THE ROLE OF THE ECONOMIC AND INSTITUTIONAL FRAMEWORK IN ENSURING FINANCIAL STABILITY IN ROMANIA, DURING 2012-2014

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Abstract:
The aim of this paper is to empirically study the concept of financial stability in Romania, from both an economic and institutional perspective. In this paper, I analyze three main aspects: the macroeconomic performance of Romania, the developments of the structural reform and the policy instruments, related to two main domains: the monetary and exchange rate policies; and the priorities of the financial sector (the strengthening of the banks' balance sheets and supporting the Romanian economy). Therefore, this paper debates the policy instruments of Romania's institutions and authorities that aim to promote financial stability.

Keywords: *financial stability, monetary policy, National Bank of Romania, policy instruments*

JEL Classification: E42, E44, E52

1. Macroeconomic performance

Romania is very exposed to weaknesses from the Eurozone. Weak external demand, accompanied by low domestic demand, while the impact of aridity on agriculture determined a significant weakening in economic performance in 2012 and. Therefore, the gross domestic product had an insignificant grow of 0.7% in 2012 and of 1.5% in 2013 (due to good export performance). Inflation has faced a sharp downward path in 2013, of 1.9%, being below the target bank of the National Bank of Romania of 2.5 +/- 1%.

Fiscal stance had good performance in 2012 and 2013, taking into consideration the political pressures, which had negative effects on financial stability through the exchange rate channel. Thus, the budget deficit target was modified from 1.9% 2.5% in 2012, due to an increase of public wages (as a result of the partial reversal of the wages cuts undertaken in 2010) and due to repayment to pensioners of pension cuts, which were established to be unconstitutional. However, the economic difficulties in the second half of 2013 raised questions regarding the public finances, destroying the pace of fiscal adjustment and disrupting the government arrears' clearance, affecting financial stability. The deficit of 2.5% had exceeded the revised target, which determined the government to access a three-month extension of the Stand-By Arrangement, in order to gain more time in order to meet the targets of decreasing payment arrears of the state administration and of the state-controlled companies. Despite these slippages, the fiscal performance was quite good, considering the fact that 2012 was an election year, major expenditure overruns were avoided. Therefore, the government has revised the budget for 2013, increasing the deficit target from 2.3% to 2.5%.

Romania experienced a moderate recovery in 2013, the economic growth being higher than 2%, due to a strong export performance and a proper agricultural season. Medium-term prospects are still favorable, due to a diversified economy and a strong catch-up potential, even if the gross domestic product per capita is less than %0% than the European Union average. A more efficient utilization of the European structural funds would improve growth expectations, with positive effects on financial stability .

2. Structural reform developments

Absorption of European funds is at a low level. Disregarding the government's efforts aiming to increase the pace of absorption, in 2013 only 21.4% of the structural, cohesion and agricultural funds available to Romania were paid. The absorption of certain

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funds is very low, because of problems related to management and control system, so that several operational programs have been pre-suspended in 2012. Some of these programs were unblocked in 2013, after several remedial action undertaken by the government. The European Commission has granted an extension of one year for the 2007-13 financial perspective, in order to minimize the loss of these funds.

Privatization and the restructuration process of the state-owned companies has been recording a good advance. The state has an important role in the Romanian economy, 240 companies being owned by the state, while 700 being owned by the local government. Still, the sale of the majority stake in the freight rail company "CFR Marfa" has failed. Although the private railway operator, Grup Feroviar Roman was selected to be the buyer in June 2013, after bidding 202 million euro for 51% of the company, and after promising an additional investment of 200 million euro, the deal was cancelled because the private operator failed to secure the approval from the antitrust body, while not making timely necessary payments. But there are other sales of state shares that are ongoing in the gas sector and in the electricity sectors, including a 10% initial public offering of Nuclearelectrica in September 2013, and a 15% initial public offering of the natural gas producer, Romgaz, in October 2013. The efforts of selling the postal company and one of the large chemical companies, Oltchim, have been unsuccessful. For example, Oltchim is under insolvency procedure since January 2013, so that the privatization steps will continue after exiting this process.

Incentives for renewable investments have decreased. In June 2013 the government adopted an emergency ordinance under which, so that between July 2013 and March 2017, out of the total green certificates awarded to solar photovoltaic, wind and small hydro projects, the trading of some of them will be postponed until 2017 (for hydro and solar) and 2018 (for wind). Permission to trade these certificates will be from April 2017 (for solar and hydro) and January 2018 (wind), but until the end of 2020. Several features are unclear regarding the non-retroactivity of the ordinance's provisions, so there are some uncertainties regarding the predictability and transparency of the business environment of renewable energy, which affect financial stability.

