<u>Speech on the Evolution of the Financial Sector in Romania Since 1990</u>

Dear Governor Isărescu,
Dear conference participants,

It is a great honor to be with you today, at already the 15th edition of this very reputable annual seminar on financial stability, organized by the NBR together with the IMF. I have had the privilege of seeing Romania's financial sector evolve over the last three decades, from the very start of the 1990s to the present day. Allow me today to address this very topic, one of great importance to Romania's economic trajectory, while also looking ahead. In my presentation, I will distinguish three phases: phase 1 – the move to market economy; phase 2 – the road toward EU membership; phase 3 – the post Great Financial Crisis (GFC) period and the look ahead into the future.

My own journey with the National Bank of Romania (NBR) began in 1991, when I was working as an economist at the International Monetary Fund. I was brought in to advise the Bank on setting up the foundations for market-oriented supervision and market-operations departments. It was a time of immense change, not just for the banking sector but for the entire country, and I remember those early days vividly. Romania was making the crucial step from a state-controlled command economy to a modern market one. At that time, Mugur Isărescu had just become Governor of the NBR, and little did I know that this professional collaboration would turn into a friendship that has lasted for decades. Our bond, built on trust and mutual support, has been a steady presence for me throughout my work in Romania, just as Romania's financial sector itself has become a resilient, stable presence in the economy.

Transition to a Market-Based Financial System (1990–2000)

I remember arriving in Romania in 1991; the airport, the roads, the hotels, the city were incomparable to what we see today. Also, the banking sector was almost unrecognizable: like much of Romania's economy, it was heavily state-dominated, and banks operated more like extensions of the state than as independent institutions. The banking infrastructure and services were outdated, and financial innovation was practically non-existent.

However, this was also a moment of great opportunity. Together with the introduction of new banking legislation and creating a regulatory framework to govern private banking operations, one of the most significant milestones was the entry of foreign banks into Romania. These foreign institutions brought with them not just capital but expertise, modern banking practices, and competitive pressure that pushed the state-owned banks to improve. By the end of the 1990s, the landscape of the Romanian banking sector was already starting to transform. A similar trend was visible, somewhat later, in the insurance sector.

Yet, I also remember the challenges you faced. The process of privatizing state-owned banks was not easy. Many of these institutions were burdened with bad loans, the result of a lack of experience with market mechanisms, inadequate risk management, and credit extended to politically connected firms. This period was a harsh reminder of the need for stronger financial supervision and better risk management. It was during these times, that the NBR really began to assert itself as a more proactive institution, intervening in failing banks, and taking steps to close those that posed systemic risks.

The Asian crisis in the late 1990s exposed even more the vulnerabilities in the banking sector. It made us realize that we needed to be better prepared for such shocks. This is when the NBR began focusing more heavily on capital flow management and the resilience of the financial system. In 1999, Romania introduced Basel I standards, an important step in aligning Romania's banking regulations with international norms. In the meantime, at IMF, we were working on the development of the Financial Sector Assessment Program (FSAP), that we also launched in 1999. Romania benefited from three FSAP assessments, published in 2003, 2010 and 2018, with the last one emphasizing the significant strengthening of the financial system.

I also remember the persistent issue of inflation. Throughout the 1990s, inflation was a major challenge. Like today, one major cause was procyclical fiscal policy. By the end of the 1990s, inflation was still high, but it was on a downward trend, thanks in part to tighter monetary policies.

EU Integration, the Transformation of the Banking Sector and the Great Financial Crisis (2000–2010)

The 2000s marked a turning point in Romania's financial sector's evolution. With Governor Isărescu temporarily holding the PM position, Romania formally started in February 2000 the negotiations with the EU. The accession process was a catalyst for a wave of reforms aimed at modernizing the financial sector, aligning it with EU standards, and preparing the country for integration into the broader European financial system.

With the NBR being granted full independence in 2004, the adoption of an inflation-targeting regime helped stabilize the economy and foster a more predictable environment for businesses and consumers.

