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Indexed and/or Abstracted in:
EconLit; Index Copernicus; RePec

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The ROMANIAN ECONOMIC AND BUSINESS REVIEW (REBE) is a refereed journal published four times annually by the Romanian-American University. The editors invite submissions of articles that deal with important issues in economy and business. Papers that focus on specific phenomena and events affecting Romanian economy are particularly encouraged. Because REBE seeks a broad audience, papers should be comprehensible beyond narrow disciplinary bounds.

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Subscription rates:
Institutions - \$100/year
Individuals - \$30/year

ROMANIAN ECONOMIC AND BUSINESS REVIEW

FALL 2010

VOLUME 5

NUMBER 3



ISSN 1842 – 2497

ROMANIAN ECONOMIC AND BUSINESS REVIEW

CONTENTS

ARTICLES

WALTER E. BLOCK	<i>REJOINDER TO BOETTKE ON COASEAN ECONOMICS AND COMMUNISM</i>	9
YOJI KOYAMA	<i>ECONOMIC CRISIS IN NEW EU MEMBER STATES IN CENTRAL AND EASTERN EUROPE: FOCUSING ON BALTIC STATES</i>	31
MADHUSUDAN RAJ	<i>THE CREDIT CARD FRAUD: INFLATION, CULTURE OF BORROWING AND RISING ECONOMIC INEQUALITY</i>	56
VACLAV RYBACEK	<i>NATIONAL ACCOUNTS OF ROBINSON 'S ECONOMY</i>	63
RALUCA CRUCERU MIHAELA-GEORGIA SIMA	<i>INTERVENTIONS IN HUMAN RESOURCES RETENTION</i>	79
IULIAN MITUȚ	<i>MANAGERIAL INVESTMENT ON ORGANIZATIONAL STRESS</i>	89
LUMINIȚA TULEAȘCĂ	<i>THE CAUSES OF INSURANCE COMPANIES BANKRUPTCY IN ROMANIA</i>	100
MARINEL RIZEA, ELENA LUCIA CROITORU MIHAI DRAGOȘ UNGUREANU	<i>ACTS OF TAX EVASION AND FRAUD AND FINANCIAL IMPACT OF THESE PHENOMENA IN THE EUROPEAN UNION</i>	116
DANIELA POPA	<i>ROMANIAN PARTICIPATIONS AND CONTRIBUTIONS TO THE SECURITY GLOBALIZING ENVIRONMENT. BENEFITS FOR THE NATIONAL SECURITY</i>	126

SYMPOSIUM:

The economic crisis: new challenges and perspectives

ELENA ENACHE, CAMELIA VECHIU, GEANINA TUDOSE	<i>SURPASSING THE CRISIS AND RESUMING THE ECONOMIC GROWTH – MAIN OBJECTIVE OF THE MONETARY POLICY PROMOTED BY THE NATIONAL BANK OF ROMANIA</i>	131
ALINA HAGIU, EMILIA UNGUREANU	<i>THE EFFECTS OF THE WORLD ECONOMIC CRISIS ON THE EMPLOYMENT IN THE AUTO INDUSTRY</i>	145
MARIANA MIHAILESCU, MARINELA LAZARICA	<i>REMODELLING OF INVESTMENT ACTIVITY WORLDWIDE WITHIN THE WORLD ECONOMIC CRISIS</i>	154
RAMONA ORĂȘTEAN SILVIA MĂRGINEAN	<i>NOMINAL CONVERGENCE: THE CASE OF ROMANIA</i>	167
LAURA POPESCU, BOGDAN ZURBAGIU	<i>IT – CAUSE AND RECOVERY TOOL IN THE ECONOMIC CRISIS CONTEXT</i>	177
CRISTIAN GIUSEPPE ZAHARIE, ȘTEFANIA-DIANA IONIȚĂ- BURDA, ANCA BĂLĂȘOIU	<i>THE ECONOMIC CONTINENTAL UNIONS OF THE 21ST CENTURY</i>	190
ZIZI GOSCHIN, DANIELA-LUMINITA CONSTANTIN, ANIELA-RALUCA DANCIU	<i>A REGIONAL PERSPECTIVE ON THE IMPACT OF THE CURRENT ECONOMIC CRISIS IN ROMANIA</i>	204
LILIANA BUNESCU	<i>GLOBAL FINANCIAL CRISIS AND REVERBERATIONS ON CAPITAL MARKET</i>	226
MIHAELA COSMINA PETRE CRISTINA BUNEA BONTAȘ	<i>EFFECTS OF INTERNATIONAL FINANCIAL CRISIS ON THE FINANCIAL SYSTEM AND MONETARY POLICY</i>	236
DAN MICUDA, SORIN VISINESCU	<i>SOME ASPECTS REGARDING THE RECOVERY OF THE EUROPEAN BANKING SYSTEMS AFTER THE FINANCIAL CRISIS</i>	246

**MIHAELA GRUIESCU,
CORINA IOANĂȘ,
DAN DRAGOȘ MOREGA**

*THE RISK CONNECTION OF AN ORGANIZATION WITH INTERNAL
AUDIT. SPECIFIC CORPORATE
GOVERNANCE PRACTICES* 258

**ALIN OPREANA
DIANA MARIETA MIHAIU**

*CORRELATION BETWEEN THE PUBLIC SECTOR'S PERFORMANCE
AND THE SOVEREIGN DEBT, IN
THE CONTEXT OF
THE CURRENT ECONOMIC CRISIS* 271

REJOINDER TO BOETTKE ON COASEAN ECONOMICS AND COMMUNISM

Walter Block*

Abstract

In the view of Boettke (1998), Coase (1960) casts lights of understanding in a myriad of fields, including, preeminently, property rights theory and the Soviet system of economics. The claim of the present author, in sharp contrast, is that this seminal article of Coase's is a snare and a delusion. It has led economists down a mistaken path for lo this past half century, and Boettke (1998) is but one more unfortunate example of this.

Keywords: Ronald Coase; Communism; Central Planning; Property Rights

JEL classification: P2, P14

I. Introduction

There are valuable lessons to be learned from Boettke (1998). We gain knowledge of all the subjects he touches upon, as would be expected from the writings of an expert in all these disparate fields. For example, Coasean economics, the economics of the Soviet Union, the transition of such an economy to one based more on private property and decentralization. However, this is not a perfect paper, none is. The present essay is an attempt to correct some of the errors in it. Perhaps in this way our economic understanding can be developed to an even greater degree than his publication, on its own, provides.

What then are the mistakes in this paper? We cover them under the following rubrics: II. Socialism, III. The firm, IV. Praxeology, methodology, tautology, V. Suppression; VI. Coase and property rights, VII. Manager vs entrepreneur, VIII. Rent seeking; IX. Collective property, X. Transformation, XI. The fetish of transactions costs, XII. The Federal Communications Commission, XIII. Security of property rights; we conclude in section XIV.

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The author wishes to thank for helpful suggestions William Barnett II, Art Carden, David Gordon and Peter Klein. All remaining errors, both of commission and omission, are of course his alone.

II. Socialism

Boettke (1998, 193) starts off on the wrong foot. He claims that Coase's youthful disposition toward socialism was "dispelled by his understanding of economic processes...." Not so, I contend. Coase's entire intellectual career can be best understood as a *support* for socialism, not a renunciation of it. Well, that is not quite accurate. Better to say, Coase's oeuvre functions to undermine the basic foundation of one of socialism's main competitors, laissez faire capitalism. Which bulwark? Private property rights, of course.¹

III. The firm

Boettke's (1998, 193) next error also occurs on the very first page of his essay. He asks: "If the market is so efficient and powerful in organizing our affairs, then why were there business organizations?" But this bespeaks a profound misunderstanding of markets and/or business organizations, or both. The point is, business firms, too, are part of the market. Boettke is here of course referring to Coase's (1937, 387) famous "buttermilk" simile: "As D. H. Robertson points out, we find 'islands of conscious power in this ocean of unconscious co-operation like lumps of butter coagulating in a pail of buttermilk.'" The economy is like buttermilk: the globs represent firms, within which non market transactions, or orders without monetary exchange, take place, and the non-"globby" parts stand for interactions between different businesses, where such monetary transactions do occur.

But this is a distinction without (much of) a difference, as far as Boettke's reliance on Coase is concerned. That is, Coase is of course correct in pointing out that within firms there are no financial transactions, and that between them, there are.² But, neither is entitled to claim that business firms are not part of the market. Under free enterprise, "market" transactions take place every bit as much within firms as between them. Both occur, in both cases. Yes, there are short term contracts between companies: a restaurant purchases butter from a grocer. But there are also long term arrangements in such cases: the grocer can deliver the butter to the restaurant on a five year fixed term contract. Thus, there is no transfer of funds accompanying each and every delivery. And, similarly, within firms. There can be extremely lengthy contracts, as when the employees of a fishing boat are paid off only after the long voyage is completed. And there are relatively short ones, where the worker is paid weekly or even daily. The most extreme case in this direction is piece work: the employee is compensated each and every time he completes a task in

¹ For the case that Coase is an intellectual enemy of property rights, see Block (1977, 1995, 1996, 2000, 2003, 2006), Block, Barnett and Callahan (2005), Cordato (1989, 1992a, 1992b, 1997, 1998, 2000), Krause (1999), Krecke (1996), Lewin (1982), North (1990, 1992, 2002), Rothbard (1982) and Terrell (1999). Unhappily, Boettke (1998) fails to confront this literature, even, to do so much as mention it.

² See, also, Hart, 2008, Klein, 1996, on this.

some cases, although, to be sure, in some cases, he is paid only at the end of the day. But, if the task takes an entire eight hour shift, there is no difference.

Do not be fooled by Coase's (1937) emphasis on orders being given within firms, but not between them. Yes, the foreman "orders" the worker to tote that barge or lift that bale, but in terms of Kantian terminology, this is a hypothetical imperative, not a categorical one. No matter that what is actually being said might well be "Hey, Jones, lift that bale, etc." and this *sounds* like an order, it really is not. There is a hidden clause buried inside this so called order. It is, "if you want to be paid," then tote that barge, etc. But the "orders" that arise within the firm are precisely the same as those that transcend companies. When Hertz "orders" a car from Toyota³ it is in precisely the same manner as in which the rental company "orders" an employee to serve a car rental customer: "If you want to be paid, do so and so."

The latter statement is ubiquitous, both within and outside of, the bits of buttermilk that comprise the business enterprise. That is, the hypothetical imperative statement, "If you want to be paid, do so and so" operates both within the company and between firms. Coase's distinction is one without (much of) a difference. Yes, of course, there is indeed a distinction to be drawn between inter and intra firm contracts, but it is not the Coasean one. Rather, it concerns residual income claimancy status. The owner of each company is the residual income claimant of his own firm's interactions, and not of any other firms', or individuals'.

For Coase, what occurs within the firm is orders from managers to workers, not markets. Buying and selling takes place only between companies. But, this is not so. Within some big businesses, divisions buy and sell to and from each other. They are free to patronize vendors completely outside of their own corporations, if they can get a better deal externally than internally.

There are also freebies. McDonalds gives out "free" straws, napkins, bathroom service, ketchup, air conditioning, etc., even to those who make no purchases. This, then, furnishes another counterexample to the thesis that between firms (or, in this case, between a company and individual customers) all interactions are those of buying and selling. Then, too, there are such things as smorgasbords and buffets. Here, no charge is made by companies for specific foodstuffs consumed. Instead, in the latter two cases there is one price paid, and then the consumer may help himself to what he wishes. These are all dealings not within a business, but between it and others.

Thus, Coase and Boettke notwithstanding, the difference between firms and non firms is not non markets versus markets. There are no market interactions when corporations offer freebies, and there *are* markets (purchases and sales), even within firms, as when divisions within a single company buy and sell to and from each other. No. The boundary between firms is that the owner of each is a separate residual income claimant of the actions of his own company, and not of any of the

³ Note, I do not say GM or Chrysler; those firms no longer exist as part of the market.

others.

Does all this amount to no more than a verbal dispute? This objection might be couched in these terms: Coase is choosing to characterize what occurs within market based firms as “non market,” and I am insisting that what takes place within a company is every bit as much “market”⁴ as are interactions between firms. I think not; I think there are substantive differences, insofar as sometime inter-firm activities take place without the intermediation of the monetary nexus, and there are counter examples, too, in the other direction: intra-firm purchases and sales. But, even if this were only a dispute over words, still, it behooves intellectuals to use words carefully.⁵

An anonymous critic of an earlier draft of this paper writes as follows:

“Re your Section III: I think you are misreading Coase (1937) here.... When Coase distinguishes ‘firm’ and ‘market’ he does not mean to imply, as you suggest he does, that ‘firms are not part of the market.’ He is simply distinguishing inter-firm from intra-firm market activity. By ‘market’ in this context he does not mean the market system as a whole, but specific market transactions, as one would distinguish a firm from a network of independent contractors. When we say ‘firm X has decided to produce its own widgets instead of (out)sourcing them on the market,’ we do not mean that in doing so, firm X is somehow not part of the market system. We simply mean that firm X is not going to the spot market for that particular transaction. In short, I think you putting words into Coase's mouth, so to speak. If you want to argue that Coase really does mean that firms are not part of the market as a whole, you'd better find some textual evidence in Coase to support that. (The same applies to your discussion of “suppression” in section V. I don't think Coase ... believe(s) that the firm ‘suppresses’ the market in the literal sense.)

“Moreover, I think you also misunderstand Coase's idea of managerial fiat. Again, he would not deny that when a manager ‘orders’ a worker to do something, the manager is implying ‘if you want to get paid.’ Coase is simply distinguishing among two categories of voluntary transaction: the simple, one-time, spot exchange, and the employment relationship, a more complicated type of exchange in which A agrees to do what B wants him to do, subject to certain restrictions, for a given period of time in exchange for a given payment. By managerial fiat Coase simply means that A and B do not sit down at the bargaining table every time there is a specific activity to be performed. Rather, if A has signed an employment contract with B, he agrees to let B decide what specific activities he will do each day, in

⁴ It behooves us to define “market” at this point. It needs to be defined sans any relationship to money, as there are market transactions in a barter economy. The definition is in terms of voluntary exchanges, and also without mention of mutual exchange in that a donation is a market transaction. As such, “markets” occur both within firms, and between them, Coase to the contrary notwithstanding. In contrast, a non market activity is one where one of the two parties to a “transaction” is coerced by the other. One would think that this elementary and crucially important distinction should be pellucid. But, as Coase (1974) demonstrates in his work on the lighthouse, this is beyond him. See fn. 7, below, for more on this.

⁵ For more on this point, see section VII below.

exchange for the hourly or daily or monthly wage. In short, you devote quite a few paragraphs to critiquing a position that nobody holds (and, again, without citations to specific texts to back up your interpretation.”

About this, a few words. First, note how this critic goes from “Coase” to “we” in the first of the two above quoted paragraphs. This critic, in my opinion, is reading Coase (1937) far too sympathetically. The “we” parts of this paragraph are sensible; indeed, very sensible. The trouble with this interpretation, though, is that the “we” is really the critic, giving his own quite reasonable interpretation, not of what Coase actually said, but, what he *should* have written, were Coase’s analysis to rise to the level of my critic’s.

Second, my critic is certainly correct in claiming that my original draft did not contain the “textual evidence” to support my interpretation. I now move to make good this initial omission of mine.

Consider, then, the following, from Coase (1937, material in brackets and emphasis added by present author):

“If a workman moves from department Y to department X, he does not go because of a change in relative prices, but because he is ordered to do so. Those who object to economic planning on the grounds that the problem is solved by price movements can be answered by pointing out that there is planning within our economic system which is *quite different* from the individual planning mentioned above and which is akin to what is normally called (socialist) economic planning.”

Note the “quite different.” Coase, here, at least as I interpret him, is saying that the “individual planning mentioned above,” that is, the kind that occurs *within* the firm, is “akin” to socialist central planning.

Now consider this gem, also from Coase (1937, emphasis added by present author):

“Why are there these ‘islands of conscious power’? Outside the firm, price movements direct production, which is coordinated through a series of exchange transactions on the market. *Within a firm, these markets transactions are eliminated* and in place of the complicated market structure with exchange transactions is substituted the entrepreneur-co-ordinator, who directs production.”

It seems pretty clear that for Coase (1937) what goes on in the bowels of the firm is *not* part of the market. “Within a firm, these markets transactions are eliminated” seems definitive in establishing this claim. Were this not so, why oh why are market transactions eliminated within the firm. Why are not these a *different kind* of market transaction that occur when a man is transferred from one department to another? Why not? Because Coase’s understanding of what a market is, is very different from that of my critic. I go so far as to say that not only is Coase’s comprehension of free enterprise sharply divergent from my critic’s, but that Coase’s is erroneous.⁶

⁶ This failure of Coase’s to distinguish market from non market activity carries through in his work on the lighthouse. See Coase (1974). For a demonstration that in this context Coase is unable to discern

IV. Praxeology, methodology, tautology

In the view of Boettke (1998, 194-195):

“throughout his career Coase represented a style of economic reasoning which could be termed ‘economic minimalism.’ Simple economic concepts – some could be termed mere tautologies – are deployed to offer insights which are of great empirical significance. They may be tautologies, but there was nothing ‘mere’ about them. These theoretical conceptions come mainly as ‘limit theorems’ in that they demonstrate the pure logic of a situation as the starting point of the analysis. In other words, they establish what the world is not so that we get on with the task of explain (sic) the world as it is. In a world of zero transactions costs, for example, firms would not be necessary as all economic activity could be coordinated through the market.”

This is a curious way to put matters, particularly for an economist who characterizes himself as an “Austrian,” as Boettke does. First of all, tautologies confer *no* information about the real world at all. Rather, they ‘merely’ signify how we have agreed to use language. For example, “all bachelors are unmarried men” is a tautology. It defines a “bachelor” as an unmarried man. This is of course useful for a person interested in learning how to speak the English language, but certainly is not of “empirical significance,” certainly not of “great” empirical significance, as Boettke contends. Of course, this author cannot be read to say that *all* tautologies are of empirical significance, much less great empirical significance. My quarrel with him, rather, concerns the fact that the non “mere tautologies” in the Austrian tradition refer to praxeological statements, and Boettke steadfastly refuses to employ this nomenclature. It is as if a Christian were to choose not to employ the name of his Savior, Jesus Christ, while still proclaiming his Christianity. Not necessarily a logical flaw, but, still, at least more than passing “curious.”

In contrast, synthetic apriori statements seem to be what Boettke has in mind when he remarks on the ability of theoretical considerations to shed great light on the empirical reality of economics. Curiously, Boettke does not so much as mention praxeology, which is the science of employing synthetic apriori insights to help us understand economic realities.⁷ One would have thought that since praxeology is the essence of Austrianism, and Boettke characterizes himself as a member of this school of thought, that this would have been his preferred way of proceeding. But ‘twas not to be, which calls into question his Austrian or praxeological credentials.

the difference between the two, see Barnett and Block, (2007, 2009), Bertrand (2006). For the argument that Coase, in general, is an opponent of free enterprise, not a supporter, see Barnett, Block and Callahan (2005).

⁷ If Boettke wants to acquaint himself with this concept, I recommend especially the work of Hoppe, but, also, any of the following: Block, 1973, 1980, 1999; Batemarco, 1985; Fox, 1992; Hoppe, 1989B, 1991, 1992, 1995; Hulsmann, 1999; Mises, 1969, 1998; Polleit, 2008; Rizzo, 1979; Rothbard, 1951, 1957, 1971, 1973, 1976, 1997a, 1997b, 1997c, 1997d, 1993; Selgin, 1988.

The essence of what Boettke is saying is that Coase, shorn of Boettke's imprecise language⁸ is a praxeological or Austrian economist. Nothing, however, could be further from the truth. Rather, Coase is squarely within the neoclassical empiricist logical positivist camp (Wang, 2003; Hoppe, 1994a).

V. Suppression

Either Boettke is very, very, *very* careless with language or he, for some reason best known to himself, declines to distinguish between the operation of soviet style socialism and free enterprise. Consider the following statements of his (1998, 1996, emphasis added):

A: "The very existence of business organizations implies that the transactions associated with market coordination are positive, and thus *suppression* of atomistic competition was beneficial."

B: "... the organizational costs of hierarchy (and the *suppression* of markets) possesses costs that must be accounted for and place limits of the growth of hierarchy."

C: "The motivating ideology of the Russian revolution was a form of Marxism which stressed that abolition of all vestiges of the market economy and the complete substitution of production for direct use through a unified plan, for a social system based on production for profit. Such a project ran afoul in practice due to the difficulties associated with attempting to *suppress* markets completely."

The first two quotes, A and B, apply to the market system, if I read them correctly.⁹ The key, here, is this author's use of the word "suppress." That free enterprise "suppresses" explicit buying and selling, in favor of intra firm orders due to the zero transactions costs assumption would appear to be a curious way to express the matter. After all, when firm X outcompetes firm Y, and drives the latter into bankruptcy, this is due to X's ability to satisfy consumers, suppliers, investors, etc., to a sufficient degree so as to spell the economic demise of Y. But, there is no "suppression" going on here, unless X resorts to extra market activities, for example, has prevailed upon the political authorities to give it a competitive advantage denied to Y.¹⁰

Were this all there were to the matter, we would pass this by with little or no comment, attributing this logical lapse to something akin to a typographical error. However, two facts militated against so facile an interpretation. One, Boettke uses this curious expression, "suppression," to describe the operation of the free market not once (A) but a second time too, (B). Secondly, this author *also* employs the phrase to describe the operation of the Soviet economy (C). But while it full well

⁸ "Mere" tautologies indeed.

⁹ I say this since, I confess, I am having no small difficulty in understanding what he is saying in these two cases.

¹⁰ See on this: Domhoff, 1967, 1971, 1998; Hoppe, 1990; Hughes, 1977; Kolko, 1963; Mises, 1978; Oppenheimer, 1926; Raico, 1977; Rockwell, 2001

applies literally in the latter case, it does not at all pertain to either of the former two cases. In the USSR, markets were indeed “suppressed,” and with a vengeance. But to characterize a free market economy in the same way is surely ludicrous.

One of the most basic elements in all of political economy is to distinguish, on the one hand, between free enterprise, where economic freedom holds sway, and interaction is voluntary, and, on the other hand, the operation of hampered economic interaction, severely regulated as in the case of the USSR, where *laissez faire* capitalism is brutally forbidden. To characterize both such phenomena as “suppression” all too eloquently bespeaks a failure to make this vital distinction.¹¹

VI. Coase and property rights

In the view of Boettke (1998, 197), “A Coasean perspective leads one to look for the underlying property rights arrangement within the actual organizational structure of an economy.”

I take a different position on this matter. This is not the time nor place for a full bore investigation of how deeply and seriously the Coasean system is a deviation from one based on private property rights.¹² Suffice it at this point to briefly review the justification of this claim.

For Coase (1960), there are two possible states of the world, one, featuring zero transactions costs, and the second, the real world, with positive transactions costs. In the former case, if there is a dispute over property rights, in Coase’s view, as far as the allocation of resources is concerned,¹³ it does not matter to whom the court awards the rights in contention. If the judge rules in favor of the person who values it more, he will keep it. If to the one who values it less, the other will compensate him to transfer title.¹⁴ It costs nothing to arrange for this financial interaction, under the zero transaction costs assumption.

In the latter more realistic case, if the transactions costs are sufficiently high, as they are in many, if not most, cases it *does* matter to whom the judge makes the award, because the high transactions costs would preclude the rearrangement of property titles after the judicial decision is made. And what, pray tell, is Coase’s advice to the judge in such a case? It is to give the nod to the person who more highly values the disputed property in question; to the one, that is, who, in the zero transaction cost scenario, would have ended up with the property.¹⁵

¹¹ Coase’s failure to distinguish a voluntary payment, which is part and parcel of the market system, from a compulsory tax levy, an accoutrement of the state, is most obvious in his work on the lighthouse. See on this *supra*, fn. 7.

¹² See fn. 1, *supra*.

¹³ But not the wealth of the two contending parties

¹⁴ For a critique of this contention, see Block, 1977.

¹⁵ If Bill Gates and I are having a dispute as to the ownership of the dog that has been in my house for these many years, I am in trouble. If the court thinks that in the zero transactions cost world Gates would have been willing to pay more for this canine than I, and I would scarcely dispute this, then he

What of Boettke's claim? Does the Coasean "perspective" pass muster as a property rights system at all, let alone demonstrate that "A Coasean perspective leads one to look for the underlying property rights arrangement...?" It does not. If Bill Gates and I are having a dispute as to the ownership of the dog that has been in my house for these many years, that I purchased as a puppy, I am in trouble. If the court thinks that in the zero transactions cost world Gates would have been willing to pay more for this canine than I, and I would scarcely dispute this, then he can take my pet away from me even though I bought it, I brought it up since it was a pup, etc. This is not exactly justice in action. It is difficult to see how Boettke, as a libertarian, can acquiesce in any such unjust judicial decision. It is difficult to see how Boettke, as an economist, let alone a member of the Austrian School, can acquiesce in any such inefficient¹⁶ judicial decision. For, with this Coasean rule the law of the land, it would pretty much put paid to the institution of private property rights, and, with it, the generation of wealth.

Moreover, relative prices are constantly changing. In a dispute between the owner of wandering cows, and the proprietor of a neighboring cornfield, at t_1 the judicial nod, under the Coasean system, may go to the farmer. But, at t_2 , with the relative prices of corn/meat moving in the direction of the latter, a Coasean judge would support the "property rights" of the cattleman. A property rights system? No. More like the total *abnegation* of property rights.

Boettke (1998, 198, material in brackets added by present author) very properly castigates "a world where formal [property] rules are absent or defined in an

can take my pet away from me even though I bought it, I brought it up since it was a pup, etc. This is not exactly justice in action. Coase and Boettke would surely disagree with this analysis. They would say that this "rule" ought to be applied *only* when a title is in question. Coase and all of his supporters would argue that the title to the dog was never in question – I had the clear title, not Bill Gates.

How, in such clear cut cases, much less in more murky ones, does one establish title so that it cannot be brought into serious question merely by the filing of a court suit; i.e., any decent court would immediately throw out the suit and assess court costs and defendant's legal fees against such plaintiffs. One might argue that a title registered with some governmental agency – or in a better world, a private agency would serve the purpose. But that would mean that one would have to register title to everything they owned – a real way to increase transactions cost, thereby making it necessary to register title to everything.

But this applies to "any decent court" in the real (non Coasean) world. In the Coasean world, in contrast, there is simply *no* way to determine whether or not a title is in (legitimate) question. In this system, we look forward in time to determine property rights. They are defined in terms of least cost avoiders, or maximizing wealth. We do not look to the past, for homesteading, or any other such basis for property rights. The Coasean system is as a result vulnerable to all sorts of *reductio ad absurdum*. For example, in any rational world, either O.J. Simpson murdered his wife, and ought to be penalized to the full extent of the law, or, he is innocent of this crime, and ought to be freed. But, the Coasean vision provides us with a third option, a splendid *reductio*: O.J. *did* commit this horrendous crime, and yet *still* ought to be freed. Why? Because in the zero transactions cost world, he would have purchased his wife into slavery (he values her more than she values herself). Therefore, O.J. is the proper owner of this woman. Thus, he has the *right* to kill her. For more on this craziness see Block (1996).

¹⁶ Boettke is more than a self avowed Austrian. He is also a libertarian. Yet, it is a challenge to square this viewpoint of Coase's with the libertarian philosophy.

incoherent manner.” However, I go so far as to say that there is no more “incoherent” property rule than that which emanates from the Coasean system: it sees judges as veritable central planners, and property titles change in a helter-skelter manner, potentially with every alteration in relative prices, and every divergence in necessarily-subjective judicial determinations as to which complainant values property more than the other.

VII. Manager vs. entrepreneur

One of the (many, many) differences between the Austrian and the neo classical schools of economic thought is that the former places great weight on the entrepreneur, and the latter on the manager. The entire MR=MC analysis of the mainstream confers a manager’s eye view of the economy. Should Q be where it now is, or slightly more or slightly less, is a question confronting the *manager* of a plant. Whether the factory should be built or not in the first place, and if so, to produce exactly what, be located where, be of what size, is an issue that only the entrepreneur can deal with.

How does Boettke stand on this issue? Not too well. For a supposed Austrian, and a presumed admirer of Mises (1998) and Kirzner (1973),¹⁷ Boettke (1998, 197) takes a strangely neoclassical position. The Soviet problem, according to Boettke, was *not* that there were neither entrepreneurs nor private property rights¹⁸ but, rather, that the *managers* were not disciplined by the market. True, this author advocates that the managers become residual income claimants, an important step toward entrepreneurship. But doing so, merely, for extant managers leaves the entire system in place to a great degree. What about setting up new factories, entirely new industries? Residual income claimancy is part of the entrepreneurial role: it rids us of business failures. But, it neglects to address the positive: how do new factories, plants, firms, industries, arise in the first place?

VIII. Rent seeking

Boettke (1998, 198) also falls for the “Public Choice” malpractice of characterizing theft as “rent seeking.” This, too, confuses two very different ways of generating income. Through the market there are: rents, wages, profits, interest; via the political process there are: theft, booty seeking, obtaining monopolistic privileges, etc.

It cannot be denied that here Boettke and the present author are engaged, merely, in a verbal dispute. But, verbal disputes are not always so “mere.” First, in

¹⁷ The latter of whom has made virtually an entire career out of emphasizing the importance of entrepreneurship vis-à-vis management. See also Klein, 1999.

¹⁸ He does not mention these; instead, in the last three sentences but one of Boettke (1998, 197) the word “managerial” or “manager” appears five times.

every case, it behooves a careful writer to use words accurately. Imprecision in language renders communication less effective than it would otherwise be. But, second, in this particular case, lack of precision is fraught with all sorts of dangers: a bias in the direction of statism, in that what the government is doing has nothing to do with “rent,” and everything to do with unjust enrichment by some at the expense of others. Why paper over this vital distinction? The task of the libertarian, one would have thought, is to highlight the distinction between market and non market activities. What is Boettke doing here?

IX. Collective property

According to Boettke (1998, 199) “The idea of collective property is incoherent.” This must be rejected as a vestige of Randoidism. For Ayn Rand,¹⁹ the idea of anything collective is anathema. But, we need not be unduly influenced, as perhaps Boettke is, by this prejudice. Not only is collective property not “incoherent” we find it all around us, and it plays a vital role in our economy. Every partnership, whether in business or in the home (marriage)²⁰ every corporation, every condominium development, every housing co-op, every time share arrangement, is an instance of “collective property.” Nor is this form of ownership an “ambiguous arrangement” (Boettke, 1998, 199), as is state control, which is subject to legal whims, or Coasean “property” which is inherently unstable.

Why is this an important issue, one not merely a verbal dispute? This is because perhaps the most fundamental distinction in all of political economy is that between voluntary actions based on legitimate property rights, and those that are not so based, e.g., coercive ones.

According to Oppenheimer (1926, pp. 24–27):

“There are two fundamentally opposed means whereby man, requiring sustenance, is impelled to obtain the necessary means for satisfying his desires. These are work and robbery, one's own labor and the forcible appropriation of the labor of others. . . . I . . . call one's own labor and the . . . exchange of one's own labor for the labor of others, the ‘economic means’ for the satisfaction of need while the unrequited appropriation of the labor of others will be called the ‘political means.’ . . . The State is an organization of the political means.”

Only imprecision of language, something that seems to victimize Boettke from time to time, or philosophical confusion, could lead someone to fail to distinguish between collective property, a market phenomenon, and property that is under government control. It is imperative that the distinction between the political and economic be drawn. “Collective” property is not “incoherent.” If in the economic

¹⁹ It does not logically follow that if Boettke holds the same view of collective property as Rand, that his position derives from hers. Boettke might have come to this perspective in a different way. However, as a historian of economic thought, this is indeed my guess.

²⁰ At least for those families operating with common property.

means, it denotes a partnership, or some other form of group ownership. If in the political means, the state owns it, and does with it as it wishes. In neither case is it “incoherent.”²¹

X. Transformation

In the view of Boettke (1998, 199):

“The path from ‘here to there’ requires then not only an idea of the ‘there’ intended, but also the ‘here’ from which one is starting, *before* an appropriate strategy for the path can be determined. With regard to the question under examination (i.e., the transfer of ownership) the steps required for the divestiture of property from some owners, the legitimization of property held by others, and the establishment of conditions for the attainment, use, transformation, capitalization, and transfer of assets for new owners are the focus of attention. The appropriate policy path is necessarily multi dimensional, and grounded in the previous historical pattern of ownership.”

Boettke (1998, 200) rejects an egalitarian division of property rights in the USSR for the post-communist society on several grounds, all of them specious.

First, “it fails to recognize the existing property rights structure in Soviet-type economies.” But why should we be guided by the “here” in terms of previous property rights?²² By stipulation, the old regime was an unjust one, and if, presumably, the goal of the transformation is to promote fairness,²³ would we not be better off completely ignoring the status quo ante, except, perhaps, for incarcerating some of the more egregious rights violators?

To be sure, the usual libertarian perspective on reparations of property²⁴ maintains that “possession is nine tenths of the law” and that therefore all extant property titles are considered just, and the burden of proof rests with those who would overturn them. But, surely, in a vast kleptocracy such as the USSR, this should

²¹ The anti fractional-reserve banking system literature, to which I have contributed, makes the point that more than one person cannot have full title to the same good. I define “collective property” so as to exclude, *inter alia*, fractional-reserve deposits. For more on this see Bagus, 2003; Barnett and Block, 2005, 2008, forthcoming; Block, 2008; Block and Caplan, 2008; Block and Garschina, 1996; Block and Humphries, 2008; Block and Posner, 2008; Davidson, 2008; Hoppe, 1994b; Hoppe, Hulsmann and Block, 1998; Huerta de Soto, 1995, 1998, 2001, 2006; Hulsmann, 1996, 2000, 2002a, 2002b, 2003, 2008; Reisman, 1996; Rothbard, 1975; 1990, 1991, 1993

²² What were the “existing property rights?” My understanding was that virtually the only property rights individuals had was to some consumers’ goods. The nomenclatura, because of their positions of power in the state structure, had *de facto* titles to the various capital goods, including all real estate. Does Boettke mean that that these “rights” *should* be recognized in the “here.” This would be difficult to reconcile with any notion whatever of libertarianism. I cannot believe this of him. And yet, he takes no pains to distinguish his own position from such a claim.

²³ Perhaps I am speaking incautiously here. Maybe that is not the goal; perhaps it is some notion of Coasean efficiency. As a devotee of Coase’s, we cannot rule this out in the case of Boettke.

²⁴ Alston and Block, 2007; Block, 2002; Block and Yeatts, 1999-2000

almost be turned on its head. That is, the limousines and dachas of the nomenclatura should be seized from them forthwith, at the very outset of the process. Membership in the middle and upper reaches of the Communist Party²⁵ should, in the absence of proof to the contrary, render property owned by such people as null and void.

Second, Boettke (1998, 200) opposes adding up the “aggregate value of assets in the economy” and then dividing that number by the size of the population. He does so on the ground that “the proposal is caught in the following trap – it presupposes that we can assess the asset value of the economy, when in fact the purpose of creating the market in the first place is to find out the appropriate values of assets. In other words it presupposes what it hopes to attain.” But we not at all need know the asset value of that which is to be distributed in order to effectuate that division.²⁶ If it is impossible to determine who are the rightful owners of state property, one possibility is to give everyone any reasonably large but equal number of tokens, and then hold an auction, in which people can bid these tokens for the various shares in the wealth of the country. An alternative is to divide the entire wealth of the nation – land, buildings, roads, factories, whatever – into, say, 50,000 corporations, and then give each citizen $1/n$ shares in each one of them, where n equals the entire population.²⁷ If one simply *gives* away in such an equal manner all Soviet property to its citizenry, there is no need to presuppose knowledge of property values, contrary to Boettke.

Nor can I see my way clear to agreeing with Boettke’s (1998, 200) assessment that “If an accurate asset value was available to economic decision makers prior to marketization, then, in fact, there would be no need for marketization.” There are three main critiques of socialism in the calculation debate. Boettke does indeed mention the most important of these, the one stressed by Mises (1981):²⁸ accurate asset evaluations, based upon market appraisalment.²⁹ But there are two others that go unmentioned. The dispersion of knowledge as stressed by Hayek (1945), and, also, the incentives issue. But we should not be too harsh on Boettke in this one instance. As Hoppe (1989A) explains the first of these encompasses the other two. As long as there is private property, markets will arise. And with markets comes prices, which provide not only information, but incentives too.

However, the main reason to disagree with Boettke on this point is with his “If...then....” With his “if” he assumes a logical impossibility, much as positing a square circle. The key point of Mises (1981) was that you *can’t* have accurate asset values absent private property in capital goods. Boettke’s statement would have been

²⁵ My presumption is that membership in the lower orders was occupied by victims, not victimizers.

²⁶ We are here assuming the justice and reasonableness of dividing the assets of the USSR equally among its population, strictly for the sake of argument.

²⁷ Minus, of course, those guilty of imposing communism on the remainder of the populace; they would, in the just society, be in jail, paying off their debts.

²⁸ See also Salerno, 1990, 1995

²⁹ However, he offers no cites to this literature.

correct had he said, instead: “If an accurate asset value was available to economic decision makers, then, in fact, there would be markets.”

XI. The fetish of transactions costs

Thanks to Coase (1960) transactions costs have been imbued with portent that would seem to be, in the vast majority of cases, far greater than warranted by reality. Transactions costs have “outcompeted” other cost considerations such as resource costs indeed, *virtually all* alternative costs.³⁰ Boettke falls into this trap. He (1998, 201) goes so far as to say: “Absent transactions costs and neither the business firm nor the law would be important components of everyday economic life.”

This is highly problematic, at least insofar as the law is concerned. Even Coase himself would not agree with this misunderstanding of his views. Remember, for Coase, in the zero transactions cost world it does not matter *for resource allocation*³¹ what the law says; who the law will force to build the fence to stop the wandering cows; or who will be legally responsible, the railroad or the farmer, for the flying sparks, etc. But as far as wealth effects are concerned, the judicial decision is of *great* moment. Will the cattleman have to bribe the corn grower, or the reverse? Will the railroad be forced to install the smoke prevention device, and if so, *who* will pay for it? These are matters of importance for the wealth position of the contending parties. So, to say that “absent transactions costs” the law would not be important is to turn Coase on his head, surely not Boettke’s intention, given his otherwise hagiographic treatment of Coase. It is to say, in effect, that one’s wealth position would not be among the “important components of everyday economic life.”³²

³⁰ Rothbard (1982) states: “The love of the farmer for his orchard is part of a larger difficulty for the Coase-Demsetz doctrine: Costs are purely subjective and not measurable in monetary terms. Coase and Demsetz have a proviso in their indifference thesis that all ‘transaction costs’ be zero. If they are not, then they advocate allocating the property rights to whichever route entails minimum social transaction costs. But once we understand that costs are subjective to each individual and therefore unmeasurable, we see that costs cannot be added up. But if all costs, including transaction costs, cannot be added, then there is no such thing as ‘social transaction costs,’ and they cannot be compared...”

³¹ For a critique of this point, see Block, 1977. The argument here is that the ability to make a bribe, the wealth necessary to do so, is an entirely different issue than which contending party will end up owning the disputed resource, and that this is ignored by Coase. That is, there are not one but two phenomena that might be characterized as “wealth effects” in play, and that Coase ignores one of them.

³² Firms would still arise absent transactions costs, because different people have different attitudes to uncertainty, and thus to a willingness to be a residual claimant, save that in extremis (of the firm) everyone, even labor, may become a residual claimant.

XII. The Federal Communications Commission

Next, we consider Boettke's (1998, 201) views on the Federal Communications Commission (FCC). Here, our author takes the position that the Coase theorem explains airwave problems in terms of the "failure to assign broadcast rights." But this is erroneous. The (1960) Coase theorem is unjustly famous *not* for its insistence that property rights be assigned; rather, it is infamous for insisting, at least under zero transactions costs conditions, that (as far as resource allocation is concerned) it matters not one whit *how* they are allocated by law or courts. No matter which way, they will end up in the hands of the person who values them more. If they are given to this person initially, by judicial decision, he will keep them. If they are awarded to his legal opponent, he will purchase them from him.

Yes, Coase (1959), not Coase (1960) does indeed come out in favor of what may best be characterized as traditional property rights in the airwaves; he opposed the alternative FCC regulatory institution, insisting that property rights, traditional ones, that is, not Coasean (1960) ones, could indeed function in this arena, and would be more efficient than government control. The point here is that there is all the world of difference between the main burden of Coase (1959), and that of Coase (1960). The latter articulates the Coase theorem, the former is mainly concerned with applying traditional property rights to an area that previously had not benefited from them, radio and television. Yes, there is a complication that Coase (1959) was historically Coase's first articulation of his theorem (Moss and Fein, 2003), that he would fully articulate in 1960. But that is no justification for conflating the two publications, as does Boettke.

XIII. Security of property rights

Perhaps the most astounding misunderstanding of Coase in this entire article arises when Boettke (1998, 203) attributes to Coase emphasis on the importance of making "property rights secure over the long run." Yes, of course, this is the sine qua non of economic development. When property is not secure, the advantages of saving, of investment, of owning goods, factories, etc., pretty much evaporate, and with that, most chances for improving the underdeveloped economy. But to attribute to *Coase* the idea that property rights must be secure is utterly fallacious. If there is anything that Coase (1960) stands for it is the *very opposite* of long run security of property rights. Remember Coase's advice to the judge: in making a finding, do not look to the past, to the history of property, to documents such as bills of sale, contracts, agreements. Rather, be guided by the future. Ask of any judicial decision, will some measure of wealth such as GDP be maximized in the future. Will A or B, the disputants over a piece of property, value it more, and thus contribute more to national wealth, if they are given the award. In the real world of high transactions costs, post judicial bargaining will not enable resources to be allocated to their most important valuable use; rather, the judge will have to take on this role.

But given that continually changing relative prices will lead to a victory in court from one type of plaintiff today, and the very opposite one tomorrow, this is *anathema* to property rights security. At time t_1 , the nod will, say, be given to the cattleman; at time t_2 , however, when the corn price rises relative to that for meat, the court determination will go in the opposite direction. Now, the owner of the cows will be responsible for the fence. This is security of property?

It cannot be denied that Coase (1960) focused mainly, or, indeed, only, on actual court cases. In reality, the Bill Gateses of the world do not demand ownership of other people's puppies. But they *could*, based on a strict reading of Coase (1960), and how else are we to read this document? Loosely, as Boettke does?

XIV. Conclusion

Boettke (1998) constitutes an attempt to stuff a round peg into a square hole: to reconcile Coase (1960) with an emphasis on the importance of property rights in economic development in general, and on the USSR case in particular. No odder couple than this can possibly exist. Coaseanism is practically 180 degrees away from, for example, property rights stability. I do not blame Boettke for failing in this impossible job. Rather, I take him to task for trying to do so in the first place. One might as well attempt to show that Ayn Rand was a believer in socialism, or that the pope is an atheist.

Why would Boettke engage in such a futile undertaking? Our answer here, dependent as it is upon motives, can only be speculative. But one thread running through Boettke's oeuvre is an attempt to reconcile his supposed Austro libertarian approach with that of mainstream economists who reject this economic and political perspective. The attempt of his now under analysis can possibly be understood along these lines.

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ECONOMIC CRISIS IN NEW EU MEMBER STATES IN CENTRAL AND EASTERN EUROPE: FOCUSING ON BALTIC STATES

Yoji Koyama*

Abstract

After giving a general view of the economic crisis in new EU member states in Central and Eastern Europe, this paper examines the causes, focusing on Baltic States, especially Latvia.

Thanks to the Single Market of the EU, workers in this country became able to migrate to advanced EU countries, especially the UK, decreasing the unemployment rate and at the same time causing a sharp increase in wages due to a tightened labor market. Banks from Nordic countries, Sweden in particular, came to operate in Latvia and competed for market shares, stirring a consumption boom. In a situation in which people can easily get loans denominated in foreign currency, monetary policies of the central bank are of no use. The Latvian economy already showed a sign of overheating in 2005. However, in the spring of 2007, the government turned to restrictive policies, causing depression at the end of 2007. In addition, the Lehman shock dealt the Latvian economy its final blow.

Baltic States have shared a common weakness in terms of their development relying heavily on foreign capitals. In the case of Estonia and Lithuania, however, the circumstances in which foreign-owned banks have been overwhelmingly dominating the banking sector benefited these countries. As parent banks of foreign-owned banks coped with difficulties, both countries were able to avoid the worst case scenario.

Latvia, which is reconstructing its economy under support from the EU and the IMF, set up the introduction of the euro in 2013 as an exit strategy. Latvia is in dilemma: If the country does not devalue its national currency and tries to satisfy the Maastricht criteria (especially having a budget deficit of less than 3% of the GDP) soon, it will be obliged to adopt pro-cyclical policies, causing economic stagnation.

There is a scenario in which the financial crisis in Latvia might cause disorder in the EU economy via the possible collapse of Swedish bank(s), but the likelihood that this will come to pass seems very small.

Keywords: Global financial crisis, EU-Phoria, Central and Eastern Europe, Baltic States, Latvia

JEL Classification: E30, E44, F41.

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1. Introduction

More than twenty years have passed since the system change in Central and East European countries (Central Europe + South Eastern Europe + Baltic States). These countries have undergone remarkable development since the mid-1990s and have realized a long-cherished desire, i.e. membership of the European Union (EU) from 2004 through 2007. The new EU member states (NMS) seemed to continue their economic development in a relatively satisfactory way even after dark clouds began to hang over the world economy in 2007 due to the subprime loan problem in the USA. However, the global financial crisis arising from the collapse of Lehman Brothers in September 2008 caused NMS to take a direct hit. The NMS have been more or less in economic crisis. The economic crisis has been very serious in Hungary and the Baltic states. Some newspapers reported that the crisis in NMS might shake advanced EU member states (for example, Austria, Sweden, etc.) due to a huge amount of credit which banks in the latter countries have given¹.

To begin with, this paper tries to grasp the general picture of the economic crisis in the NMS in Central and Eastern Europe, mainly based on studies by a research group at the Vienna Institute for International Economic Studies (wiiw). Then focusing on the Baltic States, Latvia in particular, which has supposedly been in a most serious situation, reasons for why the crisis has become so serious are explored. Next, questions which the economic crisis in the Baltic States raised are examined, that is, the effectiveness of the prescription from the EU and the IMF, as well as a scenario in which the financial crisis in Latvia might cause disorder in the EU economy via the possible collapse of Swedish bank(s). Finally the paper reaches some conclusions.

2. Economic Crisis in NMS: Various Scenes

Among NMS we can find various scenes of the economic crisis, ranging from countries with very serious crisis to countries with rather milder crisis. These countries can be classified into several groups. When we look at the extent of the fall in GDP growth rates in Q1 of 2009 compared with Q2 of 2008 (Table 1), six countries have experienced double-digit falls in GDP growth rates, starting with Lithuania at -18.8% to Bulgaria at -10.6%. It is in Lithuania, Latvia and Estonia that GDP growth rates continued to make double-digit falls in 2009. These three countries belong to a group which is hardest hit by the crisis.

¹ For example, a news item that reported on “Latvia’s crisis” causing unrest in Europe. *Nihon Keizai Shimbun*, June 10, 2009.

Table 1 Extent of the Growth Reversal

	Change in quarterly GDP growth rates, Q1 2009 compared to Q2 2008, percentage points	GDP growth rates real change in % against preceding year		
		2008	2009	2009
		Q2	Q1	Forecast
Lithuania	-18.8	5.2	-13.6	-16
Latvia	-16.1	-1.9	-18.0	-20
Romania	-15.5	9.3	-6.2	-6
Estonia	-14.0	-1.1	-15.1	-16
Slovenia	-14.0	5.5	-8.5	-4
Slovakia	-13.5	7.9	-5.6	-5
Bulgaria	-10.6	7.1	-3.5	-3
Hungary	-8.8	2.1	-6.7	-6.5
Czech Republic	-8.2	4.9	-3.3	-1.5
Poland	-5.1	5.9	0.8	0.8

Source: Richter, et al (2009), p.3.

Table 2 Changes in the Unemployment Rate

	Forecast										
	1991	1995	2000	2004	2005	2006	2007	2008	2009	2010	2011
Czech Republic	4.1	4.0	8.8	8.3	7.9	7.1	5.3	4.4	7	7	6.5
Hungary	7.4	10.3	6.4	6.1	7.2	7.5	7.4	7.8	10.5	11	10
Poland	11.8	13.3	16.1	19.0	17.8	13.8	9.6	7.1	9	10	9
Slovakia	n.a.	13.1	18.6	18.1	16.2	13.4	11.1	9.5	13	14	14
Slovenia	8.2	7.4	7.0	6.3	6.6	6.0	4.8	4.4	7	7.5	7
Bulgaria	11.1	16.5	16.9	12.0	10.1	9.0	6.9	5.6	9	9	8
Romania	3.0	n.a.	6.9	8.0	7.2	7.3	6.4	5.8	9	9	8
Estonia	n.a.	9.7	13.6	9.6	7.9	5.9	4.7	5.5	15	18	18
Latvia	n.a.	18.9	14.5	10.4	8.7	6.8	6.0	7.5	18	22	20
Lithuania	0.3	17.5	16.4	11.4	8.3	5.6	4.3	5.8	15	19	18

Source: Richter, et al. (2009), p.19; *wiiw Handbook of Statistics 2007*, p.19; For 1991, EBRD (1998), *Transition Report 1998*.

Although there are certain influences from the global financial crisis, depression is milder in the Czech Republic and Poland compared with the Baltic states. In other countries the magnitude of the impact is in the mid-level range in the Baltic states, and in the Czech Republic and Poland.

A point which surprises many outside observers when looking at statistics on loans in Central and Eastern Europe is the fact that households and companies have had a very high share of loans in foreign currency of all total loans (Table 3). The share of loans denominated in foreign currency of all total loans has been very high in the Baltic States, especially in Latvia and Estonia, which ranged from the 80% mark to nearly 90%, and in Latvia it exceeded 90% in 2009. In Lithuania, Hungary and Romania it accounts for about two-thirds of total loans. In Bulgaria it has been fluctuating on the 50% mark. In Poland it increased from a quarter to one-third of total loans during the period April 2008 through April 2009. It is noteworthy that in three countries, i.e. the Czech Republic, Slovakia and Slovenia it has been very low².

Table 3 Share of Loans in Foreign Currency in% of Total Loans, End of period

	2008							2009						
	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Feb	Mar	Apr	
Czech Republic	12.9	13.0	12.4	12.6	13.1	13.1	13.2	13.6	14.1	14.4	14.4	13.8	13.4	
Hungary	53.8	56.6	56.3	55.7	56.9	58.7	63.7	63.0	64.6	67.3	67.4	68.2	66.3	
Poland	24.3	24.1	24.6	24.2	25.8	27.0	30.1	30.0	33.1	34.8	35.8	35.5	33.9	
Slovakia 1)			17.7			17.3			17.6			3.9		
Slovenia 2)	6.8	6.6	6.5	6.4	6.6	6.7	7.0	6.8	6.7	6.6	6.4	6.1	6.0	
Bulgaria	52.7	53.3	54.2	54.7	55.8	55.7	56.3	56.6	57.1	57.4	57.7	57.6	57.7	
Romania	62.4	62.5	62.8	62.7	63.0	63.4	63.5	63.6	63.9	64.2	64.1	64.1	63.9	
Estonia	82.5	82.9	83.6	84.3	84.6	84.7	84.9	85.1	85.3	85.7	86.0	86.4	86.7	
Latvia	85.8	83.9	87.7	89.8	88.2	87.4	88.9	88.6	89.8	91.6	91.9	92.1	91.0	
Lithuania	61.2	61.7	62.3	62.3	62.7	62.8	62.8	63.4	64.0	64.9	65.7	66.2	66.9	

Note: 1) From 2008 non-euro currencies only; 2) Non-euro currencies only.

Source: Richter, et al (2009), p.11.

Among countries relying on foreign capital, the Czech Republic has not suffered such serious damage. In this country the share of loans denominated in foreign currency of total loans is low. The exposure of the Czech banks to sub-prime securities is negligible. Despite quite vigorous GDP growth, the domestic credit

² In contrast to those countries, short-term foreign debt as a percentage of foreign reserves has been very high in the Baltic States. In Latvia this share was 277.8% in Q1 2007, and it increased to 302.7% in Q4 2007 and then decreased but was still as high as 250.7% in Q1 2009. Similarly in Estonia this share has been high, fluctuating around 250%. In Lithuania this share is lower, fluctuating between 100% and 150% (Richter, et al, 2009, p. 23).

expansion has been rather sluggish when compared with other NMS. The deposit/loans ratio exceeds 1 by a large margin and the net external position of Czech banks is positive (unique among the NMS). Moreover, unlike the situation in other NMS, loans denominated in foreign currencies were not attractive since Czech interest rates have tended to be lower than the foreign ones (Richter, et al. 2009, p.13).

Table 4 Exchange Rate Regime and Prospect for Introduction of the Euro

Country	Exchange Rate Regime	Target Date for Introduction of Euro
Estonia	Currency Board	Currently ERMII. 2011
Latvia	Pegged to Euro	Currently ERMII. Changed from 2008 to 2013.
Lithuania	Currency Board	Currently ERMII. Not fixed.
Slovenia	Euro (since January 1, 2007)	
Slovakia	Euro (since January 1, 2009)	
Poland	Floating Exchange Rate	2013, but will be extended.
Hungary	Floating Exchange Rate	After 2012
Czech Republic	Floating Exchange Rate	Changed from 2010 to 2012.
Bulgaria	Currency Board	Not fixed.
Romania	Floating Exchange Rate	Plans to join ERM II in 2012, and Euro in 2014.

Source: Extrapolated by the author, based on information from *CEE Quarterly* and newspapers.

Among NMS in Central and Eastern Europe, only Poland managed to maintain positive GDP growth in 2009. One of the reasons is that a depreciation of domestic currency enhanced competitiveness and absorbed the shock to a certain extent. This point is shared with some other NMS. What makes Poland different from the other NMS? Richter, et al. (2009) mention the following points: i) the country's size; ii) its relatively low levels of exports and imports; iii) a production structure more diversified than in other NMS; and iv) Poland's domestic financial system appears to be in good shape with debt levels (of households, the government and corporate sectors) significantly lower than elsewhere³. In addition to these points, we can add another factor: This country has had a relatively high share of people engaged in agriculture (19% of all employed people in 2004) and enjoyed higher prices of agricultural products after EU accession as well as support from the Common Agricultural Policy (CAP) of the EU. Therefore domestic demand has been kept in good shape⁴.

³ However, Richter et al. (2009) say, "This fact is not a sign of an exceptionally forward-looking policy. Rather, it follows from the brevity of the preceding GDP growth speedup which started only in 2006 and did not have time to reach the unsound proportion which characterized many other NMS" (p.4).

⁴ Professor Witold Morawski (Kozminski University) and Professor Masahiro Taguchi (Okayama University) provided the author with useful opinions on this point.

The general picture of the economic crisis can be summarized as follows: First, countries with fixed exchange rates (countries adopting the euro, or with a national currency pegged to the euro or currency board regime) could not mitigate the shock through depreciation of their national currency and suffered severely. Among them, however, countries with fiscal room (Bulgaria and Slovenia) were able to increase their budget expenditure to stimulate their domestic demand and therefore were able to somewhat mitigate the shock.

Second, in countries with floating exchange rates, and where the share of loans denominated in foreign currency of all total loans was relatively small (the Czech Republic and Poland), the shock was also relatively small. In addition, the Czech Republic was able to adopt anti-cyclical policies by increasing budget expenditure. In contrast, however, countries where the share of loans denominated in foreign currency of all total loans was higher (Romania and Hungary), the shock was relatively large.

Third, one country with a floating exchange rate, a higher share of loans denominated in foreign currency of all total loans and, in addition, a higher share of public debt compared with the GDP (Hungary) was not able to afford to undertake deficit spending, and in consequence its economic policies have become pro-cyclical, resulting in a more serious situation.

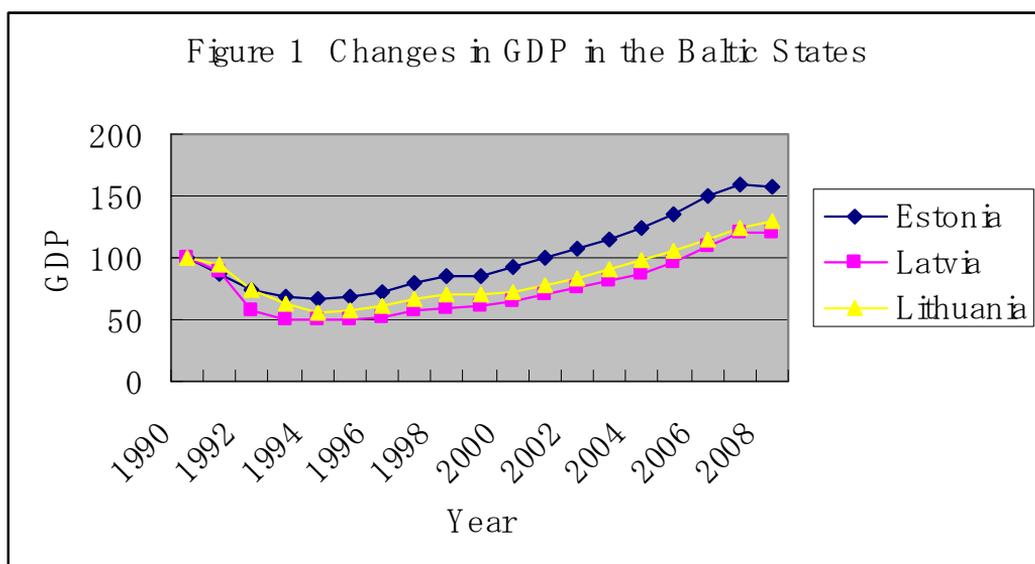
Fourth, since the Baltic States have had not only fixed exchange rates (currency board regime in Estonia and Lithuania, and euro-peg in Latvia), but also a huge amount of current account deficit, relatively large external debts, a very high share of loans denominated in foreign currency for total debts, etc. their economies have been very vulnerable to external shocks.

3. The Baltic States

3.1 General View

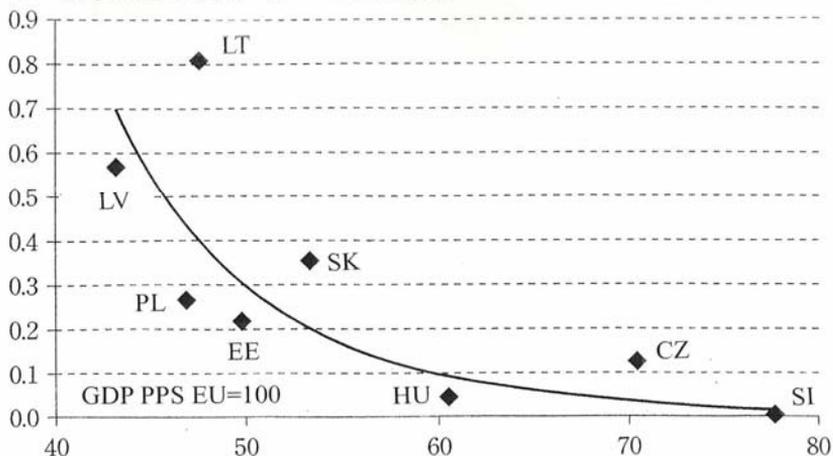
The Baltic States are all small countries with the population of Estonia, Latvia and Lithuania being 1.35 million, 2.3 million and 3.4 million respectively. These three states were forcibly incorporated into the Soviet Union in 1940. They shared their destiny with the Soviet Union for almost half a century, but they gained independence in September 1991. In 2003 the population of the rural areas in these countries ranged between 31% and 33%. Since the 19th century the Baltic States have been agricultural countries. It was after incorporation into the Soviet Union that full-fledged industrialization began. The impact on the Baltic States of the collapse of the Soviet Union and their secession from the COMECON block was enormous (Yoshino, 2004, pp.30-31). In the transition to a market economy all of them experienced 'transformational recession'. In the meantime they became beneficiaries of the PHARE program in September 1991. In June 1995 they concluded European Agreement with the European Union, and in December of the same year they together made applications for full membership of the EU. Finally in May 2004 they accomplished their long-cherished desire, i.e. full membership of the EU. Thanks to

this, the Baltic States joined the Single Market in the EU, enabling them to enjoy four freedoms: free movement of goods, free movement of services, free movement of capitals and free movement of labor. The extensive economic area of the EU, in fact, consists of five regional groupings, like the five-ring Olympic emblem, in which relatively independent activities based on the specific characteristics of the regions are allowed. Among them a ‘microcosm of Europe’ such as ‘the Baltic Sea economic area’ has practically been formed with Sweden playing an outstanding role in the area.



The economies of the Baltic States turned upward around 1995. Although under the influence of the financial crisis in Russia in August 1998 their economies stagnated in 1999 (GDP growth rates declined in Latvia, Estonia and Lithuania to 3.3%, -0.1% and -1.5% respectively.), they began to have high economic growth from 2000 (see Figure 1). Latvia in particular accomplished double-digit economic growth for three consecutive years from 2005 and also Estonia for two consecutive years from 2005. Such high economic growth can be partly ascribed to their active measures to attract foreign capital (reduction in corporate income tax, etc.). The amount of FDI inflow was already very large before their accession to the EU. Although it decreased at the turn of the 21st century, it increased again around 2004 when the Baltic States were admitted to the EU. In Estonia the amount of FDI inflow as a percentage of GDP reached as high as 20.5 percent and it recorded double-digits until 2007. Both Latvia and Lithuania attracted a huge amount of FDI, although the amount was not as much compared with Estonia.

Figure 2 Job Applications in UK by People from EU-8 Countries
% of population applying for work in UK



Source: World Bank (2005), p.11.

During this period the unemployment rate rapidly decreased in these countries. In 2001 the unemployment rate recorded a double-digit figure in these countries, 12.9 percent, 11.9 percent and 17.4 percent in Latvia, Estonia and Lithuania respectively. The unemployment rate was gradually decreasing. Being attracted by higher wage levels, labor migration to EU-15, especially the UK became popular after EU accession in 2004 (Figure 2), and the unemployment rate decreased more rapidly to around 5 percent in 2007. In parallel with this process domestic labor markets became tight, and consequently gross wages began to surge around 2004. The inflation rate was gradually increasing and in 2007 it rose suddenly to critical levels (14.1 percent in Latvia, 9.6% in Estonia and 8.1% in Lithuania). Around 2005 the economies of the Baltic States reached the situation of overheating. Imports increased reflecting domestic consumption booms. Although there have been significant amounts of transfer from overseas, their current account deficits expanded, reaching unsustainable levels (current account deficit as a percentage of GDP in Latvia, Estonia and Lithuania was -22.8 percent, -17.4 percent and -13.7 percent respectively).

Table 5 Ten Most Important Product Groups in Merchandise Exports to the EU-27 in 2008, SITC Classification

	Latvia		Estonia		Lithuania	
Ranking	Product label	Share	Product label	Share	Product label	Share

1	Cork & wood	12.3	Electrical machinery	8.4	Petroleum & petro.products	26.4
2	Iron and steel	10.3	Road vehicles	6.6	Fertilizers	6.3
3	Cork & wood manufacture	7.0	Telecom apparatus	6.5	Furniture & parts thereof	4.9
4	Road vehicles	6.5	Manufacture of metals	5.6	Plastics in primary form	4.3
5	Telecom. apparatus	3.7	Cork and wood	5.2	Apparel & clothing	3.8
6	Apparel & clothing	3.6	Furniture and parts thereof	4.9	Miscellaneous manu.articles	3.4
7	Manufacture of metals	3.5	Miscellaneous manu. articles	4.9	Road vehicles	3.4
8	Miscellan.manu. articles	3.0	Petroleum & petro.products	4.6	Diary products	2.5
9	Cereals	3.0	Cork & wood manufacture	4.3	Electrical machinery	2.5
10	Metal.ore & scrap	2.8	Iron & steel	3.6	Manufacture of metals	2.3

Source: Gligorov, Vladimir, Josef Poeschl, Sandor Richter, et al. (2009), pp. 146-147.

Latvia

The industrial structure can be outlined as follows: About 5 percent of Latvia's GDP is produced by agriculture, forestry and fishery and about 25 percent by manufacturing. The main items of export are products of so-called low-technology and middle-high technology including wood products such as wood and furniture, cast iron and steel (see Table 5). Nearly 70 percent of the GDP comes from the service sector, which includes the wholesale and retail trade, transport, shipping, and storage, real estate and information technology, etc. (Docalavich, 2006, pp.32-33).

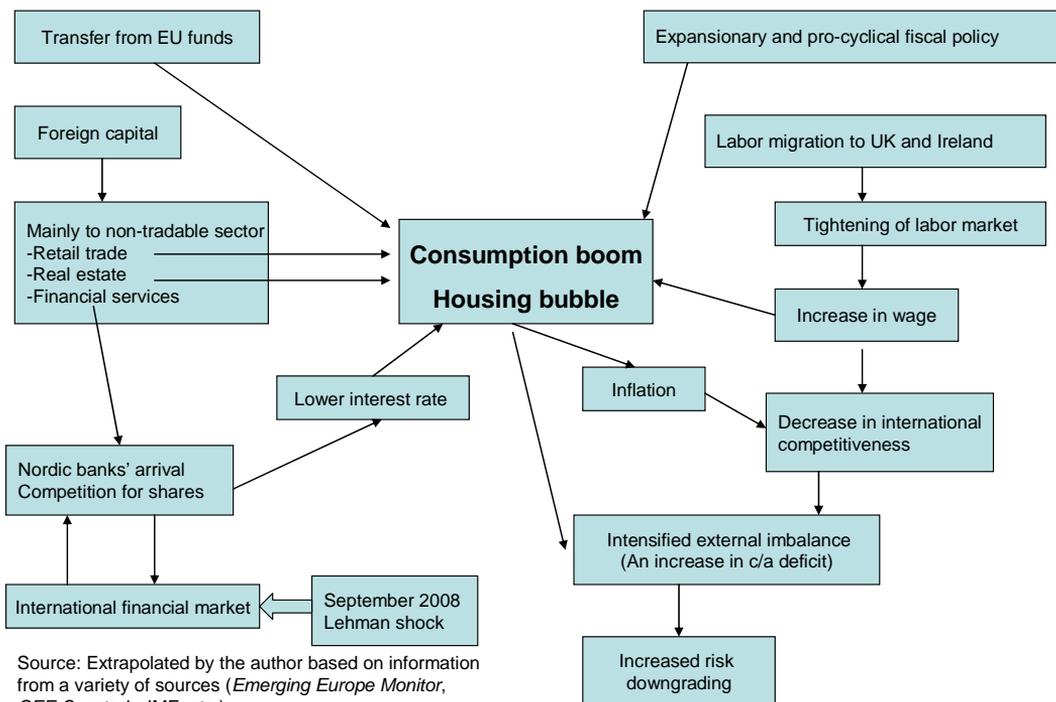
Since the mid-1990s, Latvia has made remarkable strides and accomplished rapid convergence in income with its income per capita at purchasing power parity increasing by 16 percentage points compared to the average of EU15. It was among the fastest growing of the eight NMS in Central and Eastern Europe (IMF, 2006b). Seemingly for several years in the mid-2000s both government and people in Latvia indulged themselves in EU-Phoria⁵. The economy continued to grow at a double-digit rate for three consecutive years from 2005. Apparently the country was doing well, but around 2005 the economy began to show signs of overheating as illustrated by increasing inflation, rising wages and a widening current account deficit. In an interview in May 2009 a staff-member of the IMF said "As far back as 2005, we warned publicly that this economy was in danger of overheating"⁶(IMF, 2009b). In a similar way, *Emerging Europe Monitor* published by Business Monitor International and

⁵ This expression is taken from the title of Rahman (2008).

⁶ A Finish economist Jari Jumpponen (2005) pointed out signs of overheating in the Latvia's economy in early 2005. p.50.

CEE Quarterly published by Unicredit group often pointed out in 2007 the necessity for soft landing to moderate economic growth.

Figure 3 Overheating of the Latvian Economy, 2004 - 2007



The mechanism of the overheating of the Latvian economy (Figure 3) can be explained as follows: Foreign capital, which had flowed into the Latvian economy since the mid-1990s, greatly contributed to the economic development. Inward FDI stock amounted to € 7.261 billion as of 2007. As for investor countries, investment from Estonia, a neighboring country in the Baltics, rapidly increased in recent years. In terms of inward FDI stock Estonia exceeded Sweden in 2006 occupying first place. In 2007 Estonia occupies first place with its stock being € 1,044.8 million (14.5%), followed by Sweden (13.9%), Denmark (8.9%), Germany (8.9%), Finland (6.2%), the Netherlands (5.8%), USA (4.8%) and Russia (4.7%). It appears a little strange that the UK which is the second largest importer for Latvia is in 12th place (3.1%) in inward FDI stock. Possibly companies in the UK may have been investing in Latvia via their subsidiaries in Estonia. When we examine inward FDI stock considering economic activities, Financial intermediation takes up the biggest share (28.3%), followed by Real estate, renting & business activities (18.3%), Other activities not elsewhere classified (13.1%), Wholesale, retail trade, repair of vehicles, etc. (12.4%), Manufacturing (8.8%), Transport, storage and communication (7.9%),

and Electricity, gas and water supply (5.3%). In this way, the share for manufacturing is very small (Hunya, 2008, pp.85-87). In recent years FDI inflow concentrated mainly in the non-tradable sector such as the retail trade, real estate and financial services.

