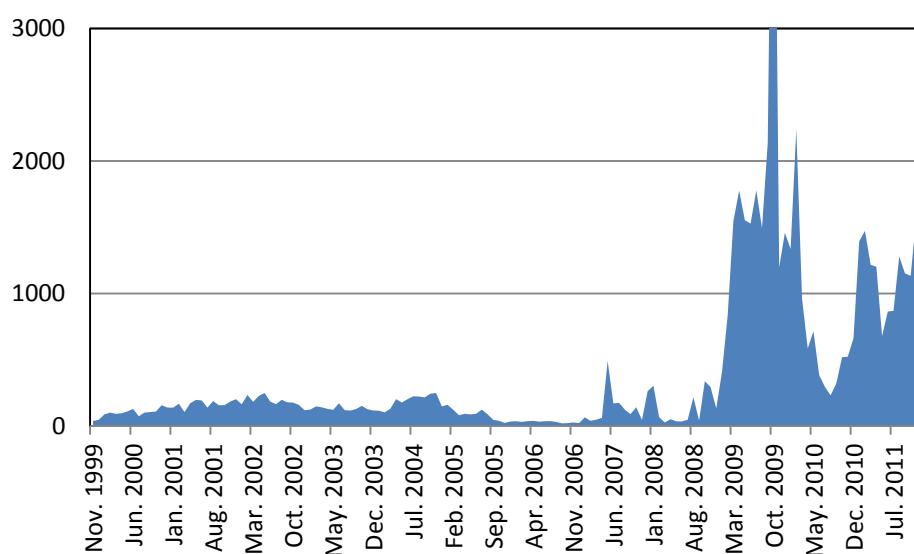
Year	No. of Trading Sessions	No. of Trades	No. of Bonds Traded (volume)	Turnover (RON)	Avg. Daily Turnover (RON)	No. of Bonds Issuers	No. of new listings
2001	17	5	45	481	28	2	2
2002	247	10	59,050	782,679	3169	4	2
2003	241	39	187,870	17,135,352	71,101	10	8
2004	253	1,116	530,466	289,794,852	1,145,434	22	16
2005	247	394	397,101	127,369,059	515,664	19	6
2006	248	570	3,917,457	985,517,593	3,973,861	19	5
2007	250	268	6,652,467	794,335,511	3,177,342	22	11
2008	250	552	1,214,353	231,929,951	927,720	50	33
2009	250	965	2,892,920	1,284,618,845	5,138,475	60	16
2010	255	543	3,014,375	2,571,065,247	10,082,609	55	7
2011	255	248	1,857,248	545,978,257	2,141,091	60	6
2012	232	374	233,773	1,323,719,648	5,705,688	68	8

Source: BSE data

Government bonds are mainly traded over the counter under the supervision of the National Bank of Romania (IMF, 2010). On the BVB segment, trade increased from EUR 5 million in 2008 to EUR 214 million in 2009 and EUR 544 million in 2010, as government's funding needs increased in the crisis, matched by demand from institutional investors

(pension funds) and non-resident. Trade on the interbank secondary market administered by the central bank registered higher volumes since the crisis, particularly throughout 2009 and then the second half of 2010 (see Figure 24). This reflects both supply and demand factors. The government has increased rapidly its issue of debt instruments to meet larger funding needs; tighter liquidity conditions on the interbank money market requires commercial banks to strengthen their collateral portfolios to access central bank liquidity; and finally, government bond instruments have proven an attractive asset for non-residents and pension funds.

Figure 24 Secondary government bond market (BNR segment), RON million, 1999-2011



Source: central bank of Romania data

In sum, capital markets have experienced a mixed evolution. The stock market grew rapidly before 2008, dominated by financial institutions both in terms of market capitalization and trading activity. The various segments of the bond markets exhibited highly volatile trading volumes, reflecting a small number of issuers that has grown since 2008. Increased issues of sovereign bond instruments are expected to increase liquidity on that segment,

demonstrated by the increased non-resident interest: the share of non-resident holdings of RON-denominated sovereign bonds increased from 7% in December 2009 to 18% in June 2011.

6. The financialization of the currency market

The financialization of currency markets is an important feature of dependent financialization. Currency market become financialized when the driving reason for currency flows is no longer 'real' economic activity, including international trade and foreign direct investment, but risk-trading and market portfolios described in the literature as carry-trades. Indeed, the currency markets of emerging and developing countries have become increasingly shaped by complex cross-currency trading strategies. Carry-trade investors rely on leveraged borrowing in low-yielding currencies (funding currencies) to take positions in high-yielding asset markets, typically in high-interest rate countries. However, carry-trades are notoriously difficult to measure, as most take place in off-balance sheet transactions (Curcucu et al, 2010).

Large and volatile capital flows, driven by short-term risk trading, have come to dominate the balance of payments and become the conduit for the transmission of global volatility to developing countries (Ostry et. al, 2010). Romania experienced these structural changes: its balance of payments, often in deficit throughout the 1990s due to structural current account deficits and limited access to international financial markets, turns to increasingly large surpluses after 2000 due to debt-generating capital inflows.

Three factors underpin the financialization of currency markets: yield differentials, ease of entry and ability to exit, and policy preferences for capital account management. First, countries with a high-interest rate environment or a rapidly growing economy will attract carry-trade activity. Higher capital inflows perversely feed asset bubbles, generating higher returns that increase the attractiveness to carry-trade activity (Hattori and Shin, 2009). For example, Brazil drew attention to a 'currency war' since 2009 because the cheap funding provided through unconventional monetary policies in high-income countries found its way into its high-yielding asset markets, appreciating the exchange rate and denting the competitiveness of its exports (Gallagher and Ocampo, 2013).

Second, ease of entry/exit refers to existing capital controls and the availability of domestic liquidity. Financial institutions, domestic or non-resident, can benefit from carry-trade opportunities if they face little restrictions on taking positions in high-yielding asset markets (including the sovereign debt market, the stock markets or bank deposits). Capital controls can curtail access to specific asset markets: for example, Romania decided to delay lifting barriers to non-resident holdings of RON bank accounts to April 2005, and to fixed income instruments in January 2006, because of concerns with speculative behaviour (BNR, 2007).

Even with a fully liberalized capital account, ease of entry depends on liquidity conditions on the interbank money market (see Section on Interbank money market). In carry-trades, financial actors hold liquid, short-term assets in the target currency. For this, the funds borrowed in the funding currency must be exchanged in the target currency market, either on the spot segment or through derivative instruments. Non-resident investors must find counterparties willing to provide domestic liquidity. The central banks can, in principle, restrict domestic banks' willingness to do so directly through caps on interbank transaction volumes (see Buiter and Sibert, 2008) or by tightening liquidity conditions on the interbank money market (Croitoru, 2011; Gabor, 2012b). This points to the importance of capital account management: if the central bank relies on sterilized currency interventions, it effectively supplies resident banks with domestic liquidity that can be lent on to non-residents for carry-trade positions.

Lastly, ability to exit is fundamental to financialization (see Hardie 2011 for government bond markets). Carry-trades represent a bet against the uncovered interest parity condition, the theoretical proposition that currency trading cannot generate speculative returns because an interest rate differential reflects expected depreciation of the high-yielding currency (Plantin and Shin, 2011). During periods of market uncertainty, carry-trades remain profitable if traders can close positions in response to either increased interest rates in the funding currency or volatility in the exchange rate of the target currency. Controls on capital outflows – successfully imposed by Iceland after 2008 (see

Helgadóttir, 2012) – can prevent carry-traders from rapidly unwinding positions. In other words, capital account management plays a crucial role in the financialization of the currency markets, both directly through regulatory restrictions on distinctive types of flows and indirectly through the liquidity management strategies (in the context of capital account management) of the central bank.

This chapter details the increasing financialization of the Romanian currency market. It first outlines balance of payment dynamics since 1990, noting the increased reliance on large capital account flows, intermediated by the banking sector. Next, it documents the increasing dominance of financialized actors and practices in the currency market.

6.1 Capital account liberalization

Romania committed to capital account liberalization as part of its strategy for integration into the European Union. It outlined a detailed timetable for capital account liberalization in 1999, when it started by liberalizing medium and long-term international trade and financial loans extended by non-residents to residents. Full liberalization would be achieved in 2006 so that the country could enter the European Union in January 2007.

In 2001-2002, Romania proceeded to liberalize capital inflows with a limited impact on the balance of payments. These included resident real estate and direct investments abroad; Romanian financial instruments on international capital markets; non-resident collateral extended to residents; personal capital transfers, including donations, inheritances, non-resident short-term loans extended to residents; medium and long-term international trade loans extended by residents to non-residents; capital transfers linked to life and credit insurance contracts.

Capital flows with a significant potential impact on economic activity were liberalized starting with 2003. These included residents' trading in foreign financial instruments, short-term financial loans extended by non-residents to residents; collateral lending by

residents to non-residents. Foreign securities, including mutual funds instruments, started trading on domestic capital markets in 2004.

Policy makers decided to liberalize of capital flows with a clear carry-trade intention just before the EU entry. It is important to remember that carry-trade strategies rely on investors' ability to hold assets in domestic currency – be those bank deposits, government debt or other tradable instruments – with higher yields relative to the funding currency. The central bank thus delayed lifting restrictions on non-resident holdings of RON bank accounts from January 2004 to April 2005. Non-residents were allowed access to government bonds, bills and money market instruments in 2006.

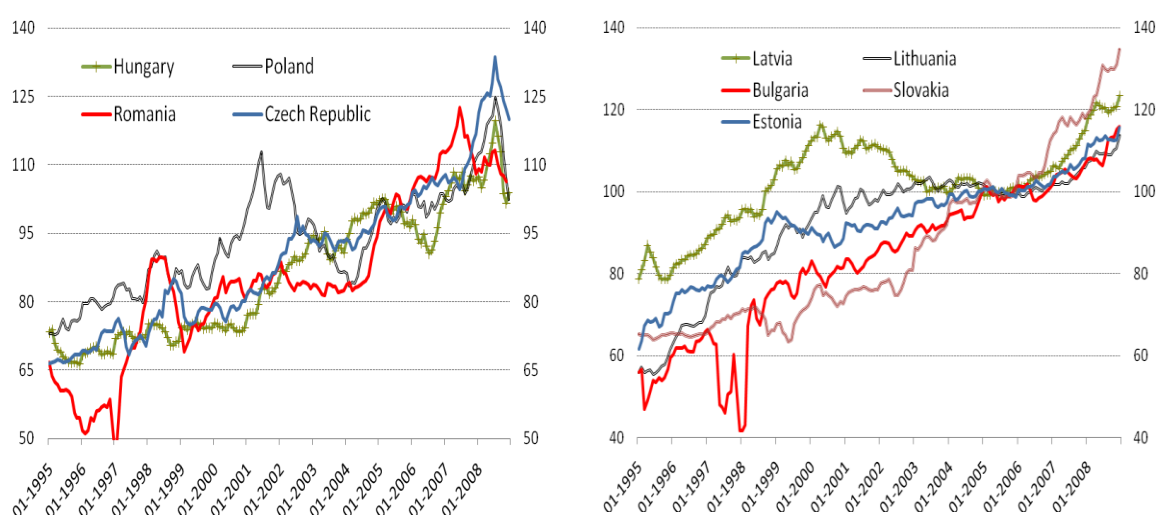
Indeed, according to the central bank governor, the IMF advised Romanian authorities to postpone the liberalization of carry-trade flows, pointing to the substantial yield differential and the limited capacity of the banking sector to accommodate such flows without endangering financial stability (Isarescu, 2012). But to heed such advice, Romania would have had to postpone its EU entry, conditional on a fully liberalized capital account. Instead, the central bank identified a series of measures that would curb the incentives for speculative capital inflows. Throughout 2005 and 2006, it lowered policy rates at an accelerated pace, increased required reserves on foreign liabilities, tightened prudential measures governing banks' lending and insisted that wage and fiscal policy had to target capital account sustainability.

6.2 Balance of payments dynamics

An IMF paper comparing the regional growth performances before 2008 commended Eastern Europe, including Romania, for successfully matching East Asia's record after the initial 'shock of transition' (Fabrizio et al, 2009). It recognized that distinctive preferences for integration in international financial markets underpinned the success story. Contrary to the East Asian experience, in particular after the 1997 crisis, formerly planned economies embraced financial integration and real exchange rate appreciation. Indeed,

pre-crisis exchange rates saw a coordinated strengthening independent of the exchange rate regime. The countries that adopted an inflation targeting regime and (formally) renounced currency interventions (Romania, Poland, Czech Republic and Hungary) experienced real exchange rates appreciations similar to fixed exchange rate regimes (see Figure 25). Romania bucked the trend in 1995 and 1996, when the exchange rate depreciated in real terms as nominal devaluations outpaced inflation. It converged to the regional trend after 1997, experiencing a rapid appreciation driven by increasingly large capital inflows.

Figure 25 Real exchange rate movements, comparative trend, 1995-2008 (2005=100)



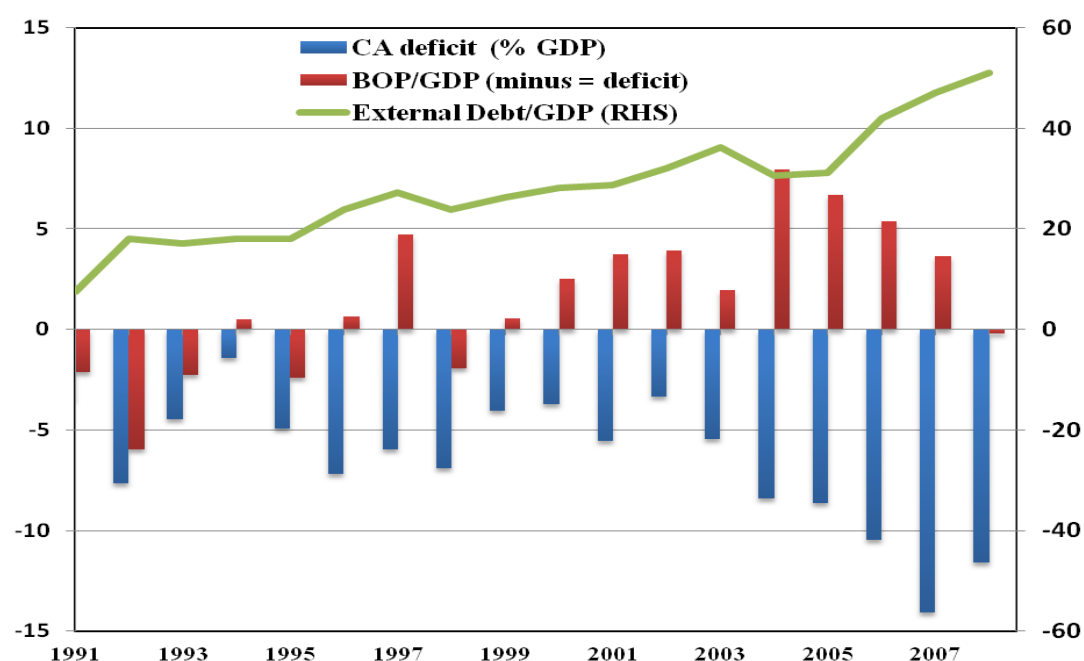
Source: Bank for International Settlements statistics

The common trend was explained as corrections in relative prices through productivity gains, described as the Balassa-Samuelson effect. Assuming wage equalization across sectors, productivity increases in the traded sector would trigger upward wage adjustments, higher prices for the non-tradable sector and higher inflation (Egert et al, 2002). Disagreements of magnitude aside, the Balassa-Samuelson explanations suggested that policy concerns with exchange rate trends were unnecessary. Such a position dovetailed well with the prevailing view of optimal exchange rate management after the

Asian crisis: corner solutions, either hard pegs or floats, functioned better than soft pegs to deter speculative attacks. Furthermore, the increasing appeal of inflation targeting regimes among emerging countries endorsed the idea of devolving exchange rate dynamics to the market: the credibility of a well-performing inflation targeting regime would avoid swings in investor sentiment (Taylor, 2000).

Indeed, Romania's external position reflects the structural differences between the two phases of financialization. Before 2000, it faced difficulties in securing international funding for its structural current account deficits (see Figure 26). Throughout the 1990s, it only registered a significant balance of payment surplus in 1997 (coupled with a large trade deficit), as it received large portfolio inflows into the sovereign debt market, attracted by high yields that governments paid to raise market funding (see IMF, 1998). The capital account liberalization, initiated in 1999, has been accompanied by larger current account deficits (predictable given the real exchange rate appreciation documented above) but also larger balance of payments surpluses, accumulated through debt-generating capital inflows. Indeed, external debt increased rapidly as a share of GDP after 2000, from 12% to almost 55% by 2008. The capital account surplus turned into a deficit in 2008, due to large capital outflows in the aftermath of Lehman.

Figure 26 Balance of payment dynamics, Romania, 1990-2008



Source: data from the ECB Statistical Warehouse

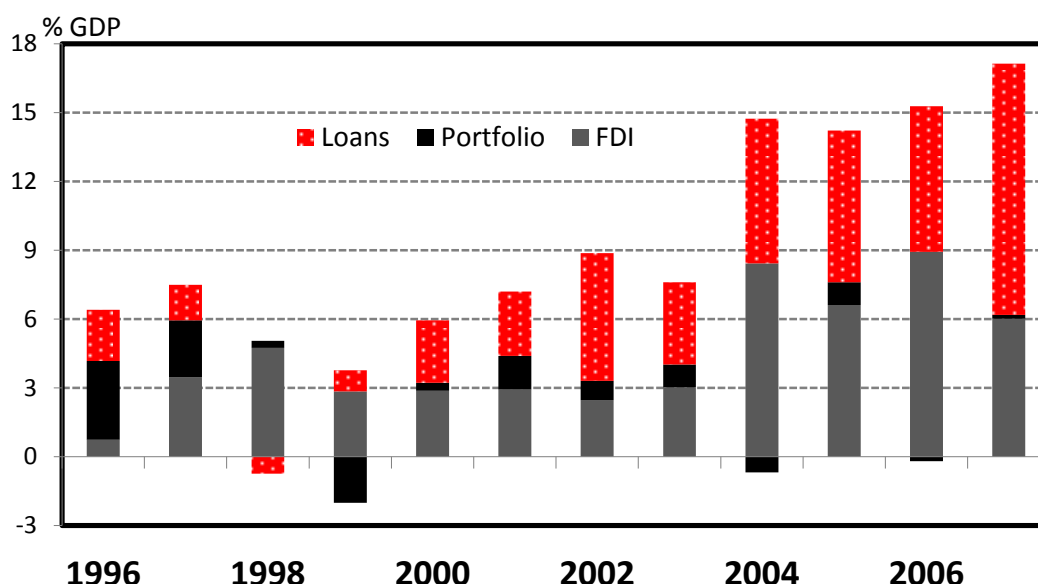
On the capital account, debt-generating inflows have consistently outpaced foreign direct investment. Indeed, FDIs have made a volatile contribution to financing the current account deficit, rising above 6% of GDP from 2004 onwards (see figure 27).

Throughout the early years, FDI was mainly privatization-related, often in situation of crisis when governments faced increasing international pressure -from both the IMF and the World Bank - to privatize state companies. For example, the high inflow in 1998 was driven by the privatization of the state-owned telecommunications monopoly and a large state-owned bank. After 2000, FDIs increasingly targeted non-tradable sectors including services, constructions and utilities, as in other Eastern European countries (according to Eurostat data for 2007-2009, around 80% of FDI flows). For Romania, over 60% of the outstanding FDI stock in 2009 focused on sectors without export activity, contradicting the initial optimism that foreign direct investment would help the country improve its export competitiveness. In fact, Voinea (2012, p.15) suggests that on the contrary, FDI flows were

‘speculative investments in disguise’ as half of incoming FDI for 2007 and 2008 consisted of inter-company loans chasing short-term yields. In other words, in dependent financialization, ‘real’ flows may in fact mask new forms of carry trades.

The reliance on portfolio inflows, arising from international debt issuance (bonds or other financial instruments), throughout 1996 and 1997 produced a peak in debt service in 1999. In net terms, portfolio flows ebbed off afterwards compared to both FDI and loans.

Figure 27 The structure of capital flows, 1996-2007. Romania

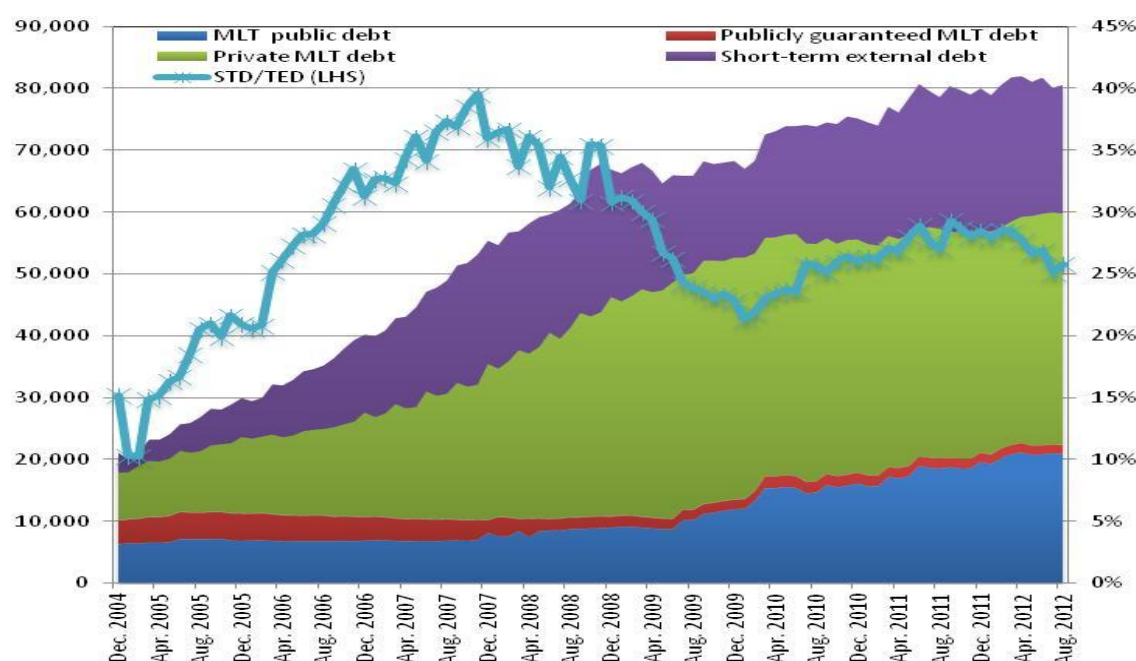


Source: data from ECB and National Bank of Romania

A detailed view of the external debt dynamics reveals that the private sector has been the key factor behind the growth in external debt, particularly through the banking sector. Indeed, banks funded rapid asset growth increasingly by borrowing from parent banks or through wholesale cross-border markets. Cross-border lending to Romanian banks accelerated after 2002 to reach almost 18% of GDP by 2008, raising the distinct possibility of intra-group contagion. Further notable, and concerning for financial stability, has been the shortening of the maturity profile accompanying the increasing liberalization of the

capital account (see Figure 28). Between 2004 and 2008, the share of short-term debt in total increased from around 15% to almost 40%, driven by banks' short-term funding liabilities and the increasing presence of non-resident investors in Romanian asset markets. That exposure proved costly in 2008, when non-residents left Romanian asset markets after a failed speculative attack (Croitoru, 2011), leading to a rapid exchange rate depreciation and a contraction in the share of short-term debt to 25% of total debt within a year.

Figure 28 External debt dynamics (EUR million), 2004-2012.



Source: Bank for International Settlements statistics. Note: STD/TED: share of short-term debt in total external debt.

