CONSIDERATIONS REGARDING THE ROLE OF FOREIGN DIRECT INVESTMENT IN ROMANIAN BANKING SYSTEM

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A*bstract.* *The foreign banks could be a key element in the process of financial integration of our country in the international and European financial system. This paper analyses the importance of foreign capital in world economy and implications of foreign direct investment in Romanian banking system.*

Keywords: *investment, banks, mergers, acquisitions*

JEL Classification*: G21, G 34*

1. The evolution of foreign direct investment at international level

The processes of globalization and economic liberalization have had a great impact on flows of foreign direct investment (FDI). More and more countries, especially the developing countries, have adopted a number of measures for the liberalization of foreign investment regime; at international level, there is a real competition to attract foreign capital. The liberalization of FDI involves **the elimination of market distortions**, the improvement of foreign investment treatment (the national treatment is offered to foreign investment), the development of market supervision, the granting of tax and financial incentives. This process is necessary for attracting foreign investment, but, as practical examples show, the transnational companies must analyze many aspects in

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order to invest in a foreign country. Efforts made by both developed and developing countries, to improve the investment climate, have been translated by the spectacular growth of FDI especially in recent years, as the data presented show.

Table 1

The value of FDI inflows (millions of dollars)

	2004	2005	2006	2007
World	742,143	958,697	1,411,018	1,833,324
Developed countries	418,855	611,283	940,861	1,247,635
European Union	204,245	498,400	562,444	804,290
Romania	6,517	6,483	11,366	9,774

Source: *World Investment Report 2008, UNCTAD, p. 254-256*

In recent years, the specialists from UNCTAD have considered that the spectacular growth of foreign direct investment is due to the increase of transnational companies' profits and stock prices, which led to the completion of international takeovers, in the form of mergers and acquisitions, at very high values. The upswing of FDI is going to stop because the financial crisis triggered in the U.S. will affect FDI flows. According to market research conducted among the transnational companies by the United Nations Conference on Trade and Development in 2008, one third of respondent firms anticipate negative effects on FDI, while half do not anticipate any impact. However, specialists believe that developed countries will be affected by a decrease in the bank liquidity and by a reduction of the supply of loans and corporate bonds. The financial crisis triggered a decrease in market value of many commercial or investment banks from America and Europe.

The disorder in financial markets and the problems of banks have generated a new wave of consolidation in the banking sector through mergers and acquisitions. The banks, which take lower loss, saw an opportunity to purchase shares of some banks with financial problems, the purchase prices being 40-60% of the value before the crisis (UNCTAD 2008). In order to forestall a higher share of the market, large transnational corporations have completed mega business (over 1 bn USD). The number of these mega transactions rose spectacularly from 141 in 2005 to 172 in 2006. Still, the main ways of implantation of FDI in the world economy are mergers and acquisitions. The percentage of this way of implantation is around 90% at international level, while for EU is 97% (for FDI inflows at 2007 level).

Table 2

Value of cross-border M&As (millions of dollars)

	2004	2005	2006	2007
World	380,598	929,362	1,118,068	1,637,107
Developed countries	317,431	820,358	969,116	1,454,084
European Union	185,809	579,026	556,888	782,024
Romania	2,200	1,851	5,324	1,784

***Source**: World Investment Report 2008, UNCTAD, p.272*

The services sector attracts ever more foreign direct investment, most investment projects in this field being done through mergers and acquisitions. According to data provided by the United Nations Conference on Trade and Development, the mergers and acquisitions made in the financial sector accounted for 12.25% in 2005 in 2003, 15% in 2006 and 21.2% in 2007 from the total value of takeovers at international level. Actually, the expansion of transnational financial conglomerates are carried out both in developed and in developing countries, remarking here the countries of Latin America and Central and Eastern Europe.