Table 6 Latvia - Main Economic Indicators

	2001	2002	2003	2004	2005	2006	2007	2008	2009*
GDP (y-o-y %-growth, constant prices)	8	6.5	7.2	8.5	10.6	12.2	10.3	-10.3	-19.6
Industrial production (y-o-y-growth)	6.9	5.8	6.5	6	5.6	4.8	0.5	-6.7	-18.5
Inflation (CPI, end period, y-o-y %-change)	3.2	1.4	3.6	7.3	7	6.8	14.1	15.4	2.5
Gen.government budget balance (% of GDP)	-2.1	-2.3	-1.6	-1	-0.4	-0.2	0	-4	n.a.
Gross wage (period average, EUR)	282	297	298	314	350	430	683	678	670
Unemployment (% end of period)	12.9	11.6	10.3	10.3	8.7	6.8	5.4	9.9	16.7
Exports (€ million, current prices)	2232	2416	2559	3204	4085	4594	5727	6202	2327
Imports (€ million, current prices)	3910	4284	4634	5671	6879	8828	10986	10534	3241
Export/Import ratio	57.1	56.4	55.2	56.5	59.4	52	52.1	58.9	68.5
FDI inflow (€ million, current prices)	n.a.	223	248	489	568	1324	1797	909	50
FDI inflow as % of GDP **	n.a.	n.a.	n.a.	4.4	4.4	8.3	7.8	4	n.a.
Current account (% of GDP)	-7.6	-6.6	-8.1	-12.9	-12.3	-21.1	-22.8	-12.6	1.1

* As for 2009, for GDP and unemployment data as of Q2, for gross wage and current account data as of Q1, for exports and imports data as of January - June, for FDI inflow data as of January - March, for industrial production data as of June, for inflation data as of July, and for budget balance an estimate for the whole year. ** Based on the author's own calculation.

Source: *Baltic Rim Economies*, No.4, 2009, p.2.

After EU accession unemployed persons, low-skilled workers and construction workers migrated to EU member countries, mainly the UK and Ireland, on a massive scale (It is officially estimated at 5% of the total labor force). For two years until early 2006 the unemployment rate decreased by 2.5 percent to 7.75 percent, and the labor market became tight. As a result, combined with de facto wage indexation, nominal incomes increased in an accelerative way for two years and recorded an increase of more than 19% y-o-y in Q1 2006 (IMF, 2006a, pp. 9-11). This increase substantially surpassed the growth in productivity.

Owing to the liberalization of financial services, banks from the Nordic region, Sweden in particular, came to operate in Latvia and competed for market shares. As mentioned above, the amount of FDI inflow had been relatively large, but it has been substantially surpassed by the current account deficit every year (Table 6). How has the gap been covered? The table of international payment (Bank of Latvia, 2009)

indicates that the amount of inflow of portfolio investment has been small (it often recorded negatives and consecutively recorded negatives from Q4 2008 through Q4 2009). As a matter of fact, ‘other investment’ (it overwhelmingly has been borrowings by foreign-owned banks from parent banks) in the financial account has exceeded the amount of FDI inflow and covered most of the current account deficit every year until the end of 2007 (Banincova, 2009). Major banks in Europe depend to a lesser extent on deposits by general customers, however, as for financial resources in recent years they increasingly finance themselves on wholesale markets (Hoshino, 2009). Swedish banks obtained euros in exchange for Swedish Krona on the international financial market (for example, in London) and gave customers in Latvia (through subsidiaries in Latvia) loans denominated in euros⁷. Thus households and enterprises in Latvia became able to enjoy lower interest rates. Credit to private sector residents increased by nearly 65 percent in 2005, and the loan to GDP ratio reached 70 percent, which was three times higher than the level in 2000, the highest among the EU8. Collateral loans to households increasingly became Euro nominated (IMF, 2006a, p. 11). The real estate sector came to occupy nearly half of all total loans⁸. Economists at UniCredit group described Latvian people’s behavior as a ‘spree of high consumption’ (*CEE Quarterly*, 03/2007). The IMF mission which visited the country in April 2007 warned the government of Latvia that the mindset of ‘buy now and pay later’ had taken root, increasing systemic risk.

The fiscal policy was expansionary. In addition there has been inflow of EU grants amounting to 3-4 percent of the GDP every year. Programs such as the Common Agricultural Policy (CAP) provide households with direct income support. EU funds from Structural Funds and Cohesion Funds flowed into this country through public infrastructure projects and employment policies. Private companies were able to use EU funds in the form of upgrading of equipment (Allard, 2008). The fiscal policy was at the same time pro-cyclical. The budget revenue recorded natural increases due to a boom at that time, and it became a normal pattern that over-performance of the budget was not saved but instead consumed through additional expenditures on a supplementary budget towards the end of the year. At the Article IV Consultation⁹ with the government of Latvia in 2006, IMF staff advised avoiding a pro-cyclical fiscal policy. Finance ministry officials were mindful of the advisability of avoiding the pro-cyclical fiscal policy, but they said that it would be infeasible to leave a budget surplus this year in view of pre-election spending measures and large public sector wage increases. Rather taking into consideration the

⁷ Christoph Roseberg, Senior IMF Regional Representative for Central Europe and Baltics, says “Banks refinance themselves abroad and then pass on the currency risk to their clients”. Rosenberg (2008).

⁸ According to IMF country report, banks in Latvia offer mortgage loans very easily, and “some banks are actually offering mortgages with LTV (loan to value) ratios above 100 percent”. IMF (2006c), Chapter III, Box 1.

⁹ The IMF is to make consultations with governments of its member states once a year on the basis of the Article IV of the Agreement.

over-performance of the budget revenue, the government was planning a phased 10 percentage point reduction in the personal income tax rate to 15 percent beginning in 2007 in order to bring it into line with the corporate income tax rate and to encourage legalization of the shadow economy. However, responding to criticism by IMF staff, this plan was not implemented (IMF, 2006a pp.13-14 and p.23).

The growth rate was as high as 12.2 percent in 2006. Economists at the UniCredit Group viewed it as consumption-led economic growth¹⁰, saying the following: On the demand side, overheating domestic demand, in particular private consumption and capital formation, remained the main engine of growth, while on the supply side, sector serving consumption needs, i.e. trade, finance, commercial services, hotels and restaurants and construction were the ones to fuel growth. The manufacturing industry, however, grew at a below average rate. At the same time, external imbalances became more pronounced, with imports growing twice as fast as exports (*CEE Quarterly*, 01/2007).

Reflecting the consumption boom and the housing bubble, the inflation rate increased. It fluctuated between 1.4 percent and 3.6 percent until 2003 but jumped to 7.3 percent in 2004 and recorded 7.0 percent and 6.8 percent in 2005 and 2006 respectively. In November 2006 the central bank raised the refinancing rate by 50 bps to 5 percent, which was still lower than the inflation rate – which meant the interest rate was practically negative – and proved quite insufficient to dampen the overheating economy (*CEE Quarterly*, 01/2007). Since its EU accession in 2004 Latvia had had a goal of adopting the Euro in 2008, it was difficult for this country to have an interest rate quite different from that of the European Central Bank. In addition, when people can freely get loans in foreign currency it would be no use for banks to increase the borrowing rate in Lats¹¹. In 2006 Latvia satisfied all the criteria of Maastricht except the inflation criterion, and the country had to give up its plan to adopt the Euro in 2008.

Increase in wages, surpassing a rise in productivity, as well as inflation gradually eroded Latvia's export competitiveness. Every year the country recorded a huge amount of trade deficit, which was partly covered by FDI inflow, but it had still a wide current account deficit. In 2005 the current account deficit accounted for 12.7 percent of the GDP, which was already an alarming amount, but rapidly increased to 21.2% of the GDP in 2006. At the Article IV Consultation in Autumn 2006 the IMF mission expressed a view that measures were urgently needed to moderate domestic demand in order to decrease imbalances, preserve external competitiveness, bring forward compliance with the Maastricht criteria, and limit vulnerabilities ahead of Euro adoption. However, government officials did not have such a perception that the economy was overheated, and they were more sanguine in their assessment of economic developments and, accordingly, were not planning a significant change in the course of fiscal or other policies. Rather, Finance Ministry officials welcomed

¹⁰ The IMF staff made a similar remark. IMF (2006b), Public Information Notice, No.113.

¹¹ National currency of Latvia. 1 Euro =0.7028 Lat.

Latvia's dynamic growth as essential to deliver income catch-up within a reasonable time horizon. They attributed the rise in inflation mainly to convergence in wage and price levels, rather than to overheating. On the other hand, the central bank officials were less sanguine, and saw overheating as a concern that was unlikely to subside in the near term (IMF, 2006a, pp. 14-16).

3.3. Switchover to restrained policies

Even if the government was sanguine, foreign observers were very much concerned with the Latvian economy. Since the government left a huge amount of current account deficit with the external debt, exceeding 100 percent of the GDP, and in spite of the receding prospect of introducing the euro, S&P, a grading company, degraded Latvia from stable to negative in February 2007. From the end of February through early March of the same year the Lat came under pressure of depreciation on the foreign exchange market, the central bank was forced to intervene in the market for the first time in several years (*EEM*, May 2007). The government of Latvia finally switched its policy to manage aggregate demand more actively and launched a package of measures geared to delivering a durable reduction in inflation as follows: i) The government promised to balance the budget in 2007-2008 by restraining spending growth; ii) Capital gains tax would be levied on real estate held for less than three years and state tax on registration of mortgages would be hiked; iii) Loans would be assessed on the basis of the legally declared income of prospective borrowers; iv) A maximum loan to value ratio would be established. At the same time, the central bank hiked the key refinancing rate from 5.0 percent to 5.5 percent and reiterated its commitment to the current exchange rate regime (*EEM*, May 2007). In April in the same year the inflation rate increased to 8.9 percent. The central bank hiked interest rates by 50bps to 6 percent in May to support disinflationary measures. Accordingly, interest rates on mortgage loans in Euros and Lats have risen by about 100bps since 2005 to 5.7 percent and 7 percent respectively (*EEM*, July, 2007).

Such a package of measures did not have any impact on the economy immediately, and the consumption-led boom continued through Q3 of 2007. As the anti-inflation measures proposed by the government required time for discussion in the Parliament it was in July that they were approved and translated into action. Real GDP increased by a faster-than-expected 11.3% y-o-y in Q2 2007 (slightly up from 11.2% in Q1). Manufacturing output declined by 0.2% from 2.4% in Q1 to 2.2% in Q2 owing to downturns in wood processing, furniture, radio, television and communication equipment sectors (*EEM*, October 2007). Although at a somewhat lower pace in Q3 2007, real GDP increased to a still high 11.9% y-o-y.

The government measures introduced in July began to have an effect in autumn. Property prices started to decline and by October were around 12% lower than at the start of 2007. The number of housing sales in the secondary market also started to fall, adding to the negative wealth effect (*EEM*, January 2008). The BNP Pariba shock, which happened in August 2007, increased financing costs at interbank

markets, making credit activities more cautious (Tanaka, 2009). Among ‘other investments’ in the Latvia’s Balance of Payments (Table 7), the borrowing of funds by subsidiaries from parent banks showed positive so far, but turned negative in Q1 2008, which meant backward flow of funds. Namely, the withdrawal of funds by parent banks from their subsidiaries occurred (although subsequently this item recorded positive in Q2 and Q3 2008, it recorded negatives for a consecutive five quarters from Q4 2008 through Q4 2009) (Bank of Latvia, 2009). Thus both companies and households came to feel a shortage of money. Real GDP growth eased to 9.6% y-o-y in Q4 2007, and the overheated economy began to lose its momentum. Retail sales growth dropped to a six-year low of 1.7% y-o-y in December, and industrial production contracted for the third consecutive month (*EEM*, April 2008).

In this way, the Latvian economy made a hard landing. The Latvian housing market bubble burst. The number of transactions in the property market dropped by almost 18% in 2007, with prices for apartments in the capital city falling by a similar amount after having peaked in April at over € 1,700 (*CEE Quarterly*, 02/2008). In Riga, apartment prices fell by around 25% during the year to June 2008 (*CEE Quarterly*, 03/2008). In turn, the slowdown of the real estate sector negatively influenced consumption, via a wealth effect, and investment.

Consumers had become more cautious in the face of the rising debt burden (household debt has risen from 9 percent of the GDP to approximately 55 percent at the end of 2007) and increased uncertainty about the outlook for jobs and income, while persistently high inflation (17.5 percent in April 2008) started to damage household purchasing power. Inflation-adjusted retail trade turnover fell by 1.1 percent y-o-y in Q1 2008 while the number of newly registered cars was down 49 percent y-o-y in March 2008. Private consumption was also being dampened by negative wealth effects associated with the steady decline in property prices, 7 percent y-o-y in Q4 2007. The construction industry was also slowing down (*EEM*, July 2008). The economic growth rate rapidly decelerated from 12.2% in 2006 to 10.3% in 2007 and -1.9% in Q2 2008. In contrast, the unemployment rate increased to 15.5% on average in 2008. It was stagflation.

The Latvian economy fell into depression in December 2007. In addition to this, the Lehman shock in September 2008 dealt the Latvian economy a final blow. In October of the same year Parex Bank¹², the second largest bank in Latvia, was greatly exposed to sudden outflow of non-resident deposits and faced serious liquidity constraints. In the ranking of the top ten banks in Latvia there are four domestic banks with their total market share being 29.5% (Table 8). A remaining share (70.5%) is occupied by six subsidiaries of foreign banks, of which three are Swedish banks. In

¹² According to Professor Sonoko Shima, Parex Bank was founded about 15 years ago by a Latvian of Russian descent, who started his business from an exchange house after the transition to the market economy. She presented this information at the annual conference of the Japan Association of Russian and East European Studies, held on November 17, 2009 at Akita University.

contrast to this, subsidiaries of foreign banks occupy an overwhelming majority of the total share in Estonia and Lithuania with their share in the total asset in 2007 being 98.7% and 85.3% respectively (Banincova, 2009). Thanks to this, both countries, Estonia and Lithuania, were able to find their way out of the financial crisis. In Latvia, however, Parex Bank was an indigenous bank which rapidly grew by collecting deposits from non-residents (people in Russia and CIS) and had no parent bank behind it, and therefore could not find a way out of the financial crisis. In early November the government nationalized this bank in order to prevent bankruptcy.

Table 8 Top Ten Banks in Latvia

Banks	Market share	Parent banks
Hansabanka	21.7%	Swedbank (Sweden)
Parex banka	14.6%	A private bank, taken over by the government on November 8, 2008. On December 5, 2008 State Collateral and Land Bank of Latvia became a majority owner. On February 24, 2009 shares owned by the government were transferred to the Privatization Agency.
SEB Unibanka	14.1%	SEB (Sweden)
DnB Nord	8.3%	DnB Nord: Joint Venture of DnB (Norway) and Nord/LB (Germany)
Nordea	7.9%	Nordea Group (Sweden)
Rietumu banka	5.6%	Majority private capital
Aizkraukies banka	5.1%	Private local capital
Latvijas Hipoteku un zemes banka	4.2%	State
UniCredit	3.4%	UniCredit Group (Italy)
Latvijas Krajbanka	3.1%	Snoras (Lithuania)

Source: CEE Banking – Still the right bet, UniCredit Group, July 2008.

The nationalization of Parex Bank aggravated the Latvian economic situation. A huge number of deposits were removed from other Latvian banks and placed in Estonian banks because they were perceived to be the safest due to their well-capitalized Scandinavian parent banks. In the meantime, the central bank of Latvia had to intervene in the foreign exchange market to defend the fixed exchanged rate, resulting in a significant decrease in its official reserves (Banincova, 2009). In mid-December the central banks of Sweden and Denmark hurried to rescue Latvia and concluded swap agreements with the central bank of Latvia. These arrangements enabled the central bank of Latvia to use a maximum € 500 million (of which € 375 million came from Sweden) in exchange for Lats. These arrangements served as bridging loans until the IMF program for Latvia was finalized. Soon the rescue package for Latvia was decided as follows: The IMF provides Latvia with about € 1.7 billion (\$ 2.4 billion), supplemented with loans from the EU, the World Bank and Nordic and Central European countries. Specifically, the EU provides € 3.1 billion (\$ 4.3 billion), Nordic countries € 1.8 billion (\$ 2.5 billion), the World Bank € 0.4 billion

(\$ 0.5576 billion), the Czech Republic € 0.2 billion (\$ 0.2788 billion), and EBRD, Estonia and Poland € 0.1 billion (\$ 0.1394 billion) each (IMF, Press Release No.08/332, December 19, 2008). The total amount is € 7.5 billion (\$ 10.5 billion), which is equivalent to a third of the Latvian GDP in 2008.

The credit is to be released in several tranches from the end of 2008 until mid-2011. About half of the money is envisaged for covering the budget deficits, a third for financing the government debt and the rest for further bank recapitalization and loans to enterprises (Leitner, 2009, p.59).

With this external help, the financial market in Latvia managed to hold on, but Latvia was regarded as a highly risky country and it had difficulty to get loans from the international credit market. People's complaints against the government increased, leading to riots in the streets of Riga in mid-January 2009, which were the first riots of this kind since Latvia's independence in 1991. In February the coalition government led by Prime Minister Ivars Godmanis dissolved. In March a five-party coalition government led by Valdis Dombrovskis¹³ was formed.

It should be noted that the rescue package by the EU and IMF was accompanied by strict conditions. The government of Latvia was obliged to make a promise to cut its expenditure and reduce the budget deficit to 5% of the GDP. By April 2009, however, it was proved that the fall in government revenues was more dramatic than expected. The Minister of Finance announced that the budget deficit was expected to amount to at least 9% of the GDP in 2009, even when taking into account the planned additional, drastic expenditure cuts (Leitner, 2009, p.60). The attitude of the EU and the IMF was very strict in keeping to the tight fiscal policy. The EU and the IMF refused to release the second tranche of the rescue package, worth about € 1.7 billion (when adding the contributions of the Nordic neighbours), which was envisaged for the end of May¹⁴.

By the end of May, forex reserves of the Bank of Latvia had dropped by almost 40% y-o-y and were dwindling day by day. In the first week of June the sovereign default of Latvia was looming, when the authorities failed to sell any Treasury Bills in a public debt auction. In the following week the development of the overnight Rigibor - the interest rate of Riga's interbank market - , escalating to more than 20%, showed that interbank lending was drying up and in forward markets the Latvian Lat was traded for 50% of its nominal value (Leitner, 2009, p.60).

At that time, a possibility of devaluation of the Latvian national currency was whispered about both outside and inside (even within the government) of Latvia.

¹³ Mr. Dombrovskis was 36 years old when he was inaugurated Prime Minister. He is an economist with experience of working at the central bank of Latvia and has served as a member of the European Parliament. He formed a coalition government comprising the center-right New Era – his own party - , Civic Union, For the Fatherland and Freedom/LNNK, the People's Party and the Union of Greens and Farmers (*EEM*, May 2009).

¹⁴ According to the IMF Survey Magazine, the EU's Economic and Monetary Affairs Commissioner Joaquin Almunia said May 6 that the EU would like to see more progress on budget and structural reforms before it releases the second tranche of its aid program, worth about € 1 billion (IMF, 2009b).

However, the devaluation of the national currency would enhance the international competitiveness of Latvia's export products on the one hand, but it would bring a sudden rise in the debt service obligation denominated in national currency for both companies and households on the other hand.

After all, the government of Latvia abandoned the nominal depreciation and chose 'internal depreciation' (adjustment of real economy), namely, a way of decreasing domestic prices primarily through cuts in wages and pensions, etc. and enhancing competitiveness of exports. The government opted for further austerity amendments to the budget for 2009, fixing a cut in government expenditures by 40% in 2009 compared to 2008, in nominal terms. The public wage bill was to be reduced by another 20% nominally, pensions by 10% for non-working pensioners, and for those working by 70%. Expenses for health and education were to be cut severely, two-thirds of the nation's 73 inpatient hospitals and dozens of schools were announced to be closed.

The non-taxable minimum for personal income tax was reduced by 60% and child benefits by 10%. Even Dominique Strauss-Kahn, Managing Director of the IMF, identified this as disputable due to the impact on the country's poor (Leitner, 2009, p. 60). The *EEM* voiced fears that an internal devaluation would lead to a painful debt-deflationary spiral, which would prove disastrous for social stability (*EEM*, August 2009).

Towards the end of July 2009 the IMF and the government of Latvia reached a staff-level agreement that could lead to the completion of the first review under the Stand-By Agreement. It was decided that Latvia would be given access to about € 195 million (\$ 278.3 million) in new financing after the staff-level agreement, which was endorsed by the IMF's Management, if it gained approval by the Executive Board in early September. The point that the IMF staff stressed was that across-the-board cuts provide a "quick fix" in the short term, they disproportionately hurt the poor and that they also have a negative influence in the longer run on the quality of government services. The IMF staff recommended a comprehensive strategy to improve the social safety net which includes guaranteed minimum income payments covering health copayments for the most vulnerable, increasing funds for emergency housing support, protecting schooling for six-year-olds, and promoting job creation through active labor market policies. In addition, the staff recommended improvements in tax administration and broadening of real estate and personal income tax, i.e. adopting progressive tax rates instead of a flat tax which had been adopted since 1997 (IMF Survey Magazine: Interview, July 28, 2009).

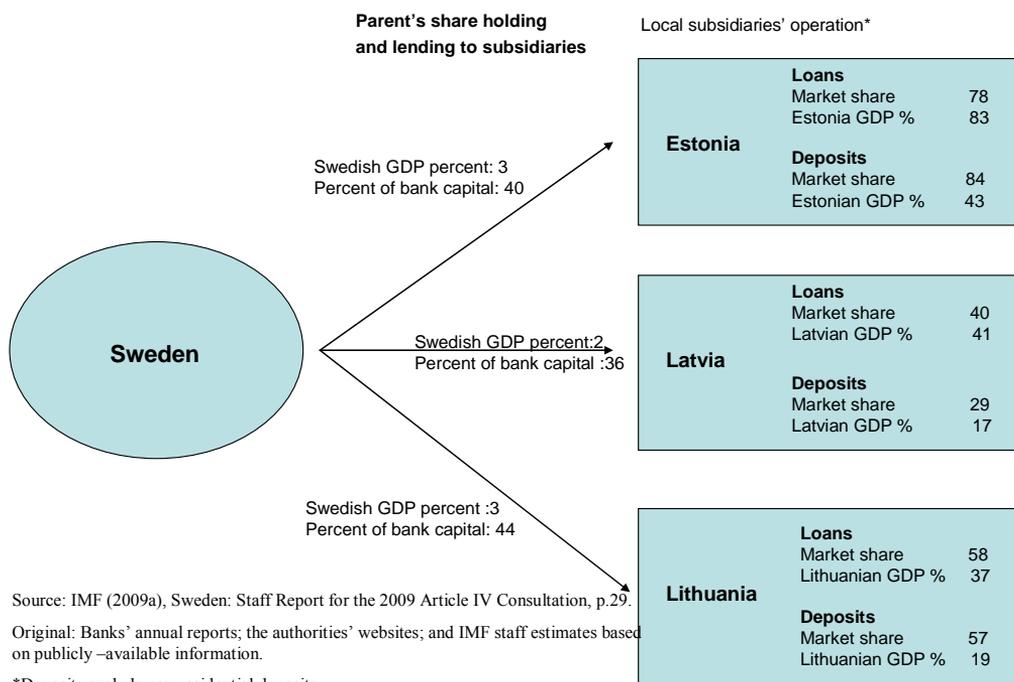
Of course such consideration for the most vulnerable people is necessary, but being bound by the conditionality for the financial support from the EU and the IMF the government of Latvia is not allowed to adopt more active fiscal policies to boost the economy. In spite of relentless cuts in expenditure and the increases in tax rates as mentioned above, the budget deficit was expected to expand to 10% of the GDP in 2009 and 8.5% in 2010 (Leitner, 2009, p.61; IMF, 2009b). While the EU and the IMF allow such a substantial budget deficit for the time being, together with the

government of Latvia they set the introduction of the Euro for 2013 as an exit strategy. In order to accomplish this, Latvia is required to satisfy the Maastricht criteria having a budget deficit of less than 3% of the GDP, public debt of less than 60% of the GDP, etc. In this way, the government of Latvia is obliged to adopt procyclical policies following the framework of the EU and the IMF. As exemplified by cases in which neoliberal prescriptions have often failed in Latin America (Sano, 2009), the Latvian economy will stagnate for a long time in the future. Latvian people are forced to practice austerities with increasing unemployment and cuts in wages and pensions, but I wonder until when they can endure such difficult lives.

4 Sweden

SEB and Swedbank hold significant market shares in Baltic States (40-80% in loan markets and 30-85% in deposit markets), and the financial authorities remain engaged with these activities (see Figure 4). Swedish banks' equity and loan claims on their Baltic subsidiaries at the end of 2008 represented 8 percent of the Swedish GDP, while their loans to their subsidiaries amounts to 35-45 percent of bank capital. In addition, Swedish banks' reliance on operating profits from Baltic operations is extensive (25% for Swedbank and nearly 10 percent for SEB) (IMF, 2009b, p.29).

Banks' profitability fell sharply during 2008-09 despite negligible exposure to US subprime – or other structured – assets. Two of the largest banks (SEB and Swedbank), both increasingly funded on wholesale markets and were exposed to Baltic states, and both saw sharp increases in loan losses with their rating marked down accordingly (IMF, 2009b, p.14). It is also reported that share prices of banks such as SEB and Swedbank, which have huge balances of loans in Latvia, dropped by more than 10 percent in June 2009 (*Nikkei Shimbun*, June 10, 2009).

Figure 4 SEB and Swedbank: Exposures to Baltic Countries (As of End-2008)

Riksbanken (the central bank of Sweden) as well as Finansinspektionen (Finance Inspection Agency of Sweden) conducted stress tests for the largest banks (Nordea, SHB, Swedbank and SEB) independently. According to a memorandum published by Finansinspektionen, this stress test presupposed the following scenarios:

1. Conservative base scenario
2. Extreme stress in Eastern Europe
3. Scenario 2 + a prolonged recession in Western Europe

In the base scenario, all of the banks meet the minimum regulatory capital requirements by a solid margin and none of the banks fall below a nine percent Tier 1 capital ratio. In scenario 2, two banks, Swedbank and SEB, credit losses exceed profits during the above mentioned three years. SEB and Swedbank reach significantly lower Tier 1 capital ratios¹⁵ at the end of 2011, 8.2 percent and 6.0 percent respectively. In scenario 3, for three banks not including SHB credit losses exceed profit. For all of the four banks Tier 1 capital ratios decrease at the end of 2011, but all of them fulfill the minimum regulatory requirements by a solid margin.

Scenario 2 and 3 assume very high credit loss levels. Finansinspektionen views that these scenarios are improbable but not impossible. It calls banks' attention,

¹⁵ Tier 1 refers to banks' owned capital in the narrow sense.

saying that the future continues to be highly uncertain and the banks must be in a good state of preparedness, even for improbable scenarios (Finansinspektionen, 2009).

According to economists at the central bank of Sweden, in contrast to US and British economies, banks play a very important role in the Swedish economy. Because both companies and households in this country are heavily dependent upon loans from banks and other credit institutions. Bank loans account for over half of corporate debt financing. The portion of debt financed via the securities markets plays a significantly lesser role for companies. Corporate bonds and commercial papers comprise only 9 and 2 percent, respectively, of companies' total borrowing. The remainder, other loans, mainly consists of loans raised within the corporate group (including cross-border loans). In 2008 a number of companies encountered difficulties in finding buyers for their bonds overseas. Although inflow via issues of bonds in foreign currencies increased in Q1 of 2009, repayments exceeded inflow of funds from the second half of 2007 through November 2008. The central bank of Sweden estimates the shortfall in financing for major companies arising during 2008 has partly been replaced by foreign bank loans and partly by bank loans in Sweden (Ekici, Guibourg and Asberg-Sommer, 2009).

During the global financial crisis the central bank of Sweden did everything in its power in order to protect the banking system. The banks have become unwilling to assume counterparty risk by lending money without collateral to other banks, especially at longer maturities. Banks that have surplus liquidity now prefer instead to deposit this money at the central bank even though the interest rate on such deposits may be lower. At the same time an increasing number of banks choose to borrow from the central bank against collateral instead of on the interbank market. During the crisis, alongside its normal operation, the central bank has taken other more unconventional measures which are listed as follows: 1) providing loans to commercial banks at longer maturities; 2) providing loans in US dollars; 3) approving a wider range of securities as collateral for loans; and 4) increasing the circle of monetary policy counterparties (Sellin, 2009). The economists at the central bank say that although there was a decline due to cyclical factors, there are no signs of any credit crunch thanks to such unconventional measures (Ekici, Guibourg and Asberg-Sommer, 2009).

In addition, central banks in Nordic countries and the Baltic states have kept up a network of close cooperation (Ingves, 2008). It seems the least probable scenario that the financial crisis in Latvia will cause disorder in the EU economy via the possible collapse of Swedish bank(s).

5 Conclusion

Taking all of the above into consideration, we can conclude as follows: First, in Latvia a boom continued in the mid-2000s, and the economy showed a sign of overheating already in 2005 but the government responded to it too late. Only in the spring 2007 did the government turn to restrictive policies, causing depression in the

end of 2007. In addition to that, the Lehman shock dealt the Latvian economy a final blow. EU membership has both positive and negative aspects. Thanks to the Single Market in the EU, workers in this country became able to migrate to advanced EU countries, especially the UK, decreasing the unemployment rate and at the same time causing a sharp increase in wages due to a tightened labor market. Owing to the liberalization of financial services, banks from the Nordic region, Sweden in particular, came to operate in Latvia and competed for market shares, stirring the consumption boom. In a situation in which people can easily get loans denominated in foreign currency the financial policies of the central bank of Latvia are of no use. Within the framework of the EU monetary authorities in Sweden, which is the home country of Swedish banks' subsidiaries operating in Latvia, are responsible for supervision, but they have not regulated these financial institutions there.

Second, Baltic states have had a common weakness in terms of their development relying heavily on foreign capitals. In the case of Estonia and Lithuania, however, the circumstances in which foreign-owned banks have been overwhelmingly dominating the banking sector benefited these countries. Namely, as parent banks of foreign-owned banks coped with difficulties both countries were able to avoid the worst situations.

Third, Latvia, which is reconstructing its economy under support from the EU and the IMF, set the introduction of the Euro in 2013 as an exit strategy. Latvia is in a dilemma: If the country does not devalue its national currency and tries to satisfy the Maastricht criteria (especially having a budget deficit less than 3% of the GDP) soon, it will be obliged to adopt pro-cyclical policies, causing economic stagnation. It is a noteworthy opinion that the IMF should offer credit lines to governments rather than the central banks of developing countries so that they can afford to have expansionary budgetary programs (Frenkel & Rapetti, 2009).

Fourth, financial authorities in Sweden have been properly responding to difficulties the domestic banking system has been facing. It seems the least probable scenario that the financial crisis in Latvia will cause disorder in the EU economy via the possible collapse of Swedish bank(s).

Fifth, new EU member states are required to satisfy the strict criteria mentioned above in order to adopt the Euro. Nevertheless, since they have experienced the global financial crisis they will make greater efforts towards the introduction of Euro, echoing a Japanese proverb saying "Look for a big tree when you seek shelter".

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THE CREDIT CARD FRAUD: INFLATION, CULTURE OF BORROWING AND RISING ECONOMIC INEQUALITY

*Madhusudan Raj**

Abstract

The use of credit card has become a fashion and a symbol of social status, but very few people understand the problems related with its use. Credit card is a tool of the practice of fractional reserve banking of today's banking industry. This paper tries to explore the implications of the use of credit card in specific, and through that the fractional reserve banking in general. It shows how credit card generates inflation, how it promotes the culture of borrowing by discouraging honest living and how it increases economic inequality in the society.

Keywords: *Credit card, Fractional reserve banking, Central bank, Debit card, Money, Money creation, Inflation, Borrowing, Economic inequality*

JEL Classification: E31, E44, E51, G21.

Introduction

Credit card and its originator the banking industry is a big fraud. The whole business of credit card is unlawful¹, immoral, and unethical. It would be very much surprising for many people to know this, but the credit card is a major tool through which the banking industry is wrecking the whole economy², is discouraging an honest living and promoting the culture of borrowing and living beyond one's means which discourages hard work and is increasing the economic inequality in the society. All these should be a surprise for the laymen because they do not understand the fundamental principles on which today's banks work or they are deluded by the banking industry's propaganda. In this paper I will show how the banking industry is doing all the unlawful, immoral, unethical and economically dangerous business.

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I thank Prof. B.V. Acharya, Dr. Akash Acharya, Jonathan Mariano and Behroz Baria for their valuable comments and discussion

¹ How the credit card and the whole system of fractional reserve banking on which basis the credit cards work is unlawful and fraudulent in its nature, and for the evidence of the court cases around the world declaring the system of fractional reserve banking illegal please refer to, (Soto 2006).

² For example, the credit card is one of the main causes of the present global economic meltdown and the financial crisis. We will see how credit card is the cause.

Credit Cards and Inflation

Those readers who have taken a class of introductory economics know the money creating process of banks³. But very few know the fact that the money which is created by the banks is created out of thin air i.e., without any production of goods or services. This creation of money out of thin air is the major way in which banks wreck the economy and create inflation. Let us understand in a bit deeper sense how this money creating process of banks creates inflation. To understand this we start by analysing the actions of individuals first. We see how an individual can earn more money i.e., create more money if he want more of it. Then we understand what banks do to create money when they want more of it. Once we understand the difference between the process of creating money by an individual and by the banks, we will be able to clearly see how bank's money creation process result into inflation and the wreckage of the economy.

Individual v/s bank's action for creating money

The chief and the only lawful way in which a person can create more money for himself is by working more in the market. S/he can earn more only when s/he produce more and sell more. Other than this process, an individual does not have any other just and lawful method of earning or creating more money for himself⁴. This means that, individual's earning is backed by production of goods or services. To understand this whole process let us assume an economy of 5 people A, B, C, D and E on an island. Each individual on this island initially in 1st year is producing US\$ 100 worth of goods and services, and so each is earning US\$ 100 income per year by selling those goods and services in the market. The total production and income of this economy in a year thus is, US\$ 500 (US\$ 100 x 5 person = US\$ 500). We here assume that there is no saving in the economy in this 1st year. That means, US\$ 500 being earned is spent on US\$ 500 worth of production by these 5 people. In this case the prices of goods and services will remain stable⁵ because there is no excess demand for goods and services compared to their supply. So right now, there is no problem of inflation here in our imaginary economy. Now suppose all 5 members in the 2nd year want to earn extra US\$ 100 worth of income. What are the ways through which they can earn extra US\$ 100? The only way is to work hard and produce goods and services which are worth US\$ 100 more. So now they work hard and produce

³ For those who have not taken such class please refer to, (Rothbard 2004: 805-809; Samuelson and Nordhaus 1998: 477-481)

⁴ Running a money printing press in home is illegal and a crime for sure in the present system of fiat money. I won't discuss the issue of money production by an individual in a system of gold or any other commodity standard. Suffice it to say that in a gold standard anyone can go and dig gold mine and can produce gold legally.

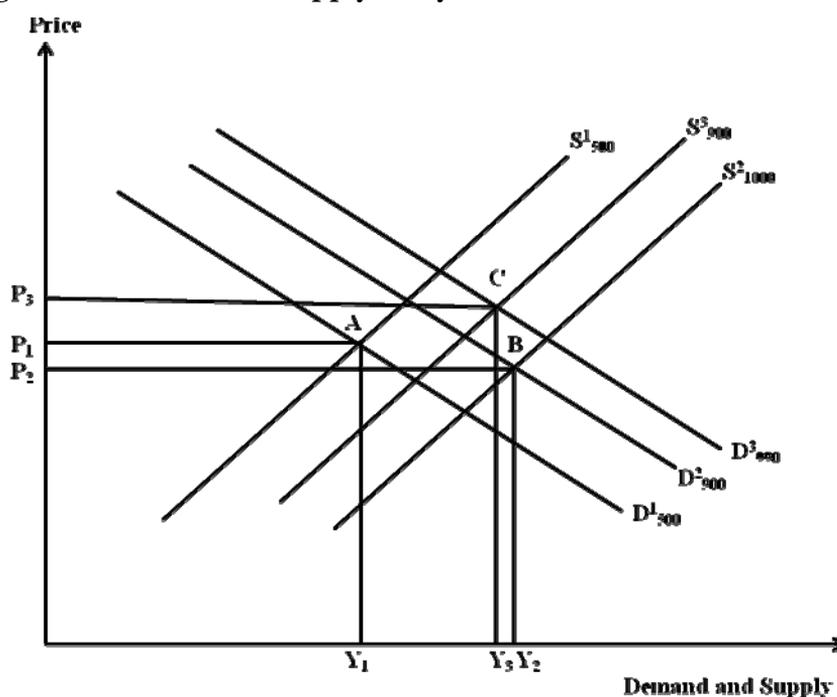
⁵ For the simplicity we right now ignore the technological, natural, and all other such factors which can decrease or increase the price.

extra US\$ 100 worth of goods and services in 2nd year. This way now the total production in the economy is US\$ 1000 and total income is also US\$ 1000 in 2nd year. Now let's drop our assumption of no saving on this island economy, and with that introduce a bank in this economy and see clearly how a bank through its credit cards creates inflation.

Suppose now a bank arrives on this island from the mainland. Let's say that α bank opens up one branch on our small island economy. Now from our 5 people, person A feels that he has earned enough for his future so he now decides to live a more comfortable leisurely life by working less in the 3rd year. In 3rd year he decides to work less only producing goods and services worth US\$ 100. And he also decides to save US\$ 100 out of his US\$ 200 of income of 2nd year for his future time in 3rd year where he might need that US\$ 100 for the unforeseen contingencies and uncertainties. He keeps his savings in α bank as a safe deposit. So now α bank branch has US\$ 100 worth of reserves with it. Now, because α bank is working on a fractional reserve banking standard (just the way today's banks are functioning), it Instead of keeping this US\$ 100 as a safe deposit for A (which he can demand at any time from the bank), decides to loan this money to person B to earn an illegitimate⁶ profit. By loaning this money, bank is now engaging in the process famously called, *money creation*. Suppose the reserve ratio of bank is 10% so bank issues a credit card to person B worth of credit limit of US\$ 90. This adds US\$ 90 worth of money into the circulation and total money supply thus becomes US\$ 990. On the other side the production of goods and services is only worth of US\$ 900 in 3rd year because now A decides to work less only for US\$ 100 worth of goods and services in this 3rd year. So on one side total production of goods and services is only worth US\$ 900, and now with the credit card worth of US\$ 90 with person B, total income in the economy is US\$ 990. Now, because Person B's time preference hasn't changed, he will use the credit card worth US\$ 90 in present consumption with his US\$ 200 of cash income. Other 3 person (C, D, and E) are also using all of their US\$ 200 on consumption of goods and services. So now in the market place, the production of goods and services is only worth US\$ 900 and their demand is worth US\$ 990. Demand is greater than the supply. In this situation the prices of goods and services will increase until there is a balance between demand and supply. Figure 1 shows the graphical representation of this whole situation.

⁶ Illegitimate because by loaning the deposit money of A to others without the consent of A, the bank is committing the crime of misappropriation.

Figure 1. Demand and Supply analysis of the effect of a Credit Card



As we can see, in 1st year the demand and supply both were equal at US\$ 500 worth so prices were stable at P_1 level were it cleared the market. In 2nd year prices fell to level P_2 because person A consumed US\$ 100 less to save it for his future in the 3rd year out of his total income worth of US\$ 200. In this way, in 2nd year, supply (S^2_{1000}), which was US\$ 1000 worth, is greater than the demand (D^2_{900}), which resulted in a price fall. But in 3rd year this situation of price fall did not continue because now banks, instead of keeping US\$ 100 of A as a safe deposit in its reserve, issued a credit card worth US\$ 90 to person B, and this money person B has decided to spend because his time preferences hasn't changed. This resulted in higher demand in the market (D^3_{990}) than the supply (S^3_{900}), which has now fallen to only 900 rupees worth of goods and service because person A is working less in this 3rd year. This imbalance between higher demand and lower supply in turn has resulted in to price rise (P_3) of goods and services to the point where market again clears. Stretching this analysis in the future years with increased savings⁷ and with it bank's rapid money creation process (the so called money multiplier effect) will show that prices will continue to rise in every year with less production and continuously increasing demand due to the issuance of credit cards (and other such loaning mechanisms).

Thus, credit cards have created price rise i.e. inflation in mainstream economics

⁷ For the sake of focusing the inflationary effect of bank's credit cards and other such loaning practices I am here completely ignoring the *investment* process in this island economy. We assume that people either save their money for safe future in banks or consume it in present time.

language! The problem here is that *too much of money is chasing too fewer goods and services*. And this imbalance in the demand and supply can only be corrected through a rise in the prices of the goods and services in the market. This way, the more credit cards banks issue the more inflation it will create. The more people use money in the form of credit cards without producing anything the more inflation will take place in the economy.

Now we see how credit cards promote the culture of borrowing, how it discourages honesty and how it increases economic inequality in the society.

Credit cards: The culture of borrowing, discouragement of honesty and the economic inequality

After understanding how banks through their credit cards give birth to inflation and wrecks the economy, now we turn our attention to other problems of promotion of culture of borrowing and living beyond one's means, the discouragement of honesty, and the rise in economic inequality.

The fraudulent nomenclature of various cards by banks

Banks discourage honesty by promoting the culture of borrowing as a good means of living one's life. And this borrowing is in the form of their credit cards. To hide their insidious motives of misappropriation and making more profit through this misappropriation by issuing credit cards to the people, banks have very tactfully changed the nomenclature of the whole debt and credit system. In general, debt is considered to be a bad thing and credit as something very good by the people. To sell their credit cards banks have reversed the naming of the cards and thus have glorified the use of credit cards. I now discuss this fraud of using linguistics to lure people into using credit cards.

The whole naming of cards itself is fraudulent. Let us see, why. Firstly, we discuss credit card. The way bank enshrines credit card and the way people take credit card as a symbol of higher status itself is a big fraud and an illusion. Credit means, *Money available for a client to **borrow***. The word borrow here is of great importance. Credit actually is borrowing which in turn means ***debt***. *So credit is not credit but credit is debt and thus credit card is not a credit card but is a debit card*. And borrowing and debt are never regarded as a good way of living the life by people. Society sees the heavily indebted people as persons who do not know how to take care of their economic matters, and as persons of extravagance and irresponsible character. But banks, just by changing the name of what should be a *borrowing card* or a *debit card* to credit card fool everyone. Through this way they encourage a culture of borrowing and discourage honest people, who want to live their life within their means, by tempting them to use credit cards and using borrowing as a means of living their life.

The naming of debit card is also a fraud and an illusion being perpetuated by the banks to encourage the use of credit cards. Let us see, why. What is a debit card?

Debit card is a card which is actually backed by a money account in the bank. When someone uses his debit card at a shop, the money (hard cash) is immediately deducted from his account electronically. So in a way when someone uses a debit card s/he is actually paying in cash only, but indirectly through his/her bank instead of giving hard cash to the shop owner. So debit card, as the name suggests, is not actually a debit or borrowing card. You do not owe anything to anyone when you use your debit card. When I use my debit card I do not borrow anything from anyone. I actually use cash electronically which I have in my bank account. So in my view, the name of debit card should not be debit card (which depicts borrowing) but it should be, as I have named it, *Cash card* because that plastic card just represents my cash holdings in bank account. It's just a convenient way of making a transaction *in cash*. But, because the name of an actual cash card is given debit card (borrowing) people are discouraged to use it because they see it as a lower status symbol in the society. People like to have more credit cards in their wallet than debit cards!

Not only this, the whole banking system is geared towards promoting the use of a credit card in stead of a debit card (the type of debit card which I call the cash card). For instance, if someone is living in India and wants to purchase something online from a store located in a foreign country then this transaction is only possible through a credit card. Debit card just doesn't work. This is my personal experience here in India where my debit card never works for an online transaction for foreign shops, and my friends have similar experiences in USA where the shop owners refused to take cash even when they were given cash and demanded a credit card instead! The difficulties which honest people have to suffer are immense. In an era of information technology the use of online transaction is increasing, and in such an environment use of credit card becomes a must when debit cards are not working. This way banks promote the culture of credit card use. They discourage honest people who want to purchase things only available by their purchasing power i.e. their cash holdings. It is very weird to observe that, in such a fraud environment, a person who actually has a cash balance in his account (i.e., the debit card user) *can not* buy a good or service s/he wants, but a person who does not have any money (i.e., the credit card user) can buy the goods and services of his wish!

The whole system of credit cards and giving consumer loans by the banks is also a major reason for increasing economic inequality in the society. Why? Because most of the middle class and rich people have access to the consumer loans and those credit cards to consume more without producing more while the poor are grossly denied such (phony) luxuries of life by the banks. No bank will issue a credit card to the poor person. No bank will give any consumer loan (or even a business loan) to the poor person. Poor people have to rely on their day to day cash earnings of their hard work. Not only this the inflation being created by the fraudulent bank's malpractices of fractional reserve banking also affects poor people in a much harder way than the other well to do people in the society. Poor person gets crushed in between the steadily increasing prices and the meagre family income. This way the mal-practising banks are the real culprits and one of the major causes of increasing

economic inequality in the society and hardly anyone looks at this very important fact.

Conclusion

We have seen above how banks and their certain malpractices (fractional reserve banking) are the main culprits of damaging people's lives and lowering their standard of living by creating inflation and wrecking the economy. We also analysed how they damage the culture of sound finance (the dislike for borrowing) by perpetuating the myth of credit card and through that promoting the culture of functional finance (the glorification of borrowing as a way of living the life), how they discourage honest people by disabling the use of debit cards and how they give rise to the economic inequality. There are ways of stopping the fraudulent bank's malpractices from injuring our life and property. One way is to educate people of its wrong doings and underlying hidden agendas. This paper is one such attempt to do exactly that sort of education of the common man. We must not glorify borrowing and credit cards as the way of living our lives. The result of such a glorification of borrowing and credit cards is in front of our eyes in the form of the collapse of the whole American economy. Hard work is the only way of improving our standard of living. We must not forget the ancient wisdom of *not stretching one's feet beyond the blanket*⁸. What our elders told us about living inside our means is absolutely right. They probably understood the very important economic law that, "*without producing anything first, consumption is impossible*". We all should not forget this very important economic law if we want to avoid the problems being faced by millions of Americans and other people around the world today. We must not forget that living beyond one's means is doomed to fail in the long run, and it will make everyone bankrupt. Economy will never grow; civilization will regress to primitive levels without hard work and increased productivity. To stop banks from doing all these damage, apart from education, we fundamentally need to change the whole banking industry. These fundamental and important measures of change I will discuss in future.

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⁸ And if you want to stretch your feet then increase the size of the blanket i.e., if you want to spend more then first you have to earn more through hard work instead of borrowing.

NATIONAL ACCOUNTS OF ROBINSON'S ECONOMY*Vaclav Rybacek****Abstract**

The system of national accounts provides data for economic analysis, especially analysis of business cycle. While properties of time series are continually under discussion, much less formation and predicative ability of the aggregates. Aim of this paper is to contribute to activation of this discussion, to draw the attention on possible weak points in the relationship between the national accounts system and business cycle. These points refer to key concepts of the system of national accounts as a value-added approach, production-borders, recording of capital goods, disposable income definition, definition of savings or the strong concentration on the consumption. In the paper, we use the model of the economy of Robinson Crusoe that enable us to record the effects of economic activity from the very beginning and to show the effects of this activity on the aggregates of the national accounts system.

Keywords: national accounts, business cycle, value-added, savings, capital goods, wealth effect

JEL Classification: E01, E20, E30

Foreword

The national accounts system (SNA) became indispensable part of economic policy. The SNA provides data for economic analysis, macro-predictions or business cycle analysis. But the SNA is not neutral description of economy; the way of arrangement of macro-aggregates in the SNA represents the Keynesian view of economy¹. This fact is not surprising; pioneers of the national accounts were Lord Keynes, and his followers Simon Kuznets and Richard Stone, both Keynesian economists and also Nobel laureates. Thus, by use of balance items of the SNA as GDP or GNI for business cycle analysis, we implicitly accept Keynesian economics as the most successful theory in explanation of business cycles movements.

Key feature of Keynesian economics is suppression the importance of capital, this fact is fully reflected in the SNA. Restricted recording of capital is represented by use of value added concept and definition of disposable income that are in the center of the SNA. As we will show later, this methodology of aggregates can leave fundamental processes in economy hidden. Owing to continuity of the SNA concepts, this will also hold true in the future. Thus, we can identify certain

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¹ First attempt to record flows in economy is dated back to 18th century namely to Francois Quesnay.

dichotomy in the relation of business cycle and the SNA. While use of data and interpretation of characteristics of time series are still under discussion, compilation of data and concept of the SNA is in essence kept unchanged.

Following text is a modest contribution aiming at fill this gap. Questionable concepts of the SNA and their linkage to business cycle analysis are demonstrated on the example of Robinson's economy. The reason for this choice lies in the fact that this model makes it possible to proceed from the very beginning of economic activity to more complicated phenomenon of common economic life and, above all, to be very illustrative. It is naturally important to mention, that analysis of the Robinson's economy follows the actual methodology of the SNA, as well as revised methodology that will enter in force in the future.

1. Methodology

Use of Robinson's economy model needs to solve methodological difficulties or to accept some compromises that will not misapply our model to economic science and the SNA simultaneously. There are two substantial problems, production boundary and valuation issue. Inevitably, by focusing on Robinson's economic activity we will deal largely with his production for final use. By it, we are getting out of production boundaries, as it is defined in the SNA. But this does not contradict to the fact that these activities² are commonly exercised by households (as Robinson), because they are necessary for sustenance of their living standard.

As was already mentioned, these activities are ignored in reality of the SNA. This is based two reasoning³. The first one is usual problem with data availability. The second one is the difficulty with valuation of products resulting from these activities. As Kuznets itself admits, even if we ignore these activities from practical reasons, these activities are productive⁴. So, we can afford to include these activities in our analysis of the SNA concepts. The problem with data availability can also be easily overcome; we will simply make assumption on Robinson's economic activities aiming at survive in the wild nature. Thus, we are in such position that we dispose of micro-data on individual activities. But, the second problem of valuation still remains to solve.

Robinson's products are not traded (before next individuals will enter the analysis and market come into existence), thus there are no market prices. Purpose of this text is to explain basic concepts of the SNA and the link of this concept to business cycle analysis. First, we use for valuation of products the commodity that can most satisfy Robinson's needs. According to our assumption, this commodity will be bananas. In the first days of Robinson's life on island, we suppose Robinson

² For example cooking, washing, custody of children; if these products or services are not purchased on the market.

³ Kuznets [1941], p.9

⁴ Dtto.

to consume just this one commodity (banana). All consumer goods then exchanged on the market will be valued by use of this commodity.

But for production of more time-consuming products with longer period of production, Robinson needs to dispose of capital goods. We do not miss the aim of this paper, if we will evaluate the capital goods on the base of opportunity costs, even if this concept is to SNA fully unknown currently⁵. Thus, we choose the method that evaluates the capital goods on the base of costs and as costs will be understood the amount of consumption goods that could be produced instead of capital goods production. Capital goods are then expressed as a value of primary inputs and opportunity costs of their production.

2. Life on desert island

Let's move on our island. Robinson's ship has gone to wreck and his passenger is now left to himself on the deserted island. We are starting on the first day of his involuntary stay, when Robinson begin to think about allocation of his resources (time), using of his knowledge and available natural resources to satisfy his physical needs. In such situation, he plan naturally produce consumption goods. Suppose that Robinson picks 10 bananas, which are sufficient for his first-day needs. The rest of his time is devoted to relaxation after physically demanding ship-wreck. Table 1 records the effects of Robinson's activities on the national accounts aggregates of our economy.

Table 1: First day (t)

Production account			
Intermediate consum.	0	Production ⁶	10
Value added	10		
Generation of Income Account			
Wages	0	Value added	10
Mixed Income	10		
Use of Income Account			
Final consumption	10	Disposable Income	10
Savings	0		

In our simplified sequence of account, there are displayed only those accounts that are affected by the economic activity of Robinson on the first day. As we can

⁵ In the study of Ruger and Varjonen [2008], non-paid work of households is evaluated by opportunity costs, if there is not a market equivalent (market replacement cost method), p. 19. In addition, cost method is standard procedure of evaluation of government and non-profit institution, see ESA95. Question of expansion of production boundaries is discussed in Eisner [1988]

⁶ Production in the SNA is based on the neoclassical definition of productive activities, i.e. „all potentially marketable activities...“, see Shaikh, Tonak [1994], p. 3. Keynesian economics took over this convention and this concept was integrated into national accounts. For interesting discussion of economic activity definition see Ogle [2002], Holcombe [2004], Eisner [1988], Rothbard [1963].

read, the result of Robinson's activity is value-added amounting to 10 (bananas). There is no intermediate consumption, because the only input was "time" that is not assessed in the SNA⁷. Thus, labour is now the only production factor. This fact is not so evident from the entries on "Generation of Income Account", because "Mixed Income" is mixed because of payments to capital and labour inputs put together that is specific case of households' productive activities. Due to urgency of needs and thus high time preference, total income is allocated to final consumption (see Use of Income Account).

Table 2: Second day, occurrence of exchange(t+1)

Production Account			
Intermediate consum.	0	Production	20
		R: for own use	5
		for exchange	5
		P: for own use	5
		for exchange	5
Value added	20		
Generation of Income Account			
Wages	0	Value Added	20
Mixed Income	20		
Use of Income Account			
Final consumption	20	Disposable Income	20
Savings	0		

On the next day Friday has appeared on the island. He is using his skills and shape for fishing. Thus, suppose that Friday crops 10 fishes. But he evaluates additional five fish's less than five bananas. And because Robinson would like to make short commons more manifold, both now decide to exchange five bananas and five fishes. Thus, the market price of one fish is equal to one banana. As is evident, the phenomenon of market exchange enters into our analysis. This fact strongly affects not only values of macro-aggregates, but also total satisfaction of Robinsons' and Fridays' needs. As table 2 shows, production of the economy consists of production for own use and for the market. If we evaluate the production of Friday by the market price (fully in accordance with the SNA methodology), we receive total production of Robinsons' economy amounting to 20.

There is one important characteristic to which should be paid attention. Robinson has exchanged his products because five fishes are more useful for him than five bananas exchanged. Thus, the use value is higher than transaction value. What is then production? Just sum of "revenues", production or GDP cannot be a rate of satisfactions of human needs or the reflection of welfare improvements⁸.

⁷ It is worth mentioning that time devoted by Robinson to relaxation is not estimated in the national accounts. But, estimation of time is not impossible, in principle, see Stiglitz, Sen, Fitoussi [2008]

⁸ This fact was already mentioned by Kuznets itself: „Market prices are of course a far from perfect

Difference between real satisfaction and production will rise with number of market transactions. Production and exchange increase total utility in the economy, but we cannot say about it nothing more than that this total utility surpasses production.

Table 3: Occurrence of capital goods (t+2, t+3)

Production Account			
Intermediate consum.	0	Production	50
		R: for own use	20
		for exchange	10
		P: for own use	10
		for exchange	10
Value added	50		
Generation of Income Account			
Wages	0	Value added	50
Mixed Income	50		
Use of Disposable Income Account			
Final consumption	40	Disposable Income	50
Savings	10		
Capital Account			
GFCF ⁹	0	Savings	10
Changes in stocks	10		
Valuable	0		
Closing Stock			
Stocks	10	Net wealth	10

When basic needs are met, Robinson is starting to think about dwelling. But this demands larger time investment, this need of time is supposed to be four days. Thus, Robinson needs to produce sufficient stock of consumption goods that will be consumed during the time of production of dwelling, i.e. his target stock of consumption goods is 40. So, next day Robinson will intensify his production effort and, as a result, he will create stock in the amount of 5. After two days, Robinson realizes that it is more effective to devote actual stocks of consumption goods (10) to production of capital goods – axe that will make possible to increase productivity and to reach the target stock sooner than by current procedure.

Table 3 records the activity in following two days. Robinson has devoted more time to production of consumption goods and has increased his production to 30; one third of the production is saved. Friday hasn't change his behaviour, he has produced and consumed every day the amount of 10. But, due to change in the behaviour of Robinson, the stock of consumption goods has increased to 10 (bananas) without absolute restriction of consumption. As was mentioned, saved

measure of how well goods satisfy society's needs." Viz. Kuznets (1941), p. 55.

⁹ GFCF = gross fixed capital formation.

consumption goods will be consumed during the process of production of capital goods. Fifth day, Robinson is producing the axe, i.e. capital goods, which will increase his productivity. Look at the situation in the national accounts (t+4).

Table 4: Production of capital goods (t+4)

Production Account			
Intermediate consum.	0	Production	20
		R: for own use	10
		for exchange	0
		P: for own use	5
		for exchange	5
Value added	20		
Generation of Income Account			
Wages	0	Value added	20
Mixed Income	20		
Use of Disposable Income Account			
Final consumption	20	Disposable Income	20
Savings	0		
Capital Account			
GFCF	0	Savings	0
Changes in stocks	0		
Valuable	0		
Closing Stocks			
Stocks	10	Net Wealth	10

Friday hasn't change his behaviour, one half of his production he has exchanged with Robinson, which has drawn the consumption goods from his stocks. Thus, Robinson's stocks are lowered by 10, which value was intended for consumption. How should be capital good estimated? According to assumption, we assess capital good on the base of opportunity costs. "Cost value" of capital good is then 10 (bananas). So, instead of production of consumption goods, result of the Robinson's activity in this period is capital good. In effect, the amount of stocks *didn't change*, the only change is in the structure of stocks that are now formed not by consumption goods, but capital good. This is very important change in economic situation.

Table 5: Rise in productivity (t+5, t+6)

Production Account			
Intermediate consum.	10	Production	80
		R: for own use	50
		for exchange	10
		P: for own use	10
		for exchange	10
Value added	70		

Generation of Income Account			
Wages	0	Value added	70
Mixed Income	70		
Use of Disposable Income Account			
Final consumption	40	Disposable income	70
Savings	30		
Capital Account			
GFCF	0	Savings	30
Changes in stocks	30		
Closing Stocks			
Stocks	40	Net Wealth	40

Consider period $t+5$ a $t+6$. Due to capital good, Robinson has increased daily production of consumption goods from 15 to 30. Because of use of the axe is taken as intermediate consumption in the SNA, intermediate consumption is introduced into our analysis. Intermediate consumption is de facto expenditure for production purposes, inputs into production activity. The existence of intermediate consumption and investment activity as such is, at the same time, the reflection of lengthening of production into more phases that are necessary to produce such time-consuming product as a dwelling by use of capital good¹⁰.

Thus, the axe is recorded as intermediate consumption. For clearness, in table 5 we summarise two periods. The amount of production is sufficient for satisfaction of more urgent needs and for formation of additional stocks of consumption goods necessary for time of producing dwelling (four days). By taken one half of the value of axe in each period, we are again fully consistent with the national accounts approach. As Kuznets quotes: „...; and one of the first difficulties encountered in estimating national income for an interval as short as a year is to get annual values of the intermediate consumption of such goods.”¹¹ We solve this problem by assumption on lifetime of the axe, i.e. two periods.

The production of Robinson economy amounts to 80, whereas ten has been consumed as intermediate consumption. Value added is, in our case, simultaneously the mixed income and disposable income (there is no redistribution, etc.). Robinson produced 60, part of value added (50) has been consumed (20) and the other part he has saved (30). Final consumption of the economy as a whole amounts to 40, the rest is net element – change in the stocks (+30). Net wealth of Robinson economy has risen due to savings to 40 and this is formed by capital goods intended for

¹⁰ Here we touch the issue of “double counting” (see. Samuelson [1995]), that is the issue of capital goods being included in the value of final product. This can be compared to the situation of fixed capital serving more than one period. Naturally, duration of period is fully arbitrary choice of national accountants. The differentiation of capital goods between intermediate consumption and fixed capital is important distinction between Keynesian and Austrian economics. For discussion see Reisman [1999], Skousen [2008], Johnson [2002].

¹¹ Kuznets [1941], p. 41

production of dwelling (in modern expression – durable).

Table 6: Economic activity in t+7 - t+10

Production Account			
Intermediate consum.	10	Production	90
		R: for own use	50
		for exchange	0
		P: for own use	20
		for exchange	20
Value added	80		
Generation of Income Account			
Wages	0	Value added	80
Mixed Income	80		
Use of Disposable Income Account			
Final consumption	80	Disposable income	80
Savings	0		
Capital Account			
GFCF	40	Savings	0
Changes in stocks	- 40		
Closing Stocks			
Fixed capital	40		
Stocks	0	Net Wealth	40

Following four days, Robinson is attending to production of fixed assets (dwelling) and, at the same time, he is consuming stock of consumption goods. Due to lifetime of the axe (capital good), Robinson has to renovate it. So, first day of time devoted to housing formation he has to renovate capital good (the axe) and three days he is producing housing. The result of his effort is fixed capital formation that will serve for many of periods. The important question is, again, how should we estimate this fixed capital?

Relevant is approach recommended by methodology of national accounts¹². In the national accounts, products produced and intended for own final uses are assessed in basic prices of similar goods traded on the market. In our case, there is not some housing market. But, we do not deviate from the SNA, if we estimate the housing in the amount of costs expended on the production¹³. As production costs we then understand the sum of intermediate consumption, wages, fixed capital consumption a taxes on production¹⁴.

¹² ESA95, ESA2010 (SNA2008, respectively).

¹³ Dtto, par. 3.49

¹⁴ Dtto, par. 3.33

In Robinson's case, of course, we can ignore wages, fixed capital consumption and taxes on production. Only intermediate consumption comes on force. Table 6 describes the situation after four days, during which Robinson produced and consumed capital good (axe), as well as stock of consumption goods, but, at the same time, he produced fixed capital in the form of house. So, the value of production is formed by the amount of direct inputs (axe) and opportunity costs (i.e. non-produced consumption goods), amounting to 50. For completeness we should add, that Friday's economic activity didn't change and during surveyed periods (days) he produced goods in the amount of 40.

3. Business cycle of Robinson's economy

Assumptions on economic activity described in the second part are not essentially different from real economic activity of households. People often try to get foodstuff or build houses also by self-help. Now, we examine time series recording economic activity in all surveyed periods. As we know, consumption goods as well as capital goods were produced. Thus, we can observe change in time preferences as a necessary condition of capital goods formation. The existence of capital goods caused changes in the production process and productivity.

Chart 1: Production, intermediate consumption and value added

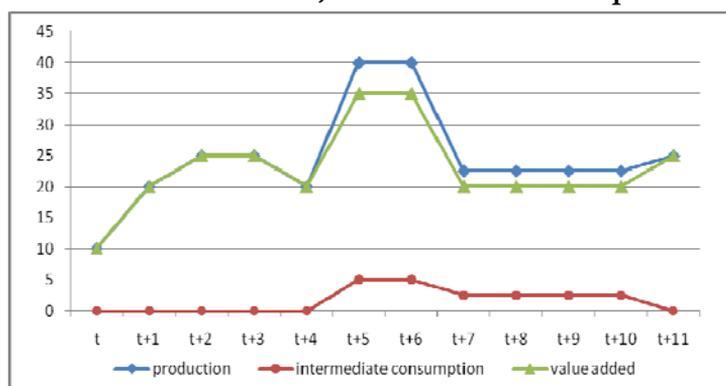


Chart 1 displays main aggregates, i.e. production, intermediate consumption and value added in the Robinson economy. Identical rise in production and value added can be observed in the first five periods. The reason is evident, the absence of capital goods.

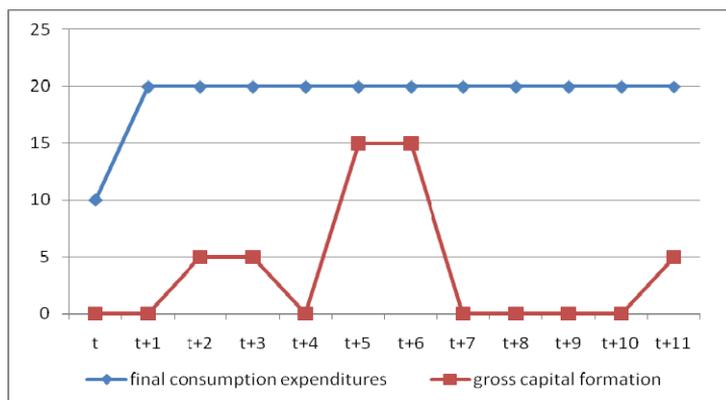
In the period t+4, Robinson changed his time preferences, i.e. relative price of current goods has decline in comparison to prices of future goods. In other words, Robinson has created savings and, as a consequence, interest rate in our fictitious economy falls. Savings are then used to finance working capital (intermediate consumption). Intermediate consumption requires more attention. First of all, intermediate consumption gives rise to difference between course of production and value added. Value of production is adjusted by intermediate consumption according to assumption that value of input enters into the value of production! Or from other perspective, value of produced goods has to cover value of inputs¹⁵.

¹⁵ Very interesting discussion on this topic can be found in Akhiapor a Reisman [2005]. There is also

Intermediate consumption is reflection of economic process as a time-consuming activity¹⁶. This can be understood as goods and services intended for utilization in further stages of production¹⁷. In reality, capital goods formation is not negligible sphere of every capitalistic economy, these amounts usually to 70 percent of total production. Thus, by exclusion of goods and services classified as intermediate consumption (in accordance with value-added concept of the SNA) we lose many information, on all (in very truth all) goods and services produced in the economy in certain period, on range of activities creating certain “value added”, we repress the view of production as a process in time¹⁸.

In addition, capital goods are formed for future productive use, they represent the fact that before the good is completed as consumption good, it changes its form many times. Thus capital goods have principal link to future situation of the economy, production, productivity, consumption or welfare¹⁹. This fact has clear connection to predictive power of GDP. We can raise the question, how can be future course of the economy predicted on the base of indicator that does not takes fully goods and services that determine the future course of the economy? As a result, GDP overestimates the role of consumption; but consumption is very stable in time, so aim at avoiding double counting impedes correct business cycle analysis.

Chart 2: Expenditures on GDP by type



Production and consumption of capital goods is purely question of production sphere of the economy. Importance of omission of majority of capital goods is indicated by standard deviation that is significantly higher in simplified Robinson economy in the case of production (7,9) than for

value added (6,6)²⁰. Because most stable course is recorded in case of consumption, thus value added concept has stabilizing effect on the indicator of total economic activity.

Chart 2 give us picture of Robinson economy from the “demand” side, i.e. GDP as

important issue of ineffective activities creating non-positive value added, these can show decline in economic activity.

¹⁶ Skousen [2007]

¹⁷ Intermediate consumption reflexes process of production in time, consumption of inputs and entrepreneurs' expectation, as well as rising specialization and lengthening of production processes.

¹⁸ Skousen [2007]

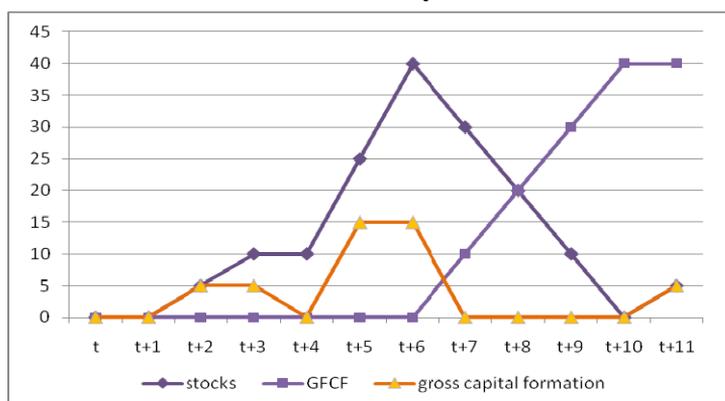
¹⁹ Popper [2000]

²⁰ That most stable aggregate is the aggregate of consumption expenditures, see Rybáček [2009].

a sum of expenditures on value added. Since we can ignore export and import, the only expenditures on GDP are consumption and investment (gross capital formation); these expenditures signify different volatility. Significant rise in consumption expenditure between t and $t+1$ is caused by the rise in number of households. In subsequent periods, the level of consumption is stabilized and standard deviation of this aggregate is markedly low (2,8). Much stronger volatility can be identified for investment (5,5) formed by fixed capital (4,7) and changes in the stocks (8,8).

Now it is evident, that it is not necessary to restrict consumption to create savings (see production in chart 1 and consumption in chart 2), but this restriction can be only relative²¹. In other words, consumption does not reach its potential maximum level determined by production²². Accumulation of stocks in $t+2$ and $t+3$ is the result of decline in time preferences. In period $t+4$, Robinson produced capital goods. This important moment in his effort is not displayed by GDP, due to proportional decrease in stocks of consumption goods. There is no new good produced during this period from the GDP perspective, stocks of consumption goods were only “transformed” into stock of capital good²³. This net element (stocks) in “demand” GDP is counterparty of value added concept in GDP by “production approach”²⁴. Between $t+6$ and $t+7$ significant fall in GDP by more than 40 % is recorded that is caused by “falling” investment activity (due to stock utilization), even if there was no decline in economic activity at all.

Chart 3: Investment activity



So, due to gradual increasing value of produced fixed asset and counter decrease in consumed stocks, there is no economic activity observed in the GDP that would result from this endeavour of Robinson. In modern terminology we could say, that the economy

²¹ Ropke [2000]

²² All produced things are not consumed at the same time. In other words, it is no possible to consume good or service that has not been produced. Thus, an amount of consumption is fully dependent upon volume of production. This fact contradicts to the mainstream view of production being dependent upon consumption. This mainstream view is valid on micro-level, but on macro-level this must be to the contrary. See Reisman [1991]

²³ Production of capital good is important moment. This enables to Robinson to increase production and reach goods and services with longer production process. Thus, the existence of capital goods connects the presence and future (Popper [2000]).

²⁴ For discussion of net element of stocks see Reisman [1999], Johnsson [2002]

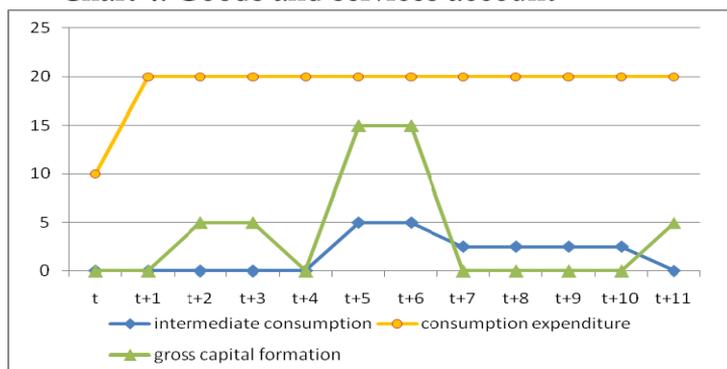
was pulled up by consumption. But, against the backdrop of this consumption driven economy, there are huge changes taking place in the economy, i.e. production of asset that will significantly influence the living standard. This is the consequence of restricted sight of economy from the GDP position that does not take into account (among others) stocks of assets or liabilities. Thus, GDP in these periods can be expressed in following way:

$$\text{GDP} = C + I = C + [\text{GFCF} + \text{change in stocks}] = 10 + (10-10) = 10$$

It is not absolutely clear on theoretical level, if dwelling has consumption or investment nature. But, this is not important for our analysis. In the case of dwelling as consumption good, we can rewrite GDP to following form:

$$\text{GDP} = C + I = 20 + (-10) = 10$$

Chart 4: Goods and services account



Now we turn our attention to uses side of “goods and services account” that is sum of use in form of intermediate consumption, final consumption or investments (export is ignored). In chart 4, we can see smoothed course

of consumption during all periods. Use for production purposes (investment and intermediate consumption) indicates much stronger volatility of production sphere. This in accord with the fact, that business cycle was historically caused by production and not consumption activity²⁵. This is result of changing time preferences and variable amount of savings. The illusion of stability providing by GDP can be avoided by abandonment of value added concept by business cycle analysis.