6.3 Actors and strategies on the currency market

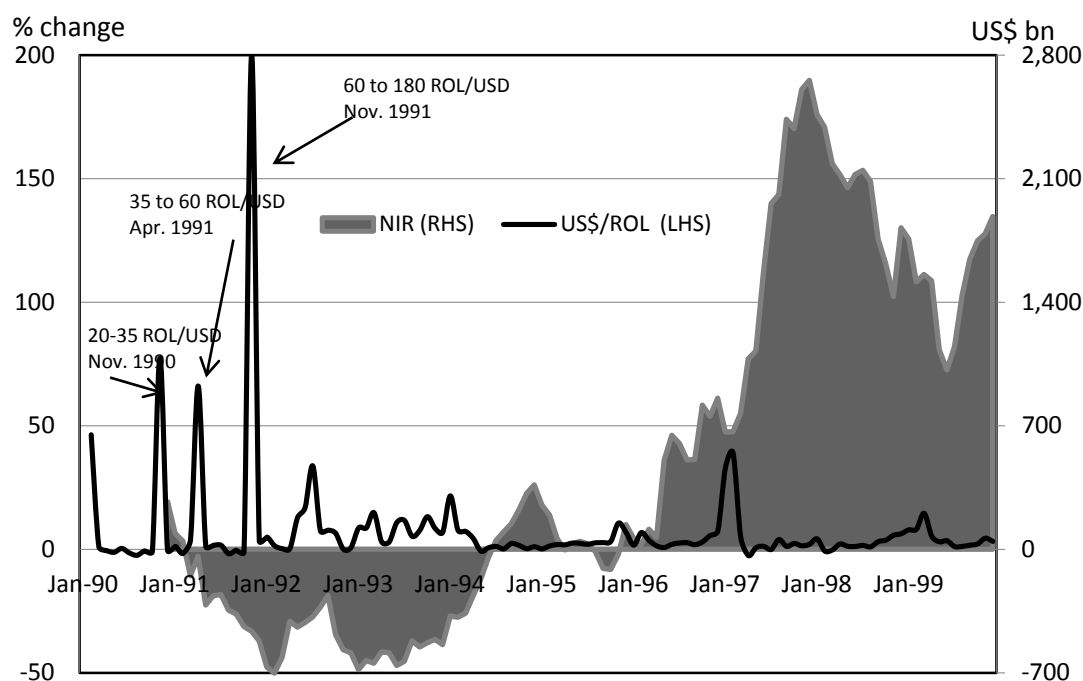
Recent research on institutional changes in currency markets has recognized the increasing importance of cross-currency trading strategies known as carry-trades. Indeed, Kohler (2009) draws attention to a qualitative shift in the process of contagion during a

financial crisis with regional or global implications. Unlike the Asian crisis or the Russian debt default, the global financial crisis saw a rapid contagion across the currency markets of developing countries irrespective of the underlying economic conditions, quickly followed by a sharp reversal. This, she argues, points to the increasing importance of interest rate differentials and practices of carry trade. The dynamics of the Romanian currency market illustrate well the structural changes arising from financialization.

The currency market was formally created in 1994²², and experienced little financialization before 1997. Demand for foreign currency was generated by importers of consumer goods or intermediary products necessary in the industrial sector and by households and companies increasingly shifting their savings to foreign currency as protection against inflation and rapid exchange rate depreciation. In turn, supply often failed to match increasing demand due to poor export performance arising from industrial restructuring, lost export markets and tight monetary policy that restricted state-owned companies' access to long-term investment finance (see Macroeconomic Policy). The exchange rate depreciated rapidly before 2000, without correcting current account deficits (see Figure 29).

22 Interbank currency auction sessions were liberalized in April 1994 and a fully fledged currency market began fully operating from August 1994, in fulfilment of an IMF structural performance criteria (see Gabor 2010a).

Figure 29 Nominal exchange rates (change) and central bank net international reserves, 1990-2000



Source: central bank data.

While formally committed to exchange rate flexibility, the central bank often tried to arrest the rapid exchange rate depreciation (see Chapter on Exchange rate policies). Its interventions implicitly recognized that flexible exchange rates could not restore the external balance since the current account remained in a structural deficit because the productive sector depended heavily on imports of intermediary products, as developing countries typically do. In turn, the IMF's refused to support a managed exchange rate, instead demanding large devaluations to accompany its balance of payment support (as in April 1991). Without IMF support, the central bank could not follow the Polish strategy of a Zloty Stabilization Fund (Sachs, 1996) that underpinned both exchange rate and macroeconomic stability. Instead, the net international reserves of the central bank

remained in negative territory between 1991 and 1994, depleted by large current account and balance of payment deficits.

After 1997, financialization picked up, driven by resident banks' market portfolios and the central bank's macroeconomic strategies. Indeed, the central bank enabled this trend when it shifted, with IMF support, to a managed exchange rate strategy in early 1997. It tailored its policy efforts to achieving sustained exchange rate appreciations that would, through the exchange rate pass-through, support its disinflation efforts. A sterilization game ensued, a form of carry-trade strategy through which commercial banks intermediated capital inflows to place in two highly profitable target assets – government bonds and central bank sterilizations (Christensen, 2004; Gabor, 2010a,b, 2012b).

Rather than simple liquidity management tools, sterilizations can alternatively be viewed as part of strategy to attract capital inflows that the central bank needed to reduce inflation (see section on interbank money markets). With capital controls and financial markets too underdeveloped to create attractive carry assets (stocks for example), the central bank offers resident commercial banks sterilization assets. Resident banks thus become intermediators of capital inflows, obtaining significant carry-trade profits by depositing the RON liquidity obtained from the central bank on the currency market in sterilization instruments. Thus, the interbank segment of the currency market first outpaced in relative importance non-bank transactions in 1998, a dynamic that the central bank explicitly linked to speculative (i.e.) carry trade activity:

In previous years, non-banks' transactions accounted for a major proportion of total forex operations but, since 1998, interbank transactions have been competing with the non-banks' transactions (in the beginning, with equal volumes of up to USD 550 million per month to reach, as of August 1998, more than USD 1 billion per month on the side of banks). The interbank forex market became increasingly transparent, robust and steady, on the back of higher amount of transactions, though the key

negative effect was a more speculative behaviour of banks, which made the intervention of the central bank even more costly. (BNR annual report 1998,p.65).

That same year, Romania first experienced a crisis of financialization, against a peak in external debt service and the Russian crisis (see Section 6.4.2 on Speculative Attacks). The central bank sought to reduce exchange rate volatility throughout December 1998, and again in March-April 1999, by combining foreign currency sales with sterilizations at very high interest rates, pushing interbank short-term interest rates high. The ensuing liquidity shortages contributed to the banking crisis in 1999, suggesting that financialized currency markets entail a problematic trade-off between the external balance and domestic credit conditions. Although the central bank recognised this trade-off (BNR, 1998), it continued with its sterilization strategy and contributed to the increased financialization of banking activity. By 2003, the central bank's sterilizations rose to 38% of GDP, to decrease afterwards. Almost a third of commercial bank assets were generated through operations with the central bank between 1997 and 2005.

6.3.1 The 2005 failed attempt to decouple interbank money and currency markets

Prior to the 2008- crisis, the central bank attempted once to abandon sterilization games that tied money market liquidity and currency markets (see Gabor, 2010a). In September 2005, it announced that it would shift to exchange rate flexibility and change its liquidity management strategy in line with the newly adopted inflation-targeting regime. It explicitly identified commercial banks' demand for sterilization instruments as speculative, carry-trade practices arising from currency trading and warned that it would only offer sterilizations to non-financialized banks (with excess reserves from retail deposit activity):

We will resume sterilizations when placements will reflect deposit-taking activity rather than currency trading. When I sterilize, I check three elements of the balance sheet: liabilities, assets and volumes bid for sterilization – and I cannot accept

sterilizations bids from banks with a very low deposit base' (Ziarul Financiar, October 5, 2005).

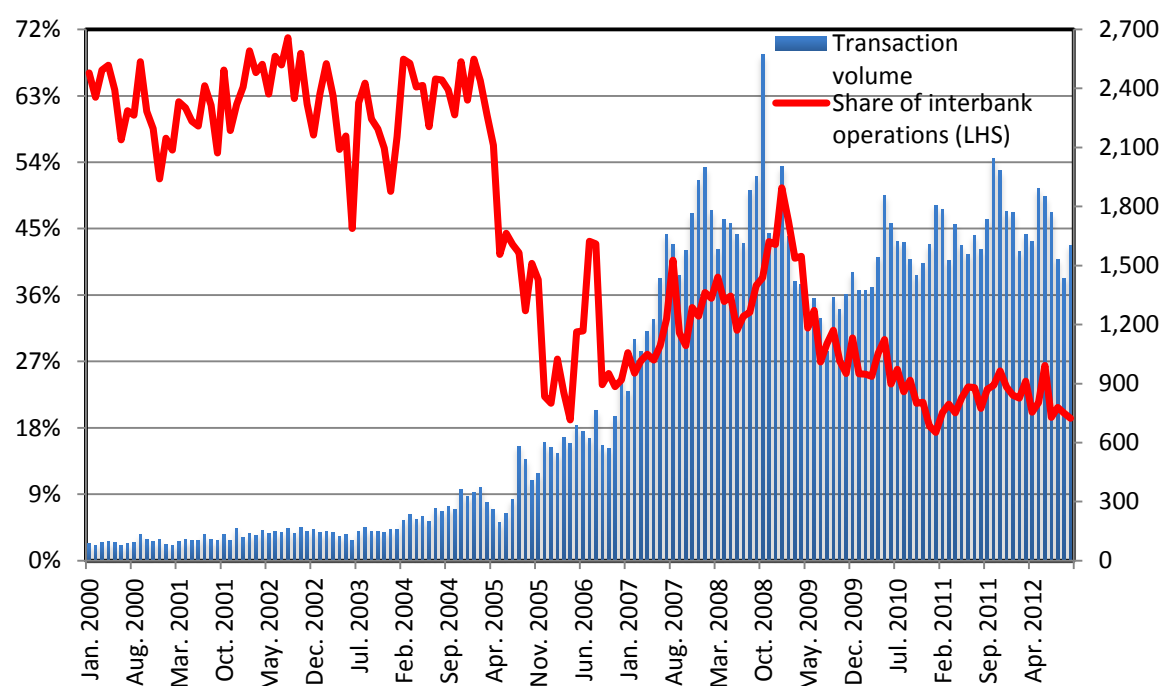
The shift in liquidity management revealed how interconnected the financialized money markets and currency markets had become. As resident banks could no longer place liquidity in sterilization instruments, they had to turn to the central bank's deposit facility. Whereas sterilization instruments offered resident banks yields above 10%, the deposit facility only paid 1% of overnight deposits. With one stroke, the central bank curbed carry profits for resident banks. The foregone profits were substantial. During September and October 2005, resident banks placed Euro 60bn (in domestic liquidity) at the deposit facility, 200 times higher than in July 2005 (Gabor, 2010a). Interest rates on the interbank market collapsed while the exchange rate began depreciating and confronted the central bank with increasing inflation in its first year of inflation targeting. Concerned with the impact on the credibility of its new regime, the central bank lost its resolve and resumed sterilizations, bringing the exchange rate back onto an appreciation trend.

6.3.2 The entry of non-resident investors

The shift to inflation targeting and the 2005 attempts to decouple money and currency markets partly reflected policy concerns that the last stage of the liberalization of the capital account, allowing the unrestricted entry and exit of non-resident investors, would have detrimental consequences for financial stability. Indeed, although Romanian authorities initially planned to lift restrictions on non-resident access to bank accounts in domestic currency in January 2004. The date was pushed back to April 2005. Non-residents were allowed to hold and trade government bonds, bills and money market instruments in 2006. In this reluctance, the central bank suggested that it was well aware of the potentially destabilizing effects of non-resident carry-trades.

Indeed, the entry of non-resident investors accelerated rapidly the financialization of the currency market. Currency trading increased rapidly from a daily average of EUR 537 million in January 2006 to around EUR 2 bn by January 2008 (see Figure 30), driven by non-residents. According to the central bank, in the first year after the full liberalization of the capital account (2006), non-resident trades on the currency markets registered a fourfold increase, higher in volume than trading by residents or domestic banks. The transactions volume peaked in October 2008, when non-resident took large shorting positions betting on an exchange rate depreciation.

Figure 30 Volume of transactions and share of interbank transactions, currency market, 2000-2012



Source: central bank data.

Simultaneously, interbank transactions lost relative importance, falling from around 60% of overall transactions before 2005 to less than 30% by 2007. This again reflects non-resident activity, since such transactions are typically over-the-counter, through derivative

contracts. Indeed, BIS data from the Triennial Survey of currency markets suggests that in Romania, as in other neighbouring countries, derivative contracts constitute the bulk of currency trading, at 60% of overall transactions compared with 75% for Poland and over 85% for Hungary in 2011. Non-resident investors dominate the derivative segment, trading in short-term instruments: 85% of derivative contracts had maturities for less than a week in 2007, a share that changed little with the crisis. Such a short maturity points to the carry-trade motives driving currency trading. In comparison, in 2007, derivative trading in Brazil or South Korea's saw limited non-resident involvement and longer maturities, suggesting that derivative positions arose from exporters/importer hedging activities. For Brazil in particular, this configuration changed rapidly with the crisis. Currency trading saw a threefold increase, driven by non-resident presence on the derivative segment, putting into context the 'currency war' rhetoric of its government.

Table 12 Profile of currency markets, selected developing countries

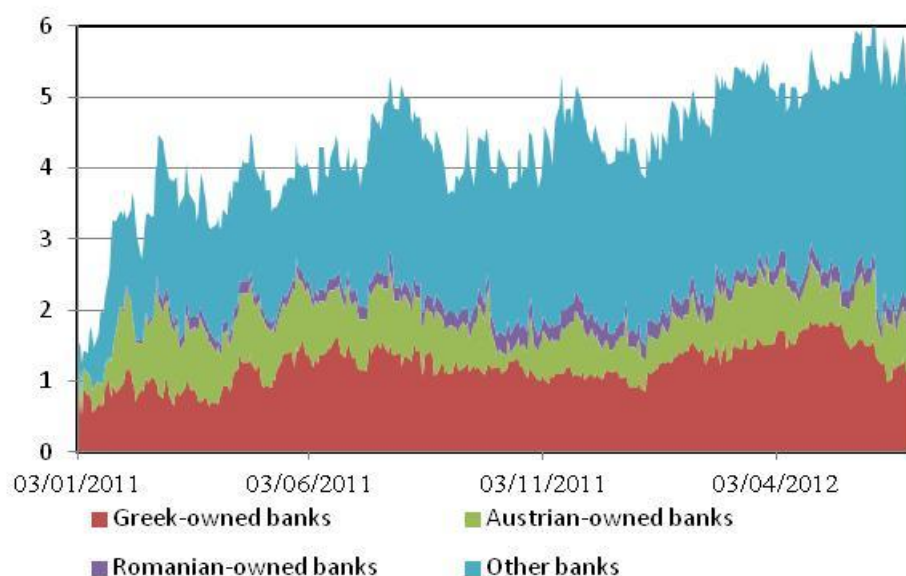
Country/ variable	Volume (daily average, million USD)		Derivatives (share of non- total trading)		of which residents		Instruments with maturity <7days	
	2007	2010	2007	2010	2007	2010	2007	2010
Brazil	5,456	14,094	7%	38%	33%	66%	27%	39%
South Korea	33,396	43,842	48%	58%	15%	31%	34%	47%
Turkey	3,362	16,817	77%	67%	89%	88%	58%	65%
Czech Republic	4,947	5,110	72%	79%	83%	78%	78%	84%
Hungary	6,715	4,196	67%	82%	87%	66%	78%	65%
Poland	8,813	7,847	73%	75%	83%	75%	77%	82%
Romania	2510	3,169	60%	61%	90%	85%	81%	79%

Source: own computation from BIS (2007, 2010) and Gabor, 2012b.

The transactions between resident banks and non-resident investors are thus crucial for the dynamics of financialized currency markets. Non-resident actors need domestic counterparties to lend them domestic liquidity necessary to purchase domestic assets or to take directional bets in the currency market. In the most extreme of cases, that directional bet takes the form of a speculative attack, as in October 2008. That attack eventually failed, and non-resident actors suffered losses (some failed to close positions), because the central bank prevented resident banks from providing counterparty liquidity to non-residents (Gabor, 2012b). The central bank of Latvia followed a similar strategy, imposing caps on resident bank' loans in domestic currency that were not justified by 'real' activity, in order to prevent speculations against its fixed exchange rate regime (Buiter and Sibert, 2008).

Conversely, resident banks may rely on non-residents to raise short-term funding in foreign currency once risk appetite returns. Indeed, the Romanian central bank reported that resident banks' currency swaps with non-residents increased sharply from around EUR 1.5bn in January 2011 to above EUR 5bn in August 2012 (see Figure 31), largely conducted at short-term maturities (FSR, 2012: 64). In the context of the European sovereign debt crisis, Greek-owned banks in particular resorted to this funding strategy, providing domestic liquidity to non-resident investors attracted by large yield differentials in the government bond market and in the stock market. Indeed, the share of non-resident holdings of RON-denominated sovereign bonds increased from 7 percent in December 2009 to 18 percent in June 2011. Whereas this solves the short-term funding problem of resident banks, particularly for subsidiaries with parents struggling in their home markets, the dependency on volatile funding contributes to financial fragility since non-residents can quickly unwind carry trades once, for example, central banks in high income countries signal exit from unconventional monetary policies.

Figure 31 Currency swaps with non-residents, 2011-2012, Romania, EUR billion.



Source: central bank data.

To sum up, the financialization of the Romanian currency markets went through two stages, distinguished by the type of actors and strategies prevailing in the market. In the first stage, with a partially liberalized capital account, commercial banks dominated the currency market and linked its dynamics to the interbank money market. Commercial banks obtained speculative returns from the central banks' sterilization instruments, transformed into an asset class for carry-trade portfolios (see Ooi, 2008 for a similar experience in East Asian countries). The increasing presence of foreign banks strengthened this tendency by allowing subsidiaries access to foreign currency funding, to be then exchanged on the spot segment and placed in sterilization vehicles. The entry of non-resident investors after April 2005 marked a new stage. Currency trading increased sharply, driven by short-term positions through the derivatives market. Aside from proprietary trading, commercial banks initiated new financialized practices, most importantly to provide counterparty liquidity to non-resident investors. Given growing difficulties for parent banks in European wholesale funding markets, subsidiaries have responded by turning to short-term currency swaps with non-resident investors to meet liabilities in foreign currencies.

7. Regulatory framework

The Romanian central bank is the institution primarily responsible for financial stability and accountable directly to the Parliament. The National Council for Financial Stability was established as late as 2007. The central bank authorizes the creation of new financial institutions that take deposits or other public liabilities. The government has no legal methods for challenging central bank independence. The 2004 Banking Act set out the legal framework for banking supervision, including objectives, independence, powers, transparency and coordination. Subsequent amendments to the legal framework typically occur to transpose new EU Directives or in response to local developments. Deposit insurance was introduced in 1996, during the first wave of (private sector) bank instability. Initially, companies did not have access to deposit insurance. The maximum threshold was adjusted repeatedly since the fall of communism in line with inflation.

Although Basel II provisions were officially adopted in 2006, credit benefited from another two years to comply with the standards. The central bank identified two reasons for the delay (FSB, 2006). It first cited a high level of liquidity in the banking sector that it viewed to mitigate the risks underpinning the Basel II regulatory framework. Second, the central bank accepted private banks' arguments that the costs associated with the implementation warranted a longer timeframe. However, in the Romanian context, the delays in the implementation of Basel II cannot account for the build-up of vulnerabilities in the financial sector. For example, by Basel II standards, Romania had adequate protection from the global financial crisis – in December 2008, Capital Adequacy Ratios for Romanian banks were well above the threshold required by European and international regulation (13.8% compared to 8%). Only three months later (April 2009), Romania requested IMF support to address the exposure of its banking sector to short-term external debt accumulated during the boom years.

A two-tiered supervisory framework is in place for non-bank financial intermediaries, the second largest type of financial institutions. Large entities, accounting

for over 90% of total assets in this sector, must register with the Special Register and are subject to supervision since 2006, whereas the rest of NBFIs belong to a General Register and are only subject to monitoring. The new legislation sought to address the lower standards of appraising credit worthiness and high concentration of currency risk. Credit unions remain outside the scope of various regulatory and prudential measures because they are not allowed to take deposits.

7.1 Prudential measures

Before entering the European Union, the Romanian central bank operated with a tight regulatory regime, particularly on the household credit segment. Indeed, regulatory measures introduced in February 2004 and strengthened in September 2005 envisaged a comprehensive range of counter-cyclical macroprudential measures. These included a maximum monthly payment commitments to 35% of net income for borrower and family; a loan-to value-ratio of 75% for both purchases of existing dwellings or cost estimates for building new ones; a collateral to loan value of at least 133%; ceiling on lenders' exposure to currency credits of 300% of own funds for credit to un-hedged borrowers. These measures constrained the pace of lending to households. By the end of 2006, the central bank reported that the average mortgage loan registered values well below the average house price, and that over 65% of all mortgage loans remained below the average value (FSR, 2006).

The prudential provisions eased considerably in January 2007. Paradoxically, the central bank decided to eliminate macroprudential measures at a time of rapid growth in foreign currency credit, invoking the need to align to European regulatory standards once the country became a member of the European Union. Financial institutions would henceforth

rely on their own risk assessment models for lending²³. The central bank only retained reserve requirements as a tool to stem rapid credit growth. The effects became apparent immediately, with household housing credit increasing by 80% in real terms in 2007, three times faster than in the previous year. The bulk of this credit growth came from foreign currency credit, with a growing share from ‘exotic’ currencies such as Swiss Francs and Japanese Yen. This trend largely reflected parent bank strategies of raising funding in low-yielding currencies in international money markets. The growth rate subsided significantly in the last months of 2008, and the levelled off completely by 2010.

The developments on the insurance sector triggered regulatory interventions both before and during the crisis. As the household-lending boom picked up pace in 2003-2004, regulators became concerned that practices on the credit insurance segment, dominated by companies affiliated to banking groups, could trigger systemic instability. On that segment, companies were providing insurance contracts for both mortgage and consumer credit that borrowers could use as collateral to access bank borrowing. In other words, the banking group, through its lending and insurance arms, manufactured collateral in order to sustain a rapid pace of growth in the highly profitable housing segment. In a coordinated move, the central bank and the insurance commission established constraints on underwriting risk attached to consumer and mortgage loans in March 2004. The share of credit insurance decreased from 7.7 % of the general insurance volume in 2004 to less than 2.7% in 2008, with further decline during the financial crisis. This trend suggests that, with adequate regulatory measures in place, the interconnectedness between various financial market segments that underpins systemic risk can be successfully contained. Furthermore, additional prudential measures in the insurance sector were implemented

²³ According to the central bank: “BNR Regulation No. 3/2007 on limiting credit risk associated with loans to households, published in Monitorul Oficial al României No. 177/14 March 2007 stipulates that the maximum accepted monthly payment commitments are established by lenders, in terms of categories of clients, in their regulations, which must be approved by the BNR. The Regulation sets forth that, until the approval by the BNR of the internal regulations of credit institutions and non-bank financial institutions, monthly payment commitments shall be no higher than 40 percent. The Regulation repealed BNR Norms No. 10/2005, as subsequently amended and supplemented, on limiting credit risk associated with loans to individuals”.

once tensions in the international financial markets spread to Romania. These referred to gross technical reserves, tightening quality and dispersion requirements, and shifting to mark-to-market accounting for financial instruments included in prudential indicators (BNR, 2010).

7.2 Regulatory struggles in dependent financialization

Transnational banks have dominated the Romanian banking sector since early 2000. This was the result of privatization processes and green entries underpinned by a broader belief that foreign-owned banks would increase the availability of capital and improve its allocation in a post-socialist context. However, the global financial crisis has demonstrated that the regulatory framework, both in the national provision and cross-border cooperation in the institutional architecture of European transnational banking, were ill equipped to mitigate the risks specific to transnational banking (Kudrna and Gabor, 2013).

The post-Lehman threats that Western banks would withdraw support to subsidiaries in Romania (and elsewhere in Eastern Europe) could not be addressed through the existing institutional mechanisms. Instead, the European Bank for Reconstruction and Development and the International Monetary Fund became essential actors in setting up an ad-hoc arrangement – known as the Vienna Initiative – that brought together parent banks and regulators from host and home countries in order to secure the former's commitment to maintain their presence in Eastern Europe (see Nitsche, 2009).