2. Determinant factors of foreign direct investment in banking sector

The reasons for the presence of foreign direct investment in the banking sector are identical to those for any transnational company: increase in market share, increase in efficiency and use of resources or strategic assets, which are achievable through the acquisition of local banks at good prices or which have important regional networks. In addition, the infusion of foreign investment into the banking sector can be explained by the "follow the customers" technique (Clarke, 2001). The foreign banks make investment in the host countries only after large transnational corporations, which they serve in developed countries, set up subsidiaries in host countries. The intensification of competition in the countries of origin has forced some banks to extend the activities by opening branches abroad. The expansion of foreign banks has been supported by liberalization and financial reforms initiated by the countries from Latin America and Central and Eastern Europe.

The opening of the Romanian economy to foreign direct investment, conducted since 1989, has generated annual differentiated flows of foreign capital, fact explained by factors such as the state of economic development, the policy of privatization, the signing of the association agreement and integration agreement with the European Union.

Now, Romania is following the trend shown in the world, namely the concentration of FDI in the tertiary sector. In recent years, the foreign banks' interest in the Romanian market have increased as a result of the perception of foreign investors who consider that the local financial system is sound and credible and monetary policy taken by the National Bank of Romania is wise and has ensured a stable environment for the development of products and banking services. In fact, the improvement of the local financial infrastructure reduces the risk of foreign banks operating. The events like those in Russia (1998) or Argentina (2002) have increased the sensitivity of financial institutions to the possible consequences, least likely, of situations with high country risk that are generating important costs. In order to reduce the impact of country risk, foreign managers are considering the use to a greater extent of local funds and they focus on the establishment of financial sources for extreme situations.

The financial liberalization is driving inflows of foreign capital. The liberalization of the capital movements has considered enhancing the interest of foreign investors for acquisition and integration of financial companies into the global economy. In fact, foreign investment in the banking sector is seen as an important step in the process of consolidation and globalization of the financial industry (BIS 2004).

The development of the capital market and the increasing interest of companies for non-banking financing led to a reduction of banks' profits and the banks' need for geographic diversification and orientation towards new financial segments. The financial liberalization has created opportunities for exploiting complementarities between sectors like banking, securities and risk management, the result being the emergence of derivative products on the OTC market and improvement of the distribution of such products and financial services. For example, mobile banking and Internet banking have been used by foreign banks for a rapid access to markets in Europe or Asia. The countries of Central and Eastern Europe have become major vessels of foreign capital in the banking sector with the privatization of state-owned banks and accession to the European Union.

3. Foreign banks present in Romania, ways of implantation and action

The involvement of foreign capital is intense in the Romanian banking sector. The commitment of foreign banks in Romania started in 1970 when Société Générale and Chase Manhattan have set up branches in Bucharest. Shortly after 1989, other foreign banks like ING, ABN Amro and Citibank have entered the Romanian market. **Initially, the five banks had served mainly international companies.** In the third wave, after Romania became associated country to the European Union, banks like BNP-Dresdner Bank, Austria Creditanstalt, Raiffeisen Bank, Daewoo, Demirbank have set up branches in Romania. In general, **all banks with foreign capital**, by developing networks or promoting new banking activities (Internet banking or mobile banking) **have been oriented towards retail**.

After 1989, the Romanian banking system has developed both through the efforts and initiative of local authorities and foreign investors. The quantitative development is shown by the increase in the number of banks, from 8 in 1991 to 43 at the end of 2008. **The privatization of state-owned banks by foreign investors' participation has led to a radical change in the structure of the banking system.** If in 1998, the five state-owned banks (Romanian Commercial Bank, Romanian Development Bank, Bancorex, Agricultural Bank and CEC) had 56% of the capital from Romanian banking system, at present, after the processes of restructuring and privatization, the weight of state-owned banks decreased to 12.8%. The decrease in importance of state owned banks is even more dramatic if we take into account the weight held in total assets of the banking system that was reduced from 71.8% in 1998 to 5.3% at the end of 2008.

