

The physics of human nature

"The supposed efficiency of the free economy as it was promoted in the 50's and 60's looks more like a propaganda against communism rather than science."

Jean Phillipp Bouchaud

The global economic crisis raises – beyond its consequences – a principal issue: is Economics a science?

The founding assumption of Economics is that it reveals the regularities generated by the market. The rational basis of Economics seems to offer the provable rules of rationality. From the scarceness of the resources to the usage of added value, Economics offers principles, rules and laws with claims of generality. In the microeconomic component, as well as in the macroeconomic and socioeconomic ones, Economics recommends itself as a science.

There is no doubt that it is an image of transfer from that which is considered to be science starting from geometry and, especially, physics. The economists' call on the suggestion of co-relativity specific to geometrical figures which offer the explicative support in the functioning of a mechanism – meaning the economy seen as a mechanism – says a lot about the epistemic model of Economics.

The truly delicate part of the consistency of Economics as a science lies in the fact that it is much too tributary to the imprint of the geometrical model and too little developed for it to draw upon the significances of the epistemic model represented by physics. This means this is a constitutive state of the economic model where the explanation is relevant from the perspective of a physical mechanism – maybe of the type of the "perpetuum mobile" and not of a physical system, of a critical nature and with the capacity to adapt.

The attitude of the responsible actors toward the emergencies of the present crisis is symptomatic: they struggle to keep the mechanism from stopping, the "perpetuum mobile" of wealth, by suggesting material solutions for the recovery. The goal is to fix the mechanism in order for it to re-gain its performance until the next fix.

The epistemic repositioning with regard to the economy is the real problem bearing the sign of the crisis' ultimatum. The epistemic model represented by critical systems with a capacity for learning changes the perspective, focusing on

the specifics of the economy as a sum of some individual behaviors validated by rationality.

Economics thus becomes not a "science" on the perpetual functioning of the mechanism of wealth as a goal, but the normal science of behaviors motivated by wealth as a means.

The leap in adequacy is tremendous: from geometry and mechanisms, on which even the neurotic advantage of social mechanism was speculated, to the "physics" of human nature, meaning a science responsible for the sensitive and rational part of nature in general.

There is – obviously, through this revolution, a need for an epistemological reconstruction of Economics, meant to bring it out from under the paradigm of the mechanical and quantitative Enlightenment, and to bring it closer to what Economics should be as an open system, with a self-regulation of individual behaviors within rationality's guidelines of opportunity.

The complications so far – coming from the Enlightenment's epistemic model, based on void abstractions mortifying subtractions – are revealed in the form of the crisis and constitute the cause of the cyclical nature of crises. Overcoming them is possible only by changing the epistemic model.

The founding anew of Economics on the new vision eliminates another series of complications continuously played out all along history, coming from the ideological perverting of the solutions for coming out of the crisis. This way it becomes more important, for instance, for the mechanism of wealth to be saved rather than the saving of man and human nature from the threat of chaos. This would lead to the persistence of the vicious cycle of the explicative model, supposed by the vision of the Cartesian mechanism, which would mean the continual paying off of the enormous bill of cyclical repairs which is the crisis.

The global crisis fought by the world's governments has essentially a miracle solution: the changing of the vision on the founding principles of Economics!

Marin Dinu

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Contextualism Revisited: Towards a More Relevant Conceptualization of Public Administration for Ethical and Sustainable Leadership in the Global Context

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***Abstract.** The paper examines how the contextual approach to the conceptualization and the design of public administration systems can still be a viable alternative for today's environment. By making reference to a proposed conceptual model, predominantly based on the cultural and social values in different contexts, the paper juxtaposes both the traditional Universalists and recent NPM approaches to the Contextual model by reviewing the literature on the impacts of globalization and other recent developments in the area public administration and public policy both at the national and international levels. Special attention is paid to the significance of two major elements of ethical leadership and governance for creating a viable and sustainable public administration system that incorporates and emphasizes the process of political development and enhancing the civil society based on indigenous cultural and social values. The conclusion of the paper reinforces the validity and utility of the contextual approach by including these two major elements into its original conceptual framework.*

Key words: universalism; contextualism; ethical leadership; cultural values, globalization.

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Introduction

The core argument of this paper is what would be the direction of public administration (PA) in the new millennium to cope with unprecedented changes the world is facing. Among many recent initiatives, NPA, the whole of the government, and few others postulate some kind of universal approach, although theirs might be somehow a modified version in terms of traditional universalism. The dialog on how the new direction of PA must be seems to be a kind of never ending discussion as how the public administration must tackle with issues facing different societies in attempting to enhance the quality of life internally and peaceful relationships with other nations externally. While in recent years there has been some criticism extended to the Universalists' viewpoints on the functional side, it seems that its very philosophical and conceptual directions have not been challenged. This author feels that at the heart of the matter lies the old controversy between Universal and Contextual approaches both in term of overarching philosophies, methodology and practices. While in recent years many new labels are being created for PA, when discussing the increasing complexity and dimensions of its issues, agenda, and challenges, little attempt has been made to understand the fundamental and philosophical differences of these two approaches that may divert attention from dealing with the causes to the symptoms of existing and emerging problems. Anyway that we look at it, the perennial question seems to be whether PA theories, concepts, models and practices, or in other terms the "PA Paradigm", using Khun's terminology (1974), are indeed universally or

contextually bound when applied to a variety of situations and contexts. The argument has become too complex in the wake of new information technology, globalization, and new capabilities for easier oversight and control by central authorities that may give Universalists a kind of leverage for supporting and reinforcing their traditional position. On the other hand, qualitative changes and developments in the very fabric of present day societies evolving continuously, provide some unique and unprecedented contexts manifested by increasing expectations of citizens for more involvement and bigger say in the political decision making process, public policy formulation and implementation, as well as other claims they have regarding civil liberties and individual rights, pose many challenges to that traditional position and mindset. The adverse impact of globalization, environmental concerns, hegemony of powerful countries, struggle of a majority of developing countries in Africa, Asia, and Latin America in providing a decent life for their citizens, as well as their fights against poverty, illiteracy, fatal diseases like Aids, among many others as manifested by the U N Millennium report and goals (UN, 2005), are examples of serious global challenges. Added to that are failures of international agencies in helping these countries due to their aggressive, if not dysfunctional, imposition for imported democratization as manifested by the outcome of misguided one size-fits-all policies. Market liberalization, free trade, defensive budget approaches of international organizations like IMF, WB, and WTO, and impositions by hegemonic powers, among many others are examples of such imposed policies. All of these seem to be indicative of dysfunctionality, and to some

extent obsolete philosophy and practices, rooted in Universalists' approach. As a kind of reaction to such centralized, power based, and cliché mode of operation, as opposed to contextual and consensus based ones, even in progressive developing countries, one can observe that new emerging trends are geared towards pushing for more engagement and participation in public policy decisions by citizens in order to shift the weight from what traditionally governments used to have in shaping such policies, to non governmental institutions and other components of the civil society. This paper will first present a brief summary of universalism and its modern substitutes manifested in postulates like NPM, along with a Contextually based model presented a couple of decades ago by this author and his co-author intended to offer a different venue for some societies to move towards a more meaningful, relevant, and culturally based public administration system. Next, it will address some of the compelling issues confronting the PA particularly with regard to Globalization, its success and potentials as well as its failure and drawbacks along with the emerging interest in issues like ethics, accountability and the role of governance that go beyond the traditional authority based models. The role of leadership in shaping and directing an ethical and responsive public administration system will be explored and a few leadership approaches that have emerged in recent years and seem to have potential towards that end will be examined. Finally, based on such review and examination, the paper will revisit the role of contextualism and the contextual approach in this new environment along with some recommended revisions.

The universalists approach

The Universalists approach that has its roots in several evolutionary trends and in a sense gets its roots from the era of industrial revolution sought general principles for running efficient and effective organizations. Dating back to Adam Smith's *Wealth of Nation*, and moving to organizational researchers and practitioners like Charles Babbage, Galbreths (1904), Taylor's *Principles of Scientific Management* (1911), Henri Fayol (1916), Weber's ideal type Bureaucracy (1922), Mooney and Reiley (1931) and Culick's famous POSDCORB (1937), as noted by Shafritz et al. (2007), all were the precursors of what became known as Universalists approach to management and administration. According to this approach, general and firm principles had to be adopted if private and public sector entities were to be managed efficiently and effectively in order to attain what they are made for. In case of public sector, laws and regulations as the foundation and guidelines for operation and compliance, manifested by bureaucracy's legal-rational authority described by Max Weber, were considered the golden rules (1964). Although the emergence of Simon's Decision Theory (Simon, 1979), application of System Approach (Checkland, 1981) and later Contingency approaches to management all created some shake ups in most of these foundations. Nonetheless, Universalists' theories and principles that served well in its own time survived and some were revitalized under disguise up to the present as a blue print for attaining efficiency and effectiveness. Such serving was more rigorous in public sector that was in quest of stability and order as its

overarching values. While in private sector the authenticity and utility of those principles have been questioned easier and a host of new trends emerged to replace them, the public sector did tend initially to ignore and later adopt them partially and more slowly.

Over time, in public sector the dysfunctions of bureaucracy particularly with regard to the “development administration” gained some impetus as more and more developing countries became frustrated with the lack of results as promised by Universalists by following one size fits all theory. Shafritz and Russell mention that it is such a blind conformance that gives bureaucracy its catch-22 quality. What Merton referred to as its “tainted incapacity” in reference to a “state of affairs in which one’s abilities function as inadequacies or blind spots” (2007, p. 266). Such tainted vision and rigidity, not prone to flexibility that was required for the design and implementation of modified and in some case very different administrative system in a given society, was the order of the day. This ironically has been considered, by those with dominant powers like international agencies and powerful countries, as the source of stability that developing countries needed in order to improve their administrative systems for attaining their developmental goals. This is the theme that Baaklini brings to the fore with regard to both scientific, Universalists approach of development administration that subsequently omit the political development so crucial for most developing countries. In his argument about the challenges of new development administration, he convincingly argues that the Anti-Political stance of the development administration has been the source of a failure to benefit from the rich

intellectual history of this field in America. He counts several sins committed in preventing developing countries in reaching the long-range paradise where a democratic political community is supposed to flourish (Baaklini, 2002, p. 59) Among the sins he refers to, one is the sin of omission of democratic development. This has to do with how government activities might impinge on the political rights in such a way that they fail to inform how democratic political institutions, as an end product, can come about from development goals, policies and programs that are essentially either contradictory to or altogether oblivious of those political institutions (p. 59). He also refers to the centralization of power, and not dispersion of it, as means of achieving development, and substantiates this assertion by making reference to Huntington (1998), Binder (1971) and others who echoed such proposition before. Thus, according to him, uncontrolled economic central planning and accumulation of power in the hands of a few affects individual freedoms and political rights which is considered an insignificant matter that can be handled by the “ripple” effect or “filtering down” of the fruits of economic development (p. 60). Baacklini’s main point, however, is focused on the impact of development ideologies on the centralizing tendencies. Quoting Illchman (1965), he states that according to this theory bureaucracies are considered the best and most objective instrument for achieving development that by some authors like Janowitz (1964) and Johnson (1972) even got to the point of advocating the advantage of military bureaucracies as instrument for development. He presents this as a full review of the

anti-democratic nature of much of the development literature (public administration) taught at our universities. He rightly considers negative perception towards politics and legislature, poor capabilities of newly established legislatures including lack of access to information system needs and its management, absence of comprehensive legislative development strategy, impart of emerging private markets and the global economy as the major challenges of development administrative that must be dealt with (p. 61).

In spite of such valid criticisms, however, even among the contemporary researchers there are those who still advocate the Universalists position as the right path for PA and International PA. For example Minuva and Chackerian, in their report on Zimbabwe civil service reform (2002), see globalization as worldwide integration and transcendence that pervades the field of PA today and make an optimistic assessment of this process predicting the advent of the global village and world order beyond nation states that eventually will lead to a single world government and a global management system. They believe in international diffusion of common public administration professional standards leading to efficiency, effectiveness and responsiveness in the operation of PA system worldwide. They use institutional theory as a framework to examine the civil service reforms recommended by international agencies and adopted by the government of Zimbabwe to develop their development model inspired by globalization (p. 98). Their main argument and conclusion is the notion of PA based on principles that can be universally applied that goes back to its roots as a

discipline. They state that from Woodrow Wilson on application of management science, pervasive then in France and Germany, the notion of the universalism was the core of the emerging discipline and that the post World War II, the application of administrative science worldwide, and proliferation of training institutions became the method of administrative reforms. They continue that based on global forces, the reminiscent of classical modernization theory again view PA system as gravitating towards a single form of “modern organization” (p. 93). It is somehow ironic that they refer to the pervasive adoption New Public Management (NPM) reforms by advanced and developing countries alike as an illustration of the internalization of best practices, as preached and reinforced by international agencies like UNDP responsible for administrative reform in the Third World countries. These examples denote the fact that at least a major stream of scholarship and research is still prescribing the Universalists approach as the best way for PA to flourish and create the most relevant and effective system worldwide. The concluding part of this paper will revisit these viewpoints along with some evidences that, ironically, offer some counterpoints to their very own theoretical position.

This kind of tendencies prevalent in development administration and to a large extend in developing countries as to relay heavily on the power of central governments has created so many tensions for scholars, practitioners and concerned citizens on the real role of public administration as manifested by the executive branch. This trend seems to have gained momentum even in developed countries, to a large extent as the consequence

of 9/11 catastrophe. One cannot go very far to see many compelling issues facing the United States in the past few years. Wire tapping, bypassing congress for continuing and escalating war in Iraq, avoiding fair and impartial investigation on CIA leaks, and most recently the controversy over the dismissal of 8 general attorneys by the department of Justice, allegedly inspired by White House top aids are just a few examples of challenges and controversial and dubious acts by top level public administration officials. These, as well as many other issues, confronting public administrations in different countries point to the direction that most public administration systems are striving for more power, centralization of authority, that consequently overshadows the people's rights as manifested by the legislative bodies, as well as weakening the civil society.

Justice cannot be done to any discussion on these issues unless we look at the very fabric of both the structure and function of governance at the societal level as well as the role that ethics leadership can play in maintaining the delicate balance of protecting civil liberties and security in such a turbulent environment on one hand, and maintaining a responsive and effective public administration system on the other, while facing so many limitations and hurdles like environmental issues, energy crisis, poverty, illiteracy, health service, civil turmoil and tumultuous international relations.

NPM and the universalists

To what extent Universalists approach differs from the NPM? Cheung provides some good insight into this issue. Although his point

of reference is the Asian countries administrative reform, nonetheless, his account is very informative about the differences and similarities of these two approaches. In his report on administrative reform on Asian countries, he states:

A common explanation of administrative reforms at the global level is NPM, the substance of which is well articulated in the literature (e.g., Hood 1991, Lane, McLaughlin, Osborne, Ferlie, Pollitt Bouchaert). As reform prescription, NPM represents a critique of the traditional model of public administration based on state bureaucracy (Dunleavy, Hood, Hughes) and of the general failure of government – expressed as an unresponsive but invasive state, overextended state, or private-interest state captured by privileged groups (Minogue). Because of PNM's growing international currency, it is easy to understand its impact on Asian and other countries in the newly developed or developing world, which feel the urge to follow the latest international "best practice." Paul DiMaggio and Walter Powell saw public-management changes as heavily driven by "mimetic" processes. These are in addition to policy learning and international organizations that promote ideas about "best practice" and benchmarks on "good governance," such as the World Bank and OECD (Cheung, 2005, p. 259).

In explaining the Asian PA reforms Cheung refers to both supply and demand sides of the equation. On the former, he says it may rest on the claim that certain ideas and practices proving to be effective (such as NPM) are being spread or "exported" by reform pioneers and leaders to the follower/learner/imitator countries. Such an exporting process can be logically sustained by policy transfer and

policy diffusion theorizations. However, the force of such supply-side explanation is not without conditions or bounds. Such conditions fanged from limit to the internalizing of policies in spite it given some legitimacy to the national reform, but if such exportation is not distilled by national politics (most policies are local by nature) and also from the fact that a global reform paradigm, even in its place of origin, may not represent a single fixed set of reform instruments or strategies. In the case of NPM, it embraces a whole range of measures and strategies lumped together for government reformers to pick and choose. And he refers to Christopher Pollitt and Geert Bouchaert categorization of these as the strategies of four “Ms” – maintaining, modernizing, marketizing, and minimizing the public sector (p. 274).

On this point Kettle also brings the fact that the actual strategic choice is determined by national conditions and the political agenda, as well as by motives and preferences of decision makers, resulting in distinct national reform styles representing diverse philosophies (Kettl, 2000). As Pollitt reports, Chung (1997), Hood (1996) and Ingraham (1997) all assert that NPM reforms are noted more for their divergence than for uniformity and that its convergence may mean quite different things – talk, decisions, actions, and results. As Pollitt mentions, there is a lot more information around the world on discursive and probably decisional convergence, yet far less evidence on practice and results convergence (Pollitt, 2001). One can also argue that NPM, by its very nature, was intended to reform the PA systems within the pre-established boundary as defined by this field. Those who are critical of NPM not only have been skeptical about its universalism, but themes that are not in the forefront of both

academic and professional circles like capacity building, corruption, stakeholders, citizen empowerment and overall decentralization that seem to be outside the conventional domain of NPM. Most attention now-a-days may be as a post NPM movement that points out to the importance of civil society (Polidano, Hulme, 1999), and new forms of governance, as will be discussed later, all go well beyond the managerial component of NPM.

The contextual approach

Contextual approach came to prominence since late 1970s when not only different societal administrative arrangements faced with problems of unqualified adoption of others’ models and practices, but also it manifested itself within different organizations in the same society as a viable alternative to the idea of one size fits all. May be the best example of contingency approach as depicted by authors like Daft (p. 26) is contingency approaches to leadership that defied the authenticity of previous models like Trait and Behavioral models of leadership. This new recognition while, maintaining the usefulness of some of the old techniques, but at least implicitly, demonstrated that major contextual factors as the dominant factors in determining what fits a given situation.

Couple of decades ago, Björk and Zomorrodian presented a conceptual framework for developing a contextual-based, indigenous framework of administration in their article presented to the Symposium on Cultural Differences and Development Administration (IRAC, 1987) based on several years of research and practice in some developing and developed countries. They took on the idea of

contingency approach that was in its infancy, but started from a kind of more in-depth premise that would lay the foundation of an emerging framework that eventually leads to the application of different techniques and models primarily in public organizations and institutions. Their framework, as indicated the Figure 1, outlines steps helpful in identifying values in the background culture that affect the success and failure of administrative process and techniques (both invented and borrowed) by a given society that can be tested for match or mismatch against basic values guiding the organized, collective action in a given context.

The proposed framework, called *indigenous model*, was based on several important assumptions that would have been essential in approaching the design of such model:

1. In every culture, coordinated activities occur in multi-employee organizations even though neither subordinate nor superior has had any formal training in administrating. This argues that the local culture has socialized its members with training in various roles and values necessary to organizational functioning.

2. The study of administration during the past century is generally recognized as a rational effort to enhance the value of efficiency in collective action. Efficiency is simply defined as efforts to maximize output while minimizing costs.

3. Some of the values and behaviors taught in a culture and are natural allies in this drive towards efficiency, while others are its logical and behavioral enemies. Every cultural context, therefore, presents a different mix of values “allies” and “enemies” in the administrative pursuit of efficiency.

4. It can be observed that in some organizations (and in some entire cultures)

efficiency, although valued, has been made subservient to other overarching values in day-to-day administrative practices (Bjur, Zomorrodian, 1987, p. 398).

The logic of using culture as the bedrock of such theorizing according to the authors stems from the fact that “...many problems and failure in attempts to borrow its (administrative) precepts and techniques for application in other cultural context (predominantly US).. and the problems of transfer of administrative theories and practices ... (are) due to lack of consonance in the basic value structures of donor and borrower societies” (p. 399).

The Conceptual model as depicted in Figure 1 (See Appendix) points out to four levels starting from the domain of cultural values, denoting the most fundamental values which establish the norms by which leaders and followers alike are able to distinguish between “right” and “wrong” decisions and actions (p. 403). Then, at the second level, Institutional values are addressed that are inspired and drew from the fundamental values and represent the dominant political, economic, social and cultural values and these enduring social, political and economic organizations derive their basic legitimacy from adherence to, and or representation of, these perennial values (p. 404).

Level three focuses on the instrumental values that incorporate into the organizational structure, which establish hierarchies or responsibilities between employer and employees and include a host of organizational structure and behavior elements discussed in management literature necessary for running effective organizations. Issues like efficiency and effectiveness, productivity, competency, etc. are dealt with at this level. Finally, the forth

level addresses specific techniques and models designed for selective organizations and entities of a given system based on those value premises. The authors make a comparison and provide examples as how the ideological based cultures are compared with those secular-instrumental cultures in dealing with the way each proceed with structuring and functioning of their institutions. These approaches are direct consequences of the directives from the fundamental values with a profound impact on both the direction and control of those institutions. Using a previous model developed by Zomorrodian, the authors show how administrative theories find their indigenous shape and application within a given society both normatively and instrumentally as depicted in Appendix, Figure 2, although the latter might not manifest itself clearly in all domains of institutional activities (Bjur, Zomorrodian, p. 403).

The gist of the Indigenous theory as summarized by the authors encompasses three important points. One has to do with legitimacy that draws predominantly by the culture. They state that “it has seemed obvious that any administrative theory which pretends to describe existing reality, to guide administrative practice and clarify legitimate administrative objectives must necessarily spring from the cultural values which govern social interactions and dominate intra- and inter-organizational relations... more dramatically apparent in the Third world than in US...” (p. 415). The second has to do with organizing and ranking in hierarchical importance some of the cultural values of most concern to administration. “It points out that values such as efficiency, to be unquestionably superordinate for assessing and improving administrative functioning, may in

fact be secondary to other valued objectives in some culture settings. And thirdly by the proposed framework, the authors hope that it provides a base for a conceptual approach to organization/ administrative theory building, particularly for those who are wrestling with the problems of innovation and adaptation in the field” (p. 416).

While the theory may need improvement based on the new developments in the field and a few major changes occurred in the area of development administration in the past 20 years or so, the gist of the argument remains the same. The conceptual foundation seems to have been validated by new developments in the new focus of public administration to the culture, diversity, societal norms and particularly religious beliefs as the foundation of thinking and behavior in different societies. Strong emphasis on the role of political development, in terms of governance and civil society, with their different formats, stemming from the societal and cultural foundations, are evidences that support the validity of contextual approach. These developments attest the fact that any sustainable theory building must be based on the indigenous cultural value system that directs the development of any institutional and organizational systems and processes.

The impact of globalization

No phenomenon has attracted more attention, discussion, and controversy than globalization in the past several years. This section will examine some definitions, characteristics, and specific features of globalization in order to see what impacts this phenomenon have for public administration at both national and international levels.

Definition: There are many definitions for Globalization. Stiglitz, in his best sellers (2003), provides an informative account based on his experience and work in different countries and as VP of the World Bank, from 1997 to 2001, a kind of disillusioning tale of how most developing and former communist countries failed to benefit from globalization and states that for most part what is remained about this phenomenon is discontent. Providing ample evidences ranging from Russia, China, South East Asia to Africa, he shows how the cliché policies of international entities like IMF and to some extent WB, and WTO hurt and not helped these countries in their quest for economic and social development. In most cases, according to him, such interventions affected negatively these country's very constructive efforts for development as manifested by the famous South Asian Crisis of 1997 (Stiglitz, 2003, pp.104-109). The overall theme of Stiglitz focus has to do with the flexibility and "made at home" approaches to development, in terms of policy formulation and implementation and getting away from the imposition of international agencies of what he calls "conditionality" imposed by them in extending aids and loans supposedly to help them in their development efforts. At the same time he does not totally ignore the huge potential of globalization for both developed and developing countries in terms of benefits from modern information technology, foreign trade, technical and scientific exchange, as well as all sort of collaboration that may make the world a better place to live as well as in coping with numerous challenges of poverty, disease, illiteracy, and security facing virtually all nations. He is advocating the process of institutional building and generating right

policies by individual countries themselves, by enjoying more freedom instead of imposition by powerful countries, and through encouraging more regional alliances. Although his ideas are mostly concerned with economic and to some extent political development (p. 27), they clearly support the application of contextual models advocated by this author. A major theme of Stiglitz has to do with unavoidability of globalization and everything that goes with it that puts all societies in one boat, so not only the world problems are becoming global, but solution to any problem will be the responsibility of all, and not any individual country or countries.

Chung, too, addresses the impact of globalization from the perspective of public administration reform in Asian countries and the fact that these countries have been riding increasingly on the global movement of public sector reforms. He adds that since the 1997 Asian economic crisis, which caused doubt to be cast on the validity of the previous "East Asian Miracle" thesis (World Bank), there have been calls for institutional reforms in some Asian countries to cope with the challenge of globaliza-tion and catch up with some recognized "best practices" (Asian Development Bank [ADB] 1999, 2000, Schiavo-Campo, Sundaram). Countries relying on the assistance of international organizations or developed donor countries have become particularly prone to imposed conditions of aid in the form of requirements on speciûc reform targets and strategies (p. 276).

He also adds that apart from economic and fiscal pressures, however, domestic political changes, including regime change, democratization, and the collapse of the preexisting political order, have also resulted

in a new articulation of governance that underlies new institutional arrangements. This is in addition to the innate influence of national administrative traditions such as the colonial, military, or imperial legacies of some countries. Asian administrative reforms. According to him, are often closely linked to political reforms arising from decolonization and nation building and also “socialist” countries such as China and Vietnam that have embarked on paths of economic and administrative transformations because of systemic reform and ideological revision (p. 278). As was mentioned earlier he refers to some examples of global influence on public administration the “new public management” (NPM) and “good governance”. However, for these countries may be the regional alliances and influence has been equally important, if not more in their quest for globalization. Examples of these are OECD, Organization of Economic Co-operation and ASEAN, emphasizing on good governance, an objective advocated by regional and international organizations. However, a major point expressed by Cheung and others again refer to the fact that not all OECD countries shared the same past in the form of a “traditional bureaucracy.” In many countries, more autonomous state bodies existed. Similarly, Asian national situations cannot be casually lumped together into a regional pattern and for that matter Asian reforms are noted for their features of nation building and state capacity enhancement, which have been motivated by national politics as much as by external inspirations. He refers to Christopher Pollitt (2000, p. 185) who observed that, “path dependent” explanations fit public management reform rather well. Some countries (such as Germany) have found

it more politically and legally difficult to change central administrative structures, and, however, the “political” nature of such reforms cannot be stretched too far; after all, reforms in most countries are not devoid of political motives and calculations as Kettl states, not to mention the domestic need to build and sustain political coalitions for change. Overgeneralization is as much an analytical risk as overplaying local uniqueness (p. 280).