The financial performance of water companies is improving. Water companies are undergoing a process of regionalization, leading to the consolidation of the sector and to reduction of several operators, from 260 in 2007 to 42 in 2013.

The business environment is still problematic. It is known that the Romanian businesses are facing many and various long-standing problems during their day-to-day operations, arising difficulties, in the last years, in attracting foreign direct investment. Thus, Romania is ranked 73 of 189 countries in the 2014 World Bank's *Doing Business* report. The main problems are of getting electricity, paying taxes and dealing with construction permits. The perception regarding the competition authority's effectiveness has worsened in 2013, as shown by the World Economic Forum's Competitiveness Report. Regarding the progresses that have been made, there is one regarding the land reform: from January 2014 foreigners are allowed to buy land in Romania, without establishing a joint venture with a domestic firm. But a functioning land market is still not effective, while the sizes of the farms being small and very small. The problems within this sector negatively affects financial stability.

Measures to strengthen the stability of the financial sector are paying off. The banking sector managed quite well the effects of the economic downturn during the last four years. Thus, the banking supervision has been considerably strengthened, the deposit insurance coverage being in line with the European standards. The framework for medium and small sized enterprises financing has improved, strengthening the framework for collateral and security over movable property. The National Bank of Romania is still promoting the lending in domestic currency. In 2012 the National Bank of Romania issued a new regulation on lending in foreign currency, so that banks have to conduct foreign exchange stress tests, and only then are allowed to extend their foreign currency denominated loans. Moreover, the level of non-performing loans is high (of 21%), but their risks are reduced by high provisioning levels (of 90%).

3. Policy instruments

3.1 Monetary and Exchange Rate Policies

But there are still tensions that may arise. For example, the fall of 2012 was characterized by a high inflation of food prices, increases of administrative price, a weakened exchange rate, that have pushed inflation outside the inflation band. Thus, the authorities highlighted the necessity of for a prudent monetary stance, aiming to contain the capital outflows and the exchange rate depreciation, considering the high foreign currency exposure of the Romanian economy, and anchoring inflation expectations. At the end of 2012, the National Bank of Romania tightened the liquidity and kept maintained the policy rate. To stop the pressures on the exchange rate, the National Bank of Romania has undertaken market interventions, reducing reserves that led to the missing of the inflation target at December 2012. The exchange rate has been stabilized, but the cost was that the inflation returned to the inflation band in September 2013. Yet, the real exchange rate was in line with fundamentals.

The National Bank of Romania needs to maintain a prudent monetary policy stance, in order to promote financial stability. Inflation (figure 2) decreased to 1.1% in January 2014, from 1.6% in December 2013, being under the lower band of the consultation mechanism. The deceleration was mainly due to the reversal of base effects for food prices, the cut in the value added tax for flour and bakery products, the abundant harvest in 2013, and due to inflation expectations improvement against the background of a weaken economy. The recent inflation developments are part of the inflation consultation mechanism. In the short term, inflation is possible to stay at levels that are below the target band, and afterwards it will probably return into the band, moving into the upper part in the second quarter of 2014. The end-year inflation target was converted, by the National Bank of Romania, to a continuous target, starting with January 2014.

The policy rate was decelerated during September 2013 and January 2014 by 100 basis points, to 3.5%, since inflation is keeping its declining trend, in the context of negative output gaps. These cuts led to higher average interest rates on new loans, the maximum being recorded in December 2013, of 7.6%; the deposit yields faced a strong development during this period. In January 2014, the minimum reserve requirements by 3 and 2 percentage points for RON and for foreign exchange denominated liabilities, in order to gradually bring the minimum reserve requirements (figure 1) closer to levels used by the European Central Bank, which prevail in most European countries. These decisions were considering both the headline and core inflation, which are expected to maintain within the central bank's comfort zone during the projection horizon between a negative output gap and a subdued credit. But the reduction in the minimum reserve requirements exacerbated the excess liquidity, since the emerging market turmoil left no space for the Romanian financial markets to remain unharmed from the RON pressures.

