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# ROMANIA'S FOREIGN TRADE BETWEEN 1945 AND 1989

Andrei – Cristian Balasan\*

**Abstract:** *In this paper we have analysed a “special” period in the history of Romania’s trade, namely the period when market economy was replaced by the state economy. It is the period preceding the transition. We analysed how Romania’s exports and imports have evolved between 1945 and 1989, highlighting the events that influenced trade, and also what changes occurred in the structure of exports and imports by product groups and, not least, who were the main external partners of Romania.*

**Keywords:** foreign trade; export; import; trade balance.

**JEL Classification:** F1; O24; O52.

## INTRODUCTION

The period between 1945 and 1989 was a unique stage for Romania’s economy because during this period the state economy has replaced the market economy. The state has established its monopoly on foreign trade and the gap, both economically and socially, from the developed capitalist countries, has emphasized.

The economic policy pursued by Romania had a pronounced autarchic nature, with excessive diversification and extensively developed, with no rationality and no solid anchorage in the international market. Thus foreign trade activity was ineffective, but, if there was a clear specialization on more competitive products, and also required by the foreign market, including the western market, it was possible to obtain it (Constantinescu, 1988, p. 22).

## 1. ANALYSIS OF EXPORTS AND IMPORTS, TRADE BALANCE AND THE DEGREE OF COVERAGE OF IMPORTS THROUGH EXPORTS BETWEEN 1945 AND 1989.

The entire analysed period 1945-1989, highlights an accelerated evolution of Romanian foreign trade, possible only in a state economy. We observe (from table 1) that in comparison with 1948, year in which total trade had a value of 274.4 million dollars, in 1989 total trade increased by 69 times reaching a total value of 18.922 million dollars. Exports increased from 1948 to 1989 by

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70 times, and imports by 67 times. The average growth rate of foreign trade from 1960 until 1980 was of 15.9 %, outpacing industrial production which grew by 12%, the national income with an increase of 11 % and the GDP with a growth of 9.5 %.

According to some authors (Sută et al., 1996, p. 195) Romanian foreign trade's rhythm of growth has been different from one period to another and comparing with other indicators of national economic development, such as national income and GDP, Romania could not fit the world wide trends.

**Table 1 – Average growth of Romanian exports and imports (%)**

	1950/87	1950/60	1960/70	1970/80	1970/75	1975/80	1980/87
<b>Export</b>	13,3	23,8	9,9	20,1	26,3	16,4	1,2
<b>Import</b>	12,5	15,2	10,6	21,5	25,3	20,4	-3,9

Source: Sută, N., Drăgan, G., Mureșan, M., Sută-Selejă, S. (1996) *Istoria comerțului exterior românesc – o prezentare sintetică*. București: Editura Eficient, p. 195.

**Table 2 - Evolution of exports and imports, trade balance and the degree of coverage of imports through exports between 1945 and 1948 (million \$)**

Year	Total	Export	Import	Balance	Degree of coverage of imports through exports (%)
<b>1945</b>	29,8	6,3	23,5	-17,2	26,8
<b>1946</b>	76,6	25,9	50,7	-24,8	51,1
<b>1947</b>	99,9	38,6	61,3	-22,7	63,0
<b>1948</b>	274,4	149,3	125,3	+24,0	119,1

Source: Ghișă, V., Păunescu, Gh. (2001) *Parteneriatul comercial extern al României 1900-2000*. București: Editura Camera de Comerț și Industrie a României, pp. 133-134.

In reference to Romania's trade between 1945 and 1947, the data available to us do not include products and services that were available to the Soviet Union Army located on Romanian territory, and the level of imports is bigger because it included the Soviet military supplies for the Romanian army (Niță, 2010, p. 70).

1948 is the year in which Romanian nationalization began, triggering agricultural collectivization (communization), being also the first year, since 1945, when Romania's trade balance encountered a surplus and, as it can be observed in table 1, it remained the singular case until 1956.

Romania's new political orientation caused the monopolization of foreign trade, starting from 26 June 1949. Also, during this year, the first enterprises specialized in export/import activities, "Romanoexport" for consumer goods and "Exportlemn" for wood and wood products, were founded (Sută, Miron and Sută-Selejă, 2000, p. 56).

State economy involved planning and thus the first annual plans for 1949 and 1950 were made and the first five year plan for the period between 1951 and 1955 afterwards. One of the

recommendations made by Soviet officials asserted: “the draft export / import for 1954 must be revised, taking recovery measures of the trade balance and ensuring, in 1954 and subsequently, a foreign trade without deficit” (Ghişa and Păunescu, 2001, p. 88).

**Table 3 - Evolution of exports and imports, trade balance and the degree of coverage of imports through exports between 1949 and 1955 (million \$)**

Year	Total	Export	Import	Balance	Degree of coverage of imports through exports (%)
1949	386,9	193,2	193,7	-0,5	99,7
1950	455,8	212,4	243,4	-31,5	87,3
1951	536,0	263,0	273,0	-10,0	96,3
1952	668,0	304,0	364,0	-60,0	83,5
1953	829,0	366,0	463,0	-97,0	79,0
1954	757,0	369,0	388,0	-19,0	95,1
1955	884,0	422,0	462,0	-40,0	91,3

Source: Ghişa, V., Păunescu, Gh. (2001) *Parteneriatul comercial extern al României 1900-2000*. Bucureşti: Editura Camera de Comerţ şi Industrie a României, pp. 133-134.

As we can see, between 1949 and 1955, foreign trade's total level has increased in each year of this period, with an increase in both exports and imports. We also noticed that from 1949 until 1955 both exports and imports have doubled in value, the maximum volume of exports being registered in 1955, 422 million dollars, and imports peak was registered in 1953, 463 million dollars. During this period trade balance was negative; the maximum deficit has been registered in 1953 reaching 97 million dollars.

**Table 4 - Evolution of exports and imports, trade balance and the degree of coverage of imports through exports between 1956 and 1965 (million \$)**

Year	Total	Export	Import	Balance	Degree of coverage of imports through exports (%)
1956	846,0	444,0	402,0	+42,0	110,4
1957	903,0	411,0	492,0	-81,0	83,5
1958	956,0	468,0	482,0	-14,0	97,1
1959	1024,0	522,0	502,0	+20,0	104,1
1960	1365,0	717,0	648,0	+69,0	110,6
1961	1608,0	793,0	815,0	-22,0	97,3
1962	1759,0	818,0	941,0	-123,0	86,9
1963	1937,0	915,0	1022,0	-107,0	89,5
1964	2168,0	1000,0	1168,0	-168,0	85,6
1965	2179,0	1102,0	1077,0	+25,0	102,3

Source: Ghişa, V., Păunescu, Gh. (2001) *Parteneriatul comercial extern al României 1900-2000*. Bucureşti: Editura Camera de Comerţ şi Industrie a României, pp. 133-134.

This period between 1956 and 1965 can be described as one of reforming and modernization of the socialist system and encouraging economic relations with the Occident. The major events for the economic relations were the entry into UN (1955), cancellation of mandatory quotas of agricultural products (1957), the entry into COMECON (1959), redemption by the Romanian side



of the 8 SovRoms which managed the Romanian debts to the Soviets, the conclusion of the collectivization process (1962), “The statement from April 1964” in response to Soviet plans of country's specialization in agricultural production when it was firmly decided to focus on foreign economic relations and towards capitalist developed countries or developing (Niță, 2010, p. 71). In this period foreign trade grew rapidly and, in 1965, it was almost double in comparison with the level recorded in 1956. The entry into COMECON in 1950 brought a considerable increase in exports, the trade balance recording an excess of 20 million dollars. The maximum budget surplus for this period was recorded in 1960 and had a value of 69 million dollars, and the maximum deficit was recorded in 1964 being 168 million dollars. 1965 is the first year in which the trade balance recorded an excess of 25 million dollars after four consecutive years in which the trade balance was deficient.

After 1965 the principle of economic independence was exacerbated by the state party, which led to an autarchic development planning, aiming to produce all. Romania's trade policy consisted in promoting exports. During the period which we are about to analyse, from 1966 until 1980, important events for Romania's economy have been recorded, such as: entering into GATT in 1971, accession to the IMF and World Bank in 1972, the inclusion of Romania in the Generalized Reciprocal Custom System of Preferences for developing countries in 1974, sectorial agreements with the EU and the establishment of a joint commission through which Romania recognized *de facto* the EU. Romania was the first socialist country that recognized the EU (Sută et al., 1998, pp. 85-86).

**Table 5 - Evolution of exports and imports, trade balance and the degree of coverage of imports through exports between 1966 and 1980 (million \$)**

Year	Total	Export	Import	Balance	Degree of coverage of imports through exports (%)
1966	2399,0	1186,0	1213,0	-27,0	97,8
1967	2941,0	1395,0	1546,0	-151,0	90,2
1968	3087,0	1469,0	1609,0	-140,0	91,3
1969	3374,0	1633,0	1741,0	-108,0	93,8
1970	3811,0	1851,0	1960,0	-109,0	94,4
1971	4204,0	2101,0	2103,0	-2,0	99,9
1972	5215,0	2599,0	2616,0	-17,0	99,3
1973	7243,0	3738,0	3505,0	+233,0	106,6
1974	10018,0	4874,0	5144,0	-270,0	94,7
1975	10683,0	5341,0	5342,0	-1,0	100,0
1976	12233,0	6138,0	6095,0	+43,0	100,7
1977	13997,0	6979,0	7018,0	-39,0	99,4
1978	17324,0	8237,0	9087,0	-850,0	90,6
1979	20639,0	9724,0	10915,0	-1191,0	89,1
1980	24601,0	11401,0	13200,0	-1799,0	86,4

Sursa: Ghișa, V., Păunescu, Gh. (2001) *Parteneriatul comercial extern al României 1900-2000*. București: Editura Camera de Comerț și Industrie a României, pp. 133-134.



Throughout entire period between 1966 and 1980 foreign trade growth was spectacular, total trade volume growing 11,3 times in 1980 in comparison with 1966, from 2399 million dollars in 1966 to 24601 million dollars in 1980, exports growing 10,3 times and imports 13,2 times. During year 1980 foreign trade reached the highest value considering 1948 – 1989 period, foreign trade's volume being 24601 million dollars, exports reaching a value of 11401 million dollars, and imports a total value of 13200 million dollars. Excepting two years, 1973 and 1976, throughout the entire period between 1966 and 1980 the trade balance encounter deficits (the highest in 1980 of 1,799 billion dollars), the overall deficit encountered during 1966-1980 reached 4.4 billion dollars.

**Table 6 - Evolution of exports and imports, trade balance and the degree of coverage of imports through exports between 1981 and 1989 (million \$)**

Year	Total	Export	Import	Balance	Degree of coverage of imports through exports (%)
1981	22158,0	11180,0	10978,0	+202,0	101,8
1982	18171,0	9848,0	8323,0	+1525,0	118,3
1983	17495,0	9847,0	7648,0	+2199,0	128,7
1984	17627,0	9898,0	7729,0	+2169,0	128,1
1985	18754,0	10173,0	8401,0	+1772,0	121,1
1986	17847,0	9763,0	8048,0	+1679,0	120,8
1987	18805,0	10492,0	8313,0	+2179,0	126,2
1988	19035,0	11392,0	7643,0	+3749,0	149,1
1989	18922,0	10468,0	8463,0	+2050,0	124,3

Source: Ghişa, V., Păunescu, Gh. (2001) *Parteneriatul comercial extern al României 1900-2000*. Bucureşti: Editura Camera de Comerţ şi Industrie a României, pp. 133-134.

The period between 1981 and 1989 was called the National Socialism multilaterally developed. The measures that were taken *between 1981 and 1985 and between 1986 and 1990* considerable focused on forcing drastic limitation of exports and imports, with negative effects for the living standards of the population and for the national economy's developments. Romania's total foreign trade between 1981 and 1989 gradually decreased from 22,158 million dollars in 1981 to 18,922 million dollars in 1989, reaching in 1989 to only 85.4 % of the level recorded in 1981. Between 1981 and 1989 although the total volume of trade decreased, the exports level was higher than the imports level, the trade balance encountered a surplus in each year, total trade surplus reaching a value of 17.5 billion dollars, amount used for paying Romania's external debt.

## **2. CHANGES IN THE STRUCTURE OF ROMANIA'S EXPORTS AND IMPORTS BETWEEN 1945 AND 1989**

Foreign trade and especially exports structure, and also the share of industry in Romania's GDP are important evidence that the period which we are referring to was one of industrialization,

but still autarchic and inefficient because of the concept “multilaterally developed socialist society” of the national note given by the last decade and because of the international isolation to which it led, culminating with getting the most favoured nation clause treatment in the relations with US (Niță, 2010, p. 73).

**Table 7 - Evolution of exports structure for the key product groups between 1950 and 1989 (million dollars and %) in the order held in 1989**

	<b>Years/Product groups</b>	<b>1950</b>	<b>1960</b>	<b>1970</b>	<b>1980</b>	<b>1985</b>	<b>1989</b>	<b>1989/1950</b>
	<b>Total – mil. \$</b>	212,4	717,0	1851,0	11401,0	10173,0	10486,0	493,7
	<b>%</b>	100,0	100,0	100,0	100,0	100,0	100,0	-
<b>1</b>	<b>Fuels, raw materials, minerals and metals</b>	32,8	37,0	22,6	29,5	30,1	32,1	97,9%
<b>2</b>	<b>Machinery and means of transportation</b>	4,2	16,7	22,4	24,9	28,7	29,3	697,6%
<b>3</b>	<b>Industrial and consumer goods</b>	1,3	5,8	18,2	16,2	16,7	18,1	1392,2%
<b>4</b>	<b>Chemicals, fertilizers, rubber</b>	1,7	2,1	7,2	9,7	10,5	9,5	558,8%
<b>5</b>	<b>Food</b>	14,1	12,1	12,1	8,5	6,2	4,3	30,5%
<b>6</b>	<b>Non-food raw materials and processed products thereof</b>	28,9	14,7	10,2	4,8	4,7	4,1	14,2%
<b>7</b>	<b>Building materials and supplies</b>	4,4	2,5	2,8	2,2	1,6	2,0	45,5%
<b>8</b>	<b>Food raw materials</b>	11,6	9,1	4,5	4,2	1,5	0,6	5,2%
<b>9</b>	<b>Live animals (other than for slaughter)</b>	-	0,4	0,3	0,3	0,2	0,1	-

Source: Own processing after Ghișa, V., Păunescu, Gh. (2001) *Parteneriatul comercial extern al României 1900-2000*. București: Editura Camera de Comerț și Industrie a României.

From the data presented in this table we find out that the Romania's export structure has radically changed by the end of the analysed period in comparison with the beginning. Thus, between the years 1950 and 1960 the export of agricultural products represented approximately between 55 and 60 % from the export potential, while industrial goods were exported in proportion of approximately only between 40 and 45 %. Starting with the 70's and until the end of the analysed period, industrial goods accounted between 75 and 80 % of total exports, while the share of agricultural products exported fell to less than half the value recorded in the 50's to only between 20 and 25 %.

Analysing the degree of processing of the products we see that in the early 50's raw products accounted more than 70% of total export, while the processed products approximately 30%, but starting with the 70's the share of the basic products fell sharply at approximately between 30 and 35 % for the share of processed products to grow at between 65 and 70%.

A careful analysis of the product groups highlights that the group fuels, raw materials, minerals and metals constantly stood first in exports, the minimum share being owned by 22.6 % in the 70's and the maximum 37 % in the 60s.

The group of machinery, equipment and means of transportation has been constantly increasing ranging from 4.2% in the 1950's to 29.3% in 1989. Within this group Romania recorded outstanding performances in export in 1980: 48,000 tractor units compared to 3,256 tractors in 1969, ships worth \$ 107.8 million compared to \$ 12.5 million in 1960, oilfield equipment \$ 386.9 million compared to \$ 14.6 million in 1960, 6582 wagon pieces compared to 3000 pieces in 1960, 1720000 tons of cereals, 191.4 thousand tons of meat and meat products, 9494 trucks, 17,400 city vehicles, furniture worth 403 million dollars (Niță, 2010, p. 75).

The group of industrial and consumer goods registered a spectacular growth during this period by almost 14 times from 1950 until to 1989. The share of food products group decreased only in value terms from 14.1 % in the 1950's to 4.3 % in 1989, because the quantities exported increased early. It is interesting that the reduction of exported food products share was possible only by faking statistics, reporting less data, to induce the idea that food shortages were not caused by export. We refer here to the food commodity group that faced the most drastically decrease in export share, from 11.6% in 1950 to 0.6% in 1989.

Another group of products which has drastically decreased was food raw materials and processed products thereof, from 28.9 in 1950 to 4.1 in 1989 due to the new orientation of no longer exporting logs and timber, but manufactured goods, especially furniture.

**Table 8 - Evolution of imports structure for the key product groups between 1950 and 1989 (million dollars and %) in the order held in 1989**

	<b>Years/Product groups</b>	<b>1950</b>	<b>1960</b>	<b>1970</b>	<b>1980</b>	<b>1985</b>	<b>1989</b>	<b>1989/1950</b>
	<b>Total – mil. \$</b>	212,4	717,0	1851,0	11401,0	10173,0	10486,0	493,7
	<b>%</b>	100,0	100,0	100,0	100,0	100,0	100,0	-
1	<b>Fuels, raw materials, minerals and metals</b>	32,8	37,0	22,6	29,5	30,1	32,1	97,9%
2	<b>Machinery and means of transportation</b>	4,2	16,7	22,4	24,9	28,7	29,3	697,6%
3	<b>Industrial and consumer goods</b>	1,3	5,8	18,2	16,2	16,7	18,1	1392,2%
4	<b>Chemicals, fertilizers, rubber</b>	1,7	2,1	7,2	9,7	10,5	9,5	558,8%
5	<b>Food</b>	14,1	12,1	12,1	8,5	6,2	4,3	30,5%
6	<b>Non-food raw materials and processed products thereof</b>	28,9	14,7	10,2	4,8	4,7	4,1	14,2%
7	<b>Building materials and supplies</b>	4,4	2,5	2,8	2,2	1,6	2,0	45,5%
8	<b>Food raw materials</b>	11,6	9,1	4,5	4,2	1,5	0,6	5,2%
9	<b>Live animals (other than for slaughter)</b>	-	0,4	0,3	0,3	0,2	0,1	-

Source: Own processing after Ghișa, V., Păunescu, Gh. (2001) *Parteneriatul comercial extern al României 1900-2000*. București: Editura Camera de Comerț și Industrie a României.

As presented in table 8, as concerns Romania's imports, we notice that the goods intended for productive consumption prevailed, with a share amounting to approximately between 85 and 90%

of total imports, while the remaining 10-15% have represented goods intended for individual consumption. Industrial products prevailed imports with an oscillating share between 75 and 80 %, the difference between 15 and 25 % being assigned to agricultural products.

By analysing the table data we notice that until the 1980's an important share, 40 % of Romania's import, has been held by the machinery and means of transportation group, but starting with the '80s the group of fuels, raw materials, minerals and metals predominated, owning over 50 % of total imports.

A continued reduction in the value of imports has been registered by the group of non-food raw materials and processed products thereof, their share steadily dropped from 21.4 % in the 50's to only 5.4 % in 1989.

The most dynamic increase was recorded by the group of fuels, raw materials, minerals and metals, from 31.2 % in 1970 to 56.0 % in 1989, due to the construction of the giant steel plant in Galati.

The policy of substituting industrial consumer goods imported with those produced in the country led to a drop in group share from 10.2% in 1950 to 3.4% in 1989.

1980 was the year with the highest imports: 16 million tons of iron ore in comparison with 0.9 million tons in 1960, oil in value of approximately 6.6 billion dollars, 120,000 tons of cotton in comparison with 50,000 tons in 1960, 145,000 tons of ferroalloys comparative with 25,000 tons in 1960, 3.2 million tons of metallurgical coke compared with 0.7 million tons in 1960.

### **3. GEOGRAPHICAL ORIENTATION OF FOREIGN TRADE BETWEEN 1945 AND 1989**

Romania's external economic relations have been influenced both by internal and external factors, such as the political change of the regime, that approached us to USSR and the discrimination of the socialist countries by capitalist countries. These influences have reduced the geographic scope of our foreign economic relations, our foreign trade being mostly made with socialist countries.

According to the data published by GATT, in 1988 Romania was on the 38<sup>th</sup> place in terms of export (13.1 billion dollars), representing a total share of 0.5 % from worldwide export, and on the 45<sup>th</sup> place (10 billion dollars) in terms of imports, with a total share of 0.3 % from worldwide import.

**Table 9 - Geographical distribution of Romania's foreign trade between 1950 and 1988 (in percent from total exports + imports)**

Years	Trade with socialist countries			Trade with non-socialist countries		
	Total	CAER countries	Other socialist countries	Total	Capitalist developed countries	Developing capitalist countries
1950	83,2	-	-	16,8	-	-
1960	73,0	66,8	6,2	27,0	22,3	4,7
1965	65,0	60,7	4,3	35,0	29,0	6,0
1970	56,0	49,3	6,7	44,0	35,8	8,2
1975	44,8	38,0	6,8	55,2	36,7	18,5
1980	41,0	34,6	6,4	59,0	33,0	26,0
1985	56,7	51,0	5,7	43,3	23,7	19,6
1986	64,2	58,3	5,9	35,8	20,6	15,2
1987	63,7	55,0	8,7	36,3	23,7	12,6
1988	61,9	54,0	7,9	38,1	24,7	13,4

Source: Own processing after Sută, N., Drăgan, G., Mureșan, M., Sută-Selejan, S. (1996) *Istoria comerțului exterior românesc – o prezentare sintetică*. București: Editura Eficient.

1955 is the year that marks the resumption of trade with Romania's traditional partners from Western Europe: Germany, Great Britain, Austria, France, at the same time USSR's share of the total trade operations being reduced from 57.5% between 1945 and 1948 to 53.6% between 1949 and 1955. In 1965 the impartiality of Romania's foreign trade towards non-socialist countries is confirmed, these countries already owning over 35 %.

The share of the socialist countries in Romania's trade relations decreased drastically from 73% in 1960 to only 41% in 1980. Between 1980 and 1989 Romania brings a new shift towards socialist countries reaching to about 62% of the Romanian foreign trade in 1988. Romania isolated itself during this period and the trade conducted with the capitalist countries dropped to 38.1 %, comparable to the level in 1965. We distinguish a peculiarity of Romania's economic relations namely the fact that the share of developing countries has tripled in 10 years from 8.2% in 1970 to 26% in 1980.

In 1970 Romania had one hundred and ten economic ties, increasing to one hundred and fifty two in 1980 and decreasing to one hundred and forty two in 1989.

Hence we notice that geographical orientation of foreign trade relations had an inconstant evolution. Three stages are being distinguished: a first period of forced tightening between 1954 and 1964, in which socialist countries were the main trading partners, a second stage between 1965 and 1980 in which the number of economic ties reaches 152, and a third stage in the 80's in which Romania limited it's economic relations deliberately.

## CONCLUSIONS

In this paper we have analysed Romania's foreign trade between 1945 and 1989 highlighting its evolution, its group structure and geographical orientation of the economic relations.

Because of forced industrialization that was much more induced between 1945 and 1989 in comparison with the interwar period, exports structure improved radically and processed products have replaced basic products and the two shares of 30 % and 70 % have been reversed, respectively.

The export trade offer has also been diversified, but many products were ineffective taking into consideration their low value, reduced quality and technical performance, exported in clearing or on credit. These were the consequences of a forced economic independence, which lacked economic rationality and implicit efficiency.

Having a constant growing share mechanical engineering products, metals and industrial consumer goods were the most dynamic. The agro-alimentary products have played an important internally role because it worsened the population's food situation and externally served as currency exchange at import of raw materials from the USSR.

The dependence on imported raw materials became visible as industrialization and oil, iron ore, coking coal and metallurgical coke have reached 56% in 1989, compared to 23.5% in 1950.

Romania has pursued a policy of replacing imported products by internally manufacturing them and the share of consumer goods fell from 10.2% in 1950 to 3.4% in 1989.

The degree of coverage of imports by exports is significant in each group; the only group being deficient was the one of fuels, ores and metals.

As we have noticed, Romania's main trade partners were socialist countries, to a lesser extent between 1975 and 1980, during which non socialist countries were the central trade partners.

Foreign trade's structure in an state monopoly economy could not be different than that of an excessive centralism, in which the central body had all the leverages (planning, authorization, control, appointment of managers) and the trade was not an exception, as it didn't have any autonomy, but only to follow the import-export plan and it could benefit of small rewards when exceeding the plan only.

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# PROPOSALS FOR CONSTRUCTION OF TOURIST IMAGE IN BOTOSANI COUNTY

Maria-Simona Cuciureanu\*

**Abstract:** *The article aims to highlight the main elements that make the tourism potential in Botosani County unique and the need to develop a touristic image of this area. The touristic potential of the rural areas is huge, but it is harnessed and exploited. We believe that through authenticity we can create an attractive territory for tourists. And that the existing potential of the rural tourism is an opportunity to improve the living standards, which should have three primary phases: identification, promotion and development. The study proposes the creation of several priority axes and an rural tourism brand, with the priority items identified.*

**Keywords:** tourism image; rural tourism; development potential recovery.

**JEL Classification:** L83; Y91.

## INTRODUCTION

The touristic image is the key to tourism development in a certain area, so identifying unique items and branding is a crucial step for tourist use.

The retrieval of touristic representative elements generates a positive impact on an area. In the case of the Botosani county we can speak about tourism identity identification and the promotion of county socioeconomic development. The local image can be perceived positively or negatively based on the promoting receiving area, but tourism is based on local identity and local uniqueness which is an asset to identify a brand.

The study aims to highlight the unique elements of Botosani county which can be attractive in terms of tourism and symbols can be key to creating a tourist pictures. Botosani enjoys a rich and varied tourism potential but poorly capitalized. It does not have a tourist image, although there are many unique elements which could be „ambassadors” capable to promote tourism. So as nationally there are cities or area is identified with a construction or customs, traditions and Science - Culture Palace, Brasov - Black Church, Bucovina - monasteries, Maramures – tradition, for Botosani there are no clear association in the minds of tourists although there are unique elements that are known to them. Thus the problem is caused by the lack of touristic images. To be clear, this can be solved by identifying key symbols and possible creation of tourist images that can address several categories of tourists, which will mean that every tourist will retain tourist symbol representing him.

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The need to propose priority axes, to create local touristic images and to promote them is determined by the economic importance of tourism and by the need to recovery Botosani's touristic potential. The economic importance of tourism activities is a priority for the study area like the need to improve the socio-economic situation by capitalization of touristic potential.

## 1. LITERATURE REVIEW

The literature is vast in terms of touristic image, brand or rural tourism. So our paper will be summarized with the use of the clear concepts of brand and touristic image. Since the study is a multidisciplinary one the references are from the fields of economics, geography and social sciences.

Building and strengthening the concept of image is particularly important for achieving marketing objectives and default global policy objectives because they depend on communicative objectives. The image knowledge that buyers have about a product or service is of great importance, so image is an important factor that has been recognized and studied since the 1950. Philip Kotler in „Marketing Management” defines image as „all perceptions that an individual has vis-a-vis an object” but A. Denner defines image as „a halo of representations of ideas, feelings, attitudes and beliefs more or less explicit, more or less profound, more or less consciously, with emotional content more or less dense, more or less important. "image synthesizing definitions are all reflections of nature material or immaterial, rational or emotional content, objects or events, products or services, brands or companies formed over time in the consciousness of an individual (whether consumer or customer nonconsumer the product or the company, employee or manager of a company or its competitors, representative of the media or the media).”

Image is important for all promotional strategies because it is a product or brand. Promotion should highlight the characteristics and authenticity of an object, place, symbol, defining the essence of the image: value, design and personality.

Significant interest in creating an image synthesis is carried out in that picture because elements must be cognitive, emotional, social and personal product among buyers.

In theory we can approach the concept of image in terms of an ideal image and the one real or perceived. Such differences always occur because of how well the image is promoted or received.

The concept of image has many meanings, but tourism is the impression made on a tourism product, a company or a tourism destination. „The image is an important element to be considered in destination marketing as bad or good image of a tourist destination will affect its popularity. Building a destination or tourism product image is performed using information sources such as

brochures, leaflets, tourism radio and TV programs, articles in newspapers, periodicals, etc. or by using the stories of recently returned travelers. In tourism the main marketing means are using concepts of „brand image” and „product image” representing the company or destination image, and that image services. To conduct business efficiently, tourism companies are trying to achieve and maintain a positive image permanently, notably through advertising and public relations”(Stancioiu).

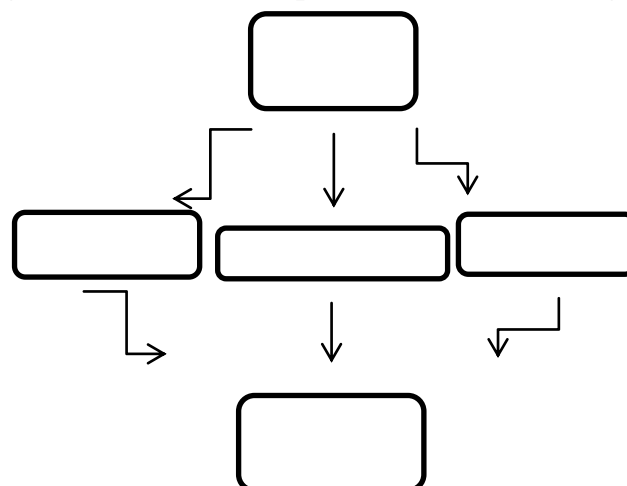
Developing an effective brand image for an area requires the inclusion of a generic term by which local products and services will be immediately recognized. Such a mark would help create an identity for the area symbolizing the connection in the minds of residents and consumers regarding the conservation of nature and community welfare, and the proper management of the environment and high-quality local products.

Tourism is a dynamic phenomenon due to expansion trend / regression, enhancement / mitigation rhythmic that it has along its evolutionary path, which does not affect the general plan of continuous development of regions with tourism potential and by their nature generate changes and transformations of goods and individual values, not least by cultural models. Tourism potential, represented by attractive resources and infrastructure is a static factor analyzed phenomenon, claiming its existence. Dynamic element of the process is provided by the qualitative tourists who exploit resources and use the services infrastructure (Cocean, 2002).

Types of tourism like the rural tourism and agro tourism types are appreciated and practiced internationally, but are also of scientific interest. So the interdependence of rural tourism and tourist image may be vital for the effective potential of tourism. In the same idea promoting unique elements and traditions in a given area depend on the touristic image created for this purpose.

Creating a turistic image involves several key elements such as the tourist icon outstanding at the place identity, authenticity and uniqueness.

**Figure 1 - The scheme implementation tourist image**



## **2. PRIORITY AXES TOURIS IMAGE BUILDING BOTOȘANI**

Using the uniqueness of Botosani County elements highlighted by diversity and richness, we can create an brand for tourism development. There are prospects for creating a positive touristic brand, by highlighting the three priority directions for creating tourist images: birthplace of some famous personalities of Romania, abundance of ponds and intact traditions.

### **2.1 Botoșani –realm evening stars**

Some of the county symbols are national and international brands that can be attractive for tourists (Eminescu, Iorga, Enescu, Antipa, Luchian, Bancila, and so on). These figures were international ambassadors of culture and science for the Botosani county. Analysing the great human values from this area, we can find in Botosani creative personalities of monumental dimensions: Eminescu - poet, Iorga - historian, Enescu - musician, Luchian - painter. To these we can add: Dimitrie Pompeiu and Octav Onicescu mathematicians, the great naturalist and botanist Grigore Antipa, outstanding figures of Romanian literature such as Ion Pillat, Demostene Botez and George Tăutu and the great painter Octav Bancila. They are part of the national gallery of great values that conceive the county for posterity.

Botosani county has many notable figures in world culture, is known as global brands (Eminescu, Iorga, Enescu and Luchian). Eminescu due to its importance should mean Botosani (as just about Barcelona Gaudi), and it should not be associated with other places than the native. The promoting of these great personalities can be achieved by organizing specific events: literary, cultural, music or painting large, which are now poorly promoted. They can be associated as ambassadors of poetry (Eminescu), culture (Iorga), music (Enescu) and painting (Luchian) at the level of the county or at a national or international level.

The image of these stars is used everywhere, whether in books or internet media, but the symbols are porley used in the county, that is why Botosani should create an image representative tourism to attract more tourists. (e.g. when Sibiu was the European Capital of Culture it has attracted an impressive number of tourists, promoting at international expansion).

Traditions are representative for Botosani because they were kept pure and as philosopher H.-R. Patapievici noted that this traditions are best represented here, and not in Maramures, where peasants still wear traditional costumes but simoultaneously use cellulars and computers, but in

northern Moldavia, where the language and customs have not yet fallen victims of modern influences.

## **2.2 Botoșani - an oasis of pure and unaltered Romanian traditions**

Botosani county is recognized as a specific traditionally area where traditions and customs are kept perpetually popular. The county is characterized by the impressive number of folk festivals, some in the national circuit of cultural events. Traditions are highlighted through festivals and Botosani is recognized nationwide as one of the counties with a high number of festivals, being named by the media as „The County of Festivals”. Festivals arise from the desire to facilitate contact with residents in the city art culture, spirit, that opens new horizons for them, to bring them about artists and works that they would not like to meet them.

Festivals occur from the Botosani desire to preserve tradition and customs, folk values, thus emphasizing purity retention. Institutions showed interest in organizing and supporting festivals because they can highlight the traditions in this county. For preserving traditions, the Directorate of Culture, with the support of Popular Creation Centre wants to establish village museums, as cultural centers.

Local authorities, believe that festivals can contribute to a local image that can determine a development of tourism, especially rural tourism. Since the media called this area as „The county of festivals” which highlights traditions, this means that festivals are seen as tourism potential.