Bolia and Lechner take a different approach in describing globalization. They define globalization from a broader cultural perspective and see it as a process that involves expanding worldwide flows of material objects and symbols, and the proliferation of organizations and institutions of global reach that structure those flows. They also define the world culture as a cultural complex of foundational assumptions, forms of knowledge, and prescriptions for action that underlie globalized flows, organizations, and institutions, encompassing webs of significance that span the globe, conceptions of world society, world order, and models and methods of organizing social life that are assumed to have worldwide significance or applicability (p. 6263). They state that while many types of global flows have been rising cyclically for centuries, it was only in the second half of the nineteenth century that a transnational cultural complex took a sufficiently organized form to constitute an emerging world culture. They consider Western Europe as a source that promoted political and philosophical principles, societal and individual goals, modes of organizing, and ways of conceiving and manipulating reality that they deemed universally applicable (p. 6264). Epitomized above all by technical and scientific

principles and practical knowledge presumed to be invariant across time and space, emerging world culture also included more historically bound constructs and ideologies, such as nationalism, citizenship, and individualism (p. 6265). They look at this early version of world culture, as “transeuropean” culture, was carried far and wide by missionaries, traders, military expeditions, colonialists, intellectuals, and travelers. In this same period, transnational organizations and global structures emerged with increasing frequency, eventually to form a structural backbone or framework for world culture. Of our interest is their reference to a vast majority of transnational organizations as products of international or global “civil society” – voluntary associations founded and operated by individuals from many countries to pursue specific goals through democratically coordinated action. Typical early examples include the International Charity Association (1855), the International Sugar Union (1864), the Scandinavian Dental Association (1866), the Permanent International Committee of Architects (1867), and the International Meteorological Organization (1873). By the 1890s, such international nongovernmental organizations (INGOs) were appearing at the rate of more than 10 per year, across a wide range of social sectors, drawing participants mainly from Europe and North America but also from Latin American and some Asian countries, particularly India. These bodies defined themselves as global actors and sponsored periodic conferences at which universalistic issues, problems, methods, and solutions were proposed and debated. They came to constitute a formalized global public realm in which world culture was defined, documented, elaborated, and propagated to

what the growing number of participants in this public realm were beginning to think of as a single world society.

They see the world wars and other major events impediments to cultural structuring, but believe that the process rebounded quickly and that the transnational cooperative relationship increased through intergovernmental organizations, but more so by number of INGOs that soared into the thousands after the WWII. This helped expanding complex of global organizations came to center on the United Nations, whose agencies and programs became axes of global governance regimes in such major institutional areas as education, health, and development (p. 5265).

These two authors conclusion of their lengthy treatment of the global culture is that the World culture is not only a homogenizing force but the fact that it also engenders and supports diversity and differentiation. According to them five explains how the world culture promoted heterogeneity that ironically may serve the world culture’s homogenizing capacity. They are:

(a) Success of the nation-state political form. Rapid decolonization after 1945 produced a world organized almost entirely as independent states. Most new states have eagerly joined global governance organizations, debating and helping to shape agreements expressing world-culture principles and prescriptions.

Citizens of the new countries became avid joiners of INGOs, expanding the range of their memberships much faster than citizens of older countries (p. 6263).

(b) Cultural relativism and the ideology of cultural authenticity. Intellectual movements in the social sciences and humanities, coupled

with the ideologies of nationalism and national self-determination, have made the principle of the fundamentally equal value of all human cultures a central assumption of world culture. Ethnocentrism has come to be seen as both trap and injustice; tolerance and, indeed, the championing of difference occupy the moral high ground. Of particular moral virtue in contemporary world culture are the poor, the excluded, the oppressed – marginal peoples whose right to their own cultures has been violated by the onslaught of globalization. This universalistic form of particularism impels peoples to emphasize or invent tradition and distinctiveness in counterpoint to universalistic world-cultural principles that are supposed to operate uniformly in all places.

(c) Regionalism. Roughly half of the international organizations founded since 1950 have been regional in scope, activating European, Latin American, Asian, francophone, Islamic, Andean, and many other sub-global identities. Like ethnonationalism, regionalism has flourished in the wake of world-cultural intensification. Global structures, ideologies, principles, and models provide an overarching framework of commonality and shared meaning for disparate social units. With the framework well in place, diverse regional organizations and movements have expanded to implement, modify, and argue about the framework's content and implications.

d) Consumerism as adaptive interpretation. While global popular culture contains products and symbols that penetrate most local markets, its accompanying ideology of economic freedom and consumer choice encourages varied uses and interpretations of standardized consumption patterns. For instance, consumers in Hong Kong might appreciate a McDonald's

restaurant as much for its clean facilities as for its food.

(e) Creolization. In many domains, the homogenizing force of world culture encounters ingrained local tastes and traditions, which may in turn be the residue of earlier such encounters with neighbors or colonizers. Due to creative interaction processes, common elements take different forms in different places.

In spite of their optimism about the unifying role of culture they also look at it as a source that engenders conflict in world society through a process that has, as it was, turned the West against itself. By the 1970s, when scores of new states had formed in Africa and Asia, vociferous opposition to continued economic and cultural domination by Western countries (labeled neocolonialism and cultural imperialism, originally formulated in the West) began to penetrate global organizations, especially UN bodies. Various associations of less developed countries called for a restructuring of world society – a New World Economic Order and a New World Information Order that would put restraints on the operations of transnational corporations and shift resources to the poorer countries (p. 6264).

Their final observation goes somehow further than this and points out to the cultural conflicts that directly and indirectly many cause many complex problems, discontent and even dysfunctional relations among nations if differences among them are ignored or taken for granted. This a point that has been emphasized by other authors, Stiglitz included. They observes:

As non-Western cultures and regions have become more prominent in the world policy, it makes increasing sense to speak of world cultures (in the plural) rather than a singular

world culture. Dominant Western models have penetrated deeply in most places, but they have also evoked resistance as well as efforts to revivify and globalize alternative models. Most notable in this regard is the assertiveness of Islamic cultural carriers, particularly since the 1970s. Many Muslim leaders and organizations promote a societal model that infuses the state with religious precepts and recasts the relationship between state and citizen (codified in 1981 as the Universal Islamic Declaration of Human Rights). African and Asian models of social organization and development have also emerged, and some observers argue that conflict in the twenty-first century will revolve primarily around grand civilizational axes rather than the nation-state clashes that have dominated in recent centuries. The same token, more fine-grained analyses of world culture(s) identify multiple models of central world-cultural constructs. For example, derived from the Western tradition are liberal, socialist, corporate, and welfare models of the state; from Asian sources, quasifamilial and state-led development models. Multiple models of the individual, the business enterprise, and the national polity are further examples. World-cultural complexity has increased rapidly in recent decades, perhaps most sharply since the collapse of Communism and the end of the Cold War, as ever more cultural centers generate more alternative cultural constructions. Their conclusion is that in a nutshell. In sum, religion is a central aspect of cultural globalization, as traditions spread, transnational networks expand, national cultures become more mixed, and new ways of experiencing the world emerge. In many countries, religion mediates the pluralizing effect of world culture. It plays an important role in the intense contest

concerning global values and world order. Yet the construction of world culture has become a mainly secular process; it has no transcendent content in the conventional sense. Cultural heterogeneity and conflict themselves take many forms, only some of them religious. While world religion is intimately connected with globalization and involved in the latter's dynamics, it is by no means a dominant force. Whether it can, or should, take on a greater role in defining the desirable world order is likely to be a central issue in future global cultural contestation (p. 6266).

Ethical leadership and the issue of accountability

Transparency & Legitimacy

Regardless of the applicability of the a given set or sets of public administration, a few important issues that call for immediate attention at both national and international levels has to with accountability, legitimacy and ethical leadership that ply a decisive role for public administration in action. The prominence of these issues as challenges of the present day PA has gained more momentum due to so many national and international events in the recent years. Lack of transparency and exceeding the boundary of legitimate power by public officials across the globe, and problem with lack of oversight and corruption that resulted in loosing public trust in both corporate governance and public institutions are challenges that call for different approaches to leadership and governance. One does not have to go too far to see what impacts notorious actions by some US corporations like World Com, Global Crossing, Tyco, and Enron cause in public trust in both governance of private

companies and public agencies ability or will in fulfilling their oversight responsibilities. Lack of effective oversight and consequences of such fraudulent activities affected the lives of hundreds of thousands of people directly and poor response on the part of the government that make them look as partners in such wrongdoings are so note worthy for bringing the issues of accountability and transparency as vital issues to be dealt with. With loosing trust or at least increasing suspicion of public sector, more push are being directed toward establishing stronger civil society and their role of ethics and ethical leadership. The issue of transparency and accountability takes a more sophisticated role in helping (and in some cases hindering) the challenging role of public policy in that area. As an example, Curtin and Mejer, in their research on transparency and legitimacy, focus on the European Union's policy that the Internet is to be used to increase its transparency by providing more information to citizens. They cite EU's main portal: "European Union On-Line" or "Gateway to the European Union" (europa.eu.int) as web site that allegedly is "the largest website in the world" and contains 6 million pages and receives 50 million consultations per month. They raise the question that if enhanced transparency indeed boost the legitimacy of the EU and provide what they call a critical perspective on the assumptions underlying the relation between transparency and legitimacy. Their definition of transparency is the one borrowed from Odehman who states it as: "the process through which public authorities make decisions should be understandable and open; the decisions themselves should be reasoned; as far as possible, the information on which the decisions are based should be available to the public" (p. 111).

In tying Transparency with Legitimacy and by using Spicer's (1995) assertion that legitimacy "means conformity" to the broadly accepted principles or rules and customs of a political and social order, they refer to three types of transparency that include Input legitimacy, Output legitimacy and Social legitimacy (p. 112), each having direct impact on the perception of citizens on the level and degree of transparency and judgment that if decisions or actions are being held as legitimate by them.

Cawley in his addressing environmental problems emphasizes on legitimacy as extremely thorny issue that deserves much attention. Addressing legitimacy, he brings a very valid point about the political nature of the public administration by citing Woodrow Wilson (1887) who asserted that the objective of administrative study as to discover, first, what government can properly and successfully do, and secondly, how it can do these proper things with the utmost possible efficiency and at the least possible cost either of money or of energy." Then he makes reference to a few major government reforms like the Brownlow Report (1937), that defined the goal of their reorganization proposals as an attempt "to make our Government an up-to-date, efficient, and effective instrument for carrying out the will of the Nation." As well as Gore's NPR of 1993, all evidences of how politics define the objective and the role of the public administration. He looks at the industrial society as being the major cause of environmental problems that at the same time has made lots of contribution to increasing stable standard of living for most people in recent decades. This, according to him, explains that the underlying situation of public

administration as manifested in the conservation movement and reform environmentalism. Thus, in accepting the goal of maintaining industrial society, the political dialogue has focused almost exclusively on the techniques of management and dealing questions like how can we use natural resources which are crucial for the welfare of the (human) population while minimizing the environmentally disruptive aspects of that use? He sees the answer to this type of question as being framed in the language of technique (Cawley, p. 85) while this concept of legitimacy might be true when it comes to the areas of instrumental values (choosing the best technique to solve a practical problem), it will have a broader policy (basic value) implication as what direction the society wants to take. Even when the direction is set one cannot be sure the legitimacy is going to be attained in action. One example in recent action of the US House of Representatives may shed light on this issue. The Prescription Drug legislation, as reported vastly by media, was put into an Act by legislature based on following the established legitimacy of this entity and majority vote of the members of congress. However, based on the numerous accounts there has been exemplary manipulation by the House leadership is getting the approval for this Act that would have provided a windfall for the drug companies. Representatives had to read some 10,000 pages in just a few hours and then vote in an extended session of the House that stretched into mid-night, when the audience of CSPAN are very few to watch the voting process via live broadcast. The House leadership (then Republican majority) extended the voting time for three hours, outside of the schedule, to force some of the

representatives to change their initial votes that was not in favor of the Bill (CBS 90 Minutes, 3/3/07). What was the catch? The Bill prevents the Medicare Administration from negotiating a better deal (based on competitive market) from drug companies. Ironically 15 people, who pushed for this Bill rigorously, including the chair of the relevant Subcommittee, were later hired as drug companies' lobbyists after of the passage of the Bill. The Chair is reported to make a salary of \$2M million a year! (60 Minutes, 3/30/07). So, this might only be one example of how the very established legitimate mechanisms, in this case market economy as backbone of the capitalist society, is being compromised at the highest level of political structure!

Cawley's final remark and conclusion base on his thorough analysis of the environmental problem as a case to discuss the legitimacy is interesting too. Using his Industrial movement and industrial society as his main metaphor, he ties it to the ideology and the pragmatism as main sources of struggle. He asserts that "In losing sight of the fact that industrialism is an ideological posture, we have tended to misunderstand the political character of public administration. Herein is yet another connection to governmentality." Foucault (1991, p. 103) asserted that in an age of governmentality the "techniques of government... become the only political issue, the only real space for political struggle and contestation" (Cawley, p. 94).

The leadership factor

One may argue that there is no topic that has been more important to business and government success than leadership. There have been approximately 1,700 books written

on leadership and those topics that are closely related to leadership. Bennis and Burt Nanus, when they wrote their book titled “Leaders” in 1985, found over 350 different definitions of leadership (p. 12). Modern leadership, in spite of its too many definitions, and deliberation, all contain some common process elements like personal commitment, relationship building, vision creation, ethics, and vision into reality as few examples.

Van Wart states that there is a timeline for the leadership phenomena that spans for many years from pre-1900 to this present time (Van Wart, 1951). The timeline provides information concerning many leadership eras such as the great man era that has emphasis on the emergence or entry of a great figure like Martin Luther King Jr., George Washington, Gandhi and many others along with their business counterparts known as captain of industries. This era described people who had a substantial impact on society whether it was negative or positive. The timeline also talks about several other eras such as trait, behavioral, contingency, and more contemporary leadership approaches.

Generally speaking as time passed by leadership theories moved from simplicity to more complexity in order to cope with the complex environment. Simplified trait and behavioral theories were replaced, at least theoretically, by more sophisticated theories and models known as contingency theories, transformational leadership, and more participatory approaches like super leadership. Along with that another movement that started in late 1970, obtained a new momentum for focusing on the ethics and morality of the leaders and leadership styles. Prompted by his famous article, Greenleaf coined the term

“Servant Leader” and “Servant Leadership” that now-a-days are the focus of most academic and professional circles. While the focus of contingency models is to explain the relationship between leadership and various situations that could occur within companies, approaches developed and recommended by researchers like Fiedler, House, Hersey and Blanchard started with the idea of matching the situation with the appropriate leadership style (Daft, 2003), and were extended rigorously to the quality of the leader-member relationship, thus emphasizing the importance of followers. The first manifestation of this was shown through a more advanced contingency theory called the path-goal theory by Evans and House. Leaders have the ultimate responsibility to enhance or increase the subordinate’s motivation by clarifying their path to rewards that are available and to provide the necessary support system to help the followers by adopting the appropriate leadership style that fits a given situation (Robbins, 2005).

At the heart of the effective leadership both the organizational and societal levels two major issues are at work. The first one has to do with issue of power and the second is the role of leadership in jumpstarting, facilitating or hindering, the change process that is the salient feature of any organized system at the present time.

Leadership and the issue of power

Different types of power might be classified into three major categories. The Position Power in which the leader gets his or her power through position whether it is in the organization or in the political arena. This is also called the legitimate power in that it is

given to the individual based on the virtue of the position or the office held. Most of the time the power comes from a person's position within the organization as Daft (2003) states. Legitimate Power (position) comes from a formal management or leadership position and varies in terms of amount that normally is tied to the hierarchy. Thus CEO's and Executive Directors, usually at the very top of the organizational chart, have more power than other management positions just because of the spot they hold in the organization. The same thing is true in public sector as Van Wart (2005) refers to that department heads have more power than the subordinates, and division director and secretary or minister more until you get to the pinnacle of the pyramid that the President or Prime Minister who has the most authority due to the office she/he holds. The second source of power is Personal Power that either has nothing to do with the position power or builds upon it both in terms of quality and quantity on the top of position power. As we move away from the hierarchical directive styles of leadership, the application of power seems to be moving from position to personal and the quest for complacency on the part of the leader will switch to "identification" i.e. understanding the reason behind following a particular path, or "internalization" that has to do with adopting the very "values" that the leader espouses and make it (their own.) This approach is more in line with several major styles known as participative, servant, charismatic, super and transformational leadership, all appealing to the empowerment of the followers through the decision making and implementation process.

The third source of power comes from coalition and alliances with others. Leadership

does this both for achieving goal and establishing mechanisms for joining forces in terms of capabilities (pooling resources and know-how) and or consensus and agreement (issues dealing with diversity and pluralism) as well as achieving synergy in attaining the power and ability that otherwise would be lacking for such an attainment. This last part is more relevant with the issues of public administration and at the same has great implications for achieving check and balance, safeguarding ethical principles and on-time accountability. Like any other phenomenon when it comes to power all these sources and their relevant mechanism might unfortunately be misused by unethical and self-serving leaders. There are many evidences of misuse of position power, and expanded power gain thru collusion and alliance for the purpose of attaining personal objectives and agenda in private, public and international arenas, mostly refer to as corruption. While most examples of leaders who rely on their personal power and charisma are positive, both in the organizational and political/societal arenas, there are instances for such leaders who misled the followers toward illegitimate and even destructive goals based either on extreme ideology or even personal whims. The expression that "power corrupts" stands tall at all time and calls for unavoidable mechanisms for check and balance.

At the corporate level, as Nolan states, good leadership makes a significant difference in an organization. It helps develop good employees that will work hard to make sure that everything is working well and that the working environment is good and healthy at all times for everyone. The "human element" is far greater than any leadership style or theory

utilized by the leader (Nolan, 2000). Leaders must be fair and consistent in their employee dealings at all times. While leadership has such a profound impact on the life of organizations, its impact can be much more in the public service arena. This is the arena that the impact of the decision is so profound that it may shape and perhaps shape the direction and even the destiny of a nation or even the whole. Overall while there zillions of topics can be associated with leadership for our purpose here “leadership style” and the “leader” himself or herself, and the concept of ethical leadership are the main topics to discuss.

Leadership styles

After the great man approach that led to the Trait theory (early 1900s) and then to Behavioral theories (1930s and beyond) that sought effective styles for leadership in organizations based on two major research projects (Michigan and Ohio State studies), contingency/situational approaches came to prominence due their broader and more flexible conceptual framework. In spite of the emergence of quite a few other approaches that normally are studied independently and not under the rubric of situational approach, all of them virtually stick to the main premise of contingency approach in that they make the adopted leadership style a function of situational variables. Situational variables, the core of contingency/situational leadership models, focus on factors like technology, nature of the task, size of the organization, organizational environment, organizational culture, and structure among others. May be “The Factor” in contingency/situational equation can be considered the “followers”, the one that eventually will determine the

optimal style of leadership to be adopted in a given situation. The new trends of leadership offered more sophisticated and dynamic models that ranged from Fiedler’s Contingency model to Heresy and Blanchard’s Situational Leadership, and Hous and Michell’s Path-Goal theory as major models that help leaders to be effective in complex organizational environment (Zomorrodian, 1998, pp. 29- 30). Contingency theories, though, embraced the very principle of behavioral approach that leadership not innate rather can be learned full-heartedly and focused on creating effective leaders through education, training, practice, mentoring, and a host of other developmental techniques.

The leader

Although traditional Trait theory and the concept of Great Man both are no longer hold well, nonetheless, contemporary approaches to leadership focus on the leader per se, as the most important theme in leadership studies. Building on the conceptual base of Contingency/Situational models, individual leader’s character, readiness, commitment, and distinctive qualities in terms of Emotional Intelligence (EI) that for most part can be mastered by intersected individuals came to the fore in making the leadership approaches more humanistic, realistic and for most part empowering the followers. It is no surprise that contemporary leadership approaches focuses on the individual leader along with the leadership styles in relation to the followers. Since this element (leader him or herself) is so important for institutionalizing an effective ethical leadership, both at organizational and societal levels, a few specific contemporary approaches to leadership like Transformational,

Charismatic, and Servant leadership will be discussed in more details.

Transformational leadership

Transformational leadership is inspirational leadership that is characterized by the ability to bring about the significant change. Transformational leaders have the ability to lead changes in the organization's vision, strategy, and culture as well as promoting innovation. That is why normally this type of leadership is considered for major and fundamental changes needed for the organization or social entity that faces an existing and potential challenge. By nature it is strategic and in that sense it can be equated to strategic leadership since the leader has to facilitate the process of strategy implementation through creating and fostering the right culture in the organizations (Zomorrodian, 98, p. 35). Daft states that Transformational Leader (TL) can take the organization through several major changes by successfully achieving the following:

1. Create compelling vision.
2. Mobilize commitment.
3. Empower employees.
4. Institutionalize a culture of change (Daft, 2005, pp. 507-508).

Thus Transformational leadership is not only forward-looking, but at the same time can be seen as inspirational and ethical based on the legitimate values and leader's credibility enabling the followers to internalize those values.

Charismatic leadership

Robbins account of charismatic leadership theory states that followers make attributions of heroic and extraordinary leadership abilities when they observe certain

behaviors (p. 363). Prominent figures in the political, military, and social arenas like Kennedy, Clinton, Martin Luther King, Mother Teresa, and Gandhi on the positive side and Adolph Hitler, Charles Manson and Jim Jones, on the negative sides are examples of charismatic leaders.

Several characteristics of charismatic leaders identified by Conger and Kanungo, and reported by Robbins are ability of these leaders to articulate visions; taking personal risks, sensitivity to the environment, sensitivity to the followers and unconventional behavior meaning engaging in behaviors that are perceived as novel and counter to norms (Robbins, 2005). Thus, in a sense, charismatic leaders are more or less change agents like transformational leaders but with a stronger sense of dedication that may go beyond the limited boundary of a given organization. Although charismatic leadership seems to have been around since the dawn of history, a major difference in new theorizing is that most of the charismatic qualities and abilities can be learned and the traits/abilities are not confined to exceptional people who are born with them. In fact, a major issue in contemporary leadership that cut across all recent theories has to do with Emotional Intelligence (EI). These qualifications, that can be learned, developed and nurtured, denotes to the ability/readiness of leaders who are charismatic, transformational, and are able to appeal to their community or society for major change and redirection. Key components of EI consist of self-awareness, self-management, self-motivation, empathy, and social skills, all giving the leader sufficient proficiency in interacting with the followers, relating to them and inspiring them toward worthy end (Robbins, pp. 368-369).

Servant leadership

Servant leadership is one of the major leadership concepts or theories to have been conceived and studied by scholars and practitioners. The late Robert K. Greenleaf, who after retiring from corporate life started a new career as a leadership consultant and writer, coined the term.

Greenleaf (1970) observed that a leader who was also a servant (served his followers in support of their daily task or duties) accomplished a great deal of their workload because of the symbiotic relationship between servant and leader. Each could and would help the other to achieve their goals. This leadership concept is very different from the traditional hierarchical or tyrannical leadership models (paradigms) of the past and present. Sendjaya refers to servant leadership not so much a theory as an attitude of the heart, which shapes the decisions and actions of corporate leaders at all levels. It is not another leadership style one can choose to use whenever she likes or when the situation calls for it. It is not something that can be turned on and off. Servant leadership is a commitment of the heart to engage with others in a relationship characterized by service orientation, holistic outlook, and moral-spiritual emphasis. He accounts for six multidimensional concepts of servant leadership. They include Voluntary Subordination, Authentic Self (the state of knowing and being who we really are), Covenantal Relationship, Responsible Morality (behaviors of the leader which elevate both leaders' and employees' moral convictions and actions as manifested in the leader's moral reasoning and moral action), Transcendental Spirituality, and Transforming Influence, all so important for public or non-profit sectors leaders (Kettl, 2005).

Historically speaking, in the US many leaders like George Washington and Thomas Jefferson have conducted themselves as servant leaders. With regard to George Washington, Kettl states that argument will be made that his successes in performance follower loyalty and alignment of his duties with national needs was based more on his administrative skills than his military skills or political skills. As a military man, he certainly had more failures than successes, and possibly only one great success during the American Revolution. As a politician, he disliked factions and frequently was nearly derailed by the politics of his own army staff or his divisive cabinet. In the end it was a mix of traits, skills and behaviors that we identify with an administrator that enabled him to succeed and ultimately inspired the epithet father of the Republic" (Kettl, Fesler, 2005, p. 428).

Van Wart states that the final or the highest level of exemplary leadership is often perceived as the willingness to make sacrifices for the common good and/or show uncommon courage. David Hawk (1992) discusses such leaders as they confront moral episodes. Sacrifice is denying oneself commodities that are valued in order to enhance the welfare of others or the common good. Leaders who sacrifice may give extraordinary time, do without financial emoluments, pass up career advancement's, or forsake prestige as part of a passion to serve others. The best leaders may be those who are able to make sacrifices but nonetheless feel joy at the opportunity to help (Block, 1993, De Pree, 1989). Greenleaf (1977) calls these servant leaders. Servant leaders are highly concerned about empathy, development of others, healing, openness, equality, listening, and unconditional

acceptance of others. When they act, they do so with quiet persuasion that places a high threshold on inclusion. They'll avoid the unequal power paradigm typical in hierarchical organizations and instead use the *primus inter pares* (first among equals) paradigm (Greenleaf, 1977, pp. 61-62). Indeed, they assert that the hierarchical model of leadership is often damaging to leaders. However, some leaders are willing to make exceptional and painful sacrifices or decisions that required great courage (Van Wart, 2005).

Ethics in leadership

Ethics is a code of moral principals that sets standards of what is good and right or what is bad or wrong in the conduct of a person or group (Schermerhorn, 2002). Recent history has warned us that there are people who have low ethics and will do just about anything to fill their pockets with the almighty dollar. Ethical leadership can become a personal challenge and be quite easy for most executives and most difficult for some men and women. Trusted executives have engaged in unethical behaviors that have advanced a few but hurt many others because of their greediness. They made some decisions that resulted in people losing their jobs, losing their retirement pensions and yes some went to jail or prison (Schermerhorn, 2002). The executives who engaged in the unethical behavior had no idea how many people would be affected by their decisions. Some people just engage into what is called ethical leadership and have leadership integrity. In relationship to Enron and World com we ask the question of what type of people were the executives. It seems that it would be much easier to do the right thing because when there is wrong doing it takes much more effort

to conceal the lies or the wrong doing. That's why it has been necessary to develop some safe guards for companies to protect the innocent people within the company's or organizations structure. Sometimes unethical behaviors are brought to light by whistleblowers. Whistleblowers are employees who discover and report the unethical behavior or conduct. The Fair Claims Act was developed in 1863 but has had several amendments or provisions down through the years. One of the provisions was put in place to help protect or give the whistle blowers certain protections against the employer (Schermerhorn, 2002).

Kaptein and his coauthors have done some resort in this area and state that from a moral and legal point of view, managers are increasingly held responsible not only for what they know, but also for what they could and should have known (Kaptein et al, 2002). As one manager of a Dutch government department remarked: "It's not what I know that scares me – it's what I don't know" (Kaptein et al., p. 302). He states that without an understanding of the ethical quality of the organization, management cannot determine whether it is in control or at risk, and whether current oversight activities are effective or other measures are needed. Kaptein reports on a survey technique as instrument for measuring ethics because of its potential to generate valuable information. Involving employees in the measurement of organizational ethics also demonstrates ethical leadership. His reference to 2000, KPMG National Family Opinion, to create a representative database on US employee perceptions and behavior with respect to integrity in the workplace is informative both in terms of results and the conceptual models (Figure 3) used.

