ROMANIAN ECONOMIC AND BUSINESS REVIEW

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Editorial

EDITORIAL

JANUARY 1ST, 2007: ROMANIA'S ACCESSION INTO A CHANGING EUROPEAN UNION

Florin Bonciu[*]

In an ideal world, characterized by the ever increasing, linear type of history described by Jacques Turgot[1], in case developing countries have a higher growth rate than developed ones they may catch up in a number of years that can be easily computed.

Back in the '60s and '70s of the last century this scenario was quite widespread and indeed it was mobilizing for many countries and people.

Unfortunately, history has the tendency of not being linear and, the more so, of not being ever increasing from the point of view of economic and social development. And changes in development patterns do occur because of changes in technology, energy sources, ideologies, demography and many other reasons.

Being in Romania and writing just a number of days before accession to the European Union one could find easily numerous reasons for optimism. But because European Union itself is not a sitting target, another approach of reflection is that of analyzing the target and not the follower. Romania is, for all practical purposes, a middle income country, a developing/evolving market with a GDP per capital which is about 30 % of European Union average. Romania is trying hard to catch up and having a model or rather being inside a model is definitely helpful. But what is Romania trying to catch up with ?

European Union[2] has already a long history as organization and in 2007 it celebrates 50 years since the first practical achievement in economic integration, i.e. the establishment of the European Steel and Coal Community. But since 1957 a lot changed both inside and outside European Union.

European Union started with six members relatively comparable from the point of view of economic and social development level. In time, and especially after 2004 and 2007, European Union has to cope with the diversity of development levels of its members.

If we look outside European Union, back in the late '50s there were some developed countries and a lot of developing countries, some of them very young. That situation

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[1] Anne Robert Jacques Turgot, Reflections on the Formation and Distribution of Wealth, London: Printed by E. Spragg, For J. Good, Bookseller, No. 159, New Bond Street.

[2] We use here the term "European Union" in a generic sense as European integration organization, although in time the official name changed.

determined a favorable position for the developed countries if we speak about terms of trade or, generally, about bargaining political power. If we look around, from the standpoint of 2006, we can see a much different world, a world characterized by globalization, with a single super-power structure, with new important actors (like China or India), with a growing importance of countries that posses important energy or raw materials resources (like Russia or Brazil, among others), with international risks like terrorism or climate changes.

Faced with so many internal and external challenges the core countries of the EU (i.e. EU-15) have to adapt on an unprecedented scale. The adaptation required is so huge that the European Commission decided to analyze the "European values in the globalized world"[1]. Among the most important challenges one may list:

- ageing population which requires not only new social policies to stimulate natality, but also an immigration policy similar to that of USA;
- globalization and speed of change that require a new approach to education, skills and employment mechanisms that will make life long learning and easiness in shifting jobs a reality;
- mobility of population within EU which will require standardization and/or comparability of education and adult formation as well as harmonization of job related practices including social security and pension schemes.

Although there is no such thing as a "single European social model", anyway there are a lot of discussion on the need to change this social model. In fact, the discussion is about changing the attitude to work and the expectations vis-à-vis social security. They are both a bit too generous in a globalized world with a lot of competition in all areas of activity.

The combination of globalization, technological change and energy and raw materials price increases forces European Union to think about a reallocation of its resources within the budget, more funds being required for the research and development activities and less funds to be allocated to agriculture. Although the need for this refocusing was accepted, it will be taken into account only for the 2014- 2020 financial exercise. In this context, some ideas point to the fact that some parts of the Common Agricultural Policy may be re-nationalized in the sense that certain responsibilities may be given back to member states.

In a different area, global competition, demographics, enlargement of the EU and technological change require a more open market for services. But despite the fact that services represent more than 70 % of the GDP of many member states, this area is still not a single European market as it should be despite the recently adopted Service Directive. Therefore changes are expected in the coming years.

The EU has to change also from an institutional point of view. But while the idea as such is widely accepted, in practice things are getting more and more confusing. After the rejection of the Constitutional Treaty in France and Netherlands in 2005, the EU member countries took one year of reflection, followed after the lapse of time by another year of reflection. Anyway, in the meantime other member countries continued to ratify the Treaty (like Finland on December 5, 2006), even if, as such the Treaty will never be

1 European values in the globalised world, Commission of the European Communities, Brussels, 20.10.2005 , COM(2005) 525 final .

adopted. Again, changes are expected in the coming years.

The conclusion of the above which are just some of the changes and challenges which European Union has to address in the future is that Romania has indeed a fast moving target after its accession. As result, Romania will have to look carefully not only to the EU directives, norms and other pieces of legislation with which it has to harmonize but also to the global environment which induces and requires adaptations from the part of the EU. Romania will have to anticipate some of these adaptations and will have to be part of the decision process teams that will design these adaptations.

The accession of Romania to the European Union by January 1st, 2007 is a positive thing in itself because being the less developed part of a otherwise developed entity is better than being less developed on your own. Another positive issue is the fact that Romania may benefit of the late comer effect and do whatever improvements to upgrade its infrastructure, its economy, its education and social security systems according to the now-a-days technologies and practices. That means it can be more modern in certain respects than other member countries with more mature economic and social networks.

The moment of accession has its positives and less positives aspects. The positives are that Romania will benefit of all existing experience of older member countries and will be part of the changing process. The less positives refer to the fact that now the various rules and regulations are more strict than some years ago and some programmes are less generous than they used to be. Also a less positive issue is the fact that Romania has to comply at once with a lot of requirements (environment, consumer protection, etc.) while the older member countries had much more time to include such requirements into their activities.

A final remark: the less positives happen anyway, the positives happen only if we know how to handle them. Therefore, Romania and Romanians have to learn a lot in a very short time if they want to balance the positives with the less positives and, at best, even to get an surplus in the process.

IS THERE A VISION BEHIND BANKING SUPERVISION?

Bogdan Glăvan*

Abstract

Banking supervision has attracted considerable attention in the last decades, as attempts to prevent the occurrence of financial crisis have intensified. We argue that past regulations have had unintended negative effects, which because of a lack of clear understanding of the fragility of banking activity and the mechanism of political decisions, will continue to contaminate the results of present, upgraded regulation. Thus, a reorientation in thinking about banking supervision is necessary in order to build a safer financial system.

Introduction

Banking supervision has been one of the fastest growing pieces of regulation in the last decades. Its latest achievement, Basel II, has been discussed at length by many economists. Despite the amount of literature on the subject, the most fundamental question of all has remained relatively untouched: is the Basel Accord – that is, the international harmonization of capital standards – necessary or desirable to have a stable financial system? This paper attempts to provide an answer to this issue. The article is structured as follows. The first section explains the fragility of banking organization. The next section presents the attempts to solve this issue by international banking supervising authorities. Then, we turn our attention to the critique of baking regulation and explain its failure to manage the fragility of banking systems. The final section concludes the paper.

Banking and financial stability

Traditionally, banks have been subject to greater government regulation than most other sectors of the economy. Regulation of banks has historically come in the form of entry restrictions, limits on activities, geographical restrictions, reserve requirements, and capital requirements (Rodriguez 2000, p. 116). This raises the question about what makes banking so special to deserve the attention of public authorities.

At the origin of government's interference in this field of business is the special status of banking. This special character attracted the attention of early economists, including A. Smith, who was alluding to the inherent instability of banks operating in a fractional reserve system, which, if true, merits their regulation (Smith [1776] 1937: 285, 308). Banks are financial intermediaries that take in deposits, which they then use to make loans and to invest in marketable securities and other financial assets. In the process, for the system as a whole, there is a multiple expansion of the money supply. Because banks' liabilities (i.e., the deposits they take in) are usually fixed in value and

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payable on demand, while banks' assets (i.e., the loans they give out and the securities in which they invest) are of variable value and not collectable on demand, it has generally been believed that banks are prone to failure and runs – the sudden withdrawal of funds by a large number of depositors who have lost confidence in the bank. In turn, this has the potential of negatively affecting solvent institutions through a contagion effect, which could adversely affect the entire financial system.

This was the main rationale behind the adoption of a safety net to protect depositors. Traditionally, private banks themselves have attempted to deal with this inherent fragility of fractional reserve banking. First, they included an "option clause" in their contracts (mainly banknotes) that allowed them to suspend payments for a (in)definite period. Alternatively, they created private clubs, then clearinghouses and, eventually, a bankers' bank centralizing the reserves of the entire system in order to respond more effectively to potential bank runs. However, given that total reserves are only a fraction of banks demand liabilities, central banks are able to contain only localized panics, not systemic crises. Moreover, central bank, by its mere existence, creates a "climate of credibility", which encourages private banks to take more risks than before – the so-called moral hazard problem. This, in addition to the government's scheme of deposit insurance, determined banks to behave even more irresponsibly, increasing the danger of systemic crisis.[1]

As Stevens (2000, p.1) states, "The moral hazard of a safety net as well as prudent scrutinity of the central bank's customers provide a rationale for regulating and supervising banking organizations – to curtail risk taking." However, banking supervision has the potential of creating a vicious circle: banks have fewer incentives to adopt a prudent behavior to the extent that public supervision and control replace private risk management. Put it differently, there is an attempt to circumscribe moral hazard by a policy which has the result of further enhancing the moral hazard problem.[2]

With no supervising authority, lender of last resort and government guarantees, bankers bear exclusively the risk of their activity. In the absence of a safety net, banks are stimulated to preserve a higher amount of capital, in order to cover potential losses and remain in business. State intervention has the unintended effect of substituting public responsibility for private responsibility, creating incentives for banks to keep a lower capital. From that moment, responsibility in case of failure is shared by bank and its supervisors, while profit in case of success is retained by the bank (Oatley, p. 36).

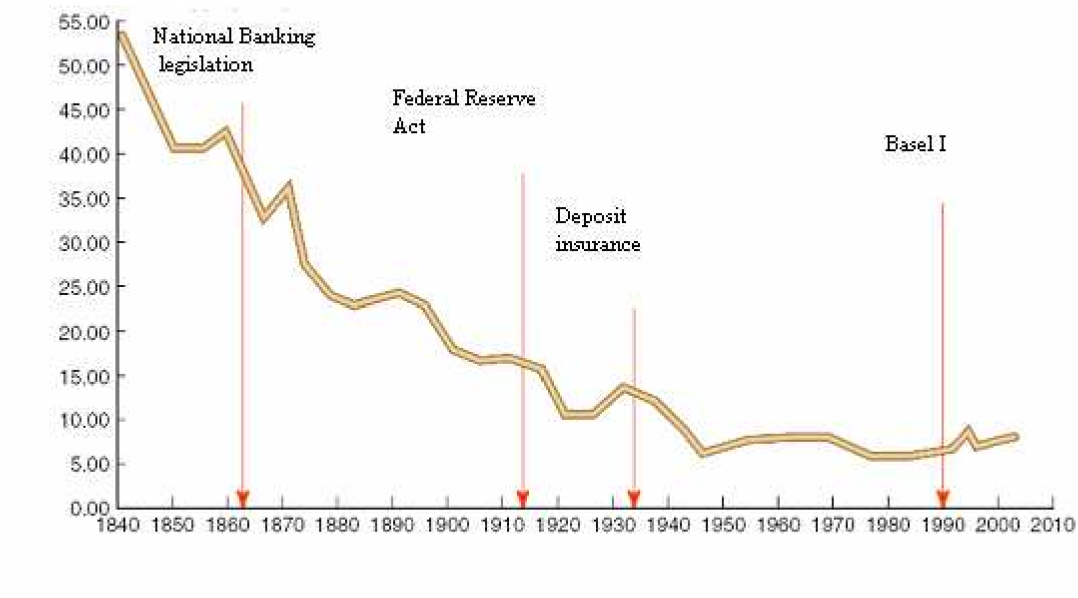
As one can see from the figure bellow, during the 20th century, the banks' capital ratio has continued to decrease. This is perhaps the most significant aspect of the fragility of banking system and, has attracted the attention of monetary authorities.[3] Stabilizing the capital ratio – or, the adequacy of capital ratio – became, in the last decades, the target of official regulators throughout the world.

[1] Insolvent as they were, "the threat of bank run served as a powerful source of market discipline. At the turn of the century, capital ratios at banks were closed to 25 percent" (Kaufman 1988, p. 17). The practical result of protecting fractional reserve banking has been a decreasing in banks' capital relative to their liabilities.

[2] We can speak of a dynamic of interventionism. For a comprehensive discussion of the consequences of interventionism, see Mises (1996; 1998).

[3] See Dowd (1993) for a larger discussion.

The evolution of banks’ capital rate



At the beginning of the regulatory movement, the capital banks were required to maintain was usually calculated as a certain proportion of their total assets (Machlachlan 2001). This measure induced banks to alter their portfolio in favor of riskier investments, which if successfully fulfilled have a higher return.[1]

Moreover, disparities in banking regulation across countries led banks to adjust their policy in order to reap the benefits of more permissive countries. Soon, it became obvious that differences in legislation could provide a source of competitive advantage, as well as a potential generator of financial instability.[2] To contain this phenomenon,[3] representatives of developed countries agreed to harmonize their legislation concerning bank’s capital. Thus, the Basel Committee has issued the famous Basel Accords, the effects of which will be analyzed in the next section.

From a more broad perspective, Basel Accords are specific cases of regulation, and consequently present all the weaknesses of regulatory policy in general. Regulations are by their nature static prescriptions, virtually senseless in a dynamic world. Regulators have neither proper incentives nor adequate information to establish adequate “rules of

[1] The famous “regulatory capital arbitrage” generated by Basel II Accord is only a higher-level case of the same attempt to avoid the impact of regulations (known as “gaming the system”.

[2] As a practical matter, the demands of American banks in the 1980s for an elimination of cross-countries differences in bank capital regulations in order to resist better foreign competition, especially Japanese banks, constitutes one of the factors that led to the adoption of Basel I Accord. See Oatley (p. 37).

[3] As BIS (1988) put it explicitly, one of the main goal of the arrangement was to obtain “a high degree of consistency in its application to banks in different countries with a view to diminishing an existent source of competitive inequality among international banks”

the game". Furthermore, Basel II's overly prescriptive approach could end up stifling market-based innovation in risk-management practices, which are still in their early stages of development.

Basel Accords: mission impossible I and II

The Basel Committee on Banking Supervision was established in 1974 by a number of developed countries (G-10),[1] primarily in response to banking problems in Germany that contaminated other foreign banks and foreign exchange markets. As losses at some large international banks from loans to less developed countries mounted in the late '70s, the Committee became increasingly concerned that the potential failures of one or more of these banks could have serious adverse effects not only for the other banks in their own countries, but also for banks in other countries, through cross-border contagion.[2] In the '80s, governments became concerned especially about Japanese banks, which were rapidly expanding globally based on valuations of capital that included large amounts of unrealized capital gains from rapid increases in the values of Japanese stocks that they owned.

After years of deliberation and the unpleasant experience of the Latin American default in 1982, the Basel Committee on Banking Supervision completed the Basel Capital Accord in 1988. The Basel Accord was established with two fundamental objectives: to strengthen the soundness and stability of the international banking system and to obtain "a high degree of consistency in its application to banks in different countries with a view to diminishing an existing source of competitive inequality among international banks" (Basel Committee on Banking Supervision 1988). To that end, the accord requires that banks meet a minimum capital ratio that must be equal to at least 8 percent of total risk-weighted assets.

Base I incorporated off-balance sheet assets in the base as well as on-balance sheet assets and weighted individual assets by a risk factor. However, the formula constructed was simple and treated all banks equally ("one size fits all" method). Individual assets were divided into four basic credit risk categories according to the identity of their counterparty and assigned weights ranging from 0 to 100 percent (0%, 20%, 50% and 100%). Cash and government securities get a risk weight of zero, claims on banks in OECD countries, 20%, fully secured mortgages on residential property, 50% and all other claims on business have a 100%. The weighted values of the individual on- and off-balance sheet assets were then summed and classified as "risk-weighted assets". Banks were required to maintain capital of no less than 8 percent of their risk-weighted assets.

Many economists maintain that Basel I has contributed to those crises, because of its

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[1] Currently, the Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, United Kingdom and United States. See BIS (2004)

[2] In the 1980s, many large American banks have incurred heavy losses on their loans to developing countries, especially in what has become known as the Latin American debt crisis. Thus, "the dozen largest American banks lent between 83 percent and 263 percent of their capital to five heavily indebted Latin American countries that latter announced they were incapable of servicing their debts" (Oatley, p. 37).

many weaknesses, which in the long run, lead to a classical case of unfortunate "unintended consequences". Let's mention them briefly:

1. The use of arbitrary risk categories and arbitrary weights that bear no relation to default rates, which incorrectly assumes that all assets within one category are equally risky or that one type of asset is, for instance, 100 percent riskier than another.

2. The risk assessment methodology is flawed in that it assumes that a portfolio's total risk is equal to the sum of the risks of the individual assets in the portfolio. No account is taken of portfolio effects that can greatly reduce the overall risk of a portfolio, or the size of the portfolio, which can greatly influence its total risk profile.

3. The accord gives preferential treatment to government securities. With respect to credit risk, the Basel categorizations have been criticized as arbitrary. They also do not take account of market risk (i.e., long-term government bonds are viewed as riskless). That means that banks need not hold any capital against those securities, if issued by OECD countries, or less capital than against loans to corporate borrowers, if issued by non-OECD countries. "But as the sovereign defaults of Russia in the summer of 1998 and Argentina in early 2002 show, government debt is not a risk-free investment. Nor is a loan to many developing countries safer than a loan to a "Blue Chip" company" (Rodriguez, 2003, p. 120).[1]

Finally, the existence of risk categories that create a divergence between economic risks and measures of regulatory capital has led to widespread regulatory capital arbitrage—that is, the assumption of greater economic risks without an increase in regulatory capital requirements. Two main techniques were used to undermine the regulation.

The first confirms the principle that if a certain class of assets requires a given level of capital, the incentive is to adjust the portfolio in favor of the highest-yielding (also highest-risk) assets in that class. This behavior is also known as "cherry picking". It refers to the practice of choosing, among a number of loans considered by regulators in the same risk category, the riskier loan which also brings, if successfully, the highest return.

Banks also shift risk off the balance sheet by means of an ever-expanding array of new financial contracts – technique that is called "securitization". For example, a bank can lend to business units indirectly, thus avoiding the capital requirements. In practice, it can create an independent financial institution, which issues securities in order to fund the loans it, grants to its clients. While the bank provides guarantees to the buyers of these securities, thus facilitating the financial intermediation process, it avoids being considered a direct originator of the loan and is consequently able to calculate a lower risk-adjusted assets. Other more complex methods of disguised lending were used, according to the particular circumstances of its customers.

"In sum, Basel I, already adopted by more than 100 countries, failed to achieve its main goal and may have made the international financial system less, not more, stable. Indeed, it is widely acknowledged that assigning a 20 percent weight to short-term bank lending (as opposed to the 100 percent that lending to most private nonbank institutions carries) led to an increase in lending to Asian banks, which in turn contributed to the Asian crisis of 1997–98. Sixty percent of the $380 billion in international bank lending to

[1] To all these we may add the notorious example of Korea in 1997, not to mention the developing countries debt crisis in the 1980s.

Asia at the end of 1997 had a maturity of one year or less" (Rodriguez 2003, p. 120).

Aware of this bad record, the Basel Committee has started to work on an upgraded Basel accord, in order to "align regulatory capital requirements more closely with underlying risks and to provide banks and their supervisors with several options for the assessment of capital adequacy." The result is Basel II, a piece of legislation which will be implemented in a number of countries, including Romania (starting with January 2007).

Basel II is based on three mutually reinforcing pillars: capital requirements, supervisory review, and market discipline.

The structure of the Basel II Accord

Pillar 1 Minimal capital requirements	**Pillar 2** Supervisory review	**Pillar 3** Market discipline

Risk-based capital requirements, however, continue to be the major focus. In particular, Basel II will add a new charge for operational risk and allow some banks to use their internal risk-measurement models to determine capital costs. Under the advanced Internal Ratings-Based (IRB) approach, banks supply their estimates of the probability of default, exposure at default, loss given default, and maturity to come up with the risk weight associated with a particular asset. That option, however, could turn into a regulatory nightmare, even in industrialized countries for at least three reasons. Although banks are in a better position than regulators to estimate their risk exposure, giving them that option presents them with obvious conflicts of interest when the government acts as the ultimate guarantor of deposits.

The issue of complexity is one that remains. The Basel Committee on Banking Supervision has characterized the complexity of Basel II as a natural reflection of the developments that took place in the financial marketplace. Undoubtedly, the financial marketplace is far more complex than it was 15 years ago when Basel I was being framed, and banking organizations are also more complex in their activities and in the ways in which they manage their risks. However, as Rodriguez (2003, p. 122) has pointed out, this "is not a justification for making the *rules* under which those large complex banking organizations operate equally complex". For any sensible economist, it is clear that a good deal of the present sophistication of banking activity is the result of past external interventions upon the financial market, rather than any inherent feature of the latter.

As Kaufman (2003, p. 10) pointed out, "While market discipline is likely to encourage disclosure, disclosure per se is less likely to encourage market discipline in the absence of a significant number of at-risk stakeholders. Because of the fear of substantial economic harm caused by the failure of large banks, governments and bank regulators in almost all countries have tended to avoid failing such institutions and, where they have, protected all depositors and other creditors in a de-facto policy termed 'too big to fail'. Thus, few de-facto at-risk stakeholders have existed in even privately owned banks, no less state owned banks."

Criticism and an alternative solution

The goal of Basel Accords is to increase the capital ratio of banks. While adequate capitalization is an essential attribute of a sound banking system, the Accords have not (and will not) succeed in their intentions because they fail to address the root of the problem. By focusing on the consequences of lower capitalization, supervising authorities to forces private banks adjust their capital to their portfolio of assets. The only problem (for which Basel I apparently failed to deliver the promised improvement in financial stability) seems to be improper calculation methods used in evaluating the riskiness of various assets.