The most important festivals that occur annually are: „Hold Gold” - June 29 (Tudor), „Inherited from elders” - May and „Forest Festival” - September 8 (Vorona), „Hora from Flamanzi” - 15 august (Flamanzi), „Festival Village Hearth” - 15 august (Stauceni), „Proud village garden” - 15 august (Bucecea), „Watermelon festival” - 15 august (Rachiti, Lunca). Botosani days - April 23, „Fair craftsmen” - April 23 (Botosani) and „Winter Traditions Festival” - December (Botosani). Some festivals coincide with a major celebration, which demonstrates people's faith and respect for these holidays, especially if the day chosen for the festival coincides with the feast of the village, it is an additional cause for celebration for the locals. There were other two important festivals but were stopped for pecuniary reasons: Carp Festival (near the pond Dracsani) - Sulița and Garlic Festival- Copalau.

Choosing names for the festivals plays an important role in attracting tourists, because the name suggest if traditions are involved, and that will increase the interest of people to participate to

this festival. Some festival sames suggest that the people's of the villages are important in terms of tourism.

Traditions were kept intact despite the facilities of nowadays broke in less accessible places, which means that traditions disappear or lose value. Traditional culture is trying to survive under the aggressive burden of modernity. The traditions behind the modernity have highlighted the efforts of those who seek to restore the natural rights traditions, customs and habits, our symbol of continuity in this region.

It can be seen that there is a symbiosis between tradition and festivals, eventually taking them in evidence and promoting them. Building a local image that is based on complementing traditions and festivals can be a tourist attraction.

For example the Garlic Festival, held between 2001 and 2004, promoted primarily the traditions implied by the culture of garlic and other traditions of the area. Concrete consequences of the festival were: establishment of professional associations „Garlic-successful attempt to adopt rules entailed rural tourism” (which proves that rural tourism or rural tourism based on garlic crop in this region can developed) have set up an ethnographic museum and an outdoor sculpture camp, agricultors had the opportunity to sell at wholesale prices the garlic cultivated by them, which allowed them to gather the money to paint the exterior of the village church and to repair the bridge over Miletin. It can be seen that after this festival people of this community have benefited from numerous economic advantages. This festival was promoted in other countries, and organizers kept in touch with organizers of similar festivals such as The wine and garlic festival from Antherst, Virginia U.S.

Even though the festival stoped for a period after 2004, the organizers were thinking to focus on producing and commercialization of numerous garlic based products such as garlic-flavored ice cream. These specific products can be a reason for tourists to visit the area and taste them and see how they are produced.

Tourism activities can develop in Botosani County by creating an image that has as a defining element pure and unspoiled traditions, highlighted by the festivals as they give authenticity to the places.

### **2.3 Botoșani –land ponds**

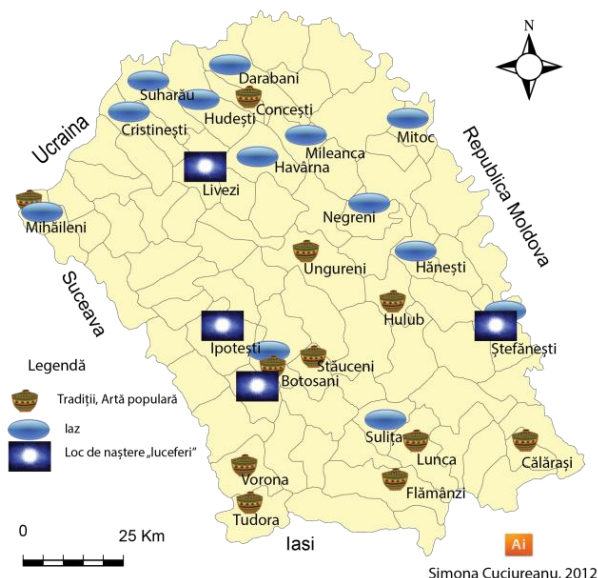
Botosani country is famous as the county with a large water surface, the second country after Tulcea county. Moldavian Plain ponds (Botosani) on streams and rivers valleys of this region are

very picturesque and are a great number of small and medium opportunities. The largest ponds are: Calul Alb, Negreni - Baseu river, creek Mileanca – Podriga and Catamarasti and Dracsani - Sitna River. You can add to these stretches of water the lake from Stanca -Costesti (Botosani county), one of the largest water reservoirs in Romania. It covers an area of 140,000 hectares, and it is the largest lake on the River Prut and the second in the country, after the Porțile de Fier Lake. The dam is Stanca - Costesti customs at the border with Moldova. The lake view is impressive for the visitor and the place is often frequented by fishermen and archaeologists (Ripiceni area). Therefore its image might be called Botosani-land ponds and used to build an accurate brand.

We can develop an image based on the name „land of ponds” to promote the existing fish resources. Thus we can organize themed festivals or fishing competitions, promoting that way many forms of tourism including: fishing tourism, sports tourism, leisure tourism, and tourism birdswatching (travel forms approved by tourists).

The location and spread of the main towns in the territory and of the major touristic points of interest were represented on the map in Figure 2. Apparently the places with unique values are concentrated in the north-east, but places with unique element traditions are sometimes identified with localities that have representative ponds (Mihaileni Hanesti, Catamarasti Deal). The combination of unique elements can lead to the creation of a brand able to exploit all that is unique and authentic, with a significant impact on media level.

**Figure 2 - Locations of major touristic destinations in Botosani**

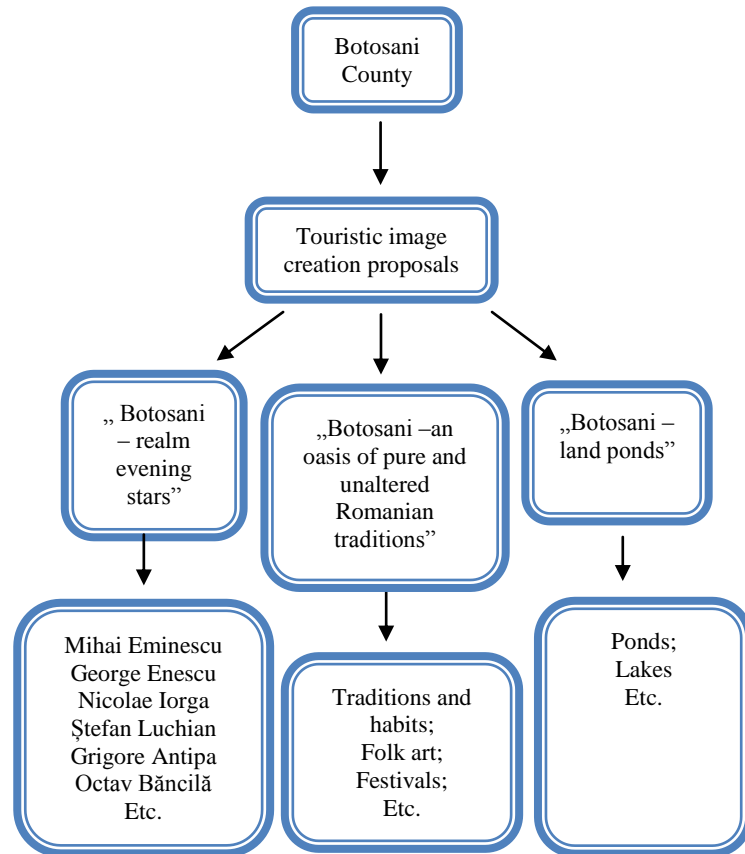


Proposals for tourism development and for the creation of tourist images, containing unique elements of Botosani, can be summarized in a diagram which reflects the potential of the county



touristic brand. For the creation of the brand we can follow three directions to create distinct touristic images, depending on the tourist market addressed, or we may combine them to offer a single view of the Botosani county, including all the unique and defining characteristics of this area.

**Figure 3 - The scheme of Botosani county touristic brand**



The prospects for the development of tourism are based on unique and local identity, and on the diversity which highlights the authentic elements from the studied area.

## CONCLUSIONS

The Botosani county should create a defining tourism image to develop and promote tourism as a competitive economic activity. Several steps are required in defining a touristic image: identifying unique symbols, creating an image or multiple touristic images and promoting the uniqueness of places. The expected effects of these efforts are to create a specific identity of the county at local and regional level and to attract tourists.

The touristic brand aims to be the visual identity element for this territory. The creation of an touristic image will have an important impact on the development and promotion of the Botosani county, and it is a solution to transform this area into a competitive one.

The proposals for the creation of a touristic image for the Botosani county are an important stage for the development of tourism and for the transformation of tourism activities into productive and competitive economic activities. This study can be deepened by investigating current tourism projects and proposals that aim to develop tourism in conjunction with targeted markets, by investigating the types of touristic proposals based on their potential and existing facilities, by identifying of diversified tourism potential and by modern touristic facilities.

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# SHORT DESCRIPTION OF THE RELEVANT ASPECTS OF THE DUTCH ECONOMY IN THE GLOBAL ECONOMIC SYSTEM

Răzvan Hagimă\*

**Abstract:** *Despite of its reduced population number and small area, the Netherlands is one of the top countries in terms of trade and FDI. The aim of this article is to present its trade, FDI flows and to highlight some of the advantages that the country has in the mentioned fields. Even though it was hit by the economic crisis, the state recovered fast and, since 2009, maintained a positive trend to its foreign trade and FDI. Moreover, because it has a stable economic environment and a professional labour force, foreign investors are eager to start investing in businesses in this country.*

**Keywords:** trade; FDI flows; investment projects; destination.

**JEL Classification:** F19; F63; O52; P45.

## INTRODUCTION

Although it is a state with a small area and population, Netherlands is one of the main European players in economic terms. The size of the investments made in different countries and the high level of foreign trade recommends this state as a continental power.

The Dutch trade is the mainstay of the economy. The geographical position of the country represents one advantage because is situated in the highest populated place on the continent. In fact, nearly 160 million people are within a radius of circa 450 kilometres from the Netherlands, giving this country multiple areas where commerce can be carried out. Roughly 80% of the exports are destined for the European countries and 70% of the imports are from Europe.

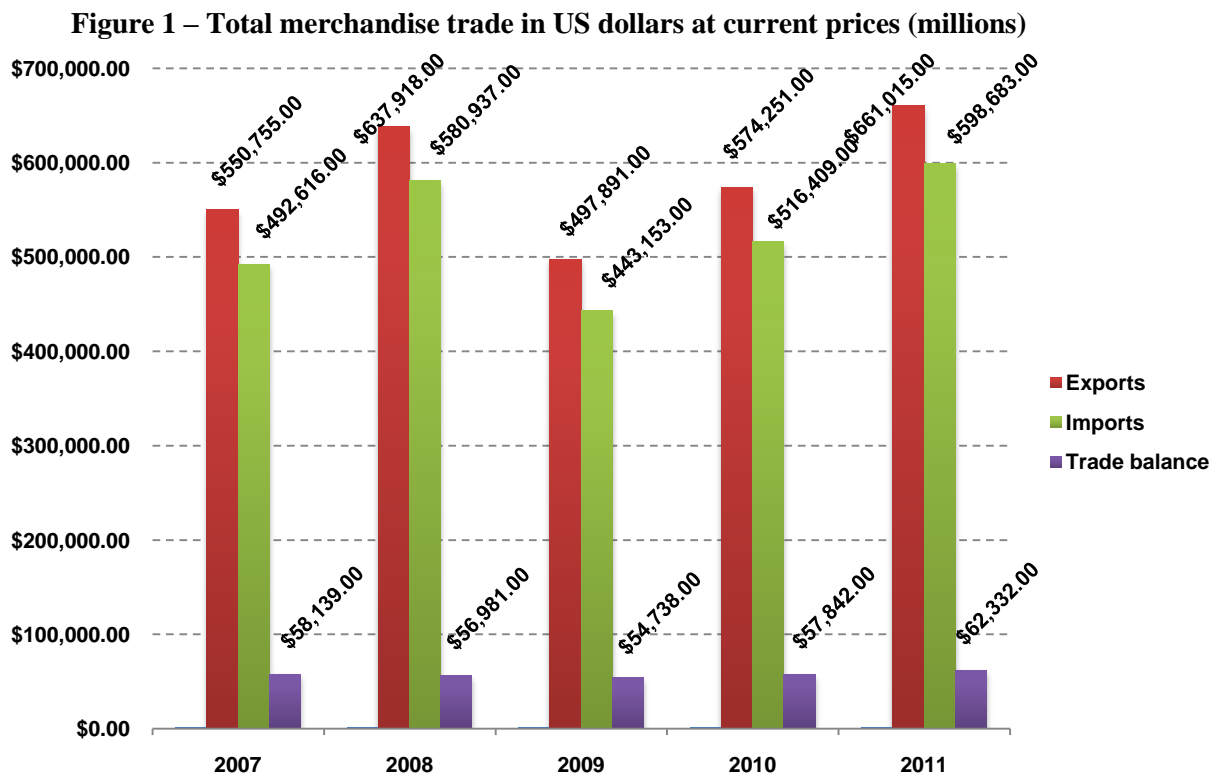
Foreign direct investments in the Netherlands increased by 25% in 2011 compared to the previous year, indicating that the country held its position as a stable and competitive location for foreign companies. Netherlands Foreign Investment Agency (NFIA) reported that more than 4300 new jobs were created in 2011, investment commitments capped out at approximately 1.74 billion Euros and 41 multinational companies have set up operations in this area, concentrating in Amsterdam. Overall, NFIA made 193 foreign investment projects, increasing their volume by about 25% (Middleton, 2012). As previously mentioned, foreign companies are keen on this location due to its strategic positioning, being near the main developed countries in Europe, like France, United Kingdom and Germany. Another key advantage is represented by the languages spoken in this state,

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widely circulated, such as German, French and English, the populations high level of education and the tax system.

## 1. THE VOLUME AND STRUCTURE OF THE FOREIGN TRADE

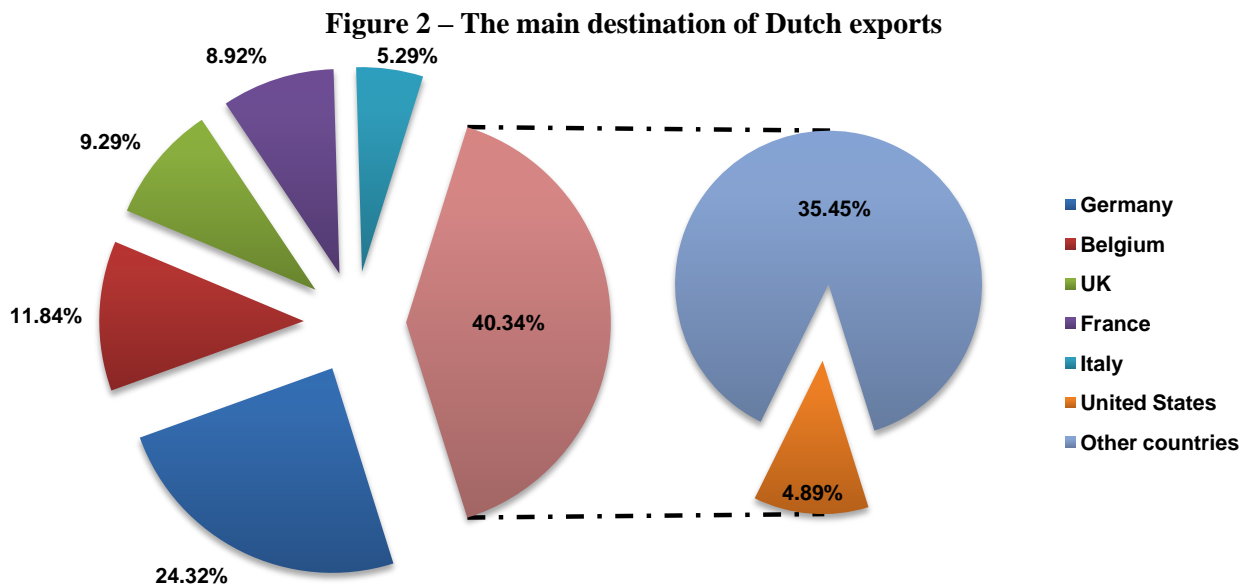


Source: WTO database, <http://stat.wto.org/StatisticalProgram/WSDBViewData.aspx?Language=E>

2011 has marked a revival in terms of export value, by circa 15% increase versus 2010, rising from \$574 billion to \$661 billion. From this point of view 2009 was not very profitable: the foreign trade decreased by 21.95%, from \$638 billion in 2008 to roughly \$498 billion in the next year.

As figure 1 points out, the foreign trade balance of Netherlands from 2007 to 2011 is in excess. Among the reasons that the trade balance of this country is in redundancy, which can be attributed to the following (Dutch trade: more European than global, 2011):

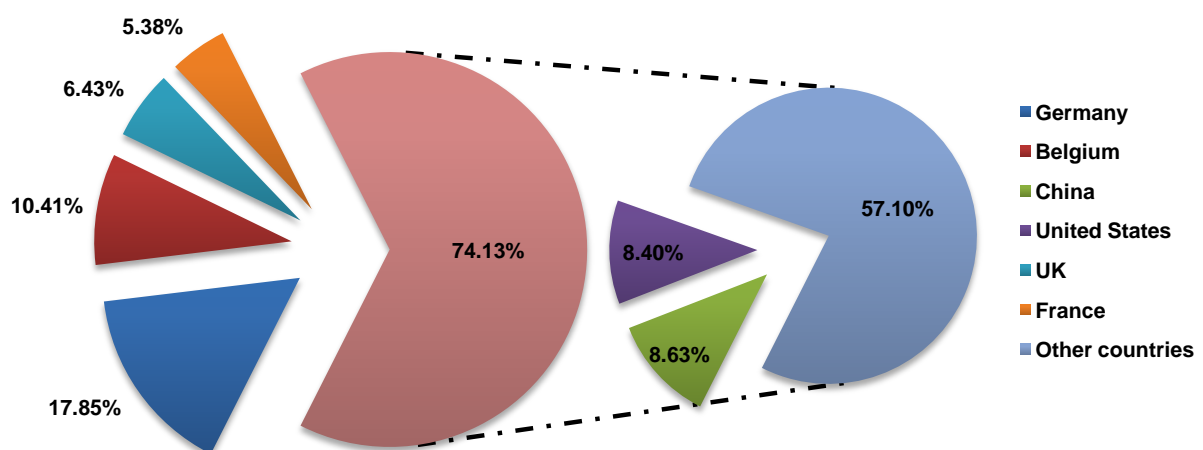
- The Dutch products are highly competitive and they have a high added value;
- A large part of the production is export-oriented;
- The transit exports hold a large share, equating to circa 10% from the GDP;
- Although the labour productivity has decreased due to the economical recession, labour force is still effective due to the high level of qualification.



Source: [http://countries.bridgat.com/Netherlands\\_Trade\\_Partners.html#.UVNsKFc4Rfk](http://countries.bridgat.com/Netherlands_Trade_Partners.html#.UVNsKFc4Rfk)

As figure 2 shows, the main destination of the Dutch exports are developed countries such as Germany (24.32% of total), Belgium (11.84%) and UK (9.29%). These destinations are proof that the Dutch products are highly competitive since they were able to penetrate those markets. Moreover, it was shown that the five mentioned European countries, totalling 59.66%, with the European Union as a whole, totalling 74%.

**Figure 3 – Main importers in Netherlands**



Source: [http://countries.bridgat.com/Netherlands\\_Trade\\_Partners.html#.UVNsKFc4Rfk](http://countries.bridgat.com/Netherlands_Trade_Partners.html#.UVNsKFc4Rfk)

Following the imports trends, Germany is the the most important import partner, with a share of 17.85% of the total, followed by Belgium (10.41%) and China (8.63%). An interesting fact is the China's presence in this ranking. As the figure 3 points out, important countries like Germany, US or China see in the Netherlands a good environment to start or to develop a business because they can find there an attractive tax system and a very skilful labour power.

According to World Trade Organization, the Dutch exports reveals that the most popular products are the manufactured ones, with a share of 28.8% from the total, followed by fuels and mining products (15.9%) and machineries and transport equipment (14.4%). Table 1 highlights the next issue: the exported products have a high market value, which is exacerbated by the total value of the exports. A significant proportion have the re-exports, which are goods that were originally imported and underwent various transformations to be subsequently sent for export, such as printers, laptops or medical devices.

The import structure is similar to the one seen in exports. The manufactured products still have the largest share of the total, 28.58%, followed by fuels and mining products, 19.78%, and machineries and transport equipment, with a share of 14.63% of total.

**Table 1 – The Netherlands exports and imports structure**

Product	Share of total exports	Share of total imports
Manufactures	28,80%	28,58%
Fuels and mining products	15,90%	19,78%
Machinery and transport equipment	14,40%	14,63%
Office and telecom equipment	7,80%	8,19%
Agricultural products	7,70%	5,50%
Chemicals	7%	5,45%
Food	6,20%	4,62%
Electronic data processing and office equipment	4%	4,28%
Telecommunications equipment	2,80%	2,89%
Pharmaceuticals	1,30%	1,16%
Iron and steel	1,10%	1,03%
Integrated circuits and electronic components	1%	1,02%
Other products	2%	2,87%
<b>TOTAL</b>	<b>100%</b>	<b>100%</b>

Source: World Trade Organisation

## 2. FOREIGN DIRECT INVESTMENT

United Kingdom, Ireland and the Netherlands are amongst the main investors in each other's economies. By assisting companies from the UK, Ireland, United States and Asia to facilitate their penetration in Europe, the NFIA office in London contributed significantly to the results obtained by the parent companies in 2011.

In 2011, circa 21% from the 193 projects that were related to international headquarters comprised of 30 new operations, 9 expansions and 2 retentions. Those headquarters provided nearly 1200 jobs and the high majority of the projects came from Asia and North America. Examples in this direction are the headquarters of Kuwait Petroleum (Hague), Menicon (Emmen), the US guitars producer, Taylor Guitars, and New Zealand Dairy Cooperative Fonterra, both based in Amsterdam (Government of the Netherlands, 2012) .

In 2010 a total of 19 research and development projects have been confirmed in the Netherlands. One of the most important investment in this field is the one that refers to the Nijmegen Heinz infrastructure. On the other hand, small companies, most of them from Asia and Europe, operate their activities of research and development in food and high-tech industries (Government of the Netherlands, 2012).

Northern provinces have absorbed most of the investment projects in 2011. For example, the TAQA Company from AUE has invested in Bergermeer Gas Storage between Bergen and Alkmaar and due to this investment; the Dutch energy sector has incorporated most of the investment funds in 2011.

The Dutch technologic sector produced, in 2011, most of the projects and jobs. Exactly 100 projects were from Asia, 50 from North America and 31 from Europe. At country level, the United States remained the most important source of investment projects, 46 projects were from that state, followed by China, with 29 projects, Korea, 25 projects, and Japan, with 24 projects (NFIA, 2011).

**Table 2 – Total structure of the net FDI inflows in the Netherlands by sector of activity in 2009**

<b>Economic sectors</b>	<b>Industry</b>	<b>The value of FDI inflows (million \$)</b>
<b>Primary economic sector</b>	Mining and quarrying	80,1
	Oil industry	4.757,6
<b>Secondary economic sector</b>	Unspecified activity	25.136,7
	Food and tobacco	-680,8
	Chemicals	455,1
	Metals and metal products	1.764,8
<b>Tertiary economic sector</b>	Wholesale and retail	5.061,1
	Business activities	1.256
	Transport, storage and communications	866,4
	Unspecified activities	276
	Constructions	-686,3
	Financial services	-5.688,7
<b>TOTAL</b>		<b>32.599</b>

Source: International Trade Center

As table 2 shows, the wholesale and retail commerce is the economic sector that attracts the most significant part of the net FDI inflows in the Netherlands. The oil industry is very important



for foreign investors. Approximately 4.8 billion dollars were invested in this sector in 2009. Ranking third in this section is the metal and metal products industry where the FDI inflows that reached circa 1.8 billion dollars. At a closer glance, it stands out that the FDI inflows are attracted to industries that have a high added value.

**Table 3 – Total structure of the net FDI flows from the Netherlands by sector of activity in 2009**

Economic sectors	Industry	The value of FDI inflows (million \$)
<b>Primary economic sector</b>	Mining and quarrying	15,7
	Oil industry	14.778
<b>Secondary economic sector</b>	Unspecified activity	3.298,3
	Food and tobacco	8.632,6
	Chemicals	-19
	Metals and metal products	-762,5
<b>Tertiary economic sector</b>	Wholesale and retail	316,1
	Business activities	-13,5
	Transport, storage and communications	2.197,4
	Unspecified activities	3.235,6
	Constructions	2.271,2
	Financial services	-5089,7
<b>TOTAL</b>		<b>28.965,9</b>

Source: International Trade Center

The most attractive sector in terms of net FDI flows of the Netherlands is the oil industry, with roughly 14,8 billion dollars invested in this field. Another sector where the size of the net FDI flow is high is represented by the food and tobacco industry, with an amount of 8,6 billion dollars. The Dutch invested 2.2 billion dollars in the transport, storage and communications industries.

It should be noted that the net FDI inflows in the Netherlands exceed those made by this country abroad by 11.15%, respectively 3.6 billion dollars.

**Table 4 – Favourite destinations of FDI stocks and the most important investors' countries in term of FDI stock in 2010**

Country	Foreign direct investment in the respective country and the position in the overall standings	Foreign direct investment from the respective country and position in the overall standings
USA	1 Place – 2.581 billion USD	1 Place – 3.597 billion USD
France	2 Place – 1.207 billion USD	2 Place – 1.837 billion USD
UK	3 Place – 1.169 billion. USD	3 Place – 1.705 billion USD
Germany	4 Place – 1.057 billion. USD	4 Place – 1.484 billion USD
Belgium	5 Place – 741,7billion. USD	9 Place – 632,8 billion USD
<b>Netherlands</b>	<b>6 Place – 687,8billion. USD</b>	<b>5 Place – 950,8 billion USD</b>
Romania	42 Place – 80,16 billion. USD	67 Place – 1,8 billion USD

Source: Centrall Intelligence Agency, *World Factbook*

According to table 4, the Netherlands ranked, in 2010, sixth place as the preferred destination of FDI and was the fifth most important investor in other countries in terms of FDI stock. These achievements, together with those presented above suggest that the Netherlands is one of the main investors in the world. In 2010 this country had a share of 5.86% of the total FDI performed worldwide (16,220 billion dollars). As an investment destination, the analysed economy attracted, 2010, nearly 4.21% of the total FDI, circa 16,360 billion dollars.

## CONCLUSIONS

Perhaps the best health indicator for Netherland's economic environment is given by the inflows of the FDI. Due to the fact that this country has de ability to attract such a large proportion of FDI, it indicates that it has an optimal economic system. The inflows mentioned above generate new jobs, help to develop new industrial technologies and bring a lot of other advantages. It is easy to understand that the foreign investors should not try to enter in a market where there is not a good economic stability. Moreover, although the Dutch labour force is relative expensive, and this represents a solid statement for foreign investors to avoid investing in this region, the rate of FDI upright trend year on year. This happens because investors are attracted by the efficient tax system and the highly skilled labour force.

Because the Netherland's riches are not natural resources, they were forced in some way to undertake trade acts in order to develop. Items like a very high degree of industrialization, a large know-how possession and a very well established infrastructure helped the country to develop an impressive commerce network. Moreover, the Dutch products managed to penetrate important markets like the ones in the US or Germany, which is clear proof that the Dutch economy is competitive, efficient and very well positioned in the global economy.

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# QUALITATIVE STUDY ON PHYSICIANS' MOTIVATIONS AND DRUG PRESCRIBING BEHAVIOUR

Luminița Mihaela Ion\*

**Abstract:** *The proper prescription of medicines by specialists from healthcare, especially physicians, it's a major challenge of the healthcare services concerning the financial implications respectively the effects upon the patient's health status. The assurance of a proper and adequate prescription for the patients is influenced by a series of factors which act upon the prescription decision of the medicines, as: the medicine features (quality-price, availability), the patient's situation, the prescriber, respectively the professional environment. The estimate of a physician behaviour concerning the action of prescribing to the patients leads to the discovery of the major role that the intention has on the behaviour. The present study aims at carrying out a thorough research on drug prescribing behaviour to patients, trying to identify the motivations which underlie the action of prescribing.*

**Key words:** patients; factors; drug prescribing behaviour to patients.

**JEL Classification:** M14; M19; M39; I11; I13; I19.

## INTRODUCTION

The final goal of any prescribed medical treatment is to obtain certain desired results from the patients in question. However, despite best intentions and efforts from healthcare professionals, these results would not be achieved if patients did not follow the treatments. As regards to developing countries, drug abuse becomes a problem of the healthcare system. Studies (Jacoby, Smith and Eccles, 2003) showed that, on average, 2.4 to 10 medicines are recommended in a medical prescription. Another challenge of the prescription habit refers to the fact that between 40-50% of prescriptions contain antibiotics as an antidote for patients' affections (Dinarvand and Nikzad, 2000). Ensuring a suitable and adequate prescription represents a major challenge for healthcare services. The unsuitable prescription of a drug presents both clinical and financial implications. Different research studies (Cockburn and Pitt, 1997; Soumerai and Avorn, 1987) identified some of the factors which influence the prescription decision, among these the following there can be enumerated: drug characteristics, the patient's situation, prescriber, and professional background, respectively.

The current situation of excessive drug prescription to patients, and their conformity to the physicians' prescribed treatments represent aspects which form the basis for understanding behaviours behind the action of prescribing, which needs to be carefully considered.

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## 1. THE ANALYSIS OF DRUG PRESCRIBING BEHAVIOUR TO PATIENTS

The aim of prescribing medicines refers to the fact that they are beneficial to the patient, implicitly to their health.

Cognitive mechanisms which lie at the basis of individual behaviours, for example adopting health behaviour, are important to be analysed and studied taking into consideration the importance of the individual decision in adopting that behaviour. Healthcare professionals are permanently exposed to new research discoveries, which can contribute, through efficiency and efficacy, in the overall process of taking care of the patient. Healthcare professionals' medical activity can be influenced by a series of factors, for example individual motivational predispositions which lead to the change of medical behaviour (for example, the action of prescribing medicines, carrying out a medical examination, the recommendation of specialists to patients, counselling, etc.).

The change which takes place in a healthcare professional's behaviour can be explained after carrying out thorough theoretical research (Grimshaw et al., 2002). The study of the mechanisms which underlies the adoption of a new behaviour was treated from the perspective of the socio-psychological theory, starting from the idea that most decisions in clinical practice are of an individual kind (Godin et al., 2008). Social-cognitive theories describe an individual's opinions/knowledge as processes which take place among external noticeable stimulus and the reactions which appear in real situations. In order to forecast the specific healthcare behaviours, a series of social-cognitive theories were approached on the basis of which the behavioural intention and the behaviour itself were explained, with the help of the *variance* indicator (Conner and Sparks, 2005). An important discovery regarding the assessment of a healthcare professional's behaviour (for example, a doctor, a nurse, a chemist, etc.) highlighted the major role which intention has on behaviour (Eccles et al., 2006). The study carried out by Eccles and his team did not measure the power of the connection between intention and behaviour for healthcare professionals, but the contribution they brought emphasized that the previously mentioned association is similar in magnitude to that encountered among non-professionals and that the different constructs through which the cognitive theories are highlighted (Theory of Planned Behaviour/Motivated Action Theory) can predict the intention and behaviour among different medical groups. For example, in a meta-study, Sheeran (2002) came to the conclusion that on average intention influences the variation of behaviour in a proportion of 28%, by estimating the determining ratio ( $R^2$ ). According to the indications of Fishbein and Ajzen (1975), intention and behaviour must correspond in terms

of action, aim/goal, context/circumstances related to the patient, and time (period when he adopted the behaviour).

The way in which behavioural changes take place as far as drug prescription is concerned was approached and studied from the perspective of the Theory of Planned Behaviour (TBP). TBP belongs to the category of social-cognitive theory which perceives individuals as rational actors which process information before forming certain behavioural intentions, which would subsequently transform themselves into the behaviour itself (Ajzen, 1991). The behavioural intention is formed on the basis of the simultaneous influence of attitude about that behaviour, perceived social pressure (subjective norm) and the perception of control on adopting that behaviour respectively. The intention which refers to certain behaviour represents the main factor which influences the formation of behaviour, compared to the perception about the behavioural control. The intention is considered the basis of TBP, both as a dependent variable and a predictor of behaviour, but the intensity of intention represents the variable predictor important to behaviour. Through the influence of intention, by means of attitude, the action of variables, the subjective norm and the perceived control can contribute to the formation of intention. The theory suggests that the variables, attitude, the subjective norm and the perceived control are based on beliefs and strong opinions. Attitude is formed on the basis of a set of opinions about the consequences triggered by the adoption of behaviour and the assessment of considered consequences. The subjective norm is based on the others' perception about the adoption of that behaviour and the extent to which a certain individual wishes to adhere to that perspective. Similarly, perceived control is determined by the opinions which refer to exercising control and the perception of power of these opinions respectively. For example, for a general practitioner to adopt a positive attitude to the prescription of a certain drug to a patient he should evaluate positively the expected change in the patient's health; he would also have to believe that prescribed drug is capable of producing that positive health modification.

