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# ROMANIAN ECONOMIC AND BUSINESS REVIEW

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# THE RACE FOR PREFERENTIAL TRADE AGREEMENTS – CAUSES, PATTERNS AND EFFECTS

**Agnes GHIBUŢIU**[1]

## Abstract

*Over the last decade, members of the World Trade Organization (WTO) have increasingly turned towards negotiating preferential trade agreements (PTAs) as a means for achieving improved market access for exports of goods and services, and investment. In particular, the year 2013 witnessed a remarkable revival of the regional trade agenda, with numerous new PTA negotiations being launched, including by WTO members accounting for substantial shares of world GDP and global trade and investmen – the so-called "mega-PTAs". While PTAs are not new to the WTO system, striking is however the fresh impetus to regionalism worldwide, which manifests itself not only in the steep numerical rise, but also the unprecedented pace and scale of new PTA initiatives.*

*Against this backdrop, this paper addresses several key issues related to the new active phase of regionalism from the perspective of the multilateral trading system governed by the WTO. It first looks at the systemic factors underlying the unabated drive towards PTAs among WTO membership, and distils the rationale behind the current surge in regionalism. Second, it examines the patterns of new PTAs and evidences the qualitative differences vis-à-vis previous PTAs in terms of scope, composition and depth. Finally, it discusses the economic and geopolitical factors driving the new PTAs, and highlights some of the potential effects upon the world trading system and global trade patterns.*

**Key words**: preferential trade agreements (PTAs), trade policy, trade negotiations, world trading system, World Trade Organization (WTO), Doha Round

**JEL** classification: F10, F13, F15, F23, O19

## 1. Introduction

Over the past decade, members of the World Trade Organization (WTO) have increasingly turned towards negotiating bilateral and regional trade

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arrangements – named hereafter preferential trade agreements (PTAs)[2] – as a means to further market-opening and rule-making outside the multilateral trading system. In particular, the year 2013 witnessed an outstanding revival of the regional trade agenda, with a whole range of new regional and bilateral PTA negotiations being launched, including by WTO members accounting for substantial shares of world GDP and global trade and investment. These include several large regional and bilateral PTAs – the so-called "mega-PTAs" – initiated by the major trading powers, namely the US, EU and Japan.

PTAs are not new to the world trading system governed by the WTO since 1995, or its predecessor, the General Agreement on Tariffs and Trade (GATT) signed in 1947 by 23 nations. The proliferation of these agreements started already in the 90s and has intensified since then constantly, especially after the establishment of the WTO. PTAs have in common that, unlike *unilateral* preferential trade agreements, they are *reciprocal trade agreements* between two or more partners. The multilateral trading system has always allowed for preferential trade arrangements to be created, and both the GATT and now the WTO have specific rules providing scope for this. Such deals are permitted under the GATT/WTO system as a derogation from the most favoured nation clause, which lies at the foundation of the multilateral trading system. However, WTO members (as, previously, GATT contracting parties) are bound to notify the agreements in which they participate.

Not even mega-regional agreements are entirely new, as their forerunners date back to the mid-1990s. Relevant examples are the *European Single Market*, which has been largely completed at the beginning of 1993, and the *North American Free Trade Agreement (NAFTA)* between Canada, Mexico and the US, which came into force one year prior to the establishment of the WTO in 2015. And worth mentioning is also the *Free Trade Area of the Americas (FTAA),* the project launched in 1994, but failed in 2005, which sought to tie 34 economies in the Western Hemisphere into a single economic bloc. All these initiatives had in common the pursuit of a much deeper regional integration among the partner countries than the global integration provided for among WTO members (Koopman and Wittig, 2014, p. 1). They also offered models to further extend and refine the original WTO rules as well as those embedded in the PTAs concluded later on.

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[2] Throughout this paper we use the term *preferential trade agreement* (PTA) to refer to customs unions, free trade agreements, and other interim arrangements leading to one of these forms of integration, according to the provisions of GATT Article XXIV and GATS Article V. Its connotation is similar to the term *regional trade agreement* used by the WTO, both terms being equally usual in the literature.

Hence, the PTAs concluded over the last decade, including the recent new mega-regional initiatives – such as the *Trans-Pacific Partnership (TPP)* currently under negotiation among 12 developed and emerging countries in Asia-Pacific, or the bilateral EU-US *Transatlantic Trade and Investment Partnership (TTIP*) – have to be seen, first and foremost, as the continuation of a trend in regional cooperation that dates back to the mid-1990s, with the US and EU as its main supporters.

But whereas PTAs are not new to the GATT/WTO system, these preferential trade deals show every sign of continuing to increase both in number and complexity. Apart from growing at an unprecedented rate over the last decade, striking is the spread of new PTA initiatives involving multiple parties and/or major trading countries that have a significant combined economic weight. In addition, PTAs concluded or negotiated in the twenty-first century are qualitatively different from previous PTAs in their scope, composition, depth as well as consequences for the international trading system.

Starting from these few introductory remarks, this paper addresses the recent revival of trade regionalism through the lens of the multilateral trading system governed by the WTO, with a view to shed light on its drivers and patterns as well as some of its consequences for global trade and its governance mechanisms. In doing so, it draws on insights from current literature and relies on statistical data provided by the WTO and other relevant international organizations. The paper is organized as follows: Section 2 provides an overview of the numerical surge in PTAs concluded by WTO members over the last decade, and highlights the outstanding speedup of the regional trade agenda since 2013. Section 3 looks at the key structural transformations that have marked the WTO over recent decades, and distils the systemic factors underlying the fresh impetus to regionalism worldwide. Section 4 discusses the patterns of twenty-first century PTAs vis-à-vis previous PTAs in terms of scope, composition and depth as well as economic relevance. The analysis in Section 5 focuses on the economic and geopolitical reasons behind the current race for bilateral and regional approaches, while the final section outlines some of its consequences, and concludes.

## 2. The exponential increase in preferential trade agreements: facts and figures

The recent surge in trade regionalism worldwide manifests itself not only in the steep rise in the number of new bilateral and regional initiatives, but also their scale and pace. Particularly visible is this trend since 2013, with the pace and scale of negotiations on PTAs witnessing an unprecedented speeding up.

Major PTA developments in 2013 have included the start of negotiations on several large regional and bilateral PTAs – the so-called "mega-PTAs" – by major trading powers, such as the US, EU and Japan. Particularly remarkable is the pace of these initiatives, namely:

- ✓ the start of negotiations, in March 2013, on an *EU-Japan free trade agreement*;
- ✓ the joining by Japan, in March 2013, of the negotiations on the *Trans-Pacific Partnership Agreement (TPP*), involving 12 developed and emerging countries in Asia-Pacific; and
- ✓ the launch of negotiations, in July 2013, on a *Transatlantic Trade and Investment Partnership (TTIP)* between the US and EU.

And this image of prominent WTO members being strongly involved in the regional agenda has to be completed with two other undertakings in 2013, which, though not related to PTAs as such, are of particular relevance, given the large share in global trade and investment flows of the partners involved, i.e.:

- ✓ the launch of plurilateral negotiations, in March 2013, on a new *Trade in Services Agreement (TISA*) among 23 WTO members (including the EU); and
- ✓ the start of negotiations, in November 2013, on an *EU-China investment agreement*, followed by similar negotiations between the EU and Myanmar/Burma since March 2014.

Moreover, to these most recent initiatives a whole series of PTAs should be added such as the EU-Canada, EU-Singapore, China-Switzerland, and Australia-Korea agreements, which are waiting for final approval or ratification (UN/DESA, 2014, p. 58). And apart from the PTAs that have been signed and will soon enter into force, a number of agreements are currently being negotiated, most of them between partners in different geographical regions. Hence, the unabated push towards regionalism is unlikely to be stemmed. Moreover, this is likely to be further reinforced through the recent new initiatives, including those related to large regional and bilateral PTAs – the mega-PTAs – that are being negotiated.

PTA activity has been particularly robust among the WTO membership over the past decade, with the number of such agreements in force increasing exponentially. According to WTO figures, on average 14 PTAs have entered into force annually since 2003 (WTO, 2014a, p. 53). Unlike *unilateral* preferential trade agreements, PTAs are *reciprocal* trade agreements between two or more partners, and WTO members are bound to notify the agreements in which they participate.

As of April 2015, some 612 notifications of PTAs (counting goods, services and accessions separately) had been received by the GATT/WTO, of which 406 were in force. These WTO figures correspond to 449 physical PTAs (counting goods, services and accessions together), of which 262 are currently in force (90% representing free trade agreements and 10% customs unions (WTO, 2015a). Yet the WTO Secretariat furthermore estimates that there are almost 100 agreements in force but that have not been notified to the WTO (WTO, 2014a, p. 53).

It is important to note, that PTAs have grown much more rapidly since the WTO came into being compared to the days of its predecessor, the GATT. Whereas GATT received just an average number of 3 notifications annually, the WTO has received from its members on average 24 notifications per year (WTO, 2014b). While in the period 1948-1994 the GATT received 124 notifications of PTAs (relating to trade in goods), of which 50 were active in 1995, since the creation of the WTO over 400 additional preferential arrangements covering trade in goods or services have been notified (WTO, 2015b). Several factors account for the stronger upward trend in regionalism in the context of the WTO as compared to the GATT-ruled system. These pertain basically to the important changes in the multilateral trading system following the creation of the WTO in 1995, which we refer to as the ***systemic drivers*** of trade regionalism, and which we are going to tackle in the next section.

## 3. WTO and the systemic drivers of the regional trade agenda

Trade regionalism appears to be a phenomenon deeply embedded in the multilateral trading system itself. As frequently stressed by the WTO Director-General Roberto Azevêdo, the multilateral trading system of today has its roots in the reciprocal trade agreements that countries had been pursuing for many years prior to agreeing the GATT. In fact, those PTAs pre-dated the multilateral trading system inasmuch as it may be argued that the GATT itself was effectively a multilateralisation of the network of previous reciprocal trade agreements. So these initiatives are important – they *co-exist* with the multilateral system – and they can bolster it in a significant way. But while they are important for the multilateral trading system, they cannot substitute but only complement it (WTO, 2014b). Hence, a question of utmost importance in this context is how to make PTA provisions complementary to the multilateral trading system, and how to ensure that PTAs are ”building blocks” and not ”stumbling blocks” for this system.

Starting from the above assumption and having in mind the continuous rise in the number of PTAs since the mid-1990s, and especially in the last decade, we may argue that the recent revival of regionalism worldwide should be seen as a shift in focus rather than a fundamental course change in the evolution of the regional trade agenda. It also follows, that the factors underlying this shift have to be sought, to a large extent, in the structural transformations that have marked the multilateral trading system and the WTO itself in the wider context of the changing global political and economic environment. Therefore, a brief insight into the main developments that have shaped the organization over the recent decades seems appropriate for shedding light on the systemic factors that are driving regionalism, including in our days.

According to the Marrakesh Agreement on the establishment of the WTO, as a result of the Uruguay Round (1986-1994), the organization fulfills five basic functions, namely, it provides for: (1) a set of rules designed to govern the conduct of international trade; (2) a forum for negotiating trade liberalization; (3) a trade dispute settlement mechanism; (4) transparency of trade relations; and (5) coherence in global economic policy-making. By virtue of these functions and the whole body of multilateral trade agreements that is administered by the WTO, the organization lies at the very heart of the global trading system and plays a central role in global trade governance. And precisely the WTO's centricity is at stake when it comes to discuss the outstanding surge in preferential trade deals concluded outside its remit.

The years following the creation of the WTO have been characterized by robust global trade growth, with world trade in goods and services substantially outpacing world GDP growth – a trend that has lasted until the outbreak of the global economic and financial crisis. Along with strong expansion, global trade flows have been also accompanied by sweeping structural changes in the patterns of international trade and organization of global production. Rapid advances in technology, and especially new information and communication technologies, but also market opening worldwide ranked among the main factors driving these changes. As a result, new actors and new forms of trade have emerged, and important changes have occurred in the hierarchy of traders, in the geographical orientation and structure of trade, and its very nature. Together, these changes have triggered an unprecedented increase in interdependencies among economies worldwide. In this context, two important and interrelated developments stand out for their major consequences for global trade and its governance mechanisms.

Firstly, numerous developing countries, especially in Asia, have emerged as major players in global trade, such as the BRICS (Brazil, Russia, India, China and South Africa). These countries account today for more than half of the world's economic activity and over half of global exports, with China emerging as the number one world exporter. A similar picture of shifting composition arises with respect to foreign direct investment (FDI), with the share of emerging and developing countries in global FDI inflows rising to over half over the last decade.

The rise of emerging economies and the subsequent shift in economic power and influence within the world economy have profound implications not only for international trade, but also international trade cooperation and global leadership. Essentially, this means that the long-standing equilibrium in global trade cooperation inherent in the GATT/WTO system based on the traditional two-speed model of a world divided between developed and developing countries no longer reflects today's economic realities. Hence, serious conceptual adjustments are needed and a new balance between reciprocity and flexibility must be found if the WTO is to deliver on multilateral trade opening and designing global trade rules (Lamy, 2013). Yet, the two major group of countries cannot agree upon what would exactly constitute a proper balance of rights and obligations within the WTO. This is essentially a political issue that needs a political solution. Consequently, adjusting politically and organizationally to the new economic realities will take time, and until a new equilibrium in global trade cooperation will emerge multilateralism is likely to be under heavy pressure.

Secondly, the last decade has also seen the rapid expansion of global production networks (GPNs) or global value chains (GVCs). These are in effect "global factories", as firms increasingly locate various stages of the production process in the most cost-efficient markets. As a result, a vast and growing amount of world trade is now conducted through global supply chains, whereby parts and components cross many borders since production is shared in many different locations. About 80% of global trade in goods and services is, in one way or another, linked to supply chains, according to estimates (UNCTAD, 2013a, p. 135). Essentially, this new form of trade – known also as "supply-chain trade" or "twenty-first century trade" – combines traditional trade in goods with services, FDI and knowledge (Baldwin, 2012, p. 1). This is not only more complex than traditional trade, but is also the fastest growing segment of global trade, and calls for a deeper integration among participants. But the WTO is not equipped to deal with issues related to supply-chain trade since its current rules and disciplines have been designed to facilitate only traditional trade, i.e. selling goods and services internationally (Baldwin, 2012, p. 1). In the absence of global regulation, the rules related to supply-chain trade have been devised outside the WTO, predominantly through PTAs. It follows, that the WTO is faced with the challenge to take better account of the growing importance of global production networks by devising proper trade and investment rules to support the evolution of these networks, which currently involve not only developed but also developing economies.

The challenges arising from these major shifts in geopolitics and economics for the WTO have to be seen, in our opinion, the major *systemic factors* that are underlying the unabated drive of WTO members towards PTAs, including the current surge in trade regionalism. And to these factors a third one should be added, which relates to the dramatic transformations experienced by the WTO itself, whether in respect of the issues on its agenda or in geopolitical terms. Over the last two decades, WTO membership expanded by 33 new members to 161 at present, accounting together for 98% of world trade. The continual expansion of WTO membership and the integration into the multilateral trading system of a number of large emerging economies (e.g. China, Russia etc.) have radically changed the structure of the organization, hindering consensus-based decision making, reducing the effectiveness of its activity and affecting the conduct of multilateral negotiations under its aegis. Besides, trade policies and trade agreements have increased in complexity, since the very nature of trade barriers has evolved. Nowadays, trade deals are no longer confined to negotiating just the reduction of tariffs, but also non-tariff barriers and behind-the-border regulations, which have gained enormous importance but are more difficult to tackle (Lamy, 2013). In short, the world economy and global trade relations have become more complex.

This is why the first round of multilateral trade negotiations hosted by the WTO and launched in 2001 – the Doha Round – has evolved under much more complex and difficult circumstances than similar rounds of negotiations under the auspices of the GATT in the past. So, it is not surprising that the round could not be completed till now, though the original intention was to conclude it by the end of 2004.

Moreover, the Doha Round negotiations practically stalled in July 2008 largely over a major divide between developed and developing countries on major issues such as industrial tariffs, agriculture subsidies, and non-tariff barriers. And with this impasse, two of the WTO's central functions have been also blocked, namely: (1) as a venue for multilateral trade negotiations, ensuring market-opening; and (2) its legislative function, responsible for developing new trade rules and disciplines. Consequently, the WTO trade rule-book could not be adjusted so as to keep pace with the dramatic changes in the global trade landscape over the recent decades. Basically, the bulk of these rules remained stuck in the mid-90s when they were negotiated and agreed as an outcome of the Uruguay Round (1986-1994) – which stands in fact for the last major market access agreement under the auspices of the GATT/WTO and also the last period of active global governance. Under these circumstances, the market-opening and rule-making agenda required by twenty-first century trade shifted increasingly towards PTAs concluded outside the multilateral system governed by the WTO.[3]

Undoubtedly, lack of progress in the multilateral trade negotiations and hence the inability to adjust WTO rules and disciplines to the structural and geopolitical changes in the global economy and trade have led many countries of the world to increasingly resort to PTAs as a means for achieving improved market access for exports of goods and services as well as investment. The deadlock in the Doha Round has also increasingly reinforced the perception that decision-making at the multilateral level is inefficient. Actually, for the private sector both in developed and developing countries trade liberalization and rule-making via PTAs has proven to be more effective than multilaterally, the latter being seen as a cumbersome and too lengthy undertaking, and also unpredictable and overly politicized. But it is also true that the major traders' growing interest in finding solutions for regulating and liberalizing markets outside the WTO has diverted substantial energies from the multilateral negotiations, by channeling them towards PTAs. And not least, opening trade and devising new multilateral rules has been further affected by the biggest economic crisis since the 1930s, which distracted attention from the global trade agenda and spurred the promotion of defensive trade policies and even protectionist actions worldwide. It was not until the Ninth WTO Ministerial Conference in Bali (Indonesia), in December 2013, that a window of opportunity arose for relaunching the Doha Round.[4]

[3] Yet, trade liberalization progressed at an unprecedented rate in the 2000s. For example, the average tariff applied on imports stood below 1% in developed countries and averaged 4-10% in developing countries in 2012. As of 2012, almost 40% of world trade was fully liberalized under MFN terms, with an additional 35% free because of preferential trade regimes (UNCTAD, 2013b, p. 5-7). But the trade policy reforms backing up this liberalization have been implemented by means of deep PTAs as well as unilateral (national) reforms and bilateral investment treaties, and not multilateral initiatives within the WTO (Baldwin, 2013, p. 26; 2014, p. 26).

[4] In Bali, WTO members have adopt the so-called Bali Package, consisting of a set of measures to liberalize and spur international trade, including the *Agreement on Trade Facilitation*, which represents the first comprehensive agreement achieved since the creation of the WTO in 1995. WTO members have also committed to conclude the Doha Round trade talks. For this purpose, the WTO was mandated to develop a clearly defined work program on the remaining Doha agenda issues by the end of 2014 (later extended to July 2015) (Ghibuţiu, 2015, p. 5).

## 4. Patterns and economic relevance of twenty-first century preferential trade deals

As in the case of agreements in force, most new negotiations are bilateral. Among the key bilateral negotiations in terms of the parties' share in world trade rank: the ***TTIP*** between the EU and US, EU-Japan, EU-India, EU-MERCOSUR, as well as Australia-China, Canada-South Korea, and Canada-India (WTO, 2014a, p. 54).

However, a more recent development relates to establishing plurilateral PTAs or consolidating existing bilateral agreements among a group of members. Several ongoing negotiations illustrate this trend, including (WTO, 2014a, p. 54):

- negotiations in the Asia-Pacific Region for a ***Trans-Pacific Partnership (TPP) Agreement***, launched in 2010, and currently involving 12 parties, involving the US and a number of American and Asian states;
- the ***Regional Comprehensive Economic Partnership Agreement (RCEP),*** negotiated since 2012 and aiming to harmonize existing bilateral agreements between the 10 economies of ASEAN and 6 other WTO members (Australia, China, India, Japan, South Korea, and New Zealand);
- the ***Pacific Alliance*** in Latin America, which brings together Chile, Colombia, Mexico and Peru; and
- the ***Tripartite Free Trade Area Agreement*** in Africa, striving to consolidate three existing plurilateral agreements related to the East African Community (EAC), the Common Market for Eastern and Southern Africa (COMESA) and the Southern African Development Community (SADC), and involving 26 parties.

Recent research by the WTO Secretariat based on PTAs notified since 2000 reveals that twenty-first century preferential trade deals are not only more numerous, but they are becoming increasingly complex. Of particular relevance are the following aspects (WTO, 2014b):

- While over 80% of PTAs notified are bilateral agreements, there are more and more large regional agreements.
- PTAs are increasingly concluded between countries in different regions, rather than between neighbours, which is very different from the patterns prevailing in the GATT system.
- In addition, many more developing countries are negotiating PTAs today than in the past.
- The last years have also seen a significant increase in the level of complexity of the rules enshrined in PTAs and in their relations with other

agreements. The continuous numerical proliferation of PTAs, with each having its own set of trade rules and disciplines has been dubbed the "spaghetti bowl" in WTO parlance. Most PTAs of today contain deeper and more extensive commitments, and have moved beyond commitments only in market access in goods. In terms of *commitments* undertaken by the parties through PTAs notified to the WTO since 2000, the following aspects are relevant (WTO, 2014b):

- Around 60% of PTAs contain commitments in both goods and services.
- Over half of PTAs contain rules on investment.[5]
- More than half of the PTAs incorporate other issues than market access, such as provisions on government procurement, competition, technical barriers to trade, sanitary and phytosanitary regulations, trade defence measures and intellectual property rights. These are known as "WTO-plus" provisions, as they go beyond existing multilateral WTO rules, in that they refer to areas already subject to commitments under multilateral agreements, but involve additional commitments.
- A smaller proportion of PTAs include additional issues such as environmental and labour standards and electronic commerce, which are not at all covered by existing WTO rules. These are known as "WTO-extra" provisions, as they relate to new areas, which fall outside the scope of current multilateral rules and disciplines.

It follows, that the patterns of twenty-first century PTAs are quite different from previous PTAs in their scope, composition and depth.

Firstly, their major focus is regulatory behind-the-border barriers to trade rather than only tariff measures at the border. In this regard the new PTAs go well beyond existing provisions in the WTO and even earlier PTAs, aiming to promote deep integration between members. They strive to achieve high-standard integration through WTO-plus and/or WTO-extra provisions on regulatory measures, such as technical regulations, standards, services, investment, intellectual property rights, state aid, government procurement,

[5] At the global policy level, trade and FDI are dealt with by different institutions and legal arrangements. While trade is covered by the WTO multilateral framework, FDI is dealt with by: (1) bilateral investment treaties – with a total number of 3,236 by the end of 2013 (UNCTAD, 2014, p. 114); and (2) bilateral/regional PTAs. In the absence of a multilateral framework, the rules governing global FDI are mainly implemented through PTAs. A growing number of PTAs contain trade and investment chapters, and the provisions on both are often included in the same legal article. This reflects the need to deal with trade and investment together in a context where trade increasingly takes place within individual companies, and where decisions about the location of economic activity involve both trade and investment as means of accessing markets (Ghibuţiu, 2015, p. 15).

competition policy, environment, and labour market regulations (UN/DESA, 2014, p. 58).

Secondly, in addition to full market opening, twenty-first century PTAs encompass behind-the-border regulatory measures that are consistent with the requirements of trade conducted through global production networks (GPNs), i.e. supply-chain trade or 21st century trade. In other words, they entail under various forms the set of new rules and disciplines that provide for the *trade-investment-services-intellectual property rights* nexus (Baldwin, 2013, p. 42). Hence, they are oriented towards a more comprehensive integration with a strong regulatory focus on providing a viable platform for GPNs by ensuring a duty-free and non-tariff-barrier free trading environment (UN/DESA, 2015, p. 55).

Thirdly, especially the new bilateral and regional initiatives currently being negotiated such as the ***TPP***, ***TTIP*** and ***RCEP*** differ qualitatively from previous PTAs in their size and depth, as they are generally drawing on a template developed by major players and are striving for deep liberalization and high-standard, cutting-edge regulatory harmonization that covers an increasing share of the global economy. These new mega-PTAs relate to widespread trade deals involving a group of countries that have a significant combined economic weight, whether in terms of their share in world GDP and trade (**Table 1**) or global FDI flows (**Table 2**).

**Table 1: The economic relevance of selected mega-PTAs under negotiation**

| PTAs under negotiation | Number of members | Percentage share in world exports | Intra-group trade as a percentage of global trade | | Combined GDP as a percentage of world GDP | Number of bilateral agreements among parties |
|---|---|---|---|---|---|---|
| | | | Exports | Imports | | |
| **TPP** | 12 | 26.0 | 46.3 | 38.3 | 38.9 | 25 |
| **TTIP** | 2 | 43.9 | 17.3 | 14.3 | 45.4 | 0 |
| **RCEP** | 16 | 27.3 | 42.0 | 47.4 | 29.5 | 23 |

Source: Based on UN/DESA (2015, p. 56).

Note: Trade and GDP figures are for 2012. EU is counted as one entity. TPP = Trans-Pacific Partnership; TTIP = Transatlantic Trade and Investment Partnership; RCEP = Regional Comprehensive Economic Partnership Agreement.

Finally, it is noteworthy, that a significant proportion of PTAs involve either the EU or the US as partners, which is evidence of the prominent role of the two big trading powers in promoting preferential trade deals. Actually, the `EU and US have developed a "hubs and spokes" system of bilateral agreements, within which they constitute the "hubs" in the constellation of PTAs, while the "spokes" are made up of different countries that are parties to their agreements

(Horn *et al.*, 2009, p. 3). Through this ”hubs and spokes” system of PTAs, the EU and US have sought to reduce regulatory divergences facing companies engaged in trade because of the complex and nontransparent rules inherent in these agreements (the so-called ”spaghetti bowl of PTAs”). Indeed, this system alleviated to some extent the condition of companies placed in a ”hub”, but the problems remained unresolved in the case of companies from ”spokes” countries, such as Mexico, Israel, Jordan, Chile, etc., that have signed deep PTAs with both the EU and US (Baldwin, 2013, p. 43).

**Table 2: FDI inflows to selected mega-PTAs under negotiation, average 2005-2007 and 2013 (Billions of US dollars and per cent)**

| PTAs under negotiation | Average 2005–2007 | | 2013 | | Change in share (percentage point) |
|---|---|---|---|---|---|
| | FDI Inflows ($ billion) | Share in world total (%) | FDI Inflows ($ billion) | Share in world total (%) | |
| **TPP** | 363 | 24 | 458 | 32 | 8 |
| **TTIP** | 838 | 56 | 434 | 30 | -26 |
| **RCEP** | 195 | 13 | 343 | 24 | 11 |

Source: Based on UNCTAD (2014, p. xvi).

Note: TPP = Trans-Pacific Partnership; TTIP = Transatlantic Trade and Investment Partnership; RCEP = Regional Comprehensive Economic Partnership Agreement.

Due to the continuous numerical proliferation of PTAs, the international trading system is currently managed not only by multilateral WTO rules and disciplines, but also a growing number of PTAs, most of which represent deeper trade deals that address rules beyond traditional tariffs or traditional preferential access. Consequently, the share of world trade covered by PTAs increased continuously. Nearly 60% of trade in developed countries has been covered by some PTAs in 2012, and each developed country had preferential access to an average of 23 countries in the same year – a steep increase from an average of 8 countries in 2002 (UNCTAD, 2013b, p. 18). And it goes without saying that these figures will further soar due the effects of the plethora of new PTAs, including the mega-bilaterals and regionals launched in 2013 by countries with considerable weight in the global economy. According to a recent report by the European Commission, the ambitious trade agenda pursued by the EU currently will lead to a radical expansion of the coverage of EU trade by PTAs: while less than a quarter of EU trade was covered by PTAs before 2006, the current figure is around one third, and is likely to rise to two-thirds of EU trade once all on-going negotiations are concluded (European Commission, 2015a, p. 6).

Hence, if concluded successfully the new PTAs and especially the new mega-PTAs are likely to have important implications not only for the multilateral trading system and global trade patterns, but also the international investment regime and global investment patterns. Therefore, it is not surprising that the current negotiations of mega-PTAs have become a hot topic in the public debate wordwide, attracting both criticism and support.

## 5. The economic and geopolitical factors behind the race for PTAs

Beyond the systemic factors that account for the ceaseless proliferation of trade regionalism, and which relate in large part to changes in the multilateral trading system itself, the conclusion of PTAs is mainly driven by economic and commercial motivations, which can be both offensive and defensive in nature.

The most obvious reason for pursuing trade agreements is to achieve improved market access for exports of goods and services and FDI. Among the traditional motives of the public and private sector for using PTAs to expand access to international markets are: the search for growth markets, diversification of markets and risk, economies of scale, the enhancement of competiveness, export-led growth, insertion into and/or increased participation in global supply chains, and the use of trade agreements to self-impose domestic economic reforms (Schwab and Bhatia, 2014, p. 18).

More importantly, conclusion of PTAs brings about another series of such arrangements, usually as a trade policy response from excluded countries (defensive reasons), triggering a ”domino effect”. According to many observers, trade regionalism generates a competitive dynamics: if two countries negotiate a preferential reduction of trade barriers, one or more non-participating countries will be hurt. As a result, the excluded countries will have an incentive to negotiate PTAs themselves, and this process would go on until achieving the goal of global free trade, at least theoretically (Subramanian and Kessler, 2013, p. 59 ). Actually, the guidelines currently underlying the US and EU’s trade policy options are basically rooted in the theories of regionalism as promoting competitive liberalization.

Under the impact of the global economic and financial crisis and the slow and uneven recovery in the world economy, the economic motivations driving PTAs have become more acute, particularly as the major advanced economies failed so far to wholly overcome the adverse effects of the crisis. From such an angle, the large trading powers’ recent offensive to conclude new PTAs is an attempt to definitely exit the crisis (Ghibuţiu and Oehler-Şincai, 2013, p. 4-5). By promoting assiduously business opportunities for their firms in international markets, the EU, US and Japan aim to stimulate growth domestically, especially as the slowdown in global production and trade in the aftermath of the crisis has been largely caused by subdued economic activity and weak import demand in these countries.

The new mega-regionals also aim to meet the need of developed countries to liberalize trade and investment flows through promoting the creation of high-level standards that would enable them to tap the potential of trade and investment constrained by existing rules and regulations imposed by the WTO and bilateral arrangements (Yong, 2014, p. 20). The new deals are essentially meant to place these countries at a competitive advantage, given that they are used as vehicles for breaking new ground on tackling regulatory barriers to trade and setting a global template for regulatory issues, especially as tariffs continue to come down around the world, and behind-the-border regulatory measures are in turn increasingly gaining importance as barriers to international trade.

But apart from purely economic motives (offensive or defensive in nature), the explanation for the hasty rise in PTAs in general and mega-PTAs in particular has to be sought in ***geopolitical factors***. The new mega-PTAs should be seen, above all, as policy responses by the large trading powers to the challenges raised by the shift of economic and commercial power towards developing and emerging countries. From such a perspective, the US, EU and Japan's receent initiatives demonstrate their firm option for PTAs as a swift way to ensure market opening by their trading partners, in the wider context of reconsidering the very fundamentals of their economic and trade policies. Actually, we are witnessing an attempt by these countries to counter the growing erosion of their position in world trade and reposition themselves in the global trade landscape, as with the decline in their share of world trade, the US and EU's role as the leading exporters of the world's standards and norms is also at risk.

Though the cumulative weight of the US and EU does not exceed one third of world GDP (at PPP) and a quarter of world trade (excluding intra-EU trade), the two great powers are traditionally viewed as the "regulators of the world" since they account together for around 80% of the norms governing the functioning of world markets (Horn *et al.*, 2009, p. 4). The fact that all WTO-extra provisions in the US and EU's new trade deals relate to domestic regulations (such as investment protection, competition policy, labour standards and environmental protection) provides evidence that the new PTAs are effective tools for the two "hubs" to export their own regulatory systems to their PTA partners and preserve thereby their primacy in determining the rules applicable to trade and investment in the 21st century.[6] And there is a widely

[6] According to a recent EC report, "the ***TTIP*** negotiations with the US have a particularly important strategic dimension as a comprehensive Agreement including strong regulatory disciplines could not only boost trade between the Parties but also establish an innovative

shared perception that this primarily serves the interests of the two "regulators of the world", i.e. the US and EU (Horn *et al.*, 2009, p. 43). This perception is further reinforced by the finding that the WTO-extra provisions in the US and EU's new PTAs, which aim at creating new rules in areas that are not covered by WTO rules, have been the subject of earlier, but failed, attempts by the EU and/or the US to incorporate them into WTO rules, against the wishes of developing countries.[7] To the extent that these provisions can be seen as breaking new ground compared to existing WTO agreements or PTAs, it should not come as a surprise that they give rise to concerns about unfairness and even potentially abusive behavior in international trade relations. When taking also into account that PTAs are often negotiated under substantive power asymmetries among participating countries, such concerns seem all the more justified.

And certainly, behind the US and EU's interest to keep a decisive role in the formulation of global trade and investment rules are also other geopolitical considerations, which relate particularly to US endeavours to mitigate China's growing influence in the global economy and prevent the emergence of a China-centred East Asia economic bloc (Yong, 2014, p. 7). In fact, the mega-regionalism promoted by the US is an attempt to exert pressure on China, that is increasingly asserting its economic hegemony. An agreement by the US and EU to common regulatory standards through the conclusion of the ***TTIP*** deal would pre-empt China from imposing its own standards in international markets and even force China to adhere to these common standards (Subramanian and Kessler, 2013, p. 56). Ultimately, at issue is – in our opinion – how the US and EU handle the shift in economic power and influence from the advanced countries towards the emerging countries in general, and the rise of China in particular.

## 6. Concluding remarks

The increasing prevalence of PTAs is the most significant challenge to the multilateral trading system governed by the WTO.

While PTAs are not a new phenomenon for the GATT/WTO system, striking is however the speed, scale and complexity of twenty-first century

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model for regulatory convergence and set a global template. An ambitious deal with the US could thereby consolidate and further project the EU's role as a global regulatory leader" (European Commission, 2015b, p. 10).

[7] Investment, competition policy, government procurement and trade facilitation were initially included in the Doha Round agenda under pressure from the EU and US. But due to vehement opposition from developing countries, these subjects were removed from the agenda in 2004 (except for trade facilitation, where a multilateral deal was agreed at the last WTO Ministerial Conference in December 2013).

PTAs. Unlike other similar undertakings in the past, the new bilateral and regional initiatives such as the ***TPP***, ***TTIP*** and ***RCEP*** have the potential to cover an overwhelming proportion of global trade and investment and go well beyond provisions in existing WTO rules and disciplines and even PTAs. Hence, if successfully concluded, they are likely to reshape not only the global trading system but also the international investment regime, and thus trigger substantial changes in the patterns of global trade and investment.

The outstanding revival of the regional trade agenda since 2013 and particularly the major trading powers' new trade initiatives have prompted worldwide discussions on the future of the world trading system. While proponents of PTAs view the new preferential trade deals as alternatives to multilateral liberalization and updating of trade rules, the opponents raise serious doubts over their reach and effectiveness, arguing that the surge in PTAs in general and mega-PTAs in particular will have a potential negative impact upon developing parties and non-parties, and upon the wider trading system and patterns of international trade.

Indeed, to the extent that the new PTAs will include issues not currently covered by the multilateral agreements administered by the WTO this represents an opportunity to negotiate new trade rules and disciplines on these issues, thus helping to improve the global trade rule-book and promote trade liberalization worldwide. Besides, the new mega-PTAs, once in force, have the potential to reduce the ”spaghetti bowl of PTAs”, especially if they supersede existing bilateral agreements and develop common rules (e.g. rules of origin) to be applied by all the parties to the agreement. However, with behind-the-border policy regimes becoming so important in the new PTAs, the multilateral trading system runs the risk of regulatory divergence and resulting fragmentation of markets. This may further reduce transparency and uniformity in the global trading system and increase transaction and administration costs, thus diminishing trading opportunities. Ultimately, there is a real risk of scattering instead of levelling the trade playing field, which is economically harmful for the whole trading community.

Furthermore, the new PTAs may discriminate against those WTO members who are not parties to the agreements and result in trade negotiations at two speeds. A significant number of countries, ranging from the most dynamic emerging economies (such as the BRICS) to the smallest and most vulnerable ones, are excluded from their coverage. And since these new trade deals will cover a substantial part of world trade and investment and establish new global rules and regulations, these might be inappropriate for the level of development or trade interest of excluded countries. Hence, fear of marginalization and negative consequences for their competitiveness could lead many outsiders to seek alternative solutions, including the launch of new PTAs, thereby weakening even more the multilateral trading system.

As the new mega PTAs currently under negotiation such as the ***TTP***, ***TTIP*** and ***RCEP*** would all create giant economic zones covering substantial proportions of both world trade in goods and services and investment, they could affect incentives for multilateralism, and further undermine world trade governance by eroding the primacy of the multilateral system and WTO's centricity as the forum for liberalizing trade and creating new trade rules. Moreover, as multilateral market-opening and rule-making practically stopped in the last decade, with the major actors pushing more aggressively than ever for PTAs, there is a risk for the world trading system to be again dominated by power politics, similarly to the 19th century, with the smaller and poorer countries being deprived of the ability to negotiate on an equal footing with the great powers.

The current race for regional and bilateral PTAs does not seem to meet the stringent need for closer and more efficient multilateral cooperation required by the increasingly interconnected and interdependent world economy. Instead, we are witnessing a paradox which the former WTO Director General Pascal Lamy described this way: "While the world is *multipolarising* at an unprecedented scale and speed, and production and trade value chains are *multilateralising*, trade governance seems to be *bilateralisin*g" (WTO, 2013). Undoubtedly, the plethora of bilateral and regional trade agreements would produce a multitude of regulatory standards with which businesses will hardly comply. Therefore, the question arises whether these bilateral rules will adequately respond to the needs of global value chains that now make up a majority of world trade. A further question of utmost importance is how to make PTA provisions complementary to the multilateral trading system, and how to ensure that the current push for regional and bilateral PTAs does not lead to an even greater fragmentation of the world trading system and the world economy? Yet, for the time being these remain open questions.

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# FACTORIAL ANALYSIS APPLICATION IN POLITICAL MARKET – CASE OF ALBANIA

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## Abstract

*The purpose of this paper is to identify the key elements that affect the behavior of the electorate's political marketing in Albania. By factorial analysis it is proven that voters are more influenced by political product, political advertising, public relations and direct marketing. A better focus by the political parties in these elements provides a growing group of loyal voters and ensures swing voters support. Political marketing has attracted the attention of political actors in recent years in Albania. The importance of political marketing makes political actors not only act, but also to think in terms of marketing. Marketing discipline encourages businesses to understand their customers in order to provide those products and services needed.*

**Key words:** Factorial analysis, Marketing, Political marketing
**JEL Classification:** M 31

## 1. Literature Review

In politics, parties are representative of the people, so they need to understand or at least find out what the electorate wants in terms of public policy and civic leadership. Using the tools and techniques of marketing in a political context, generally known as political marketing, has become increasingly common in developed democratic countries, e.g. the United States, Canada, Western Europe, in the last 30 years (Lees-Marshment 2001, Newman 1994). The election campaigns of Margaret Thatcher and Ronald Reagan, respectively during 1979 and 1980, are generally seen as the beginning of the application of marketing methods in the political sphere. Since that time, the candidates running for all levels of government have become more sensitive and more experienced in terms of marketing and tend to the needs of the voters (Hamburger and Wallsten 2006, Newman 1999). All studies show that this trend is expected to continue in the future, which means that marketing will play an increasingly important role in election outcomes (Newman 2001). So it

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is very important that marketers understand how to affect the electorate expertise and skills.