The main problem with this approach is that it depends on bank regulators to identify undercapitalized banks, and to enforce regulatory accounting standards. There are many examples (the US in the 1980s is a prominent one, as are Mexico and Japan in the early 1990s) of a government conspiracy not to report inconvenient facts associated with declines in bank capital. Government regulators are not immune to political pressure or to bribery by banks. In the US, supervisors were bribed by bankers and regulators were pressured by politicians. Critics of the FDICIA reforms have argued that nothing in FDICIA will prevent this from happening again when the stakes once again become large. Chilean regulation attempts to get around this problem by requiring independent private audits of banks. But this is an unlikely solution since private auditors face incentives similar to those of government supervisors.

The possibility that a highly risk-sensitive capital requirement will reduce the supply of loans in a recession and therefore amplify cyclical fluctuations is a very real one. It is easy to see that if all loans were initially equally distributed among the rating classes and they all migrated to the class immediately below because of a generalized increase in the probability of default, the total capital requirement will increase approximately by considerably.

Another critical aspect of the proposed regulation is that it may deliver significantly different results as a consequence of the many alternative rules banks are allowed to choose among, of differences in banks' internal methodologies, of subjective judgements in the validation of such methodologies by supervisors and of the ample discretion implied by the supervisory review process. By giving the national supervising authorities a lot of discretion, the new accord may possibly lead to two negative outcomes. First, it will fuel corruption and rent seeking, as each bank – or nation banking system – will try to derive as many privileges as possible from their relation with monetary authorities. Secondly, this process will undermine the most basic objective that Basel Accord intends to reach, namely harmonization of banking regulation.

The moral hazard problems associated with the safety net are widely recognized (Short and Robinson 1998). In relation to deposit insurance, the problem is that depositors no longer discipline the banks by refusing to place their money in risky institutions. The lender of last resort further insulates banks from the downside consequences of risky activities. The traditional approach to dealing with moral hazard involves a combination of supervision, regulation of bank activities, and capital standards. Each component poses problems. Regulations are static, but the financial environment is dynamic. For example, regulations put in place at the time deposit insurance was adopted in the United States in the 1930s created serious problems for banks when economic conditions changed and interest rates rose to unprecedented levels in the 1970s and 1980s. Regulations restricting the range of assets prevented banks from taking advantage of the principle of diversification. Savings and loan (S&L) institutions, in particular, ran into trouble because their lack of diversification led to substantial interest-rate risk exposure. Interest-rate ceilings gave rise to disintermediation as depositors pulled their money out of banks in search of market rates of return. Supervisors may not have incentives to do an adequate job—the same principal agent problem that arises whenever government agents are given the responsibility of acting in the public interest. Typically, supervisors do not bear the cost when they do a poor job of discovering excessive risk and of forcing banks to take corrective action. Bankers, on the other hand, may attempt to hide their exposure to excessive risk, and in some cases they may reward regulators who turn a blind eye to it. The S&L crisis brought to light the related problem of regulatory forbearance (Kane 1989). When regulators close an institution, they effectively admit that they did not do their job properly by dealing with the institution's problems earlier. They were tempted to allow the bank to stay open, hoping that the situation would right itself. Regulators have a bias toward keeping banks open (even under the more stringent rules of the FDIC Improvement Act), and an appreciation of that bias encourages bankers to take on more risk than they otherwise would.

Basel II introduces a two-layer framework for the calculation of the capital requirement for credit risk: (i) a very risk-sensitive internal ratings-based (IRB) approach that will be used by large sophisticated banks and (ii) a standardized approach, much less risk sensitive, which will be used by smaller, less sophisticated banks. We show that because the two bank types compete in the loan market, Basel II may induce sophisticated banks to specialize on low-risk borrowers and unsophisticated banks to specialize on high-risk borrowers. As a consequence, we may face a trade-off between the capital adequacy of the two types of banks, with an ambiguous net effect on financial stability: the risk sensitivity of the IRB approach improves the capital adequacy of sophisticated banks, but it deteriorates the capital adequacy of unsophisticated banks, as their increased risk taking is not appropriately reflected by the standardized capital requirement.

Still another objection against Basel II is that it affects companies doing business in developing countries, because their activity is by definition riskier. This argument applies also to smaller companies in developed countries, because it is generally assumed that small enterprises' operations carry a greater risk than big firms.

Basel II is already a very complicated regulation but suggestions are that it should be even more complicated![1] In fact, the entire philosophy underlying Base Agreements and much of their criticisms is fallacious, because it does not address the roots of the moral hazard problem. One can only expect that this problem will exacerbate even more in the future. Knowing that they can rely – now more than ever – on the supervision of monetary and banking authorities, private banks will have less incentives to watch for themselves. The heavier external supervision, the greater is the temptation for economic agents to incur higher risks.

[1] Indeed, one commentator has pointed that the need for Basel II arose because Basel I was not complex enough to deal with the specific problems of banking. See Georgescu (2005).

A system that relies more on competition among different national regulatory regimes, not the harmonization of those regimes, is likely to produce more stability and soundness, and be fairer, than the current approach. Thus, at the national level, the trend should be toward *regulatory simplicity* because regulators are unlikely to be able to keep up with the rapid pace of innovation in financial markets.

Conclusions

Capital requirements are necessary because in the presence of a safety net, bank owners are tempted to leverage their stake. In the absence of a safety net, banks would maintain an adequate cushion of capital because, without it, they could not borrow. The attempt stabilize the banking system by legislating a capital ratio has failed in the past and will continue to do so in the future.

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INTERNAL AUDIT – AN ESSENTIAL ELEMENT FOR THE SUCCESS OF A COMPANY

Victor Munteanu*

Abstract

The report of the European Commission from October last year regarding Romania, has underlined a series of key domains in which the country still has to make progresses for the integration in the EU. The most important aspect continues to be the intensification need of the fight against corruption, which still affects numerous domains from the public life. Other important subjects underlined in the report were the harmonization request of the control mechanisms of the environment with the E.U. standards, as well as the improvement of the public purchase procedures and a better utilization of the informational technique concerning the receiving of incomes by the state.

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Although the report makes reference to the Government's obligations to promote the reform in the public services, many of these requests could be recommended as well in the private sector, which still needs considerable improvements in the work practices, aiming for the promotion of a better efficiency, the consolidation of the integrity, transparency principles, the corporatist governance and corporatist social responsibility. The change is essential if the societies want to prosper in the competitive environment which will exist after Romania will adhere to the European Unique Market. In addition, the European Union has shown an increased interest in the establishment of the standards of audit and corporatist governance, initially defined in the Eighth Norm emitted in 1984, and recently repeated through the implementation of the International Audit Standards (IAS) for the statutory audit in the European Union starting from 2005.

The internal audit (IA) is an efficient promoting manner of these objectives, being an accustomed practice in the developed countries, although up to now it has been more rarely applied in Romania. AI implies the setting up of a special department within a company, separated by the accustomed managerial structure, whose objective is that

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toensure the respecting of the efficiency standards (procedures and controls) and of ethics at all of the company's levels, as well as the fact that the company behaves itself with responsibility in its relations with the larger community. The Department of Internal Audit (DIA), normally, reports directly to the Company's Managing Board or to the Audit Committee. The department can be relatively small consisting from two or three specialists with assistance personnel, so that the setting up of a DIA doesn't imply a significant additional bureaucracy. DIA has the authority to investigate the company's operations at all levels, but it is independent from the management, having the power only to make recommendations, which the Managing Board can accept or decline.

The Institute of Internal Auditors (IIA) with the headquarters in the United States is the international organization which establishes the standards that are at the basis of the profession at international level. IIA has defined the internal audit as being 'an objective, independent ensuring and a consultancy activity meant to add value and to make efficient the organization's operations. The internal audit helps the company to reach its objectives, contributing with a systematic and disciplined approach to the evaluation and increase of the efficiency of the risk management, of the control and of the governance processes'.

The main role of the DIA is that of promoting the company's efficiency. Having a general image of the whole structure, it can come with suggestions for a better coordination of the departments.

For instance, a DIA can observe that certain members of the personnel, employees in a certain department, have abilities which could be used successfully in another. Its recommendations could, consequently, lead to a better utilization of the personnel resources and to the increase of the contentment grade of the employees. Also, a DIA could recommend a better harmonization of the IT policy, which can contribute to a more efficient communication between the company's departments, as well as to the reduction of expenses in the purchases sector. A DIA is useful not only for its capacity to observe the company's operations at all levels, but also because an observer who is less involved in the daily routine of the department, is often capable to come with suggestions of improvement, which those directly involved in the fulfillment of some tasks could not have taken into consideration. An efficient DIA can, also, indirectly contribute to the company's development because it offers an additional guarantee to the shareholders, creditors, and regulation organs, thus, consolidating the organization's position on the market.

The second function of a DIA is that to ensure the respecting of the principles of the corporatist governance within the company. This means the respecting of the ethical standards in the practice of businesses, from the pint of view of the internal procedures, as well as in the manner in which the company treats the clients and the state authorities. The corporative governance is a relatively new concept in Romania, which will have to be adopted by more and more companies from the moment in which this country will become member of the European Unique Market. The investors will want ever more to have the guarantee that the organization in which they invest respects certain healthy practices. Considering that the corporatist governance is a well established principle in the developed countries, the ignoring of this concept in the acquisition policy can affect the international reputation of an investor. In the last years, there has been a series of investors in Romania, whose image at international level suffered because, in the activities unfolded in this country, they appeared to neglect certain ethical principles of well established businesses. Moreover, the ethical standards in investments tend to become a request in the international law. The Convention of Fighting against the Bribe concluded within the Organization for Economical Cooperation and Development (OECD) penalizes the granting of bribe by a citizen of a signatory country within another country (a principle initiated previously by the United States through the *Foreign Corrupt Practices Act*).

Romania's integration in the EU will impose further on the adoption of laws concerning the respecting of the corporatist governance standards, especially regarding the environment's protection.

In the same time, the companies recognize ever more, that the corporatist governance means much more than to generate positive relations with the public, underlining the company's commitment towards the ethical principles. The corporatist governance confers a value plus to businesses. A company that respects the integrity standards in its relations with clients and with the larger community, gains trust, a critical element in the business environment. An organization which treats it's the employees with respect, establishing in the same time some strict norms of ethical conduct for its personnel, will build a culture of team work based on loyalty and pride towards the company's standards and realizations. An efficient DIA will understand the advantages of a healthy policy of corporatist governance and will look to consolidate these principles at every level of the company.

Starting from the corporatist governance, a DIA can ensure, in the same degree, the development of a solid policy of corporatist social responsibility (CSR), which means that the organization should an active role within a larger community, passing beyond the direct relations with the clients or with the state authorities. CSR doesn't necessarily have to imply high costs it is sufficient to be only the result of an imaginative thinking, based on knowing the needs of those around us. For example, a surplus of IT equipment which has become available could be donated to the organizations that work in the community's benefit like schools, hospitals or ONG.

These activities are not expensive and can bring significant advantages to a company, increasing its reputation within the community. The sponsoring of arts is another example which illustrates the way in which the corporatist social responsibility can bring benefits to the community and, in the same time, can promote the company's image.

The Department of Internal Audit makes an evaluation of the company's activities based on a risk analysis. Starting from this evaluation, DIA elaborates an audit plan which, usually, is annual. Immediately after it is approved by the Managing Board, the plan is executed by the DIA. The Department of Internal Audit supplies then, a feedback valuable to the management and to the board under the form of internal audit reports.

These reports present the risks or observations made during the audit, and there are made recommendations for improvements.

For instance, if the organization doesn't fulfill all of its responsibilities connected with the environment, the role of the DIA is to inform the Managing Board about the risks associated to some inadequate policies and to come with recommendations regarding the best practice. The final responsibility for the implementation of the recommendations made by the DIA belongs to the management and to the Managing Board. The principle of separating the DIA from the rest of the company is especially important, so that DIA has only a consultancy role but without having the decisional power in an official manner.

For a department of internal audit to be successful, the independence is an element of maximum importance. In Romania the profession's standards have been defined by the Chamber of Financial Auditors, that are based on the international instructions emitted by the Institute of Internal Auditors. The instructions underline the internal auditors' obligation to unfold their activity in an objective way, establishing in the same time rules for preventing the apparition of conflicts of interests. For example, an internal auditor shouldn't normally have to supervise operations for which it was previously responsible in a leading position, because this could lead to a subjective attitude. A team of internal auditors shall comprise professions that vary depending on the company that is audited, but in a typical way it will be formed from specialists in accountancy (for instance an accountant or an auditor), specialists in operations (with managerial qualifications) as well as an IT expert, considering the fact that the efficient use of the technology becomes ever more an important part of the modern commercial environment. The necessary qualifications shall depend in the last resort on the objectives of the audit department. In Romania the law requests that the head of the internal audit department to be a member of the Chamber of Financial Auditors from Romania.

As one goes along the Romanian companies start to see the advantages that result from the development and consolidation of the internal audit operations, they will also be aware of the advantages, which are offered by the consultancy offered by specialists with international experience. In spite of the name given to this practice, the internal audit doesn't have to be necessarily realized by the company's personnel. The difference from an external control consists from the fact that the observations and conclusions of the internal auditors remain confidential. One of the main advantages of involving an external consultant in the internal audit is that of an additional guarantee of independence. It is therefore much more probable that this will contribute to the development of an efficient department of internal audit, which will obtain results in the improvement of practices in the company's businesses.

An external consultant can help a company in its activities of internal audit in four main manners. Firstly, it can lead alone the department of IA, which means that the company will integrally externalize the activities of internal audit to the external consultant. Secondly, the external consultant can contribute to the setting up of an IA department, this meaning that it can employ personnel, and it can help to the establishing of objectives and the definition of the basic principles according to which the department will function. Thirdly, the external expert can help to the restructuring of the IA department, for example by making recommendations for the recruiting or professional reorientation of the personnel. And finally, the consultant can make an evaluation of the IA department from the point of view of ensuring the quality. This implies an evaluation depending on certain established reference elements and the ensuring of respecting the professional standards emitted by the Institute of Internal Auditors. The evaluation can also, imply the effectuation of a comparison between the internal audit department and the departments of other companies, as well as the examination of the manner in which these are fitted in the company's general activities.

The internal audit has become an essential component in the structure of a modern company. The internal audit ensures a bigger efficiency through a more adequate utilization of the human and material resources, as well as a better coordination between the different departments of a company. Guaranteeing that the company respects the standards of corporatist governance, the internal audit contributes to the building of a reputation of integrity, which in its turn will help the development of relations in businesses based on trust. Also, the internal audit will offer the necessary premises so that the company would play a positive role in the community, ensuring a public image and consolidating the image of seriousness. As one goes along Romania gets closer to the moment of integration in the EU, the companies will have to develop their activities of internal audit if they want to compete successfully on the European Unique Market. The first step for many of these it will be to look professional consultancy from some experts in the field.

TRENDS IN INFLATION-UNEMPLOYMENT RELATIONSHIP BEFORE AND AFTER ACCESSION TO EU

Lucian-Liviu Albu*

Abstract

First of all, we present synthetically a few empirical results regarding changes in the inflation-unemployment relationship in West European countries during last three decades and in few Central and Eastern countries during the last fifteen years. Then, coming from a general standard model for estimating natural unemployment (Ball and Mankiw, 2002) and using four smoothing filters, we estimate some possible trajectories for this relationship and for the potential GDP in Romania.

First of all, we present synthetically a few empirical results regarding changes in the inflation-unemployment relationship in West European countries during last three decades and in few Central and Eastern countries during the last fifteen years. Then, coming from a general standard model for estimating natural unemployment (Ball and Mankiw, 2002) and using four smoothing filters, we estimate some possible trajectories for this relationship and for the potential GDP in Romania.

As in standard literature is asserted there is an implicit circular relationship between productivity growth and potential level of production (and consequently the estimation of natural rate of unemployment is also altered). In order to avoid such emerging impediment in any estimating macroeconomic model, an autonomous dynamic model to estimate the trend of productivity growth must be used. Moreover, taking into account that current level of productivity is implicitly influenced by the actual unemployment rate, usually it is recommended as a more accurate solution to try to obtain firstly an estimate for the "pure" productivity. This must be neutral relating to short-run changes in employment, but in long-run it is affected by factors such as general technological progress, rising of education level, growth of R&D system, extending of the "new economy", etc. We use a simple dynamic model to estimate the growth of pure productivity independently from the actual level of employment and implicitly of unemployment rate. Then estimated changes in pure productivity level are compared with potential production trend in case of Romanian economy during transition period.

Empirical studies demonstrate, on the background of business cycles, several major changes in economies of West European countries during last three decades (Dăianu and Albu, 1996; Albu, 1998 and 2001). Among trends it can be noted the impressive decrease in inflation followed by a continuing growth of unemployment and general diminution of the yearly growth rate of production (GDP). An important result of investigation is that of a smaller volume in 3D map (estimated by including the variation of the three macroeconomic indicators), which represents a stronger economic stability and

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consequently less strain in economic system. In the figure of Annex 1 it is shown a graphical representation of the evolution during three decades (1970-2000) in the three-dimensional space: unemployment rate (u%) - annual growth rate (y%) - inflation (π%), including ten EU countries (Belgium, Denmark, England, France, Germany, Italy, Ireland, Holland, Portugal, and Spain). The trend was from a period in which high inflation predominated toward one in which unemployment plays the main role. This evolution could mean that on the unemployment-side occurred a relaxation, higher levels of unemployment being viewed as normal but is not the case for the inflation level. A deeper analysis showed the possibility of some persistent trends and long-run attractors.

On the other hand, in East European countries there was an opposite situation at least during the first years of transition; open inflation rose rapidly in the region whereas unemployment did also rise but at a smaller pace. There are evidences demonstrating that the long-run trends tend to be similar to those registered in Western countries. In the figure of Annex 2 it is shown a graphical representation of the evolution during the last fifteen years (1990-2004) in the three-dimensional space: unemployment rate - annual growth rate - inflation, including six transitional economies from Central and Eastern Europe (Bulgaria, Czech Rep., Hungary, Poland, Slovakia, and Slovenia).

In case of each individual Eastern economy the most important question is how long the transition period will be. Despite of a relatively short period since 1989, in case of Eastern countries it seems to emerge a convergence process relating the natural rate of unemployment. The main problem continues to be a relatively high inflation comparing with the EU standards (especially in case of Romania where the annual inflation will decrease below 10% only since this year).

Following some studies existing in literature (Staiger et al., 2001; Ball and Moffitt, 2001; Ball and Mankiw, 2002), in order to estimate natural rate of employment we used aside the simple linear trend (Ye) other four trends based on the following filters: *regress* (Y_TR), *loess* (Y_L), *ksmooth* (Y_TL), and *Hodrick-Prescott* (Y_HP). On the base of simulations, we can also see the unfavourable impact of positive difference between the effective unemployment rate and its natural rate on inflation dynamics (Δπ). In case of linear trend the unemployment gap is ΔU=U-Ye, but in case of the four selected filters it is noted ΔUR=U-Y_TR, ΔUL=U-Y_TL, ΔUK=U-Y_TK, and respectively ΔUH=U-Y_HP. As we can see from the Figure 1, as general rule, the points in 2D space, ΔU-Δπ, are distributed in sectors II and IV (in trigonometric sense) over the right line transcending the origin of coordination axes. Eventual differences (the evading from two mentioned sectors) can be attributed to the short run supply shocks.

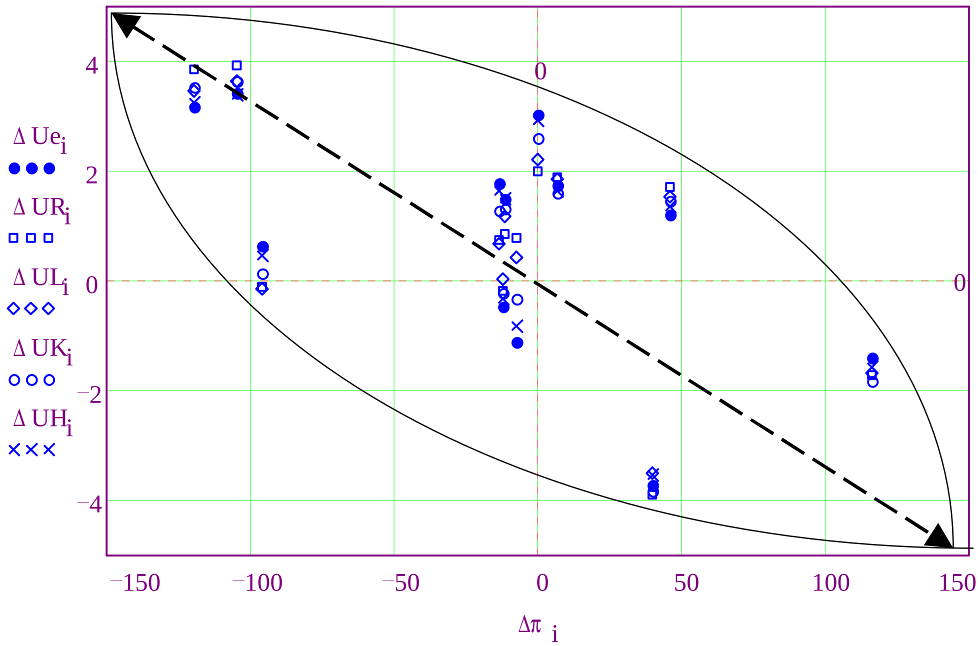

Figure 1.

Moreover, corresponding to the four used filters, we computed the natural (or potential) level of GDP, the output gap, and respectively the correlation coefficient between it and inflation variation. The general level of correlation coefficient between output gap and variance of inflation (Δπ), for the period 1992-2003, was positive (between +0.616 and +0.644). From Figure 2, we can see that in the first part of transition period (before 1998) the inflation is accentuated procyclical relaying to output gap (correlation coefficient between +0.669 in case of TL filter and +0.714 in case of HP filter). However, after 1998 it is countercyclical (correlation coefficient between -0.420 in case of HP filter and -0.836 in case of TR filter), that could mean a favourable temporary situation when a growth in output may be accompanied by a negative change in inflation. Indeed, after the accession to EU this favourable correlation will probably change, as is the standard situation in a consolidated market functioning economy.