Physicians' drug prescribing behaviour cannot be fully understood if we analyse only their actions. Prescribing behaviour takes place in a social context, physicians-patients, influenced by a series of aspects: patients' expectations, following or ignoring the treatment respectively. The model of interaction between the doctor and the patient starts where the existence of a problem requires a doctor's advice who, in turn, offers all his gained knowledge and abilities to solve the problem. The patient accepts the solution offered by the doctor and follows the instructions he gives. This simple model may be visualized in the following way:

*Patient with a problem > Doctor > Solution (for example, prescribing a drug) > Patient follows treatment previously prescribed*

In reality the previously described model is much more complex and is supported by the results of several research studies which identified the influence of various factors on the relationship between the physician and the patient. For example the patients differ in what concerns the availability to be seen by a certain physician for a certain problem, the patients and the physicians are not on the same page in what concerns the volume of information which they provide to each other and respectively the patients does not obey the instructions given by the physicians (Stimson and Webb, 1975). People shape their expectations before any consultation about what the physician is going to do. Physicians on the other hand can perceive these expectations in the form of a request coming from the patients about how they should proceed. The expectations of the patients are rarely expressed in explicit requests. The relationship patient – physician was tackled in recent studies which analysed the expectations of the patients regarding the solutions offered by the physicians but also the perceptions of the physicians regarding the expectations of their patients. Virji and Britten (1991) expressed the premise that physicians can be aware of the pressure of the patients on them for obtaining a prescription. Various studies showed that no matter whether a physician prescribes or not a prescription, the action itself is associated significantly with the expectations of patients to get a prescription from the physician (Britten and Ukoumunne, 1997; Cockburn and Pit, 1997). A report drawn up by the Audit Commission regarding the prescription of medicines in England and Wales in the year 1994 (Audit Commission for Local Authorities and the National Health Service in England and Wales, 1994) suggested that the excessive prescription of the medicines is influenced largely by the expectations of the patients regarding the treatment which they are to get from the prescribing physician. The results of the Audit Commission are equivocal because the researchers did not define and measure directly the demand for prescribed medicines. The study was based on the research of the perceptions of the physicians about the requests from the patients and respectively on the claims of the physicians that the expectations of the patients influenced the real or presumptive decisions regarding prescription of medicines. Nevertheless the existing studies which analysed the premise regarding the influence of the medicines demand of the patients on the prescription behaviours came to contradictory results. Thus two studies drew the conclusion that the medicines demands has no influence on the prescription (Hepler et al., 1982; Segal et al., 1982), a study showed that the perception regarding the medicines demand influences the prescription little (Stephenson et al., 1988) and other five studies showed that the medicines



demand is associated with higher rates of the prescription (Hadsall et. al., 1982; Schwartz et al. 1989). Four of the five studies which got positive results considered the complexity of the prescription behaviour so that they came to the conclusion that the degree of severity of the illness to be treated, the type of prescribed medicine or the previously made programming for a consultation at a physician contributed to influencing the prescription of medicines. The general conclusion is that the medicines demand from the patients represents one of the factors which lead to the prescription of medicines. The interaction physicians – information and education campaigns in the health field represents an important element that can influence directly the behavioural patterns of the professionals – through the activity of prescription of a formula, as well as indirectly the expectations of the patients regarding what is to be prescribed by the physician. The premises mentioned above suggest that the physicians can be motivated in their activity to prescribe as a consequence of the performed information campaigns, especially if their active participation in those campaigns (Bero et al., 1998). The medicines are an appropriate topic to be explored within the public health campaigns because suggesting a wise consumption of pills can lead through the associated advantages and risks to influencing to a greater degree the behaviour of a patient than by suggesting a healthy life style, which is difficult to practice despite the advantages for the health. The involvement of the patient in taking decisions (for example that to prescribe a certain prescription) is a strong example of the changing attitude within society in favour of obtaining more autonomy and more possibilities to choose from (Department of Health, 2001, 2002; Wanless, 2002). The role of the specialists in the health field these days becomes one in which help is offered in the taken decisions by the patients and also one in which they are supported as soon as they have made a certain decision.

## **2. ELEMENTS WHICH LEAD TO PRESCRIPTION ERRORS**

An inappropriate prescription decision of the medicines to the patient is caused by a lot of elements which are in permanent interaction. The elements which lead to the emergence of the prescription errors can be: insufficient information of the physicians regarding the last innovations in the field of pharmacology, intense promotion of the medicines by the medical representatives of the pharmaceutical companies (Avorn, Chen and Hartley 1982), errors which are based on omissions from the prescribing physicians, ignoring the cost elements of the medicines, pressure from the patient or his family to be recommended a certain medicine contrary to the indications, increased trust for the previous medicine experiences regarding certain medicines in the treatment

of certain illnesses to the detriment of the scientific studies, the necessity to be given by physicians a medicine for health problems which have no clear medical solution (for example dementia) and respectively the big volume of the medical practices focused on the prescription of medicines as a strategy to decrease the time of medical examination. Between a third and a half of the consultations carried out by physicians result in filling in a prescription. The appropriate customs for the prescription of medicines to the patients involves the use by the physician of a limited number of pills which this one knows beforehand. The risk of an inappropriate prescription is higher in case of physicians who recommend a large number of medicines. The changes emerging within the medicines prescription customs are influenced by a series of elements, from which we can specify the scientifically works, recommendations of the specialists, of the colleagues, of the patients or of the pharmaceutical companies (Bjerrum, Larsen and Søndergaard, 2002).

### 3. MOTIVATIONS REGARDING THE PRESCRIPTION BEHAVIOR OF THE MEDICINES

In a study (Schwartz, Soumerai and Avorn, 1989) which investigated the motivations of physicians which are at the basis of the prescription of medicines of non-scientific type analysed the opinions of a sample consisting of 141 specialists. The request of the patient was on the first position in the list of motivations of the physicians with 46%. The next reason, which is to be found in the model of prescription of medicines to the patients, was the use of that medicine as a consequence of the placebo effect, with 24%. Another motivation of the prescription of medicines to the patients resulted from the study referred to the clinical experience of the physician which confirmed that those recommended treatments represented appropriate therapies to be pursued. The elements which influence the prescription behaviour of the medicines by physicians were investigated in a study (Girdharwal and Singh, 2007) which tackled the topic of the behaviour of the physicians towards the marketing practices of the pharmaceutical products. The factors of influence on the prescription behaviour which were identified in the study were assessed by the physicians according to the importance given to each one on a scale from 1 to 10. On the first positions there were the factors *quality of the prescribed products*, *the price of the products* and *respectively their availability* (see Table 1). The most important of the identified factors in the study were the quality of the product prescribed by the doctor, for reasons related to the fact that it helps in the cure of an illness but also related to the contribution to the **reputation**. Thus physicians assess the quality of a product on the basis of the image of the producing pharmaceutical company and respectively

considering the results which a certain product has in the remission of the illness for which it is used. The image of the producing pharmaceutical company is another important factor in terms of priority in what regards the intention of the physicians to prescribe a certain product.

**Table 1 - Factors of influence on the behaviour of prescription of the medicines by the physicians according to the associated importance**

Position	Factor	Average
1.	Quality of the product	9,89
2.	Price of the product	8,50
3.	Availability of the product	8,46
4.	Image of the company	8,37
5.	Regular visits of the representatives of the producing companies	8,20
6.	Research in the molecular domain	7,90
7.	The specialty literature/journals	7,54
8.	The personality of the medical representatives	7,40
9.	Sponsorships for participating in conferences	7,00
10.	New combinations	6,90
11.	Medical educational programs	6,35
12.	Presentation way (package)	6,20
13.	Obtained incentives	5,34
14.	Personally received gifts	4,94
15.	Samples of the products	4,78
16.	Free campaigns for the identification of illnesses	4,70
17.	Existence of the websites of the medicine producers	4,66

Source: Nitin Girdharwal, Ajaypal Singh, A Study of Physicians Behaviour toward Marketing of Pharmaceutical Products (A Case Study of Indian Market, Vol.5, Issue, 6, 2007, available on <http://www.pharmainfo.net/>).

The low purchasing power of the patients contributes to the introduction of the price among the factors which influence the behaviour of the physicians to recommend a certain medicine. The regular visits of the medical representatives from the medicine producing companies represent the most appropriate mean of promotion for the pharmaceutical companies. The presentation of articles in the specialty literature, of the journals and respectively granting sponsorships in order to participate in different conferences or congresses are amongst the motivations of the physicians to recommend a certain pharmaceutical product or to choose a certain producing company. Among the promotion instruments which were less preferred by the pharmaceutical companies in order to be used in the strategy of promotion of medicines there were the organization of free campaigns, granting personal gifts or other types of incentives, as a consequence of the reduced importance degree which these factors have in the decision making process for recommending a medicine by the physician or pharmacist.

The diversity of the medicine brands and respectively of the companies which produce and sell them hinders the decision of the people who make the decision to recommend or prescribe a certain pharmaceutical product. In the decision making process for the recommendation of a

medicine by doctors or pharmacists there intervene a series of factors which contribute to *brand remembrance*. In the same study (Girdharwal and Singh, 2007) five factors were identified which help to remember the names of the brands in the prescription process. These factors were classified according to the importance which they have in remembering the name of the brands (see Table - 2).

**Table 2 - The importance of factors in remembering the names of the brands in the process of prescription by physicians/pharmacists of the medicines**

Position	Factor
1.	Names associated with molecules/the producing company/illness
2.	Short names of the products
3.	Constant remembering (actions of direct marketing)
4.	Names easy to pronounce
5.	Placing little gifts on the table or in the doctor's/pharmacist's office

Source: Nitin Girdharwal, Ajaypal Singh, *A Study of Physicians Behaviour toward Marketing of Pharmaceutical Products (A Case Study of Indian Market, Vol.5, Issue, 6, 2007, available on <http://www.pharmainfo.net/>*

From the table above one can notice that the physicians/pharmacists prefer to mention to the patient brands whose names are correlated with the names of molecules or with the name of the producing company or are related to the illness that they treat. Regular remembrance by means of telephone constant calls and messages sent to physicians/pharmacists at regular intervals is a more efficient option than that of giving small gifts (on which the name of the brand is printed) in order to be found in the office of the physician or on his table.

Among the motivations which determine the physicians/pharmacists to change the recommended or prescribed brand in the situation of the same therapeutic category there are the price, the introduction of new molecules, persistence of the medical representatives, *the effort made by the producing company to promote its products, and respectively campaigns testing of new brands*.

The high quality of a medicine is a key factor which contributes to the success of any pharmaceutical company on the market as a consequence of the fact that this represents a priority for the majority of physicians/pharmacists when they recommend or prescribe a certain product. Pharmaceutical companies must communicate with the physicians constantly in order to promote the products in its portfolio. The producers must also invest in the research and development activity in order to launch new pharmaceutical products (Harrison and Hart, 1987). Another key factor in the process of decision making in the recommendation of a medicine is the task of the professional sale force which becomes an integral part in this process through which the clinical behaviours and the prescription customs of the pharmaceutical products can be changed. The

scientific information presented by the medical representatives must be described in terms of learning opportunities and opportunities of improvement of the process of solving the problems so that all participants in the medical process can be advantaged – physician, patients and sales force.

## CONCLUSIONS

The development of a qualitative study regarding motivations and physicians' behaviour towards the prescription of medication was based on articles from specialized medical literature approached from a marketing perspective. Medication prescription for patients represents a challenge as well as a current issue in the health system, taking into account the fact that the physician - patient interaction is subject to the simultaneous action of several factors that influence the individual decisions of the two actors in the prescriptive act.

On one hand, the physicians' suitable prescription is influenced by several factors that act on the decision to prescribe medication, such as: drug characteristics (quality, price, and availability), patient's state, the prescriber, professional background. On the other hand, the expected results following a medical treatment can be obtained if patients comply with treatments. Excessive prescription of medication, the compliance of the patient to the doctor's recommendations constitutes individual behaviours that define and influence the act of prescribing, therefore requiring additional studies.

Human behaviours are based on cognitive mechanisms that increase the role and importance of individual decision in adopting certain behaviour.

In order to anticipate the behaviours that are typical for the health system, behaviour intention and behaviour as such have been approached from the social cognitive theory where variables were estimated by using variation. Therefore, assessing the behaviour of a health professional regarding medication prescription leads to the discovery of the major role of intention towards behaviour itself.

Understanding physicians' prescriptive behaviour should not be limited to analysing their final actions, it requires understanding the social context of the physician – patient interaction, patients' expectations regarding drug prescriptions, patients' level of acceptance towards the prescribed treatment. The relation physician- patient was intensely studied within theoretical studies on one hand, through patients' expectations regarding drug prescription, rarely expressed in open requests for physicians and on the other hand the relation was explained from the physicians' perceptions regarding patients' expectations. Various studies showed that irrespective of a physician prescribing

a treatment or not, the action in itself is significantly associated with patients' expectation to receive a prescription from the physician (Britten and Ukoumunne, 1997; Cockburn and Pit, 1997). Furthermore, patients' expectations are responsible for excessive drug prescriptions by physicians.

Inadequate drug prescription is caused by several factors that are in permanent interaction and have as a result the respective errors. Prescription errors can be caused by physicians' insufficient knowledge regarding pharmacology innovations, by intense drug promotion by representatives of pharmaceutical companies, prescriber's omissions, ignorance of drug costs, the pressure put by patient or patient's family towards recommending a certain drug despite indications, increased trust in past medical experiences regarding using certain drugs to treat illnesses in spite of scientific studies, physicians' need to prescribe a drug treatment for illnesses that do not have clear medical solutions (dementia, for example), the big volume of medical practices based on drug prescription as a strategy to reduce the time spent in the physician's cabinet.

The increased quality of a drug constitutes a key factor that leads to the success of any pharmaceutical company on the market, as this is a priority for most doctors/ pharmacists when they recommend/ prescribe a drug.

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# AN OVERVIEW OF THE EUROPEAN TAX HAVENS

Loredana Maftei\*

**Abstract:** *In the actual context of economic globalization, tax havens represent a significant obstacle for global governments seeking to increase their fiscal incomes and a source of polarization of income and wealth. Statistics reports showed that tax havens hold at least \$10 trillion in assets, money generally controlled and hidden by major players from the political and financial areas, as well as from criminal ones. The paper introduces the present situation of European tax havens, with the major poles of action. The conclusion finds the real efforts of international bodies such as OECD, to interdict opportunities to avoid taxation.*

**Keywords:** tax haven; offshore financial centres; globalization; illegal markets.

**JEL Classification:** H25; H26; H87; F21.

## INTRODUCTION

The last decade was characterized by a considerable amount of attention devoted to offshore financial centres (OFCs) and tax havens around the world, that have evolved surprisingly in the context of economic globalization, dimension which has led to a significant increase in capital mobility and in demand for tax haven operations. For example, Kudrle (2008) reported a 154% growth in total liabilities from 1998 to 2006 for a sample of 20 tax havens (Blanco, 2012, p. 291).

Usually, the expression, “tax haven” is a truly modern term and a label for sunny images or beautiful islands. Despite this way of thinking which generally seduces the rich people and wealthy states of the world, tax havens offer not only beautiful islands but also safe shelter from most financial regulation and international agreements and a significant obstacle for governments in their activity to increase the fiscal incomes.

The aim of this paper is to describe the recent development of classical European tax havens. According to its history, the subject is quite controversial. Myths and legends have replaced tax havens reality. In fact, the phenomenon is very old. Tax havens existed even before the twentieth century, but it was around World War I when the wealthy increased use of their services, when the U.S. income tax, as well as increasing taxes in European countries, motivated capital to seek safety in low or no – tax locales. Switzerland became more popular as a place to park assets after it passed strong banking secrecy laws in 1934 (Larudee, 2009, p. 344). Ronen Palan (2009) suggested in a recent study, that the history of tax havens could be organized into four sections. First, he points out

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the historical emergence from the late nineteenth century to the 1930s of three distinct instruments of tax haven: low or zero taxation for non-residents, easy methods of incorporation, and legally-protected secrecy. The second section of Palan's study describes the phase of multiple tax havens from World War I to 1970, a phase characterized by the importance of Switzerland regarding the easy development of tax havens regimes and the first institution of protection assets secrecy. The third section brings into the light the period 1970-1990, the true explosion of tax havens around the globe. The last section follows the intensification of international concerns since 1998, regarding the impressive volume of financial assets through the tax havens hands, the beginning of several OECD's publication and reports on harmful tax competition, and the real efforts of European Union to combat and to pressure the activity of such financial shields, along with the consequences of the 2007 crisis that intensified the global reaction to the huge expansion of OFC's.

Several studies suggested that tax havens have an important role in the global economic system due to their activity profile, characterized by multiple factors such as tax evasion, lack of transparency, unconventional states strategy, hard traceability of assets, the code of agreements secrecy, a safe route for laundered money and a drain actor position which constitute most of the time, a security financial shield for developing countries' economies.

A tax haven, or OFC, is a jurisdiction that offers two things: (1) zero or near-zero taxes on business activities; and (2) secrecy regarding financial assets (Larudee, 2009, p. 344). Today, some researchers have classified the modern offshore financial centres, into three main groups: the United Kingdom tax havens with a strong pole linked to the City of London region; European havens and the last and probably the most popular are the havens of less developed economies in South America and Africa.

## **1. TAX HAVENS VERSUS OFFSHORE FINANCIAL CENTRES**

Labeled as tax paradise in French or tax oasis in German, the term "tax haven" has been widely used since the 1950's (Palan, 2009). Nevertheless, globalization aspects have made possible the flows of financial services industry which led at the end, to a sizeable expansion of an "offshore" financial sector.

Tax havens are low-tax jurisdictions that provide investors opportunities for tax avoidance (Desai, Foley and Hines, 2004, p. 1) or in other words a country that offers the possibility to reduce the volume of taxes that you usually pay. Between the concept of tax havens and OFC has always

been some confusion. The literature itself is very vast. Some recent studies see no difference between these two terms, and very often are considered interchangeable, but on the other hand other studies argue that OFCs are not the same as tax havens. OFCs are commercial communities hosted by tax havens which exploit the structures that can be created using the tax havens legislation for the benefit of those residents elsewhere. In other words, OFC is made up of the accountants, lawyers, bankers, plus their associated trust companies and financial intermediaries who sell services to those who wish to exploit the mechanism the tax haven has created (House of Commons Treasury Committee, pp. 10-11).

Thus, the expression “offshore financial centre” (OFC) has become the modern phrase of tax havens and it has been accepted and used by experts, because it is less offensive than the old concept. OFC also suggests a very low or no tax jurisdiction facilitating a broad range of international financial activities, which operates in a less regulated environment than that experienced onshore (Donaghy and Clarke, 2003, p. 382). The term “offshore” itself suggest a nautical image of some entity (ship, rock, or island) located at a distance from the mainland (a larger island or continent) (Vlcek, 2004, p. 228). Moreover, Palan et al. (1996, p. 180) argue that tax havens are “*nothing less than the cornerstone of the process of globalization*”.

#### •Other possible definition of offshore financial centres

*“An offshore centre is a country which provides to the residents of other countries the opportunity to establish companies and to use its financial services for activities outside this centre, offering in most of the cases some advantages such as low taxation rates. In other words the aim of the users of the offshore centres is to take advantage of the lower tax rates offered by the offshore centre which is not synonymous to tax evasion as is the general perception. [...] Certain jurisdictions establish themselves as offshore financial centres in order to attract funds, provide jobs and facilitate economic development”* (Di Nicola, 2006, p. 3).

According to Mattias Levin, OFC`s normally combine some of the following characteristics: a high number of financial institutions that mainly serve non-residents, financial systems out of proportion with the domestic economy`s need, low or no taxes, light financial supervision and regulation, flexible use of different company structures, and high levels of bank secrecy and anonymity (Levin, 2002, p. 2).

## 2. LOCATION AND TYPES OF TAX HAVENS

Experts tend to organize the tax haven in order to make a clearly distinction between them. For example, Lee Hadnum (2012) suggests that are three main types of tax havens:

- *Nil-Tax Havens* associated with no corporate and income tax, no inheritance and capital tax, specifically to The Cayman Islands, Dubai, Monaco, The Bahamas, Anquilla and so on;

- *Foreign Source Exempt Havens* – these countries do levy taxes and sometimes they can be quite high. Maybe, what makes them tax havens is the fact they only tax you on locally derived income (Hadnum, 2012, p. 3). The best examples are given by Panama, Seychelles, Hong Kong or Singapore;

- *Low Tax Havens* - a different situation when the expression “tax advantage” is implied (for example the capital gains tax) or the situation when it is allowed to lower your tax bill. Some good examples are Cyprus, UK, Switzerland, The Netherlands, Denmark, Belgium and Austria.

There is a substantial theoretical literature on the importance of tax havens. Some studies pointed out that are roughly 40 major tax havens in the world today (Dharmapala and Hines, 2009, p. 1058) while other publications identified 70 countries, divided into islands and urban centres (London, Luxembourg). Despite the initial OECD report which showed a map of 47 countries as tax havens, the current list of tax havens seems to be much longer than OECD estimations (see Table 1).

**Table 1 - Tax Justice Network's List of Tax Havens**

The Caribbean & Americas	Africa	Middle East & Asia	Europe	India & Pacific Oceans
Anquilla*	Liberia*	Bahrain*	Alderney	The Cook Islands*
Antigua and Barbuda*	Mauritius*	Dubai	Andorra*	The Maldives
Aruba*	Melilla	Hong Kong	Belgium	The Marianas
The Bahamas*	The Seychelles*	Labuan	Campione d'Italia	Marshall Islands*
Barbados*	Sao Tome e Principe	Lebanon	City of London	Nauru*
Belize*	Somalia	Macau	Cyprus*	Niue*
Bermuda*	South Africa	Singapore	Frankfurt	Samoa*
British Virgin Islands*		Tel Aviv	Gibraltar*	Tonga
Cayman Islands*		Taipei	Guernsey*	Vanuatu*
Costa Rica			Hungary	
Dominica*			Iceland	
Grenada*			Ireland (Dublin)	
Montserrat*			Ingushetia	
Netherlands Antilles*			Isle of Man*	

New York	Jersey*
Panama*	Liechtenstein*
St. Kitts & Nevis*	Luxembourg
St. Lucia*	Madeira
St. Vincent & The Grenadines*	Malta*
Turks and Caicos Islands*	Monaco*
Uruguay	Netherlands
US Virgin Islands*	Sark
	Switzerland
	Trieste
	Turkish Republic & Northern Cyprus

Source: TJN, "Tax Havens by Region" - <http://www.taxjustice.net/cms/upload/pdf/mapamundi.pdf>

Note: Asterisks mark those jurisdictions that were also on the OECD's list of 39 tax havens in GAO. San Marino is on the OECD list of 39, but not on the TJN list of 72.

The last 10 years have concentrated a large amount of research in this field, given by several international bodies such as the International Monetary Fund, the OECD or the G-7. The OECD has given its view on tax evasion, the IMF on stock market speculation and insider trading, and the G-7 on drug trafficking and the financing of terrorism (Deneault, 2007, p. 261).

Based on the academic literature, the OECD estimated that in 2007 the capital placed through offshore companies in tax havens reached a value between 5.000 and 7.000 billion of dollars, also the international group, named Tax Justice Network, estimated great losses, up to 255 billion of dollars, as a result of the global system of taxation through tax havens (Radu, 2012, p. 398). The total amount of financial assets hidden in safe shelters is supposed to be equal with the USA and Japan economy, according with, "The Price of Offshore Revisited" study, realized by the economist, James Henry.

Nicholas Shaxson (in Kilkenny, 2011), the author of *Treasure Islands*, explained that „The biggest tax havens are big, rich countries, particularly the United States, the United Kingdom, Switzerland – of course, the Cayman Islands is very big too – but also countries like Ireland and Luxembourg, Luxembourg is absolutely huge”.

### 3. THE EUROPEAN TAX HAVENS

Despite its culture and history, Europe has always been a strong player on the global financial market, taking into account its financial strength found in the heart of the United Kingdom, its confidence, neutrality and banking secrecy of Switzerland, its egocentrism as a result of a new born



community (EU) but also to its tough financial system, found in different countries such as France, Germany and so on.

Regarding its very high taxes, Europe can be in the mind of its citizens, a “trouble hornet”. A good example is given by the high cost of living in London. The British pound costs \$2, up from \$1.75 just a year ago. So, two round-trip bus tickets cost \$8 and two movie tickets \$36. And worst of all, if you import income of \$200.000 to the U.K, taxes may eat up \$90.000 of it. The high taxes combined with high cost of living generate very constraining living conditions (Fitch, 2007). Also, a considerable attention was devoted to France, because of its new politics of high wealth tax. Thus, it is not surprising at all, that the Old Continent can gather some important tax havens that simply can avoid the new European tax practices.

The most popular tax havens that you can find in Europe are illustrated in the Figure 1: Switzerland, Luxembourg, Lichtenstein, Monaco, Andorra, Dublin, Isle of Man, Cyprus, Jersey, Malta, Guernsey and Gibraltar.

**Figure 1 - European Tax Havens**



1.Isle of Man, 2.Dublin, 3. Guernsey, 4.Jersey, 5.Luxembourg, 6.Switzerland, 7.Lichenstein, 8. Monaco, 9.Andorra, 10.Gibraltar, 11.Malta, 12.Cyprus.

Source: Reszat (2005), at <http://reszatonline.wordpress.com/2012/07/29/offshore-centres/>.

Along with the events in the period 2008-2009, the peaceful activity of tax havens put an end to the relationship between OECD and these safe shelters. It must be emphasized that Europe has been in the middle of several tax scandals launched by the governments of France, Germany and the US and directed to the financial institutions in Switzerland, Liechtenstein or Austria, who helped a great number of citizens to invest and to hide millions of dollars in these countries banks without any concern to pay taxes required in their home country. Nevertheless, the G20 leaders have

articulated at the London Summit in 2009, the imperative need to put an end to the era of banking secrecy.

In the heart of Europe there is Switzerland, an Alpine nation of the most well-established tax havens and one of the most popular in the world. But what does Switzerland offer? It is very well recognized for its long tradition exposed in political stability, neutrality and also for its bank discretion and secrecy of assets. For many years, this country hosted the wealth of many well-known political, economic and artistic figures.

The laws enacted by the Swiss banks have transformed this country into a favourite destination for the top elite who seek to avoid different high taxes.

Although Switzerland is considered the top Euro-tax haven, the truly Euro-haven is represented by Andorra, a very popular country due to its duty free politics. A small country like Andorra, surrounded by mountains, between Spanish and French border, is a wonderful attraction because it offers no income tax.

Another important tax haven of Europe is Monaco, a dream location for rich people around the world. This wonderful Mediterranean coast of France it is very well known due to its generous offer, 0% income tax for residents. Thus, the cost of live is very high; practically you have to be a very rich person to afford to live here.

## CONCLUSIONS

Globalization became a catalyst in every section of global activity. It has contributed to an important increase in foreign investments, technology, business relations, and the speed of world transactions. The freedom launched by the globalization process has made possible the ease transfer of assets around the globe and the development of new way of taxation and the channelling of considerable amount of money on the underground financial markets.

The globalization process articulated an expansion of tax havens around the world, from the most famous and modern in the West, the Caribbean pole, to the more classical one placed in the Europe, such as Benelux, Switzerland or Cyprus. It must also be emphasized that tax havens can be described in a variety of ways, but today, the main concern of international bodies such as OECD, IMF and so on, is the lack of transparency of such jurisdictions. For example, OECD has maintained for many years several campaigns against tax havens.

Regarding the geographical location, tax havens are very well-represented on all the continents. From small states, recognized under the term, classical tax havens' such as *inland*



*states*: Liechtenstein, Luxembourg, Belgium; *costal states*: Monaco, Hong Kong; or *island states* such as British Virgin Islands.

Roughly, Europe has been a shelter of many reputable countries, as Switzerland, Monaco, Luxembourg, Liechtenstein, and Andorra and so on, that have offered multiple financial services as, for example: banking and commercial secrecy, liberal currency control, lower standards regarding the regulation of banks and insurance activity. European governments continue to be affected by the activity of tax havens, especially concentrated in the Euromarkets sphere, the City of London, Switzerland, Monaco and Cyprus. Furthermore, the last decade was an extension of OECD efforts and initiative to combat harmful tax competition.

Presently, there are several initiatives targeting directly or indirectly tax haven jurisdictions. These include, inter alia, the 1998 OECD initiative against harmful tax competition, the FATF work directed at combating money laundering, the 1998 United Nations Office for Drug Control and Crime Prevention Report on Financial Havens, Banking Secrecy and Money Laundering and the work of the Financial Stability Forum concerning offshore centres (Orlov, 2004, p. 104).

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# FUNDAMENTAL RIGHTS IN THE EEC TREATY AND WITHIN COMMUNITY FREEDOMS

Konstantinos Margaritis\*

**Abstract:** *It has been widely argued that the European Economic Community (EEC) was based on principles of economic integrity and growth through the creation of a common market; this is not far from reality. The Treaty of Rome was full of provisions that enhanced economic co-operation and increased the sense of liberalization in Europe, such as the four, now traditional, Community freedoms. Although all the above applied, there were articles within the EEC Treaty where fundamental rights were guaranteed; more than that, fundamental rights that occurred from the Community freedoms, even in a basic level. This is of highest importance since the interpretation of those provisions gave the initiative for further development in the field of fundamental rights protection within the Community legal order, throughout legislative procedure and case law. The aim of this paper is to present the fundamental rights as highlighted in the EEC Treaty and critically approach their concept under Community law.*

**Keywords:** Fundamental Rights; Economic Freedoms; EEC Treaty; ECJ case law.

**JEL Classification:** E61; F68; J83; K39.

## INTRODUCTION

Beyond dispute, the establishment of the European Economic Community in 1957 constituted an innovative procedure; based to a large extent on principles of economic integration and development too. The Treaty of Rome (EEC Treaty) can be understood as the institutional framework for an economic and monetary union with the establishment of a common market to be the far reaching aim (Belassa, 1961, pp. 3-4). This can be easily proved by the grammatical structure of article 2 EEC Treaty, where the economic growth and stability as well as the rise of living standards were demonstrated as main targets of the Community.

Under this perspective, the development of methods for fundamental rights protection within the above mentioned framework could not be characterized as a priority for the newly-established Community. Consequently, it seemed absent from the Treaty of Rome. On the other hand, even on this strictly economic institutional construction, there have been provisions related to the protection of traditional fundamental rights. Moreover, freedoms of economic nature were introduced in the Treaty of Rome, highly connected to the target of common market. The so-called Community freedoms were related to the free movement of goods and capital, free movement of workers and free provision of services to the citizens of the member states. However, even on basic level, a

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framework of fundamental rights protection could be observed within the concept of Community freedoms, which emanated from them and completed their implementation.

The aim of this paper is to analyse the form of protection of fundamental rights within the Community as included in the EEC Treaty from two perspectives; first, from the standpoint of provisions that guarantee the protection of certain fundamental rights *per se*, additionally, within the concept of the four basic Community freedoms. For the better understanding, relevant case law of the ECJ will be used. At the end, useful conclusions will be drawn regarding the level of protection of fundamental rights in the most important of the Communities through the EEC Treaty.

## **1. FUNDAMENTAL RIGHTS IN EEC PROVISIONS**

### **1.1 Principle of equality**

The most important principle, the cornerstone for the true function of democracy, is beyond dispute the principle of equality. The concept of equality derives from the fact that all people are born equal, have the same value and need to be respected at the same way. As mentioned at the US Declaration of Independence in 1776 “*we hold these truths to be self-evident, that all men are created equal; that they are endowed by their Creator with certain inalienable rights*”, therefore all inalienable rights exist for all people.

Instituted as a general principle, article 7 EEC Treaty stated that any discrimination on grounds of nationality shall be prohibited. Any discrimination implied all aspects, such as the equal fees for an educational institute (ECJ case C-293/83 Gravier vs. City of Liege). However, the principle of equality was guaranteed on peculiar terms. It applied only under the framework of the Community and without prejudice to any special provisions contained in the Treaty. The use of more intense terms that could describe equality in a more absolute way was avoided as the founders did not intent to give to the Treaty any form of fundamental rights declaration by any means. In addition, the basis for discrimination drawn on article 7 was inadequate; it excluded regular reasons that someone could be discriminated, such as religion, race, colour, political views.

### **1.2 Right of establishment**

Although in the same Title with free movement of persons, services and capital in the Treaty of Rome, the right of establishment should be treated as a separate fundamental right guaranteed in

the Community. In line with this opinion, the term “right” instead of “freedom” was used with the former underlying the concept of a traditional right and the latest being related to the economic freedoms provided in the EEC Treaty.

In article 52 EEC Treaty, the abolishment of restrictions on the right of establishment for citizens of a member state to another member state was mentioned. The same provision gave the definition of establishment which included the right to take up and pursue activities as self-employed persons and to set up and manage undertakings under the conditions laid down for its own nationals by the law of the country where such establishment was effected.

In that sense, a primary right was guaranteed inside the Community (Toth, 2005, p. 242). For example, a Belgian businessman could establish his enterprise in France under the French law that is applied for his French colleagues. Moreover, the right of establishment contained a secondary right (Toth, 2005, p. 242). In the same example, the Belgian businessman could establish a part or a subsidiary company in another member state, while keeping his initial one in France.

This was exactly the aim of the founders of the Community; the freedom of development of entrepreneurship within the borders of the Community and its improvement at inter-state level. Therefore, every self-employed citizens of member state was given the right to choose freely where to run his business while keeping in mind relevant important parameters, such as taxation, bureaucracy, business law, etc.

It has been widely accepted (ECJ case C-1/93 Halliburton Services BV vs. Staatsecretaris van Financien; ECJ case C-55/94 Gebhard; ECJ case C-70/95 Sodemare; ECJ case C-212/97 Centros Ltd. See also Schermers, 1993, p. 450) that the right of establishment was granted to both natural and legal persons. The difference between natural and legal persons is based on the legal status and could not be a basis of distinction in the sense of the right of establishment. The only exception referred to non-profit organizations. Since the right of establishment was guaranteed within a strictly economic institutional framework and hence was connected to business activity, could not cover non-profit organizations that, by definition, do not aim for profit.

The right of establishment could be limited only under specific circumstances. The first one was related to issues of public policy, public security and public health. The second pertained to activities that were connected with the exercise of official authority, even occasionally. More specifically, the provisions of right of establishment were deactivated when the natural or legal person pursued activities of state authority; any opposite approach would violate the core of national sovereignty of the member state.

### **1.3 Equal pay for equal work**

Article 119 of the EEC Treaty instituted the principle of equal pay for equal work between men and women. In that way, equality at work was ensured between men and women; the aim was mostly social, so that a part of the labour force would not get exploited by being less paid (mostly women) within the labour arena of the Community of highest competition (Claussen, 1991, p. 787).