A questionnaire with 133 data-collection points was sent to a representative sample of the working population consisting of 3,075 adults. This sample was obtained from a panel of the US population, consulted frequently by the National Family Opinion for all types of surveys and carefully composed to be representative of the workforce. See Table 3 in the Appendix.

The results of the survey of US public servants clearly show that public organizations face the risk of unethical behavior undermining their performance, credibility, and legitimacy. Managers can only manage organizational ethics if they have a clear idea of the effectiveness of current efforts (e.g., codes of conduct and compliance programs) aimed at preventing unethical behavior and stimulating ethical behavior. Because management is not omniscient and organizational hierarchies may prevent employees from freely communicating violations, it is advisable to conduct ethics audits to determine whether management's view of the organization is a true reflection of the state of affairs (Kaptein et al., p. 309).

Servant leadership in public sector

Servant leadership is in a sense a variation of the ethical or moral leadership concepts. As stated earlier, ethics as well as accountability are important elements of servant leadership. They are also characteristics of a desirable public servant. This concept of ethics and accountability are so important to the administrative process in the public arena that Kettl closes his text with the ethical concerns and significance of serving in the public arena (Kettl, 2005). Bureaucratic accountability and ethics in the public arena are based on the Constitution and the law. Fiscal, process, and

program accountability are areas of accountability that must be maintained and implemented. Servant, ethical or moral leadership concepts provide just the background and training to keep leaders ethically balanced and accountable. Kettl states: Citizens and elected officials alike demand a higher standard of ethics than typically prevails in the private sector. Indeed, that ethical upgrade often comes as a shock for political appointees who come to government from the private sector (Kettl, Fesler, 2005). Donna Shalala, the former secretary of US health, education, and welfare, identified 12 points in her leadership practice that she used while giving a speech at the national conference of the American Society for Public Administration on March 28, 2004 in Pollard, Oregon. She said that the principles kept her focused, effective, and out of trouble (her boss was impeached). The 12 points expressed principles that apply to all public servants. She also stated that public servants need to build ethical considerations into their decision-making. Here are the heading of her 12 points of leadership in public sector. The twelve principles are as follows:

- "Always adopt the attitude". The buck stops here.
- "Choose people based as much on the content of their character as their expertise."
- "The game is often won in the huddle." Planning requires team work, which requires a genuine openness to the ideas of others.
- "Bureaucrat is NOT a four letter word."
- "You must accept bad news and learn from it."
- "Stop shoveling." When you make a mistake, admit it.

- “You can’t cultivate honesty and integrity in the dark.” Transparency is always the best long-term policy.
- “You can’t subordinate policy to politics.”
- “You have to look at issues through a prism-may perspectives.”
- “It is your friends, not your enemies, who get you into trouble.”
- “Ethical employers care about their employees.”
- If you don’t tell people where you are going, you might end up somewhere else (Van Wart, 2005, pp.88-89)

Leadership in public service has also been fused with experiential learning under a new name called service-learning. Service-learning or “learning by doing” as the term servant has become very popular in public universities and the public policymaking arena. Service learning is now one of the major programs focuses of the National Society for Experiential Education. Servant leadership is seen as the philosophical basis for these new service-learning programs (Spears, 2002). Gerston’s book, *Public Policy in a Democratic Society: A guide to Civic Engagement*, was written as a service-learning supplement for college courses in public policy, government, and history (and other subjects) that have service-learning components (Gerston, 2002). Service-learning allows the servant leader or participant to become personally involved with the subject, area, or topic being studied. The emphasis in service-learning is to provide service first and at the same time learning from the wisdom of others. Participants in service learning programs are placed in organizations or situations where they can serve the community while assisting public service or community-

based workers and at the same time complete their academic coursework. This, especially, helps students who are placed in public service organizations where the main emphasis is to serve the citizens. This is consistent with the servant leadership emphasis, which is to first serve the followers, or the organization represented before serving oneself.

One major application for service-learning in the public arena is public policy advocacy. A service-learning student serving as a public advocacy trainee has the opportunity to combine the theory from their book learning with the practical application from their on-the-job training. Students could get the opportunity to serve in soup kitchens, homeless shelters, community service centers, political advocacy groups, or as government aides or interns. The insider experience would give students the opportunity to learn characteristics of true citizenship, while at the same time getting a first hand account of what the recipients are experiencing. This experience is invaluable when making decisions that will affect the citizens being served (p. 94).

Involvement is also a key to becoming a servant leader. Service-learning and servant leadership are in many ways one and the same thing. They both support the idea (or paradox) that to serve is to ultimately lead.

Modern-day paradoxes of connection and alienation describe the new science (The Internet connects people, yet the lack of physical contact can be lonely and alienating). The new science promotes participation among individuals and introduces new ways of human participation. The new science, which can be typified by principles of quantum physics, can also be applied to organizational practices. This new science (using quantum physics principles)

provides radically different approaches to change within a living or organizational system. It provides a new way of thinking about life and organizations and has the ability to illuminate most critical leadership issues. Although the Newtonian science (or traditional science) is materialistic and focuses on physical senses, the new science is holistic and focuses upon relationships within given organizations, societies, or systems. Concerning the new science, as Wheatley states, ethical and moral questions are no longer fuzzy religious concepts but key elements in the relationship any organization has with colleagues, stakeholders, and communities (Wheatley, 1992, p. 14).

This brings us to the fact that new leadership theories and models, like servant leadership, are imbedded in the two twin concepts of participation and empowerment and any derivatives from them for preparing people at all levels, educational institutions as just one case, that eventually may lead to more accountability, ethics and transparency.

The issue of governance

Any discussion about the validity of universal, contextual, new or Universalists practices of public administration might not be relevant unless the very fabric of governance systems is examined. This issue lies at the heart of modern public administration that surrounds the access to and application of power. It addresses the questions like: Who has the legitimacy and access to power? Who actually is in the position to apply the power? What are the checks and balance to insure the appropriate use of power? All these will bring us to the question how public administration is or can be defined in the present era that deals the concentration of power and its easier access

to control mechanisms due unprecedented advancements in information technology. The rising exceptions of citizen for participation and safeguarding their rights and destiny from the whims of public officials who intentionally or unintentionally may go astray on using or misusing their power is the side of the same coin. When it comes to developing societies and emerging democracies, governance gets more significance since it may signify the degree and level of “political development”, to some even more important than other aspects of development like economic and technological, considered as a narrow focus of failed traditional approaches. Since governance has a lot to do with the acquisition and application of power by different actors, it will to large extent create a context for exercising the right or wrong leadership. It can facilitate, encourage and demands ethical and responsive leadership, or it can nurture an environment prone to complacency, lack of oversight, no response to misuse of authority becomes the norm thus prolong the problems of the society and the chance to bring back the society to the its right direction.

What Governance is and what role (s) it plays in enhancing the public administration and the societal development as a whole? Different scholars and researchers have examined this phenomenon from different perspectives. Hyden describe governance alongside two dimensions. One, the substantive content that addresses two viewpoints of governance. It concerns with rules of how to conduct public affairs and those who look at it as steering or controlling public affairs, on one hand, and the governance process and an activity, on the other (Hyden, 2002, p. 14). He suggests that the issue of governance cross over

the boundaries of different fields like international relations, comparative politics, international development and public administration. As far as the latter, he argues while the European scholars first referred to the point that conventional jurisdictional boundaries of administration no longer have the same relevance as the past, it also gradually became an integral part of the American public administration theory as well (pp. 14-16). An important point that Hyden brings to the fore is the role of governance for sustainable development. He defines sustainable development as the process that development is owned and generated by real people working together. He calls this process as a shift from macro to micro level and as an important ingredient of the new approach that calls for realigning relations between state and society, government and citizen (p.19). This emphasis demands a greater reliance on local resources and strategies to cope with local and economic issues, empowerment of local actors and the need for improving their access to additional resources that can help them make progress on their own. In short, Hyden argues that such strategies not only reduce the sense of vulnerability and powerlessness of people but create an environment that is not only *enabling* – in terms of economic liberalization – but also *reassuring* – a concept closely aligned with sustainable development (p. 19).

Kersbergen and Waarden look provide a broader conceptualization of governance. They refer to this phenomenon from different disciplinary perspective and come up with at least seven definitions based on disciplines orientation of which several might be more relevant to our discussion. They generally believe that it is kind of too much to expect for

a common theory of governance to appear in the near future. They assert that the political meaning of governance as depicted by political science perspective was largely in ignorance of other disciplines. Their reference to Janning's (1997) as the first prominent modern usage of "governance" is in the field of economic development, where the World Bank and other international organizations have been stressing for sound or good governance is interesting. Good economic governance belongs to the so-called "second generation reforms", consisting of reducing wasteful public spending; investing in primary health, education and social protection; promoting the private sector by regulatory reform; reinforcing private banking; reforming the tax system; and creating greater transparency and accountability in government and corporate affairs as postulate by researchers like Rosenbaum and Shepherd (2000), Woods (2000), Philip (1999) and Kiely (1998) among others who come close to post NPM postulates.

Another meaning of the concept stems from international relations theory and refers to the possibility of governing without government depicted by Rosenau and Czempiel (1992), in the form of international or even global governance; by Prakash and Hart (1999) and global democracy by Holden, Murphy, and Sassen (2000) and host of others. The main thrust of this orientation seems to point to the possibility of policy cooperation between nation-states in an international system and the fact that such system lacks a hierarchy, or in other words is characterized by an anarchy of competing, interdependent states that acknowledge no authority other than their own as asserted by Lieshout (1995).

And yet, another difference comes from using governance to self-organization of societies and communities, beyond the market and short of the state. Kersbergen and Warden refer to the work of Elinor Ostrom (1990), who studied the capacity of communities in different places and times to manage common pool resources and prevent their depletion and the fact that small local communities have done so without the help of a formal government through bottom-up self-government by associations, informal understandings, negotiations, regulations, trust relations and informal social control rather than state coercion (p. 167).

Governance as constellation of Networks

May be the most interesting definition of governance is what these two authors refer to as governance through networks. They state that while there are many strands of this approach, a main distinction is between those that refer to networks of public and of private organizations, and of mixes of public and private ones. However, in most the relevant literature, networks are explicitly conceptualized as pluricentric forms of governance in contrast to multicentric (market) and unicentric or hierarchical forms state, firm hierarchy (p. 146). Networks, according to Rhodes (2000), are considered to be self-organizing, and to “resist government steering, develop their own policies and mould their environments and are characterized by an exchange of resources and negotiations, and by game-like interactions “rooted in trust and regulated by rules of the game negotiated and agreed by network participants. /... by making reference to a few major research state that while networks of public policy organizations have been considered to be ‘the analytical heart of the notion

of governance in the study of public administration, there are many versions of the literature, varying from early analyses of corporatist networks of interest groups via the state’s (limited) capacity of societal steering and the actor-centered institutionalist (ACI) analysis of policy net-works to network society and the sociocybernetic analysis of public-private mixes of societal problem-solving” (p. 148).

Their reference to the combined public and private organizations network that empathizes that many public services are not exclusively delivered by government but through networks of actors from the government, private and voluntary sectors that coordinate and allocate resources, and are again an alternative to, not a hybrid form of, the market or the state, might be a form that show us how governance move more towards the creation and enhancing the civil society and away from public sector monopoly of power. This in line of what they refer to of what Marks et al. (1996) mention as criticism of unitary theorists (government a rational actor) by multilevel theorist, who in case of EU deny that nation-states are the exclusive connection between domestic politics and intergovernmental bargaining and stress the importance of policy networks that are organized across policy areas and government levels. They also refer to an important study by Kohler-Koch and Eising (2000) prefers to speak of “network governance” in the EU, the core of which is stated as: political actors consider problem-solving the essence of politics and that the setting of policy-making is defined by the existence of highly organized social sub-systems....The “state” is vertically and horizontally segmented and its role has changed from authoritative allocation “from above” to the role of “activator”. Governing

the EC (European Community) involves bringing together the relevant state and societal actors and building issue-specific constituencies. Thus, in these patterns of interaction, state actors and a multitude of interest organizations are involved in multilateral negotiations about the allocation of functionally specific “values” (Eising, Kohler-Koch 2000 cited in Kersbergen and Waarden).

A more restrictive definition of governance is used by Cheung, who in his account about Asian countries PA reform sees this phenomenon form a more traditional, state-based format. He starts with the definition that governance may be defined in terms of a wide variety of values that contribute toward enhancing government’s capacity to deliver good performance to meet citizen needs and expectations, such as accountability, participation, transparency, and predictability (ADB, 1995, pp. 7-13, Commonwealth Secretariat, 2000, pp. 7-9). As a concept, governance goes beyond the issue of public management to address the more fundamental question of how to strengthen government and other institutions in society to help solve problems and meet challenges, entailing government-market, government-society, and intra-government relationships. Under the good governance paradigm, public management reform is necessary in many developing countries whose public sector has been tainted by “uneven revenue collection, poor expenditure control and management of a bloated civil service, (and) a large para-statal sector” (Commonwealth Secretariat 2000, p. 11; also ADB, 1995, pp. 26-33). State institutions have to be reformed to make them more efficient, accountable, and transparent.

Civil service reforms are needed to restore the morale and integrity of the public service through merit-based recruitment and promotion.

One has to consider that his reference make sense in discussing PA since some of these countries share colonial heritage and at least one experienced a long-term party-state centralized system in case of China. That is why he refers to Nunberg’s account of: In most Southeast Asian countries, public sector jobs provided employment for constituents and opportunities of patronage for political supporters, helping to consolidate the power of the ruling elites, for example, in Indonesia, Thailand, the Philippines, and Malaysia. Cutting the size of the public sector often failed to go beyond the rhetoric and would anyway be opposed strongly, forcing the regime to provide substitute provision, for example, through state-sponsored or government-linked enterprises. Overall, some bureaucracies were too strong and too resistant to reform, while others, like in the Philippines and Indonesia, had a capacity level too low to undertake vigorous modernization (Nunberg, 2002, p. 12).

Researchers and scholars who focus on governance from the development administration and international devotement perspectives have a kind of more focused emphasis on governance and see it as the key to the success of development programs prompted by UN and other international entities. They consider it as the heart and soul of the administrative reform that can make or break the new global programs in fighting poverty, illiteracy, health care crisis, and even international conflicts and more so for civil liberties and promoting the rights of minorities as women, like those indicate as the NU

Millennium goals. The gist of some these ideas are as follows.

Jerisat echoes the fact that there is lack of precise definition for governance and adds that it is frequently associated with three dimensions of How, Why, and What? How and why refer to the way the governance is structured, while, what refers to process employed and results accomplished. He believes that for real public administration reform in the 3rd world the better hope is better governance and to substantiate his point he cites Kuffi Annan's remark on this issue: "The issue is primarily one of governance-how the international community of sovereign states and multilateral organizations cope with global challenges and how individual nations manage their own affairs so as to play their part, pull their weight and serve their people" (Annan on DCs, quoted in Jerisat, 2002, p. 3).

He also states that Millennium Summit and others' unoptimistic view of development efforts/the past few decades can be attributed to lack of effective governance. Among major impediments, "exploitation by greedy, self-regarding, corrupt and all too often incompetent economic and political elites" (p. 4) are eye-catching.

As for the role of governance in developing countries, Jerisat refers to powerless public institutions controlled by corrupt and authoritarian leaders that made the governance process almost inoperable and made the catalog of governance failure quite lengthy. Political leaders decline the opportunity to develop reliable methods of succession; Failure to advance sustainable & equitable economic policies that are institutionally-based; Lack of enforceable legal rights of citizens within a civil society. In order for these countries to become

an equal partner in globalization efforts must realize that governance is no less important than "Free Market" and that they lose the directions of their economy, in the absence of effective governance that supports functioning legal system and regulatory process and accountable/legitimate authority. He uses governance also in a more focused context that has to do with process of institution building and processes of decision making as well as consequences of them, rather than nation and state building prompted by few others as well politicians (p. 16).

Elsenhans, another international development scholar, looks at governance as the art of managing the interaction of three mechanisms: The Market; The State; and The Civil Society. His major point is not exclusively about the autonomy each of these three, but also a more synchronized combination of the measures at a variety of regulatory levels complemented by appropriate economic policies (Elsenhans, 2002, p. 28). He emphasizes on the fact that reliance on the private sector for rapid development works when certain constellations of a lean state, thriving private non-profit associations of a civil society and a non-monopolistic world market create synergies conducive to such reliance. His reference to market failure under certain conditions and the issue of checking the state by means of non-market actors and non-government organizations (NGOs), as transparent actors are all very informative and directly relate to the problems of governance and political development not only in developing but in developed countries as will be referred to a few examples and the conclusion of this paper.

Baaklini examination of the role of public administration in developing countries,

mentioned before, see the key in being prepared to face the formidable challenges of the twenty-first century, as the democratic transition and institution building for enhancing capacities to insure proper control over the administrative process. His main emphasis is on strengthening of the legislative branch that in most cases may lack enough power and information to act properly (p. 55). This, by the way can be a kind of syndrome in the well developed societies like US. In order to properly use their responsibilities and commitment assigned to them by the public.

Mavima and Chackerian focus on the global public administration system as moving towards common norms and standards those results in efficiency, effectiveness and good governance (p. 78). Although there seems to be more inline NPM and even to some extent the renovation of Universalists themes, nonetheless they took governance, like others, as a key dimension of success for a meaningful PA system.

Hyden's account of governance as the "conscious management of regime structures with a view to enhancing the legitimacy of the public realm" identifies difference between how to conduct and how to control public affairs and between activity and process as mentioned earlier. He also links sustainable development trends to associate governance with regime rather than state or civil society. Sustainable Development (SD) the major theme; SD rests on three fundamental premises; We must live on the planet as if we are here to stay; We must take a holistic approach to dealing with our livelihood predicaments; That people themselves must have an interest and stake in any effort improve their livelihood (p. 17). It seems that his take on the governance comes

closer to that of Chung and other NPM theories to tie this concept to the formal political structure of the society. This become clearer when he refers to two aspects of governance and state that: First, it is associated with regime rather than state or civil society. In this sense it refers to the alignment of state-society relations, constitution or reconstitution of rules that guide public or political actions. The second, it is different from policy-making, public administration, or project management. It takes place at an analytical meta-level, meaning that other activities listed above are circumscribed by the rules established at the regime or government level (p. 19). Nonetheless, his four stages of operationalizing governance: Articulation; Mobilization (developing skills for civil engagement); Distribution of power: leadership readiness to distribute power to individuals and groups so that political system becomes more pluralistic); and Confirmation (readiness of citizens and public institutions to respect the principles of rule of laws, and by decision of Judicial Institutions) denote to a more participative and civil society based orientation (p. 23).

So, development administration theories, regardless of their theoretical position of being more inclined towards the NPM or Post NPM, like many others, consider governance as the center of any administrative reform and restructuring. Most of them expand the domain of this mechanism to the combination of market, state and a rigorous civil society. As Kersbergen and Waarden (p.153) rightly mention, all strands of literature that use the term "governance" identify, hypothesize and discuss one or more crucial shifts in governance. To advance interdisciplinary learning it is important to bring these shifts to

light. They add that vertically, there are upward shifts from nation-states to international public institutions with supranational characteristics such as the EU, the WTO (World Trade Organization) or NAFTA (North American Free Trade Association). Controversies focus on the centrality of states in the international system and effects on their capacity for autonomous policy making. When it comes to EU Member States, they raise several questions like: if – as the classic international actors – they had to make way for transnational and supranational actors? To what extent are policies decided at the European level? What policy-making capacity do nation-states still have? The formal and informal European policy-making institutions' influence the capacity and autonomy for policy making at the national level. On the one hand, European integration may enhance the capacity of national institutions to deal with the effects of economic internationalization. On the other hand, it may exert pressure on Member States to adapt to European rules and regulations, and thus may affect the national institutional framework of policy making. In the final analysis it seems that with the changes in the location of policy and in rule production, the style of governance seems to change as well. In more complicated network structures, the traditional approaches of command and control and enforcement are less effective and efficient. New forms of governance come to replace them, such as negotiation and concentration and the management or manipulation of information in networks. These new reforms include, for instance, the comparison of information and of performance scores, exemplified in the increasing popularity of benchmarking and the comparison of best practices, initially in the

private and now also increasingly also in the public sector. Several recent and ongoing trends seem to be redrawing the boundaries of the various societal spheres like those between the public and private and the political and economic. These trends are interlinked, sometimes mutually reinforcing, but at times also contradictory. They seem to be affecting the governance capacity of existing arrangements. Decision-making power is being shifted, and with that sources and relations of regulation, of providing social order. Again, such issues are the core business of political science, but by their nature can best be dealt with by adopting a multi-disciplinary approach.

Also one has to consider the increasing role of judiciary in policymaking and creation of a host of constitutional, administrative and other types of court. All of these might ironically create more problems with the expansion of regional alliances like EU, ASEAN, and similar institutions that are so vital for achieving a better global understanding, and sharing resources not only to improve the living conditions of the citizens and cope with unprecedented problems affecting the world. How might these new problems of governability, accountability and legitimacy be solved? Is it what Hirst refer to as large-scale institutional reform, the adoption of the so-called “associative democratic model”, which “involves devolving as many of the functions of the state as possible to society and democratizing as many as possible of the organizations in civil society” (Hirst, 2000). Or a move towards the development of new levels (vertical) and arenas (horizontal) in public and private multilevel networks as suggested by implying that these different levels and arenas form checks and balances for each other, just

as federalism at the level of the nation-state has traditionally been a major check on central state power (p. 162).

Contextual approach revisited

So, how does the contextual approach stand the acid test of new realities? It seems that the very conceptual base of the model is not only intact but it gets more rigor and relevance by new evidences and applications due to technological advances and globalization. Comparison of rapid marketization of Russia vs. indigenous approach of China, growth of South East Asian countries, in spite of imposed universal policies by IMF and WB, and comparison of two African and Asian countries approaches to development namely Ethiopia and Thailand as reported by Stiglitz (p. 32 and p. 198) testify to such claim. More so, as unfortunate as it is, we learn from the negative experiences of some countries due to ignoring the very fundamental cultural and ideological values as how imposed cliché approaches did so much harm than good to them. Democratization of the Third World countries after the Western pattern, as manifested by Iraq War, and tumultuous situation in Lebanon, and recent developments in some Latin American countries that more extreme governments came into power are all examples that can shed some light on the very fact that Public Administration theories and models must be built, developed and nurtured based on the indigenous/cultural values in the first place, and then once such conceptualization is in place, and then adopt techniques, models, and instruments that can function effectively with higher level of relevance, thus safeguarding the suitability of achievements.

As for Universalists approach, I have already referred to Mavima and Chackerian's study of Zimbabwe as the focal point. They complain that one the major factor for the reform failure has to do with the resistance of the local organizations in complying with the reform initiated and supported by international agencies. It is ironic when they discuss their methodology of institutional approach and define the term "institution" as being used to refer to phenomena such as customs and norms that provide parameters for organizational structure, the influence of local factors, legitimacy and the power of sanction by local institutions, that is exactly the opposite of what their Universalists position. Also it is interesting that in discussing the synergy and tradeoff in global and local factors (to development) they state: The way international and local forces influenced each other depend on the political and economic contingencies prevailing at a given time. Local political and economic conditions have the potential of either inhabiting or supporting the adoption and implementation of the reform. The key is situational adaptation that is contrary to the forced adoption imposed upon a given society... and that the tenet of Institutionalism is to place the importance of constraining effects that institutions have on organizational and individual actions. And finally the authors see global public management capacity enhancement as sociological institutionalism that suggest organizational structure and process are functions of cultural and inter-organizational influences (p. 97).

Thus, it seems even the researchers who belong to the Universalists camp acknowledge the differences of various contexts based on their cultural and other major value systems,

customs, traditions in adopting the PA systems offered to them and criticize unqualified imposition on them. Such contradiction, if not a fallacy, stems from the fact that most of these authors do not distinguish between the domains of “Basic” vs. “Instrumental” values. The former belongs to the cultural and ideological ones that set the direction for the society and what is right or wrong, for the people who believe them, and shaping the very framework of social order. The latter belongs to the domain of techniques and methods, adaptation of new and progressive technology that comes with it and must be subject to qualified adaptation within the framework of the basic values. This is the tenet of the proposed “Indigenous Theory.” It not only attempts to provide a meaningful and effective framework for such adoption and cooptation, but also aims at offering a border spectrum of different expectations in different societies and localities, resulting in adding to the reservoir of the knowledge and scholarship in the field. It seems that the original Indigenous model may need a couple of major adjustments with regard to a few major elements, i.e., Governance and Ethical Leadership. Both elements definitely have to do with basing their foundations on the indigenous values systems, the same values that are used in building, shaping, and developing the social, political, cultural and economic institutions. Thus, level II of the conceptual framework (Figure 1) needs to be expanded in order to explicitly incorporate these two elements. As such, for the ethical

leadership and governance, a major thrust of the institution building that is part of Administrative Subsystem provision (level III) would heavily emphasize the “political development” leading to an effective and functional Civil Society. The system adjustment might also be needed in the General Schema for Indigenous Model (Figure 2). There would be a need to add an additional level between Stage II and Stage III, to reflect building the foundations of such institution. This new level can also act as an interface between the domains of basic and instrumental values.

A final note on the emerging trends that focus on the human choice even at the level of techniques and methods in line with the postulates of indigenous theory of administration is in order. Chambers redefine the whole spectrum of development very differently, compare to what was traditionally dealt with, and looks at it as a process of *human development* to give it a kind of prior order over techniques and models and even institutions (Chambers, 2004). Dale goes even further and in his account on Development Planning, looks at planning process as a people oriented endeavor that incorporates continuous interventions on the part of constituencies and stakeholders throughout the whole planning process and making it subject of adjustments and readjustments as the emerging values of people in a given situation call for (Dale, 2004). This comes a long way and seems to be a significant departure from the Universalists’ theoretical and practical positions.

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Appendices

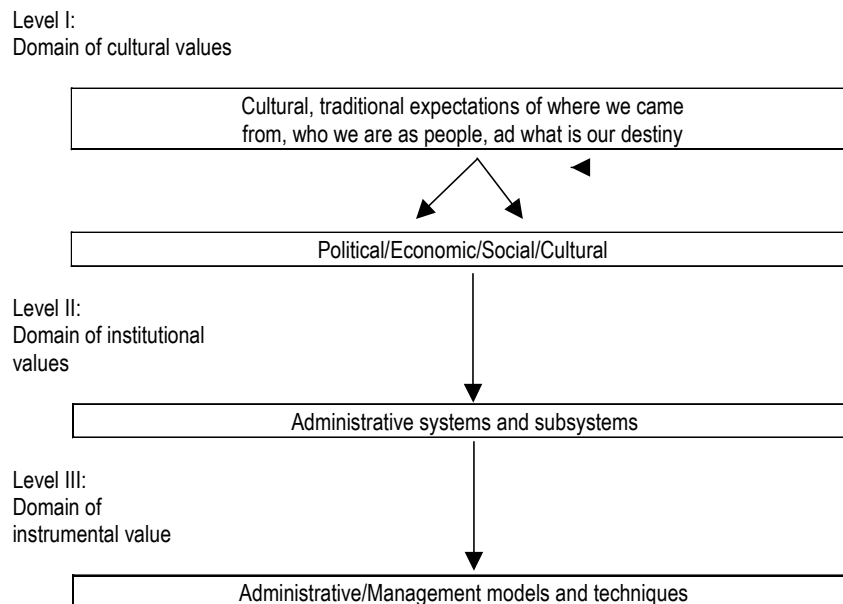


Figure 1. Conceptual formwork for indigenous administrative theories

Source: Bjur, Zomorrodian, 1986.