According to (Kotler, 2003), "Marketing Management is the art and science of choosing target markets, customer retention and growth through the creation, dissemination and communication of a superior value." On the other hand, political marketing is the marketing of ideas and opinions that relate to public or political issues or individual candidates. (Clemente, 1992 and Butler & Collins, 1994).

Political marketing is simply "marketing that aims to influence public intended to vote for a person, party or certain proposals" (American Marketing Association, 2007).

(Wring, 1997) Party or candidate uses pollsters opinion or analysis environment to produce and promote a competitive offer which will help in achieving organizational objectives and satisfy voter groups in exchange for their vote.

Mauser (1983) adds, "Political Marketing is a set of practical procedures to identify effective strategies used in the campaign based on the principles and modern marketing techniques."

Newman (1999) elaborates on this definition by describing political marketing as "the application of marketing principles and procedures in political campaigns by individuals and organizations. Procedures used include analysis, development, execution and management of strategic campaigns by candidates, political parties, governments, lobbyists and interest groups that seek to promote the public, assist in the progress of their ideologies, win elections, and pass laws responding to the needs and desires of people and certain groups in society. "

Butler and Collins (1994) argue that political marketing is "marketing ideas and opinions relating to public issues or political or particular candidates. In general, political marketing is intended to have an impact on people's votes during elections. However, political marketing uses many of the techniques used in the marketing of products, such as advertising, public relations and direct marketing, etc."

Lees-Marshment (2001) argue that political marketing is related to the fact that "political organizations use business concepts and marketing techniques to help them achieve their goals.

Marketing consists of actions taken to obtain the desired responses, including behavioral responses such as votes or support from their target audience. Marketers analyze what they expect parties and voters through mutual interaction (Kotler, 2003). For example, politicians want trust and commitment (Henneberg, 2004), long-term electoral success (Ingram & Lees-Marshment, 2002), brand loyalty and long-term support or loyal voters (O'Cass, 1996), and the maximum electoral support (Wring, 1997). Voters want information and political facts, reliable, intellectual and honest leaders, (Newman, 2001), better governance and policy (O'Cass, 1996).

Political marketing management has reached such a conceptual level that parties/governments to some extent are "oriented voters" that can be paralleled as an analogy with the orientation of clients in business marketing. Political marketing is to focus on exchange relations, a long-term perspective, while the voters oriented business marketing concept "relationship marketing" is aimed at creating long-term benefits for all parties involved (Henneberg, 1996). This is analogous to mutually satisfying relationships with key stakeholders - customers, suppliers, distributors - in order to obtain and maintain preferences and businesses in the long run.

A deeper comparison in political marketing business marketing tells us that a large set of business concepts and marketing tools are used in political marketing. According to Shama (1976), some well-known concepts of business marketing as sellers and buyers, consumer behavior, market segmentation, image, brand loyalty, product concept and product positioning are also political marketing concepts. Also some popular tools used in business marketing as market research, media, publicity, factorial analysis, discriminate analysis, etc.,are extensively used in political marketing. Table 1.1 presents the similarities between business marketing and political marketing.

*Table 1.1. Similarities between political and business marketing*

| **Business Marketing** | **Political Marketing** |
|---|---|
| Products | Candidate |
| Product Image | Candidate's image |
| Product positioning | Positioning of the candidate |
| Product Publicity | Publicity of the candidate |
| Personal Sale | Face to face meeting with the voters |
| Product Manager | Candidate Manager |
| Brand Loyalty | Party Loyalty |
| Clients | Voters |
| Segmentation of the market | Segmentation of the pool of available voters |
| Customer satisfaction | Voter satisfaction |
| Customers' opinion leaders | Political opinion leaders |
| Customers market | Voters market |
| Customer search | Voter search |
| Marketing campaigns | Political campaigns |

*Source Shama 1976*

Political marketing is related to communication with party members, the media and potential sources of funding and the electorate. Parallel objectives regarding the members, collecting votes do not have the same equivalence in most traditional marketing situations. The authors can identify some significant areas in which political marketing is different

1. In the case of any election whether parliamentary or local elections, all voters make their choice within one day.
2. Despite that it may be argumented that there are individual's long-term cost in elections, the fact is that there is no price associated directly or indirectly with the vote or election of a party.
3. Although the current action ballot may not have a price associated with it, a voter must live with the collective choice even when it was not his preference.
4. Political party or candidate is a product of immune complex and the voter cannot separate them from each other.
5. Although there may be ways to influence the direction of the parties at the local or national level which has similarities with traditional modifications made to products or brand extensions, the possibility of introducing a new brand in the form of a new party is relatively small.
6. In most marketing situations, brand leaders tend to hold this position. In politics, since governments can win successive elections, there seems to be an increased tendency to remain behind in opinion polls between elections.

These key differences between electoral elections and election related to customer purchases pose clear challenges to marketing, both from the theoretical sense as well as practical challenges that need to be analyzed in a systematic way.

## *2. Politics as an industry and campaigns*

Although the policy is a non-profit activity, ideally it is a business sector that is growing rapidly. Politics is becoming an increasingly large industry over the years. Campaigns are becoming more costly. Most of the money is being spent on television advertising campaign, promotional materials, rallies and political consulting services.

During the election campaign for the parliamentary elections of June 28th 2009, according to audit reports the total amount spent by political parties is 66,599,376 ALL. The three main parties the Democratic Party, the Socialist Party and the Socialist Movement for Integration, accounted for 77% of total expenditures, respectively 43%, 28% and 6%.

Publicity expenses occupied a central place in total expenditure that were carried out during the June 2009 parliamentary election campaign. Specifically, publicity expenses realized in the mainstream media in the country for three main parties DP, SP, SMI occupy respectively 21%, 51% and 66% of total expenses realized during the campaign by either party.

Foreign consultancy offered by lobbying groups is another important item of expenditure that have carried out the three main parties in the election campaign. Accordingly, DP consultancy costs account for 29% of total expenditure, SP 8% and 26% of total expenditure for the SMI.

Transparency declaration of actual expenditure by political parties is a very controversial issue which is also put into question by the following results which are inconsistent with the statements of the parties. According to the study conducted by the Institute for Research and Developmet Alternatives (IRDA) on "Promoting Financial Transparency and Accountability of Political Parties in the General Elections of Albania" for the June 2009 elections if we get only one element of political marketing used during parliamentary elections this year, we see that there is a discrepancy between the amounts declared and the results of this study. Table 1.2 shows the costs for publicity carried out by the three main parties according to audit reports and IRDA study

| Political Party | Spending according to the report of the Central Election Council | Spending according the IRDA |
|---|---|---|
| **DP** | 32,855,779 | 67,488,905 – 74,987,672 |
| **SP** | 67,056,776 | 36,944,076 – 41,048,973 |
| **SMI** | 11,550,695 | 8,325,695 – 9,250,772 |

The high level of spending during the election campaigns so naturally stimulates the question as to why follow this model. The obvious answer lies in marketing. "This dependence on expensive publicity is a key factor behind the increase of the cost to run for office. This rising cost is considered by some as discouraging to candidates who have not about wealthy donors, or do not have the money itself "(Francia 2001). However, most of the rising costs of campaigns comes from greater use and trust in traditional media, and the use of sophisticated marketing techniques such as telephone surveys.

## *3. The methodology*

The methodology used in this paper combines primary data with secondary ones. Secondary data are the result of the analysis of a wide and contemporary literature on political marketing. Primary data is based on the analysis of data collected via questionnaires. The sample obtained in the study is approximately 650 randomly selected individuals in 11 units of Tirana, Kamez and Vora municipality, and the municipalities Berxull, Fark, Kashar, Ndroq, Peza, Preza, Vaqarr, Baldushk, Berzhite, Dajt, Paskuqan, Petrele, Shengjergj, Zall-Bastar, Zall Herr and Krrabë. The participants in the study are individuals who have earned the right to vote, which means that they are 18 years and older. 638 individuals really responded to the questionnaire.

Within each group, individuals were selected by PPS method that is proportional probability selection according to population size. Allocation of selection is proportional to the population interviewed. Interviewing method used is direct interview of selected persons. Data collected from the questionnaire are cast to be processed in the statistical program SPSS 17.0. Since the variables in this study are qualitative, a classification was needed before inputting them unto the program.

### *4. Analysis and interpretation of results*

Factorial analysis is a set of procedures that are used primarily for the reduction and collection of data. In marketing research there can be a large number of variables, most of whom are correlated, which should be reduced to a manageable level. In this analysis we examined the relationship between several variables related and presented them in terms of a few key factors. In the case of factorial analysis each variable is expressed as a linear combination of key factors.

For the analysis of the main components in our case we have analyzed intra-relations between some political marketing variables that affect the behavior of the electorate. Observed variables are:

V1- Party ideology
V2- Party program on economic and social problems
V3 - Party leader personality
V4 - The image of the party
V5 - Advertising on TV
V6 - Advertising on radio
V7 - Billboards
V8 - Posters or leaflets
V9 - Internet (Facebook)
V10 - Calls (SMS)

V11 - Personal meetings
V12 - Politicians' statements
V13 - News on TV
V14 - Newspaper articles
V15- Party program about national issues
V16- Party program on your surroundings
V17 - TV debates

Cronbach value (alpha) for the reliability of the scale used is 0862 (> 0.7), the acceptable limit for the further analysis of these variables. Components analysis was used to identify the factors leading to its value greater than 1 and varimax rotation (since it is required for all factors not to be co-related) to more easily interpret factor loads. Its values indicate factor variance explained by each factor. Loads of factors, i.e. the correlation coefficients between the variables and factors are chosen to be greater than 0.55. Percentage of variance of a given variable can be explained by factors called the common variance, and in the case under study the variance is greater than 0.4.

Table 1.4 presents the results of tests of Kaiser-Meyer-Olkin (KMO) and Bartlett. It can be seen that for the Bartlett test $\chi2$ (136) = 3832.827, $p < 0.001$ of the correlation matrix is therefore different statistically unit matrix in which the variables may not correlate with each other. Thus, the variables are suitable to perform a factor analysis. KMO index = 0885 (greater than 0.60) shows that the variables are suitable for factor analysis.

**Table 1.4.** KMO dhe Barlett Tests

| | | |
|---|---|---|
| Kaiser-Meyer-Olkin Index | | .885 |
| Bartlett Test | $\chi2$ | 3832.827 |
| | df | 136 |
| | Sig. | .000 |

Table 1.5 presents the total variance explained, which is one of the most important tables because it contains its own values for each factor, the percentage of variance explained by each factor obtained as well as cumulative percentage of variance explained by all factors before and after rotation (varimax). (Labar, 2008)

| Component | Initial Eigenvalues | | | Extraction Sums of Squared Loadings | | | Rotation Sums of Squared Loadings | | |
|---|---|---|---|---|---|---|---|---|---|
| | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % | Total | % of Variance | Cumulative % |
| 1 | 5.583 | 32.839 | 32.839 | 5.583 | 32.839 | 32.839 | 3.226 | 18.976 | 18.976 |
| 2 | 2.450 | 14.414 | 47.253 | 2.450 | 14.414 | 47.253 | 2.973 | 17.490 | 36.465 |
| 3 | 1.374 | 8.081 | 55.334 | 1.374 | 8.081 | 55.334 | 2.343 | 13.784 | 50.250 |
| 4 | 1.001 | 5.886 | 61.221 | 1.001 | 5.886 | 61.221 | 1.865 | 10.971 | 61.221 |
| 5 | .784 | 4.610 | 65.830 | | | | | | |
| 6 | .713 | 4.192 | 70.022 | | | | | | |
| 7 | .678 | 3.988 | 74.011 | | | | | | |
| 8 | .642 | 3.778 | 77.789 | | | | | | |
| 9 | .607 | 3.573 | 81.362 | | | | | | |
| 10 | .531 | 3.126 | 84.488 | | | | | | |
| 11 | .502 | 2.952 | 87.439 | | | | | | |
| 12 | .407 | 2.396 | 89.835 | | | | | | |
| 13 | .398 | 2.343 | 92.178 | | | | | | |
| 14 | .374 | 2.199 | 94.378 | | | | | | |
| 15 | .341 | 2.008 | 96.386 | | | | | | |
| 16 | .335 | 1.973 | 98.359 | | | | | | |
| 17 | .279 | 1.641 | 100.000 | | | | | | |

*Extraction Method: Principal Component Analysis.*

Thus, factor 1 explains 32.84% of the variance of the variables, factor 2 explains 14.41% of the variance of variables, factor 3 explains 8.01% of the variance of variables, factor 4 5.89 explains variance variables and the four factors together explain 61.22% of the variance total variables.

Table 1.6 presents the correlations between variables and factors is one of the most important tables of the results of the analysis. In this table, load factors are chosen to be greater than 0.55. Four factors obtained from the first factorial analysis variables contained in them can be defined as a political product, political advertising, public relations and direct marketing. Factorial analysis was used to reduce the list of variables considered in the study that affect the behavior of the electorate in a limited set of variables that have the greatest importance. So, the analysis shows that voters are more influenced by political product, political advertising, public relations and direct marketing. A better focus by the political parties in these elements provides growing and loyal voters.

**Tabela 1.6.** Factorial analysis for political marketing elements

| | | Components | | | |
|---|---|---|---|---|---|
| | | 1 | 2 | 3 | 4 |
| V2 | Party program on economic and social problems | 0.804 | | | |
| V15 | Party program about national issues | 0.734 | | | |
| V3 | Party leader personality | 0.692 | | | |
| V16 | Party program on your surroundings | 0.665 | | | |
| V4 | The image of the party | 0.648 | | | |
| V1 | Party ideology | 0.634 | | | |
| V7 | Billboards | | 0.813 | | |
| V6 | Advertising on radio | | 0.792 | | |
| V8 | Posters or leaflets | | 0.776 | | |
| V5 | Advertising on TV | | 0.775 | | |
| V13 | News on TV | | | 0.792 | |
| V14 | News paper articles | | | 0.733 | |
| V17 | TV Debates | | | 0.731 | |
| V12 | Politicians' statements | | | 0.557 | |
| V10 | Calls (SMS) | | | | 0.726 |
| V9 | Internet | | | | 0.689 |
| V11 | Personal meetings | | | | 0.681 |

### *Conclusions and recommendations*

Political marketing is closely related to political campaigns. From the perspective of marketing, political campaigns can be seen as an attempt to identify the desires and needs of consumers / voters, which can then be satisfied by the political promise of a service or product.

Political marketing is much more than political publicity. A common misconception in political science circles is that advertising and marketing are essentially the same. Political publicity is one of the most expensive, but it is only one of several elements that are included in the category of political marketing.

Electoral campaigns in Albania are "Americanized". Electoral campaigns carried out on the basis of polls, media mock results, and personalization campaigns to key leaders of parties and negative publicity as one of the key elements used in publicity campaigns are the main elements of the "Americanization" campaign in Albania.

Four factors obtained from the first factorial analysis variables contained in them can be defined as a political product, political advertising, public relations and direct marketing. A better focus by the political parties in these elements provides growing and loyal voters the opportunity to expand the number of voters supporting.

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# UNFAIR COMPETITION IN ONLINE COMMERCE

Anca – Elena Bălăşoiu

**Abstract:**
*E-commerce represents a new area of interest in South – East Europe, that still needs a clear legislation, as phenomena such as unfair competition are common for this type of transactions, on an ever-expanding market. E.U. legislation regarding unfair competition comes as a complex system of legal measurements, that need to be transposed in the internal provisions in a broad and efficient manner.*

**Key words**: e-commerce, E.U. legislation, competition law, sale – purchase industry.
**JEL Classification**: K20.

## Introduction

By definition, e-commerce (electronic commerce or EC) is the buying and selling of goods and services, or the transmitting of funds or data, over an electronic network, primarily the Internet. These business transactions occur either business-to-business, business-to-consumer, consumer-to-consumer or consumer-to-business. The terms *e-commerce* and e-business are often used interchangeably. The term *e-tail* is also sometimes used in reference to transactional processes around online retail. [1]

E-commerce represents a growing part of the sale – purchase industry world wide, with changing features, as the technological part of it evolves. Aslo, from the human component point of view, the number of consumers/ buyers is growing and so, the competition between producers and distributors becomes an important aspect. Thus, the need for a proper legislation package.

**Unfair competition regards the situation in which** the competitors compete on unequal terms, because favorable or disadvantageous conditions are applied to some competitors but not to others; or that the actions of some competitors actively harm the position of others with respect to their ability to compete on equal and fair terms. It contrasts with fair, legal competition in which the same rules and conditions are applied to all participants, and the competitive action of some does not harm the ability of others to compete.

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[1] http://searchcio.techtarget.com/definition/e-commerce

Often, unfair competition means that the gains of some participants are conditional onthe losses of others, when the gains are made in ways which are illegitimate or unjust.[2]

A fair competition law is found in every state within European Union. All the regulations that exist in this matter serve five purposes. First, the law seeks to protect the economic, intellectual, and creative investments made by businesses in distinguishing themselves and their products. Second, the laws seek to preserve the good will that businesses have established with consumers. Third, the laws seek to deter businesses from appropriating the good will of their competitors. Fourth, the laws seek to promote clarity and stability by encouraging consumers to rely on a merchant's good will and reputation when evaluating the quality of rival products. Fifth, the laws seek to increase competition by providing businesses with incentives to offer better goods and services than others in the same field.

Although the laws of unfair competition help to protect consumers from injuries caused by deceptive trade practices, the remedies provided to redress such injuries are available only to business entities and proprietors. Consumers who are injured by deceptive trade practices must avail themselves of the remedies provided by other types of legislation.

## 1. Legal remedies for unfair competition in E.U.

In general, businesses and proprietors injured by unfair competition have two remedies: injunctive relief (a court order restraining a competitor from engaging in a particular fraudulent or deceptive practice) and money damages (compensation for any losses suffered by an injured business).

At European level, The European Parliament issued Directive **2000/31/EC[3].** Just looking at the Preamble of the Directive we find that The European Union is seeking to forge ever closer links between the States and peoples of Europe, to ensure economic and social progress. According to European Union Function Treaty, in E.U., the internal market comprises an area without internal frontiers in which the free movements of goods, services and the freedom of establishment are ensured; the development of information

[2] F.Sandu, A.E. Bălăşoiu – Present legal aspects regarding unfair competition, Instituţii Juridice Contemporane în contextul integrării României în Uniunea Europeană/Contemporary Legal Institutions within the Context of EU Integration, Bucharest, 7th Edition, 2013, p. 44

[3] Directive 2000/31/EC of the European Parliament and of the Council of 8 June 2000 on certain legal aspects of information society services, in particular electronic commerce, in the Internal Market ('Directive on electronic commerce'), published in Official Journal L 178 , 17/07/2000 P. 0001 - 0016

society services within the area without internal frontiers is vital to eliminating the barriers which divide the European peoples.

The development of electronic commerce within the information society offers significant employment opportunities in the Community, particularly in small and medium-sized enterprises, and will stimulate economic growth and investment in innovation by European companies, and can also enhance the competitiveness of European industry, provided that everyone has access to the Internet.

Community law and the characteristics of the Community legal order are a vital asset to enable European citizens and operators to take full advantage, without consideration of borders, of the opportunities afforded by electronic commerce; this Directive therefore has the purpose of ensuring a high level of Community legal integration in order to establish a real area without internal borders for information society services.

It is important to ensure that electronic commerce could fully benefit from the internal market and therefore that, as with Council Directive 89/552/EEC of 3 October 1989 on the coordination of certain provisions laid down by law, regulation or administrative action in Member States concerning the pursuit of television broadcasting activities, a high level of Community integration is achieved.

The development of information society services within the Community is hampered by a number of legal obstacles to the proper functioning of the internal market which make less attractive the exercise of the freedom of establishment and the freedom to provide services; these obstacles arise from divergences in legislation and from the legal uncertainty as to which national rules apply to such services; in the absence of coordination and adjustment of legislation in the relevant areas, obstacles might be justified in the light of the case-law of the Court of Justice of the European Communities; legal uncertainty exists with regard to the extent to which Member States may control services originating from another Member State[4].

According to European legislation, Member States shall ensure that their legal system allows contracts to be concluded by electronic means. Member States shall in particular ensure that the legal requirements applicable to the contractual process neither create obstacles for the use of electronic contracts nor result in such contracts being deprived of legal effectiveness and validity on account of their having been made by electronic means. Still, Member States may lay down that this shall not apply to all or certain contracts falling into one of the following categories:

[4] Preamble 2.nd- 4.th paragraph of Directive 2000/31/EC

(a) contracts that create or transfer rights in real estate, except for rental rights;

(b) contracts requiring by law the involvement of courts, public authorities or professions exercising public authority;

(c) contracts of suretyship granted and on collateral securities furnished by persons acting for purposes outside their trade, business or profession;

(d) contracts governed by family law or by the law of succession.

Member States shall indicate to the Commission the categories that not refer to e-commerce and every five years a report must me summited in order to give explanations of the reasons why they consider it necessary to maintain restriction on some e-commerce domains. In addition to other information requirements established by Community law, Member States shall ensure, except when otherwise agreed by parties who are not consumers, that at least the following information is given by the service provider clearly, comprehensibly and unambiguously and prior to the order being placed by the recipient of the service:

(a) the different technical steps to follow to conclude the contract;

(b) whether or not the concluded contract will be filed by the service provider and whether it will be accessible;

(c) the technical means for identifying and correcting input errors prior to the placing of the order;

(d) the languages offered for the conclusion of the contract.

Member States shall ensure that, except when otherwise agreed by parties who are not consumers, the service provider indicates any relevant codes of conduct to which he subscribes and information on how those codes can be consulted electronically.

Contract terms and general conditions provided to the recipient must be made available in a way that allows him to store and reproduce them.

Member States have the obligation to ensure, except when otherwise agreed by parties who are not consumers, that in cases where the recipient of the service places his order through technological means, the following principles apply:

- the service provider has to acknowledge the receipt of the recipient's order without undue delay and by electronic means,

- the order and the acknowledgement of receipt are deemed to be received when the parties to whom they are addressed are able to access them.

Member States shall ensure that, except when otherwise agreed by parties who are not consumers, the service provider makes available to the recipient of the service appropriate, effective and accessible technical means allowing him to identify and correct input errors, prior to the placing of the order.

Where an information society service is provided that consists of the transmission in a communication network of information provided by a recipient of the service, or the provision of access to a communication network, Member States shall ensure that the service provider is not liable for the information transmitted, on condition that the provider:

(a) does not initiate the transmission;

(b) does not select the receiver of the transmission; and

(c) does not select or modify the information contained in the transmission.

The acts of transmission and of provision of access include the automatic, intermediate and transient storage of the information transmitted in so far as this takes place for the sole purpose of carrying out the transmission in the communication network, and provided that the information is not stored for any period longer than is reasonably necessary for the transmission.

Where an information society service is provided that consists of the transmission in a communication network of information provided by a recipient of the service, Member States shall ensure that the service provider is not liable for the automatic, intermediate and temporary storage of that information, performed for the sole purpose of making more efficient the information's onward transmission to other recipients of the service upon their request, on condition that:

(a) the provider does not modify the information;

(b) the provider complies with conditions on access to the information;

(c) the provider complies with rules regarding the updating of the information, specified in a manner widely recognised and used by industry;

(d) the provider does not interfere with the lawful use of technology, widely recognised and used by industry, to obtain data on the use of the information; and

(e) the provider acts expeditiously to remove or to disable access to the information it has stored upon obtaining actual knowledge of the fact that the information at the initial source of the transmission has been removed from the network, or access to it has been disabled, or that a court or an administrative authority has ordered such removal or disablement[5].

Regarding practical cases on unfair competition in online commerce, the recent case of Google being investigated for such acts is highly notorious, as E.U. sets to file antitrust lawsuit against Google for unfair practices.

If the Commission finds Google guilty, it can order the company to change its business practices and impose fines of up to 10 percent of the company's global proceeds – more than $6 billion based on its annual revenue.

[5] For more details, see art.6-13 of Directive 2000/31/EC

The E.U. has been investigating Google since 2010 over complaints by some 20 European and US companies, including Microsoft and Yelp. They want the EU to compel Google to stop favoring its own services with search algorithms – an issue they also raised with US regulators.

A 2012 Federal Trade Commission investigation found that the California-based company had tampered with search algorithms to favor its own services, but the FTC declined to press charges after Google explained it was seeking to improve user experience by ensuring overall result diversity.

Although there have been several antitrust investigations into Google in recent years, this is the first time formal charges will be brought against the company. Under EU rules, Google will have 10 weeks to respond to the allegations and call a hearing to present a defense. 6

## 2. Romanian E-Commerce Market

According to the statements given by the main players of the Romanian e-commerce market at the 8th edition of eCommerce Awards Gala (GPeC), which took place in November 2013 in Bucharest, the local online retail market reached approximately 600 million Euros in the recently concluded year.

This number only refers to products sold online (whatever their nature) and not services, bills, air tickets, tickets to shows, vacations and trips etc.

The data was published at the beginning of 2014. According to these, the number of Internet users reached 10 million in 2013 (1 million more than in 2012 – source: Eurostat). 27% of the Romanian people connect to the Internet, meaning that approximately 1 in 4 Internet users buy online (source: Daedalus Millward Brown) and most online buyers (84%) live in urban areas, while 16% live in rural areas.

The average age of online buyers is between 25 and 35 years, but 2013 brought an increase of 5% in the 45 to 55 age segment, which now accounts for 15% of eCommerce users (compared to 10% in 2012 ).

Regarding online card payment, the number of transactions increased by approx. 35% YoY in 2013, according to the statements of the VISA, MasterCard and RomCard officials from the eCommerce Awards Gala. However, the preferred payment method of the Romanian people remains cash on delivery, being used in over 90% of transactions.

The total value of online credit card transactions processed in the RomCard's 3D Secure System is approx. 220 million Euros in 2013 (a figure similar to the value recorded in 2012 ).

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[6] http://rt.com/news/249733-eu-google-antitrust-case/

According to VISA Europe, the average value of transactions was around 37 Euros (paid in RON), compared to the higher value in 2012 when the average value of transactions was 45 million (paid in RON).

A very interesting fact is that the majority of online credit card transactions are international (60%), while only 40% are domestic transactions, according to the MasterCard statistics. In other words, Romanian people spend more money on websites abroad than on Romanian websites.

In Romania there are currently over 12 million cards enrolled in the 3D Secure system (compared to 11.3 million in 2012) and the number of active cards (actually used in online trading) increased from 410,000 in 2012 to over 600,000 in 2013.

Towards the end of the last year, over 17,000 online credit card transactions were taking place in the RomCard 3D Secure system each day, resulting in more than 500,000 transactions each month.

The Romanian e-commerce market consists now of approx. 4,500 online stores, according to the estimates given by the main players. Of the total number of e-shops, over 1,000 are enrolled in and certified by the RomCard 3D Secure standard, a raise from the total of 781 stores in 2012.

The figures published by GPeC are based on statistics and estimates made by VISA, MasterCard, RomCard, GPeC, Daedalus Millward Brown and the main players of the eCommerce market (representatives of top online shops).[7]

**3.Unfair competition in online commerce in Romania.**

In Romania, The Romanian Competition Authority started its activity on the 6th of September 1996 by drafting the necessary secondary legislation necessary for enforcing the Competition Law (no.21/1996), which entered into force on the 1st of February 1997.

As national competition authority, the institution enforces and ensures the application of the national and Community rules on competition.

At the same time, the Competition Council has the role of national contact authority on State aid between the European Commission, on one hand, and the pubic institutions State aid suppliers and beneficiaries, on the other hand.

Therefore, the mission of the Romanian Competition Authority can be synthetically defined as to protect and to stimulate the competition on the Romanian market so as to develop a normal competitive environment, finally ensuring a better promotion of consumers' interests. [8]

Regarding the international cooperation activity of this Authority, it is part of the European Competition Network (ECN), that represents a forum for

[7] http://www.gpec.ro/blog/romanian-e-commerce-market-reached-eur-600-million-in-2013

[8] http://www.consiliulconcurentei.ro/en/about-us/description/role.html

cooperation constituted from the national competition authorities and the European Commission in order to exchange information and cooperate in cases where Articles 101 and 102 of the Treaty on the Functioning of the European Union apply.

The main objective of setting up the European Competition Network regards the unitary application of the EU competition rules to create a competitive environment and foster competition in the internal market, according to the provisions of the Treaty on the Functioning of the European Union. [9]

At national level, still, this Authority has a limited activity regarding online area, since so far, no case involving unfair competition in online commerce has been brought to the public attention.

One of the moments in wich the Autority has taken a stand was in 2013, when The Competition Council opened a sector inquiry on electronic communication services offered as bundled services (known as Multiplay) and separately.

The inquiry included an assessment of the impact of Multiplay package over the development of markets afferent to each service. Also, the inquiry aimed at identification of potential competition problems caused by marketing the Multiplay services packages.

The "Multiplay" concept refers to different services packages that combine two or more electronic communications services. For instance, *triple play* refers generally to a package consisting in telephony, television and Internet.

The result of this inquiry was not brought to the public attention so far.

Still, according to The Romanian Competition Authority's Anual Report for 2014, there is a project aimig to adapt the legislation to unfair competition situations regarding electronic communication.[10]

Regarding legal remedies, also in Romania, as well as at European level, the private law legislation provides two remedies: injunctive relief (a court order restraining a competitor from engaging in a particular fraudulent or deceptive practice) and money damages (compensation for any losses suffered by an injured business).

Courts are rulling in more and more cases involving unfair competition in online commerce, therefore this kind or remedy is more popular among the companies that just adressing to the Romanian Competition Authority with a complaint. 11

In **conclusion**, unfair competition in online commerce represents a real problem, present up until the highest level of what Internet means for

[9] http://www.consiliulconcurentei.ro/en/international-relations/ecn-en.html

[10] http://www.consiliulconcurentei.ro/ro/despre-noi.html

[11] http://www.euroavocatura.ro/jurisprudenta/2609/Acte_de_concurenta_neloiala

consumers. Either big or small, national or foreign, any company may become a subject of unfair competition practices, ar good reputation may hide technological aspects that can mislead the consumers.

In Romania, e-commerce is a growing area in sale – purchase industry, but also an area in which unfair competition activities are still possible and sometimes, difficult to perceive or prove.

An internal legislation more adaptated to particular situations is to be desired, as well as a consumer's guide regarding all the above aspects.

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# THE RISE OF CHINA AS THE LARGEST ECONOMY IN THE WORLD: GEOPOLITICAL IMPLICATIONS FOR JAPAN

Florin Bonciu*

**Abstract:**

*The paper attempts to evaluate some of the geopolitical implications for Japan resulting from the new position of China as the largest economy in the world in PPP terms. As the economic dimension is accompanied by similar aspects related to China's military and research and development capabilities, the world economy is becoming more and more a multi-polar entity in which Japan has to play a new role. The emergence of Asia-Pacific cooperation structures as well as of international development banks belonging to Asian or BRICS countries requires Japan to make some strategic decisions for finding a balance between its special relation with USA and its geographical position.*

**Key words:** world order, geopolitics, Chinese economy, Japan geopolitical options, Japan – US relation

**JEL classification:** F01, F02, F50, F55

## The international context of the rise of China

The first thing to be mentioned is that the preeminence of China is not at all a new phenomenon as China was the biggest economy for nearly two millennia and was still the largest economy in the world in 1870[1]. To reformulate the previous phrase, China has been the largest economy of the world for 19 of the past 20 centuries. This fact is not new in the circles of historians but it is so often overlooked by the vast majority of people that it needs to be repeated. After about 150 years China is back to its centuries old position and this should put things into a different perspective. From one point of view it is a return to a status quo, from another it is a repositioning in the global balance of power for the Western world and first of all for US.

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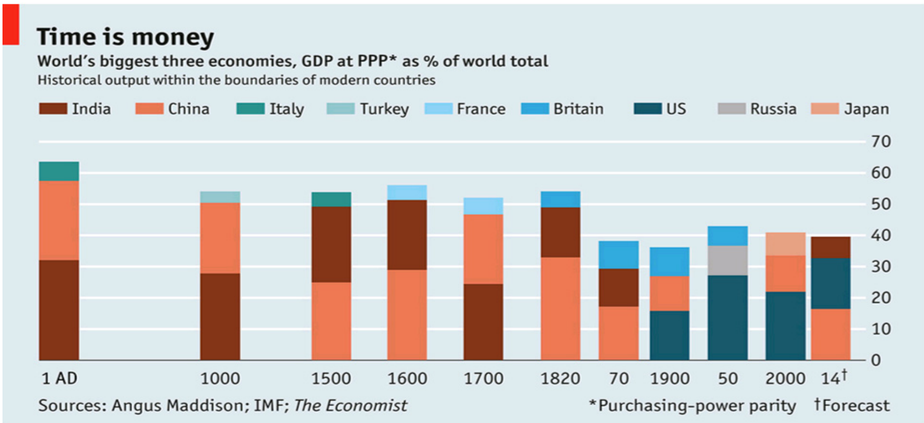
[1] Angus Maddison, Chinese Economic Performance in the Long Run, 960–2030 AD, OECD, Paris 2007, p.43

Figure 1. World's Biggest three economies




In the recent years there were several estimates made by international organizations like World Bank or research institutes on the date when China will overpass US as the largest economy in the world, in real or PPP terms. The estimates varied from early 2020s to 2040s but in October 2014 the International Monetary Fund stated that China already over passed US in PPP terms by a small margin (17.6 trillion US \$ compared to 17.4 trillion US \$)[2].

The most common mistake in relation to this subject is to treat it as a sport contest where some people negate the fact and some others are happy or unhappy about the result. Anyway the international context is much more complicated and the following may attempt to support this statement.

The world after the 2008 crisis is passing through substantial structural changes. The balance of power has been based more and more on multi polarity, while US has had to interact and rely on different local or regional actors in order to pursue its aims. China has been building step by step its position as a global actor while Russia is back on the front stage not only in its immediate neighborhood but also in more distant places like Middle East or Latin America. In the meantime European Union has been struggling with the consequences of the crisis, with structural issues and with a declining position in the world economy. The Asia Pacific area has become gradually the center of the world economy and a competition of negotiations is underway for new rules of the game, with a peak in 2015, between Trans Pacific Partnership (supported by the US) and Regional Comprehensive Economic Partnership

[2] Keith Fray, China's leap forward: overtaking the US as world's biggest economy, Financial Times, 8 October 2014, at page http://blogs.ft.com/ftdata/2014/10/08/chinas-leap-forward-overtaking-the-us-as-worlds-biggest-economy/

(centered around ASEAN but having China as main economic player). The Middle East witnessed a new stage of conflict and instability that includes the conflict situation in Yemen determined mainly by the Houthi rebels, the war situation generated by the Islamic state and Al Qaeda, the continuation of the fights with Talibans in Afghanistan. In this region Iran is starting to play a more significant role, while in the neighborhood Turkey is thinking about a more nuanced position in relation to European Union and NATO.

At the same time, in 2013 the developing and emerging countries contributed for the first time with more than 50 % to the world GDP in PPP terms as compared to only 33 % in 1990. The Economist considered this fact the most important economic transformation in modern history[3].

Robert Kagan synthesized this global context by saying:" "We're sort of seeing the world order cracking around the edges[4]". This statement is just a remember that world order has always had a historical dimension in the sense that a certain world order is specific for a period of time but not perpetual.

The fact that we assist to a return of the geopolitics means in our opinion not that we go back to the cold-war period but rather that we go back to the situation mentioned in the 19th century by Lord Palmerston:" Britain had no eternal allies and no perpetual enemies, only interest that were eternal and perpetual[5]." Countries big or small, even if they are members of integration organizations like European Union, rediscover openly that they have interests not only ideals and that their people keep the decision makers accountable for the quality of their daily life and not for the probabilistic fulfillment of some distant and abstract goals.

From the perspective of short to medium term the quite strong impression popular in the Western world that after 1990 the humankind witnessed "the end of history" and the generalization of liberal democracy can be explained by the limitation of the scope of analysis mainly to Europe (where Germany has been reunited, the Soviet Union disappeared as entity and European Union enlarged quite substantially) and by the equally strong belief that liberal democracy is an absolute principle that only needs some time to be willingly applied all over the world[6].

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[3] The Economist, When Giants Slow Down, July 27, 2013, at page http://www.economist.com/news/briefing/21582257-most-dramatic-and-disruptive-period-emerging-market-growth-world-has-ever-seen

[4] Robert Kagan quoted by Michael Crowley in World War O, 23 April 2015, at page http://www.politico.com/story/2015/04/world-war-obama-117303.html

[5] David Brown, Palmerston and the Politics of Foreign Policy, 1846-1855, Manchester University Press, 2002, pp. 82-83.

[6] Walter Russell Mead, The Return of Geopolitics - The Revenge of the Revisionist Powers, Foreign Affairs, May/June Issues 2014,

In our opinion the picture of the world after the 2008 crisis is more and more based on diversity, not only as centers of economic, political or military power, but also as approaches (democracy and liberalism co-existing with different degrees of authoritarianism, liberalism co-existing with illiberalism, laic with religious states. A key point in the previous statement is that co-existence does not mean implicitly peaceful co-existence). For the coming decades, accepting and capitalizing diversity may be the compass to guide countries, companies or individuals through stormy times.

## Geopolitical implications of the rise of China

The rise of China as a global player, even if it is regarded only from an economic point of view, determines a number of objective implications related to its need to secure its access to natural resources and energy as well as its transit routes for inputs and outputs, particularly the maritime ones. One a more general note at this point one have to take into account that usually when a new power emerges there is some sort of conflict (of a military nature or not) with the existing power(s). From this perspective Nouriel Roubini considers that "keeping China's rise peaceful is our biggest geopolitical challenge"[7].

From an economic point of view the statement of Mr. Roubini can be better understood if we correlate it with another one, belonging to Robert Preston, BBC economic editor: "We should be under no illusion that the really big thing in the world, which will have an impact on our living standards is what happens in China. Nothing else really matters in comparison"[8].

The huge impact of China on many other countries in the world economy is explained by the size of its economy, by the size of its exports and the number of transnational corporations that operate nowadays from China as well as by the size of its lending money to other countries, particularly US.

This challenge determined by the rise of China is particularly complex after 2008 because of a set of new circumstances among which: some of the new leaders in Asia tend to be more nationalistic; many Asian nations have to find new growth strategies as structural reforms are needed to replace export

[7] Nouriel Roubini, Keeping China's rise peaceful is our biggest geopolitical challenge, The Guardian, 30 April 2014.

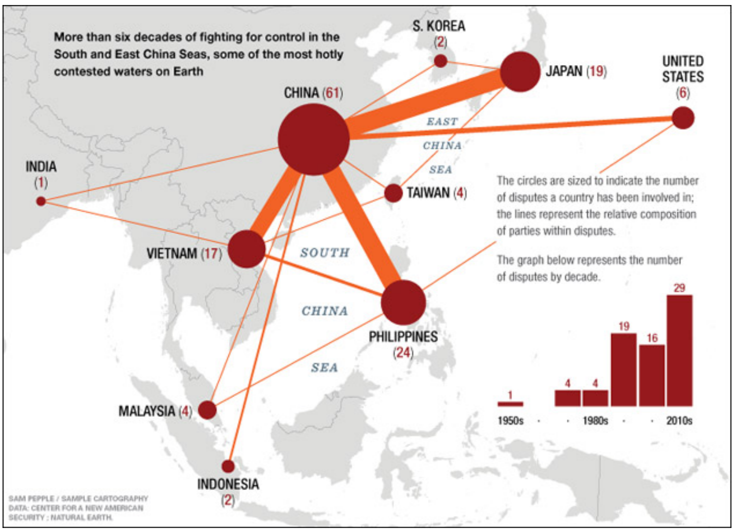
[8] Robert Preston, Why China Matters, 16 December 2014, at page http://www.bbc.com/news/magazine-30483762

oriented strategies with new ones based on domestic consumption and/or regional cooperation; the role of US in the Asia Pacific region is not so clear anymore and, at the same time there is a lack of strong institutional mechanisms to prevent the escalation of conflicts.