The concept of pay for the purposes of the Treaty was further analysed. Article 119 covered the ordinary, basic, minimum wage or salary and any other consideration, whether in cash or in any kind, which the worker receives, directly or indirectly, in respect of his employment from his employer. Equal pay without discrimination based on sex meant that pay for the same work at piece rates should be calculated on the basis of the same unit of measurement and that pay for work at time rates should be the same for the same job.

The importance of this principle of equality was further underlined with its direct applicability on the member states. Citizens could use the protection granted in article 119 in national courts which were obliged to guarantee the right affirmed in that provision (ECJ case C-43/75 Defrenne vs. Sabena; Crisham, 1977, p. 108). Since the concept of this provision was from the very beginning of highest importance for the development of the Community in the field of social policy, article 119 should be interpreted in a broad sense so that a substantial protection of the right to equal pay for equal work between men and women would be achieved.

### **1.4 Access to Justice**

A major right of highest importance, which absence substantially deactivates every possible provision related to fundamental rights protection, is the right to access to justice. From the very beginning of the European integration this particular right was explicitly guaranteed in article 173 of the Treaty. In the first paragraph, it was refereed that both the member states and the Community institutions (the Commission and the Council) may proceed to the ECJ on the ground of incompetence of the institution that legislated, infringement of an essential procedural requirement, infringement of the EEC Treaty or any law related to its application, misuse of powers.

In addition, according to the second paragraph of article 173, the right to access to justice was guaranteed to natural or legal persons as well, under major differences compared to the member states or Community institutions. In order for a citizen to proceed, there should be a decision addressed against that person or a decision which, although in the form of a regulation or a decision

addressed to a third person, is of direct and individual concern to the former. The second was a very complicated occasion that raised interpretational problems especially with reference to the terms “direct” and “individual”.

When a regulation is of direct and individual concern is hard to be described. The interpretational approach on behalf of the ECJ has been characterized quite strict (Barav, 1974, pp. 191-198; Rasmussen, 1980, p. 112; Greaves, 1986, pp. 119-123). Under the above conditions, the proceedings against an EEC act that underlie the legal basis for further harming measures against a citizen were declined since the initial act did not affect the citizen “directly”. Particularly, in ECJ case *Plaumann*, the Court ruled that a citizen is affected “individually” when an act affects him in such a way that substantially attributes particular characteristics of peculiar nature to a citizen or when the act, under particular circumstances in which he is differentiated from all other citizens and by virtue of these factors, distinguishes him individually just as in the case of the person addressed. From the above mentioned, it can be easily understood that the successful proceedings against an EEC act on behalf of a citizen was on the edge of being practically impossible within the framework of article 173.

The approach of the concept of access to justice for natural and legal persons in Community level is rather deficient. For full protection to be achieved, the right to access to justice must be effective. This means that the proceedings against a legal act of the Community shall have fair possibilities to be successful, which was definitely not the case under article 173. The rather vague notions of “direct” and “individual” that are included in the provision in conjunction to the strict interpretational position of the ECJ make access to justice totally ineffective in a way that the true meaning of Justice cannot be applied as far as citizens are concerned.

Despite the strong criticism (Rasmussen, 1980, p. 112; Hartley, 2007, pp. 368-369), article 173 still remained innovative for the standards of the Community at that time. It was the first attempt to guarantee right to access to justice in the legal system of a brand new legal entity. Especially, the last legal basis for proceedings, the misuse of powers, constitutes the main reason of institutionalization of fundamental rights protection which generally is the protection of citizens from power abuse of the governors. The access to justice presupposes the violation (and hence guarantee) of certain rights that clarifies the action of power abuse. In that sense, no matter how incomplete it was, the provision of article 173 triggered the Community institutions for further development of fundamental rights protection in the Community legal system. Since there was no concrete catalogue at the time, the ECJ found other sources as basis for protection and hence cover this legal gap.



## **2. FUNDAMENTAL RIGHTS IN COMMUNITY FREEDOMS**

### **2.1 Free movement of goods**

Article 9 of the Treaty of Rome instituted the free movement of goods. It was explicitly stated the establishment of a custom union and the prohibition between Member States of customs duties on imports and exports and of all charges having equivalent effect as well as the adoption of a common customs tariff in their relations with third countries. The concept of “goods” was delineated in various ECJ cases which ruled that everything valued in money that can be object of commercial transactions could falls into the concept of “goods” (ECJ case C-7/68 Commission vs. Italy par. 2).

In addition, every tax burden related to the free movement of goods was prohibited according to article 12 EEC Treaty. This burden did not have to be necessarily characterized directly as “charge” but also burdens that substantially have equivalent effect to charges were not in compliance with Community law (ECJ case C-7/68 Commission vs. Italy par. 5). In the same line, in other cases (ECJ case C-24/68 Commission vs. Italy; ECJ joint cases C-2/69 and C-3/69 Diamantarbeiders; ECJ case C-87/75 Conceria Daniele Bresciani vs. Amministrazione Italiana delle Finanze), the Court constantly prohibited every form of tax charges related to issues of free movement of goods in Community member states (a case regarding charge not being characterized as having equivalent effect to tax charges may be seen in ECJ case C-18/87 Commission vs. Germany). In the same institutional framework, the imposition of taxes, direct or indirect, by a member state to goods from another member state, higher than the ones imposed to national goods is prohibited. Finally, under article 30 EEC Treaty, all quantitative restrictions on imports are prohibited between member states.

The liberal spirit that prevailed with reference to free movement of goods consequently empowered the general economic freedom as a fundamental right of the citizens. In an attempt to define economic freedom, it applies when institutions and policies allow voluntary exchange and protect individuals and their property within the legal order. Hence, the key ingredients of economic freedom are personal choice, voluntary exchange, freedom to compete in markets and protection of person and property. The protection of economic freedom is guaranteed as fundamental right in liberal European Constitutions; for example, article 18, paragraph 1 of the Finnish Constitution, article 41 of the Italian Constitution, article 38 of the Spanish Constitution and article 5, paragraph 1

of the Greek Constitution (Gerondas, 2002, p. 303) and constitutes a special aspect of development of personality of the person in society.

With the establishment of the EEC, this particular right was not guaranteed, but also promoted to the maximum. The creation of a common market in Europe with the gradual abolishment of restrictions with reference to movement of goods provides further opportunities for increasing exports and trade; a fact that leads a growing number of citizens to participate in economic life of Europe by exercising in practice their right to economic freedom. In that sense and by taking the theoretical approach of Adam Smith into account that economic freedom leads to economic growth, the whole Community structure was based exactly on that right of economic freedom in order to achieve the targets of economic growth, stability and the rise of living standards as referred in article 2 EEC Treaty.

## **2.2 Free movement of workers**

Free movement of workers within the Community was instituted in article 48, paragraph 1 of the EEC Treaty. The parallel reference to the abolition of discrimination based on nationality might be one of the clearest examples of fundamental right guarantee connected to a classical economic Community freedom in the founding treaty.

Paragraph 2 of article 48 prohibited any form of discrimination based on nationality between workers of the Member States as regards employment, remuneration and other conditions of work. This was the initiative for entrenchment of non-discrimination in labour affairs in Europe (see also ECJ case C-379/87 *Groener vs. Minister for Education*; ECJ joint cases C-267/91 and C-268/91 *Keck and Mithouard*; ECJ case C-18/95 *F.C. Terhoeve vs. Inspecteur van de Balstingdienst Particulieren/Ondememingen Buitenland*).

The principle of non-discrimination in labour affairs was further explained in paragraph 3. It contained the right to accept offers of employment actually made, to move freely within the territory of Member States for this purpose (ECJ case C-53/81 *D. M. Levin vs. Staatsecretaris van Justitie*), to stay in a Member State for the purpose of employment in accordance with the provisions governing the employment of nationals of that State laid down by law, regulation or administrative action, to remain in the territory of a Member State after having been employed in that State (Grant, 2002, pp. 153-155).

Furthermore, it has been widely argued (ECJ case C-13/76 *G. Dona vs. M. Mantero*; Blanpain, 2010, pp. 276-277) that this principle has direct effect so that it could be appealed to the

courts of the member states. The protection of workers referred to every form of discrimination based on nationality, either directly based on nationality of the worker, or indirectly, based on different criteria that reach the same outcome (ECJ case C-152/73 Sotgiu; ECJ case C-419/92 Scholz; Baldoni, 2003, p. 7).

However, traditional bases for discrimination were excluded from the provision, such as colour, culture or language, religion, family status etc. Furthermore, this principle applied only to EEC citizens and only in the geographical borders of the Community. Finally, principle of non-discrimination in labour affairs was not absolute; it was limited on the grounds of public policy (ECJ case C-41/74 Van Duyn vs. Home Office; ECJ case C-30/77 R vs. Boucherau), public security or public health and referred only in private sector not in public according to article 48, paragraph 4 EEC Treaty (ECJ case C-149/79 Commission vs. Belgium).

Apart from the recognition of non-discrimination as a fundamental right within the EEC Treaty, the free movement of workers contributed to the development of another fundamental right, that of freedom of work. The core of this particular right consists of the right to freely choose and change working environment (Mayer, 1985, pp. 225-242). Under the establishment of the Community, this right of choice was highly improved in the sense that not only many more opportunities were provided to workers from a greater range of occupations, but also the possibility to compare working conditions in the member states and choose accordingly.

Nevertheless, as it has been mentioned above, the aims of the Community, especially during the initial period, were strictly economical. Being development in such an institutional environment, free movement of workers was unavoidably related to economic prosperity. Thus, working for rehabilitation did not fall on the scope of article 48 EEC Treaty (ECJ case C-344/87 Bettray vs. Staatsecretaris van Justitie). To sum up, the approach on free movement of workers seemed to seek a balance between the concept of worker as a production unit that contributes to the common market and the financial growth of Europe on one hand and the opportunity of the worker as a human being to choose to work in another country for improving his living standards and at the same time not being discriminated on the ground of his nationality on the other (Craig and de Burca, 2003, p. 701).

### **2.3 Free movement of services**

As referred in article 59 EEC Treaty, restrictions on freedom to provide services within the Community should be abolished in respect of nationals of member states who are established in a

member state of the Community. In that sense the right of establishment was a prerequisite for the free movement of services to take place as without the guarantee of the former, the latest could not be exercised. Hence, the strong connection between the fundamental right of establishment and the economic freedom of services was proven there.

The definition of the concept of “service” was attempted in article 60 EEC Treaty. Consequently, always by taking into account the economic spirit of the Community, services were provided generally for remuneration; a fact that was confirmed in the ECJ case law where the term “profitable” service was used (Steindorff, 1987, p. 351), in so far as they are not governed by the provisions relating to freedom of movement for goods, capital and persons (ECJ case C-279/80 Webb). Thus, the liberalization of the common market was substantially completed, a main target for the Community from the very beginning, by covering all aspects of trade in modern economy.

The principle of non-discrimination on the ground of nationality or residence (ECJ case C-279/80 Webb) applied regarding restrictions within the free movement of services, according to article 65 EEC Treaty. Moreover, the legal status of the service provider (natural or legal person) could not be used as a basis for discrimination for the purposes of freedom of services (article 66 combined with article 58 EEC Treaty).

A particular issue appeared with reference to the scope of the rights guaranteed under the freedom of services, whether it included the people for whom the services are intended. Advocate General Lenz, based on the grammatical structure of article 59 EEC Treaty, denied relevant rights by stating that the provision guaranteed rights to people who provide service, not to whom services are intended (Opinion of Advocate General Lenz in the ECJ case C-251/83 Haug-Adrion). A different approach was expressed by Advocate General Mancini who stated that under the guarantee of rights also to people who accept the service, the freedom of service was substantially completed (Opinion of Advocate General Mancini in the ECJ joint cases C-286/82 and C-26/83 Luisi and Carbone vs. Ministerio del Tesoro). Perfect examples could be the cases of tourism or health services; the person who accepts the service may have to move from one member state to another, where the service provider has been established (Hermans, 1997, p. 14).

The limits set in the right of establishment applied in the free movement of service as well, since articles 55-58 EEC Treaty were valid for the latest (see also the relevant sub-chapter on the right of establishment). The strong connection between the two was proven again in the structure of article 66 EEC Treaty. So services could not be provided to activities which in that State are connected with the exercise of official authority. Also the freedom could be limited on the ground of public policy, public security and public health.

## 2.4 Free movement of capital

As a major economic factor, provisions on capital could not be excluded from the EEC Treaty. According to liberal approaches, free movement of capital, like free movement of goods, increases the right of economic freedom which leads to economic growth within society.

In terms of fundamental rights protection, the principle of non-discrimination was included in the relevant EEC provisions in a peculiar way. Article 67, paragraph 1 stated that member states should progressively abolish between themselves all restrictions on the movement of capital belonging to persons resident in member states and any discrimination based on the nationality or the place of residence of the parties or on the place where such capital is invested. The structure of the provision led to various interpretations. According to one opinion (Oliver, 1984, p. 414), this principle was simply an explanation of the general abolishment of restrictions on the movement of capital. This implies that non-discrimination was not guaranteed independently as a fundamental right but as a potential restriction that a member state might have imposed and should be abolished.

Another opinion (Vaughan, 1986, p. 637) distinguished two elements in article 67, paragraph 1. Two kinds of obligations arose from this provision for the member states; on one hand the abolishment of restrictions, on the other hand non-discrimination on movement of capital. The aim of the second obligation was the equal treatment on capital regardless of the citizenship of the people involved in the trade (Mohamed, 1999, p. 56). In that sense, the principle of non-discrimination was guaranteed in the EEC Treaty as a fundamental right.

Another interesting issue on the structure of the provision was the basis of non-discrimination. Unlike other cases, non-discrimination was connected not only to nationality, but also to residence. Thus, two different notions appeared with the former being narrower to the latest (Lasok, 1986, p. 80). As long as the provision guaranteed protection from discrimination based on residence, it covered both “European” and “non-European” citizens that reside at member states. Therefore, the concept of nationality that under the framework of Community law was related to citizens of member states did not seem to pervade movement of capital.

In that sense, article 67, paragraph 1 was one of the very few cases where the protection of third country nationals was guaranteed in the EEC Treaty. This confirmed the focus of the newly-established Community on the total abolishment of any type of restrictions on the free movement of capital. In the same line article 68, paragraph 1 EEC Treaty stated that as regards the matters dealt with capital, the member states should be as liberal as possible. The meaning of the use of two concepts covering each other (nationality and residence) was rather symbolic and demonstrated the

dynamics of true combat against any possible burden related to development of the common market.

An additional basis for non-discrimination according to article 67, paragraph 1 was the place where the capital was invested. Issues were raised regarding the scope of “place” since in the modern business practice, an investment may have more than one places. For example, an Italian could have taken a business loan in Germany for investing purposes in the Netherlands and Belgium. Hence, by taking the grammatical interpretation of the provision, the place of investment in the above example is the Netherlands and Belgium and not Germany, since the loan is not an investing action by itself but a preparatory action for investment.

It has been argued (Lasok, 1986) that the principle of non-discrimination on the basis of the place of investment should not include the place of origin of the capital. However, a more expansive interpretation of the provision would be more applicable. The liberal spirit of the founders of the Community totally opposed obstacles to action that promote the movement of capital within Community, even if those actions are not purely investing. The main aim was the enhancement of common market; this aim could not be fully achieved without facilitation of actions that finally lead to investment of capital.

In any case the problem could be solved with reference to the first obligation of article 67, paragraph 1 EEC Treaty which was the abolishment of restrictions on the movement of capital. The word “movement” was used there instead of “investment”, so the transfer of capital from one place to another for investing purposes could be covered by that obligation. This provision in conjunction to the general principle of non-discrimination of article 7 EEC Treaty leads to the conclusion that non-discrimination should apply also for the place where actions of capital transfer were carried out for the investment of capital.

A final issue worth mentioning derived from the structure of article 67, paragraph 1 EEC Treaty. The responsibility of the member states to abolish restrictions on free movement of capital was up “to the extent necessary to ensure the proper functioning of the common market”. Hence, it appears that, despite the liberal background which was obvious in article 68 EEC Treaty, free movement of capital was not instituted in absolute terms unlike the other freedoms provided in the EEC Treaty (Usher, 2007, p. 1534). This issue was discussed in the *Casati* case where the ECJ ruled that the Council should decide as to the extent of application of this particular provision by taking into account the possible dangers that the abolishment of restrictions could depress.

In that sense, the Council could review that provision and allow the abolishment of restrictions at will, on a case by case basis. Hence, the application of article 67, paragraph 1 ended

up to be substantially an issue of political nature for the Council, rather than a legal norm that could be appealed to national courts in case of violation of the right to economic freedom or non-discrimination (Usher, 2007, p. 1535; for deeper analysis on Casati case see Louis, 1982, pp. 443-454; Petersen, 1982, pp. 167-182).

## CONCLUSIONS

Fundamental rights protection was definitely not instituted in the Treaty of Rome; in fact it was far from the Community's targets as inspired by its founders in 1957. Nevertheless, the existence of provisions such as article 7 or article 119 EEC Treaty that contained basic principles such as equality and article 52 EEC Treaty that guaranteed the right of establishment, set the basis for further development of the level of fundamental rights protection in Europe, even though expressed on a basic, inadequate level and in accordance with economic principles.

Additionally, the integral notions of rights to the Community freedoms (capital, services, workers and goods) substantially assured a certain level of protection to citizens under the main target of the establishment of the common market. Still, this was of particular importance since it gave the opportunity for a more "humanistic" interpretation in certain cases before the ECJ.

Finally, the guarantee of the right of access to justice was from a personal point of view, the most significant fundamental right example in the Treaty of Rome. Despite its inadequacy, the right of access to justice not only triggered the ECJ for developing the protection of fundamental rights in the Community in its case law, but also it substantially demonstrated a deeper will of the founders of the Community to keep a balance of powers. From a technical perspective, as underlined in the relevant chapters, all provisions needed improvement in order to be complete for the full protection of rights in a modern, democratic society.

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# BUSINESS VALUATION IN TERMS OF INDICATORS OF SUSTAINABLE DEVELOPMENT

Leontina Pavaloaia\*

**Abstract:** *The indexes regarding the sustainable development have an important role in the decision-making process and that is why several bodies and institutions are concerned about their development. This fact happens not only at macro-level, but also at micro-level, the entities being encouraged to take into account the sustainable development principles and to relate its individual performances to the environment in which they operate (local, regional, global). The usage of the indexes regarding the sustainable development offers information regarding the evolution in time helps at identifying the possibilities of improving the activity and the weaknesses; they can be used in order to establish and achieve the objectives, the values being easily communicated both within and outside the company. A main disadvantage is the aggregation level, which hinders comparisons. This paper analyzes the information regarding the sustainable development published by the companies ranked at the Stock Exchange of Bucharest in the 1<sup>st</sup> category and the subsidiaries of 30 national companies.*

**Keywords:** sustainable development; environmental indicator; microeconomic.

**JEL Classification:** Q01; Q56.

## INTRODUCTION

The intensity and complexity of the economic activities under the actual conditions cannot be approached without taking into account the aspects related to the environment. The traditional instruments used in order to plan the economic development are not capable of identifying the effects on the environment. They do not allow the realistic assessment of the economic increase and of the welfare of a country, because they do not take into account the market external factors, such as the natural resources value and either the impact on the environment of the pollution determined by the anthropic activities, mainly by the productive ones. The usage of the traditional instruments for the assessment of the economic activities, without taking into account the natural limits, does not offer the possibility of checking whether there is a progress or retrogression with regard to the sustainable development. That is why it is compulsory to use indexes regarding the sustainable development, which aim at performing certain effective activities for the environmental protection and maintaining a favourable relationship with the community.

Taking into account the fact that the sustainable development is one of the objectives of the public policies and of the organizational strategies, several bodies focused on the effort to transpose the concept into practice. The need to assess better the activity of an entity and to align its

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objectives to a complex range of external factors amplified the necessity to define certain performance indexes on sustainability, accepted on a wide scale.

In the development of the indexes regarding the micro-level sustainable development, one must have in view aspects regarding the three piles of the sustainable development (Azqueta and Sotelsek, 2007):

- *Environment*: the compatibility between the activity of the company and eco-systems maintenance. It comprises an analysis of the impact of the companies and their products in terms of resources consumption, generated waste, emissions, etc.;

- *Social*: the social consequences of the company for all the partners: employees (working conditions, wages, non-discrimination, etc.), suppliers, customers (safety and psychological impact of the products), local communities (pollution, respect of the local culture, etc.) and society, generally speaking;

- *Economy*: “classic” financial performances, impact of the exchange value, capacity to contribute to the economic development of the area, observance of the competition principles (corruption absence, dominant position, etc.).

Measuring the environmental and social performances of a company involves a lot of challenges, such as (Barret and Drevetton, 2007):

- The environmental and social aspects are complex and often difficult to quantify;
- The comparison of the environmental and social impact for the companies of the same area is difficult, because of the absence of harmonization when the economic activities are different and diverse and disparate information is aggregate;
- The instructions for the measurement and report of the information are often interpretable;
- The availability and quality of the data regarding the sustainable development often leave a lot to be desired.

All the essential information for the users in order to assess the economic, environmental and social performance of the entity has to be presented so as to reflect the declared limits, spatial dimensions and the time period. This approach is based on the idea that the global performance of an entity can be measured according to the contribution to the economic prosperity, environmental quality and social capital (Maha and Incaltarau, 2011). Briefly, this notion refers to the frame which allows the measurement and report of the results of an entity, according to the economic, social and environmental parameters. In a broader meaning, the term refers to all the processes that an entity performs in order to minimize the unfavourable effects of its activity. This involves a clear

objective of the entity and the acknowledgement of the needs of all users (shareholders, customers, employees, trade partners, public authority, etc.).

## **1. WHICH IS THE UTILITY OF THE INDEXES REGARDING THE SUSTAINABLE DEVELOPMENT AND HOW CAN THEY INFLUENCE THE DECISION-MAKING PROCESS?**

In order to find a relevant answer to these questions, several international and national bodies gathered their efforts, developing indexes/systems of indexes able to measure all the aspects regarding the sustainable development. Unfortunately, no unitary point of view on the manner of approaching these problems has been reached so far. However, we must highlight that in recent years important progresses have been made in approaching the aspects regarding the sustainable development. Such concerns were identified both at theoretical level by developing a conceptual frame, but also at applied level by developing certain models enforceable at macro-economic level (Environmental Vulnerability Index – EVI, Human Development Index – HDI, Environmental Sustainability Index – ESI, Environmental Performance Index – EPI, Commitment to Development Index – CDI, Index of Measure of Economic Welfare – IMEW, Index of Sustainable Economic Welfare – ISEW, Genuine Progress Indicator – GPI, Wellbeing of Nations, Millennium Development Goals Indicators – MDI, Commission on Sustainable Development Indicators – CSD, Sustainable Society Index – SSI, etc.) or at micro-level (ISO, DJSI, WBCSD, EMAS, GRI, etc.). Even if the indicators/indexes developed so far do not succeed to cover all the target objectives it is necessary, in order to ensure a sustainable development, to use the available instruments and to identify new methods and techniques.

For a company, the indexes employed do not have to be too many, so as to be easy to use. Moreover, it is necessary to focus on results' interpretation. The absence of certain norms imposing the use of a range of indexes regarding the sustainable development makes difficult the comparison of the information regarding the sustainable development published by the companies. Most of the companies at international level chose to enforce the GRI referential. At national level, the companies do not use to enforce such norms. We make this assertion after the analysis of the information published on the sites of the important companies.

Then, the main indexes developed at macro-level are reviewed:

*World Business Council for Sustainable Development – WBCSD* (<http://www.wbcd.org>) was developed in 2000 and it is an eco-efficiency index which combines the economic indexes with the

environmental ones. WBCSD develops and ensures the promotion of the eco-efficiency indexes for measuring the progress in economic and environmental terms in different industrial sectors for the members of the organization. An entity is deemed eco-efficient when it supplies goods and services at competitive prices, reducing at the same time the negative effects on the environment during its life cycle.

*Dow Jones Sustainability Indexes – DJSI* (<http://www.sustainability-indexes.com>) is developed by a financial guidance private company from Switzerland which aims at guiding the investors in order to include the sustainable development in the investment strategies. DJSI proposes an assessment system of the strategy based on the concepts of opportunity and risks for the sustainable development. The opportunities reflect the capacity of the entity of exploiting the market potential of the products and services with regard to the sustainable development. The risks focus on strategies aiming at reducing and eliminating the costs related to the environment.

*Eco-Management and Audit Scheme – EMAS* (2003/532/CE) allows the voluntary participation of an entity to an environment and audit management system. From the moment when an entity decides to adopt the EMAS system, it must observe the regulation norms for this system. It ensures a credible and stringent approach of the environment management. EMAS objectives are to ensure an environmental performance, to comply with the environmental laws, to communicate the efforts made in the environmental field and the particular effort for the entity activity integration.

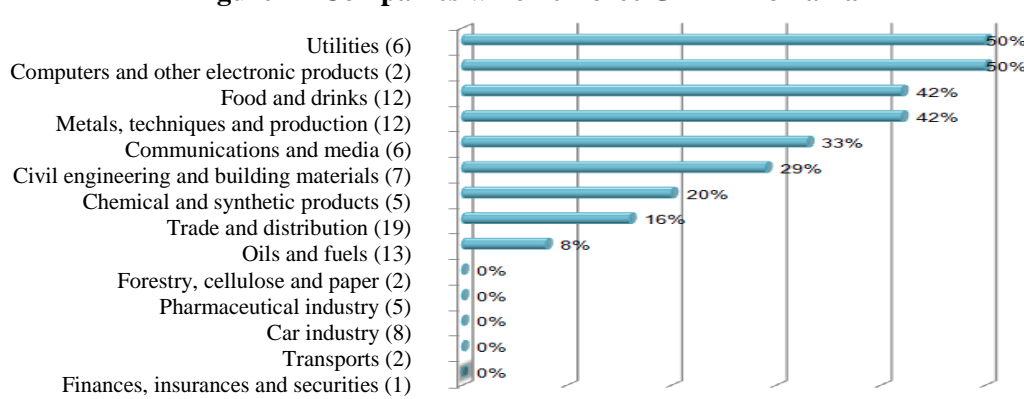
*International Standard Organization – ISO* (<http://www.iso.org/iso/home.htm>) is a non-governmental world organization which aims at issuing a series of technical norms. The family of ISO 14000 standards focus on the environmental performances of an entity, establishes a series of indexes which can measure the performances regarding the environmental management. These indexes can also be determined by the entities which do not have an integrated system of environmental management, being also used in order to communicate the information regarding the environmental management system.

*Global Reporting Initiative – GRI* (GRI, 2002) is an international institution which aims at establishing guidelines for publishing the non-financial information regarding the sustainable development. It was established at the initiative of the non-governmental organizations and of the important companies in Boston by the Coalition for a Responsible Economy (CERES) in partnership with the UNEP. Initiated in 1997, GRI became independent in 2002. In 2006, an update of the previous frame (published in 2002) under the name of G3 was performed, which presents an improvement of the previous provisions for an easier use and the establishment of some pertinent, comparable and easily verifiable indexes. The review process started in 2011, and in 2013 the final

form of G4 will be published, according to the amendments established after the public consultations. The review was determined by the fact that the agenda regarding the sustainable development was amended and the companies face new challenges regarding the report.

GRI adoption is the result of a voluntary undertaking, because no provision obliges its enforcement (Quairel, 2004). According to the KPMG study in 2011 (KPMG has been carrying out this study for 18 years, at present 16 sectors of 34 countries are analyzed), 80% of the reports published by Global 250 entities (77% in 2008) and 69% by N100 publish information according to GRI (KPMG, 2011). In Romania, only 23% of the companies publish reports regarding the corporate responsibility (KPMG, 2011). The Romanian companies were subject to the expertise within the KPMG study only in 2008. One of the most important remarks of the study was that there is a difference of engagement regarding the report of the corporate responsibilities by the multinational companies which operate in Romania, which are more active in other countries (Figure nr. 2.7). The result shows the fact that the Romanian companies are less mature with regard to publishing non-financial information in a voluntary manner.

**Figure 1 - Companies which enforce GRI in Romania**



Source: KPMG, *International Survey of Corporate Responsibility Reporting*, 2008, <http://www.kpmg.com/LU/en/IssuesAndInsights/Articlespublications/Documents/KPMG-International-Survey-on-Corporate2008-copy.pdf>, p.23

At technical level, GRI appears as a management referential. In fact, GRI does not regulate the behaviour of an entity but, rather it helps to describe the result of the adoption and enforcement of certain practices, policies and management systems. GRI's undertaking of normalizing the content of a report is minimal. It leaves the entity up to set up the report, besides the eventual pressure of the users, the imitation and the market being the only constraints for the voluntary publication undertaking.



Most of the companies ranked at the important exchanges publish separate financial and environmental reports. However, certain companies started trying out the issuance of one annual report only which includes financial, economic, environmental and social information. GRI considers that both the financial reports and the ones regarding the sustainable development fulfil fundamental functions by means of which they complement each other. GRI encourages the coordination between the two report processes and hopes that in the long run the financial performance assessment will be influenced in a beneficial manner by the assessment of the economic, environmental and social performances.

## 2. TO WHAT EXTENT ARE THE ROMANIAN COMPANIES INTERESTED IN OFFERING INFORMATION ON THE SUSTAINABLE DEVELOPMENT?

At national level, the Green Revolution Association in partnership with the Green Area Association and the Ministry of Environment developed an index which measures the sustainable development within the companies, *Green Business Index – GBI* (GBI, 2010). The action was initiated for the first time in 2010 in order to assess the situation of 2009, and in 2012 the third report was published. The participation in index determination is based on volunteering. The companies register on the site of the Green Revolution Association and fill in a questionnaire, based on which they will be assessed by independent specialists. The final assessment might require also the supply of certain additional documents and information. In 2010, the questionnaire included questions structured on 7 topics and the hierarchy was made for all the 180 participating companies. The debates with the participants and the difficulties faced during the quantification of the data determined the decision of amending the questionnaire and singularizing the questions on two main groups: industry-production companies and trade-services companies (<http://www.gbindex.ro/ro/organizatori.html>). Table 1 presents the classification of the questions in the questionnaire and their number according to topics and sub-topics for 2010 and 2012. For the determination of the GBI index in the report of 2010, we mention that the 7 topics have different weights, the highest being related to resources use 21.6%.

**Table 1 - Structure of the GBI 2010 and 2012 questionnaire**

	<i>Sustainable development</i>	<i>Impact on the environment</i>	<i>Sustainable transport</i>	<i>Resources use</i>	<i>Buildings condition</i>	<i>Green acquisitions</i>	<i>Waste management</i>
<b>No. questions 2010</b>	18	20	17	35	18	15	20
<b>Sub-topics 2010</b>	5	7	6	9	5	4	6

<b>Weight (%) 2010</b>	11.2	11.2	13.5	21.6	13.3	11.2	18
<b>No. questions 2012</b>	17	20	16	33	18	15	18/21*
<b>Sub-topics 2012</b>	5	5	5	9	5	4	6

\* 18 questions for the industry/production companies and 21 for the services/trade ones

Source: <http://www.gbindex.ro/>

In fact, over the 3 years, the assessment procedure had improved. Therefore, in 2010 the opening degree of the companies for a responsible behaviour with regard to the environment was analyzed, in 2011 the index was adjusted on the two sectors, and in 2012 environmental performance indexes were introduced in all the topics of the questionnaire, and the application generates the SWOT analysis for each company (GBI, 2012). After the classification carried out the top companies receive prizes for the two groups of activities and, within these ones, for each topic.

In 2010, most of the participating companies were subsidiaries of the foreign companies, the situation changed a little in 2012, 60 % of the companies have foreign capital. According to the GBI report of 2012, 87% of the participating companies drafted a sustainable development strategy, but certain companies mentioned that they developed no such policy, because the developed activity does not affect the environment\*, and one of them mentioned that an action plan for the environment represents an absolute novelty (GBI, 2012). The obtained results cannot be extrapolated at national level, because of the small number of participants (almost 300 of the total no. of 235,000 companies) and of the territorial distribution (more than 60% are from Bucharest). However, this initiative must be welcomed and supported in order to make the companies aware of the long-term beneficial effects of adopting a responsible behaviour towards the environment.

In order to analyze indexes situation at micro-level in Romania, we had in view the companies ranked at the Stock Exchange of Bucharest in the 1<sup>st</sup> category. In this respect, we consulted the websites of the 26 companies, in order to identify information regarding: ISO 14001/EMAS certification, OHSAS 18001, existence of the integrated environment authorization, statements regarding the environmental and social policies, involvement in volunteering activities, investments for the environmental protection or social actions, current expenses for the environmental protection, environmental or sustainable development reports, eco-labels, conflicts, penalties or fines related to pollution, CSR reports, etc. The absence of the constraints regarding the issuance of such information determined the partial finding of the information had in view, which imposed the direct demand of this information, but unfortunately the response rate was very low. Analyzing the information published on the websites of the companies, we can state that: 30.7%

\* In fact, the indirect effects of the developed activity are omitted and the hidden consumptions are not taken into account. For instance, the production of a cup of coffee supposes a consumption of 140 litres of water, and of one kilo of beef almost 16,000 litres of water.

have an ISO 14001 certificate (Alro, Antibiotice, Transelectrica, Electromagnetica, Oltchim, Prefabricate București, Transgaz, Socep), 15% have integrated environmental authorizations (Alro, Antibiotice, Transelectrica for 98.83% of the locations, Concefa), 19% have an OHSAS 18001 certificate (Alro, Antibiotice, Transelectrica, Electromagnetica, Prefabricate București), only 7% provided information related to environmental investments (Alro 20 million dollars and Oltchim 10.3 million lei), 3.8% presents on the website statements regarding the policies of improving the performances related to the environment, involvement for waste collection. A report on the sustainable development is available only at Petrom (a part of the OMV group), and the BRD annual report includes a chapter consecrated to the environmental information (energy consumption reduction, water consumption reduction, paper acquisition from certified sources, displacements reduction).