Thus, Romania's vulnerabilities to global financial tensions reflected changing business models for large European banks present in the domestic banking system. The Liikanen (2012) report provides detailed evidence about the shift to market-based banking. Indeed, large banks become increasingly less reliant on traditional deposit activity to fund their asset portfolios, turning instead to wholesale funding markets. Consider the nine parent banks that signed the Vienna Initiative for Romania: Erste Bank Group, Raiffeisen Group, Eurobank EFG, National Bank of Greece, Unicredit Group, Société Générale, Alpha

Bank, Volksbank International and Piraeus Bank. Of these, the Financial Stability Board identified Unicredit and Societe Generale as institutions of global systemic importance. Furthermore, Liikanen Report data for 2011 showed that Societe Generale funded only 28.8% of its total assets through customer deposits, Unicredit 44%, Raiffeisen Group 45% and Erste Bank 56.6%. Several of the banks that were systemically important in both the home market and the Romania market had turned to wholesale funding sources.

For host countries such as Romania, such a structural shift is relevant where transnational banks centralize funding and liquidity decisions rather than follow a decentralized model where the subsidiary depends on the domestic deposit base (BIS, 2010). The rapid growth in cross-border bank liabilities before 2008, documented earlier, confirms that large transnational banks present in the Romanian banking sector relied extensively on internal capital markets to allocate financial resources across the group. Banks can thus expand faster than the local deposit base would allow, by accessing funding raised by parent banks from home or other host countries (De Haas and van Lelyveld, 2010). Because banks factor in economic and political developments in home and host countries alike when making decisions about liquidity (re)distribution through internal capital markets, host country regulators face distinctive challenges both during normal and crisis times.

A foreign-owned banking sector renders the conduct of monetary policy, and regulatory activity, more complex. During normal times, liquidity premia depend on the parent bank, and global liquidity conditions, rather than the central bank's decisions about the supply of liquidity (Woodford, 2007). Indeed, Kudrna and Gabor (2013) explain that loan-pricing decisions in transnational groups with centralized liquidity management depend less on the policy interest rate of the host central bank. Instead lending rates depend on internal prime rates - reflecting broader funding conditions for the group - and the risk premium for the countries where subsidiaries operate. This was the case for Romania until 2010, when the implementation of the European Directive on Consumer Credit resulted in a more transparent mechanism through which banks calculated lending rates on consumer

lending in relationship to a market rate (LIBOR or EURIBOR) rather than internal prime rates.

Impaired monetary control constrains central banks' ability to curb credit cycles, particularly in the upturn phase. For example, when the Romanian central bank raised the policy rate rapidly throughout 2007 in order to contain credit growth, banks responded by switching to foreign currency credit, on terms more attractive for borrowers than the domestic currency loans. Furthermore, transnational banks may actively arbitrage distinctive regulatory provisions across the different jurisdictions where subsidiaries operate.

Thus the Romanian central bank warned that half of active banks in Romania made recourse to loan externalization in order to circumvent regulatory caps on foreign currency credit or to take advantage of cheaper funding conditions (FSB, 2010). According to the central bank, the practice of loan externalization took two distinctive forms. Banks transferred loans from their balance sheet, usually to the parent or other counterparty in the same group. This constituted the predominant form of externalization, with a share of 70% of total loans externalized, estimated at around EUR 10bn in September 2009. Banks also intermediated loans for companies demanding large-value loans, either because of balance sheet constraints or due to the preference of the company to rely on existing relationships with the parent banks. Although the central bank statistics do not offer a detailed picture of the activity undertaken by companies involved in loan intermediation, the large-volumes identified in the central bank reports suggests that these were companies involved in the development or purchase of real estate assets, probably on the commercial segment, with FDIs masking speculative investments (see Voinea, 2012).

However, the existing regulatory framework paid little attention to indicators that would trace how shocks in any country of activity, be it parent or subsidiary, would be transmitted through the internal capital markets of transnational banks. In fact, the Romanian central bank relaxed prudential measures in 2007, fully aware that its interest rate decisions would be unable to curb credit growth (BNR, 2008). Its regulatory retreat,

proven costly only fifteen months later, at the time signalled optimism about European financial integration, a shared belief in the necessity to minimize the regulatory burden for banks and a poorly understood division of regulatory responsibilities that saw home and host regulators relying on the other to contain the systemic risks associated with transnational banking (see Pistor, 2010).

7.2.1 Coordinated crisis responses and regulatory reform: the Vienna Initiative(s)

The global financial crisis first raised doubts about the perceived benefits of transnational banking and the regulatory wisdom of allowing banks to move liquidity through internal capital markets (Helleiner and Pagliari, 2011). In a crisis, home and host regulators may witness the emergence of conflicting regulatory priorities (see Kudrna and Gabor, 2013).

In countries with dependent financialization, regulators may see tensions in the funding markets of parent banks triggering capital outflows as subsidiaries transfer resources to the parent bank. Such a scenario exacerbates financial cycles, since subsidiaries will tighten the supply of domestic credit further during a crisis, pro-cyclical effects that may take the country into a recession *cum* rapid currency depreciation (Lumpkin, 2010). Increased competition to raise deposits and send them to the parent could undermine the central bank's efforts to ease lending conditions in response to the crisis. Similarly, internal prime rates may increase when the parent bank sees its wholesale funding costs increasing, resulting in higher lending rates practiced by the subsidiaries.

Host regulators are also confronted with the externalities of crisis policy measures in home countries. Home regulators may seek to ring-fence extraordinary liquidity support in case parent banks re-direct these to subsidiaries that can either find better yields or are experiencing funding problems themselves. Regulatory initiatives would thus aim to constrain the free flow of resources through internal capital markets and instead seek to segment cross-border banking across national lines into self-sustaining subsidiaries entirely reliant on the rules and markets of the host-country.

These scenarios, unthinkable during the first two years of Romania's EU membership, suddenly became a possibility in the early months of 2009. Uncertain funding conditions for parent banks exposed to the post-Lehman deleveraging raised the distinctive possibility that Romanian subsidiaries may not be able to rollover short-term credit from parent banks. This threatened the country with a banking and currency crisis, particularly dangerous given the relative importance of foreign currency lending to households.

The particularly large exposure of the Austrian banks to Eastern Europe (around 55% of Austria's 2008 GDP) motivated the Austrian authorities to mobilize the key stakeholders: parent banks, home country authorities (the central bank and the government) and several European (the European Commission, the ECB participating as observers) and international institutions (the EBRD, the World Bank). That the EBRD and IMF initiated, and then oversaw the proceedings reflected the complex political economy of the European Union and the absence of a well-defined institutional framework for coordinating policy responses to a systemic threat in transnational banking aside from the ECB's provision of lender of last resort liquidity. Whereas the financial crisis triggered ad-hoc coordination between Old Member States, applauded by Quaglia (2009) as Europeanization in action, in the New Member states, the European Commission relied on the EBRD and IMF to ensure that EU's emergency assistance (smaller in volume) would restore macroeconomic stability and prevent a banking crisis.

Ultimately, the Vienna Initiative succeeded in averting a disorderly withdrawal from Eastern Europe. Scholars interpreted this as evidence that the presence of transnational banks can be a stabilizing factor in the crisis (see de Haas et al, 2012; Epstein, 2013). Indeed, parent banks committed to maintain exposure levels and to ensure that subsidiaries would maintain adequate capital buffers, conditional on the orderly implementation of IMF/EC conditionality targets. International organizations in turn offered balance of payment support for the worst affected countries (Romania, Hungary, Latvia, Serbia) while national authorities offered to undertake a series of budgetary, monetary and

structural measures that would ensure macroeconomic stability and a return to economic growth.

In particular host authorities committed to provide non-discriminatory liquidity support in domestic currencies for banks active in their financial system, whereas home country authorities pledged to support parent banks in renewing foreign currency credit and recapitalization of subsidiaries. Aside from macroeconomic commitments to austerity, the central banks were to perform a series of stress tests for national banking system, simulating the impact of a shock (such as a substantial devaluation) on the commercial banks' balance sheets. In light of the role that cross-border regulatory ambiguities had played in allowing cross-border systemic risk, national authorities committed to improving cross-border regulatory cooperation. However, policy documents recognized that further reform was necessary to ensure that banks adjusted business models that had triggered cross-border exposure in the first place.

This challenge is yet to be resolved. Governments in both home and host countries failed to reach a conclusive answer to the question of the systemic risks generated by either banks' reliance on internal capital markets, or by regulators' attempts to segment these in the context of the ongoing European banking crisis. Indeed, Kudrna and Gabor (2013) detail various attempts initiated by both home (Austria) and host (Hungary, Romania, Latvia) regulators to curtail the cross-border activities of transnational banks, eventually unsuccessful because of opposition from counterparty regulators or from European institutions concerned with preserving the freedom of capital movement.

During the Vienna negotiations, participants created two ad-hoc public-private institutional structures to explore these questions: the Local Currency and Capital Market Development (LCCMD) Group and the Role of Commercial Banks in the Absorption of EU Funds. Both envisaged unilateral (host country), gradual and largely market-based solutions to the specific nature of systemic risk in integrated European banking for new member countries. Arguably more important, it is through these Working Groups that the imperatives of financialized banking became visible.

The assumption underlying the Absorption of EU Funds group was that transnational banks would remain committed to the region if regulators supported new modes of profit generation. Just as the Romanian central bank had offered sterilization instruments to induce resident banks into channelling capital inflows, this Working Group called for a well-designed institutional framework that enabled commercial banks to contribute to improving absorption of EU funds in the region, a long-standing challenge in most CEE countries (EBCI, 2011a). Transnational banks would effectively intermediate official capital inflows from the European Commission.

In turn, the Local Currency and Capital Market Development Group recognized that foreign currency lending in Eastern Europe had been a key contributor to financial fragility. For resident banks, the danger became that regulators would attribute this mechanism to their extensive reliance on internal capital markets and centralized liquidity allocation, a poignant argument given evidence of widespread pre-crisis regulatory arbitrage (Pistor, 2010). For the first time in the history of European integration, European banks were confronted with regulatory threats to enforce institutional change along decentralized subsidiary models of the type preferred by Spanish banks with an international presence.

The LCCMD working group instead allowed banks to reframe their foreign currency lending activity as an outcome of poorly developed financial markets in host countries (ECBI, 2011b). According to this account, transnational banks would move to local currency lending if host countries improved the availability of domestic savings and developed funding markets in local currency, particularly at longer maturities. In other words, wholesale cross-border funding followed, rather than triggered, foreign currency lending in Eastern Europe (Brown and de Haas, 2011) because local currency markets could not support the pace of household demand for loans. The profit-orientated nature of banks created incentives for these to finance abroad.

This account conveniently ignores the most pervasive features of dependent financialization, and in particular of financialized banking. This study documented extensively how those transnational banks with complex business models had in fact

contributed to the creation of a structural excess of liquidity on the interbank money market after 2000, the very opposite of the ‘domestic savings constraint’ account. In fact, one of banks’ most profitable activities before 2008 consisted of placing excess reserves in the central bank’s sterilization instruments or lending them to non-resident carry traders. If banks chose to lend in foreign currency, they did not do so because of constraints in domestic currency funding, but because foreign currency loans provided better yield differentials judged in the context of the internal capital market, while transferring currency risk to the borrower. Instead, the Vienna Initiative allowed transnational banks to effectively shape the narrative of their contribution to crisis in such a manner that their ability to move resources through internal capital markets would not suffer from a crisis-induced regulatory push for segmenting transitional banking.

To sum up, transnational banks successfully averted the threat of greater regulatory interference with their business models in the aftermath of Lehman’s collapse. The Vienna Initiative offered banks a useful platform to intervene in regulatory debates about the changes needed to ensure more sustainable business models. Indeed, a second round of the Vienna discussions, taking place in early 2012, saw banks successfully arguing that the implementation of Basel III would lead to a credit crunch in Eastern European economies unless regulators allow them to pool capital and liquidity freely across their subsidiaries (EBCI 2012b). This is a common outcome for collective transnational regulatory initiatives (Tsingou, 2011) because private financial institutions are effective in watering down the initial regulatory proposals. Kudrna and Gabor (2013) argue that long-term regulatory reform ambitions that would contain the systemic risks triggered by cross-border banking will not be resolved without significant progress in the supervision, regulation and resolution of banking crisis at the European level.

8. The impact of European legislation

Romania officially applied for EU Membership on June 22, 1995. Three years later, in March 1998, the European Union initiated the enlargement process for 13 applicant countries. The Council of Ministers and the European Commission together approved the start of negotiations for accession in December 1999. However, Romania did not belong to the first wave of Central and Eastern European countries joining the EU in 2004 because the European Commission did not recognize the country as a 'functioning market economy' suitable for EU membership until October 2004. Romania signed the accession treaty in April 2005 and joined the EU on January 1, 2007. According to the European Commission, the delays were due to the comparatively slow speed of economic reform and the adoption of the *aquis communautaire* in three areas: Competition, Environment and Justice and Home Affairs.

The negotiations for becoming a member of the European Union had important consequences for macroeconomic policy, banking supervision and regulation of retail and wholesale financial activities. The central bank identified the accelerated pace of capital-account liberalization, and in particular the entry of non-residents on various segments of financial markets, as a key reason for switching to the inflation targeting regime in 2005 (BNR, 2005). EU membership also redefined the regulatory terrain. It narrowed the range of prudential measures that the central bank could adopt in response to large and volatile capital inflows; particularly those intermediated through the internal capital markets of transnational banks (see previous chapter).

8.1 Banking Supervision

The Romanian regulatory framework is well aligned with the requirements of the European legislation. The IMF (2010:47) identified departures from European standards in the

methodology for identifying overdue loans and provisioning. It suggested that national regulators complement the existing financial ratios with qualitative and technocratic judgment, particularly for large credits. The suggestion is particularly relevant in light of the rapid increase in the share of non-performing loans for credit institutions.

Romanian transposed the EU Directive on the Acquisition and Increases in Holdings of the Financial Sector (2007/44 EC) in 2009. This applies across three financial sectors: credit institutions, investment firms and insurance undertakings. The Directive recognizes the challenges involved in the regulation of large financial groups with operations in various member states. It establishes that large financial groups be defined as Financial Conglomerates, to be regulated by a coordinating regulatory agency. This initiative is particularly important for New Member States with a large foreign presence in their financial sectors, allowing for a better definition of regulatory responsibilities and cross-border resolution of bank failures. It also reflects an increasing recognition in the literature on large financial groups that these may generate intra-group contagion risk that regulators have difficulties identifying because of non-transparent transactions in internal capital markets, or that subsidiaries may be encouraged to take excessive risks because of their reliance on parent bank funding (Lumpkin, 2010).

8.2 Securities Market

The Romanian National Securities Commission, established in 2002, regulates the securities market. Regulatory efforts have been focused on aligning the legal framework with the EU aquis, including the establishment of a single capital markets law.

The aquis communautaire for mortgage-backed securities translated into Romanian law in 2006. The Securitization package entailed two laws, the Securitization Law governing the securitization of receivables and the Mortgage Bond Law. The Securitization law allows a wide range of receivables for securitization, including mortgage loans, credit cards,

leasing credits, consumer credits or any other form of sale contract with instalments. The Investment Vehicle must be registered with the CNVM in a special public register and requires a minimum share capital of EUR 25.000 (RON equivalent).

8.3 Retail financial services

National policy makers retain significant regulatory authority with respect to the provision of financial services to households and companies as there is no European Single Market in this segment. In 2007, the European Commission published two documents setting the background for further integration of regulatory regimes: the *White Paper on the Integration of EU Mortgage Credit Markets* and the *Green Paper on Retail Financial Services in the Single Market*. The (revised) Consumer Credit Directive, published in 2008, and translated into law in 2010 in Romania, established common rules for strengthening competition in the retail finance sector.

The translation of this Directive in Romanian legislation has generated controversy unusual for such processes. The Romanian Association for Consumer Protection proposed that the intention of the Directive - improved competition - should be extended to mortgage loans rather than the consumer credit activities that the Directive specifically targeted (see Chapter 9). European institutions initially refrained from intervening in the controversy, unlike the IMF that opposed the proposals invoking concerns that commercial banks would suffer further losses and erode the already fragile financial stability. Eventually, at the insistence of the central bank and under threats from the IMF that it would suspend lending, the Romanian Parliament dropped the most ambitious provisions of the legislation at the end of 2010 (see Kudrna and Gabor, 2013). Consumer groups disputed the decision at the European Court of Justice. In July 2012, the institution ruled that Romanian legislators could 'enhance' a European Directive as they saw fit. With this ruling, it became apparent that European legislation served to set a minimum set of regulatory principles that Member States could tighten further.

8.4 The Fiscal Compact - the Treaty on Stability, Coordination and Governance in the Economic and Monetary Union

The sovereign debt crisis in the Eurozone has prompted various initiatives to modify the institutional architecture. These efforts have been informed by the recognition that monetary union alone cannot preserve future economic and financial stability, and that improved fiscal coordination is necessary. Consistent with narratives that have attributed the sovereign debt crisis to the lack of fiscal discipline (Trichet, 2009) or to bank-sovereign feedback loops, reform focused on removing the incentives, and the opportunities for governments to conduct discretionary fiscal policies. Against this context, the Fiscal Compact proposes that strict rules should govern the conduct of fiscal policy, rules that seek an improved enforcement compared to the discredited Growth and Stability Pact.

9. Nature and degree of competition in the financial system

9.1 Competition in the banking sector

Romania initiated its shift to a capitalist system with a highly concentrated, state-owned banking sector. Banking concentration, measured with either the share of total assets/lending activity of the largest five institutions and with the Herfindahl Index, decreased since 1990s (see Table 13). The largest five institutions held together 86% of bank assets and 72% of bank deposits in 1991. The most pronounced concentration was registered on the lending segment, where the top four banks, all in state-ownership, together held over 90% of the outstanding loan portfolio for the entire banking sector. The stronger concentration on the lending segment was due to the relative importance of the Savings Bank in collecting household deposits. With the double movement from state to private and from national to foreign ownership, concentration has reduced significantly. By 2008, the top five banks had a 54% share in total assets, 53% in total loans and 54% in total deposits. Since the crisis, the increasing competition for stable, domestic sources of funding reduced concentration in the deposit market.

Table 13 Banking concentration, Romania, 1991-2010

	Assets of top five banks/Total assets	Loans of top five banks/Total loans	Deposits of top five banks/Total deposits	HH index
1991	86.0	95.0	72.0	n/a
2002	62.8	56.2	63.0	1264
2007	56.4	57.1	60.0	1046
2008	54.3	53.3	54.0	926
2009	52.4	53.4	52.0	857
2010	52.7	51.5	55.4	874

Source: data from the central bank of Romania.

On the home savings and loan market, concentration is higher. Only two banks, part of larger, foreign-owned banking groups, are active on this market: BCR Housing Bank and Raiffeisen Housing Bank. Given the government's direct support— offering an annual premium to savers of up to EUR 250 – this form of financial intermediation is expected to grow in the future.

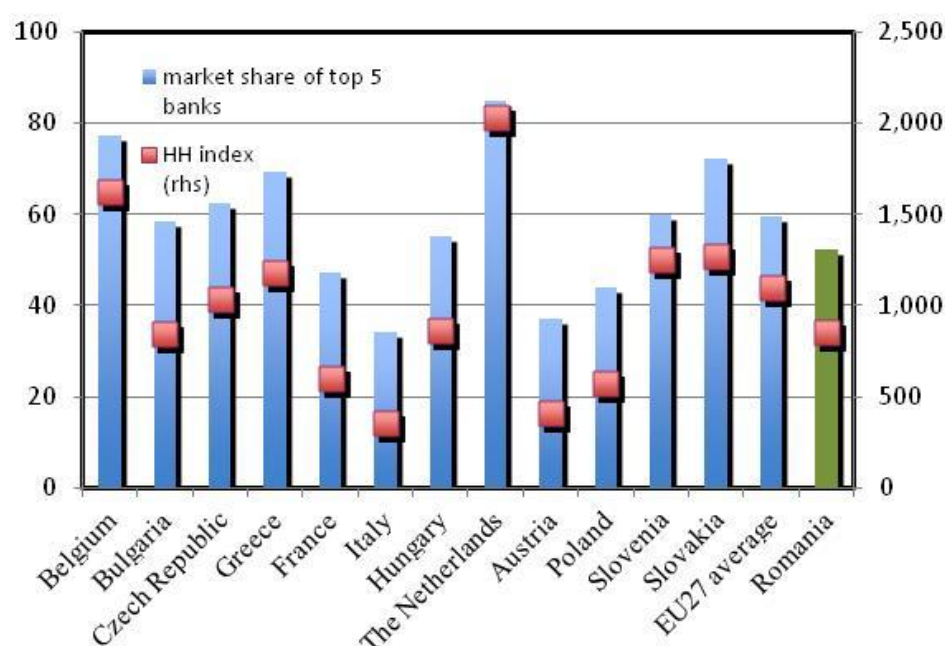
The literature on banking presents two distinct views on the link between bank concentration and lending activity. One strand focuses on the market power prevailing in highly concentrated banking systems, that results in higher lending rates, credit rationing and entry barriers for new firms (Black and Strachan, 2002). In contrast, the relationship-based theory suggests that concentration allows banks to reduce information asymmetries characteristic to transactional lending (where information is based on readily observable credit characteristics) and instead build, and rely on, existing relationships (Hake, 2012). However, banking reform immediately after the collapse of communism rejected the positive aspects of relational banking attending highly concentrated markets (see chapter on restructuring). Instead international policy makers and the Romanian central bank assumed that relational banking would serve to reinforce soft-budget constraints in the non-financial sector and set to prevent such an outcome by tightening banks' access to liquidity. A rapid disintermediation ensued, only reversed once the banking sector passed into foreign ownership and could raise funding from parent banks or generate banks reserves from trading with the central bank on the currency market (see currency market section).

Although Petersen and Rajan (1995) proposed that new firms could face easier lending conditions in concentrated markets because large banks can afford to spread the cost of lending over a longer period, this does not seem to be the case in Romania. According to central bank reports, concentration on the segment for lending to large non-financial companies is higher than in other segments, reflecting the relationship between parent banks and parent companies of multinational corporations operating in Romania

(BNR, 2009). In contrast, small and medium companies have very limited access to bank borrowing.

In a comparative European perspective, larger countries tend to have less concentrated banking systems. Indeed, France, Poland or Italy have the market share of the largest five banks, and the Herfindahl index, low below the European average (see Figure 32). In contrast, banking activity is more concentrated in the Netherlands, Greece and Belgium. In 2009, Romania registered values below the European average on both indicators.

Figure 32 Comparative concentration indicators, 2009.



Source: data from European Central Bank

9.1.1 Concentration and competition in dependent financialization: the European Directive on Consumer Credit and the ROBOR 'scandal'

The indicators of concentration do not always capture the actual conditions of competition in the financial system. Indeed, banks in seemingly competitive sectors may in fact have consolidated market power by constructing barriers that prevent borrowers from responding to new, or more advantageous, market conditions. Where such anti-competitive structures are in place, banks will resist measures to improve competition.

Such resistant became apparent in 2010, when Romania adopted the law that transposed the European Directive 48/2008 on Consumer Credit. The Directive recognized that banks' dominant position in the consumer credit market may involve anti-competitive practices through which banks imposed hidden taxes on borrowers, and thus prevented them effectively from switching to other lenders that offered more competitive lending conditions. The impact on households was further aggravated by banks' practice of varying interest rates according to non-transparent, internal costing decisions that reflected liquidity management decisions in the internal capital market of the transnational banking group rather than funding costs in the domestic interbank market. The Directive thus sought to strengthen banking competition and improve consumer protection (Silaghi, 2012).

The Romanian Authority for Consumer Protection, one of the various bodies involved in drafting the law, saw the new legislation as an opportunity to introduce more radical regulatory change than the European Commission envisaged through the Directive, with a sense of urgency arising from the crisis in the household lending sector since 2008. Kudrna and Gabor (2013) discuss three important extensions to the provisions of the European Directive. Firstly, the law would be extended to mortgage lending, although the initial directive only specified measures for consumer credit, reflecting the difficulties of drawing up a common European position on this segment. The move would have important consequences for banks' profits given the wide range of additional fees imposed as a

percentage of the value of mortgage loans- cash handling fees, risk commissions and early repayment charges (Silaghi, 2012). Second, the legislation established that the new rules should be applied retroactively too, rather than only to new loans. Lastly, the legislation set mandatory refinancing rules that would allow creditworthy borrowers to refinance at the new lending conditions.