Unfortunately, the new methodology of the SNA doesn't bring any change in this respect, it rests on the assumptions put by Keynesian economics, in which the indicator GDP originally served as indicator of the taxable capacity of (British) economy. So, it necessary to calculate separate indicators, this debate can be found in Reisman [1999] or Skousen [2006], empirical application of alternative indicator of business cycle in Johnsson [2001] and Rybacek [2009].

²⁵ Rothbard [2002]

4. *Wealth effect and macro-aggregates*²⁶

Finally, we mention specific case that is very topical. Suppose that Robinson discovers some place full of precious stone called topaz. He picks some for embellishment of his new dwelling. There was no value except his psychic return. But, Robinson comes upon village in which tribesman use topaz as money. In this moment, value of Robinson's stock of topaz has risen and Robinson can purchase any products produced by inhabitant of this village, if this product will be more valuable for him than stocks of topaz held by him.

Thus, Robinson's wealth has risen due to exogenous rise in the value of non-financial asset in Robinson's "portfolio". This rise is not a result of productive activity; it is just question of changes in prices. From other perspective, Robinson can purchase consumption or capital goods made in village and to increase GDP, but this rise in expenditures is not caused by rising income generated by expanding productive activity. So, *the income didn't change, but consumption has risen*. This takes us to the conclusion that GDP doesn't take into account the way of financing of expenditures. Last but not least, what is the rate of savings of Robinson?

Suppose that Robinson thank to his productive activity generates (disposable) income amounting to 10 (and this income is fully consumed). But except this Robinson reached holding gains above mentioned amounting to 5. Robinson uses this unexpected gain to purchase (consumption) goods from tribesman in the amount of 4. To compare disposable income and consumption expenditure (as is the practise of the SNA) we obtain the amount of savings -4 and savings rate -28,6 %²⁷. In reality, Robinson's resources are 15. Thus, real savings are +1 and savings rate 6,7 %. SNA savings rate and "adjusted" savings rate give us completely different picture on human behaviour.

Because the holdings gains are not reflected in disposable income, it doesn't make sense to compare income generated by productive activities and final consumption expenditure that can be realised not only out of current income. As logical consequence, we cannot conclude that savings is non-consumed part of disposable income! The reason is, again, that there are more sources of consumption financing than only disposable income. Thus, it seems to be misguided to assess savings behaviour and business cycle position of economy on the base of the national accounts concepts of disposable income and savings. The crucial problem is in both, restricted production boundary and restricted disposable income definition²⁸.

²⁶ Concept of this chapter is based on the paper presented on the conference „Group of Experts on National Accounts“ in Geneva [2010]

²⁷ Thus, it is not possible to conclude that negative saving rate (in the SNA) tell us something on real savings creation. We can make two notices. First, in the case of positive holding gains reached by asset holders, these can have no incentive to make savings out of disposable income. And second, these holding gains can be used to consumption rise, if owner sold his assets for higher price, or rise in price can serve to increase of debt as in the case of houses. Rybáček [2009]

²⁸ Gains reached by price changes are not included in disposable income, as was already mentioned.

This state of affairs is the result of theoretical discussion preceding the development of the national accounts. As was mentioned, the SNA is based on Keynesian concept. Keynes [1936] called discussed gains (or losses) as a „windfall“²⁹. Keynes admits that consumption doesn't depend only on net disposable income, but he argues: „..., although the windfall loss (or gain) enters into decision, it does not enter on the same scale.“³⁰ This flows shouldn't be included in the disposable income, according to Keynes. This approach is still preferred, even if this has serious impact on predictive power of macro-aggregates. “Non-income” transactions (as a holding gains or losses) serving to consumption financing change the Keynesian view of relationship between disposable income and consumption expenditures, as described by Keynes: „ ... the amount of aggregate consumption mainly depends on the amount of aggregate income.“³¹

Concluding remarks

Correct analysis of business cycle must take into account time preferences, creation of voluntary savings and investment activities as driving factors of business cycle and economic growths, i.e. crucial is the role of capital. The SNA is based on theoretical reasoning of Keynesian economics that suppresses the importance of capital and this is fully introduced in the SNA. As was shown, concepts of the SNA aggregate are not compatible with proper business cycle analysis. Main problems are restricted definition of economic activity; value added concept; restricted definition of investments and resulting orientation on consumption.

For proper identification of the business cycle position, it is thus necessary to develop alternative indicators of economic activity fluctuation that will far less serve to fiscal needs of fiscal authorities (as the SNA and GDP do) and much more to correct business cycle analysis; these are discussed in Skousen [2008], De Soto [2006] or Reisman [1998]. Revision of approach to business cycle analysis is one of the most challenges of current economic crises. Without correct information on business cycle position, there are erroneous reaction of individuals and institutions as we have witnessed in last decades.

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This is the result of Keynesian concept and recommendation of International Expert Group on Households Statistics [2001], see also Kuznets [1961]. Opposite opinion can be found in Eisner [1988].

²⁹ Keynes [1936], chapter 6.

³⁰ Dtto.

³¹ Dtto.

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INTERVENTIONS IN HUMAN RESOURCES RETENTION*Raluca Cruceru and Mihaela-Georgia Sima****Abstract**

Keeping the organization's best employees is one of the main purposes of human resources and management companies. Through the work, top employees are those who bring the highest sales, customers and quality products. In other words, they ensure the success of the company. However, if management does not appreciate business services, which would be why these experts did not find a better job in another organization? To counteract this momentum, the human resources department can use a set of "retention techniques" presented in this paper. Along with these techniques, there are ways of avoiding / resolving conflicts arising, so as not to generate conflict situations unsolvable and would result in leaving the institution for reasons other than professional.

Human resources is very complex and the techniques and methods used in working with people are very large, different, however, applicable only in certain situations. Therefore, each specializing in human resources has to fold the situation and be able to recommend the best solutions for top management to get best results.

How we select the right people and why we should help the most ambitious employees to develop their career are things whose importance becomes evident when a valuable employee resigns. Unfortunately, it is too late!

Keywords: human resources, retention, motivation, salary.

JEL Classification: A12, J53, K41

Scholastically speaking, to maintain function is to ensure that those working conditions of employees as deemed necessary to determine to remain in the organization.

It is well-known fact that key actors in a company's success are the quality of human resources. Given this, the work of human resources is extremely important to provide the company with valuable employees to contribute to achieving its objectives.

Maintaining human resource refers to the administrative aspects of human resource management: employment contracts, wages, employment protection, etc. Activity management personnel must comply with strict legal rules designed to protect the interests and health of employees.

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A company's ability to retain, preserve and develop human capital creates a positive perception in the human resources market, a perception that propelled the top employer brands. A high rate that helps to attract top professionals who will contribute through their company's success.

Staff retention is the opposite of staff turnover. Retention means retaining those employees who share the company values, proving their expertise in business and an appropriate moral profile.

Maintaining human resources is closely related to their satisfaction, so one way to reduce turnover and thereby to increase staff retention, is control over the correspondence between expected rewards and satisfaction of their employees, which can reduce the problems caused by fluctuation. Another way to eliminate the fluctuation is improving selection in employment, but to dismiss.

A better orientation of employees can reduce turnover. Workers who are given opportunities for training and retraining, which are placed on job matching their training, are less inclined to leave the organization. If people receive more general information on company performance which is desired of them, will think that's good or not remains. If individuals believe that they have the chance to be advanced, will leave the organization. Consequently, internal promotion and career planning can help keep employees in the organization.

In addition, a fair payment system can help prevent turnover. Studies have shown that determined job satisfaction is strongly influenced by the feeling of paying employees to be paid correctly compared with others inside or outside the organization. An employee who is paid less than another worker on a job with similar requirements may leave the organization if he was offered a better alternative. In extreme cases, when a shortage of skilled employees, companies to be competitive, can spend a lot of improvement. Such situations have led to "return the funds agreements" where employees leave the organization in a given period.

In Romania, apparently due to low labor costs, turnover is high, owners and managers that neglecting the losses caused by continuous 'go come' employees. Principle if not better, hire another 'is absolutely wrong and prove managerial incompetence. Moreover, raises questions on personnel selection practices (often hasty), the capacity of the drive and motivation and thus the prosperity of the company.

Another component of the process of maintaining human resources is to maintain a low stress.

Stress management is to: a. Identify the causes which produce and measures such as: - changing individual responsibilities (reducing or increasing them) - the empowering tasks - agreeing employee objectives - providing training appropriate (eg in time management techniques), how we select the right people and why should we help the most ambitious employees to develop their career are things whose importance becomes evident when a valuable employee resign. Unfortunately, it is too late!

After investing considerable amounts of time and money in recruiting and training employees, companies must ensure that they become productive and loyal. Losing an employee with experience often translates into additional costs that the company must embrace and to cover fragmentation relationship with customers, team cohesion or weakening efforts to recruit new staff are just a few.

Moreover, statistics show that with the retirement of so-called Baby Boomers, available workforce in the United States will drop almost by half - from a total of 76 million people, only 44 million - will decrease to extend worldwide. It is easy to realize that the burden of companies to retain valuable employees is becoming increasingly challenging.

Motivating and retaining employees but requires strong managerial skills to facilitate a system working properly: as fit company needs employees, so they need and are given the tools and conditions to achieve daily attributions. An equally important aspect is also a performance-based compensation plan that reinforces loyalty to the company employees and to encourage it to make a significant contribution.

Likewise acting and a good communication system in place designed on the one hand, fluidifica exchange information to achieve tasks and, secondly, to give every employee the opportunity to give and receive feedback on work it takes. Identify frustrations that employees can accumulate and solutions for their elimination are also steps that such a system can facilitate communication.

Equally, employees are assessed to recognize the value and appreciate their efforts are. Sometimes, the assessment, involvement in important decisions and trust that is granted, weighing more than a financial reward for the employee received a foul and oppressive work environment.

Undoubtedly skills and knowledge they hold those responsible for human resources will determine success in creating an atmosphere where employees feel motivated and remain loyal to the company.

Staffing & Career Development, a course supported by Florin Petrescu (Citibank) during 2007-2008, (Citibank), extensively discuss issues of staff retention, among other key issues related to the Staffing and Career Management, giving participants both a clear definition of concepts involved and concrete examples and models with a large application development.

Retention, recruitment and selection, training and employee development are among issues that managers will face this year, but the HR teams. Thus, having announced wage estimates, the Hay Group experts have made us a cold shower again, announcing that 70% of companies surveyed will have problems with employee retention.

According to the study 'Compensation and Benefits' conducted by the Hay Group company, the challenges they will face more than 50% of companies surveyed are: retention (the proportion of 70%), selection and recruitment, training and employee development system motivation and performance management. "Retention is a fundamental problem today, but we can not say that a particular sector is more

affected than other.

Monetary values that are part of salary package still matter, but not the only motivating factor. What we want to emphasize is that the salary itself is a poor tactic general remuneration strategy, because it is very easy to copy by competitors. Rewards intangible non-financial are more difficult to reproduce and it is unique, here is the real difference ", says Alina Popescu, Manager of Research Division of Remuneration, Hay Group Romania.

The study reveals an annual salary increase of 15.7% for levels of 15.5% for management and workers, justified by the fact that 69 percent% of companies reported difficulties in recruitment for certain jobs, leading wage increase. It is not coincidence that Tataru Florin, National HR Director Vel Pitar, expect an even larger increase in wages for workers, given the acute shortage of trained personnel. "Traditionally, the baking industry was an industry with a lower salary levels than average, but I do not think the labor market leave us many options on this issue. Moreover, the Romanian, I think most often these are unsustainable wage increases (in terms of labor productivity) and we risk losing one of the important benefits that the country has potential killers struggle to attract investment: costs low ', said representative Pitar Vel. Also, experts estimate that the Hay Group management positions will focus on variable reward systems, based on financial performance, market and operational. This is true when implementing a performance management system, solid and transparent.

Taking into account the pressure on wage growth, Michael Dragoi, HR Manager Arctic raises the stakes. 'A possible renegotiation of the minimum wage can bring new elements in wage equation. Therefore, an approximately 18-20% salary increase for 2008 is not a surprise. Regarding the electronics industry, lack of skilled workers in the labor market, increasing competition and diversifying methods of attracting and recruiting specialists will cause wages to at least follow the same trend ", says HR manager of Arctic. And because I brought about the shortage of people, Alina Popescu, Division Manager Remuneration Studies, Hay Group Romania, noted that the labor market in Romania is still not attractive for skilled workers, although progress has been made by both authorities and by companies, the latter must be understood that the recruitment process and to focus on continuous training.

A possible answer to the question "have problems with retention?" Would be: "Try retention bonus!". Generally companies that have high turnover of employees begin by identifying whether a problem primarily related to wages and then to protect this fluctuation, providing a retention bonus. 'In 2007, the number of companies reported that they offered such a bonus for specialists increased by 10% compared to 2006', says Alina Popescu. Thus, as the wage issue is resolved, companies moving to implement programs such as Performance Management and Evaluation and leadership capacity. "These are companies that have reached a certain maturity and understood that management styles have a huge impact on organizational culture and climate and an environment increases the company's total results. Moreover, management style has a large impact on an employee's decision to

leave the company 'representative complement Hay Group.

Retention is also on the agenda of Michael Dragoi, HR Manager Arctic, which argues that salary is one of the most important factors in employee retention, but not far from the only lever that can be used to retain valuable people in the company. 'To emphasize the importance of becoming more fluid which methods should have in companies, will give the example of a colleague at another company, newly arrived in Romania, which asks for the Romanians willing to change their work for only 20 euros in addition to wage 'representative complement the Arctic.

Money is not far from a prime motivator of employees. This was confirmed in a recent study done on 1500 people.

The key is the manager. Roxana Rotaru, Human Resources Manager, Orange Romania has a different view regarding the reasons why many employers do not Reuss retain employees in companies, bringing it to the fore in his role of manager and reasons. It believes that retention is primarily a task manager and depends largely on the experience of his special skills SSI to treat: be proactive, by allocating the time to listen and understand their employees or reagent. 'Trying for years to create a diverse work environment, to motivate and recognize different employee performance: competitive for those who need challenges for those who appreciate a stable predictable environment with development opportunities and career progression or different ways of recognizing individual worth. Manager bears primary responsibility, however. It is the main motivational factor for people in the team ', complements the Orange representative.

Regarding staff turnover size, Delamode company faces a fluctuation of about 6% for the whole company, the biggest fluctuation of personnel registered in the storage department. 'The difficulty of finding workers in this segment, both numerically and qualitatively, and required a greater attention to creating a structure based on fixed element (salary) plus other variable factors. This structure comes to ensure proper retention and rewarding employees in this department ', says Ioan Vlad, HR Director Delamode.

Moving in the bakery, we find that the company currently Vel Pitar highest turnover of staff positions requiring unskilled and poorly trained staff and the reasons are varied. 'One of the specific problems we face is the loss of qualified personnel specialized in bakery industry. Training system no longer fails to generate potential candidates, while existing qualified staff are approaching retirement or switching industries more profitable and less physically demanding ', says Florin Tataru.

And telecommunications companies are staffing fluctuations. Orange is the case where customer service department has the highest rate of departures. According to Roxana Rotaru, Director of Human Resources, the reasons for these departures are clear: the work is complex and requires a series of specific skills and stress level is high. Also, young people working in this department are the labor market more flexible. They have very high ambitions and expectations and are willing to change what they're not much easier.

It is noted that the strategies of motivation and retention of employees vary depending on the industry, said company policy and HR department, but also the degree to detect the true needs of the employee. Wage tends to remain the engine that determines the number of employees to start each morning to office, but not the only piece of mechanism.

One of the factors most positive effects on employee retention performance is developing a relationship based on trust between employer and employee. This trust is often reflected in the package of compensation and how it is administered.

For a compensation plan to build relationships based on trust must have four supporting pillars: honesty, clarity, consistency, merit. It's harder than it seems at first sight to meet all these conditions. This is because due to circumstances change some of those characteristics may conflict with others:

- An activity in which to keep learning and freedom of choice tasks. Employees exploit learning opportunities that can develop and improve new skills. Also appreciates the opportunity to choose tasks where appropriate.

- Flexible working hours and leisure time. Employees that the employer worth their free time it provides. Flexibility of working hours to enable them to balance between work and personal life balance.

- Personal recognition. People like to feel that they need and that their work is appreciated. However employees report that their boss rarely thank them for the work they submit.

- Increased autonomy and authority in relation to their work. Greater autonomy and authority shall send the employee that the organization has confidence in him that they act independently and without the others.

- Time spent together with his manager. When managers spend time with their employees instead of two phenomena:

1. The first of them: a manager's time is precious because employees have a sense of recognition and validation.

2. The second phenomenon: the manager supports employees to listen to them, answer their questions and provide advice.

Those who participated in this study said that money is indeed important but less important than those above.

Researchers have discovered that there are seven areas that make a difference in retention of personnel, namely: work environment, work content, development opportunities, compensation and awards, organizational culture, relationship with managers, relationship with colleagues.

For many organizations, employee retention topic performance is down to one thing - compensation.

Companies say that "to keep your best employees, you must pay well. To a certain extent this is true, but only in negative terms. If employees are not paid performers well, leave.

But paying him well not only means that remain in the organization.

The compensation is a factor of satisfaction, satisfying and motivating.

Changing this compensation is a temporary effect on the employee and no one claimed the long term.

Study of "Employer of Choice" performed by Daedalus Millward Brown in collaboration with Catalyst Solutions shows that two out of three employees with higher education are affected by measures taken recently by the companies they work as a result of recession. Eliminating bonuses, restructuring processes and even lower wages are relatively common phenomena encountered lately organizations in Romania. employees are affected indirectly by reductions in budgets and development of organizations in which they work.

Concern for the future is even greater. Thus, 3 of 4 employees graduate is expected to cost reduction actions that affect them directly or indirectly. In an attempt to reduce costs, expect top managers rather restructuring processes, while employees without managerial positions believe that the restructuring will take place near elimination of low salaries and bonuses.

The study was conducted in March 2009 on a sample of 1158 employees with higher education by age 45 years. The sample is nationally representative for the population studied.

70% of highly educated workers have seen measures to reduce expenses in companies they work and almost half (46.4%) of highly educated workers are affected by budget reductions of corporate development.

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Changes made in the organization	%
Budget cuts were made (professional development, marketing, research, rewards, etc.)	44.7
Bonuses were eliminated	30.5
Restructuring took place	30.2
Low wages	19.1
A number of employees/all personal is working part-time	9.0
Some staff entered technical unemployment	8.6
None of the above	30.2

Source: Daedalus Millward Brown and Catalyst Solutions

Base: 1158 graduate of employees younger than 45 years

Since budgets were already set for 2009, concern about the low budget increase not decrease significantly from already established budgets. Percentage of employees with higher education who believe that they will take place in organization actions to reduce personnel costs in return is significantly higher than that of employees already exposed to such actions. Thus, 39.2% believe that there will be restructuring, 38.3% believe that bonuses will be removed and 25.8% think that wages will be deducted from her organization.

Predominant concern in small firms is related to low wages, while the biggest concern of those working in large firms is related to the restructuring plan.

There is also a major discrepancy between top management and employees with non-managerial positions with regard to perceptions of future activities to reduce costs in the organization: top management sees as rather reduce costs through restructuring, while non-management employees expect wage reductions and the elimination of bonuses.

Fields and companies analyzed:

Softwin, IBM, Google, Siemens, Hewlett Packard, Route 66, Nokia) - Telecom (Vodafone, Cosmote, Orange, Zapp/Telemobil, Romtelecom, RDS/RCS, UPC/Astral, GTS Telecom, Media Sat) - Professional/Media (Media Pro, Ringier, Intact, Realitatea, Catavencu, Deloitte & Touche, Price Waterhouse Cooper, Leo Burnett, McCann Erickson, Ogilvy, Ernst & Young, KPMG Romania, Accenture, Genpact) - FMCG (Danone, Friesland, Cadbury/ Kandia, Excellent, Kraft Foods, Heineken, Ursus Breweries, InBev Romania/Interbrew, Pepsi, Coca-Cola, Nestle, Ferrero, McDonald's, Unilever, Procter & Gamble, Henkel, Oriflame, Avon, Sarantis/Elmiplant, Beiersdorf/Nivea, Farmec Romania, Colgate-Palmolive) - Financial/banking (Raiffeisen Bank, Millennium Bank, BRD, BCR, ING, CEC Bank, Banc Post/Eurobank EFG, Banca Romaneasca, Alpha Bank, Credit Europe Bank, Unicredit Tiriatic Bank, Banca Transilvania) - Pharmaceutical (Sensiblu, Help Net, Dona Pharmacies, A&D Pharma, Romastru/Wyeth, Bayer Romania, Zentiva/Sicomed, Glaxo Smith Kline (GSK), Ozone Laboratories, Pfizer, Roche

Romania, Sanofi Aventis) - Distribution/Retail (Carrefour, Auchan, Billa, Mega Image, Kaufland, Selgros, Real, Cora, Plus, Metro) - Construction/building materials (Holcim, Lafarge, Cement Carpat/Heidelberg, Dufa Deutek, Policolor, Kober, Lasselsberger, Cesarom, Fabryo) - Auto (Dacia, Renault, Romcar, Tiriac Auto, Porsche Romania, Toyota, Automobile Bavaria, Iveco, Pro Truck, Mercedes) - Other Industries (Petrom, Rompetrol, OMV, Lukoil, MOL, JTI, Philip Morris, British American Tobacco (BAT)) [1]

Conclusions

Motivating and retaining employees but requires strong managerial skills to facilitate a system working properly: as fit company needs employees, so they need and are given the tools and conditions to achieve daily attributions. An equally important aspect is also a performance-based compensation plan that reinforces loyalty to the company employees and to encourage it to make a significant contribution.

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MANAGERIAL INVESTMENT ON ORGANIZATIONAL STRESS*Iulian Mituț****Abstract**

In a society affected by the economic and financial crisis and in the increasingly competitive environment it is important for any organization to adopt an organizational strategy to reduce costs without affecting its performance and market competitiveness. Human resources in a knowledge-based organization are increasingly affected by occupational stress, a phenomenon that generates lack of productivity. Technological development, scientific organization of production, development of the means of communication and transportation and the tightening of the competitive environment creates stress, which affects the ability of employees and managers to work efficiently, while also generating high costs for the organization as a whole. In this context, managerial attitudes and strategies need to invest, for the sake of the organisational welfare, in motivation, increased determination and coordination of the human resource, as the only resource capable of generating organizational effectiveness or non-effectiveness. Thus, in addition to economic and financial investment, in order to avoid the effects of occupational stress, there is a great need for a managerial "investment" defined by all the actions dealing with human resource coordination / motivation and by adequate managerial attitude, with the ultimate goal of attaining professional effectiveness and high level of organizational performance.

Keywords: leadership, modern market economy human capital, motivation, organization, occupational stress.

JEL Classification: J24; J81; O15; O33.

Introduction

The economic and organizational environment affected by current crisis, work overloads and organizational tensions are influencing the performance of the human resource, who feels increasingly stifled by work overloads, considerable mental and relational pressures and uncertainty of their future. When the needs of individuals are affected by lower living standards, job uncertainty or by social and organisational pressures and strains, human resources will lose efficiency. However, organization members can easily feel dismayed by today's fast pace, mergers, restructuring, relocations, as well as by the demands for stretch-targets that are increasingly hard to achieve and by contradictory orders, lack of support, organizational failures and many other factors generated by the individual as such, by the organization or by the society, which are doing nothing but facilitating the occurrence of stressful situations. Under these circumstances, any employee / member of an organization is subjected to *occupational stress* – a complex phenomenon resulting from confrontation of human

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resources with tasks/situations perceived as difficult to perform, as result of imbalances between the demands of the management and the material, intellectual and organizational resources of the employees.

1. Stress Related to Organizational Environment and Modern Market Economy

Occupational stress is a serious problem in the current organizational environment. A study conducted in 2003 by the European Foundation for the Improvement of Living and Working Conditions entitled “*Working Conditions in the Acceding and Candidate Countries (Report)*” confirms this assumption. Data obtained from this study define stress as the second largest health problem at workplace, with 22% of the human resources declaring themselves affected by occupational stress. Also, in most European states the percentage of occupational stress is ranging from 30% - 50%, in correlation with work supportability by employees.¹

Table 1 - Occupational stress among EU
(Legend: VS - Very Satisfied, PS - Pretty Satisfied; NVS - Not Very Satisfied, NS – Not Satisfied)

State	Stress	Work Supportability	Satisfaction with Work Conditions			
			VS	PS	NVS	NS
Bulgaria	51%	41%	22%	43%	22%	13%
Cyprus	45%	51%	27%	51%	17%	5%
Estonia	46%	61%	10%	61%	24%	5%
Lithuania	45%	56%	14%	54%	26%	6%
Latvia	39%	51%	17%	53%	23%	7%
Hungary	31%	48%	18%	62%	14%	6%
Malta	20%	54%	33%	49%	16%	2%
Poland	43%	54%	20%	54%	20%	6%
Romania	42%	48%	15%	53%	23%	9%
Slovenia	34%	30%	17%	48%	28%	6%
Slovakia	39%	47%	14%	57%	24%	6%
Czech	34%	56%	13%	65%	18%	3%

Source: *European Foundation for the Improvement of Living and Working Conditions, 2003.*

¹ European Foundation for the Improvement of Living and Working Conditions, 2003, *Working Conditions in the Acceding and Candidate Countries*, [http://www.protectiamuncii.ro/fop/romania/ro/pdfs/ Report on Working Conditions in EuropaEF0306RO.pdf](http://www.protectiamuncii.ro/fop/romania/ro/pdfs/Report%20on%20Working%20Conditions%20in%20EuropaEF0306RO.pdf).

Whatever the of type organizational environment, the main causes of occupational stress are generated by:

1. *Professional activity carried out in unstable conditions* – cause for job insecurity, a situation which significantly increases the degree of occupational stress among human resources;

2. *Professional dissatisfaction* - more common in times of crisis when job restructuring, development of new communications technologies and allocation of a higher number of tasks to a smaller number of employees result into a soaring level of occupational stress;

3. *Work-related hassle* - a situation that damages self-esteem, generates anxiety, depression and even suicidal attempts, caused mainly by violence and intimidation at workplace;

4. *Imbalance between personal and professional time* – caused by work overload, inflexible working hours and the inability to adjust working hours according to personal needs, with the stress arising from such circumstances adversely impacting on occupational health and on work and family life ratio.

As a consequence of the organizational situations described above, as well as of the various *physical* (noise, strong light etc.) and/or *psychosocial* stressors (a sense of difficult situations, poor communication with others etc.), human resources suffer from negative effects having a disruptive role, which may be classified into the following five categories:

A. *Physical effects*: cardiovascular disease, headaches, obesity, stroke, increased glucose level, dilated eye pupils etc;

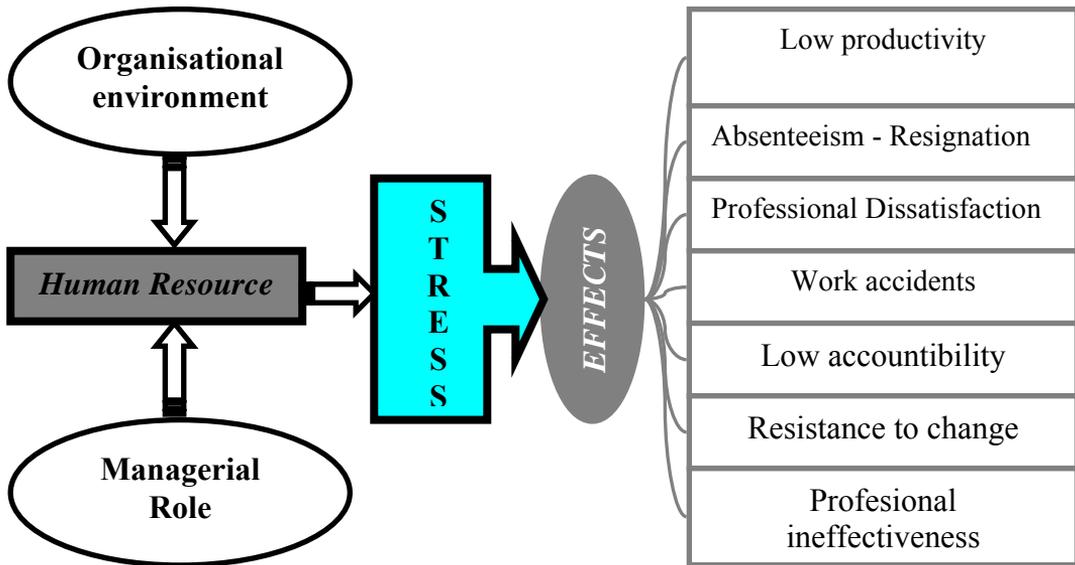
B. *Mental effects*: anxiety, apathy, depression, loss of self confidence, feelings of inferiority, frustration etc.;

C. *Behavioural effects*: predisposition to accidents, abuse of coffee, cigarettes, alcohol, aggressive and deviant behaviour, refusal to communicate with others;

D. *Cognitive effects*: diminished ability to rational decision making, poor concentration, poor attention, mental block etc;

E. *Organizational effects*: low productivity, absenteeism, professional dissatisfaction, impaired loyalty towards the organization, decreased professional accountability, sick leaves and even resignations.

Figure 1 - Effects of Occupational Stress on the Organisation



When occupational stress level is high, the negative effects mentioned above materialise at organizational and even social level in the form of economic and financial costs. A study on occupational stress conducted prior to the current economic crisis by The American Institute of Stress points out that “40% of staff replacement costs are due to stress”, which “causes losses of \$ 200-300 billion annually for the American economy² due to absenteeism, staff replacement, decreased productivity, accidents, direct medical expenses, legal costs, compensation and health insurance costs. In US, there are one million workers per business day absent from work for stress-related causes.

In the European Union, the financial cost of occupational stress is affecting approximately 40 million employees, with expenditures estimated at about “EUR 20 billion per annum”³, productivity losses exclusive.

In a throbbing social environment such as the one we are living in, the huge work overload the human resource has to handle is one of the main cause of occupational stress, with long working hours generating overstress, loss of ability to concentrate and even health problems. A study conducted by the *Finnish Institute of Occupational Health* shows that there is a link between stress caused by number of hours worked and the health of the employees, particularly heart health. The results of the study performed on a sample of 2214 subjects have revealed that employees working 11 hours a day are exposed to a 60% higher risk of suffering from a heart attack, compared with employees who work three or four hours less . It was also

² www.stress.org/job.

³ Griffiths Cox, Gonzales Rial, 2000, *Research on Work-Related Stress*, Report to the European Agency for Safety and Health at Work, Luxembourg, OPOCE.

found that those who work one hour or two over a seven-hour program do not show an increased cardiac risk⁴. At the European Union level, the highest average mandatory number of working hours per week is most common in retail industry (38.8 hours / week), followed by the chemical industry (38.6 hours / week) and the services industry (38.3 hours / week).

In Romania, according to a survey done by BestJobs in 2008 on a sample of 1660 subjects, 90% of Romanian employees do overtime work and 44.5% of them claim to have a work program of minimum 10 hours/day, with 25.8% remaining daily at work after hours doing overtime, while 29.7% working between 1 to 2 extra hours per day in addition to their mandatory work program. Also, most subjects, i.e. 56.8%, claimed that they have never been paid for overtime⁵.

Besides these causes and the macro-costs of the occupational stress, *social – interpersonal costs* are also relevant for the management of the knowledge-based organisation. Within each modern organisation there are various individuals and groups of people, whose needs and aspirations, attitudes, beliefs and lifestyles differ, in spite of their constant interacting with one another. The stability of an organization depends, amongst other factors, on maintaining an acceptable balance between all these groups. For employees, any disturbance in the organisational balance will lead to lower work efficiency, loss of career opportunities and even loss of employment, as well as to relational and/or familial tensions and depression. Often, in a lucrative environment, irritability caused by stress is transferred to the social life of the employee, where worker or manager role is inactive and unreasonable conflicting situations can be easily identified at family or relational level, as a proof of the social costs of work-related stress.

Such situations cause the organisation to incur material and temporal costs with recruiting and training new hires or training and counselling employees experiencing stress-related problems, with an adverse impact on production flow and organisation profitability / breakeven.

Profitability of a knowledge-based organization depends both on work ergonomics and employee's skills and corporate motivation system, as well as on the level of occupational stress, which affects inversely proportional work proficiency, according to the formula:

$$PP = A * M - S \quad [1]$$

where,

PP – *Professional performance*;

A – *Ability* (effect of employee's qualification, training and expertise);

⁴ Marianna Virtanen, Archana Singh-Manoux, Jane E. Ferrie, David Gimeno, Michael G. Marmot, Marko Elovainio, Markus Jokela, Jussi Vahtera, and Mika Kivimäki, 2009, *Long working hours may be a risk factor for decline in cognitive function*, *American Journal of International Epidemiology*, volume 169 (no. 5), Helsinki, Finnish Institute of Occupational Health, pp. 596-605.

⁵ <http://www.wall-street.ro/articol/Careers/48362/Noua-din-zecce-salariati-din-Romania-spun-ca-fac-ore-suplimentare.html>;

M – *Managerial motivation*;

S – *Organisational stress*.

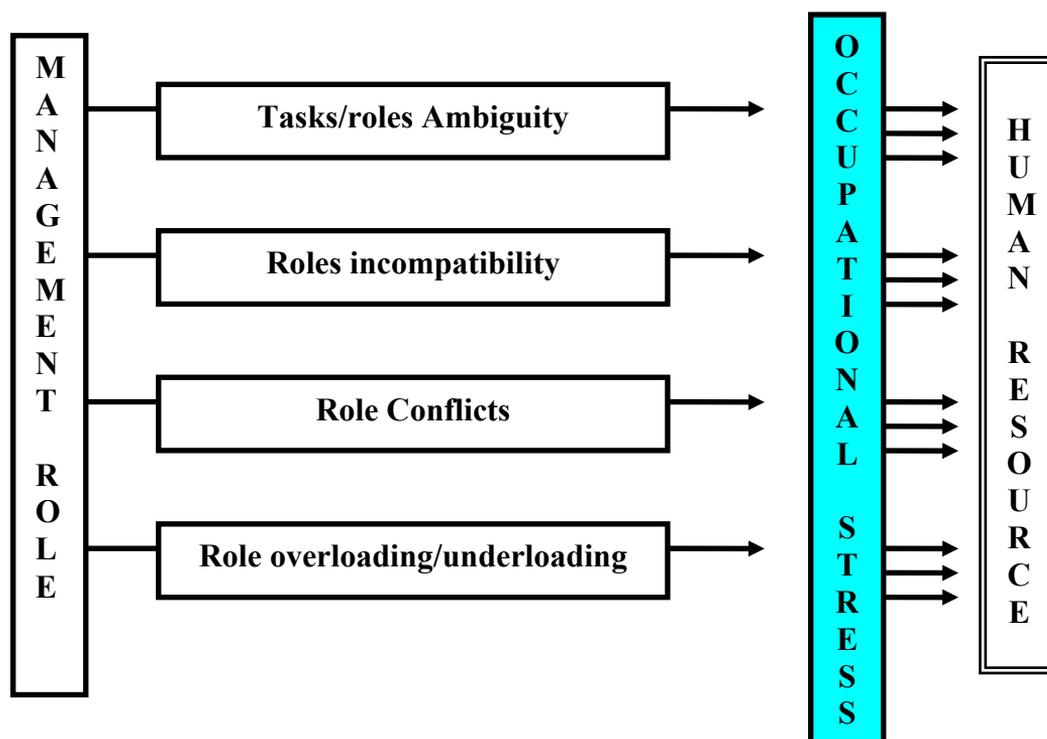
The lower the occupational stress level, the stronger the effect exerted by managerial motivation and professional capability of the human resource. In a crisis situation, an excessive amplification of the stress level may nullify the entire managerial effort designed to motivate and involve the human resource, causing lack of productivity or even bankruptcy/collapse. Managerial capability can be the key to organizational success, given that the manager is responsible for the efficiency / inefficiency of the motivational strategies or for the employees' level of professional training, which are tasks coming under the manager's specific coordination and representation powers.

Also, managerial capability does not necessarily lie in eliminating "*the scourge*", but in controlling it and in anticipating its possible consequences, along with taking specific measures to counteract, avoid or mitigate adverse effects. The manager's investment in combating occupational stress is not necessarily a financial one, which would be difficult to achieve in times of crisis, but rather an investment based on direct influence and situational adaptability, which is less costly and more effective from the professional and/or organizational viewpoint. Besides a positive managerial attitude, successful stress management programs implemented in some organizations involve specific techniques for training staff to become able to perceive any stressful situation and develop appropriate mechanisms to cope with it.

2. Managerial Investment in Organizational Stress Control

In a situation where a good choice is difficult to make, the manager's professionalism plays an essential role in raising employees' awareness and their sense of full and active involvement in attaining corporate excellence and avoiding inefficiency and professional ineffectiveness. Occupational stress is the effect of mismanagement of human resources, insofar as, besides the many different social and / or organizational causes, *managerial role and organizational climate* are crucial for avoiding tasks and roles ambiguity, incompatibility, conflict and overloading/underloading, as these are potentially stress-generating factors within the organization.

Figure 2 - Occupational Stress Factors Generated by Managerial Roles



Professional / organizational activity as such is not a stress in itself, as stress is normally the result of individual response to certain stimuli. The four organisational stressors mentioned above, whose primary cause is the managerial role, are the most frequently encountered in organizational-managerial situations - triggering stress at workplace. Absence of an adequate prognosis on the effects of such situations and lack of managerial concern for prevention of these effects can easily lead to organisational stress and professional ineffectiveness. Examining each such situation in relation with the organisational-managerial context will define its stressor “nature” as follows:

- *Roles / tasks ambiguity* - an employee occupying a position whose tasks and roles are not clearly defined will be confused about the work he/she is expected to perform and will experience ambiguity-related stress, working less effectively, which will generate dissatisfaction and increase stress levels. A similar effect occurs in case of duplication of the tasks / roles of an employee, a situation which will generate a feeling of insecurity, mistrust and irritation. Role ambiguity occurs when the employee does not know what is expected of him/her, is uncertain about his/her job responsibilities and about his/her manager's expectations. The main consequences of stress caused by role and task ambiguity are low motivation, defidelisation, poor performance of the human resource;

- *Roles incompatibility* – occurs when an employee's expectations with regard to his/ her roles and tasks differ significantly from those of his/her peers. Contradictory demands and imperatives, which do not seem appropriate and consistent with the employee's personality or his/her set of values, will generate conflicts of the *individual vs. role* type, which will ultimately result in stressful situations.

Unlike role ambiguity, in the case of a *role incompatibility* situation, the employee knows what his/her superiors expect of him/her, but the expectations concerned are incompatible with the employee's personality, skills and standards. Because of this type of conflict, the so-called *traitors* will emerge at organisation level, who will readily disclose their organization practices, thus causing significant economic losses to the organisation in the benefit of its competitors;

- *Roles conflict* - occurs when an employee has to fulfil several different, with conflicting situation generated by the request that he/she should simultaneously fulfil them all. This type of conflict is obvious when an employee does not know what expectation he/she should meet faster and better. In the course of one's professional life, the most disturbing role-related conflict is the employee vs. parent / spouse role. This conflict can be avoided only through application of an appropriate organizational motivation policy, which best meets the needs of the employee. Stress generated by role conflict will lead to poor health of employees (anxiety, depression, stress), fear and sense of hopelessness, dissatisfaction with career development, job fluctuation, early retirement or resignation;

- *Role overloading or underloading* – these are organisational situations typical for human resources working at an inadequate pace, with work-related stress being the consequence of the diversity and the quantity of the work performed (*role overload*) or of the underutilisation of the human resource within the organization (*role underload*). Stress caused by *quantitative overload* (within a given timeframe employees are required to do more work than they can actually handle) or by *qualitative overload* (employees perceive the task assigned as difficult to achieve, feeling incapable to cope with the manager's request) generates payment complaints, conflicts between work and family life, feelings of dissatisfaction etc. Also, *quantitative underloading* (employee has little work to do and experience a feeling of "boredom") and *qualitative underload* (employee feels that he/she is not used to his/her full mental potential and therefore experiences a feeling of "daily routine") are impacting on the organizational interests by reducing employees' response capacity and increasing the risk of work accidents.

All the situations described above are the effect of poor managerial strategy / attitude and are generating organisational stress, which are adversely impacting on the performance of the human resources, causing significant economic and financial costs to the organisation. These negative effects could be significantly diminished by a competent managerial "investment". Determining employees to actively involve themselves in the business of their organisation, applying efficient employee motivation and business management policies, coupled with an optimal communication, will reduce occupational stress and implicitly the rate of resignation,

absenteeism, occupational accidents, medical expenses etc., while enhancing employees' loyalty and increasing work productivity. To this end, in order to prevent occupational stress, prioritization of managerial pursuits is effectively provided only that it is based on the motivational theory developed by the American economist of Japanese origin, William Ouch, known as "Theory Z", which postulates the need for the individual attain self-achievement at workplace and the need of intersection between the employee's work environment and his/her family and social environment, a strategy which may potentially counteract the negative effects of organizational stress.

Table 2 - Stages of "Z Theory" and stressful organizational situations generated by unprofessional managerial conduct adversely impacting on the human resources

<i>"Theory Z"</i>	<i>Stressful organizational situations generated by unprofessional managerial conduct</i>
<p>Higher needs (<i>recognition, esteem, status, self-achievement</i>)</p>	<ul style="list-style-type: none"> • Lack of concern for efficient management of human resources due to exclusive orientation of the management towards economic and financial interests of the organization; • Lack of consultations with employees with regard to decisions that are concerning them; • Lack of recognition of personal merits of the employees and superficial or careless approach to the organizational issues raised by them;
<p>Increased attention paid to human resource (teamwork, decision-making by consensus, the average individual in the organization and realization of its intersection with the social environment and family, emphasizing group responsibilities)</p>	<ul style="list-style-type: none"> • Lack of social support to human resources; • Failure to build up accountability among employees or to delegate responsibilities; • Biased managerial attitude, namely the unreasonable favouring of some employees in the detriment of others, with negative impact on teamwork; • Lack of empathy for employees' personal / family issues;

<p>Increased confidence among members of the organization (job security - long-term job occupation, individual allegiance to corporate culture and his/her involvement in its development, goals setting and improved outcomes, informal control)</p>	<ul style="list-style-type: none"> • Inducing a sense of insecurity among human resources by adopting a rigid management style, with frequent reproaches / threats (job insecurity, wage loss, reward reduction /cancelation); • Failure to involve human resources in attaining company goals; • Inhibition of the cross-interaction between employees, as well as ignoring the importance of team buildings.
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Managerial investment is reflected in the manager's attitude relative to how well he/she is aware of / examines the human resources under his/her subordination and their expectations and personality, as well as to how human resource strategies are being implemented. Managers can alleviate or even counteract stress within their organization by investing their knowledge and skills in implementing methods and means of dealing with human resource issues, such as:

✓ *Defining jobs* in such a manner as to enable the employee to apply his/her own skills and judgement, assigning him/her varied tasks, which are difficult enough to maintain his/her interest active;

✓ *Designing human resource activities* to such extent that the employee attains a certain degree of responsibility and is allowed to take part in decisions impacting on the company business;

✓ *Manager-employee meetings* (quarterly or at least yearly) to discuss about employee's performance and responsibilities, expectations of the employee's superiors, as well as issues dealing with corporate objectives, employee's restrictions and expected course of action, possible support and rewards;

✓ *Encouraging communication between departments and sectors*, as well as vertical communication, along the entire hierarchical management chain, and ensuring constructive feedback to each individual (with regard to work outcomes, performance evaluation etc.)

✓ *Delegation of decision powers* so that people at every level of the organization may take part in the decisions affecting their employment and promotion opportunities;

✓ *Implementing a time management strategy* according to a clearly defined planning and prioritization made public to all employees, given that a reduction in time-off in favour of business activities is generating stress and poor productivity;

✓ *Implementing a proper motivational strategy* based on unbiased assessment of the needs of the human resources. Satisfaction of higher needs (esteem, security, social, self-achievement) enhances employee's loyalty to the company and influences his/her behaviour and drive to act in the best interest of the organization;

✓ *Promoting ergonomics at workplace*, since the pursuit of lucrative activities in a healthy environment (work space, air, light, noise etc..) is a comfort factor with

positive effects on work productivity;

✓ *Management through objectives* – employees' participation to business planning, goals setting and decision-making within their organization.

Conclusion

The impact of stress on a person can manifest in a variety of forms. Repositioning the center of gravity in the effective use of human capital that stands out the diminution or even eliminate occupational stress is par excellence the substance of economic efficiency and a measure of fertility vitally important work, which is why saving time reasonably be regarded as a last court as labor-saving and labor productivity growth as a fundamental form through which the economy of time.

Organizational success depends on the balance attained among organization members. This balance may be easily disturbed by occupational stress, frustration, dramatic drop in work productivity and efficiency, passivity, unwillingness to assume responsibility, low motivation, personal conflicts and even employees' dissatisfaction with their leaders / managers, all these being symptoms of occupational stress within the organisation. The extent to which a manager is capable to promptly identify and invest his/her own skills and abilities in trying to reduce or even counteract such symptoms is crucial for the success of the organization and for its professional/organizational performance.

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1. www.stress.org/job.

THE CAUSES OF INSURANCE COMPANIES BANKRUPTCY IN ROMANIA

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Abstract

The essential indicator of the financial stability of the insurance companies: their solvency, determines the substantial amendment of the enforcement terms of the insurer's bankruptcy procedure in reference to those imposed for the initiation of the bankruptcy procedure of the regular trading companies, even if the main general coordinates are maintained: the condition concerning the debtor's capacity and the one related to its financial situation.

The survey analyzes the bankruptcy of the insurance companies from the perspective of its main cause, the insolvency, of its specific display forms and last, but not least, from the perspective of the fundamental principles of the functioning of these special entities, by pointing out the extremely particularized features of the insurers' insolvency and, implicitly, of the cause of their bankruptcy in Romania.

Keywords: insolvency, bankruptcy, solvency, insurance companies, Solvency II.

JEL Classification: G33, K12, K22.

I. Introduction

1. Any approach of the bankruptcy of the insurance companies should consider the general characteristics of these special entities: they operate on the financial market, are regulated entities (subject to the permanent monitoring and control of the member state of origin), the risk is the defining coordinate of their activity¹, they perform activities considered to be of general interest and benefit from special legal regulations at European and national level.

These particularities of the activity of the insurance companies justified the adoption of a distinct regulation on their failure and bankruptcy as well.

For a long period of time, the insurers' bankruptcy was not considered to represent a hazard factor for the financial market, but the current stage of the protection need, the main product provided by the insurers determined the unprecedented increase and extension of the insurers' market and, implicitly, the increase of the number of natural persons and legal entities holding insurance policies.

On the other hand, the financial products diversified and thus the risks and investments of the insurance companies, their exposures, are much bigger and much

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¹ Risk notion particularities in the insurance field in: Veronica Stoica, "risk and incertitude idea in the insurance contract", in Commercial Law Magazine no. 12/20003, p.89;

more complex and the interconnection of the players on the financial market is intense.

Financial systems in the Community are closely linked and events in one Member State can have a significant impact on financial institutions and markets in other Member States. The continuing emergence of financial conglomerates and the blurring of distinctions between the activities of firms in the banking, securities and insurance sectors give rise to additional challenges at national and Community level².

Under these circumstances, the insurers' bankruptcy, especially of those holding significant shares of the insurance market, has detrimental, economic and social consequences, even independently from the bank crises and/or financial crises.

At the same time, the known risks of the banking activity, such as: panic and the systemic crises recently affect the insurance sector as well³.

The bankruptcy of the insurance companies in Romania (EUROASIG, ADAS, CROMA, GRUP AS, METROPOL CIAR⁴) and on the international market {Eurolife Assurance (International) Limited (GIB)⁵, Sprinks, Marf⁶} proved that the operational, prudential requirements are not infallible.

For this reason, according to the current conception, the insurers' bankruptcy should be avoided, but when they become a danger for the security of the system, their liquidation should be effected and be carried out so that the insurance service consumers and the public should keep their confidence in the financial market and the protection of the insurance creditors should be guaranteed.

These principles are considered by the current European regulation on the insurers' liquidation -Directive 2001/17/EC- and by the Romanian law: Law no. 503/2004 on the recovery and bankruptcy of the insurance companies⁷, in line with the principles of unity, universality and coordination of the bankruptcy procedures or, as applicable, of the winding-up procedures.

2. The essential indicator of the financial stability of the insurance companies: their solvency, determines the substantial amendment of the background conditions of the application of the insurer's bankruptcy procedure as compared to those imposed for the initiation of the bankruptcy procedure of the regular trading

² Commission Decision of 23.01.2009 establishing the Committee of European Insurance and Occupational Pensions Supervisors, Brussels, 23.01.2009, C(2009) 178 final, http://ec.europa.eu/internal_market/finances/docs/committees/c-2009-178_en.pdf;

³ Benjamin Laurent, "*Raisons Fondamentales d'une Regulation Prudentielle du secteur des Assurances*", Working Paper no. 08-020, 2008, <http://www.solvay.edu/EN/Research/Bernheim/documents/wp08020.pdf>;

⁴ Source: Insurance Supervisory Board – Guaranteeing Fund Department: <http://www.csa-fga.ro/>;

⁵ The winding-up procedure initiation resolution against Eurolife Assurance (International) Limited was published in the Official Journal of EC no. 12/January 17th, 2008, p.6, <http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2008:012:0006:0006:FR:PDF> ;

⁶ Source: Jerome Bonnard, quoted work, p.40;

⁷ According to the provisions of art. 77 in Law no. 503/2004; the provisions of this law are supplemented by the provisions of Law no. 85/2006;

companies, regulated by Law no. 85/2006 on insolvency, even if the main general coordinated are maintained: the *condition on the debtor's capacity and the one related to the financial state hereof, the insolvency state, as well as the bankruptcy procedure initiation cause.*⁸

The particularities of the causes of the application of the insurers' bankruptcy procedure, reflect the specificity of the insurers' activity and will be analyzed in this study exclusively from this perspective, derogatory from the insolvency general law.

The insurers' bankruptcy procedure regulated by Directive 2001/17/EC and Law no. 503/2004 is a special procedural, intended exclusively for the insurers and/or reinsurers, and not to the insurance intermediaries as well⁹.

Directive 2001/17/EC does not define the notion of insurers, but refers to the significance hereof granted by the European Directives regulating the insurance activity¹⁰, and Law no. 503/2004 very clearly determines the debtors to which the special bankruptcy procedure is applied: the insurance and/or reinsurance companies¹¹, Romanian legal entities (art. 2 paragraph 1 in Law no. 32/2000) - inclusively to their branches seated abroad, as well as to the subsidiaries and branches of the insurance companies in other third states, that are seated in Romania-.

As regards the condition on the financial situation of the insurance company, it should be in an insolvency state, genre concept including three particular causes of the application of the procedure to these special entities.

Consequently, the insurance company bankruptcy procedure may be applied only to the insurance companies in a state of insolvency.

Representing a topic insufficiently approached by the specialized literature, the insurers' insolvency has not always been perceived in accordance with its complex and specific significance and we will

try to analyze it from the legal and economic perspective as a useful and important step towards the good comprehension of the causes of the insurers' bankruptcy.

⁸ G.Ripert/Roblot, Philippe Delebeque/Michel Germain, *Traité de droit commercial*, Tome 2, 16^e édition, L.G.D.J., Paris, 2000, p.836; Yves Guyon, *Droit des Affaires*, Tome 2 –Entreprises en difficulté. Redressement judiciaire – Faillite, 7^e édition, Economica, Paris, 1999, p.109;

⁹ The express provision of exclusion of the insurance intermediaries: the brokers ("*registered brokers*", "*courtiers d'assurances*") and insurance agencies ("*Independent insurance agents*", "*agent general d'assurance*") in the field of application of the regulations on the insurers' bankruptcy or, as applicable, of the insurance companies is justified by the fact that they are not insurers; for the analysis of the insurance intermediaries, see: Radu N.Catana, *Insurance Law. Insurance Activity Regulation. General Theory of the Insurance Contract*, quoted work, p.61;

¹⁰ „*Insurance enterprise means the insurance enterprise having received an official authorization according to art. 6 in Directive 73/239 EEC or art. 6 in Directive 79/239/CEE*” – art. 2 letter a in Directive 2001/17/EC;

¹¹ The provisions of art. 1 paragraph 1 and art. 2 paragraph 2 in Law no. 503/2004 should be interpreted in a coordinated mode, so that we may not limit the application range of this law only to the insurance companies provided that its application on the “insurers and/or reinsurers” is specified;

II. Application Cause of the Insurance Company Bankruptcy Procedure

3. All the causes that may generate the bankruptcy of the insurance companies are reunited under the form of its insolvency state, generating all the particular causes of the bankruptcy thereof.

Definitely, *the Romanian legislative did not randomly use the insolvency notion¹², due to a perception error of the legal significance of this notion, but considering the real, purely technical or economic cause of the insurers' bankruptcy, cause that it legally consecrated for the performance of the congruence between the economic reality and the legal one.*

The insurer's solvency represents its capacity to deal with all risks or, more precisely, with the risk occurrence. We envisage the risks uncovered in the category of risks that we referred to as technical¹³ (the risks taken over from the policy holders)¹⁴ and the risks inherent to its capacity of participant in the financial market: the credit risk, market risk, subscription risk, liquidity risk, operational risk and reputation risk.

The coverage of the technical risks from the technical reserves and the fact that these technical reserves are not taken into account in the determination of the insolvency margin available to the insurer, do not represent aspects that could entail the exclusion of the technical risks from the category of risks insured by the available solvency margin.

From the economic perspective, the specificity of the insurer's activity is that of the "production cycle reversal" in the sense of the service pricing (the value of the insurance premiums) upon the conclusion of the insurance contract and the subsequent determination of the actual cost of the services ulterior, upon damage occurrence.

For this reason, the initial estimations of the price of the services may not correspond to the actual price thereof, this aspect being assimilated to the subscription risk¹⁵, uncovered by the technical reserves, but from the insurer's net assets.

¹² In the same sense, also see: Radu N.Catana, Insurance Law. Insurance Activity Regulation. General Theory of the Insurance Contract, quoted work, p.86;

¹³ In the same sense: Gheorghe Bistriceanu, Insurance system in Romania, Ed. Economica, Bucharest, 2002, p.412;

¹⁴ Recent economic analyses establish a classification of the main 10 risks of an insurer, among which: the demographic amendments or shifts from the specific market, climate changes and natural calamities, markets of the countries newly entered in the market economy, diversification of the distribution channels, intervention of new regulations and other. In this respect, see: Ernst & Young, „Strategic business risk 2008 – Insurance”, [http://www.ey.com/Global/assets.nsf/International/Industry_Insurance_StrategicBusinessRisk_2008/\\$file/Industry_Insurance_StrategicBusinessRisk_2008.pdf](http://www.ey.com/Global/assets.nsf/International/Industry_Insurance_StrategicBusinessRisk_2008/$file/Industry_Insurance_StrategicBusinessRisk_2008.pdf);

¹⁵ The subscription risk is the risk of recording losses or of non-obtaining of profits estimated because of the inappropriate determination of the premium fees and/or of the technical reserves, as compared to the undertaken obligations and which may result, without limitation, from frequency fluctuations and the severity of the insured events in reference to the estimations upon subscription –art. 1 item 4 in the Norm implemented by the C.S.A Order. no. 18/September 16th, 2009, published in the Official Journal, Part I no. 21/September 16th, 2009;

The insurer's liquidity risk is deeply related to the technical reserves, as the assets admitted to cover these reserves are mainly liquid assets.

On the other hand, the insurer's solvency is measured by reporting the available solvency margin to the minimal solvency margin¹⁶ or the minimal theoretical margin¹⁷ and the minimal solvency margin determination methods consider either the value of the subscribed gross premiums or the annual average of the paid gross damages.

4. The current mode of determination of the insurer's solvency margin - according of the European norms known as Solvency I - does not fully comply with the prudential requirements, considering the fact that, in the determination hereof, the representative factor of the commitments and the activity volume are taken into account, and not the undertaken risks¹⁸.

Solvency II₂ project initiated in 2001 by the European Commission, materialized in Directive 2009/138/EC of the European Parliament and of the Council as of November 25th, 2009 on the access to the activity and the performance of the insurance and reinsurance activity (Solvency II)¹⁹, restructures the conception on the insurers' solvency, according to the banks' solvency model.

The structure of Solvency II project, instituted on the template of Basel II Agreement, considers 3 landmarks: *The first refers to the calculation of the technical reserves (provisions) and equities; the second landmark to the supervisory rules; and the third landmark regulates transparency and the dissemination of the information to the insurers.*

As regards the insurers' solvency, Solvency II analyzes and regulates the equities from the perspective of two levels: the solvency capital and the insurers' minimum capital.

The equities are intended to cover 4 types of risks: the credit risk, payment risk, subscription risk (characteristic of the general insurances and of the general ones) and the operational risk whereas each type of risk comprises as well the technical risks uncovered by the technical reserves.

The solvency capital of the Solvency Capital Requirement (SCR) will have a level of alert of the control authorities, that will indicate the difficulties faced by the insurance company as well as the necessity to apply the recovery measures, and it is intended to absorb the unexpected significant losses and the providing of the payment performance guarantee during these periods²⁰.

¹⁶ The reporting of the solvency margin available in the security fund, encountered in one of the particular causes of the insurer's bankruptcy considers the exception situation and not the rule;

¹⁷ Antigono Donati, Giovanna Volpe Putzolu, *Manuale di diritto delle assicurazioni*, Giuffrè Editore, Milan, 2006, p.55;

¹⁸ Benjamin Laurent, "*Solvency II: Avances des travaux; Solvency II – Where do we stand?*", p.5, *Revue Bancaire et Financier* no. 2/2007, <http://ideas.repec.org/p/sol/wpaper/06-022.html>;

¹⁹ Directive 2009/138/EC of the European Parliament and of the Council as of November 25th, 2009 on the access to the activity and the performance of the insurance and reinsurance activity (Solvency II), published in the Official Journal of the EU L 335/December 17th, 2009;

²⁰ Benjamin Laurent, "*Solvency II: Avances des travaux; Solvency II – Where do we stand?*", *quoted work*, p.10;

❖ i). Insurers' Insolvency

5. The correct comprehension of the solvency of the insurance companies creates the premises of the detection of the essential aspect of the solvency of these entities, namely of the difference between the usual significance of the solvency of the regular trading companies²¹ and the significance of the insurers' solvency.

In fact, the solvency of the insurance company indicates the insurer's capacity to cover the unexpected losses.

Thus, an insurer is solvable if the equity capital - available solvency margin (as the positive difference between the total assets and liabilities) is at least equal to the necessary equity capital determined by mathematic and probabilistic calculations - minimal solvency margin.

The insurer's insolvency indicates an increased risk of incapacity of unexpected (current and possible) loss coverage, and hereby of payment of its liabilities (certain and possible in the future) and should be understood independently from the patrimonial unbalance: the liabilities exceeding the assets.

For this cause, insolvency represents the general cause of application of the insurer's bankruptcy procedure.

Starting from this insolvency significance, according to the law, insolvency state is that state of the insurance company characterized by one of the following situations:

- a) obvious incapacity of payment of the exigible debts using the available funds;
 - b) decrease of the value of the available solvency margin below half the minimal limit stipulated by the applicable legal regulations for the security fund;
 - c) impossibility of recovery of the financial situation of the insurance company within the financial recovery procedure (art. 3 letter j in Law no. 503/2004).
- All these situations constitute manifestation forms of the insurer's insolvency, particular cause of initiation of the bankruptcy procedure²².

❖ ii). Insurers' Insolvency Forms

A) Valid Insolvency of the Exigible Debts by Cash (Liquid Fund Crisis)

6. This form of insurer's insolvency is the correspondent of the insolvency state in the general insolvency regulation and we find, in this cause of the insurers' bankruptcy, the conditions of the insolvency in the general regulation: incapacity of payment and non-payment of the due dates so that we will reveal herein below only

²¹ Patrimonial balance or the equality situation of the patrimonial assets and liabilities;

²² In the same sense: Radu N. Catana, Insurance Law. Insurance Activity Regulation. General Theory of the Insurance Contract, quoted work, p.87;

the specific aspects thereof.

As resulting from the text of art. 3 letter j item 1 in Law no. 503/2004, the defining elements of the insolvency of the insurance company are *the non-payment of the exigible debts and the obvious payment incapacity.*

The prudential requirements dedicated to the insurer's liquidity and its situation in reference to these requirements constitute the specific aspects of the insurer's insolvency in a manner that is similar to the one encountered in terms of banks. The importance of these aspects is revealed particularly under the aspect of proving the existence of the insurer's insolvency.

The insurer's activity is subject to the liquidity risk²³ and, for this reason, the prudential norms determine the coverage modes of this risk by regulations on the insurer's financial investments and by the establishment of the liquidity coefficient as a criterion of the determination of the insurer's capacity to cover the liquidity risk.

The liquidity coefficient represents²⁴ the ratio of the insurer's liquid assets²⁴ and short-term liabilities towards the insured and indicates the liquidity risk coverage degree.

In this respect, the insurer is bound to have the liquidity coefficient for the general insurance activity and for the life insurances of at least 1 (one)²⁵ situation in which the value of the liquid assets is equal to the quantum of the short-term liabilities.

According to the law, the insurer's short-term liabilities towards the insured are represented by the gross damage reserve but, on the one hand, this reserve is constituted by the insurer under the form of assets as well and, on the other hand, the insurer's exigible debts consider other liabilities too, not only the ones towards the insured.

Under these circumstances, the same as in the case of the regular trading companies, *the available funds consider first the cash, the operational cash-flow provided by the funds generated by the subscription operations and the incomes obtained from investments*²⁶.

²³ The liquidity risk represents the possibility of recording losses or of non-obtaining of estimated profits resulted from the insurers' impossibility to capitalize assets to honor at any moment and with reasonable the short-term payment obligations or from the difficult collection of the receivables in the insurance /reinsurance contracts - art. 1 item 8 in the CSA Norm as of September 7th, 2009 on the organization principles of an internal control and risk management system, as well as the organization and the development of the internal audit activity in insurers /reinsurers, published in the Official Journal, Part I no. 621/September 16th, 2009;

²⁴ The following are considered liquid funds: government bonds and bonds issued by the public administration authorities, bank deposits, cash in bank accounts and cashier's office, transferable securities traded on regulated and supervised markets, equity securities in collective investment bodies in transferable securities;

²⁵ Art. 5 paragraph 6 in the Norm implemented by the CSA Order no. 113130/2006 as amended by the CSA Order no. 17/November 5th, 2008 published in the Official Journal, Part I no. 762/November 11th, 2008; art. 7 paragraph 6 in the Norm implemented by the CSA Order 113131/2006 as amended by the CSA Order no. 18/November 5th, 2008 published in the Official Journal, Part I no. 762/November 11th, 2008 ;

²⁶ Dan Anghel Constantinescu, quoted work, volume I, p.371;

The insurer may resort, at any moment, to its liquid assets to honor its exigible liabilities, without this indicating the insufficiency of the available funds.

But, a liquidity coefficient below the one determined by the prudential norms indicates the liquidity crises or the imminence of the insurer's liquidity crisis.

The incapacity of payment representing the insufficiency of the available funds²⁷, equivalent to the liquidity crises of the "cash incident", does not represent an element sufficient to determine the occurrence of the insurer's insolvency state.

The insurer's liquidity crisis may only be overcome by the injection of liquidities obtained from the sale of assets, loans and others

The insurance company should be in valid incapacity of payment, of obtaining sufficient available funds for the payment of the exigible debts respectively, when it is impossible for it to overcome the liquidity crisis.

Among the most recent and significant examples, we indicate that of the American International Group.Inc (AIG), one of the biggest international insurers which, in September 2008, declared its liquidity crisis and requested support from the State to prevent its bankruptcy. The liquidity crisis could be overcome by the loan amounting to 85 billion US\$ granted by the American state - United States Federal Reserve.

A last specification needs to be made as regards the nature and quantum of the insurer's exigible debts that it cannot pay.

The failure of the legal standing of the insurance creditors to formulate a petition of the initiation of the insurer's bankruptcy procedure may not indicate the exclusion of the debts generated by the insurance contracts from among the debts considered upon the establishment of the insurer's insolvency state.

When the insolvency is invoked and proved by the debtor insurance company all its debts are taken into accounts: civil, commercial, fiscal, salary and others, therefore including the ones resulted from the insurance contracts.

The minimum quantum of the exigible debts, other than the ones resulted from insurance contracts, should be compliant with the threshold value determined by the general insolvency regulation: 30.000 lei Ron and the equivalent of 6 minimal wages per economy in terms of salary debts.

7.The insurance company may request the initiation of the bankruptcy procedure within 20 days of the intervention date or, as applicable, of the creation of the insolvency state (art. 29 paragraph 2 in Law no. 503/2004).

This situation is similar to the one in the regulation of the banks' bankruptcy by the indication of two distinct moments for the calculation of the interval within which the insurer is bound to request the initiation of the bankruptcy procedure: *a) as of the insolvency intervention date ; b) as of the insolvency state creation date.*

Thus, *the distinction is made between the current and imminent insolvency, both insolvency*

²⁷ Stanciu D.Carpenaru, Roman Commercial Law Treaty, Ed. Universul Juridic, 2009, p.708;

types representing causes of the insurer's bankruptcy.

Beyond this specification, the two insolvency types present interest only in case of the insurer's insolvency manifested under the form of its insolvency, as regulated in art. 3 letter j item 1 in Law no. 503/2004.

And this because the insurer is not entitled to request the initiation of the bankruptcy procedure when it is in the insolvency manifested under the forms set out in art. 3 letter j item 2 and item 3 in Law no. 503/2004 respectively in the insolvency crisis or in impossibility to recover the financial situation within the financial recovery procedure.

The significance of the imminent insolvency state granted by art. 3 item 1 letter b in Law no. 85/2006²⁸ presents gradations in the case of insurers as *its debts exigible in the future are not precisely known*. They are anticipated based on the actuarial calculations.

Obviously, the insurer's imminent insolvency adverts to its liquidity coefficient. If this coefficient drops below 1 (one), the insurer is in imminent insolvency.

This situation indicates the fact that the insurer will be in incapacity to pay its forecasted exigible debts using the available funds.

Insolvency supposes the valid incapacity of payment of the exigible debts using the available sums of money²⁹ so that the obvious character of the payment incapacity characterizes the insurer's imminent insolvency as well.

By the *obvious* character of the imminent payment incapacity we understand *the obvious inability of payment, the impossibility to successfully deal with the liquidity crisis*, to obtain liquid funds in view of regaining the balance of the liquidity coefficient.

The insurer's imminent insolvency is not manifested on the outside and may be invoked only by the debtor insurance company.

As regards the obvious insolvency or the obvious imminent insolvency, it represents a fact, so that in principle, the proof of the insurer's insolvency may be provided by any testimonial means set out in art. 46 in the Commercial Code

The issues raised by the proof of the insurer's insolvency under the aspect of the scope of evidence and of the testimonial means are, to a large extent, similar to those in the general insolvency regulation and we will approach herein below only the derogatory aspects, specific to the insurers' bankruptcy.

Firstly, the demand of the bankruptcy procedure initiation made by the insurance company does not represent an acknowledgement of the insolvency state.

On the other hand, we consider the additional conditions stipulated by law for the admissibility of the demand of bankruptcy procedure initiation formulated by the insurance company or by its creditors, other than the insurance creditors: *"the Insurance Supervisory Board communicated by a statement of defence that there are no actual*

²⁸ Insolvency is imminent when proven that the debtor will not be able to duly pay the contracted exigible debts, by the cash available on the maturity date;

²⁹ Stanciu D. Carpenaru, Roman Commercial Law, Ed.5, All Beck Printing House, Bucharest, 2004, p.585;

possibilities of recovery of the company's financial situation and of payment of the debts to all its creditors within a financial recovery procedure" –art. 31 paragraph 2 letter b in Law no. 503/2004.

Consequently, the confirmation of the insolvency of the impossibility to successfully deal with the liquidity crisis is necessary, by the Insurance Supervisory Board, authority certifying the insolvency existence.

And last but not least the insolvency presumption: "*insolvency is presumed as being obvious when the debtor, 30 days after the maturity date, failed to pay its debt towards one or several creditors*" instituted by art. 3 item 1 letter a) in Law no. 85/2006, is applicable in the insurers' bankruptcy as well, with the specification that this presumption may be reverted by the Insurers' Supervisory Board, if it indicated by statement of defence it indicates the existence of the possibility of the insurer's financial recovery within the financial recovery procedure.

B). Decrease of the available solvency margin value below half the minimal limit stipulated by the legal regulations for the security fund (solvency crisis)

8. The insurer's financial stability, a priority of both the insurer and the supervisory board, is mainly provided by the appropriate coverage of the risks undertaken and guaranteed and of those afferent to its investment activity.

Thus, the insurer is bound to cumulatively the paid share capital and the minimal solvency margin.

In fact, the insurer is bound to hold, at any moment, the available solvency margin³⁰ at least at the level of the minimal solvency margin calculated for each operated class of insurances.

The minimal solvency margin – net assets necessary to cover the losses – is calculated according to the Norms implemented by the CSA Order no. 3/2008 and the CSA Order no. 4/2008.

Essentially, for the general insurances, the minimal solvency margin is determined either by reference to the value of the gross premiums subscribed over the last 12 calendar months, or by reference to the annual average of the gross damages paid over the last 36 calendar months.