Given the fact that there is little information published on the sustainable development, the websites of the multinational companies' subsidiaries were consulted too. They provided several data, but there were no strict requirements at national level which impose the issuance of these data, so they chose to publish the sustainable development reports at group level and not for the Romanian subsidiaries. Therefore, of the 30 subsidiaries had in view, 73% have an ISO 14000 certification (in the report for the year 2011, Danone group stated that 58% of its locations are certified, 51.6% of the GDF SUEZ group, and 98% for Arcelor Mittal), 50% have an ISO 9000 and OHSAS 18001 certification (89% of the locations of the Arcelor Mittal group) and only 6.67% detained information regarding the integrated environmental authorization (Danone and Arcelor Mittal for the platform of Galați). Dacia and Ford present the list of the locations for the collection of the out of service cars, offers information regarding a responsible driving, which reduces pollution, CO<sub>2</sub> emissions. In fact, Dacia received the eco<sup>2</sup> label for the reduced level of CO<sub>2</sub>. Information regarding the environmental protection was found in all the 30 companies, and 70% have in the main menu a box for the sustainable development, CSR or the environmental protection. Coca Cola and Ursus Breweries have had individual reports for the Romanian subsidiaries since 2012 and the annual report of Rompetrol includes a chapter on the sustainable development. Analyzing the reports drafted at group level, we noticed that only 20% of them use the GRI norms (Siemens being the only company which obtained A+; Coca Cola, Arcelor Mittal and GDF SUEZ have a B+ certification and Danone and Raiffeisen did not mention the certification level). Mol, Coca Cola, Holcim and Vodafone entered in the DJSI.

The study showed that most of the Romanian companies (except the subsidiaries of the foreign companies) are concerned of the sustainable development at declarative level. The websites

of certain companies (Transelectrica, Impact, and Turbomecanica) present statements regarding the environmental policy, but do not present the manners of implementing and monitoring it.

These conclusions are also supported by the information published by the National Statistics Institute, which mentions that in 2010, 1,414 companies implemented environmental management systems (1,181 in 2008), less than 1% of the total number of companies. The same thing can be said about the eco-labelling; only 6 products at national level received this certification.

The analysis carried out shows that the environmental indexes are instruments which offer a good cost-performance ratio, because (Singha et al., 2012):

- They allow the integration and optimal usage of the dispersed and incomplete primary data, contribute to organization of the existing data and serve as assessment basis (for instance, when the primary data is not available on an annual basis);
- Are integrated with other data (particularly, with traditional financial information and can be associated to the social aspects in order to ensure the sustainable development) offering information mainly to the external users;
- Represent an important basis for the analysis and integrated modelling of the environmental information, such as the cost-efficiency analysis, modelling of the economic scenarios and previsions;
- Because of an integrating frame, they allow framing the sectorial policies and indices in a global economic context;
- Guarantee the comparability of the results, because of the common concepts and methods.

Surely, the advantages offered by the use of indexes regarding the sustainable development are substantial and have a major impact on adopting decisions. For instance, at UE level, with regard to the use of the greenhouse gas emissions certificates, over the period 2005-2007, the distribution of too many certificates was a signal for the modification of the policy, for that it was reduced in the following period.

## CONCLUSIONS

To sum up, the indexes system regarding the sustainable development is in a continuous change, because of the permanent modifications of the information needs. Moreover, we must highlight that the implementation of such a system at micro-level offers to the entities several advantages in the planning, prevision and control of the actions carried out for the environmental protection. By analyzing the environmental information published by different groups, we noticed

the importance of reporting them and, moreover, the need to adopt certain norms which can ensure their unitary treatment. Additionally, the absence of norms leads to the presentation of diverse information which does not allow performing comparisons among entities of the same activity field or even for the same entity from a financial year to another, because of the modification of the approach manner and the presentation of the respective information. Unfortunately, because of the weak approach of the aspects regarding the sustainable development, the Romanian companies lose their competitiveness as compared to the companies from the UE and from other countries.

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# EARLY WARNING SYSTEMS FOR FINANCIAL CRISES - A CRITICAL APPROACH

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**Abstract:** *This research paper aims to analyse some Early Warning Systems (EWS) for predicting financial crises. The importance of such a study is undeniable in the context of the current and future mix of policies applied by the monetary authority, in which financial stability and price stability play an important role. The EWS for crises enable the prediction of the occurrence of a crisis within a specified time period. Hence, the theoretical approach of the main early warning systems for crises, the models based on signal extraction and the logit/probit models represent an important stage in preventing and fighting financial crises.*

**Keywords:** financial crisis; currency crisis; Early Warning System; signal extraction; crisis prediction.

**JEL Classification:** E44; E47; F31; F47; G01.

## INTRODUCTION

The current global financial crisis has led to an increase in the interest of policy makers and the public (after almost a decade of stability which followed after the crises of the emerging markets in the 1990s) in the Early Warning Systems (EWS) with a view to anticipating future crises. But how will these systems actually manifest themselves? How do they operate? And how efficient are they?

The experience of previous crises shows us that the incurred costs are very high for emerging economies, as well as for the developed ones. Even if these economies have their own particular characteristics, almost all of them present similarities when exposed to fundamental economic vulnerabilities, as well as to specific mechanisms which trigger the crises. The most frequent fundamental vulnerabilities are: the credit, the overrating of the price of assets, budget deficits; on the other hand, any significant event may trigger a crisis – political crises, the evolutions on the capital markets or, in the case of the current crisis, the collapse of the American market of “subprime” credits.

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What is an early warning system? An early warning system consists in an accurate definition of a crisis and of a mechanism which may predict crises. Researchers have adopted various approaches concerning the conceptual and practical aspects related to the definition of a crisis, as well as to the means of predicting it.

The EWS for crises enable the prediction of the occurrence of a crisis within a specified time period. Such models may apply to currency crises, as well as to banking or fiscal crises. The methods consist in the analysis of the economic and financial indicators which enable the acquisition of information related to a potential vulnerability of the balance of payments or the lack of sustainability of the exchange rate.

The remaining of this article proceeds as follows: section 1 captures a brief overview of the economic literature on the main findings on the EWS while section 2 completes it with some theoretical approaches, section 3 and 4 presents and critically analyse some methods based on signal extraction (signal - based approach) and logit/probit models (limited dependent variable – ldv) while the final part of the study resumes the main findings of this research.

## **1. LITERATURE REVIEW**

As a result of a large number of financial crises in emerging market economies in the last decade, international organizations as private sector institutions started to develop EWS models aiming to anticipate whether and when individual countries can „collide” with a financial crisis. The lead position in this „race” was taken by IMF which put important effort for developing EWS models for the above mentioned countries, resulting in papers of reference: Kaminsky, Lizondo and Reinhart (1998) and Berg and Pattillo (1999). Simultaneously a lot of central banks, like the US Federal Reserve (Kamin, Schindler and Samuel, 2001) and the Bundesbank (Schnatz, 1998), academics and different private sector institutions have designed models in the last years.

The literature distinguishes three types of financial crises: currency crisis, banking crisis and external debt crisis. However, pure forms of crises do not exist in reality.

Kaminsky and Reinhart studied the interference between currency and banking crises and concluded that banking crises are a good leading indicator of currency crises. Also they found that financial liberalization has a robust explanatory power in predicting banking crises (Kaminsky and Reinhart, 1999).

Eichengreen and Rose, analysing the banking crises in emerging markets (using a multivariate binomial probit to estimate the probability of crises), highlighted the importance of changes in

foreign conditions in the emergence of banking crises in developing countries (Eichengreen and Rose, 1998).

Over time several methods for building an early warning system were suggested: models based on signal extraction, which consist in the monitoring of a set of indicators (Kaminsky, Lizondo and Reinhart, 1998), logit/probit models (limited dependent variable – LDV) using an econometric model of the logit/probit type (Frankel and Rose, 1996; Bussiere and Fratzscher, 2006), etc.

Even though the models of EWS for financial crises have a significant value for policy makers, enabling them to identify fundamental economic vulnerabilities and the possibilities of adopting preventive measures to reduce the risk of occurrence of crises, Berg and Pattillo claim that these models have proven to have a modest functionality in anticipating crises (Berg and Pattillo, 1999).

## **2. THEORETICAL APPROACHES**

The crisis is defined as “a significant decrease of economic activity over a time period, reflected in the decrease of the GDP, the decrease of individual income, the reduction of the level of employment, the diminution of industrial production and consumption”.

The economists analyse the crisis according to specific criteria and perceive it as a phenomenon with unfavourable consequences for institutions, organizations and social groups affected by inflation, unemployment, stagnation, recession, etc.

Sociologists argue that crises have their origin in social inequalities, in the decrease of motivation and initiative, in the rebellion against authorities, in the deficiencies manifested at the level of the social control mechanism, in the decline of the family, community, civic and religious heritage.

Historians evaluate crises at a global level and explain them through the imbalances which appear between the constitutive elements of societies as a result of the occurrence of social dynamics phenomena: the increase of the military power of some states, the intensification of automation, etc.

Psychologists perceive the crisis as the restructuring of the identity of individuals, of their sense of evaluation and capacity to assign meaning as a result of instinctual impulses, an influence of the forces of the collective unconscious.

The term financial crisis designates situations in which institutions or financial assets suddenly lose a significant part of their value. The financial crisis is a form of manifestation of the economic crisis and illustrates the lack of confidence in the financial system, a significant reduction of the volume of stock exchange trading, a dysfunction at the level of market mechanisms.

The prevention of systemic crises has started to present interest for economists and, of course, for monetary authorities, since the 1990s, following the crises which affected the European Monetary System (1992), Mexico (1994), the countries in South-East Asia, such as Thailand, Malaysia, Indonesia, Philippines and South Korea (1997) or the Russian Federation (1998).

The literature distinguishes three types of financial crises: currency crisis, banking crisis and external debt crisis. However, pure forms of crises do not exist in reality. The twin crises – currency crises and banking crises – are an important concept in economic theory. The crises in Asia (1997), the Russian Federation (1998) or Turkey (2000) are the best examples in this respect. Other types of complex crises are the currency and fiscal crises (Rocar, Copaciu and Lapteacru, 2006): Brazil (1999) or the currency and external debt crises: Mexico (1994), Argentina (2001).

The necessity of estimating systemic crises led to the construction of a monitoring mechanism called the early warning system (EWS).

The EWS enables the anticipation of a crisis within a given future time period. Such a method can apply to currency, banking or fiscal crises. The early warning models for financial crises are built based on a series of economic and financial variables which may indicate the vulnerability of the balance of payments or an unsustainable level of the exchange rate in time: indicators of macroeconomic imbalances and of the weakness of the banking system (for example, the fiscal deficit and the growth rate of internal credit), of the overrating of the exchange rate (indicators of relative prices, the current account deficit, the growth rhythm of exports), of external vulnerability and of the contagion risk (the ratio between external liabilities and international reserves, the incidence of the crises from other countries).

There are several methods used for building an early warning system, the most important ones being (Rocar, Copaciu and Lapteacru, 2006):

- Models based on signal extraction (signal - based approach), which consist in the monitoring of a set of indicators. If they exceed a certain threshold, which was previously calculated, this is considered a warning signal. These indicators can be calculated – composite vulnerability indicators (pressure indicators of the foreign exchange market, stability indicators of the banking system, external position indicators) – or economic and financial indicators (sentiment

indicators): the growth of the GDP, budget deficit, indicators of the capital market, spread of government bonds (Kaminsky, Lizondo and Reinhart, 1998);

- Logit/probit models (limited dependent variable – LDV): consist in the estimation of an econometric model of the logit/probit type in which the dependent variable which indicates the occurrence of the crisis is calculated based on the pressure indicator of the foreign exchange market, and the economic and financial indicators are variables which have an explanatory role. The model has the advantage that it enables the measurement of the effect of each explanatory variable on the crisis probability (Frankel and Rose, 1996; Bussiere and Fratzscher, 2006).

Even in the case of advanced econometric models, adjusted based on historical data; the obtained prognoses should be carefully assessed, for the quality of the results is limited by:

- The difficulty of generalizing past experiences based on the particularities of the currency crises from various states;
- The mutations which occurred over the years at the level of the decisive factors (for example, between the Mexican crisis and the South-East Crisis);
- The difficulty of quantifying macroeconomic characteristics which reveal a vulnerability;
- Lack of information.

### **3. METHODS BASED ON SIGNAL EXTRACTION (SIGNAL - BASED APPROACH)**

The EWS were discussed in detail in a series of papers belonging to Kaminsky, Reinhart and Lizondo - KLR.

The signals of the strategy elaborated by KLR are projected to monitor a number of variables which tend to manifest an unusual behaviour in the periods preceding a currency crisis and to send a warning signal when a variable reaches an “extreme”. A crisis is defined as a period during which a crisis indicator is significantly different from its average. For example, in case the current account deficit (expressed as a percent of the GDP) drops below a certain threshold, this indicator lights up and flickers, just like a red lamp.

A set of indicators which may be used to reflect the possibility of the occurrence of currency and banking crises may be:

- Indicators associated with financial liberalization (the M2 multiplier, the ratio between internal credit and the nominal GDP, the real passive interest rates, the ratio between the active and passive interest rates);

- Other financial indicators (real monetary mass in a restricted sense – M1, real time deposits in the banking system, the ratio between M2 and currency reserves);
- Indicators related to the current account (deviation of the exchange rate from the trend, expressed in percents, the level of imports and exports, terms of trade);
- Indicators associated with the capital account (currency reserves, interest rate differential);
- Indicators of the real sector (industrial production, stock exchange indicators);
- Fiscal variables (consolidated budget deficit expressed as a percent of the GDP).

Kaminsky (2000) conducts a detailed analysis of the indicators for the creation of an early warning system and focuses on the real exchange rate, the sudden increases in interest rates on international markets, capital flight, simultaneously with the increase in external debt, liquidity problems, the liberalization of the capital account, credit increase and the evolution of the stock exchange (captured by the M2 multiplier, the internal credit expressed as a percent of the GDP, stock exchange rates), real interest rates for banking crises (Kaminsky, 2000).

The increase over the normal level of internal credit contributes to the accumulation of pressures which will trigger the currency crisis, being favoured by capital inflows or financial deregulation measures – throughout the entire period preceding the crisis, the values of the internal credit/GDP ratio are above the trend previously registered by the same variable. The fast deterioration of the M2/international reserves ratio, triggered by the expansion of M2 and the limitation of official reserves, has also been noticed in the period preceding the crisis. Given the fact that it represents the degree to which the internal liquid liabilities are covered by reserve assets, this ratio reveals the extent to which the economy can defend itself against a speculative attack without resorting to a drastic correction of the exchange rate and can thus be considered an indicator of the investors' confidence in the internal financial system (Codirlascu, 2002).

The KLR approach is generally univariate, each indicator being analysed separately. This approach involves the monitoring of these variables from country to country and the identification of the moments when a variable deviates from normalcy. These extreme values are said to issue a warning signal about a possible currency crisis. A “good” signal is one which is followed by a crisis within a specified time period. When a variable issues a signal and the signal is not followed by a crisis, the signal is designated as being “false” (Kaminsky and Reinhart, 1999). The performance or efficiency of indicators can be determined according to the matrix below (Table 1):

**Table 1 – Analysis of the issued signal depending on the specified period**

	<b>Crisis during the specified period</b>	<b>No crisis during the specified period</b>
<b>Signalling a crisis</b>	A (good signal)	B (false signal)
<b>Failure to signal a crisis</b>	C (failed signal)	D (calm)

Source: Shi, J., Gao, Y. (2010), pp. 254 – 275.

In order to simultaneously capture an indicator's capacity of issuing good signals and of not issuing false signals, Kaminsky suggests the use of the noise to signal ratio, defined as a fraction between the ratio between the signalling of a crisis which does not occur and the periods without crisis ( $B / (B+D)$ ) and the ratio between the signalling of a real crisis and the periods of crisis ( $A / (A+C)$ ) (Kaminsky, 1998). For an indicator which issues random signals and for a sufficiently large sample, the law of large numbers involves a noise to signal ratio equal to 1. Thus, those indicators which have a noise to signal ratio bigger than 1 have an extremely low power of signalling crises (Rocaru, Copaciu and Lapteacru, 2006).

Based on these indicators, Kaminsky and Reinhart examined 26 banking crises and 76 currency crises in 20 countries over the period 1970-1995 and reached the conclusion that the problems in the banking sector generally precede currency crises – the currency crisis depends on the banking crisis (Kaminsky and Reinhart, 1999). Another important conclusion that the authors have reached is that financial liberalization usually precedes a banking crisis. In addition, the crises occur during the entry into recession of the economy after a period of prolonged boom which was supported by crediting, capital inflows and an overrated exchange rate (Cheang, 2008).

#### **4. LOGIT/PROBIT MODELS (LIMITED DEPENDENT VARIABLE – LDV)**

The method based on signal extraction is a non-parametric approach which is usually univariate and does not allow the testing of the statistical significance level of the variables. These shortcomings can be overcome by applying the logit/probit model. Eichengreen, Rose and Wyplosz and Frankel and Rose were the first to apply this method for predicting currency crises (Eichengreen, Rose and Wyplosz, 1995; Frankel and Rose, 1996). All the information about a crisis is comprised by the probability of predicting the crisis. By comparing the model based on signal extraction with the probit models, Berg and Patillo show that the probit models are better for predicting crises (Berg and Patillo, 1999).

The logit/probit models consist in the evaluation of an econometric logit/probit model in which the dependent variable which signals the occurrence of the crisis is calculated based on the pressure indicator on the foreign exchange market, and the explanatory variables are the economic

and financial indicators. The advantage of this model is that it enables the measurement of the effect of each explanatory variable on the crisis probability (Frankel and Rose, 1996, or Bussiere and Fratzscher, 2002).

The construction of a warning model which relies on a multinomial logit involves the following stages (Rocaru, Copaciu and Lapteacru, 2006):

- The calculation of a pressure indicator of the foreign exchange market: this indicator enables the definition of the crisis interval which includes not only the successful attacks affecting a currency (forcing a central bank to give up the fixed system), but also moments of external vulnerability when the measures taken by the monetary authority or the country's favourable external situation made it possible to avoid a currency crisis;

- The calculation of the currency crisis indicator;
- The calculation of the crisis indicator per se (multinomial);
- The approximation of the model by using the econometric method of the multinomial logit type;

- Establishing the optimum threshold for signalling a currency crisis.

The multinomial logit model is created with the help of the crisis indicator. The explanatory variables applied are those variables which can define the external, financial and economic situation of a country. The most important variables used in a model were:

- The external competitiveness indicators: an over-rated exchange rate, current account, external balance, the ratio between imports and exports – in absolute terms and as growth rhythm. The use of an effective exchange rate instead of a real exchange rate is justified by the necessity of identifying the problems related to external competitiveness and offers the possibility of evaluating the economies with a fixed exchange rate;

- External exposure: the ratio between short-term debt and reserves, total debt and reserves, as well as the growth rhythm of the short-term debt;

- Internal economic indicators: the growth of the real GDP, budget deficit, inflation rate;

- Financial indicators: the value of credits in the private sector, the value of credits at governmental level, the value of banking deposits in the private sector;

- Contamination indicators: contamination of the banking system.

The contagion indicator of the banking system is calculated by using the method suggested by Fratzscher (2000):



$$CB_{ij} = \sum_d \left( \frac{F_{dj}}{F_d} \frac{F_{di}}{F_i} \right)$$

where  $F_{di}$  represents the credits granted by country  $d$  to country  $i$ , and  $F_d$  represents the total credits granted by country  $d$ .

The countries  $d$  are countries with developed economies, whereas countries  $i, j$  ( $i \neq j$ ) are emergent countries included in the analysis of this study. The interpretation of this indicator relies on the common lender effect: if a currency crisis occurs in country  $j$  and the degree of indebtedness of country  $d$  to country  $j$  is high, the probability for country  $d$  to refuse to prolong the debt or to withdraw the capital invested in country  $i$ , increases.

The signalling of a crisis for the countries and the time period will be selected by taking into consideration an optimum threshold (a probability which exceeds this threshold is considered a crisis signal).

The selection of the time period and of the optimum threshold should be based on the number of non-signalled crises and false alarms considered optimum when it comes to making decisions related to the monetary policy. Given the following cost function (Bussiere and Fratzscher, 2006):

$$L(T) \equiv \theta * P_{CN}(T) + (1 - \theta) * P_{CS}(T)$$

where  $T$  is the probability threshold;  $PCN$  is the probability of signalling a crisis;  $\theta$  is the cost of not signalling a crisis or the degree of risk aversion.

The increase of the time period and of the probability threshold determines the increase in the number of non-signalled crises, but reduces the number of false alarms.

Frankel and Rose shifted the attention of these studies towards the modelling of currency crises for developing countries, using the probit analysis on annual data corresponding to a number of 105 countries over the period 1971-1992. They observe that the low level of direct foreign investment, the reduced international reserves, the powerful increase of internal credits, the big foreign interest rates and the overrating of the real exchange rate increase the probability of a currency crisis. Following these significant findings, the two authors reach the conclusion that their model can be used for the early signalling of a possible currency crisis (Edison, 2003).

If the dependent variable could be assigned the value 1 in the past, representing a period of crisis, or the value 0 for a normal period, it was implied that such variables behaved differently in moments of crisis and non-crisis. However, the reality is much more complex than this. Apart from the fact that the variables deviate from their normal level prior to the crisis, it has been noticed that the studied variables also behave differently during post-crisis periods. Consequently, instead of

comparing only two states (crisis and non-crisis), an early warning system may also illustrate a post-crisis trend.

## CONCLUSIONS

The number, frequency or severity of financial crises did not decrease during the last two decades; on the contrary, they intensified. Each crisis causes enormous costs in the countries in which its effects are felt. Thus, international financial institutions should invest in research concerning the EWS for crises. At present there are numerous available studies, without real convergent results, but which cover a big number of countries and a long time period, with different methods applied for different types of crises.

The EWS comprise important information and may provide, through the analysis of the crises which occurred in various countries and with the help of the models examined in this study, estimates of the probability of occurrence of a crisis, enabling at the same time the classification of the countries based on their degree of external vulnerability.

Financial stability is extremely important for any economy. Hence, ensuring financial stability through EWS for financial crises should be the main objective of all countries.

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# A COMPARATIVE ANALYSIS OF THE BUILDING STOCK IN EU AND ROMANIA

Claudiu Romila\*

**Abstract:** *Buildings occupy an important role in our modern society. However, the existing buildings have a very low thermal protection, leading to high levels of energy consumption making the buildings sector among the most significant CO<sub>2</sub> source in Europe. Even if new buildings have high performance levels, the majority of the building stock is represented by older buildings which require renovation work. The European Union has imposed important reduction of specific energy consumption in all sectors, but energy conservation in buildings remains a key element in obtaining the sustainable development as evidence of human solidarity beyond the limits of space and time.*

*In this paper the importance of the energy reductions in the building sector is outlined and both the energy policy and building stock statistics in EU and Romania are presented. Moreover, some measures and initiatives at European level are discussed, focusing on some important themes: demography, housing stock age and energy requirements.*

**Keywords:** construction; building sector; energy consumption; building stock.

**JEL Classification:** A12; F64; L74.

## INTRODUCTION

The worldwide economic impact of the construction sector is considerable. Its global market volume consists of almost 3 trillion US dollars and accounts for as much as 10% of world GDP, function of the accepted definition of the sector. The construction sector is the biggest industrial sector in Europe (10-11% of GDP) and in the United States (12%). In the developing countries it represents about 2-3% of GDP while in most countries it accounts for more than 50% of national capital investment. It provides almost 7% of world employment with a total workforce of about 111 million workers, 74% of which are in low-income countries (UNEP, 2003).

The global population has risen with more than 100% since 1950. Most of this increase has occurred in the developing countries. If the actual demographic trend continues, in the next two decades, around 98% of world population growth will happen in developing world. Presently, almost 75% of the people in developed countries already live in urban areas and the share of the population living in cities is expected to reach 40% before the end of this decade. This percentage was less than 20% in 1950. These demographic trends translate into an increased demand for buildings and infrastructure (UNEP, 2003). The residential sector has experienced annual growth rates around 1% but most countries have encountered a decrease in the rate of new build

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construction in the recent years, reflecting the impact of the current economic crisis on the construction sector.

Building sector accounts for 42% of final energy consumption at European Union level but it has the greatest potential in obtaining energy and emissions reductions. Energy efficiency work can provide half the emissions reductions needed by 2050 (80% compared to the level of 1990). Moreover, investments in energy efficient buildings have negative costs, which can bring between 12 and 60 Euros for residential houses and between 74 and 107 Euros in the industrial sector per ton of CO<sub>2</sub> not emitted into the atmosphere.

## 1. CLIMATE CHANGE IMPACT ON WORLD'S ENERGY POLICY

Recently, it has become increasingly clear that human society cannot continue with the current socio-economic models. The progress of human civilization was based on excessive consumption of energy and resources that has led to an increased dependence on oil, natural gas and coal. Currently almost 85-90% of total energy consumed worldwide comes from fossil fuels. Therefore, the concentration of greenhouse gases has increased continuously, and if the present rate continues, the concentration of carbon dioxide (CO<sub>2</sub>) will exceed the accepted maximum limit of 450 ppm (parts per million). After some scenarios, CO<sub>2</sub> concentration will exceed 750 ppm (MacKay, 2009), global average temperatures will rise by a value between 1.8 – 4.0 °C, and in the worst case scenario by 6.4 °C (Solomon et al., 2007).

The considered reference temperature is 2.0 °C above the level at the beginning of the industrial age. At the present day it has risen with almost 0.8 °C. Overcoming this reference temperature will lead to an increase of the climate change intensity with irreversible and potentially catastrophic risk on the planet. The exact causes are still debated, but the effects have become faster and more severe than initially expected. Among them, of a severe gravity are considered to be water shortages, melting glaciers, floods and rising sea and ocean levels.

Fighting climate change can be effective only if global actions are enforced. A first important step was taken in the Kyoto conference in 1997, when the resulted protocol was ratified by almost all countries. Five years before, at Rio de Janeiro, the *sustainable development* concept was imposed, which was initially seen as a solution against the continuing degradation of natural environment. It stated a basic principle accepted today: to satisfy the needs of today's generation without affecting the generations of tomorrow. With time, this concept has grown to include a

balance between socio-economic systems and the natural capital and to ensure equity between countries and not only between generations.

Taking into account the progress made so far, the 2.0 ° C temperature target will not be obtained earlier than 2050. Therefore, at the international meeting in Copenhagen in 2009, the leaders of EU member governments have pledged to reduce emissions by 30% by comparison to the value of 1990, if the approach was supported by other developed countries. Because of the opposition of U.S., China, Brazil, South Africa and India, the conference ended in a failure, any reference related to global temperature reduction targets and emissions of greenhouse gases by 2050 being removed from the treaty.

A few years later, amid the economic crisis, the lack of firm political decisions taken in Copenhagen and new information regarding climate change (concentrations of CO<sub>2</sub>, CH<sub>4</sub> and N<sub>2</sub>O in 2010 reached the highest level recorded so far; the United Nations recommended in its report of 23 September 2011, that the target of CO<sub>2</sub> emissions reductions must increase from 6 to 11 Gt by 2020, in order to achieve the target of reducing with 2 ° C the average global temperature; the new scenarios put the average temperature increase to at least 3.5 ° C by 2100), delegates from 195 countries met in Durban, South Africa, from 28 November to 11 December 2012. The conference proved a greater success than in Copenhagen because several important decisions were taken to fight climate change (Tuddenham, 2012):

- Kyoto Protocol, which expired at the end of 2012, has been extended from January 1, 2013;
- Big polluters (U.S., China and India) agreed to sign the first document to be legally obliged to comply with a series of commitments;
- Differences between the measures taken so far and the need to achieve the 2 ° C are stated clearly;
- Countries are no more classified as developed and developing countries, which produced inequalities between the assumed objectives.

## **2. ENERGY POLICY AND BUILDING STOCK IN THE EUROPEAN UNION**

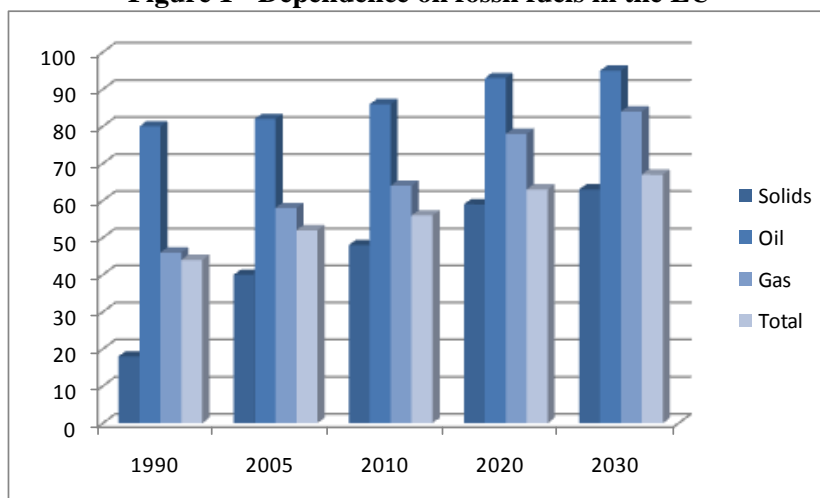
### **2.1 Energy policy**

Dependence on natural gas imports in EU will increase from 57 to 84% until 2030 and from 80 to 93% for oil (Figure 1). Therefore, efficient use of energy resources is above all an economic reason, even before considering the benefits of reducing greenhouse gas emissions. It is estimated



that the implementation of European directives cost of gas and oil imports will fall by 50 billion per year until 2020.

**Figure 1 - Dependence on fossil fuels in the EU**



Source: prepared by author based on processing data from European Commission available at [http://ec.europa.eu/research/energy/eu/index\\_en.cfm?pg=policy-energy-and-climate-policy](http://ec.europa.eu/research/energy/eu/index_en.cfm?pg=policy-energy-and-climate-policy).

Although the treaties of Maastricht, Amsterdam and Nice have not provided a common energy policy, the European Union (EU) has developed an integrated energy and climate policy approach that pursues the following key objectives:

- *Energy security*, in order to coordinate the demand and supply of energy in the EU according to the international context;
- *Competitiveness* of European economies, to ensure development and affordable energy;
- *Sustainability*, to combat climate changes, to promote energy efficiency and renewable energy.

European Commission estimates the investment costs necessary to achieve a low carbon based economy at 0.5% of GDP between 2013 and 2030. The prospects are encouraging, emissions of the EU 27 member states in 2006 were already 10.8% below those of 1990, although the EU economy grew during this time by approximately 1.5% per year. The economic crisis has certainly played an important role, decreasing fossil fuel consumption by 5.5% in 2009, while the share of renewable energy in the European energy mix grew to 10.3%. Moreover, the annual cost for achieving this goal has become increasingly smaller.

The 30% emissions reduction target becomes more and more feasible both technically and economically, while the European leaders are promising reductions energy and fuel consumption in all sectors by 2050. The European Commission estimates that switching to the 30% target would

generate an extra 2 million jobs to the already existing 3.4 million which provide almost 2.5% GDP in EU, representing about 40% of global market share.

## 2.2 Building stock

EU territory covers around 35° geographic latitudes (from the 36° parallel in Greece to 70° parallel in northern Scandinavia). Therefore climatic conditions can vary significantly from one country to another. For example, the average exterior temperature in January is -6 °C in Helsinki while in Athens is +10 °C. In temperate and cold climates, approximately 80% of total energy consumption is used for space heating, 12% for heating hot water and the remaining for consumer electronics, communications and lighting (Eicker, 2009). The large energy consumption for heating results mainly from the insufficient thermal protection of existing buildings, which account for almost 90% of the total housing stock. However, in southern regions, energy consumption for heating is, in absolute terms, at the same average value of 50 kWh/m<sup>2</sup>/year due to low values of thermal resistance imposed on the envelope and low efficiency building services.

Lately, there has been given a considerable effort toward classifying the EU existing building stock in order to have a better assessment of the existing data. Such an investigation was performed by Nemry et al. (2010) using Eurostat data from 2005. In order to obtain comparable climatic boundary conditions, the heating degree days (HDD) of EU-25 countries were utilised as an indicator to group similar zones in the EU-25 countries (Table 1).

**Table 1 - Grouping of countries according to heating degree days**

Geographical zone	Countries	Population, 2003 (10 <sup>6</sup> inhabitants)	Building stock (in 10 <sup>6</sup> m <sup>2</sup> )
<b>Southern Europe</b>	Cyprus, France, Greece, Italy, Malta, Portugal, Spain	181.1	6378
<b>Central Europe</b>	Austria, Belgium, Czech Republic, Denmark, Germany, Hungary, Ireland, Luxembourg, Poland, Slovakia, Slovenia, The Netherlands, United Kingdom	252.3	7909
<b>Northern Europe</b>	Estonia, Finland, Latvia, Lithuania, Sweden	21.3	624

Source: prepared by author based on processing data from Nemry et al. 2010, p. 978.

In 1995, among 150 million existing residential dwellings in the European countries, approx. 66% are single family homes, with a percentage of more than 80% in Germany, Ireland, Luxembourg and the UK (Gavrilas, 2006).

An important share of the building stock in EU countries is older than 50 years, while many buildings in use are hundreds of years old. More than 40% of the residential buildings have been constructed before the 1960s when restrictions on building energy consumption were almost nonexistent. UK, France, Denmark, Sweden, Czech Republic and Bulgaria have the largest share of old buildings. With a few exceptions, it can be stated that the building stock has doubled between 1961 and 1990 (BPIE, 2011).

There are two major phenomena that now influence the European Union building stock in the European Union. Due to the population decline, fewer children and younger single person households, dwellings across the EU become smaller and smaller. On one hand the population decline reduces the housing demand, but on the other hand the larger number of smaller households will balance the decline. Another important change in the past decades was the change in tenure form, generally from renting to owning.