The risk of conflicts due to the emergence of a new significant power, China, is not theoretical. The existence of various forms of conflicts and tensions in the South and East China Seas has been a permanent phenomenon after the second World War. But what can be noted is an increase in the number of such conflicts and also in the number of the parties involved. Figure 2 offers a synthetic view of the geographical areas involved, the participants and the number of conflicts as well as their distribution in time.

As it can be noted the number of conflicts are higher with some of the nearest neighbors (Philippines, Japan, Vietnam) while more distant countries (like US, India, Indonesia) are less involved. A particular case refers to the conflicts of China with Taiwan which are not so numerous and are however related to the historical and ideological division of the two parts of China.

**Figure 2. Conflicts in the South and East China Seas**




**Source:** Center for a New American Security, at page http://www.cnas.org/research/regions-and-states/asia-pacific-security

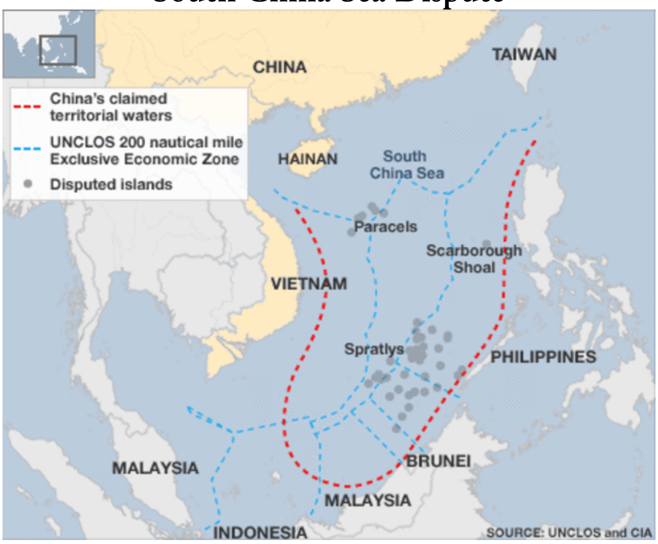
In a more concrete and recent form some of territorial disputes in the South China Sea refer to two island chains, Spratlys and Paracels. The countries involved in the disputes are besides China, Vietnam, Philippines, Brunei and Malaysia and the reason of disputes are the potential natural reserves that may be found in the areas around these islands.

In the recent years a number of disputes on this topics were recorded as follows[9]:

- In 2012, China and the Philippines accused each other of intrusions in the Scarborough Shoal area;
- In July 2012 China entered in conflict with Vietnam and the Philippines when it formally created Sansha city, an administrative body with its headquarters in the Paracels which it says oversees Chinese territory in the South China Sea;
- In 2012 large anti-China protests took place in on Vietnam with reference to claims that the Chinese navy sabotaged two Vietnamese exploration;
- In January 2013, Philippines announced that it was taking China to a UN tribunal under the auspices of the UN Convention on the Laws of the Sea;
- In May 2014, the introduction by China of a drilling rig into waters near the Paracel Islands led to multiple collisions between Vietnamese and Chinese ships.
- In April 2015, satellite images showed China building an airstrip on reclaimed land in the Spratlys.

A graphical representation of the above is presented in Figure 3.

**South China Sea Dispute**




**Source:** South China Sea Dispute, BBC, at page http://www.bbc.com/news/world-asia-pacific-13748349

[9] Q&A: South China Sea dispute, BBC at page http://www.bbc.com/news/world-asia-pacific-13748349

## Implications for Japan

The rise of China as not only a regional but a global power has without any doubt serious implications for Japan. For many decades Japan had been the second largest economy in the world and the rise of China generates a conflict of interest between a former super-economic power and the new one. To this we have to add the geographical proximity which induces the risk and also the manifestation of territorial disputes determined by implications related to natural resources (such as the Senkaku / Diayou islands). At the same time, if one takes G – 20 Group as a reference, the most tensioned relation between any two members of G – 20 has been that between Japan and China[10].

As an economic power in the region Japan is affected by the aging of its population as well as by the changing balance of power in the world economy. Its natural reaction in face of such a context is that of introversion[11]. Despite the fact that such a position is a reactive one, the historical experience of Japan is that of finding extraordinary original solution as result of the action of external forces. This statement can be demonstrated by at least two major moments: the opening of Japan's ports as result of naval pressures from U.S. Commodore Matthew Perry's fleet in 1853 and transformation of Japan after the 1945 – 1952 period when the country witnessed comprehensive reforms during the US occupation under the control of General Douglas A. MacArthur.

At present and for the coming decades Japan has to cope with the close geographical presence of a large economic power that has interests to control as much as possible its neighborhood. At the same time, given the close relations between US and Japan any escalation of tensions and/or conflicts between Japan and China will be reflected somehow in the US – China relations and the other way round. Due to the mentioned close relations one can not speak strictly about Japan – China relations but rather about Japan – US on the one hand and China on the other hand. The Japan – US part of the binom does not represent a homogenous part as Japan and US, while being close allies, have distinct characteristics and specific historical heritages.

Anyway both Japan and US as part of the Asia Pacific geopolitical equation have to cope with some similar challenges generated by the rise of China. Among them there are: the huge impact of China as a major world exporter;

[10] Henry Blodget, Paul Szoldra. The Japan-China Crisis Is The Most Significant Geopolitical Tension In The World, Business Insider, 24 January 2013, at page http://www.businessinsider.com/japan-china-crisis-is-a-huge-geopolitical-problem-2013-1

[11] Stratfor, The Geopolitics of Japan: An Island Power Adrift, August 31, 2009

the rise of China's military power; the active position of China by using political and military means for solving territorial disputes in the region[12].

In this context Japan has to measure any action and reaction from at least two perspectives: the immediate one and the long term one. While the immediate reaction may ask for a more assertive position the long term prospects may require a more moderate and wise response. The need for a dual perspective may be easily explained by the following table that present the GDP ranking in PPP terms for three time horizons: 2011, 2030, 2050.

The balance of power among the key players of the world economy is important because in politics one can not discuss only about being right or wrong but also about the relative power and superiority or inferiority one country has in relation to another.

**Table 1. GDP ranking in PPP terms for top 20 countries in 2011, 2030 and 2050**

| | 2011 | | 2030 | | 2050 | |
|---|---|---|---|---|---|---|
| **PPP rank** | **Country** | GDP at PPP **(2011 US$bn)** | **Country** | **Projected GDP at PPP (2011 US$bn)** | **Country** | **Projected GDP at PPP (2011 US$bn)** |
| 1 | US | 15,094 | **China** | 30,634 | **China** | 53,856 |
| 2 | **China** | 11,347 | US | 23,376 | US | 37,998 |
| 3 | India | 4,531 | India | 13,716 | India | 34,704 |
| 4 | Japan | 4,381 | Japan | 5,842 | **Brazil** | 8,825 |
| 5 | Germany | 3,221 | Russia | 5,308 | Japan | 8,065 |
| 6 | Russia | 3,031 | **Brazil** | 4,685 | Russia | 8,013 |
| 7 | **Brazil** | 2,305 | Germany | 4,118 | **Mexico** | 7,409 |
| 8 | France | 2,303 | **Mexico** | 3,662 | **Indonesia** | 6,346 |
| 9 | **UK** | 2,287 | **UK** | 3,499 | Germany | 5,822 |
| 10 | Italy | 1,979 | France | 3,427 | France | 5,714 |
| 11 | **Mexico** | 1,761 | **Indonesia** | 2,912 | **UK** | 5,598 |
| 12 | Spain | 1,512 | Turkey | 2,760 | Turkey | 5,032 |
| 13 | South Korea | 1,504 | Italy | 2,629 | **Nigeria** | 3,964 |
| 14 | Canada | 1,398 | Korea | 2,454 | Italy | 3,867 |
| 15 | Turkey | 1,243 | Spain | 2,327 | Spain | 3,612 |
| 16 | **Indonesia** | 1,131 | Canada | 2,148 | Canada | 3,549 |
| 17 | Australia | 893 | Saudi Arabia | 1,582 | South Korea | 3,545 |
| 18 | Poland | 813 | Australia | 1,535 | Saudi Arabia | 3,090 |
| 19 | Argentina | 720 | Poland | 1,415 | **Vietnam** | 2,715 |
| 20 | Saudi Arabia | 686 | Argentina | 1,407 | Argentina | 2,620 |

*Source: World Bank estimates for 2011, PwC estimates for 2030 and 2050*

[12] Francisco Ambrogi, Geopolitics in Asia-Pacific: China, Japan and the US, International Political Forum, 6 August, 2013, at page http://internationalpoliticalforum.com/geopolitics-in-asia-pacific-china-japan-and-the-us/

In analyzing the above table one should note that while 2011 represent past and therefore confirmed data, 2030 and the more so 2050 represent estimates. But even as we speak about estimates Japan, as well as US and all other countries of the world economy have to take into account these rankings and see the interests of the respective powers in their dynamic interaction. Looking at the top ten economic powers one may note the shift from a situation in 2011 where Western countries (and their type of culture) were predominant to a situation where other types of cultures will predominate (China, India, Brazil, Russia, Mexico, Indonesia) and this shift will very likely change the way international relations of all sorts are carried out.

Another reason that may ask for a cautious reaction from the part of Japan in relation to China's actions is the fact that these rankings of the world economic powers have already started to determine changes in the international institutions arena.

BRICS countries announced in July 2014 the establishment of two institutions that will represent smaller versions of the World Bank and IMF: the New Development Bank ( a multilateral development bank) and the Contingency Reserve Arrangement (an institution to provide financial assistance). In the same context on October 24, 2014 a number of 21 Asian states signed a memorandum for the establishment of Asian Infrastructure Development Bank with an initial capital of 50 billion dollars. Such developments and the possible change of IMF voting rights in order to correlate them with the new GDP ranking place China in a much stronger position internationally and therefore tensions with it may be counterproductive for Japan.

The delicate position of Japan in this new international context can be supported by this example. As of 15 April 2015 there were 57 prospective founding members for the Asian Infrastructure Development Bank (AIIB) among which United Kingdom, Germany, France, Italy, Australia, New Zeeland or Israel while Japan stood together with US and Columbia outside the process. Japan has an important position in the Asian Development Bank (where it has more voting rights than China) and may see the success of the Chinese initiative with the Asian Infrastructure Development Bank (AIIB) as a sign of the eroded power of US in the region but also as a sign that its position and influence will be diminished[13]. The acceptance of this new position in the region and the understanding that business opportunities determined by the

[13] Emmanuel Navon, Israel, US, China and the Asian Infrastructure Investment Bank (AIIB), 24 April, 2015, at page http://www.i24news.tv/en/opinion/68831-150424-israel-us-china-and-the-asian-infrastructure-development-bank

establishment of the Asian Infrastructure Development Bank (AIIB) are huge made the Japanese firms and officials to reconsider their initial rejection and to announce a possible joining of AIIB in June 2015[14].

## Conclusions

The world economy is nowadays on its path towards a new world order, characterized by a new ranking of world economic powers and the gradual shift towards a multi polarity of international institutions that may be regarded as a decentralization of global governance. At the same time, Asia – Pacific area will be dominated by economic giants like China but also India while the relative importance of Japan is very likely to decline. This picture should be divided into two different domains, economic and foreign affairs. While in the economic area Japan has been a full player after mid 1950s, comparable to any other significant economic power, in the foreign affairs area Japan after the second world war has been a "middle power" in the sense that it has been a subordinate ally of US[15].

As a global economic power China will play a significant role in the establishment of alternative international financial institutions, international currencies and at least regional terms of trade. In this context, from a pragmatic point of view, Japan might be better off if it adopts the position of an early supporter or adopter of new regional rules rather than a latecomer. A common denominator for the interests of many if not all Asian countries that can be used by Japan is the interest to secure the economic stability and growth of the region[16].

An important and at the same time interesting aspect that may influence the relations between China and Japan is related to the presence of Chinese diaspora in many Asian countries but not in Japan. In case of many Asia countries this dispora may act as a link between China and the respective countries and also as a guarantee for the existence of mutual interests[17]. The

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[14] Henny Sender, Japan expected to join Asian Infrastructure Investment Bank, 30 March, 2015, Financial Times, at page http://www.ft.com/intl/cms/s/0/40b0fff8-d6ae-11e4-97c3-00144feab7de.html#axzz3YK6Yydkj

[15] Masayuki Tadokoro, Japan's Reactions to Rising China, 6th Berlin Conference on Asian Security, Berlin, 18 – 19 June, 2012

[16] Leika Kihara, Japan, China, South Korea agree to ensure geopolitical risks don't threaten recovery, Reuters, 19 September, 2014

[17] Henry Blodget, Paul Szoldra. The Japan-China Crisis Is The Most Significant Geopolitical Tension In The World, Business Insider, 24 January 2013, at page http://www.businessinsider.com/japan-china-crisis-is-a-huge-geopolitical-problem-2013-1

absence of such a Chinese diaspora in Japan prevents the creation of a natural link of trust between the two countries and the feeling that Japan is a totally “foreign” (that is with no Chinese diaspora) country.

Another aspect that puts Japan in a sensitive position refers to the negative feelings existing in many Asia countries in relation to Japanese abuses and war crimes during World War II that affected people from China, Indonesia, Korea, Philippines, Indochina and other areas. While this is not a current topic, it may easily be raised either in case Japan takes a more assertive position or in case other countries in the region have an interest to use this as an argument against Japan.

In view of the above elements in response to the rising of China there are some geopolitical options for Japan. One of them is to further strengthen the alliance with US and with other democratic nations in the region. The possibilities in this respect are not very large and they will depend on the economic status of the Japanese economy. In strengthening the alliance with US Japan will remain a subordinate ally. In developing alliances with democratic nations in the region Japan will have more room for initiative but not many options to choose from.

Another option will be to join, as a developed economy, the rest of Asia – Pacific countries, supporting the Chinese initiatives and negotiating for its maximum benefit. Given the characteristics of the post World War II period we consider unlikely the possibility for Japan to adopt a stand alone attitude, base on building up its own military force, and aiming to become a regional power.

In our view Japan  can be better off adopting a cooperation attitude with China and other powers in the region, supporting its interests and capitalizing on its technological and scientific achievements and, in this way, contributing to a peaceful Pacific century.

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13) Henny Sender, Japan expected to join Asian Infrastructure Investment Bank, 30 March, 2015, Financial Times, at page http://www.ft.com/intl/cms/s/0/40b0fff8-d6ae-11e4-97c3-00144feab7de.html#axzz3YK6Yydkj

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15) The Economist, When Giants Slow Down, July 27, 2013, at page http://www.economist.com/news/briefing/21582257-most-dramatic-and-disruptive-period-emerging-market-growth-world-has-ever-seen

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# THEORETICAL ASPECTS OF RISK IN CAPM THEORY

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Stănescu Maria Cristina **

## Abstract

*Risk can be described as a combination between the probability of risk and the consequences in terms of loss or gain because of risk. Risk is an inherent part of all economic activities. The definition of risk (Passenheim, 2010) can be rather difficult as expectations are focused into the future and therefore there is no room for uncertainties. Additionally, these uncertainties could end in an outcome that is either more positive or more negative than expected. CAPM is used to illustrate a particular connection between the degree of uncertainty in earnings flow for a monetary investment as well as level of return, and as a result, it describes how shares are usually valued and how discount rates are established.*

**Keywords:** risk, CAPM, Security Market Line, portfolio, market risk, beta index.

**JEL Classification**: G31, G32.

Generally speaking, "risk" is a social, economic, political or natural notion originating from the possibility that a future action will cause loss because of incomplete information at the moment of making the decision or an inconsistency in logical reasoning. Risk can be defined as the degree of exposure to an event that may be in favor or at the expense of an activity. It can be described as a combination between the probability of risk and the consequences in terms of loss or gain because of risk. Risk is an inherent part of all economic activities.

An accepted definition of risk describes the possibility that a future event will affect the company's objectives in terms of costs, planning and resources. Generally, favorable events and their consequences are named "*opportunities*" and the unfavorable events are named "*risks*". Risk represents the possibility of an unwanted event with dangerous consequences to the company's activity.

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Risk also describes the possibility of an anticipated result to be better or worse than the expected one, this feature emphasizing over the fact that risk is equivalent to the variability of possible results.

Most of the time, risk has a negative meaning, investors being interested more in lack of appreciation to gains. Therefore, risk can also mean the possibility of getting better results than expected. Therefore, risk means hazard, the danger of loss, "*the possibility of exposing oneself to loss*" or a possible lost "*that modern policy tries to prevent or fix*".

The risk management procedure is based upon reiteration and feedback, therefore its effectiveness must be constantly analyzed through several strategies: risk avoidance, reduction, protection, risk managing and risk transfer; feasible techniques of performing that consist of taking out insurance coverage or sub-contracting.

**The Capital Asset Pricing Model (CAPM)** is used to illustrate a particular connection between the degree of uncertainty in earnings flow for a monetary investment as well as level of return, and as a result, it describes how shares are usually valued and how discount rates are established. This model separates the shares' risk in two categories: systematic and unsystematic risks (Allan Hill, 2010).

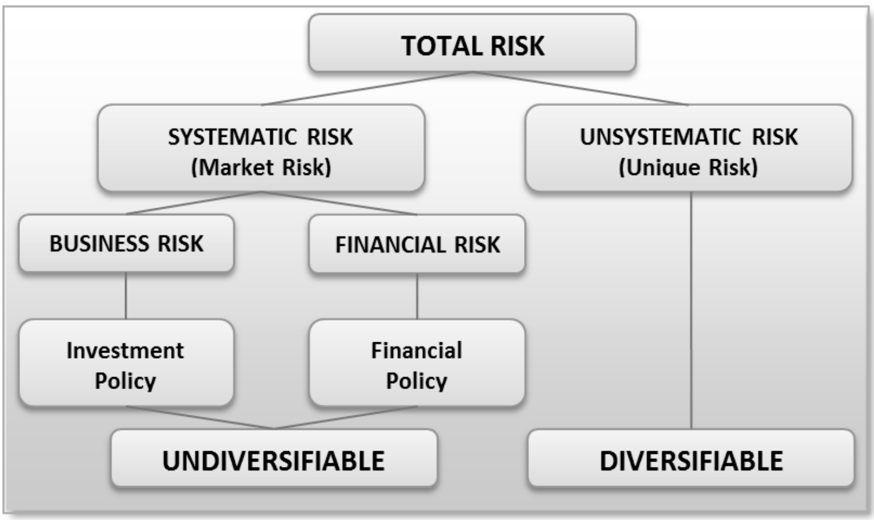


*Figure 1: The Inter-relationship of Risk Concepts (Allan Hill, 2010)*

**Systematic Risk** Systematic Market Risk bears its name due to the endemicity characteristic (through the system) and its lack of diversity and predictability. Systematic risk refers to the extent to which share returns vary when the returns on the market as a whole change; it is measured by beta. It relates to general economic factors that affect all firms and financial securities and explains why share prices tend to move in sympathy. A share with *a* beta of 1 tends to rise by *10%* for a *10%* rise in the index; a share which has a beta of 2 tends to rise by *20%* once the returns to the market rise by 10% percent. To put it simply, shares of businesses with increased *betas* are far more volatile.

No company is completely unaffected by modifications in these variables and therefore the costs of practically all shares tend to move together and are usually positively correlated (Allan Hill, 2010).

**Unsystematic Risk** Unsystematic risk is that portion of complete risk, which is unique to a company (industry); frequently referred to as residual or specific risk, it relates to particular economic aspects, which influence individual industries, firms, securities and projects, for instance the quality of management or equipment failure. Due to the fact that this kind of risk is specific for the company, it is actually possible to reduce the variability of investors' returns by choosing not to place all funds in a single firm. It could also be removed completely, by means of effective diversification, as it can be seen in Figure 2, where the quantity of unsystematic risk minimizes as the amount of individual types of share in the portfolio increases:

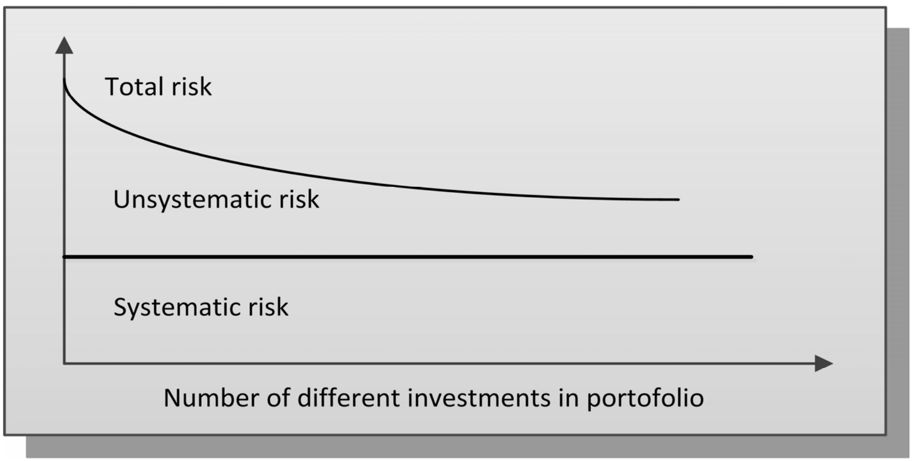


*Figure 2: Risk and diversification (Crowther, 2010)*

The implication of Capital Asset Pricing Model (CAPM) materializes upon the fact that investors will not be rewarded for bearing unsystematic risk, considering that these are able to diversify this risk away.

After removing the unsystematic risk, the risk of an individual's share is evaluated as the volatility of the share relative to the market as a whole (beta), and not as a standard deviation of return.

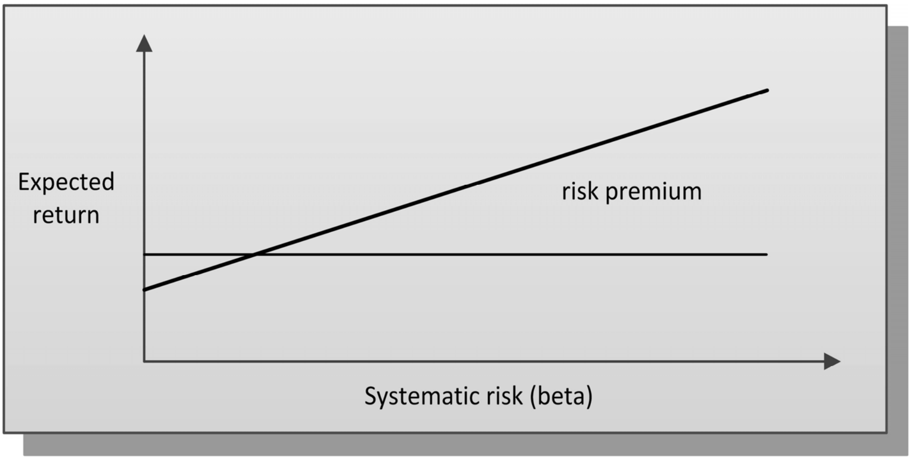


*Figure 3: Corporate Governance and Risk Management (Crowther, 2010)*

The basic portfolio concept generally describes the expected return from a dangerous financial commitment as a risk-free come back, plus a premium risk. However, we have noticed that this top quality is determined not by the overall chance of the financial commitment, but only by its systematic risk (market risk).

$$\boldsymbol{\beta_j = COR(j_m)\sigma_j/\sigma(m)} \qquad [1]$$

Based on the figure which presents the Security Market Line (SML) that decides the industry risk premium (β), several instructors, especially Ho (1963) followed by Lintner (1965), Treynor (1965) and Mossin (1966) were fast to create (quite independently) the Capital Asset Pricing Model (CAPM) as a logical extension to primary basic portfolio theory.

Nowadays, many people regard the CAPM as a superior model of security price behavior compared to others based on the wealth maximization criteria. For example, unlike the dividend and earnings share valuation models of Gordon (1962), Modigliani and Miller (1961) covered in our SFM and SFME texts, the CAPM explicitly identifies the risk associated with an ordinary share (common stock) as well as the future returns it is expected to generate. Moreover, the CAPM can also express investment returns for personal securities in two forms (Allan Hill, 2010):

$$\boldsymbol{R_j = R_f + (R_m - R_f) \times \beta_j} \qquad [2]$$

$$\boldsymbol{R_p = R_f + (R_m - R_f) \times \beta_p} \qquad [3]$$

For a given level of systematic risk, the CAPM decides the predicted return rate for any financial commitment (security, venture, or portfolio) compared to its beta described by the SML (an industry index). As we shall find out, it also ensures whether personal investments, tasks (or their portfolios) are under or above, comparative to the market (hence its name). The CAPM can therefore be used by traders or control, who wish to remove unsystematic danger through effective variation and determine the required come back for a given level of non-diversifiable, methodical (market) danger. As an impact, they can customize their portfolio investment strategies to match their personal risk-return (utility) profiles.

**The CAPM Assumptions** The CAPM is a single-index model because systemic risk is prescribed entirely by one factor, the beta factor. The CAPM is defined by random variables that are normally distributed, characterized by mean expected returns and covariance, upon which all investors agree (Allan Hill, 2010).

The use of the CAPM and beta aspects is simple as far as stock markets methods are concentrated. The style suggests that traders have three options when handling a portfolio: trade, hold, substitute.

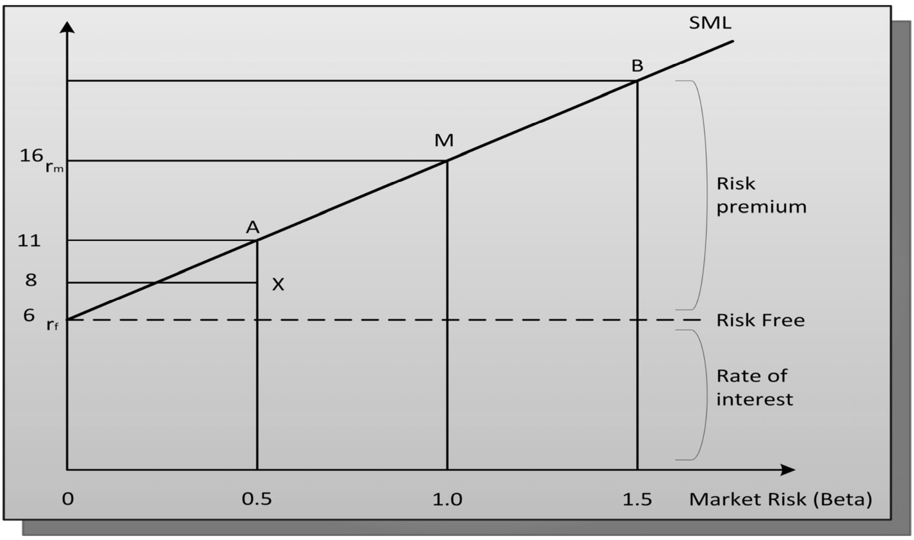


*Figure 4: The CAPM and SML (Allan Hill, 2010)*

**Evidence Regarding the CAPM** Like many other concepts, in contemporary economic theory, experts in the CAPM sustain that its presumptions are so limited that they invalidate its results, especially the buyer rationality, the ideal marketplaces and the linearity.

The CAPM is a single-period model, according to the reports for the risk-free rate, the return and the beta aspect, which all seem to create difficulties in practice. The CAPM also implies that traders will create an optimum portfolio. Therefore, the CAPM ignores unsystematic risk, which may be critical to traders who do not. However, as we have emphasized elsewhere in our research, the appropriate concern is whether a style is suitable, despite its limitations (Allan Hill, 2010).

Although Black (1993) suggested that the CAPM does not perform perfectly for investment strategies with high or low betas, overstating the necessary return for the former and understating the necessary return for the latter, most assessments examine the CAPM for a wide array of beta values (Allan Hill, 2010).

The beta-return features for personal investments can also be used for portfolios. Actually, the beta of a portfolio seems more constant because variations among its components usually cancel each other.

Way back in 1972, Black, Jensen & Scholes evaluated the NYSE, over a 35-year time interval by splitting the list into 10 investment stock portfolios, the first composed elements with the lowest beta factors. According to time sequence assessments and cross-sectional studies, they discovered that the indentify phrase was not similar to the risk-free rate, Rf. Moreover, their research unveiled an almost linear connection between a portfolio's beta and its medium return (Allan Hill, 2010).

Researchers sustained that beta will only be constant as long as a business's systematic risk continues to be the same, because it runs in the same area; however, following studies using traditional data, to identify the balance of beta over time, proved that, if beta factors are determined from past visible profits, this problem can be solved. The longer the time interval evaluated the better. The more information, the better; which indicates the use of a sector beta, rather than a company beta.

As a substitute to the primary CAPM, Black (1972) also examined a two-factor style, according to which traders could not lend at a risk-free rate but at a rate, Rz, described as the return on a portfolio with zero-beta value. This is achieved in comparison with a portfolio whose covariance with the industry portfolio's amount of come back is zero.

$$\mathbf{R_j = R_z + (R_m - R_z) \times \beta_j} \qquad [4]$$

The two-factor models achieved according to the research carried out by Black, Jensen and Scholes states that a zero-beta portfolio with an predicted return, Rz surpasses the risk free rate of interest, Rf.

Despite further variations to the unique style, the CAPM in its conventional guise continues to entice critique, particularly with regard to its basic assumptions.

For instance, although we assume that all traders can lend or offer at the risk-free rate, this does not mean that Rf represents a risk-free investment commitment in real conditions. Upcoming inflation prices are neither pre-determined, nor do they affect people similarly (Allan Hill, 2010).

Minimal improvements to a portfolio's elements may also be restricted by significant expenditures that over-shadow their upcoming benefits. The financial system can also be inclined with differential tax rates on earnings and investment profits to such a great extent that different traders will create or join investment stock portfolios that reduce their individual tax obligation (a customers effect).

We estimate an inefficient stock market. As we have mentioned before in this paper and in our SFM section, traders cannot only revenue from legitimate information by paying for the benefit. Having access to specialized data, which can even predict general activities, they may also destabilize the market. On the other hand, even if we believe that the market is effective, it has not always addressed significant changes in information, including models of results submission, takeover action and the political guidelines through to international geo-political activities. The only way to "*beat*" the market is through speculations or specialized insider details (Allan Hill, 2010). Otherwise, one can only embrace a passive policy of "*buy and hold*" to monitor the industry trend and wish for the best.

Other forces are also used to invalidate the CAPM. The model indicates that the best possible portfolio is the market portfolio, which can be found on the Security Market Line (SML) with a beta coefficient of one. Personal investments and portfolios with different stages of risk (betas) can be costly, because their predicted rate of return and beta can be in contrast to the SML. On the other hand, all investments will be on the line, because those above or below are either under or over cost as to their predicted return. As a result, the market demand, or the deficit of it, will either generate an increase or drop on cost, until the return suits that of the market (Allan Hill, 2010).

Nevertheless, defining the market seems to be a problem. Little notice is paid to the fact that the CAPM is a linear model depending on the partial equilibrium analysis that subscribes to the Modigliani&Miller (MM) law of one price. Based on their arbitrage procedure, described in the SFM section, it should noticed that two identical resources must be valued similarly.

Consequently, two portfolio elements that lead the same risk level to the overall portfolio are close substitutes; therefore, they should present the same return.

Nevertheless, it could happen that a resource has no near alternative, such as the market itself. In this case, the question is how to identify whether the market is under or overvalued.

As Roll (1977) first mentioned, most CAPM assessments may be incorrect because all stock market indices are only a partially measure of the real international market portfolio. To put it simply, the industry portfolio should involve security worldwide. If betas and profits resulting from a market list were unrelated, the investments might still be priced properly comparative to the international market portfolio. On the other hand, even if the list were effective (shares with great betas did display great returns) there is no apparent reason to suppose that each constituent's return is only having difficulties from the methodical risk. A further evaluation of the CAPM states that, irrespective of how one represents the financial commitment market, activities up and down are protected with price changes in the financial commitment strategies of larger companies. As Fama & French (1992) first discovered, it is to these companies that institutional selection financial managers (active or passive) are attracted, though they may underperform relative to smaller companies. The basic description of finance supervisors with millions to invest is that they are hostages to great amounts of money, even in venture situations. They have neither the time, nor the analysis costs to scrutinize numerous organizations "*neglected*" by the industry with little capitalization (Allan Hill, 2010).

Switching to bear marketplaces, classified by growing methodical risk, multi-national portfolio finance supervisors still have little room to move. According to Mountain and Meredith (1994), the first choice is to entirely or partially liquidate the portfolio. However, "*if the whole portfolio were sold, it could be challenging to easily obtain a huge finance without influencing the market. If the only aspect of the portfolio were liquidated, the problem would be what investments to offer. A second choice would be to decrease all holdings to be followed by the next reinvestment when the industry bottoms out. However, the drop in expenditures may have a surplus of 2% to protect deal and commission payment expenditures.*" (Allan Hill, 2010)

Clearly, both solutions may be untenable and bring considerable restrictions upon the possibilities to management risk. Indeed, those skeptical of portfolio management usually and the CAPM in particular, regard successful financial commitment as a issue of success rather than thinking, specialized information, or unlikely financial conditions where all costs shift together (Allan Hill, 2010).

**Security Market Line (SML)** is the line that results, when we plot predicted returns and betas coefficients, is clearly of some significance, so it is useful to provide it with a name. This line, which we use to explain the connection between systematic risk and predicted return in marketplaces, is usually known as the Security market line (SML).

The Security market line (SML) is "*a positively sloped straight line displaying the relationship between expected return and beta*" (Whitehurst, 2003).

Our main summary was that the required or predicted come back on a risky financial commitment is determined by three things: risk- free rate Rf, market risk premium, E(Rm) – Rf and systematic risk of the asset relative to average, which we called its beta.

Using the SML, we can write the expected return on the company's equity, E(Re) as:

$$\mathbf{E(R_e) = R_f + \beta_e \times [E(R_m) - R_f]} \qquad [5]$$

Where βe is the estimated beta. To make the SML approach consistent with the dividend growth model, we will drop the Es denoting expectations and henceforth write the required return from the SML, Re as:

$$\mathbf{R_e = R_f + \beta_e \times [R_m - R_f]} \qquad [6]$$

**Implementing the SML Approach** To use the SML approach, we require a risk-free rate, Rf, an estimation of the market risk premium Rm – Rf and an estimation of the appropriate beta, βe.

The SML approach has two important advantages. First, it clearly tunes for danger. Secondly, it is appropriate to companies other than just those with stable results development. Thus, it may be useful in a wider range of conditions.

There are obviously disadvantages, too. In order to approximate it, the SML strategy needs two elements: the industry danger top quality and the try out coefficient. To the level that our reports are inadequate, the producing price of value will be inaccurate. For example, the value for the market risk premium, 9,1%, is according to about 75 decades of profits on a particular portfolio of shares. Using different routines or different shares could outcome in very different reports.

As a final aspect, just as in the case of the results dividend growth model, we basically depend on it to estimate the long-term prospects, when we use the SML strategy. Both strategies, the dividend growth model and the SML, are appropriate worldwide and they provide identical solutions. Thus, we might have some assurance in our reports.

**Market Stock Portfolios** Determining the equation for the SML is a demand. A portfolio designed for all of the assets in the market will be considered. Such a portfolio is known as market portfolio, and we will mark the expected return as E(Rm).

Since all the assets in the market must be illustrated on the SML, so must the market portfolio designed for these assets. In order to determine where exactly it appears on the SML, we should find out the beta of the market portfolio. Because this selection is affiliate of all of the assets in the market, it must have an average risk. In other terms, it has a beta that equals 1. We could therefore express the slope of the SML as:

$$\mathbf{SML_{slope}} = \frac{\mathbf{E(R_m) - R_f}}{\boldsymbol{\beta_m}} = \frac{\mathbf{E(R_m) - R_f}}{\mathbf{1}} = \mathbf{E(R_m) - R_f} \qquad [7]$$

E(Rm) – Rf is called the market risk premium The slope of the SML, the difference between the expected return on a market portfolio and the risk-free rate (Whitehurst, 2003).

*Let us stop for thought:*

- *Total risk consists of unsystematic and systematic risk.*
- *Unsystematic risk, exclusive to each company, can be removed by collection variation.*
- *Systematic risk is undiversifiable and is determined by the industry as a whole.*

*These editions between unsystematic and combined risk are important to our understanding of the development of Modern Portfolio Theory (MPT). They approved the beta factors as an evaluation of the only risk that traders will pay a top quality to prevent. This new connection becomes obvious if we restore the CML to type what is known as the Security Market Line (SML).*

*Unfortunately, the SML only calibrates complete risk not all of which is diversifiable. Luckily, the SML provides investors a lifeline, by discerning between non-systemic and wide spread danger. The latter is determined by a beta aspect that actions comparative (systematic) danger, which describes how logical traders with different application (risk-return) specifications can choose between the optimum portfolio by credit or loaning at the risk-free amount (Allan Hill, 2010).*

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# BRAND LOYALTY AND LOYALTY PROGRAMS; A LITERATURE REVIEW

Elvira Tabaku*, Mirela Zerellari (Mersini)**


## Abstract

*Global and competitive markets have led businesses to cope with many challenges. Technology development has brought many businesses to deal with advantages which last less than before. It becomes increasingly difficult for a company to differentiate its products as they are perceived as easily imitable and fairly standard. Brand and brand loyalty come as a solution for creating a strong and long term competitive advantage for any business. The main objective of this paper is to examine the construct of brand, brand loyalty and loyalty programs. It uses secondary data from the existing literature to describe the significance of each of these constructs and their implementation on the business. It explains the benefits derived for the businesses and customers from having a strong brand and creating and developing brand loyalty. It also describes the use of loyalty programs and the benefits derived from these programs. The findings demonstrate that brand and brand loyalty are important means on the activities of today businesses. They should be studied thoroughly and empirically not only in developed but also on developing countries and in different sector of the economy. Loyalty programs should be applied properly in order to gain profitability.*


**Keywords:** brand, brand loyalty, behavioral loyalty, attitudinal loyalty, loyalty programs

**JEL Clasification:** M31

## 1. Introduction

During the last decades, economies worldwide have undergone economic transformations. Economic and financial crisis have put many organizations in severe difficulties. As a matter of fact, competition is one of the most

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important features of business in recent years. Some of these changes have created new opportunities to business organizations all over the world.

In this global market, branding is an important characteristic of the buying and selling of products, services and ideas. The research of the past decades has shown that brands are one of the most valuable assets a company could have. The companies that spend more time and effort in building strong brands and strong brand loyalty have proved to be more successful in the long run. Brands are able to augment the performance of businesses and ensure them with an important advantage. When loyalty is added to the equation, organizations are provided with a powerful competitive advantage. Strong brands and brand loyalty has shown to be significant weapons in the long run profitability of a business. Many businesses have created loyalty programs in order to enhance customer loyalty. This paper gives a theoretical approach on the conceptualization of the brand and its role for the customer and the business. After that, it focuses on the construct of brand loyalty and on the role of loyalty programs.

## 2. The brand

Companies are always striving to retain existing customers and to gain new ones. In this increasingly competitive market, it has become very important for any organization to maintain strong relationships with customers. By doing so, they can take information, understand and elaborate it and develop the proper products and services that customers want.

Brands have an important role in everyday life and are at the focus of most marketing strategies [Kapferer, (2004)], [Keller, (2003)]. Brands have a significant role in today’s trade and business. Their role has gained great importance beginning from the twentieth century although signs of brands have been found from many centuries ago. [Aaker, (1991)] suggests that branding has been practiced since the medieval era in Europe, when tradesmen and craftsmen used their names on products to avoid substitution. Branding has been around for centuries as a means to distinguish the goods of one producer from those of another. The brand is one of the most valuable intangible assets a firm may have. Building a strong brand is both an art and a science. It requires careful planning, a deep long-term commitment, and creatively designed and executed marketing [Kotler and Keller, (2012)].