However, as Romania prepared for EU accession, rapid economic growth brought its own challenges, particularly related to the sharp expansion of credit. Banks, many foreign-owned, aggressively expanded loan portfolios in foreign currencies, in particular in mortgage markets, creating significant risks due to currency mismatches. Although Basel II standards were introduced in 2007 and risk management practices had certainly improved, rapid credit growth amid a liberalized capital account exposed vulnerabilities, which became more evident during the Great Financial Crisis.

A frontrunner among the central banks from the emerging economies, the NBR began implementing early forms of macroprudential policies aimed at curbing the risks associated with rapid credit growth, especially foreign currency denominated credit expansion. Moreover, stricter capital adequacy requirements were put in place to ensure that banks had sufficient buffers to absorb potential losses. These measures were critical in preventing the buildup of excessive risk in the banking sector, although the scale of foreign currency lending remained a challenge.

While Romania wasn't at the epicenter of the Great Financial Crisis (GFC) of 2008–2009, the impact was deeply felt here. I worked at that time at the IMF again and remember the strong (prior) warnings issued on the vulnerabilities, particularly around foreign currency lending and an over-expansionary fiscal policy, points made very clear by the later director Poul Thomsen also present here.

Amid higher risk aversion and domestic and external imbalances, the depreciation of the leu caused the cost of foreign currency loans to rise considerably, leading to a sharp increase in non-performing loans, which put pressure on the banking system. While Romania avoided a full-scale banking collapse, and remains one of the few countries in the EU which has not used public money to recapitalize failing banks, the crisis highlighted the need for stronger regulation and better risk management in the banking sector.

One of the key challenges, was the pro-cyclical fiscal policy that Romania had pursued in the years leading up to the crisis. The NBR had done its part, tightening monetary policy to control inflation, but fiscal policy remained overly expansionary. When the crisis hit, the fiscal position of the country made it harder to respond effectively. In 2009, Romania secured a €20 billion package from the IMF, EU, and World Bank, which played a crucial role in stabilizing the country's finances and restoring confidence in the financial system.

Post-Crisis Reforms and the Development of Macroprudential Policies (2010–present)

In the aftermath of the crisis, Romania's financial sector underwent significant reforms aimed at strengthening resilience, enhancing regulatory oversight, and addressing the vulnerabilities exposed by the crisis. The central bank under governor Isărescu took a leading role in implementing these reforms, with a particular focus on developing a more robust macroprudential framework.

I am quite familiar with the financial sector challenges you faced and the reforms you implemented, as in the decade following the crisis I was the Director for Supervision Policy and Financial Stability at the Dutch Central Bank, while I was also a member of the Basel Committee during that period.

Basel III introduced key reforms to strengthen global banking stability. It required banks to hold higher capital ratios, ensuring they could better absorb losses during economic downturns. Additionally, it imposed stricter standards on the quality of capital, focusing on Tier 1 capital, which is most effective in absorbing losses. The framework also introduced new liquidity requirements, such as the Liquidity Coverage Ratio (LCR) and Net Stable Funding Ratio (NSFR), to ensure banks had enough liquid assets to manage short-term and long-term risks. This by itself was an interesting development, as previous Basel agreements basically abstracted from liquidity issues. The philosophy behind that was that if banks were sufficiently capitalized, they could always attract sufficient funding, and if not, there must be something wrong with their capitalization. The GFC however showed that even well capitalized banks could run into liquidity problems due to contagion and other factors. Negotiating these reforms took time, but by the late 2010s, agreement on their implementation was reached, allowing for a gradual transition to the new standards.

In Romania, stricter rules on foreign currency lending were introduced, limiting the ability of individuals to take out loans in foreign currencies. Capital adequacy requirements for banks were raised, ensuring that they maintained sufficient buffers to absorb potential losses. These requirements were aligned with the Basel III standards, introduced starting January 2014. Moreover, the countercyclical capital buffer was introduced starting 2016, requiring banks to build up capital during periods of economic growth, so that they have sufficient reserves to weather economic downturns.

In addition to capital requirements, the NBR also introduced liquidity requirements to ensure that banks had sufficient liquid assets to meet their obligations during periods of financial stress. This, as I noted, was particularly important given the liquidity shortages that many banks faced during the GFC.