Currently, many local banks have foreign capital. This situation is explained by the privatization of Banc Post, Agricultural Bank and Romanian Commercial Bank and by the acquisition of private domestic banks by foreign investors. Thus, Alpha Bank took over Bank of Bucharest, the Romanian-American Investment Fund bought Romanian Bank, Piraeus Bank took over Pater Bank, OTP bought the entire package of shares of the RoBank. To these, we must mention the bankruptcy of private banks such as Bee Bank, International Bank of Religions or Bankoop. The result is a present massive foreign capital in the Romanian banking sector. Among the first ten banks in Romania, only two banks have Romanian majority shareholders: CEC and Transilvania Bank, which together have a market share of 9.6%.

Table 3

The top of 10 Romanian banks

	Market share	**The major shareholder**
Romanian Commercial Bank	25.3%	Erste Group
Romanian Development Bank	16.0%	Societe Generale Group
Raiffeisen Bank	6.4%	Raiffeisen International
Transilvania Bank	5.6%	Romanian capital
Bank Post	5.3%	EFG Eurobank
Alpha Bank	5.1%	Alpha Bank Group
UniCredit Tiriac Bank	5.1%	UniCredit Group
Volksbank	5,1%	Volksbank International
Piraeus Bank	4.1%	Piraeus Group
CEC	4.0%	Romanian state

Source: *CEE Banking – still the right bet, UniCredit Group, july 2008, p. 50, http://www.bankaustria.at/en/index.html*

From the total of 43 credit institutions, two are state-owned banks - CEC and Eximbank, three have Romanian majority private capital - Transilvania Bank, Carpathian Commercial Bank and Libra Bank, and 37 are banks with foreign capital. The increase in number of foreign banks generated a weight of the assets of these banks around 88.1% at the end of 2008.

Table 4

The market share of foreign banks

	2005		**2006**		**2007**	
	RON mil	**%**	**RON mil**	**%**	**RON mil**	**%**
Banks with Romanian capital	48,391.7	37.8	19,710.3	11.4	30,330,5	12.,1
Banks with foreign capital	70,091.8	54.7	142,528,1	82.8	207,906,7	82.9
Total commercial banks	118,483.5	92.5	162,238,4	94.2	238,237,2	95.0
Foreign banks' branches	9,606.1	7.5	10058,7	5.8	12,545,8	5.0

Source: *Report of National Bank of Romania 2007, p. 59*

The increasing capitalization of the banking system in Romania is not only due to local efforts, but especially banks with foreign capital. Thus, the increase in capital by 16.6% in nominal terms and 9.4% in real terms was generated by the foreign capital too, according to data presented in Table 5.

Table 5

The weight of foreign banks in aggregate capital of Romanian banking system

	2005		2006		2007	
	mil lei	**%**	**mil lei**	**%**	**mil lei**	**%**
Banks with Romanian capital	2,287.7	31.1	2,002.4	21.2	2,273.8	20.6
Banks with foreign capital	4,561.2	61.9	6,702.3	71.0	8,060.4	73.2
Total commercial banks	6,848.9	93.0	8,704.7	92.2	10,334.2	93.8
Foreign banks'branches	517.0	7.0	740.0	7.8	681.6	6.2
Romanian banking system	7,365.9	100.0	9,444.7	100.0	11,0158.0	100.0

Source: *Report of the National Bank of Romania 2007, p. 60*

The financial crisis has not had a major impact on the Romanian banking system, because bankruptcies are not recorded. Moreover, the numbers of credit institutions and assets managed by them have increased. Compared with the previous year, the share of private credit institutions and share of foreign banks have remained constant.

Table 6

The evolution of specific indicators of the Romanian banking system in 2008

	December 2007	**March 2008**	**June 2008**	**September 2008**	**December 2008**
Number of credit institutions	42	42	41	42	43
Foreign banks' branches	10	10	9	9	10
Assets (RON *millions)*	251,425.8	264,448.3	279,812.8	297,200.4	314,639.7
Assets of private credit institu-tions/ assets of banking system	94.6%	94.6%	94.6%	94.7%	94.7%
Assets of foreign credit institutions/ assets of banking system	87.7	87.6	87.7	87.9	88.1

Source*: www.bnr.ro*

A large part of international takeovers in the banking sector has been achieved through the privatization process; we notice that the countries of Central and Eastern Europe have attracted foreign banks by the sale of state owned banks. If in the second half of the past decade, this situation is noticed in countries such as Poland, Hungary and the Czech Republic; in the last 5 years, the interest of foreign banks in the privatization of state-owned banks moved to Romania and Bulgaria, countries that started later the procedures of bank privatization.