For the life insurances, the minimal solvency margin represents a certain percentage of the mathematical reserves.

³⁰ *The overall assets items free of any liens, except for the non-tangible assets correspond to the available solvency margin – art. 2 paragraph 2 in the CSA Norms on the calculation methodology of the solvency margin available to the insurer operating general insurances, of the minimal solvency margin and of the security fund, implemented by the CSA Order no. 3/April 24th, 2008, published in the Official Journal, Part I no. 346/06.05.2008 and art. 2 paragraph 2 in the CSA Norms on the calculation methodology of the solvency margin available to the insurer operating life insurances, of the minimal solvency margin and of the security fund, implemented by the CSA Order no. 4/April 24th, 2008, published in the Official Journal, Part I no. 346/06.05.2008, as both CSA Norms have been amended by the CSA Order no. 12/July 24th, 2009 published in the Official Journal, Part I no. 543/August 5th, 2009;*

The available insolvency margin representing the positive difference between the assets and the liabilities – certain and the ones that may materialize in the future (net assets)³¹, the insurer's capacity to cover its losses without resorting to the equity should exceed or at least be equal to the minimal solvency margin.

According to the law, one third of the minimal solvency margin should constitute the *security fund* that should have a minimal value equivalent to 3.5 million Euro for the life insurance and a minimal value equivalent to 2.3 million Euro for the general insurances. If the insurer subscribes one or several risks ranged in classes 10, 11, 12, 13, 14 or 15 set out in title B "General Insurances" in appendix no. 1 to Law no. 32/2000³², with the subsequent amendments and supplements, the minimal value of the security fund will be the equivalent in lei of 3.5 million Euro³³.

Thus, as said, the available solvency margin represents the main indicator of the insurer's financial health, its capacity to cover the unexpected losses so that its decrease below the minimal value set out by the prudential norms (below the value of the minimal solvency margin) indicates financial problems of the company, under the form of solvency crisis.

Under these circumstances, the decrease of the solvency margin below half the minimal limit set out by the legal regulations for the security fund indicates a profound solvency crisis, an irremediably compromised financial situation requiring the initiation of the bankruptcy procedure.

This form of the insurer's insolvency may be accompanied or not by a liquidity crisis and may be independent from the actual ratio of the insurer's assets and liabilities.

The possibility that the future debts, unpredicted loss may not be covered is maximal and, for this reason, the solvency crisis represents the cause of application of the insurer's bankruptcy procedure.

The insurer's insolvency, under the form of the solvency crisis will be provided by the Insurance Supervisory Board by specific documents: the financial statement, financial reports and others, and the scope of the evidence is represented by the value of the insurer's solvency margin below the minimal limit set out by the applicable regulations for the security fund.

C). Impossibility of Recovery of the Financial Situation of the Insurance Company within the Financial Recovery Procedure

9. The insurance companies having a difficult or non-regulatory situation will be subject to specific recovery and/or reorganization measures in view of the avoidance

³¹ Dan Anghel Constantinescu, Insurance Treaty, Volume II, quoted work, p.361;

³² The civil liability insurances for motor vehicles, civil liability insurances for the means of air transport, civil liability insurances for the means of sea, lake and river transport, general civil liability insurances, credit insurance and security insurances are considered;

³³ According to the provisions of art. 9 paragraph 2 in the Norm implemented by the Order of the Insurance Supervisory Board no. 3/2008;

of the insolvability or of its insolvency, in fact in order to avoid bankruptcy.

The financial recovery procedure represents the entirety of the modes and measures having an administrative character disposed by the Insurance Supervisory Board, as relevant authority, which are intended to maintain or reestablish the financial situation of an insurance company.

The recovery of the insurance companies is an insurers' recovery procedure and not a reorganization one, as the latter is defined by the general insolvency regulation or the European legislation wherein it is indicated that the insurance companies in difficulty may be subject to distinct procedures: of recovery and of reorganization.

In all cases, the insurers' recovery or reorganization is characterized by the absence of the insurer's insolvability or insolvency state as, in terms of the special trading companies, the insolvency or insolvability state indicates the impossibility of financial recovery and initiation of the bankruptcy of these companies.

The causes of the application of the financial recovery procedure are common to both procedure accomplishment modes: based on a recovery plan and by special administration.

According to the law, the insurance company initiates the financial recovery procedure when:

➤ the insurance company fails to present the Insurance Supervisory Board, within 48 hours of the latter's request, with the financial situation and the minimal solvency margin and when the non-observance of any other legal provisions related to the insurance activity is ascertained, endangering the honorable fulfillment of the obligations undertaken towards the insurance creditors;

➤ the value of the available solvency margin decreases below the minimal limit set out by the regulations issued by the Insurance Supervisory Board;

➤ the value of the available solvency margin decreases below the minimal limit set out by the legal regulations for the security fund (art. 7 in Law no. 503/2004).

All the causes of initiation of the recovery procedure indicate the positioning of the insurance company outside the range of the prudential, operational requirements. It is in the insolvency risk situation.

Statistically, the insurance company may survive with an available solvency margin lower than the minimal solvency margin or lower than the minimal legal value of the security fund (without the value of the available solvency margin decreasing below half the minimal value of the security fund), but the activity performed under these circumstances is affected by an increased insolvency risk, which is unacceptable for the insurance market.

By exception, the insurer's precarious financial situation is presumed when the insurer fails to comply with the request of the Insurance Supervisory Board to present its financial situation - in a broad sense – indicating all the basic elements of its stability (the financial situation and the available solvency margin).

The right of the Insurance Supervisory Board to estimate the financial situation of an insurance company beyond the used classical elements (the available solvency margin and the security fund) *is revealed by its possibility to decide on the application of the recovery procedure in all the situations on which the insurance company, by the non-observance of the legal provisions, endangers the honorable fulfillment of the obligations undertaken towards the*

insurance creditors.

Consequently, the recovery procedure may also be initiated as a consequence of the non-observance of the liquidity indicator, of risky investment policies, of the non-compliance of the requirements on the type of assets wherein the security fund and others should be found.

Thus, the range comprising the cases determining the application of the recovery procedure of the insurance companies is much broader, the law providing the basic criteria of its determination.

10. The Insurance Supervisory Board disposes the initiation of the recovery procedure by motivated resolution wherein the financial recovery form applicable to the insurance company in difficulty is indicated: recovery based on a recovery plan or recovery by special administration, procedure intended to reestablish the insurer's operational balance.

The impossibility of recovery of the insurer's financial situation within the financial recovery procedure results in the adoption of the CSA resolution whereby the procedure closure, the withdrawal of the insurer's operation authorization and, as applicable, the revocation of the special administrator are disposed.

If the insurance company was subject to recovery by special administration, the CSA resolution of procedure closure and withdrawal of the operation authorization will have as grounds the reports of the special administrator, whereby it is ascertained that the conditions for the recovery or for the maintenance of the financial situation of the insurance company are not met.

If the insolvency state of the insurance company is ascertained, the registration of the petition of initiation of the insurer's bankruptcy procedure is also decided by the resolution of the financial recovery procedure closure.

The recovery procedure based on a recovery plan or recovery by special administration is intended to reestablish the insurer's operational balance and *the failure to fulfill this objective by specific recovery measures applied in the regulated framework of the administrative procedure of financial recovery corresponds to the insurer's impossibility of recovery, particular cause of the application of the insurer's bankruptcy.*

The proof of the impossibility of recovery of the financial situation of the insurance company within the recovery procedure supposes firstly proving the initiation of the insurer's financial recovery procedure by resolution of the Insurance Supervisory Board (in any of the accomplishment modes of this procedure).

Last but not least, the company's impossibility of financial recovery within this recovery procedure and the insurer's insolvency should be proven as well.

In this respect, according to the provisions of art. 15. letter c), art. 21 paragraph 1 letter b) and art. 32 paragraph 2 letter b) in Law no. 503/2004, the CSA resolution of elaboration of the petition of initiation of the insurer's bankruptcy procedure is based not only on the failure of the financial recovery procedure, but also on the insurer's

insolvency³⁴, that should be ascertained by this resolution.

III. Conclusions

11. The causes of the application of the bankruptcy procedure of the insurance companies substantiates on the irremediably compromised financial situation.

In the general insolvency regulation, the case of the insolvency procedure application: the insolvency state is not similarly estimated, taking into account the fact that the regular companies are provided with the possibility of the judicial reorganization of the activity.

Law no. 503/2004 opted for the insolvency state as a basic conditions, the cause of the application of the insurance company bankruptcy procedure, considered as genre concept containing three particular causes of application of the bankruptcy of this special trading company: termination of payments (liquidity crisis), insolvency (solvency crisis) and the impossibility of financial recovery.

Insolvency under the form of the liquidity crisis is the common cause of the initiation of the bankruptcy procedure of the insurance companies and regular trading companies.

But, due to the specificity of the insurance activity and to the condition of the obvious character of the incapacity of payment of the exigible debts by the available funds, in this situation, the cause of the application of the bankruptcy procedure is the impossibility to successfully deal with the insolvency, to overcome the liquidity crisis.

The insurers' insolvency as a particular cause of the application of their bankruptcy procedure is not related to the traditional significance of insolvency: the patrimonial liabilities exceeding the patrimonial assets.

The value of the insurer's available solvency margin indicates the coverage degree of the main risks and not the coverage degree of the debts /liabilities.

Insolvency under the form of the insurer's solvency crisis does not indicate liabilities exceeding the assets, but the fact that it faces the incapacity of covering its risks, i.e. the possible losses that could be generated by the occurrence of the main risks of the insurance activity (excluding the insurer's technical risks) and, obviously, is not manifested towards the exterior.

This cause of application of the insurers' bankruptcy is specific of these special procedures, insolvency not being the cause of the application of the insolvency procedure to the common trading companies.

The impossibility of the insurer's financial recovery by means of the recovery procedures represents the ultimate cause of the application of their bankruptcy procedure and it is specific of this special bankruptcy procedure as well.

³⁴ The insurer's insolvency forms considered herein may only be the ones set out in art. 3 letter j item 1 and item 2 in Law no. 503/2004;

The particularities of all the insurers' insolvency forms justify not only their special regulation, but also a better legal regulation.

The elimination of the use of the insolvency notion as a genre notion and as cause of the insurer's bankruptcy, and the express indication as causes of their bankruptcy of the three real causes of the insurers' bankruptcy (indicated at present as insolvency forms) are necessary.

The causes of the insurers' bankruptcy substantially deviate from their current significances, as encountered either in the general insolvency regulation or in the specialized literature dedicated to the general insolvency regime and are mainly determined by the necessity to approach the insurers' insolvency from the economic and legal perspective, in accordance with the extremely special characteristics of their activity.

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ACTS OF TAX EVASION AND FRAUD AND FINANCIAL IMPACT OF THESE PHENOMENA IN THE EUROPEAN UNION

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Abstract

Tax evasion has always been one of the most serious problems a country is facing, regardless of its level of development. At EU level, the situation is no different, largely due to lack of legislation to regulate this phenomenon. However, major reform efforts made in recent years by all Member States and EU bodies have brought additional clarity.

Keywords: *tax evasion, tax fraud, financial impact, suspected fraud, EU,*

JEL Classification: G28, H26

Introduction

Tax evasion is one of the economic and social phenomena of the utmost importance. In the context of strengthening international economic cooperation and development between states with different tax systems, tax evasion occurs worldwide. Unfortunately, what can be done effectively in this area is limiting this phenomenon at the maximum possible, as it is virtually impossible to eradicate it.

The international *geography* of tax evasion shows the global spread of the phenomenon that includes all countries, whether highly developed or developing states, situation which is found in the European Union as well.

Tax evasion has a critical evolution determined by the action of several factors, such as taxation levels, the dynamics of the real economy, the institutional and legal frame and other internal and external factors. The escapist phenomenon is very complex. Therefore, it has to be monitored at all times to be fought.

In the EU a department has been established for the education and informing Member States and their taxpayers, in connection with the proper preparation of tax returns and keeping of accurate work-related records. Also, they

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are informed in connection with sanctions and penalties applicable to those who violate the law.

The EU budget is an anonymous funding source. It represents the joint effort and commitment of Member States and EU citizens to turn their vision into reality by supporting economic and social solidarity, promoting research, technological development and training and promoting sustainable development worldwide.

The Commission and Member States coordinate their measures to protect the EU budget and to fight fraud and other illegal activities affecting it. Indeed, Member States should be as rigorous in protecting the EU budget and controlling expenditure in national budgets.

Member States are in proper position to fulfill this role. National authorities are in fact responsible for the supervision and daily management of the greater part of the Community budget, approximately 80% of the EU's annual budget. The Commission has a general supervisory role, setting standards and conformity assessment. Major reform efforts made in recent years have brought additional clarity regarding the roles of authorities concerned, and, through increased vigilance at all levels, sound financial management of EU funds is improving gradually throughout the EU.

During recent years, tax evasion has been one of the most serious problems in the economy of any country, whether developed or developing. With the EU creation and enlargement, this phenomenon has seen an upward trend, given in part to the absence of legislation to regulate the situation.

Thus, all EU Member States together with its governing bodies are trying to fight this phenomenon of fraud. The European Commission has a general supervisory role, setting standards and conformity assessment. Major reform efforts made in recent years by all Member States and EU bodies have brought additional clarity. Thus, the bodies of the Union provide detailed statistics on irregularities and suspected fraud and exchange information on the quality and speed of data concerning irregularities affecting the EU budget.

Although tax evasion is not legislated at EU level, the Community legislation compels Member States to report suspicions of fraud and other detected irregularities, affecting the Communities' financial interests. But precisely in this context, it is important to distinguish between fraud and other irregularities. An irregularity is any infringement of a Community provision by an economic operator who may or might harm the Communities' financial interests [Regulation (EC, Euratom) no. 2988/95]. Fraud is a wrongdoing committed intentionally, which represents criminal offense [Convention on protection of the European Communities' financial interests, OJ C 316, 27.11.1995].

In 2007-2008 the situation per areas where Member States implement the budget, is described as follows:

Area	Number of reported irregularities		Total financial impact of such irregularities, including suspected fraud (million of Euros)		Assessed financial impact exclusively for suspected fraud (million of Euros)	
	2007 ²	2008	2007 ³	2008	2007	2008
Agriculture (FEOGA and FEADR)	1 548	1 133	155	102,3	44,8 (~0,1% of allocated funds)	4 (0,01% of allocated funds)
Structural funds and Cohesion Fund	3 756	4 007	804	585,2	141 (~0,31% of allocated funds)	57 (~0,11% of allocated funds)
Pre-accession funds	332	523	32	61	5 (~0,38 % of allocated funds)	13 (~0,9% of allocated funds)
Direct expenditure	411	932	33	34,7	18,1 (~0,17% of allocated funds)	3,2 (~0,03% of allocated funds)
Total expenditure	6 047	6 595	1 024	783,2	208,9 (~0,22% of expenditure in all four areas)	77,2 (~ 0,07% of expenditure in all four areas)
Own resources ⁴	6 097	5 344	401	351	130,78 (~0,81% of total value of own resources ⁵)	75 (~0,46% of total value of own resources)

Source: Commission's Report to the European Commission and Council.

“Protection of the Communities' financial interests – Fight against fraud – Annual Report 2008”

We consider interesting to present the situation for each area in 2004-2008 for a better understanding of how tax evasion occurs in the European Union and the measures it has adopted as regards tax fraud cases.

Agricultural expenditure (European Agricultural Guarantee Fund and the European Agricultural Fund for Rural Development)

Irregularities reported in the case of agricultural expenditure were on a downward trend compared to 2007; their percentage in 2008 was 27%. Of these, 7% of them are suspected fraud, registering a downward trend. The estimated financial impact was 4 million Euros.

² For certain areas, the statistics has been updated following the 2007 report

³ Idem

⁴ Customs duties and farming tax

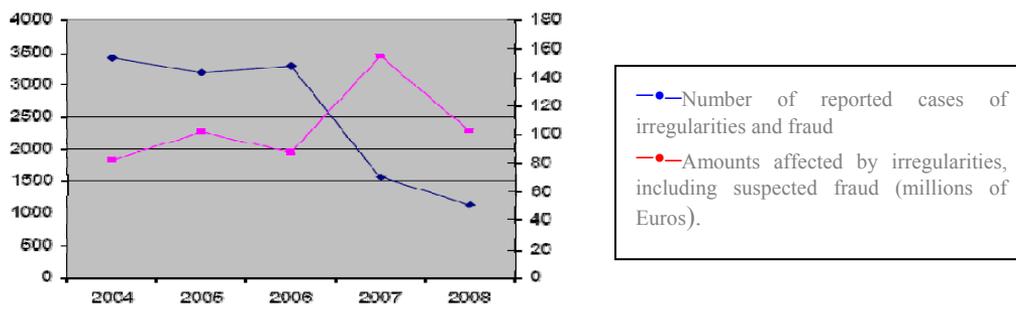
⁵ This percent is calculated based on own traditional assessment in the 2008 general budget and not based on accounting records.

The most affected areas were fruit and vegetable sectors, rural development and the vineyard production sector. Together, they represent more than 70% of the total amount affected by the large number of irregularities as shown in Chart No.1.

Chart 1: Number of irregularities and estimated financial impact – agricultural expenditure – 2004- 2008

Number of cases

Amounts affected by irregularities



Source: Commission's Report to the European Commission and Council.
 "Protection of the Communities' financial interests – Fight against fraud – Annual Report 2008"

The European Union has provided under Article 32 of Regulation (EC) no. 1290/2005 of the Council, the implementation of an automatic mechanism for checking the amounts unduly paid. If a Member State does not recover from the beneficiary an amount unduly paid within four years after the first act of administrative or judicial finding (or eight years from bringing an action in a national court), 50% of the unrecovered amount is supported by the relevant Member State budget, within the annual check of EAGGF and EAFRD accounts.

Since 2008, the European Union has imposed more drastic measures according to which, if improper payments are the result of administrative errors committed by national authorities, the entire amount is deducted from the annual accounts of the concerned paying agencies and therefore excluded from the Community financing.

Because of this mechanism of "50-50" checking that has been applied in recent years by charging some of the unrecovered amounts to Member States, the amount outstanding to the EU budget was reduced to approximately 900 million Euros.

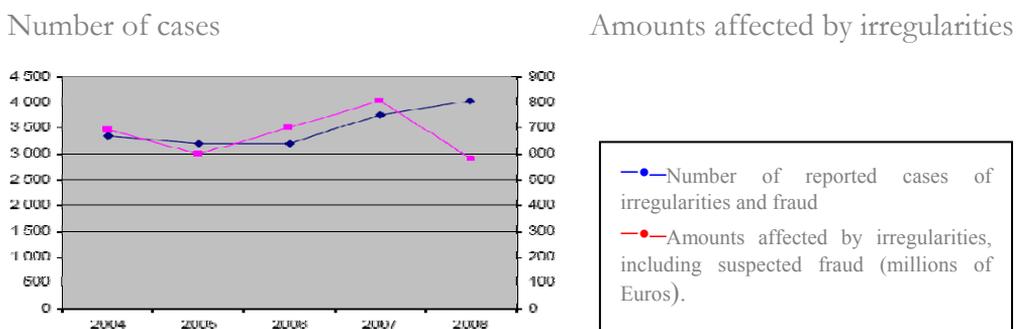
Structural Funds and the Cohesion Fund

As regards Structural Funds and the Cohesion Fund, the number of reported irregularities increased by 6.7% in 2008 compared to the previous year, while their

financial impact declined by 27%. Suspected fraud accounted for 7.4% of irregularities communicated, with an estimated financial impact of 57 million Euros, on a downward trend compared to 2007.

As in previous years, the highest number of irregularities was reported by the European Regional Development Fund and the European Social Fund (approximately 88% of irregularities - see chart no. 2).

Chart 2: Number of reported irregularities and estimated financial impact – structural measures – 2004 – 2008



Source: Commission's Report to the European Commission and Council.

“Protection of the Communities’ financial interests – Fight against fraud – Annual Report 2008”

As measures in 2008, the Commission adopted three decisions on the treatment of 24 cases of irregularities, for which the concerned Member States asked the Commission to bear the financial consequences of irrecoverable amounts.

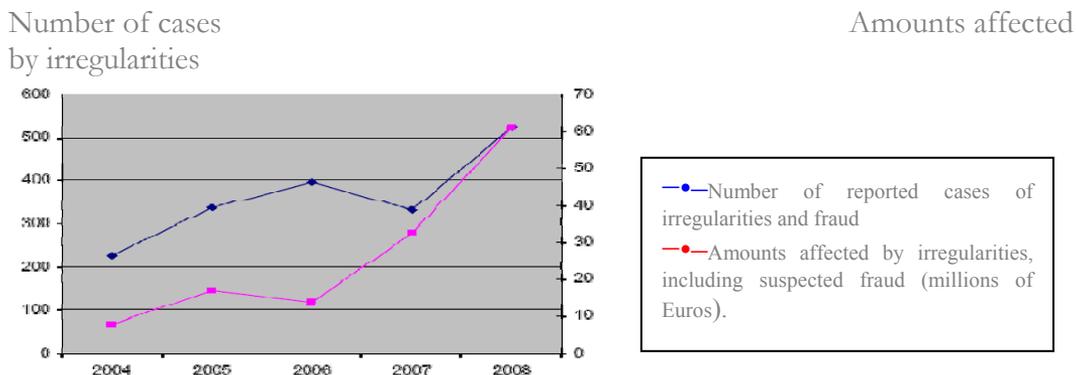
Thus the Commission, Court of Auditors and European Anti-Fraud Office, through its auditors, applied financial corrections to the States concerned.

Pre-accession funds

As regards pre-accession funds (PHARE, SAPARD and ISPA - including, in 2008, CARDS, Transition Facility and Pre-accession assistance for Turkey), an increase was recorded both in the number of reported irregularities (an increase of 58% compared to 2007) and in terms of financial impact (an increase of approximately 5.4%).

Suspected fraud accounted for 21.7% of the irregularities reported in 2008, with an estimated financial impact to 13 million Euros, or about 0.94% of the total annual budget.

Chart 3: Number of reported irregularities and estimated financial impact – pre-accession funds – 2004-2008



Source: Commission's Report to the European Commission and Council.

“Protection of the Communities’ financial interests – Fight against fraud – Annual Report 2008”

A good example of measures taken by the Union is Bulgaria, for which the Commission prepared a report on the management of funds from the European Union in July 2008. Thus, following allegations of irregularities, suspected fraud and possible conflicts of interest in awarding contracts, the Commission (OLAF) initiated investigations in the management of EU funds by the Bulgarian authorities. As a consequence, the Commission decided to temporarily interrupt the pre-accession funds and to block payments under various financial instruments until correct implementation by the Bulgarian authorities of corrective measures necessary to ensure proper financial management of EU funds.

Own resources

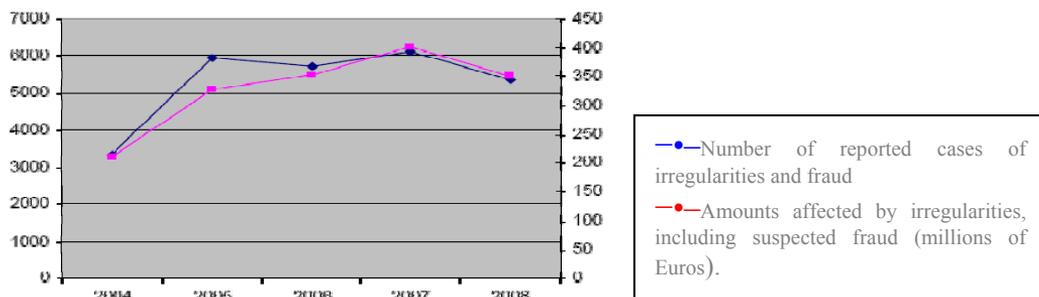
As regards own resources, the number of irregularities reported and estimated value in 2008 decreased by 12.5% compared to 2007. Suspected fraud is about 20% of cases of irregularities reported, accounting for an estimated financial impact of 75 million Euros, or about 0.46% of total own resources in 2008.

The most affected products were, as in previous years, TVs and monitors. The most frequent irregularities were false statements (wrong description, wrong value, origin and preferential regimes) and omissions of form (non-fulfillment of obligations or commitments). Tobacco came in the second position. Sectors such as clothing, tools, meat increased in importance. The segments of the automotive and motorcycle industry remained stable, while improvements occurred in the vegetable area.

Chart 4: Number of reported irregularities and estimated financial impact — own resources — 2004-2008

Number of cases
by irregularities

Amounts affected



Source: Commission's Report to the European Commission and Council. "Protection of the Communities' financial interests – Fight against fraud – Annual Report 2008"

Member States are compelled to recover established amounts. Where non-recovery of a debt is not attributable to a Member State, it may request the deletion of irrecoverable amounts. In this situation, in 2008, the Commission refused requests for deletion of Member States in 32 cases totaling approximately 17.4 million Euros, because it deemed that the non-recovery was attributed to Member States.

One of the measures which the Union can take is to initiate an investigation by the European Anti-Fraud Office, if the final report of a case it managed concludes that certain amounts have been unduly paid to a beneficiary or the beneficiary has not received them, although the beneficiary had to. Responsible authorities, usually Member States or third countries concerned, should recover those amounts. The European Anti-Fraud Office aims to implement these recovery procedures.

The methods used include: monitoring the recovery of own resources, regular inspections in the Member States to establish and recover resources, and not least specific monitoring of Member States followed by a recovery in each of the registered cases, which have a significant financial impact and involve mutual assistance.

Community legislation requires Member States to report all deficiencies within two months from the end of the quarter when the irregularity was subject to primary administrative or judicial finding and/or new information on a reported irregularity becomes known. The term from discovery to communication of irregularities should not exceed five months.

Analyzing the situation in this regard, the agriculture sector has recorded certain improvements - in 2008 the percentage of irregularities reported in the

stipulated deadline increased to 84% from 33% as it was in 2007. About the average time between discovery and reporting of irregularities, no details can be given concerning 2008 due to technical problems (introduction of a new technical module).

In terms of structural actions, the situation is positive with a rate of 86% of irregularities reported in due time in 2008 as compared to a rate of 75% recorded in 2007. In terms of finding and reporting period, it increased from 0.9 years in 2007 to 1.1 years in 2008. Both for agriculture and structural actions, Member States have offered a large number of reasons for late reporting.

The European legislation [Regulation (EC, Euratom) no. 2988/95] defines infringements that may harm the financial interests of the Community and imposed administrative sanctions. Thus, an action represents misconduct by an economic operator if, by reducing or losing revenue or existing unjustified expenditure can harm the general budget of the Community or budgets managed by it.

Any such infringement entails the removal of undue advantage by: obligation to pay amounts due or to repay amounts wrongly received and by total or partial loss of security provided in support of the request for an advantage granted upon receiving an advance.

One of the following administrative sanctions is applied in terms of international infringements or those committed intentionally:

- Payment of an administrative fine;
- Payment of a sum greater than the amounts wrongly received or evaded, bearing interest if necessary (calculated as percentage determined by specific rules and which cannot exceed the strictly required level in order to represent a deterrent factor);
- Total or partial withdrawal of a benefit granted by EU rules, even if the economic operator has unduly benefited only by a part of such advantage;
- Exclusion or removal of a benefit for a period after committing offense;
- Temporary withdrawal of approval or recognition necessary for participation in a Community aid scheme;
- Loss of a security or deposit provided to comply with conditions laid down by rules or reconstitution of security unduly released;
- Other purely economic sanctions.

Community administrative penalties may be imposed on all economic operators, and those compelled to take responsibility for infringement or to ensure that it is not committed.

Even if the European Union has adopted many measures to prevent and fight tax evasion by actions based on strategies, impact studies and work programs, they are not sufficient. We deem they should lead to improvements in tax legislation systematic correlation with the overall legal framework of Member States economies and the mutations involved in their socio-economic environment.

As a phenomenon present in the economic and social environment, with multiple manifestations, tax evasion is a threat to the delivery of the EU budget

revenue. The extent of this phenomenon is worrisome because the lack of prevention and control measures can have negative effects on the economic stability.

Total eradication of tax evasion is impossible, but the EU, by its means and subordinated institutions, must undertake to identify and fight tax evasion and its effects.

The global economic crisis and recent scandals related to tax evasion cases have spurred calls for fairness and transparency of the tax system, but without a thorough and systematic analysis of the Member States' internal mechanisms in conjunction with those of the Union, as regards tax evasion, it is difficult to trigger tools and measures leading to efficient fight and prevention of tax evasion.

In the modern world tax systems are not perfect, inequity free, but their improvement in this direction is a goal of the Member States.

Conclusions

Even though the European Union has adopted many measures to prevent and fight tax evasion by actions based on strategies, impact studies and work programs, they are not sufficient. We deem they should lead to improvements in tax legislation systematic correlation with the overall legal framework of Member States economies and the mutations involved in their socio-economic environment.

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ROMANIAN PARTICIPATIONS AND CONTRIBUTIONS TO THE SECURITY GLOBALIZING ENVIRONMENT. BENEFITS FOR THE NATIONAL SECURITY

Daniela Popa¹

Abstract

Globalization is a complex phenomenon with implications of both geopolitical and institutional nature. The evolution of the globalization process as well as the involvement of the local, regional, state and international level institutions into it determine a thorough analysis of the place and role of national institutions in a globalized and globalizing world. The international structures and the national institutional structures must find those mechanisms of adapting to the challenges of a so complex process, with influences on the international order, and Romania must assume its position within the international system.

Keywords: globalization, international institutions, defense policy, international order, European Union

JEL Classification: F51, F52, F59

The globalization is a complex phenomenon with implications of both geopolitical and institutional nature. The evolution of the globalization process as well as the involvement of the local, regional, state and international level institutions into it determine a thorough analysis of the place and role of national institutions in a globalized and globalizing world. The international structures and the national institutional structures must find those mechanisms of adapting to the challenges of a so complex process, with influences on the international order, and Romania must assume its position within the international system. In the international relationships, an important role is taken by the trans-Atlantic dialogue and intra-European cooperation. The coherence of partnership actions of UN, OTAN, OSCE and EU, intended to provide an efficient frame of security, of fighting against hazards and threats within the security environment, as well as the consistence if military, political, economic, social, diplomatic, scientific, cultural etc. actions are priorities from the perspective of peace, security and stability provisions of the European and Euro-Atlantic area.

The majority of globalization definitions indicates the fact that it is a multi-cause process which has as a result the fact that events occurring in a part of the world have consequences more and more ample on the societies and issued in other parts of the world.

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When the vulnerabilities, risks, threatens, hazards and aggressions are under globalization, the success of actions regarding the provision of overall security is mainly conditioned by the multi-dimensional co-operation of the international community – firstly by outlining the dialogue within institutional frame and by activating the decisive role had by the major international organizations to define the worldwide security status.

The *United Nations* brought particular contributions to the Euro-Atlantic security and stability, the Security Council of UN having further on an important liability to keep the international peace and security, also having an important role in the edification of worldwide security and stability. As well, due to its unique capacity and expertise within the field of preventive diplomacy, prevention of conflicts and management of crises, consolidation of observing the human rights, democracy and lawful state and promotion of all aspects of civil society, and the *Organization for Security and Cooperation in Europe* shall play on an important role in the promotion of a joint security area. It shall contribute to the trust consolidation within the military field and to the promotion of security by cooperation. *OTAN* has a major role in the consolidation of Euro-Atlantic security, especially that its political role is increasing, mainly after the adoption of a new strategic concept of the Alliance in the summit of Washington, in 1999. Based on a negotiation force substantially increased during the latest decade, *OTAN* opened and developed the political-military partnership, strong cooperation and dialogue with other stated, shown continuous interest and receptivity. Within a geopolitical environment characterized by globalization and deepening of interdependence, the number increase of states and state factions, puppet-governments and states with no authority, antagonistic leaders and disorder, *OTAN* must relate and interact with the political and social environment.

The security interests and objectives of the European stated do not generate conflict statuses; the security environment is positively influenced by the European and Euro-Atlantic integration processes. Although the risks of occurring a traditional military confrontation on the European continent were significantly decreased, there still persist instability and crisis phenomena at sub-regional level and trends of fragmenting, marginalization or isolation of certain states. Countries from Central, East and South-East Europe are facing economical, social and political difficulties associated to the transition process towards the society based on the principles of democracy and market economy, which can generate sufficient risks related to the security of states within the area.

The *European Union* is passing through an internal reform process, the progresses within the evolution of the joint external policy and security, the involvement and the solution chosen by the European institutions to settle the difficult situations on the continent demonstrate that Europe undertakes a substantial role in the architecture of its own security, including the defense one, and offers models of setting up the relationships between states and nations, on rational equitable bases, by harmonizing their interests.

OTAN and EU must develop a strategic partnership, to extend beyond their cooperation in Balkans and to cover the entire spectre of political-military challenges within the security field.

As regards the Parliament, there must be considered the legitimacy problematics of political decisions at European level and the manner they respond to the challenges of globalization phenomenon. The consolidation of parliamentary dimension, both at national and European level, is intended to bring a consistent contribution in the democratic legitimation of the political process of decision making.

The risks and threatens to the Romanian security are of various natures: of political, economical-financial, informational, ethnical-religious, ecologic or military nature. Romania proves its valences of stability factor in South-East Europe by its active participation in all projects and regional and security bodies, especially by its significant involvement into the initiatives of OTAN, EU, UN and OSCE related to this area.

There is a close correlation between globalization, regional integration and national interest. The stated choose the regional integration both as a primary manner of satisfying the national interest, by multilateral cooperation with the other states, and as a modality to actively and advantageously participate in the globalization.

The European Union disposes of its own security and defense policy. That allows it, on one hand, to act in an coherent and systematical manner in order to achieve the joint security and defense, and, on the other hand, allows the member states to integrate their national policy of security and defense into the European Union's one. Thus, an efficiency amplification of the joint security and defense policy promoted by the Union, as well as of the national one. In this chapter there were shown the evolution of PESA since its foundation up to present, the institutional frame, missions carried out under the aegis of PESA, as well as the civil and military abilities of EU.

The declarative conclusion of the Cold War precipitated a re-orientation of UN operations of peace-keeping. Under the new cooperation spirit, the Security Council founded ampler and more complex missions, by often having the mandate to apply the peace agreements between the heroes of conflicts within some countries. The notion of "peace-keeping" commenced to include more and more non-military elements precisely to ensure the peace sustainability. The UN department for peace-keeping operations was created in 1992 with the purpose of supporting the increasing demand of complex operations.

Our country perceives and decides its future evolution within the European and international context by an opening as larger as possible to tall cooperation forms. Romania has actively involved itself in the structuration and operationalization process of European Policy of Security and Defense, also contributing to the discussions within the Convention on the Future of Europe regarding the Treaty for setting up a Constitution for Europe, to those for the drawing up of the European

Strategy for Security and participating in the development of concepts related to the Reform of security field, Civil-Military Coordination and Long Term Vision as regards the European capacities. The positions expressed by the Romanian representatives within the various activities reflected the will of our country to play a role suitable to its potential, as well as the support for the affirmation of the European Union as a global and responsible player of the international system.

The contribution of our country in the globalized security environment is important, when it comes to the obligations resulting from the quality of a member of OTAN, or it comes to the contribution to PESA implementation, or when it comes to the participation in the operations developed under the UN aegis. The advantage lays also on the Romanian part, the benefits for its intern security being obvious.

Romania has the major role in the securing of Eastern frontiers of OTAN and EU. By undertaking a long term vocation and commitment, Romania intends to become a vector of stability, democracy and Euro-Atlantic values within the region and an anchor of this region towards the Occident. Romania undertakes a long term commitment to invest into the extension of democracy area, market economy, of values characterizing an open society as far as possible to the East.

CONCLUSIONS

A series of conclusions regarding the place and role of the institutional system from the perspective of national security in a globalizing external environment resulted:

- The globalization phenomenon shall involve more and more states, with benefic effects especially on the field of the economy, diplomacy, human rights and consolidation of community and national security.

- The international bodies shall proceed to consolidate their role and their cooperation with the national ones shall increase, deciding together on the practical modalities to strengthen the global and national security. The crisis management has become an important component of the strategies of international bodies.

- The national security policy is a process implying drawing up, decision-making process, implementation and assessment. Its drawing up must be transparent and participating.

- The security interests of Romania are based on the values assumed and promoted by the Romanian society, the final objective is to provide prosperity, protection and safety to its members, as well as the state stability and continuity.

- The organization and working of public administration authorities at central and local level as well as the professional structures playing a role in the implementation of National security Strategy of Romania must be based on the compliance with the principles of full legality, political equidistance, objectivity and impartiality.

- Romania has actively involved itself in the process of crisis management. Its contributions are highly recognized both by the allies with which we acted as well as the host countries where various operations have been carried out.

- OTAN and EU achieved a high importance and security finality, at regional, continental and global level.

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SURPASSING THE CRISIS AND RESUMING THE ECONOMIC GROWTH – MAIN OBJECTIVE OF THE MONETARY POLICY PROMOTED BY THE NATIONAL BANK OF ROMANIA

*Elena Enache, Camelia Vechiu, Geanina Tudose**

Abstract

In 2008, the global financial crisis has generated a feeling of distrust from investors and significantly increased their risk aversion. The size of current account deficit, the relatively high external financing needs and the dependence of the banks on it, the high ratio between loans in foreign currency and deposits in foreign currency made of the Romanian economy, a risky destination for investors. In these conditions, since the end of 2008 and throughout 2009, the government's economic program was focused on reducing the external deficit in both public and private sector, on minimizing the effects of recession, on avoiding a crisis of the exchange rate and on cooling the inflationary pressures.

Keywords: monetary policy, exchange rate, external financing, budget deficit

JEL classification: E30, E58, E65.

1. Introduction

The financial system in Romania has evolved under circumstances powerfully marked by the increasing manifestation of the global economic crisis. At the beginning of the crisis, the Romanian economy had passed through a period of many years of high economic growth, at the same time accompanied by the accumulation of a relatively important foreign deficit and by the increase of the short term foreign debt.

The banking sector has withstood those pressures well due to its dominant position in the financial system. The financial stability was submitted to a new challenge, that is, the volatility of the foreign financing.

The consequences of the deterioration of the foreign economic environment manifested themselves with a small delay upon the Romanian economy, with negative effects upon the credit portfolio, with profound implications upon the crediting risk.

Under the circumstances, The National Bank of Romania, as a surveillance authority, has reacted by promptly assuring liquidities, monitoring the banks more strictly, taking measures to improve the framework of prudential adjusting and signing some financing agreements with the International Monetary Fund and The European Union.

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2. Economic Evolutions Registered in 2008

In 2008, the global economy decreased his growing rhythm due to the expansion of the effects of the financial crisis and its transformation in an economic crisis. The global production increased by 2%, comparatively to 3.8% in 2007. Halfway through September, the global economic conditions deteriorated rapidly, against the background of the diminishing of the consumers' trust and of the corporatist sector, the restrictions regarding the global crediting conditions and the decrease in the prices of the houses and the stocks value.

The influence of the financial crisis upon the real activity resided in a moderation of the global trade, which registered an increase of 4.4% in 2008, comparatively to 6.3% in 2007.

The Euro zone¹ has known a significant economic decrease from 2.7% in 2007 to 0.8% in 2008 due to the worsening of the economic conditions starting with September, together with the intensification of the tensions on the financial market. The reduction of the economic growth has come from the majority of the components of the Gross Domestic Product. The domestic demand has been considerably tempered due to the reduction of the real incomes of the population's house-holds under the circumstances of the growth of the international prices of merchandises in the first half of the year. To this one can add the decline of the residential investments (affected by the fall of the real estate markets) and of the productive investments (because of the harshening of the financing conditions). The foreign demand was limited to a decrease of the economic growth in both the advanced economies and the emergent ones. The exports of goods and services of the Euro zone have tempered the increase from 5.9% in 2007 to 1.0% in 2008 and the imports of goods and services from 5.8% to 1.0%, as a reaction to the evolution of the domestic demand. From a sector perspective, the decrease of the economic activity was reflected in all domains, especially in the manufacturing industry – determined by the decrease of the foreign demand, by the rapid diminishing of the order stock and by the reduction of activity in the auto industry.

The conditions on the work market from the Euro zone have deteriorated in 2008 too, after 2 years of substantial improvements. The rate of unemployment which followed a descendent trend starting with 2005, began to increase from the second trimester, reaching to 8.2% from 7.3% at the end of the precedent year. The budgetary deficit of the Euro zone was majored to 1.9% from the Gross Domestic Product, from 0.7 in 2007, against the background of the evolution of the financial crisis and the deterioration of the macroeconomic environment. The rate of the public debt in the Euro zone increased by 3.3% in 2008 in comparison with the previous year to 69.3% from the Gross Domestic Product, as an effect of the

¹ The states referred to are the 15 members of the European Union situated in the Euro zone at the end of 2008: Austria, Belgium, Cyprus, Finland, France, Germany, Greece, Ireland, Italy, Luxemburg, Malta, Holland, Portugal, Spain and Slovenia.

government's interventions to stabilize the financial system.

As far as the countries members of the European Union **outside the Euro zone**² are concerned, these have witnessed a decrease of the economic growth in 2008 to 1.3% from 3.6% in 2007. In general, the domestic demand of these countries was affected by the deterioration of the foreign environment and the intensification of the financial crisis which have weakened the trust of both the consumers and the representatives of the business environment. The highest growth rates, of over 6.0% were realized by Romania, Bulgaria and Slovakia, while Latvia, Estonia, Denmark and Sweden have registered negative rates. In 2008 the annual average rate of inflation has increased in most of the country's regions (with the exception of Hungary), against the background of an ascendant trend registered in the first half of the year in the majority of countries. On the average, the countries members of the European Union outside the Euro zone have recorded an annual inflation rate of 4.7% in comparison with 2.9% in 2007. The highest rates of inflation, between 10.6% and 15.3%, have been registered in the Baltic states and in Bulgaria, followed by Denmark, Poland, Slovakia, Sweden and Great Britain (with 3.3-3.4%). Beside the main cause of the evolution of inflation – the increase of the global prices to food and energy, one can identify factors with a differentiating action from one country to another, such as the depreciation of the national currencies, the increase in the administered prices and the indirect taxes.

In the same context, the fiscality evolution has continued to be heterogenous in 2008, the whole region recording an average number of the budgetary deficit of the Gross Domestic Product of 3.3%, comparatively to 1.5% in 2007. Three of the European Union states outside the Euro zone (Bulgaria, Denmark and Sweden) have registered budget savings and the other nine have ended the fiscal year with a deficit.

In 2008, the global financial crisis generated a feeling of distrust from the part of the Romanian investors too and their adversity to risk increased substantially. The dimension of the deficit of current account, the relatively high demand of foreign financing and the banks' dependence on this type of financing, the high ration between currency credits and currency deposits have turned Romania's economy into a risky destination for investors.

Under the circumstances, from the end of 2008 and throughout 2009, the government's economic agenda was centered on the reduction of the foreign deficit both in the public and the private sectors, on minimizing the effects of recession, on avoiding a crisis regarding the exchange rate and on tempering the inflation pressures. The same requirements are to be found in 2010 too all the more so as our country has obtained important borrowings under severe circumstances.

² The states referred to are the 12 members of the European Union situated outside the Euro zone at the end of 2008: Bulgaria, The Check Republic, Estonia, Latvia, Lithuania, Great Britain, Poland, Romania, Slovakia, Sweden and Hungary.

3. The Deficit of Current Account and its Financing

The accentuation of deficit of current account brings forward the possibility of its important adjustment, a thing which began to materialize at the end of 2008.

The correction of the deficit of current account could be done through two important challenges: (1) the deterioration of the financial situation of the companies, especially of those with an import-export activity and (2) the risk of the adjustment taking place especially through the diminishing of the investments.

As far as the first challenge is concerned the companies of foreign trade have felt the effects of the diminishing of the activity overseas, including through the deterioration of the paying capacity of the obligations to the financiers.

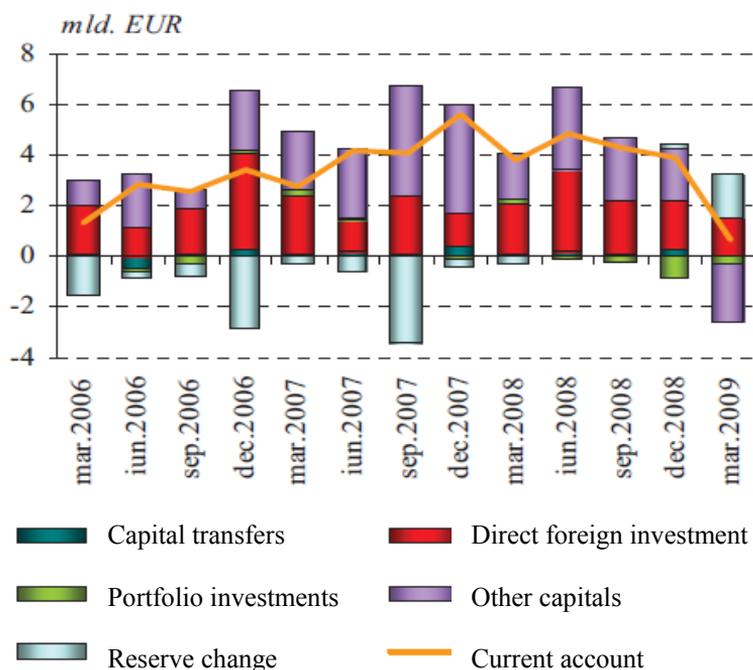
The manufacturers of intermediary goods engaged in the activity of import and export have suffered a rapid deterioration of the economic activity. The reduction of the foreign demand has led to an important decrease of the exports of these companies contributing by 90% to the correction of the exports from November 2008 to February 2009. The financial stability of these firms was deteriorated too. The quality of the domestic bank credit witnessed the most rapid and significant worsening (the rate of the arrears has increased more than three times in a few months from 2% in June 2008 to 7.5% in March 2009). The implications on the Romanian bank sector are relatively limited because these companies own 6% from the total of given credits. On the other hand, the foreign creditors could be more affected because 85% of the financial resources of these firms come from abroad.

The trade companies with an activity based exclusively on import (which reach 30% of the imports and represent over 50% from the number of importing firms) have been confronted with a diminishing of the profitability rate ever since the first half of 2008 (from 15.6% in June 2007 to 10.3% in June 2008). The business turnover started adjusting considerably and decreasing by 40% in the case of the cars trading firms (Ist Trimester 2009 compared to Ist Trimester 2008). The companies based exclusively on imports have been mainly financed by means of domestic currency credits which represent over 50% of the total financing from local and foreign creditors.

Although the turnover of the companies based exclusively on import has diminished, the negative impact did not affect the honoring of the duty service too. The rate of the arrears has increased at a slower pace than the average one in economy; the fact remains that the level was already low (0.6%, March 2009). The more difficult access to financing, especially to commercial credits, continued to be a challenge for the importers. Short term foreign commercial credits decreased by over 73% (respectively by 2.7 billion Euros, September 2008 - March 2009).

As for the second challenge which the adjustment of the deficit of current account might trigger, we could say that all economic sectors (companies, population and authorities) have accumulated financing deficits in the last years, deficits which have been replaced by foreign saving. In the context of the crisis this could not be applied to Romania. The portfolio investments and other capitals were the first to retire at the end of 2008 (Chart 1).

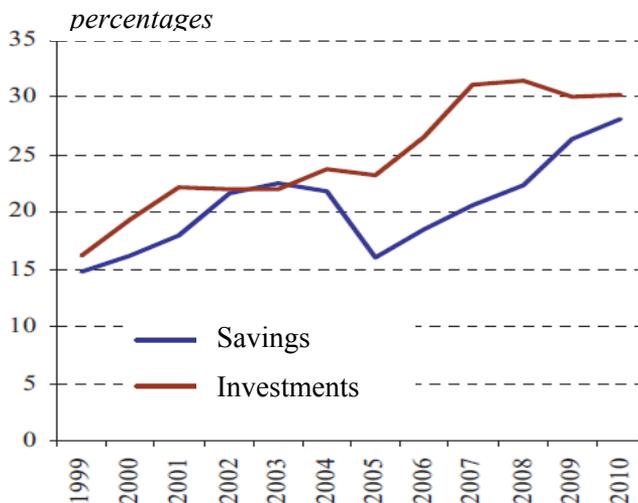
**Chart no. 1. The Capital Cost and the Deficit of Current Account
(unadjusted trimester data)**



Source: NBR

The expectations are that the adjustment of the current account to be attained by the capping of the investments rate and the stimulation of the domestic savings (Chart 2). As a matter of fact, the increasing investments rate drastically decreased in the IVth Trimester 2008 (to 2.3%, the IVth Trimester 2008 compared to the IVth Trimester 2007).

Chart no. 2. The Savings and Investments Rate (share in the Domestic Gross Product)



Note: The broken line represents the estimated values, and the values for 2009 and 2010 are foreseen.

Source: Eurostat

The investments could be financed by means of both domestic and foreign saving, but the excessive use of foreign financing is not sustainable on the long term. The balance between the domestic and foreign saving could be altered by many factors, among which the massive foreign capital inflow, essential since it discourages the domestic savings. Romania's experience is mixed. During the period of massive capital inflow, the savings rate increased by 15.3% of the Domestic Gross Product in 2004 to 19.1% of the Domestic Gross Product in 2008. Nevertheless, the savings rates were relatively small if we compare them to the average global savings rate which oscillated between 21 and 25% of the World Domestic Gross Product since 1980 until today.

A survey of the countries with the highest convergence rate shows that the accelerated process of the savings increase is preceded by an investment period strongly financed by foreign savings. The rise in deposit interest represents a part of the present monetary policy in Romania. Since the deposit accounts carry the income tax and the current accounts do not, the banks have oriented themselves towards methods to attract the clients, that is: current accounts with interests higher than those in the case of deposits.

As for the companies, the reduction of the profit perspectives against the background of diminishing the domestic and foreign demand could have mixed effects upon savings. The firms benefiting of a solid financial position could delay the investments decisions and save the resources thus released. The companies

indebted with investments projects in course will try to finalize or freeze them in conformity with their financing capacity. The bank savings of the companies was more volatile and the expectations are in the sense of the increase of this volatility if the difficulties in getting liquidities will be amplified.

Against this background, in 2008, the deficit of current account (16 897 million Euros) was covered in proportion of 58.4% through direct investments and capital transfers and the difference by means of other capital investments.

Table no. 1. Financing the Deficit of Current Account

	Millions EURO	
	2007	2008
Deficit financing	16 677	16 897
Net capital transfers	704	602
Net direct investments	7 047	9 272
<i>out of which:</i>		
- direct investments of non residents	7 251	9 085
⇒ capital participation	2 220	2 992
⇒ reinvested profit	1 327	1 585
⇒ intergroup credits	3 704	4 508
Net portfolio investments	482	-834
Other capital investments	12 949	7 819
- long, medium term credits	5 228	6 130
⇒ entries	11 113	12 497
⇒ returns	5 885	6 367
- net long and medium term credits	156	48
- net short term credits	604	-1 025
- others*	6 961	2 666
NBR reserve assets	-4 505	38
(“-“shows growth)		

* includes the following net positions: intangible / non-financial assets, financial derivatives, cash and deposits, other assets, other liabilities, errors and omissions

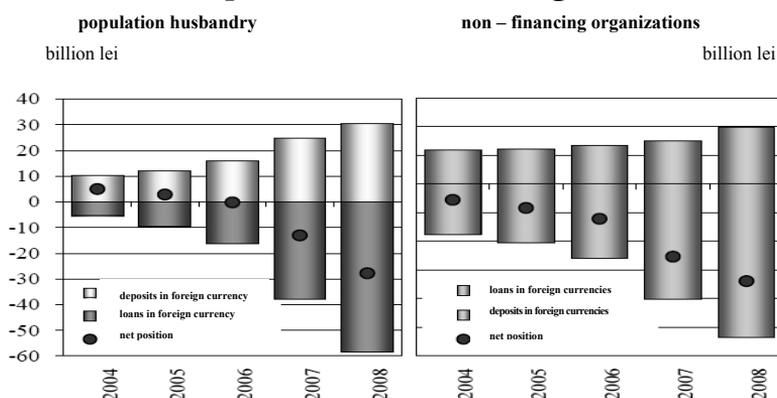
The net foreign financing out of borrowings and short term and medium term credits totaled 6 130 million Euros, growing with 17.3% compared to 2007, an evolution determined by the increase of the credits contracted by the real economy, the public administration and the bank sector. In 2008 there was a net outflow from borrowings and short term credits of 1 025 million Euros, in comparison with net influxes of 604 million Euros in the previous year.

4. The Policy of the Exchange Rate and its Implications upon the Financial Stability

Supported by the global financial crisis, the evolution of the Leu rate has raised

major problems. As in the period 2005-2006, the currency incomings have overestimated the Romanian national currency way above the level indicated by the fundamental factors of the exchange rate, the reduction of the foreign financing and the incertitude have afterwards determined an unjustified depreciation of the Romanian Leu. In spite of the high acquisition of currency in the anterior period, The National Bank of Romania has managed only to attenuate the unsustainable appreciation of the Leu, although the challenges in the bank system were very big. In the period 2004-2008, the continuous dynamics of the currency credits would have created negative effects at the level of the bank system under the circumstances of a rapid and excessive depreciation of the Leu (Chart 3).

Chart no. 3. Deposits and loans in foreign currencies



Source: National Bank of Romania

Between October 2008 and April 2009, the Leu depreciated by 12% in comparison with the Euro (and by 21% in comparison with the Dollar), while the volatility exceeded 30% (Chart 4). These powerful contrasts between the two periods of 2008 could not have been anticipated, considerably affecting the reaction of the members of the economic environment and the business plans.

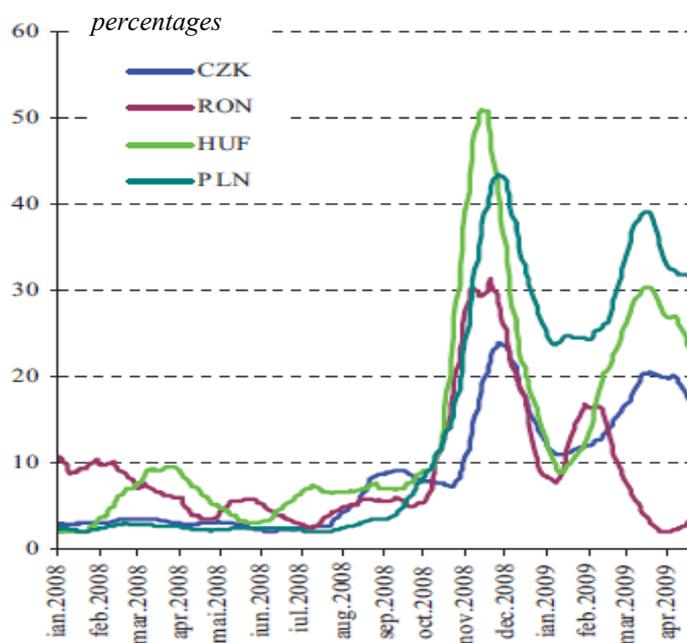
The factors which contributed to this interruption in the dynamic evolution of the exchange rate were: **global** – a high incertitude regarding the situation of the global monetary system and the possible repercussions upon the emergent countries and **specific** – the worsening of Romania's qualification credit (of sub-investment) by two rating agencies (Fitch Ratings and Moody's).

As one can notice from Chart 4, the volatility of the national currency, although in a significant progress, has remained under the level of other currencies in the region, and at present it registers some of the lowest values.

In this context, the policy of the central bank concerning the **interventions on the foreign exchange market** was oriented by the idea that a higher volatility of the exchange rate is detrimental to both the objective regarding inflation and the solidity of the real and financial sectors. Even more as the Romanian economy considered to

be of small dimensions and with a high degree of openness is permanently exposed to the danger of some unfavourable capital movements at the level of the financial and especially the foreign exchange market.

Chart no. 4. The Conditioned Volatility of the Main Currencies EEC compared to the Euro (percentage, average on a period of 20 days)



Source: NBR calculations, Bloomberg

The option of the National Bank of Romania to intervene on the foreign exchange market was not singular in Central and Eastern Europe, the system of managed floating of the national currency being practiced by other Central Banks too, their foreign exchange interventions being amplified after the beginning of the global financial crisis. Under the circumstances, the National Banks from the Czech Republic, Poland and Hungary, which have a flexible foreign exchange system have pronounced themselves against the excessive depreciation of the local currencies which could create destabilizing movements, promising, in their turn, to intervene in order to combat the phenomenon.

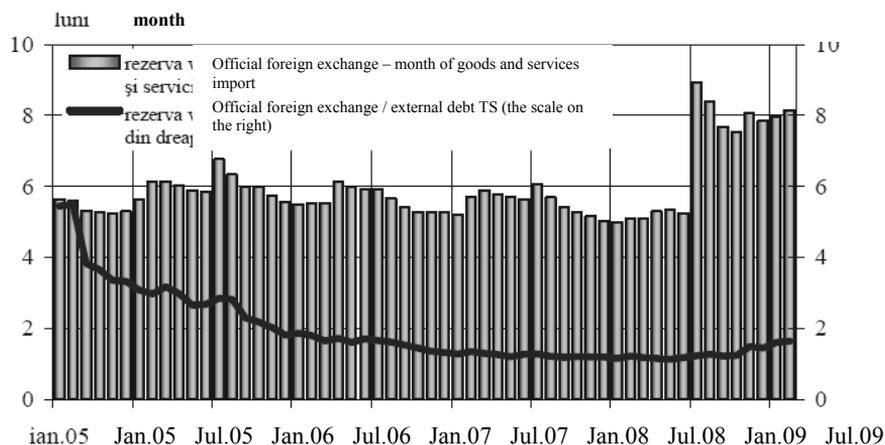
These interventions of the National Bank of Romania on the foreign exchange market have been aimed at the excessive depreciation of the national currency and the depreciation level was correlated to the progress registered by the adjustment of the current account.

These foreign exchange interventions were adjusted according to the **foreign exchange reserves** too. The foreign exchange reserves constituted due to the interventions from the period of overrating (2004-2008) and the sums received as a

result of the financing agreement with the International Monetary Fund, the European Union and other international financial institutions have offered the central bank the possibility to support the national currency. Romania's National Bank aims at both the absolute value of the foreign exchange reserves and the derived indicators, respectively the foreign exchange reserve expressed in months of imports of goods and services and the report between the foreign exchange reserve and the short term foreign debt.

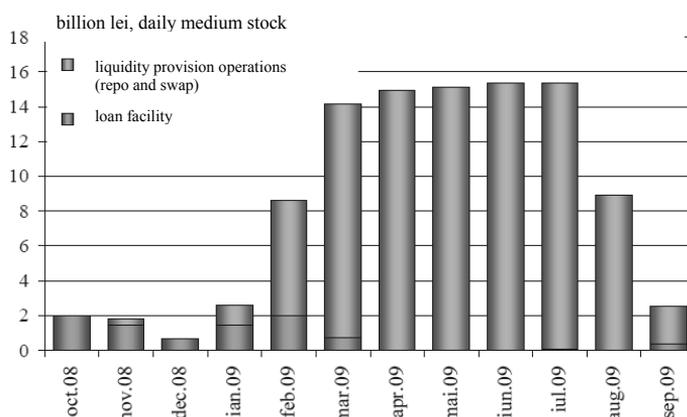
The strategy of the National Bank of Romania to reduce the effects of the crisis has been aimed at both the correlated **amount and the moment of the foreign exchange interventions** and **the liquidities control on the monetary market**, under the circumstances in which the financing of the budgetary deficit was mainly done through the usage of the sums received from the International Monetary Fund and the European Union. In 2009, the National Bank of Romania supplied liquidities to the banks after it had been a net debtor towards the bank system due to the liquidity surplus generated by the massive capital inflow in the Romanian economy in the period 2004-2008. The foreign exchange intervention generated by the National Bank of Romania had as a purpose the attempt to avoid the reversal of its position as a creditor towards the bank system, a situation which could have caused problems for the implementation of the monetary policy (Chart 6).

Chart no. 5. Foreign exchange reserves at NBR: derivative indicatives



Source: National Bank of Romania, National Institute of Statistics

Chart no. 6. Liquidity provision operations



Source: National Bank of Romania

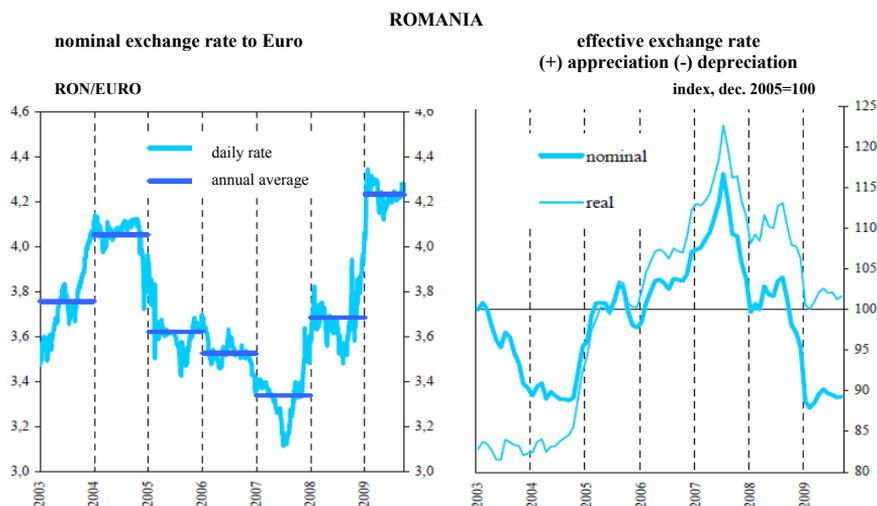
In this context, we can say that the foreign exchange interventions were necessary not only to maintain the exchange rate but also to properly manage the liquidities on the monetary market (Chart 7).

Diminishing the depreciation of the Romanian Leu and implicitly the inflation pressures which appear by means of the exchange rate together with the fiscal consolidation efforts have allowed the National Bank to pass on to the **cautious relief of the monetary policy** ever since the beginning of 2010. The National Bank has taken the following **measures**: decreasing the monetary policy interest rate to 6.5%³ per year, maintaining the present levels of the minimum reserves rates applied to both domestic and foreign currency liabilities of the crediting institutions (15%, respectively 25%), firm administrating of liquidities in the bank system in order to consolidate the signals sent by the monetary policy.

The monetary policy interest is a targeted interest which leads the fashion on the market, but every national bank has its own specific set of interest and other instruments to establish the monetary policy and this set of instruments depends upon the conditions specific to every market (the repo rate, the deposits and reserves interest, the short term interest on the interbank market).

³ During the meeting on 29 March 2010, the Administrative Board of Romania's National Bank decided to reduce the monetary policy interest rate to 6.5% per year.

Chart no. 7



Source: BCE, BRI

In the case of Romania, the National Bank has adopted a smaller monetary policy interest meant to attenuate its dispute with the commercial banks regarding the crediting of the real economy in the sense of resuming the crediting process.

From the perspective of the commercial banks, they try to reduce the risks through a more rigorous client selection, even if statistics were not exactly encouraging in this respect. The share of non-productive credits (listed as Losses because the recovery chances are minimal) in the credit portfolios of the banks significantly increased to over 9% at the end of 2009 compared to 3.5% in 2008. The credits listed under Losses and Uncertain represent 12.3% of the credits given by the bank institutions compared to 5% in 2008 and all the credits listed under Substandard, Uncertain and Losses reached 20.8% compared to 10.5%.

5. The Agreements with the International Monetary Fund and the European Union - a Support for the Consolidation of the Macroeconomic Balance and the Financial System

Under the circumstances of a slow recovery from the crisis, the loan agreements negotiated with the International Monetary Fund and the European Union and with the Global Bank and other international financial institutions purport to financially support the Government's economic program of macroeconomic and financial consolidation. The agreement with the International Monetary Fund and the European Union indirectly aims at an ordered adjustment of the foreign deficit with direct positive effects upon the exchange rate and implicitly upon the financial position of the companies, the population and the bank sector. These agreements have a clear preventive character ensuring a higher degree of credibility to the

Government's economic program as well as the financial resources for the correction of the macroeconomic lack of balance.

Taking into consideration the general positive evaluation regarding the bank sector, the agreements with the International Monetary Fund and the European Union aim at ensuring the solvency of the Romanian banks in order to have a safety margin in front of some possible new pressures generated by the global financial crisis. For this reason, the solvency of the banks will be of at least 10% during the agreement (2009-2010) compared to 8% as it is stipulated.

The agreements with the International Monetary Fund and the European Union stipulate other temporary (2009-2010) or permanent measures too. The banks which commit themselves to maintain the exposure on Romania during the program and raise their own funds to ensure a solvency above 10% will no longer be expected to have minimum reserves for the subordinate loans coming from the action holders or the international financial institutions.

At present, Romania can not get a smaller interest than that demanded by the International Monetary Fund (3.5% per year) or by the European Commission (3.14 per year) from the foreign banks abroad. The Romanian Government's most recent loan from the local banks of over 2 billion Lei was contracted at an interest of 8.86% while for the loan of 1.42 billion Euros contracted in November 2009 the Government committed itself to pay an interest of 4.25% per year. Following in time the evolution of the loans contracted by the Romanian Government since the beginning of the crisis we note: in 2009 the Government borrowed no less than 18 billion Euros from the banks, five times more than in 2008. In 2010 the Government will have to borrow another 8.3 billion Euros in order to cover the budgetary deficit of 5.9% from the Gross Domestic Product, respectively of the difference between the Government's expenses and incomes.

The credibility acquired due to the influence of the European Commission and the International Monetary Fund ensured the financing of the Romanian economy, a financing which has reflected positively in a few directions: relatively hire investments comparatively to the situation in which the agreements would not have been closed; the attenuation of the Leu exchange rate depreciation in comparison with Euro and other currencies. Signing the Vienna Treaty by means of which the banks have committed themselves to renew the financing lines and preserve the capital rates at satisfactory levels.

6. Conclusion

Resuming the capital inflow in 2010 could mean increasing the amount of money in economy which has to be sterilized by the National Bank of Romania. Otherwise, if the capital inflow could not be sufficiently reduced, then the National Bank of Romania could be forced to increase the international reserves by means of purchases on the interbank market. At the same time, this process of resuming the capital inflow determines new requests of coordination between the monetary policy

and the fiscal policy. In order to attenuate the inflation pressures, in 2010 the budgetary deficit should be diminished. Otherwise, the monetary policy would have to compensate the differences and adopt the necessary measures, among which the one referring to the dimension of the monetary interest rates.

Due to the process of foreign financing and capital inflow resuming, the adoption of political decisions in conformity with the European measures of pump priming represents a positive sign since the IIIrd trimester of 2010.

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THE EFFECTS OF THE WORLD ECONOMIC CRISIS ON THE EMPLOYMENT IN THE AUTO INDUSTRY

Alina Hagi, Emilia Ungureanu*

Abstract

The paper aims to realize an analysis of the employment evolution in Romania and in all the European Union member states in the context of the economic crisis, with an emphasis on the employment on the auto industry, one of the most affected sectors by this crisis.

In the same time, we will analyze the employment policies for soften the impact of the economic crisis on the labor market. We will also analyze the link between the employment rate, labor productivity per employee and the car production and export.

The unprecedented crisis in global financial markets which gathered pace last year has led to the most severe recession since the Second World War, affecting the wider economy and increasingly impacting on labor markets in the EU. After many years of relatively high growth and job creation the global financial crisis and its repercussions on the real economy are hitting businesses, jobs and households.

As unemployment continues to rise, the spotlight has fallen more and more on limiting the effect of the crisis on jobs and addressing the social impact.

Acting in concert, the EU has already taken important steps to address the fallout from the crisis, having taken action to prevent a meltdown in the financial markets last autumn. In December it agreed to put in place a European Economic Recovery Plan to lessen the effects of the downturn and create the conditions for recovery.

The top employment challenge for the EU must be to minimize job losses, prevent unemployment from becoming entrenched, favour transitions back into employment and boost job creation, and pave the way for economic renewal and for sustainable recovery and growth.

Keywords: *labor market, employment, auto industry, economic crisis, employment policies;*

JEL Classification: E24, E27, J21

Introduction

Until the financial crisis broke in the summer of 2007 the EU labor markets had performed relatively well. The employment rate, at about 68% of the workforce, was approaching the Lisbon target of 70%, owing largely to significant increases in the employment rates of women and older workers.

Labor markets in the EU started to weaken considerably in the second half of 2008, deteriorating further in the course of 2009. Increased internal flexibility coupled with nominal wage concessions in return for employment stability in some

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firms and industries appears to have prevented, though perhaps only delayed, more significant labor shedding so far.

Even so, the EU unemployment rate has soared by more than 2 percentage points, and a further sharp increase is likely in the quarters ahead. The employment adjustment to the decline in economic activity is as yet far from complete, and more pronounced labor-shedding will occur as labor hoarding gradually unwinds.

However, on a more positive note, in a number of European countries, job losses have been contained so far, largely due to recourse to increased internal flexibility in the form of shorter hours or temporary partial unemployment benefits.

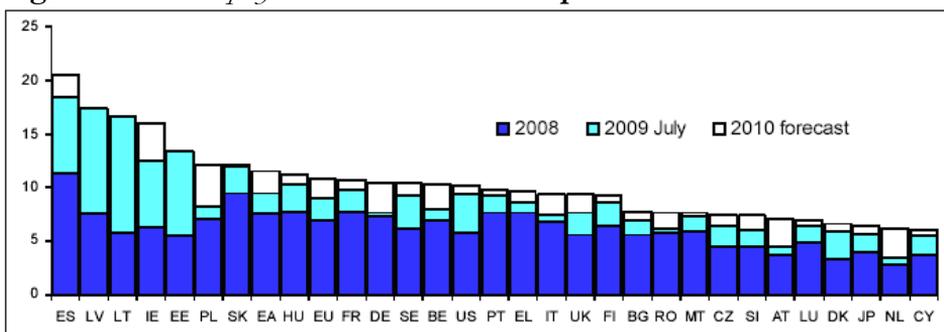
The impact of the economic crisis on the labor market and employment

The economic and financial crisis and the ensuing global downturn are beginning to impact significantly on labor markets. While the bulk of the increase in unemployment so far has been concentrated in Spain and the United Kingdom, it is now beginning to rise across all Member States. The Commission forecast indicates that, on current policies, employment will decline substantially in absolute terms over the next two years leading to a steep rise in unemployment. Employment is expected to contract by 1½% in 2010. In sharp contrast with the creation of about 9½ million additional jobs during 2006-2008, employment is thus expected to fall by some 8½ million in the EU. As a result, the unemployment rate would increase to close to 11% in the EU by 2011 (11½% in the euro area). The most pronounced increases in unemployment are expected in countries facing substantial downturns in activity, notably Estonia, Ireland, Latvia, Lithuania and Spain.