[Aaker, (1991)] stated that a brand is a distinguishing name and/or symbol (such as a logo, trademark or package design) intended to identify the goods or services of either one seller or a group of sellers and to differentiate those goods or services from those of competitors. Brand names provide symbolic meanings which facilitate the decision-making process of the customers [Sullivan, (1998)]. The American Marketing Association defines a brand as "a name, term, sign, symbol, or design, or a combination of them, intended to identify the goods or services of one seller or group of sellers and to differentiate them from those of competitors." The brand serves as a protection for both the customer and the producer. It defends them from competitors who deliver products that appear to be identical. So, branding has become important as it is the only way for the consumer to differentiate between the increasing number of similar products. Brand is thus a product or service whose dimensions differentiate it in some way from other products or services designed to satisfy the same need. These differences may be functional, rational, or tangible—related to product performance of the brand. They may also be more symbolic, emotional, or intangible—related to what the brand represents or means in a more abstract sense [Kotler and Keller, (2012)].

The brand is a complex mixture of attributes. After reviewing 100 articles, [de Chernatony and Riley (1998)] found twelve main themes on brand definitions. The brand was defined as: legal instrument, logo, company, shorthand, risk reducer, identity system, image in consumers' minds, value system, personality, relationship, adding value and evolving entity. These authors declared that the brand is a multidimensional entity that exists in the communication between the organization and the customers.

Brands are unique combinations of product characteristics and added values both functional and non-functional that contain a relevant meaning which is inextricably linked to that brand, awareness of which might be conscious or intuitive [Morgan and Pritchard, (1999)]. Brands are therefore composed from functional and symbolic elements so of tangible and intangible variables [Keller, (1993); Morgan and Pritchard, (1999)]. They are of great significance on representing and differentiating one service or product from another in the perceptions of the consumer [Kotler et al., (2003)]. As composed of these different kinds of attributes, they are unique aspects of a product or service. These characteristics of the brands have compelled the marketers to put special attention on their study and their effective management has become of vital importance.

In defining brand equity, assets and liabilities are grouped into five categories which should be linked to the name and/or symbol of the brand. These are: brand loyalty, brand awareness, perceived quality, brand associations and any visual signifiers, including logos as other brand assets [Aaker, (1991].

Brand loyalty is a valuable aspect of brand equity. This is due to the fact that it is less expensive to retain the existing customers than to gain new ones [Reichheld and Sasser, (1990)].

In the process of brand-building, a business should build strong relationships with its customers. These arouse from the experience with the brand and with the multiplication of the experiences the brand gets stronger. Successful brand building involves identifying with the customer's desires and giving what they want as value (price and quality) plus the characteristics of image being sought, aspired or accepted.

## 2.1. The role of the brand

Brands today play a number of important roles that improve consumers' lives and enhance the financial value of firms. They are important for marketers, in making their offerings desirable and essential for consumers through building and communicating brand stories.

Brands are engaged in the creation of differences between products or between services. Marketers have the task to teach consumers "who" the product is, what it does and why consumers should care. They do these by giving it a name and other brand elements to identify it [Kotler and Keller, (2012)]. The power of the brand stands in its role to create mental structures that help consumers organize their knowledge about products and services in a way that clarifies their decision making provides value to the firm [Kotler and Keller, (2012)]. For branding strategies to be successful and brand value to be created, consumers must be convinced there are meaningful differences among brands in the product or service category. Brand differences often relate to attributes or benefits of the product itself.

Brand strategy is a multidimensional concept that consists of brand loyalty, brand awareness, perceived quality, brand association, and the other strategies [Aaker, (1991)]. As brands are of great significance to the buyers and sellers, building and maintaining strong brands offers many advantages to both these groups.

Brands identify the producer of a product or the provider of a service and allow consumers (either individuals or organizations) to assign responsibility for their performance to a particular manufacturer, distributor or provider [Kotler and Keller, (2012)]. Customers learn about brands through their past experiences with the product and also through the brand's marketing program. In this way, they may find out which brands are good to them as satisfying their needs and which do not. It has also the ability to simplify the decision making process [Kotler and Keller, (2012)].

The advantages to the provider are listed below:

a. The brand creates a differential advantage which leads to a competitive advantage and to consumer loyalty [Tepeci, (1999)]. It contributes to the competitive advantage of the business [Aaker, (1996)] and provides identity to the product which is being differentiated from the competitors.
b. The brand affects demand of the product or service. Literature suggests that the brand name is often indicative of the quality of the product [Sullivan, (1998)]. Therefore, when two products act as almost perfect substitutes for one another, the consumer will rely on the brand name as an indicator of the quality of the product and as a choice criterion. Hence, the brand positively affects the demand for a product leading to greater market share and profitability.
c. The brand helps to create brand loyalty. When the same brand is bought repeatedly upon a strong commitment to it, it creates loyal customers which choose the same brand, have a positive attitude toward it and recommend it to the others.
d. The brand allows for price premiums. Building a strong brand can translate into greater market share, ability to dictate a price premium, and reduced promotional expenses which all result in greater incremental cash flow for the firm today and in the future [Doyle, (2000)]. Customers have knowledge of the product or service, like it and are ready to pay e higher price (as in periods when the offer is limited). Brand loyalty also allows firms to employ premium pricing strategies which increase the level of cash flow which could be otherwise achieved [Aaker, (1996); Chaudhuri and Holbrook, (2001)].
e. The brand creates entry barriers for other competitors. Brand preference provides predictability and security in revenues for a brand over time, and possibly creates barriers of entry in the market. This can be a sustainable source of competitive advantage for the firm [Keller et al., (1998)].

The advantages to the consumer are:

a. The brand has the power to reduce the risk in purchasing. The main advantage for customers of purchasing a branded versus an unbranded product is that of risk reduction. The stronger the brand in terms of quality offered, the lesser the risk customers bear in terms of purchasing a brand which may not perform to expectations [Keller et al., (1998)].

[Kapferer, (2004)] identifies that strong brands perform a number of functions to reduce the perceived risk such as identification, practicality, guarantee, hedonistic satisfaction and other functions.

b. Facilitates product identification. From the buyer's standpoint, branding helps in identifying and recognizing the product, thus spending less time in the everyday shopping.
c. The brand creates value for the customer. The brand has the ability to create value for the consumer, and hence, the firm [Aaker, (1991); (1996)]. As consumers face difficulties in making choices due to the proliferation of similar products in the markets or product categories, brands create value by simplifying the choice process [Doyle, (2000)]. Brands not only identify the source of the product, but also promise the quality and performance which consumers trust as a result of past experiences [Keller, (1998)].
d. The brand assures quality. Branded goods or services assure certain quality and standard which are consistently maintained by the producer. By purchasing branded goods with which a number of buyers are familiar, they are sure of getting a good quality – price level. In addition, some brands confer status on those who purchase them.
e. The brand creates preferential demand. The branded products or services are often those which the customer is most familiar. Branding necessarily facilitates for the creation of preferential demand for product and service in a class of products and services. Organizations often try to convince buyers, through their combined branding and promotional efforts that their products or services are significantly better than those of competitors. It is also expected that the customer be loyal to that brand and prefer the same one over other similar competing products.

Even in cases when the competitors may duplicate manufacturing processes and product designs, they cannot easily match lasting impressions left in the minds of individuals and organizations by years of product experience and marketing activity of the brand [Kotler and Keller, (2012)]. Marketers can apply branding physical good, a service, a store, a person, a place, an organization or an idea.

## 3. Brand loyalty

From several decades, researchers and practitioners have recognized the importance of brand loyalty in the marketing literature [Aaker, (1996)]. The concept of loyalty is well known among researchers in various disciplines due to its significant marketing implications. However, despite the increasing numbers of studies on brand loyalty, there is little general agreement among researchers about what loyalty is and how it should be measured. Brand loyalty and loyal customers are very important for the future of the business and should be studied carefully [Aydin and Özer, (2005)]. Loyal customers are important for the development of the clientele of a business and have considerable impact on its profits. Different studies have shown that attracting new customers costs a business 5 times more than attaining existing ones [Kotler and Armstrong, (2012)] so brand and customer loyalty become very desirable.

Brand loyalty has been used in a business context to explain customers' repetitive purchasing models of the same brand or product/service category. Loyalty is found to be an important construct of the long-term financial performance of business firms [Reichheld, (1996)]. According to Aaker (1996) brand loyalty is a premise to the firm's competitiveness and profitability. Different researchers have found that brand loyalty is a very important strategy of achieving a competitive advantage while others have argued that brand loyalty is at the heart of the marketing activities of firms and is a key to integrated marketing. Almost all the marketing strategies are directly and indirectly related to it [Reichheld and Teal, (2001)] which makes necessary the study of loyalty.

Brand loyalty is different from the other major dimensions of brand equity because it is related more closely to the use experience. It cannot exist without prior purchase and use experience while awareness, associations and perceived quality are characteristics of many brands that a person has never used. However, brand loyalty is influenced in part by the other major dimensions of brand equity; brand awareness, brand associations and perceived quality. The strategy to repurchase the same brand refers to brand use satisfaction, perceived superior value, and a preference or loyalty for the brand [Prasad and Dev, (2002)]. Brand loyal consumers provide the basis for a stable and growing market share of a company.

Several studies are dedicated to brand loyalty as a result of its significant role for both the businesses and the customers. Different authors have conceptualized brand loyalty in different ways. Brand loyalty is the biased (non-random) behavioral response (purchase) expressed over time by some decision-making unit with respect to one or more alternative brands out of a set of brands and is a function of psychological processes and emotional response [Jacoby, (1971)]. While, Jacoby and Chesnut (1978), suggested that brand loyalty "is a biased (non random) behavioral response (purchase), expressed over time from a decision making unit, considering one or more alternative brands and is a function of psychological processes (decision making, evaluative)". These authors specified also four kinds of brand loyalty:

1. *True focal brand loyalty* is when the consumer demonstrates loyalty to the brand that is being investigated, referred to as the focal brand.
2. *True multi-brand loyalty* is when the focal brand is included in a set of brands that the customer patronizes.
3. *Non loyal repeat purchasing of focal brand* occurs when a consumer patronizes a brand even though he or she does not hold a strong emotional commitment towards it.
4. *Happenstance purchasing of focal brand* occurs when consumers of a different brand patronize the focal brand in the absence of their personal choice.

One of the most cited definitions of brand loyalty is the one given by Oliver (1999), which states that "brand loyalty is a deeply held commitment to re buy or re patronize a preferred brand consistently in the future, thereby causing repetitive same brand or same brand set purchasing, despite situational influences and marketing efforts having the potential to cause switching behavior". Special attention in the literature is dedicated to the study of Dick and Basu (1994). They conceptualised customer loyalty as a combination of repeat patronage and relative attitude toward an aim or object which could be the brand, the service or the business. Dick and Basu (1994) explored different levels of customer loyalty stating that through the comparison with other competitors can be reached a better indicator of repeated purchases. By this combination, they identified four categories of loyalty.

*True loyalty* can be reached by the combination of high attitude and high patronage from the same provider. This is the ideal case for every business and service provider who wants to have loyal customers. *Latent loyalty*: is the case when the level of repeated purchases at the same provider is low or there are not such purchases while the favorable attitude is strong. The reason for this may be situational factors or social norms which lead the customers toward a competitive provider while having a stronger attitude toward another one. So, these factors have a greater impact than the attitude in determining of buying behavior. Customers who are more oriented toward price may choose the service provider based on the offered price although they may have strong positive attitude toward another provider. Customers who cannot change the actual provider may show latent loyalty to other providers and managers should try to impact on these situational factors. *Spurious loyalty*: is the case when there is no relative attitude or this attitude is weak while the level of repeated purchases is high, so there is behavioral but not attitudinal loyalty. Customers continue to buy to the same provider without having a strong relative attitude but for other reasons such as familiarity with the provider, prior agreement or because of the absence of other alternatives. This kind of loyalty may be with products or services that demand little involvement or when the customer cannot percept the differences between brands or services. It may be the result of interpersonal relationships where the purchase is continuous even though the service or product is perceived to have minor differences from the one of the competitors. The provider should know to change this situation in true loyalty encouraging the positive attitude through the marketing strategy that aims the attitudinal loyalty. *No loyalty:* is the combination of weak attitude and low purchases. The cause for the low relative attitude may be the entry of a new service/product so it is impossible for the customers to compare it to actual ones. Another reason may be the competitiveness of brands or services as they may be viewed as very similar and without differences with each-other.

There are many benefits that accompany brand loyalty. The importance of consumer brand loyalty to the success and continued growth of brands has been recognized in different studies [Chaudhuri and Holbrook, (2001)]. Organizations should ensure that creating and holding brand loyalty is central to their marketing strategies in order to ensure greater leverage of trade, reduced costs, customer retention, satisfaction and attraction [Aaker, (1991); Keller, (1993)]. In many markets there is substantial inertia among customers even if there are very low switching costs and low customer commitment to the existing brand. Existing loyal customers expose the brand to new customers through word of mouth. Loyal customers are considered very valuable to the organization because they represent continuous revenue that can be for a long time. The level of switching for loyal customers will be lower, causing their value to be higher. So, customer loyalty is an important construct of the long term financial performance of business firms [Reichheld, (1996)]. Brand loyalty generates value to companies. It leads in a substantial entry barrier to competitors, an increase in the firm's ability to respond to competitors' threats, greater sales and revenues, a customer base less sensitive to the marketing efforts of competitors.

Consumers will have a preference for a particular brand and will develop loyalty towards it when exists a positive brand attitude and image. Brand loyalty is dependent upon consumer trust within a brand [Lau and Lee, (1999)] and is a result of maintaining positive brand equity [Aaker, (1991)].

### 3.1. Dimensions of brand loyalty

There are different dimensions of brand loyalty in the literature and the result of different brand loyalty studies are not the same. This is due to the fact that the conceptualization, the development and the analysis of the construct of customer loyalty have changed with time. Some studies have conceptualized customer loyalty as a one dimensional construct, while others have conceptualized it as more than one dimensional.

*Behavioral loyalty*

The early studies have conceptualized customer loyalty as composed of one dimension, the behavioral one. From a behavioral view, customer loyalty is defined as patronage, the proportion of times a purchaser chooses the same product or service in a specific category compared to the total number of purchases made by the purchaser in that category [Rundle-Thiele and Bennett, (2001)]. Referring to this approach, customer loyalty is interpreted as repeated purchases that result in the extension of the purchases and expenditures with the same provider [Russell-Bennett et al., (2009)]. Only the customers who buy continuously from the same provider could be considered loyal ones. But, only the behavior indicators of loyalty do not represent an accurate framework of the reasons why these customers buy, the way customer loyalty is developed and the factors that cause it [Jacoby and Chesnut, (1978; Dick and Basu, (1994); Pritchard et al., (1999); Zeithaml et al., (1996)]. Different researchers [Dick and Basu, (1994); Jones and Taylor, (2007)]; [Russell-Bennett et al., (2009)] have criticized the use of the behavior approach of customer loyalty. They have emphasized that the conceptualization of customer loyalty must be done through the inclusion of attitudinal loyalty.

*Attitudinal loyalty*

The attitudinal dimension explains why people patronize a product or service. It contains a preference, a positive attitude over time and a psychological commitment. Attitudinal loyalty consists on the commitment toward a brand or service and on the intention to buy it [Mellens et al., (1996); Russell-Bennett et al., (2009)]. It is seen as a psychological connection with the service or product [Jones and Taylor, (20070; Oliver, (1999)]. Researchers have conceptualized attitudinal loyalty as an attitude, preference, intention to buy

[Zeithaml et al., (1996)], desire to recommend the service provider to other potential customers [Reichheld, (2003)], commitment to continue to buy at the same service provider and strong relationship with him [Pritchart et al., (1999)] and encouraging others to use the service. Despite the positive elements, the conceptualization of loyalty as attitudinal has gained different criticism. Despite the thought that attitude can precede the behavior, attitudinal loyalty has not the power to predict the actual and future behavior [Mellens et al., (1996)]. There is little assurance that customers who have the attitude to buy will do it in the future and this way attitudinal loyalty will lead to scarce profits for the organization [Kumar and Shah, (2004)]. The reliance only on the attitudinal loyalty cannot satisfactorily explain brand loyalty.

*Two dimensional loyalty*

The combination of the behavioral and attitudinal loyalty is a more valid and reliable method to measure customer loyalty [Jones and Taylor, (2007); Russell-Bennet et al., (2009); Oliver, (1999)]. The use of both behavioral and attitudinal components of loyalty was first proposed by Day (1969) and since then many other studies have proposed the use of behavioral and attitudinal elements in the conceptualization of brand loyalty [Baloglu, (2002); Day, (1969); Dick and Basu, (1994); Jones and Taylor, (2007)] because neither behavioral loyalty nor attitudinal loyalty alone cannot asses and analyze thoroughly the construct of brand loyalty [Baloglu, (2002)].

Despite the number of studies dedicated to it [Baloglu, (2002); Kumar and Shah, (2004)] there is no agreement between the researchers about the dimensions of customer loyalty [Jones and Taylor, (2007)] and only a few studies are focused on both dimensions simultaneously. The literature has proposed the relationship that may exist between both dimensions of loyalty [Li and Petrick, (2008b)] indicating that the understanding of attitudinal loyalty can be a better predictor of future behavior than past one.

## 4. Loyalty programs

In this increasingly fierce competition, it is necessary for businesses to hold customer data and to create customer databases. By doing so, they could have greater knowledge for the base of their customers and could also offer more personalized services and products to them. This way, businesses would have the opportunity to fulfill customers' preferences and to enhance brand loyalty [Reichheld and Schefter, (2000)]. Recent developments in information technology have provided instruments for marketing managers to create new Customer Relationship Management tactics. One of these tactics is the loyalty program [Uncles et al., (2003)]. The primary aim of these programs is to collect and record various data about business customers. When all data in the information system have been adequately processed, they become a competitive advantage in designing various types of programs that focus on present and future customers. Because the majority of loyalty programs simply reward repeated purchases, the effectiveness of loyalty programs is often gauged only by the level of repeated patronage, which as indicated above, does not indicate true loyalty. For this reason [Dowling and Uncles, (1997)] suggested that loyalty programs should not only focus on repeat patronage, but also on attitudinal loyalty. Referring to [Uncles et al., (2003)], customer loyalty programs have two aims:

a. to increase sales revenues by raising purchase/usage levels, and/or increasing the range of products bought from the supplier.

b. to build a closer bond between the brand and current customers, hoping to maintain the current customer base.

The goal of such programs is to enhance customer relationships by offering high value to profitable market segments [Kumar and Shah, (2004)]. Managers believe that it is desirable and expected for a properly executed loyalty rewards program to increase usage of the company's product or service offerings [O'Brien and Jones, (1995)].

Loyalty programs are often perceived as being part of a marketer`s repertoire of promotional tools, fostering repeat purchase rather than attitudinal commitment, indicative of a short rather than long-term

relationship orientation [Bridson et al., (2008)]. Almost every industry has developed card issuance systems that offer card members various types of deals, discounts and incentives. Different kind of businesses such as stores, gasoline stations, telecommunication companies, airlines, credit card companies, hotel chains and banks intensively use various means to attract potential customers to their loyalty programs by way of advertisements and newspaper articles [Wirtz et al., (2007)]. As many service firms suffer from undifferentiated offerings and low switching costs [Reinartz and Kumar, (2000)], loyalty reward programs might be an effective tool to relationship building. [Wirtz et al., (2007)], examined the impact of loyalty programs and the effect of perceived switching costs on behavioral loyalty, as well as the moderating effect of attitudinal loyalty on this relationship. They affirmed the effectiveness of loyalty programs and also demonstrated how attitudinal loyalty moderates the relationships between loyalty programs attractiveness, perceived switching costs, and behavioral loyalty.

Despite the facts mentioned above, some researchers still question whether the positive financial outcomes of the loyalty reward programs exceed the investments made in the program [Bolton et al., 2000)]. They call for other empirical studies on the outcomes of brand loyalty and loyalty programs.

## 5. Conclusions

The constructs analyzed on this paper are considered important elements of marketing research and they have gained much attention in the marketing literature, in the last decades. The critical analysis of the literature suggests that brands are significant elements of the everyday focus of marketers. Companies worldwide are striving to create and develop strong brands which will lead to higher profitability. The advantages of the brand mixed with the advantages of brand loyalty have provided businesses with powerful competitive advantages. Because of the many benefits customers but especially businesses gain from the implementation of these constructs much attention is dedicated to loyalty programs and the profitability they generate for the business. These elements have made the basis of the competitive strategies businesses use to deal with the fierce competition of the global markets nowadays. Many studies have aimed on theoretical and empirical investigation of brand loyalty and loyalty programs. They call for the performance of other studies on these constructs in order to have a thoroughly conceptualization of them. The aim is to have more useful information and knowledge for the proper application of the marketing strategies from practitioners.

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# INVESTMENT-LED DEVELOPMENT IN CHINA – FROM PAST ACCOMPLISHMENTS, TO FUTURE CHALLENGES[1]

Sarmiza Pencea
Iulia Monica Oehler-Sincai

## Abstract

*For over three decades, investment-driven development has generated great results in Chinese catching-up endeavour. China is now second only to the USA among the world's largest economies, it ranks the first manufacturer and the top exporter and importer of goods globally, is the second most important destination for global investments, and it dominates many of the world's markets. At the same time, following for too long a high investment rate development path, China has evolved into a highly unbalanced economy, that has accumulated vulnerabilities and distortions which signal that its investment-led development model is no longer sustainable, posing the economy to considerable risks. It, therefore, needs to be changed.*

*Against this backdrop, the main questions we are trying to answer to in this paper are: first, if no longer relying so heavily on investments is a feasible development for China in the near to medium-term future, and secondly, what could be the expected impact of the Chinese investment wane on the other actors on the global stage. To this end, we will use the most recent data and statistics, as well as the accumulated knowledge on the subject from the scientific investigations carried out by other researchers, both westerners and Chinese, trying to push further our own previous research findings.*

**Key words:** China, development model, investment-driven, investment deceleration, external impact, investment-led development, consumption-led development, economic rebalancing

**JEL Classification:** E21,E22, O16, O41, O53, P21, P27

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## 1. Introduction

For over three decades, investment-driven development has generated great results in Chinese catching-up endeavour. China is now second only to the USA among the world's largest economies, it ranks the first manufacturer and the top exporter and importer of goods globally, is the second most important destination for global investments and it dominates many of the world's markets. At the same time, following for too long a high investment rate development path, China has evolved into a highly unbalanced economy, that has accumulated vulnerabilities and distortions which signal that its investment-led development model is no longer sustainable.

China's economy has become increasingly dependent on investments in time (Box.1) and, consequently, it became increasingly unbalanced, unstable, uncoordinated and unsustainable.[2] The last decade, especially the years of the global economic crisis, have aggravated its addiction to public investments, once the huge, USD 586 billion investment and fiscal stimulus was implemented (2008-2010) to counteract the global economic crisis. The stimulus helped both China and many of its partner countries keep growing and deal better with the crisis, but it has also generated distressful consequences in the short run (inflation) and in the long run (speculative bubbles, increased indebtedness, nonperforming loans, infrastructure and industrial overcapacities, wastage, corruption), worsening previous imbalances and creating new ones.

Box 1: **Evolutional Stages of the Chinese Development Model**

Subsequent to 1978, the year when the reform and opening strategy was launched by Deng Xiaoping, one can identify six distinct evolutionary stages of the Chinese growth model:

- 1978-1988 – balanced, domestic market-led growth;
- 1988-1991 – investment-led slowdown, following the "Tiananmen Square Event";
- 1991-2001 – investment-led growth, intensively stimulated by Deng Xiaoping's Southern tour (1992) and the "Go Out Policy/Going Global Strategy" of 1999;
- 2001-2007 – export and investment-led growth, after China's accession to the WTO;

[2] The four "un-s" identified in 2007 by former Chinese premier Wen Jiabao as features of the Chinese economy condition.

- 2008-2010 – need for change – the international financial and economic crisis revealed the structural weaknesses of the Chinese economy:
  - flawed pricing and
  - the consequently flawed resource allocation;
  - overinvestment and repressed domestic consumption;
  - an oversized manufacturing system vs. an anemic services one;
  - a natural resource and energy intensive manufacturing system generating high pollution;
  - an excessive dependence on foreign technology, R&D, innovation;
  - an excessive dependence on foreign markets;
  - a yawning income gap
- 2011-present – the start of China's "Great Rebalancing".

Source: Zhu and Kotz (2011), completed and updated by the authors.

According to Chinese authorities, a 7.2% minimum growth rate would be currently needed to create yearly the necessary 10 million new jobs, and keep the unemployment rate in the urban areas around 4% of the active population (Reuters, 2013). With real GDP growth rates sliding from 9.3% in 2011, to 7.7% in 2012-2013, 7.4% in 2014 and even lower levels in the years to come (IMF, 2014a) there are clear signals that the economy might soon not be able to create enough employment, in spite of the still high investment growth rates. Obviously, the Chinese economic model has run out of steam and it needs to be changed.

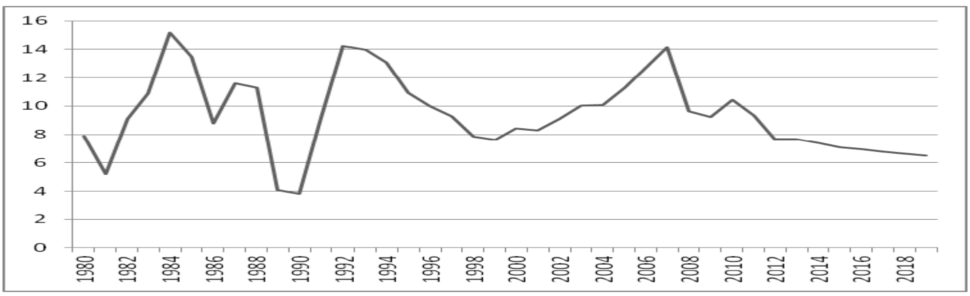


Fig. 1: GDP, constant prices, 1980-2019 (percent change)
Note: 2014 estimations, 2015-2019 prognoses.

Source: Own representation based on IMF (2014a).

International experts recommend a transition of the Chinese economy from an export and investment-led model to a more balanced growth, underpinned by private consumption (IMF, 2014b). Many Chinese scholars also point out that a distinct "problem of China's growth trajectory" is its high dependence on manufactures, exports and investment, aiming at maintaining its high growth (Zhu, Kotz, 2011), to the detriment of the services industry and consumption. In spite of a yearly 9% average growth rate of the domestic consumption, its share in China's GDP not only remained low during the 1980-2010 time-frame, but it was also falling due to a speedier average growth of both GDP and investments. This is not a unique country case. Along their development path, some other Asian economies recorded low and decreasing shares of consumption to GDP due to a similar growth strategy, the export-promotion industrialization supported by massive investment (McKinsey Global Institute, 2011, pp. 17-18), but they were not so extreme as in China's case.

China's transition from an investment-driven growth and the prominence of manufacturing – relying on cheap local inputs (labour, capital, energy, land), foreign technology and foreign demand – to a domestic consumption-driven growth model, with a dominant tertiary sector and high local innovation capabilities, is not a simple, linear, or brief endeavour. We think that investments will play further a major part in China's economy, because, on the one hand, their abrupt cut would be dangerous to China and to the world, on the other hand, because there are powerful vested interests in favour of keeping investments growing and they are expected to oppose change (state-owned enterprises/SOEs, banks, influential party and state administration members who control these units and profit from them) and, finally, because the restructuring processes and policies themselves (urbanization, R&D development, climbing the technological ladder, environment protection, FDI encouragement, etc.) require or imply investments.

That is why, despite the emphasis on economic rebalancing, **the official data show that GDP growth is still driven by investment** and fixed investment annual growth rate in real terms continues to be close to 20% (NBSC, 2014).

What is reasonable to expect is that the investment growth rate will start to slow while the domestic consumption growth rate accelerates, until their respective contributions to China's GDP would be reversed. Besides the fact that this is easier said than done, what is more important than this switch, in our opinion, is that such a recalibration of the aggregate demand components should be accompanied by a qualitative shift to a much more efficient resource allocation.

## 2. Notions of Risks and Advantages of investment-driven development

The idea that China should rely more on domestic demand is not new, as emphasize Stiglitz and Yusuf (2001). It has only got more intense in recent years.

There is a large literature related to over-investment and investment misallocation in China (Lee *et al.*, 2012). It is estimated, by comparing the investment and capital-to-output ratios, that "*China may have been over-investing by between 12 and 20 percent of GDP relative to its steady-state desirable value*". Also, it is revealed that the marginal contribution of an extra unit of investment to growth has been diminishing and the costs of over-investments transferred to households and SMEs through the financial sector (Lee *et al.*, 2012, p. 14, 16).

Ma *et al.* underscore that the current levels of consumer spending (household consumption estimated at 35% of GDP) and investment (close to 50% of GDP)[3] in China are the lowest and highest such rates, respectively, among all major economies. The increase in savings was even more accelerated than that in investments, which contributed to large current account surpluses (Figures 2 and 3). High savings and investment rates in China (Figure 2) were encouraged by factors such as the rural-urban migration starting with the 1990s, the SOEs restructuring in the 1990s, the transition to a new pension system and the introduction of private home ownership, the market opening and the increased foreign competition associated with the WTO accession (Ma *et al.*, pp. 74-76).

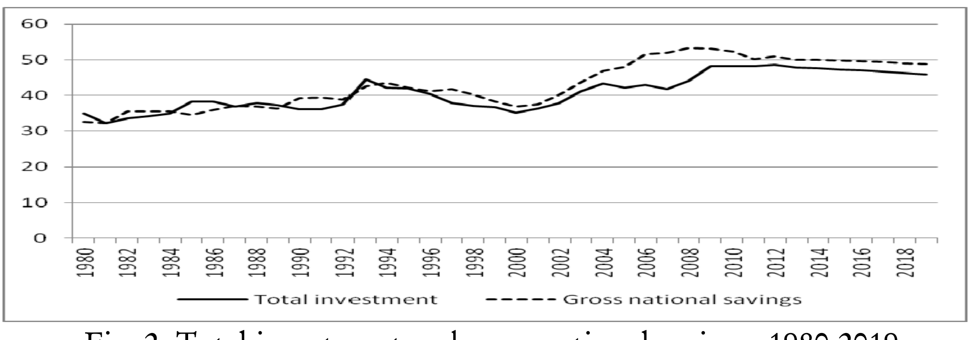


Fig. 2: Total investment and gross national savings, 1980-2019 (percent of GDP)

Note: 2014 estimations, 2015-2019 prognoses.

Source: Own representation based on IMF (2014a).

[3] Much larger than those of developed countries, of 20% or less, according to The Economist, 2012.

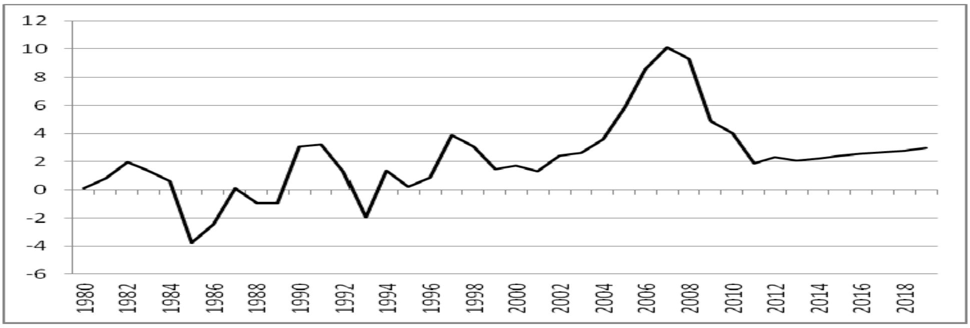


Fig. 3: Current account balance, 1980-2019 (percent of GDP)
Note: 2014 estimations, 2015-2019 prognoses.
Source: Own representation based on IMF (2014a).

The Chinese high investment rate is explained by some authors by turning to the capital-labour ratio which is still below the steady-state level (Knight, Ding, 2009, p. 4). According to Bai *et al.* (2006), the aggregate rate of return to capital averaged 25% during 1978-1993, it fell during 1993-1998, and has become flat at roughly 20% since 1998 – a “reasonably high level”, as indicated by Knight, Ding (2009, p. 31).

Additionally, a massive reallocation of resources towards more productive categories took place: from the state sector to the private sector, from agriculture to industry and services, and from domestic to foreign markets (Knight, Ding, 2009, p. 31). We would also add the massive reallocation of resources from households to SOEs by way of financial repression, which became the main mechanism for subsidizing industrial development. According to Pettis (2013a), households still subsidize growth by 4% of GDP, yearly.

An important positive mutation took place in 2013, when, for the first time, the value added by the tertiary sector (46% of GDP) surpassed that of the secondary sector (44% of GDP), while the primary one maintained around 10% of GDP, similarly to previous years (NBSC, 2014). The investments in fixed assets (excluding rural households) were distributed in proportion of 2.1% to the primary sector, 42.3% to the secondary sector and 55.6% to the tertiary sector, reflecting the government’s drive to spur the development of services.

On the other hand the real estate sector is worrisome, recording an unusual high growth rate during 2001-2013, and bringing its share in the total fixed assets investment from around 17% in 2001, to an alarming level of 25% in 2013. Much of this increase can be explained by rural-urban migration but also by “white elephant projects” and their financing through the obscure channels of shadow banking (Oehler-Sincai, 2014).

Another important by-product of the investment and export-driven growth is the unbalanced regional development in China. In spite of the governmental program of investment in the regions that lag behind ("Go West" strategy), the eastern areas still record the largest share of the total investments in fixed assets (40%), as compared to the central (24%), western (25%) and northern regions (11%) (NBSC, 2014).

## 3. Investment-led, consumption-led development in China, or both?

According to official statistics, consumption makes less than 50% of China's GDP (as compared to the worldwide rate of 80% of GDP, or the US rate of 88%), while the gross savings rate is more than 50% (Zhang, Zhu, 2013). Some research papers emphasize that China's consumption is underestimated in the official statistics, due to a set of factors, most of them underlining the poor methodology (Zhang, Zhu, 2013, Cai, 2014). Consequently, the real rate of consumption could account for 60-65% of GDP, which is 10-15 percentage points higher than the official data. These figures should be correlated with other investigations, that assert that investment is overestimated by more than 10% of GDP (Cai, 2014).

Some of the Chinese specialists state that the artificial stimulation of consumer spending could be more dangerous than investment, providing examples from the 1997-1998 Asian financial crisis and from the global collapse of 2008-2009. Therefore, not the axiom "spend more and invest less" should be the solution for rebalancing the Chinese economy, but the quality of investment in high technology and education, in order to increase the total factor productivity (Cai, 2014). Other studies underline that China needs to increase the efficiency in input use, to innovate and make the shift to higher-value services (IBRD and DRC, 2013, p. 11).

At its current level of per capita GDP, China is already the largest market in the world for cars and many consumer products, including most luxury goods (Forbes, 2012). According to some specialists, the continuous rise in GDP per capita (Figure 4) "*will create a market for consumer goods unlike any the world has ever seen before*" (Forbes, 2012). Consequently, consumption will become dominant in the economy.

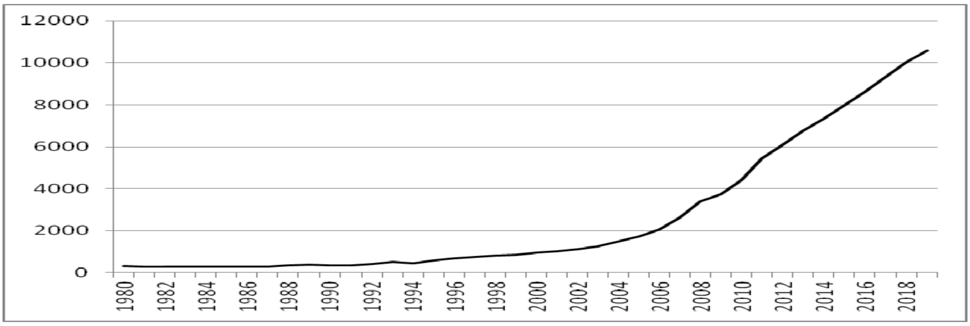


Fig. 4: GDP per capita, current prices, 1980-2019 (USD)
Note: 2014 estimations, 2015-2019 prognoses.
Source: Own representation based on IMF (2014a).

Still, investment will continue to play a significant role, due to a host of factors. We will mention below only some of them.

(1) To develop a more advanced and a technology-driven economy, the State Council adopted in 2010 the Decision on Accelerating the Development of Strategic Emerging Industries (SEIs). There are seven nominated SEIs: energy efficient and environmental technologies (correlated with the "Go-green policy"), next generation information technologies (IT), biotechnology, high-end equipment manufacturing, new energy, new materials and new energy vehicles (NEVs). These industries are projected to account for 8% of GDP by 2015 and 15% of GDP by 2020 (The US-China Business Council, 2013, Xinhuanet, 2012, Eurasia Group 2011);

(2) There are investment policies that encourage manufacturers to expand into central and western China (Eurasia Group 2011) and renewed efforts to improve the investment climate. In February 2014, the State Council (China's Cabinet) approved a plan to reform business registration, which will contribute to fairer, opener and more transparent market rules (Xinhuanet, 2014a). The amendment to China's Corporation Law came into force in March 2014.

(3) Although at lower pace, investments in infrastructure will continue to augment. An amount of USD 3.6 trillion is forecasted until 2020 (Eurasia Group 2011). In March 2014, the Chinese authorities unveiled a National New-type Urbanization Plan for 2014-2020, intended to encourage the urbanization process centred on people and the environment (Xinhuanet, 2014b).

It should be underscored that some driving factors spur simultaneously consumption and investment. One example is the internal migration from rural areas to cities, inducing both investment and a natural consumption "windfall" (Eurasia Group, 2011, p. 24). In 2013, the total number of migrant workers was estimated at about 270 million people, accounting for almost 20% of the total population (NBSC, 2014).

Considering such determinants and trends, experts from the World Bank and the Development Research Centre of the State Council appreciate that consumption to GDP ratio will come to exceed 60% in the next ten years, while the investment to GDP ratio will fall under 40% (Table 1).

**Table 1: China – Growth pattern until 2030 assuming steady reforms and no major shock**

| Indicator | 1995–2010 | 2011–15 | 2016–20 | 2021–25 | 2026–30 |
|---|---|---|---|---|---|
| GDP growth (percent per year) | 9.9 | 8.6 | 7.0 | 5.9 | 5.0 |
| Labor growth | 0.9 | 0.3 | −0.2 | −0.2 | −0.4 |
| Labor productivity growth | 8.9 | 8.3 | 7.1 | 6.2 | 5.5 |
| Structure of economy (end of period, %) | | | | | |
| Investment/GDP ratio | 49 | 42 | 38 | 36 | 34 |
| Consumption/GDP ratio | 47 | 56 | 60 | 63 | 66 |
| Industry/GDP ratio | 46.7 | 43.8 | 41.0 | 38.0 | 34.6 |
| Services/GDP ratio | 43.1 | 47.6 | 51.6 | 56.1 | 61.1 |
| Share of employment in agriculture | 36.7 | 30.0 | 23.7 | 18.2 | 12.5 |
| Share of employment in services | 34.6 | 42.0 | 47.6 | 52.9 | 59.0 |

Source: The World Bank and the Development Research Center o f the State Council, P. R. China, 2013, p. 9.

To conclude, rebalancing and changing the growth model in China – and everywhere else, for that matter – is hardly a question of "either dominant investments, or dominant consumption", but rather a question of identifying the optimal mix of the aggregate demand components, for each development stage in this country's evolution.