These proposals met with strong resistance from private financial institutions, the central bank and the IMF. The last two expressed concerns that financial stability would be threatened by the new legislation because parent banks, confronted with diminished profit opportunities, would reverse their Vienna commitments to roll-over funding for subsidiaries. The government's initial determination to proceed with tighter lending legislation disappeared once the IMF threatened to halt the disbursement of its next lending tranche²⁴. Ultimately, the European Directive suffered far more modest modifications than initially envisaged, particularly in what concerned the application of new provisions to existing loans.

The controversies generated by regulatory conflicts mobilized borrowers to question the close alignment of the central bank, the IMF and private banks. Several consumer groups initiated legal challenges against banks lending practices, eventually culminating in a European Court of Justice decision that supported the initial regulatory efforts of the Authority for Consumer Protection. In July 2012, the European Court of Justice ruled valid the extensions of the European Directive proposed by the Romanian legislators, and watered down at the insistence of the IMF and the commercial banks' lobbying. It accepted that a Member State can introduce measures to restrict banks' commissions on credit activity, that new European legislation can be applied to outstanding loans and to other lending activity than that initially targeted, and that the Agency for the Consumer Protection has legal authority to sanction banks.

24 <http://www.zf.ro/banci-si-asigurari/bancherii-au-castigat-lupta-pentru-oug-50-7819898>.

A second high-profile investigation into banking competition took place in the aftermath of the 2008 speculative attack. The Romanian Competition Authority set to explore resident banks' collusion on the interbank money market, collusion suggested by the rapid increase in the interest rates that banks were quoting for lending reserves. Both foreign-owned and Romanian banks came under scrutiny in the ROBOR/speculative attack scandal (Banca Comercială Română SA (Erste Bank), BRD Groupe Société Générale SA, Unicredit Țiriac Bank SA Raiffeisen Bank SA, ING Bank N.V. Amsterda, RBS Bank (ROMANIA) SA, Bancpost SA, CEC Bank SA, Eximbank S.A, Banca Transilvania SA).

Four years later (April 2013), the Competition Authority closed the investigation without providing any insights or regulatory proposals whatsoever²⁵. It imposed two procedural fines, for refusing the regulator's access (BRD Societe Generale) and for providing wrong information (Raiffeisen). Beyond this, it simply warned resident banks that interbank money markets play an important role in setting monetary conditions in the Romanian economy. It made no reference to the speculative attack or to the relationship between resident banks and non-resident speculators.

The refusal to shed light on the October 2008 episode highlights again the regulatory dilemmas underpinning dependent financialization. First, regulatory struggles involve both national and foreign institutions, with possibly competing interests. Indeed, the head of the Romanian Competition Authority suggested in November 2012 that it would make the investigation public once it had shared a preliminary draft with the Romanian central bank and the European Commission. Its refusal to do so five months later would indicate that either the Romanian central bank, or the European Commission, opposed transparency²⁶. While at this point there is no evidence for any of the two, the example of the struggles over consumer credit throughout 2010 would suggest that it was the central bank's opposition that mattered. Second, transnational banks can easily influence regulatory debates, in both

25 http://www.consiliulconcurentei.ro/uploads/docs/items/id8298/banci_aprilie_2013.pdf

26 <http://www.zf.ro/banci-si-asigurari/consiliul-concurentei-a-trimis-la-bnr-date-privind-atacul-speculativ-asupra-leului-din-2008-10354757>

multilateral contexts (the Vienna Initiative) and national arenas, as long as they can convince some important official actor (usually the central bank) that their interests are closely aligned.

9.2 Competition among non-bank financial institutions

The sector of non-bank financial intermediaries exhibits relatively higher concentration than the banking sector. According to central bank data for 2005, 80% of total assets were held on the balance sheet of the 10% largest non-bank financial intermediaries. The growing concentration, driven by the increasingly relative importance of bank-affiliated NBFIs, is expected to continue in the future given the impact of the financial crisis on this, heavily affected by losses.

9.3 Competition in the insurance and private pensions sector

The Romanian insurance sector had 72 active companies in 2000, and 42 by 2007. The crisis contributed to an increasing concentration, as foreign-owned companies merged. In 2010, seven insurance groups together accounted for 82% of the overall market. The largest insurance group, the Vienna Insurance Group, alone held 24% of the market share, after it purchased the insurance operations of the Erste Group, the Austrian owner of the largest Romanian bank, the BCR. Concentration is higher on the life insurance segment, where the top three insurance companies (two bank-affiliates) held 60% of gross premium written in 2010 (CSA, 2010).

Concentration is high on the private pension segment, introduced in 2008. Two companies, ING and Allianz Tiriatic, members of transnational banking groups, together accounted for around 65% of the total private pension market in 2010.

10. Profitability of the financial sector

10.1 Overall profitability dynamics

At a first glance, key financial indicators for the Romanian banking sector, most available since 1996, present the following dynamics. During the period when state-owned banks dominated the system, profitability remained volatile, falling from high return on assets and equity in 1996 and 1997 to negative ratios in 1998 and 1999 as the banking crisis unfolded and several banks experienced severe losses or became bankrupt. Once foreign banks became dominant after 2003, profitability stabilized at lower values for both return on assets and return on equity - comparable to regional peers (see Table 14). In fact, banks experienced small increases in their return on equity between 2005 and 2008. Several factors can explain this trend, including a normalization of returns due to increased macroeconomic stability, higher competition and increased cost-to-income ratios. Since 2008, profitability has deteriorated considerably for every year until 2012, reflecting an increasing share of non-performing loans accompanying the economic crisis.

The evolution of cost-to-income ratios provides a mixed picture on the expected efficiency gains for transnational banks. Indeed, the 'optimal' bank size literature suggests that large banks can achieve economies of scale and scope by pooling resources across various subsidiaries (centralized liquidity management, centralized IT functions etc). This will reduce operating costs and improve the efficiency of banking operations; two key reasons that international financial institutions offered to explain the push for privatizing state-owned banks in Romania. However, the increased foreign ownership of the Romanian banking sector has been accompanied by an increase in operating costs. Indeed, throughout the late 1990s, when state-owned banks dominated the financial system, cost-to-income ratios remained consistently below 50%. By 2006, that ratio had increased to

67%, to then fall once the crisis hit Romania. According to central bank data (BNR, 2007: 36), staff costs account for up to 40% of operating costs in 2005.

Table 14 Indicators of profitability and efficiency, banking sector, Romania, 1997-2011

	Return on Average Assets (ROA)	Return on Average Equity (ROE)	Cost to Income Ratio
1996	5.6	48.8	n/a
1997	8.2	75.1	49.9
1998	-2.88	-25.9	43.1
1999	-1.7	-17.3	46.1
2000	2.5	14.0	57.4
2001	2.8	15.3	54.1
2002	2.0	11.6	62.9
2003	1.2	7.6	68.2
2004	2.6	19.4	57.2
2005	1.9	16.0	67.7
2006	1.9	18.7	67.2
2007	1.7	18.9	60.7
2008	2.1	23.7	52.9
2009	0.9	9.8	48.2
2010	0.6	5.5	49.6
2011	0.3	2.7	54.6

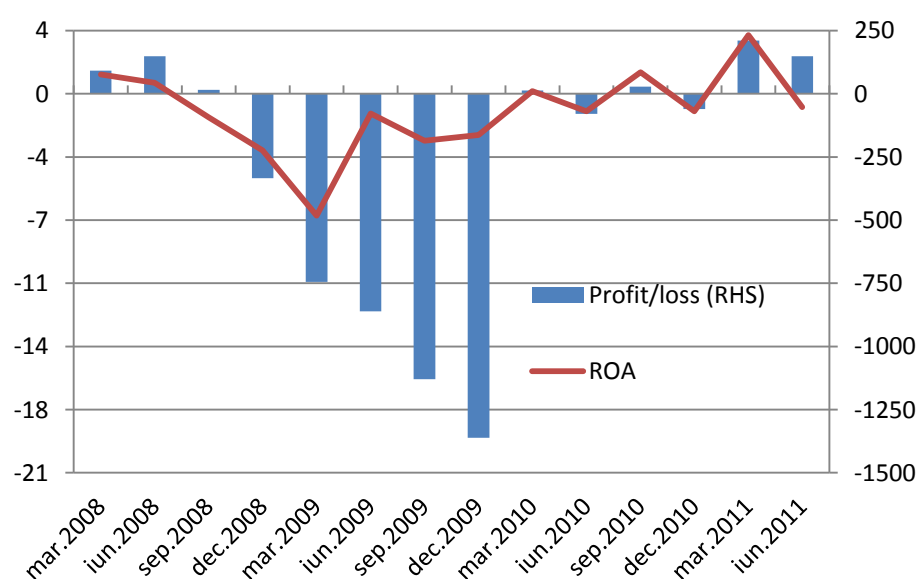
Source: Bankscope and National Bank of Romania

The non-bank financial intermediaries, the second most important credit institution in the Romanian financial system, have seen a rapid erosion of their profitability since 2008²⁷. From low volume profits and positive return on assets in the first half of 2008, NBFIs have

²⁷ Profitability data for this sector are only available since 2008.

experienced increasingly large losses throughout 2009, and then a moderate improvement since 2010 (See Figure 33). According to the central bank, this sector has been particularly affected by the crisis because of pro-cyclical lending practices: the share of non-performing loans increased from less than 2% of their balance sheet at the end of 2007 to around 18% by 2011. Indeed, central bank statistics suggests that the worst performing loans on the NBFIs balance sheets are those granted in 2005 and 2006 as a form of regulatory arbitrage that saw banks moving lending to their NBFIs arms in response to tighter prudential measures (FSR, 2011). The relaxation of the regulatory regime after 2007 further contributed to this pro-cyclical behaviour as NBFIs have been more willing to take on credit risk through lending practices orientated towards rapid growth. Profitability is expected to improve given tighter lending standards and reduced demand for credit.

Figure 33 Profitability of the non-bank financial intermediaries, 2008-2011



Source: data from the National Bank of Romania

Insurance companies have experienced a different profitability trend compared to credit institutions. This partly reflects the distinctive drivers of profitability on this segment, including earnings from underwriting activities and the management of their portfolio

investments (see Table 15). The ten largest insurance companies have seen their return on assets moving from negative territory in 2007 and 2008 to small but positive levels in 2009 and 2010. The losses were due to the slowdown in leasing and bank lending that had a negative impact on the largest non-life insurance activity, for land vehicles (CSA, 2011). The unit link life assurance segment has in turn experienced growth during the crisis as households perceive it as an alternative portfolio choice. The most profitable insurance companies have seen their return on assets increasing throughout the crisis, to levels well above those in the banking or NBFi segment. Losses have also been relatively higher on the insurance segment, leading to mergers and increased concentration in the sector.

Table 15 Return on assets, ten largest insurance companies, Romania

	maximum ROA	minimum ROA	average ROA
2007	5.20	-13.11	-0.85
2008	7.82	-17.89	-1.90
2009	8.60	-7.60	0.99
2010	8.16	-7.87	0.47

Source: data from the National Bank of Romania

10.2 Solvency dynamics

The global financial crisis has demonstrated that adverse shocks to bank solvency can have lasting effects on the economy. Romanian banks have experienced high, if declining, solvency ratios after the 1999 banking crisis. Indeed, solvency ratios have fallen across all types of banks, if somewhat more pronounced for large banks, from around 19% in 2003 to 13.6% in 2010, the second year of crisis in Romania (see Table 16). Both small banks and medium banks have remained better capitalized, with ratios closer to 20% compared to the European regulations of 8% and Romanian requirements of 12%. Furthermore, the ratio of Tier 1 capital (including equity and retained earnings) to risk weighted assets decreased

rapidly before 2008, from 18% to 10.6% as banks increased lending activity. It then recovered throughout 2009 and 2010 as foreign-owned banks complied with commitments to support the recapitalization of their subsidiaries.

Table 16 Solvency ratio, bank size, and capital adequacy ratio, Romania

	Solvency ratio			Tier 1 capital ratio
	large banks	medium banks	small banks	
2003	21.3	32.2	20.1	18.10
2004	19.20	20.38	31.55	16.00
2005	17.05	25.19	30.96	16.30
2006	14.06	24.55	25.31	13.40
2007	12.00	20.05	18.70	10.65
2008	12.51	15.95	20.30	11.78
2009	13.15	20.28	19.28	13.37
2010	13.83	18.95	18.50	14.22

Source: data from the National Bank of Romania

This picture of solvency suggests that the Romanian banking system should have emerged unharmed from the financial crisis. It is now well known that such microprudential approaches only provide a partial account of the vulnerabilities that financialized banking activity engenders. Indeed, Romania's crisis, its request for the support of the IMF and the Vienna Initiative arrangements all testify to the cross-border interconnectedness that transnational banks generate. The Basel III reforms acknowledge that these require new, liquidity-based regulatory instruments.

10.3 Measuring profitability for transnational banks

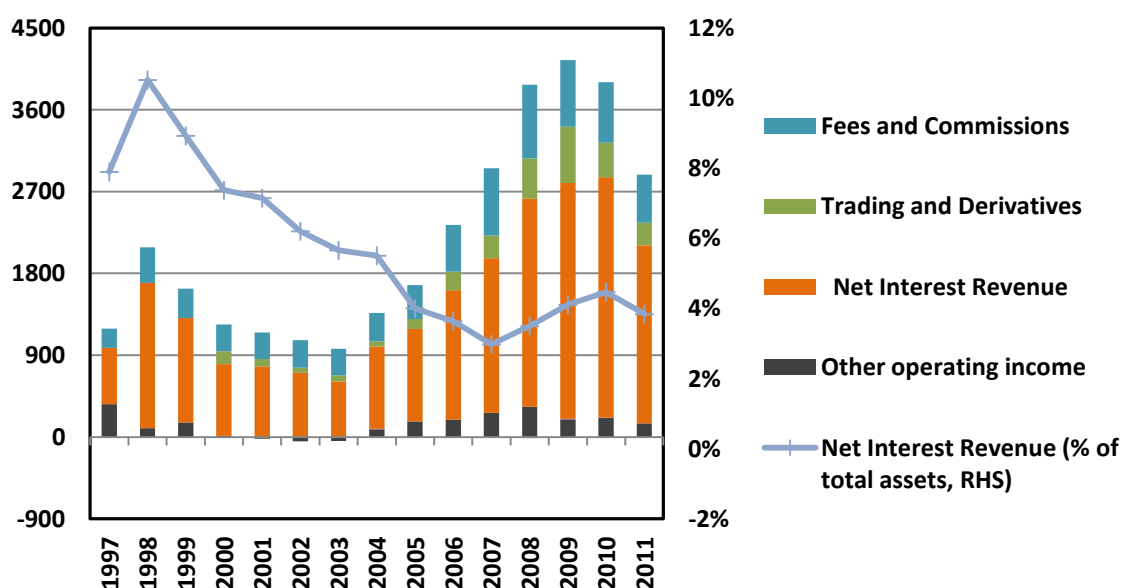
The Liikanen (2012) report on European banking recognizes that banks' financial disclosures may not always convey an adequate picture of what drives profitability, liquidity or indeed solvency in the banking sector. These problems are compounded where banks belong to transnational groups with centralized funding and management decisions (Lumpkin, 2010). From this perspective, pricing decisions in internal capital markets, based on the internal prime rate, no longer reflect the cost of funding balance sheet expansion in domestic financial markets, but a broader set of funding conditions and alternative profit opportunities in other subsidiaries of the same banking group (De Haas and van Lelyveld 2010). Thus, eroded interest margins or declining overall profitability in the distinctive segments of a particular jurisdiction may cloud the picture of profit opportunities in that jurisdiction with i transfer pricing or other less-transparent pricing decisions of the parent bank. Put differently, where foreign owned banks depend on parent bank financing, their host regulator may have difficulties assessing the actual sustainability of that subsidiary if its costs are determined, to a significant extent, by the parent bank.

Such pricing strategies point to another aspect underpinning the financialization of banking activity. Internal capital markets generate a shift away from the traditional relationship-based loan pricing to market-based instruments for pricing credit (Norden and Wagner 2007). The move to market-based transnational banking exposes countries to global liquidity cycles. Even if subsidiaries do not engage in non-core activities such as investment banking, venture capital and trading activities that their parent banks undertake (see Brunnermeier et al, 2012), systemic risk may be transmitted through internal capital markets because of the currency and maturity mismatches generated through cross-currency, cross-border funding and reliance on swap markets.

The evolution in the different sources of income for banks indicates a diversification of activities (see Figure 34). The share of net interest income in total assets, arising from the traditional intermediation activities (deposit taking and lending), has fallen from over

10% in 1998 to around 4% by 2011. Nevertheless, this share compares positively with banks in countries such as Sweden, UK, Finland, Ireland and Luxembourg, where net interest revenue accounts for less than 1% of overall assets. Relative to overall operating income, the share of net interest income remained above 60%, increasingly slightly since the crisis (63.7% in 2011). Similar to other countries, the share of fees and commissions in total operating income increased from 17.8% in 1997 to 31% in 2005, to then return to 20% by 2008, as lending activity, and interest revenue, picked up rapidly on the household segment. Trading and derivatives saw their share increase since 2008 to above 10% of overall income, due to increased activity on the government bond market segment and counterparty to non-resident carry trades on the money markets.

Figure 34 The evolution and composition of commercial banks' income (volume and as % of total assets).

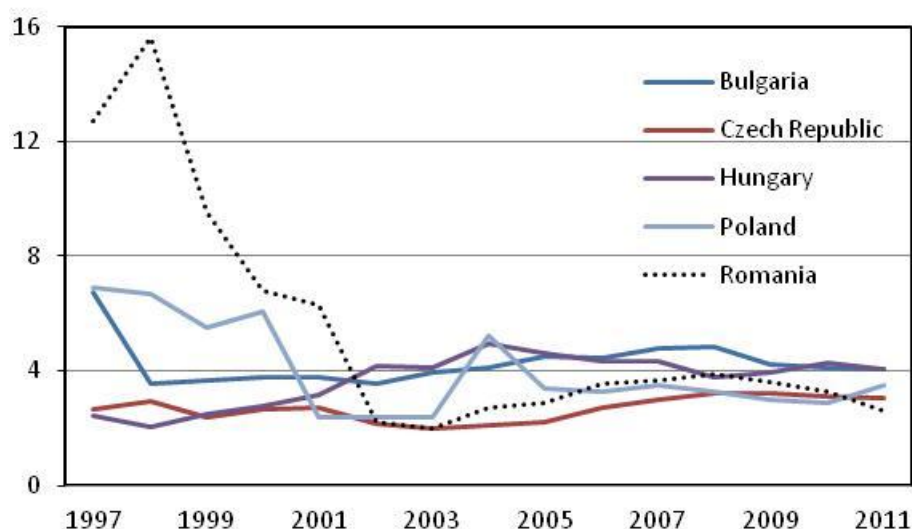


Source: data from Bankscope. Note: EUR million on the left hand scale.

Over the past fifteen years, the Romanian banking system has experienced a convergence to other new member states, as net interest margins have fallen to around or even below 4% from over 15% in the late 1990s (see Figure 35). The net interest margin measures the

difference between the interest income that financial institutions generate and their funding costs, relative to earning assets. In contrast to the interest rate differential, NIM takes into account all funding sources, rather than deposits alone. Remarkably however, when in state-ownership, the Romanian banking sector enjoyed higher margins, particularly in the two years before the banking crisis (1999). Although the aggregate figure does not capture the solvency problems that several state-owned banks experienced in that period, it does suggest that the majority of banks were profitable in a high interest rate, volatile macroeconomic environment. Market power and favourable funding conditions obtained through activity on the currency market, coupled with high interest rates on central bank's sterilization instruments (see chapter on macroeconomic policy) contributed to high profitability. Furthermore, although Romanian banks experienced lower interest margins after 2001, these allowed for increasing returns on equity up to 2008 because of increased leverage.

Figure 35 Net interest margins, New Member States, 1997-2011.

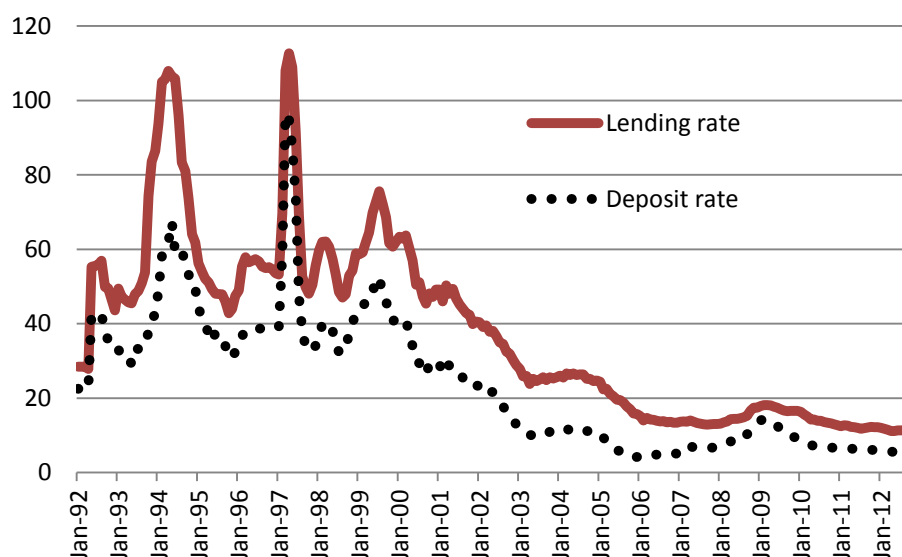


Source: data from Bankscope.

In turn, several factors may have contributed to the decrease in net interest margins after 2001. First, the improved macroeconomic conditions after 2000 brought price stability and set both lending rates and deposit rates on a downward trend (see Figure 36). Indeed, throughout the 1990s, banks often resorted to higher interest rates on both lending and deposit in moments of crisis that worsened risk perceptions. Major spikes were registered when central bank increased its lending rates in early 1994 and then in 1997 (see chapter on Macroeconomic Policies), on both occasions in the context of a new IMF program. Furthermore, throughout the early 1990s, banks chose not to meet borrowers demand for credit because they worried that it would be difficult to fund assets given the central bank's efforts to restrict lending to state-owned companies by curtailing their access to its lending facilities and keeping refinancing rates at high, positive ex-post, levels.

Interest spreads remained high in that period, consistently above 15% and raising to over 40% in late 1993. Banks preferred to perform limited maturity transformation, lending mostly on short-term while households and companies increasingly turned to foreign currency deposits to protect their portfolios from exchange rate depreciation. From 2000, interest spreads narrow, as lending rates and deposits interest rates fall under 10% by early 2008. With the crisis, both lending rates and deposits rates increase, although the spread narrows as banks initiate a strong competition on the deposit segment, similar to other European countries.

Figure 36 Interest rate (domestic currency, nominal) dynamics. Romania, 1992-2012



Source: data from National Bank of Romania.

However, the lending and deposit rates offer only a partial explanation because funding costs and loan pricing practices reflect a broader set of considerations for transnational banking groups. Economic theory offers two accounts of pricing behaviour. The interest rate channel underpinning inflation targeting regimes assumes that policy rate decisions are transmitted – one for one – into retail interest rates, allowing for minimal mark-up for normal profits and risk premiums often established on the basis of existing relationships with traditional borrowers. From this perspective, policy rate decisions have no distributional effects across banks that operate in a perfectly competitive market. Nevertheless, banking markets are rarely perfectly competitive. In oligopolistic markets, the mark-up theory proposes, banks price loans depending on the degree of market power (varying with the extent of competition between oligopolistic banks) and banks' perception of the riskiness of their assets (Rousseau, 1992). While both approaches conceive of banking as a national-based activity, theories of loans pricing in transnational banking remain undeveloped. However, the mark-up theory is particularly pertinent for transnational banks that centralize liquidity management, since it suggests that different

funding structures may lead to heterogeneous loan pricing behaviour beyond the common pro-cyclical component linked to banks' liquidity preference. Transnational banks rely on 'internal prime rates' that reflect overall market conditions for the banking group, rather than liquidity conditions in individual countries of operation, and country risk premiums for subsidiaries (Kudrna and Gabor, 2013).