The in-built capacities of the social safety nets are also fully playing their role as automatic stabilizers to cushion the impact of the economic downturn. In addition, Member States are pursuing a wide range of employment policies aimed at containing the impact of the crisis on labor markets.

Accordingly, the European Commission's latest forecast indicates that, on current policies, employment would contract by 2½ % this year and a further 1½ % in 2010. The unemployment rate is forecast to increase to close to 11% in the EU by 2010 (and 11½ % in the euro area).

Figure no.1 *Unemployment rates in the European Union*



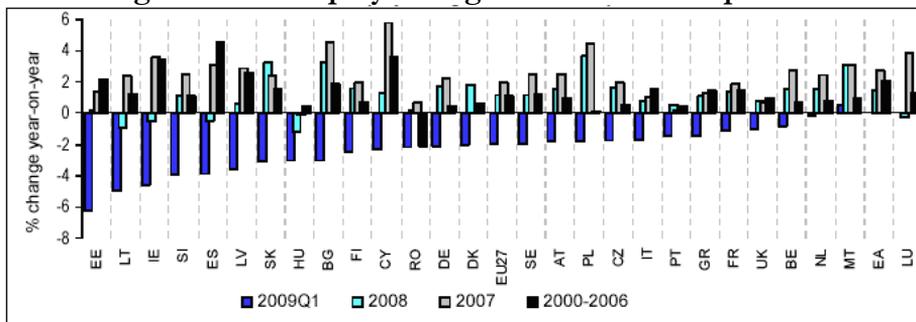
Source: *European Commission, winter Forecasts, 2009*

A considerable increase in unemployment is registered among craft workers and those previously employed in elementary occupations, largely working in services. Women are less affected than men, given that the crisis hit first and foremost sectors where male employment is relatively high (car industry, construction). Even so, in the first quarter of 2009 a decline in female employment was registered for the first time since the fourth quarter of 2005.

As noted, increased internal flexibility (flexible working time arrangements, short-time working schemes, temporary closures etc.), coupled with nominal wage concessions in return for employment stability in some firms/industries, may have prevented, though perhaps only delayed, more significant labor shedding so far (with short-time working and temporary closures in the car industry as the most prominent example).

Given the decline in output, this has led to significant increases in unit labor costs which are unlikely to be sustainable for an extended period of time. The increase in unemployment has so far been limited also by a contraction of the labor force (which declined by 0.3% in the fourth quarter of 2008 and 0.5% in the first quarter of 2009), which may be due to discouraged worker effects.

Figure no. 2 *Employment growth in the European Union*



Source: *European Commission, spring Forecasts, 2009*

On current policies, employment is forecast to decline substantially over the next two years, by 2½ % in both the EU and the euro area this year and a further 1½ % in 2010. After 9½ million jobs had been created in the EU in the period 2006- 2008, employment is thus expected to fall by some 8½ million during 2009-2010. In the early phases of the crisis, the bulk of job losses were concentrated in just a handful of Member States, largely as a result of pre-existing weaknesses as well as a larger exposure to the direct consequences of the shocks (e.g. adjustments in the financial sector and housing markets, relative exposure to international trade).

Employment in the auto industry in the context on the context of the world economic crisis

The first signs that something is going on the Romanian car market has started in autumn of 2008, when automotive companies like Ebyl Romania and Lisa Draexlmaier sent the first people on unemployment. In their turn, suppliers of the producer Dacia Pitesti announced offs of employees.

Dacia Pitesti plants estimated at the beginning of 2009, that it could fire from 3,000 to 4,000 employees, a plan later abandoned due to success of the fleet renewal program started by the German Government.

In Romania, for example, there are over 400 companies producing automotive parts which had in 2008 a combined turnover of eight billion euros. Three quarters of them are small companies that usually produce for a single beneficiary. They feel extremely harsh effects of the crisis, especially if they depend on one manufacturer.

In these circumstances, firms are forced to resort to layoffs or to find solutions like reduce working time, vacations without pay. Equally serious affected are tire manufacturers.

Given the large number of employees of all these companies, we consider that it is necessary to include auto parts and tire manufacturers in any future support formula in the context of the economic crisis.

Most employees in the economy, regardless of age, gender or training feel their jobs threatened.

The current situation will have serious repercussions on employment, given that in 2008 were sold with 8% fewer cars compared with 2007.

Table no. 1 The situation of the employment in the auto industry in Romania

Year	Car production change over the previous year (%)	Automobile export change over the previous year (%)	Employment rate (%)	Employment rate change over the previous year, in the car industry (%)	Labor productivity per employee comparatively with EU 27 (EU 27 = 100)	Growing rate of the labor productivity per hour (%)
2001	-12,0	+69,7	62,4	-	25,6	6,8
2002	15,6	241,9	57,6	-6,2	29,3	16

2003	19,9	+52,5	57,6	-12,5	31,1	7
2004	28,3	-15,5	57,7	4,0	34,5	9,8
2005	59,4	-5,4	57,6	-4,6	36	5,4
2006	9,6	+70,2	58,8	-2,1	39,6	6,2
2007	13,2	+202,2	58,8	1,2	43,3	5,4
2008	1,5	+37,0	59	-	50,2	7,6

Source: Realized by the author bases on the dates from www.apia.softnet.ro

Annual capacity of the European automotive industry amounts to 12 million vehicles, representing 6% of jobs in the EU that representing the sixth EU export industry. If in 2007 were 19.6 million cars produced, in 2008 their number decreased by one million. Currently, 2 million unsold vehicles are in stock, representing a capacity in excess of 20%.

Table no. 1 The situation of the direct automotive employment in the auto industry in the European Union

	Direct automotive employment	As share of total manufacturing
Portugal	22590	2,7
UK	173184	5,7
Latvia	1433	0,7
Sweden	85561	10,7
Finland	6346	1,7
Ireland	3863	1,8
Lithuania	2500	0,4
Poland	137000	4,6
Germany	833837	11,8
Czech Republic	122223	8,3
Austria	33075	5,3
Slovak Republic	76000	7,1
Hungary	58806	6,6
Slovenia	12200	3,8
Romania	60281	4,0
Bulgaria	3155	0,4
Greece	2913	0,7
Italy	168435	3,6
Spain	159052	6,1
Denmark	6758	1,5
Estonia	2729	1,7
Netherlands	22284	2,9
France	258304	7,3
Belgium	45075	7,7
EU- 27 - average	95608.5	4,46

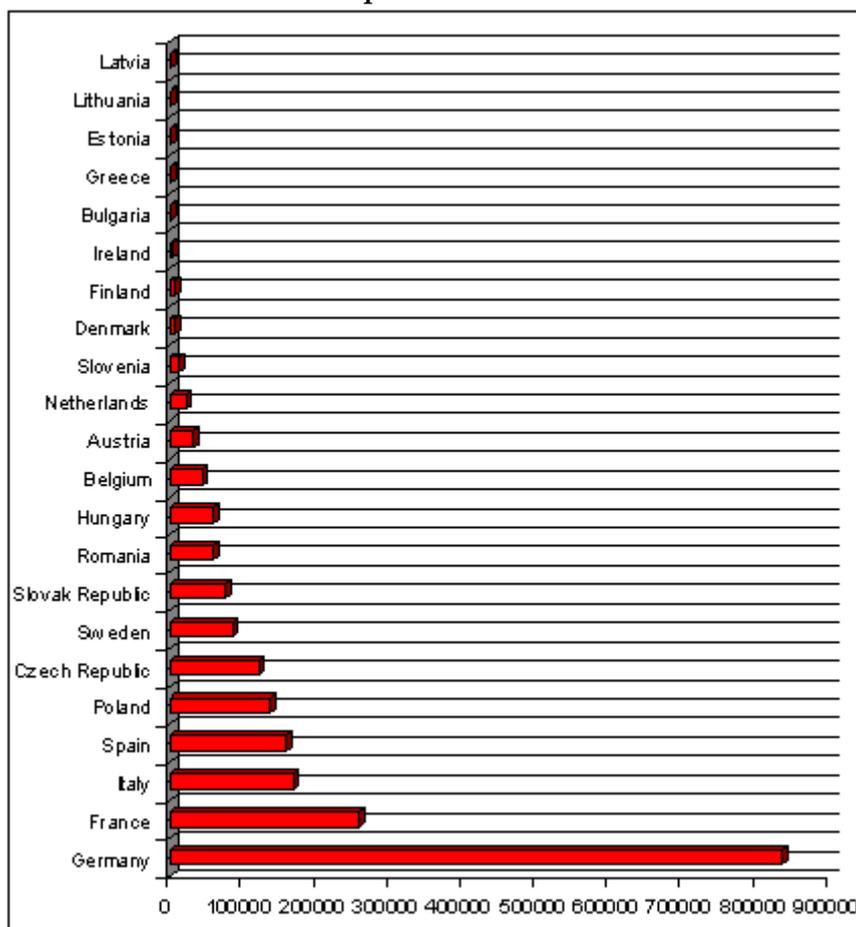
** The study does not include: Cyprus, Malta and Luxembourg.*

Source: Realized by the author bases on the dates from www.eurostat.ec.europa.eu

June 2009 marked negative performances in all 27 EU countries in terms of registration of new motor vehicles, accompanied by lower production, confirming the downward trend of the business. If at the end of 2007 the automotive industry gave a total of 2.3 million people directly working and indirectly to a total of 10 million people, in the first quarter of 2009 the situation looks very different. Approximately 10% of employees were dismissed, most of the raw materials, parts, etc., supplying companies of car manufacturers.

If this trend continues, automotive producing companies will emergency this year measures to rationalize, leading to loss of a significant number of jobs.

Figure no. 3 Direct automotive employment in the auto industry in the European Union



The study does not include: Cyprus, Malta and Luxembourg.

Source: Realized by the author bases on the dates from www.eurostat.ec.europa.eu

Among the measures proposed at EU level is included the facilitation of loans through the European Investment Bank, including for manufacturers of automotive components, amounting to 9 billion euros.

This crisis has serious consequences for employment in the automobile industry and must be taken rapid measures. Europe must take a greater role in this respect and support jobs. Coordinated policy is needed, especially in state aid area, and should be encouraged the competitiveness in the automotive sector.

Policies for soften the impact of the economic crisis on the labor market

The European Economic Recovery Plan which was endorsed by the European Council underlined the importance of stabilizing economies, restoring growth and maintaining social cohesion and called for a co-coordinated approach given the increasing interconnections, spill-overs and common challenges.

The basic approach is articulated around a set of overarching principles to devise appropriate labor market measures aimed at mitigating the impact of the crisis and shaping a sustainable recovery.

In particular, measures should aim at reducing the costs of adjustment and speed up transitions from old to new jobs to avoid more permanent losses in employability (hysteresis effect). In addition, policies should be in synergy with the social policy goal of supporting the incomes of the most disadvantaged groups of the population, which in itself will assist with stimulating aggregate demand given the relatively high propensity to consume out of these incomes. Especially in euro area countries these policies should also facilitate structural adjustment, in particular with regard to addressing significant divergences in external competitiveness, through their impact on unit labor costs.

Finally, short-term measures should be time-consistent with long-term reform objectives: policies to address the crisis should not run counter to long-term reform strategies, notably the implementation of the flexicurity principles under the Lisbon strategy. A major responsibility of the governments is to avoid damaging the long-term health of their economies and to look beyond the crisis at the recovery that will eventually come. The European Commission is intensifying its efforts to help governments overcome the crisis and prepare an "exit" strategy for the longer term.

The most recent employment measures undertaken by the European Union member states to combat the employment effects are:

- *maintaining employment, creating jobs and promoting mobility;*
- *upgrading skills and matching labor market needs;*
- *increasing access to employment;*

The top employment challenge for the EU must be to minimize job losses, prevent unemployment from becoming entrenched, favour transitions back into employment and boost job creation, and pave the way for economic renewal and for sustainable recovery and growth. This requires stronger cooperation between all stakeholders, better policy coordination and mutual learning – i.e. with a shared

commitment to develop and implement the right policies and actions: to preserve sustainable jobs in sound economic activities and help people into productive employment; to support the most vulnerable; and to prepare for the jobs and skills of the future.

Conclusions

Although the picture varies across Member States, the economic crisis is expected to have significant consequences for all of their labor markets; for many this will manifest itself as a substantial increase in unemployment. Initially the bulk of the negative impact on labor markets was concentrated in Spain and the United Kingdom (UK), but more recently unemployment has begun to rise across all Member States.

In a number of European countries, job losses have been rather restrained to date, largely due to recourse to increased internal flexibility in the form of shorter hours or temporary partial unemployment. However, even if labor markets have proven to be more resilient, the European Union (EU) is still expected to lose some 8.5 million jobs over 2009–10, with unemployment potentially reaching around 11% by 2010. Indeed, historical experience shows that employment reacts to economic conditions with a certain lag; hence labor market conditions can be expected to worsen for some time even after the trough in the economic situation has been reached.

At the same time, the crisis appears to be affecting some groups of workers more deeply than others. Although men still have higher employment rates than women, to date the former have been more affected by the downturn than the latter, reflecting that many of the sectors hit hardest by the crisis are predominantly male oriented in terms of employment.

There has also been a continued strong rise in unemployment among young people, with young men being particularly affected, highlighting a rising need for support to tackle youth unemployment.

Measures undertaken so far are moving in the right direction. The in-built capacities of the social safety nets are fully playing their role as automatic stabilizers to cushion the impact of the economic downturn and there is considerable "policy innovation" to avoid significant labor shedding. However, the forecast figures suggest that, given the risk of a particularly deep and protracted recession, policies may need to be intensified in order to avoid very high levels of unemployment with potentially long lasting effects on the labor markets and potential growth. While it is impossible to put a precise figure on the budgetary impact of an intensification of policies, it is clear that this could be significant. This means that decisions on key structural reform measures relating to social security systems, which are needed in any event in many Member States to guarantee the long-term sustainability of public finances in view of an ageing population⁶, should be brought forward even if the implementation of such reforms would only kick in over time. This would restore

confidence in the sustainability of public finances which has come under pressure as a result of the crisis and which would further suffer from additional expenditure on labor market measures.

Finally, in view of the spill-over effects these further measures are likely to have and to minimize distortions in competitive positions, especially across the euro-area; a better coordination of such measures would be warranted. In particular, a common approach to the design of supporting measures to temporary unemployment or adjustment schemes to working time would be highly beneficial.

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REMODELLING OF INVESTMENT ACTIVITY WORLDWIDE WITHIN THE WORLD ECONOMIC CRISIS

*Mariana Mihailescu, Marinela Lazarica**

Abstract

Starting from 2008 the development of investment activity worldwide has been earmarked by the world economic crisis, its effect resulting in a major decline of direct foreign investment flows, after an extremely favourable evolution in the past years.

The activity of transnational corporations, a major source of developing foreign investments in the previous years, has declined considerably. Under these circumstances, the managers of transnational corporations had to make decisions concerning activity restructuring, cost cutting by fair means or foul, or requiring the government support in order to save from bankruptcy. Some succeeded to survive, some didn't.

Information and communication technology (ICT) industry witnessed an enormous increase in the process of globalization. In the last years, the vast implementation of ICT in all levels of society represents a global tendency of world development. The ICT sector became one of the most dynamic and viable sectors of the national economy, and the investments and advanced use of technologies have generated a real revolution in this domain.

The present paper aims to emphasize some aspects related to changes occurred in the field of investment activity worldwide, subject to the impact of the current economic downturn.

Keywords: foreign direct investment inflows, foreign direct investment outflows, transnational corporation, ICT industry

JEL Classification: A10, F21, O16

Introduction

The most powerful and dynamic companies in the world are the transnational companies. Their strength is driven by the huge volume of goods and services carried out by them. Either they are named multinational companies, transnational corporations or international companies, they represent those firms that carry out their activity beyond the borders of a country, considered the country of origin, by means of affiliates controlled more or less by the parent company.

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The development and expansion of transnational companies is based on the foreign capital investment. In their turn, investments can be direct or portfolio. The foreign direct investments assume the investment control, and the portfolio investments enable participation in the decision making process, but not in the control exercise. Regardless its type, a foreign investment involves: time (an investment takes place and becomes profitable after a certain span), risk (any investment involves a risk related to its profitability and other elements that come from the fact that they take place outside the country of origin), profit (final goal of any activity) and foreign environment (destination of investment is different than the country of origin).

At present, the market of transnational corporations is a huge market in an on-going expansion. Its dimension is easy to guess just by noticing that in the current world economy there is a number of 82,000 TNCs, approximately 810,000 affiliates that operate abroad, wherein over 70,000,000 employees work.

1. Changes in the development of foreign direct investment flows worldwide

The current world economic crisis has resulted in the slowdown of international production of goods and services carried out by the major transnational corporations. Within these companies decreases of profits, capital recedes, redundancies as well as a number of major restructurings or even bankruptcies have been registered. Thus, starting from the middle of 2008, capital recedes rose above the foreign direct raw investment flows (FDI) in a number of countries. Nearly a third of the cross-border mergers and acquisitions in 2008 and in the first half of the year 2009 involved the sale of foreign affiliates to other companies.

The Annual Study of the United Nations Conference for Trade and Development (UNCTAD) – The World Investment Report 2009 – makes a thorough analysis of the investment landscape in the world economy. According to this report, cross-border mergers and acquisitions, a major source of rising the DFI in the previous years, has declined considerably as the financial markets blocked in the second half of the year 2008. The development of this phenomenon, as well as other world economic indicators are shown in the following table:

Table no. 1

Selected indicators of FDI and international production, 1982-2008												
Item	Value at current prices (Billions of dollars)				Annual growth rate (Per cent)							
	1982	1990	2007	2008	1986-1990	1991-1995	1996-2000	2004	2005	2006	2007	2008
FDI inflows	58	207	1 979	1 697	23.6	22.1	39.4	30.0	32.4	50.1	35.4	-14.2
FDI outflows	27	239	2 147	1 858	25.9	16.5	35.6	65.0	-5.4	58.9	53.7	-13.5
Cross-border	..	112	1031	673	32.0	15.7	62.9	28.4	91.1	38.1	62.1	-34.7

M&As													
Sales of foreign affiliates	2 530	6026	31764	30 311	19.7	8.8	8.1	26.8	5.4	18.9	23.6	-4.6	
Gross product of foreign affiliates	623	1477	6295	6 020	17.4	6.8	6.9	13.4	12.9	21.6	20.1	-4.4	
Total assets of foreign affiliates	2 036	5938	73457	69 771	18.1	13.7	18.9	4.8	20.5	23.9	20.8	-5.0	
Exports of foreign affiliates	635	1498	5775	6 664	22.2	8.6	3.6	21.3	13.8	15.0	16.3	15.4	
Employment by foreign affiliates (thousands)	19 864	24476	80396	77 386	5.5	5.5	9.7	12.2	8.5	11.4	25.4	-3.7	
GDP (in current prices)	11 963	22121	55114	60 780	9.5	5.9	1.3	12.6	8.4	8.2	12.5	10.3	

Source: UNCTAD, The Annual Study of the United Nations Conference for Trade and Development (UNCTAD) – The World Investment Report 2009

As it can be noticed, the value of cross-border mergers and acquisitions in 2008 went down to \$ 673 billion, compared to \$ 1031 billion in 2007. The same situation is registered in the field of FDI inflows. Therefore, they registered a major decline: from \$1979 billion in 2007 to \$1697 billion in 2008. According to the same report, FDI inflows have started going down in 2009, too, reaching about \$1200 billion. In 2010, a slight recovery is expected to take place, without exceeding the value of \$ 1400 billion, but hoping that in 2011 it will come closer to \$1800 billion. After a period when sales of foreign affiliates experienced a significant rise, the year 2008 is the first wherein their decline took place by 4.6% compared to the previous year. The same situation is when production is made by foreign affiliates. One of the most affected sectors was that of the labour market, 2008 being the year of massive redundancies concerning employees.

Having the USA as the country of origin, the world crisis progressively spread all over the world, having different intensities and extents from one region to another. Though it occurred later in the emerging countries, the world economic crisis affected this group of states very much. At present, while strong economies start recovering, emerging countries are still affected because of reducing the global trade, small wages of the workers and decline of tourism earnings.

Of all emerging countries, Europe and Central Asia were hit the toughest by the world crisis as it is shown in the Report of the World Bank, entitled „Financing the World Development 2009”. The same report shows that in the first quarter of 2009, Romania has registered a decline of economic activity by 6.4% compared to the similar period of the last year. Another negative aspect emphasized by the World Bank is the simultaneous diminishing of capital and export inflows, that resulted in the decrease of industrial production by 12% in the first quarter of this year, compared to the same period in 2008.

Fig. No. 1

FDI inflows, by quarter, 2007–2009
(Billions of dollars)

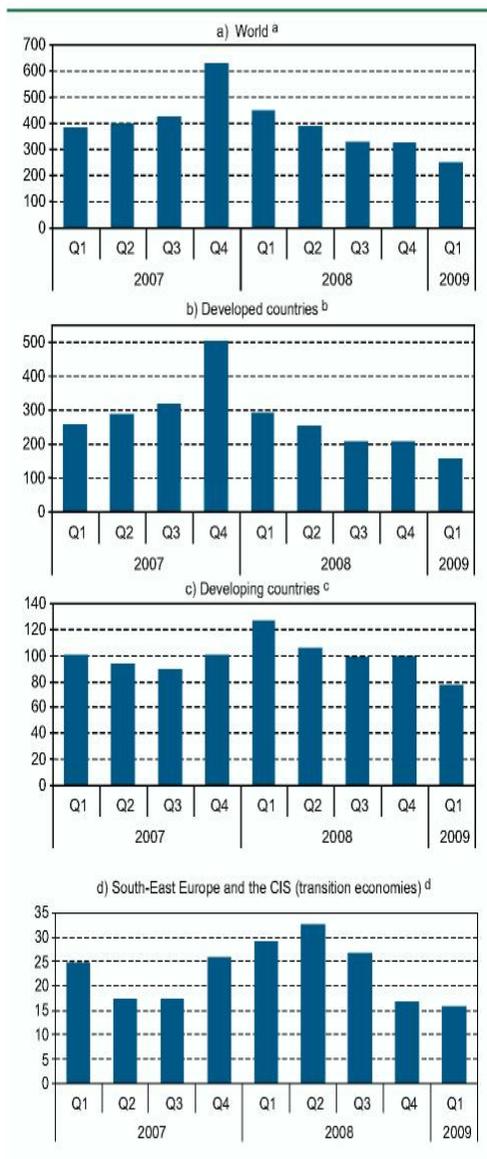
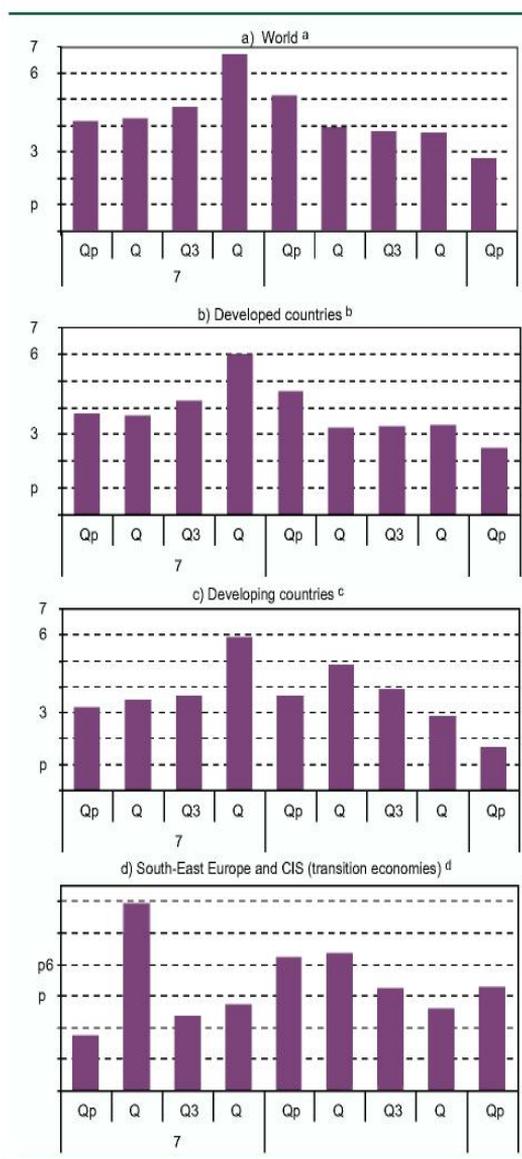


Fig. No. 2

FDI outflows, by quarter, 2007–2009
(Billions of dollars)



The development of FDI inflows and outflows, both globally, as well as on groups of states can be noticed in the figures below:

Source: UNCTAD, The Annual Study of the United Nations Conference for Trade and Development (UNCTAD) – The World Investment Report 2009

After a maximum of FDI inflows reached worldwide, in the last quarter of 2007, the trend showed, both in 2008 and in the first quarter of this year, a continuous

decline (from around \$ 630 billion in the last quarter of 2007, to less than \$ 300 billion now). The same trend is also noticed in case of developed countries. In exchange, the situation within the other groups of countries is completely different. Thus, in the developing countries, the growth trend of FDI inflows occurred in the first half of 2008, and then its decline was slower (from \$ 125 billion, the maximum level of FDI inflows reached in the first half of the last year, to \$ 80 billion in 2009). A similar situation has been also registered in the Southern-Eastern European countries, where the rise of these flows took place until the half of the last year, followed by their decline.

The FDI inflows generated by the developed countries experienced a marked decrease, since early 2008. In the developing countries, these flows diminished later but more „abruptly”. Slight signs of recovery are also noticed in the Southern-Eastern European countries.

2. Aspects concerning FDI development on countries or groups of countries

Despite all predictions that were showing disfavouring the USA in the world business, at present, this country is still the most important receiver and issuer of FDI. The same annual report of UNCTAD contains the top of countries focusing on the FDI inflows and outflows in 2008. As far as the FDI inflows, the first ten places belong to the following: the USA, France, China, Great Britain, the Russian Federation, Spain, Hong Kong (China), Belgium, Austria and Brazil.

Concerning the FDI outflows, the top is the following: the USA, France, Germany, Japan, Great Britain, Switzerland, Canada, Spain, Belgium, Hong Kong (China).

The presence of China and Russia in the top of the first five beneficiaries of FDI is noticed.

Despite the crisis, China and other countries in South-East Asia succeeded to keep a high level of FDI. In China, the FDI flows increased, reaching \$ 52 billion in 2008, showing a rising trend by 132% compared 2007. The Chinese companies in mining and metal industry became more and more interested in purchasing shares of foreign affiliates. Moreover, a significant fluctuation of exchange rates and prices, due to crisis, created opportunities for these firms to carry out cross-border mergers and acquisitions. Also, the active intervention of the state in the Chinese economy, including an incentive package of \$580 billion contributed to keeping the confidence of foreign investors in this country and maintaining the high levels of FDI flows.

The year 2008 was the eighth successive year of rising the FDI flows for countries within the Commonwealth of Independent States (CIS). The FDI inflows were extremely dynamic in the Russian Federation, Kazakhstan and Ukraine, representing 84% from their total in 2008. The value of \$ 70 billion of the FDI flows to the Russian Federation was driven by the major investments in the electric power industry, car industry and real estate.

The FDI outflows in South-Eastern Europe and CIS maintained their upward trend in 2008, amounting to \$52 billion. These flows were again dominated by the Russian transnational corporations. In the first half of 2008, the Russian transnational corporations continued to search for new markets for their products. In exchange, in the second half of the last year, investment withdrawal, acquisition cancellation reduced considerably the FDI outflows.

In 2008, the development of investment activity in the European Union (EU) was severely marked by the world economic crisis, its effects resulting in a major decline of the received and generated FDI flows, after their extremely favourable evolution in the past years.

In 2008, the main member countries of the EU that generated and attracted investments outside this group were: Luxembourg, France and Great Britain. Of the former socialist countries, EU's members, Hungary remarked in 2008, as the main FDI beneficiary (with a total volume of received FDI of Euro 33 billion), being followed by Poland (Euro 11 billion) and Romania (Euro 8.9 billion).

3. Changes in the picture of transnational corporations worldwide

The most recent opinion survey carried out by UNCTAD within the managers of major TNCs in the world economy, in connection with the prospects of investments in the world (2009-2011), reveal that the main threats that could affect the investment plans now are: deepening of global economic downturn, increasing of financial instability, the states implemented protection measures, instability of oil prices, raw materials and fluctuations of exchange rates.

In the World Investment Report 2009, UNCTAD makes a top 100 of the main non-financial TNCs in the world, based on the value of foreign assets. Information focuses on the year 2007. As in the previous years, the top is dominated by manufacturing and oil companies. As the demand lowers, for both manufactured products, and fuels, the profits of these companies were affected. In this top the developed countries have the most non-financial TNCs. The European Union has 57 positions in this top, USA– 20 and Japan is present with 10 companies. It should be mentioned the presence of TNCs in the developing countries. Thus, in the top 100 carried out by UNCTAD there are 6 companies belonging to the developing countries: Hong Kong (China), Mexic, South Korea, Malaysia, China.

The first 40 places from the above mentioned top are shown in the following table:

**The world's top 100 non-financial TNCs, ranked by foreign assets
(Millions of dollars and number of employees)**

Table no. 2

2007 ranking by foreign assets	Corporation	Home economy	Industry	Assets		Sales		Employment	
				Foreign	Total	Foreign	Total	Foreign	Total
1	General Electric	United States	Electrical & electronic equipment	400 400	797 769	97 500	182 515	171 000	323 000
2	Vodafone Group Pic	United Kingdom	Telecommunications	204 920	222 593	51 975	59 792	68 747	79 097
3	Royal Dutch/Shell Group	Netherlands/United Kingdom	Petroleum expl./ref./distr.	222 324	282 401	261 393	458 361	85 000	102 000
4	British Petroleum Company Pic	United Kingdom	Petroleum expl./ref./distr.	187 544	228 238	283 876	365 700	76 100	92 000
5	ExxonMobil	United States	Petroleum expl./ref./distr.	161 245	228 052	321 964	459 579	50 337	79 900
6	Toyota Motor Corporation	Japan	Motor vehicles	183 303	320 243	143 886	226 221	123 580	320 808
7	Total	France	Petroleum expl./ref./distr.	141 442	164 662	189 784	250 489	59 858	96 959
8	Electricite De France	France	Electricity, gas and water	128 644	278 759	41 775	89 463	17 180	155 931
9	Ford Motor Company	United States	Motor vehicles	102 588	222 977	75 853	129 166	134 000	213 000
10	E.ON AG	Germany	Electricity, gas and water	141 168	218 573	50 437	120 742	57 292	96 573
11	ArcelorMittal	Luxembourg	Metals and metal products	127 127	133 088	124 936	124 936	248 704	315 867
12	Telefonica SA	Spain	Telecommunications	95 446	139 034	51487	80 649	197 096	251 775
13	Volkswagen Group	Germany	Motor vehicles	123 677	233 708	119 869	158 397	179 323	357 207
14	ConocoPhillips	United States	Petroleum expl./ref./distr.	77 864	142 865	74 346	240 842	15 128	33 800
15	Siemens AG	Germany	Electrical & electronic equipment	110 018	131 473	90 095	107 623	295 000	427 000
16	DaimlerAG	Germany/United States	Motor vehicles	87 927	184 021	103 070	133 435	105 463	273 216
17	Chevron Corporation	United States	Petroleum expl./ref./distr.	106 129	161 165	153 854	273 005	35 000	67 000
18	France Telecom	France	Telecommunications	81 378	132 630	34 689	74 444	79 193	182 793
19	Deutsche Telekom AG	Germany	Telecommunications	95 019	171 385	45 624	85 826	96 034	227 747
20	GDF Suez	France	Electricity, gas and water	119 374	232 718	65 631	94 536	129 134	234 653

21	BMWAG	Germany	Motor vehicles	63 201	140 690	59 093	74 039	25 467	100 041
22	Hutchison Whampoa Limited	Hong Kong, China	Diversified	70 764	87 747	38 201	44 947	182 148	220 000
23	Honda Motor Co Ltd	Japan	Motor vehicles	96 313	130 236	89 689	110317	165 589	186 421
24	Eni Group	Italy	Petroleum expl./ref./distr.	95 818	162 269	90 799	150 519	39 400	78 880
25	Eads	Netherlands	Aircrafts and parts	66 934	105 964	55 070	60 216	73 625	118 349
26	Procter & Gamble	United States	Diversified
27	Deutsche Post AG	Germany	Transport and storage	72 135	365 990	55 597	80315	283 699	451 515
28	Nestle SA	Switzerland	Food, beverages and tobacco	66 316	99 854	66 230	103 326	274 043	283 000
29	Wal-Mart Stores	United States	Retail	62 514	163 429	98 465	401 244	648 905	2100000
30	Nissan Motor Co Ltd	Japan	Motor vehicles	61 703	112 832	67 319	92 969	81 249	159 227
31	General Motors	United States	Motor vehicles	40 532	91 047	73 597	148 979	145 229	243 000
32	Roche Group	Switzerland	Pharmaceuticals	59 572	71 532	42 886	43 370	44 922	80 080
33	IBM	United States	Electrical & electronic equipment	52 020	109 524	66 944	103 630	283 455	398 455
34	RWE Group	Germany	Electricity, gas and water	53 557	130 035	25 408	68 128	26 688	65 908
35	Endesa	Spain	Electricity, gas and water	19 112	60 199	13 009	31 783	14 170	26 908
36	Mitsubishi Motors Corporation	Japan	Motor vehicles	63 952	120 309	46 762	246 712	11 384	33 390
37	Pfizer Inc	United States	Pharmaceuticals	49 151	111 148	27 861	48 296	49 929	81 800
38	Fiat Spa	Italy	Motor vehicles	36 413	85 974	62 720	82 644	115 977	198 348
39	Sanofi-aventis	France	Pharmaceuticals	50 328	100 191	21 534	38 369	69 990	98 213
40	Rio Tinto Plc	Australia/United Kingdom	Mining & quarrying	47 064	89 616	42 061	58 065	88 356	105 785

Source: UNCTAD, The Annual Study of the United Nations Conference for Trade and Development (UNCTAD) – The World Investment Report 2009

The distribution of these companies on fields of activity is interesting. The car industry is on the first place with 10 companies in top 40, followed by oil industry with 7 companies, energy, gas and water with 5 companies, telecommunications with 4 companies, electric equipment with 3 companies.

Looking back in time we can say something about stability, about the way they have developed over the time. Therefore, the top carried out by UNCTAD for 2005 ranks for instance, General Motors on the third place, while in 2007 it is placed on the 31st place. Sudden changes occurred at other major companies such as: Chrysler, Toyota, Ford and Volkswagen.

In 2008, one of the fields most affected by the world economic crisis was the car industry. As a result of the economic slowdown generated by the credit crisis, the car companies had to fire personnel, make massive restructurings and even require government support to avoid bankruptcy.

For instance, when trying to avoid bankruptcy, in 2009, Chrysler company was involved in the alliance with the Italian Group, Fiat. The American company's restructuring process consisted in grouping the viable assets into a new company named Chrysler Group. This is the property of Fiat (20%), the USA government (9.85%), Canadian authorities (2.46%) and the Pension Fund of the Labour Union (67.69%). The new company starts its activity with considerably diminished debts, lower production costs and expenses, with a partner well capitalized and with experience in the production of low fuel consumption engines. In 2008 the losses of Chrysler amounted to \$ 16.8 billion, and sales declined by 30%.

General Motors, a company that until last year was the symbol of the American industry, had to fire tens of thousands of employees and closed several plants. Therefore, the most recent restructuring plan presented by General Motors provides the voidance of 47000 jobs and the closure of 12 plants in the USA.

In Japan the main car companies – Toyota, Honda and Nissan reduced their production as the difficult lending requirements and deepening of investors hesitation have affected their car sales. Toyota Motor, the second car manufacturer in the world, estimated the first operational loss in the last 71 years, caused by the drastic decline of sales in Europe and North America.

According to analyses carried out by specialists in economy, the development of macroeconomic indicators in the main countries of the world currently registered proves the resurgence to stabilization or a moderate economic growth beginning with the last quarter of this year. The commercial and financial interactions existing in the world economy will result in the dissemination worldwide of resurgence that can be seen, it does not mean a simultaneous recovery worldwide but a different recovery in time and space.

4. The opportunities created by new technologies, Information and communication technology (ICT) industry, in this turbulent global economic environment

Our society is facing increasingly complex issues, unprecedented in the history of mankind. We are witnessing a period of instability that has called on Member States and International Institutions to invest considerable budgets to face the ongoing financial and economic crisis. These remarkable efforts were necessary to contain the economic downturn. But, what can we do more to ensure that these interventions will generate lasting and structured effects on our economies and societies?

We believe that there are three essential directions we can already identify from the ongoing crisis:

- Firstly, we need to build solid and sustainable businesses and economies based

on real high-value goods and services and responding to real market needs.

- Secondly, we must reinforce our investments in research to improve our future capacity to innovate and grow. It is only through research that new technologies and innovation can be developed for the benefit of all businesses and citizens around the world.

- Lastly, we need to work all together not only to find short term remedies, but also for achieving ambitious goals that no country or region alone is strong enough to tackle by itself.

History tells us that global economic crises often occur in the context of socio-economic transformations that bring us not only risks, but also opportunities to build more solid foundations for a new phase of growth and prosperity. These opportunities lie in our capability to fully reap the benefits of scientific and technological innovations.

Because of their increasing pervasiveness in our society, we believe that Information and Communication Technologies (ICT) are main drivers of this epochal change, impacting at least three dimensions: economic, social and environmental.

ICT driving the economic transformation

ICT is the enabling technology underpinning the entire economy. Recent OECD studies [OECD. (2009)] have shown that ICT has contributed to more than 25% of GDP growth in the last 10 years.

One of the main vectors of this impressive impact is the Internet. A new economy of Internet-based services is flourishing, characterized by new trends in content creation and delivery, where services are paid as they are consumed. The emergence of Web 2.0 as a business tool and as a way of delivering government services will further accelerate this trend. The Internet will be the highway to connect and better manage all type of critical infrastructure in the field of transport, power supply, health, banking, enabling consistent cost savings and increasing quality of services.

All these new applications and services will create new opportunities and even more structural market changes that need to be tackled at global level.

ICT driving the social evolution

But the importance of ICT cannot be measured only in economic terms: think of the impact that mobile telephony, e-mail, electronic databases, and of course the Internet, has had on our way of living and interacting, on our access to knowledge, on our political choices.

ICT played its role during the last US electoral campaign, when President Barack Obama used Web 2.0 technologies to communicate with millions of Americans.

In most industrialized countries, new generations cannot even conceive a world without the Internet, and their lifestyle is strongly dependent on the Internet developments.

But, this increased freedom of communication and networking enabled:

- Firstly, the increased ability of hackers, organized crime and terrorists to attack

people's identities and their online lives in cyber-space. It is detrimental to the trustworthiness of the Internet.

- Secondly, the increased anti-terrorist measures based on massive gatherings of data on individual basis poses concerns related to civil liberties and privacy protection.

In conclusion, it is therefore important to stimulate the development of new technologies that provide the required security and trust for organizations and the citizen, while respecting human values and supporting privacy.

ICT enabling a new revolution in energy efficiency and environmental sustainability

ICT and the Internet are also bringing about several other possibilities to tremendously improve the sustainability of our environment: think of the applications of ICT for improving energy efficiency, for monitoring environmental changes, for implementing smart power grids, for integrating new sources of renewable energy in the power supply.

Furthermore, ICT can enable changes in business models, working practices and lifestyles that are inherently more energy-efficient. The Internet, for example, has enabled the substitution of physical products and processes by digital ones.

The report Information Economy Report 2009: Trends and Outlook in Turbulent Times [UNCTAD, (2009)] focuses on the implications of the global economic crisis on ICT. The picture that emerges is one of great contrasts. Some parts of the industry have been seriously affected, with dramatic declines in trade and employment. At the same time, investments in telecommunications and trade in ICT-enabled services appear to be among the most resilient areas of the global economy; only one major telecommunications firm has gone bankrupt in this downturn.

Different types of ICT applications influence the performance of companies in different ways, but the use of computers, the Internet and broadband all point to beneficial effects. Mobile phones have emerged as the most widespread ICT in the developing world. In many developing countries, particularly in Africa, Asia and the Pacific, they are used extensively for voice communication and SMS (short message service), and increasingly also for other data applications such as m-commerce and m-banking. They enable users to access information, especially that relating to news, education, health, jobs and family. In a number of African countries, notably Kenya, South Africa, the United Republic of Tanzania and Zambia, mobile telephones enable individuals to gain access to banking. They provide the possibility to make person-to-person payments, transfers and pre-paid purchases without a bank account.

Data collected through the UNCTAD global survey of national statistical offices (NSOs) on ICT usage by businesses allow for a unique opportunity to compare the extent and nature of ICT use by businesses. The digital gap between companies in developing and developed countries is particularly pronounced in the case of Internet use, web presence and broadband access.

There are also wide variations within countries, such as:

- In both developed and developing countries, large enterprises use ICTs (such

as computers and the Internet as well as broadband) more than SMEs (this may partly be a result of their greater financial and human resources and partly of their greater need for such technologies).

- Is also a rural/urban divide, which is more accentuated the more sophisticated the technology is (this may constitute a particular challenge given that these are typically the economies with the greatest dependence on rurally based economic activities).

- From the perspective of reaping maximum benefits from ICTs, it is important to consider how companies use them. (Even in countries where the adoption of the Internet by enterprises is relatively high, the way it is used suggests a large unexplored potential. In many developing countries, the main purpose of Internet access is to send and receive e-mails; few companies use it as a marketing tool or to make banking transactions. To leverage the Internet more effectively, enterprises need to rethink some business and productive processes around new ICT tools and invest in ICT skills development).

In view of its potential positive contributions to growth and development, there are good reasons for governments to take active steps to promote greater use of ICTs in the business sector. Although it is up to each company to decide if and in what way ICTs could enhance its business performance, governments fill a critical function in terms of creating an environment that is conducive to the greater use of ICTs, especially in developing countries. Governments' role in stimulating ICT use is especially important in times of economic crisis.

Special attention should be given to SMEs, as they are lagging behind larger firms in terms of ICT uptake. In addition, SMEs typically represent the backbone of developing economies and employ a large majority of the workforce.

Faced with the current economic crisis, many governments have identified enhanced ICT use as a strategy to quicken recovery. Several developed countries have made ICTs an integral part of their economic stimulus packages, both by stimulating the demand for ICT goods and by continuing to enhance the supply side (from infrastructure to spectrum). Measures aimed at supporting demand and shoring up the financial sector should help boost ICT use in that area. Measures targeting the rolling out of broadband to areas with low connectivity may help alleviate some infrastructure bottlenecks. Innovation through ICTs is also being encouraged, including in education, energy (for example, "smart power grids"), government, health care and transportation. While the effects of these measures remain to be seen, economic policies are increasingly looking at the cost and efficiency benefits of ICT to support the path to recovery.

Conclusions

Under the circumstances of slowing the economic growth worldwide and economic downturn in major economies of the world, the companies' capability to make investments slipped significantly. Because of shrinking

production capacities, laying-offs and cost cutting, the major TNCs had to drastically revise their global expansion projects.

These evolutions reflected on the investment flows accomplished worldwide. Under these circumstances, diminishing of the FDI flows received and generated worldwide was expected.

Concerning the prospects of FDI flows in the medium term worldwide, these flows are difficult to evaluate as they were influenced by several factors, such as: financing capability varies from one country to another, efficiency of public policies adopted by the world states in order to combat the crisis and regain the investors' confidence, countries have a different capability to prevent protection pressures and last but not least, duration of global economic downturn.

However, according to the opinion of UNCTAD specialists, there are some factors that seem to act in the direction of relaunching investment activity and companies' internationalization process. This issue will drive reentering of the global FDI flows on an upward side.

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NOMINAL CONVERGENCE: THE CASE OF ROMANIA*Ramona Orăștean, Silvia Mărginean****Abstract**

The main objectives of this paper are: determining the extent to which the indicators of nominal convergence reflect the reality of the Romanian economy, in order to find an optimal correlation between nominal and real convergence from the point of view of a dualist approach, meaning that there are opinions according to which nominal convergence (by the formal meeting of the Maastricht criteria) must be carried out before real convergence, or on the contrary, that real convergence has positive effects on nominal convergence; short term forecasting for the evolution of nominal convergence indicators in Romania comparing with other new EU member states.

Keywords: nominal, convergence, Romania, euro area

JEL Classification: E31, E43, E62, F31

Under the Maastricht rules, a EU member country must achieve a high degree of price stability, keep its government finances sustainable and maintain a stable exchange rate and convergence in long term interest rates in order for it qualify for Eurozone membership. The challenge the new member states are facing is how to proceed with monetary integration in order to enter in a large monetary union. The Maastricht criteria form a coherent package based on a set of economic indicators that is neither negotiable nor subject of change.

Prior to the euro adoption, a country must be a member of the Exchange Rate Mechanism - ERM II for a minimum 2 years, that means fixes its exchange rate to euro with a central rate with a fluctuation band of $\pm 15\%$. The entry in ERM II should not be considered before a sufficient degree of nominal convergence and structural adjustment has been reached [De Grauwe, Schnabl, (2004)]. First, by setting the central rate misalignments need to be avoided. Equilibrium exchange rate is extremely difficult to asses when major structural adjustments have not yet been achieved and nominal convergence is not in advance stage. Second, if participation in ERM II occurs too early, maintaining simultaneously price stability and exchange rate stability could become extremely difficult.

The real and nominal convergence coincides with two particular macroeconomic phenomena:

- many new member states have experienced large capital inflows in the form

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of foreign direct investment. The prospect of future productivity increased, the low capital stock and the abundance of well-educated work force has fostered these inflows. FDI fosters capital accumulation and has brought in transfers of technology. It increases the linkage of new member states and EU-15 and helps the achievement of real convergence and cohesion [Issing, (2004)];

- an expected trend appreciation of the real exchange rate due to the occurrence of the so-called Balassa-Samuelson effect, that gives a supply-side explanation for the differences in the price levels between countries in different stages of economic development [Balassa, (1964)]. The Balassa-Samuelson model describes a possible path of convergence in the price level as developing economies catch up with those that are more developed. Higher labour productivity in the traded goods sector will raise the wage level in the whole economy. Due to the model's assumption that the production elasticity of labour is higher in the non-traded goods sector than in the traded goods sector, labour productivity increases in the former will be smaller. The rising wage level will therefore lead to higher prices for non-traded goods and a rising price level. However, as the Balassa-Samuelson model only focuses on one aspect of price level convergence, its applicability for new members in the catch-up process is limited.

The greatest difference between the new EU member states and the EU-15 is the level of economic development measured in terms of GDP/capita. Macroeconomic stabilization, pursued in order to achieve the nominal convergence criteria, is also compatible with real convergence i.e. the capacity to achieve, in parallel, high enough rates of real GDP growth in order to maintain progress towards real convergence. Experience has shown that the two processes can be mutually reinforcing, notably if the process of nominal convergence acquires enhanced credibility, affecting thus the formation of key variables such as interest rates, wages and prices.

It is often argued that enlarging the euro area by admitting countries still in the catch-up process would impair the ECB's policies, because real convergence in the new member states is inevitably connected with higher inflation rates [Sinn, Reutter, (2001)]. In such circumstances, the ECB would only be able to achieve its target of a maximum inflation rate of 2% for the Eurozone as a whole if the more advanced member states had a correspondingly lower inflation rate.

Nominal convergence can be forecasted by the completion of the criteria established by the Maastricht Treaty regarding: inflation rate, budget deficit, public debt, exchange rate and long term interest rate.

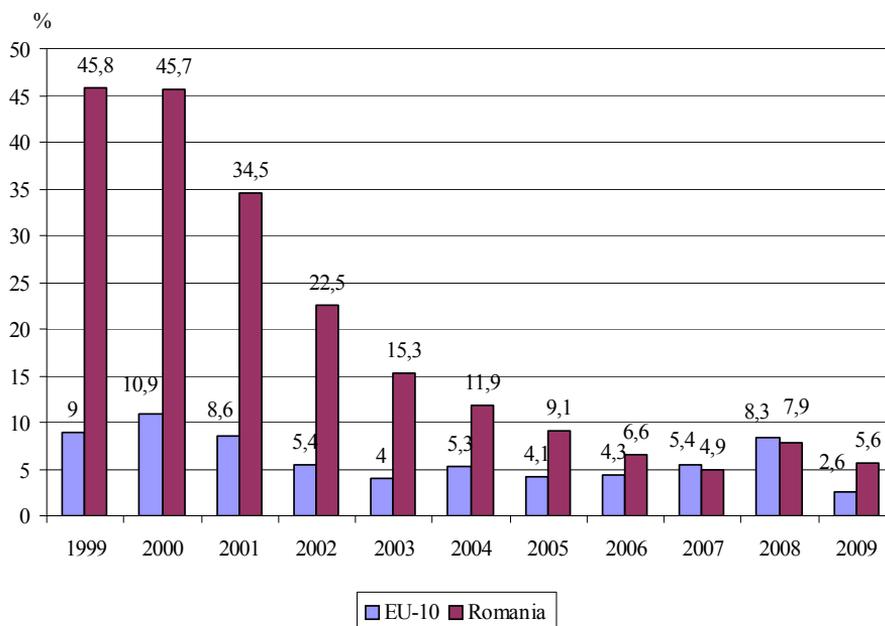
Inflation is one of the most important and painful phenomena that the Central and Eastern countries have confronted with repercussions both on the business environment but also regarding the flows of foreign direct investments.

Performances registered by EU regarding inflation management, although very different, have had as a common trait a continuous decreasing tendency. Therefore, the year before the adhesion, the medium level of inflation in the new member states was almost equal with that in EU.

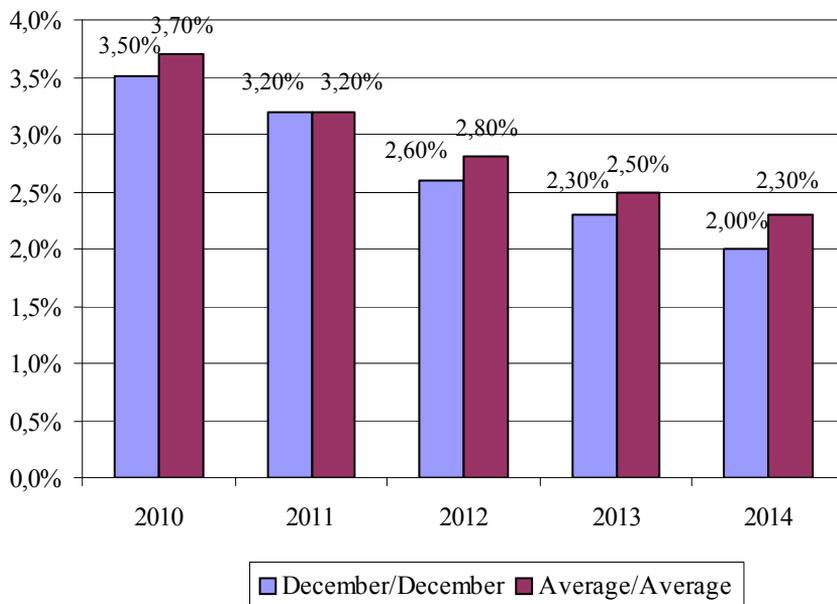
The same thing can't be said about Romania which reached at inflation level a number of 8 years distance from EU-10 countries (Bulgaria, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, the Slovak Republic and Slovenia), the level of inflation the year before the adhesion was higher, 6.6%.

In European Union, after reaching its peak in mid-summer 2008, Harmonized Indice of Consumer Prices started to fall back quickly. In the EU-10 region it has fallen sharply (from 8.3% in 2008 to 2.6% in 2009), similar to trends in the euro area, while in Romania it decreased less, from 7.9% in 2008 to 5.6% in 2009 (graph 1).

Graph 1. Annual average rate of change in Harmonized Indices of Consumer Prices in Romania and EU-10 in 1999-2009 (%)



In autumn 2009 forecast, National Commission of Forecast in Romania predicts for the period 2012-2014 an annual inflation rate (measured by the Consumer Price Index) between 2-3% (graph 2). This represents an objective with a special importance in carrying out the Maastricht criteria which states maintaining the inflation rate under the level of 1.5 over the average of 3 most performing members.

Graph 2. The forecast of the inflation rate in Romania (2010-2014)

According to National Bank of Romania, in 2009 annual inflation (December/December) dropped to 4.74%, with 0.24 percentage points over the upper limit of the range around the target of 3.5%. Favourable effects of lower inflation were exercised by persistent demand deficit and exchange rate dynamic of the Romanian leu. Current projects of the NBR incorporate favourable premises to continue disinflation, placing annual inflation at 3.5% in 2010 and 2.7% in 2011.

In consequence, the disinflation process in Romania must have a powerful slope, because starting with 2012 price growth has to be constantly situated around the limit of 3%. This is possible only if there is developed a strict fiscal discipline in order to eliminate the financial deficiencies, increasing the level of efficiency for activities in public companies which will continue to hold monopoly positions as well as maintaining a more restrictive monetary policy ensuring the objective's completion of inflation targeting.

One of the constrain factors of both the economic growth and the development of the Central and Eastern European countries was the unbalance of the budgetary balances during the period of economic crisis at the beginning of the '90s.

Thereafter, during the recovery period a positive trend has been registered in most of the Central and Eastern European countries. However, the comparisons between the EU-10 countries reveal a divergent evolution of the *budget deficit*, expressed as a percentage in the GDP, as follows: Estonia and Lithuania have had a constant positive evolution for the entire period; starting with 2001, Estonia was the only European country that registered a budget surplus; in Latvia and Slovenia,

although the budget deficit evolved in a changing trend, its values stayed under 3% of GDP; the Czech Republic, Hungary and Poland have confronted a raise in the budget deficit during 2000-2006, from 3.7% in 2000 to 6.8% in 2002 and a decreasing to 2.6% of GDP in 2006 for the Czech Republic, from 3% in 2000 to 9.3% of GDP in 2006 for Hungary, after that reducing to 3.8% of GDP in 2008 and from 3% in 2000 to 6.3% in 2003 and a decreasing to 1.9% of GDP in 2007 for Poland; Slovakia has the largest budget deficit in 2000 (12.3% of GDP) and then decreased to 2.8% in 2006.

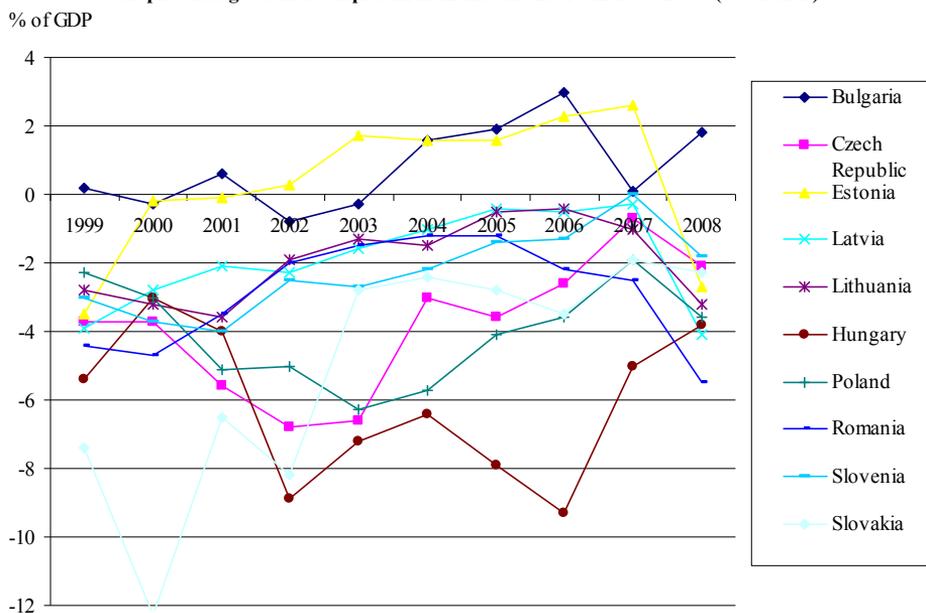
The year before the adhesion, only three countries registered a budget deficit situated around the value of 1% of GDP, namely: Latvia, Lithuania and Slovenia. In 2004 most Central and Eastern European countries registered a reduction of the budget deficit as a consequence of applying certain budgetary austerity programs together with new methodologies of collecting taxes.

In Romania, the budget deficit has continuously lowered, in the years before the EU adhesion reaching 1.2% in 2004, 1.2% in 2005 and 2.2% of GDP in 2006. Taking into consideration the relative high levels registered by most of the Central and Eastern European countries the year before the adhesion to the EU, Romania was situated on a much better position regarding the budget deficit.

After 2007 the level of budgetary income and the expenses in Romania raised. The level of incomes was higher as a consequence of the improvement of tax collecting (direct and indirect) by deepening the financial discipline. Furthermore, as a member of the European Union, Romania received financial resources from the European Union's budget through the Structural and Cohesion Funds. At the same time the budgetary expenses registered an ascending trend especially because of the supplementary efforts demanded by fulfilling the obligations that come with the quality of being a member of the EU (financing the Union's budget) and the investments made by the Government as a self financial effort in completing the sums received from European funds (co-financing the community funds).

Budget deficits have widened in 2008 in all EU-10 countries, except Bulgaria (with a budget surplus of 1.8% of GDP). Latvia (4.1%), Lithuania (3.2%), Hungary (3.8%), Poland (3.6%) and Romania (5.5%) have exceeded the 3% of GDP deficit threshold (graph 3).

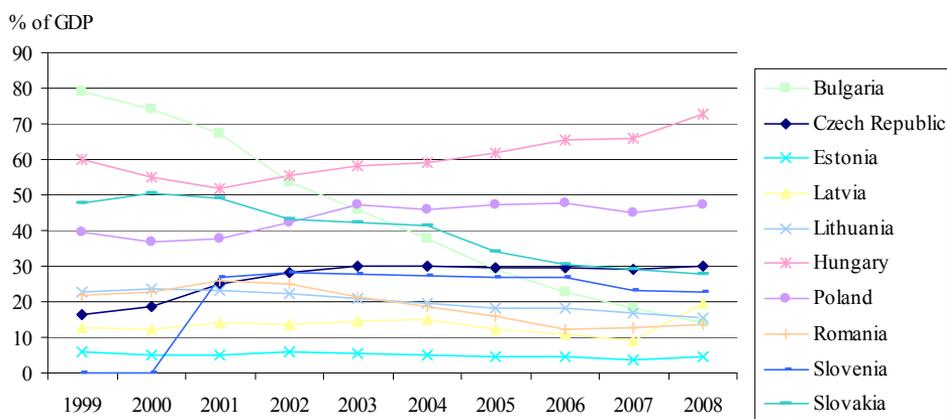
Graph 3. Budget deficit/surplus in Romania and EU-10 in 1999-2008 (% of GDP)



The estimates of the Ministry of Finance foresee a slight reduction of the budget deficits during 2010-2011, to 4.1% in 2010 and 2.9% of GDP in 2011.

A favourable situation is registered in Romania regarding the *public debt* in comparison with some countries from the EU-10 (graph 4). Its dynamics in relative figures was positive in the last few years, and so at 2006 level the government gross debt represented 12.4% of GDP, much under the 60% level established in the Maastricht Treaty.

Graph 4. Government gross debt in Romania and EU-10 in 1999-2008 (% of GDP)



In comparison to the year before the accession some countries from the EU-10 group have confronted much higher levels, for example: Hungary (58.4% of GDP),

Poland (47.1% of GDP), Slovakia (42.4% of GDP), and the Czech Republic (29.8% of GDP).

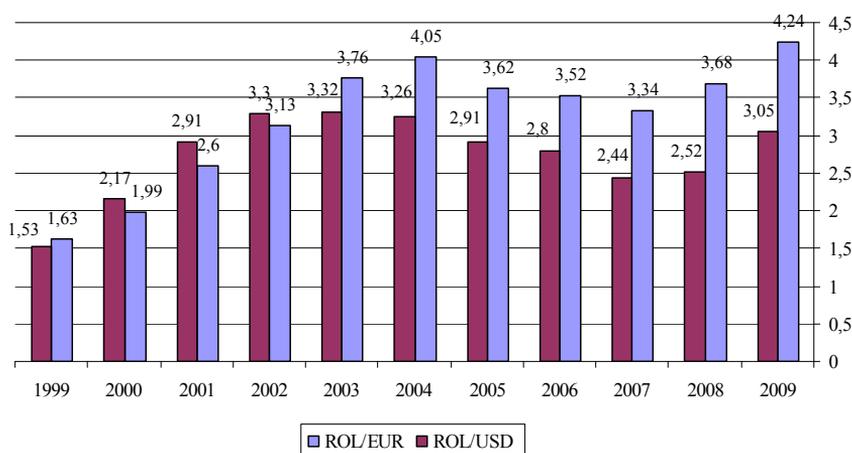
The public debt represents an important factor of economic growth as source of financing the investments projects for developing the major sectors of the economy. It was assumed that after accession the public debt in Romania will register a growth in absolute figures as a consequence of financing the supplementary budget deficit and the investment projects with a special importance for the following economic development. But in 2008, Romania's public debt level stood at 13.6% of GDP, a slight increase over the previous year.

The package of external financing contracted in 2009 from the IMF, European Commission, World Bank and other international financial institutions, totalling EUR 19.95 billion, the Ministry of Finance is considering the use of foreign loans. Incorporating in the indicator of government gross debt (according to ESA95 methodology) this financial package, the public debt in Romania will represent 30.8% of GDP in 2011.

According to the National Bank of Romania data, in 1999-2009 the *evolution of the exchange rates* of the Romanian Leu to American Dollar and Euro was unstable (graph 5). In 1999-2004 both currencies followed an ascendant trend, from 1.53 ROL to 3.26 ROL in the case of the USD, respectively from 1.63 ROL to 4.05 ROL for EUR. In 2005-2007, as a consequence of the appreciation of the national currency, the exchange rate of the American Dollar reached 2.91 ROL, 2.80 ROL respectively 2.44 ROL and that of the Euro followed the same trend till 3.62 ROL, 3.52 ROL respectively 3.34 ROL.

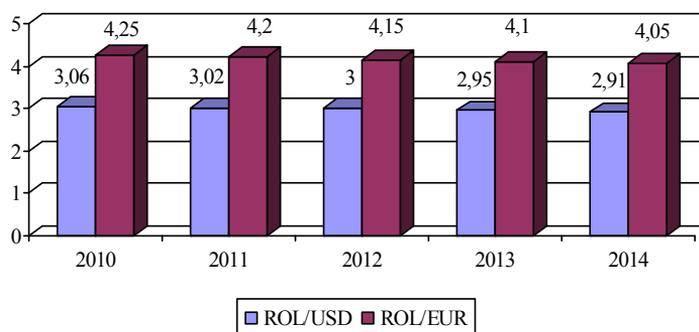
In the period 2008-2009, EU-10 countries with flexible exchange rate systems experienced strong depreciation pressures relative to the euro, especially the Polish Zloty (from 3.51 in 2008 to 4.33 in 2009), Hungarian Forint (from 251.51 in 2008 to 280.33 in 2009), Czech Crone (from 24.95 in 2008 to 26.44 in 2009) and Romanian Leu (from 3.68 in 2008 to 4.24 in 2009).

Graph 5. The exchange rate in Romania in 1999-2009 (annual average)



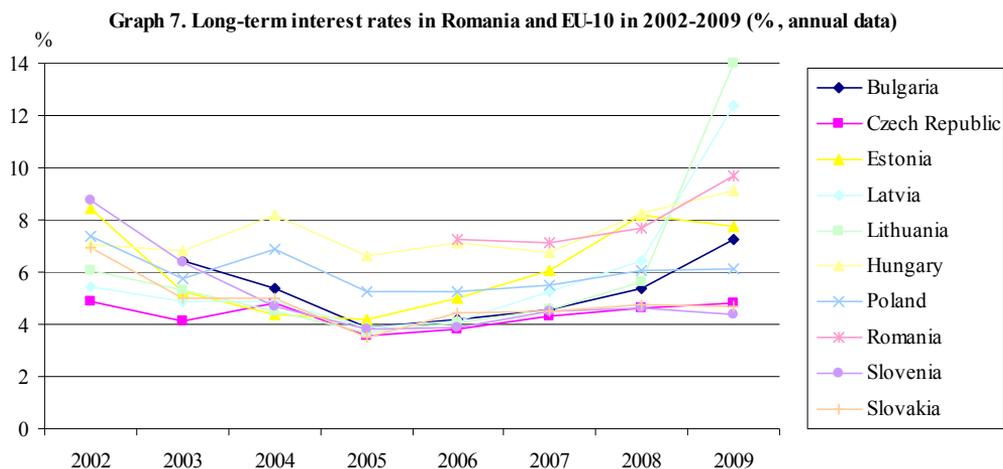
In autumn 2009 forecast, National Commission of Forecast in Romania estimates that the national currency will appreciate slowly, and so that in 2014 the ratio Leu/Euro will be 4.05 and Leu/Dollar 2.91 (graph 6).

Graph 6. The forecast of the exchange rate in Romania in 2010-2014 (annual average)



It's obvious that in the future the national currency will know both a nominal and a real appreciation. The real appreciation of the national currency correlated to an accentuated growth of the GDP (especially because of the labour productivity) would allow Romania to reduce the existent gap to the EU average regarding the level of the GDP per capita. On the other side, an excessive appreciation of the national currency can negatively affect exports, which would pressure the budget in case there are needed adjustments to the balance of payments.

Maastricht convergence criterion *long term interest rates* is defined as central government bond yields on the secondary market, gross of tax, with around 10 years' residual maturity. In 2002-2008, the values for this indicator ranged between 3% and 10% for the EU-10 region, with an increase in 2009, especially in the case of Latvia (from 6.43% in 2008 to 12.36% in 2009) and Lithuania (from 5.61% in 2008 to 14.0% in 2009). In Romania the growth was smaller, from 7.7% in 2008 to 9.69% in 2009, but the level is still difficult to analyse, because only in April 2005 were launched the first bonds with 10-year maturity (graph 7).



Conclusions

Romania should enter the ERM II only when all nominal convergence criteria and the majority of real convergence criteria are met.

The inflation rate criteria remain the main critical point of the Romanian economy, not fulfilling it, assuming the non-sustainability of the economic macro stabilization process. Taking into consideration the predictions of the National Commission of Forecast the criteria of the budget deficit and that of the public debt will be in the limits stated by the Maastricht Treaty. The criteria of exchange rate stability depend on fulfilling the criterion regarding the inflation rate. An appreciation in real terms of the national currency increases the disinflation process. The limited intervention of the National Bank of Romania on the exchange market should keep on so that the exchange rate should be as flexible as possible, which will allow to the central bank to assure an internal price stability by growing the monetary policy efficiency. Regarding the criteria of the long term interest rate, in 2009 the euro area average was 3.81%, comparing with the value for Romania of 9.69%.

The progresses in fulfilling the nominal criteria of convergence influence the real economic variables. Initially the nominal convergence can generate a reduction of the performances. Thus, imposing to respect the Maastricht criteria (especially in what regard the budget deficit and the public debt) can affect the process of convergence of those economies where the level of investments is low. But fulfilling all the Maastricht criteria is able to assure a higher macroeconomic stability, which will create the premises for a superior rate of economic growth.

The financial crisis strongly affected the EU economy from the autumn of 2008, hitting the member states to a different degree. A great deterioration in public finances is taking place so that the fiscal costs of the crisis will be enormous for all European countries. In this context it will be more difficult for new EU countries to comply with the Maastricht criteria for euro adoption. Yet only Cyprus, Malta,

Slovenia and Slovakia have entered in the euro area. Lithuania saw its application rejected in 2007 because it missed the inflation criteria.

In a recession period, keeping the budget deficit below 3% of GDP will be much harder. For this reason, most analysts think that the targets for euro adoption are unrealistic and could be reviewed.

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IT – CAUSE AND RECOVERY TOOL IN THE ECONOMIC CRISIS CONTEXT

Popescu Laura, Zurbagiu Bogdan*

Abstract

The present paper aims to identify some of the weaknesses in the IT area that have contributed to the current financial crisis. At the same time, the crisis impact over the IT&C industry is analysed. Some case studies are introduced: credit risk evaluation software applications with low performance are one of the main causes for the collapse in the loan market, while investments in software applications for virtual campuses have the potential to contribute to the recovery as they reduce costs. Therefore, the IT&C is presented from two opposite perspectives: a factor that contributed to the on-going economic turmoil and an important tool in the recovery process.

In the economic recovery plan designed by the European Union, an important place is dedicated to the investments in IT&C networks, in the Research & Development area or in the development of the global commerce as companies can make profit from every opportunity that appears on the market.

Under these circumstances, the authors design a set of performance metrics that are meant to quantify the efficiency of software applications. The conclusion is that the existence of performant information systems with high quality metrics and user-friendly interfaces undoubtedly leads to an improvement in the economic pressure factors that characterize the crisis.

Keywords: economic crisis, IT, virtual campuses, credit risk evaluation applications, metrics

JEL Classification: E50, D81, D83, G32

Introduction

There is no doubt that the society deals with what Media considers to be „the greatest financial crisis of past generations”. According to [Cagle, (2009)] the birth of the crisis is located in 2007, when the mortgage loan field has strongly declined. The current situation has been encouraged by the existence of prices that are higher than the true value of the good on the housing market. This tendency has been sustained by the banks’ policy of granting a massive amount of loans. The increased number of clients that defaulted on reimbursing their credits has determined a massive reduction in the amount of liquidities of financial institutions around the world. The main consequence is the abrupt decline of prices on the housing market. The current status could have been avoided by implementing performant informatic systems. The replacement of simplistic evaluation models with software applications that

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implement expert systems, neural networks and performant statistical models for risk analysis and the development of user-friendly applications are solutions for overcoming the recession.

In an era when people talk about their knowledge, and researchers have developed theories based on organized knowledge management, virtual campuses existence is absolutely necessary. One of the most important areas in which collaborative systems have been successfully applied is education.