## 4. The External Impact of Chinese Investment Deceleration

Changing the development model will play a vital role in rebalancing the Chinese economy, but, given the size of this economy and its deep global integration, the shift will influence in one way or another, directly or indirectly, to a smaller or greater extent, all the other countries of the world. Both foreign companies operating in China and the host of companies present in the international markets will have to cope with a changing and more volatile environment under the impact of the mutations taking place in this country, and both companies and economies should adapt and reform themselves in parallel with it.

The global spillovers will be transmitted both by trade, financial, investment channels and through the global value chains (GVC) and networks of the international production system, having a bearing on both the counties' GDP and on the global trade and growth. A slower growth of China's fixed investments and the shift in their structure will greatly influence the size and direction of trade and money flows, international prices and all the actors in the marketplace.

Following 1978, China implemented an explicit strategy of internal and external accumulation of capital (Palley, 2005), which allowed for a swift industrialization and modernization, and for turning the country into the no. 1 manufacturer of the world. This process implied an import basket where capital goods, machinery and equipment, parts and components had a dominant share. As the country developed, industrialized and became in many industries the final link of global value chains (GVCs), but especially after the implementation of the 2008-2010 stimulus, which favoured infrastructure investments, China's import basket changed radically. Altering the investment profile to a dominance of infrastructure and urbanism projects and to nurturing services and high-tech (HT) industries, has generated a downward trend in the imports of capital goods and a surge in those of commodities, raw materials for industry, real estate and infrastructure development.

Slowing the investment growth rate is supposed to induce new alterations in China's import basket, affecting directly some of China's trade partners, and indirectly, through its impact on the international prices, having a bearing on all the other actors in different global markets.

- The most exposed to a slowing investment growth rate in China will be the Asian exporters of components involved in regional value chains (VCs) which have terminal links in China (such as Taiwan, South Korea, Malaysia, Thailand, Philippines, Japan, etc.). Ahuja&Nabar (2012) estimate that one percentage point (pp) decline in the Chinese investment growth rate could trigger a significant decrease of the GDP growth rates in these countries: over 9 tenths of a pp in Taiwan, 7-8 tenths in Malaysia and South Korea, 4 tenths in the Philippines and 1 tenth in Japan. If the investment slowing would be located in Chinese manufacturing, the impact on these countries would be similar, but if it would be located in the tertiary sector, the impact would be considerably milder.

In spite of the apparently small numbers, such an impact is not at all negligible. According to Lee *et all.* (2012), the investment share in Chinese GDP should be lowered by at least 10 pp (to 40%) in five years, which means that investments should grow much slower than GDP during this interval.

Considering Pettis' (2013a) estimation that, for such an adjustment to be possible, the investment growth rate should be 4.5 pp lower than the GDP growth rate, and taking into account the fact that in China investments keep growing annually by 19-20%, while the 2014 GDP growth will only hardly reach the 7.5% target, it results that Chinese investment should grow by maximum 3% yearly. It results, further, that a massive reduction, of 16-17 pp of the investment rate would be required to bring the total investment share in GDP to 40%, in five years. Although the estimated spillovers in the countries mentioned above will not be 16-17 times larger, this still provides a telling image of the magnitude of impact China could inflict on its VCs partners.

- Excessive infrastructure capacities in China will lead to significantly slowing investments in this sector (Eurobiz, 2013), with a further negative bearing on the companies exporting infrastructure-building and transport equipment to China. Governmental policies will decisively influence which of the sectors will suffer or not (Pettis, 2013b), but we expect that assured beneficiaries of further investments and incentives will be HT industries, green industries and high value-adding services. Therefore, exporters of HT equipment, the ones that can provide productivity-enhancing equipment and technologies, or can contribute to fighting pollution and developing environmental-friendly industries are best positioned to take advantage of the opportunities opened by the Chinese economic rebalancing. Similarly, foreign companies interested in developing joint research and innovation projects with local partners will also enjoy considerable opportunities in China in the following years (Pencea, 2014).
- In case of a temporary shock to China's fixed-asset investments, the impact would be felt the world over, triggering a global trade slowdown, but the most significant negative impact would be felt by capital goods manufacturers with a sizable direct exposure to China, especially the ones from Germany and Japan (Ahuja&Nabar, 2012). Less severe outcomes would be registered in the USA, EU, South Korea, India, Brazil or Canada, while Australia or Indonesia would be insignificantly touched.
- Another category of exporters that might benefit from Chinese reforms are those from countries with a strong manufacturing sector, especially emerging and developing economies where labour and other inputs are still relatively cheap. They will be able to take advantage of China's inevitable loss of competitiveness in international markets, once economic rebalancing reforms are implemented. Increasing costs with inputs – either labour (rising wages), capital (rising interest rates), land, energy or natural resources (rising prices, once markets are gradually liberalized) – and the costs incurred by

overcapacities, as well as a potential strengthening of the yuan will all lead to a loss of competitive force on China's side, to the advantage of its former competitors in various markets. A good example is provided by Mexico, whose manufacturing sector was almost decimated by China's aggressive pricing, but it now already feels the outcomes of a relatively weaker competition from China (Pettis, 3013b).

- A strongly affected group of China's trade partners will be the exporters of commodities for industry (iron ore, copper, aluminium, etc.) and real estate and infrastructure building (cement, steel). The most affected are going to be the countries with undiversified economies, which export mainly mineral resources and have a large exposure to China (such as Chile, Zambia, Saudi Arabia, Iran, Kazakhstan). In these countries, for each pp reduction of the investment growth rate in China, there might be an almost 40% of a pp loss in their economic growth (Chile, Zambia, Saudi Arabia). On the other hand, large mineral resources exporters with diversified economies, such as Australia, Brazil, or Indonesia will be less affected by the Chinese economy evolutions (Ahuja&Nabar, 2012).
- A declining Chinese demand for resources it once consumed in excess just as a result of its investment-intensive development, such as aluminium, copper, iron ore, etc., is expected to entail a sharp decline in international prices of these commodities, with a double and contradictory impact on the actors in the specific international markets: (i) on the one hand, the providers of these goods, mainly mines, will face a major double loss – they will export less, and they will gain less for their exports, due to the fall in prices. Also, they will be hit harder if they had made investments to increase capacities so that they could meet China's demand (producers in countries such as Peru, Brazil, South Africa, Australia are in this position); (ii) on the other hand, the buyers of these goods will be favoured, taking advantage of price cuts by up to 50% in the following years (Pettis, 2013b). Additionally, a slowdown of the global growth triggered by China's measures to calm investment could also determine a 3-9 pp reduction in the growth rate of prices for iron ore, aluminium, copper, lead, nickel and zinc. The largest impact would be felt in zinc prices, followed by the nickel and lead ones (Ahuja&Nabar, 2012).
- Swift investment growth in China is responsible for multiple imbalances, but one of the most acute is that of overcapacities, an issue which is vital for the industrial system reform. In this respect, one of the expected consequences of changing the growth model is a speeding up of consolidation processes. Relatively inefficient, uncompetitive Chinese companies in the industries where the government intervenes less, or those lacking access to cheaper capital are

already subject of mergers and acquisitions (M&A). It is not yet clear what the government is going to decide for SOEs, but there is a moderately positive expectation regarding a probable acceptance of private, and possibly even foreign capital involvement in their restructuring processes (Eurobiz, 2013).

- On the other hand, Chinese companies will further internationalize and the Chinese government will further search the world for profitable investments of its huge foreign exchange reserves, so that capital outflows from China are expected to intensify. Already the gap between capital inflows (FDI) and outflows (ODI) is quickly narrowing (Figure 5) and soon China will become a net capital provider for the world economy. Consequently, for the capital-hungry companies and economies new opportunities to attract Chinese investments are expected to appear.

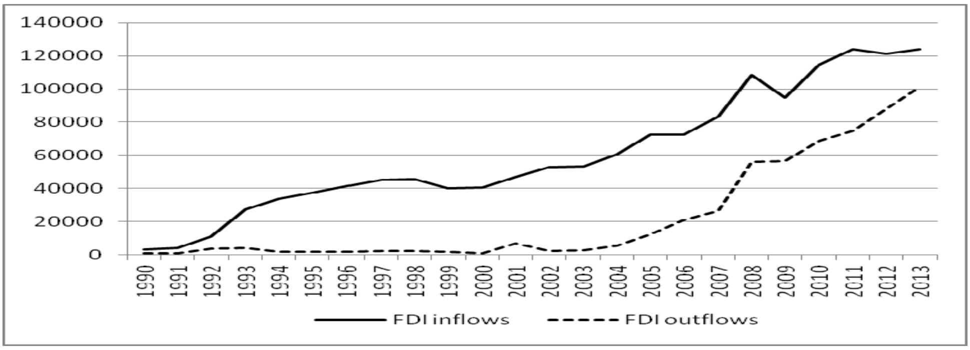


Fig. 5: China – FDI inflows and outflows, 1990-2013 (millions of dollars)
Source: Own representation based on UNCTAD (2014).

- As the incomes of Chinese population keep increasing, by deliberately having wealth transferred from state, back to households, reversing the actuality of households still subsidizing economic growth by 4% of GDP (Pettis, 2013a), as Chinese middle class becomes more robust and public services become strong enough to oust precautionary saving, households will increasingly spend and consume more and exporters around the world will have better opportunities in Chinese markets. Still, the process will be rather slow and it will tightly depend on how the government decides to increase household incomes. It makes a great difference if the government chooses to either (i) increase wages (negatively affecting competitiveness), (ii) liberalize interest rates (bearing on bank profits and on the financial repression as an instrument supporting cheap investment capital), or (iii) make imports cheaper, by letting the RMB appreciate (discouraging exports), because each of these measures benefits a different household category and, consequently, different providers of goods and services for these consumers. Additionally, the degree of market openness to foreigners and the levelled playing field will also depend on government's vision and policies.

Pettis (2014) considers that a substantial increase might take place in China's imports of food and agriculture products and there will be good opportunities for exporters in this field. On the contrary, exporters of consumer goods should not expect significant volume increases in China, as this market will absorb mainly locally manufactured goods. Similarly, Ahuja&Nabar (2012) conclude that for consumer goods exporters the impact of increased consumption in China might be marginal. At the same time, considering the low intensity of imports in Chinese consumption, they appreciate that for the exporting countries to China the spillovers generated in terms of GDP growth by an increased Chinese consumption are, for the time being, negligible.

## Conclusion

To capitalize on China's growing domestic consumption, foreign companies must be extremely flexible, adapting their supply to the local specificities and tastes, attending to the large cultural diversity of Chinese provinces and to the fragmented market it generates. Consumers in Beijing, Shanghai, or Souzhou are different and they should be targeted in different ways. Additionally, they are prone to change themselves, due to increased contacts with the western world and improved access to information.

China's market has always been a mix of great opportunities and challenges for westerners. The current reform, upgrading and rebalancing processes in China imply deep, complex and interconnected transitions, with multiple implications both at home and abroad, making both local and foreign companies, both domestic and international markets face challenges and opportunities like never before, in a more volatile and risky environment. Laying new stress in China on market freedom, domestic consumption, efficient allocation, innovation, productivity, competitiveness, etc. will radically change the economic environment in both Chinese domestic market and global markets, and the potential "earthquakes" in some of the Chinese industries will undoubtedly shake the world economy, trying the adaptive power of both partner countries and companies. In a changing world striving for redefining itself, many of the "recipes" that worked in the past might become inefficient and only the capacity to innovate in every way will make the difference between losers and winners.

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# PROPERTY RESTITUTION IN ROMANIA – COSTS AND BENEFITS

Alexandru-Cristian Roşu*

**Abstract:**

*The issue of property restitution in Romania remains even in XXI Century a challenging legal institution. It has been linked to civil, commercial and even criminal law, as our economy has been affected in a significant way by the property restitution process. Due to the legislation lacks or misinterpretations, Romania has become a subject of criticism regarding property right, more specific regarding the properties that were abusively taken by the state during the communist regime. According to Government estimations, a total of EUR 21 billion will be needed to pay the compensation provided for by the compensation law.*

**Keywords:** National interest, property right, compensation measures, laws, restitution of properties, budget cost.

**JEL Classification**: P16, P21.

The broad concept of national interest reunites the sum of ideals and objectives in areas as economy, military action, culture, politics and social wellbeing in a state, as this notion is often associated with the realistic approach of international affairs.

The components of national interest are expressed through values that translate themselves into real objectives that need to be fulfilled. In order for the objectives to be established, the right means must be chosen and with them, the concrete ways to further proceed. This is accepted both when an initiative is launched by the author of those objectives and when he has to answer to an initiative that is proposed by another, therefore to answer to an external stimuli. The finality of the process consist by identifying an answer (following the same sequel: objective- method- mean) to assure the highest degree of national interest value[1].

In 1991, 1995 and 2001 Romanian Parliament passed laws for property restitution to their lawful owners who lost their possessions during the

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[1] http://bogdanmandru.wordpress.com/relatii-internationale-ce-reprezinta-interesul-national/

Communist regime (1945- 1989). Te main goal of these laws was to clarify and accelerate the Communist abuse restoration process. Without such normative acts, the alternative for former previous owners would have been to address the court directly and in some cases no resolving what so ever.

The February 1991 land reform, which followed the Romanian Revolution of 1989, sought to privatize land resources that were in state hands during the Communist period. The goal was to restitute land in state cooperatives to its pre-collectivization owners, with families that did not own land at the time also receiving small allotments. Amidst an anti-Communist public mood of 1990-91, the restored interwar parties (PNL and PNŢCD) loudly called for restitution; initially, the governing ex-Communist National Salvation Front resisted the demand and sought to grant all rural residents 0.5 ha, but in a bid to capture the rural vote, it gave in to pressure to dismantle the collectives, although capping the size of restored properties to 10 ha [2]. (The Front claimed this would promote social equity, with others claiming a political motivation: the recreation of a viable, propertied middle class in agriculture, one that could exert certain kinds of pressure on the state, was precluded.)

In addition to righting a perceived historical injustice, the reform also pleased Romanian farmers, who have a long tradition of working their own land and are tied to it not only for subsistence needs but also out of sentiment (for instance because their ancestors retained it through fighting in wars). Given that many families still held legal title as evidence of their claim to the land, and retained a clear memory of where their plots were located (a memory kept alive during Communism), failure to restitute risked creating significant social unrest. As well, given the relatively egalitarian land structure prevailing in 1949, historical justice (emphasized by the opposition) coincided with the social equity considerations that preoccupied the government.

Law no. 112/1995 stated that the former owners - natural persons - of dwelling-houses, passed as such into the property of the State or of other legal persons, after March 6, 1945, with title, and were in the State or other legal persons' possession on December 22, 1989, shall benefit by the remedial measures provided by law. By the provisions shall also benefit the heirs of the former owners, according to the law[3].

The persons benefited by the restoration in kind, by reacquiring the property right on the flats in which they lived as lessees or of those which are not occupied, and for the other flats they shall receive indemnification. In the case of flats passed into State property for which indemnifications were

[2] Official Gazette of Romania, Part. I, No. 37 of February 20, 1991

[3] Official Gazette of Romania), Part I, No. 279/November 29, 1995

received, if they are occupied by the former owners or are free, they shall be restored in kind. The reacquisition of the property right is conditioned by the repayment of the sum received as indemnification, brought up to date. By flat in the sense of the law, shall be understood the dwelling consisting of one or more rooms, with outhouses, garages and annexes connected with the dwelling, service rooms, garrets, cellars, sheds and suchlike, too, regardless of whether they are situated on the same level or at different levels, and which, at the date of their passing into the State's property, constituted a single self-coif the former owner or the respective heirs were living on December 22, 1989 as lessees in the flats passed into State property, they shall become owners of the respective flat, under the provisions of the law.

In case that several heirs were living on December 22, 1989 each in a flat passed into State property from the former owner, they become the owners of the respective flat. The former owner or the respective heirs, who were living on December 22, 1989 in the same flat together with other lessees, became owners of the whole flat. Evacuation of the lessees and giving possession to the owners were made only after the public authorities or the owner effectively provides an adequate dwelling.

Heirs in the sense of the Law no. 112/1995 were considered by right the acceptors of the inheritance after the date when the petition provided by law was registered. If relatives up to the second degree of the former owner still alive were lessees on December 22, 1989 in the flats taken over by the State from the former owner, the flats shall become their property, with the written consent of the owner.

The law stated that contract titular lessees of flats that are not restored in kind to the former owners or their heirs may choose to buy these flats with down payment of the price or by installments. So many of the lessees of flats that were not restored bought the flats.

According to Law no. 10/2001 all properties abusively taken over by the state, by the cooperative organizations or by any other juristic persons during March 6, 1945 - December 22, 1989, as well as those taken over by the state on the basis of the Law No. 139/1940 on requisitions and not restored, shall be restored, as a rule, in kind. In the cases in which the restoration in kind was not possible, reparative measures through an equivalent were established. The reparative measures through an equivalent shall consist of compensation with other goods or services offered as an equivalent by the holder, with the agreement of the entitled person, of granting shares in trading companies transacted on the capital market, of face value securities used exclusively in the privatization process, or of pecuniary compensation.[4]

[4] Official Gazette of Romania, Part I, No. 75 of February 14, 2001

By properties abusively taken over it was to be understood:

a) the properties nationalized through Law No. 119/1948 on the nationalization of the industrial, banking, insurance, mining and transport enterprises, as well as those nationalized without valid title;

b) the properties taken over by confiscation of the fortune, as a result of a conviction for crimes of a political nature, provided for in the penal legislation, committed as a manifestation of the opposition to the totalitarian communist system;

c) the properties donated to the state or to other juristic persons on the basis of some special normative acts adopted during the period March 6, 1945 - December 22, 1989, as well as other properties donated to the state, if the action for the rescission of the deed of gift or for the acknowledgement of nullity of the gift by a final and absolute judgment was admitted;

d) the properties taken over by the state for non-payment of taxes for reasons independent of the owner's volition, or those considered as abandoned, on the basis of an administrative order or of a judgment, during the period March 6, 1945 - December 22, 1989;

e) the properties taken over by the state on the basis of certain laws or other normative acts unpublished on the date of the takeover in the Official Gazette or the Official Bulletin;

f) the properties taken over by the state on the basis of Law No. 139/1940 on requisitions, and which were not been restored or for which the owner did not receive equitable compensation;

g) any other properties taken over by the state with valid title, such as it is defined in art. 6 paragraph (1) in Law No. 213/1998 on public property and the legal regime thereof;

h) any other properties taken over without valid title or without the observance of the legal provisions in force on the date of the takeover, as well as those taken over without legal grounds by decision documents issued by the local organs of the power or of the state administration.

The persons whose properties were taken over without valid title maintain the quality of owner they had on the date of the takeover, which they shall exercise after the receipt of the decision or judgment of restoration, in accordance with the provisions of the law.

A problem appeared when the rightful owners of the buildings that were abusively taken over by the state during March 6, 1945 - December 22, 1989 tried and obtained the property of the houses that were bought by tenants according to Law no. 112/1995. Another problem was the delay process in solving the problem. The best solution would have been to have a clear cut decision at some point, even if on the legal edge or even a more restrictive one, in terms of restitution conditions. Another problem, even more important, is that of buildings which are returned twice: once to the rightful owners confiscated after 1949; and the second time, to those living in the houses in the 80s, with a right to live there but without property rights, who were evacuated when the buildings were demolished due to public utility works.

According to the Romanian Government, 202782 claims had been registered with the local authorities under Law no. 10/2001. 119022 files had been examined and an award of compensation had been proposed in 56000 cases; 46701 files compiled under Law no. 10/2001 and 375 under Government Emergency Ordinances nos. 83/1999 and 94/2000 had been forwarded to the Central Board, which had issued 10.345 “compensation certificates”. The remaining files were under consideration; With regard to Laws nos. 18/1991 and 1/2000 concerning agricultural land, according to a partial calculation relating to eight out of forty-one counties, almost one and a half million claims for restitution or compensation had been lodged with the local authorities. A total of 55271 files compiled under the laws in question had been forwarded to the Central Board, which had granted 21279 of the claims and had issued 10915 “compensation certificates”. The remaining files were under consideration; With regard to claims for restitution of land or compensation under Law no. 247/2005, over 800000 claims had been registered with the local authorities. Approximately 172000 of these had been granted and compensation had been proposed; Of the persons who had received “compensation certificates”, 15059 had opted to receive part of the sum in cash, amounting to a total of about RON 2 billion (approximately EUR 400 million). 3850 people had received payments totaling about RON 350 million (approximately EUR 80 million). Shares in the Proprietatea Fund, in existence since December 2005, are still not listed on the stock exchange. However, since 2007 the Fund has been paying dividends to its shareholders and since March 2008 its shares may be sold by means of direct transactions under the supervision of the stock exchange regulatory authority. By way of example, 206 sales of shares were registered in May 2010. According to the information published on 4 June 2010 by the Proprietatea Fund, the Ministry of Finance is the majority shareholder, with 56% of the Fund's shares. A further 12% are held by 103 legal entities, while 31.4% are owned by 3622 individual shareholders. According to Government estimates a total of EUR 21 billion will be needed to pay the compensation provided for by the compensation law.[5]

[5] http://propertyrightsintransition.com/denying-justice-by-delaying-it

The lawfulness of the public administration implies a relation between legislative and executive powers, independence of justice that functions as a guardian of constitutional rights in relation with state's institutions giving certain juridical guarantees regarding the predictability of judicial ruling and a juridical protection against those rulings, as well as a law making process that national parliament must obey.

Guarantying fundamental rights and equality in front of the law represent a decisive element for any state of law. The basic function for this principle is to protect de individual against any unlawful intrusion of the state, protecting him of any administrative action whenever his freedom is affected. Also, the state has to guarantee the fundamental rights and protection against any illegal actions against an individual.

Giving this context, the necessity of academic debate regarding the promotion of state of law in an ever changing Europe is beyond any doubt. European judges criticized the lack of consistency in our internal legislation as well as a lack of limitation regarding financial compensations that can be given in property restitution matter.

Also, the magistrates have noticed that aside from all this problems, few of juridical decisions have been respected. In the last 15 years, European Judges have solved thousands of cases coming from Romania, as in the current year, 1000 more have been registered. Giving the lack of progress for Romania in this matter, and the numerous cases in which the European Court of Human Rights underlines the problems of our legislation, it becomes obvious that our national interest is affected as Romanian citizens can not find an answer to their juridical problems at national levels.

Beyond juridical details of property restitution process, there are two features that make Romania unique in Central and Eastern Europe: inconsistency in giving compensation or assets to previous owners, as several laws were given in the last decade and created confusion; abusive behavior both at central and local level made possible by laws that can be avoided and non unitary juridical practice, visible in what concerns property restitution proceedings from one county to another.[6]

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[6] http://sar.org.ro/wp-content/uploads/2011/08/Policy-memo341.pdf,

# THE DETERMINING OF WAL-MART EFFICIENCY USING "DU PONT" FORMULA

Iuliana Militaru, Elena Lucia Croitoru, Zoltan-Fabian Mehes[1]

## Abstract

*The purpose of this paper is to study the efficiency of a company using "Du Pont" and implicitly the most common and important ratios (such as ROE and ROA) taking into consideration the cash flow and dividend payout. The impact that this figures have on the average company growth and how it could be improved lowering the dividend payout or improving the ROE and/or ROA.*

*Due to the importance of "Du Pont" formula this study aims to show how different indicators depend on one another when you are trying to run a financial analysis on a company. How different indicator or ratios can mean one thing in a certain situation that doesn`t apply in general, especially when the analysis scope is to find a sustainable growth.*

**Key Words:** Du Pont formula, sustainable growth, ROE, ROA.

**JEL Classification:** G30, G32, G35, M20, O40

## 1. Introduction

In financial management a common form of analyzing the financial statement is through ratios that clearly illustrates the situation of the company. The positive outcome of this analysis is that you can find out if it's a good opportunity for investment or not. In this study we will use: Net Profit Margin (NPM), Asset Turnover (Asset T/O), Financial Leverage (FL), Return on Equity (ROE), Capital Ratio (CR), Dividend Payout Ratio (DPR) and Return on Assets (ROA).

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The financial performance could be assessed through ratio analysis so we can further obtain a description of the future and past financial development of the company. In this study it will be measured the profit growth using “Du Pont” formula because it’s an important tool to illustrate the performance of the management and the strategic decisions they have made in the past for the company’s future.

The following study has the objective to study if the NPM is high or low, if it’s high than there is a sustainable growth. To see if the Asset T/O is high so the assets generate enough revenue to be efficient and if the financial leverage could allow the company to borrow more capital to invest more in their assets. Based on ROE and CR we can find out what is the required ROA in order for the company to have a sustainable or satisfactory growth. Based on ROE and DPR we can find out which is the possible growth per year and how can we improve the growth per year reducing DPR and increasing ROE.

## 2. Analysis of the financial situation of Wal-Mart

Wal-Mart is an American company that started its activity with a small grocery store in the state of Arkansas U.S.A. in 1962 that became the most successful retailer in the world with sales of over 485 billion dollars worldwide. It is the biggest private employer in the world with almost 1.8 million employees in over 11 000 chain stores from 27 countries[2].

The study contains the financial data for the past 5 years regarding the ratios and financial indicators that have led them to be the most successful retailers in the world. The interpretation of the study will be based on secondary data from different text books and articles in order for it to be up to date with the latest information and see what should be or not be improved.

Table 1 – Wal-Mart financial indicators[3]

| Date | 1/31/15 | 1/31/14 | 1/31/13 | 1/31/12 | 1/31/11 | 1/31/10 |
|---|---|---|---|---|---|---|
| Gross profit margin | 24.29% | 24.31% | 24.38% | 24.50% | 24.74% | 24.78% |
| Operating profit margin | 5.63% | 5.68% | 5.96% | 5.98% | 6.10% | 5.91% |
| Net profit margin | 3.39% | 3.39% | 3.65% | 3.54% | 3.91% | 3.54% |
| Assets T/O | 2.38 | 2.33 | 2.31 | 2.31 | 2.33 | 2.39 |
| Sales (millions) | $485,651 | $476,294 | $468,651 | $446,950 | $421,849 | $408,085 |
| Financial leverage | 2.37 | 2.52 | 2.48 | 2.55 | 2.64 | 2.34 |
| Return on Equity (ROE) | 20.10% | 21.01% | 22.27% | 22.01% | 23.91% | 20.26% |
| Capital Ratio | 42.19% | 39.73% | 40.24% | 39.17% | 37.91% | 42.72% |

[2] *Gereffi G., Ong R. (2007),* Wal-Mart in China, *Harvard Asia Pacific Review, vol 9, no.1, pp. 46-49*

[3] *http://stock.walmart.com/investors/financial-information/annual-reports-and-proxies/default.aspx*

| Date | 1/31/15 | 1/31/14 | 1/31/13 | 1/31/12 | 1/31/11 | 1/31/10 |
|---|---|---|---|---|---|---|
| Dividend Payout Ratio | 37.80% | 38.31% | 31.54% | 32.15% | 27.07% | 29.42% |
| Return on Assets | 8.03% | 7.83% | 8.37% | 8.12% | 9.07% | 8.40% |
| Assets (millions) | $203,706 | $204,751 | $203,105 | $193,406 | $180,782 | $170,706 |
| Equity (millions) | $85,937 | $81,339 | $81,738 | $75,761 | $68,542 | $72,929 |

Source: Own calculation based on Wal-Mart Balance Sheets

"Du Pont" Formula:

ROE= Net Profit/Sales * Sales/Assets * Assets/Equity

ROE= Net Profit Margin * Asset Turnover * Financial Leverage

The indicators were calculated using the following formulas[4]:

NPM= Net Profit / Sales*100

Asset T/O= Sales / Assets

FL= Assets / Equity

ROE= NPM*Asset T/O*FL

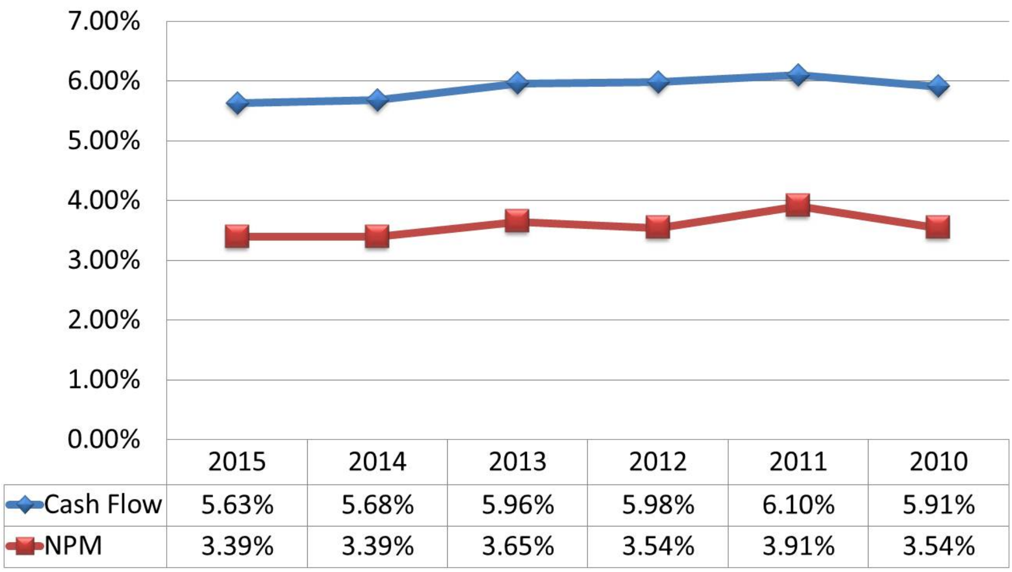
Others:

CR= Total Equity / Total Assets*100

DPR= Dividends / Net income*100

ROA= Net income/ Total Assets*100

Graphic 1 – Cash Flow Evolution

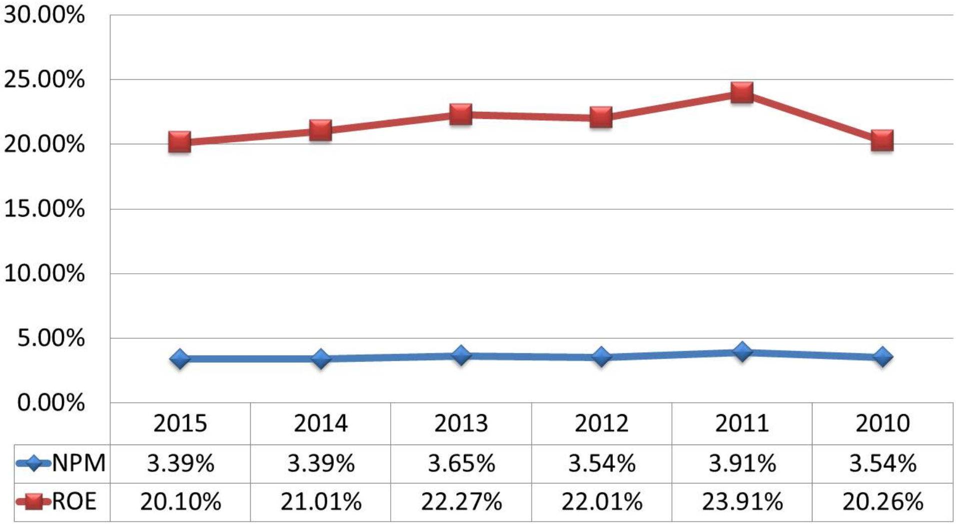



As we can see in the ratios and figures there is a significant difference between cash flows (operating profit margin) and net profit margin which shows that they are making further investments to expand and have short term and medium term debts. By short term debts we mean suppliers costs and

[4] Emery D., Finnerty J., Stowe J. (2006), Corporate Financial Management 3rd Edition, *Prentice Hall publisher*

shareholders that may loan the company cash to help it run its operations. This might be the case of Wal-Mart.

Graphic 2 – NPM Evolution




The net profit margin is fairly good and consistent for the past five years oscillating from 3.3% to 3.9% in 2011, due to the massive revenue that the company is generating. Let's take for instance 2014 the company had a net profit of $16.5 billion from which they paid in dividends $6.2 billion to its shareholders. They have successfully integrated the economy of scale in their company reaching the profitability that other competitor dream of. The American company is the first, Carrefour coming second with about $123 billion in revenue. The small NPM could be related to the big cash flows that create interest rates that have to be paid to its stakeholders, but is good because the ROE is generating enough revenue to be efficient with the correlation with ROA. The secret of having an excellent NPM in this case is to make the assets work efficient to generate higher income. This company has a sustainable growth correlated to its size. But if this was the case to a smaller company it would have needed to increase the NPM taking into consideration its size.[5]

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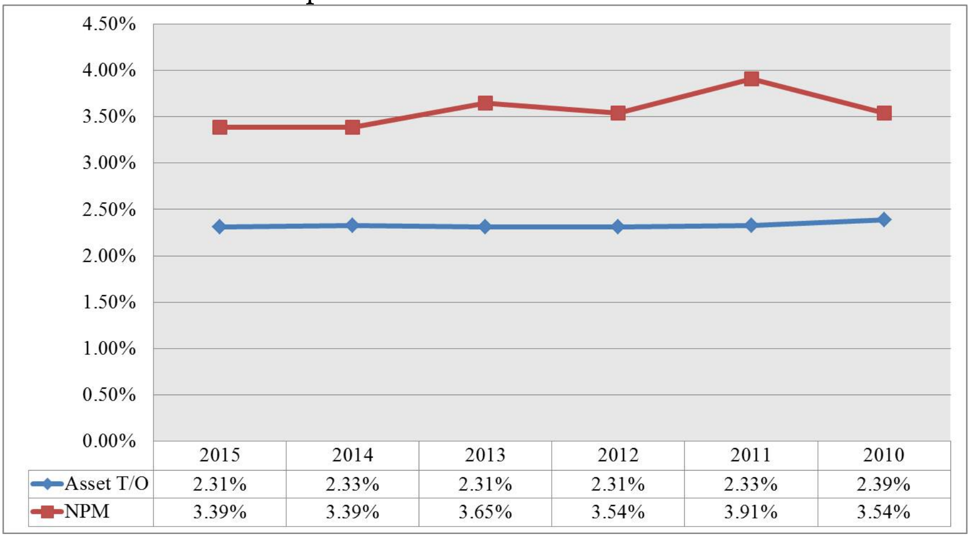
[5] Heikal M., Khaddafi M., Ummah A.(2014). Influence Analysis of Return on Assets, Return on Equity, Net Profit Margin (NPM), Debt to Equity Ratio (DER) and current ratio (CR), against Growth in Automotive in Indonesia Stock Exchange. *International Journal of Academic Research in Business and Social Sciences*, Vol. 4, No 22, 101-114

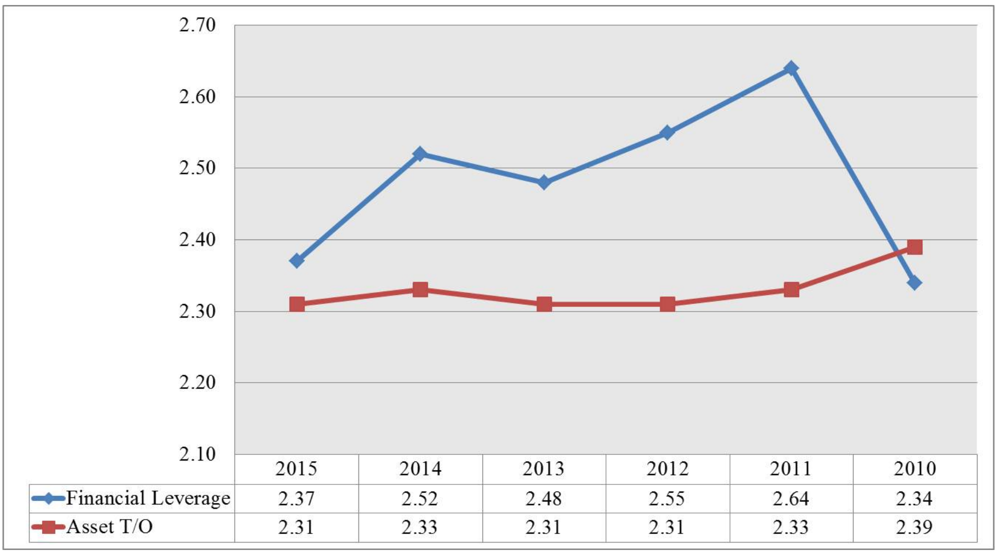
Graphic 3 – Asset T/O Evolution




| | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|
| Asset T/O | 2.31% | 2.33% | 2.31% | 2.31% | 2.33% | 2.39% |
| NPM | 3.39% | 3.39% | 3.65% | 3.54% | 3.91% | 3.54% |

The assets T/O is stable for the past five years at 2.3-2.4; this shows the sales that the assets create yearly. They are you using their assets efficiently maximizing their sales, this with the NPM show how solid their growth strategy is and should continue by lowering the DPR with 5% - 10% to have a boost in capital, available for future investments.

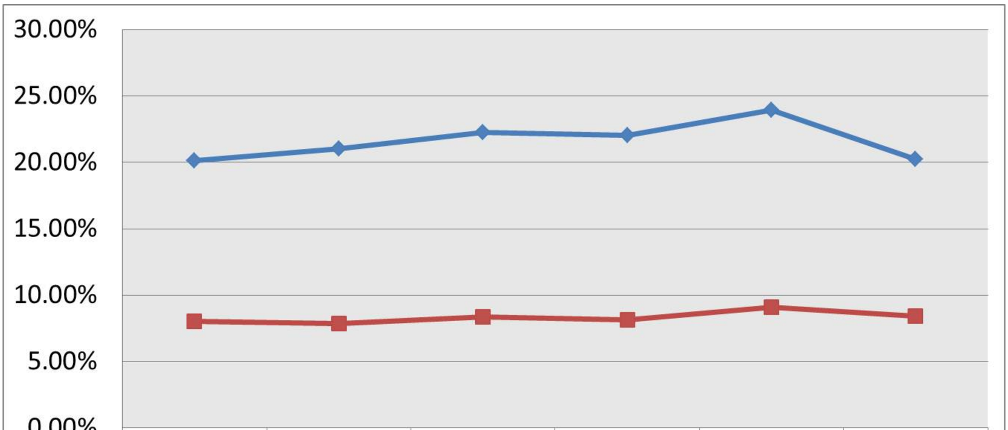
Graphic 4 – Financial Leverage Evolution




| | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|
| Financial Leverage | 2.37 | 2.52 | 2.48 | 2.55 | 2.64 | 2.34 |
| Asset T/O | 2.31 | 2.33 | 2.31 | 2.31 | 2.33 | 2.39 |

The financial leverage is good at 2.37 and allows them to get loans for future expansion strategies if they won't like to increase the NPM or decrease the DPR. Getting external loans could stress the entire balance sheet although the interest rate would be very low for them, depends on the value of the loan, they could easily try to get the necessary capital from other sources. The financial leverage is recommended to be as low as possible at 1 or even lower, taking into consideration all the factors that are presented by this specific company it is understandable but not ok. It would be recommended to increase their equity in order to get to a more effective and stable financial situation.

Graphic 5 – ROE & ROA evolution




| | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|
| ROE | 20.10% | 21.01% | 22.27% | 22.01% | 23.91% | 20.26% |
| ROA | 8.03% | 7.83% | 8.37% | 8.12% | 9.07% | 8.40% |

The return on equity (ROE) gives the investors an idea of the growth rate the company could have for a period of time. Investors consider that a company that has a ROE between 5% and 10% will have a medium growth over the next 3 to 5 years.[6] Taking into consideration that, investors need to take a close look over the balance sheet, so they can understand what is really happening in that organization, within the market. As we can see Wal-Mart has a ROE of 20-22% which is very high compared with CR and ROA linked together. The reason why there is such a huge gap is that they have a large cash flow that allows them to pay out dividends to the shareholders. That is why ROA and ROE are so far apart.