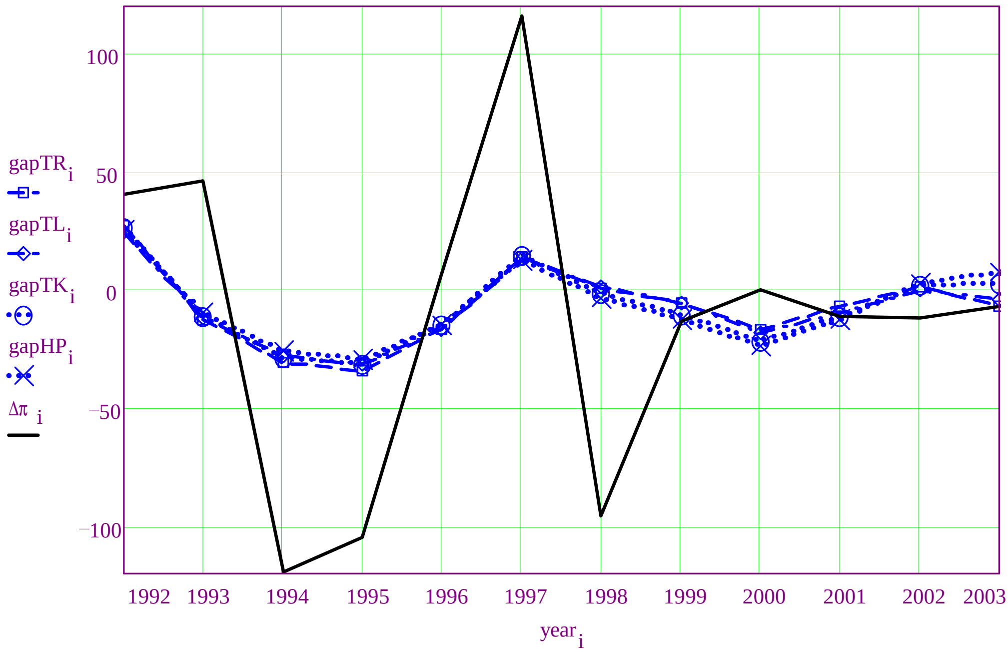

Figure 2.

Related to the past evolution, more explanation could be extracted in case of considering the dynamic process of real reforming and restructuring of the national economy: a prolonged and hesitant restructuring process of economy in first part of transition (before 1998); and a more determinate and accelerated process of it during last years (after 1998).

In order to estimate the level of pure productivity and its trend in case of Romanian economy, we conceived a simple particular model having as hypotheses the following two equations (the time subscript, i, being omitted):

$q = A\, La^{\alpha} = A\, L^{\alpha}\, \mu^{\alpha} = qmax\, \mu^{\alpha}$

$s = s0\, La$

where q and s are production (GDP) and respectively all costs implied by its achievement (taking into account that the production function has an alone factor, so the active labour force); La and L are employment and respectively labour force; qmax and s0 are production under the hypothesis of an integral utilization of labour force (La=L) and unitary cost (indeed including also salary) per person in active labour force, La, respectively; α is a positive and sub-unitary coefficient, which determinates how look the production curve function of employment share, μ, in total labour force, L (μ=La/L). For the moment all considered variables are evaluated in real terms, therefore under the hypothesis of constant prices (of one year selected as base).

The difference between q and s can be interpreted as being the profit or net accumulation, therefore the quantity that stimulates entrepreneurs to make future investments and to develop their affaires. It mainly depends on two factors: employment degree, μ, and respectively coefficient α. Since the evaluation of the employment share in total available labour force is not a problem, to estimate α is an extremely difficult issue, as well as its economic interpretation. Economists generally accept the sub-unitary restriction, as it ensures the concavity of production function. The explanation is: as employment share growths, tending to value one, the average level of labour productivity tends to decrease (as well as the adapting possibilities of entrepreneurs to some permanent moving markets). In order to solve the problem of estimating the production function curvature, we took into account also the long-run price evolution. The hypothesis that we adopted, however very restrictive, is referring to the absence of some pertinent information on the future evolution of prices (as it is the case of an economic system functioning in high inflation, as well as that of Romanian economy in transition period). The remained solution is to compute maximization of the future profit by reporting to actual level of unitary costs (although knowing that in reality this is not the case for the future period). It would be reasonable that even such decision (founded on a highly restrictive hypothesis, like that of basing the maximization of the future profit on maintaining unchanged the specific costs) could yield sweet fruit in the future, in any way larger than in case of no evaluation calculus. The real adjustment to be operated (indeed instantaneously conforming to the "new wave" theory of rational expectations) then when the pressures on cost (such as for instance the trade unions' pressures) will not confirm the effective pre-evaluation. The implicit hypothesis of this "backward dynamics" mode of interpretation is that the effective change of unemployment rate in current period from precedent period corresponds even to the solution of profit maximization under the hypothesis of maintaining unchanged cost between the two consecutive periods, but also to the modification of total price of production exactly at the value effectively registered. So, the actual level of unemployment rate means even its optimal level, however computed previously on the base of total cost in precedent period together with the index of prices in current period. Since we accept this interpretation, the maximization function will be:

$$Be(\mu) = Q - s = q\,p - s$$

WHERE BE IS THE ANTICIPATED PROFIT (DESPITE OF KNOWING THAT THE PLANED BENEFIT WILL NOT BE INTEGRALLY OBTAINED), Q IS VALUE OF PRODUCTION IN CURRENT PRICES, P. THIS FUNCTION ADMITS A MAXIMUM GIVEN BY THE SOLUTION OF THE FOLLOWING EQUATION:

$$p = (\mu^{1-\alpha}) / \alpha$$

THE RESTRICTION IMPOSED BY THIS EQUATION ALLOWED US TO ESTIMATE, ONLY BY USING A SPECIAL NUMERIC PROCEDURE, THE VALUES OF α COEFFICIENT FOR THE PERIOD 1990-2003. THE MODEL PERMITTED TO ESTIMATE ALSO OTHER SYNTHETIC INDICATORS CHARACTERIZING THE EVOLUTION OF THE ROMANIAN ECONOMY DURING THE TRANSITION PERIOD, SUCH AS:

- Coefficient of using capacity (or the degree of using potential GDP, noted here as qmax)

$k = q / qmax = \mu^{\alpha}$

- Share of profit

$b = B / Q = (Q - s\,p) / Q = (q - s) / q = 1 - \mu^{1-\alpha}$

In order to identify the type of relation between unemployment and productivity, we examined the estimated data supplied by the above two models (model of natural rate of unemployment and respectively the “pure” productivity model) together. Many times the authors are using for the productivity growth an inverted scale to reflect better the two supposed inverse movements: the long-run unemployment trend and productivity growth trend. In case of our application on Romanian economy in transition period, we maintained the original scales, but used a calibrating procedure to force the two trends to come in a closer region of their co-joint space. In Figure 3 we are presenting the natural rate trends and the growth rate of “pure” productivity (noted as y_wL90) together. On the graph, time, t, means the years in period 1992-2003, noted as 2…13 (the estimated levels of natural rate are here considered at the beginning of each year). From this graphical representation it is an evident inverse correlation between the estimated natural rate of unemployment and productivity growth. So, we could conclude that, at least in case of transition period, the productivity acceleration is accompanied by a decrease in the natural rate and when the productivity decreases the natural rate increases rapidly.

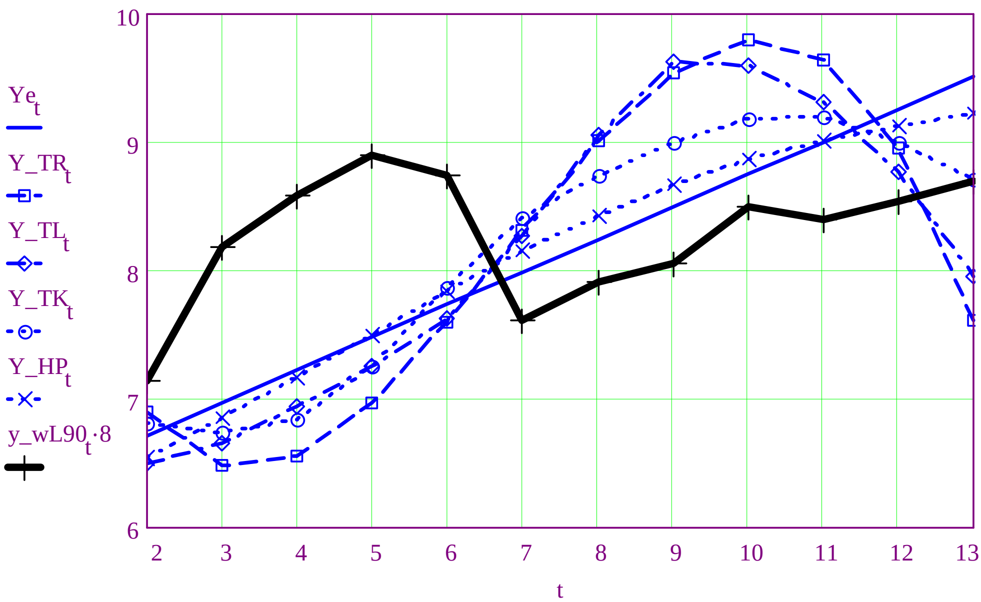

Figure 3.

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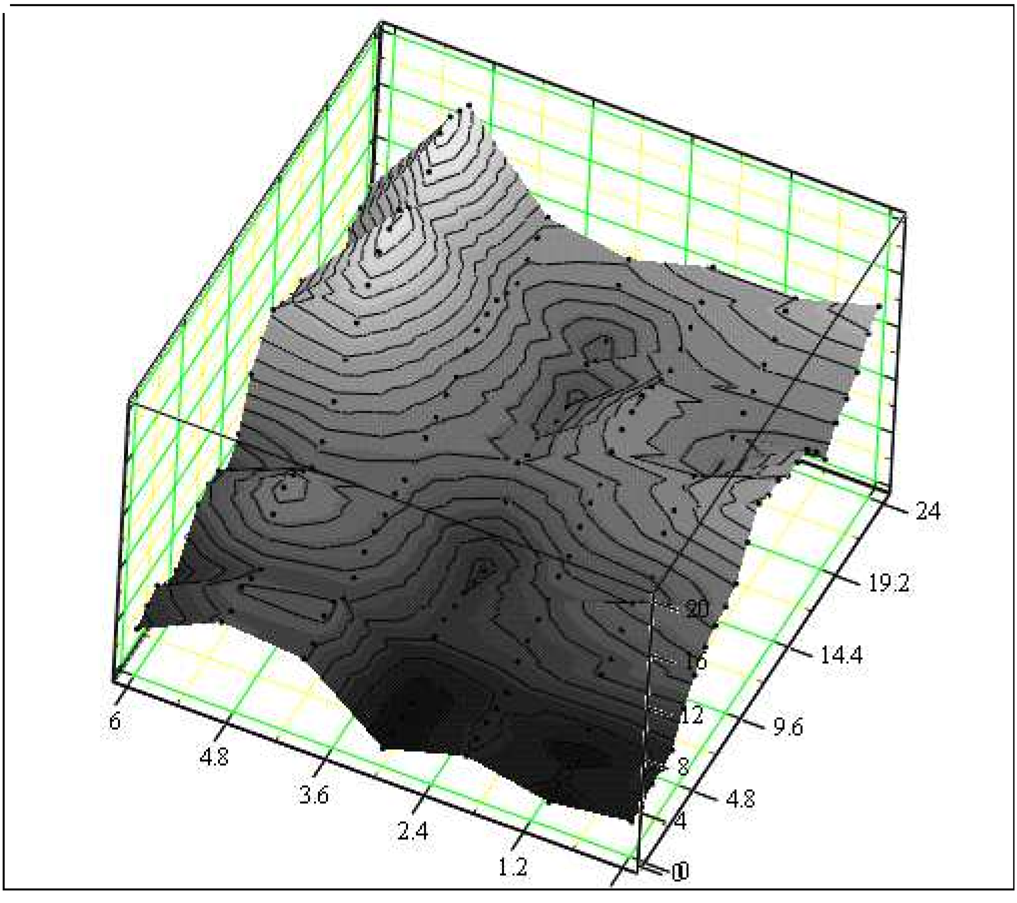
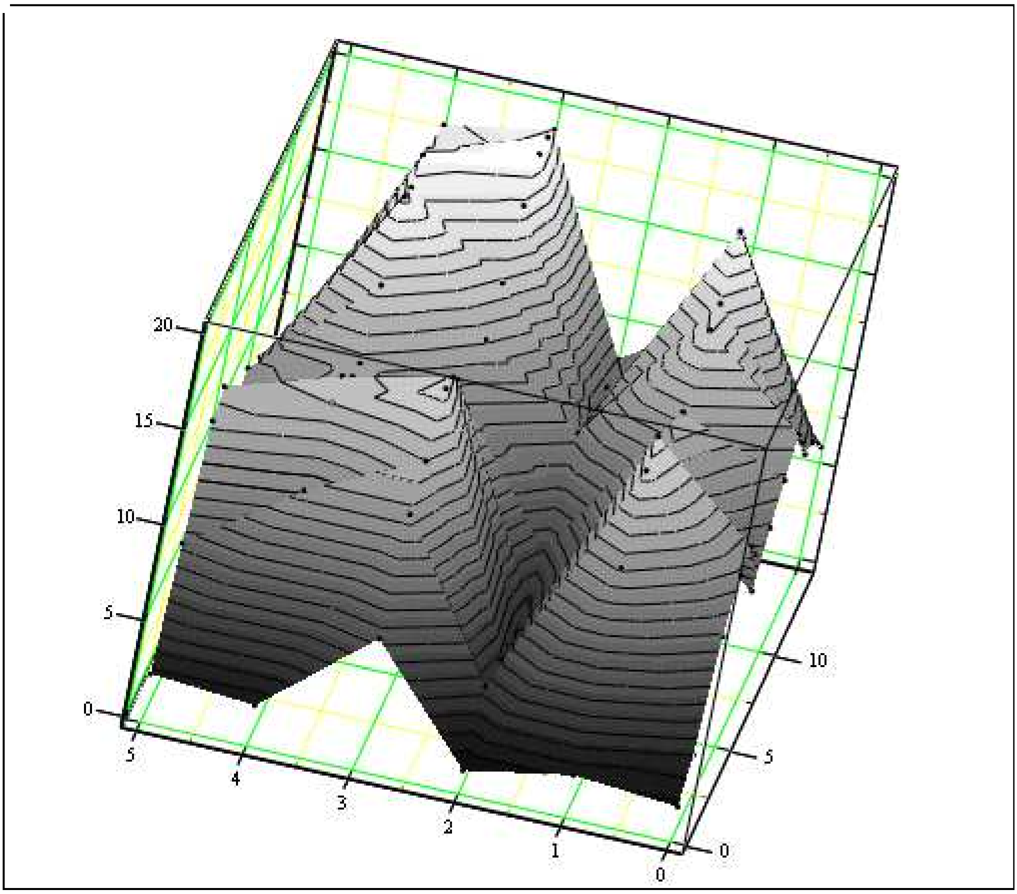
Annex 1



u%, y%, π%

Annex 2



$u\%, y\%, \pi\%$

INTERNATIONAL LABOR MIGRATION: BETWEEN HUMAN RIGHTS AND POLITICAL OBJECTIVES

Radu Mușetescu[*]

Abstract

This paper deals with the relation between the human right to migrate and the objectives of immigration policies. We argue that the temporary work migration is the clearest sign of the failure of political governance in both the host and native states, even if we may argue, to a different degree. The only way to reduce the pressure of immigration in developed countries would be to allow a freer global environment, in trade, industrial and taxation policies.

1. The present situation

Among the core trends that define the contemporary process of globalization is the significant increase in cross border flows of workforce. While in 1990 there were 154 millions of foreign residents on the Globe, in 2000 their number reached 175 millions (that is, approximately 3% of the world population)[1]. The rate of growth in foreign residency surpasses the rate of growth of the world population and the foreign residents are sometimes called, due to their number, “the fifth largest country in the world”. 60% of them live and work in the developed countries, where 5% of the workforce has a foreign passport. United States of America absorbs 80% of the annual flow of individuals who leave developing countries in order to go to work in developed countries while Canada and Australia another 11%.

The amplitude of the process cannot be fully revealed unless we take into consideration the so-called “irregulars”. They are individuals who breach somehow the regime for international movement of persons as they may be illegal immigrants (who illegally cross the borders), legal tourists who take a job (so they are not really tourists), persons with forged documents and so on, comprising another 10-15% of the entire number of foreign residents. In United States of America, their number is conservatively assessed at around 10 millions, in a population of 300 millions[2] while in Western Europe the number of persons with an irregular status is appreciated – also conservatively – at around 4 millions.

As a consequence, we witness a significant trend in the international economy by which an increasing number of individuals choose to work (legally or illegally) in a

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[1] ILO (2004, p. 8); of course, the main motivation of a foreign resident is not always a higher wage but can be also political, security and other factors;

[2] GCIM (2005); other less official sources advance figures between 25-50 millions (maybe in order to determine a more radical political reaction).

foreign country. Such a development may seem to be a true paradox as the contemporary process of globalization also comprises freer global flows of commodities or foreign direct investments. Why aren't the latter sufficient to level the international differences in the price of factors of production and consumer products? Labor, together with land, has been traditionally considered less mobile than capital, information as well as final products and even production activities.

2. The right to migrate and immigration policies

Individuals always attempt to maximize their personal welfare (which others call "*psychic profit*"). Personal welfare can be either material (an individual will always attempt, *ceteris paribus*, to maximize his monetary income) or psychic (an individual will always attempt to satisfy his subjective preferences). As Hoppe points out, „what constitutes welfare and wealth is subjective and one might prefer lower material living standards and a greater distance from certain other people over higher material living standards and a smaller distance"[1].

A person who is born in a mountain village and loves living in such an environment, will not immediately go to work in a big city as soon as he is offered a larger wage. There are subjective considerations, like culture, religion, family, social bonding but also language or the uncertainty of living in a foreign environment that, as a norm, may prevent individuals from attempting to "always" choose the highest monetary income. We do not exclude the real possibility that working and living in a different community may represent by themselves personal preferences and certain individuals are even ready to incur different types of costs (monetary as well as psychic) in order to reach that goal. As a consequence, an individual may be willing to leave his large hometown and go to live and work in a small mountain village, where he may earn a smaller monetary income, just because he values more the fresh air, quietness and social bonding of such a community.

Human beings seem to prefer, as a norm, to accomplish their lives in a community they feel they belong, with similar cultural, ethical (including political) and consumer values[2]. There may also be significant exceptions. An European may discover that he feels closer to the values and customs of an Indian-Hindu community. In a world without frontiers, such an individual will leave his native community in order to live in a new environment. The fundamental issue is that any person who changes his location must observe the property rights of the others. As long as he does not become an aggressor, his liberty of movement is natural and is the purest manifestation of his own property rights. In a contemporary international context, „as long as the immigrant moves to a piece of

[1] Hoppe (1998, p. 224).

[2] Internet and the proliferation of new communcations technologies, which also define the contemporary globalization, may also change the identity of the people and their feeling of belonging. Other factors than ethnicity, language or local community may define these new dimenssion of identity, like ethical values, political values, entertainment and (neo)cultural value, and so on. Thse change of identity may become, even in a world without differences in income, a strong incentive of migration.

private property whose owner is willing to take him in (maybe for a fee), there can be nothing untoward towards such a transaction ... there is no freedom of movement of the person per se. This is always subject to the willingness of property owners in the host nation to accept the immigrant onto their land”[1].

In fact, the right to migrate is only, on a free market, a right to transact as long as any “immigrant” must rent or buy property (generally speaking, land) from the owners in the community of destination. There is not such a right as the right to a have a car unless the individual who desires a car has the money to pay for that product[2]. The real right to migrate is nothing but the right to freely exercise the property rights. As Rothbard points out, “the current immigration barriers restrict, not so much a „human right” to immigrate, but the right of property owners to rent or sell property to immigrants”[3].

We reach a vivid debate in the contemporary social sciences and public policy regarding the correct immigration policy a state should adopt. On the one hand, there are free immigration policies where the state allows anyone to enter the country. On the other hand, there are restricted immigration policies where the state forbids any foreign individual to enter the country. The most cited example of free immigration policy is the XIXth century USA while the best example of restricted immigration policy is present day Switzerland. We should however realize that two forms have never existed in their purest forms (or just for very short periods of time). In the case of XIXth century USA, there existed barriers in the path of Chinese immigration[4], for example.

The correct answer to this debate, from the perspective of private property rights, is offered by Hoppe: „immigration, to be free in the same sense as trade is free, must be invited immigration”[5]. Suppose that an American entrepreneur decides to invite on his property (in USA) and hire 1000 Mexican workers. The guest workers will live and work on his property and will in no way aggress against the property rights of other Americans. A political system that protects the property rights and the free exercise of these rights cannot oppose such a “migration” without infringing the rights of the American entrepreneur.

Moreover, „if the government excludes a person while there exist a domestic resident who wants to admit this very person onto his property, the result is forced exclusion; if the government admits a person while there exists no domestic resident who wants to have this person on his property, the result is forced integration”[6]. As a consequence, restrictive immigration policies not only aggress against the property rights of the immigrants (who are prevented from buying or renting land in destination countries) but

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[1] Block (1998, p. 173).

[2] Rothbard concludes that, in fact, the human rights are property rights. A human right should not impose a burden on others who are forced to pay for ***my*** right.

[3] Rothbard (1962, p. 550).

[4] West (1982, p. 38). Because of the fear that the Chinese would become a majority, the political elite banned from 1882 the immigration of Chinese (for 60 years). The same political debate was centered around the immigration of Italian Catholics at the beginning of the XXth century. The principle behind such an approach was to not let a particular ethnicity to dominate in the immigration flows.

[5] Hoppe (1998).

[6] Hoppe (1998, p. 230).

also of some of the citizens of the host countries (who are prevented from selling and leasing their property).

3. Public goods and immigration

In a society where all the resources (more specifically, land) are in private hands (private property), migration cannot occur unless the immigrants have the consent of the owners of the land. Otherwise, it is an outright invasion and aggression of property rights and the owners have the right to defend the integrity of their property.