Figure 1. Minimum reserve requirements (RON – orange; foreign exchange – blue)
Source: National Bank of Romania

The National Bank of Romania has intervened in order to support the RON, eliminating the excess liquidity and increasing the interbank rates above the policy rate. In addition, anchoring inflation expectations and volatile international capital flows require a prudent monetary policy stance, followed by a consistent macroeconomic policy mix, since there is little space of maneuver for the monetary easing, which includes interest rate cuts. National Bank of Romania has to further monitor the inflation developments in order to ensure that inflation expectations remain anchored, while market conditions are favorable, and financial stability is safe.

Base money creation has increased, reflecting the treasury operations, related to the growing disbursements of European funds. The excess of liquidity has explained the divergence between interbank rates and the policy rate. So, the National Bank of Romania has to ensure adequate liquidity conditions within the banking system, that are the basis of a proper functioning of money markets, and which reduce the divergence between interbank rates and the policy rate, strengthening the transmission of the signals of the monetary policy. These imply a further reducing interest rate corridor (figure 3), and also liquidity absorbing operations. The National Bank of Romania has to maintain the wedge between minimum reserve requirement ratios, for domestic and foreign currency liabilities, discouraging foreign-currency lending. Any other changes regarding the minimum reserve requirements have to be implemented gradually, evaluating the effect of each step, taking into consideration the impact on inflation expectations.

The National Bank of Romania has to continuously reassess the effectiveness of the monetary policy framework. So, regarding the excess of liquidity, rather than absorb it by using the regular toolkit, the National Bank of Romania has focused on foreign exchange sales, considering their limited impact on the bank's profitability. Moreover, the divergence between interbank rates and the policy rate and the excessive interbank rate volatility risk, have the power of undermining the monetary policy transmission. Thus, the National Bank of Romania has to create a more clear-cut operational framework and also an effective transmission mechanism, narrowing the interest rate corridor and improving the liquidity management. When talking about liquidity absorption, while maintaining the forex reserve adequacy, the National Bank of Romania has to implement it firstly through deposit taking operations, or by issuing certificates of deposit.

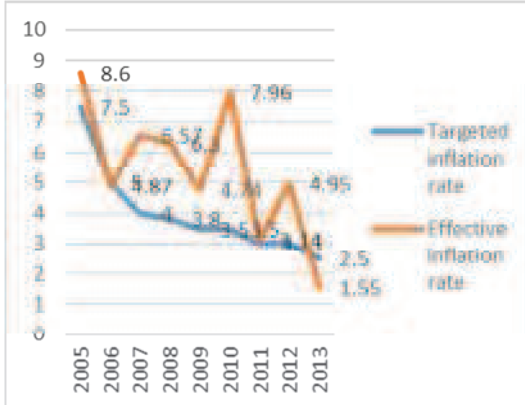

Figure 2. Inflation rate
Source: National Bank of Romania

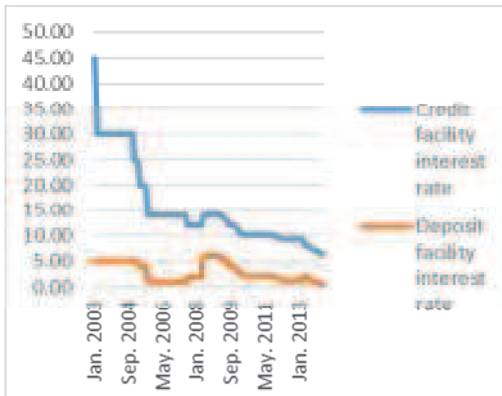

Figure 3. Interest rates (%)
Source: National Bank of Romania

The central bank has improved the operation of the inflation targeting framework, increasing financial stability. High foreign currency denominated lending and a large interest corridor of +/- 400 basis points around the policy rate (between the deposit facility rate and the credit facility rate) has weakened the monetary policy transmission, decoupling the money market and the policy rate. Specific measures in order to reduce the divergence implied an active use of open market operations in order to manage market liquidity. A deepening of the interbank market would require specific measures, such as a tighter corridor around the policy rate.