Housing stock in Europe changes slowly in quality and numbers. Although there are thousands of dwellings being built annually, new constructions account only for a few percents of the existing housing stock. Therefore, the quality profile of the dwelling stock changes can be considered to have low impact on the energy profile in the building sector.

### **3. ENERGY POLICY AND BUILDING STOCK IN ROMANIA**

#### **3.1 Energy policy**

Romanian energy policy has been set in line with the EU requirements. The set targets for the renewable energy consumption are ambitious. The proposed target in 2010 for the consumed electricity from renewable energy sources was of 33% (including nuclear power) with an increase to 38% in 2020. Romania has taken advantage of the opportunities related to large scale hydropower projects, but the potential for small scale hydropower projects has remained largely untapped.

Even if our country has favourable conditions for renewable energy production, so far many potential investors have been hesitant to invest in Romania due to uncertainty related to the required legislation, the high level of corruption and the bureaucratic processes. However, by far, the most promising opportunities come from wind energy. The wind energy potential is estimated to be around 23 TWh, largely located in the eastern part of the country. In the recent years there has been a lot of investment from large companies like CEZ, Energias de Portugal, RWE and Enel.

The largest percentage of energy reduction comes from the residential sector. According to present official evaluations, the majority of buildings in Romania are classified between C and D classes on the energy certificate level. There are voices that consider this evaluation to be too optimistic and that in reality most buildings could be closer to an “E”-standard (BPIE, 2012). Given the low thermal performance of the building stock older than 15 years, the energy consumption for heating is almost twice the equivalent of other European countries.

### **3.2 Building stock**

The housing stock in Romania consists of approximately 8.2 million dwellings concentrated in some 5.1 million buildings. The majority of dwellings in the urban area (72%) are represented by blocks of flats, while in rural areas the majority (94.5%) is represented by individual dwellings. There are around 81 000 blocks of flats, making about 2% of the building stock but which account for 37% of the dwellings in Romania.

In urban areas 23.5% of the buildings can be found, which is more than half of residential units (52.54%), while in rural areas are 3 times more buildings than in urban housing. As a result of privatization of the housing stock, housing is now privately owned 97.2% of all households while the state-owned housing represents 2.6% of the building stock. Over 50% of private dwellings and over 75% of the state property are found in urban areas (BPIE, 2012).

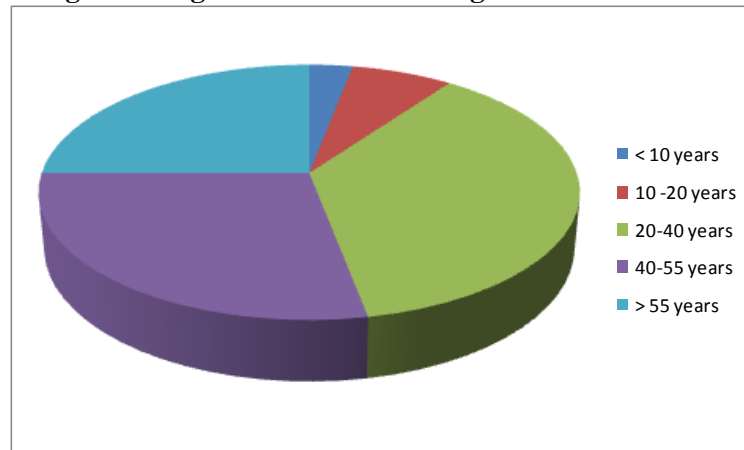
The largest share of buildings is represented by the single family residential (95% of the existing housing stock), mostly built before 1989. Most of these homes are located in buildings with an age between 15 and 55 years, characterized by an advanced degree of wear and low thermal insulation.

Percentage age of dwellings in our country in 2001 was as follows (Pavel et al., 2006):

- Under 10 years old: 3%
- 10 to 20 years old: 7%
- 20-40 years old: 37%
- 40-55 years old: 28%
- Over 55 years: 25%

The graphical representation of the current building stock in Romania is presented in Figure 2.

**Figure 2 - Age structure of building stock in Romania**



#### **4. EU POLICY IN THE BUILDING SECTOR**

CO<sub>2</sub> emissions need to be reduced with the absolute urgency. In Europe there are three main types of actions being taken: actions for climate change mitigation, adaptation measures for construction and measures on educating residents.

The CO<sub>2</sub> approach against the climate change consists of finding solutions that reduce the amount of carbon dioxide emitted to the atmosphere. Further developments of present technologies (fossil fuels and bio fuels, coal and carbon sequestration, nuclear fusion and fission, amongst others) reduce CO<sub>2</sub> emissions without significant changes in the contemporary energy scenario, with smaller financial costs.

The energy savings approach in the buildings is focused on the energy losses reduction, on managing energy gains in the cooling and heating seasons and by improving the equipments efficiency. This negative energy approach favours consumption reduction and behavioural changes, which can be translated into less emissions and smaller energy needs.

Given the limits on the extent and speed of the application of carbon-free energy sources, it is important that a significant absolute reduction in the energy demand to be achieved over the coming decades. Reductions in the energy intensity (annual energy use per unit of floor area) of new buildings by a factor of 3–4 relative can be achieved and that reductions in the energy intensity of existing buildings by factors of 2–3 can be accomplished through comprehensive renovations (Harvey, 2009).

European Parliament Directive on the energy performance of buildings (Directive 2010/31/EU), reiterates the need to reduce emissions of greenhouse gases by 20% by 2020. The residential sector is responsible for almost 40% of total energy consumption and 24-36% of total

CO<sub>2</sub> emissions (values vary depending on the author). Energy saving potential is high, in EU being estimated at around 20%.

As previously mentioned, reducing energy consumption is a priority assumed by the European Union. If building energy efficiency is improved by 22%, 45 million tons of CO<sub>2</sub> will be released into the atmosphere, which is about 14% of the target by 330 million tons. With the implementation of European Directives on the energy performance of buildings, in force since 2003, most European countries have increased the minimum thermal resistance values allowed to reduce heat loss through the building envelope.

The main directions of obtaining energy savings proposed by the EU are: construction of energy efficient buildings (passive houses with minimal energy consumption with zero energy, zero carbon emission, energy independent, and so on), the upgrade of existing buildings with energy efficient equipment (heat pumps, heat recovery systems, rainwater collection, solar panels, wind turbines, etc.) and physical and thermal rehabilitation of buildings.

Brito et al. (2012) quantified the separate share of these strategies in obtaining global potential energy savings between 2020 and 2050 (Table 2). Consumption reductions from other sectors were considered to be irrelevant for the study or absorbed by population growth.

**Table 2 - Potential of energy savings in buildings and overall reduction in 2050**

Strategy	Target	Energy savings	Overall reduction in 2050
Construction of energy efficient buildings	1% / year	95%	25%
Upgrade or retrofitting	2% / year	50%	23%
Rehabilitation	2% / year	25%	9%

Source: prepared by author based on processing data from Brito et al., 2012.

By the year 2050, energy targets can only be achieved through simultaneous application of all three strategies, although from the previous table the importance of constructing energy efficient building and equipping existing buildings with energy efficient equipment can be observed. Although it can seem that the impact of thermo physical rehabilitation of buildings is small, its importance cannot be neglected due to the large share of old buildings. It is estimated that in 2050, 60% of residential areas will be represented by old buildings (Eicker, 2009). Building retrofitting can provide energy saving and ensure interior comfort for the occupants.

## CONCLUSIONS

Climate changes are the greatest risk facing mankind in the last millennia, threatening the natural environment, the global economy, human lifestyle, security and safety of all.

Energy from fossil fuels is becoming more and more expensive and if the current situation continues, the energy price will be economically unbearable for most of the population. Moreover, the rising energy price also increases the price of new efficient materials needed for building's retrofitting. So far the safest and most accessible form of clean energy is saved. In this way, energy conservation in new buildings and in existing thermal rehabilitation has become a widely accepted necessity.

With their potential to deliver high energy and CO<sub>2</sub> savings, as well as many societal benefits, energy efficient buildings have an increasingly important role in the construction of a sustainable future in Europe.

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# A GLANCE AT THE EUROPEAN ENERGY MARKET LIBERALIZATION

Delia Vasilica **Rotaru**\*

**Abstract:** *This paper offers a presentation on the liberalization process on the energy markets that started two decades ago and takes place across Europe in the attempt to create a single European energy market. Several benefits are expected following the deregulation process such as higher competition, market transparency, lower prices, increased efficiency and product development in the clients favour. Three very different energy markets are analyzed before and after the liberalization process –UK, Germany and France –a short insight on the current Romanian energy market is also offered. The aim of this paper is to provide a better understanding on liberalizing European energy markets.*

**Keywords:** energy market; liberalization; deregulation; competition; monopoly.

**JEL Classification:** L16; L94; Q43.

## INTRODUCTION

The liberalization of the energy market was a very important step for the energy industry as it has influenced the economy of different countries, but most of all it had a significant impact on both industrial and domestic consumers. Over the last 25 years more and more developed and emerging economies started to streamline the process of privatization, restructuring, reorganization and liberalization in this strategic sector, initially monopolized by the government which took action through price regulation.

Government ownership on the electricity market involves a high level of responsibility. The monopolistic market is characterized by no competition in the sector, market entrance barriers, non-transparent pricing and regulation necessary in order to avoid any abuse of a market dominant position. The government's role is to protect the consumers by keeping the prices at bay and bring a restriction to possible negative effects like produced quantity limits. On the other hand, a liberalized energy market involves higher competition, consumers' right to freely choose their supplier, transparent pricing and encouragement of investments into the energy sector, all of these factors leading to overall consumer welfare.

The final objective of the liberalization process throughout Europe is to create an EU-wide integrated energy market. Though important results have been achieved in the energy market

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liberalization area in different countries from Europe, the final objective is far from completion and will not be reached soon. Significant differences between EU members in the energy market development will delay the process. For example, whilst the energy market in United Kingdom is fully functional and liberalized, some other countries, like Romania, are just starting this process. The integrated energy market involves removing differences between member states, setting common rules, competition between suppliers at a European level, price alignment, common objectives in environment protection, etc. The European Union has adopted different legislation packages in order to support the energy market liberalization and the integration of the members' energy markets. The first directive was adopted in 1996 for electricity and 1998 for gas concerning common rules for internal electricity and gas markets. The second one was adopted in 2003, a more complex directive having as final objective to set up the legal frame for full market liberalization. Finally, the third energy directive, adopted in 2009, supports the further opening of the energy markets and establishes an agency for the cooperation of energy regulators.

## 1. THE BEFORE AND AFTER OF THE ENERGY MARKET LIBERALIZATION

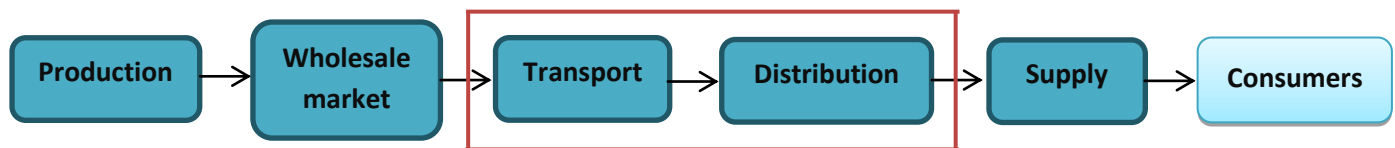
In order to better understand the liberalization process it is necessary to analyze how the energy market operates before and after deregulation. The energy market is very different from other industrial sectors as it has some unique characteristics. Electricity represents a product that cannot be differentiated in terms of quality, it cannot be stored and its cost depends mostly on the way it is produced. Also, the demand of electricity is highly inelastic and as it has no substitutes, the supplier must be sure he can deliver as much electricity as it is required at any given moment. Due to all these factors the energy sector has been organized as a state owned monopoly in most European countries and the liberalization process can often be troublesome (Domanico, 2007).

A fully state owned energy market is vertically integrated, meaning that one actor is involved in all the delivery process, from generation to retail. This is represented better in the following scheme:



The liberalization process is a long run and involves following different steps like the privatization of the state-owned electricity monopolies, separation of competitive segments, restructure of generation and transmission, creation of a public wholesale energy market (Joskow, 2008). Another view on the energy market liberalization presents almost the same action points: separating the generation from supply, applying measures that prevent a big market share of one single player, creation of competitiveness in generation, trading systems, introducing a system operator that manages the spot market, competition in the retail market and the control of one authority over issues like fair competition (Grimston, 2004).

After liberalization parts of the supply chain are open to new market entrants and to competition as presented below:



The liberalization process creates competition in the buying and selling of energy and brings an advantage to the consumers who are able to freely choose their supplier. The transport and distribution area often remains a natural monopoly due to high investments costs but is unbundled from the production and supply part. In order to access the transmission system, third parties have to pay regulated tariffs. The wholesale market enables multiple parties to trade energy on a number of platforms, leading to transparent pricing. New entrants are allowed in the production sector because the government encourages investment into efficient. In practice, these advantages take long to appear and some of the disadvantages tend to discourage the consumers, but these will be discussed at a later date.

## 2. ENERGY MARKETS IN EUROPE

Across Europe, the energy market liberalization has reached different levels as each member state approached the process in its own way. While some of the countries viewed the liberalization process as a necessity in order to maintain the community prosperity, evolution, international competitiveness and economic growth, others preferred to maintain the government monopoly.

The liberalization process started in late 1990's when the creation of the European Common Market brought into attention the fact that the differences between energy prices in the European countries affects the competitiveness of national companies. Fearing that some companies may relocate their production to obtain lower prices, the members started to consider reforming the

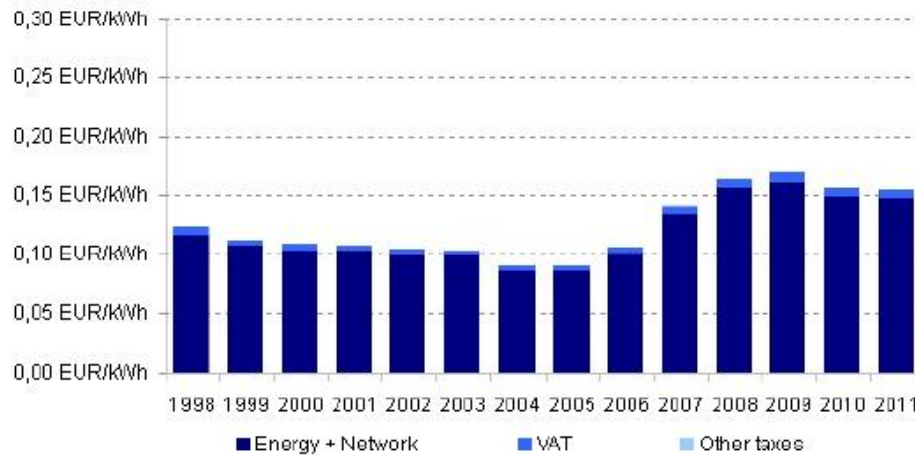
electricity market to support the price alignment (Heddenhausen, 2007). In order to make the liberalization process possible and easier, the EU-members were advised to take a series of measures in order to deregulate their national markets respecting a certain deadline. The European Union also promoted the improvement of cross-border trading rules and widening of cross-border transmission links. As mentioned before, the final objective of this process is to develop a single energy market in Europe (Jamassb and Pollit, 2005). This paper is going to analyze further the energy market evolution in some countries across Europe.

## **2.1 UK energy market**

The UK energy market is at the moment fully mature and liberalized. The deregulation process started with the adoption of the Electricity Act from 1989 that supported the privatisation of the UK electricity market, the creation of supply, generation, distribution and transmission structures and the removal of old Central Electricity Generation Board. Between 1990 and 2001 a major change occurred in terms of supplier and generation market evolution characterized by new entrants and consolidation. Another major step in the liberalization process came with The Utilities Act from 2000 that made possible the creation of the first wholesale trading market for electricity which came live in 27<sup>th</sup> of March 2001.

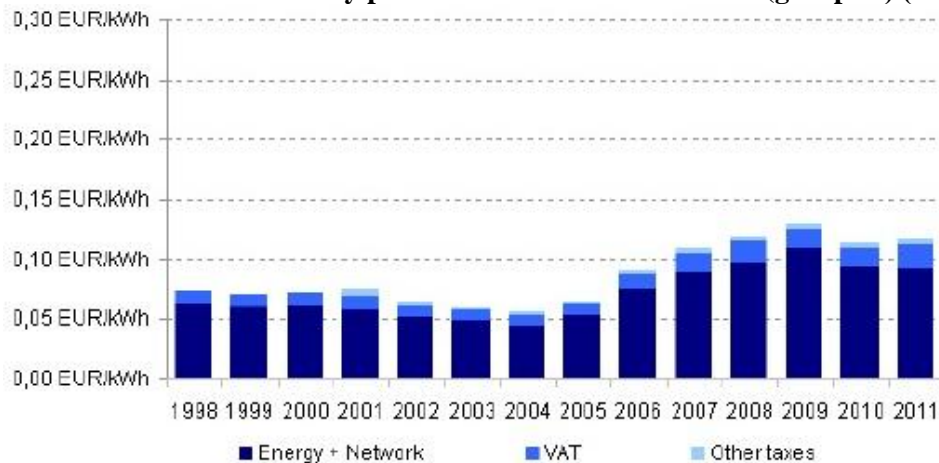
Although the liberalization process is supposed to involve lots of advantages including price reduction, this is not happening all the time. For example, at the beginning, due to the fact that the energy price is obtained freely on the market through the offer/demand confrontation and because the government subsidies and protection are withdrawn, this tends to grow. Also, a lot of other negative effects appeared: the electricity market lost 110 000 jobs, the prices grew for domestic consumers fluctuating from 0.103€ with a 0.027€ per kWh average value per month between 1991 and 1998 (Hall, 2005). From 1998 onwards the prices began to decrease mainly due to the higher competition on the market and the services offered by the suppliers were better in terms of quality. Graphics from a study presented by the European Union on the price development on the EU retail markets for electricity for both household and industrial consumers is shown below:

**Figure 1 – UK: Retail electricity prices for domestic consumers (group Dc) (€ 2005)**



Source: Eurostat

**Figure 2 – UK: Retail electricity prices for industrial consumers (group Id) (€ 2005)**



Source: Eurostat

As the graphics show, both prices for domestic and industrial consumers have decreased starting with 1998 until 2005 and 2004 when the prices started to grow again. However there is a big discrepancy between the prices paid by the two categories of consumers, domestic consumers having to pay double the price for energy than industrial ones. This happens because the industrial consumers have larger power in the negotiation of their contracts due to higher levels of consumption.

To conclude, the UK energy market after liberalization was characterized by mergers, failures and new entrants that have changed the supply market, generation market split by various companies, a clear split between generation, distribution and supply, product evolution and volatility as the main concern alongside curve liquidity.

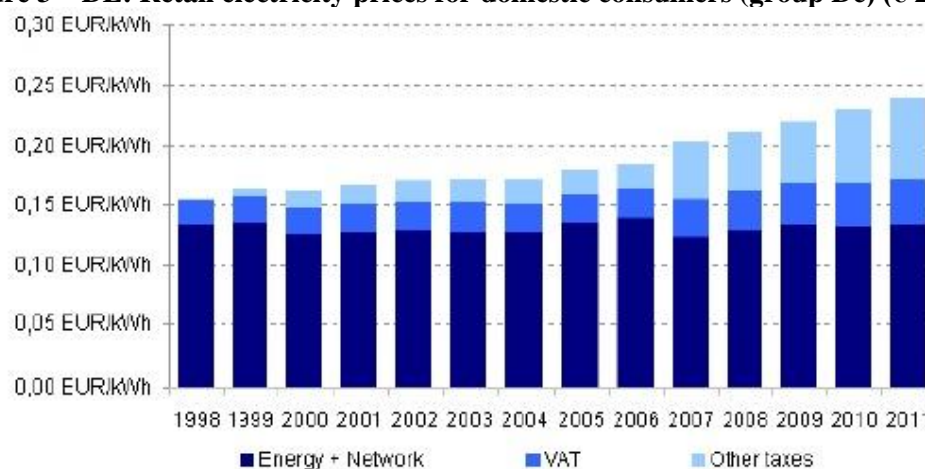
## 2.2 German energy market

Another market characterized in present by full liberalization is the German one. Germany started the liberalization process in April 1998 having as objectives the promotion of diversification of energy supply, reduction of energy costs and improvement of energy efficiency and development of renewable sources. In Germany there was never a national electric monopoly established under the government. Though a big number of suppliers were active on the German electricity market prior to deregulation, the market was not highly competitive. Suppliers were splitting different areas between them by signing contracts with other providers explicitly to exclude competition (Danwitz, 2006).

The electricity prices started to decline for both industrial and domestic consumers starting with the liberalization process with 20%, respectively 5% but mostly due to high market pressure and induced rationalization. Employment dropped with a number of almost 82 000 in the energy sector between 1993 and 2000 and the mergers and acquisitions that took place on the German market lead to the reduction of the market players. Although the previously mentioned facts, the German market shows a strange behaviour among suppliers that prefer to cooperate rather than practice competition although this is the factor that should improve efficiency and productivity (Madlener and Jochem, 2001).

After 1998 the prices for electricity for industrial and domestic consumers began to increase slightly each year. Unlike in the United Kingdom, in Germany the difference between the prices paid by industrial and domestic consumers is lower than double. The graphics presented below show the price evolution for both type of consumers starting with 1998:

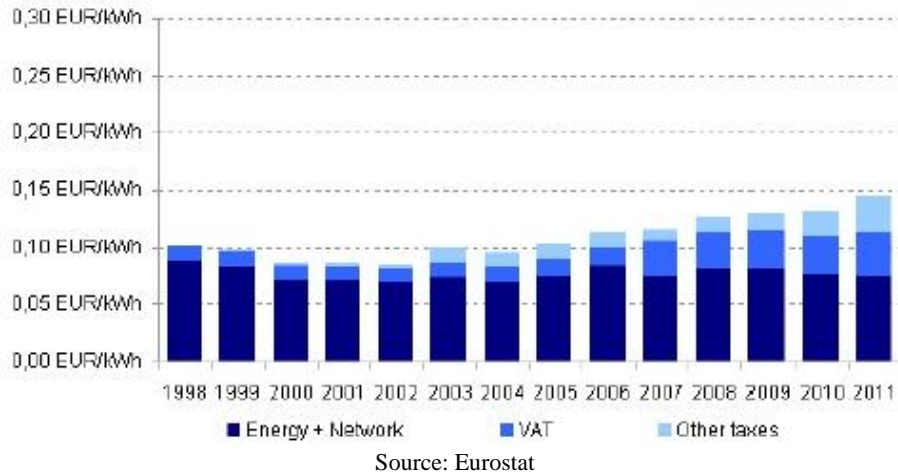
**Figure 3 – DE: Retail electricity prices for domestic consumers (group Dc) (€ 2005)**



Source: Eurostat



**Figure 4 – DE: Retail electricity prices for industrial consumers (group Id) (€ 2005)**



Although the country enjoys a fully liberalized market in theory, the practice shows technical difficulties and obstacles. Only 2-3% of the domestic consumers have switched suppliers in Germany (Mossavar-Rahmani, 2001).

### 2.3 France energy market

Unlike the other two markets presented that are fully liberalized, France has preferred to follow the minimum steps required by the European Union in terms of deregulation. The country tends to disregard the agreements put in place by the EU. The liberalization process started only in 1999 and the level of state protection is still very high. The degree of liberalization in France has only reached 30%, one main supplier – EDF, having a huge market share of 98%.

Due to the lack of the country cooperation in this area, others members of the European Union started to complain. Spain threatened to start blocking the access of French companies on their own market, whilst The Nederland's said they may put an end to the energy import from France as long as this country refuses to cooperate (Froggatt, 2000). It is not rare that France has been referred in this deregulation process started at the European level as being the “black sheep”, stubbornly maintaining the national energy model with strong state intervention (Meritet, 2007). With all this, it is not a surprise that the prices have been decreasing from 1998 onwards and are among the smallest ones across Europe, the government having to put a special effort in maintaining these prices at these levels.

### 3. TOWARDS ENERGY MARKET LIBERALIZATION IN ROMANIA

The liberalization of the energy market in Romania means, as we've seen so far, the separation of the main activities of generation, transport, distribution and supply, step that has already been taken. At the moment, a consumer can freely choose their supplier in theory. The next step would be the government's release of the price control. Over the last year, the country's government has adopted a law that pledges to bring its national legislation at the same level reached by other EU members by taking into consideration the latest regulations and directives on electricity and gas. The ultimate goal for Romania is to eliminate the monopoly over the energy industry so that the prices will be determined by the supply and demand action in order to obtain a transparent market, where competition allows consumers to benefit from lower prices and quality services.

According to the plan adopted by the government the price liberalization will be made in several stages in order to protect the consumer from price explosion, as following:

-For industrial consumers the electricity price will be liberalized in proportion of 15% by 1<sup>st</sup> of September 2012, 30% by 1<sup>st</sup> of January 2013, 45% by 1<sup>st</sup> of April 2013, 65% by 1<sup>st</sup> of July 2013, 85% by 1<sup>st</sup> of September 2013 and 100% by 1<sup>st</sup> of January 2014;

-For domestic consumers the electricity price will be liberalized in proportion of 10% by 1<sup>st</sup> of July 2013, 20% by 1<sup>st</sup> of January 2014, 30% by 1<sup>st</sup> of July 2014, 40% by 1<sup>st</sup> of January 2015, 50% by 1<sup>st</sup> of July 2015, 60% by 1<sup>st</sup> of January 2016, 70% by 1<sup>st</sup> of July 2016, 80% by 1<sup>st</sup> of January 2017, 90% by 1<sup>st</sup> of July 2017 and 100% by 1<sup>st</sup> of January 2018.

Therefore, the current regulated tariffs will be eliminated in six stages for the industrial consumers and ten stages for domestic consumers. These percentages suggest the quantity of energy that will be delivered on the free market for price determination; it doesn't mean that the prices will increase with the same level. A set of measures to support competition development and market transparency is also considered.

This scenario was adopted for several reasons: price increases will also come in stages allowing the gradual implementation of competitive prices from suppliers in order to avoid sudden and significant price increases. Moreover, the scenario permits a better control over the process with the possibility of postponing a further step and also to return to a previous one if the effects are difficult to handle by the consumers. The liberalization will most probably bring price increases at the beginning and the advantages later, but Romania committed to undertake this step when it became member of EU.

#### **4. ADVANTAGES AND DISADVANTAGES OF THE ENERGY MARKET LIBERALIZATION PROCESS**

The effects of the liberalization process are long disputed. On the good side, the liberalization process should bring a transparent market, with fewer regulations and restrictions in the economy for greater participation of private entities, major investments in the generation capacity, shift to renewable energies, consumers' right to choose their supplier, etc. On the other hand, the energy market liberalization doesn't necessarily bring lower prices; on the contrary, these may rise at the beginning of the process and employment in the energy sector may drop.

Liberalization of the energy market is expected to increase efficiency because of the competition pressure and furthermore, to price reduction. In both UK and Germany we have seen this happening. Also, higher levels of efficiency achieved should lead to cost reductions and possibly lower prices. At the moment, across Europe, prices vary, causing distortions in competitive conditions across EU-members that can be canceled by the price alignment through liberalization. Competition gives customers the right to choose the nearest, cheapest supplier offering the best services for him. Competition will also stimulate suppliers to improve their services (Dizdarević, Host and Galović, 2010).

The higher level of efficiency obtained by technological improvement will translate into job losses, as a negative effect of the deregulation. More than 250 000 jobs have been lost from the beginning of the process. Also, the privatization process involves significant costs, exceeding the benefits. But the main disadvantage remains the price that tends to increase in the first years of deregulation.

#### **CONCLUSIONS**

Over the last decades, important steps have been taken across Europe in order to liberalize the energy market at the national level of each member to make possible the birth of a common energy market at a European level, characterized by price alignment, market transparency, access of suppliers on every energy market in Europe, consumers' right to choose the best possible offer. Though the level of market liberalization reached by the members on their attempt to deregulate their national market is different from one country to another, the basic steps have been taken by most countries meaning that, in theory, each consumer can freely choose their supplier. In practice, this hardly applies, the markets are not that open and there are still several barriers that need to be

overcome. The common energy market will not be achieved too soon. At the moment, prices are not sufficiently competitive, consumers have difficulties in adapting to the new situation and understanding their rights as they are used to the idea that decisions should be taken for them.

The liberalization should bring benefits to both consumers and to the economic environment. But the liberalized markets cannot influence two important price components: the price of energy, often related to global/regional prices of fuels and the level of taxes and levies. This means that the price evolution cannot be determined. Competition and fair prices that reflect the real costs can only be achieved with a high level of commitment in this direction. Even when these conditions are satisfied, it takes a long time for markets to be fully implemented and developed so that consumers can benefit from competitive prices.

The deregulation process is still in progress. The complexity of the analyzed sector combined with the resistance of the traditional market operators has made this process difficult. National interests represent another obstacle to liberalization. Although the first step in opening the market was successfully made by most European members, several measures still have to be taken so that consumers can enjoy the full benefits of a free market. Since empirical evidence suggest that, in general, deregulation has played a positive impact on efficiency and consumers welfare in other sectors – telecommunications, air transport – the same results are expected for the electricity sector.

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# SETBACKS AND ACHIEVEMENTS IN MANAGING THE EASTERN NEIGHBOURHOOD

Loredana Maria **Simionov**\*

**Abstract:** *Since its latest enlargements, the European Union has constantly developed various actions and initiatives in order to secure its borders and consequently to be surrounded by countries with dynamic economies and secure and stable political situations. So far, the presence of the union in its Eastern neighbourhood did not have the expected outcome. Where has the European Neighbourhood Policy failed? How is the European Union perceived by its neighbours: social partner, protector, sponsor or regional hegemonic? Is the Eastern Partnership sufficient to revive the Eastern dimension of the ENP? This paper will focus on answering these questions by connecting the theoretical framework of the neighbourhood policy with the existing empirical evidence through an interdisciplinary approach.*

**Keywords:** European Union; Eastern neighbourhood; conditionality; power; democracy.

**JEL Classification:** N44; N74; R58; F59.

## INTRODUCTION

The paper, entitled “Setbacks and achievements in managing the eastern neighbourhood”, aims to analyse various challenges and opportunities that the European Union meets in managing its Eastern dimension of the Neighbourhood Policy. The analysis of these issues is based on a multidimensional approach, taking into consideration both, political and economic aspects. Therefore, this paper is not intended to simply present the evolution of the European Neighbourhood Policy, but seeks to analyse the main orientations and current challenges, focusing on the potential impact of the ENP upon its Eastern neighbours.

The first section of this paper will focus on the inconsistencies and setbacks of the European Neighbourhood policy within the Eastern side of the continent. Despite the EU’s constant efforts and ambitious objectives, the political, economic and cultural backgrounds of these countries have raised many challenges and have proven that the ENP might have reached its limits.

The second section of the paper, as a continuation of the first section, it will address several issues concerning the Eastern Partnership which represents the future of the ENP in relations with the neighbouring countries in Eastern Europe. Overall, the Eastern Partnership responds to the desire of the Eastern neighbours to develop closer ties to the EU. At the same time, it stands within the vital interest of the union to contribute to the stability, better governance and economic

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development at its Eastern borders. Thus, the Eastern Partnership initiative is of great importance because it represents a new stage in our relations with the eastern neighbours as well as it helps strengthening the Union's external policy.

The scientific approach of this paper holds as a marching point the assumption that the future and security of Europe depend on a more efficient management of the Union's relations with the eastern part of the continent.

## **1. THE EUROPEAN NEIGHBOURHOOD POLICY – AN ALTERNATIVE TO EU MEMBERSHIP**

### **1.1 The ENP – general background**

The ENP is regarded as a young and dynamic policy which is aimed to promote and consolidate stability on both economic and political levels, as well as modernization and democratization of EU's neighbours and it is addressed to the countries on the southern shores of the Mediterranean (Barcelona process countries) and to Ukraine, Belarus, Moldova and the Caucasus republics. The Eastern neighbourhood represents a direct consequence of the latest enlargement waves. Thus, after 2007, six former socialist republics, namely: Moldova, Ukraine, Belarus, Georgia, Armenia and Azerbaijan are now steps away from the European bloc. Their attitude vis-a-vis the ENP, namely the European Union differs according to ties and relationships they have with Russia. Thus, for Moldova, Georgia and Ukraine the inclusion in the European agenda therefore their inclusion in the ENP means a lot. Through a subjective approach, the European Union is perceived as a "corner of the abundance of material wealth." (Varwick and Olaf, 2007, p. 131) Armenia and Azerbaijan gives great importance to the economic factor of the ENP, being less interested in integration into European structures. Belarus remains a Russian satellite, still interested in attracting European investors in order to reduce the dependence that this country displays towards Russia.

Overall, within the expanded borders of the EU there are countries which are considered to be strategic partners, although without any foreseeable prospects of integration within European structures. In concept, the ENP was designed so as to avoid the emergence of dividing lines between the enlarged EU and its neighbours, giving them the opportunity to participate in the activities of the EU through closer political and economic cooperation.



Among the most important advantages a country could have by participating in the ENP there are: improving cross-border cooperation, access to financial assistance offered through the European Neighbourhood and Partnership Instrument (ENPI) which, from the 1<sup>st</sup> of January 2007, replaces MEDA and TACIS, as well as the union's support for the promotion of existing regional and sub-regional cooperation initiatives and processes (Bordeianu, 2007, p. 29).

On the other hand, in order to effectively manage the Eastern dimension of the ENP, the European Union has to overcome several challenges which rise in all aspects and levels: political, economic, cultural and geostrategic, especially as Russia is not a passive actor in these relationships. Consequently, it is not difficult to grasp why the European Neighbourhood Policy, designed to manage these relationships has not known major breakthroughs but rather often has failed to achieve its initial objectives which proved to be too ambitious.