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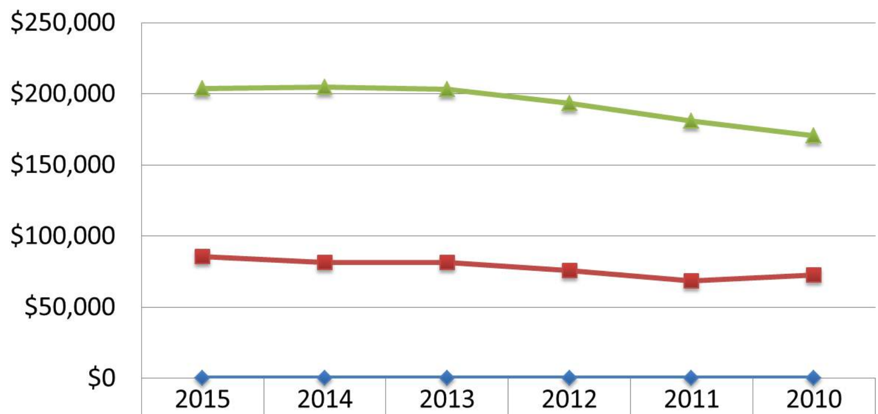
[6] Haque M. (2005). Impact of leverage on Return on Equity, *Proceedings of the Academy of Accounting and Financial Studies*, vol. 10, no. 1.

To understand better the importance of the "Du Pont" formula, we will simulate a situation where we have two companies but have to invest in one. Both have the same ROE of 12%. Which is better to invest in?

| Company | A | B |
|---|---|---|
| Net profit margin | 15% | 15% |
| Asset T/O | 1.5 | 2 |
| Financial Leverage | 2 | 1.5 |

As you can see both have the same net profit margin and ROE, but Company A has Asset T/O of 1.5 and company B has 2. That means that company B is more efficient in generating more revenue with their assets than company A. Company B has FL of 1.5 which is better than company A, otherwise it would've had a higher NPM. Company B could take more loans to invest in the company and make it generate more profits and get a higher Asset T/O. The conclusion here is that the investment should be made in company B, not in company A.

Graphic 6 – Capital Ratio evolution




| | 2015 | 2014 | 2013 | 2012 | 2011 | 2010 |
|---|---|---|---|---|---|---|
| Equity (millions) | $85,937 | $81,339 | $81,738 | $75,761 | $68,542 | $72,929 |
| Assets (millions) | $203,706 | $204,751 | $203,105 | $193,406 | $180,782 | $170,706 |
| Capital Ratio | 42.19% | 39.73% | 40.24% | 39.17% | 37.19% | 42.72% |

The capital ratio shows that the company has increased its equity and sold some of its assets. The company has taken on additional debt for future investments or sold some additional stock and has sold some of its assets. But is stable due to the high ROA (due to volume) and a high cash flow, otherwise the company in hand could be heading straight to bankruptcy. The best scenario would be a decreasing capital ratio that would mean that the company would have bought back some stock or finished paying up some loans.

Based on the DPR the company has distributed to its shareholders to get 37.8% of the profit, taking into consideration the ROE[7] of 20% should allow them normally to have a growth of around 10% for the next year, but taking into consideration the high cash flow that goes through Wal-Mart it will be limited at 4-6%, which is still good for a retailer this size. The company growth is higher when the DPR is low and the ROE is high. The following table will show you how DPR and ROE influences the growth per year indicator.

Table 2 – Possible company growth per year ratios

| **DPR** | **ROE** | | |
|---|---|---|---|
| | **10%** | **12%** | **16%** |
| **20%** | 8% | 9.6% | 12.8% |
| **30%** | 7% | 8.4% | 11.2% |
| **50%** | 5% | 6% | 8% |

The return on assets is fairly stable at around 8% over the past 5 years with a few oscillations, but none to take note of. The ROA is low compared to ROE; this could mean that the managers are having some problems, not making the best decisions. It is easy to invest a huge capital and make money out of it, but it is very hard to make a lot of money out of a small capital. This shows that the management isn`t that good at what it is doing although we have a big cash flow through the company and a huge ROE and a big DPR. ROA should still be at 12-13%. Wal-Mart is not generating that much revenue with their assets. they are concentrating their resources on making money out of ROE. This is interesting, because of the size of the company, there assets are huge, but taking into consideration the size of the assets and the size of the equity they should be close. So if you just have ROA and ROE you would consider that the company has management problems, but looking over the assets and equity and taking into consideration the cash flows it all makes sense.[8]

## 3. Conclusion

This study has shown us how to conduct a financial analysis over a company in order to find the possible growth it will have in the future. As you

[7] Kolbe L., Vilbert M., Villadsen B. (2005). Measuring Return on Equity Correctly. *Public Utilities Fornightly*, 143, no.8, p. 23-27

[8] Jewell J, Mankind J (2010). What is ROA? An investigation of the Many Formulas for calculating ROA, *Proceedings of the Academy of Education Leadership*, Vol.15, no.2, 62-64

can see just the "Du Pont" formula could give you enough to get started. The "Du Pont" formula contains the NPM formula, Asset T/O formula and the Financial Leverage formula; all of them have been included in ROE so you may conduct your own analysis. As a bonus to go deeper into the company analysis you may use the capital ratio to see the recent activity if they have gone further into debt or have paid up loans so you know what you are investing in. The dividend payout ratio helps us understand how much of the net income is given to its stakeholders or what could be the growth per year in correlation with ROE. ROA could give the gist of how their managers are taking decisions if they are good the ROA would be high, if the ROA is low, some counter-measures should be taken into consideration, for example changing the managing team.[9]

Wal-Mart has shown us how a big company works from a financial point of view, how things that in a small company are considered bad, in a big company they are the best choice for a high performance. The high DPR with the high cash flows are enormous, but come to think of it it's just a small portion of their revenues. The high Asset T/O shows us how much they generate with 1 dollar worth of assets. There assets are working marvelous in generating revenue this feeds there need in capital to have a calibrated capital ratio although they should either increase the equity to have a boost they need in the next 5%. As we can see from their capital ratio, that's what they are doing now, slow and steady. It is not recommended to do it otherwise at this size. The ROA is a bit low, but it is still good taking into consideration there line on of activity, retailing.

As we demonstrated before, Wal-Mart might afford some additional loans, but is not recommended, they could try to increase the NPM so it would generate more revenue for an aggressive expansion, or they could try lowering the DPR. Other than that I would recommend them getting more assets by getting more capital through the methods just explained. Otherwise, Wal-Mart is a company looking up for, good for investments with a solid financial situation, a steady growth plan and a slow but steady expansion strategy inland and abroad in emerging markets that have a lot of opportunities for the future.

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[9] Altman, E.I. (1968). Financial Ratios Discriminant Analysis and the Prediction of Corporate Bankruptcy. *Journal of Finance*, 23 (4), 589-609

*Operational Programme for Human Resources Development 2007-2013. Investing in people!*

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# THE IMPACT OF FISCAL DEPRECIATION OVER THE ECONOMIC AND FISCAL PERFORMANCE OF THE COMPANY

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**Abstract**

Depreciation, together with net result, define self-financing capacity of the company and any movement at the depreciation generates inverse effects on profit tax. For this reason, the system of evaluation and depreciation of fixed assets should be coordinated with maintaining the capital. In the case of depreciation, accounting policy may concern choosing one of the methods of depreciation, for example linear depreciation, accelerated or diminishing. The choice of a method of depreciation involves an accountable option. Article presents a comparative approach of the methods of depreciation and its implications on the economic and fiscal performance of the company, but it all depends on the business objectives, the strategy and the fiscal management.

**Keywords:** depreciation, fiscal, performance, profit

**JEL Classification**: G32, H20, H25, H32

## 1. Introduction

The present study aims to show the impact of tax depreciation on economic and financial performance of any businesses, in this way data from SC GMG MEDIA BOX S.A are being used. The present paper aims at present and quantify tax depreciation on net profit in the current period, as well as offering solutions that businesses can use tax depreciation in their favor, in relations with competitors.

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To determine the profit a series of analyzes can be made regarding the establishment of a fiscal strategy, in such way that using applicable possibilities of fiscal laws, the net profit result to be as large as possible. Thus, in determining the taxable base, the method of fical depreciation chosen has a majore importance.

From a fiscal view, the expenses regarding acquisition, production, construction, assembly, instalation and improvement can be recovered through fiscal depreciation deduction. Expenses with depreciation of the fixed assets has impact on diminishing operation's result, consequently, the net result. How big is the impact of these expenses is decided at the management level because it can be managed according to the depreciation method used.

The companies can apply different methods to accounting depreciation:

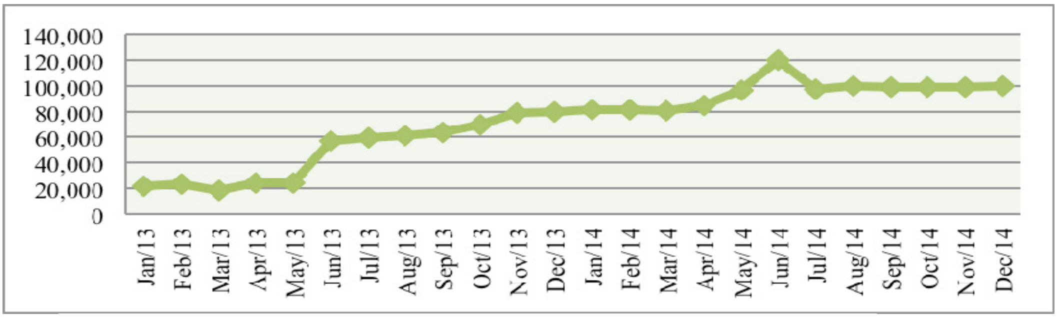
- Linear depreciation;
- Diminishing depreciation;
- Accelerated depreciation.

In establishing the expenses with depreciation, the period of normal use of the fixed asset has a major importance, besides chosen depreciation method, and it represents the number of years in which the value of the fixed asset can be recovered through depreciation method. The period of normal use is set through laws, and companies are being able to establish depending on their policies the period of amortization based on a catalog that sets the maximum and minimum period for any fixed assets. By appling linear amortization, the value of fixed asset can be moved evenly to expenses, in equal values for the entire period of normal use. By appling diminishing amortization, the established expenses for every year are decreasing (diminishing amortization rate is applied to the remaining amount to be recovered at the end of the amortization), and from a certain point it should move to linear depreciation.

In the case of accelareted amortization, expenses as much as 50% of the value of fixed assets can be made in the first year, and the difference should depreciate linear in the final period. In the case of calculated diminishing depreciation allowances (higher in the first half of its life and smaller in the second half) obtained tax savings during the first years are more important in the value of the company than its losses in recent years. In the current value, cash-flows from the first years are more important than the lasts (due to digressivity of the update factor related to exploitation period of the investments).

S.C. GMG MEDIA BOX S.A. practices a monthly straight-line amortization method, highlighted in the figure below:

Fig. 1 - Depreciation during January 2013 - December 2014




Source: Calculation on the basis of the results of the company

It can be seen that in May 2013 expenditure on depreciation increased dramatically, as a result of an investment made by the company to move to a new headquarters and the purchase of computers, furniture, all new investment generating new opportunities, and that is why the trend is increasing also in the following months. In the same time, with the change of establishment, the company will open a place of work in Cluj, where again it was necessary to purchase computers, monitors, furniture, by registering for a new amortization expense.

To determine fiscal advantages of depreciation, we will simulate the other 2 methods of depreciation: the accelerated and the degressive to see if the tax savings are higher than in the case of depreciation straight-line.

Linear depreciation is determined by the straight-line amortization input on the value of the asset.The fixed assets held by S. C GMG MEDIA BOX S.A. are mainly furniture and computers, and average duration of their lifetime is 5 years, so dimension of depreciation = 100/5= 20%. So, we want to know which is the duty of the company's tax, the income tax through the prism of applying linear depreciation (table no. 1). We're going to take the period of analysis year 2014, because in 2013 the company records loss at the end of the financial year in the first place thanks to the investment made.

Table no. 1 Tax advantages: straight-line amortization in the year 2014, mil.lei

| | |
|---|---|
| The amount of the fixed assets depreciation tangible is : | 5,654,830 |
| Normal duration of use of the above equipment is : | 5 |
| Cota de amortizare liniară este de : | 0.2 |
| Straight-line amortization rate is : | **1,130,966** |
| On the basis of income, expenditure, the elements and the non-deductible deductible: | |
| = > taxable profit (in accordance with previous calculations) : | 9,864,572 |
| = > and profit tax was : | **1,614,454** |

***Source:*** own processing based on data provided by the company

In the case of the depreciation method degressive depreciation shall be calculated by multiplying the shares straight-line amortization by the coefficient 2.0, specific of fixed assets depreciated over time between 5 and 10. In the first month, depreciation shall be calculated by applying the depreciation rate multiplied by the corresponding input value of asset, following that each month same rate to be applied to the amount remaining after deduction of annual cumulated. Such quotas for the depreciation economies decrease from year to year, as the Table no. 2 shows:

Table no. 2 Estimation of annual depreciation 2014, mil.lei

| | **Annual depreciation** |
|---|---|
| 2014 | 2,261,932 |
| 2015 | 1,357,159 |
| 2016 | 814,296 |
| 2017 | 610,722 |
| 2018 | 610,722 |
| = | **5,654,830** |

*Source:* own processing based on data provided by the company

As the table no. 3 shows, using the degressive depreciation method, in the year 2014, we noticed an expense much higher than using straight-line amortization method, which brings business tax advantages, will have to pay a income tax in May 2014.

Table no. 3 Tax advantages: degressive depreciation in 2014, mil.lei

| | |
|---|---|
| Additional annual depreciation (and deductible) in relation to the straight-line method is | 1.130.966 |
| = > taxable profit (by deducting additional depreciation) is now: | 8.959.372 |
| = > and profit tax is : | 1.433.499 |
| Accordingly net profit is : | 7.525.872 |
| So we obtained an economy of profit tax in the first year of : | (180.955) |

*Source:* own processing based on data provided by the company

Also the accelerated amortization method retrieves the input value of the equipment, but with a significant share in the first year (2014) and in equal shares in the other months of normal use. Due additional depreciation obtained in time through accelerated procedure, the impact on the tax savings shall be positive, but at the end of 5 years of depreciation the amount recovered will be the same.

Accelerated depreciation obtains a tax saving higher In the first month we saw half of the total depreciation. Tax saving is significant only in the year 2014, during the remainder of the period the impact will be much less.

Table no. 4 Tax advantages: accelerated depreciation 2014, mil.lei

| | |
|---|---|
| Additional annual depreciation (and deductible) in relation to the straight-line method is: | 1.696.449 |
| => taxable profit (by deducting additional depreciation) is now: | 8.393.889 |
| = > and profit tax is : | 1.343.022 |
| Accordingly net profit is : | 7.050.866 |
| Is obtained an economy of profit tax in the first year of : | (271.432) |

*Source:* own processing based on data provided by the company

Tax advantages may be obtained depending on the method of depreciation chosen but depends on the management of each company. The financial manager of S.C. GMG MEDIA BOX S.R.L. decided to use a policy of linear depreciation due to the fact that there is no very large investment which would require an economy subtantial from tax in a specific period, preferring to recover the investment of degree environment equally in the years ahead. A policy of accelerated depreciation or diminishing it would have been useful in 2013, on their investment to open a working place in Cluj, but the company recorded losses at the end of the year, in such way that those tax advantages being invalid.

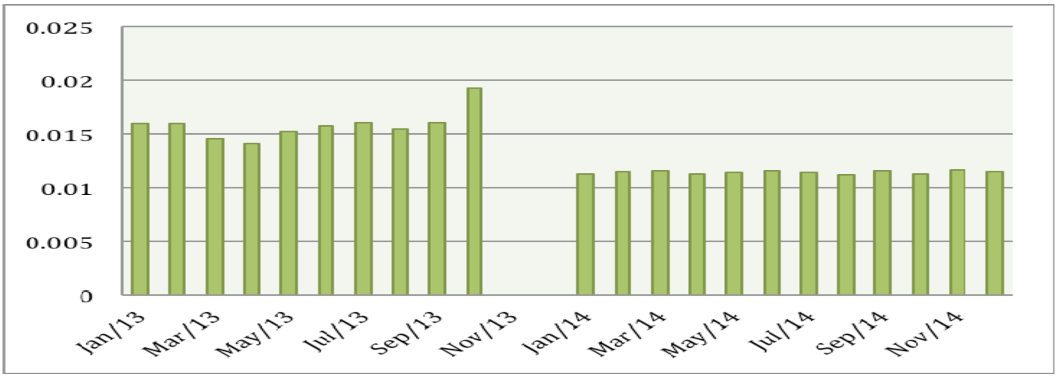
## 2. Methodology and data desciption

Empirical studies have shown that net result in the course of a financial year is influenced by the accounting amortization expense which is deductible from payment of the profit tax. Trying not to use absolute values which are likely to influence the result of the regression, bringing with it very large calculation errors, we have taken into account the weight profit in turnover correlated with the share of depreciation in turnover.

Therefore we apply an econometric model to the company whose financial performance has been highlighted in the first part of the paper. Data used in the model have been recorded during the period January 2013 to December 2014, relevant period for the company because it grows very much when it was buyed by the American business. Results have been obtained using software package Eviews 4.1.

To determine which is the most suitable to be estimated (linear regression model - showing a linear relationship between the variables explained and explanatory - or non-linear regression model, the regression function can be any other form) we will graphically represent the two variables of interest (the share of net profit in turnover and the share of depreciation in profit net).

Fig. no. 2 : The share of depreciation in PN 2013 -2014

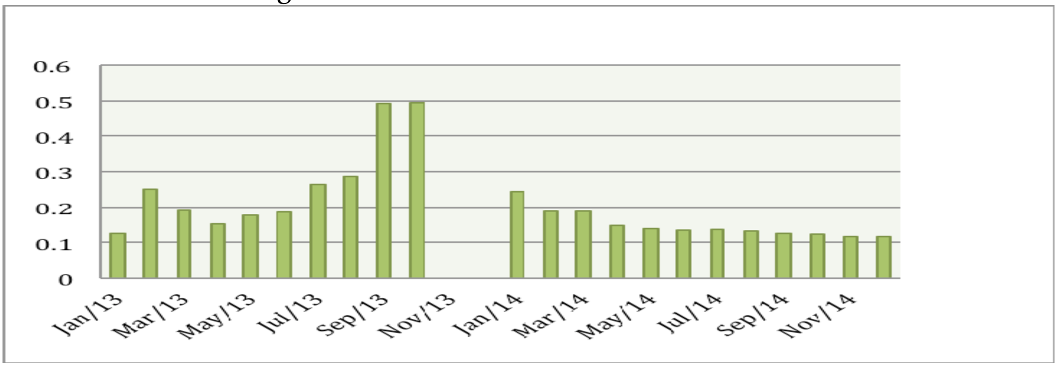



*Source:* own processing based on data provided by the company

According with the analys by the calculations carried out, it is to be noted that straight line method adopted by the company, involves a uniform allocation of depreciation during the whole period of operation in these years, then affecting taxable result with constant levels of expenditure on depreciation, the size of these costs vary depending on the duration of use: short duration, heavy expenditure (1.130.966 lei per year in the case of depreciation in 5 years), i.e. expenditure lowest for longer duration of time (565,483 lei per year in the case of depreciation in 10 years). In other words a considerable influence on rate of return on investment exerts size normal use (number of years).

As we can see the most share of depreciation in net profit is in October 2013 due to investments made by the firm to move to a new office, and that is why at the end of the year the business records negative financial results. And in 2014 on the basis of the opportunities arising from the investment made, the company shall decide not to make investments, preferring to adopt the strategy of recovery of the entire investment with all expenditure incurred.

Fig. no. 3 : Profit share in turnover 2013 -2014




*Source:* own processing based on data provided by the company

Besides measuring the impact of fiscal depreciation on net profit, we have found that, at the level of investment made by the company, the analysis can be more processed through the determination and quantification of net profit share in turnover. According to the fig. no.3 we notice that most prominence in the net profit in turnover shall be recorded in September and October 2013, this amounting to almost 0.5 % (September 0,4914 % and month of October 0,4952 %), but after an investment made by the company, revenue has decreased considerably, so the business records at the end of the year a negative profit and loss account. And as a result of investments in the year 2014 it is to be noticed an evolution of the weighting of fluctuating profit in turnover.

Futhermore, we will use an econometric model which has the next form:

$$\mathbf{PN / CA_i = \beta_0 + \beta_1 AMO / PN_i + \varepsilon_i, \qquad i = 1 \ldots 24,}$$

Where:

- PN represents the net profit registered in the month "i";
- AMO reprezents the depreciation registered in the month „i";
- CA reprezents the turnover;
- i reprezents the number of the months;
- $\beta_0$ represent the intercept;
- $\beta_1$ represents the coefficient og the amo/pn;
- $\varepsilon$ represents the residues.

Trough this model we intend to determine how the depreciation influences the net profit, with other words the determination of $\beta_0$, $\beta_1$ and $\varepsilon_i$.

For the purposes of the estimation of model parameters we have applied motoda OLS and we have obtained the following results (table no. 5):

Table no. 5: The influence of depreciation on net profit

| | | | | |
|---|---|---|---|---|
| Dependent Variable: PN_CA | | | | |
| Method: Least Squares | | | | |
| Date: 22/03/15 | | | | |
| Sample: 2013:01 2014:12 | | | | |
| Included observations: 24 | | | | |
| Variable | Coefficien | Std. Error | t-Statistic | Prob. |
| CA | 0.396371 | 0.057085 | 6.943575 | 0.0000 |
| AMO_CA | -16.99824 | 2.622219 | -6.482386 | 0.0000 |
| R-squared | 0.656365 | Mean dependent var | | 0.049589 |
| Adjusted R-squared | 0.640745 | S.D. dependent var | | 0.162819 |
| S.E. of regression | 0.097590 | Akaike info criterion | | -1.736426 |
| Sum squared resid | 0.209524 | Schwarz criterion | | -1.638255 |
| Log likelihood | 22.83711 | F-statistic | | 42.02133 |
| Durbin-Watson stat | 1.301140 | Prob(F-statistic) | | 0.000002 |

Source: own processing based on data provided by Eviews 4.1.

Quality model can be assessed on the basis of several statistics:

- Probability associated with the two estimators $\beta_0$ and $\beta_1$ (p = 0.00 and p = 0.00 ) are smaller than the threshold of 0.05, indicates both terms are significant in the model.
- Test t, recording mode values greater than or equal to t tabelat ( t0.05 ;24 = 2,064 ), determine acceptance null hypothesis, according to which estimators are significant.
- The coefficient of correlation - Rsquared - having the value 0.656365 it can be concluded that the variation in PN/AS is explained proportion of 65,63 % of the variation AMO/AS.
- Durbin-Watson Statistics has the value d = 1.3011. For a threshold of significance of 5 %, $d_1$= 1.04, and $d_2$= 1.20. Since d$\in$ [$d_2$ , 4-$d_2$]. It follows that there is no interference between autocorelation of grade I.
- Information criteria Akaike and Schwarz are used to choose between several models, the optimal. The decision rule used in the case of the application of these tests is that, according to which, is chosen that model for which the values of these two criteria are smaller. It is to be noted that both criteria give small values, -1,73 respectively -1.63. Therefore, we can say that they chose the model optimally.
- Statistical F is used, as well as the two criteria mentioned above, in order to choose the optimal, thus enhancing the conclusions obtained by criteria Akaike and Schwartz.. As it registers a higher value, the better.

- Statistics probability model F indicates the significance. As this has a value closer to zero, it follows that the model, in total, has a powerful meaning.

## 3. Empirical results

After testing its validity and estimating the parameters, the model can be written as:

$$PN/CA_{\,i} = 0{,}396371 - 16{,}99824 * AMO / PN_i + \varepsilon_i$$

This regression model allowed us to establish a number of aspects regarding the relationship between the variables, the most important being that between them there is a significant direct relationship.

The most important result is the fact that a decrease 1 unit of the share of depreciation in net profit will lead to a decrease of 16,99 units in the net profit determined as share in turnover.

From here we want to appreciate the size of the depreciation and the implications on the net profits, it is necessary to identify, first, the method of depreciation which generates the largest positive effect on companie's cash flow namely on net profit, taking into account the normal duration of the use of asset and even the profits which are derived from its use, for the purposes of any deduction for depreciation costs size.

It is to be noted that a decrease in the depreciation lead by default to a change in the same direction of the indicator of performance, namely in the net profit. Therefore, at the level of investments, the interest opposite amortization method is linked to a priority that this generates expenses which shall be deducted from taxable profits, and consequently improves profit tax due. The tax saving obtained is equal to the product of the amount of depreciation recorded and the share of profit tax, the size depending on the level of expenditure with annual depreciation and the share of the profit tax.

Company accounting policy relating to depreciation has influence on the outcome and profit tax by the impact that it has annual depreciation recognition as an expenditure for the period. Therefore, any recognition or registration error, as well as any change of estimates to future economic benefits arising from the use for tangible and intangible causes a new resizing of the outcome of financial year, due to changes of important depreciation calculus for tangible assets: life use; for intangible assets; depreciation period. Registration of depreciation represents an important lever in establishing the company's financial situation. Each of the elements underlying the calculation of depreciation may influence its size. Under the conditions in which a company has the possibility to choose as regards depreciation, taking into account that the interest is the investment, interest which shall enter in competition with most of the state.

## 3. Conclusion

Economic and Financial Performance of the companies are influenced by fiscal amortization. Fiscal amortization influences cash flow and the profit tax also. The option for a system of depreciation determine tax load distribution over the life of capital goods used by the company. To quantify correctly the impact fiscal depreciation economy through tax, we must consider the value of money over time, whereas the size of savings result in a decline in the corresponding tax paid, i.e. of cash flows out from the company.

Theory and practice recommended that the regime of depreciation used to be logically and systematically. In other words, the regime of the depreciation chosen should reflect the service capacity reduction of fixed assets. The cost of entry should not be assigned to exercise arbitrarily, without taking into account the manner in which they will lose some of its value useful over the years.

It is well known that the choice of a system of depreciation is a matter of discretion.

Linear depreciation is a advantage which is simple to apply, being the most used because of its time's cost and uniform expenses. If a diminishing or a accelerated system is chosen, they are good for the companies which benefits from this fact. Quick depreciation is degressive, they may postpone the date of payment for a part of the tax, in this way they benefit from currency depreciation. If they are scarce as a result in the next few years, businesses are allowed to circumvent permanently from the tax. No matter what method of depreciation the business use, depreciation brings new sources of financing reflected in its ability to self-financing, and if applicable, those methods of depreciation costs may increase in the first years after the revolution, in this way it manages to create an economic advantage by increasing net profit.

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# DATA ANALYSES OF THE CONNECTION BETWEEN IT&C AND THE ECONOMIC PERFORMANCE IN EUROPEAN UNION. STUDY CASE: ROMANIA

Crisan Daniela Alexandra*

**Abstract**

*Technology, especially IT&C, is vital to national competitiveness and has become a key factor for increasing economic performance and quality of life. But how could the relationship between IT&C and the economic performance be described? This paper will propose three data analyses using two indicators: GDP per capita, as a measure of the economic development of a country, being also an indicator of living standards, and ISOC - Individuals computer use, as a measure of the IT&C skills penetration into the population. The results highlight the importance of the development of the information society, as a critical step towards meeting the demands of society and the EU economy.*

**Keywords:** IT&C, GDP, data analysis, clustering, trendline, regression

**JEL Classification**: C22, J24, M15

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## 1. Introduction

Computer skills are essential for efficiency in all aspects of our fast changing world. The usage of IT&C by the population is in a direct relationship with its welfare and with the economic development of the country. In this paper we'll

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describe the connection between IT&C and the economic performance, proposing three data analyses at national level for the 28 European Union countries.

We used two indicators:

- GDP per capita, as a measure of the economic performance of a country;
- ISOC - Individuals computer use (percentage of individuals), as a measure of the IT&C skills penetration into the population.

For both indicators we have use historical data from 2006 until nowadays, obtained for the 28 European Union countries. The data are provided by EuroStat, a portal maintained by European Union as its "statistical office" with the task of providing the EU with statistics at European level that enable comparisons between countries and regions [3].

The three data analyses are:

(1) a 4-partitions clustering of the 28 EU countries using the two indicators. The 28 EU countries were divided into 4 clusters with similar properties related to their GDP and ISOC indicators. For every cluster, the most representative country was selected;

(2) an analysis of the time series of the individual usage of computers in some EU countries. We've considered two selections: first, the four countries selected at the previous step, as the most representatives for their cluster, and, second, the five countries in cluster 3, containing Romania as well;

(3) a description of the relationship between the GDP per capita and the individual usage of computers in Romania in the last years.

## 2. Clustering the European Union-28 countries in 2014

In this section, a 4-groups clustering of the 28 EU countries is proposed, emphasizing the relationship between the development stage of a country and the level of computer usage among population. For every cluster, the most representative country was selected.

The partitioning was obtained using the K-means algorithm for two series of data: the GDP-per capita and the ISOC indicators for 2014. The method is an iterative process that aims to partition n objects (the 28 countries) into k clusters in which each observation belongs to the cluster with the nearest mean (centroid), serving as a prototype of the cluster [8]. We've run the K-means algorithm for k=4 clusters.

For short, the algorithm consists in reiterating the next three steps until the system stabilises:

- compute the distance between every object to every centroid;
- for every object, determine the nearest centroid;
- move the centroids in the middle of their cluster.

Initially, the centroids are placed anywhere; for computational reasons, we placed them in the first k=4 objects. The algorithm was implemented by the author in C++ programming language using the Visual Studio IDE. After stabilisation, for every centroid the nearest object (country) was selected, as the most representative of its group.

In order to provide a relevant analysis, the two series were normalized. The results of the clustering process are tabled below. The countries in every cluster are listed according to their GDP per capita value (from the lowest to the highest). In the Annex 1 the 4-partitions clustering is graphically represented.

**Table. 1. Grouping the 28 EU countries into four clusters**

| Cluster 1 | Cluster 2 | Cluster 3 | Cluster 4 |
|---|---|---|---|
| 1. Italy (IT) | 1. Luxembourg (LU) | 1. Bulgaria (BG) | 1. Malta (MT) |
| *2. France (FR)* | 2. Finland (FI) | **2. Romania (RO)** | 2. Cyprus (CY) |
| 3. United Kingdom (UK) | 3. Denmark (DK) | 3. Portugal (PT) | 3. Estonia (EE) |
| 4. Germany (DE) | 4. Austria (AT) | *4. Greece (EL)* | 4. Latvia (LV) |
| | *5. Belgium (BE)* | 5. Poland (PL) | 5. Lithuania (LT) |
| | 6. Sweden (SE) | | 6. Slovenia (SI) |
| | 7. Netherlands (NL) | | 7. Croatia (HR) |
| | 8. Spain (ES) | | 8. Slovakia (SK) |
| | | | *9. Hungary (HU)* |
| | | | 10. Czech Republic (CZ) |
| | | | 11. Ireland (IE) |

The first cluster contains four countries with a very high GDP indicator. Even the highest state of development of these four, the usage of computers is not so extended; in case of Italy, for instance, less than 60% were reported as IT&C users.

The second cluster has a very high performance in IT&C terms, the largest majority of the countries (7 of the 8) trespassing 80% computer use.

The third cluster contains five countries, characterized by slowly increased GDP values, having the lowest percentages in computer use. Romania has a concerning low percentage of computer use, 55%, the lowest among the 28 EU countries in 2014. Even though, its GDP value trespasses the values of almost countries in the fourth cluster, excepting Czech Republic and Ireland.

The fourth cluster contains 11 countries characterized by low GDP values, but high performances in computer usage terms, the ISOC values are grouped around 70-80%.

As shown above, the nearest country to every centroid will be considered as representative of its cluster. Using the distances between every object (country) and every centroid, we selected the four representatives:

**Table. 2. The coordinates of the four centroids and the most representative countries for every cluster**

| Clusters | Coordinates of the centroid | | The most representative country |
|---|---|---|---|
| | GDP per capita* | ISOC* | |
| Cluster 1 | 76.13 | 25.78 | France |
| Cluster 2 | 14.29 | 34.76 | Belgium |
| Cluster 3 | 6.31 | 6.6 | Greece |
| Cluster 4 | 1.93 | 21.21 | Hungary |

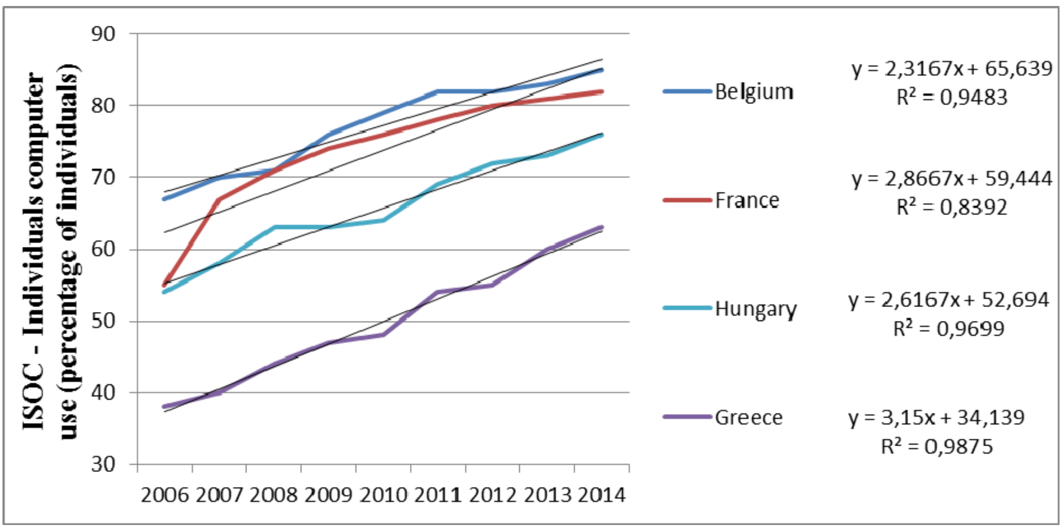
*) the values are normalized

## 3. The evolution of the individual usage of computers in the period 2006-2014 in some EU countries

Some European countries were selected in order to deeper analyse their state in terms of computer usage.

First, the four cluster representatives were considered: Belgium, France, Greece and Hungary. Plotting their ISOC indicators in the last nine years (2006-2014), it can be clearly noticed their linear evolution, demonstrated by the standard errors' high values.

**Figure. 1. The evolution of individual computer usage indicator for the cluster representatives in the period 2006-2014**



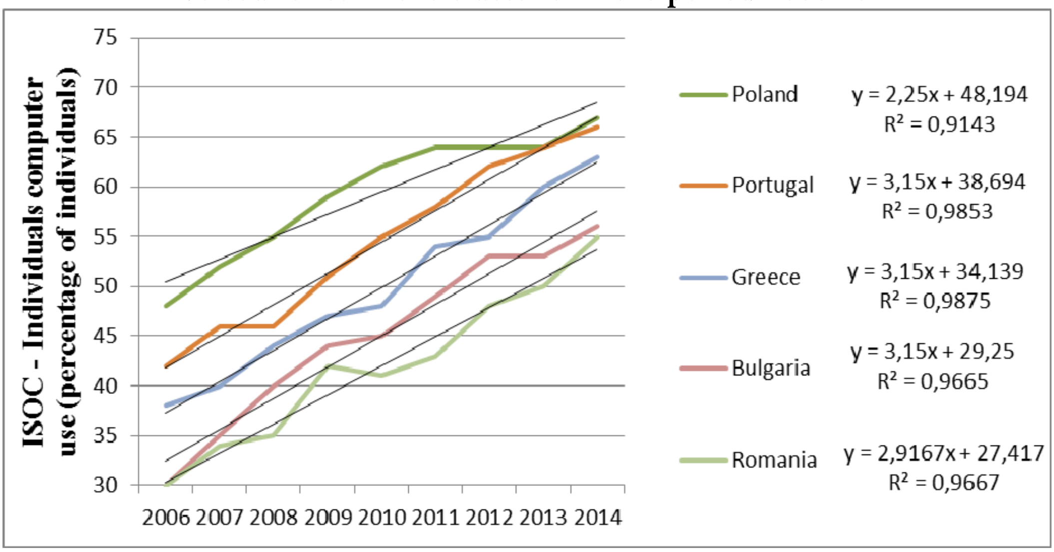
Belgium, France and Hungary have higher performances in this particular segment of IT&C usage, but Greece, the representative of the third cluster, has the most accelerated progress (slope 3,15).

**Table. 3. The trendlines' coefficients corresponding to the four cluster representatives**

| Cluster | Country | Slope | Standard error |
|---|---|---|---|
| 1 | Belgium | 2,31 | 0,94 |
| 2 | France | 2,86 | 0,83 |
| 3 | Greece | 2,61 | 0,96 |
| 4 | Hungary | 3,15 | 0,98 |

At cluster level, we compared to evolution of the five countries in cluster 3, including Romania.

**Figure. 2. The evolution of individual computer usage indicator for the five countries in the cluster 3 in the period 2006-2014**




The coefficients of the trendlines prove again a constant progress in time; the growing degree is similar in case of Greece (the representative of the cluster), Bulgaria and Portugal (slope 3,15). The slowest evolution corresponds to Poland, the country in the group having the highest values for ISOC.

**Table. 4. The trendlines' coefficients corresponding to the five countries in the third cluster**

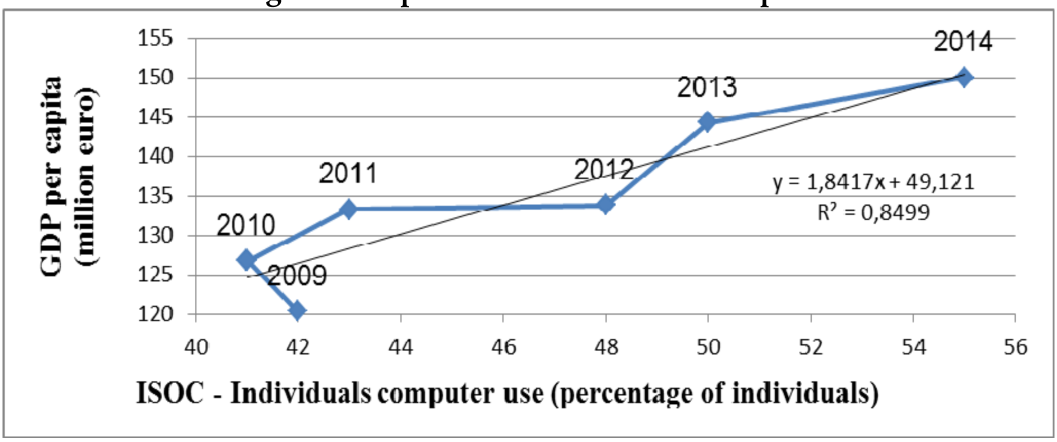
| Country | Slope | Standard error |
|---|---|---|
| Poland | 2,25 | 0,91 |
| Portugal | 3,15 | 0,91 |
| Greece | 3,15 | 0,98 |
| Bulgaria | 3,15 | 0,96 |
| Romania | 2,91 | 0,96 |

In case of Romania, the computer usage has been increasing in time, although it has the lowest values in the considered period in comparison with the other states, indicating a constant gap between Romania and the other four countries in the cluster.

## 4. The relationship between the GDP per capita and the individual usage of computers in Romania in the period 2009-2014

In the last analysis, we measured the strength of the relationship between the GDP per capita and the individual usage of computers in Romania. We considered the values of the two indicators in the last six years (period 2009-2014).

**Figure. 3. The relationship between the GDP per capita and the individual usage of computers in Romania in the period 2009-2014**




As figure 3 shows, the dynamics of the ISOC indicator is characterised by a slow decrease, in 2010, followed by a constant improvement. The coefficients of the regression line suggest that the two indicators ISOC and GDP per capita are in a strong relationship. The Anova analysis is detailed in Annex 2.