Last but not least, the NBR began conducting regular stress tests on the banking sector to assess its resilience to various economic scenarios and shocks. These stress tests have become a critical tool for identifying potential vulnerabilities in the banking system and ensuring that banks are prepared to handle adverse economic conditions.

Starting late 2020, as Executive Director of the Dutch-Belgian Constituency at the IMF, my interactions with Romania have become stronger again, as we have worked together to navigate some of the most significant economic and social challenges in recent history.

Both fiscal and monetary policies played key roles in supporting the swift recovery of the Romanian economy following the shocks of the last few years. However, the fiscal policy stance remains expansionary and pro-cyclical, with notable fiscal imbalances driven by spending pressures. The government continues to face challenges in implementing a stronger fiscal discipline and the necessary structural reforms, particularly in improving tax collection and addressing inefficiencies in public spending.

In the context of our IMF Constituency, which includes many countries in the region, I want to use this occasion also to express my great gratitude for Romania's extensive support for Ukraine and Moldova, both of which members of our Constituency that were hit hard by the fully unjustified invasion of Ukraine by Russia. Romania's unwavering support for the millions of Ukrainians who fled their country during this crisis, has been nothing short of remarkable, and it speaks to the country's leadership and commitment to its neighbors.

Challenges and The Way Ahead

Romania's financial sector has undergone a remarkable transformation over the past three decades, evolving from a state-controlled system to a competitive and resilient banking sector, with the National Bank of Romania playing a key role. Despite this progress, structural vulnerabilities remain, particularly the low level of financial intermediation. Addressing this, requires structural reforms, such as improving firms' financial soundness and enhancing financial education. In terms of regulation and supervision, continuing to implement the Basel reforms and CRR/CRD requirements, complemented with regular stress-testing and the broad set of macroprudential measures, will increase the robustness of the financial sector. Additionally, considering the recent geopolitical shifts, Romania should further strengthen its domestic banks to be able to play a larger regional role.

Looking further to the future, one of the most exciting opportunities—and challenges—is the role of financial technology, including artificial intelligence (AI), in reshaping the financial landscape. I believe that AI can play a pivotal role in improving operational efficiency and decision-making, while also presenting new regulatory challenges, particularly in areas such as data security and ethical dimensions. The adoption of AI will require balancing innovation with risk management, and I am confident that the NBR will guide this transition responsibly. The Financial Stability department will play an increasingly important role, and developing advanced skills will be key to managing new challenges and seizing opportunities. The recent macroprudential cyber-risk stress test, focused on systemic liquidity runs, exemplifies the National Bank of Romania's efforts to address emerging risks from rapidly evolving technologies.

In addition to AI and cybersecurity, the growing emphasis on climate change poses another important challenge for the financial sector looking ahead. The transition to a greener economy will require significant adjustments in how banks assess risks, particularly in relation to environmental sustainability and the financing of green projects. And I know you carefully monitor this topic, as well. I recall that during the 2019 edition of our NBR-IMF seminar, your

Financial Stability experts presented the results on their first innovative climate stress-testing exercise using micro data.

At the same time, alongside these advancements, fiscal policy discipline remains a critical issue. Romania has faced challenges related to expansionary and pro-cyclical fiscal policies in the past, and there is still a pressing need for disciplined and sustainable fiscal management. A disciplined fiscal policy will not only support macroeconomic stability, but also provide the necessary foundation for continued growth and financial resilience.

The ongoing enhancement of regulatory frameworks, digital transformation, the integration of advanced technologies, and a focus on climate resilience, paired with disciplined fiscal management, will be key to sustaining the impressive progress you have made in developing your financial sector. Let me sum up. Over the past half hour, I have guided you through the three key phases in the development of Romania's financial sector: phase 1 – the transition from a command to a market economy; phase 2 – becoming an EU member; phase 3 – post GFC regulatory and supervisory reforms, including Basel III. It was cleary a period of great change. One thing however did not change: the leadership of the NBR. Governor Isărescu, you have guided the financial sector through three important and key changes, with a very steady hand. You deserve great credit for that, and you earned great respect, both nationally, and internationally, including at the IMF. I am confident that under your leadership Romania's financial system will continue to grow and adapt to the challenges and opportunities of the future.

Thank you very much.