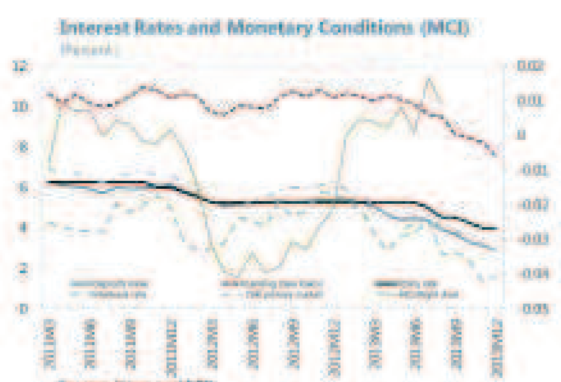

Figure 4. Interest rates and Monetary Conditions (%)
Source: National Bank of Romania

International reserves are adequate, having positive effects on financial stability. International reserves have been sustained by the Eurobond placements. The net international reserves performance criterion for the end of December have been met with a wide margin, the short-run term debt coverage of reserves remaining below 100 percent. Net international reserves have been adjusted in order to reflect the temporary pressures on financial markets that appeared as a result of spillovers that emerged from the emerging market turbulences. The real exchange rate is in line with fundamentals, so that the National Bank of Romania must continue to permit the exchange rate to adjust with market conditions, and to limit the interventions, supporting the domestic currency and smoothing the exchange rate volatility.

The floor on net foreign assets is pursuing multiple objectives, and may be simplified. The floor includes the international reserves and the commercial banks' foreign currency reserves that are held at the central bank. The commercial banks' reserves have the purpose of constraining the changes in foreign currency reserve requirements, with prudential purposes. Yet, this approach increased the risk of missing the net foreign assets target in the case of deposit outflows and insufficient net international reserve accumulation. Moreover, the design of the net foreign assets didn't allow additional external issuances in order to build buffers. During 2012-2014, intra-month movements increased in foreign currency reserves, supporting the net foreign assets' levels. Moreover, the political uncertainty led the National Bank of Romania to intervene in order to spoke the pressure on the exchange rate. Therefore, a more standard net international reserves target is able to better serve the objective of maintaining adequate reserve buffers.

3.2. Financial Sector Priorities: Strengthening the Balance Sheets of the Banks and Supporting the Economy

The capitalization of the Romanian banking sector is strong, being of 15% in 2013, whilst some differences between banks. The level of the system-wide provisions significantly increased in the second quarter of 2013, due to the interim audit of the banks' financial statements and to the inspections performed by National Bank of Romania to the first 20 banks on capital adequacy (figure 5) and loans restructuring practices. The collateral audit undertaken in the second quarter of 2013 identified a system-wide provisioning gap of 800 million RON. The liquidity position was less restrictive in 2013 than in 2011 and 2012 for the banking system as a whole, while the funding conditions being uneven among banks. The pace of foreign-owned bank deleveraging has hasten in line with the region, with a parent funding decline of 30% 2011 (up to 19% in 2013). As an effect, trust in local funding has increased, reducing the system-wide loan-to-deposit ratio to 105% in 2013, from 117% in 2012. The risks of parent funding reduction is significant, especially if the credit demand will recover, even if the risk is reduced by the lower prudential filter and by the minimum reserve requirements.

Parent bank deleveraging and credit supply constraints require policies that improve financial intermediation and financial stability. So, lower reserve requirements increased liquidity and eased the funding pressure from the withdrawals of the parent banks. But the authorities have to maintain their vigilance in order to avoid unwanted capital outflows and the exchange rate pressures. The wedge between the foreign currency and the domestic minimum reserve requirement discourage foreign-currency lending, but prudential measures, macroeconomic stability and the funding mix are able to boost the national currency lending in the long-run. Therefore, the long-run bank funding will benefit intermediation. On the demand side, the small and medium enterprises face difficulties in accessing bank lending, since they have the highest ratio of non-performing loans. In order to solve this situation, the government has created a guarantee scheme for this sector, where it shares the loan's credit risk with the bank.

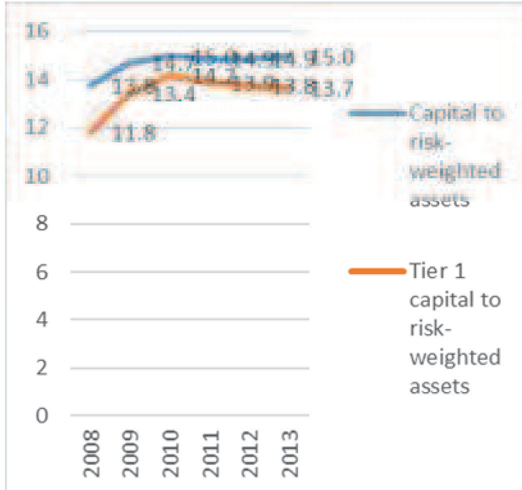

Figure 5. Capital adequacy
Source: National Bank of Romania

Regarding foreign banks deleveraging, the parent banks' exposures was stable during the financial crisis, foreign bank deleveraging being accelerated in the second quarter of 2012. In 2012, short-term foreign borrowing, especially from parent banks, were an important component of the total bank borrowing. In 2013, parent banks funding (figure 6) reduced by 20% compared to the level in 2011. Meanwhile, the crisis in Greece and Cyprus led to the fragmentation of the interbank markets, deteriorating the liquidity for some banks.