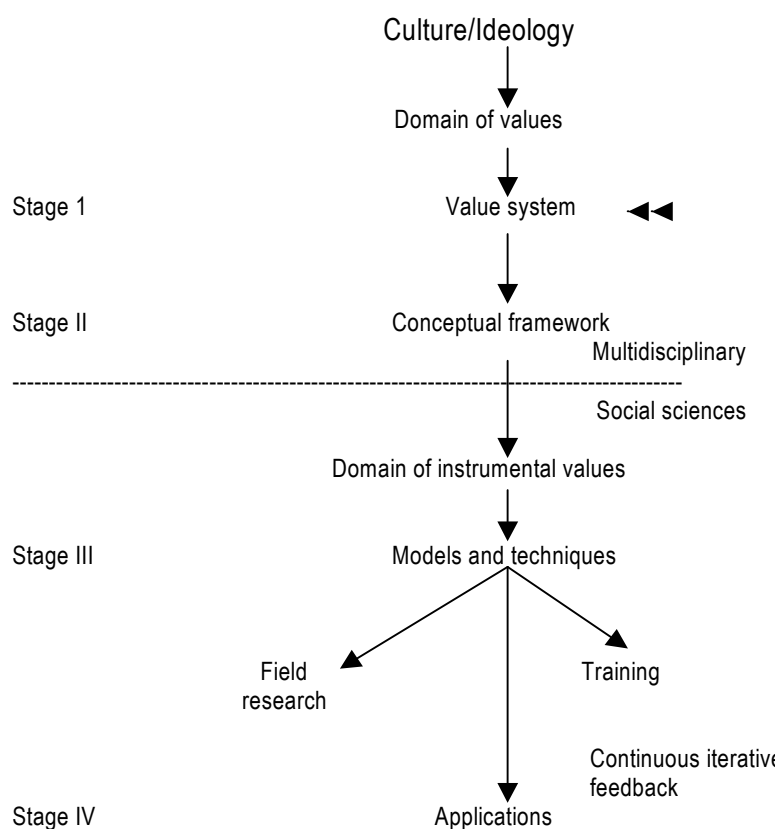


Figure 2. General schema for indigenous administrative theories

Source: Zomorrodian (1979).

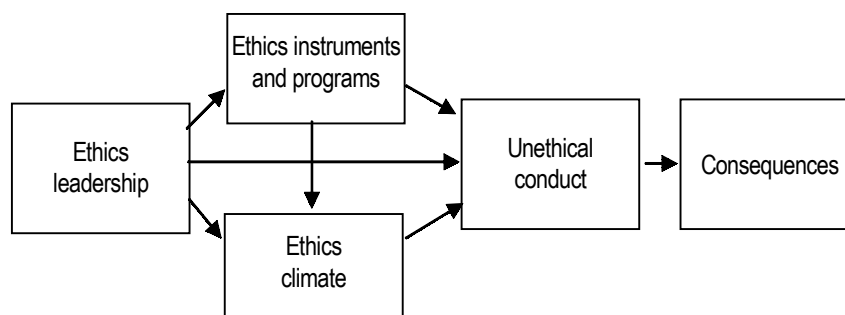


Figure 3. Research model

(adopted from: Captein et al., 2002)

Characteristics of Managing Operational Banking Risk

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***Abstract.** The objective of this paper is to provide a global perspective of the operational risk from a banking societies' viewpoint. We describe the main regulations and settlements in the field and examine the various approaches of the operational banking risk. The paper presents the need of banks to managing operational risk. We study comparatively for a banking society the capital charge for covering the operational risk under the basic indicator approach and under the standardized approach. We present a case study of implementing current capital requirements at the level of a Romanian banking society. From the theoretical approach and from the description of quantifying of operational banking risk, the results of this study insist on the importance of measuring of operational banking risk and identifies major issues that need to be considered to improve the managing operational banking risk.*

Key words: operational; banking; risk; capital adequacy; challenges.

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JEL Codes: G21, G32.

REL Codes: 11C.

1. Aim and research methodology

The aim of this study is to provide a comprehensive description of the framework and methodology for identifying, measuring and modelling operational banking risk. We concentrate our approach on the investigation of the regulatory implications of varying characteristics of operational risk and different methods to identify operational risk exposure. After the presentation of the general frame of reference of the theme in the specialty literature and in the specific national and international legislation, the study approaches the present stage of the operational banking risk management in Romania. First, we questioned the necessity of measuring the banking operational risk, trying to find out what extent banks need to know the quantitative aspects of this type of risk. The arguments for the necessity of measuring this risk were essential. There wasn't only about some regulatory restrictions, which impose the measurement of this risk for banks, but also about the objective and real necessity of the banks to know the losses they could register out of the events generating operational risk. Once established the necessity for measuring the banking operational risk, we approached the real methods that banks can use in measuring this type of risk. Due to the character of operational risk of being produced or not in a future period of time, measuring it means in fact an activity of forecasting the potential losses that the events generating operational risk can bring for a banking society.

The information on the study theme was realized by studying the national specialty literature and international one in the field, by analyzing the legislation and by consulting the available information's from the institutions level which make studies and researches on the operational banking risk such as the Bank of International Settlement and National Bank of Romania. The direct documentation tasked to assure the information and the knowledge of the practical phenomenon of operational risk management was realized at the banking societies from Romania through studying their internal regulations.

2. Theoretical background

The banking operational risk issue has been the object of several debates in the last years, the specialized literature offering multiple studies and analysis on this subject.

R. J. Herring (Herring, 2002) analyses the evolution of the operational risk studies and regulations. It is by no means clear that capital regulation is the most efficient means of achieving a reduction in the exposure of institutions to operational risk. Moreover, there is no systemic risk rationale for imposing capital requirements because losses due to operational risk tend to be idiosyncratic to a particular institution. The sorts of institution-destroying operational losses that have occurred – often due to the actions of a rogue trader – are usually attributable to a failure of internal controls rather than inadequate capital. No reasonable amount of capital would be sufficient to cover such an extreme event.

The most effective means of reducing operational risk are sound policies, practices and procedures, and insurance.

M. Power's opinion (Power, 2003, p. 2) about the management of the operational banking risk holds our attention, through an original approach regarding to the invention of the operational risk. He affirms that is not merely figurative or fanciful to suggest that operational risk has been "invented". He examines the rapid emergence of operational risk from Basel II epistemic status to its institutionalization as a key component of global banking regulation. The author remarks the three keys domains of operational risk policy controversy as being: definitional issues, data collection and the limits of quantification.

D. Rowe, D. Jovic and R. Reeves (Rowe et al., 2004, pp. 15-21) study the capital of the financial institutions and affirm that the capital is the key to any financial institution. Companies in other industries need capital to buy property and production equipment. For financial institutions, the primary function of capital is to cover unexpected risks losses, because risk of such losses inevitably accompanies a bank's core business of lending money and making markets. The authors explain why it is crucial for financial institutions to build an advanced economic capital framework and how that plays into current initiatives to implement the Basel II Capital Accord.

A. Sheen (Sheen, 2005, pp. 313-323) seeks to identify the general operational risk standards embodied in the Basel and EU

documents and to distil these standards into ten qualitative operational risk elements that are likely to be considered as part of any assessment of a credit institution's and investment firm's operational risk framework.

F. Flores, E. Bonson-Ponte and E. Escobar-Rodriguez (Flores et al., 2006, pp. 383-401) analyse the capacity of response of the banking sector's information systems, in the light of the new requirements of Basel II on the measurement and control of operational risk. They developed a structured case with a Spanish savings bank of medium size; an analysis is made of the practices and structures that may need to be modified to prevent a loss of competitive position.

K. Dutta and J. Perry (Dutta, Perry, 2007) model the operational risk through the severity distribution using three different techniques: parametric distribution fitting, a method of Extreme Value Theory (EVT), and capital estimation based on non-parametric empirical sampling. They found that applying different models to the same institution yielded vastly different capital estimates. They also found that in many cases, applying the same model to different institutions, yielded very inconsistent and unreasonable estimates across institutions even when statistical goodness-of-fit was satisfied. This raises two primary questions regarding the models that only imply realistic estimates in a few situations: (1) Are these models even measuring risk properly for the cases when they do yield reasonable exposure estimates, or are some reasonable estimates

expected from any model simply due to chance? (2) If an institution measures its exposure with one of these models and finds its risk estimate to be reasonable today, how reasonable will this estimate be over time?

A. Fernandez-Laviada (2007, pp. 143-155) describes the new role of the internal audit function in reviewing the operational risk framework. An efficient operational risk management framework will improve and reinforce the internal controls of the organization. Internal audit should be alert to the whole process of implementation of the systems for managing operational risk in entities.

A.A. Jobst (2007, pp. 423-449) consider amid increased size and complexity of the banking industry that operational risk has a greater potential to occur in more harmful ways than many other sources of risk. He seeks to provide a succinct overview of the current regulatory framework of operational risk under the New Basel Accord with a view to inform a critical debate about the influence of data collection, loss reporting, and model specification on the consistency of risk-sensitive capital rules.

In the field of the approached theme, the specialty literature detains theoretical analysis and empirical studies of the operational banking risk and its quantification. In the last few years, the importance given to the studying of the operational banking risk was the biggest one. Proves of this importance are offered by the analyzed representative papers.

3. General banking operational risk management framework

3.1. Operational banking risk – a significant banking risk, according to the Basel II Agreement

The first tendency for the one who is preoccupied with measuring the operational risk within an entity is to declare that this type of risk is a non-measurable risk. Such an attitude is based on the risk's essence itself. Generally, the risk is associated with uncertainty. The risk is often identified with uncertainty, and uncertainty affects any field of activity. The banking field is more affected by uncertainty than other economic fields. Measuring the risk would mean measuring the uncertainty in this case. Recent approaches of banking risks are based on defining these risks as being rather effects of exposure in an uncertain situation. With such an acceptance of the banking risks, measuring them becomes possible using advanced statistics methods of valuation, which establish the probability of an unfavourable situation's appearance.

Contemporary banks don't aim at eliminating the risks (an impossible approach in the present banking field), but they concentrate on learning the potential danger and the level of impact for the risks affecting their activity. In this way they create the premises for an efficient management of the banking risks by the possibility of forecasting the risk event's happening in a certain measure and of taking in time decisions necessary for reducing the risk of eventual unfavourable consequences.

Between the significant banking risks, the operational risk detaches due to the complex character of the events generating banking operational risks and due to the difficulties of measurement. Generally, managing the banking risks means identifying, measuring, supervising and controlling. Speaking of the banking operational risk, these activities are difficult to implement and imply the banks' efforts in drawing up methods and mechanisms of reducing the negative effect of the events generating operational risk.

The banking operational risk is given a great importance also because it is considered a category of significant banking risk, according to the Basel II Agreement. The banking operational risk has been a preoccupation for the banking and academic fields before the Basel II Agreement, too. The banks have become aware of the operational risk's importance, but they have differently reacted according to their consent of investment in monitoring this risk. In the most times, banks considered the banking operational risk an unknown component of their costs. The reason is the insufficient preoccupation for managing this risk, but also the substantial costs for developing the databases with events generating operational risk.

We can say that adopting the Basel II Agreement brought a revolution in the operational risk field. This category of risk is taken into account for the first time in an international agreement for determining the banks' capital requirements.

The Basel II Capital Agreement, the name of the International Convergence of

Capital Measurement and Capital Standards – a Revised Framework, has been finalized by the Basel Committee and has been signed in November 2005. The Basel II Agreement doesn't have an imperative character for any national state; it is just a guiding frame for adopting the specific national legislations. As for the countries part of the European Union, the Basel II settlements had been the base for configuring the European Directive adopted under the name of *Capital Requirements Directive CRD* or *Capital Adequacy Directive CAD* by the Council and European Parliament in June 2006. The directive represents in fact the combination of two directives: Directive 2006/48/EC regarding the building and activity of the credit institutions (revised) and the Directive 2006/49/EC regarding the capital adequacy of the investments societies and credit institutions (revised). European Union's member states had to transpose the settlements of the Directive CDR and the credit institutions had to apply them starting with the beginning of 2007. Romania's adhesion to the European Union from January the 1st 2007 implied the obligation to enforce the communitarian regulations in our banking system, too. But in 2007, credit institutions were able to choose between the settlements of the first Basel I Agreement and the first or average approaches of the new Basel II Agreement. The most sophisticated approaches of the new agreement (advanced approach IRB for the credit risk and AMA approach for the operational risk) are available since the year

2008, when all credit institutions from the European Union have to apply the Basel II Agreement.

The Basel II Agreement defines the operational risk in part V, point 644 like this: operational risk is defined as the risk of loss resulting from inadequate or failed internal processes, people and systems or from external events. This definition includes legal risk, but excludes strategic and reputation risk. Legal risk includes, but is not limited to, exposure to fines, penalties, or punitive damages resulting from supervisory actions, as well as private settlements. Banks must allocate extra capital for this type of risk. The Agreement presents three methodologies of measurement of operational risk, being in fact methods for calculating operational risk capital charges in a continuum of increasing sophistication and risk sensitivity: the Basic Indicator Approach, the Standardized Approach and Advanced Measurement Approaches. We consider that the first two approaches are not properly named methodologies for measuring the banks' exposure at operational risk, they being rather „security screens” (more or less inspired) established by the Basel II Capital Agreement in order to determine the capital requirement for operational risk. Only the third methodology permits the measurement of potential losses registered by a banking society out of events generating operational risk.

3.2. Operational banking risk in Romanian legislation

Intensely discussed in the Basel II Agreement, the operational risk can be found in the Romanian banking environment

before the Basel II Agreement. The first minimal structure of the significant banking risks is presented by the National Romanian Bank's Regulation no.17/2003 regarding the organisation and internal control of the credit institutions' activity and management of the significant risks, the organization and development of the internal audit in the credit institutions. Regarding the operational risk, it is defined as the national settlement as the risk of getting losses or not realizing the estimated profits, being determined by internal factors (the inappropriate development of some internal activities, the existence of inadequate people or systems) or external factors (economic conditions, changes in the banking environment, technological progresses). The legal risk is a component of the operational risk, arising due to not applying or defectively applying the legal or contractual regulations and negatively influences the operations or the credit institutions' situation.

The actual stage of development in the Romanian banking system reveals a banking system that needs to follow a complex transformation process for the premises of the Basel II Agreement's efficient application to be guaranteed. The first element that had to be configured was the specific national legislation. The National Romanian Bank is given an important part in this standardizing measure. The National Romanian Bank's activities during 2006-2008 show that the central bank has learned its lessons, has understood that in the Basel II “world” the rules of the game are complicated and has configured an action plan to face the Basel II challenges. The central bank has made public

its preoccupations in this domain and has also established a calendar of implementing the suggested actions.

We identify legal amendments made during 2006 and 2007 in operational banking risk domain. Also, the harmonization of the national legislation in the field with the European one continued in 2008, through transposition into the National Bank of Romania regulations of the guidelines issued by European System of Central Banks. The main settlements regarding the operational banking risk are:

- Government Emergency Ordinance No. 99/2006 on credit institutions and capital adequacy, as subsequently amended and supplemented by Law No. 227/2007 *settles* the general frame of risk management in banks. It shows that banks have to apply one of three methods in operational risk administrating: the Basic Indicator Approach, the Standardized Approach and Advanced Measurement Approaches.

- Regulation No. 18/23/2006 issued by National Bank of Romania and National Securities Commission on own funds of credit institutions and investment firms *requires* credit institutions, Romanian legal entities, branches of third-country credit institutions operating in Romania, financial investment services undertakings, credit co-operatives within credit co-operative networks and investment management companies to maintain a level of own funds at least equal to the amount of capital requirements for credit risk, dilution risk, position risk, settlement risk, counterparty credit risk, currency risk, commodities risk and operational risk.

- National Bank of Romania Order No. 12/2007 on the reporting of minimum capital requirements for credit institutions *transposes* into the Romanian legislation the COREP (*Common solvency ratio reporting framework*) reporting forms drawn up by the Committee of European Banking Supervisors (CEBS), which stands for the instrument of banking supervision according to Basel II principles. The new norms require the observance, both on an individual and on a consolidated basis, of requirements for own fund structure and the capital requirements for credit risk, market risk, operational risk, dilution risk, position risk, settlement risk, counterparty credit risk, commodities risk.

- Regulation No. 5/2008 issued by National Bank of Romania on approving the use of Standardized Approach or Alternative Standardised Approach for operational risk *presents* the way through every banking society can apply one of two approaches in operational banking risk measurement.

But there are some regulations that will be finalised, such as those regarding the internal framework for activity management, internal process of assessing capital adequacy to risks and outsourcing of the activity of credit institutions and those regarding the validation of internal models for the assessment of operational risk.

3.3. Managing the banking operational risk

Nowadays, in Romania all the active banking societies must apply the following procedures for managing the operational risk: valuation procedures; monitoring

procedures and risk decreasing procedures, either in the internal field, by correcting in time the determined errors and by introducing adequate technologies for processing and insuring the information security, or by transferring the risk to other domains of activity (for example insurances against some events).

At a detailed study, these three types of procedures enforce the banks to develop activities which permit them the following:

1. For the *valuation procedures*, to identify, notify and quantify the banking operational risks they are confronted with. Identifying an event generating banking operational risk means establishing the moment (data) when the effective banking unit in the territory or the central administration of the bank takes knowledge of this event's happening for the first time, also including the existence of a real or potential compensation demand appeared in the bank. In this way, the banking society must take into consideration at least the following types of events generating the operational risk:

a) The internal fraud, identified in the shape of losses generated by acts as those committed with intention of fraud, fraudulent appropriation of goods (in a legal meaning) or infringement of regulations, legislation or politics of the credit institution, in which at least an inner person is implied; events as discrimination or infringement of diversity principles (for example bad-faith reporting the positions, theft, concluding of transactions by employees on their own).

b) The external fraud, identified in the shape of losses generated by acts as those

committed with intention of fraud, fraudulent appropriation of goods or infringement of legislation, committed by a third party (for example robbery, fake, breaking informatics systems' codes).

c) Conditions for hiring the personnel and the safety of working place, identified in the shape of losses generated by actions contrary to the legislation and hiring, health and working safety regulations, by payment of compensations for body prejudices or by discrimination or infringement of diversity principles (for example compulsory demands of the personnel, not respecting the labour protection regulations, promoting discriminatory practices).

d) Deficient practices regarding the customers, products and activities – business practices, identified in the shape of losses generated by the not intentioned infringement or negligence of professional duties towards the customers (including those regarding trust or security and those regarding services' adequacy) or generated by the nature or characteristics of a product (for example inadequately using the confidential information about the customers, money laundry, selling unauthorized products, wrong use of products and services regarding the electronic banking system by the clients).

e) Endangering the tangible assets, identified in the shape of losses generated by destruction or deterioration of tangible assets as an effect of natural disasters or other events (for example terrorism or vandalism, acts fires and earthquakes).

f) Interrupting the activity and defective functioning of systems, identified in the

shape of losses generated by interrupting the activity or by inadequate functioning of systems (for example defections of hardware and software components, telecommunication troubles, defective projection, implementation and maintenance of the electronic banking system).

g) Execution, delivery and management of processes – the treatment applied for customers and commercial counterparts, as well as the defective processing of customers' data, identified in the shape of losses generated by inadequate operation of transactions or management of processes; losses from business partnerships (for example wrong recording the income data, defective management of the real guarantees, incomplete legal documentation, unauthorized access to the customers' accounts, disputes).

Banking societies have internal structures at the central administrations, through which they centralize the operational risk events from all the territorial units. The notification of a banking operational risk event is the action of reporting to the mentioned structure an operational risk event identified in the territorial banking unit or in the central administration of the bank.

2. For the *monitoring procedures*, registering and following the evolution of identified operational risk events. The organizational structures in each bank having responsibilities in managing the risks analyse the events generating banking operational risk and propose adequate measures, according to those events' gravity. Each banking society draws its own

system of operational risk indexes, detailed on types of operational risk events.

3. For the operational risk *decreasing procedures*, the banking society draws its own procedures for correcting in time the errors that generate banking operational risk. The banking societies are also obliged to take measures for increasing the security of information processed in their territorial units and in the bank's central administration. Banks have the possibility to use alternative instruments for reducing the banking operational risk, as those offered by assurances, through which the risk is transferred to other domain.

4. Quantifying operational banking risk

4.1. Approaches permitted for quantifying the banking operational risk in Romania

According to the New Basel II Agreement the banking companies must accomplish specific capital requirements regarding the total credit, market and operational risk. The capital ratio is calculated using the definition of regulatory capital and risk-weighted assets and must be no lower than 8%, according to the 40 article from the Basel II Agreement:

Total Amount of Capital/Risk –
Weighted Assets $\geq 8\%$ (1)

In the Basel II approach, average assets risk-weighted must include capital requirements for covering the operational risk.

The active banks in Romania must determine their capital necessary for covering the operational risk using one of the three means of quantification mentioned by the Basel II Agreement, assumed by the Capital Requirements Directive CRD and by the national legislation – the National Romanian Bank's regulation regarding the operational risk: *the Basic Indicator Approach, the Standardized Approach and Advanced Measurement Approaches*. Banks may choose one of the three methods mentioned above.

The first approach – the Basic Indicator Approach can be used by any bank, without being necessary the fulfilling of some extra requirements or the obtaining of approvals. Banks can calculate the necessary of capital for covering the operational risk applying the standardized approach and the advanced measurement approaches only after a pre-available approval from the supervising direction of the Romanian National Bank.

4.2. The basic indicator approach

Banking societies must permanently have funds for covering the operational risk to which they are exposed. In the framework of the base indicator approach calculating the capital required for covering the operational risk is done by applying the 15% quota upon a relevant indicator determined according to the methodology exposed below. The relevant indicator is calculated as an arithmetic average of the *annual gross results of the bank's activity* recorded by the credit institution in the last three ended financial exercises.

Banks using the basic indicator approach must hold capital for operational

risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income. When calculating the average, figures for any year in which annual gross income is negative or zero should be excluded from both the numerator and denominator. The charge may be expressed as follows:

$$K_{BIA} = \left[\sum (GI_{1...N} \times \alpha) \right] / N, \quad (2)$$

where:

K_{BIA} = the capital charge under the basic indicator approach;

GI = annual gross income, where positive, over the previous three years;

N = number of the previous three years for which gross income is positive;

$\alpha = 15\%$, which is set by the Committee.

The gross result of the banking activity is determined as an algebra sum of some specific elements based on the elements from the profit and losses account at December 31, audited.

The negative or null values of the annual gross result, if such situations appear, are not considered in calculating the relevant indicator. In such cases, the relevant indicator is calculated through reporting the positive values' sum of the annual gross result to the number of years in which bigger than zero values has been recorded. If the credit institution does not have the necessary data in an audited form, it must use the estimations of those data.

We present an abridgement from Income Statement of a bank, with the necessary lines of the calculus of the gross annual result and the capital charge under basic indicator approach:

The minimum necessary capital for the covering of the operational banking risk in the basic indicator approach BIA

Table 1

- in RON (Romanian National Currency)

No.	Elements from income statement	Year 2005	Year 2006	Year 2007
1.	Interest income and assimilated income, out of which:	78,137,566.1	104,733,877.9	203,462,797.2
1.1.	<i>From debentures and other fixed income bonds</i>	832,174.3	17,720,234.5	39,701,945.9
2.	Interest expense and assimilated expense	26,802,094.0	34,548,626.0	74,234,546.8
3.	Income from shares and other variable income securities	-	-	-
4.	Commission income	15,053,607.0	29,078,397.5	44,261,561.8
5.	Commission expense	2,337,631.5	3,543,705.6	5,116,394.2
6.	Net profit/(loss) from financial operations	(5,285,912.2)	10,101,591.7	12,956,099.8
7.	Other operating income	2,042,768.7	1,270,116.6	509,685.7
8.	GROSS RESULT FOR THE YEAR (COL: 1-2+3+4-5+/-6+7)	60,808,304.1	107,091,652.1	181,839,203.5
9.	Capital charge under BIA	17,486,057.985		

Because all three values of GI are strictly positive numbers, N will be equal to 3. In this case, capital charge under BIA takes value:

$$K_{BIA} = (60,808,304.1 + 107,091,652.1 + 181,839,203.5) \times 0.15 / 3 = 17,486,957.985 \text{ RON}$$

So, in 2008, the minimum necessary capital for covering the operational risk under Basic Indicator Approach is of 17,486,957.985 RON.

The current model in which is elaborated Income Statement in Romania permits the identification to all the necessary elements of the settlement of gross annual result, depending on which is established the prerequisite for extreme the covering risk operationally. This means that which banks makes ones choice for base approach in the quantification risk operationally, aren't obliged to achieve adjacent situations. The banks dispose of the primary information for the determination of the requirement of capital concerning the operational risk, on the strength of Income Statement.

4.3. The standardized approach

According to the standardized approach, banks' activities are divided into eight business lines. In the purpose of determining the capital request related to the operational risk, the banking societies have the obligation of establishing policies and adequate criteria of framing different activities on the eight lines and to transpose them clearly and transparently in the internal norms.

Yearly financial situations of an active banking society from Romania do not contain the detailed activities of the bank on the activity lines requested by the settlements according to the Basel II Agreement. In such context, every banking society which wants the quantification of

the banking operational risk through standard approach is obliged to configure its evidence system of the operations, based on which it can identify the eight activity lines according to the Basel II Agreement settlements.

Such a system can't be operational and efficient only through an integrated informatics application, of the level of the entire banking society, as well as at the level of the Central unit, as at the level of each territorial operative banking unit.

Because the measurement of the banking operational risk in standard approach imposes to the bank to establish the yearly gross incomes on activity lines from the last three years, the banking society must act post factum in grouping the activities on lines, for at least three financial closed exercises.

Grouping the activities developed by a banking society on activity lines, according to the requests from the standard approach of the operational risk, represents a difficult exercise for the bank. Information from the yearly financial situations that the bank is disposing does not allow it to classify the banking activities on lines, only after detailed analyzes.

For each of the activity lines, the banking society must establish the gross income, for the last three financial exercises closed. For this there are used information from the profits and losses account, which are presenting the expenses and incomes of the banking societies. Only that, the format of the profits and losses account of the active banking societies from Romania does not contain the activity lines settled by the Basel II Agreement.

Standard approach of the banking operational risk does not suppose sophisticated calculus for the banking units. *The difficulties are related of identifying correctly the activity lines.* Once established the yearly gross incomes for each activity line, it proceeds to effective calculating the needed capital for covering the operational banking risk.

Within each business line, gross income is a broad indicator that serves as a proxy for the scale of business operations and thus the likely scale of operational risk exposure within each of these business lines. The capital charge for each business line is calculated by multiplying gross income by a factor (denoted beta) assigned to that business line. Beta serves as a proxy for the industry-wide relationship between the operational risk loss experience for a given business line and the aggregate level of gross income for that business line. It should be noted that in the Standardized Approach gross income is measured for each business line, not the whole institution, i.e. in corporate finance, the indicator is the gross income generated in the corporate finance business line.