In the case of contemporary societies, a large part of the resources (and especially land – infrastructure, government facilities like asylums) are however public property of the state. They are both “private” property of the state (as an economic actor), public goods and so on. Public goods are those goods that the state qualifies them as not being scarce so it prevents the act of homesteading[1]. In such a situation, no individual who uses the resource can become the owner so he has the same rights on the good as any other individual in the society. „Hand in hand with the institution of a government comes the institution of public property and goods, that is, of property and goods owned collectively by all domestic residents and controlled and administered by the government”[2].

Such a situation creates a huge challenge when the government adopts, for example, a totally free immigration policy. Any individual on this world will have the same right to walk the street as the owners of nearby houses who walk it every day. These owners do not have the right to prevent a foreigner from walking, sleeping or working on that street. As long as in a society there are public goods and public property, the immigrants can cross the border uninvited by the citizens of the communities of destination.

As Rothbard concludes, „the private ownership of all streets (that is, public goods) would resolve the problem of the „human right” of freedom of immigration”[3]. Moreover, Hoppe notices that one of the reasons to immigrate is, from a broader perspective, the social welfare policies of the host nations (social security being qualified as a public good by authorities). Due to the redistributionism in the developed countries, certain individuals from less developed areas are motivated to immigrate only to benefit at least from a part of such redistributionism. Foreigners who illegally entered Germany at the beginning of the nineties were receiving more money as asylum seekers from the German government than the average wage in their home countries.

Edwin G. West[4] makes an interesting parallel between a human society and a joint stock company. That is, “suppose that five Scotsmen buy an island and incorporate it in a joint company in which each of them is allocated an equal share … these five shareholders will have the power to exclude any outsiders from entering their island and from participating in the jointly owned property … the terms of the agreement can

[1] Homesteading is the act through which individuals who first use an un-owned resource (that is, a general condition of the environment or an abandoned resource) are recognized as their owners.

[2] Hoppe (1998, p. 230).

[3] Rothbard (1962, p. 550).

[4] West (1982, p. 40 and following);

include provisions to allow others to purchase entry into the corporation. Among these provisions would be the stipulation of the required majority to approve transferability of shares". Even if this scholar agrees that the parallel between public governments and private companies are forced, he misses the real difference. While joint ownership allows the liberty to exclude because it is still private property, the government does not allow such liberty as the public property is something different. First of all, public goods do not allow the citizens to directly exclude foreigners as such exclusion would mean embordering and homesteading of the public goods. The exclusion may be made only by the government itself which is elected (let's simplify) by the majority of citizens of a country. But why should the citizens in a different town have a saying in issues that matter for a particular town? The majority rule is usually in conflict with the private property as the owner of a resource is always in minority with those interested in the use of his resources. The scenario in which the majority of the members of a community vote to allow an individual member of the community to invite foreigners (to work, live or marry) is as aggressive as the scenario of total restriction.

In consequence, the problem of non-invited migration will endure as long as there is any public property. While the state may have the ability to defend "its" property and prevent the foreigners from entering it, it also does have different political objectives. In fact, the contradicting political objectives of the states prevent them from adopting a coherent approach in the immigration policies.

4. Geographically differences in labor prices

Differences in monetary incomes among geographically distinct labor markets are always natural. They reveal the local balance between supply and demand for a specific type of labor service as labor markets – like any other type of market – also know the core market mechanism. When differences in geographical prices for labor services become significant, we may witness the start of a flow of workforce.

To be sure, not any small difference between two geographic labor markets is in fact sufficient to determine individuals to leave their native community in order to work in the better rewarding community. The labor is among the stickiest factors of production – as compared with capital (in its monetary and even capital goods forms) so the arbitrage among geographic labor markets is not the norm on a free market. Ludwig von Mises calls this subjective (non-monetary) factors the "attachment component": "We may call the maximum difference between the market rate and the standard rate which does not yet result in the migration of workers from the places of lower market wage rates to those of higher market wage rates the attachment component"[1].

Political institutions play however the essential role on the international labor markets. They are the main factors that explain why there are huge differences between geographic labor markets in the contemporary international economy, both as a source of origin but also as a barrier against arbitrage.

On a free market, significant differences in geographically distinct labor markets are not however the norm. The market process is continuously and incrementally adjusting to the natural dynamic of the economy. Exceptional events may disrupt even this natural

[1] Mises (http://www.mises.org/humanaction/chap21sec9.asp).

adjustment. The discovery of gold in the mountain village and the opportunity of earning significantly higher incomes may disrupt the labor markets both in the village and in the big city in the proximity. Entrepreneurs who discovered the gold will bid the price of the workforce until they succeed in getting the gold on the market.

Despite the possibility of such exceptional events, huge differences in prices between close geographic markets are not lasting as the cultural, language or other types of "soft" barriers will be overcome by the desire of individuals to increase their monetary income. Today world is anything but a free market. Political institutions – through positive law and aggressive action – have always interphered with the natural mechanisms of the market and created and maintained huge differences which couldn't be arbitraged because of state barriers.

5. International trade, foreign direct investments and capital intensive technologies: alternatives to arbitrate between international differences in labor prices

A huge difference of prosperity like the one between northern Mexico and southern United States (across Rio Grande) cannot be the outcome of a free market. Centuries of separate and antithetic political evolution and development of local institutions have given birth and widened huge price differentials, both in product markets but also on the labour market.

Such price differentials can generate different types of entrepreneurial action:

1. Mexican entrepreneurs will start exporting labour-intensive products across the frontier in USA (arbitrage through the product market);
2. American entrepreneurs will start businesses in Mexico in order to export back into USA such labour intensive products (arbitrage through the location of the production assets);
3. American entrepreneurs will research and develop capital intensive technologies that can balance the more expensive workforce (arbitrage through the technology ideas);
4. Mexican workforce will start to migrate into USA in order to offer its cheaper services to the American entrepreneurs (arbitrage through the labour market).

All of these scenarios were confirmed. Through the creation of NAFTA (entered into force on 1st January 1994), products can freely cross the border between the two states. Meanwhile, American investments (especially in northern part of Mexico – the so-called *macquiladoras*) have attempted to access directly in Mexico the cheap workforce. As Hoppe points, „the relationship between trade and migration is one of elastic substituibility (rather than rigid exclusivity): the more (or less) you have of one, the less (or more) you need of the other. Other things being equal, businesses move to low wage areas, and labor moves to high wage areas, thus effecting a tendency towards equalization of wage rates (for the same kind of labor) as well as the optimal localization of capital"[1].

The dilemma is why the first three types of actions have not resulted in a strong trend towards equalization in the price of the workforce. As the market process is free to operate, the prices (goods but also workforce) will also tend to equalize. That is, more

[1] Hoppe (1998, p. 224)

Mexican and American entrepreneurs will start businesses in Mexico in order to export on the US market, higher their demand for workforce and the price they pay for its services. As American entrepreneurs go into Mexico in order to produce for the American market, less demand for American workforce in USA and lower its price on the labour market.

The present day situation is however characterized by an amazingly strong flow of workforce from Mexico into USA which seems not to be disturbed by the existence of the free trade zone or the *macquiladoras* system. The inability of the products or capital goods market to generate a more significant equalization in prices means that other types of profound barriers prevent such a dynamic. The inner political institutions of the two states seem to operate in such a manner that they determine on a permanent basis the effect of income inequalization. The core differences cannot be but in the field of private property enforcement: the market incentives can operate only in the case that the basis of exchange, which are property rights, can be exercised. The fact that, despite strong incentives to move into a direction, the prices refuse to move is a consequence of a wrong regime of property rights.

Besides this factor, other elements may operate:

- taxation: a higher taxation in Mexico means that the increase in income of Mexican entrepreneurs and workforce will be wiped out by fiscal authorities;

- redistributionist policies: a large chunk of the increase in income of the Mexican entrepreneurs and workforce will be redistributed through different mechanisms – mainly the same taxation but also other ways – to the population not involved in such productive activities) and so on;

- the two mechanisms couldn't exhaust the supply of labour on the Mexican market and the additional supply pressures the wages downwards.

Several sociologists have noticed the challenges that such a workforce flow determines in the American society, especially in the South Western states. Samuel Huntington was widely criticized for his article "The Hispanic Challenge"[1] in which he noticed that the south west of United States is no longer similar with the rest of the country. He does not hesitate to cite Mexican writers who call it "Amexica" or "Mexifornia". According to Huntington, such a flow of population will change the fabric of the American society as the traditional "melting pot"[2] seems to no longer function.

The alarmist signals of American political scientists however may point in the wrong direction. The initial factor that generated the huge Hispanic workforce inflow into USA was in fact the decision of American authorities to invite between 1942 and 1966, through a guest-workers program called Bracero, a large number of Mexicans (estimated around 4 millions) as agricultural workers. Such an initiative cannot be clearly qualified as a step in the right or in the wrong direction. It clearly allows certain individuals to have a choice and obtain higher incomes in USA but because it is a controlled workflow, the equalization in the labour market cannot be accomplished. In fact, such a political project

[1] Huntington (2004, p. 30).

[2] The concept of „melting pot" signifies the fact that when immigrants join a foreign community, they will abandon their former identity and totally adhere to the culture, values and customs of the new community they belong to.

cannot reveal but failure of governance of the two countries.

From the part of Mexico, the core reason is easily to detect: the need to reduce the social pressures on the internal labour market. High unemployment and slow growth may be the fundamental factors that pressured the Mexican government in this direction. In a certain sense, we may also speculate that Ciudad de Mexico anticipated the later developments and the demographic expansion of Mexicans into South Western USA.

From the part of United States, the main motivation is also easy to understand. Such a program cannot be but the result of the desire to artificially maintain certain sectors competitive by supplying them cheap labour. That is, this above mentioned program allowed the southern-western states an improvement – albeit artificial – in the cost structure of agricultural production. That is, such a program allowed the American agricultural producers from the south to be competitive towards Third World competitors on the national – and maybe international markets. The interesting thing is that the program may have dramatically reduced even Mexican agricultural exports into USA because they lost their labour cost advantage and maybe even the quality of the labour services (as some argue that the best agricultural workforce used the opportunity of the Bracero program). We may also imagine the motivation that all these guest workers spread a positive image about the prosperity in USA and fight the left wing policies in Latin America.

The case of Mexico and USA is just the most manifest discrepancy of development and income in close geographic markets. However, the situation is by all means the same all over the world. Western Europe and Eastern Europe know the same income differentials, similar borders with the Mexican – American one being, from this point of view, the Greek – Bulgarian or the German - Polish. The European Union knows a similar situation than United States of America. Its Mexicans are the Eastern Europeans and North Africans.

All these situations around the world reveal the same failures in political governances of both the home countries and the visited countries. Even if the term slave isn't, for sure, the proper one (the individual who make the choice has the liberty not to go to work abroad), it is purely and simply a political bargain that offers political benefits to both states. Such a bargain allows both governances to continue with the status quo and avoid troubling political and economic reforms. As ILO reports argue, "there would appear to be an emerging convergence of interests between richer and poorer countries. In simple terms, the former are running short of working-age people, while the latter have such people to spare"[1]. The normal consequence of such a demographic development would be a change in the nature of technology used in these socities. In a developped country where the natality is reducing and labor become scarce, businesses should adopt more capital intensive technologies and less labor intensive technologies. They should allow, finally, the free relocation of labor intensive production in low income countries. However, such a change is more difficult and more expensive than importing cheap labor.

[1] GCIM (2005, p. 24).

Conclusions

In today world economy, we may state that when products and investments do not freely cross the border, the workforce will. The temporary work migration is the clearest sign of the failure of political governance in both the host and native states, even if we may argue, to a different degree. Such a trend however determines strong challenges that may alter demographic and political communities and have long-term effects. Today world may witness, in a larger extent than in the past, the emergence of “societies inside societies”. The traditional “melting pot” seems to no longer operate. Because of communication technology or maybe deeper political factors, today immigrants are no longer integrating into the host societies.

As Hoppe concludes, „insofar as the US engaged in protectionist policies against the products of low-wage area and in welfare policies at home, immigration pressure would be kept high or even raised”[1]. Such a conclusion confirms that the only way to reduce the pressure of immigration in developed countries would be to allow a freer global environment, in trade, industrial and taxation policies. In a world with increasing differences in incomes, such a prospect is not very close. And the fabric of Occidental societies will change as a result of the amplitude of foreign migration as well as the failure to integrate these individuals into the societies. Labor migration penalizes failures in governance in all the countries in the world.

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ARE ECONOMIC IDEAS A SUSTAINABLE COMMONS? A STUDY OF THE EXCHANGE OF CREATIVE ECONOMICS

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Abstract

In this essay I claim that productive markets need not necessarily involve clearly defined and enforced property rights, upon which a price system can be used to allocate resources. I shall pursue this thought by an examination of the mechanisms that facilitate the exchange of economic ideas, and link academic norms to the emerging theoretical justification for open source software, and "free culture".

I. Introduction

"Along with a sense of awe and gratitude for the good fortune of having received this remarkable gift from the past, we shall do well to maintain a sobering awareness of the extent to which our future welfare has come to depend upon the continued smooth workings of an intricate, imperfectly understood piece of social machinery – one that need have no adequate capabilities for self-repair, but readily may be damaged by careless interventions."

David, P, 2001, p10

In this essay I claim that productive markets need not necessarily involve clearly defined and enforced property rights, upon which a price system can be used to allocate resources. I shall pursue this thought by an examination of the mechanisms that facilitate the exchange of economic ideas, and link academic norms to the emerging theoretical justification for open source software, and "free culture".

The chain of logic will be that a relaxation ofc property law in the realm of culture would be efficient. I then offer evidence to suggest that journals are governed by the same *"ethos and norms of disclosure"* (David, 2001) as the movement behind free culture.

It is important to state that I will confine my study to the field of economics, and to analyze it *given* the institutional framework in which academic discourse resides. Alternative subjects may charge authors to submit articles – as in the case of Biology – and this might be more efficient than a system of free submissions. Indeed any efficiency within economics might not be genuine, and merely appears so due to lavish governmental subsidy of higher education. Such questions are important, but beyond the scope of this initial paper. Only once the exchange of economic ideas is better understood, can a comparative study be possible.

Part II will look beyond the ideology of open source software and suggest that it is

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comparable to economic property. By looking at the history of "open science" however, it still remains closer to communal than many economists might believe to be efficient.

Part III will explore the free culture movement by looking at the licenses that move property rights from "all rights reserved" to "some rights reserved". The Creative Commons and GNU license will be delved into. I will claim that this development is a classic solution to Hobbesian anarchy, and an attempt to voluntarily contract away from predation/ protection to enable production.

Part IV will analyze the primary means to exchange economic ideas: journals. I will claim that the principal determinant of a competitive industry is contestability, and trace a history of journal emergence to gage how responsive the market is to changing conditions. Apart from the barriers to entry I will also look at refereeing as a medium of exchange absent of pricing, and suggest reasons for its ability to contribute to the quality of articles.

Part V will look at branding in academia, given the crucial role of reputation as a

substitute for pricing. In this light, much "pedantic" squabbling over terminology can be better understood.

Part VI acknowledges the opportunity for economist's to earn vast sums *per article* in non-academic exchange. I will make a distinction between "articulation" and "creation" of economic ideas and suggest that economist's can earn income from complementary, traditional exchange mechanisms.

Part VII concludes.

II. Open Science and Open Source

Open Science can be traced to relatively recent changes in the institutional structure that supports the quest for frontiers of scientific enquiry. It displaced a practice of secrecy where competing researchers attempted to hide, and internalize, their findings. The movement toward a Republic of Science[1] in the c16th and c17th:

"should be seen as a distinctive and vital aspect of the Scientific Revolution, from which there crystallized a new set of social conventions, incentive structures, and institutional mechanisms that reinforced scientific researchers' commitments to rapid disclosure and wider dissemination of their new discoveries and inventions."

David, P, 2001, p3

Open Science has an undeniably communal ethos, with the belief that the method of acquiring knowledge is a social process, a conversation characterized by universalism.

Universalism has two components. Firstly, that it must be open to entry and socially accessible; establishing the mechanism of reputations. "*The norm of 'openness' is 'incentive combatable' with a collegiate reputational reward system based upon accepted claims to priority"*[2] and offers reason to willingly disperse knowledge. The other component of universalism is full disclosure of methods, so that replication and

[1] See Merton (1973).
[2] David (2001, p.4).

verification is possible[1]. Notice the similarities to the open source coding: freedom to tinker and emphasis on reproduction. In spite of the rhetoric, however, there are reasons to believe that free and open source software, and Open Science itself is closer to a private property system than is assumed. Tellingly, the Open Source Initiative says:

"We think the economic self-interest arguments for open source are strong enough that nobody needs to go on any moral crusades about it"

Open Source Initiative[2]

This suggests that much "communal" rhetoric can obscure the economic functioning of the market. Precisely this study was attempted by Chiao where he advocates a distinction between legal and economic ownership:

"the exclusive right, recognized by the community at large, to re-distribute modified versions of that software … is not inconsistent with the Alchian-Cheung general definition of property rights"

Chiao, 2003

This insight can be used to explore the transition of the Chinese economy, and view it as an increasingly market based system with communist rhetoric. One way in which free and open source software can be considered private property is the release of source code, and the retaining of trade secrets. Whilst a scientist publishes methods of research there will always be elements that can remain privately known, be they actual methods or mere peculiarities of personal style. Even these can be open to scrutiny[3], and the point is to align Open Science to the Open Source methodology. Even with a full list of references and disclosure of theory, an author has an income extraction right with regard to technique. Whilst the explicit overtones overemphasize the communal nature of both, neither are traditional markets. My claim is that there are two parties, both of which are misinformed:

- Ideological collectivists, who fail to appreciate the source of efficiency is substitute mechanisms for traditional exchange
- Ideological individualists, who fail to notice the informal communal nature of scientific Enquiry

III. Free Culture

The consequences of the Internet's triumphant ubiquity are immense. Perhaps the biggest impact of the digital age has been with regard to property law: low cost replications of files, and the ability to exchange them between computers explode the instances of copyright violation. A debate on intellectual property (IP) rages, and poses an

[1] See McClosky (1997)

[2] Open Source Inititative, Frequently Asked Questions, 2002, http://www.opensource.org/advocacy/faq.php, visited November 28th 2004

[3] Posner has written about Coase, and Tollison about Buchanan. T. Clark Durant informs me that Adam Smith would habitually walk many miles a day to clear his head.

interesting dilemma by forcing people to choose between freedom and property. Usually property is seen as the foundation upon which freedom exists, and that the two are complements. Sometimes, however, they can conflict. It is a common mistake to associate “free” with “zero cost”, and we do no such thing here. “Free Culture” is equivalent to “free trade” or “freedom” implying above all liberty and rights. In his book ‘Free Culture[1]’ Lawrence Lessig opens with the case of the Causbys; North Carolina farmers. They made a legal challenge against government aircraft trespassing on their “land”, since American law held that a property right extended to “an indefinite extent, upwards[2]”. The verdict was:

“[The] doctrine has no place in the modern world. The air is a public highway, as Congress has declared. Were that not true, every transcontinental flight would subject the operator to countless trespass suits. Common sense revolts at the idea. To recognize such private claims to airspace would clog these highways, seriously interfere with their control and development in the public interest, and transfer into private ownership that to which only the public has a just claim”

United States vs Causby, U.S. 328,1946, 256,261

Lessig acknowledges the valid property claim regarding a decrease in property value for being in a flight path, but the point is that just as aircrafts had done before, the Internet is forcing a radical update of property law. Previously a copyright meant, “All rights reserved”, meaning that permission must be acquired prior to use. The Creative Commons[3] is a “some rights reserved” license where permission is implied. A contributor will choose a license based on the following criteria:

- Attribution
- Commercial use
- Modifications

The difficulty of implementing a new legal structure is the special interests of those who’s property is under threat. A Free Culture is a classic example of an attempt to write a Constitutional contract to step out of a Hobbesian anarchy[4]. The extent of litigation for IP infringement, and the unseen reductions in production demonstrate a predation/protection system. Of course the problem in achieving voluntary contracting is that there is no Veil of Ignorance: the players know precisely what they stand to lose.

“Copyright may be property, but like all property, it is also a form of regulation. It is a regulation that benefits some and harms others. When done right, it benefits creators and harms leeches. When done wrong, it is the regulation the powerful use to defeat competitors”

Lessig, 2004, p194

A solution will not be easy, but the relevance to academia, and the exchange of

[1] The catalyst for the Free Culture movement
[2] See Lessig (2004, Introduction)
[3] http://www.creativecommons.org
[4] See Buchanan (1975)

economic ideas relates to the emergence of the Free Culture movement, and the Internet generally. Academics were instrumental in the early creation and expanse of the Internet, and there's evidence to suggest that the norms of journal debate is the driving force behind the attack on copyright. HTML links are conceptually identical to citations, and both academics and "bloggers" are habitually governed into giving credit to other sources in the belief that doing so strengthens the system.

It is my belief that the Free Culture movement, and the Creative Commons license is introducing the norms and structure of academic discourse to culture at large. When writing a paper the permission to cite a past paper is implied: you do not have to track down each individual author. This is acceptable because it won't be used for commercial gain, and/or the end product will be a sufficiently unique derivation.

In a critique of the Open Source movement Richard Epstein centers his argument on the lack of a capital structure[1]. Indeed a commons will collapse when individuals realize that they cannot withdraw their productive value, but non-rivalry is the fundamental characteristic of software. The commune is no poorer from the withdrawal of the harvest. Indeed currently there is no shortage of bandwidth, so the lighthouse harbor is expandable. Demsetz may have the last laugh, and pricing per download may alter the institutional structure of Open Source software however my analysis remains firmly in the now. Besides, as Part V. will demonstrate the lack of clear property rights does not obstruct the development of capital structure.

Economists have the same incentives to contribute to economic knowledge as software developers have to create open-source programs, and the medium to do so is journals.

IV. The Mechanism of Exchange: Journals

a. Historical Perspective[2]

In the 17th and 18th Century political science was articulated via privately produced books and pamphlets[3]. The first journals, *Journal des Savants* and *Philosophical Transactions of the Royal Society* emerged in response to the abundance of thought. They did not print original essays, rather reviewed and filtered those that existed. The first journal that we would recognize was the *Encyclopedia*: it was theoretical, bound, regular, subscribed to, and offered little private pecuniary gain to the originator. The social conditions of the time played an important role in the feasibility of this journal. The enlightenment changed the nature of demand for academic thought, as educated scholars engaged in debate, and the middle classes sought to better themselves.