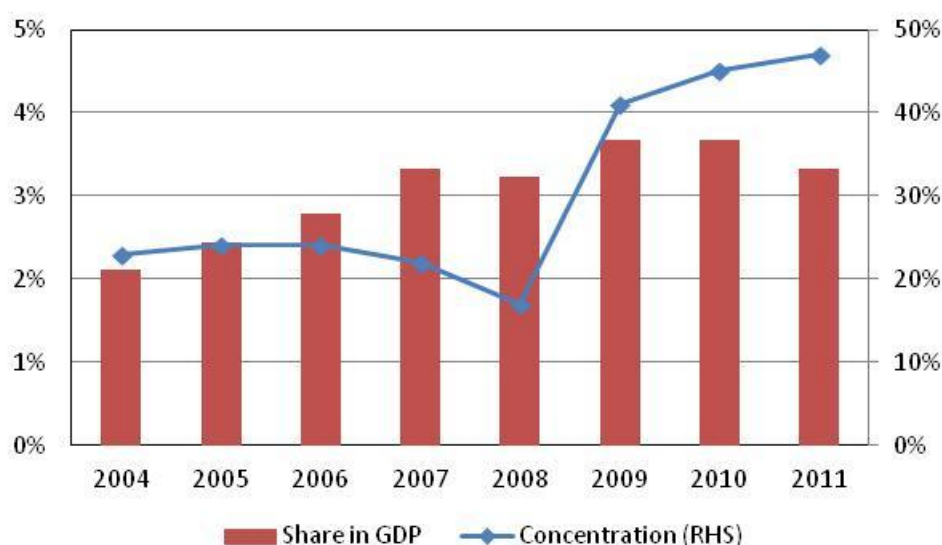
Before 2010, foreign-owned Romanian banks calculated interest rates as a sum of the internal reference rate and a mark-up. The European Directive on Consumer Credit 50/2010 proposed a more transparent mechanism that would ask banks to impose a fixed mark-up on an official market rate, such as LIBOR or EURIBOR, on both consumer and mortgage lending. In other words, the variable component became market determined, rather than depending on liquidity conditions across the transnational banking group. In the low interest rate environment in international currency markets, banks would have seen net interest margins reducing rapidly, particularly if the legislation imposing mandatory refinancing remained in place (see Chapter on Regulation of Transnational Banks). Indeed, banks opposed regulatory provisions for mortgage lending vigorously, and obtained support from both the central bank and the IMF, in their turn concerned with the financial stability implications, and more immediately, with the renewed possibility that parent banks would decide to leave the country in the absence of clear profit opportunities.

11. The relationship between financial sector and insurance

The insurance sector was one of the first non-bank financial intermediation sectors to develop in Romania, providing various policies, including vehicle insurance, home insurance, life insurance, annuities (BNR, 2007). In 2010, a new law established an obligatory house insurance seeking to transfer some of the burden that catastrophes (such as frequent flooding that Romania experiences) place on the government budget. The Insurance Supervisory Commission (CSA) regulates the insurance sector. The IMF (2010c) recommended that the CSA estimated the remaining potential liability for the government under the new scheme.

The sector grew at a moderate pace compared to other segments of the financial system. It doubled its share in GDP between 2002 and 2007, and then contracted slightly after 2008. Furthermore, the crisis rather brought an increased concentration in the sector (see Figure 37). The share of the top five insurance companies in total gross premiums written more than doubled to reach 47% by 2011, a consequence of mergers between foreign-owned companies. Concentration is higher on the life insurance segment, where the top three insurance companies (two bank-affiliates) held 60% of gross premium written in 2010 (CSA, 2010).

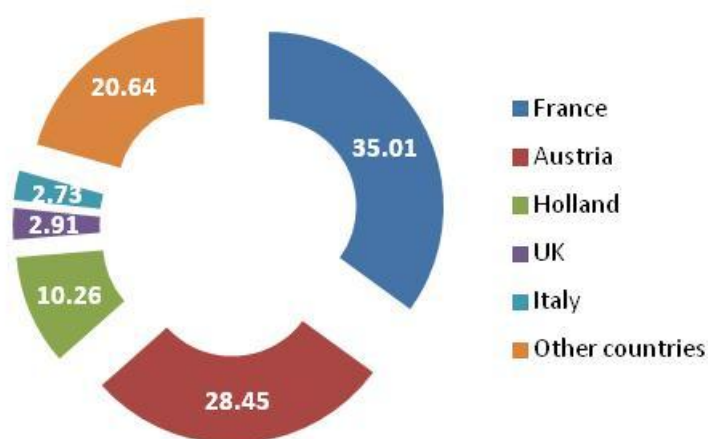
Figure 37 Dynamics of the insurance sector, 2004-2011



Source: Insurance Supervisory Commission. Note: the concentration index captures the share of the top five insurers in total gross premiums.

Foreign ownership in the insurance sector reached 88% by 2011. French capital held the largest share, followed by Austrian, Dutch, Italian and British capital (see Figure 38). Several banking groups have insurance arms. Indeed, three of the top five insurance companies, by gross premiums subscribed, belong to foreign-owned banks (BCR, Allianz-Tiriatic and ING).

Figure 38 Ownership, insurance sector, 2011.



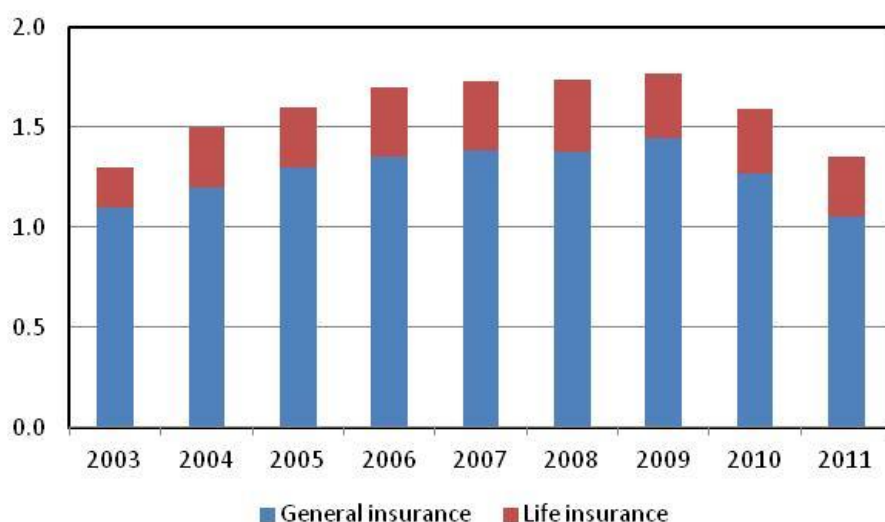
Source: National Insurance Commission Report (2011).

In contrast to other EU member states, the Romanian insurance market is largely dominated by the general insurance sector. Indeed, the share of gross premiums written for general insurance has increased steadily before 2009. In 2009, the general insurance segment was dominated by the mandatory vehicle insurance (80% of total), followed by housing insurance (around 10%) and health insurance. Credit insurance diminished in relative importance, from 7.7 % of the general insurance volume in 2004 to less than 2.7% in 2008, as a consequence of regulatory action to contain interconnectedness.

The introduction of the Obligatory Housing Insurance in 2010 is expected to contribute significantly to the growth of this sector. In turn, the share of long-term life insurance component has remained below 0.5% of GDP throughout the period (see Figure 39). Indeed, life insurance is more sensitive to business cycle movements, so that a decline in disposable household income during a crisis will affect households' willingness to demand life insurance as a savings instrument. Over the medium to long-term, the push for

the privatization of the Romanian health system is expected to benefit the private life insurance sector.

Figure 39 Share of gross premiums written in GDP



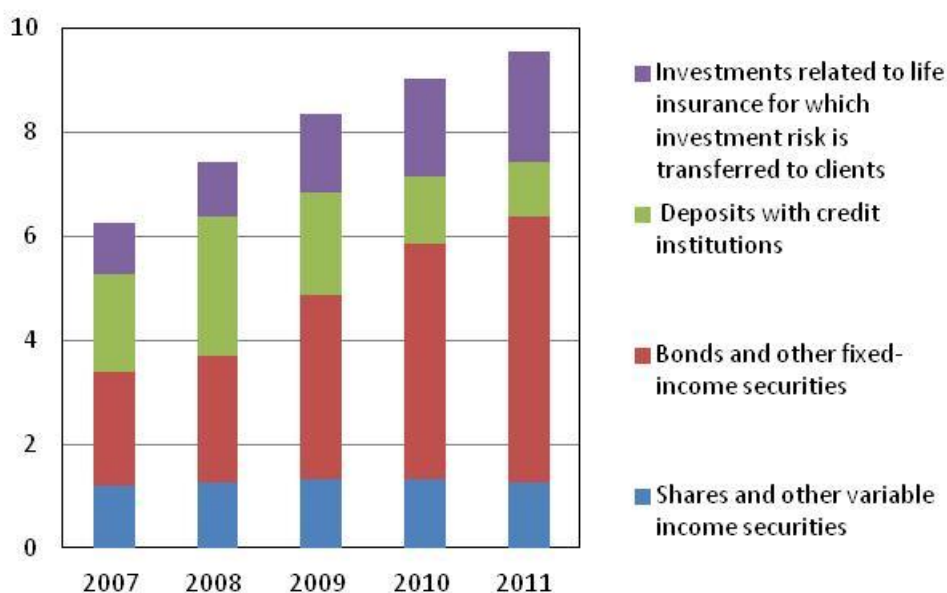
Source: central bank data from Financial Stability Reports.

There is limited concern in the literature on Romania with the link between financial activity in general and the insurance sector. A notable exception, the policy documents of the central bank recognized that the increasing interconnectedness between the banking sector and the insurance sector may have systemic implications (BNR, 2004), as banks were relying on insurance companies (often within their group) to protect themselves against the credit risk associated with consumer and mortgage loans. Indeed, companies affiliated to banking groups have dominated the credit insurance market. Regulators became particularly concerned with the banks' practice of extending consumer credits with the only requirement that the borrower agreed to an insurance contract for that loan. That practice in effect amounted to the banking sector manufacturing collateral through the insurance arm in order to sustain a rapid growth in the consumer segment. In response, coordinated regulatory action from the central bank and the CSA established constraints on

underwriting risk attached to consumer and mortgage loans in March 2004. The share of credit insurance decreased from 7.7 % of the general insurance volume in 2004 to less than 2.7% in 2008, with further decline during the financial crisis. This decline provides evidence for the effectiveness that regulatory measures can have in containing the interconnectedness between various financial market segments that underpins systemic risk.

The growth in the investment portfolio has been accompanied by a change in its composition. Insurance companies have shifted portfolios away from bank deposits and cash into increased holdings of fixed income and long-term securities (see Figure 40). Indeed, the share of bank deposits decreased from 30% to 19%, whereas fixed income securities saw their share rise to 54% from 35% registered in 2007. Furthermore, the growth in the life insurance market translated into a larger contribution from investments for which risk is transferred to the clients. Several demand and supply factors account for this. Thus, the initial large share of bank deposits reflected the reduced availability of government bonds before 2008 and the sector's reluctance to hold higher risk assets (share and other variable income instruments) given the liquidity and credit risks involved. This has limited consequences for the funding strategies of credit institutions, since the insurance sector provided, at most, around 1% of total funding needs (in 2007). Since the crisis, larger government bond issuance, reflecting expanding financing needs, allowed insurance companies to shift portfolio demand, particularly since yields on government bonds have been higher than bank deposit rates. Demand remains constrained by the maturity profile of government debt, as insurance companies prefer long-maturity instruments.

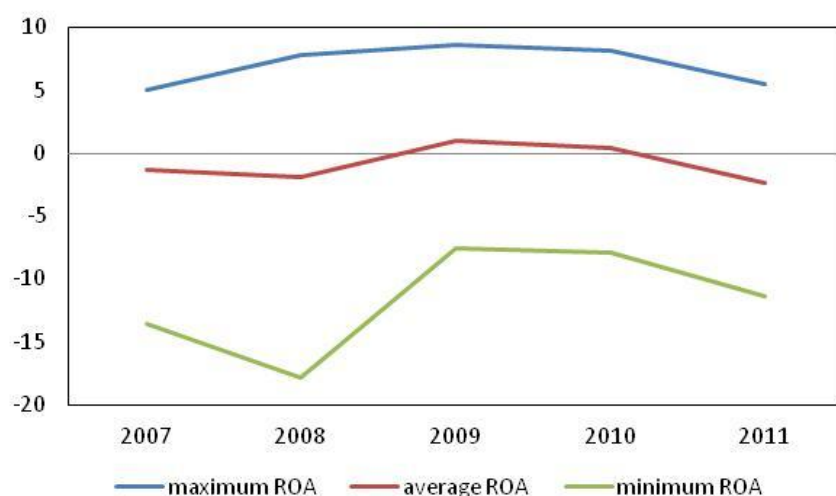
Figure 40 Portfolio composition, insurance companies, RON bn.



Source: central bank data from Financial Stability Reports.

Profitability in the insurance sector has suffered in the crisis (see Figure 41). Average profitability remained rather stable since 2007; however, some insurance companies registered large losses in 2008 and 2009, particularly on the general insurance component, in the context of increased bankruptcies and worsening macroeconomic conditions.

Figure 41 Profitability in the insurance sector, 10 largest companies.



Source: central bank data from Financial Stability Reports.

To sum up, the Romanian insurance market has been influenced to some extent by dynamics in other financial markets, pointing to some dynamics associated with financialization. The market is dominated by general insurance, of which vehicle/other means of transport represent the largest share (between 70%-80% throughout the period). Thus, the pre-crisis boom in consumer credit for durable goods and leasing contributed to expansion of the insurance market. Once the crisis slowed down lending activity, it also reduced gross premiums written in the general insurance segment. Regulatory measures taken at the start of the household lending boom curtailed banks' practice of creating insurance contracts as collateral, slowing down the credit insurance market. The life insurance segment is expected to grow at a faster pace in the future given the pressures for privatization of the health system. Furthermore, the crisis has triggered a consolidation in the insurance sector, with mergers between foreign-owned groups that increased concentration in the sector.

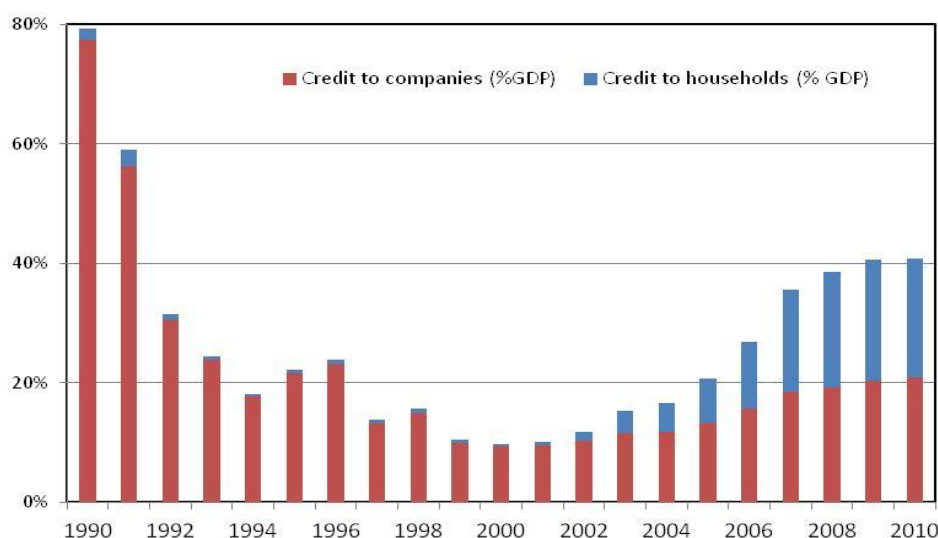
12. Relation of financial to non-financial sector

12.1 Introduction: overall trends

Prior to 2000, the Romanian financial system experienced a rapid process of disintermediation. Households had little access to credit, whereas companies, state-owned and private, reduced significantly their reliance on bank loans, from around 80% of GDP to less than 10% by 2000 (see Figure 42). Different factors contributed to this trend: the IMF's and central bank's efforts to tighten monetary conditions and restrict the access of state-owned enterprises to bank credit; following from this, banks' reduced willingness to lend long-term (the financialization of the relationship between banks and productive companies); enterprise restructuring and privatization; the reduction in subsidized and/or preferential credit. Impatient banking contributed to the erosion the industrial capabilities of the Romanian economy (see Gabor, 2010a).

The disintermediation trend reverses after 2001, with distinct patterns for households and companies. Household indebtedness increases rapidly to almost 20% of GDP by 2008, driven by foreign currency credit for consumption and real estate purchases. The global financial crisis then curbed this upward dynamic. In turn, domestic lending to companies doubled as share of GDP between 2000 and 2010, also mostly denominated in foreign currency. However, at 20% of GDP, it remained well-below the 75% of GDP registered at the fall of communism.

Figure 42 Domestic credit to companies and households, % GDP, Romania, 1990-2010

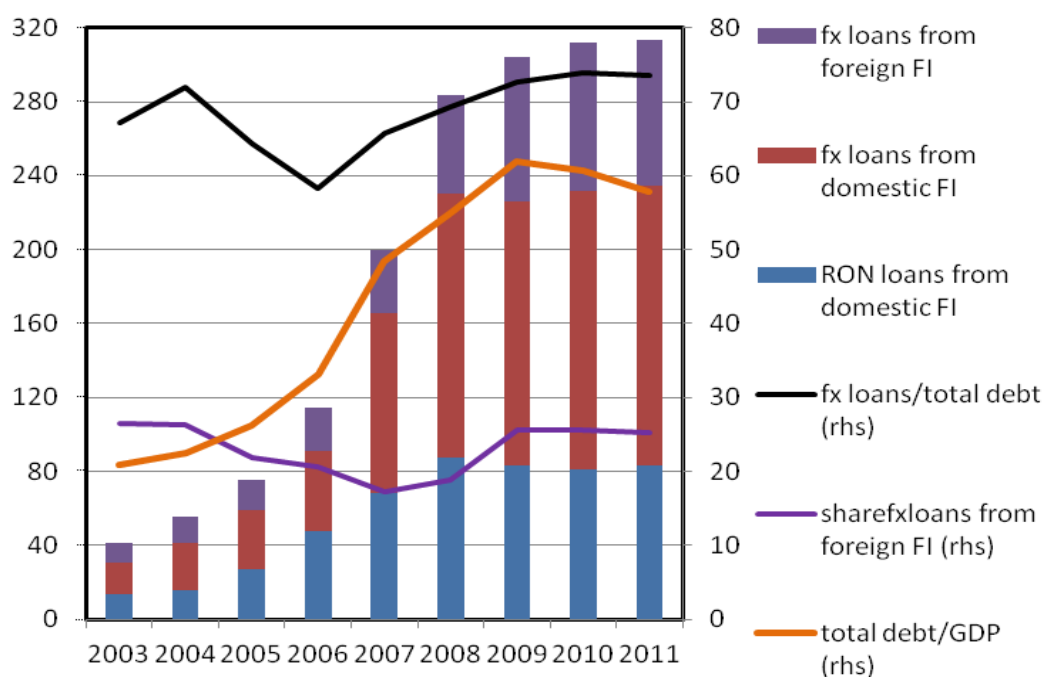


Source: data from the Romanian National Bank

A closer look reveals distinctive dynamics. Since 2000, companies and households have seen their indebtedness rising rapidly (see Figure 43). This growth was sustained by foreign currency credit, extended by both domestic financial institutions and foreign financial institutions. Indeed, the share of foreign currency loans from foreign intermediaries (direct cross-border lending to companies) remained roughly similar throughout after 2000 at around 25% of overall indebtedness. In other words, the rapid growth in overall credit was partly supported by borrowing from foreign financial institutions. This reflects the corporate dynamics of what Nolke and Vliegenhart (2009) termed the dependent economy variety of capitalism. Transnational companies dominate the economy, and influence the mechanisms of external dependency. Transnational companies rely on cheap and skilled labour to set up subsidiaries, thus integrating economies in international production chains and funding these through foreign direct investment. In turn, transnational banks channel capital to their subsidiaries through internal capital markets, depending on the local profit opportunities. The transformation of the Romanian economy into an increasingly dependent

took longer than for most other Eastern European countries because of the distinctive struggles over enterprise restructuring taking place throughout the 1990s, an era that Cernat (2006) described as cocktail capitalism.

Figure 43 Household and companies' indebtedness from external and domestic sources. 2003-2011



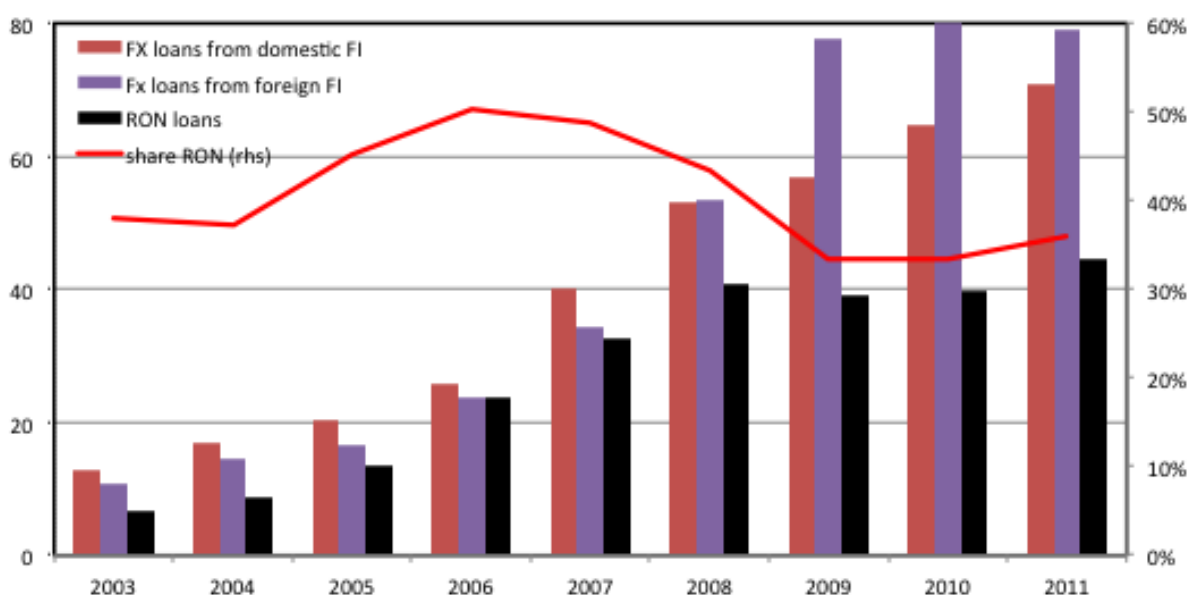
Source: data from the Romanian National Bank

The institutional complementarities between transnational corporations and transnational banks result in increasing reliance on cross-border loans from foreign financial institutions. Banks in turn rely on practices of loans externalization, often undertaken to arbitrage distinctive regulatory and prudential provisions. For example, the external debt contracted by both companies and financial institutions in 2008 could have funded the entire stock of domestic credit extended to households and companies for that year (BNR, 2010).

12.2 Sources of funds for business investment

This dynamic raises distinctive macroeconomic challenges. In the inflation targeting model deployed by the Romanian central bank after 2005, the central bank influences the pace of private liquidity creation through the manipulation of the interest rate. But since 2000, the share of RON-denominated credits has remained under 50% of overall credit extended to businesses operating in Romania (see Figure 44).