1. The informatic system – one of the causes of the economic crisis

The main cause of the economic crisis (the defaulted credits) can also be identified in the Romanian banking system. The indicators computed by The National Bank of Romania (BNR) refer to the number of loans that have been granted but proved to be unsuccessful and to the gross value of granted credits related to the total amount of deposits. The researchers indicate an unprecedented increase in the amount of defaulted credits in december 2008 (their weight in the total value of granted credit was 35%) compared to the value of the same indicator for december 2007, when the percentage was 22%. At the same time, the total value of granted loans represent 122% from the value of deposits, but the metric has decreased by 2.71 percentage points when compared to its level in december 2008. An analysis of the Romanian credit risk evaluation models applied for three of the most important Romanian banks (The Romanian Commercial Bank, Piraeus Bank and The Romanian Development Bank) proves the fact that the applied models and technologies lack performance and efficiency. [Diosteanu, (2009)]

Another informatic cause that has encouraged the on-going economic turmoil is the lack of collaborative informatic systems that are able to facilitate the interoperability in different types of companies or in the financial system. Although service oriented standards have been designed (*Business Plan Modeling Notation*), institutions lack the implementation of an open system that is able to design all the business flows based on finding, automatic building and extracting useful information from the web services' semantic.

2. IT&C - symptoms induced by recession

Under the current economic turmoil, companies have been obliged to redefine their activities. The IT processes are among the first aspects to be taken into consideration. The IT strategies for the recession period consist of: maintaining the IT technologies and projects that are strictly needed by the clients and the members of the organization, the improvement of the infrastructure only if this aspects proves to be helpful, the consolidation of the IT security, the proactive monitorization of the IT services (it is better to foresee than to repair), the consolidation of the *back-up* and *disaster recovery* mechanisms, redefining the *business intelligence* applications in order to create user-friendly systems that are able to satisfy both users and clients. Some of the long-term projects, complex CRM implementation projects or projects that aim to replce the database management systems have been postponed and their budgets

have decreased for the short term. Companies are trying to identify cheaper alternatives for the CRM solutions. At the same time, investing in the technologies that are meant to virtualize some of the processes or in software applications that are able to diminish the costs is going to be encouraged. Changes have also affected the IT management: communication has intensified and transparent human resources evaluation applications have been developed.

As it is compulsory to reduce costs, the market is affected by an increased implementation of open source softwares: approximately 46% of the IT companies have implemented such softwares or were about to test them in 2009, according to an enquiry operated by Forrester Research.

A survival method under the context of the financial crisis consists in the externalization of certain services, phenomenon known as outsourcing. More than 41% of the IT companies in Europe buy services from the external providers. In the second half of 2008, the outsourcing contracts on the European market have decreased by 25% when compared to the same period in 2007. The main cause of this result is the decrease of the demand for software products in the financial system. Despite these facts, the IT market has not registered remarkable decreases on the stock exchange, because the outsourcing facilitates cost reduction inside companies. The IT Asian market has been the least affected by the crisis as their services are characterized by a high quality accompanied by a reduced price. Therefore, they create an ideal environment for outsourcing [Deutsche Bank Research, (2009)].

3. IT&C – the economic rehabilitation tool

The IT industry is considered to be a strong set of tools that can contribute to the rehabilitation of the economy as it can increase the competitiveness and improve both quality of life and the professional skills of all the actors that are involved in the working process. The IT sector can also lead to an increased performance in the public sector (Figure 1).

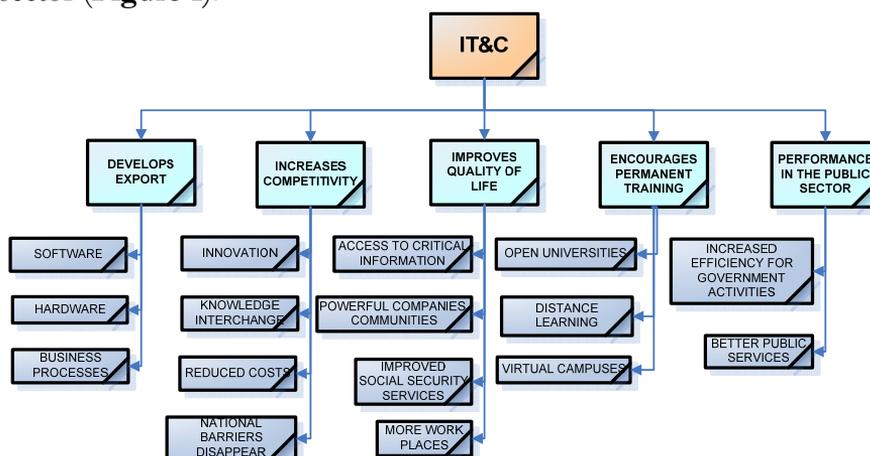


Figure 1. IT&C features – an economic rehabilitation tool

The IT can contribute to *significant increases in export*. Many countries around the world owe important percentages of their exports to the services in the IT industry. For example, India, Ireland and Israel are software exporters, while India, Philippines and Caribbean export business services and processes. The most accountable hardware suppliers are Costa Rica, China, Taiwan and Malaysia.

Another characteristic of the IT industry that is useful for economic development is that it *encourages the increase of competitiveness* as it promotes the innovation and it facilitates the knowledge exchange between people. At the same time it reduces the national barriers and the transactional costs.

At the same time, the high quality of the software applications determines *an improvement in the quality of life* and it contributes to the idea of permanent training and continuous learning. Firstly, it defeats distance problems as it creates the opportunity to access critical information for citizens that are located in areas characterized by less local means of information. Companies and communities develop their power to communicate through the help of software resources and the educational process is extended by introducing permanent learning programmes and concepts such as open universities, virtual campuses and distance learning. Another strong point consists in the improvement of social security systems as distance consultancy becomes available. Taking into account the fact that the unemployment is one of the most important menaces in the crisis context, this is an area that will combat the increased unemployment rate: 7.8 billion people work in the IT industry in Europe and according to the European Software Association another billion workplaces will be created by the end of 2011.

Another aspect is that the performance is increased in the public sector as many activities are divided in subactivities and the efficiency is improved through highly performant software applications that reduce transactional costs.

There are several emergent technologies that are able to provide an insight over the real status of the market in which they develop their activity and over the innovation potential they have. An investment in the appropriate technology leads to an important decrease in the losses. For example, the employees of a building company are more efficiently redirectioned to the closest place where their intervention is required through the help of the mobile gadgets that have access to the management information. The reporting and all the additional documents is completed through these devices as the employees are not obliged to be physically located at the company's headquarters. Consequently, time losses between two interventions are minimized.

Another example which is worth taking into account is the reorganization of the government system in Baltimore: a new software application was introduced (CitiStat) [Gullino, (2009)]. The aim is to improve public services and to find appropriate answers for the problems of the local community. The main objective is to reduce the criminality by identifying the crimes and positioning them through a GIS system (Geographical Information System).

4. Credit risk evaluation applications – A POTENTIAL CAUSE

The origins of the current crisis, which blocked the blood in the arteries of finance across all markets, are to be found in the financial sector. In March 2008 Bear and Stearns collapsed and the Dow Jones Industrial Average hit its lowest level since 2006. A second notable spike in the banking sector occurred in late summer 2008, which coincided with the bankruptcy of Lehman Brothers in September 2008.

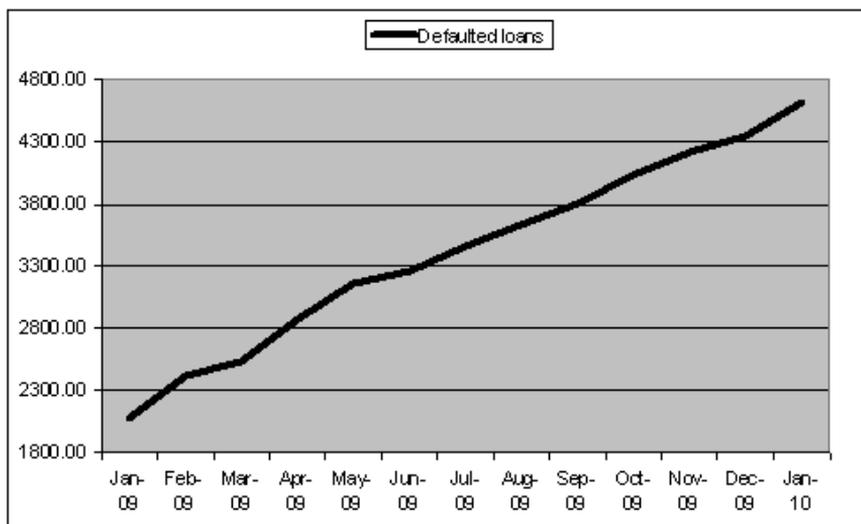
Similar to the recession in 1990-1991, the main driver of the 2008 credit crisis appears to be an increase in subprime mortgage defaults, which was first noted in February 2007. The subprime market is the riskiest segment of the mortgage market, so it is hardly surprising that some borrowers default on their loans. According to [Buraschi, (2009)], the incidences of defaults have been “the catalyst for the crisis”. Consequently, one of the main causes has been represented by the difficulty of valuing structured credit products. Most of the banks use very simple risk evaluation application, most of them being based on regressions and statistical algorithms. Therefore many of the loans have been granted due to the result computed by a software application that did not use an appropriate model.

As argued by [Brunnermeier, (2009)], a possible trigger was the extent of securitization. For years, the asset-backed securitization markets fueled the explosion in consumer borrowing, allowing lenders to easily spread their risk to other investors like pension funds, hedge funds, and insurers. Securitization not only made the exposure of institutions to credit counter-party risk more opaque, increasing systemic leverage, but it also made these products more difficult to value. Therefore, the lack of a software application that is able to determine the “true” value of the parameters behind the inflated amounts induced by the crisis, has often led to spurious results and wrong decisions.

According to the National Bank of Romania, the trend in the evolution of defaulted credits indicates a progressive growth throughout the months of 2009 (Graph 1)

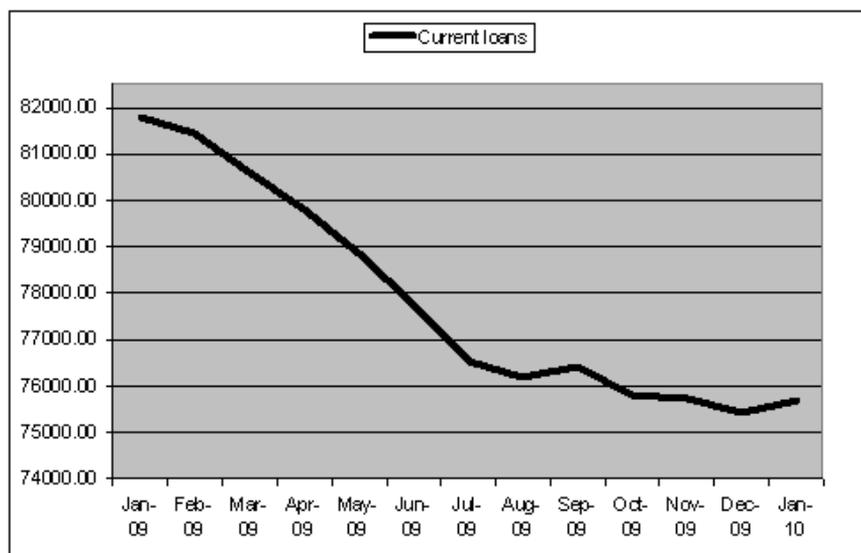
	Jan-09	Feb-09	Mar-09	Apr-09	May-09	Jun-09	Jul-09	Aug-09	Sep-09	Oct-09
Total amount of granted loans	83868.17	83861.48	83143.63	82703.05	82011.26	81007.37	79990.67	79829.06	80219.38	79840.85
Current loans	81798.85	81440.32	80603.03	79833.69	78849.58	77749.43	76522.66	76197.32	76408.36	75806.75
Defaulted loans	2069.32	2421.16	2540.60	2869.36	3161.68	3257.94	3468.01	3631.74	3811.01	4034.10

Table 1. The evolution of granted loans over 2009 (millions of RON)

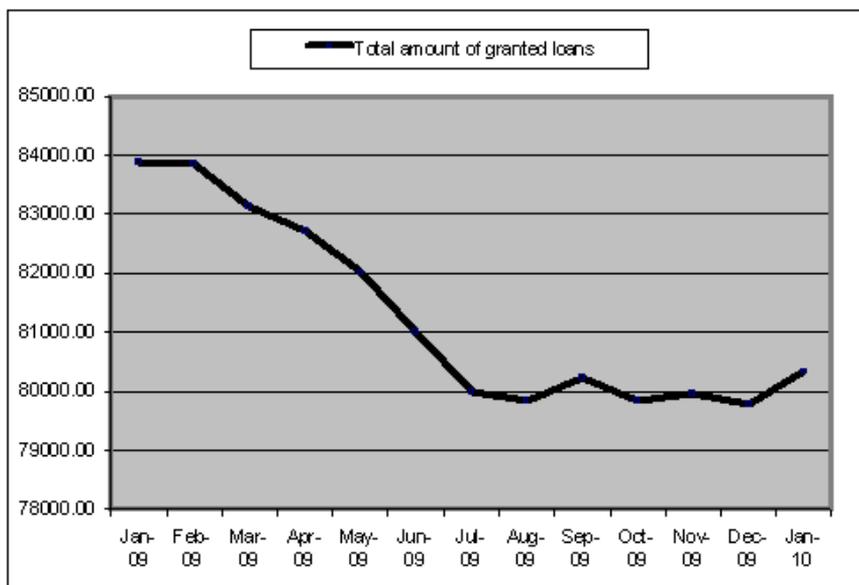


Graph 1. The 2009 evolution of defaulted loans (millions of RON)

The negative impact of this evolution is emphasized by the fact that the total amounts of granted credits and current loans have decreased (**Graph 2**).



Graph 2. The 2009 evolution of current loans (millions of RON)



Graph 3. The 2009 evolution of total amount of granted loans (millions of RON)

The conclusion is that even though credit risk applications have become more restrictive and fewer clients were accepted, their performance and ability to correctly identify default credits and reject them has decreased. Consequently, these software tools are not able to adapt to a crisis environment. Unless factors that include the economic turmoil influence are taken into account and spurious influences are dropped from the values of the model's parameters, these evaluation methods will contribute to inflating the current crisis.

5. Virtual campus investments – a recovery tool

In the context of the second largest economic crisis known to modern human kind, investing in the development of human capital is the wisest long term measure to be taken, ensuring a secure and stable economic growth. In [Bravo, (2008)] it is considered to be “particularly necessary to look in more depth at the joint analysis of the collaborative process and its resulting product”.

Virtual campuses provide their members with a virtual community in which knowledge sharing is the governing law. Inside a virtual campus, students perform specific activities specially developed to fit each one's level of understanding. In a knowledge based economy, one of the most efficient means to obtain a high degree of skill is the online collaborative system.

Companies are getting more involved than before in the educational process by taking part in the curricula organization, arranging meetings with the managerial staff of the virtual learning communities, purposing new ways of teaching, offering

specialized consultation, etc., with the purpose of hiring highly educated and creative people that will bring added value.

Nowadays, the biggest asset of a company is the employee. The creative and visionary employee will create new business lines or will develop the existing ones. But in order to create added value, firstly the companies must invest in their current employees but also in the community, from where there new employees may come.

Virtual Campus is an online tool that requires educational programs carried out online, without the necessary physical presence. The term is usually associated with the concept of virtual education, describing education using virtual courses delivered via the Internet. The notion of virtual is, in this case, a course that is not supported in one physical location, but given the alternatives.

According to [Le Beux, (2007)] “modern approaches to teaching and learning... include collaborative learning, problem based learning and the use of computer simulations”.

The purpose of virtual universities is to provide access to educational materials to those people who can not attend a traditional education system, because the distance or the need for flexibility.

Many virtual universities are accredited and work according to the same standards as those classics, therefore, issued diplomas are recognized worldwide.

Distance learning, at first, assumed the study through correspondence courses offered via television or recorded in audio and video formats.

Distance learning is the principle of making possible learning where a professor specialized professor is missing, in the desired area.

The development of virtual campus is accelerated, along with the wireless networks and, the quality characteristics become strictly related to the security characteristics.

Comparing collaborative training with classical training is found that in the case of collaborative training assimilation of knowledge is made more efficient due process of learning within the teams. Collaborative work can be successful if all members show goodwill and responsibility.

The objective of the virtual campus is the development and diversification of the online education for all the race, held on the e-learning platform of the university, providing logistical support, e-learning monitoring, training the participants and developing student and teacher’s guide online.

6. Efficiency metrics for software applications

The previous two chapters of the current paper proved that the efficiency of the informatic system is an important issue to be analysed and quantified. The higher is their performance, the greater will be the recovery chances of a certain entity and of the whole economy.

Therefore, the informatic systems that are designed for the new economy – the digital economy – should be characterized by the following: are portability, a high

degree of accessibility, the ability to answer to the client's needs and the possibility to be accessed from as many locations as possible.

An important metric is the **User Fidelity Rate** (UFR) which is computed as a monthly indicator that is able to quantify the percentage of users that have accessed the on-line application in two successive months. It is computed as a ratio between the number of users that have accessed the application both in month $n-1$ and in month n and the number of total users that have accessed the application in month $n-1$ (**Formula 1**). The counter is determined as the cardinality of the dataset that represents the intersection between the set of users that access the application in month $n-1$ and the set of users that use the application in month n .

$$UFR = \frac{\text{number_of_common_users}(\text{month}_{n-1}, \text{month}_n)}{\text{total_number_of_users}(\text{month}_n)}$$

Formula 1. The User Fidelity Rate

Another important aspect refers to the application's **Accessibility** (A). This indicator is determined as the ratio between the number of successful accesses and the total number of accesses in a period of time (Formula 2). The definition of a „successful access” depends on the type of application that is evaluated. For example, in the case of a credit risk evaluation application, a successful access refers to the ability of the user to answer all the required questions and determine his credit score. If, for any reason, the user is not able to end his evaluation (the connexion brokes, the application is very difficult to use and he abandons, etc.), his access is considered to be unsuccessful.

$$A = \frac{\text{number_of_successful_access}}{\text{total_number_of_accesses}}$$

Formula 2. The Accessibility Rate

This metric can be computed for different time periods: daily, weekly, monthly, annually.

Security metrics are used by virtual campus platform administrator to determine the ideal level of security to be applied. The security level applied in day $t+1$ will be determined on the SMITU level of day t and will determine the security mechanisms used in the virtual campus platform. The security level applied daily (day $t+1$) in the virtual campus platform will automatically adapt depending on the values of the SMITU_{*t*} indicator. The details of the security levels and the measures taken are shown in **Table 2**.

Security level	Values of SMITU _t indicator
SL1	Between 0% and 5%
SL2	Between 5,01% and 10%
SL3	More than 10,01%

Table 2. Security levels associated with different SMITU values

Security level SL1 involves the default security measures, allowing the highest level of accessibility, while SL3 will determine the most strict security measures and in the same time the lowest level of accessibility.

$$SMITU_t = \frac{\sum SMIU_{it}}{TNU_t}$$

Formula 3. Security Metrics Indicator for Total Users

where:

SMITU_t (Security Metrics Indicator for Total Users – **Formula 3**) indicates the average confidence level, showing the average probability that the virtual campus platform is being subject of attacks in day *t*. It calculated by adding the values of **SMIU_{it}**, for user *i* in day *t*, and dividing them to the total number of users.

SMIU_t (Security Metrics Indicator for User) shows the average confidence level when declaring a user as performing unauthorized activities. It is determined by calculating a percentage on the basis of multiple indicators and reflects the level of probability when declaring a user is an unauthorized one that performs different attack activities in day *t*.

TNU_t represent the total number of users that have accessed the virtual campus platform in day *t*.

As shown bellow, the **SMIU_{it}** indicator (**Formula 4**) is calculated based on multiple specific indicators. Each specific indicator will have assigned a level importance.

$$SMIU_{it} = 0,1 * UIP_{it} + 0,3 * EA_{it} + 0,25 * LC_{it} + 0,35 * CI$$

Formula 4. SMIU Indicator

where *i* = user *i*; *t* = day *t*;

UIP_{it} (Unknown IP) – the indicator shows if the user *i* has connected from an unknown IP address. The virtual campus platform will store the activity of each user and the IP's from where is has connected. The indicator will take value 0 if there was no appearance of the event or 1 of the event has taken place at least once.

EA_{it} (Erroneous Authentications) - this indicator counts the number of erroneous authentications the user has performed before connecting to the virtual campus platform. The indicator will take value 0 if there was no appearance of the event or 1 of the event has taken place at least once.

LC_{it} (Logical Course) – this indicator shows if the user has connected to one of the virtual campus functionalities and did not use the normal path of reaching the functionality. The indicator will take value 0 if there was no appearance of the event or 1 if the event has taken place at least once.

CI_{it} (Code Input) – this indicator will reflect the number of times the user has input code text in different text areas of the virtual campus platform. The indicator will take value 0 if there was no appearance of the event or 1 if the event has taken place at least once.

Table 3 illustrates the values computed for the SMIU metric in a particular situation. The software application has been accessed by 10.000 users per day. For example, 300 users have performed an activity that has determined a SMIU value of 0.35, while 8000 did not perform any suspect activities.

Occurrences	Value
1000	0.1
500	0.3
200	0.25
300	0.35
8000	0

Table 3. Occurrences table for SMIU indicator

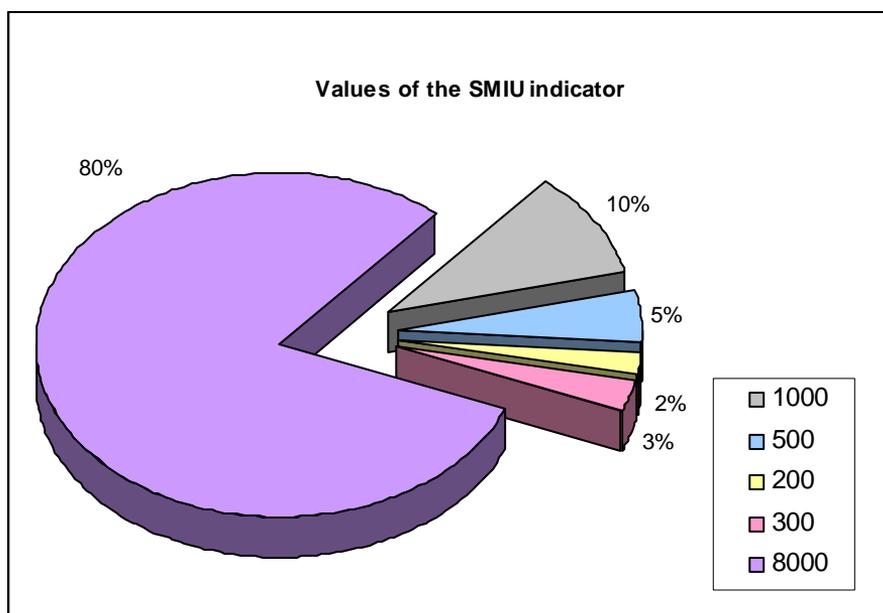


Figure 2. Values of SMIU indicators

An adaptive security measure will ensure a low level SMIU indicator, reflecting a good security status of the software. As long as there will be protected virtual campuses, the distance learning projects will prove their superiority by increasing the efficiency of human resources development and in the same time decreasing the costs.

7. Conclusion

Issues related to the information transparency, application's security and performance are more and more evident and have negative effects that induce a negative influence on the clients and influence their trust in the institutions that use these applications. The importance of investing in strong informatic solutions that aim to develop the digital economy and to encourage the recovery of the world economy after the crisis has been emphasized by UK's prime minister at the Digital Britain Summit. At the same time, [Gates, (2009)] made public his opinion according to which the innovation is the main tool that humanity should use in order to overcome the effects of the recession, and the first area in which it should be applied is software.

Acknowledgements

This article is a result of the project POSDRU/6/1.5/S/11 „Doctoral Program and PhD Students in the education research and innovation triangle”. This project is co funded by European Social Fund through The Sectorial Operational Programme for Human Resources Development 2007-2013, coordinated by The Bucharest Academy of Economic Studies, project no. 7832, Doctoral Program and PhD Students in the education research and innovation triangle, DOC-ECI.

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THE ECONOMIC CONTINENTAL UNIONS OF THE 21ST CENTURY

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Abstract

The present study proposes a display of the forming and developing of the modern economic continental unions within the context of the latest economic evolutions.

Also, it presents an amazing parallel between the map of the new post-war world, as it was imagined by the visionary Maurice Gomberg and the latest evolutions regarding new world's order reconfiguration.

Keywords: continental union, world order, regional integrative organization, economic superpower, supra-state structure, Gross Domestic Product (GDP).

JEL Classification: E01, E20, Y90

Between 1941 and 1942, Maurice Gomberg proposed a reorganization of the world, at the end of World War 2.

This proposal regarding a division of the world after the end of the conflagration was obviously not put into practice as the suggestion was considered to be contrary to the interest of U.S.A. (see pact mania), U.R.S.S. (the revolution export) and being against the wishes of United Kingdom, France, Portugal, Netherlands and others to keep their colonial domains.

The project of Maurice Gomberg proposes in 1941 that U.S.A. in co-operation with its allies to decide over the complete destruction of the Axis powers and its satellites, for reasons of national safety and international morality enshement (art. 1).

After the Axis powers would have been destroyed, U.R.S.S., U.S.A. and United Kingdom would assure the institution of a new world order that would lead to a permanent peace (pax Americana) and the freedom would be a felicitous result of the war led by the allies.

For reasons regarding historical matters, economic organizing and geographic (continental) neighborhood, the U.S.A. should have taken the deliberate role of world leader and establish the new democratic world order.

The project regarded the demilitarization of several countries, the submission of those countries to an international control and including them into political unions and international organizations.

All of the states would have to obey common economical (global) rules, but the U.S.A. would oversee the abundance of the political freedoms.

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The plan would consist in:

- controlling at a global level the world's natural wealth for the purpose of assuring equal access and distribution for all the countries;
- controlling at a global level the bank institutions, the financial international organizations and the foreign investments;
- controlling at a federal, regional level the external relations and the international trade practiced by the member states.

The countries all over the world would have to become part of the regional or continental forms of association, political unions of states, mostly federations. The states or union of states would become also members of the United Nations Organization. This Organization would have to have social, economic and military institutions of its own, with the help of which it would be able to intervene anywhere in the world to reestablish peace and democracy.

The shocking matter regarding this map is that it appears to anticipate with about seven decades the phenomena of a state association trend that is happening in the present days or are planned at a political level to happen in 10-20 years.

So far, generally speaking, these continental state unions come in the shape of integrative economic organizations, but in the case of 3-4 of them some tendencies of forming federations or other types of state unions appear.

These resembles between the map, the present world order and some political tendencies that are starting to materialize have made some persons to sustain that The United States as well as other world influence polls (states or union of states) is trying - independently from the people's will – to reorganize the world in order to be able to control its economic, financial and human resources.

In fact, the project regards the creation of a world map of political union states that are to be organized at a continental level (continental unions). In Asia, where the civilization diversity is greater than average, the organization is to be done at a sub continental level (regional).

There would have been the following structures:

- a North American Union of States as a dominant world power that would include U.S.A., Canada, Mexico, Central America and several islands;
- a union of socialist republics led by Russia (member states of C.S.I. And the ones from the late C.A.E.R.); the map is an anticipation of the later appearing of the European social post war states.
- a union of South American states including all the states from the South America (see The Union Nations of South America).
- a union (federation) of states including the entire Africa (see The African Union and The United States of Africa).
- a union of states including the Arabic Peninsula (see The Cooperation Council of the Arab States of the Gulf).
- a union of republics in the space of Indian civilization that is formed in the contemporary political system by Afghanistan, Pakistan, India, Nepal, Bhutan,

Bangladesh and Myanmar (see S.A.A.R.C. - South Asian Association for Regional Cooperation).

- a federal Chinese state (see the federalization project regarding China).
- A union formed by the European states, as a federation that would include France, Switzerland, West Germany, Italy, Spain, Portugal, The Netherlands, Belgium, Luxembourg, Malta (see The European Union, The United States of Europe).
- Israel and the Palestinian states would form an independent state.
- Greece, Turkey, Japan and Ireland would be independent states.
- a state union in Pacific Oceania area, including The United Kingdom (see the Pacific Union or the Economic Union of A.S.E.A.N.).
- a state union in the Scandinavian area.

In short, this was Maurice Gomberg's proposal.

We will now analyze the actual aspects and the premises for the future regarding the political economic integrative organizations that are formed in our days at continental level.



Post war map proposed by the visionary in 1941 (Source: <http://sun-bin.blogspot.com/.../outline-of-post-war-new-world-map-1941.html>).



Continental unions in present period. These take form of political economic integrative organizations (Source: http://en.wikipedia.org/wiki/Continental_union).

The European Union. It is a political, social and economic regional organization, having 27 member states as it consist in a form of pan European unity.

The resulted from the treaties political system reflects, through its structure, the democratic principle of the state power separation in: legislative power, executive power and juridical power, and regarding the legislative process, it following the principles of subsidiary and proportionality.

According to Article 7 of the Treaty on European Union, as it has been revised by the other treaties, the integrative organization has communitarian institutions. These are:

- The European Parliament that represents the European Union citizens, at they elect its members trough direct vote.
- The Council of the European Union (Council of Ministers) that represents each member state.
- The European Commission, that represents the general interests of the E.U.
- The Court of Justice for the European community, that watches over the abidance of the European legislation.
- The Court of Auditors, that verifies the financings of the E.U.s activities.



The E.U. states (Source: Europa, The E.U. at a glance-maps, <http://europa.eu/abc/maps/>).

Currently, the Union is in an expanding process as other three countries – Croatia, The Republic of Macedonia, and Turkey are candidate in acceding at the membership of the European Union (ro.wikipedia.org/wiki/Uniunea_Europeană).

Romania and Bulgaria have become member states at the 1st of January 2007.

Because of the religious and cultural differences in comparison with the rest of the Europe, Turkey confronts itself with a powerful opposition from the conservatory and religious E.U. governments.

Croatia is another candidate state for adhering at the Union. This process has delayed by the non cooperation of Croatia with The International Criminal Tribunal in Hague. At 9th of November 2005, The European Commission recommended the provision of the candidate state for Macedonia that became the third ex-Yugoslavic

country to receive this statute.

Three of the AELS (EFTA) states – Iceland, Liechtenstein and Norway are members of the European Economic Space (SEE/EEA) and this allows them to participate in most of the aspects regarding the single market of the E.U., without the obligation to adhere.

Switzerland, which is the fourth EFTA state has rejected the participation at EEA through a referendum, yet it has signed several bilateral treaties with similar effects.

The territory and the population of the E.U. have grown after the German reunification in 1990, among other reasons, while their parameters were lowered (especially the territory) by the retreat of the autonomous territory of Greenland in 1985.

If it were to consider the Union as a whole entity, it has the world's greatest economy (de la Reya, 2009, p.15-18).

It is assumed that E.U. economy will increase in the next decade, by receiving new states, especially due to the fact that new members are usually poorer than the European average and the rapid increase of the DGP will contribute to the united Europe dynamics (Source: Institutional reform of E.U. http://europa.eu/roadtoconstitution/index_en.htm).

Still, The United States, China and India are advancing as well.

The integration of the E.U. states into N.A.T.O. and the non existence of a treaty towards the security of each specific state (for example an opened confrontation with another military force), these are factors that will generate a reduction of the cohesion level between the countries and will decelerate the process of forming a single European state. Giving the advanced level of communitarian integration, the state unity is no longer necessary.

Never the less, the Union is an Economic Superpower of both present and future, being in competition with other state's or union of states economies: The U.S.A., China, India, Russia, Brazil (U.N.A.S.U.R.), Japan, South Africa (The African Union).

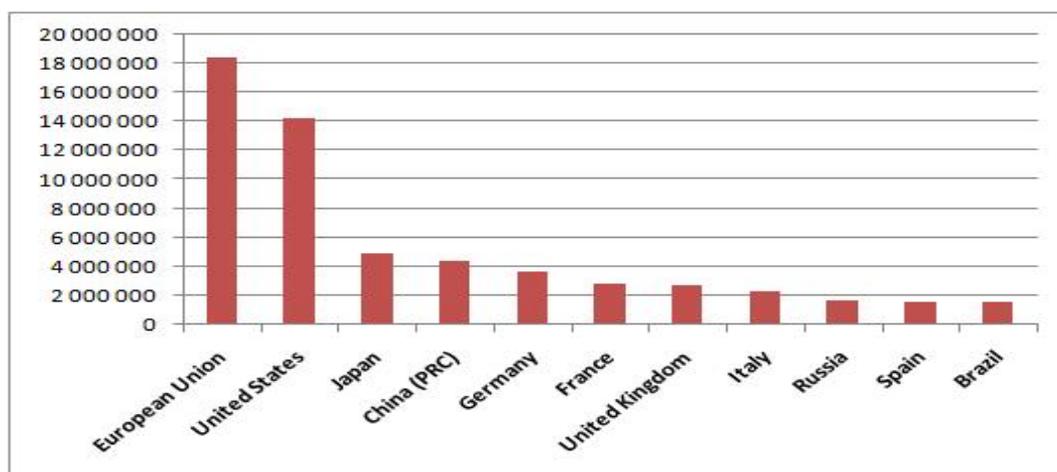


Potential economic superpowers of the XXI Century (Source: <http://en.wikipedia.org/wiki/Superpower>).

According to the International Monetary Fund, in the present, the European Union is on the first place in the world regarding the DGP expressed in million of USD:

- U.E.: 18,387,785;
- S.U.A.: 14,441,425;
- Japan: 4,910,692;
- China: 4,327,448;
- U.N.A.S.U.R.: 1900 (Source:www.contrarianprofits.com/...unasur.../2516);
- Russia: 1,676,586;
- Brazil: 1,572,839 11;
- Canada: 1,499,551;
- India: 1,206,684;

-The African Union-515, from which 276,764 for South Africa (Source: [Http://imf.org/external/pubs/ft/weo/2009/02/weodata/weorept.aspx-](http://imf.org/external/pubs/ft/weo/2009/02/weodata/weorept.aspx-) International Monetary Fund, World Economic Outlook Database, October 2009: Nominal GDP list of countries).



The DGP of the European Union and other states in 2008
([http://en.wikipedia.org/.../List_of_countries_by_GDP_\(nominal\)](http://en.wikipedia.org/.../List_of_countries_by_GDP_(nominal))).

The Mediterranean Union. The European Union has a territorial neighbors two regional integrative organizations: a Community of Independent States that seems shattered by profound flusters and an African Union with regional state leaders worried by the perspective of a too fast, too big pan African integration.



The Mediterranean Union – member states (Source: http://en.wikipedia.org/.../Union_for_the_Mediterranean).

Egypt, Turkey and Morocco (the last one bothered by the recognize of the Democratic Arab Republic of Saharawi's independence by its African partners) have agreed upon a close political relation with the European Union. The North African states share the same opinion towards the creation of a political state union in Africa.

The commercial connections between the European countries and the African ones are very important. They have created the premises for a future economic union between the Mediterranean non European states and the communitarian countries.

The Mediterranean Union reunites countries from Europe, Middle Est. and North Africa countries that have access to the Mediterranean Sea, forming an economic community by taking the model of the early European Union (Source: en.wikipedia.org/.../Union_for_the_Mediterranean).

Both France and Spain have proposed a geo political real space by creating a Mediterranean Union.

Turkey did not exclude its participating; still it stressed the fact that no Mediterranean Union will be an acceptable alternative to the effort that Turkey made for 46 years in becoming an E.U. member.

As it would be formed by the E.U. states and the Mediterranean countries, the Mediterranean Union would have a State President Council, an executive council, ministerial councils, a Permanent Commission that would act like a Secretary Department, a consolidated Parliament reunion and its own bank (Source: www.setimes.com/cocoon/setimes/xhtml/.../reportage-0-SETimes.com. The debate regarding The Mediterranean Union heats up Europe, 2007).

Such an organization could have a big role in the area in solving diverse problems, form ecological issues to immigration (Source: ec.europa.eu/social/main.jsp?catId=81&langId=ro...).

The African Union (A.U.). This is the organization that follows The Union of African Unity. Founded in July 2002, it has Thabo Mbeki, a South African as president, him being the ex – president of O.U.A.

The entity was created after E.U. model, having the promotion of democracy, human right and development of Africa as goals, especially increasing the level of foreign investments through The New Partnership for Africa Development programme (NEPAD) (Source: www.africa-union.org/).

Elected in 2004, The Pan African Parliament opened in March 2004, initially having its headquarters in Addis Ababa, in Ethiopia. It is currently having its headquarters in Midland, South Africa.

Initially, the Pan African Parliament only had a consult role, but now it also has legislative powers. It has 265 members that are also members of the national Parliament of the 53 component states (http://en.wikipedia.org/wiki/Uniunea_African_Union).



The African Union (Source: <http://www.africa-union.org/>).

The African Union was created according to the plan, from the economic regional communities, like the Organization of African Unity (O.A.U.) or The African Economic Community. It has its own army (that has intervened as a peace force in the regional conflicts, like the one in Darfur or the one in Somalia), a single Bank (The African Development Bank), a Court of Justice (The African Court of Justice). The Union's institutions are currently planning upon issuing a unique currency named AFRO.

Pan Africanism and the United States of Africa. Several African leaders are sustaining the idea of forming a state federation called The United States of Africa.

During a speech at Accra-Ghana in 2007, the president of the Republic of Zimbabwe, Robert Mugabe stated that the African countries should help each other, instead of relying on the international aids. "If we don't organize in putting our resources together, and we do have many resources, we will never prosper, no matter the external help", said the president Mugabe.

One of the main supporters of the African union, the Libyan leader Muammar al-Gaddafi, is requesting an action now, by starting a state federation, while other African leaders desire a more step-by-step acting in this direction.

President Muammar al-Gaddafi along with Laurent Gbagbo, the president of

Ivory Coast and Guillaume Soro, the Ivorian prime minister, launched in 2007, during a meeting, a call for the African people to unite in one single state and to put an end to civil wars, a call that was quoted by AFP. “We have to build a strong state, with a single government, a single 2 million soldiers army, a single currency, a single African identity, a single passport”, stated Ghaddafi in front in 5000 persons gathered in a hall in Treichville, a quarter of Abidjan.

The African leaders summit in Ghana ended only with the creation of a Committee mend to establish a project and a calendar for the future Continental Union Government that should be established by 2015. The idea dates back 50 years ago, as it has originally been issued by Kwame Nkrumak after the gaining Ghana’s independence.

The Union of South American Nations (UNASUR). The former South American Community Nations (until April 2007), is a political-economic regional organization, founded by 12 states from South America. It was created on the 8th of December 2004 in Cuzco, Peru, during the Third Meeting of the South American presidents.

The forming treaty of U.N.A.S.U.R. was signed on 23 of May 2008. It provides the creation a unique currency, the creation of a central bank (the Bank of South) and of a South American Parliament in a new union capital, Quito, Ecuador. The former secretary general of The Andes Community, Allan Wagner Tizon, announced that the deadline for the integration process to be finalized is 2019.



The member states of The Union of South American Nations (Source: http://en.wikipedia.org/.../Union_of_South_American_Nations).

In the founding declaration, the following objectives have been established:

- Political and diplomatic coordination in the area;
- A union between Mercosur, The Andes Community and Chile to form a single free trade area. Surinam and Guyana can associate without losing their status in Caricom.
- Physical, Energetic and Communication integration of South America, stimulated by IIRSA (The integration in initiative for regions of South America).
- Political armonisation regarding the rural and food market development;
- A technology transfer and horizontal cooperation in all scintific, educational and cultural areas;
- Increasing the interaction level between the commercial environment and the civil society;
- Increasing promovation of measures and acting areas in accordance with the existent institutions.

The integrative organization structure will include:

- The committee of Foreign affairs ministers that will elaborate action proposals and take executionals decisions;
- A reunion of states presidents; the first reunion took place on 29-30th of September 2005 in Brazil.

The suprastate structure moved on in achieving real objectives toward increasing the economic and social integration of the associated countries.

The Union of South American Nations begun the integration plans by:

- constructing an access way between Brazil and Peru via Bolivia. As a result, Brasil will have access to the Pacific Ocean and Peru to Atlantic Ocean. The construction begun in September 2005, being financed by Brazil 60% and Peru 40%.
- Constructing The South American Energy Ring, a pipeline trough which Argentina, Brazil, Chile, Paraguay and Uruguay will receive natural Peruan gas. The Proposal was approved and the construction begun in 2006.
- Constructing bination gasoduct, a project designed for the energetic integration od Columbia and Venezuela. The construction begun in mid 2006. The beneficiary of the project will be PDVSA- The national oil company from Venezuela. This project will cost over 300,000,000 USD.

The South American nations will also form a single military alliance for the first time. This new institution of The Union of South American Nations, The Council of Defense, is designed as an integration dialog and defense cooperation mechanism for the 12 Union states.

Brazil's president Luiz Inacio Lula da Silva insisten upon creating this institution after the conflict between Columbia and Ecuador.

The military leaders will have periodic meetings in Cono Sur. The deputy ministers of defense will have 2 annual meetings, while the ministers will have a single annual meeting.

Among the objectives of these new military institutions, we find:

- the increasing of military cooperation;

- humanitarian missions and peace operation coordination
- creating a Defense Institute in South America
- elaborating quantification method for the military expense.

Following the euro model, there will be a new commune currency for the countries that will form The Union of South American Nations. South American nations are planning to adopt a single currency as part of the integration in The Union of South American Nations. Another important issue regarding this union is the creation of a central bank that will coordinate the new currency.

The plan for the union also involves a regional council of defense. This council would resolve conflicts in the area, would promote the military cooperation and would oversee the gun production in the area (Source: <http://www.nuwireinvestor.com/articles/unasur-uniting-south-america-51659.aspx> ...).

The Slavic Union (Rusia-Belarus State Union). It is an interstate form of association that has been established by 2 treaties: Russia – Belarus Treaty (signed in Minsk, on 2th of April 1997) and The Slave Union Treaty (signed in Moscow on 8th of December 1999). The component countries keep their suzerainty (Source: http://ro.wikipedia.org/wiki/Uniunea_Statala).



The member states of The Slavic Union (Source: en.wikipedia.org/wiki/Union_State).

Serbia is also part of this structure since 1999 and its participation was confirmed in 2003 and 2006. South Osetia and Adhazia are part of this Union, even though they aren't well known countries at an international level. Both states have adhered in 2008 – 2009. Among other candidates there are Transnistria, Kazakhstan in 2010 and Kyrgyzstan (Source: en.wikipedia.org/wiki/Union_State).

The Cooperation Council of the Arab States of the Gulf. This is an international organization that formed a commercial community counting 6 Arab states: Bahrain, Kuwait, Oman, Qatar, Saudi Arabia and United Arab Emirates. The state community hardly receives any new members. Still, Yemen is expected to join the Arab community in 2016 (Source: http://en.wikipedia.org/.../Cooperation_Council_for_the_Arab_States_of_the_Gulf).



The member states of The Cooperation Council of the Arab States of the Gulf (Source: http://en.wikipedia.org/.../Cooperation_Council_for_the_Arab_States_of_the_Gulf).

The South Asian Association for Regional Cooperation.

It is a political economic organization that had in 1995, 7 Asian members: India, Pakistan, Bangladesh, Sri Lanka, Nepal, Maldives and Bhutan. Since 2007, at the 14th Organization Summit, Afghanistan became the 8th member

(Source: en.wikipedia.org/.../South_Asian_Association_for_Regional_Cooperation).

The organization's cohesion and its role in Asia are questioned by the military rivalry between India and Pakistan. This conflict represents the cause for which an Asian Union is impossible to conceive in the area, in spite of the existing dream regarding one big India. Still, the Trade Agreement came into force on the 1st of January 2006.



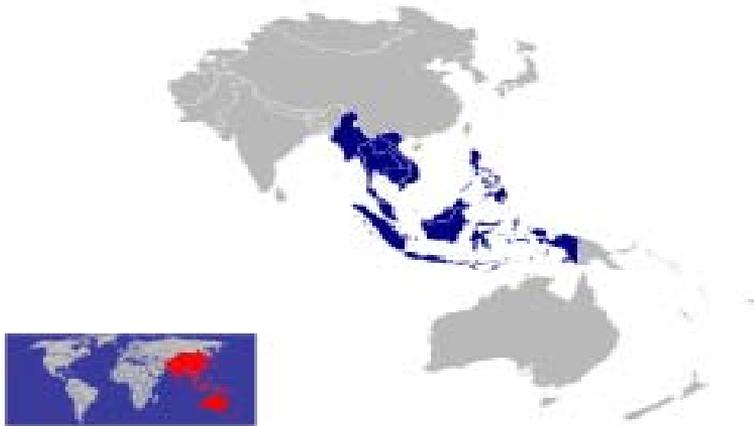
SAARC Member Countries (Source: <http://www.mapsofworld.com/saarc-member-countries.htm>)

The Nation Association of South Est Asia (A.S.E.A.N.). This association ia a geo political and economic organization counting 10 countries in South East Asia, formed at 8 August 1967 by Indonezia, Malaysia, Filipines, Singapore and Thailanda.

The Organization is supporting the economic developpment of the member countries and also their social development(Source:en.wikipedia.org/wiki/ASEAN).

The Economic Comunity A.S.E.A.N. – It is planned to be created in 2020 and it suppose to have some resembles to the European Union, because it should have the three fundamental movement freedoms, regarding goods, people and capital. Still, a unique currency is not planned to be issued.

The single market should number over 530 milion persons form ten states: Malaezia, Indonezia, Singapore, Brunei, Thailanda, Filipine, Vietnam, Laos, Myanmar (Birmania) and Cambogia.



The Economic Comunity A.S.E.A.N. (Source: <http://en.wikipedia.org/wiki/ASEAN>).

The first 6 member states are older members of the organizations, having higher developed economies than the others, and wish to accelerate the creation of the economic community.

Malaesia has already launched a call to its partners to speed up the unification plans, especially in order to avoid loss in favour of China and India, the main representants of the competition. Even though the prices for most of the good have been reduced according to the free trade agreement existing between those ten countries, sill they face delays due to the difficulties in inacting some measurements and birocratic procedures (Source: <http://www.aseansec.org/21083.pdf>).

Conclusions

At least 125 countries of the total, all over the world could be included in at least one of these 8 continental unions.

The creation of these unions is based on values, istorical, cultural, economic and political common interest of the members.

It is important to see that Maurice Gomberg considered these continental unions as being political state associations, federation generally speaking, organized after the American model.

Still, until now, these continental unions are only considered to be regional integrative organizations. It is true that in Africa, Europe and South America there is some political interest in future forming political state unions.

In our opinion, Maurice Gomberg should be looked upon as a visionary man, with preoccupations regarding a peaceful evolution of human civilization in a single economic and cultural environment, created through political regional union (at a continental level).

Even if we were to admit that the continental contemporary unions would transform into future state confederations, their borders do not fit perfectly with the ones presented in the map (differences appear in Europe, Russia, Central America).

How anticipative Maurice Gomberg's plan really is, that we will see in the next decades.

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A REGIONAL PERSPECTIVE ON THE IMPACT OF THE CURRENT ECONOMIC CRISIS IN ROMANIA

*Zizi Goschin, Daniela-Luminita Constantin, Aniela-Raluca Danciu**

Abstract

The outbreak of the financial crisis in Romania at the end of 2008 marked a turning point from the strong economic growth of the previous years. Starting from the nature and the key features of the current economic crisis, we examine its impacts in Romania, both from the national and regional perspective, and the corresponding policy responses.

Keywords: economic crisis, regions, Herfindahl specialisation index, location quotients, Romania

JEL Classification: O18, R11, R12.

The nature of the current economic crisis

The current crisis, the most difficult financial and economic turmoil since the Great Depression, has severely affected the global economy. It emerged in the USA, but rapidly spread into a global economic shock due to the tight connections within the financial system itself and also the strongly integrated supply chains in global product markets. The transmission of financial distress to the real economy also evolved at record speed, with credit restraint and declining confidence hitting business investment and household demand, notably for consumer durables and housing.

Various attempts have been made in order to explain the nature and the underlying factors of the current economic crisis. The prevalent approach is to accept the crises as natural phenomena for market economy, as they come and go quite regularly and differ depending on the actors and sectors of the economy which either initiate the next crisis cycle or deepen it. From this perspective the present crisis was produced by the slump on the subprime mortgage credit market, combined with the collapse of the real estate market and the weaknesses of consumer goods market, partly due to a high level of household debt. The current crisis must reach its bottom (as any previous cyclical one) before reaching a new equilibrium, by a gradual self correction process of the market. Therefore, the changes caused by the crisis will mainly apply to the scope of control over financial flows and instruments and the crisis is expected to 'cleanse' economic structures of inefficient companies and ventures, although this process may be obstructed by excessive state intervention.

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The second approach implies the rejection of the neoliberal model, based on a more profound view of the long-term business cycles, which are not self-generated, despite the fact that they recur with great regularity. According to leading economists such as Joseph Stiglitz, Paul Krugman, George Soros, each crisis has its own causes and produces different effects, leading to deep social and political changes. It is argued that the current crisis, which is the first truly global crisis, leads to complex processes from which a self-regulated exit is not possible, therefore need for the intervention of the state, able to perform regulatory functions based on its strong institutions and aided by large-scale support provided by the central bank (Stiglitz, 2008). This interpretation of the current crisis stresses that without strong financial state support for the banking system and active regulations of the financial system, the market economy will not be able to overcome the slump and even with the state's assistance, the process will be long and may last several years.

The third approach is focused mainly on the qualitative aspects of the current crisis compared to the previous ones. Firstly, it is argued that the current crisis does not have its roots in the finance sector, being rather a crisis of the relations between the state and financial institutions which changed to a point which made any state control over financial institutions impossible and, moreover, it actively supported processes of contracting loans with practically no chances of repayment (Gowan, 2009). Secondly, the ongoing qualitative processes fundamentally changed the principles on which the current market mechanisms were based, and disconnected the banking from the other sectors of the economy.

The European perspective on the crisis

The crisis impacted different economies with varying intensity. For instance, Japan has been hit by the greatest recession in sixty years and its exports have dropped by half, the US recorded negative growth rate, continuing decline of the stock market, drastic drop of real estate prices, and increase of unemployment and falling demand as well and the EU economy entered the steepest downturn on record since the 1930s.

In Europe, the effects on particular economies are considerably differentiated – from a major collapse of such economies as Iceland and Latvia, through serious difficulties of Hungary and southern EU countries to a relatively stable, though greatly weakened, economic situation in Poland, the Czech Republic, and Slovakia.

From the autumn 2008, the crisis has propagated in the new member states of the EU, showing its first signs in the capital flow reversals, reduced access to liquidity, etc. The impacts varied from moderate decline in economic growth (Poland) via significant drop (e.g. Slovakia, Czech Republic, Bulgaria) to sharp drop (e.g. The Baltic states, Romania), owing to differences in economic structure and openness of the economies

Although the present economic downturn has directly affected the new member states with about one year delay, the depth of the crisis is not likely to be

smaller than in advanced economies either, due to insufficient financial and institutional strength of the state in countering the crisis. Moreover, crisis management in the euro area has been blamed for worsening the crisis in Central and Eastern Europe as it primarily served the interests of the financial institutions and the economies of the euro area (Darvas and Pisani-Fery, 2009), thus creating the danger of a new political and economic divide within Europe. Western European ownership of new member states banks had a role in the pervasive development of foreign-currency loans to the private sector in many countries in the region, which now adds to their vulnerability face to the financial crisis.

Effects of the economic crisis in Romania

The financial crisis initially hit the Western Europe, while Romania, like other peripheral countries in the EU, was still experiencing strong economic growth. The global financial turmoil has reached Romania during the last quarter of 2008 and very soon it became obvious that the crisis would have serious effects on the real economy. The international economic crisis has impacted the Romanian economy through various channels, as follows (Isarescu, 2009):

- The trade channel: the exports slow down and even decrease.
- The financial channel: the access to external financing is limited, which determines a contraction of the crediting volume and generates difficulties with the private foreign debt.
- The exchange rate channel: the reduction of external financing has been reflected by the national currency depreciation.
- The trust channel: withdraw of foreign investors from East-European countries.

Romania had experienced robust economic growth for eight consecutive years, but as the financial crisis started spreading across the economy, things took a sharp turn for the worse. A drop in external and domestic demand led to a slowdown in **real GDP growth** - from an average of 8.9% on an annualised quarter-on-quarter basis during the first three quarters of 2008 to an almost 13% decline in the fourth quarter, one of the sharpest turnarounds among emerging markets.

The worst affected economic activities were, in a first stage, manufacturing and financial activities, real estate, lending and services for enterprises. Other activities decreased as well, but managed to maintain positive growth rates. Manufacturing turned from a 4.9% increase in the first three quarters to - 7,7% in the fourth one, while financial activities moved from +5.3% to - 1.5% in the same period.

The negative impact of the crisis in Euro-area has continued in 2009, the Romanian real GDP recording -7,1 annual percentage change. The fall in demand on the main Romanian export markets combined with the decrease of FDI severely hit domestic manufacturing triggering an overall decline due to the reduction or even temporary stop of the activity in many of the production units. In the industry sector

the sharpest decline in production capacities has occurred in some key sub-sectors: goods made of non-metal ores, metallurgy, computers and electronics. In spite of that, a revival of the economy is still expected to start in 2010, considering the low point of the economic decline will be reached in the coming two-three quarters.

Export growth has also declined, but imports have dropped even more steeply, from +28.3% in the first three quarters of 2008 to -10.2% in Q4. Meanwhile exports fall from +25.9% to +1.6% growth and the declining trend continued in 2009.

The *current account deficit* had been very large in recent years, as imports chronically outstripped exports. A large part of the consumption was financed by private sector debt, most of it in foreign currency. Now the stronger decrease in imports generates a rapid correction in the current account deficit: the current account deficits are expected to drop from 12.3% in 2008 and 3.9% in 2009 to 3.3% in 2010. Among the factors explaining this reductions, consumption contraction (especially durables) and an improvement of the negative saving rates are playing important roles.

Although *unemployment rate* usually increases in Q4, its escalation in the fourth quarter of 2008 (0.4% increase against the common 0.1-0.2% in the previous years) has to be considered a clear manifestation of the current crisis. After many years of low unemployment, mainly due to over two million Romanians working abroad, annual unemployment rate raised from 4.1% in 2007 and 4.4% in 2008 to 7.8 % in 2009.

Net investments recorded a severe decline, dropping from their long recorded tendency of 15-30% growth on a year to year basis to just + 2.3% in the fourth quarter of 2008 and -0.3% in the first quarter of 2009. *Foreign direct investments* declined as well. The value of FDI, which had been 7 billion euro in 2007 and 9.3 billion in 2008, dropped to only 4.8 billion euro last year, which is though considered a moderate decline compared to the average international investments trend in the current economic environment.

While some important foreign companies (e.g. Unilever, Kraft Foods and Coca Cola) relocated their Romanian subsidiaries in cheaper workforce countries as Moldavia and Bulgaria, new companies decided to invest in Romania. For instance, PepsiAmericas, one of the world's most important fizzy drinks production companies, opened in September its largest European production unit, located in Ilfov county. The company also finalised in May this year a ten million dollars investment to modernise and enlarge the production line capacity for mineral water in Covasna. On the other hand, an encouraging tendency is the orientation of foreign investors to Greenfield projects in South-East of Romania, in counties like Prahova, Buzau, Gorj, Calarasi, Giurgiu and Dobrogea zone. Till now preference was given to Bucharest and the West of Romania.

Return migration and remittances. The global economic recession significantly reduced in 2009 the amounts of money sent by the Romanians working abroad, which had been quite large before, reaching a peak of 5.1 billion euro, or 4%

of the economy in 2008. According to the World Bank data, Romania is among the top ten states by size of remittances.

Statistical data show that by May 2009, remittances sent in Romania amounted to only 1.8 billion euro, down by a third from the same period of 2008. Remittance flows are expected to further decrease due to job losses, lower earnings, slower migration, and even return of immigrants (especially from Italy and Spain) in Romania. This is an worldwide trend: the Institute of International Finance predicts continually dropping net private-capital inflows into emerging economies: from \$929 billion in 2007 and \$466 billion in 2008, to around \$165 billion in 2009.

The banking sector has been less affected so far thanks to Romania's lack of exposure on financial products which generated this turmoil (subprime loans) as well as to "the Central Bank's prudential measures and its monetary policies" (Isarescu, 2008). According to the Central Bank Governor Mugur Isarescu, the Romanian financial system is stable and sure for the time being and new measures are prepared in order to ensure liquidity or to increase prudential rules and to strengthen the deposits guarantee policy.

Regional distribution of the recession in Romania

Romania's administrative-territorial structure includes eight development regions, corresponding to NUTS2 level of the EUROSAT, which have been established on a voluntary basis (without being administrative units) in order to ensure the regional development policy elaboration and implementation framework. Each region comprises between 4 and 7 counties (excepting Bucharest-Ilfov region).

As far as the regional disparities are concerned, the distance between the richest and the poorest NUTS2 regions is about a factor of three, more precisely 3.39:1. Thus, in Bucharest-Ilfov region the GDP per capita reached 83.8% of the EU-27 average in 2006, whereas the lowest GDP per capita compared to the EU-27 average was recorded by the North-East region of Romania, namely 24.70%. These figures reflect an increase in regional disparities determined by the rapid development of Bucharest-Ilfov region: its growth rate between 2001-2006 was two times higher than the national average.

Five out of the eight NUTS2 Romanian regions are included in the fifteen lowest EU regions in terms of GDP per capita. Apart from Bucharest, the only region that has succeeded to leave this group since 2004 is the West region. In 2006 the GDP per capita at PPP of the West region was 45.2% of the EU average.

Moreover, the disparities are even higher at the NUTS3 level, between the counties included in each region. For example, in South-Muntenia region there are well developed counties such as Prahova, Arges, Dambovită but also much less developed ones such as Calarasi, Giurgiu, Teleorman.

The current economic and financial crisis displays an uneven distribution of its effects at regional scale, depending on the specific economic and social structures, regional specialisation degree, export orientation of economic activities, etc. A study

supported by the Romanian journal “Capital” (Amariei and Hritcu, 2009), estimates that 25 counties out of the total of 42 are in danger to be seriously hit by recession. In these counties the industrial production already decreased by 30% to 70% in the first quarter of 2009 compared to the same period of 2008, while the unemployment doubled in many cases in just five months (end of February 2009 compared to end of September 2008). New foreign investors have not been attracted whereas some of the old ones are about to leave. The worst situation is recorded by the cities of a high specialisation degree, where the economy is mostly depending upon only one big employer as, for instance, Galati city in Galati county -dominated by Acelor Mital (steel industry) and Pitesti city in Arges county – highly dependent on Dacia Renault (car industry). The methodology employed was based on a series of indicators such as: the evolution of the unemployment rate, the industrial production index, foreign investments per capita, the share of employment in vulnerable sectors, the export dependency ratio, private debt, banking employment degree, average salary, economic diversification, vacant jobs, number of construction permits per capita, all of them calculated at county level.

Usually the crisis induces a **higher vulnerability** of the most developed counties, which are much closer to the world economy’s evolution and, thus, more exposed to the crisis shocks. Within this category the profile of the most crisis-vulnerable counties can be described as follows: a mono-product based industrial development, predominantly export-oriented, industrial firms re-located from Western Europe (e.g. lohn-type production), big investment projects of multinational firms, large industrial parks, etc. On the other hand, in our opinion, given the economic potential of the most developed counties, it is likely that they will recover easier after the highest crisis intensity will have been left behind. In particular, the counties displaying a higher production diversification will be in a better position. Among zones of a higher vulnerability are also those characterised by a high indebtedness degree of agricultural producers, food industry producers and SMEs in general.

The study identified the top 3 most vulnerable counties to be:

- Galati (South-East region). Its economy is excessively dependent on the Acelor-Mital steel works, whose production recorded a serious drop in the Autumn 2008 and continues to be confronted with recession caused problems.
- Arges (South region). The whole economy is dependent on Dacia-Renault car company: a serious problem of this company might bankrupt the whole area.
- Arad (West region). The big employers are car components producers, largely dependent on the foreign demand.

At the opposite pole are situated the predominantly agricultural counties, of a traditional economy, located in South and East of Romania. The experts estimate that these counties, with a high share of rural population will suffer less than the developed ones as a result of their subsistence agriculture, where the crisis influence is very low. In fact, in such counties the current overall economic situation is overlapping on a previously low development level. In the counties resistant to crisis

the stability is also based on the low vulnerability of their most important industrial branches, mainly represented by milk processing, mineral water bottling, wood processing, etc., less sensitive to crisis compared to car industry or constructions, for example.

In the top 3 most resistant to crisis counties are:

- Suceava (North-East region). Its big advantage consists in high tourism potential. Other well developed sectors are milk processing, mineral water bottling and wood processing industry.

- Dambovita (South region). It has a diversified economic structure. The highest share is recorded in agriculture.

- Giurgiu (South region). Food, textile and chemical industries have the highest share, but agriculture is also very well represented in county's economy.

Some relevant examples of counties in each category, with their strengths (S) and weaknesses (W) in terms of resistance to crisis are presented below.

Severe vulnerability

Arad. S: Important investments in infrastructure. Well qualified labour force. **W:** Big employers are car components producers. Export dependency.

Arges. S: Expected big investments in constructions. Low indebtedness degree. **W:** Major dependency on Dacia-Renault company. Low level of public investments.

Galati. S: Quite low crediting rate. Low banking employment degree. **W:** Extreme economic dependency on the Acelor-Mital works activity.

High vulnerability

Bucharest. S: High level of foreign investments, high saving ratio and economic diversity based on activities connected to the international economy. At the same time, more opportunities to recover after the trough of the cycle. **W:** High share of employment in service sector and export dependency.

Cluj. S: Economic diversity based on activities connected to the international economy. High income level. Low unemployment rate. At the same time, more opportunities to recover. **W:** High indebtedness degree. Export dependency. High banking employment degree.

Average vulnerability

Dolj. S: Ford recent investment. High amount of funds allocated to infrastructure projects. **W:** High indebtedness degree. Decrease in industrial production. Low job offer.

Low vulnerability

Suceava. S: Diversified structure of local economy. Important share of food industry. **W:** High unemployment rate.

Our own calculations regarding the specialisation degree at county level support most of the findings mentioned above. Thus, Appendix 3 shows the values recorded by the Herfindahl specialisation index, which confirms the well-documented positive linkage between the development level and the degree of the diversification of the economic activity with the best developed counties having the most diversified economic structure, while the least developed ones usually display a high degree of specialisation.

Although it is largely accepted that the bigger the specialisation level the higher the economic risks in case of economic shocks, from the perspective of the current economic crisis, territorial specialisation may entail vulnerability only for the regions dominated by economic activities open to the current crisis such as banking and finance sector, constructions, real estate, automobile industry, etc.

On the opposite side there are highly specialised counties, based to a great extent on a subsistence agriculture, that are less sensitive to the economic crisis. These are counties with a low development level and a low diversification of economic activities, agriculture having an important share in their economy (the location quotients for agriculture are also above 1 – see Appendix 1 for methodology and Appendix 5 for data) and making their economies more stable and less vulnerable to economic downturn. In this respect can be mentioned counties like Botosani, Vaslui, Calarasi, Giurgiu, Ialomita, Teleorman – all of them concentrated in the two least developed Romanian regions, namely North-East and South-Muntenia.

The values recorded by the Herfindahl specialisation index (Appendix 2) indicate an important diversification of activities in the best developed counties like Cluj, Constanta, Brasov or Bucharest Municipality, mainly based on activities connected to the international economy. Such a situation makes these counties more receptive to the economic crisis effects. Besides the counties already mentioned, in this category can be included Iasi, Arges, Prahova, Valcea, Arad, Timis, Bihor, Mures, Sibiu, Ilfov. As highlighted by Appendix 5, in these counties the location quotients are above 1 for activities such as manufacturing industry, construction, hotels and restaurants, real estate transactions, finance and banking, etc., more open to economic crisis effects.

An overall view points out that the most developed regions also present the highest diversification of the economic activity. For example, in the case of Bucharest-Ilfov region the development index of 0.7208 (see Appendix 1 for methodology) and the Herfindahl specialisation index of 0.1174, for West region the values of these indices are 0.3793 and 0.1560 respectively, for Centre region – 0.3471 and 0.1598 respectively. These regions display a high amount of foreign direct investments per capita as well (Appendix 3).

Unemployment is a major symptom of any crisis as it is one of its most visible and socially significant

effects. Despite having grown pretty fast in 2009, the unemployment rate is still moderate so far. In Europe as well as in Romania, it is currently not as high as several or a dozen years ago (e.g. in Spain in the mid-1990s and it reached almost 20 per

cent, and was slightly lower in Ireland and Finland) and is far from the extremely high rates of the Great Depression (30-40%). The evolution of the unemployment rate in Romania, depicted in Figure 1, indicates high territorial variation, ranging from 1,3% (Timis) to 8,2% (Mehedinti) in 2008 and from 1,8% (Bucharest Municipality) to 12% (Vaslui) in 2009. Except for Bucharest, in the 2008-2009 period there was an increase in unemployment in all counties, the highest relative growth of the unemployed being +162% in Bistrita-Nasaud, followed by Timis (139%), Sibiu and Arad. All these counties previously had very low levels of unemployment (below 2.5% in 2008). On the contrary, the countries less affected by the increase in unemployment were the ones which had higher inactivity levels earlier.

To understand the underlying reason for this we have to take into account the economic environment of backward regions. The historically higher inactivity levels in these areas have shown a lower than expected increase because they were undertaking economic activities less exposed to the crisis shocks. Nevertheless, the situation for a huge number of working age inactive population in backward regions is worse than before the crisis in the sense that their already small chance of getting formal employment has further decreased.

The growing unemployment will most likely have an impact on the rapid growth of the shadow economy and on the deepening of social inequalities. One of the consequences of unemployment could be remigration, mainly from big cities to villages or small towns – places of the migrants' origin and the return migration from abroad.

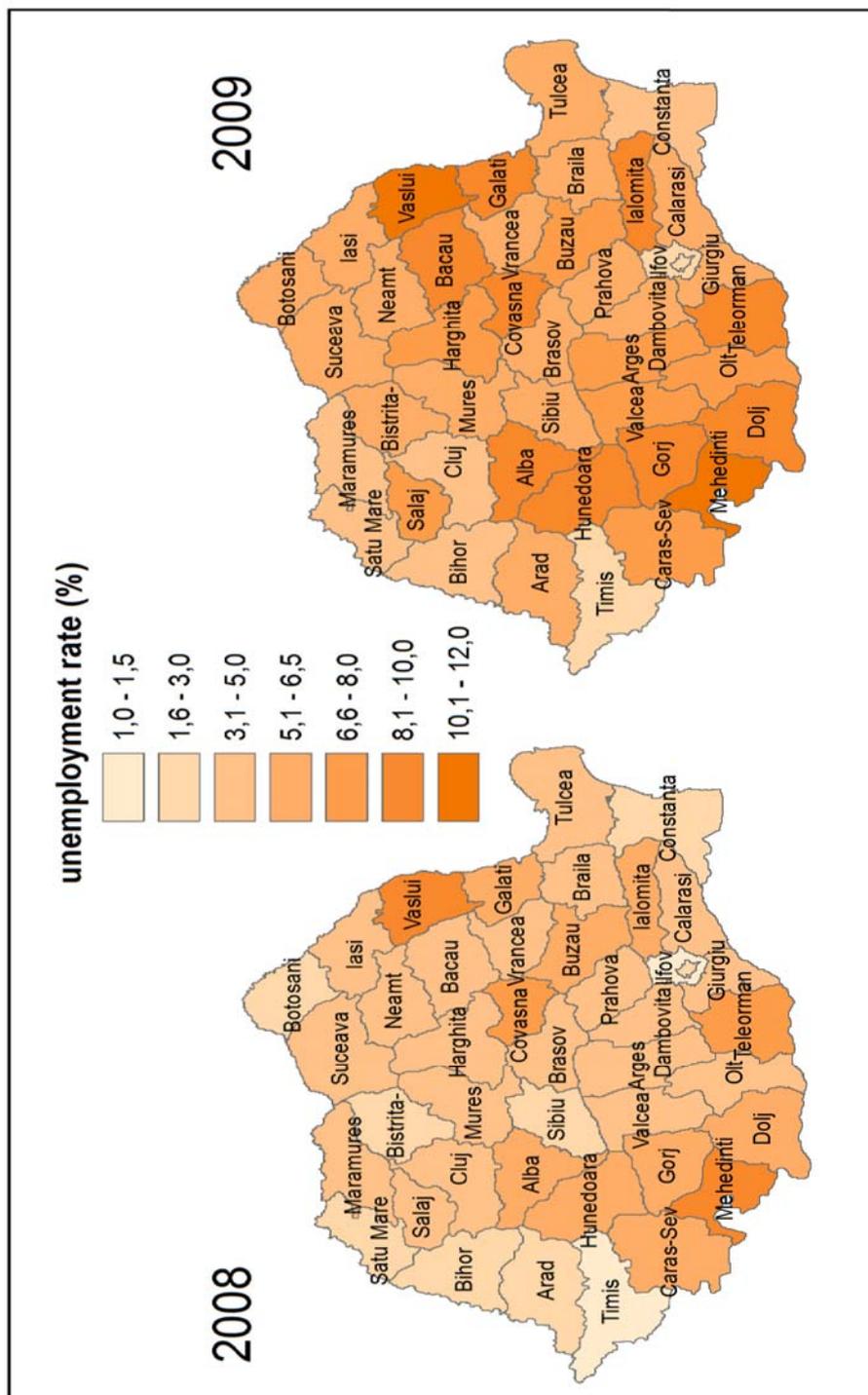


Figure 1. The territorial variation of the unemployment rate
 Source: authors' processing based on data issued by the Romanian National Institute of Statistics

Policy response to the crisis

The response to the adverse effects of crisis in Romania cannot be similar to those formulated by various European countries and the US, considering the particularities of the Romanian economy, especially its big current account deficit, which indicates its dependence on external financing. Consequently, the National Bank Governor considers that strong fiscal and salary policies are necessary, accompanied by significant allocations for investments, able to create spillovers effects for other economic sectors and induce a further relaxation of the monetary policy (Isarescu, 2009). In other words, an optimal combination between budgetary, salary and monetary policy, of a similar degree of restrictiveness for each of them, which will be able to direct the economic activity to work and productivity.