Very few financial institutions have the capacity to conduct banking activities worldwide, and that is why most banks have a regional involvement. In fact, a study conducted by the Bank for International Settlement, the specialists has achieved a split of foreign investors in the financial sector into banks with global activity, regional banks and other non-banking institutions such as financial companies and investment funds (Domanski Dietrich, 2005). While the banks with global activity have been oriented to promote certain products (consumer loans or credit cards), the banks with regional strategy have invested abroad to gain the economies of scale and to compensate for the lack of prospects for the development of their countries. In Central and Eastern Europe, 70% of banks are foreign banks with regional involvement, which come mainly from countries of Western Europe.

In the banking system as in the Romanian economy, foreign investors come mainly from the EU countries, like Austria, Greece, the Netherlands, France, Hungary. In addition to the countries listed in Table 7, two international financial institutions: the European Bank for Reconstruction and Development (EBRD) and the International Finance Corporation (IFC) have made investment in the Romanian banking system. The EBRD was involved in the privatization and restructuring of the Romanian Commercial Bank by the acquisition of a minority package of shares of 12.5% (the EBRD invested Euro 97.8 million). In addition, the EBRD have participated in the increase of social capital of the Transilvania Bank, investing over Euro 20 million. The Romanian Bank, Banc Post and Tiriac Bank are other banks that have obtained an infusion of capital from EBRD.

Table 7

The foreign investors' implication in the Romanian banking system

Country	Austria	Greece	Netherlands	France	Hungary	Italy
Participation value (Euro millions)	2,419.8	2,391.9	846.4	551.9	535.8	433.3
Weight (%)	22.0	21.7	7.7	5.0	4.9	3.9

***Source**: Report of National Bank of Romania 2007, p. 60*

4. Effects of the foreign banks on the national economy

The increasing role of foreign banks in emerging markets is due to the globalization of the financial sector, which led to an intensification of competition from non-banking sources of financing, with implications for profits recorded. This has led to a reduction in the profitability of traditional banking activities, banks choosing regional diversification and achieving other financial activities. The expansion of foreign banks and winning new market shares have been encouraged by more liberal rules and technical progress.

The impact of foreign direct investment on the banking system is influenced by certain variables such as the degree of foreign capital involvement and foreign investor type (private or public). In this sense, China's experience is remarkable, because the authorities allow limited participation of the foreign investors in the banking system. Thus, according to banking reform in 2003, the limits of participation in the capital are 20% for a single investor and 25% for a collective investment. Chinese law allows the establishment of subsidiaries and branches, but very strict control over their work involves a very slow development.

The existence of foreign banks leads to increased stability and efficiency of the banking system of the host country. As a result of competition, an improvement of quality, price and availability of banking services is recorded. In addition, foreign banks have achieved a more efficient allocation of credits because they have more sophisticated risk-assessment systems. Also, foreign banks achieve a better allocation of credits and estimate the risks associated with various financial products because of their experience in international financial markets. The injection of foreign capital in countries in transition to market economy has taken on particular importance after the financial crises in Latin America by participating in the privatization of banks in Central and Eastern Europe.

Numerous studies have revealed that increasing penetration of foreign banks in developing countries limited access to loans for small and medium companies. A study conducted by specialists of the World Bank confirms, to some extent, the results obtained previously by other economists: small and medium-sized companies benefit from the presence of foreign banks, but the positive effects are more consistent on big companies. Moreover, unlike the local banks with state capital that can be subject to political pressure to grant credits, the foreign banks are more intransigent, contributing to strengthening the discipline of business.