In the early 19th century the specialized journals for economics seems to disappear. I'm not sure why. Smith, Ricardo and Say wrote books, and there was a return to pamphlets. This precipitated the rise of the newspaper/magazines such as The Economist,

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[1] See Epstein (2004).

[2] This chronology of Journals has been heavily influenced by The Newschool, http://homepage.newschool.edu/het/

[3] Whether journals were privately or publicly produced is an interesting but irrelevant diversion to my study. I am more concerned with the actual exchange mechanism.

who spoke of economics affairs, but in a highly relevant manner.

The rise of the modern journal can be attributed to the explosion of universities and their quest for reputation. Johns Hopkins, Chicago, MIT and the LSE needed means to demonstrate their worthiness, and an in-house journal was an essential tool of controlled self-promotion. Having changed the landscape of the debate, Cambridge and Harvard were forced to respond and engage. Also, this period saw a fundamental attack on the credibility of "economics" as a discipline. The *Quarterly Journal of Economics* was launched by Harvard in 1886, in 1890 Chicago introduced *The Journal of Political Economy*, a year later the Royal Economic Society was founded who would create the *Economic Journal* and 1911 saw the American Economic Association, the controllers of the *American Economic Review*.

Going back to the origin of Open Science, intellectuals received patronage from ruling families because:

"It was very much in the interest of a patron for the reputations of those he patronized to be enhanced in this way, for their fame augmented his own"

David, 2001, p.6

Indeed there's a mutual enhancement of reputation in the relationship between scholar and institution, and creating a journal is means to bolster the reputation of faculty, and in doing so, the university as a whole.

The point was to promote their own institution, and Editors were highly selective in achieving that end. They were the voice of the institution, and intended to outperform their rivals. They were promoting their own brand, but the "market" was competitive. It was competitive, because it was contestable.

The LSE created *Economica* as a means to challenge Cambridge orthodoxy, and

the classic institutional confrontation found battleground in the journals. Keynes' revival of the *EJ* fortunes was a direct result of his arguments with Hayek, and then the Stockholm challenge. Other countries entered the market for ideas, and journals erupted in research institutes and indeed banks. *Econometrica* was entered as a vent for economists who wanted to publish more mathematical models and soon most institutions had an in house journal.

Laband and Piette found that from 1970-1990 membership of the American Economic Association rose by 14%, but the amount of articles written increased by 23% and there was a 50% rise in published pages. From 1976-85 an additional 51% of journals had entered the market; and these figures corresponded to Lovell's survey from 1850-1969. They say:

"It seems clear that market entry must be responsible for a substantial proportion of the noted growth in citations"

Laband and Piette,1994, p652-53

Contestability remained. Specialization meant a continuing flow of new journals for several reasons. The economics profession itself was expanding, increasing the supply of papers[1]. Where professional prestige is related to publications, activity increased. Commercial houses were happy to back new entrants, because university libraries were insatiable consumers. Ever more heterodox journals were created, and as means to filter the bountiful crop, survey journals such as the *Journal of Economic Perspectives* were formed.

Modern journals are now electronic, for example the Electronic Society for Social Sciences[2] offer a journal 50% cheaper than most, and Econ Journal Watch[3] further supports the contestability claim and shows journals to be imaginative and responsive. The market seems to be contestable, but it's efficiency depends on the process of publication.

b. Editing and Refereeing

Hammermesh[4] found that referees are heavily cited and at the peak of their careers. Editors choose to use the top people in their specialty, and those whom they have access to. Apart from when the submission comes from an elite author, there's no correlation between the citations of the author and referee. In other words, referees are not assigned to authors of similar quality. Hammermesh catalogues referees into three groups: a "doer" offers quick feedback; a "refuser" declines the invitation but does so promptly, and a "loser" who hangs on to a paper drastically slowing the review process. 5% of delinquent referees accounted for half of the 10% of articles that are held up for ten months or more. Consequently, a slow response from a referee will be either down to the bad luck of getting a "loser", or the better fortune of reaching an experienced scholar where the delay is offset by valuable feedback. Also, since the better journals will use better referees, an article submitted to a higher ranked journal will end up being a better paper.

Overall, 50% of refereed feedback is received within 6 weeks, and 75% within 10. Much of the perceived inefficiency in the system stems not from the refereeing stage, therefore, but the publishing stage. Many journals operate on a quarterly schedule, and Marshall[5] found that there's a 3 month lag after all Editorial work is finished.

Aside from acting as gatekeepers it is important to note the middleman role of journal editors. Because economic ideas *are* such a commons, a credibility issue arises. Such vast circulations of ideas call for some institutional means to sort, and signal the appropriate ones requiring attention. With the advent of blogging, we can expect to see similar measures emerge to mimic journal editors. When opinion has such a low cost to share, those with rich things to say have an incentive to devise significantly high barriers, and form the networks that signal academic inclusion. Networks not only provide warranty against academic deceit, they offer positive returns to editors that use them to "capture" good articles[6]. Such evidence is contrary to an "old boys" story. It is also important to note the facility journals provide emerging fields.

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[1] Lovell (1973) calculated output to double every 14 years
[2] http://www.elsss.org.uk/.
[3] http://www.econjournalwatch.org/main/index.php.
[4] Hammermesh (1994).
[5] Marshall (1959).
[6] See Laband, D and Piette, M. (1994).

"An important ingredient in the success of law and economics research has come from the establishment of specialized journals"

Parisi[1]

That said, marginalization might stifle the creative flow of ideas necessary to nourish a field. Anecdotal evidence suggest that Vernon Smith was reluctant to establish a dedicated journal to experimental economics, and much criticism of the modern Austrian School stems from the confines of their influence. My point is that the market is ripe for entrepreneurial manipulation.

c. Suggestions

Hammermesh suggests a bribe to referees to speed up responses, but accepts that when tried they've had little impact on "losers", the main source of delay. Zetland[2] goes further, and proposes an auction market for journal articles. He acknowledges that for-profit publishing has had little impact thus far, and constructs a system where articles are bid for, and *citations* receive income. He wishes to better compensate the Shoulders of Giants.

I believe most of the suggestions for improvement are instigated by an assumption that a pricing system is more efficient than the current institutional structure. I am less convinced, and believe there's real evidence to suggest that the journal market is efficient as it is. Specifically, the greatest lag in bringing articles to market concerns publishing constraints. Since academia is already so well intertwined with the Internet, scholars should embrace the open content approach to generating knowledge. The journal market has proved to be very adaptable, and as researchers move away from hard copies toward digital content further change is needed. Economist's have always exchanged papers with a relaxed "some rights reserved" license, and have a significantly lower transitional gains trap compared to culture at large. J-Stors worth is not so much in its property right, rather it's central administration that facilitates search. Before a paper is distributed, however, some degree of sorting will need to take place. And there can be no mistake that the forces that have ensured the dominance of leading journals can survive in an institution of even freer exchange, and reputation mechanisms are the crucial reason why.

V. Branding and other reputation effects

One of the principle reasons for the success of the *Journal of Economic Perspectives* was the fact that the *"AEA puts its credibility and reputational capital on the line with a new journal. This serves as an implicit guarantee of product quality."*[3] Not only is reputation the driving factor behind the rise and fall of journals, but no economist works in anonymity. Recognition is crucial, since the proxy for "impact" is citations. Whilst institutions are a signal about a scholars credentials, his surname carriers the weight of his reputation. The alphabetical arrangement of references is not by chance, and reflects the

[1] source currently unknown

[2] Zetland (2004).

[3] Laband, D and Piette, M (1994, p. 653).

categorization of authors. Reputations demonstrate that there is a capital structure to economic ideas, and it can be increased by writing heavily cited articles in respected journals, or diminished by distributing it too thinly across low impact co-authorships. The economist will optimize his portfolio by choosing a combination of sole-authorship "impact" papers and investing in the capital of students by writing jointly.

A means to earn high returns on reputational capital would be to create a theory that bears your name, and then even though you receive no pecuniary income from it's application, there will be an increase in your reputation, and a corresponding prospect of tenure ship at a high ranked institution, for a large salary. But consider the distinction between "Keynesian Economics" and "The Economics of Keynes". A similar tale can be told regarding "The Coase Theory[1]". In both situations, debate rages regarding the alignment of individual to theory. In light of reputation capital, this is a very important and understandable situation. Without pecuniary exchange, academic squabbles result and the competitive "expert" market of academic debate exists instead of a democratic market where rights go to the highest bidder.

Whilst not often explicitly stated, these insights are implicitly understood as some schools of thought align themselves to individual authors (and then the debate concerns "what he said" which is relatively verifiable, although then time passes and the question becomes "what he meant" or "what he would have said"). Other schools have explicit tenets or beliefs, but to function efficiently these must be common knowledge, and are open to misinterpretation. Again, as time passes the network of scholars that tacitly knew the methodological foundations dissipates and arguments are more likely to grow. To pre-empt this, notice how the New Institutional Economics movement attempt to define themselves clearly. As knowledge, generally, increases there are incentives to protect reputational capital by codification and formalization. Most of the economic literature on methodology falls into this category.

VI. Levels of Economic Ideas: Creation, Articulation and Repetition

Thus far we have concentrated on the exchange of economic ideas, specifically via journals, but there is a theoretical distinction between production and exchange. Journals play a significant role in the production of economic ideas, but primarily tend to exchange encapsulated works. Such works will either cement previous theory with a temporal restatement; assemble fragments of previous theory into a sufficiently original derivation, or push the frontier with genuine advancement[2]. An individual article will therefore require a productive stage prior to submission, even in expectation of useful feedback from the refereeing process. Institutions such as seminars, conferences and private correspondence will act as the productive stage. But economist's written output extends far beyond refereed articles, and this is because the exchange of economic ideas exists

[1] This leads to the interesting case where a concept become so imbedded it no longer requires citation. Here lies the importance of the *name* since there will still be a means to arrive at the original source. Presumably the passage from requiring citation to being taken as given will have already conferred prestige upon the author. I can't think of many people who've lent their names to theorems *within their lifetime* and not received prestige.

[2] See Oakeshott (1975).

along a spectrum of <<knowledge>>, and maps directly into the commons/private type of market.

The *creation* of economic ideas is the academic process of production and exchange via scholarly journals. As I have demonstrated, this is currently arranged in a non-market setting and is contestable and innovative. So close to such abstract notions as “ideas” and “thought” policing of a property rights regime would be vastly expensive, and stifle creativity. Proxies such as reputation capital have emerged, to facilitate the flow. Freely available papers and pamphlets are strong examples of creativity, where the intention is a broad audience and few restrictions on replication.

The *articulation* of economic ideas spans journals and more popular press. A step away from the frontier of research, articulation moves toward a conventional market type; for example Cato use a price mechanism. At one extreme it is articulation that includes clarifications and assemblies of ideas, for example review articles, think-tank pieces and the emergence of journals that facilitate them. Another extreme is books, since these can be governed as a combination of copyright license.

The *repetition* of economic ideas concerns the introduction of settled thought into a new forum, or indeed repeating already known ideas. Many economists earn money per article, and participate in a traditional market just as most journalists do. But their audience is noneconomist, and therefore by definition op-eds are not academic. Immense private wealth can be gained by engaging in market activity like private speaking and books, but these are not efficient means at dialogue within an academic community. These are profits not for the creation of economic thought, but an ability to discuss them with a wide audience. Academic discourse is a fundamentally different type of market, and is efficiently governed by fundamentally different mechanisms of exchange.

VII. Concluding Comments

Professional attention to the governance of academia is surprisingly sparse. This has been a preliminary and speculative attempt to replace casual anecdote with an interesting theoretical understanding. In a world of such change, provincialism of time is understandable yet dangerous. In private correspondence I have learnt that Jstor will soon be cross-referencing all of it’s articles, and incorporate a “track back” facility. Just as can currently be done on the Internet, an article will not only include the tradition list of references, but will include a list of articles that have since cited the original. There can be no denying that Jstor is the Napster of academia but one that falls within copyright law due to the open source foundation of modern science. As we beat on with the current, bound ceaselessly into the future… the blossoming economists will appreciate and understand the complementary means to produce and exchange economic ideas.

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A MARKETING REALITY AND ITS IMPLICATIONS

Theodor Purcarea[*]

Abstract

Marketing situations involve a larger commitment in accepting the challenge of creative thinking, progressing through knowledge and understanding towards reciprocal trust, converting emotions into transactions and the relationship based on these transactions into an emotionally and loyally connected one.

Communication is essential though, being considered the broker of the relationship that takes place in a dynamic environment and it involves liveliness and adaptability in offering the right answers to all those affected by the activity of the company.

Of course marketing situations differ, and the enterprises that are preoccupied with the essence of success understand better and better the importance of strategic alignment of relationships among all those who have key-interests (shareholders, employees, clients) in an organisation and the power of these relationships to strengthen and improve their reciprocal value and through this the performance and profitability and even the relational landscape as a whole, turning clients into real brand promoters, thus multiplying the marketing effort. This marketing reality thus involves a larger commitment in accepting the challenge of creative thinking, progressing through knowledge and understanding towards reciprocal trust, converting emotions into transactions and the relationship based on these transactions into an emotionally and loyally connected one. Which presumes the recognition of the strategic relations which the client desires, concentrating efforts on that well targeted client and to whom an offer is made in proportion to his known demand so that he resists the offers of the competition. Communication is essential though, being considered the broker of the relationship that takes place in a dynamic environment and it involves liveliness and adaptability in offering the right answers to all those affected by the activity of the company.[1]

1. Witnesses to the dawn of a new day in marketing communication

The trial to encourage a behaviour which is specific of the adequate finalisation of a marketing action, namely to make people look where you want them to and to buy what you want them to, is a real challenge. Andrew Byrne said that: “Specifics sell. Generalities don’t.” Experts claim that people are more willing to conform to an undetermined social standard when they presume they are being observed.[2]

On the base of the increase of scepticism towards official sources of information audiences tend to be more and more influenced by the use of new instruments, methods

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[1] Purcarea (2006, p. 99).

[2] Carrabis (2006).

and vehicles, being today the witnesses of the dawn of a new day in marketing communications: in all the elements of the marketing mix “social media” can be utilised creatively and thoughtfully, becoming influential in the critical areas due to the conversation that niche individuals, communities and audiences authorise and encourage action. More and more companies are incorporating the “social media” into their communication plans, thus supplying a conversational medium for the delivery of information. What matters is its quality though[1], its dependency and the processed data as a result of an adequate search for the latter to understand the relevant market, the way in which clients think about the products and services and how they associate the multiple brand terms and how they move through the purchasing process.[2]

In fact, online communication – whose specifics are continous improvement and advancement – can support the building of the brand and generate sales individually and simultaneously. It is considered that testing the new approaches (Customer e-mail, Really Simple Syndication, Branded desktop applications and Instant Messaging, Mobile communication, Online media marketplace changes, Multichannel marketing coordination and marketing-mix analysis etc.)[3] includes “smart segmentation and targeting across platforms”.

2. Complexity, flexibility and emphasis on new practices

The increase in pressure to create and communicate information about goods/services and the company is obvious. The business environment is complex and demands the increased flexibility of entrepreneurs. In the opinion of the experts flexibility is the capacity to achieve a leap in the mastery of complexity (temporal dimension is indispensable to any approach of complexity), a good complexity being that which can be mastered to produce an economic advantage, immediate or not.

As one cannot ignore knowledge management nor innovation in the area of capitalising on the unique capacity of the Internet to transport messages cheaply and quickly from person to person, the preoccupation to identify and involve those who can offer the necessary expertise, being influenced to share their knowledge and arming oneself with relevant information to leave ignorance behind. This process involves proper listening and an adequate reaction to the messages of more and more Internet “consumers”, monitoring the information and the opinions offered “freely” every day, amplifying the positive messages and reducing the negative ones. It is the caqse of earning respect by speaking openly, earning trust by promoting clear values and offering the power to express themselves to those who are dissatisfied and bringing errors to light, by promoting the honest battle for higher standards.

For our companies, the strongest challenge at the moment is emphasis on new practices which allow the increase of the speed of adaptation to change as an opportunity and continuous correction, by transferring knowledge in the matter regarding what works effectively and what did not work properly. Which implies using adequate strategies (according to the level: functional, business, corporate) and effectively and properly

[1] Stewart (2006).
[2] Balzer (2006).
[3] Perlstein (2006).

implementing them on time. How? The answer could be "simple", namely: identifyingthe action levers as against the established competitive objectives, drawing up the action plan (accompanied by the backup plan), operating with stratagems, following models, controlling the process, evolving along the path of the ensured perspective via steps.

3. Knowledge, education, innovation: a more proactive marketing style

The process of knowledge makes up this construction in the mastery of the complexity whose segments are made accessible to the capacity to understand through proper training on which the result of the knowledge process depends. Without knowledge through education innovation suffers in the context of harsh competition, business promoting accelerated change in education. Education is the most important instrument of the company for adaptation to change as an opportunity (the strategiv vision of training also stimulates the feeling of belonging; creating new knowledge and competencies, the capitalisation of this knowledge presumes: an inventory of existing competencies, the foresight management of vital competencies, defining the strategic knowledge of the company in its competitive environment, creating new knowledge starting from intangible resources etc.).

Knowledge and creativity are considered key factors in the "new society," in which comparative opportunities are offered. In the economy of knowledge, ingeniousness and dynamism, innovation and technology are considered essential levers. The internet has offered marketing people new innovation opportunities, accessing their target clients more easily, relying on new research instruments and measuring their needs, improving the marketing operations which are better researched and measured in turn. There is a noticeable growth, thus, in the awareness of the fact that the internet and new technologies have created a global network in real time regarding information on prices and products[1].

Kotler and Keller[2] show the fact that the internet has become an effective instrument in all things, from gaining information freely and directional export lines, to carrying out market research and offering clients, which are many time zones away, a sage process to order and pay for products.

On the 11th of March, 2006, on the occasion of a traditional online – dialogue with students of the Management-Marketing Faculty of the Romanian-American University involved in a marketing project (TENSMASHER), we began from the fact that economic problems can be fixed with a good policy, a good policy being informed by education. Education offers the capacity to adapt to change, emphasizing of course the reality that confirms progress in passing from the Ford-Taylor development model to the "Innovation-Mediated Production" one, as it was called in "Locating Global Advantage: Industry Dynamics in the International Economy", Edited by Martin Kenney with Richard Florida, Stanford University Press, December 2003, in the context of the increase of the application of knowledge in the production process, on the foundation of the minimization of the differences between physical and mental work (the fundamental change reflecting the technological-economic paradigm of the industrial organisation).

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[1] Purcarea (2005).
[2] Kotler, Keller (2005, p. 675, 680).

This new reality is appreciated as being marked by two elements: an increasingly more sophisticated living environment; a constantly evolving work market. As such, students will have to develop the capacity to learn new abilities and to assimilate new knowledge, to think independently, to exercise the right judgement and to work in a team, adequately perceiving the sense of the new situation which they are facing. The existence of an alternation of the identities of the clients between two extremes (the traditional buyer and the online one) forces a more proactive marketing style.

The dialogue followed a debate – which took place in the Romanian-American University on Thursday, March 9th, 2006 – regarding the globalization of education in the context of globalization (on the occasion of a visit paid to the Romanian-American University by professors Mohamed Latib and Galen Godbey from DeSales University, Pennsylvania, SUA). As discussions also continued after the debate, we reminded that in the context of globalization the following are evident: structural changes which take place in the production and distribution processes; the growing application and integration of information technology and communication in the key business processes. The activities unfold at a dizzying pace, the marketing ones, for example, being able to take place at a global scale with niche tactics. In the context in which new technologies allow easy use (Internet, World Wide Web, IDSN, EDI, ATM etc.), the Internet "boulevard" is already a marketing channel – different of course – stimulating the adoption of always new strategies and innovating tactics, full of teachings, which we must study with the necessary judgement. In face, it is considered that the speed of marketing on the internet accelerates the understanding of that which is happening on the market, there being the opportunity to make a quick diagnosis.

4. Invisible marketing and the preoccupation for "client engagement"

Transparency, explicability, personalisation are already reference points for the stage of development of marketing in virtual space due to current technological support. It is considered, even, that new technologies place marketing in the situation of becoming invisible, the result being a closed-loop business (the relationships which clients want are built by new instruments such as blogs, podcasts, RSS etc.) where an increase or a decrease of marketing expenses can be directly connected to income and profit.

In the past two years, the best enterprises in the world began to invest powerfully in creating maps capturing and reflecting a complete view of experience in terms of client, becoming reference standard for clients in terms of the success obtained thanks to the initiatives connected to the client. This practice, known as « Touch Mapping[1] » (a Customer Relationship Management instrument), allows the delivery of specific maps in a combination of substantiation of the data, of visual wall maps and scenarios regarding the client. These can be improved by presenting recommendations to change the behaviour of the enterprise and its partners. The company can improve its performance by: capitalising on new data and intuition regarding the life cycles of the clients and the profiles of the clients; the creation of a vision and a platform which will lead to improvements appreciated by the client (communication and commitment of the worker

[1] Quaero (2006): "« Touch Mapping » can be key to improving your behavior toward your customers".

in the enterprise with the products and services of the enterprise); behavioural changes concentrated on the most valuable clients; interaction of the representative workers with the clients, direct and indirect marketing contacts, customer service, their expectations and the answers offered etc.

The collection and utilization processes of the data regarding the clients – in the perspective of drawing the map – depend on the contact point with the latter and include marketing, sales and service planning and operational activities. Clients always prize the way in which the enterprise and its partners approach dissatisfaction, inefficiency and opportunity. It is something that can make the difference as against the competition, stimulating the engagement of the client.

Thus we notice that the "machine" made up of the engagement of the enterprise worker and the engagement of his clients can significantly influence the performance of the enterprise. Opinions expressed in the spring of this year even prove[1] the fact that "engagement" has entered the list of traditional marketing activities and an increase in demand for evaluations connected to Return on Investment (ROI). The latter in the context in which engagement – defined as the result of marketing activities and advertising which substantially increase the power of the brand in the eyeas of the client (if it has been measured adequately in can really forecast sales and profitability) – is used more and more to allocate marketing budgets.