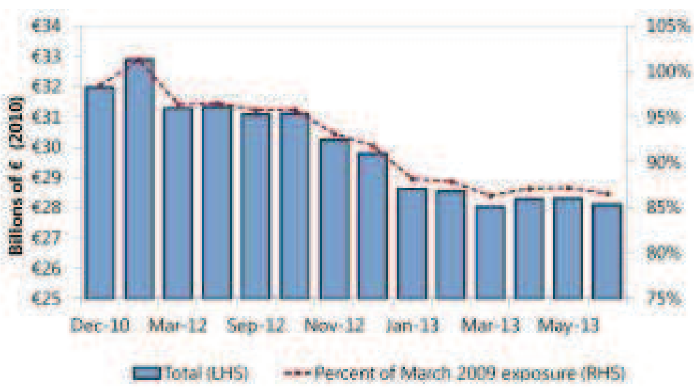

Figure 6. Bank system parent funding
Source: Romania Central Credit Register

Strengthening the balance sheets of the banking system needs a plan of reducing the non-performing loans, while monitoring the asset portfolio quality of the banks. The recent gradual closing of the provisioning gaps kept provision coverage at 89.8% in 2013. Yet, due to unprecedented accumulation of the non-performing loans (figure 7), the National Bank of Romania is developing some elements of reducing it through an action plan, establishing the role of the National Bank of Romania during the process, setting the responsibilities of the supervised entities, and providing adequate incentives for self-discipline regarding the write-off of unrecoverable loans. Moreover, it is necessary to increase the transparency to the system's balance sheet, so the action plan will specify the accounting treatment in order to distinguish between fully-provisioned and unrecoverable non-performing loans from other impaired loans. Non-performing loans in Romania exceed the levels of its peers. The problem loans is a result of the previous years of high credit growth during the pre-crisis period, characterized by relaxed credit standards and external funding that increased FX loans at low interest rates. In addition, the upward trend in 2012-2014, despite a stable macroeconomic environment, is given by the denominator effect (low overall credit growth). Most of the problem loans are concentrated in the small and medium enterprises sector, having an average ratio of 26.9% versus 21.9% for the entire system in 2013. Households have a lower average of loan deterioration (13.6%), excepting the sub-segment of credit card debts and debts in foreign currency. The dispersion of non-performing loans in the economic sectors of corporate borrowers is less evident, even if companies in agriculture and utilities have a higher probability of default.

Since domestic demand and external demand were revised downwards, the banking asset quality has deteriorated. The non-performing loans (figure 8) increase was led by the difficult operating environment, mainly for the small and medium enterprises, and difficulties in writing off the non-performing loans.

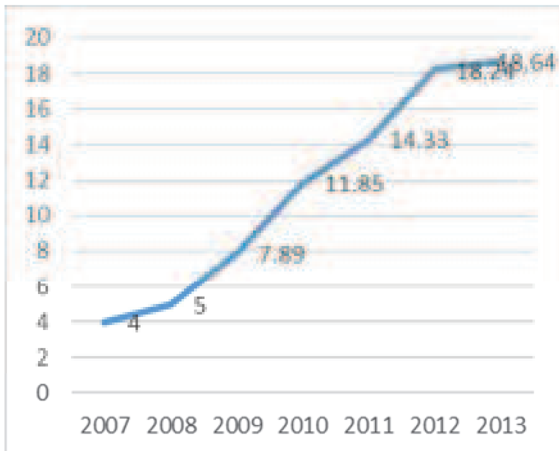

Figure 7. Non-performing loans (%)
Source: National Bank of Romania

In the first quarter of 2013, the rate of non-performing loans reached 20%, from 12% in 2010, despite some positive but limited loan growth. Due to the necessity of provisioning, and to high operating costs, in 2012 bank profitability was negative (figure 9), while the credit started to reduce. Supply side constraints and weak demand were the key factors of the negative credit growth and of the inability of banks to support economic recovery. Banks are still exposed to major exchange rate risks, foreign currency lending being above 60%.