In theory, the greater involvement of the EU in its neighbourhood area can be classified as a positive and welcomed initiative because of the beneficial effects it has on the Union, as well as on its partners. Nevertheless, the reality surrounding the actual actions of the European Union, especially through the European Neighbourhood Policy, indicates numerous inconsistencies.

The following section of this paper will focus on these inconsistencies and will further analyse their causes and effects, outlining the necessity to revive the Eastern dimension of the ENP.

## **1.2 Inconsistencies of the ENP – a critical approach**

The relationships created between the Union and its neighbours do not fit usual patterns of traditional external policy; therefore, the ambiguity and efficiency of this policy are accompanied by many disjunctions and cleavages. Although theoretically it can be considered a unified policy with a comprehensive framework, the implementation of the European Neighbourhood Policy highlights several weaknesses.

The European Union has not introduced a strong regional component in the ENP, being considered a policy based on strengthening bilateral ties between the EU and each neighbour, a policy of neighbours, rather than a neighbourhood policy. The umbrella of the European Neighbourhood Policy includes a large geographical area in the same policy; more precisely, two different sides: South and East. Consequently the ENP was often accused of lack of consistency by including eastern and southern neighbours of the Union in the same framework, countries which have nothing more in common other than being neighbours of the Union and which are located in totally different geo-strategic regions. Due to these major differences between them, these

Southern/Eastern neighbours have particularities and problems which do not resemble, that require different resolutions as well as the use of different instruments in order to overcome them (Muresan, 2005, pp. 22-23).

The wide diversity of countries included in the neighbourhood policy lead to inconsistent approaches and reduced the ability of the EU to act in accordance with the numerous regional problems. Although the policy has connected these disparate countries and different regions within a single policy, (Smith, 2005, p. 771) the ENP has failed to create a general framework for the provision of regular meetings or contacts between neighbours (Smith, 2005, p. 772).

The divergent geopolitical interests of the European great powers represent another negative aspect of the Neighbourhood Policy. For instance, France, Italy and Spain actively manifested preferences in shaping relations with the South Mediterranean neighbours (Varwick and Olaf, 2007, pp. 129-132), while Poland and Sweden are mainly involved in the Eastern Partnership. This lack of consensus between the European member states' interests in the area reflects negatively upon the neighbourhood, leading again to a division of the ENP framework.

Besides the absence of a regional component of the ENP as well as the existence of different interests of the member states in the neighbourhood area, the new policy is also criticized for the lack of attractiveness, limited resources or its conditionality which brings into perspective a hegemonic behaviour on the behalf of the European Union.

The process of adaptation of the neighbours' legislation to the EU's standards and requirements as a first means to participate in the Internal Market has not proved to be very successful so far, as it is accompanied by other concerns. The main problem is the difficulty which the Union has in opening its market completely in sensitive area such as agriculture, areas in which the neighbouring countries could compete better.

In theory, the ENP aims to create stability by exporting the EU model to its neighbours (Casier, 2006, p. 37). Therefore, the EU is accused of doing nothing else but exporting its institutional and cultural model to the countries within the neighbourhood area (Chilosi, 2006, p. 29). Although the neighbours' EU ascension is not in question, the enlargement and the neighbourhood policies are very similar. ENP is based on "policy tools and methodologies that have been borrowed from the enlargement portfolio in an almost mechanical manner" (Varwick, 2007, pp. 129-132). In other words, the criticism comes down to the fact that the ENP is based on the enlargement tools and conditionality, without providing its benefits, namely it does not offer to its neighbours ascension prospects.

Thus, the neighbourhood policy documents, such as action plans and progress reports are similar to the ascension ones, both in structure and in language (Kelley, 2006, 19). Moreover, the whole process is driven and coordinated by the same officials from the European Commission, to a considerable extent. Many critics have stressed that the European Neighbourhood Policy does not seem to be anything but "new wine in old wineskins" (Kelley, 2006, p. 29). The ENP is overall criticized for the weak incentives it offered, especially the lack of prospects, (Casier, 2007, p. 37) as the ENP does not offer any credibility nor guarantee of long-term sustainable results (Muresan, 2005, p. 25).

Contrary to its ambitious objectives, the European Neighbourhood Policy has extremely limited resources. Due to this inconsistency, the credibility, efficiency and success of this policy are questionable as they all directly depend on the resources destined to its proper management. The financial perspective for the 2007-2013 ENP budget highlights very modest sums, only € 11.967 billion (down from € 14.929 billion initially proposed) (Bordeianu, 2007, p. 45).

The European Neighbourhood Policy highlights numerous omissions. What is particularly striking about the ENP is the asymmetrical way in which the neighbours are rewarded conditionally according to their "good behaviour", asymmetry which highlights the hegemonic character of the EU, a very mild form of imperialism (Ganze, 2005, p. 29). Therefore, the EU conditionality is not always considered to be applied consistently, which damages EU's credibility. For example, when it comes to democracy and the rule of law, Belarus is often admonished for misbehaviour, while the EU is much more relaxed with Azerbaijan, a country rich in energy resources but almost as autocratic (Boonstra and Shapovalova, 2010, p. 6).

### **1.3 Setbacks and achievements in the Eastern Neighbourhood**

Despite all the inconsistencies mentioned above, since 2004, the European Union has become increasingly present in its Eastern neighbourhood, namely: Ukraine, Moldova, Georgia, Belarus, Armenia and Azerbaijan. The trade between EU and its Eastern neighbours has considerably increased and the EU is moving towards free trade agreements with most of its eastern neighbours.

EU has become progressively more involved in managing conflicts in its eastern neighbourhood. The Union is a mediator in negotiations between Moldova and its breakaway Transnistria region, starting the EUBAM border assistance operations in Ukraine and Moldova. EU also has developed a monitoring mission in Georgia and acts as a mediator in the talks in Geneva between Russia and Georgia (including Abkhazia and South Ossetia). Through these missions, in its

Eastern neighbourhood, the Union provides the highest number of personnel in conflict management in its missions abroad except Balkans (Popescu and Wilson, 2010, p.1).

Since the launch of the ENP, the EU and its Member States have intensified and improved diplomatic relations with these countries. The number of Delegations in the region increased from two to six, so now the Union is represented in each of the six Eastern Partnership countries.

As it has been previously mentioned, the union's relations with its eastern partner countries were based on conditionality, namely the offer of rewards, without the use of sanctions (except for Belarus). On one hand, this approach proved to be effective (Albi, 2009, p. 1213). Progress was made, despite the opposition or scepticism of Member States, which opposed either to allocate funds for the eastern neighbours or to strain their relations with the Russian Federation. Although the EU has had some successful projects and initiatives in the neighbourhood, it was not enough against the Eastern countries' negative trends.

Therefore, in recent years, almost all the EU's eastern neighbours followed opposite directions from union expectations. Azerbaijan turned to a life presidency, in 2008 Armenia has chosen a Putin-Medvedev sequence type which determined demonstrations where 10 people died, Georgia has moved to centralized power and in august 2008 was at war with Russia (Popescu and Wilson, 2010, p. 3).

Between 2005 and 2010 the leaders of the Orange Revolution in Ukraine gradually lost ground to the opposition, namely to Viktor Yanukovich who was elected as president in 2010 and began an intense process of centralization of power. Finally, Belarus retains a Russian satellite position. The only exception is Moldova which met some progress, although its political system is still unstable and the situation in Transnistria is weighing on the country's progress (Popescu and Wilson, 2010, p. 3). But despite the modest progress met the Republic of Moldova, the country is too small to affect the region.

Overall, the EU assistance and support for its Eastern neighbourhood are relatively of low impact compared to the needs and challenges of the region. According to Freedom House statistics, the state of democracy in these countries deteriorated in the period between 2006 and 2009 (Boonsta and Shapovalova, 2010, p. 21). Paradoxically, the only country that showed some progress is Belarus who unquestionably remains the least democratic country among the six former Soviet states.

Behind the EU's failure to turn power into presence in its Eastern neighbourhood there are three structural trends. The first trend is a regional one: the increasingly authoritarian and semi-authoritarian regimes within most of the partner countries. The second trend is a worldwide one and

consists of the emergence of a multipolar world which allows countries in the Eastern neighbourhood to play "neo-Titoist" roles by balancing between external actors. The third trend is an internal one and relates primarily to institutional reforms of the union and then to the ability to manage the economic crisis (Popescu and Wilson, 2010, pp. 5-7).

In some respects, the eastern neighbourhood resembles more and more the EU's Southern neighbourhood before the recent uprisings (Wojna, 2011, p. 13). Thus, Eastern European neighbouring countries face consolidated authoritarian regimes, rather than dynamic states in search of European solutions.

According to most indexes concerning the expected reforms - be it about democracy, freedom, corruption or costs of doing business – the Eastern neighbours are still much better situated than the southern ones. So far, only Moldova has shown a tendency to remove political centralization. Regarding Georgia, this is undoubtedly a kind of leader in institutional reforms, but its politics are still very polarized and centralized around the president (Popescu and Wilson, 2010, 6).

The second trend that has significantly undermined the effectiveness of the EU foreign policy, namely the implementation of the ENP, consists of the multipolar environment where the eastern neighbours function (Leonard, 2011, p. 1).

Since the 1990s the EU had a quasi-monopoly when it comes to influencing Central Europe and the Balkans, but in the Eastern neighbourhood area, the union has to compete with Russia, Turkey, Iran and even China (Popescu and Wilson, 2010, p. 6). This allows the partner countries in the region to be able to perform a "neo-Titoist" game in order to balance the gain of resources and to strengthen local elites, thus providing an excuse for the lack of reforms.

The third reason why the ENP showed rather low performance so far in the East consists in the lack of commitment from sides, the EU and the Eastern Neighbourhood countries. A senior EU official believes that "our partners are less interested in ENP than ourselves, and we are not really that interested" (Popescu and Wilson, 2010, pp. 5-7). Thus, any strategy to improve the performance of the EU Eastern neighbourhood should try to strengthen the role of EU as a soft power as well as a hard one.

## 2.THE EASTERN PARTNERSHIP (EaP) – FUTURE OF ENP

### 2.1 EaP – the necessity of a new initiative

The several existing gaps within the European Neighbourhood Policy make it necessary to establish and develop an initiative to strengthen the Eastern dimension of the ENP. Thus, in May of 2009, in Prague, a new initiative aroused in order to strengthen the ENP's eastern dimension, known as the Eastern Partnership. This initiative is an extremely important step in differentiating our neighbours in Southern and Eastern countries.

This ambitious Partnership foresees a substantial upgrade of the level of political engagement, including: the prospect of transition to a new generation of Association Agreements, extensive integration into the EU economy, easier travel for this region's citizens to the EU provided that they comply with certain security requirements, to establish improved ways for energy security that are beneficial for all the parties involved and increased financial assistance.

There are several novelties that the Eastern Partnership brings up, concerns that the ENP missed out, novelties which present a high degree of importance, such as: regional cooperation, Association Agreement or the involvement of Civil Society (Ivan, 2011, pp. 226-228).

The **bilateral basis** still represents the centre pillar of the Eastern Partnership. The bilateral relations between the EU and the Eastern neighbouring countries will be based on association agreements, on Deep and Comprehensive Free Trade Agreements (DCFTA) and agreements on visa liberalization (IS1, 2013).

Besides the bilateral basis which is very important, the Eastern Partnership initiates a **multilateral dimension**. The multilateral cooperation is being based on four thematic platforms of policy, namely: 1. Democracy, good governance and stability; 2. Economic integration and alignment with EU policies; 3. Energy Security, 4. Relationships between people. Some topics included in the platform (energy security, environment, human relationships, etc.) have a more high- lightened multilateral approach than others (Good governance) (IS1, 2013). Therefore, the EP novelty is the **regional component** that complements the bilateral approach that the EU promoted in its relations with its neighbours. Thus, the bilateral dimension shall be complemented by inter-state relations, as well as the involvement of the EU and its Member States in regional policies, as well as in mobilization of the international community efforts (Ivan, 2011, pp. 226-227).

Another very important step that the Eastern Partnership took consists in promoting the involvement of civil society. Previously, the relations with the governments of the former Soviet

republics were privileged at the expense of civil society cooperation. The Eastern Partnership aims to redress the balance. NGOs are key actors in promoting democratic reforms and a vibrant civil society is an obstacle to authoritarianism.

Thus, the Eastern Partnership offers a more efficient support for the **civil society** development by establishing a Civil Societies Forum in order to help civil society organizations to develop their "advocacy" and to enhance their ability to monitor the reforms. In addition, it will focus on developing "people-to-people" actions such as increasing funds destined for the development of students' exchanges together with other legitimate measures which facilitate the mobility of persons within the EU, while guarding the security of its citizens (Ivan, 2011, pp. 227-228).

Last but not least, through the Eastern Partnership initiative, the Partnership Agreements which were the basis of bilateral relation between EU and its neighbours within the ENP have been replaced with **Association Agreements** which are more efficient whereas much of their content is legally binding and the monitoring and evaluation systems are more accurate and improved. These changes will eventually lead to a more efficient implementation (Boonstra and Shapovalova, 2010, p. 3).

Unfortunately, the modest funds allocated for the implementation of the Eastern Partnership represent still a major setback for the achievement of the proposed objectives. Funding remains one of the major weaknesses of the EP. It is clear that funding is inadequate for what the program wants to achieve. The EU should also clarify how it plans to coordinate the partner countries in other initiatives such as the Black Sea Synergy, with other international and regional organizations and agencies, as well as with Member States' bilateral programs.

## 2.2 Perspectives of the Eastern Partnership

Overall, the launch of the Eastern Partnership (EP) has not brought major improvements in the eastern neighbourhood region. The economies in this area were severely affected by the global economic crisis, some of them (Ukraine, Armenia) experienced severe contractions of their gross domestic product (GDP) in 2009, up to two digits (IS1, 2010). Also, as regards to the democratic environment there have not been any great successes, Moldova being probably the only exception. No major improvements were made when it comes to the frozen conflicts in the region. Overall, the EU's current policies have not brought great results in the region and the EU is still far from having the role and position it desires among its neighbours (IS2, 2010).



Regarding the economic integration of the eastern neighbours within the EU's Internal Market, it is clear that the free trade area is very remote for some members in particular. Two feasibility studies commissioned by the European Commission to Armenia and Georgia have shown that the area could bring important benefits to both countries, but that "none of the two countries can negotiate trade liberalization of such scale and even less to be able to implement and sustain the required commitments" (Boonstra and Shapovalova, 2010, p. 13). Azerbaijan and Belarus are far behind, as none of them is a member of the WTO. Actually, in 2010, Belarus joined a customs union with Russia and Kazakhstan and made it almost impossible to have free trade with the EU (IS1, 2010).

The EU Member States have diverging and conflicting interests in the neighbourhood and regarding the enlargement policies. In the same way, the six eastern neighbouring countries have different views on what their level of cooperation with the EU should be (Varwick, 2007, pp. 129-132).

Although the EU is quite popular among Armenians, the **Armenian** political elite is divided on the issue of European integration. The Eastern Partnership is positively perceived because the country has moderate ambitions on developing its relations with the union. Armenia's location between Azerbaijan and Turkey makes it a reliable ally for Russia in the region, but also a very isolated country. The Eastern Partnership is therefore seen as a way out of regional isolation, as well as a way of obtaining new funds to modernize the country. In this respect, Armenia received from EU macro-financial assistance totalling 100 million Euros (65 million as a loan and 35 as a subsidy) (Boostr and Shapovalova, 2010, p. 16).

The Armenian government declared its interest in visa liberalization as well as in the creation of a free trade zone with the EU. Armenia also hopes that the EU could play an important role in stabilizing the troubled Caucasus region (Ivan, 2011, p. 229). The European Commission together with Armenia started already the negotiations for an Association Agreement which will replace the present Partnership and Cooperation Agreement. The EU is particularly interested in improving human rights and the quality of elections in this country.

**Azerbaijan** is one of the most authoritarian countries within the Eastern Partnership and thus is not interested in EU integration, while intends to strengthen its relations with the EU. Azerbaijan tends to see the Eastern Partnership as a remodelling of existing programs and not as a completely new initiative (Ivan, 2011, p. 229).

Azerbaijan is particularly interested in security issues because of an on-going conflict with Armenia over Nagorno-Karabakh, as well as economic issues (especially related to energy) and visa

liberalization (Boonstra and Shapovalova, 2010, p. 18). However, the EU is less involved in solving this conflict than those in Georgia and Moldova.

By being rich in energy resources, Azerbaijan is less dependent on the EU conditionality's and less interested in EU economic assistance. Overall, Azerbaijan does not seem willing to implement democratic reforms. The Eastern Partnership was generally well met by the Azerbaijani civil society as a way of Europeanization of the regime. Despite this deficiency, Azerbaijan remains a key energy partner for the EU; both parties are currently negotiating an Association Agreement to succeed the PCA (IS4, 2013).

Starting at the Pink Revolution in 2003, the regime of President Saakashvili urged the country's integration into European and Euro-Atlantic structures. However, **Georgia's** access to NATO was seriously affected by the 2008 war with Russia and currently it seems to be delayed. As a result of the war, the country has lost control of Abkhazia and South Ossetia and consequently seeks support from the EU to regain the territorial integrity of the state (Ivan, 2011, p. 230).

Georgia is interested in EU involvement in conflict resolution in the Caucasus, as well as visa liberalization and the establishment of a free trade zone with the EU. The country also hopes to receive financial assistance from the EU, especially to rebuild the areas affected by the 2008 war. Since Georgia is an important energy transit country, the government is also interested in energy security and developing new energy transit routes (EU Nabucco pipeline project) (Boonstra and Shapovalova, 2010, p. 17).

However, the war with Russia, the impulsive style of the president Saakashvili, the suppression of opposition mass-media and the disproportionate use of force by the police during street protests in 2007 have seriously damaged Georgia's reputation and reduced the support it used to get from few European capitals. Like the other two Caucasian countries, Georgia is currently negotiating an Association Agreement with the EU.

Just like Armenia, **Belarus** perceives the Eastern Partnership as a way out of isolation, especially since the relations with Russia have become increasingly steep in recent years and have been negatively affected by the Russian-Georgian war in 2008. For the EU, inviting Belarus in the Eastern Partnership as a full member caused a moral dilemma since President Lukashenko is known for human rights violations. However, because the regime had made several liberalization attempts and since the previous EU strategy of isolating Belarus has not brought significant results, the EU went ahead and accepted the regime in Minsk.

Belarus's invitation to participate in the Eastern Partnership was criticized by several opposition parties. The Belarusian civil society was more enthusiastic about the proposal and seems

to be quite active in PE Civil Society Forum (Ivan, 2011, p. 230). The access of Belarus in the Eastern Partnership raised high expectations among EU Member States, but they were tempered shortly after when it became clear that regime in Minsk was interested only in economic benefits and the EU are expected to refrain from any efforts to get involved and take actions to democratise the country (Boonstra and Shapovalova, 2010, p. 19).

Some EU institutions such as the European Parliament have adopted an inflexible attitude of compliance towards the Belarusian government and this was reflected in the problems faced by Euronest. Belarus has no plans to become member of the EU and the country has the most authoritarian regime of the six states. The population is almost equally divided between those who prefer European option and those who want a closer integration with Russia.

**Ukraine** is by far the largest of the six countries, with a population larger than that of the other five together. Ukraine wants to join the EU structures and it remains a strategic goal even after the change of political power in Kiev, even if the new Ukrainian leaders have more nuanced views on foreign policy options.

In 2004, Ukraine was rather sceptical regarding the ENP because it treated European countries like it as those in North Africa. From this point of view, the Eastern Partnership is perceived as positive as it makes the difference between the European neighbours of the EU and other neighbouring countries (Ivan, 2011, p. 231). However, it is clear that the Ukrainian political elite was still dissatisfied that their country was put together with other countries like Azerbaijan, Belarus and Armenia, countries that do not have such close ties with the EU. Doubts about the added value of the new instrument for Ukraine were also expressed (Boonstra and Shapovalova, 2010, p. 19). There were disappointments related to the low level of funding of the Eastern Partnership.

Ukraine can be considered a regional leader in terms of its relationship with the European Union. It was the first country which started negotiations for an Association Agreement with the EU as well as the first country to have concluded a Deep and Comprehensive Free Trade Agreement, as a part of the future Association Agreement which is expected to be finalized in the near future., although strong economic groups in Ukraine oppose such an agreement with the EU (IS2, 2013).

Despite the previous challenges that the ex-communist Moldovan government raised, the new ruling coalition formed after the 2009 elections, the Alliance for European Integration adopted a more optimistic and opened approach towards the Eastern Partnership by fully cooperating with the EU. In January 2010, **Moldova** started negotiations with the EU Association Agreement and in April it received several European consultants on high level policy reforms that will hasten within

ministries (Ivan, 2011, p. 232). Moldova's EU negotiations developed more quickly than those of Ukrainian maybe due to the fact that the country is much smaller in size and it displays an increased availability to accept EU conditions. Overall, it is estimated for the negotiations to end by the summer of 2013 (IS3, 2013).

### **2.3 What went wrong in the Eastern Neighbourhood?**

Overall, through the Eastern Partnership, the EU should be ready to intervene and help these countries to cope with their economic and political crises.

The EU is interested in the security and prosperity within its immediate neighbourhood, but it is clear that some countries' security expectations are not met by the Eastern Partnership. The EU is partially involved in resolving conflicts in the area, but quite often merely reacts to events, without having a clear strategy or political determination.

The European Union's attitude, that of a soft power which is reflected in the union's reduced involvement in conflict (frozen) resolution of the area, led the EU to pay the bill for reconstruction in cases such as Georgia (IS5, 2010). It takes a reinforced external dimension of the EP and a secured conflict resolution strategy for the region, especially since NATO membership is out of the question (Boonstra and Shapovalova, 2010, p. 19).

Some of the countries in this region are highly vulnerable to economic pressures because they depend on the energy markets or resources of larger players (Bahgat, 2006, p. 356). The EU should develop clear steps forward in order to enhance energy security and reduce dependence on a single supplier. In this sense some of the thematic platforms and flagship initiatives related to these issues might prove to be very important.

EU has provided significant support to the civil society organizations from EaP countries. Even the current financial allocations are largely oriented towards governments. The EU should invest more in capacity building for civil society organizations (CSOs) in the EaP countries and also to properly involve CSOs in the development program (Boonstra and Shapovalova, 2010, p. 18).

Overall, the European Neighbourhood Policy states that the new neighbours are important for the Union and therefore are offered a new kind of relationship. Although the European Neighbourhood Policy was expected to be a very ambitious foreign policy which should have provided the neighbours with clear references for reform, it can be said that the main objectives have not been achieved.

The EU has an almost annual ritual to improve the European Neighbourhood Policy (ENP), through initiatives like "new Ostpolitik" ENP Plus, Black Sea Synergy and, more recently, the Eastern Partnership. They tend usually to make the ENP more attractive offering new benefits to its neighbours.

The ENP is designed on the basis of EU enlargement instruments (harmonization of legislation, action plan, annual reports, twinning, etc.) but without offering a membership perspective (Kelley, 2006, p. 22). However, a major problem is that the EU Eastern neighbouring countries are very different than the ascension candidates in Central Europe in the 1990s or the Balkans today.

The EU enlargement model in Central Europe was a rather simple process: countries should adopt the *acquis communautaire*, namely the entire EU legislation. This model leaves little room for maneuver or negotiation because the relationship was totally asymmetrical. Membership rules were negotiated, but dictated by the EU. The only thing Central Europe could negotiate was the deadline for the adoption of the *acquis* (Chilosi, 2006, p. 16). But, unlike "candidate neighbours" in Central and Eastern Balkans, the EU's eastern neighbours have two other alternatives to EU membership: to accept Russia's sphere of influence or to attempt to balance between East and West, keeping semi-democratic regimes (or semi-authoritarian) and not adhere to any regional power centres (Kelley, 2007, p. 27).

The new neighbours can more easily dodge EU conditionality and related reforms. Most of EaP countries have deeply corrupt authoritarian elites, whose primary purpose is to stay in power. The imperative to remain in power is more important than the imperative of Europeanization. However, such a strategy can easily fail because countries like Moldova or Ukraine do not have the size and resources to play for a long time "a sovereignty game". Without accelerated reforms and closer ties with the EU, falling under the Russian influence is more likely, rather than perpetual balancing between Russia and the EU (Popescu and Wilson, 2010, pp. 4-7).

The external pressures on the sovereignty of EU's eastern neighbours are very high, because neither Russia nor the EU treats them as truly sovereign states. Russia believes that they do not possess the ability to be sovereign and the EU exports its own standards in all partner countries, regardless that neighbours are not candidates for accession (Boonstra and Shapovalova, 2010, p. 17). However, the EU's neighbours often use their relations with the EU neither for modernization nor choice but as a tool to enhance their freedom of action in relation to Russia. All EU's eastern neighbours - from Belarus to Azerbaijan – perceive themselves as a "bridge" between East and West and they develop partial multi-vector policies (except for Georgia) (Albi, 2009, p. 1132).

Most Eastern European governments want a selective European Neighbourhood Policy. EU's neighbours are often not interested to import the entire *acquis communautaire*. Azerbaijan is interested in energy cooperation, Georgia wants more EU support against Russia, but none expressed enthusiasm regarding Deep Free Trade regime from the EU, which involves harmonizing national regulatory framework with the EU (Ivan, 2011, pp. 228-234).

Eastern neighbours are different in several ways. Broadly, Moldova and Ukraine shape their domestic and foreign policies in compliance to EU's requirements. Both elites and public opinion are fundamentally pro-European and, at least declaratively, support the union's conditionality. This makes them partially similar to the candidate countries.

Georgia's foreign policy is based on a continuous conflict with Moscow, which it uses to get attention and support from the international community. Georgian government wants from the EU what it considers to be good for the country, not what the union has to offer. Georgia wants some kind of "selective convergence" with the EU, not to adopt its *acquis*.

All three countries have a common core set of characteristics. Moldova, Georgia and Ukraine are fundamentally pro-European, but none of them has elites fully committed to Europeanization as a process of internal reforms;

At the other end of the spectrum are Armenia and Belarus, for which Russia is the foundation of security and economic welfare, and are likely to be strongly, perhaps irreversibly integrated the Kremlin's area of influence. Therefore, for these countries, relations with the EU are of less importance and they are subordinated to their relations with Russia.

At the extreme end of the spectrum is Azerbaijan, the only country in Eastern Europe which calls for "sovereignty" in external relations and does not accept lessons of values or any interference in their internal affairs from external actors. But Azerbaijan's ability to maintain its position depends on its oil reserves; thus, it is vulnerable to oil price fluctuations.

EU entered a new game in its Eastern neighbourhood by launching the Eastern Partnership. It is clear that the Eastern Partnership initiative was generally welcomed in the region, since it made a long-awaited differentiation between eastern and southern dimensions of the ENP. However, the current form of the European Neighbourhood Policy can relatively function in Moldova and Ukraine, but not in the case of countries that do not have any interests in joining the EU (Boonstra and Shapovalova, 2010, p. 28).

However, countries like Moldova and Ukraine should understand that their true differentiation from Morocco, Jordan, Belarus and Azerbaijan do not stand in higher ambitions in joining the EU, but in the quality of reforms. In the eight years of the ENP, the real issues in EU relations with

Ukraine and Moldova are not coming because of ENP format (i.e. including North Africa). There was no EU initiative in Moldova or Ukraine to be blocked because Azerbaijan and Morocco or part of the ENP. Most of the EU initiatives in Moldova and Ukraine were blocked for completely different reasons. First, because neither Moldova nor Ukraine have had good performances in terms of domestic policies – authoritarianism in Moldova and instability in Ukraine and then, because some member states are afraid of further enlargement of the Union or are more interested in their southern neighbours or simply do not want to strain relations with Russia.

## CONCLUSIONS

Since the launch of the European Neighbourhood Policy in 2003, the European Union has become increasingly present and somehow involved in its problems at the Eastern neighbourhood. It became therefore the most important trading partner for some of the countries in the region, carrying discussions and negotiations on free trade operations, conflict management, facilitation of visa regime, and even discussion of erasure.

However, through the ENP, the EU has failed to turn its "presence" into "power". Regarding the areas of security and democracy, the EU was reluctant not only to achieve its objectives but also to prevent the deterioration of the democratic climate in the EaP partner countries. Specifically, each country in the eastern flank, except for Moldova, is “less democratic” than it was five years ago. While the southern neighbourhood undergoes a democratic transformation of its own, it is extremely important for the EU to learn the lesson of the ENP failure in order to strengthen the democracy in post-revolutionary societies from its eastern neighbours, such as Ukraine or Georgia.

At the same time, most Member States are concerned about the revolutions in North Africa and the Middle East, which could probably lead to worsening the eastern neighbourhood's democratic climate. Within the Southern flank of the ENP, the revolutions have toppled authoritarian regimes in Tunisia and Egypt, announcing their spread throughout the region, while the eastern flank countries seem to shift to the opposite direction - in other words to strengthen their authoritarian regimes.

Paradoxically, the southern neighbourhood gradually shows the same features of the eastern neighbourhood within the period of the colour revolutions in 2003 - 2005: a number of countries with close economic relations with Europe, but centralized, with non-competitive policies which regularly afford to ignore the needs and wishes of the EU on key issues of politics and security. To prevent the unfolding of this trend, the EU will have to pay much more importance and energy to its



policies for the Eastern neighbourhood in order to turn its presence into a real power capable to influence this region.

The power to influence the Eastern neighbourhood democratization does not consist only in allocating financial resources to the EaP partner countries in order to encourage trade. This power primarily consists in the ability to achieve expected results, establish an agenda and define the needs of partner countries.

Overall, the power to influence Eastern neighbourhood would mean the EU's ability to drive partner countries towards democratic reforms and benefit from the support and adoption of European interests and values in the region. But so far the union's influence on its Eastern neighbours proved to be somewhat marginal in terms of trajectories of democratization, foreign policy and conflict management. In other words, the increased presence of EU in its eastern neighbourhood did not materialize in the power of political influence. Conversely, the more attention and energy the union turned to the Eastern neighbourhood, the less it was able to influence the development or policy decisions in this region.

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# THE AUSTRIAN SCHOOL OF ECONOMICS AND MARKET INSTABILITY

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**Abstract:** *Market equilibrium is an illusion. The economic reality shows us that the main characteristic of the markets is the state of instability.*

*The complexity of the phenomenon and the strong implications engendered by the economic fluctuations in the macro system, justify the rich scientific research activity of the main schools of economic thought to explain it. The Austrian school of economic thought has one of the most realistic analyses of the factors who generate the market instability.*

**Keywords:** Market equilibrium; economic cycle; Austrian School; interest rate.

**JEL Classification:** B13.

## INTRODUCTION

During the past 20 years, the Austrian economic school saw a major revival upon, its principles and values. Mainly, this is due to the commitment and tenacity of Rothbard, Kirzner and Lachmann to save and develop the ideas inherited from Mises and Hayek. This work has received contributions from a new generation of Austrian economists such as Vaughn, Langlois, Rizzo, O'Driscoll and Garrison who were involved in the spreading and grounding the liberal doctrine. Strongly anchored in the economic theory of Carl Menger from "Principle of Economics" and built on the visionary principle of Eugen von Bohm-Bawerk's on capital and interest, the attitude of the Austrian School towards economic cycle and market instability is at the same time profound and multisectoral extended. Austrian School studies the nature of the economic crisis, highlighting variables such as time, money, and capital structure and coordination failures.

"It's not about just the two macroeconomic variables, time and money, says Garrison, but also focuses on issues of coordination. Focusing on the capital structure heterogeneity we can offer a theory that not only takes seriously the existence of capital and capitalists but allows an integration of economic growth theory with the cyclical fluctuations one by removing the distinction between micro and macro analysis" (Snowdon, Vane and Wynarczyk, 1996, p. 353).

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The Austrian vision on markets does not impose a clear dichotomy between the actions of factors and may also explain the structural instability. The market is seen as a multi-sectorial entity based on a network. Factors which act combined to create instability are, from the point of view of the Austrian economists, the structure of the property, as the foundation of the economy and of the vector "of human action" and Government intervention that distort the normal flows of the economy and, as well, structural intervention upon interest rate to produce structural instabilities by over sizing some sectors over others.

## **1. PRIVATE PROPERTY, ENTREPRENEURS AND "SHOCK" THERAPY RESTRUCTURATION**

In an attempt to identify the entrepreneurial elements of the market, Mises shows for the first time, an appropriate methodology for this social science: "economics, as Say understood it, is not based on a table of raw statistics. It was based instead on general facts, deeply rooted in human nature and the world... and the implications derived from these facts so widely rooted in human nature and the natural law (Rothbard, 1995, p. 12).

This is the method of praxeology. It wants to explain any phenomena of society deriving its ultimate causes from the human action. In a broad sense, entrepreneurial activity coincides with human activity. On a small lever, purely economic, an entrepreneur is a person who acts in the changing conditions of the markets. Its function is to achieve its objectives in the context of events and circumstances which cannot be associated with probability functions. Mises's entrepreneur does not act in an economy with a state of balance, but rather in an unstable environment, tense up by the lure of profit. From here, the Austrian economists identify the optimal framework in which human action is developing, being dominated by the private property, the only concept able to motivate and generate profit.

The most obvious failure of socialism has been the inability to create wealth. The absence of private property and voluntary contacts between members of society has completely removed the ability of entrepreneurs to take the uncertainty of social production.

To provide the possibility of expressing the creative energies of the entrepreneurs, Austrian school recommends a massive removal of State property from the productive structure of an economy. The main structural factor of instability in an economy is the dominance of public property in preference to those. This will open the "Pandora's box" of massive state intervention in the economy and a waste of resources (Rothbard, 1995, p. 54). The essence of the transformation

consists in creating a structure of property rights, to support the functioning of a viable economic entity or a market based economy.