Why is this phenomenon possible? Because in reality people feel more than they think, while "models" (traditional marketing and research, according to the critical conclusion of a study coordinated by the Advertising Research Foundation, built testing systems for advertising on "accepted" models regarding the way advertising worked) demanded and expected too much thinking from customers. Today's marketing people, brand manager are more preoccupied with customer engagement rather than finding them, the difficulty lying in the fact that the recognition of the need to engage a customer and the actual measurement of the real engagement are two different things. And real engagement is the consequence of the marketing/communication programme which produces and increased level of perception of the brand as meeting and surpassing customer expectations ("brand equity"), while customer expectations are generally based on emotions.

5. Increasing the application of a contextual marketing: the very rapid growth of the ability to follow behaviour in the media

In a large editorial published by the prestigious "Harvard Magazine"[2], deputy editor Craig Lambert quotes, in context, Economy Professor David Laibson (whose research explores the fundamental tension between "grabbing the available reward in the present and being patient for rewards in the future"), which explains the evolution of behavioural approaches, pointing out that: there are large behavioural regularities which include things like self control and imperfect social preferences, as opposed to pure egoism; people find, for example, that financial transactions connected to investments are

[1] Passikoff, "Rules of Engagement", www.chiefmarketer.com/rules_engagement_02132006

[2] Craig Lambert – "The Marketplace of Perceptions", http://www.harvardmagazine.com

unpleasant and generate confusion and are happier with the idea of doing them tomorrow. Lambert quotes another Economy Professor, Sendil Mullaintham, who shows that economists and other people engaged in political debates like engaging in disputes regarding large problems at a macroscopic level, the practical details of execution (how the shapes should look, what is in the brochures, how they are communicated) being given to the support personnel, even though this work is central; that is why these design choices must have the same amount of intellectual energy dedicated to them as to the choice of a policy in the first place, behavioural economic science being able to help us sensibly design these choices, which represents a large empty space which needs to be filled both in policy as well as in science. On the other hand, Eric Warner of the Russell Sage Foundation – also quoted by Lambert – draws attention to the fact that in behavioural economic science the choice depends on the way in which the decision maker describes the objects, there being a vulnerability to the way in which choices are described. In Lambert's opinion: the eclipse of the hyper-rational Economic Man opens the way for a model of a wealthier and more realistic human being on the market, where the brain, with all its classic instincts and vulnerabilities can be both a predator as well as prey; the models of behavioural economic science can help in the design of a company with more compassion for the creatures whose strong and weak points evolve under much simpler conditions.

We cannot omit the fact that advertising uses more and more behavioural targeting technology as an integral part of online campaign strategies, either. This means the increase of the application of a contextual marketing, as the ability to follow behaviour throughout the media increases greatly, sales people accepting technology and better accessing and understanding the people who visit their web sites. Of course the problem of that demarcation line between what is not and what can become bothersome from the point of view of observation remains to be further clarified, according to the perception of the one under observation in terms of a possible threat. This is where the explanation arises of the confrontation of ideas regarding: offering more control to the consumer; the contextual relevance based on realistic behaviour models of the consumer; the possibility of dynamic and automatic analysis of the available content of the messages in the perspective of a more intelligent internet; the evolution of the relationship between purchasing behaviour online and offline, in the context in which, for example, retail outlet locations are considered more and more as another media channel.

6. Marketing, the art of building a brand: we must never forget anyone

A year ago, Philip Kotler[1] attracted our attention to the imperative of "the development of better abilities in innovation, differentiation, branding and service, in a work Marketing," recommending the development of a stronger marketing: holistic, strategic, technologized, financially oriented. The "father of marketing" emphasizes, among other things, **the need to resort to a lateral marketing, conceiving new product and service ideas.** In Kotler's opinion marketing is the art of brand building, what is not is a brand is goods and then the price is everything, the only winner being the low-cost producer.

[1] Purcarea (2000).

He also showed that one of the shortest definitions[1] of marketing is the profitable fulfilment of needs, the commercial world is no longer what it was, though, and more and more marketing people acknowledge the need to have a more complete, cohesive approach which goes beyond traditional applications of the marketing concept. An approach that attempts to acknowledge and reconcile the sphere and complexity of marketing activities in holistic marketing (development, design and implementation of programmes, processes and marketing activities which acknowledge content and interdependencies) whose components are: relational marketing, integrated marketing, internal marketing and marketing of social responsibilities. Marketing management means, according to the same authorised opinion, the art and science of choosing target markets and winning, preserving and increasing the client base by creating, delivering and communicating a superior value to the client. The latter has, in many cases, undefined preferences, which are ambiguous or even conflicting.

That is why Kotler considers participational marketing as a more appropriate concept – compared to permission market (which presumes to a degree that what is desired is known) – taking into consideration the possible need for assistance of customers who are "in training" and the expression of their preferences, because marketing people and clients need to work together to discover how the company can better satisfy its customers. On the other hand, the mentor of the father of marketing, Peter Drucker says that the purpose of marketing is to know and understand the customer so well that the product or service is suited to him and sells itself.

But customers respond differently to the image of a company and a brand, the identity (the way in which a company identifies itself, self-positions itself or positions its products) and the image (the way in which the public perceives the company or its products/services) requiring their distinction. The key to branding, emphasized Kotler (who reminded of the "Y&R" model of brand strength in Bucharest: vitality and stature) and Keller, is the perception by customers of the differences between the brands of a category of products. A branding strategy identifies which elements of a brand (name, term, sign, symbol, design, a combination of the previous) the company chooses to apply to the different products it sells. To follow multiple market segments often multiple brands are required (the basic principle in designing a brand portfolio being the maximisation of market coverage, so that no potential customer is ignored.)

We note the increase of the existing preoccupation with virtual space for the adequate building of a brand[2]. When the launching of a new brand is intended naturally one tends to think of it as the producer wishes it to be, namely a stable and successful presence on the market. For the latter one must take into consideration the life cycle of the brand and the profile of the consumer. If, for example, we are talking of new brands which rely on advances in the extension of a new product, then it is considered that it is recommended to take into consideration the opinions of large "influencers" such as "innovators." The latter are those customers who always wish to be first to try out new experiences, having a very different life concept versus others (even as against those who adopt a brand early, not only against the majority or the last to adopt a brand) and so very different lifestyles, including from the point of view of media consumption habits.

[1] Kotler, Keller (2005, pp. 5-6,13,16-17, 285, 300-303, 320-321, G1).

[2] Bates (2006).

We attend numerous trials to clarify the way in which brands can enter the digital zone to meet the needs of the generation which “bathes” in an environment saturated by the media. Interesting evolutions are emphasized in this sense also by a recent opinion poll confirming the fact that young consumers, who research marketing messages, include key influencers and early adopters of technology[1].

Here are, for example, a few questions which are waiting for adequate answers, in the situation of a launch of new brands: How will the target market change in the first 12 months from the launch of the new brands? How can the change of the profile of a customer who must be reached be shown on a map? How can one reach the “innovators” first and commit them, as a base for building the brand?

A brand which benefits from the value given by a considerable accumulation of psychological force is hard to attack, especially when it was introduced favorably, a strong expectation for it is always created and benefits at present as well of a special atmosphere, maintaining a constant dialogue with the customers. In fact, present in Bucharest, in May 1998, with the occasion of the work of the International AIDA Brussels Congress (organised by the Romanian Distribution Committee – CRD, affiliated to AIDA), William S. Webb, the Director of the London Institute of Distribution Management, again drew attention to the fact that: “the legitimacy of the brand depends on consistency and continuity, otherwise clients cease to believe you.”

One must remark in this context, for example, that one of the ten commandments of global branding covered by Kotler and Keller lies in avoiding shortcuts in the building of a brand. In building a brand on new markets it is recommended to start from the “bottom”, both strategically (building awareness before brand image), as well as tactically (creating sources of brand equity on these new markets.)

Kotler and Keller[2] underline the need to build a creative marketing organisation, the capacity for strategic innovation and imagination coming from the assembly of instruments, processes, abilities and measures which will allow the company to generate more and better ideas than their competition. This on the base of assuming social responsibility because the success of the business and the continuous satisfaction of the client and other affected parties are closely connected to the adoption and implementation of high leadership standards of a business and marketing.

We began from the essential role of communication, considered the broker of a relationship that takes place in a dynamic environment and implies vivacity and adaptability in offering the right answers to all those affected by the company’s activity. A relational marketing strategy can produce an infusion of set singular concentration, which is distinct of the capabilities and the huge advantage on the market giving the ability to exceed the innovation of the competition, to motivate people who matter most for the clients and to organise achievement of basic results for each customer. It is necessary to resort to integrated marketing because non-integration means sale at a loss, inconsistent image, confused customers etc., respecting rules concerning: passing for payment; achievement possibilities; stimulation; processing; observation; emphasizing the emotional side of the brand; raising the barrier of profit and loss declaration and… the fact that we must never forget anyone.

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[1] Geraci (2006).

[2] Kotler, Keller (2005, pp. 704, 706).

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THE OPENING – DEPENDENCE ON THE EUROPEAN UNION AND GLOBALIZATION

Sorica Sava*

Abstract

Globalization is the result, as well as the cause of the expansion of trade agreements and liberalization of capital flows. Regionalism is a side effect of globalization, of particular importance in EU. The article compares the opening and dependence of EU member states with that of similar regions in the world. It argues that the combination between free trade and regionalism is destined to evolve in time.

The 80's operate a reshaping of the global economy. Two powerful and closely bound forces have created conditions for the nedw tendencies.

The first one, the globalization of economy – resulting from the expansion of multinationals – accentuates the international interdependence to such an extent that the part of the production destined to trade increases and the direct foreign investments accumulate.

The second one, the resurgence of regionalism – a phenomenon better observable in Europe, but also existent in other regions – has important consequences either.

The increase of both regionalism and globalization leads to a certain number of matters: the expansion of trade agreements and a new relation between regionalism and multilateral liberalization of international trade. Globalization expresses the growing influence of this movement and of the competitive game affecting the economy as a whole.

This dynamics of international economic relations reveals the role of the regional integration process. The regionalization of the trade is distinctly more pronounced in the European Union. The European market has got a new physiognomy since the creation of the customs, economic and monetary union. So the EU has become a vast economic space, the most developed regional group and the biggest commercial entity. It is about a market of 309 millions of inhabitants (for countries members of the European Monetary Union). Therefore, Europe together with United States and Japan represents the biggest commercial triangle of the world.

Besides, the European market has been the market with the strongest growth in the world for the last several years, as a result of the beneficial effects determined by these changes of structures. Among certain arrangements of regional integration, the EU is by far the most important regional zone whose total of exports and imports represents more than 40% of the world trade in goods and services. Since exports to countries of the third world have progressed faster than their imports, the intra-EU weight of trade of the total trade itself stays at a pretty high level of about two thirds of the total trade.

The evolution of prices, the home demand and the monetary oscillations explain

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variations of relative importance in the intraregional trade. But these trades between member countries contribute to themselves with more than a quarter of the world exports. Although the European Union represents a model of regional integration, it has become a component of the world free trade because of the commercial, financial and industrial interdependence and of the geographical, economic and political stakes.

This approach incites us to place the European Union stakes between the creation of an integrated economic space and the national extraversion stimulated by the globalization of activities.

The interaction between the liberal nature of the integration process and the national economies insertion in the globalization process expresses the specificity of this European economic space. This double liberalization submits the European Union to two types of forces, centrifugally produced by the globalization process and centripetally generated by the economic and monetary integration objectives. The creation of a general union including all sectors of the economic activity answered to an internal necessity, the opening of the economies through the development of four liberties: free circulation of goods, services, capital and labor. But at the same time it is about a simultaneous opening under the notable external influence.

The globalization – Europeanization relation was influenced by the involvement of the European countries in various multilateral negotiations of WTO (GATT) as well as in several agreements of association and other nature. The empiric analysis of the rates of commercial dependence and of the opening to the exterior can show us the impact of the constant interaction between the regionalization of trade and the advance of globalization.

The opening –dependence of the European Union in the period 1994-2004[1]

Billions of dollars and in percent

	1994	**2000**	**2004**
Export[2]	770	792	1204
Import[3]	762	920	1281
GDP in value[4]	6806	6100	9500
Rate of dependence[5]	11,2	15,1	13,5
Rate of opening[6] (%)	11,3	13,0	12,7
E+I/2/PIB[7](%)	11,3	14,0	13,1

Source : Organisation mondiale du Commerce (1995 et 2005), Le commerce international : tendances et statistiques, Genève

Rates of commercial dependence and opening to the exterior of the European Union

[1] 1994: 12 countries, 2000 et 2004 -25 countries.
[2] Extra European.
[3] Extra European.
[4] Gross domestic product.
[5] Import of the region/GDP of the region *100.
[6] Export of the region/GDP of the region * 100.
[7] Average of exports and imports brought back to the GDP of the considered area.

show the relative importance of the world insertion. Data show us the greatest opening - dependence of the EU (13.5% of the GDP in 2004) compared to that of other areas, for example the United States (nearly 10% of the GDP). There is a meaning in comparing the United States to the European Union, because these two big partners have the most important commercial and economic weight in the world. So, among the twenty leading exporters and importers of the world, eight and respectively twelve are EU member countries. As main part of possessions and commercial services world trade, EU had a considerable impact on the total trade and the international economic relation dynamics.

However, the commercial extraversion is accompanied by an increasing opening of the economies to the productive and financial capital flows. This phase of opening of the economies to the productive and financial capital flows accelerated the process of globalization.

Such an evolution is justified by the needs of the economic private or public agents as a whole to reach the world market of capitals. It is about the necessity to finance the diversification of enterprises and the improvement of the efficiency on the financial markets as well as to cover the macroeconomic unbalances.

In this perspective, for a better adequacy between the financing capacities and needs, the world financial system has become a big market through the permanent interconnections of national spaces. The European Union is not part of this movement, representing 54% of the world direct investments and reaching 42% of the foreign direct investments.

The EU has actively participated in this movement of globalization of the capital through the creation of a big market and through the globalization of the financial system. This world insertion of the EU member countries was achieved in several stages:

- Globalization of goods and services trade
- Globalization of production and financial capital flows
- Global strategies development of the companies

So, these are the characteristics of the international economic relations:

- On one hand, the increasingly important role played by the multinational businesses in the world environment has the tendency to reach an integration of the production processes.
- On the other hand, there is the acceleration of the world exchanges at an immaterial level (information, services…), these domains modifying the local/global, national/international ratios.

Nevertheless, the implication in this international relations dynamics since the middle of the eighties hasn’t involved in any way slowing down the regionalization process, as attested by the tendencies of regional integration, which has stayed the most intense in the world, even if it does exist in other regions, either.

The regionalization of the intra-European trade stays the most intense in the world. Since the end of the sixties, goods trade in Europe and EU has known such a strong growth, that in 2004 it represented more than 40% world exports and imports.

The home market and the monetary union can explain the commercial and financial regionalization and its effect produces the distribution of FDI flows: an intra-European flows’ intensification and the concomitant inflation of European origin FDI stocks. But the regionalization of capital and production movements, of alliances and fusions between companies is conjugated with the increasing opening of the European economies.

In this way, EU has become a well integrated and also open economic space. These evolutions, justified by the need of private or public actors as a whole to reach the world economy, show us that the new axis of common cooperation has become “the co-regionalism free trade”.

Therefore, parallel to the geographical redeployment of various activities, the commercial arrangements sustaining different forms of cooperation of the EU with the rest of the world are the object of a structural reconfiguration. The European Union sustains an open and free trade regionalism, able to procure gains of competitiveness.

This combination between free trade and regionalism is destined to evolve. For instance, the relations of the Union with the developing countries are in resonance with the multilateral doctrine of the OMC and beyond, with the liberal representation of a global economy.

The possibilities that EU influence the relations reside in the fact that fifteen, respectively twenty-five member states provided in 2004 almost half of the world trade of goods and services. In fact, the economic action remains the fundamental dimension of the European Union foreign policy as international actor.

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PRODUCT INNOVATION APPROACH IN SUCCESSFUL MANUFACTURING ORGANISATIONS

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Abstract:

Fast product innovation and creativity is driving the development strategies of the most nations enjoying high economic growth. The development of fast innovative new products needs to be based on a close alignment between technology, products and markets, with a focus on achieving increased aggregate value. This paper is dealing with important technological and organizational integration variables of new organizational products and with the motivation of workers to innovate.

1. Introduction

The diverse range of technological possibilities creates unprecedented change bringing both product and market uncertainty and as a consequence new challenges for organizations. To meet such challenges organizations need to engender both a responsive and adaptable approach to market demands. For many product innovation and creativity is a strategy of fundamental importance, in sustaining development in turbulent and volatile environments.

Competitive advantage is viewed by organizations as being directly related to various integral elements of a product which includes: product superiority, uniqueness, and competitive pricing. Issues of common importance to organizations, which affect the processes of new product development and subsequent performance outcomes, include:

- organizational management style;
- attention to detail in the processes of new product development;
- support for product innovation by top management;
- organizational strategic thinking, and manufacturing facilities to support new product development.

A common theme of all the issues identified as important to organizations in the development of new products is the relevance of both technological and organizational integration.

Organizations are increasingly concentrating on responsiveness and flexibility through product innovation. The rapid delivery of new products clearly requires effective communications between design, engineering, marketing and manufacture enabling organizations to be adaptable and responsive to market conditions.

From other point of view, motivation to innovate is an outcome of the existence of certain antecedents that are responsive to the dynamics of motivation in organizational environment, this work develops a conceptual model synthesizing motivations "what" and "how" that will bring human creativity in organizations which thrive on innovation.

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Since productive knowledge in organizations is ultimately a product of the human mind, it cannot be manipulated like sophisticated machines, fancy systems, or efficient controls. Organizations that desire to use knowledge in their products, processes, and services, have to know how to engage the human mind in their operations.

Therefore, understanding the theory and application of motivation is very important in managing human resource in making these new organizations succeed.

The question surrounding how to motivate employees has intrigued behaviorists for over a century. This interest started when the large corporation became the economy's most dominant player.

2. Technological and organizational integration variables of new organizational products

Manufacturing involvement along with marketing and research & development (R&D), from the beginning creates a solid commitment throughout the new product development processes. When manufacturing enters later, integration with R&D and marketing may only be partly achieved in the following new product development processes and as a consequence creates a lack of harmony and trust between functional groups (Figure1). Even though early involvement by manufacturing is accepted as being important for the success of product innovation, many organisations continue to use a sequential approach to the processes of new product development.

Phases of the new development product

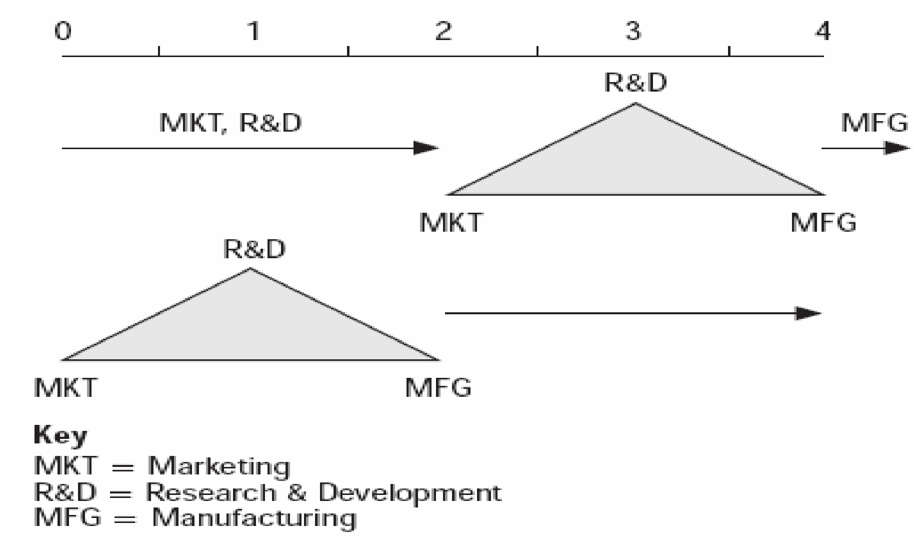

Figure 1 – Changes in the new development process

Plant equipment such as automatic assembly, can help to attain seamless integration of technology in organizations (Figure2). Long term investment enables organizations to achieve performance gains such as speed of new product development but must be done with consistent long term objectives and a view to maintaining compatibility within operations. The shift towards international standards which has occurred over the past five to ten years, has helped to improve overall integration and speed of new product development.

Cultural integration variables of key importance for improving speed of new product development were R&D and marketing openness, and the need to create deep understanding between marketing and manufacturing. The findings would appear to suggest the need for both a market orientation and design for manufacture to be followed simultaneously.

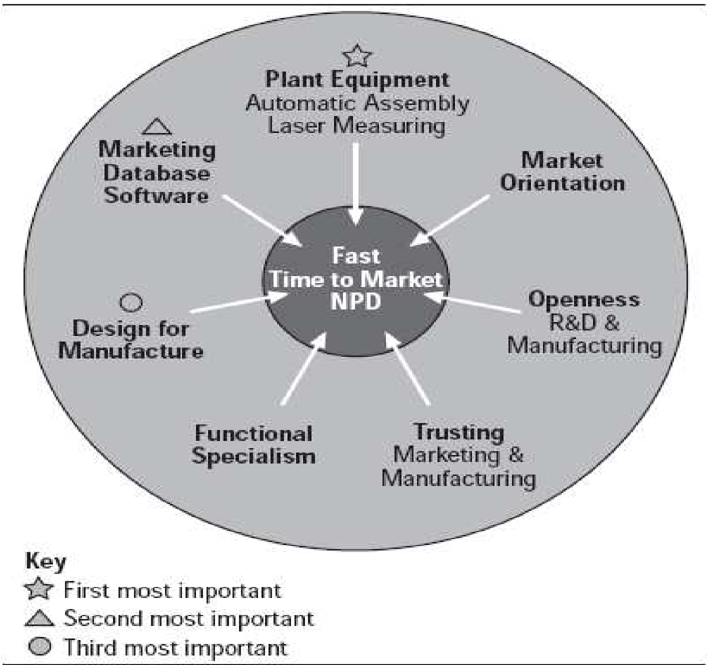

Figure 2 – Technological and organizational integration variables of new organizational products (NPD)

3. Drivers of motivating behaviour for innovation

There are a number of succinct factors present in the contemporary organizational environment that have opened up and are forcing a review of the motivation theory and its practice, which, until now, had been considered as formulated, empirically tested and established. These factors affect both content and process of motivation. That is why these are the drivers of motivation in the knowledge work environment. It becomes important for managers to decide how to motivate their employees only after considering these factors as they apply to their organizational environment and, preferably, after making some adaptations specific to each department, section, and employee.