The total capital charge is calculated as the three-year average of the simple summation of the regulatory capital charges across each of the business lines in each year. In any given year, negative capital charges (resulting from negative gross income) in any business line may offset positive capital charges in other business lines without limit.

However, where the aggregate capital charge across all business lines within a

given year is negative, then the input to the numerator for that year will be zero. The

$$K_{TSA} = \left\{ \sum_{years:1-3} \max \left[\sum (GI_{1-8} \times \beta_{1-8}), 0 \right] \right\} / 3, \quad (3)$$

where:

K_{TSA} = the capital charge under the standardized approach;

GI_{1-8} = annual gross income in a given year, for each of the eight business lines;

β_{1-8} = a fixed percentage, set by the Committee, relating the level of required capital to the level of the gross income for each of the eight business lines.

total capital charge may be expressed as:

The values of the betas are: corporate finance – 18%, trading and sales – 18%, retail banking – 12%, commercial banking – 15%, payment and settlement – 18%, agency services – 15%, asset management – 12%, retail brokerage – 12%.

We present the activity lines for the gross income of a banking society during 2005-2007 and we calculate the capital charge for the covering the operational risk under the Standardized Approach:

Yearly gross income of a banking society, detailed on activity lines

Table 2

- in RON -

Activity line	Gross income GI		
	Year 2005	Year 2006	Year 2007
Corporate finance	-27,610,785.7	-34,256,450.6	-42,491,199.7
Trading and sales	12,721,043.7	27,276,700.7	57,277,132.3
Retail banking	0	0	0
Commercial banking	36,689,803.5	51,714,063.4	87,245,376.9
Payment and settlement	4,974,269.6	8,567,921.8	14,067,149.9
Agency services	0	0	334,647.2
Asset management	107,066.5	156,011.1	0
Retail brokerage	0	0	0

We are mentioning those elements that can not be framed in a certain activity line, had been take over in the first line corporate finance, which is weighted with a coefficient of maximum 18%. It can be observed the recording of some yearly negative gross income for dome activity lines, which leads to a negative request of

capital for that activity line. This negative request line is deducted from the capital request belonging to the financial exercise to which is referring to.

The regulatory capital charges across each of the business lines for each three years are presented in the following table:

Capital request for each banking activity line

Table 3

- RON -

Business lines	$GI_{1-8} \times \beta_{1-8}$		
	Year 2005	Year 2006	Year 2007
Corporate finance	-4,969,941	-6,166,161	-7,648,416
Trading and sales	2,289,788	4,909,806	10,309,884
Retail banking	0	0	0
Commercial banking	5,503,471	7,757,110	13,086,807
Payment and settlement	895,368.5	1,542,226	2,532,087
Agency services	0	0	50,197.08
Asset management	12,847.98	18,721.33	0
Retail brokerage	0	0	0

The summation for each year, over all eight business lines will be:

Capital request referring to the banking operational risk

Table 4

- RON -

Year 2005	Year 2006	Year 2007
3,731,533	8,061,702	18,330,558

Since all three values are positively, we obtain the following value for the capital charge under the standardized approach:

$$K_{TSA} = \frac{3,731,533 + 8,061,702 + 18,330,558}{3} = 10,041,265$$

So, in 2008, the minimum necessary capital banking studios society for the covering the operational risk under the standardized approach is of 10,041,265 RON. The same banking society had been studied through the basic indicator approach of the banking operational risk, situation in which had been obtained a value for the capital request for covering the operational banking risk of 17,486,957.985 RON.

We consider that the difference of capital between the two approaches, base and standard approach is considerable. In such

a context, the banking societies should adapt the evidence and transactions recording system, so that it can apply the standard approach in quantifying the operational risk. This approach is also a starting point in implementing the most advanced shape of quantifying the operational banking risk – the advanced measurements.

4.4. The alternative standardized approach

By applying the alternative standardized approach, banks are able to find out the capital requirement for covering the operational risk, if they receive the previous approval of the National Bank of Romania's Surveillance Head Office. A bank may apply this type of approach of the operational risk if it carries on mainly retail banking business and/or commercial banking business, the obtained incomes being at least 90% of the bank's total incomes.

The methodology for determining the capital requirement for covering the operational risk using the alternative standardized approach is the same as for the standardized approach, except the two business lines: Commercial banking and

retail banking, for them the annual gross income is replaced by an alternative indicator for the normalized income, equal to 0.035 of the medium annual volume of loans and advances according to this two business lines, estimated on the basis of the data from the last three financial years.

4.5. The advanced measurement approach

Advanced approach measurements represents a set of operational banking risk's quantification methods, found in the Basel II Agreement. Advanced evaluation approach in quantifying the banking operational risk is not an accessible method to any credit institution, including also active banking company from Romania. On the other hand, banking companies are discouraged in applying this method by the complexity of evaluating methods, and, on the other hand, by the restrictions imposed by the national supervising authority – Romanian National Bank, in applying these methodologies of quantifying the operational banking risk.

In determining the capital requirements for covering the operational risk, institutions include also the expected and un-expected losses, so:

$$\begin{aligned} \text{Capital Charge under AMA (CC}_{\text{AMA}}) &= \\ &= \text{Expected Loss (EL)} + \\ &+ \text{Unexpected Loss (UL)} \end{aligned} \quad (4)$$

If ELs are already captured in a bank's internal business practices, then capital charge set at the unexpected loss alone:

$$\text{Capital Charge under AMA (CC}_{\text{AMA}}) = \text{Unexpected Loss (UL)} \quad (5)$$

In AMA approach, there is no specification regarding the analytic approach that has to be used by the banking companies. However, banks must demonstrate that their measurement system is sufficiently “granular” to capture severe tail loss events, e.g 99.9% VaR. Quantifying the operational banking risk must include also the low frequency risk events and with potential major negative effect, case given by the extremity of the statistic distribution curve, so that it will assure a rigorously standard compared to the a trust interval of 99.9% for a year time horizon.

Regarding the achievement of the mentioned rigorously standard, the operational risk quantification system of an credit institution must include a series of essential criteria, among which at least: internal data use, external data use, scenario analysis and business factors use and the internal control system. A bank needs to have a credible, transparent, well-documented and verifiable approach for weighting these fundamental elements in its overall operational risk measurement system. In such cases, scenario analysis, and business environment and control factors, may play a more dominant role in the risk measurement system. The correlations between the losses estimations from the operational risk can be recognized only if the institution can demonstrate adequately in the Romanian National Bank's opinion, which the correlation

measurement systems are rigorously, are correctly implemented and take into consideration the incertitude level corresponding to such estimations, especially in the crisis periods. Institution must validate the hypothesis referring to the correlations by using corresponding quantitative and qualitative techniques.

The operational risk quantification system must be well preserved on the internal plan and it must be avoided taking into consideration for more than one time the positive results of the qualitative evaluation or the diminution of the risk techniques, which have already recognized in other segments of the capital adequacy framework.

Operational risk quantifications generated by the institution must be substantiated on a *historical observation period of at least five years*. In the case in which an institution applies for the first time the advanced approach of quantifying the operational risk it can be accepted a historical observation period of *minimum three years*.

For applying the advanced evaluation approach in quantifying the operational risk, a credit institution must have *the capacity of splitting the internal historical data regarding the operational risk on some activity lines and loss events' categories* and can send these data to the Romanian National Bank, on its request. There are eight activity lines set through the Romanian National Bank's Regulation regarding the operational risk and they are according to the Basel II Agreement: *financing the commercial companies, transactions and sells, retail brokerage, commercial banking activity, retail banking*

activity, payments, agent services and assets' management.

There are seven types of operational banking risk generator activities specified by the Romanian National Bank's Regulation regarding the operational risk and they are adapted after the Basel II Agreement: *internal fraud, external fraud, employment practices and working place safety, clients, products and business practices, damages upon the corporal assets, activity breaking and inappropriate functioning of the systems, execution, delivery and processes' management*. Criteria of allocating the losses on activity lines and on events' categories must be objective and well documented.

5. The Romanian banks' attitude in managing operational risk and, in following, the requirements for the banking capital adjustment

The national regulations in the field of banking capital adequacy, according to the Basel II Agreement, establish the two sorts of capital:

1. Tier 1 (Core Capital or Basic Equity) considered the key element of capital on which the main emphasis should be placed is equity capital and disclosed reserves. This key element of capital:

- is the only element common to all countries' banking systems;
- it is wholly visible in the published accounts and is the basis on which most market judgments of capital adequacy are made;
- it has a crucial bearing on profit margins and a bank's ability to compete.

This emphasis on equity capital and disclosed reserves reflects the importance the national supervisor authorities attaches to securing an appropriate quality, and the level of the total capital resources maintained by banks.

Tier 1 comprises the highest quality capital elements which fully satisfy all of the following essential characteristics:

- provide a permanent and unrestricted commitment of funds;
- be freely available to absorb losses;
- rank behind the claims of depositors and other creditors in the event of winding-up.

In Romanian banking system (pursuant to Regulation No. 18/23/2006 issued by National Bank of Romania and National Securities Commission on own funds of credit institutions and investment firms), Tier 1 capital consists of:

a) subscribed and paid-up share capital, except cumulative preferential shares or, as appropriate, the core capital made available to the branch in Romania by the third-country credit institution;

b) share premiums, received entirely, related to the equity capital;

c) legal reserves, statutory reserves and other reserves, as well as the retained earnings, following profit distribution;

d) net profit of the latest financial year, before its distribution in accordance with the decisions made at the General Meeting of Shareholders, to the limit of the amount intended to be earmarked for each of the destinations (stipulated under let. a) – c)).

2. *Tier 2 (Supplementary capital)* includes other elements which, to varying

degrees, fall short of the quality of Tier 1 capital, but nonetheless contribute to the overall strength of an entity as a going concern. It is divided into: Upper Tier 2 capital – comprising elements that are essentially permanent in nature, including some forms of hybrid capital instruments which have the characteristics of both equity and debt; and Lower Tier 2 capital – comprising instruments which are not permanent.

In Romanian banking system (pursuant to Regulation No. 18/23/2006 issued by National Bank of Romania and National Securities Commission on own funds of credit institutions and investment firms), Tier 2 capital comprises:

- a) base Tier 2 capital;
- b) additional Tier 2 capital.

Base Tier 2 capital consists of reserves from tangible asset revaluation, adjusted for the related fiscal obligations, which are foreseeable upon calculating own funds and other items and perpetual securities and other similar instruments that fulfill cumulatively the specific conditions. To these may add the cumulative preferential shares (other than those representing items of the additional Tier 2 capital). The additional Tier 2 capital includes temporary cumulative preferential shares and the capital in the form of subordinated loans.

We present a case study of implementing current capital requirements at the level of a Romanian banking society. National Bank of Romania sets and monitors capital requirements for the banking society as a whole and requires the bank to maintain a prescribed ratio of total capital to total

risk-weighted assets. We analyze the bank's regulatory capital into two tiers:

- Tier 1 capital, which includes ordinary share capital, share premium, translation reserve and minority interests after deductions for goodwill and intangible assets and 50% of the interest in financial and insurance companies
- Tier 2 capital, which includes qualifying subordinated liabilities, fixed assets revaluation reserves after deduction of 50% of the interest in financial and insurance companies

The national legislation sets two capital ratio: *a risk-based capital ratio* (solvency ratio that will be >8%) and *ratio of Tier 1 capital to risk weighted assets*.

Under the risk-based capital adequacy framework, a Tier 1 and Tier 2 capital adequacy are measured by means of a risk-based capital ratio calculated by dividing its capital base by its total risk-weighted assets:

$$\text{Solvency Ratio} = \text{Risk - based Capital Ratio} = \text{Capital base} / \text{Total Risk - Weighted Assets} \quad (6)$$

Ratio of Tier 1 capital to risk weighted assets shows Tier 1 capital as a share of total risk-weighted balance sheet assets and off-balance sheet items, net of provisions.

A bank's regulatory capital position in accordance with the statutory regulations issued by the National Bank of Romania at 31 December year 2007

Table 5

- RON -

Indicator	31 December 2007	31 December 2006
<i>TIER 1 CAPITAL</i>		
Share capital	611,080	393,355
Share premium	98,601	94,199
Translation reserves	447,902	216,601
Less intangible assets	(7,397)	(9,056)
Less 50% of the interest in financial companies	(73,483)	(35,868)
TOTAL	1,076,703	659,231
<i>TIER 2 CAPITAL</i>		
Revaluation reserves	26,896	9,855
Subordinated liabilities	243,485	236,764
Less 50% of the interest in financial companies	(73,483)	(35,868)
TOTAL	196,898	210,751
Total regulatory capital	1,273,601	869,982
Risk weighted assets	10,459,289	5,958,940
<i>CAPITAL RATIOS</i>		
Solvency ratio (total regulatory capital expressed as a percentage of total risk-weighted assets)	12.18%	14.60%
Ratio of Tier 1 capital to risk weighted assets (total Tier 1 capital expressed as a percentage of risk-weighted assets)	10.29%	11.06%

Findings. The example has revealed that the bank recorded the lower solvency ratio (12.8 percent at end- N 2007, down 2.42 percentage points from end- N-1,

2006). The main factor behind this development is the ongoing expansion of non-government credit, given that bank's own funds posted a slower growth pace.

Nevertheless, the solvency ratio has been maintained at an adequate level, exceeding the minimum level laid down in prudential regulations applicable in Romania (8%).

An adequate level of capitalization indicators of credit institutions, including banks, secures the maintenance of the overall financial system stability, considering that these institutions are the key component of the Romanian financial market. The level of capitalization is relevant for the ability of credit institutions to absorb the losses generated by either exogenous shocks induced by the domestic and international macroeconomic environment, or by the inappropriate management of the endogenous risks associated with banking activity.

In the field of capital adequately, since 2007, the Romanian active banking societies, as credit institutions, had to *maintain permanently* the solvency ratio at minimum of 12% (according to article 7 of the National Romanian Bank's Regulation no. 12/2003 regarding the monitoring of the solvency and the high exposures of the credit institutions). Thereafter, the minimum solvency ratio was harmonized with the 8 percent level applicable in Europe (according to article 2 of the National Romanian Bank's Regulation no. 18/23/2006 on own funds of credit institutions and investment firms). The minimum level of the solvency ratio established in our country was higher than that of 8% presented in the Basel I Agreement, which denotes an attitude of prudence from the part of the regulatory authority in this domain – the National Bank of Romania.

According to Financial Stability Report for 2008, published by National Bank of

Romania, in 2007, the downtrend followed in the past years by the overall solvency ratio of credit institutions was sharper, this indicator dropping 5.4 percentage points as compared to the end-2006, to 12.7 percent. The main factor behind this development is the ongoing expansion of non-government credit, given that credit institutions' own funds posted a slower growth pace. Nevertheless, the solvency ratio has been maintained at an adequate level, exceeding the minimum level laid down in prudential regulations applicable in 2007 in Romania (12%) and that required by European and international regulations (8 percent).

Amid the fast expansion in non-government credit, banks' tendency to migrate towards lower solvency ratios continued in 2007 as well. Hence, for the first time in the past eight years, three banks reported solvency ratios in a range between 8 percent and 10 percent, whilst other three banks recorded solvency ratios ranging from 10 percent to 12 percent. The largest concentration is seen in the range of 12 percent and 16 percent, as twelve banks reported solvency ratios within this range. At end-2007, only five banks posted solvency ratios higher than 30 percent, as compared with eight banks at end-2006.

Since 1st January 2008, as concerns the options of credit institutions, it is worth mentioning that banks, Romanian legal entities, *regarding the operational risk*, 22 banks, Romanian legal entities, opted for the Basic Approach, 9 banks for the Standardized Approach and one bank for the Advanced Measurement Approach.

It's obvious that only one of the Romanian banks applies the advanced measurement approaches in managing the operational risk. Banks are discouraged in applying this approach because the banks internal historical data regarding operational risk generating events either don't exist or are insufficient. The quality of the statistical data for supplying the internal models may be insufficient. And the external potentially operational risk generating events must be adequately estimated, and for this a bank needs adequate risk parameters. It is very difficult for a bank to estimate the probability and the impact of the banking operational risk generating events. The probability and impact of the risk events measuring scales (regarding the financial outcomes, strategic objectives, and the bank's reputation) are, in essence, subjective. Then these measuring scales must be correlated efficiently with operational risk events control procedures. In order to apply the Advanced Measurement Approaches a bank has to invest huge amounts for the support software applications, the training of the personnel and for the alternative instruments for managing the banking operational risk (insurance). The Advanced Measurement Approaches involve approvals for a bank from the National Bank of Romania based on complex studies and researches.

All of these aspects have discouraged the banks – Romanian legal persons – to apply the Advanced Measurement Approaches AMA. Also, the active banking institutions from Romania are not tempted to adopt in the near future internal methods for quantifying the operational risk, because the solvency is superior to the minimum

level regulated at present in Romania (8%), therefore there isn't any stimulus for saving own funds by using more advanced methodologies. In the case of the banking institutions that are a part of multinational groups, the Romanian banking market may be considered too small at the group's level in order to justify the costs of implementing the Basel II advanced approaches, banks being oriented at the present towards the increase of the market rate.

We believe that for now, the first two approaches in quantifying of the operational banking risk are more suitable for the Romanian banking system, although the capital requirements for covering the operational risk are considered superior in these approaches unlike the Advanced Measurement Approaches. The present capitalization level of the Romanian banking system allows banks not to decide to implement the Advanced Measurement Approaches – an effective management of banking operational risk.

Conclusions

We consider that the decisional factors from the banking societies perceive the Basel II Agreement firstly as an imperative frame for them to manage the banking societies and only after that as a possibility of efficient management of the banking societies. That's because the Agreement hasn't proved its importance for the credit institutions yet and its favourable effects for them. Otherwise, any new thing proves its utility and importance only after the practice has tested the theoretical settlements of that regulation.

All banks from Romania are still planning or in the process of implementing their plans for Basel II. The majority of banks are continuing to struggle with Pillar I (the minimum capital requirements necessary for covering specific risks of banking: credit risk, market risk and operational risk). For the second (the process of prudential supervision) and third (the market discipline) Pillars it was remarkable the absence of the banks concentration.

Each Romanian bank has adopted a certain strategy regarding the Operational Risk Management. The objective of the strategy regarding the Operational Risk Management is becoming conscious of the operational risk and of the responsibilities in managing this risk at the whole bank's level in order to maintain the risk at adequate parameters to permit the development of the bank's activity in optimum conditions. Banks have in place principles for managing the operational risk as well as procedures for monitoring, assessing and reducing the threat of events that might result in losses. The process of managing the operational risk is a cyclic one, meaning the repeated development of four steps (identification, valuation, monitoring and management) and means *identifying and catching the losses* generated by the operational risk's development. In this way importance is given to the identification of the type of followed losses, the persons responsible for reporting the losses, the criteria and methods of validating the registrations. After validating and insuring the information's consistency, these will be stored in a

database regarding the losses from operational risk – “Loss Database”, and this database will be the foundation for the future valuations of this risk. The database will contain information regarding the registered losses, and also regarding their retrieval, for example the retrieved amounts, the moment of retrieval, sources of retrieval etc.

To the initial costs regarding to Basel II implementing it be added continuous outgoes. This is especially in IT zone, for authorization and maintenance, and for specialized human resources qualifications in risk management. The banks will have to constitute the team which study the models of risk administration and this operation cost very much. Foreign banks shareholders who are actively in Romania will make the decisions for sustain or not these costs, considering this factor: banking market quota in Romania. It is a lot of worries that a lot of banks in Romania will be applied the based Approach Basel II, because of big outgoes for Basel II implementing.

However, it is difficult to establish the impact of the entry into force of new prudential regulations regarding capital adequacy, which stipulate the enforcement of Basel II principles from 1st January 2008. We consider that there is a major risk for banks (especially for the banks whose solvency ratio is close to the 8 percent minimum level) to have solvency problems. This risk is associated with the difficulty to currently assess (at the end of 2008) the impact exerted by the entry into force of the new prudential regulations on capital adequacy, which set forth the enforcement of Basel II principles since 1 January 2008.

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A New International Economic and Financial Order

■

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***Abstract.** The today's world is trying to find solutions to problems related to the global recession, which is accompanied by a deep financial crisis. In the present article we are set to make a dynamic analysis of the causes that led to the emergence of the economic crisis and also of the catalysts that made possible its spreading to a global scale. Another important point of our research will be the correct identification of a viable set of solution to the present crisis.*

Key words: global recession; financial crisis; inflation; monetary policy; growth; depression; fiscal facilities; economic and financial order.

■

JEL Codes: G14.
REL Codes: 8A.

Starting with the 80's the global economy has undergone a stage which might be characterized by the following general elements (which have influenced all economic and financial areas, and have brought us to the current, without precedent, crisis):

- The long-term downtrend in inflation, greater macroeconomic stability, more confidence in fiscal and monetary policy have encouraged a reduction in both nominal and inflation-adjusted interest rates. As the real returns on governmental bonds have enjoyed a downtrend, many investors have shifted to higher risk asset categories (equities, hedge funds, private equity).
- The current account surplus of China and the petrodollars have been deposited in financial institutions from USA, Europe or Asia and have been immediately recycled into debt markets, private equity, hedge funds or other instruments. Such surpluses accumulated at the level of several countries (supplying the sovereign funds) have been matched by the willingness of households and companies to borrow and spend more and more. The result was a long period of time of a synchronized but non-inflationary growth between 2003 and 2007, with an inflationary pressure towards the end of the period.
- Smaller cyclical variations and the financial system's ability to restore the normal situation relatively quick

after Asian and Latin American crisis, after some large bankruptcies (see Enron), or 9/11 events, have made investors more confident and increased their appetite for taking higher risks, in exchange of a greater return. More than that, the investors have shown more tolerance for short-term volatility, as their focus was mainly towards higher return from long-term capital growth.

The result of these trends and events was a long period (2003-2008) of sustained growth, with low inflation and low long-term interest rates. Former Fed Chairman Alan Greenspan described the failure of long-term rates to rise as a "conundrum".

Once the current crisis has started to send its first signals we have entered a reverse trend, characterized by a more hostile environment:

- The forthcoming volume of US Treasury debt issues is inviting the investors to consider higher long-term interest rates. It is well known by now that in October 2008 the estimated borrowing needs of US Treasury for the next 12 months reached more than USD 3 trillion, and this just for the time being.
- The expected fall in commodities prices and the downtrend of the exports will diminish the expected increases of the FX reserves of several countries and therefore investing part of such excesses in USA will not reach the desired levels
- Higher and harder to predict volatility will diminish investors' appetite

towards new transactions or will push them to look after higher return. All these will bring the financing costs to higher levels and will impact negatively the world production, the investments and households spending.

The global economic growth will definitely suffer.

We estimate that the 2009 global GDP real growth will be around 1.7%, similar to the one experienced during 1991 recession. Probably the emerging world will have a real GDP growth of around 4.5%. At the same time the already mentioned countries can make use of the crisis situation by implementing a series of middle-term structural measures that would make future systemic crises easier to avoid (Claessens Klingebiel Laeven, 2004).

I would like to mention some of the recent developments and events:

a) The emerging economies are going to suffer a shock. This will be brought by a downtrend in the imports of the developed nations and diminished FDI. Therefore the economic growth of such countries will be much lower compared with last years' trend. Only China will benefit from a higher GDP growth of 7.5-8% (but below the average of last years).

b) The deepening of the financial crisis and the difficulties the emerging nations are facing have brought an economic contraction in USA, Europe and Japan

c) The programmes and the facilities implemented by several countries will bring visible results not earlier than the second half of 2009.

There are several opinions that the world economy might enter into a depression after the current recession period. I consider that there are still sufficient ingredients in the world economy to make us more optimistic and to say that most probably the word economy will enter a recovery era, in stages, due to the programmes launched by several governments and central banks, which have been materialized by the following:

- the state intervention in the financial sector by capital injections (in several cases the state becoming main shareholder in some financial institutions) or a system of guarantees covering current and forthcoming engagements of the most important banks (national champions);
- decisions and programmes meant to bring a better and easier access to financial liquidities, accompanied by an important reduction of the official interest rates (having final target the reduction in the cost of borrowing by the companies and households);
- fiscal facilities.

In the current environment the market value of shares and real estate have reached extremely low levels. This is diminishing the value of collateral in case the companies or households intend to use same for obtaining any credit from banks. The modern economic crises are usually solved by classical institutional reforms through direct intervention in the real economy (Coe, 2002). The famous 1929-1933 crisis was successfully overcome by using, at that time, innovative economic policy measures

of The New Deal. In the view of all the economists, the liberalization of markets had no grounds (Krugman, 2007). The market cannot always rescue the economy from the clutches of the crisis. Thus, what are the events that block the economy's endeavour to recover by its self?

We estimate an insignificant increase or in most cases a decline of the households' income. These will bring down the spending. The situation may further deteriorate within the context of more macroeconomic imbalances and increasing public debt, pushing the households to save more because their trust in the ability of the governments to materialize their promises concerning health and pensions will be reduced.

I estimate that in most of the countries the governments will reassess the current situation of the tax regime and will decide to increase several tax levels. The short and medium term spending will be negatively impacted.

The current downtrend in the market value of equities will push back the investors from considering new capital investments. In January and March this year I have anticipated the current situation in which all banks have become more selective in financing the private sector and the raising cost of financing. Most probably such banks' policy will be imposed by a more severe supervision activity (from central banks and shareholders; not to forget that the state has become or will become in many instances main shareholder), requiring additional capital and a reduction of the current risk exposure. Therefore private

sector access to financing will be restricted and much costly.

I have mentioned a downtrend in inflation during next years as a result of a reduction of the commodities prices, a contraction of the production and of the labor market (the unemployment level will rise). The analysts estimate a global inflation level of around 4%. I cannot agree with the analysts which predict a deflation, and my conclusions are based on the following:

- The decline in inflation is a temporary reverse trend.
- The companies will bring down their excess production capacities to match the demand.
- It is possible that the inflation expectations will be influenced by the policies implemented by FED and other central banks.

We estimate an increase of the inflation level in 2010 to 2.3% from 1% in 2009 as a result of increased oil and commodities prices, and as a result of the first recovery signals of the developed nations.

The investors are concerned because of the increased macroeconomic imbalances and public debt in several countries. They are questioning the ability of several countries to meet the debt service agenda. Generally speaking we might agree with them, but we disagree in the case of state capital infusions in the banks, as this action is not spending, but it is meant to be a temporary financing of a capital eroded by defaults. A concern might be in relation with governments' protectionist policy which may be seen more and more.

What about CEE countries, Romania included? We estimate a downtrend in FDIs. Such situation will bring to the table and will exacerbate the imbalances experienced by the respective countries:

- The average current account deficit in CEE is 9% (from only 2% in 2000).
- The intermediation and loans have gone through a huge increase.
- F/X risk which might be materialized by the increase in FX Loans (especially in the cases of borrowers having local currency income only) and the foreigners' current exposure to local currencies (equities and local bonds).

The FX storm, once it starts, will be bigger than the one taking place few years ago in Asia or Latin America, because the fundamentals are much more deteriorated in CEE.