Figure 44 Sources of funds for non-financial corporations, 2003-2011



Source: data from the Romanian central bank. FI= Financial Institution

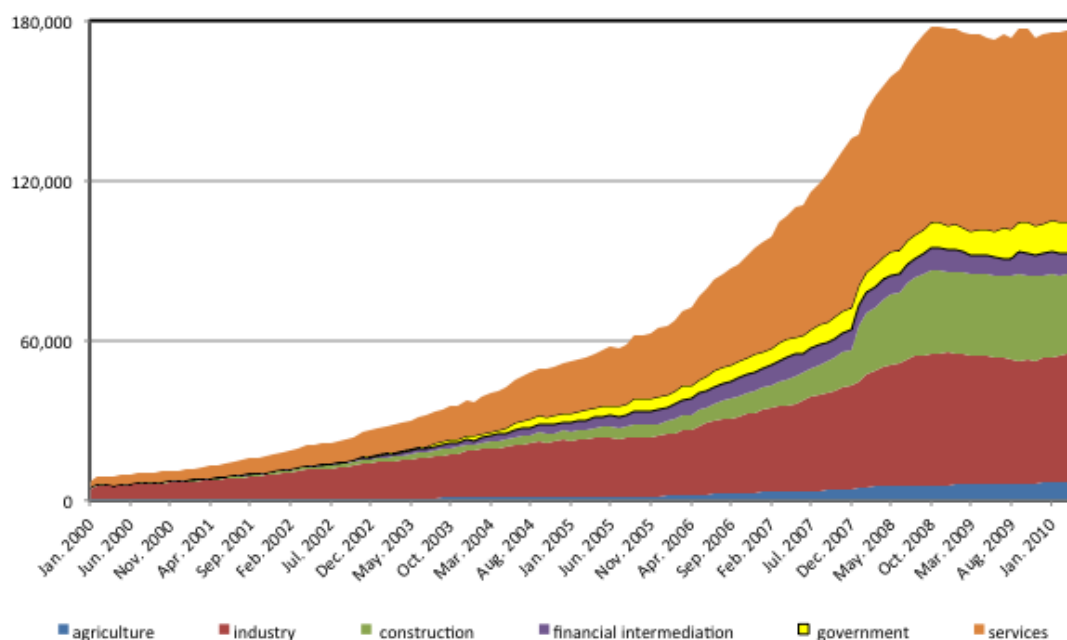
The practice of loan externalization became pervasive throughout the 2000s. For instance, in 2003, the bulk of foreign currency lending came from domestic financial intermediaries (FIs). By 2008, foreign FIs were lending more to Romanian business than domestic FIs, a development the central bank attributes to regulatory arbitrage through practices of loan externalization (FSR 2010, 2011). Foreign-owned banks became increasingly successful at

avoiding regulatory provisions seeking to curb foreign currency growth by ‘outsourcing’ the demand for credit to the mother bank or other subsidiaries that faced lesser regulatory pressures. Foreign owned banks were able to exploit the lack of a coordinated European regulatory framework that would have curtailed the possibilities for arbitraging distinctive regulatory preferences (Kudrna and Gabor, 2013). In addition, cross-border intra-company loans (medium and long-term) registered an increasing share, reaching almost 14% of overall credit to corporations by 2008 (FSR, 2008: 14).

Furthermore, access to bank credit is uneven. The Romanian central bank reports that small and medium companies had limited access to, or willingness to contract, bank loans. In 2006, only 15% of SMEs had an outstanding bank loan (FSR, 2011). On the demand side, a contributing factor has been the availability of high quality collateral – according to central bank statistics, companies post real-estate assets as the main collateral (for over 70% of outstanding bank loans throughout the 2000s). SMEs may not be able/willing to use real estate as collateral. Conversely, around 40% of bank deposits belonged to companies that did not have a bank loan, rendering them net creditors to the banking sector.

The sectoral destination of loans shows the fall in the relative importance of the manufacturing sector for domestic credit institutions (see Figure 45). Thus, in 2000, the industrial sector amounted to 56% of outstanding credit, followed by the service sector (34%). By 2008, the share of industrial credit fell to less than 20%, outpaced by both credit to the service sector and households. Together these last two amounted to around 60% of outstanding credit. Conversely, the real-estate bubble was inflated not only indirectly through mortgage-loans, but also directly through credit to the construction sector – with a share rising rapidly to almost 12% of overall credit by August 2008.

Figure 45 Destination of domestic credit, 2000-2010, Romania



Source: data from National Bank of Romania

In this context, credit to non-tradable activities generates macroeconomic vulnerabilities given the high-share of foreign currency credit extended to sectors without foreign currency revenues. As consequence, two observations stand out for the dynamic of financial intermediation in general, and for financial stability in particular.

The interest rate on domestic currency lending plays a limited role in influencing investment or pricing decisions. Companies have little exposure to RON interest rate volatility because of the low recourse to bank credit. Indeed, central bank statistics suggest that bank loans (both in domestic and foreign currency) have not passed above 15% of overall debt for companies (see Table 17). Conversely, the share of debt service in total operating costs remained low – the central bank put these at less than 2% in 2005, a share that remained the same in the run-up to the crisis. In fact, given the currency composition of companies' debt, it would appear that companies became more exposed to the interest

rate decisions taken in the Eurozone than to those of the National Bank of Romania. Global liquidity conditions thus matter even for countries with less financial depth.

Table 17 Indebtedness indicators for companies, Romania

	leverage ratio (rhs)	bank debt/total debt	bank debt/equity
2005	1.6	10.8	19.3
2006	1.5	12.3	18.5
2007	1.7	13.2	22.7
2008	2.0	12.7	25.0
2009	2.0	12.3	24.2
2010	2.1	12.6	25.9

Source: data from National Bank of Romania

Furthermore, the exchange rate is the key financial variable for non-financial companies. Companies are thus exposed not only through the traditional channel of the exchange rate pass-through into prices, but also directly to volatility in international financial markets because of their reliance on foreign loans.

12.3 Privatisation – role in relation to non-financial sector

The plans for the privatization of the state-owned companies were based on new institutional, liberal models of restructuring (Ibrahim and Galt, 2002; Pickles, 1998). These ignored the legacy of central planning, institutional inertia or the role of powerful political actors in the negotiation of post-socialist restructuring processes.

Scholars agree that privatization processes in Romania had limited success throughout the early 1990s (Pop, 2006). Governments chose a mass privatization approach, in which the population got property rights through coupons (tokens). Banks played a limited role in the process since the privatization method involved a transfer of ownership

rights. For this reason, privatization for such companies did not involve mobilizing new sources of funding or sale of assets.

Privatization often involved chaotic approaches, driven by the degree of ideological commitment to market processes and the pressure of international institutions. The IMF made privatizations part of its structural conditionality. For example, in 1997, the newly elected government promised to privatize 50 companies a week in order to accelerate privatization. When it only achieved half of the targeted numbers, international analysts interpreted this as a gap between rhetoric and pragmatic politics that made right-wing governments as prone to vested industrial interests as its 'neo-communist' predecessors (EIU, 2001). In turn, less attention was paid to the conditions that investors were prepared to offer, or indeed to any demand side constraints. This constituted a powerful narrative: if privatization lost momentum, it did so because the Romanian state failed to sustain investors' interest. Privatization accelerated after 2000, when foreign direct investment targeted strategic industrial sectors, including banking, oil extraction/refineries and public monopolies (see Pop, 2006).

Such accounts of privatization sideline the role of that the shift from relational to impatient banking in the early years of transition played in the restructuring of the Romanian industry.

12.4 The involvement of the financial sector in restructuring non-financial corporations

Two assumptions dominated the discussions on the relationship between the financial sector and state-owned companies after the fall of the socialist system. The first pointed to the share of industry in economic activity to suggest that post-communist countries were overindustrialized (World Bank, 2005). The second questioned the possibility of reforming state-owned enterprises without privatization because of the pervasiveness of the 'soft

budget constraint' (Kornai, 1998; Gabor, 2012a). Particularly in the policy advice of international financial institutions, 'restructuring' seldom involved new investments to upgrade production lines but instead a downsizing of the industrial sector (Long and Rutkowska, 1995). In other words, the restructuring of the state-owned enterprises would not be designed as part of an industrial policy, but instead left to the disciplining hand of the market. Yet this approach to restructuring did not prevail uniformly across former communist countries. Governments did propose, and often successfully implemented, industrial policies in Poland, Hungary or the Czech Republic.

Initially, Romanian reformers intended to do the same. The Commission for Transition (1990) focused on industrial upgrading as the basis for catching up with Western European economies. It drew an ambitious set of measures that would promote capital investments in strategic industrial sectors, neglected during the 1980s, to rebuild the technological capabilities of the Romanian industry. The Commission's report emphasized the key role of the financial sector in this process, through an endogenous money approach that would combine competitive interest rate setting with subsidized credit to strategic industrial sectors. Relational banking, rather than arm's length finance, was deemed essential for this process. To support industrial upgrading, the report emphasized that managed exchange rates and price controls were necessary because the vertical integration of the Romanian industry would translate price liberalization or rapid exchange rate devaluation into an inflationary spiral, threatening the restructuring process. In other words, the home-grown preference for industrial restructuring sought to achieve a coordinated type of capitalism.

Policy priorities changed once Romania had to turn to the IMF for balance of payment support in early 1991. For the IMF, the complex networks of bargaining underpinning the relationship between banking and industry threatened the move to a market-driven system where prices had clear signalling properties, and where profit, rather than bargaining skills, determined the survival of a company (Demekas and Khan, 1991; Allen and de Haas, 2001). Romania had more severe problems compared to regional

peers because the country had undertaken limited market reforms during the years of socialism, and had therefore a greater share of state involvement in economic activity. Furthermore, the IMF manifested concerns that the soft-budget constraint would have negative consequences on the macro level as well, undermining efforts to ensure macroeconomic stability (IMF, 1991). These efforts highlight the importance of approaching financialization not only as a material shift in practices, but also as a discursive regime concerned with re-shaping relational banking: the IMF insisted that soft-budget constraints would feed excess demand, creating both inflationary pressures and higher external imbalances.

But the definition of the reform problem through soft-budget constraints, rather than active industrial restructuring, confronted policy makers with a paradox. Who would enforce discipline on state-enterprises, and how? The immediate answer would be banks as the key actors in constructing hard-budget constraints, whereas the medium-term plan envisaged privatization of state-owned companies. However, assigning banks the task of hardening budget constraint raised a new set of problems, as banks were also state-owned. Since mainstream finance scholarship doubted that private banks could overcome soft-budget constraints (see Boot, 2000), 'transition' scholars went as far as to suggest that state-owned relational banking could never do so (McKinnon, 1991). They recommended that state companies be forced to raise funding only from capital markets or own resources, and have access to banking loans severely constrained until their viability in a market system is proven. The World Bank put it as follows:

For the most part, banks are not financing enterprise restructuring. On a voluntary basis they are providing short-term commercial credit for profitable firms with adequate collateral. For banks this is and should be the focus of their lending.

Restructuring weak enterprises is a diversion (Long and Rutkowska, 1995, p.11).

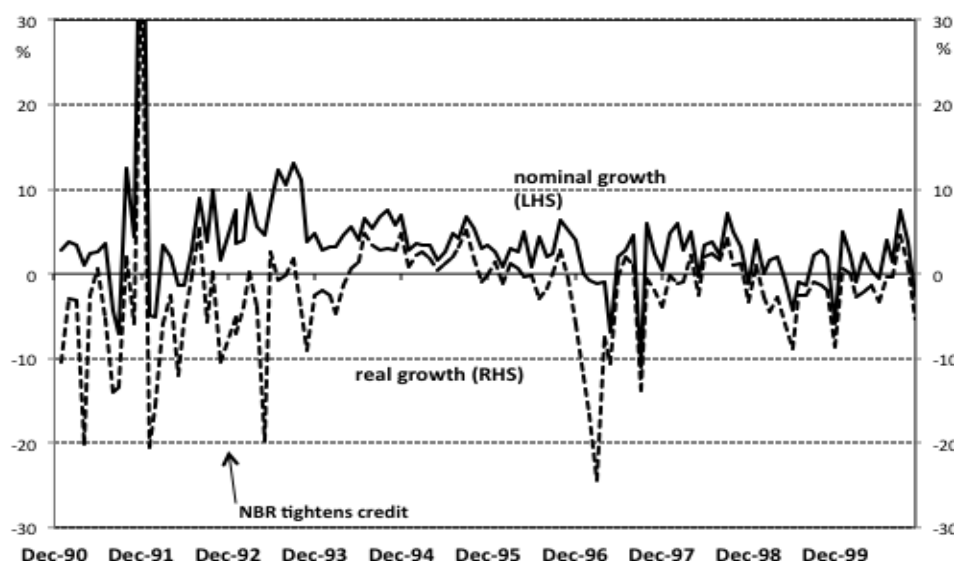
The IMF and the Romanian central bank proposed macroeconomic solutions to micro imperfections in order to create the conditions under which banks would be able to enforce discipline on state companies. Macroeconomic stability relied on, and would accelerate, the

restructuring of the relationship between banking and industry. This was the fundamental building block of central bank-led financialization: that the central bank would prevent ‘weak’ banks from supporting ‘weak’ state companies.

Successive IMF agreements during the period of central bank led-financialization focused on two variables that would improve relational banking: tight lending conditions and exchange rate flexibility (IMF, 1997). The first would actively prevent banks from feeding soft-budget constraints, whereas the second would subject industry to the rigours of international competition. The IMF’s programs established contractionary monetary targets, positive real interest rates and flexible exchange rates (see Chapter on Macroeconomic Policies). However, neither the Romanian central bank nor the successive governments could uphold these policy preferences, inscribed as quantitative or structural criteria in the IMF programs, for long (Gabor, 2010a). The IMF repeatedly suspended its programs as Romanian authorities failed to either comply with the money supply targets or when the central bank intervened to curtail exchange rate depreciation (Pop, 2006).

This singularly unsuccessful relationship with the IMF indicates the economic, social and political costs entailed by the transformation of relational banking into impatient banking. The instruments that the central bank used to enforce tighter lending conditions - including credit ceilings, reduced access to central bank liquidity or high interest rates - saw a rapid deterioration in economic conditions, deindustrialization and liquidity shortages (see Gabor, 2010a). Indeed, it is well documented that the IMF’s stabilization programs throughout the 1990s produced liquidity shortages, both in Latin America (Schadler, 1995) and Eastern Europe (Calvo and Corricelli, 1992). In turn, lending to companies contracted in real terms (see Figure 46) between 1991 and 1993 and then again after 1997. Sustained nominal and real growth occurred during 1994 and 1996, as the Romanian central bank made liquidity available; albeit at very high real interest rates (see section on macroeconomic policies).

Figure 46 Nominal and real trends in credit to non-government sectors, Romania



Source: data from National Bank of Romania

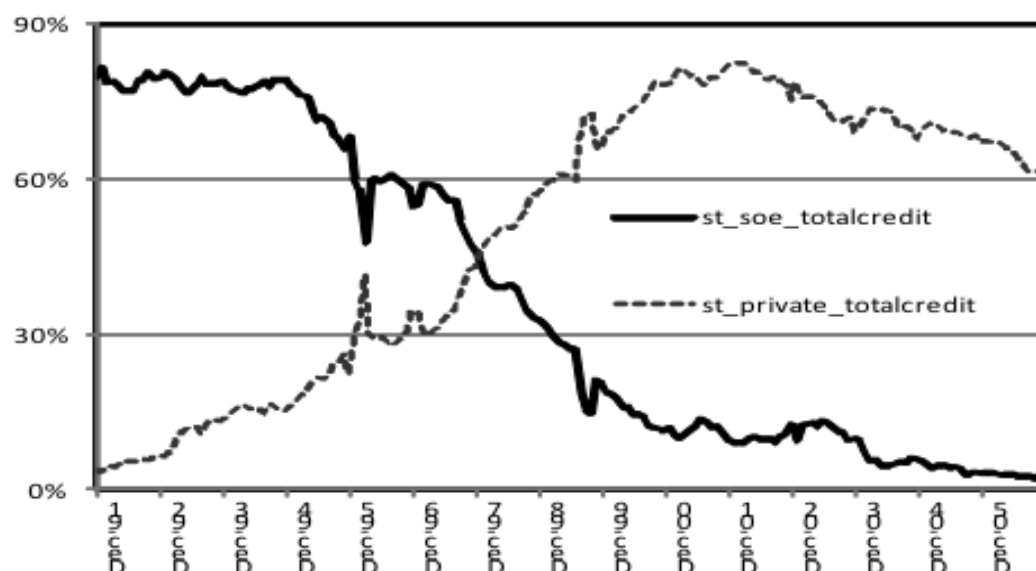
Throughout the period, governments did commit temporarily to the IMF's contractionary policies, and when they renounced these commitments, they did so because of the political consequences involved in the wholesale, rapid dismantling of the state-owned industrial sector. The private sector proved unable to generate the employment opportunities and export earnings that the state-owned companies had shed. Romanian governments remained painfully aware that the international pressures for restructuring had to be balanced with the domestic pressures for growth, employment and foreign currency revenues. The increasing financialization of banks, both state-owned and private, played a crucial role in this process.

Pressured by the macroeconomic policy stance into the task of 'disciplining' state-owned companies, commercial banks rapidly shifted towards impatient practices. Confronted with liquidity shortages throughout the early 1990s, state-owned banks dominating the banking sector often refused to release the deposits of state-owned companies, delaying their payments to suppliers by weeks and even months (for instance throughout 1993, during the second IMF program, see Gabor, 2010a).

In turn, companies responded to payment blockages by resorting to inter-enterprise arrears, taking advantage of the existing relationships in supply chains and political connections. Such behaviour confirmed the prediction of old institutionalist theories. These warned that the policies of rapid privatization ignored the institutional legacies and path-dependence confronting policies seeking to effect rapid transformation (Ibrahim and Galt, 2002). Companies generated credit relations built on existing supplier networks when monetary policy sought to constrain relational banking.

State-owned banks proved less willing to sustain soft-budget constraints than the pessimistic advisors had feared. While state-owned banks did extend preferential credit when required by governments, their other lending activities became increasingly short-term, for both private and state-owned companies. Indeed, the share of short-term credit in total credit for non-financial companies remained above 75% throughout the 1990s (see Figure 47). Impatient banking, underpinned by tight financing conditions of the central bank and an uncertain macroeconomic environment, affected private companies as much as state-owned companies. Even by 2004, when more than half of banking assets were under private ownership, private companies raised around 60% of their RON financing from banks on short-term basis.

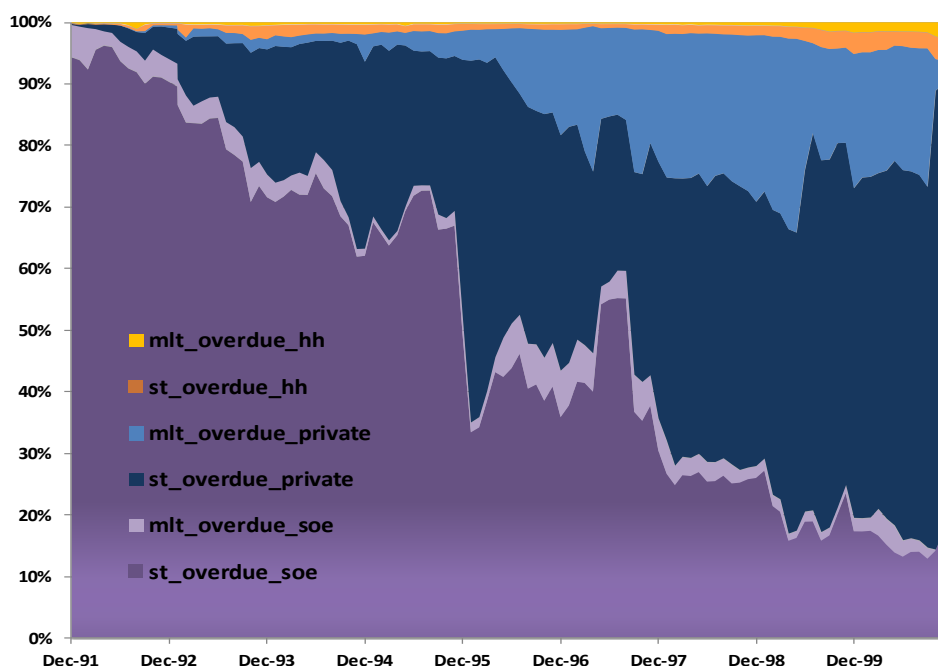
Figure 47 Share of short-term lending to non-government, RON-denominated, Romania, 1991-2000



Source: data from central bank of Romania and Institute of National Statistics. Note: soe = state owned enterprises

Impatient state-owned banking translated into prohibitive funding conditions for both state-owned and private companies. Although policy discourse typically focused on the difficulties that state-owned companies faced in servicing bank loans as evidence that privatization was urgently required, private companies faced similar difficulties. The statistics of overdue credit show an increase share of overdue credit contracted by private companies (see Figure 48). In fact, by 1995, private companies had a higher volume of overdue short-term credit than state-owned companies

Figure 48 Overdue RON credit, composition, by sector, Romania, 1990-2000.



Source: data from the Romanian National Bank Annual Reports (1993-1996).

Note: mlt_overdue_soe = medium and long-term overdue credit to state owned companies; hh = households

Yet the central bank and the IMF refused to attribute the growth of impatient banking to liquidity shortages stemming from tight monetary policy, and to link rampant inflation to rapidly depreciating exchange rates.

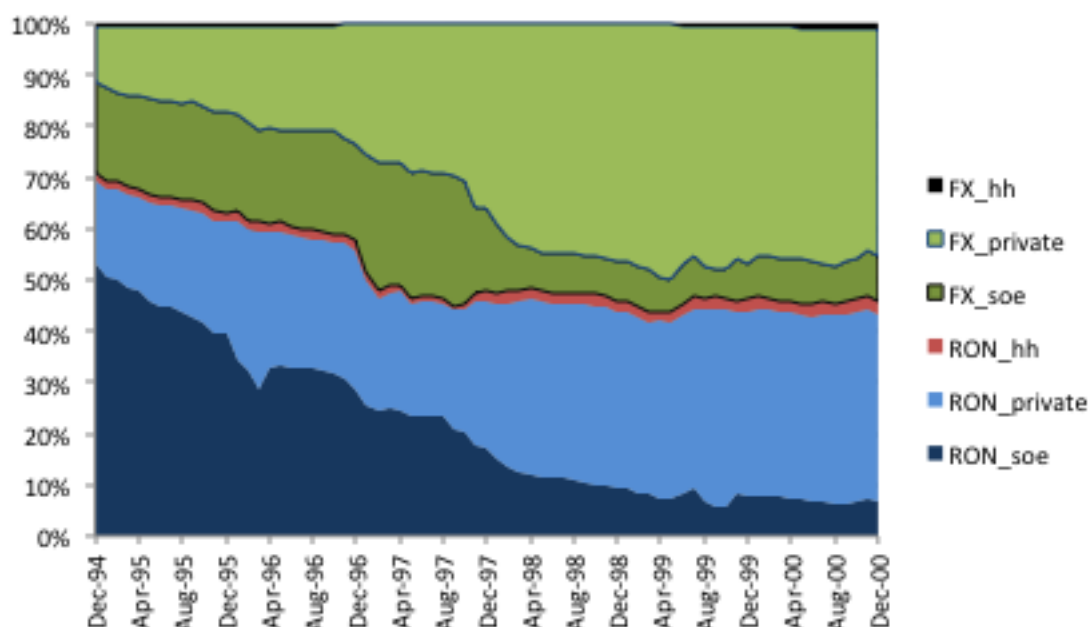
Instead, inter-company arrears and overdue loans were treated as evidence of pervasive soft-budget constraints and vested political interests, to be treated by further tightening of monetary conditions in the short term and structural reform (privatization). This position thus prevented the emergence of a well-designed industrial policy that could have carefully identified both state-owned and private companies with potential competitiveness in international markets, as 'transition' economies in Asia did. In the absence of clear competitiveness criteria, only powerful industrial actors with political connections had access to the short-lived populist measures that governments described as industrial policy (see Pop, 2006).

By the end of the 1990s, the IMF recognized that it had been mistaken in rejecting the link between exchange rates and prices. It only changed its mind in 1997, once the right wing party finally won the elections. At that point, it shifted from the previous insistence on exchange rate flexibility to endorsing a managed exchange rate regime. The 2001 country report made that mistake very clear “the role of money and credit growth has also been important, but harder to demonstrate empirically” for price stability, “the actual path of inflation was largely determined by policy decisions regarding the timing and magnitude of price liberalization and exchange rates” (IMF, 2001:10).