The restructuring requires the passing of ownership of labour, land and capital in the hands of individuals. How each person is naturally his owner, it is necessary to complete a removal of restrictions and Government interventions, enabling each person to conclude contracts and to associate with others freely.

Reaffirming the institution of private property will significantly reduce the size of Government and reduce the production and supply of goods by the State, as well as the massive bureaucracy. Instead of the State apparatus will be specialized entrepreneurs; which will pay close attention to market signals and not complying with a central plan. They will provide the highest revenue to the original owners of land, labour and capital. This voluntary method of creating entrepreneurial capital, by the virtue of their association with the free market, is the only one that eliminates the structural tension of the goods production and services and ensures that, through free market competition, prices will never be artificially changed the Government's economic decisions.

Austrian ideas in terms of the transformation of the economy through systemic privatization of the enterprise environment were retrieved and brought together in a set of economic policies during the 1980s, known as followers of the "Washington consensus". The phrase was coined by the American economist John Williamson and designates a convergence of concepts on the path of economic restructuring. Also called "shock therapy", the reform plan can be summarized in three fundamental concepts: deregulation, privatization and liberalization.

Price liberalization is necessary in order to achieve efficient allocation of resources and eliminate consumer goods shortages. Abandoning control of interest rates, exchange rates and external trade is imperative to stimulate exports, attract foreign capital and avoid over-lending to State enterprises could be measures aimed at Deregulation. Deregulation measures aims to replace administrative measures by limiting state interventionism in the economy.

In spite of solid arguments, "shock therapy" was rather the exception than the rule of structural transformation. Criticism has come from followers of the 'gradualist approach', being influenced by the neo-institutionalism theory and the study of socio-biological systems. The main thesis of this approach is that institutions create rules of the game, generates and creates economic incentives to businesses behaviours. In the early 1990s, the gradualists felt that the old institutions, including centralized planning agencies, must be maintained until, gradually, will be replaced by new institutions built by the virtue of change. Their idea was that the partial privatization should be

privileged, in a process step by step, enterprise by enterprise, because in that way they would become more efficient.

Broadly, gradualists criticized the Austrian privatization perspective, by shock, due to the following aspects: the impossibility of eliminating the State and its institutions in the economy, dramatic lowering of the output, substantially reducing the living standards and the blatant inequality of income distribution (Işan, 2002, p. 43).

In fact, these taunts to "shock therapy" are nothing more than signs of structural instability caused by inheritance and maintaining old institutions and their functioning in a so-called competitive system between public firms and „young entrepreneurship".

Hayek, referring to the British liberal tradition, emphasizes the importance of the State in these moments of transformation. Hayek argued in this regard that "it is not a form of magic, but the evolution of well constructed institutions, where rules and principles for reconciling the conflict of interests and reaching compromise in terms of benefits, is the key that has successfully channelled individual efforts towards socially beneficial goals" (von Hayek, 1964, p. 138). The wisdom and success of the transformation of an economy, based on planning, to a private one led by entrepreneurial instinct and gain, depends on the role that State institutions will play in creating and securing property rights, the legal and institutional framework which provides the manifestation of the spirit of enterprise.

In terms of reducing the output, gradualist theory believes that could be avoided through effective management of public enterprises. John Williamson, a partisan of the radical liberal measures, views the situation from a different angle (Işan, 2002, p. 44):

- Statistical data from the socialist period are less feasible because they are known to have inclination toward exaggeration due to Communist regimes;
- Industrial production structure in ex-socialist countries were largely ineffective, heavy industries with outdated technology and products, unaffected by the pressure of international competition did not have appropriate quality,
- Many businesses, unexposed to market harshness, were totally ineffective and produced negative added value;
- Value of GDP was distorted.

From this point of view, the reduction of production in the case of shock therapy is a positive result because the resources released from inefficient industries will be able to be used in new industries, where private businesses are profitable.

In the same logic, we can analyze the hypothesis of massive unemployment, in the case of radical liberal interventions. Over employment in socialist regimes was not an effective use of labour, but a phenomenon of "disguised unemployment". Creation of jobs has to be a function correlated with the demand of the market and not an artificial indicator of a central plan or a method of attracting voters. The expression of a strong structural unemployment is just the result of disparity and lack of realism of the old structures.

If we were to summarize the two approaches, we could say that the first one, with its liberal views, seeks the reduction of interventionism, while the second is pointing its look upon the government for solving the problems of the economy. The first is based on the free market potential to produce positive economic results, while the second one emphasizes the inability of markets to bring prosperity and stability, encouraging the control in order to avoid shortfalls of the economy.

## **2. THE EXPANSION OF LOANS AND INSTABILITY OF THE AUSTRIAN MARKET**

The instability theory is centred on the market that offer the disproportion between consumer goods and capital, in an integrated manner, to show how a "disorder" of one of them generates effects upon each other and on the economic system itself.

In explaining country's instability, the Austrian school's theory is built on three elements presented separately before. The first step was the revitalization of Ricardian analysis which shows that the expansion of credits used by the Government and the banking system will lead to a rise in prices, followed by a leak in the amount of gold out of the country - the economic contraction. The second element of Mises's pyramid was the analysis of capital and interest presented by Bohm-Bawerk.

It started from the time when preference determined the rate of profit in business, pointing out that in fact the normal profit rate is the interest rate. The normal rate of profit is determined by the different time preference rates. Analysis of capital and productive structure of Bohm-Bawerk was taken away by Mises. The capital, which looked like a complex network that has a time dimension, was analyzed by Mises in a manner where the aggregate money and the price level are no longer regarded as separate variables from the rest of the economy. The third pillar of Mises's theory is the reviewing of Wicksel's theory, which demonstrated that differences between the natural rate of interest (the interest rate in the absence of expansionist bank credit intervention) and the rate actually charged, affects the price and production system.



For the Austrians, it is not so much the size of the money supply, as well as the way they are making their way into the economy and affect all real variables as well as the final output. This effect of Cantillon distribution highlights the insertion of money in the economy and stresses that money neutrality hypothesis is a utopia, because money always matters and is not neutral in their impact on the real economy. Mises argued that "the extra money finds its way to the pockets of all individuals; not every individual receives the same amount and not everyone reacts in the same way" (von Mises, 1990, p. 54). Money affects the real economy by changing relative prices and time structure of production. Machlup observes that while "additional money causes instability .... Real phenomena form it".

In explaining economic instability, Mises made the distinction between actual credits (commodity credit) which are transfers of savings in the hands of the one who saved initially in the hands of entrepreneurs who intend to use these funds in the production process and the loan of circulation (circulation credit) granted by banks, which is how Mises said "an increasing amount of money substitute. We can say that they are accepted and spent by the public as if they were their own money. Credit movement increases the purchasing power of the borrowers, they entered the market with a request that does not exist in the absence of newly created deposits, inducing a new trend of increasing prices of goods and salaries"(von Mises, 1933, p. 28). If the amount of credit is limited strictly to the amount of capital accumulated in savings, the moving credit amount depends mainly on the bank financial management if it can be extended beyond the limits of the deposit.

The results of government interference in the market will always be misleading. The inevitable trend of increasing prices and wages is not the only consequence of the credit expansion. It has a powerful effect on the level of interest rate, which has a tendency to descend below the level that would be achieved in an unaltered loan funds market. The expansion of credit is today the main tool of cheap money policies. The interest rate is a market phenomenon, not the product of some unscrupulous exploiters, "the settlement of future goods by comparisons with present goods is a permanent class of human actions, which cannot be abolished by bureaucratic measures" (von Mises, 1933, p. 35). In a free economy, the market determines prices, wages and interest rates. This is the element that keeps the entrepreneurial activities oriented towards production, where they can meet the wishes of consumers in the most appropriate manner and at the lowest expense.

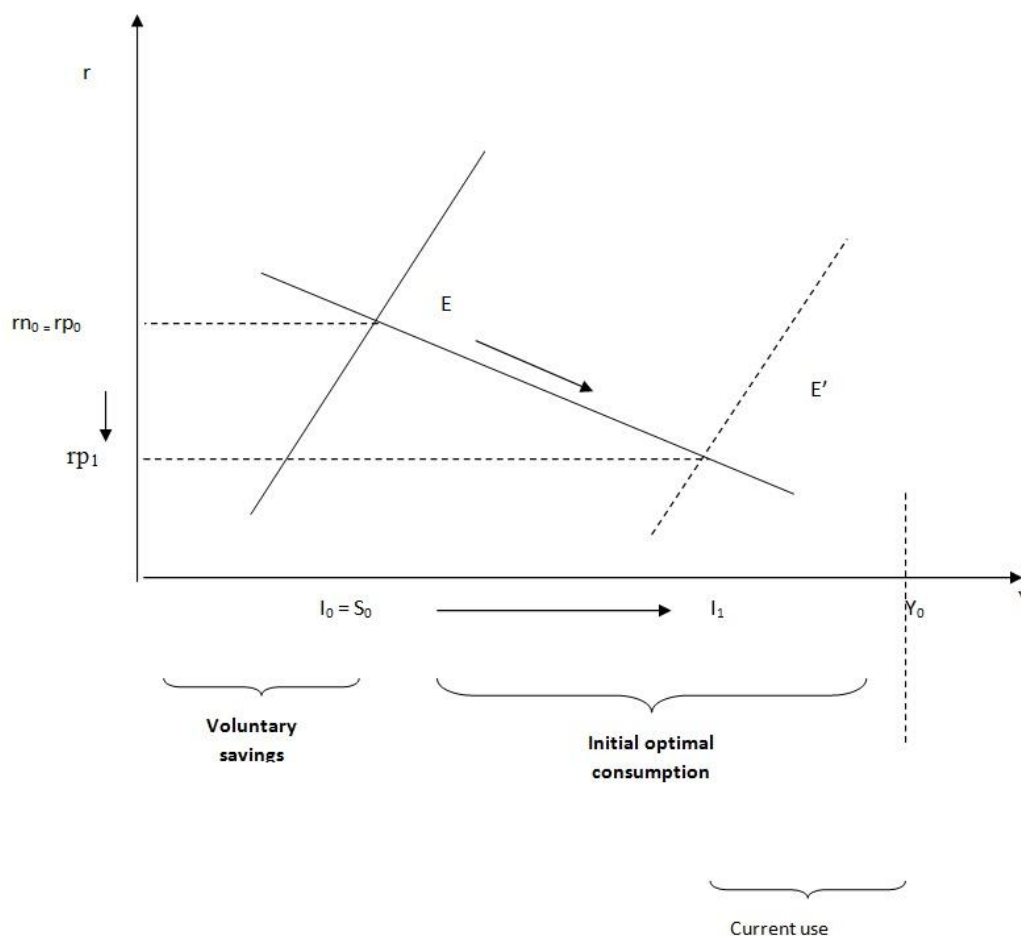
Government intervention on the lending activity, by manipulating the amount of money in the economy, generates a disproportion between the production of capital goods and consumer goods. The following chart presents a simplified picture of the effects which the difference between the

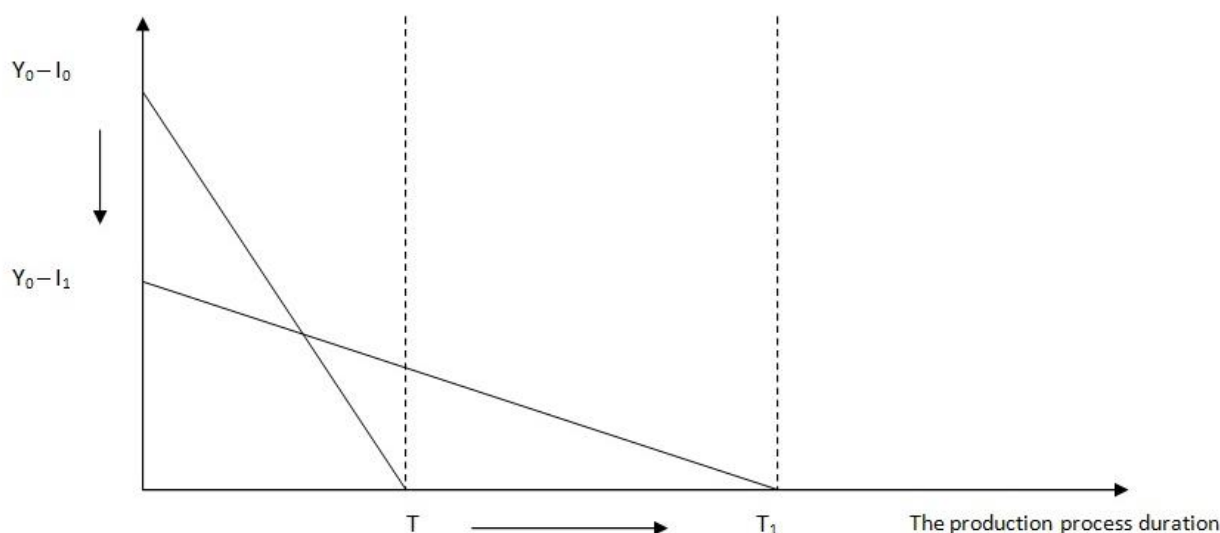
natural rate of interest and a market one, affected by credit expansion, has on the structure and time of production.

Artificial reduction of the interest rate, below the natural rate, is called by Hayek as the trigger of "capitulation". This is the main factor of the cyclical developments in the economy and the main culprit of market variables instability.

In Hayek's view, an expansionist credit policy induces in economy an artificial feeling of optimism, of well-being illusion. Many of the investment projects, which were considered ineffective by reference to the natural rate of interest, are now viable. Tempted by easy credit, many manufacturers will lend and invest in the sectors of high productivity, and in the means of production. The consequence will be to reduce investments in sectors producing consumer goods and the emergence of an excess of production means, in relation to the purposes for which they were designed.

The effects of these distortions in the investment process upon the structure and duration of the production process can be schematically presented in the following figure (von Hayek, 1984, p. 76).





When the natural rate ( $r_n$ ) and the market rate ( $r_p$ ) are identical there is no disproportionality between the production of consumer goods and capital goods. The economy is in equilibrium (point E) and total investment will be financed from the voluntary savings (commodity credit).

If the market rate will be lowered under the market rate,  $mr_1$ , we will witness an increase in the investment volume  $I_1$ , and will be funded in part from voluntary savings and partly from the forced credit (circulation credit). This will cause an involuntary reduction in consumption from the  $Y_0 - Y_0 - I_0$  to  $I_1$ , along with an extension of the production structure from  $T_0$  to  $T_1$ . This extension of the production structure will not be able to continue as long as consumption is not allowed to return to its original level.

If the growing demand for capital goods would have been caused by a growing inclination towards saving (moving the chart to the right is saving  $\rightarrow E'$ ), then the extension could be continued and supported. Returning to initial levels will be made through a policy of decapitalization or divestments. It will give up its investment in the production of capital goods sector process, together with rising unemployment and higher interest rates. We're talking about at this time of a deflation.

## CONCLUSIONS

Thus, the recommendations of Hayek's economic policy, aimed at the complete elimination of the fluctuations in the monetary mass, is approaching in this way to Friedman theory and Monetary Economics, with their belief in sustaining a constant an increase in money supply.

A neutral monetary policy is seen by Hayek as an theoretical ideal, which is difficult to follow in practice, taking into account the lack of knowledge regarding the way in which you have make the adjustment. Recognizing this Hayek said: " It is very important that we become fully aware of the enormous difficulties presented by the problem of eliminating disturbing monetary influences, difficulties that monetary reformers are always inclined to undervalue. We are still far from the point where either our theoretical knowledge or education of the general public gives us justification for revolutionary reform or hope that such reforms lead to a successful end (von Hayek, 1931, p. 176).

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# FINANCIAL ANALYSIS FROM AN ACCOUNTING POINT OF VIEW<sup>\*</sup>

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**Abstract:** *Despite the developments which tend to relax the relationship between financial analysis and accounting, property information provided by the latter irreplaceable render its use for diagnostic approaches financial foundation. An efficient information system can provide relevant indicators to users based on accurate and real information and financial analysis results are based on a diagnosis of return and risk.*

*The aim of this article is to present primarily the origin and evolution of the relationship between financial analysis and accounting, and the fundamental role which accounting holds, through the information it produces, into analysts' work. The used research method is the bibliographic one, being studied timely books and articles of the domain. Literature does not provide concrete answers to this problem, resolutions being expected especially from practitioners.*

**Keywords:** stock analysis; financial diagnosis; information; performance; normalization.

**JEL Classification:** D82; G14; M41; N80.

## INTRODUCTION

Financial analysis is a specialty of finances aimed at formulating a diagnosis and a prognosis relative to the situation and the financial performance of a company or an organization. To achieve its objectives is striving to make an assessment of the level and variability of results and risks affecting the enterprise bankruptcy. Thus, it seeks to measure the value of the entity and its titles.

Given the nature and purpose which it pursues, financial analysis develops the steps of collecting, shaping and treatment of a range of management information which may clarify the wanted diagnosis and prognosis.

Information handled by the financial analysis is given traditionally, by general accounting, which led to the misnomer of “accounting analysis”. However, recent evolution led to considerable expansion of information sources handled by the financial analysis, which is profoundly renewed.

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<sup>\*</sup>AKNOWLEDGEMENT: This work was supported by the the European Social Fund in Romania, under the responsibility of the Managing Authority for the Sectoral Operational Programme for Human Resources Development 2007-2013 [grant POSDRU/CPP 107/DMI 1.5/S/78342].

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## 1. OBJECT AND GOALS OF FINANCIAL ANALYSIS

Over the past decades, financial analysis underwent major developments affecting the object depth, its themes and methodological guidelines.

Financial analysis consists, primarily, as a discipline of enterprise-oriented diagnosis. But in exploring this general objective, it has followed a real change of perspective. While traditional orientation led it to focus on studying the financial size of grounding companies, its recent development guides it to consider more than stock characteristics and performance of securities issued by these entities.

Traditional object clearly orients the analysis to study the financial characteristics of firms considered legal and economic entities endowed with effective autonomy. In this perspective, the diagnosis to be made is clearly oriented to the concerns of outside business partners, but directly interested with the survival and development prospects. Taking into account these concerns, leads to a focus on assessing the company's ability to honour commitments it has entered into its business relations and, in particular, those that subscribed to its bankers and others borrowed funds or to suppliers.

This guidance provides a central to solvency study into the analysis. Insofar as it expresses the ability of an economic entity to ensure debts when they occur at maturity, solvency conditions the viability of an enterprise of any independent entity.

Historical profile of financial analysis expresses a predominant point of view of others and a solvency issues. The external financial balance is then the central element of diagnosis. It does not exclude the study of economic performance and financial profitability. But the imperative necessity of enhancing the profitability and capital assigned to the undertaking are not clearly discernible than in market economies where financial investors in general and shareholders in particular, are able to put pressure on companies it finances. In the leverage economies marked by the central role of financing by banks and financial intermediaries, analysing solvency problem remains dominated by the condition reimbursement compliance commitments made to the lenders and not the firm's survival.

The renewal of missions assigned to financial analysis is inseparable from the important changes affecting the financing regime. This shift calls into question as well the financial structure of firms, i.e. financing circuits on which they are articulated.

Traditional financial analysis approach is deeply consistent with the mechanisms and imperatives of a debt economy. In such an economy, the financing of productive system is

essentially based on the establishment of funding and external inputs provided by banks and other financial intermediaries. Consequently, management of credit relationship that is established between businesses and their lenders is one of the major concerns of managers. From the point of view of enterprise compliance period provided for debt service is then a major financial constraint. From the point of view of bankers and other lenders, a priori assessment and monitoring real-time borrowers repayment capacity, assumes a crucial importance. In this perspective, financial analysis acquires the status of a methodological discipline that provides to companies and their borrowers common tools, mainly oriented towards solvency analysis. In conclusion, as far as obtaining a satisfactory economic result makes the future repayment ability, the analytical tradition also interested in analysing operational effectiveness and the intrinsic economic profitability of the company. Given the particular features of French financial system, dominated until the 1980s by a logic of economic leverage, financial analysis French school register, traditionally an analysis perspective external solvency and economic profitability in coherence with nature management profound problems that actors of the productive system and the financial system they had to solve.

Whether the assertion of a financial market economy was recent in France, it has operated long before in the United States and the United-Kingdom and other countries endowed with great tradition stock. Such an orientation of the financial system provides a central financing by issuing shares. It gives, therefore, to shareholders and potential investors a marked influence on the leaders. By expressing their approval of the management of listed companies, the acquisition and retention of securities which it has issued, the stock market actors involved in valuing such securities and consolidate enterprise transmitters and its leaders. Expressing their distrust refusal or title by assignment or by refusing to subscribe to the investors participating in the company's capitalization and depreciation, under certain conditions, bring into question the control and management. Thus, financial market economy allows shareholders to obtain value by force, their remuneration and by imperatives of valuing their contributions. Under these conditions, it requires active management leaders one of their relations with shareholders and pays a close attention to the requirements and enhance market share. Asserting financial market imperatives moving so dominant issue of the financial analysis and constraint inquire more determinants of valuing securities exchange than the problem of debt repayment.

This change of perspective, already old tradition of financial analysis noticeable in the United States or the United Kingdom, not engaged in France until the late 1980s. The gap between national traditions to open the field of financial analysis is only a manifestation of the differences between the characters and the history of the financial systems of those countries. It explains the coexistence



in financial analysis “à la française” of a traditional current, always active, oriented economic profitability and solvency analysis and a fast curing currently being oriented to stock analysis.

The renewal of the missions of financial analysis affects the directives that it seeks, and the approaches, methods and nature of the information which it processes. For this purpose, it also tends to change in depth, the traditional relationship between financial analysis and accounting.

## **2. AN EMPOWERMENT TENDENCY OF FINANCIAL ANALYSIS**

Historical relations between the two disciplines, allow for the accounting as an information provider for the financial analysis and the latter as a specialty and value-oriented accounting information exploitation. Undoubtedly, this historical report is always running in the work of financial analysts that the financial information they feed extensively with materials analysis. However, recent developments lead to questioning and increase the complexity of relations between the two disciplines.

Concerning the financial analysis from a historical perspective, the first fields of application of the discipline regard credit analysis and stock analysis. Credit analysis is to assess the risk of creditor banker or bankruptcy for a debtor. In the analysis of stock market, it is growing in relation to investors' concerns looking to explore their portfolio management, financial markets, assessing risk and return associated with a set of financial assets, shares or other securities issued by various entities in the market. Cost-credit analysis, as well as stock analysis, is therefore oriented to clear operators objectives, dictated by administration issues faced by an actor accurately identified as a creditor or an investor. The initiated efforts are coming, in both cases, from the treatment of a range of management information that can clarify the behaviour of this operator and the two specialties, accounting information is privileged as a source required by the steps of financial analysis.

Through some development, financial analysis tends to be emancipated from its historical relationship with privileged accounts. Relaxation of this relationship essentially depends on four factors.

Firstly, the development of financial markets and various forms of collective management gives high importance to financial analysis application portfolio management. Or, these applications tend to use mainly the statistical data relating to the behaviour of stock market securities that these data refer to performance indicators, such as cost-benefit action, relative indicators of the variability of income gained or series of developments course and transactions observed. It thus appears that

information used to open wider on data market than the data accounting records arising from broadcasters' titles.

In its most traditional applications as credit analysis, financial analysis seeks to rely on expectations relating to situation and business results that we study. Or, accounting information by its nature may only provide guidance retrospective. As a consequence, financial analysts orient their economic investments by seeking indications of commercial or industrial, who may soon clarify their effort prediction, but to treat accounting data whose horizon is not a suitable stage.

Finally, numerous sources of information with an extra-accounting character are today proposed by the economic and financial information providers. Although some of these data are originally derived from the accounting documents, given that they will be provided to the analyst, disrupting latter relationship one has with steps and accounting documents. Indeed, many financial databases are in the form of statistical data collection, in which the structure of accounting information is hidden; the organization of these data favours statistical criteria pertinent to the portfolio management methods. Consequently, it tends to fade accounting model underlying the production of monographic data, which is the ultimate source of information relating to companies.

### **3. METHODOLOGICAL DEVELOPMENTS AND THE EMERGENCE OF NEW RELATIONSHIPS BETWEEN FINANCIAL ANALYSIS AND ACCOUNTING**

The increased importance of the portfolio management assumed by financial analysis of the new missions tends to relax its link to the accounting model, if not with the accounting information. But other major developments of financial practice and theoretical and methodological research tend instead to revive, renew and extend this link in new directions.

On the one hand, operator elections and theoretical models related to the financial structure and financing, require an analysis of the structure of liabilities, its evolution, and highlighting the cost of capital. Or, theoretical and practical developments related to funding, require the use of general accounting data. But these are developments of organizational finances, focusing on new concerns, shift objectives and stakes financial analysis steps in a direction that emphasizes information and open up vast prospects stakes links between financial analysis and accounting. Generally, these concerns relate to the links between the financial management of the company and its mode of organization, relations between managers and shareholders, confrontation or adjustment between these different actors strategies, modes of control, of inciting and leading sanctioning relationships among these "actors". Issues of government relations and business brokerage provide

a coherent theoretical framework to integrate all these concerns. However, these issues give a major informational dimension of business management. Opening a new field of application for accounting information in financial analysis and valuation, they contribute to strengthening and renewing the historical relationship between the two disciplines. Finally, industrial economic development stress the links among sectorial structure, market structure and business strategy analysis. They relate so important management decisions taken by management in the context of industry and markets in which they must operate. Of course, the industrial economy and analytical approaches of strategic management is widely used in the industrial sector data and commercial technology. But, as shown by the work carried out by plants sectorial nature balance, they can also rely, effectively, given the accounting data expressed in quantitative terms, certain features of technical and economic structures that extend activity and heritage organizations and sectors.

The research with methodological nature also opens new leads that influence the ambivalent line among financial analysis and accounting, as some progress tend to strengthen this link, while others tend to relax instead.

In a first perspective, the research opens up the implementation of statistical methods that allow information on enterprise valuation. This is the case of bankruptcy prediction approaches, called scoring methods. These methods may use extra-accounting information, but in all cases they restructure information blurring reference model uses the default account. To this, it should be noted the ambivalent role played by a number of institutions that have contributed to the creation of databases of financial information and the development of methodologies that allow their valuation. On one side, these institutions, particularly the balance, insurance, credit and financial information providers, contributed largely to the collection of accounting information and the standardization of analytical methods. But otherwise, these bodies have contributed to a statistical approach, which tends to blur the accounting period in which the data that it treats were produced. Also, the statistical approach tends, by its nature, to certify individual characteristics of each unit feeding databases to obtain population profiles of companies that it studied. If it opens wide analytical perspectives, developing statistical treatment of accounting data contributes to a certain relaxation of the link among financial analysis and accounting.

In a second approach, methodological research on the application of artificial intelligence and the development of expert systems oriented towards financial diagnosis, even if the information entered into the accounting system can be known, these approaches tend to fade once more, accounting models, expert systems because the user does not need a detailed overview of the mechanisms that enable the production of all information treated in order to state the diagnosis.

In a third perspective, the financial analysis is developed with reference to the assessment made by experts and operators in the market. It is the meaning of approaches oriented to market consensus, developed in consultation with experts in various offices attached financial analysis that operates on one or more stock exchanges. It is clear that these approaches are based more on the reception and follow-up of expert opinions, as they are based on objective assessments and intuitive than direct treatment of the fundamentals that allowed these experts to make their determination. In matter, the link among market consensus and characteristics of each company, as they expressed general accounts is largely hidden.

General accounting provides financial analysis a source of systematic and homogeneous; in conclusion, it requires a global representation company that proves particularly effective steps to substantiate the diagnosis.

Bookkeeping is a legal obligation for all operators. Specific constraints are, therefore, referred for legal firms with some features that reach a certain size or that affect certain operations. Due to these legal obligations, any company must have the registration and systematic treatment of information concerning its activities and assets. It draws up a material that can serve as support to financial diagnosis.

If accounting information production has a systematic nature it is also clear rules or perceptions of relatively homogeneous. Indeed, the process of normalization has made companies in different parts of the world to keep records on terminology and common rules for presenting documents synthesis in an identical manner. Or, the relative homogeneity of accounting information allows financial analysts to improve readability and, in general, for all its users. From a diagnostic perspective, it first allows applying the same analytical tools for different companies, thus providing a solid foundation of statistical and comparative studies that prove indispensable for formulating a diagnosis, as well as for preparing management decisions based on search for specific external references (benchmarking).

Secondly, homogeneity of approaches always provides some accounting methods and presentations which allow the study of significant financial developments that affect an enterprise over time. Accounting normalization is thus a prerequisite for the development of analysis tools that can have a wide application and to generalize observations regarding the financial behaviour of firms.

General accounting pursues a global representation of an entity. Income statement provides a global view of the expenditure and revenue flows that crossed the undertaking, considered as a whole without internal circulation between components to be highlighted. Also, the balance sheet

provides a global situation that entity rights and delegations held firm that she has, that is an overview of the economic situation. Or, such a global representation is particularly suitable point of view of financial diagnosis, because the latter favours the company's financial unit, unit collection, capacity beneficiary and its overall value. Although the analytical guidelines may be useful to clarify certain features of enterprise financial diagnosis tends to propose a synthetic assessment of the situation and accommodate business and therefore the overall representation provided by general accounts.

#### **4. THE LIMITS OF ACCOUNTING INFORMATION AND THE NEED OF EXTRA ACCOUNTING INFORMATION FOR THE FINANCIAL DIAGNOSIS**

If financial markets are efficient, all information must be immediately and fully integrated into courses. One of the problems comes from the fact that the produced accounting information is often regarded as late, which is why it is expected from the careful observers of enterprise trends and their environment to anticipate long before official communications. In such a case, the accounting information should be integrated into security prices even before being published. Content information is then nonexistent; communication would not entail any change in the quoted prices, regardless of the degree of market efficiency. Consequently, if there is a significant reaction to the announcement of accounting data rates, information content and informational efficiency of the market, failure to respond may come from the fact that the date does not convey anything new or that the market is not effective.

Due to their nature and concerned objectives, general accounting and financial analysis have deep understanding ways distinct from economic and financial information they need to treat them. Accounting is presented mainly as a system for recording and processing of financial and economic information on the company or any other entity. It is therefore essential to find the right vocation: it adopts a positive approach. Financial analysis develops, in turn, an interpretative approach. It seeks to use the information it deals, in order to make an assessment of the situation or performance of the company (or companies) concerned. It adopts a regulatory approach.

In order that accounting to proceed at records and treatments it must fold to strict rules, or at least the formal principles. It is registered, in conclusion, in a regular framework that, despite the openings listed, is subject to relatively stringent in terms of referral information and presentation documents it produces. Accounting (and only general accounting) is therefore subject to formalism

necessary to normalize, even if the reference to the notion of fair picture comes to moderate risk of mechanical application of principles rather than formal regularity.

Financial analysis is widely released instead of formal constraints. In its efforts, it is less concerned than in the rules of relevance assessments priori that it must enunciate. A “good financial analysis” is not only an analysis that proposes a correct calculation for certain indicators or a flawless presentation of pictures and diagrams. It must also identify the most significant financial characteristics of the company, respectively and eventually prioritize in order to achieve a meaningful assessment of the situation, activity and lucid anticipation development prospects. Obviously, the definition of a “good” diagnostic is not an internal criterion of regularity, but one of relevance to the proposed analysis in relation to its object. When drafting and presentation modes of accounting and financial information necessarily requires the use of formal rules, interpretation of accounting information and stating the diagnosis resulting from explanatory and analytical approaches that lend themselves to a hard limit effort or formal normalization.

On the other hand, the diagnosis of enterprise requires consideration of general accounting indicators that it cannot express in a natural context.

Diagnosis calls for the assessment of quality characteristics which in a monetary expression, respectively quantification, prove problematic. Thus, assessing company’s performance and its associated risks, require an assessment of its potential indications based on extensive field overflows accounting information. Assessing by analysts of the technical and trade potential, of the quality or capacity of the management organization, test the appropriateness or quality management system of labour relations, largely escapes a direct understanding of general accounts. In contrast, the latter provides a relevant basis for reporting to global business and wealth. But even on this aspect of diagnosis that seems closest to its own object, general accounting provides only partial guidance.

In conclusion, the importance of quantitative data that must be taken into account in drafting the diagnosis, justify the use of information varied extra-special, even if the accounting framework provides an indispensable reference.

But mostly, diagnosis necessarily involves financial forecasting dimension. If the study of past developments and current situation analysis is an essential moment, the latter mainly aims to make an assessment of expected developments in the near or distant future. Financial analysis thus seeks to assess the sustainable capacity of the company they are studying, i.e. the ability to generate a level term stable performance. It is also looking for appreciation ability of the company to maintain solvency and to face various risks that may affect its future. Diagnosis begins with a

necessarily forecast; which carries a dimension of anticipation although accounting information allows only the finding of a situation or operation. In conclusion, it only gives a more contemporary and retrospective information.

Finally, financial analysis maintains with accounting information a necessary, but critical report. Financial diagnosis must be necessarily based on accounting matters. **It shall also has to overcome** the inherent limitations of this source of information, collecting qualitative or quantitative indication of origin and researching or developing extra-forecast guidance that may clarify further development of the company in terms of performance and risk.

## CONCLUSIONS

Developments that affect financial and accounting analysis tend to trivialize the traditional relationship between the two disciplines. While financial analysis has long been confined to a role of implementing and interpreting accounting material, today it also has the role to diversify its sources of information. In essence, it appears more than one specialty diagnostics business by working to identify a true engineering collection, treatment and interpretation of management information relating to companies and their market position. But if financial analyst tends to adopt a position that combines materials assembled from multiple sources to substantiate the diagnosis, his approach cannot fully accounting stalemate on contributions; rather than a loosening of ties between financial analysis and accounting, it is undoubtedly a profound renewal and reinstatement overview of these links.

If accounting information is necessary for financial diagnosis, financial analysis approach however introduces a notable change of perspective; indeed, it remains a gap between optical and financial accounting, despite the progress achieved by accounting normalization openings.

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