The unsustainable increase of the current account deficit coupled with an increase in loans, especially the ones in FX, may produce an extremely dangerous combination during today's world crisis, when the aversion to risk is more visible. The FX vulnerability will put much pressure on the local currency.

We may reach the conclusion that a boomerang effect against the European banks can take place, because this group of banks (not including UK banks) are sitting on a large portfolio of loans granted to CEE, estimated volume being USD 1.5 trillion. Same type of portfolio maintained by the banks in USA, UK and Japan reaches only USD 120 billion.

The exposure by countries is showing the following levels: Austria –USD 297 billion, Germany – USD 214 billion, Italy – USD 212 billion, France- USD 176 billion. Under the circumstances, we question the programmes against the crisis put in place by the respective countries, which include the recommendations of financing just the activity of domestic companies, and the policies imposed to the banks to reduce the exposure against CEE countries. This will reduce or stop any cross border financing to CEE, and any financing of the local banks controlled by the UE developed countries or their national “champion” banks.

I would like to mention few details included in their programmes against the crisis by different countries:

Given the present economic crisis, the government policy measures must try to avoid the wicked effects that could be generated by the unlimited deposit insurance or by the central bank's erroneous policy of providing capital without restriction to the inter-banking market (Honohan, Klingebiel, 2000). For this reason, of avoiding the bankrupts of the banking sector, we must try to invent a caution system for the debtors. But what are the measures we expect of some of the countries in the world?

USA: We have realized that the Obama administration which will be on stage as of next January is very pragmatic and understands the urgency of a national consensus for bringing to work a explicit

and implicit plan, everybody being eager to see early birds out of such implementations. The facts and the early results will reinforce the confidence in the new administration. The plan is targeting the increase of the budget revenues and a large increase of the macroeconomic deficits (estimated levels exceeding the ones reached within the last 50 years in USA). We are expecting a new cut in interest rates by the FED, such new level to be kept over the entire year 2009. The plan is meant to have the economy enter a recovery stage. Realizing that the monetary policy alone is insufficient to restore the domestic financing, the plan includes a fiscal relaxation. On the long run the Administration will be focusing on infrastructure projects, the reforms of the health system, of financial legislation, education, energy and trade.

China: Will continue to enjoy an important GDP growth, but less than the one of last years due to a diminished contribution of the net exports and a lower investment in real estate. The authorities will concentrate on increasing the financing towards large infrastructure projects. China has formalized a program against the crisis, which will be “fiscally proactive and moderately restrictive concerning the monetary policy”. It will sustain a “reasonable” increase of the bank loans.

Generally speaking the Chinese program is including the following:

- a downtrend in the level of interest rates coupled with a steady reduction of the minimum reserves;

- public bond issues in order to secure proper financing for the infrastructure projects;
- an increase in the tax levels;
- additional decisions in order to sustain the real estate sector development;
- bringing the energy prices to normal levels;
- important financial facilities and financing extended to the farmers.

The launching of such programme has been made by high level officials through explicit commitments and undertakings, increasing the confidence that such plan will be finalized.

Similar plans have been put in place by the governments and central banks in CEE countries. They were meant to freeing and better utilization of the liquidities, capital injection, sustaining the recovery of the capital markets, especially the bond markets, the restoration of trust in the market players.

Russia: Has been very proactive, already employing 60% of the USD 200 billion allocated to the plan against crisis. The main beneficiaries of the utilized amount have been the two national champion banks, i.e. Sberbank and VTB (together enjoying more than 50% of the amount used). The government has intensified the banking sector supervision and has imposed to the banks a restart of the financing activity, allocating important amounts to the strategic sectors of the economy.

Ukraine: Has launched a “REPO” programme for the banks using USD 5.5 billion. The country has signed a financing agreement with IMF for USD 16,5 billion.

Kazakhstan: Is managing an USD 18.5 billion plan for the financial sector.

Hungary: Has signed a financing agreement with IMF, having as cofinancing partners EU and ECB. The country is allocating USD 2.25 billion for assisting OTP (the national champion bank).

Poland: Has launched a plan for freeing the financial liquidities in foreign currency. The country has signed a SWAP agreement with Swiss National Bank for supplying the market with Swiss francs. Recently the country has signed with ECB a financing agreement for EUR 10 billion, to assist the liquidity needs of the banking sector.

On 29th of October this year IMF has launched a new short term financing facility. The countries proving good track

record concerning the macroeconomic policy, the countries still eligible for the international capital markets financing (showing eligible ratings) and having a sustainable debt level, may borrow under such facility up to 500% of the national quota maintained with IM, for a maximum period of 3 months, not more than 3 times within a 12 months period.

It is more and more clear to everybody that the world is characterized by various and dangerous imbalances, every one of them a potential source of crisis. It is also clear that some emerging nations, after accumulating huge FX reserves, want to play an equal role to the developed nations in fixing the trend of global economy and finance.

The recent international summits meant to find solutions to the current global crisis have proved the fact that the world has entered into a new economic and financial order, requiring its own rules and players. Reaching international agreement is not an easy mission, but the earliest finalization is a must.

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Considerations Regarding GW as a Way for Evaluation of the Efficiency of the Reenterprise of the Enterprises

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***Abstract.** For the importance of goodwill, in substantiating the management decisions regarding the business strategies of enterprises, the whole scientific step is circumscribe to some relevant aspects that evidence and integrates the benefic influences of goodwill on the global value of the enterprise. In this matter, the approach starts from presenting some essential aspects regarding the development stages of a business, for surprising the moments of generating the goodwill and for developing its own quantification indicators. The appearance of goodwill as a factor of maximization of the enterprises value represents an unquestionable hint of the success of the enterprises value, and its amplification is the most eloquent expression of the accumulation of some solid competitive advantages.*

Key words: business strategy of the enterprise; goodwill; active intangibles; global value of the enterprise; the elasticity of global value in relation with goodwill.

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JEL Codes: C00, G30, G31, G34.

REL Codes: 9A, 11F, 11D.

The problem of considering goodwill (GW) as a method of evaluating the company's business strategies efficiency may be relevant under a cognitive aspect, only if it is approached in the company's development context. In this matter the scientific step starts from the presentation of some fundamental aspects regarding the development phases of a business, for surprising and integrating the benefic influences of goodwill on the global value of the enterprise and for formulating indicators with amazing informative power on the management decisions regarding the reorganization strategies of the businesses. Any business has a certain cycle of life formed from phases of development characterized through a specific level having a determined profile. Therefore, in the initial phase (launching) and the primary development of the business is the constitution of the minimal patrimonial structures, which permits the exceeding of the enter "threshold" in the respective domain of business (Lorina, 1997, pp. 13-16). More exactly, the enterprise at its beginning activity must invest in the acquisition of the active volumes, with some techniques and functional characteristics to constitute the business infrastructure or the exploration system. The growth of the economic patrimony through the reinvestment of the created excess (net profit, amortizations), respecting the competitively requests of the field of the activity, will determine the extension of the business and the increase of the economical results and, therefore, the growth of the global value of the enterprise. This economical patrimony will be made from the initial phases of the evolution of

the enterprises preponderant from the active tangibles (equipment, machines, constructions, stocks, disposables, etc.) "usual", common for the field of the activity. For example, an enterprise in the launch and initial development phases has a normal structure of exploitation, without being characterized through distinct aspects, in measure to differentiate substantially by the other similar businesses. It is possible that in the late development phases, the company's management has to propose itself the differentiation of its business compared to the rival companies. Actually, the idea of the differentiation through the obtaining of the concurrencies advantages hardly to imitate, remarks the main motivation of some performed strategy of business (Jauch, Gluech, 1998, p. 20). How can be made this differentiation? Where must be searched the concurrencies advantages in measure to assure distinctive competences for the enterprises and, on this way, a number of business and financial performances over the media in the field. *The industrial dynamic from the last decade demonstrates that this element of differentiation is situated more frequently in the area of the intangibles actives, most of them being not registered in the balance.* Factors such as reputation, institutional image, the image of the products, portfolio of the clients, commercial wave, position in the network of the partnership relations, managerial, commercial and technological competences, qualification and creativity of the human resources, the performance of the enterprisaal models and of the managerial systems, innovational system, the capacity of the enterprises to learn and

to create knowledge, etc represents in the present the most important sources of the concurrent generative of superior performance and, therefore, of value for the enterprises. *Most of the mentioned elements, though exercise positive influences over the wealth of business, cannot be evaluated with precision independently of the rest of the economical patrimony, their evaluation is possible, but, in a global manner through of the goodwill calculus* (Guatri, 1994, pp. 99-101). *That is why, through interference, it may be said that the appreciation of the goodwill is the consequence of the elements accumulation of the described active intangibles.* A superior goodwill is the expression of some active intangibles which may bring concurrent advantages of a superior quality.

The continuation of the scientific step implies some explanations attached by the notion of goodwill. In some authors opinion, in rapport with the patrimonial elements, the goodwill has some essential features (Stan, 1999a, pp. 77-79):

- is connected direct with the advantageousness of the enterprise, which is influenced by it and amplifies it through its elements while the advantageousness of the enterprise diminishes, the goodwill is transformed, with the minus sign, diminishing the patrimonial value of the enterprises;
- is an immaterial value, which the enterprise may obtain over value its patrimonial actives and which is generated only if the enterprise functions. In other words, the goodwill may not be attached to an

economical patrimony which is not in exploitation;

- exists as long as the determinant elements actions;
- may not be transferred separate, but only with the enterprise and only if the new proprietary actions for the maintaining and for its amplification.

The presented features reveal that the enterprise doesn't have only concrete values, directly identified and easy quantifiable, which is the source of a part from its global value – the goodwill, respectively he is the single intangible active which the concurrence may not destroy, nor depreciate or imitate.

Strictly mathematic, the goodwill represents the difference between the real global value of the enterprise and his value of utility (“just”) of the identifiable elements of the net active. Beside its simplicity, the deductive optic presents disadvantage that doesn't explain the structure, respectively the composition of the “invisible part” of the enterprises. Another way of landing of the goodwill is based on additive logics, proves scientifically on the direct distinction of its components, but which, according to this fact, ignore the interdependency of the component elements and their effect over the efficiency of the enterprise.

A complex way and more subtle for evaluation of the goodwill has its fundament on the estimations regarding the capacity of the enterprise to emit superior economical results to those normally obtained in the field of the enterprise' s activity. Therefore, considers, generally, that the economic capital of the enterprise, reflected in the active net, the substantial

values or the permanent capitals necessary for the exploitation – “the visible part” of the enterprise – is remunerated at a “normal level” without risk, specific to the majority of the field enterprises. A superior advantageousness superior to the “normal” one is generated by the “invisible part” of the enterprise – the goodwill (Moehrle, Reznolds-Moehrle, 2001, pp. 55-56). Therefore, this corresponds to an additional value, over the economic patrimony, which the enterprise creates it through its functionality. This surplus value is generated by the monetary fluxes assured by the active, as result of the efficient administration and the judicious positioning of the enterprise in his medium of business. From this point of view, the goodwill is the expression of the positive appreciation which the market makes at the address of the exploitation structure of the enterprise (Martory, Verdier, 2000, pp. 256-285). The superior advantageousness and, in consequence, the extra value represents the financial image of this appreciation. From this optics, the goodwill is, actually, a capitalized profit, which is an economic income with the value of the generated capital. Must be specified that the goodwill doesn’t generate availability fluxes independently by other actives or groups of actives, that is why is very important the identification of the existent connections between goodwill and some concrete active of the enterprise (Vintilă, 1998, pp. 218-222).

We based on this “differentiated optics” (the approach of the goodwill as source of the positive difference between advantageousness) to propose the fundamentals of a new model of calculus of the goodwill. In general, the goodwill may be defined as a

capitalized over – profit. A simple definition has financial significations. To elucidate them it is necessary to closely exam some implications of the notion of over-profit about goodwill:

1) The over-profit is the absolute expression of the advantageousness of the intangible active of the company which formally doesn’t figure in the balance-sheet, but which is the consequence of the way of the relation of the company with different elements from its economic medium and the domination of some components strategically distinctive, which concurs to make a global value of the enterprise.

2) The normal profit is the remuneration of the economical patrimony, reflected in the balance, at a normal medium rate specific to the activity field of the enterprise (r_{ns}).

3) The net profit made by the company is the sum of the “normal” profit and of over-profit, explaining the real remuneration of the functional economical patrimony (active balance + intangibles active non-balance) at a rate of advantageousness effectively realized by the company (r_{pf}). From the accounting point of view, the intangibles active bringing profit „doesn’t exist”, the rate being applied to the economical patrimony of balance, representing an economical advantageousness of the invested capital (Vintilă, 2005, pp. 190-194).

4) In consequence, the over-profit (the difference between the total profit obtained and the „normal” profit) is explained through the difference between the rate of advantageousness r_{pf} and the rate of advantageousness r_{ns} .

5) The supplement (deficit) of advantageousness evident through the difference ($r_{pf} - r_{ns}$) is equivalent with a rate of advantageousness specific to the intangibles actives non-balanced (r_{ai}):

$$r_{ai} = r_{pf} - r_{ns}$$

This supplement of advantageousness causes the over-profit.

6) To pass to an economic result – the over-profit in this case – to a value of the capital – the goodwill – it is necessary the capitalization of the result with the return on economic assets rate is represented by the medium cost level-headed of the capital (cmpe), but may be utilized others variant of the capitalization rate:

$$7) \text{ GW} = \frac{\text{overprofit}}{\text{cmpe}} = \frac{(r_{pf} - r_{ns}) \times \text{VP}}{\text{cmpe}} = \frac{r_{ai} \times \text{VP}}{\text{cmpe}},$$

in which:

GW = goodwill;

VP = value of the patrimony (economic patrimony) of the enterprise;

Total profit = $r_{pf} \times \text{VP}$;

“Normal” profit = $r_{ns} \times \text{VP}$;

Over-profit = $(r_{pf} - r_{ns}) \times \text{VP} = r_{ai} \times \text{VP}$.

8) The goodwill has at its basis the difference between two advantageousness ($r_{pf} - r_{ns}$). This conclusion is the basis of the financial-accounting concept about goodwill.

If $(r_{pf} - r_{ns}) > 0$, respectively if $r_{pf} > r_{ns}$, results a positive goodwill (GW) as expression of the businesses performance of the system in the company.

If $(r_{pf} - r_{ns}) < 0$, respectively if $r_{pf} < r_{ns}$, results a negative goodwill (GW) or a badwill (BW) as expression of the non-performance of the business system in the company.

The global value of the company (VG) is obtained through the sum of the patrimony value with the value of the goodwill (Dumitrescu, Dragotă, 2000, p. 10):

$$\text{VG} = \text{VP} + \text{GW} \text{ (or BW)}$$

If in calculus relation for goodwill (no.7) we note that the rapport (r_{ai} / cmpe) through α , we may rewrite this calculus relation as follows:

$$\text{GW} = \alpha \times \text{VP}$$

And results:

$$\text{VG} = \text{VP} + \text{GW} = \text{VP} + \alpha \times \text{VP} = \text{VP} (1 + \alpha)$$

10) Starting from this arguments, we consider that it may be established a dependency relation between the relative variation of the global value of the enterprise (ΔVG) in rapport with the relative variation of the goodwill (ΔGW). This kind of relation is an index of elasticity of the global value in rapport of the modifications of the goodwill and which would have the following calculus relation:

$$E_{\text{VG} / \text{GW}} = \frac{\Delta \text{VG}}{\text{VG}} \div \frac{\Delta \text{GW}}{\text{GW}} = \frac{\Delta \text{VG}}{\Delta \text{GW}} \times \frac{\text{GW}}{\text{VG}}$$

Because the general relation between the global value and the goodwill is one the direct proportionality (the growth of the good-will determines the growth of the global value and otherwise), the elasticity coefficient which reflect the sensibility of an independent value, in this case the global value of the enterprise, in front of the fluctuations of an independent value, in this case the goodwill will take supra unitary values. The coefficient points out with how many percents the global value vary when the goodwill vary with a percent. *The informational value of this indicator consists in the fact that permits the*

delimitations of the strategically area towards which the management must focus its attention to conserve and enforce the advantages of the concurrence so that to be assured the continuous growth of the global economical value of the enterprise.

Analytically, the relation no. 10 may be described on influence factors according to Du Pont de Nemour principle, as follows (Anghelache, Vintilă, Dumbravă, 2006, pp. 41-44):

$$E_{VG/GW} = \left(\frac{\Delta VG}{\Delta R} \times \frac{\Delta R}{\Delta CA} \times \frac{\Delta CA}{\Delta GW} \right) \times \frac{GW}{VG}$$

■ The last relation (10) has a rich informational content, under the aspect of financial evolvement, as it results from the presentation of the three factors of influence:

1) $\Delta VG/\Delta R$ has the signification to a spore of the global value of the enterprise determined by the spore with monetary units of the results (R). On the results can be considered the profit margins, monetary accumulation margins: the gross excess of exploitation (EBE), operating result (RE), net profit – in continental approach or, as considered, the gross excess before the tax, interest, depreciations and writing-off (EBITDA), gross excess before interests and taxes (EBIT), total gross excess (EBT) – in Anglo-Saxons optic, or self-funding capacity (CAF). The growth of this report is benefic for the enterprise, showing how the improvement of the financing performances contributes to the maximizing of the global value and stagnation or report diminishing reflects of the loss by the enterprise of its economical substance. As follows, the report acts as an influence

lever on the global value, having the significance of a “*lever of the performances*” for the global value of the enterprise.

2) $\Delta R/\Delta CA$ has the signification of some financial marginal results, showing the spore of the financial results (R) determined by the growth of the turnover with a unitary unit (in what extent the growth of the turnover is transposed in a growth of the enterprises financial results). This report reflects the efficiency of the commercial politics of the enterprise because makes the bond between the development of the market, materialized in the growth of the turnover and, implicitly, in the improvement of the financial performances. That is why the report may be considered a “*commercial lever*” of the global value of the enterprise.

3) $\Delta CA/\Delta GW$ may be interpreted as a growth of the turnover determined by the growth of the goodwill with a monetary unit as a result of the investments in the creation of the intangible actives of the enterprise. Therefore, the development of the intangibles active non-balanced find their synthetic financial expression in the goodwill of the enterprise and this report may be seen as an “*intangible lever*” of the global value of the enterprise.

■ The report GW/VG reflects, evidently, the weight of the goodwill in the global value of the enterprise, suggesting significant contribution the intangibles active non-balanced to the global forming (Dumitrașcu, Tudoran, 2002, pp. 172-174). This report may be interpreted as a *coefficient of the strategically investments in the intangibles active* (immaterial).

Having in view all the presented elements, the calculus relation $E_{VG/GW}$ (no. 10) becomes:

$$E_{VG/GW} = \text{Lever of performances} \times \text{Commercial lever} \times \text{The "intangible lever"} \times \text{Coefficient of intangibles investments.}$$

■ It may be observed that *the goodwill may influence the global value of the enterprise in two ways:*

- directly, through the weigh which has the global value of the enterprise, weigh expressed with the help of the direct intangibles;

- indirectly, through the fact that represents the source of some supplementary financial results (turnover, the profit margins, auto-financing capacity, results), which give to the enterprise a bigger global value.

The possible values of coefficient of elasticity of the global value in rapport of the modifications of the goodwill may be interpreted as follows:

a) if $E > 1$, results a growth/diminishing with a monetary unit of the goodwill determines a spore/a diminishing of the global value of the enterprise with more than a monetary unit- the global value grows/ diminishes faster than the goodwill. It is an elastic global value – sensible, strongly dependent – in rapport with the goodwill.

b) if $E = 1$, it means that the variation with a monetary unit of the goodwill generates at equal variation of the global value, this modifying in the same rhythm with the goodwill. It is an unitary elasticity of the global value in relation with the goodwill.

c) if $0 < E < 1$, then the variation with a monetary unit of the goodwill determines a variation lower of a monetary unit of the global value. It means that the global value modifies slower than the goodwill. It's an inelastic global value (little dependent) regarding he evolutions of the goodwill. Even if the enterprise invests in intangible actives of goodwill's nature, these investments have moderate effects on the amelioration of the turnover, of the results and thereby of the global value.

■ There are sectors, activities or sensitive affairs (elastic) of insensitive (inelastic) in comparison with the intangible actives goodwill generators for the enterprise (Doz, Santos, 2001, p. 115). In this context *the establishment of the value of the coefficient $E_{VG/GW}$ allows the clarification of the hierarchy of the strategic priorities of the enterprise* and the precise identification of the areas of its strategic efforts concentration:

- where $E > 1$ there is a strong dependence or at least an obvious one of the enterprise of the intangible actives bearer of goodwill, consequently the strategy of the enterprise must be centered on the making, the capitalization and protection of this actives;

- where $E < 1$ there is a shortened dependence of the enterprise of the actives that generate the goodwill, which means that the strategy of the enterprise must be centered on the optimization of the tangible economical patrimony and of the afferent costs to its exploitation.

In fact *its about two distinct strategies of maximization of the global economical*

value of the enterprise, respectively the first (when $E > 1$) considers the increment of the global value preponderant by the accumulation of the intangible actives goodwill bearer, and the second ($0 < E < 1$) foresees the maximization of the global value preponderant by the increment of the patrimonial value – the second component of the global value (Stan, 1999b, pp. 132-133).

Also, the coefficient $E_{VG/GW}$ may be a pertinent selection criterion of the strategic development options of the business especially through acquisitions, absorptions and fusions. This way it will be followed the combination of some business structures as approached as possible as value of the coefficients of elasticity $E_{VG/GW}$. If the new or taken over business has however a coefficient or taken over lower than that of the basic affair it will be followed its approach, through strategic investments in intangible actives, of the value of the specific coefficient of the enterprise/main affair. If the new or taken over affair enjoys of a bigger $E_{VG/GW}$ than that of the basic affair, it will be exploited at

maximum the external synergic effects for increasing the efficiency of the enterprise/main affair. This way, $E_{VG/GW}$ can also serve as *criterion of selection of the investment projects for development* – will be preferred the project that endorses the development of an affair with a bigger $E_{VG/GW}$.

Next we will present in a *practical study* case the method of calculus of the elasticity value $E_{VG/GW}$, its decomposition in influence factors and its utilization the complementary selection criteria of the investment projects, showing concomitantly the integration effects of the new investment project in the business system of the absorbent company.

1. The direct calculation of the elasticity $E_{VG/GW}$ coefficient:

The company *Software Ltd* has as main activity the informatical servicies and it is characterized through the model's parameters gravel present in table 1, which synthesizes the main operations necessary for determining the $E_{VG/GW}$ coefficient:

Model's parameters and determining the $E_{VG/GW}$ coefficient for Software Ltd

Table 1

Parameters	Years	2003	2004	2005	2006	2007
r_{pf}		3.41%	7.64%	13.35%	23.64%	26.85%
r_{ns}		4.62%	4.7%	5.9%	7.5%	8.1%
cm_{pc}		2.63 %	10.89 %	12.01 %	15.37 %	15.76 %
r_{ai}		-1.21 %	2.94 %	7.45 %	16.14 %	18.75 %
α		-0.46	0.27	0.62	1.05	1.19
VP - lei		2,520,397	3,104,576	3,672,908	4,186,954	4,586,023
GW - lei		-1,159,382	838,235	2,227,203	4,396,302	5,457,367
VG - lei		1,361,015	3,942,811	5,950,111	8,583,256	10,043,390
ΔGW - lei		-	+1,997,617	+1,388,968	+2,169,099	+1,061,065
ΔVG - lei		-	+2,581,796	+2,007,300	+2,633,145	+1,460,134
$\Delta VG/\Delta GW$		-	1.2924	1.4451	1.2139	1.3761
GW/VG		-	0.2125	0.3743	0.5121	0.5433
$E_{VG/GW}$		-	0.2746	0.5409	0.6216	0.7476

It is observed that in all the years of the analyzed chronological series the value of the $E_{VG/GW}$ coefficient is sub unitary, although it develops a strong increasing tendency from 0.2746 in year 2004 towards year 2003 to 0.7476 in year 2007 towards year 2006. The fact that $E_{VG/GW} < 1$ reflects that the global value of the company registers a rhythm of increment slower than the rhythm of increment of the goodwill. More exactly, its increment in year 2004 towards year 2003 of the goodwill with 1 leu determines an increment of the global value of only 0.2746 lei, as the increment in year 2007 towards year 2006 of the goodwill by 1 leu generates an increase by 0.7476 lei of the global value. Even if the effects of the goodwill increment on the evolution of the global value are so far moderated, the tendency of global value dependency reinforcement of the goodwill

variations is obvious and firm. This tendency is certainly due to the fact that the goodwill's weight in the global value becomes more and more significant: 21.25% in year 2004, increasing to 54.33% in year 2007. In consequence, the accumulation of intangible actives goodwill generating, although initially is modest enough, gradually displays a tendency of consolidation, its positive effects on the global effects of the enterprise becoming more striking.

2. Factorial decomposing of the $E_{VG/GW}$ elasticity coefficient

The decomposition in influence factors of the elasticity coefficient with the help of the "levers", it suppose considering also the financial results under the shape of the profit margins (EBITDA or EBE), represented in table 2, next to the turnover:

Factorial analysis of $E_{VG/GW}$ coefficient for Software Ltd

Table 2

Parameters	Years	2003	2004	2005	2006	2007
EBITDA lei		93,008	309,834	691,317	1,558,247	1,839,620
CA lei		3,684,476	4,562,314	5,436,473	6,913,607	7,658,768
Δ EBITDA lei			+216,826	+381,483	+866,930	+281,373
Δ CA lei			+877,838	+874,159	+1,477,134	+745,161
$\Delta VG/\Delta$ EBITDA			11.9072	5.2618	3.0373	5.1893
Δ EBITDA/ Δ CA			0.247	0.4364	0.5869	0.3776
Δ CA/ Δ GW			0.4394	0.6293	0.6809	0.7022
GW/VG			0.2125	0.3743	0.5121	0.5433
$E_{VG/GW}$			0.2746	0.5409	0.6216	0.7476

In each year, from the period submitted to analysis, one observes the benefic effects generated by the gained growing influences of the financial levers (1.292 in 2004; 1.445 in 2005; 1.2138 in 2006; 1.376 in 2007) under the shape of performance lever,

commercial lever and intangible lever on the elasticity coefficient $E_{VG/GW}$.

Clearly, the improvement continuous of the value of the coefficient E in the analyze period is due to the positive actions exercised by the goodwill through:

- the continuous growth of the “intangible lever” (0.4391; 0.6291; 0.6823 and 0.7019);
- the growth of the goodwill’s weigh in the global value or of the coefficient of the intangibles investments (21.25%; 37.43%; 51.25% and 54.33%).

In this way, the goodwill consolidation determined in the analyzed period the continuous growth of the turnover and on this way, the growth of the global value of the enterprise.

3. Utilization of the $E_{VG/GW}$ coefficient as complementary criterion of selection of investments

- *General description of the investment situation:*

At the beginning of year 2008 the company *Software Ltd* decides to launch a strategy of diversification downstream (in the domain of affairs specifically to customers). The main action of this strategy consists in the acquirement of an advertising agency and its

integration in the affair system already existent. The company *Software* must choose between two advertising agencies – *Informatique Ltd* and *New Computer Ltd* – whose owners appeared to be willing to sell their affairs. The gravel and the analysis of the “classical” financials indexes – net value update (VAN), profitability index (IP), recovery term (TR) and internal rate of return (RIR) – haven’t permitted a clear analysis of the problem and also taking a good decision in favor of a agency since the respective pointers didn’t suggest convergent solutions (table 3).