This “policy mistake”, commonly attributed to the misguided monetarist underpinning of the IMF’s conditionality, reflected ideological preferences about the role of state-owned companies. A managed exchange rate would have provided indirect support to state-owned companies in the industrial sector, heavily reliant on imports of intermediary inputs. For example, the ‘communist champions’ of the steel industry (later purchased by Mital Steel in a highly controversial privatization involving the British Prime Minister, Tony Blair), had high foreign currency needs because 95% of the iron ore and 70% of the coal needed for production had to be imported. For such large state-owned companies, exchange rate volatility and tight lending conditions severely undermined the scope for planning production and for restoring profitability. The IMF rejected exchange rate management because it viewed the rapid privatization of state-owned companies as the only viable policy option for the restructuring of the Romanian industry.

Confronted with such uncertainties, banks and non-financial companies increasingly turned to foreign currencies. By 1997, almost 50% of the outstanding loans to non-government were in foreign currency (see figure 49), better suited to mitigate the exposure to a volatile macroeconomic environment and tight lending conditions imposed by the central bank for credit in domestic currency.

Figure 49 Lending to non-financial companies and households, currency composition, 1994-2000.



Source: data from the Romanian National Bank Annual Reports (1993-1996).

Note: FX_hh= foreign currency credit for households; soe = state-owned enterprises.

The shift to impatient banking puts in perspective the structural changes that the Romanian economy experienced during the 1990s. (State-owned) banks curtailed access to long-term finance during a period when companies had no other source of external finance, while the central bank failed to provide exchange rate stability. Companies also lost virtually all state support mechanisms in place during the socialist period (providing inputs, distribution and market networks), export markets and faced increasing competition in domestic markets because of the IMF's requirements for liberalizing trade. In turn, they could only rely on informal domestic networks of credit and sporadic, ill-designed support from governments. Although the mainstream transition literature emphasizes the last two to explain the failures of the Romanian economic reform, the pace and nature of deindustrialization questions the 'vested political interests' argument. Indeed, industrial output halved by

1995, the largest fall in the region with the exception of Bulgaria (see Table 18).

Table 18 Dynamics of industrial output, selected Eastern Europe countries, 1995.

	Romania	Bulgaria	Poland	Hungary	Czech Republic
Industrial production index (1989=100)	55.9	52.1	91.9	80.6	71

Source: compiled from national statistics data

Furthermore, the industrial structure underwent a rapid change, from the early dominance of capital-intensive sectors (chemical products and metal manufactures) to low value-added textiles (see Table 19). Whereas in 1989, textile export only amounted to 10% of total exports, that share increased to 32.1% in 2000. In turn, the share of chemical products in total export earnings halved throughout the period. Furthermore, employment in industry contracted by 50% from around 4.16 million in 1989 to 2 million in 2000. Conversely, little private capital investment took place in the industrial sector. By 1995, the private sector accounted for about 45% of GDP. Its activities concentrated in the agricultural and services sectors (80% and 44% of total output respectively).

Table 19 Source of export revenues, economic sectors, Romania

	1989	1994	2000
Textiles	10.2	23.8	32.1
Chemical products	28.6	21	14.1
Metal manufacturing	35.4	23.3	27.9
Basic metals	13.4	16.3	11.7

Source: data from Institute of National Statistics

In conclusion, a financialization standpoint provides a different account of the 1990s process of restructuring the Romanian industrial sector. This account emphasizes the changing nature of the relationship between banks and non-financial companies, and the role of the central bank in accelerating the shift to impatient finance. Confronted with tight liquidity policies and high interest rate on central bank credit, banks turned increasingly to short-term credit. Companies, both private and state-owned, found it increasingly difficult to mobilize long-term external finance from banks, and had no alternative sources of external funding given the embryonic nature of capital markets. In contrast, the common account describes restructuring as a heavily politicized project where state-owned companies in heavy industry, chemical and agricultural sectors took advantage of the poor legal framework for bankruptcy and political connections to obtain subsidies and thus delay the necessary structural change that would have brought Romania in line with its regional peers (OECD, 1998; Ibrahim and Gault, 2002). This account may well capture the importance of political influence for companies' abilities to mobilize access to subsidized credit, but it neglects the changes in the banking practices or the non-neutrality of monetary policies (Dow, 2003). Rather than becoming part of the economic fabric, banks withdrew their support for economic activity and in particular for long-term capital formation during the period of central bank-led financialization.

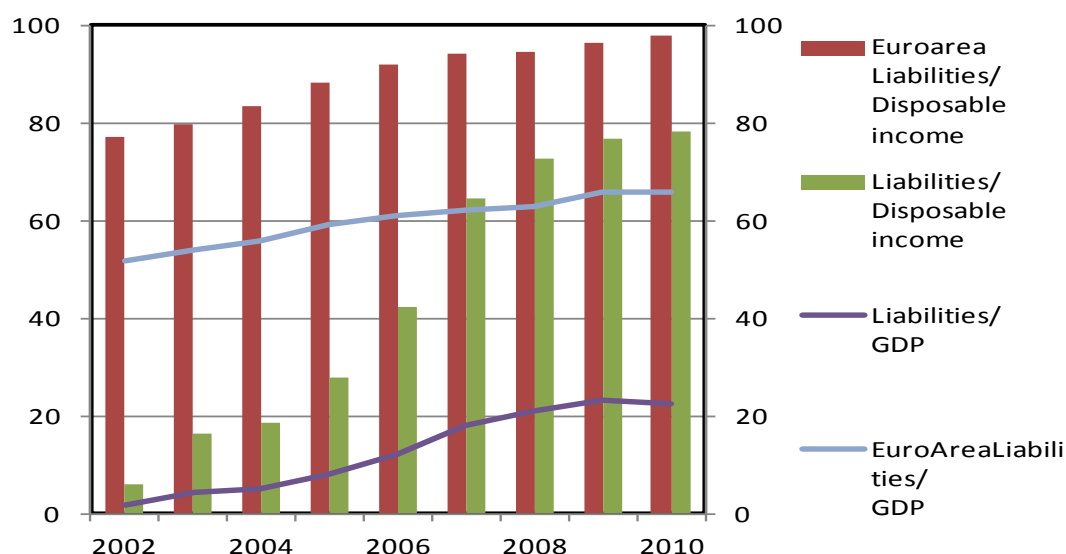
13. Culture and norms/ finance of households

Before 2000, households interacted with the banking sector mainly as depositors. While they maintained deposits – albeit increasingly in foreign currency - with banks (and in particular the state-owned Savings Bank), households' access to credit remained minimal. Public confidence in financial institutions was undermined by various pyramid schemes and financial scandals, including the collapse, in 2000, of a large private investment trust, FNI, that affected 300.000 depositors and various shareholder banks (EIU, 2001). These schemes proved attractive in an environment of negative real interest rates (accompanying high price inflation) by offering high rates of return.

Since 2000, banks and NBFIs increasingly relied on the household segment as a significant source of revenue, following broader trends of financialization in high-income countries (Lapavitsas, 2011). The financial sector came to increasingly mediate spending decisions as households accumulated growing financial obligations through what Langley (2009) called networks of mortgage and consumer credit.

As a result of the easing of credit requirements and the high availability of forex loans at competitive rates, household's exposure to the financial sector increased rapidly. The share of household loans to GDP increased fifteen fold between 2002-2008 from less than 2% of GDP to about 22% of GDP. This growth mirrored, if outpaced, the overall trend increase in household indebtedness in the Euroarea. Still, Romania started from a very low level of private indebtedness and even after the credit boom its level remained well-below the Euroarea average of around 65% of GDP in 2008 (see Figure 50).

Figure 50 Household indebtedness, comparative perspective to Euroarea, 2002-2010



Source: BNR Monthly Bulletin, January 2001-2010.

A second notable trend is the growing share of foreign currency credit in total household credit in Romania, a trend that characterized to an even greater degree the Baltic countries and Bulgaria, all of whom had pegged currencies (Barrell et al, 2009). Whereas in 2000, domestic currency credit amounted to almost 75% of overall household credit, that share had fallen to around 40% by 2008 (See Table 20). Put differently, the forex-denominated household credit grew faster than RON-denominated credit. On the supply side, financial institutions, and banks in particular, preferred to extend foreign currency credit because of their funding strategies, and in particular their increasing reliance on internal capital markets for subsidiaries of large transnational banks. Banks could thus mitigate currency risk by transferring it to households (Gabor, 2012a).

Table 20 Household Indebtedness Indicators, Romania, 2002-2008

	Household credit (mil. RON)	Growth Rate	Share of domestic currency credit	Average interest rate RON (new loan)	Average interest rate EUR (new loan)	RON/EUR exchange rate
2000	573	60%	74%	53.2	n/a	2.48
2001	798	39%	83%	45.7	n/a	2.78
2002	2089	162%	73%	36.6	n/a	3.5
2003	7501	259%	71%	27.8	9.9	4.1
2004	11874	58%	54%	26.9	10.3	3.9
2005	21371	80%	56%	13.73	8.98	3.67
2006	39271	84%	59%	13.86	8.58	3.38
2007	71508	82%	47%	11.94	7.58	3.6
2008	99210	39%	41%	17.64	8.05	3.98

Source: BNR Monthly Bulletin, January 2001-2010; for interest rates, data for end of year.

Households took on currency risk for several reasons. Since 2000, national currencies in the region had appreciated continuously in real terms, and for Romania even in nominal terms after 2003 (see Table 20). This grounded expectations that such a trend will be sustained in the future. Few central banks, or indeed financial market analysts, recognized that a rapid devaluation would be possible. Furthermore, interest rates on foreign-currency credit remained more attractive than RON-denominated credit. Indeed, foreign currency credit grew rapidly after 2003 on the back of a substantial interest rate differential that reduced up to 2008, to increase afterwards. In sum, financialized households imitated the carry-trade practices of private financial actors: borrowing at low interest rates in Euros and Swiss francs in order to finance housing or consumer purchases, a practice widespread in Eastern European countries with high interest rates and Austria (Beer, Ongena and Peter, 2009). Yet unlike financial players, financialized households had not

developed exit strategies to prevent carry losses (from exchange rate volatility) because the assets targeted were far less liquid.

This development highlights a well-recognized problem with inflation targeting regimes that also affected Romania: tailoring interest rate decisions to price stability prevents central banks from taking into account credit cycles and in particular the rapid expansion in foreign currency credit (see Galati and Moessner, 2011). Although the Romanian central bank manifested concerns about foreign currency lending to households, and sought to implement regulatory measures to curb rapid growth (see chapter on regulation), these had limited success because of regulatory arbitrage and ill-defined cross-border regulatory responsibilities in the case of transnational banks (Kudrna and Gabor, 2013). A further easing of the regulatory environment in 2007, when the central bank decided to allow banks to draw their own risk management strategies, strengthened the procyclicality of household lending. In sum, households became increasingly exposed to exchange rate risks, and financial institutions indirectly to a rapid increase in non-performing loans in the event of a devaluation of the domestic currency.

Furthermore, boosted by changes in labor market dynamics, pension policy and taxation, increasingly optimistic expectations that household incomes would converge to European levels also contributed to the rapid demand for credit (in foreign currency). After a long-period of real wage compression throughout the first decade of transition, households were enjoying rapid increases in real wages. For example, in 2006, real wages (net average) increased by 11%. Migration also supplemented net wealth. Remittances through the banking sector quadrupled between 2002 and 2006, largely arising from the transfers of long-term workers in Spain, Italy, Ireland and the United Kingdom (FSR, 2007). Indeed, by the middle of the decade remittances were roughly at a similar level with FDI and had switched to formal means of transfer, prompting central bank officials to factor in remittances in their perspectives on the exchange rate (Ban 2012). According to central bank reports, remittances contributed to an increased demand for real estate assets, the single largest component of net wealth (see Table 21). From this perspective, the rapid

increase in net wealth was then partly driven by the real-estate boom, artificially inflating perceptions of wealth. Indeed, the ratio of net wealth to disposable income increased by two and a half times between 2002 and 2007, to fall by a third by the end of 2008, once global deleveraging affected Romania.

Table 21 Household wealth indicators

	Net wealth/ disposable income	Net financial assets (%GDP)	Non- financial assets (% GDP)	Debt/Financial Assets	Current transfers (remittances, EUR mil.)
2002	404.4	29.7	78.5	4.6	1612
2003	499.8	29.1	101.6	13.1	1639
2004	564.5	36.7	116.7	13.1	1412
2005	672.2	44.7	147.9	16.6	3804
2006	807.4	46.1	183.0	24.7	5317
2007	1012.8	58.7	225.3	29.3	5120
2008	708.1	41.4	161.0	46.5	5139

Source: Monthly Bulletins, National Bank of Romania

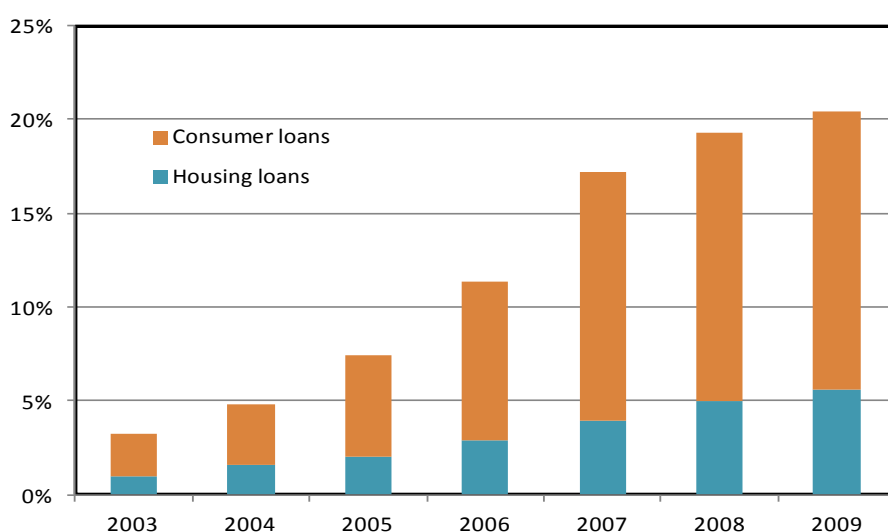
The Romanian central bank statistics distinguish between financial and non-financial assets. The first comprise of cash, bank deposits, equity and contributions to private pension funds. In turn, housing provides the bulk of non-financial assets. The comparative dynamics show that financial assets grew at a much slower pace than non-financial assets throughout the period. In other words, the credit-inflated housing market drew the overall increase in net wealth. From a financialization standpoint however, housing should also be treated as a financial asset for two reasons. Households may treat houses as a savings/investment vehicle, particularly when alternative savings instruments are limited or where there are confident expectations of future price increases. Furthermore, since

houses can be used as collateral to access to credit, households view housing as another asset that can generate higher exposure to finance.

Furthermore, the destination of household loans indicates that the credit boom mainly supported a consumption boom (see Figure 51). The bulk of credit serves consumption purposes, whereas households borrowed less to fund house purchases. Since the early 2000s, consumer loans amounted systematically to around 70% of overall household credit, the opposite of Euroarea, where mortgage loans dominate household liabilities (less than 15% consumer credit for 2008).

This composition of household credit reflects particular trends in income and inequality in Romania. Indeed, the first decade of transition saw a sustained deterioration in standards of living and well-being in general. Official data suggest that households' disposable income contracted by 25% between 1995 and 2000 (Molnar, 2010), reducing demand for durable goods in particular. In contrast, the improved economic outlook after 2000, growth in real wages and rapidly increasing remittances strengthened general consumer confidence, and increased demand for goods to replace, for many households, durable goods purchased during the communist era (white goods, automobiles).

Figure 51 Destination of household loans, % of GDP



Source: BNR Monthly Bulletin, January 2001-2010.

Yet not everyone benefited equally. The differentiated impact on consumer and mortgage loans further magnified income inequalities. Access to mortgage credit was restricted because financial institutions typically require collateral for high-value loans. The dynamics in households' net wealth suggests that real estate contributed most to the rapid increase after 2000. Thus, the households already owning a real estate had the easiest access to acceptable collateral, whereas households dependent on wages or other financial assets would not have the same access to acceptable collateral. In contrast, households at lower levels of income could gain easier access to consumer credit since that type of credit did not require borrowers to post collateral, particularly since non-bank financial institutions sought to grow rapidly on the back of consumer credit.

Beginning with 2005, NBFIs increasingly focused their attention on the household retail finance market. According to central bank reports, NBFIs growth reflected both expectations of profit in high-growth markets, but also commercial banks' attempts to bypass regulatory efforts to stem a credit bubble. Before 2006, commercial banks set up NBFIs to take advantage of a regulatory gap, since the central bank did not apply prudential measures to these financial intermediaries while it tightened significantly the conditions for bank lending to households. Even after prudential measures were extended to NBFIs, central bank research suggests that commercial banks used these to arbitrage regulatory measures aimed at curbing forex lending (FSR, 2010). From this perspective, NBFIs acquired some of the functions of shadow banks in the US that allowed off-balance sheet activity for large commercial banks, although unlike shadow banks, they did not perform the full range of maturity transformations nor did they engage in securitization. NBFIs relied either on own sources, or use internal capital markets if they belong to transnational banking groups (FSR, 2007).

Easing regulatory pressures further contributed to the growing share of consumer credit in NBFIs' portfolios (see Table 22). In January 2007, the central bank decided to allow

financial institutions to set their desired exposure to the household sector. As a consequence, financial institutions-both banks and NBFIs- adopted increasingly pro-cyclical practices. One illustrative case is the proliferation of consumer credit (or credit cards) extended without any evaluation of borrower risk - described as “ID credit” because financial institutions would grant low-value consumer loans once they verified the identity of the borrower, but without undertaking any meaningful evaluation of borrower’s risk - with the attending consequences for moral hazard and adverse selection. Newspaper reports suggested that by late 2008, “ID consumer credit” funded around 80% of purchases of electronic goods²⁸.

Table 22 NBFi lending to households

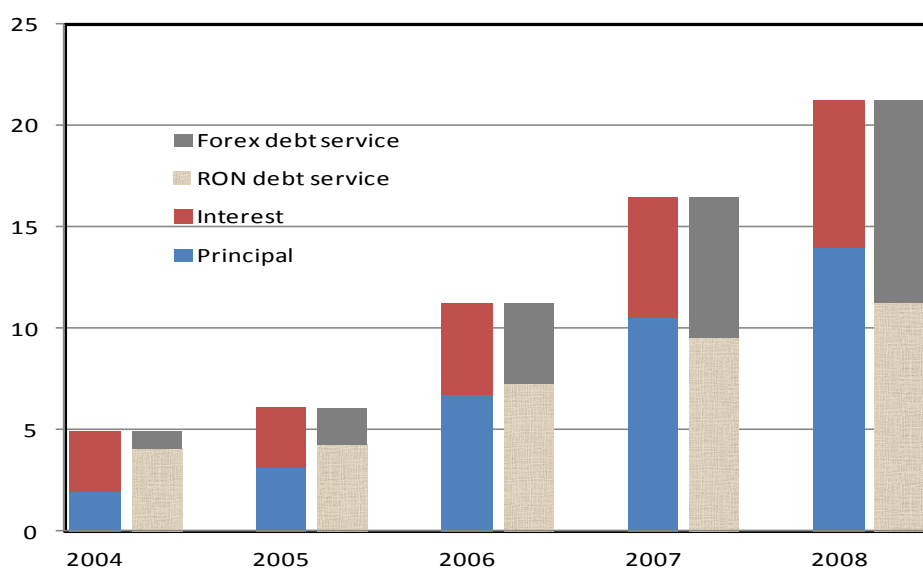
	Total lending (RON bn)	Share of GDP	Consumer Credit
Mar-08	6.4	1.5%	77.4%
Dec-08	8.3	1.6%	73.1%
Dec-09	6.1	1.2%	87.4%

Source: central bank statistics

Increased exposure to the financial sector places a significant burden on the household sector. In 2004, households spent less than 5% of disposable income on servicing their debt (see Figure 52). By 2008, that share saw a fourfold increase, to above 20%. Further changes in composition are relevant to consider. In 2004, households were paying more in interest than principal - a composition that changed by 2008 as the maturity of loans increased. On the contrary, the change in currency composition suggested increased vulnerability to exchange rate volatility. Debt service denominated in RON lost ground to foreign currency debt service by 2008. Indeed, financial obligations in foreign currencies became a key feature of financialized households.

²⁸ <http://www.ziare.com/articole/credit+cu+buletinul>

Figure 52 Household debt service, % of annual disposable income



Source: data from the Romanian National Bank Annual Reports.

13.1 Housing finance

The dynamic of the Romanian housing market has been influenced by various historical, social and regulatory pressures. First, during state socialism (1949-1989), the state was the main developer of new properties, with family projects dominating rural real estate. Extensive redistribution schemes gradually new state-owned housing into private ownership at rock-bottom prices. According to Palacin and Sherburne (2005), 75% of dwellings were privately owned in 1980. The centralized welfare provision further implied that the state provided heavy subsidies for rents and utilities for public housing, so that spending on housing represented a small share of disposable income.

The privatization of public housing proceeded rapidly after the fall of socialism, with 2.2 million formerly public rental dwellings being sold to their tenants at affordable prices. The move was an attempt by postcommunist governments to cement their economic legitimacy in what some called a “super homeownership state” (Amman et al, 2011). By the

2000s the ownership rate was above 95 percent, one of the highest in the world. However, on the supply side, the 1990s saw a rapid fall in the number of new dwellings as a result of large fiscal contractions and the withdrawal of the state from the provision of housing. According to OECD data, the volume of new dwellings provided by the state fell by more than 60% in the first five years of transition. In turn, private developers faced limited access to finance given the high nominal interest rates and banks' reduced willingness to extend long-term credit. The result was a high level of overcrowding, with the usable floor space per capita being one third below the EU-27 average.

To address the bottleneck, new laws governing mortgage lending were passed in 1999 and state provision of affordable housing returned as a public policy priority after 2000. The newly established National Housing Authority initiated several programs to develop new housing targeted at younger families with limited access to housing finance. The government contributed through a new program (The First Home/*Prima Casa*) meant to encourage young people to take up the loans via a subsidy of 30 percent of the housing value (up to 10,000 euros).²⁹ However, UNECE (2006) reports cast doubts about the effectiveness of targeting, supporting anecdotal evidence that high-income households accessed the NHA programs through their political connections.³⁰ Moreover, in 2002 the government used the German model (Bausparkassen) to establish a system of contract-savings banks for the construction and purchase of housing via low-rate housing loans stimulated by provisions that made interest tax deductible (Amann et al, 2011).

In sum, before the 2008 crisis, the Romanian housing market, and the residential sector in particular, gained attention as sources of potential growth with high rates of profitability.

29 For an overview of Romanian social housing and the role of the state in this sector see Wolfgang Amann, Ioan Bejan and Alexis Mundt, "Romania: The National Housing Agency-A key Stakeholder in Housing Policy" in Jozsef Hegedus, Martin Lux and Nora teller eds, *Social Housing in Transition Countries*, London: Routledge, 2012.

30 No reliable statistics is available on the allocation process of social dwellings.

13.2 The residential sector

The residential segment experienced a boom prior to 2008, to then contract rapidly afterwards. Indeed, the number of new dwelling units rose rapidly between 2002 and 2008. At the peak of the residential bubble, in 2008, that growth rate reached 36%, reflecting equally fast developments in both urban and rural areas (see Table 23). The state contributed with a diminished share to this dynamic, as the share of private financing for new developments remained above 90% after 2006. Furthermore, the available statistics for residential prices in the Bucharest area strongly suggest a housing bubble – prices registered an eight-fold increase between 2002 and 2008. The crisis curtailed this rapid expansion, both in volume – with new projects completed falling by 20% by 2010 – and prices. Indeed, residential prices in Bucharest fell by almost 50% between 2008 and 2010.

Table 23 Residential housing trends, Romania

Year	Units completed (y-o-y growth)	Urban share	Private Financing	Residential prices Bucharest (EUR/sqm)
2002	6.6%	n/a	n/a	250
2003	7.1%	n/a	n/a	400
2004	7.3%	n/a	n/a	450
2005	8.6%	47%	83%	800
2006	18.2%	47%	88%	1200
2007	21.4%	50%	91%	1600
2008	36.3%	48%	93%	1900
2009	-5.7%	51%	91%	1500
2010	-20%	48%	94%	1100

Source: data from Institute of National Statistics

Yet it is important to note that the housing boom was not solely driven by banks' (easy) lending. Compared to consumer credit, housing loans grew at a relatively slower pace. The dynamics of the housing market reflected in turn distinctive institutional, operational and social characteristics.