## 5. Conclusion

Increasing ICT adoption is a key piece of Europe's productivity, with direct links to the economic development of a country. Through three data analyses we've described the nature of this relationship. First, we depicted the four groups of European Union countries with similar features, choosing a representative for every partition. Then we analysed the behaviour in time of the representatives, and we provided a second analysis dedicated to Romania: we compare the trendlines of Romania and the other four countries in its group. As a conclusion, we can state that there are obviously gaps between clusters (through their representatives) and also at cluster level, in term of computer usage, but, at some point, the progress is more significant in countries less performant. The third data analysis focused on the relationship between computer usage and the economic performance of Romania. There is a strong linkage between the two variables, suggesting that improving IT&C skills among Romanian population could be a key factor toward Romania economic development.

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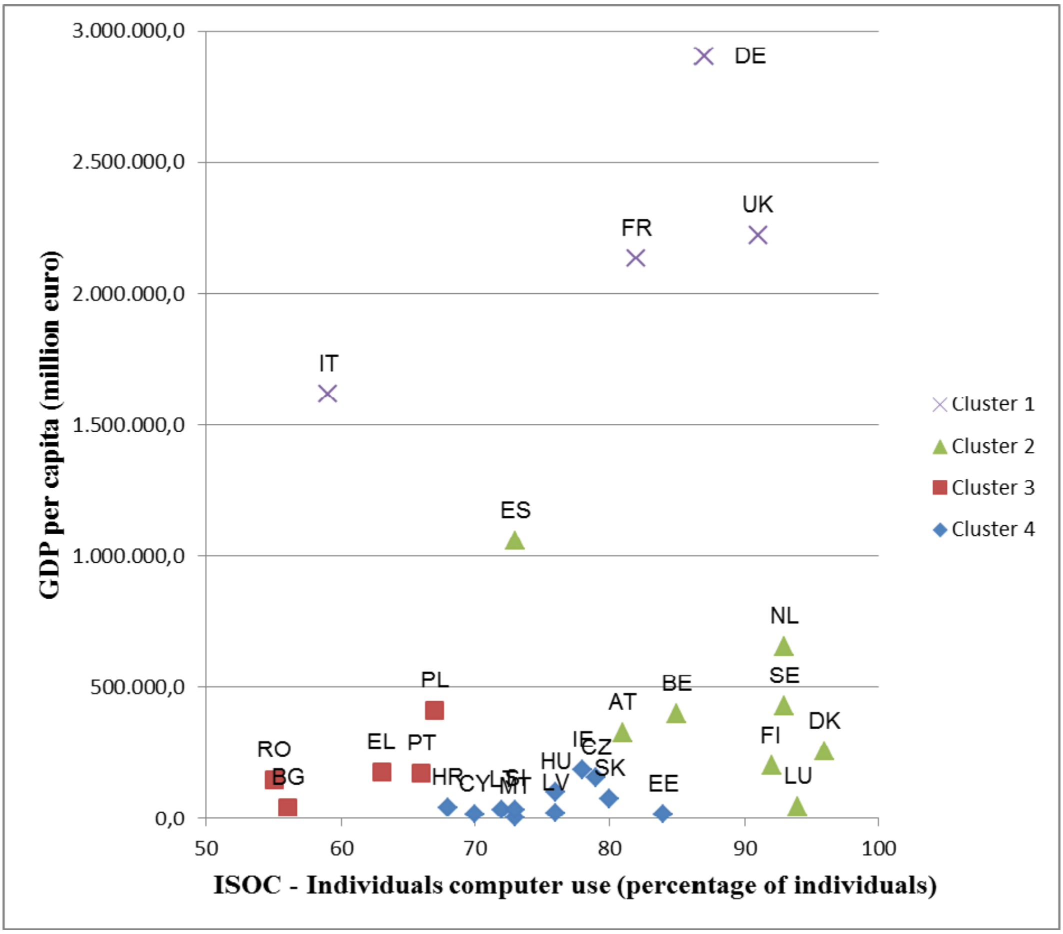
## Annex 1. The four clusters of the 28 EU* countries showing the relationship between GDP per capita and individual computer usage (ISOC)




*) The 2014 GDP per capita value for Luxemburg was estimated through extrapolation, being not available at the time of writing this paper.

## Annex 2. The Anova analysis for the linear relationship between the GDP per capita and the individual usage of computers indicators in Romania in the period 2009-2014

Regression line equation: *GDP per capita = 1,8417 * ISOC + 49,121*

SUMMARY OUTPUT

| *Regression Statistics* | |
|---|---|
| Multiple R | 0,921876 |
| R Square | 0,849855 |
| Adjusted R Square | 0,812319 |
| Standard Error | 4,732569 |
| Observations | 6 |

ANOVA

| | *df* | *SS* | *MS* | *F* | *Significance F* |
|---|---|---|---|---|---|
| Regression | 1 | 507,0928 | 507,0928 | 22,6409 | 0,008917 |
| Residual | 4 | 89,58883 | 22,39721 | | |
| Total | 5 | 596,6817 | | | |

| | *Coefficients* | *Standard Error* | *t Stat* | *P-value* | *Lower 95%* | *Upper 95%* |
|---|---|---|---|---|---|---|
| Intercept | 49,12149 | 18,10161 | 2,713653 | 0,053335 | -1,136642 | 99,37963 |
| ISOC | 1,841718 | 0,387058 | 4,758245 | 0,008917 | 0,767072 | 2,916364 |

## FINANCIAL INNOVATION AND A GLOBALIZED FINANCIAL WORLD

George Horia Ionescu and Ruxandra Dana Vilag *

### Abstract

*In the last 25 years, financial systems around the world have gone undergone unprecedented changes. Investors can borrow large amounts of money at cheaper rates than ever before, invest in a very large variety of sophisticated financial instruments, seeking the profits and sharing the risk with strangers from across the globe, at speed of light. Because of the globalization of financial markets throughout the world, entities in any country seeking to raise funds need not be limited to their domestic financial market. Nor are investors in a country limited to the financial assets issued in their domestic market. Globalization means the integration of financial markets throughout the world into an international financial market. Have these undoubted benefits come at a cost?*

**Keywords:** financial innovation, financial market, globalization, financial crises

**JEL Classification**: G01, G15, E44

Financial flows increased globaly over the last decades. Wanting to channel funds from lenders tp borrowers banks and financial institutions have expanded their activities, gaing new markets, other then the national one.

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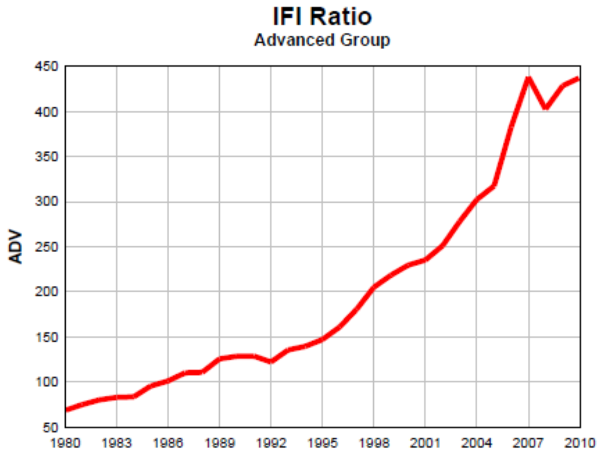


Figure 1. Taken from P.R.Lane, „Financial globalisation and the crisis”, 2012[1]

As showen by figure 1 and 2, the sum of foreign assets and liabilities (IFI ratio expresses their ratio over GDP) had grow from almost 75% to 450% for developed countries and from 35% to 75% for emerging countries, prooving that globalisation realy exists.

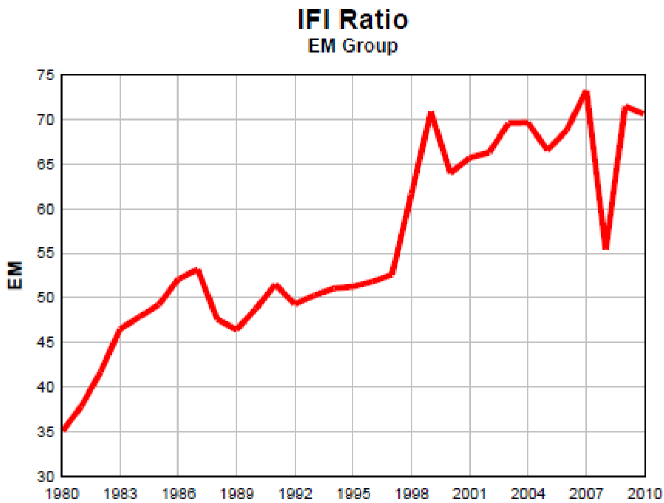


Figure 2. Taken from P.R.Lane, „Financial globalisation and the crisis”, 2012[2]

[1] P.R.Lane, „Financial globalisation and the crisis”, 2012, https://www.google.ro/url?sa=t&rct=j&q=&esrc=s&source=web&cd=3&ved=0CCsQFjAC&url=http%3A%2F%2Fsiteresources.worldbank.org%2FINTABCDESK2009%2FResources%2FPhilip-Lane.pdf&ei=ISVOVbjyJMHoUISJgegP&usg=AFQjCNE7ZhGLphMiurz_8zOnNRMYCHzZbA

[2] Idem1

The process of globalisation was well suported by technological advances and financial innovation. In fact we can speak about four factors that boost the process of financial globalization[3]:

- *Advances in information and computer technologies;* it's easier for today investors to stay in touch with foreign markets and their characteristics due to the proliferation of the IT industrie;
- *The globalization of national economies;* companies tend to became more and more globelized as they try to benefit from scale economy or from competitive advantages;
- *The liberalization of national financial and capital markets*, this came as a response investors' demand of new markets were they can send their surpluss funds in order to mitigate risks or to gain more;
- *Competition among the providers of intermediary services*, investors can acces differnet markets due to the development in the IT industrie so they crate a fierce competition between intermediary services' providers.

Due to globalization large events that ocurre in an economy may influence others, through direct or indirect chanels. The proofe is the recent financial crisis that trigger a large economic crisis. There are some economists that are blameing financial inovations that were introduced by banks and financial institutions in order to reduce their risk and to atract more investors. We can argue that not financial innovations „per se", but not understending them was might be a cause. In fact innovations „good or bad" are the main mechanism behind the developing of every economic activity.

"Innovation is the central issue in economic prosperity" [4] or „Innovations enhance the efficiency with which needs are met and that is why the innovation process will never cease"[5] .

Financial innovation is old phenomenon. Modern banking first started in 14th-century Florence and insurance practice can be traced to Lloyd's Coffee House in 17th-century London. Reinsurance is one of the oldest innovations in the insurance sector.

The most important future of the present financial system are innovations. So analyzing this financial innovation is paramount. The recent global financial crisis has highlighted risks brought by financial innovation while forgeting about its benefits for an economy, but innovation has helped individuals and

[3] www.imf.org

[4] Michael Porter

[5] Mugur Isarescu

businesses to attain efficiency by presenting new possibilities for mutually advantageous exchanges of goods and servicesc

Innovation means "*creation (a new device or process) resulting from study and experimentation*". So financial innovation would mean "*creation of a new security resulting froms study and experimentation*".

***Financial innovation*** is "the act of creating and then popularizing new financial instruments, technologies, institutions, markets, processes and business models – including the new application of existing ideas in a different market context".[6]

In fact "by increasing the variety of products available and facilitating intermediation, financial innovation can promote savings and channel these resources to the most productive uses. It may widen the availability of credit, help refinance obligations and allow for better allocation of risk, matching the supply of risk instruments to the demand of investors willing to bear it. In addition, innovation may encourage technological progress when the requirements for information technology generate new technological projects, and induce their funding as in the case of venture capital."[7]

There are studies that show how a better developed financial market may help a country economy firstly by reducing the cost of capital and then by growing the productivity.

We can say that the financial system is defined as "the collection of markets, institutions, instruments and regulations through which financial securities are traded, interest rates are determined and financial services are produced and delivered around the world"[8].

As financial system is part of global economic system, it is the one influence the price and quantity of available funds in the economy. It's the creator of the flow of funds between various economic entities: companies, financial and governments' institutions, households.

Some authors classify financial system functions as[9]:

1 – monetary function (connected with money creation process and the process of money transfer between economic entities);

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[6] World Economic Forum, A World Economic Forum report in collaboration with Oliver Wyman, „***Rethinking Financial Innovation, Reducing Negative Outcomes While Retaining The Benefits***", 2012

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2 – capital allocation function (enables the transfer of surplus funds);
3 – controlling function (monitoring the flow of funds in the economy).

There are different reasons for financial innovation, like:

- Hedging against different types of market' risks (development of interest rate swap and of credit default swaps)
- Mathematical innovations ( development of option market, development of Collateralized Debt Obligation, flash trading)
- Tax and regulation avoidance (development of checking account, total return swaps).

J.Schumpeter distinguish between the following groups of innovations[10]:

- new products
- new methods of production
- opening new markets
- new sources of supply of raw materials
- new organization forms and busbiness structures
- new methods of management.

There are different criteria for innovation clasification[11]:

- ***sources of innovations***: *supply-driven innovations* (financial institutions being the ones that determin the apperence of financial innovations in their quest to of catching the eye of investors ; considering a growing market that will consume this new financial instruments) and *demand-driven innovations(*or 'consumer voice',what investor wants, needs and their preferences for a special type of financial investment) . Choosing wich of the two will have a more positive role over the financial market its not a simple thing because as Henry Ford famously said, "If I had asked people what they wanted, they would have said faster horses."
- ***factors of innovations***: *external factors driven innovations* (factor determined by global economy prospects) and *internal factors driven innovations* (requiered by the development of the financial system)
- ***motives of innovations***: *adaptive innovations* (new financial products that seek to get respond to new trends), *aggressive innovations, defensive innovations* (innovations induced in sectors adversely affected by

[10] J.Blach, " ***Financial innovations and their role in the modern financial system – identification and systematization of the problem***", published in Efinanse, 2011, vol. 7, nr 3
[11] J.Blach, " ***Financial innovations and their role in the modern financial system – identification and systematization of the problem***", published in Efinanse, 2011, vol. 7, nr 3

openness that might offset part of the comparative advantage), *protective innovations* and *responsive innovations*

- ***elements of the financial system***: *financial market innovations, financial institutions innovations, financial instruments innovations* and *financial regulations innovations*
- ***types of innovations***: *product innovations, process innovations, risk-shifting innovations*
- ***underlying assets***: *debt-linked innovations* and *equity-linked innovations*

Almost all economist think that financial innovation's "effects are uncertain, unmeasurable and depend upon the interactions of innovators, users, consumers, competitors, etc."[12]

As the recent economic crises proved there are some innovations that were not understood by investors like:

- securitization - process allows global investment to be spread out to reduce risk. This made easier for individuals to purches homes, so the houses' prices rise and so did the default on this loans. In 2009, an estimated $8.7 trillion of assets globally were funded by securitization.[13];
- credit default swaps – parties involved agreed that in a third party will not pay the loan they will pay it insted (used by AIG) . The lack of transparency made this innovation turn in a bad one, because the parties did not know the extent of the risk they were taking on;
- colaterized debt obligations - mortgages, instead of being held by banks and mortgage companies, were sold to investors that took the risk;
- hedge funds – initially this investment funds were created to reduce different types of risks, but they evolved into „gainig instruments" that brought a rising of the accompaining risk;
- subprime loans – loans available for individuals that usually who faill to respond to credit demands. Setting-up this kind of credits rise the risks of credit institutions.

Unsuspected risks of financial innovations led national supervisors and regulators to take defense reactions, imposing new regulations to prevent the occurace of financial crisis. In our opinion the firts rule will be to make this

[12] World Economic Forum, A World Economic Forum report in collaboration with Oliver Wyman, „***Rethinking Financial Innovation, Reducing Negative Outcomes While Retaining The Benefits***", 2012

[13] "Too Big to Swallow," Economist, 16 May 2009, 11

products more transparent and make them available only to trained public, if not only to financial institutions..

Contemporary financial markets are in continuous transformation, and their diversification and grow is determined on one hand by the existence of increasingly tough competition in the financial market, and on the other hand by regulations,: there are new financial instruments, new market segments and new financial institutions, most appropriate new context, or that respond better to the needs of investors and financial intermediaries. The financial market is continuously dynamic, always new; however, new financial products bring with them new risks and new challenges for supervisors. But we should take into account that the innovation process can be so dynamic and sophisticated that those that regulate or supervise the markets can not keep the pace.

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# SMEs AND STRATEGIC MANAGEMENT BASED ON KNOWLEDGE

Anca Cruceru*

## Abstract

*The transition to the knowledge based economy involves the adjustment of SMEs to the new changes, an aspect emphasized both by the need for knowledge as the primary element in their current activities, but also by the emergence of new types of SMEs. Accordingly,the top management of SMEs will have to adapt their strategies and strategic management to the new organizational context.*

**Key words:** SME, strategy based on knowledge, strategic management based on knowledge

**JEL Classification:** M10, O30

## Introduction

Together with the transition to the knowledge based economy within SMEs, information and knowledge resources, and consequently, human resources have become vital for achieving competitive advantage, essential for their creation, maintenance and development. As a result, top management of SMEs began to perceive the need to understand the concept of strategy based on knowledge and usefulness of implementing a strategic management adequate to the context in which they operate. Thus, managers have begun to develop and implement strategies that have as a central element - the knowledge, which, in this context, will become strategic knowledge for SMEs.

## Strategies based on knowledge and strategic management based on knowledge

Starting with this distinctive element, knowledge-based strategies that are chosen by SMEs, differentiates from classical strategies through the following [1]:

- the knowledge resource is incorporated in all of the components strategy - mission, objectives, efforts, strategic options, deadlines, responsible parties and competitive advantage;

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[1] Ovidiu Nicolescu, Luminiţa Nicolescu, 2005

- strategic objectives aim to apply and exploit the knowledge;
- in the process of substantiation of strategy, the human resource occupies an essential place because it holds, applies and capitalizes the knowledge that exists within a SME;
- information resources will be much better transmitted through a development of the communicational techniques, but, simultaneously they will be more accurate and more rapidly achieved due to the evolution of the means of information processing;
- in the strategy substantiation and development processes it will increase the consideration of the key stakeholders and it will develop the consolidated vision based on the chain value relying on knowledge, in the context of the influence of internal and external factors on SME;
- the flexibility of the strategy will be improved by using the sliding approach;
- improvement of the innovational capability of the strategy by expressing the creativity in all its components;
- the usage on a large scale of the participative elements in the establishment, formulation and operationalization processes of the strategy, which needs the cooperation of the employees based on knowledge and the cooperation of internal and external stakeholders that influences the strategy ;
- impressing a motivational background in the formulation and operationalization processes of the strategy;
- decreased perception of the degree of strategy formalization due to the intangible character of the knowledge;
- among the results achieved through the implementation of the strategy can be found the customer satisfaction through knowledge-products or knowledge related-services etc.

Since obtaining competitive advantage in an SME is conditioned by its strategic knowledge, it should be noted that this resource must be identified in the development and substantiation processes of the strategy. This identification can be made by recognizing and understanding the features[2] that differentiate strategic knowledge from the rest of the SME knowledge: they are rare or even unique; the effect of using them is creating added value in the SME; they are very difficult to duplicate and substitute; they are easily harnessed in

[2] a.) Ovidiu Nicolescu, Luminiţa Nicolescu, 2005
b.) Scott Bryant, Ken Colwell, 2002
c.) Paul James, 2004

order to achieve the objectives of the SME; they adapt to internal and external environment of the SME; and they are consolidated by means of learning processes, an aspect that supports the other features.

Returning to the knowledge based strategy, specialists in the field, defined the concept as follows:

- A. Moslehi[3] - application "guide" of knowledge resources and of the organizations capabilities (SMEs);
- M. Zack[4] - believes that they are formulated with the purpose of diminishing the "disagreement" ("gap") between what an organization knows and should know (an SME) in order to be competitive (a) on the market;
- P. James, S. Callahan şi M. Zack[5] - an assembly of actions which guarantees the consistence between the intellectual assets and the fulfillment of the goals established at the organizational level(SME); these actions are aimed towards: establishing the necessary knowledge, obtaining and creating new knowledge, transformation of the existing knowledge, maintaining the knowledge, dissemination of knowledge and establishing the unnecessary knowledge.

After analyzing these definitions, I believe that the strategy based on knowledge ”represents that strategy that harnesses the intellectual capital (including knowledge resource) in its three forms - human, organizational, relational - with the aim of generating added value, in order to help achieving the desired competitive advantage in terms of meeting the organization's mission (SME).The results of intellectual capitalization would result in setting targets for the SME on medium and long term, in ways of achieving them and establishing the necessary resources "[6].

Moreover, experts in the field said that "knowledge based strategies differ depending on the knowledge management aspects on which they focus: some focus on knowledge (content), others on processes and others on the results"[7].

All kinds of classic strategies can be implemented within the knowledge-based SMEs, taking into account significant changes in their contents, both in light of the peculiarities of management functions, and the fact that in this case, knowledge, are the raw material, production factor and finished product.

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[3] Adel Moslehi , 2004

[4] Paul James, 2004

[5] Paul James, 2004

[6] Anca Cruceru, 2012

[7] Consultanţi TRAINMORE – KNOWMORE, 2005 - 2008

Approaches on the typology of knowledge-based strategies are relatively few, but the most representative include the following:

- Nemura şi Ogiwara[8] - after the level of which the objectives are established : strategy based on vision, strategy based on professionals and strategies for emerging situations;
- Wiig şi Centrul American pentru Productivitate şi Calitate – Modelul Wiig[9] - after various natures and strengths identified in the SME: knowledge based strategy as an organization strategy; management strategy of the intellectual assets; individual knowledge management strategy; knowledge creation strategy; knowledge transfer strategy; knowledge based strategy focused on customers;
- Hansen, Nohria şi Tierney[10] - after the nature of knowledge involved in the foundation and development strategies: the coding strategy; personalization strategy.

Unlike traditional strategies, knowledge-based strategies are used only within SMEs (organizations) based on knowledge, which involves strategies that are linked with knowledge management processes implemented by these SMEs (organizations).

Also, as conventional strategies are adopted depending on the life cycle of organizations (SMEs), knowledge-based strategies are subject to that statement, with certain clarifications [11]:

- strategies for each stage of the life cycle of SMEs should contain one or more major processes related to knowledge;
- in the early stages of SME (start - up phase), strategies should be oriented to production processes and knowledge production;
- in the development phase (growth phase), strategies should focus on the process of dissemination, use and maintenance of knowledge;
- in the mature stage (maturity phase), strategies should focus on the process of knowledge exploitation.

Implementation of strategies based on knowledge involves the adoption by SMEs of strategic knowledge management.

Although research on the concept of strategic management knowledge are at an early stage, it can be said that strategic management based on knowledge includes the processes of substantiation, drafting, implementation and control –

[8] Ovidiu Nicolescu, Luminiţa Nicolescu, 2005

[9] Consultanţi TRAINMORE – KNOWMORE, 2005 - 2008

[10] a.) Ovidiu Nicolescu, Luminiţa Nicolescu, 2005
b.) Adel Moslehi, 2004

[11] Scott Bryant, Ken Colwell, 2002

the assessment of knowledge-based strategies that requires certain adjustments indispensable in order to adapt them to the phenomena and processes taking place in the knowledge-based SMEs.

Before proceeding to the presentation of each process of the strategic management knowledge, it must be noted that in 2001, S.A. Carlsson [12] recommended a reference framework to support this type of strategic management, the cornerstone of the organization's resource-based theory and the theory of knowledge-based organization. In this frame of reference it is considered that acquiring and maintaining competitive advantage is gained using the expertise and knowledge of major processes through the six tasks[13]: formulating strategic vision encompassing the integration of knowledge management activities; identifying key-resources knowledge and expressing the vision about the prospects of the intellectual capital (including resources - knowledge); establishing the methods by which to achieve the requirements of a knowledge-based organization's vision; protection of knowledge and sources of knowledge; determining and implementing tactics that are intended to implement knowledge resources; use and evaluation of the knowledge. The tasks included in this frame of reference were important issues that were considered in the further development of strategic knowledge management processes.

Returning, strategic knowledge management processes are carried out using existing methodologies, plus certain processes and phases that are indispensable for the strategic knowledge management practice, as follows:

- developing the strategy and assessing its content using tacit and explicit knowledge of SME by exploiting its intellectual capital;
- establishing the knowledge that helps to substantiate, develop and implement strategic options ;
- recognizing the internal and external knowledge `gaps` of competing SMEs;
- specifying the means by which the SME are assimilating strategic knowledge;
- incorporating those "new" strategic knowledge in knowledge-based strategic management processes, using mainly individual and organizational learning, in order to create within the SME, added value;
- the need of partial or total managerial reengineering of SME for providing the required framework for the operational strategy by focusing on treatment processes knowledge exploitation.

[12] Lena Aggestam, Per Backlund, 2007
[13] Lena Aggestam, Per Backlund, 2007

The process of substantiation of the knowledge based strategy will cover the research of the strategy premises, investigation and forecasting strategies at micro and macro – economical level, but also the preparation of diagnostic, marketing and environmental studies.

The process of developing a knowledge-based strategy involves designing a strategic vision to help integrate knowledge management in SME activities, SME mission statement, determination of the strategic goals, establishment of strategic alternatives, specifying necessary resources, establish terms and competitive advantage, stating the strategies and operational policies.

When formulating a strategy based on knowledge, that strategy must seek the integration of five factors [14]: the emphasis of both individual and organizational learning, creation and "protection" of the intellectual capital; procurement and inclusion of informations from competing organizations in its own strategy; propagation of innovation and the improvement of the organization`s performance.

Also a feature of the development process of the knowledge-based strategy is to establish and incorporate strategic knowledge in SME. For the materialization of this characteristic feature, Charles Seeley, recommends the following steps[15]:

- to define those elements that have strategic importance for SMEs;
- to determine those who have these items and their location;
- specifying those primordial related knowledge that allow the support of SME competitiveness, with the aim of possible outsourcing;
- identifying knowledge that are obsolete or peripheral the level of their importance for SMEs, other organizations and stakeholders, research of the means of exploitation through various sales actions, joint – venture, etc.

The process of implementation of the strategy based on knowledge involves adjusting of the organizational culture to the changes ingrained by the strategy, budget preparation needed to operationalize the strategy, reengineering of SME management system and the actual implementation of the strategic changes planned.

For the development and implementation of strategies based on knowledge, Sue Brelade, proposes that certain key decisions and actions within these processes are to be based on the following ethical principles: "the principle of

[14] Ovidiu Nicolescu, Luminiţa Nicolescu, 2005
[15] Ovidiu Nicolescu, Luminiţa Nicolescu, 2005

reciprocity, the principle of using and the principle of recognition or of rewarding the parties involved"[16].

The process of evaluation and control of the strategy involves the following: assessment and estimation of results from operational strategy, confronting them with the results that should have been achieved, and where appropriate, corrective measures.

In a knowledge-based SME, strategic management processes based on knowledge are exploiting its intellectual capital in order to create added value that would allow increased performance and hence its development.

## Conclusion

In conclusion, the research on the concepts of strategy and strategic management based on knowledge is a comprehensive development process, because of the needs of SMEs to survive and grow in the new organizational context, which is also changing.

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## INFORMATION TECHNOLOGY – A TOOL TO REDEFINE THE AIR TRAVEL ESSENTIALS

Camelia M. Gheorghe*,
Cristina Stoenescu**

**Abstract:**

In an era where technology changes people's way of living, the companies in the tourism industry are struggling to exist and cope with a continuously increasing demand from a new and more sophisticated tourist. As aviation has always been the leading field in technological innovation, changing tourism and the whole society in a significant way, a particular attention was given to the way airports respond to these new challenges. This paper highlights the way technology shaped the new typology of tourists, focusing on the way passenger service is being reinvented in airports. The analysis concentrates on 2 aspects: the actual problems encountered by airports nowadays and the changes occurred in the behavior of the modern passenger.

**Key words:** information technology, travel, airport, biometrics, geo-location, mobile, bluetooth, internet, passenger.

**JEL Classification**: L93.

## INTRODUCTION

Over the past years, as technology kept evolving at a high pace, all sectors have been confronted to new opportunities and challenges. Technology determined the evolution of the whole society, changing people's ways of living and habits, creating new trends and new consumer typologies. Travel and Tourism is one of the sectors which developed as technolgy evolved, benefiting from it and influencing its evolution in the same time. The airline industry is the most dynamic component of the travel and tourism industry, and the pioneer of the technological developments in the field.

Airports represent a key point in the travel and tourism industry as they represent the connection between airlines, consumers and destinations. More

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and more specialists refer to the airpors of the future as "airport cities", beginning to have the caracteristics and the functions of an independent city. Airports have evolved significantly during the last 30 years and all these changes have been directly connected with the evolution of technology. The purpose of this study is to reveal how technology is the key element in the evolution of airports. An analysis is conducted in order to explain the challenges of the system in order to understand how technology could help airports provide better passenger service.

## SHORT HISTORY OF ICT EVOLUTION AND ITS IMPACT ON THE TRAVEL AND TOURISM INDUSTRY

Travel and tourism have always been closely connected with the information and communication technologies (ICT) sector, benefiting from the technological developments and, in the same time, contributing to its evolution. Due to the new technological developments, enterprises and destinations needed to adjust to the new trends and to a new consumer typology, adopting innovative approaches. The modern consumer is more familiar with IT technologies, he has access to information which made him more sophisticated and demanding, requiring specialised and interactive services. The evolution of ICT shaped and re-engineered the travel and tourism industry[1]. The tourism industry is highly fragmented and diverse, linking a „worldwide supplier community"[2] with consumers also distributed globally, bringing together different cultures, regions at different development stages, each with enterprises of different sizes. The evolution of ICTs demonstrated that centralizing data is a key element in the development of tourism as well as transforming distribution into an electronic marketplace[3].

The pioneers of the technical developments in the tourism industry were the Computer Reservation Systems (CRS) in the 1970s and the Global Distribution Systems (GDS) in the 1980, among the first multi-organisational and global information systems[4], followed by the Internet in the 1990.

Starting the 1990s, "world wide web" (WWW) became the primary mean of information distribution, redefining the society, the habits and consumer profiles. The first step associated to the development of the "world wide web"

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[1] Buhalis Dimitrios, *Strategic use of information technologies in the tourism industry*, p.3

[2] Werthner H, Klein S, *ICT and the changing landscape of global tourism distribution,* Electronic Markets, Volume 9, Issue 4, 1999

[3] Buhalis Dimitrios, *Strategic use of information technologies in the tourism industry*, p.6

[4] Abel Usoro, *ICT (Information and Communications Technologies) and Tourism: An Initial Exploratory Study of Developing Economies as Suppliers of Hospitality and Destination*, p. 1

was "web 1.0", characterized by connecting information, as a collection of static sites that the users can access. At this stage, the consumer gained access to information, enterprises started to have visibility, but there was no interaction between them, the consumer having a passive role. "Web 2.0", also called the social or community web[5], had a significant impact on the society and on the existing business models. Its main characteristic is being people centric, linking users and allowing them to be a part of the creation process. Web 2.0 represented the beginning of social networks, virtual groups, dynamic content and personalized services, explaining why it had a strong influence on the consumers profile and on business models[6].

The consumer becomes an active participant, sharing experiences, pictures, preferences, allowing enterprises to better understand their public and its needs and to develop a closer relationship with them. Consumers started to have an online profile, shaped by their personality and preferences and enterprises could personalize their services according to their target audience. In the same time, internet has become the main information and communication source, influencing more people than television or any other source[7]. According to Yoo and Gretzel (2011), the main contribution of Web 2.0 is the new form of word of mouth created, which offers specific and experiential information with access beyond the boundaries of one's immediate social circle[8].

One of the main characteristics of tourism services is intangibility and the fact that they are purchased before and away from the moment and the place of consumption. Hence, an important role is played by descriptions and representations[9], explaining why this stage of internet had a strong impact on the development of the industry trends, affecting all the participants to the process. Through Web 2.0, the consumer has access to information, is able to make online bookings and has much more choices than in the past. Now, the consumer has direct access to the tourism providers (hotels, airlines), not only to the intermediates (the travel agencies), which made significant changes and a switch of power in the system. The consumer starts to become the central piece of the tourism system.

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[5] Mistilis N, Buhalis D, *Challenges and potential of the Semantic Web for tourism*, eRTR, vol 10, 2012, p. 51

[6] Hamid Ouyoub, *Apports et applications du Web 2.0 dans l'industrie du tourisme*, 2011, Universite de Fribourg, p.11

[7] Anne CHABOT, *Travel 2.0: future of tourism?*

[8] Noti Elton, *Web 2.0 and its influence in the Tourism Secto*r, European Scientific Journal, July 2013

[9] Buhalis Dimitrios, *Strategic use of information technologies in the tourism industry*, p. 3

The modern consumer is sophisticated, he has access to information and he has many choices, explaining why he is interested in personalized services. In the same time, because of the gain of visibility on the internet of small and medium enterprises and also the direct communication between providers and consumers, the competition increased and all enterprises had to reinvent their strategies and find innovative approaches to attract the modern travel consumer. Being confronted to multiple choices and because of the changes in his personality (dynamic lifestyle, multitasking activities), the new sophisticated consumer needs a rapid identification of its needs and personalized approaches, in order to fulfill these specific needs[10].

Web 3.0 contributed to the emancipation of the consumer and changed the whole existing system. Also named the Semantic Web, Web 3.0 was introduced in 2001 and it makes data interoperable and capable of manipulation by computer programs[11], the foundation basis of personalization. These new stages of web development focus on recomandation systems. A recomandation system indicates the appropriate options in a specific case, to a certain category of consumers (Resnick & Varian, 1997, Gretzel et al., 2004)[12]. Recommandation systems extract the data from the virtual identity of the user and use it in order to create a typology and create recommandations corresponding to it. Still, the travel and tourism industry is very complex and highly fragmented. Also, due to the fact that the industry has developped in the same as the evolution of technology, there is a high number of informatic systems of different structures, which determines a lack of commun standards and a fragmentation of the information process. [13] At this level, centralizing the existing data would be the key to better personalization of services.

## REINVENTING CUSTOMER SERVICE: AIRLINE INDUSTRY – A PIONEER IN EXISTING TRENDS

The progress of technology had a big impact over the years on aviation and on the tourism industry. The airline industry has always been considered a pioneer in the tourism industry. The international tourism began shaping once the international flights started to develop; CRS and GDS were the first stages

[10] Buhalis D, *Progress in information technology and tourism management: 20 years on and 10 years after the Internet —The state of eTourism research*

[11] Mistilis N, Buhalis D, *Challenges and potential of the Semantic Web for tourism*, eRTR, vol 10, 2012, pag 1

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[13] Rosemary Stockdale, Bernhard Rieder, Sven Ktihne, *Developing a Business Model using Open Source Software: A Tourism Case Study*

of the electronic multi-distribution systems; with new routes opening, new technology allowing to extend the capacity of the airplane, traffic grew significantly and aviation became an important part of the modern society, becoming also the main target of terrorists, which is an important risk that the tourism industry faces nowadays.

The new necessary security regulations had a strong impact on airports, airlines and the passenger experience and determined considerable changes. The rigorous security controls determined more stressful time spent at the airport which led to the congestion of airports, considerable delays and money loss for airlines, missed flights and negative passenger experience. The airport is an important element, as it represents the connecting point between the airline and the passenger. An improper organization of the airport determines direct and indirect (insatisfied customer) losses for the airlines.

One of the main priorities of the airport today is to fluidize traffic, keeping the necessary measures of security and concentrating on the passenger and his needs, trying to make the airport experience an enjoyable one. This is important especially from an economical point of view. The airport has different business partners: the airlines and other companies that generate money out of aviation, but also companies, which have a contribution not generated directly by aviation (Duty Free, Duty Pay, retail, catering, car rental, ticketing, ATM, parking, offices etc)[14]. In the past, the main income of an airport was aviation; due to the liberalization, airlines had to keep the prices low and grow the number of passengers, reducing the expenses and the financial flow[15]. In the same time, airports were forced to find other ways to ensure revenue growth and maintaining profitability, mostly by focusing on revenue generated out of non-aviation activities (retail, services, food and beverages, parking and passenger access)[16]. The centerpiece of the non aviation activities in airports is represented by the passenger[17]. As a result, it is important to create to him the state of mind to explore these possibilities, trying to make the experience unstressful and also offering him services according to his needs and profile.

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One of the most important factors the airports must consider is that collaboration with the stakeholders is fundamental. The lack of data exchange between the airlines, the airports and the authorities leads to a fragmented passenger flow, discontinuity of the airport operations and passenger insatisfaction. Technology is the element able to connect the airport to its stakeholders for an exchange of information and services. This way, the passenger flow would be more compact and a less stressful experience for the passenger, who would also appreciate being constantly informed in real time and having personalized services delivered to him.

Airports have evolved significantly over the last 30 years, as a necessity of supporting the global development of the airline industry. The liberalization determined the growth of the passenger traffic as well as the number and variety of flights. Both airlines and airports had to adopt new strategies in order to face the new market demands: airlines became part of partnerships and alliances and airports were grouped in "hubs", which together contributed to the creation of "air transportation ecosystems"[18]. As the airports developed, different development stages have been distinguished[19]:

**a. Conventional Airports -** This stage existed in the 1980s and ensured a safe and efficient management of flight operations (landings, departures and other aircraft operations). The services offered are basic: check-in, boarding, security, baggage drop and pick-up and moderate retail and food and beverage services[20], without any collaboration actually existing between these services, which were independent.

**b. E-airports -** There is a converged network which allows offering shared services to passengers, still, with limited collaboration among the components of the airport ecosystem. Also named "the agile airport", this stage offers advanced operational efficiencies, with faster turnaround times for airlines and improved passenger experience[21]. Airports implement different programs and applications meant to create a more pleasant passenger experience. Some of the airports implemented the Passenger Gait Mapping using Augmented Vision Technology (identifying parameters as stride, speed, movements of the passenger in order to eliminate airport congestion), most of the airports and airlines are using social media applications in order to directly communicate

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[18] Idem

[19] Pethuru Raj, Anupama C. Rama, *Intelligent Cities: Enabling Tools and Technology*, p. 384

[20] Dr. Fattah Amir, Lock Howard, Buller William, Kirby Shaun, *Smart Airports: Transforming Passenger Experience to Thrive in the New Economy,* Cisco Internet Business Solutions Group, 2009

[21] Idem

with the passengers, conduct surveys, advertise promotional offers or even offer services on board (selecting co-passengers based on an existent internet profile). Many of these airports focus on entertaining activities, creating digital interactive areas but also other facilities as spa, movie theaters, art and gaming zones.

**c. Intelligent Airports** - These airports are using systems build around a unique converged IP network which enables rapid communication and exchange of information between all the components of the ecosystem (airlines, airport, authorities, other parties). Using the common passenger data, the system is able to anticipate the needs of the passenger and offer recommandations for personalized services.

Considering that between 2010 and 2030, commercial passenger traffic is expected to increase globally from 4.9 billion to approximately 13.3 billion[22], it is important for the airports to find ways to better manage their operations and to find innovative solutions. According to SITA, global leader in the sector of ICT in the airline industry, the airport of the future should include[23]:

- Systems allowing to monitor the airplanes
- Real time communication between the ground services in order to avoid discontinuity in flight operations
- Identification of the passenger's location in the airport, keeping them updated on the delays, flight or terminal changes
- Tracking the luggages, in order to facilitate transfers and to avoid baggage loss
- Creating a centralized system to control all the operations is the key element of the modern airport and the basis of personalized services.