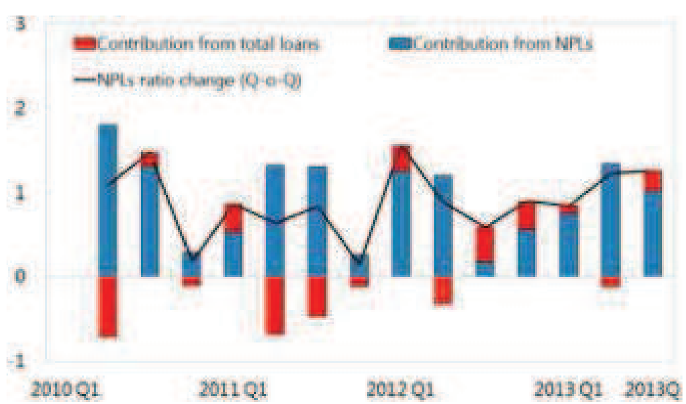

Figure 8. Contributions to changes in the banking non-performing ratio (%)
Source: International Monetary Fund

Enhancing the insolvency law may deal with high non-performing loans. The new insolvency code approved by the government is part of a government emergency ordinance. The insolvency code aims to support early rescues of viable firms and quickly exit of non-viable firms, including minimum provisions on: creditor voting, pre-insolvency procedures, automatic stay, and priority financing and ranking of claims.

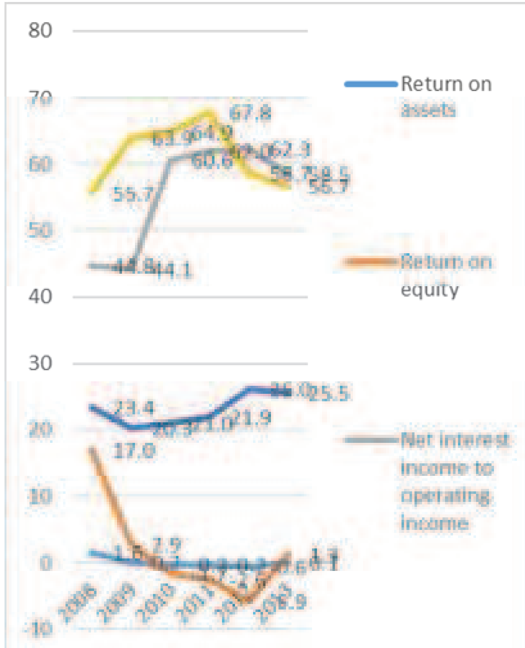

Figure 9. Earnings and profitability
Source: National Bank of Romania

The risk of financial instability determined by the recent civil procedure code has to be reduced. The application of the new code civil procedure code starting October 2013, that creates interpretations of the abusive clauses provisions, which applied to financial sector contracts may lead to higher prohibition of interest charges, to decisions with retroactive impact and to class action suits regarding loan financial terms. Thus, those interpretations, already being sanctioned in several court cases, could represent a source of instability for some banks. In order to avoid such situations, the authorities are stablishing a new specialized court in Bucharest, in order to ensure a proper application of the provisions.

The non-banking system and capital market and the supervision mechanism and authorities have to be developed and strengthened. Due to limited market share, risks in the insurance, securities and pension funds sectors are non-systemic, the Financial Supervisory Authority placing one important insurance company under special administration, and named a certain private accounting firm to administrate it. So, the Financial Supervisory Authority has the responsibility of developing a proper framework of regulation and supervision of funds' sources, protecting the consumers' and investors' protection, promoting the development of the capital market, and promoting financial stability. Moreover, the Financial Supervisory Authority supports the growth of the stock exchange, ensuring of its transparency and efficiency, one of the priorities being that of managing the fees' types and levels.

The authorities have to maintain an enhanced supervision, in order to reduce financial instability. The authorities have secured a proper non-performing loans provisioning, requiring capital injections in order to cover the shortfalls emerging under the mandated collateral audits. The authorities also have restricted foreign currency lending to households and corporations that are un-hedged, keeping prudential filters after the introduction of

International Financial Reporting Standards in order to ensure a prudent loan provisioning. The authorities also increased the liquidity monitoring of parent exposures, introducing weekly deposits reporting. All these actions, together with a stronger financial safety net, aim to contain the impact of the previous and future financial crises on the Romanian banking system, maintaining the depositors' confidence. Banks are well capitalized and liquid, while non-performing loans being well provisioned (90%-100%), although profitability has declined, since the growth of non-performing loans has required additional provisioning.