Typically, motivating behaviour drivers to innovation of knowledge workers is the work itself – the assignments or projects they get:

- In their perception, how important is the work that they would be doing?

- Is it exciting?
- Is it challenging?
- Would they succeed at it?
- This assignment will result in working with whom? For example, would it result in being surrounded by the best of the best? Would the assignment be in an organization where there is respect, trust, fairness, and good management?
- What would the experience bring as outcomes, such as rewards, recognition, career advancement, learning, and satisfaction?

Answer to the above questions helps managers understand the drivers of motivating behaviour of knowledge workers. The whole spectrum of these drivers is classified into the following five groups:

(1) *The sociological driver.* Sociology has always been important in the understanding of any aspect of human behaviour, such as work motivation. Motivation theory and practice considers this; however, human sociology that had largely remained constant for a long time started to experience revolutionary changes in the later parts of the second half of the twentieth century.

(2) *The psychological driver.* Work motivation theory applicable to traditional work is based on human behaviour that has its roots in positive reinforcement – primarily, in money. Its practices carry a premise that given proper incentives, all workers would give their best to their employers. This forms the basis for learning, training, and behaviour modification in traditional organizations. In innovation instead of money, self has become the prime positive reinforcer. For example, some managers who have strategically used self-esteem in assigning jobs to their employees have succeeded in motivating them to innovate and give higher productivity.

(3) *The generational driver.* Employers report that younger employees are too keen to take on responsibility, quickly move up the hierarchy and become successful. However, they cannot deduce if it means that they are too interested and motivated to work or simply too impatient to get rich. These younger employees are employees of the newer generations. Many knowledge workers are likely to fall in this category. The last decade saw their introduction to the workplace. The future of knowledge organizations really belongs to them. It is for these reasons that developing a new understanding on human motivation at work without giving meaningful consideration to young generations not result in a durable theory of knowledge worker motivation.

(4) *The knowledge work driver.* During the later part of the twentieth century, we saw a change in work dimensions and demands due to the induction of the technology, not only in the workplace but in every sphere of human life. In some form, science and technology have been incorporated into almost all jobs in almost all organizations, a process expected to continue into the future. The rise of technology has also resulted in a new large breed of organizations whose primary input, output, or both, are dependent on scientific or technological knowledge typically possessed by individuals rather than owned by an organization. Organizational success that previously depended on job-relevant skills in the long term and experienced employees of the firm shifted to explicit and tacit knowledge – the scientific and technical knowledge that employees mostly acquired through university education and training which might have nothing to do with age, experience, or years on the job, and innate knowledge – making younger, newer

employees with appropriate work knowledge more important to organizations. Every new job is being designed to incorporate the use of human knowledge to innovate what is done and how it is done. The change in work and workplace brought in by the technology has been so revolutionary and sudden that it caught many managers and motivation the researchers off-guard. These resultant dramatic changes in the basic character of work are not incorporated in the established theory and practice of motivation.

(5) *The cultural driver*. Another important change that organizations have experienced during the last couple of decades is the spread of globalization throughout the world. During this period, the European Community further perforated its boundaries to include the free labour movement all over its member states. The USA experienced a surge of immigrants like it never had in the past. A large number of these new immigrants are knowledge workers, not blue-collar, skilled labour. Furthermore, what makes this pattern of American immigration more interesting from the motivation perspective is the variety of regions of the world from where these workers have immigrated to the USA. The lands from where these new immigrants have come have cultures that are quite different from the cultures of the American immigrant workers of the first half of the twentieth century who came predominantly from Europe. Their value systems and religious and spiritual beliefs are not Euro-centered – the systems known to America based on which the past motivation theory and practice were formulated. Work culture, not only in America but also in many other parts of both developed and developing worlds, has been seriously impacted by the revolution in the integration of advancements and efficiencies in computing and telecommunication technologies into work processes. This made it possible for the workers physically away from work, in many cases, far, far away – like in a different country – to impact, through their work etiquettes, the culture of their organization as do those physically present there. These cultural changes put a special emphasis on revising our understanding of how to enhance the motivation of workers since none of the traditional motivation theories is formulated considering the dynamics of these variables.

Explaining what motivates knowledge employees that innovate and how the process works in such organizations is quite different from the description that comes from the content and process theories of motivation established during the last century. We recognize that when it comes to understanding the wants and needs of workers a lot has changed due to the shifts in worker demography, culture, work patterns and demands, human sociology, and psychology. These changes are so pronounced that they raise doubts on the validity of the established motivation theories.

To successfully motivate their knowledge workers, organizations should do the following:

- *put in assertive, deliberate effort in dynamically studying the drivers of their employees' motivating behaviour;*
- *respond to the resultant changes in these drivers by devising responsive motivation antecedents;*
- *load these antecedents into major sources from where motivation can emanate.*

4. Conclusion

Becoming the most economical competitive society in the world in 2010 is one of the targets of the European Union. This target is based on the optimistic planning ideology that within ten years knowledge and expertise can be organized in such a way that added value can be created at the macro and micro level of the Union, states and companies. Producing intelligent products, and producing them in an intelligent way as a reaction to mass production has focused very much on the use of information technology to become creative and smart. Knowledge creation is therefore perceived as one of the major assets of innovative organizations, and innovative organizations are defined by knowledge creation. It seems that innovation and knowledge creation are defined by themselves.

Based on the observations regarding what works and what does not in motivating knowledge employees to innovate and how to make it work, it is recognized that there are three sources in most organizations from where work motivation could emerge.

The first and the most important source of work motivation is the job that the employee is doing.

The second source of motivation is the outcomes from the job. The outcomes include all kinds of known and unknown extrinsic and intrinsic rewards and punishments – whatever employees consider having positive and negative effects on their work behaviour.

The last source of motivation is the organizational system, which includes the usual constituents of the management system, such as organizational policies, practices, culture etc. and the establishment items, including the firm's product line, image, position in its industry and market, financial soundness, and all the other related items that can excite employees about their organization as an entity.

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EURO ZONE EASTERN ENLARGEMENT AND ECB'S VOTING MECHANISM REFORM

Mihai Sebea*

Abstract

The present paper analyses the issue of the voting mechanism reform within the ECB, as a consequence of the Eastern enlargement of the EU. Now it is known that beginning with the 1st January 2007 the euro zone will "go east" as Slovenia will be the first Eastern country the will join EMU's 3rd stage.

The eastern enlargement raises more complex challenges for the ECB because of three main aspects: 1. the new member states have to "catch up" and this is very important when setting the interest rate, 2. the new member state's economic weight is very small comparative with their prospected position in the Governing Council, and 3. in the absence of the reform the ECB's Governing Council would become the body evincing the highest number of voters, as compared with other decision-making structures of other central banks, such as the FED, being very difficult for such a body to take monetary policy decisions.

Based on those challenges, the ECB will implement a new voting mechanism. Even so, this will not solve the problem of having large economies with weak representation, and small economies that have strong representation in the Governing Council.

1. The Eastern enlargement and the real convergence: why does it matter for ECB and its voting mechanism?

Real convergence means the reduction or even elimination of per capita GDP gap between the EU 15 and new member states or acceding countries. This challenge of real convergence needs economic growth for SEE countries greater than EU's, which implies the convergence of prices and wages. Eastern countries have a weak performance concerning per capita GDP.

Should real convergence be reached within the EMU, it is to be expected that poorer countries should have growth rates that are superior to the overall euro zone, until the levels of prices and productivity no longer substantially differ. This process will go on due to competitive markets, until the GDP per capita is the same all throughout the euro zone.

Before 1999, there used to be a trend stating that an enlarged monetary union including Portugal, Spain, Italy and Greece will pose difficulties to the ECB in implementing a restrictive monetary policy. Experience has shown that "poorer" countries register higher growth rates than the strongest, France and Germany. Moreover, the real convergence process involving "poorer" countries also entails higher prices hence higher inflation rates. Such countries would rather have a tighter monetary policy than the

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ECB's current one, addressing the overall interests of the euro zone.

Currently, even a fast convergence in the case of Portugal, Spain or Greece is not likely to pose problems for the Eurosystem to reach its inflation target. These countries are nonetheless close to the EU average, and their ratio in the harmonized commodity price index for the euro zone is and shall remain low.[1].

After EMU enlargement, things became more complicated because ECB will follow a monetary policy for the euro area interest, and it will not look at a specific country's inflation.

Anyway the Eastern countries will still have a low per capita GDP at the moment of EMU accession, when they will have voting rights in the Governing Council. This will complicate the voting process, in the context of more dynamic economies.

That means that an enlarged euro area will be more dynamic and will need higher interest rates. Are there any chances for higher rates to be in the interest of the euro area as o whole? Which are the challenges for the Governing Council voting system? How important will be the inflation rate in Eastern countries for euro area inflation? We can see a few more challenges that EMU members as well as Eastern Countries have to meet.

From this standpoint, we can see that both the ECB and the euro zone states would have reasons to fear new members acceding to the EM, even the more so if we take Great Britain's accession into account.

2. The necessity of a reform of the ECB's voting mechanism

As we know, the EMU institutional framework is underlain by centralized decision and decentralized implementation. The voting mechanism is extremely important since the participation of national representatives to decision-making is not to hold national interest into account. Even if the current mechanism is deemed adequate, the situation is likely to change following EMU enlargement by new members.

The prospect of EMU enlargement thus raises challenges for the ECB organizational structure. Starting from the assumption that the euro zone will be enlarged by 15 new members, and lacking an ECB reform, we would have a Governing Council comprising 33 members. The ECB Council would become the body evincing the highest number of voters, as compared with other decision-making structures of other central banks, such as the FED. Many analysts have proved that it will be very difficult for such a body to make monetary policy decisions.

Another issue of the enlarged euro zone would be an overemphasized representation of national central banks in the decision-making mechanism (as compared with Bundesbank or the FED, where the Executive Board members dominate decision-making bodies). Moreover, taking into account the low ratio of the new members' economies, they would have a political representation that surpasses by far the size of their national economies[2]. As an example, from the 1st January 2007 Slovenia will join the euro zone,

[1] Spain and Portugal's ratios are 1,8 respectively 9,1, meaning that even in the case of rampant 10% inflation in these countries, the zone target can be reached if it is under 1% in the other countries. Anyway this situation could have negative effects by affecting the competitiveness of these economies.

[2] For a sound analysis, see Berger et alia (2003).

and its Governor (Mr. Mitja Gaspari) will have a voting right in the ECB's Governing Council. As long as Slovenia's GDP represents almost 0,4% of the euro zone GDP, Mr. Gaspari will have one vote, which will represent 7,6% of the governors voting rights, or 5,2% of the total 19 voting rights.

In this respect, the voting mechanism of the ECB decision-making bodies will change. There were a series of proposals for change in publications in the field, among which: setting up a limited participation Monetary Policy Council that would operate under the Governing Council; introducing constituents, as in the case of the IMF; increasing the Executive Board's number of votes or adjusting the national governors' vote rights function of the economic size of every country.[1]

Consequently, the reform issue has been seriously taken into consideration. In December 2002, the ECB Governing Council has unanimously decided on the content of the voting mechanism reform proposal, which is absolutely necessary when contemplating the euro zone enlargement prospects.[2]

Once the Nice Treaty was in force on February 1st 2003, the ECB has formally adopted a recommendation regarding the change of the Governing Council's voting mechanism. The ECB recommendation was passed on to the EU Council in February 2003. Based on this recommendation and taking into account the opinions expressed by the Commission and the European Parliament, The EU Council, convened at the level of state or government heads, has unanimously decided[3] to change article 10.2 of the SBEC statute. The decision was ratified by the 15 member states in order to be in force[4].

What does the decision comprise? According to it, all the members of the *Governing Council will continue to attend meetings*. Yet the number of national central bank governors having a right to vote will not be larger than 15, the 15 votes being covered by rotation based on a pre-set rule, whereas the Executive Board members will preserve their vote rights. In order to cover the necessity that governors with a right to vote should at all times be from countries that would represent together the euro zone interests, they will have the right to vote with a certain frequency, based on groups of countries.

Governors will thus be part of different groups, function of their economies' ratios in the euro zone, resulting by calculating an index that will comprise, apart from the GDP, the size of financial markets. When the number of countries in the euro zone reaches between 16 and 21, the rotation system will operate based on two such groups, and when the zone is made up of 22 members, the system will be based on three groups. Governors in each group will hold the right to vote for equal periods of time.

Let us now exemplify its operation with 21 and 27 members. According to the above-presented data, the proposal stipulates that once the EMU reaches 16 members, the number of national central bank governors with a right to vote in the Governing Council should be restricted to 15, based on the rotation system. Thus, in the case when EMU

[1] Also see De Grauwe (2003), Berger (2003), European Commission (2004).

[2] The proposal was made based on the Nice Treaty provisions. European leaders have been unable to find a solution at the Nice meeting but they have inserted the empowerment clause, which has allowed the Council to change the voting system based on a proposal from the Commission or the ECB.

[3] On 21.03.2003.

[4] European Commission (2004).

comprises 21 members, the two group system will be used. Member states among the 5 large economies will have 4 votes, whereas the other 16 countries will hold 11 votes. In case the EMU is enlarged to 27 members, the three group system will operate, where the first 5 economies receive 4 votes, the following 14 have 8 votes, and the other 8 will have 3 votes. (See annex 2)

To conclude, the new voting system is characterized by soundness, being designed to adapt to the euro zone enlargement up to 27 states (the current EU states, which Romania and Bulgaria will join).

Nonetheless, one can appreciate that in time, the rotation system might prove difficult even if sound and robust, and *that it is likely to lead to decision-making gaps when the euro area comprises a high number of members.*

Anyway, even in the event that the reform does not fully eliminate the difficulties in the decision-making system, it nonetheless represents a step forward. We should not forget that Bundesbank or the Federal Reserve System (FED) have improved the operation of their bodies in time. It took years for these institutions to learn how to combine the benefits of a regional structure with the effectiveness of a centralized decision[1].

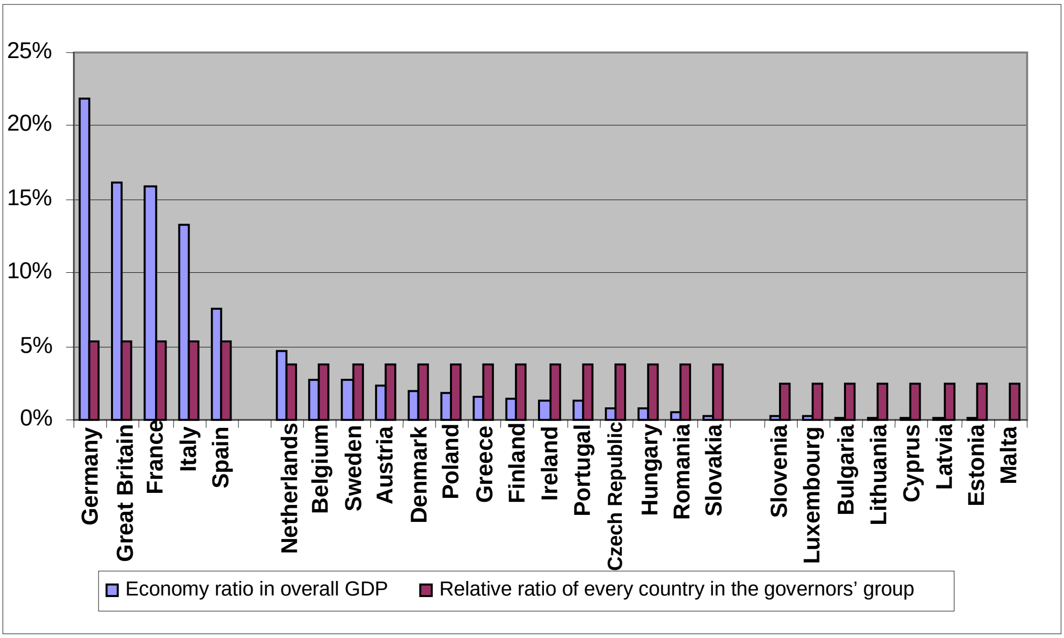
3. Will the new voting mechanism eliminate the problems?

Thus, the reform of the ECB Governing Council's vote system is of special importance to eastern enlargement, and as we have shown, entails a limited number of 21 votes[2], regardless of the number of members the euro zone will comprise.

The proposed ECB reform will not fundamentally respond to enlargement challenges. With a total number of 21 members with a right to vote, the Governing Council will be smaller than without a reform but larger than, for instance, the similar FED body.

[1] See also Berger 2002.

[2] 15 of the Governors + 6 of the Executive Board



Graph 1 Economic importance and each country's weight in the governors' group

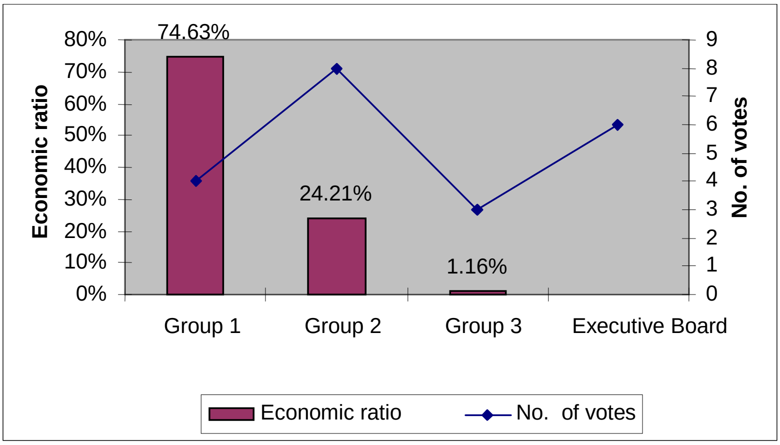
Source: according to the annex, own calculations[1]

Moreover, the reform will not do away with the issue of member state representation. Even in the case of the proposed reform, states such as Italy, France or Germany will be insufficiently represented, whereas states such as Malta, Latvia or Estonia will have a larger ratio than the size of their economies. There are fears that a "tyranny" of minority might emerge even with a reform.

Graph 1 proves the lack of symmetry between the economic importance of every country and the part they will play in an EMU enlarged to comprise 27 members.

The lack of correlation between economic importance and the role of national governors is even better outlined by graph 2, where one can see that the first group has a 74.63% economic participation and 4 votes, whereas the second group would have just a 24.21% GDP ratio and 8 votes!

[1] See also Berger (2004).



Graph 2 Economic ratio and number of votes per group of countries
Source: calculations in the annex

If we are to refer to the last group as well, it will represent just 1,16% of the GDP yet it will hold 3 votes in the Governing Council. If in the case of the current euro zone composition, the Executive Board could vote for an average interest rate, in case of enlargement it is highly likely that the desired interest rate distribution should be asymmetrical. Therefore the voting process will be difficult, running the risk that certain countries with major economic importance should be unsatisfied with the interest rate decided by the Governing Council. In this sense, the ECB and large states' apprehension might be, again, grounded.

Consequently, even if prone to controversies, the reform is a step forward. One should not forget that it took years to the Bundesbank or the FED to perfect the operation of their bodies.

Conclusion

The EU's Eastern enlargement means the possibility of euro zone eastern enlargement as well. In this sense we can imagine how hard will be to implement a monetary policy for 25 or 27 members.

Based on this assumption that the euro zone will be enlarged by 15 new members, and lacking an ECB reform, we would have a Governing Council comprising 33 members, being very difficult for such a body to make monetary policy decisions.

Moreover, an enlarged euro zone would be an overemphasized representation of national central banks in the decision-making mechanism (as compared with Bundesbank or the FED, where the Executive Board members dominate decision-making bodies).

This is why the ECB's viting mechanism is a reform subject. The voting syetem will change when the euro zone will comprise more than 15 members. From this point on the national governers total number will not exceede 15.

The 15 votes will be covered by rotation based on a pre-set rule, whereas the

Executive Board members will preserve their vote rights. Governors will be part of different groups, function of their economies' ratios in the euro zone, resulting by calculating an index that will comprise, apart from the GDP, the size of financial markets. When the number of countries in the euro zone reaches between 16 and 21, the rotation system will operate based on two such groups, and when the zone is made up of 22 members, the system will be based on three groups. Governors in each group will hold the right to vote for equal periods of time. Thus the new system is designed as a robust one, in order to assure the functioning of the euro zone comprising even 27 members.

Anyway, if we look at the ECB's voting mechanism, the proposed reform will not fundamentally respond to enlargement challenges: the Governing Council will be smaller than without a reform but larger than, for instance, the similar FED body.

Moreover, reform will not do away with the issue of member state representation. Even in the case of the proposed reform, larger economies such as Italy, France or Germany will be insufficiently represented, whereas smaller economies states such as Malta or Estonia will have a larger ratio than the size of their economies.