For the growth of relcatlessness of the indicators in substantiation the investment decisions, the management of the company *Software* had proceeded in applying $E_{VG/GW}$ coefficient – as a complementary selection criteria of the project.

For the $E_{VG/GW}$ determination, particular to both advertising agencies, while taking the decision of investments have been used the informations present in table 3:

$E_{VG/GW}$ coefficient for the investment projects

Table 3

Indicators		Informatique	New Computer
VAN		986,463	1,005,755
Profitability index		1.22	1.19
Recovery term		3 years and 2 months	2 years and 11 months
RIR		18.05 %	17.86 %
VG_i	lei	1,726,543	2,005,117
VG_a	lei	1,189,358	1,370,171
ANC_i	lei	720,409	435,311
ANC_a	lei	697,992	260,671
$GW_i = VG_i - ANC_i$	lei	1,006,134	1,569,806
$GW_a = VG_a - ANC_a$	lei	491,366	1,109,500
? VG	lei	537,185	634,946
? GW		514,768	460,306
GW/VG		0.5827	0.7829
$E_{VG/GW}$		0.608	1.08

Parameters signification:

- VG_i is the initial value of the investment, respectively the negotiated price of acquisition of each advertising agency;

- VG_a agreed as the “initial” global value to be esteemed at an equal level with the total economical actives of the enterprises decontrolled by “fictional” actives (non-values);

■ GW has been calculated using the deductive method, respectively as a difference between the global value and the net accountant actives.

Because $E_{Informatique} < E_{New Computer}$ ($0.608 < 1.08$), the enterprise *Software* management has decided to invest in the acquirement of the *New Computer* enterprise advertising since it is characterized by a bigger the elasticity coefficient. $E_{New Computer}$ is actually superior from the elasticity coefficient the enterprise *Software* in year 2007 (0.7476). More, $E_{New Computer}$ is over unitary, meaning that a 1% increment of goodwill induces 1.08% increase of global value.

4) New Computer enterprise integration effects in affair system of the enterprise Software

New computer enterprise inclusion effects in the enterprise *Software* affair system can be determinated with the help of the $E_{VG/GW}$ value after the incorporation. This value can be induced as a ponderate amount of elasticity coefficients ($E_{VG/GW}$) from both societies:

$$E_{integrat} = a \times E_{Software} + b \times E_{New Computer},$$

where:

a and b are weight coefficients calculated as weights of global values of the two societies in "consolidated" global value, resulted after the input of New Computer enterprise by the enterprise Software at the beginning of year 2008.

"Consolidated" global value = *Software* global value + *New Computer* global value =
= 10,043,390 + 2,005,117 = 12,048,507

Software weight in VGC = 83.38%

New Computer weight in VGC = 16.62%

$$E_{integrat} = 83.38\% \times 0.7476 + 16.62\% \times 1.08 = 0.6233 + 0.1795 = 0.8028$$

It's noticed that the incorporation of the enterprise *New Computer* in the enterprise *Software* affair system has positive effects leading to a superior value of the integrated elasticity coefficient; then the value of the elasticity coefficient of *Software* company ($0.8028 > 0.7476$). This means that the enterprise *New Computer* acquisition has been a judicious decision forasmuch it has assured a growth of competitively for the affair system of the enterprise *Software*.

As a result, we appreciate the importance of the elasticity coefficient $E_{VG/GW}$ for the relevance of the decisions implied by the reorganization processes of business, being also an indicator with a remarkable informative power for primness the opportunities of capitalization of the available resources of the companies.

As follows, we choose that goodwill, as part of the global value of the company, represents an unquestionable hint of the success of some business strategies, and its amplification reflects from a financial point of view the state of financial performance of the company and it makes up the most eloquent expression of accumulation of some solid competitive advantages.

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Economic Efficiency of EU Decision Making Process. Case Study: Measurement of Voting Power Indices of Romanian Parliament 1996-2004

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***Abstract.** The power distribution of Member States of EU represents a problem of major importance concerning the future decisional structure. The article analyses the distribution of vote power in the CM, showing the influences of states over the decisional process as well as the modification that appears along with the enlargement. Within the organizations with vote decisions systems, an efficient decisional process supposes the knowledge of the possibilities that exists in formation of coalitions in case of a proposal. Starting from the analysis realized at EU level, the article presents a case study regarding the distribution of vote power and its influence over the decisional process in Romanian Parliament during 1996-2004.*

Key words: decisional making process; coalitions formation; voting game theory; Shapley-Shubik index; Banzhaf index.

■

JEL Codes: C43, C71, D72.

REL Codes: 20C, 7L, 10E.

1. Measurement of voting power

Many organizations with systems of governance by voting have influence over decision making processes dependent on voting weight of each member. The decision rule, quota or vote threshold determines how many votes must be in favor of a proposal to guarantee simple majority or qualified majority and declare it a winning one. For example in the Finland for 200 seat of Eduskunta⁽¹⁾ three different majority rules are in use: a simple majority=101/200, a 2/3 qualified majority =2/3x200 and in some case 5/6 majority=5/6x200=167/200. For some national parliaments a unanimous decision is required for important decisions such as constitutional amendments.

For the measure of voting power there is two classical index: the Shapley-Shubik power index and the Banzhaf power index. First index is calculated as base of pivotal or decisive voter and on all possible voter permutation, from which all the pivotal positions for a voter i is analyzed. The sum of all the pivotal positions is divided by all possible orderings (voter permutation) giving voter i 's share on all pivots (Paterson, 2007, pp. 3-4).

The *Shapley-Shubik index* for a player $i \in N$, for a game (N, v) is defined by

$$\phi_i(v) = \sum_{\{S \notin W; S \cup i \in W\}} \frac{s!(n-s-1)!}{n!}$$

where:

$$n = |N|, s = |S|.$$

If we assume that all $n!$ are equiprobable, then $\phi_i(v)$ is the probability that player i be the pivotal member⁽²⁾ of a winning coalition, that is, S is losing coalition and

$S \cup i$ is winning. For every player i we obtain

$$\phi_i(v) = \sum_{j=0}^{n-1} \frac{j!(n-j-1)!}{n!} d_j^i \text{ where each } d_j^i \text{ is}$$

the number of swings⁽²⁾ of player i in coalitions of size j . When the game (N, v) is given by $v = v_1 \wedge v_2$, where $v_1 = [q; w_1, \dots, w_n]$ and $v_2 = [l; p_1, \dots, p_2]$, then we have the formula

$$d_j^i = \sum_{k=q-w_i}^{w(N \setminus i)} \sum_{r=l-p_i}^{p(N \setminus i)} a_{krj}^i - \sum_{k=q}^{w(N \setminus i)} \sum_{r=l}^{p(N \setminus i)} a_{krj}^i$$

where:

a_{krj}^i is the number of coalition such that $i \notin S$ with $w(S) = k$ and $p(S) = r$.

The *(absolute) Banzhaf (or Penrose) Power Index* β for a simple game (N, w) is defined without considering orderings, but in terms of swings it's:

$$\beta_i = \frac{\sum_{S \subseteq N} [v(S) - v(S - \{i\})]}{2^{n-1}}$$

The summation is thus over all negative swings for player i . A simple voting game is an n -person game which can be defined as a pair (N, w) which satisfies cumulative conditions $\phi \in \omega, N \in \omega$, if $S \in \omega$ and $T \supseteq S$, then $T \in \omega$. A coalition S has a value of 0 (all losing coalitions). The characteristic function v for a coalition indicate the value of S : $v(S) = 1$, if S is winning, otherwise $v(S) = 0$.

The subset of all winning coalitions is denoted by W and using a shorthand notation and write $S \cup i$ for the set $S \cup \{i\}$, and $S \setminus i$ for $S \setminus \{i\}$ we introduce a special class of simple games named weighted voting games. The set $[q, w_1, \dots, w_n]$ will be used, where q si $w_1, \dots, w_n$ are positive integer

with $w_i \leq \sum_{i=1}^n w_i$, for $i = 1, \dots, n$. Here there are

n player w_i is the number of votes of player i , and q is the quota needed for a coalition to

win. A weighted majority game is the game $(N, v_1 \wedge \dots \wedge v_m)$, where the games (N, v_t) are the weighted voting games represented by $[q^t; w_1^t, \dots, w_n^t]$ for $1 \leq t \leq m$. Then the characteristic function is given by $(v_1 \wedge \dots \wedge v_m)(S) = 1$ if $w^t(S) \geq q^t$, where $1 \leq t \leq m$ or 0 otherwise where $w^t(S) = \sum_{i \in S} w_i^t$.

If $m=2$ or $m=3$ then we obtain weighted double or triple majority game, turn a coalition from losing to winning and it requires to know the number of swings for each player i . A swing for player i is a pair of coalitions $(S \cup i, S)$ such that $S \cup i$ is winning coalitions and S is a losing coalitions, that is, the number of winning coalitions in which player i is pivotal. For each $i \in N$, we denote by $\eta_i(v)$ the number of swings for i in game v , and the total number of swings is $\bar{\eta}(v) = \sum_{i \in N} \eta_i(v)$. The normalized Banzhaf index is the vector $\beta(v) = (\beta_1(v), \dots, \beta_n(v))$ given by $\beta_i(v) = \frac{\eta_i(v)}{\bar{\eta}(v)}$, $1 \leq i \leq n$.

The power indices focus on different of winning coalition which have different definitions and restrictions and thus for example the number of winning coalitions may vary. In the largest possible group of winning coalitions W we define two subset: the set of minimal winning coalitions MW , and the set of strictly minimal winning coalitions SMW . Note that the names of these coalition types vary in the literature. To make a distinction between W and MW we use the notion of swing. In a MW at least one of the coalition members must be pivotal and thus have a swing. This does not imply that there could not exist any surplus members. There could as well be more than one decisive member in the same MW . The

difference between a MW and a strictly minimal winning SMW is in the number of swings. Where in a MW at least one of the members must have a swing in a SMW each of the voters must have a swing, so no surplus members exist within the coalition and thus not even one of the voters can withdraw from the coalition in order to keep it winning. For a given voting game v on the voter set the set $N = \{1, 2, \dots, n\}$ of SMW $M(v)$ is $M(v) = \{S \subseteq N / v(S) = 1 \wedge v(T) = 0 \forall T \subseteq S\}$. From this definition it follows that every T which is a subset of S is always non-winning: $v(S) \setminus \{i\} = 0 \forall i \in S$. The $S \setminus \{i\}$ is a strict subset of S given that $i \in S$.

2. Power distribution of EU-27 members

In the European Union, a measure of the decisional process, must predict how the EU members will be aligned in coalitions *yes* and *no* in case of a proposal. A specific indicator of efficiency of decisional process is the probability of passing. The probability of passing measure the way in which a majority can be obtained having specific rules of voting and it represents the number of all coalition possible winners divided to the number of all possible coalitions. We can calculate the number of possible coalitions between the EU members, having in mind an image over the combinations *yes* or *no* voted by the member states. The total number of EU coalitions 27 is 134217728 possible coalitions. The probability of passing is affected by the number of members, the distribution of votes and the majority bridge. The evolution dynamic of probability of passing was modified during the time. Once new states adhere, the member's votes were reallocated, changing the power of

votes toward bigger states. Two new criteria were added, the criteria number of members (50%) and the population criteria (62%) from the population of EU. Starting from 2014 according with the Lisbon Treaty from 2007, in order to take a decision in the CM a majority of 55% of member states, representing at least 65% from the European population will be necessary. These regulations will be valid from 2014 if not a single member states will solicit the prolongation with another 3 years until 2017 the application of the actual regulations – the 17-th amendment at TUE, art 9c, alignment 3 and 4. Also until 2027, 75% from EU population will be entitled to invoke “*the compromise from Ioannina*”. After 2017, this compromise will remain entitled, but with percents from the number of states, respectively from the European population decreased at 55%. These dispositions represent a concession made for Poland.

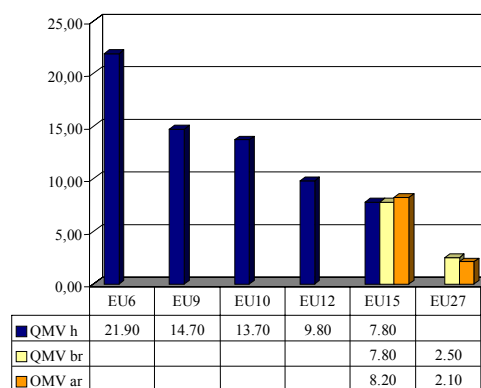


Figure 1. Vote efficiency in EU enlargement⁽³⁾

An important aspect of decisional process of EU is represented by the distribution of power between the members of EU, meaning the capacity to influence the decisions of EU by finding a position that should realise a winning coalition in the Council of Ministers. The most direct measure of power is the number of votes assigned to the country in the Council of Ministers. Thus for the 27 countries we have the following dates:

Distribution of votes and seats in CM and European Parliament⁽⁴⁾

Table 1

Country	Population	Index of Population	Proportional votes in CM	Nice - votes assign in CM	Seats in European Parliament		
					2007	Nice 2009	Lisbon 2009
Germany	82.038	0.170	58	29	99	99	96
UK	59.247	0.123	42	29	78	72	73
France	58.966	0.123	42	29	78	72	74
Italy	57.612	0.120	41	29	78	72	73
Spain	39.394	0.0819	28	27	54	50	54
Poland	38.667	0.0804	28	27	54	50	51
Romania	22.489	0.0467	16	14	35	33	33
Netherlands	15.760	0.0328	11	13	27	25	26
Greece	10.533	0.0219	7	12	24	22	22
Czech	10.290	0.0214	7	12	24	22	22
Belgium	10.213	0.0212	7	12	24	22	22
Hungary	10.092	0.0210	7	12	24	22	22
Portugal	9.980	0.0207	7	12	24	22	22
Sweden	8.854	0.0184	6	10	19	18	20
Austria	8.230	0.0171	6	10	18	17	19
Bulgaria	8.082	0.0168	6	10	18	17	18
Slovak	5.393	0.0112	4	7	14	13	13
Denmark	5.313	0.0110	4	7	14	13	13
Finland	5.160	0.0107	4	7	14	13	13
Ireland	3.744	0.00778	3	7	13	12	12
Lithuania	3.701	0.00769	3	7	13	12	12
Latvia	2.439	0.00507	2	4	9	8	9
Slovenia	1.978	0.00411	1	4	7	7	8
Estonia	1.446	0.00301	1	4	6	6	6
Cyprus	0.752	0.00156	1	4	6	6	6
Luxembourg	0.429	0.000892	0	4	6	6	6
Malta	0.379	0.000788	0	3	5	5	6

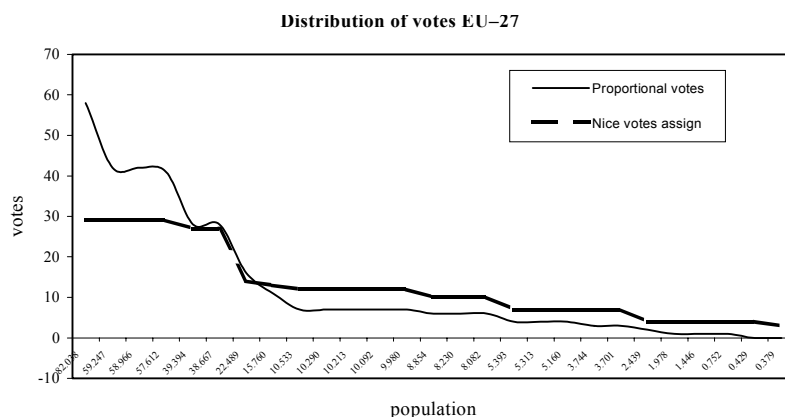


Figure 2. *Distribution of votes: proportional and assign according to Nice*

One of the most important consequences of power is referred to the budgetary allocation. The annual budgets must pass also over the Council of Ministers and the European Parliament. But in each case there are different threshold of majority. If in case of European Parliament, the majority bridge is of 50%, in the case of Council of Frontbench it is of 71%. Taking in consideration the fact that the allocation of members per states in PE is similar with the allocation of votes per states in the Council of Ministers, any winning coalition that can pass a budget through the Council of Ministers can pass it also through the European Parliament.

In Table 3 it may be observed that the redistribution of power toward large member states (an upward reform in terms of the power gradient) is moderate in the transition from the

EU-15 to EU-25, but is dramatically increased in the transition from EU-25 to EU-27. We refer here to Shapley-Shubik index and also for the Banzhaf index. For example in EU-27 members, Germany, the largest EU member state, would have a power index of 16.27, only somewhat short of its share of EU population at 17.05%. Indeed the power gradient shows a very large increase from 56.2% at 86.1%. In contrast, Banzhaf calculations would indicate only a further moderate increase in power gradient due to the Treaty of Reform. Such a result runs contrary to the effects of the reform of qualified majority voting as perceived by various political commentators to the inter-governmental negotiations. The Banzhaf results may have certain difficulty in acceptance by interested parties.

Power indices changes in EU enlargement

Table 3

Country	EU-15			EU-25				EU-27				
	S-S	Shapley-Shubik				norm. Banzhaf index		Shapley-Shubik			norm. Banzhaf index	
		%	SQ	Nice	Lisbon	Nice	Lisbon	%	Nice	Lisbon	Nice	Lisbon
		pop.						Pop.				
Germany	11.67	18.16	8.30	9.49	15.76	8.56	10.42	17.05	8.73	16.27	7.78	11.87
UK	11.67	13.05	8.30	9.37	10.25	8.56	7.54	12.25	8.71	10.82	7.78	8.69
France	11.67	13.12	8.30	9.37	10.30	8.56	7.58	12.32	8.71	10.88	7.78	8.74
Italy	11.67	12.61	8.30	9.37	9.88	8.56	7.38	11.84	8.71	10.41	7.78	8.44
Spain	9.55	9.14	6.51	8.67	7.05	8.12	5.82	8.58	8.03	7.37	7.42	6.37
Poland		8.41	6.51	8.67	6.65	8.12	5.56	7.89	8.03	6.81	7.42	5.89
Romania								4.50	3.98	4.21	4.25	4.22
Netherlands	5.52	3.56	3.97	3.95	3.49	4.23	3.76	3.34	3.69	3.26	3.97	3.50
Greece	5.52	2.42	3.97	3.61	2.78	3.91	3.33	2.28	3.39	2.42	3.68	2.88

Country	EU-15		EU-25				EU-27					
	S-S	% pop.	Shapley-Shubik			norm. Banzhaf index		Shapley-Shubik			norm. Banzhaf index	
			SQ	Nice	Lisbon	Nice	Lisbon	% Pop.	Nice	Lisbon	Nice	Lisbon
Czech		2.25	3.97	3.61	2.67	3.91	3.25	2.11	3.39	2.29	3.68	2.78
Belgium	5.52	2.28	3.97	3.61	2.69	3.91	3.29	2.14	3.39	2.32	3.68	2.80
Hungary		2.23	3.97	3.61	2.66	3.91	3.25	2.10	3.39	2.28	3.68	2.77
Portugal	5.52	2.30	3.97	3.61	2.70	3.91	3.29	2.15	3.39	2.32	3.68	2.8
Sweden	4.54	1.97	3.25	2.99	2.50	3.27	3.18	1.85	2.82	2.09	3.09	2.63
Austria	4.54	1.78	3.25	2.99	2.38	3.27	3.10	1.67	2.82	1.95	3.09	2.52
Bulgaria								1.62	2.82	1.92	3.09	2.49
Slovak		1.18	2.34	2.07	2.00	2.31	2.88	1.11	1.95	1.52	2.18	2.19
Denmark	3.53	1.18	2.34	2.07	2.00	2.31	2.88	1.11	1.95	1.52	2.18	2.19
Finland	3.53	1.15	2.34	2.07	1.98	2.31	2.84	1.08	1.95	1.50	2.18	2.17
Ireland	3.53	0.87	2.34	2.07	1.82	2.31	2.76	0.82	1.95	1.31	2.18	2.02
Lithuania		0.76	2.34	2.07	1.75	2.31	2.73	0.72	1.95	1.23	2.18	1.96
Latvia		0.51	2.34	1.17	1.60	1.33	2.61	0.48	1.09	1.05	1.25	1.82
Slovenia		0.44	2.34	1.17	1.56	1.33	2.58	0.41	1.09	1.00	1.25	1.78
Estonia		0.30	2.34	1.17	1.47	1.33	2.54	0.28	1.09	0.90	1.25	1.70
Cyprus		0.16	1.57	1.17	1.38	1.33	2.50	0.15	1.09	0.80	1.25	1.62
Luxembourg	2.07	0.10	1.57	1.17	1.34	1.33	2.46	0.09	1.09	0.76	1.25	1.59
Malta		0.09	1.57	0.88	1.34	0.99	2.46	0.08	0.83	0.75	0.94	1.58
47.0%			43.2%	56.7%	73.3%	49.1%	41.2%		56.2%	86.1%	47.5%	59%
PG			Power Gradient					Power Gradient				

3. Measurement of power voting indices in Romanian Parliament 1996-2004

We will analyze the distribution of power by calculating the specific indicators in The Romanian Parliament during 1996-2004 period of time. Although the Romanian Parliament is constituted according with the Constitution from the Deputy Chamber and Senate, we will accomplish the calculation by considering all the mandates that are located in the common meetings, by the joining of the two forums, in the moment in which a series of important decisions are taken (for example the budget adoption) with simple majority.

We calculate Shapley-Shubik index SSI, the normalized Banzhaf index NBI. There are three modified Banzhaf power indices which we also examine: the

Penrose index or absolute Banzhaf index ABI, which divides the number of swings for a voter only by the number of swings for all the other players. Two other indices are the power to prevent action PPA, which is the number of swings for an agent divided by the number of outcomes that lead to a decision and PIA power to initiate action. The purpose of PPA is to measure the power of an voter to block decisions. The PIA is the number of swings for an agent divided by the number of outcomes that do not lead to a decision. This measure the power of a voter to get a decision made. We also calculate the Baron-Ferejohn index which is specific of coalition's formation theory⁽⁵⁾.

Indices calculation for Parliament, 1996

Table 4

Party	Seats CD+Senat	SSI	NBI	BF	ABI	PIA	PPA
CDR	175	0.395	0.37	0.316	0.627	0.351	2.916
PDSR	132	0.229	0.222	0.211	0.368	0.206	1.712
USD	76	0.229	0.222	0.211	0.358	0.201	1.666
UDMR	36	0.062	0.074	0.105	0.124	0.069	0.578
PRM	27	0.029	0.037	0.053	0.090	0.050	0.421
PUNR	25	0.029	0.037	0.053	0.083	0.046	0.387
Others	15	0.029	0.037	0.053	0.049	0.027	0.228

NMWC=9

Indices calculation for Parliament, 2000

Table 5

Party	Seats CD+Senat	SSI	NBI	BF	ABI	PIA	PPA
PDSR	220	0.60	0.636	0.429	0.906	0.587	1.986
PRM	121	0.10	0.091	0.143	0.093	0.060	0.204
PD	44	0.10	0.091	0.143	0.086	0.056	0.189
PNL	43	0.10	0.091	0.143	0.085	0.055	0.186
UDMR	39	0.10	0.091	0.143	0.079	0.051	0.173
Others	18	0	0	0	0.039	0.025	0.086

NMWC=5

Indices calculation for Parliament, 2004

Table 6

Party	Seats CD+Senat	SSI	NBI	BF	ABI	PIA	PPA
PSD+PUR	189	0.40	0.385	0.333	0.639	0.399	1.604
PNL-PD	161	0.233	0.231	0.222	0.360	0.224	0.902
PRM	69	0.233	0.231	0.222	0.431	0.269	0.820
UDMR	32	0.067	0.077	0.111	0.161	0.100	0.403
Others	18	0.067	0.007	0.111	0.087	0.054	0.218

NMWC=5

From the analysis of dates presented in tables 4, 5 and 6 we observe for example that in 1996 PDSR had almost twice mandates more than USD, but they had the same power of vote. The dates obtained demonstrate the fact the distribution of preferences expressed in function with the population votes is not a sufficient measure of a party power, but we should have in mind also the mandates obtained according with the elective algorithms and the calculated values of power indexes. Thus for the 3 cases

the minimum number of wining coalition is 9, 5, 5 without taking in consideration the compatibility of ideologies or the pre-elective alliances.

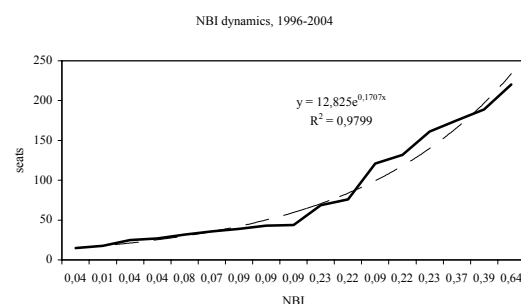


Figure 3. NBI changes depending on seats share

There is an exponential relationship between NBI, SSI and share of seat. In the first case this relationship is with $R^2 = 0,9799$ and in the second case with $R^2 = 0,9774$.

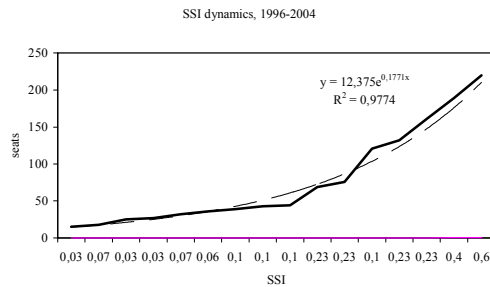


Figure 4. SSI changes depending on seats share

Notes

- (1) Finland Parliament.
- (2) Swing (engl.) is an oscillation of a voter such as a withdrawing of his support can turn (swing) a winning coalition into a losing one or adding his support can turn a losing coalition into a winning one.
- (3) QMV h = qualified majority voting historical, QMC br = qualified majority voting before reform, QMV ar

The power indices give values indicative of a player's voting power to involve himself in forming coalitions which can be an effective tool to understand decisions making processes in organizational systems based on voting games. The major goals of any power voting analyses is to assess relative power of a player or homogeneous groups of players which participate to decisions making, to evaluate the system itself in terms of fairness and maximizing voting power and to understand the benefits of coalitions and bloc voting.

qualified majority voting after reform (Baldwin, 2006: pp. 98-100).

- (4) Dates from www.europarl.europa.eu
- (5) All results are computed using the algorithms from <http://www.warwick.ac.uk/~ecaae/> The number of minimum winning coalitions is calculated using algorithm Minimum Integer Weights in Java.

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Aspects Regarding the Motivation and Forms of Foreign Banks' Penetration in Central and Eastern Europe

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***Abstract.** The transformation process in the Central and Eastern Europe economies after 1989 has generated considerable changes in the bank sector. In all emerging economies in the region, the foreign capital involvement took place first by the way of cross-border flows, and then by direct investments, e.g. foreign banks implantation. The motivations and forms of their penetration change over time, toward a more local involvement of these banks. Nowadays, the expansion is achieved more and more by taking over existing banks threw the privatisation process or acquisitions of smaller private banks.*

Key words: foreign banks; Central and Eastern Europe; Romania; motivation; form of penetration.