Moreover, the Government can contribute to the improvement of the foreign investors' perception by various measures, such as the increase in the absorption capacity of EU funds and, thus, the replacement – to a certain extent – of the private foreign financing by public foreign financing or the creation of the new jobs in promising sectors such as infrastructure, tourism, agriculture, food industry, etc., which are seen as sectors able to gradually take over the role of economic growth engine. Also, the agreements with international institutions such as European Commission, European Investment Bank, International Monetary Fund are welcome, as they can compensate the significant diminishing of private capital inflows.

Financial support package from IMF and World Bank

The downturn led Romania to approach *the IMF* for a loan in March 2009. The IMF, together with the European Union and the World Bank, committed to supporting the authorities' efforts to counter the effects of the international crisis. The IMF's Executive Board has approved a 24-month Stand-By Arrangement for €12.95 billion as part of a total €20 billion financial support package to help cushion the effects of the downturn. The program covers three main areas: fiscal consolidation, banking reform, and reducing inflation to help restore financial stability (Franks, 2009):

- The *fiscal reforms* include measures to improve budgeting, streamline public wages and pensions, and make public enterprises more efficient to ensure that the deficit will remain low in the future; measures have already been taken to contain the fiscal deficit. Runaway spending will be curbed, but at the same time, the government will increase public investment to ensure a long-term improvement in competitiveness. To make sure vulnerable groups in society are not hit overly hard by these reforms, the government will make arrangements to protect the lowest paid public employees, the poorest pensioners, and others exposed to the economic downturn by boosting social safety net spending.

- To ensure that the *banking system* remains sound, the deposit insurance

system is being strengthened and bank resolution laws are being improved so that the government can respond immediately if banks were to get into trouble; Banks have agreed to provide additional capital as a safety bag against future losses, and foreign banks in Romania have agreed to keep their money in the country.

- **Monetary policy:** Romania's National Bank is committed to bringing inflation down within its target range; lower inflation should result in greater financial stability and make it possible for the central bank to gradually reduce interest rates and stimulate a return to growth—without risking capital flight or instability in the exchange rate.

Romanian officials discussed late July with the officials of the International Monetary Fund the measures implemented in the framework of the anti-crisis plan and the progresses made so far.

On July 2009 *the World Bank* approved a 300 million euro loan for Romania as a first part of a programme that could total 1 billion euro to help mitigate the impact of the global turmoil. The next two tranches of 360 million euro and 340 million euro, respectively, are expected to be approved by the middle of 2010. According to Benoit Blarel, the chief of the World Bank Office in Romania the loan will underpin measures to reduce the impact of the international economic crisis, revive economic growth and convergence. He stressed that this fund are going "to strengthen public expenditure management, to cushion the impact of the crisis on the poor and vulnerable, and to minimise risks of a domestic financial sector crisis by addressing current and potential vulnerabilities" (Capital Online, 2009b). It is important for the future of the Romanian economy to make good use of these loans. The increase of expenditures stimulating the economy will cause an further increase of the already important state fiscal deficit creating a lasting burden for the post-crisis period.

Anti-crisis governmental plan

As conditions in the region worsened, the Romanian authorities decided to put together a comprehensive policy package to bolster their economy's ability to withstand the crisis. On March 2009 Prime Minister Emil Boc presented a government anti-crisis plan to parliament, including investing in infrastructure, maintaining the current flat tax rate, and injecting capital into the Romanian Savings Bank and Eximbank. The plan also includes measures to protect the low-income population, including a programme to subsidise medicines for pensioners.

The Romanian Government has also decided on the setting up of the credit counter-guarantee fund for small and medium-sized enterprises, a proposal included in the anti-crisis measures plan (Post Privatisation Foundation, 2009). The normative act was approved in order to improve SME access to financing by taking over some of the risks undertaken by guarantee funds upon extending guarantees. Under the emergency ordinance approved by the Government, the counter-guarantee amounts to a maximum of 80 percent of the contracted guarantees. The requirements for the award of the counter-guarantees are set up in a counter-guarantee scheme suggested

by the fund and authorized in accordance with the state aid legislation into force.

Other proposed measures envisage the credit guarantees for exports, agricultural producers and SMEs and the speed up of the access to EU funds as a solid financing source that does not create further foreign debt. The EU funding can contribute to agriculture development, tourism re-launching, social, transportation, energy and environment infrastructure modernisation, urban revitalisation, etc. – all of them able to revitalise the Romanian economy within the economic crisis context.

Some parties voiced criticism at the address of Romania's current anti-crisis policy which is considered to fail in providing the needed strategic vision and coherent solutions aimed at overcoming the crisis or limit its effects. For instance, the President of the Social Democratic Party (PSD, in ruling coalition) Mircea Geoana stated on June 16th that just three of the ten anti-crisis measures proposed by the ruling coalition produced coherent effects in economy (Financiarul, 2009). He warned that

“Irrespective of how many resources we will attempt to mobilize for capital investments, in the absence of some extremely energetic measures for combating corruption in the public acquisitions zone, solutions to the current crisis will be late to appear (...) We must think not only how we can overcome the crisis, but how we can prepare Romania's economic re-launch and positioning, as well as the European economies, in advantageous positions after this crisis. The biggest incurred risk in an electoral year is that the majority of important decisions are taken within an extremely tight and electorally oriented logic, with populist tendency.”

He also drew attention upon the lagging behind between the European Union states and the risk of a “several speeds” Europe, with divergent economic and fiscal policies.

The government anti-crisis measures do not represent any radical intervention in the economy and are not likely to have strong regional effects, as well. Although territorial issues were not taken into account when these measures were designed, the anti-crisis policy may still have some regional impacts, for instance because of the regional concentration of the target groups.

In the 2007-2013 financial exercise, 16% of the funds allocated to the Regional Operational Programme¹ are directed to the North-East region, which might be an important opportunity for this region to cope with the severe underdevelopment: almost all its counties have a lower vulnerability to crisis in terms of sectorial economic structures, the biggest challenge being the capacity to ensure the requested co-financing. In this point the adverse effects of the crisis have to be overcome. Much lower allocations are directed, according to the distribution procedure, to the developed regions, which are already confronted with the crisis difficulties, given their orientation to activities affected by recession and export dependency. An important share of the sum allocated to the Regional Operational programme has as destination the social and transportation infrastructure modernisation as well as

¹ The sum allocated to the Regional Operational Programme is 4.5 billion euros, which means that the North-East region will receive 725 million euros.

tourism promotion and development , which are sectors capable to generate high multiplier effects and, thus, to help the economy to recover.

Even if several engines of the economic growth in Romania until 2008 – real estate transactions, banking and finance, car imports, steel industry, chemical industry, car industry – are in a severe decline, there are other industries that can develop and support the economic growth: IT, telecommunications, food industry, pharmaceutical industry, public services, etc.

Final remarks

It is obviously too early to provide any definite prediction about the impacts of the current crisis, but, nevertheless 2010 is likely to be another difficult year for the Romanian economy. Even with help from the IMF and the World Bank, the recovery is very much dependent on the external economic evolution. Although many signs of economic recovery are visible in the advanced economies first hit by the downturn, it is premature to estimate when the economic crisis will come to an end and if Romania can made a quick recovery.

In line with the belief that Romania, as a peripheral country of minor importance in the world economy, has practically no influence on controlling the processes caused by the crisis and we have to expect for the global recovery to return, the government anti-crisis measures do not represent any radical intervention in the economy. Therefore, the policy makers are rather pursuing a crisis management programme that focus on alleviating the impact of the crisis and preparing for the likely post-crisis situation, in order to restore the economic growth as quickly as possible.

The anti-crisis governmental plan does not encompass measures which would have intended regional impacts. Nevertheless, all policy measures do have some regional impact, for instance because of the regional concentration of the target groups.

Romania has its own weaknesses which add to the challenges of the current crisis. A restrictive fiscal policy will be needed in the next period in order to correct for the fiscal imbalances of the last years. The IMF has been stressing the need to cut public expenditure, demanding a severe control of the finances of the government and local administrations and careful monitoring of state-owned companies, especially the ones registering losses.

If properly managed, the government's policies should allow Romania to avoid the worst effects of the crisis, although the ongoing recession is likely to leave deep and long-lasting traces on economic performance and social hardship.

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Appendix 1. Methodology

The Location Quotient LQ, is a simple measure of both concentration and specialisation of a region/county i in an industry j and can be computed based on either the concentration ratios g_{ij}^C or the specialisation ratios g_{ij}^S :

$$LQ_{ij} = \frac{E_{ij} / E_j}{E_i / E} = \frac{E_{ij} / E_i}{E_j / E} \Leftrightarrow LQ_{ij} = \frac{g_{ij}^c}{E_i / E} = \frac{g_{ij}^s}{E_j / E}, \quad g_{ij}^s = \frac{E_{ij}}{\sum_{j=1}^m E_{ij}} = \frac{E_{ij}}{E_i},$$

where:

g_{ij}^s - the specialisation ratio: the share of the industry j in the total employment of region/county i;

E_{ij} - employment in industry j in the region/county i;

E_i - total employment in the region i;

i – region/county; j- industry.

E is the total country employment.

Owing to their simplicity, the location quotients are an easy to analyse and an useful tool in the early explanatory stages of the research. Values that surpass one unit indicate a level of regional/county concentration bigger than the average, while values under one are specific to regions/counties less concentrated compared to the national average. The pattern of change in the quotients over time depends upon the degree of industrial disaggregation. When interpreting the values of the location quotient we have to take into account that it is a relative measure that indicates the position of a territorial unit (region/county) compared to the average.

The Herfindahl Specialisation Index, an absolute measure of territorial specialisation:

$$H_i^S = \sum_{j=1}^m (g_{ij}^S)^2, \text{ where: } g_{ij}^S = \frac{E_{ij}}{\sum_{j=1}^m E_{ij}} = \frac{E_{ij}}{E_i}$$

i – region; j- branch

E_{ij} - employment in branch j in region i;

E_i - employment in region i;

g_{ij}^S - the share of branch j in the total value of region i.

The Herfindahl index is increasing with the degree of specialization, reaching its upper limit of 1 when one region is specialized in only one branch. The main weakness of the Herfindahl index is the sensitivity of its lower limit to the number of observations: the lowest specialisation is 1/m (when all branches have equal shares in region i). As an absolute measure, this indicator has another important shortcoming: big regions, because of their larger shares, heavily influence the changes in the specialisation (the index is biased towards the larger regions). When computed out of county level data, the Herfindahl Index ranges between 0.0238 and 1 in Romania. We also have to note that the results are very much dependent on the fineness of the industrial classification employed.

The economic and social development of the counties and regions was estimated by means of a *Composite Territorial Index of Development* computed as an

weighted average of various indicators grouped in the following blocks: economy, health, education, infrastructure and standard of living (Mitrut and al., 2010).

Appendix 2. Development and specialisation level of Romanian regions and counties in 2007

Regions Counties	Development level*	Specialisation index (Herfindahl)
1. North - East	0.2593	0.2097
Bacău	0.3141	0.1616
Botoşani	0.2002	0.2784
Iaşi	0.3697	0.1634
Neamţ	0.2649	0.2391
Suceava	0.2882	0.2409
Vaslui	0.1187	0.2728
2. South - East	0.3059	0.1675
Brăila	0.3027	0.1733
Buzău	0.2601	0.2286
Constanţa	0.4222	0.1238
Galaţi	0.3006	0.1602
Tulcea	0.2658	0.1823
Vrancea	0.2841	0.2461
3. South - Muntenia	0.2762	0.1961
Argeş	0.3977	0.1744
Călăraşi	0.1432	0.2733
Dâmboviţa	0.3147	0.1971
Giurgiu	0.2446	0.3064
Ialomiţa	0.2347	0.2461
Prahova	0.3928	0.1523
Teleorman	0.2059	0.3312
4. South - West Oltenia	0.3129	0.1972
Dolj	0.3455	0.2112
Gorj	0.3528	0.1382
Mehedinţi	0.2523	0.2327
Olt	0.2418	0.2532
Vâlcea	0.3722	0.1747
5. West	0.3793	0.1560
Arad	0.3855	0.1786
Caraş-Severin	0.2552	0.1843
Hunedoara	0.3418	0.1359
Timiş	0.5349	0.1545

6. North - West	0.3558	0.1793
Bihor	0.3596	0.1840
Bistrița-Năsăud	0.3178	0.2006
Cluj	0.5558	0.1390
Maramureș	0.3060	0.2108
Satu Mare	0.2880	0.2221
Sălaj	0.3080	0.2024
7. Center	0.3471	0.1598
Alba	0.3446	0.1837
Brașov	0.3752	0.1393
Covasna	0.2845	0.1859
Harghita	0.2807	0.1922
Mureș	0.3839	0.1724
Sibiu	0.4135	0.1541
8. Bucharest - Ilfov	0.7208	0.1174
Ilfov	0.5113	0.1642
Bucarest Municipality	0.9303	0.1199

*Composite Development Index (Mitrut and al., 2010)

Source: authors' processing based on data provided by the Statistical Yearbook of Romania

Appendix 3. Regional Foreign Direct Investments in relation to the development level, 2007

Regions	Development level*	FDI (%)	FDI per capita (euro)
1. North - East	0.2593	1.6	180
2. South - East	0.3059	5.7	863
3. South - Muntenia	0.2762	6.9	888
4. South - West Oltenia	0.3129	3.2	601
5. West	0.3793	5.5	1,227
6. North - West	0.3558	4.5	698
7. Center	0.3471	8.3	1,399
8. Bucharest - Ilfov	0.7208	64.3	12,397

* Composite Development Index

Source: authors' processing based on data provided by the National Institute of Statistics and the National Bank of Romania

Appendix 4. The ten largest foreign equity investors in Romania at December 30, 2008

Rank	Investor	Country of origin	Activities	Subscribed capital (EUR mn)
1	EON Romania SRL	Germany	Energy	72.3
2	Roche SRL	Switzerland	Healthcare	41.5
3	Unita Vienna Insurance Group SA	Austria	Insurance	35.9
4	WS Renewable Energy Hydro SRL	Austria	Energy	22.3
5	Lidl Romania SCS	Germany	Retail	21.4
6	Degi Titan SRL	Germany	Real estate	17.5
7	Nova Imobiliare SRL	Cyprus	Real Estate	15.8
8	Kato Drys SRL	Cyprus	Real estate	14.8
9	Siret Furniture Company SRL	Netherlands	Furniture	12.0
10	Trellborg Automotive SRL	Sweden	Automotive	11.9

Source: *Larive, based on the data from the Romanian Trade Register Office, December 2008, www.larive.ro*

Appendix 5. Location quotients by main economic activity, 2007

Region County	Agriculture, hunting and syiviculture	Fishery and pisciculture	Mining and quarrying	Manufacturing	Electric and thermal energy, gas and water	Construc-tion	Trade	Hotels and restaurants	Transport, storage and communica-tions	Financial Intermedia-tions	Real estate and other services	Public administra- tion and defence	Education	Health and social assistance	Other activities
North - West	1.103	0.211	0.447	1.125	0.729	0.835	0.983	0.876	0.940	0.884	0.685	0.797	1.066	1.024	0.792
Bihor	1.107	0.899	0.954	1.180	0.826	0.766	0.983	1.091	0.906	0.696	0.671	0.797	0.994	1.034	0.443
Bistrița-Năsăud	1.230	0.000	0.241	1.141	0.638	0.774	0.950	0.619	0.818	0.698	0.523	1.119	0.975	0.923	0.693
Cluj	0.786	0.000	0.371	1.019	0.921	1.193	1.179	1.038	1.078	1.369	0.963	0.634	1.269	1.193	1.206
Maramureș	1.317	0.000	0.360	1.106	0.544	0.628	0.824	0.764	0.946	0.650	0.524	0.737	0.993	0.980	0.922
Satu Mare	1.320	0.000	0.136	1.242	0.449	0.770	0.797	0.597	0.691	0.803	0.453	0.833	0.958	0.852	0.701
Sălaj	1.222	0.000	0.200	1.166	0.728	0.446	0.976	0.715	1.090	0.632	0.686	0.984	1.015	0.910	0.414
Center	0.833	0.238	0.739	1.296	1.023	0.852	1.091	1.338	0.979	0.845	0.742	0.873	1.084	0.995	0.949
Alba	1.021	0.000	0.412	1.335	1.013	0.592	0.977	0.971	0.915	0.651	0.755	0.941	0.902	0.931	0.873
Brașov	0.465	1.054	0.344	1.284	1.082	1.312	1.312	1.966	1.100	0.952	1.105	0.900	1.165	0.933	1.158
Covasna	0.979	0.000	0.231	1.388	0.995	0.499	1.087	1.272	0.682	0.731	0.671	1.042	1.105	0.877	0.718
Harghita	1.129	0.000	0.537	1.237	0.660	0.618	0.984	0.886	0.864	0.606	0.513	1.006	1.176	0.931	0.661
Mureș	1.054	0.000	1.329	1.130	1.192	0.734	1.020	1.015	0.897	0.745	0.498	0.756	1.076	1.161	0.991
Sibiu	0.556	0.000	1.192	1.489	1.015	0.997	1.085	1.657	1.219	1.257	0.779	0.745	1.086	1.022	1.019
North - East	1.398	1.188	0.558	0.816	0.862	0.849	0.871	0.823	0.705	0.613	0.620	0.882	1.159	1.085	0.831
Bacău	1.059	1.110	2.038	0.961	1.170	1.232	0.952	0.549	0.778	0.752	0.677	0.873	1.182	1.100	1.000
Botoșani	1.729	1.629	0.133	0.717	0.660	0.555	0.749	0.586	0.583	0.473	0.456	0.900	1.033	1.038	0.826
Iași	1.126	1.680	0.034	0.795	1.022	1.140	0.914	0.906	0.791	0.732	0.911	0.830	1.427	1.398	1.100
Neamț	1.514	0.000	0.208	0.858	0.619	0.673	0.985	1.144	0.604	0.534	0.585	0.873	0.921	0.845	0.412
Suceava	1.570	1.026	0.712	0.715	0.777	0.675	0.851	1.038	0.757	0.563	0.442	0.910	1.110	0.863	0.896
Vaslui	1.686	1.714	0.000	0.847	0.741	0.503	0.663	0.539	0.600	0.497	0.455	0.946	1.114	1.168	0.483
South - East	1.115	3.313	0.551	0.939	1.126	1.066	0.922	1.053	1.147	0.710	0.782	1.002	0.920	0.970	0.983
Braïla	1.053	0.000	0.617	1.150	1.227	1.100	0.946	0.722	0.787	0.732	0.747	1.013	0.938	1.038	0.693
Buzău	1.442	1.374	0.898	1.004	0.743	0.775	0.844	0.618	0.692	0.532	0.484	0.966	0.872	0.815	0.639

Constanța	0.757	0.826	0.607	0.765	1.450	1.450	1.105	1.614	1.880	0.906	1.127	0.871	0.886	1.008	1.384
Galați	1.035	1.211	0.296	0.993	1.374	1.202	0.933	0.871	1.078	0.742	0.887	0.993	1.043	0.943	0.870
Iulcea	1.239	31.215	0.811	0.960	0.690	0.783	0.660	1.020	0.932	0.549	0.632	1.472	0.969	1.130	1.359
Vrancea	1.549	0.000	0.141	0.938	0.746	0.577	0.757	1.007	0.743	0.556	0.409	1.039	0.827	0.961	0.777
Bucharest - Ilfov	0.124	0.413	0.337	0.771	0.954	1.758	1.424	1.345	1.560	2.882	2.631	1.412	1.015	1.043	1.941
Ilfov	0.811	1.673	0.342	1.135	0.452	0.708	1.519	1.316	1.392	0.324	1.334	0.896	0.463	0.666	0.848
Bucharest Municipality	0.028	0.235	0.336	0.720	1.024	1.906	1.411	1.349	1.584	3.242	2.814	1.485	1.093	1.095	2.095
South - Muntenia	1.268	1.235	1.462	1.037	0.884	0.798	0.827	0.828	0.888	0.564	0.774	1.020	0.848	0.883	0.672
Argeș	0.966	0.000	1.218	1.348	1.145	1.046	0.829	0.930	0.808	0.714	0.864	0.902	0.931	0.784	0.814
Calărași	1.700	2.463	0.101	0.818	0.666	0.579	0.580	0.553	0.737	0.556	0.584	1.154	0.961	1.046	0.486
Dâmbovița	1.239	1.233	1.912	1.073	0.833	0.463	0.979	0.748	0.972	0.398	0.752	1.011	0.912	0.895	0.538
Giurgiu	1.881	2.854	1.631	0.383	0.848	0.821	0.631	0.513	0.833	0.552	0.574	1.433	0.812	0.884	0.442
Ialomița	1.587	7.448	0.304	0.750	0.604	0.744	0.831	0.669	0.743	0.561	0.606	1.163	0.848	0.813	0.804
Prahova	0.765	0.000	1.949	1.318	1.001	1.137	0.956	1.332	1.178	0.638	1.017	0.882	0.790	0.976	0.742
Teleorman	1.945	0.000	1.862	0.630	0.638	0.333	0.645	0.354	0.574	0.406	0.531	1.080	0.691	0.794	0.643
South - West Oltenia	1.348	0.000	2.624	0.812	1.490	0.911	0.824	0.758	0.753	0.590	0.706	1.052	0.931	0.943	0.680
Dolj	1.398	0.000	0.628	0.788	1.247	0.771	1.005	0.691	0.779	0.642	0.611	0.969	1.023	0.977	0.637
Gorj	1.008	0.000	11.768	0.656	2.517	1.157	0.682	0.966	0.732	0.635	0.965	1.109	1.019	1.014	0.631
Mehedinti	1.550	0.000	0.992	0.716	1.910	0.921	0.642	0.496	0.838	0.570	0.809	1.146	0.808	0.860	0.622
Olt	1.585	0.000	0.529	0.956	0.700	0.854	0.578	0.485	0.641	0.511	0.517	1.084	0.889	0.892	0.689
Vâlcea	1.171	0.000	1.600	0.895	1.570	0.989	1.014	1.142	0.784	0.562	0.772	1.045	0.838	0.938	0.818
West	0.839	0.575	1.855	1.271	1.096	0.862	1.026	0.950	0.976	0.696	0.892	0.953	0.926	1.049	1.069
Arad	0.794	1.181	0.627	1.525	0.894	0.694	1.114	0.717	1.026	0.800	0.781	0.929	0.836	0.816	0.998
Caras-Severin	1.214	0.000	0.250	1.020	1.157	0.850	0.742	1.191	0.953	0.526	0.571	1.502	0.962	1.209	0.862
Hunedoara	0.751	0.000	6.547	1.103	1.761	0.957	1.101	0.845	0.933	0.687	0.837	1.070	0.866	1.076	0.794
Timiș	0.782	0.745	0.426	1.303	0.806	0.915	1.030	1.072	0.979	0.697	1.113	0.698	1.006	1.121	1.354

Source: author's processing based on data provided by the Statistical Yearbook of Romania

GLOBAL FINANCIAL CRISIS AND REVERBERATIONS ON CAPITAL MARKET

*Liliana Bunescu**

Abstract

Crises can be defined as situations characterized by a pronounced instability, therefore they are accompanied by volatility and a growing uncertainty. The stock market is the barometer of the economy and it trades businesses of different sizes and from different sectors. The main purpose of this paper is to identify what reverberations has the current financial crisis on the financial market, especially on the stock market. The approach of this topic is done by three perspectives (effects on financial institutions, effects on the stock volume and quotes, effects on the investors' behavior on the market, effects on capital market regulation) matching Romanian financial reality with international issues. What are the lessons that Romanian investors would have to learn from experiencing this global economic crisis?

Keywords: economic crisis, effects of financial crisis, capital market

JEL Classification: G01, G14, G29

Introduction

Crises can be defined as situations characterized by a pronounced instability, therefore they are accompanied by volatility and a growing uncertainty. In a crisis situation (no matter what form it may take) we find ourselves in a permanent state of restlessness and uncertainty about our future, fear and even panic. The problem with defining a crisis consists in specifying how severe the volatility and downfall of the market must be to frame such an evolution as a crisis. Conventionally it was established that there is a recession when after two successive quarters we are dealing with the dropping GDP of a country or region. National Bureau of Economic Research (NBER) defines crisis as a significant decline in economic activity for several months reflected in lower GDP, lower individual income, reduced employment levels, reduced industrial production and consumption". It is difficult to make assessments about when a financial crisis becomes an economic one or if an economic crisis generates a financial one or vice versa. Basically we always talk about an economic crisis generated by financial, political or social reasons.

The financial crisis is a form of the economic crisis and reflects a mistrust in the financial system, a significant decrease in the volume of the transactions on the stock market, a disorder of market mechanisms. The stock market is the barometer of the economy and it trades businesses of different sizes and from different sectors. The

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financial crisis of 2007 - 2008, initially called "the credit crisis" by experts, began in mid 2007 with the loss of investors' confidence in financial assets based on portfolios of securitized mortgages issued in the U.S. market. This led to a liquidity crisis followed by an infusion of liquidity into the system by U.S. and European authorities. Investment banks that have encountered problems were either nationalized (Northern Rock) or went bankrupt (Bear Stearns, Countrywide Financial Corporation, IndyMac Federal Bank, Fannie Mae și Freddie Mac, Lehman Brothers Holdings Inc).

Reverberations on capital market

Many economists have offered theories about how financial crises develop and how they could be prevented. There is little consensus, however, and financial crises are still a regular occurrence around the world. The financial crisis of 2007–present is a financial crisis triggered by a liquidity shortfall in the United States banking system. It has resulted in the collapse of large financial institutions, the "bail out" of banks by national governments and downturns in stock markets around the world. It is considered by many economists to be the worst financial crisis since the Great Depression of the 1930s.¹ The crisis rapidly developed and spread into a global economic shock, resulting in a number of European bank failures, declines in various stock indexes, and large reductions in the market value of equities and commodities. It contributed to the failure of key businesses, declines in consumer wealth estimated in the trillions of U.S. dollars, substantial financial commitments incurred by governments, and a significant decline in economic activity.² The crisis itself has a number of dimensions but three in particular are crucial. The first is the build-up of debt, both corporate and household debt, but especially household debt. Linked with this is the likelihood of a return to international monetary instability and of the refusal of the rest of the world to fund US (and UK) trade deficits. The third factor is the effect of the ecological crisis on the world economy, which brings with it the prospect of an end to two decades of low commodity prices.

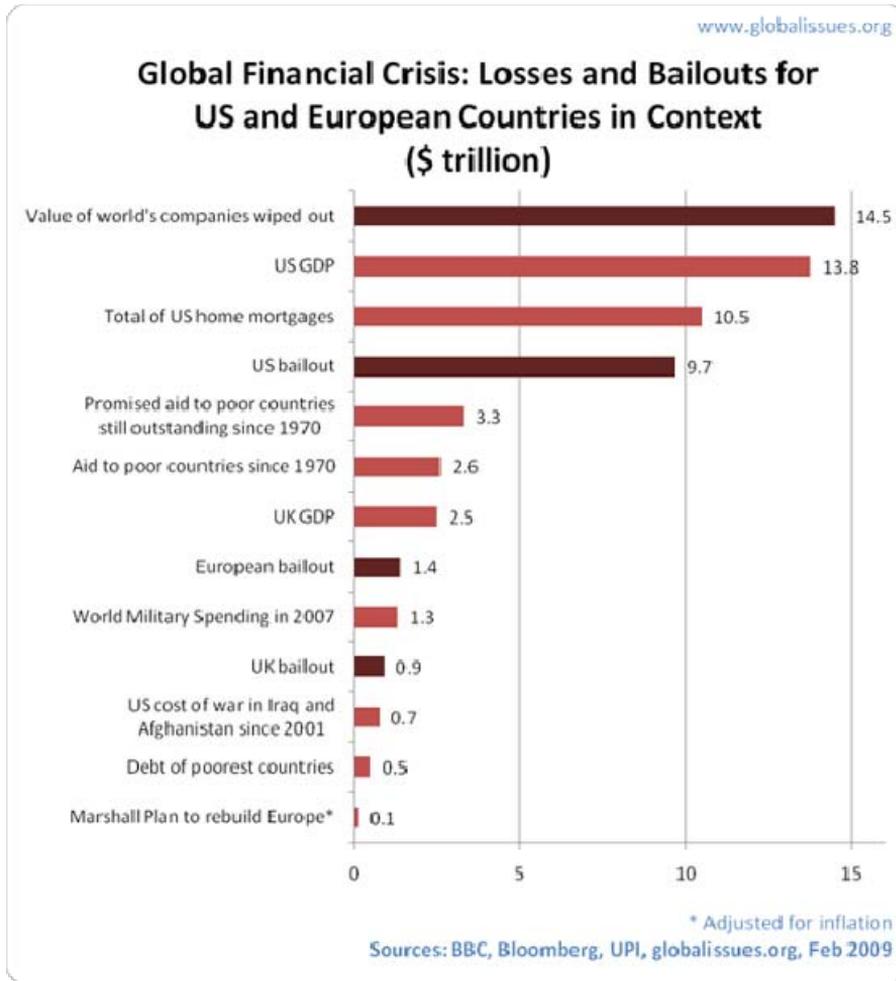
The International Monetary Fund estimated that large U.S. and European banks lost more than \$1 trillion on toxic assets and from bad loans from January 2007 to September 2009. These losses are expected to top \$2.8 trillion from 2007-10. U.S. banks losses were forecast to hit \$1 trillion and European bank losses will reach \$1.6 trillion. The IMF estimated that U.S. banks were about 60 percent through their losses, but British and euro zone banks only 40 percent.³ Governments and central banks responded with unprecedented fiscal stimulus, monetary policy expansion, and institutional bailouts. The total amounts that governments have spent on bailouts

¹ Business Wire News 2009, Reuters, 2009-9-30, <http://www.reuters.com/article/idUS193520+27-Feb-2009+BW20090227>

² Martin Neil Baily, Douglas J. Elliott, *The US Financial and Economic Crisis: Where Does It Stand and Where Do We Go From Here?*, Business and Public Policy at Brookings, June 2009

³ <http://www.reuters.com/article/idCNL554155620091105?rpc=44>

have skyrocketed. From a world credit loss of \$2.8 trillion in October 2009, US taxpayers alone will spend some \$9.7 trillion in bailout packages and plans, according to Bloomberg.⁴ \$14.5 trillion, or 33%, of the value of the world's companies has been wiped out by this crisis. The UK and other European countries have also spent some \$2 trillion on rescues and bailout packages. More is expected. It is also important to recognize that the immediate impact of this government spending is only a small part of the projected increases in budget deficits in the medium term. More important is the loss of tax revenue and the extra expenditure resulting from the slowdown in growth arising from the crisis.



The global system is favorable to financial capital, which has the liberty to move where it is better rewarded, leading to a rapid development of global financial markets. The result is the appearance of a giant circulatory system, which absorbs

⁴ Mark Pittman, Bob Ivry, *U.S. Taxpayers Risk \$9.7 Trillion on Bailout Programs*, February 2009 <http://www.bloomberg.com/apps/news?pid=washingtonstory&sid=aGq2B3XeGKok>

capital through markets and financial institutions at the center, then delivers it to the outskirts, either directly, in the form of loans and portfolio investments, or indirectly through multinational corporations. However, the system is profoundly deficient. Earning money has priority over all other social considerations⁵. In the analysis of the crisis of 2008, George Soros⁶ starts from the following idea: we are in the middle of the most serious financial crisis since the 1930s. In some ways, it resembles other crises that have occurred over the past 25 years, but there is one big difference: the current crisis marks the end of an era of credit expansion. But let's take notice of some reverberations of the current crisis on the capital market.

The effects of the financial crisis on the capital market can be structured as follows:⁷

1. Direct effects on financial institutions: the financial crisis has given rise to stunning bankruptcies, restructuring of companies and financial institutions, takeovers and mergers, direct financial support with significant funding from the government. Many of these institutions are or were listed on the stock exchanges, their removal from the market affected not only the credibility of the capital market but also stock trading volume, price volatility, efficiency levels. One of the first victims was Northern Rock, a medium-sized British bank. Several major institutions either fell, were acquired under duress, or were subject to government takeover. These included Lehman Brothers, Merrill Lynch, Fannie Mae, Freddie Mac, Washington Mutual, Wachovia, and AIG.

a. Financial institutions assisted, supervised or taken over by the government: Bradford & Bingley (part nationalized in September 29, 2008 and part sold to the Abbey bank from the Spanish bank group Grupo Santander), Fortis (taken over by the Belgian government in October 5, 2008 and sold to BNP Paribas), Dexia (on September 30, 2008 the governments of Belgium, France and Luxembourg have announced they will support this bank with funding of 20.4 billion euros), Kaupthing (suspended from trading on October 8, 2008 and subject to supervision by the government of Iceland through the Icelandic Financial Supervisory Authority), ING Group (received on October 19, 2008 funds of 10 billion euros from the Dutch government);

b. Financial institutions bought or taken over by other financial institution: Countrywide Financial (taken over by the Bank of America for 4.1 billion USD on January 11, 2008), Bear Stearns (taken over in March 2008 by JP Morgan Chase after having first received a loan from the U.S. government), Merrill Lynch (bought by the Bank of America), HBOS (becomes in January 2009 part of the Lloyds Banking Group), Lehman Brothers (part sold to Barclays PLC and Nomura Holdings, part declared bankrupt).

⁵ Silvia Marginean, "George Soros: de la criza capitalismului global la criza creditorilor ipotecare", Euroeconomia XXI, nr. 194 / 28.11.2008

⁶ George Soros in his book "The New Paradigm for Financial Markets", May 2008, has described a "superbubble" that was built in the last 25 years and is ready to explode, providing financial crisis. (Born in 1930 in Hungary, emigrated to the USA, known for its wealth gained from speculation on the stock exchange in 1992).

⁷ <http://cristianpaun.finantare.ro/2008/12/23/pietele-de-capital-si-criza-financiara/>

c. Institutions declared bankrupt: Terra Securities (Norwegian financial company specializes in selling various financial instruments), Kaupthing Singer & Friedlander (British bank, part transferred to the ING Group, part went bankrupt), Yamato Life (Japanese insurance company went bankrupt on October 10, 2008).

d. Institutions that are being restructured: ACC Capital Holding (American savings bank specialized on mortgage loans).

2. Effects on the stock volume and quotes: the volume of stock transactions is slightly decreased but the crisis had the strongest impact on the volatility (risk) and on the associated stock performances, especially on the variable income instruments.

2008 was the worst year in BVB's recent history – the steepness of the downward trend probably being enhanced by the downgrade of sovereign rating for Romania from BBB (investment grade) to BB (non investment grade) at the beginning of November 2008. This action of lowering Romania's sovereign rating came from all the 3 main rating agencies (Standard & Poors', Fitch and Moody) in almost the same period of time. The economic outlook for Romania, as expected, was considered negative, and the combined information had a further negative impact on investors' attitude toward BVB. The steep decline registered at BVB during 2008 was induced by the financial crisis that started to show its first acute signs during the first quarter of 2008 and generated the world market turmoil since September. As expected, foreign investment funds redrew most of their money invested in Romania and the domestic investors followed their behavior.⁸ BVB's perspectives for 2009 are pessimistic. As the financial crisis evolved in an economic crisis, Romania's economic outlook looks poor. The foreign investors' attitude toward the Romanian capital market is excessively prudent and influenced by the fact that the country is not in the 'investment grade' category by the main rating agencies.

Table no. 1 Romanian Stock Market Capitalization⁹

Data	Capitalization BVB - RON -	Capitalization Rasdaq - RON-
24.12.2009	80.074.496.089,64	12.345.344.834,23
30.09. 2009	80.432.614.828,83	12.868.187.477,14
30.06.2009	56.214.944.935,20	12.359.818.472,99
31.03.2009	38.453.215.429,03	11.799.297.770,07
23.12.2008	45.701.492.618,85	12.099.865.128,89
30.09.2008	87.228.690.259,97	15.985.353.929,42
30.06.2008	110.449.659.649,22	18.498.366.047,96
31.03.2008	116.817.385.616,18	19.885.521.740,79
21.12.2007	85.962.389.148,60	24.410.022.239,33

⁸ Cornelia Pop, Cristina Curutiu, Partenie Dumbrava, *Bucharest Stock Exchange – The Effects of the Current Financial Crisis*, Interdisciplinary Management Research Journal, Vol. no. V, 2009, pg. 815-816

⁹ Processed data www.bvb.ro Bucharest Stock Exchange

Late 2008 and early 2009 is marked by a sudden drop of stock quotes, the capitalization of BVB recording at the end of the first quarter 28.453 million lei, that is only 34% of the value recorded the year before, more than 110.449 million lei. We can see that the OTC market value did not depreciate as much as the stock market. The Rasdaq market reached in the first quarter of 2009 only 61% of the level reached in the same period of 2008.

The Stock Exchange, pressured by economic problems and, above all, political instability, no longer follows the direction given by the international capital markets in October. The political crisis currently affects the stock exchange more than the economic one. The instability of the government acts and the presidential elections have reduced in October, the degree of correlation between Bucharest Stock Exchange (BVB) with the New York Exchange and U.S. indices. According to the calculations of Intercapital Invest, the correlation degree between the Bet index, which follows the evolution of the most important 10 companies from BVB, and S&P 500, the most representative American index, has dropped from 0.97, the score for October 2007-present, to 0.78, in the period since early October (a score of 1 represents a similar trend).¹⁰ Shares of financial investment companies, the most liquid shares on the BSB, have been affected more seriously - the correlation coefficient dropped to only 0.23 from 0.95. The lack of correlation between BET-FI, the index of the five SIFs, and S&P 500 is also caused by the investors waiting for a signal to increase the threshold for holding SIFs. The evolution of the international market, justified by the signals of the end of the recession, helped the local stock market to rise, despite deepening economical problems. The change from last year's perception was based on the fact that scenarios which have foreseen a collapse of financial and economical systems were not justified. The S&P 500 index has depreciated by 52.5% between October 2007- February 2009, it recovered over 60% of the loss. Investors' optimistic expectations reflected on the Romanian market through the foreign acquisitions in last months. The uncertain evolution of quotes in the current quarter is due to the political crisis. The absence of a legitimized government to adopt next year's budget, which also led to the delay of the installment from the International Monetary Fund, forced the investors to be precautious, at least until the end of the presidential elections.

3. Effects on the invertors' behavior on the market: in the conditions of a market that no longer offers certainty and stabile and slightly increasing efficiency, investors are moving away from the capital market and radically changing their investment options. This has a direct impact on the cost of capital and financial interests. Panic, fear, herd effect, hysteria are feelings that dominate the masses of investors which are faced with growing losses each day. The total number of investors in Romania is also shown in the Annual Report 2008 of the Investor

¹⁰ Aurel Dragan, « *Tot mai rupti de directia pietelor internationale* », Ziarul Capital, 26.11.2009

Compensation Fund (ICF).¹¹ The report presents the total number of investment accounts in Romania as being 65,604 in 2006, 87,664 in 2007 and 92,865 by 31.12.2008. The number reported by ICF is higher than the actual number of investors from our country, because some investors have opened more investment accounts at BVB or other institutions of the capital market.

The major losses caused last year by shares listed on the stock exchange justify the reorientation of investors towards other instruments, with lower risks and acceptable efficiency. The financial crisis has changed the investment preferences. If in 2007 shares were the most wanted, offering a superior efficiency to bank interests and bonds, in 2008 there was a withdrawal of investors from risky investments and the acceptance of safer, even with lower efficiency.¹² Investment opportunities as a result of a strong decrease of share prices and also the perspectives of a revival of the global economy will be the ingredients which will, at some point, determine a halt to the negative trajectory of the capital markets.

In Romania, the economic crisis has led insurance companies to adopt the Polish model and to significantly reduce the investments on the capital market. In Hungary, for example, the investors chose to buy share, at a lower price, but which after overcoming this impasse will have a much higher value.

4. Effects on capital market regulations: the crisis has led to a series of lessons that have resulted in a series of measures to increase control over the areas which remained outside the jurisdiction of central banks or supervisory committees of capital markets. Simultaneously, were brought increasingly into question the criteria for grant funding and risk and rating methodologies used in the financing decision. Furthermore, state intervention in financial markets had also legitimated by a series of legislative measures unprecedented since the Great Depression. The financial crisis has called into question the status of areas (components) of the capital market less regulated and controlled (mortgage market, securitized asset market, derivatives market). One obvious effect that the financial crisis has is the reconsideration and reformation of financial systems by introduction new measurement and financial risk assessment systems and also by exercising greater control by the regulatory institutions in the investment funds, pension funds, life insurance funds and mortgages.

In this context, there have been taken measures to encourage investors on the Romanian capital market. After extended discussions between government representatives crisis solutions for BVB were found in order to boost capital market development in the context of international financial markets crisis. Thus, the state budget is deprived in 2009 and 2010 of incomes from capita gains made from stock transactions, both for short-term holding, as well as for those which exceed one year.

¹¹ Investor Compensation Fund, "*Annual Report 2008*", Bucharest

¹² Rodica Orjanu, "Criza financiara deschide apetitul pentru obligatiuni", *Saptamana Financiara*, 16.01.2009

This is a temporary solution, which will take effect from January 1, 2009. Constantly blamed by capital market representatives for high fees levied even in conditions of crisis, CNVM decided to adopt a series of measures meant to limit the effects of the international crisis on the local stock market. Therefore, for a predetermined period (2008), the fees of 0.08% for the value of transactions with shares and 0.04% of that of bonds and preference rights were suspended, together with exemption from fee for companies launching public offers of sale for listing (IPO). Through this set of measures, CNVM has dropped more than one third of the incomes that they normally receive, in conditions in which decreased activity on the stock exchange has already affected the budget.

When investors on the Romanian capital market have lost almost all hope that they will see an extended increase in the BVB since this year, the saving hand of the government appeared, hoping to restore optimism. It is hard to believe that after record drops, investors still have the courage to buy shares on the Romanian stock market, even if they no longer pay tax on capital gains since 2009, they can carry forward losses and pay lower fees.

The shock felt by BVB in late 2008 – early 2009 in the context of the international financial crisis, has shattered any hopes of investors of seeing their portfolios bloom. After nine months of almost continuous decline, and only after U.S. authorities have announced the first set of measures to stabilize the situation on the financial markets, the Romanian authorities reached the conclusion that the local stock market needs a helping hand. Especially since 2008 has shown a paradoxical situation between the course of economy – with record-growth – and of the prices of listed securities.

The current financial crisis affects developing countries in two possible ways. First, there could be financial contagion and spillovers for stock markets in emerging markets. Stock markets across the world – developed and developing – have all dropped substantially since May 2008. Second, the economic downturn in developed countries may also have significant impact on developing countries. The channels of impact on developing countries include: trade and trade prices, remittances will decline, foreign direct investment (FDI) and equity investment will come under pressure, commercial lending (banks under pressure in developed countries may not be able to lend as much as they have done in the past), aid budgets are under pressure because of debt problems and weak fiscal positions, other official flows. Each of these channels needs to be monitored, as changes in these variables have direct consequences for growth and development.

The world financial crisis has some positive aspects. These positive effects on stock market may be¹³: 1. Financial crisis ushers in an end to the domination of the sole magnate in international financial relations, which was a major cause of the

¹³ Robin Bal, *The Positive Effects Of A Financial Crisis*, October 2008, <http://www.fortunewatch.com/the-positive-effects-of-a-financial-crisis/>

crisis. 2. The financial crisis revolves around redrafting laws and rules that regulate global financial institutions, especially the International Monetary Fund (IMF), World Bank (WB), and the World Trade Organization (WTO). 3. The financial crisis leads to a change in the world investment map and more opportunities to be provided by the emerging investment hubs, which offer guarantees and opportunities for world capitals. 4. The next global financial and banking system will be strictly regulated and supervised by applying the measures of control, transparency and global governance. 5. Nowadays, the absence of giant financial institutions, which dominated stock markets in the world for long decades, is due to the financial crisis.

Conclusions

The downward that began in mid 2008 at BVB brought, in addition to losses, a number of benefits for investors in terms of culture, education and deeper understanding of the concepts of risk and investment psychology. Among the lessons that the Romanian investor ought to have learned from this period of decline there are:¹⁴

⇒ Lesson of realism: clearer perceptions on the concept of risk. If until now risk perceptions were not defined, the strong drops of quotes taught investors that the risks are higher than they imagined.

⇒ Lesson of wisdom: you can loose on the stock market. The stock market has its logical and natural cycles, ascending and descending trends. The stock market is not a financial institution where everybody makes lots of money fast. The capital market has its schedule, a cycle of highs and lows which must not be neglected.

⇒ Lesson of diversity: mutual funds – alternatives with lower risk. In case of a falling stock market, the necessity and benefits of diversification for limiting losses seems obvious and it can be achieved though portfolio approaches of a mutual fund. Focusing investments in a small number of shares can be risky, there are examples of securities on BVB which dropped well below the market average although in the past had an excellent performance.

⇒ Lesson of time: medium and long term investments. In addition, during all this period, patience, calm, and a large investment horizon helped many not to panic and sell or go after small profits in comparison with those gained when the trend turned around. A philosophy of the capital market states that medium and long term investments brought the greatest profits.

In conclusion, future market developments may give other examples from which investors can learn, that is not to sell when faced with drops or panic (global financial crisis) and not to remain outside the market.

The crisis settled in slowly, but it was anticipated some years ago. Its origin has been the explosion of the internet (internet bubble), in early 2000. However, the

¹⁴ <http://www.wall-street.ro/slideshow/Piete-de-capital/42023/Ce-am-invatat-din-criza-pietei-de-capital.html>

current crisis has a totally different nature. Financial markets and financial authorities were very reluctant to admit that the real economy is directly related and will be affected. The crisis we are living is clearly financial, economic but is, above all, a crisis of confidence, a crisis of ethics which, if not overcome, may jeopardize the democratic organization of developed countries and the rise of others from underdevelopment.¹⁵

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¹⁵ Rober Labbe, “Criza! Da, dar ce...criza”, *Euroeconomia XXI*, nr. 196 / 12.12.2008

EFFECTS OF INTERNATIONAL FINANCIAL CRISIS ON THE FINANCIAL SYSTEM AND MONETARY POLICY

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Abstract

The current financial and economic crisis seems to be unprecedentedly in the last half century. The economic downturn extended in the USA, Europe and Japan seems to be much more painful than the economic downturn in 1981-1982. A massive drop of confidence is under way, both across the business sector, and the consumers, both reacting by cutting costs. The U.S. Government and some governments in Europe, are trying to recover stability, and nationalized parts of their financial sectors to an extent that is in conflict with the modern capitalism basics. Today the entire world seems to change its direction, shaping its course to a period wherein the state role will be higher, and that of the private sector will be lower. This will be probably the most dramatic consequence of the current economic crisis.

Keywords: liquidity, inflation, financial-accounting reportings, fiscal policy, financial markets

JEL Classification: E30, E50, E60.

1. Introduction

Many people consider the current financial crisis originates in the dramatic drop of housing price in the USA or in falling the credit market for housings. This vision is at least incomplete. The basic reasons of the financial crisis are deeper, both macroeconomic and microeconomic, issue recently mentioned by several analysts: Altman (2009), Buiters (2008), Blanchard (2009). The two types of reasons have interconditioned in causing the crisis. I will refer in turn to both types of reasons.

The profound reason of the financial crisis was the high liquidity created by the main world central banks (FED, BOJ) and by the desire of the oil and gas exporting countries to restrict the currency appreciation. Also, there was a satiation with savings, generated by the increasing integration of some countries in the global economy (South-East Asia in general), with high accumulation rates, and by the global redistribution of wealth and income to the strong asset exporters (oil, natural gas etc.). High liquidity and satiation with savings created available resources for investment, including in sophisticated financial tools, not easy to understand by some investors.

The consequences of high liquidity have been the very low interest rates and

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their low volatility. Together, these consequences have led to rising the appetite for high income assets. Moreover, the low volatility on the market has created the trend of risk underestimation and a real lack of vigilance from investors. The risk margins have also been very low and non-discriminatory. Together, the low interest rates, the appetite for high income assets, the low vigilance to risk and the low margins hampered the warnings of prices on the financial markets and led to an incomplete understanding of the involved risks.

Under these circumstances a series of microeconomic reasons has also worked as aggravating: cracks in the business model of the rating agencies, privately rational outsourcing but socially ineffective and, finally, an increased international competition for deregulations.

Establishment of investors' distrust has placed rapidly the bonds issued by the special purpose vehicles (SPV) in the risky category (quality of assets financed was not clear any longer) and refinances became impossible. Due to discrepancy between maturities on assets and liabilities, these SPV have started relying on financing from sponsoring banks. Finally, the liquidity demand, in conjunction with the loss of confidence in banks, drove the rush after cash and the effective interest rate has started rising.

In the USA and some states in Europe, governments and central banks responded by improving liquidity; granting of governmental warranties for loans; recapitalization of financial institutions; warranty of the newest issuance to insured banks; prevention of erratic collapse of major interconnected enterprises; purchase of stocks in banks; coordinated reductions of interest rates. Although such kind of measures have been implemented, after 17 months from starting the turbulences, the market remained non-transparent, and hence financial crisis increased and shifted to the real sector of economy, first in the USA, then in other developed countries.

In the short term the main challenge consists in finding solutions to recover the investors' and consumers' confidence. In the long term, the main challenge consists in adjusting the principles that guide the reform of the foreign financial system, chiefly related to transparency, improvement of regulations concerning safekeeping account bookkeeping, assurance of a suitable regulation of markets, firms and financial products, assurance of financial market integrity (concerning market handling and fraud), and strenghtening of cooperation between the world financial institutions (modernization of the governance structures of the IMF and the World Bank). The business ethics is not missing in this list of future challenges.

2. Financial crisis and Romania's economy

The effects of international financial crisis have also extended on Romania's economy. However, as regards the direct impact, the banking system has been scarcely affected as it has not been exposed to harmful assets, as well as thanks to the prudential and administrative measures adopted in the course of time by the National Bank of Romania. But indirectly, the international financial crisis and especially its obvious consequence – economic downturn in the developed countries – extend

over Romanian economy on several directions. As regards the commercial direction, it slows or even reduces the increase in exports. As regards the financial direction, it restricts the access to foreign financing, and thus curtails the amount of lending, and generates difficulties in the service of private external debt. As regards the exchange rate, reduction of external financing reflected in the depreciation of local currency. As regards the confidence direction, investors have retreated from the Eastern European countries. As a result, some moments of panic and speculative attacks took place on the monetary-money market like that in October in Romania that required the National Bank's support. Finally, as regards the direction of wealth and balance effect, the damage of population and companies' net asset occurs, as a result of high weight of foreign currency credits (correlated with the leu depreciation) and decline in prices of personal assets and property from speculative values, non-sustainable (*"bubble"* type).

Spreading of these effects makes the extent of uncertainty concerning the evolutions of economic variables be extremely high. In its turn it results in deepening the crisis by means of negative effects it has on expectations and by augmentation of the extent of caution with consumers and companies. In Romania, the feedback to the adverse effects of crisis cannot be similar to that stated by some European states or that in the USA. There are some differences between the Romanian economy and these economies, that do not enable simply the copy of the measure package developed there. Basically, it is about the fact that Romanian economy has a high current account deficit, indicating its dependance on foreign financing. We have to choose between the ordinate reduction of this deficit or its reduction by the market in the current circumstances of strain and distrust, with dramatic consequences on exchange rate and economic growth.

Although the progress of the economic adjustment process cannot be planned accurately, however, promotion of some coherent and credible economic policies could avoid occurrence of an orderless adjustment (hard landing). Therefore, the government should avoid an emotional approach of crisis under pressure of labour unions and patronizing federations, that would result in the adoption of some stimulation measures of domestic demand, making difficult to bring the current account deficit to a sustainable level. If the macroeconomic policies combination is focused only on the adjustment process of external imbalance (current account deficit) and the domestic one (budget deficit) can result in sustaining a smooth landing of the economy and improvement of foreign investors' perception.

Basically, a significant strengthening of the fiscal policy and wage policy is required (widely, comprising increments and cvasiwage bonuses). To this effect, the budget for 2010, approved recently, is a praiseworthy first step, especially thanks to the assignment of some relatively high funds for investments having the potential to create *"spillover effects"* over the other economic sectors. The possibility of a gradual easing of monetary policy will occur as it is put into practice. Therefore, a suboptimum combination existing in the past years (slack fiscal and wage policies, a *"very tight"* monetary policy respectively) could be replaced with an optimum

combination wherein all policies (budgetary, wage and monetary) have a similar restrictive nature and guide economic activity to work and productivity.

In addition, the government may contribute to the improvement of foreign investors' perception by means of measures such as improvement of the absorption ability of European funds and thus replacement of private financing with public external financing to a certain extent, or by creating new jobs in insufficiently developed fields (infrastructure, tourism, agroalimentary), that should gradually become the drive force of economic growth. Generally speaking, the settlement of some financing agreements with world organizations, starting with the European Commission and the European Investment Bank, to balance the slight reduction of private capital inflows is welcome. If all these steps will be followed, it is very likely that investors improve their perception about Romania and prefer investing here than in other Central or Eastern European countries. However, the high probability does not amount to certainty: one cannot reject the scenario wherein Romanian authorities do their best, so as foreign investors react positively and make no difference between Romania and its neighbours. However, the awareness regarding this possibility should not lead to defeatism and resignation of the so necessary adjustment measures.

3. Targeting inflation and financial crisis

Hereinafter I shall refer to the monetary policy strategy of the National Bank of Romania– targeting inflation – in close connection with the current financial crisis and with the problems our contry is confronting with.

The option for adopting targeting inflation as a monetary policy strategy has been justified by the need of reaching a sustainable desinflation. Implementation of the inflation targeting strategy was not easy before the occurrence of financial crisis and fiscal dominance, massive capital inflows, net debtor position of the National Bank of Romania in regard to the banking system and mechanism of rendering the monetary policy have combined, thus, between 2005 and 2007, there were periods of time when inflationary anticipations and currency marked estimations coexisted. This arose a severe dilemma for the Central Bank. Increases of interest rate required to bring anticipations in line with the inflation target were attracting even more foreign money, appreciating the leu non sustainably.

At the same time with starting the financial crisis in July 2007, some of these circumstances dissapeared. Today the National Bank of Romania tends to be a net creditor of the banking system, and foreign capital inflows have diminished significantly. But it does not simplify the implementation of monetary policy. On the contrary, financial crisis has increased volatility on the monetary and foreign exchange markets and tends to increase the slackening of economic activity. On the one hand, reduction of foreign finances and existance of significant foreign imbalances have triggered the leu depreciation, that fuels inflation and makes necessary a relatively high interest rate. Moreover, those with debts expressed in

Euros and other currencies, and therefore the financial system, are vulnerable to a significant leu depreciation. On the other hand, higher interest rates would tend to hamper economic growth and, furthermore, would create costs for those with debts, risking to destabilize the financial sector. Under these circumstances it occurs the delicate issue of the compromise between the monetary policy objectives: assurance of price stability and assurance of financial stability.

Friedman (1968) and Phelps (1968) have showed there is not compromise between inflation and unemployment in the long term. Hence it results the objective of the monetary policy in the long term should be the accomplishment of a low and steady inflation. It has been noticed the low and steady inflation helps the sustainable economic growth in the long term. Consequently the low and steady inflation is both a purpose itself, and a means of accomplishing a sustainable economic growth (Bernanke, 2006).

However, the efficiency of monetary policy in reaching this purpose is limited if there is not financial stability. One of the main macroeconomic principles states that financial frictions substantially affects the business cycle. Today, this issue is obvious worldwide. The world central banks are trying to keep financial stability and avoid economic downturn.

The previous experiences seem to confirm the vision wherein inflation is the main source of financial instability. As usual, the periods of time characterized by high inflation have been those with severe financial instability and crisis across the banking sector or have been followed by downturn as the authorities adopted some unsuitable measures of reducing inflation.

However, the recent economic literature emphasizes that a low inflation is not an adequate requirement to secure financial stability in the long term (Crockett, 2003). In modern economies, a low and steady inflation has led to the creation of a new economic climate, requiring the accurate reconsideration of the relationship between price stability and financial stability. Therefore, a new battle front has opened, dedicated to fighting against financial instability. To this effect, experience of some Asian countries in 1997-1998 and the current economic and financial crisis drive the reconsideration of the measure wherein the central bank is able to secure price stability and financial stability simultaneously assuming their accomplishment requires the adoption of some conflicting measures.

Romania's experience shows that financial stability has a major importance for stability of prices. With good reason, Romania has been criticised for delays in desinflation. These delays have been caused by deficient structural reforms. Our country reached an average desinflation rate of 5.8 percentage points a year in 2000-2007, in parallel with maintaining the stability of the financial system. But if the National Bank of Romania would have balanced this lack of reforms by means of steeper increases of the interest rate the financial situation of firms and households would have worsened. Therefore financial stability of the banking sector would have worsened. Finally, the desinflation pace itself would have been probably lower than that accomplished. The lesson that should be learned is that, in the long term,

incapability of maintaining financial stability only leads to a rise of inflation.

By adopting targeting inflation it has opted to make as much place as possible to market in setting the exchange rate. However, there were cases when the leu fluctuations were by far out of the limits justified by the exchange rate basics. That was the case several times in 2004-2007, when massive capital inflows occurred and the leu appreciated largely. It happened so in some periods of time, even after the current foreign financial crisis started, including in 2009. These were the reasons for which a managed floating of the exchange rate. It does not mean one may interfere on the foreign currency market in a discretionary way.

The policy of the National Bank concerning its supports on the foreign currency market has been guided by the philosophy according to which a high volatility exchange rate is harmful for both inflation concerning objective, and financial health of the real sector and the financial sector. With this philosophy, the National Bank of Romania has promoted a floating exchange rate, that enabled it to use both the free market opportunities and discourage speculative behaviours, and to avoid outrageous appreciations.

The consistent implementation of this philosophy required relatively important foreign currency purchases from the market by the National Bank of Romania in 2004 – August 2007. When the foreign currency was purchased, the National Bank of Romania was criticised as it did not allow the exchange rate to appreciate in line with the market requirements. Today it is a fact this policy was suitable. The current financial crisis has introduced a steep inversion of the leu appreciation trend, with important episodes of volatility. As the case stands, in the past, the foreign currency inflows have appreciated the leu much more than the level indicated by the basic factors of the exchange rate, nowadays reduction of foreign financing and uncertainty tend to cause leu depreciations not justified by the basic factors of the exchange rate. Today the reserves purchased on the foreign currency market in the moments of superappreciation serve for supports required to ease the leu depreciation.

The National Bank of Romania is sending the market a message concerning annealing of the political situation and confidence regarding continuation of the disinflation process in 2010 and stability of exchange rate, that highlights the importance of correlating the market interests with the key interest. The Managing Board of the National Bank has decided to lower the monetary policy interest from 8% to 7.5%, level that has not been reached for 2 years, by means of a surprise-measure for the market, as most analysts were anticipating the interest rate remained at the same level or it decreased by a quarter of a percentage point, to 7.75%.

The message sent by means of the central bank's decision is an optimistic one. The National Bank of Romania is confident that we shall realign with the provisions of the agreement with the International Monetary Fund and the European Commission, i.e. most uncertainties vanished. Moreover, the National Bank of Romania does not see depreciation pressures exerted on the exchange rate and in the very short term, there are inflationary pressures occurred as a result of increasing

excise, but the National Bank of Romania considers the inflation will continue to diminish.

Except January, when inflation will be higher, the disinflation process will likely restart in February and we shall probably see annual inflation rates less than 4% in the first part of 2010.

In the meeting dated 5th of January 2010, the Managing Board of the National Bank of Romania (BNR) decided the following: reduction of the monetary policy interest rate to 7.5% a year from 8% a year, starting from the date of 6th January 2010, the adamant management of liquidity in the banking system in order to strengthen transmission of monetary policy signals and maintaining the current levels of the compulsory minimum reserves rates applicable to the liability in lei or in foreign currency of lending institutions.

In 2009, the central bank diminished the key interest by five times, from 10.25% to 8%, and lowered the minimum compulsory reserves required to commercial banks to 15% from the reduction of compulsory minimum reserves was made within a surprise-meeting of the National Bank, in the mid-November 2009, when the Managing Board decided to reduce them from 30% to 25% for the banks' foreign currency liabilities, as a result of delaying the third tranche of Romania's foreign loan from the International Monetary Fund, that had to be delivered last December.

4. Role of accounting within the current financial crisis

Financial crisis hallmarked on economies all over the world, that experienced the economic recession: the GDP of some countries with a very developed economy has registered major declines, exports have reduced significantly, damage of estate markets has exacerbated, car markets have declined, the deflation risk has increased, unemployment has gone up significantly, and countries of the third world have started receiving less aids, resulting in worsening poverty and famine. The sweeping bankruptcies continue to occur, many specialists consider that one cannot talk about a way out from the crisis.

As regards the increasingly significant economic effects of financial crisis and as some saving plans are increasingly expensive for common people, there were opinions that tried identifying the causes for these events and those responsible for the current crisis. Opinions were different, but many specialists agreed that one of the factors that generated the current events has been the unsuitable use of some complex financial tools that became impossible to understand even for their creators. The consequences of their use consisted in increasing the opacity of the financial system and financial reportings, accused of hiding the existing risks and, as a result, distorting the information sent to the interested public.

Perception on a close connection between crisis and certain types of financial tools has led to discussing prevalently about *accounting standards* concerning these tools. The topic became hot in mass media, the accounting standards being mainly considered responsible for the fair value related rules. The bankers and insurers

have put the blame on them as being responsible for some huge losses registered by financial institutions related to financial tools whose markets became non-liquid, losses accounted as a result of some effective transactions that worsened a situation already poor.

Other opinions thought that for the current crisis the accounting rules are not responsible but financial reportings related to financial tools, fair value and risks, that were short of transparency and comparability because of an unsuitable application of the information description norms. The main reason of critics consisted in the fact that financial reportings should have provided a clearer and more desirable picture of the risks involved by using some sophisticated financial tools, in order to enable the investors and other interested parties to evaluate the companies' assets, debts and equity capitals correctly.

The role of fair value accounting and financial-accounting reportings within the current crisis can be evaluated by surveying and commenting the information published through financial statements carried out by the American and European financial institutions, as it is known that financial sector is one of the most affected by the current events.

Studies carried out by various bodies, the Securities and Exchanges Commission in the USA, the Merrill Lynch Study, the Council for Financial Accounting Standards and others respectively have surveyed the impact of fair value accounting on financial institutions.

The Report of the Securities and Exchanges Commission is focused on surveying the weight of assets and debts evaluated at fair value in total assets and debts, effects of fair value fluctuations over the revenue account, using the fair value by financial institutions in compliance with their wish, the nature of assets and debts evaluated at fair value. The Merrill Lynch Study has taken into consideration the recent bank crashes and losses or significant profit reductions in the field, identifying the main causes of these evolutions and the Council for Financial Accounting Standards has surveyed the institutions that did not survived the crisis and went forward comparing the market value of some important commercial banks with that resulted in account books.

Following the survey of this studies, the conclusion was that the fair value accounting was the main cause of triggering the current crisis. This has not played a major role either in far-reaching bankruptcies of some American financial institutions, rather caused by significant losses registered at credits granted very easily, the unsuitable risk management policy, financial engineering were out of hand and the lack of some appropriate prudential regulations.

The specialists drew a set of conclusions related to the role of accounting within the current financial crisis:

- ✓ Accounting rules, especially those related to fair value cannot be considered responsible for triggering and spreading the crisis, for which more profound causes have been identified.

- ✓ The role of accounting does not consist in securing financial stability, but in

providing useful information to users interested in decision-making, even if they put the managers in a tight corner. Therefore, the accounting should not be used as means of reaching stability, as it could affect its transparency, and it cannot be a working tool against the pro- cycle, as it should remain neutral.

✓ The fair value accounting should not be eliminated or suspended, not even in situations of crisis, as investors consider it the best method to evaluate financial tools, that can be improved by means of guides and further recommendations, hereupon the normalizing bodies are working to.

In connection with financial reportings it can be stated that:

✓ Information shown is extremely complex, and hence it does not help at all the restoration of investors' confidence in financial markets, confidence strongly shaken by the current crisis.

✓ In order to reach the required transparency and comparability, only implementation of the accounting standards is not enough, information presented should be detailed and explained accordingly.

✓ The accounting normalizing bodies are required to improve the reporting requirements.

5. Conclusions

In this period of turbulences and uncertainties I think the Euro Adoption Program will be the best guide. Romania should keep its calendar announced previously for Euro adoption, on condition that entering the ERM-II exchange rate mechanism on the 1 st of January 2012 and running the compulsory minimum period of two years within this mechanism is imposed by the requirement that many suitable and efficient reforms should be carried out in Romania, up to 2012.

Under the current economic circumstances, companies start providing a higher attention to the efficient management of resources and use to this end the income and expenditure budget – as a financial management tool, within the firm and within the main types of the firm's activities. The basic component of the control record, having direct connections with the planning structures, observation-control and accounting the entire activity, the budget is an important planning tool in the short term. It is considered the accounting and financial expression of the action plans retained to be applied, for which the targeted objectives and means available in the short term converge to the accomplishment of the operational plans.

If until now most markets in Romania have been „seller markets”, wherein producers and merchants had not to apply sophisticated strategies to stimulate sales, today companies should revise their strategy in order to „sail” on the economic and financial crisis successfully.

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SOME ASPECTS REGARDING THE RECOVERY OF THE EUROPEAN BANKING SYSTEMS AFTER THE FINANCIAL CRISIS

*Dan Micuda, Sorin Visinescu**

Abstract

From the beginning of the crisis in 2007 the financial markets in Europe have lost approximately one half of their value and those in the emerging countries declined by at least three quarters. Also in the banking sector of the Western Europe and US a large portion of the equity portfolio that they've own are drastically reduced forcing many large banks to go insolvent or to request government aid. Governments, both in the US and in the EU have attempted to aid the banking system by recapitalizing the banks in trouble but these efforts proved badly designed and implemented.

Currently financial markets in the Western Europe have stabilized but the signs of recovery are still weak especially for Central and East Europe countries, the so called "Emerging Europe". Their banking systems are heavily depended on their western counterparts and they are still struggling to find their balance.

Keywords: Banking Systems, Financial Crisis, Developments, Central and Eastern Europe

JEL Classification: E30, G15, G21

Introduction

The banks in the EU zone have taken more leverage than their US counterpart and therefore are more exposed to the effects of the current financial crisis. They had almost doubled the leverage ratios in comparison to their American counterparts. To compensate for these exposures they bought credit default swaps especially from AIG the most important American insurer which was saved in last moment by the US authorities from bankruptcy using the taxpayers money. If the Americans didn't save AIG the position of most European banks would be even riskier in the present.

Particularities of the EU Zone banking systems that make them more vulnerable to crisis

At the current discussion time, banking systems, in a global perspective, remain largely dysfunctional and the local credit markets dropped to historical lows in EU

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and also in the US. The losses from the toxic asset are reaching to about 4 trillion dollars, mainly in the Western Europe countries (2 trillions dollars), US (1,8 trillions dollars) and 150 billions dollars in the emerging economies.

Some \$3 trillion of the total losses resulted from assets originated in the US, while the other quarter originated in Europe. US bank loan losses total \$1.1 trillion, of which half have already been written down, while euro zone and UK bank loan losses will be over \$900 billion. Of the \$4.6 trillion of foreign bank loans to emerging economies, euro zone banks account for 73.4 per cent while US banks account for only 0.3 per cent; UK banks also have exposure. Thus, European banks are being more affected by a global slowdown. By March 2009, EU governments had provided \$380 billion for bank recapitalizations and guaranteed \$3.17 trillion of bank loans.

One of the characteristics that put European banks at risk in the current economic environment is that they are very large when comparing to the GDP of their home countries. So, in the case that one of these large banks fails, the government can guarantee, in one way or another, the depositors funds only in short amounts. This, in turn, encourages owners of large capital in emerging market and small economies to transfer their funds to more solid economies, looking for cover against default risks. One especially eloquent case is that of Iceland where the banking system had assets ten times larger than the country's GDP. Another more recent case is that of Greece who currently suffers a confidence crisis from the international financial community and especially from the large wealth owners. Almost all local billionaires had redrawn their funds from the local banks into foreign accounts.

In the EU there is also another big problem that currently affects even the stability of the EURO: in US the Federal Reserve can act as the lender of last resort if the US government is unable to obtain the needed funds through taxes or borrowing. But euro zone governments have no lender of last resort to monetize their debts. The European Central Bank is not authorized to do this. The European situation has been described quite accurately as one where "the banks are too big to fail but too large to save".

Currently there is a large uncertainty about the degree and especially the value of the toxic assets that European banks hold. Their value cannot be determined and in the last instance the European governments will have to intervene in one of the following ways:

- Nationalize their problem banks
- Bail them out
- Purchase their toxic assets at a premium

All these methods pose serious threat to the specific government finances and, more importantly, none of these approaches was, since now, especially effective.

This type of bailout have already taken place in several European economies like Belgium, Greece, Germany, Iceland, Ireland, Netherlands and the UK and western banks still need to raise between 160 and 300 billion dollars in new capital. Ireland is

a special case, being the first and only European country that set up a “bad bank” after the Swedish model from the 1990’s crisis. Germany tried first to discern between illiquid and insolvent banks and after that only guaranteed for the last ones.

Europe financial sector based on national regulations and institutional structure is not fit to deal with the current financial crisis. Although US had implemented a system of insuring bank deposits after the Great Depression, EU doesn’t currently have such a scheme to protect bank customers. After the crisis manifested in the EURO Zone the national government acted largely uncoordinated and, on some occasions, even against each other, trying to extend guarantees to bank deposits. One example is the UK, where banking supervision was so separated from the central bank’s lender of last resort facility that the latter had no idea in its dealings with Northern Rock whether it was insolvent or just illiquid.

Another characteristic of the European banking system that jeopardized his reactions to the current crisis was that, although the banking activity is regional or global, the majority of the regulation is national. So cross border entities in the banking market had not a clear idea on how to treat financial losses and furthermore, if an intervention is needed to help the bank there is not a clear arrangement on which government will provide it and if it is provided to a subsidiary of the bank, an unsolved obligation of the parent bank not to withdraw the funds, draining the local bank, still remains. This is the case of the National Bank of Romania intervention to aid some local branches of foreign banks which, immediately after that transferred the fund to their parent entity, making NBR intervention futile and useless. Also parent country governments did not want the assistance they were providing to their domestic institutions to be transferred to subsidiaries abroad and one such example was the warning of the Greek government to the local banks with international or regional operations not to transfer funds provided by them in January 2009 in a \$37 billion support package to foreign subsidiaries abroad.