The entry of foreign banks to the local market means also import of more stringent prudential rules, at least for a part of the banking system. Moreover, during periods of crisis of the banking system, the branches and subsidiaries of international banks could help to stabilize the situation, because the depositors prefer them to banks from other markets. The foreign banks are considered to be sources of more stable lending, making the banking system of the host country more robust to shocks. Thus, the subsidiaries and branches of foreign banks have access to additional funds from the parent companies. The banks with international activity have better access to international financial markets, benefiting from portfolio diversification and higher incomes that are less correlated with local shocks. The Asian crisis of 1997 revealed a different policy of foreign banks, namely the "cut and run". In addition, the increased involvement of foreign banks in the national economy can attend to the biggest exposure to the events in the countries where these transnational banks operate.

Some experts consider that foreign banks adopt a policy focusing on companies with a stable financial situation ("cherry pick" policy), leaving local banks with weak customers, thus contributing to increase of local banks' risks. Moreover, as a result of increased competition, the local banks with a worse situation, in order to improve their position, could involve in risky activities and the final result could be bankruptcy. In addition to the challenge that foreign banks issued to the monetary authorities of the host country, a concentration of foreign investors in the banking sector could create a monopoly situation, with immediate effects on the efficiency of the local banking system.

The local banks are facing a number of disadvantages compared to the foreign banks: the limited access to capital, the lack of geographic diversification, the lack of experience on the activation of several markets, the delays in the implementation of new services and products, the limited ability to achieve investment in technology information and communications. The takeovers of local banks by foreign banks has effects like the access to the human and financial resources of the parent company, the transfer of software infrastructure (specific routine back office operations and control system of credits) or "transfer" a reputation that will lead to a widening base of customers.

The foreign banks operating in Romania have initially targeted activity to multinational companies, Subsequently, in order to increase their market share, they have been focused on local companies and population. Thus, ABN Amro has been successfully involved in the issue of Petrom Eurobonds, in financing Termoelectrica and the Ministry of Health through a syndicated loan. To ensure distribution of retail, some banks like ING and Volksbank have launched franchise trend. The foreign banks contribute to the launch and development of financial products such as OTC derivatives and structured products. It also points out the interest of foreign banks in the development of local financial markets in order to increase opportunities for hedging financial risks locally. Thus, the foreign banks have a preference for the use of local markets in the conduct of hedging strategies to cover currency risk and interest rate risk. For example, Raiffeisen launched, on the Romanian market, structured deposits, which are a combination of a classic bank deposit and options on the exchange rate, allowing yields above the market average. Also, banks with foreign capital like BRD or HVB provide tools for hedging currency or interest risk such as forward rate agreement, currency swap or swap on interest rates. In addition, the foreign banks contribute to promote the introduction of new clearing and settlement systems, which help them reduce operational risks.

In Romania, the foreign investors are involved in the establishment of the first specialized banks. Thus, in 2004, the National Bank of Romania approved the set up of two new banks, specialized in providing loans for housing (Raiffeisen Housing Bank), respectively for the purchase of vehicles (Porsche Bank Romania). The process of financial innovation undertaken by foreign banks has an impact on the legal framework specific to the banking market. The foreign banks have important financial resources, but they can accede more easily to available funds on international capital markets. For example, the Romanian Commercial Bank launched at the end of 2005 an international bonds offer in order to obtain a credit of 300 million euros. The foreign investors from over 16 countries had shown a special interest, the amount of purchase orders amounting to 750 million euros. Finally, the total amount attracted was 500 million euros.

5. Conclusions

The foreign banks could be a key element in the process of financial integration of our country into the international and European financial system. Currently, the interest of foreign banks has gone from big transnational corporations to the opportunities offered by local markets; however, some restrictions in granting loans to small and medium companies should be considered. The way of entry in the local market influences effects on the national economy. Thus, if the implantation was done by acquiring a local bank, the lending process to small local companies is affected, in this case, the local banks' response being decisive. Therefore, small firms may not have immediate benefits from increased financial integration through the emergence of foreign banks. The presence of foreign banks may lead to increased concentration in the banking sector, because the foreign banks proceed to further acquisitions to increase market share (for example, in Romania, HVB took over Tiriac Bank).