The National Bank of Romania has ensured that weak asset quality (figure 10) does not undermine the soundness of the banking sector, which may lead to higher levels of financial instability. A higher prudential supervision of loan classification standards and collateral valuation have led to higher provisioning, so that the provision coverage includes the prudential filter. The tax liabilities to non-performing loans sales and the National Bank of Romania's plan that aims to support the reduction of fully-provisioned non-performing loans are established in order to gradually converge towards normal levels of the business cycle.

The year 2013 was characterized by financial vulnerabilities regarding the aspects of new liquidity and asset quality challenges. These problems are able to be partially fixed by distributing the liquidity across banks, expanding the range of eligible collateral for the overdraft facility, while providing liquidity support in foreign currency using swap arrangements. In order to ease the removal of fully provisioned non-performing loans from banks' balance sheets, the fiscal authority has modified the tax code, in order to ensure a neutral tax treatment for selling bank receivables, while the financial authority has clarified the accounting rules (under the new adopted International Financial Reporting Standards) applicable to the write-offs of the impaired loans. Moreover, due to high levels of non-performing loans, the authorities have planned to eliminate the impediments to insolvency and foreclosure procedures, while facilitating the resolution of the non-performing loans.

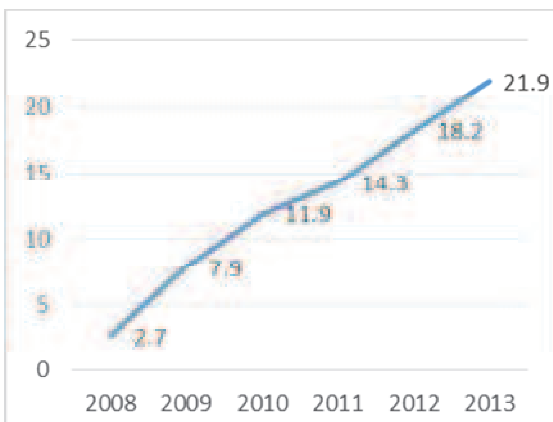

Figure 10. Asset quality
Source: National Bank of Romania

The National Bank of Romania is continuously monitoring and supervising the banking system, while taking the necessary measures in order to ensure that banks have enough capital and liquidity (figure 11), considering the framework of uncertain economic environment, which is still able to challenge the asset quality, the parent funding retrenchment and the profitability for most banks. The central bank also is regularly conducting top-down and bottom-up solvency stress tests and liquidity stress tests of the banking sector. The National Bank of Romania illustrated in 2013 that under the hypothesis of an adverse scenario, a prolonged recession and 20% depreciation, the aggregate solvency ratio would decrease by 4 percentage points, to 10.8%, which is above the prudential threshold, while the banking system is supposed to remain resilient, yet revealing the necessity for some non-systemic credit institutions to increase their capital.

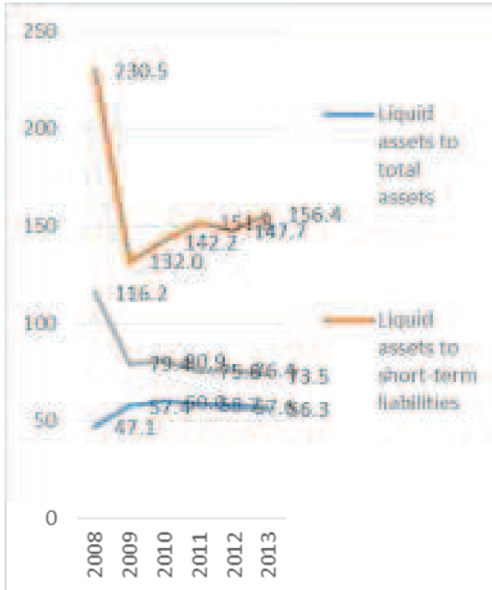

Figure 11. Liquidity
Source: National Bank of Romania

Other initiatives aim to strengthen the loan portfolio of the banks and to stimulate lending. The government started in 2013 a guarantee scheme for the non-performing loans of the small and medium sized enterprises, where the government shares, together with the lending bank, the credit risk of the loan. The success of this program will depend on its adoption by the private sector, and by the speed of minimizing the moral hazard. Moreover, in September 2013, the program providing housing loans guarantees was switched to domestic currency, in order to decrease the FX risk (figure 12) in the portfolio of the banks.