First, the legal framework established two laws for extending mortgage loans. The Banking Law (1998) set the conditions under which banks could provide housing finance secured by real estate, whereas the Mortgage Law (1999) extended permission to non-bank financial intermediaries and allowed for loans against future built property. The choice between the two relied on banks' preference for the maturity of the housing loan. Since the Mortgage Law imposed a minimum ten-year maturity, it was the provisions of the Banking Law that initially set the pace of housing loans.

Furthermore, the housing bubble further contributed to the growth in the insurance market because the Mortgage Law required borrowers to insure the property for the duration of the mortgage contract. Borrowers were allowed to choose their own insurance provider if they do not wish to use the insurance subsidiaries of the mortgage provider. Lenders often required borrowers to take out a life insurance as a condition of the mortgage contract.

The regulatory regime governing housing loans placed severe prudential conditions on mortgage lenders before January 2007. Indeed, regulatory measures introduced in February 2004 and strengthened in September 2005 envisaged a comprehensive range of counter-cyclical macroprudential measures. These included the following:

- a) debt service to income ratio at 35% of net income for borrower and family, if applicable
- b) a loan to value ratio of 75% for both purchases of existing dwellings or cost estimates for building new ones
- c) collateral to loan value of at least 133%.
- d) ceiling on lenders' exposure to currency credits of 300% of own funds for credit to un-hedged borrowers.

These prudential measures narrowed access to housing loans. By the end of 2006, the central bank reported that the average mortgage loan registered values well below the average house price, and that over 65% of all mortgage loans remained below the average value. However, the Romanian Central Bank decided to eliminate all macroprudential measures in January 2007, invoking the need to align the Romanian regulatory regime to European regulatory standards. It only retained reserve requirements as a tool to stem rapid credit growth. The effects became apparent immediately, with household borrowing for housing increasing by around 80% in real terms in 2007, three times faster than in the previous year (see Table 24). The bulk of this credit growth came from currency credit, with a growing share from ‘exotic’ currencies such as Swiss Francs and Japanese Yen. This reflected to a significant extent the lenders’ strategies of raising funding in low-yielding currencies in international money markets. The growth rate subsided significantly in the last months of 2008, and the levelled off completely by 2010.

Table 24 Housing finance, household sector

	Total (RON mill)	Real growth (YOY)	Share NBFI	Share RON	Share Euro	Share Other currency
2009	24,665	3.5%	1.7%	7%	78%	15%
2008	22,606	39.1%	7.6%	7%	75%	18%
2007	15,379	89.7%	7.7%	10%	75%	15%
2006	7,902	26%	n/a	14%	76%	10%

Source: central bank statistics

International investors played an important role in fuelling the real estate bubble because the Romanian market provided important yield differentials, both on the residential and commercial segments. First, real estate attracted increasingly large FDI flow, with its share in overall direct investment doubling within 2 years between 2006 and 2008. To put it

in a comparative perspective, consider the three funding sources for real estate sector – housing credit to households, credit to the construction sector and outstanding FDIs (see Table 25). In 2006 FDI in the real estate sector was similar in volume to household lending for housing, and less than lending to the construction sector. By 2008, FDI had outpaced both, having almost tripled within two years. According to market participants, international participation took two forms. Investors engaged in development of new residential or commercial projects, to be either sold or maintained in portfolios and rent out. The second, more apparent speculative practice saw investors purchasing finished projects in anticipation of further price increases (Cushman and Wakefield, 2011). Thus international demand, motivated by speculative intentions, supported the bubble, particularly in the Bucharest area. Financialized investment practices signal the increasing importance of real estate as an asset class.

Table 25 FDI in real estate/construction sectors

	Share in FDI stock	Outstanding housing loans (households) (EUR bn)	Outstanding construction loans (EUR bn)	Outstanding FDI (EUR bn)	Growth rate
2006	6.4%	2.3	3.44	2.2	n/a
2007	7.8%	4.2	3.07	3.3	50%
2008	12.7%	5.67	5.37	6.1	85%
2009	12.9%	5.84	5.33	6.5	7%

Source: central bank data

There is a distinct geographic dimension to the housing market. The capital, Bucharest, contributes 18% to the stock of urban dwellings. Furthermore, central bank data suggests that residential lending concentrated in key cities, particularly Bucharest where both the number and the average value of the housing loan was twice as high then in other counties. This partly reflected a combination of inequality and remittances. Thus rural housing

development projects relied less on housing finance because of significant financial exclusion, so that the remittances tended to fund new dwellings in the rural sector

Regulatory authorities took little decisive action in the years of rapid growth, 2006-2008. The central bank recognized that the real estate sector had a substantial exposure to short-term foreign debt, but dismissed the policy relevance in terms of currency risk. It argued that the nature of counterparties to real estate transactions - non-resident investors that preferred transactions in foreign currency - implied that construction companies had limited exposure to currency risk. In other words, for the central bank, the non-resident demand for real estate assets reduced systemic risk, rather than contribute to it through the inflating the real estate bubble. Indeed, as late as 2008, the central bank hesitated to describe the rapid growth in real estate prices as a bubble – instead arguing that it reflected an equilibrium process accompanying the convergence to European wealth levels. The relatively limited role played by bank financing cemented the central bank view that rapid price increases were in fact an equilibrium process³¹ (FSR, 2008).

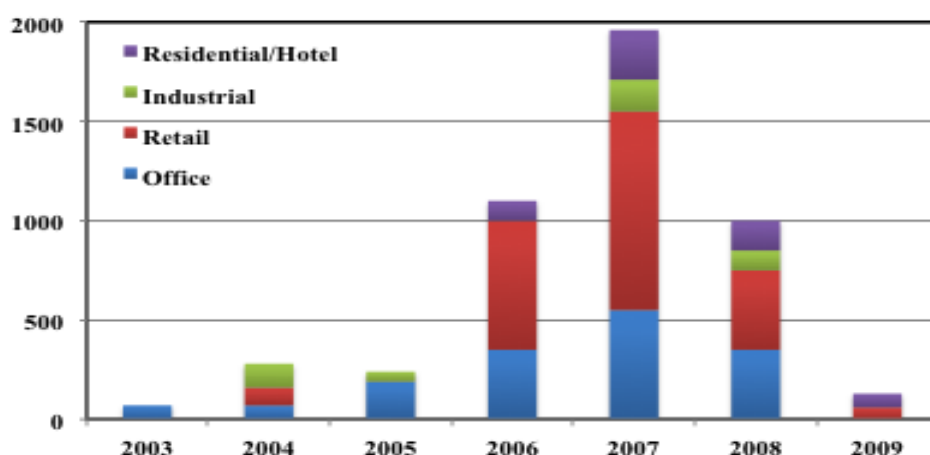
13.3 The commercial estate sector

The distribution of real estate transactions suggests that commercial estate activity played a considerable role throughout the 2000s. Office market activity picked up from 2003, to be outpaced by retail by 2006 (see Figure 53). Indeed, throughout 2006 and 2007 transactions on the retail segment – including shopping malls and warehousing – reached almost EUR 1bn, reflecting buoyant consumer credit and demand for consumer goods. Market players reported 100% occupancy rates before 2008, as developers found growing demand from

31 According to the Financial Stability Report (2008:23) “The development of real estate prices raises the issue of a potential bubble. In the context of the structural factors under scrutiny, the dynamics of prices in Romania does not necessarily show a bubble on the real-estate market, but rather an adjustment to reach the expected market equilibrium. The analyses of the international real-estate market have shown that, generally, in the long run, real prices of real estates tend to change with the growth rate of the income per capita. Nevertheless, the increased uncertainty about the long-term equilibrium, specific to an emerging economy, enhances the tendency for adjustment of long-term expectations based on short-term specific circumstances.”

retailers. Initially, most of the shopping centre construction concentrated in Bucharest, to then pick up in other large cities. In comparative terms, the residential segment played a minor role, amounting to less than 15% of transactions throughout the years of booming real estate activity. By 2009, activity in most sectors collapsed to levels registered in 2003.

Figure 53 Transactions on real estate sector, EUR mill., 2003-2009.



Source: data from Cushman and Wakefield, 2011.

The development of new projects attracted international players searching for attractive placements. Data availability limits a detailed exploration of the role of international companies, however reports suggest that commercial estate transactions typically had international investors involved on the purchase side – for example in 2008, no domestic investors initiated purchases of newly completed developments. Press reports suggest that even in 2012 – when the market had gone through three years of contraction – foreign companies continued to dominate (see Table 26), holding large portfolios.

Table 26 Real estate actors, Romania, April 2012

Company	Real Estate Portfolio (EUR mil)
Immofinanz (Austria)	663
Iulian Dascalu (Romania)	505
Global Trade Centre (Israel)	377
Gabriel Popoviciu (Romania)	350
RREEF Real Estate (Deutsche Bank)	340
New Europe Property Investments (South Africa)	141

Source: data from Capital.ro, for April 2012³²

Throughout the boom years, returns on real estate projects proved attractive for developers. In 2006, yields for new developments in office, industrial or shopping centres ranged between 7.25% and 8.5% (see Table 27). Yields decreased in 2007 across all sectors, to return to previous levels in 2008 across all commercial sectors. New projects were suspended once the market collapsed in 2009.

Table 27 Yields on real estate activities, Bucharest

	Office	Industrial/logistics	Shopping centers
2006	7.5	8.5	7.25
2007	6.25	7.5	6.25
2008	7.5	8.5	7.5
2009	9	9.5	9

Source: data from Cushman and Wakefield, 2010.

Limited data availability constrains the analysis of financing conditions for the commercial estate sector. Reports from private market actors suggest a significant tightening of bank lending conditions, as the crisis saw a rapid increase in non-performing loans in the

³² <http://www.capital.ro/detalii-articole/stiri/top-10-investitori-imobiliari-din-romania-164657.html>

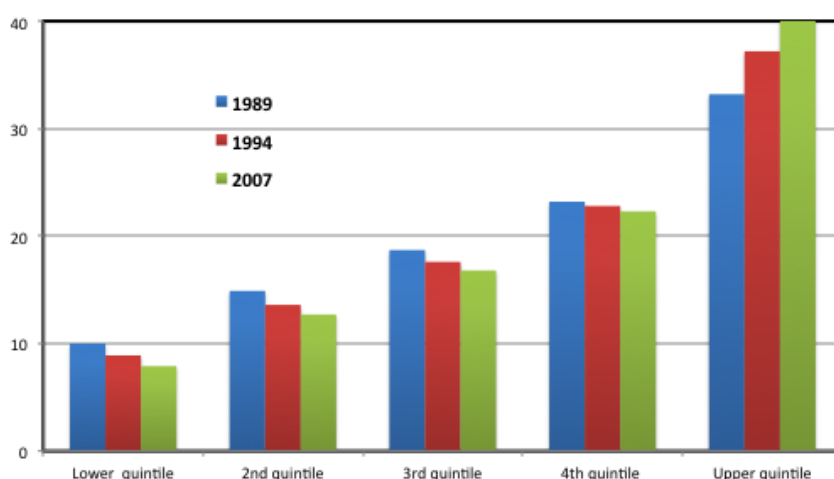
construction and real estate sector (IMF: 2010). Banks tightened lending conditions both through the direct cost of credit – increasing EURIBOR mark-up to 4-5% - and by establishing minimum pre-lease ratios (40-50%), higher equity contributions and syndicated loans for projects above EUR 200 million (Cushman and Wakefield, 2011).

14. Inequality and financial exclusion

In 2008, Romania had the lowest GDP per capita in the European Union. This reflected an extended period of macroeconomic instability, real wage compression and increased inequality. Indeed, at the end of the first post-socialist decade, almost half of the Romanian population lived under the poverty line (EIU, 2001). Although disposable income increased rapidly after 2000, growth was not spread evenly. Pay outpaced inflation in the highest-paid sectors (including air transport and financial services), but fell behind in the worst-paid sectors, especially education, health and public administration (which also have the highest proportion of female employees). Raising inequality accompanied the improvement in income levels.

Thus, the distribution of national income by quintiles shows a progressive deterioration in the share of income for all but the richest quintile. Since the fall of communism, the richest 20% of the population saw its share in national income increase systematically to over 40% (see Figure 54).

Figure 54 Distribution of national income, Romania, quintiles



Source: data from National Institute for Statistics.

Several trends have contributed to the growing inequalities in the Romanian society. The de-industrialization of the economy saw a reversed migration from urban to rural areas. Even in 2008, around 20% of the Romanian workforce was employed in agriculture, compared to less than 5% for the EU average. The construction and retail sectors employed 21% of the workforce, and only 22% employed in industry. Inequality between the top and the bottom 20 percent increased the most after 2005, with the upper income groups benefiting disproportionately from a regressive and pro-cyclical “flat” tax policy adopted by a conservative government (Voinea and Mihaescu, 2009).³³ In addition to taxation, inequalities were increased by tax loopholes for high-income professions (lawyers, notary publics), dividends and high return activities (real estate transactions) and wage inequality between private and public sectors that briefly converged before the 2008 crisis. This convergence was reversed by the agreement with the IMF that entailed an across the board cut in public wages of 25%, higher VAT and large public sector redundancies. Voinea (2012) describes these crisis measures as the most radical austerity plan implemented in the European Union.

Furthermore, consider the situation of poverty. At a cursory glance, Romania did not do very badly during the boom. A combination of large remittance inflows, minimum income schemes, economic growth, reduced unemployment, the doubling of the minimum wage through social bargaining and pension increases shortly before the crisis contributed to a reduction in *absolute* poverty levels from 32 percent to 6 percent between 2000 and 2008.³⁴ On average, the income of a person in the bottom 20 percent of the income

³³ Voinea and Mihaescu found that by several measures of inequality, the flat tax had a regressive impact, benefiting clearly the richest 20% of the population. Similarly, they found that 10% of the total employees received 40% of the total flat tax gains and that the average flat tax gain represented 3.73% of the net wage. Only 2% of the total employees gained more than 10% of their net wage. See Liviu Voinea and Flaviu Mihaescu, “The impact of the flat tax reform on inequality: The case of Romania,” *Romanian Journal of Economic Forecasting*, 4, 2009, pp. 19-41. For a critique of the Romanian flat tax from a macroeconomic perspective see Cristian Socol, Aura Socol and Marinas Marius, “The traps of the flat tax in emerging countries” *African Journal of Business Management*, 3 (11), 2009, pp. 781-785.

³⁴ Absolute poverty uses a poverty threshold determined by the costs of a consumer basket of minimum calories. Relative poverty is set at 60 percent of the median disposable income per adult, after social transfer.

distribution was 94 percent higher in 2008 than in 2000.

These are remarkable figures but the single focus on absolute poverty hides a few inconvenient truths. Eurostat data suggests that in terms of household monetary income, Romania's *average* poverty rate affected a third of the population, the highest level in the EU. This is a development that sits in stark contrast with the much lower poverty levels in other new EU member states. *Relative* poverty increased as well. The incomes of the wealthiest 20 percent rose a lot more (120 percent) and their absolute gains from growth were six times greater. Moreover, rural poverty increased during this period the traditionally vulnerable groups (the self-employed, the elderly living alone, children and the Roma living in poor Southern regions) lost out compared to the rest of society (Molnar, 2009).

These remarks on Romanian social inequality have to be moderated by the importance of the informal economy in Romania, a sector that accounted for nearly 38 percent of GDP in the late 2000s, a level second only to Bulgaria by World Bank estimates (Leibfritz, 2011). According to domestic data, the Gini coefficient is slightly lower if one factors in the importance of income generated within the households themselves.³⁵ According to the Romanian Institute for Research on the Quality of Life (ICCV), a branch of the Romanian Academy, between 1995 and 2000 this kind of income represented 30 percent of the income of rural households and 35 percent of waged employees. This means that the real Gini level in 1997 was not 35 but 30. However, its importance decreased during the 2000s and so did its role in shrinking the real level of inequality, so that the real level of Gini equality for 2006 was not 27.7 but 32.6 (ICCV, 2010)³⁶.

³⁵ Even in 2008, around 20% of the Romanian workforce was employed in agriculture, compared to less than 5% for the EU average. The construction and retail sectors employed 21% of the workforce, and only 22% employed in industry.

³⁶ The ICCV report is the most extensive exploration of social inequality to date.

Romania's income inequality was magnified during the boom years by inequality of access to finance. Romania, on par with Bulgaria, has the highest levels of financial exclusion in the European Union. Data for 2008 suggest that nearly three in four individuals did not have a bank account, and only 12% had a credit or store card (see Table 28). Only 8% of poor individuals had access to a bank account, and only 3% to a credit card or store card. In comparison, on average 88% of Europeans had a bank account and 48% a credit/store card, with much lower values for the poorer population. The inequality in access to financial services is further confirmed by overdraft statistics: only 1.2% of households owing more than a third of their annual disposable income had an imbalance on their bank account, compared to 5.3% for the European average.

Table 28 Access to financial services (share of total population), Romania, 2008

	Total	Poor	EU Total	EU Poor
Bank account	24.6	7.9	88.4	77.5
Imbalance on bank account (>33% owed of disposable income)	1.2	1.4	5.3	5.4
Credit/store cards	12	3	48	28

Source: EU-SILC statistics (2008).

The Romanian transformation into a capitalist economy has been accompanied by increasing income inequality. Households in turn enjoyed the temporary benefits of the real estate boom, with an apparent increase in net wealth driven by rapidly rising real estate prices in both rural and urban areas. Indeed, the ratio of net wealth to disposable income increased by two and a half times between 2002 and 2007, to fall by a third by the end of 2008, once global deleveraging affected Romania. This artificially inflated perception of wealth further contributed to the consumer credit boom, encouraging households to satisfy some of the pent-up demand for white goods. For example, the only segment where Romania had depth comparable to its regional peers was financial leasing, driven by a

rapidly growing car market. Financial institutions in turn came to increasingly recognize the growth potential in the household segment, and engaged into a struggle for market shares. The central bank initially contained the credit boom by imposing a tight regulatory framework up to 2007. With the entry into the EU, the central bank embraced the European ideas of financial integration by dropping the requirements that ensured adequate lending practices. This saw foreign currency lending rising rapidly, and with it, increasing exposure to unknown, and un-accountable, vulnerabilities brewing in the internal capital markets of the transnational groups.

15. Conclusions

The evolution of the Romanian financial system suggests that transnational banks integrate, and expose, national financial systems (in)to international financial markets even at relatively lower levels of financial intermediation. Qualitative changes in the nature of financial intermediation mirror those in highly developed financial systems, both on the asset side – where market portfolios become increasingly important – and on the liabilities side – where market funding gains importance compared to traditional sources of funding (retail deposits).

Since their entry in the late 1990s, transnational banks and other non-resident financial actors developed complex networks of cross-border interconnectedness that contributed to the dependent financialization of the economy before the 2008 crisis, and to the distinctive mechanisms through which Romania was affected by the crisis:

- **Financialized banking:** transnational banks engage into a variety of market activities, including proprietary trading on the currency market, demand for sterilization assets and provision of counterparty liquidity to foreign investors searching for yield. These mark a shift from relational to market-based or impatient banking; and create new mechanisms of interconnectedness between currency markets, the interbank money market and other asset markets. Furthermore, banks dominate the non-bank financial intermediaries sector, having set up affiliates to overcome regulatory constraints; the recently created private pension market; the insurance sector; banks account for a substantial share of stock market trading and dominate the (illiquid) corporate bond market.
- **Destabilizing banking:** transnational banks have actively participated in speculative attacks either directly or by lending domestic currency to non-resident actors, even though the success of such attacks would have affected their lending portfolios and financial stability.

- **Internal capital markets of transnational banks:** banks take lending and trading decisions on the basis of costs for funding in internal capital markets and relative yields available across the banking group. From this perspective, transnational banks choose to lend in foreign currency not because of constraints in domestic currency funding, but when foreign currency loans provide better yield differentials (while transferring currency risk to the borrower).
- **Financialized currency markets:** demand and supply reflect cross-currency risk trading in search of yield differentials rather than currency flows associated with international trade activities. Off-balance sheet relationships between resident banks and non-resident investors sustain the financialization of the currency market.
- **Financialized interbank money markets:** demand and supply of bank reserves no longer arising from relational banking but from transactions on currency and other asset markets. The central bank can accelerate financialization of this market by offering sterilizations as carry-trade assets. The entry of non-resident investors changes dynamics as banks trade reserves to provide counterparty liquidity for non-residents targeting asset markets.
- **Financialized sovereign bond markets:** after the bruising experience with impatient banks in late 1990s, the sovereign bond market 'escaped' financialization as sovereign debt managers decided to avoid issuing debt instruments, instead relying on captive sources (the state pension fund and other Treasury accounts) to fund deficits before 2008. The flat tax system, the crisis and the pressures for privatization of the pension provision (reducing captive sources) have seen a rapid increase in new issues, increased liquidity and increased bank holding of government debt, at short maturities and high yields.
- **Severe data constraints** prevent a close monitoring and public scrutiny of financialized banking or financialized markets. Most evidence of destabilizing practices is anecdotal (as in the case of speculative attacks) or depends on the willingness of the central bank to resist arguments about market sensitivity and instead opt for transparency. One

important reason why financialization remains difficult to theorise is that scholars lack detailed data about: trading positions in currency markets on spot and derivatives segments; the residency of the actors undertaking such trades; the links between currency trading and interbank money market liquidity; trading patterns vs. ownership in secondary government bond markets; pricing and allocation decisions in the internal capital markets of transnational banks; the mechanisms for setting interbank interest rates.

- **Political power in countries with dependent financialization:** while transnational banks can resist regulatory measures both through arbitrage – transferring loans to their parents – what matters is the considerable political power that arises from their systemic role, with the tacit support of the central bank. In Romania, transnational banks used the Vienna Initiative to intervene in cross-border regulatory deliberations in the wake of the crisis and eventually persuade regulators to support their narrative of the crisis (poorly developed financial systems in host countries) and to accommodate their preferences for regulatory reform: that regulators do not view their reliance on internal capital markets as a source of systemic risk.
- **Discursive dominance through the imperative of market liquidity:** pervasive financialization operates on a discursive level to establish market liquidity as a policy priority across all financial market segments since low market liquidity translates in higher financing costs or asset price volatility. This narrative sidelines both the procyclical nature of financialized market liquidity (impatient actors improve liquidity during boom times) and severely restricts the room for designing policy measures that would select ‘non-financialized’ or patient holders of government debt if such measures are deemed detrimental to market liquidity.

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THE ABSTRACT OF THE PROJECT IS:

The research programme will integrate diverse levels, methods and disciplinary traditions with the aim of developing a comprehensive policy agenda for changing the role of the financial system to help achieve a future which is sustainable in environmental, social and economic terms. The programme involves an integrated and balanced consortium involving partners from 14 countries that has unsurpassed experience of deploying diverse perspectives both within economics and across disciplines inclusive of economics. The programme is distinctively pluralistic, and aims to forge alliances across the social sciences, so as to understand how finance can better serve economic, social and environmental needs. The central issues addressed are the ways in which the growth and performance of economies in the last 30 years have been dependent on the characteristics of the processes of financialisation; how has financialisation impacted on the achievement of specific economic, social, and environmental objectives?; the nature of the relationship between financialisation and the sustainability of the financial system, economic development and the environment?; the lessons to be drawn from the crisis about the nature and impacts of financialisation? ; what are the requisites of a financial system able to support a process of sustainable development, broadly conceived?

THE PARTNERS IN THE CONSORTIUM ARE:

Participant Number	Participant organisation name	Country
1 (Coordinator)	University of Leeds	UK
2	University of Siena	Italy
3	School of Oriental and African Studies	UK
4	Fondation Nationale des Sciences Politiques	France
5	Pour la Solidarite, Brussels	Belgium
6	Poznan University of Economics	Poland
7	Tallin University of Technology	Estonia
8	Berlin School of Economics and Law	Germany
9	Centre for Social Studies, University of Coimbra	Portugal
10	University of Pannonia, Veszprem	Hungary
11	National and Kapodistrian University of Athens	Greece
12	Middle East Technical University, Ankara	Turkey
13	Lund University	Sweden
14	University of Witwatersrand	South Africa
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