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ANNEX 1 THE RATIO/WEIGHT CALCULATION IN THE CASE OF ECB'S VOTING MECHANISM REFORM

TABLE 1.1

Crt. No.	Country	Wheight in overall GDP (2003)	Each country's relative ratio related to the overall number of governors' votes
	GROUP 1		
1	Germany	21.84%	5.33%
2	United Kingdom	16.08%	5.33%
3	France	15.83%	5.33%
4	Italy	13.30%	5.33%
5	Spain	7.58%	5.33%
	GROUP 2		
6	The Netherlands	4.63%	3.81%
7	Belgium	2.72%	3.81%
8	Sweden	2.71%	3.81%
9	Austria	2.28%	3.81%
10	Denmark	1.93%	3.81%
11	Poland	1.88%	3.81%
12	Greece	1.56%	3.81%
13	Finland	1.46%	3.81%
14	Ireland	1.36%	3.81%
15	Portugal	1.36%	3.81%
16	Czech Republic	0.76%	3.81%
17	Hungary	0.75%	3.81%
18	**Romania**	**0.50%**	**3.81**%
19	Slovakia	0.29%	3.81%
	GROUP 3		
20	Slovenia	0.25%	2.50%
21	Luxemburg	0.24%	2.50%
22	Bulgaria	0.18%	2.50%
23	Lithuania	0.16%	2.50%
24	Cyprus	0.12%	2.50%
25	Latvia	0.09%	2.50%
26	Estonia	0.08%	2.50%
27	Malta	0.04%	2.50%
Total		**100%**	**100%**

Table 1.2

	1	**2**	**3**	**4**	**5**	**6**
	No. of countries	Votes	Group frequency (**2/1**)	Country frequency	Group weight	The relative weight of each country
Group 1	5	4	80.00%	16.00%	26.67%	5.33%
Group 2	14	8	57.14%	4.08%	53.33%	3.81%
Group 3	8	3	37.50%	4.69%	20.00%	2.50%
	27	**15**			**100.00%**	

Source: Eurostat, ECB - Monthly Bulletin 05/03*; own clculations*

Notes:

1. The division per groups (table 1.1) is performed function of the GDP weight only;
2. In table 1.2, columns 1 and 2, groups and number of votes comply with the ECB proposal;
3. In column 5, the group weight in the overall governors' votes is calculated by dividing the number of votes (4, 8 or 3) to the whole number (15);
4. In column 6, every country's ratio/weight matches the group ratio to the number of countries in the group;

Annex 2 **The reform of ECB's voting mechanism**

Table 2.1 The euro zone having between 16 and 21 members: two-group rotation system (first stage)

		Number of governors in the Governing Council						
		16	**17**	**18**	**19**	**20**	**21**	**22 and more**
1st group	No. of voting rights/ No. of governors	**5/5**	**5/5**	**5/5**	**4/5**	**4/5**	**4/5**	*Second stage: rotation system with three groups (table 2.2)*
	Voting frequency	***100%***	***100%***	***100%***	***80%***	***80%***	***80%***	
2nd group	No. of voting rights/ No. of governors	**10/11**	**10/12**	**10/13**	**11/14**	**11/15**	**11/16**	
	Voting frequency	***91%***	***83%***	***77%***	***79%***	***73%***	***69%***	
The sum of voting rights		**15**	**15**	**15**	**15**	**15**	**15**	

Table 2.2 The euro zone having more than 21 members – three-group rotation system (second stage)

		Number of governors in the Governing Council						
		16-21	**22**	**23**	**24**	**25**	**26**	**27**
1st group	No. of voting rights/ No. of governors	*First stage: rotation system with two groups (see Table 2.1)*	**4/5**	**4/5**	**4/5**	**4/5**	**4/5**	**4/5**
	Voting frequency		***80%***	***80%***	***80%***	***80%***	***80%***	***80%***
2nd group	No. of voting rights/ No. of governors		**8/11**	**8/12**	**8/12**	**8/13**	**8/13**	**8/14**
	Voting frequency		***73%***	***67%***	***67%***	***62%***	***62%***	***57%***
3rd group	No. of voting rights/ No. of governors		**3/6**	**3/6**	**3/7**	**3/7**	**3/8**	**3/8**
	Voting frequency		***50%***	***50%***	***43%***	***43%***	***38%***	***38%***
The sum of voting rights		**15**	**15**	**15**	**15**	**15**	**15**	**15**

Source: ***The adjustment of voting modalities in the Governing Council,*** în ECB, Monthly Bulletin, may 2003

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THE IMPACT OF STN ON DEVELOPING MARKETS IN RELATION WITH GLOBALIZATION

Alexandru Ionescu*

Abstract

Economic reality worldwide is marked by the evolution of globalization. This process entails effects that are perceived differently at national economy levels, function of their degree of development. We will proceed by attempting a survey of aspects pertaining to the relationship between globalization and developing economies, stressing on internationalizing Transnational Corporations and its effects.

1. Globalization – approaches and concepts

Internationalization, globalization, and regionalization - these are all concepts that make up contemporary reality. According to specialists, the above-mentioned concepts have seen various approaches. If globalization and internationalization are sometimes deemed synonymous, on other occasions analysts see globalization as a mere stage in reaching internationalization.

Subject to long scrutiny, globalization has turned into an objective, unprecedented phenomenon in history, through its scope and evolution. At the same time criticized and praised, it nonetheless follows through with its evolution. Albeit evincing negative aspects, it also comprises important ones providing balance and welfare. Globalization has emerged and developed following an unprecedented tightening of competition at all levels: economic actors, states, regions.

Market liberalization in developing countries, even if it has affected domestic economic activity, has brought about benefits for poor consumers, by increasing their access to cheaper goods and in larger quantities. Proponents of globalization view this reality as a progress. Yet to skeptics, the deepening chasm between the rich and the poor is “an attack to democracy and welfare”. Critics accuse developed countries of hypocrisy since they have forced poor states to adopt an open market policy, by doing away with trade barriers, yet without reciprocating.

Some analysts feel that when setting up globalization priorities, poor countries are always the ones standing to lose or to gain a low benefit in terms of economic growth. The effects of globalization differ in terms of size and focus, their approach always brings about different and even conflicting stances. Worldwide anti-globalization and anti-regionalization movements are well-known, amassing impressive ranks of supporters. Former UN Secretary General, Butros Butros-Ghali, would remind us that “we live amidst a world-scale revolution… Our planet is under the pressure of two giant, opposing forces: globalization and dissolution.” On major source of worries stems from the increasing world population, while resources, most of which limited and irretrievable are

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approaching a critical point. In this context, the only solution to problems is globalization. The whole universe is caught into the thralls of a revolution, a transformation of present reality that spares no one. To most nations, globalization is a forcefully imposed process they cannot elude.

The principles underlying this process are set up by the great economic powers. To the US, globalization is an ongoing process supported by the political and economic elite. Through its economic power, the US has turned into a keeper of order in the chaos of global interdependence. Against the background of globalization, the US rules the roost on the financial market and in international trade, having all means through which to exercise its world super-power attributes.

In contemporary economists' opinion, the world should be an organized system, governed at global level, where competition among the main power poles – the US, EU and Japan – should be stimulated. Super powers have an important say in setting up the world's development strategies, with the poor showing their discontent more and more vocally, so that marginalizing them could spark conflicts.

Anti-globalization movements are the response to the position of international organizations that are unfavorable to developing countries' economies and tip the scales in favor of super powers.

The growing terrorist threat during the past few years has drawn attention on the existing cracks when drawing up these policies entailing severe losses. A solution to global problems can only be reached through joint, balanced actions.

Globalization is therefore a highly controversial system. The world economy has seen unprecedented evolutions during the past years. Even economic process cycles have changed, so that coming out of crises no longer spans long periods of time, yet economic efforts and attempts to find solutions are tremendous. Experts claim that any economic growth should not spin out of control since it may entail a huge consumption of natural, human, financial and information resources, part of which are exhaustible and irretrievable, which could lead to natural disasters. Ideally, economic development should be underlain by scientific research focused on the effective use of resources. Research entails high costs that are inaccessible to developing countries. Consequently, while certain states evince an obvious economic growth, others trail at subsistence level.

Optimists claim that, through its very nature, globalization will improve the social and economic situation of every state, even if differently, while pessimists feel that the gap between the rich and the poor will grow ever wider, with no chances of improvement. The overall process should be carefully developed in order to mitigate its negative impact.

2. Developing countries and transnational corporations

Globalization is strongly supported by transnational corporations that make up the bulk of economic internationalization. Economically speaking, corporations make up one of the most important factors of progress.

Transnational corporations are deemed the main manifestation of an authentic global economy. With reference to transnational companies, K.Ohmae stated that these unaffiliated corporations have become the main "driving engines" of an interconnected economy, concentrated in North America, Europe and Japan.

At global level, the scope of businesses has become an essential parameter, expressed by opening up out plants in various areas of the world. Corporate development beyond the borders of the mother company brings about a synergistic approach to operations and finances, aimed at decreasing their vulnerability and increasing their resistance to economic shock. Transnational corporations represent the main actor in international trade, with sales registered by subsidiaries currently making up more than double the amount of world exports.

Corporations have come to change the structure of production factors in many countries as an aftermath of human capital shift, as well as the movement of technology from one part of the world to another, making up a new basis for fixed tangible assets.

An increasingly dynamic development is underlain by a well thought out strategy regarding the use of opportunities provided by the global economic environment. Corporations have always focused their investments in high potential areas.

Developing countries are a good example in this respect, by providing an economic, social and political environment that is auspicious to development. Theoretically speaking, these countries have a series of advantages stemming from corporate investment, embodied in high economic growth levels, increased occupancy, higher living standards and, not in the least, effects visible at the level of balance of payments and trade output.

The issue of foreign trade in developing countries is delicate, since the majority of transition economies are confronted with high trade deficits and problems brought about by economic deregulation.

Economic deregulation entails the liberalization of economic policies, opening up national markets and allowing all types of direct foreign investment. In fact, investments are the main financing source for developing economies worldwide. During the past few years, direct foreign investment has proved to be the steadiest source of financing, as opposed to portfolio investments or bank loans, since they have been less affected by financial crises.

By acknowledging the importance of direct foreign investment, governments open up their economies in order to facilitate the exchange of goods, the access to information, as well as human resource turnover and capital flows.

Corporations' investment behavior is strongly influenced by short and long term changes occurring in the business environment. Recession and economic boom periods affect the evolution of all parties involved. Any change in the world political or business environment will equally reflect on economic performance and, implicitly, on directing capital flows.

Statistics show that in 2001 alone, 208 changes have occurred in legislation pertaining to direct foreign investment in 71 countries. Over 90% of the changes were directed at setting up a more welcoming investment background. Moreover, a large number of states have been involved in signing bilateral investment agreements – approx. 2,100 in 2001 alone. The issues of investments make up an important topic for discussion within the WTO, as well.

Given the situation that is a common occurrence in developing countries, Romanian included, where the State take on a foreign-oriented approach, according to classical and neo-classical concepts, theoretically speaking, the respective country should be recording an economic growth due to effective resource assignment. However, reality proves that, without significant direct investments, generally performed by transnational corporations, exports continue to cling to modest levels because of low product competitiveness on the world market. Competitiveness is closely related to the degree of technological endowment evinced by a country. Sadly, international technology transfers are also performed and controlled by large corporations, which are the only actors with the necessary capital worldwide. Even when developing economies settle their capital problems, domestic activities still evince a competitive advantage of transnational corporations, as opposed to national companies.

Initially, transnationals have focused on fields where the cost margin of production factors was the most significant, but gradually operations have increased, comprising the majority of production fields and factors, which they have drawn into a global competition, oftentimes bearing negative effects on developing economies.

Corporations are doubling their efforts to set up global production networks, mainly through mergers and acquisitions. Actually, a global market for the sale and purchase of companies has emerged, with whole industries being strengthened or restructured at global and regional scales.

Alongside the advantages that developing countries have through globalization and actions undertaken by transnationals, there are also shortcomings, under the form of social and environmental concerns.

Transnational corporations mainly focus on maximizing profits and dividends, therefore outplants are set up only in areas evincing competitive advantages. Keeping these targets close in check, a corporation will operate on a certain market for as long as the advantages provided are at an expected level. Throughout this time, all those involved in the activities of he respective transnational corporation have something to gain. When the out-plant's activity is starting to show signs of decline following an increased level of mobility, the respective operation will be immediately relocated on a more attractive market. Once the operation has been relocated, the former transnational corporation market evinces a decline in its economic activity, under the former of social unrest related to decreased standards of living and increased unemployment in the area. Employees who can afford to follow the company will move away, whereas the rest will remain and cling to the hope that there will be employment for them as well, some time in the future. As far as shareholders are concerned, they are not bound by places, the distance between themselves and the companies whose shares they own bears little importance, the only significant point being the dividends they cash in.

Labour globalization allows large corporations to employ intellectual elite worldwide, with no significant material and financial efforts.

On the other hand, social effects of globalization are also brought about by the increasing complexity of technology and economic activities' nature, which force people to take on a new type of professional training, lifelong learning that entails constantm ongoing intellectual and financial efforts that many people cannot afford. At the same time, advanced technology has cancelled the space and time barriers that people were supposed to overcome when moving from one place to another in order to perform their activities within companies.

Another major issue that heavily features in developing countries is environment pollution. Pursuing profit regardless of consequences, transnationals have got as far as exporting polluting technology to areas where legislation allows it, global reality thus proving that we live within an accelerated social and environmental dissolution.

As world economy is developing, limiting economic growth in order to keep a balance between the former and nature ever more necessary. Production needs to be kept within sustainable limits.

Ideally, sustainable economic development, with a heavy stress on environmental protection should be globally promoted. These principles need to be adopted not only within develop countries, members of OCDE, but also within developing countries, by supporting them in order to set up the necessary legal framework that would ensure sustainable economic progress, based on non-polluting techniques and technologies.

The targets detailed in the present paper are difficult to reach, due to a decreased state power when confronted with corporation pressures.

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CUMULATIVE EFFECT OF A CHANGE IN ACCOUNTING PRINCIPLE: REMOVE IT FROM THE INCOME STATEMENT

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Abstract:

The comprehensiveness of income, a key definition in accounting, remains contentions despite decades of debate.

A review of this debate reveals that investors have traditionally argued for more comprehensive definitions of income, whereas managers have traditionally argued for less comprehensive measures. We compare performance for both income definitions and component sets. Our results reveal that among income definitions, comprehensive income defined by Statement 130 dominates both traditional net income and fully comprehensive income. No definition dominates clearly.

This, our findings indicate that different definitions of income are more decision useful in different applications and that comprehensive income component disclosures are useful.

Of the two basic approaches to income measurement, the all-inclusive approach has generally been recognized as more useful to financial statement users than the current operating performance approach. The all-inclusive approach requires that all income items flow through the income statement before being closed to retained earnings. In recent years, however, FASB has promulgated several exceptions to the all-inclusive approach, allowing the income effects of certain transactions to be reported directly in owner's equity.

To bring greater awareness to these bypass items ant to aid financial statement users in assessing a firm's activities and the timing and amounts of a firm's future cash flows, SFAS 130 requires firms to disclose comprehensive income.

Comprehensive income consists of traditional net income and the bypass items, called *"other comprehensive income".* Although firms are expected to apply accounting principles consistently, a firm is allowed to change an accounting principle when justified by economic conditions. When a change in principle is made, the cumulative effect is disclosed on the income statement for most changes, although it is a paper entry with no impact on cash flows or current operating activities.

Moreover, some accounting changes are reflected on the income statement, while others are reported in the retained earnings statement.

Recognizing the *"cumulative effect of accounting changes"* as other comprehensive

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income statement items would both enhance the credibility of net income and provide greater consistency.

Cumulative effect of changes in accounting principle

Companies can change methods of accounting in response to economic or business conditions. The principle under *APB Opinion 20, Accounting Changes*, requires restating the affected balance sheet account to reflect the balance as if the new accounting principle had been used from the beginning; the offsetting debit or credit is reported in the income statement as *the "cumulative effect of a change in accounting principle"*. The cumulative effect is disclosed net of tax and presented as the last line item before net income.

Comparative income statements are not restated using the new principle; the firm must report however pro forma information on income and earnings per share as if the new principle had always been applied.

Exceptions for certain changes in accounting principle

The APB recognized that the cumulative effect of some accounting principle changes could be so large as to skew net income in a misleading wag. Consequently, for certain exceptions, the cumulative effect, net of taxes, does not appear on the income statement. Instead, the cumulative effect is carried directly to retained earnings as an adjustment to the beginning balance. For example, when Chrysler Corporation changed form LIFO to FIFO, the cumulative effect of the change was $ 53.5 million. If the cumulative effect had been disclosed on the income statement instead of the retained earnings statement, Chrysler would have reported a net income of $ 45.9 million instead of a reported net loss of S 7.6 million. In addition, all comparative income statements are restated using the new principle.

The following changes are exceptions that do not appear on the income statement:

1.A change from the LIFO method of inventory pricing;
2.A change in the method of accounting for long-term construction contracts;
3.A change to or from the full cost method in the extractive industries;
4.A change from retirement – replacement – betterment accounting to depreciation accounting. Issuance of financial statements for the first time by a closely held company to obtain equity capital, to effect a business combination, or to register securities.
5.A change to the equity method of accounting for investments.

Another exception is made for a change to LIFO. No cumulative effect is required due to the difficulty, if not impossibility, of such a calculation. The beginning inventory in the year of the change is considered the first layer, and LIFO is applied prospectively.

IASB discussions of an operating/financing classification

During the past few years the IASB and the UK's ASB have been discussing and considering several guiding principles for their joint project on performance reporting.

The Boards of the IASB and ASB agreed that a conceptual approach should be grounded on a primary performance reporting principle, which is:

The investors' perspective suggests that information relating to predicting the rate of change in financial statement items should a primary differentiator between performance statement components.

The staff believes that FASB's task force members also suggesting that *"predictability"* is a most important characteristic for purposes of distinguishing items of information.

However, the staff also observes that such items could be distinguished with line items within components of a performance statement. That is, distinguishing between such items need not be the primary reason for distinguishing between components of a statement of financial performance. For example, a business activities versus financing activities cut is a functional or activity classification scheme that could be used with required distinctions within those components for items having different predictive characteristics. Primary components based on a core/no core distinction would seem more consistent with the above principle if the definition of no core rests primarily the notion that all of the items included in the component (whether operating or financing) are those that are not expected to recur for an extended interval of time.

Application of Guiding Principles

The staff of the IASB/ASB identified Principles 3 and 1 as basis for making two primary distinctions for components of a performance statement. Those principles are:

Principle 3 – When current values are used to measure assets and liabilities, income and expenses can be divided between those resulting from economic activities of the period and revisions to estimates of future economic activity.

Principle 1 – A performance statement should be able to distinguish the return on total capital employed from the return on equity.

Principle 3 is used as the basis for distinguishing economic activity of the period form revisions to expectations of future economic activity.

The purpose of the distinction is to help users identify separately the performance of the current period that can be used to extrapolate future performance from value changes that are not directly useful in making predictions because they are derived form revised expectations of future performance. Principle 1 is used as the basis for distinguishing between operating and financing activity, which is accomplished by presenting all items of operating activity first followed by all items of financing activity.

The IASB/ASB staff suggests that the order three performance reporting principles can be applied in determining additional desegregations within the four main components.

Those principles are:

Principle 2 – Components of gains and losses should be reported gross unless they give little information with respect to future income.

Principle 4 – a performance statement should identify gains and losses where the change in economic value does not arise in the period in which it is reported.

Principle 5 – Within the prescribed format and without the use of proscribed subtotals, the performance statement should allow reporting in the form of:

- ✓ Information on the entity as a whole, analyzed by nature or function;
- ✓ The activities in disaggregated by business segments (geographic or product-based);
- ✓ Additional distinctions according to managerial discretion.

Evolution of comprehensive income

As early as 1936, arguments were made to support the all-inclusive or *"clean surplus"* concept, in which the income statement contains all changes in equity except for investments and dividend distributions.

In *"Introduction to Corporate Accounting Standards" (1940),* Patton and Littleton state: irregular factors – should be reported in the *"All determinants of income in the broadest sense – including unusual and* i*ncome statement before the net results are passed to the stock-equity section of the balance sheet".*

In *Accounting Research Study 3 (1962),* Sprouse and Moonitz state that *"the net profit (earnings, income) of a business enterprise during any given period of time is the amount of the increase in the owners' equity, assuming no changes in the amount of invested capital during the period either from price-level changes or from additional investments and no distributions of any sort to the owners."*

In 1966, *APB Opinion 9, Reporting the Results of Operations*, again emphasized the all-inclusive approach. The APB concluded that all changes recognized during the period should be reflected in the income statement, with the sole exception of adjustments of the income in prior periods. The APB later reaffirmed the all-inclusive approach in *APB Opinion 20, Accounting Changes*, and in *APB Opinion 30, Reporting the Results of Operations-Reporting the Effects of Disposal of a Segment of a Business and Extraordinary, Unusual and Infrequently Occurring Events and Transactions.*

The concept of *"comprehensive income"* was first introduced in 1980 in *Statement of Financial Accounting Concepts 3* (superseded and replaced with Concepts Statement 6), *Elements of Financial Statements.*

Comprehensive income was defined as *"all changes and equity during a period except those resulting from investments by owners and distributions to owners."*.

FASB has defined comprehensive income broadly, so that many items currently excluded from income determination could eventually be included. For example, appreciation in the valuation of plant assets could at some point be included in comprehensive income. SFAS 130, however, does not include any item that does not currently appear as owner's equity.

Net income, as traditionally measured, continues to be reported in the income statement. Comprehensive income, consisting of *"traditional"* net income and other comprehensive income components, is displayed with prominence in the financial statements in one of three formats combined with the income statement (one-statement approach); as a separate statement (two-statement approach); or included in a statement of changes in stockholder's equity.

Time for a change: a proposal

Although one of the primary objectives of the income statement is to provide information to aid financial statement users in assessing future cash flows, the inclusion of the cumulative effect of a change in accounting principle in the income statement can be misleading in interpreting past results and is useless in predicting future cash flows.

The cumulative effect of a change in accounting principle is simply a book-keeping entry.

In addition to potentially misleading income statements, current GAAP permits inconsistencies because some exceptions go directly to retained earnings. With the availability of a comprehensive income statement, all changes in accounting principle should be shown as comprehensive income and omitted from the traditional income statement. This proposal would permit the comprehensive income statement to present an all-inclusive approach to comprehensive income, but would focus the traditional income statement on current operative performance.

The items currently considered as other comprehensive income are gains or losses that have not been realized and that may be offset in future years by other gains and losses. The cumulative effect of an accounting change is a one-time adjustment and will not be offset in future years. In addition, the cumulative effect is the result of income measurements and should ultimately be included in retained earnings. Consequently, the cumulative effect of accounting changes should be included in the comprehensive income statement and subsequently (the same statement) transferred to retained earnings.

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