The National Bank of Romania is continuously overseeing the bank practices, in order to ensure that the International Financial Reporting Standards' loan-loss provisioning, collateral valuations, and the assessment of restructured loans' credit risk remain prudent, in concordance with the international practices. The National Bank of Romania prepared a resolution action plan for the non-performing loans in May 2014, intending to implement it by the end of June 2014, which establish the role of the central bank in this process, setting the responsibilities of supervised entities, while foreseeing the changes to prudential regulations, in order to avoid moral hazard and to provide adequate incentives for a timely balance sheet clean-up from unrecoverable loans.

Since maintaining debtors' credit discipline is enhancing financial stability, the Romanian authorities are making multiple efforts in order to avoid the adoption of legislative initiatives that deal with personal insolvency that create moral hazard and undermines the credit discipline. In order to avoid threats to financial stability raised by the provisions on abusive clauses in the law for the application of the civil procedure code (which was implemented in October 2013), the new specialized court has to set-up the budget allocations for the both the headquarters and the supplementary personnel, taking the necessary measures in order to apply these provisions. If the new institutional arrangement of the specialized court fails in avoiding the threats on financial stability, there are necessarily alternative solutions, removing the impediments to corporate and household out-of-court debt restructuring and non-performing resolution.

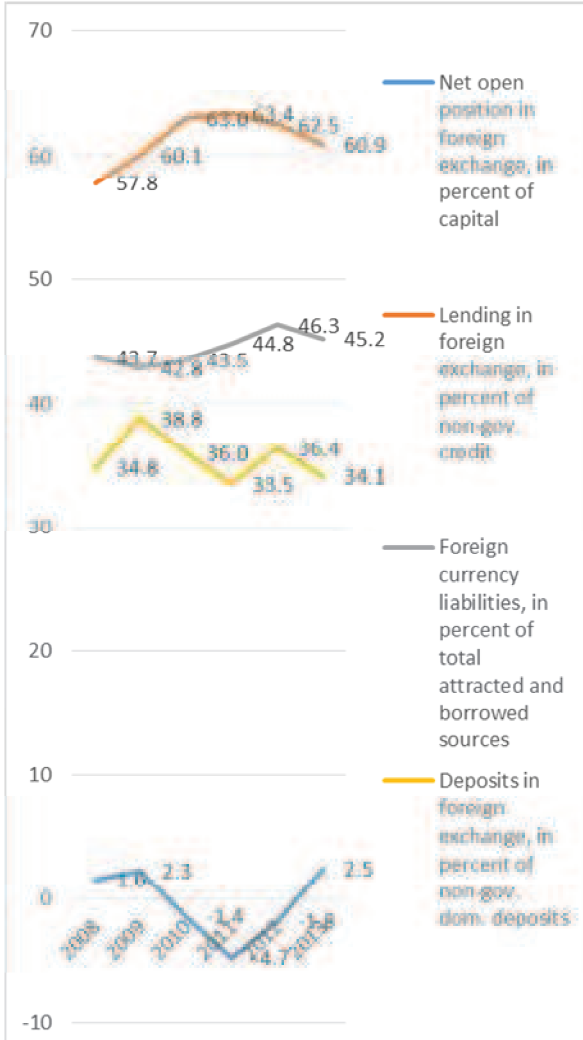

Figure 12. Foreign exchange risk
Source: National Bank of Romania

The Romanian authorities that are focused on completing the already initiated reforms have to strengthen the resolution framework and to improve transparency. In Romania, banks are well capitalized and liquid, credit is expected to grow, economic recovery is expected to accelerate, while the non-performing loans will stabilize and the banks' profitability will improve. But the authorities have focused on strengthening the financial safety net and the bank resolution framework, introducing bridge-bank powers and also the possibility to initiate purchase-and-assumption transactions, improving data exchanges between the National Bank of Romania and the deposit guarantee fund, developing additional contingency plans in order to address financial pressures. In order to improve transparency and to align to European standards, Romania adopted in 2012 the International Financial Reporting Standards for the banking sector.

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Acknowledgements

This work was cofinanced from the European Social Fund through Sectoral Operational Programme Human Resources Development 2007-2013, project number POSDRU/159/1.5/S/142115 "Performance and excellence in doctoral and postdoctoral research in Romanian economics science domain".