Despite the negative effects, the positive impact (in the form of increased stability of the local banking system, increasing competition with implications for the cost of credit and quality of services, the knowledge transfer, the financial innovation, the disappearance of less efficient firms that cannot face the rigors imposed by foreign banks) is important. Although our country has made important progress as regards the development of the banking system, its position in the region of Central and Eastern Europe is modest in terms of banking penetration (share of population over 15 years using banking services in the total population), of share of banking assets in GDP, etc.

Table 8

Some elements for banking system evaluation

	No. of banks	No. of branches	Banking penetration (%)	Market share of foreign banks	Weight of assets on GDP	Weight of loans on GDP	Weight of deposits on GDP
Poland	645	353	56	67	73	40	43
Hungary	38	151	76	68	108	61	46
Czech Rep.	37	192	82	97	104	47	67
Slovakia	24	217	8s2	96	91	45	57
Bulgaria	28	330	43	75	105	66	65
Romania	41	255	52	89	64	39	34
Croatia	33	259	87	90	122	78	70
Serbia	35	294	70	75	71	35	35

***Source**: CEE Banking – Still the right bet, UniCredit Group, July 2008, p. 37, http://www.bankaustria.at/en/index.html.*

The prospects are encouraging. Once Romania joined the European Union, 143 foreign institutions have notified the Romanian financial authorities on the intention of engaging in financial activities directly on the territory of our country, of which 134 are financial institutions, 3 are non-banking financial institutions and 6 are institutions issuing electronic money.

The increase in FDI efficiency involves intervention of central, regional and local authorities in the direction of using the banking resources to turn to good account the competitive and comparative advantages, that we have in agriculture and tourism. Also, it is necessary to increase financial assistance to boost exports, as import growth through FDI does not serve sustainable growth, but on the contrary. This is based on the fact that in recent years the cover of the current account deficit and trade balance deficit through FDI has decreased. As it is known, Romanian authorities have supported both directly and indirectly, rising foreign capital in Romania, including in banking sector. It is expected, at least in a relative idea of compensation, a logistics by which to ensure rising Romanian capital in border economic zones, especially in the Balkans and Russia. Increased foreign direct investment contribution to the promotion of the competitive and comparative advantages of the national economy can only be accomplished by increasing the share capital holdings and net profit reinvested in total FDI. Unfortunately, we have witnessed in the past three years a decrease in the weights of the two types of direct investments, respectively, from approximately 80% in 2005 to approximately 50% in 2007. The continuation of these trends will lead to at least increase of the current account deficit, with serious implications for economic and financial stability of the country. In addition, Romanian monetary authorities should impose the orientation of foreign capital from the domestic banking market to a greater extent to diversify and increase local production and housing construction.

The impact of the global financial crisis on the Romanian banking system is low, one reason being the massive presence of the European capital and insignificant presence of U.S. banks. Unlike other economic sectors facing bankruptcies and activity restriction, the Romanian banking sector has undergone a constant evolution. For example, the amount of loans granted by private credit institutions (largely with foreign capital), has not decreased, in fact the credits granted have increased during 2008, from RON 166,792 million in January 2008 to RON 216,720 million in November 2008.

Table 9

Credits granted by credit institutions in Romania in 2008 (RON millions)

	2005	2006	2007	January 2008	June 2008	Novembe r 2008
Private credit institutions	64,670	103,399	163,863	166,792	199,948	216,720
Foreign banks' branches	4,746	6,527	10,218	10,457	12,693	14,693

***Source**: www.bnr.ro.*

The same trend can be observed in the case of Romanian branches of foreign credit institutions, the amount of granted loans have increased by over 40% in the 11 months of the year 2008 according to the National Bank of Romania data. The uncertainty specific to the international financial market was translated in Romania by raising interest rates, currency depreciation and the imposition of restrictions on the granting of loans. However, long-term credits (with maturity over five years) have increased both in value and as share of total loans during the period January-November 2009.

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