TSA (Transportation Security Administration) started working with SITA to implement a management system of the passenger services, using Bluetooth. The system is to be implemented the next years in over 179 airports in the United States and will allow the airport staff to prioritize the services, receive real time information about every passenger, its location in the airport and the time he has left until boarding[24]. In the same time, having the exact location of the passenger inside the airport, additional services can be offered to him, in order to enhace his experience. The first system of this kind has been implemented in 2011 in the Copenhagen Airport[25]. This application offers passengers assistance inside the airport (directions, flight information), suggestions regarding shops, restaurants or other services, according to the geo-

[22] http://www.ccadf.cn/upload2/0119909319065294bbef1b9ede189de2.pdf
[23] Sita.aero.com (Air-Transport-IT-Review-issue3-2012-v2.pdf)
[24] Sita.aero.com (Air-Transport-IT-Review-issue3-2012-v2.pdf)
[25] Sita.aero.com (Air-Transport-IT-Review-issue3-2012-v2.pdf)

location of the passengers as well as his online identity and preferences. The application uses different signals to determine the location of the mobile phones of the passengers, giving important information according to the point where they are (check in, security, border, gate). The airport in Copenhagen collaborates also with the retail companies, giving different discounts and special offers to the passengers, according to their preferences and online identity.

Although the number of airports which implemented this kind of system is reduced and most of them face a fragmented flow of operations, all big airports started the process of reinventing passenger service: using the mobile or online kiosks for check-in, baggage self tagging or mobile apps allowing the passengers to choose additional services before boarding. The airline industry is inventing a new form of customer service, according to the requirements of the industry but also according to the profile of the new tipology of the modern traveler. It is a form of "assisted self-service", the passenger having the option to act on his own, but being given the correct guide lines and suggestions.

Introducing "self service" in airports, the passenger gains control over the offered services, confort and flexibility, as it can be done at any moment and from multiple locations, reducing the waiting time at the airport (Meuter, 2000)[26]. The passenger can make his own check in, tag and check his own luggage. These are the most basic exemples reflecting how technology has changed so far passenger service in airports. Introducing biometric systems continue this process, giving a more secure process, confort for the passenger, decongestion of passenger flow, reduced waiting times, personalized services during the whole process, with the collaboration between airlines, authorities, airport and other parties.

Still, there are some disadvantages to be considered: the security of information, violation of privacy or religious considerations in some cases. Also, on a larger scale, the question remains if the technologization of service is an alternative suitable for all the age categories. Statistics indicate that persons over 65 years old represent an important segment of the potential tourism market (between 2006 and 2011, when the economic crisis affected the tourism industry, the number of tourists decreased in all age categories, except the 65+, which had a 10% increase in 2011, compared to 2006)[27]. Another industry report indicates that active seniors represent one of the four segments which will have an impact on the airline industry in the next 15 years[28].

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[26]Meuter L Matthew, Ostrom L. Amy, Roundtree I. Robert, Bitner Mary Jo: *Self-Service Technologies: Understanding Customer Satisfaction with Technology-Based Service Encounters*

[27] http://epp.eurostat.ec.europa.eu

[28] Drennen Hannah, *Self Service Technology in Airports and the Customer Experience*, PhD thesis, 2011, University of Nevada, Las Vegas, p.16

In this context, the question is how are these generations going to accept this new approaches and how would they face the new changes? Is self service and computerized interaction generally accepted or is it suitable only for a specific category of travelers? Introducing "self service" or other technological applications will allow the airport staff to providing assistance to the passengers who face difficulties during the process[29]. Self service technology will allow the passengers to get control over the easy processes, giving them confort, flexibility, control and the airport staff will have more time to offer special assistance to the passengers who require more attention. In the same time, IBM, representing one of the most important kiosk distributors, is planning to launch special equipement for persons with disabilities[30].

## CONCLUSIONS

The evolution of technology has been closely connected with the development of tourism and especially of the airline industry. This process started with the systems of reservations CRS and with the global systems of distributions GDS, then it was followed by internet and its considerable impact, redefining the entire society, human behavior and business models. Technology represented the key point in the development of the international tourism, through the development of the airline industry. The airplane became the most important transportation mean, allowing to reach in a matter of hours different parts of the world which were not accessible before.

The modern passenger lives in a world where his family and friends are in different parts of the globe, at a flight distance, where international commerce made territorial borders disappear and where internet gives the opportunity of traveling in time and space. The modern traveler has access to information, has a dynamic lifestyle, lives in a digital world and uses technology for each aspect of his life.

In the tourism industry, information technology represented the opening of international markets, the development of the small and medium enterprises, the beginning of the direct contact between the consumers and the providers, decreasing the role of the intermediairies, which were dominating the sector in the past. All these aspects led to the creation of the typology of the new "sophisticated tourist", who needs control, personalized services, confort and flexibility.

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[29] Drennen Hannah, *Self Service Technology in Airports And the Customer Experience*, PhD thesis, 2011, University of Nevada, Las Vegas, pag 16

[30] http://www-03.ibm.com/able/news/selfservkiosk.html

Starting from these points, the approaches of the companies had to change and the business model had to be reinvented. Tour operators are oriented in personalizing tourist packages, providers are trying to make an online identity and communicate directly with the consumers, and intermediairies also are oriented to gaining an online profile. In the same time, the development of internet led to a strong fragmentation of the sector. The researchers mention more and more the necessity of a centralized system in order to take advantage of the new trends and respond to the modern traveler's needs. Destination management systems have already been implemented in some regions with the purpose of better connecting and managing their entities. Still, the biggest efforts of centralizing information are done within airports, because of the strong fragmentation of their operations, the constantly growing traffic and the specific requirements (security). This process is in an early stage of development, but it is expected to evolve rapidly. In the specialized literature, the new intelligent cities of the future and the airport - cities are already mentioned, having the exact concept of informatics and centralized data networks.

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# THE ROLE OF YOUTH IN SUSTAINABLE DEVELOPMENT OF ROMANIAN RURAL COMMUNITIES

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**Abstract**

**The rural area** is an area vital to our country, both by its size and by the complex effects they generate. Agriculture Committee of the Council of Europe believes that European rural areas is more than 85% of the continent and affect directly or indirectly more than half of the European population. Exodus of young people in particular to urban areas, labor migration to EU countries and beyond, and the refusal of young professionals to return to rural areas, are just some of the reasons why human resources in rural Romanian are largely aged and unskilled. ***Employment in agriculture*** is an indicator on the one hand the development of the sector (i.e. the degree of capitalization of farms), and on the other hand provides guidance on sustainability and "youth" categories of farms, responsiveness to new development efforts and entrepreneurial capacity. Romania's population is also affected by aging, a phenomenon that manifests differently in most member states of the European Union. In Romania, according to the National Institute of Statistics, South and South - West region faces an aging of the population, with the highest percentage of population older than 65 years (16.2% of total population ), expecting an increase in this trend. The higher percentage of young population recorded in the North - East (18.3%).

**Key words:** sustainable development, youth population, Romanian rural communities.

JEL Classification: O15, R10.

## INTRODUCTION

*The national interest of solving the problems of rural Romanian* is the most eloquent, the more rural areas representing 87% of the country and where

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they live more than 50% of its population. The proposed research finds its place in the economic sciences, and social, addressing a topic of national interest, given that, at present, Romania is at the stage of finding real solutions for sustainable development of rural areas. The importance given to rural areas results inclusive from the Recommendation of the EC 1296/1996 on developing a document specifically for this problem as the European Charter of the countryside. Perhaps the most serious current problem is the Romanian rural population aging and lack of professionals who work both in the public and private sectors.

***Throughout Europe are suffering from demographic stagnation or decline*** more or less pronounced, resulting in, among other things, general aging of the population. For the countries of Central Europe that joined the European Union the situation is worrisome because of very low birth rates and thus the gradual reduction of the working age population, the exodus of young people and having highly skilled, the unsatisfactory level of training according to market requirements and acquisition of the skills necessary to transition to the information society, based on knowledge and innovation.

It is estimated that there is a real risk that, in the coming decades, the countries of Central and Eastern Europe to become a sparsely populated region with a declining labor force, forced to bear the burden of an aging population.

Scientific approach to **sustainable rural development** is essential in the current European Romania. The theme of finding ways of returning young professionals in rural areas addressed in this article is one recent and addressed sporadically in economic and social sciences in Romania.

In the current research landscape of rural economy, this subject is something new, unique, but starts today's need to convince young graduates and graduate to return to rural areas (especially in the areas of residence) to live and work. This would be a solution of Romanian rural rejuvenation and to ensure their sustainable development prospects.

## MATERIALS AND METHODS

In preparing this article were used as **materials for documentation and information sources**: national and international literature; magazines devoted; studies and research conducted by the authors in the doctoral and postdoctoral training stages; studies and research conducted in the projects developed at the Institute of Agricultural Economics, the National Economy Institute and other institutes of the Romanian Academy; official statistics provided by the National Institute of Statistics etc. The main **research methods** used to compile this article were: bibliographic synthesis; mathematical and statistical processing of data; induction and deduction; observation etc.

## RESULTS

According to statistical data used by national legislation, rural Romania covers 87.1% of land surface and are home to 45% of the population, i.e. approx. 9.6 million of Romanian.

In 2012, the Institute for Quality of Life Research (www.iccv.ro) and Institute Social Economy (www.ies.org.ro) made public the results of a representative field surveys among farmers' associations, those forest owners and co-owners, rural communities in Romania, which shows that *75% of **rural residents live in poverty***. According to the same survey, over 1,000,000 Romanian living in rural areas are unpaid family workers, people without any wage, and live in their own homes.

Figures from the study "*Romania in figures 2011*" National Institute of Statistics (www.insse.ro) attests, however, that ***employment of people in rural areas*** are part of a trend of slight growth, even while the Romania has been seriously affected by the crisis in 2009-2010. Paradoxically, employment recorded a peak increase of 5.4% in 2009, the most difficult year of the economic crisis in Romania, 0.5% more than in 2007. At the same time, ***long-term unemployment in rural areas*** decreased on average by 2%, even among young people, the group most affected by unemployment. This could be a signal to decision makers about the ability of poor rural communities in Romania to respond to crises.

According to the same survey of INS, in the countryside of Romania, employment opportunities are close to zero, and access to services, not always of good quality, is slow. These are the reasons for *migration phenomenon* manifests itself in rural areas, especially among young people, 8.3 per thousand inhabitants in 2010 to 6.8 in 2007 and 6 in 2009. The migration phenomenon occurs in reverse, the environment in rural areas, 13.8 per thousand in 2010 to 12.2 in 2007 and 10 in 2009, only those migrating to areas no longer young, which emphasizes the aging rural population.

**Peasant farming in Romania** is characterized by the fact that owns the land around the house and about 1-5 ha field at a certain distance from home. The production is generally mixed (speaking mainly of field crops and granivores - poultry, pork, and vegetables and fruits for family consumption). In general, lack of means of production and financial resources, making them vulnerable to market pressures means of production and have little chance of survival without capitalize upgrade. Usually, production, distribution and consumption of goods is done in strict relation to the requirements of the family, in the case of subsistence or semi-subsistence farms that produce mostly, sometimes solely for their own consumption.

In this subsistence agriculture, *labor force* is priceless; in the sense that it is not economically evaluated, not investing, it supports very low yields per hectare and harvest is not sold on the market, but is intended for self-consumption (for human food, the farmer and his family and / or animal feed household).

*Owners subsistence households are generally elderly*, people with little training or heirs who live in urban areas. Some of these households will be able to resist but in the practice of part-time agriculture and non-agricultural diversification of economic activities in rural areas. The combination of farming with activities of manufacturing industries, with service activities for agriculture, trade, tourism, etc., can be a way of improving the incomes of farmers in this category and their integration into overall economic development.

**Working in agriculture** is the decisive factor for the enhancement of resources in this branch, represented by capital and operating capital land, decisively influencing the production results. Many economists recognize the economic importance of agrarian labor in agriculture through the large share in the structure of production costs related to the workforce. This share is estimated between 30-60% of the total, depending on the type of farm production systems that practice intensive or extensive, etc.

***Labor in agriculture*** must be completely and acknowledge the very special, not only because of economic importance, but also the social importance resulting from the new functions of agriculture. The special nature of agricultural work is not diminished at all from the continued reduction in the number of active participants in agriculture.

The process of gradual reduction of labor in agriculture, caused by increased development (growth) economic, in addition to the beneficial aspects related to productivity growth resulted in a deep crisis in rural areas. Rural life crisis arises, first, the rural exodus, which led to the depopulation of Romanian villages (and not only Romanian) but also the "remoteness of the peasantry" of Romanian peasant, phenomena that shatter lives in rural areas. Another problem is the general assessment methods and procedures work in agriculture. This problem can be addressed in three aspects, namely: labor available, work effectively used (used) and the work required.

Sociological research showed that *work in agriculture - as a factor of production* - has some features and peculiarities of its own. It can be said that, in agriculture, labor is not homogeneous and uniform as in industry. The complexity of work processes in agriculture is determined by the complex structure of agricultural activities, the biological laws of development of plants and animals, the variety of culture systems and technological structures and natural conditions that determine a range of technical features, economic and social.

Working in agriculture is "subordinated" objectively needs (of needs) living beings. Whatever the adopted animal husbandry system, their care is daily (feeding, watering, etc.). The crop execution of certain treatments should be done only at the right times, all non-execution may jeopardize their respective harvest.

***The need for labor in agriculture*** is seasonal workers prefer, as is natural, a service (service) more regular, as in industry. Seasonal agricultural employee is in constant insecurity due to frequent work breaks typically caused by unfavorable weather. There is often a social conflict generated by this situation, the "downtime". Solving is one: guaranteeing a minimum wage for unfavorable weather. In agriculture the number of employees with employment contract of indefinite duration is extremely low. Employment of this type is less adapted to conditions in agriculture where work rhythms and intensities knows very different, where job insecurity is almost constant, where, as noted above, assessing the quality of work performed is quite cumbersome and where production processes are difficult to control.

Regarding the qualitative dimension of labor supply in the labor market in agriculture can show that the more rural labor force has a skill level higher education and the higher productivity, efficiency and overall balance of employment receive their consistency.

***The influence of the demographic factor on the potential supply of labor in the labor market in agriculture*** is not simply to change the number of people of working age, but also includes changing age structure. Among the implications of demographic trends on labor supply and labor market in Romania that can play the following:

**a.** *a numerical decrease in the supply of labor*, both on account of the actual demographic aging and retirement from activity, as well as new entrants into the labor market. On the other hand, the pressure on labor supply will relax, while emphasizing of a series of social problems, especially in the economic dependency ratio and the ability to create their resources needed for social security;

**b.** *reducing school population* that will put serious and difficult problems (re) conversion teacher professional before all of the compulsory education;

**c.** *changes in migratory behavior of labor*. Internally it is possible to reverse the direction of migratory movement from agriculture - farming, the farm - non-farm, especially due mainly to the development of social services, to the rural production etc.[1]

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[1] *After Pert Steliana, Impact "demographic crisis" on the labor market (Impactul "crizei demografice" asupra pieței muncii), Notebooks debate sessions of the Sustainable Development Strategy of Romania "Horizon - 2025", vol. I - Sectoral strategies, Demography, Bucharest, 2004.*

Employment in agriculture is an indicator on the one hand the development of the sector (i.e. the degree of capitalization of farms) and on the other hand provides guidance on sustainability and "youth" certain categories of farms, receptivity to new development efforts and entrepreneurial capacity.

Next we analyze employment in Romanian farms in various structural aspects (economic, social, educational, etc.). From a demographic post-revolutionary period marked: more permanent mobility of the population in rural communities; emphasizing distortion demographic balance by age and sex; natural growth rate decreased due to higher general and infant mortality; emphasizing discrepancy regarding the instructional - educational the rural population compared to urban population.

*The trend of demographic aging of the rural population* and the pressure of elderly quotas increased the load active population. The phenomenon of migration continued especially after 1989. Thus, in 1990 over 616,000 people migrated from rural communities through urban relocation. This was possible due to the closed nature of the abolition legislation of their residence requirement cities and in rural areas where they work.

Regarding internal migration trends were quite stable, and the region has "lost" the greatest number of inhabitants has always been the North - East. People with the highest willingness to migrate are usually young, the working age population who migrate to urban areas in search of better jobs and a social life more attractive.

In the period 2000 - 2007 was dominated by internal migration flows urban - rural, urban flows followed - urban and rural - urban. As a result of the worsening socio-economic conditions in urban areas there was a massive migration of population to rural areas, rural population increased significantly in most regions. During this period there were major changes in socio-demographic structure of the rural population, making their appearance in rural communities socio-economic new categories. Also, there is a drastic reduction of active rural population with superior instructional educational status; 60% are junior level training.

There were also changes in the composition of households rural families. The census of 1992 marked the massive increase in the number of rural households without active persons from 7.54% in 1986 to 30.6% in 1992, while the share of households consisting of 2-4 persons from 63% in 1986-41 % in 1992, the average number of people per household was for rural is 3.12. Another negative factor was that the active population in agriculture - namely the young - numerically decreased at a faster pace with the population of other ages. Also, young people aged 25-29 years are the least numerous of those who remained in the villages.

**The analysis of employed population by age and activities** of the national economy, we can draw some conclusions with profound socio-economic implications, as follows:

- over 1/5 of the workforce in agriculture is the elderly (65 years or more);
- Romanian peasant, reached retirement age is forced to work to secure basic needs, because the amount of pension is insufficient (lowest pensions they are still peasants, the pension system is still discriminatory in their disadvantage net compared to other socio-professional categories of pensioners);
- over 50% of the working population are employed in agriculture in other fields, practicing agriculture "in the limit of available time" with adverse effects on labor productivity and quality of agricultural production.

In Table 1 are shown a number of issues concerning the structure of employment in the Romanian agricultural holdings year by:

- the category of classification or degree of involvement in farming;
- the level of training (especially the heads of holdings);
- distribution by sex and age of the individual farmers and their families etc.

**Table 1**

**The structure of the labor on Romanian farms**

| SPECIFICATION | The agricultural area of the holding (ha) | | | |
|---|---|---|---|---|
| | < 5 | 5 - 20 | 20 - 50 | > 50 |
| *Family labor force* | | | | |
| Thousands persons | **2248,6** | 702,0 | **35,0** | **14,5** |
| Thousands annual work units (AWU) | 846,1 | 308,3 | 17,7 | 8,1 |
| *Non-familial regularly engaged workforce (permanently)* | | | | |
| Thousands persons | 10,4 | 5,2 | 3,2 | 52,4 |
| Thousands annual work units (AWU) | 7,9 | 2,5 | 2,2 | 40,8 |
| *Non-familial labor force employed irregular (seasonal)* | | | | |
| Thousands annual work units (AWU) | 54,1 | 36,2 | 6,9 | 24,2 |
| **Heads of holding** (thousand) in which: | **918,2** | **289,6** | **14,9** | **13,3** |
| - women *(%)* | 19,8 | 20,6 | 14,5 | 10,6 |
| - part time - less than 50% (%) | 63,7 | 54,9 | 44,0 | 42,4 |
| - full-time - 50% and above (%) | 34,0 | 40,4 | 44,2 | 41,8 |
| - only basic training in agriculture (%) | 7,9 | 8,6 | 16,2 | 16,9 |
| - higher education in agriculture (%) | 0,9 | 2,1 | 9,1 | 26,9 |
| **Individual farmers** (thousand), of which: | **917,3** | **287,5** | **14,1** | **5,9** |
| - women *(%)* | 20,2 | 21,5 | 14,8 | 11,0 |
| - age distribution (%) | | | | |

| **SPECIFICATION** | **The agricultural area of the holding (ha)** | | | |
|---|---|---|---|---|
| | < 5 | 5 - 20 | 20 - 50 | > 50 |
| - under 35 years | 3,8 | 2,8 | 6,4 | 6,7 |
| - 35 - 44 years | 9,8 | 7,5 | 14,3 | 20,6 |
| - 45 -5 4 years | 15,8 | 14,5 | 22,2 | 29,1 |
| - 55 - 64 years | 24,6 | 23,3 | 24,8 | 21,6 |
| - 65 years and over | 45,8 | 51,9 | 32,3 | 22,0 |
| - the main occupation (%) | 16,4 | 15,8 | 12,2 | 14,3 |
| - as a secondary occupation (%) | 5,1 | 5,4 | 5,6 | 7,2 |
| **Individual farmer's wife, who works on the farm** (thousand) | **630,6** | **183,9** | **9,6** | **3,7** |
| - age distribution (%) | | | | |
| - under 35 years | 9,1 | 6,5 | 11,7 | 15,7 |
| - 35 - 54 years | 36,4 | 32,9 | 45,9 | 56,1 |
| - 55 years and over | 54,5 | 60,5 | 42,4 | 28,2 |
| - with another activity (%) | 21,8 | 20,2 | 19,5 | 23,2 |

Note: AWU = Annual Work Unit (1,960 hours, equivalent to 245 working days of 8 hours/day); Unit ESU (UDE) = Economic Dimension Units, equivalent to a size of holding 1,200 Euro.

*Source:* EUROSTAT - "Structure of agricultural holdings", Newsrelease 60/2007, www.europa.eu, www.epp.eurostat.ec.europa.eu.

A first feature is observed age distribution of heads of holdings; in almost half of farms considered (more than 1 ESU), i.e. in 47% of cases, the manager is aged over 65 years. The size classes ranging holdings 5-20 ha, over half (52%) of heads holdings over 65 years and under 5 ha farm category, the percentage is close (46%).

***Young farmers*** (under 35) appear only in 4% of farms surveyed, but it is interesting to note that the categories of medium and large farms (between 20-50 ha and 50 ha), most heads of holdings aged between 35 and 64 years, and 27% have higher education specialist.

Also in case of holdings with animals, farmers over 65 years to a greater extent in the position of head of the holding (47%). Large animal farms (over 50 LU - livestock unit) are led by young farmers (under 35 years) in 10% of cases, while vegetable farms profile, the percentage is less than half. Most balanced age distribution of heads of holdings can be found in large animal farms, 75% of them aged between 35-64 years; this proportion drops to 47% in farms with fewer animals. On farms with low-profile animal and the plant, between 60-80% of individual farmers work only part-time (less than 50% of the total) holdings; 21% of them having a different activity as the main source of income.

Labor issues in various aspects, was often a subject of study in the research of "Rural Microeconomics" sector of Agricultural Economics Institute of the

Romanian Academy. In numerous research projects was studied the structure of employment in agriculture and Romanian rural areas. In its surveys and investigations there have been questions about the workforce. ***The issue of youth as the workforce in agriculture and rural areas***, and their role in sustainable rural development process has always been present in these studies.

Next will be presented some results obtained from a research project carried out between 2006 - 2008 in 419 farms, of which 268 individuals and 151 legal entities, relatively uniformly distributed at the national level.

**The dynamics of the labor market** is a result of the restructuring of the economy and employment opportunities offered by the various sectors. Employment rate of population in Romania has remained relatively constant over the period 2000 - 2007 (58% in 2005, 58.8% in 2006), according to data from statistical yearbooks.

At the regional level, employment rates above the national average in less developed regions - North - East, South and South - West - caused by high employment rates in agriculture. Bucharest - Ilfov also records, employment rates above the national average, due to much higher labor supply and diversified.

The phrase "Romanian rural population is aging" is checked and if the results of our studies. At the level of 419 farms studied, the age distribution of heads of holdings is as follows (Table 2):

**Table 2**

**The age distribution of the farms heads from the sample**

| Groups of age | The number of people (heads of holding) | % |
|---|---|---|
| 30 – 40 years | 22 | 5,25 |
| 41 – 50 years | 44 | 10,50 |
| 51 – 60 years | 98 | 23,38 |
| 61 – 70 years | 55 | 13,12 |
| 71 – 80 years | 34 | 8,11 |
| over 81 years | 81 | 19,33 |

*Source:* Database obtained in CNCSIS research project "Sustainable development potential farm", 2006-2008.

Given that **sustainable development of the farm** is, first, a development that is part of the "continuity in time and space" and can be measured by the level of income, equity, employment, the occupation of the territory and the preservation and protection of the environment and biodiversity, the present study aims at knowing how labor as the main factor of production employed in Romanian agriculture can contribute to "permanent" farming in certain territories and the further development of existing farms.

In our view, the crucial issue is to reform the peasant class in Romania, a qualitative and vocational rehabilitation. *Romanian peasant training problem* is not new. For example, S. P. Radianu (1881) designed and proposed a whole system design and gradual training, the level of the most advanced European countries. One of the great followers of S. P. Radianu, Gheorghe Ionescu Siseşti developed his predecessor thesis on "*improving agriculture through education*". According to his conception, agricultural education must develop parallel in all branches and fields of higher education must train managers and researchers, while lower education aims to form particularly good cultivators of their own land.

Therefore, restoring peasant class as a great democratic, modern organization goes through a unified and multilateral education, keeping everything we better in this area, it is natural adding new elements conducive to recovery - on new bases - a social class - Romanian peasantry, based regeneration nation and ancestral traditions.

From all the data it is clear **the important position of agriculture in the Romanian economy** and the fundamental role of labor resources in the sector and agricultural holdings within each part. No matter how we characterize the national economy of Romania (developing, still in transition during the restructuring period), one fact is certain, agriculture, the natural and human resources available (categories of land, labor) by its contribution to the creation of macroeconomic indicators (GDP, GVA etc.) continues to hold a dominant position in the economy. *Human resource management in Romanian agriculture* currently seeks rapid increase farm income (especially family holdings) to their maintenance costs and rapid growth of productivity in relation to average farm project expenditures (family farmer).

The population of Romania, located in a declining, is affected by aging, a phenomenon that manifests itself differently in most Member States of the European Union. In Romania, according to the National Statistics Institute, South and South - West facing an aging of the population, with the highest share of population aged over 65 years (16.2% of total population), expecting an increase in this trend. The highest share of young population is recorded in the North - East (18.3%).

Due to the current economic crisis and social problems caused by this, more and more EU countries are beginning to face an acute shortage of labor in agriculture and a growing phenomenon of migration of seasonal workers in a country in another. On the economic crisis, some of the cheap labor from the East, be returned to their countries of origin, began to migrate to northern states, which can provide better pay and decent working conditions.

Despite the shortage of labor force growth, the employment rate of the labor force is still low and unemployment is high, so there is, in principle, an important source of unused labor. Unfortunately, the agricultural sector is still totally unattractive, especially for young people, due to the very low pay, difficult working conditions and lack of other facilities and opportunities. According to managers, labor migration is the main factor determining the difficulties of finding new employees. Poor training of graduates is the second factor affecting the ability of firms to fill available jobs.

***The education of the rural population aged 25-64 years*** registered in the past decade an increasing trend in the share of persons with secondary education or higher. The need for vocational training comes with the increasing competitiveness and diversification of products and services in agriculture and forestry, the restructuring and modernization of agriculture and forestry, processing and marketing sectors for agricultural and forestry products, encourage market oriented businesses the requirements for a wide range of economic and management skills and the objective of sustainable land management and environmental protection, application of environmentally friendly technologies and practices and the use of renewable energy. Therefore, *it is necessary that training activities, information and diffusion of knowledge to be extended to adults who are involved in areas related to agriculture, food and forestry*. Training activities, information and diffusion of knowledge is particularly necessary in disadvantaged in terms of natural, wherever the continuation of farming contributes significantly to maintaining the viability of rural areas. Thus, it is necessary to extend the scope of training, information and diffusion of knowledge to all adults who are or will be engaged in the agricultural, forestry and food.

**The National Rural Development Programme (NRDP) 2007-2013** included activities related to human resource development, being in complementarity with the Sectoral Operational Programme Human Resources Development (SOP HRD). The demarcation between SOP HRD and NRDP was based on the type of interventions and territorial demarcation. The NRDP, Priority I - "Increasing the competitiveness of agriculture and forestry" were financed only short training programs (core courses and specializations) to improve knowledge workers in agriculture and forestry. Also in this direction, the NRDP has considered and early retirement in order to transfer farms from old to young farmers in exchange for compensation. Thus, increasing the competitiveness of agriculture was promoted by stimulating the transformation of rural households in commercial family farms, and increasing middle class in rural areas by promoting young farmers and farm concentration. The human factor plays a decisive role in increasing the performance of Romanian agriculture, in this modern age, the individual management (farmers) and collective (conducted in organizations and agricultural companies). Developing entrepreneurial skills in the great mass of farmers remains a goal of integration success Romanian agricultural structures in community structures.


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# LEADERSHIP VERSUS MANAGEMENT

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## Abstract

It is important to distinguish the difference between leadership and management, both of which are considered necessary. Leadership and management are often used interchangeably, but they are two distinctive and complementary processes.

Organizations need strong leadership and strong management for optimal effectiveness. In today's dynamic workplace, we need leaders to challenge the status quo and to inspire and persuade organization members. We also need managers to assist in developing and maintaining a smoothly functioning workplace.

**Key-words:** leadership, management, workplace

JEL Classification : M10, M20

## INTRODUCTION

The present debate about 'management' and 'leadership' is not new. There is a long history of research into what management is, what managers do, and what managers need to have in order to do their jobs well. 'Leadership' has been of interest at different times and in different ways.

The subject of the differences between leadership and management has been discussed at length in the literature. John Kotter (1990) developed a structure for determining the difference between leadership and management behaviour and tasks. Kotter's view was perhaps more extreme than Drucker's, but also supported it to a large degree. Kotter argued that leaders and managers have tasks that are almost opposite in nature. He felt that management works towards order and stability. Management does this because order will lead to consistency, and consistency to smooth and efficientrunning operations – a goal of management. Conversely, Kotter purported that leadership strove to deliver constructive change and movement in organisations. He argued that successful leaders would seek "continual adaptive change" with a goal of continuously

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improving organisations for success. Kotter felt that leaders should aspire to continually 3 improve organisations so that they would have a greater chance of survival in a continually adapting business environment and those that stay static will not succeed. Kotter was a strong supporter of both leaders and managers in organisations however, arguing that both were necessary to an organisation that runs effectively. A sense that can be gained from some an academic study by Kotter is that managers make the vision of leaders work. For example, leaders provide a sense of direction, reviewing the big picture, and then creating a vision. Managers take this vision and direction, commit to it and then establish timelines and agendas and secure resources to deliver on this vision. Managers make it happen, according to Kotter.

Management and leadership are terms that are frequently used interchangeably, however, they are not the same thing – they have quite distinct meanings. The two do have similarities but they also have important differences. This research report aims to understand the difference between leadership and management and why these differences are important.

## THE DIMENSIONS OF MANAGEMENT

For most, the definition of management is seen quite differently. This doesn't mean that an individual can't hold both management and leadership responsibilities simultaneously, but management is considered a term separate from leadership. The definition of management is to exercise executive, administrative, and supervisory direction of a group or organization.

Katz defined the management as exercising direction of a group or organization through executive, administrative, and supervisory positions (Katz, 1955). Katz thought that management responsibilities are usually tasked-oriented, and it involves developing staff, mentoring persons with high potential, and resolving conflicts while maintaining ethics and discipline (Katz, 1955). Kappa states that the aim from a good management is to provide services to the community in an efficient and sustainable manner (Kappa, 1991). Moreover, Kotter defined the management as a job which takes care of planning, organizing, budgeting, coordinating and monitoring activities for group or organization (Kotter, 2001). Northouse defined the management as a process by which definite set objectives are achieved through the efficient use of resources (Northouse, 2007). Thus, Management in general is a process that is used to achieve organizational goals. Managers focus on formal directing and controlling of their assistants, resources, structures, and systems (Kotter, 2001). Managers aim to reach short term goals, avoid any risks, and establish standardization to improve efficiency (Kotterman, 2006).

The employees follow a manager's direction in exchange for being paid a salary, known as a transactional style (Kotter, 2001).Research shows thatbeing an effective manager depends upon three special skill sets: technical, human and conceptual. The technical skill refers to the proficiency in a specific type of work. This may include competencies within a specialized field, or the ability to use appropriate tools and techniques. Human skill refers tothe ability to work with people, which allow a manager to assist group members to complete a task. Conceptual skill refers tothe ability to work with ideas (Katz, 1955). In addition, an effective manager needs to have specific qualities like: good communication; organizational; negotiation; and delegation skills (Kappa, 1991).

Because management responsibilities are generally much more task-oriented than some leadership responsibilities, one important way to operationalize effective management is to discuss necessary skills. Skills are different from traits or characteristics in that they are the ability to use one's knowledge and competences to accomplish a set of objectives.

Kristina G. Ricketts afirm that the effective administration depends upon three personal skill sets: technical, human and conceptual. The following is a discussion of each:

- Technical skill: knowledge about and proficiency in a specific type of work or activity. This may include competencies within a specialized field, analytical ability, or the ability to use appropriate tools and techniques.
- Human skill: knowledge about and ability to work with people, often considered "people" skills. These skills allow a manager to assist group members when working cooperatively as a group to achieve a task or assignment.
- Conceptual skill: the ability to work with ideas and concepts. This skill set doesn't involve working with people or things, but focuses on ideas.

Each of these types of skills is important for effective management, and are necessary within different levels of management within a group or organization.

## THE DIMENSIONS OF LEADERSHIP

The word „leadership" has been used in various aspects of human endeavour such as politics, businesses, academics, social works, etc. Previous views about leadership show it as personal ability. The individual leader traits depends not only on personal abilities and his characteristics, but in special on the characteristics of the situation and environment in which he finds himself. People could become members of an organization in other to achieve certain personal objectives, the extent to which they are active members depends on how they are convinced that their membership will enable them to achieve their predetermined objectives. The leader will support an organization if he believes that through it his personal objectives and goals could be met otherwise the person's interest will decline. The type leader or style of leading in an organization is one of the factors that play significant role in enhancing or retarding the interest and commitment of the individuals in the organization.

The term 'leadership' causes considerable confusion. Some people assume leaders are those near the top of organisations and therefore define leadership in such terms, often emphasising strategy and vision. Others use the term 'leadership' to describe the more transformational aspects of management at any level, especially the motivation of employees and the management of change. So in English, the idea of 'leadership' embodies both the heroic leader at the top (Wellington or Nelson) and the brave foot soldier - a pretty confusing mix. Management on the other hand, appears a more mundane and formal affair, the dictionary definition including words like 'direct', 'control' and 'resources.'

Different authors define leadership in different ways, so it can be said that there are almost as many definitions of leadership as there are authors who have attempted to define the concept (Stogdill, 1974, p. 259). From the period when Stogdill noticed this till today, number of those definitions has increased. And from all those definitions, it follows that leadership has been defined in terms of traits, behavior, influence, interaction patterns, role relationship, and occupation of an administrative position (Yukl, 2002, p. 2).

From all these definitions, Yukl concludes that leadership is the process of influencing others to understand and agree about what needs to be done and how it can be done effectively, and the process of facilitating individual and collective efforts to accomplish the shared objectives (Yukl, 2002, p. 7).

Different definitions of leadership style derive from different definitions of leadership. Stogdill (1974) thus finds that leadership style means a method and capability aimed at achieving organizational targets and further affects all organizational activities. Fiedler (1967) states that a leadership style is a type of relationship by which someone uses his rights and methods to influence many employees to work together in pursuit of a common goal.

## THE DIFFERENCES BETWEEN MANAGERS AND LEADER

The literature varies on the core skills of leadership and management. Some researchers have taken a more extreme view, stating that management and leadership perform activities that are almost opposite in nature. For example, in 1990, John Kotter presented a framework for understanding key differences between leadership behaviour and management tasks. It was strongly argued by Kotter that management tries to establish security and order, whereas leadership has the goal of promoting change and fluidity within organizations.

Kotter proposed that the main function of managers is to drive consistency, which in turn should lead to an efficient-running organization. However, leaders were determined by Kotter to do the converse to this, by seeking "continual adaptive change". Kotter did not mean that leaders were looking for change for change's sake, rather, in such unpredictable times continual change is required for an organization to even survive at all.

The research of Henry Mintzberg found that managers have different roles, the general categories of which include interpersonal, informational, and decisional. Each may be segmented. For example, the interpersonal role includes figurehead and influencer, informational includes monitor and spokesperson, and the decisional role includes entrepreneur and negotiator. Successful managers integrate these various roles and are likely to engage in them without making a clear distinction. Another way to understand managers' work is to identify their competencies, some of which are found in the categorizations discussed earlier. Conceptual, technical managerial/ clinical, interpersonal/collaborative, political, commercial, and governance competencies are used in different proportions by managers at various levels of the organization.

Managers are the people to whom this management task is assigned, and it is generally thought that they achieve the desired goals through the key functions of planning and budgeting, organizing and staffing, problem solving and controlling. Leaders on the other hand set a direction, align people, motivate and inspire (Kotter, 2001).

Paul Birch noticed that in large managers devote more attention to the tasks they have to accomplish while leaders are more concerned about people. That does not imply that leaders do not pay attention to the tasks to be performed, just as tasks and good support is done by other team members. The leader sees people as people, while manager he considered a "resource". Thus, he remarks that management act, namely the phenomenon of the leader, not only manifests itself as a business phenomenon, but also in various fields unrelated businesses.

Other researchers consider that a leader has soul, the passion and the creativity while a manager has the mind, the rational and the persistence. A leader is flexible, innovative, inspiring, courageous and independent and at the same time a manager is consulting, analytical, deliberate, and authoritative and stabilizing (Capowski, 1994).

The most important differences between leaders and managers concern the workplace and are concluded in table I:

Table I: Comparison of Management and Leadership Process Differences in the workplace (Kotterman,2006).

| Process | Management | Leadership |
|---|---|---|
| **Vision Establishment** | Plans and budgets<br>Develops process steps and sets timelines<br>Displays impersonal attitude about the vision and goals | Sets direction and develop the vision<br>Develops strategic plans and achieve the vision<br>Displays very passionate attitude about the vision and goals |
| **Human Development and Networking** | Organizes and staffs<br>Maintains structure<br>Delegate responsibility<br>Delegates authority<br>Implements the vision<br>Establishes policy and procedures to implement vision<br>Displays low emotion<br>Limits employee choices | Align organization<br>Communicates the vision, mission and direction<br>Influences creation of coalitions, teams and partnerships that understand and accept the vision<br>Displays driven, high emotion<br>Increases choices |
| **Vision Execution** | Controls processes<br>Identifies problems<br>Solves problems<br>Monitor results<br>Takes low risk approach to problem solving | Motivates and inspires<br>Energizes employees to overcome barriers to change<br>Satisfies basic human needs<br>Takes high risk approach to problem solving |
| **Vision Outcome** | Managers vision order and predictability<br>Provides expected results consistently to leadership and other stakeholders | Promotes useful and dramatic changes, such as new products or approaches to improving labor relations |

## CONCLUSION

Finally, we consider the differences that exist between a manager or a leader and keep perspective. It should be noted that there are many real situations in which the manager does not perform as leader of the group, but one member is the one who directs the team's actions in a particular direction. This aspect is often of conflict due to differences of opinion between the opinion leader and manager and the fact that the latter can consider them as authority is questioned.

Ricketts (2009) also delineates a clear difference between leadership and management, but proposes that an individual can successfully practice both simultaneously if he possesses the right knowledge. However, while Kotter considers leadership and management to be complementary because they are equally necessary to achieve organizational aims, Ricketts (2009) focuses on the overlap of the traits that form each one. Because leadership is a group process that utilizes influence to attain goals, and management is an administrative means of supervising and directing, the two are likely to coexist (Ricketts, 2009). Concordantly, leaders often find themselves managing and managers are often compelled to lead, but success at one activity does not guarantee success at the other (Lunenburg, 2011; Ricketts, 2009).

I have found that leadership is the essential tool for commitment from employees. Without a leader, employees lose hope and their commitment to the company is drastically reduced. It's not that they don't want to do better it's that they have no one to inspire them or encourage them to do so. Companies today hug the philosophy of management. They have forgotten what leadership is. Without leadership, all else is lost. Wars are not won on management alone. A leader is essential to inspire an organization to go beyond what they thought possible and to believe it is possible.

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