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JEL Codes: G21, F23.

REL Codes: 11C, 17G.

1. Introduction

Foreign capital involvement in emerging post-communist economies was achieved in the general framework of the great transformations in these countries after 1990. The economic liberalization, massive privatization, general opening of the economies were factors which have driven developed economies to consider the CEE region as an interesting opportunity for businesses' extension. However, till middle 90s, entries in CEE countries, except Hungary and Poland, were not significant, and, in the case of Czech Republic, due to the high degree of concentration, foreign banks had taken small niche positions before gaining important shares and positions on market.

2. The general economic framework of the foreign capital's involvement in emerging European economies

The motivations of this late and hesitant involvement of foreign capital on the CEE markets have to be seeking in many directions.

First, even foreign banks' activity has enormously increased in the last decades; we can say it is a international industry only in a limited sense and since short time. Although the international capital market is very large, the greatest part of the banking activity takes place on domestic markets and the largest number of banking services continue to be purchased inside the national boundaries. The bank industry continues to be significant less international than other

industries, such as auto-motive for example. There are many reasons to explain why banking was and, in a great measure, still is more resistant to internationalisation. On one side, the service sector is, generally, less internationally integrated compared to the industrial sector, and, on the other hand, the bank activity in many countries – with an important exception, USA – is highly concentrated; the state property (in many banks, in many countries) creates an un-competitive environment and thus discourages new entries, foreign or domestic.

Even in Western Europe, a surprisingly large number of free economy states had till recently high quotas of state capital in bank sector. For example, in 1989, the weight of public sector in overall bank assets was 87% in Portugal, 84% in Greece, 68% in Italy, 50% in Germany, 44% in Austria, 42% in France (Gardner, Molyneux, 1990). In the last 10-15 years, in the general context of globalization, de-regulation and financial liberalization, but also on the background of enlarging European economic integration, in Western Europe took place a lot of major changes in bank system, following the EU directives related to the creation of a single market in the financial services. As a result, many Western banks were concerned by the transformations on their own markets, by the necessity of consolidation and focus on survival, as by their own fears⁽¹⁾. After 1990-1995, a lot of national and transnational mergers and acquisitions, minority share participations and strategic alliances between banks took place⁽²⁾. After this consolidation process, the number of credit institutions in euro area decreased from 9,500 in 1995 to 6,406 in

2004 and 6,130 in 2006 (ECB May 2005, October 2007). Many financial services companies developed strategies to enable themselves to act as multinationals and exploit scale-economies opportunities. It is interesting to compare the weight of foreign banks in overall assets of the banks in euro

area with the new member states: if foreign banks detained at the end of 2006 around 27% of the total assets of the credit institutions on the whole EU, the weight were 67.7% in the new member states, respective 17.9% for the countries in euro-area (ECB Report, October 2007) (see also next figure):

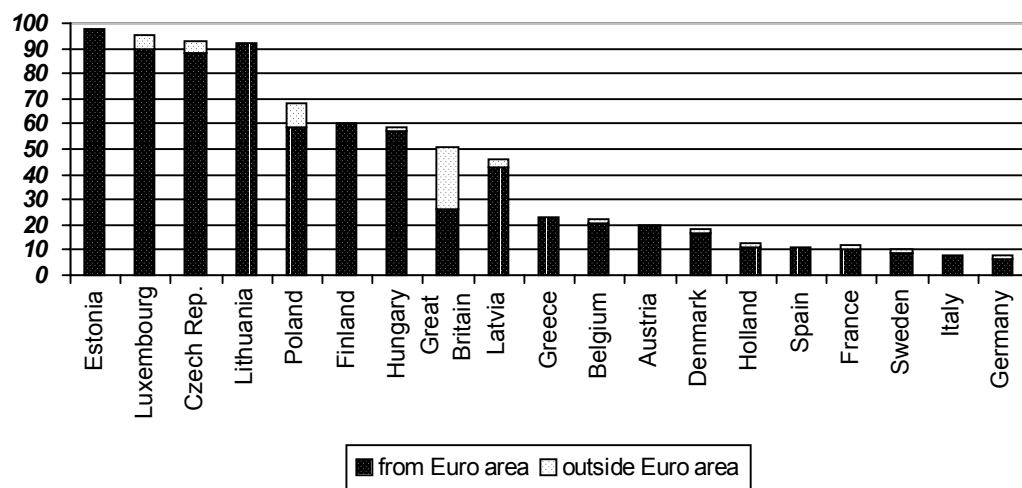


Figure 1. .

Source: *EU Banking Structures*, European Central Bank, October 2007.

Second, it has to be mentioned the relatively low interest of the investors for the former communist economies, compared to the interest for other emerging economies. The potential investors, not familiar with a different business environment, accused the lack of banking experience and had shown prudence about the management quality in domestic banks, un-orthodox way to do business, the fear related to potential government' influence and interference in the activity of the new managers and shareholders etc.

In all emerging countries, the involvement of foreign capital was achieved in the first time by the way of cross-border flows (which increased from 500 billion dollars in 1990 to 1500 billion dollars now, according to BIS, June 2006), and only after that by direct investment, respective foreign

banks implantation. If between 1990 and 1995, on all emerging countries, only 10% of the external claims were local (loans granted by branches and subsidiaries locally implanted), the rest of 90% being external loans; now, almost half of those flows are local claims of foreign banks to emergent economies (BIS, June 2006). Of course, foreign direct investment in banks, e.g. foreign banks' implantation in emerging economies, were not an entirely new thing in 1990, except the Central and Eastern Europe economies. In some emerging economies in Asia, very open economies, foreign banks counted huge weights in the overall assets of those countries. For example, in Hong Kong and Singapore, almost 90% of the bank assets were owned by foreign banks. The same in some Latin-

America economies: in 1990, foreign banks counted 19% of the overall bank assets in Chile, 10% in Argentina, 6% in Brazil (BIS, Dec. 2005). However, foreign direct investment in banks from outside their home country is a very recent situation, after 1995. For example, the overall value of the acquired banks in 1994 in all emerging countries was under 1 billion dollars, but in 2001 it reached 21 billion (later it decreased, in the context of panic generated by the financial crisis (BIS, December 2005). The main countries targeted by foreign capital were from Latin America. The cumulated value for 1990-2003 of buying transactions targeting the banks was 22 billion dollars in Mexico, 14 in Brazil, 6.5 in Poland, 6 in South Korea, 5.5 in Argentina, 5 in Czech Republic etc. (Thomson Financial).

Here is, briefly described, the “wave” of bank globalisation after 1995 (foreign implantations, bank mergers and acquisitions) which, corroborated with the specific macroeconomic framework of the origin countries (oscillation between financial liberalisation and the need for domestic consolidation) and of the host countries (spectacular economic transformations in Central and Eastern Europe), generated the expansion of foreign capital in the region.

3. Theoretical consideration on the foreign banks’ entry in region

The transition from a planned economy to a market economy, lasting more than a decade, consistently modified the banking sector in Central and Eastern Europe. If in the communist times the banks were mostly a vehicle, a government tool for resource

allocation according to the central plan, in post-communist times, the banks had to make credit decisions based on commercial criteria. Especially in the first years of transition, this new position proved to be a real challenge for most of them. The government’ approaches on bank system’ reform and consolidation were various, and the results were various as well (E. Zoli shows that the costs associated with a banking restructuring process consistently varied from one country to another (Zoli, 2001)). After almost 20 years after the first reforms, we can now analyse and pertinently evaluate the effects of the followed policies, focusing on different aspects of foreign banks’ entry on European emergent markets (motivation, entry mode), as well as on evaluating their effects on the economic environment in the host economies.

Conceptually, by foreign financial institution we understand an organisation legally incorporated in a foreign institution or an organisation supplying financial services with a significant part of the owners having foreign origin. Consequently, foreign banks in Central and Eastern Europe can be defined as organisations with banking functions legally incorporated in a foreign institution or an organisation with a significant foreign participation to the property structure (Konopielko, 1999, pp. 463-485). The first part of the definition refers to organisational forms from representative offices to branches, so it is about foreign institutions supplying financial services⁽³⁾. The second part of the definition refers to banking institutions owned by foreign persons and organisations, but considered, from a legal point of view, as

domestic institutions⁽⁴⁾. The only difference between those and other domestic banking institutions is that a part or even all owners are from outside the host country.

Legally speaking, all companies (including banks) paying taxes in one country have to be recognised as domestic entities (Gierszewska, 1996), the frontier between domestic banking and international banking varying according to the analysed issue (Aliber, 1984, p. 662). It has to be pointed out that there is another definition of financial multinational corporations that restrain their field of action only to supplying banking services, so that the existence of a simple representative offices in a given country does not mean the existence of a financial multinational corporations; the representative offices “have more a connection function with the parent company but cannot effectively operate on the host market” (Hoschka, 1993, p. 17). On what we are concerned, we will include also the representative offices in the concept of foreign banks because, unlike the developed economies, in Central and Eastern Europe the representative offices accomplish some banking activities (Konopielko, 1999, pp. 463-485) and, in many cases, they were platforms for following effective entries on these markets. The concept of foreign bank, as we define it, is consistent with the approach the pioneer of the theory of multinational banking, H. Gruber (Gruber, 1977, pp. 349-363), who considers multinational banks as referring to the “ownership of banking facilities in one country by the citizens of other country”. Three banking activities can be achieved, in his opinion, and all of them are present in

Central and Eastern Europe: retail banking, bank services and wholesale banking.

4. An essay of applying the multinational banking theory to Central and Eastern Europe

The multinational banking theory was initially developed by H. Gruber (Gruber, 1977, pp. 349-363), who opened a new camp for further researches. One of the main pillars of this theory is to identify the source of the comparative advantages in the international banking, e.g. the factors driving the option for a certain location. We think necessary to point out some issues in order to reflect the framework for applying this theory to the post-communist economies' realities.

First of all, the entry of foreign capital in bank sector of the Central and Eastern Europe economies can be defined as the settlement or acquisition of existing banks, which become thus foreign banks. Generally speaking, there are also vehicles for entrance, other than those concerning the direct ownership: the strategic alliances. In the case of Central and Eastern Europe, being the unstable economic situation and the underdeveloped financial structure, foreign capital entry was realised exclusively by the ownership way, e.g. acquisition of existing entities or settlement of new entities.

Second, it has to be made an observation regarding the distinction between the two internationalising ways: inward and outward (Pintjens, 1994). The inward internationalisation describes the situation in which foreign bank institutions enter a country or region and/or that in which the banking

activities from a specific country or region are mostly denominated in foreign currency. The outward internationalisation concerns the situation in which bank institutions from a country are establishing their presence in other country. Nevertheless, in the case of Central and Eastern Europe economies, the level of inward internationalisation is high, in some economies even very high, while outward internationalisation is very rare⁽⁵⁾.

Third, the analysis of the international banking concerns two subjects: the issue of the patterns for outward expansion of the banks, from a industrial organisation point of view and the issue of banks' role in cross-border financial flows (Aliber, 1984, pp. 661-678). The conditions and main motivations of foreign direct investment are, generally, the following:

- Motivations relying on the efficiency of internationalisation: the imperfections of the output markets (mainly caused by entry barriers and market segmentation), the imperfections of the input markets (related to the comparative advantages that could be obtained by expansion), the scale-economies reached by expansion etc.
- The advantages of certain locations as motivations for entry (the approach being thus focused on explaining the specific location for implantations): existing clients' serving and following in their own expansion, the entry on a growing market, able to supply gain opportunities, and gaining control on some input sources.

All these considerations concern, in general, the foreign direct investment in one economy; we will try to apply them to the bank sector, in order to discover specific features of foreign banks expansion,

expansion that means in fact the specific form of foreign direct investment in bank sector.

The first condition, the imperfections in the output market, related to the entry barrier, can be maintained also in the bank sector, if, by this expansion, the investor can enter a particular market. If the entry is successful, they can be obtained rental gains, until the moment of full liberalisation and removing the entry barriers. This kind of situation occurred particularly in the case of early entry (in the first years after 1989), when indeed the new entrants reported gains and advantages superior to those of late entrants. In the first years of post-communist times, some Central European transition economies were particularly very liberal, allowing foreign banks entries. Nevertheless, very soon, the authorities were not so glad of the bank sector developments, the new banks (domestic or foreign) involving in risking activities, in a time when regulation and supervision were not well imposed. Many of the foreign participations were speculative and little capitalised. In Hungary, some foreign banks accumulated great losses, and in Poland and Baltic States were exposed even cases of fraud with the involving of new banks. Subsequently, more strict regulations were imposed, in attempt to control the quality of market entries.

The imperfections on the input markets, related to the comparative advantages, can be an explanation for particular situations: it is the case, for example, of German land banks, who beneficiated of access to government funds with low interest reporting gains that normally wouldn't obtain.

The scale economies are close related to the endogenous conditions of the firm, so it can be assumed that the companies having

scale economies inside the national territory can do the same outside their country.

Maintaining the existent clients and supplying for them financial services outside their home country, on the principle of following clients in their own expansion, are valid motivations also for bank expansion, especially in the first years; later, the banks extended their operations and their client portfolio.

The entry on a growing market and the perspective of potential gains are obvious motivations for any outward expansion, including the case of foreign banks, especially for those coming from economies with a small domestic market (Netherlands, Belgium) or very competitive ones.

The last motivation, the access or control on factor markets, can be considered, in the bank sector, as the desire to create a stable client base, risk diversified (in many countries, in more currencies), in order to face the potential shocks on domestic market.

A research conducted between 2001 and 2002 (Uiboupin, Sorg, 2006) reveals the following main reasons for foreign banks' entry in Central and Eastern Europe: looking for new business opportunities (a score of 4.58 on a scale from 5 – the most important reason to 1 – the less important reason), local clients' support (3.68), following the existent clients (3.33), international trade finance (3.3), competition prevention (3.18). As we will notice, in time there were many important changes: even initially foreign banks were focused more on existing clients' support and follow, later they have more and more targeting the local clients, expressing more availability and interest for local economies.

Among the factors favouring the option for a destination country, the same study

reveals the importance of the economic and politic stability of the country, the liberal economic policy, the potential to future integration in European Union, the existent and potential local clients. It can be noticed that the general determinants of foreign direct investment are also valid for foreign banks' implantation (Magri et al., 2004).

On the other hand, international banking usually requires a physical presence, so that the main reason for direct investment in bank sector is the need for a direct contact between the bank and their clients (Walter, Gray, 1983, pp. 597-609). At least in the beginning, many banks open branches or representation offices in order to support their clients from the origin countries. These representative offices can establish a physical presence on the market without a clear commitment of foreign capital entry on the host market; many times, this presence relied on the hypothesis that banking will develop. The future development of bank sector led to entries by the way of greenfield direct investment, meaning the settlement *ex nihilo* of a bank institution, and also control acquisitions, by purchasing stocks or other capital forms, going from 100% participations to minority participations.

From an institutional point of view, foreign banks entry can take the following forms:

- Offices, representative offices, branches (with no legal personality);
- Participations or minority share acquisitions in domestic banks;
- Strategic acquisitions in domestic banks;
- Subsidiaries settlement and operating⁽⁶⁾.

The choice of one form or another was decided also in connection with the type of bank expansion. Thus, the specialised banks, such as investment banks, prefer to operate

through representative offices or even the settlement of a non-bank financial institution, due to the fact that, usually, these institutions do not accomplish classic bank operations (deposits, loans); in fact, representative offices are sufficient, low risky and less controlled by the state and central bank in the host country. Moreover, as alternative to bank development on markets not particularly open or interesting, foreign banks developed other banking services: consulting, investment etc. The start-up of the operations has also many kinds. For example, Citibank, in many countries, is focusing on international corporate clients or on private individuals. Other banks prefer to

get a small capital and avoid involvement in major infrastructure projects, and in other cases the option can be participation and ownership of minority shares in domestic banks. It is difficult to generalise on the involvement of foreign banks, because this is varying from closed entities to full involvement as major player on the banking market.

In Central and Eastern Europe countries, the evolution of the way of entry followed the evolution and pace of the privatisations; on the measure of it's advance, foreign capital in the banks involved less and less through greenfield investment and more and more by acquiring local banks (see figures 2 and 3).

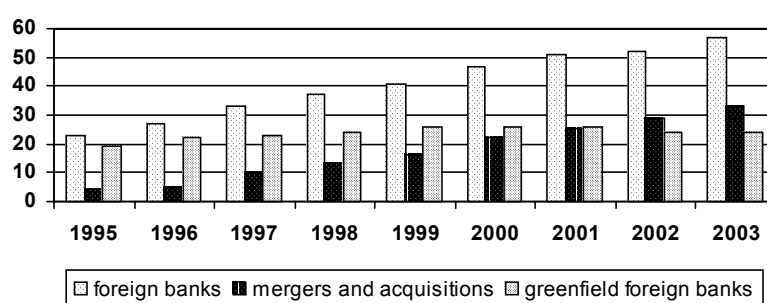


Figure 2. Foreign banks' position in Central and Eastern Europe, by way of entry (number of banks)

Source: Claeys, Sophie și Hainz, Christa, *Acquisition versus Greenfield. The Impact of the Mode of Foreign Bank Entry on Information and Bank Lend Rates*, European Central Bank, Working Paper 653/ July 2006.

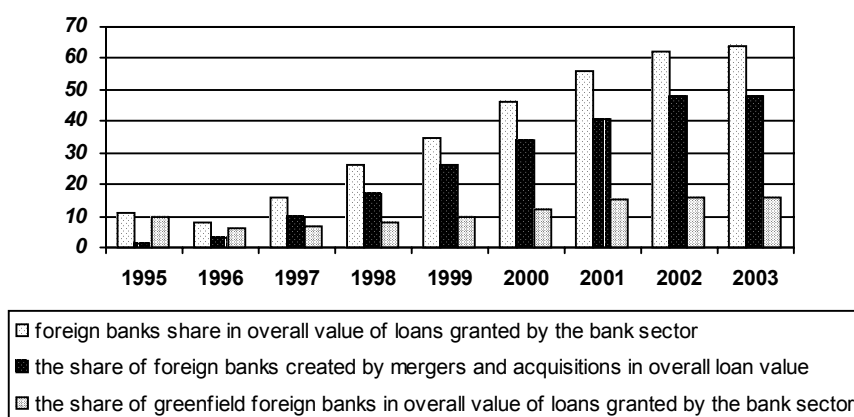


Figure 3. The market share of foreign banks in Central and Eastern Europe (in overall loans granted by all banks), by the way of entry

Source: same as Figure 2.

An interesting research, carried out at the end of 1996 among managers from main foreign banks investing in Central and Eastern Europe (Konopielko, 1999, pp. 463-485), revealed some interesting issues, which consisted in the basis for an econometric model to reveal the determinants of the entry process on a specific bank market.

Thus, the main reasons for entry were, in a decreasing order, as follows: support for existing clients, search for new business opportunities, foreign trade finance, the pressure of other banks' competition.

Following the existing clients in their own expansion abroad is the main reason mentioned and probably this is one explanation for the massive presence on the market of this region of players from nearby countries: the Austrian and German banks were among the first entrants, and nowadays they are present in a large number, both big institutions and some considered in their home countries not very expansive abroad (this is the situation for German land banks or the Raiffeisen case). Many foreign banks implanted in those countries with a massive presence of non-financial companies from the same home country. This reason also explains the outward implantations, e.g. intra-regional subsidiaries of banks originated in Central and Eastern Europe, following the region's development and the increasing intra-regional co-operation.

The second reason, e.g. searching for new business opportunities, operates in the case of some banks' expansion, such as Citibank or the Dutch banks, which, even in the beginning, were limited to their own clients' support, later they have been

extended the provided services and the clients' portfolio, highly involving themselves on the local market, including in operations not related at all with their initial clients from their home country (*retail banking* for example). The follow-up behaviour was replaced by the client searching process. This is the same situation with the trade finance reason: even in the beginning big banks' gains came from the comparative advantages of their products (by better and more sophisticated services), gradually their comparative advantages diminished, as domestic banks provided similar services; this fact pushed big banks to extend the products and services they provided, and also to extend the clients' portfolio. The case of Citibank Poland is eloquent: in 1995, Citibank Poland was the 20th bank in Poland by equity, but the 2nd in foreign trade finance and related services (Konopielko, 1999, pp. 463-485).

Follow-up the competition was the last mentioned reason, which can be the result of the marginal character of emerging European markets, compared to the Latin-American and South-East Asian ones.

Concerning the way of entry, the research revealed the preference for subsidiaries, followed by take over of existing banks and settlement of branches; the minority participations and representative offices were considered not very relevant ways for entry. It has to be mentioned that, in spite the fact that subsidiaries' opening was the dominant form, in some cases it was preferred the take over of existing banks (the case of Hungary, due to the fast and early privatisation) and branches opening (the case of Czech Republic, due to the very liberal

strategy toward foreign branches). Certainly, advancing on the recovery process of domestic banking systems of less advanced economies, the progresses on the way of reforms and privatisation and the decreasing suspicions toward the domestic institutions, the most frequently form chosen was the acquisition of an existing bank.

Regarding the operations and activities preferred by foreign banks, the most interesting domains proved to be, in increasing order, corporate finance, foreign trade finance and project financing (in fact, the operations with the greater know-how involved, the less staff requirements and, in the same time, the most profitable), while the less standard operations (bonds and securities, leasing, non-financial operations), as well as retail banking, were considered, in the first place, less desirable. Generally, the retail banking did not constitute motivations for entry (Tschoegl, 1997). The main causes were related to the low purchasing power of individuals, as well as to the high costs (well-represented and extended network, consistent staff) imposed by this kind of banking. It is interesting to notice that, as the development of the market and of the region in general advanced, many banks claiming, in the beginning, their lack of interest for retail banking, started to develop this segment as well. For example, the strategy for Romania of ABN Amro and ING Bank did not include the retail operations (but later both of them reconsidered their position and became highly involved in retail), while the strategy of the same banks on more interesting markets as dimension and consumers' power included from the beginning retail

involvement (ING-Bank Slaski in Poland, ABN Amro-MHB Poland).

5. A research about Romania

For Romania, last August we carried out an empirical research, based on a questionnaire launched to a number of 20 top and middle managers of foreign banks located in Romania. The results of this questionnaire, regarding in its first part the motivations and reasons for entering the Romanian market, are as follows:

First, the interview revealed that the main reasons for entry are, in increasing order, as follows: searching for new business opportunities (4.6 points out of 5); the general expansion strategy (3.95 points); supplying banking services to their existing clients and its following in their own expansion (3.25 points). On the other hand, motivations such as: developing a local clients' portfolio (2 points) and competition imitation (1.2 points) were not seen as priorities for the entry process. So, in Romania it is also empirically validated the main motivations revealed by the above mentioned studies. The Romanian market is considered as a growing market, rich in opportunities and it has to be naturally integrated in the expansion strategy. It has to be noticed the gradual integration of the banks in the local environment, serving the existing clients from the home countries is not a reason for entry anymore. However, the development of a local clients' portfolio is not a motivation for entry (especially for Greenfield settlements, because privatised banks present a different approach), but moreover a consequence of the market developments and expansion opportunities.

Second, the research revealed the most preferred operations of foreign banks. Thus, the most preferred activity is mentioned to be corporate finance (4.5 points), followed by foreign trade finance and international operations (4.1 points) and asset management, derivatives, consulting and others (3.15 points). Significantly less interesting were retail banking – individuals (2.15 points) and SMEs financing (1.1 points). So this is an empirical validation of what the literature calls *cherry picking*, e.g. the selection by foreign banks of the most gainful activities and clients. Certainly, in these operations foreign banks exploit their comparative advantages, mainly the access to cheaper funds in foreign currency and thus, the availability to more consistent and lower interest lending, but also their know-how and experience in relatively new operations for the Romanian market. Retail banking, individuals lending, are not among the most preferred operation, even in the last 4 years the retail oriented banks substantially gained after the exponential increase of this sector. SMEs financing is the less preferred operations, but this fact does not mean a give up of such activities (for example, for BRS-GSG the SMEs sector represents 52% of the overall client portfolio, constant share in the last years, according to BRD-GSG, 2001-2006). It is a question of preference, also depending on the investment type (Greenfield or take-over).

Third, another question focused on the motivations for selecting Romania as destination of the foreign direct investment. Among the attractions exercised by Romania

were mentioned, very close one to another: the market potential and the development rhythm (3.8 points), expansion opportunities (3.75 points) and consistent gains (3.7 points), which denotes the “opportunistic” character of the expansion (otherwise natural in a pragmatic approach), searching for gains and opportunities. It is interesting the fact that Romania’s EU membership was assigned with a barely score of 2.55, while the macroeconomic and political stability only 1.2 points. In other words, Romania is not yet considered a very stable economy, but moreover a fast growing economy. This comes unlike other Central and Eastern European markets, where stability was mentioned among main factors of choice. It appears that, however, this stability is perceived as above a certain necessary critic level, which, together with the increasing market, motivates the entrance on Romanian economy.

6. Conclusion

The reasons and interests of foreign banks certainly changed during the time, leading to a more local involvement of those banks, unlike the initial entries from the middle of 90s. The way of expansion changed too, in the sense that big Greenfield investments were settled 10-12 years ago; in the past 2-3 years, the expansion took place by acquiring existing banks: by the way of privatisation process or by taking-over private small banks. This is the way that 92% of the interviewed managers indicated for further expansion.

Notes

- ⁽¹⁾ It is interesting to mention the case of Austria, where it happened for long time a particular situation: the fear and opposition against foreign ownership in banks resulted in a stagnation of the privatization process for many years. For example, in the beginning of 1990s, Austria was looking for an investor to sell 49% of the shares of the second domestic bank, Creditanstalt, at the time when this bank became one of the most active banks in Central and Eastern Europe. About this privatisation process, the ex-Austrian chancellor Franz Vranitzky stated that the fact that “the potential investor is Austrian ore has a special relationship with Austria is a very important issue” (Reuters European Business Report, August 1995), and the ex-Austrian ministry of economy, Johannes Dits, said: “The national interest must be taken into consideration. The selling price is not the only criterion. It is important the Austrian influence in this bank to be maintained” (idem)
- ⁽²⁾ In Germany, Hypo Bank and Vereins Bank Munchen form HVB Bank; the German company Allianz acquires Dresdner Bank; in France BNP acquires Paribas, ING (Holland) buys Kredit Bank, in Spain Bilbao Vizcaya buys Argentaria Caja Postal y Banca Hipotecario on competition with Banco Santander Central Hispano, each of them being the result of some consecutive mergers and acquisitions etc.
- ⁽³⁾ It is the case, for example, of ING branch in Romania.
- ⁽⁴⁾ It is the case, for Romania, of the large majority of foreign owned banks, acting as subsidiaries of foreign parent banks; one important exception is ING.
- ⁽⁵⁾ The case of OTP is one of the extremely rare examples in that way. OTP Bank is a Hungarian bank opening subsidiaries in some countries in region, including Romania.
- ⁽⁶⁾ Legally speaking, the subsidiaries are legal entities of the host country, while branches are foreign entities.

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