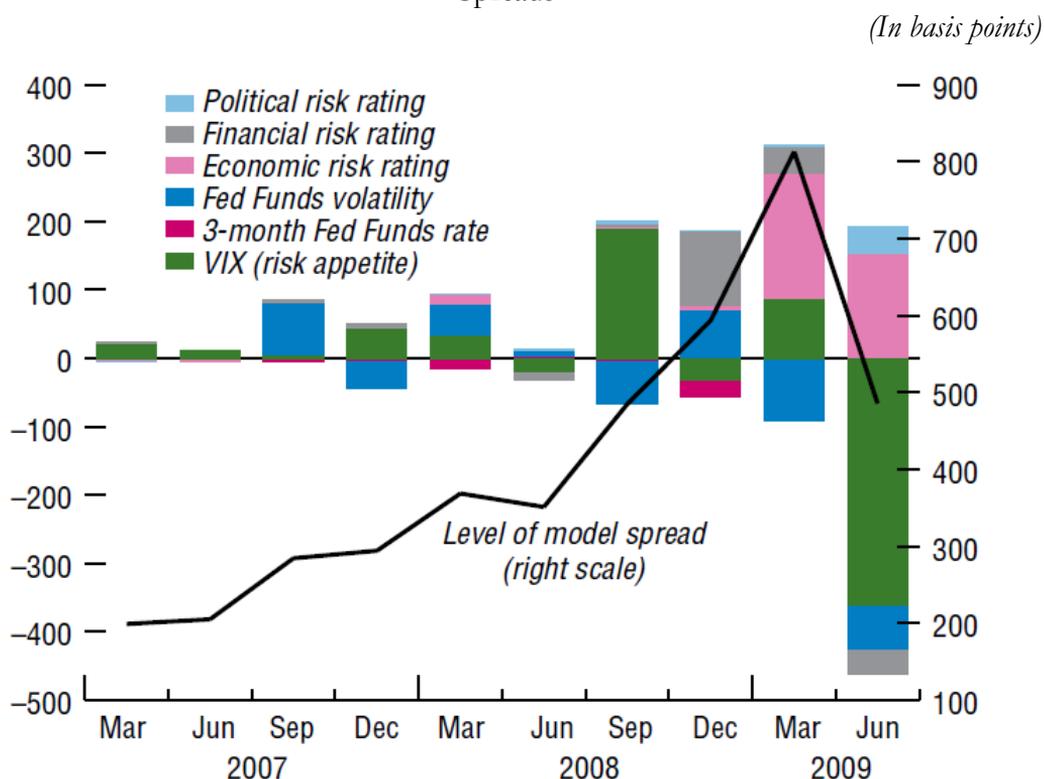
“Emerging Europe”-the same goals in dealing with the crisis but different paths

The economies of “Emerging Europe” (mainly CEE states) pass through extreme difficulties in 2009, being directly affected by the developments in their Western counterparts. Some of them managed to better cope with the crisis and implemented measures aimed to retain capital, control exchange rate extreme fluctuations and eliminate default risk. Most of them have managed to strengthen their position and defer short term risks, that being seen also in the evolution of the credit default swap (CDS) spreads which tend to rearrange to levels prior to the start of the crisis in 2007 (Figure 1).

Although the risks of default in macroeconomic collapse have passed there are still some sectorial vulnerabilities that can jeopardize economies in “Emerging Europe” such as: current account balance levels, needs of refinancing the external debt for 2010, net external position vis-à-vis BIS-reporting banks, average real credit

growth, loan/deposit ratio or Forex share of total loans. (Table 1)

Figure 1. Contributions to Changes in Emerging Market Sovereign External Spreads



Source: IMF, Global Financial Stability Report October 2009

External financing risks to Central and East European (CEE) banking systems have now subsided and the main focus for the medium-term outlook has shifted toward domestic variables. While it is likely that the downward trend in asset growth will reverse in the beginning of this year, the recovery process will be fragile and the pace of expansion will not return to pre-crisis levels. Ultimately, fundamental demand conditions across (CEE) might not be favorable to a rapid expansion of loans. Moreover, persisting risks from widespread deleveraging in Western Europe, presented above, capital market volatility and asset quality deterioration will contain growth in banking sectors across Emerging Europe. The deteriorating trend in CEE's banking sector asset growth is expected to reverse in the beginning of 2010, in congruence with an acceleration of a regional macroeconomic recovery. In addition, the variations between divergent economies are pronounced and the pace of asset expansion will not recover to pre-crisis levels.

The growth potential for 2010 in the banking sector of Central and Eastern Europe will be affected by some factors, such as:

- The lack of demand on domestic markets will not permit a rapid recovery for the loan activity
- Prolonged and sustained deleveraging in Western Europe capital markets
- An ongoing asset quality deterioration who has never stopped especially for the high risk markets: Baltic States, Greece, Hungary, etc.
- The increasing level of reglementation which followed the crisis and also the growing fiscal burden from the governments facing default risk from lack of adequate tax incomes.
- The investment banking sector will also be affected by large volatility in capital markets who still did not regained a clear upward trend after the events following the beginning of the current crisis.

Table 1. Heat Map of Macro and Financial Indicators in Emerging Europe Market Countries

	Current Account Balance (percent of GDP)	External Debt Refinancing Needs in 2010 (percent of reserves)	Net External Position vis-à-vis BIS-Reporting Banks (percent of GDP)	Average Real Credit Growth over the Last Five Years (percent, year on year)	Loan/Deposit (ratio)	Forex Share of Total Loans (percent of total loans)
Europe and CIS						
Bulgaria						
Croatia						
Czech Republic						
Estonia						
Hungary						
Kazakhstan						
Latvia						
Lithuania						
Poland						
Romania						
Russia						
Serbia						
Turkey						
Ukraine						

Source: IMF, Global Financial Stability Report October 2009

Due to the particularities of the banking systems in Central and Eastern European (CEE) that have most part of their assets allocated to domestic credit, the main focus that will drive the growth in 2010 will be the local demand for new loans. But this demand has also economic and mainly fiscal implications that currently are not very good for these countries. So a slow recovery is also expected for the baking systems in the region.

Currently a fundamental increase in demand determined by productive investments from the private sector is less likely given the fact that the private sector is still hurt from recent developments and under a heavy fiscal burden from local governments. On the other side, that of household credit demand, the current growth in GDP will eventually affect the employment levels and their incomes but not in a fast way, more probably with a significant “lag” that will further contain

growth in the credit market to low levels. The mortgage and personal low, real engines for growth in the retail credit market before the crisis will tend to remain well below the 2007 levels.

One of the main aspects that affect credit demand is the willingness of the banking system to lend. From this point of view there are not many reasons to encourage banks to increase lending at this moment. Economies and also banking systems in Eastern Europe are umbilical depended on the large commercial banks based in Western Europe or U.S. But this entities already face many difficulties on home markets and currently there are not willing to extend credit in the Eastern Europe markets and it is also unlikely that Western European banks, will be in a position to re-leverage and re-establish the investment positions they had in Central and Eastern Europe pre-recession.

This reluctance to extend credit in from western banks reflects not only their deteriorating conditions on their main markets but also an above the limit deterioration of their assets on the emerging markets especially due to the real estate crisis. These deteriorations will also reflect in their balance sheets also in 2010 by the loss provisions they took in 2008 and 2009, regardless of the relative stabilization of the real estate market. This is especially the case in higher-risk places including the Baltic States, Russia, Ukraine, Hungary and Bulgaria, where the economies are undergoing structural contractions over a multi-year time horizon.

Also rates of nonperforming loans (NPL) skyrocketed from the 2008 levels in most Central and Eastern Europe states (Figure 1.), especially Russia, Ukraine and the Baltic States. Even in relatively better economically positioned Central and Eastern European countries, such as Poland, Hungary, Czech Republic Turkey, NPL rates raised further to new multi-year highs.

Corporate loan quality has been deteriorating more rapidly than household credit quality, reflecting the higher leverage and the worsening business climate, and overall loan quality is likely to deteriorate further in the next 12 to 18 months.

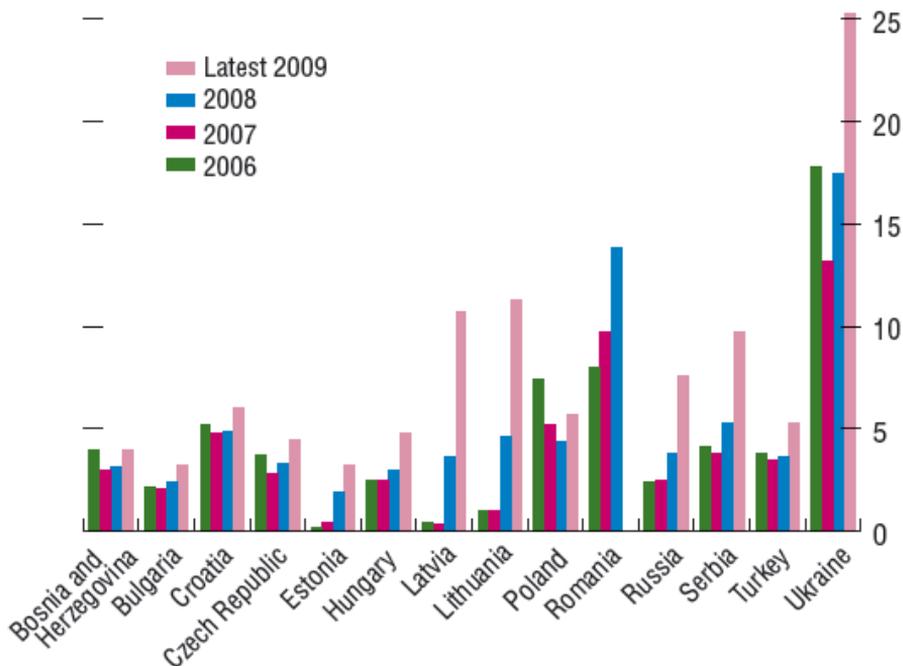
Nonperforming loan ratios are forecast to peak up to twice the current levels, according to various central bank projections. While the current level of provisions is generally sufficient to cover loan losses at this time, the additional provisioning required going forward will limit banks' capital positions and their ability to issue new loans. While we can expect asset quality deterioration to hit its trough in 2010, it will take several years for NPL rates to unwind back to pre-crisis lows. The resulting shift higher in loan loss provisions will accentuate limitations on capital allocations to new loan growth throughout banking sectors in the region.

This will result in a broader asset allocation shift towards government treasuries and away from private sector credit, which will further limit asset growth potential over the medium term. Already, Central and Eastern European bank asset holdings are shifting to more conservative securities, which have been facilitated by a marked surge in state borrowing requirements alongside broader fiscal stimulus programmes. With those stimulus measures unlikely to be wound down until 2011, the increase in the supply of treasury bonds will at least in part have a crowding-out effect on the

private sector. The sustained capital market volatility over the medium term can also encourage the shift to government securities. The combination of ongoing macroeconomic uncertainty, unprecedented monetary easing and weak demand conditions will mean that profitability on the investment banking side will similarly be volatile, affecting headline performance.

Figure 2: Emerging Europe: Nonperforming Loan Ratios

(In percent)



Source: IMF, Global Financial Stability Report October 2009

Policies in the region should be aimed at managing an orderly adjustment of bank, corporate, and household balance sheets. This will prevent a resumption of the adverse feedback between financial conditions and the real economy and limit the risk of contagion among vulnerable countries. Decisive measures are required to deal with nonperforming assets and troubled banks, including removal of problem assets from bank balance sheets, bank resolution, and recapitalization. This will limit the scope for further banking sector deterioration and prevent the possibility that weak banking systems will impede the recovery from the current recession. Further, while governments should continue to support viable corporate facing rollover difficulties, there may be a need for encouraging further debt restructurings to share the burden of losses with international creditors.

While the broad trend across the region will be for the recovery in 2010 to be only mild, there will remain wide variations in the growth potential and stability of banking sectors throughout the region. Relative performance of the varying sectors will continue to be closely linked to the degree of leverage the outlook for domestic demand and the degree and nature of the exposure to other eastern and western European banks.

Taking those factors into consideration, we hold to our core views that banking systems in Poland, Turkey, the Czech Republic and Slovakia will be in a better position to take advantage of the regional macroeconomic recovery. In turn, those sectors in the Baltic states, Bulgaria, Hungary, Ukraine and Kazakhstan will likely underperform on a relative basis.

Romania - on the road to recovery

Although Romania's banking sector has so far avoided any major systemic ructions, it is expected that asset quality deteriorate in 2010 as the number of non-performing loans (NPLs) heads higher. Last year political crisis resulted in market sentiment taking a turn for the worse, which sended borrowing costs higher and upset financial stability at a time when the banking sector remained vulnerable to financial market volatility.

Romania's banking sector continues to muddle through the global downturn, with immediate systemic risks largely diffused as a result of improving global liquidity and risk appetite, plus unprecedented stimulus programmes across the world. Falling external borrowing costs have bolstered the banking sector's debt repayment capacity, while improving risk sentiment has prevented massive decapitalisation of the industry. In addition, the implicit and explicit support of Western parent banks to their subsidiaries in Central and Eastern Europe (CEE) has further shored up the outlook for Romania's banking sector.

Banking sector leverage remains around 11:1 (10:1 is considered appropriate for a mature banking sector) and the loan-to-deposit ratio (indicative of pressures on external financing) stood at 77% in October 2009, suggesting a fairly limited degree of external borrowing (Figure 4 and 5 and Table 2).

This is certainly reflected in the National Bank of Romania (NBR)'s gross external debt data, with the banking sector's foreign debt standing at around 20% of GDP, fairly modest compared to elsewhere in the region. The limited deleveraging requirement and apparent lack of systemic crisis risks can keep the banking industry on an even footing in 2010, which in turn can help support the broader economic recovery over the medium term. That said, it is expected to see some asset quality deterioration as weak corporate profitability and high unemployment drive nonperforming loans higher.

A further rebalancing of the industry's asset profile is expected, with banks absorbing more government bonds on the back of a weaker outlook for private sector loan demand, plus a higher return on treasuries as the government seeks

additional financing to cover its bloated fiscal deficit. Signs of this have already begun to emerge, with the banking sector's bond holdings nearly quadrupling in October 2009 compared to same month in 2008.

Table 2. Comparison of key banking indicators

	Loan deposit ratio %	Loan/ Asset ratio %	Loan/ GDP ratio %
UK	97	58,1	304,1
Slovenia	96	80	120
Latvia	201	61,1	94,4
Greece	85	47,6	85,4
Ukraine	201	84,9	81,5
Croatia	115	69,2	80
Bulgaria	125	73,1	72,6
Hungary	125	50,5	67,1
Kazakhstan	203	75,9	60,5
Bosnia	116	71,4	59,5
Czech Republic	82	49,5	58
Poland	111	62,1	53,9
US	80	55,7	53,1
Romania	77	63,5	51,9
Slovakia	81	45,4	50,4
Rusia	129	63,8	43,6
Turkey	62	40	27,9

Figure 4. Loan/assets ratio's for emerging European economies and UK

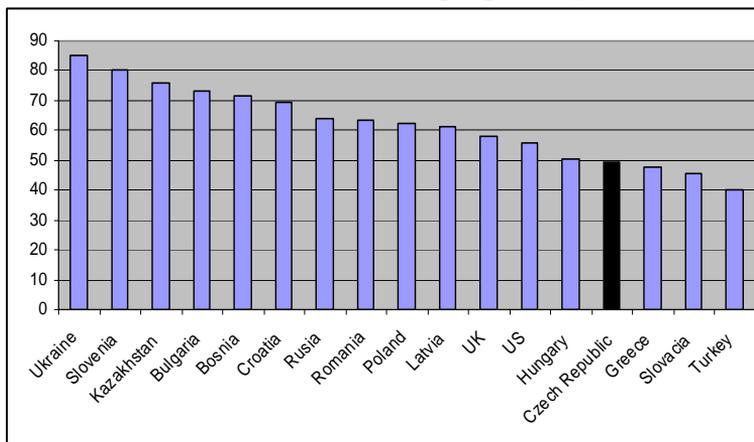
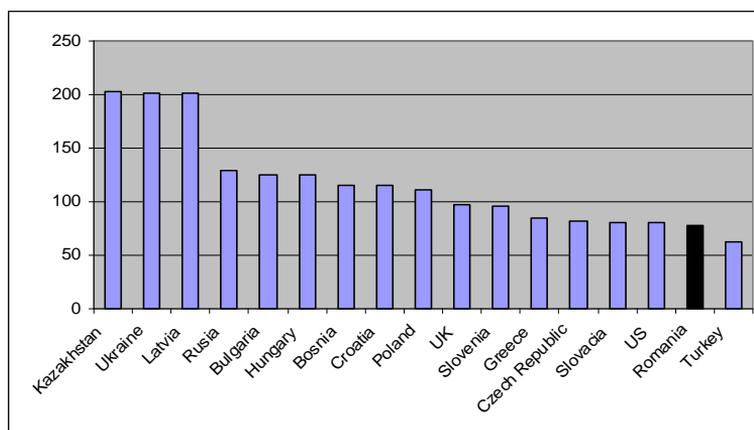


Figure 5. Loan/deposit ratio's for emerging European economies and UK



Source: Central banks statistical bulletins

In the current economic conditions a SWOT analysis for the Romanian commercial banking system would look like this:

Strengths

- The high grow rates of the Romanian banking system in previous years, partially because of the low usage of banking service by the population.
- The macroeconomic indicators look better than other countries in the region (Bulgaria, Hungary, etc.)
- Romanian banking system is dominated by some major foreign banks who can support their subsidiaries in case of failure, saving also the whole system (Societe Generale, Erste Bank, ING Bank, Unicredit, etc.)
- The National Bank monitoring of the Romanian banking system is highly effective and the monetary policies are well targeted and implemented.

Weaknesses

- The global economic condition will further affect the profit margin and operations of banks on the local market
- A high number of Greek banks are currently holding important assets in the Romanian banking system, inducing a negative effect from their home country (Piraeus, Alpha Bank, Emporiki, Bancpost)

Opportunities

- The current economic conditions offer great opportunity for concentrations in the banking sector
- Also these developments induce a good setting for foreign banks who are not yet present to enter the Romanian market

Threats

- One of the main threats is the contagion effect from other countries in the

region who suffer from the economic crisis effects, especially Greece.

- The weak recovery for Romanian economy can bring further challenges to the banking sector although we can witness a “back-fire” effect due to the high cost of capital induced by the interest rates that the local banks are charging for new loans.

Conclusions

In conclusion, the banking sectors of the European emerging markets are heavily dependent on external capital markets and when world capital markets froze in 2008, were unable even to roll over existing funds. As their domestic economies began to decline, they also had increasing numbers of non-performing loans which could reach up to 25 per cent of assets. The new member states of the EU and countries south-east Europe benefited to some degree from the fact that their external borrowing was by local subsidiaries from parent banks in Western Europe which were somewhat accommodating but in the end they should correct their internal economic imbalances which weight heavily on their banking systems recovery prospects.

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THE RISK CONNECTION OF AN ORGANIZATION WITH INTERNAL AUDIT. SPECIFIC CORPORATE GOVERNANCE PRACTICES

*Mihaela Gruiescu, Corina Ioanăș and Dan Dragoș Morega**

Abstract

There is risk in everything we do. A risk-free situation is one where we know exactly what will happen and there is no variation doubt, which is otherwise impossible. But not all risks have only a negative connotation, some of them can even create opportunities. A good risk management means to keep an unwanted risk in certain permissible limits and exploit its „opportune” side.

Corporate governance represents an innovative method of supervision on firms’ activity. Executive boards now exert more and more influence, the investors become more and more pretentious, and the managers have become more aware of the key problems their business have to confront (every day). All these are tendencies that result from the higher importance laid on corporate governance in the business world.

Given the reasons, this theme awoke in us a great attention, considering the present tendencies of organizing the management of companies. They consist in finding those ways that would prevent investors and the taxation from being manipulated.

Keywords: risk appetite, risk management, SOX model, corporate governance, the Cadbury Report

JEL classification: G34, M42, M14

Introduction

Capital markets and general public have always depended on the reliability of the information communicated by the companies. As a final effect these notifications influenced considerably the investment behavior of private and institutional investor. Many collapses of some companies and balance sheet scandals in the last years, as for instance Enron or WorldCom, weakened this necessary trust of investors in the capital market and all legal existing regulations on Corporate Governance.

The adoption of Sarbanes-Oxley Act during the US-Congress in 2002 was interpreted as a reaction of the American legislature about this lost of trust. SOA developed at the same time not only a national, but also a large international radiance effect.

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There is considerable debate about what actually constitutes corporate governance but its key elements concern the enhancement of corporate performance via the supervision, or monitoring, of management performance and ensuring the accountability of management to shareholders and other stakeholders. These aspects of governance and accountability are closely interrelated and introduce both efficiency and stewardship dimensions to corporate governance. Good corporate governance is as much concerned with correctly motivating managerial behavior towards improving the business, as directly controlling the behavior of managers.

The risk for internal audit

The internal audit is an independent and objective activity that insures assurance and advice, and is designed to bring more value and to improve organization's activity. The internal audit helps an organization to achieve its goals, by taking systematically and methodically the evaluation and the improvement of the effectiveness of the processes for risk management, control and governance.

In order to accomplish these assignments, the internal auditors need to understand the risk and to realize the importance of its management in an organization. The internal audit does no longer focus on control, but on risk. Also, the auditors have become more interested in the present and future, unfortunately for the past and present. The undue attention paid to the control of transactions has "buried" the internal auditor in details of the past, and has limited this way the amount of information gathered. Therefore, by analysing especially the risks associated with current and future business, the auditor has exceeded the level of details, and can, now, deal with the obstacles that stand in the way of the success of an organization. The information obtained from such expeditions is more valuable and useful to the management in its mission to build a good governance.

Lately there have been developed and popularized many models and frameworks for risk management. There have been made extensive research in an attempt to produce a universally valid framework. This is widely known as COSO 2 and has managed to be recognized and accepted in all sectors, including the public one, and has the support and recommendation of internal audit institutions worldwide.

The UK Government defines the risk as the uncertainty of a result in a wide range of exposures that come from a combination of impact and the likelihood of some potential events.

The risks that should worry us are the future ones. If an certain event took place and it's risks didn't materialize, either we were lucky, or the risk has been managed effectively. New trend towards future risks is the greatest challenge of the risk management, but it can also bring real benefits to the organization. It is better to predict, to anticipate and to try to reduce the likelihood that a risk can be produced and to reduce the impact that it will have on the organization, rather than to react to an already materialized risk or learn how to live with its consequences.

The risk management of an organization is a dynamic process, which aims at finding all the reasonable measures to find and treat all the risks that have an impact on a company's objectives. The company's reaction to risks is very important, as the decisions made depending on the options available, established in accordance with the available resources. So, the resources and the organizational processes are aligned to face the risks every time they are identified.

The risk management is recognized as a part of the good management practices. For maximum effectiveness, the risk management must be integrated in the corporate culture, in the practice and in its action plans, rather than being seen as a single episode. And when they succeed in its implementation, the risk management becomes the job of every person in the company.

The risk strategy of an organization is a strategy coordinated by the Board or by a body with similar powers, thru which it is established the level of the risk appetite of the organization, the risk-taking preferences and the resolve options.

The risk appetite. This is an assessment of the level of exposure to risk, that the organization is prepared to accept or to tolerate. The general attitude of risks acceptance, the risk appetite, should be established starting with the highest levels of the organization. The organization will not want a "lost" executive to be exposed to unacceptable risks, as neither will want an executive to be a declared risk opponent and to wish to eliminate them, because this way he will only waste the resources , producing a ruthless bureaucracy, which will gradually smother the activity.

The risk for internal audit. The internal audit activity should be undertaken so that we can express a relevant opinion towards the way that, the management, was able to achieve the balance between the residual risk (the residual risk – is the risk that remains after they have implemented diminution actions; a risk could never be exterminated, therefore there will always be a residual risk, that can also be called, the net risk) and the risk appetite. If we find discrepancies from this goal, it is recommended to take measures in order to rebalance the situation.

We must remember that an effective risk management can not be achieved overnight, it takes time and effort to introduce, implement, integrate and benefit from it. The internal audit should promote this concept and should help reduce the time between the initial moment and the benefits realization, because it represents a catalyst of the change for the better.

Therefore, we can say that the risk management remedy is to achieve a satisfactory position in which the current risk is equal to the risk we are prepared to tolerate (the risk appetite).

Among the risk management advantages we can mention: planning the work on a closer to reality basis, a greater safety that the objectives and goals of the activity are achieved, a better control of losses, a better control of operational costs, less expensive surprises; a greater flexibility by using a wide range of options.

In organizations, frequently, the risks cross several hierarchical levels of management and if nobody takes responsibility for these risks, chances are that the organization will be exposed, or the risks mitigation efforts will be duplicated

unnecessarily or could even be incompatible. Without a clear assignment of the responsibility on a risk, the risk management is likely not to be effective. It is important to mention that the risks responsibility must be transparent and clear, and accepted by the appointed person. Most of the organizations appoint a "champion" (a fighter) against the risks, to take the lead in managing the risks that emerge in the company.

A framework of corporate governance

Different stakeholders have different objectives. Of particular importance is the conflict between directors and shareholders. But, who are the shareholders of the company? The governance of a company will depend in part on the answer to this question. The most important distinction to be made here is between private companies, which cannot offer their shares to the public, and the public companies, which include all companies quoted on the Stock Exchange.

A private company is likely to be owner-managed, in which case it will be run by a small group of shareholders or directors. Minority shareholders in private companies are usually in a weak position if they are not on the board, since the small group controlling more than 50% of the voting shares will be able to control the make-up of the board directors.

Under London Stock Exchange rules, at least 25% of the shares of quoted companies must be held by members of the public. Although a small group might still control the majority of voting shares, the minority shareholders of quoted company has the advantage that there is a secondary market for the shares. If the shareholder does not like the way the company is run, it is possible simple to sell the shares, an alternative which is often not available to the private company minority shareholder.

Although ordinary shareholders are the owners of the company to whom the board of directors are accountable, the actual powers of shareholders tend to be restricted, except in companies where the shareholders are also the directors. They have no right to inspect the books of account, and their forecast of future prospects are gleaned from the annual report and accounts, stockbrokers, journals and daily newspaper.

The day-to-day running of a company is the responsibility of the directors and other management staff to whom they delegate, not the shareholders. For these reasons, there is the potential for conflicts of interest between management and shareholders.

The relationship between management and shareholders is sometimes referred to as an agency relationship, in which managers' act as agents for shareholders, using delegated powers to run the affairs of the company in the shareholders' best interests.

Agency theory propose that, although individual members of the business team act in their own self-interest, the well-being of each individual depends on the well-being

of the other team members and the performance of the team in competition with other teams.

Agency theory was advanced by two American economists, Jensen and Meckling, in 1976 as a theory to explain relationship within corporations. It has been used to explain management control practices as well as relationship between management and investors. They proposed that corporations be viewed as a set of contracts between management, shareholders and creditors, with management as agent and providers of finance as principals. Financial reports and external audit are two mechanisms by which the agents demonstrate compliance with their obligations to the principals.

The agency relationship arising from the separation of ownership from management is sometimes characterized as the agency problem. The agency problem arises when agents do not act in the best interest of their principals. For example, if managers hold none or very little of the equity shares of the company they work for, what is to stop them from working inefficiently, not bothering too look for profitable new investment opportunities, or giving themselves high salaries?

One reason why managers might do their best to improve the financial performance of their company is that managers' pay is often related to the size or profitability of the company. Managers in very big companies, or in very profitable companies, will normally expect to earn higher salaries than managers in smaller or less successful companies.

Agency theory sees employees of businesses, including managers, as individuals, each with his own objectives. Within a department of a business, there are departmental objectives. If achieving these various leads also to the achievement of the objectives the organization as a whole, there is said to be goal congruence.

Goal congruence is accordance between the objectives of agents acting within an organization and the objectives of the organization as a whole. Goal congruence may be better achieved and the agency problem better dealt with by giving managers some profit-related pay, or by providing incentives which are related to profits or share price. Examples of such remuneration incentives are:

- profit-related pay, that means pay or bonus related to the size of profits.
- rewarding managers with shares. This might be done when a private company goes public and managers are invited to subscribe for share in the company at an attractive offer price. In this way, managers become owner-managers.
- executive share options plans. In a share option scheme, selected employees are given a number of share options, each of which gives the holder the right after a certain date to subscribe for share in the company at a fixed price. The value of an option will increase if the company is successful and its share price goes up.

Such measures might merely encourage management to adopt creative accounting methods which will distort the reported performance of the company in the service of the managers' own ends.

There is also evidence that in many company the primary driver of decision-making has been to increase share price and hence managerial rewards in the short-

term. The longer-term consequences of failure to invest in research and development were ignored in the drive to cut costs.

The Cadbury report

When Adrian Cadbury began his pioneering work in the governance, he set the term "Corporate Governance" in order to represent the fact that his recommendations referred to and were applied exclusively to the organizations with commercial activity. The term "Corporate Governance" has also been used, lately, in the public sector organizations, as much as in the commercial ones, so the word Corporate is therefore seen as a comprehensive term which means "the entire organization", ie it refers to all the internal parts working together, which are finally integrated into a single structure recognized by the management.

The system of *corporate governance*, which is the director's responsibility, should seek to ensure *goal congruence* between the objectives of the organization and those of its teams or departments and individual team members.

The Cadbury Committee was set up because of the lack of confidence which was perceived in financial reporting and in the ability of auditors to provide the assurances required by the users of financial statements. The main difficulties were considered to be in the relationship between auditors and boards of directors. The *Cadbury Report* defines corporate governance as "the system by which companies are directed and controlled".

The roles of those concerned with the financial statements are described in the Cadbury Report. The directors are responsible for the corporate governance of the company. The shareholders are linked to the directors via the financial reporting system. The auditors provide the shareholders with an external objective check on the directors' financial statements. Other concern users, particularly employees are indirectly addressed by the financial statements.

The Cadbury Report has clarified many of the contentious issues of corporate governance and sets standards of best practice in relation to financial reporting and accountability.

The *Code of Best practice* included in the Cadbury Report was aimed at the directors of all UK public companies, but the directors of all companies are encouraged to use the Code. Directors should state in the annual report and accounts whether they comply with the Code and give reasons for any non-compliance.

The *board of directors* must meet on a regular basis, retain full control over the company and monitor the executive management. A clearly accepted division of responsibilities is necessary at the head of the company, so no one person has complete power.

The following points are made about *non-executive directors*, who are those directors not running the day to day operations of the company:

- they should bring independent judgment to bear important issues, including key appointments and standards of conduct;

- they should be no business, financial or other connection between the non-executive directors and the company, apart from fees and shareholdings;
- fees should reflect the time they spend on the business of the company, so extra duties could earn extra pay;
- they should not take part in share option schemes and their service should not be pensionable, to maintain their independent status;
- appointments should be for a specified term and reappointment should not be automatic; the board as a whole should decide on their nomination and selection;
- procedures should exist whereby non-executive directors may take independent advice, at the company's expense if necessary.

In relation to the *executive directors*, who run companies on a day to day basis, the main points in the Code relate to service contracts (contracts of employment) and pay. The length of such contracts should be three years at most, unless the shareholders approve a longer contract.

A major recommendation in the Code is that all listed companies must establish effective *audit committees*, consisting entirely of non-executive directors, if they have not already done so. The committee must have the authority, resources and means of access to investigate anything within its terms of reference.

Differing approaches to corporate governance

The establishment of a voluntary code of practice on corporate governance in the Cadbury Report characterizes a different approach to that adopted in many other countries.

In the *USA*, the system of corporate governance is rather more oriented to legal rules and stock exchange regulation, through the Securities and Exchange Commission, which imposes stringent quarterly reporting requirements on listed US companies and requires all such companies to maintain independent audit committees.

Strengthened statutory rules are being introduced in America as a result of the 2002 Sarbanes-Oxley Act, passed in the wake of corporate scandals, most notably Enron. Under the Act companies will not be able to obtain a listing unless they have an audit committee, and are prohibited from offering a variety of non-audit services to audit clients. The Act also requires investigations to be undertaken in a number of areas including compulsory rotation of auditors and the areas of reporting that are most susceptible to fraud.

The Sarbanes-Oxley Act of 2002 ("the Act") is the most sweeping securities legislation enacted in the United States in the past 70 years. The Act applies not only to publicly owned U.S. companies but also to all companies (whether organized in the U.S. or elsewhere) that have registered equity or debt securities with the Securities and Exchange Commission ("SEC") under the Securities Exchange Act of 1934. The Act defines "issuer" as any company whose securities are registered, whether the issuer is domiciled in the United States or elsewhere.

The Act provides that any foreign public accounting firm that prepares or furnishes an audit report with respect to any issuer shall be subject to the Act and the rules of the Public Accounting Oversight Board and the SEC issued under the Act, in the same manner and to the same extent as a public accounting firm that is organized and operates under the laws of the United States. However, the Act also explicitly provides that registration of a foreign public accounting firm shall not by itself provide a basis for subjecting such firm to the jurisdiction of U.S. courts, other than with respect to controversies between such firms and the Public Accounting Oversight Board.

The Audit Committees must be directly responsible for the appointment, compensation, and oversight of the work of auditors, and requires auditors to report directly to the Audit Committee. Audit Committee members must be members of the board of directors of the company, and must be independent. To be considered independent the Audit Committee member may not accept any consulting, advisory or other compensatory fee from the issuer or be affiliated to the issuer or the issuer's subsidiaries other than in the member's capacity as a member of the board of directors or any board committee. If an issuer does not have or create an independent Audit Committee, then the entire board of directors is defined to be the Audit Committee and each director would have to meet the "fully independent" requirement and the other criteria for audit committee members, discussed herein.

The Act requires Audit Committees

- to have in place procedures to receive and address complaints regarding accounting, internal control, or auditing issues;
- to establish procedures for "confidential anonymous submission" by employees of concerns regarding accounting or auditing matters;
- to have authority to engage independent counsel and other advisers as they determine necessary in order to carry out its duties; and
- to have appropriate funding, as determined by the Audit Committee, in its capacity as a committee of the board of directors, for payment of compensation to the auditor and any advisers employed by the Audit Committee.

The Act requires the SEC to adopt rules requiring issuers to disclose whether their Audit Committees include among their members at least one "financial expert" - a person who understands GAAP and financial statements, has experience preparing or auditing financial statements and applying accounting principles in connection with the accounting of generally comparable issuers, has experience with internal accounting controls, and understands Audit Committee functions.

An auditor for a public company must timely report to that company's Audit Committee the critical accounting policies and practices to be used and all alternative treatments of financial information within GAAP that have been discussed with management and the treatment preferred by the auditor, any accounting disagreements between the auditor and management and other material written communications between the auditor and management. The SEC must establish minimum standards of professional conduct for attorneys appearing and practicing

before the SEC in any way in the representation of issuers.

These rules must:

- require an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent, to the chief legal counsel or the CEO of the company (or the equivalent thereof); and,
- if the counsel or officer does not appropriately respond to the evidence (adopting as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the Audit Committee of the issuer, to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.

The Act imposes a number of new disclosure requirements requiring more extensive financial disclosures by issuers. Each financial report that contains financial statements and that is required to be prepared in accordance with (or reconciled to) GAAP and filed with the SEC, must reflect all material correcting adjustments that have been identified by the auditor in accordance with GAAP and applicable securities rules. Additionally, the SEC must develop rules requiring that annual and quarterly financial reports required to be filed with the SEC must disclose all material off-balance sheet transactions, arrangements, obligations, (including contingent obligations), and other relationships of the issuer with unconsolidated entities or persons that have a material current or future effect on the issuer's financial condition, results or operations, liquidity, capital expenditures or resources, or significant components of revenues or expenses.

The SEC is also required to issue rules providing that pro forma financial information included in any periodic report filed with the SEC, in any public disclosure, press release or other release must be presented in a way that does not contain an untrue statement of a material fact or omit to state a material fact necessary in order to make the pro forma financial information, in light of the circumstances under which it is presented, misleading; and that reconciles it with the financial condition and results of operations of the issuer under GAAP.

The Act amends the list of filings in Section 16(a) of the 1934 Securities Act that must be made by officers, directors and owners of more than 10% of any class of equity security. Changes in equity ownership and ownership in security based swap agreements by directors, officers and 10% stockholders must be reported within two business days after the day of the transaction. Within one year of enactment the Act, such "Section 16 filings" will have to be filed electronically and posted on the company's website.

The Act requires the SEC to issue rules requiring annual reports filed by issuers to include an internal control report. Such report must state the responsibility of management for establishing and maintaining an adequate internal control structure and procedures for financial reporting, and must contain an assessment as of the end of the most recent fiscal year of the effectiveness of the internal control structure procedures of the issuer for financial reporting. The issuer's auditing firm is required

to attest to and report on such assessment in accordance with rules to be promulgated by the Public Accounting Oversight Board.

The Act requires the SEC to review the disclosures including financial statements by public companies with securities listed on an exchange or traded on NASDAQ on a regular and systematic basis, which is defined as at least once every three years. In scheduling reviews, the SEC will consider whether the issuer has issued various material restatements of its financial results or experienced significant volatility in the stock price as compared to other issuers; issuers with the largest market capitalization; emerging companies with disparities in price-to-earning ratios; and issuers whose operations significantly affect any material sector of the economy.

The Act directs the SEC directly or through a national securities association or national securities exchange, to adopt rules governing securities analysts' conflicts of interest that can arise when securities analysts recommend equity securities.

The stated objectives of the rules are to foster greater public confidence in securities research and to protect the objectivity and independence of securities analysts by:

- restricting the prepublication clearance or approval of research reports by persons employed by the broker or dealer who are engaged in investment banking activities, or persons not directly responsible for investment research, other than legal or compliance staff;
- limiting the supervision and compensatory evaluation of securities analysts to officials employed by the broker or dealer who are not engaged in investment banking activities; and
- requiring that a broker or dealer and persons employed by a broker or dealer who are involved with investment banking activities may not, directly or indirectly, retaliate against or threaten to retaliate against any securities analyst employed by that broker or dealer or its affiliates as a result of an adverse, negative, or otherwise unfavorable research report.

The rules must also (1) define periods during which brokers or dealers who have participated, or are to participate, in a public offering of securities as underwriters or dealers should not publish or otherwise distribute research reports relating to such securities or to the issuer of such securities; (2) establish structural and institutional safeguards within registered brokers or dealers to assure that securities analysts are separated by appropriate informational partitions within the firm from the review, pressure, or oversight of those whose involvement in investment banking activities might potentially bias their judgment or supervision; and (3) address such other issues as the SEC determines appropriate.

The Act directs the SEC directly or through a national securities association or national securities exchange, to adopt rules reasonably designed to require each securities analyst to disclose in public appearances and in research reports conflicts of interest that are known or should have been known by the securities analyst or the broker or dealer, to exist at the time of the appearance or the date of distribution of the report, including:

- the extent to which the securities analyst has debt or equity investments in the issuer that is the subject of the appearance or research report;
- whether any compensation has been received by the registered broker or dealer, or any affiliate thereof, including the securities analyst, from the issuer that is the subject of the appearance or research report;
- whether an issuer, the securities of which are recommended in the appearance or research report, currently is, or during the 1-year period preceding the date of the appearance or date of distribution of the report has been, a client of the registered broker or dealer, and if so, stating the types of services provided to the issuer;
- whether the securities analyst received compensation with respect to a research report, based upon (among any other factors) the investment banking revenues (either generally or specifically earned from the issuer being analyzed) of the registered broker or dealer; and
- such other disclosures of conflicts of interest that are material to investors, research analysts, or the broker or dealer as the SEC determines appropriate.

In continental Europe, reporting requirements tend to be more statutorily based in tax law, although all EU members are subject to EU company law directives. In *Germany*, The common two-tier board system, with a separate management board and supervisory board, may be claimed to encourage management to take shareholders' interests more closely into account than the typical one-tier UK system.

Japanese companies are characterized by what is sometimes called a flexible approach to corporate governance, with a low level of regulation. All stakeholders are supposed to collaborate in the company's best interests, unlike the UK and US traditions of directors working primarily in the interests of shareholders.

Conclusions

Corporate governance is one of the key issues of the 1990s due to a number of well-publicized corporate problems in the late 1980s. This paper presents the most recent evidence on key topics within corporate governance including: internal control and the management audit, the remuneration of the corporate board, audit committees, the performance of firms in relation to institutional ownership.

Given the accelerated nature of change, innovation and progress in the U.S. and global markets, and in light of notable exceptions to a system that has generally worked well, we believe it is appropriate to restate the guiding principles of corporate governance. These principles, we believe, should help to guide the continual advancement of corporate governance practices, and so advance the ability of U.S. public corporations to compete, create jobs and generate economic growth.

First, the paramount duty of the board of directors of a public corporation is to select a Chief Executive Officer and to oversee the CEO and other senior management in the competent and ethical operation of the corporation on a day-to-day basis.

Second, it is the responsibility of management to operate the corporation in an effective and ethical manner in order to produce value for stockholders. Senior management is expected to know how the corporation earns its income and what risks the corporation is undertaking in the course of carrying out its business. Management should never put personal interests ahead of or in conflict with the interests of the corporation.

Third, it is the responsibility of management, under the oversight of the board and its audit committee, to produce financial statements that fairly present the financial condition and results of operations of the corporation, and to make the timely disclosures investors need to permit them to assess the financial and business soundness and risks of the corporation.

Fourth, it is the responsibility of the board and its audit committee to engage an independent accounting firm to audit the financial statements prepared by management and to issue an opinion on those statements based on Generally Accepted Accounting Principles. The board, its audit committee and management must be vigilant to ensure that no actions are taken by the corporation or its employees that compromise the independence of the outside auditor.

Fifth, it is the responsibility of the independent accounting firm to ensure that it is in fact independent, is without conflicts of interest, employs highly competent staff, and carries out its work in accordance with Generally Accepted Auditing Standards. It is also the responsibility of the independent accounting firm to inform the board, through the audit committee, of any concerns the auditor may have about the appropriateness or quality of significant accounting treatments, business transactions that affect the fair presentation of the corporation's financial condition and results of operations, and weaknesses in internal control systems. The auditor should do so in a forthright manner and on a timely basis, whether or not management has also communicated to the board or the audit committee on these matters.

Sixth, the corporation has a responsibility to deal with its employees in a fair and equitable manner.

These responsibilities, and others, are critical to the functioning of the modern public corporation and the integrity of the public markets. No law or regulation alone can be a substitute for the voluntary adherence to these principles by corporate directors and management and by the accounting firms retained to serve American corporations.

We continue to believe that the most effective way to enhance corporate governance is through conscientious and forward-looking action by a business community that focuses on generating long-term stockholder value with the highest degree of integrity.

The principles discussed here are intended to assist corporate management and boards of directors in their individual efforts to implement best practices of corporate governance, and also to serve as guideposts for the public dialogue on evolving governance standards.

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CORRELATION BETWEEN THE PUBLIC SECTOR'S PERFORMANCE AND THE SOVEREIGN DEBT, IN THE CONTEXT OF THE CURRENT ECONOMIC CRISIS

*Alin Opreana and Diana Marieta Mihaiu**

Abstract

The current economical situation determined by the effects of the crisis is causing the governments of the countries worldwide to streamline their processes in terms of collecting revenue from the state budget and then redistributing them on the principle of performance and economical efficiency. In this respect, we have studied the public sector performance through a scoring function, and especially the correlation that exists between the EU Member States public sector performance and budgetary outcome, the budgetary surplus or deficit.

Keywords: *public expenditure, efficiency, input, output, outcomes.*

JEL classification: H0, D61, G14

1. Introduction

In general sense, the efficiency can be achieved under the conditions of maximizing the results of an action in relation to the resources used, and it is calculated by comparing the effects obtained in their efforts. Measuring the effectiveness requires: a) estimating the costs, the resources consumed the effort in generally, found in the literature as the input; b) estimating the results, or the outputs; c) comparing the two. The efficiency is given by the relationship between the effects, or outputs such as found in the literature, and efforts or inputs. The relationship is apparently simple, but practice often proves the contrary, because identifying and measuring inputs and outputs in the public sector is generally a difficult operation.

In many cases the direct and immediate economical benefit is missing in the public sector. For example, if a school is built in a village the efforts involved in this investment can be easily identified: all costs incurred for the construction, the material basis, the salaries, etc. But under what form are the benefits in this case found? Can we identify direct economic benefits? The answer is "no"; in which case we meet only social benefits, such as: increasing literacy, ensuring better labor market, higher living conditions, difficult to quantify in cash. So, in conclusion, we can say that the economical efficiency of this investment is zero, starting from the definition of the efficiency (effects / effort), precisely because the effects are difficult

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to assess in money. When building a highway by the public sector the investment may be considered ineffective if we refer to the increased time of recovering the initial investment from the future cash flows generated by the collection of highway taxes, but the objective of the investment is not only one of economical nature (tax collection), but it considers reducing the number of road accidents and reduce traveling time. So in this case the calculated efficiency is much lower than the real one.

An important public benefit is the concern for human life and for quality of life. Providing insurance services for national defense, maintaining the public order, spatial planning, disaster prevention and control are one attribute of the state, without which no nation could exist. These types of public services needed, cannot be provided by the private sector because they don't have the economical power necessary for sustaining them, their majority brings no profit, so there is no interest for providing such services from the private sector, and not in the least it would be a too great risk for the people that these services belonged to the private sector (Scutaru, 2009). When we speak of efficiency, most analysts refer to the economic efficiency, taken from the private sector and subjected to analysis in the public sector, in order to illustrate the so-called inefficiency of the latter. The efficiency in the public sector must thus be seen as an amount between the economical efficiency and the social-environmental one.

As it is mentioned in a study by David Hall and Emanuele Lobina from The Greenwich University in 2005 it can not be said that there is a significant difference in efficiency between public and private organizations. Following a study conducted both in the developed countries but also in the ones that are developing and in transition, it can not be expressed a relevant conclusions in terms of efficiency in the two sectors, the ineffectiveness of an organization is not entirely influenced by their ownership (Hall D., Lobina E., 2005). Analyzing the processes of privatization in the UK, Massimo Florio concluded that they had no visible effect over an organization's performance and the net gain is zero, given the transfer of value from workers to owners (Florio, 2004). The efficiency in the public sector could be compared with that obtained in the private sector only when the objectives are identical; and even in this case it's not fully comparable because the public sector develops complex projects, which take into account not only the economical benefits but also social problems (Stoian M., Ene N.C., 2003).

2. Efficiency, effectiveness and performance of the public sector

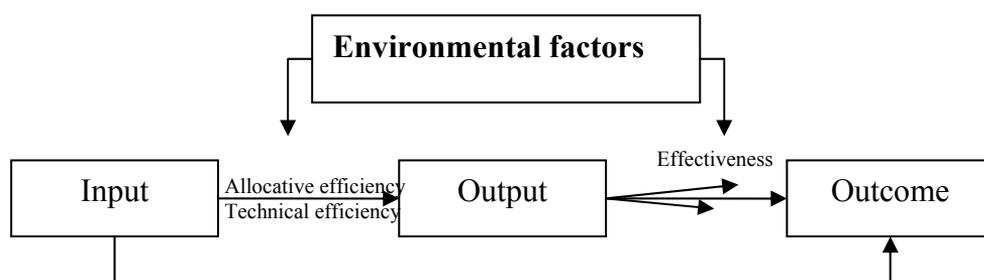
As seen in the previous subsection, the efficiency is an indicator that is obtained by reporting the outcome effects to the efforts made. *The efficiency of public expenses implies a relation between the economical and social effects resulted from implementing a program and the effort made to finance that program. The effectiveness is the indicator given by the ratio between the result obtained and the one programmed to achieve.*

Peter Drucker believes that there is no efficiency without effectiveness, because

it is more important to do well what you have proposed (the effectiveness) than do well something else that was not necessarily concerned (Drucker, 2001, p.147). The relationship between effectiveness and efficiency is in part to a whole, the effectiveness is a necessary condition to achieving efficiency.

Ulrike Mandl, Adriaan Dierx and Fabienne Ilzkovitz in the paper "The effectiveness and efficiency of public spending" indicate that the efficiency and effectiveness analysis is based on the relationship between the inputs (entries), the outputs (results) and the outcomes (effects).

Figure 1: The relationship between the efficiency and the effectiveness



Source: Mandl U., Dierx A., Ilzkovitz F., (2008): "The effectiveness and efficiency of public spending", pg.3.

As it can be seen in Figure 1, the efficiency is given by the ratio between inputs and outputs. The authors mentioned above distinguish between the *technical efficiency* and the *allocative efficiency*. The technical efficiency implies a relation between inputs and outputs on the frontier production curve, but not any form of technical efficiency makes sense in economical terms, and this deficiency is captured through the allocative efficiency that requires a cost / benefit ratio. The effectiveness, in terms of this study, implies a relationship between outputs and outcomes. In this sense the distinction between the output and the outcome must be made. For example, for education, an output is represented by the degree of literacy, and the outcome can be the level of education of the active population from that country. So the effects resulted from the implementation of a program (outcomes) are influenced by the results (outputs), as well as by other external factors. Therefore, effectiveness, illustrating the success with which resources were used in order to achieve the objectives pursued, is harder to achieve than efficiency, since the latter is not influenced by outside factors (Mandl U., Dierx A., Ilzkovitz F., 2008).

The direct factors of influence of the efficiency are:

- *the inputs*. In the public sector the resources are much harder to quantify than in the private sector, because most of the times the public services overlap, and there are used resources from several sources. But in general the inputs are given by the expenses incurred for the project / service in matter.

- *the outputs*. These are more difficult to quantify in the public sector than the inputs, because they can have both an economical and a social dimension. In the private sector the outputs have a market value; they are easily evaluated, while in the public sector this process is cumbersome, and much more forecast. To evaluate the outputs from the non-market sector, which is the public sector, we must first define some indicators that will be evaluated, and through which there will be determined a level of efficiency. The mechanism is complicated and kind of vague in some areas.

The effectiveness has as influence factors the outputs, the outcomes and the environmental factors. The latter, the environmental factors (such as lifestyle and various socio-economic influences) exercise a major influence over the effectiveness. The effects covered by a project (the outcomes) are often achieved in a longer horizon, and more outputs are needed in order to achieve an outcome. For example, the economical growth, which is an outcome of the economic policy of a country, in order for it to be achieved several years and several results are required, such as low inflation, more investments.

In the opinion of Profiroiu M., *the performance* in the public sector implies a relationship between objectives, means and results, so performance *is the result of the simultaneous pursuit of efficiency, effectiveness and a corresponding budget* (Profiroiu M., 2001, p.8)

In the paper “Cadrul de analiză a performanțelor sectorului public” (“The analysis of public sector performances”), Profiroiu A. and Profiroiu M. have illustrated possible performance evaluation methods of a public organizations. Establishing a public organization's performance is difficult, caused by the difficulties that exist in the definition of performance: the first difficulty appears from the meaning of the concept of performance; the second appears from the way the performances are obtained, and the third from evaluating the performance. *Measuring the public sector performances*, in the conception of the authors, implies taking into consideration the distinction between: the means used (inputs), the process (throughput), the product (output) and the effect achieved (outcome). *Performance assessment* can be achieved through some measurement categories (Profiroiu, M., Profiroiu, A.):

1. *Measuring the resources economy*, which can be determined by comparing the purchase price of the inputs with the designated value.

2. *Measuring the costs*, which involves measuring in monetary expression the resource consumption in order to provide a particular product or service.

3. *Measuring the efficiency*, which takes into account the obtained result in relation to the resources used, and a project is effective if the maximum results are achieved with a given level of resources, or if it uses the minimum resources for a certain level of the result.

4. *Measuring the effectiveness*, its quantifying is given by the ratio between the actual result and its expected level. The process of measuring the effectiveness faces difficulties concerning the assessment and the quantification of the results, which often have no physical form, and cannot be directly measurable. The results of the

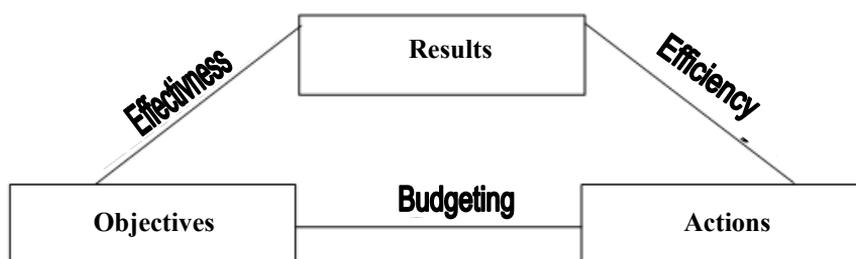
public projects can have both economical and social nature.

5. *Measuring the quality of services*, is designed to follow the degree to which the public product / service satisfies the requirements of the citizens. In this sense, the quality includes the effectiveness of a project. The deficiency of this method consists in the fact that the quality is a vague concept and far too complex that is not sufficiently reflected by indicators. The concept of quality encompasses not only the quality of the product / service offered, but also the quality of the production process and the quality of the system.

6. *Measuring the financial performance*

7. *Measuring the overall performance*

Figure 2: The triangle of the performance

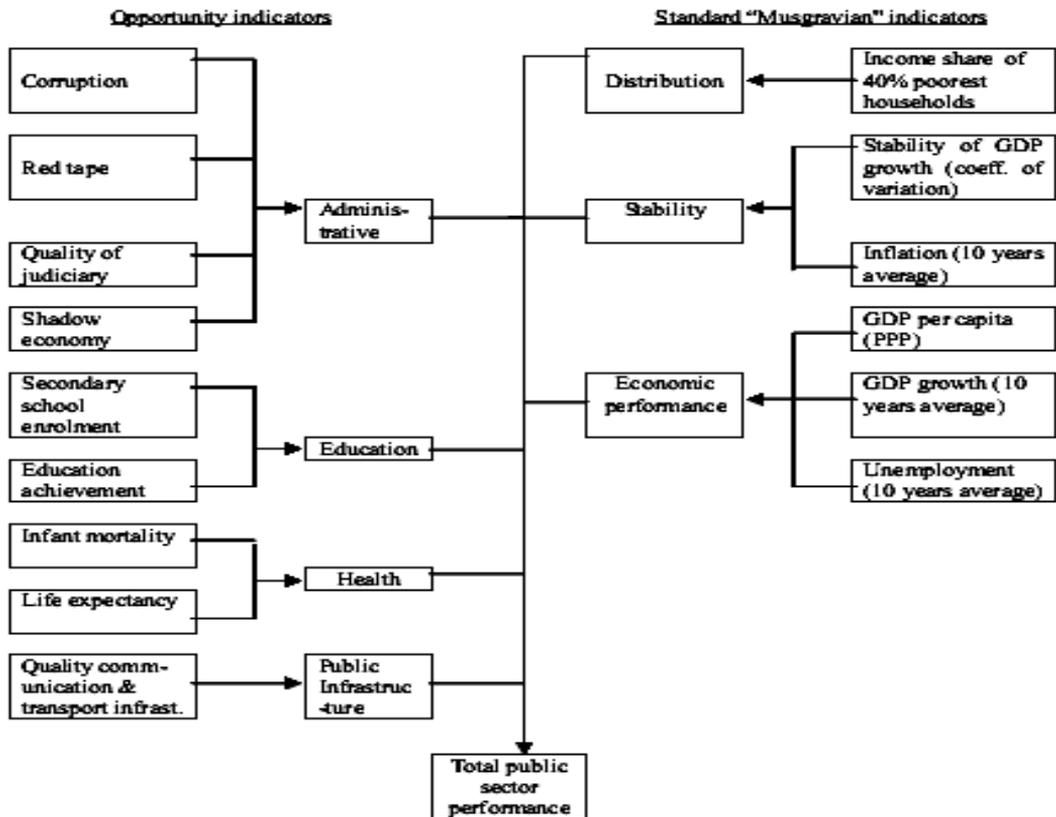


Source: Florișteanu E., “Eficiența și eficacitatea în sectorul public” pg.1

Afonso A., Schuknecht L., Tanzi V., in his paper "Public sector efficiency: an international comparison", proposes for measuring the overall public sector performance an indicator (PSP), obtained on the basis of a set of seven sub-indicators, each of them developed themselves on indices, as can be seen in Figure 5.

It is noted that he proposed four sub-opportunity indicators: the performance indicator in education, health, public infrastructure, administrative performance of the government, and took three sub-indicators from Musgrave, that reflect the goals which should be pursued by any government: stability, distribution, economical performance. Applying the non-parametrical method: Free Disposable Hull (FDH) on a total of 23 industrialized countries over a 10 years period, from 1990 to 2000, for the seven sub-indicators, the authors of the study mentioned above have achieved the overall public sector performance indicator (PSP), presented in Table 1 shown below:

Figure 3: Public sector performance indicator



Source: Afonso A., Schuknecht L., Tanzi V., (2003): "Public sector efficiency: an international comparison", European Central Bank, Working Paper no.242/July 2003, pg.10.

Table 1: The public sector performance indicator

Country	Opportunity indicators				Standard "Musgravian" indicators			Total public sector performance (equal weights 1/)
	Adminis- tration	Education	Health	Infra- structure	Distribu- tion	Stability	Economic perform.	
Australia	1.17	1.02	0.94	1.00	0.87	1.31	1.00	1.04
Austria	1.21	1.00	0.98	1.10	1.22	1.28	1.01	1.12
Belgium	0.73	1.00	0.94	0.91	1.17	1.10	0.83	0.95
Canada	1.11	1.05	0.95	1.16	0.92	1.00	0.92	1.02
Denmark	1.16	1.00	1.03	1.03	1.19	1.10	0.91	1.06
Finland	1.26	1.07	1.04		1.18	0.75	0.73	1.01
France	0.72	1.03	1.03	1.01	0.90	1.12	0.70	0.93
Germany	1.02	0.98	1.01	1.01	0.98	0.91	0.81	0.96
Greece	0.60	0.94	0.93	0.81	0.97	0.55	0.69	0.78
Iceland	1.02	0.98	1.25			0.59	1.29	1.03
Ireland	1.06	0.94	0.88	1.00	0.89	1.22	1.40	1.05
Italy	0.52	0.96	0.93	0.84	1.10	0.76	0.69	0.83
Japan	0.87	1.09	1.12	1.09	1.20	1.40	1.18	1.14
Luxembourg	1.05	0.81	0.95			1.22	2.04	1.21
Netherlands	1.16	1.04	0.97	1.09	1.00	1.42	1.06	1.11
New Zealand	1.18	1.03	0.89		0.62	0.99	0.84	0.93
Norway	0.97	1.04	1.09	0.94	1.17	1.45	1.26	1.13
Portugal	0.54	0.94	0.90	0.75	0.92	0.64	0.92	0.80
Spain	0.77	1.00	1.10	0.86	1.02	0.82	0.67	0.89
Sweden	1.16	1.07	1.19	1.10	1.17	0.69	0.91	1.04
Switzerland	1.32	0.97	1.14	1.23	0.95	0.79	1.09	1.07
United Kingdom	1.00	1.05	0.91	0.99	0.79	0.78	0.84	0.91
United States	1.15	1.00	0.82	1.08	0.76	1.14	1.20	1.02
Average	0.99	1.00	1.00	1.00	1.00	1.00	1.00	1.00
Small govs 2/	1.11	1.01	0.98	1.08	0.94	1.17	1.17	1.07
Medium govs	0.93	0.98	1.00	0.93	0.92	0.89	1.03	0.97
Big govs	0.99	1.02	1.01	1.01	1.12	1.03	0.85	1.01
EU 15 3/	0.88	1.00	0.99	0.98	0.98	0.93	0.80	0.94
Euro area 3/	0.84	0.99	1.00	0.97	1.00	0.96	0.78	0.93

Source: Afonso A., Schuknecht L., Tanzi V., (2003): "Public sector efficiency: an international comparison", European Central Bank, Working Paper no.242/July 2003, pg.12.

It may be noted that there are not recorded notable performance differences among the states analyzed. However, the countries with a low level of public expenses below 40% of GDP have superior performance to those with a wider public sector, over 50% of GDP (Afonso A., Schuknecht L., Tanzi V., 2003).

The authors mentioned above have subsequently used for public sector performance measurement the method "Data Envelopment Analysis" (DEA) as an alternative to the non-parametric method FDH, but the results were similar (Afonso A., Schuknecht L., Tanzi V., 2006).

3. Analysis of the correlation between public sector performance and the budgetary deficit / surplus at the European Union level

In order to accomplish an analysis of how the budgetary result is influenced by the performance of the public sector in the EU member states (except Malta), two indicators were chosen, namely: PSP score (performance of public sector), and the average budget result registered by member states during 2000-2009. PSP score is the result of a polynomial function applied to the EU states, built in a previous paper by the authors of this article.

Score function of the public sector in EU is:

$$\text{PSP}_{\text{UE}} \text{ SCORE} = 1,0848 \times X_1 + 1,9045 \times X_2 + 3,3264 \times X_3 + 1,414 \times X_4 + 0,857 \times X_5 + 0,6253 \times X_6 + 2,9896 \times X_7$$

and will measure the performance of the public sector based on proposed indicators by Afonso A., Schuknecht L., Tanzi V.

So, X_1 = administrative; X_2 = education; X_3 = health; X_4 = public infrastructure; X_5 = income distribution; X_6 = economic stability; X_7 = economic performance.

The following table shows the PSP values for EU member states, and also the deficit/surplus average level, based on results from 2000 to 2009 inclusive.

Table 2: PSP score and budgetary surplus/deficit in EU

UE COUNTRIES	PSP SCORE	PUBLIC surplus/ deficit 2000-2009
LUXEMBOURG	9.873	2.080
SWEDEN	9.483	1.460
FINLAND	9.184	3.440
NETHERLANDS	9.022	-0.930
SLOVENIA	8.935	-2.500
AUSTRIA	8.856	-1.560
FRANCE	8.784	-3.250
DENMARK	8.750	2.230
IRELAND	8.634	-0.970
GERMANY	8.486	-2.100
CYPRUS	8.442	-2.490
BELGIUM	8.240	-0.990
CZECH REPUBLIC	8.070	-4.120
GREAT BRITAIN	7.924	-3.010
ESTONIA	7.898	0.560
PORTUGAL	7.437	-4.110
SPAIN	7.309	-1.300
GREECE	7.108	-6.130
SLOVAKIA	7.045	-4.950
LITHUANIA	7.011	-2.560

HUNGARY	6.981	-5.950
ITALY	6.910	-3.090
LATVIA	6.556	-2.410
POLAND	6.384	-4.530
ROMANIA	5.572	-3.250
BULGARIA	5.538	0.370
AVERAGE	7.863	-1.925
PEARSON COEFFICIENT	0.523	
SPEARMAN COEFFICIENT	0.564	

Source: personal computation

It should be noted that the average public sector performance in the EU, according to the authors proposed score function, is 7.863 and the highest values were obtained by Luxembourg, Sweden, Finland and Netherlands, while the lowest were recorded by Poland, Romania And Bulgaria.

Analysis of correlation between the two indicators was performed using Pearson and Spearman correlation coefficients and the results are presented in the following section. The Pearson coefficient is used to measure the degree of correlation between two variables. The lack of correlation is indicated by values close to 0, the “positive” correlation is indicated by a coefficient value close to 1, while the “negative” correlation is indicated by a coefficient value close to -1; as in the case of the Spearman coefficient.

Table 3: Pearson Correlation
Correlations

		Score	Result
Score	Pearson Correlation	1	.523**
	Sig. (2-tailed)		.006
	N	26	26
Result	Pearson Correlation	.523**	1
	Sig. (2-tailed)	.006	
	N	26	26

** . Correlation is significant at the 0.01 level (2-tailed).

Table 4: Spearman Correlation

Correlations

		Score	Result
Score	Correlation Coefficient	1.000	.564**
	Sig. (2-tailed)	.	.003
	N	26	26
	<hr/>		
Result	Correlation Coefficient	.564**	1.000
	Sig. (2-tailed)	.003	.
	N	26	26

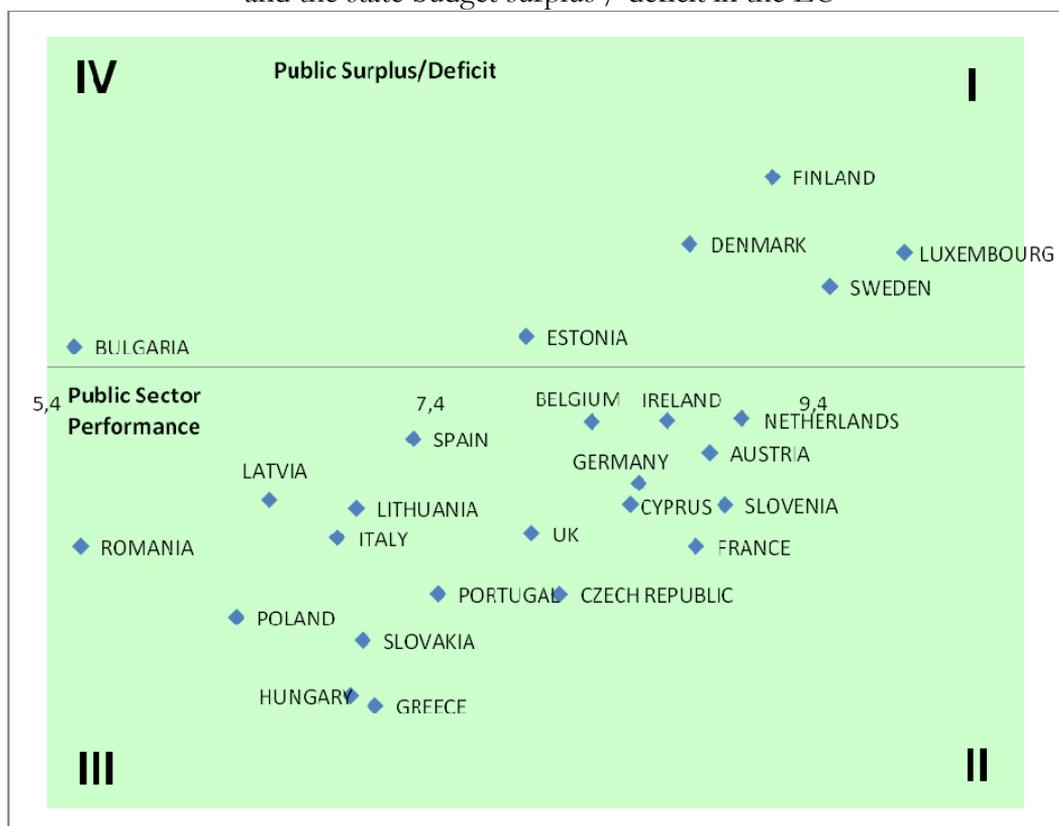
** . Correlation is significant at the 0.01 level (2-tailed).

After the calculations, two values were obtained, the Pearson coefficient with a value of 0.523 and the Spearman coefficient (calculated upon ranks) of 0.564, which suggests a close and direct correlation between the two indicators, namely a high performance public sector leads to budget surplus (or low budget deficit, see Luxembourg, Sweden, Finland, Denmark), and a low performance of public sector (a small PSP score) leads to budget deficits (see the case of Romania, Poland, Hungary and Greece). The significance level of the correlation, calculated by chi square test, is 99%, a very high level, for which it can be stated the fact that the performance of the public sector has a notable implication upon budget deficit.

Afterwards, we plotted the relationship between the score measuring public sector performance and the budgetary surplus / deficit in the EU, and through this analysis we obtained the following situation at the EU level, presented in the chart below.

Positioning countries on the graph shows the risk in terms of budget balance and public sector performance. The countries positioned closer to the upper right corner point of the graph have a higher performance and their risk of entering into a sovereign debt crisis is lower.

Chart 1: Relationship between the score measuring public sector performance and the state budget surplus / deficit in the EU



From the chart above, four quadrants can be distinguished with the following meaning:

QUADRANT	CHARACTERISTICS	COUNTRIES
I	High performance of the public sector Reduced risk of budgetary imbalances	Finland, Luxembourg, Denmark, Sweden, Estonia
II	High performance of the public sector Medium risk of budgetary imbalances	Belgium, Ireland, Netherlands, Austria, Germany, Slovenia, France, Czech Republic, Cyprus, Great Britain
III and IV	Performance of the public sector below the EU average High risk of budgetary imbalances	Spain, Portugal, Slovakia, Lithuania, Italy, Greece, Latvia, Poland, Hungary, Romania, Bulgaria

As it can be observed from the chart, there is a strong connection between the public sector performance (measured with the PSP score) and the sovereign debt situation of the Member States.

Thus, states in quadrant I are countries which, due to appropriate programs that have met requirements for the efficient use of budgetary instruments and a high performance public sector, have the ability to keep control of sovereign debt.

Countries in quadrant II are countries with a high performance of the public sector, but due to the implementation of the government's massive recovery programs to overcome the financial crisis, sovereign debt has increased.

Quadrants III and IV consist of the countries with medium or low performance of the public sector and which are affected at the moment by the problem of the sovereign debt, due to inefficient public management policies; this problem has been discovered in this unfavorable economic circumstances that characterizes the world's economy in general and Europe's in particular. These are the countries that have lost the control over public spendings and have the highest risk of entering a sovereign debt crisis.

4. Conclusions

To resolve the existing unfavorable situation, caused by the existence of high sovereign debt, the solution should help balancing the state budget by reducing government costs, and the medium-term solution is to reduce the state personnel while reducing taxation (reducing the tax burden), so that the economy could be released by private sector.

Finally, we can state that efficiency in the public sector is a problem which most governments have to face, and which is determined, mainly, by the existence of some major deficits, a bureaucracy that makes it hard to collect money to the budget and their redistribution as soon as possible, but also as a result of implementing some public programs which are based on some performance objectives. Thus, the optimal dimensioning of the public sector's management and staff is the starting point for obtaining real performances that have an impact over the private sector (which also contributes to the state budget with taxes and may lead to increasing the state's revenue). First, this optimum sizing should be done by considering the performance criteria given by various models and methods to measure the performance in the public sector. In this way, major important performances could be obtained and this will have a positive impact on medium and long term over the private sector and hence over the entire economy.

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